CONJONCTURE
PluriConseil
THINKING OUT OF THE BOX !
Bilingual Journal of PluriConseil
Numéro 27 - Novembre 2007

"Tout l'art de la politique est de se servir des conjonctures." Louis XIV

The real challenge facing the Mauritian economy

By Sameer Sharma

Savings and economic growth have always been linked. Traditional economic theory has taught us that higher savings leads to higher investment which leads to higher growth (Lewis 1955). If one were to analyze all high growth economies since the 1960s till today, it is evident that savings and economic growth are highly correlated. This relationship has also been widely used by local politicians and others who comment on the Mauritian economy to criticize the downward trend in the Gross National Savings rate and its potential impact on long term growth.

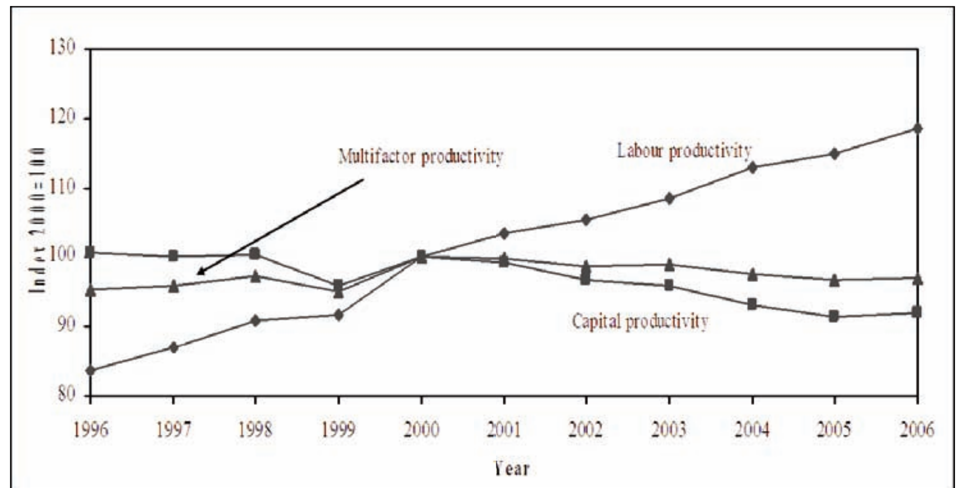
In a country with so many arm chair economists, such opinions have received widespread media coverage and hypothesis has over time been transformed into economic law, Mauritian style. Most people are however missing the boat because correlation does not give the direction of causality and that the real challenge lies in improving our dismal record on total factor productivity growth.

Rather than focusing on improving the savings rate, economic policies need to focus on improving growth which can lead to higher savings

Recent econometric studies (Granger causality) conducted by Edwards (1995), Sinha and Sinha (1998), Salz (1999), Anoruo and Ahmad (2001), Overland, and Weil (2000) and other noted econometricians have found that in many countries it was actually higher growth that caused higher savings. If utility, they argue, depends partly on how consumption compares to a habit stock determined by past consumption, an otherwise standard growth model can imply that increases in growth rates can lead to increased saving.

More interestingly, Mohan (2006) examined the direction of causality in low, middle, upper middle and high income economies. He found that (after differencing the natural logs of GDP and GNS and running the causality tests at the optimal lag level) the direction of the causality ran from growth to savings for low income, lower middle income and high income economies (bar Singapore) and was bidirectional for upper middle income economies.

These results are also consistent with what I observed when conducting the same tests for the upper middle income economy that is Mauritius, i.e. that the causality was bidirectional. My sample size however only went back to the early 1990s and accounting for lags on reducing the sample size, my results cannot be deemed as conclusive but recent economic studies seem to point in the same direction.

