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Economic Update

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MCB GROUP

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Main economic indicators

Figure 1 **Main economic indicators**

	Unit	2018	2019	2020	2021[1]	2022[1]
Real sector						
GVA at basic prices	Rs bn	422	438	379	407	449
GDP at market prices	Rs bn	481	498	430	461	508
GVA growth (at basic prices)	%	3.6	3.2	-14.7	3.9	6.7
GDP growth (at market prices)	%	3.8	3.0	-14.9	4.0	6.7
Gross Domestic Saving	% GDP	9.0	8.8	8.2	8.4	8.8
Gross Fixed Capital Formation	% GDP	18.8	19.6	17.9	19.3	19.6
Private sector investment	% GDP	14.2	14.3	13.6	14.9	14.9
Public sector investment	% GDP	4.5	5.3	4.3	4.4	4.7
Headline inflation	Dec, %	3.2	0.5	2.5	4.0	3.9
Unemployment rate	average, %	6.9	6.7	9.2	8.9	7.8
Fiscal sector						
Budget balance	FY, % GDP	-3.2	-3.2	-13.6	-6.0	-6.0
Budgetary Central Government debt	FY, % GDP	57.0	57.8	75.0	87.2	79.6
Public sector gross debt	FY, % GDP	63.4	65.3	83.4	96.2	88.7
External sector						
Balance of visible trade	% GDP	-23.3	-24.1	-22.2	-28.3	-26.9
Current account balance	% GDP	-3.9	-5.4	-12.6	-13.6	-12.7
Memorandum item:						
Per capita GDP	*USD*	*11,124*	*11,058*	*8,665*	*8,784*	*9,136*

[1] MCB revised forecasts

Sources: Statistics Mauritius, Ministry of Finance, Economic Planning & Development, Bank of Mauritius and MCB staff estimates

International developments

Latest indications portray a global economy that continues to recover but has entered 2022 in a weaker position than previously envisaged, reined in by the continued grip of the pandemic being exacerbated by the rapid spread of the Omicron variant and supply chain disruptions that are contributing to higher inflation. Against this backdrop, following the World Bank's downgrade of its growth prognoses for 2022 in its Global Economic Prospects published earlier this year, the IMF has, in the latest update to its World Economic Outlook, revised downwards its global growth forecast for this year to 4.4%, 0.5 percentage point lower than previously forecast. In particular, the Fund anticipates that Omicron infections would weigh on activity notably in the first quarter of 2022, with the effect thereof starting to fade as from the latter part of the year. Global output is set to grow a little faster than previously thought in 2023 as the pandemic shocks dissipate.

Coming back to the downgrade to the Fund's global growth projection for this year, it mainly reflects cuts in growth forecasts for the two largest economies, the United States and China. In the case of the US, this embodies the lower prospects of legislating the Build Back Better fiscal package, an earlier withdrawal of

extraordinary monetary accommodation, and the impact of continued supply disruptions. China's downgrade essentially reflects the continued retrenchment of the real estate sector and a weaker-than-expected recovery in private consumption. Likewise, mobility restrictions imposed toward the end of 2021, prolonged supply constraints and COVID disruptions are expected to drag on performance across the euro area with the single-currency region's growth prognosis in 2022 having been slashed by 0.4 percentage point, reflecting downgrades in France, Germany, Italy and Spain. Economic growth in the United Kingdom has also been marked down while output growth in the sub-Saharan African region is, on average, projected to stand at 3.7% in 2022, 0.1 percentage point lower than the Fund's October forecasts. Particularly, South Africa's growth forecast has been downgraded by 30 basis points to 1.9% in 2022 in light of the ramifications of a softer-than-expected second half in 2021 and a subdued business sentiment.

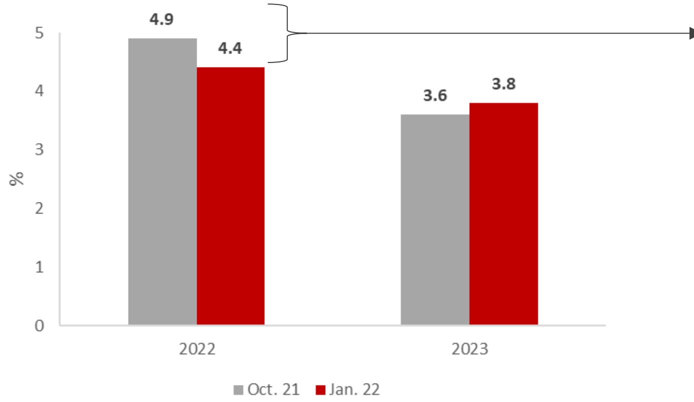
Besides, the IMF has revised up its 2022 inflation forecasts for both advanced and emerging market and developing economies, with elevated price pressures now expected to persist for longer with ongoing supply chain disruptions and high energy prices continuing in 2022. Assuming inflation expectations remain well anchored, supply-demand imbalances decline and the pandemic eases, inflation is anticipated to subside in 2023. On a related note, the rapid increase in fuel prices – driven by strong demand, geopolitical tensions as well as mounting supply concerns – is also expected to moderate during 2022–23. Futures markets indicate oil prices will rise about 12% this year. Oil prices, captured by the simple average of prices of UK Brent, Dubai Fateh, and West Texas Intermediate crude oil, is projected to average USD 77.31 in 2022 before somewhat retreating to USD 71.29 in 2023. As regards financial markets, less accommodative monetary policy in some large economies, notably the US, is expected to prompt tighter global financial conditions, thereby adding to currency pressures in emerging market and developing economies and raising borrowing costs.

