Occasional paper **No: 73**

MCB Focus

Post-Budget Outlook

June 2018

MCB GROUP

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RECENT DEVELOPMENTS

The international landscape

Health checks that have been issued in recent times further corroborate the view that world economy has performed encouragingly well lately and would grow at a generally improved pace over the short term at least. This outlook is being underpinned by multiple factors. They include the adoption of accommodative monetary policy, the provision of fiscal stimulus, improving labour market conditions and a relative recovery in international commodity prices. In this context, investment and trade would stand in favourable territories across countries. In the June edition of its Global Economic Prospects, the World Bank asserted that, *"The global economy seems to be leaving the legacy of the global financial crisis behind. All the consensus forecasts for 2018 and 2019 reflect optimism."* Such views are broadly in line with projections formulated by the IMF in its World Economic Outlook of April last. The Fund predicted that, after expanding by an estimated 3.8% in 2017, the world economy would grow by 3.9% for both 2018 and 2019. Worth highlighting, this figure, which represents an upward revision of 20 basis points in each case, would be the fastest pace of global GDP growth since 2011.

As regard our main export markets, mixed fortunes can be observed. In spite of a lower-than-previously-envisaged expansion in the first quarter of the year on the back of harsh weather conditions as well as downward revisions to inventory investment and consumer spending, real GDP growth in the US is anticipated to gain steam in the short term. In particular, activity levels would be boosted by the wide-ranging fiscal stimulus measures passed in the Tax Cuts and Jobs Act of 2017 and Bipartisan Budget Act of 2018. Citing solid economic expansion and job gains, the US Federal Reserve has, at its latest meeting on June 13, voted to raise its benchmark interest rate by 25 basis points, for the seventh time since 2015. This widely-anticipated decision lifted the target range for the federal funds rate to 1 ¾ % to 2%, which is the highest level since 2008. Concerning the euro area, compared with the corresponding period of 2017, real GDP rose by 2.5% in the first quarter of the year, which is slightly down when compared to readings of recent quarters. This performance was attributable to an unusual cold spell affecting construction activity as well as periods of instability in peripheral countries, while strikes in Germany and the political turmoil in Italy also weighed in the balance. Moving forward, while remaining resilient, notably supported by accommodative monetary policy, the expansion of the euro area is expected to be quite moderate in 2018 and 2019. The IMF's Managing Director recently indicated that the institution is likely to marginally lower its near-term economic growth forecasts for the 19-member region in the forthcoming July update of its World Economic Outlook. For its part, in spite of stronger exports growth, the United Kingdom expanded by a mere 0.1% during the first three months of 2018 relative to the first quarter of 2017, its weakest result since 2012. This prompted the Bank of England to put on hold a much-anticipated rate hike at its last MPC meeting, despite inflation being above target. Real GDP growth is projected to remain modest over the near term, with the March 2018 agreement on the transition period only partially dissipating uncertainties about the final outcome of Brexit negotiations. As regard emerging market and developing market economies, prospects appear generally solid, even though there are divergences across the major constituent countries. Growth in China would edge down gradually in the near term, partly due to policy tightening, while economic activity is forecast to gain further steam in India in the periods ahead. As for sub-Saharan Africa, growth is, on average, projected to accelerate in 2018 and 2019, aided mainly by stronger global growth, firming up commodity prices and improved market access. Upon excluding the region's two powerhouses, namely South Africa and Nigeria, from the computations, growth rates for the sub-Saharan African region are expected to stand at 4.8% and 5.4% for 2018 and 2019 respectively as per the IMF. Overall, while non-negligible challenges subsist at various levels, the region is deemed to be engaged into a generally favourable socio-economic transformation process, with the near-term growth outlooks for several countries being quite appreciable.

Overall, while the outlook appears favourable on balance, the near-term global growth projections would still lag behind previous expansion phases. As highlighted by the World Bank, notwithstanding the ongoing upturn internationally, only 45% of countries worldwide are expected to experience a further acceleration of growth in 2018, down from 56% in 2017. Besides, the global growth outlook is exposed to some notable downside risks, including the possibility of worsened financial market stress, escalating trade protectionism and heightened geopolitical tensions. As per the Washington-based institution, countries with elevated corporate debt, wide current account and fiscal deficits and/or weak growth prospects could be particularly vulnerable to any potential jumps in global financing costs. Over the medium term, world growth is likely to edge down on the back of the moderation of trade and investment patterns as well as a tightening of financing conditions. Markedly, economic growth in the group of advanced economies is anticipated to slide towards subdued potential levels as the process of monetary policy normalisation gradually gathers steam and the support emanating from the US fiscal stimulus wanes, while long-standing challenges include low labour force participation rates and weak productivity growth patterns. Besides, as the international trade landscape and global financing conditions become less supportive and commodity prices stabilise as per current expectations, growth in emerging market and developing economies is forecast to plateau over the medium term. Also, downside risks to the global outlook subsist. Threats that could impact the baseline growth scenario include the likelihood of: (i) further escalation of protectionist trade policies and counter-restrictions disrupting vital global value chains and undermining business confidence; (ii) more-pronounced hikes in international commodity prices adding to inflationary pressures and aggravating external imbalances in various countries; (iii) renewed financial market disruptions driven by any sudden tightening of monetary policy in the US, with ripple effects on debt service costs in emerging markets; and (iv) non-economic factors such as geopolitical tensions, political discord, weak governance, extreme weather events, as well as terrorism and security concerns.

On another note, a generally marked and sustained increase in crude oil prices has been witnessed in recent months. Whereas a rise in US oil production was noted, the evolution in oil prices was triggered by a confluence of factors, including robust demand, the agreement between most OPEC members and some non-OPEC oil producers to extend output cuts and the exacerbation of geopolitical concerns in the wake of the US

Government's decision to reinstate sanctions on the Islamic Republic of Iran. It is worthwhile to note that, as from February, Brent oil prices have risen by around 17% to attain USD 80 per barrel at around mid-May, which is the highest level since 2014. While they have somewhat receded in recent weeks, oil prices have remained relatively elevated, standing at around USD 75 as at mid-June. As per the World Bank, oil prices are likely to average USD 70 per barrel in 2018, i.e. nearly 33% up from the corresponding level of 2017, before averaging around USD 69 per barrel in 2019. On currency markets, a key observation relates to the notable strengthening of the US dollar, particularly against the euro in recent months. This was notably due to macroeconomic releases, especially those pertaining to inflation and the labour market. Additionally, the strengthening of the greenback was triggered by rising bond yields, increased bouts of risk aversion which prompted flows to liquid and safe havens, and the firming up of interest rate expectations.

