

I. INTRODUCTION

1. **This collection of selected issues papers provides background information and analytical support for key policy issues discussed in the 2004 Article IV consultation discussions with Mauritius.** The Article IV consultation report identifies three immediate and medium-term challenges facing Mauritius, namely, the need to adapt the economy to the impending loss of trade preferences in sugar and textiles, the urgency of carrying out structural reforms to lessen labor market rigidities and the requirement to reduce fiscal deficits over the medium term to ensure fiscal sustainability and macroeconomic stability. Regarding the latter, the staff report for the consultation discussions contains a detailed appendix on the medium-term path toward public debt sustainability. The consultations also assessed the monetary policy framework in Mauritius and identified further structural reforms that should be pursued in order to strengthen the financial system.

2. **In the first of the four papers, the impact of the erosion of trade preferences on exports, growth, and employment is assessed under two scenarios—a moderate and an extreme scenario.** To quantify the adverse impact of trade liberalization, the paper estimates various elasticities of GDP growth to exports, and unemployment to growth. The analysis finds that in the worst case scenario, medium-term growth could be up to 50 percent below the staff's baseline projections of 4 percent annual growth.

3. **The paper on labor market institutions and low-skilled employment uses a simple stylized model of the job creation and destruction process to assess the potential benefits of labor market reform.** The conclusion is that even relatively minor wage compression and restrictions on the redeployment of workers can have a dramatic impact on the fragility of jobs and the extent of unemployment and labor-market churning.

4. **Mauritius has achieved success in its informal inflation targeting framework.** By combining a standard macro-finance model with an open economy model, an empirical assessment is made of the critical channels through which the central bank has been able to implement credible monetary policies. The empirical results indicate that the informal inflation targeting framework (by targeting inflationary expectations) has been able to provide a strong nominal anchor even in the context of a managed float exchange rate system.

5. **Finally, the last paper discusses the institutional requirements for developing a corporate bond market in Mauritius.** Credit concentration in the banking sector is a major concern in Mauritius. Development of an efficient bond market would not only provide alternative investment opportunities for institutional investors, but would also spread credit risk in the economy. Successful development of an active bond market will require a deepening of the market for government debt, a strengthening of the legal and credit risk infrastructure and a broadening of the investor and issuer base.

II. IMPACT OF THE EROSION OF TRADE PREFERENCES ON EXPORTS, GROWTH, AND EMPLOYMENT IN MAURITIUS¹

A. Introduction

6. **Mauritius faces significant challenges in the sugar and textile sectors in an increasingly competitive global environment.** Increased trade liberalization is expected to have a positive impact on international trade and growth in the long run, but could have adverse effects on Mauritius in the short run. In particular, Mauritius will have to cope with the decision of the WTO regarding the liberalization of the sugar sector and with the phasing out of the textile quotas with the expiration of the WTO Agreement on Textiles and Clothing (ATC) in January 2005. In addition, Mauritius does not qualify for the third country fabric under the U.S. African Growth and Opportunity Act (AGOA) II. These developments could lead to a temporary deterioration in Mauritius's current account balance.

7. **In the past three decades, Mauritius showed the ability to cope with challenges and registered impressive growth rates.** Growth rates of the economy averaged around 6 percent and the exports² to GDP ratio currently hovers around 40 percent, which puts Mauritius at the forefront of export-oriented economies. Three decades ago, Mauritius mainly relied on the sugar sector for its exports earnings. The economy subsequently diversified to include tourism and textile manufacturing in the export processing zone (EPZ). In light of the current challenges, the authorities now aim to develop the economy into a hub for the technology and financial services sectors.

8. **In the medium term, the baseline growth projection in the Article IV consultation report is 4 percent per annum.** This baseline scenario assumes a weak performance in both the sugar sector and the export processing zone (EPZ), reflecting increased global competition, a reduction in the area used for sugarcane production, and a gradual disinvestment of some foreign textile companies. These developments are expected to be balanced by the economy's partial adjustment to the changing international business environment through the restructuring of the economy and the development of other sources of growth, including the Information and Communications Technology (ICT) and financial services sectors.

9. **The rest of the paper is organized as follows:** Section B analyzes the relationship among exports, economic growth, and the labor market in Mauritius in order to derive elasticities that are used to estimate the effects of negative shocks in subsequent sections. Section C examines the current situation in the sugar sector and the likely impact of trade liberalization. Section D discusses the textile sector and the possible impact of the phasing out of textile quotas in international trade on growth and employment. The impact of combined shocks to the sugar and textile sectors are also considered. Section E provides concluding remarks.

¹ Prepared by Marwan Mikhael.

² Exports of goods.

B. Exports, Growth, and the Labor Market

10. **The literature has extensively examined the relationship between exports and economic growth.** Since exports are part of GDP, it is expected that GDP and exports will be positively correlated (Kravis, 1970). In addition, exports might stimulate output through a number of channels. McKinnon(1964) and Chenery and Strout (1966) point out that the foreign exchange earned from exports allows imports of intermediate and capital goods that increase production potential. Keesing (1967), Michaely (1977), Balassa (1978), Krueger (1980), and Tyler (1981) show that exports contribute to GDP by more than the export volume by pointing to the positive external benefits of exports, including greater capacity utilization, economies of scale, incentives for technological improvement, and more efficient management of the firm due to competitive pressures of foreign markets.