On the whole, global growth projections remain subject to high uncertainty and risks are tilted to the downside. As stressed by the IMF, the emergence of deadlier variants could prolong the crisis and induce renewed economic disruptions. China's zero-COVID strategy could exacerbate global supply disruptions, and if financial stress in its real estate sector spreads to the broader economy the ramifications would be felt widely. Higher inflation surprises in the US could elicit aggressive monetary tightening by the Federal Reserve and sharply tighten global financial conditions. This could pose risks to financial stability and lead to a downturn in capital flows in emerging market and developing economies. Rising geopolitical tensions and social unrest could also pose risks while, as per the World Economic Forum in its Global Risk Report 2022, "*a divergent economic recovery from the crisis created by the pandemic risks deepening global divisions at a time when societies and the international community urgently need to collaborate to check COVID-19, heal its scars and address compounding global risks.*"

Box I: Underpinnings of the disrupted global recovery

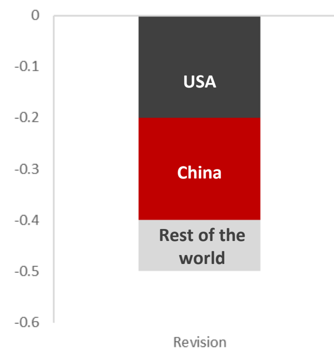
The IMF has slashed its GDP growth prognosis for 2022 …

Percentage change



… the downgrade being largely driven by markdowns in the USA and China…

Percentage points



Note: Revision shows the difference between projections for 2022 global GDP in the Jan 2022 WEO Update and Oct 2021 WEO

Key downside risks to the growth outlook

- *The emergence of deadlier variants*
- *Global supply disruptions*
- *Higher inflation surprises*
- *Aggressive monetary tightening*
- *Tighter global financial conditions*
- *Rising geopolitical tensions and social unrest*

Zoom on key global risks as per the World Economic Forum's Global Risk Report 2022

Top short-term global risks

Over the next 0 – 2 years

- Extreme weather
- Livelihood crises
- Climate action failure
- Social cohesion erosion
- Infectious diseases
- Mental health deterioration
- Cybersecurity failure
- Debt crises
- Digital inequality
- Asset bubble burst

Top medium-term global risks

Over the next 2 – 5 years

- Climate action failure
- Extreme weather
- Social cohesion erosion
- Livelihood crises
- Debt crises
- Human environmental damage
- Geo-economic confrontation
- Cybersecurity failure
- Biodiversity loss
- Asset bubble burst

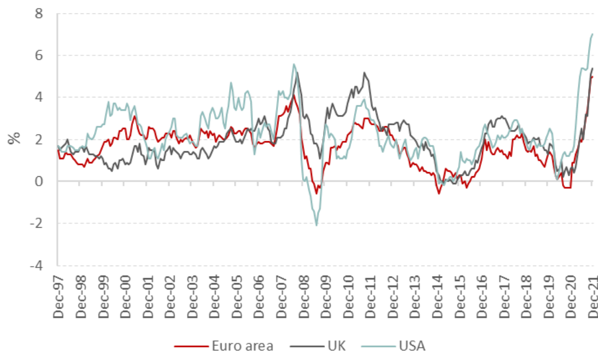
Sources: IMF WEO January 2022, WEF Global Risk Report, Bloomberg, Office for National Statistics, European Central Bank, Bureau of Labor Statistics and other Central Banks

Box I: Underpinnings of the disrupted global recovery (Cont'd)

"Monetary policy is at a critical juncture in most countries where inflation is broad based, alongside a strong recovery, or high inflation runs the risk of becoming entrenched" Gita Gopinath

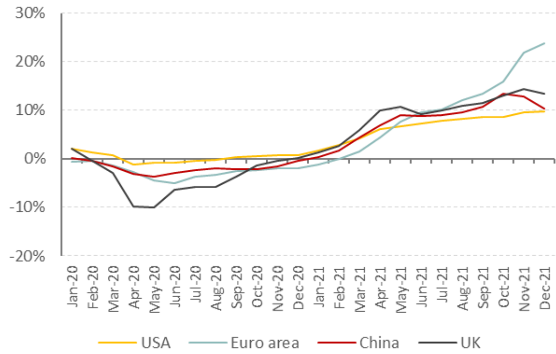
Inflation rates have risen above Central-Bank targets in key advanced economies….

Year-on-year change in consumer price index



Producer price index pursued an upward trajectory…

Year-on-year change in producer price index



Inflation outlook (IMF)

"Inflation is expected to remain elevated in the near term, averaging 3.9 percent in advanced economies and 5.9 percent in emerging market and developing economies in 2022, before subsiding in 2023"

Central Banks are set to chart different paths on monetary policy

Heightened inflationary pressures are likely to prompt the Federal Reserve, Bank of England and Bank of Canada to hike interest rates at some point this year while other central banks including in Norway and Brazil have already raised rates. Meanwhile, their counterparts in the Euro area and Bank of Japan are likely to hold rates at emergency lows to anchor economic expansion amidst pandemic-related upheavals. As for China, it is expected to take a more accommodative stance.

