

# 1 Review of the Economy: 2002-03

Viewed against the background of the global economic slowdown, a significant cyclone-induced drop in sugar output and contraction of the Export Processing Zone (EPZ), partly due to political and social disturbances in Madagascar, the Mauritian economy registered a commendable performance during fiscal year 2002-03<sup>1</sup>. Economic performance was underpinned by a real GDP growth of 2.9 per cent, a fall in the consumer price inflation from 6.3 per cent in 2001-02 to 5.1 per cent, the containment of the fiscal deficit as a proportion of GDP, a continued increase in the current account surplus of the balance of payments and a substantial rise in the level of net international reserves. On the external front, the current account of the balance of payments recorded a surplus for the third consecutive year, with the surpluses on the services and current transfers accounts more than offsetting the pronounced deficit on the merchandise account. Net credit to Government from the central bank contracted further. Broad money supply M2 grew by 11.7 per cent during the period under review as a result of increases in both net foreign assets of the banking system and domestic credit. The closure of a number of EPZ firms has produced a negative impact on the level of unemployment. The rise in unemployment, which reflects mainly mismatches between job availability and the quality of education and training, as well as rigidities in the labour market, needs to be firmly addressed.

Gross Domestic Product (GDP) at basic prices increased by 6.7 per cent, from Rs117,578 million in 2001 to Rs125,411 million in 2002. In real terms, GDP growth of only 2.3 per cent in 2002, compared to 5.6 per cent in 2001, was accounted for mainly by negative growth in the agricultural and manufacturing sectors, due to a lower sugar output and a contraction of the EPZ, respectively, in 2002. However, the economy is expected to pick up and grow by 4.8 per cent in 2003.

The agricultural sector registered a negative growth of 14.4 per cent in 2002, largely driven by a fall of 19.3 per cent in sugar output to 520,887 tonnes, reflecting the effects of cyclone Dina and unfavourable climatic conditions prevailing during the harvest season. The manufacturing sector contracted by 1.2 per cent in 2002. Manufacturing enterprises of the EPZ registered a negative growth of 4.0 per cent with exports totalling Rs33.5 billion in 2002 compared to Rs33.7 billion in 2001. The EPZ is expected to again contract by around 2 per cent in 2003, with exports estimated at approximately Rs34 billion against the backdrop of the current weak external economic environment and limited developments emanating from AGOA II. The tourism sector, after registering a mild growth of 1.0 per cent in 2001, picked up in 2002 and expanded by 3.2 per cent in spite of security concerns worldwide stemming from potential terrorist attacks and the slowdown in economic activity in major industrial countries. The number of tourist arrivals increased from 660,318 in 2001 to 681,648 in 2002. Gross tourism earnings, however, recorded a marginal increase of 0.9 per cent, from Rs18,166 million in 2001 to Rs18,328 million in 2002, compared to a growth of 27.6 per cent in 2001. The construction sector posted a robust growth of 7.8 per cent in 2002, reflecting higher levels of investment in building and construction works. The "Financial Intermediation" sector registered a lower growth of 2.0 per cent in 2002 compared to 11.0 per cent in 2001. This was mainly attributable to a zero growth rate in the non-insurance sub-sector, resulting from a decline in the level of offshore banking activities.

In nominal terms, aggregate consumption expenditure increased by 9.6 per cent in 2002 compared to 8.2 per cent in 2001. In real terms, it registered a growth of 3.2 per cent in 2002, the same as in 2001. Gross National Savings (GNS) increased, in nominal terms, by 4.2 per cent in 2002. The savings rate, defined as the ratio of GNS to GDP at

<sup>1</sup> The fiscal year extends from 1 July to 30 June.

market prices, declined from 28.4 per cent in 2001 to 27.5 per cent in 2002, and is expected to decrease further to 27.4 per cent in 2003.

Gross Domestic Fixed Capital Formation (GDFCF), exclusive of the acquisition and disposal of aircraft and marine vessel, increased by 10.4 per cent in nominal terms in 2002. In real terms, this represented a growth of 6.8 per cent in 2002 as against a contraction of 2.6 per cent in 2001. The ratio of GDFCF to GDP at market prices declined from 22.6 per cent in 2001 to 22.2 per cent in 2002, but is expected to increase to 22.6 per cent in 2003.

The population of the Republic of Mauritius was estimated at 1,216,773 as at end-December 2002. The total labour force, inclusive of foreign workers, grew marginally by 0.4 per cent to 540,900 in 2002. Taking account of the closure of a number of EPZ firms and the large number of employees opting for the Voluntary Retirement Scheme (VRS) in the sugar industry, employment in the economy contracted by 0.1 per cent in 2002. The total number of persons in employment, inclusive of foreign workers, decreased from 490,800 in 2001 to 490,100 in 2002. Forecasts for 2003 show that total employment in the economy is expected to grow by 1.0 per cent to 495,200 with the number of foreign workers rising by 8.8 per cent, from 17,000 in 2002 to 18,500 in 2003. The unemployment rate edged up by 0.6 percentage point to 9.7 per cent in 2002 compared to a 0.3 percentage point increase in 2001 and is forecast to reach 10.2 per cent in 2003. The rising unemployment trend observed since the early 1990s has been further exacerbated by the closure of a number of EPZ firms and the lay-off of workers during 2002-03.

