The small *economies of* Latin America *and the Caribbean*

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Population, natural resources and domestic market size have been the traditional components of the equation determining the wealth of nations, according to classical economists. The new lines of research opened up by endogenous growth theories and the results of comparative statistical studies into the factors determining this growth have reawakened interest in the relationships between scale effects, market size and the role of international trade in the economic growth of small economies. At a time of ever-increasing globalization, these economies are being confronted with a number of challenges and opportunities in relation to which their small economic size is generally regarded as a disadvantage. Diseconomies of scale increase their production costs, while their relatively undiversified exports mean they are extremely vulnerable to shocks of external origin. All these factors weigh all the more heavily in that trade has become one of the key factors in economic development, as is demonstrated by the sharp increase in imports and exports as a share of GDP since the second half of the 1980s. The central role played by intraregional trade or the North American market as non-traditional export engines is heightening the importance of price competitiveness, and thus of subsidy or tax exemption programmes to ensure an outlet to these markets. For those small developing countries in the region that suffer relative disadvantages, success would therefore seem to depend on the preferential terms under which they do business with their main developed-world trading partners, namely North America and, for members of the ACP group (the developing countries of Africa, the Caribbean and the Pacific), the European Union. Again, excessive specialization to serve a large regional market (Brazil or the United States) entails risks that merit consideration.

I

Main economic characteristics

There is no universally accepted definition of a small economy. Theoretical analyses often go by whether or not a country is able to influence international pricing. A similar classification, but one which is more useful from the economics point of view, identifies small economies as ones that lack the freedom to take economic policy decisions and have to adjust to the environment created by the economic policies of the major economies. This is the definition used by De Sierra (coord., 1994), in particular. Definitions of this kind are unhelpful in empirical research, however, as they are difficult to observe and measure. For practical reasons, the size of an economy is usually measured by its population, land area or domestic revenue (Damijan, 1997). Gutiérrez (1996) remarks that in Latin America there is a strong correlation among the different indicators that are generally used in the literature on the subject and that a classification by population provides a simple but clearly acceptable way of ranking the region's economies.

If small economies are defined by population (10 million inhabitants or less at the beginning of the 1990s),[1] most of the Latin American economies are small: all those of the Caribbean except Cuba, those of the Central American isthmus, Bolivia, Ecuador, Paraguay and Uruguay. Many Caribbean islands are very small indeed, containing less than a million inhabitants (and in some cases fewer than 100,000), which heightens their specificity and makes them particularly vulnerable (table 1). Nonetheless, they are all very different in terms of natural resources, per capita income, culture and society, which means that the general conclusions formulated later on need to be kept in perspective if excessive reductionism is to be avoided.

1. Growth and competitiveness

The recent literature on economies of scale and endogenous growth in open economies tends to regard a small domestic market as a disadvantage, at least in the early stages of development. The freedom of access to external markets that globalization can provide should in principle help such economies to make up for this constraint. Nonetheless, there is no consensus about the results of trade liberalization and free trade when the trading partners are very unevenly matched in terms of size and development level. Both theory and practice tend to suggest that some countries move on to a slow track and specialize in declining markets, while others take advantage of external markets to develop a dynamic specialization (Ros, 2000).

Among developing countries, "large economies" have per capita income levels considerably higher than those of "small economies"; by contrast, "very small economies" have average per capita incomes comparable to those of the largest economies. The same relationships hold true when growth rates are examined. Seemingly, small economies (but not very small ones) suffer from certain comparative disadvantages (Salvatore, 1997). According to this author, those disadvantages are associated with development level and are generally not found when developed economies are analysed. These results are found to apply, albeit in an attenuated form, in Latin America and the Caribbean. Over the last 20 years, the smallest economies (less than a million inhabitants in 1990) have had a per capita income growth rate at least comparable to, if not higher than, medium-sized or large countries (over 10 million inhabitants). Small economies (between one and 10 million inhabitants) have generally grown more slowly than the other two groups.

