The Economic Development of Small Countries: Problems, Strategies and Policies

GUIDELINES FOR MONETARY POLICY IN SMALL DEVELOPING COUNTRIES

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THE IMPORTANCE OF SAVING AND INVESTMENT

When attempting to speed up the process of structural transformation of small economies in developing countries, policy makers are confronted with a dire lack of finance. Such economies are often characterized by the presence of only one export industry, partly run with imported factors of production and based on the exploitation of the available natural resources. This industry usually has a dominant influence on the various macro-economic variables. However, as a rule, it has only limited industrial links with the rest of the economy, whose development potential is still being inadequately exploited. Consequently, the production base of the economy is usually dualistic and disharmonious, leading to substantial differences in productivity and income levels between different regions and sectors of industry. In these what might be termed "enclave economies," many projects must be undertaken to reform their unsatisfactory structure. For this purpose, the encouragement of domestic saving and a maximum use of the resulting savings for the financing of directly and indirectly productive investments are of vital importance.

The importance of saving and investment is evident from various growth models, for instance, that of Harrod and Domar. In that model, an increase in the savings and investment ratios - with unchanged capital coefficient - leads to a higher growth rate of domestic product. The growth rate is governed by the relationship between the savings ratio and the capital coefficient. Under certain conditions, a low savings ratio could cause a situation of absolute scarcity of capital and hence of structural unemployment. The only way of reversing this situation without interrupting the economic process is through increased savings and correspondingly increased investment. Scarcity of capital is a major problem for small countries. Using the model referred to above, it is simple to calculate that a number of these countries require savings ratios somewhere between 35% and 40% if unemployment is to be brought down to an acceptable level. The exceptionally high level of the required savings ratio is a direct consequence of the small size of the population and the specific structure of the economies concerned. Relatively few people must contribute comparatively large amounts to finance the investments necessary for increasing prosperity. Consequently, the

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sacrifice in terms of savings per head of the population should be of major proportions.

Against the background outlined above, it is understandable that for some time countries have endeavored to increase their savings. They have done so by extending the financial apparatus and by introducing new forms and systems of saving. In the majority of cases the central banks have played a positive and stimulating role in this process. Yet it must be concluded that these countries have generally failed to achieve even saving target of the second Development Decade. According to the United Nations, the savings ratio in developing countries in the seventies would have had to increase by an annual average of 0.5%, so that a level of 20% would have been reached by 1980.

The disappointing development of the savings ratio is due to a combination of domestic and external factors. The small countries have firstly been confronted with a dramatic deterioration of their terms of trade owing in part to the energy crises and their weak position within the world economy. Moreover, the harsher overall international economic and financial climate has had major consequences for these countries. As a result of these developments and of the insufficient volume and growth of domestic income, the scope for increasing the savings ratio is *de facto* extremely limited.

Moreover, savings are depressed because scarce funds are used for low-productive investments, including projects having little more than prestige value and the expansion of the military capability. Furthermore, the often negative real rates of interests, the weak confidence in the external value of the currency and, in some cases, political instability discourage the holding of savings deposits with domestic financial institutions. These factors and the low interest rates compared to other countries also contribute to capital flight and discourage inflows of foreign capital. Moreover, there is a tendency to hold part of savings in the form of cash or certain goods, such as precious metals and strong foreign currencies. When spending savings, preference is sometimes given to speculative investments with short pay-back periods, for instance in trade stocks. As a consequence, the already low savings are used to a very small extent only for productive investments. In combination, these factors result in a structural shortage of savings and investment.

If allowances are made for the specific structure of small countries and their limited potential for development, it must be accepted that their domestic savings cannot be increased to such an extent that they will be able in the near future to finance the required investment largely from domestically generated funds. Consequently, they cannot yet enter the growth phase of sustained economic development. This phrase is marked by the absence of a structural national savings deficit. For the still relatively poor countries, a savings ratio on the order of 35% to 40% is generally not feasible. If no other sources of funds can be tapped, the risk that these countries will be trapped in a vicious circle is by no means

imaginary. The fact is that the low income in absolute terms is the main cause of the insufficiency of saving and investment, while the very insufficiency of saving and investment stands in the way of the achievement of the desired growth of income. In that case these countries remain poor just because they are poor!