Impact of exports on growth

11. **In our analysis, we examine the impact of a change in nominal exports on real GDP and the labor market in Mauritius.** An external shock in one sector will not only have an impact on the output of this sector but it can also have a spillover effect on other sectors of the economy. In Mauritius, foreign exchange is the main source of wealth and the main driver of domestic consumption, given the high share of exports in total output.

12. **Our empirical analysis is based on a demand-oriented theory of growth, first emphasized by Kaldor (1970) and then explored by McCombie and Thirlwall (1994).** This paper will investigate the relationship between exports and growth, but unlike the above mentioned theories, it will not analyze the determinants of exports,³ and therefore exports are considered as a totally exogenous variable. In addition, this paper will include other demand variables such as consumption and investment in order to avoid an overestimation of the elasticity coefficient of exports.

13. Let us define:

$$X_t = X_{St} + X_{Tt} + X_{Ot} \quad (1)$$

Where: X_t is total exports of goods, X_{St} is exports of sugar, X_{Tt} is exports of textile, and X_{Ot} are other exports. From this equation we have $\partial X_t / \partial X_{St} = \partial X_t / \partial X_{Tt} = \partial X_t / \partial X_{Ot} = 1$ implying that the elasticity of total exports to any of the sectors is equal to the ratio of the exports in this sector to total exports.

14. In order to compute the impact of a variation of exports on GDP, we use a simple dynamic ordinary least squares (OLS) estimation method to regress the real growth rate of the economy at time t (Δy_t) on the real change in consumption at time t (Δc_t), investment at

³ In this case, it will not be necessary to introduce another equation to the model where exports are specified and could depend on world income and exchange rate.

time t-1 (Δi_{t-1}), and the nominal change in exports at time t (ΔX_t). Results of this exercise should be taken with caution, since the sample period is short, as it stretches over 25 years only (1978-2002) and the data is annual. The equation is the following:

$$\Delta y_t = \alpha \Delta c_t + \beta \Delta i_{t-1} + \gamma \Delta X_t + \xi_t \quad (2)$$

15. It appears from the results that investment does not have a significant impact on the growth rate. Although this result appears to be worrisome, it could be the consequence of a data collection problem. Therefore, we introduced the growth rate for the period t-1 to account for the investment and other factors. Thus the equation will become:

$$\Delta y_t = \alpha \Delta c_t + \gamma \Delta X_t + \delta \Delta y_{t-1} + \xi_t \quad (3)$$

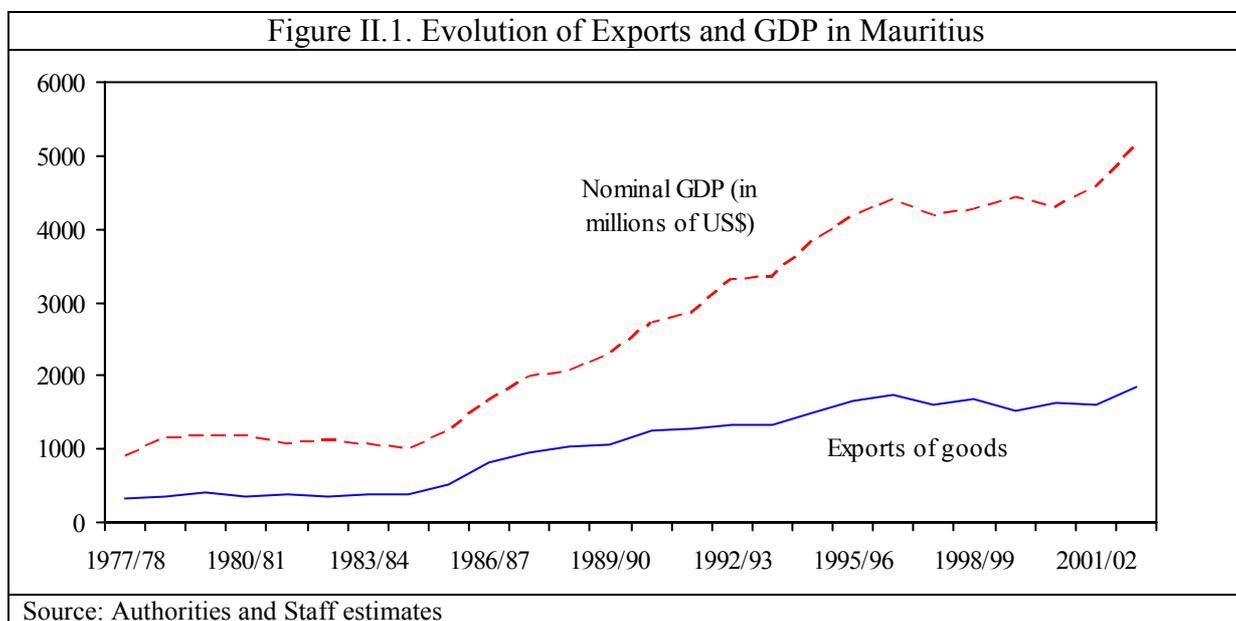
Parameter estimates are:

$$\Delta y_t = 0.47 \Delta c_t + 0.13 \Delta X_t + 0.27 \Delta y_{t-1} + \xi_t \quad (4)$$

$$\text{t-stat: } [3.84] \quad [3.26] \quad [2.60]$$

The Durbin-Watson test did not show any serial correlation problem.

