BANK OF MAURITIUS

INFLATION REPORT

April 2014

The Bank of Mauritius publishes the Inflation Report twice a year as required by Section 33(2) of the Bank of Mauritius Act 2004. The Bank normally releases the Report in April and October. The Report provides an assessment of factors underpinning monetary policy and concludes with an economic outlook. This issue of the Inflation Report refers to information since the last Inflation Report in October 2013 to the end of March 2014 unless otherwise stated.

Acknowledgements

A team from the Economic Analysis Division prepared the Report. The team comprised Mr K. Ramnauth, Chief – Economic Analysis Division, Ms N. Mihdidin and Mr F. Sooklall, Analysts. Ms M. Heerah-Pampusa, Head – Economic Analysis Division, reviewed the Report.

The following officers also contributed to this Report: Mr V. Punchoo, Head – Statistics Division, Ms P. Hurree-Gobin, Chief – Statistics Division, and Mr G. Beegoo, Mr A. Massafeer, Mr S. Jugoo and Ms F. Atchia, Analysts; Mr S. Ramnarainsing and Mr C. Ellapah, Chiefs – Financial Markets Operations Division and Mr N. Daworaz, Analyst.

Dr J. L. Roberts, Consulting Editor, reviewed the Report and the Publications Review Committee of the Bank of Mauritius cleared the Report for publication.

The Report is available in PDF format on the Bank's website at https://www.bom.mu under the menu item Research and Publications. The Bank of Mauritius welcomes any comments or suggestions on this publication, which may be sent to publications.ead@bom.mu.

Inflation Report April 2014

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1. EXECUTIVE SUMMARY

The global economy has generally strengthened since the October 2013 Inflation Report. Economic activity picked up in advanced economies, particularly in the US and UK. Fiscal consolidation, which has been a heavy drag on global growth in many advanced economies, has diminished. The Eurozone economy continued to grow, albeit at a slow rate. Growth is still uneven across the region, with stronger expansion in the core economies compared with countries with high debt and financial fragmentation. Emerging market economies have recorded sluggish growth, partly reflecting weak external demand and internal imbalances. In its latest World Economic Outlook (WEO)[1], the IMF expects global growth to improve from 3.0 per cent in 2013 to 3.6 per cent in 2014 and further to 3.9 per cent in 2015. Whilst the risks to the global growth outlook appear lower than in earlier periods, there are still a number of concerns regarding the sustainability of growth in China and other emerging market economies, low inflation in advanced economies and the possible impact of geopolitical tensions. Inflationary pressures are expected to remain subdued in 2014, with fears of deflation in the Eurozone remaining at the forefront of many policymakers' minds.

In Mauritius, the economy lost some momentum in the last quarter of 2013 as the slow pace of the Eurozone recovery continued to impact negatively on external demand. The sluggish rate of growth also reflected declining private investment and prolonged weakness in domestic consumption. All the main sectors recorded positive rates of growth, except the construction sector which contracted further. For the year 2013, the pace of growth declined slightly to 3.2 per cent, from 3.4 per cent in 2012.

With the pick-up expected in the global economy in 2014, the outlook for domestic growth has improved. Real output is projected to increase to a range of 3.7-4.0 per cent for 2014. Given the reliance of the country on exports, adverse external developments still pose downside risks to the growth outlook. The need for continued fiscal consolidation and for the private sector to decrease its high-debt burden also constitutes threats to growth. Statistics Mauritius forecast growth for 2014 at 3.7 per cent.

The labour market has remained relatively stable, with unemployment forecast to stay at around 8 per cent during 2014 due to a cautious expansion strategy on the part of firms and persistent structural skills mismatch. The projected improvement in the domestic economy and possible increase in business confidence may induce firms to increase their production capacity, thereby generating more employment opportunities.

Reflecting the pace of economic activity so far, money and credit aggregates have continued to grow moderately despite high liquidity conditions prevailing in the domestic money market. Excess liquidity rose to a daily average of Rs8.2 billion in the first quarter of 2014, mainly as a result of the increasing recourse by Government to foreign financing of its budget deficit. The net purchase of foreign currency by the Bank on the domestic foreign exchange market has also contributed to the excess liquidity. The Bank raised the cash ratio requirement to 8.0 per cent in October 2013, but it is expected that liquidity will remain high throughout 2014.

Y-o-y inflation rose in November 2013 in line with the hike in excise duties on alcoholic beverages and tobacco. It further recorded sharp increases in the first two months of 2014 due to temporary shocks to food prices from adverse weather conditions. As the impact of those shocks subsided, y-o-y inflation fell back in March 2014. Headline inflation has been rather stable since the October 2013 Inflation Report although it has increased slightly at the beginning of 2014. Core measures of inflation have indicated a moderate increase in underlying inflation pressures. The Bank's Inflation Expectations Survey carried out in February 2014 indicated that a majority of respondents expected a rise in the mean inflation rate to 4.6 per cent a year ahead.

The Bank staff forecast y-o-y inflation in the range of 3.9-4.1 per cent by June 2014, equivalent to a headline inflation forecast of 3.8-4.2 per cent. Over the longer forecast horizon, it is assumed that the temporary supply

[1] *IMF World Economic Outlook April 2014*

shocks to food prices will fade away as agricultural supplies return to normal. For December 2014, the Bank staff forecast that the y-o-y inflation will be in the range of 3.9-4.3 per cent, equivalent to a headline inflation forecast of 4.0-4.4 per cent.

At the Monetary Policy Committee (MPC) meetings held in February and April 2014, the majority of members were of the opinion that domestic economic conditions and the inflation outlook did not warrant changing the monetary policy stance. Some members, however, viewed that it was time to start normalising the Key Repo Rate (KRR) to better address banking system vulnerabilities. The KRR was left unchanged at 4.65 per cent per annum.

2. THE GLOBAL ECONOMY

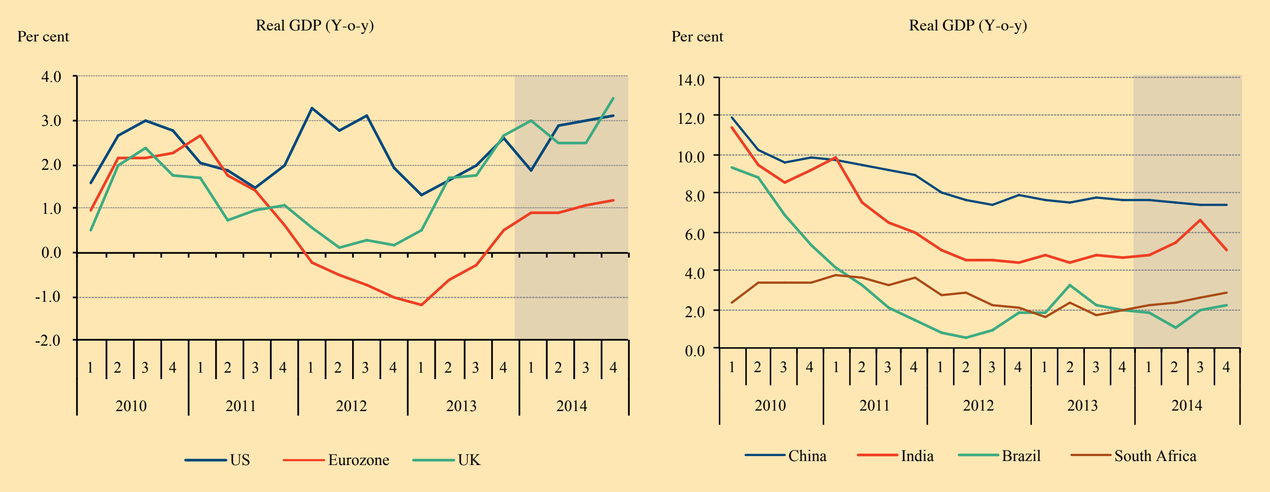
The global economy continued to recover since the October 2013 Inflation Report. While the US economy was adversely affected by fiscal uncertainties and severe weather conditions in the final quarter of 2013, it continued to grow at a reasonably robust rate. Meanwhile, the improvement in economic activity allowed the Federal Reserve to start tapering its expansive monetary policy. Conditions in the Eurozone have improved slightly and the situation is looking increasingly positive although regional differences remain. Growth across major emerging markets has slowed and some emerging economies have been exposed to capital outflows and currency depreciation. Inflation in the major economies remained low, although it had increased in some emerging economies. Looking ahead, global growth is poised to improve further in 2014, but risks to the outlook remain, mainly due to the uncertainties arising from moves to unwind unconventional monetary policies and the possibility of renewed deflation in the Eurozone[2].

2.1 Demand and Output

Recent developments confirmed the trend of an ongoing recovery in advanced economies and sluggish economic activity in large emerging economies (Chart 2.1). Overall, global output is firming and, in its April 2014 World Economic Outlook (WEO), the International Monetary Fund (IMF) forecast the world economy to expand by 3.6 per cent in 2014 and 3.9 per cent in 2015, from 3.0 per cent in 2013. Shocks from adverse weather conditions in the US and Japan when coupled with geopolitical developments in Eastern Europe are expected to be temporary and to have a minimal impact on the output growth forecast for the year.

Latest global Purchasing Managers' Index (PMI) data are consistent with the view that the global economy is improving. However, they highlighted the growing disparity between advanced and emerging economies. Whilst the developed markets PMI is mostly stabilising at relatively high levels, the emerging markets PMI has continued to fall, mainly due to a sharper slowdown in China (Chart 2.2)[3]. In its latest WEO, the IMF maintained the growth outlook for advanced economies for 2014, but downgraded the growth forecast for emerging and developing market economies by 0.2 percentage points to 4.9 per cent.

Chart 2.1: Growth in Selected Economies



Source: OECD, JPMorgan and Thomson Reuters

2 *IMF's April 2014 World Economic Outlook*

3 *JPMorgan Purchasing Managers' Index releases, Markit Economics*

Advanced economies are replacing emerging economies as the main drivers of global growth. The US economy has markedly recovered on the back of better economic fundamentals as a result of less severe budget cutting, a recovering housing market and an easy monetary policy stance[4]. Consumer and business sentiment remained at solid levels while the labour market continued to improve, with the unemployment rate at 6.7 per cent in February 2014. Conditions in the manufacturing and services sectors improved in March, as reflected by the ISM PMIs. Despite severe US weather conditions in 2014Q1, growth for the year is expected to increase to 2.8 per cent, from 1.9 per cent in 2013.

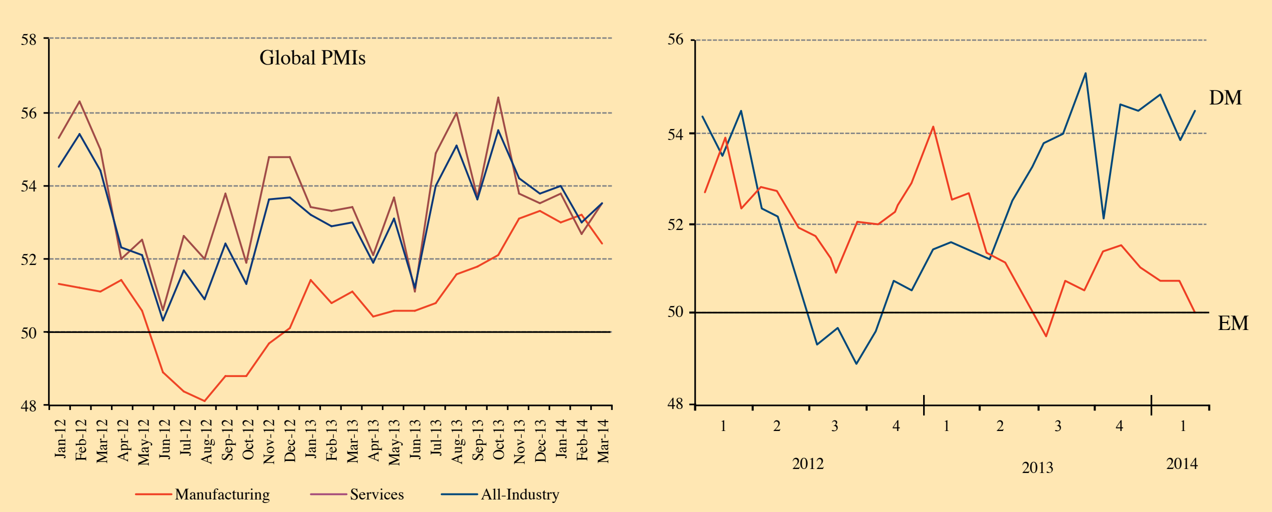
Whilst latest indicators for the Eurozone point to better economic performance, the growth momentum remains weak[5]. The recovery is still unbalanced from a regional perspective, with the major French economy showing some signs of weakness whereas Germany continues to power ahead. The upbeat German performance had positive spill-over effects on other core economies, including Spain and Italy. Peripheral economies also registered an improvement in economic activity. The PMI surveys for March were consistent with higher Eurozone growth for 2014Q1, but major issues, like high unemployment rate, low inflation and financial reforms, are still to be resolved. The IMF expects growth in the Eurozone to rise to 1.2 per cent in 2014.

The UK recorded one of the fastest expansion rates among advanced economies in 2013Q4[6]. The labour market continued to stabilise, with improved consumer confidence. Business surveys as well as manufacturing and services PMI suggest that economic activity remained buoyant at the beginning of 2014. Low inflation, a booming housing market and rising employment levels as well as continued monetary accommodation are expected to support growth, which the IMF forecast at 2.9 per cent in 2014.

