# TRADE AND ECONOMIC GROWTH IN SMALL DEVELOPING ECONOMIES
# LESSONS FOR THE CARIBBEAN

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## 1. Overview of Trade and Growth in Small Developing Countries

Is there much we can glean from economic theory, empirical analysis and observation of economic performance about the trade policies which might best promote growth in the Caribbean? Will Caribbean countries enhance their growth potential by the use of policies which promote a greater proportion of traded activity? Does it matter what commodities are traded, and do countries need official policies to determine the composition of trade? Are trade deficits essential to growth and is there a limit on the feasible size of the deficit? Should these issues be examined in the context of individual states or at the level of the Caribbean region as a whole?

There is a confusing number of theoretical propositions about the relationship between trade and growth, offering a variety of responses to the question whether trade promotes growth, and a welter of policy implications. Drawing on Findlay's [1984] comprehensive survey we may first identify the dynamic Ricardian view, that trade boosts saving and investment by switching income from feckless rentiers to thrifty industrialists, or, more generally, from sectors which are less competitive to those that are more competitive in international markets. In a world of many commodities, many countries, slack resources, technical change and varying tastes it is difficult to identify the circumstances which might secure this outcome.

There is an alternative less optimistic model attributed to Lewis [1961], [1977] which warns of unequal returns from trade to countries with low productivity in the supply of the wage good. Some, including Findlay [1982] have expressed reservations, and the model has received little empirical attention. Dependency theorists insist that unequal exchange between developed and developing countries is inherent in the nature of capitalist production, or in the structure of multinational corporations or in international political relationships. The difficulty lies in demonstrating that the inequality is inevitable.

Neoclassical theories may be constructed to show how trade may accelerate or depress growth, depending on factor intensities, factor supply, the bias in technical progress and the elasticities of demand and supply for the many products traded around the world. The Harrod-Domar class of models may be applied to open economies, to derive a rate of foreign savings to national output which is consistent with stable growth. Foreign savings will be matched by the trade deficit, which can therefore be deduced. Yet another school of thought is sceptical of increased trade dependence and seeks to promote growth through trade protection, to protect infant industry, to overcome obvious distortions of the world market and to provide an opportunity for domestic firms to learn by doing. Then there are the two-gap and three-gap models, where growth is limited by the available

foreign exchange, domestic saving or domestic absorptive capacity. Detractors claim the theory is invalid because changes in policies affecting relative prices may relieve any of the constraints, but they neglect the time dimension for such adjustment.

The theories of trade and growth seem to fall into three categories. There are those that suggest trade enhances growth potential by allowing a country to specialise in the things it produces most efficiently, and to exchange them for a wide variety of consumption goods, at the same time providing a larger surplus for investment. The Ricardian and neoclassical theories are of this genre. Secondly, there are the theories which imply that trade allows the exploitation of the country's human, natural and financial resources for the benefit of larger, stronger or more developed nations. The Lewis, dependency and protectionist theorists are in this camp. Then there are those who believe that trade allows a country access to international resources and knowledge to supply local deficiencies, thereby enhancing growth prospects. Lewis is also in this camp, along with two-gap models and, more recently, open systems theories. The most signal theoretical contribution in the Caribbean in recent times has been the stress on the importance of the supply from abroad of knowledge and information as inputs for growth.

Country size is an important additional dimension of the theory as it relates to the Caribbean. The larger a country the

better the prospect that it may internalise the classical gains from trade. But trade is vital to small countries because it is only by selling abroad that firms may grow large enough to benefit from economies of scale and have access to a diversity of resources. And only by purchases from abroad may the small country satisfy a demand for an increasing range of sophisticated consumption goods. This circumstance need not condemn small economies to perpetually inferior status and welfare. If size is ignored and classical policies applied the small economy may stagnate, but with studied use of appropriate policy growth is possible.

What may we say about the policies appropriate to small economies, using the available theory? It will be necessary to base the discussion on a model which incorporates specific institutional features, since not all trade strategies will be helpful, in every circumstance. In particular, we shall have to consider the implications of limited capital and labour mobility. In experimental models based on a north-south division of the world, Findlay [1984] found that capital mobility depressed growth in the south, but that labour mobility was always benign.

