The Impact of Macroeconomic Policies in Trinidad and Tobago

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AID AND MACROECONOMIC PERFORMANCE

The Impact of Macroeconomic Policies in Trinidad and Tobago

The Firm Under Adjustment

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For my mother

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Series Editor's Preface to *The Impact of Macroeconomic Policies in Trinidad & Tobago*

Countries such as Trinidad & Tobago that gained their independence from colonial rule after the Second World War had great hopes of overcoming poverty and gaining a respected place in the concert of nations within a generation. However, the hopes of the peoples of small states were soon dashed by a cycle of external debt, forced devaluations, social service retrenchments and defensive reactions to external trade shocks that characterized the 1970s. The dream of planned industrialization and balanced development – which had been shared by all political parties – had been shattered. However, international and national policymakers held out a new promise in the 1980s – that a shift from state-based to market-based development strategies could achieve the original objectives of development planning, only more quickly and less wastefully. A central feature of life for island states – and for developing countries as a whole – in the closing decades of the century has thus become the experience of ‘structural adjustment’.

From the very outset of the design and implementation of structural adjustment policy in developing countries, international financial institutions such as the World Bank held the position that private sector response to such policies was central to their success. Indeed, the approach that came to be known as the ‘Washington consensus’ was designed to promote private investment through the increased incentives provided by the reduction of government claims on resources, the liberalization of domestic markets and integration to the world econ-

omy. This key assumption was a matter of economic doctrine rather than empirical experience, as no studies had been carried out of how, whether and when the private sector might respond to such policies. This doctrine was reinforced by the evident failure of the previous state-led economic strategies, from which it was deduced that the markets could only do better.

More surprisingly still, after two decades' experience with such policies, there is still little detailed evidence of private sector behaviour during structural adjustment. Almost all the evidence produced is of three kinds. First, there are computable general equilibrium models which 'test' the effects of policies (usually relative prices) under a set of arbitrary assumptions about sectoral behaviour. These tell us little about private sector behaviour because their initial assumptions, usually imputed supply elasticities, have not been empirically established. Second, there are econometric exercises on macroeconomic data such as output growth or trade performance, which attempt to show how those countries which have successfully adjusted perform better than those which have not. Third, there are detailed surveys of household expenditure that attempt to gauge the effect of adjustment policies on income distribution and poverty. None of these actually address the central question of how firms themselves respond to structural adjustment.

There is thus an urgent need for more studies of private sector behaviour under adjustment. Further, such studies should differentiate clearly between large and small firms on the one hand, and domestic and foreign firms on the other. Small firms are the main providers of employment, so their nurture is a central part of a pro-poor adjustment policy. The support of domestic firms so that they can compete internationally without the benefits of scale or natural protection may be necessary if a poor small country is to maintain some degree of autonomy in an increasingly hostile global economic environment.

Small business has particular problems with lack of credit, information and agency asymmetry, as well as with lack of skills in the family firms or lack of scale to compete effectively. Modern investment theory indicates that uncertainty is one of the major determinants of the decision to invest because the option value of delaying investment is high. However, this option value depends on two factors: the ability of the firm to acquire and use information effectively on the one hand, and the degree of competition – i.e. the likelihood of a competitor moving into

the market if investment is delayed – on the other. Small firms are not in such a position because they have little information (particularly about technology) and cannot afford to wait due to intense market competition. As a consequence, they are often forced to invest badly and too soon.

The affiliates of foreign firms in small poor countries are disproportionately large in relation to domestic firms, a fact which is recognized in international trade rules which provide for national treatment only 'in like circumstances'. Modern finance theory indicates that banks will tend to lend to foreign rather than domestic firms (and still less to small firms) because of the lack of collateral in the latter and the high unit cost of administering loans. In a context of credit constraints brought about by stabilization policy and financial liberalization widening the investment options for banks, it is commonly observed that small as well as domestic firms find it more difficult to adjust than large or foreign firms do.