Indeed, over a long period, only the very small economies have seen a significant rise in per capita output, while in the medium-sized and large ones the recovery in growth that occurred in the 1990s was barely enough to offset the losses suffered 10 years before as a result of the borrowing policies of the 1970s and the

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[1] This is a very relative criterion. Twenty years earlier, the limit would have been 6.1 million for a similar group of Latin American countries (Real de Azúa, 1997); today it is 13 million, and Cuba would now be considered a small economy (table 1).

TABLE 1

Latin America and the Caribbean: Selected demographic and economic indicators

	Population (thousands of inhabitants)	Average annual population growth rate	Population density (inhabitants/km^2)	Per capita GDP (dollars, at purchasing power parity)	Average annual GDP growth rate		External trade (% of GDP)
Period or year	2000	1991-2000	2000	1998	1981	1991	2000
Latin America and the Caribbean (total)[a]	519 752	1.7	25.0	6 340	1.2	3.3	43.4
Countries (by population)							
Saint Kitts and Nevis	41	–0.3	113.4	9 790	5.8	4.1	128.5[b]
Antigua and Barbuda	68	0.6	152.0	8 890	6.1	3.3	157.7[b]
Dominica	71	0.0	97.3	4 777	4.4	2.1	115.7[b]
Grenada	94	0.3	282.9	5 557	4.9	3.5	99.3[b]
Saint Vincent and the Grenadines	116	0.9	290.3	4 484	6.5	3.2	121.5[b]
Saint Lucia	154	1.3	249.2	4 897	6.8	2.2	133.1[b]
Belize	241	2.6	10.5	4 367	4.5	4.1	101.9[b]
Barbados	270	0.5	617.7	...	1.1	1.4	130.4[b]
Suriname	417	0.4	2.6	...	0.5	1.7	...
Guyana	861	1.0	4.3	3 139	–2.9	5.3	203.3[b]
Trinidad and Tobago	1 295	0.7	250.5	7 208	–2.6	3.0	97.7[b]
Jamaica	2 583	0.9	237.9	3 344	2.2	0.1	111.7[b]
Panama	2 856	1.8	37.1	4 925	1.4	4.4	146.8[b]
Uruguay	3 337	0.7	18.8	8 541	0.0	3.0	38.0
Costa Rica	4 023	2.8	69.1	5 812	2.2	5.0	94.6
Nicaragua	5 071	2.9	39.5	1 896	–1.5	3.3	117.8
Paraguay	5 496	2.7	13.1	4 312	3.0	2.2	81.2
El Salvador	6 276	2.1	292.4	4 008	–0.4	4.6	66.3
Honduras	6 485	2.9	55.0	2 338	2.4	3.1	101.5
Bolivia	8 329	2.4	7.3	2 205	0.2	3.8	41.8
Haiti	8 357	1.9	277.5	1 379	–0.5	–1.0	47.0
Dominican Republic	8 396	1.8	170.6	4 337	2.4	6.3	100.9
Cuba	11 199	0.5	101.1	...	3.7	–1.4	...
Guatemala	11 385	2.7	99.6	3 474	0.9	4.1	47.6
Ecuador	12 646	2.1	44.0	3 003	1.7	1.7	77.3
Chile	15 211	1.5	19.8	8 507	3.0	6.6	60.8
Venezuela	24 170	2.2	26.3	5 706	–0.7	2.0	51.1
Peru	25 662	1.8	19.4	4 180	–1.2	4.2	33.2
Argentina	37 032	1.3	13.2	11 728	–0.7	4.2	23.1
Colombia	42 321	1.9	39.3	5 861	3.7	2.6	36.5
Mexico	98 881	1.7	50.2	7 450	1.9	3.5	65.0
Brazil	170 693	1.4	19.6	6 460	1.6	2.6	23.1

Source: ECLAC and World Bank.