Trade theory in the Caribbean in the post-world-war-II period first derived from the ideas of Lewis [ ]. To assure gains from trade, productivity in agriculture should be raised; industries were to be encouraged to absorb the labour released by more productive agriculture, and to reduce the number of the

already unemployed. Foreign saving was to be solicited for the new industry. These policies were displaced in the 1970s by the adherents of the dependency school who believed that trade led to exploitation and impoverishment. Their policy prescription was for a closed economy, depending on the development of internal linkages. Recently there has been a return to open economy strategies, though their theoretical justification still appears confused. Insofar as the new strategies originate with the recommendations of the World Bank and the IMF, they bear a neoclassical stamp (though, we shall argue, neoclassical theories may be constructed to suggest a bias against trade with the same facility as for trade-supporting versions). There are also infant industry arguments for a trade-oriented strategy. The time may now be ripe for a more fully articulated theory of the link between trade and growth as it might obtain in the Caribbean, so as to determine what policies best service the relationship.

The small developing economy will not necessarily benefit from promoting trade. One may write scenarios where all the gains from trade are lost to larger, more developed partners and where domestic skills, money and natural resources are depleted. But small countries must trade in order to enhance material well-being. With appropriate policies it is possible to avoid exploitation and realise gains. This will be the thrust of the argument in the present study. There will be sections devoted to

analysing why the small economy is necessarily open, how that economy may nevertheless achieve trade independence, the role of economic integration in securing independent trade policies and growth, the nature of the foreign exchange regime needed for the same goal, and other policies which may enhance prospects of growth through trade.

## 2. Size and the Relative Importance of Trade

Until very recently most Caribbean economists viewed the considerable importance of trade in these economies as undesirable, to be curtailed or reversed in the interests of growth. The antipathy to high trade ratios was largely grounded in historical experience. The old mercantilist system typical of much of Caribbean history rationalised trade on the basis of surpluses for use in the mother country. Colonical interests could be neglected, and there was little effort to encourage home-grown expertise, diversification and sympathetic consumption patterns in the colonies. The first theories of development in the Caribbean were based on the development of export agriculture, which seemed to condemn the Caribbean to be a source of cheap agricultural labour in perpetuity. Lewis argued for open industrialisation but his strategy still seemed to be based on cheap labour and limited retention of surpluses for domestic investment (arguably a misinterpretation; see Findlay [1982], p.10). Hence, in the late 1960s, a majority of economists turned toward strategies involving less trade orientation.

The late 1960s were a period when there was considerable international opinion in favour of import-substituting policies in third world countries. Import substitution was said to offer possibilities for backward and forward linkages, maximising the domestic spin-off from every activity and increasing the retention of earnings. Backward linkages derived from the basic materials and ancilliary services used by new industry and forward linkages were measured in terms of further elaboration of industrial output. This integrated production system was to be complemented by domestically-oriented consumption patterns, using policies such as tariffs, quotas and public investment to guide the economy away from trade towards a greater measure of self-sufficiency.

Import substitution has rapidly fallen from grace in the 1970s, in the Caribbean and elsewhere. The extraordinary success of the far eastern 'Gang of Four' has given the lie to sceptics of trade-oriented development strategies for small economies. The concurrent revival of the neoclassical tradition in economic theory has been used by advocates of free trade to take the high ground, supported by articulate restatement of arguments for trade liberation by Balassa, Krueger, Ranis and others.

However, the neoclassical arguments are no more convincing today than their predecessors were twenty years ago. We will

discuss some of their ambiguities. Fortunately, one may support export-led growth without resort to neoclassicism. It has to be admitted that import substitution strategies for small nations are weakly based in theory and have completely fallen down on implementation.

(a) Import Substitution

The import substitution strategy placed heavy emphasis on domestic links in production - suppliers in the home country would look to purchases from local producers. However, it turns out that there are very few domestic linkages of any importance in small economies, while there are very rich possibilities for linkages to the international economy. The catch is that trade linkages require greater skill and knowledge, and the returns may have to be shared with trading partners.