The domestic scene

Main thrusts of the National Budget

On the local front, the major highlight relates to the unveiling by the Government of its National Budget 2018-19, on June 14, which was themed 'Pursuing our transformative journey'. The Government is attempting to put the Mauritian economy on a higher growth path, with a view to lifting the standard of living of the population and graduating Mauritius to an inclusive and high-income country. Policies have been earmarked to boost the employability of the younger generation and enhance the participation of women in the labour force. Also, the authorities intend to boost economic activities and the country's competitiveness by promoting use of digital practices and innovative technologies. Moreover, fiscal incentives have been announced to stimulate both import-substitution activities and export-led production. Importantly, the Government reaffirmed its ambition to boost growth by pursuing massive investments in strategic infrastructure-upgrading ventures. Illustratively, total public sector investment is, as per the authorities, projected to stand at Rs 153 billion over the next five years. Project are also being contemplated by means of Public-Private Partnerships, notably those relating to energy and urban terminals. Overall, if implemented in a timely, comprehensive and efficient manner, envisioned outlays would help to boost the country's competitiveness levels and development aspirations.

It can further be observed that the Budget is, as formulated by the authorities, cast within the context of a Three-Year Strategic Plan 2018/19 – 2020/21, which is itself articulated on the basis of the longer term Vision 2030 of the Government. Broadly speaking, while project design and implementation aspects would need to be monitored in due course, it is comforting to take note of the conceptualisation of an underlying framework, which contains strategic directions and relevant enablers that aim to assist the authorities in realising their objectives across multiple economic areas, backed mainly by the tracking and evaluation of progress made over time. The report also makes allowance for a Three-Year Strategic Public Investment Plan which sets out to track the performance of capital projects in terms of their expected completion timelines. As per the plan, projects will be closely monitored to identify and address constraints and bottlenecks.

Key areas warranting attention

That said, the budgetary pronouncements call for relevant assessments. To start with, the authorities now face up to the formidable challenge of realising contemplated moves in a comprehensive manner, while proceeding in an efficient and effective way to optimise socio-economic gains therefrom. Furthermore, it appears essential that we guard ourselves against the potentially distortionary outcomes of some policy measures and preserve the optimal allocation of resources. Another focus area relates to the speed at which envisioned measures are executed, particularly given project implementation lags observed in previous years. Importantly also, a more extensive range of action points is called for to address key macroeconomic challenges facing Mauritius. In the end, while ensuring that the execution of socio-economic measures is undertaken in a smooth and sustained way, it is crucial to foster credible fiscal and public debt management in order to support long-term growth.

Guarding against the potentially distortionary outcomes of some policy measures

While multiple amendments to the tax regime had already been brought about last year, the latest Budget has introduced further differential treatments on the income tax front. Key changes announced as regard the tax system include *inter alia* the provision for: (i) a wide range of differential rates in the corporate tax system, with exemptions, credits and incentives being applied to a broader range of sectors and activities; (ii) differential rates with respect to personal income tax, with multiple exemptions and reliefs; (iii) income tax holidays to a wider array of sectors (e.g. infrastructure in Special Economic Zones in Africa, projects under the Sheltered Farming Scheme as well as smart parking solutions and other green initiatives), in addition to exemptions already applicable, notably to investment banks issued with an 'Investment Banking and Corporate Advisory Licence'; (iv) a reduced corporate tax rate of 3% to companies involved in global trading activities, with this rate already applicable to profit derived by any company from exports of goods; (v) a progressive tax regime for banks, with two-tier rates applicable in respect of chargeable income (with no distinction made with regard to locally and foreign-sourced income) and with any amount of chargeable income in excess of an individual threshold for a set base year to be taxed at the same rate as the lower band if pre-defined conditions are satisfied – such developments to be coupled with the application of the special levy under the Value Added Tax Act, with differentiated imposition on the net operating income derived from domestic operations; (vi) the review of the taxation of global business companies and differentiated treatments as regard foreign-sourced dividends, interests and royalties between the banking and non-banking segments; and (vii) exemptions and differentiated treatments for Value Added Tax as well as customs and excise duties. Overall, in addition to helping to foster social gains, these fiscal developments aim to help sectors cope with the challenging operating context, while attempting to provide them with breathing space to gear up their operations and enabling them to boost their competitiveness. In addition, it is understood that Mauritius is committed to adhere to prevailing international codes and practices, notably in view of demands addressed by the European Union and the OECD with respect to our tax regime.

As the situation stands however, Mauritius is departing ever more from a simple and integrated approach to taxation to a relatively complex and segmented regime targeted to boost specific economic sectors. As such, the medium and long-term efficiency and competitiveness impact of these fiscal changes warrant scrutiny. To start with and as per economic theory, targeted fiscal incentives normally end up providing only short-term and temporary economic stimulus, alongside potentially delaying the adoption of the fundamental economic policies and reforms that are deemed as necessary to judiciously and conspicuously deal with macroeconomic strains and challenges confronting any country. Furthermore, as highlighted by IMF in its Country Report on Mauritius in the context of its Article IV Consultation, dated December 2017: "*The generous use of tax incentives risks eroding the tax base. It is unclear whether foreign investors of substance in their investment and location decisions rank tax incentives higher than other factors (such as macroeconomic and political stability, transparent legal and regulatory frameworks, etc.). Moreover, the revenue costs of tax incentives can be high: these range from the distortions to resource allocation arising from the selective nature of the benefits, to the lost revenue, the cost of the resources required to administer the incentives...*" Also, some years back, another IMF Country Report on Mauritius had stressed that: "*As a general principle, tax policy should be designed to raise revenues in the least distortive, most efficient and least burdensome manner, while equity objectives are best addressed by expenditure policy.*" Basically, empirical evidence across several countries worldwide has demonstrated that, although transformations should be tailored to individual circumstances, successful tax revenue reforms often stem from simplifying tax procedures and structures as well as curbing exemptions, which would notably help to foster taxpayer compliance. Insights from country case studies have shown that, when duly upgraded and streamlined, mainly via the elimination or reduction of distortions, the design of tax systems can play a meaningful role in reducing resource misallocation and combating market failures, thus rendering the tax regime more efficient from a Pareto perspective. With this mind, it appears appropriate, from a microeconomic standpoint, to curtail the potentially mixed signalling effect of any amendments on the investment community when implementing tax reforms, alongside avoiding any sub-optimal rechannelling of business flows. Towards this end, a key focus area is to address tax treatments that discriminate by asset type, sources of financing or firm characteristics. Such postures should drive total factor productivity gains, which are recognised as a meaningful lever to persuasively boost real GDP growth rate over time. All in all, given the still unsteady economic context and while ensuring adherence to international standards, it is primordial that the fiscal regime endorsed by Mauritius be suitably administered, while ensuring that it remains, in its scope, predictability and transparency, supportive of the strategic development and international competitiveness endeavours of key economic sectors.