[a] Includes Aruba, Bahamas, Montserrat, Netherlands Antilles, Puerto Rico and Virgin Islands.
[b] Visible trade only, 1998.

economic crisis that followed (table 2). In the group of 14 small countries, average per capita income was lower in 2000 than in 1980, so that for them the famous "lost decade" would seem to have lasted 20 years. This indicator fell in eight countries of the group in the period 1981-2000, the worst affected being Haiti and Nicaragua (2.6% and 1.7% average annual falls in per capita GDP, respectively). The size factor is just one of many that can influence growth rates, so the workings of other possible causes need to be ascertained if the specific contribution made by a country's size is to be isolated. To this end, an equation has been developed to bring in the various other factors identified by Escaith and Morley (2000) for a panel of 17 countries in the region during the period 1971-1996, excluding the smallest economies. Although the authors' caveats

TABLE 2

Latin America and the Caribbean: Economic size and income, 1981-2000

Countries	Per capita GDP, 1990[a]	Average annual per capita GDP growth rate		
		1981-1990	1991-2000	1981-2000
Total [b]	...	*–0.9*	*1.5*	*0.3*
Of Latin America[b]	...	–0.9	1.5	0.3
Of the Caribbean[b]	...	–0.9	1.0	0.0
With over 10 million inhabitants[c]	7 029	–0.5	1.5	0.5
With 1 to 10 million inhabitants[c]	4 056	–1.2	1.1	–0.1
With less than 1 million inhabitants[c]	6 655	3.1	2.4	2.7

Source: Table 1.

[a] Dollars at purchasing power parity.
[b] Average weighted by GDP.
[c] Simple average.

TABLE 3

Latin America and the Caribbean: Empirical evaluation of growth determinants

Variable	Ratio	t-Stat.
Constant	3.237	0.96
Average population in 1971-1975 (logarithm)	0.261	2.02
Rural population as proportion of total, average 1971-1975	–0.033	–2.50
Per capita income at beginning of each five year subperiod	–0.001	–7.71
Investment ratio (in relation to GDP)	0.060	1.94
Change in developing country exports to OECD	0.175	8.51
Contribution of primary sectors to GDP	–0.125	–4.16
Change in export ratio (in relation to GDP)	0.127	2.46
Currency reserves as share of M2	0.007	1.72
Budget balance (in relation to GDP)	0.154	2.97
Fluctuations in real exchange rate	–0.097	–4.55
Change in proportion of credit going to private sector	0.037	2.83
Average structural reform index value at beginning of each subperiod	0.084	0.93
Square of this average index value at beginning of each subperiod	–0.001	–1.19
Change in average reform index during each subperiod	–0.097	–2.88

Source: Author's calculations. Origin and description of data: Escaith and Morley (2000).

[a] Annual change in per capita GDP.
[b] Generalized least squares method, weighted and corrected for heteroscedasticity. R-2: 0.83, using 85 observations (17 countries, five subperiods of five years between 1971 and 1996).

regarding the limitations of this type of analysis have to be taken into account, the results (table 3) tend to show that, other things being equal,[2] large countries had higher per capita output growth rates.

The deviations seen in relation to the predictions of neoclassical theory, which are size-neutral, are due primarily to microeconomic considerations. When a domestic market is small, there are certain economies of scale and complementarities that cannot be achieved, which means higher relative costs and lower competitiveness. These costs, which affect both the public and private sectors, take various forms that can be summed up as below.

[2] Among the factors, international trade developments and the stability of the domestic macroeconomic framework are the most crucial. Structural reforms have not had a significant global effect, but the lack of progressiveness in their application has clearly had a negative impact.

a) *Indivisibility, public goods and infrastructure*

Most public services are characterized by indivisibility, which means that for small countries their per capita cost is generally high. Furthermore, as will be seen further on, incomplete or deficient markets often force the State to play an important role in the economy. Furthermore, current public spending as a share of GDP, and the taxation ratio, tend to fall with the size of economies. The need to keep State spending under control also means that the coverage and quality of these services are often less than ideal.

