The EU Small States and the Resilience/Competitiveness Nexus

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1. Introduction

Characteristics of small states

In this presentation, the small states of the EU are defined as those with a population of about 3 million or less.

Small States tend to be highly exposed to external economic shocks because of their inherent characteristics, mostly associated with trade openness. This is the result of their small domestic market compelling such states to be highly dependent of exports for survival. In addition their limited natural resources endowments lead such states to depend highly on imports. Small economies that do not sufficiently engage in international trade are likely to fail.

Such exposure to external shocks is exacerbated by their high export concentration and high dependence on strategic imports including food fuel and industrial supplies.

Resilience building in small states

Many Small States face additional constraints associated with small economic size which results in their limited ability to reap the benefits of economies of scale.

The major messages of this presentation are that :

(i) economic resilience building and the enhancement of competitiveness are multifaceted involving economic social political and environmental measures;

(ii) Small States should assign major importance to resilience-building policies which could also enhance their competitiveness and should embed such policies into their national strategies.

2. Economic Vulnerability

Inherent economic vulnerability

In studies by the present author economic vulnerability is associated with:

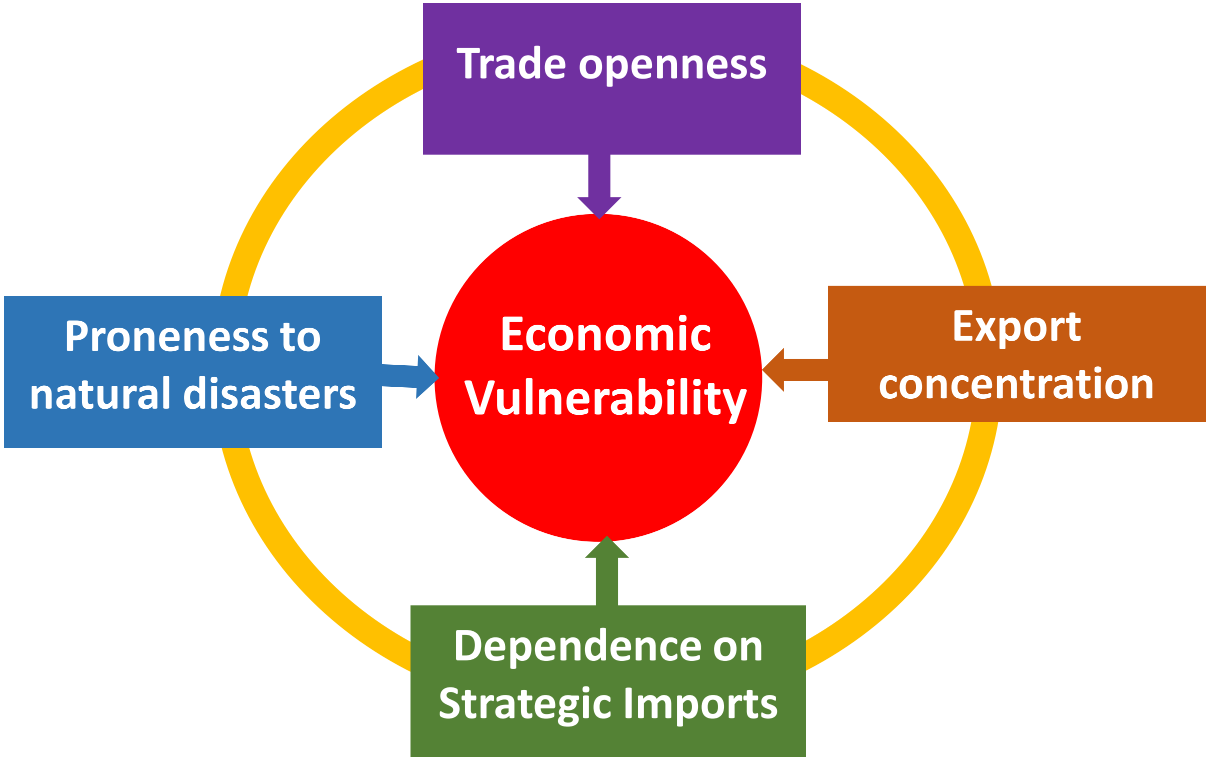
(a) **Trade openness** rendering the economy of a country exposed to external shocks. This is not a matter of policy choice as small states must export a high proportion of their sales and import a large proportion of the expenditure in order to survive.

(b) **Export concentration** which exacerbates an open economy’s exposure to shocks . Again this is an inherent feature of small states due to their limited diversification possibilities

(c) **Dependence on strategic imports** such as food and fuel which are very price and income inelastic and which also exacerbates an open economy’s exposure to shocks.

(d) **Proneness to natural disasters**, which leads to economic shocks and exacerbate the effects of external shocks.

Components of the economic vulnerability index



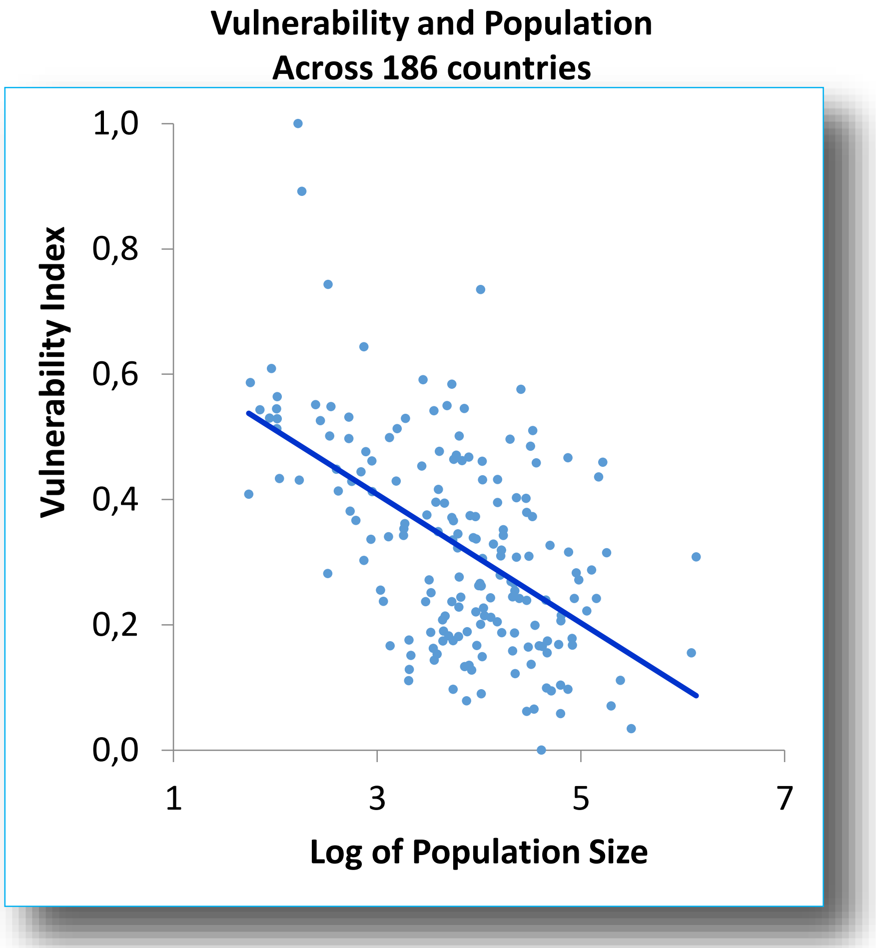
Note: The calculations relating to the economic vulnerability index are derived from Briguglio, L. (2016).*

* Briguglio L. (2016). "Exposure to external shocks and economic resilience of countries: evidence from global indicators." *Journal of Economic Studies 43*(6): 1057-1078.

