5. MONETARY AND FINANCIAL DEVELOPMENTS

Since the October 2013 Inflation Report, monetary and credit developments continued to reflect relatively subdued economic activity. While broad money supply continued to increase at a moderate pace in 2014, credit to the private sector followed a downward trend. Credit was mostly routed to the construction, personal and tourism sectors. Overall excess liquidity continued to prevail in the banking system although the Bank increased the cash ratio in October 2013. On a weighted average dealt basis, the rupee initially appreciated against the US dollar as the latter lost its safe haven appeal on international markets, but it then broadly stabilised. The domestic currency depreciated slightly against the euro but lost more ground against the Pound sterling due to the latter's broad-based strength on the back of the continued improvement in the UK economy.

5.1 Monetary and Credit Developments

Monetary and credit developments continued to reflect relatively soft economic activity. After trending downwards since the beginning of 2013, the annual growth rate of Broad Money Liabilities (BML) picked up as from November 2013. It moved from a trough of 4.6 per cent in October 2013 to 7.0 per cent in February 2014 (Chart 5.1). In real terms, in line with increasing y-o-y inflation, y-o-y growth in BML fell from 4.2 per cent in January 2013 to 1.4 per cent in February 2014.

In February 2014, growth in BML was mostly driven by an increase in claims on other sectors and to a lesser extent by net claims on central government. Net foreign assets made a marginal contribution to BML growth as the increase of 16.0 per cent in the net foreign assets of the Bank was offset by a 4.5 per cent decrease in the net foreign assets of other depository corporations (Chart 5.2).

Within claims on other sectors, growth in credit to the private sector followed a downward trend during 2013 and beginning 2014 to stand at 5.1 per cent in February 2014. In real terms, the growth in credit to the private sector, which stood at 9.4 per cent in January 2013, fell to minus 0.5 per cent in February 2014.

During 2013, there was a downward trend in credit to the private sector as a percentage of GDP. This was reflected in the credit utilisation rate, which is closely related to developments in economic activity and aggregate demand, and calculated as the annual change in credit to the private sector as a percentage of GDP. The credit utilisation rate mostly fell over 2013, due to the deceleration in credit (Chart 5.3).

The growth in banks' credit to the private sector over the year to February 2014 was mostly channelled to the construction sector (2.5 percentage points), followed by credit to the 'personal' sector (2.0 percentage points) and to 'tourism'

Chart 5.1: Y-o-y Growth in Broad Money Liabilities and Credit to the Private Sector

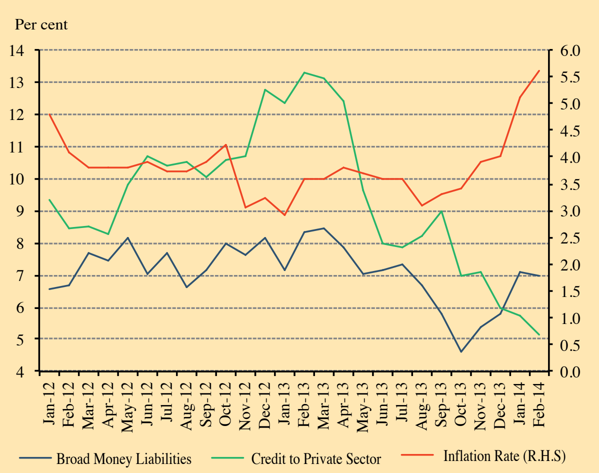
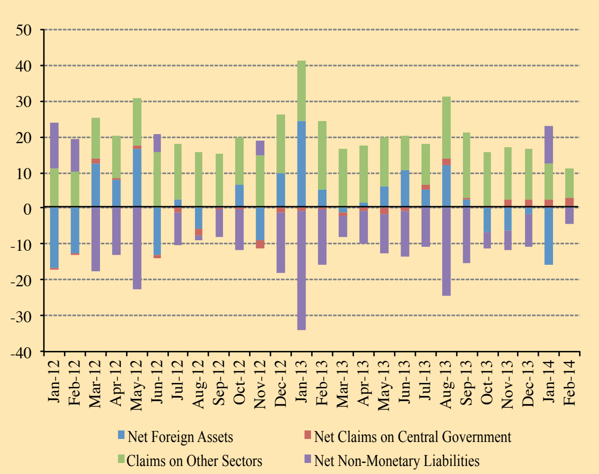


Chart 5.2: Contribution to Y-o-y Growth in Broad Money Liabilities



(1.2 percentage points). Credit to 'public nonfinancial corporations' and 'traders' contributed negatively to total credit growth (Chart 5.4).

