Comment on Jean Crusol's "Monetary and Economic Problems of Small Island Economies: The Caribbean Case"

By Harry G. Johnson*

The so-called "small open economy assumption" has become a standard starting point of analysis of balance-of-payments and related problems based on the "monetary approach". There are two alternative ways of justifying the use of this assumption. The first is as a means of isolating the purely monetary aspects of problems from the complicating trivia of relative price and interest rate changes associated with the international transfers implicit in balance-of-payments disequilibria; these "transfer effects" can be ignored for theoretical purposes because, according to the "monetary approach", they are inherently transitory.

The other justification is provided by the concentration of analysis on particular economies for which the "small open economy assumption" fits the empirical facts. This is the approach implicit in *Crusol*'s paper on the island economies of the Caribbean — Barbados, Guadeloupe, Jamaica, Martinique, Puerto Rico and Trinidad — two French Departments, three former British colonies, one in the American free-trade zone, all with less than three million inhabitants, 15,000 square kilometers or less of territory, one or two industries accounting for over 50 % of exports, having a preferential overseas market and with a very limited home market. They have shared over the past 25 years two common problems: a chronic unemployment rate over 10 %, and a large chronic trade deficit; and a common debate over two policy alternatives, "real" and "monetary", both diagnosing insufficient capital and internal investment and insufficient export competitiveness, but one stressing foreign investment and export promotion and the other manipulation of the money supply and the exchange rate.

The paper argues (1) that increased investment won't necessarily reduce unemployment and external "disequilibrium", (2) that monetary manipulations alone cannot cure the problems, (3) that the reason is

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that both rest on theories for advanced countries which do not fit small underdeveloped open economies, (4) that the outlines of a relevant theory can be easily sketched.

On proposition 1, *Crusol* argues that despite a rapid rise in the rate of capital formation, the unemployment rate has not fallen but has in fact increased in the past quarter-century. This cannot be explained by an increase in the total labor supply. Further, increased investment has not improved the trade balance, which has worsened.

On proposition 2, *Crusol* produces the formula for the credit multiplier

$$\Delta C_r = \frac{\Delta S}{r + (c + d)(1 - r)} \qquad 0 < c < 1$$

where ΔS=increase in reserve, ΔC_r=money creation, r the bank reserve ratio, c and d the internal and external leakeages of money. *Crusol* argues that in a small open economy (a) the new credit will go into short-term commercial lending, (b) there will be an immediate leakage through the balance of payments. An alternative policy is devaluation, which will work subject to certain conditions of elasticities; but in a small open economy, real wages will be maintained, and the policy becomes only an exchange rate policy.

Some technical criticism may be entered here. First, as the monetary approach shows, except in the short run the "money multiplier" approach is quite wrong (we should get $\Delta C_r = \Delta S = 0$, $\Delta S_f = - \Delta S_d$, where S_f = foreign exchange reserves and S_d = domestic credit reserves), since it either ignores the demand for money or assumes that there exists some variable that adjusts demand for money to supply without other effects on the system. Second, the devaluation condition is not $\eta_m \geq 1$, $\eta_x > 0$, $e_m = 0$ (referring to elasticities of demands for imports and exports, and supply of imports) but $\eta_m + \eta_x \geq 1$ (approximately) with less than elastic import supply reducing the critical value below unity. In any case, the elasticity condition is only an impact effect, and *Crusol*'s criticism of it is well known from "the monetary approach".

Reverting to exchange rate changes, *Crusol* distinguishes an active policy of exchange control and a neutral policy of a floating rate. I do not follow his analysis of an optimum rate of exchange, which seems to mean an equilibrium rate, determined by the market or by official calculation of the demand and supply curves. He explains why the authorities have instead adopted fixed rates and free convertibility into the "dominant money" (the pound, in the three British cases, the others involving use of the "metropolitan" money). He then points out that if one accepts these policies directed at "external" development one has to explain why development has not solved the unemployment and trade deficit problems, whereas a different view of development as transformation suggests that overseas-centered development policy has itself created the problems.

This brings us to the final subject of *Crusol*'s paper, his sketch of a theory of foreign-oriented development [dévelopement excentré]. The central point is the implantation of a high-productivity vertically-integrated new sector ("le nouveau sector vertical" or N. S. V.) in the traditional island economy. Initially this is highly profitable given traditional wages; it leads to rapidly rising nominal and real wages in the N. S. V., a marginal propensity to consume above unity, and a rapid growth of demand for imports. This leads to increased influence of outside inflation and increasing money wage demands, and lower profitability. I must admit I do not see the relevance of outside inflation here — rising real wages, expressed in rising nominal wages, reduces real profitability, but foreign inflation seems to play no essential part. In any case, comparative advantage is reduced by the rise in real wages; offsetting by cost-rationalization and increasing capital-intensity reduces employment demand for labor, while higher real wages tend to kill off the plantation and traditional domestic sectors. Incidentally, I think the author tries to have it both ways in arguing that higher real wages in the N. S. V. attracts labor from the traditional sectors while the rise of internal prices depresses real wages and increases the reservation price of labor in the N. S. V., increasing industrial strife. The two arguments can only be reconciled by positing increasing unemployment — which still needs to be explained.