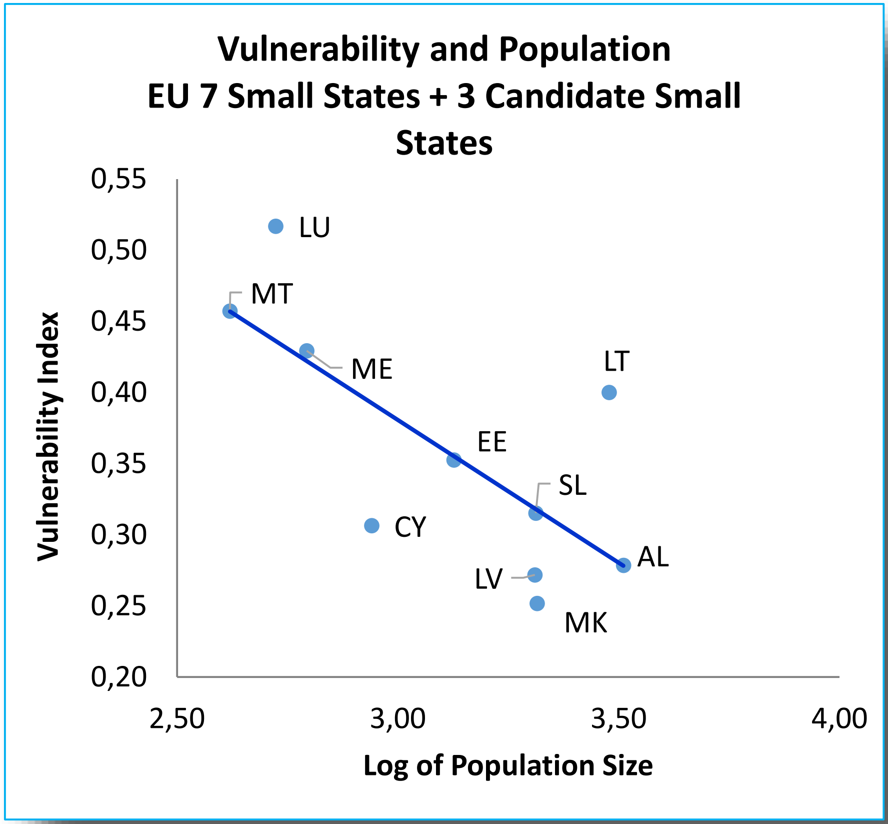
Small states are highly economically vulnerable

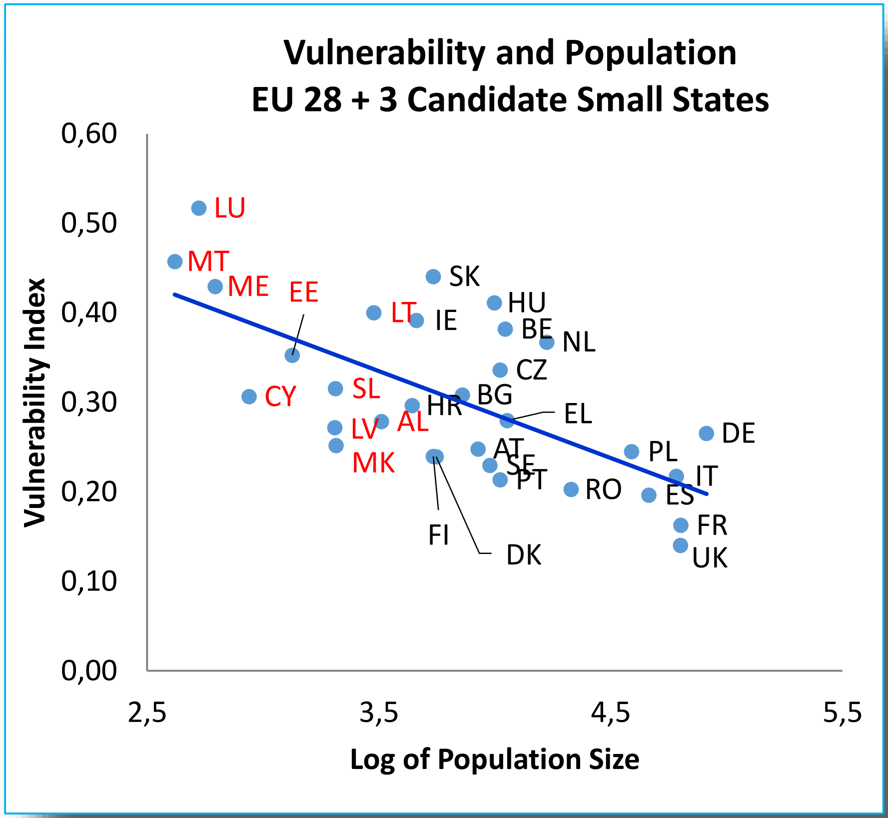
The diagram on the right shows the Economic **Vulnerability Index**, scaled from 0 to 1 (as calculated in Briguglio, 2016) plotted against country size, for 186 countries.

Vulnerability indices of the type constructed by the present author generally conclude that SIDS tend to be more economically vulnerable than other groups of countries.



The same tendency occurs in the EU members





The smaller EU members states tend to be more exposed to external shocks than the larger ones. Three candidate small states, namely Albania, Macedonia and Montenegro, are included in the graphs.

3. Economic Resilience

Policy measures that lead to economic resilience

The present author (Briguglio 2016) associated economic resilience with:

(a) **Macroeconomic stability** which allows policy manoeuvre following an external shock.

