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

It's a monetary phenomenon

EDITORIAL – By Eric Ng Ping Cheun

Most people, including professionals, economists and central bankers, equate inflation with a general rise in prices. This is incorrect. Inflation is basically an increase in the quantity of money which, in turn, sets in motion a general increase in the prices of goods and services.

Consider a situation where the money stock remains fixed. The price of a particular good will increase whenever people raise their demand for this good and thus allocate more money to it. Meanwhile, the prices of other goods will fall as less money is spent on these goods due to a decrease in the demand for them. There is no general increase in the money supply, and therefore no inflation.

But most central bankers still stick to the standard model of monetary policy which teaches that aggregate demand responds directly to an interest rate. This theory, which minimises, even ignores, the role played by the quantity of money in the transmission mechanism, is based on the argument that the "demand for money" (the relation between money stock, output, interest rates and prices) has become unstable, at least in the short term.

The Consumer Price Index cannot establish the true status of inflation

The fact remains that, in order for an economy to experience a general rise in prices, there must be an increase in the money stock. Real incomes fall because of increases, not in prices, but in money supply, as the purchasing power of money is eroded.

The relation between money growth and inflation can be established through Irving Fisher's equation of exchange, which states that the stock of money (M), multiplied by the number of times a money unit is used for financing purposes (V), equals real output (Y) multiplied by the price level (P). Assuming that V is equal to one (the change in velocity of money is zero) and that real output growth oscillates around a stable level (the economy's "trend growth"), then money growth is directly proportional to price increases.

In other words, money growth in excess of real gross domestic product (GDP) growth should be closely connected with inflation. Inflation is the result of too much money chasing too few goods.

Mauritius money stock, in the form of M2, captures only currency with public and bank deposits, and it is now adjusted for the transactions of banks holding a Global Business Licence.

Cont.../ Pg 2

The myth of economic growth

By Siow Ming Li Ting Tung

The concept of economic growth usually carries a positive connotation. Different countries are often compared using economic growth figures such as Gross National Product and Gross Domestic Product. Governments have compared their performance with that of previous administrations using such figures. In Mauritius, the promise of higher economic growth has become a common political slogan.

Economic growth is certainly an important objective and the lack of it would bring about economic stagnation. However, the figure itself just does not tell the whole story. High economic growth does not mean the economy is being well managed and it is certainly not a measure of the economic well-being of the population in general.

First, the growth figure is misleading because it does not take into account the situational variables. While China and India have high growth economies, they must produce such stellar growth in order to create new jobs to accommodate a large number of people joining the workforce every year. A 5% growth would be considered recessionary for China.

Also, mature economies (European Union, United States of America and Japan) are expected to grow slower than emerging economies as they have already achieved a high level of development – the law of diminishing returns is applicable. Therefore, it would be wrong to compare the GDP of Mauritius, which is around 4.5% this year, to that of the EU which is around 1.5%, and conclude that we are somehow doing a better job at managing the economy.

Neither the government nor the central bank can support the economy indefinitely

Governments can run up deficits to support their economies. Debt is essentially financing current consumption with future payment.

The situation worsens when such spending deviates from the essential. In Mauritius, public debt level has risen to a dangerous threshold at approximately 60% of GDP, and that does not include accumulated losses at various parastatal bodies. What do we have to show for all the money spent? Do we have world class infrastructure? Do we have quality social services such as education and health care?

In the long run, an ever increasing level of public debt is unsustainable. Depending on the nature and magnitude of the public debt, there may be a generational shift in the responsibility for repayment.

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It's a monetary phenomenon

***EDITORIAL – By Eric Ng Ping Cheun** (Cont., from Pg 1)*

A still better measure would be to include also deposits of non-bank financial institutions authorised to transact deposit-taking business, namely leasing companies.

Taking the GBL holders into account, the annual growth of M2 was around 10% in May 2006. As the Mauritian economy grew by 3.4% in the year ended June 2006, we can suggest that the annual rate of inflation was above 6%, and not the 5% official rate worked out by the Central Statistics Office (CSO).

The Consumer Price Index (CPI) used by the CSO cannot establish the true status of inflation simply because it is not possible to calculate an average of prices of goods and services. One pound of rice and one pound of wheat cannot be added together as they are two different goods and their valuation is different. Even John Maynard Keynes, in his *General Theory*, underlines *"the well-known, but unavoidable, element of vagueness which admittedly attends the concept of the general price level"*.

Oil price is not an inflationary trigger

Changes in money supply are not totally revealed in general price increases. First reason, they affect prices with a time lag. As a matter of fact, the CSO forecasts that the inflation rate will jump to a hairy 8.5% for the year ended December 2006.