The IMF trimmed its forecasts for some of the largest emerging market economies, including Russia, Turkey, Brazil and South Africa, which were affected by geopolitical factors, financial markets volatility in the wake of the US Fed tapering, and structural problems. The Chinese economy continued to grow, but at a slower pace than in previous years as it faced lower global demand and undertook significant reforms to improve its credit market. The latest HSBC Manufacturing PMI for China confirmed the weakness of the manufacturing sector amid clear signs that the risks to growth are tilting to the downside. India's economy remained weak due to high inflation and tighter monetary policy. Manufacturing activity picked up in 2014Q1 but the recovery is still likely to be delayed due to lingering structural constraints.

Global trade conditions improved in 2013Q4. Latest data from the Netherlands Bureau of Economic Research indicated that global trade volumes went up by 4.6 per cent in the year to December 2013, with a 7.7 per cent expansion in imports of emerging economies being the main driver of higher trade volumes (Chart 2.3)[7]. Looking ahead, the recovery in the US economy and in the Eurozone in 2014

Chart 2.2: JPMorgan Global Purchasing Managers' Index



Source: JPMorgan.

4 US Bureau of Economic Analysis 5 Eurostat 6 OECD

7 Netherlands Bureau for Economic Policy and Analysis

should contribute to higher growth in world trade. The IMF expects world trade to grow by 4.3 per cent and 5.3 per cent in 2014 and 2015, respectively, after exceptionally low growth in 2012 and 2013.

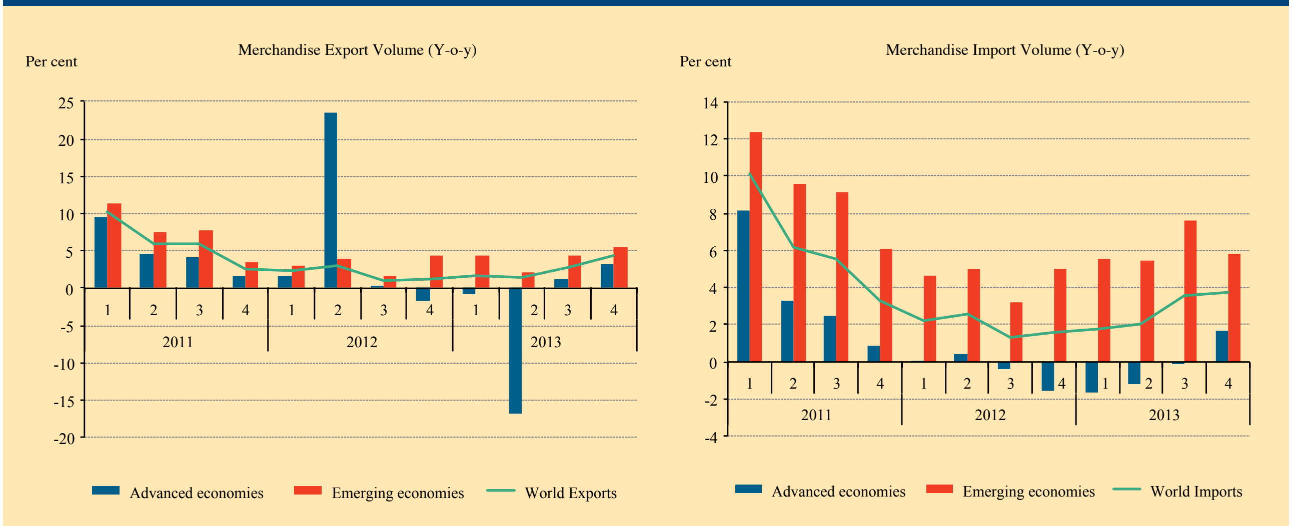
2.2 Recent Developments in Prices

2.2.1 Consumer Price Inflation

Global inflation has moderated recently reflecting modest global growth, sluggish demand and generally stable food and oil prices. Consumer price inflation continued to fall in advanced economies, raising the fear of deflation particularly in the Eurozone. In emerging market and developing economies, although inflation has eased, there are upside risks due to weakening exchange rates.

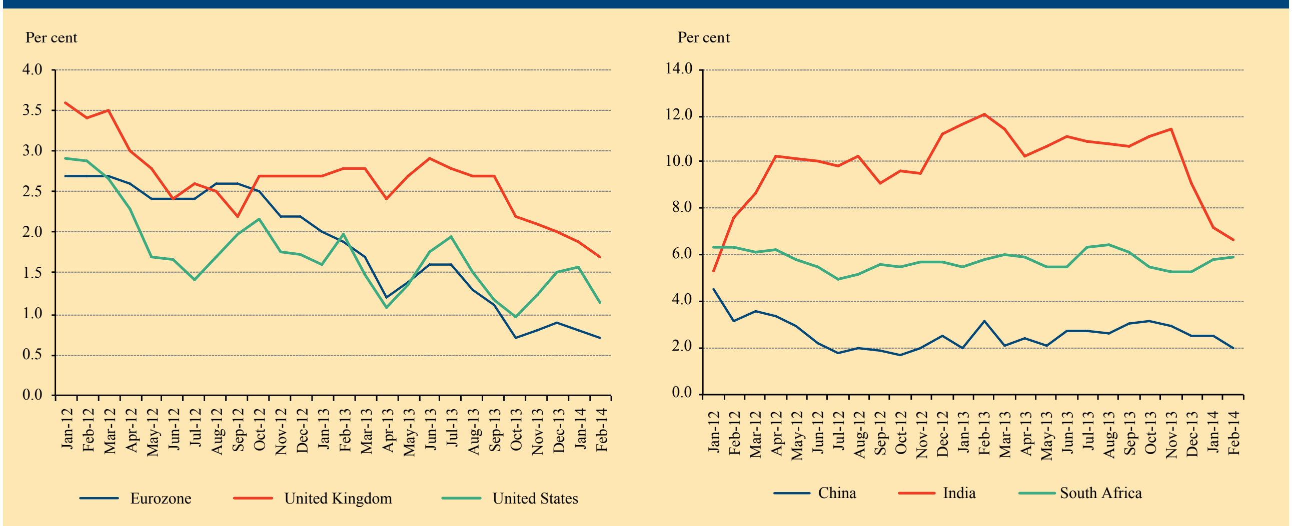
In the US, inflation reached 1.1 per cent in February 2014 given persistent weakness in energy prices. Inflation in the Eurozone eased substantially to 0.5 per cent in March 2014, well beneath the European Central Bank's (ECB) definition of price stability, of inflation below but close to 2 per cent. The ECB expects underlying price pressures to remain subdued over the medium term. In the UK, the inflation rate came down following slower increases in the prices of food as well as recreational

Chart 2.3: Global Trade Growth



Source: Netherlands Bureau of Economic Research

Chart 2.4: Consumer Price Inflation in Selected Economies



Source: OECD and The Economist.

goods and services. Among the major emerging and developing economies, inflation in China edged down in February 2014. It fell considerably in India, mainly on account of a significant fall in food prices (Chart 2.4).

The IMF projected that inflationary pressures would remain subdued in 2014, with output remaining below potential in advanced economies and close to or somewhat below potential in emerging market and developing economies. In 2015, prices are expected to rise moderately as economic growth strengthens.

2.2.2 Commodity Prices

Commodity prices remained broadly stable in 2013Q4. However, in 2014Q1 signs of strengthening global activity and adverse weather conditions impacted negatively on some commodity prices. The outlook for commodity prices for the remainder of 2014 would depend on demand and supply conditions.

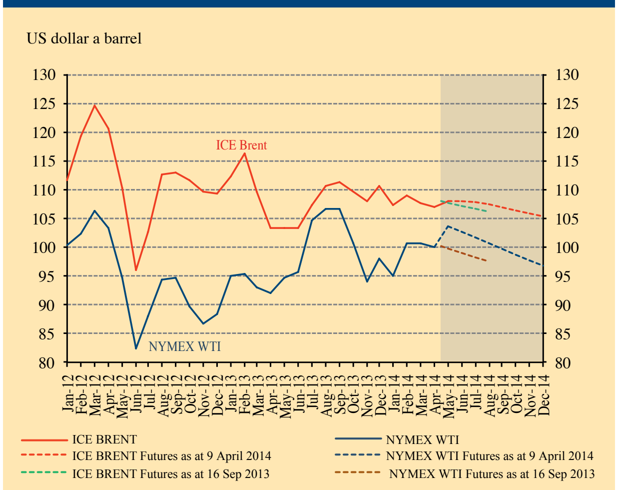
While ICE Brent crude oil prices have remained mostly stable since the last Inflation Report, NYMEX WTI prices fell significantly, mainly on account of higher supply from North America. They recovered thereafter amid geopolitical tensions and increased demand in the US due to the cold weather. ICE Brent averaged US$107.7 a barrel in March 2014 while WTI crude prices averaged US$100.5 a barrel. Looking ahead, oil prices, based on market expectation of future oil prices as at 9 April 2014, are projected to decline during 2014 (Chart 2.5). The March 2014 US Energy Information Administration (EIA) report expects the Brent crude oil price to weaken as non-OPEC supply growth exceeds growth in world consumption. The Brent crude oil price is projected to average US$105 per barrel and US$101 per barrel in 2014 and 2015, respectively[8].

After stabilising for the most part of 2013, food prices started to rise in early 2014, largely supported by the political uncertainty in Eastern Europe and adverse weather conditions affecting crop productions in various regions of the world. The Food and Agriculture Organisation's (FAO) food price index averaged 212.8 points in March 2014 compared with 205.8 in December 2013 (Chart 2.6)[9]. However, the production outlook is favourable for most major crops.

2.3 Exchange Rates[10]

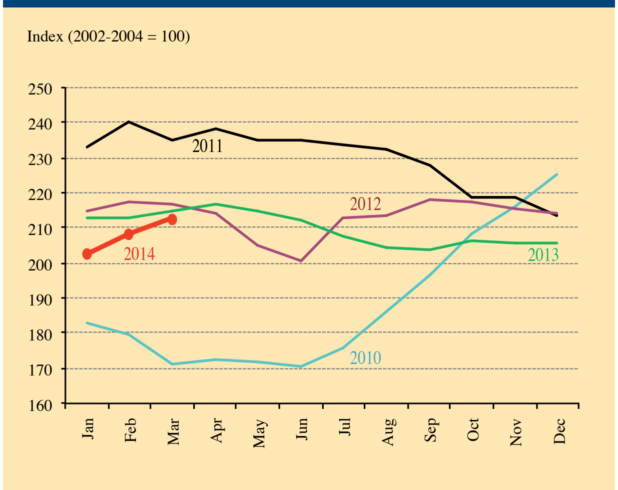
Currency markets were mainly influenced by the improving growth dynamics in advanced economies and the projected pace of normalisation in their monetary policies. The US dollar initially strengthened on signs that the US economy remained on a healthy growth track, but thereafter lost ground as its safe haven appeal diminished. The euro, which had been affected by the threat of deflation in the Eurozone, subsequently reversed trend on the back of capital flows into Europe and ECB interest rate policy. Over the medium term, a bullish view of the US dollar against major peer currencies is

Chart 2.5: Monthly Average NYMEX WTI and ICE Brent and Futures Prices



Sources: Thomson Reuters and ICE.

Chart 2.6: FAO Food Price Index



Source: FAO.

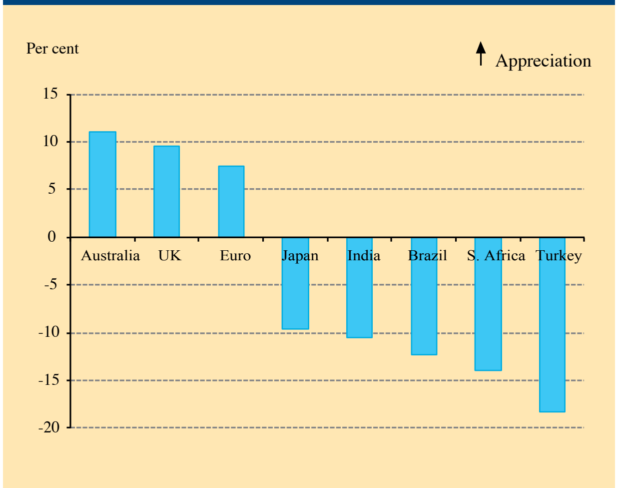
[8] *Energy Information Administration* [9] *Food and Agriculture Organisation of the United Nations* [10] *Thomson Reuters*

maintained with the expected gradual normalisation of monetary policy in the US. As the Fed moves away from unconventional policy instruments, the euro is projected to face a weakening bias.

Among the currencies of other advanced economies, the Pound sterling rallied against the US dollar as a result of relatively better economic performance and expectations of higher interest rates. The Japanese yen remained the best performing developed market currency in 2014, though it might resume a weakening trend due to the Bank of Japan turning to more aggressive policy measures.

A number of emerging market economies with large current account deficits saw their currencies stumbling against the US dollar as the US Fed started to wind down its massive stimulus although their currencies have recently recovered. The Indian rupee stabilised, reflecting a much improved external balance, following government measures to temporarily reduce the current account deficit. While the Brazilian real fared better, it is expected to remain sensitive to asset allocation shifts in favour of developed markets and retain a fragile tone in the near term. The Turkish lira recovered about 7 per cent against the US dollar following aggressive tightening by the central bank at the end of January 2014, but it has since weakened slightly again on political instability. With regard to the South African rand, increased investor unease resulting from frequent bouts of labour unrest, combined with the country's twin deficits and modest stock of foreign reserves, continued to expose the currency to capital flows and

Chart 2.7: Performance of Selected Currencies against the US dollar (March 2013 – March 2014)



Source: Thomson Reuters.

exchange rate volatility (Chart 2.7). The Chinese Yuan has sharply changed direction, weakening against the US dollar at the end of February as the central bank re-introduced two-way risk, increasing speculation over a potential shift in the exchange rate mechanism in place.