Central Bank	Current rate	Last decision	Comments
Federal Reserve Bank	0.00%-0.25%	Unchanged	Announced the withdrawal of its net asset purchases in March and hinted at possible rate hikes
European Central Bank	0.0%	Unchanged	Announced the roll back emergency pandemic asset buys in March-2022
Bank of England	0.25%	Increased	Ruled out interest rates returning to pre-financial crash levels
Bank of Japan	-0.10%	Unchanged	Raised inflation forecasts but ruled out policy tightening
People's Bank of China	3.70%	Decreased	Warned against the effects of tightening on the global financial stability
Central Bank of Brazil	9.25%	Increased	Pledged for additional hikes this year
Central Bank of the Russian Federation	8.5%	Increased	Bloomberg expects an easing late in 2022

Unchanged ▲ Increased ▼ Decreased

As at 26th January 2022

Sources: IMF WEO January 2022, WEF Global Risk Report, Financial Times, Bloomberg, Office for National Statistics, European Central Bank and Bureau of Labor Statistics

Revised forecasts for Mauritius

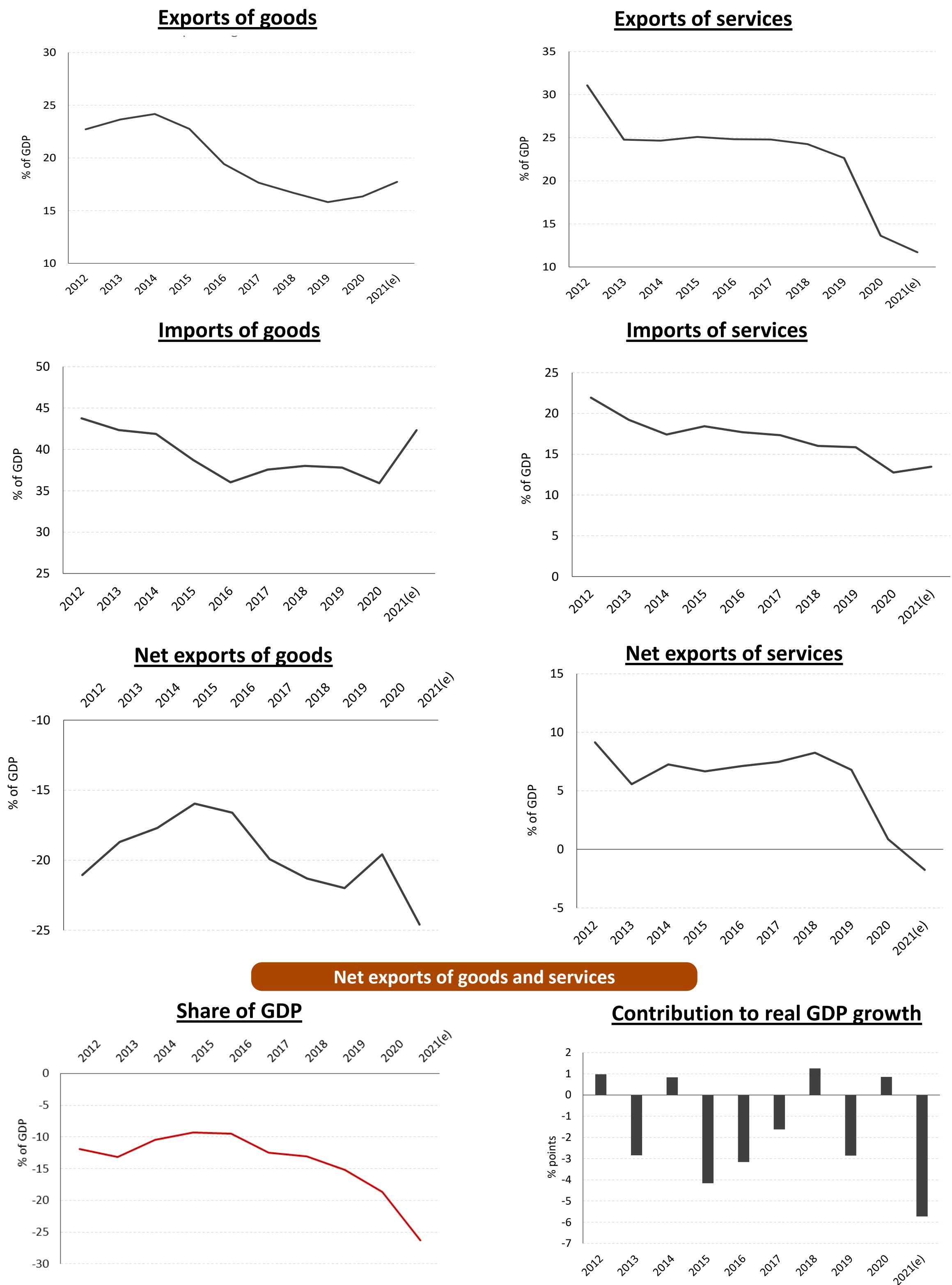
Revised estimates for 2021

Our latest estimates indicate that real GDP growth stood at 3.9% when measured at basic prices and 4.0% when computed at market prices in 2021, representing a cut of 30 and 40 basis points respectively from our previous projections made in early November last. In fact, the downgrade has been prompted by the materialisation of some of the downside risks that had been identified in our November issue of MCB Focus. At the output level, our lower nationwide growth estimates essentially reflect the downward revision in tourist arrivals for the last month of the year in the wake of travel disruptions triggered by the emergence of the Omicron variant. The lower tourism outturn relative to our previous forecasts has, coupled with a slower rebound in the textile manufacturing sector amidst the testing conditions in the country's key export markets as well as a more pronounced decline in sugar production, more than offset the marginal upward revisions in respect of growth in value added in the financial services sector and in construction activities.

