

CONJONCTURE

PluriConseil
THINKING OUT OF THE BOX!

Bilingual Journal of PluriConseil
N u m é r o 32 - M a i - J u n 2008

"Tout l'art de la politique est de se servir des conjonctures." Louis XIV

The pampering state

By Eric Ng Ping Cheun

It is not surprising that the Minister of Finance and Economic Development, Rama Sithanen, has brought in a social budget for the fiscal year 2008-2009. In the wake of the criticisms levelled at the economic reforms embodied in the last two budgets, he could not be expected to react differently. If the art of politics consists in making capital out of the combination of current events, then he will have succeeded in giving his budget package a strong social dose. However, on the strictly economic level, it is not certain he will win his bet on growth next year.

It is hard to believe the 2008-2009 budget is the doing of economist Sithanen. One could think it might be the work of Paul Bérenger. Remember in 2001 the former Finance Minister presented a budget with a big commitment of the state to revamp the Mauritian economy. The current Minister of Finance adopts an approach that is quite similar: more than 75% of his budget speech spells out what the state will do, as if it falls on the government to solve out all our economic and social problems. It is a public sector budget, not one meant for the private sector really.

Minister Sithanen has honoured almost all the priorities of the budget he had announced before its presentation. As expected, it contains numerous measures to modernise the infrastructures, to tackle the food crisis and the energy crisis, and to assist the vulnerable groups. All these provisions, especially the abolition of customs duty on almost all foodstuffs, are appropriate in the current situation. But how about economic growth?

While the word 'growth' echoed like a leitmotiv in his pre-budget statements, Mr Sithanen has hardly referred to it in his budget speech. Yet the current slowdown of the world economy also requires policies to boost our economic growth in the very short run, precisely over the coming year. A reduction in the value added tax (TVA) rate would have had an immediate effect on growth by way of household consumption. Not only is this missing but even the budget falls short of expectations with respect to private investment and exports, despite a few measures to open further the Mauritian economy.

To be fair, some good economic measures are worth mentioning. In particular, a small and medium enterprise will be able to secure a loan from a commercial bank with no more than 10% equity as the government will share the business risk equally with the latter. Also, in conjunction with economic democratisation, the government will give a preference of 15% on price for small domestic enterprises for its procurement.

Another laudable innovation is the issuing of inflation indexed savings instruments by the government.

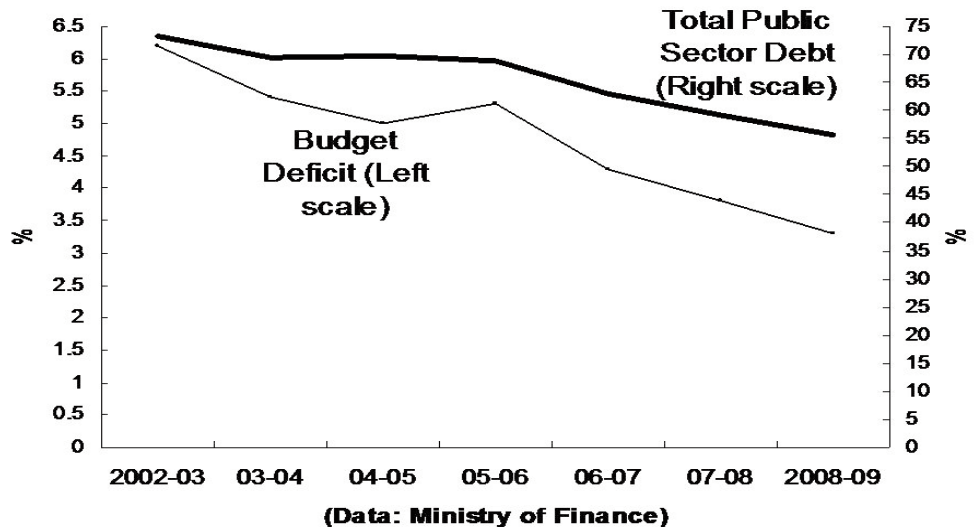
Unfortunately, specific measures favouring large business activities like textile, tourism, financial services and information and communication technologies are absent in this budget. Against all appearances, private sector organisations must be disappointed. Nonetheless, they must deem it happy for not being penalised by the budget.

projections of last year's budget) instead of 3.3%. Thus, with Rs 1.8 billion at his disposal, Mr Sithanen could have reduced the rate of VAT from 15% to 13.5%. The whole population would have benefited from such a decision. But the government has chosen to indulge the civil servants too much.

True, the abolition/reduction of customs duties on various commodities will lead to consumers benefiting from Rs 1.8 billion, equivalent to a reduction of VAT of 1.5 percentage points. But this measure does not have the same impact on the economy as a fall in the rate of VAT. First,

An electioneering budget

As % of Gross Domestic Product



It is the public sector that emerges as a winner. The civil servants will receive in toto their salary increase as recommended by the Pay Research Bureau (PRB) report. However, the annual income exemption threshold has been raised by only Rs 25,000. Income earners who fall in category A will be taxed if their monthly gross salary exceeds Rs 18,500. Well, a civil servant who formerly earned Rs 16,500 will get Rs 24,000 with the result that his earnings will become taxable. A greater number of civil servants will be caught up in the fiscal net and will probably pay the National Residential Property Tax.

If only 75% of the PRB report were paid in the first year, the state would save Rs 1.3 billion. It would have got an additional sum of Rs 500 million if it had chosen to bring down the budget deficit next year to 3.5% of gross domestic product (as set out in the macroeconomic

unlike customs duties, VAT applies also to services and has therefore a greater effect on the consumer price index. Second, the local industry will face stiffer competition from foreign goods. And third, encouraging imports brings big pressure on the rupee.

The state has elected to pamper the civil servants, the small planters, the fishermen, the small borrowers of the Development Bank of Mauritius and the vulnerable groups. Judging from its liberality, the 2008-2009 budget appears to be an electioneering one. But it is the middle class electorate, not the poor, that decides the outcome of elections.

The 2008-2009 Budget of the Government of Mauritius, presented at the National Assembly on 6 June 2008, can be downloaded on <http://mof.gov.mu>.

Rupee depreciation won't heal our woes

By Samad Ramoly

"Price stability is not everything, but without price stability everything is nothing."

