

Mauritius
Reigniting the Engines of Growth
A Teaching Case Study

Teaching Notes

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Part I

This is a fascinating story of a poor, small country that succeeded in achieving a major improvement in the living standards of its population through integration into the world economy. This case has been written specifically for use with non-economists, notably labor union leaders. The prominent role of a labor leader (Paul Bérenger) and labor issues (unemployment and wage levels) should make it particularly appropriate for such an audience. However, it also should be useful for economists, especially with the additional information provided in the annexed tables and these notes.

This story is first and foremost about export promotion and foreign investment and, secondly, about the more complex notion of sound macroeconomic management. However, it also tells an interesting story of successful structural adjustment. On both counts, this story is particularly useful because it takes place in a society full of ethnic diversity, with a vibrant democracy and a strong trade union movement. As such, it differs from many of the Asian cases that so often are used to make similar points, and so often are rejected by others (notably in Africa) for this reason.

The export processing zone (EPZ) played a critical role in the impressive growth record of Mauritius in the 1970s and 1980s. However, this case is not intended as an endorsement of EPZs as a development strategy. This is a somewhat different question about which there is much debate. It appears to have worked in Mauritius, given some very specific conditions that may or may not hold in other countries. It is even possible that some other policy, of more general openness to trade that was not restricted to EPZ companies, could have worked better. For labor audiences in particular, it will be important to admit that some of the labor policies adopted in the early years of the EPZ were probably excessive and unnecessary and that labor unions played a significant role in publicizing these abuses and thereby reducing them.

Nor is this case intended to justify World Bank and International Monetary Fund (IMF) adjustment lending. The case does not go into the details of the various loans made or the extent to which their provisions may or may not have contributed to the turnaround in the economy. Mauritius did become the only African country to successfully conclude its structural adjustment program during the 1980s. Its second adjustment loan from the World Bank in 1983 was its last of that type, as was its sixth macro policy agreement with the IMF in 1985. In that year, Mauritius achieved a surplus on its external current account. For those who feel adjustment is a never-ending process, this case provides some hope.

However, it is not easy to say how much of this success was due to the advice of the Bretton Woods institutions, and this case is not intended to make that judgment. The Mauritian leadership understood the need for adjustment and played a major role in designing the program. In the process, several components proposed by the lenders were resisted by the government. Subsidies on rice and flour were reduced but not eliminated, parastatal reform was very slow, and no agreement was reached on rationalization of the overall tariff structure until 1987. The purpose of this case is to help participants understand one of the few success stories of sustained economic growth in Africa and to identify some of the more general lessons that emerge.

The problem with the topic of economic growth is that there are many factors that come into play and change over time. It is difficult to focus on a few key themes without oversimplifying. The challenge is still greater in teaching a case, where instructors can only lead the discussion indirectly and will have to deal with a wide range of observations and questions. One of the reasons for choosing Mauritius is that it is a relatively simple economy to begin with. While the case has been simplified in writing, there are nonetheless a lot of details about the Mauritian society and economic policies. It will be important to keep in mind the key points that are to be made and to get to them as quickly as possible.

Exports as Leading Sectors

While this case can hopefully be used for several different purposes, it was designed to get readers to think first of all about the sectoral sources of growth in an economy. A few leading sectors usually drive an economy at any one point in time and, in small economies, these are inevitably those with major export potential. It is important for policymakers to provide the necessary enabling environment for these key sectors to flourish, avoiding obstacles to their expansion, and perhaps providing some incentives.

Students and participants using this case should recognize that the Mauritian market is too small to generate much demand for goods and services by itself. It needs to exploit the possibilities offered by the vast global market with whatever resources it possesses. The advantage of using Mauritius as a case is that it should be relatively clear that there are only three significant options: sugar, tourism, and labor-intensive manufactured exports. Furthermore, the period covered by the case provides at least an initial testimony to the sizable benefits that can be derived from such integration into the world economy.

