CONJONCTURE

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THINKING OUT OF THE BOX !

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

2009 Economic Outlook

By Sameer Sharma *(Cont on Pg 5,6,7)*

If one is to believe in the mean variance framework, hedge funds are an amazing addition to a portfolio and tend on average to deliver similar returns to those of stock markets with considerably less risk as defined by the standard deviation. The reality however is quite different. Various strategies in the hedge fund world are highly leptokurtic and are subject to considerable left tail risk. Once you begin to incorporate the higher moments of the return distribution in your optimization toolkit, you begin to get the whole picture. If you perform various multi factor regressions on hedge fund returns, you begin to realize that the alpha you were seeking is mostly made up of repackaged Beta being sold to you at alpha prices.

The roller coaster ride in the US stock market over the past two months has been a story about the crisis of the hedge fund industry as well. In fact this once upon a time 1.7 trillion dollar loosely regulated business is expected to be worth less than half that by the end of June 2009. It is panic selling by hedge funds that has largely been responsible for the downward spiral of US stock markets in October. Of course naked shorting did not help matters either.

All the printing of dollars and euros will create another headache

The hedge fund story can be summed up as follows. Whatever money was made by hedge funds from January to August 2008 can be mostly attributable to small cap investing in commodities and alternative energy related companies. These funds then took short positions on the stock market index and were able to generate substantial alpha when the commodities story was still on. Other hedge fund strategies such as convertible arbitrage and distressed securities arbitrage have not been working too well as credit spreads have continued to widen, and margin requirements on highly levered portfolios have certainly made many a fund disappear.

When the Baltic Sea Dry Index fell below important resistance levels signaling the end of the commodities play, the hedge funds were sitting ducks. A fund of hedge fund is a much hated type of hedge fund in the hedge fund world that essentially invests large sums of money in various other hedge funds that follow various strategies. They are the dirty middlemen of the hedge fund industry because they force other hedge fund managers who receive their investments to think short term.

When the fund of funds managers saw the credit spreads continue to widen and when they saw the end of the commodities play, they began to redeem like there was no tomorrow. This forced various hedge funds to sell their already loosing positions on small cap stocks. Hedge fund managers had to prevent further losses and increased their short exposure on various market indices which pushed the entire market down on small volume making the month of October one of the worst months on record.

The problem was that this shorting did not work because the diversified market indices had more solid and stable consumer staple and large cap stocks than the hedge funds did and they still lost money. What do you do when you are a hedge fund that loses money? You short the market index futures some more!

Market neutral hedge funds which essentially are fully computerized hedge funds that trade based on various trading algorithms which are in themselves econometrically derived also could no longer make any money because stock markets were no longer behaving on fundamentals but on panic. Many hedge funds have liquidated and disappeared. In fact that is why you see the Dow Jones going up by 400 points until 2.45pm on a typical day and down 600 points after the last minute hedge funds have to sell stocks in order to meet redemption requirements.

Of course, the US economy has not helped matters for the poor hedge fund manager and the US Treasury's flip flop on buying bad bank assets can only make matters worse.

Real estate, investment and saving

By Eric Ng Ping Cheun - *(Cont Pg 4)*

The global financial crisis has sparked off a debate over whether the impending world recession and the resultant limited availability of credit are going to impinge on the Mauritian real estate sector and consequently affect the construction industry. Some anticipate only a slower growth in property value while others believe that the risk of recession is certainly there as Mauritius does not have a diversified property market.

Two reports published by *l'express* on 13 and 14 November threw light on this conundrum. The first one mentioned that the crisis did not have a curb on Integrated Resorts Scheme (IRS) projects. Conversely, the second one announced a slowdown in construction projects, quoting the administrator of the Building and Civil Engineering Contractors Association as saying that *"some IRS promoters have reduced the scope of their investments"*.

The real estate market has a low correlation with the real economy

Once a taboo, the IRS is now lauded by the authorities, so much that they appear sensitive to negative comments on this sector. True, IRS activities contribute to some extent to the economy in terms of job creation, foreign direct investment and revenue for government. But they cannot be a key performance indicator. In a country with very limited land resources, it is not a sensible policy to make the real estate sector become a crucial generator of economic growth.

The world recession will definitely impact on the sale of IRS villas as foreign buyers diminish. Moreover, the sharp depreciation of the rand and of the pound sterling against the rupee dents the country's competitiveness in its two main markets, South Africa and England. The downside risks to property growth are reflected in the fall of IRS-related stocks listed on the Port Louis Stock Exchange: the prices of Ciel Investment, Deep River Beau Champ and Médine S.E. have tumbled by a further 24% since the financial crisis unfolded on 15 September.

The opening of the Mauritian property market to foreigners four years ago has put buyers into a feeding frenzy. Some say that the market is not really in a bubble or rather is still in the early stage of a boom, and it has yet to burst. The truth is that nobody can tell how far into a bubble the market really is, because property valuations are done roughly and real estate indices are lacking.

The Central Statistics Office (CSO) computes a construction price index (CPI) which measures the change in the level of construction prices for residential buildings only. The index shows overall increases of 9.8% for July, 10.7% for August and 11.7% for September compared to the corresponding months of 2007. With such high rates, it is difficult to overlook an industry buzzing with activity.

However, the CPI does not have a good record in predicting important turns in the business cycle. In 2000, when economic growth rebounded strongly to 9.3%, the index rose by only 1.4%. In 2005, when the economy slowed down to 2.3%, the index shot up by 7.7%. Besides, the real estate market has a low correlation with the real economy simply because returns are based on appraisal value.

One can certainly make money in property investment in Mauritius. Most property funds that have been set up are captive as the promoters already had the properties. These funds are just another way of raising money. The question is how adequate a return an investor will get that compensates for the risk incurred.

The risks involve the liquidity nature of the property investments, the volatility of the demand, the location, the valuers, the tenants and the management of the property.

One may find four good properties in Mauritius, but they are not enough to build a diversified property portfolio that will generate great returns. When rental income is assessed against appraisal value, rental yields are found to be quite low and even close to zero in real terms. Hence, developers have to bank on capital appreciation.

Turbulence financière ou crise politique ?

Par Jacques Garello

Le débat sur la situation financière mondiale et sur la façon de la gérer tourne autour de l'idée que nous vivons actuellement la crise la plus profonde que les pays riches aient traversée depuis 1929. Même quand ils se veulent rassurants, gouvernants et médias partent du postulat que si rien n'est fait, on s'achemine vers l'apocalypse économique.

Un conflit n'était-il pas en train d'exploser entre ceux qui ont peur de la faillite et ceux qui ont peur des impôts, entre ceux qui appellent l'Etat et socialisent l'économie au prétexte de socialiser les dettes et ceux qui remettent l'Etat à sa place et préfèrent la responsabilité à l'impunité ? Et si les libres transactions sur le marché étaient finalement capables de digérer la « crise » ? Et si la crise n'était en fait qu'une turbulence financière, sans trace durable sur l'économie mondiale ? Et si la dramatisation ne devait rien au hasard, mais avait pour mobile la réhabilitation de l'État, du dirigisme, de Roosevelt et de Keynes ?

