

**SMALLER ECONOMIES AND EXTERNAL FACTORS**  
(Some random thoughts)

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**I**

Mark the correct answer on the following multiple-choice question: in facing the globalization of the economy, smaller countries are more likely than the larger countries to:

- A. Obtain disproportionate benefits from the liberalization of trade and investment;
- B. Sustain disproportionate costs from the liberalization of trade and investment;
- C. Both of the above.

While the last answer defies logic, it is, in fact, the one that comes closest to responding to a complex question, whose real answer would begin with the caveat: "it all depends on..." followed by a long list of assumptions and conditions. The last answer is also close to the proposition that international trade is not a zero-sum game, and that while there will be "winners" and "losers" in each country participating in enhanced trade, due to a reallocation of resources, in the end everyone will be better off.

In support of the first answer, Gerry Helleiner reminds us of the neoclassical paradigm which holds that when a small country liberalizes trade with a large one, the resulting gains flow disproportionately to the small country, since it will experience relatively larger changes in its price structure with subsequent greater gains from the domestic reallocation of production and consumption that ensues from enhanced trade. On the other hand, and in support of the second answer, the Economic Commission for Latin America and the Caribbean's single most influential contribution to development thinking in the post-war era stressed the asymmetrical relations between developed and developing countries, which, as is well known, were based mostly on uneven production structures that reflected the international division of labor, but included "smallness" as one of the factors that inevitably distributed the benefits of trade and development unevenly.

Indeed, it became conventional wisdom that smaller and weaker economies had built-in disadvantages to compete with larger and stronger economies. It was not only a matter of economies of scale, but of resource endowment, human capital, physical infrastructure and organizational capacity. Hence, in the realm of international relations, outside of those activities where the smaller economies had "natural" comparative advantages (in the case of smaller developing economies, these were usually based on the exploitation of abundant cheap labor), the only way to "level the playing field" was to seek preferential, non-reciprocal treatment. This belief became the conceptual underpinning in the realm of





international economic relations of instruments such as the generalized system of preferences, applied from 1968 onwards by many industrialized nations, as well as the preferential treatment accorded to selected countries in the Lomé Conventions and in the Caribbean Basin Initiative. It also found its way into numerous formal integration agreements, through specific provisions for the relatively less developed countries of any particular sub-regional grouping.

## II

The question of the potential costs and benefits to the smaller and the weaker economies in their dealings with larger and stronger economies has taken on new urgency in the context of unilateral trade liberalization that came with the globalization of the economy, and, for Latin America and the Caribbean, with the mere prospect of creating a Free Trade Area in the Americas. Can Central American and Caribbean enterprises really compete with analogous Mexican enterprises, not to mention U.S. or Canadian firms? Will the smaller and weaker economies be pushed into the type of situation ECLAC denounced in the late forties, where their role will be relegated to producing basic commodities or goods that require cheap labor, all of which would condemn them to a sort of low-productivity trap? Will they even be able to meet the conditionality to participate in any type of agreement, deep or shallow, that would lead to hemispheric integration? And, in more general terms, how will they fare in a world where non-reciprocal preferences are rapidly giving way to either reciprocal preferences or no preferences at all?

## III

Some of the macro-trends present in the globalization of the economy are well known and have been described in numerous documents. Among the more important aspects that are germane to "smallness" one can mention new technologies in the areas of design, production, transport and communications, based on microprocessors and numerical control, which have had far reaching effects on production patterns, the localization of firms, and styles of production and marketing. Former constraints related to economies of scale and the size of domestic markets tend to lose importance with the development of flexible manufacturing principles. New production methods based on electronic and data-processing technologies favor less vertical integration within the plant, which means more outsourcing and subcontracting within and outside of the country; greater specialization in the final stages of assembly, which dispenses with the intermediate manufacturing of parts and components; a smaller variety of locally manufactured products and direct importing of finished units; greater integration within globalized productive systems or chains of a transnational character, in which each firm contributes only a small portion to the larger system and therefore uses more

standardized and internationally approved technologies; real-time production techniques (just-in-time, total-quality production with minimal inventories), and growing professionalization of technical and managerial networks and better financial management, attuned to opportunities for obtaining domestic and foreign financing.

These trends pose both risks and opportunities for smaller economies. The risks gravitate around the increasing complexities and demands that the new technologies impose on firms and countries, which acts to the detriment of those economies that lag in technological and institutional development. In this respect, the quality of physical infrastructure, the regulatory framework, the caliber of human resources and organizational capacity become crucial elements of improving linkages with the international economy. None of these attributes appear to be overabundant in most of the smaller economies. On the other hand, new technologies are less sensitive to economies of scale, while the practice of outsourcing and the need for greater flexibility, while not necessarily being advantageous to smaller economies in relation to larger economies, at least open opportunities that would have been denied the smaller economies altogether one or two decades ago.

