

Nyamtseren, Lhamsuren

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Challenges and Opportunities of Small Countries for Integration into the Global Economy, as a Case of Mongolia

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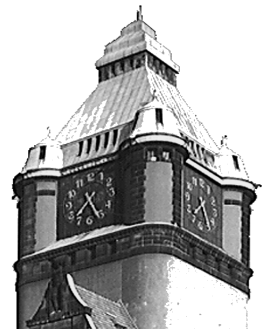
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**Challenges and Opportunities of Small Countries
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LHAMSUREN NYAMTSEREN

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Address of the author(s):

Lhamsuren Nyamtseren
Dresden University of Technology
Faculty of Business Management and Economics
01062 Dresden
Germany

e-mail : lnyamtseren@yahoo.com

Editors:

Faculty of Business Management and Economics, Department of Economics

Internet:

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Working paper coordinator:

Oliver Greßmann

e-mail: wpeconomics@mailbox.tu-dresden.de

Challenges and Opportunities of Small Countries for Integration into the Global Economy, as a Case of Mongolia

Lhamsuren Nyamtseren
Dresden University of Technology
Faculty of Business Management and Economics
01062 Dresden
lnyamtseren@yahoo.com

Abstract:

This paper examines the impacts of globalization on small countries, covering the main features of globalization, the quality of national economic and commercial environment, main characteristics of small countries including important facts and concrete indicators for their development, and their challenges and opportunities for regional integration. It concludes that: 1) globalization is a process of continuing integration of the countries of the world that is beneficial, inevitable and irreversible. No any country can afford to remain isolated from the world economy. 2) some of small countries might have higher income and much richer than others. But all small countries do not posse such an advantage. Therefore, the small countries were in this paper differently considered according to their per capita income level which varies significantly from each others. 3) For most developing countries, in particular the small and poor countries, a North-South Regional Integration Agreement with a large industrial country is likely to be superior to a South-South Regional Integration Agreement with a developing or poor small country.

JEL-Classification: F-02; F15; F-21; F-43

Keywords: Globalization, small countries, economic integration, income distribution.

1. Introduction

The objective of this study was to examine the impacts of globalization on small countries (SCs), covering the main features of globalization, the quality of national economic and commercial environment, main characteristics of small countries including important facts and concrete indicators for their development, and the challenges and opportunities for regional integration.

The author has selected 39 small countries with the population less than 5 million from 130 countries listed in World Bank Development report, 2002, 2003. Then they were classified in 3 categories, namely developed, developing and less developed small countries. The literatures relating to the main features of globalization, main characteristics of small countries were reviewed.

The paper contains 5 sections including the introduction as section 1. Section 2 examines the main features of globalization, its impacts on small countries and implications of the domestic economic and commercial environment.

Section 3 analyzes the main characteristics of small countries, including the facts of selected small countries and a broad number of concrete indicators, which might reflect the economic and social development of selected small countries as result of impacts on small countries in confrontation with globalization.

In section 4, the political and economic arguments of small countries for membership in Regional Integration Agreements (RIAs) have been examined and some positive and negative impacts of hypothetical Regional Integration Agreements have been assessed by comparing the alternative types of RIAs. Some possible policy choices in joining RIAs with regard to: 'With whom?', 'How open to the outside world?'; 'Customs Union or free Trade Area?'; 'How deep?' and 'What effects on nonmembers?' were discussed. Finally, section 5 concludes the main outcomes of the above sections.

2. Globalization and Small Countries

2.1. Globalization as a Beneficial, Inevitable and Irreversible Process

Though the term globalization is widely used, its meaning is not always entirely clear. Although there are some critics and opponents, globalization is a powerful real aspect of the new world system, and it represents one of the most influential forces in determining the future course of the planet (Micheal D.Intriligator, 2002) ¹. It means major increases not only in traditional international trade in goods and services, but also in exchanges of currencies; in capital movements; in technology transfer; in people moving through international travel and migration; and in international flows of information and ideas.

Globalization, in short, can be thought of as the widening, intensifying, speeding up, and growing impact of world-wide interconnectedness. Global markets are borderless. In this borderless economy, states have no option other than to accommodate global market forces ². That means that no any country can afford to remain isolated from the world economy.

It is a process that is beneficial - a key to future world economic development - and also inevitable and irreversible ³.

¹ - Micheal D.Intriligator, Globalization of the World economy: Potential Benefits and costs and a Net Assessment, 2002.

² - David Held, Anthony McGrew, Globalization: Entry from Oxford Companion to Politics, 1998.

³ - Globalization: Threat or Opportunity, IMF staff, January 2002

Economic globalization is a historical process, the result of human innovation and technological progress. It refers to the increasing integration of economies around the world, particularly through trade and financial flows.

Globalization is therefore, a process of continuing integration of the countries in the world, supported by accelerating pace of technological change, by price and trade liberalization, and by growing importance of supranational rules, where the mechanism deciding the allocation in goods and factor markets is increasingly operating at a global level, is a highly complex and controversial concept, has exposed national economies to much more intense competition than ever before⁴. It has many dimensions: economic, political, social, cultural, environmental, security, and others.

As globalization has progressed, living conditions have improved significantly in virtually all countries. However, the strongest gains have been made by the advanced countries and only some of the developing countries.

2.2. Some General Implications of Globalization

Nevertheless the about implications of globalization affect small countries, but it is too early to conclude that globalization has caused the divergence, or that nothing can be done to improve the situation. Most cross-country studies conclude that increased trade and foreign direct investment flows are, at least in the long run and in most cases, correlated with higher rates of economic growth and productivity increases for the economy as a whole.

Economic globalization has brought with it an increasingly unified world for elites - national, regional and global - but divided nations and communities as the global workforce is segmented, within rich and poor countries alike, into winners and losers (David Held , Anthony McGrew, 1998).

The globalization does not reduce national sovereignty. It does create a strong incentive for governments to pursue sound economic policies. It should create incentives for the private sector to undertake careful analysis of risk. However, short-term investment flows may be excessively volatile.

Liberalization measures have resulted in the build-up of a large stock of financial capital that can move from one country to another almost instantaneously and at limited transaction costs. Specially, short-term capital flows have grown spectacularly and, partly reflecting the integration of financial markets, transactions in foreign exchange markets are nearly 80 times larger than world trade (IMF Staff, 2002). As a result, national economies have become more vulnerable to the changing perceptions and interests of international investors. There is a real danger that capital flows will increasingly determine exchange rate movements, in turn affecting trade, output and employment levels.

If it is assumed that countries aim to achieve sustainable growth, low inflation and social progress, then the evidence of the past 50 years is that globalization contributes to these objectives in the long term.

In the short-term, as we have seen in the past few years, volatile short-term capital flows can threaten macroeconomic stability. Thus in a world of integrated financial markets, countries will find it increasingly risky to follow policies that do not promote financial stability.

2.3. Some General Challenges of Globalization

Challenge lies in selecting the appropriate mix of domestic policy measures (by governments and social partners) to improve the returns from globalization while reducing the social costs. The country studies show that, in contrast to the view that national governments are powerless in the face of globalization,

⁴ - Mojmir Mrak, Globalization: Trends, Challenges and Opportunities for Countries in Transition. UNIDO, Vienna, 2000, P3.

domestic policies can have a strong bearing on the relationship between globalization and social progress⁵.

Macroeconomic stability, financial soundness, open economies, transparency, and good governance are all essential for countries participating in the global markets.

Economic stability, institution building, and structural reform are at least as important for long-term development. Components of such a package might include³:

- Macroeconomic stability to create the right conditions for investment and saving;
- Outward oriented policies to promote efficiency through increased trade and investment;
- Structural reform to encourage domestic competition;
- Strong institutions and an effective government to foster good governance;
- Education, training, and research and development to promote productivity;
- External debt management to ensure adequate resources for sustainable development.
- Well-targeted social safety nets to assist people who are displaced.

The IMF supports reform in the poorest countries through its new Poverty Reduction and Growth Facility. It is contributing to debt relief through the initiative for the heavily indebted poor countries (HIPC).

In nowadays globalization process, the gains are typically distributed unevenly among countries and groups within countries, and some groups may lose out. For instance, workers in declining older industries may not be able to make an easy transition to new industries. In such case some governments try to protect particular groups, like low-paid workers or old industries, by restricting trade or capital flows. Such an approach might help some in the short-term, but ultimately it is at the expense of the living standards of the population at large. Rather, governments should pursue policies that encourage integration into the global economy while putting in place measures to help those adversely affected by the changes. The economy as a whole will prosper more from policies that embrace globalization by promoting an open economy, and, at the same time, carefully address the need to ensure the benefits are widely shared.

2.4. Differences of “Large” and “Small” countries in Trade Policy Effects⁶

If the country is "**large**" in international markets, then the countries imports or exports are a significant share in the world market for the products, **domestic trade policies can affect** supply or demand on the world market sufficiently to change the world price of the product.

Large importing countries are said to have "*monophony power in trade*", while large exporting countries are said to have "*monopoly power in trade*."

When a large exporting country implements a trade policy it will affect the world market price for the good. That is the fundamental implication of largeness. For example, if a country imposes an export tax, the world market price will rise because the exporter will supply less. An export tax set optimally will cause an increase in national welfare due to the presence of positive terms of trade effect. This effect is analogous to that of a monopolist operating in its own market. A monopolist can raise its profit by

⁵ - GB.276/WP/SDL/1, 276th Session, Geneva, November 1999

³ – Globalization: Threat or Opportunity by IMF staff, January 2002

⁶ - Steven M.Suranovic. International Trade Theory and Policy Lecture Notes, 1997-2004.
<http://internationalecon.com/v1.0/ch90/90c250.html>

restricting supply to the market and raising the price it charges its consumers. In much the same way a large exporting country can restrict its supply to international markets with an export tax, force the international price up, and create benefits for itself with the terms of trade gain. The term monopoly "power" is used because the country is not a pure monopoly in international markets. There may be other countries exporting the product as well. Nonetheless, because its exports are a sufficiently large share of the world market, the country can use its trade policy in a way that mimics the effects caused by a pure monopoly. Hence the country is not a monopolist in the world market but has "monopoly power" instead.

A monopsonic represents a case in which there is a single buyer in a market where there are many sellers. A monopsonic raises his own welfare or utility by restricting his demand for the product and thereby forcing the sellers to lower their price to him. By buying fewer units at a lower price the monopsonic becomes better-off. In much the same way, when a large importing country places a tariff on imports, the country's demand for that product on world markets falls, which in turn lowers the world market price. An import tariff set optimally will raise national welfare due to the positive terms of trade effect. The effects in these two situations are analogous. We say that the country has monopsony "power" because the country may not be the only importer of the product in international markets, yet because of its large size it has "power" like a pure monopsonic.

If the country is "**small**", its share in international markets is so small, that domestic policies are unable to affect the world price of the goods. Domestic firms and consumers must take international prices as given because they are too small for their actions to affect the price.

This implies that in a small country case, the price of the import goods in the importing country will rise by the amount of the tariff. The higher domestic price reduces import demand and export supply.

When a trade policy is implemented by a small country such as a tariff, the domestic producers of the product will receive a higher price for the goods they sell and domestic consumers will pay the same higher price for the goods they purchase. Similarly, if a domestic production subsidy is implemented by a small country, it will raise the price producers receive when they sell their good, but it will not affect the price paid by domestic consumers when they purchase the good. The foreign price would remain equal to the domestic consumer price. If a domestic consumption tax is implemented by a small country, it will raise the domestic consumer price of the good but will not affect the domestic producer price. The foreign price will remain equal to the producer price in this case.

Domestic policies of small countries can lead as a basis for trade, for example, the imposition of domestic taxes or subsidies can induce international trade.

2.5. Globalization and Its Impacts on Small Countries

For small and low income countries, effective participation in the global activities remains a serious problem, especially in view of the increasing complexity and range of issues handled by the WTO. This raises difficult technical and institutional problems for small countries.

Globalization rises some concern and several problems regarding the participation of small countries in the multilateral system as well as the socio-economic implications of the trade agreements:

- Trade liberalization tends to increase export specialization, which in the case of certain developing and small countries might translate into heavy reliance on a small range of export products. Such a narrow export base can increase economic and labour market vulnerabilities to terms-of-trade shocks.