Toutes ces questions m'ont troublé, et je prends aujourd'hui le risque d'affirmer que la crise n'est pas une crise, ou n'est pas la crise que l'on croit. J'engage ma réputation dans ce diagnostic, mais j'ai de bonnes raisons pour le faire, et de rassurer les peuples affolés par les discours alarmistes, les épargnants, les contribuables, les travailleurs et les entrepreneurs.

L'effet d'assainissement des crises

La crise est-elle une crise ? Courons-nous le risque d'une récession mondiale, d'un chômage massif, d'une réduction spectaculaire du commerce mondial, comme on l'a vu dans les années 1930 ? Je remarque déjà qu'après la Grande Dépression l'économie américaine s'est finalement relevée, pour devenir dix ans plus tard la plus grande puissance mondiale. Les prophètes de malheur en ont été pour leurs frais : le capitalisme renaissait de ses cendres.

J'observe encore qu'aujourd'hui la production et les transactions internationales ne sont pas à l'arrêt. Les contre-performances de l'économie française ne doivent rien à la « crise », puisqu'elles lui étaient bien antérieures et qu'on en connaît les causes : délabrement des finances publiques, impôts et charges sociales trop lourds, rigidité du marché du travail, réglementation paralysante, faillite du système de formation et d'éducation.

Mais la crise a bon dos, et il est facile pour les responsables de l'échec français de passer leurs erreurs au débit des financiers américains, et de donner des leçons d'éthique au reste du monde. Je ne vois pas non plus la raison pour laquelle la Chine et l'Inde stopperaient brutalement leur expansion parce que Wall Street se porterait mal.

Je vois enfin que progressivement on en revient à des méthodes éprouvées par les financiers : les actifs sont enfin passés au crible, les créances douteuses sont revendues à bas prix par des financiers qui anticipent que le taux d'impayé va diminuer, une fois le gros du ménage effectué. Nul doute que depuis plusieurs mois on purge et, chacun balayant devant sa porte, la ville devient propre.

L'effet d'assainissement des crises a été observé et expliqué à plusieurs reprises. Friedrich Hayek a attribué les turbulences économiques au mal-investissement : trompés par les politiques monétaires et les faux prix, les investisseurs ont pris des initiatives inconsidérées. Il faut ensuite procéder à une réaffectation des investissements et mieux répartir les ressources rares.

Douter du marché, c'est douter de l'homme

Ces moments de remise en ordre sont difficiles à passer : ils impliquent une grande capacité d'adaptation et d'innovation. Les économies complexes et mondialisées du XXIème siècle sont plus solides, parce que plus souples, avec des liens moins rigides entre elles. Au XIXème siècle une mauvaise récolte se propageait à l'ensemble de l'économie. Aujourd'hui quand un secteur est en panne, un autre prend le relais. Trop d'argent, trop de crédit pour l'immobilier ? On repartira sur d'autres bases, plus proches de la vérité du marché, et on reviendra à un autre immobilier un jour ou l'autre.

Les grands discours sur les connexions de la finance internationale ne résistent pas à la réalité : tous les jours de nouveaux produits et de nouvelles techniques apparaissent, de nouveaux contrats sont signés : les hommes veulent progresser et améliorer leur sort. Le marché est l'expression de la créativité de l'homme. Douter du marché, c'est douter de l'homme.

J'en viens ainsi à la vraie nature de la vraie crise : elle est politique. Le doute profond s'est installé dans l'esprit d'une élite éclairée, qui ne croit pas que de simples hommes et femmes puissent régler leurs problèmes. Aux yeux de cette élite, la mondialisation et la finance sont des choses trop complexes pour être laissées entre les mains de simples mortels. Ils veulent leur revanche sur cette mondialisation qui les a descendus de leur piédestal, parce que dans un monde ouvert et concurrentiel, il n'y a pas besoin de direction ni de régulation. Il n'est besoin que d'un état de droit, du respect de la parole et de la responsabilité de ses choix. Les étatistes sont poussés par tous ceux qui vivent de l'Etat, et veulent protéger leurs privilèges contre les menaces d'un marché mondial qui exige la compétitivité et élimine le parasitisme.

Aux Etats-Unis, les sénateurs républicains ont eu raison de plaider contre l'élite, contre le dirigisme, contre son cortège d'impôts, de privilèges et de réglementations. Ils ont souligné la nécessité de restaurer la responsabilité. La liberté exige la responsabilité. Sans responsabilité il n'y a pas de liberté. Ces sénateurs ont fait le choix de la liberté, rappelant que c'était une valeur fondatrice de la civilisation américaine. Choisissons aussi la liberté, et misons sur la confiance.

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La bourse est-elle devenue folle ?

Par Jean-Yves Naudet

Et si le président français Nicolas Sarkozy avait raison ? On se souvient du discours de Toulon : *« L'idée de la toute puissance du marché qui ne devait être contrarié par aucune règle, par aucune intervention politique, était une idée folle. L'idée que les marchés ont toujours raison était une idée folle »*. Dans le domaine de la bourse, on peut se demander s'il n'a pas dit vrai : la bourse semble devenue folle, avec la chute des cours, puis maintenant l'alternance de périodes de hausse et de baisse. En réalité, la bourse se comporte d'une manière très compréhensible. Il y a des explications rationnelles aux mouvements actuels.

La bourse est indispensable au financement des entreprises

D'abord, le marché n'est pas une personne ; il y a des personnes – chacun de nous – qui opèrent sur le marché qui ne fait que traduire leurs choix. Ni la bourse, ni un autre marché ne peut devenir fou, mais chacun d'entre nous le peut. Le marché est une procédure de libre choix, de coordination et de découverte, dont la raison d'être est l'échange. On peut faire de mauvais choix, mais dire que le marché a tort, c'est dire que de mauvais choix ont été faits. Qui peut en juger ? Les hommes politiques s'en croient capables, alors que leurs choix sont au mieux hasardeux au pire ruineux.

La bourse n'est qu'un marché parmi d'autres, le marché des capitaux à long terme. On y échange de la monnaie contre des titres, et avant tout contre des actions. La bourse n'est pas apparue par hasard, ou parce qu'une autorité politique l'aurait voulu, mais pour répondre à de vrais besoins et tout d'abord celui des entreprises de se financer en recueillant l'épargne de ceux qui ont une capacité de financement. Acheter une action nouvelle, c'est apporter des capitaux propres aux entreprises ; c'est leur permettre d'investir et de se développer.

L'actionnaire est copropriétaire de l'entreprise. L'achat ou la vente d'actions existantes est donc un échange de droits de propriété. C'est ce qui assure la mobilité du capital, ce qui permet (par exemple lors d'une Offre Publique d'Achat) de changer des équipes dirigeantes peu dynamiques en les remplaçant par d'autres qui pensent pouvoir mieux la gérer. La bourse, confrontant toutes les offres et demandes, fait apparaître un vrai prix, porté à la connaissance de tous, qui donne une information sur la situation de l'entreprise ou sur ce que les opérateurs en pensent.

