

# In Uncertain Seas: Positioning small countries to succeed in a changing world

*David Skilling*

Discussion Paper  
March 2012

## Executive Summary

Small, developed countries – advanced economies with populations of less than 20 million people – have out-performed larger developed countries over the past few decades on multiple dimensions. These small countries are over-represented in terms of measures such as per capita income, economic competitiveness, international economic engagement, as well as various social outcomes.

This paper identifies three classes of reasons for this strong small country performance. First, the global economic and political environment over the past several decades has provided a supportive environment for small countries. Small countries are commonly argued to be one of the primary beneficiaries of the globalisation process experienced over the past few decades. However, this is better seen as the removal of disadvantage to small size than as conferring an advantage on small countries.

Second, small countries have domestic intrinsics that support performance. Small countries tend to have high levels of social capital and trust, well-functioning political institutions, and a well-developed sense of external orientation. These factors make it easier to sustain a deliberate strategy and to change course when appropriate. This combination of shared purpose and agility makes policy management easier, particularly in challenging times, and has supported the design and delivery of policy agendas that have positioned many small countries to perform well.

And third, many small countries have well-deserved reputations for the quality of their policies, and this has contributed to their strong performance. There are some policy areas in which small countries have distinctive policy settings, such as R&D and fiscal policy. But more importantly than these policy specifics, small countries tend to adopt a more deliberate policy approach that is focused on competing in the global economy. Small countries choose to compete in different ways, but it is the ability to adapt policy to the external environment that has been the key driver of strong small country performance.

However, although small countries have performed well as a group, there is substantial variation in performance among small countries. Those small countries that have not been active globalisers, that have weak domestic intrinsics, or that have not adapted their policies to emerging global realities, have performed poorly. And this distribution of small country outcomes is likely to widen further as the world continues to change in structural ways, placing additional pressure on small countries.

Over the past two decades, globalisation has moved into a more intense phase, with economies much more tightly linked together. In addition to the opportunities this creates, the intensity of competition, the pace and scale of change, the global economic – and political – reordering, combine to make the global environment more complex. Performing in this environment will require a sustained, deliberate response by governments of all developed countries, both large and small.

This emerging environment also raises two additional challenges specific to small countries. First, the weakening of multilateral institutions, and the increased importance of big powers in the global political system, both reduce the influence of small countries. Small countries are better placed to perform in an open, rules-based global environment because it provides a relatively level playing field. And second, the potential for a sustained increase in the level of economic turbulence and the incidence of shocks,

which creates particular exposures for small economies. So is this the end of the golden weather for small countries?

Not necessarily. Indeed, many small advanced economies are responding successfully to this emerging environment; they are continuing to generate strong economic outcomes, are investing heavily in R&D and education, are strengthening their macro policy settings (including through fiscal consolidation), and are strengthening their external relationship (such as through negotiating FTAs). But this environment will be very challenging for some small countries; indeed several small countries have been hit hard by the ongoing financial crisis.

And even for well-performing small countries, the challenges will likely continue to intensify, and small country governments will need to work hard – and to do things differently – to navigate this more challenging environment. Small countries will need to invest in strengthening their competitive positioning. And in a more volatile and complex international environment, small countries will also need to make judgements about where they enter into external alliances and relationships to bulk up their size – and where they remain independent, to retain the flexibility and benefits of small size. In some areas, being a small, independent country may be an uncomfortable and exposed place.

The ability of small country governments to make these policy changes rests on their domestic intrinsics. The cohesion, effectiveness of institutions, and external orientation of countries will become increasingly important as drivers of national performance. In these respects, small countries may be better placed than large countries: the challenges may be substantial, but many small countries seem to have the capacity, institutions, and social consensus to respond. In contrast, some large countries may struggle to accommodate themselves to this new world; the ability to respond, and to overcome sclerotic tendencies, may be weaker in large countries than in small countries.

For these reasons, small countries are likely to continue to be over-represented at the frontier of economic and social outcomes. However, the distribution of possible outcomes among small countries is likely to widen significantly. Well-managed small countries will continue to out-perform, but small countries with even average strategies and approaches are likely to struggle and to under-perform – as is clear from recent events in Europe. Small countries have much less margin for error.

In sum, central to the success of many small countries over the past decades has been the ability to respond appropriately to a changing world through deliberate policy, supported by strong domestic intrinsics. These characteristics will matter even more in the future. In many cases, but not all, small countries are well-positioned to prosper in the emerging environment. Delivering on this potential will require ongoing hard work, deliberate strategy, and policy innovation to prosper in an unforgiving environment. In this regard, small countries are likely to play a global leadership role, providing guidance to other advanced countries in how to respond to a changing global environment.

## 1. Introduction

Small, developed countries have performed strongly over the past several decades, out-ranking large, developed countries on many economic and social measures. Of the 34 advanced economies, as defined by the IMF, 23 have populations of less than 20 million people. These small countries currently make up 11 of the top 15 advanced economies by per capita income, 4 of the top 5 positions in the World Economic Forum's global competitiveness ranking, and 14 of the top 20 positions in the UN's Human Development Index.

This paper sets out to understand the reasons for the strong performance by small developed countries, as a way to provide insight into the priorities for action by small developed country government policy-makers. What should small country governments do to sustain or improve this performance?<sup>1</sup>

From the perspective of small country policy-makers, a key question is whether this strong performance is due to good management or to a favourable environment. Many small countries have been well-run, and rank highly on indicators of the quality of governance and policy. And small countries such as New Zealand, Singapore, and Denmark have all earned reputations at various times for policy innovation.

But it is also the case that the external environment has been positive for small advanced economies over the past few decades, with sustained global growth, an intense process of globalisation and the extension of multilateral institutions. Princeton historian Harold James, for example, has noted that "In the heyday of modern globalisation in the 1990s, it looked as if the small open states would be the winners: New Zealand, Chile, Ireland, the Baltic Republics, Slovakia, and Slovenia".<sup>2</sup>

However, the global situation is changing markedly. Power is shifting rapidly from developed countries to emerging markets, the multilateral system is weakening, many developed countries are confronting serious economic and social challenges, and economic turbulence is on the rise.<sup>3</sup> The next decade is likely to be characterised by disruptive change.

These trends create real challenges for small countries. The global financial crisis that started in 2008 has rendered some of these challenges more obvious; for example, the difficulties experienced by some of the small countries on the periphery of Europe. Indeed, the conventional wisdom on small countries has changed significantly. Small countries have moved from being seen as the primary beneficiaries of globalisation to being seen as exposed and vulnerable. Harold James noted that, "as the new century began, a new vision emerged in which the main beneficiaries would be very large emerging markets with powerful states".

---

<sup>1</sup> *The focus of this paper is on developed countries, and all references to small countries should be read as referring only to small developed countries. Similarly, references to large countries should be read as referring only to large developed countries.*

<sup>2</sup> *Harold James, The Creation and Destruction of Value, Harvard University Press, 2009.*

<sup>3</sup> *Richard Haass, 'The Age of Non-Polarity', Foreign Affairs, May/June 2008; Ian Bremmer and Nouriel Roubini, 'A G Zero World', Foreign Affairs, March/April 2011.*

A pair of columns by Financial Times columnist Gideon Rachman illustrates this change in sentiment.<sup>4</sup> In December 2007, he wrote a column headlined ‘For nations, small is beautiful’, arguing that “this is the age of the small state” as small countries were able to act in a more agile and flexible manner than the large established powers. Two years later, in the post-crisis world of October 2009, his column was headlined ‘How small nations were cut adrift’, noting the significant exposure of small countries to external economic shocks and the more challenging international political environment.

So do the changes in the global economic and political environment signal the end of the golden weather for small countries? Or will the intrinsic characteristics and policy approaches of small countries enable them to continue to perform strongly?

This paper commences by describing the strong performance of small countries over the past few decades on a range of economic and social measures. Section 3 then considers three classes of explanation for this relatively strong performance: the global environment; small country intrinsics; and policy settings. This analysis provides a basis for considering the sustainability of the strong performance of small countries in a changing global context. Specifically, section 4 examines the emerging challenges and opportunities that may particularly impact on small countries.

Section 5 considers the priorities for action by governments of small countries to respond to these changes in the global environment. Section 6 then examines how well placed small countries are to respond to these changes relative to larger countries. Section 7 concludes with some thoughts on the broader relevance of the small country experience.

## 2. Small country performance

For the purposes of considering the performance of small, developed countries, this paper restricts its analysis to countries in the IMF’s advanced economy group. The IMF define advanced economies as those with high per capita income, with a diversified export base (to restrict the group to industrialised economies), and that are integrated into the global financial system. There are currently 34 of these countries. These countries are described in Exhibit 1.

In this paper, I define small countries as advanced economies with populations of less than 20 million people.<sup>5</sup> This is an arbitrary definition, but seems to capture the countries that think of themselves as small.<sup>6</sup> On this basis, 23 out of the 34 advanced economies are defined as small countries. The remaining 11 countries, with populations of 20 million and above, are defined as large countries in this

---

<sup>4</sup> Gideon Rachman, ‘For nations, small is beautiful’, *Financial Times*, 3 December 2007; Gideon Rachman, ‘How small nations were cut adrift’, *Financial Times*, 19 October 2009.

