6. GROWTH AND INFLATION OUTLOOK

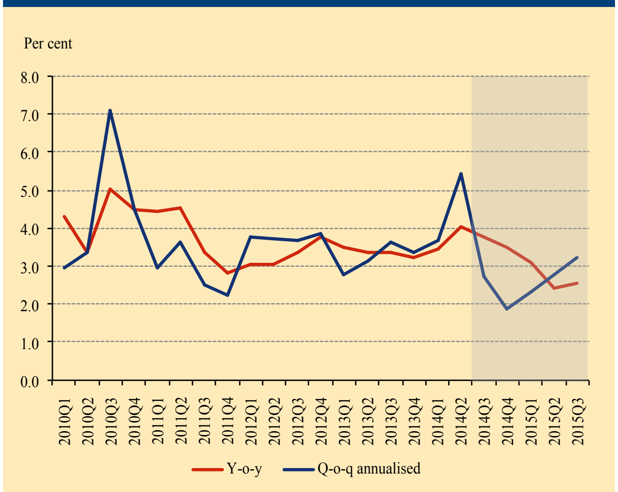
6.1 Growth Projection

Recent economic developments have confirmed that the global recovery is becoming more entrenched in advanced economies in general and in main export markets, in particular. Economic activity is expanding quite rapidly in the US and the UK. Growth in the Eurozone is more moderate, but it appears to be broad-based with better output data being recorded in both the core economies and in an increasing number of peripheral economies. The rising optimism about growth in advanced economies contrasts with sluggish growth expected in emerging market economies.

In its latest April 2014 World Economic Outlook, the IMF maintained its upbeat view of the US economy and upgraded its projection for the UK. While prospects for the Eurozone improved, growth was still expected to be weak. The IMF viewed that the global economy is still far from a normal recovery phase, with growth projected to remain slow and uneven throughout 2014. It emphasised that acute downside risks to growth have decreased but have not disappeared. New risks include the prospect of low inflation in advanced economies, weaker momentum in emerging economies and geopolitical tensions.

The prospects for stronger external demand support an increase in growth in 2014 for Mauritius. It is forecast that real output will expand within a range of 3.7-4.0 per cent for the year, up from 3.2 per cent estimated for 2013 (Chart 6.1).

Chart 6.1: Y-o-y Growth Forecast



Factors supporting increased growth include a stronger-than-expected growth in the economies of our main trading partners. This could reduce business uncertainty and induce firms to undertake new projects. Domestic demand would then start to improve in the second half of this year as consumer and business confidence gradually gets better. However, private investors are still concerned about a number of factors, such as the still fragile economic recovery in main trading partner countries, increased competition on international markets, subdued business confidence and high indebtedness of the corporate sector. As the global recovery slowly takes hold, it may take some time before businesses return to normal conditions and resume investment to improve competitiveness and expand capacity to meet sustained external demand.

Consumers are expected to remain prudent in 2014, with their spending constrained by relatively weak demand for labour while growth in wages in the private sector has not kept pace with the increase in salaries in the public sector. Statistics Mauritius forecasts a marginal improvement in the growth of household consumption expenditure to 2.7 per cent in 2014 compared with 2.6 per cent in 2013.

Major sectors, except the construction sector, are expected to contribute to growth in 2014 though there are some structural constraints that may prevent local businesses from taking full advantage of the global recovery. Productivity issues as well as the relative concentration of markets despite recent diversification efforts are among the greatest obstacles that the export industry faces. High competition in the export of traditional goods, such as textiles, makes it necessary to be constantly on the lookout for niche markets and to find more ways to keep down production costs. The exports of 'miscellaneous manufactured goods' might possibly revert to growth in 2014 though there are concerns that there has been a sharp contraction in exports to the UK and to the South African markets, which are major destinations for textiles. The exports of 'food and live animals', which have fallen during 2013, are expected to increase to higher levels in 2014 as a result of higher foreign investment in this sector, which may contribute to boost production capacity.