Among the components of BML, narrow money liabilities grew by 12.1 per cent y-o-y in February 2014 as a result of growth of 14.6 per cent in transferable deposits while currency with public expanded by 6.2 per cent. Quasi-money liabilities grew by 5.6 per cent y-o-y, mainly as a result of an increase in savings deposits.

The monetary base increased by 22.4 per cent y-o-y in February 2014, mainly as a result of the rise in the Bank's net foreign assets. Within the components of the monetary base, reserve deposits held by Other Depository Corporations (ODCs) at the Bank increased by 33.3 per cent following the increase in the cash ratio in October 2013 and reflecting the excess of banks' cash balances over the cash reserve ratio requirement (Chart 5.5).

Chart 5.3: Credit to GDP and Utilisation Rate

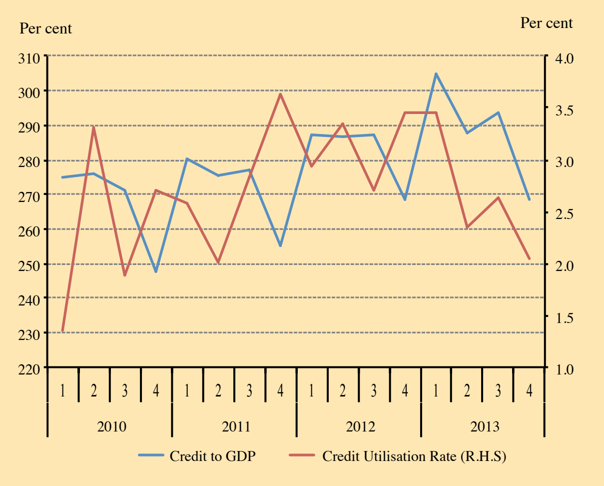


Chart 5.5: Contribution to Y-o-y Growth in the Monetary Base

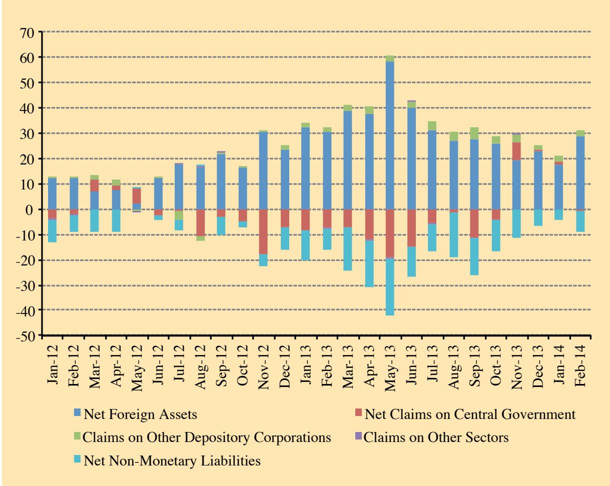
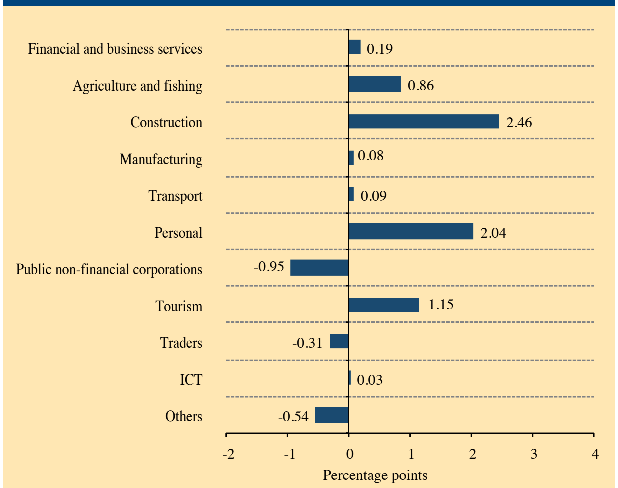


Chart 5.4: Sectorwise Contribution to the Change in Banks' Credit to the Private Sector – end-February 2013 to end-February 2014



Box II: Monetary Policy Decisions

At the February 2014 MPC meeting, the Key Repo Rate (KRR) was left unchanged at 4.65 per cent per annum, with the majority on the Committee in favour of a neutral monetary policy stance. At the April 2014 meeting, a majority of members considered it premature to tighten the monetary policy stance and consequently decided to maintain the KRR at its current level.