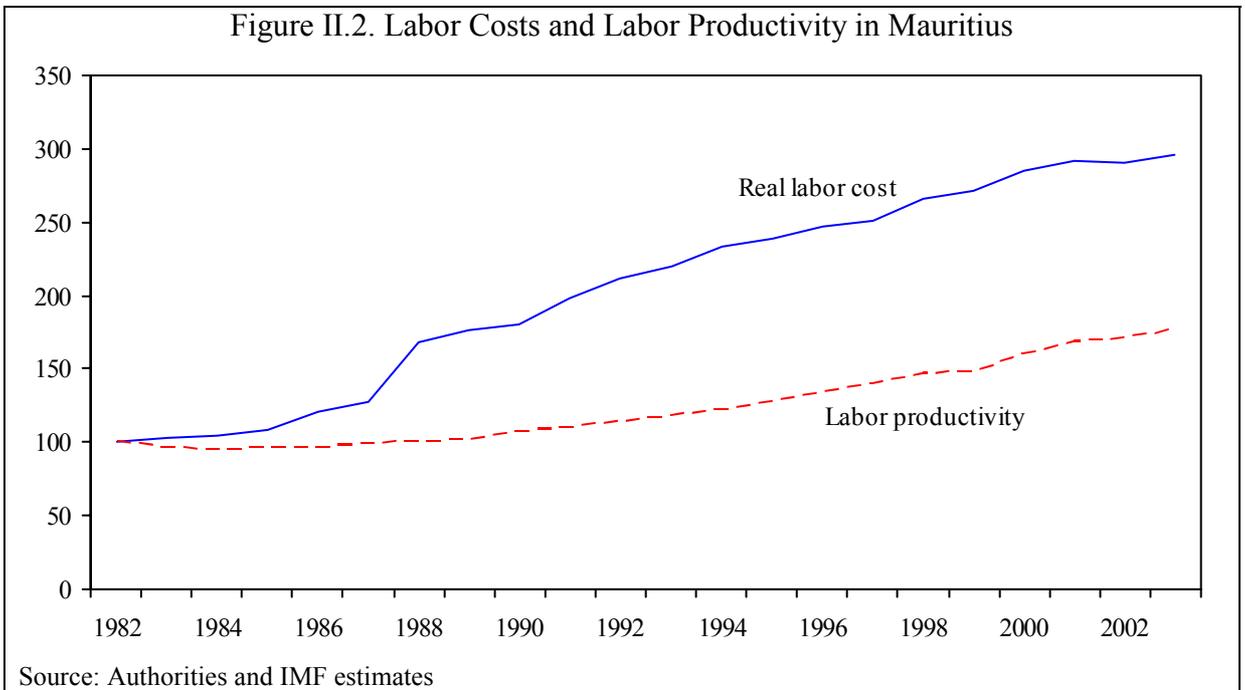
Figure II.1. Evolution of Exports and GDP in Mauritius



Relationship between growth and the labor market

16. **The impact of exports on job creation is more uncertain, given that the impact is not only on jobs in export industries, but also on industries that distribute the outputs or supply the inputs.** Increased exports are expected to increase production and jobs that are

characterized by higher levels of worker productivity. As a result, higher wages could arise when the labor market is competitive. Trade, however, should lead to the elimination of jobs in less competitive industries. In Mauritius, in both sugar and textile sectors, international trade is affected by several constraints and world markets are not competitive. Mauritius has benefited from a quota system and is protected from foreign competition by bilateral or multilateral trade agreements. As a result, Figure II.2 shows that real compensation did grow faster than labor productivity in Mauritius, which has led to an increase in unit labor costs over the past twenty years.



17. **The main objective of this subsection is to compute the contribution of the labor costs to the value added of the sugar sector, which will help us to estimate the impact on employment of sugar trade liberalization.** We assume a Cobb-Douglas production function of the Mauritian economy with constant returns to scale.⁴ Such a function links the quantity of labor, L , and capital, K , that are used for producing, each period t , the GDP Y .

$$Y_t = L^\alpha K^{(1-\alpha)} \tag{5}$$

Taking the logarithm of terms on both sides of the equation:

⁴ It is important to note that this representation of the economy does not contradict our previous demand-oriented representation for economic growth, since both representations are independent, and the Cobb Douglas function is only used to derive contribution of Labor to the value added of the sugar sector.

$$y_t = \alpha l_t + (1 - \alpha)k_t \quad (6)$$

Where:

$$y_t = \log Y_t, \quad l_t = \log L_t, \quad k_t = \log K_t$$

We divide the economy into three sectors: the sugar sector (S), the textile sector (T) and other sectors (O). Therefore we can rewrite equation (2) as:

$$y_t = y_{St} + y_{Tt} + y_{Ot} \quad (7)$$

$$y_t = \alpha' l_{St} + (1 - \alpha)' k_{St} + \alpha'' l_{Tt} + (1 - \alpha)'' k_{Tt} + \alpha''' l_{Ot} + (1 - \alpha)''' k_{Ot} \quad (8)$$