b) *Company size and production costs*

Private-sector companies are faced with the same problems, as the small size of the domestic market prevents them from taking advantage of economies of scale. This is particularly true for the non-tradable goods and services sector, whose market is by definition domestic. These disadvantages are less marked in the case of the tradable goods and services sectors, as exports can make up for the small size of the domestic market. Even with access to external markets, however, it is difficult to achieve economies of scale, as even the "large firms" of small countries are small in comparison with their regional competitors and, like many small companies, find it difficult to keep up with the pace of technological progress. Furthermore, they have to incorporate locally produced non-tradable goods and services into their processes at prices that are generally much higher than those paid by their international competitors. In these circumstances, successful participation in regional or international markets must involve a degree of specialization sufficient for critical mass to be achieved. Such specialization tends to be detrimental to complementarity with the rest of the national economy.

c) *Market structure*

The smallness of domestic markets, with all this implies for competitiveness, has important consequences for the way they are organized. There are fewer viable firms in sectors exposed to external competition, owing to the high unit costs of production. In protected sectors, a monopolistic structure tends to prevail more or less unchallenged, as the initial costs of breaking into these small markets are high in comparison with the revenue that can be expected.

This monopolistic tendency of domestic markets requires public-sector intervention –be it spontaneous or forced from without by multilateral trade agreements– to correct market failures and regulate competition. Financial constraints and a lack of specialists, however, generally mean that the local public authority is unable to deal with the complex legal and technical implications of this type of regulation. The consequences in terms of lower market efficiency then create a suboptimal situation from the economic point of view.

Both the small size of the labour market and the relative lack of diversification in production activities entail substantial friction and adjustment costs. During growth periods, companies find it hard to take on the skilled labour they need. At times of recession, on the other hand, employment options are few because activities are not very diversified. The unemployment to which this gives rise is difficult to reverse, and shocks tend to be perpetuated.[3] This last aspect is particularly important if we consider the social costs of any production restructuring that would be required if an economy of this type opened up to free trade.

d) *Governance*

Small markets, on the other hand, offer advantages associated with the diseconomies of scale that characterize transaction and supervision costs. In a situation where information about trading partners (customers, suppliers) is readily available, the costs associated with information asymmetries and moral hazard diminish. Reputation, and pressure from society to follow recognized ethical standards, are a partial substitute for the creation of a formal system of regulation and oversight. The small size of the population is also a factor for greater social cohesion and greater citizen participation in the management of public affairs.[4] These advantages will only bear fruit, however, if the minimum conditions for governance are met, something that is far from being the case in the region.[5]

[3] Small economies are also characterized by large-scale labour emigration.

[4] Aristotle saw this cohesion as a source of strength for the State, an idea that was followed up on many occasions by eighteenth century writers (Real de Azúa, 1977).

[5] As is borne out by the civil wars that have ravaged Central America, the ethnic and religious conflicts of the Caribbean and the fractures that have opened up in Ecuadorian society.

2. Vulnerability

Over and above differences in growth or development levels, small economies as a group are intrinsically more vulnerable to external shocks than larger ones. In fact, vulnerability is one of the main issues for analyses of the relationships between economic size and welfare in open economies, to such an extent that many small countries have tried –unsuccessfully so far– to introduce this concept as an alternative differentiation criterion in the entitlement clause extending reserved treatment to the least advanced countries in WTO agreements. Three interdependent factors need to be distinguished: geography, demographics and economics.

In combination, the geographical and demographic factors translate into higher population densities that increase pressure on natural resources, threatening fragile ecosystems. Haiti is the most extreme example, but ecological vulnerability is to be found in many of the region's small economies, whose location in tropical regions prone to natural disasters (hurricanes, seismic or volcanic phenomena) compounds the problem yet further. These natural disasters are recurrent and each episode affects a large percentage of the population, or in some cases the whole of the country's territory. In certain Caribbean islands, the damage inflicted on infrastructure and productive activity may exceed GDP. In such situations, the resources available to the national authorities for coping with the emergency and meeting reconstruction costs are woefully inadequate.