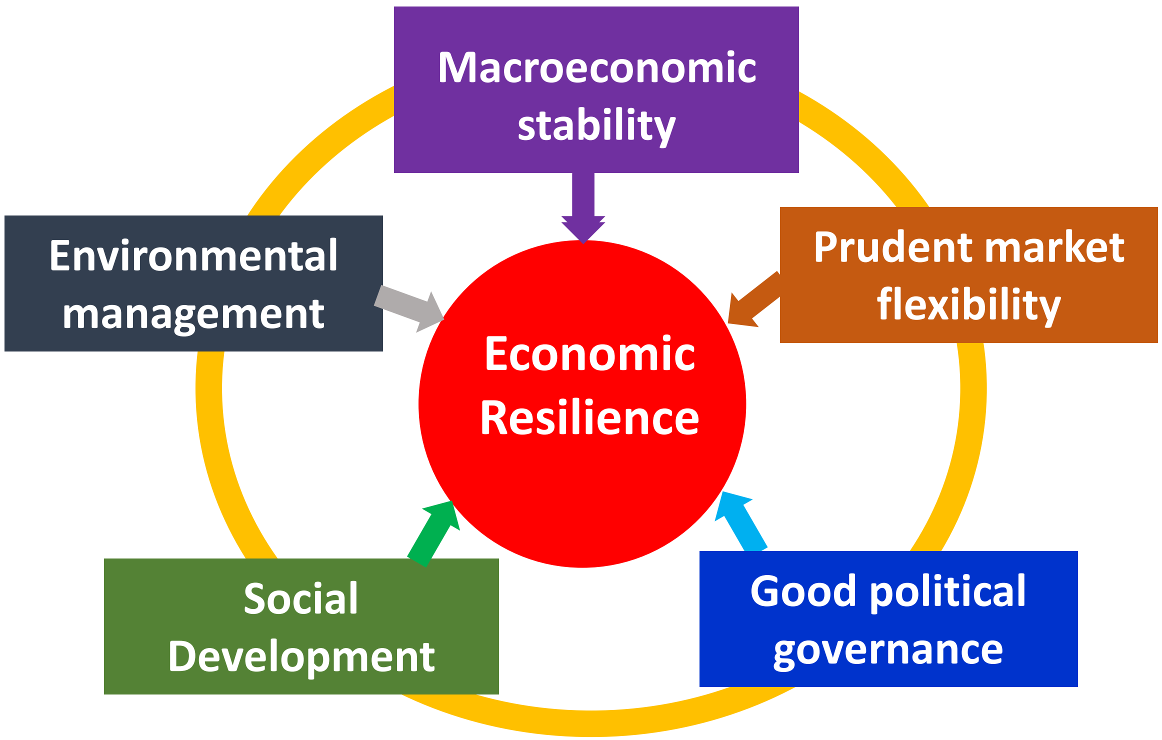
(b) **Prudent Market flexibility** enabling the economy to adjust following external shocks (prudence means due diligence to avoid excess financial riskiness and market abuse).

(c) **Good political governance** which is essential for an economic system to function properly.

(d) **Social development and cohesion** which enable the economy to function without the hindrance of civil unrest.

(e) **Environmental management** which generates stability through enforceable rules economic instruments and moral suasion.

Components of the economic resilience index

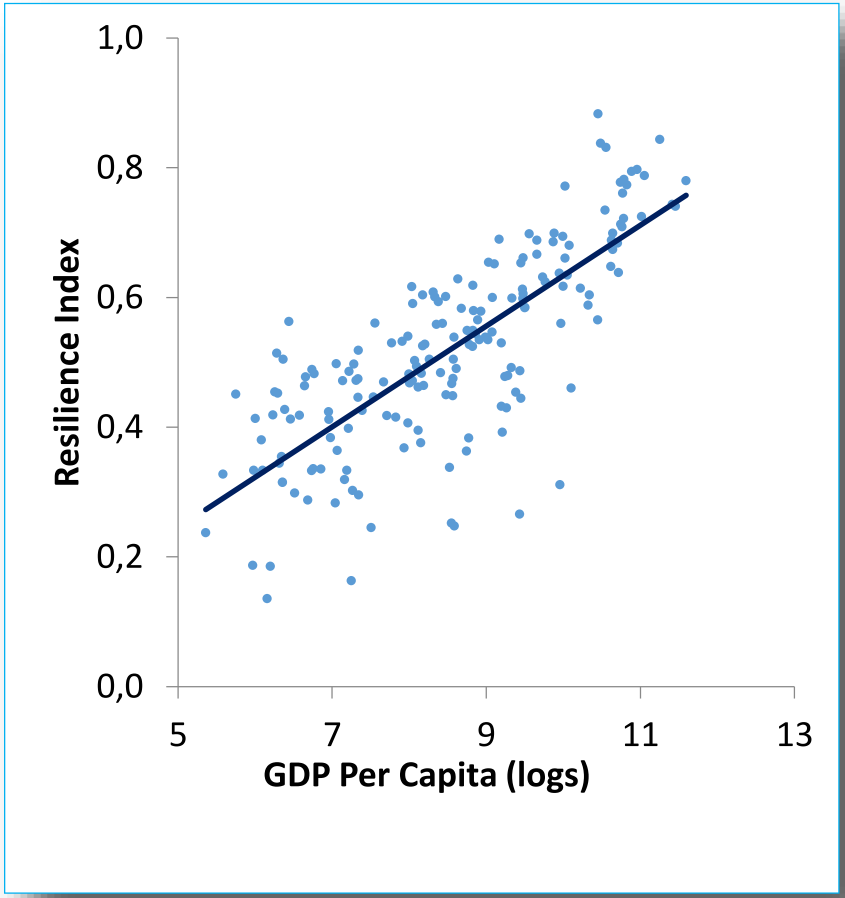


Note: The calculations relating to the economic resilience index are derived from Briguglio (2016).*

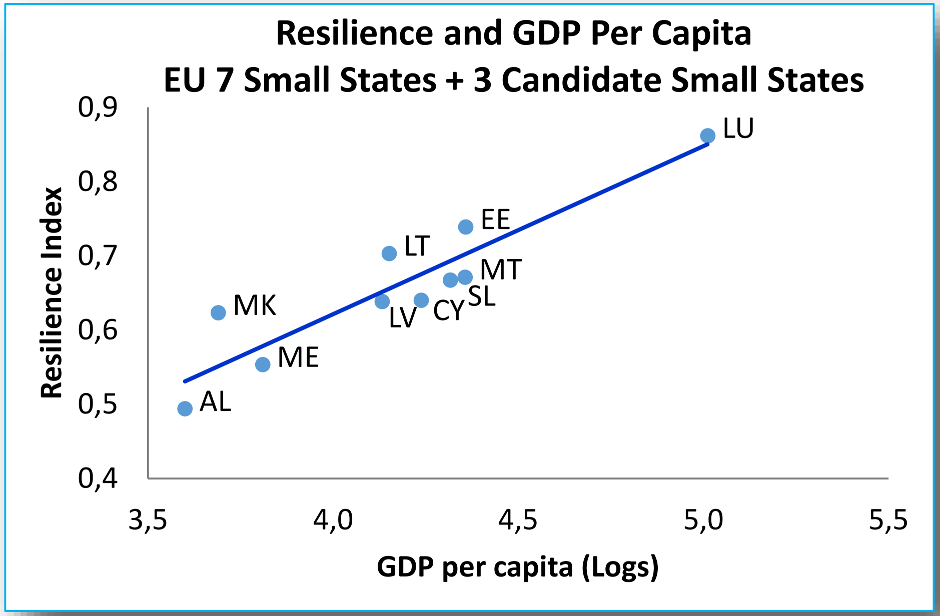
* Briguglio L. (2016). “Exposure to external shocks and economic resilience of countries: evidence from global indicators.” *Journal of Economic Studies 43*(6): 1057-1078.

