Trade, Finance and Currency: Interrelationships with Special Reference to Small Economies

Presentation by Prof. Bishnodat Persaud on the 15th November 2007, at the 40th Anniversary Celebrations of The Bank of Mauritius

I am delighted to have been asked to give this Lecture. Who would not wish to be in beautiful Mauritius, with its pleasant climate, varied peoples and cultures, secure in one's safety to go around enjoying the many physical, social and cultural delights the country has to offer?

The Bank of Mauritius deserves hearty congratulations on its 40th anniversary. Like Mauritius, it has made good progress without major mishaps. But it is not just parallel progress with the country. It is also mutually contributory progress. The Bank has contributed to the great economic achievements of Mauritius.

But the progress made by the Bank has not been steady. There have been ups and downs with large devaluations in the late 1970s and early 1980s, IMF support programmes, as well as changes in the peg for the rupee from the pound, to the SDR and to a trade –weighted currency basket.

It was a difficult period for many countries. The Bank did not have independence in its monetary policy and it had to cope with whatever weaknesses there were in government policy. Now it has that independence, it has better control. This poses a great challenge, which is added to by having to manage a floating currency. And all this is happening at a time when matters such as the macro-economy, export earnings and the terms of trade are not in good shape.

But Governor Bheenick, his staff and the Monetary Policy Committee have a lot of domestic and international experience from which to draw. We wish the Bank well, and I have confidence in their ability to cope.

On the whole though, this has been a responsible country with a responsible Central Bank. There is adequate proof of this in the spectacular rise in per capita income in post-independence years from US$260 in 1968 to over $ 5000 now. I wish to congratulate Governor Bheenick, his board, his staff, and all those who over the years have contributed to the stature of this institution, which this august Conference room and new Bank of Mauritius Tower reflect.

We are at this time also celebrating this new building. It seems that its towering position in the urban landscape does represent its true significance to Mauritius.

Beyond the ambience of Mauritius, there are other reasons why I wanted to be here. It is a place where I have long had a close interest. Mauritius is a member of the Commonwealth, to which I was attached for nineteen years. But even more important, as an island Commonwealth state, with a history of preference-dependence, Mauritius has many similarities to the Caribbean, to which I belong.

If I had Caribbean experience alone, I doubt I would have been invited here. Unfortunately, we have no great claim to valuable economic knowledge from superior performance to Mauritius. Your country is not ahead of all our states in level of development, but your relative rate of progress in recent decades has exceeded that of all our countries. From the Caribbean, we cannot tell you what to do. We can perhaps only tell you, what not to do. My real claim to be here, is because of a wider exposure.

Lectures sponsored by this Bank are usually on Money and Finance. I want to bring to you a wider perspective. I will bring into the picture production and trade. I will therefore be looking at the real economy. For practical purposes, we tend to compartmentalise policy discussion into trade, finance, money and so on. But it is also necessary to take integrated views, because all branches of economics are inter-related, and more strongly so in a small state.

The Bank of Mauritius has responsibility for monetary policy. It has regulatory powers in relation to the banking sector. In these functions, especially in relation to monetary policy, it needs to take an integrated view, and I am sure this is reflected in the work of its research department and in preparatory work for its important monetary policy committee.

This integrated view is what I shall attempt. In the limited time available to me, I shall focus on a few areas that are important in this relationship.

Let me start by dealing with a conceptual point—the issue of the size of a country and its bearing on development. This is an old issue but it is worth revisiting, because our view of it, affects our thinking on development prospects. If a country takes the view that it is severely or permanently disadvantaged, then it is unlikely to get out of its donor-dependent or preference-dependent mode.

Mauritius is a small state. The view has become popular that small states are vulnerable and face considerable disadvantages in trying to make economic progress. It is true that scale economies are difficult to secure in small states in production, in transportation and in administration. It is also true that small states do not find it easy to attract the attention of foreign investors.

These problems, I do believe tend to be exaggerated. These perceptions became popular in the past, when economies were more isolated from each other by high levels of import duties and other import restrictions and high transportation costs. But these barriers have come down. We live in a globalising world. As one American economist put it, the world has become flat. This might be an exaggeration. But it really has become flatter. Technological advances in transportation and telecommunications and the lowering of trade barriers have made contact and trade easier. Thus states do not have to rely greatly on domestic markets.

Small states have in fact historically been forced to become more open economies. Thus Mauritius and some Caribbean countries by concentrating on sugar for export markets, have been able to produce on a large scale, and so avoiding scale problems. In fact, this early openness, encouraged by smallness, has given these countries an advantage. They have learnt to look to the outside world, and this exposure, and the outlook and experience it inculcates, have been helpful in many ways.

