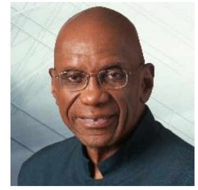

Working Paper

An Alternative Policy Approach to Growth and Stabilisation in Small Open Economies

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Abstract

This chapter recommends an alternative to the standard approach to economic stabilisation and growth policy for small open economies. The standard view, reflected in the analyses of the IMF, other international institutions, most think tanks and the media, is that a combination of credible inflation targetting regimes, flexible exchange rates, and fiscal sustainability are the core elements of a policy regime that is appropriate for all countries, regardless of size. Instead, for small open economies we propose the use of fiscal management to maintain and improve the international competitiveness of the economy, to maximise the inflow of private foreign capital motivated by attractive rates of return, and to stabilise inflation expectations by anchoring the exchange rate to an international reserve currency. This chapter explains the alternative policy framework, and compares it with the standard approach.

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For better or worse, the International Monetary Fund has become the modern oracle of economic policy advice and analysis. The Fund's view on the economic strategies of all countries is reflected in its own publications, in the design of national economic strategies that attract Fund assistance and finance and in its staff reports on member countries. The analysis which underpins the Fund's view is also reflected in the analysis and comment by the media, think tanks and universities around the world.

A succinct summary of this orthodoxy with respect to desirable policies for growth and adjustment is offered in Carney (2019). That strategy is a combination of the establishment of credible inflation targetting regimes, maintaining flexible exchange rates, fiscal sustainability, developing an effective macroeconomic toolkit to curtail the damaging extremes of financial cycles and developing deep capital markets. The orthodoxy insists that this suite of policies will be conducive to growth and maintaining economic stability in any country, irrespective of size.

This chapter recommends an alternative policy approach to growth and economic stability in small open economies, one that is sensitive to the economic structure of such economies. The small open economy grows by attracting international investment, drawn by the competitive rates of return on offer for investment in the domestic economy. The main focus of growth policies, therefore, must be to maintain and improve international competitiveness. The first section of this chapter is devoted to policies to improve competitiveness in small open economies, drawing on Caribbean examples.

Economic growth is best assured in an environment of low and stable inflation. In place of the orthodox policies of inflation targetting with an independent central bank, we recommend targetting the exchange rate, the principal source of inflation in the small open economy, with the use of fiscal tools. This approach, which is fully articulated in my chapter "Why and How to Use Fiscal Policy to Target the Exchange Rate" in this volume, is briefly summarised in the second section of this chapter.

The third section is an analysis of the weaknesses of the orthodox approach to stabilisation and growth policies. The efficacy of the orthodox strategies may be questioned even in large advanced countries, but that is not our concern here; we focus on the reasons why small open economies are unable to deploy the standard suite of policies, except for fiscal policies.

Competitiveness Is the Key to Economic Growth

This chapter advances the argument that policies to maintain and enhance international competitiveness are key to unlocking the growth potential of small open economies like those of the Caribbean. Although Caribbean economies are so small, they can interest foreign financiers in any investment project which offers an internationally competitive rate of return. The task of domestic policy makers is to stimulate such investment by identifying the factors which make the economy stand out in the international market, and to provide incentives and support for investment in those competitive-enhancing qualities. Policy makers also need to identify the domestic barriers to investment and growth, and find ways to overcome them.

Investment drives growth in the small open economy

As investors seize opportunities to make profit, in tourism, agriculture, manufacturing, services, transport, renewable energy and other competitive activities, they create additional capacity, which promotes employment and growth. There is no limit to the international demand for Caribbean products and services that offer value for money to foreign consumers. These are the products that provide the foreign exchange on which economic growth depends.

There is never a shortage of finance for investments which are clearly profitable, undertaken by companies with strong balance sheets. However, it is often the case that there is insufficient finance for investments in infrastructure, health, education, public order and other public services which may not offer opportunities for private investors to make a competitive rate of return. As we shall see, these are all desirable investments to provide public services that impact the country's economic competitiveness. This is where fiscal policy comes to bear: government's revenue, expenditure and financing policies play a vital role in the growth strategy, through providing the infrastructure and public services that by their nature cannot attract private investment that seeks a competitive market return.