From an expenditure perspective, the downgrade in the country's economic growth performance has mainly been driven by a more significant deterioration in net exports of goods and services. The indicator is now estimated to stand at an all-time high of some 26% of GDP in 2021. In addition to factoring in the impact of a higher import bill, with imports of goods attaining around 40% of GDP last year, the tepid evolution of net exports of goods and services captures: (i) the moderate rebound in exports of goods despite benefiting from the significant base effect consequent to the real contractions of 5.2% and 23.3% in 2019 and 2020 respectively and the impact of the weakening of the rupee; and (ii) a further downturn in exports of services amidst the difficult situation in the tourism sector. Whilst being partly understandable on account of dampened demand from key markets and supply disruptions in the wake of the pandemic, our trade patterns warrant attention as they testify to the limitative nature of our economic model as well as our productivity and competiveness foundations. This is a source for concern as the drop in exports of goods and services is indicative of a decline in the contribution of key productive sectors to economic growth. Moreover, whilst consumption expenditure provided further support to nationwide growth, its net impact on real output is generally constrained by its high import content – be it in level or marginal terms. Besides and on a more positive note, we have upgraded our estimate for private investment marginally which contributed to a slight uplift in the gross fixed capital formation ratio to 19.3% of GDP, compared to a previous forecast of 19.1%.

Overall, after factoring our revised real GDP growth estimate, total wealth generated in the country – measured by GDP at market prices – is now estimated at around Rs 461 billion in 2021. When measured in US dollars, GDP stood at USD 11 billion. Subsequently, per capita GDP improved slightly to attain USD 8,784 in 2021 which, however, remains some 21% below its pre-pandemic level.

Figure 2 Overview of trade dynamics and their significance for the Mauritian Economy



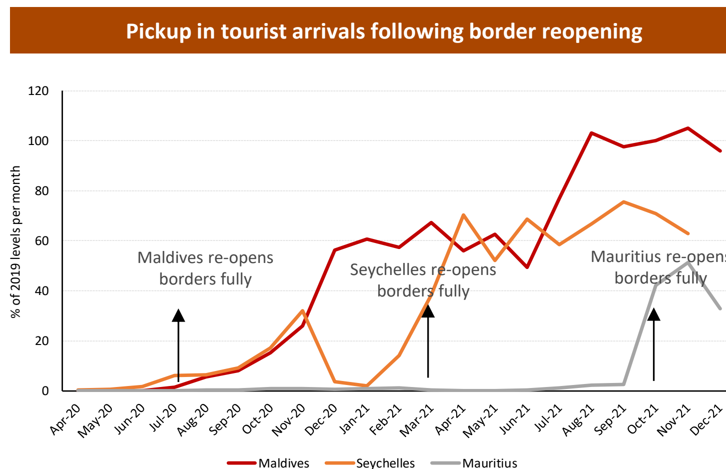
(e) estimates
Sources: Statistics Mauritius and MCB Staff estimates

Zoom on the tourism sector

With regard to the tourism sector which is, currently, the discriminant factor in the country's growth equation, it is worth recalling that we had, back in November, upgraded our forecast for total arrivals for year 2021 following the promising uptick witnessed in travel to our destination, notably from the French market, in the wake of the re-opening of the country's borders. In fact, we were, at that time, hoping to see the country welcoming some 225,000 tourists in total by year-end in our baseline scenario which would still have constituted a drop of 27.2% from the 2020 outcome of 308,980. That said, right towards the end of November, we began to observe a slight deceleration in the pace of forward bookings. This was further compounded by: (i) the disruptions caused by the inclusion – albeit temporarily – of the Mauritian destination on the 'scarlet' list of the French authorities and maintenance of restrictions on travel from Reunion Island; and (ii) the decision taken to close our borders to South African tourists amidst the emergence of the Omicron variant. On the whole, arrivals for 2021 attained 179,780 as per Statistics Mauritius figures, representing a 41.8% drop relative to 2020. Particularly, the afore-described disruptions triggered by the Omicron variant in December have contributed some 25 basis points to the downgrade in our nationwide growth estimate. For its part, Maldives has witnessed a sustained pickup in arrivals thanks to its successful diversification strategy. As such, the country managed to attract over 1.3 million tourists in 2021 in spite of the borders of China, which was its largest source market prior to the pandemic, being closed for outbound travel. Likewise, arrivals in Seychelles grew by 59% relative to 2020 to attain 182,849 last year.

Figure 3 **Evolution of tourist arrivals: Mauritius v/s regional peers**

Pickup in tourist arrivals following border reopening



Tourist arrivals

	Initial target set for 2021	Actual arrivals in 2021	% change 2021/2020	% change 2021/2019
Mauritius	325,000	179,780	-41.8	-87.0
Maldives	1,000,000	1,321,932	+138.0	-22.4
Seychelles	189,000	182,849	+59.2	-52.4

Sources: Maldives Monetary Authority ,Seychelles National Bureau of Statistics and Statistics Mauritius

Updated projections for 2022

For this year, the economic recovery is set to continue, albeit at a softer pace than envisaged in our previous forecasts. In fact, we now expect real GDP growth to attain 6.7% in 2022 when measured at market prices, in line with the latest IMF projection. In spite of the positive base effect of 40 basis points emanating from the slower growth rebound observed in 2021, we have downgraded our growth prognosis by 20 basis points relative to our November figures, on the back essentially of: (i) the ramifications of the disrupted global recovery, notably across the country's key markets, on our export sectors; and (ii) pressures on consumption and construction activities amidst the higher inflation environment. As regards the tourism sector, we have cut our forecast for arrivals in the first quarter of the year amidst the pandemic's continued grip on our key markets but this is being offset by a slightly better outlook for the latter part of the year, assuming the rise in Omicron infections abate and constraints to international travel ease. That said, it is essential that we remain vigilant in our appraisal of the growth forecast, insofar as it is subject to exceptionally high uncertainties, with an unusually wide confidence interval in respect of tourist arrivals.

