This paper discusses some of the analytical aspects related to the implementation of fiscal and other related macroeconomic policies in the context of very small developing economies. The presentation is divided into three sections.

The first section discusses the economic characterisation of very small economies which differentiates them from other types of developing countries, and which conditions the effectiveness of their economic policies, as well as their ability to generate enough domestic investments and/or attract foreign capital.

The second section elaborates on the role and the functions of fiscal policies in developing countries in general, while the third considers the specific role that fiscal and other related macroeconomic policies can play in the smallest of the developing countries.

THE ECONOMIC CHARACTERISATION OF VERY SMALL ECONOMIES

Although many attributes can be used to define the economic concept of a small economy, it has been frequently argued that when the smaller of the developing countries are taken as a group, two main criteria stand out: population and the size of the country’s gross domestic product (GDP). Since the size of the GDP is a variable that could widely fluctuate over time and across countries owing to valuation problems, as well as to oscillations in external terms of trade, it seems more proper to follow the population criterion and
include in the group of so-called ministates those countries with a population of about one million inhabitants. Following such somewhat arbitrary criterion, many of the countries of the Caribbean region and of the Pacific Basin would qualify. We observe that many of those countries display a number of economic characteristics which may have important implications for the evaluation of their economic policies. Those implications may result in the need to use an economic framework of analysis which does not share the same features as the standard models applied to larger developing countries, and may call for the application of alternative concepts when designing and implementing economic policies.

In general, very small economies can be classified into a special category because they share a number of specific characteristics. For example, geographical isolation (particularly in the case of small island economies), an extremely narrow production base that results in marked diseconomies of scale, endowments of natural resources concentrated in a few commodities, and a relatively small base for the development of highly sophisticated financial structures. As a consequence of these conditions, ministates have been characterised by a number of common patterns in the nature of their economic development. The most prevalent is the extremely high level of openness of both their goods and capital markets. Indeed, very small economies have been shown to be largely open to international trade and to display a relatively large degree of capital mobility. This combination of small size and high degree of openness has had two notable consequences—an unusually large export dependence with an extreme vulnerability to international market fluctuations, and highly ineffective monetary and exchange rate policies. Such ineffectiveness is reinforced by the apparent optimality of adopting a policy of fixing or at least of keeping largely constant, the effective value of the exchange rate. The effects of these elements, for macroeconomic policies as well as for sustained economic growth, will be analysed following a discussion of some additional implications of a large degree of openness.1

Evidence of the openness of ministates on the trade side has been compiled by Galbis,2 and this indicates that the ratio of imports to GDP in most ministates exceeds 50 per cent, a proportion far higher than that in larger countries of similar level of development. Evidence of the same type can be obtained for exports. In addition, it is observed that trade openness tends to increase with the level of development more quickly in ministates than in larger countries.