On the revenue side, fiscal policy should provide incentives for investment in foreign exchange earning activities, and taxes should be structured to have a modest redistributive effect on incomes. Government services should be delivered with tolerable levels of efficiency, by international standards. All Caribbean countries suffer from public services that are well below acceptable standards, and this is a serious brake on investment. Government should also provide performance-related finance and other support for small and medium enterprises and for innovations in which the private sector has first shown interest. Experience has taught us that our governments are hopeless at identifying potential for competitive new investment. Instead, government should target promising activities in which there is already serious private sector interest. Protection of the most vulnerable in society through suitable safety nets should also be a priority of government spending. The management of fiscal resources to achieve these objectives simultaneously, while respecting the preferences of a substantial majority in society, is a matter on which the academy offers governments little by way of practical guidance, even though it is a central concern of actual political economy.

The financing of government expenditures matters for competitiveness and investment because it may affect foreign reserves and the stability of the exchange rate. An exchange rate which is subject to capricious changes is a major deterrent to investors, because of the resulting uncertainty of wages and prices. When this happens, expected returns on investment become less predictable, and returns to domestic investment become less attractive compared to what may be available in competing markets.

Government borrowing causes a fall in foreign reserves when government needs more financing than private lenders at home and abroad are willing to provide. That invariably results from overspending by government on wages, subsidies and other recurrent expenditures. Such expenditures should always be met fully out of tax revenues, with a small percentage of all revenues remaining as savings to help with funding capital expenditure. By managing its budget in this way government ensures that all borrowing is devoted to investment that adds to public wealth. That provides government with the wherewithal to service the borrowing which was used to finance the public investment.

If government manages its budget in this way, it will be able to fully finance public investment with a combination of domestic and foreign borrowing, from official institutions and by the issue of domestic and foreign currency bonds. Financiers will be happy to buy bonds at competitive interest rates that remain affordable because prudent fiscal management ensures Government of a favourable "investment grade" credit rating.

However, government will begin to encounter problems when it becomes necessary to borrow to cover shortfalls in revenues to cover the recurrent costs of government operations. Private financing will soon dry up as investors question government's ability to service debt which adds nothing to public assets. Officials then resort to the central bank for the funding needed. Central bank lending is problematic, because the central bank's funding is in domestic currency. However, when this money is spent, whether for wages, purchases or transfers, it generates a demand for imports, as do all expenditures in small open economies. Securing the foreign currency from Central Bank to purchase additional imports subtracts from the Bank's foreign reserves. If the overspending on government's current account persists, the loss of foreign reserves triggers a devaluation of the currency. Fiscal policy that respects the Golden Rule,[1] setting aside enough tax revenue in current account savings to cover downswings, remains the surest protection for the stability of the exchange rate, and a strong incentive for investment and growth.

All investment in the small open economy requires foreign finance

All investment in countries as small as those in the Caribbean requires finance in foreign currency to purchase equipment, vehicles, materials, fuels and other inputs from abroad, for each new project. This is true whether the project is large or small, private or public, for domestic production or export. It follows that all investment of necessity requires a substantial proportion of foreign finance. The implications of this obvious circumstance are not well understood. Everyone laments the low domestic savings ratios in the Caribbean, and there are regular exhortations to increase domestic savings, supposedly in order to stimulate growth. However, domestic savings are in local currency; in order to do any investment the saver has to acquire foreign currency in addition to (or in exchange for) their savings, because their domestic currency cannot be used to pay for the imports they need. On the other hand, foreign currency can be used to buy domestic goods and services if domestic savings are in short supply. It then follows that there can never be a shortage of finance for competitive investment in the small open economy - if local savings are insufficient, foreign financiers are happy to step in to take advantage of the competitive rate of return on offer. Equally, domestic entrepreneurs who are well established and of good standing never have a difficulty in securing foreign funding to cover the imports needed for their investments.

It is the competitiveness of investment projects, not the supply of domestic finance, which limits the rate of investment in well-established areas of activity. There are, however, important areas that banks and financial institutions will not fully take care of, and where government policy intervention is needed. These include innovative projects, investment in public goods, and small and medium enterprises.

