7. GROWTH AND INFLATION OUTLOOK

7.1 Growth Projection

The growth outlook for the remainder of 2013 and beyond remains uncertain. Exports to the main Eurozone market continue to be under pressure, while both public and private investment are declining and consumer spending growth is relatively weak.

Latest data on external trade point to a moderate export performance in 2013Q2. The overall y-o-y growth of goods exports, excluding ship's stores & bunkers, slowed and exports to key markets such as the UK, France, and South Africa contracted. The fragile conditions in the Eurozone remain. The difficulties, which it is expected to face, in regaining momentum, after it emerged from its lengthy recession will continue to undermine domestic export performance and weigh on business confidence. Any improvement to the outlook for domestic growth therefore depends on increased demand for exports to the Eurozone and other main trading partners. The uncertainty about the pace of the Eurozone recovery continues to have an impact on economic activity in Mauritius.

Firms in Mauritius have tried to maintain prices at current levels while cost pressures have remained elevated, leading to a reduction in profit margins. The recent salary review in the public sector together with cost of living compensations to employees of the private sector will exert further pressures on labour costs and impact negatively on the balance sheets of enterprises. Moreover, a number of firms have seen their debt levels go up sharply in recent years and may need to deleverage to improve operational efficiency. Private investment is projected to contract in 2013, reflecting weak demand conditions, reduced business confidence and declining cash flow in the corporate sector. Imports of machinery and equipment as well as investment in machinery and equipment have been lower.

Against the backdrop of declining private investment, public investment is also expected to decline given delays or postponement in the implementation of major projects. Any scaling back of Government investment will have an adverse economic impact particularly in the construction sector.

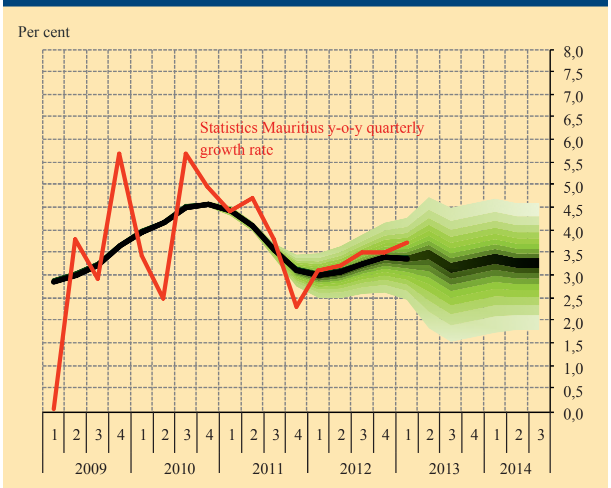
The uncertain economic outlook is also affecting consumer confidence, which combined with high debt levels and relatively high unemployment, is expected to contain household appetite for spending, especially in the low to middle-income groups. Households faced with a tight budget tend to spend on essential items, switch to cheaper brands and wait for intermittent price discounts in retail outlets. Growth in government consumption expenditure, which was negative in 2013Q2, is also expected to remain subdued due to budget constraints. Thus demand conditions are broadly expected to stay soft not only for export-oriented enterprises but also for firms that concentrate on the domestic market.

It is expected that the economy will continue to be supported by the financial and insurance, distributive trade and emerging sectors, such as seafood and ICT. The outlook for the textile sector will depend on the capacity of firms to diversify as external demand is likely to remain subdued, especially from the euro area. There is some evidence that forward bookings in the last quarter of 2013 are gaining positive momentum in the tourism sector, but there is an urgent need to address structural issues such as air access policy, cost of air tickets, hotel prices and corporate structure. In addition, the tourist sector needs to continue to consolidate its position in traditional markets and penetrate into new markets. The construction sector, on the other hand, is likely to continue to be constrained from the excess capacity reflecting substantial debt. The declining trends in private and public investment will also adversely affect activity in the construction sector.

The Bank's staff has therefore revised down its forecast for economic growth for 2013 to a range of 3.1- 3.5 per cent (Chart 7.1). For 2014, based on current information, there do not seem to be any major factors that could either provide a significant lift to the economy or push activity significantly lower compared with 2013. The Bank's staff forecast that growth is likely to stay in the range of 3.1-3.5 per cent, with some possible upward potential if exports increase.

In the short to medium term, downside risks continue to exist. They arise mainly from very low growth or stagnation in the euro area, the danger for a less orderly process of tapering of the US Federal Reserve's stimulus program, that could adversely affect emerging and developing economies, and a prolonged fiscal deadlock in the US. In terms of domestic factors, growth dynamics would be influenced by speedy implementation of public investment programmes and the willingness and ability of the corporate sector to deleverage and restructure its operations with a view to achieving productivity gains.

Chart 7.1: Y-o-Y Growth Forecast



7.2 Inflation Outlook

With excess capacity in advanced economies remaining elevated and with more subdued commodity price pressures, global inflation is expected to remain low. Crude oil prices are expected to remain stable or even decline if OPEC maintains output at current levels. Recent trends in global food prices also point to a moderation in the near future despite the fact that overall prices, remain significantly high, compared with historical levels. Lower food prices in future can, however, contribute to balance out any expected surplus food production as farmers facing higher marginal costs pull out of the market. Though the FAO expect improved supply prospects in 2013 and higher stock-to-use ratios that will bring greater stability to world market prices, the latter will remain vulnerable due to weather-related shocks.

On the domestic front, the inflation rate has moderated amid a persistently negative output gap and a rise in the unemployment rate, which together contributed to some extent to subdued wage and domestic demand pressures. Looking ahead, however, wage developments in excess of inflation and productivity gains continue to remain the main upside risk to inflation in the short to medium-term, especially in the wake of the public sector wage award and its possible spillovers to private sector wages together with the recent cost of living compensation to employees in the private sector. The cost of the compensation to the private sector is estimated at around Rs2.6 billion.

Given subdued domestic demand conditions, most firms have maintained prices at current levels, despite elevated cost pressures, to ensure a certain level of activity. As a result, several firms are operating with low profit margins. A recent private survey of entrepreneurs pointed to emerging price pressures in the next quarter as firms pass on higher costs to consumers to restore profit margins.

Over the past months, the rupee has been broadly stable, in nominal effective terms. A weaker rupee, especially against the US dollar, could pose some risks to inflation. From this perspective, a sudden stop of capital flows financing the chronic current account deficit and sustaining the level of exchange rate of the domestic currency can be a major risk factor in the medium term. The main downside risks to inflation emanate from a more pronounced downturn in the domestic economy, leading to a marked deterioration in labour market conditions. A higher than projected decline in global oil and food prices could restrain price pressures in the domestic economy.

Assuming a similar impact on the 2014 Budget as was the case in the previous two years and on the basis of no change in the monetary policy, the Bank staff forecast y-o-y inflation to stay within a range of 4.5 per cent to 4.9 per cent by December 2013, before rising to a range of 4.9 per cent to 5.5 per cent by June 2014. Headline inflation is forecast within a range of 3.7 to 3.8 per cent by December 2013, and for the year ending June 2014, within a range of 4.2 to 4.5 per cent (Chart 7.2). Assuming that the budget 2014 has no impact on prices, the staff's y-o-y inflation forecast is reduced to a range of 3.7-4.0 per cent for December 2013 and to 4.1-4.6 per cent by June 2014.

Chart 7.2: Inflation Forecast