

# Small Island Tourism Economies: A Snapshot of Country Risk Ratings

**Riaz Shareef**

Department of Economics, University of Western Australia, Perth, Australia.

**Abstract:** Over the last twenty years, there has been a growing fascination about the livelihood of islands with small populations and territories which overwhelmingly rely on tourism as a source of exports. The Small Island Tourism Economies profiled in this paper were colonised, and had depended heavily on financial aid from their former colonists for infrastructure development that has declined dramatically since the collapse of the Soviet Union. The economies profiled in this paper are developing countries which need a consistent inflow of Foreign Direct Investment to maintain economic growth. These small economies have limited resources, are perceived to suffer from frequent natural disasters, and therefore the international financial community considers them to be risky entities. The snapshot images given in this paper provide a comparative assessment of the international country risk ratings, and highlight the importance of economic, financial and political risk ratings as components of a composite risk rating for Small Island Tourism Economies.

**Keywords:** *Small Size; Islands; Tourism; Volatility; Country Risk*

## 1. INTRODUCTION

Small Island Tourism Economies (SITES) are developing countries with small populations, narrow productive capacities, and a consistent inflow of Foreign Direct Investment (FDI) in order to facilitate economic growth. When such economies have access to capital markets, they can smooth out consumption over time while absorbing adverse domestic production shocks. A common feature of SITES is that they have to rely intensively on international development assistance, particularly from their former colonists, mainly for infrastructure development expenditures. This assistance has declined since the collapse of communism in Europe in the early 1990s. To compensate for the decline in development financing, SITES have turned toward the international financial community. It is difficult for SITES to borrow from the international capital markets, because they are perceived to suffer from frequent natural disasters, they are susceptible to adverse macroeconomic shocks and are considered to have high risk. The main impediments to lend to small island economies are considered to be the costs of obtaining information and country risk.

Country risk has become a topic of major concern for the international financial community over the last two decades. Various risk rating agencies employ different methods to determine country risk ratings. They combine a range of qualitative and quantitative information regarding alternative measures of economic, financial and political risk into associated composite risk ratings. This paper

compares international country risk ratings for 1984-2002 compiled by the International Country Risk Guide (ICRG), which is the only rating agency to provide consistent monthly data for an extended period for a large number of countries.

The plan of this paper is as follows. Section 2 provides an analysis of what SITES are. Economic characteristics of SITES are assessed in Section 3. A comparison of Country Risk Ratings compiled by the ICRG for six representative SITES from 1984 to 2002 is given in Section 4. Some concluding remarks are presented in Section 5.

## 2. WHAT ARE SMALL ISLAND TOURISM ECONOMIES (SITES)?

### 2.1. Small Size

In the literature on small economies, numerous attempts have been made to conceptualise the size of an economy. The notion of size first emerged in economics of international trade, where the large country is the price maker and the small country is the price taker with respect to imports and exports in the world market. It has been argued by Armstrong and Read (2000) that this concept is flawed because it aims to explain the relative largeness of an economy by including the larger ones and excluding the smaller ones.

Size is a relative rather than an absolute concept. In the literature, size deals with quantifiable variables, where population, GDP and land-area are the most widely used. Moreover, there is debate as to the definition of a 'small' country.

SITE	Mean (1980-2000)		Mean 2000		Surface Area (km <sup>2</sup> )
	Pop. (mills)	GDP per capita ('000 US\$)	Pop. (mills)	GDP per capita ('000 US\$)	
Bahamas	0.26	13.1	0.30	13.9	10,010
Cyprus	0.69	10.0	0.76	14.1	9,240
Dominica	0.07	3.4	0.07	3.4	750
Haiti	6.54	0.5	7.96	0.4	27,560
Jamaica	2.40	1.7	2.63	1.8	10,830
Malta	0.37	7.0	0.39	10.2	320

Source: WDIs 2002, The World Bank

Note: For Dominica population is for 2000 only

**Table 1.** Common Size Measures of SITES

In this paper, six economies namely the Bahamas, Cyprus, Dominica, Haiti, Jamaica, and Malta, are profiled. The commonly used size measures for these six SITES are given in Table 1 above. Taken together, they are home to over 12 million people. Haiti, which is one of the poorest countries in the world, has the highest population estimate among the six SITES profiled. This estimate explicitly takes into account the effects of excess mortality due to the high prevalence of HIV/AIDS in Haiti.