Official support for innovation

Of all the new activities that are under active consideration in the region, renewable energy is the sector that has the greatest potential for accelerating Caribbean growth. With a combination of solar, wind, thermal, biogas and hydro power, many Caribbean nations can switch all their power needs to renewable sources, using established, proven technologies for electricity generation, transportation and power. However, no Caribbean country has developed the road map and long-term action plan that would put the country on a path to 100 per cent renewable power.[2] In the absence of a road map that is published by government and endorsed by the population at large, and of an action plan that provides annual checkpoints to measure progress towards the target, the 100 per cent goal will not be achieved.

A second area that is yielding significant growth for the Caribbean is culture. It is a fact of life in our small economies that any activity that rises to a level of national economic significance must of necessity be aimed at an audience beyond the national boundary. Caribbean cultural products do have a global audience, and have had an international following since the earliest days of sound recording. Nowadays Caribbean music is consumed worldwide, Caribbean singers and musicians have achieved legendary status, Trinidad has redefined the street festival and provided the world with a fabulous new musical instrument of fascinating complexity (the steel pan), Caribbean writers are household names in English

[1] The Golden Rule states that over the economic cycle, government will borrow only to invest and not to fund current spending (Wikipedia).

[2] The Central American country of Costa Rica generates almost all (98 per cent) of its electricity from renewable sources, mostly hydro, but also geothermal, biomass, solar and wind (Wikipedia). However, that constitutes only about half the country's total energy needs.

literature, and Caribbean islands offer singular cultural experiences of many varieties. All told, the income earned by Caribbean cultural practitioners annually must surely be considerable and the numbers employed significant.

However, in the national accounts of Caribbean countries, the contribution of culture does not appear. That is because of the way the accounts are prepared. In the tourism sector, the consumer comes to the product, a holiday in the Caribbean; in the cultural sector, the musician travels to their overseas gig, and the writer publishes in London, Toronto or New York. Their earnings may or may not come to the Caribbean, even if that is where they live, but that does not matter because, whether they live in the Caribbean or abroad, their business calls for frequent foreign travel and involves the purchase of computers, equipment and supplies which must be sourced abroad. Even though their lifestyle and quality of life depends mainly on the consumption of foreign goods and services, wherever they reside, if they live in the Caribbean their consumption is included in the GDP, and if they live abroad it is not, because of the way GDP is measured.

The fact that we measure cultural income inappropriately leads government policy astray. Caribbean governments aspire to national policies for the development of cultural industries, with no clear idea of what such policies might consist. Common sense suggests that the way forward is to obtain feedback from successful cultural practitioners as to their future plans and aspirations, and collaborate through regional collaborative mechanisms to facilitate these activities in whatever way seems most effective. Once again, a road map which is widely endorsed and an action plan with annual markers for progress are essential. In the case of the cultural industries, both road map and action plan would need to be regional in scope.

There is much that might be done along similar lines to sharpen the Caribbean's competitive edge in tourism, internationally traded services, agriculture and manufacturing. Examples include seed funding for eco- and heritage tourism, providing design and customer orientation services for international companies, and promoting Caribbean branding of quality rums and value-added products. What is required of our governments is to take the lead from successful private entrepreneurs, large and small, and to offer the support these pioneers need, conditional on the achievement of performance targets.

Public services

There is a consensus in Caribbean societies that services such as law and order, primary education, health and sanitation should be available to all, regardless of income, physical ability or mental acuity. Exactly where the boundary of public services lies varies from country to country, and both the outer bound and the quality of services provided depend on average incomes, the efficiency of the public service, and the social consensus on the balance of the burden of taxation and the quantity and quality of public services provided.

