Comments on 'Small States: A Composite Vulnerability Index' and 'Small States, Small Problems?'

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The juxtaposition of the two studies 'Small States, Small Problems?' and 'Small States: A Composite Vulnerability Index' and the presentations by Dr. William Easterly and by Dr. Christopher Easter are instructive. The studies address an issue of great salience to a very significant number of countries in the international community. I welcome the opportunity to intervene as a discussant.

The two studies conclude firmly that small states:

- are very vulnerable in the sense of high output volatility which derives significantly from
  - economic openness or high dependence on international trade and the volatility of commodity terms of trade
  - vulnerability to natural disasters;
- under normal conditions have growth rates which are not dissimilar to those of large states;
- experience volatility the fundamental causes of which are outside their control.

The study on the Composite Vulnerability Index (CVI) is particularly instructive. An analysis of 111 countries, including 37 small economies of which two-thirds were small island states, shows that 34 small states were among the 50 most vulnerable countries. In fact, of the 30 most vulnerable states on the CVI, 28, or 93 per cent, were small states and only three small states were among the 61 least vulnerable states.

A preponderance of small states, vulnerable to factors outside their control and hence not subject to national policies, constitutes a major challenge to international policy-makers. This also raises a question mark over the efficacy of the emphasis placed in recent years by international financial institutions (IFIs) and bilateral donors on national policies and the macroeconomic framework of small states as the primary cure for their economic difficulties. Sound national policies and engagement in the international economy are necessary, but definitely not sufficient, conditions for the sustained development of small states, especially small island states.

In the face of the factual evidence, Dr. Easterly and Dr. Kraay conclude firmly from their econometric analyses – what they put in and omit to put into the black box – that: 'small states are no different from large states, and should receive the same policy advice' and, we presume, treatment in terms of access to market and to financial (capital) resources. They even go so far as to entitle their study 'Small States: Small Problems?'. The implied message to international policy-makers is clear.

The logic of their conclusion is, however, difficult to fathom. It invites a closer analysis of their arguments. The authors accept that growth volatility and volatility to terms of trade shocks are higher for small states. They even overstate the cause as 'due *entirely* to their greater trade openness' (my emphasis). They then proceed, on the basis of the argument, to state that 'the net benefits of openness on growth are positive' and to argue not only for greater trade openness, but to recommend that small states 'diversify their risks by opening up to international capital movements'. Put differently, small states are being urged to put in place more of the openness which heightens their vulnerability and the volatility of their growth.

The authors fail to assess either the extent (size) of the net positive benefits or its underpinnings. They also fail to analyse the factors which have underpinned the robustness of the historical growth in small states. It might be instructive, however, to note that the authors posit that 'the negative effects of high initial income and high volatility *are roughly offset* by the positive effects of trade openness and better education attainment' (my emphasis). What would be the net effect of a greater negative effect from even higher initial income and greater volatility and a lower positive effect from trade openness? *There is a point at which the net result can turn negative.*

An analysis of the underpinnings of the growth performance of the small states in the 1960s to the 1990s. and particularly up to the mid-1980s, would have been instructive. In that period of good growth and income performance of small states, the international community expressly accepted that small states were different and treated them differently. Special and differential treatment was reflected in, for example:

- access to concessional or grant financing for capital and infrastructural development. These 'soft' resources not only financed the building of infrastructure but facilitated much of the re-building of capacity after natural disasters;

- preferential access to export markets. This permitted the beneficial effects of higher and assured export earnings to be combined with more competitive import sourcing. Built-in market assurance mechanisms, such as the longstanding national quota systems in Europe for bananas and the European Union licensing system and hurricane licences after 1993, mitigated the impact of natural disasters and assured re-entry to the market when production was restored;
- stability of export earnings (many of the small states, as ACP members in association with Europe under the Lomé Convention, had much of their export earning fluctuation stabilised through STABEX and SYSMIN);
- importance of natural resources to the expansion of global production and trade gave some small economies particular importance for a period. Petroleum-based energy, bauxite and strategic location in a Cold War context significantly influenced the growth performance of small economies such as Bahrain, Trinidad and Tobago, Jamaica, Singapore, the Bahamas, Malta, Mauritius and Gabon.

The current global approach and the policy which would be reinforced and encouraged by Dr. Easterly's firm conclusion would remove all these advantages which underpin the performance on which the analyses leading to the policy decisions are based.

The GATT Uruguay Round of negotiations, for example, has significantly undermined the provisions for special and differential treatment for small states in relation to trade, including non-reciprocal preferential arrangements. Simultaneously, resource constraints as a result of the policies of major donor countries and new demands from large states have significantly reduced the availability of financial resources available to small states, even to deal with difficulties arising from global threats such as climate change and the resultant more destructive and frequent natural disasters, drug trafficking and money laundering.

Technological developments, especially in respect of new materials and re-cycling, are reducing significantly the importance of many raw materials. These developments, combined with the end of the Cold War, are also reducing the locational advantage of some small states.

The above factors suggest that an effort to project the growth and income prospects might have yielded very different results.

No Nobel Prizes are in fact likely to be awarded for predicting the outcome.

The firmness of Dr. Easterly's conclusion is astonishing for another reason.

The study admits in several places to results which are not easily explained. Consider the following examples:

- 'We are not sure why microstates are so much richer than their regional neighbours . . . but we see this as a decisive refutation of the macro arguments that microstates suffer from a development disadvantage';
- '. . . we should take with more than a grain of salt the result that investment accounts for even as much as one-third of the income advantage of small states . . . It may reflect an omitted third factor . . .'

  This third factor is not identified. There is no discussion as to whether such a factor could be negatively influenced by new policies and so undermine performance in the future.
- 'We find that there is a highly significant microstate effect, with the standard deviation of terms of trade shock larger by 0.013 . . . in microstates.'
- 'It is also possible that some of this observed volatility reflects difficulties in measuring per capita incomes . . . particularly acute in small states . . .'
- The authors did not consider whether the statistical measurement difficulties have similar distorting effects on the growth of per capita incomes on which their conclusions so much depend.

In looking closer at the issue of statistics, it is clear that the authors interpreted the numbers very conveniently. It is well known that the larger the number, the smaller the impact of any change, and conversely for small numbers. A country which produces one motor car will increase its motor car output by 100 per cent when in the next year it produces two motor cars. Conversely, a country which produces 100 motor cars will only have increased its output by 1 per cent when it produces 101 cars.

Are small states different? As you ponder the question, reflect on the impact of Hurricane Andrew on the USA and that of Hurricane Gilbert on Jamaica. I left Miami just before the airport was closed for Washington, DC where Hurricane Andrew was not even an item of news. Conversely, I had to wait for almost a week after Hurricane Gilbert had struck to get one of the first international flights into any part of Jamaica. Reflect, also, on the often publicised statistics on the higher transportation costs and higher per capita cost of infrastructure for small stages. The counter-intuitive nature of the finding of the Easterly and Kraay Study should have forced the authors to be more sceptical.

I note the disclaimer in the study that the views expressed are not necessarily those of the World Bank. I hope the word 'necessarily' was an error. Alas, however, the similar disclaimer in 'Bananarama' did not prevent that equally weak study being quoted by the World Bank and other officials.

In conclusion I wish to draw attention to the fact that while Easterly and Kraay entitle their study 'Small States: Small Problems?', the 1994 UN Conference on Small Island Developing States had as its title 'Small States: Big Problems'. Those words are still on the walls of the Sherbourne Conference Centre in Barbados.