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Policy Implications

A major finding of this study is that small states are likely to see their exports fall fairly substantially, and that for some of them the reduction may be critical. These countries need to adopt both short-term and long-term policies to mitigate and (eventually) counteract the effects of the crisis and increase their resilience to possible future shocks, which are not rare, as this crisis has once again shown. We review these policy implications in turn.

6.1 Long-term policies

The wide variation in trade effects is related to the varying composition of countries' exports in terms of both markets and sectors. It is clearly more difficult to change the sectoral specialisation of a country than to change its trading partners, especially for a small state. In this context, diversifying export markets is a strategy with a high return in times of crisis. Often, however, small states have been locked in to export to certain markets via preferential schemes; the most important of these are schemes with the EU, covering a number of agricultural products. Moving away from this preferential system is likely to facilitate the market diversification process.

In addition, for those small states exporting commodities and minerals and fuel in particular (e.g. Brunei Darussalam, Papua New Guinea, Trinidad and Guyana), diversifying export markets is not a solution, as exports are to world markets and the export value in the short term depends on the price which is set internationally. Obviously, in the medium to long run the export is also a function of supply capacity (e.g. capital invested in new oil exploration or in expanding the area under production of tropical products). But even that is often ultimately driven by the international price. The crisis is showing once again how vulnerable to demand shocks mineral and oil markets can be. Therefore, small states need to build resilience to these types of shock. One possible way to reduce the drop in exports in these sectors would be to increase the quantities sold. However, with dwindling incomes and demand this strategy seems very difficult to implement. The most feasible option for mineral and oil exporters is probably sectoral, rather than market, diversification. Although booming mineral export sectors are often a problem for sectoral diversification owing to 'Dutch-disease' type effects, this need not be the case. Chile is illustrative in this respect. In Chile copper booms have been accompanied by the development of successful non-traditional export sectors. This underscores the importance of managing the response to swings in commodity prices in a careful way, extracting resources from the mineral sector during boom times in order to cope when times are lean. As noted by Calì and te Velde (2007), if enough windfall revenues are chan-

nelled into the public sector, there is an option of creating a trust fund to save for periods of adverse terms of trade and to take pressure off the currency (along the lines of the Chilean experience). This will also have the effect of not constraining the growth of other sectors during mineral boom times. The success of granting preferential market access has been mixed, especially as falling tariffs and increasing numbers of countries with preferential access have greatly reduced the scope for preferences.

On the other hand, to the extent that services exports are more resilient than exports of goods in the face of the global financial crisis, the crisis may induce a further switch to a services-based specialisation. This has already been identified as one of the most viable specialisation patterns for small states (Briguglio, Persaud and Stern, 2006), as for services exports the penalties of smallness and remoteness are generally less severe than for exports of goods. Within the services sector, several small states, and in particular small island countries, have an inherent advantage in tourism. However, tourism is one of the most negatively affected services exports. Business and professional services appear to be more resilient and they could provide interesting areas for future export specialisation for small states, including via temporary movement of persons. This requires consistent and focused investment in tertiary education that not many small states are able to make, due to the economies of scale needed to develop an effective tertiary education system (e.g. a critical mass of students to establish a university degree in a particular subject). This may be a further reason for investing in these types of activity at the regional level, e.g. by creating regional universities.

6.2 Short-term policies

In the short run, small states are constrained in the policies they can implement to limit the adverse effects of the export crisis. A first possibility is to use exchange rate policy by devaluing the domestic currency vis-à-vis that of the major competitors in order to improve the competitiveness of the country's exporters. However, the scope of this measure is often constrained by the pegged and semi-pegged exchange rates adopted by small states. Moreover, devaluation will increase the price of imports and the costs of external debt.

Another possibility is to use fiscal policy to stimulate exports by reducing (or eliminating) both explicit and implicit forms of export taxes (e.g. via import taxes on inputs). A measure of this type appears to have yielded some success in Vanuatu, which recently scrapped the fee charged to cruise ships to dock in the port. This seems to have contributed to the recent increase in tourist arrivals via sea. In general, all measures that reduce the costs of trading may be particularly effective in a period of price-sensitive international demand. Trade facilitation activities may help reduce these costs in the short run, and have proven to be particularly effective in decreasing the costs of exporting in SVEs (Calì and te Velde, 2009b). Upgrading and developing infrastructure are possibly more effective in reducing trading costs,

but are longer-term measures. In some cases, the latter could be an effective way of implementing counter-cyclical fiscal stimulus packages.

As argued in Section 2, one of the major factors responsible for the fall in trade has been the lack of general credit, of which trade finance is one part. This tends to constrain especially those firms that lack assets (and thus guarantees), for which producing and exporting (or import competing) becomes increasingly difficult. Ensuring access to credit to such firms in particular may help limit the fall in exports and in some cases may support and save domestic industries.

One possible implication of falling prices in commodity export sectors is that these may receive government transfers to offset part of the falling revenues (IMF, 2009a). This will happen if commodity marketing boards or state-owned export enterprises, which are quite common in small states, decide to subsidise domestic producers by maintaining higher domestic prices than the corresponding export prices. This will obviously have negative effects on domestic consumers, and thus needs to be carefully evaluated.

The crisis has also had a negative effect on the prospects of the offshore financial centres, which have come under closer scrutiny. This may explain in part the drop in financial services imports by the USA and could suggest re-orienting existing offshore centres, which are present in a number of small states, to offer more sustainable types of financial services.[15]

Finally, all the efforts of the international trade community to minimise the impacts of the crisis on international trade will be particularly beneficial for small states, given their high degree of openness and dependence on international trade. Such international policy responses could include the fight against any form of trade protectionism, the provision of adequate funds and guarantees to ensure sustained trade finance, and the provision of AfT in effective areas of intervention.