Ensuring the effective and comprehensive operationalisation of measures

In another respect, though further insights will be unveiled in the forthcoming Finance Bill, additional clarifications are sought on the modalities, configuration and strategic objectives of specific measures. In fact, specific pronouncements deserve appropriate circumspection and judicious structuring by virtue of their inherent significance and likely repercussions on activity levels. This is notably the case for measures aimed at further opening up our economy and country to the rest of the world as well as the intended review of the fiscal regimes for the financial services industry. Furthermore, the timely and comprehensive execution of announced initiatives, mainly those earmarked to upgrade the national infrastructure set-up and boost employment creation, warrants attention. Especially, given the high level of complexity of some envisioned ventures, the growth-enhancing potential of intended measures can be optimally harnessed by strengthening project implementation capabilities and mechanisms at public and private sector levels. In particular, Mauritius will benefit from the adoption of dedicated actions to foster institutional capacity building, ensure judicious resource mobilisation, bolster statistical data collection, achieve the proper prioritisation and alignment of projects, and stimulate the use of innovative techniques. Above all, a key axis underpinning opportune project implementation relates to the formulation of appropriate governance frameworks to ensure that identified moves are adequately designed and judiciously executed. All in all, endorsing the right strategies and moves is all the more called for given that, in recent years, a notable share of enunciated projects – with the Road Decongestion Programme and utilities sectors being key examples – has not materialised in a prompt and comprehensive fashion, partly due to capacity inadequacies, administrative bottlenecks and the technical complexity of such undertakings. These concerns were further confirmed by official figures showing that the gap between initially projected and actual expenditure in the context of the Public Sector Investment Programme stayed high in FY 2017/18. The under-spending stood at Rs 16.4 billion, consistent with an overall execution rate of some 61%, which is lower than the corresponding ratio of 69% as estimated for FY 2016/17.

In another light, while the announced setting up of committees in some instances can be viewed in a positive light (e.g those in relation to FinTech, the Mauritian International Financial Centre (IFC), cane industry, pensions), concrete actions remained to be identified to ensure that key macroeconomic challenges facing Mauritius are duly identified, ascertained and tackled. Actually, an extensive and ambitious range of structural reform measures that will help the country to confront its supply-side impediments and assist its businesses and sectors to achieve their aspirations is warranted. This is especially the case given difficulties being, in particular, faced by the sugar, global business and export oriented manufacturing industries to preserve their competitiveness levels and revenue generating abilities. Amongst key focus areas, conscientious moves are, in the near term, required to underpin the underlying growth path and international strategic positioning of the financial services industry. This is, especially, required given increasingly competitive and stringent operating circumstances, notably associated with the ever more prominent nature of global compliance and fiscal standards as well as the ambition of Mauritius to position itself as an International Financial Centre of repute and substance.

<u>Fostering sound, sustainable and credible fiscal and public debt management</u>

Another key success factor towards ensuring that the budgetary announcements achieve their goals is the adoption of a credible, robust and transparent medium-term fiscal consolidation agenda. While assisting in reducing debt vulnerabilities, the latter would help the economy to be impregnated with greater flexibility to respond to shocks and create an adequate fiscal space for financing growth-inducing expenditures. In this respect, the Government affirmed that the fiscal strategy for the short to medium term is geared towards maintaining macroeconomic stability to support inclusive growth, employment creation and uplifting the quality of life of the population. Gross public sector debt is projected to be brought down in coming years and attain the statutory level of 60% as at end-June 2021 as per the Official Medium Term Macroeconomic Framework. Furthermore, the authorities expressed their intention to manage the foreign exchange, refinancing and interest rate risks facing the debt portfolio. Notably, as per official projections and despite recourse to foreign loans on a bilateral basis, the share of external debt in Government debt portfolio will be reduced from 17% at present to 12% by end-June 2021. Also, the portfolio of foreign debt will be further diversified in terms of currencies.

Notwithstanding the above, the fiscal and debt metrics prevailing at various levels require due attention in view of the unsteady economic context and major infrastructure projects earmarked for implementation in periods ahead. Given this context, the authorities face up to the formidable challenge of meeting their objective to bring down the gross public sector debt level in the years ahead. Noticeably, as forecasted by the authorities, the fast-paced improvement of nearly three percentage points in the debt ratio over the year ending June 2021 appears quite ambitious. Thus, a prudent and disciplined fiscal stance is called for to ensure that the funds at the disposal of the public sector are collected and utilised in a judicious way, while tackling potential downside risks to the debt outlook. A key challenge for the authorities is to preserve debt sustainability, while, at the same time, meeting their objectives of upgrading the nationwide infrastructure set-up and achieving broad-based socio-economic objectives.

In another light, the treatment and composition of the debt deserve appropriate appraisal. This view particularly holds given that projects such as the Metro Express would, by virtue of their envisioned structuring, not be accounted for in the official definition of public sector debt, although it is understood that no drawdown has, up to now, been made in respect of the line of credit from India. Furthermore, the debt situation needs to be viewed holistically in the context of the contingent liabilities that the Government is deemed to be exposed to via guarantees. Such a situation warrants attention from a debt management perspective, with the IMF arguing, in its latest Article IV Consultation Report on Mauritius, that: "*Rising public debt, including contingent liabilities of the central government, has left Mauritius' gross financing needs more exposed to adverse real growth, real interest rate, and fiscal shocks…Fiscal risks are increasing, and fiscal consolidation is required to preserve debt sustainability.*" As per the IMF in its Public Sector Debt Statistics Guide, fiscal risks contribute to the vulnerability of public finances and go beyond those captured in the portfolio analysis framework, since they are notably also instigated by contingent liabilities. As a first step toward comprehensive fiscal risk analysis and management, the IMF calls for the preparation and publication of a Statement of Fiscal Risks, to be submitted to the legislature as part of the annual budget. A key function thereof is to provide a framework for understanding and managing contingent liabilities and help governments decide how much risk to take on. In turn, the identification of fiscal risks will contribute to more informed risk-management decisions and promote earlier and smoother policy responses. All in all, it would help if the authorities in Mauritius undertake the treatment and management of the external liabilities positioning of the country from a holistic perspective, in sync with the debt management strategy, while laying due emphasis on the timely achievement of set targets, notably those relating to the origination of debt from local and external sources, the currency composition of the debt, as well as its interest rate mix and the maturity structure. In the same vein, depending on the timing, quantum and usage of available funds, the sizeable inflows of externally-sourced capital – which have become increasingly topical in the wake of the recent grant and loans obtained from India – call for scrutiny as they can potentially exert upward pressures on the external value of the rupee and extensively permeate throughout the domestic banking system, thus potentially fuelling the relatively high excess liquidity levels that have prevailed therein.