- Developed countries fear competition from low-wage economies, while firms from developing and small countries find it difficult to compete against powerful multinational companies from developed countries.
- The developing and small countries claim that globalization has rendered their economies more vulnerable to international shocks, especially where their export base is very narrow and their exposure to changes in the terms of trade is correspondingly high.
- The gains of the globalization are typically distributed unevenly among countries, specially very low to small and poor countries.
- The income gap between high-income and low-income countries, including low-income small countries has grown wider.
- Poverty is still a serious problem in poor small countries.
- Developing and small countries often specialize in markets subject to fierce pressures in terms of price and cost, such as textiles and raw materials. As a result, these countries are more vulnerable to fluctuations in exchange rates and sudden international changes in wages and prices. By contrast, developed countries tend to specialize in the trade of relatively differentiated products, for which competition takes place mainly in the form of quality changes and innovation. Such a pattern of specialization greatly helps cushion against external shocks.

Followings summarize the review of the literatures related to positive and negative impacts of globalization on small countries.

There are number of theories, empirical studies and literatures related to impacts of globalization in small countries. It seems some are contradicting with each other. However, all the conclusions are valuable to consider in policy implications of small countries. For example, Easterly and Kraay have made very optimistic conclusions that small states have higher per capita GDP than other states, and that they are actually significantly richer, the infant mortality is significant lower, while life expectancy is about four years higher than other states. This income advantage should be largely due to a productivity advantage, constituting evidence against the idea that small states suffer from an inability to exploit increasing returns to scale.

However, such a conclusion might be too overestimated. Of course, some of small countries might have higher per capita GDP and much richer than others. But all small countries do not posse such an advantage. Therefore, it would be suggestible the small countries to be considered differently according to their per capita income level which varies significantly from each others.

The following conclusions and characteristics are seems to be important for small countries:

1. Positives:

- Smallness is neither a necessary nor sufficient condition for slow economic development (T.N.Srinivasan, 2002).
- Small countries have more cohesive populations which allows them to adapt better to change (Kuznets, 1960).
- Small states typically have much larger trade ratios than larger states (Easterly & Kraay, 1999).
- Small states are well-positioned to take advantage of opportunities for international risk sharing, since the correlation of economic fluctuations in small states with the world business cycle is surprisingly low (Easterly and Kraay, 1999).
- Globalization brings opportunities as well as risks, and more integrated global economy may enable smaller states to adapt quickly to changing conditions, and to more readily pursue strategic development policies (Bräutigam and Woolcock, 2001).
- Small countries are better in terms in foreign aid (Streeten, 1993).

- Most global economies tend to be small nations for which openness allows access to goods, services, and capital. Small trading nations tend to show higher levels of integration with other countries (Kearney, 2003).
- The gains to developing and small countries from removing their own barriers are much greater than the gains from increased access to the markets of rich countries (Mark Weisbrot & Dean Baker, 2002).
- Small countries tend to have a comparative advantage in semi-manufactures and a disadvantage in finished manufactures. Small countries are likely to gain the most from trade liberalization and regional integration because their opportunities will tend to be equalized with those of larger nations (Balassa, Bela. 1969).

2. Negatives:

- Small states do have greater volatility of annual growth rates (Easterly and Kraay, 1999).
- Small states have always been vulnerable in the global economy and are more aid and trade dependent (Bräutigam and Woolcock, 2001).
- Small countries may have smaller pools of qualified people to select from in staffing their bureaucracies. Their greater openness and small size make an initial stage of import substitution industrialization very difficult (Streeten, 1993).
- Small countries seem to have larger problems, in particular higher poverty and inequality as well as greater vulnerability to shocks. Many small states suffer from poor location in that they are remote or landlocked. When combined with poverty, low levels of public sector capacity may create a vicious circle (Commonwealth Secretariat, 1998, 2000).
- Although small countries gains from removing their own barriers, they also incur substantial costs from opening their markets, which are often overlooked (Weisbrot and Baker, 2002).
- The limited size of domestic markets appeared insufficient to support production operations for industries that experience economies of scale. Many of small countries are Land-locked, often at a major competitive disadvantage as exporters of the high bulk low value products due to high freight and insurance costs incurred in the transit to the sea. They have relatively remote location from major OECD markets (Francis Ng and Alexander Yeats, 2003).
- They have also relatively limited natural resource endowments. Although countries with relatively large exploited endowments of valuable natural resources may experience “Dutch disease” effects that adversely influences the level and composition of exports (Sachs and Wagner, 1996).
- The trend towards multilateral trade may put small states at a disadvantage because they presently benefit from many bilateral trade concessions (Armstrong and Read, 1998).
- Small countries political centralization tends to be greater and political arrangements tend to be more closely knit’ However, it is possible that these close-knit political arrangements and centralization can lead to higher levels of corruption (Peter Katzenstein, 1985).

3. Main Characteristics of Small Countries

3.1. Important Development Facts of Small Countries

Real facts are important to answer why some small countries are well developed and some are not or less developed. In general, the developed small countries have a good starting point, free market system, integration or historical ties with developed countries such as Western Europe, USA, Canada or Japan. Some have a fortune with natural resources e.g. oil and gas like Norway and Kuwait. They have also diversified modern industrial economy, high agriculture productivity, and well-educated workforce. They implemented structural reforms to improve the business environment and government welfare measures.

In contrast, the less developed small countries such as Sierra Leone, Eritrea, Togo, Central African Republic and Mauritania have mostly problems or constraints like their economy is largely based on

subsistence agriculture, and the economic and social infrastructure is not well developed, and have high inequality in income distribution, a largely unskilled work force. Some have serious social disorders, civil war or war from outside, and a legacy of misdirected macroeconomic policies etc.

Some country specific facts of developed and some developing and less developed small countries are summarized in following:

Norway

- Discovery of oil and gas in adjacent waters in the late 1960s boosted Norway's economic fortunes.
- Norwegian economy is a prosperous bastion of welfare capitalism, featuring a combination of free market activity and government intervention. The government controls key areas, such as the vital petroleum sector (through large-scale state enterprises).
- The country is richly endowed with natural resources - petroleum, hydropower, fish, forests, and minerals - and is highly dependent on its oil production and international oil prices, with oil and gas accounting for one-third of exports.
- Norway has been saving its oil-boasted budget surpluses in a Government Petroleum Fund, which is invested abroad and now is valued at more than \$43 billion.

Denmark

- Denmark has evolved into a modern, prosperous nation that is participating in the general political and economic integration of Europe. It joined NATO in 1949 and the EEC (now the EU) in 1973.
- Its thoroughly modern market economy features high-tech agriculture, up-to-date small-scale and corporate industry, extensive government welfare measures, comfortable living standards, a stable currency, and high dependence on foreign trade.

Finland

- Finns made a remarkable transformation from a farm/forest economy to a diversified modern industrial economy.
- As a member of the European Union, Finland was the only Nordic state to join the euro system at its initiation in January 1999. Finland has a highly industrialized, largely free-market economy.
- Rapidly increasing integration with Western Europe - Finland was one of the 12 countries joining the European Economic and Monetary Union (EMU).

Ireland

- Ireland is a small, modern, trade-dependent economy with growth averaging a robust 8% in 1995 - 2002.
- Agriculture, once the most important sector, is now dwarfed by industry and services. Industry accounts for 46% of GDP and about 80% of exports and employs 28% of the labor force.
- Although exports remain the primary engine for Ireland's growth, the economy has also benefited from a rise in consumer spending, construction, and business investment.
- Over the past decade, the Irish Government has implemented a series of national economic programs designed to curb inflation, reduce government spending, increase labor force skills, and promote foreign investment. Ireland joined in launching the euro currency system in January 1999.

Singapore

- One of the world's most prosperous countries with strong international trading links (its port is the world's busiest in terms of tonnage handled).
- A highly developed and successful free market economy, enjoys a remarkably open and corruption-free environment, stable prices, and a high per capita GDP.
- The economy depends heavily on exports, particularly in electronics and manufacturing. Fiscal stimulus, low interest rates, and global economic recovery should lead to much improved growth.

Kuwait

- Kuwait is a small, rich, relatively open economy with proved crude oil reserves of about 98 billion barrels - 10% of world reserves. Petroleum accounts for nearly half of GDP, 95% of export revenues, and 80% of government income.

New Zealand

- Over the past 20 years the government has transformed New Zealand from an agrarian economy to a more industrialized, free market economy that can compete globally.
- This dynamic growth has boosted real incomes, broadened and deepened the technological capabilities of the industrial sector, and contained inflationary pressures.
- Per capita income has been rising and is now 80% of the level of the four largest EU economies. Thus far the economy has been resilient. Expenditures on health, education, and pensions will increase proportionately.

Slovenia

- Slovenia, with its historical ties to Western Europe, enjoys a GDP per capita substantially higher than that of the other transitioning economies of Central Europe.
- In March 2004, Slovenia became the first transition country to graduate from borrower status to donor partner at the World Bank.
- Privatization of the economy proceeded at an accelerated pace in 2002 - 03, and the budget deficit dropped.
- Structural reforms to improve the business environment allow for greater foreign participation in Slovenia's economy and help to lower unemployment.

Uruguay

- Uruguay's well-to-do economy is characterized by an export-oriented agricultural sector, a well-educated workforce, and high levels of social spending.
- Cooperation with the IMF and the US has limited the damage.
- The debt swap with private creditors carried out in 2003, which extended the maturity dates on nearly half of Uruguay's \$11.3 billion in public debt, substantially alleviated the country's amortization burden in the coming years and restored public confidence.

Estonia

- Estonia has been free to promote economic and political ties with Western Europe.
- It will accede to the EU in May 2004 and to NATO in the summer of 2004. Estonia, as a new member of the World Trade Organization, is steadily moving toward a modern market economy with increasing ties to the West. The economy benefits from strong electronics and telecommunications sectors.

- The economy is greatly influenced by developments in Finland, Sweden, Russia, and Germany, four major trading partners.

Costa Rica

- Although still a largely agricultural country, it has expanded its economy to include strong technology and tourism sectors.
- Land ownership is widespread. Costa Rica's basically stable economy depends on tourism, agriculture, and electronics exports.
- Poverty has been substantially reduced over the past 15 years, and a strong social safety net has been put into place.
- Foreign investors remain attracted by the country's political stability and high education levels.
- The government continues to grapple with its large deficit and massive internal debt.

Panama

- Panama's dollarised economy rests primarily on a well-developed services sector that accounts for three-fourths of GDP. Services include operating the Panama Canal, banking, the Colon Free Zone, insurance, container ports, flagship registry, and tourism.
- The government has been backing public works programs, tax reforms, new regional trade agreements, and development of tourism in order to stimulate growth.

Slovak Republic

- Slovakia has mastered much of the difficult transition from a centrally planned economy to a modern market economy.
- The government made excellent progress during 2001 - 2003 in macroeconomic stabilization and structural reform.

Sierra Leone

- Sierra Leone is an extremely poor African nation with tremendous inequality in income distribution.
- The economic and social infrastructure is not well developed, and serious social disorders continue to hamper economic development, following an 11-year civil war.
- About two-thirds of the working-age population engages in subsistence agriculture.

Eritrea

- Since independence from Ethiopia on 24 May 1993, Eritrea has faced the economic problems of a small, desperately poor country.
- The economy is largely based on subsistence agriculture, with 80% of the population involved in farming and herding.
- The Ethiopian-Eritrea war in 1998 - 2000 severely hurt Eritrea's economy.

Central African Republic

- Important constraints to economic development include the CAR's landlocked position, a poor transportation system, a largely unskilled work force, and a legacy of misdirected macroeconomic policies.
- Factional fighting between the government and its opponents remains a drag on economic revitalization.

- Distribution of income is extraordinarily unequal.

Togo

- Togo has come under fire from international organizations for human rights abuses and is plagued by political unrest. Therefore, most bilateral and multilateral aid to Togo remains frozen.
- Production fell an estimated 22% in 2002 due to power shortages and the cost of developing new deposits.
- The government's decade-long effort, supported by the World Bank and the IMF, to implement economic reform measures, encourage foreign investment, and bring revenues in line with expenditures has moved slowly.