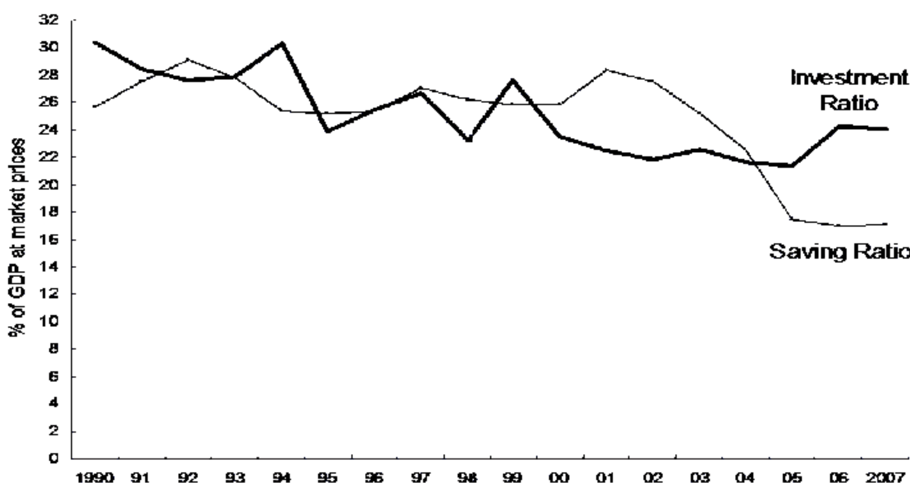


The empirical results found for upper middle income economies suggest that these countries are in transition to reach a similar steady state as the high income economies. Theoretically even the old Solow growth model and club convergence theory provide a basis for expecting different causality for different per capita income levels.

Such results have major implications for economic policy. For example, rather than just focusing on improving the savings rate, economic policies will need to focus more on improving growth which can in turn lead to higher savings. In this context, it becomes increasingly important to focus more on our dismal record of registering near zero total factor productivity growth over the past decade!

Improving total factor productivity growth is a must

In the simplest of economic models, there are three main factors that contribute to economic growth for an economy, that is the growth in your labour stock, capital stock and the growth of the residual (defined as total factor productivity growth that measures everything that is not captured by the other two factors such as technological progress, efficiency, human capital development). As countries and as both labor and capital inputs expand (where capital inputs are linked to investment and hence savings), it becomes increasingly difficult to produce an extra unit of output for every unit of labour and capital.



In the long run, all economists agree that focusing on factors that improve total factor productivity growth play a major role in sustaining moderate to high per capita income growth. If we take into account the causality issue discussed in the previous paragraph, focusing on improving productivity growth becomes even more important.

Between 1996 and 2006, Central Statistics Office research indicates that total factor productivity growth has averaged a dismal 0.2% growth and has only accounted for 8% of total GDP growth while growth in the capital stock has averaged 5.6% and has accounted for 82% of economic growth.

This underreported track record on productivity is indeed not new and stems from the 1990s when Mauritius still enjoyed a favourable macroeconomic environment.

Cont., Pg 3 /

The Monetary Trap

By Samad Ramoly

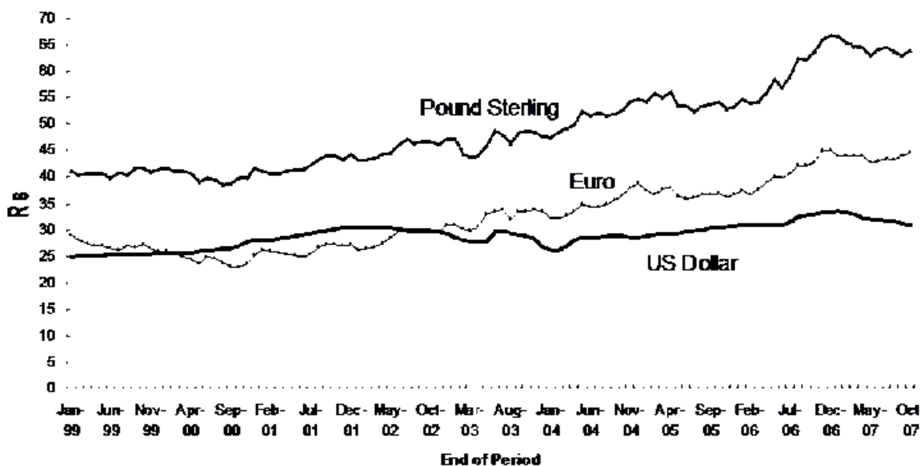
"Common sense is the habit of practical reason by someone whose soul is open to reality. Ideology is not simply opinion, but a libidinous refusal to perceive reality."
Abdolkarim Soroush, a philosopher and currently one of Time magazine's top 100 most influential people in the world

Due to the relative small size of their domestic markets, small economies have no alternative but to boost their integration into the global market in order to sustain their economic expansion. To put it bluntly their very survival is tributary to their degree of openness. However, unless the State, through its institutions and their policies, can instil a reasonable degree of integrity, stability and flexibility into the system, more openness will only translate into an ineffective, if not dramatically polarised, allocation of resources.