Thus, when an export industry is getting into trouble, these countries have tended to be able to find other export industries. And by looking to the outside world, they have become exposed to large markets, really huge markets, relative to their small size, and if successful in them, they have benefited tremendously. This has enabled many small states to punch above their weight.

In Mauritius for example, we saw the rise of textile and clothing exports, and when sugar and textiles are facing difficulties, Mauritius continues to expand tourism, financial services, fisheries, fish processing and is making considerable effort to develop an IT sector. In these, there is a noticeable shift to service exports through tourism, financial services, business outsourcing and information technology, where size disadvantages are less.

The availability of natural resources is sometimes also given as a disadvantage of small size. But there is no evidence that small states are less well endowed. And there is no reason why they should be. Because of small size, there may be a narrow range of resources, but endowment per capita is usually no less than bigger states, and in many cases is larger. I am not just thinking of small states with oil, gas or other mineral wealth. They do exist, but leaving them aside, most small states are islands. Islands have relatively large coastal zones and such zones, if account is taken of fisheries and beaches and resources for sailing and water sports, natural endowment may be very valuable per capita. There is a downside however in often larger exposure to natural and man-made disasters such as cyclones, floods and oil spills.

Freight rates do tend to be high, especially for isolated small economies, but improvements in transport technology, have reduced the isolation problem. Thus in the case of Mauritius, while distance may have led to a late development of tourism, improvements in air transport and telecommunications have diminished this constraint. These technological developments have increased exposure to the world and to world markets and world ideas.

It would seem that small states would not be attractive to foreign investors. Many small states do, however, have a good record in securing investment. This problem is also therefore an exaggerated one. What we have been learning is that capital is not such a scarce resource in the world as was made out in the past. If a small state provides a space in which competitive returns to capital can be obtained and that small state does its investment promotion, is expeditious in dealing with foreign investors, has a good legal framework, and can be a little ingenious with tax competition, then capital will come.

Capital will come to tap natural resources, which as I said is not likely to be in short supply. It will come if that small state has or concentrates on having good human resources, as high quality human resources is becoming ever scarcer in an expanding globalising world and because of demographic changes in older industrial countries. Capital will come also if that small state has good social capital, by which I mean, a low crime rate, a good functioning democracy, credible law and order and is fairly socially stable.

What I am emphasising is that whatever problems do exist are surmountable, or could be largely compensated for, by dedicated effort and ingenuity. It is important to understand the nature of the problems so that domestic policies or donor policies could be made to respond to them.

The success of many small states—some reaching developed country status—and many like Mauritius-- middle-income status, confirm the possibility. Examples of such success, without major resource endowment, include Singapore, Ireland, Iceland, Barbados, Malta and Cyprus.

Mauritius has greatly relied on preferences in the past for its development. Part of the background rationale for the provision and seeking of these preferences was smallness and the disadvantage that goes with smallness. In the case of sugar, mutuality of interest in stable market and prices, was also a factor behind the original Commonwealth Sugar Agreement, which was succeeded by the Sugar Protocol under ACP/EU association agreement. It led to a long-term contractual arrangement and an expectation, almost of permanence. It is understandable, therefore, that Mauritius and other small states in a similar position, should clamour to retain their preferences as long as possible, and should want to use arguments about smallness and disadvantage in their negotiations.

There needs to be, however, a sense of proportion in dealing with this issue. In the case of Mauritius, this sense of proportion depends on what we think of prospects for Mauritius outside of preferences in the longer-term. I say longer-term, because preferences will not end immediately, even though they are being greatly eroded. This sense of proportion depends also on the genuine prospects for the retention of preferences in the long-term and for pushing back erosion in the short-term. This sense of proportion depends, too, on a matter, we need to think more seriously about, and that is the real economics of preferences. Is it all beneficial or are there serious downsides to it?

My bold statement on trade policy is that in a globalising world, becoming internationally competitive is crucial for economic development. It is especially so for small countries.

It is important to understand that there has been a continuing liberalisation of trade since the Second World War through the GATT and its successor the WTO. That process has moved on to services and agriculture albeit slowly. It is an important part of the process of globalisation. Many countries, developed and developing, have perceived genuine benefits from globalisation. This process of globalisation and trade liberalisation is very unlikely therefore to be put in reverse, even in conditions of recession.