Summarizing his theory, *Crusol* mentions as elements "imported technology, imported tastes, the propensity to consume, the influence of foreign capital, and the relation beween nominal salaries and productivity" (the latter makes no sense as stated — real not nominal wages matter, unless productivity means value of product in the world market). He recommends as policies:

(1) adjustment of technology to local factor endowments,

(2) orientation of consumption to local goods, and development of local production of consumption goods,

(3) reduction of the propensity to consume to increase internal savings,

(4) reinforcing participation of internal capital in development, to discourage capital flights,

(5) modifying the rate of increase of money wages to conform to the rate of increase in productivity. This is said not necessarily to

mean a lower rate of increase of real wages, the answer depending on the rate of increase of prices of local consumption goods — which in the long run may be modified by development of local supply,

(6) generally, extending the local markets through regional integration.

I turn now to critical comments. The main problem with this paper, as with many others like it, is to sort out the economics from the youthful activism and the popular slogans.

As a beginning, one must criticize the xenophobic stress on the undesirability of imports of consumption goods, and the attribution of the trade deficit to "tastes for foreign goods" and to excessive consumption generally. Failing a large initial stock of reserves, or an established "mature creditor" international financial position, a trade deficit must be covered by a capital inflow, and with a similar provision against massive reserve accumulation a capital inflow must lead to a trade deficit. The deficit cannot be attributed to preference for foreign goods, or overconsumption, since these would have purely internal consequences without foreign capital inflow to finance them. All the figures show is that domestic saving is not enough to cover the total investment needed for development on the scale realized — which is not surprising. Further, and more important, without increasing domestic saving or reducing the rate of growth the trade deficit cannot be corrected by policies aimed at reducing the alleged preferences for foreign goods. This point has been amply confirmed by postwar experience with import-substitution policies in developing countries all over the world. But somehow activist young politicians, including political economists, ignore this experience and keep recommending import-substituting policies with the same old childish fallacies and disregard of the elementary tautology that production produces goods on one side and incomes on the other. In some of *Crusol*'s argument this fallacy is slightly disguised in the slightly more sophisticated form of implicitly assuming that workers can be induced to accept lower real wages (and get more total employment in consequence) by the higher cost of import substitutes, when they will not accept the same results brought about by competition of unemployed labor in the labor market.

The balance of trade deficit problem, in other words is not a problem; it only appears to be a problem because governments and their so-called economic advisors keep saying it is a problem. Correspondingly, import-substitution is no solution, though it is accepted as such by local capitalists who naturally like being given monopoly positions and profits, and by economic advisors who like to be popular. In case anyone gets the wrong impression, that I am attacking Mr. *Crusol* personally or as a representative, I should point out that I used to illustrate this set of fallacious arguments by reference to Canadian policy, and that a number of people present here now think of it as a British vice.

The real problem is the problem of unemployment, which is now recognized as a common problem of developing countries, though almost invariably without explanation of why development policy leads to unemployment, apart from moral indignation directed at "foreign influence" or "capitalist exploitation" or "imperialism" or "dependence". This problem happens to have close analogies with a great deal of work that has been going on recently on the explanation of unemployment — both cyclical and „secular" — in advanced economies. The basic explanation is fairly simple, if we posit labor monopoly (which may be enforced either by government protection of trade unions, or by the interest of employers in overpaying employees to keep them happy and politically approving, or by "social standards" concerning pay in advanced and governmental sectors), and especially if we add in explicit unemployment insurance, or implicit social security provided by the extended family and kinship system. (We can also bring in "leisure preference", or the assumption that workers are satisfied with a standard of living lower than they can obtain by continuous full-time employment.) Under these conditions, the availability of work at a wage above alternative opportunity income in the subsistence and plantation sectors generates an equilibrium amount of unemployment, which will not be removed by competitive forcing down of the high wage by the availability of alternative lower-alternative-opportunity-cost labor, unemployed or employed in the traditional sectors.

It follows that the appropriate policy approach for the economist is to concentrate on the role of labor monopoly (broadly defined) and to insist that the unemployment is *not* a development problem but a labor market problem; and *either* to say that it represents a social choice of sanctioning labor monopoly, *or* to stress that policy to overcome unemployment must concentrate on destroying the monopolistic pricing of N. S. V. labor.

In this connection, it would be useful for further research — which I hope Mr. *Crusol* will undertake — to concentrate on the measurement of the differential in real wages between the N. S. V. and the traditional sectors and its development over the past 25 years in the various islands; also on the effects of government policies, such as minimum wages, in creating unemployment (very important in Puerto Rico); and in the sensitivity of labor migration to unemployment and the availability of social security provisions.