How does the choice of monetary policy set the basic condition to achieve convergence with the developed world? There seems to be an ingrained consensus in Mauritius, at least within some affluent circles and their "useful idiots", about the inevitability of resorting to rupee (MUR) depreciation. For instance, citizens are forced to surrender to a trade off between MUR depreciation and job security. In other words they must bear with an annual collective pay cut if they do not want to lose their jobs. Today, with such waffling, even the most seasoned spin doctor would struggle to lure thousands of workers laid off from the export industries over the years.

The conventional nation-centric view of an economy is completely obsolete. Nowadays we live in a world where tightly knitted supply chains and financial markets are a reality. As a small and open economy itself, Mauritius has indeed subscribed to this rational assessment, albeit under preferential treatment for many decades. An export business operating in Mauritius, say a garment manufacturer, no matter how vertically integrated, is dependent on imported fibre, yarn, fabric, technology, human resource and so on. In case imported inputs are not denominated in the same hard currency as the sales receipts, futures markets are available to hedge against currency risk that can dent bottom lines.

Should a business, a sugar exporter, a hotel or a freeport operator for example, have less import content, depreciation may provide a temporary cost cushion (not to mention a "windfall gain") under some circumstances, but as depreciation filters through a broad spectrum of prices it breeds a vicious circle, or a "mess", as Francois Woo, a leading textile industrialist, warned. Export performance is not linked to currency valuation but to other factors such as demand, supply and, more critically, the productivity of each and every individual, firm and service provider, big or small, export-oriented or not, in the exporting country.



Mind The Gap

Internally, a firm can astutely create a working environment that stimulates productivity gains to some extent. However a business does not operate in a vacuum as its activities are connected to those of a multiple of players in other sectors. When offering value for money is far from the norm, this inescapable inter-dependence insidiously erodes our competitiveness. The shortcoming reflects a mindset problem and it takes much more than just pep talks to tweak it. Worse, blaming a demotivated workforce for its output deficit is bound to produce a dead-end scenario.

Instead, the government must strive to provide the incentives and disincentives within the mechanism that defines the interactions between all stakeholders so as to foster a synergy. It means heeding to progressive demands while resisting corporatist pressures. It also implies, more centrally, that as long as citizens anticipate an improvement or maintenance by default of their living standards, they will be cheery and productive. When, alternatively, ordinary working citizens perceive that the manifestation of wealth generation is at their expense, it is only a matter of time before the more fortunate residents are driven to seek refuge in "gated communities".

Paul Volcker, the former Federal Reserve chairman widely credited for putting the clamp on the runaway inflation of the 1970s in the United States, once referred to rising prices as *"a cruel and maybe the cruellest tax, because it hits in an unexpected way, in an unplanned way, and it hits the people on a fixed income hardest"*. Inflation that goes unaccounted for might help explain an increasing squeeze on the Mauritian working and middle classes, which many observers feel are too deeply in debt to cope with an economic downturn.

Since 2002, the US dollar (USD) is down about 24 percent against a basket of 26 currencies. Because of the marginal pass through of the depreciation to prices and their food self-sufficiency, American citizens do not feel the pinch as would people in a highly open economy like Mauritius that must even rely on imported food staple. Moreover, the U.S. can afford the depreciation because the cut-throat competition in its vibrant and large domestic market has a tendency to force businesses to relinquish profits for market share.

If, as standard theory contends, exchange rates must reflect "fundamentals", the USD must then be allowed to depreciate to accommodate the accounting shortfall. Notwithstanding the empirically-tested rebuttal of *Morgan Stanley's Eric Chaney* that in *"the real world of financial markets, fundamentals matter only in the long term and deviations from fundamentals may last for long periods of time"*, one can safely bet one's life on the assumption that the USD will reverse the trend.