<sup>5</sup> Other measures of national size sometimes suggested include land mass, military spending, size of foreign exchange reserves, industrial base, and the like. And size is sometimes a relative concept; Canada, for example, is small compared to the US. But population gets at the core of the distinction between small and large countries.

<sup>6</sup> 10 million is sometimes used to define a small country, but there are some countries with a size of between 10 million and 20 million that are better understood as small countries. Using 20 million as the definition also introduces a conservative bias into the analysis described in this paper; the differences between large and small countries are more marked when a 10 million population limit is used.

paper. This small country group ranges from the Netherlands with a population of 16.7 million people through to Iceland with a population of 330,000. Together, these small countries have a collective population of 139.6 million, about 2% of the global population – and about 9% of global GDP.

This (two thirds) share of small countries in the advanced economy group is roughly in line with the representation of small countries in each of the IMF’s other income categories. Overall, 70% of IMF member countries are small (or 57% if countries with populations of less than 500,000 are excluded). And 50% of the UN’s current members have populations between 1 and 20 million people.

Geographically, many of these small countries are from Europe, but there are also countries from the Middle East (Israel) and Asia (Singapore, Hong Kong SAR, and New Zealand). Of the 23 small countries, 19 are from Europe (of which 16 are EU members), with the remainder coming from Asia (3) and the Middle East (1).

**Exhibit 1: IMF advanced economies**

■ small country

Country	Population	GDP/Cap (USD)	Country	Population	GDP/Cap (USD)
Iceland	329,000	39,025	Sweden	9,293,000	49,183
Malta	410,000	19,707	Czech Republic	10,411,000	18,277
Luxembourg	492,000	108,952	Belgium	10,698,000	42,845
Cyprus	880,000	28,854	Portugal	10,732,000	21,542
Estonia	1,339,000	14,405	Greece	11,183,000	27,311
Slovenia	2,025,000	23,648	Netherlands	16,653,000	46,986
New Zealand	4,303,000	32,163	Australia	21,512,000	55,672
Ireland	4,589,000	46,298	Taiwan	23,072,000	18,558
Singapore	4,837,000	43,117	Canada	33,890,000	46,303
Norway	4,855,000	84,144	Spain	45,317,000	30,639
Finland	5,346,000	44,496	Korea, South	48,501,000	20,756
Slovakia	5,412,000	16,104	Italy	60,098,000	34,059
Denmark	5,481,000	55,986	United Kingdom	61,899,000	36,164
Hong Kong	7,069,000	31,514	France	62,637,000	40,704
Israel	7,285,000	29,264	Germany	82,057,000	40,274
Switzerland	7,595,000	67,779	Japan	126,995,000	42,783
Austria	8,387,000	44,988	United States	317,641,000	46,860

Source: IMF 2011 World Economic Outlook, UN population division – all figures for 2010.

The performance of the small countries is assessed against large countries on several measures of economic performance, the extent to which countries are actively engaged in the global economy, and various measures of social outcomes.

### Economic performance

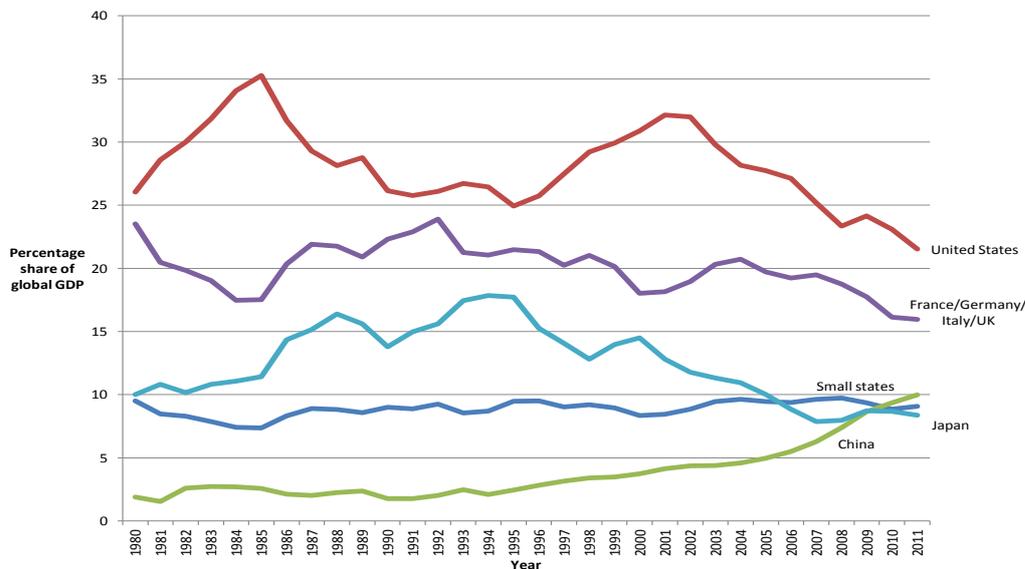
The first point to note is that, as can be seen in Exhibit 1 above, small countries are over-represented in terms of per capita income levels. 7 of the top 10 countries by per capita income in the advanced economy grouping are small countries – and 11 of the top 15. The US, Canada, and Australia are the 3 large countries in the top 10.

Small countries have relatively high per capita income levels because economic growth rates have been stronger among the small country grouping over the past few decades. There was a roughly equal mix of small and large countries in the per capita income rankings in 1950 and 1970. It is not an advantaged starting point that has led to high levels of small country income, as much as strong growth performance over the past several decades. Ranking the advanced economies by GDP per capita growth rates since 1971, small countries take 8 of the top 10 positions, and 14 of the top 20 (the strong growth of Singapore and Hong Kong boosted the small country average, but this performance is broad-based).

There is some interesting time series variation in this growth performance. The overall picture is that small countries significantly out-performed large economies in the 1970s, but large countries have an edge over the small countries in the 1980s. However, over the past 20 years per capita income growth rate has been higher in the small countries, by about half a percentage point on average. This gap was slightly wider over the past decade than it was through the 1990s. Since 1995, small countries have made up 8 of the top 10 countries by per capita income growth (and 15 of the top 20).

As a group, small countries have done disproportionately well in this globalising world. Indeed, the small country group has been able to maintain their share of global GDP over the past few decades while the larger countries have gone backwards. And over the past 15 years, between 1996 and 2011, the share of small country GDP remained unchanged at 9% while the share of the large country GDP reduced from 72% to 55% (mainly driven by declines in Japan and Continental Europe, with a smaller contribution from the US).

**Exhibit 2: Share of Global GDP, 1980-2011**



Source: IMF World Economic Outlook Database; data are expressed in current USD (market exchange rates)

It is instructive to note that the share of global GDP accounted for by small countries is only just below China, and a touch above Japan. This is a useful reminder that small countries, taken together, are a substantial economic grouping.

Small countries are also disproportionately assessed as being among the most competitive economies in the world. The top five countries in the World Economic Forum's Global 2011/12 Competitiveness Report were Switzerland, Singapore, Sweden, Finland and the US. Of these five countries, four are small.

### International economic engagement

One related dimension of economic performance, which is particularly important for small countries, is international economic engagement. There is a well-documented positive relationship between country size and the level of international engagement. The high level of international economic engagement by small countries is partly due to necessity, in order for firms to grow beyond a small domestic market.

And there are substantial differences between the levels of international economic engagement by large and small countries. The average level of exports/GDP for small countries (in 2009) was 73%, compared to 27% for large countries. And outward direct investment/GDP was 87% for small countries compared to 39% for large countries. By ranking, small countries fill all of the top 10 places in terms of exports/GDP and 9 of the top 10 in terms of outward direct investment/GDP. Similarly small countries are much more reliant on inward direct investment, accounting for all of the top 10 places in the advanced economy group, at an average of 101% of GDP compared to 27% of GDP for larger countries. Small countries have been active globalisers.

In addition, the growth rates with respect to these measures of international economic activity have been much stronger among small countries. Between 1992 and 2008, for example, the average exports/GDP ratio increased by 22 percentage points for small countries and 11 percentage points for large countries (removing a few outliers such as Singapore does not change the picture). Similarly, between 1990 and 2010, outward investment/GDP increased by a remarkable 83 percentage points for small countries compared to 27 percentage points for large countries. Even in a much more competitive global economy, small countries are doing well in terms of their global market share.

Another useful indicator of international economic engagement is the number of large companies from a particular country. One measure of this is the host country of the companies on the annual Forbes Global 2000 listing (the world's largest listed companies as measured by an index of market capitalisation, profits, assets, and sales). Small countries host 2.3 companies per million population, in comparison to 1.4 for the large countries. Small countries take 8 of the top 10 places on the number of Forbes 2000 companies per head of population. Small domestic markets have not prevented companies from small countries establishing leading international market positions.