Amidst this dearth of rigorous research on firm behaviour under adjustment, the original doctoral research by Philomen Harrison at The Hague, upon which this volume is based, is a particularly valuable contribution to our understanding of the process. She was originally drawn to the Institute of Social Studies by our critical work on structural adjustment and came to form part of the 'International Capital Flows and Economic Adjustment' research programme. The work of our group at The Hague – which emphasized that the response of the economy to external shocks depends critically upon the distinct production, investment and savings decisions of economic agents in the private sector (foreign corporations, domestic firms, small business and households) – seemed to her to offer an approach which could combine institutional specificity with econometric rigour.

Her study of Trinidad & Tobago is the fourth country monograph in the International Finance and Development Series, having been preceded by studies of the Philippines (R. Vos and J. Yap *The Philippine Economy: East Asia's Stray Cat?* 1996), Thailand (K. Jansen *External Finance in Thailand's Development: An Interpretation of Thailand's Economic Growth*, 1997) and Bolivia (L. Jemio *Crisis and Reform in Bolivia: Biting the Bullet*, 2001). A number of other cases are summarized into our comparative studies of development assistance (H. White (ed.) *Aid and Macroeconomic Performance: Theory, Empirical Evidence and Four*

Country Cases, 1998) and of adjustment policies (K. Jansen and R. Vos (eds) *External Finance and Adjustment: Failure and Success in the Developing World*, 1997). Philomen's approach shares many of the principles upon which the other case studies are based, particularly the notion that the heterogeneous and constrained nature of the different constituent parts of the private sector would mean that similar macroeconomic and liberalization policies could have quite distinct effects in different countries. More specifically, this implies that the private sector may not be able to respond to 'shock therapy' because of its own financial, technological and organizational weaknesses. However, she also made her own special contribution to our work as a group by embarking on an ambitious but ultimately fruitful exploration of detailed survey data at the firm level. This econometric analysis confirmed many of our hypotheses, but in ways different from those we had expected – defining much more clearly the linkages between profitability, finance and investment.

Furthermore, Philomen was also concerned that the tradition of 'dependency theory' in the Caribbean had been based on an important historical insight, but she was hampered by a lack of rigorous economic analysis to support her concern. In contrast, the neoclassical approach, while manifestly inappropriate to a small poor economy with weak institutions and a powerful neighbour, had become ascendant because of its domination of modern analytical techniques. In this book she has demonstrated that a view based ultimately on political economy rather than general equilibrium can be tested rigorously using modern techniques, and it can lead to greater understanding of how the private sector behaves in small island economies. It is only upon this understanding that sound policies, which enable poor people to enhance their welfare within a hostile global economy, can be built.

In Chapter 9 of her study, Philomen draws a number of valuable and practical policy implications for Trinidad & Tobago. But what wider policy lessons for island states – or more generally for vulnerable open economies – can be drawn from this book? One, of course, is methodological: that even in a small economy, firms can be highly heterogeneous. Thus, policy design must be based on a thorough understanding of institutional behaviour, which requires dedicated research and careful consideration of local history. International financial institutions do this when considering a large economy such as Brazil or India, but it is just

assumed that a 'one size fits all' policy is adequate for smaller economies.

The second lesson is that financial markets remain highly segmented even after financial liberalization, and discriminatory credit allocation can continue by banks against firms based on criteria of size, ownership, ethnicity and 'social connections'. Public intervention in the form of prudential oversight may thus be necessary, not only to ensure solvency but also to guarantee all forms of equitable access to available financial resources. A third lesson is that the financial structure of firms may make them more (or less) vulnerable to external shocks. Thus, in order to protect shareholders the prudential oversight of company solvency in small open economies, employees and other stakeholders must include currency exposure. The fourth lesson is that firms that invest perform best in the adjustment process. In consequence, support for macroeconomic adjustment policies should involve not only foreign investment promotion but also low real interest rates, credit availability and tax incentives for domestic firms.

In sum, this book forms a valuable contribution not only to the research literature on structural adjustment in developing countries, but also to the policy debate on economic strategy for island economies in general and the Caribbean in particular.

Valpy FitzGerald
Oxford and The Hague
Series Editor

December 1999