In implementing import substitution policies a majority of developing countries supplanted private marketing arrangements wholesale. 'Free' markets do not exist anywhere in the world: all trading arrangements are controlled by specific laws, conventions and habits which may vary tremendously from place to place and over time. Where markets are not subject to intelligent regulation they are invariably exploitative and inefficient, poorly informed and manipulated to the unfair advantage of a few participants. But that does not mean that markets are always inefficient and that government officials

should determine economic allocation. We need a theory of regulated markets to provide generalisations about the extent of intervention for different market structures. The widespread use of quotas (for imports and foreign exchange, in particular) and abortive attempts at global price controls are the principal evidence of misguided intervention. Quotas should be employed only where tariffs will not achieve the same objective, and administered allocation should be selective, never replacing prices completely. Prices allow freedom of choice and they distinguish the more enterprising firms from those which employ resources which could be put to better use elsewhere. But they have none of these beneficial effects in the absence of careful regulations and adequate institutional support.

The protagonists of import substituting policies usually attempted to limit freedom of choice in consumption. This approach is objectionable on moral grounds: has the society given the political leadership a mandate to restrict their freedom of choice? It is also a practical question: can consumption choices be restricted so as to enhance production growth and raise material well-being? It appears the answer is no. Attempts to restrict consumption encourage rent-seeking, weaken incentives to produce, shield incompetent firms and provide no legal redress against sloppy workmanship and service. In any event the diversity of consumption needs

in any society which has risen above subsistence severely limits the possibilities for import substitution in a small country.

(b) Neoclassical Arguments for Trade Orientation

Theoretically it is simply not true that more trade will enhance a small country's growth potential, having regard to changing technologies, the limitless variety of forms of information, myriad information channels, shifting cartels and oligopolies in world trade, a variety of co-operative arrangements and quotas voluntary and imposed. By choosing appropriately among these features you may derive any result you like.

Neoclassical arguments for trade orientation remain vague about the source of comparative advantage, but the basis apparently remains factor intensity. Since capital and technology are mobile internationally this reduces to a basis of labour intensity. However, labour is not homogeneous. To some extent labour may be differentiated by level of skill, which can be measured, however inadequately. But even with the same training and equipment workers from different cultures and with different backgrounds show differences in productivity which swamp the effects of skill differentials. To determine comparative advantage implies comparisons of real unit labour costs (combinations of real wages and productivity),

but the problems of measurement are formidable. This difficulty lies behind much of the confusion in recommendations on trade policy (for example the magnitude of devaluation needed to ensure competitiveness). It is also difficult to measure a country's labour endowment in terms of a basket of different productivities.

Neoclassical theorists are wont to pretend, in the face of all evidence to the contrary, that trade relationships are not unequal. Although dependency theorists have failed to make a convincing case for the inevitability of unequal exchange in all circumstances, they have provided a large body of documented cases of inequity. Lewis makes a convincing case against the cruder interpretations of the neoclassical arguments for growth. They presume that competitiveness may be enhanced by selling domestic labour services more cheaply than the services of equally productive workers elsewhere. This passes the benefits of productivity gains to the consumers of industrial countries, and any strategy founded on this premise will impoverish the producers, relatively if not absolutely.

Neoclassical theories share with import substitution theories an inability to deal with uncertainty and expectations, except in a mechanical and unrealistic fashion. This allows them to relegate to the periphery questions of exchange rate uncertainty, capital flight and interest rate volatility, not to mention social and political factors. Even if comparative

advantage may be defined, for some countries their comparative advantage may be unattainable because investment is inhibited by a government with poor claims to political legitimacy or by a history of apparently capricious exchange rate and interest rate changes.

(c) An Alternative Rationale for Trade Orientation

The Lewis strategy for development deserves reconsideration. Admittedly, the attempt to combine improved agricultural technology, industrialisation led by foreign capital and measures to slow down population growth has not been a conspicuous success in the Caribbean. With the help of foreign investment the manufacturing sector did make a major contribution to employment, but it fell short of what was needed to absorb the surplus labour force. The major contribution to growth in the Caribbean in the post-war period came not from agriculture and industry but from minerals and tourism. Nevertheless, there seems nothing inherently flawed in the Lewis argument and it continues to have intuitive appeal. The objections which have been advanced based on experience have validity, and they indicate that expectations about the speed of growth and degree of economic independence should be tempered, but they leave the fundamentals of the strategy intact.

One objection to the industrialisation strategy was the relatively small contribution to income and foreign

exchange because of the proportion of leakages to total output. Clearly the manufacturing sector could not be the main source of income growth, unless its expansion were exceptionally rapid. However, its contribution to employment was disproportionately large, and labour absorption has proved the major contribution of the manufacturing sector.