Otmar Emminger, former President of the Deutsche Bundesbank

Every year, in the run-up to the budget presentation, there is a tug-of-war between representatives of employees, employers and government to agree on a quantum for the annual pay review. Now they sit together in the freshly set up National Pay Council (NPC) with an independent chairperson expected to settle the dispute with the proposal of a quantum after assessing the views of all parties. Nevertheless, the mechanism, however good-intentioned, is still unable to meet expectations. Why does the cycle continue ad infinitum and ad nauseam?

On the one hand, trade unionists claim that pay review must solely be concerned by redress of loss in purchasing power. Alternatively, from the employers' perspective, and indeed the government's, capacity of employers to pay the increment and productivity data must also be considered. Officially, the three parameters – compensation for erosion of purchasing power, capacity to pay and productivity – constitute the basis of the mandate of the NPC.

In practical terms, the parameters, all critical it must be emphasised, cannot be reconciled because they rest on flawed assumptions. Among which the rate of inflation computed by the Central Statistical Office is the most notable. The rate actually measures average changes in the prices of a basket of goods and services which itself is an average representation of the spending patterns of the average household. But is there such a thing as a typical household?

The weight of say, food and electricity bills, in monthly expenses of different households varies according to their levels of income. The lower the income, the heavier the burden, especially when there is a surge in global food and fuel prices. Mauritian consumers are even more vulnerable since they live in a country which has failed to commit itself to a reasonable programme of food and energy security and must almost entirely rely on ever-costlier imports – to a large extent the inevitable consequence of the endemic slide of the rupee.

Econoclasm

In an interview, Cader Sayed-Hossen, Chairman of the Commission for Democratization of the Economy, disclosed how, during a meeting with representatives of the Bank of Mauritius (BoM), a business tycoon was advocating rupee depreciation to accommodate the fall in sugar revenue, going as far as even suggesting a quantum. Ironically, a closer look at the behaviour of the rupee over the years reveals that, barring seasonal delusion of new-found vigour as recently, the quantum has already integrated the system.

Had their lobby been as mighty, employees would not have to content themselves with a quantum, the one validated by the government,

that in most cases hardly mitigates the negative impact of inflation on their income. This is so because employees tend to be allocated the strict minimum in terms of increment as the income targeted for maximum increment is extremely conservative, if it reflects reality at all.

When the most cynical foreign currency earners fret over the international value of the rupee, they contend that a weak rupee is "good" for the Mauritian economy. Such rumination is dubious. Belief in the salutary effects of a depreciating rupee is based partly on the expectation that rising exports of manufacturing production will increase employment and spur economic expansion. Evidence in Mauritius confirms large recurrent swings in both job creation and economic growth despite persistent depreciation.

While the intimate relationship between inflation rate and currency valuation in a highly open economy like Mauritius cannot possibly be challenged, the alleged relationship between currency depreciation and real competitiveness draws its rationale from tunnel vision rather than from contextualised thinking. As currency depreciation feeds into the system, it stimulates a vicious cycle. Sooner rather than later the illusion of short-lived relief wakes up to a situation of self-inflicted damage.

Brain Pain

Human capital is the key driver in the pursuit of higher competitiveness. Yet, the depreciation bias has dented the morale of citizens whether subtly, when the slide is smooth, or harshly, when the slide is steeper. Productivity cannot be conjured out of thin air by rewarding the few. Real wealth generation is achieved when the system is imbued with the required incentives that energise the majority.

For decades exporters have been blessed with preferential market access and a weak rupee. To some of them, now that the era of preferential access is fading, there is only the depreciation lobby to cling to. Bad habits die hard. When policymakers give in to them, they also lose grip on strategising to keep up with global capitalism. Hence the tremendous lag in national logistics, such as road networks, port and airport facilities, water supply and so on, that strains operations.

The BoM cannot cope with the complexity of an economy alone. Little wonder it is stuck in a role of a fire-fighter spraying the market with erratic moves. The country is at the crossroads, the time is ripe to rid itself of the aberration of rupee depreciation, arguably the most pervasive distorter and disincentive in the system. Jointly with corruption, producer capture and high risk premium due to low predictability, it skews market prices and embitters industrial relations. Contrary to conventional thinking, it is not always conducive to sound economic fundamentals, such as trade balances. Worse, it often destabilises them, when hit by staggering fuel prices for instance.

No doubt, the US Federal Reserve, the Bank of England or the European Central Bank can provide the BoM with guiding principles such as Jean-Claude Trichet's *"ensuring price stability is the best, if not the only, way to lay a foundation for long-term growth"*. But when it comes to minimising the risk of rupee volatility, on either side, Mauritius must tailor its policies to its own specificities. Singapore and Hong Kong, two of the stars of globalisation with similar profiles to Mauritius, should instead provide us with the inspiration.

Successive Mauritian governments have earned themselves a reputation of heeding to all sorts of lobbies, no matter how insane, as long as they are loud enough. By adopting such an attitude, governments waste considerable amount of energy and time to manage the resulting distortions, discontents and their domino effect instead of focusing on how to address pressing issues. Under these circumstances, policies tend to be misdirected and eventually backfire.

Detox

Policymakers should get their bearings right regarding the grumblers of the export sector. It is not about bashing of profit-making, but about exposing deception. Policymakers must not lose sight firstly, on the actual returns which for some brush with the returns of luxury items retailers in terms of percentage; then, on the fact that manufacturers import spirited workers to beat the demotivation of local workers; and finally, more pivotally, on the high import content in the manufacturing process.

In a newspaper report, Serge Seeneyan, Managing Director of *Soniawear*, said that *"when the rupee appreciates, it is up to businesses to take initiatives to mitigate its impact, reduce their operation costs and become more efficient. We are going through tough times, but I remain upbeat. I trust that I will catch up with today's losses in the future"*. What else but a typical expression of entrepreneurial spirit.

The signal that Mauritius is poised for globalisation will come when, namely, similar refreshing comments make the headlines and when trade unionists are eager to let go of end-of-the-year bonuses that are not performance-based. That is, when according to the gut feelings of the majority of businesses and households, regardless of what anointed statistics may boast, their efforts are being adequately rewarded.

Such transformation cannot be presided over. It can merely happen through an enlightened leadership capable of creating the synergy for long-term and sustainable economic expansion that is inclusive and non-inflationary.