As regards the specific issue of social vulnerability, particular attention needs to be paid to the small island developing States of the Caribbean, which are sometimes used as transit or money laundering points by international drug traffickers. Domestic crime linked to the trading and consumption of drugs undermines legal and financial systems and ultimately corrupts all the institutions involved in governance. The social fragility of these islands, and the effects this has on governance, are accentuated yet further by deep-rooted social and cultural fault lines in societies where income is unevenly distributed and ethnic or religious divides are hard to bridge.

The economic dimension of vulnerability in small economies is closely linked to the relative importance of international trade and the lack of export diversification. The coefficient of international trade openness (imports plus exports of goods and services) of the small economies of Latin America and the Caribbean is as much as 85% of GDP, compared with just 30% in the region's other economies (ECLAC, 1996). What is more, these exports are largely confined to a small group of products and markets, which makes foreign currency income from external sales highly volatile. Given that the openness coefficient is so high, and that these small economies are extremely dependent on imports to meet the bulk of their domestic demand, fluctuations in export revenue –which is usually not enough to finance imports even in normal times– have a significant impact on domestic activity and the generation of domestic revenue.

The preferential nature of the access that these countries' export products have to the European and United States markets (Lomé agreements, Caribbean Basin Initiative) also makes them dependent on the continuity of the unilateral preferences agreed on. Yet the very spirit of these preferences is being increasingly challenged by the new rules governing international trade since the end of the Uruguay Round.

Specialization in sensitive items such as agricultural, textile and clothing products makes export markets vulnerable to protectionist reactions by the developed economies. Furthermore, the manufactures exported by the countries of Central America and the Caribbean (from *maquila* industries) have a low capital intensity, which means that subcontracting firms can easily move and are highly sensitive to small changes in comparative production costs.

Nonetheless, this great vulnerability to external trade shocks is compensated for by relative immunity to shocks of a financial nature, which have been the main cause of the latest economic crises in Latin America. Because their financial markets are undeveloped, small economies have not attracted the interest of speculative capital, the scale and volatility of whose flows have given rise to large variations both in relative prices –because of distortions in real exchange rates– and income transfers.

The great trade-related external vulnerability of the region's small economies has led them to adopt macroeconomic policies that are generally more prudent than their neighbours'. Thanks to this relatively conservative approach and to their isolation from speculative capital movements, during the last 20 years the growth rates of the region's small economies have generally fluctuated less than those of larger countries. This result also confirms that the consistency and quality of macroeconomic policy have heavily influenced the long-term growth outcomes seen in the region as a whole over the last 30 years (Escaith and Morley, 2000).

3. Economic policy

Both their size and their external openness give a distinctive character to the economic policies followed by the region's small economies. Rather than being a voluntary choice, this character is due to their having little room for manoeuvre owing to the incompleteness of their domestic markets and an external openness that extends not just to trade, but to the currency markets as well. The small size of local financial markets and the unreliability of domestic saving reinforce the classic "trilemma" of open economies, where the objectives of openness to trade and capital flows, exchange-rate stability and an independent monetary policy cannot all be achieved simultaneously. Under these conditions, it is very difficult for the national authorities, when faced with a recessionary shock, to offset declining domestic demand by expanding domestic financing without running the risk of destabilizing the economy.[6]

Exchange-rate stability is one of the primordial objectives in these small economies that are so open to international trade, and their real exchange rates fluctuate less than those of their larger neighbours. During the period 1989-2000, the standard deviation in exchange-rate indices (normalized to a value of 100 for 1995) was 11 for the small economies, as compared to 21 for the other countries. Most small economies maintained a fixed exchange rate long after the dollar standard agreed on at Bretton Woods came to an end. Costa Rica was the first of the Central American countries to devalue (December 1980), but this was an isolated case, and fixed parities continued to be the rule during the 1980s, although a price was paid for this in the form of multiple exchange rates, non-tariff import restrictions and growing balance-of-payments disequilibria. In the Caribbean, the main economies (the Dominican Republic, Guyana, Haiti, Jamaica and Trinidad and Tobago) also tried to maintain their exchange-rate parities despite alarming domestic and internal disequilibria that finally resulted in hasty devaluations and the application of adjustment programmes.