Second reason, prices are also determined by real factors, such as competition, which can pull things in an opposite direction to monetary factors. Third reason, excessive money growth affects prices of assets like stocks, bonds, real estate and housing, rather than final product prices (measured by CPI).

Asset price inflation weakens the relation between money growth and consumer price inflation. Since asset prices are not included in the CPI, but form part of the economy's price level, it is high time for the Bank of Mauritius (BoM) to factor them in its interest rate policy.

Does our central bank use money supply as a yardstick for setting monetary policy? Nobody knows. In an interview to *Reuters*, published on 6 July, the BoM Governor blamed oil for the acceleration of Mauritian inflation rate, saying that *"it's not a monetary phenomenon. If you raise the interest rate, do you think it will lower the price of oil?"*

Two working days later, the BoM increased the Lombard rate by 50 basis points. In its accompanying statement, the central bank wrote that *"monetary expansion, in particular the growth of money supply and credit, heralds upside risk to inflation"*. Which is which?

Even the US Fed chairman Ben Bernanke, addressing the Economic Club of Chicago on 15 June, stated that *"a significant increase in energy prices can simultaneously slow economic growth and raise inflation"*. But oil prices can cause inflation only if those who are in command of the money supply allow them to pass through the economy.

Since its creation in 1913, the US Federal Reserve has reduced the dollar to 5 cents today. Since its existence in 1967, the Bank of Mauritius has lowered the rupee to 2.3 cents today. The dollar and the rupee are irredeemable paper or fiat money.

Spikes in prices of petroleum products or other commodities cannot be responsible for the ongoing destruction of the currency value. The only ultimate culprit is the *"persistent over-issuance of money"*, as the former Fed president Alan Greenspan once put it, after admitting that Milton Friedman's famous notion that 'inflation is always and everywhere a monetary phenomenon' *"is no longer a controversial proposition"*.

The principles of sound money

Rightly so, the Nobel Prize winner considers money supply as the only tool that can stabilise general rises in prices and thereby promote real economic growth. But, according to Friedman, all that is required is pursuing a pre-determined rate of money expansion (the *k*-percent rule) so that inflation is "expected" correctly by producers and consumers, and this will be harmless to the economy. The problem is that fixing the rate of money growth does not change the fact that money supply continues to expand.

Conventional wisdom has it that the purchasing power of money can be preserved by, first, making the central bank politically independent and, second, assigning a mandate to it, enshrined in its constitution, to keep inflation low. But even if those two conditions are met, they do not guarantee sound money, especially when there is a continuous rise in government debt-to-GDP ratio, as we have seen in Mauritius over the past ten years.

That is why there must also be institutional restrictions put in place to prevent a build-up of public debt and, finally, a firm commitment by the BoM to maintain money and credit supply expansion in line with output gains.

Economics is about money. A policy which ignores monetary aggregates as signals for setting interest rates is doomed to failure. True, our interest rate policy has entered into a tightening cycle. But it should be sufficiently pre-emptive so as to lean against excessive credit expansion and asset price increases.

MAIL

Mashood **:** The articles in the last issue of *Conjoncture*, very informative, precise and right to the point, remind me of a BBC Business Report, where there was a debate among present and former prominent personalities on outsourcing and its consequences on the USA economy. There was a phrase uttered by one participant that struck me: *"The United States of America has been outsourcing the hands/arms, and now the mind/brains"*. Mauritius has to seize this opportunity and capture a part of this niche market.

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The myth of economic growth

By Siow Ming Li Ting Tung *(cont., from Pg 1)*

Central banks may also help economies along by dropping interest rates and/or increasing the supply of money. However, the subsequent inflation would reduce the value of people's income and savings. Inflation in Mauritius, according to the Central Statistics Office, would gallop at 8.5% for the year 2006. Should the Bank of Mauritius pull the reins on inflation or should it be worried about the impact of further tightening on economic growth?

There is much debate as to whether economic growth should be the concern of central banks. In some countries, the only function of the central bank is to control inflation: the Reserve Bank of New Zealand is bound by a contract (Policy Targets Agreement) to keep inflation within 1 to 3 per cent. Likewise, the Reserve Bank of Australia, which raised interest rates on 2 August in response to a consumer price report, has an annual inflation target of 2 to 3 per cent.

Neither the government nor the central bank can support the economy indefinitely because neither can create wealth. Wealth can only be produced by enterprise.