Taken together, these measures of international economic engagement suggest that small countries have done well in adapting to the emerging global environment.

## Social outcomes

In addition to this strong economic performance, small countries have also generated good outcomes on various social measures. For example, of the top 20 advanced economies on the UN Human Development Index (HDI), 14 are small countries. The HDI looks at a variety of measures, such as life expectancy at birth, years of schooling, and per capita income, to provide a comprehensive measure of welfare.

And income inequality tends to be lower in small countries. Small states have slightly lower Gini coefficients than large countries, averaging 32.4 compared to 33.2. However, it is important to note that there is a wide distribution of outcomes among small economies. Small countries have 8 of the lowest ten Gini coefficients in the advanced economy grouping, mainly due to the outcomes generated in small Northern European countries.<sup>7</sup> But other small advanced economies such as Singapore, Hong Kong, New Zealand, and Israel rank poorly. It is a bar-bell distribution.

Another way of capturing social outcomes is to look at measures of quality of life. One of the most common measures of wellbeing is self-reported life satisfaction. Recent research from the OECD, using data from the results of a range of surveys which asked questions about life satisfaction, found that small countries accounted for 9 of the top 10 rankings among OECD members. Small countries were also over-represented in terms of people being more satisfied than can be explained by reference to income levels.<sup>8</sup> Taken together, the overall sense is that small countries perform strongly in terms of measures of social outcomes and quality of life.

## Overall assessment

Small countries seem to have done better than larger countries over the last few decades on economic and social outcomes. Interestingly, this out-performance seems more pronounced over the past 15 years, suggesting that many small countries are adapting well to the current phase of globalisation.

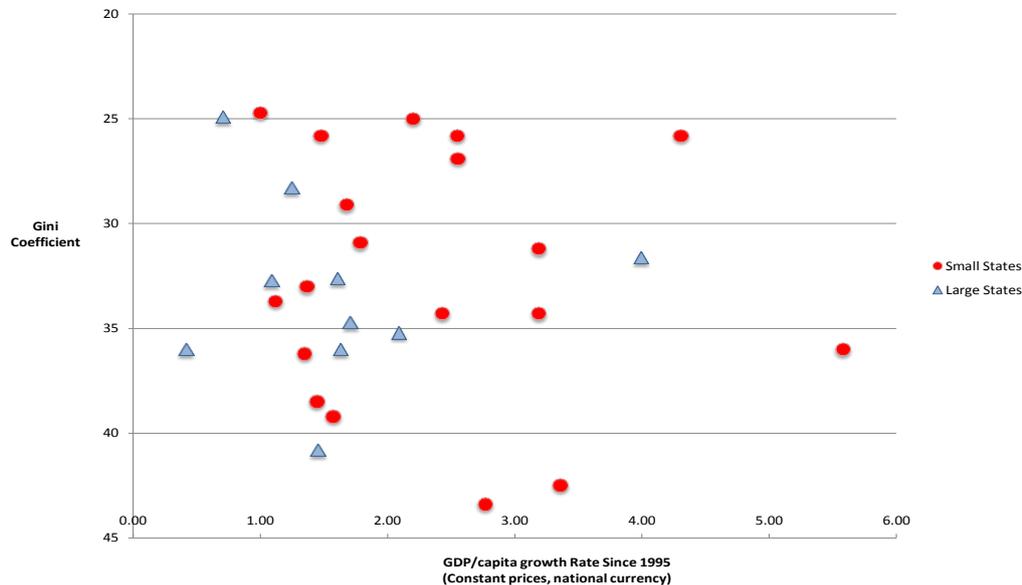
To capture this in summary form, Exhibit 3 plots all the advanced economies in terms of both per capita income growth since 1995 as well as the current Gini coefficient (plotted on a reverse scale). Although these measures are summary indicators only, this gives an indicative sense of combined economic and social performance. Exhibit 3 shows that small countries tend to be over-represented in the upper right of the chart – to score well on both dimensions – relative to their large country peers.

---

<sup>7</sup> A recent OECD publication (*Divided We Stand: Why Inequality Keeps Rising, 2011*) notes that inequality in many small countries has been increasing (although most small countries still have more equal income distributions than the OECD average).

<sup>8</sup> Fleche, S., C. Smith and P. Sorsa, 'Exploring Determinants of Subjective Wellbeing in OECD Countries: Evidence from the World Values Survey', *OECD Economics Department Working Papers, No. 921, 2011*.

**Exhibit 3: Advanced economy economic and social performance**



Source: IMF and UN Development Report 2010

However, this claim is based on rankings and differences in averages between large and small countries that are in many cases not statistically significant (although the differences are consistently in the right direction across a range of variables). This lack of statistical significance is because of the substantial variation in economic and social performance in small (and large) countries. Not all small countries have performed well; indeed, some small countries are perennial under-performers. But overall, the strong sense is that small countries have an edge over their larger peers – and the good small countries are very strong performers. Some support is lent to this analysis by findings of strong performance by small countries in other research. And subsequent academic work has generated similar findings with respect to small countries.<sup>9</sup>

In addition, in interpreting these results, it is important to bear in mind that the relatively strong performance of small countries is unusual in historical context. Over much of recorded economic history there has tended to be a premium to national size. The general tendency is for countries with larger domestic markets to perform relatively well; there is a strong relationship, for example, between population size and income growth as well as innovation.<sup>10</sup> And there is strong evidence on the

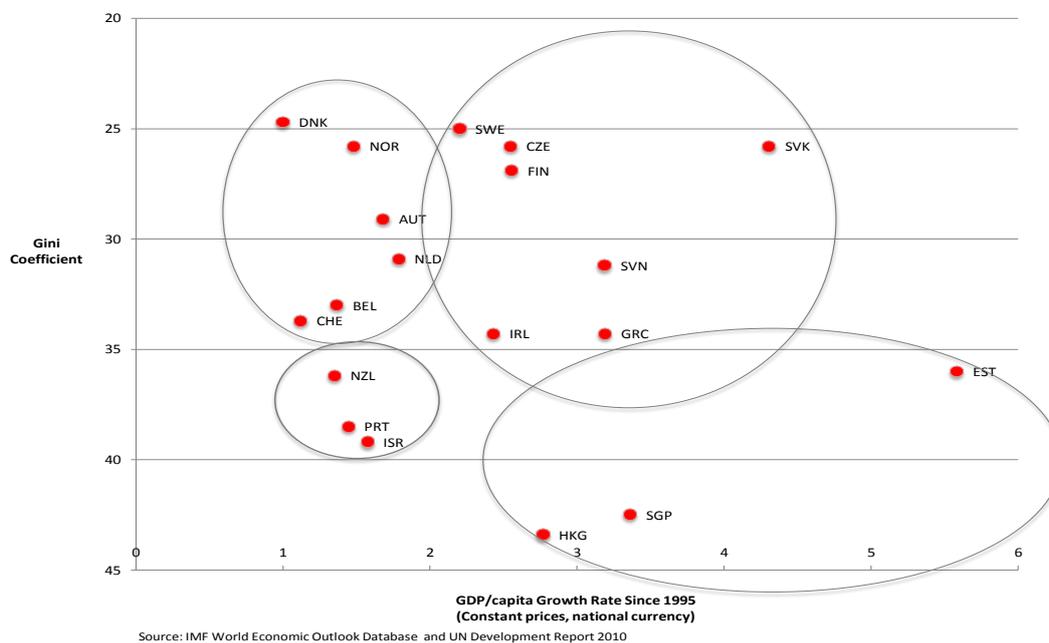
<sup>9</sup> Peter J. Katzenstein, *Small States in World Markets: Industrial Policy in Europe*, Cornell University Press, 1985; Peter Katzenstein, 'Small States and Small States Revisited', *New Political Economy*, Vol. 8, No. 1, 2003.

<sup>10</sup> Jared Diamond, *Guns, Germs & Steel*, W.W. Norton & Co., 1999; Michael Kremer, 'Population Growth and Technological Change: One Million BC to 1990', *Quarterly Journal of Economics*, 1993, pp. 681-716; Jeffrey A. Frankel, and David Romer, 'Does Trade Cause Growth?', *American Economic Review*, 1999, pp. 379-399; Alberto Alesina and Enrico Spolaore, *The Size of Nations*, The MIT Press, 2003; Alberto F. Ales, and Edward L. Glaeser, 'Evidence on the Growth, Increasing Returns, and the Extent of the Market', *Quarterly Journal of Economics*, 1999, pp. 1025-1045.

economics of agglomeration, in which larger economic units support investment, innovation, and economic activity that may not be feasible in smaller units of analysis.<sup>11</sup>

However, in addition to the strong performance of the group of small countries, it is important to note that there is significant variation in performance across the small country group. Using the same two dimensions of performance as in Exhibit 3, and defining good performance as countries that generate average per capita income growth of more than 2% and that have a Gini coefficient of below 35, Exhibit 4 separates the small countries into four groups.