At some point in time, all of the SITES profiled in this study were colonised. The ownership of these SITES had changed between Britain and France. All of them, except for Haiti, are former British colonies, which gained independence in the latter half of the 20<sup>th</sup> Century, and they are now in the British Commonwealth. Haiti has the longest history of independence, which it gained from France in 1804.

## 2.2. Island Economies

The six SITES sketched in this paper are sovereign island states. They are geographically surrounded by oceans, visitors normally reach them by air, and freight is usually carried by sea. These economies have one of the world's most delicate ecosystems, and are threatened by frequent natural disasters and the effects of environmental damage. These island economies are insular and are situated in remote areas of the globe. Insularity and remoteness lead to problems in transport and communications. These SITES are scattered in regions where they are frequently affected by unfavourable climatic conditions and other adverse natural events, which typically affect the entire population and economy.

## 2.3. Reliance on Tourism

Tourism plays a dominant role in the economic well-being of these SITES. Tourism earnings account for a significant proportion in their GDP, and they have an overwhelming reliance on tourism as a source of exports. The fundamental aim of tourism development in SITES is to

increase foreign exchange earnings to finance imports.

The large proportion of what is being earned through tourism leaves the economy almost instantaneously. In SITES, tourism facilities are mostly enclave developments, and their effects on the domestic economy can sometimes be limited. Tourism is an industry where careful planning is required so that it can be developed with the intention of sustaining it for the long term besides minimising environmental damage. Tourism development has contributed to economic development in many of these SITES, but may not last forever. Further discussions of the above characteristic features of SITES are given in Shareef (2003).

## 2.4. Implications of Being a SITE

The most prominent feature of SITES is their narrow production base and small domestic market. Many of these SITES are necessarily and relatively undiversified in their production of exports. In order to tackle this problem, they have to rely on international trade and foreign direct investment.

SITES do not have advanced capital markets to hedge against adverse macroeconomic shocks. Access to international capital markets is difficult because SITES are considered risky entities. The absence of reliable institutional frameworks in SITES makes the distribution of income more uneven and results in higher levels of poverty.

There are substantially qualitative differences in per capita incomes and economic growth rates between SITES and other relatively large developing countries. A possible explanation for this outcome is that SITES have relatively large natural resource abundance that fosters tourism, and offsets the inherent disadvantages of being small. Some key social indicators, such as formal education attainment of population, access to better health care and safe drinking water in these SITES, are highly favourable. This is a clear indication of sound domestic social policies.

It is widely claimed that, due to the increased emissions of green house gasses, there will eventually be widespread global warming. The subsequent rise in sea levels would increase by a metre over the next one hundred years, which would result in the extinction of SITES like the Maldives.

There is diversity among these economies if, for instance, one compares their stages of economic development. Therefore, one could not draw up a single set of policy prescriptions for all SITES. Instead, an emphasis should be given to their

domestic and regional circumstances since each SITE is unique.

### **3. ECONOMIC CHARACTERISTICS**

#### **3.1. High Volatility of Real GDP Growth**

The square of the deviation from the mean of a GDP growth rate is known as the volatility of GDP growth. In SITEs, the volatility of the GDP growth rate tends to be very high. The high volatility of the GDP growth rate recorded among SITEs is due to three main reasons, as follows. (i) SITEs are open to external markets due to their high dependability on imports and exports, and are more susceptible to changes in external market conditions; (ii) SITEs have a small range for uncompetitive exports and limited options to avoid losses; (iii) SITEs are prone to natural disasters which affect every activity within the economy.

The significance of the above reasons varies quite differently among SITEs because smallness is associated with relatively high levels of specialisation in production and trade.