Mauritania

- Half the population still depends on agriculture and livestock for a livelihood, even though many of the nomads and subsistence farmers were forced into the cities by recurrent droughts in the 1970s and 1980s.
- The decline in world demand for ore has led to cutbacks in production. In the past, drought and economic mismanagement resulted in a buildup of foreign debt. Substantial oil production and exports probably will not begin until 2005.

3.2. Domestic Economic and Commercial Environment of Small Countries

The domestic economic and commercial environment is important for integration in the global economy and for their growth.

Recently, the Wall Street Journal and Heritage Foundation (WSJ-Heritage) compiles and updates annually an index that measures the general overall commercial policy environment in over 150 countries. This initiative produced similar indices on government policies relating to ten business factors, namely the extent of trade controls, the level of taxation, the extent of government interventions in the economy, national monetary policy and its contribution to inflation, restrictions on capital flows and their impact on foreign investment, government controls on banking, the extent of government imposed wage and price controls, the security of property rights, the extent of government regulation of industry, and the size of the black market.⁷ The WSJ-Heritage index shows that the countries with relatively attractive economic and commercial environment achieved significantly higher levels of GDP per capita, they experienced higher growth rates for exports, imports and GDP, and more successful in integrating into the global economy. The WSJ-Heritage Indices for each of ten variables are assigned on the basis of objective criteria, and can take a value of one to five with lower values indicating an environment more conducive to economic growth. The overall index of the quality of the national economic environment was derived for each country by averaging the ten WSJ-Heritage policy indices. This overall index is often viewed as one measure of the attractiveness of a country for foreign investment and its ability to sustain industrialization and economic growth. Table 3.1. shows the Domestic Economic and Commercial Environment Index of the commercial environment in selected small countries. The most small countries that have a free economic and commercial environment as classified in this Table are developed small countries, while the small countries that are classified restricted, are less developed.

⁷ - The Wall Street Journal and Heritage Foundation , 2002

Table 3.1. Domestic Economic and Commercial Environment Index of Selected Small countries

WSJ-Heritage Index Range	Commercial Classification	Classified Countries
2 or under	free	Singapore, New Zealand, Estonia, Ireland, Denmark, Finland
over 2 and under 3	relatively free	Latvia, Uruguay, Costa Rica, Armenia, Jordan, Kuwait, Botswana, Jamaica, Mongolia , Lithuania, Slovak Rep., Namibia
3 to under 4	relatively restricted	Mauritius, Central African Republic, Slovenia, Lebanon, Nicaragua, Albania, Mauritania, Moldova, Georgia, Lesotho, Kazakhstan, Togo, Congo Republic, Paraguay, Macedonia,
4 to 5	restricted	Turkmenistan, Lao Republic

3.3. Analyses of Important Indicators of Small Countries

3.3.1. Size of the Economy and Annual Growth of GNP

The per capita GNP can be considered as a result of country's economic, political and social activities in which the country succeeded in confrontation with globalization. Among the small countries, there are many variations in GNP per capita. For example, it varies at the maximum from US\$ 38, 731 by Norway, which is much higher than average of high income countries (US\$ 25,730) of the world, at the minimum to US\$ 140 by Sierra Leone, which is almost 3 times lower than the world's low income countries. Therefore, the income level among small countries should be differently considered because if we consider the income level as an average of all small countries then as the best and as well as the worst will be overclouded. Thus, the author has selected 39 small countries with less than 5 million population from 130 countries listed in World Development Report, 2002 and 2003. Then, they were classified in 3 categories, namely developed, developing and less developed small countries.

Table 3.2. summarizes the size of the economy of selected small countries. The average per capita GNP of 8 developed small countries is 14% lower than the average of high income countries of the world, while this figure by 22 developing small countries is 10,6% higher than the middle income countries of the world. However, the average per capita income of less developed small countries is far (about 30 percent) below than the low-income countries of the world.

Table 3.2. Size of the Economy of Small Countries

Economy	Populati on	Population density	GNP		GNP per capita	GNP measured at PPP		
	Millions	People per squarekm	Billion s of \$	Avg.annual growth rate (%)	Dollars	Avg. annual growth (%)	Billions of \$	Per capita dollars
	1999	1999	1999	1998-1999	2002	1998- 1999	1999	1999
1. Norway	4,5	15	146,4	0,6	38731	0,1	118,1	26522
2. Denmark	5,3	125	170,3	1,3	30261	1	129,1	24280
3. Finland	5,2	17	122,9	3,7	23891	3,5	109,6	21209
4. Ireland	3,7	54	71,4	8,6	23031	8	71,5	19180
5. Singapore	2,3	5283	95,4	5,6	20691	3,6	87,1	27024
6. Kuwait	1,9	108		-	16341	-	-	-
7. New Zealand	3,8	14	52,7	2,7	13761	1,9	63,3	16566
8. Slovenia	2	98	19,6	3,5	10371	3,5	29,8	15062
Developed SC	28,7	714,25	678,7	3,71429	22135	3,0857	608,5	21406
1. Uruguay	3,3	19	19,5	-3,4	4341	-4,1	27,4	8280
2. Estonia	1,4	34	5	1,9	4191	2,4	11,3	7826
3. Costa Rica	3,6	70	9,8	1,5	4071	-0,3	20,7	5770
4. Panama	2,8	38	8,6	1,7	4021	0,1	14,1	5016
5. Slovak Rep.	5,4	112	19,4	1	3971	0,9	52,9	9811
6. Lithuania	3,7	57	9,7	-4,1	3671	-4	22,5	6093
7. Latvia	2,4	39	6	0,5	3481	1,3	14,4	5938
8. Lebanon	4,3	418	15,8	1	3391	-0,04	17,6	4129
9. Bostwana	1,6	3	5,1	4,7	3011	3	9,6	6317
10. Jamaica	2,6	240	6	0,1	2691	-0,7	8,5	3276
11. Namibia	1,7	2	3,2	3	1791	0,6	9,1	5369
12. Jordan	4,7	53	7	0,8	1761	-2	16,6	3542
13. Macedonia, FYR	2	79	3,4	2,9	1711	2,3	8,8	4339
14. Albania	3,4	123	2,9	1	1451	-0,1	9,8	2892
15. Paraguay	5,4	13	8,5	-1,5	1171	-4,1	22,5	4193
16. Armenia	3,8	135	1,9	2,7	790	2,3	8,4	2210
17. Nicaragua	4,9	41	2,1	8	710	5,3	10,6	2154
18. Turkmenistan	4,8	10	3,2	14,9	660	13,5	14,8	3099
19. Georgia	5,5	78	3,4	4	650	3,8	19,7	3606
20. Congo Rep.	2,9	8	1,9	7,7	610	4,8	2,6	897
21. Lesatho	2,1	69	1,2	-0,8	550	-3	4,3	2058
22. Papua New Guinea	4,7	10	3,7	3,8	530	1,6	10,6	2263
Developing SC	77	75,0455	147,3	2,33636	2237,5	1,0709	336,8	4503,5
1. Moldova	4,3	130	1,6	16,5	460	17	10,1	2358
2. Mongolia	2,6	2	0,9	2,7	430	1,2	3,9	1496
3. Lao PDR	5,1	22	1,4	4	310	1,5	8,8	1726
4. Mauritania	2,6	3	1	4,8	280	2	4	1522
5. Kyrgyz Rep.	4,7	25	1,4	2,6	290	1,7	10,5	2223
6. Togo	4,6	84	1,5	2,1	270	-0,3	6,1	1346
7. Eritrea	4	40	0,8	3,7	190	0,8	4	1012
8. Sierra Leone	4,9	69	0,7	-8,1	140	-9,8	2	414
Less developed SC	36,3	42,3333	10,3	3,55556	291,11	1,7777	53,4	1469,8
World	5.975 s	46w	29,232	2,7w	4.890w	1,3w	38.804,9t	6.490w
Low Income	2417	73	987,6	4,4	410	2,5	4315,1	1,79
Middle income	2667	40	5323	2,6	2000	1,5	13022	4880
High income	891	29	22921	2,6	25730	2,1	21763	24430

Source: World development report 2000, 2003-World Bank and author's calculations

**Box 1. Mongolia – landlocked country with a large territory between two big powers
of the world as a case of small countries**

Mongolia is a landlocked, sparsely populated small country in terms of its population size with huge land of grasslands, mountains and desert and with some of 2.4 million inhabitants that lies between Russia and China. The country is rich in natural resources which indicate large mineral and agro-industrial potential.

Mongolia began moving towards free market economy in the early 1990's. Since successive governments has implemented policies aimed at liberalizing the economy and ensuring a private sector-led development. Mongolia's GDP fell sharply in the initial years of transition. In 1991, the country recorded a negative growth rate of 9,2 percent and in 1992, of 9,5 percent. Overall economic recovery began in 1995, mainly as a result of the government's free trade and economic policies, market-oriented legislation and private ownership of property designed to accelerate the radical economic reforms in the country. The government is actively encouraging foreign investment, especially those in the export-sector, notable minerals and live stock products such as cashmere and wool.

Agriculture, mining, light industry are the key sectors of the economy, with the most important commodities being copper, molybdenum, gold, coal, fluorspar concentrates, wool, leather and cashmere. Most industries were built during the past 30 years with assistance from the former Soviet Union and some East European countries.

Since 1995, the Mongolian economy has grown steadily, though growth has been rather weak in recent years. Real GDP went up by 1,0 percent in 2001 and by 4,0 percent in 2002 and by 5.5 percent in 2003. The decline in economic growth in 2000 and 2001 was the consequence of past three consecutive years of harsh winter situation and drought with a great number of livestock loss. This resulted in decline of main industry of Mongolia's economy - animal husbandry – and had negative impact on the overall economic condition of the country. The composition of GDP has undergone a significant change between 1995 and 2002. In 1995, agriculture accounted for 37.1 percent of GDP. By 2002, this share had dropped to 20 percent. Over the some period, the share of services went up from 34.5 percent to 56.8 percent in 2002. The inflation was stable at round 8.0 percent in 2000 and 2001. In 2002, it fell to 1.6 percent- the lowest since 1991. However, interest rates remain strikingly high and the supply of credit remains limited.

Mongolia with its per capita GNP of US\$ 430 is the second highest among less developed small countries after Moldavia and little more than the world's low income countries, but about 5 and 60 times lower than the middle and high income countries of the world, respectively. Its annual growth rate was very low in the last 12 years, only 1.5 per cent. But as mentioned above, the growth seems to increase after 2002.

Table 3.3. Average annual growth of GDP, %, 1990-2002

	GNP per capita US\$	Growth of GDP, %
	2002	
Max, Ireland	20691	7,8
Developed SCs	22134	4,2
Developing SCs	2237	2
Less developed SCs	2000	1,18
Min, Moldavia	140	-7,1
Mongolia	430	1,5
World	4890	2,7
Low Income	410	4,3
Middle income	2000	3,2
High income	25730	2,5

Source: World development report 2000, 2003-World Bank and author's calculations

If we look at the average annual growth of GDP from 1990 to 2002, Ireland has the maximum by 7.8 per cent, while Moldavia has the minimum by - 7.1 per cent. The annual growth rate of developed small countries is 4.2 percent as about the same level of low income countries of the world, which reflects high growth potential at average. However, both developing and less developed small countries seem to have a problem with the growth because they have the growth rate only 2 and 1.18 per cent in the last dozen years, which are 0.7 and 1.52 per cent lower than the world average, respectively.

In this paper, Mongolia was considered as a case of small countries, and tried to compare as with other developed, developing and less developed small countries as well as with world average and with world's low, middle and high income countries.

