Mr Governor,
Members of the Central Committee of the SPPF,
Honorable Ministers,
Excellencies of the Diplomatic Corps,
Distinguished Guests,
Ladies and Gentlemen,

I should like first of all to thank the Government and people of Seychelles and the Central Bank of Seychelles for the warm welcome given to us and for the excellent arrangements to make our stay pleasant in your delightful country.

Seychelles and Mauritius share common ideals and cultural heritage. Both countries are guided by the same ideal of creating better conditions of living for their people. Our common lingua franca i.e. the Creole, and cultural values should greatly facilitate co-operation at various levels between the two countries.

President Albert René has visited Mauritius on two occasions and the recent visit of the Prime Minister of Mauritius, Sir Anerood Jugnauth to the Seychelles reflect the willingness of the two countries to consolidate the good relationship between the two countries. My presence here, to-day, is itself a reflection of the desires of the two countries to share their experiences for our mutual benefits. We look forward to having stronger ties between the two nations in years ahead.

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FIFTH ANNIVERSARY LECTURE OF THE CENTRAL BANK OF SEYCHELLES

Management Problems of Small Island Economies - the Mauritian Experience

by

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It is a great pleasure and privilege for me to be invited to deliver the Fifth Anniversary Lecture of the Central Bank of Seychelles. I thank Governor Morel for this invitation.

I will speak on a subject which is of common interest to us namely the management of small island economies within our region including the recent experiences of Mauritius and the scope for regional co-operation.

One of the most significant developments of the post World War II era has been the dismantling of the various colonial empires and the accession to independence of many countries. Within a period of 40 years, about 90 newly independent states have joined the international community. While the large countries - in terms of population and/or land area - like India, were deemed justified in their claim for independence from colonial rule, there were strong doubts about the viability of the

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emerging small island nations. Whereas the discussion of viability *per se* has trailed off since the international community has accepted small island countries as participants in world affairs, discussions as to whether small island states can achieve self reliance are continuing. My presence here in Seychelles to-day is itself a living evidence of such on-going discussions.

Let me begin with some definitional aspects of small economies. Experts have devised arbitrary cutoff points in certain characteristics to define smallness. In a multidimensional approach, the most commonly used parameters for defining smallness of an economy are national income, population and land area. Other factors such as geographical location of the country, availability of arable land area etc have been considered in arriving at a functional definition for small economies. None of them has proved sufficiently useful.

However, the cutoff point of 5 million in population has been adopted by both the UNCTAD and the Commonwealth Secretariat as the working definition for small economies. Even this broad definition is refined into a sub-category encompassing very small

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economies, with a population of up to 1 million, variously termed as microstates or ministates. Mauritius, the Seychelles, the Maldives, Comoros Islands and Reunion obviously fall within this sub-category.

There is a preponderance of agreement that the general economic characteristics of small economies like ours present special constraints and problems that are not encountered by large ones in engineering economic and financial development.

Smallness of the economies necessarily implies openness, openness implies dependence, dependence implies vulnerability which in turn implies fragility. To this inter-linked series of what I would prefer to call, biological pecularities originating in the smallness of our economies, is added the problem of remoteness from the rest of the industrial world which, as you are aware, are the suppliers of our imports and purchasers of our export products. None of these small economies is endowed with natural resources which further exacerbates the constraints to development alternatives. All this may lead us to conclude that small island economies are condemned to remain underdeveloped and weak.

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The size factor of small island states affects specifically their resource base. The restricted land area limits the availability of arable land and/or mineral endowments thereby limiting the potential for extensive agricultural and mining development. However, they have one important asset - their easy access to marine resources which may compensate for the relative under-development of the primary sectors.