With the assumption of constant returns-to-scale, the elasticity of output with respect to a given factor is equal to the share of its revenue (net wages, in case of labor) in total income, when factor markets are competitive. In the sugar sector, we have:

$$Y_{St} = L_{St}^{\alpha'} K_{St}^{(1-\alpha')} \quad (9)$$

Having marginal product equal to marginal cost and assuming that w_{St} is the wage in real terms in the sugar sector and is $w_{St} = W_{St} / P_{St}$, where W_{St} is the nominal wage in the sugar sector and P_{St} is the price index in the sugar sector, it follows:

$$w_{St} = \partial Y_{St} / \partial L_{St} = \alpha' L_{St}^{\alpha'-1} K_{St}^{(1-\alpha')} = \alpha' Y_{St} / L_{St} \quad (10)$$

This implies:

$$\alpha' = L_{St} w_{St} / Y_{St} \quad (11)$$

Where the computation of the average of α' during the last four years gave us $\alpha' = 0.65$. The same reasoning could be applied to the textile sector and we will have:

$$\alpha'' = L_{Tt} w_{Tt} / Y_{Tt} \quad (12)$$

C. Sugar Sector

18. **Mauritius's sugar sector is governed by two important agreements with the European Union.** The two agreements are the African Caribbean and Pacific (ACP), European Union (EU) sugar protocol and the Agreement on Special Preferential Sugar (SPS). The fundamental principles enshrined in the sugar protocol are (i) agreed quantities of cane sugar, raw or white, (ii) guaranteed prices, and (iii) indefinite duration. The agreed quantities cannot be reduced without the individual consent of each concerned country. The guaranteed prices are in practice the same prices given to Community sugar producers. The ACP guaranteed prices are linked to the EU intervention price for the domestically produced raw sugar and the guaranteed price of white sugar to the derived intervention price in the U.K.

The sugar agreements

19. **The sugar protocol was annexed in 1975 to the Lomé Convention, which has regulated the trade and aid relations between the EU and its ex-colonies (together with other protocols on bananas, rubber, rice, beef, and rum) since then.** The protocol was revised and included in the new ACP/EU agreements that were signed in 2000 in Cotonou, Benin. The Cotonou Agreement provides for the continuation until 2007 of the Lomé arrangements for trade in goods. Between September 2002 and December 2007, the agreement calls for the negotiations of new trade arrangements to take effect no later than January 2008.

20. **The new trade arrangements envisaged in the Agreement are referred to as “economic partnership agreements” (EPAs).** There is also provision for a review of the negotiations in 2004, at which time the possibility will be explored of “alternative trade arrangements” for those ACP states that are not in a position to enter into EPAs with the EU. The Cotonou Agreement itself continues for 20 years, and its development assistance provisions will remain in force for the whole of this period. The trade provisions, however, expire in December 2007. There are thus no trade arrangements currently in place between the EU and the ACP states covering the period from January 2008 onward.

21. **The SPS agreement was introduced in order to meet the needs of EU sugar refiners after the accession of Spain and Portugal to the EU.** It was signed between the EU and the ACP countries in June 1995 for a period of six years, and it was renewed in 2001 for another five years. Unlike the ACP/EU sugar protocol, it is of a fixed duration and the ACP states are jointly and separately liable to supply the quantities of sugar covered by the SPS agreement. The conditions of the SPS agreement include a minimum delivered price to be paid by EU refiners, equivalent to approximately 85 percent of the ACP guaranteed price for raw sugar. Under the SPS, the European Community undertakes to open a special tariff quota for the import of raw cane sugar for refining originating in ACP states, on the basis of the needs determined by the Commission concerning the SPS. Although the agreement was renewed for the period 2001-06, the expected progressive reductions of the SPS quantities as a result of the Everything But Arms (EBA) initiative is a matter of concern for the ACP sugar exporting countries.

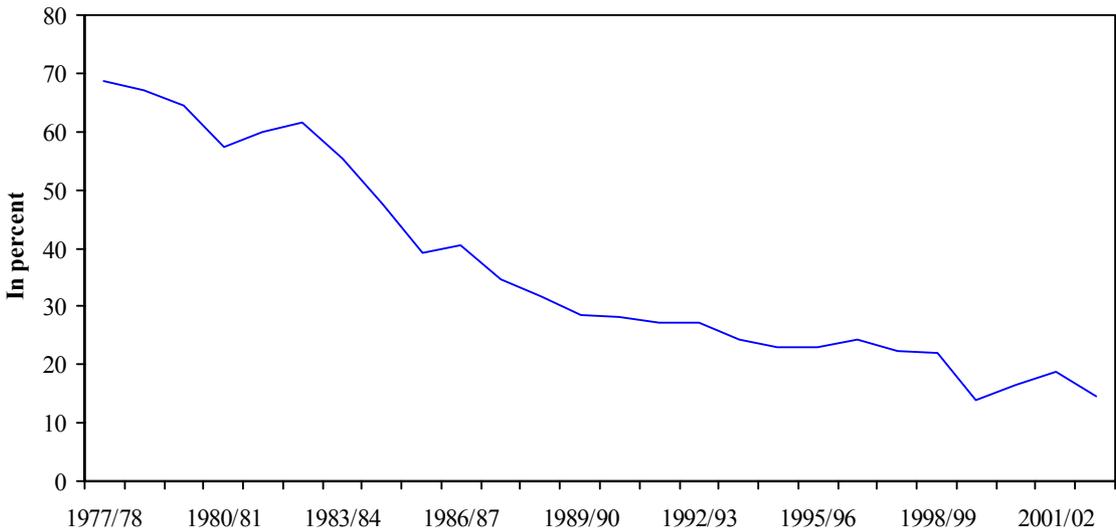
22. **The EBA regulation grants duty-free and quota-free access to imports of all products from the least developed countries, with the exception of arms and munitions.** It was adopted by the EU in February 2001 and covers 49 least-developed countries. The EBA foresees that the special arrangements for LDCs should be maintained for an unlimited period of time and not be subject to the periodic renewal of the Community's scheme of generalized preferences.