Official Medium Term Macroeconomic Framework

The significance of budgetary announcements can be perceptibly assessed by means of an appraisal of interconnected forecasts provided in the authorities' Medium Term Macroeconomic Framework (MTMF). In this context, it has been highlighted that the nation's economic expansion rate would firm up in the coming years. Indeed, real GDP growth is officially projected to stand at 4.1% in FY 2018/19 before edging up to 4.3% in FY 2019/20 and 4.5% in FY 2020/21. In addition to factoring in a favourable outlook for the global economy, the latter figures would be mainly driven by a sustained improvement in the national investment ratio. From a sectorial perspective, economic growth in the years ahead would, as per the authorities, be underpinned by construction activities amidst the implementation of major public and private sector projects, the financial services industry on the back of its competitiveness headway, the tourism sector in the wake notably of the execution of market diversification strategies, ICT in a context of capacity building and enlarged product base, as well as retail trade segment. The economy is also likely to benefit from steady growth in activities in emerging sectors such as the film industry, knowledge hub, renewable energy, medical hub and the ocean economy. However, it is essential to highlight that such anticipations are predicated on the timely and comprehensive execution of economic policy measures meant to preserve the quality of the business climate, uphold the competitiveness of our businesses, and maintain investor confidence in the Mauritian jurisdiction. On another note, a close look at macroeconomic forecasts unveiled by the authorities indicates that the overall performance of the Mauritian economy would improve only moderately in future periods. For instance, in spite of gradually increasing, the ratio of gross fixed capital formation to GDP would still remain below the 20% threshold in FY 2010/21, which is several percentage points below the level that is deemed necessary to satisfactorily achieve the country's socio-economic ambitions. Another telling observation is that, as per the MTMF, economic growth would, in spite of measures assigned to support export activities, be hampered by a projected subdued path for exports of goods and services in the years to come. In fact, the indicator's share of GDP is, as per the authorities, anticipated to fall gradually over time and reach 40.4% in FY 2020/21. This would contribute to a major deterioration of the country's current account deficit. The latter's share of GDP is, as per the MTMF, projected to worsen to 8.5% in FY 2019/20 from 4.8% in FY 2018/19, before declining, but remaining quite elevated, at

7.3% in FY 2020/21. This situation can be viewed with some concern and calls for appropriate remedial actions insofar as persistently high current account deficits usually tend to exacerbate the country's vulnerability to potential external financial and economic shocks, alongside stifling conditions for healthy and durable growth.

ECONOMIC OUTLOOK

Main economic indicators

	Unit	2014	2015	2016	2017[(1)]	2018[(2)]
GDP at market prices	*Rs bn*	392	410	435	460	491
Per capita GDP	*USD*	10,151	9,228	9,598	10,453	11,239
GDP growth (at market prices)	*%*	3.7	3.6	3.8	3.7	3.8
GVA growth (at basic prices)	*%*	3.6	3.1	3.6	3.5	3.7
Gross Domestic Saving	*% GDP*	10.6	10.4	11.0	10.7	10.9
Gross Fixed Capital Formation	*% GDP*	18.9	17.4	17.2	17.3	17.7
Private sector investment	*% GDP*	14.0	12.6	12.8	13.2	12.9
Public sector investment	*% GDP*	4.8	4.7	4.4	4.1	4.8
Headline inflation	*Dec, %*	3.2	1.3	1.0	3.7	3.8
Budget balance	*CY, % GDP*	-3.2	-	-	-	-
Budget balance	*FY, % GDP*	-	-3.9*	-3.5	-3.5	-3.2
Public sector debt	*Dec, % GDP*	60.7	63.6	64.4	63.4	63.2
Balance of visible trade	*Rs bn*	-77.3	-74.7	-81.0	-99.7	-109.4
Current account balance	*% GDP*	-5.6	-5.0	-4.2	-6.6	-6.1
Overall balance of payments	*% GDP*	5.9	4.9	6.0	6.2	4.8
Unemployment rate	*average, %*	7.8	7.9	7.3	7.1	6.9

(1) MCB revised estimates (2) MCB revised forecasts

** The budget deficit for 2015 in the table relates to the January to June period as per official disclosures and based on computations from GDP for 2015H1*

Sources: Statistics Mauritius, Ministry of Finance & Economic Development, Bank of Mauritius & MCB staff estimates

Economic growth

Revised outlook for 2018

For this year, against the backdrop of the unfolding global landscape and developments within the domestic economy, we now expect real GDP growth to stand at 3.8% when measured at market prices, which undershoots our prognosis of February last by 10 basis points. When measured at basic prices, real growth in Gross Value Added (GVA) is anticipated to attain 3.7%.

From the expenditure perspective, the downward revision in our growth prediction partly reflects a more pessimistic outlook as regard the country's external position. Whereas net exports of services have remained in a positive territory, key concerns prevailed with regard to the country's net exports of goods. In the latter respect, while the value of imports has been rising lately, total exports of goods evolved at a subdued pace.

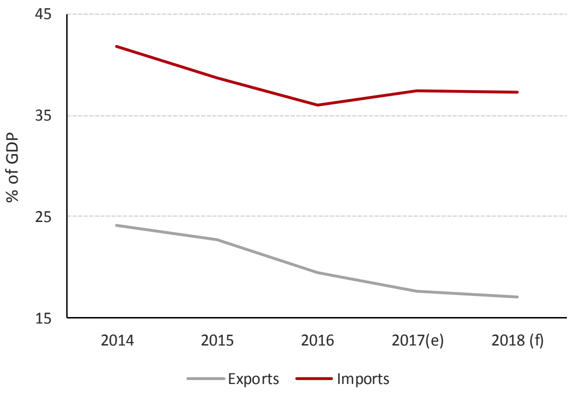
Indeed, the latter posted a year-on-year decline of around 8% during the first quarter of 2018. On such trends, the share of our total exports of goods to GDP is expected to decline for the fourth consecutive year and attain around 17% in 2018, which is far inferior to the rate of around 27% witnessed around a decade ago. On this basis, our net exports of goods and services would – amidst the demanding global context and compounded by the prevalence of domestic imbalances – exert a non-negligible impact on nationwide activity levels this year by rubbing off around one percentage point from the growth in national output. Strategically, the overall trends characterising our exports of goods and services warrant particular inspection given the importance of this indicator as a pivotal engine for achieving high real GDP growth over the medium and long run. This posture is, all the more, called for when considering the small size of our economy, which tends to constrain the leeway in stimulating continuous growth in domestic demand, especially given that the net impact of household consumption on output is generally limited by its relatively high import content. On another note, we have somewhat lowered our forecasted growth for private investment, notably reflecting a slight delay in the incurrence of intended energy projects. Yet, private investment should post a positive growth this year, supported by the realisation of ventures in specific fields, especially those related to real estate and property development as well as tourism. As for public sector investment, several projects pertaining to the road network and land transportation have shaped up and progressed in recent times, with a key case in point being the Metro Express project. Ventures also unfolded or have been kick-started recently in the context of the Road Decongestion Programme. Moreover, mention can be made of the initiation and/or unfolding of ventures on the administrative as well as social and community empowerment fronts. That said, whereas the extensive line-up of projects makes for interesting reading, it is important to factor in their sizeable import content. In addition, while project implementation delays have been noted in some cases, it can be concurred that several large-scale undertakings would take time to influentially pan out in coming months, partly due to their relative technical complexity and sophistication. On balance, public sector investment is anticipated to register a double-digit expansion rate this year, thus providing a boost to GDP growth. Consequently, the share of public sector investment to GDP would increase by 70 basis points to stand at 4.8%. This would contribute to the national investment ratio improving to 17.7% of GDP. While this evolution can be positively viewed *per se*, this metric continues to lie several percentage points underneath the level advocated to foster high and sustainable activity and job creation.

