



Marc Hollingsworth, Media Support International

How Small States Prosper Despite their Economic Dependence

Small states are like pygmies in a world of giants on whom they depend for their very existence. Caribbean countries are all wholly dependent on the wealthy countries of North America and Europe from which their tourists come, to which they sell their exports and from which they buy their imports. That is as true of the politically independent countries as it is of Martinique and Guadeloupe, which are integral parts of the French Republic, Puerto Rico and St Thomas, territories of the US, Aruba and Curaçao, constituent members of the Kingdom of the Netherlands, and Anguilla and the Caymans, which are UK dependencies. Foreign currency is the source from which all incomes are ultimately derived while imports provide the consumables, vehicles, machinery and inputs with which all economic activity is conducted. The values of the local currency are determined by the amount of local currency needed to purchase one US dollar.

We should not think of the dependence of small economies as a weakness; it is simply a circumstance of their existence that they must negotiate.

There are numerous examples of states as small as those of the Caribbean that are among the world's wealthiest and most developed countries. Their number includes Bermuda, a UK dependency, Malta, a member country of the European Union, and Iceland, which is wholly independent politically.

Key factors in the performance of all successful small economies are their reputation for prudent management of the public finances, efficient public sector administration, and public services and infrastructure that is of high quality.

A simple test of good financial management compares the current spending of the public sector - the cost of operations and interest payments - with tax revenue. A prudent government maintains current expenditures below revenue so as to sustain a small surplus that may be used to contribute to public investment projects and to build precautionary reserves.

The prudent government borrows sparingly on local and international markets and only for hospitals, schools, public infrastructure and other public facilities that are vital to the economy and society. It manages its debt conservatively, to ensure that it has the capacity to service debt fully and on time in all probable circumstances.

Prudent management of the public finances provides several benefits.

It earns the government an Investment Grade of credit worthiness in international financial markets, leading investors to value the country's bond issues highly, and they attract favorable rates of interest as a result. A country with an investment grade rating is also able to improve economic resilience using its access to the international market for loans to accommodate shocks that were not anticipated, as Bermuda did during the Covid-19 pandemic.

An investment grade rating for the country's sovereign debt has the added benefit of making investment in profitable domestic companies a more attractive proposition for foreign investors. The standard practice of credit rating agencies is to use the sovereign credit rating as the baseline for the evaluation of the credit worthiness of domestic companies. The fact that so few Caribbean sovereigns enjoy an Investment Grade of international credit worthiness puts domestic firms at a disadvantage in accessing finance from the international market.

In addition to their reputation for financial prudence, the governments of prosperous small economies are known for the efficiency of their public administration, the high quality of health, educational and social services, and investment in modern ports, airports, road networks, and transport and communications services. These services not only contribute importantly to public well-being and the quality of life; they are also among the factors that attract foreign investors to the economy and enhance the country's international competitiveness.

The experiences of small wealthy countries suggest that, in their quest for faster growth and greater resilience, Caribbean governments would do well to focus on the fundamentals of good financial management and the efficient delivery of high-quality public services and infrastructure. The payoffs are enhanced competitiveness that attracts growth-promoting investment and improved access to international finance for structural changes to cope with international supply shocks and the impact of climate change.

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