25 000 milliards partis en fumée ?

Depuis quelques mois, partout, les bourses font du yoyo, avec une tendance générale à la baisse. La bourse de Paris a perdu environ 43% de sa valeur depuis le début de l'année, c'est-à-dire que les cours ont reculé de 43%. Depuis début octobre, les principales places financières mondiales ont reculé de 25%, avant de remonter brutalement, mais la tendance générale à la baisse existe depuis plus de dix mois. On a calculé, même si le calcul est forcément un peu imprécis, que l'ensemble des bouses ont vu « partir en fumée » près de 25 000 milliards de dollars, soit presque le double du produit intérieur brut des Etats-Unis.

Parfois c'est pire, comme la bourse de Moscou, qui a perdu 72% de sa valeur, ou celle de Reykjavik, 94% ! Tout cela n'est-il pas fou ? Certains voudraient fermer les bourses : autant casser le thermomètre ! Mais pourquoi les opérateurs n'ont-ils pas réagi positivement à tous les plans concoctés par le pouvoir, qui, tout en avouant être « en faillite », trouve des centaines de milliards pour soutenir les banques ou les entreprises, en nationalisant une partie de leur capital ? Comment les opérateurs ne peuvent-ils pas être reconnaissants de tout ce que font pour eux les pouvoirs publics ? Enfin les opérateurs ne sont-ils pas fous quand un jour la bourse baisse de près de 10% et qu'elle remonte de 7 ou 9% le lendemain !

Tout cela s'explique très bien. Les opérateurs en bourse, et chacun d'entre nous peut l'être, ne sont pas des philanthropes qui donnent leur argent, ni des hommes d'Etat qui dépensent l'argent des autres. Ils opèrent avec leur argent et sont donc attentifs au rendement (le dividende, part des profits distribuée) et au risque (possibilité de gain ou de perte en capital). Ceux qui vendent des titres ont été ces temps-ci plus nombreux que ceux qui en achètent, c'est ce qui fait baisser les cours, car les épargnants sont nombreux à penser que l'économie entre en récession, du moins dans les pays développés et que les profits vont reculer (c'est déjà le cas), donc les dividendes, et que la valeur même des entreprises en sera affectée.

Dans l'incertitude, garder son sang froid

Si la bourse a baissé, c'est que l'on a perdu confiance dans la solidité de nos économies et de nos banques. Les épargnants ont compris que des erreurs majeures ont été commises dont on est en train de payer le prix. Ils ne savent si l'agitation politique actuelle, les mesures prises, les sommets qui se succèdent, ne vont pas aggraver la situation. Surtout ils se demandent si l'économie est aussi solide qu'il n'y paraît, quand on leur annonce chaque jour que le bâtiment, l'automobile, le transport et la sidérurgie réduisent leur activité.

Mais, en sens inverse, les opérateurs en bourse se disent que les cours sont tombés si bas qu'acheter des actions sous-évaluées est aujourd'hui une bonne affaire. Ils apprennent aussi que certains pays (les émergents) ou certains secteurs (chimie, électronique) ou certaines entreprises (Essilor par exemple) semblent poursuivre leur expansion. Enfin, et non le moindre, la grande peur d'une récession massive et durable ayant déjà été anticipée dans la baisse des cours, il n'y a aucune raison de l'enregistrer à nouveau. Au total, comme la situation est incertaine, cela se traduit par l'incertitude des comportements.

Que va-t-il se passer ? Va-t-on retrouver l'euphorie ? Personne ne peut le dire, car personne ne sait si la récession va s'aggraver, si les gouvernants vont aller dans le bon ou le mauvais sens. Ce qui est certain, c'est que la récession ne durera pas toujours ; dès que les marchés financiers (qui sont plus clairvoyants que tous les instituts de prévisions) vont anticiper durablement une reprise, avant qu'elle ne se soit traduite dans les chiffres, les cours remonteront.

A long terme, la bourse est toujours gagnante, parce que la croissance finit par revenir. Cela nécessite de garder son sang froid (tant qu'on n'a pas vendu, on n'a pas perdu) et cela nécessite surtout que les pouvoirs publics gardent le leur, au lieu de commettre de nouvelles bévues. Une nouvelle flambée de « régulation et supervision » n'arrangerait certainement pas les choses.

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Real estate, investment and saving

By Eric Ng Ping Cheun - (Cont from Pg 1)

Investors need to think in terms of risk premium. Rental yields are unattractive compared with risk-free after-tax 7-year government bond yields. No one would invest in commercial real estate at an internal rate of return (IRR) of 10%. To raise the IRR, developers inject a dose of leveraging through debt financing. But going beyond 70% leverage carries a lot of risk.

Cantillon effects in real estate

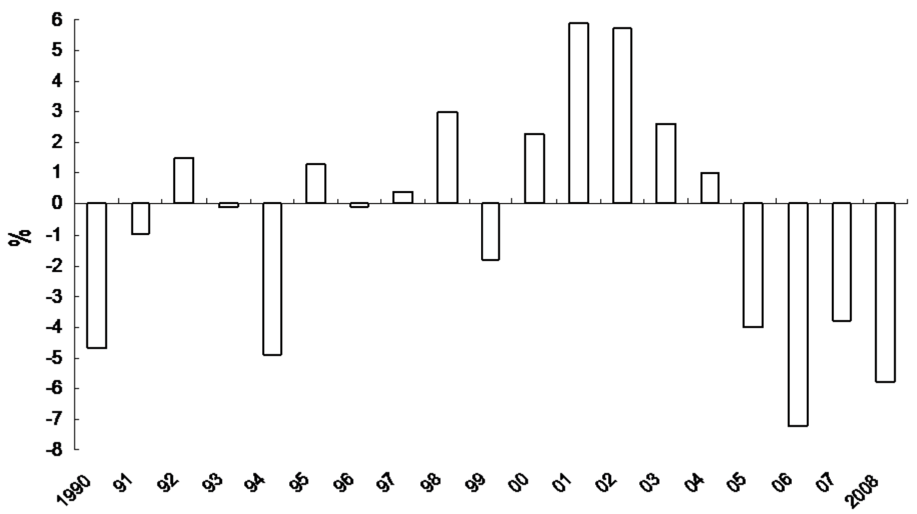
There is a flip side to leverage when bubbles pop. We can define a bubble as activities that spring up on the back of loose monetary policy. Monetary pumping gives rise to misallocation of resources which manifests itself through a relative increase in non-productive activities.

Surely, just as constructing buildings does not cause economic collapse, so there are linkages between construction booms and financial busts when monetary expansion, overinvestment and speculation constitute the nexus of capital intensive activities. The interest rate (the relative price between consumption goods and capital goods) is what makes the construction business a speculative activity. Changes in the interest rate can have Cantillon effects, named after the French economist Richard Cantillon, on real estate projects.