At its meeting on 03 February 2014, the MPC noted that the global economy had picked up since the September 2013 MPC meeting, with recovery taking hold in the US and UK. The Eurozone had emerged out of recession, although growth was expected to remain weak and uneven. Emerging market economies continued to face downside risks, mainly from the US Fed tapering and internal rebalancing in China.

The domestic economy had continued to hold up well to the external headwinds and output was estimated to be near its potential. With a recovery in global economic activity, the Bank staff forecast that GDP growth would pick up to a range of 3.7-4.0 per cent in 2014, which would represent an increase of 0.5-0.8 percentage points compared with the estimated growth of 3.2 per cent in 2013 by Statistics Mauritius.

The MPC noted that global inflation had eased in advanced economies but had remained steady in several emerging countries. On the domestic side, y-o-y inflation had risen to 4.0 per cent in December 2013, from 3.1 per cent in August 2013. Core measures of inflation had also increased, reflecting underlying inflationary pressures in the economy. Prices of locally produced goods and services had a higher impact on domestic inflation than prices of imported goods and services.

During discussions, some members expected inflationary pressures to remain subdued during the year and viewed that the economic recovery taking place could be jeopardised by premature monetary policy tightening. Other members argued that domestic growth was firmly recovering while upside risks to inflation were increasing; on a no-policy change basis, y-o-y inflation could, in their view, rise to 5 per cent by the end of 2014Q1 and end the year at around 4.0 per cent. Conditions in the banking system, notably from persistently high and growing excess liquidity, had also deteriorated. Members were divided on the need to rapidly normalise the KRR to address the risks to inflation and the problem of excess liquidity while stimulating savings in the economy. The Committee voted with a majority of 5-3 to keep the KRR unchanged at 4.65 per cent per annum.

At its next meeting held on 28 April 2014, the MPC noted that the global economy had improved since its February 2014 meeting. However, growth remained slow and uneven. Economic activity was projected to expand quite rapidly in the US and UK, and at a slow pace in the Eurozone. The growth outlook for emerging economies had been downgraded.

On the domestic front, notwithstanding the slowdown in growth in 2013Q4, economic activity was projected to pick-up as the recovery in main export markets took hold. The Bank staff's growth forecast had accordingly been maintained within a range of 3.7-4.0 per cent for 2014.

The MPC noted that global inflation was relatively low, but a number of emerging market and developing economies had recorded significant inflationary pressures due to weaker currencies. While global oil prices had subsided, global food prices had increased sharply in the first quarter of the year. The domestic y-o-y inflation had risen to 4.5 per cent in March 2014, from 4.0 per cent in December 2013, reflecting mostly fluctuations in prices of fresh vegetables. On a no-policy change basis, the 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.

The MPC weighed the risks to the growth and inflation outlook over the policy relevant horizon and discussed alternative interest rate scenarios. A majority of members argued that domestic economic conditions were broadly unchanged from the previous MPC meeting. They considered it premature to tighten the current monetary policy stance given continued downside risks to the growth outlook and subdued inflationary pressures. Other members considered it important to start the process of normalising interest rates to encourage savings in the economy and address increasing vulnerabilities in the banking and financial system due to a prolonged period of low interest rates. Members also underlined the need to remain vigilant against the risks of heightened market volatility in the wake of the US Fed tapering. The MPC decided by majority vote to keep the KRR unchanged at 4.65 per cent per annum (Table 1).

Table 1: MPC Decisions on the Key Repo Rate

Date of MPC meeting and effective date of decision	**Decision on the Key Repo Rate**	**Key Repo Rate** (post-decision level, per cent per annum)	**Voting pattern**
3 February 2014	Unchanged	4.65	Majority of 5-3
28 April 2014	Unchanged	4.65	Majority vote*

* The actual voting outcome would be released on Monday 12 May 2014 at 13:00 hours.

5.2 Money Market

The Bank increased the cash ratio from 7.0 per cent to 8.0 per cent in October 2013 in an effort to reduce overall excess liquidity in the banking system. This measure led to a withdrawal of nearly Rs2.0 billion from the system, and excess liquidity fell to an average of Rs4.7 billion in 2013Q4. However, excess liquidity started to rise again and reached a daily average of Rs8.2 billion in 2014Q1.

The main factors that contributed to the rise in excess liquidity were: (i) the decision by government to have recourse to increased external financing, which had resulted into foreign exchange inflows that needed to be sterilised; (ii) the accumulation of foreign exchange reserves by the Bank through Operation Reserves Reconstitution (ORR) programme; and (iii) special funds and Government deposits placed by the Treasury with commercial banks.

