

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

The Fiscal Overhaul

Editorial - By Eric Ng Ping Cheun

Tax specialists may become an endangered species. By introducing a new system of taxation that is simple, transparent and easy to comply with, the government is making their job somewhat irrelevant. This is the last time you can see a billboard advert where an insurance company proposes to minimize your chargeable income. With the abolition of personal exemptions and deductions goes away the tax incentive for individuals to take an insurance policy scheme or a collective investment scheme.

Lobbyists may disappear too. By relinquishing his discretionary power to remit duties and taxes and grant exemptions, the Minister of Finance shrugs off the overimportance of the Joint Economic Council, its member organisations and other pressure groups. By bringing new rules which would allow the obtaining of all business permits within three working days, the government encourages would-be entrepreneurs to rely less on consultants. These are tough times, and our ministers cannot afford to bargain under pressures from various quarters.

Everything starts from the tax system. To reform it is to reform the economy. An economic restructuring worth its name involves the implementation of a new fiscal architecture. It is on this article of faith that the Deputy Prime Minister and Minister of Finance, Rama Sithanen, has focussed the 2006/2007 Budget: only fiscal modernisation is likely to revamp the Mauritian economy and bring about a sustainable economic growth, so essential for the creation of jobs.

At least, the government has chosen not to stifle growth, which has lifted its head this year. People, who feared a hike in the rate of Value Added Tax, can keep spending to back up growth. Thanks to our tax buoyancy system, the government expects to collect an addition of Rs 1.3 billion in VAT during the next financial year on the back of an economic growth of 5.3%. Meanwhile, the private sector, which dreaded a dividend tax, can go on investing to create jobs. Private consumption and investment should be our two growth engines in the coming years.

As 40,000 income earners currently paying taxes will be removed from the tax net and will gain up to Rs 12,000 in tax savings a year, this should boost up consumption spending. To the business community, the government sends a strong message by lowering the corporate income tax from 25% to 22.5%, a figure close to that in Singapore, a model which our Prime Minister wants Mauritius to emulate. Better still, the corporate tax will be reduced each year to

reach a uniform rate of 15% for all sectors by 2009/2010. By setting the course for the next four years, the 2006/2007 Budget creates a predictable environment for investors.

However, the abolition of the 25% investment allowance is a wrong move because this tax relief did provide an extra incentive to invest on new capital goods. Besides, heavy capital investment is needed to increase the capacity of our industrial plant to manufacture high quality products that can be competitive on the export markets.

Rightly, the government does not intend to boost the economy through public spending, as it aims to bring the budget deficit to 4% of gross domestic product next year. On the contrary, it is determined to make an optimum use of government revenue in social allowances. Avoiding the word "targeting", the Chancellor of Exchequer refers to "reorienting" subsidies towards the most vulnerable people. This is a sensible policy which will enable him to use more wisely Rs 350 million by combining social fairness with economic efficiency.

In effect, this sum will help finance the Empowerment Programme which will receive a budget allocation of Rs 750 million for the year 2006/2007. This programme will promote the emergence of small entrepreneurs and the training of unemployed women. The objectives are well targeted because the female unemployment rate has shot up to 16.5% while the male unemployment rate has stabilised at the rate of 5.8% in 2004 and 2005. On the other hand, it is the SME sector which provides jobs – 27,600 between 2000 and 2005. A tax holiday for a period of four years will be granted to small enterprises converted into companies and which register for the first time with Income Tax.

Time will tell whether the Minister of Finance is preparing the ground for the introduction of a wealth tax and a dividend tax by 2009/2010

Introducing a national residential property tax, reducing the maximum customs duty to 30%, opening the economy to foreign talents, instilling flexibility in the labour market, cutting red tape drastically and reforming the public sector pension are among the most audacious measures. But more importantly, the overhaul of our tax system makes room for a more efficient tax collection. Employees will not be able to mislead their employers by paying a lesser amount of tax under the Pay As You Earn system.