**Exhibit 4: Economic and social performance by small advanced economies**



There is a group of countries that do well on both dimensions, which are primarily the Northern and Central European countries; countries that are economically successful, but with higher levels of income inequality (such as the small Asian countries); countries that perform well socially but less so on the economic dimensions (the rich but slow growing European countries); and a few countries that have not performed strongly on either dimension (New Zealand, Portugal and Israel).

The discussion below will consider the reasons for the small country over-performance relative to large countries, and will also use the cross-country variation in performance within the small country group to generate additional insight into the most important drivers of performance.

<sup>11</sup> Masahisa Fujita, Paul Krugman, and Anthony J. Venables, *The Spatial Economy: Cities, Regions, and International Trade*, The MIT Press, 1999; Edward Glaeser, *The Triumph of the City*, MacMillan, 2011.

### 3. Explaining small country performance

So why have small countries tended to perform better than large countries over the past few decades? And what can explain the variation in performance across small countries? This section considers three explanatory factors that are often referred to, and tries to assess the extent to which each of these is important. The three factors are: the nature of the external environment; the intrinsic characteristics of small countries; and policy choices made by small country governments.

#### Positive external environment

The global economic and political environment over the past 60 years, since the end of the Second World War, has been much more supportive of small country performance than have previous periods of history.

In terms of the global economic environment, there has been an active process of globalisation, supported by multilateral institutions like the GATT and the WTO, national decisions to remove barriers to trade and capital flows, strong global growth (most recently from emerging markets), as well as by innovations in information and communications technology. Indeed, over the past several decades, growth in exports of goods and services, as well as cross-border flows of capital, have significantly out-paced global growth in GDP.

This has benefited countries that have been able to integrate into the global economy. In particular, it has enabled many small countries to overcome the constraints of a small domestic market. Although the evidence shows that global markets are an imperfect substitute for domestic markets, and that geography and national borders still matter, improvements in the ability to access foreign markets will have a positive effect. Indeed, as described in the previous section, small countries have been very active globalisers. It is hard to imagine the success of some of the small East Asian tiger economies, such as Singapore and Hong Kong, being possible without this favourable external environment.

And small countries have also benefited from a relatively benign global political environment. In the decades since the end of World War II, many small countries have been able to take shelter in a system of security alliances – and at least in the West, to benefit from the hegemonic influence of the US. It is less risky to be a small country when there is reduced likelihood of conflict (and there is also less need to spend on the military).

Taken together, this has created a supportive environment for small countries. One useful measure of this is the increase in the number of new countries. Alberto Alesina and others argue that periods of economic openness and political stability create the conditions in which it becomes feasible for new countries to establish themselves independently. Countries can get to scale by accessing foreign markets, and have to worry less about security threats. Indeed, these studies document a strong

relationship between periods of trade openness and an increase in the number of countries over the past 100 years.<sup>12</sup>

At the start of the 20<sup>th</sup> century, there were estimated to be around 60 countries. This increased over the first half of the 20<sup>th</sup> century, partly with the beginning of the fragmentation of colonial empires. And there has been an explosion in the number of countries over the past 60 years. The number of UN members has increased by a factor of almost 4 since the establishment of the UN in 1945, from 51 to 193 today. This is partly due to the ending of the colonial period after the end of the Second World War, and more recently the formal independence of countries in Eastern Europe. The emergence of many new countries over this period suggests the existence of an environment in which it has been feasible to be a small country.

However, the significance of these features of the global environment for small countries should not be over-stated. The external environment has become more positive, but it does not remove all the economic disadvantages of small national size. Restrictions on cross-border activity still exist, large countries still act in accordance with their national interest, and national borders still constrain international activity. The size of the domestic market continues to matter.

So the changes in the nature of the external environment are better seen as the partial removal of a disadvantage, rather than as conferring a specific advantage on small countries. Indeed, large countries have also benefited from globalisation, and the ability to access other markets, although perhaps less so in proportional terms. The global environment is an important factor in explaining why small countries have done better over the past several decades, but does not yet explain why small countries have out-performed.

And of course, an improvement in the external environment does not convert into superior performance for small countries unless they respond to it and take advantage of the improvement. As noted above, there is substantial variation in performance across small countries even though the changes in the global environment should provide broad-based benefits. This suggests that some small countries have done a better job than others in taking advantage of the improved environment. Overall, the change in the external environment is a helpful but not determining factor.

## Intrinsic

The second explanatory factor that is examined is relevant to the way in which small countries respond to changes in the external environment. Small countries are often thought to be easier to manage because of their internal characteristics. This section groups the common claims in this respect into three categories, and describes the evidence.

---

<sup>12</sup> Alberto Alesina and Enrico Spolaore, *The Size of Nations*, The MIT Press, 2003; Alesina, Alberto, Enrico Spolaore, and Romain Wacziarg, 'Economic Integration and Political Disintegration', *American Economic Review*, December 2000, pp. 1276-1296; Alberto, Alesina, and Enrico Spolaore, 'On The Number And Size of Nations', *Quarterly Journal of Economics*, November 1997, pp. 1027-1056; Alesina, Alberto, and Romain Wacziarg, 'Openness, country size and government', *Journal of Public Economics*, September 1998, pp. 305-321.

- Social capital and trust

In terms of social capital and trust, small countries regularly rank at the top of the global listings. The World Values Survey provides data for 19 of the 34 advanced economies on citizens' responses to questions about whether they are generally trusting towards other people. The average positive response for small countries was 50%, compared to 32% for large countries. And the academic research indicates that countries that have higher levels of trust are better able to make good policy decisions and to generate stronger outcomes.

There is related evidence that there are higher levels of trust in more homogenous communities. For example, research suggests that people have a higher willingness to have wealth transferred to people with whom they share some affinity, which may be one reason why welfare systems are larger in Europe than in the (more diverse) US.<sup>13</sup> The relevance of this evidence to the current discussion is that it may mean that tough choices are easier in high-trust countries. In smaller or more homogenous societies, it may be easier to allocate losses around a society – Iceland, Ireland, and Estonia are good recent examples in Europe, where more rapid fiscal consolidation has taken place.<sup>14</sup> Countries are better able to move because there is a sense that 'we are all in this together'. In some small countries, notably Singapore, this community-building is a direct objective of policy.

- External orientation

Small countries generally have an acute sense of their exposure to the external environment. External economic and political forces impact much more forcefully and rapidly on small countries than on large countries, and so small country policy agendas and national discussions tend to be more focused on responding to the external environment.

Among other things, this means that small countries tend to have better developed sensing mechanisms in terms of what is happening in the rest of the world. They see themselves as 'price takers', having to respond to external developments rather than believing that they are in a position to shape them. And the humility that comes with this perspective means that they are more likely to be able to change course when necessary to adapt to a changing global landscape. As one piece of evidence in this regard, the IMD Competitiveness Yearbook reports data showing that small countries have more positive attitudes towards globalisation than large countries, being more open to the global economy.

In contrast, large countries are sometimes afflicted with what the late US diplomat George Kennan called "the hubris of inordinate size", leading to a lack of modesty and "vulnerability to dreams of power and glory".<sup>15</sup> And in general, large countries are more focused on domestic issues – and advancing their

---

<sup>13</sup> Alberto Alesina and Edward Glaeser, *Fighting Poverty in the US and Europe: A World of Difference*, Oxford University Press, 2004; Robert D. Putnam, 'E Pluribus Unum: Diversity and Community in the Twenty-first Century', The 2006 Johan Skytte Prize Lecture, *Scandinavian Political Studies*, Vol. 30 – No. 2, 2007

<sup>14</sup> For example, Anders Aslund, *Post-Crisis: What Europe Can Learn from the Baltic States*, Peterson Institute for international Economics, February 2011.

<sup>15</sup> George Kennan, *Around The Cragged Hill*, cited by John Paul Rathbone in the *Financial Times*, 29 November, 2011.

interests – than on positioning themselves in the global economy. They may be less comfortable with the need to accommodate themselves to changes in the external environment.<sup>16</sup>

The other important benefit of the external orientation is that small countries are less likely to be subject to the economic sclerosis that Mancur Olson famously identified in many advanced economies.<sup>17</sup> Katzenstein argues that sclerosis is likely to be much less powerful in small advanced economies than it is in large advanced economies because the openness of small countries – and the consequent vulnerability – make it less likely that rent-seeking distributive coalitions are able to be sustained. Small countries are better able to learn, adjust and adapt to changing international circumstances.

- Effectiveness and quality of government

International rankings consistently show that small country governments perform better in terms of effective government. For example, 8 of the top 10 countries on the Government Effectiveness measure from the World Bank’s Governance Indicators Project are small countries.<sup>18</sup> Many small country governments have a record of policy innovation and well-developed reputations for quality governments; countries like Singapore and Denmark spring to mind in this regard. And New Zealand has been described as the ‘laboratory of the world’ because of its pioneering economic and social policies over more than a century.