Samad Ramoly is a global policy observer.

Raise the Cash Reserve Ratio now

By Sameer Sharma (cont., Pg 4-5)

The latest Goldman Sachs and Morgan Stanley forecasts point towards oil exceeding USD 141 a barrel by the end of this year. Oil supplies remain constrained and around 1.2 million barrels below daily demand as at April 2008 and uncertainty about future supplies had transformed the futures curve from backwardation to contango during the month of May. Rising demand from China, India (which subsidize gasoline prices) and other emerging markets have certainly increased their demand for oil in recent years while supply problems in Nigeria, Russia and Mexico have made things worse this year but this is not the full story.

Ever since the creation of index funds that invest in oil futures, hedge funds, investment institutions, pension funds, small investors seeking a hedge against inflation and speculators have pumped billions into this market (commodities are increasingly forming part of a diversified portfolio) driving demand upwards. With index fund demand for oil now equal to the demand coming from giant China, supply constraints have become more telling. While exchange traded funds (ETF) do not hold oil forever as it eventually gets to the consumer, a contango means that arbitragers are long on the spot price and are short on medium term maturity futures contracts. Hence holding onto oil until the contracts expire makes the current supply constraint even worse.

Until the perception of future oil supply constraints changes (the contango curve itself changes shape), a major correction in the oil price is hard to predict. All the news about major oil finds in Brazil which have proven to be a very expensive drilling proposition and suspended oil deliveries going to the US strategic oil reserve have done little to stem price growth so far. Refining capacity has also remained a concern. Furthermore the weak dollar is negatively correlated to oil prices. As higher energy prices translate into higher input costs, the core producer price index in the US has risen and the Fed is now likely to hold off from cutting rates any further as inflationary expectations rise along with the realization that a stronger dollar is needed to stem inflation. This is a major change of tone.

The Bank of Mauritius must continue to intervene by selling dollars when needed in an uncertain global context

The likelihood of downward growth pressures coupled with uncertainty about the future direction of commodity prices along with the desire to avoid nasty second round effects have limited the ability of central banks to loosen monetary policy and hence most banks have taken a wait and see approach over the past few months despite dismal growth in their respective export sectors. The Bank of Mauritius (BoM) of course has done things differently despite these uncertainties. While prices of some agro commodities such as wheat and rice had witnessed recent corrections, higher grain and energy prices are already predicted to have an impact on global dairy and cattle prices.

The recent earthquake in China along with

existing supply constraints are already having an impact on copper and other metal prices. While oil prices may see a correction as demand growth slows with these prices (Car travel in the US fell by 4.2% in March before the most recent bullish trend), future oil supply constraints (or the perception of this), the beginning of the hurricane season in the Atlantic along with the simple fact that commodities are now an asset class easily accessible via the very liquid ETF route may not allow oil prices to fall as much as previously estimated.

USD/EUR exchange rate year end forecasts have also been revised upwards to between 1.45-1.57 range from 1.38 despite better than forecast GDP figures as housing inventories and negative real interest rates remain high which does not bode well for the oil price to fall by a large margin. It may not even fall at all and may even increase as forecasted by some. The potential for stagflation has increased and the bond market has reacted accordingly. The probability of an ECB rate cut has gone down to less than 15% as per the futures market while the probability of a 25bps rate increase has gone up to 65% and the US dollar forecasts should be taken with a grain of salt at best.

Politicians in the US have already threatened to impose more regulations (margin requirements would be positive but higher taxes would be bad) in the oil futures market which along with weaker US oil demand data and petroleum price hikes in subsidy dominated developing Asia had recently led to the slight easing we have witnessed as the contango had flattened. But it is difficult to know who a speculator is and who is not and in any event a speculator follows the trend, he does not set it. Speculators also add liquidity to the futures market without which many companies would not be able to hedge as they can now. You can only go long if others go short.

Any supply shock or dollar depreciation could again see the oil price skyrocket. If the ECB raises rates and the Feds are unable to follow suit due to lingering economic weakness in the US, we could be in for another rollercoaster ride. We need to see a dollar rally and further oil demand destruction in the US for the bears to win this one. As per most experts the fight between bulls and bears is a sixty forty proposition.

During the last week of April, the MUR/USD exchange rate crossed its short term exponential moving averages leading to a three week depreciating trend for the Rupee. This happened at around the same time when distributors and retailers were beginning to translate the positive impact of a stronger Rupee into lower prices. The roller coaster rupee ride can certainly create uncertainties that can end this pass through. Volatility in the FOREX market as defined by the popular 30 day rolling volatility of the MUR/USD exchange rate (or the widening Bollinger bands) has continued to increase in recent weeks and if we go back in time, its trend has been stochastic reflecting uncertainty.

In the medium term, it is difficult to predict whether the Rupee will strengthen or weaken

because capital inflows remain strong while higher oil prices and/or lower tourist arrivals (higher ticket prices) may drive the Rupee downwards. The BoM must continue to intervene by selling dollars when needed in the market in an uncertain global context. Higher energy prices and currency depreciations do not go well together. Over the last few weeks the 30 million dollar injection into the market has had a positive impact on stabilizing the currency and may even have broken the short term trend.

By influencing liquidity and credit, the BoM can prevent the "second round" effects of the inflationary burst from spiraling out of control

Some economic theories circulating in Mauritius deserve the attention of the Nobel committee. It is true that prices can rise because of supply shocks, such as an externally induced rise in oil or food prices. But that is already in current inflation, and indeed the BoM can do nothing about it since it is already in the bag so to speak. The key is what this will do to inflation over the medium term. By influencing liquidity and credit, the BoM can control demand and can prevent the "second round" effects of the inflationary burst from spiraling out of control.

Wages are just one example of the costs that can react to a rise in the price of inputs and anyone who reads Mauritian newspapers and who has witnessed the increasingly unrealistic demand of unions know that, especially when we know that the bargaining power of labor unions tends to increase as elections draw ever closer. The local distributor and shopkeeper can also react to a rise in costs by increasing their prices more than proportionately. Higher oil prices lead to higher input costs which will eventually filter towards Core inflation.