In fact one can safely say that the international environment and WTO rules are becoming increasingly hostile to preferential arrangements. Small countries have made no progress in getting recognition that because they are small and vulnerable, they should secure differential and favourable treatment.

We need to remember also that the WTO rules are not favourable to non- reciprocal preferential arrangements between groupings of developed and developing countries. Thus arrangements like the Cotonou Agreement require waivers or to be treated as exceptions, which are becoming increasingly hard to obtain. There is the fact, also, that legal challenges in the WTO to preferential arrangements are increasingly succeeding. This is enhancing preference erosion. But even when preferential arrangements remain intact, the preferences they offer are being effectively eroded because trade barriers are coming down all over the world or because preferences are given to others by our preference-giving partners or through the proliferation of free trade agreements.

On the economics of preferences, we have tended to focus on immediate tangible benefits through obtaining more certain markets and higher than world prices for our products. If, however, we look below the surface, we see that the low-risk returns in large preference-dependent industries, can inhibit movement to higher risk, higher return alternative industries. They can deter more competitive and efficient enterprises from emerging. Preferential industries also inhibit non-preferential ones by reducing their access to scarce capital and scarce managerial and skilled people. They could inhibit also by encouraging artificially high values to the local currency.

These arguments do not negate the fact that preferences have encouraged the emergence of new industries. In the case of Mauritius, for instance, the establishment of a large textile and clothing industry was helped by preferences provided by the European Union, through Lome and Cotonou and through the U.S. Africa Growth and Opportunity Act backed by the setting up since 1970 of Export Processing Zones.

I have raised all these considerations, to indicate that the attitude to preference erosion should not be that because of smallness and vulnerability, the situation is hopeless or dire. We need to remember that such a negative attitude is not without consequences for the image of Mauritius or any small state in that position, and image is important not only for national pride, but also for national confidence and the attractiveness of a country as a serious place for doing business and with a hopeful future.

In the negotiations with trading partners, Mauritius should stress the serious adjustment problems caused by rapid preference erosion, especially at a time of other shocks such as steeply rising oil prices and high food prices It must negotiate to prolong preferences therefore, but with some flexibility in being prepared to trade in long prolongation for adequate adjustment assistance. It must ask for support for adjustment of a positive kind. By positive, I mean not an attempt to prop up industries that have no long-term future, but an emphasis to make, where possible, traditional industries competitive by efficiency and product transformation, and to look for new and dynamic industries.

What is needed in Mauritius and other preference-dependent countries is repositioning. By repositioning what I mean is not the creation of a new industrial structure, but the evolving of an internationally competitive industrial structure comprising new and transformed traditional industries, such that the description, preference-dependent, would become dated. It seems to me that this is the best response to preference erosion. It is one that is not only good for the long-term future of Mauritius, but one that is likely to get better support from donors.

Mauritius is moving in this direction. My aim is to reinforce this thrust and to strengthen more forward-looking thinking towards a more confident place with an improving international image.

In trade policy, another pertinent and imminent issue for Mauritius is the transformation of trade arrangements under the Cotonou Agreement to Economic Partnership Agreements (EPA) between the EU and regions within the ACP. This involves moving from the current non-reciprocal Cotonou trade preferences to a reciprocal arrangement, in which for continued and extended preferential access into Europe, ACP countries would provide preferential access for Europe in the regional markets concerned, except that the Least Developed Countries, would be exempted from having to reciprocate.

For countries not exempted from reciprocity, like Mauritius, there is the concern about offering the EU preferential access to their markets, fearing exposure of local industries to competition from Europe. My own view is that Mauritius should be active in these negotiations, because it has much to gain from a well conceived EPA. Except for sugar, which has a separate agreement, it would secure improved access into Europe and judging from the negotiations with the Caribbean region, which are very advanced, Mauritius should be able to secure agreement for a very gradual offer of preferences to Europe. Securing the Caribbean pace is not likely to be disruptive to local industries in Mauritius.

Fortunately the position I am advocating for Mauritius has already begun to happen. Trade policy is moving towards lower import duties generally, and a reduction of tax discrimination against industries not, in Export Processing Zones. I fully support this move in trade policy. It is a move from a very defensive position to a more confident and forward looking policy, in which Mauritius is not just demanding access to outside markets, but is prepared to reciprocate

Mauritius has much to gain from an EPA or other Free Trade Area Agreements through which it is prepared to negotiate better access by being prepared to offer reciprocal access, albeit on an asymmetrical basis. Where its regional partners are slow in moving in this direction, it must be prepared to consider how it can push matters forward or take initiatives on its own, even if for practical or regional cooperation reasons, it might do temporary arrangements until other partners are ready.