From an output perspective, the construction sector is, on the heels of the generally favourable investment outlook, foreseen to post a notable expansion in value added. It should, thus, remain a key driver of nationwide output growth this year. In another respect, a marginally less upbeat outlook now holds as regard growth in value added for the tourism sector. This is the case given the increasingly competitive market environment,

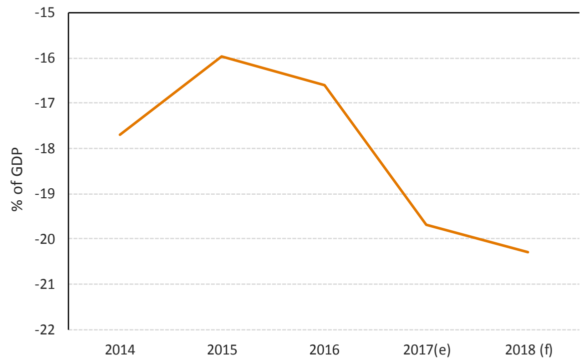
Box I: Overview of the relevance of trade for the Mauritian economy

Trade in goods

Exports and Imports of goods

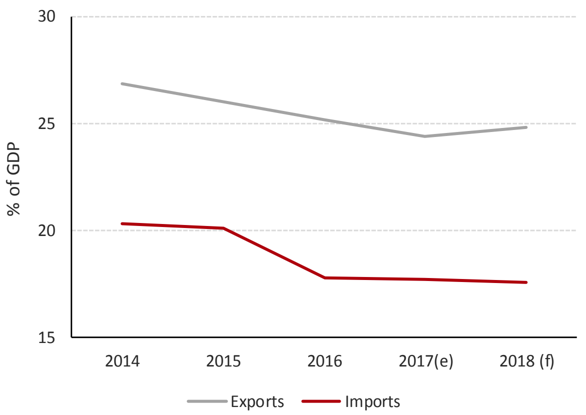


Net exports of goods

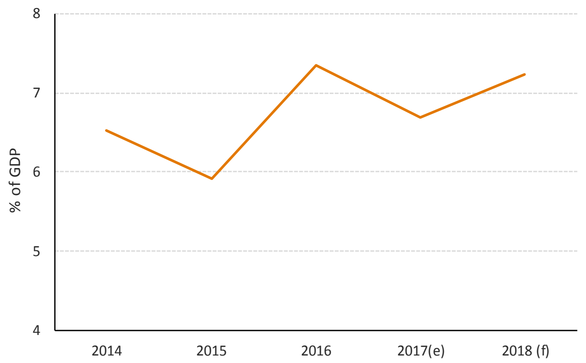


Trade in services

Exports and Imports of services

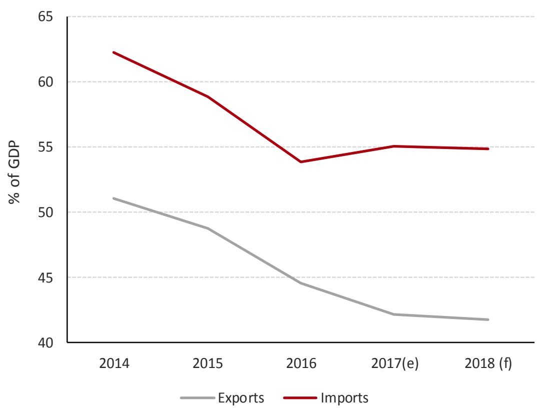


Net exports of services

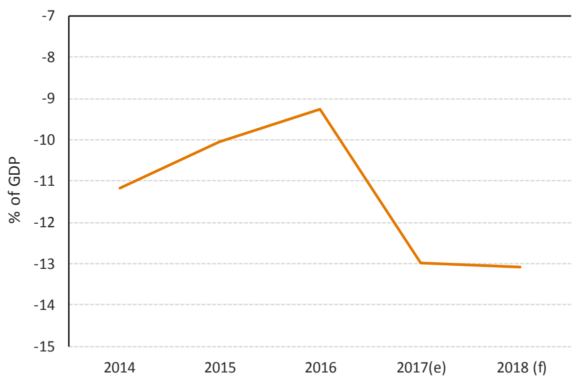


Trade in goods and services

Exports and Imports of goods and services



Net exports of goods and services



(e) Revised estimates (f) MCB forecasts

Sources: Statistics Mauritius and MCB Staff estimates which played some part in engendering a year-on-year rise of only 2.7% in arrivals during the first five months of the year. Yet, in spite of bearing up with the statistical impact of the high base effect attributable to the good outcomes of previous years, the tourism sector would post an appreciable growth, after capitalising on its competitiveness and market diversification breakthroughs. It would also benefit from the partial liberalisation of the country's air access, which has been initiated some years back. Noteworthy performances are also likely to be registered by the ICT as well as the financial and business services industries on the back of their harnessed market development headway. Within the latter segment, a slightly lower-than-expected growth is being envisaged in respect of the global business industry, as operators face up to market uncertainties and challenges in adapting to the evolving operating environment, in particular those relating to endeavours to diversify into new markets and broaden the product base. Furthermore, on the back notably of the adverse climatic conditions that have prevailed during the first quarter of the year, the non-sugar agriculture sector is forecast to post an inhibited performance, while value added for sugar is likely to be relatively flat, notably reflecting restrained production levels. Along the same lines, it is worth noting that, notwithstanding the array of measures earmarked by the authorities to boost the activity levels and the competitive positioning of operators, the expansion of the domestic oriented sector is anticipated to remain soft, partly explained by the persistence of competitive pressures amidst rising production costs and lingering local structural bottlenecks. As for the export oriented manufacturing industry, value added would expand modestly. Notably, the textile segment would remain in a difficult zone, partly due to lukewarm private demand from some markets, notably the UK, as well as persistence of high competitive pressures on international markets. As for the seafood sector, it fared relatively well last year, but would, per latest assessments, record a subdued growth rate in 2018. This outcome would be noticeably attributable to market access and supply-side pressures, with a key challenge being the implementation of the Yellowfin tuna quota, pursuant to the Indian Ocean Commission resolution to limit the amount fished in the region.

The balance of risks to our baseline growth outlook are broadly balanced, with our estimate to hinge principally on the speed and extent to which public sector infrastructure programmes unfold in periods ahead. Also, our predicted GDP growth continues to evoke a relatively sub-par performance. As opposed to being comprehensively underpinned by a broadening of idiosyncratic growth-stimulating foundations, the outcome would be partly instigated by the low base effect spawned by the cumulative statistical impact of numerous years of restrained economic expansion. Besides, though unemployment levels have been encouragingly engaged into a downward trend lately, economic growth is still deemed to fall short of the level required to entrench extensive grounds for job creation and achieving the nation's social inclusiveness aspirations.