Further, some of the economic activities that have shown dynamic growth in the recent past, prominently including tourism, appear to be in areas where smaller economies --certainly the island States of the Caribbean-- have traditionally held comparative advantages.

Another major trend that has accompanied globalization has been the dramatic increase in financial flows across borders. Frequently those flows are linked to trade, often in the hands of transnational enterprises. But capital flows have developed their own logic, as capital markets themselves have become transnationalized. Some of the smaller economies of the Caribbean have been successful not only in attracting direct investments linked to developing their respective export sectors, but also to participate in the service of providing off-shore financial services to international capital markets.

From the smaller economies' vantage point, it would seem to be superfluous to ask whether, in balance, the globalization of the economy holds greater risks or opportunities. Rather, domestic policies should be oriented in such a manner as to mitigate the risks and to enhance the opportunities. Intraregional cooperation between smaller economies seem to offer an important mechanism to achieve such a purpose.

#### IV

Given the points raised thus far, probably the most useful way to approach the topic of how smaller economies relate to the global environment is to examine domestic policy measures to facilitate

the integration of smaller economies into the global economy (or into the FTTA), rather than exploring those external factors that are particularly relevant to smaller economies. In this respect, attention has rightly been focused in recent times on the degree of "readiness" of different categories of countries to confront the emerging international economic realities. It should be pointed out that, from the conceptual point of view, the conditions for integrating effectively into the world economy are quite similar to those faced in approaching a formal trade liberalization agreement, especially if it involves relatively more developed economies than those of the country facing trade liberalization policies. The major challenges appear to lie in: i) the spheres of macroeconomic management and the regulatory environment; ii) the capacity of the productive structure to face increasing levels of competition; iii) the trade policy regime; iv) the "investment climate" (which covers a wide range of institutional reforms, including such areas as property rights, the administration of justice, personal security and the relations between labor and firms); v) the quality of physical infrastructure; vi) the quality of human capital and technological development (i.e., organizational capacity, entrepreneurship, quality of the work force).

A few general comments are in order regarding how these different categories of "readiness" could differentiate the smaller from the larger economies.

#### i) Macroeconomic management and the regulatory environment

A precondition for strong long-term economic growth is a stable economic platform in which such macroeconomic imbalances, as may exist, are held within sustainable limits. "Smallness" does not seem to pre-ordain either better or worse macroeconomic management than would be the case for larger countries. In other words, there is no compelling argument that would put smaller economies at a disadvantage to meet certain criteria in the realm of fiscal and price stability or coherence in monetary policy *vis à vis* larger countries. While it is true that fiscal receipts depend on foreign trade to a larger degree in smaller than larger countries, and thus make them perhaps more vulnerable to changes in the international environment, it is equally true that the greater contribution of foreign trade to GDP has traditionally helped keep inflation in check in most countries. Be that as it may, improved integration into global markets has already imposed greater discipline on countries in macroeconomic management and has forced smaller economies to restructure their tax systems to take into account the effect of unilateral trade liberalization on the collection of tariffs. Accession to formal integration schemes such as the North American Free Trade Agreement would require enhanced discipline which would no doubt put additional burdens on smaller economies, but then again the same applies to the larger ones.

Macroeconomic policy-making and the maintenance of an efficient and market-oriented regulatory environment requires modern legislation and good quality public sector management. It could be argued that smaller economies might have greater difficulties than the larger ones to mobilize the professional cadres and expertise required, but empirical evidence does not necessarily bear out such a presumption. On the contrary, it could be argued that the greater discipline of public service that seems to exist in the English-Speaking Caribbean gives numerous smaller economies of that particular subregion an edge over other, larger, Latin American economies. In other words, quality of public service is not necessarily specific to size, but rather to other factors.

ii) The degree of competitiveness of the productive structure

In the absence of factors that spur the global dissemination of technology, the initial conditions historically prevailing in each country will tend increasingly to strengthen the correlation between a country's size, capacity for efficient innovation and national growth rate, thereby possibly widening the gap between the smaller, less developed countries and other countries when they come to integrate their markets. In this respect, the smaller economies would presumably be at a disadvantage in most manufacturing activities, and especially those that are more intensive in the use of technology or economies of scale, as well as organizational capacity.

Still, it would be erroneous on the part of policy makers of the smaller countries to think in terms of exposing **all** of their industrial plants to competition from analogous plants of larger countries. Rather, a two-pronged approach is called for: on the one hand, whenever possible, helping existing producers to reconvert in order to become competitive within a certain time span; on the other, and perhaps more significant, to think in terms of expanding certain industrial activities based on present or potential comparative advantages, and develop fields of excellence within the expanded market that the FTAA would presumably offer. In this respect, it should be recalled that "smallness" has not been a hindrance to developing subcontracting activities, especially in garments and footwear or in the electronics industries. Nor would "smallness" impede moving from the production of sugar and molasses into biotechnology, which is an important by-product of the process of fermentation.