The next step is to elicit the fact that the sugar sector has done its job and can not be expected to contribute much more growth. There is room for improved efficiency within the sector, but not much more. This leaves manufactured exports and tourism as the most likely candidates to serve as the engines of growth in the 1980s. But what constrains their continued expansion?

Obstacles to Export Promotion and Foreign Investment

Conditions in the international market are certainly important, especially at the time this case takes place in 1982, when the world economy was still suffering from one of the longest recessions since World War II. The significance of such external shocks must not be underplayed, and it is worthwhile to acknowledge that they become more important as a country becomes more integrated. But the world economy always rebounds and, in any event, there is not much a small country can do about external shocks. Thus, it makes sense to focus on those factors which are under a government's control, namely, domestic economic policy.

The question then is what must the government do to get these two sectors moving again? The short answer is to promote further investment in factories and hotel capacity. To be more precise, more foreign investment will be the key. Domestic entrepreneurs and local capital from the sugar sector have played a major role, but they need the technical and marketing expertise of overseas partners, as well as their capital, to expand in these competitive industries.

In any event, both domestic and foreign investors will need at least two critical factors if they are to be attracted in greater numbers:

- *Sound macroeconomic management.* Investors need both a supportive and a stable policy environment. In the late 1970s, Mauritius had given some serious, negative signals about the soundness of its economic management. Inflation and the fiscal deficit were allowed to rise to dangerous levels. This does not bode well for the level of input costs (notably labor), interest rates (for domestic loans), and tax rates.
The change in government in 1982 toward an untried, "radical" alternative further exacerbated the situation by raising the specter of accelerated government spending, making it more difficult to predict the direction of future policy. Investors sometimes dislike uncertainty even more than poor policy. That such a government would continue the reform program of the previous administration sent a strong signal that Mauritius was a good place to invest.
- *Competitive prices.* Exporters (and to a lesser extent, hotel operators) depend in particular on two key prices to become or remain competitive: the price of foreign exchange and the price of labor. Inflationary pressures and rising balance-of-payments deficits make it more difficult to maintain an appropriate exchange rate, especially if regular devaluation is not considered politically feasible. Mauritius has avoided an overvalued exchange rate with two devaluations and the adoption of a new, flexible exchange rate policy, allowing a gradual depreciation over 1982–86.

But the bigger problem for the new government appears to be the need to preserve a realistic wage rate, for fiscal balance and job creation, as well as international competitiveness. This is particularly important for the EPZ. Increases in the wage level in the 1970s proved premature and came at the expense of greater unemployment, while contributing to the government deficit. By controlling wage increases from 1982 to 1986, Mauritius was able to eliminate unemployment and offer jobs to new female workers who traditionally had not participated in the formal labor force.

These points will pose some problems for a non-economist audience, although the last one on wages should be clear, if controversial, especially for labor unionists.

Other Factors

There were, of course, other factors that played a role in the success of the EPZ and tourism, and hence the adjustment process. Some of these get passing reference in the case as presented. These could be brought into the discussion, depending on the teacher and the interests of the participants:

- *Education.* The labor force in Mauritius was relatively well-educated. The primary enrollment rate was already 100 percent in 1965, when other lower middle-income countries were below 80 percent. Low-income countries (excluding India and China) still averaged only 74 percent in 1992. The successful export of some manufactured goods may not require a skilled labor force, but it does require one with some degree of education.
- *Domestic private sector.* Domestic entrepreneurs and private savings helped get the EPZ going. They also maintained the momentum by providing local partners and resources for foreign investors, who often are unwilling to shoulder all the risk themselves. About 60 percent of total investment has come from local sources. There were also highly qualified, local professionals, such as lawyers and accountants, who are necessary to facilitate the operation of a business. Finally, strong local involvement helped build domestic support for the EPZ strategy. These zones are often criticized as primarily benefiting foreigners.
- *International trade agreements.* Mauritius enjoyed duty-free access to the EEC for its EPZ exports as a result of the Lomé convention (and the preceding Yaoundé convention). This was an advantage that most of its East Asian competitors did not have and which other ACP (African, Caribbean, and Pacific) member countries were unable to exploit. Further, indirect benefits were drawn from the U.S. policy of applying quotas whenever imports from a given country exceeded 1 percent of total U.S. production. As a newcomer and a relatively small player, Mauritius seldom reached this 1 percent ceiling. Thus, investors in Hong Kong were attracted to Mauritius by its favorable conditions of access to both the EEC (European Economic Community) and U.S. markets, as well as its Chinese population and stable macroeconomic environment.