Asset bubbles eventually burst and that hurts the economy

Some countries are highly dependent on the extraction of non-renewable resources such as oil, minerals, or precious stones. In that case, growth is ultimately unsustainable and will eventually lead to economic difficulties if proceeds from the sale of the resource are not reinvested in other sectors. Therefore, one must be careful when looking at the growth figure of certain resource based countries. High growth may be the result of a higher extraction rate and this accelerates the rate of resource depletion.

Other countries exploit renewable resources at an unsustainable rate, such as timber which is a renewable resource that must be managed with cutting rules and reforestation plans. With the ambition of turning Mauritius into a seafood hub, care must be taken to exploit our marine resources only at a sustainable rate by establishing strict quantity and size limits. The exclusive economic zone of Mauritius is also vulnerable to pillage by foreign fishing fleets.

Another type of unsustainable growth is based on financial speculation in real estate or stock markets. Nothing is actually being produced. It is just assets changing hands at ever higher prices. Some would argue that there is a "wealth effect" as people would spend their gains on goods and services. This may be true to a certain extent. However, all bubbles eventually burst and that hurts the economy. Following a long speculative boom, the spectacular crash of 1929 on Wall Street brought about the Great Depression in the US.

The perverse form of capitalism

Very often, economic development is accompanied by costs that are not so quantifiable. How much does traffic congestion cost the country in terms of wasted time and fuel? What about the cost of pollution in terms of environmental degradation and health consequences? When forests are cleared to make way for farms, there is loss of habitat for the indigenous fauna. What is the cost when species go extinct?

Poor countries are more vulnerable because of lax regulations or corruption. And with globalisation, rich countries have taken advantage of these weaknesses. Multinationals will often move their most polluting operations to third world countries with little regard for the environment and the well-being of the population. In other cases, rich countries pay poor countries to accept their industrial waste. These wastes are too expensive to be processed in their country of origin and they are toxic. So they get sent to some country in Africa, Asia or South America.

Certain types of development also carry hidden social costs. In Mauritius, gaming (horse racing, lotteries, and casinos) is a growth industry. However, this can also give rise to compulsive gambling behaviour and result in increased crime rate and other social problems.

Finally, high economic growth may not benefit to the population at large. If you were a black person under the apartheid regime in South Africa, did it matter to you that the economic growth was 7% or 10%?

Apartheid may be a thing of the past, but economic exclusion is alive and well in many countries. The rich get richer and the poor get poorer. Also, more and more families join the ranks of the poor. A common term for this problem in Mauritius is *"économie à deux vitesses"* or a dual speed economy.

Many think that this widening gap between rich and poor is a natural consequence of the free market economy. While there will always be rich and poor in any society (except perhaps under communism in its purest form), this extreme inequity is definitely not the characteristic of a free market economy evolving under the rule of law. Instead, it is a rather perverse form of capitalism commonly called "crony capitalism".

A crony is defined as a long time friend or companion. Crony capitalism arises when the relationships between businessmen and politicians form a kind of aristocratic social hierarchy. Private businesses or wealthy individuals finance political campaigns and in return governments grant special favours to these benefactors. These favours may be in the form of removing certain taxes, relaxing certain regulations, promoting certain industries, concentrating development of infrastructure in certain areas, granting of permits and leaseholds.

The poor subsidising the rich

In any case, when government intervenes in the economy in order to help certain sectors, it either spends public money or forgoes on revenues which would otherwise have flowed to the state coffers. And since government has to borrow money or tax the population in general to raise funds, it becomes a case of the poor subsidising the rich.

Poor planning or wrong policies also contribute to the polarisation of society. In Mauritius, unemployment has remained stubbornly high even as the economy has kept growing. It is ironic that a country with such high local unemployment should also have a large number of foreign workers.

Foreign workers occupy jobs in virtually all sectors of the economy from low skills construction jobs to top management positions. Of course, there are jobs requiring specialised skills, and foreign recruitment is therefore unavoidable. However, such employment contracts must contain a skills transfer scheme and a definite time-frame for handover to local employees.

The issues raised here are complex and may be inter-related. Low interest rates may contribute to the formation of speculative bubbles in asset prices. A grossly unequal economy may also create social problems and affect the quality of life (hidden cost) for both the rich and the poor. Attention should be focused on the stark realities behind the myth of economic growth.

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The flat tax revolution

By Eric Ng Ping Cheun

So the Finance Act 2006 provides, in its First Schedule, that a tax rate of 15% will be applied to the total chargeable income of an individual or a company as from the year 2009-2010. During the three transitional years, the corporate tax rate will be 22.5%, 20% and 17.5%. Concurrently, the same rates will constitute the marginal tax rates applicable to personal income other than interest in excess of Rs 500,000. All interests are now taxed at 15%. Residents are entitled to an income exemption threshold of Rs 215,000 if he does not have any dependent, Rs 325,000 (one dependent), Rs 385,000 (two dependents) or Rs 425,000 (three dependents).