A second criticism has centred on the foot-loose nature of most foreign-owned manufacturing in the Caribbean. Since the Caribbean has a relatively narrow resource base and a tiny market, most secondary and tertiary activity is resident by choice rather than necessity. The ability to migrate if there is sufficient incentive is not peculiar to foreign-owned firms. A third objection, that foreign owned firms do little re-investment is based on the common assumption that scarcity of saving is a brake on investment. This view will not bear the weight of critical scrutiny.

The combination of increasingly productive agriculture and manufactured exports contains the germ of a feasible trade-oriented strategy. However, it will not suffice to produce food for the home market only; export markets must be found to absorb the increasing output which fewer agricultural labourers are able to produce. The third plank of the strategy must be the judicious exploitation of natural resources, including minerals and tourism potential. They earn foreign exchange to support the investment

programmes in other sectors and they may provide a cushion of foreign exchange reserves to improve the insulation of the economy against external disturbances. Population control and the encouragement of migration are helpful adjuncts to the strategy.

A trade-oriented strategy opens the economy to knowledge from the wider world - about products, processes, markets and technology. Improved knowledge and investment in the human resource is ultimately the key to self-generated economic growth in small economies. Knowledgeable people will be able to identify investment opportunitites by virtue of their familiarity with markets and production processes. They are less likely to fail because they understand the hazards of new ventures, and will develop flexibility, by looking at a variety of scenarios and by developing contingencies. They will be more adept at bargaining and at coping with the regulations that govern all markets. They have better understanding of the tools of market penetration. It has come to be accepted that government cannot direct the growth of Caribbean economies; initiatives are required in thousands of different areas of the economy. The largest gains are realised when the information and skills of individuals who are in positions to take these initiatives are constantly enhanced. The most effective way to achieve this is by interacting with the rest of the world.

(d) A Trade Oriented Growth Strategy

Small developing countries may secure dependable growth by the use of an export-led strategy. It provides foreign exchange to support variety in consumption, it encourages the acquisition of knowledge by intensifying international contacts and it exploits international production linkages, which enable the small country to benefit from economies of scale. In order to maintain competitiveness managers must be skillful enough to choose products and processes suitable to the economy's institutional wage. The wages bill is the principal instrument for improving material well-being. The elasticity of demand for labour must be quite high if wage reduction is to induce sufficient additional employment to enlarge the wages bill. With wages everywhere in the Caribbean at levels which are generally considered at or below the minimum required for a decent standard of living, wage reduction is more likely to result in industrial dislocation than in substantial employment gains. Business success depends on the ability to choose technologies which are profitable at the institutional wage, and to anticipate changes in products, markets and processes as real wages increase.

3. Size and Dependency

This section enquires whether small countries are necessarily dependent. By dependency we mean an inability to

secure improvement in material well being through domestic decisions. Small countries are very vulnerable to the vagaries of world trade, but their unobstrusiveness can be made to work to advantage. If policies are implemented without regard to size economic independence may be impossible, but by taking actions to accommodate to their limitations small economies may provide themselves with scope for independent action.

Small countries are exposed to the fluctuations of international commerce which affect all developing countries, but to a greater degree than for large developing nations. Where they have not recorded terms of trade losses the variance of export prices has been destabilising, and factor prices have not kept pace with those of the industrial world. Small nations have weak bargaining power in negotiations among governments and with international firms. The available technology is seldom geared to their needs, since it is developed by people who do not share their concerns. There is an acute brain drain because of the limited scope which the local economy can offer to first-rate minds. It is often difficult to establish and maintain up-to-date information systems. It is more difficult to reach a scale of operations where the firm begins to reap economies, because that involves the demanding business of exporting. Except for a few areas of great geopolitical importance small countries suffer from

political neglect which further diminishes their international bargaining power.

On the other hand, the trade policies of small economies are unlikely to invite retaliation, and a small slice of any major export market will be sufficient to provide a considerable boost to output. A few major successes can quickly show up as a faster overall growth rate. Internal communications are less costly per capita, and it is cheaper to provide the infrastructure to spread gains from economic growth throughout the community. If they can arrange joint positions small countries may achieve disproportionate voice in the international community where representation is invariably on a national basis. Good leadership may achieve notable economic success in small economy, but poor government may be more harmful than for larger countries.

Small countries must accept that trade will be very large in relation to GDP and that growth will depend on the expansion of exports. If they are to gain economic independence they must search out policies which give local decision makers greater influence on the export sectors and resilience in the face of world trade fluctuations.