Two discreet measures brought by the 2006-2007 Budget need to be put into perspective. First, any individual who owns more than one residence, or an immovable property with price at time of purchase exceeding Rs 2 million, or a car with an engine capacity exceeding 2,000 cc, or a private pleasure craft, will be required to file an income tax return. This individual, anybody can guess, must be wealthy. So one can ask whether this obligation to declare these assets is a first step towards the determination of a wealth tax in the near future.

Second, all persons will be required to declare in their income tax returns the total exempt income, such as dividends, derived in the year. Here also, one can ask whether this requirement, which can be seen as an embarrassment imposed by the Ministry of Finance, is a device for the latter to eventually determine the dividend threshold above which a dividend tax will apply. Such tax, which was subject to rife speculation before the Budget Day, has finally remained in abeyance probably because of a lack of data on the distribution of dividends among individuals. As soon as the authorities gather sufficient information to be able to determine a fair threshold which would exempt small shareholders from paying dividend tax, will the government reintroduce it?

The timing could be politically motivated. Is it just sheer coincidence that the uniformisation of both the personal income tax and the corporate income tax into a same flat tax of 15% will come about in the year 2009/2010? This is the year when the next general elections will be organised.

As the government will have forgone a big chunk of income taxes by decreasing the income tax rates, and as the share of customs duties will have come down, it will have to find other sources of tax revenue. Now l'Alliance Sociale will commit political suicide if the rate of VAT is raised on the eve of general elections! Instead, new direct taxes against the rich and the wealthy would generate political gains for the party in power.

Time will tell whether the Minister of Finance is preparing the ground for the introduction of a wealth tax and a dividend tax by 2009/2010. For sure, the debate on taxes will continue unabated. As Minister Sithanen said in his Budget speech, *"the means may be painful, especially for the next two to three years"*.

(11 June 2006)

What has investing got to do with football?

By Christopher Tan

What has football got to do with investing? Actually, quite a lot. Like the football manager, the investment manager studies the past performances of the different asset classes over a time period and after making adjustments to accommodate financial forecast, he produces his strategic asset allocation plan which, in effect, is a plan that shows what asset classes and their proportions he will be investing in, to win his "investment game".

Next, he will scour for the best and most suitable fund managers (similar to finding the best players) to implement his strategy. Once the investing start (just like a football game), the investment manager may need to make minor changes to the asset allocation plan as some of his assumptions about the future may be wrong or have changed. This is termed as tactical asset allocation and it is in effect making changes or adjustments to the proportions of the asset classes he is investing in (like making tactical changes in the game).

From time to time, the investment manager has to make sure that the fund managers are in top form or are still relevant to his plan, otherwise, he will have to change these fund managers (like substituting the players). The investment manager does not always make the right calls, so sometimes his tactical moves may work but other times it may not. But ultimately, just like the football game, what is most important is that the investment portfolio achieves the target return and risk objective, as determined by the client.

So what investment lessons can we learn from football? There are a few:

1) Have a well-thought out strategy: How was your investment portfolio created? Did you or your investment manager take into consideration of what happened in the past as well as make reasonable forecast about what is going to happen in the future, before coming out with the plan? Did you document these assumptions and analysis so that you can know what went wrong and right? We all know that if we don't do our homework before going into a game, we will most likely lose it. If you do the same thing in investing, you are not really investing but speculating. It is very difficult to win when you are speculating.

2) Choose the best fund managers to manage your monies: Did you take pains to study each fund managers before choosing them to manage your wealth? Different managers are good at managing different asset classes and markets. Don't settle for the good

managers but choose the best in its class that is available. In choosing managers, do not simply look at their historical performance. The team that achieved this performance may no longer be there, or not able to repeat their performance. Look also at the current team and be convinced that they can do as good a job or even a much better job.

3) Have balanced strategy and team: Have you ever seen a football team with all 11 players in defense, or all 11 players in midfield or all of them in attack? Of course not! That's suicidal. Likewise, in investing, have a portfolio that invests in different asset classes of different risk-return characteristics.

As long as your investments are behaving according to how you expect them to behave based on your strategy, you will achieve your financial goals

Many who consider themselves experienced investors may argue that since equities have always beaten bonds in the long run and if they are prepared to invest long term, they need not diversify. Firstly, there is a fatal flaw in the argument that stocks have always beaten bonds in the long run as reliable figures before 1871 do not exist. Back in the US then, stock indexes used to represent the market only had 7 stocks. In the history of stock markets, many companies went bust but stock indexes have ignored them and thus may potentially over stated equities return.