So, while it is true that smaller economies are unlikely to develop comparative advantages in large capital goods, there is scope for developing new clusters of manufactured goods, taking advantage of potential comparative advantages and the expanded markets resulting from regional or hemispheric integration.

iii) The trade policy regime

Smaller economies have, in general, been more open to international trade than the larger ones, although some activities have been highly protected, leading to relatively wide tariff spreads. However, there has been a clear movement --as in the larger countries also-- in the direction of trade liberalization and diminishing dispersion. Thus, the general trend of trade policies has been favorable to integration into the world economy, as any anti-export or pro-import biases have tended to be reduced over time.

There are, however, two areas of trade policy that seem to be somewhat specific to smaller economies. The first has been mentioned above: the relatively high dependence on tariffs as a source of fiscal income, and hence the reluctance on the part of some policy-makers to liberalize trade --in general or in the context of preferential agreements-- without alternative sources of fiscal receipts. The second is that many of the smaller economies of the Caribbean and Central America have agreed to a common tariff applied to goods from third countries, which makes decision-making at the national level more difficult or, what is worse, generates tensions when individual countries face the temptation to liberalize at a faster pace than other members of its particular grouping.

Still, when trade policy and macroeconomic management are taken together, it is not clear that smaller economies face peculiar difficulties to facing increased competition (on a global or hemispheric level) which are significantly different than those that face the larger economies.

iv) The "investment climate"

The overall system of incentives and the regulatory and institutional framework (property rights, the administration of justice, personal security, labor policies, environmental standards) all seem to be determining factors in attracting international investment. Some of these factors, especially in the realm of institutional development, might be linked to size and level of development, although other factors also come into play. Clearly, there are many smaller economies in the Caribbean which enjoy higher levels of institutional development in areas such as property rights, law enforcement and the administration of justice than is the case in some of the larger Latin American countries.

v) The quality of physical infrastructure

Empirical evidence available suggests a close relationship between the level of development and the adequacy of infrastructure, rather than between size per se and the quantity

and quality of infrastructure.<sup>1</sup> On the whole, indicators for the smaller economies do not differ significantly from those of larger ones. Indeed, on the face of it they seem to be even better in several Caribbean countries. Greater unit costs of infrastructure for the smaller economies mean that they have probably exerted greater efforts, or relied on a greater proportion of international financial cooperation, to achieve their present levels of infrastructure. In several of the latter cases, the burden of maintaining the existing infrastructure is onerous.

Nevertheless, the smaller countries with lower levels of development, especially in Central and South America, must make a particularly forceful investment effort in this area. The significant experience accumulated as a result of the high level of international lending for infrastructure projects in the past, and the largely successful implementation of these projects, makes it an area where international cooperation can be implemented more easily and have a greater impact.

vi) Organizational capacity and human resources

Other factors that have become increasingly important to achieve improved linkages with the international economy refer to the quality of human resources, including the level of entrepreneurship, the caliber of the work force, and the adequacy of educational and vocational training systems.

Here, one can suspect that the smaller, less developed economies are at a distinct disadvantage, in spite of the fact that when looking strictly at the educational systems, there seems to be no close correlation between the average level of human resources and the size of Latin American and Caribbean nations.<sup>2</sup> Specifically, only Central America's educational achievement index, which combines the adult literacy rate with the average years of schooling, is significantly lower than in the larger countries of the region. The situation of the English-speaking Caribbean differs somewhat, since on average it assigns a greater proportion of public expenditure to education than the larger Latin American countries. Within the broad aggregates, however, there is wide variation between Caribbean countries.

At any rate, educational reform should be at the top of the list of priorities of the smaller economies if they wish to integrate successfully into the international economy. Since the larger economies will presumably be doing the same, the first order of business will be to avoid a widening gap.

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<sup>1</sup> ECLAC, Internal Policy Measures to Facilitate the Integration of Smaller Economies into the FTTA (LC/R/1641), 31 May, 1996, pp. 16-17.

<sup>2</sup> ibid., pp. 14-15.



The whole issue of "smallness" or relatively retarded development within integration schemes has changed over the years, since liberalization has reduced the trade diversion costs that the relatively less developed countries had to pay if they signed preferential agreements with other countries. It is still true, however, that the more economically backward countries of the hemisphere are still likely to have fewer opportunities to tap the potential of integration agreements than more advanced countries. In addition to their own response in the realm of domestic policy application, what else can be done at the regional or hemispheric level to facilitate hemispheric integration of **all** economies, regardless of size?