2.4 Global Monetary Policy[11]

The stance of monetary policy in advanced economies remained highly accommodative although the US Fed has begun to taper its large-scale asset purchase programme. At its March 2014 meeting, the Fed modified its so-called forward guidance for a potential interest rate hike, acknowledging that the 6.5 per cent unemployment rate threshold had become outdated. The Fed removed this threshold and moved towards a reference to progress toward its objectives of maximum employment and 2 per cent inflation. There are expectations in the market that the Fed could now raise interest rates sooner than previously thought.

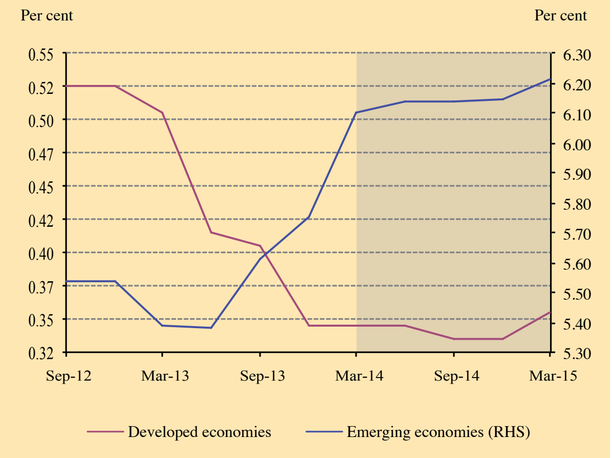
The ECB reduced interest rates to 0.25 per cent in November 2013 upon a prolonged period of low inflation below the 2 per cent target. It also reaffirmed its forward guidance for monetary policy to remain accommodative for as long as necessary. While the Bank of England (BoE) left its Bank rate at 0.5 per cent, Britain's surprisingly strong turnaround forced the central bank to come up with a new version of its forward guidance policy that focusses on a wider assessment of spare capacity in the economy. The BoE also indicated that the first rate hike could come in the second quarter of 2015.

The Bank of Japan (BoJ) maintained its accommodative monetary policy stance and extended special loan programs to support economic growth, signalling its resolve to prevent the reflationary policies from fading. The central bank reiterated its upbeat view on the economy and suggested that any additional stimulus would not be for the immediate future.

[11] *Central Banks' websites and JPMorgan Global Data Watch*

The central banks of Brazil, India, Turkey and South Africa had to significantly raise their policy rates at the start of 2014 to quell inflationary pressures arising from a depreciation of their currencies. Generally, emerging market central banks remain under pressure to raise rates further to ensure that the real yields on their domestic assets remain internationally competitive as they balance the dampening impact on economic activity from higher rates against rising inflation from a decline in their exchange rates (Chart 2.8).

Chart 2.8: Expected Policy Rates in Developed and Emerging Economies



Source: JPMorgan.

3. RECENT DEVELOPMENTS IN INFLATION

Since the last Inflation Report in October 2013, headline inflation has been rather stable, albeit showing some increase at the beginning of 2014 while year-on-year inflation rose in November 2013 in line with the hike in excise duties on alcoholic beverages and tobacco. Year-on-year inflation showed some volatility in the first three months of 2014 with sharp increases in January and February 2014 and witnessed a substantial drop in March 2014, mainly due to movements in the price of vegetables and other food products.

3.1 Consumer Prices

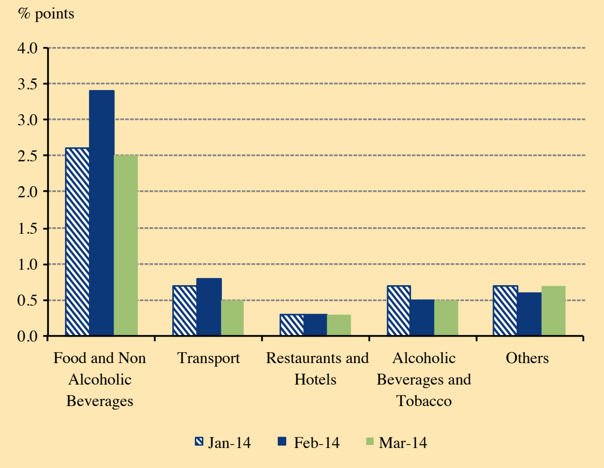
In the last Inflation Report, the effect of the Budget 2014 on prices was still uncertain and Bank staff had forecast that y-o-y inflation could reach a range of 4.5 per cent to 4.9 per cent. This was based on the assumption of no change in monetary policy and a similar impact of the budget as in the previous two years. Assuming that the Budget 2014 would have no impact on prices, the Bank staff 's y-o-y inflation forecast was lower, within a range of 3.7 per cent and 4.0 per cent by December 2013. It turned out that taxes on 'alcoholic beverages and tobacco' went up by a lower percentage than forecast. The Consumer Price Index (CPI) went up from 103.9 in October to 105.0 in November 2013, when the budgetary measures were announced, and remained almost unchanged in December 2013.

At the beginning of 2014, a significant increase was noted in the CPI which increased to 107.2 in January 2014 and further to 108.5 in February 2014. 'Food and non-alcoholic beverages' contributed 3.4 index points to the increase in the CPI. This reflected mainly hikes in the prices of vegetables during this period due to unfavourable climatic conditions that severely affected crop production causing a supply shortage. The other divisions notably, 'Transport' and 'Alcoholic beverages and tobacco' added 0.7 index point and 0.5 index point, respectively, to the CPI. The contribution of the remaining divisions to the CPI was either flat or increased marginally between 0.1 and 0.3 percentage points. However, in March 2014, the CPI fell to 107.7, as the impact of adverse climatic conditions receded and prices returned to more normal levels (Chart 3.1).

Y-o-y inflation, which had started to rise gradually since August 2013, went up to 3.9 per cent in November 2013 on account of the increase in excise duties on 'alcoholic beverages and tobacco'. It surged further from 4.0 per cent in December 2013 to 5.1 per cent in January 2014 and 5.6 per cent in February 2014 following the temporary shocks to food prices. In March 2014, as the impact of those shocks subsided, y-o-y inflation fell to 4.5 per cent. Headline inflation has increased gradually since the last Inflation Report, reaching 4.0 per cent in March 2014.

Core inflation measures, which exclude the volatile elements of the CPI, indicated a moderate increase

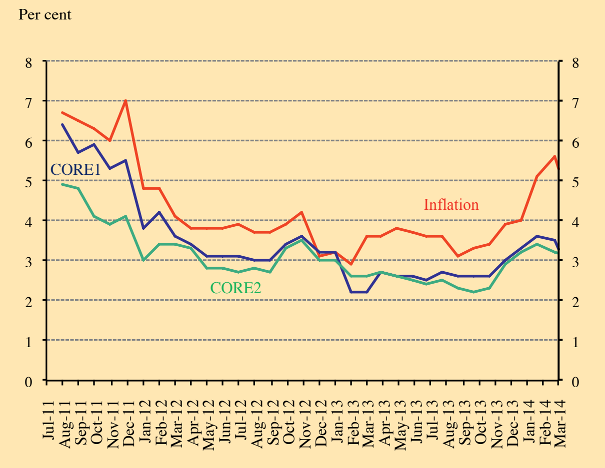
Chart 3.1: Contribution to Y-o-y Changes in CPI



* *Others include clothing and footwear; housing and utilities; furnishings and household equipment; health; communication; recreation and culture; education and miscellaneous goods*

Sources: Statistics Mauritius and Bank of Mauritius.

Chart 3.2: Y-o-y Inflation



CORE1 excludes "Food, Beverages and Tobacco" components and mortgage interest on housing loan from y-o-y CPI inflation.
CORE2 excludes Food, Beverages, Tobacco, mortgage interest, energy prices and administered prices from y-o-y CPI inflation.

Sources: Statistics Mauritius and Bank of Mauritius.

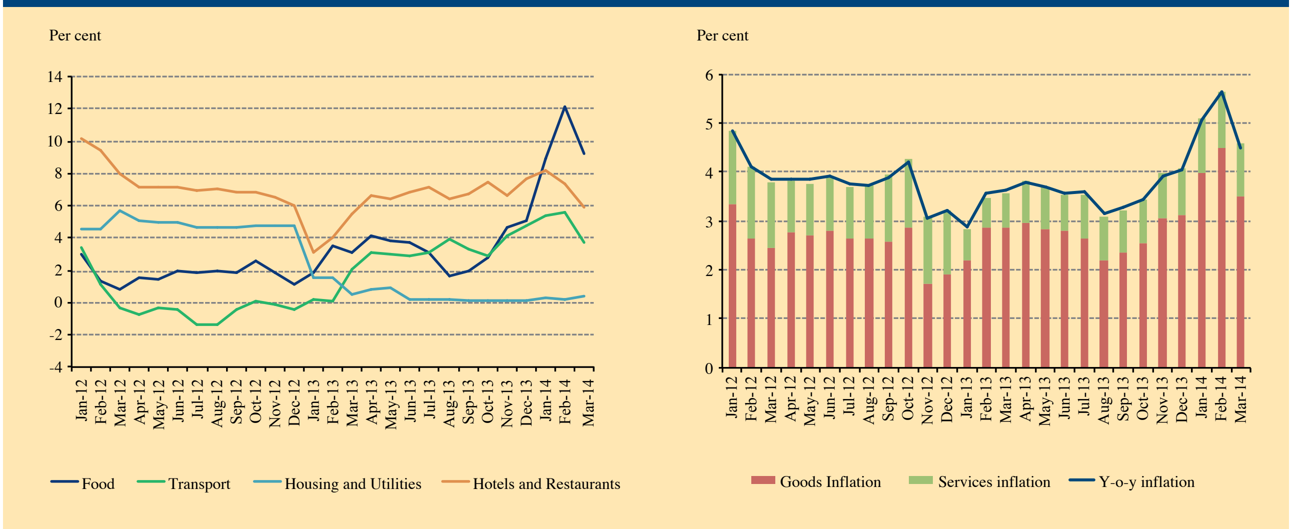
in underlying inflationary pressures. Y-o-y CORE1 and CORE2 inflation reached 2.7 per cent and 3.1 per cent in March 2014, from 2.6 per cent and 2.3 per cent, respectively, in August 2013 (Chart 3.2).

Reflecting the sharp rise in the prices of vegetables on the domestic market, the y-o-y food price inflation rose from a trough of 1.6 per cent in August 2013 to a peak of 12.2 per cent in February 2014 before dropping to 9.2 per cent in March 2014 (Chart 3.3). While local climatic factors were behind the recent increase in food inflation, risks to domestic food inflation from global developments persist.

Y-o-y goods inflation displayed a similar pattern to food inflation, mainly reflecting the hikes in prices of alcoholic beverages, tobacco, vegetables and other food products. It rose from a trough of 2.2 per cent in August 2013 to a high of 4.5 per cent in February 2014 before retreating to 3.5 per cent in March 2014. Annual services inflation rose from 0.9 per cent in August 2013 to 1.1 per cent in March 2014, mainly affected by the rises in the prices of 'Transport' and 'Restaurant & Hotels'.

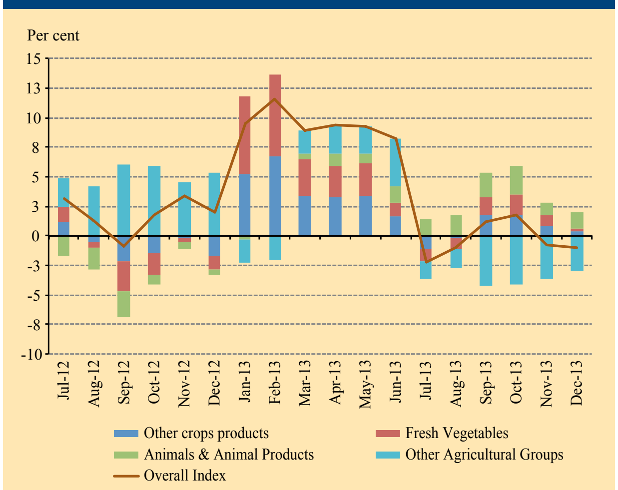
Data on the Producer Price Index (PPI) are available up to December 2013. They show that agricultural prices fell substantially as from 2013H2 as a result of a drop in the prices of crop products, excluding sugar cane, and fresh vegetables. In absolute terms, the PPI-A fell from 116.3 index points in June 2013 to 109.2 index points in December 2013. On a y-o-y basis, PPI-A inflation declined from 8.3 per cent in June 2013 to -1.0

Chart 3.3: Y-o-y Change in Prices of Selected Components



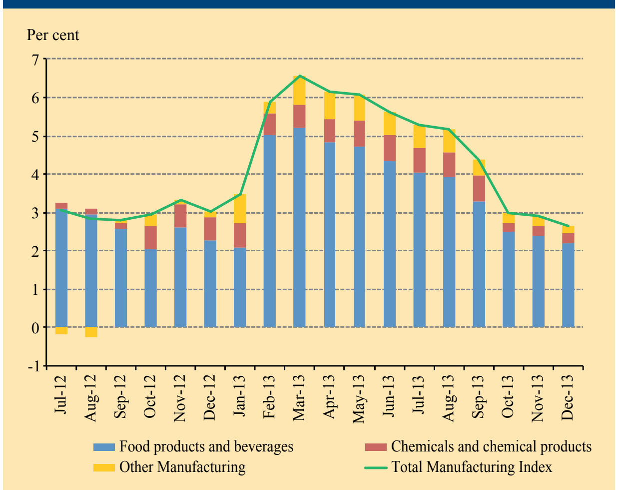
Sources: Statistics Mauritius and Bank of Mauritius.

Chart 3.4: Contribution of Selected Commodity Groups and Products to PPI-A



Sources: Statistics Mauritius and Bank of Mauritius.

Chart 3.5: PPI-M by Main Industry Group



Sources: Statistics Mauritius and Bank of Mauritius.

per cent in December 2013 (Chart 3.4). Going forward, it is expected that PPI-A could increase during 2014Q1 reflecting the recent rise in vegetable prices.

