

**SIZE IN THE CONTEXT OF THE FREE TRADE
AREA OF THE AMERICAS**

by

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March 1996

Size in the Context of the Free Trade Area of the Americas

So far as I can tell the discussions about the FTAA neglect several vital consequences of small size as they affect the Caribbean. They are as follows:

1. Size has implications for trade policy. Small countries cannot significantly alter their trade dependency via trade policy. The fundamental openness of small economies is demonstrated by all available (Briguglio, 1995; OAS, 1995) evidence. Trade policy may change the composition of imports (though even that is hard to detect in the Caribbean) but it will have no effect on the ratio of imports to GDP. The corollary is that trade liberalization has no effect on the openness of small economies. The removal of non-tariff barriers and the lowering of tariffs may lead to substitution of final goods imports for imported raw materials and it may bring underground imports into the official record. However, it cannot affect the fundamental unchanging outward orientation of the economy. In contrast, for large economies, trade liberalization may reorient the economy towards international markets. There are gains in efficiency to the extent that firms producing for the competitive international market must be more

productive than firms producing for the domestic market. This process does not occur in small economies.

2. Because economies of scale are universal in production, trade and transactions, small economies must specialise in a narrow range of exportables. This well-known circumstance is widely documented (Lloyd & Sundram, 1982). It is at best disingenuous to imply that an offer of free trade access over a wide range of products in which small Caribbean countries have no demonstrated comparative advantage is a contribution to the Caribbean's development potential. The list of actual and potential Caribbean exports of goods and services is short: tourism, oil and petroleum products, bauxite/alumina and aluminium, sugar, bananas, information services, music, processed foods and beverages and clothing and footwear. Few items on this list are subject to tariff. Free trade agreements therefore improve access only where they eliminate non-tariff barriers.
3. Large size is a distinct advantage in developing new export markets. Entering competitive international markets is an extremely costly and high risk business. Returns may be delayed and learning costs may have to be

written off. Large firms may have the resources to take the long view. Moreover, because of uncertainty firms may underinvest in export market development. The central ingredient of the successful export strategies of Japan, South Korea, Taiwan, Singapore and Malaysia was consistent large-scale Government technical assistance and financial support. That was complemented by joint ventures between local producers and international marketers. In both large and small countries governments find it necessary to subsidize the cost of export market development. This requirement is vital in small countries because of high risk, uncertainty, long gestation periods and external economies of learning by doing.

4. The fair trading provisions of trade agreements are of little benefit to small economies. The administrative and human resource cost of activating dispute settlement mechanisms are so high as to be prohibitive for small economies. Small countries have no meaningful sanction against perceived inequitable treatment by large countries. For example, countervailing tariffs have no effect on the volume of imports; they merely increase prices to domestic consumers. The knowledge or suspicion that a challenge

- may be mounted is often enough to dissuade small country attempts at new market development even where a potential competitive advantage exists.
5. Small countries with large wealthy neighbours are drawn into the area of that neighbour's currency. In much the same way that Holland, Denmark and Austria are part of the Deutschemark currency area the Caribbean is part of the US Dollar area. This immediately constrains domestic monetary policy and inflation performance, irrespective of any formal trade arrangements. Small countries in a currency area may secure credibility for domestic policy by anchoring the exchange rate at a fixed value in terms of the dominant currency. Small countries begin to see real benefit when they go beyond free trade to negotiate agreements to borrow among central banks sufficient to deter speculative attack on the currency. Japan has negotiated a series of such agreements with countries in South East Asia. The Caribbean might seek to negotiate similar facilities with the US Federal Reserve. Because Caribbean countries are so small there would be no measurable additional risk to the Fed. Currency stabilization yields an immediate gain in terms of fixed productive investment.
 6. Different exchange rate strategies are recommended for large and small countries in an effective currency area, whether that area is formally constituted or not. For the small country the exchange rate should be fixed to that of the dominant neighbour. Exchange rate flexibility does not serve to insulate the domestic economy because of the high import content of production and factor services, infinite elasticities of export demand and import supply and the imperviousness of the trade structure to changes in relative prices. Instead, a flexible exchange rate encourages inflationary expectations. Producers do not bargain hard to contain wage increases because they can more than compensate by devaluation and inflation. Government may be tempted to fiscal excess because it can impose the inflation tax. Real interest rates must be maintained at high levels to discourage exchange rate speculation but high real interest rates signal continuing inflation. Producers will inflate domestic prices and seek more local currency for each unit of foreign sales in order to cover excessive finance costs. Although a large country is motivated by similar concerns it faces a trade-off between exchange rate flexibility and economic performance because the economy will respond to changes in relative prices to a significant extent. In Mexico, where the wage good is a domestic

product, it may be possible to improve relative price competitiveness without depressing the living standards of workers. In contrast in the insular Caribbean, where the wage good is imported, devaluation improves relative price competitiveness only when it depresses living standards.

7. Small countries which fall within the economic sphere of large neighbours may find non-resource based industry drawn away from their shores. Because of external economies industry tends to cluster in major established centres away from isolated green field sites (Krugman, 1991). The location of these centres sometimes defies economic logic but the fact that they are already established is an irresistible magnet. Within the US and Canada these polarising tendencies are countered by special incentive regimes offered by state and federal governments. Small countries within the North American economic sphere suffer the adverse effects of polarisation. To the extent that trade liberalization causes a switch from intermediate to final goods imports it aggravates the situation. An already notable consequence of trade liberalization in the Caribbean has been the foreign takeover and closure of domestic manufacturing industry with local requirements being serviced from abroad. As a boost to the development of small economies

in the Caribbean trade liberalization is not enough. These countries do not begin to see a benefit unless and until there is a major financial contribution by the US and Canada to the establishment of major producing centres in the Caribbean for non-resource based activities where there seems to be a potential comparative advantage.

Summary

The point is not that small size limits a country's potential for sustained growth but that the structure of small economies means that different policies are needed and the outcome of the same measure is very different than in large countries. In particular, with respect to the Free Trade Area of the Americas:

- (i) trade liberalization is not a growth promoting policy; at best, it makes no difference;
- (ii) a fixed exchange rate is highly recommended for small countries. It reduces uncertainty, increases policy credibility and promotes investment and growth. In contrast to trade liberalization,

arrangements to lock in the exchange rate are decidedly growth promoting;

- (iii) to ensure that small countries have equal access to international markets it is not enough to lay down trading rules and establish dispute settlement procedures. Direct financing and skills transfers are necessary to overcome learning costs, information costs and other market development costs.

The lack of enthusiasm for the FTAA by small Caribbean countries - both Governments and the business sector - is not surprising. They face exactly the same challenges as before the trade liberalization. Neither item that might make a significant contribution to their ability to meet these challenges (financial transfers for market research and development or currency stabilization funds) is being contemplated in the negotiations.

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March 7, 1996