POSSIBILITIES AND LIMITATIONS OF MONETARY FINANCING

At first sight, it would appear that the insufficiency of savings could be offset, thus allowing the poor countries to break out of this vicious circle, by bringing money into circulation through monetary financing. Such finance is generated not by current production, but by domestic money creation, by activating old cash balances and by importing capital. In principle, monetary financing permits expenditure without prior production and income generation. Consequently, there is no need to adjust expenditures in all cases and in full to the level of income. This possibility would appear to be of essential importance, considering the unduly low level of both consumption and domestic savings.

However, the question is within what constraints monetary financing can be used to an advantage. It is this fundamental question which is discussed below. Firstly, it must be realized that monetary financing leads to an interruption of the economic process, contrary to cases where expenditure is financed from current income. Consequently, financing from current income and financing by increasing the money supply must definitely not be viewed as alternatives. Under the conditions now prevalent in small developing countries, it is not to be expected that monetary financing and the ensuing increase in effective demand will result in an appreciable increase in domestic production. The domestically generated supply of goods is insufficiently diversified and, as a result of physical and organizational bottlenecks, has barely any short-term elasticity. Owing to this and to the ample opportunities for imports, despite the exchange controls in force, the additional demand will focus largely on the supply from abroad. The so-called monetary approach to the balance of payments - which seeks the causes of disequilibria on external payments in the monetary sphere - proves to be highly topical for these countries.

Furthermore, it is notably important that the balance-of-payments effect cannot be adequately cushioned by reducing the relative openness for current transactions by means of more protectionist measures. Government intervention will be counter-productive. Unduly large money creation will in all probability result in accumulation by the public of involuntarily held cash balances and give rise to black markets in commodities and services, with all their consequences for the actual level of prices. Sharp price increases will likewise ensue from forced import substitution. In a small economy, the favorable effects of setting up an import-substituting industry on the overall level of economic activity, employment and the balance of payments will be either modest or insufficient. Another effect of an unduly large monetary expansion is

the adverse influence of inflationary and exchange rate expectations, which has repercussions for capital movements and for the process of saving and investment. If finally, in an attempt to keep the officials cost of living artificially low, the government should decide to fix maximum prices for certain foodstuffs, that can only lead to an erosion of the profitability of production, higher government subsidies or to discouragement of production. All these factors may help create an atmosphere of social unrest, broad strate of the population feeling aggrieved and attempting to shift the effects of the price increases onto others. In this way a self-reinforcing income-price spiral may be set in motion, severely impairing the country's competitive position, also via overvaluation of the currency. Ultimately, contact with the world economy may be increasingly lost and the viability of the economy may be jeopardized. Under such conditions, the existing physical bottlenecks can only be aggravated by disequilibria in the financial sphere.

The foregoing implies that in small open economies the opportunities for meaningful utilization of monetary finance are basically very limited. The possibilities of stimulating these economies through monetary measures alone are correspondingly limited. An excessive monetary expansion will rather tend to produce adverse effects. If such effects are to be avoided, the total money supply must be limited and brought into line with the optimum real economic long-term development potential of the country. The total amount of money in circulation must, in principle, be roughly equal to the demand for money consequent on the structural level of the potential volume of production, which is determined by real economic factors. Thus, a situation of capacity equilibrium is created, marked by harmonious monetary conditions at the highest possible level of general economic activity.