In the manufacturing sector, producer prices were on a declining trend during most of 2013, mainly on account of decreases in the prices of 'food products and beverages' (Chart 3.5). Y-o-y PPI-M inflation fell from a high of 6.6 per cent in March 2013 to 2.6 per cent in December 2013.

The decrease in PPI-M was consistent with the fall in the Import Price Index (IPI) registered since 2012H2. The IPI went down to 120.7 in 2013Q4, representing a y-o-y drop of 5.0 per cent. The fall in the IPI was mainly due to decreases in the prices of 'machinery and transport equipment' (-14.5 per cent), 'food and live animals' (-6.8 per cent) and 'mineral fuels, lubricants and related materials' (-4.0 per cent) (Chart 3.6).

Inflation Expectations

The Inflation Expectations Survey carried out in February 2014 showed that the proportion of respondents perceiving inflation to be higher increased from 8.7 per cent in August 2013 to 22.4 per cent in February 2014. While a majority still expected inflation to go up over the next twelve months, the proportion has decreased in the last three quarters (Chart 3.7). Respondents expected the mean inflation rates to be at 4.1 per cent, 4.4 per cent and 4.6 per cent, respectively, for the twelve months ending June 2014, December 2014 and a year ahead (Chart 3.8). Most respondents viewed external factors as the primary source of inflation in Mauritius.

Chart 3.7: Diffusion Index for Inflation Expectation

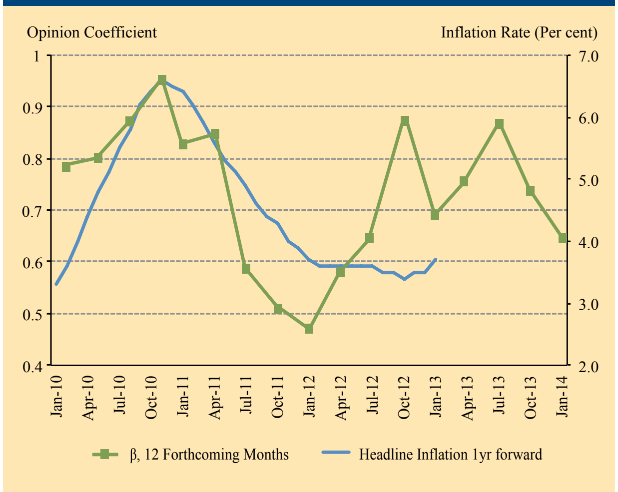


Chart 3.8: Inflation Expectations Mean-trend - A year ahead

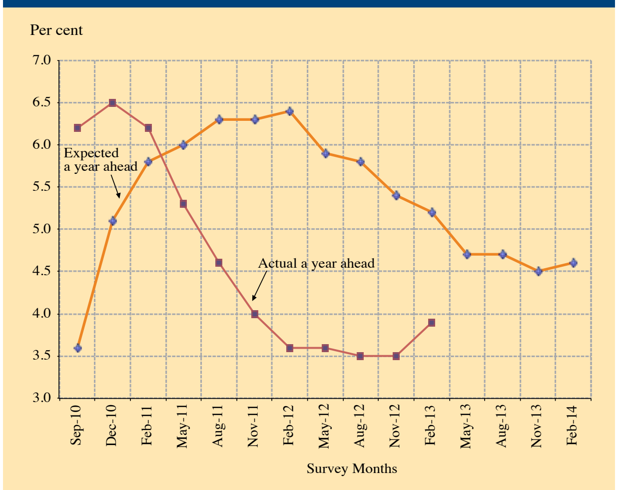
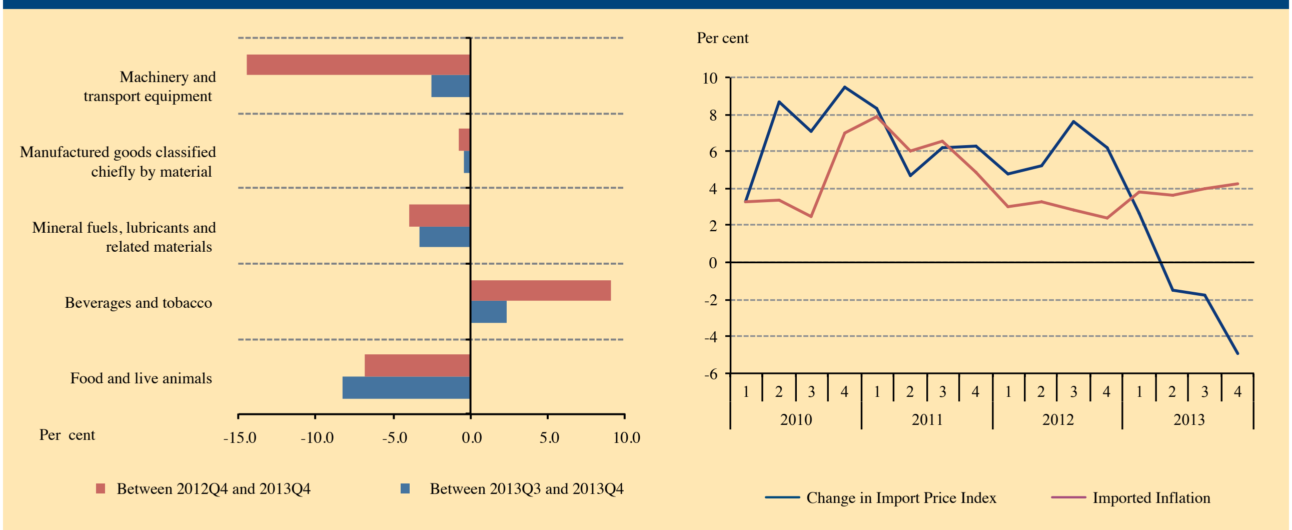


Chart 3.6: Import Price Index and Imported Component of Y-o-y Inflation



Source: Statistics Mauritius.

Box I: Factors Driving Recent Changes in the CPI

During the months of January and February 2014, a significant increase was registered in the consumer price index which increased to 107.2 in January 2014 and further to 108.5 in February 2014. 'Food and non-alcoholic beverages' contributed 3.4 index points to the increase in the CPI. This reflected mainly hikes in the prices of vegetables during this period due to unfavourable climatic conditions.

The substantial impact of higher prices of fresh vegetables on the overall CPI relative to previous years was due to a methodological change in the way Statistics Mauritius (SM) factors in the prices of fresh vegetables in the computation of overall CPI inflation.

Prior to July 2013, SM was using a seasonally-adjusted price series for fresh vegetables by carrying out a moving average of prices over 12 months. However, following an IMF Mission recommendation in January 2013, this practice was ceased and the actual monthly prices of fresh vegetables collected over 4 weeks during the month are now used for the index compilation, underscoring the importance of a CPI for a given month to be only influenced by prices in that month. As a result of this methodological change, there have been substantial fluctuations in the price index of fresh vegetables whenever there have been severe disruptions in supplies. Because of this methodological change, actual inflation trends are not strictly comparable with those prevailing prior to July 2013.

Table 1 gives the change in weighted contribution to inflation between December 2013 and March 2014 and the y-o-y change in March 2014.

	Consumer Price Index				Weighted contribution to inflation (per cent)	
DIVISIONS	**Weights**	**Mar-13**	**Dec-13**	**Mar-14**	**Dec-13 to Mar-14**	**Mar-13 to Mar-14**
Food and non-alcoholic beverages	273	102.2	105.3	111.3	1.6	2.4
of which						
Fresh vegetables	39	102.6	110.5	147.3	1.3	1.7
Alcoholic beverages and tobacco	96	110.2	116.2	116.6	0.0	0.5
Clothing and footwear	45	102.7	107.8	109.0	0.1	0.3
Housing, water, electricity, gas and other fuels	120	100.9	100.3	101.3	0.1	0.0
Furnishings, household equipment and routine household maintenance	61	102.5	102.0	102.8	0.1	0.0
Health	40	103.3	105.5	108.4	0.1	0.2
Transport	151	102.1	105.0	105.9	0.1	0.5
Communication	39	100.0	100.0	99.9	0.0	0.0
Recreation and culture	44	100.1	104.1	104.8	0.0	0.2
Education	45	102.6	101.9	103.3	0.0	0.0
Restaurants and hotels	45	105.0	109.5	111.3	0.1	0.3
Miscellaneous goods and services	41	102.7	102.3	104.7	0.1	0.1
Overall	**1000**	**103.1**	**105.3**	**107.7**	**2.3**	**4.5**

Out of the 1.6 percentage point contribution of 'Food and non-alcoholic beverages' to the overall CPI inflation between December 2013 and March 2014, higher prices of fresh vegetables in January and February 2014 contributed 1.3 percentage points (Table 1). The price index for fresh vegetables shot up from 110.5 in December 2013 to 135.4 in January 2014 and further to 167.4 in February 2014 on account of heavy rains disrupting supply and declined to 147.3 in March 2014. For the year ended March 2014, higher prices of fresh vegetables contributed for 1.7 percentage points out of the 2.4 percentage point contribution of 'Food and non-alcoholic beverages' to the overall CPI annual inflation.

Other divisions' weighted contributions to the overall increase in CPI inflation between December 2013 and March 2014 were either flat or negligible, not exceeding 0.1 percentage point. Over the year to March 2014, 'Alcoholic beverages and tobacco' and 'transport' contributed 0.5 percentage point each followed by 'Clothing and footwear' and 'Restaurants and hotels' with a 0.3 percentage point each. The remaining 0.5 percentage point came from contributions of higher price level in 'Health' and 'Recreation and culture' with 0.2 percentage point each while 'Miscellaneous goods and services' added 0.1 percentage point.

Food, other than fresh vegetables, added 0.2 percentage point to the overall CPI inflation between December 2013 and March 2014 and contributed an estimated 0.6 percentage point in the overall CPI inflation over the year to March 2014.

Within food, the contribution of imported primary commodities to the overall CPI inflation continued to be tame reflecting lower international price pressures in rice and dairy products. However in March 2014, there was a notable increase in the international price of wheat according to the IMF primary commodities statistics due to adverse weather conditions in some major exporting countries. For several other food items, their respective weighted contribution to food inflation was either negative or flat.

4. THE DOMESTIC ECONOMY

The growth momentum of the domestic economy slowed in the last quarter of 2013 as the mild pace of the Eurozone recovery continued to have an adverse impact on external demand. The slower rate of growth reflected low private investment and prolonged weakness in consumption. With the exception of the construction sector which declined further in the last quarter of 2013, all major sectors recorded positive growth rates. Conditions in the labour market remained relatively subdued, partly reflecting a cautious expansion strategy on the part of firms and structural skills mismatch. Domestic economic growth is expected to improve in 2014 as global economic activity picks up with real output projected to grow close to its potential. Nevertheless, downside risks to the domestic growth outlook remain and stem from the continued process of fiscal consolidation and the need for the private sector to reduce its high-debt burden. Besides, external demand might still be constrained by the weak recovery in the Eurozone.

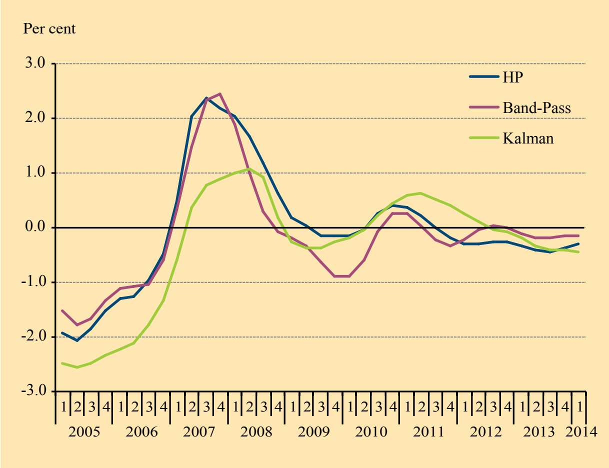
4.1 Economic Activity and Demand

The rate of domestic economic growth slowed in 2013Q4, with seasonally adjusted q-o-q growth falling to 0.3 per cent compared with 1.0 per cent in 2013Q3. On a y-o-y basis, growth fell to 2.9 per cent, from 3.4 per cent in the previous quarter (Chart 4.1). According to Statistics Mauritius, the Mauritian economy is forecast to grow by 3.7 per cent in 2014 compared with 3.2 per cent in 2013.

Taking into account the latest national accounts data, it is assessed that the domestic economy continued to operate with some degree of spare capacity given the continued weakness of domestic and external demand (Chart 4.2).

