BANK OF MAURITIUS

Inflation Report

October 2013

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INFLATION REPORT

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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 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 to end of August 2013 unless otherwise stated.

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1. EXECUTIVE SUMMARY

Prospects for the global economy have improved slightly since the April 2013 Inflation Report, as a result of improved performance in advanced economies. Global growth is, however, expected to remain uneven. Reflecting the slowdown in emerging economies, the International Monetary Fund (IMF) has, in its October 2013 World Economic Outlook (WEO), downgraded its initial global growth forecast by 0.3 per cent to 2.9 per cent for 2013. Growth should improve somewhat in 2014 rising by 3.6 per cent. Downside risks emanating from still fragile financial market conditions in the Eurozone when coupled with the chance of a reduction in monetary stimulus by the Federal Reserve in the latter half of 2014 remain important and could negatively impact the already moderate global growth outlook. Against this backdrop of vulnerable and uneven global economic recovery, global inflation has remained subdued, though faced with capital outflows and depreciating currencies, some emerging economies have seen an increase in inflation. Global inflationary pressures are expected to remain contained in the medium term as commodity prices continue to ease and demand factors remain weak[1].

The domestic economy continued to hold up relatively well to the soft external economic conditions in our main trading-partner countries. However, conditions remained sub-par, with economic performance below trend. Excluding the negative performance recorded in the construction sector, major sectors recorded positive growth rates. For 2013, sectoral prospects remain mixed. While manufacturing may record higher growth, real activity in 'accommodation and food service activities' is expected to grow only slightly and the construction sector may face a deeper contraction as a result of delays in major public and completion of private projects. The outlook for the emerging 'seafood' and 'ICT' sectors appear relatively better.

The growth outlook for the remainder of 2013 is broadly positive albeit it remains uncertain, with exports weighed down by poor external demand, negative growth in public and private investment and consumer spending relatively weak. While downside risks still exist, some upside potential has recently emerged as the worst of the Eurozone recession appeared to be behind us. Barring negative developments, the expected recovery in the Eurozone, while modest, is forecast to have a positive impact on domestic exports and business as well as on consumer confidence. In September 2013, Statistics Mauritius revised its growth forecast downward for the year from 3.3 per cent to 3.2 per cent. The Bank Staff forecast growth within a range of 3.1-3.5 per cent, down from a previous estimate of 3.2-3.7 per cent made in June 2013.

The domestic economy is still characterised by labour market rigidities, with a mismatch between available jobs and skills within the labour force. Additionally, gender imbalances and youth unemployment continue to prevail, with the female unemployment rate surpassing the male unemployment rate. In the short to medium term, the unemployment rate is likely to remain at around current levels as firms continue to remain cautious when it comes to capacity expansion and hiring, taking into account the weak corporate balance sheets and the uncertain economic climate.

While headline inflation remained steady, y-o-y inflation has experienced a sharp decline in August 2013, mainly as a result of a fall in food prices, the first in the last ten years. Core inflation has remained moderate since the last Inflation Report. The Bank's Inflation Expectation Survey, carried out in August 2013, showed that a majority of respondents expected a rise in the mean inflation rate to 4.7 per cent a year ahead.

Since the last Inflation Report, the majority of members of the Monetary Policy Committee (MPC) have continued to be concerned about the risks of reduced growth, which they saw as outweighing the upside risks to the inflation outlook. The MPC in June 2013 voted to cut the Key Repo Rate (KRR) by 25 basis points to 4.65 per cent. It decided to keep the KRR at this level at the September 2013 meeting, though some members

[1] *IMF's October 2013 World Economic Outlook.*

considered it important to rapidly normalise the KRR to address the vulnerabilities facing the Mauritian economy and offer attractive rates of interest to increase savings and reduce spending.

Assuming no change in the monetary policy stance and a similar impact of the Budget 2014 on prices, as in the previous two years, the Bank's staff forecast of y-o-y inflation is in the range of 4.5-4.9 per cent for December 2013, equivalent to a headline inflation forecast of 3.7-3.8 per cent. By June 2014, y-o-y inflation could reach a range of 4.9-5.5 per cent, equivalent to a headline annual inflation forecast of 4.2-4.5 per cent. Assuming that the budget 2014 has no impact on prices, the staff y-o-y inflation forecast is reduced to a range of 3.7-4.0 per cent for December 2013 and to 4.1-4.6 per cent by June 2014. In the medium term, wage developments in excess of both inflation and productivity growth, continue to pose the greatest risk to price stability.

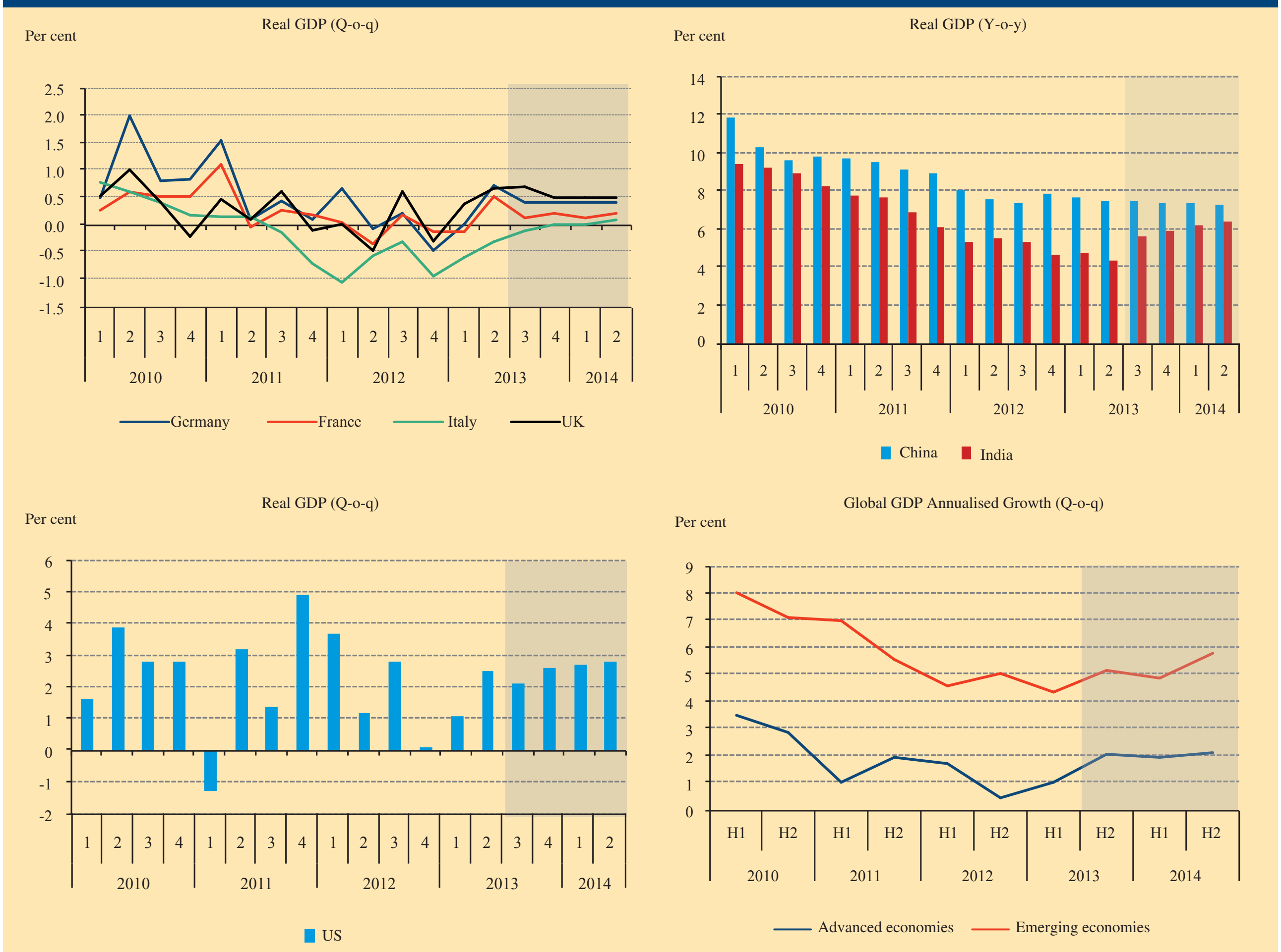
2. THE GLOBAL ECONOMY

The world economy has improved slightly since the April 2013 Inflation Report, as a result of the somewhat better performance of advanced economies. The Eurozone notably emerged out of recession after six consecutive quarters of contraction. In several major emerging economies, including China and India, growth has slowed and looks unlikely to return to previous highs in the medium term. Looking ahead, there is still considerable uncertainty surrounding the global growth outlook and a number of downside risks remain. Against the backdrop of fragile and uneven global economic recovery, global inflation has remained subdued though, faced with capital outflows and depreciating currencies, some emerging economies have seen an increase in inflation. Global inflationary pressures are expected to remain contained in the medium term as commodity prices continue to ease and as demand factors in high income countries remain weak [1].

2.1 Demand and Output

Latest data showed that global economic activity picked up with better prospects expected in the near term. However, the growth momentum remained uneven. Among major advanced economies, which experienced a small rebound in 2013Q2, the US is expected to drive the recovery. While emerging markets are experiencing a sharper slowdown than expected, growth will remain above those of the advanced economies but below the elevated levels seen in recent years. Some of these economies have also experienced significant outflows of capital following the announcement by the Federal Reserve

Chart 2.1: Growth in Selected Economies



Sources: OECD, IMF and Thomson Reuters

[1] *IMF's October 2013 World Economic Outlook.*

(FED) that it might start tapering its asset-purchase programme. The subsequent decision to maintain the pace of monetary stimulus in the US provided some relief to these economies.