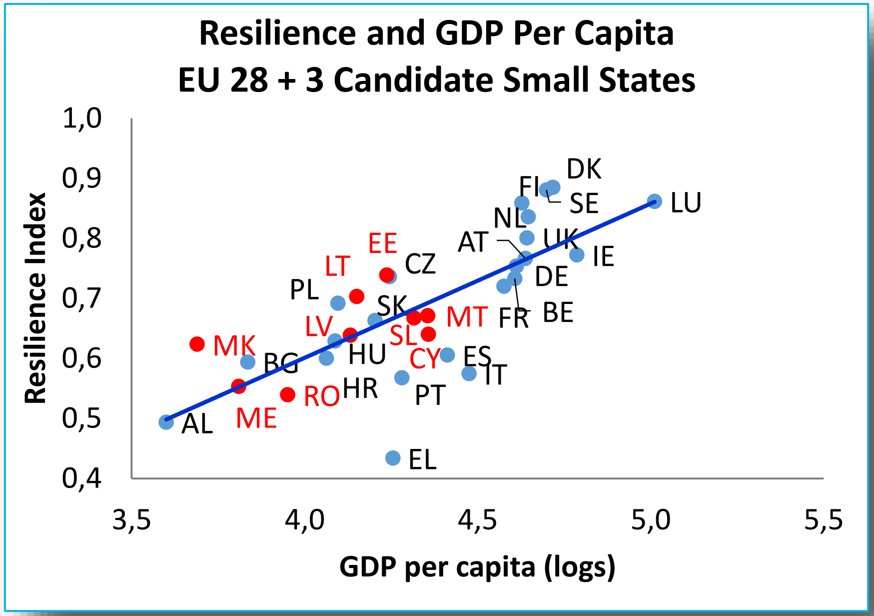
Economic resilience is related to GDP per capita

The diagram on the right shows the **Economic Resilience Index** rescaled from 0 to 1 (as calculated in Briguglio 2016) and GDP per capita . The resilience scores are not related to country size meaning that small as well as large countries can register high scores. However economic resilience is highly related to GDP per capita.



The same tendency occurs in the EU members





In the EU, there is a clear correlation between the resilience index and GDP per capita. Again here, three candidate countries, namely Albania, Macedonia and Montenegro, are included in the graphs.

4. The Vulnerability/Resilience Framework

The risk of an economy being harmed by shocks

The vulnerability/resilience framework proposed by the present author (Briguglio, 2016) is summarised in the next diagram. It deals with the risk of an economy being harmed by external economic shocks.

In brief: **RISK OF HARM = VULNERABILITY MINUS RESILIENCE**

Increased risk (higher vulnerability score): This is associated with <u>inherent conditions</u> that expose a country to shocks.

Reduced risk (higher resilience score): This is associated with <u>policy-induced measures</u> that enable a country to reduce the harm of external shocks.

The Vulnerability/Resilience framework

Risk =

Risk of an economy being harmed by an external economic shocks

Vulnerability
(adds to risk)

EXPOSURE
Inherent features of an economy rendering it exposed to external shocks

Inherent Features

- Trade openness
- Export Concentration
- Dependence on strategic imports
- Proneness to natural disasters

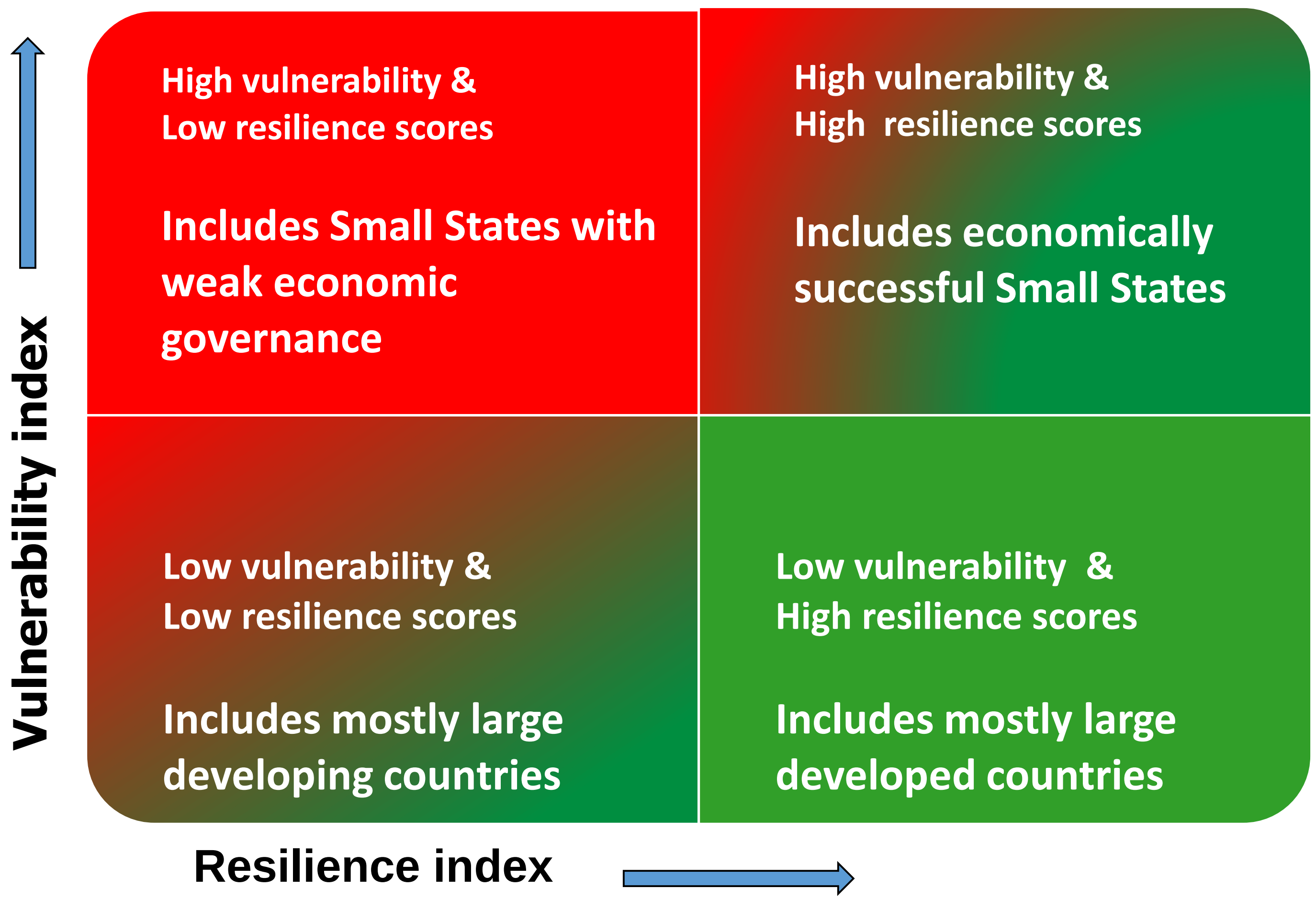
- Resilience
(reduces risk)

COPING ABILITY
Policy-induced measures enabling a country to withstand external shocks