The same could hardly be said of the MUR, which, barring few sporadic lapses of respite, has experienced a general downward slide, more precisely a loss of about 90 percent of its purchasing power vis-à-vis the USD over the last 30 years or so, induced by a recurrent stop-and-go monetary stance. Large interest rate differentials prompt market participants to act in ways that tend to push exchange rates in the "wrong" direction, amplifying rather than reducing accounting imbalances. With overwhelming trade shares and high foreign-currency debt, Mauritius cannot afford to ride out the ups and downs of the exchange rate of the MUR.

Contextualisation

In the wake of the 1997 East Asian financial crisis and in a bid to explain "international financial perplexity", after honestly revising his earlier off-the-cuff comments, Paul Krugman, a caustic economic thinker from Massachusetts Institute of Technology, devised "The Eternal Triangle": Adjustment-Confidence-Liquidity.

His insight: the majority opinion (namely influential economists like Robert Mundell, Robert Barro, late Rudiger Dornbusch and, contrary to popular beliefs late, Milton Friedman too) seems to be that the burden of foreign currency debt and the risk of inflation from massive currency overshooting make flexible exchange rates unacceptable to small and open economies. Such countries must either strongly manage their currencies (e.g. Singapore), adopt a currency board (e.g. Hong Kong), start off down the road to monetary union (e.g. parts of Europe, Africa, Latin America, Middle East, Asia) or they must restrict capital movement until the market cools down (e.g. Malaysia). In short the features that have relatively insulated the few countries from the 1997 shock.

Practically all SIDS (Small Island Developing States), financial centres or transition economies around the world have also solidly tied their currencies either through a currency board (e.g. Bermuda, Cayman Islands, East Caribbean Islands, Br*itish Overseas Territories, Estonia*) or a more conventional peg (e.g. Bahamas, United Arab Emirates). Even Denmark's krone is pegged to the Euro. Panama has gone all the way to adopt the USD as its legal tender. As an aspiring financial hub where financial and capital markets are deeply integrated into the global market, Mauritius would be wise to embrace a little bit of realism.

Furthermore, "The Eternal Triangle" vividly exposes the sloppiness behind the full exchange control liberalisation in 1994 when the Mauritian government stooped to comply with the shoddy prescriptions of the International Monetary Fund. It is not that liberalisation is not commendable, it is even desirable in this case, but in typical "Washington Consensus" fashion, it was implemented without ensuring the equilibrium of all parameters. Since then reality has been settling in. While it has been a boon for most foreign exchange earners, liberalisation has been the bane of most MUR

earners.

A weak MUR also pushes up interest rates because sooner or later investors demand higher yields to offset the weak currency. It is doubtful, however, that bolstered exports could significantly overcome the economic drag of higher inflation and steeper borrowing costs. Now that the demise of protected markets heralds the imminence of smart management, it is expected that even the most self-absorbed voices of our export sector will be compelled to give up their fantasy of having the cake (a weak MUR) and eating it (competitive borrowing cost) too.

What Matters Is What Works

The Monetary Authority of Singapore (MAS) "promotes sustained non-inflationary economic growth". *To achieve low inflation, the MAS manages the Singapore dollar (SGD) by allowing it to fluctuate within either side of a pre-determined trading band against a basket of currencies whose weights vary according to their relevance in the international trade of Singapore. What's more, the modest appreciation bias – the SGD has appreciated by about 30% against the USD over the last 30 years – has remained supportive of economic growth while ensuring price stability.*

"Let the historians and the Ph.D. students work out their doctrines. I'm not interested in theories per se", *Lee Kuan Yew, the first Prime minister of independent Singapore confessed in an interview with International Herald Tribune. With such legacy, little wonder everything Singapore does seems so groundbreaking. Its monetary policy is no exception.* The MAS has reiterated the government's inflation forecast of 1.5 to 2 per cent for this year *in spite of the* overall strong price pressure from rising food and energy costs. Here *"price stability" is not an abstract and elusive concept.*

Singapore has not been waiting for a future Nobel laureate's model to weigh the benefits and costs of "inflation targeting" in small and open economies. It has just been doing it, applying rational common sense and dumping statistical bunkum such as "real" exchange rates that The Economist *finds* "difficult to model empirically" *and* "while theories *abound, there is only weak empirical evidence supporting quite plausible theories like purchasing power parity and the Balassa-Samuelson effect". The MAS has sensed that, given the specificities of the economy of Singapore, the most reliable road to tempering rising prices is via a nominal exchange rate target.*

The ultimate job of any institution is to exude credibility. Monetary institutions that are not perceived to be immune to unhealthy lobbies and with a dismal track record in terms of issuing sound money will never be trustworthy. At first glance Mauritius can replicate the monetary mechanism of the MAS. But under one precondition, that the credibility gap of our institutions is restored. A daunting task ahead, to say the least.