Box 2. Financial Sector Issues of Mongolia

The financial sector in Mongolia as well, was rapidly liberalized in the early years of transition. A number of private banks were formed which extended large amount of credit without appropriate safeguards. Commercial banks almost all were directly or indirectly owned by the state and were extending large amount of loans on the basis of political considerations rather than credit, risk and cash flow analyses. At the same time, outstanding bad loans that were kept in the balance sheet of the State Bank of Mongolia (which was the only bank in the country before 90's) were transferred to different newly created banks. Bank failures resulted from low Government monitoring and management capacity, and much state interference in credit provision. In addition, financial services are concentrated in urban areas and cater to formal sector activities. As a result, there are real credit constraints inhibiting the potential growth of the informal sector especially in rural areas. In general, financial markets are not very well developed, as evidenced by the high spreads between deposit and lending rates, which were in the range of 25.0 per cent in 2000. Furthermore, insurance and long-term capital markets are poorly developed and are ill-equipped to serve productive and beneficial investment projects as well as risk-prone communities, in particular in rural areas. The non-banking financial sector has grown with a rapid speed in the urban areas over the past 5 years, however people living in rural areas to a large extent still lack access to micro-financial services. This is especially the case for people living outside the regional centers, where Savings and Credit Cooperatives are more widespread as in the capital city.

3.3.2. Life Expectancy, Infant Mortality and Urban Population

Figure 3.2 and Table 3.4 show that small countries have large variations in life expectancy at birth which is more or less correlated with per capita GNP. The life expectancy of developed small countries is very close (only 1.3 years below) to the high income countries of the world. However, the life expectancy of developing small countries is 2 years below than the middle income countries while the life expectancy of less developed small countries is far below (3.8 years) than the low income countries of the world. At the maximum, Norway has the life expectancy with 78.5 years as an average of males and females (females 81, males 76) which is 0.5 years higher than the world's high income countries. Norway has the same level with 81 years of life expectancy by females as the average of world's high income countries while males have 1 year higher than the average of high income countries.

In contrast, at the minimum, Sierra Leone has an average life expectancy of 37.5 years (females 39, males 36) which is 22.5 years below than the world's low income countries (60 years).

These figures seem to be largely influenced by the infant mortality rates shown in Figure 3.3 and Table 3.5. The under 5 mortality rate per 1,000 people varies at maximum from 283 by Sierra Leone, at minimum to 5 by Finland. The average under 5 mortality rate of developed small countries is close (1 Mortality more) to high income countries of the world, while this figure in developing and less developed small countries is about 10 mortality more than the middle and low income countries of the world, respectively. Surprisingly, the under 5 mortality in less developed small countries is much higher than the world average (43 mortality more).

Table 3.4. Life expectancy at birth, years, average of males and females, 2002

	GNP per	Life expectancy at birth, years		
	2002	average	female	male
Max, Norway	38731	78,5	81	76
Min, Sierra Leone	140	37,5	39	36
Developed SCs	22134	76,7	79,6	73,8
Developing SCs	2237	67,5	70,3	64,6
Less developed SCs	291	54,2	56,2	52,2
Mongolia	430	66,5	68	65
World	4890	67	69	65
Low Income	410	60	61,00	59
Middle income	2000	69,5	72	67
High income	25730	78	81,00	75

Source: World development report 2000, 2003-World Bank and author's calculations

Table 3.5. Under 5 mortality Per 1,000

	GNP/ cap.	under 5 mortality per 1000
	US\$ 2002	1998
Max, Sierra Leone	140	283
Developed SCs	22134	7
Developing SCs	2237	48
Less developed SCs	2000	118
Min, Finland	23891	5
Mongolia	430	60
World	4890	75
Low Income	410	107
Middle income	2000	38
High income	25730	6

Source: World development report 2000, 2003-World Bank and author's calculations

Table 3.6. Urban Population

	GNP/ cap.	Urban population
	US\$ 2002	% of total 1999
Max, Singapore	20691	100
Developed SCs	22134	77,4
Developing SCs	2237	56,9
Less developed SCs	2000	38,9
Min, Papua New Guinea	530	17
Mongolia	430	63
World	4890	46
Low Income	410	31
Middle income	2000	50
High income	25730	77

Source: World development report 2000, 2003-World Bank and author's calculations

The urbanization measured as percentage of urban population to the total, seems to be more or less correlated to income level measured as per capita GNP. This can be explained by the fact that most economic activity takes place in densely populated metropolitan areas (Solow growth model, 1990). The developed small countries have about the same level of urbanization like the high-income countries of the world. The developing small countries have about 10 percent higher than the world average. Although the urbanization of less developed small countries lay about 8 percent higher than the low-income countries, but this is even 7 percent lower than the world average.

3.3.3. Poverty, Gini Index and Income Distribution to Lowest and Highest 20%

The poverty, Gini index and income distribution to lowest and highest 20 % of the population are very important indicators that are with each other correlated and reflect the end results of political, economic and social activities of the country in confronting with globalization.

At the maximum, 68 per cent of the population in Sierra Leone is below the poverty line among small countries. Estonia has the least poverty, that means, 8.6 per cent of its population is the below poverty line. Developed small countries have actually no poverty. But, the developing and less developed small countries have a number of poverty which counts 23.4 and 43.3 percent of the population below the poverty line, respectively.

Table 3.7. Poverty

	GNP per capita US\$ 2002	Population below poverty line %
Min, Sierra Leone	140	68
Min, Estonia	4191	8,9
Developed SCs	22134	0
Developing SCs	2237	23,4
Less developed SCs	291	43,3
Mongolia	430	36,3
World	4890	
Low Income	410	
Middle income	2000	
High income	25730	

Source: World development report 2000, 2003-World Bank and author's calculations

Box 3. Poverty is a Problem to Be Seriously Addressed in Mongolia

The social consequences of the first decade of transition have been worrying. There has been an increase in poverty and many other social ills. In addition, the quality of public services in education and health has generally deteriorated. The share of public spending on health and education has fallen sharply from pre-transition times. In addition, reforms to the health and education sectors have been slow in coming.

Poverty remains widespread in the country despite efforts to reduce it. Official figures suggest that around one third of the total population live in poverty (36.3 per cent of the population is below the poverty line), defined as the inability to afford a basket of basic food and non-food items. Many others are very close to the poverty line. Poverty most certainly increased dramatically in the early years of transition as national income plummeted, unemployment increased, price inflation soared and social spending fell. The real income per capita, food consumption and herd sizes among the poor had improving trends from 1995 until the severe winter disasters, beginning in 1999. Many rural people lost their animals and are left without means to survive. A high in-migration rate has been observed to Ulaanbaatar, Darkhan and Erdenet. This implies high urbanization process in Mongolia, which account 63 percent of total population are in urban areas, mostly in these 3 cities. This is 13 percent higher than the level of middle-income countries of the world. However, there is no income growth in connection with this concentration because these migrated people are still not fully involved in economic activities or they are still in poverty.

Mongolia's Gini index or income inequality within its population lays close (2.3 point higher) to the average of developed small countries. That means that Mongolia distributes 7.3 per cent of its income to the lowest 20 per cent of the population, while 40.9 per cent of its income to highest 20 per cent of the population which are also close to developed small countries.

The Gini Index provides a measure of income inequality within a population. It is a dimensionless index scaled to vary from a minimum of zero to a maximum of one hundred; zero representing no inequality and one hundred representing the maximum possible degree of inequality. Income or resource distribution has direct consequences on the poverty rate of a country. With regard to Gini Index, Sierra Leone has the maximum with 62.9 and Denmark has the minimum with 24.7.

This index is also close correlated with the distribution of income to lowest 20 per cent and highest 20 per cent of the population shown in Figure 3.6 and 3.7 and Table 3.8 and 3.9. For example, Sierra Leone distributes only 1.1 per cent of its income to lowest 20 per cent while 63.4 per cent of its income to the highest 20 per cent. In contrast, Slovak Republic distributes 11.9 per cent of its income to lowest 20 per cent, and 31.4 per cent to highest 20 per cent of the population.

Table 3.8. Distribution of Income, Gini Index

	GNP per capita US\$ 2002	Gini index
Max, Sierra Leone	140	62,9
Min, Denmark	30261	24,7
Developed SCs	22134	30,9
Developing SCs	2237	41,3
Less developed SCs	2000	43,9
Mongolia	430	33,2
World	4890	
Low Income	410	
Middle income	2000	
High income	25730	

Source: World development report 2000, 2003-World Bank and author's calculations

Table 3.9. Distribution of income to lowest 20%

	GNP per capita US\$ 2002	Income distribution To lowest 20%
Max, Sierra Leone	140	1,1
Developed SCs	22134	7,8
Developing SCs	2237	5,9
Less developed SCs	2000	5,4
Min, Slovak	3971	11,9
Mongolia	430	7,3
World	4890	
Low Income	410	
Middle income	2000	
High income	25730	

Source: World development report 2000, 2003-World Bank and author's calculations

Table 3.10. Distribution of income to highest 20% of Population

	GNP per capita US\$ 2002	Income distribution to highest 20%
Max, Sierra Leone	13761	63,4
Developed SCs	22134	38,5
Developing SCs	2237	47,8
Less developed SCs	2000	49,9
Min, Slovac	140	31,4
Mongolia	430	40,9
World	4890	
Low Income	410	
Middle income	2000	
High income	25730	

Source: World development report 2000, 2003-World Bank and author's calculations

3.3.4. Public Expenditure on Education, Health and Communications & Information

The public expenditure on education and health, the indicators of the communications and information development are very important measures to the development of any country. Among the small countries, Moldavia spends maximum public expenditure of 7.8 per cent of its GNP on education and Macedonia spends the maximum expenditure of 7.8 per cent of its GNP on health, while at minimum, Eritrea spends expenditure of 1.8 per cent of its GNP on education and Georgia 0.7 per cent of its GNP on health. In general, in terms of percentage of GNP the small countries whether developed, developing and less developed spend higher expenditure on education than the average of the world, low and middle income countries of the world. The developed and developing small countries have even the same or higher expenditure on education as per cent of GNP than the high income countries of the world. Although the high income countries have the most expenditure in average with 6.2 per cent of GNP, the small countries whether developed, developing or less developed, have in average higher expenditure on health than the average of the world.

Table 3.11. Public expenditure on education % of GDP, 1997

	GNP per capita US\$ 2002	Public Expenditure on education % of GNP
Max, Moldava	460	7,8
Developed SCs	22134	6,2
Developing SCs	2237	5,6
Less developed SCs	2000	4,9
Min, Eriteria	140	1,8
Mongolia	430	5,7
World	4890	3,9
Low Income	410	3,4
Middle income	2000	3,8
High income	25730	5,6

Source: World development report 2000, 2003-World Bank and author's calculations

Table 3.12. Public expenditure on health % of GDP, 1990-98

	GNP per capita US\$ 2002	Public expenditure On health % of GNP
Max, Macedonia	1711	7,8
Developed SCs	22134	5
Developing SCs	2237	3,8
Less developed SCs	2000	2,7
Min, Georgia	140	0,7
Mongolia	430	4,3
World	4890	2,5
Low Income	410	1,3
Middle income	2000	3,1
High income	25730	6,2

Source: World development report 2000, 2003-World Bank and author's calculations

There are number of indicators regarding with communications and information. It was selected only one indicator, namely the internet hosts per 10,000 people. This indicator has much variation among small countries. For example, Finland has at maximum 1218 internet hosts per 10,000 while Lao PDR has at minimum zero. With this indicator, the developed small countries are 4 times higher than the world average and nearing the high income countries of the world. However, the developing and less developed small countries are with this indicator far behind the average world development, this are 5 and 100 times lower than the world average, respectively.

Table 3.13. Communications information Internet hosts per 10,000

	GNP/ cap. US\$ 2002	Internet hosts Per 10,000
Max, Finland	23891	1218
Developed SCs	22134	523
Developing SCs	2237	23,8
Less developed SCs	2000	1,2
Min, Lao PDR	310	0
Mongolia	430	0,2
World	4890	120
Low Income	410	0,4
Middle income	2000	10
High income	25730	777

Source: World development report 2000, 2003-World Bank and author's calculations

3.3.5. Agricultural Productivity and Role of Government in the Economy

The economy of most small countries is based on agriculture. Therefore, their agriculture productivity as well as the role of government in the economy are important for their development. The agriculture productivity, namely the agricultural value added (1995 US\$) per agricultural workers varies much among small countries at minimum from US\$ 411 by Sierra Leone, at maximum to US\$ 41,673 by Singapore. There are big differences between developed, developing and less developed small countries, namely, the agricultural productivity of developed small countries are 6.5 times higher than the

developing small countries while it is by less developed small countries again 5.5 times lower than by developing small countries.