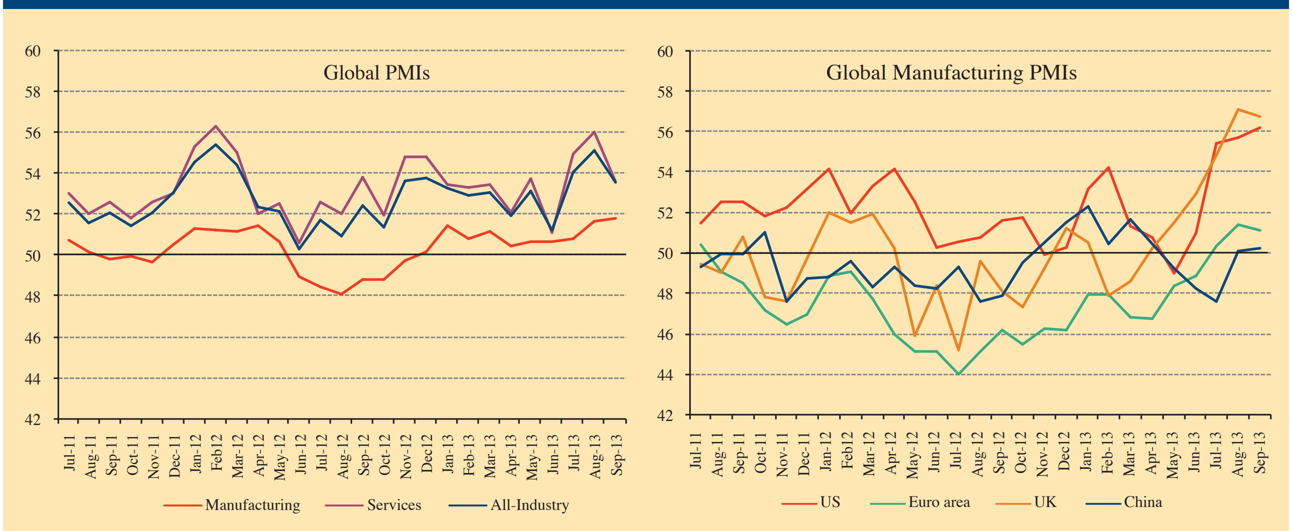
In the October 2013 release of the World Economic Outlook, the IMF downgraded its initial global growth forecast by 0.3 per cent to 2.9 per cent for 2013. This was mainly attributable to downward revisions in growth of emerging and developing market economies, from the 5.0 per cent expected previously to 4.5 per cent. Growth in advanced economies remained unchanged at 1.2 per cent. In 2014, the world economy is projected to grow by 3.6 per cent, with growth forecast at 2.0 per cent in advanced economies and 5.1 per cent in emerging and developing economies (Chart 2.1).

The JPMorgan Global All-Industry Purchasing Managers' Index (PMI), a leading indicator of global output, fell in September 2013 but still pointed to a strong pace of growth in global output. The decline in the All-Industry PMI was driven by a drop in global services PMI whereas the global manufacturing PMI continued to increase, reaching 51.8 in September. New orders and finished goods inventory continued to support global manufacturing output. By country, the manufacturing PMI for China indicated better prospects for manufacturing activity as the index crossed the 50-level mark that indicates expansion (Chart 2.2)[2].

In the US, private domestic demand supported by very accommodative monetary conditions was the main engine of growth. The economy grew by 2.5 per cent in 2013Q2 following a revised growth rate of 1.1 per cent in the previous quarter[3]. The housing sector continued to improve, with continuous gains in residential construction and home prices. The labour market was also recovering, but at a slow pace, with slight declines in the unemployment rate. The FED's announced intention to reduce quantitative easing tightened financing conditions in the US and possibly delayed actual tapering. There were, however, reasonably good data from the US to indicate that tapering might effectively take place in the near future. Continued uncertainties about the debt ceiling in the US and reductions in Government debt were important risk factors for the US economy. The IMF has forecast US GDP growth to be lower at 1.6 per cent in 2013 but to increase to 2.6 per cent in 2014.

After six consecutive quarters of contraction, GDP in the euro area expanded by 0.3 per cent in 2013Q2, marking the end of the longest recessionary phase recorded to date[4]. Faster-than-expected growth in Germany and France, led the rebound. A number of peripheral countries also appeared to perform better in the second quarter. Consumer and business confidence improved in some countries. The unemployment rate, which has been near record highs for some time, is not expected to worsen. Overall prospects have improved for the Eurozone but severe fiscal austerity measures in some countries, as well as fragile financial conditions will continue to weigh on growth. According to the IMF, the euro area is expected to contract by 0.4 per cent in 2013 and grow by 1.0 per cent in 2014.

Chart 2.2: JPMorgan Global Purchasing Managers' Index



Source: JPMorgan.

[2] *JPMorgan Purchasing Managers' Index releases, Markit Economics.*

[3] *US Bureau of Economic Analysis.*

[4] *Eurostat.*

UK economic growth accelerated to 0.7 per cent in 2013Q2, from 0.3 per cent in 2013Q1[5]. Recent data indicated that the UK manufacturing sector continued to expand at a marked pace in September while the services sector performed strongly. The labour market continued to stabilise and consumer confidence improved. A fundamental shift in the UK housing market has taken place over the past nine months, with credit conditions easing and house prices starting to rise. However, risks remain that the US growth will be more moderate than expected and renewed troubles in the euro area may hinder the current bounce in the economy. The IMF forecast that the UK economy will grow by 1.4 per cent and 1.9 per cent in 2013 and 2014, respectively.

Emerging markets have lost considerable momentum following a period of double-digit growth, in which they drove the world economy in the aftermath of the financial crisis. GDP growth in China has moderated for two consecutive quarters, to 7.5 per cent in 2013Q2 due to sluggish external demand and weak private investment[6]. However, monthly activity indicators have shown some positive signs. The September's HSBC China Manufacturing PMI recovered to 50.2, from an 11-month low of 47.7 in July. In India, GDP growth slowed markedly to 4.4 per cent in 2013Q2, hurt by a decline in mining and manufacturing[7]. While ample monsoon rainfall may support agricultural production in 2013H2, business conditions in the Indian manufacturing sector deteriorated. Judging from market reaction to the planned cutback in US monetary stimulus, there are continued risks of an abrupt cut-off in capital flows to emerging market economies as well as severe balance of payments disruptions. The economic outlook is generally weaker for emerging market economies. The IMF forecast China and India to grow by 7.6 per cent and 3.8 per cent, respectively, in 2013. For 2014, the IMF estimates growth at 7.3 per cent and 5.1 per cent, respectively, for these two countries.

Latest data from the Netherlands Bureau of Economic Research indicated that global trade volumes were up by 3.6 per cent in the year to July 2013, with a 8.2 per cent expansion in imports of emerging economies being the main driver of higher trade volumes[8]. In October 2013, the IMF downgraded the forecast for world trade volume growth by 0.2 percentage point to 2.9 per cent in 2013, reflecting subdued momentum in global economic activity. The IMF estimated that trade would grow by 4.9 per cent in 2014.

2.2 Recent Developments in Prices

2.2.1 Consumer Price Inflation

The factors that contributed to the low inflationary environment on the global front stemmed mainly from sliding commodity prices, including low energy prices, and the weak demand in China and Europe. In advanced economies, inflation rose slightly but remained below target while in some emerging economies, faced with capital outflows and depreciating currencies, inflation has increased. With the slight pickup in activity in the advanced economies not expected to lead to a major reduction in output gaps, it is projected that inflationary pressures will remain subdued. The IMF forecast consumer prices in advanced economies to stand at 1.4 per cent in 2013 and at 1.8 per cent in 2014. While the

Table 2.1: Consumer Price Inflation in Selected Countries

Per cent

	2009	2010	2011	2012	February 2013	August 2013
China	-0.7	3.3	5.4	2.6	3.2	2.6
Euro area	0.3	1.6	2.7	2.5	1.8	1.3
India	12.4	10.4	8.4	10.4	12.1	9.5
Indonesia	4.8	5.1	5.4	4.3	5.3	8.8
South Africa	7.1	4.3	5.0	5.7	5.9	6.4
Thailand	-0.9	3.3	3.8	3.0	3.2	1.6
Turkey	6.3	8.6	6.5	8.9	7.0	8.2
United Kingdom	2.1	3.3	4.5	2.8	2.8	2.7
United States	-0.3	1.6	3.1	2.1	2.0	1.5
Mauritius	2.5	2.9	6.5	3.9	3.6	3.5

Sources: IMF and The Economist.

[5] *Office for National Statistics.*

[6] *National Bureau of Statistics of China.*

[7] *Central Statistics Office of India.*

[8] *Netherlands Bureau for Economic Policy and Analysis.*

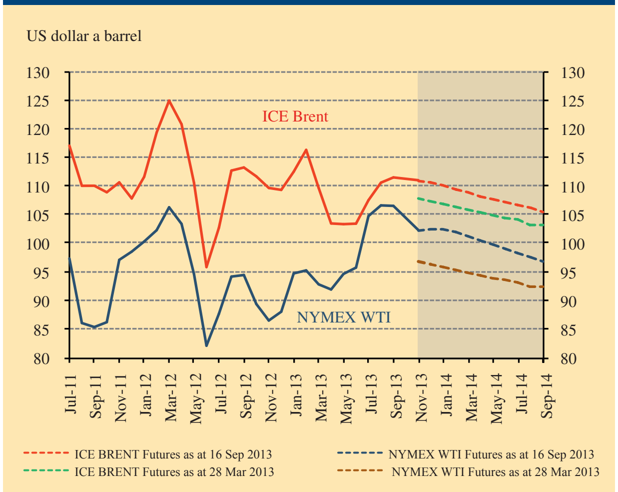
drop in commodity prices and lower growth should contain price pressures in emerging and developing economies, continued capacity constraints and the pass-through from weakening exchange rates are expected to keep inflation relatively high. According to the IMF, inflation could reach 6.2 per cent for 2013 before coming down to 5.7 per cent for 2014.