Overall, activity levels this year should be upheld by a recovery across all sectors. In particular, we expect a noteworthy rebound in the hospitality sector this year with positive spill-over effects on related sectors, considering its significantly low statistical base, enhanced efficiency of operators and the progressive improvement being expected in the sanitary and health conditions globally. Nonetheless, the direct contribution of the tourism sector to GDP growth would be constrained by its significantly lower weight in the economy, with the latter having dropped nearly fourfold in 2021 relative to its pre-pandemic level. Overall, value added in the tourism sector is set to remain well below its pre-pandemic position when making allowance for the uncertainties regarding seat capacity, the multifaceted pressures facing our key markets and, the evolution of the pandemic and prospects for global air travel. With regard to the latter, the International Air Transport Association's Director General recently stressed that: *"People have not lost their desire to travel. But they are being held back from international travel by restrictions, uncertainty and complexity."* In the same vein, as per the latest World Tourism Barometer issued by the United Nations World Tourism Organization, a majority of experts now expect international tourist arrivals to return to their 2019 levels only during the course of year 2024 or later. Regarding other economic sectors, the export oriented manufacturing sector is expected to sustain a positive expansion although higher input costs and the testing conditions in key markets should weigh on activities. Additionally, whilst remaining faced with competitive pressures, the sugar sector should post a rebound after two consecutive years of contraction with momentum in respect of exports of special sugar notably to China after the signing of the Free Trade Agreement likely to be sustained and support from the remuneration linked to the setup of the National Biomass Framework. As for value added in the retail trade segment, it should be impacted by the higher

inflation environment. The construction sector should continue to benefit from public sector investment in various infrastructure ventures and private capital spending notably in projects in the logistics, energy and real estate sectors, although the higher price of construction materials is likely to weigh on the residential building segment. That said, the latter segment should sustain a positive expansion. Support to growth should also come from the continued momentum of the ICT sector on the back of the shift to online operations and transactions, as well as the good showing of the financial services industry. In fact, the exit of Mauritius from the EU list of high-risk third countries which should take effect in the coming weeks should reinforce the reputation of our International Financial Centre as a robust and credible jurisdiction and give a boost to the sector while banks are set to uphold their resilience on the basis of their financial soundness and regional diversification inroads.

Risks to the growth outlook

Overall, the risks to the domestic growth outlook are broadly balanced for the year, with dynamics that could, as elaborated below cause the upswing to be either stronger or weaker than envisaged in our baseline.

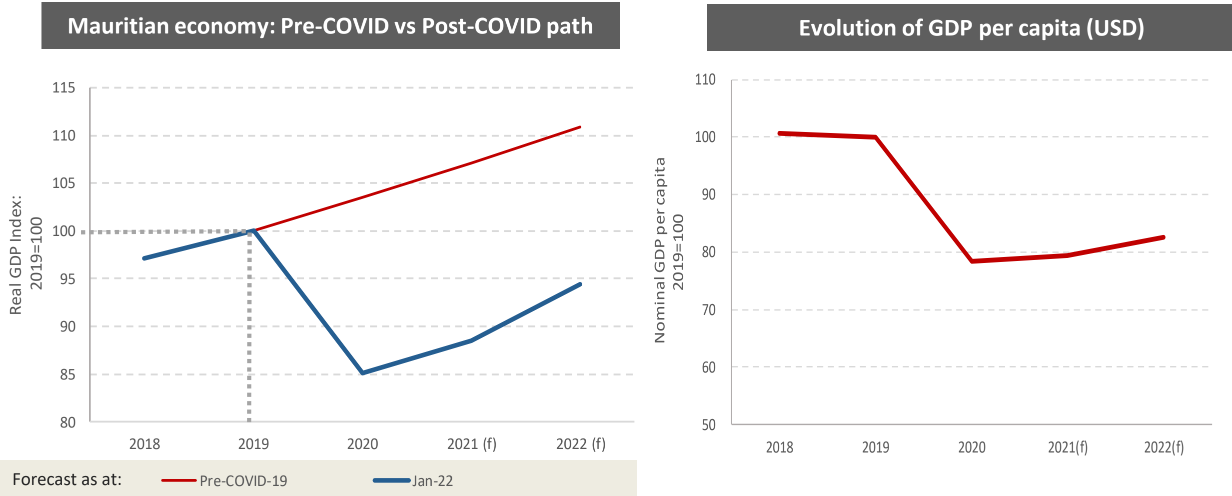
Figure 4 Alternative growth scenarii for 2022

