

Mauritius—Assessment Letter for the World Bank
December 15, 2008

This note provides an IMF staff assessment of recent macroeconomic developments and prospects for Mauritius based on information available through November 2008. A comprehensive assessment of macroeconomic developments, undertaken as part of the 2008 Article IV consultation, was published in July 2008 (Country Report No. 08/238, available at <http://www.imf.org>). The next Article IV consultation is scheduled for mid-2009. The authorities have made good headway in recent years in implementing reforms and easing fiscal pressures. The first-round impact of recent global financial market turmoil on Mauritius has been modest, but the international downturn poses a greater challenge for key sectors of the economy.

Recent Economic Developments

Mauritius has seen good results from the wide-ranging reform program it launched in 2005/06 following the loss of trade preference in sugar and textiles. The reforms have targeted reductions in the fiscal deficit, enhancing public financial management, restoring economic competitiveness, and improving the investment climate. A bold tax reform, incorporating a flat tax on corporate and personal income and a new revenue authority, has significantly improved tax revenues. Combined with reductions in the cost of doing business and labor reforms, these policies have spurred foreign investment and growth. In the past three years, GDP growth has recovered and macroeconomic vulnerabilities have been reduced.

Economic growth progressively recovered from 2005/06 through mid-2008, averaging over 5 percent. This has lowered unemployment, which is expected to fall from 9.3 percent in 2005/06 to 8 percent in 2008, the lowest level in five years, but it has also led to growing supply bottlenecks. The main drivers of growth have been large inflows of foreign direct investment (FDI) into the real estate development and tourism sectors; the offshore Global Business License (GBL) sector, which services investments in major Asian markets; and a rebound in sugar and textile production. Mainly because of price increases for imported food and fuel, inflation rose to about 12 percent in mid-2008 but eased to 9.7 percent in October as international food and fuel prices have dropped.

Because of the fiscal reforms, the overall deficit was lowered to 3.4 percent of GDP in 2007/08, from 5.4 percent in 2005/06, and public sector debt was reduced to about 58 percent of GDP in June 2008 from close to 70 percent in June 2005. The tax reform and better tax administration boosted the tax revenue effort from 17.4 percent of GDP in 2006/07 to over 19 percent of GDP, through greater compliance and a broadening of the base. A new public debt management law was introduced in 2008 with the aim of reducing public sector debt to 50 percent of GDP by 2013. Program-based budgeting was introduced with the 2008/09 budget to make government spending more effective.

Monetary policy through mid-2008 grappled with the need to contain the impact of strong capital inflows and rising import prices without putting too much pressure on growth. The monetary authorities raised interest rates and increased the cash reserve ratio in

mid-2008 to reduce credit growth and contain inflation. Importantly, the Bank of Mauritius (BoM) issued its first inflation and financial stability reports. However, it had difficulty implementing its new monetary policy goal of keeping the repo rate within stated policy bounds for much of the year in the face of strong capital inflows. Inflation remains a concern, though the recent plunge in food and fuel prices and slackened global demand have helped reduce inflationary pressures. As capital inflows eased in late summer, the BoM reversed its external reserve accumulation and monetary policy was eased in November and again in early December, in step with international developments. The banking system appears well capitalized, underpinned by sound regulation, and has limited exposure to subprime products.

Despite continued recovery of the textile sector and high growth in tourism and services, the external current account deficit deteriorated in 2007/08 to 9.0 percent of GDP (from 7.7 percent of GDP in 2006/07), largely because of on the spike in food and fuel prices and the counterpart imports to unprecedented FDI inflows. However, the analysis is clouded by continuing large errors and omission items caused by persistent difficulties in adequately surveying the operations of the GBLs.

Structural reforms have advanced with the recent passage of the flexi-security law on social security, aimed at protecting the individual rather than the job, and revised procedures to improve the implementation of public capital investment.

Outlook Risks and Policy Challenges

The healthy growth of recent years is expected to decelerate in 2008/09 as global demand slackens. GDP growth in 2008/09 is now projected to be much lower than earlier expectations of more than 6 percent and down from 6.6 percent in 2007/08. Uncertainties surrounding the outlook reflect the rapidly changing external environment, but a growth deceleration to about 4 percent or lower is projected. The current account deficit is not expected to change greatly in 2008/09 as lower demand for tourism, textiles, and offshore investment services are offset by lower imports as FDI weakens and on lower commodity prices. Inflation is expected to ease significantly with lower imported food and fuel prices and slackened demand.

While economic vulnerabilities have been reduced in recent years, the downside risks to the Mauritius economy from the global recession will pose challenges for key export sectors. An abrupt slowdown in global economic growth and a sustained reduction in risk appetite could significantly impact the Mauritian economy. The main risks are from much lower demand for tourism, textiles, and real estate development. Continued turmoil in global financial markets, reduced risk appetite, and outflows from emerging markets are expected to reduce FDI inflows into Mauritius and reduce activity in the offshore GBL sector. The recent sharp depreciation of the rupee (against the U.S. dollar) will be helpful to export competitiveness, although it may result in a slower reduction in inflation.

It is important that fiscal stimulus initiatives being considered be measured, targeted to need, and temporary so as not to jeopardize hard-won gains in fiscal sustainability. Public debt, while on a downward trend, is still high and calls for sustained fiscal prudence.

Pressures to relax fiscal discipline may rise in the run-up to the electoral campaign in the next fiscal year, but may be contained compared to previous cycles as a result of stronger fiscal rules embedded in a medium-term fiscal framework.

The recent monetary easing, consistent with global developments, was appropriate, but the monetary authorities must remain vigilant against inflation, which remains of concern. In particular, the BoM needs to resolve its internal conflict and reinforce the effectiveness of its stated intervention policy. Sustained efforts are needed to resolve statistical issues, which cloud the analysis of the external accounts, and to improve the framework for analyzing the monetary transmission mechanism.

While Mauritius has made notable progress, further structural reforms are needed to streamline the public sector and otherwise address supply bottlenecks and infrastructure constraints. Reform of the parastatal sector would bring important benefits in terms of economic efficiency and competitiveness. A disengagement and divestment strategy for parastatals in the import and distribution of basic goods should be pursued, as should further steps to liberalize domestic trade and phase out administered prices. To raise economic efficiency, indirect product subsidies should be replaced with a targeted safety net. Careful targeting of social spending, where work is underway supported by key donors, would also introduce a beneficial countercyclical component into fiscal policy.

Relations with the IMF

The 2008 Article IV consultation was completed on July 2, 2008. The next consultation is expected in mid-2009. Technical assistance missions from the Fiscal Affairs Department, covering program-based budgeting, and the Monetary and Capital Markets Department, covering banking supervision and monetary modeling, will be in the field in the interim.