Our fittest alternative: a currency board

It is very likely that the implementation of a currency board that two visiting monetary specialists, namely Alan Walters, formerly from London School of Economics, and Peter Sinclair from University of Birmingham, have advocated is our fittest alternative. The rule-based mechanism of an orthodox currency board is arguably its hallmark since restricted discretionary powers tend to depoliticise monetary policy.

The "currency board" which was under close scrutiny during the Argentine debacle was placed into proper perspective by Steve Hanke, a professor of applied economics at Johns Hopkins University, in ""Currency Board" a Misnomer for Argentine system" published in *Financial Times* and also by Gary Becker, the 1992 Nobel laureate, in "*Deficit Spending Got Argentina into This Mess*" published in *Business Week*.

To factor in the "decoupling" pattern of world markets from the greenback, the Hong Kong Monetary Authority (HKMA) has adjusted its currency board, officially known as Linked Exchange Rate System, in 2005. Now the Hong Kong dollar (HKD) is not pegged to the USD so much as it is corralled within a narrow trading range referred to as "Convertibility Zone". More importantly from a currency board operations perspective, it is relatively easy for the HKMA to defend the HKD at the strong end of its trading band.

In theory, there is no limit to the amount of USD the authority can take in. It can simply create all the HKD it needs to buy them. The currency board is also self-correcting and it does not have to set interest rates. As the supply of HKD arising from such purchases grows, interest rates fall, depressing demand for the local currency. Mauritius can either follow the footsteps of the HKMA or can still pioneer another modified currency board with a basket of currencies aligned with our international trade as anchor instead of one single currency to inject a dose of flexibility.

While trying to control local interest and exchange rates in blissful ignorance of the moves of the Federal Reserve and increasingly of the European Central Bank is merely an act of wishfulfilment in an era evolving towards "fewer monies, better monies", shifting from a de facto link to an official one should not bother any forward-thinking policymaker. Like Rundheersing Bheenick, Governor of the Bank of Mauritius, for instance, who is a proponent of unifying the MUR with a common Southern African currency in the future.

Winning Formula Redux

A stable currency and low inflation lengthen economic horizons and are conducive to investment and risk taking. As a bonus, households and businesses in Mauritius can potentially benefit from up to four times less borrowing costs. A sound monetary policy is a decisive driver in the journey towards a rewarding destination but in no way is it the only driver. Together with a strong commitment to spend taxpayers' money efficiently, governments must get their priorities right, like planning for food and energy security, before chalking out other policies with a clear-cut strategy of redistribution, inclusion, and opportunity.

It is essentially due to the foundation laid by John Cowperthwaite, the spirited visionary who managed Hong Kong's finances from 1961 to 1971 and helped create its free-market economy, that Hong Kong can today boast to run the gauntlet of boom and bust so nimbly. Popular dissent to policies being implemented is an indication that governments are trading off elements reminiscent of "trickle up economics". Any attempt to transform a country without a balanced approach will surely backlash into outcry for "social justice" as Germany is currently witnessing.

If our business, intellectual and political elites do not wish to hover like ghosts over future generations for writing a tale of two or more Mauritius, they must mull over the advice of Stephen Roach, a senior executive with Morgan Stanley, in *New York Times*: *"Yet history is clear: no nation has ever devalued its way into prosperity"*. Common sense also seems to suggest a link between "bread and butter issues" and true competitiveness.

Samad Ramoly is a global policy observer.

The real challenge facing the Mauritian economy

By Sameer Sharma (cont., from Pg 1)

Inflexible labour laws, low labour productivity growth relative to both unit labour cost growth and compensation of labour growth have certainly played key roles in keeping our productivity growth at a very low level. Furthermore, insufficient expenditure on education, especially tertiary education by all Governments over the years has certainly not helped in terms of improving human capital. The strong influence that leftist groups have in terms of policy making and the political realities that exist in Mauritius that have contributed to our cash strapped welfare state have certainly not helped matters.