The small size of the domestic market, the lack of indigenous technological base and the non-availability of raw materials locally for processing industries are some of the main considerations which emphasize the need to increase openness and, hence rely overwhelmingly, but inevitably, on international trade with all its attendant advantages and disadvantages. In consequence, the export sector of these countries has a great tendency towards both product and market concentration - a few products going to a small number of countries. In the case of Mauritius, sugar and textiles account for as much as 75 per cent of total exports with the bulk of these products being exported to the U.K. and France.

However, openness, while providing enlarged economic opportunities, results in greater exposure to external vicissitudes. The dependence on the world market, where price

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instability is a normal feature, especially as regards that of primary commodities increases the vulnerability of the domestic economy.

While the contribution of transnational corporations to small island states is recognised in terms of much-needed capital, technology, market outlets and employment creation, they also tend to pose special difficulties for these states. Because of the disparities in negotiating skills and international influence which often exist between a small state and a huge transnational corporation, the former may find itself faced with inequitable contractual arrangements and even political interference which will prove harmful in the long-run.

Domestic entrepreneurs have therefore a major role to play in the economic development of the country and hence they should be encouraged to develop and build up the necessary expertise. The development of an indigenous and skilled workforce coupled with a well-established class of entrepreneurs will be crucial not only in helping to secure self-reliant development but will also increase opportunities for joint ventures, thus reducing the dangers posed by transnational corporations.

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As I mentioned earlier, small island states tend to depend heavily on international trade. But in view of their weak bargaining power as exporters and importers on the world market, they are 'price takers' in the sense that they are not in a position to determine or influence the price of their goods.

Moreover, as the demand and prices for the goods that are exported as well as prices of imported goods are determined outside the domestic economy, the scope for monetary policy to stimulate the local production of such goods and also to influence their prices are limited.

In most island economies savings are not responsive to interest rate policy; they are rather determined by the performance of the export sector and, therefore, by national income. Moreover, as the average income of individuals in these countries is comparatively low, even high positive real rates of interest do not create the desired impact on savings mobilisation. The effectiveness of interest rate policy in the stimulation of savings for investment in the productive sectors is therefore undermined.

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As regards fiscal aspects, there is not much leeway for Governments to choose from systems of taxation and budgetary expenditure. The major income and expenditure flows originate in foreign trade and hence Government's overwhelming reliance on import duties.

Decision makers in small island economies thus have limited room for manoeuvre in macro-economic policy. Against this backdrop of natural constraints and inherent weaknesses of policy, effective management of small island economies tends to become a difficult task. However, central banks have in the circumstances a major role to play. It is common place that banking business is generally carried out by expatriate banks in most of the small island economies. These banks tend to be very active in the financing of foreign trade - the most profitable line of business in banking - and lesser attention is given to the productive sectors of the economy due to the risks involved and/or low return. The intervention of Central Banks therefore becomes necessary for the direction of bank credit to facilitate the process of economic development. Central banks in these countries should also assist in the setting up of indegenous banking and credit institutions to introduce

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competition in the system as well as to encourage resource flows to sectors that are crucial in the promotion of economic development.

The inherent problems of small island states I have just outlined make their weights pervasively felt in any growth strategy they seek to adopt. The natural handicaps of the Indian Ocean islands are practically impossible to get rid of. Nonetheless, the problems posed by smallness could be overcome in varying degrees depending upon the specificities of the countries concerned. Even a marginal access to the markets of large economies easily help the small island states to acquire relatively large amount of external resources that can be utilized to give a solid boost to the development of the economy.

None of the island states in the Indian Ocean, other than Singapore for example, has the great advantage of location at the cross-roads of strategic air and sea routes. Nor do they have the advantage of proximity to large and fairly rich markets in this part of the world. It is therefore compelling to be creative, innovative and decisive in the endeavour to sustain economic development.

In spite of its smallness and remoteness, Mauritius presents an interesting case of development record. In 1961, the world re-nowned economist, Professor James Meade painted a bleak picture of the economic prospects of Mauritius, which then had a population of 650,000. All the disadvantages associated with smallness of island states weighed heavily in his conviction that Mauritius was caught in a *Malthusian trap* and, therefore, if economic progress could at all be achieved, it would be to a very limited extent. Subsequent developments, however, belied this prognosis.