Table 3.14. Agricultural productivity Agr.value added (1995 US\$) per agr.workers 1996 - 98

	GNP per capita US\$ 2002	Agr. Value Added per agricult. workers
Max, Singapore	20691	41673
Developed SCs	22134	32255
Developing SCs	2237	4965
Less developed SCs	2000	895
Min, Sierra Leone	140	411
Mongolia	430	1151
World	4890	
Low Income	410	
Middle income	2000	
High income	25730	

Source: World development report 2000, 2003-World Bank and author's calculations

The role of government in the economy measured on subsidies and other current transfers as per cent of total expenditure varies at minimum by Congo Republic from 5 per cent, at maximum by Norway to 70 per cent. The role of government of developed small countries is about 6 points higher than the world average, but this is again about 6 points below by developing and less developed countries than the world average.

Table 3.15. Role of government in the economy Subsidies & other current transfers, 1997
% total expenditure

	GNP/ cap. US\$ 2002	Subsidies & Other current Transfers, % of Total expenditure
Max, Norway	38731	70
Developed SCs	22134	46,7
Developing SCs	2237	30,7
Less developed SCs	2000	31
Min, Congo Rep.	610	5
Mongolia	430	44
World	4890	37
Low Income	410	
Middle income	2000	40
High income	25730	60

Source: World development report 2000, 2003-World Bank and author's calculations

3.3.6. Global Trade and Openness to Globalization

The economy of most small countries is trade dependent as shown in Figure 3.14; 3.15; 3.16 and Table 3.16; 3.17, 3.18. The merchandise export measured as per cent of GNP among small countries varies at minimum by Sierra Leone from 1, at maximum by Singapore to 115.2 per cent. The developed, developing and less developed small countries are with their merchandise export 23, 10.7, 8.6 points higher than the world average, respectively, which reflect their trade dependencies.

The merchandise import measured also as per cent of GNP shows also similar figures as mentioned above. It varies at minimum by Sierra Leone from 13.5, at maximum by Paraguay to 376.5 per cent. The developed, developing and less developed small countries are with their merchandise import about 25, 48, 23 points higher than the world average and as well high income countries of the world.

Table 3.16. Global trade Merchandise export, % of GNP

	GNP/ cap. US\$ 2002	Export % of GNP
Max, Singapore	20691	115,2
Developed SCs	22134	40,9
Developing SCs	2237	28,6
Less developed SCs	2000	26,5
Min, Sierra Leone.	140	1
Mongolia	430	41,1
World	4890	17,9
Low Income	410	16,7
Middle income	2000	21,1
High income	25730	17,3

Source: World development report 2000, 2003-World Bank and author's calculations

If we measure the global trade turnover with the sum of merchandise export and import as the percentage of GNP, which can reflect the openness to globalization, it varies at minimum by Sierra Leone from 14.5, at maximum by Singapore to 221.5 per cent. The developed, developing and less developed small countries are with their openness to globalization about 48, 59 and 31 points higher than the world's average and the average of high income countries of the world.

Table 3.17. Global trade, Merchandise Import, % of GNP

	GNP/ cap.	Import % of GNP
	US\$ 2002	
Max, Paraguay	20691	376,5
Developed SCs	22134	43
Developing SCs	2237	66,5
Less developed SCs	2000	40,8
Min, Sierra Leone.	140	13,5
Mongolia	430	52,4
World	4890	18,4
Low Income	410	17,9
Middle income	2000	21,5
High income	25730	17,7

Source: World development report 2000, 2003-World Bank and author's calculations

Table 3.18. Global Trade Turnover (Merchandise Exp.+Imp.,) % of GNP

	GNP/ cap.	Exp.+ Imp. % of GNP
	US\$ 2002	
Max, Singapore	20691	221,5
Developed SCs	22134	83,9
Developing SCs	2237	95,1
Less developed SCs	2000	67,3
Min, Sierra Leone.	140	14,5
Mongolia	430	93,5
World	4890	36,3
Low Income	410	34,7
Middle income	2000	42,7
High income	25730	34,8

Source: World development report 2000, 2003-World Bank and author's calculations

Box 4. Mongolia's Trade, Official Development Assistance and External Debt Patterns

Since most of Mongolia's exports are concentrated in a few raw materials, it is especially vulnerable to falls in world market prices. In the period 1995 to 2001, the average annual price for copper concentrate fell by 54.3 percent and the price of cashmere dropped by 4.4 percent and has caused the export value fall, and also led to a decline in government tax revenues, therefore worsening the budget deficit.

Mongolia has rapidly embraced free trade and currently has one of the most open economies in the world. In 1997, it joined the World Trade Organization and abolished duties on the majority of imports. At present, it imposes a flat 5.0 per cent tariff on most imports and a modest tax on exports. In 2000, the total turnover of goods (exports + imports) exceeded 1.0 billion US dollars, a 40.0 per cent increase over the decade.

The liberalization of the trade regime in Mongolia was intended to meet population needs, increase the competitiveness of domestic industries and spur exports. It has resulted, however, in persistent and growing trade deficits since 1996. Trade deficit in 2001 amounted 116.2 million US dollars, whereas it is

escalated by 40 per cent to 166.7 million US dollars in 2002. In addition, the very low tariffs have led to a reduced share of customs tax in the state budget since 1992.

Export earnings are highly dependent on world market prices of a few commodities, in particular copper and cashmere. Further, exports of traditional goods such as leather, sheep skin good, carpets and wool blankets have declined sharply. In addition, there has been an influx of cheap imports in the aftermath of the Asian crisis.

Total external trade turnover reached 1160.0 million US dollars in 2002, of which exports 500.9 million US dollars and imports 659.1 million US dollars. 78.1 percent of exported goods come to transactions paid in hard currency, while barter is 4.0 percent and goods for inward processing is 17.5 percent. In total export of minerals, 83.4% is copper and molybdenum concentrate, 8.5 % is fluorspar concentrate.

In total exports, minerals is 44.2%, textiles and textile products 27.3%, gold 23.8%, products of animal or vegetable origin and foodstuff is 5.7%, raw hides and skins, processed hides and skins, furs, and products thereof are 8.6%. Export structure by countries: 41% to China, 32% to USA, 9% to Russia, 4% to South Korea and 14% to other countries.

In total imports, machinery, mechanic equipment and parts thereof, electric appliances, parts thereof are 19.5%, minerals 18.6% (among them 89.5% is oil products), products of vegetable origin and foodstuff 19.0%, chemical products 5.0% and base metals and products thereof is 4.5%. Import structure by countries: 34% from Russia, 20% from China, 12% from South Korea, 6% from Japan, 5% from Germany, 4% from USA and 19% from other countries.

Mongolia's merchandise exports and imports together as percentage of GNP with 93.5 percent is much (57.2 points) higher than the world average like the other developed, developing and less developed small countries reflecting the openness to global economy.

The close linkage between debt and official development assistance calls attention to issues of aid effectiveness and coordination. Mongolia is among the most aid dependent countries in the world. Over the 1990s, ODA averaged around 25.0 per cent of GDP, or twenty times the average of low income countries. The fact that the very high levels of foreign aid have not translated into appreciably higher rates of economic growth or poverty reduction raises questions about aid effectiveness. At the very least, they call for more concerted efforts to gauge the impact of development assistance and to strengthen mechanisms of aid coordination.

The burden of debt is becoming increasingly seriously in Mongolia. External debt in convertible currency jumped from 6.0 per cent to nearly 85.0 per cent of GDP between 1991 and 2001. In 2001 annual debt service amounted to around 4.0 per cent of GDP or approximately 15.0 percent of central government revenue (excluding grants). Virtually all of this debt is held by a multilateral and bilateral creditors of which the Asian Development Bank, Japan and the World Bank account for the lion's share. Estimations up to the year 2010, applying common international standards such as the ratio of external debt and debt service to GDP and other indicators, show that Mongolia could become a HIPC category country as soon as 2009. There are unresolved questions about the sustainability of this debt. The target is to constrain levels of debt outstanding to below 94.0 per cent of GDP.

The analyses indicate that critical levels of key indicators could be breached in the following years: (a) Total Debt to GDP ratio in 2006; (b) Total Debt to exports ratio in 2008; and (c) Total Debt to Government Revenue ratio in 2009.

3.3.7. Net Private Capital Flows, Foreign Direct Investment, Official Development Assistance and External Debt

Net private capital flows, foreign direct investment and official development assistance are important factors for the development of small countries. Net private capital flows as percentage of GNP varies at minimum, zero by developed small countries and by Eritrea, at maximum to 81.6 percent by Costa Rica. The developing small countries have the most net private capital flows.

Table 3.19. Net Private Capital Flows, % of GNP

	GNP/ cap.	Priv.Cap.Flow % of GNP
	US\$ 2002	1998
Max, Costa Rica	4071	81,6
Developed SCs	22134	0
Developing SCs	2237	12,1
Less developed SCs	2000	2,3
Min, Eritrea	190	0
Mongolia	430	0,8
World	4890	
Low Income	410	0,001
Middle income	2000	0,005
High income	25730	0

Source: World development report 2000, 2003-World Bank and author's calculations

The foreign direct investment measured as percentage of GNP varies at minimum, from zero by Eritrea, at maximum to 22.1 percent by Lesotho. The foreign direct investment in developed, developing and less developed small countries is 3, 3.3 and 0.5 points higher than the world average and also 3.2, 2.5, and 0.7 points higher than the high income countries of the world, respectively.

Table 3.20. Foreign Direct Investment, % of GNP

	GNP/ cap.	FDI % of GNP
	US\$ 2002	1998
Max, Lesotho	550	22,1
Developed SCs	22134	5,1
Developing SCs	2237	4,4
Less developed SCs	2000	2,6
Min, Eritrea	190	0
Mongolia	430	2,1
World	4890	2,1
Low Income	410	0.1
Middle income	2000	3.0
High income	25730	1.9

Source: World development report 2000, 2003-World Bank and author's calculations

The official development assistance for small countries measured as percent of GNP varies at minimum, from 0.1 percent by Uruguay, at maximum to 28.1 percent by Nicaragua. The developing, particularly the less developed small countries receive much more official development assistance relative to GNP than

other countries. Thus, they are much official development assistance dependent. For example, the official development assistance for developed and less developed small countries is 2.5 and 15.5 points higher than the world average.

Table 3.21. Official development assistance, 1998, % of GNP

	GNP/ cap.	ODA % of GNP
	US\$ 2002	
Max, Nicaragua	710	28,1
Developed SCs	22134	0
Developing SCs	2237	3,1
Less developed SCs	2000	16,1
Min, Uruguay	4341	0,1
Mongolia	430	20,6
World	4890	0,6
Low Income	410	1,3
Middle income	2000	0,4
High income	25730	

Source: World development report 2000, 2003-World Bank and author's calculations

The present value of external debt among small countries measured as percentage of GNP varies at minimum from zero by developed small countries and 10 per cent by Botswana, at maximum to 280 percent by Congo Republic.

Table 3.22. External Debt, Present Value % of GNP

	GNP/ External cap.	Debt, PV % of GNP
	US\$ 2002	1998
Max, Congo Rep.	610	280
Developed SCs	22134	0
Developing SCs	2237	65,1
Less developed SCs	2000	73,3
Min, Botswana	3011	10
Mongolia	430	49

Source: World development report 2000, 2003-World Bank and author's calculations

Box 5. Special Needs of landlocked Mongolia

1. Development of transit and multi-modal transportation

The issue is being addressed through regional and sub-regional meetings, serving as input to the International Ministerial Conference of Landlocked and Transit Developing Countries and Financial and Development Institutions on Transit Transport Cooperation. The North-East Asia Subregional Seminar was held on 6 and 7 March 2003 in Ulaanbaatar, Mongolia, under the auspices of the United Nations Economic and Social Commission for Asia and the Pacific. The subregional seminar principally agreed on regional platform and recommendations to the Almaty ministerial conference. For the landlocked country like Mongolia the recommendation on completion on transport services, which recognizes the special need of landlocked countries to use their own trucks to transport transit cargo and to pick up goods in transit, is of the utmost importance. In policy related actions establishment of national transport facilitation committee which include all relevant stakeholders (government, private sector, international transport associations, etc.) is also vital for Mongolia. The facilitation committee will enable coordination and links between ministries and agencies in transport policy and related activities. The improved coordination of national stakeholders would contribute to Mongolia's transport policy and goals.