Projections for 2019

Outlook

Preliminary forecasts made in our baseline scenario suggest that the country's real GDP growth would edge up to reach 4.0% next year when measured at market prices. When computed at basic prices, the real growth in GVA would stand at 3.9%. That said, given the unsteady operating context prevailing both locally and on the international front, it is essential that we remain vigilant in our assessment of the growth outlook insofar as it is deemed to be subject to notable risks. In particular, growth will depend on a timely and adequate operationalisation of intended infrastructure-upgrading programmes. As such, any delays or acceleration in the initiation/accomplishment of key investment projects will weigh in the balance. Also, growth will hinge on the pace and magnitude to which policy measures are implemented, while being impacted by the resoluteness of initiatives to preserve the quality of the business environment and underpin private investment.

Coming back to our baseline growth forecast, it is noticeably founded on another notable expansion in public investment. Illustratively, public sector investment – which is estimated to aggregate some Rs 153 billion over the next 5 years – would, as per the authorities, stand at Rs 53 billion in FY 2018/19 and Rs 38 billion in FY 2019/20. Overall, aided by a relative improvement in project execution rates, the country should, during the course of next year, benefit from the full-year impact of some key ongoing projects, while recently kick-started ventures and those intended to be launched in periods ahead would likely gather steam. Among the main earmarked capital projects for next year, Phase 1 of the Metro Express system, which involves linking Port Louis to Rose Hill, would be operational by September 2019 as per the authorities. Besides, in the context of the Road Decongestion Programme, several sizeable projects would, as per pronouncements made, spread out next year. In other areas, key projects that are, as per official statements, likely to unfold during the course of next year relate to the reinforcement of power generation and distribution set-ups, the upgrade of water distribution network through the pipe renewal programme, undertakings aimed at transforming the port as a logistics and maritime hub, cargo and Freeport development at the airport, the construction of the Multi-Sports Complex at Cote D'Or and the new Supreme Court, as well as social and community development initiatives. Nonetheless, notwithstanding declarations made, it is essential to factor in the non-negligible import content of envisioned undertakings. Importantly also, some earmarked infrastructure-upgrading endeavours should take time before being instigated and/or expansively put in train. Thus, their full-fledged impacts on GDP growth are most likely to be felt beyond 2019. As for private sector investment, an appreciable growth is foreseen next year on the back of envisioned ventures across *inter alia* the real estate and property development, tourism, energy, education and some emerging segments. All in all, the ratio of gross fixed capital formation to GDP is predicted to improve by around half a percentage point in 2019. Against this backdrop, the construction sector would, for next year as well, post a notable growth in its value added. In addition, in spite making allowance for the statistical impact of a high base effect and the competitive market landscape internationally, nationwide economic growth is, albeit to varying magnitudes, expected to be underpropped by the continuing good showing of key economic sectors, with cases in point being tourism, ICT as well as financial and business services. With respect to the latter, the spotlight would be cast on the global business industry, which is projected to register a relative growth slowdown next year. In fact, while efforts are ongoing by operators to upgrade their value proposition and diversify their markets, the latter industry is expected to be confronted by business development challenges and market access uncertainties, partly engendered by the coming into force of the full provisions of the new Protocol that was signed some time back between India and Mauritius to amend the Double Taxation Avoidance Agreement linking them. Yet, it is hoped that the recommendations to be unveiled in the forthcoming Blueprint are implemented in a comprehensive and effective manner to help in boosting the competitiveness of the Mauritian IFC in coming years. In other respects, notwithstanding measures announced by the authorities to cope with difficulties faced by operators, the domestic and export oriented manufacturing industries would continue to post moderate growth rates amidst the challenging, albeit improving, context.

Quality and sustainability of the growth pattern

To start with, notwithstanding trends witnessed on the economic growth and labour market fronts, apprehensions subsist in respect of the intrinsic ability of the country to generate and harness robust conditions that will engender wide-ranging employment creation avenues within economic sectors over the medium term. As another note of caution, while the country's economic expansion rate is on course to improve next year, it is essential that we do not be lulled into a false sense of security as regards the inherent aptitude of the Mauritian economy to nurture strong conditions in support of a high, sound and balanced growth pattern over the medium to long term. In fact, the Mauritian economy continues to face up to key challenges, with its idiosyncratic capabilities and external competitiveness levels being put into light by the recent performances of some key economic sectors. In effect, though remedial measures have been identified or have been executed by the authorities at several echelons, pockets of concern prevail regarding the intrinsic ability of Mauritius to (i) display adequate resilience when confronted by external shocks; (ii) cope with market access constraints and competitiveness imperatives that continuously surface on the regional and international markets; and (iii) opportunely capitalise on international growth-inducing avenues. As for the main growth-inhibiting factors, they especially stem from limitations regarding: (i) the effectiveness of the institutional and governance set-up; (ii) the efficiency of product and labour markets; (iii) the appeal and adaptability of the business and investment facilitation framework when factoring in the demands and necessities spawned by the international economic and market landscapes; (iv) the prompt dissemination of innovative technologies across productive sectors; and (v) human and capital productivity levels. Whereas they are welcomed as an influential means to reinforce the country's physical capacity and competitiveness levels, the currently-enlisted infrastructure undertakings are, by virtue of their assigned time span, expected to, *per se*, provide only a relatively short-lived stimulus to economic growth. Therefore, alongside ensuring that the commercial viability of projects is duly catered for, a key challenge for the country is to uncover and embrace more solid and durable underpinnings for achieving high, sound and sustainable growth. Actually, Mauritius is called upon to improve its long-term-term potential output, which would be a decisive move that will help sustain and outspread the improvements in living standards registered in recent decades. As the situation stands, it is reassuring to note that the predicted growth for 2019 would close the gap vis-à-vis the country's long-term potential growth rate. Yet, alongside considerably improving execution rates for infrastructure projects, the country will, in future years, only succeed in increasing its potential growth rate from its current level of 4.0 - 4.2% range to around 5% if it manages to wrestle with the deep-seated structural impediments to activity levels. This can be accomplished via a further broadening and deepening of the national structural reform agenda, with focus on initiatives which are well-sequenced and adapted to the country's inherent circumstances. The country should benefit from measures geared towards achieving improved total factor productivity, enhanced competitiveness levels, and a further expansion and diversification of its economic base and foreign market space. An improvement in labour supply will prove vital in boosting our potential growth rate, aided by the careful recourse to high-skilled foreign human capital and rising labour participation rates, with particular focus on women.

