International Development Policy, Macroeconomic Management, Debt and Trade[1]

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Introduction

I propose to cover several issues of pressing importance to the region, and I hope not too sketchily. I shall begin by referring to what I term the 'sea-changes' in 'official' development theory and practise, which have taken place since development economics as a formal discipline took root after World War II. I shall then proceed to examine briefly the relationship between, on the one hand, short-run macroeconomic balance and stability and, on the other, economic growth and development. Following this I shall examine the proneness of small poor open economies to debt vulnerabilities and highlight some critical features of the debt dynamics in the Caribbean. I shall then conclude by looking at some aspects of small states in global trade, including issues of size and the question of small states and preferences.

Sea-changes in official development theory and practise

Within the decision-making structures of the dominant international development organisations (international financial institutions [IFIs], aid-agencies of donor countries, regional development banks, United Nations [UN] agencies and similar bodies) there occurred during the late 1980s and 1990s a virtual sea-change in the ruling economic ideas. In turn, this led to sweeping reverses in the development strategies, prescriptions and policies, which these organisations had previously promoted and practised.

Purely as points of reference, and not for purposes of stereotyping these ideas and approaches, they may be labeled originally as the Washington Consensus after Williamson 1989, and later as the Augmented Washington Consensus after Rodrick 2001. They are also commonly referred to in recent times as 'market fundamentalism' (Soros) or neoliberalism.

It is widely acknowledged that these ideas have been framed within the theoretical constructs of monetarism and competitive general equilibrium analysis. These presume there is perfect non-asymmetric information flows among economic agents and that therefore, speculative behaviour in financial and goods markets is stabilising, and that economic 'shocks' are intrinsically transitory and minimal even though there is a universal tendency toward government induced distortions (policy surprises, lack of credibility and time inconsistency).

When applied to developing countries, the central pillars of these ideas include a number of financial precepts familiar to the region. Here I refer to considerations such as: fiscal discipline, interest rate liberalisation, competitive exchange rate, foreign direct investment (FDI) liberalisation, financial codes and standards, 'prudent' capital-account opening, non-intermediate exchange rates, and independent central banks operating with inflation targetting.

To these can be added several others, which are more indirectly related to financial considerations; such as, trade liberalisation, privatisation, deregulation, secure property rights, tax reform, public expenditure reallocation, corporate governance, anti-corruption, flexible labour markets, World Trade Organisation (WTO) agreements, social safety nets, and targeted poverty reduction.

In regard to the linkage among these concepts Ravi Kanbur (1999) notes:

> 'Williamson's organised formulation became transformed such that the term Washington Consensus became associated with neo-liberalism. And there is no question that this happened'. (Kanbur, 1999)

What is more instructive is that, for someone who was an 'operational part of the World Bank' as Kanbur describes himself, he was able to recognise how these ideas were propagated in retrospect:

> 'Mindset, and stance, are all important. There is no question in my mind that in the 1980s, and to a certain extent well into the 1990s, many saw the main task as being storming the citadel of statist development strategies. In this mindset, nuances were beside the point-intellectual curiosities which [arose,] paled in comparison to the benefits of rapid and deep movements away from the former paradigm. And, moreover, Washington institutions were deeply suspicious of the real intentions of those they were dealing with. They suspected, perhaps rightly, that those on the other side were hell bent on preserving the status quo. In this setting, a negotiating stance, rather than a dialogue based on mutual comprehension, was appropriate. So the negotiators from Washington always took a more purist stance, a more extreme stance than even their own intellectual framework permitted (they were all surely well schooled in the theory of the second best). Give them an inch of nuance,

> and they'll take a mile of status quo, seemed to be the mindset and the stance. If you want 28 enterprises privatised, start by asking for 56, seemed to be the opening gambit.' (ibid, 1999)

Prior to this sea-change I am describing here, the ruling ideas and practise in official circles and institutions were framed in the context of Keynesian macroeconomics, which had a very different reading of development experience, both as seen from a short-term and long-term perspective. The Keynesian perspective of short-term experiences emphasised that private capitalist markets were prone to:

- Frequent currency and exchange rate crises.
- A systemic tendency toward destabilising speculation in foreign exchange markets.
- The corrosive effects of unscheduled and uncontrolled capital flight.
- Endemic manifestations of casino-like behaviour (and properties) of financial and stock markets.
- Frequent business cycles, both national and international in their scope.