2.2.2 Commodity Prices

Commodity prices continued to face downward pressure from generally improved supply prospects and subdued demand conditions, which were exacerbated by the slower growth in emerging and developing economies.

Crude oil prices, which increased for some time during 2013Q3 on account of geopolitical tensions, are expected to remain range-bound. However, they may face some downward pressure if OPEC were to maintain output at current levels in a context where shale oil extraction has enabled many countries, including the US, to reduce oil imports dramatically. The October 2013 US Energy Information Administration (EIA) report expects the Brent crude oil price to continue to weaken, averaging US$107 per barrel during 2013Q4 and US$102 per barrel in 2014. West Texas Intermediate (WTI) crude oil prices are expected to average US$101 per barrel during 2013Q4 and US$96 per barrel during 2014[9]. Between March and September 2013, the oil price futures curves for ICE Brent and NYMEX WTI have shifted up, albeit less for ICE Brent, mainly on account of higher geopolitical risk premium and signs of improvement in the global economy. These

Chart 2.3: Monthly Average NYMEX WTI and ICE Brent and Futures Prices

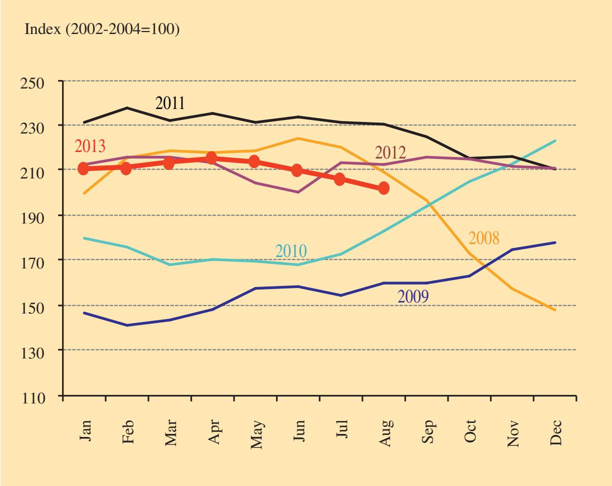


Sources: Thomson Reuters and ICE.

geopolitical tensions are expected to fade in the coming months. Current market expectation of future oil prices continue to confim the downward path of oil prices (Chart 2.3).

Global food prices remained moderate during the period under review. The Food and Agriculture Organisation (FAO) food price index that measures price changes for a basket of cereals, oilseeds, dairy, meat and sugar, fell from 210.9 points in February 2013 to 201.4 points in August 2013. This was its lowest level since June 2012 (Chart 2.4). Cereal prices have led the aggregate index down, with maize prices in particular recording significant falls on the back of good harvests in many producing areas across the globe. Looking ahead, global food prices are expected to fall on the assumption of normal weather conditions and improved harvests[10].

Chart 2.4: FAO Food Price Index



Source: FAO.

Among other commodities, metal prices retreated, reflecting the moderation in global demand, particularly from China, and high stocks for most metals. Copper prices fell by 10.8 per cent while nickel and zinc prices declined by 19.1 per cent and 10.8 per cent, respectively. Gold prices fell by 17 per cent during the period under review as investors shifted to stocks and real estate due to a rebound in investors' confidence. According to the World Bank Commodity Markets Outlook July 2013, metal prices are expected to fall due to abundant supplies and weakening demand conditions, but prospects still depend to a large degree on Chinese demand, as the country accounts for almost 45 per cent of global metal consumption[11].

[9] *Energy Information Administration.*

[10] *Food and Agriculture Organisation of the United Nations.*

[11] *World Bank Commodity Markets Outlook, July 2013.*

2.3 Exchange Rates[12]

During the period under review, currency markets were mainly influenced by major central banks' decisions, positive developments in the US and Europe and lower risk aversion among investors. Initially, the US dollar remained supported against most currencies as investors factored in that the FED would limit its quantitative easing program. Subsequently, however, weaker jobs' data that scaled back expectations that the FED would taper its monetary stimulus contributed to weakening the US currency. Between April and August 2013, the trade-weighted US dollar index depreciated by 1.4 per cent.

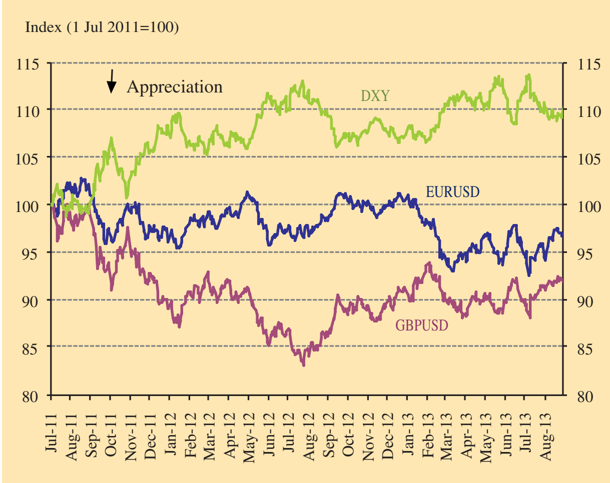
Movements of the euro were largely related to changing market expectations about the economic and financial outlook for the euro area, relative to other major economies, as well as developments in the policies of major central banks. After a slight appreciation in early June, the euro tumbled to as low as US$1.2754 on 9 July 2013, after rising borrowing costs in some peripheral euro area countries. It recovered thereafter as investors sold emerging-market currencies and shifted to less risky assets, including the euro. Better-than-expected economic reports, indicating that the economy was picking up, also supported the euro.

Among other major currencies, the Pound sterling remained mostly supported by improved domestic economic data, bolstering expectations of an early monetary tightening, whilst also capitalising on the US currency's broad-based weakness. During the period under review, the British currency appreciated to trade above US$1.56 by mid-August 2013.

The Japanese yen weakened, mainly as a result of massive monetary easing by the Bank of Japan. It crossed the 100 mark against the US dollar in May 2013.

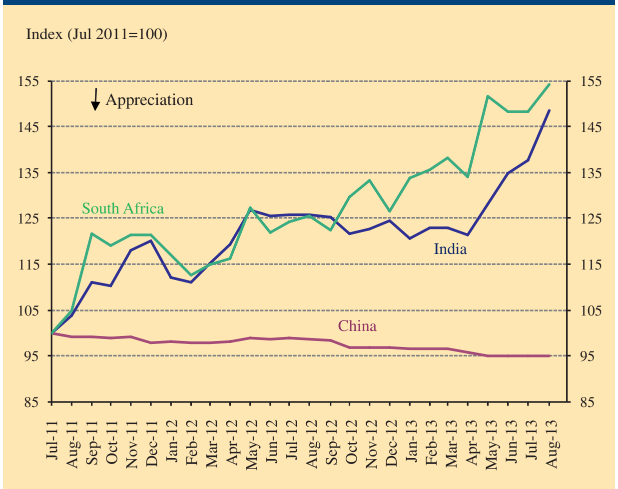
Many emerging economies saw a depreciation of their currencies as their economies weakened and capital flowed out. Except for the Chinese yuan, the BRICS currencies were all affected by important capital outflows. Countries with large current account deficits, like Indonesia and Turkey, were also affected. The Indian rupee lost more than 20 per cent of its value and fell to an all-time low of 68.80 to the US dollar by end of August 2013, while the Turkish lira, the Indonesian rupiah and the Brazilian real depreciated in the range of 10-18 per cent against the US dollar. The South African rand suffered significantly, hitting four-year lows, as poor economic data and labour market tensions additionally weighed on sentiment.

Chart 2.5: Evolution of the US dollar



Source: Thomson Reuters.

Chart 2.6: Trends of the Indices of Currencies in Emerging Markets against the US dollar



Source: Thomson Reuters.

[12] *Thomson Reuters.*

2.4 Global Monetary Policy[13]

Whilst monetary policy remained expansionary in advanced economies, central banks have been increasingly intent on providing forward guidance as to when they might eventually reduce monetary stimulus. They see forward guidance as an important step toward greater transparency about the factors that will guide policy rates and are increasingly using such guidance to communicate monetary policy and anchor market expectations.

In the US, the Federal Open Market Committee (FOMC) maintained its asset purchase program of USD85 billion per month despite an early announcement in May 2013 that it was considering to trim it down. In its forward guidance to the market, the FED pledged to keep interest rates low at least until the unemployment rate falls significantly below 6.5 per cent, and inflation rates remain close to the long-term goal of 2 per cent.

In May 2013, the ECB cut interest rates by 25 basis points to 0.5 per cent. Its forward guidance strategy makes explicit reference to rates being held at present levels, or lower, for an extended period. This was premised upon the euro area's subdued medium-term inflation outlook and broad-based weakness in the real economy, and could pave the way for another cut in the deposit facility rate.