Small country governments are often thought to be advantaged because they have less complex systems that are able to make decisions quickly. However, the reality in many small countries is a little more complicated. Small countries are more likely to have coalition, minority governments in proportional representation systems of government, characterised by consensual styles of governance, than are large countries.<sup>19</sup> However, although the systems of government common in many small countries can sometimes make it more difficult to move quickly, such systems also make it more likely that there is a shared understanding. The sense of shared purpose helps the decision-making process and increases the ability of countries to sustain a particular policy direction.

In contrast, large countries sometimes seem to be too big and complex to manage effectively, particularly in a world with disruptive changes occurring. The risk is that larger countries become hierarchical or bureaucratic states because they cannot take decisions. External observation of some large countries, such as the US, suggests that they are facing major issues in having a national conversation about strategically important issues and making sensible policy decisions.

---

<sup>16</sup> Gideon Rachman, ‘America must manage its decline’, *Financial Times*, 17 October 2011.

<sup>17</sup> Mancur Olson, *The Rise and Decline of Nations*, Yale University Press, 1982. Olson noted the point about the relevance of size, but did not develop it formally.

<sup>18</sup> Daniel Kaufmann, Aart Kraay and Massimo Mastruzzi (2009), ‘Governance Matters VIII: Governance Indicators for 1996-2008’, *World Bank Policy Research*, June 2009. This captures measures of government effectiveness such as perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government’s commitment to such policies.

<sup>19</sup> Arend Lijphart, *Patterns of Democracy: Government Forms and Performance in Thirty-Six Countries*, Yale University Press, 1999.

Small country governments also seem to find it easier to organise themselves in a structured and coherent way around a national strategy. It is more difficult to conceive of a coherent national strategy for a country the size of the US or the UK; although there can be some broad directional themes, it is more difficult to develop a detailed national strategy. Qualitatively, the policy conversations that are common in small countries have a much more deliberate, strategic feel than those in large countries.

Overall, small countries have effective, responsive governments, with a well-developed sense of strategic capacity, high levels of trust and social cohesion, and the ability to adapt in response to changing international circumstances. For the most part, these have been long-standing national characteristics. But it is plausible that these characteristics are becoming increasingly important as the world has become more complex over the past few decades.

Indeed, there seems to be a close relationship between the intrinsic factors associated with specific small countries and their reported performance, as described at the end of the section 2. The high performing small countries, such as those in Northern Europe, perform well on many of the intrinsics discussed above (effective government, social cohesion, external orientation), while the worst-performing small countries seem to be less externally-focused, to have more issues with interest groups (e.g. Greece), and to lack a sense of strategic direction.

This suggests that the foundations provided by the intrinsic factors are an important explanatory factor, both distinguishing the performance of small and large countries and also helping to explain the differences in performance among small countries.

### Policy settings

The contribution of these intrinsic factors is to help countries adapt, and so the discussion now turns to a consideration of the differences in policy approaches between small and large countries. What is it that small countries have done that has enabled them to respond to the challenges and opportunities of globalisation?

The first observation is that on most measures of policy settings that are regarded as important for growth, there are few substantial or systematic differences between the large and small countries. On standard measures of the business environment, regulatory quality, labour market flexibility, and macro policy settings, the averages for the large and small country groups are similar.

My sense is that the important distinction is the qualitative differences in the way that large and small countries approach economic policy. In particular, small countries pay more attention to deliberate economic strategy as a way of dealing with global forces. Small countries seem to have a deeper understanding that their economies need to be distinctive in some way, and responsive to market realities, or they will be out-competed. The ways in which many small countries have successfully responded to globalisation vary according to national circumstances, preferences and objectives. The Singapore model is different from the Denmark model which is different again from the Swiss model, in terms of fiscal policy, the reliance on FDI, approaches to regulation, and so on. The specifics of small country policy settings are instructive, but should not be treated as a simple template.

But although the specific ways in which small countries compete vary according to context, the notion of a deliberate strategy to position their countries to compete is a unifying theme across small countries. There is a deliberate focus on the strategic coherence of policy. Small countries tend to regard globalisation as something that needs to be managed, rather than as an exogenous force.

In contrast, larger countries find it more difficult to act selectively in their economies and so are more likely to emphasise broad policy instruments, such as macroeconomic policy, with less explicit focus on building competitive advantage. Because of their greater size and diversity, it is more difficult to focus and to design targeted policy.

These qualitative differences may help to explain why small countries perform better than would be expected by their measured policy settings. Recent OECD research used a stripped-down model to predict per capita income levels across OECD countries on the basis of a range of policy settings that are thought to be linked to growth (such as education, labour market regulation, and so on).<sup>20</sup> This predicted income level was then compared to the actual level of per capita income. Small countries were expected to slightly under-perform the OECD average, based on their policy settings, but over-performed it significantly. The difference between predicted and actual per capita income levels was 9% for small countries, compared to -8% for large countries; small countries over-perform relative to expectations, and large countries under-perform.

There are many possible explanations for this finding. But one interpretation of these findings is that small countries may be better at assembling the right set of policies to enable them to compete effectively. The success factor is not the specific policy settings as much as the nature of the overall policy strategy that is employed.

In this sense, it is instructive to consider two areas in which small countries do appear noticeably different from large countries: fiscal policy, where small countries tend to have larger government budgets and lower deficits; and economic structure, where small countries tend to have larger industrial sectors and a greater focus on innovation. These differences reflect choices in terms of how small countries deliberately position themselves to compete in the global economy.

- Fiscal policy and external balance

On fiscal policy, the stylised facts are that small countries spend significantly more than larger countries but are much more prudent in terms of the size of the fiscal deficits they run and the level of public debt they accumulate. Of course, small countries are exposed to tax competition like all other economies (perhaps more so), but this record suggests that it is more than simply a race to the bottom.

On government spending, small countries consistently spend a few percentage points of GDP more than large countries (about 43% compared to 40% currently). Again, there are counter-examples: Singapore and Hong Kong have low levels of government spending (at least for the moment) of about 20% of GDP, but most small countries have relatively large government budgets.

---

<sup>20</sup> Barnes, S. et al., 'The GDP Impact of Reform: A Simple Simulation Framework', *OECD Economics Department Working Papers*, No. 834, 2011.

It is often argued that these larger government budgets are a deliberate response to the consequences of being an open, exposed economy. Dani Rodrik, for example, argues that small countries have higher levels of government spending than is the case for larger countries because of the higher degree of economic volatility they experience.<sup>21</sup> The government spending provides a degree of insurance, moderating the volatility in household incomes.

However, small country governments tend to be more conservative in terms of fiscal balance. Since 1995, the average primary deficit among small country governments has been 0.9% of GDP compared to a deficit of 2.4% of GDP for the large country governments. Small countries also have substantially lower levels of net and gross government debt as a percentage of GDP (29% and 64%, compared to 64% and 85% respectively). This is at least partly because small countries face more significant negative consequences if they get into fiscal difficulties (as several European countries have recently found out) and are more focused on ensuring that they are resilient to external shocks. Larger countries like the US and Japan have more fiscal leeway.

Relatedly, small countries generate superior performance in terms of the current account balance. Over the past decade, small countries have had a current account balance about one percentage point of GDP stronger than have large countries. Indeed, 8 of the top 10 performers in terms of the current account balance are small countries. As with the fiscal conservatism observed across small countries, this is likely because small countries want to limit their exposure to external forces (such as the preferences of global capital markets in terms of extending credit to small countries).

- Economic structure and innovation

International benchmarking exercises consistently show that small countries perform strongly on measures relating to innovation and technology. For example, small countries invest heavily in R&D. Countries like Finland and Israel stand out with R&D spending as a share of GDP of 4% or more. Larger countries like Korea, Taiwan, and the US also invest substantial amounts in R&D, but small countries are well-represented. One area of difference is the share of private R&D spending as a proportion of total R&D spending. Small countries take 9 of the top 10 positions on this measure.

Small countries are also home to a disproportionate amount of human capital because of a combination of investing in the domestic education system as well as attracting foreign talent. In a Global Creativity Index measure of talent, defined in terms of education levels and the number of people working in the 'creative class', small countries take 8 of the top 10 spots among advanced economies.

This emphasis on innovation and technology is linked to differences in the economic structure and export composition of small countries. Small states have higher levels of high technology exports. Such exports account for an average of 6.2% of GDP for small countries, and 3% of GDP for large countries. Ranked by this metric, small countries occupy 8 of the top 10 places.

---

<sup>21</sup> Dani Rodrik, 'Why Do More Open Economies Have Bigger Governments?', *Journal of Political Economy*, October 1998.

And the share of the industrial sector is significantly higher in small countries than in large countries; 8 of the top 10 advanced countries in terms of the industry share of GDP are from small countries. These small countries have a more diversified economic structure than larger countries, which tend to be more focused on services. This sector mix is sometimes influenced directly by policy; Singapore, for example, aims for the manufacturing sector to account for about 25% of GDP. And sometimes the sector mix is indirectly supported, through policy measures such as the nature of the vocational education system or the type of FDI that is attracted.

### Overall assessment

It is not possible to precisely disentangle the relative importance of the external environment, intrinsic, and the quality of policy settings in contributing to the strong performance of small countries. And they are clearly related in any case. But the following interpretation seems reasonable.