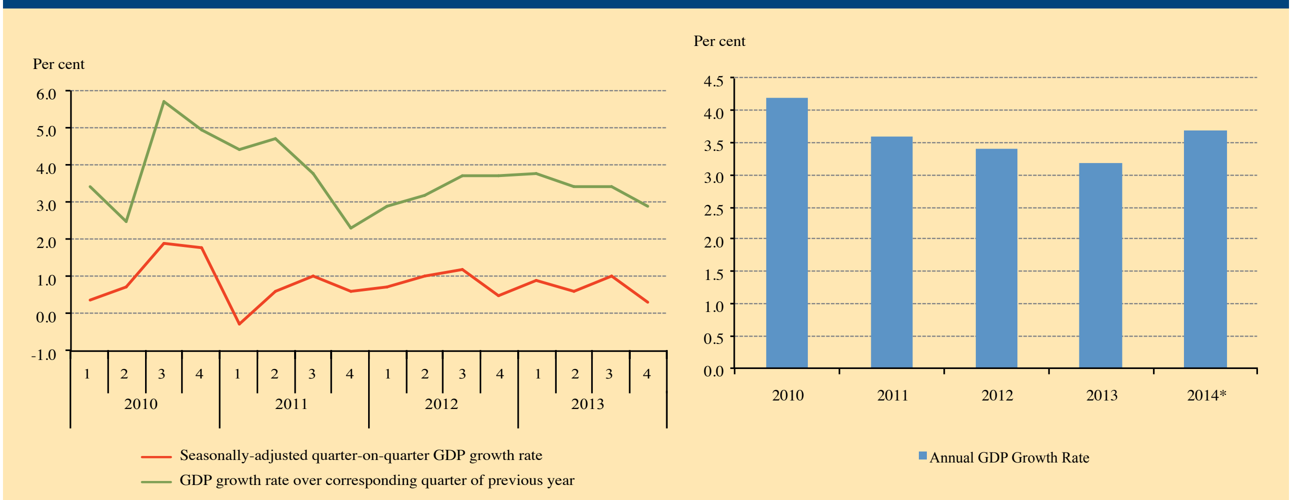
The sluggish rate of growth primarily reflects low private investment. Gross domestic fixed capital formation (GDFCF) contracted by 3.5 per cent in 2013 despite an increase in 2013Q4 as a result of the acquisition of several fishing vessels, which had a one-off impact on investment. In 2014, GDFCF

Chart 4.2: Domestic Output Gap



Sources: Statistics Mauritius and Bank of Mauritius Estimates.

Chart 4.1: Real GDP Growth Rate



**Forecast.*

Source: Statistics Mauritius.

is expected to grow by 1.2 per cent, led by growth of 12.8 per cent in public sector investment whilst private investment is forecast to decline for the third consecutive year (Chart 4.3).

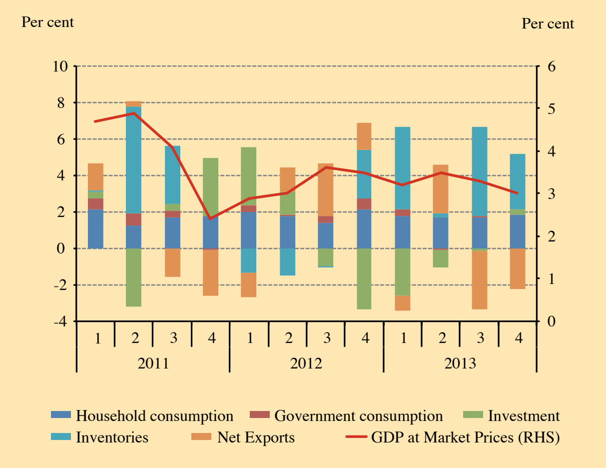
It is expected that private investment would continue to be affected by the slow economic recovery of our main trading partners, the muted business confidence and high levels of indebtedness in the corporate sector. The financial positions of some businesses remain difficult, thus restraining their ability to invest.

The business confidence survey of the Mauritius Chamber of Commerce and Industry (MCCI), carried out in March 2014, revealed that only 23 per cent of respondents were planning to increase their investment level over the next twelve months while 26 per cent mentioned that they would reduce it. The survey showed a decline in business confidence for all the three sectors of activity, namely, manufacturing, services and distributive trade, with the overall index going down by 2.7 points to 85.3 points in 2014Q1 (Chart 4.4). The cost of doing business was assessed as the main factor having a negative impact on business performance.

The projected recovery in public investment in 2014, after the contraction of 4.9 per cent registered in 2013, is based upon the expectation of additional investment already earmarked for various infrastructural projects. However, the implementation of those public sector projects is subject to uncertainty as there may be capacity constraints. In fact, the public investment rate has been on a declining trend for more than 10 years (Chart 4.5). The quarterly pattern of capital expenditure has remained broadly similar in recent years whilst the medium-term macroeconomic projections in the Budget 2014 indicate that public investment may stagnate over the next 3 years (Chart 4.6).

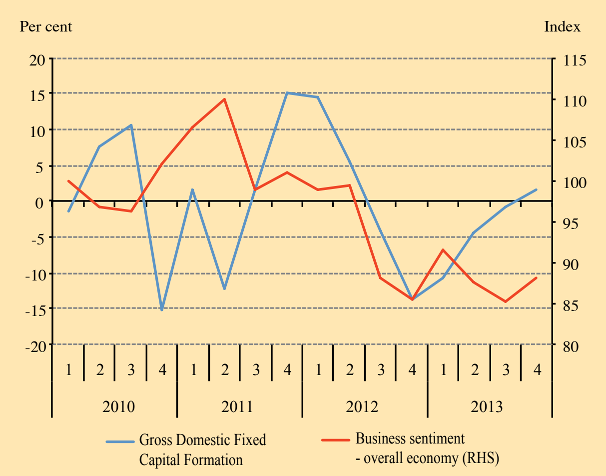
Growth in consumption remained low in 2013Q4, still falling short of the rates observed in the pre-crisis years. Growth in final consumption expenditure picked up by 0.1 percentage point to 2.3 per cent, led by an increase in household consumption expenditure which expanded by 2.8 per cent, from 2.6 per cent in 2013Q3. Statistics Mauritius projects that final consumption expenditure will grow by a higher rate of 2.6 per cent in 2014, from 2.3 per cent in 2013.

Chart 4.3: Contribution of Components of Aggregate Demand to Growth



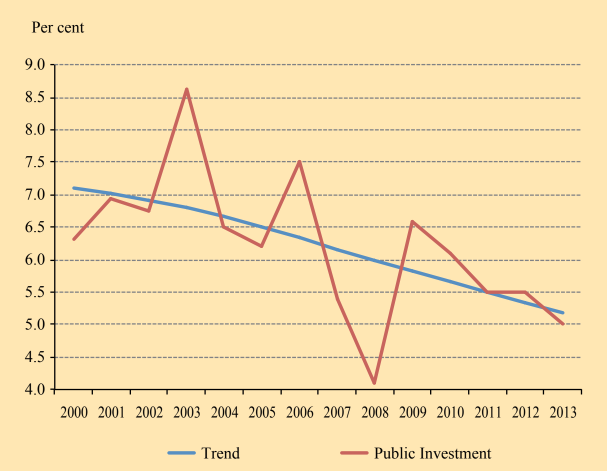
Source: Statistics Mauritius

Chart 4.4: Gross Domestic Fixed Capital Formation and Business Sentiment Index



Sources: Statistics Mauritius and MCCI.

Chart 4.5: Public Investment Rate



Sources: Statistics Mauritius and Bank of Mauritius Estimates.

Nevertheless, growth in household consumption expenditure, the major part of final consumption expenditure, is still moderate. This is due to low economic activity and relatively subdued labour market conditions that will continue to impact negatively on income and consumer confidence. Salary increases in the private sector have not kept pace with the increases in the public sector, but we may expect households to begin slowly to spend more during 2014. Statistics Mauritius estimates that household consumption expenditure will grow by 2.7 per cent in 2014 compared with 2.6 per cent in 2013.

The TNS Analysis survey carried out in January 2014 indicated renewed consumer confidence mainly as a result of seasonal factors. The consumer confidence index increased to 79.4 in 2013Q4, from a low of 65.4 in the previous quarter, while the proportion of respondents who were pessimistic about the future economic outlook went down to 41.8 per cent, from 54.9 per cent in 2013Q3.

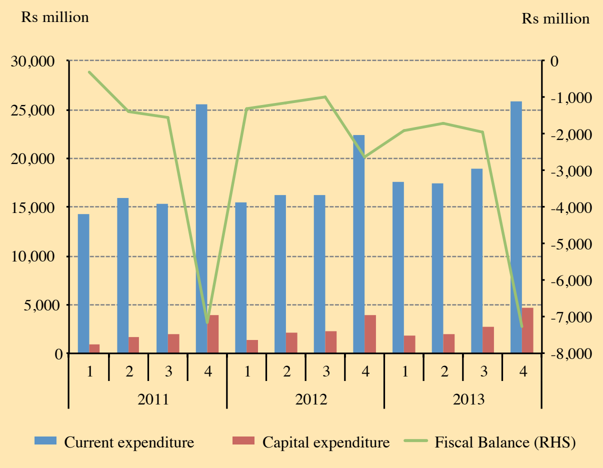
Reflecting the low savings rate in the economy, it is found that households continue to consume more than their disposable income. This indicates that the household savings index, which is defined as the difference between household disposable income and household consumption, is negative (Chart 4.7). The negative real interest rate on savings deposits may have partly contributed to this situation in recent years.

Government consumption expenditure declined by 0.1 per cent in 2013Q4 as against an expansion of 0.4 per cent in 2013Q3. It is expected to register a higher expansion of 2.0 per cent in 2014, from 0.6 per cent in 2013, although the contribution of government consumption to GDP growth should remain minor, as in previous years.

The contribution of external demand to output growth was mostly negative in 2013, indicating that the domestic economy remained vulnerable to the challenging conditions in main export markets (Chart 4.8).

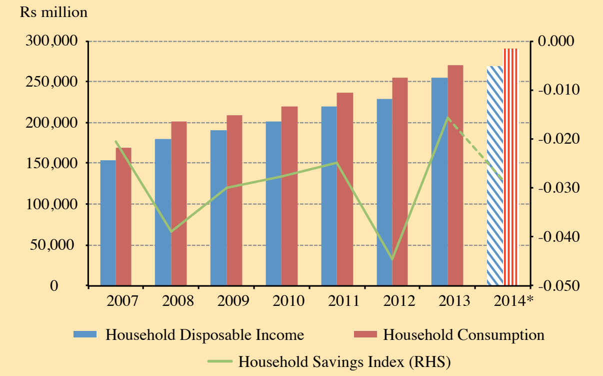
For 2014, the external demand indicator, which is constructed by weighing the real GDP growth of countries making up at least 70 per cent of Mauritian goods exports, shows that foreign

Chart 4.6: Government Fiscal Balance



Source: Ministry of Finance and Economic Development.

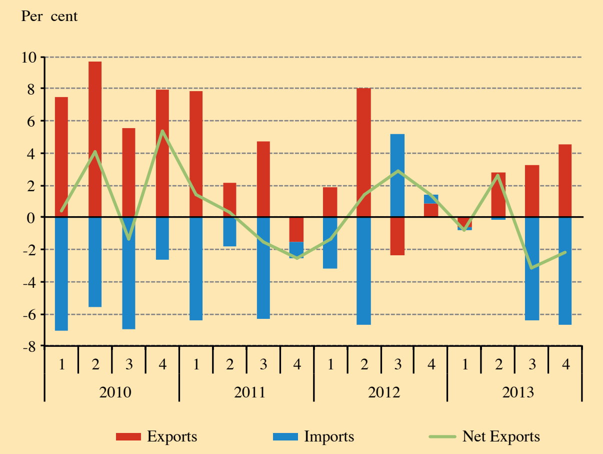
Chart 4.7: Household Disposable Income, Consumption and Savings Index



**Forecast.*

Sources: Statistics Mauritius and Bank of Mauritius Estimates.

Chart 4.8: Contribution of External Demand to Growth

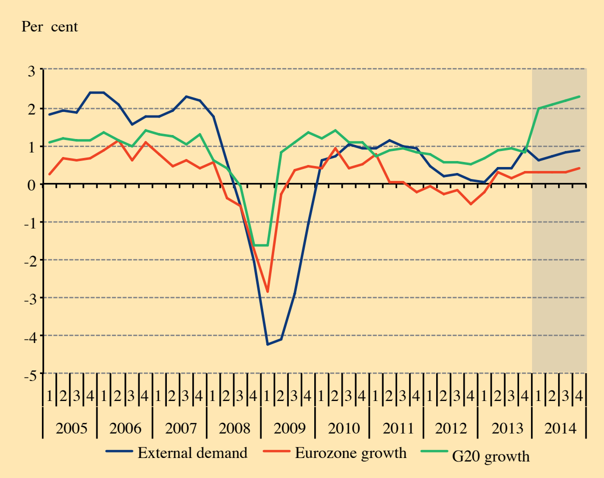


Source: Statistics Mauritius.

demand for domestic exports is likely to remain subdued. However, there has been a gradual improvement during the year as growth in the Eurozone, our main export market, has been picking up (Chart 4.9).

Latest trade data showed that total exports of goods increased by 11.3 per cent y-o-y in 2013H2, primarily led by a pick-up of 33.8 per cent in ships, stores and bunkers. Excluding this item, exports of goods grew at a slower pace of 7.4 per cent in 2013H2. There was a substantial increase of 114.3 per cent in the exports of 'machinery and transport equipment', which reflected a large rise in freeport re-exports of telecommunication equipment that contained a sizeable import element. Exports were also led by 'food and live animals' and 'manufactured goods classified chiefly by material', which registered growth rates of 8.3 per cent and 17.3 per cent, respectively. By contrast, there was a decline in exports of 'miscellaneous manufactured goods', mainly explained by a decrease in exports of 'articles of apparel and clothing accessories' which have constituted one of our main export commodities. This highlights the persistent difficulties faced by local exporters (Chart 4.10).