The Bank of England (BoE) maintained both its key policy rate and its asset purchase program of GBP375 billion unchanged. Outlining its forward guidance concerning the future conduct of monetary policy at its meeting of August 2013, the BoE stated its intention neither to raise the Bank Rate nor reduce the stock of asset purchases at least until the unemployment rate has fallen to a threshold of 7 per cent.

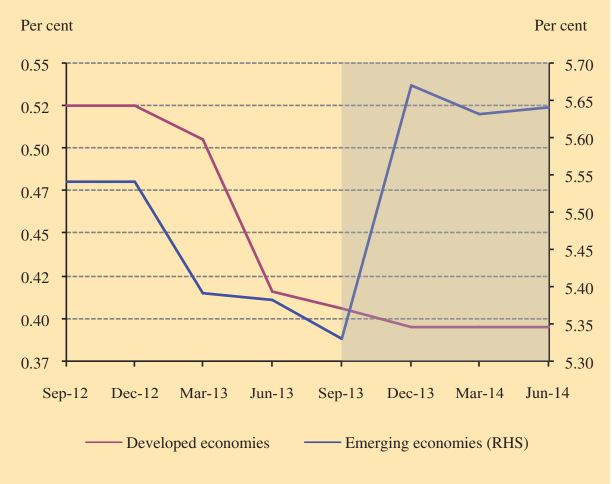
The Bank of Japan (BoJ) embarked on a more aggressive phase of quantitative easing in April to achieve an inflation target of 2 per cent. It undertook to provide a massive boost to the monetary base, which became the main operating target of money market operations instead of the uncollateralised overnight call rate.

A number of emerging market central banks tightened policy while intervening in currency markets, owing to sharp reversals of capital inflows. The People's Bank of China began to tighten the availability of liquidity in June and also removed the floor on lending rates. The Reserve Bank of India tightened interbank liquidity and raised the cost of shorting the rupee in July to restore stability in the foreign exchange market. It also increased the repo rate by 25 basis points to 7.50 per cent in September 2013 mainly on account of price pressures. The Central Bank of Indonesia raised its benchmark policy rate by a cumulative 150 basis points from June to September to 7.25 per cent in an effort to anchor inflation expectations amid the hike in subsidised fuel prices. Brazil's central bank increased rates by a cumulative 150 points in May, July and August to 9 per cent.

A smaller number of central banks reduced their monetary policy rates since the last Inflation Report. Among them, the central banks of Korea and Thailand reduced rates by 25 basis points in May 2013, on account of lower growth and contained inflation rates.

It is widely expected that central banks in emerging economies will increase key interest rates more rapidly than in advanced economies to counter exchange rate depreciation and rising inflation. Central banks in advanced economies are projected to keep key interest rates low for an extended period of time to boost growth though some of them may partially reduce monetary stimulus (Chart 2.7).

Chart 2.7: Expected Interest Rates in Developed and Emerging Economies



Source: JPMorgan.

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

3. RECENT DEVELOPMENTS IN INFLATION

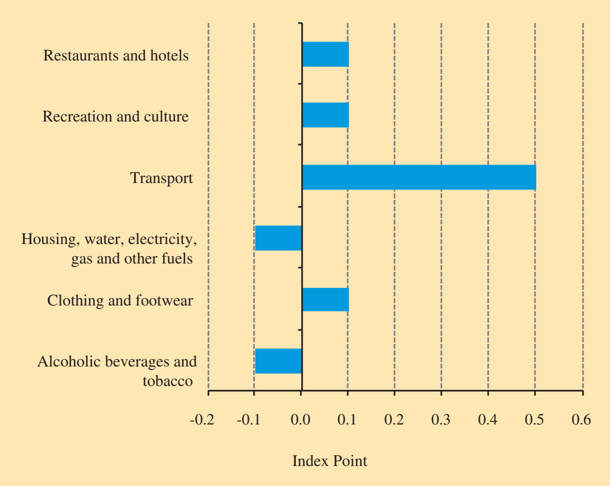
Since the last Inflation Report, headline inflation has been rather steady while y-o-y inflation has dropped substantially after having hovered within a narrow range. A decline in the price of food products which more than offset the increase in bus fares drove y-o-y inflation downwards. The core measures of inflation continue to indicate moderate inflationary pressures.

3.1 Consumer Prices

Effective April 2013, the Consumer Price Index (CPI) has been calculated on the basis of an updated basket of goods and services derived from the 2012 Household Budget Survey conducted by Statistics Mauritius. The base period for this new CPI series is the twelve-month period January 2012 to December 2012.

Since the last Inflation Report, the CPI has increased to 103.3. The largest contributor to the CPI increase was 'transport', more specifically the increase in bus fares, which contributed 0.5 index point to the increase in the CPI. 'Clothing & footwear', 'restaurants & hotels' and 'recreation & culture' each added 0.1 index point to the CPI while 'alcoholic beverages & tobacco' and 'housing, water, electricity, gas & other fuels' each withdrew 0.1 index point from the CPI (Chart3.1).

Chart 3.1: Weighted Contributions to the Change in CPI: February 2013 - August 2013



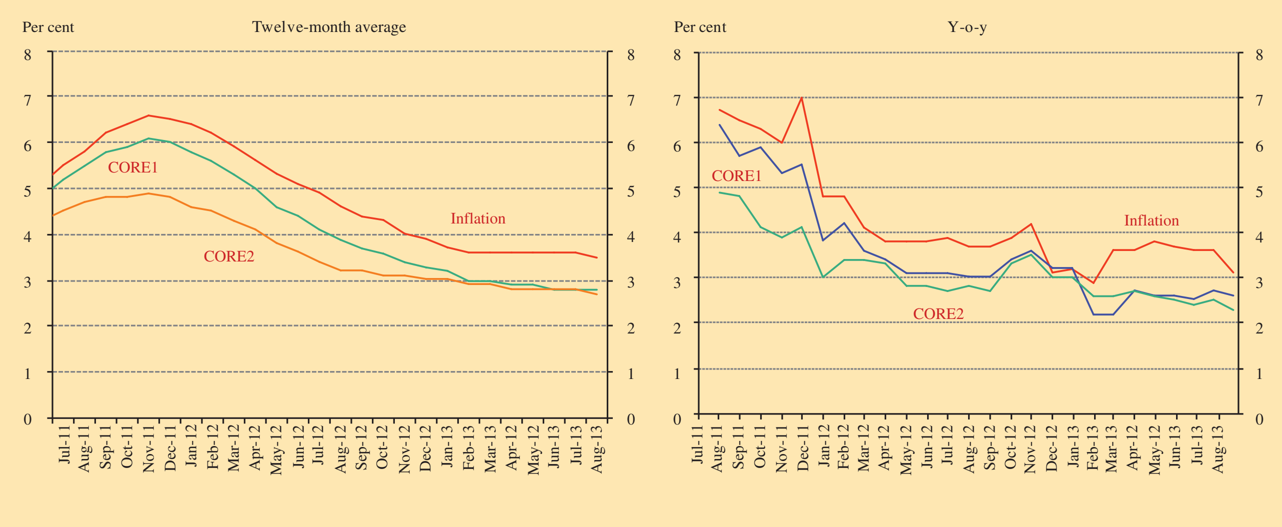
Sources: Statistics Mauritius and Bank of Mauritius.

Headline inflation edged down slightly to 3.5 per cent in August 2013, after remaining steady at 3.6 per cent in the preceding five months. Y-o-Y inflation hovered within a narrow range of 3.6 per cent and 3.8 per cent between February 2013 and July 2013 as base effects remained favourable, external price pressures continued to be subdued and the rupee exchange rate remained relatively stable. In August 2013, contrary to expectations, y-o-y inflation fell noticeably to 3.1 per cent on the back of a decline in the price of food products, which more than offset an increase of 12 per cent in bus fares. As a result, 'food and non-alcoholic beverages' contributed 0.5 percentage point to y-o-y inflation in August 2013 while 'alcoholic beverages and tobacco' and 'transport', respectively contributed 1.1 and 0.6 percentage points.

Movements in the underlying inflation measures remained moderate. Y-o-Y CORE1 inflation rose to 2.6 per cent in August 2013, from 2.2 per cent in February 2013, while CORE2 inflation fell from 2.6 per cent in February 2013 to 2.3 per cent in August 2013 (Chart 3.2).

The y-o-y food price inflation went down from 3.5 per cent in February 2013 to 1.6 per cent in August 2013, reflecting low dynamics in the prices of vegetables and other food products on the domestic market. The unexpected decrease in food prices in August 2013 was a first over the last ten years. Other divisions also experienced declines that could not have been expected gauging from past price behaviour. Box 1 provides an understanding of these recent price dynamics.

Chart 3.2: CPI Inflation

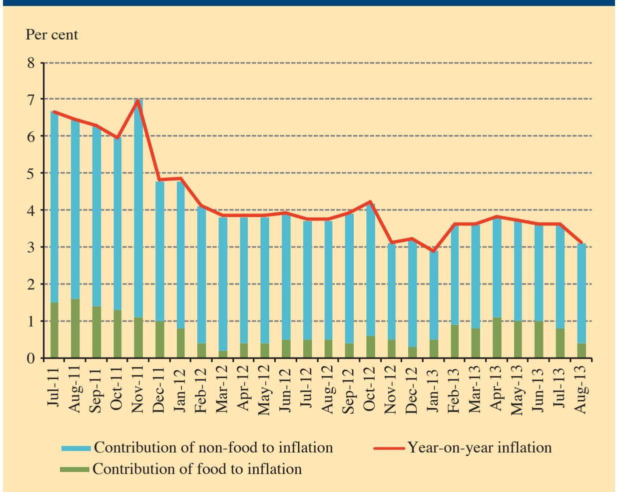


Sources: Statistics Mauritius and Bank of Mauritius.