Nonetheless, the smaller economies of the Caribbean have managed to preserve stable parities (first with the pound, then with the dollar) under normal fixed exchange-rate regimes (Bahamas, Barbados, Belize) or a conversion monetary system administered by the Eastern Caribbean Central Bank, which covers six countries. This strategy has only been possible because of conservative macroeconomic policy and resource transfers, be they direct (development assistance) or through the provisions of preferential trade agreements (specific protocols in the Lomé agreements with the European Union). In South America, for geographical and historical reasons, macroeconomic policy in the small economies during the 1980s was kept close to that followed by their larger neighbours. Exchange rates there were also generally anchored as part of the stabilization efforts of the 1990s.

Fiscal policy likewise has little independence, owing to the precariousness and external dependency of the public finances. Small countries tend to have higher budget deficits than their larger neighbours. In addition, current government revenues come largely from external trade. What is more, in less developed small countries, public-sector investment relies on what is a high level of external aid by regional standards.

Table 4 shows that the countries which are most vulnerable to economic fluctuations, according to the twofold classification of fiscal deficit levels and external dependency, are almost without exception small economies. Thus, macroeconomic policy in these economies remains very reactive, and is more focused than elsewhere on controlling inflation and preserving nominal exchange-rate stability, two objectives that are highly interdependent in economies of this type. Indeed, the facts show that small economies have fewer problems of inflation or devaluation than their larger counterparts in the region (ECLAC, 1996).

These structural constraints on the active and autonomous use of short-term macroeconomic policy, however, do not mean that development policy has to be given up on. Fiscal constraints have not prevented certain small economies –in particular Costa Rica and those of the English-speaking Caribbean– from setting up programmes to invest in human capital (health and education) or applying the fiscal instruments of an aggressive export strategy.

As they are unable to finance costly industrial development assistance programmes, many small economies have introduced productive investment subsidies in the form of exemptions from taxes, both direct and indirect. This has happened particularly in the case of the *maquila* activities that have been set up in free trade zones, in both Central America and the Caribbean. Some countries have cooperated to build up the infrastructure needed for new activities, as the

[6] Nonetheless, these constraints on the ability of macroeconomic policy to react to external shocks do not translate into more volatile growth rates, thanks to the isolation of small economies from speculative capital flows.

TABLE 4

Latin America and the Caribbean: Budgetary position and dependence on customs revenue
(Averages 1995-1999)

Budget balance / Dependence on customs revenue:	Surplus or small deficit[a]	Moderate deficit[b]	Large deficit[c]
Low	Trinidad and Tobago	El Salvador Mexico	Bolivia Brazil Costa Rica Uruguay
Moderate	Chile	Argentina Barbados Guatemala Panama Paraguay Peru	Ecuador Guyana
High	Dominican Republic	Netherlands Antilles Saint Kitts and Nevis Saint Lucia Saint Vincent and the Grenadines Venezuela	Antigua and Barbuda Bahamas Belize Colombia Dominica Grenada Haiti Honduras Nicaragua Jamaica

Source: Escaith and Inoue (2001).

[a] Budget surplus, or deficit of less than 1% of GDP.
[b] Deficit of between 1% and 2% of GDP.
[c] Average deficit in excess of 2% or highly unstable.

Dominican Republic did as part of its tourism development programme. These initiatives involve major costs, in the form of budgetary spending or uncollected taxes.[7]

These incentive programmes, however, are often

is that they have very often been the key to the success of non-traditional export diversification programmes in the small economies of Central America and the Caribbean (Stallings and Peres, 2000).

The new conditions obtaining in the international

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