Despite the increase in the Value-Added Tax (VAT) rate, from 12 per cent to 15 per cent in July 2002, and increases in the administered prices of certain goods such as flour, cooking gas and cement, the rate of consumer price inflation declined from 6.3 per cent in 2001-02 to 5.1 per cent in 2002-03, lower than the initial target of 6.0 per cent set by the Bank of Mauritius at the beginning of 2002-03.

Against the background of the global economic slowdown and the general decline in interest rates in major international financial markets, there was some degree of monetary easing by the Bank of Mauritius. The Lombard Rate was brought down successively by a total of 125

basis points during the period under review. The reduction in the Lombard Rate was mainly geared towards stimulating investment and enhancing business confidence, thereby supporting growth in the economy through a reduction in lending rates. The Lombard Rate was reduced from 11.50 per cent to 11.25 per cent on 13 November 2002, to 11.00 per cent on 11 December 2002, to 10.50 per cent on 5 February 2003 and further to 10.25 per cent on 7 May 2003. Category 1 banks adjusted their interest rate structure more or less in line with the changes in the Lombard Rate. Through its regular conduct of repurchase operations, the Bank promoted stable liquidity conditions conducive to its overall objective of maintaining price stability.

Following the establishment by the Bank, since 1 February 2002, of a Primary Dealer System with a view to promoting an active secondary market for trading in Government securities, four Category 1 banks, namely, Barclays Bank PLC, The Hongkong and Shanghai Banking Corporation Limited, The Mauritius Commercial Bank Ltd and State Bank of Mauritius Ltd, continued to operate as primary dealers during the period under review. In order to enhance the scope for primary dealership activity, the Bank of Mauritius discontinued its over the counter (OTC) sales of Treasury Bills to individuals and non-financial corporations with effect from 1 October 2002. The implementation of the Primary Dealer System also led to an overhaul of the bidding process at primary auctions. During 2002-03, the Bank embarked on a gradual process of phasing out non-primary dealer bidders such that, eventually, only primary dealers would be entitled to bid at primary auctions. Another development under the Primary Dealer System during the period under review was the introduction of three new bands for the trading of securities with maturities ranging from 365 to 728 days.

Aggregate monetary resources, that is money supply M2, expanded by 11.7 per cent in 2002-03 compared to an increase of 13.0 per cent in 2001-02. Net foreign assets of the banking system went up by 19.0 per cent, from Rs39,974 million at the end of June 2002 to Rs47,568 million at the end of June 2003, reflecting essentially an increase in the net foreign assets of the Bank of Mauritius. Domestic credit increased by 7.6 per cent in 2002-03, slightly down from 7.9 per cent in the preceding year. Credit to the private sector expanded by 6.4 per cent in 2002-03, lower than the increase of 8.1 per cent in 2001-02. Net credit

to Government by the banking system grew by 13.2 per cent in 2002-03 compared to a rise of 8.0 per cent in 2001-02, reflecting an increase in the level of net credit from Category 1 banks that more than offset the substantial contraction in net credit to Government from the central bank.

The budget deficit for 2002-03 was Rs9,068 million, equivalent to 6.0 per cent of GDP at market prices, that is the same level as in the preceding year. The process of fiscal adjustment has been set in a medium-term framework and corrective measures to address fiscal imbalances and restore fiscal discipline have already been initiated. The budget deficit in 2002-03 was financed mostly from domestic sources. Net financing from the central bank was negative for the fourth consecutive year. Total public debt reached Rs95,487 million as at end-June 2003 with internal and external debt amounting to Rs86,413 million and Rs9,074 million, respectively. Total public debt as a percentage of GDP at market prices increased from 55.4 per cent at the end of June 2002 to 63.5 per cent at the end of June 2003. The debt service ratio of the country fell from 8.5 per cent in 2001-02 to 8.1 per cent in 2002-03.

Exchange rate movements during the period under review reflected the combined effects of international trends and local market conditions. Between the 12-month period ended June 2002 and the 12-month period ended June 2003, the rupee, on an average basis, depreciated by 10.9 per cent against the euro, 6.1 per cent against the South African rand, 5.3 per cent against the Pound sterling and 0.9 per cent against the Japanese yen, but appreciated by 4.0 per cent against the US dollar. Liquidity conditions in the domestic foreign exchange market showed a marked improvement and remained comfortable. Reflecting this situation, the Bank of Mauritius purchased a total amount of US\$189.0 million through intervention on the interbank foreign exchange market during 2002-03.