Deliberate policies should be undertaken to foster a variety of exports. It is still typically the case that the small country specialises in the export of one or two

commodities. Because of the importance of trade, diversification is especially desirable as a cushion against the vagaries of any one market. Diversification is also especially difficult for small countries to achieve, more because of their limited export marketing skills than on account of their narrow resource base. In addition, export growth may be made more resilient by building loyalty to the country's products and establishing a durable presence in specialised markets.

These policies require the support of high powered information systems, and they can be implemented only by knowledgeable managers. The greatest emphasis should be placed on the development of information and communications; they are the means to relieving many of the constraints on small economies. A well informed agent for a small nation is much better able to secure a favourable contract, to uncover a firm potential market, to find a way around technical barriers and to identify appropriate technologies. Equal emphasis must be placed on developing human potential, so as to augment the supply of skillful managers. International standards in education, encouragement of overseas travel and migration and support for intellectual pursuits make important contributions to an enlightened productive citizenry.

The small country must also provide itself with good insurance policies, the most crucial being a healthy reserve

of foreign exchange to cushion the impact of balance of payments fluctuations. Ample reserves improve the country's credit worthiness, giving an additional balance of payments cushion. Fiscal deficits should be small enough to leave free resources in the financial system, so that government may moderate the effects of economic fluctuations by evening out expenditures somewhat without calling on the Central Bank.

Small economies should target expenditure growth on the medium term prospects for exports, using conservative estimates of market potential. Foreign reserves and fiscal policies should be designed with the worst-case scenario in mind, so that there is enough insurance to cover this eventuality. It should then be possible to avoid abrupt destabilising shifts in policy and to adapt to changes in foreign markets for goods, services and finance. The small nation also needs co-operative arrangements with neighbours and others who share its interests, at the level of the firm, the sector and the nation.

A small country may secure its economic independence by controlling the pace of export-led growth in a world of larger neighbours with volatile economic fortunes. It requires able, well-informed managers, and a diversified basket of exports, containing some highly differentiated items for which the country has become well-known. The balance of payments and public policy must be geared to providing ample

foreign reserves, and a network of international agreements, with neighbours, other small countries and others who share particular interests should be maintained.

4. <u>The Economic Community</u>

Those who believe that small size condemns a country to economic subservience see the creation of an economic community as essential for development. Since we insist that small nations may indeed chart their own economic course we do not ascribe to economic integration such a central role. A grouping of countries as small as those in the Caribbean hardly gains in size on the world scene, compared to individual members, and will be subject to most of the same size disabilities. Furthermore, integration will be to no avail if individual countries do not develop the human resource, give priority to information systems and manage expenditures in a conservative manner. However, with good policy regimes integration can enhance growth prospects, provided there are safeguards against uneven distribution of gains and losses.

Classical customs union theory, based on Pareto optimality, does not offer a strong argument for economic union in the Caribbean. Because of weak complementarities there is not much scope for Pareto-optimal trade creation; most intra-regional trade is diversion, which reduces welfare

according to the Pareto criterion. The union would nonetheless be beneficial if it served to improve income distribution, but it is not clear that it would necessarily do so.

The argument for the creation of Caricom was therefore based heavily on the potential economies of scale and the need to nurture infant industry. Once we accept the need for an export-oriented growth strategy the economies of scale which may be obtained in industries producing for the regional market are seen to be of trivial importance.

The economic community is more important as an incubator for new industries which are potential exporters outside the Caribbean. Many firms need to be protected until their output grows to a level where they begin to experience scale economies. Ideally, support for infant industry might be in the form of a subsidy, but for budgetary reasons, protective tariffs are usually preferred. Within the community a larger variety of processes might be encouraged in this way. There has been some academic scepticism about the need for infant industry protection. If firms expect to be profitable why would they not absorb the learning costs, to be set off against future profits? However, in an uncertain world only large corporations can contemplate this kind of risk without the benefit of official assistance. Furthermore,

official action may foster the growth of industrial centres, where individual firms may benefit from external economies.

The firms established in the embryonic industrial sector must eventually be competitive at world market prices. There is the risk of encouraging activities which are not competitive, under the protective shelter. In principle, the official support should be temporary; however, it is often difficult to remove tariffs, especially if they are set at a high level. It is therefore advisable to allow only moderate tariff protection, which will probably be insufficient to encourage marginally competitive activities, even if the tariff is not discontinued.