Small countries have benefited from a more positive, supportive external environment. But more importantly, they have responded appropriately to the changing global environment. The strong performance of small countries is largely a matter of deliberate choice and management. Many small countries used their domestic intrinsic to support the development of an appropriate policy response to the emerging global environment, and have consequently done better than many large countries.

The ability of small countries to continue to generate strong economic and social outcomes, as well as to continue to grow into international markets, is evidence of adapting to this emerging global environment. This has been supported by a policy agenda that has emphasised R&D and education, prudent macroeconomic settings, active international engagement in terms of FTAs, and so on.

The national debates in these small countries also seem to be more deliberately focused on responding to the emerging challenges and opportunities in the global environment. Examples of this focus include the Economic Strategies Committee process in Singapore, the work of the Danish Globalisation Council, and the Mission for Finland project. These illustrative pieces of work are ways in which small country governments are seeking to deliberately engage with global forces. There is not the sense of policy fatalism that is sometimes evident in large countries.

Interestingly however, the performance of several small countries that did not respond actively to the changing global context is significantly worse. The small southern European economies are one notable example of this. And the relatively poor performance of New Zealand is partly due to its physical remoteness hampering full participation in the global economy. The negative consequences of failing to engage seriously with the changing global economy are serious.

In sum, the overall message from the small country experience is one of strategic responsiveness based on shared perspectives that allow them to make long-term decisions and to respond quickly in terms of crisis. These messages are consistent with the success characteristics of other organisations. In a classic study of companies that had survived for several hundreds of years, a few shared characteristics

appeared: sensitivity to the environment (with an ability to learn and adapt); cohesion and identity; tolerance and decentralisation; and conservative financing.<sup>22</sup>

This discussion suggests that many small countries have responded better to the changing global context than have large countries. Perhaps this is because large countries do not face the same pressure to respond, as the market pressures are less acute. For example, because the US dollar is the reserve currency, the US does not face the market pressures associated with its fiscal position and so is able to accumulate more debt – ultimately to its detriment.<sup>23</sup> And the protection afforded by the euro has contributed to debt problems for some small European countries. But in general, although small countries have more substantial exposures to the external environment, these countries are more likely to see these structural changes quickly and to respond appropriately.

The next two sections consider the extent to which the world is likely to change in ways that may impact on the performance of small countries, and identify several areas that should be on the agenda of small country governments.

#### 4. A changing world

As a group, small countries have performed well because they have adapted to the changing global environment of the past few decades. But the small countries that have not adapted have generated poor performance. And the world is continuing to experience rapid structural change, generating new challenges and opportunities.

The world is more global, more inter-connected, and more rapidly moving. This has many well-documented positive features, but also raises a series of challenges for policy-makers in advanced economies. To name just a few: the operation of global markets has placed pressure on the income distribution and labour markets across many advanced economies (due in part to declining competitiveness and employment in a range of higher wage, tradables sectors); peripheral regions are more exposed to the exit of mobile companies and people due to the agglomeration effect (a flat world does not lead to a flat distribution of economic activity); and an increased incidence of systemic shocks in both the financial and real sectors as economies have become more tightly linked together.

The entry of China and other emerging markets into the global economy over the past few decades, a process which is still in its early stages, has super-charged this process. The global economy is becoming genuinely global, with emerging markets now accounting for over half of global GDP growth. The share of global GDP produced by advanced economies has been reducing relatively slowly, from about 75% in 1980 to about 68% in 2010. Advanced economy GDP is projected to reduce to about 40% of the global total by 2030.

---

<sup>22</sup> Arie de Geus, *The Living Company: Habits for Survival in a Turbulent Business Environment*, Harvard Business School Press, 1997.

<sup>23</sup> Fred Bergsten, 'The Dollar and the Deficits: How Washington Can Prevent the Next Crisis', *Foreign Affairs*, November/December 2009.

Globalisation is reaching further into the domestic economies of all developed countries. Technology and new business models are increasing the share of the economy that is exposed to international competition; much less is genuinely non-tradable. Even large countries are affected by sharp exchange rate movements, external economic shocks, and by global pressures on the income distribution.

This is generating structural pressures across many developed countries – and policy changes are needed to restore competitiveness, redefine the social contract, and respond to a changing global environment.<sup>24</sup> These pressures will require all developed countries, large and small, to step up their performance. But in addition to these general changes, there are two emerging features of globalisation that may be particularly problematic for small countries: the weakening of multilateralism and greater economic turbulence.

### The weakening of multilateralism

Small countries have benefited from a liberal, rules-based approach to the global economy. The multilateral approach to liberalisation has made it easier for small countries to access larger markets. However, for various reasons, making progress through the multilateral approach is becoming much more difficult; the Doha Round looks unlikely to be successfully concluded, there is no clear global approach to issues like exchange rate management and external imbalances, and so on. The multilateral approach to globalisation is weakening.

Many countries now emphasise regional and bilateral solutions (for example FTAs rather than the Doha Round). And the new international architecture that is being assembled, such as the G20, makes it more difficult for small countries to participate than was the case in more multilateral processes. It is harder for small countries to take on large countries in situations in which interests diverge. This may make the relatively small size of the domestic market of small countries more of a constraint on growth in the future than has been the case over the past few decades.

Big power politics means that smaller countries can be pushed around more easily. Small countries can operate more easily in environments with relatively level playing fields and open markets. While globalisation is unlikely to reverse, the global economy will have a more managed – and perhaps a more negotiated – flavour to it. The next decade seems likely to be a period of marked change relative to the experience of the past few decades. It may be the ‘age of continents’, as David Miliband has termed it, in which the big powers of big groupings exert much greater influence.<sup>25</sup>

Of course, small countries have always had to fight for market access. Barriers to access have remained, and the informal effects of distance and national borders meant that small countries could not fully overcome the constraints posed by small domestic market size. But in this new world, small countries will need to work harder even harder and more creatively to gain access and to project influence.

---

<sup>24</sup> Dani Rodrik discusses the tension between globalisation, democracy, and national sovereignty in *The Globalization Paradox*, 2011.

<sup>25</sup> David Miliband, ‘Strong Britain in a Strong Europe’, speech to the International Institute for Strategic Studies, October 2009.

## Economic turbulence

The second major structural change is increased risk and turbulence in the global economy. There are major challenges in the global economy, such as external imbalances, sovereign debt problems, and the robustness of banking sectors and financial systems. And the structural changes that are underway contribute to the potential for increased volatility, particularly those associated with the shift of economic gravity from advanced economies to emerging economies. These economic and political dynamics are likely to interact in significant ways.

Changes of this magnitude are likely to cause disruption and volatility – at a minimum, there will be heightened uncertainty. Indeed, periods of structural change are often coincident with periods of elevated risk and uncertainty. The US National Intelligence Council recently noted that “Historically, emerging multipolar systems have been more unstable than bipolar or unipolar ones...the next 20 years of transition to a new system are fraught with risks.”<sup>26</sup>

So although there are substantial growth opportunities because of strong fundamental forces – demographics, urbanisation, technology, productivity catch-up – the distribution of possible outcomes will likely be significantly higher.

Small countries are likely to be disproportionately exposed to this increased turbulence. The external sector is a more important part of the economies of small countries relative to large countries. As noted above, the ratios of exports and foreign investment to GDP are significantly higher in small countries. Because of this larger exposure, volatility and turbulence in the global economy has a relative large impact on economic outcomes such as GDP and employment.

This exposure also tends to be more acute for smaller economies because in general they are more specialised, with reliance on a smaller number of important sectors than is the case for larger economies. Small economies can generate critical mass in fewer areas than can larger economies. Larger economies, such as the US, are likely to be more diversified and so can absorb sector-specific shocks more easily. Small countries are qualitatively different than large countries, and are not simply scaled-down versions of larger economies.

Indeed, the crisis has hit several small countries particularly hard. Recent events on the periphery of Europe demonstrate that small countries are highly exposed to global events, such as Iceland and Greece (exacerbated by policy errors, which in Greece’s case were long-standing). And even strong performers such as Singapore, one of the most open small economies, are subject to significant economic volatility; Singapore’s GDP fell by 10% in 2009 and then rose by almost 15% in 2010.

## Overall assessment

Overall, small countries face a much more challenging, less benign environment. However, these changes should not be over-stated – at least not yet. Globalisation remains, and while change is likely (such as increased regionalism, capital controls, and other frictions) a reversal is unlikely. Small

---

<sup>26</sup> National Intelligence Council, *Global Trends 2025: A Transformed World*, November 2008

countries have had to manage the emerging challenges of economic turbulence and weakening multilateralism over the past decade, and seem to be doing so with some success. There is no evidence that small countries are systematically struggling in this emerging new environment. Indeed, the reverse seems true. Many small countries are actively responding, as indicated by their participation in FTAs, the active programmes of fiscal consolidation, and the like. Indeed, many small countries seem to be more comfortable in this emerging world than many of the larger countries, several of whom are struggling to respond to the disruptive changes.