And, the perspective on long-run experiences emphasised:

- Over time a growing nexus between national and international business cycles.
- A recognition that industrialisation and export expansion are essential foundations for long run economic growth.
- The need for steering long-term capital flows into countries that were seeking to catch-up with the industrial leaders.

The short-term and long-term perspectives converged in support of an active interventionist role for the state. As seen through the eyes of Keynesians, only the state is able potentially to be a guarantor of short-run macroeconomic balance and long-term growth of potential output.

The deliberate (and as we saw from Kanbur ideologically-driven) charge on 'the citadel of statist developmental strategies' has had profound consequences for developing countries. At a general level the world economy (and also the developing countries as a group) had in the period prior to the rise of neoliberalism attained rates of economic growth that have not been since matched. This was also a rare long run period in which the spread or gap in per capita GDP across regions in the world did not widen. However, in the period of neoliberalism that followed, growth faltered to the extent that for some regions like Latin America and the Caribbean, the period is described as the lost decade(s). And as if this were not enough, during the 1980s there was also a worsening inequality of income, due both to the economic slowdown and to the neglect of equality concerns in the practise of neoliberal policies.

The evidence is strong that for many developing countries the initial benefits that followed the application of monetarist policies, deregulation and market liberalisation, the reduction in state inefficiencies and the expansion of the role of the private sector in promoting growth, soon reached a plateau, as growth leveled off. Furthermore, global financial crises, political instability, wars, and natural events (exogenous factors) litter the period of neoliberal ascendancy. Indeed, I believe that the consequences of these have been sufficiently adverse for there to have arisen in recent times a strong challenge within official circles and institutions against the rigid orthodoxies of their previously practised neoliberalism/market fundamentalism. To this extent therefore, another sea-change in economic ideas and development practise may well be underway. We need to keep this possibility of a further sea-change at the forefront of our awareness, as we pursue the tasks of regional development. Often times we become so immersed as actors in the process of development and change that it is difficult to stand back from day to day pressures and events and separate the trees from the forests.

Short-run macroeconomic balance, economic growth and development

It is not my intention to pursue these great debates on international development theory and practise for their own sake, important as this task is. My purpose is to set the stage for intervention on matters of more immediate import to the region. One of these is how to situate the maintenance of short-run macroeconomic balance and stability in the pursuit of economic growth and development, given the size and other constraints of the region's economies.

One lesson we should learn from the experiences of the 1980s and 1990s, which I have briefly reviewed is that the maintenance of macroeconomic balance and stability in economies like ours is a necessary, even though by no means sufficient, condition for ensuring growth in potential output and development of the region. There is one inescapable reason why this is so; persistent macroeconomic imbalance and instability in a country expose that country's development authorities to the corrective policies in fashion at the institutions they would eventually have to turn to for help in correcting the situation.

Putting this truism aside, it is also true that small poor economies face excruciating dilemmas in regard to short run macroeconomic stability and long term growth and development. Furthermore, it can be confidently anticipated that these dilemmas will intensify, if the world economy becomes more and more integrated and market liberalisation becomes more and more accepted as the unchallengeable principle for regulating global economic activities and allocating global resources.

The dilemmas I refer to can be captured in a brief re-statement of the fundamentals [ABC] of macroeconomic management of small open poor economies that an audience with so many distinguished persons and financial and economic experts also may do well to bear in mind.

As I have indicated elsewhere, in a small poor open economy realising macroeconomic balance means fulfilling its two components, namely 1) maintaining *internal balance* [briefly defined as potential full employment non-inflationary growth, with the smallest possible deviations in the long run in the size and duration of economic fluctuations as a consequence of shocks, taking into account the national preferred trade-off between price stability and output and employment stability] and 2) *external balance* [briefly defined as a zero balance on the current account], as simultaneous independent targets. The simultaneous attainment of these however, is not feasible, either theoretically or practically, if the authorities rely only on market-based instruments to reach these goals.

Thus I have reasoned that maintaining *external balance* in the regional context may require 1) sustaining a current account deficit if the region is to ensure a real, as distinct from a nominal, transfer of resources from abroad into the region and 2) some administrative/discretionary regulation of international transactions (in particular short-term inward and outward flows, such as bank debits, bonds and portfolio equity). Otherwise there is no other known way to ensure 1) that a national resource deficit is effectively financed from abroad into a domestic economy and/or 2) that private choices do not result in the de-capitalisation of the economy.