When Mauritius achieved independence in 1968, it was basically a monocrop economy depending overwhelmingly on the export of sugar which was the principal source of foreign exchange. Sugar accounted for 30 per cent of GDP and 85 per cent of total exports while manufacturing contributed only 12 per cent of GDP. Non sugar agriculture was confined to the cultivation of a few food crops. Infrastructure in terms of electricity and water supply, road and other communication networks barely met the standard required for industrial development. Institutional back-up to initiate economic development was also practically non-existent. Access to higher education was limited to only a

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a small section of the population. Moreover, the Government was faced with the difficult and urgent task of providing employment opportunities and a decent standard of living to the growing population. To make matters worse, Mauritius was also constrained by the scarcity of foreign exchange and development finance.

It was evident that in order to get out of this morass of economic difficulties Mauritius could not depend solely on agriculture. Ways and means had to be devised to diversify the economy. Industrialisation with emphasis on labour-intensive industries was the only development alternative open to Mauritius at that time. Though there were some scope for import substitution industries, smallness of the domestic market, lack of technological know-how and absence of raw materials acted as constraints for any meaningful development. Government had therefore to opt, at the same time, for an outward looking export-oriented strategy for promoting economic development. It adopted a two-pronged strategy, one to encourage the setting-up of import-substitution industries and hence save on scarce foreign exchange and the other to promote export processing activities.

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Two distinct policy packages were designed for this two-pronged industrial strategy. The existing Development Certificate scheme was revised whereby firms producing goods for the local market were given fiscal incentives and import protection. Also concessional finance was extended to these firms by the Development Bank of Mauritius and the commercial banks. The then emerging class of entrepreneurs, being still in a state of infancy, did not fully respond to the incentives provided by Government, probably due to uncertainties about the viability of Mauritius as an independent nation. Import-substitution thus received a lukewarm start initially.

While continuing with the policy to encourage import substitution, Government also established in 1970 the Export Processing Zone (EPZ). Incentives such as tax holidays, exemption from import duties and preferential treatment in respect of credit from commercial banks were provided to both foreign and domestic investors willing to set up industries for the manufacture of goods for exports.

Industrialisation could not proceed at the desired pace unless infrastructural facilities and finance were made available to prospective investors. The Development Bank of Mauritius, was entrusted with the specific task of establishing industrial

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estates providing the necessary infrastructural facilities and also of extending medium and long-term finance to both EPZ and Development Certificate firms. The necessary infrastructure was gradually built up. Institutional supports were provided for attracting foreign investors, evaluating project feasibility, marketing of the goods produced and monitoring of the evolution of the EPZ. The preferential access of Mauritian goods to the EEC market under the Lome Convention placed the country in a privileged position to attract foreign investors.

As is the case with many newly independent countries, the few commercial banks in Mauritius were mostly foreign-owned and were primarily engaged in the business of financing trade rather than in the financing of development oriented enterprises which were risky banking operations. In order to bring about the necessary change in banking attitudes and approach Government set up the State Commercial Bank in order to introduce competition in the banking system and also to ensure that the emerging entrepreneurs - big or small - obtain adequate finance for projects compatible with development objectives and also to extend banking services to cover the whole country.

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The EPZ, largely supported by foreign investment responded positively to Government policies and rapidly expanded in terms of investment, employment and exports. The rising prices of sugar in the mid seventies provided an opportunity to local entrepreneurs for investing in the EPZ sector. Equity participation by local entrepreneurs in the EPZ evidenced the emergence of a new class of entrepreneurs in Mauritius. It was thus possible to tackle the constraint of smallness by inter-alia the creation of the Export Processing Zone.