First introduced by William Pitt the Younger to finance the war against Napoleonic France, income tax is a penalty on individual effort. It is also a mechanism which removes money out of the taxpayers' pockets when, alternatively, this money could have been put into savings or investment.

Worse, income tax is a means for state intervention made at the expense of economic efficiency. If the Mauritian private sector has remained averse to diversifying into other activities, it is precisely because the heavy hand of the state has misallocated resources in unproductive sectors. Money doled out by government encourages rent-seeking which destroys wealth.

The most efficient allocator of resources is the market which knows best where to create wealth. The gains that the economy derives from the impersonnal market process override the economic costs caused by the government's interfering pervasively in the allocation of resources.

Income exemption thresholds on the low side

Under our former tax system, a person could deduct Rs 85,000 from income tax for his dependent spouse. The new system will allow him to claim, instead, a higher additional income exemption of Rs 110,000 as he falls in category B. In case he has a child receiving tertiary education in Mauritius (a second dependent – category C), his total additional exemption will be Rs 170,000, higher than what he would have claimed as deduction under the former system (a maximum of Rs 165,000). If he has another child receiving free secondary education (a third dependent – category D), his total additional exemption will be Rs 210,000, still more than under the former system (a maximum of Rs 195,000).

Normally, both spouses must work to be able to send two children to a tertiary educational institution in Mauritius. In this scenario, only one spouse can claim an additional income exemption of Rs 170,000 whereas, under the former system, the combined deduction for the two spouses would have been up to Rs 160,000. Of course, in case the two children attend a university outside Mauritius, the new tax system allows for less deduction than the former one. But let us be honest: only rich families can afford to give their children overseas education. They can therefore pay more tax...

At this stage, the four income exemption thresholds appear to be on the low side, the more so as taxable income is not restricted to salary but includes interest among others. It is also worth noting that the National Residential Property Tax will apply to exempt income (such as dividend) together with taxable income: the sum may quite easily exceed the exemption threshold of Rs 215,000.

The proof of the pudding is in the eating. Next year, we will really know whether 40,000 persons currently paying income tax will have been swept out of the tax net and whether only 33,000 families will pay the NRPT. If this is not achieved, the government will have to make some adjustments in the next budget as tax issues are always politically sensitive. It should either reintroduce an interest exemption threshold or raise the income exemption thresholds.

Promoting the emergence of a new entrepreneurial class

For Mauritius to survive in today's competitive world, we must foster individual initiatives and help our talents move out of the salaried class to become entrepreneurs. The rationale behind the current fiscal reform is that it flattens taxes on personal and corporate income to promote the emergence of a new entrepreneurial class. Experience is proving that it works: the Estonian economy enjoyed double-digit growth in 1997, hardly three years after the introduction of a single uniform income tax rate of 26%.

Under a flat tax regime, the rich cannot exploit complexities to avoid taxes. Taxing pay packets and profits at the same rate discourages tax arbitrage. The costs of compliance, administration and enforcement are reduced. And the system sharpens the incentive to work harder.

It is commonly held that flat tax rules out the principle of progressivity and thus favours the rich. This is a specious argument by virtue of the proportionality principle: the more income you earn, the more tax you pay in absolute terms. In fact, since it combines a threshold with a single rate of tax on all income above it, a flat tax on personal incomes is progressive in that these two variables (threshold and rate) can be varied.

It is understandable that, in order to clean up public finance, the incumbent government has started with rather low income exemption thresholds in its first budget. But the Ministry of Finance will come under mounting popular pressure to top up the exempt amounts in subsequent budgets. We can possibly imagine a flat income tax that is not levied on savings (such as interest and dividends), in which case it would act as a consumption tax like Value Added Tax.

A system that taxes less on income but more on assets should pass successfully the test of efficiency and equity. To quote a study on tax rates in the world, carried out by the Canadian think tank CD Howe Institute, *"personal and corporate taxes with high marginal rates are much more harmful to growth than levies on consumption and immobile assets such as land"*.

The American Revolution occurred in the wake of a simplifying tax reform. Every government, in every country, dreads a conservative backlash against tax changes. Here, in Mauritius, while some bank on a tax revolt fuelled more by emotion than by the pursuit of reason, we must hope that the flat tax policy will trigger a new dynamism that will transform our economic and social landscape from backwater to bellwether.