As regards *internal balance*, it should also be noted that, while the authorities have a monopoly in the supply of base money (currency and bank deposits with the central bank), in the absence of administrative/discretionary controls they cannot control both the supply and price of money. And, since the price of money has two aspects to it, namely, the interest rate and the exchange rate, the authorities can in practise set either the interest rate, the exchange rate, or the supply of base money, but not all three. We can say therefore that monetary policy and exchange rate management are intrinsically integrated, and moreso in small poor open economies. I have argued elsewhere, and it is worth repeating here that, in the real life conditions of the region, this represents the textbook case of the 'policy trilemma' becoming literally a '*policy straightjacket*' as it narrows the policy space to almost zero.

It is clear from this discussion so far that what has come to be known in the literature as capital-management techniques, and which have been, I am happy to see, promoted in recent times by the United Nations Council on Trade and Development (UNCTAD) form an essential ingredient for successful macroeconomic management and the promotion of development in our region. Such capital management techniques should not be confused with blanket capital account controls for their own sake as was practised earlier. At all times they are aligned to rigorous prudential control and oversight of financial institutions operating in the local economy. Unless such an approach is adopted, the inevitable result is that maintenance of the fixed exchange rate and inflation targetting become the central preoccupation of the authorities and expenditure (absorption) control the principal adjustment mechanism.

When this occurs alternate counter-cyclical measures, economic growth and job creation are invariably retarded. There is a consistent deflationary bias. We are all familiar with the sequences that accompany this deflationary bias: expenditure decline, cuts in capital expenditure, wage freeze, job cuts, reduction of public transfers and public sector credit, capital account liberalisation, removal of interest rate subsidies, trade liberalisation and so on.

Proneness to debt vulnerabilities

I am aware of regional efforts in the direction of prudential and regulatory reform, having seen the draft Caribbean Financial Services Agreement and having also been informed of other planned developments to accompany the Caricom Single Market and Economy (CSME). However, I am also cognisant of the reality that small states are, in periods of stress, systematically prone to the emergence of debt vulnerabilities and critical debt situations. And, as night follows day, whenever government indebtedness reaches dangerously enhanced levels, there is grave systemic market risk facing locally based financial institutions in particular.

Arising in large measure from their openness and narrow export specialisation, small states generally are biased in their growth to produce what they do not consume and to consume what they do not produce. Because of this dynamic divergence, access to imports is essential for sustaining their growth and development. Because they lack a domestic producer goods sector; adequate engineering, scientific, and technological capabilities and a good research and development infrastructure, fruitful investment in small states is heavily dependent not only on imports, but more specifically on there being no bottlenecks in the importation of goods, services and skills. Furthermore, even in cases where small states specialise in food exports, there is to be found a high dependence of the working population on imported food as well as other wage goods. Other things being equal, we would expect the significance of these conditions to rise with the overall import dependence of the country. Consequently, in order to provide for these necessary imports, export growth is clearly essential. At the same time, however, it is equally essential for there to be strong linkages between export growth and economy-wide growth, if broad-based development is to occur. Without these, trade relationships are not going to raise the level of development.

Crucial as it is, export growth alone in small states, even in the best of circumstances, is likely to be inadequate. This is particularly the case because of 1) the lumpiness and indivisibilities of infrastructure investments and 2) the urgent demands placed on small states to develop rapidly a range of complementary capabilities, institutions, regulatory and incentive frameworks, and services. The result is that international assistance, financial, technical and material inflows, are essential *even under the best circumstances of export growth.* As a rule also, such assistance would have to be efficient and effective if it is to ensure that international trade works for the people.