Secondly, even if equities may do better in the future than in the past, you must recognize that when investing, you are dealing with two different time frames. The first covers the long time frame (say in excess of 10 years or even more) and the second applies to what is going to happen to you both financially and psychologically during the intermediate periods of your investments. There may be unexpected circumstances and you may need to get out of the market and having all in equities can be dangerous. Even investment guru, the late Benjamin Graham (the teacher of Warren Buffett and one that influenced him the most) advises never to put more than 75% of your portfolio in one asset class and in this case, stocks.

4) Monitor your investments and be prepared to make tactical change: Your investment strategy was developed based on certain assumptions about the past and the future. But assumptions will and most likely go wrong. It is thus important for you to know what exactly has change and make suitable adjustments to your

strategy as soon as possible. Keep a close watch on your selected managers. Sometimes, they may not perform as you expect them to and be prepared to change them when necessary.

5) Don't be discouraged with occasional losses: Just like you cannot win every match in a football game, don't expect your investments to do well all the time. The value of your investments may sometimes be up or down. This is what we term as volatility. In football, it is not about winning every single game. As long as your players are playing according to what you expect them to, what matters most is that you win the competition at the end of the day. Similarly, in investing, as long as your investments are behaving according to how you expect them to behave based on your strategy, you will achieve your financial goals.

If you understand football, you will have no problems understanding investing. Like football, there is no shortcut to victory. Taking an easier route will may mean winning a few matches but risk losing the competition. As an independent private wealth management firm, we are simply appalled by the many so called "champion" product offerings that many of our affluent clients received from their financial institutions. We have to dissect the product and painstakingly explain to our clients why this approach to investing can be dangerous. Buying individual products without knowing how it fits into your overall plan is an easy approach to investing but a sure way to failure. Since the mid 2003, the good returns from the equities market may have caused us to forget that financial markets are volatile.

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MAIL

Bertrand : I have read with much interest your article "Against the flow" in the last issue of *Conjoncture*. I certainly share your views on the sustainability of external payments deficits so long as external debt accumulation remains "manageable". I would further argue that indigenous private investment is as healthy as foreign direct investment, transfer of technology and marketing considerations apart. Certainly such investments do not lead to outflows within the current account by way of investment income.

L'inflation est-elle de retour?

Par Jean-Yves Naudet

Les marchés financiers se sont globalement affolés à la suite de la publication de quelques mauvais indices des prix en Europe et aux Etats-Unis : ils ont anticipé un retour de l'inflation. Faut-il partager cette crainte ? Il est certain que le retour de l'inflation serait une mauvaise nouvelle, car elle finit par paralyser toute l'activité économique. Mais il existe de puissantes barrières anti-inflationnistes, avec la mondialisation et en dernier ressort l'inflation dépend de la politique monétaire qui est suivie par les banques centrales. Ce n'est pas tant l'inflation en elle-même qu'il faut craindre que les mauvais penchants des banques centrales qui oublient que pour maîtriser l'inflation, il faut maîtriser la création monétaire.

Dérapiage des prix en avril

31 mai, mercredi noir sur les principales bourses mondiales. A Paris, le CAC 40 a perdu 3,18%, repassant en dessous de la barre des 5000 points ; les autres places européennes ont baissé en moyenne de 3% et même de 3,40% à Francfort. Aux Etats-Unis, le Dow Jones a cédé 1,88% et le Nasdaq 1,50% et même le Nikkei à Tokyo a perdu 1,35%. Les jours suivants ont été incertains. Qu'est-ce qui a rendu les places financières si nerveuses ? La perspective d'un retour de l'inflation et avec celle-ci d'une politique de hausse des taux d'intérêt.