The governor of the Bank of Mauritius (BoM) prides himself on having successively cut the benchmark interest rate, from 9.25% to 7.75%. One of the Cantillon effects is that a lower rate of interest tends to increase the value of land as it reduces the opportunity cost or full price of owning land. It will also stimulate the demand for land and result in a rise in land prices. However, since the deciding factor with land is location, a change in interest rate has differential effects on land prices.

As the worldwide crisis prompts multinationals to outsource their business in cheaper locations, developers in Mauritius will build speculative office buildings which are investments that rely on an uncertain flow of rental income. Profit calculations cannot show for sure whether interest rates will remain low. Overbuilding is a problem of too much financing at too low a rate. Highly leveraged building projects are a natural response to government-sponsored, not market, interest-rate signals: the latter distort the structure of production into bad investments and improperly allocated labour, at a time when liquidity should flow into productive activities.

Resource Balance (Difference between saving and investment) as a % of GDP at market prices



The BoM has taken the risk of an endogenous shock to the economy as a result of the lowering of the key Repo rate by 50 basis points on 31 October. The decision is based on the ground that the global financial crisis will be hitting Mauritius' textile and tourism industries which account for 15 per cent of its gross domestic product (GDP). A slowdown of the Mauritian economy, which is a likely eventuality in 2009, will be caused by real factors in the form of falling export orders and tourist arrivals.

Society's investment cannot exceed its voluntary saving for long periods

At present, the crisis is doing collateral damage to the stock market and the property market. Both are asset markets sharing the common belief that they will keep rising no matter what happens to the real economy. This is an illusion but it has led Mauritians to become reckless in their speculations. Now the stock bubble bursts and the real estate boom starts to unravel.

Since the day Lehman Brothers declared bankruptcy, the all share index of the Port Louis Stock Exchange has lost 355 points, or 21 per cent, but has crashed 800 points, or 38 per cent, since its peak of 2,101 points achieved on 18 February 2008. Although the values of the blue chips remain within their fundamental worth, stockholders prefer to convert assets into cash.

For their part, many property owners are still convinced that real estate is the one sure bet in economic life. But they have pushed property prices so high, in some cases up to three times their original value, that they can only fall back drastically as the supply of new buyers runs out.

The substantial rise in the prices of real estate assets and capital goods has been fuelled by negative real interest rates on the back of an inflation rate higher than term deposits rates and even treasury yields. The Mauritian economy has been buoyed up by an investment boom in the most capitalistic sectors, namely the construction industry. In its September last issue of National Accounts, the CSO writes that the 11.3 per cent real growth in private investment estimated this year *"would be mostly attributable to high investment in commercial and office buildings, hotels and IRS projects"*.

The real risk to the Mauritian economy is that these excesses will unwind as building and real estate developers realize that their investment projects are overly ambitious. The latter have been financed by credit expansion when economic agents have been unwilling to sacrifice their consumption and raise their voluntary saving. Entrepreneurs act as if households had increased their saving when they have actually not done so.

Voluntary saving has not only failed to keep pace with economic growth, but it has also fallen to a negative rate in real terms. In 2008, gross national saving (GNS) rose by only 3.3 per cent against a nominal GDP growth of 12.2 per cent and at a lower rate than the 6.3 per cent inflation rate shown by the GDP deflator. More worrying is the fact that saving lags well behind investment for the fourth consecutive year.

The crux of the economic problem of Mauritius lies in its resource gap as a consequence of higher investment relative to saving. The resource gap, as measured by the difference between GNS and gross domestic fixed capital formation, stood at 4 per cent of GDP in 2005, exploded to 7.2 per cent of GDP in 2006, narrowed to 3.8 per cent of GDP in 2007 but widens again to 5.8 per cent of GDP this year. Society's investment cannot possibly exceed its voluntary saving for long periods.

The final amount of saving and investment must always be identical ex post. No society can durably force economic development by inflating investment through credit expansion unbacked by a parallel increase in voluntary saving. Any level of investment that exceeds that of saving results in wrong investments of the country's saved resources and finally in an economic crisis.

The government should reprioritise spending in favour of viable firms

Misallocation of resources has been encouraged by uncontrolled growth in the money supply as loans have been granted at below the natural rate of interest that balances voluntary saving and demand for capital. From 1991 to 2006, the money supply M2 in the form of bank notes and deposits grew at an average rate of 13 per cent per year, thus increasing six times. Between March 2000 and January 2004, the savings interest rate was continuously cut from 9 to 4 per cent.

The shock of monetary growth has distorted the productive structure and made it artificially capital intensive. The Austrian business cycle theory, first propounded by Ludwig von Mises and Friedrich Hayek, teaches us that recession is triggered by a shortage of saving, i.e. saving insufficient to complete capital intensive investments launched by error. Borrowers who have invested in long term capital projects will be called upon to improve their balance sheet.

In public pronouncements, the Finance Minister, Rama Sithanen, regards recession as reflecting a fall in demand for products or labour, which can be corrected by ramping up spending. According to this view, common to Keynesians and monetarists alike, injecting more money in the economy would help stave off a recession. But such a policy could delay necessary liquidation of unwise investments.

Instead, the government should reprioritise spending in favour of viable firms that can restructure and have the potential for securing a return on capital employed above its weighted average cost of capital. A fiscal response, if well targetted and geared towards productivity growth, can help avert a recession.

Meanwhile, Mauritian banks need to be extremely cautious about credit quality. They may suffer large losses on property lending as credit to construction has posted a 34 per cent annual growth in August. The BoM may respond to the surge in property prices by using regulation, not monetary policy, with a tightening of mortgage lending standards.

2009 Economic Outlook

By Sameer Sharma- *Cont from Pg 1 - cont.,Pg 6-7*

Here is the story on that. You have 700 billion dollars, half of which is being spent on directly recapitalizing banks via the preferred shares buy route and another half which was meant to buy bad debt. The problem is that all the money you have been giving banks (with the first half) is not being lent to consumers and small businesses thereby hurting the economy even more.

Many problems are popping up everywhere, banks do not still trust each other in the US despite implicit guarantees by the central bank on various instruments and the US auto industry is nearly bankrupt because it cannot get access to short term financing anymore. It is becoming increasingly difficult to get small time loans and even credit cards and so the Treasury finds itself in a situation where that 700 billion dollars is looking mighty small from its stand point.

The private sector is delivering and does not want to play at this point. The Federal Reserve has already made some 2 trillion dollars worth of emergency loans and has an awfully interesting balance sheet for it and only God knows where the money for this endless spiral of bailouts will come from next under an Obama regime. Suffice to say that a lot of dollars are being printed these days.