In addition to the increase in the cash ratio requirement, the Bank had to engage in costly sterilisation to withdraw excess liquidity from the banking system. It issued its own instruments amounting to Rs9.8 billion and conducted a short-term reverse repo transaction to drain out some of the excess liquidity. By the end of March 2014, a total amount of Rs20.8 billion of Bank of Mauritius securities was outstanding, while the Bank's foreign assets reached an equivalent amount of Rs110.5 billion, representing 5.5 months of imports (Chart 5.6). All these operations on the domestic money market had a substantial adverse impact on the Bank's profitability.

Following the increase in the cash reserve ratio, the weighted average overnight interbank interest rate went up to a peak of 3.79 per cent on 11 November 2013, from 1.62 per cent on 30 September 2013. However, as excess liquidity started to increase again, the weighted average overnight interbank interest rate fell to close at 2.15 per cent on 31 March 2014. Similarly, the overall weighted yield on Government of Mauritius Treasury Bills initially increased before coming down to 3.05 per cent by the end of March 2014. The weighted yield on Three-Year Government of Mauritius Treasury Notes increased from 3.88 per cent in September 2013 to 4.96 per cent in December 2013 and then declined to 4.17 per cent in March 2014.

Yields on longer-term instruments have increased since the last Inflation Report. The weighted yield on Five-Year Government of Mauritius Bonds rose from 4.28 per cent at the end of September 2013 to 5.83 per cent at the end of February 2014. The weighted yield on Ten-Year Government of Mauritius Bonds went up from 6.22 per cent to 6.80 per cent while the weighted yield on the Fifteen-Year Government of Mauritius Bonds increased from 6.96 per cent to 7.60 per cent over the same period (Chart 5.7).

5.3 Deposit and Lending Rates

Since the last Inflation Report, banks' Savings Deposits Rate (SDR) and Prime Lending Rates (PLR) have fallen to a range of 2.50 - 3.40 per cent and 6.25 - 8.50 per cent, respectively, mainly as a result of a change in the structure of interest rates by one bank. This did not affect the banks' modal SDR and modal PLR, which remained unchanged at 3.40 per cent and 7.15 per cent, respectively. The real interest rate on savings deposits declined considerably from 0.2 per cent in August 2013 to minus 2.3 per cent in February 2014, as a result of the rising inflation rate over the same period (Chart 5.8).

5.4 The Domestic Foreign Exchange Market

Since the publication of the October 2013 Inflation Report to March 2014, total turnover on the domestic foreign exchange market (inclusive of spot and forward transactions) amounted to US$3,531 million, representing a daily average of US$35.0 million. The daily average amount of transactions on the interbank foreign exchange market reached US$6.3 million. The Bank maintained its ORR programme and purchased an aggregate amount of US$126.9 million and EUR191.4 million from banks and foreign exchange dealers.