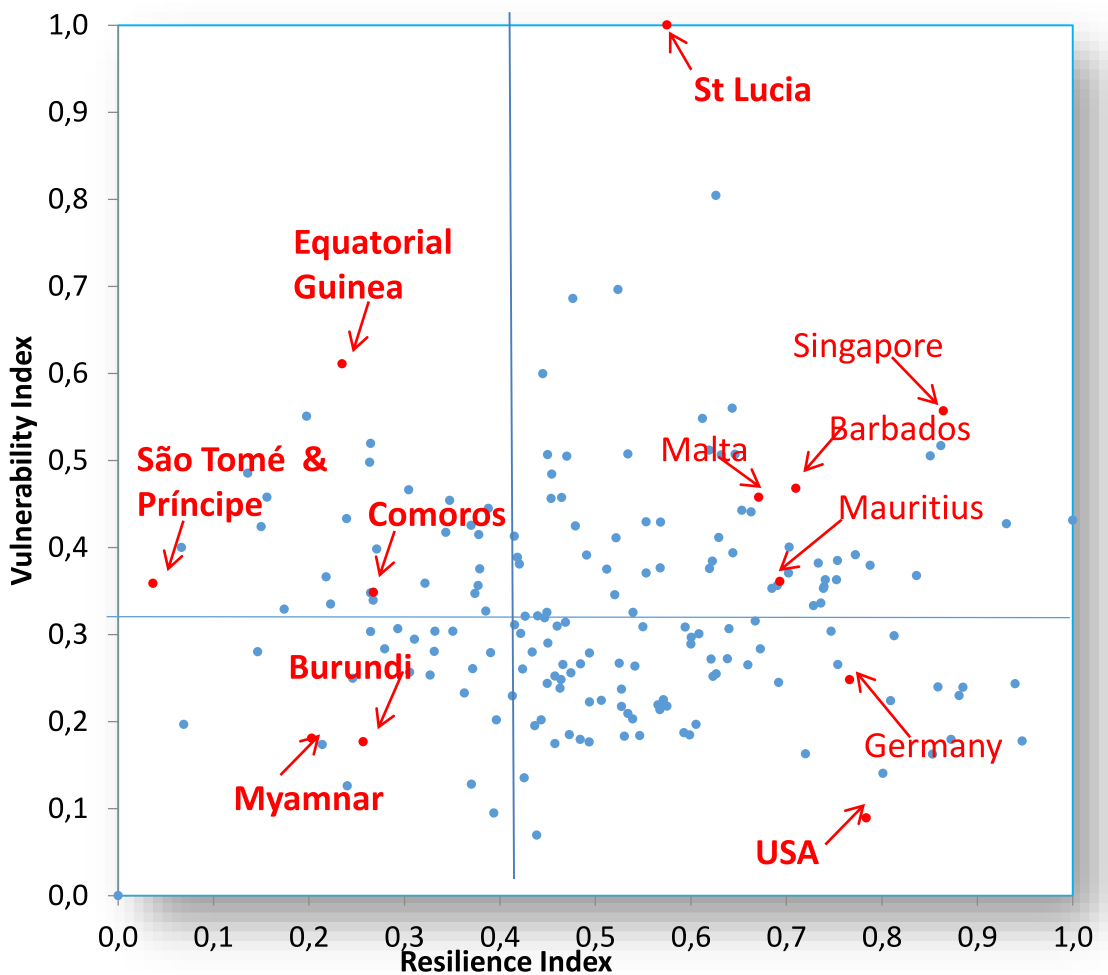
Policy Measures

- Macroeconomic Stability
- Prudent market flexibility
- Good political governance
- Social development
- Environmental management

Four country scenarios



Some countries classified by the V&R indices



EU members fitted in the V&R framework

The EU member states exhibit relatively high resilience scores, with the smaller states registering relatively high vulnerability scores.

Overall tendencies of the V&R framework

Best- case scenario	• **Low vulnerability scores** • **High resilience scores** • Includes mostly large developed countries
Self-made scenario	• **High vulnerability scores** • **High resilience scores** • Includes a number of small island states (such as Malta Mauritius Barbados Singapore)
Prodigal-son scenario	• **Low vulnerability scores** • **Low resilience scores** • Includes mostly large developing countries
Worst-case scenario	• **High vulnerability scores** • **Low resilience scores** • Includes small island states with weak economic governance

5. Competitiveness and Small States

The paramount need for small states to be competitive

In a globalised free trade context competitiveness is the means for firms as well as for countries to survive and thrive. The alternative to competitiveness namely protection from competition has time and time again proved to be futile as it results in inefficiencies and poor returns.

Competitiveness is especially important for small states because of their very high dependence on international trade which results from their small domestic markets (leading to high dependence on exports) and limited availability of natural resources (leading to high dependence on imports).

The meaning of competitiveness

There are various definitions on competitiveness.

We define competitiveness as the ability of an entity (firm economic sector or whole economy) to supply a good or a service by combining price and quality, with due respect to the environment and workers' dignity, in such a manner that buyers would prefer to buy such good or service from the said entity, when similar goods or services are supplied by other entities.

This is the sense in which the term competitiveness is used in this presentation. Thus being able to reduce prices by disregarding the environment or by exploiting employees or by dumping products, is not, in our view, the manner in which competitiveness can sustainably be attained.

Competitiveness is multifaceted

Competitiveness is multi-faceted, spanning economic social political and environmental dimensions and involves various stakeholders.

The achievement of competitiveness across all these dimensions in a sustainable manner will depend upon appropriate economic, social and environmental policies as well as an appropriate institutional set-ups.

Competitiveness is multifaceted

The multifaced character of comeptitivess is emphaised in the Global Competitivness Report , where competitiveness is associated with a set of institutions policies and factors that determine the level of productivity of a country . For this reason, the report measures comptitiveness of countries on 12 pillars namely :

1. Institutions
2. Infrastructure
3. Macroeconomic environment
4. Health and primary education
5. Higher education and training
6. Goods market efficiency
7. Labour market efficiency
8. Financial market development
9. Technological readiness
10. Market size
11. Business sophistication
12. Innovation.

Each of these pillars have a number of components

A competitiveness environment- UNIDO

According to UNIDO* an environment that leads to competitiveness requires:

- A conducive regulatory environment and market information;
- Adequate institutional and technical support infrastructure that enable industrial performance and competitiveness of SMEs;
- Knowledge and skills on the side of entrepreneurs;
- Access to financial services; and
- Low up-front investments and transaction costs.

* http://www.unido.org/en/what-we-do/poverty-reduction-through-productive-activities/business-investment-and-technology-services/competitiveness-business-environment-and-upgrading.html

Role of government in fostering competitiveness

Briguglio and Cordina (2004)* argue that competitiveness is to a large extent an enterprise issue and it is the individual firm at the micro level that needs to be competitive in order to enhance national competitiveness.

However they further argue that the government has a major role to play in this regard not least by placing competitiveness high on the policy agenda and taking the lead in (a) putting in place measures that encourage entrepreneurship and efficiency and (b) removing bottlenecks when these occur.

* Briguglio L and Cordina G. (2004). *Competitiveness Strategies for Small States* University of Malta and Commonwealth Secretariat.

The competitiveness constraints of small states

Small states are characterised by a number of special features which tend to constrain their competitiveness:

- Limited ability to exploit economies of scale.
- High per capita cost of public administration due to indivisibility of overhead costs.
- Limitations on diversification possibilities.
- Limitations on domestic competition due to the ease of monopolising a small market.
- Small states are price-takers and unable to influence international prices of industrial supplies and other imports.

However for small states competitiveness is of paramount importance due to the fact that their small domestic market compels to depend highly on exports.