Latest projections indicate that the world economy is expected to slow down dramatically and grow by a mere 1.8-2.4% in 2009 and projections for eventual economic recovery are being continuously pushed back. The world is only now expected to recover in a very moderate fashion in late 2010. Growth in emerging market economies is now expected to slow down towards the 5.5-6.5% range, nearly a 30% drop in growth. In the medium term, demand for commodities is not expected to pick up. Oil prices are expected to remain within the 50-80 dollar range over the next 12 months. There is no threat of food and commodities based inflation in the short to medium term although all this printing of dollars and euros will create another headache in the longer term.

Inflation forecast at between 5.5% and 7% by December 2009

This brings me to the much hyped and loved Keynesian economic theories that Mauritian policy makers love to adhere to. I do not blame them: in the 1960s and 1970s, the last time many of them went to school, Keynesian economics was still in fashion. The Great Inflation refers to the period when U.S. inflation rose from negligible levels in the mid-1960s to double digits in the early 1980s. Though the episode scarred a generation, the memory of the fire has evaded Mauritian policy makers for the past decade.

As a recently well respected economist named Samuelson wrote in the Washington Post, *"far from being an unavoidable accident, the relentless wage- price spiral that ravaged the 1970s was the direct consequence of a well-meaning attempt to keep the economy permanently near full employment."* That the government must increase fiscal spending in order to have a soft landing is beyond debate but the question of how much and on what is where the abuse tends to come from. When governments try to do too much, that is precisely when they make things worse.

Before I get to the fiscal side, let me entertain the monetary side. Have you ever noticed how articles about doom and gloom tend to mysteriously appear a few weeks before there is a major policy move in Mauritius? What is funny is that the articles tend to talk about the same things on and on over and over again every day. This has always been happening and eventually such campaigns get policy makers to hold emergence meetings.

Does anyone remember how the current Governor of the Bank of Mauritius (BoM) was characterized as being an autocratic king in the weekend edition of a local newspaper one day before the Monetary Policy Committee (MPC) met in September? In a country where many newspapers are so easily influenced by powerful lobby groups and the economic think tanks that work for them, I do not find that surprising at all. A sense of panic was created in October, not that the fundamentals were strong either, which forced policy makers to negotiate and react.

Firstly, the good news. The change in the way the Automatic Pricing Mechanism works is the right thing to do, not only for the short term but for the long term as these one time quarterly shocks did more to increase inflation variability than diminish it. Assuming that crude prices remain around the 50-75 dollar range and that the rupee remains relatively stable (an uncertain proposition), inflation in Mauritius is now forecast to hover around 9.7% in December 2008, at around 9% by March 2009, between 7.5% and 8.6% in June and between 5.5% and 7% by next December. Convergence towards pre-June 2008 Core2 inflation levels is hence expected to occur much more quickly. While forecasts are error prone, I can make one that is more likely than not to be in the money: the Finance Ministry will ask for a further cut in the Repo rate as it continues to try to prop up an oversold and overheated growth "miracle".

If you have been listening to the lobby groups and the pretend economists who work for them lately, being bombarded with their propaganda, your reasoning is more likely than not to resemble the following. Because India, China, the US, Europe, Japan, Korea and a host of other countries have cut interest rates, why should we not be doing it too? After all it is a crisis and we must lower the cost of capital! Why should we be increasing our rates or keeping our rates so high when the global economy is slowing down? Even if I am telling you that headline inflation is going to fall starting January 2009, heck year on year inflation will begin to fall in November 2008 itself and will probably stand at around the mid 5% range throughout 2009 unless the rupee plays the spoil sport, a not to be dismissed scenario!

Since the beginning of this year, what I have been trying to warn against and explain is that monetary policy in Mauritius has been loose, not restrictive. It is not the nominal but the real that matters and in real terms we have had an expansionary monetary policy since 2007. Remember how the same people who are telling you that rates need to be cut now because of what the Indians and the Chinese are doing were telling you that Mauritius was a different country and could not be compared to those countries when these countries' central banks were raising rates a few months ago?

The Mauritius Bankers' Association has recently compared Mauritius to India. The next time they make such loose comparisons, they should at least bother to check the following facts. Interbank lending rates in India had tripled to over 20% and the credit market was nearing collapse and may still do. The Reserve Bank of India had also sold some USD 32 billion in the foreign exchange market thereby sucking in an equivalent rupee amount out of the money markets. High loan to value lending habits have begun to hurt "conservative" Indian banks as real estate prices in various Indian metros have collapsed. This is also due to highly levered positions by speculators on bare land outside major metropolitan areas. India was not cutting rates and the cash reserve ratio (CRR) because the US was cutting rates, but because India was facing a major domestic problem. Anyone who convinced you that the Indian real estate market was in the early stages of its growth cycle is probably bankrupt right now if he invested in Mumbai or Delhi.

Before other policy makers compare Mauritius to China, perhaps they should look at both headline and core inflation in China first. Do they know that inflation in China currently stands at 4% and is forecast to fall to 2% next year? All central banks in any half decent country cut interest rates when inflation is expected to fall to or below their inflation targets especially when the economy is slowing down or is nearing recession. There is nothing wrong in that and that is why the US, Europe and South Korea have done so.

In fact this whole crisis started because the former Fed president Alan Greenspan kept rates in the negative territory for too long thereby encouraging excess leveraging and risk which has cost us far more than it ever earned. Of course our policy makers will not mention that point since they have been ignoring negative real interest rates domestically themselves and our journalists will not ask the tough questions and the lobbies will do the rest because let us face it, they are the ones in control.

Economic growth in 2009 forecast at 3.7%-4.7%

Do you still want to compare Mauritius to other countries now? Ever heard of loose anchoring of inflationary expectations and wage pressures? Have you seen the latest *PluriConseil* survey where most analysts still believe that inflation will remain above 9% next June despite falling oil prices?

Have you ever wondered about the qualifications of the voting members of the MPC? Only one voting member holds a PHD in Economics. Many of them are actually accountants. I have nothing against accountants but I am not too sure about what part of the ACCA curriculum covers advanced applied economics, in particular monetary policy? What is next a lawyer? Now qualifications are not always everything, the Governor is well educated, one accountant at least voted more like an economist than some of the other so called economists. But what I am trying to say is that this MPC has not been and is not credible.

The reason why the CRR needed to be raised from 4% to 6% was not because there was a suicidal urge but because interbank rates had gone well below the Repo corridor even after the creation of the Special Deposit Facility. Normally interbank rates are supposed to be close to or slightly higher

2009 Economic Outlook

By Sameer Sharma- *Cont from Pg 5*

than short term Treasury bill rates. In the rest of the world, we call this the TED spread. If you look at the evolution of various interest rates in Mauritius since 2007, the whole system has been upside down.

The BoM's instruments were quasi sterile and the BoM made up some excuse of not conducting more reverse Repo transactions because it was scared that this would attract more foreign capital. Only recently, following the CRR increase to 6%, did interbank rates come within the corridor? Now the CRR is not a good tool, we all know that and it was always going to be a temporary thing to do. It hurts small banks more and in the long term does not help in the competition front and hence does not lower those spreads our two largest local banks enjoy but there was no other choice at the time because a country cannot have a central bank whose instruments are worthless.