The world sugar market

23. **In general, the competitive world market for sugar is of marginal importance.** Only around 30 percent of world sugar production is exported and in almost every country the domestic sugar market is protected. Additionally, around one third of world sugar exports

are based on preference agreements or long-term contracts. Consequently, only around 20 percent of world sugar production is traded under free market conditions.

Figure II.3. Ratio of Sugar Exports to Total Exports of Goods



Sources: The Mauritian authorities and taffs estimates.

24. **World demand for sugar is assumed to be inelastic to price changes.** However, it generally depends on the economic situation in the importing countries. We can divide the world market into the liberalized market (D_1, S_1, P_1, Q_1) and the preferential market (D_2, S_2, P_2, Q_2), where D is the demand for sugar, S the supply of sugar, P the price, and Q the quantity. In both markets, the demand for sugar is relatively inelastic to price changes. Thus, we have:

$$Q_{D_t} = \alpha Y_t + \beta \quad (13)$$

$$\begin{aligned} Q_{D_1} &= A = cte \\ Q_{D_2} &= B = cte \end{aligned} \quad (14)$$

Q_{D_1} is equal to 20 percent of the total world demand Q_D , and Q_{D_2} constitute the remaining 80 percent.

On the supply side, the quantities supplied on both the liberalized and the preferential markets depend on weather conditions (WT). Nevertheless, prices in the liberalized market depend on the quantities supplied. Therefore,

$$P_1 = \alpha' Q_{S_1} + \beta' \quad (15)$$

Since preferential prices are related to quotas and they are not related to the quantities supplied, it is safe to assume a fixed preferential price.

$$P_2 = C = cte \quad (16)$$

$$Q_{S1} = \delta + \gamma WT \quad (17)$$

$$Q_{S2} = \delta' + \gamma' WT \quad (18)$$

We can rewrite P_1 :
$$P_1 = \alpha' \delta + \alpha' \gamma WT + \beta' \quad (19)$$

25. The liberalization of the sugar market is expected to have adverse effects on high cost countries, and it will alter demand and supply functions, thus impacting prices.

Total world demand D will be the sum of the demands on the liberalized market D_1 and the preferential market D_2 . Total supply is projected to decrease, since prices on the previous preferential market are expected to collapse, and several sugar producers will find themselves unable to compete due to their high production costs.

26. As a result, the equilibrium price level after liberalization is expected to be slightly higher than the actual equilibrium price in the liberalized market and much lower than the actual price in the preferential market. In a liberalized sugar market, several producers in industrialized countries will shift from producing sugarcane or beet to the production of other sweeteners such as the HFCS⁵ because of its lower production costs. It is also expected that the total supply slope will be steeper than in the actual liberalized market since producers will become more sensitive to any change in price as it will have an impact on their profitability.

Liberalization impact

27. We consider two scenarios for the sugar sector. The first one is a gradual decrease in sugar prices in the coming years. The Mauritian economy will therefore have some time to adapt to the declining prices. The second scenario is a more extreme case and assumes a full liberalization of sugar prices beginning 2005.

28. In the moderate scenario, we assume that prices will be reduced in 2005 to the average world price of US\$0.16/lb. The price will then decrease to US\$0.13/lb in 2006, and US\$0.10-0.12/lb in 2007, and US\$0.10/lb in 2008. Recall from section B that the elasticity of GDP to exports is 0.13, and the elasticity of total exports to sugar exports is of 0.14. For the fiscal year 2004/05 (July-June), some caution is warranted, since it will depend on when the sugar crop is sold. If the prices are set to decrease starting 2005 and the stock of sugar is sold before the end of 2004, then the impact of the price decrease on fiscal year 2004/05 will be

⁵ HFCS is a synthetically sugar obtained from fructose which is a very sweet sugar derived from dextrose. Dextrose is a sugar derived synthetically from starch and most commonly from corn.

amortized, but if the bulk of the crop is sold in 2005, then there will be a full impact of the price decrease on exports and thus on GDP growth.