In order to formulate integrated policy on transport, especially transit transportation policy, improve coordination between related ministries and agencies, increase active participation of private stakeholders, train human resources, participate dynamically in activities of international organizations responsible for transport issues, and to formulate integrated action plan the Government of Mongolia has established the Facilitation Committee under the recommendation of the UNESCAP. The draft General Framework Agreement on Transit has been consented among Mongolia, Russia and China. The establishment of the Framework Agreement will enable Mongolia to access sea not only through railway but by auto road. In addition, this country is opening prospect of linking with the Asian Highway. The above opens way in to any ports of Asian shores.

2. Maritime transportation

Cabinet meeting of the Government of Mongolia of 31 January 2001 under the activities for access to the sea in the first place took decisions to raise Mongolian flag and register ships. Under the Government the resolution of 8 January 2003 "Rules of Registering Ships of Mongolia" was adopted.

In order to register ships with Mongolian flags, the Transportation Department -the implementing agency of the Government- concluded agreement with "Maritime Chain" company of Singapore and established Office for Ship Registration. The UN 1982 convention on Maritime Law provides right for every nation to journey ship with its won flag. The IMO requires nations to join special conventions in order to register requested individuals and entities to conduct maritime transportation⁸.

Ship registration of Mongolia is conducted on foreign soils, in which Mongolian diplomatic representation takes some part.

4. Regional Integration and Development of Small Countries

4.1. Review of Some Theoretical Assumptions Relating to Trade and Distribution

There are a number of trade models demonstrate that movements to free trade will cause a redistribution of income, which are considered only the essence in following. One of the key distinctions between these

⁸ Accordingly, Mongolia is party to 7 conventions:

models is the degree of factor mobility.⁹ The immobile factor model represents one extreme, in which factors are stuck in one industry and cannot move between sectors. The Heckscher-Ohlin model represents another extreme in which factors can move freely and costless between sectors. The specific factors model represents an intermediate special case in which one factor is completely immobile while the other is completely mobile. Ricardo model assumes labor as the only factor of production, goods are homogeneous across firms and countries, labor is homogeneous within a country but heterogeneous (non-identical) across countries, labor is always fully employed, production technology differences across industries and across countries and the labor and goods markets are perfectly competitive in both countries.

Ricardo model showed that the specialization good in each country should be that good in which the country had a comparative advantage in production. To identify a country's comparative advantage good requires a comparison of production costs, namely the *opportunity* costs of producing goods across countries. Thus, each country would export the good in which they have a comparative advantage. Workers in the technologically advanced country would enjoy a higher standard of living than in the technologically inferior country. The initial differences in relative prices of the goods between countries in autarky will stimulate trade between the countries. Trade flows would increase until the price of each good is equal across countries. In the end, the price of each country's export good (its comparative advantage good) will rise and the price of its import good (its comparative disadvantage good) will fall. A "general equilibrium" arises when prices of goods, services and factors are such as to equalize supply and demand in all markets simultaneously.

Stolper-Samuelson theorem suggests that an increase in the price of a good will cause an increase in the price of the factor used intensively in that industry and a decrease in the price of the other factor. It was noted that there will occur a **magnification effect**. If output prices change by some percentages, then the rental rate would rise by a greater percentage than the price of output, while the wage rate would fall. The size of the effect is *magnified* relative to the cause. This magnification effect for prices is a generalization of the Stolper-Samuelson theorem. These changes would occur as a country moves from autarky to free trade and when trade policies are implemented, removed or modified.

Heckscher-Ohlin theorem, which represents and demonstrates that income will be redistributed from owners of a country's scarce factor, who will lose, to owners of a country's abundant factor, who will gain. Each country exports the good intensive in the country's abundant factor. Free trade will raise aggregate welfare for both countries relative to autarky. Both countries are better-off with free trade. Some individuals will likely benefit from free trade while others will suffer losses. An increase in aggregate welfare means *only* that the sum of the gains exceeds the sum of the losses. A country's relatively abundant factor gains from trade while a country's relatively scarce factor loses from trade. In the long-run, capital owners are shown to gain regardless of whether their capital is used in the expanding export sector or the declining import sector. Similarly all workers lose, even those working in the expanding export sector.

If we look the distribution effects over time, the owners of capital in the export industry would suggested that initial short-run gains would be followed by an increase in these gains in the medium-run but owners would suffer a reduction in their gains in the long-term, while owners of capital initially in the import industry lose in the short-run, will lose further in the medium-run but will ultimately gain in the long-run. The workers who initially work in the export industry will experience gains in real income in the short-run, followed by ambiguous effects in the medium-run, followed by losses in the long-run. Finally, the models suggest that workers initially in the import sector will lose in the short-run, experience ambiguous effects in the medium-run and ultimately lose in the long-run.

⁹ - Treven M. Suranovic. International Trade and Policy Lecture Notes. 1997-2004.
<http://internationalecon.com/v1.0/ch70/70c300.html>

The factor-price equalization theorem, which derived out of the Heckscher-Ohlin model stated that when the prices of the output goods are equalized between countries, as countries move to free trade, then the prices of the factors (capital and labor) will also be equalized between countries.

The immobile factor model concludes that income will be redistributed from workers in the import-competing industry to workers in the export industry. Free trade will raise aggregate welfare for both countries relative to autarky. Both countries are better-off with free trade. However, since one group of workers realize real income gains while another set suffers real income losses, free trade causes a redistribution of income within the economy. This means that a movement to free trade will benefit those workers who work in the export industry and harm those workers who work in the import-competing industry. In short-run, both workers and capitalists affiliated with the export industry will benefit from trade liberalization, while workers and capitalists affiliated with the import-competing sector will lose from free trade.

The specific factor model concludes that owners of capital in the export sector will gain at the expense of capital owners in the import-competing sector and that the effects on workers in both industries are ambiguous. In the medium-run, the real return to capital owners in the export industry will rise with respect to purchases of both goods while the real return to capital in the import industry falls with respect to purchases of both goods. But the effect on workers is, in general, ambiguous. The real wage of workers in terms of purchases of the import good rises, while the real wage in terms of the export good falls. Whether a worker benefits or loses depends, in part, on the worker's preferences. If a worker has a high demand for the import good, for which the real wage rises, then the worker may benefit. If, however, a worker has a relatively high demand for the export good, then the worker would lose.

Theory of the Second Best formalized by Lipsey and Lancaster (1956) represent applications of trade policies with market imperfections and distortions. Market imperfections and distortions, generally, mean any deviation from the assumptions of perfect competition. This includes monopoly and oligopoly markets, production with increasing returns to scale, markets that do not clear, negative and positive externalities in production and consumption and the presence of public goods.

Lipsey and Lancaster show that, generally, when one optimal equilibrium condition is not satisfied, for whatever reason, all of the other equilibrium conditions will change. Thus if one market does not clear, it would no longer be optimal for firms to set price equal to marginal cost or for consumers to set the price ratio equal to the marginal rate of substitution.

In a perfectly competitive economy where there are no market imperfections or distortions the optimal government policy is *laissez-faire*. Any type of tax or subsidy implemented by the *government* under these circumstances can only reduce economic efficiency and national welfare. Thus with a *laissez-faire* policy the resulting equilibrium would be called **first-best**.

But, the real world is unlikely to be so perfectly. Instead markets will likely have numerous distortions and imperfections. In general, second-best equilibria arise whenever there are *market* imperfections or distortions present.

An economic rationale for government intervention in the private market arises whenever there are uncorrected market imperfections or distortions. In these circumstances the economy is characterized by a second-best rather than a first-best equilibrium. It is for this reason that many types of trade policies can be shown to improve national welfare. Trade policies, chosen appropriate to the market circumstances, act to correct the imperfections or distortions.

Many different types of trade policies can be applied even for the same distortion or imperfection. Governments can apply taxes, subsidies or quantitative restrictions or some policies like tariffs or export taxes, are designed to directly affect the flow of goods and services between countries. Other domestic

policies can also be applied like production subsidies or consumption taxes, are directed at a particular activity that occurs within the country but is not targeted directly at trade flows. An optimal policy choice in the presence of a particular market distortion or imperfection is referred to as a first-best policy.

If any policy raises welfare to a lesser degree than a first-best policy, then it would be called a second-best policy. If there are many policy options which are inferior to the first-best policy, then it is common to refer to them all as second-best policies.

When a country is "large" in international markets and thus can affect international prices with its domestic policies. In this case, the trade policy such as optimal tariffs, quotas, and export taxes can be the first-best policy.

In summary, the theory of the second-best provides the theoretical underpinning to explain many of the reasons that trade policy can be shown to be welfare enhancing for an economy. In most of the cases in which trade policy is shown to improve national welfare, the economy begins at an equilibrium that can be characterized as second best. Whenever there are market imperfections or distortions present it is always theoretically or conceptually possible to design a trade policy that would improve national welfare. As such the theory of the second best provides a rationale for many different types of protection in an economy. For example, tariffs applied by a small country in the presence of domestic distortions can sometimes raise national welfare.

When more complex markets are considered, as when there are multiple distortions or imperfections present simultaneously, our ability to identify welfare improving policies rapidly diminishes. The theory of the second-best states that is correcting one distortion in the presence of many may not improve welfare.

4.2. Political and Economic Features of Regional Integration Agreements

Most of small countries are members of major Regional Integration Agreements (RIAs) and many belong to more than one and some are still not included in major RIAs as shown in Table 19. Regional integration agreement is one of the major international relations developments of recent years. This developments have occurred against the backdrop of globalization.¹⁰

World Bank concluded that no country is immune from the effects of regionalism as it shapes world economic and political relationships and influences the development of the multilateral trading system, and all countries face policy choices concerned with regionalism. There are many questions with regard to policy choices, namely should we enter a RIA?, with what other countries?, what measures should be implemented - simple trade liberalization or deeper harmonization of domestic policies? There are no simple answers to these questions. Countries differ in their circumstances and in their political and economic objectives.

Many of the arguments for membership in a RIA are political, including the issues of security, conflicts, international tensions, bargaining power, and "lock-in" effects, domestic political pressures and the activities of lobbies and as well as economic, including the issues of raising the costs and loss of income, "scale and competition" effects, and "trade and location" effects.

Some important effects are as follows:

Political

1. A regional agreement may enhance a country's security in its relationship with other members. Regular political contacts can build trust and facilitate other forms of cross-border cooperation.

¹⁰ - www.worldbank.org/trade%20bloccs

But, a regional agreement can also create international tensions, particularly if driven by economic rather than security considerations and if the economic appears to bring an unfair distribution of benefits.

2. A political effect is the bargaining power with the hope that from unity comes strength. For example, regional agreements between small developing countries cannot aspire to EU's weight or political power, but can nevertheless enter negotiations more effectively than separate countries might be able to.
3. A regional agreement can provide a "commitment mechanism" for trade and other policy reform measures and therefore may "lock-in" the domestic politics.
4. Domestic political pressures and the activities of lobbies can influence the form of regional agreements.

Economic

1. Removal of trade barriers lead to market enlargement, as separate national markets move towards integration in a regional market. This allows firms to benefit from greater scale and attracts investment. Removing barriers also forces firms from different member countries into closer competition with each other, possibly inducing them to make efficiency improvements. That are "scale and competition" effects.

