Mauritius—Assessment Letter in the Context of the Aid for Trade Initiative
September 8, 2006

This note presents the IMF staff's assessment of recent macroeconomic developments in Mauritius and the authorities' reform strategy to address the negative impact of the loss of preferential access for the textile and sugar sectors and to raise potential growth. Drawing on the findings of an IMF staff visit to Mauritius in August 2006, it also updates the most recent staff report on the 2005 Article IV consultation discussed by the Executive Board on December 2, 2005 (published as Country Report No. 06/209 at www.imf.org).

Background and Economic Challenges

1. **Mauritius must overcome two major economic challenges:** (i) a high fiscal deficit and potentially unsustainable public debt; and (ii) a permanent deterioration of the terms of trade resulting from the loss of trade preferences in textiles and sugar, which together make up some 12 percent of GDP, 20 percent of employment, and over 50 percent of goods exports (excluding freeport). These challenges come on top of a secular economic slowdown, exacerbated by higher world oil prices: average real GDP growth slowed from over 7.5 percent in the second half of the 1980s to below 3.5 percent during the past five years.

2. **The loss of trade preferences has seriously hurt the Mauritian economy.** Over the past three years, declines in export prices (in U.S. dollar terms), in combination with higher oil prices, have contributed to a 17 percent reduction in the terms of trade, equivalent to an estimated cumulative loss of income of over 4 percent of GDP. Moreover, reform to the European Union's sugar protocol will lower Mauritius's sugar export prices by 36 percent during 2006–10—a drop that will further deteriorate the terms of trade by about 8 percent, equivalent to an income loss of some 3 percent over the next four years.

Recent Economic Developments

3. **Economic performance remained subdued in fiscal year 2005/06 (July-June):**

- Estimated real GDP growth was 3.5 percent, largely owing to declining output in the textile and sugar sectors. The unemployment rate increased to almost 10 percent.

- The fiscal deficit reached an estimated 5.4 percent of GDP, 0.6 percentage points above budget, reflecting both the implementation of electoral pledges made before the July 2005 general elections and higher interest payments. In June 2006, Moody's downgraded Mauritius's local currency rating to Baa1, recognizing the continued increase in government debt. Public sector debt is estimated at 70 percent of GDP.

- While core inflation was contained, headline inflation rose to 10.1 percent (year-on-year) in July, mainly reflecting increases in excise rates for cigarettes and alcoholic beverages, the removal of food subsidies, and higher world oil prices. The Bank of

Mauritius (BoM) further tightened monetary policy, raising the signaling rate to 12 percent in July 2006.

- The current account deficit deteriorated to an estimated 5.5 percent of GDP, reflecting the weak performance in textiles and sugar exports, higher oil prices, and lower import tariffs. Following intervention by the BoM in 2005, the foreign exchange reserves have stabilized at the still-comfortable level of about five months of imports of goods. The real effective exchange rate has depreciated by 10 percent since early 2004.

The Authorities' Reform Program

4. **The authorities are fully aware of Mauritius's major economic challenges and the government has set out a broad-based reform program in its first budget, presented to Parliament on June 9, 2006.** The reform strategy aims at (i) addressing the potential fiscal sustainability problem, (ii) reducing balance of payments pressures associated with the terms of trade deterioration, and (iii) raising potential growth through structural reforms. The reform agenda has four pillars:

- **Securing fiscal consolidation** and modernizing the public sector by reducing current and capital expenditures, simplifying the tax system, making tax administration more efficient, and phasing out costly tax exemptions.

- **Improving the investment climate** by reducing the cost of doing business, unifying existing incentive schemes, and addressing infrastructure bottlenecks.

- **Mobilizing foreign direct investment** by upgrading human capital, drawing from the Mauritian diaspora to attract investment and skilled labor, and implementing targeted promotional marketing campaigns.

- **Restructuring the economy** by transforming traditional sectors (textiles and sugar), promoting growth in existing sectors (e.g., financial services and tourism), and developing high value-added sectors (e.g., information and communication technology and knowledge and medical hubs).

5. **The authorities' reform plan includes further trade and labor market reform.** Building on recent progress in liberalizing trade, the authorities plan to move to a duty-free island within three years, though they may continue to maintain tariff protection for sectors considered sensitive. Tariff reform introduced with the 2005/06 budget has reduced the simple average tariff rate from 17 percent to 6 percent and the top rate from 80 percent to 65 percent. During 2006/07, the top tariff rates (65 percent, 55 percent, and 40 percent) will all be lowered to 30 percent, and the number of nonzero bands will fall from seven to three. The authorities' labor market strategy envisages a new mechanism for wage negotiations, labor law reform, and a new workfare program to provide on-the-job training to the unemployed and workers affected by the restructuring of the economy.

Risks and Challenges

6. **The authorities' reform strategy, as outlined in the 2006/07 budget, attempts to break with the past and is a good starting point for confronting Mauritius's challenges.** The broad-based reform strategy recognizes the need for radical change, and the staff is encouraged by the authorities' strong commitment to reform at the highest level of government.