First, a sudden sweeping liberalization of trade between countries or sectors at different stages of development runs the risk of polarizing investments and eliminating production facilities in the relatively less developed countries, which, if given more time to adjust, could improve their competitiveness. In this sense, it would be advisable to allow more time for the adjustment process in the lagging countries that liberalize their trade with other, more advanced, economies in the region or hemisphere, and to supplement this process with further measures, particularly at the national level. In practice, the need for a longer adjustment period is explicitly recognized in the agreements concluded between Venezuela and the CARICOM members and between Mexico, Colombia and Venezuela and the Central American countries, as well as in the NAFTA for Mexico in relation to its two trading partners.

Second, the countries having less capacity to take advantage of the potential of integration should also take steps to deal with any unfair trade practices adopted by the larger firms in the region. In the short term, this means promoting anti-dumping policies which are capable of warding off the effects of predatory practices through objective, non-discriminatory and transparent procedures—accepted at the national or subregional level—, taking the Uruguay Round agreements as a frame of reference. In the longer term, a policy of fair competition could be envisaged as part of any eventual integration agreement, for the purpose of discouraging this type of practice through punitive actions that do not involve trade restrictions.

Lastly, to promote a measure of balance in reciprocal trade relations and to keep rules of origin from becoming serious trade barriers, it would also be desirable for such rules to be generally lenient, although without ignoring the existence of special cases; otherwise, they would discriminate against economies that are not sufficiently integrated to the world economy or are less likely to generate significant proportions of value added.

As to the spread of technology and intraregional investment as a means of compensating for inequalities, the integration process must provide not only for trade liberalization, but also for appropriate, compatible laws on industrial property, openness of information networks, mobility of skilled human resources and promotion of foreign investment among the countries of the region, with the aim of encouraging imitation and the transfer of technology. In addition to facilitating the spread of technology, integration agreements should allow less developed countries to reap the full benefit of their relative advantages, such as the low cost of labor or other resources. The need for special efforts to promote the inflow of foreign investment from within the region is particularly apparent in connection with the creation of channels for the spread of technology. There already appears to be a larger proportion of such investment in the region's small countries than in the rest; this could attenuate the negative effect of asymmetries between widely divergent economic structures.

The promotion of foreign investment from within the hemisphere, as a way of increasing the capacity of all the countries of the region to seize the opportunities created by integration, would require an agreement to establish mechanisms that discriminated in favor of intraregional investment. Such a decision could be justified if it generated not only the benefits deriving from investment per se, but also other advantages (externalities). In other words, if these investment flows furthered a sustainable, synergetic integration process that was not interrupted by acute trade imbalances and the resulting tensions. However, the potential costs of favoring less efficient investments, especially by comparison with private investments that could be made in a context of growing internationalization, would also have to be borne in mind.

A mechanism for promoting private investment, and one which does not necessarily exclude others, would be to use available resources to finance fiscal incentives for intraregional investment. Such incentives could include tax exemptions (on income, for example) in the case of reciprocal investments, or tax credits for Latin American and Caribbean enterprises that invested in relatively less developed countries. Regional or subregional financial institutions or development banks could provide the institutional bases for implementing some of these systems.

Finally, large and long-standing trade imbalances could be linked to the granting of resources on preferential terms for public and private investment projects. Experiments of this kind have already been carried out in the case of intraregional oil exports, as shown by the example of Venezuela's Investment Fund, which converted part of the debt incurred by the Central American and Caribbean countries through oil purchases into concessional financing for investments in infrastructure projects. Similar initiatives encompassing trade in all sectors, as well as public

and private investment, could be implemented in the future and could give priority to smaller economies. In these cases, the determining factor would be the need to not only preserve the continuity of integration efforts or enhance equity, but also help consolidate democracy in Latin America and the Caribbean through regional solidarity.

## VI

In conclusion, just as smaller economies have moved in the direction of improving their integration into the global economy, they can prepare to participate in a hemispheric-wide free trade arrangement. In some areas, they will have to make special efforts to overcome inherent disadvantages associated with "smallness" or lesser development. These refer especially to lags in the institutional framework, in physical infrastructure, and especially in organizational and managerial capacity. None of these lags appear to be insuperable. On the other hand, there would be high costs to these countries, in terms of trade and investment deviation, if integration proceeds in the hemisphere among the larger countries without the smaller countries' participation.

✓ While international and regional cooperation have a role to play in helping the smaller economies adapt to their changing external environment, the main responsibility will fall on those countries themselves. ~~Crucial elements of domestic policy-making~~ are those aimed at setting up a sound system of incentives and a sound regulatory framework. Further, major efforts will have to be undertaken in the development of human resources, the expansion of physical infrastructure and the modernization of the productive structures. It will be especially critical to build the human and institutional capacities which can remove the numerous impediments which limit the proper functioning of factor and product markets and which are endemic in smaller economies, and which can offer the basis for sustained development.