Rising Above the Orthodoxy of Finance: Competitiveness Is the Key to Economic Growth

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Abstract

This essay advances the argument that policies to maintain and enhance international competitiveness are key to unlocking the growth potential of small very open economies like those of the Caribbean. The SVOE specializes in the export of a small number of goods and services which it is able to produce at internationally competitive prices; with the foreign exchange earned, it buys the wide range of consumption and investment goods that a modern economy requires. The economy grows by attracting investment to increase productivity and add value to the competitive products and services produced for the international market, thereby increasing foreign earnings and the access to imported goods and services. The competitive returns offered by the export sectors attracts all the foreign and domestic finance SVOEs need for investment. Government's development policy role is to provide efficient public services and infrastructure and ensure macroeconomic stability, both of which affect the country's competitiveness, and to provide incentives and support for private sector-led innovation and for SMEs.

Keywords

Competitiveness, economic growth, development finance, small open economies, macroeconomic policy, economic stability, Caribbean economies

JEL classification

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This essay advances the argument that policies to maintain and enhance international competitiveness are key to unlocking the growth potential of small very open economies (SVOEs) like those of the Caribbean. Because our economies are so small, they can interest foreign financiers in any investment project which offers an internationally competitive rate of return. The task of domestic policy makers is to stimulate such investment by identifying the factors which make the economy stand out in the international market, and to provide incentives and support for investment in those competitive-enhancing qualities. Policy makers also need to identify the domestic barriers to investment and growth, and find ways to overcome them.

Investment drives growth in the SVOE

As investors seize opportunities to make profit, in tourism, agriculture, manufacturing, services, transport, renewable energy, and other competitive activity, they create additional capacity, which promotes employment and growth. There is no limit to the international demand for Caribbean products and services that offer value for money to foreign consumers. These are the products that provide the foreign exchange on which economic growth depends. (In contrast to the unlimited demand for tradable goods, the demand for Government and other nontradable services is limited to the amount of domestic income, but that does not matter, as nontradables earn no foreign exchange and therefore they cannot be the engines of growth in any case.)

There is never a shortage of finance for investments which are clearly profitable, undertaken by companies with strong balance sheets. However, it is often the case that there is insufficient finance for investments in infrastructure, health, education, public order and other public services, which may not offer opportunities for private investors to make a competitive rate of return. As we shall see, these are all desirable investments that impact the country's economic competitiveness. This is where fiscal policy comes to bear: Government’s revenue, expenditure and financing policies play a vital role in the growth strategy, through providing the infrastructure and public services that by their nature cannot attract private investment.

On the revenue side, fiscal policy should provide incentives for investment in foreign exchange earning activities, and taxes should be structured to have a modest redistributive effect on incomes. Government services should be delivered with tolerable levels of efficiency, by international standards. All Caricom members suffer from public services that are well below acceptable standards, and this is a serious brake on investment. Government should also provide performance-related finance and other support for SMEs and for innovations in which the private sector has first shown interest. Experience has taught us that our Governments are hopeless at identifying potential for competitive new investment. Instead, Government should target promising activities in which there is already serious private sector interest. Protection of the most vulnerable in society through suitable safety nets should also be a priority of Government spending. The management of fiscal resources to achieve these objectives simultaneously, while respecting the preferences of a substantial majority in society, is a matter on which the academy offers Governments little by way of practical guidance, even though it is a central concern of actual political economy.

Government has the responsibility for investment in roads, schools, sanitation, hospitals and other public infrastructure that, by its nature, cannot offer an attractive rate of return to the private investor. Some infrastructure, such as waste management facilities, is for services provided by Government; other investment, for example in the road network, provides infrastructure essential for the private sector. Some investment Government may undertake on its own account, while other public investment services may be contracted out. The choices are up to individual countries.

The financing of Government expenditures matters for competitiveness and investment because it may affect foreign reserves and the stability of the exchange rate. An exchange rate which is subject to capricious changes is a major deterrent to investors, because of the resulting uncertainty of wages and prices. Expected returns on investment become less predictable, and returns to domestic investment become less attractive compared to what may be available in competing markets.

Government borrowing causes a fall in foreign reserves when Government needs more financing than private lenders at home and abroad are willing to provide. That invariably results from overspending by Government on wages, subsidies and other recurrent expenditures. Such expenditures should always be met fully out of tax revenues, with about 2 percent of all revenues remaining, as savings to help with funding capital expenditure. By managing its budget in this way Government ensures that all borrowing is devoted to investment that adds to public wealth. That provides Government with the wherewithal to service the borrowing which was used to finance the public investment.

If Government manages its budget in this way, it will be able to fully finance public investment with a combination of domestic and foreign borrowing, from official institutions and by the issue of domestic and foreign currency bonds. Financiers will be happy to buy bonds at competitive interest rates that remain affordable because prudent fiscal management ensures Government of a favourable "investment grade" credit rating.