In the pursuit for agricultural diversification and industrial expansion, the tourism sector was not neglected. The number of tourists visiting Mauritius increased by about 25 per cent annually during 1971-75 and tourism became the third largest earner of foreign exchange.

The economy was however beset by a string of unfavourable developments in late 1970's. The depressed world prices of sugar after a two-year boom, the oil price shocks and persistent inclement weather conditions brought about an economic slump that was further exacerbated by the worsening of the world economic situation. Mauritius was faced with a situation of rising rates of employment and inflation, a widening current account deficit in the balance of payments and declining rates of

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savings and investment. The level of foreign exchange reserves of the Bank of Mauritius dropped to a level equivalent to only a few days of imports. Credit-worthiness of Mauritius withered away and access to international financial markets became increasingly difficult. Mauritius, therefore, had to embark on an economic and financial stabilization programme in 1979 with the support of the IMF and later on an Structural Adjustment Programme with the support of the World Bank.

The basic objective of the programmes was to restore external balance and internal balance of the economy through a package of monetary and budgetary measures. The conditionalities imposed by both the IMF and the World Bank were very rigid and Mauritius went through a painful austerity period during several years which however to our great satisfaction, culminated into the successful implementation of the Financial Stabilisation and Structural Adjustment Programmes.

The institutional set-up that facilitated the initiation of the process of economic development in the period immediately after independence and the rigid policy framework introduced in the latter half of the 1970's outlived its time and could no longer respond to the exigencies of further development.

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Structural reforms and a re-orientation of a global approach of economic management became essential. In this connexion innovative policies were introduced to make the Sugar Industry more efficient and viable, and also to promote agricultural diversification.

As regards non-sugar agriculture attention was focussed on land-use for foodcrops and the development of livestock in line with the existing consumption pattern in Mauritius. In a bid to speed up the pace of agricultural diversification, non-sugar agriculture is now being accorded the same fiscal incentives as the Export Processing Zone. The country has now attained self-sufficiency in several agricultural products. Mauritius is already exporting cut flowers to Europe; exports of anthurium flowers currently amount to over 6 million thus making Mauritius the second largest exporter of such flowers in the world. In spite of constraints, Mauritius has thus made some impressive headway in agricultural diversification and prospects of further diversification seem promising.

With a view to reviving the Export Processing Zone which suffered badly during the economic slump in the late 1970's, the Government launched intensive investment promotion campaigns in 1983 and 1984 in the Far East, Europe and Asia to attract new

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foreign investment. The Mauritius Export Development and Investment Authority (MEDIA) was established in 1985 with the specific task of promoting foreign investments, and exploring new export markets.

The Bank of Mauritius pursued a flexible exchange rate policy with a view to maintaining the competitiveness and profitability of the export sector. It also used its influence to direct the flow of commercial bank's credit to that sector. These measures among others have been instrumental in levering the rapid expansion of the EPZ. I must here point out that commercial banks responded positively and played a vital role in the financing and development of the EPZ. There are now 600 companies operating in the EPZ. EPZ exports reached Rs9 billion in 1988-89 whilst its imports amounted to Rs6.5 billion, resulting in a net foreign exchange earnings of Rs2.5 billion and is currently expected to attain Rs3 billion this year. In terms of employment, the EPZ has now become a key sector having overtaken the sugar sector as the largest single employer with 90,000 workers, about 1/5 of the growing labour force.

Tourism, a sector that has been lagging behind until some years ago, was given a big boost and gained greater importance in the past few years. Huge investments were made in this sector and

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incentives granted in order to encourage the construction of new hotels and an extensive marketing campaign was launched. The national airline, Air Mauritius, which now has several destinations - in Africa, Europe and Asia - has brought Mauritius closer in a way, to the rest of the world. Air Mauritius has not only enabled an increase in air cargo capacity for export goods of the EPZ but has also made an important inroad in the tourist markets abroad. Mauritius is today served by seven major airlines with 100 landings per week and transporting about 275,000 tourists to Mauritius per annum. Receipts from tourism has increased by about 35 per cent and has reached Rs2.6 billion - close to 17 per cent of total export earnings. Present thinking is geared toward the admittance of 5-star internationally recognized hotels and diversification into other affluent tourist markets.