The BoM's job is to ensure that they don't see the spurt in inflation caused by an increase in input costs as a generalized increase in the inflation rate. As I have hence argued in an earlier article, fixing inflationary expectations is key, and the BoM can best do this if it has a clearly-defined objective of maintaining low inflation (4%-5%) over the medium term (i.e. over the next 2 years). I even heard the argument that Mauritius is a different country and hence inflation targets will not work. All countries that have adopted an inflation target are of course different and in fact we used to have an inflation targeting "lite" regime (early part of this decade) when global inflation was low and hence suited the credibility of the bank! Such arguments certainly worry me more than they make me laugh these days.

Successful inflation targets are more a function of the quality of management of central banks than country differences. We seem to be forgetting that Core2 and Trim10 account for the majority of the inflation rate, let us not always blame exogenous shocks. We seem to be relying on the base effect too much, that can be dangerous when the risks of upward pressure on input costs remains very high and when inflationary expectations are so loosely anchored.

Raise the Cash Reserve Ratio now

By Sameer Sharma (cont., from Pg 3)

The world is not yet in a recession but is witnessing an important slowdown and most central banks maintain that upside risks to inflation outweigh downside risks to growth despite slowing demand for imports in major consuming countries. The BoM is going against the entire world and has created negative real interest rates. It is sad that the media does not report this more often.

Despite a global slowdown, growth in Mauritius is expected to hover above 5% while inflation is now not expected to fall below 8% in 2008. The BoM seems to be hoping that a global slowdown will eventually solve the transitory impacts of rising commodity prices and for the favorable base to do the rest. The BoM has revived its motto of balanced growth. We should not ignore struggling sectors but what I have tried to point out in vain is that monetary policy creates more harm than good when real interest rates are negative and that fiscal policy is the answer. The BoM has essentially tried to resolve an imbalance by trying to help the export sector with a weaker Rupee by cutting back on the differential and has forgotten that negative real interest rates create even more imbalances in the financial system and to the economy.

Negative real interest rates lead to decreased domestic savings, higher credit growth, real estate bubbles and higher inflationary pressures

The current Monetary Policy Committee (MPC) certainly seems to be forgetful these days. While the previous MPC statement had mentioned negative real interest rates, the latest one ignored it. Negative real interest rates do not disappear by not mentioning it. Other central banks all around the world tend to release monetary policy statements the same day or the very next day.

One week in Mauritius does not seem to be enough not to forget or worse ignore mentioning real imbalances that are created by lowering the Repo well below inflation. If you consider the way we calculate inflation versus the actual rate of growth of the consumer price index, negative real interest rates are in fact even worse. In the rest of the world negative real interest rates lead to decreased domestic savings, higher credit growth, real estate bubbles, higher consumption and higher inflationary pressures.

All the lobbying and biased newspaper articles that talked about "excessive" currency appreciation will not change that. For too long the BoM has resorted to its drug of loose monetary policies that have only contributed to excess liquidity in the monetary system thereby furthering its impotence to deal with inflation. All we end up doing is again taxing the poor and the middle class but we do not seem to care too much about them in Mauritius because that does not suit the central bank's definition of balanced growth. After all the middle class and the poor do not get to sit with the chief economist of the BoM to talk about their problems like the exporters do.

The MPC is still not working as it should and the problem is that this is hurting the poor and the

middle class dearly and is driving unions to ask for increasingly unrealistic wage increases. Mauritius aims to become a major financial center in the Indian Ocean; we should put our record of creating negative real interest rates and how this creates Buddhist like balance in economic growth in the brochure!

This table on Page 5 shows the evolution of the 3 month money market rates (MMR) of various countries taken mostly from the Reserve Bank of India's monthly statistical bulletin. Figures for Mauritius, India, Botswana and South Africa are 3 month Treasury Bills rates taken from their respective datasets. The drop in our yields has been the highest out of all these emerging countries. Now the time period is important too because it captures the sub prime crisis and how short term interest rates have been impacted.

There are two main reasons why our short term yields have gone down so much and have been so volatile. Firstly the government has been reducing its deficit and has also been rebalancing the debt portfolio in terms of maturities (more longer term). Hence the supply of short term T-Bills fell. When supply falls, prices go up and yields go down (the relationship between yield and price is negative). On the demand front excess liquidity has been driving yields down due to high demand. The central bank has tried to sterilize liquidity by even issuing BoM bills recently (and also to make up for less Govt bills).

This is a big problem for the central bank and observers should not only think about the lowering differential here and how this can benefit the export sector and create Buddhist like balance for all. The more there is liquidity in the system, the harder it is for the central bank to control it. This affects monetary policy. Suppose one year from now, inflation were to pick up (or you can also go back to 2006), the central bank will normally raise interest rates to tighten money supply growth in the system. If there is excess liquidity in the system however, yields will fall because demand will exceed the supply of bills and create major problems and impotence to the monetary policy stance.

That is why the difference between the Repo and short term yields was so high in Mauritius. The decline in headline and Core inflation since June 2007 has more to do with the high base of the CPI than monetary policy which has largely been impotent (that's why they tried to turn things around this March). Since the beginning of the year, the BoM has been a net buyer of FOREX in excess of five billion rupees. This has of course entered the monetary system and sterilization cannot cater to this along with the other sources of monetary expansion such as negative real interest rates.

While short term yields have since stabilized above 7% partly due to the recent introduction and tweaking of monetary policy tools, they remain well below projected inflation, a major imbalance in any country of the planet. Your savings deposit hovers between 6.5% and 7% which means that you are already losing money by putting it in a bank before taxes. This means that it makes more sense to spend now and this

realization leads to higher inflationary pressures in the medium term. It works like this from Argentina to China and will not change in the case of Mauritius.

Policies should be geared towards constraining spending when capital inflow growth is high

Monetary policy is not as simple as some may think it is and the state has a major role to play in helping struggling sectors deal with appreciating currencies in the face of surging capital inflows. The best way and quite frankly the only permanent way to deal with surging capital inflows is for the state to constrain spending and double up efforts to further enhance fiscal responsibility as soon as possible. This will smooth out growth in aggregate demand and relieve liquidity inflows into the system. This will allow the central bank to better define its objectives and give itself more leeway to focus on inflation and to stabilize the currency in a more credible manner.

In fact, another concern is that capital inflows tend to be volatile. High growth in capital inflows tends to be followed by much lower growth which can have a negative impact on aggregate demand and on the currency (see the Indian Rupee in 2008). Hence policies should be geared towards constraining spending when capital inflow growth is high and raising public spending when inflow growth falls in order to smooth out aggregate demand growth.