One of the reasons for confidence in the prospects for small countries is that there is no evidence of countries seeking to formally consolidate. If anything, sub-national units are continuing to seek increased independence. For example, centrifugal forces are clearly operating in the EU area, most notably in Scotland. But, of course, this is within the context of participation in broader groupings.<sup>27</sup>

However, it is also becoming apparent that some small countries are struggling to adapt to this emerging environment. Indeed, the names of some small countries are now synonymous with the crisis, notably Greece. And the challenges will become more significant over the coming decade and beyond, creating significant exposures for some small countries. All small countries will need to work even harder and more creatively to prosper and remain relevant in this environment.

But the lesson of the past decade is that small countries can perform if they respond. Fatalism is not warranted. The absence of a widespread deterioration in performance suggests that the key thing is the extent to which small countries are able to adapt themselves to the changes. So in thinking about prospects for the performance of small countries in this emerging environment, much turns on how the intrinsics and policy options available to small countries allow them to respond appropriately. The next section considers the agenda for action for small country governments.

## 5. Performing in a challenging world

The prospects for small countries depend on how well they continue to respond to a changing global situation. Specifically, small countries need to focus on two areas in order to engage successfully in the global economy. First, develop a clear policy agenda that engages seriously with the global environment, and positions the country to compete in the changing global context. Second, to deliver this policy agenda, governments will need to invest in strengthening public sector strategic capacity, political institutions and social cohesion so that there is a shared understanding and sense of direction.

Both elements are vital to sustaining small country performance. In principle, governments seem to have access to policy actions that will compensate for a more challenging environment – but without

---

<sup>27</sup> A letter in the *Financial Times*' Letters page from a Scottish (SNP) MP in the European Parliament captures this sentiment: "In the open economies of 21<sup>st</sup> century Europe only the powers of an independent nation are sufficient to deal flexibly and successfully with the challenges we face at home and represent our interests in global forums on global challenges... We will all remain within a wider union, the EU, which guarantees our rights to trade as well as to be ourselves" [16 January 2012].

the right intrinsics (political institutions, government capacity, shared purpose and trust) it will be much more difficult for governments to implement the actions that are needed.

## Policy agenda

One of the key drivers of success for small countries has been their ability to develop a deliberate policy strategy to position themselves in the global economy. This will become increasingly important given the changes in the global environment described above. All major areas of public policy need to be informed by a perspective on the external environment; for small countries, few areas of policy can be regarded as purely domestic.

In developing the policy agenda, there are three related areas that will be priorities for governments of small countries: economic strategy; managing risks and building resilience; and building a portfolio of external relationships.<sup>28</sup>

- Economic strategy

Small countries need to be able to develop a clear perspective on how they will compete, and then invest to develop these areas of competitive strength. This will involve choices being made in terms of where to invest to develop a distinctive position. This could be an industry sector or a capacity like the innovation ecosystem, a low tax rate, or the quality of the country's human capital or infrastructure.

As is evident from the earlier discussion, the specifics of the economic strategy will vary across countries. Small countries have variously focused on R&D, inward FDI, building on existing or new sector strengths in their economy, and the like. Countries need to determine where they will be competitive against other locations, and what mix of policies best suits the country given its preferences and circumstances.

There is no one-size-fits-all approach, and no race to the bottom – consider the different strategies employed successfully by countries like Denmark, Finland, Singapore, and Hong Kong. Many small countries have been thoughtful about issues of employment and income distribution in developing an economic strategy that supports a larger government role. The critical thing is that the choices be calibrated and coherent, and the various policies be lined up deliberately.

The development of this strategy needs to be done in the context of the way in which the global economy is changing. Given the nature and scale of some of the challenges to small countries described above, these countries will need to review their existing approaches to ensure they are robust to changes in the global environment. Even historically successful approaches to economic policy may need to be altered in light of the emerging realities.

---

<sup>28</sup> *This is a high-level discussion, intended to identify the key elements of the government response. The specific national policy actions will depend heavily on local context, and will be the subject of separate work.*

- Risk management and resilience

Governments of small countries will have to think hard about managing risks and building resilience, particularly given the increased economic volatility that is likely.<sup>29</sup> There are at least three parts to this process. First, governments need to better understand the full set of risk exposures they face, and make a decision as to which to bear and which to seek to manage and offload.

Second, governments need to consider more deliberate approaches to managing risks; ranging from the nature of the exchange rate regime, to security of supply of key imports, to the level of sectoral diversification in the economy. In this respect, there is a clear link between risk management and the design of the economic strategy – the risk profile of key sectors and markets, and the overall sector and geographic diversification, matters a great deal. In this regard, it is interesting that small countries operate more conservative fiscal policy settings, and have stronger current account balance positions, than do large countries. And many small countries are leading in their efforts on fiscal consolidation.

Third, governments need to build resilience by increasing their ability – as well as that of households – to absorb shocks. This will need to occur at multiple levels, from government balance sheet management to the provision of social insurance. It is notable that small, open countries tend to have higher levels of social insurance than larger, less open countries, partly to compensate for the increased volatility associated with openness.<sup>30</sup>

Many governments – large and small – have taken a relatively hands-off approach to risk management and building resilience. Indeed, many countries have reduced resilience at the same time as risk exposures have increased, often in the name of efficiency. The working assumption has been that markets can be relied on to manage risks. These attitudes are changing, partly because of the lessons from the financial crisis, and there is a growing sense that risks need to be more deliberately managed. This is particularly so for small countries, given their high level of exposure to external shocks. As one example, it suggests that a conservative approach to fiscal policy – such as a bias towards more rapid fiscal consolidation – makes sense for small countries.

- Build a portfolio of external relationships

A key part of small countries being able to deliver a robust economic strategy and to manage risks is determining how best to engage with other nations. This is particularly so given the erosion in strength of the multilateral approach that small countries have been inclined to rely on. For small countries, the feasible set of economic strategies, and the ability to manage risks, is tightly linked to the nature of the country's portfolio of external relationships.

To navigate this more complicated environment, small countries will need to build portfolios of relationships to allow them to advance and protect their interests. In particular, small countries will

---

<sup>29</sup> For a more detailed treatment of these issues, refer David Skilling, *Risk and resilience in a changing global economy*, Landfall Strategy Group, June 2011.

<sup>30</sup> Alberto Alesina and Romain Wacziarg, 'Openness, country size and government', *Journal of Public Economics*, September 1998, pp. 305-321; Dani Rodrik, 'Why Do More Open Economies Have Bigger Governments?', *Journal of Political Economy*, October 1998.

need to make judgements in terms of the dimensions on which to ‘bulk up’ and where to remain small. Although there are benefits to being small, as have been described above, the extent to which these benefits can be captured depends on the way in which the country is positioned in the global environment. And there are some areas in which being a small country in a turbulent world can become a clear liability.

For example, one obvious area in which external relationships are needed is in the context of trade, to ensure that market access to foreign markets continues to be available on favourable terms. Indeed, small countries have been the most active in negotiating bilateral and regional FTAs. Other dimensions where small countries may want to become part of broader groupings, or to develop particular relationships, may include the capital account and exchange rate arrangements, energy and food security, as well as in the context of conventional security alliances.

There is increasing activity in this space, and it is an issue at the top of national agendas in many small countries. For example, several of the small countries in Europe are currently trying to balance independence and integration within the context of discussion about the future of the EU. And it is instructive that despite the current problems with respect to Eurozone management, some small European countries are still indicating an interest to be part of the euro. The argument is that small countries are vulnerable to exchange rate volatility, and want the benefits of membership in a larger currency bloc to reduce this exposure.

Building this portfolio of relationships will require an increasing amount of creativity in terms of which instruments to use, and how to construct an appropriate portfolio of relationships. Some will be issue specific e.g. an FTA, whereas others will be more comprehensive relationships like the EU or ASEAN. This analysis also suggests that economic and strategic or security considerations will become much more tightly linked, as countries seek to position themselves in the international environment.

These ‘artificial’ ways of bulking up serve to increase resilience and provide access to markets without losing some of the advantages of small size (flexibility, agility, shared purpose). Without these efforts to bulk up, being a small, independent nation may be an increasingly uncomfortable and exposed place to be in the emerging global economy. The strong small country performance over the past few decades is not due to small size, but to being small and thoughtfully integrated into the global economic and political environment. This will become even more important in the future.

### Intrinsic strengths

The intrinsic strengths that are commonly found in small countries have been an important driver of small country performance. The relatively high levels of social capital and trust, the international orientation, as well as the capacity and effectiveness of government and political institutions, have provided the foundation that has enabled many small countries to respond to a changing global environment. Small countries have developed appropriate strategic responses that are well-calibrated and sustainable – as well as responding to shocks more rapidly (for example, the Nordic countries in response to crises in the 1990s; and some European countries responding to sovereign debt issues).