However, Government will begin to encounter problems when it becomes necessary to borrow to cover shortfalls in revenues, to cover the recurrent costs of Government operations. Private financing will soon dry up as investors question Government's ability to service debt which adds nothing to public assets. Officials then resort to the central bank for the funding needed. Central bank lending is problematic, because the Central Bank's funding is in domestic currency. However, when this money is spent, whether for wages, purchases or transfers, it generates a demand for imports, as do all expenditures in SVOEs. Securing the foreign currency from Central Bank to purchase additional imports subtracts from the Bank's foreign reserves. If the overspending on Government's current account persists, the loss of foreign reserves triggers a devaluation of the currency. Fiscal policy that respects the Golden Rule,[1] setting aside 2 percent of tax revenue in current account savings, remains the surest protection for the stability of the exchange rate, and a strong incentive for investment and growth.

[1] The Golden Rule states that over the economic cycle government will borrow only to invest and not to fund current spending (Wikipedia).

All investment in the SVOE requires foreign finance

All investment in countries as small as those in the Caribbean requires finance in foreign currency to purchase equipment, vehicles, materials, fuels and other inputs from abroad, for each new project. This is true whether the project is large or small, private or public, for domestic production or export. It follows that all investment of necessity requires a substantial proportion of foreign finance. The implications of this obvious circumstance are not well understood. Everyone laments the low domestic savings ratios in the Caribbean, and we hear regular exhortations to increase domestic savings, supposedly in order to stimulate growth. However, domestic savings are in local currency; in order to do any investment the saver has to acquire foreign currency in addition to (or in exchange for) their savings, because their domestic currency cannot be used to pay for the imports they need. On the other hand, foreign currency can be used to buy domestic goods and services, if domestic savings are in short supply. It follows that there can never be a shortage of finance for competitive investment in the SVOE. If local savings are insufficient, foreign financiers are happy to step in, to take advantage of the competitive rate of return on offer. Equally, domestic entrepreneurs who are well established and of good standing never have a difficulty in securing foreign funding to cover the imports needed for their investments.

It is the competitiveness of investment projects, not the supply of domestic finance, which limits the rate of investment in well established areas of activity. There are, however, important areas that banks and financial institutions will not fully take care of, and where Government policy intervention is needed. These include innovative projects, investment in public goods, and small and medium enterprises.

Official support for innovation

Renewable energy is the sector that has the greatest potential for accelerating Caribbean growth, of all the new activities that are under active consideration in the region. With a combination of solar, wind, thermal, biogas and hydro power many Caribbean nations can switch all their power needs to renewable sources, using established, proven technologies for electricity generation, transportation and power. However, no Caribbean country has developed the road map and long term action plan that would put the country on a path to 100 percent renewable power.[2] In the absence of a road map that is published by Government and endorsed by the population at large, and of an action plan that provides annual checkpoints to measure progress towards the target, the 100 percent goal will not be achieved.

A second area that is yielding significant growth for the Caribbean is culture. It is a fact of life in our small economies that any activity that rises to a level of national economic significance must of necessity be aimed at an audience beyond the national boundary. Caribbean cultural products do have a global audience, and have had an international following since the earliest days of sound recording. Nowadays Caribbean music is consumed worldwide, Caribbean singers and musicians have achieved legendary status, Trinidad has redefined the street festival and provided the world with a fabulous new musical instrument of fascinating complexity (the steel pan), our

[2] The Central American country of Costa Rica generates almost all (98 percent) of its electricity from renewable sources (mostly hydro, but also geothermal, biomass, solar and wind (Wikipedia). However, that constitutes only about half the country's total energy needs.

writers are household names in English literature, and our islands offer singular cultural experiences of many varieties. All told, the income earned by Caribbean cultural practitioners annually must surely be considerable, and the numbers employed significant.

However, in the national accounts of Caribbean countries, the contribution of culture does not appear. That is because of the way the accounts are prepared. In the tourism sector, the consumer comes to the product, a holiday in the Caribbean; in the cultural sector, the musician travels to their overseas gig, the writer publishes in London, Toronto or New York. Their earnings may or may not come to the Caribbean, even if here is where they live. After all, their business calls for frequent foreign travel and involves the purchase of computers, equipment and supplies which must be sourced abroad.

The fact that we measure cultural income inappropriately leads Government policy astray. Caribbean Governments aspire to national policies for the development of cultural industries, with no clear idea of what such policies might consist of. Common sense suggests that the way forward is to obtain feedback from successful cultural practitioners as to their future plans and aspirations, and collaborate through the Caricom mechanisms to facilitate these activities in whatever way seems most effective. Once again, a road map which is widely endorsed, and an action plan with annual markers for progress are essential. In the case of the cultural industries, both road map and action plan would need to be regional in scope.

There is much that might be done along similar lines to sharpen the Caribbean's competitive edge in tourism, internationally traded services, agriculture and manufacturing. Examples include seed funding for eco- and heritage tourism, providing design and customer orientation services for international companies, and promoting Caribbean branding of quality rums and value-added products. What is required of our Governments is to take the lead from successful private entrepreneurs large and small, and to offer the support these pioneers need, conditional on the achievement of performance targets.