With current uncertainty with regard to the future direction of commodity prices, it makes more sense to keep as much money as we possibly can in order to have the reserves to better deal with a potentially even worse global economic crisis (high oil prices impacting growth) by increasing spending and providing stimulus to struggling sectors if things get worse rather than relying on the BoM. We cannot be sure about the future but we cannot just assume that all will be fine and that inflation will ease and that the base effect will take care of all our inflation problems but this has been the logic of the rate cuts so far. Monetary policy should support the state in controlling capital inflows rather than being the only tool used.

Since September the IMF has been forecasting that commodity prices would fall; now they say that inflationary pressures may persist for a while yet. Our rate cuts have been too extensive and too quick and now we see oil prices rising! Since fiscal constraint should be a priority objective, part of the revenue needed for any major stimulus should be raised via a temporary solidarity levy on companies. The poor and the middle class should not shoulder everything due to our one dimensional view on monetary policy all the time. Taxation is about fairness and temporary levies on profitable companies that operate in one of the lowest corporate tax jurisdictions in the world is no sin and nor is it socialist.

Capital inflow management has not been good. We could of course have created sovereign wealth funds which include investing part of the

	MMR/TB June 2007	MMR/TB March 2008	Inflation YoY
Brazil	11.18%	11.20%	4.50%
India	7.39%	7.23%	7.80%
Botswana	8.32%	8.28%	9.0%
South Africa	n.a	10.42%	10.60%
Euro Zone	4.16%	4.72%	3.50%
United Kingdom	5.92%	6.01%	2.60%
United States	5.23%	2.26%	3.98%
Mauritius	11.15%	~7%	8.90%

FOREX reserves of the BoM in higher yielding bonds that would have made up for some of the losses of buying FOREX by the central bank and the Government could have for example tried to pay back foreign debt prematurely (creating some outflow) but there is such a thing as optimal debt portfolios and both these solutions are constrained by risk management considerations.

As it is known, it is far easier for the Government through tax-based or quantitative measures to control capital inflows through the stock market and bond market route. Controlling inflows through purchases of equity and Government bonds requires retracting some of the liberalization of foreign investment rules that have characterized Mauritius as an attractive foreign institutional investment destination (not to be confused with FDI) and should be considered very carefully and after much thought.

This is one more area where the dangers of lightly controlled or uncontrolled markets (and over-regulation too) are being driven home. It is better to learn the lessons early rather than be burdened with a crisis whose dimensions are unknown and solutions unclear. Capital inflow management should only aim for rupee volatility stability rather than value setting in an uncertain global context where depreciation could hurt even more.

Hiking the cash reserve ratio will take liquidity out of the system

The logic behind the BoM going directly after the differential to stabilise the rupee would have been completely understandable had real interest rates remained positive. In that case we would have been able to relieve an imbalance without creating another one. Unfortunately we have been blessed with excess liquidity and we also face exogenous shocks that have kept inflation high. The cash reserve ratio (CRR) that banks are required to maintain stands at 4% in Mauritius although the actual ratio as at March 2008 stood at 5.18%. In the spirit of spreading the cost of creating balance (the BoM motto) more evenly, there is a need to consider hiking the CRR in a negative real interest rate environment.

With all the liquidity that we have in the system and that we will continue to have with negative real interest rates and future inflows, it is important to take as much liquidity as we possibly can out of the system. This limits the medium term impact on the inflation front and gives more

leeway to the central bank to deal with FOREX. We need to be very careful however, a too high CRR will have a negative impact on smaller and newer banks' profitability and the costs are likely to fall on the consumer and on the economy. Before hiking the CRR, we must be able to differentiate between precautionary excess liquidity and involuntary excess liquidity which is more of a concern.

The large banks and even the already established banks have witnessed good profit growth over the years while the middle class has seen its purchasing power diminish. It is not fair for the poor and the middle class to pay for imbalances. At least everyone should, especially the more profitable sectors who may have lent a bit too much money to certain struggling sectors that have faced near collapse in the past despite a weak currency. A higher CRR, a higher Repo corridor of around 175bps coupled with a well managed inflation targeting regime will help ease the glut of excess liquidity prevailing in the system as showcased by the ever increasing M2/GDP ratio and bring credibility to central bank actions.

Let the state worry about the export sector! You do not play around with interest rates when real rates are negative unless you are planning to create inflation. We cannot claim that inflation will ease due to a favorable base when the transitory impacts are likely to last longer than expected and when the potential for filtration towards Core inflation remains high. Looking at past trend is one thing but the future may be quite different. Even if inflation falls, where it heads to is also important, anything above 5% should not be acceptable over a 2 year period. The BoM talked about reform and a new framework in 2006 but has still adopted some the failed policies of the past. For too long the BoM has been juggling with three conflicting objectives.

It tries to keep a weak Rupee to create an artificial advantage for the export sector (something that has not worked of course in a sector with high unit labor costs and dismal total factor productivity growth), it tries to minimize the cost of debt of the Government and finally it tries to manage inflation. This juggling (which lessens the credibility of the bank) simply means that our decadal 6.2% average inflation rate should not surprise you nor should you view this high rate as easing. There is no such thing as a strong or weak rupee Expectations theory teaches us that we cannot have negative real interest rates without

negatively affecting inflationary expectations. The rule of thumb is that if inflation increases by x%, interest rates need to be increased by more than x% in order to minimize its second round impact in the medium term.

We have so far been going against these laws, rewriting our own theories along the way. We cannot know for sure what may happen next year with regard to the inflation rate despite the favorable base because the risks of second round effects remains high as we head towards a third year of unacceptably high inflation in an uncertain global context.

The more the excess liquidity we have in the system, the more impotent the central bank shall be. Old mindsets need to change and policymakers need to stop relying so much on monetary policy. Some observers have argued that we need a stable rupee that is neither too strong nor too weak but there is no such thing in finance and nor are there definitions of what this not too strong and not too weak rupee is in an open market economy and nor do negative real interest rates give you any rupee stability.