Mauritius also was protected from much of the decline in sugar prices after 1975 by its arrangement under the Lomé convention and its foresight in securing a large share of the total EEC quota for ACP countries (38 percent). During the key reform period, 1980–86, EEC sugar prices averaged 54 percent above the free market price. This helped generate significant domestic resources to be invested in the EPZ, and sustained the government tax revenues.

- *Initial imbalance:* The government moved to correct emerging distortions in the economy while they were still relatively modest. The economy was still growing at 5.8 percent annually in 1978–79, when the stabilization program began. The sharp contraction of the economy in 1980 was due to exceptional climatic circumstances, not economic mismanagement. The public sector was large but did not crowd out the private sector, while maintaining significant capacity to implement reforms and other programs. The exchange rate never became seriously overvalued, and external debt was not excessive. It is inevitably easier to adjust, and reignite growth, under such conditions.

- *Institutions.* Recently it has been recognized that a country's institutional capacity has an important effect on its ability to grow and to adjust to changing circumstances. Mauritius enjoyed a tradition of democracy, freedom of expression, and judiciary independence, which were challenged by the state of emergency but never destroyed. Corruption was not a major problem. While the civil service was not particularly strong, it did have significant capacity at the top to design and implement policy. Consequently, it was able to take charge of the adjustment process, rejecting advice not considered appropriate, but having ownership of the package once it was finalized.

Luck

Finally, there is the role of luck, which can be defined to include both changes in the external environment and local shocks over which the government has no influence, such as those resulting from the weather. It is important to separate the effect of luck from that of policy, and this case lends itself well to an exploration of this distinction. This theme may be particularly useful for an economist audience, given the complexities involved in sorting out the competing factors, but instructors should be prepared to deal with this issue with any group. It should be emphasized that the problems of Mauritius were not simply due to the cyclones of 1979–80 and that its turnaround was not merely thanks to the Hong Kong announcement of 1984.

The main piece of local bad luck was the cyclones. These came just as the stabilization program was getting started and thus made the adjustment process longer and more difficult. They also hit in 1975, which helps explain the low growth rate that year.

The timing of the 1982 elections could also be considered bad luck. The government's economic managers had to cope with the usual pressures to increase expenditures and/or reduce taxation prior to the election, while the change in leadership afterward meant a break in the continuity that has helped other countries get through difficult times. The election undoubtedly encouraged investors to take a wait-and-see attitude.

The more important source of good or bad luck for such a small and open economy is typically the international environment, and Mauritius is no exception. The long recession in industrial countries in 1980–83 was a further blow to the adjustment effort, reducing tourism demand and investor interest. Note, therefore, that Mauritius had its share of bad luck during the adjustment period, and yet it prevailed. The budget deficit was being reduced and the nominal exchange rate devalued before the good news arrived from Hong Kong. This was a period of bad luck, but good policy.

By contrast, the sugar price explosion of 1974–75 was a key factor contributing to the economic boom of the mid-1970s. But note that the economy was already growing at an impressive rate in 1972–73, due to the promotion of the EPZ and tourism, coupled with sound fiscal policy. Furthermore, the sugar boom was somewhat mitigated by the first oil shock, international recession, and cyclones in 1975. Fortunately, that recession was short-lived. This period was one of fairly good luck and good economic policy (without meaning to pass judgment on the state of emergency!).