I am very flexible on the CRR front, if liquidity tightens, cut it but don't tell me that it is perfectly fine when interbank rates are well below the Bank rate and the Repo corridor! The MPC watched this for months and did nothing about it until recently. In any event, the Finance Minister has already announced that the CRR would be cut back to 4% in December. Forget the policy decision, this simply confirms the fact that the Governor is in office, not in power. It is really a sad story; rates go up and down like a yoyo in Mauritius. We all knew that the Finance Ministry was calling the shots. It is a dangerous thing when those who control fiscal policy begin to control monetary policy too.

The recent monetary policy decision was ordered by the government and I doubt anyone had the choice to vote differently. In any event, inflation in the medium term is expected to remain above 5% and those that adopt loose monetary policies are likely to see a still high mid 5% inflation rate in 2010. Remember, the savings deposit rate is likely to still yield close to zero or negative interest if they continue to cut. If they keep the Repo rate constant and deposit rates stand at 6.5%, you are at best going to earn 1% real interest in the best case before taxes after almost 15 months of negative interest. I would still settle for that but they will cut more.

I understand that Mauritians have grown used to double digit inflation, suffice to say that 5.5% is quite the high figure and that when your economy is witnessing near zero multifactor productivity growth, the private sector cannot possibly afford to dish out wage increases that are close to inflation without negatively affecting the long term growth prospects of the business. I do not work for the lobbies but I can certainly understand them on this issue. It also does not serve any great purpose to dish out 20% PRB increases to the public sector and thereby increase wage pressures in the private sector when they were already facing high commodity prices this June. I may be pro-poor but even I can get that. This is not the kind of fiscal spending I am talking about.

Repo Rate needs to be kept on hold

What is the outlook for the Mauritian economy then? Bar the alarming current account deficit, there is nothing too alarming on the growth front until the third quarter of 2009. Based on updated forecasts in other emerging economies, and bad travel data across Europe, I am revising the growth forecast picture in 2009 from 4.5-5% (trend line) to 3.7%-4.7%. Had core and headline inflation been similar to that of China and had medium term forecasts pointed to inflation falling below 5%, I would have certainly called for rate cuts but that is another story now since they have already been cut. Rates need to be kept on hold.

There is certainly a need to work on the fiscal side. The government must continue to maintain spending on infrastructure, increasing spending in terms of marketing to attract as many tourists as possible and more importantly must provide for more cheap forms of financing to small and medium enterprises and qualified larger companies in the manufacturing sector where their return on capital employed can realistically be brought above their respective weighted average cost of capital.

In sum, we need to provide cheaper forms of financing to help relieve the private sector until inflation falls below 5% or in other words, until the BoM can responsibly cut the Repo rate to 7%. If the growth picture deteriorates further, then, and only then should the Government consider tax incentives via temporary value added tax relief on consumers and increased infrastructure spending. The reason why I mention temporary is that permanent increases in fiscal deficits send the wrong signal to the infamous rating agencies and also negatively affect the economy in the longer term.

The Finance Ministry must work with the BoM to make sure that all this liquidity injection into the system does not render monetary policy instruments hapless as has been the case all too often in Mauritius. Of course the Finance Ministry must work with the BoM, not control it. If discretionary fiscal policy is used irresponsibly, things could be made worse and crowding out of private investment could occur.

The logic to that is simple. If a bank saw that the government is borrowing more and more from the debt market to finance its spending, it would rather lend to the less risky government by taking long positions in treasuries than to lend to the private sector during an economic slowdown. Discretionary fiscal policy also tends to have this nasty tendency of doing too little too late.

The Mauritian rupee (MUR) of course worries me greatly and hence so does the current account deficit which is in any event unsustainable. MUR/USD depreciation has slowed in recent days as has been the case with other emerging market currencies and falling oil prices can only help the current account deficit. Tourist arrivals come 2009 are not expected to be stellar and contraction is possible but avoidable.

The MUR/USD exchange rate crossed its 200 day moving average two months ago, and all technical indicators indicate that it remains in fragile and bearish territory. Those who would encourage the lowering of the differential too quickly may live to regret it if they care about forex volatility or inflation. The global slowdown could be long and hard and we may indeed see dismal growth on the export and tourist arrival front. While the Bank of Mauritius must provide adequate forex in the market and can consider slowing down out of control 30 day rolling volatility of the MUR/USD, reserves can fall rather quickly.

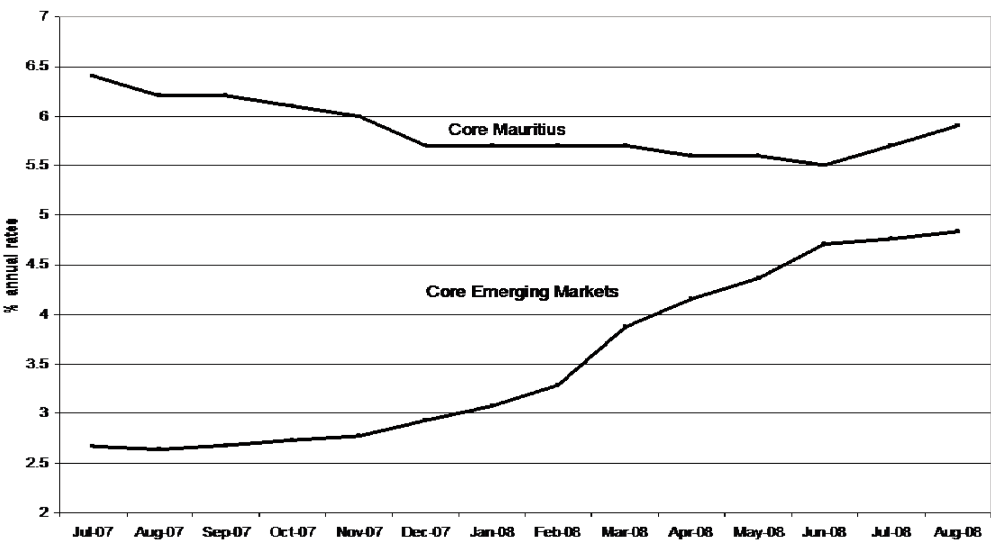
If the current account does not improve drastically despite falling oil prices in the coming months, especially if exports play the spoil sport, let the rupee fall (no choice). Limit the power of the few large speculators of the market by providing more information and simple explanations to the public on a weekly basis with regard to the domestic foreign exchange market. Allow price discovery to take place, speculators can amplify trends but they cannot set the trend, the uncertain direction of the current account deficit will do that.

While I am certainly bullish on gold in the long term and would be buying gradually on the dips as central banks and hedge funds sell in order to meet liquidity needs, I would certainly hope that politicians who have no business or qualification in managing central bank portfolios are not listened to especially when you consider the volatility, skewness and Kurtosis of gold returns. An uncertain rupee outlook could certainly negatively affect the inflation outlook.