The increasing importance of tourism, the recent rapid expansion of the EPZ and the stable performance of the sugar sector have culminated in high rates of growth of the economy. In virtually all the major sectors, labour shortage is being increasingly felt. The tight labour market is currently exerting upward pressure on wages and prices. Inflation, resulting largely from the swelling of demand pressures, will attain 13 per cent this year.

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With a view to supporting and enhancing the pace of economic activities, the trade regime was rationalized. Quota restrictions on imports were gradually eliminated. Owing to the good performance of the economy in 1984 and 1985 and the need to reinforce business sentiment, foreign exchange control is being gradually liberalized. Also, price controls on several manufactured products were phased out with a view to shifting the economy away from a system of controls to greater liberalism so as to make it more resilient and increase its ability to absorb external shocks that island economies are vulnerable to. Economic growth, buoyed up principally by the manufacturing sector, averaged 7 per cent over the last few years. Inflation rate was brought down to as low as 1 per cent in 1987. National savings, stimulated by demand management policies including the realistic interest rate policy of the Bank of Mauritius, rose to a peak of 29 per cent of GDP. Business confidence in the economy firmed up and investment - both foreign and domestic -gradually picked up significantly. Unemployment rate consequently declined from over 25 per cent to around 4 per cent and Mauritius is, therefore, in a state of virtually full-employment.

On the external front, there has been an impressive turn-around. For the first time since 1976, the current account of the balance of payments swung to a surplus equivalent to 10

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per cent of GDP in 1986-87. Over the last five years, total exports grew at an annual rate of 25 per cent attaining nearly Rs15 billion in 1988-89 while total imports grew at 30 per cent reaching Rs17 billion. The current account surpluses stem largely from increased receipts from tourism, transportation and an effective management of foreign exchange reserves. The overall balance of payments surplus gradually increased to around Rs2 billion and is being sustained at this level. As a result, the foreign exchange reserves of the Bank of Mauritius gradually rose to around Rs7 billion, equivalent to 18 weeks of imports against a level of reserves representing barely one week of imports in 1982. The improved level of foreign exchange reserves, now expected to reach Rs8 billion by the end of June next, enabled Mauritius to pre-pay its outstanding Euro-dollar loans well in advance of the due date thus boosting the financial image of Mauritius.

Looking into the future, the concensus is that Mauritius should now evolve a different development strategy shifting away from labour-intensive to labour-saving technology.

It therefore follows that the main challenge remains the continued transformation of Mauritius into a newly industrialised country, that is, to combine the agricultural and industrial

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sector with a modern financial sector. The next phase in our development strategy is therefore the development of the financial services sector.

The existing financial system has served Mauritius well up to now. However, it is deemed inadequate to meet the next challenging phase of its development and hence increasing attention is being given to the development of a sophisticated capital market and modernisation of the financial sector. **In** this connexion a Leasing Company and a Unit Trust have been set up in 1987. A modern Stock Exchange - the Port-Louis Stock Exchange - has been set up and became operational in July last and the possibility of eventually allowing participation by foreign investors is being studied.

The financial services sector is identified as providing a promising way in the modernisation of the economic structure of the country with a view to giving it a more marked international character and to maximise the country's potential gains from its competitive advantages. With this objective in mind, an Offshore Banking Centre has been set up in Mauritius and is already in operation. However, the offshore banking project constitutes the first step in the development of Mauritius as an international

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financial centre. Mauritius will soon be hosting an offshore business centre wherein foreign companies would use Mauritius as a base for carrying out their international business activities such as the setting up of operational headquarters, offshore and captive insurance, shipping, fund management, international securities dealing, trust management etc.