We cannot peg our currency to a basket or the dollar itself because that would simply tie the hands of the central bank in terms of controlling interest rates; see the Middle East for details. Others have suggested that we should increase the purchasing power of the people as compensation for inflation but any measures that involve salary increases equal to inflation, or tax rebates when real interest rates are negative will be counterproductive and create inflation in the medium term. No matter how much the BoM may try to sterilise liquidity inflows into the economy due to the recent PRB increase, this kind of money along with other sources of M2 growth will be a challenge to say the least (despite the issue of special bonds).

In any event negative real interest rates will eat it all away. Indexation of savings instruments to inflation is an excellent idea but due to liquidity requirements most households cannot allocate a large percentage of their savings towards longer term maturities and hence the costs will remain great and liquidity inflows into the system will remain high. Excess liquidity will maintain high inflation (see decadal average for a gauge of past success) even when the transitory impacts are over.

That high growth in money supply leads to inflation with a one to two year lag is supported by empirical evidence all around the world and in Mauritius and cannot be wished away. As Jean Claude Trichet recently commented, "to remain credible, monetary policy needs to be constantly alert, keeping inflation expectations in line with our definition of price stability." The state needs to stand ready to intervene if the global growth picture deteriorates further and should not engage in wasteful spending or high compensations that can only lead to wage inflation spirals. The best way to increase the purchasing power of the people is to achieve low inflation (over 2 years) and continue the path of economic reform and fiscal responsibility.

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Nuages sur le commerce mondial

Par Jean-Yves Naudet

Il y a les fausses et les vraies mauvaises nouvelles. Les fausses : la hausse de l'euro ou le recul de la consommation. Cela ne change pas en profondeur la réalité économique. Et puis, il y a les vraies mauvaises nouvelles, et celle-ci en est une : le commerce mondial se porte mal. Or, s'il y a bien un vrai moteur de la croissance et un facteur de modération des prix, c'est le commerce international. Sa croissance s'est sensiblement ralentie. On pourrait compter sur les négociations de l'Organisation mondiale du commerce (OMC) pour la dynamiser, mais celles-ci piétinent, hélas.

La croissance des échanges mondiaux ne cesse de se ralentir

L'OMC vient de publier les derniers résultats du commerce mondial. En 2006, la progression des échanges était de 8,5%, plus de deux fois la croissance du produit intérieur brut (PIB). La hausse des échanges était même de presque 10% en 2004, soit deux fois et demi celle du PIB.

Brusque ralentissement en 2007 : la progression des exportations de marchandises tombe à 5,5% seulement. Certes, c'est toujours plus que le PIB, ce qui veut dire que la mondialisation continue à progresser : chaque pays exporte année après année une part plus grande de sa production. Mais le rythme d'internationalisation est plus faible.

Les prévisions de l'OMC pour 2008 s'annoncent encore pires. Il est question de 4,5% seulement, peut-être même moins encore, car l'OMC est prudente : on en est seulement au tiers de l'année. La prudence de l'OMC dans ses prévisions vient du fait que « *les turbulences sur les marchés financiers assombrissent les perspectives* ».

Pascal Lamy, directeur de l'OMC, affirme que « *l'économie mondiale traverse une période incertaine et préoccupante* ». L'OMC se borne à constater que les pays développés voient leur activité se ralentir, donc leurs achats de produits étrangers, ce qui ralentit à son tour le commerce mondial.

Mais les choses ne sont pas à sens unique en économie. Les causalités sont complexes et on peut aussi soutenir que c'est le ralentissement du commerce mondial qui contribue à la récession en Europe et aux Etats-Unis. En toute hypothèse, ce ralentissement est une mauvaise nouvelle, car moins de commerce extérieur, c'est moins de

concurrence.

C'est l'aiguillon des marchés extérieurs qui pousse les entreprises à la compétitivité. Moins de compétitivité conduit à payer plus cher les importations. On voit que ce sont encore les Allemands qui s'en sortent le mieux, parce que leurs performances à l'exportation leur permettent de maintenir leurs importations à un haut niveau.

Pourquoi ce ralentissement ?

Mais pourquoi ce ralentissement des échanges ? On nous renvoie toujours à des considérations conjoncturelles : la flambée des prix des matières premières, l'effondrement du dollar, la hausse de l'euro, la crise immobilière des subprimes, les turbulences sur les marchés financiers.

Mais il faut aussi prendre en compte les erreurs et les maladroites commises par les dirigeants des principaux acteurs du commerce mondial. Par exemple, on sait que les Chinois continuent à surévaluer leur monnaie et ne dépensent pas le pouvoir d'achat extérieur dont ils disposent. La gestion du dollar est aussi une gêne, le président de la Fed, Ben Bernanke, acceptant la dévaluation du billet vert pour éviter une récession trop lourde de l'économie américaine, alors qu'il risque fort de déstabiliser l'économie et de relancer uniquement l'inflation.

Enfin, concernant les « marchés » du pétrole et des matières premières, les prix sont encore très artificiels, faussés par les interventions, les subventions, les cartels et les considérations politiques : la lutte pour le réseau de distribution de l'or noir et du gaz naturel en Asie centrale, dans le Golfe et dans l'empire russe est engagée.

Pour confirmer le poids des politiques économiques dans le ralentissement du commerce, il n'est qu'à observer que les pays émergents, qui sont en partie à l'écart de ces manipulations artificielles, voient leur commerce extérieur progresser beaucoup plus vite. En conséquence, la part des pays en développement dans le commerce mondial des marchandises atteint un nouveau record en 2007, avec 34%. Ils ont amorti le ralentissement des échanges mondiaux. Ce maintien a permis de conserver une forte croissance du PIB dans ces pays émergents.

Les négociations de l'OMC au point mort

Comment relancer les échanges

internationaux ? La réponse est simple : en poursuivant la politique de libéralisation des échanges, menée jusqu'à aujourd'hui par l'OMC. Or le cycle actuel de négociation (cycle de Doha) est en panne. Cela s'explique en partie par des considérations politiques : à l'approche des élections américaines, certains (les plus hostiles aux échanges mondiaux) freinent en espérant une élection démocrate, puisque les candidats de ce parti sont plus protectionnistes que Bush ou McCain.

Mais d'autres aussi freinent. C'est ainsi que, face aux blocages actuels, Pascal Lamy se contenterait d'un accord sur l'agriculture, qui est effectivement le secteur le plus protectionniste. Mais la France ne veut pas en entendre parler, car elle défend la politique agricole commune, les subventions à l'exportation ou à la production.