Il faut dire que deux mauvais indices avaient été publiés de part et d'autre de l'Atlantique. Aux Etats-Unis, les prix à la consommation ont augmenté de 0,6% en avril et de 3,5% en un an, alors que les anticipations étaient moindres. Certes, on publie aussi un indice hors alimentation et énergie, car les prix de l'énergie grimpent artificiellement ces temps-ci en raison de la situation internationale. Cet indice a progressé de 0,3% en un mois et de 2,3% en un an. C'est sensiblement plus que l'objectif que se fixe la banque centrale américaine, qui est de contenir l'inflation ainsi calculée entre 1 et 2% : on est sensiblement au dessus.

Presque au même moment, on apprendait qu'en Europe la hausse mensuelle des prix avait été, dans la zone euro, de 0,7% en avril et de 2,4% en un an. Là encore, c'est sensiblement au dessus de l'objectif que s'est fixée la Banque centrale européenne, qui est de contenir la hausse annuelle des prix en dessous de 2%. Certes, le dérapage n'est pas considérable, mais certaines hausses sont inquiétantes : 35% pour les carburants, 19% pour le gaz, 5,3% pour le logement, 2,7% pour les boissons alcoolisées ou les hôtels restaurants. Mais on notera que d'autres prix diminuent sensiblement en Europe : les télécommunications (-18%) ; les vêtements (-12%) : comme par hasard, des secteurs où la concurrence est très

vive.

L'inflation est une drogue dangereuse

On comprend que la conjonction de ces deux hausses ait inquiété les marchés. Mais faut-il avoir peur de l'inflation ? Et d'abord l'inflation est-elle dangereuse ? Un certain climat keynésien nous a habitués à croire que l'inflation, c'était bon pour la croissance, car cela donnait un peu de carburant au moteur. Et les keynésiens ont toujours préféré relancer l'économie, au risque de provoquer de l'inflation, que pratiquer la rigueur monétaire.

La réalité est bien différente. L'inflation est une drogue dangereuse. Elle n'est pas bonne dans une économie ouverte, car faire « plus de bêtises » que le voisin réduit la compétitivité : on l'a bien vu dans les années 70-80 entre la France et l'Allemagne. Mais là n'est pas l'essentiel. L'essentiel, c'est qu'une économie de marché, comme l'ont montré Adam Smith, puis Friedrich Hayek, repose sur le mécanisme des prix.

Les prix, du moins tant qu'ils ne sont pas faussés artificiellement par l'Etat avec ses impôts, ses subventions, ses réglementations, sont des vecteurs d'information sur les marchés. Ils révèlent les priorités aux agents économiques. Les ménages comme les entrepreneurs savent ce qu'ils doivent faire parce que les prix, en variant, leur indiquent l'évolution des raretés : ce sont les signaux qui poussent à agir dans la bonne direction. L'inflation vient brouiller le message des prix relatifs, comme le ferait une sorte de bruit de fond sur une station de radio : on ne sait plus ce qui est le signal du marché (variation des prix relatifs) et ce qui est dû au mouvement de fond de l'inflation (hausse du niveau absolu des prix). Voilà pourquoi, pour qu'une économie de marché fonctionne bien, il faut une inflation proche de zéro, pour que le mouvement des prix relatifs retrouve toute sa pertinence.

C'est la masse monétaire qu'il faut contrôler

Revenons à l'actualité : faut-il craindre l'inflation en ce moment ? Certains prix progressent, à commencer par ceux de l'énergie. Mais d'une part il existe aujourd'hui de puissantes barrières anti-inflationnistes, de l'autre, la hausse de l'énergie ne peut dégénérer en inflation que si la masse monétaire le permet.

Parmi les barrières anti-inflationnistes, la concurrence est l'une des plus importantes. C'est la mondialisation qui constitue le premier rempart dans la lutte contre l'inflation. On voit bien comment, dans les secteurs où la concurrence internationale est forte, les prix ont tendance à

diminuer. Voilà pourquoi la hausse d'un prix (comme l'énergie) ne suffit pas à dégénérer en inflation : la concurrence est, comme l'a expliqué Frédéric Bastiat, cette force qui pousse les entreprises à se mettre au service des consommateurs en baissant les prix.