Non-food inflation rose from 3.6 per cent in February to 3.9 per cent in March 2013, mainly on account of the hike in the prices of domestic petroleum products. It was at 3.6 per cent by the end of August 2013 (Chart 3.3).

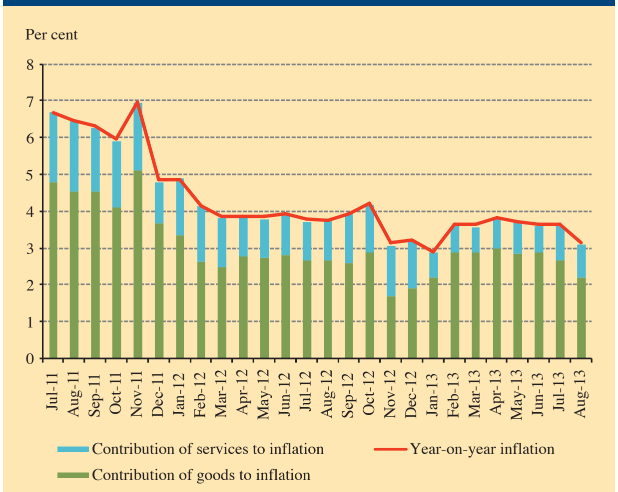
Y-o-Y goods inflation, which had hovered between 4.0 per cent and 4.5 per cent, declined significantly to 3.3 per cent in August 2013, partly reflecting the fall in food prices. Services inflation rose from 1.9 per cent in February 2013 to 2.7 per cent in August (Chart 3.4).

Chart 3.3: Y-o-Y Food and Non-Food Inflation



Sources: Statistics Mauritius and Bank of Mauritius.

Chart 3.4: Y-o-Y Goods and Services Inflation



Sources: Statistics Mauritius and Bank of Mauritius.

Box I
Understanding Recent Price Dynamics

Historical data from 2003 onwards showed that the current situation of low growth and low inflation in 2013 is not exceptional. High real GDP growth rates are generally associated with high inflation rates and vice-versa.

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Y-o-Y Inflation (Dec)	3.9	5.6	3.9	11.9	8.7	6.7	1.5	6.1	4.8	3.2	
GDP Growth Rate	4.4	4.8	2.7	5.6	5.7	5.5	3.1	4.2	3.6	3.4	3.2
Cumulative Monthly Changes in the CPI: May to August											
	2003	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Food & Non-Alcoholic Beverages	2.3	0.5	0.8	6.7	4.1	6.4	1.4	1.1	1.1	1.6	**-1.2**
Alcoholic Beverages & Tobacco	3.7	6.5	3.1	20.8	9.0	1.7	0.4	-0.2	0.4	0.0	**-0.2**
Clothing & Footwear	2.1	0.3	0.3	2.3	2.0	0.8	4.4	2.5	2.4	1.8	**0.9**
Housing, Water, Electricity, Gas & other fuels	1.8	2.4	1.1	4.4	0.9	-0.3	0.2	-0.1	0.5	0.0	**-0.6**
Furnishings, Household Equipment & Routine Household Maintenance	1.1	1.4	2.1	3.6	2.4	2.7	1.5	2.1	1.1	1.6	**-0.1**
Health	1.3	3.8	4.2	3.1	5.6	3.9	1.0	2.7	0.1	2.9	**0.3**
Transport	-0.4	4.8	-1.1	8.6	6.0	12.7	1.8	3.0	0.4	-0.4	**0.4**
Communication	-0.8	-0.3	-0.2	-3.9	0.0	-3.2	0.6	0.0	-0.1	0.0	**0.1**
Recreation & Culture	0.8	-0.8	0.0	3.2	-0.9	-0.3	0.6	0.5	1.0	-0.4	**3.4**
Education	1.4	0.0	0.0	0.0	0.0	0.8	0.0	0.0	0.0	0.6	**0.2**
Restaurants & Hotels	1.3	5.0	1.9	14.3	4.7	5.2	1.0	2.6	0.6	0.6	**0.3**
Miscellaneaous Goods & Services	3.0	2.9	-0.2	3.3	2.9	2.8	1.6	2.3	1.7	0.9	**-0.3**

The cumulative May to August month-on-month changes in the CPI are computed for each year since 2003 for comparison. The year 2013 in the table above stands out relative to the past. Indeed, it is the first time since 2003 that the sub-index for food and non-alcoholic beverages recorded a significant drop with declines also being noted in many more divisions in 2013. Moreover the magnitude of the decline is in most cases bigger than in the past. With regard to food, except for meat and dairy, all other food products recorded cumulative falls.

It is argued that the cumulative decline in the CPI in 2013 from May to August is mainly attributable to the market microstructure and price-setting behaviour (and not necessarily to a change in macroeconomic fundamentals) as hypermarkets and supermarkets change their business model to increase profits with intermittent price discounts and "sales" throughout the month, especially for goods nearing their expiry dates, rather than towards month-end as it used to be in a recent past. Statistics Mauritius collects prices in supermarkets and hypermarkets between the 12th and 18th of the month for food and non-durable household goods with an expiry date of 3 months and above. Lately it appears that price collections have been reflecting such discounts or "sales".

Research on the CPI has been inconclusive about whether intermittent price discounts, or "sales" should be incorporated in the consumer price index as there is a potential to bias the measurement of inflation.

3.2 Import Prices

Since a large proportion of goods in the CPI basket are imported, the fall in goods inflation was reflected to some extent in the measure of imported inflation. The latter is derived from the price indices of the imported components of the CPI basket.

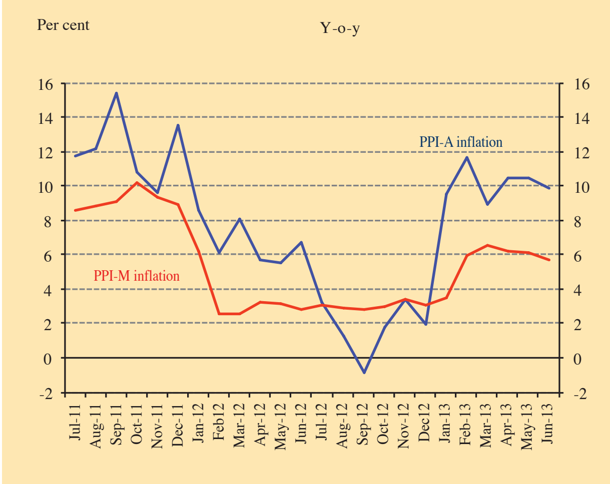
The Import Price Index (IPI), which is available on a quarterly basis from Statistics Mauritius, provides another measure of the change in imported prices. The IPI fell for three consecutive quarters to 121.8 in 2013Q2, representing a drop of 1.8 per cent compared with 2012Q2. Over the year, the drop in the IPI resulted from decreases in the prices of 'machinery and transport equipment' (-13.7 per cent) and 'mineral fuels, lubricants and related materials' (-4.2 per cent), which were partly offset by increases in the prices of 'beverages and tobacco' (+13.2 per cent) and 'food and live animals' (+8.5 per cent) (Chart 3.5).

3.3 Producer Prices

Latest data available for June 2013 show that at the production level, agricultural prices firmed up on account of net increases in the prices of fresh vegetables and fruits. Y-o-Y PPI-A inflation rose to 9.9 per cent in June 2013, up from 6.8 per cent in June 2012. In absolute terms, the PPI-A increased to 118.0 index points, reflecting the increase in the sub-index 'crop products', which accounts for nearly 76 per cent of the overall weight.

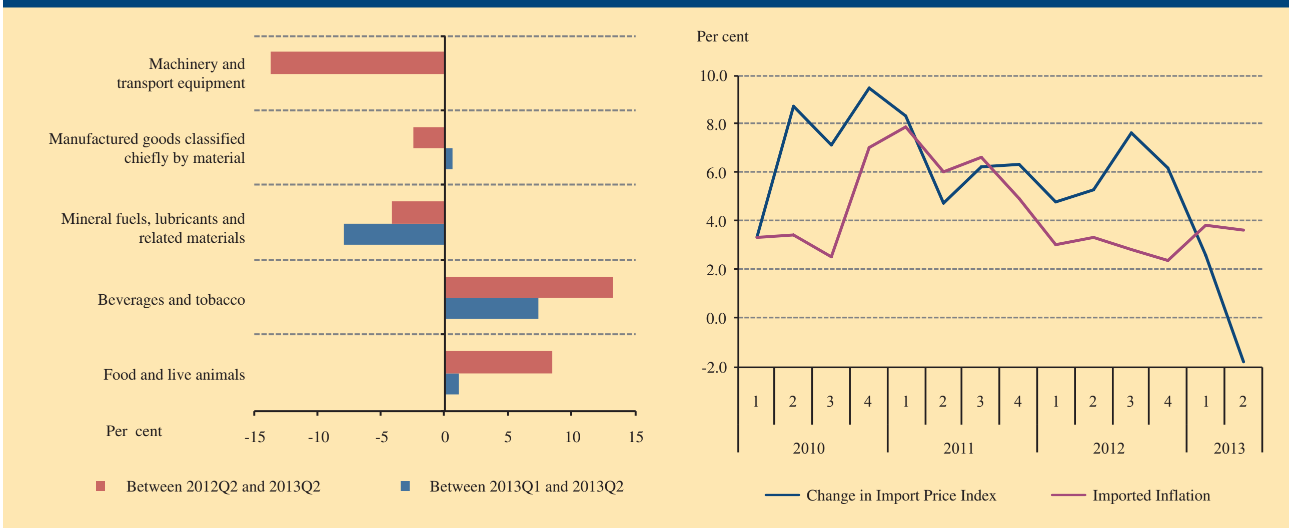
In manufacturing, the y-o-y PPI-M inflation increased to 5.6 per cent in June 2013, up from 2.8 per cent in June 2012. In absolute terms, the PPI-M rose from 127.1 index points in June 2012 to 134.3 index points, reflecting the rise in the sub-index 'manufacture of food products/manufacture of beverages', which accounts for nearly 61 per cent of the overall weight (Chart 3.6).

