OPINION

The new normal for small states

David Skilling

August 2014

The new normal is reminiscent of the 1970s: low growth, high volatility, and fragmenting international institutions. Small advanced economies need to respond.

Small advanced economies have been winners from globalisation over the past 20 years, with small country growth rates consistently higher than for larger countries. One reason for this strong small country performance has been a supportive international environment: strong, relatively stable, global growth (punctuated by a few shocks) and with an open international economic order.

But as the world emerges from the global financial crisis, small countries should not expect a return to this pre-crisis environment. The international context is changing in ways that are particularly challenging for small countries. I identify three key changes in the international environment that characterise the 'new normal'.

The new normal

First, relatively slow rates of global growth. The IMF and others are projecting historically weak growth rates, even with a strengthening US economy and ongoing contributions from emerging markets. Some of this low growth may be temporary in nature, but there are growing concerns about sustained low growth – 'secular stagnation' – despite exceptionally loose monetary policy. And there is debate about the likelihood of slow growth over the coming decades for reasons ranging from a slow-down in innovation to aging populations.

Second, increasing levels of economic volatility. Measured on a rolling ten-year basis, volatility in developed country growth rates is now at levels not seen since the 1970s. This is a significant change after more than two decades of declining global volatility. Although this is largely due to the global financial crisis that created substantial volatility in small open economies systemic shocks are more likely to occur in an increasingly complex, connected world. There is concern that after a benign period of low risk, the global economy may be moving into a more turbulent phase.

Third, a weakening multilateral system. Domestic and international politics are undermining key aspects of the international economic system on which small countries rely. Multilateral institutions such as the WTO are in trouble, and the multilateral system is being increasingly superseded by regional groupings, coalitions of the willing around specific issues, and large country groups such as the G7 and the G20. A global system that is increasingly a function of political power will be challenging for small countries.

This new normal is new in that it is distinct from the two decades prior to the crisis. But it is reminiscent of a previous period of economic history: the 1970s. The 1970s were also marked by low growth (after a few decades of strong global growth), a series of significant domestic and international economic and political shocks (Oil Shocks and wars), and weakening international institutions (such as the demise of the Bretton Woods exchange rate system).

Implications for small countries

To get a sense of the effects of this new normal, and how small countries should respond, it is instructive to consider the 1970s from a small country perspective. There are two key messages.

First, this new normal is likely to be negative for the economic performance of small advanced economies. The 1970s (and into the 1980s) were one of the few recent periods in which small advanced economies did not consistently out-perform larger countries. Several small countries suffered significant economic shocks during the 1970s, such as New Zealand, Switzerland, and some of the Nordics, which lowered growth rates – and which often had lasting effects.

And even more so now than in the 1970s, slow, volatile global growth will have a large effect on small country performance. The much increased intensity of small country international engagement over the past few decades – in terms of exports, foreign investment, and portfolio capital flows – has created a tighter relationship between international economic conditions and small country growth rates.

Indeed, many small countries are currently struggling to recapture their pre-crisis growth performance. After a relatively strong recovery from the crisis, the small country 'growth premium' has disappeared over the past few quarters. Several small open economies, notably in Europe, are struggling to generate solid post-crisis growth rates, while there is improving performance from large countries like the US and Germany.

Second, governments need to respond deliberately to the new realities. Lessons can be learned from the small country policy response in the 1970s, which often focused on trying to insulate countries from the turbulent environment rather than responding to the structural change in a more fundamental way.

Indeed, some of the weak small country performance in the 1970s and 1980s was due to poor policy choices such as protectionism, unwise industrial policy, and large fiscal deficits. It took a decade or more for some countries to respond appropriately to the changed world.

For the most part, small countries have responded well to the recent crisis with fiscal and economic reform measures. And many small countries are taking concerted action to improve the efficiency of their economies (such as through Productivity Commissions in Denmark and New Zealand), actively working to lift productivity (such as in Singapore), and implementing macro-prudential policies to manage asset prices (across a range of small countries from Singapore to Switzerland).

These are good and necessary things to do, but more is required to ensure that policies are fit for purpose in this new normal. Policy priorities across small countries include: building resilience to greater economic turbulence; targeted investments in specific areas of competitive advantage with growth potential; a clear strategy for international engagement to navigate a more complex global environment; as well as strengthened public sector capacity with respect to policy innovation and strategic anticipation.

This new normal will be challenging, but small countries that correctly interpret and respond to a changing environment can continue to out-perform.   Singapore is about as well-placed as any other small country to respond, but even here hard choices will be required. There is limited margin for error; economic history shows that strategic policy mistakes by small country governments can be costly.

Policy creativity will be required. The start of the new normal is a time for serious thinking in small countries about the next generation of policy. Indeed, the challenges of the 1970s were one of the factors that led to policy innovation in the 1980s – often with small countries in the vanguard. It is time for small countries to lead the world again.

This was published in the Opinion pages of Singapore's Straits Times on 20 August 2014.

About the author

Dr David Skilling is the founding Director of Landfall Strategy Group, which was established in 2011. David advises governments, companies, and financial institutions in several small countries, and writes regularly on global economic and political trends from a small country perspective. Previously, David was an Associate Principal with McKinsey & Company 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. 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 degree in Economics from the University of Auckland. David was named as a Young Global Leader by the World Economic Forum in 2008.

About Landfall Strategy Group

Landfall Strategy Group is a Singapore-based research and advisory firm that provides advice on strategic issues to governments, firms, and financial institutions, particularly in small advanced economies. We provide distinctive perspectives on emerging global trends, working with decision-makers to understand key global changes and how governments, firms, and institutions should respond and position themselves in the emerging global economic and political environment.

contact@landfallstrategy.com

www.landfallstrategy.com

LANDFALL
STRATEGY GROUP