Statistics Mauritius projects that the tourism sector will improve during the year, with a growth forecast of 3.9 per cent. However, mixed data from this sector recently are signs that the Mauritian product may need to evolve faster to keep up with regional and other international competitors.

While growth is set to increase in 2014, there are some concerns that underscore the need for bold measures to enhance productivity. Diversification efforts need also to be stepped up so that export enterprises do not lag behind global competitors as external demand conditions improve over the next quarters.

6.2 Inflation Outlook

Global inflationary pressures are expected to stay subdued largely due to activity remaining below potential in advanced economies and in some major emerging market and developing economies as well. According to the IMF April 2014 World Economic Outlook, "potential growth in many advanced economies is very low, while potential growth in many emerging market economies also appears to have decreased". While global oil prices have subsided, global food prices have increased in 2014Q1. The IMF forecast the price of crude oil to average US$104.17 in 2014, declining to US$97.92 in 2015. Overall, there is a low risk of higher commodity prices, according to IMF's projections, given higher supplies in crude oil production, grains and base metals as well as lower prospects for growth in the major emerging and developing economies. However, there could be some temporary rises in food prices due to unfavourable weather conditions and geopolitical tensions.

Recent CPI data in Mauritius do not suggest any major change in the current underlying dynamics of inflation. The rise in inflation in 2014Q1 reflected mostly variations in prices of fresh vegetables due to heavy rain disrupting the supply chain in January and February 2014. Vegetables prices have started to ease in March 2014, and they are expected to gradually adjust back to their normal levels. Thus, the transitory supply shocks which have caused the CPI to increase substantially in January and February 2014, are expected to fade away.

The other underlying inflation measures, do not point to any imminent upside price pressures. Y-o-y CORE2 inflation, which increased from 3.2 per cent in December 2013 to 3.4 per cent in January 2014, fell for two consecutive months, to 3.2 per cent in February 2014 and to 3.1 per cent in March 2014. Food inflation, except for the prices of fresh vegetables, remained stable over the quarter, while imported inflation has continued to remain moderate since December 2013.

In the October 2013 Inflation Report, there were still some fears that spill-over effects from higher wages in the general government sector could be a major inflationary risk. Data based on the wage rate index (WRI) released by Statistics Mauritius for 2013Q4 seemed to suggest that this risk might be subsiding. The nominal increase in the WRI for all sectors of the economy was around 7.2 per cent in 2013Q4, roughly the same rate of increase as in 2013Q3.

However, the institutional sector-split of the WRI between general government and public corporations and private sector combined, showed a wide variation. In the former, there was a large nominal increase in wages of 9.9 per cent in 2013 reflecting the PRB award, whilst for the latter, the increase was estimated at 3.8 per cent. The moderation in wage determination especially in the private sector is largely due to the labour market imbalances as well as the relatively weak balance sheets of the private sector. Nevertheless, the prospect of National Remuneration Board (NRB) awards during the year may still impact on inflation.

Exchange rate developments have so far remained very stable. The nominal effective exchange rate measured by MERI1 and MERI2 have been rather stable in 2014Q1, even showing an appreciation compared with 2013. It is likely that the nominal effective exchange rate will continue to remain stable in the future. However, if the global economy recovers well and world interest rates rise, there could be a possible reallocation of private assets into foreign currency which would rapidly change the dynamics of the domestic economy.

Going forward, on a no-policy change basis, Bank staff forecast y-o-y inflation within a range of 3.9 per cent to 4.1 per cent by June 2014 before increasing to a range of 3.9 per cent to 4.3 per cent by December 2014. Headline inflation is forecast within a range of

3.8 per cent to 4.2 per cent by June 2014, and for the year ending December 2014, within a range of 4.0 per cent to 4.4 per cent (Chart 6.2).

In comparison, the IMF April 2014 WEO forecast the y-o-y inflation for Mauritius would be 4.5 per cent in December 2014 and the 12-month average inflation for the year ended 2014 would be 3.5 per cent.

Chart 6.2: Inflation Forecast