The 1977–79 period represented a third combination. The developing problems were not really the fault of international events. The sugar price did fall, but the EEC deal was definitely a stroke of good luck, as it preserved prices well above the historic levels of 1968–72. Meanwhile the international economy was enjoying a healthy recovery from the 1975 recession. This was a period of worsening policy that was somewhat masked by good luck. As a result, GDP growth remained respectable at 6.6 percent annually, and the government hesitated to start the necessary reforms.

Finally, in 1984, good luck combined with good policy to pull Mauritius out of its slump. China and the UK announced their decision on Hong Kong, and Mauritius just happened to have a small community of Chinese entrepreneurs interested in clothing and textile exporting. But there were lots of other potential locations, too. Mauritius had brought its macroeconomic and wage policies under control just in time to take advantage of this opportunity. The situation continued to improve as the global economy finally recovered from the recession, accompanied by a fall in oil prices in 1985.

To summarize, it may be useful to construct the following two-by-two matrix characterizing the different periods of Mauritian economic performance between 1972 and 1988. Note how the GDP growth rate has varied in each time period.

The Different Roles of Policy and Luck

| | <i>Good luck</i> | <i>Bad luck</i> |
|-------------|---|---|
| Good policy | 1972– 74, 1976 GDP growth: 10.6 percent annually <ul style="list-style-type: none"> • sugar price increase • EPZ and tourism promotion | 1975, 1981– 83 GDP growth: 3.4 percent annually <ul style="list-style-type: none"> • cyclones (1975), global recessions, and oil price shocks • sound fiscal policy (1975) • stabilization and wage restraint (1980– 82) |
| | 1984– 88 GDP growth: 7.8 percent annually. <ul style="list-style-type: none"> • strong world economy and Hong Kong decision • sound fiscal policy and foreign investment incentives | |
| Bad policy | 1977– 79 GDP growth: 6.6 percent annually <ul style="list-style-type: none"> • strong world economy and good, stable sugar prices • rising fiscal deficits and large wage concessions | 1980 GDP growth: -9.3 percent <ul style="list-style-type: none"> • cyclones, oil price shocks, and global recession • legacy of bad policies continues |

Part II

The next stage of Mauritian growth is still being written, so the “right” answer is not yet available. However, Mauritian authorities have drawn up their vision of the future, which appears well-founded in general terms. It is based on greater efficiency in the traditional growth sources, complemented by the development of new manufactures, non-sugar agriculture, and regional financial and maritime services.

But how is this actually achieved? Where do the resources come from? One way is to release land and labor from activities where they are underutilized and reallocate them to more profitable ones. Another is to upgrade skills and technology. In the context of Mauritius, this could mean the following:

- *Reallocating land.* Some of the land under sugar would probably be more profitable if converted to the production of high-value agricultural exports, like flowers or exotic fruits. This has begun on a small scale. The returns from beaches and other tourism attributes would be maximized if the country adhered to the government's official policy of concentrating on upscale tourism.
- *Reallocating labor.* There is excess labor being employed in both the sugar sector and the public service that could be more effectively utilized, even in existing industries, such as the EPZ and tourism. However, the incentive structures (notably wages) need to be altered before labor will move.
- *Upgrading labor.* More investment must be made in labor. Secondary school enrollment was still only 54 percent in 1992, and tertiary enrollment a mere 2 percent (not including overseas education). The latter is far below corresponding figures in other countries at similar income levels. Within higher education, scientific and technological training is particularly underdeveloped.
- *Upgrading capital.* The EPZ has relied on fairly simple technology, and there has been little transfer of technology from the EPZ to other sectors. The low level of technical skills has hampered both the upgrading of the traditional EPZ industries and the introduction of new high-tech activities.
- *Increasing capital.* The economy will require large amounts of capital to finance the physical and human investments needed. While some of this can be borrowed externally, it will be important to match this with higher domestic savings, in order to avoid future debt problems. The gross national savings rate in 1991–93 was 27 percent, of which all but 2.5 percent came from the private sector. This performance is good and must be maintained, or even improved, notably with a greater effort from the public sector. The high-performing Asian economies have typically achieved savings levels over 30 percent in the 1980s.