The economic community was expected to promote growth through joint production, combining imports and processes from different member states. The removal of intra-regional tariffs does not offer much stimulus in this direction since most of the materials which might be used in joint processing are already allowed duty free access under incentive legislation, whatever their origin. The establishment of the community does not make joint production more profitable than it would be without the union.

Joint marketing efforts offer greater potential for developing new custom and firming up existing markets. They have been badly underutilised, perhaps because national firms

and organisations have failed to understand that they can be designed to complement national marketing efforts.

There are also significant gains to be made by sharing the talents of the citizens of member countries. This occurs independently of official policies, to some extent. But a more enlightened policy of freer movement of people within the community would greatly enhance the potential.

The community may help to increase the influence of small nations in trade negotiations. The community ought to be able to field a more skillful, knowledgeable team than any of its members. The complementarity which is a disadvantage for trade within the region is reflected in a degree of homogeneity which helps make joint negotiation effective.

The economic union was also intended to increase the range of items exported and thus to increase the resilience of foreign earnings to external shocks. However, this is to all members' advantage only if there are effective mechanisms to transfer income from those who gain to those who lose. Furthermore, there must be safeguards to protect the gains of smaller members in the event of losses by their larger partners. With countries so disparate in size as those of Caricom the greater diversity of exports of the community is probably an advantage only for smaller members.

In sum, the economic community may help to enhance the economic independence of its members by acting as an incubator for manufacturing that is potentially competitive on world markets, by encouraging joint marketing arrangements, by undertaking joint negotiation, by pooling human resources and by carefully thought out mechanisms to take advantage of increased diversity of exports. However, member countries' prospects for self-sustained growth depend principally on domestic policy, and the community will succeed only if there are strong safeguards to arrest the spread of repercussions from the misfortunes of members whose economics carry substantial weight.

## 5. The Exchange Rate Regime: Current Account Policies for Growth and Stabilisation

The management of the exchange rate is perhaps the most warmly debated issue in trade policy. The Caribbean has witnessed a range of foreign exchange regimes in the past ten years, from complete rationing and foreign exchange budgetting to experiments with managed floating. There has been a wealth of argument about the impact of the exchange rate regime on countries' growth. There is as yet no consensus about the kind of regime which encourages growth, nor has it been determined whether growth and stabilisation are compatible objectives.

The options open to foreign exchange managers depend on the adequacy of the country's foreign reserves. If reserves are

ample it is possible to support a fixed rate without rationing and without an unofficial market rate which is heavily depreciated. Where there is an excess demand for foreign exchange the offical rate must be altered in line with the excess demand or rationing must be introduced or there must be a combination of the two.

If the authorities try to take care of a large foreign exchange deficiency by depreciating the official rate only, the extent of devaluation may be so large as to destabilise expectations and set in train unpredicatable reactions. Moreover, it is all but impossible to measure the excess demand, and various elements of the private sector hold widely differing views as to its magnitude. In these circumstances there is the risk of overshooting, either by making too large a devaluation to begin with, or because the initial move fails to convince the market and further depreciation is necessary.

Rationing is usually the resort of these who fear large devaluations, but foreign exchange budgeting is virtually impossible to administer. The information requirements are staggering - quantities, qualities and identities of thousands of items with innumerable uses from many sources all need to be ordered in priority, with allocations to be spaced over the year and divided among applicants; delivery times must be allowed for and payments monitored. The system gives attractive incentives to rent-seekers, legal and illegal, and is always accompanied by unoffical markets.

A combination of some rationing with a depreciated exchange rate may be the best answer. In addition, the authorities might sanction an unoffical market if it develops and provide it with reliable information on the prices at which foreign exchange is being bought and sold. The particular combination of devaluation and rationing must depend on the magnitude of excess demand and arrears of payment. It depends also on the proportion of foreign receipts which are paid directly go government account (royalties, sales of export marketing boards, etc): the greater the proportion the more scope for rationing.