Unfortunately, as I am recognising from related research, overseas development assistance (ODA) has been falling as a share of aggregate net resource flows to developing countries (from 46 per cent in 1980 to 28 per cent in 2001). Private flows have grown by 3.6 times in total value, but the increase has been erratic in its volume, concentrated in a few countries, and shifting in its composition. Private flows have replaced ODA as the main source of capital inflows in the 1970s. They however, fell sharply during the debt crisis years of the 1980s. As that crisis eased they grew rapidly until the mid 1990s when the Asian crisis occurred, leading to another slowdown. The private flows have also changed considerably in character, from syndicated bank lending and suppliers credit to FDI. Thus between 1980-85, the former represented 69 per cent of private capital flows and in the recent period (1998-2002), it has fallen to 11 per cent. In the same period FDI grew from 30 per cent to 82 per cent of total flows. Portfolio equity investment rose from less than 0.1 per cent (1980-85) to more than 6 per cent (1998-02).

FDI flows to small states have averaged $9.2 billion for the period (1992-96). This more than doubled to $18.8 billion by 1999, but fell in succeeding years to $10.9 billion in 2002. In 1992-96 two small states (Singapore 74 per cent and the Dominican Republic 7 per cent) accounted for 81 per cent of the FDI flows. This concentration was maintained in 2002 when 86 per cent of the flows went to three countries (Singapore 70 per cent, the Dominican Republic 9 per cent and Trinidad and Tobago 7 per cent).

In recent times also remittances have become increasingly important. These have proven to be less erratic, speculative and volatile than FDI flows. In some small states, for example Jamaica and Guyana, the total value of remittances is estimated to equal more than 10 per cent of their GDP.

Given all these circumstances, experience suggests that insufficient capital flows to small poor states lead to the spectre of growing public indebtedness (external and internal); pressures on government accounts; and rising debt service obligations. These divert resources from the poor. In these situations we can say that a beneficial nexus between trade and poverty is often impeded by

1) the lack of export dynamism in some poor small states, especially commodity-dependent non-oil exporters;
2) the growing indebtedness identified above, and
3) weak links between export growth and economy-wide expansion. Those exporting certain services like tourism and off-shore finance are prone to exogenous disturbances. Taking these considerations into account UNCTAD (2004) observes:

> 'The relationship between trade and poverty is thus asymmetrical. Although LDCs with declining exports are almost certain to have a rising incidence of poverty, increasing exports do not necessarily lead to poverty reduction' (ibid, Overview, p9.)

Debt dynamics in the Caribbean

As a practical example of what I am referring to, I draw attention to the dramatic rise in the public indebtedness of Caricom countries in recent years. If we compare 1997 with 2003 we find that in all the countries except Guyana, which is under a highly indebted poor country (HIPC) programme, total public debt as a percentage of GDP has increased. In some cases this was substantial. Thus IMF data show that for the 'very highly indebted countries' (excluding Guyana, which is in a separate HIPC programme, these are Antigua and Barbuda, Belize, Dominica, Grenada, Jamaica and St Kitts and Nevis) the public debt to GDP ratio rose on average from 72 per cent in 1997 to 123 per cent in 2003. The very highly indebted countries are those with a total public debt to GDP ratio of higher than 90 per cent. High debt countries (those with a total debt to GDP ratio between 50 and 90 per cent) in 2003 include all the other countries with the exception of low debt Bahamas and Suriname (Sahay, 2004).

The IMF study unambiguously identifies fiscal slippage (mainly an expenditure rise relative to revenue) as the main contributory factor to this outcome. For the region as a whole the overall fiscal balance worsened from minus 2.6 per cent of GDP in 1997 to minus 5.9 per cent in 2003. And, for the more significant primary balance, the worsening was from a surplus of 1.1 per cent to a deficit of 1.2 per cent. While in the period 1990-97 the public debt had zero annual growth, for the period 1998-2003 the annual growth was 8.5 per cent.

The particular concern for this discussion is of course the sustainability of this debt. The same IMF paper estimates that to reduce the very highly indebted countries debt ratio to 60 per cent over the next five years would require exceptionally large primary fiscal surpluses ranging from

23 per cent of GDP in each of the next five years in Jamaica, to 4 per cent in Belize. In St Kitts and Nevis, Dominica, Antigua and Barbuda and Grenada, the requirement is an annual increase of 21, 17, 11, and 9.5 per cent respectively. In such circumstances and facing a range of potential exogenous shocks, the region's financial system is at present heavily exposed because of these macroeconomic fundamentals.