#### **3.2. The Narrow Productive Base**

There is less incentive to diversify industry when the domestic market is small. A significant feature of SITEs is where there is a dominant economic activity. When it starts to decline, another dominant activity will replace it rather than the economy becoming more diversified. For example, during the last decade, merchandise exports in SITEs have plummeted while tourism-related earnings have soared.

#### **3.3. Vulnerability**

Vulnerability means exposure to exogenous shocks over which the affected country has little or no control, and low resilience to withstand and recover from such shocks. SITEs are less likely to be resilient to these shocks, given their narrow economic structures and limited resources. In the literature, vulnerability exists in the form of economic, strategic and environmental factors. Economic vulnerability examines the narrow production base and the susceptibility of the economy to external shocks. This also takes into account the high incidence of natural disasters and combining these two aspects together. Strategic vulnerability accounts for the political vulnerability to their colonial history, as well as their larger neighbours. Environmental vulnerability explains the intensity of the fragility of the delicate ecosystems which these SITEs possess.

#### **3.4. International Trade**

In small island economies, the range of production of goods and services is low, but they consume a broad range of goods and services through international trade. Hence, the proportion of trade to GDP is relatively higher among SITEs than for other countries.

Small Island Tourism Economies hold a much greater stake in world markets because of their smaller proportion of world trade, but they are bound by the same rules and regulations. SITEs do not necessarily receive preferential treatment, except for a few former British colonies with regard to banana exports. In this regard, the terms of trade of SITEs do not exhibit irregular changes when compared with other relatively large developing countries.

#### **3.5. Capital Market Accessibility and Country Risk**

SITEs depend heavily on foreign aid to finance development expenditures, particularly from their former colonialists. Such assistance of around US\$145 per capita in 1990 declined dramatically across all developing countries to less than US\$ 100 per capita in 2000. To compensate for this decline in aid, SITEs turned toward the international financial community. SITEs have limited access to international financial markets because they are perceived to suffer from frequent natural disasters, or for reasons considered to be of high risk.

Moreover, SITEs find difficulty in attracting capital from international markets because of: (i) the lack of information they have to offer regarding their economies; and (ii) the high country risk assessment of these economies by risk rating agencies. The difficulties in prosecuting illegal activities in SITEs makes enforcing contracts very costly for investors. This is one of the main reasons why the cost of borrowing for SITEs is relatively high. Therefore, the integration of SITEs into the international financial capital markets is more difficult than would otherwise be the case.

#### **3.6. Foreign Direct Investment**

FDI plays an important role linking SITEs to the developed world. Entrepreneurship from the outside world is an important source of knowledge and expertise in creating efficiency and improving management control in the private sector of these small economies. FDI also brings in state-of-the-art technology and increases market opportunities for local firms in SITEs.

### 3.7. Poverty Prevalence

Although SITEs have achieved high average per capita GDP relative to other larger developing countries, poverty continues to be an unabated challenge. SITEs are small economies which are island archipelagos, where a large proportion of the economic activity is confined to the capital, while the dispersed communities remain poor. Due to the uneven distribution of incomes, poverty prevalence is high. The high volatility of GDP, together with the inability of the people to absorb unfavourable shocks to their incomes, means that inequality is further aggravated and hardship is intensified.

### 3.8. Institutional Distinctiveness

The public sector has played a dominant role in the economic activities of SITEs. In general, there is limited institutional capacity in the public sector among SITEs. This is mainly because SITEs incur high internal transport costs, especially when islands are spread across miles of ocean.

## 4. COMPARISONS OF ICRG COUNTRY RISK RATINGS

The concept of country risk became a topic of major concern for the international financial community in the early 1980s when Poland and the Eastern Bloc countries had debt repayment problems, and also when Brazil and Mexico defaulted on their debts.

### 4.1. Country Risk and Country Risk Ratings

Country risk refers to the inability of a sovereign country to honour its obligations to pay back its debts. There are many country-specific factors which affect country risk ratings. However, the literature addresses factors which are categorised into three main components, namely economic, political and financial risks, and are considered to be interrelated (see Hoti (2001)).