Other indicators

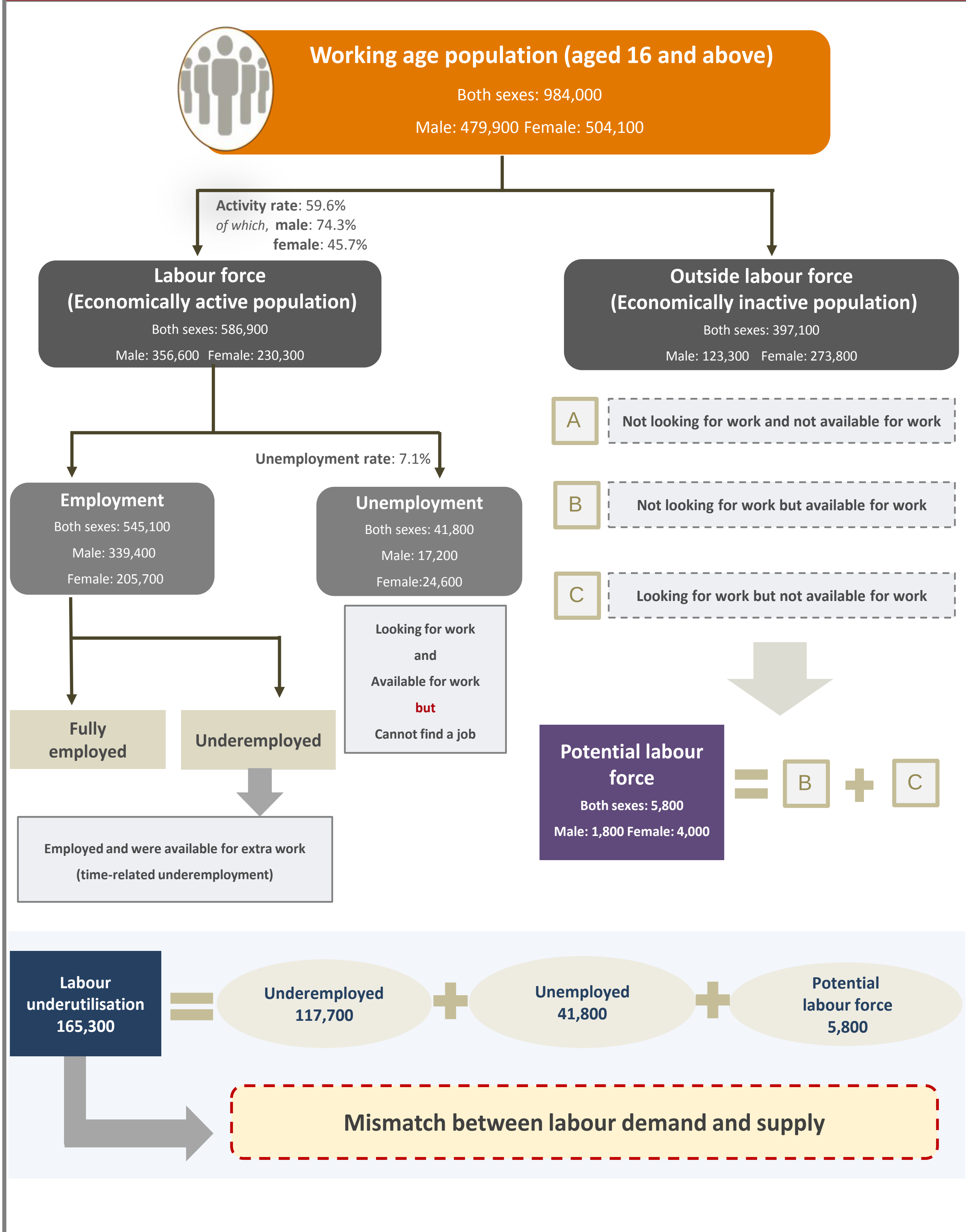
Inflation

For quite some time now, headline inflation has pursued a prominent upward movement. This trajectory gained noticeable momentum as from the beginning of this year on the back mainly of marked and repeated hikes in the prices of vegetables, while the relative weakening of the external value of the rupee vis-à-vis the US dollar on a point-to-point basis also mattered over the period. Against this backdrop, headline inflation reached 5.0% as at both March and April 2018. It however declined to 4.7% in May 2018, with the drop in vegetable prices more than cushioning the impact of higher prices of gasolene and diesel on the price index. As for CORE 1 inflation (which does not cater for the 'food, beverages and tobacco' and 'mortgage interest on housing loan' components), it went up by a noticeable margin in recent periods to reach 2.6% as at April before edging down to 2.5% the month after. Moving forward, as the repercussions of earlier price movements become increasingly diluted in the computation, a key observation is that headline inflation would, in all probability, recede in the forthcoming months. In effect, headline inflation is forecast to stand at around 3.8% as at December 2018 as per our baseline scenario. This outlook notably factors in the recent budgetary pronouncements to reduce the prices of gasolene, diesel and Liquefied Petroleum Gas, while making allowance for other developments that could eventually also impact the consumer price index in the periods ahead. Looking ahead, it is important that our baseline inflation outlook be viewed in the context of a dynamic operating environment, with the indicator remaining vulnerable to potential adverse shocks. Notably, even though the OPEC and other top crude producers have lately agreed to raise nominal output as from July by about 1 million barrels per day, the likelihood of our consumer price index being impacted by any resurgence of international oil prices in light of the volatile global landscape cannot be disregarded, with potential spillover repercussions on the administered prices of other key items locally. In fact, as stressed out by the OECD in its recent Interim Economic Outlook, *"Upside risks to inflation, at least in the short run, stem from a possible larger increase in commodity prices, particularly oil. Risks will be especially high if geopolitical concerns persist or escalate."* In addition, the institution has added that, by pushing up inflationary pressures, persistently higher oil prices could eventually lead to an aggravation of external imbalances and the softening household real income growth across countries. Moreover, in a context which is particularly marked by the reform of the US corporate tax system and monetary policy normalisation, the risk of a further strengthening of the greenback on the international markets and its attended consequences on the prices of our imports cannot be discarded.

Unemployment

In line with the expansion in activities across some sectors and the implementation of employment-creation initiatives by the authorities, the nationwide unemployment rate is anticipated to edge down further to attain 6.9% this year, as compared to 7.1% in 2017. Yet, beyond this headline figure, apprehensions subsist concerning the inherent efficiency of labour markets, while the country's ability to address structural rigidities and boost net job creation on a sustained basis continues to call for close scrutiny. In fact, latest data released by Statistics Mauritius for 2017 (see following Box for an explanation of key concepts and definitions) contain perceptive insights. To start with, a key trend capturing the limelight over the past few years relates to the general drop in the country's activity rate – i.e. the ratio of the labour force or the economically active population to the working age population (i.e. aged 16 years or more) – to relatively low levels, especially when compared to several of our peer economies. Latest official data demonstrate that this ratio stood at 59.6% in 2017, with the female participation rate depicting an even more worrisome rate of 45.7%. When dissecting the labour force *per se*, it can be further observed that the ratio of total employment to the working age population stood at a relatively restrained rate of some 55% last year. Also, within the labour force, an analysis of unemployment figures leads to insightful observations. Notably, the youth unemployment rate rose by 1 percentage point to reach 24.9% in 2017, with the rate moving up to an overwhelming 31.9% as far as the female segment is concerned. Furthermore, while decreasing in relative terms, the joblessness rate for women remained quite elevated at 10.7% last year. As for male unemployment, it was unchanged at 4.8% as at the latter period. However, this performance was achieved against the backdrop of a rise in the relevant labour force, while male unemployment rose by 300. On a comparative level, other observations are that (i) unemployed women are generally more qualified than unemployed men; and (ii) on average, women are in unemployment nearly three months more than men. As for the economically inactive section of the working age population – defined as those outside the labour force – it stood at 397,100 last year, representing a rise of some 2,600 when compared to 2016. As a

