Policies for Stabilisation and Growth in Small Very Open Economies

DeLisle Worrell
Central Bank of Barbados
September 2012

Synopsis

SVOEs face a “hard” FX constraint

- They cannot grow the economy by increasing the relative price of tradables;
- The monetary/fiscal/ER policy mix is biased towards an ER anchor;
- Growth is sustainable only when led by the tradable sector.

Openness is structural

Exports are concentrated

- Small size limits the number of products and services in which the SVOE can attain internationally competitive levels of efficiency:
  - Economies of scale are universal, in information, communication and technical change;
  - A handful of activities therefore absorbs the entire skills resource of the SVOE.

There is a mismatch between the export and import baskets

- In contrast to exports, imports range across the spectrum of consumer, intermediate and capital goods;
- To a useful approximation, all exportables are exported, because the domestic economy’s demand is so small in relation to the production volumes needed to attain an internationally competitive scale of production.

The foreign exchange constraint is built into the structure of the SVOE

- There is no possibility of import substitution, because there is so little intersection between what is imported and what can be produced locally at internationally competitive prices;
- Expenditure cannot be switched from tradables to nontradables: a real exchange rate depreciation depresses real income instead.

The capital and financial a/c of a SVOE cannot be closed

- Financial transfers are routinely effected outside of the financial system, via:
  - Central treasury management by international conglomerates;
  - Offsetting transactions and payments within international firms and groups;
  - Strategic pricing by international firms;
  - Substitution of local financing for international trade credit

Channels of financial flow, cont’d

- Exchange of goods and services in kind;
- Informal transfers; and
- Currency substitution.

Openness is structural and the FX constraint is “hard”

- The economy is an engine driven by foreign exchange: it can grow only when FX is increasing;
- Devaluation will not increase the supply of FX, and will reduce the demand only through loss of real income;
- Therefore, there is no tool that will relieve the FX constraint within the time frame relevant for stabilisation policy.

Implications of FX constraint in SVOE

- For the monetary/fiscal/exchange rate policy mix:
  - To be credible, policies must be anchored on a stable exchange rate
- For sustainable growth strategies:
  - To be sustainable, growth must be led by the foreign exchange sectors, which, as previously mentioned, are few and specialised.

Using fiscal policy to anchor the exchange rate

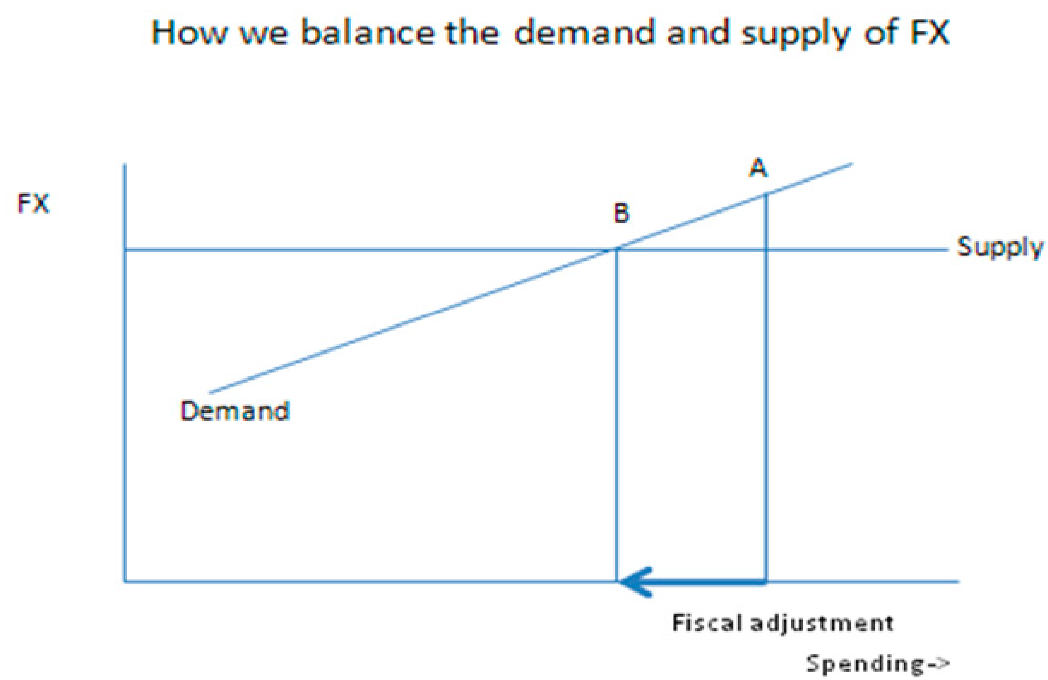
An exchange rate anchor is the easiest framework to work with