The Third World debt crisis in the early 1980s prompted country risk rating agencies such as Moody's, Euromoney, S&P, Institutional Investor, Economist Intelligence Unit, International Country Risk Guide, and Political Risk Services, to compile sovereign indexes or ratings. These ratings are considered as benchmarks by which credit risks associated with sovereign countries can be established at a given point in time. Hoti (2002) also mentions that the risk rating agencies have attempted to provide an independent analysis of country risk and a consistent method of risk assessment on a timely basis. These agencies provide qualitative and

quantitative country risk ratings, combining information regarding alternative measures of political, economic and financial risk ratings to obtain a composite risk rating (Hoti, 2002). The International Country Risk Guide (ICRG) is the only international rating agency to provide detailed and consistent monthly data over an extended period for a large number of countries.

### 4.2. Trends and Volatilities in Country Risk Ratings

From 1984 to date, the ICRG has been compiling economic, financial, political and composite risk ratings for over 140 countries on a monthly basis.

As given in Hoti (2002), the ICRG rating system is composed of 22 variables which correspond to three major components of country risk, namely economic, financial and political. These variables essentially represent risk-free measures. There are 5 economic and 5 financial variables, while political component is based on 12 variables. Using each set of variables, a separate risk rating is created for the 3 components. The 5 economic variables for the economic risk assessment are weighted equally to give a score of 50 points; the 5 financial variables, for financial risk assessment are weighted equally to give a score of 50 points, and 12 political variables for political risk assessment are weighted equally to give a score of 100 points. The composite risk rating is obtained by dividing the sum of the 3 components of risk ratings by 2; the economic and financial components account for 25% each, and the political component accounts for 50% of the composite risk rating. The lower (higher) is a given risk rating, the higher (lower) is the associated risk. In essence, the country risk rating is a measure of country creditworthiness.

	Economic		Financial		Political		Composite	
	Mean	SD	Mean	SD	Mean	SD	Mean	SD
Bahamas	74.2	3.8	75.9	7.5	72.8	7.0	73.9	3.3
Cyprus	79.0	3.0	83.3	7.1	69.0	9.6	75.1	6.3
Dominica	67.5	8.7	56.6	16.3	60.7	8.1	61.4	10.0
Haiti	58.6	4.3	40.2	19.2	38.0	10.8	43.7	9.9
Jamaica	59.1	5.9	68.9	12.3	68.5	6.8	66.3	7.1
Malta	81.4	8.0	76.3	9.1	73.5	13.1	76.2	7.5

Source: International Country Risk Guide

**Table 2.** Descriptive Statistics of Risk Ratings

There are six representative SITEs. The Bahamas, Dominica, Haiti, Jamaica, in the Caribbean, and Cyprus and Malta in the Mediterranean, are selected to provide snapshot images for the period January 1984 to May 2002, which is the longest period for which data are available. In the literature on small states, island states are perceived to be of high risk. However, except for Haiti, all of the island economies profiled here have relatively higher risk ratings in each of the four categories, showing an associated low risk.

Table 2 above provides the means and standard deviations for economic, financial, political and composite risk ratings for the six SITEs.

In the case of the Bahamas, while exhibiting high risk ratings, the means across the ratings for the four categories are reasonably close. Dominica and Haiti have shown the lowest risk ratings, while Cyprus and Malta have the highest risk ratings in all four categories apart from a slight depression in the political risk rating for Cyprus.

The snapshot images of the four country risk ratings, denoted ECO-R, FIN-R, POL-R and COM-R, and their associated volatilities, denoted ECO-V, FIN-V, POL-V and COM-V, for the six SITEs are given in Figures 1-4.

Both, Jamaica and Dominica have increasing trends in economic risk ratings, while the Bahamas, Cyprus and Haiti generally show no trends. Haiti has experienced widespread associated volatilities. At first, the financial risk ratings for Cyprus and Jamaica increase and then stabilise. Meanwhile, Haiti shows an impressive increase in the ratings for almost 10 years. The Bahamas, Dominica, and Malta have showed mixed results over the sample period. Their associated volatilities have shown a mixed degree of variation, with Haiti showing extremely high volatility. All the six SITEs have shown increasing trends in their political risk ratings, with Haiti having a major slump in middle of the sample. The associated volatilities for the Bahamas show an increasing trend, while all the other SITEs have shown considerable oscillations.