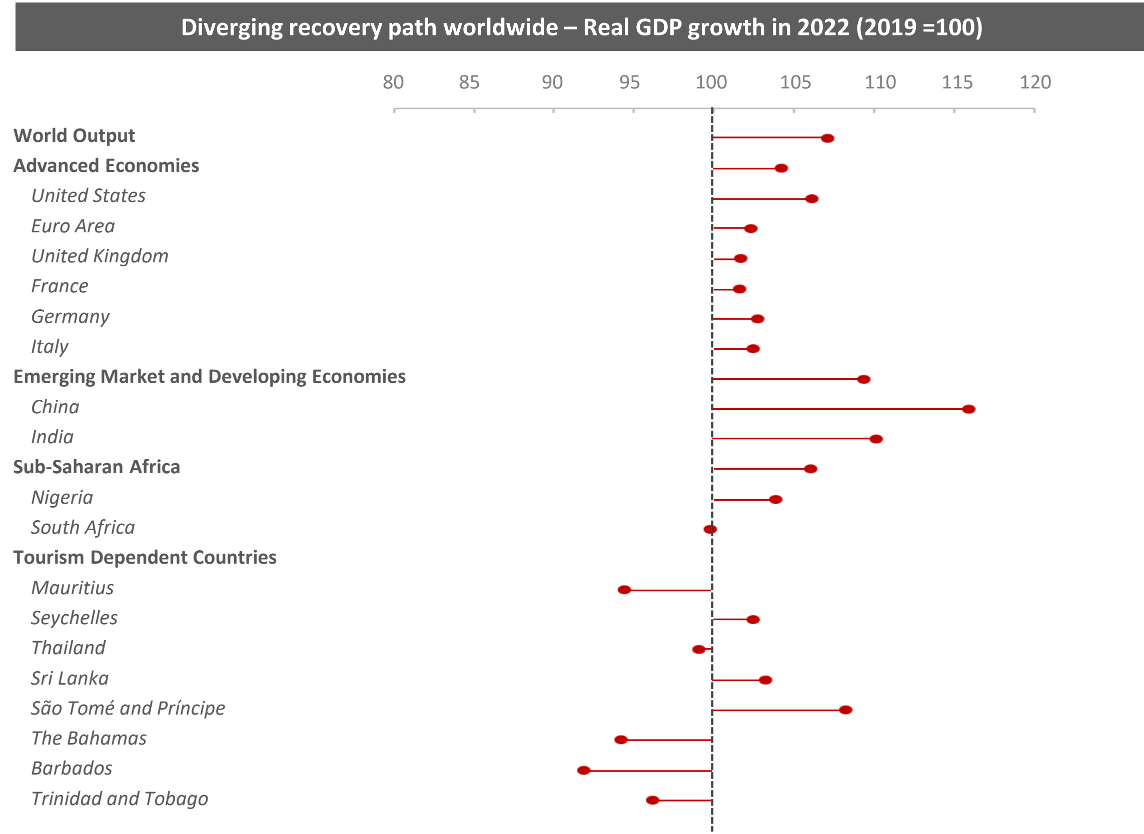
Scenario	Description and expected impact	Probability of occurence	Indicative impact on baseline real GDP growth forecast
Upside	An improvement in the outlook for the external environment, notably in our key markets, triggered amongst others by (i) higher vaccination rollout, (ii) better treatment for the virus and (iii) easing of supply shortages, translating into lower inflationary pressures and a better performance of exports of goods and services.	Low	Up to + 80 bp
	A quicker pickup in tourist arrivals, albeit still remaining below 2019 level, stemming from a faster pace of normalisation of activity level from the COVID-19 pandemic, notably across our key markets, coupled with higher air seat capacity – to notably meet high-end demand, with a mix of additional flights and/or new airlines serving the Mauritian destination.	Moderate	
	A higher-than-envisioned growth in respect of nationwide investment, spurred by the enhancement of project implementation capabilities at both public and private sector levels for instance backed by continued rapid adoption of digital technologies, thus leading to a higher growth in value added in the construction sector.	Low to moderate	
Baseline	The economic recovery from the pandemic, notably in respect of our key export markets, continues albeit at a softer pace, in line with the revised IMF baseline growth scenario for the world economy.	Moderate to high	-
	Growth in overall investment is driven mainly by large-scale government ventures, with a modest growth in private sector investment due to still testing economic climate and high input costs	Moderate to high	
	The Mauritius IFC benefits from the exit of the European Council list of high-risk third countries, thereby improving capital and financial flows in the jurisdiction.	High	
Downside	Relative to IMF's baseline scenario, the external context deteriorates markedly, especially in our export markets, reflecting Omicron-driven pandemic resurgence or emergence of new variants triggering the imposition of additional pandemic control measures that could impact the country's trade in goods and services.	Low	Up to - 90 bp
	Slower pickup in the tourism sector arising from a lower upturn in key markets delaying the anticipated pickup in passenger traffic along with more limited seat capacity - notably in respect of the business and first class segment to meet high-end demand for our destination.	Low	
	Further supply bottlenecks coupled with escalating freight cost and pressures on the external value of the Mauritian Rupee impacting imports and causing domestic inflationary pressures to persist longer than expected in our baseline, with ripple effects on economic activity.	Low to moderate	
	A prolonged period of inflationary pressures worldwide leading to abrupt monetary tightening in major advanced economies, thereby triggering outflow of capital and financial flows with adverse consequences on our balance of payments.	Low to moderate	

Source: MCB Staff estimates

Figure 5 Zoom on the growing growth divergence in the wake of the pandemic

As stressed by the IMF, the recovery from the pandemic has been increasingly diverging across regions and countries amidst differences in vaccination rates and fiscal and monetary policy responses. As for Mauritius, whilst the large policy support and appreciable progress on the vaccination front have enabled the recovery from the historic contraction witnessed in 2020, this has been constrained.