The official exchange rate ought to be set at a level which increases the supply of foreign exchange from exports over a sustained period. It is expected that devaluation will lower the local costs and increase the profitability of exports, attracting new investment such that export volumes will rise to exceed the rate of devaluation. (If the country devalues by 10% exports must rise by more than 10% if there is to be a foreign exchange gain.) Efforts have been made to resolve the issue by appealing to evidence, but the effects appear only in the medium term, and since the rest of the economy is not standing still it is very diffficult to infer the magnitude of the effects. Implementing a devaluation strategy for growth also involves the projection of cost structures for products which are hoped for but not yet in production and estimates of the impact of new technology. In addition, the effects of devaluation on local production costs must be neutralised.

A devaluation also has the effect of reducing the excess demand for foreign exchange by making imports more expensive. This is a more reliable response, easier to identify and measure because its impact is fairly immediate. As devaluation generates inflation and a fall in real income in the short run there is an additional damper on import spending. The devaluation choice depends on how it may be combined with fiscal and monetary policies, and alternatives for stimulating exports and cutting imports.

Exchange rates fixed in terms of one major currency are usually preferred by small countries. If the numeraire currency is the dominant currency in foreign transactions the fixed rate may form an anchor for expectations, essential for orderly exchange rate management. In these circumstances the benefit from the use of currency baskets (to be discussed shortly) is usually not considered worth the complexity of their implementation.

Economists have a bias towards the use of currency baskets, but nobody else cares much for them. They average the impact of exchange rate changes on the prices of imports and/or exports, according to their weights in total trade. Since import sources may be switched according to exchange rate movements the use of the currency basket does not make any difference to the level of imports. When world exchange rates are volatile the use of a basket redistributes income among

exporters, in comparison with the effects of a single currency peg. For relatively modest exchange rate fluctuations the income distribution effects are negligible. If international exchange rates are very volatile we need to know whether their impact on income distribution inhibits growth and diminishes welfare in the longer term. Unless they do it will not be worthwhile to institute a basket, with the inherent danger of destabilising exchange rate expectations, in order to alter the distribution of income.

The exchange rate may have to be changed in line with indicators of economic performance in order to establish a credible rate, if there is a large excess demand for foreign exchange. Possible targets for the exchange rate include an adequate supply of foreign exchange on the official market, a target growth rate of exports and to contain the differential between local and foreign rates of inflation.

The currencies of Western Hemisphere countries tend to be stable only when their value in terms of US dollars is not expected to alter. No exchange rate strategy can be sustained unless it fulfils this criterion. Experience plays a critical role in determining expectations, so the best strategy for those countries which have maintained a fixed peg to the US dollar is to maintain that rate unchanged and to adjust spending and output by fiscal and monetary policies. Once the country embarks on active exchange rate policies a variety of social,

political and economic circumstances cause expectations to alter in unanticipated ways.

Although large fluctuations among major currencies impose income redistribution within the small economy it is best to compensate by the use of fiscal measures rather than by altering the exchange rate. Fiscal compensation involves a deliberate decision which can be brought to bear when income distribution shifts sufficiently to warrant action. Moreoever, compensation can be applied selectively, depending on whether the losers have high priority in the country's growth strategy. The use of a currency basket offers none of these advantages.

A common exchange rate strategy for the Caricom region would foster trade among members by eliminating one source of uncertainty, but intra-regional trade is of little importance for countries' long term growth, and there are other sources of uncertainty (such as differential rates of inflation) which traders must live with. A joint strategy is feasible for economies of comparable size and comparable economic performance, provided income transfer mechanism and safeguards are in place, but it is not beneficial otherwise.

The management of the demand and supply of foreign exchange has important implications for the evolution of trade patterns and the growth potential of the economy. Policies should

provide for the long term growth of exports, along with the stabilisation of income and spending. The choice of exchange management policy is governed by the initial condition of foreign exchange reserve adequacy, the country's international credit worthiness and the expected value of local currency in terms of US dollars (compared to the existing value). Guidelines for selecting among the possible choices might be to:

(a) stay with a US dollar link (for small nations in the western hemisphere) unless the expected value of local currency (in US dollars) is not the same as its current value; use fiscal and monetary policies to stimulate exports, contain imports and compensate for exchange rate fluctuation.

If there is persistent excess demand for foreign exchange and people expect the currency to depreciate:

(b) sanction unofficial markets as they develop and provide for the certification of foreign exchange dealers (to protect the public) and establish reliable information about prices in the foreign currency market;

(c) limit official foreign currency rationing to as short a list of items as possible so as to avoid administrative overload;

(d) use indicators to alter official rates to ensure an adequate supply of foreign exchange for official sale.

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