Une libéralisation agricole permettrait au contraire de développer les exportations du tiers-monde, tandis que ces pays agricoles achèteraient des produits industriels aux autres pays. Inacceptable pour la France, qui défend le protectionnisme agricole. Pendant ce temps, d'autres pays freinent les accords de libéralisation dans l'industrie, toujours tentés par le protectionnisme. Et la France défend toujours l'exception culturelle.

Enfin, des arguments « nouveaux » apparaissent avec la hausse des cours agricoles : on reparle du concept d'autosuffisance. Chacun doit produire pour lui-même. On retourne aux politiques qui avaient ruiné le tiers-monde il y a trente ans : le développement aut centré. Bref, le protectionnisme est toujours vivant.

Les négociations de l'OMC traînent en longueur depuis des années, alors qu'une nouvelle libéralisation des échanges serait une des meilleures réponses au ralentissement mondial actuel du commerce et de l'économie. Ce sont les Etats qui ont provoqué la crise actuelle et ce sont eux qui en empêchent la solution. Comme toujours.

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L'ambiguïté des fonds souverains

Par Jean-Yves Naudet

C'est le nouveau sujet à la mode : l'Organisation pour la coopération et le développement économique (OCDE) vient de prendre position et des parlementaires français se demandent si la France ne devrait pas créer un fonds souverain français. Le sujet est important : ces fonds représentent environ 3 000 milliards de dollars. Et il est ambigu, car ce sont des fonds d'Etat : d'un côté, la liberté de circulation des capitaux nous incite à les laisser fonctionner librement ; de l'autre, l'Etat étant aux commandes, il y a un risque de manipulation politique, voire de « nationalisation » depuis l'étranger. Il faut donc essayer d'y voir clair.

3 000 milliards de dollars

Les fonds souverains sont créés par des Etats. Ce sont donc des fonds publics. D'où viennent-ils ? En général des devises gagnées par les entreprises du pays et donc des excédents commerciaux, qui aboutissent à la banque centrale (par exemple à l'occasion d'opérations pour maintenir le taux de change). Cela concerne donc avant tout les pays communistes comme la Chine, les pays très interventionnistes à fort secteur public, comme la Russie, et les pays exportant une matière première habituellement dans les mains de l'Etat, comme les pays exportateurs de pétrole.

On y trouve les Emirats arabes unis (675 milliards de dollars), Singapour (430), l'Arabie saoudite (300), la Chine (200), la Russie (100), le Koweït (70) (qui avait lancé le premier fonds souverain dès 1953 !), la Lybie (50), l'Algérie (42), Brunei (30). Les pays occidentaux sont logiquement plus rares : on y trouve la Norvège, qui y place ses revenus pétroliers et l'argent des retraites (300 milliards). Une certaine opacité régnant, les chiffres varient selon les sources. L'estimation mondiale minimale des fonds souverains est supérieure à 3 000 milliards de dollars ; on parle de 10 000 milliards en 2016.

Que faire de ces capitaux ? Les Etats, la Chine en tête, ont compris qu'il ne servait à rien de les conserver tels quels, mais qu'il valait mieux les placer. Ils les ont placés d'abord en fonds d'Etat, en bons du Trésor, et c'est ainsi que la Chine a généreusement et massivement contribué au financement du déficit budgétaire américain.

Mais les gestionnaires des fonds ont vite compris qu'on pouvait gagner plus d'argent en achetant des titres d'entreprises privées et tout particulièrement des actions. Ces fonds souverains se sont donc rendus propriétaires d'une partie du capital des grandes entreprises occidentales. La Chine vient ainsi d'acheter une partie du capital de Total.

OPA communiste sur le capitalisme

Les pays dont les entreprises ont ainsi été peu à peu rachetées ont réagi, partagés entre deux sentiments contradictoires. D'un côté, ils sont favorables à la liberté de circulation des capitaux. Attirer des capitaux étrangers est une bonne opération : cela apporte des financements, de l'argent frais, et on peut supposer que ces fonds obéissent à une logique de rentabilité et investissent là où il y a des perspectives de profits.

Mais d'un autre côté, une inquiétude a parfois grandi, par exemple en Allemagne, qui a envisagé des mesures de freinage. Pourquoi ? Parce qu'on n'est pas sûr que ces fonds souverains obéissent à la seule logique marchande. Ils peuvent choisir d'investir ici ou là, non pour des raisons de rentabilité, mais pour des raisons politiques ou comme moyen de pression.

Si leur part dans le capital d'une société devient important et qu'ils en prennent le contrôle, ne peut-on pas parler d'une nationalisation d'un type particulier ? Qu'elle soit faite non par l'Etat où se situe l'entreprise mais par un Etat différent n'est pas pour rassurer. C'est ce qui avait amené les *Echos* à parler « d'OPA communiste sur le capitalisme ».

La mode est à la dénonciation de la financiarisation de l'économie. La finance privée ne pose pourtant aucun problème si on la laisse libre : elle va là où il y a des profits à réaliser. Mais on peut s'interroger sur la finance étatisée, porteuse de menaces.

Lorsqu'on obéit à d'autres critères, on peut déstabiliser tous le système financier mondial. Ici, c'est vraiment l'opacité qui domine, pas la transparence. Enfin, on remarque que les pays à fonds souverains investissent à l'étranger, mais admettent mal la réciproque : voir la Chine ou la Russie.

Quelle attitude face aux fonds souverains ?

Les pays occidentaux semblent assez perplexes face à ce phénomène nouveau. Le secrétaire général de l'OCDE vient d'expliquer la position des pays membres sur l'attitude des pouvoirs publics à l'égard des fonds souverains. « *Les pays de l'OCDE entendent rester ouverts aux investissements des fonds souverains tant que ces fonds agissent à des fins commerciales et non politiques* ». Le protectionnisme serait en effet la pire des réponses et on ne combat pas l'étatisme par un autre étatisme. L'OCDE rappelle donc les principes qui sont les siens : « *non-discrimination, transparence, libéralisation progressive, etc.* ».