Notes:

(i) Data for world output, advanced economies, emerging market and developing economies and sub-Saharan Africa are based on the latest IMF WEO update issued in January 2022

(ii) For tourism dependent countries, figures have been sourced from the IMF WEO October 2021 database, except in the case of Seychelles and Mauritius and where latest data are available

(iii) Maldives has not been included given that the boost from the exceptional growth in tourist arrivals has not been fully incorporated in latest GDP data available

Sources: IMF WEO update January 2022 & WEO database October 2021, Statistics Mauritius and MCB staff estimates

Other indicators

Unemployment

According to official statistics, nationwide unemployment improved to 9.5% during the third quarter of 2021 compared to 10.4% during the corresponding quarter of 2020 and 10.5% during the second quarter of 2021, supported by the provision of the Wage Assistance and Self-Employed Assistance schemes. Nevertheless and as highlighted in previous editions of MCB Focus, the underlying trends in the joblessness rate continue to mirror the non-negligible section of the population who are outside of the labour force, with the latter group having risen by 47,500 relative to the same period of 2020 to attain 484,200 during the third quarter of 2021. On the flip side, the labour force fell by 40,600 relative to the same period of 2020 to attain 525,900 in the third quarter of 2021. The activity rate decreased by 4.4 percentage points to 52.1% compared to the corresponding quarter of 2020, with the female activity rate decreasing by 4.8 percentage points to stand at 39.8%. The national participation rate is, however, estimated to have picked up in the final quarter of 2021 amidst the gradual improvement in economic activities and the reopening of borders and should rebound further this year, with nationwide unemployment improving, although remaining higher than the pre-pandemic level at 7.8%, compared to an estimated 8.9% in 2021. That said, a more holistic assessment of the labour market is deemed important when considering the level of labour underutilisation – which includes those in potential labour force, the unemployed and those in time and skills-related underemployment – in the economy which was already high before the crisis but worsened as a result. This could have adverse consequences on the country's potential output and long-term growth prospects alongside exerting pressures on the country's productivity trends. On the latter front, it is worth noting that annual productivity growth has slowed in recent years while unit labour cost – in rupee terms – has sustained an uptrend, although moderating when measured in USD terms on the back of the weakening of the rupee. The country's subdued productivity trends are likely to have been aggravated by the effects of the COVID-19 shock. From a more general standpoint, the International Labour Organization has recently stressed, report entitled 'World employment and social outlook Trends 2022': *"The damaging impact of the pandemic on jobs and livelihoods, if not quickly reversed, will run the risk of inducing long-term structural change with enduring adverse implications for labour markets."*

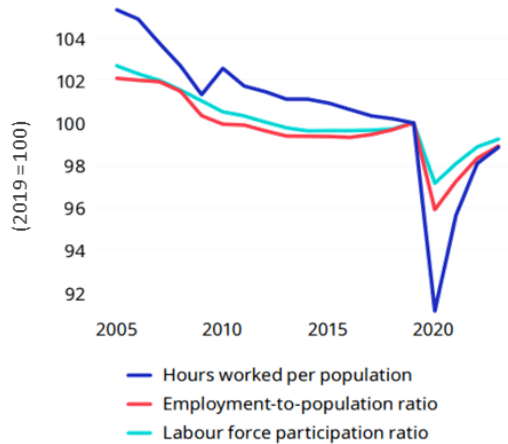
Inflation

A key development warranting attention worldwide is the uptrend in inflation with elevated price pressures set to persist for longer than previously envisioned according to the latest IMF World Economic Outlook Update. A similar dynamic is also being witnessed on the domestic front, with headline inflation rising to 4.0% as at December 2021, its highest level in a decade on account of increases in prices of various items including vegetables and other foodstuffs, the partial pass-through from higher gasoline prices as well as the relative weakening of the rupee vis-à-vis the greenback. Likewise, year-on-year inflation rose to attain 6.8% while core measures of inflation – which exclude items having volatile price movements such as food, gas

Box II: International Labour Organization – World employment and social outlook Trends 2022

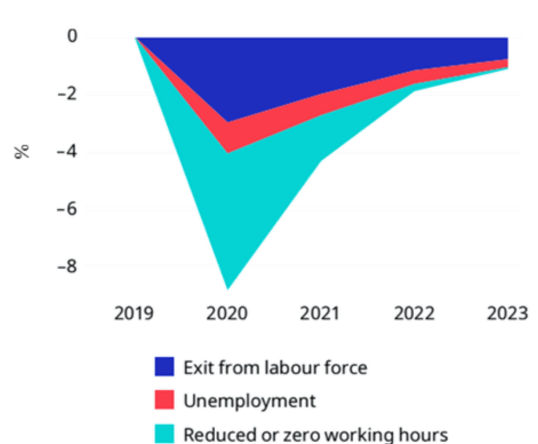
In its flagship report 'World Employment and Social Outlook Trends 2022', the International Labour Organization (ILO) downgraded its forecast for labour market recovery in 2022, projecting that total hours worked globally will remain almost 2 per cent below their pre-pandemic level, corresponding to a deficit of 52 million full-time equivalent jobs. Global unemployment is projected to stand at 207 million in 2022, surpassing its 2019 level by some 21 million and is expected to remain above pre-COVID-19 levels until at least 2023. The report also cautions that the overall impact on employment is significantly greater than represented in these figures because many people have left the labour force. The global labour force participation rate, having fallen by close to 2 percentage points between 2019 and 2020, is projected to recover only partially to just below 59.3 per cent by 2022, around 1 percentage point below its 2019 level. Moreover, the ILO warns of the stark differences in the impact the crisis is having across groups of workers and countries. These differences are deepening inequalities within and among countries and weakening the economic, financial and social fabric of almost every nation, regardless of development status. Indeed, the pandemic is among others exacerbating the digital divide and fostering gender inequities, with the disproportionate impact on women's employment expected to last in the coming years. The recovery of labour demand to pre-crisis levels can be expected to take time, which will slow growth in employment and working hours.

Index of weekly hours worked, employment and labour force as ratios of the global population aged 15–64



In 2022, the ratio of hours worked to the population aged 15–64 is projected to remain 1.8 per cent below its 2019 level*; the corresponding projected ratios are 1.7 per cent below the 2019 level for employment and 1.1 per cent below the 2019 level for the labour force.