SOURCES AND CAUSES OF MONETARY FINANCING

If a healthy monetary development is to be ensured, it is not sufficient merely to impose limits upon the total purchasing power. Considering the dominance of the balance-of-payments effect, it is equally essential in small open economies that the monetary finance originates to a sufficient degree from foreign sources. That enables an increase in imports of goods and services to be financed from the initial inflow of foreign exchange consequent on exports of goods and services or from capital imports. In the case of money creation from domestic sources, however, there is no such compensation for the induced loss of foreign exchange. This means that in the latter case the ratio of the monetary reserves to the money supply will decrease, whereas in the case of inflows of money from abroad this ratio need not - at least initially - decline. Consequently, as a result of the extremely high imports ratios in small countries, a process of monetary expansion must be attended by corresponding gross inflows from abroad if balance-of-payments disequilibria are to be avoided. No single country can afford, with impunity, to have a deficit on the overall account of the balance-of-payments for a prolonged period of time!

Moreover, in order to cushion temporary and isolated autonomous disturbances of balance-of-payments equilibrium, it is necessary to ensure an adequate volume and growth of the monetary reserves. Adequate monetary reserves are a prerequisite for safeguarding the economy's liquidity and solvency and for supporting confidence in the national currency. The required volume of these reserves is governed by all of a country's short-term international assets, including credit commitments, and all its short-term liabilities.

The foregoing means that the volume of monetary financing and its sources must be such as to help achieve the simultaneous realization of capacity equilibrium and a certain surplus on the overall account of the balance of payments. Whereas the balance-of-payments position should not constitute an impediment for domestic equilibrium, full allowance must be made, when striving for such equilibrium, for the effect on the balance of payments. If the current account yields a structural deficit, imports of private and official capital, in whatever form, are indispensable.

If it is not possible to attract sufficient capital from abroad, the balance-of-payments deficit must necessarily be brought down, even if capacity equilibrium has not yet been achieved. From the point of view of financing, the extent to which a country succeeds in attracting structural capital imports or the extent to which it is able to run down monetary reserves accumulated in the past is decisive for the permissible size of the current account deficit and the pace of economic development. If attempts were to be made, through domestic money creation, to push up expenditure more sharply than is warranted on the basis of the available foreign funds, the negative effects of monetary financing will be making themselves increasingly felt.

On the other hand, care must be taken to prevent the excessive capital imports from exerting too great a pressure on domestic production, as this would also generate unwelcome inflation. In the countries considered here, that could easily happen. After all, these countries have only a limited capacity for absorbing foreign capital into their production process. In this respect, too, these countries are caught in a vicious circle: owing to, inter alia, a shortage of capital their absorptive capacity is small, while the smallness of the absorptive capacity of the economy stands in the way of an effective use of capital. Under these circumstances the capital imported should be used partly to eliminate physical bottlenecks.

Extensive capital imports can normally not be considered permanent. Imports of capital should only provide the financial scope and the time to increase national income. If they take the form of debt-creating transfers, allowances will, furthermore, have to be made for future interest payments and - in the case of non-renewable loans - repayments. All this entails that external capital should be used to attain an acceptable and lasting increase in both production and exports. The return on

investment should, on average, exceed the costs of capital imports or at least equal them; it should result in extra domestic savings and generate sufficient foreign exchange to repay external debt. Furthermore, the pay-back period of the investment should correspond with the repayment terms of the loans.

If, in determining the use to which the capital imported is to be put, no account is taken of at least the above guidelines, the financing problems will only be put off, making themselves inexplicably felt at a future date. Sooner or later external debt obligations will have to be met. Such a line of action poses a threat to the liquidity and solvency of the economy, and generates unrest in the various financial markets. The possibility to finance investment from capital imports is consequently restricted by the necessity to pursue a well-thought-out financing policy. External indebtedness may never exceed the financing potential of the economy!

It is of fundamental importance that a shortfall in capital imports not be made up through recourse to domestic monetary financing. As noted earlier, this would, on balance, be attended by a loss of foreign exchange. In view of the major problems which might arise if these sources were tapped, monetary policy should be aimed primarily at controlling domestic causes of money creation. For this, an unambiguous norm should be formulated. Such a norm is obtained by taking the total permissible monetary financing at capacity equilibrium minus the desired growth of the monetary reserves. Subsequently, the scope thus fixed for domestic liquidity creation should be divided between the public and the private sectors. An expanding economy cannot do without some money creation for private individuals, as they need bank credit to finance their increasing activities.