- ER is a highly visible indicator;
- ER stability is an important investment incentive;
- A track record of stable exchange rate management lends credibility to official policy;
- ER stability minimises the domestic impact of imported inflation.

Equilibrating the FX market

- The FX market is insensitive to changes in the exchange rate (unless the change is so large as to depress real income);
- Because of the openness of the capital and financial markets, cross border financing imposes interest rate parity;
- We have a Hicksian “fixed price” market, where quantities adjust to achieve equilibrium.

Managing FX demand via fiscal policy



A: FC demand is too high

B : FC demand reduced in line with supply

The alternative frameworks are inferior

- They also equilibrate the FX market by depressing demand;
- However, demand contraction is achieved through the inflation that results from ER depreciation;
- In essence, the economy reaches the same (or worse) point of equilibrium, but with higher inflation.

There is nothing to be gained from ER flexibility, and much to lose

- Aggregate demand has to be reduced by the same amount, whether we use fiscal policy alone, or a combination of fiscal, monetary and exchange rate adjustment;
- Gov't loses its reputation for being willing to take tough fiscal decisions;
- ER volatility is a well known investment depressant.

Competitiveness and growth

Growth is limited by tradables

- Potential sustainable growth depends on the growth of surpluses of FX generated in the tradable sectors;
- The key driver of growth: investment to increase capacity in the tradable sector;
- Investment and growth of the tradable sector of SVOEs is driven by non-price factors and structural changes, not by relative (foreign/domestic) prices.

Competitiveness for SVOEs is *not* about relative prices

- Sources of the country's comparative advantage are country specific;
- They depend on the production structure and composition of the foreign exchange sector;
- Affected by changing tastes and technology.
- Relative prices may be determined by these factors.

Growth strategies for SVOEs

- Sustainable growth hinges on investment in the foreign exchange sectors in which the country specialises;
- Competitiveness is about raising productivity to achieve the exportable threshold, in the country’s FX specialisations.

Factors which help firms to cross the threshold into international competitiveness

- Human capital;
- R&D intensity;
- Performance based salaries;
- Reduced role of family members in management;
- Affiliation to a foreign group
  - Altomonte, Carlo, Tommaso Aquilante and Gianmarco Ottaviano, "Triggering competitiveness: a decalogue from new firm level evidence," *voxEU.org, Aug 23, 2012.*

Small states have a more limited menu of policy choice and more limited options for growth strategy

SVOEs are harder hit, and there is less they can do about it

- Openness leaves them highly vulnerable, especially to international price shocks;
- Building resilience comes at a cost;
- There is only one tool available, the fiscal;
- Using the fiscal tool to counter an external shock to income reduces FXRs;
- Absorbing the shock implies income contraction, but it protects the FXRs, anchors the ER and avoids inflation.

Sustainable growth is FX-led

- Investment in sectors that earn or save FX is key to sustainability;
- SVOEs can attain international competitiveness in only a small number of specialisations;
- In Caribbean, short term growth is out of our hands, but current investment in FX sectors can raise productivity and spur growth in medium term.

Thank you