The public services that matter for competitiveness and growth include roads, ports, airports, waste management systems, public utilities, transport and communications. The two most widely cited reports on international competitiveness are the World Bank's *Doing Business Report* and the World Economic Forum's *Global Competitiveness Report.* The World Bank assesses the Government's administrative ability in processes affecting the establishment and operations of businesses, including trade and taxation. All Caribbean countries score badly in the World Bank's assessment. The more comprehensive assessment by the World Economic Forum includes analysis of roads, ports, air transport, electricity supply, and overall infrastructure; legal and judicial systems and processes; health and education; labour and goods market efficiency; financial market development; business sophistication; innovation and technological readiness. In addition there are criteria of market size, where the Caribbean is at a permanent disadvantage, and the macroeconomic environment, which has been deteriorating across the Caribbean.

There is a general lack of appreciation in Caribbean leadership about the nature of this problem. The deterioration in all the areas listed in the previous paragraph is widespread and obvious. Throughout the Caribbean, citizens are confronted with examples of government ineffectiveness and inefficiency on a daily basis as they go about their business. Our governments have been promising improvements in public sector performance for two decades or more, but services continue to deteriorate. It should by now be clear that the policies that have been tried to date are ineffective. They consist of changes in legislation, adding additional staff and purchasing computers and software. However, there has been no change in how government is organised, and incentive and compensation systems for public servants have fallen far below comparable levels in the private sector, as well as international and government agencies abroad from whom the Caribbean might hope to attract senior officers. The change that is required must be thorough-going, involving entirely new organisational processes, replacement of the senior personnel in the public sector, a drastic reduction in numbers, and entirely new compensation systems adequate to attract an international level of skill.

Small and medium enterprises

Small and medium enterprises (SMEs) provide a significant proportion of jobs in most market economies, and they act as an essential lubricant for the labour force, easing transitions due to new technology or changing market forces. When companies fold, some employees go into business for themselves; small security firms provide employment for many retirees who need to supplement their pensions; and restaurants and the gig economy offer entry level and part-time jobs for people who need flexibility or a toehold on the job market. These are a few examples of the ways in which the SME acts as a catalyst for labour force adaptation to change.

Despite their importance, SMEs are ephemeral creatures, with a short average life span and a high failure rate. Even small family enterprises of long standing seldom survive the death of the founder. In order to ensure the vibrancy of the SME sector, given its important role, government needs to offer significant support, often including finance and guarantees. Experience suggests that this is best done via independent non-governmental organisations.

Growth-promoting strategies for Caribbean governments

The most important growth-inducing strategy needed of Caribbean governments is the modernisation of the public service to achieve internationally accepted levels of efficiency. The performance benchmarks should be small economies that are in the highest category of development in the annual *Human Development Report*, countries such as Ireland, Iceland, Singapore, Luxembourg, Malta and Cyprus. The failure of repeated attempts to reform the public sectors to date teaches us that Caribbean governments, and the international institutions they have hitherto depended on, lack the knowledge, experience and capacity to guide the Caribbean public sector towards successful implementation of the change that is needed. Caribbean governments must seek relevant expertise from the world's leading international consultants, choosing those who have experience with small countries with very high human development, such as those just mentioned. The extent of reform required will necessitate a medium term action plan for implementation, with performance criteria related to the elements of the *Doing Business Report* and the *Global Competitiveness Report.*

The reform will result in a much smaller number of employees in the public sector. Public servants will be more highly skilled and better paid, particularly in the higher levels of expertise. At the top of the public service there should be a handful of officers of international standing, whose remuneration must be adequate to recruit the calibre of person needed to build and maintain the credibility of the new, efficient public service. The process of converting our currently under-resourced, ineffective and largely demoralized public service into one that compares favourably with Ireland, Iceland and Singapore will need to be carefully prepared for, managed and financed, to ensure that livelihoods are not destroyed in the process.

Policies for stabilization in the small open economy

Variation in the exchange rate is the principal source of inflation and price volatility in small open economies. Countries with a small land area as well as a small population and/or GDP will need to import fuels, food, raw materials, machinery and equipment and consumer durables – in effect, the entire range of modern consumption items, apart from the limited range of tradables from which they derive their foreign earnings. Countries with large land area and small population and/or GDP are no different. They may be endowed with an excess of fuels and raw materials, but prices are largely at the mercy of the exchange rate nonetheless. The reason is that the international prices of fuels and other commodities are set in US dollars, so these countries' exchange rates tend to vary with commodity prices. Domestic prices vary with the exchange rate as with other small economies, but the impact is positive for any increase in the price of the commodity which the country exports.