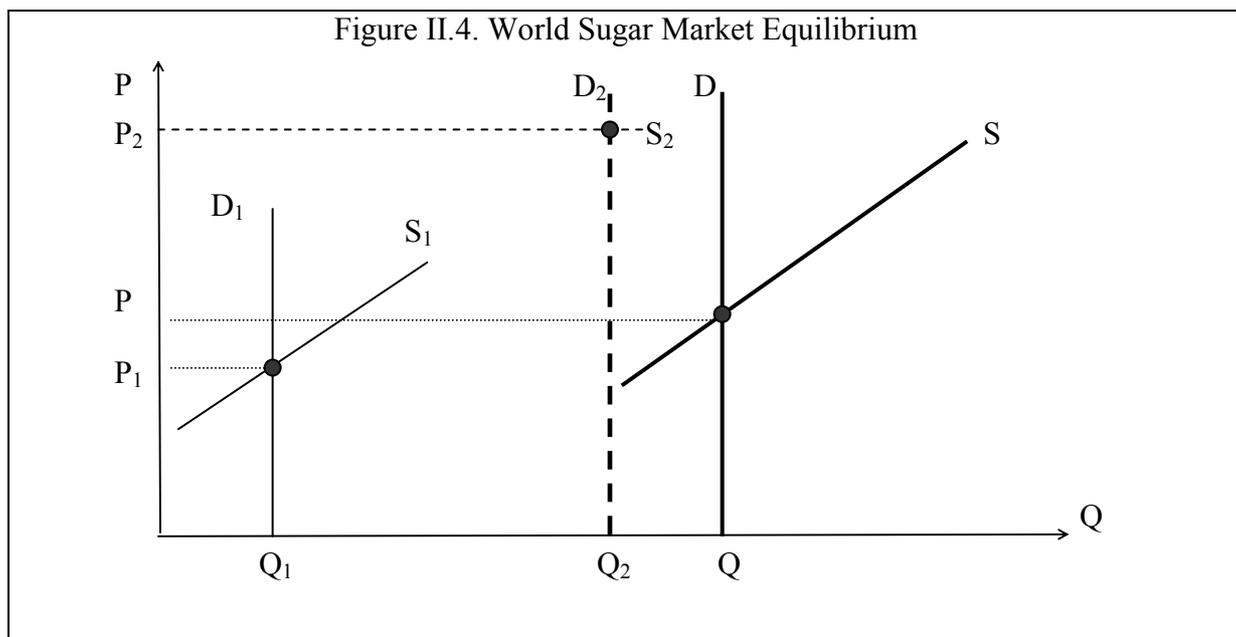


Table II.1. Growth Impact of Sugar Price Decline

	2004/05	2005/06	2006/07
Price decline	30 percent	19 percent	15 percent
Decline of total exports	2-4 percent	3 percent	2 percent
Deviation of GDP growth from baseline	0.2-0.5 percentage point	0.4 percentage point	0.3 percentage point

29. **For Mauritius’s sugar sector to compete on the world market, the strategy to reduce costs should be implemented without delay.** This will necessitate reducing the costs from US\$0.14 per pound in 2005 to US\$0.10 per pound in 2008. Costs reduction from US\$0.18 per pound in 2001 to US\$0.14 per pound in 2005 is expected to result in job losses of 7,900 jobs in the sugar sector, bringing the total working force to around 21,000 workers. Recalling equation (7) from section B, we computed $\alpha' = 0.65$. As a result, the reduction of the costs to US\$0.10 per pound by 2008, all other things being constant, will necessitate a decrease in the sugar sector labor force by up to an additional 2,800 workers.

30. **In the extreme scenario, the shocks would have a much stronger impact on the different sectors of the economy.** One assumption—although with low probability—would

be for the WTO panel to decide on the complete liberalization of the sugar trade in 2005. This would most likely cause world sugar prices to drop to around US\$0.10-0.12 per pound⁶ for raw sugar from the actual preferential prices between US\$0.20-0.24, and compared to an actual international price level of between US\$0.06 and 0.07 per pound. Only a few countries—Brazil, Australia, Thailand, and to some extent, South Africa—would be able to sell sugar at the current world prices.

31. **The equilibrium price level will depend on the reactions of industrial countries to trade liberalization.** If no direct subsidies are allocated to farmers in industrial countries, producers will likely abandon sugar cane or beet production and will move to other sweeteners such as the HFSC mentioned earlier.

32. **Under this scenario, the cost of sugar production in Mauritius would be some 40 percent higher than the world price and could lead to losses in the sector of around US\$60 million in 2005/06 for a total production of 600,000 tons.** These losses would continue until production costs are reduced to around US\$0.10 per pound in 2007/08, as called for under the sugar sector strategy.

D. Textile Sector

Textile agreements

33. **The Multi-Fiber Agreement (MFA) has had a marked impact on the global textile industry since its coming into force in 1974.** The MFA governed world trade in textiles and garments and provided the basis on which industrialized countries have been able to restrict imports from developing countries. Quotas have been negotiated on a country-by-country basis and have been established at different levels. This has affected the ability of industries to expand. For example, strict quotas generally operated on imports from Korea and Hong Kong, while the EU imposed no restrictions on textile and clothing imports from a group of least-developed countries (EBA initiative).

34. **In 1994, the ATC was introduced with the objective to phase out the MFA restrictions over a period of 10 years.** It outlines a program for the integration of all products into WTO rules by 2005, and applies to all WTO members, whether or not they were signatories of the MFA. The MFA and ATC cover trade in cotton, wool, and man-made fiber products. Existing quotas would be removed by progressively increasing permitted levels, although it has been heavily back-loaded to January 2005.

⁶ This assumption should be taken with caution since the reaction of the supply, in case of liberalization, is very uncertain due to the fact that a large proportion of world sugar producers have higher production costs, and a large portion of world sugar supply is subsidized.

35. **The ATC allows importing countries to integrate products that were not restricted in the first place, which is the reason why the integration has not made a big impact on international trade in textile and clothing.** The removal of quotas for the most sensitive products (e.g., T-shirts, men's shirts, ladies' blouses, and jeans) will take place only at end-2004. Therefore, none of Mauritius's main production lines have so far been affected by the phasing out of quotas under the ATC.