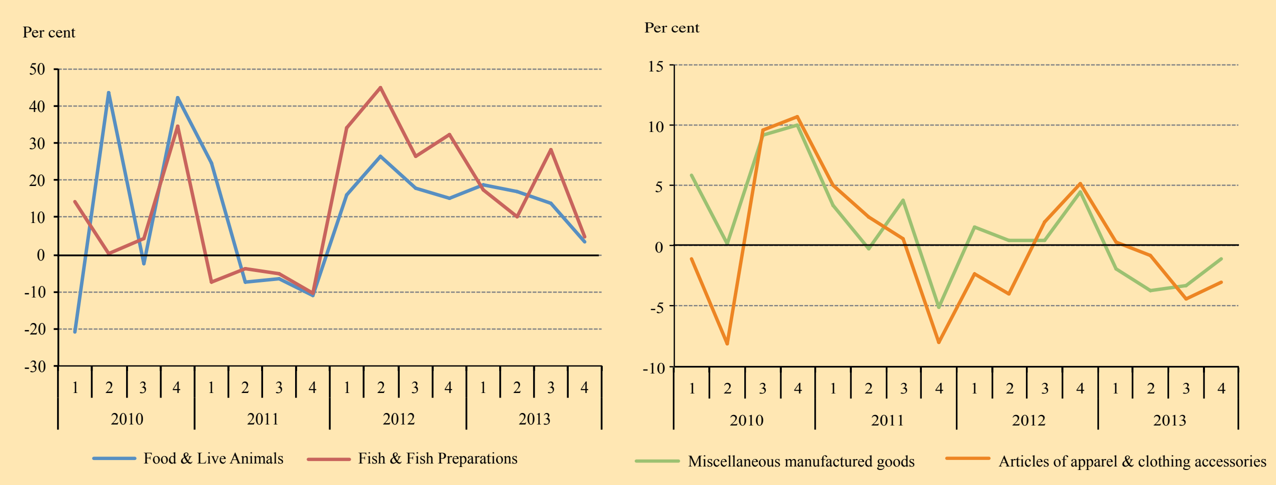
Chart 4.9: External Demand, Eurozone Growth and G20 Growth



Total imports c.i.f. went up by 6.7 per cent y-o-y in 2013H2. This largely reflected an increase of 25.8 per cent in imports of 'machinery and transport equipment' on account of the purchase of two marine vessels and, as mentioned above, higher imports of telecommunications equipment (Chart 4.11). Excluding these components which are not expected to have a considerable impact on the economy's productive capacity, it is estimated that the imports of goods went up by 2.2 per cent in 2013H2. Separately, imports of 'food and live animals' and 'mineral fuels, lubricants & related products' increased by 5.6 per cent and 5.7 per cent, respectively.

The coverage ratio, which represents the ratio of exports to imports, fell in 2013H2. Concurrently, the merchandise trade deficit deteriorated by 2.8 per cent (Chart 4.12). Reflecting lower surpluses on the services and income accounts, the current account deficit widened to Rs21.4 billion in 2013H2, from Rs16.6 billion in 2012H2 (Chart 4.13).

Chart 4.10: Y-o-y Growth in Exports by Selected Commodity Groups



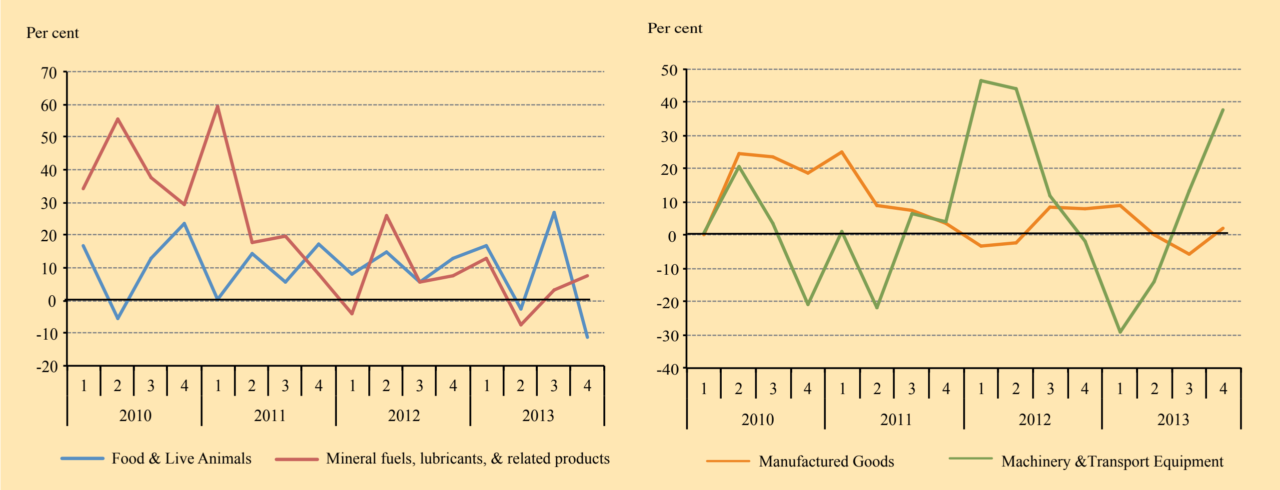
Source: Statistics Mauritius.

Going forward, given a somewhat more favourable external environment and assuming a relatively stable rupee exchange rate, it is expected that exports might gradually strengthen. Moreover, intensive marketing campaigns to consolidate the share of Mauritian exports in traditional markets and diversify exports to emerging markets are estimated to support export growth. Among the main commodities, 'miscellaneous manufactured goods' exports might revert to growth in 2014 while the exports of 'food and live animals', which had fallen in 2013Q4, are projected to increase to higher levels in 2014. Foreign investment in the seafood sector is increasing, which may contribute to boost production capacity.

4.2 Supply

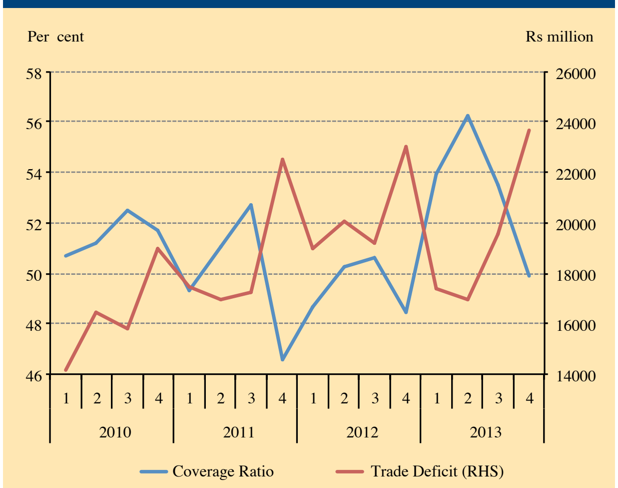
The balance between demand and supply is an important determinant of the degree of inflationary pressures in the economy. On the supply side, all economic sectors exerted a favourable impact on the quarterly change in real GDP in 2013Q4, except 'construction', which maintained a declining trend. The 'manufacturing' (0.9 per cent), 'financial and insurance activities' (0.5 per cent) and 'wholesale and retail trade' (0.4 per cent) sectors made the highest contribution to GDP growth. In contrast, the 'construction' sector contributed negatively to output growth (-1.2 per cent) (Chart 4.14).

Chart 4.11: Y-o-y Growth in Imports by Selected Commodity Groups



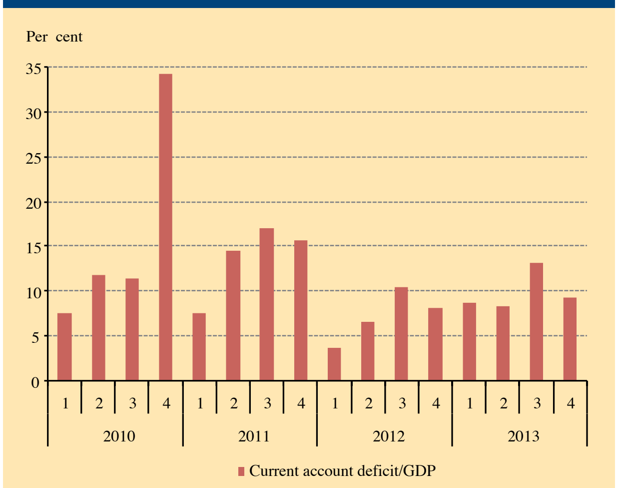
Source: Statistics Mauritius.

Chart 4.12: Coverage Ratio and Trade Deficit



Source: Statistics Mauritius.

Chart 4.13: Current Account Deficit as a percentage of GDP

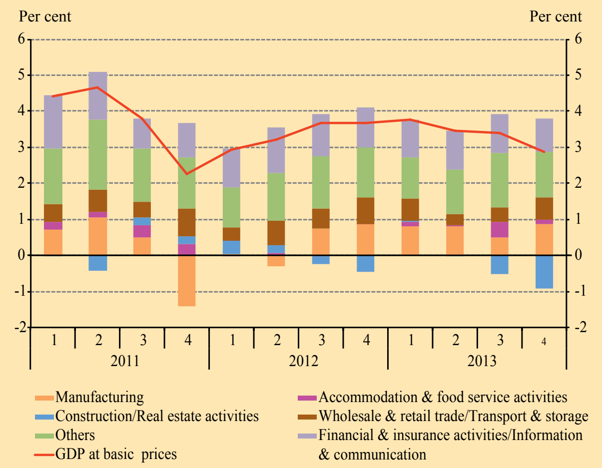


Sources: Statistics Mauritius and Bank of Mauritius.

Among the main sectors, the 'manufacturing' sector posted the fastest growth rate of output in 2013Q4 compared with 2013Q3. The 'wholesale and retail trade' sector also registered a higher growth rate in 2013Q4. In contrast, activity in the 'financial and insurance activities' and 'accommodation and food service activities' sectors decelerated in 2013Q4. 'Construction' was the only main sector that contracted in 2013Q4, as it had in the previous quarter.

In the tourism sector, arrivals increased by 2.9 per cent y-o-y in 2013 (Chart 4.15). For the first three months of 2014, however, tourist arrivals went down by 0.8 per cent y-o-y. This highlights that this sector remains vulnerable to the difficult economic situation in our main markets. Tourist earnings have not kept pace with arrivals. They are estimated to have fallen by 8.6 per cent y-o-y in 2013 and further by 4.5 per cent y-o-y in the first three months of 2014 (Chart 4.16).

Chart 4.14: Contribution of Selected Sectors to GDP Growth



Source: Statistics Mauritius.

The drop in tourist earnings led to a fall in net travel receipts, from Rs15.0 billion in 2012H2 to Rs11.4 billion in 2013H2. This translated into a lower surplus of Rs8.7 billion in the services account of the Balance of Payments (BoP), representing a y-o-y decrease of 26.3 per cent.

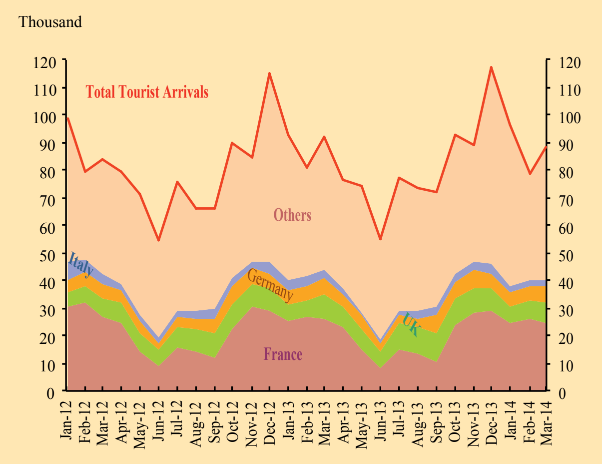
Statistics Mauritius forecast tourist arrivals to increase to 1,030,000 in 2014, from 993,106 in 2013. The Bank projects that tourist earnings for 2014 will rise to Rs44,500 million compared with Rs40,557 million in 2013.

4.3 Capital Flows

Latest BoP statistics include the results of the FALS 2013 and the GBC1s Survey 2013. There have been substantial revisions in the BoP statistics for the years 2011 and 2012 regarding income, direct investment and private external debt in the 'other investment' category mainly and to a lesser extent in portfolio investment.

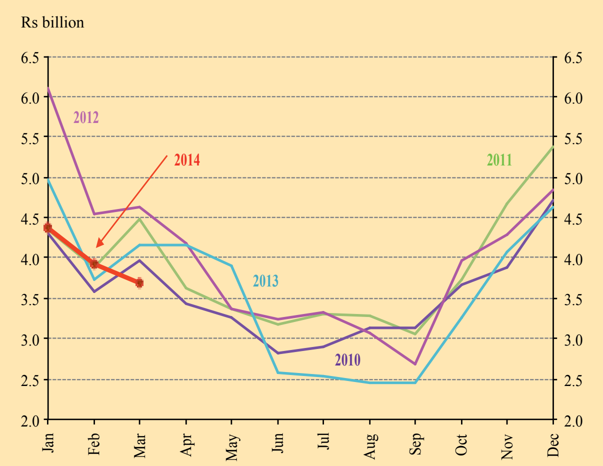
The capital and financial account posted significantly higher net inflows of Rs26.1 billion in 2013H2 due to surpluses from portfolio and direct investment which more than offset the net outflow in other investment (Chart 4.17). Direct investment, inclusive of cross-border transactions of GBC1s, posted net inflows of Rs36.6 billion in 2012H2 compared with Rs88.1

Chart 4.15: Tourist Arrivals



Source: Statistics Mauritius.

Chart 4.16: Tourist Earnings



billion in the corresponding period of the previous year. Portfolio investment, inclusive of GBC1s, recorded net inflows of Rs26.5 billion in 2013H2 compared with Rs17.6 billion a year earlier. Other investment, inclusive of GBC1s' cross-border transactions, posted net outflows of Rs35.9 billion in 2013H2 compared with net outflows of Rs98.0 billion in the corresponding period of 2012.

4.4 Labour Market

The unemployment rate, which had been on a declining trend since 2004Q1, started to increase gradually from 2010 (Chart 4.18). Latest data show that, although there was a slight improvement in 2013Q4, conditions in the labour market remained subdued, partly reflecting a cautious expansion strategy on the part of firms and persistent structural skills mismatch. The unemployment rate dropped to 7.5 per cent in 2013Q4, from 8.0 per cent in the previous quarter. Statistics Mauritius estimates that the unemployment rate has remained unchanged at 8.0 per cent in 2013 compared with 2012.