Chart 3.6: Producer Price Inflation



Source: Statistics Mauritius.

Chart 3.5: Import Price Index and Imported Inflation



Source: Statistics Mauritius.

3.4 Inflation Expectations

The Bank's Inflation Expectations Surveys carried out between August 2012 and August 2013 indicate that the proportion of respondents perceiving inflation to be low initially increased from 18.8 per cent in August 2012 to 22.9 per cent in February 2013 before falling to 17.4 per cent in August 2013 (Chart 3.7). Concurrently, the proportion of respondents who believed that prices had gone up during the past 12 months rose from 64.6 per cent to 69.6 per cent. Some 10.9 per cent of respondents viewed inflation to have remained unchanged over the past 12 months.

In most of the surveys, "external factors", followed by "changes in aggregate demand" were seen as the two most important reasons for inflation. In August 2013, "changes in the exchange rate" superseded "changes in aggregate demand" as the second most important factor behind inflation.

The results of the surveys showed that the majority of respondents (around 84 per cent on average) expected inflation to go up over the next 12 months. In the August 2013 survey, respondents expected the mean inflation rate to reach 4.1 per cent by December 2013 before rising to 4.5 per cent by June 2014 and to 4.7 per cent a year ahead (Chart 3.8).

Chart 3.7: Perception of Inflation

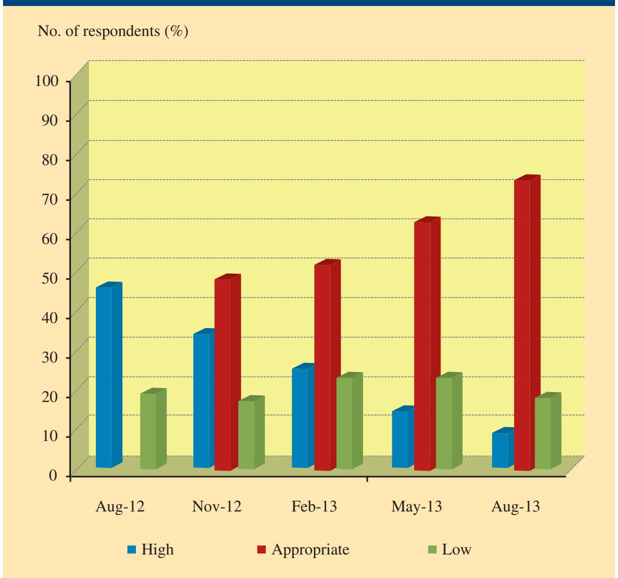
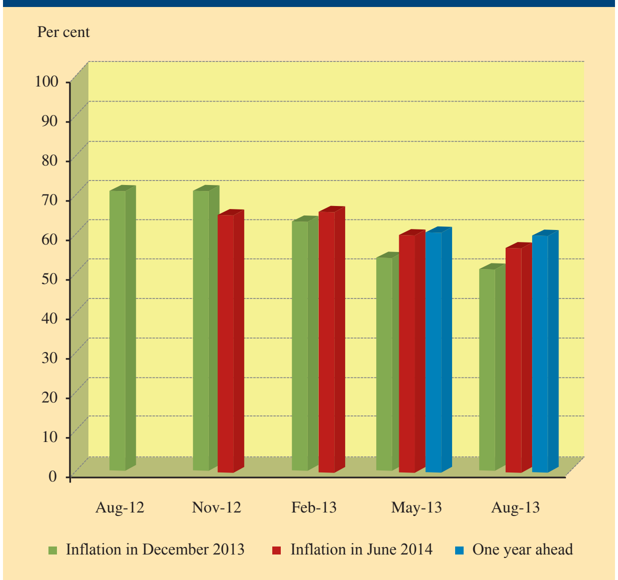


Chart 3.8: Mean Inflation Expectation



Box II
Quantifying results from the Inflation Expectations Surveys

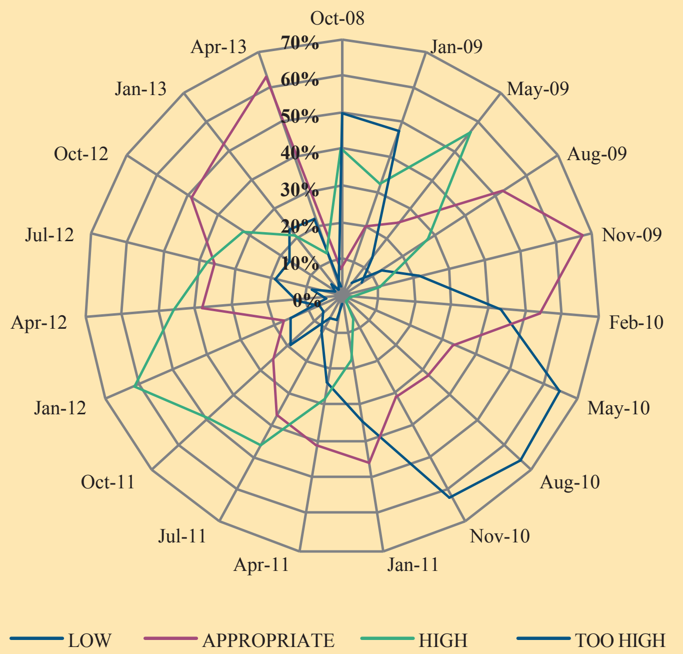
The Inflation Expectations Survey, which the Bank has conducted on a quarterly basis since October 2008, gathers the opinion of 50 stakeholders from the financial and real sectors on inflation trends within the economy. Using the qualitative data collected from the 20 surveys conducted so far, this Box computes a perception index and an opinion coefficient that merge the views of all respondents into single indicators to obtain a better gauge of stakeholders' sentiment.

I. The Perception Index

The Inflation Expectations survey, among others, asks respondents how they have perceived inflation during the twelve-month period ending in the month of the survey. Respondents have the choice between "low", "appropriate", "high" and "too high".

Figure 1 shows the evolution of respondents' perception of inflation over the 20 surveys. In October 2008, with inflation nearly reaching double-digit, 50 per cent of respondents deemed the rate "too high". Thereafter, and up to November 2010, as inflation took a declining trend, the majority of respondents' perception of inflation moved, in turn, to "high", "appropriate" and "low". Lately, with inflation rather contained, the majority of respondents have perceived inflation as "appropriate".

Figure 1: Respondents' Perception of Inflation



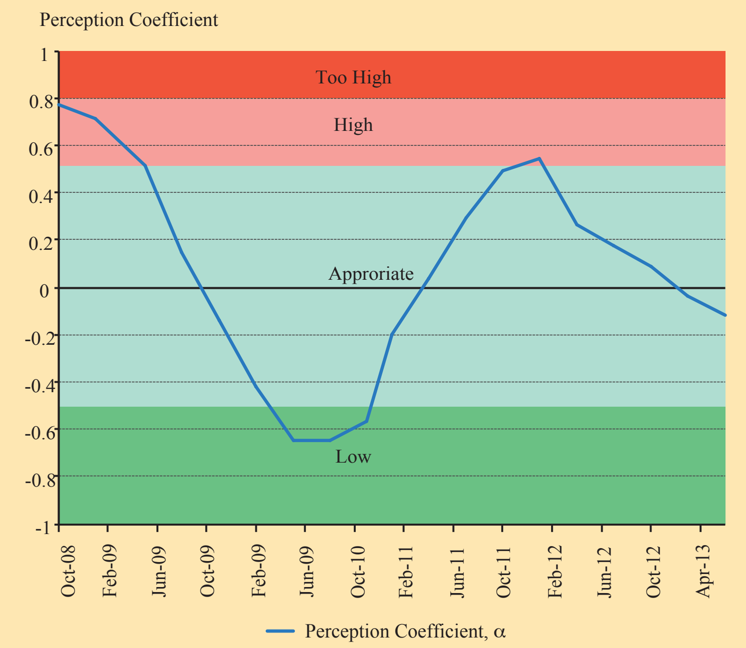
To obtain a better gauge of stakeholders' sentiment on inflation, it is necessary to combine all respondents' answers into a single indicator. A perception index is thus computed by summing up respondents' weighted responses :

$$\alpha = \sum (\text{Perception } \% * \text{Weight})$$

where α is the perception index, which can vary between -1 and +1.

Considering the data available, boundaries have been defined to indicate respondents' perception about the inflation rate. Figure 2, which displays the perception index, shows that since late 2011, stakeholders have considered the levels of inflation as 'appropriate'.

Figure 2: The Perception Index



II. The Opinion Coefficient

The survey also asks stakeholders for their opinion on price movements during the preceding 12 months and their expectations for the forthcoming 12 months. Respondents have the choice among "up", "unchanged" and "down".