36. **In addition, by not stipulating proportions of the product types to be integrated, the ATC allows importers to liberalize largely in the lower value sectors,** thus maintaining discrimination against value-added imports and protecting their own value-added clothing industries. For example, in the first tranche of liberalization, 70 percent of the products integrated were yarns and fabrics.

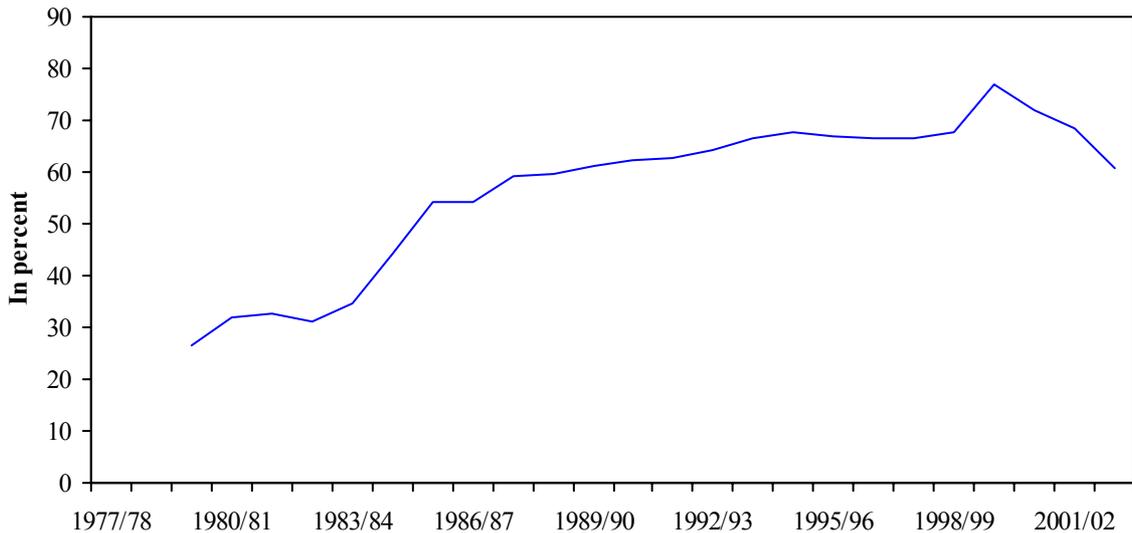
37. **Some countries will gain from the phasing out of textile quotas under the ATC while others will lose.** The expectation is that there will be an increase in the relocation of the garment industry from industrialized to developing countries. Moreover, the major relocations could be from one relatively poor country to another. The MFA did have the effect of guaranteeing developing countries with high production costs access to northern markets costs. Without the MFA there will be a more open market and the overall result is likely to be a concentration of the industry in a smaller number of low-cost locations. Marginal suppliers are likely to be squeezed out. Mauritius is an example of a country that it is likely to be among the losers, since its textile industry has higher unit labor costs than other countries such as China, Madagascar, and other Asian and African countries.

38. **Mauritius is also benefiting from the African Growth and Opportunity Act (AGOA) that was promulgated in the United States in May 2000 for a period of eight years.** AGOA significantly liberalizes access to the U.S. market for 37 Sub-Saharan African Countries (out of a total of 48). However, recent amendments to AGOA (AGOA II) have resulted in the elimination of Mauritius from the list of Lesser-Developed Countries, and therefore Mauritius was unable to use non-qualifying third-country textile inputs in the manufacture of AGOA-eligible apparel exports. As a result, only 40 percent of Mauritius's exports in the "textiles and apparel" category qualify for AGOA benefits.

Current situation of the textile industry in Mauritius

39. Output of the Mauritian textile industry, which constitutes about 80 percent of the EPZ, has been declining in the last few years. The knitwear sub-sector has been adversely affected by the delayed resolution of whether garments that are "knitted to shape" qualify for preferential access under AGOA. Many of the Hong Kong based textile firms—which account for around 25 percent of textile employment (around 15,000 workers) and 30 percent of exports—are likely to leave in the next two to three years.

Figure II.5. Ratio of EPZ Exports to Total Exports of Goods



Sources: The Mauritian authorities and staff estimates.

40. **The authorities have been supporting the restructuring of EPZ textile firms in order to avoid a possible collapse of the sector.** These efforts have resulted in the establishment of the Textile Emergency Support Team (TEST) initiative in July 2003. The TEST has commissioned the National Productivity and Competitiveness Council (NPCC) to carry out a diagnostic study of textile firms to assess their cost structure and point to areas for improvement. The government will provide funding for consultants to assist potentially viable firms to rehabilitate their operations. In addition, a corporate debt restructuring committee (CDRC)—chaired by the Managing Director of the Bank of Mauritius—has also been established to facilitate (in coordination with creditors) the restructuring of the debts of potentially viable firms.

41. **The NPCC performed the level one assessment on 42 firms and found that 16 of them are healthy, 6 promising, 11 vulnerable, and 9 at risk of closing.** In 2002, the healthy and at-risk firms each accounted for more than a third of textile employment, the vulnerable firms for 24 percent, while the promising companies for only around 3 percent. More troublingly, the at-risk firms are, on average, much larger than any of the other types of firms, being on average 80 percent larger than the healthy firms, the next largest.