In wrapping up this area of my talk, I draw attention to the substantial overhang of economic and social gaps/deficit that persist in the region although some countries have the ambitious goal of achieving developed country status by 2020 (for example Barbados and Trinidad and Tobago) and four states have achieved the maximum 'high level of human development' on the United Nations Development Programme's (UNDP's) human development index. Nonetheless, in the economic sphere we find the scourge of relatively high levels unemployment and underemployment, poverty, marked income inequality, and a substantial underground economy fed by organised transnational crime. In the social sphere, the gaps/deficits include the risk of an HIV-AIDS pandemic, the threat to law and order, the rise of organised crime, drugs and the drugs trade, family/household problems, and very high levels of external migration.

Small states in global trade: the issue of size[2]

I turn next to the issue of size as a concern in the present global trading environment. Over the years advocacy for small states has been based on many arguments linking their size to trading constraints, development challenges, and numerous other disadvantages, which they encounter in a rapidly globalising environment, preponderantly based on market liberalisation as its guiding regulatory principle and the 'invisible hand' for resource allocation. Given all these occurrences it is surprising that in its recent review of the implementation of the small island developing states (SIDS) programme of action (POA) for the Caribbean sub-region, the Economic Commission for Latin America and the Caribbean (ECLAC) (September 2003) has identified as its first-listed 'outstanding and unresolved issue' the absence after almost ten years of the POA of 'a universally accepted robust definition of SIDS … either from the international debates on the matter or in the academic literature'. This is indeed remarkable given the basic importance of such a definition for classifying these states, as well as I might add the long academic literature on the economic consequences of size.

As regards the particular relationship between size and trade, three observations should be noted up front. First, standard textbook general equilibrium trade theory portrays small size as a distinct advantage and certainly not a disadvantage in global trade. This theoretical construct appears under the rubric of 'the importance of being unimportant'. Second, the emergence of new trade theory in the last decade or so has not altered this proposition. Third, empirical work using large cross-country samples for regression analysis claims there is no significant relationship between country size and growth performance.

Within this theoretical frame it is not difficult to see why in practise the claims that small size is a disadvantage in global trade have made such limited headway in international fora. Indeed, the concept of SIDS, by adding islandness to the notion of size, seeks to bypass some of these entrenched difficulties.

Yet, going back to the 1960s, there has been a considerable literature on defining and providing measurable criteria for ‘small’ national economies. In that literature there is general agreement (even from those most sympathetic to the claims of SIDS) that because country size is a relative concept, it is intrinsically difficult to find a universally acceptable definition and set of criteria for measuring smallness, which are simultaneously simple, accurate, practical, not too arbitrary, and politically acceptable. The last criterion is perhaps the most difficult standard to achieve, since with any set of known criteria borderline cases will be excluded and the affected countries will, given past behaviour, challenge the criteria employed.

Although smallness remains an unresolved issue, this difficulty in defining country category is not unique to small states. It has also plagued the categories of ‘developing countries’ and ‘least developed countries (LDCs)’. The practise has been for the former to be a self-determining category and the latter, by agreement, are named by the United Nations Economic and Social Committee (49 countries).

At present SIDS also include low-lying coastal countries that share similar sustainable development challenges. We have therefore, a mixture of groupings of countries:

- Small countries rich and poor
- Small developing countries
- Small island countries
- Small island developing countries
- Small island developing countries, including low-lying coastal developing countries with similar characteristics.

Two additional important categories have evolved in the practical arrangements for small states in the global trading environment:

- Remote, land-locked countries (which suffer from some of the same problems of isolation and high transport costs, which SIDS do).
- Microstates or mini-states, which refer to those countries with very small populations (a few thousand) and very small territorial size.

By any standard this listing of small states constitutes a heterogeneous set of countries, all self-elected. This is, to say the least, a potentially confusing situation. While on the one hand it helps to build alliances for SIDS, at the same time it weakens SIDS, since the membership is seen as fluid, encouraging 'free riders' into the grouping.