Table 4.1. Membership of Small Countries in Major Regional Integration Agreements (RISs)

Small Countries	1.	2.	3.
1. Norway	EEA		
2. Denmark	EU		
3. Finland	EU		
4. Ireland	EU		
5. Singapore	APEC	ASEAN	
6. Kuwait	ASEAN		
7. New Zealand	APEC		
8. Slovenia	EUBAEE		
Developed SCs			
1. Uruguay	MERCOSUR	LAIA	
2. Estonia			
3. Costa Rica	CACM		
4. Panama			
5. Slovak Rep.	EUBAEE		
6. Lithuania	EUBAEE		
7. Latvia	EUBAEE		
8. Lebanon			
9. Botswana	SADC	SACU	
10. Jamaica	CARICOM		
11. Namibia	GBI	SADC	SACU
12. Jordan			
13. Macedonia			
14. Albania			
15. Paraguay	MERCOSUR	LAIA	
16. Armenia			
17. Nicaragua	CACM		
18. Turkmenstan			
19. Georgia			
20. Congo Rep.			
21. Lesotho	CMESA	SADC	SACU
22. Papa New Guine	APEC		
Developing SCs			
1. Moldova			
2. Mongolia			
3. Lao PDR	ASEAN		
4. Mauritania	ECOWAS	ECWA	
5. Kyrgyz Rep.			
6. Togo	ECOWAS	WAEMU	
7. Central Afr. Rep.	EMCCA		
8. Eritrea			
9. Sierra Leone	ECOWAS		
Less developed SCs			

Source: WTO data

Note:

1. EU - European Union
2. EEA - European Economic Area
3. EUBAEE - EU bilateral agreements with Eastern Europe

4. APEC - Asia Pacific Economic Cooperation
5. CACM - Central African Common Market
6. MERCOSUR - Mercado Comun del Sur (Southern Cone Common Market)
7. LAIA - Latin American Integration Association
8. CARICOM - Caribbean Community and Common Market
9. GBI - Gross-Border Initiative
10. EMCCA - Economic and Monetary Community of Central Africa
11. ECOWAS - Economic Community of West African States
12. CMESA - Common Market for Eastern and Southern Africa
13. SADC - Southern African Development Community
14. ECWA - Economic Community of West Africa
15. WAEMU - West African Economic and Monetary Union
16. SACU - Southern African Customs Union
17. ASEAN - Association of Southeast Asian Nations

But this effects depend on the design and implementation of the agreement, therefore the effects may not always achieved. The preferential reduction in tariffs within a regional agreement will induce purchasers to switch demand toward supply from partner countries, at the expense of both domestic production and imports from nonmembers. Many countries are too small to support, separately, activities that are subject to large economies of scale. This might be because markets are too small to generate the sales to cover costs. Regional cooperation offers one route to overcome the disadvantages of smallness, by pooling resources or combining markets. Small domestic markets make it difficult to produce goods that are subject to increasing returns to scale- declining average production cost.

In principle, a RIA combines markets, making it possible to reduce monopoly power as firms from different countries are brought into more intense competition. The increased competition leads to gains that firms are induced to cut prices and to expand sales, benefiting consumers as the monopolistic distortion is reduced. The second source of gain arises as market enlargement allows firms to exploit economies of scale more fully.

2. The trade creation and trade diversion results from changes in “trade and relocation” effects. Governments will lose tariff revenue, and the overall effects on national income may be positive or negative, depending on costs of alternative sources of supply and on trade policy toward nonmember countries. Changes in trade flows induce changes in the location of production between member countries of a regional agreement. These relocations are determined by the comparative advantage of member countries, by agglomeration or clustering effects, and by possible technology transfer between countries. In some circumstances, relocations can be a force for convergence of income levels between countries. Labor-intensive production activities may move toward lower-wage countries, raising wages there. In other circumstances, relocation can be a force for divergence. Industry may be pulled toward a country with a head start or with some natural advantage, driving up incomes ahead of other countries. This divergence is likely more in RIAs between economically small low-income countries (South-South regional Agreement). “North-South” regional agreements are more likely to generate useful technology transfer, particularly if the Northern member is an important producer of knowledge.

3. However, whereas international trade is normally beneficial, preferentially induced trade can sometimes create powerful transfers so that one partner gains at expense of another.

4.3. Policy Choices

4.3.1. With Whom?

If we look in the Table 4.1., there are many forms of RIAs, some between high income countries like EU or the EEA, some only middle income such as MERCOSUR or the ASEAN, and some only between low-

income countries such as WAEMU. Others contain a mixture, often with a dominant high-income partner such as NAFTA or EU Association agreements with Central European and Mediterranean countries. With regard policy choices, while no single country will face a menu of choices containing all these possibilities, I want to show how the effects discussed in previous chapter apply to these widely different options for regional integration. It was considered some hypothetical country pairings, which are given in Table 4.2.¹¹ Instead, the country pairs are representative of types of RISs.

Table 4.2. Pluses and Minuses of Hypothetical RIAs

RIA type	Between a middle-income, small and large high income bloc		Between 2 middle income small countries		Between 2 low income small countries		Between a small-low income country and a large bloc	
	Slovak	EU	Latvia	Lithuania	Mongolia	Lao PDR	Moldava	EU
Political								
Security	+	0	+	+	?	?	+?	0
Bargaining	0	0	+	+	0	0	0	0
Being noticed	0	0	+	+	+	+	0	0
Policy lock-in	+	0	+	+	0?	0?	+?	0
Cooperation	+	+	+	+	+	+	+?	0
Economic								
Scale & competition	+	+	+?	+?	0?	+?	+?	0
Trade diversion	-?	0	-	-	-	-?	-?	0
Fiscal	-	0	-?	-?	-	+?	-	0
Trade & location	+	+	+?	+?	-	+	+?	0
Technology transfer	+	0	+?	+?	0	0	+	0

Source: www.worldbank.org/trade%20bloccs and authors.

Slovak Republic – EU

It is a case of a RIA between a middle-income developing and transition economy such as Slovak Republic and a large high-income country or bloc- such as with East European economies and EU. On political side, the most important element of likely gain comes from the policy lock-in argument. The country seeking lock-in must care about sanctions that the partner might impose, and the partner must have the incentive to impose sanctions, rather than let policy reversals. Both these conditions seem likely met in this case. Suppose that Slovak Rep. Reneges on part of the agreement – perhaps imposing trade barriers, or violating political conditions. The partner (the EU) is so large, and likely to account for such a high proportion of the country’s trade that its actions will certainly impact on Slovak Republic. At least when the countries are geographically close, the EU is likely to want to see economic and political stability in the region, and be prepared to act to enforce it. We have also scored “cooperation” positive; there is great potential for schemes ranging from environmental projects to technical assistance programs.

Turning to economic arguments, there is considerable scope for gains from the “scale and competition” effects. The middle-income country might typically have a broad range of industrial firms, many of them

¹¹ - Analog to footnote 9.

inefficient, perhaps because of lack of competition, or because they operate at small scale. Competition in a such larger market provides the opportunity for solving these problems.

What about the changes in trade flows and location? It seems likely that factor price differences should induce movement of relative labor-intensive industrial activities to the middle-income country. Much of this might be driven by FDI, bringing with it new technology. A counter argument to this is that the established agglomeration of activity in the EU might draw activity out of the middle-income country, particularly since the EU is a “hub”, benefiting from numerous bilateral “spoke” agreements. Whether or not this happens will depend on how closely the two regions are integrated. If barriers - including transport costs - are sufficiently low then the middle-income country is likely to be drawn into Europe-wide production networks. But if obstacles to trade or to FDI remain, the outcome may be less positive; the middle-income country might find its industry threatened by importers, yet not be a sufficiently attractive place for FDI inflows.

Finally, if the middle-income country retains high external tariffs, there is scope for it to suffer from trade diversion, although this is likely to be small insofar as affected sectors have low protection in the high-income country. Tariff revenue loss may be significant, since large volumes of trade are likely to be covered by an agreement of this sort.

Latvia - Lithuania

On the economic side, a pair of countries at this stage of development offers perhaps the great potential for scale and competition effects. This might increase efficiency level in domestic firms, attract FDI, and also lead to terms-of-trade improvements, as foreign suppliers react to the more competitive market. FDI might bring with it benefits of technology transfer. However, the usual question mark remains over these effects. Securing effective competition has often been obstructed, and achieving it requires investing in “deep integration”.

What about the relocation of industries between countries? If there are differences in comparative advantage or in market size and access, then integration will create forces for relocation. However, to the extent that the economies are similar, and already have established manufacturing sectors and the infrastructure that goes with it, it seems unlikely that this would be a one-way traffic. Some industries will expand in one country, others in the other, so there may be clustering of particular sectors rather than of activity as whole, bringing gains from specialization rather than from the costs of divergence.

These are the benefits, but there are also likely costs. There is a danger of substantial trade diversion in such RIA. The countries involved may have developed their industry behind protective barriers, meaning that production costs are well above world minima. If tariff preferences induce importers to switch the source of supply from the rest of the world to inefficient production in the partner country, this will reduce income. There will also be loss of government tariff revenue, its significance depending on initial tariff rates, on initial trade volumes, and on the ease with which governments are able to activate alternative fiscal instruments.

Mongolia – Lao PDR

Regional integration between two small low-income countries may offer some real opportunities for benefits from increased cooperation on economic projects - such as water management, or development of infrastructure, particularly between coastal and landlocked countries. As far as bargaining power goes, the main potential benefit is that of “being noticed”, providing that member countries are willing and able to take a concerted position on world issues. “Lock-in” effects are unlikely to be strong; they require both that the partner itself is committed to reform, and that it has political capital to invest in securing reform in the partner country.

Turning to economics, some sectors may benefit from scale and competition effects. Rationalization and removal of inefficient duplication of plants is a possible outcome, bringing with it efficiency gains. Market enlargement may also bring an FDI flow. As usual, these potential gains can easily be frustrated, and it is also possible that even the combined market is too small for scale and competition effects to operate. Against these gains are the costs. If external tariffs remain high, then trade diversion is likely. Related to this, inward-FDI may be “tariff jumping”, in which case it is not necessarily beneficial. Both these effects will be associated with loss of tariff revenue, likely to be major source of government revenue.

It is also in relatively closed South-South RIAs that we think the scope for uneven internal development is greatest, with production concentrating in a few locations. If one region has a head start in manufacturing – due perhaps to its location, endowment of factors of production, or simply due to history - then this region may well expand at the expense of other regions. Linkages are likely to be strong, because of the paucity of the business infrastructure, and manufacturing as a whole is sufficiently small that it will not run up against the “centrifugal” forces. In this case then, the effects of the RIA will be very different across the members; beneficial for some, but possibly adverse for others.

Moldavia – EU

Moldavia - EU represents a RIA between a small low-income country and a large industrial country or bloc. In Table 4.2, we set effects on the EU at zero - simply reflecting the relative magnitudes of the countries.

What about the effects on the low-income partner? On political side, it was scored the bargaining and being noticed rows at zero. In the domains of security, cooperation and policy lock-in there are potential gains. Once again, for a regional agreement to work as a commitment mechanism we look for two conditions to be satisfied. The first is that the country seeking lock-in must care about sanctions that the partner might impose. This condition seems likely to be met. If the partner is large, constituting a significant market for exports, and perhaps also a considerable source of aid and technical assistance the threat of sanctions will be powerful. The second condition is that the partner must have the incentive to impose sanctions, rather than let policy reversals go without response. The EU is unlikely to be directly affected by policy reversal or even instability in a small remote developing country, but there may nevertheless be reasons for it to enforce an agreement. One might be a history of involvement with the region. Another is the reputation of the EU itself; if it has entered many such RIAs, then the effectiveness of all of them can be damaged by the failure of one.

Evidently, large question marks surround the willingness of our hypothetical industrial country to constitute an effective commitment mechanism. This is an argument for designing the agreement in a way that makes explicit the commitments to reform, and perhaps also the sanctions that are to be followed in the event of policy reversal.

Turning to economics, there are three dominant issues. The first is trade diversion: Is RIA with EU likely to cause the source of imports to switch from other lower-cost suppliers to relatively high-cost EU production? This effect is likely to be small, insofar as the EU itself has low protection, so production costs are close to world minima. Transport costs could however be important if our hypothetical low-income country were much farther away from the EU than from other sources of supply of manufactures. The second issue is government revenue. There may be significant loss on tariff revenue, and the low-income country should look to the agreement to make this up.