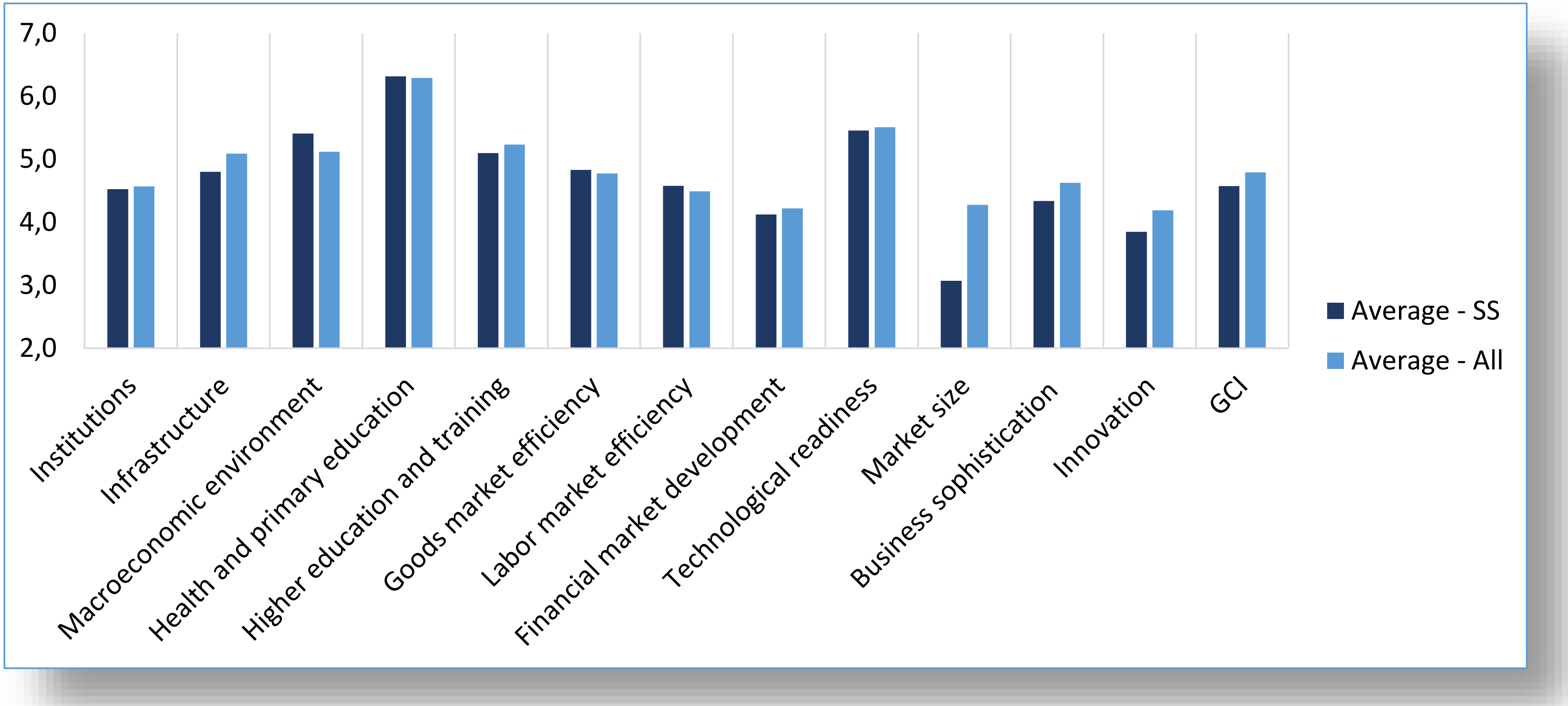
6. The Resilience/Competitiveness Nexus

Economic resilience and competitiveness

The determinants of economic resilience as identified by Briguglio (2016) and the determinants of competitiveness as identified in various studies all refer to one important driver namely good economic governance.

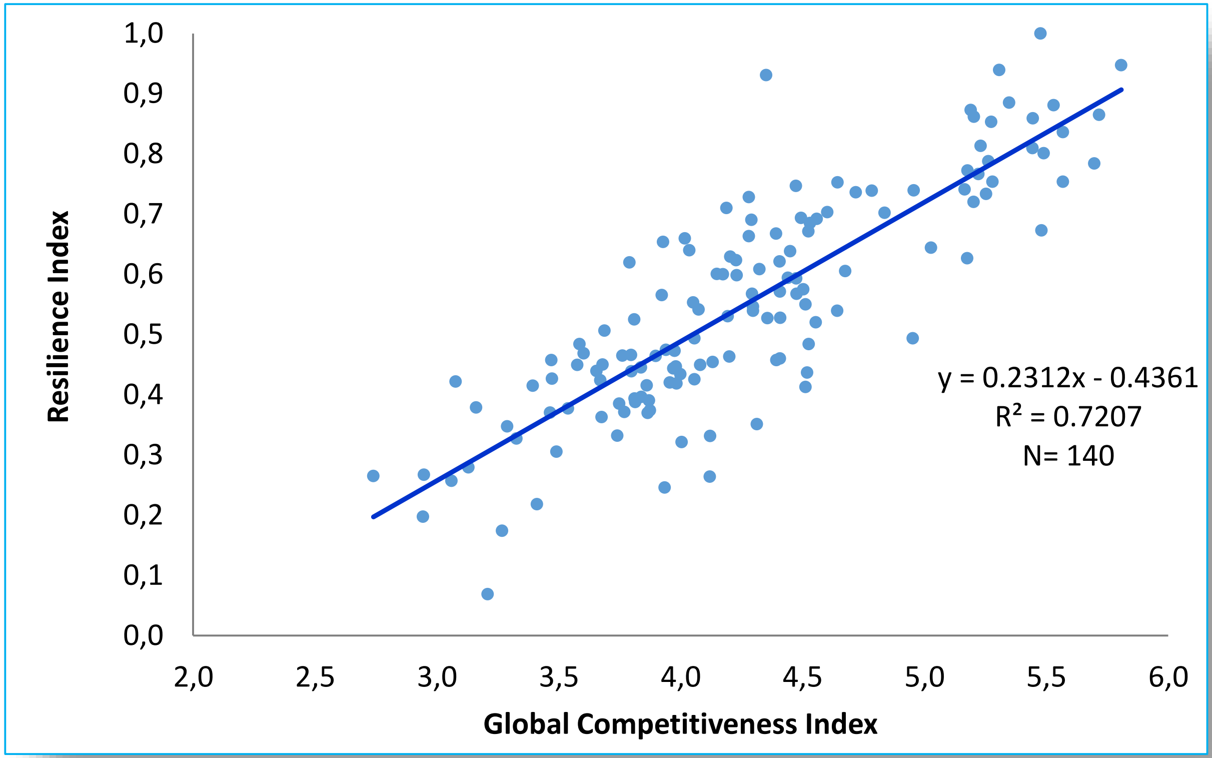
A well known Competitiveness Index is that produced by the World Economic Forum titled Global Competitiveness Index.