This gold debate among the politicians is really an interesting one. Do they even know that right now, there are discussions under way for a future Breton Woods 2 like framework for central bank reserves

CORE INFLATION

(Source: International Monetary Fund and Bank of Mauritius)



to be invested in a basket of currencies similar to the SDR? 50% in gold is not diversification for a small open market economy with an uncertain current account deficit outlook.

Portfolios are supposed to be designed by professionals with Masters level degrees in applied mathematical finance, actuarial sciences, CFA holders, FRM holders or CAIA holders. In Mauritius, politicians seem to be qualified by default without performing a single multi moment optimization on any portfolio in their life. There is no respect for the institution that is the Bank of Mauritius.

Bearish outlook of the stock market

The outlook of the stock market remains rather bearish especially if the media continues to sensationalize things. Tourist arrivals will be disappointing and I fear that there is more panic selling to come. Increased risk aversion and forced hedge fund pullouts out of funds that invest in Africa have hurt the Mauritian market. Further capital outflows from the stock market is a dangerous prospect especially if the foreigners begin to look at the current account deficit and rupee technical analysis data more closely, and they choose to pull out.

Don't try to "lower the cost of capital" too quickly, that differential may be all you have left to keep them here if exports fall more than imports. Some hotel stocks have been beaten down too much and domestic pension and institutional funds create a nice floor on the bank stocks which remain highly profitable. Heck when the two largest banks can get money from you for free and lend it at positive real interest rates, you might as well join them by investing in their depressed stocks for the long term.

Investors must think long term and not short term. The world economy will eventually recover. While I would mostly be in cash and foreign currencies if I were in Mauritius, I would certainly gradually and very slowly buy those bank and hotel stocks on the dips with a 5-10 year horizon. The stock market is not a casino but here is the problem with the regulatory body. As at the 14th of November, only five companies on the Stock Exchange of Mauritius (SEM) have released their results from the last quarter. If the lobbies were not so powerful and if fund managers were not so disorganized, things would perhaps look a bit different.

Investors must be forward looking but they cannot do that rationally when the SEM does not speed fast quarterly reporting up. Most of the companies of the SEM and the Development & Enterprise Market should have reported by now! Lobbies in Mauritius are not part of the solution but part of the problem. In a country with so many accountants, there should be no excuses!

I know that there have been some investors who have perhaps told you that the domestic property market stands tall during these difficult times. If you want to make any money, don't try to listen to them too much, especially if it is commercial real estate or land buying. Please look at the rental yields and compare that to the risk free bond yield at least before you venture in too deeply.

Remember to use a proper discount rate and more importantly remember that leverage can be good and bad and that sometimes high internal rates of return also mean high risk. Do not be fooled by those with vested interests that blubber about where Mauritius is in the real estate cycle. There may be money to be made if you are a developer but be careful. It is like asking an economist working for a bank what he thinks about the Repo rate after an MPC meet.

Over the next few months, you are again likely to be bombarded by more propaganda via the media and outlook reports by think tanks that represent institutions that would obviously profit from lower interest rates (especially when they are getting it from you for free in real terms and lending it at nice spreads). So my end of year advice is: Don't always listen to the lobby groups but do not become socialist for it, for socialism is not the answer. Do not always trust politicians who depend on them and do not believe that Mauritius has entered a second economic miracle when productivity growth remains at around zero, when core inflation performance against other emerging economies remains dismal and when the Finance Ministry controls the monetary policy.

Finally, Keynesian economics is not the answer: fiscal stimulus can be effective just like it can be destructive.

Continue the path of economic reform but limit the influence of those powerful lobby groups. Economic growth is not about 4, 5 or 6% GDP growth or about making the top 20 business tycoons of the land, the politicians, lawmen and doctors richer but about improving the economic well-being of the entire population, especially those that earn a fixed income. Inflation hurts the poor the most and in the long term hurts companies and productivity via second round effects that are characterized by unsustainable wage increases.

There is no long term tradeoff between growth and inflation and there never will be. You do not lower the cost of capital if it means creating imbalances in the form of negative real interest rates. You get a proper and independent MPC to think long term and work towards a low but flexible inflation target defined by parliament on a periodic basis.

In the long term, you get lower and more stable inflation, lower interest rates without imbalances and lower wage pressures. In the long term, companies can work on improving on their comparative advantages and productivity growth can at least leave zero territory. This is not the 1970s anymore and economics has changed since and is likely to change some more after this crisis is over.

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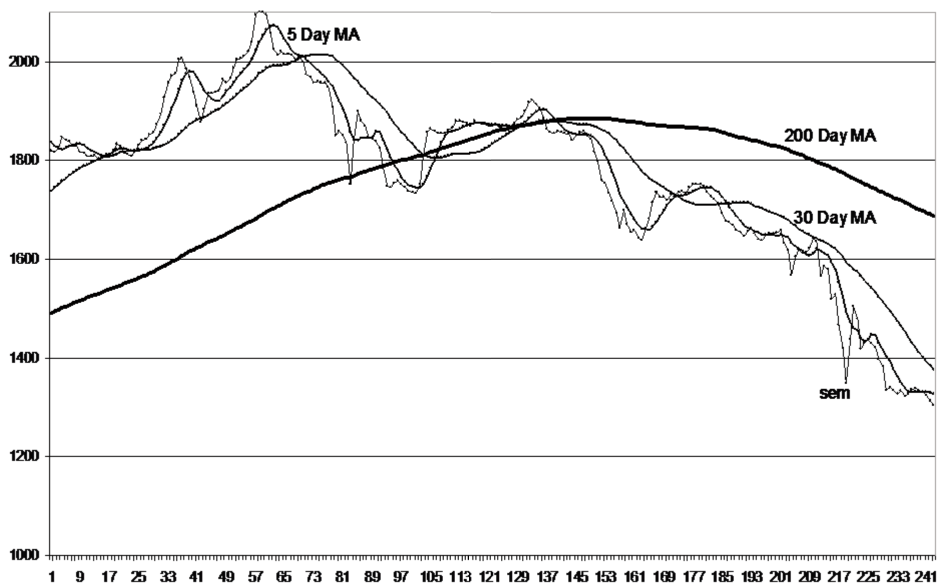
SEMDEX
(All-share index of the Stock Exchange of Mauritius)



The perfect storm

By Harold Mayer

There is a future for the textile sector in Mauritius if all stakeholders "want" a future and "act" accordingly. The textile and garment industry is made up of some 410 entities employing 'directly' 55,000 people. This can be subdivided in two segments.

Segment 1 includes large vertically integrated operations 100% on Export: this segment is made up of 10 groups who employ approximately 35,000 people (63%) of which 6,000 people in "Textile" operations (very capital intensive) and 29,000 in garment making. Segment 2 is made up of about 400 entities, equally small operations which often subcontract capacity to the large operators; partly supply the 'local' market in clothing and partly export; buy their raw materials from the 10 large groups or import from overseas; and have limited marketing and financial resources.