Decomposition of change with respect to 2019 in weekly hours worked (world)



The exodus from the labour force is projected to become the main contributor to the lasting impact of the crisis, whereas weekly hours worked per worker are projected to recover to a large degree by 2023.

** Normalizing by population aged 15–64 allows the best comparison of labour market indicators over time, since this is the population most likely to be economically active. The labour force as a proportion of the total population tends to decline over time when the population is ageing, because of the rising proportion of retirees.*

Source: 'World Employment and Social Outlook Trends 2022', International Labour Organization (ILO)

and other fuels - also depicted a non-negligible upturn recently. For this year, whereas the recent subsidy introduced on electricity bills for specific residential tariffs and the extension of price control measures should provide some relief to the consumer price index, notwithstanding potential distortionary effects, heightened inflationary pressures look set to persist with our forecast for headline inflation having been revised upwards after factoring in the recent hikes in price of various items and renewed concerns of supply bottlenecks amidst the Omicron variant which have already contributed to further increases in international oil prices. Against this backdrop, headline inflation is now expected to peak at 6% during the second quarter of the year, before moderating later to stand at 3.9% as at year-end. That said, notable upside risks characterise our outlook for inflation. The latter could turn out higher than expected in our baseline on the back, for instance, of sustained hikes in commodity prices amidst more persistent supply constraints and geopolitical tensions and unfavourable currency pressures, amongst others. Overall, with a view to guarding against adverse economic effects, mounting inflationary pressures deserve careful monitoring from a policy perspective, especially considering the country's negative output gap and fragile and uncertain recovery foundations. Indeed, as stressed in a recent report by the IMF *''Policymakers therefore must walk a fine line between remaining patient in their support for the recovery and being ready to act quickly. Even more importantly, they must establish sound monetary frameworks, including triggers for when they would reduce support for the economy to rein in unwelcome inflation.''*

Public finance

Regarding public finances, we have kept our forecast for budget deficit unchanged at 6.0% of GDP for FY 2021/22, which is higher than the National Budget prognosis of 5.0%. This reflects principally the impact of a higher-than-budgeted expansion in recurrent expenditures and the lower economic growth projection on revenue collection that should more than offset the slight underspending expected on the capital side.That said, public sector gross debt has been following a downward trend lately, having fallen to 94.3% of GDP in September 2021 from 96.2% in June 2021 and is, as per latest indications, estimated to have dropped by a further 5 percentage points during the last quarter of the year. With regard to FY 2021/22, the indicator should pursue a downtrend amidst the gradual mending of economic conditions. A similar improving trend is anticipated in respect of Central Government debt with the latter expected to attain 79.6% of GDP in June 2022 compared to 87.2% for the corresponding month of 2021. Overall, debt ratios should, nonetheless, remain relatively elevated after making allowance for bilateral and multilateral loans. In fact, although external debt remains manageable at around 25% of GDP, it has been on a rising trend lately with the situation warranting attention especially in view of potential adverse feedback loops from a faster tightening of financial conditions in major advanced economies such as the US amidst the current inflationary environment, as outlined in Box I. All in all, while recognising the need to calibrate fiscal policy to the cycle and speed of the recovery, it is essential that both the level and quality of fiscal imbalances be effectively

catered for. In this respect, it is worth noting that the authorities have stressed their intention during the recent meeting with the Word Bank to place the public sector debt to GDP ratio on a downward trend to attain 80% by 2025 and 70% by 2030 in line with budgetary pronouncements. As recently advocated by the IMF, *''Setting a credible commitment to a medium-term fiscal strategy would help boost investor confidence and regain room for fiscal support in a downturn.''* In fact, fiscal sustainability can be achieved while addressing the ongoing crisis in various ways, including by undertaking structural fiscal reforms and adopting strong and transparent fiscal frameworks that embed deficit reduction in the future. This could stem from higher revenue mobilisation through an uplift in potential GDP and an improvement in efficiency of public spending along with the careful prioritisation thereof. Such efforts should, *ceteris paribus*, enable the country to preserve the investment-grade status of its credit profile in support of endeavours to tap into international financial markets, alongside assisting financial sector operators in their regional expansion strategies.

External front

On the external front, our estimate for the balance of trade deficit for 2021 has been aggravated, with the imbalance now estimated at around Rs 130 billion, representing around 28% of GDP, after making allowance for a significant increase in the value of imports on the back of (i) hikes in international commodity prices (ii) ramification of higher freight costs, and (iii) further weakening in the external value of the rupee. That said, the larger imbalance on the merchandise trade front was partly offset by a significant rise in primary income, such that our estimate for the current account deficit has been narrowed to 13.6% compared to 14.4% in our November computations. For its part, after benefiting from the Special Drawing Rights (SDR) allocation of Rs 8.3 billion from the IMF and a noteworthy pickup in the capital and financial flows reflecting the lines of credit and financial assistance received from foreign Governments and international agencies as well as the rise in private capital flows, inclusive of capital raised by local banking institutions on international markets, the balance of payments is estimated to have moved back to surplus territory in 2021.

This year, the trade deficit is anticipated to worsen to attain some Rs 137 billion, mainly on account of a rise in the import bill due to the projected hike in international commodity prices and higher demand prompted by the pickup in economic activities, which would more than offset the anticipated upturn in exports. As for the current account deficit, it is projected to narrow slightly to 12.7% of GDP after factoring the rebound in the services account linked to the relative pickup in tourism earnings. On the whole, the balance of payments would stay in a positive zone in this year, amidst sustained levels of capital and financial flows, inclusive *inter alia* of the project-based disbursement of the lines of credit received from the Government of India.

J. Gilbert Gnany

Chief Strategy Officer January 28, 2022

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