To combine all answers to these two questions into two distinct indicators similar to the perception index, respondents' answers are weighted and an opinion coefficient is then computed as the sum of the weighted responses .

[1] Respective weights of -1, 0, 0.75 and 1 are attributed to the 4 possible responses, that is, "low", "appropriate", "high", "too high".

[2] Respective weights of +1, 0 and -1 are allocated to the possible responses "up", "unchanged" and "down".

$$\beta\beta = \sum(\text{Opinion }\% * \text{Weight})$$

where β is the opinion coefficient, which can vary between -1 and +1.

The weights applied effectively show the net balance of responses, that is, how many more respondents think that prices were up or would go up. For example, if 50 per cent of respondents viewed that prices were up in the preceding 12 months and 30 per cent thought that prices were down, then there were 20 per cent (50-30=20) more respondents who thought that prices had gone up. A positive opinion coefficient or net balance implies that more respondents are seeing inflation moving up while a negative coefficient means that more respondents think that inflation has gone down. As its name indicates, the opinion coefficient or net balance data is opinion based and does not quantify actual changes in the headline inflation.

Figures 3.1 and 3.2 below show the opinion coefficients on inflation for the 12 months preceding each survey and for the forthcoming 12 months. Figure 3.1 also shows headline inflation and Figure 3.2 headline inflation 12 months forward. While the percentage of respondents who thought that inflation had gone up during the past year did not change much over the recent surveys, there was an increasing proportion of respondents who believed that inflation would go up 12 months ahead.

Figure 3.1

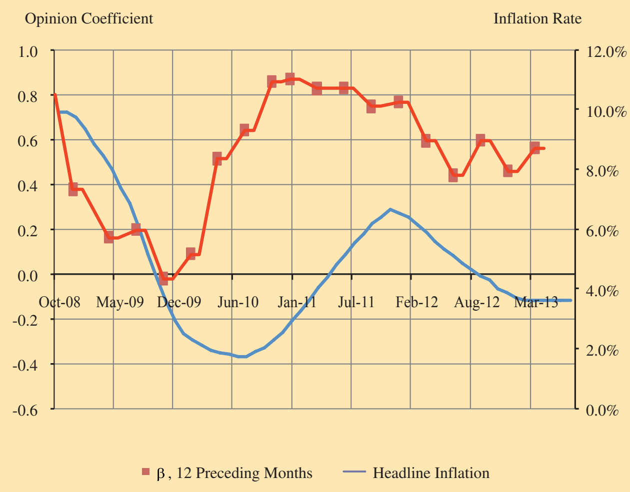
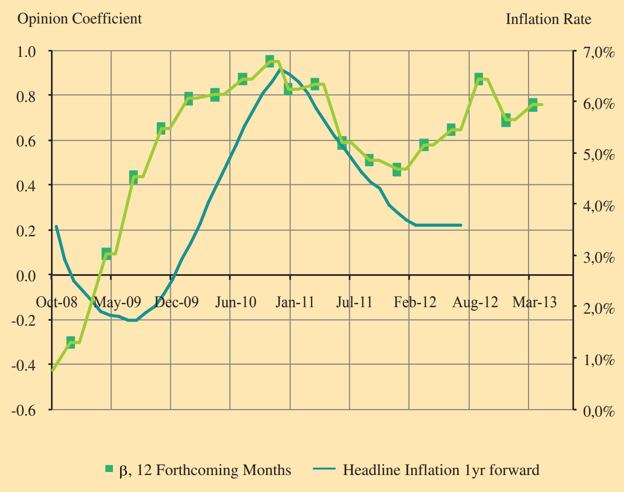


Figure 3.2



4. THE DOMESTIC ECONOMY

Latest data for 2013Q2 show that growth in the domestic economy remained constrained by weak economic developments in the main trading-partner countries. However, barring the negative performance of the construction sector, major sectors registered positive growth rates. Growth in exports as well as in final consumption expenditure continued to be subdued however. Investment contracted and declines were recorded in both private and public sector investment. Labour market conditions stayed relatively subdued, with the unemployment rate likely to remain at around current levels in the medium term. The outlook for growth remains broadly positive but it is forecast that the economy will continue to operate below trend in the medium term with downside risks to the already moderate growth outlook remaining real. Some potential for growth has nevertheless emerged in the medium term in the wake of the slightly improving outlook in the Eurozone.

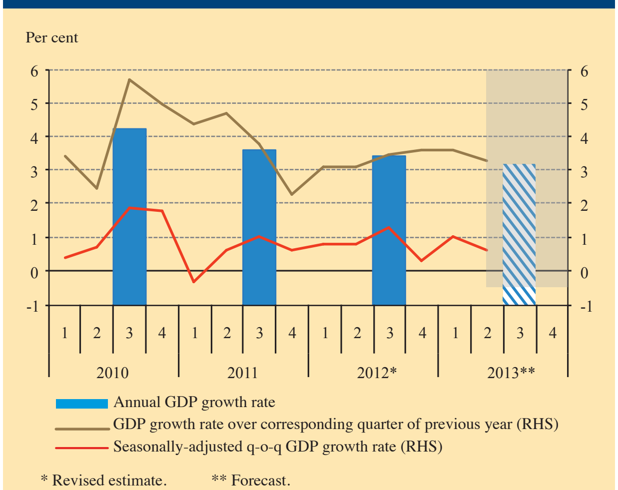
4.1 Economic Activity

The national accounts data released in September 2013 indicated that the momentum in the domestic economy remained subdued. On a seasonally adjusted q-o-q basis, the economy grew in real terms by 0.6 per cent in 2013Q2 compared with 1.0 per cent in 2013Q1. The annual rate of growth fell to 3.3 per cent, from 3.6 per cent in 2013Q1 (Chart 4.1).

Excluding the construction sector's negative performance, growth was broad-based across major sectors, which made positive contributions to y-o-y GDP growth in 2013Q2 (Chart 4.2). 'Manufacturing' expanded by 3.0 per cent, at a somewhat slower pace than in 2013Q1. It was supported by growth of 11.5 per cent in 'other manufacturing'. The 'sugar' and 'textile' sub-sectors grew by 2.3 per cent and 0.7 per cent, respectively, while 'food' contracted by 2.9 per cent. For 2013, growth in 'manufacturing' is estimated to pick up to 2.7 per cent compared to 2.2 per cent in 2012. The sector has benefited from the diversification strategies which have been undertaken to increase the shares of the Southern African and US markets to offset persistent weakness in the Eurozone. Other factors that have helped the sector have been the decreasing trend of price competitiveness in China as a result of rising labour costs as well as a restructuring of internal operations. Looking ahead, risks to diversification remain real particularly from a greater-than-expected slowdown in the Southern African market that could be further affected by tapering of monetary stimulus in the US. Moreover, developments in the Eurozone, which is still the major export market, could have a major bearing on domestic 'manufacturing', particularly in textiles.

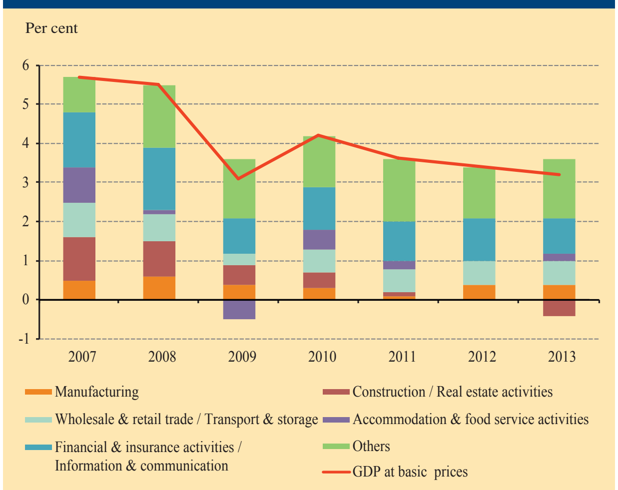
Prospects for emerging sectors, like 'seafood' and 'ICT', appeared to be relatively sustained. With

Chart 4.1: Real GDP Growth Rate



Source: Statistics Mauritius.

Chart 4.2: Contribution of Selected Sectors to GDP Growth



Source: Statistics Mauritius.

various projects underway to expand the range and breadth of activity over the longer-term, growth in the 'seafood' sector is forecast at 6.5 per cent in 2013. In the 'ICT' sector, growth of 7.9 per cent is expected in 2013. This sector is developing new areas of operations such as mobile applications, outsourcing of accounting services and legal procedures, and exploiting niche markets in higher value added services.

Partly reflecting muted tourist arrivals, growth in 'accommodation and food service activities' went up by 0.3 per cent in 2013Q2 compared with 1.5 per cent in 2013Q1. While tourist arrivals increased by 1.0 per cent y-o-y during 2013H1, latest data, especially for August 2013, tended to show a pick-up in momentum. Over the period January to August 2013, tourist arrivals grew by 2.2 per cent compared with the corresponding period of 2012. Arrivals from Europe declined by 2.9 per cent but these were compensated by significant growth of 28.5 per cent in arrivals from Asian countries, including a substantial increase of 93.9 per cent in arrivals from China. The establishment of new direct flights to this country seemed to have had an immediate positive impact on arrivals. Moreover, arrivals from the UK have been consistently rising of late, suggesting a possible turnaround in this market in line with the revival of economic activity there. Arrivals from India appeared relatively unaffected by the depreciation of the Indian rupee over the recent months but the risk remains that this factor might act as a constraint to growth further ahead.