Please note what I am saying. I am not calling for any immediate exposure of local industries to international competition. I am supporting for a process of opening up. Where protection is offered for any new industry, it must be limited in time, and such limitation must be strictly adhered to. Local manufacturers have become adept at canvassing for continued protection. But protection raises cost of production and produce an uncompetitive business environment. Competition forces constant attention to efficiency and could produce winners, who begin to export competently. Think what large export opportunities are then opened up to them.

The aim of all this is to develop a confident export oriented economy in goods and services. Remember as a small economy, it is only by becoming a successful export oriented economy, Mauritius can continue to provide improving living standards and expanding job opportunities. Growth of at least 6% per year is needed to get on top of its unemployment problems, including youth unemployment, which is urgent not only for welfare reasons but to ensure continuing social stability. Mauritius has done 6% and more in the past. It must do so again and on a sustainable basis. In the latter half of the 1980s, growth averaged 7.5%.

I have devoted a lot of time to trade policy, because it is an important extension of macro-economic policy about which the Bank of Mauritius and the Ministry of Finance are concerned. In discussions in these circles, we must never lose sight of the fact that the important underlying requirement for macro-economic stability is buoyant export earnings.

If exports are buoyant, tax revenues are flowing and Ministers of Finance are not pressed into excessive expenditure and unsustainable budget deficits. If reserves are buoyant, Central banks can afford to take firm action to ensure that inflation gets or keeps under control. Yet we do not hear enough of the primacy of export earnings. Thus exports must become central to the discussion of economic policy. This is especially so for a small economy.

In relation to monetary policy, this is a central function of the Bank of Mauritius, but the Bank recognises it cannot do monetary policy in isolation. Its mandate goes beyond the objective of price stability, to include the promotion of orderly and balanced economic development

It will not do to just get macro-economic policy right. Development policy must have a wider perspective. Mauritius has moved in recent years to less buoyant economic times. The reasons are well known. Off-shore financial services and tourism continue to grow. But its large sugar and textile industries, have lost much protection because of changes in international trade policy. It is an oil importing country and oil is now just shy of $100 a barrel. Commodity prices have risen steeply and this affects raw material and food prices all of which must have an impact on the consumer price index and on domestic inflation. The external debt is not high, but public debt is not low and its rating has been lowered by Moody's Investors Service in December 2005. Indebtedness helps to make it difficult to reduce the fiscal deficit, which is on the high side.

The relatively high fiscal deficit and inflation, calls for tighter monetary and fiscal policies but to reduce fiscal deficit at a time when the economy faces serious adjustment problems and relatively high unemployment, is not easy politically.

On the advice of its monetary policy committee, the Bank of Mauritius takes decisions on interest rate policy. This is a very good development. It is the trend internationally. It gives great power to the Bank of Mauritius. It is able to keep a firm grip on price and exchange rate stability and it prevents pressure from Government for a lax monetary policy in order to manufacture a short-term economic buoyancy for political purposes. Central banks do have therefore countervailing power against any government, which is risking macro-economic stability by practising lax fiscal policy. It can raise interest rate to thwart the expansionary effects of fiscal policies. This does not, however, solve the basic problem, which is the fiscal deficit, which will still require Government action.

The Bank has a duty to promote price stability but with inflation running around 10%, to attempt to reduce it to reasonable levels say below 5% in the short-term by steeply increasing interest rates, would be very disruptive to the economy, which is already struggling with adjustment problems. At this stage, the Bank cannot move to the adoption of inflation targeting, which is in use in some countries. It does not suit present circumstances, and in any case such a basic policy shift might require incorporation into the Bank of Mauritius Act.

The interest rate policy of the Bank must take into account present inflation rate and its prospects. It must seek to coax it down. Inflation targeting is more difficult to adopt in the circumstances of developing countries but tight monetary and fiscal policies are usually more greatly needed in these countries, not because of irresponsibility in developing countries, but because economic circumstances such as poverty and unemployment provide constant pressure for laxity.

The Bank has also to aim at currency stability. The certainty, which goes with maintaining the exchange rate is good for confidence, business planning and encouragement of foreign investment. If there is uncertainty, one other consequence is dollarisation or the increasing use legally or otherwise of a parallel currency. This complicates monetary management.

There is an increasing tendency towards the adoption of floating exchange rates but for the float to be managed, especially in developing counties, as is the case here so as to help to ensure stability. To do this, the policy on international reserves as a backing for the currency tends to be conservative.