L'OCDE demande aux Etats de ne pas être naïfs, lorsque les objectifs de ces fonds sont « *motivés par des considérations politiques, de défense nationale ou de politique étrangère* ». Mais l'OCDE appelle aussi à « *user avec modération de la clause de sécurité nationale et ne pas s'en servir comme prétexte général pour échapper à leurs engagements d'ouverture de leur politique d'investissement* ». La marge de manœuvre est donc étroite, entre la liberté qui doit rester le principe et la vigilance face aux manœuvres des Etats.

Dernier épisode en date : des parlementaires français suggèrent de créer un fonds souverain français et la ministre de l'Economie, Mme Lagarde, a commandé un rapport dans la perspective de la présidence française. La confusion est à son comble puisque la sénatrice Goulet réclame « *un fonds privé à finalité publique* », ce qui est une aberration : détourner des fonds privés de leur finalité pour en faire des instruments de l'Etat ! Nous avons déjà la Caisse des dépôts, qui joue ce rôle et qu'il faudrait au contraire privatiser. La réponse à un surcroît d'Etat ne peut pas être étatique.

A l'intérieur, si on veut avoir une épargne conséquente pour investir, il faut non des fonds souverains, mais laisser se développer les fonds de pension, en passant à la retraite par capitalisation. A l'extérieur, il faut dénoncer ces fonds d'Etat et les limiter par de vrais changes flottants qui empêcheraient ces Etats d'accumuler artificiellement des devises : leur monnaie s'apprécierait, tout simplement. Il en va de même pour la rente pétrolière : la privatisation serait une réponse appropriée. Car si on reste dans la logique des fonds souverains, demain on retournera au mercantilisme étatique du XVIIIème siècle !

What is next?

By Kris Seeburn

We had a nice and wonderfully cut budget speech delivered by the Hon. Deputy Prime Minister and Minister of Finance, Rama Sithanen. A targeted approach to address the poverty and our social layer which needs this help at a time when it is needed. How true could this statement be?

Well, looking at the budget speech from a social layer below, we could and should find so many great things coming our way. Yet, are we ready to really take this risk when the Prime Minister of Malaysia is saying that they need to raise the prices of petrol? I am not an economist to question the approach but would tend to look at the budget with a more logical approach.

Here my views can be drastically opposed. We have suffered from a high rise on price on each and every thing we know of today. We live in a country where imports are higher than exports. Many core industry pillars are yet to prove themselves. When the minister talks about the construction sector booming.

I wonder whether we can really say it will be so for X number of years. We know it with the IRS schemes. The construction sector seems to have picked up but for how long? What is the strategy behind? The minister talked about rise in employment but realistically how good are our various industries doing? Are we really stable right now to really take this cut?

The business sector will not have found anything in the budget to be happy about. In fact they need to try and align themselves with the government as now with Pay Research Bureau (PRB) award 2008 the challenge for the private sector is to still retain their people again.

There tends to be an interesting migration that we would need to observe over a number of years. Of course the budget would suggest that definitely with three years of hard labour and so many problems for the middle and lower class people, the time is back to spend more again. Are we willing to do so right now?

I would tend to say: let's not spend like hell because with the prices going up worldwide we still need to be vigilant and you never know what is next. The day after the PRB had announced a general increase of 36.5%, there was an increase in prices on milk of about 25%.

The Minister of Finance clearly has the forthcoming elections in mind with the announcement that the PRB will be paid

entirely this year and the deficit brought from 3.8% to a mere 3.3% of gross domestic product. The increase in government spending in line with inflation has been forgotten with expenditure growing day after day.

Social support and infrastructure are needed for tertiary education

Of course the approach on certain issues is nevertheless welcomed. Hard core poverty is addressed through generous targeted incentives to education. This is critical as investing in education avoids the pitfalls of direct social spending and addresses one on the fundamental causes of poverty.

A laudable gift to parents who would really like to see their children being more learned is the introduction of the government guaranteed education fund tied with an increase in capacity of the University of Mauritius (UOM) and the University of Technology, Mauritius (UTM). But the previous government had the same approach which was still never really implemented.

I see for those students willing to look at tertiary education the possibility of having a loan and then pay back when they have a job. It sounds like the typical Canadian approach where such a solution is proposed. The question is how much are the private and the public sectors ready to accommodate these students. As the education sector will find a boom sooner or later, the need to provide jobs for these graduates will be very important in the next upcoming years. Creating a social support is nice but we also need available infrastructure for those coming out.

UTM has been mentioned and the government is catering for expansion of both universities. UOM has enough leverage to still cater for students in a planned way. But what about UTM? This University was promised to have a plot in Réduit, Ebène and now Cote d'Or. Is this something we would see in the next decade? Nothing is clear and no real budget has been allocated as such.

Of particular concern is the elimination of duty on chicken, a sizeable industry in Mauritius. I wonder how this industry is going to evolve as this is a very competitive area. How are the producers going to manage that? Infrastructure was at the forefront but we have heard so much and seen so little on that front that I can only doubt the government's willingness and drive to achieve its objectives.

More specifically, the minister mentioned a toll ring road around Port-Louis and a toll 'Harbour Bridge'. Road users are not asking for two alternatives around Port-Louis. When is it going to happen?

Successive governments have been going through so much studies that I wonder whether one day something is really going to be done about it. Government is planning to allow Small Independent Power Producers to connect to the national grid. This shall only come about if the Central Electricity Board or the independent regulator offers a commercial price to operators. Do we have small and medium enterprises having enough support or money to be able to provide this?

From promises to reality

So much "Billions" put down on funds, but who will profit from that? This is a budget to calm down so many people making noise about the situation in Mauritius. But what is the real picture?

Personally I see lots of promises and ideas that have been stated, but the only benefit and reality would be when those projects become reality. We have heard so much of the Empowerment Programme. I have seen people who have gone to them but have returned without a single penny and not even a single help. And I have also seen projects worth nothing being empowered by this programme.

So much of the support is set out today to help eradicate poverty, yet we could never be able to eradicate this until we really force people to undergo a radical cultural and attitude change. We know so many who still will never go to work or willing to find a job. They seem to be happy with the way their lives go on. But we can always try.

To conclude, I personally feel the Minister of Finance has faced with too much money in the piggy bank that he has decided to give most of it away rather than trying to hold a bit by acting on some real fiscal issues. I am wondering whether we are being sold nice dreams to support our ego.

Elections cannot be too far away! We are getting ready and rolling for the next elections. One needs those people who are complaining right now to be happy to build up for the next run.

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