Over the year to 2013Q4, 13,500 jobs were created in the domestic economy, mainly in 'wholesale and retail trade' (+3,600) followed by 'manufacturing' (+2,600), 'accommodation and food service activities' (+1,700), 'transportation and storage' (+1,400), 'professional, scientific and technical activities' (+1,400), 'other service activities' (+1,400) and 'information and communication' (+1,100). Over the same period, jobs were lost in two sectors, namely, 'construction' (-1,700) and in 'agriculture, forestry and fishing' (-700) (Chart 4.19).

The drop in the unemployment rate in 2013Q4 reflects changes in labour force participation (Chart 4.20). Over the year, the participation rate of the 16-24 and 40-49 age groups declined while that of the 25-29, 30-39 and 50+ age groups increased. Lower participation of the 16-24 and 40-49 age groups partly reflected prevailing labour market rigidities, including structural skills mismatch and the unavailability of jobs due to reduced demand. Moreover, many young people often decide to pursue higher studies and are not registered in the labour force.

Over a longer time period, it is observed that the participation rate has increased quite substantially since 2012. This was mainly due to higher participation of the 30-39 and 50+ age groups. A reduction in household income in recent years

Chart 4.17: Capital flows including GBC1s

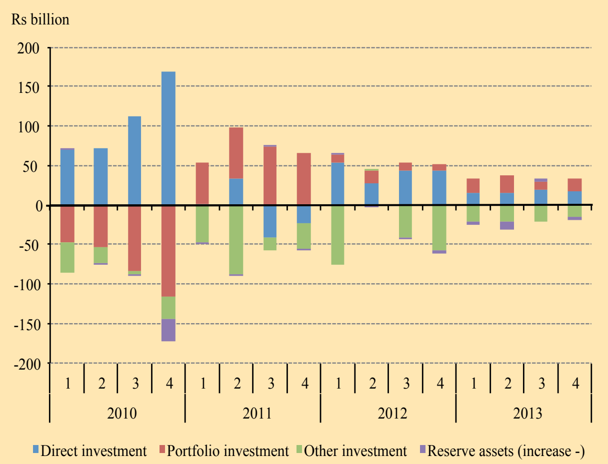
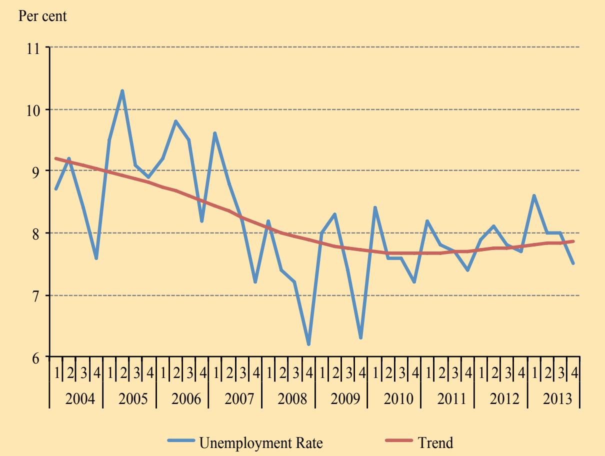
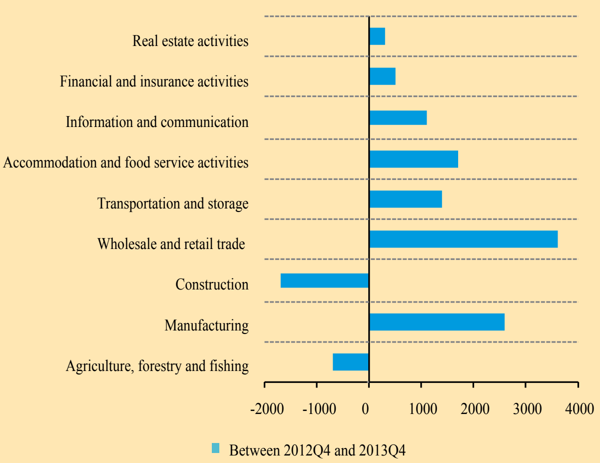


Chart 4.18: Unemployment Rate



Sources: Statistics Mauritius and Bank of Mauritius Estimates.

Chart 4.19: Change in Employment by Main Sectors

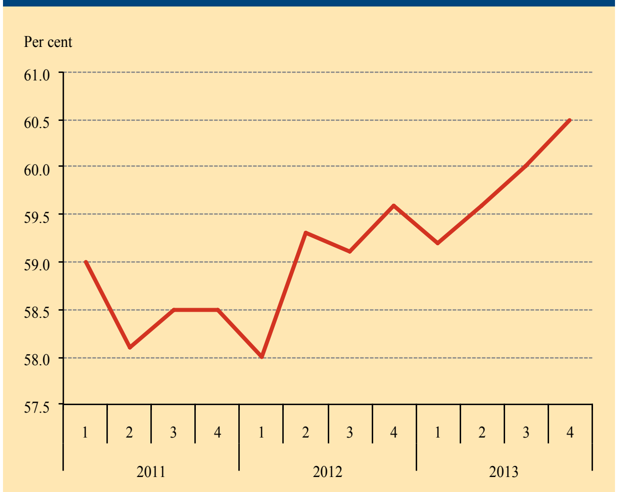


Source: Statistics Mauritius.

as well as lower savings may have encouraged more people to seek employment. In addition, rising unemployment abroad, due to the economic slowdown, has induced many Mauritians working overseas to return to the domestic labour market (Chart 4.21).

According to the latest Pluriconseil survey carried out in February 2014, a majority of analysts (67 per cent) forecast that the unemployment rate for 2014 will be higher than in 2013. The March 2014 MCCI business confidence survey showed that only 14 per cent of respondents were planning to increase their workforce in the coming months while 15 per cent were contemplating reducing their workforce given the continuing decline in domestic demand and the shortage of qualified labour in the market. Moreover, 71 per cent of entrepreneurs claim they will not increase their workforce. If the economy picks up in 2014, as expected, there might be a return of business confidence which would boost investment and create more job opportunities.

Chart 4.20: Labour Force Participation Rate



Source: Statistics Mauritius.

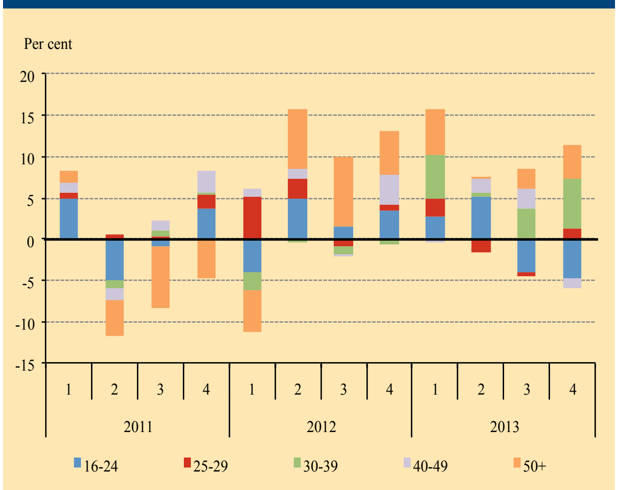
Wage Rate Index

The nominal Wage Rate Index (WRI) increased by 7.3 per cent y-o-y to reach 112.2 in 2013Q4. This increase was significantly higher than the y-o-y inflation rate of 3.5 per cent during the same period (Chart 4.22). If sustained, wage increases not matched by higher productivity could be a source of inflationary pressures.

The highest nominal wage increases were recorded in 'electricity, gas, steam and air conditioning supply' (20.1 per cent), 'education' (16.4 per cent), 'water supply, sewerage, waste management and remediation activities' (13.6 per cent), 'transportation and storage' (12.2 per cent), 'human health and social work activities' (9.7 per cent) and 'public administration and defence; compulsory social security' (8.4 per cent). Main decreases in wages were noted in 'arts, entertainment and recreation' (-0.7 per cent) and 'construction' (-0.5 per cent) (Chart 4.23).

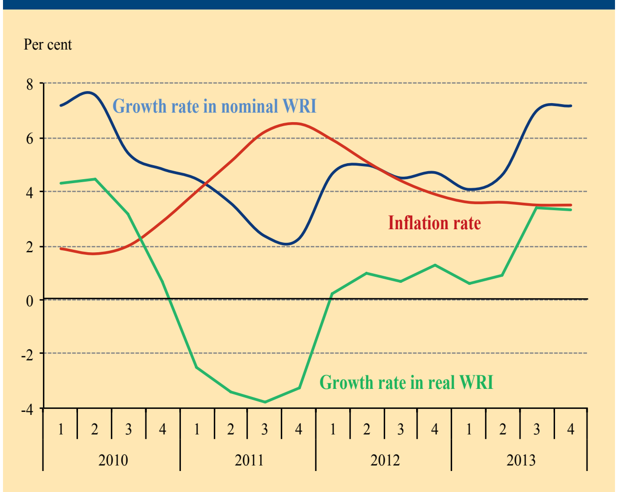
For the year 2013, the WRI for all sectors went up by 5.8 per cent but out of the 19 economic sectors, only eight sectors recorded a change in their WRI

Chart 4.21: Y-o-y Changes in the Labour Force Participation Rate by Age Group



Source: Statistics Mauritius.

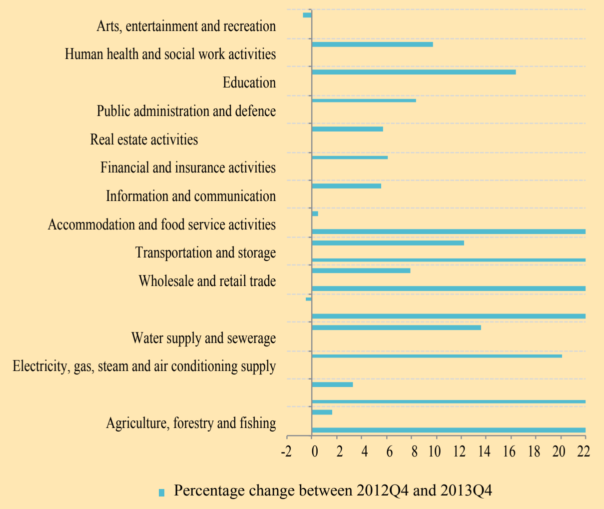
Chart 4.22: Growth in Wage Rate Index and Inflation Rate



Sources: Statistics Mauritius and Bank of Mauritius Estimates.

equal and greater than 5.8 per cent while in the remaining eleven economic sectors, the WRI was either showing a contraction or a lower increase.

Chart 4.23: Y-o-y Change in Wage Rate Index



Source: Statistics Mauritius.

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

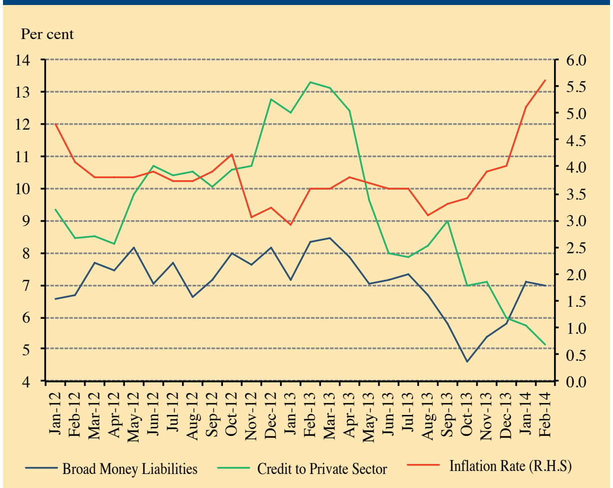
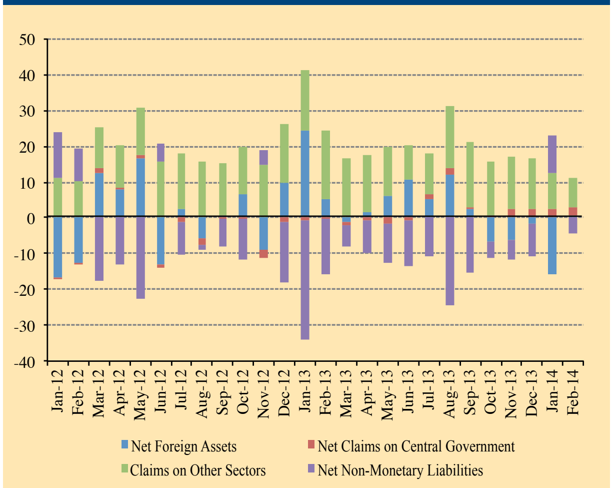