The literature on country size reveals a number of recurring propositions that describe the trading constraints and development challenges these countries face. The more significant of these are referred to briefly under six broad categories as listed below. Before I do so I should state that many of these have been contested and subjected in recent years to a number of statistical and econometric tests whose intent is to falsify them.

a) Problems of factor endowment

These include:

1) limited amount and array of natural resources;

2) wide geographic dispersion, insularity and/or remoteness from major markets, thereby raising transportation costs (especially for some island chains and states in the Indian and Pacific Oceans);
3) limited quality and variety in the skills-base of the population;
4) limited absolute size of the capital stock;
5) limited range of institutional capacities;
6) limited store of knowledge, know-how, and research and development infrastructure;
7) small populations with high rates of external migration, particularly of skilled persons; and
8) frequency of natural calamities and climatic hazards.

b) Problems of economic structure

These include:

1) limited market size and with it opportunities for diversification, specialisation and scale economies;
2) limited capacity of public, private, and civil society sectors;
3) high degree of openness and dependence on a few commodities/ services in international trade. Small commodity-dependent export countries are price-takers unable to influence world market prices. This enhances the risk of their being caught in international trade-determined 'poverty traps';
4) a group small countries account for a small share of global trade, which limits their leverage in trade negotiations;

5) limited capital markets and their weak structures add to the perception of greater risk for investors, thereby limiting the potential for capital inflows;
6) restricted capacity to cope with persistent poverty, unemployment and skewness in the distribution of income and wealth;
7) limited scope for competition in the domestic market and the tendency towards monopoly and restrictive practises; and
8) relatively higher growth rate and income volatility. This last factor may be due in large measure to their greater openness, exposure to shocks, and their pattern of export specialisation.

c) Problems of macroeconomic management

These include:

1) limited ability of the monetary and fiscal authorities to pursue an independent exchange rate, domestic interest rate, and money supply policy;
2) domestic price transmission effects are largely fuelled by exchange rate and foreign interest rate changes;
3) indivisibility of public services and the small absolute size of domestic savings (regardless of the ratio of savings to GNP) limit the capacity of the state to finance these and lumpy infrastructure investments, without recourse to transfers from overseas;
4) limited capacity to carry the transaction costs of ongoing global/regional/bilateral trade arrangements and trade-related negotiations; and
5) greater macroeconomic uncertainty as the old trade order is being replaced by the new in the context of continuing limit leverage over this transition.

d) Limited social and cultural capital

This includes:

1) constraints on the ability of small countries to resist the over-determining influence of foreign cultures. This has been aided by the further consideration that most small developing states were former colonies or dependencies (and several still are), in which such cultural domination was deliberately sought.
2) the cultural and racial heterogeneity of populations in several small countries, which has produced rivalry and competition, and has had in the past a particularly destructive character in some instances.

e) High operating cost structures

Of specific concern to this paper is that the above features of small size combine to raise the operating cost structures of enterprises in these economies and impede their adjustment to the global trading situation. Small enterprises find it difficult to move into the higher phases of export-based industrialisation, manufacturing and services without substantial support and the generous availability of market access opportunities. Within the domestic economies firms are unable to supply key non-tradables competitively, including infrastructure, utilities, energy, specialist education and health services, mass-purchased wholesale/retail supplies, and financing for small and medium sized enterprises. The combination of small market size, financing constraints, known resource availabilities, existing factor proportions, available technology, the existence of scale economies in most production processes, and prevailing factor prices poses immense obstacles for broad-based and sustained competitiveness in the production of dynamic products for exports.

f) Vulnerability

Described as proneness to the adverse effects of changes in their environment and insufficient resilience to overcome these on their own, small states have been characterised as being in general, more vulnerable than their larger counterparts. This vulnerability takes several dimensions:

Economic vulnerability, which is the greater than average risk small economies face from exogenous shocks that adversely affect incomes, employment, domestic production, distribution, markets, consumption and the stock of wealth, and their limited capacity to deal with these. These shocks can originate from anywhere: natural events, social and political disasters, the collapse of external markets, or capital flight.

Environmental vulnerability, which is the greater than average risk of damage to the natural ecosystem that small states face. Many of their ecosystems are unusually fragile and a significant number of small states are located in disaster-prone areas. These natural disasters include drought, floods, hurricanes, volcanoes and earthquakes, all of which result in disproportionate damage because of the small size of these countries, as well as their restricted capacity to surmount them.

Social vulnerability, which is the greater than average risk posed by both internal and external factors (whether exogenous or endogenous) that undermine social cohesion, introduce systemic social pathologies, and erode social capital. In these states these factors have a high ‘recurrence rate’ even as we recognise the restricted capacity of these states to respond.