The government's financing behavior has a decisive influence on the realization of balanced monetary relationships. It will be heavily pressurized to expand the social security system. Governments will always be faced with the fact that part of the population is living on a subsistence level and, in a number of cases, with social instability. On the basis of these and other considerations, priority is often given to the attempt to alleviate the burden of the needy in the short term, even if this is at the expense of financial stability. It takes time before it is realized that such a policy usually proves counter-productive and that a high price will have to be paid, also and possibly especially by the needy, for the sacrifice of stability.

Despite the urgent plea to increase public spending, the level of expenditure should always be in accordance with the available funds. Structural budget deficits should be financed from domestic capital market borrowing and capital imports. In addition, as much money as possible should be used effectively for productive projects. Everything has its price. The government simply is not a cow which grazes in heaven and is milked on earth!

The central bank has the duty to advise the government authoritatively on financial matters. This duty requires that the central bank should have far-reaching and inviolable autonomy. It may, at any rate, never degenerate into a permanent and copious source of monetary financing. In more concrete terms this means that the central bank may never cease to point out to the government that its expenditure should not exceed the sum total of:

1. the current income received at an acceptable burden of taxation;

2. funds attracted abroad, whose volume should be such that they contribute to the attainment of capacity equilibrium and equilibrium on the balance of payments, and

3. that part of permissible recourse to domestic savings and money creation which is reserved for the government.

THE ROLE OF MONETARY POLICY

The foregoing states explicitly that - in view of the specific structure of small, open economies in developing countries - extra importance should be attached in these economies to the attainment of capacity equilibrium and balance-of-payments equilibrium. Balanced monetary relationships provide the best possible guarantee for a climate of domestic and external financial stability. such a climate is indispensable if the desired structural transformation is to be achieved. Enforced disturbance of such equilibria would have the consequences mentioned earlier which impair the foundations of *enclave-economies*, such as the export industry and capital imports. These consequences are not offset by any social and economic advantages. Experience shows that prolonged and powerful monetary inflation usually ends in the imposition of a painful process of adjustment and restructuring. The pain involved in such a process will be the more acute, the further away one has strayed from these equilibria owing to an ill-judged short-term policy. And in some cases, well-nigh irreparable damage will have been done!

These negative effects of excessive monetary financing will, in a sense, be able to arise in any developing economy. In view of the basic characteristics of small, open economies in developing countries, these effects will presumably have a very dominating impact on such economies. Control over liquidity creation in accordance with the overall guidelines set out above is therefore a sine qua non for the economic development of small countries.

In connection with the high import ratio, the monetary authorities should - as noted earlier - give special attention to regulating recourse to domestic sources of monetary financing. Owing to the comparatively simple structure of the financial apparatus and the non-diversified supply of financial assets, this recourse should be fairly easy to control. In many cases it should suffice to impose ceilings on the lending of the

money-creating banking system to the various sectors. When implementing these guidelines it is impossible and, incidentally, also unnecessary to strive for a permanent and perfect atonement of the money supply to the demand for money. The latter variable will, in the short term, undergo a fair amount of fluctuations under the influence of numerous non-recurrent factors. The fact alone that statistics are not available on time and that they are mostly of poor quality, prevents effective fine-tuning. From the viewpoint of the attainment of monetary stability, much can be achieved already by structural control over the money supply based on the long-term possibilities for real growth.

In support of the monetary policy to be pursued, it would be commendable to compile annual monetary budgets, which can be calculated with the aid of precalculated bank balance sheets, and forecasts for the balance of payments, public finance and several quantities figuring in the national accounts. At the beginning of every year, the forecasts should provide an overall insight into the monetary effects of the planned expenditure and means of financing for the various sectors. Furthermore, the question should be asked to what extent these applications of funds are in accordance with the guidelines for maintaining or attaining capacity equilibrium and balance-of-payments equilibrium. If such accordance does not spontaneously ensue from the original intentions, agreements could - in the quest for structural control over the money supply - be made beforehand and economic policy measures be prepared or taken to ensure responsible spending and financing behavior on the part of the various sectors.