The current account of the balance of payments registered a lower surplus of Rs5,037 million in 2002-03 compared to a surplus of Rs7,169 million in 2001-02. The surplus on the current account represented 3.4 per cent of GDP in 2002-03 compared to 5.2 per cent in 2001-02. The surplus on the current account of the balance of payments stemmed from surpluses recorded on the services and current transfers accounts that more than offset the pronounced deficit on the

merchandise account. Total exports (f.o.b.) increased by 15.4 per cent to Rs54,953 million in 2002-03 while imports (f.o.b.) went up by 17.5 per cent to Rs63,716 million. The capital and financial account recorded a net outflow of Rs7,878 million.

Net international reserves of the country, comprising the net foreign assets of the banking system, foreign assets of Government and Mauritius' Reserve position in the International Monetary Fund (IMF), increased from Rs40,551 million at the end of June 2002 to Rs48,414 million (US\$1,684 million) at the end of June 2003. Net international reserves, which provide a more appropriate measure of import cover than the foreign exchange reserves of the Bank of Mauritius alone, represented 8.5 months of imports at the end of June 2003 compared to 8.6 months of imports at the end of June 2002.

The Bank of Mauritius has successfully introduced, as from December 2000, the Mauritius Automated Clearing and Settlement System (MACSS), which is based on Real Time Gross Settlement (RTGS) principles. In November 2002, the second phase of the modernisation of the payment system was completed with the automation of the Port Louis Clearing House, which involves the standardisation of cheques using Magnetic Ink Character Recognition (MICR) technology. The MICR feature has enhanced the processing speed of cheques at all Category 1 banks by enabling the electronic settlement and exchange of cheque details among participants through the use of the MACSS communication network. There are presently eleven participants, including the Bank of Mauritius, in the Port Louis Automated Clearing House (PLACH).

In November 2002, Barclays Bank PLC acquired the banking activities of Banque Nationale de Paris Intercontinentale (BNPI) with a view to strengthening its presence in Mauritius. BNPI surrendered its Category 1 and Category 2 banking licences to the Bank of Mauritius on 5 December 2002. Moreover, in May 2003, the Bank of Mauritius gave its approval to the merger between New Co-operative Bank Limited and Mauritius Post Office Savings Bank to form Mauritius Post and Cooperative Bank Ltd. With effect from 16 June 2003, African Asian Bank Limited, a Category 2 bank, has ceased its operations but was yet to surrender its banking licence as at end-June 2003. Two additional money-changers, namely, Max &

Deep Co. Ltd and Gowtam Jootun Lotus Ltd, were authorised to carry on the business of money-changer as from 9 August 2002 and 28 November 2002, respectively. Two non-bank deposit-taking institutions, Mauritian Eagle Leasing Company Ltd and La Prudence Leasing Finance Co. Ltd, were granted authorisation to carry on deposit-taking business in Mauritius with effect from 2 October 2002 and 31 March 2003, respectively.

During financial year 2002-03, Mauritius underwent a Financial Sector Assessment Programme (FSAP) by a joint team from the International Monetary Fund and the World Bank. In its report, the FSAP team concluded that Mauritius has a well-developed financial system and that the banking system is profitable and sound. It, however, also underlined three main sources of potential risks and vulnerabilities, namely, risks associated with external economic shocks and downturn in economic activity, the roll-over risks of growing short-term public debt and potential reputational risk that could arise from money laundering or criminal activities of offshore funds and companies.

As Mauritius braces itself to meet its future challenges, emphasis must continue to be laid on further economic diversification as well as on investment in education, training, and Information and Communication Technology (ICT), which hold out the promise of higher employment-creating growth. Indeed, the achievement of higher job-creating growth remains a central policy challenge for Mauritius in the years ahead. In this perspective, the drive for reforms that Mauritius has embarked upon needs to be maintained and pursued with much vigour. The implementation of the Sugar Sector Strategic Plan on the restructuring of the sugar industry will help to improve the long-term viability of that sector. The EPZ, particularly the textile sector, has fulfilled a key role in the economy's development strategy in the post-independence era. It has helped the diversification of Mauritius from a mono-crop economy with LDC status to a developing economy with a diversified industrial base, albeit with the safeguard of international trade protocols and agreements. The new challenges stemming from the phasing out of the preferential trade agreements call for a paradigm shift in our economic policy with a view to sustaining the pursuit of economic diversification in a changing global competitive environment. A re-engineering of our work culture, business ethics, industrial relations

framework, productivity and multi-skilled training attitudes, and quality culture should contribute to the needed turnaround in the present context. One of the challenges facing the EPZ is to intensify just-in-time, technologically-intensive, scale-based higher value added production methods and strategic financial engineering, all of which will enable a smoother market penetration in sophisticated niche markets in the medium-term. A more durable and sustainable strategy of industrial restructuring and reforms aimed at enhancing the micro-efficiency of export-oriented enterprises should go in the right direction and meet ongoing pressures from global competition. Long-term and lasting competitiveness depends not on short-term macro-economic policy accommodation, whether fiscal or monetary, but on our ability to achieve and sustain improvements in productivity across all economic sectors.

The foregoing economic and financial developments during the year 2002-03 are reviewed in greater detail in the following chapters of the report.