Chart 5.6: Outstanding BoM Assets and Instruments

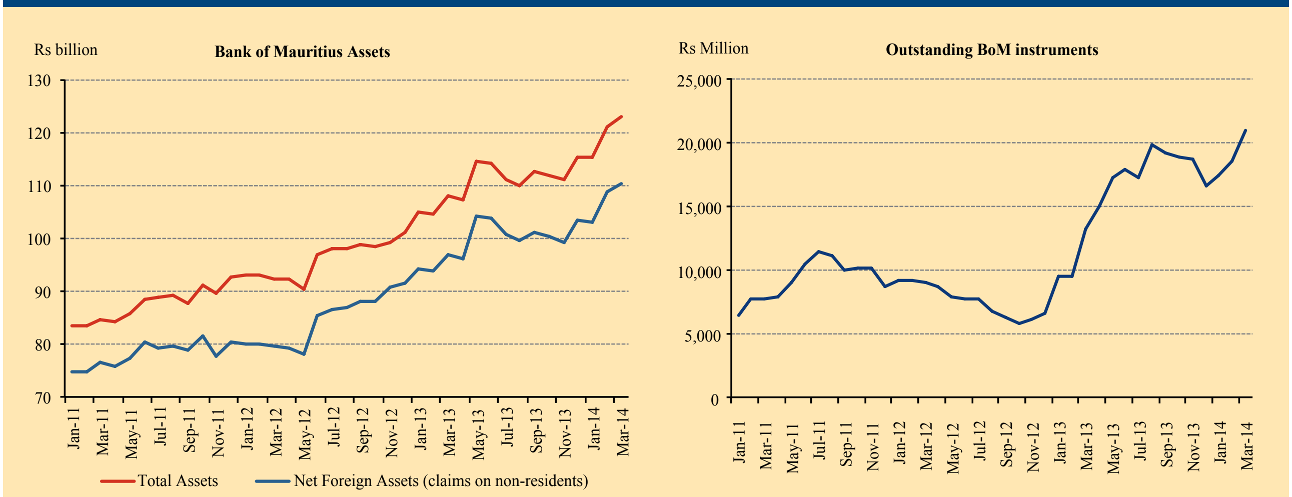


Chart 5.7: Yield on Treasury Bills

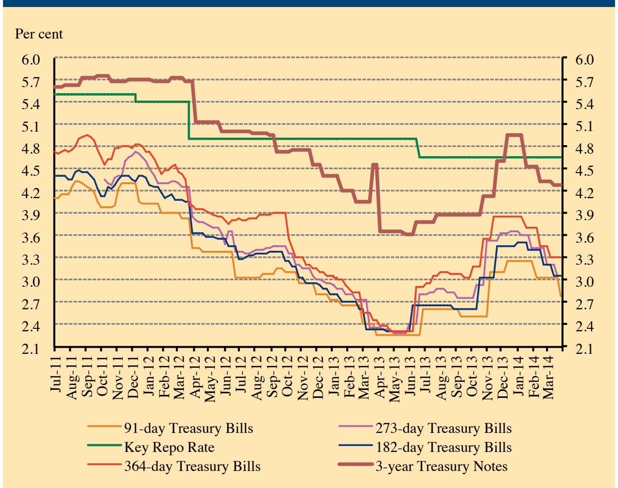
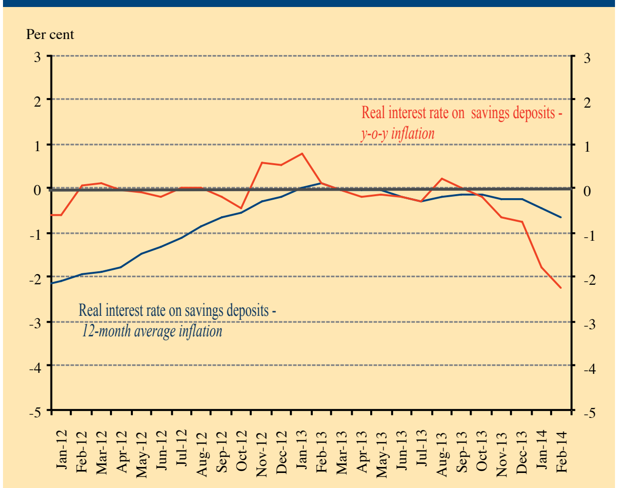


Chart 5.8: Real Interest Rate on Savings Deposits



The nominal rupee exchange rate continued to reflect fluctuations of key currencies on international markets and domestic market conditions. The rupee initially appreciated against the US dollar as the latter lost its safe haven appeal on international markets, but it broadly stabilised thereafter. The domestic currency depreciated slightly against the euro over the period under review as the latter recovered on the international front. It depreciated more significantly against the Pound sterling given the latter's broad-based strength on the back of the continued improvement in the UK economy (Chart 5.9).

The nominal effective rupee exchange rate, as measured by MERI1 which is based on the currency distribution of trade, has slightly appreciated since October 2013. However, in real effective terms and weighed by trading-partner countries, the rupee gained significantly more ground, partly on account of the depreciation of the South African rand (Chart 5.10).

Chart 5.9: Performance of the Rupee against Selected Currencies (March 2013 – March 2014)

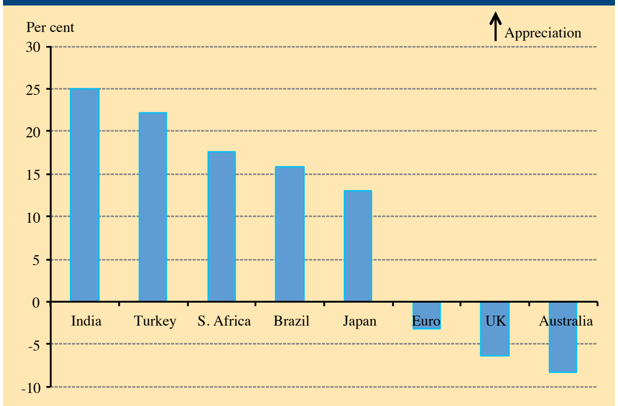


Chart 5.10: MERI1 and REER