It must be pointed out that, when talking about the problems of small economies, the fact that emphasis is placed on the importance of the financing factor by no means implies that the other conditions for a structural transformation can be neglected. It is vividly realized that at the same time changes will have to be made in many other fields to speed up this transformation. As various complementary means of production are required for the ensuing expansion of production and exports, the maximum feasible level of real economic activity is ultimately dependent on the scarcest factor of production. This factor also determines the degree to which other productive powers can be utilized. The elimination of unemployment, for example, can be hampered by a lack of complementary means of production. It depends on the concrete relationship between supply and demand which factor of production will function as the critical bottleneck. This role need not always be fulfilled by a lack of finance. In "enclave-economies", serious bottlenecks can arise as a result of, for example, the smallness of the domestic market, the dualistic structure of production, the lack of initiative, enterprise and skilled labour, and especially a shortage of managerial talents. In addition, disastrous negative effects can be exerted by inefficient government of an, in other ways, unhealthy investment climate. Insofar as such bottlenecks actually arise, the lack of money is much more the result than the cause of underdevelopment and stagnation of the economy.

On the basis of these considerations, it may be concluded that the creation of a stable financial and economic climate must be seen as a necessary, but by no means sufficient, condition for structural transformation. Social and economic progress requires, first of all, the formulation and efficient implementation of a realistic development programme for the long term. Such a programme should indicate which aims are being strived for and which instruments will be used to bring about the realization of these aims. Using the specific circumstances prevailing in "enclave-economies" perhaps a strategy along two lines should be pursued to achieve the structural transformation. On the one hand, the aim could be creation of several new growth nuclei based on the exploitation of the available natural resources - which consist of large-scale modern production complexes mainly for export - while, on the other hand, small-scale activities should be promoted to meet the basic needs of the population in the way of personal and communal necessities such as food, water, clothing, shelter, health care and education.

The above clearly shows that a comprehensive package of policy measures should be employed to influence both the supply and the demand for goods and services, and to bring them into line with each other. Doctrinal and dogmatic views based primarily on one single instrument of economic policy are thus rejected once and for all. Small countries should strive to maintain their place in the world economy with the aid of a coordinated and integrated policy. This is the only way that domestic and external factors of production can be employed effectively to realize the objectives of the development programme. This entails that the competitive position of small countries may, in any case, not compare unfavorably with those of their main trading partners. As a consequence, the various cost and price components must not take the lead vis-a-vis relevant foreign countries.

Should a strategy along two lines not provide a satisfactory solution for the structural problems of small countries, the supply of goods and services cannot be increased to the desired degree, in any case not by means of monetary measures alone. On the basis of the arguments used for the maintenance of capacity equilibrium and balance-of-payments equilibrium demand will, in that case, have to be adjusted to the unduly small supply. Major emphasis on a reduction of expenditure will, in all probability, cause a contractive disturbance of the economic process which might ultimately call forth political and social tensions. Monetary policy can, however, not be held liable for an inadequate general policy, nor take over its functions.

The line of thinking set out above warrants the conclusion that the real significance of monetary policy lies in its ability to create favorable financial conditions for structural transformation in the real economy. Before all else, monetary policy is concerned with the creation of conditions and can only promote growth to an appreciable extent. An expansionary monetary policy can, by itself, not give rise directly to a

sustained growth of production. A balanced monetary policy does, however, create a climate of confidence and stability which is indispensable for such growth. An inept monetary policy on the other hand, undermines domestic and external financial stability and results in serious troubles for real economic development. Money and monetary policy are thus of vital importance for the expansion of prosperity in small countries. However, they do not achieve miracles. Monetary medicines cannot remedy non-monetary ailments. On the contrary! In small, open economies excessive doses of such medication will soon lead to an acute weakening of the economy.

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