GCI scores of Small States against all European countries



The 2016/17 GCI overall score of the EU small states (excluding the candidate countries) are below the average of the EU28. With regard to the individual pillars the EU small states register much scores Institutions, Financial markets, Technological readiness, Business

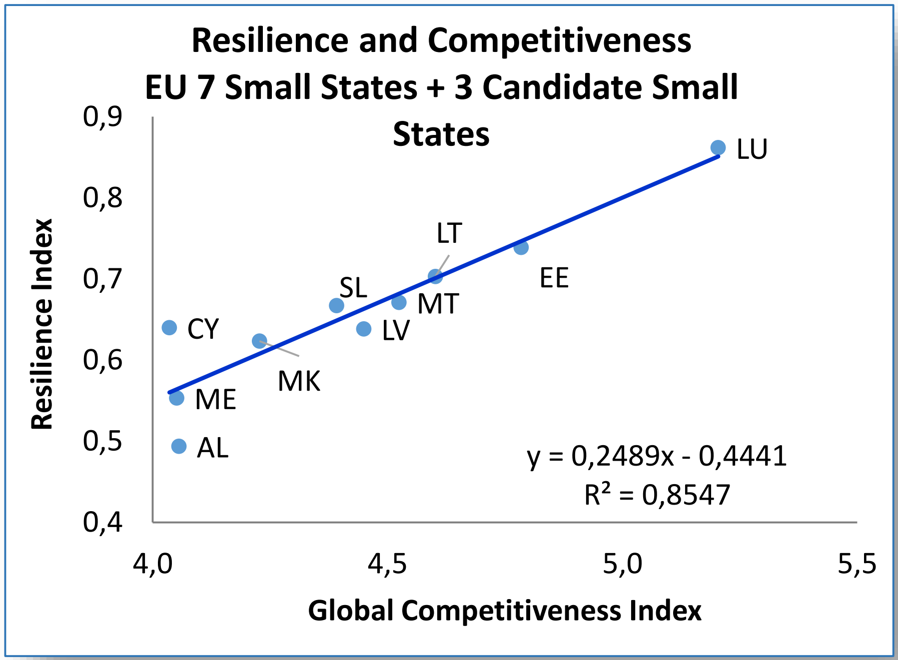
Positive relationship between ERI and GCI

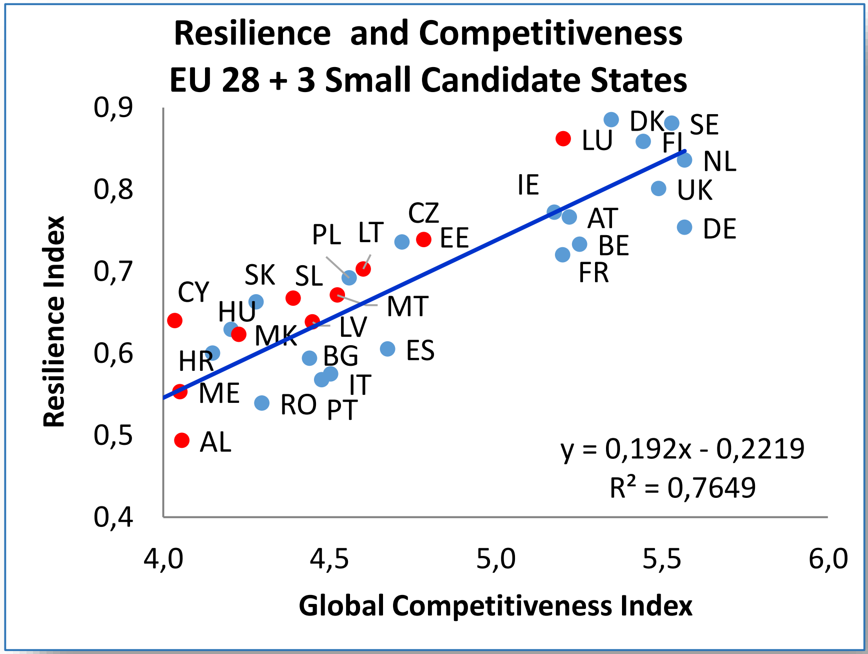


There is a significant positive correlation between the Economic Resilience Index (Briguglio 2016) and the Global Competitiveness Index.*

* The data is sourced from the 2016-2017 edition of the Global Competitiveness Report and from Briguglio (2016)

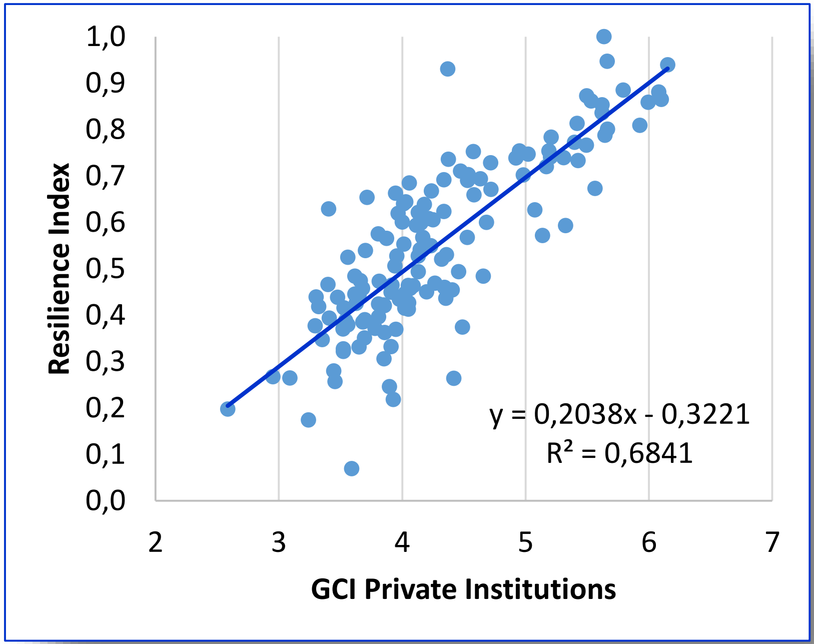
The same tendency occurs in the EU members

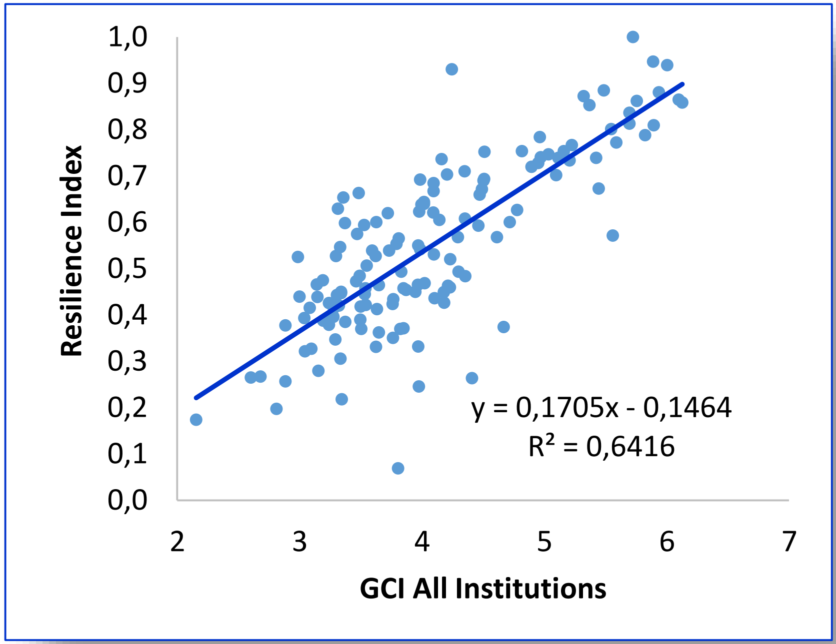




In the EU, resilience and competitiveness are highly correlated when the small states are considered as a group or when considered as part of the all EU member states.

