The diversification challenge for small Caribbean economies

Ramdath Dwarka

1 Department of Economics, Faculty of Social Sciences, Anton de Kom University of Suriname, Leysweg, Paramaribo, Suriname.

Abstract

To become wealthier, countries want to use their resources—land, labor, capital, minerals, and entrepreneurship—in the most efficient manner. Even though it makes economic sense to allocate resources to the most productive industries, no country wants to rely on only one or a few products. Doing this makes the country vulnerable to changes in the world economy, such as recession, new trade laws and treaties, and new technologies. A country that relies too heavily on one or a few products is especially susceptible to market forces. If, for example, demand suddenly drops or if a cheaper alternative becomes available, the economy of that country could be damaged. By developing a diversified economy, a country can make sure that even if some industries are suffering, other, more competitive industries will keep the economy relatively healthy. This means that a country should "not put all its eggs in one basket". Economic diversification should encourage new development in other sectors of the economy. Indeed, diversification is an investment strategy in which the country spreads its investment dollars among different sectors, industries, and securities within a number of asset classes. It both reduces investment risk and increases the odds that the country will earn a decent return over time. If, therefore, small countries such as those in the Caribbean can accumulate the appropriate knowledge skills in sufficient quantities, they can have a diversified economic structure of production by developing new products and services, and by attracting foreign direct investment.

Key words: diversified economy, economic diversification, economy of Suriname, diversified export market

Introduction

To become wealthier, countries want to use their resources — land, labor, capital, minerals and entrepreneurship — in the most efficient manner. Even though it makes economic sense to allocate resources to the most productive industries, no country wants to rely on only one or a few products. Countries such as the USA, UK, France, China, Germany and Japan are examples of economies that do not depend on one or a few products. These countries have strong economies because of the highly economic diversification. And after all, a diverse economy has long been thought to play a key role in achieving a sustainable economy.

The most important subjects in this presentation are:

1. Definitions of a Diversified Economy.
2. Advantages and disadvantages of a Diversified Economy.
3. Economy of Suriname, diversified but still NOT diversified?
4. The importance and meaning of Economic Diversification for the Small Island Developing States.

1. Definitions of a Diversified Economy

There are several definitions for a Diversified Economy:

- The financial-dictionary says ‘Diversification is an investment strategy in which you spread your investment dollars among different sectors, industries, and securities within a number of asset classes’.

- The Economist Harry Markowitz says that Diversification is ‘not putting all your eggs in one basket’. This famous phrase means that diversification is to create a portfolio that includes multiple investments in order to reduce risk. [1]
- Professor Le-Yin Zhang of the University College London noted in her presentation (2003) that economic diversification is the process whereby a growing range of economic outputs are produced. She said that it can be the diversification of markets for exports or of income sources [2].

This list of definitions can be longer. So in simple terms, ‘Economic diversification is when a country has incomes from many different sources that are not directly related to each other. It can be the production of various (export) products or the export of one or a few products to various countries. Even if some sources are suffering, other, more competitive sources will keep the economy relatively healthy’.

2. Advantages and Disadvantages of a Diversified Economy

Let us look first at the advantages:

a. By developing a diversified economy, a country can make sure that even if some industries are suffering, other, more competitive industries will keep the economy relatively healthy. Or even if some markets lose interest in the country’s export product, there will still be other markets available for its export product. This makes the country less vulnerable to changes in the world economy, such as recession, new trade laws and treaties, and new technologies. A country that has a good diversified economy is less susceptible to market forces. If, for example, demand suddenly drops or if a cheaper alternative becomes available, the economy of that country can easily manage the negative effects. So diversification can reduce a nation’s economic volatility and increase its real activity performance.

b. Economic diversification encourages new development in other sectors of the economy (spin off effect, supply companies).

c. Economic diversification both reduces investment risk and increases the odds that the country will earn a decent return over time.

d. Economic diversification creates structural employment, especially when it goes hand in hand with sustainable development.

e. External trade (exports of goods and services) helps reduce economic volatility, especially when a country also has a diversified export market) etc.

What could be the disadvantages of an (Over) Diversified Economy:

Because a strong, growing, sustainable economy is the goal of every nation in the world, all countries should strive to develop a Diversified Economy. But all countries should also ask the question ‘how much should they diversify? This graph indicates that a country’s economy cannot be diversified unlimitedly.

Graph 1: Overview of risks on over diversification [3]

In this graph you can see two kinds of risks:

1. Systematic Risk, which implies when the market sentiment is negative, your security prices may drop…..etc.
2. Diversifiable Risk, which can be reduced with good diversification.

First, the graph makes us understand that risk can be reduced to a certain extent with diversification, but cannot nullify.

Second, it shows us that there is really no advantage of extending a country’s portfolio to more than a certain number of securities in the portfolio. Managing an over diversified economy is hard and costs more. By concentrating more on diversification, a country can lose the opportunity of putting its efforts and investment on winning sectors, industries, markets and securities.