Third, and perhaps most importantly, are the trade and location issues. Will such an agreement enable a low-income country to develop effective export activities, supplying the partner country? Is there a

realistic likelihood that the low-income country can be drawn into a “production network”, undertaking labor-intensive stages of production activity? Low-wage costs suggest so, but working against this are transport costs, quality of infrastructure, and security of market access. The potential advantage of a regional agreement is that it can make progress on reducing obstacles. This suggests a need for such an agreement to be relatively deep, so it can overcome trade frictions and secure guaranteed market access, for example, by removing contingent protection.

4.3.2. External Trade Policy Matters

How Open to the Outside World?

The costs and benefits of RIA depend directly on the external trade policy. Pursuing a policy of external openness can lead to trade diversion more likely, and this is more costly if higher the external trade barriers. It is more likely, since the relative price differences created by preferential liberalization will be greater with a higher external tariff, inducing trade diversion in more sectors. It is also more costly, since a higher external tariff will provide greater incentives for inefficient sectors to expand. In general, the gains from competition with low-cost suppliers are the gains to consumers, gains in developing an efficient industrial structure, and competition induced efficiency gains at firm level. On other hand, the low tariffs lead to agglomeration, and the RIA consequently causing divergence of economic structure. One of the forces driving agglomeration is linkages between firms and the dependence of firms on other local firms for supplies, and on local firms and markets for their sales. The more closed is the RIA, the more inward-oriented will be its firms, increasing the strength of local linkages. A counter argument to external openness might be that the RIA liberalization brings with it adjustment costs, and simultaneously external liberalization magnifies these to an unacceptable level.

Customs Union or Free Trade Area?

In a free trade area (FTA), countries are free to set their own external trade policy, whereas in a customs union (CU) the RIA as a whole sets a common external policy and tariffs. A CU typically requires greater political commitment. The great advantage of CU is that it is possible to have much simpler internal border formalities. In contrast, an FTA leaves external trade policy to individual member governments, and faces a problem known as trade deflection; the redirection of imports from outside countries through FTA member with the lowest external tariff, to exploit the tariff differential. The usual solution is rules of origin- the apparently reasonable requirement that goods qualifying for tariff-free trade should be produced in a member country. In practice, the costs of implementing rules of origin are high. Although there are substantial benefits to choice CU, only few of such RIAs are realized because of a loss of national autonomy, and the potential for politically divisive redistributions, and additional adjustment costs and lobby opposition.

How Deep?

The gains from competition and scale effects might not be achieved without removing other obstacles. However, removing these obstacles is not without costs. Many RIAs retain contingent protection and restrictions on trade, which include antidumping in response to foreign subsidies, and “emergency protection” to address balance of payment problems or protect an industry from surges in imports. The threat of initiation of antidumping actions can lead to an immediate loss of markets for exporters. Dumping can be predatory, when a foreign firm seeks to force domestic competitors out of the market by pricing below cost, with the intention of raising prices once the competition is gone. In general, contingent protection is an inefficient instrument to deal with the effects of foreign subsidies or industrial policies, because it imposes additional costs on domestic consumers. Small countries in particular are unlikely to have much success by pursuing retaliatory policies, all they will end up doing is adding an additional distortion to consumption.

What Effects on Nonmembers?

The most direct way in which nonmembers are affected is through the change in trade flows caused by a RIA, causing both the exports and imports of nonmember countries to be smaller than they otherwise have been. This can lead to deterioration of terms-of-trade. That means the fall in demand for their exports and reduction in supply of imports which lead to reduce their export price and raise their import price. That means that the member countries gain at expense of nonmember countries. If the nonmember countries have their own restrictive trade policies in place, or if their trade flows are already too small, they will run at a level at which marginal benefits exceed marginal costs that lead to a relative decline in their trade. It will also happen if firms are operating in imperfectly competitive markets and are making a positive price-cost margin on each unit of sales. Losing sales in a RIA market might be particularly damaging to such firms, causing them to lose profits, and perhaps causing them to be unable to cover their fixed costs. Another damage of losing of FDI can occur if firms relocate in search of the benefits of a larger market. Another source of loss from non-membership of RIAs is the risk attached to being isolated if a trade war occurs. All these effects may increase incentives for nonmember countries to join the RIA.

5. Conclusion

This paper examines the impacts of globalization on small countries, covering the main features of globalization, the quality of national economic and commercial environment, main characteristics of small countries including important facts and concrete indicators for their development, and their challenges and opportunities for regional integration.

Globalization, its challenges and general implications

Globalization is a process of continuing integration of the countries of the world that is beneficial, inevitable and irreversible. No any country can afford to remain isolated from the world economy. As globalization has progressed, living conditions have improved significantly in virtually all countries. It does create a strong incentive for governments to pursue sound economic policies. Although globalization confronts with opponents and critics, it brought with itself an impulse for the sustainable development of global world towards a welfare development level of world community. Increased trade and foreign direct investment flows are, at least in the long run and in most cases, correlated with higher rates of economic growth and productivity increases for the economy as a whole.

However, there is a real danger that capital flows will increasingly determine exchange rate movements, in turn affecting trade, output and employment levels. The strongest gains of globalization have been made by the advanced countries and only some of the developing countries.

Globalization requires a global governance including large, small, developed, developing and least developed countries that ensure the equality all over the world.

Challenge lies in selecting the appropriate mix of domestic policy measures (by governments and social partners) to improve the returns from globalization while reducing the social costs. Macroeconomic stability, financial soundness, open economies, transparency, and good governance are all essential for countries participating in the global markets. Governments should pursue policies that encourage integration into the global economy while putting in place measures to help those adversely affected by the changes.

The implications of the domestic economic and commercial environment are of crucial importance to integrate in the global economy and to the growth.

Globalization and small countries

If the country is "**large**" in international markets, then the country's imports or exports are a significant share in the world market for the product, domestic trade policies can affect supply or demand on the world market sufficiently to change the world price of the product.

If the country is "**small**", its share in international markets is so small, that domestic policies are unable to affect the world price of the good. Domestic firms and consumers must take international prices as given because they are too small for their actions to affect the price.

For small and low income countries, effective participation in the global activities remains a serious problem, especially in view of the increasing complexity and range of issues handled by the WTO. This raises difficult technical and institutional problems for small countries. Trade liberalization tends to increase export specialization, which in the case of certain developing and small countries might translate into heavy reliance on a small range of export products. Such a narrow export base can increase economic and labour market vulnerabilities to terms-of-trade shocks. The gains of the globalization are typically distributed unevenly among countries, specially very low to small and poor countries.

There are number of theories, empirical studies and literatures related to impacts of globalization on small countries. It seems some are contradicting with each other. Some of small countries might have higher per capita GDP and much richer than others. But all small countries do not possess such an advantage. Therefore, it would be suggestible the small countries to be considered differently according to their per capita income level which varies significantly from each others.

Globalization brings opportunities as well as risks, and more integrated global economy may enable smaller states to adapt quickly to changing conditions, and to more readily pursue strategic development policies. Small states have always been vulnerable in the global economy and are more aid and trade dependent. The limited size of domestic markets of small countries appeared insufficient to support production operations for industries that experience economies of scale.

Some important facts of small countries for their development

Real facts are important to answer why some small countries are well developed and some are not or less developed. In general, the developed small countries have a good starting point, free market system, integration or historical ties with developed countries. Some have a fortune with natural resources e.g. oil and gas. They have also diversified modern industrial economy, high agriculture productivity, and well-educated workforce. They implemented structural reforms to improve the business environment and government welfare measures.

In contrast, the less developed small countries have mostly problems or constraints such as their economy is largely based on subsistence agriculture, and the economic and social infrastructure is not well developed, and have high inequality in income distribution, a largely unskilled work force. Some have serious social disorders, civil war or war from outside, and a legacy of misdirected macroeconomic policies etc.

Smallness is so complex such as largeness, particularly in globalizing economy.

There are real differences between large and small countries, but these should be considered not only in terms of population size, but in terms of economic size and natural endowments etc. If a country small in terms of population and economic size then it is more fragile in terms of politics including security. Small is not always beautiful, but globalization can offer more opportunity especially for small countries.

Main features of small countries with regard to concrete indicators

The income level of small countries varies at the maximum from the level of high income countries (US\$ 25,730) of the world, at the minimum to the level, which is almost 3 times lower than the world's low income countries. Therefore, the small countries should be differently considered in terms of their income level.

Especially the less developed small countries are with their development indicators far behind other countries. The annual growth rate of developed small countries is about the same level of low income countries of the world, which reflects high growth potential at average. However, both developing and less developed small countries seem to have a problem with the growth because they have the growth much lower than the world average.

The life expectancy of less developed small countries is far below (3.8 years) than the low income countries of the world which is largely influenced by the infant mortality. They have also much poverty which account 43.3 percent of the population below the poverty line and their income distribution is more unequal than the other countries and they have also much lower agriculture productivity, their communications and information indicator far (100 times) behind the average world development. The role of the government of developing and less developed countries much less than the world average. The developing, particularly the less developed small countries receive much more official development assistance relative to GNP than other countries. Thus, they are much official development assistance dependent.

The urbanization measured as percentage of urban population to the total, seems to be more or less correlated to income level measured as per capita GNP. This can be explained by the fact that most economic activity takes place in densely populated metropolitan areas. The developed small countries have about the same level of urbanization as the high-income countries of the world. The developing small countries have higher urbanization process than the world average. Although the urbanization of less developed small countries lay higher than the low-income countries, but this is even lower than the world average.

In general, the small countries whether developed, developing and less developed spend more expenditure in terms of percentage of GNP on education than the average of the world, low and middle income countries of the world. The developed and developing small countries have even the same or higher expenditure on education as per cent of GNP than the high income countries of the world. Although the high income countries have the most expenditure in average with 6.2 per cent of GNP, the small countries whether developed, developing or less developed, have in average higher expenditure on health than the average of the world.

The developed, developing and less developed small countries are with their openness to globalization in terms of total trade turnover as percentage of GNP much higher than the world's average and the average of high income countries of the world. The foreign direct investment in developed, developing and less developed small countries is higher than the world average and the high income countries of the world.

Challenges and opportunities with regard to the regional integration

There are a number of trade models demonstrate that movements to free trade will cause a redistribution of income, which are considered only the essence in following. One of the key distinctions between these models is the degree of factor mobility. The **immobile factor model** represents one extreme, in which factors are stuck in one industry and cannot move between sectors. The **Heckscher-Ohlin model** represents another extreme, in which factors can move freely and costless between sectors. The **specific factors model** represents an intermediate special case in which one factor is completely immobile while

the other is completely mobile. **Ricardo model** assumes labor as the only factor of production, goods are homogeneous across firms and countries, labor is homogeneous within a country but heterogeneous (non-identical) across countries, labor is always fully employed, production technology differences across industries and across countries and the labor and goods markets are perfectly competitive in both countries. **Ricardo** model showed that the specialization good in each country should be that good in which the country had a comparative advantage in production. **Theory of the Second Best** represent applications of trade policies with market imperfections and distortions.

For any Regional Integration Agreements (RIAs), lowering external trade barriers (up to optimum level) is beneficial, it will increase the RIA's gains or reduce its losses.

Though there are substantial benefits from Customs Union (CU) compared with a Free Trade Agreement (FTA) in terms of simplicity of intra-bloc regulations, there are also costs in terms of loss of sovereignty, difficulty in setting the common external tariff and sharing the tariff revenues. Thus, most recent RIAs have been FTAs, and mostly North-South ones where these costs of forming a CU are likely to be high.

For most developing countries, in particular the small and poor countries, a North-South RIA with a large industrial country is likely to be superior to a South-South RIA with a developing or small country. The reason is that South-South RIAs are more likely to generate divergence, with the less developed member losing relative to the more developed one and are more likely to generate trade diversion, while North-South RIAs are more likely to generate useful transfers of technology, are more likely to provide lock-in mechanisms in the area of politics (such as democracy) and economics (in terms of policy credibility), may provide more benefits from "deep integration". Developing countries may be able to better exploit its comparative advantage in such RIA.

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