As a weighted sum of the three indexes, the composite risk ratings for all six SITEs have increasing trends, except for the Bahamas and Haiti. The composite risk rating for the Bahamas is not noticeably influenced by any one particular rating. For the other five SITEs, it is quite apparent that the political risk rating has a substantial influence. The associated volatilities for the Bahamas and Cyprus have been quite stable, whereas for the rest there have been varying fluctuations.

The geographical region of SITEs seems to influence the behavioural patterns of the risk ratings. However, the risk rating agencies do not explicitly take geographical location into account in compiling risk ratings.

## 5. CONCLUSIONS

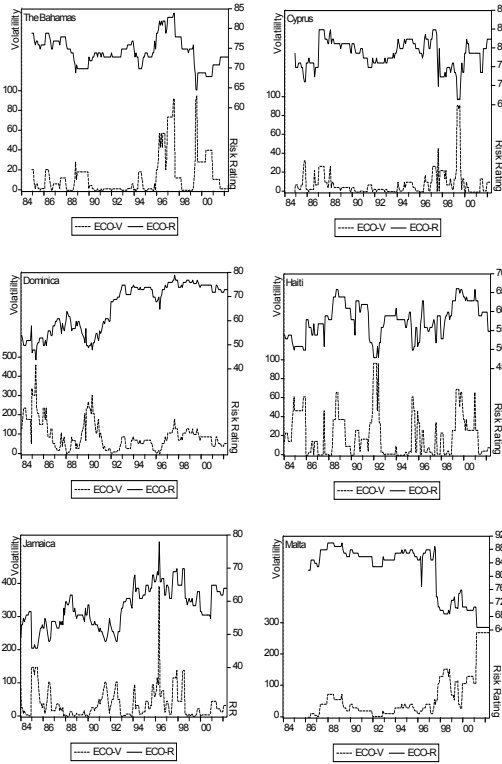
This paper evaluated the economic, social and political characteristics of SITEs where International Tourism Earnings account for a significant proportion of their GDP. Country Risk Ratings compiled by the ICRG for 6 representative Small Island Tourism Economies from January 1984 to May 2002 were compared. Such an evaluation, coupled with the comparison of country risk ratings, justifies a critical assessment of the relevance and practicality of economic, financial and political theories pertaining to country risk.

## 6. ACKNOWLEDGEMENTS

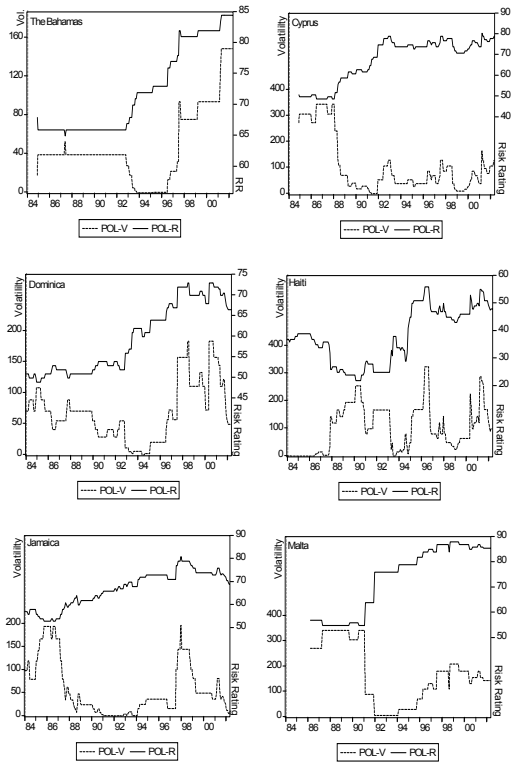
The author wishes to thank Michael McAleer and Suhejla Hoti for helpful comments and suggestions, and to acknowledge the financial support of an Australian Research Council Research Assistantship and the C.A. Vargovic Memorial Fund, Department of Economics, UWA.