Box II: Key labour market metrics (Year 2017)



Sources: Statistics Mauritius and MCB Staff estimates specific component within this category, the potential labour force – referring to persons who were not looking but were available for work or those looking but were not available for work – was 5,800 last year as per official data. When adding this figure to the unemployed and underemployed (i.e. those in employment, but were available for extra work), total labour underutilisation works out to be 165,300. This figure, which accounted for 17% of our working age population last year, warrants consideration insofar as it reflects the level of mismatch that exists between demand and supply of labour within the economy. Overall, the afore-mentioned trends and dynamics are viewed as quite worrisome to the extent that they tend to expose the country to a relative deficiency of labour inputs and a lack of intellectual capital compared to what it could potentially have afforded. In turn, bearing in mind our socio-economic ambitions and our lack of relative natural resources, such a situation warrants close attention as it tends to impede the country's latitude to foster high and sustainable economic progress. Essentially, this apprehension gathers due importance and urgency when making allowance for the increasingly competitive international landscape in which we operate, which calls for the allocation of our resources to be optimised. Looking ahead, alongside materially boosting labour participation rates and tackling deep-rooted labour market imperfections, there is, in view of recent official statistics, a compelling case for reducing female and youth unemployment levels. While the recent National Budget formulated some initiatives in this direction (notably with the earmarking of Rs 1 billion to tackle youth unemployment), further actions are deemed necessary to suitably reduce gender and age disparities with respect to job creation. This should thus provide Mauritius with an influential tool to fuel its growth aspirations. As highlighted in a recent IMF document entitled 'Pursuing Women's Economic Empowerment': *"An important repercussion of persistent gender gaps is that the potential economic contribution from women remains untapped in many countries. Greater gender equality boosts economic growth and leads to better development outcomes. It contributes to reducing income inequality and boosting economic diversification and, in turn, supports economic resilience."*

Public finance

The budget deficit is officially estimated at 3.2% of GDP in FY 2017/18, which is in line with previous projections. In fact, while an under-spending was witnessed on the capital side, mostly attributable to delays incurred in the implementation of some large-scale projects, overall revenue mobilised undershot previous estimates, principally due to lower-than-projected grants from India. Furthermore, the estimated budget deficit to GDP ratio for FY 2017/18 represents a decline of 30 basis points when compared to the previous year's outcome. The improved fiscal performance has been mainly engendered by the growth in national income, while the nominal deficit on the budget balance is estimated to have declined only marginally. On the expenditure side, higher recurrent spending has been observed, notably linked to compensation of employees and social benefits. Besides, in spite of project execution lags as afore-mentioned, a significant rise in capital expenditure has been noted on account of the instigation and unfolding of several infrastructure projects. On the other side, a major growth in tax receipts has been posted, while capital revenue has increased by nearly three-fold, significantly boosted by the receipt of Rs 4.8 billion from the closure of two Special Funds. Looking ahead, it is interesting to note that, as per projections formulated by the authorities, the budget deficit is on course to further decline, with the imbalance expected to attain 2.0% of GDP in FY 2020/21. Nonetheless, as the situation stands, the fiscal position of Mauritius continues to deserve appropriate consideration. While a sustained rise in tax receipts is being forecast, it is worth stressing that the predictions for the years ahead will hinge on an appreciable and sustained expansion in nationwide economic activities, which would, in turn, depend on the ability of the Government to maintain a sound business climate and foster higher levels of investment. Also, any slippages in connection to the expenditure estimates have been projected by the authorities need to be guarded against to avoid any undue strains on the Government finances, while the efficient and timely implementation of infrastructure projects deserves scrutiny, notably given the need to circumvent any cost overruns. On another note, as another key operational instrument to guide economic policies aiming to support debt dynamics, the primary balance is likely to register another deficit in FY 2017/18 as per estimations, amounting to 0.8% of GDP. Strikingly, the shortfall position is, as per the statement of Government operations, expected to remain on the cards in the next couple of years. From a policy perspective therefore, the exercise of sufficient fiscal prudence is deemed crucial. In addition to creating fiscal space for realising our growth ambitions, efforts to reduce and enhance the quality of fiscal imbalances should help to contain public debt within manageable levels. This notably calls for the adoption of ambitious and extensive fiscal consolidation measures, particularly in respect of an improvement of efficiency levels in relation to revenue collection and the execution of appropriate adjustment measures on the expenditure side to progressively and more weightily reduce non-productive outlays. Subsequently, postures embraced will be key to help the country preserve the investment-grade status of its credit profile in support of endeavours to tap into international financial markets, alongside supporting financial services operators in the pursuance of their regional expansion strategies.

External front

A key focus area of the Mauritian economy for some time now has been the sizeable deficit on its trade balance. The latter widened to reach Rs 99.7 billion in 2017, representing some 21.7% of GDP. This contributed to a deterioration of the deficit on the current account balance to 6.6% of GDP as compared to 4.2% in 2016. That said, alongside being boosted by nearly Rs 2 billion as net errors and omissions, the surplus on the balance of payments reached some Rs 28 billion last year, underpropped by elevated levels of capital and financial flows. For 2018, we have, as highlighted before, downgraded our outlook for the balance of trade deficit, with the imbalance being now estimated at just above Rs 109 billion, representing some 22% of GDP. Particularly, on the heels of the marked decline observed during the first quarter of the year and in spite of benefiting from budgetary measures aimed at uplifting the competitiveness and value proposition of operators as well as supporting market diversification, total exports of goods are likely to post a subdued growth rate. As for imports, they are anticipated to register a notable expansion this year, on account mainly of the annual average increase in commodity prices and outlays associated with the implementation of sizeable infrastructure ventures. With regard to the current account deficit, it is foreseen to benefit from a rise in gross tourism receipts in line with the appreciable first quarter performance as well as a surplus on the primary income account in spite of the latter being impacted by rental payments associated with the delivery of planes on the basis of operating lease. As for the secondary income account, the deficit therein is likely to drop, on the back notably of the receipt of another tranche of the external grant provided by India. Nonetheless, after factoring in the afore-mentioned sizeable deficit on the trade balance, the current account deficit is expected to remain at an elevated rate of 6.1% in 2018, with the outcome shooting up to 6.8% of national income upon excluding the said grant from India. As for the country's balance of payments, whereas the figure is forecast to narrow relative to the outcome registered in recent years, it should, in line with the positive balance of Rs 6.8 billion posted in the first quarter of the year, remain in a surplus position in 2018. This surplus is anticipated to account for 4.8% of GDP this year, underpinned by appreciable levels of capital and financial flows, inclusive *inter alia* of the project-based disbursement of the first tranche relating to the line of credit received from the Government of India. Importantly, the positive outcome on the balance of payments should continue to be subject to our monitoring given the unsteady global financial environment, with potential sudden shifts in investor sentiment. In particular, the forecasting exercise tends to be quite challenging given the intrinsic volatility of cross-border transactions by the global business sector.

J. Gilbert Gnany
Chief Strategy Officer June 27, 2018

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