The poor Finance Minister has found it difficult in passing his much needed and logical reforms in such an environment. Will Mauritians, who have been used to high compensation rates, accept a more realistic deal or will they vote for the next leftist politician? That is the real challenge facing the Mauritian economy: enhancing total factor productivity growth in an environment that does not favour economic reform.

It is important for the reform process to be carried through to its logical completion

Our near dependence on capital input growth (unless total factor productivity growth picks up steam) may certainly prove to be a major challenge in the coming years unless the investment savings gap is brought under control. Regardless of the direction of the causality between growth and savings (which is probably bidirectional for Mauritius), investment savings gaps are highly correlated with short term growth spurts as aggregate demand moves upwards but in the longer term, such growth is not sustainable.

This is why it is important for foreign direct investment to be encouraged (there is much empirical evidence to suggest that foreign direct investment does help in generating higher productivity growth) and more importantly for the reform process to be carried through to its logical completion despite widespread misunderstanding by the masses of its obvious importance. One can also appreciate the difficulties in finding extra cash for education when interest payments and the civil service take so much out of the budget.

Anyone who works in the financial sector in Mauritius is aware that salaries are on the rise as demand by companies remains strong. Today even India finds itself in a worrying situation where the lack of graduates in large enough numbers in the technology and finance sectors is seeing wages skyrocket. Some may argue that this is a good thing, but if productivity growth in an increasingly competitive global economy is not maintained, it may not prove to be so good.

When one also considers the compensation that a weakening Labour Government will need to give to the demanding masses next year (as part of the famous and eagerly awaited Pay Research Bureau recommendation), challenges remain high indeed. Attitudes will certainly need to change because improving total factor productivity growth in an increasingly leftist environment on the political front would certainly be a first in the world. The real challenge is here to stay but are Mauritians and politicians ready to take it up?

Sameer Sharma is a financial analyst.

The fruits of the reform

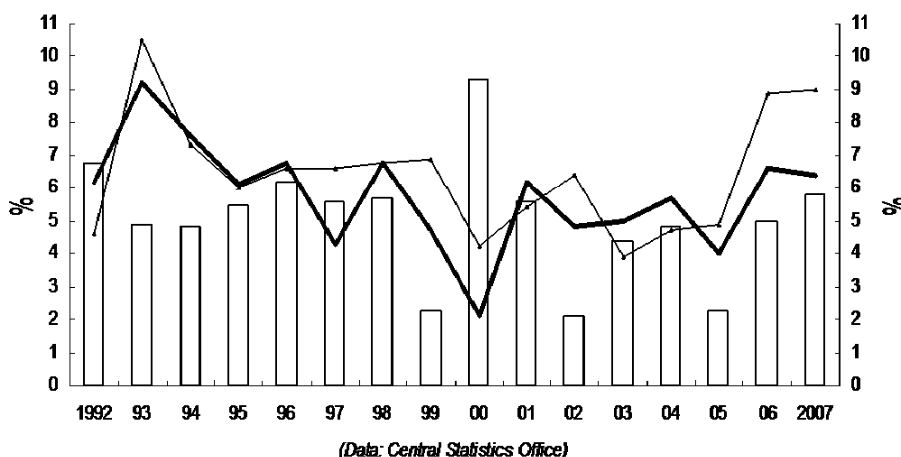
By Eric Ng Ping Cheun

Economists are often criticized for analysing problems calmly. They put aside their personal feelings to look only at facts and figures. They have no complex about money and they view the market as an impersonal mechanism which creates value for money. This may appear cynical to sensible people, but it stands good in a small multiethnic democracy like ours.

While economists rise above racial conflicts, they do not ignore the ethnic dimension of the economic structures of the country. No serious analysis of the Mauritian economy can deny realities such as the existence of protected markets. The economic reform introduced by the incumbent government calls for open-mindedness. Opening the domestic market is the only way of introducing competition for the benefit of the consumer.