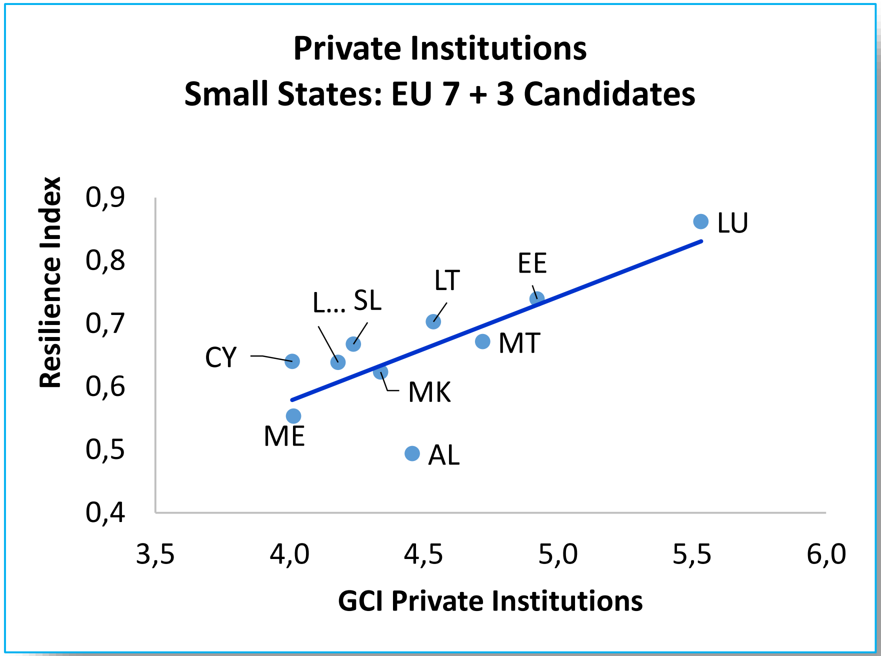
Institutions and Resilience

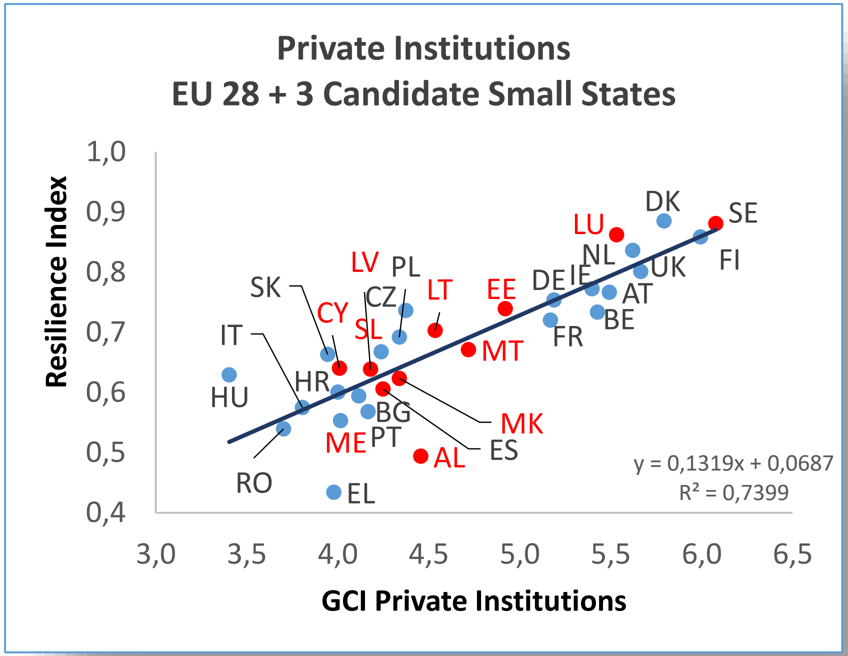




The resilience index does not contain a private institutions variable but the GCI does. So as to ensure that the two indices are not measuring the same thing, we correlated resilience with the Private Institutions Pillar of the GCI, and the result was a high correlation coefficient.

Private Institutions in the EU Small States





The positive correlation between the Economic Resilience Index and the Private Institutions of the GCI is also present in the case of the EU member states.

7. Implications for small states

Implications for small states

As argued earlier on in this presentation, the small states are highly economically vulnerable to external shocks mostly as a result of their high degree of trade openness. For this reason small states more than other groups of countries need to have a resilient economy. Resilience building also enhances small states' competitiveness as these two variables are both underpinned by good economic governance and are in fact highly correlated, as shown earlier in this presentation.

It follows that it pays small states to **embed resilience building measures** in their plans and strategies by promoting macroeconomic stability market flexibility and good social and environmental governance. These measures also enhance their competitiveness.

Identifying niche linkages

Thus while small states need to be competitive in view of their need to export due to their small domestic market, they face serious constraints in this regard. As a result they generally find it very difficult to compete in manufactured and agricultural products particularly those that can be produced cheaply by mass production.

However small states can identify niche manufactured and agricultural products as linkages to their services sector. This is particularly possible in the tourism industry which requires fresh food inputs. There may even be a market for light industry tied to the tourism sector provided that this can compete in price and quality with imported manufactured products.

In areas where mass production is not a factor, such as financial services and tourism, small states often manage to compete with larger countries.

Creating linkages through clustering

Linkages can be enhanced through clustering at the domestic and regional levels.

A cluster is a concentration of interconnected businesses which can benefit horizontally through such linkages as sharing resources and innovation networks as well as vertically by such linkages as joining a supply-chain and sharing outlets . Wignaraja et al. (2004)* argue that clustering requires sophisticated governance which may be lacking in the case of small states and therefore external support might be required for this purpose.

* Wignaraja. G. Lezama M and Joiner D. (2004). Small States in Transition: From Vulnerability to Competitiveness. Commonwealth Secretariat

Regional clustering

Clustering can also be applied at the regional level (group of countries in a given geographical location) to reap what may be called regional externalities including soft externalities such as sharing of knowledge and hard externalities in terms of availability of particular resources.

As Wignaraja et al (2004) argued regional cooperation between small states can also lead to useful synergies such as foreign direct investment sharing of institutional frameworks including financial institutions and entrepreneurship training. Such regional clustering would also reduce duplication efforts by small states who would economise on overhead costs.

Regional cooperation to mitigate scale disadvantages

As already explained, due mostly to the problem of indivisibility of overhead costs certain regulatory frameworks necessary for good economic governance and for promoting competitiveness may be prohibitively expensive for a single small state on its own but may be affordable regionally.

For this reason small states would benefit through regional cooperation by jointly undertaking policy-measures conducive to resilience building.

In this regard, the small states of the EU benefit from their membership of regional integration.

Attraction of investment

Another advantage the competitiveness and resilience building generate of small states relates to the attraction of investment.

FDI tends to be attracted by countries which have a large domestic market and natural resources endowments. Small states tend to be disadvantaged in this regard.

Good economic governance, which lead to competitiveness and resilience could make up for these inherent deficiencies, and can act as attractions for FDI.

8. Concluding Remarks

Concluding Remarks

An important message of this presentation is that while it is true that Small States are economically vulnerable and face competitiveness constraints in view of their small size, this reality should not be construed as an argument for complacency on the part of Small States because remedial policy options are available.

There are many examples of Small States that register economic success in spite of their small size and insularity. Such success is to a large extent attirbutable to good economic , social and political governance.

The End

Thank you for your attention