Institutional vulnerability, which is the greater than average risk posed by the limited capacity of domestic institutions, including the strongest of them all – the state, to respond to the complexity and intensity of pressures flowing from globalisation.

Problems encountered in putting these together in a simple formulation

At the conceptual level:

- Problems of establishing thresholds to determine immediate, medium-term, and long term effects of shocks.
- Problems of establishing the levels of independence and/or interaction between the major dimensions of vulnerability.
- Having recognised that vulnerability and resilience are functions of policy choices, and are not deterministic, the conceptual problem has arisen as to whether measures should be directed at ‘structural vulnerabilities’ alone (that is, those that are independent of policy choices and therefore outside the control of the authorities).
- Problems of conceptualising how to integrate indicators that are simultaneously domestic and external, exogenous and endogenous, as well as economic – socio-political – natural – environmental – institutional in their dimensions.

At the operational level:

- Problems posed by the lack and poor quality of available data, especially for the very small states, as this has hindered the introduction of workable standardised measures.
- Problems posed for certain economic sectors, for example the non-treatment of services in the UNCTAD concentration index, although this sector is very important.
- Problems of accurately measuring exposure to shocks and the probability of their occurrence for the range of countries under consideration.
- Problems of measuring resilience or the capacity of a state to respond effectively to these shocks.
- Econometric results.

Some of the recent empirical studies casting doubt on the presumed disadvantages small states face in the global economy are briefly referred to below:

Thus Easterley and Kraay (2000) compared the performance of micro-states (those with a population of 1 million or less) and large states and found the former to have on average 1) higher income 2) higher productivity levels and 3) a growth rate no less than that of the large states. They also suggest that the higher volatility observed in small states is more a function of the larger trade to GDP ratios, which exaggerate import and export price changes, than anything else.

Armstrong et al (1998) using data for 133 countries for the period 1980-93 also found country size to be insignificant in explaining the growth performance of small states (states with less than

3 million persons). Their study emphasises the importance of heterogeneity among small states, the impact of the particular sectoral specialisation in small states (example, whether services or primary commodities), initial resource endowment, and location, in determining outcomes.

Collier and Dollar (1999) also sampled 99 small states (with less than 5 million persons) and large countries and found that the statistically significant factor explaining the growth performance of small states was ‘good policy’. Brautyam and Woolcoch (2001) in a comparison of 102 small states (5 million or less population) and 105 large ones, found growth volatility to remain important for small states but stressed the roles of institutional capacity (particularly the state) and management of social conflicts in determining outcomes.

Finally, Escaith (2001) has shown that over the past two decades the ‘smallest’ countries in the Latin American Caribbean region (less than 1 million persons) have performed the best and the largest have performed the worst.

While these studies add further useful empirical data to the debates, they do not undermine the importance of the characteristics already identified in the Commonwealth Secretariat Vulnerability Index namely, GDP volatility; trade openness and concentration; and aid-dependence. It is important therefore, for small states that they do not confuse the claims centering on vulnerability with those based on other characteristics.

Global trade, preferences and special and differential treatment (SDT) for small states

Preferential arrangements were the original form in which SDT was granted. This is termed a 'hard' or 'robust' form of SDT, because it was linked to broader development strategies based on import-substitution, infant-industry, managed trade, and non-reciprocity, which governed international development and trade practise in the 1960s and 1970s. The successive Lomé Conventions between the European Union and the African-Caribbean-Pacific Group of Countries (EU-ACP) best typified these practices. Today the major preference arrangements are the Generalised System of Preferences offered by the USA and the EU; the Caribbean Basin Economic Recovery Act (CBERA) of the USA, which was enacted as in 1984 and is commonly known as the Caribbean Basin Initiative (CBI) (this was later modified in 1990); the Africa Growth and Opportunity Act (2000); the EU's Economic Partnership Agreement (EPA); and, the Cotonou Agreement.

Recent studies of these past and existing preferential arrangements (Perez 2003, Leslie 2002, McQueen and Stevens 1989), cast doubt on their usefulness to poor countries. Seven major weaknesses have been identified. They:

1) hamper competitiveness in the exporting economy;
2) protect inefficient sectors and enterprises;
3) create disincentives for dynamic enterprise responses to trade challenges;
4) perpetuate dependence on traditional export items (dependent on natural resources and low labour costs), which are inconsistent with the direction and growth of global demand;
5) weaken the development of linkages between the export sector and domestic output and therefore, the incentive to diversify;

6) favour enclave-type development of the export sectors;

7) restrict the scope for expanding foreign exchange earnings, thereby fostering macroeconomic and balance of payments pressures.