Whilst both segments are important for the country, a large portion of segment 2 is reliant on segment 1 for its raw materials and sub-contract work. In other words, the strength of segment 2 is partly dependant on segment 1. Enterprise Mauritius, today, caters mainly for the needs of segment 2.

How is the industry performing today? The financial performance is very difficult over the past 12 months. Exports have dropped by 10% compared to last year for the first semester. In my opinion, 10% of companies are slightly profitable since January; 30% are at break-even; and 60% are making losses. The micro economics of the sector are therefore very difficult with a "freeze" in investments and some threats of bankruptcies or structural downsizing.

The external factors faced by the operators are the worst for many years and can be called "the perfect storm". The key factors that have teamed up to provide this storm are the following:

1) The strength of the Mauritian Rupee: From 1st July 2007 to 30 June 2008, the Rupee appreciated by 15% against a "basket" of currencies against which operators export (Dollar, Pound Sterling, South African Rand, Euro). When an operator used to receive Rs 100 for a T-Shirt, he now gets Rs 85 for the same "currency" price to his customer. The Mauritian Rupee has also appreciated by 15% versus the Indian Rupee and the Bangladeshi currency (our competitor countries) over the first nine months of 2008.

2) Average increase of 15% in "input costs" driven mainly by energy, transport, salaries and wages: however, this is also true for our overseas competitors.

3) A very soft market in Europe, South Africa and USA due to slow or no economic growth in these countries, coupled with a loss of purchasing power. For this reason, there is an oversupply due to poor demand and increasing prices to customers.

This perfect storm is likely to last 18 to 24 months until such time as our export markets start pulling again. In the meantime, the industry worldwide will shrink and once the markets pick up again, prices will increase again.

The textile industry needs affirmative actions

Although Mauritius, today, is among the highest 20% in the world in terms of cost, it is cost competitive against the following countries where the textile sector still exists, namely Italy, Spain, Portugal, Greece, Turkey and Eastern Europe. Most of the operators which remain in Mauritius are locally owned and are in a fighting mood to face up the challenges. Hence, there is a future for the Mauritian textile industry.

The Indian and Chinese economies, the two textile powerhouses, are growing at 8% to 10% annually, which should lead to some inflation and strengthening of their currencies versus the Dollar and the Euro (in theory). This should help increase our "relative" competitiveness.

Why does Mauritius need the textile sector in the foreseeable future? There is consensus that a 6% to 7% GDP growth is desirable to keep employment at required levels. This will be difficult, even impossible, to achieve if the textile sector shrinks by 10% annually.

The sale of properties under the Integrated Resorts Scheme represents Sales of Assets and is non-recurring in the long term. In the absence of a significant Textile sector, the dependence on "Tourism" as the only major source of recurring foreign currency is risky, witness Bali. We need diverse recurring foreign currency sectors.

Finally, the industry employs very large numbers of unskilled people who do not have short term alternatives. Any sharp and drastic drop in the size of the textile industry could have very negative short and long term effects.

What are the solutions? Both the operators and the authorities need to take affirmative actions to help the industry through this storm: 1) need to invest in marketing and product development to move upmarket, 2) need to invest in Lean Manufacturing and reduce waste at all levels, 3) need to regionalise and internationalise. 70% of the solution is in the operators' hands.

On the authorities' side, an uncompetitive currency versus our major competitors can simply kill off the industry. An appropriate monetary policy is required to keep a competitive currency. China and India have adopted affirmative actions like cheap finance, competitive energy and utility rates, and duty drawbacks.

It is important to acknowledge the fact that we are facing a perfect storm. Once this is done, we need to agree that we need this industry for the foreseeable future. Finally, all actors must sit around the table and let common sense prevail in terms of actions to be taken.

Harold Mayer is the chief executive officer of *Ciel Textile*.

Working with the poor

By Hootesh Ramburn

A group of women doing patchwork uses textile waste to create creative hand-made patchwork. This group works with a garment company which is in the process of becoming an ISO 14000 (environmentally compliant) certified company. This socio-economic-environmental collaboration brings mutual benefits to the small women entrepreneurs as well as the larger company: it adds to the unique selling proposition of the company and provides a free source of material for the women entrepreneurs. At the same time, it represents a solution to the environmental problem of waste disposal. The Empowerment Programme is supporting both technically and financially the group of women entrepreneurs.

A group of small planters on the east coast growing crops in sandy soil next to a hotel used to sell their crops to intermediaries. They have started to supply directly to the hotel. The hotel is working with them to improve the quality of vegetable products grown in the sand. Again this market buy-back agreement represents a win-win situation for both parties: the hotel gets a supply of fresh and safe products from small planters according to the hotel's requirements while the planters learn to add value to their products and eliminate the costs of intermediaries.

Another group of poor farmers, including women, on the south-east coast have a tradition of growing a unique variety of onion which is well appreciated by Mauritian consumers for its pungency, long shelf life and attractive colour. This cultivation which has a history of a century among generations of these farmers plays a key role in reducing land erosion on this coast.

The product is being promoted as a 'produit du terroir' by a NGO working with the planters. The NGO carries out research with farmers with a view to developing a brand product and is assisting them both in improving the cultivation techniques and in developing onion processing. The farmers have networked with a small food-processing company to make trial export orders and is tapping on the latter's experience to penetrate the higher value local market, such as hotels and supermarkets. This project is supported by the Empowerment Programme as well as by GEF Small Grants Programme of UNDP.

Some former knitwear factory workers are now working with a network company which has outsourced its production to them and deals only in what it is best in, namely the marketing of the products for exports. It provides equipment and production know-how to the workers who are free to organize their own production. This is an example to be followed by other companies in the textile and garment sector where retrenchment of workers has been a trend.

Thus, large and small entrepreneurs can add value to their products and services by identifying opportunities along their respective value chain and collaborating to tap these opportunities and 'controlling' together a wider range of the chain.

Opportunities in Rodrigues

More opportunities exist. The tourist industry can increase its offers to its clients if hotels can work in a network with the 'tables d'hôtes' in their region. It can help them improve their quality standards and promote their authenticity to their tourist clients.

Rodrigues can be a source for developing organic production and tapping the "fair trade market". Buyers in Europe offer a premium price for products purchased directly from producers who are grouped in association and are able to cut down on intermediaries.

Agriculture in Rodrigues is already a low chemical agriculture. Their products (honey, Rodriguan lime, banana, 'poulet fermier') could qualify for the organic label. Businesses in Mauritius can help Rodriguan farmers in developing this label of high value agricultural products. Empowerment Programme is presently involved in assisting in-lagoon fishers to move out of in-lagoon fishing and engaging in alternative sustainable economic activities, mainly in agriculture and farming within the perspective of developing high value export quality products.

Hootesh Ramburn is the Coordinator of the government's *Empowerment Programme.*