Another aspect of the emerging international character of the Mauritian economy was confirmed last year when the Bank of Mauritius issued the Dodo Gold Bullion coins. Thus Mauritius has become one of the few countries now competing on the international Gold Bullion Coin markets where the Britannia, the Nugget, the Kruggerand and the Maple Leaf etc. are already well established.

Mauritius has thus successfully coped with the constraints of small island states and achieve an economic miracle. Mauritius is thus emerging as the first tiger of the African region.

Though Mauritius, like all ACP countries, have the benefit of a privileged access to a wider market like the EEC and the assistance of multi-lateral institutions, its ability to take advantage of such benefits is an element of paramount importance

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that cannot be ignored. This per se explains the resilience of the Mauritian economy. The prospects of economic development of small island states or of the larger countries rest, after all, with the people. It is the man, the entrepreneurial instinct and creativity that matter most. This lesson, we have drawn from our own experience.

An important means of overcoming problems stemming from smallness is through regional economic cooperation. The potential for such co-operation has been widely stressed as regards small island states, which lie clustered in specific regions like the Caribbean or the Indian Ocean. The small states in the South Pacific and the Caribbean have constituted themselves into a distinctive geopolitical group within their own regions. Those in the Indian Ocean, while being most isolated than the South Pacific and Caribbean islands, have not yet constituted themselves in such groups, and no determined efforts have yet been made in this direction though such feelings have manifested every now and then.

At a broader regional level, we have the Organisation for African Unity and The African Development Bank whose contributions to economic development of African countries are in no way insignificant. The sub-regional 16-member Preferential Trade

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Area including Comoros and Mauritius, and the Seychelles as observer has taken shape, but concrete progress, in terms of economic co-operation could have been faster. Mauritius has a Bi-lateral Current Account Convention for over three years now with Madagascar to facilitate trade between the two countries. These developments are clearly indicative of the general appreciation for regional co-operation in our sub-region.

More specifically, areas where regional co-operation can effectively play an important role for the benefit of the small island states in our region are surveillance and development of marine resources, joint sea and air transport arrangements, co-ordinated research and development that would facilitate sharing of technology and joint ventures in the industrial sector. Mauritian firms are already moving into this direction by setting up industries in Madagascar.

While even the relatively larger economies are moving more and more toward a greater degree of economic co-operation to maximize benefits as also to protect themselves against outside economic forces, Europe 1992 being a case in point, there is no reason why the small island states in our region should not adopt the same approach to overcome our natural handicaps. There

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exist several examples to prove that small island states need not remain weak and vulnerable should they embrace a regional approach to improve their individual economic welfare.

We in small island states should not lose hope. Despite the drawbacks, there seems to be some scope for better performance by the island economies from improved development strategies. Diversification of economic development appears to be the best option for economic survival. Manufacturing industries, tourism and financial services are more appropriate choices for small island states in addition to the continued development of domestic food production, fisheries etc. With a sound development strategy coupled with regional cooperation we can overcome the constraints of size, isolation and scarce resources and even, acquire the international status enjoyed by the large continental countries.

Would it have crossed the mind of anybody in the 1950's that Singapore, one of the smallest island states, could ever become one of the richest countries in the world? To-day, Singapore is, in per capita terms, the 21st richest among some 185 independent countries. Similarly, when Mauritius acceded to Independence in

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1968, there was a massive outflow of nationals, fearing for the future in this ex-British colony. Some twenty years later, i.e. to-day, the flow is in reverse direction, with more and more ex-nationals wishing to return to their country of birth, which has prospered. These two examples prove the fact that small island states can achieve prosperity and good living standard out of their own initiatives.

If you will allow me I will end my lecture on a philosophical note. A small state may have a few resources and/or a small population, but it will certainly be a strong state and enjoy international recognition if its people are united and share common values and objectives, if its institutions are firmly grounded.

Thank you.

1st December 1989