It is not for nothing that the most successful investor of our time, Warren Buffett once said: ‘wide
3. **Economy of Suriname, diversified but still NOT diversified?**

The natural resources of Suriname are: timber, hydropower, fish, kaolin, shrimp, bauxite, gold, and small amounts of nickel, copper, platinum, iron ore [4]. Still the economy of Suriname is being dominated by the exports of alumina, oil, and gold. Other export products include rice, bananas, shrimp and fish, lumber, timber, BBQ Sauce/Marinades, margarines, organic fruits and vegetables, exotic flowers, pot plants, rum, souvenirs, jewelry, tropical fruit juices, water, eco tourism, call centers, detergents and cleansers, bathroom tissue, etcetera. At first sight it seems as though the economy of Suriname is very diversified. But still gold, alumina and oil account for approximately 30%, 40%, and 10%, respectively, of Suriname’s exports (total mineral sector accounts for 80%). This account could even be more than 30%, but a great deal of the gold is mined by the informal sector. And this informal sector is responsible for at least 20% of the GDP. For comparison, the mineral sector accounts for approximately 9-10% of the GDP.

What we see is that even though great economic diversification has taken place since the last decade, the country’s economy remains dependent on its mineral resources. Things are changing now, because a few decades ago, the economy of Suriname was dependent only on bauxite. Entrepreneurs are now aware of the possibilities of doing business with other countries in the Caribbean, Europe, China, India or the USA. ICT, development of new knowledge and technology has a great impact on all this.

Maybe it is because of this economic diversification that Suriname has not been that much affected by the Global Financial crisis. Loss in one sector has been compensated by profit in the other sector. For example, the historically high price for gold has compensated for a huge part of the losses in the other sectors. In spite of this, Suriname has not totally escaped the negative impact of the global financial crisis. Real GDP growth in 2009 was 2.5% and 4.5% percent in 2010, as the worldwide slump in aluminum demand has led to a sharp contraction in the local bauxite/alumina sector in 2009. See the IMF-report of February 2010 (5).

In the graph below, we can see the negative impact of the global financial crisis on the export earnings, even though the economy of Suriname is relatively well diversified.

So suppose what would happen if Suriname were only dependent on one product (and that was not gold!) or the country’s exports were fully focused on only one market, for example, the USA-market.

**Graph 2:** The development of exports in Suriname in US$ [6]

Now, looking at the number of export products, we can say that Suriname has a reasonably diversified economy.

But why are we still a developing country? In fact, with such a diversified economy a country should be very rich and developed. (According to the World Bank, both the natural resources on land and sea give us the 17th place on a ranking of potentially richest countries in the world [7]).( Imagine that.) this should be left out.

**So what is the problem then with the economy of Suriname?**

- A high economic concentration? (mineral sector and/or a not fully diversified export market). This can lead to volatile growth and fluctuating economic cycles.
- The informal sector? (gold). This leads to loss of taxes and royalties.
- No clear diversification strategies and mechanisms to mitigate economic volatility and spillover effects, uncertainty, and perturbed business cycle transitions?
- Unstructured export policy? This can mean that economic diversification is not measurable and able to be monitored.
- Stakeholders do not encourage the movement of labor and capital into productive economic sectors, as well as the development of new knowledge and technology.
- Are policymakers not aware that the key to building a strong, sustainable economy is building a diversified economy? (not an over diversified economy)
- Or is there something else that they (policy makers) do not understand?

There has been much research on this. We should not reinvent the wheel, but see where the shoe pinches. Working together with more developed countries in the Caribbean (Trinidad and Tobago, Barbados?) who have more experience in diversifying their economies should be a step forward.

4. The importance and meaning of Economic Diversification for the Small Island Developing States

As we all know, most Caribbean countries, but especially the Small Caribbean countries, suffer from a lack of output and export diversification. Trinidad has one of the most diversified and advanced production structures in the Caribbean region [8]. (Suriname, as we have seen above, also has a strong diversified economy, but maybe not fully structured as yet). The economies of most of the other, and especially smaller countries in the Caribbean, are dependent on service exports (tourism) which tend to be less volatile than goods exports. Maybe that is why, despite the global financial crisis, export earnings are quite stable in the Caribbean. As we have seen, especially in Europe, during the times of financial crisis, people think twice before leaving for vacation in another country. They would rather stay at home than spend money on expensive holidays. This influences the economy of the Caribbean countries whose economies are dependent only on earnings from service exports.

To be able to diversify an economy, it should have comparative advantages. If this is not the case it becomes difficult to compete on international markets. Particularly, the small islands’ economies generally have, only relatively few alternatives for tourism. A related constraint is that these economies are confronted with diseconomies of scale. Therefore, a sound strategy should be developed to structurally transform these economies, including sound macroeconomic and income policies.

There is a great challenge for the Caribbean region to have a diversified economic structure of production by developing new products and services, attracting foreign direct investment and seeking for more export markets for the same product.

Countries like Suriname and Guyana have a great potential on mineral and non mineral sources. The other Caribbean states have the appropriate knowledge skills. If these states can accumulate the appropriate knowledge skills in sufficient quantities they can have a diversified economic structure of production by developing new products and services, attracting foreign direct investment and seeking for more export markets for the same product. Why cannot the Caribbean countries use their specific knowledge, skills and experiences and help each other to diversify their economies? Why should Suriname import sugar from Europe when it can be bought in Guyana? Why do we have to export our gold only to Canada and not to other Caribbean countries? Why can we not export our bananas to other Caribbean countries?

The global financial crisis must be an incentive for the Caribbean countries and especially for the Small Caribbean states, to work together to strengthen their economies. Economic diversification will help the Caribbean economy to survive changes in the world economy, such as recession, new trade laws and treaties, and new technologies. Helping each other will only make these countries stronger to survive the competition from strong economies such as America, Europe and especially the BRIC (Brazil, Russia, India and China)

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References

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