In turn, these responses to globalisation have earned many small country governments legitimacy and helped to underpin the social compact. But history indicates that economic strains will likely place these intrinsic strengths under pressure.<sup>31</sup> Investments will be needed to maintain these intrinsic strengths in order to ensure that they allow countries to respond to emerging challenges and opportunities. There are two key priorities for government action in this regard.

First, small country governments will need to invest more significantly in strategic capacity, to develop sharper perspectives on the way in which the external environment will evolve, the implications for the country, and the appropriate policy options. Delivering the policy agenda described above is a demanding task for governments. Although there is much talk of the need to raise public sector productivity, and for governments to deliver more with less in an era of fiscal constraints, strengthening strategic capacity is likely to have a more material impact on national outcomes.

To generate good performance, countries need to understand the external environment in which they are operating and position themselves accordingly. Building the institutional capacity to enable policy-makers to understand how the world is changing, and to be able to generate appropriate policy options, will become increasingly important. Strategic capacity in the public sector is likely to be a first-order driver of national competitive advantage.

However, many governments have under-invested in this strategic capacity over the past few decades. Sometimes this was because there was no perceived need due to the strong economic and social outcomes being generated. Sometimes there was a view that governments should not invest in strategy because the role of the government was simply to set the ground rules and then to get out of the way. And governments often treat strategy with some scepticism, wanting to deliver results today. This pattern of under-investment will need to be reversed.

Second, small countries will need to work hard to maintain the social consensus around the strategic direction and to retain legitimacy. As noted above, there are pressures building across the developed world (for example, due to issues of employment and income distribution). If these political foundations are weakened, it makes small countries less able to respond appropriately – and undermines one of the key advantages of small countries. Small countries who are constrained in their ability to implement policies to position their economies appropriately will face an increased risk of poor performance.

Responsiveness is not just about speed of action. Rather it rests on a shared understanding of the place of the country in the world, and the way in which decisions will be taken. This means that there is a need to ensure that the political decision-making system is in good order, that excessive partisanship is avoided, and that the right conversations are had regarding the country's place in the emerging world and the choices and decisions that need to be taken. Achieving good economic and social outcomes is not just about the policy settings, it is also about the state of the political and institutional environment.

Strengthening both the strategic capacity to develop and implement the policy agenda, as well as the intrinsic factors, matters significantly. There are policy options available that can address the changes in

---

<sup>31</sup> Benjamin Friedman, *The Moral Consequences of Economic Growth*, Knopf, 2005; Niall Ferguson, *The War of the World*, 2008.

the external environment, but without the intrinsic factors, it is unlikely that there will be the space for these policy actions to be implemented. And policy changes will be required even for the strongest performers as the global context continues to change.

## 6. Outlook for small countries

The changes in the global environment that have been described above mean that both the value and the cost of being a small country are increasing. The ability to pursue a sustained policy strategy that responds to a changing world is a substantial asset for small countries. But at the same, the costs of being small, in terms of exposure to an increasingly volatile world and potential difficulties in securing market access to larger markets, are likely to increase. The priority areas for action that are described above are designed to extract full value from being small while securing some of the benefits of being large e.g. increased resilience against shocks.

The DNA of small countries is well-suited to cope with intense globalisation, as is perhaps evident from the performance of many small countries over the past 15 years. It may even be that small countries have a competitive advantage in periods of disruptive change because they can adapt appropriately. In a constrained and uncertain world, effective government and high trust societies matter increasingly. By contrast, large countries may struggle to accommodate themselves to the emerging realities. Some countries may be too large to be manageable.

For these reasons, I expect that small countries will continue to be over-represented at the frontier in terms of the various economic and social measures. Small countries face serious challenges, but many of them also possess real advantages that enable them to respond effectively. Indeed, the discussion in the previous section suggests that there are policy options available to small countries that will enable them to respond (and many small country governments are already moving in this direction).

However, the distribution of economic outcomes for small countries is likely to grow substantially wider over the next decade. In a global environment that is becoming much more challenging for small countries, the quality of strategy and organisational capacity to deliver becomes paramount. Small countries that do not have these intrinsic strengths, that are not managed well, and that do not make appropriate strategic choices, are likely to perform particularly poorly. Small countries may also be over-represented at the bottom of the advanced economy rankings. Indeed, as we have seen recently in Europe, small countries that do not make appropriate decisions are rapidly exposed to the competitive pressures of the global economy.

## 7. Concluding remarks

Many small countries have been successful over the past few decades because they have acted deliberately to manage their competitive position and to adapt to the changes in the global environment. This responsiveness rests on the intrinsic strengths of small countries that have enabled

them to develop strategies to position themselves to compete effectively in the global economy – and to maintain popular support and social consensus. Several larger economies, whose intrinsic and complexity are of a different class, have found this process more challenging. And not all small countries have done well, which is a reminder that national choices and institutions do matter.

In order to succeed in the future, in what will be a much more challenging and complex global environment, governments of small countries need to have a deep understanding of the way in which the global economy is changing and to position themselves appropriately. There is little margin for error. As Juan Enriquez has it, “Countries that do not think, cease to exist”.<sup>32</sup> The next decade will be a period for small countries to be thinking hard. Even successful countries will need to renew their efforts to strengthen their policy agenda and their domestic institutions. Complacency is to be avoided at all costs, as is fatalism.

It might be that small countries are better able to exploit the discontinuities that emerge than are large countries. For the countries that can adapt, it may be a period of strong performance. Small countries are well-placed to undertake the fundamental re-thinking of political and economic models that is required across the developed world. Small countries will be an important source of policy insights for other countries in how to respond to the emerging challenges and opportunities. The locus of policy thinking, action, and innovation is likely to be increasingly in the small countries.

Although large countries attract much of the attention, for understandable reasons, small countries are where the attention should increasingly be focused. Not all small countries have done well, and not all small countries will do well in the emerging global environment. But an examination of the behaviour and performance of small countries provides guidance in terms of where the world’s policy-makers ought to focus their efforts. In uncertain seas, it is probably wise to follow the course charted by small countries.

---

<sup>32</sup> Juan Enriquez, *The Untied States of America*, Crown, 2005.

## Data Sources

Data	Source	Year figures for
Advanced economies listing	IMF World Economic Outlook Groups and Aggregates Information September 2011	2011
Population	United Nations Population Division, 2011; CIA World Fact Book	2010
WEF competitiveness	World Economic Forum Global Competitiveness Report 2011-12	2011-12
UNHDI	United Nations Human Development Report 2011	2011
GDP, GDP per capita, growth rates	IMF World Economic Outlook Database	1980-2011
GDP, GDP per capita, growth rates	World Bank World Development Indicators	1960-2011
GDP, 1950	The Conference Board and Groningen Growth and Development Centre, Total Economy Database	1950
Share of global GDP	IMF World Economic Outlook Database	1980-2011
Exports/GDP	World Bank World Development Indicators	2009
FDI/GDP	United Nations Conference on Trade and Development	2010
Forbes Global 2000	Forbes	2011
Gini coefficients	United Nations Development Report	2000-2010
UN member countries	United Nations (un.org)	1945-2011
Trust	World Values Survey	2005-2007
Government Effectiveness	World Bank Governance Indicators	2011
R&D	OECD Science, Technology and Industry Scoreboard	2011
Fiscal variables	IMF World Economic Outlook Database	2011
Manufacturing / GDP	World Bank Economic Development Indicators	2006
Industry/GDP	World Bank Economic Development Indicators	2006
High Technology Exports	World Bank Economic Development Indicators	2009
Global Creativity Index	Martin Prosperity Institute	2011

## About the author

Dr David Skilling is the Director of Landfall Strategy Group. David has substantial experience working with governments of small, advanced economies. David is currently the Senior Advisor, Strategy, to the Secretary of Foreign Affairs and Trade in New Zealand, and is a Fellow at the Civil Service College in Singapore. Prior to founding Landfall Strategy Group, David was an Associate Principal with McKinsey & Company's Public Sector Practice, based in Singapore, as well as being a Senior Fellow with the McKinsey Global Institute. Before joining McKinsey, David was the founding Chief Executive of the New Zealand Institute, a privately-funded, non-partisan think-tank, which focused on achieving significant impact in important areas of policy. Until 2003, David was a Principal Advisor at the New Zealand Treasury. David has a Ph.D. in Public Policy, and a Master in Public Policy degree, from Harvard University, as well as a Master of Commerce (Hons) degree in Economics from the University of Auckland. He was a Teaching Fellow at Harvard University for three years, and also worked at the OECD. David was elected as a Young Global Leader by the World Economic Forum in 2008.

## About Landfall Strategy Group

Landfall Strategy Group is a Singapore-based advisory firm that provides advice on strategic issues to governments. We provide distinctive perspectives on emerging global trends, working with government decision-makers to understand key global changes and how governments should respond and position themselves in the emerging global economy.

[contact@landfallstrategy.com](mailto:contact@landfallstrategy.com)

[www.landfallstrategy.com](http://www.landfallstrategy.com)

Copyright © 2012 Landfall Strategy Group Pte. Ltd.  
(UEN 201109428E), Singapore. All Rights Reserved.