It follows that the focus for inflation control and price stability in small open economies has to be on the exchange rate. The foreign exchange market, like any other market, clears when sellers and buyers exchange the quantity they offer or need, at a price which is acceptable to both parties. The orthodox approach seeks to achieve this equilibrium by means of price – i.e. exchange rate – adjustment. In the next section of this chapter we explain why this option is not available to policy makers in the small open economy. It is generally believed that the foreign exchange market cannot be brought into equilibrium through policies to affect the quantity of foreign exchange. This is true of the supply, in the short run; in the longer term, the supply of foreign exchange may be increased through enhancing competitiveness, attracting investment and adding productive capacity in the tradable sectors, but in the immediate circumstances it is usually impossible to increase the supply. Furthermore, an increase in domestic interest rates is unlikely to attract financial inflows in circumstances where there is a perceived inadequacy of supply in the foreign currency market.

It is possible, however, to equilibrate the foreign exchange market by reducing the demand for foreign currency to the amount of the available supply, using fiscal policy. That is achieved by fiscal contraction sufficient to reduce aggregate demand and imports by enough to bring the market into balance. Because the response to fiscal measures is not instantaneous, monetary policy may be used as a stop-gap, to buy time for the fiscal measures to take full effect. A framework for the design of institutional arrangements to facilitate the joint policy action which this requires is described in Worrell (2000), and the Barbados experience with this framework is described in Worrell et al. (2003) and in the chapter previously referred to in this volume.

Barbados has had qualified success with the use of this approach to maintaining an exchange rate peg since 1975. The foreign exchange market has been kept stable during this period, except for three episodes, the most recent of which remains unresolved. In every case the pressure on the exchange rate was the result of politically motivated surges in Government expenditure, in the context of a forthcoming general election. Having successfully gained a new five-year mandate in 1981, with the help of a surge in government spending, the Tom Adams administration applied the fiscal brakes in 1982, and boosted foreign reserves with the help of an IMF loan (Worrell, 1987: 87-88). The balance of foreign currency inflows and outflows was secured, and confidence in the peg was maintained.

The second occasion on which an unsustainable rise in public spending in advance of an election caused pressure on the foreign exchange market and a loss of foreign reserves was in 1991. On this occasion capital flight and a perilously low level of foreign reserves meant that a sharp cut in public expenditure was called for. The Erskine Sandiford administration rose to the challenge, and balance was returned to the external accounts by the mid-1990s. The foreign exchange market remained stable, and the peg secure, until the Global Financial Crisis of 2008 brought with it a decline in foreign investment in Barbados, with the collapse of the UK demand for second homes in Barbados. On this occasion, corrective fiscal policies were relaxed with the untimely death of Prime Minister Thompson, resulting in a prolonged period of foreign exchange uncertainty. As of this writing, the exchange rate peg remains under threat; foreign reserves have been boosted with the help of finance from the IMF and other international financial institutions, but foreign investment inflows remain below expectations.

The Barbados experiment may be considered a qualified success. Policy makers have an effective framework for stabilizing the balance of payments, maintaining confidence in the exchange rate peg, and thereby assuring low and stable inflation. However, the Barbados experience demonstrates that fiscal dominance is a fact of life in a liberal democracy: Government has the tools to manage aggregate demand, but the temptation to prime the pump in advance of an election always proves irresistible, whenever the current administration is apprehensive about its prospects in the election.

Orthodox policies are largely ineffective in the small open economy

Although it is now widely accepted that size matters in many areas of social, economic and environmental policy (Briguglio, 2018), the orthodoxy maintains that the standard suite of macroeconomic policies designed for the world's largest economies is appropriate for the management of small open economies. This is despite the wealth of evidence to the contrary. Their dissatisfaction with the consequences of IMF orthodoxy during the 1990s crisis have led Asian countries to shy away from the Fund ever since, and to develop a regional financial support mechanism in the form of the Chiang Mai Initiative (Berglof, 2018). In addition, despite exhortations from orthodox thinkers to float their domestic currency, most small countries in Europe, Africa, Latin America and Asia have chosen to continue to manage their exchange rates in some way.