## 7. REFERENCES

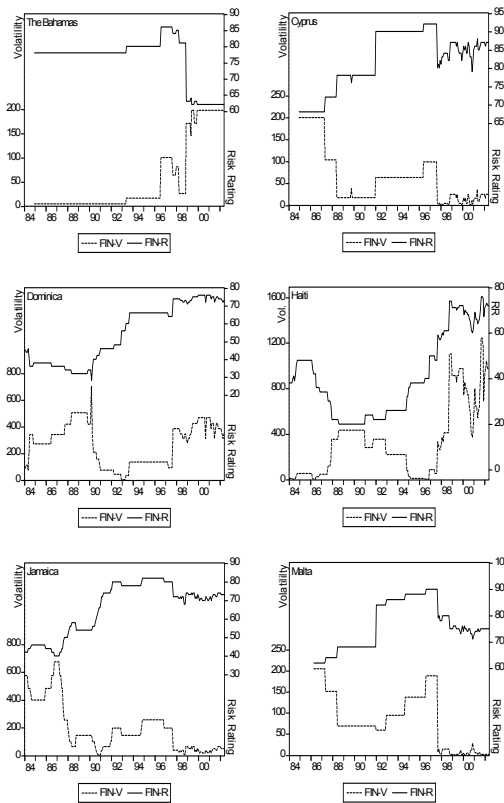
- Armstrong, H. W and Read, R, Trade and Growth in Small States: The Impact of Global Trade Liberalisation, *World Economy*, 21 (4), 563-585, 2000.
- Hoti, S, A Comparison of Country Credit Risk Ratings", in F. Ghassemi, M. McAleer, L. Oxley and M. Scoccimarro (eds.), Proceedings of the International Congress on Modelling and Simulation, Vol. 3: Socio-economic Systems, Australian National University, Canberra, Australia, pp. 1297-1302, 2001.
- Hoti, S, Snapshot Images of Country Risk Ratings: An International Comparison, in A. Rizzoli and A.J. Jakeman (eds.), Proceedings of the International Conference on Environmental Modelling and Software, Volume 2, Lugano, Switzerland, pp. 532-537, 2002.
- Shareef, R, Small Island Tourism Economies: A Bird's Eye View, in D. Post (ed.), Proceedings of the International Conference on Modelling and Simulation: Socio-economic Systems, Townsville, Australia, 2003.



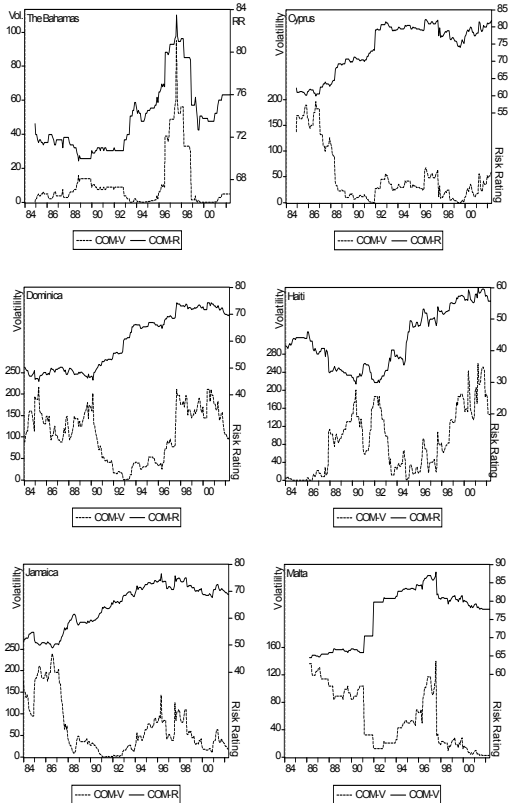
**Figure 1.** Economic Risk Ratings and their Respective Volatilities for 6 SITES.



**Figure 3.** Political Risk Ratings and their Respective Volatilities for 6 SITES.



**Figure 2.** Financial Risk Ratings and their Respective Volatilities for 6 SITES.



**Figure 4.** Composite Risk Ratings and their Respective Volatilities for 6 SITES.