The economy is reaping the fruits of the reform. According to the Central Statistics Office, gross domestic product is growing this year at 5.8%, the highest rate since 2000. The last two years have seen a net creation of 19,200 jobs. For the year ended June 2007, according to figures published by the Bank of Mauritius (BoM), the country received Rs 10.3 billion of foreign direct investment, much more than the combined amount of the five preceding years. Relatively large capital inflows have propped up the rupee against the dollar, bringing about a surplus of Rs 6.6 billion in the balance of payments. Gross official international reserves reached an all-time high of 1.7 billion dollars at the end of September.

One cannot understate the boom that is occurring in five economic sectors, as evidenced by the double-digit growth in tourism (13%), construction (12%) and professional services (10%) for the year 2007. Firms in business process outsourcing are recruiting school leavers aggressively while banks are indulging in poaching executives, thereby fuelling wage inflation. Recovery in the textile industry is now firmly on track with a real growth of 7.2%, same rate as the financial services sector.



Competition will come naturally only through the opening of the economy and the infallible law of the market

The only sectors that are struggling are the sugar industry, local manufacturing and distribution. Beset by the fall in its guaranteed export price, the sugar sector must rapidly be transformed into an energy industry in order to survive. But negotiations between producers and the government on the sugar reform are in the doldrums, and they might end up in disaster.

Threatened by relatively cheap imports due to a sharp reduction in customs duties, the local manufacturing must integrate itself into the rest of the industry to compete against foreign products. Unfortunately, the forthcoming governmental decision to increase the number of “local leaves” to twenty will put at stake the future of the local industry, let alone the objective of achieving full employment. In our country where people work five days per week and benefit a mandatory one-month end-of-year bonus, if one adds in the number of public holidays and feigned sick leaves, an employee may finally get thirteen months of salaries for ten months’ work!

Wholesale and retail trade is being severely hit by world inflation which is out of control of any government. There is not a single country where hikes in food prices are not affecting the population. In Mauritius, price control has never managed to counter cost-push inflation. Not only does it create shortages, but it also hinders the emergence of competition, which the government wants precisely to promote.

A competition law will soon be adopted. If the c ompetition commission goes by the letter of the law rather than the spirit, it will kill competition. Humans are fallible: who will guard the guardians?

Supply-side competition will come naturally only through the opening of the economy and the infallible law of the market.

Distribution activities suffered negative growth in the first quarter (-5.1%) and in the second quarter (-0.9%) and are expected to grow at a lower rate of 4.3% for the whole year 2007 compared with 5.1% in 2006. Concurrently, real growth in the food processing industry will be 3.9%, down from 9.6%. Traders are making low provisions for the end-of-year festivities as imports of goods are contracting by 2.7% this year.

Final consumption expenditure of households, which represents 84% of the total, is growing at a lower rate of 4.3% in 2007 after high growths of 7.8%, 7.3% and 5.9% in 2004, 2005 and 2006 respectively. However, salary compensation, the reduction of the personal income tax rate to 15% and the current appreciation of the rupee are likely to support demand. Core inflation, which is a measure of demand-pull inflation only, remains high at 6.8% for the twelve-month period ended September 2007.

The new monetary policy framework should be reviewed to make it workable

The reason is that too much currency is still in circulation. The 75 basis points increase in the Repo rate has not helped dry up excess liquidities on the money market. To realize this, the Bank of Mauritius must constantly conduct Reverse Repo transactions with the banks. That is what was expected under the new monetary policy framework, which was introduced to supposedly fight inflation.

Now the central bank has stopped such operations since 21st May last! So the Repo rate is not working but remains just a signal rate, like the previous Lombard rate. If the BoM remains inactive, it will be difficult for banks to maintain the interbank rates within the corridor set by the upper and lower limits of the Repo rate. Besides, the results of the auction held on 12 November showed that the highest yields accepted by the BoM on 91-day and 182-day Treasury Bills were below the lower limit of the Repo rate (8.75%)!

The Bank of England publishes its aggregate reserves target for repurchase transactions on a monthly basis so as to avoid any widening in the spread between interbank rates and the central bank’s Repo rate. The BoM should adopt the same money market policy. It would be a useful guidance for banks in their investment planning. There is too much delay in reviewing the new monetary framework to make it workable.

Published by PluriConseil Ltd

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