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***Founded in 1954 by Beekrumsingh Ramlallah**

QUOTE OF THE WEEK

*"There is no safety for honest men
except by believing all possible evil of
evil men"*

-- Edmund Burke

Analysis

The Competitiveness Mantra

-- Eric NG PING CHEUN

Politicians like stating what appears obvious to the layman. Especially when it comes to the dismal science of economics, they will tell you "*on the one hand... on the other*". But practical men, who believe themselves to be exempt from intellectual influences, need the advice of a good one-handed economist to rule the economy of a country.

So both our realistic Finance Minister and pragmatic central bank Governor are tormented by apparently two conflicting objectives, which are to enhance export competitiveness and to combat inflation. One is sitting between two stools while the other is walking a tightrope with inflation on one side and unbalanced growth on the other. But they might end up getting the worst of both worlds.

In fact, export competitiveness rather than inflation is preying on their mind. Such a policy stance assumes that rupee depreciation would boost exports and curtail imports, whereas exchange rate

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appreciation would penalise exports and encourages imports. This conventional view describes the Mundell-Fleming model which suits small open economies characterised by rigid nominal wages, like the Mauritian economy. The problem is that it ignores the import content of exports, the external demand, productivity improvements and pricing policies. Besides, empirical data do not buttress this prediction.

Since 2001, Mauritius' Export Price Index (EPI) and Import Price Index (IPI) have been moving in the same direction, thus indicating a direct causal link between them: the import content of exports is relatively large. Indeed, total imports of our export oriented enterprises (EOE) represent 60% of their total exports.

When exports depend on imported raw materials and on imported intermediate inputs, import prices affect export prices directly. In the presence of high import content, exports can face up to currency appreciation because the lower import prices due to appreciation reduce the cost of export production. The cushioning effect of lower imported input prices may even enable exporters to raise export volumes despite an appreciating currency.

Furthermore, a real growth of 6% in the activities of EOE, as forecast by the Central Statistics Office for the year 2008, implies a rise in foreign demand. Also, labour productivity in EOE grew by 5.4% in 2006 and by 5.7% in 2007. And, as a last resort, a reduction in the profit mark-up can counter the negative effects of rupee appreciation.

The EPI can be used to indicate export competitiveness. The relative price of exports and imports is affected by changes in the exchange rate. The rupee strongly appreciated against the currencies of our major trading partners in 2007. Instead of falling, EPI rose by 5.3% during that year, which means that exports were not adversely affected by rupee appreciation.

Neither did a depreciating rupee bring about a favourable movement in Mauritius' terms of trade (TOT), which measures the price movements of exports relative to imports. At the start of January 2003, the rupee traded at Rs 29.45 per US dollar, at Rs 30.95 per euro and at Rs 47.30 per pound sterling. At the end of December 2006, the dollar bought Rs 33.40, the euro Rs 45.20, and the pound Rs 66.95. Notwithstanding the decline of the rupee, our TOT dropped by 17% between 2003 and 2006, indicating a decrease in the real purchasing power of exports.

Within the Mundell-Fleming framework, when all goods are traded, real effective exchange rate can be measured by the TOT. The 17 percentage points fall in our TOT over the past four years indicates a real depreciation of the rupee. Our currency is not overvalued as exporters would make us believe.

Finally, the current account of our balance of payments turned from a surplus in 2003 to a deficit in the following years. A policy of depreciating the currency would be justified in so far as it leads to an immediate deterioration in the current account position followed by a subsequent recovery. This is what economists call a J-curve effect, but it has not yet

materialised.

To assess currency depreciation as a method, one needs to consider the elasticities of demand for imports and exports. Depreciation will increase total earnings from exports only if demand for exports and imports is sufficiently elastic (the quantity demanded is responsive to changes in price).

The Marshall-Lerner criterion states that depreciation will improve the balance of trade only if the sum of the elasticities of demand for exports and imports is greater than unity, i.e. the proportionate change in quantity is greater than that in price. Now, in view of our persistent current account deficit, our demand for exports and imports must be price inelastic. In other words, under the conditions of rupee depreciation, export volumes do not increase more than the change in export prices, and import volumes do not decrease more than the change in import prices. This is understandable given the intense competition prevailing on our export markets, and our high dependence on imports of goods.

The mantra that Mauritius' export competitiveness hinges on a weak rupee is useful to appease the textile lobby. But the rupee's yo-yo and the sky-high oil price constitute a double whammy for investors, producers and consumers alike. As the Finance Minister presents his budget on 6 June and the Monetary Policy Committee meets on 20 June, the interest of the country lies in their hands.

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