It is further claimed that since institutionally these preference arrangements were (are) 'voluntary' and not the product of a binding multilateral agreement (World Bank, 2003), they: 'Come laden with restrictions, product exclusions, and administrative rules that prevent beneficiaries from taking full advantage of them' (ibid: XXVI). Indeed data from (Inama 2003) cited in the World Bank study show declining usage rates for available preferences. Thus by the end of 2001, only 39 per cent of potential import preferences under the general system of preferences (GSP) into Canada, the EU, Japan and the United States has been utilised. Further, these arrangements seemed to have discriminated against those poor countries that are not entitled to them, so that gains where they exist may be due to the diversion of trade from those poor countries outside the preference arrangement. Preferences are also cited for creating both uncertainties in global trade and burdening it with the high costs of administering them, especially in areas like monitoring rules-of-origin. In some instances 'reverse' preferences have been identified, that is, the main beneficiaries of preferences are interests in the preference granting countries!

Perez (2003) specifically addressed the trade performance of Caribbean SIDS (Caricom) and Central American countries under their major preference arrangements with the US and EU. For this purpose he classified their exports into three major groups: natural resource based; resource based manufactures; and manufactures, not resource based, and found:

> 'SDT provisions have shaped and solidified a static export specialisation pattern that is, with a few exceptions, highly concentrated in its direction and composition, and based on a comparative advantage of depending on natural resources and low labour costs [which] does not necessarily correspond with the evolution and direction in the composition of external demand'. (Ibid: 12)

He goes on to identify SDT as not only leading to a divorce between export specialisation and the patterns of global demand but also contributing to a weakening of the linkages between exports and domestic output and the further weakening of the export sector. Thus export specialisation has remained in traditional areas of low-income elasticity and manufactures at the low value-added, low technology end of the production and value chain. This situation has led to the under-supply of quotas as can be seen in data on Caricom exports of bananas prior to the changes in the EU import regime (2001) where, on average, less than half the combined total quota, was filled. In the case of Central American exports of textiles to the US, only two-thirds of the quotas available were on average utilised. Caricom failed to maintain its overall market share in North America Free Trade Area (NAFTA) and the EU between 1985 and 2000, but gained market share in areas where it did not benefit from preferences.

From all appearances this is a formidable assault on the effectiveness of preferences. However, one has to be careful not to overstate the significance of these observations. This can easily happen if two very important considerations are not taken into account. One is the counterfactual. That is, these assessments do not attempt to address the question of what would have been the situation in these countries without past preferences? And, the other is the lack of comparative examination of the performance of countries ‘with-preferences’ and those ‘without-preferences’, in the context of the unprecedented liberalisation of global trade that has occurred since the formation of the WTO. There are also other important qualifiers to note. One is that not all agreements have been as ‘voluntary’ (and therefore unilateral) as some observers seem to indicate. For example, the EU-ACP arrangement was a firm commitment that has lasted since 1975, and its termination was painstakingly negotiated-out, not unilaterally withdrawn. Indeed, that process is still underway as the Cotonou Agreement is itself a transitional arrangement. Another is that one cannot condemn the beneficiaries of preferences to a situation in which they never learn the lessons of the better use of preference opportunities. The very research and empirical information cited above, which condemn these arrangements, should, as they become more widely known, give countries opportunities to benefit from them and to respond appropriately. Finally, many of the problems preferences faced, and still face, exist also for liberalised trade, for example, issues of timing and sequencing; concerns that ‘automaticity’ may act as a disincentive; and the dangers of a one size-fits all approach to trade policy.

Strategically, it would seem best to make the case that the call for SDT arises out of certain intrinsic features of small states, whose significance may/will decline if development is truly global and broad-based. In this sense therefore, SDT is potentially transitional to a new global economy, one where small states would have already achieved satisfactory states of ‘catch-up’ with their rich large counterparts and where built-in agreed to conditions for graduation would be reasonable. This argument therefore links SDT to not only the graduation of small states, but also to the graduation of the global economy and trading system.

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