Mais la pression de certains prix peut dégénérer en inflation ouverte si l'inondation monétaire se produit, c'est-à-dire si les banques centrales ne jouent pas leur rôle. Certes, elles annoncent une politique monétaire restrictive, en augmentant le taux d'intérêt (les taux directeurs ont été relevés seize fois consécutivement aux Etats-Unis ; l'Europe semble suivre le même chemin). Mais rien ne garantit que ces hausses entraîneront un ralentissement de la masse monétaire. Les banques centrales font en effet l'inverse de ce qu'il faut faire : elles contrôlent le taux d'intérêt, au risque de laisser filer la quantité de monnaie, alors qu'elles devraient maîtriser la masse monétaire.

Ainsi, en Europe, alors que la BCE annonce qu'elle ne souhaite pas que la quantité de monnaie M3 progresse de plus de 5%, celle-ci a augmenté sur un an de 8,6% : c'est trop et cela peut dégénérer en inflation. On ne peut contrôler en même temps le prix (le taux d'intérêt) et la quantité (la masse monétaire) : il faut choisir. S'il y a des tensions inflationnistes, elles sont dues à un manque de rigueur. Il semblerait que la BCE commence à prendre conscience du dérapage de la masse monétaire. C'est cet indicateur qu'il faudra suivre pour savoir où va l'inflation. L'inflation est une drogue dont il est difficile de se désintoxiquer. Mieux vaut s'en préserver tout de suite. Aux banques centrales d'agir en ramenant la croissance monétaire à un rythme compatible avec la stabilité des prix.

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BUDGET BRIEF 2006-2007

The Deputy Prime Minister and Minister of Finance and Economic Development, Hon. Rama Krishna SITHANEN, presented the 2006-2007 Budget of the Government of Mauritius at the National Assembly on 9 June 2006. The Budget Speech as well as the Draft Recurrent Budget and the Draft Capital Budget can be downloaded on <http://mof.gov.mu>. The Budget proposals, which are subject to amendments on their adoption after parliamentary debates, will be incorporated with finer details in the Finance Act 2006.

This Brief, prepared by PluriConseil, summarises the main policy measures and economic estimates contained in the Budget Speech.

ECONOMIC SECTORS

- Rs 500 million (US\$1 = Rs 31) earmarked by the Mauritius Sugar Authority for de-rocking, irrigation, improved cultural practices and better cane varieties.
- Elimination of customs duty on all inputs for the whole manufacturing sector.
- Rs 300 million to the Mauritius Tourism Promotion Authority to finance a promotion campaign to expand and diversify our markets.
- Setting up of a Development and Enterprise Market to allow small companies to be listed on the Stock Exchange of Mauritius.
- Possibility to carry out private banking services.
- The cost of International Private Leased Circuits on SAFE reduced by at least 25% as from 1st July 2006.

INVESTMENT FACILITATION

- New micro-enterprises and SMEs will be allowed to start their activities within three working days.
- A **tax holiday** for a period of 4 years will be granted to small enterprises converted into companies and which register for the first time with Income Tax.
- Development and building permits will be merged into one permit.
- Residence permits and work permits will be combined into an **occupation permit** for investors generating more than Rs 3 million of annual turnover, for professionals offered employment paying more than Rs 30,000 a month, and for self-employed generating an annual income of Rs 600,000 a year.
- After three years of activity in Mauritius, the foreign investor and spouse and dependents can apply for a **Permanent Residence Permit** which will be valid for ten years and allow unrestricted work and residence as well as purchase of real estate.
- International law firms will be allowed to form law corporations.
- All incentive certificate schemes will be abolished except for the Integrated Resorts

Scheme and Freeport scheme.

- Abolition of the present Tripartite mechanism for wage compensation and setting up of a **National Wage Council**.
- Labour laws will be revisited.