7. **While a very important step in the right direction, the fiscal reforms involve some uncertainties.** Under staff's macroeconomic assumptions, the announced budgetary measures reduce the budget deficit in 2006/07 by some 1 percentage point of GDP to 4.5 percent of GDP, although this is 0.5 percentage points less than budgeted. On the revenue side, the budget introduces sweeping tax changes, the revenue effect of which is subject to some uncertainty. In particular, it implements a 15 percent flat tax on personal and corporate income, phased in over three years; removes selected tax exemptions (e.g., the 25 percent investment allowance); introduces several new taxes (e.g., tax on pensions, a national residential property tax); and increases selected excise rates. Taking into account the revenue loss of tariff reductions (0.5 percent of GDP), the net revenue effect of all measures is estimated to be slightly negative. To contain current expenditure, the budget streamlines some untargeted subsidies through a cash transfer system, introduces parametric changes to the national pension system, and limits certain recurrent expenditure items. It will be essential to keep nominal expenditure within the budget envelope, even though several budgetary measures (for example, higher excise rates) are likely to push headline CPI inflation some 3 percentage points above budgeted levels.

8. **Additional fiscal effort will be needed in the medium term.** Without additional fiscal effort, staff projects the budget deficit would remain at about 4½ percent of GDP over the next five years and, as a result, public debt as a share of GDP would only decline marginally (by some 1.5 percentage points of GDP). Continued high deficits and debt would put pressure on domestic interest rates and crowd out private sector investment. Part of the debt remains sensitive to interest rate and rollover risk, although the share of short-term government debt has been reduced to around 30 percent.

9. **Several technical assistance missions from the IMF's Fiscal Affairs Department, including a recent one in February 2006, have identified options to support fiscal adjustment.** While upgrading infrastructure and improving the performance of health and education sectors, significant gains could result from the phasing out of the annual allowance in the company income tax and VAT exemptions, the better targeting of pensions, and the consolidation of the system of social transfers. According to staff estimates, implementation of these measures would allow the authorities to achieve an appropriate medium-term fiscal target for the budget deficit of about 3 percent of GDP, which would go a long way toward achieving a sound fiscal basis.

10. **Several structural reform measures outlined in the 2006/07 budget need to be more fully spelled out and promptly implemented to achieve higher rates of growth and**

reduce macroeconomic risks. In the absence of additional structural reforms, staff projects average annual real GDP growth would remain at about 3½ percent over the next few years. The authorities' labor market strategy is still evolving. Enhanced labor market flexibility, including wage flexibility at the firm level, would facilitate economic restructuring. While the training and reskilling initiative may facilitate employment in new sectors, a thorough review of labor laws and regulations should guide further reform. International comparisons suggest that there is scope for simplifying the regulations that govern firms' ability to terminate and redeploy workers. In the area of trade reform, the path of further tariff reductions and the need to maintain tariffs on certain imports has not yet been decided. A simple and transparent tariff with low, uniform rates would be preferable to a regime with multiple exceptions.

11. **To restore external balance, competitiveness will need to strengthen further.** According to staff estimates, fundamental factors, most notably the recent decline in the terms of trade, have served to significantly lower the equilibrium real effective exchange rate. Further adjustments would be required if the additional expected terms of trade decline materializes. Wage restraint and improvements in productivity should support the strengthening of competitiveness.

12. **The authorities also need to proceed with feasibility studies and action plans for infrastructure projects, the restructuring of traditional sectors, and the developments of new growth sectors, although some of these areas are outside the staff's core expertise.**[1] The authorities' highly preliminary estimates put total restructuring costs at some US$4.5 billion over 10 years. While the authorities envisage that government, domestic private investors, and foreign direct investment would finance just over half of this amount, financing sources for the remaining restructuring costs (which include, for example, investments in roads, airport, and port facilities; waste management; the restructuring of the sugar sector; and the promotion of new sectors) must still be identified. A significant increase in debt-creating financing flows could be problematic on debt sustainability grounds.

13. **To raise potential growth to levels experienced during the past two decades, the reform agenda could be strengthened by improving the monetary and financial sector frameworks, reviewing administered prices, and addressing human capital development issues.** The transparency of the monetary framework could be improved through several measures, including the use of the repo rate as an operational target, preannouncing monetary policy meetings, and monetary policy reviews. Relatively high lending rates, differences in taxation between domestic and foreign-sourced interest income, and limited competition among banks may hinder access to credit by domestic corporates. Administered prices, which are still widespread, may reduce the signaling function of prices

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[1] The World Bank's advice has focused on regulatory reforms, trade reforms, and economic restructuring, including the development of new sectors.

in the adjustment process. The education system should be reviewed, with a view to improving human capital development and supporting the growth of high value-added services.

Fund Relations

Mauritius has no outstanding use of Fund resources and is not currently seeking a financial arrangement with the Fund. The next Article IV consultation is tentatively scheduled for February 2007. A Financial Sector Assessment Program update, also scheduled for 2007, will assess potential financial vulnerabilities and other financial sector issues.