Chart 5.2: Contribution to Y-o-y Growth in Broad Money Liabilities



(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

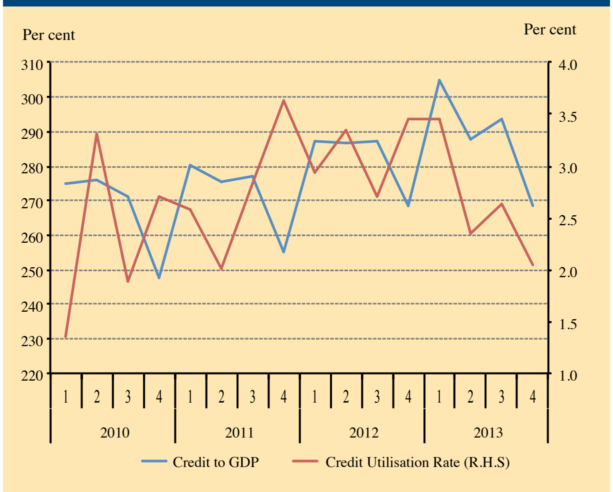


Chart 5.5: Contribution to Y-o-y Growth in the Monetary Base

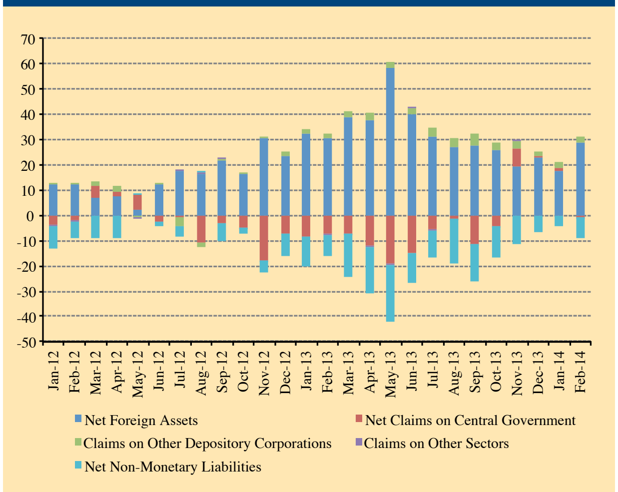
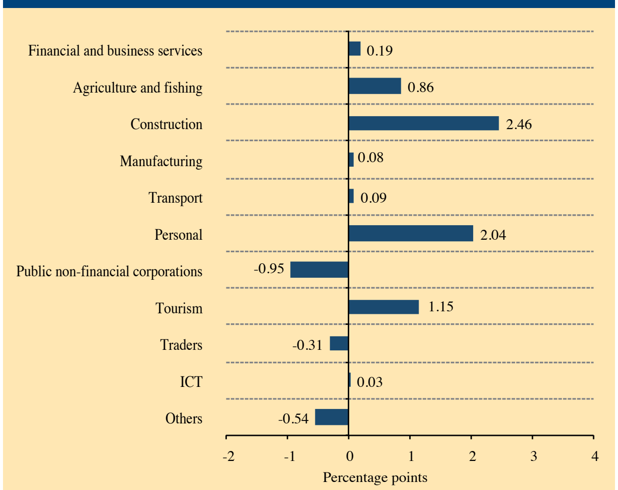


Chart 5.4: Sectorwise Contribution to the Change in Banks' Credit to the Private Sector – end-February 2013 to end-February 2014



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

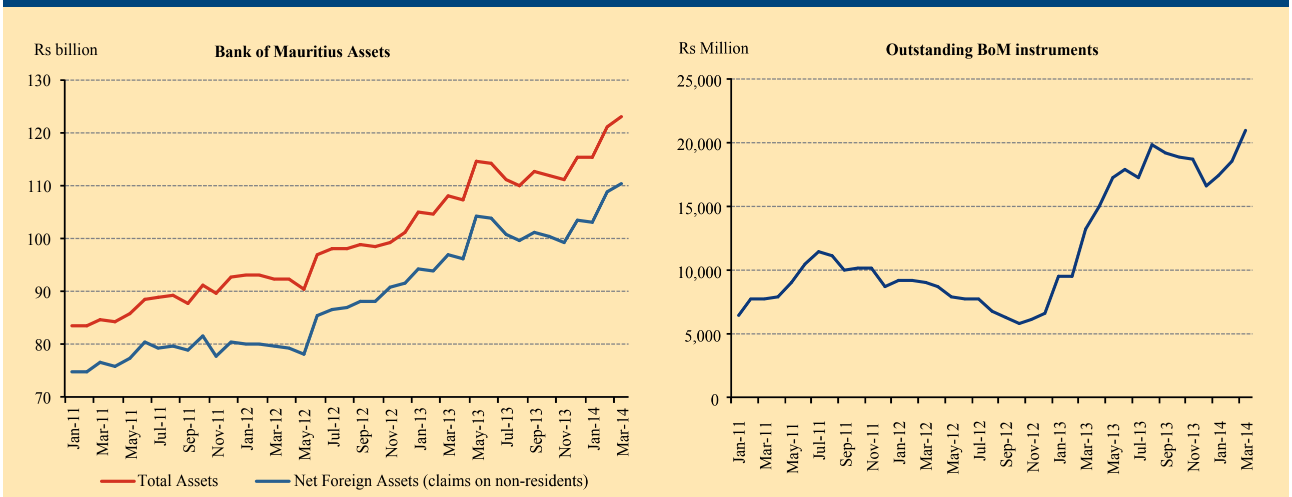


Chart 5.7: Yield on Treasury Bills

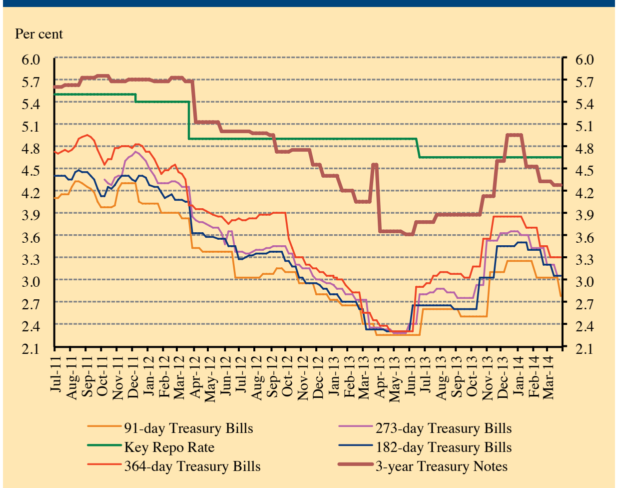
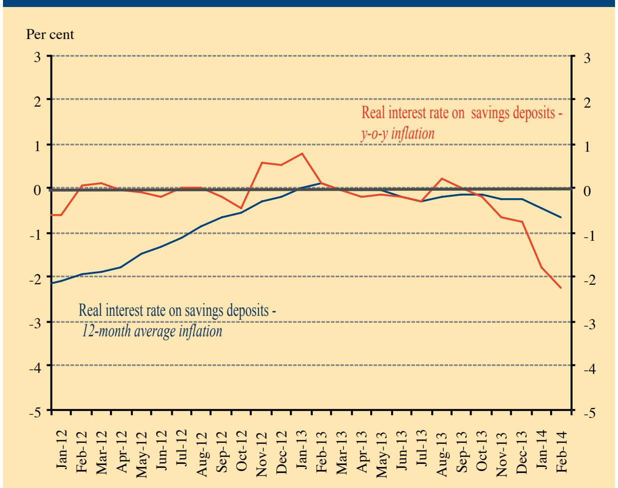


Chart 5.8: Real Interest Rate on Savings Deposits



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)

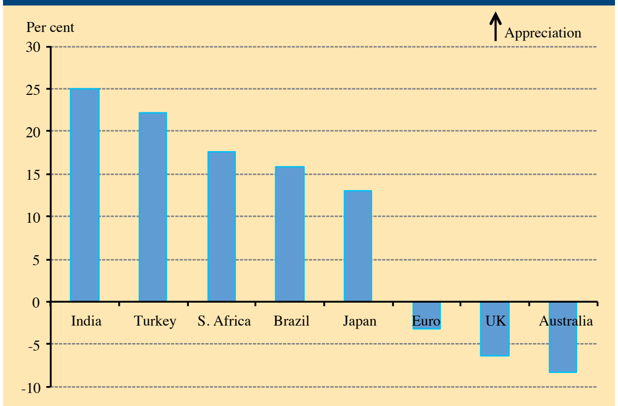
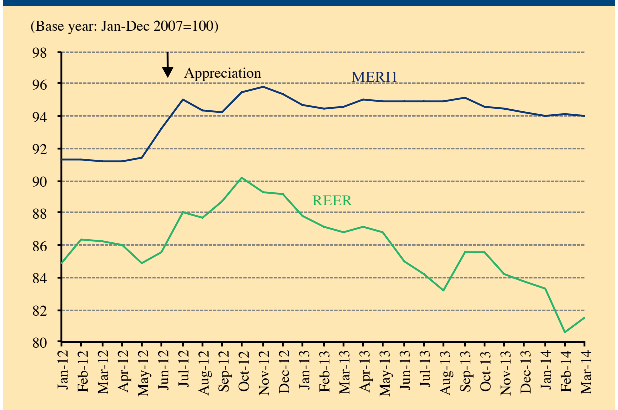


Chart 5.10: MERI1 and REER



6. GROWTH AND INFLATION OUTLOOK

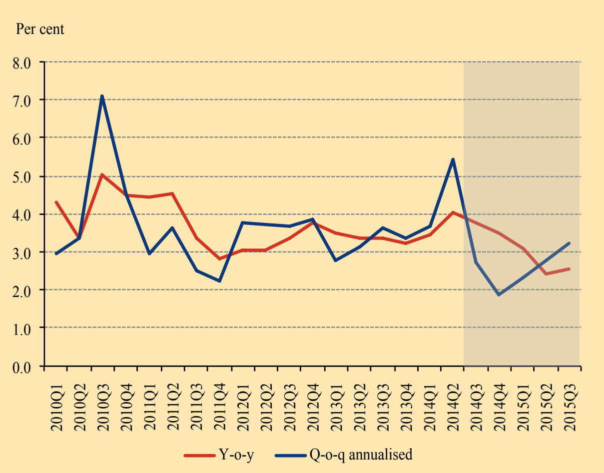
6.1 Growth Projection

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.

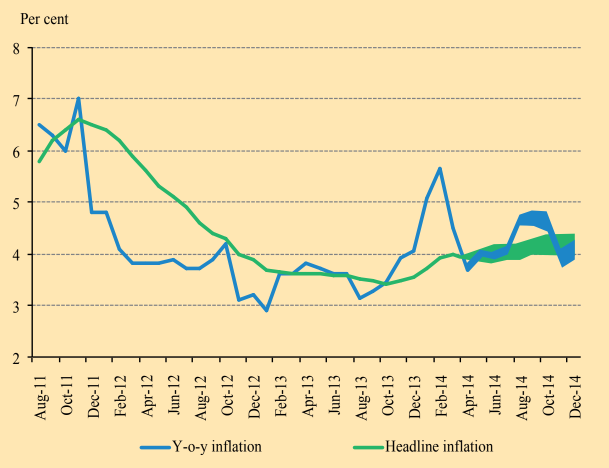
Exchange rate developments have so far remained very stable. The nominal effective exchange rate measured by MERI1 and MERI2 have been rather stable in 2014Q1, even showing an appreciation compared with 2013. It is likely that the nominal effective exchange rate will continue to remain stable in the 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



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List of Acronyms

BoE	Bank of England
BoJ	Bank of Japan
BoP	Balane of Payments
BML	Broad Money Liabilities
CIF	Cost, Insurance and Freight
CPI	Consumer Price Index
ECB	European Central Bank
EIA	Energy Information Administration
FAO	Food and Agriculture Organisation
FALS	Foreign Assets and Liabilities Survey
FED	Federal Reserve Bank
GBC1s	Global Business Companies
GDFCF	Gross Domestic Fixed Capital Formation
GDP	Gross Domestic Product
HP	Hodrick-Prescott
ICE	Intercontinental Exchange
IMF	International Monetary Fund
IPI	Import Price Index
ISM	Institute for Supply Management
KRR	Key Repo Rate
MCCI	Mauritius Chamber of Commerce and Industry
MERI	Mauritius Exchange Rate Index
MPC	Monetary Policy Committee
NYMEX WTI	New York Mercantile Exchange West Texas Intermediate
ODCs	Other Depository Corporations
OECD	Organisation for Economic Co-operation and Development
OPEC	Organisation of the Petroleum Exporting Countries
ORR	Operation Reserves Reconstitution

List of Acronyms

PLR	Prime Lending Rate
PMI	Purchasing Managers' Index
PPI-A	Producer Price Index-Agriculture
PPI-M	Producer Price Index-Manufacturing
REER	Real Effective Exchange Rate
SDR	Savings Deposits Rate
SEM	Stock Exchange of Mauritius
WEO	World Economic Outlook
WRI	Wage Rate Index

Glossary

CORE1 inflation excludes food, beverages and tobacco and mortgage interest on housing loan from the CPI basket. Both headline and year-on-year CORE1 inflation measures are available.

CORE2 inflation excludes food, beverages and tobacco, mortgage interest, energy prices and administered prices from the CPI basket. Both headline and year-on-year CORE2 inflation measures are available.

Fiscal consolidation is a policy aimed at reducing government deficits and debt accumulation.

GBC1s are resident corporations which conduct business outside Mauritius. The law has recently been amended to allow them to transact with residents provided that their activities in Mauritius are ancillary to their core business with non-residents.

Headline inflation is measured by the change in the average Consumer Price Index (CPI) over a twelve-month period compared with the corresponding previous twelve-month period.

The Hodrick-Prescott (HP) filter is a mathematical tool, especially used to determine the long term trend of a time series.

Key Repo Rate is the key policy rate used by the Bank of Mauritius to signal changes in its monetary policy stance.

MERI1 is the Mauritius Exchange Rate Index, a nominal effective exchange rate introduced in July 2008, based on the currency distribution of merchandise trade.

Narrow Money Liabilities comprise of 'Currency outside Depository Corporations' and 'Rupee Transferable Deposits'.

Other investment, which is a category in the Balance of Payments, includes all debt liabilities between unaffiliated non-residents and residents, which are not securitised. It can be classified by institutional sector: general government, monetary authorities, banks, and other sector, and sub-classified between short-term and long-term.

PMI refers to the Purchasing Managers' Index of financial activity, reflecting purchasing managers' acquisition of goods and services.

Quasi-money Liabilities comprise of 'Rupee Savings Deposits', 'Rupee Time Deposits' and 'Foreign Currency Deposits'.

Q-o-q refers to the quarter-on-quarter changes.

Seasonally-adjusted data are derived by removing the seasonal component of a time series in order to understand the underlying trends of the series.

Y-o-y change compares the value of a variable at one period in time to the same period the previous year.

Y-o-y inflation is measured by the change in the CPI for a given month compared with the corresponding month of the preceding year.