TAXATION POLICY

- **Personal income tax** rates for 2006/2007: 15% applied to the first Rs 500,000 of chargeable income, 22.5% applied to non-interest related chargeable income above Rs 500,000 (15% to chargeable income from interest).
- The 22.5% top rate will be lowered to 20% in 2007/2008, to 17.5% in 2008/2009, and to a single tax rate of 15% on all types of chargeable income in 2009-2010.
- A family with one dependent can earn up to Rs 25,000 a month, including end of year bonus, and not pay any income tax. The income exemption threshold is Rs 29,600 in the case of two dependents, and Rs 32,500 in the case of three dependents.
- 40,000 income earners currently paying taxes will be removed from the tax net and will gain up to Rs 12,000 in tax savings a year.
- A **National Residential Property Tax** will apply on any person whose total income, i.e. taxable income together with exempt income, exceeds the income exemption threshold of Rs 215,000. The rate will be Rs 10 per square meter of surface area of land for residential plots and Rs 30 per square meter of floor space for flats and apartments, from which any amount of rates paid on those properties to local authorities will be deductible.
- The **Corporate Income Tax** will be lowered to 22.5% in 2006/2007, to 20% in 2007/2008, to 17.5% in 2008/2009 and to a single rate of 15% for all sectors in 2009/2010.
- The ceiling for an equipment to be fully expensed in the first year will be raised to Rs 30,000.
- Abolition of the 25% Investment Allowance.
- All existing provisions relating to tax credits and tax holidays removed.
- The **Alternative Minimum Tax** rate raised to 7.5%.
- A deduction at source on **interest income** will apply in respect of accrued amounts exceeding Rs 120,000 in a year.
- The car benefit value adjusted to a range of Rs 48,000 to Rs 60,000.
- Any individual who owns more than one residence, or an immovable property with price at time of purchase exceeding Rs 2 million, or a car with an engine capacity exceeding 2,000 cc, or a private pleasure craft, will be required to file an income tax return.
- All persons will be required to declare in their income tax returns the total **exempt income**, such as dividends, derived in the year.
- **Registration duty** on transfer of immovable property cut to 5%. All registration duties relating to loans will be of fixed amounts.
- The rental amount charged to the lessees of **campement sites** will be between Rs 125,000 to Rs 250,000 per arpent per year, adjustable every 3 years to reflect

market evolution. Those amounts will be reduced by 25% for sites that do not have a sea frontage.

- The top **customs tariff** rates of 65%, 55% and 40% brought down to 30%.
- Duty on **motor cars** of 1,600 c.c. or less will be 55% whereas those above that cylinder capacity will be subject to a duty of 100%.
- A **Solidarity Levy** of 0.85% of turnover will apply to profitable hotels and Destination Management Companies/Tour Operators, for four years starting 1st July 2006.
- The annual turnover threshold for compulsory VAT registration lowered to Rs 2 million.

SOCIAL REFORMS

- The scheme to pay half the School Certificate and Higher School Certificate **exam fees** will be discontinued except for needy students.
- Starting August 2008, the **retirement age** will be raised by one month every two months to reach 65 years by 2018, both in the public and private sectors.
- Setting up of an **Empowerment Programme** that will unlock opportunities for the unemployed, for those recycled from their jobs, for women, for young people entering the labour force and for small and medium entrepreneurs. The project value is Rs 5 billion, but the allocation for 2006/2007 will be Rs 750 million.

ESTIMATES

- Growth rate: 3.8% in 2005/2006, 5.3% in 2006/2007.
- Inflation rate: 5% in 2005/2006.
- Unemployment rate: 9.5% in 2005.
- Budget deficit: 5.5% of GDP in 2005/2006, 4% in 2006/2007.
- Total Public Sector Debt: Rs 129 billion, or 65.7% of GDP, at end June 2006.
- External Debt of the country: 13.5% of GDP at end June 2006.
- Debt Service Ratio: 7.6% of total Exports in 2005/2006.
- Net foreign reserves: 7.9 months of imports at end June 2006.
- Money Supply M2: 85.2% of GDP at end June 2006.

KEY QUOTES

- "It is time for the nation to embrace radical change and build a new, open and competitive service platform that is fully integrated into the global economy, like Hong Kong, Singapore and Dubai."
- "Wages are relevant only if you have a job."
- "A country's public finance is a crucial indicator of macroeconomic stability and a determining factor in global competitiveness."
- "Year in, year out we must abide by the golden rule of borrowing only for investment and to the sustainable rule of putting public debt on a downward track."
- "I am relinquishing my discretionary power as Minister of Finance to remit duties and taxes and grant exemptions."