42. **Another important development that could adversely affect the textile industry is the enforcement of the Ralph Lauren trademark following negotiations with manufacturers of the brand.** In 1992, the Mauritian Government granted a Ralph Lauren trademark to a local firm. This trademark was not renewed after it expired in 2000, which led a number of local firms (in the absence of a legal holder of the trademark), to start producing Ralph Lauren products. It is estimated that the firms employ around 7,000 workers. In the first quarter of 2004, Ralph Lauren enforced its trademark rights and reached a settlement agreement, whereby the concerned firms are required to dispose of their remaining stocks by

end-December 2004. A monitoring committee, headed by the Managing Director of the Bank of Mauritius, has been established to verify stocks on a monthly basis.

Empirical analysis

43. **The phasing out of textile quotas under the ATC could lead to the textile sector shrinking by 8 percent in 2004/05, 15 percent in 2005/06, 8 percent in 2006/07, and stabilizing thereafter (the moderate scenario).** These assumptions are based on the TEST initiative, which identified that the firms at risk of closing down employ around 8,700 workers and the vulnerable firms employ 5,700 workers. Given that the number of firms that chose to go through the TEST initiative is 42, and the total number of textile firms is above 280, it can be assumed that other companies at risk have not yet approached the TEST initiative. In addition, foreign firms employ more than 15,000 workers. Assuming that firms from Hong Kong will relocate and other domestic firms will also close down or relocate to Madagascar, especially in the “pull-over” sub-sector, this could represent up to 20,000 job losses in the textile sector in the coming two to three fiscal years. While textile quotas will be phased out by end 2004, it is expected that a large part of the closures will take place in 2005/06, since companies can still process orders by end 2004.

44. **Rising labor costs is a major reason for the decline in competitiveness of the textile sector.** In the EPZ sector, average compensation grew by nearly twice as fast as labor productivity—10.9 percent compared to 5.7 percent⁷.

45. **Given that textile exports constitute around 48 percent of total exports, the impact of a moderately severe textile shock on GDP growth is summarized in the following table.**

Table II.2. Growth Impact of Moderate Textile Shock

	2004/05	2005/06	2006/07
Decrease in textile exports	8 percent	15 percent	8 percent
Decline of total exports	3.8 percent	7.2 percent	3.8 percent
Impact on GDP growth	0.5 percentage point	0.94 percentage point	0.5 percentage point

46. **The phasing out of textile quotas could have a more severe impact—although with lower probability—on economic growth in Mauritius.** An extremely severe scenario could involve the closure of all textile firms categorized as either vulnerable or at risk under the TEST initiative, in addition to the relocation of foreign and some local companies to

⁷ See the chapter on the labor market in Mauritius.

other countries with lower costs. The total impact would be a decline in the textile sector of more than 20 percent in 2004/05, 30 percent in 2005/06, and 10 percent in 2006/07. The impact on total exports and economic growth is illustrated in the table below.

Table II.3. Growth Impact of Severe Textile Shock

	2004/05	2005/06	2006/07
Decrease in textile exports	20 percent	30 percent	10 percent
Decline of total exports	9.5 percent	14.4 percent	4.8 percent
Impact on GDP growth	1.24 percentage point	2 percentage point	0.6 percentage point

Impact of a combination of shocks

47. **The big challenge facing the Mauritian economy is the simultaneous occurrence of negative shocks in the sugar and the textile sectors.** When aggregated, these sectors constitute more than 60 percent of the total exports of goods. Therefore, the impact on economic growth from the combination of both shocks could be substantial. The largest impact would be felt in 2005/06. A combination of extreme shocks in both sectors could reduce economic growth by more than 2 percentage points. The estimates are summarized below.

Table II.4. Growth Impact of Combined Sugar and Textile Shocks

Impact on GDP growth (in percentage points)		Sugar Sector Shocks					
		Moderate shock			Extreme shock		
		2004/05	2005/06	2006/07	2004/05	2005/06	2006/07
Textile Sector Shocks	Moderate shock	0.6-1	1.34	0.5-0.8	1.1-1.4	1.1-1.45	0.5
	Extreme shock	1.75	2.4	0.9	1.85-2.15	2.2-2.5	0.65

E. Concluding Remarks

48. **Mauritius's medium-term economic prospects are clouded by the impending loss of trade preferences.** Baseline economic growth is expected to register an average of 4 percent per annum, a 2 percentage points decline from the historical average. This growth rate could decrease to less than 2 percent, leading to substantial increase in the unemployment rate, depending on the severity of the impact of a liberalization of international trade in sugar and textiles.

49. **In anticipation of the coming shocks, the government has already started implementing reforms to adapt the economy to the new challenges.** The authorities

embarked on a restructuring plan for the sugar as well as for the textile sectors. They are also trying to diversify the economy through the promotion of the information and communication technologies (ICT) sector, financial services, and tourism. While ICT could present a potential source for development, it may take longer than expected in order for the new sector to have its full impact on the economy.

50. **However, a critical factor that constrains the restructuring and the diversification efforts is labor market rigidity.** Reforms in this area are discussed in a subsequent chapter, which focuses on the need to reform the centralized wage bargaining system and the current restrictions on the redeployment of labor. Reforms to the educational system and the need to address the skills mismatch in the economy were discussed in McDonald and Yao (2003).

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