A credible inflation targetting regime with an operationally independent and accountable central bank at the core is first on Carney's list of policies to "keep one's own house in order" (Carney, 2019: 6). My own view is that this is questionable policy in any country. The effectiveness of official policy depends on its credibility in the eyes of economic agents; if monetary and fiscal policies are not coordinated, markets are confused, and the outcomes are unpredictable. Whatever its merits in large industrial countries, monetary independence is impossible in the small open economy, where the main source of additions to the money supply is balance of payments surpluses. The only domestic source of additional money is central bank lending to the public sector. This is never sustainable, because it drains foreign reserves and ultimately leaves the central bank with too small a war chest to manage the exchange rate.

In the small open economy the central bank's policy tools are of limited efficacy, whatever the stage of development of the financial market. In fully developed financial markets, open market operations may affect the inflow and outflow of finance, but in perverse ways. Much depends on the credibility of fiscal policy. If fiscal policy is credible and the central bank engineers a fall in interest rates to encourage more lending, there may be an outflow of finance instead, because domestic rates will have become uncompetitive with foreign rates, after taking account of the country premium. If the aim is to curb excessive spending or a credit boom, the perverse result may be an influx of new money, attracted by an interest rate that is now more attractive than the competition.

In the absence of credible fiscal policy, monetary policy loses all effectiveness. In these circumstances monetary tightening is called for, but even large increases in interest rates will fail to impact domestic credit and spending. The money supply will invariably tighten significantly, as a result of capital flight triggered by apprehension about the consequences of the fiscal policy, whatever the central bank's monetary stance.

The tools available to monetary authorities in underdeveloped financial markets have all proved to be distortionary or without effect. Credit limits, cash reserve requirements, directed lending, foreign currency rationing have all been tried, in many countries and circumstances. Where they have had an impact, it has been to aggravate economic contraction and price instability.

The second orthodox policy recommendation is for flexible exchange rates. Even the IMF now acknowledges that small open economies are obliged to manage their exchange rates, however. For small open economies where there is a high pass-through of devaluation to domestic inflation, an IMF policy paper published in 2012 recommends a dual targetting arrangement, where monetary policy would be used to target inflation, and the central bank would buy and sell foreign exchange to stabilise the exchange rate, taking measures to ensure those sales do not affect the domestic money supply (Ostry, Ghosh and Chamon, 2012).

As with all orthodox approaches to exchange rate management, there is a failure to acknowledge the extent to which the supply of foreign exchange depends on the credibility of fiscal policy. If there arises doubt about fiscal sustainability, capital flight drains the foreign currency market of adequate supplies, and the central bank will have inadequate resources with which to intervene to manage the exchange rate. In these circumstances, even large increases in the interest rate will not stem the outflow. That is why the only feasible option for managing the exchange rate is by forward-looking fiscal policy, designed to maintain a store of foreign reserves adequate to defend the exchange rate, even under pessimistic expectations.

The burden of the argument in this chapter is that, for the small open economy, it all boils down to the third element in the orthodox policy suite, fiscal sustainability.[3] For the small open economy, fiscal sustainability is defined most realistically by the impact on the balance of external payments. A trajectory of fiscal deficits becomes unsustainable when the central bank's foreign reserves fall below a level which gives the foreign exchange market confidence in the authorities' ability to manage the exchange rate (Worrell et al., 2015). With suitable forecasting and monitoring tools, close collaboration between the monetary and fiscal authorities, and the political will, exchange and price stability can be achieved. If, in addition, government provides finance and incentives to strengthen the country's international competitiveness, it will have completed a practical framework for effective policy for growth and economic stability, whatever the vagaries of the international economic environment.

[3] The orthodox policy suite also includes "an effective macroprudential toolkit", by which is meant measures to tighten credit restrictions during periods of rapid credit growth. However, macroprudential policies are unproven and face an insurmountable practical difficulty: how fast must credit expansion be to be considered "rapid", how firmly should brakes be applied if growth is "too rapid", and which tools are effective in curbing credit without severely distorting financial markets?

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