Public services

There is a consensus in Caribbean societies that services such as law and order, primary education, heath and sanitation should be available to all, regardless of income, physical ability or mental acuity. Exactly where the boundary of public services lies varies from country to country, and both the outer bound and the quality of services provided depend on average incomes, the efficiency of the public service, and the social consensus on the balance of the burden of taxation and the quantity and quality of public services provided.

The public services that matter for competitiveness and growth include roads, ports, airports, waste management systems, public utilities, transport and communications. The two most widely cited reports on international competitiveness are the World Bank's *Doing Business Report* and the World Economic Forum's *Global Competitiveness Report.* The World Bank assesses the Government's administrative ability in processes affecting the establishment and operations of businesses, including trade and taxation. All Caribbean countries score badly in the World Bank's assessment. The more comprehensive assessment by the World Economic Forum includes analysis of roads, ports, air transport, electricity supply, and overall infrastructure; legal and judicial systems and processes; health and education; labour and goods market efficiency;

financial market development; business sophistication; innovation and technological readiness. In addition there are criteria of market size, where the Caribbean is at a permanent disadvantage, and the macroeconomic environment, which has been deteriorating across the Caribbean.

There is a general lack of appreciation in Caribbean leadership about the nature of this problem. The deterioration in all the areas listed in the previous paragraph is widespread and obvious. Throughout the Caribbean, citizens are confronted with examples of Government ineffectiveness and inefficiency on a daily basis, as they go about their business. Our Governments have been promising improvements in public sector performance for two decades or more, but services continue to deteriorate. It should by now be clear that the policies that have been tried to date are ineffective. They consist of changes in legislation, adding additional staff, and purchasing computers and software. However, there has been no change in how Government is organised, and incentive and compensation systems for public servants have fallen far below comparable levels in the private sector, as well as international and government agencies abroad from whom the Caribbean might hope to attract senior officers. The change that is required must be thorough-going, involving entirely new organisational processes, replacement of the senior personnel of the public sector, a drastic reduction in numbers, and entirely new compensation systems adequate to attract an international level of skill.

Small and medium enterprises

Small and medium enterprises (SMEs) provide a significant proportion of jobs in most market economies, and they act as an essential lubricant for the labour force, easing transitions due to new technology or changing market forces. When companies fold, some employees go into business for themselves; small security firms provide employment for many retirees who need to supplement their pensions; and restaurants and the gig economy offer entry level and part-time jobs for people who need flexibility or a toehold on the job market. These are a few examples of the ways in which the SME acts as a catalyst for labour force adaptation to change.

Despite their importance, SMEs are epheremal creatures, with a short average life span and a high failure rate. Even small family enterprises of long standing seldom survive the death of the founder. In order to ensure the vibrancy of the SME sector, given its important role, Government needs to offer significant support, often including finance and guarantees. Experience suggests that this is best done via independent non-governmental organisations.

Growth-promoting strategies for Caribbean Governments

The most important growth-inducing strategy needed of Caribbean Governments is the modernisation of the public service to achieve internationally accepted levels of efficiency. Our benchmarks should be small economies that are in the highest category of development in the annual *Human Development Report*, countries such as Ireland, Iceland, Singapore, Luxembourg, Malta and Cyprus. The failure of repeated attempts to reform the public sectors to date teaches us that the Caribbean and international institutions we have hitherto depended on lack the knowledge, experience and capacity to guide our Governments towards successful implementation of the change that is needed. Our Governments must seek relevant expertise from the world's leading international consultants, choosing those who have experience with small countries with very high human development, such as those we have just mentioned. The extent of reform required will necessitate a medium term action plan for implementation, with performance criteria related to the elements of the *Doing Business Report* and the *Global Competitiveness Report.*

The reform will result in a much smaller number of employees in the public sector. Public servants will be more highly skilled and better paid, particularly in the higher levels of expertise. At the top of the public service there should be a handful of officers of international standing, whose remuneration must be adequate to recruit the calibre of person needed to build and maintain the credibility of the new, efficient public service. The process of converting our current under-resourced, ineffective and largely demoralized public service into one that compares favourably with Ireland, Iceland and Singapore will need to be carefully prepared for, managed and financed, to ensure that livelihoods are not destroyed in the process.

The reformed public sector will stimulate growth by addressing the critical factors identified in this essay:

- Improving health, education, public order, public administration, and other public services that feature in the *Doing Business* and *Global Competitiveness* reports;
- Devising road maps and action plans with deadlines for renewables and a Caribbean regional cultural industry, in close collaboration with stakeholders;
- Fortifying the international reputation of the Caribbean brand in tourism, rum, international services and other areas where the region has a strong competitive position, working in collaboration with regional private sector organisations to eliminate regional frictions and redundancies;
- Supporting innovation with incentives and targetted finance which is performance-related, using regional and international networks to ensure access to skills and markets;
- Providing support and finance to SMEs through the agency of NGOs.

In addition, Governments should ensure a favourable climate for investment by maintaining a small surplus on the fiscal current account. All borrowing, in local or foreign currency, should be devoted to expenditure which adds to national wealth. In this way there will be no borrowing from the central bank to create new spending and imports, no excessive foreign reserve loss, and no rumours of devaluation.