The gist of all this is that there is currency stability in Mauritius, but this is maintained by high interest rates which backs up a conservative reserves policy. A long-tem weakness is that the continuation of high inflation rate above those of trading partners would erode real effective exchange rate and eventually necessitate nominal currency depreciation.

A crucial requirement is therefore a reduction of inflation to comparative levels with trading partners. This has to be the longer term aim. It cannot be achieved in the short term, because it would necessitate economic retrenchment. But it must be pursued with vigour, as its persistence would itself be economically debilitating. Bringing inflation under control, therefore, is a crucial underlying requirement for achieving sustainable development. In the past, in developing countries, inflation policy was not regarded as crucial since the origin of inflation was seen to be its importation from trading partners.

To curb inflation, action is required not only on fiscal deficits and interest rates but crucially also for Mauritius on productivity, productivity-oriented wage bargaining and labour market flexibility.

In relation to economic policy in Mauritius, I am pleased to say my main reaction is one of praise for a bold attempt at policy reform and economic expansion.

I note your many efforts such as improving the efficiency in sugar production, while attempting to diversify the economy; moving textile and clothing up-market; expanding and diversifying tourism; expanding fishing and fish processing; providing a low-tax regime to support not only financial services but also industries outside the export processing zones; port expansion; greater competition and lower prices in telecommunications; bold encouragement to ICT by establishing a Cyber Park and Cyber Tower with fibre optic wiring; liberalising imports; special attention to small and medium-sizes industries; endeavouring to make labour markets more flexible; and subsidising on-the-job training to ease unemployment.

It is difficult to improve on this programme. My only observation is that although international financial services are now the fastest growing sector, I believe it continues to have great potential. The legal and regulatory framework has been a great help to Mauritius becoming a conduit for investment into India. It is good to note your establishment of a Financial Services Commission to regulate this sector. Attention to regulation is a continuing need and crucial to the future. The aim should always be a credible regime. This does not mean the overly conservative regime that OECD countries are demanding of offshore centres. It is not heavy regulation that is required but appropriate regulation. It is not also light touch but right touch with regulation discriminating between those kinds of activities that need much scrutiny and those that do not.

International financial services are as much about competence as regulation. Great attention is therefore needed to training, which will quickly advance local employment in the high salary sector. Local people will develop expertise in an international sector that will help spread Mauritian influence widely. Hong Kong and Singapore bankers are as marketable in New York and London as they are in Hong Kong and Singapore.

Mauritius needs to aim to become a global player with the reputation of countries like Singapore. It has the advantage of complementarity with up-market tourism. It would seem to me that a great need is the establishment of a financial services research and training centre, which should be very business oriented and kept that way and must therefore be as separate as possible from existing academic institutions. Access to work and residency permits must not be an impediment to advancement of the industry as many high-level professionals and high net-worth individuals are looking for pleasant tax efficient places in which to work and live.

One further thought is the need for the wider development of the export of services. I have in mind business and professional outsourcing and education, medical and consultancy services with markets in industrial countries as well as Africa in mind, with which Mauritius has good regional cooperation.

The decline of sugar and the expanding market for biofuels are opening up opportunities for other agriculture. Serious attention needs to be given to promoting medium and small sized farming, and access to land seems to be an important requirement. Small and medium sized farms are good for entrepreneurial development and job creation.

One final thought is that I believe that there is need for greater attention to the environment. This is a need for most countries. But it seems to me that tourism-dependent countries need to give special attention to the environment. I say this not because I feel that tourism is a very polluting industry or that there is great environmental damage in Mauritius. I say it, because it tends not to be sufficiently realised that tourism is about the sale of environmental services. The environment becomes, then, an investment into tourism, especially for a country that aims to expand its up-market tourism.

The Bank of Mauritius does not have a direct practical role in these wider development efforts. But it has an influential role through its Governor, backed by its research department, to enrich the discussion of economic policy. And it has a direct role also in providing an enabling environment by ensuring currency stability, a competitive and realistic exchange rate and an interest rate policy that keeps inflation under control and thwart laxity in fiscal policy.

When I look at how policy is evolving in Mauritius, and the outlook and competence of leadership in the Government, in the Bank of Mauritius, and in business and labour, I feel confident that when the Bank comes to celebrate its 50th anniversary in 10 years time, Mauritius will be on the verge of claiming developed country status. I extend my best wishes to the Bank of Mauritius and to Mauritius in that great endeavour.