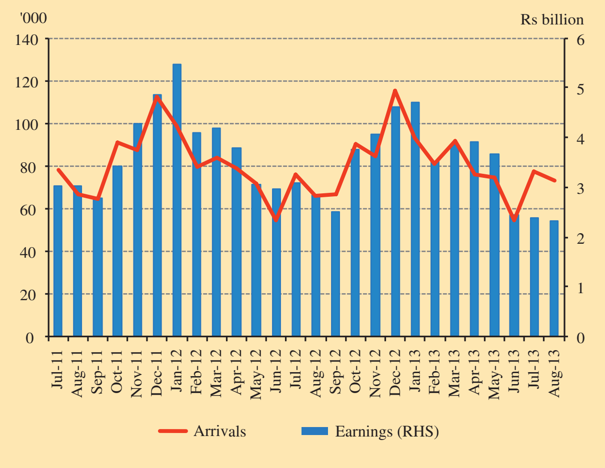
Tourist earnings dropped by 9.1 per cent y-o-y to reach Rs26,760 million over the period January to August 2013 (Chart 4.3). Accounting for exchange rate effects, tourist earnings were near the lows recorded in 2009. The drop in tourist earnings even as arrivals grew slightly underlines the vulnerability of the tourism sector, which continues to be buffeted by financial woes in traditional European markets.

Whilst market diversification coupled with intense marketing campaigns in emerging countries has helped to maintain arrivals at fairly similar levels as in the previous year, it is not occurring fast enough to provide the necessary impetus for a full-fledged recovery of the sector. This has led to a reduction in profits and losses for several hotel groups.

Meanwhile, the attractiveness of Mauritius for traditional tourist markets is ebbing amid increased competition from other countries and in the region itself. Countries in the region performed better than Mauritius in 2013H1 compared with 2012H1, with an increase in tourist arrivals of 17.8 per cent in the Maldives, 14.3 per cent in the Seychelles and 13.1 per cent in Sri Lanka (Table 4.1). Since 2009, tourist arrivals in Mauritius have increased by much less than in those countries.

There are increasing concerns that the challenges faced by the industry have become structural problems that might persist beyond the recovery in main markets. In particular, the growing imbalance between room supply and demand as well as air access limitations that contribute to relatively high travel costs is constraining the industry. According to recent reports conducted by specialised travel and hotel booking websites, Mauritius is ranked as the second most expensive destination for the French and the third most expensive destination for the British. According to the Travel and Tourism Competitiveness Index released by the World Economic Forum, Mauritius is ranked 58th, with moderate rankings in terms of environmental sustainability, air transport infrastructure and price competitiveness, among others.

Chart 4.3: Tourist Arrivals and Earnings



Sources: Statistics Mauritius and Bank of Mauritius .

Statistics Mauritius forecast total tourist arrivals of 990,000 for 2013, with gross tourism receipts projected at around Rs45.1 billion. This represents an increase of 2.5 per cent in tourist arrivals in 2013 compared with 2012 and a growth of 1.6 per cent in tourism receipts. Given the constraining factors in tourism, Statistics Mauritius forecasts growth of 2.5 per cent in 'accommodation and food service activities' in 2013.

'Construction' registered a fourth consecutive quarter of negative growth in 2013Q2, contracting by 3.0 per cent after a decline of 2.1 per cent in 2013Q1. For 2013 as a whole, the sector is forecast to register a deeper contraction of 9.4 per cent, mainly as a result of the completion of major projects such as the airport extension project coupled with delays in some major private construction works. The value added by 'construction' to economic growth is expected to decline to 5.5 per cent in 2013, from 7.1 per cent in 2009.

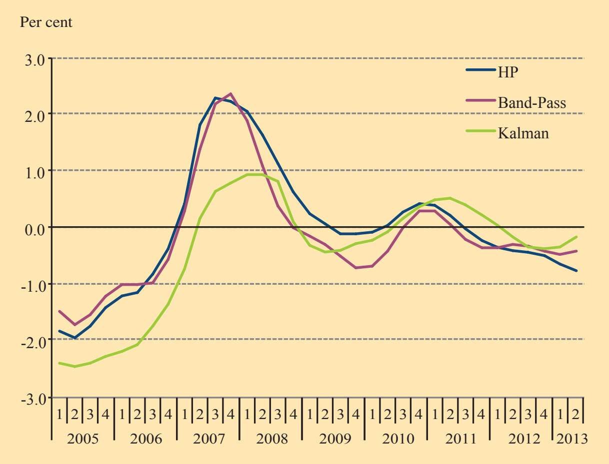
In a number of other sectors, growth was positive, albeit lower in 2013Q2 compared with the previous quarter. 'Information & communication', 'real estate activities' and 'wholesale & retail trade' grew by 6.8 per cent, 2.9 per cent and 3.3 per cent, respectively, compared with 7.1 per cent, 3.0 per cent and 3.4 per cent, respectively, in 2013Q1. 'Financial & insurance activities' registered growth of 5.2 per cent in 2013Q2, same as in the previous quarter. 'Transportation & storage' recorded higher growth of 2.2 per cent compared with 1.2 per cent in 2013Q1.

Growth in 'export-oriented enterprises' registered a decline of 5.1 per cent in 2013Q2 compared with a drop of 2.4 per cent in 2013Q1.

For 2013, Statistics Mauritius has revised down its forecast of economic growth to 3.2 per cent, down from a previous estimate of 3.3 per cent made in June 2013. The lower estimated performance compared with growth of 3.4 per cent in 2012 is mostly the result of lower growth expected in the 'information and communication', 'financial and insurance activities' and 'wholesale and retail trade' sectors as well as a deeper contraction in 'construction'.

Taking into account the latest national accounts data, it is assessed that the output gap remained slightly negative up to 2013Q2 (Chart 4.4). The economy is as such estimated to be operating below trend, with some degree of spare capacity. It is expected that sub-par growth will continue in the near to medium-term.

Chart 4.4: Domestic Output Gap



Source: Statistics Mauritius.

Table 4.1: Tourist Arrivals for Mauritius, Maldives, Sri Lanka and Seychelles

	Mauritius	Y-o-y % Change	Maldives	Y-o-y % Change	Sri Lanka	Y-o-y % Change	Seychelles	Y-o-y % Change
First half of								
2009	413,504		318,723		187,729		74,779	
2010	439,150	6.2	382,632	20.1	278,652	48.4	84,866	13.5
2011	464,604	5.8	447,967	17.1	381,538	36.9	91,960	8.4
2012	467,153	0.5	458,068	2.3	452,867	18.7	98,413	7.0
2013	471,664	1.0	539,667	17.8	512,281	13.1	112,509	14.3

Source: Statistics Mauritius; Maldives Statistics Section - Ministry of Tourism Arts & Culture; Seychelles National Bureau of Statistics; Sri Lanka Tourism Development Authority.

4.2 Domestic Demand

In 2013Q2, domestic demand was the major contributor to y-o-y output growth while external demand made a negative contribution (Chart 4.5).

4.2.1 Consumption

Household consumption expenditure has consistently driven domestic demand, and therefore output growth, though its expansion has moderated after the 2008 crisis (Chart 4.6). In 2013Q2, household consumption expenditure grew by 2.7 per cent compared with 2.8 per cent in 2013Q1. It is forecast that it will expand by 2.7 per cent in 2013, as in 2012. Government consumption expenditure turned negative in 2013Q2, declining by 0.2 per cent as against growth of 3.1 per cent in 2013Q1. It is projected to fall to 1.7 per cent in 2013 compared with 3.0 per cent in 2012.

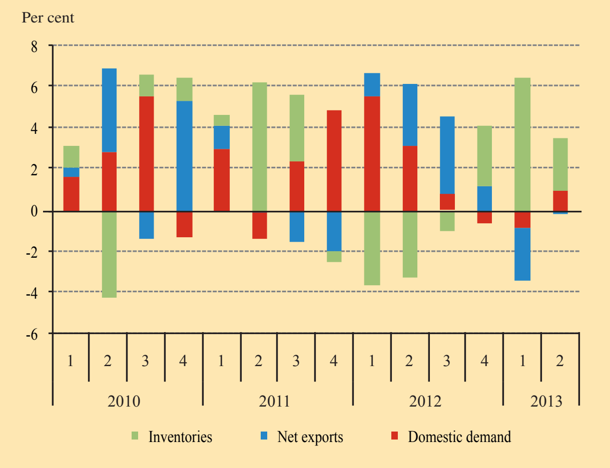
Final consumption expenditure moderated to 2.2 per cent in 2013Q2, from 2.9 per cent in 2013Q1, mainly as a result of the contraction in general government expenditure. These data continue to reflect weak conditions in the economy and fragile consumer confidence. While the public sector pay award and the recent cost of living compensations are likely to support consumption, the relatively high unemployment rate may curtail any significant improvement in consumption expenditure. Statistics Mauritius has forecast that final consumption expenditure will grow by 2.6 per cent in 2013 compared with 2.8 per cent in 2012.

4.2.2 Investment Expenditure

Gross Domestic Fixed Capital Formation (GDFCF) declined for the fourth consecutive quarter in 2013Q2. The pace of contraction was nonetheless lower at 3.5 per cent compared with 13.3 per cent in 2013Q1. By type of capital goods, the fall in GDFCF was driven by contractions in both 'building and construction work' and 'machinery and equipment'. 'Building and construction work' fell to 4.2 per cent compared with 4.4 per cent in 2013Q1, mainly following declines of 26.4 per cent in 'other construction work' and 6.1 per cent in 'non-residential building', which were partly offset by growth of 12.1 per cent in 'residential building'.

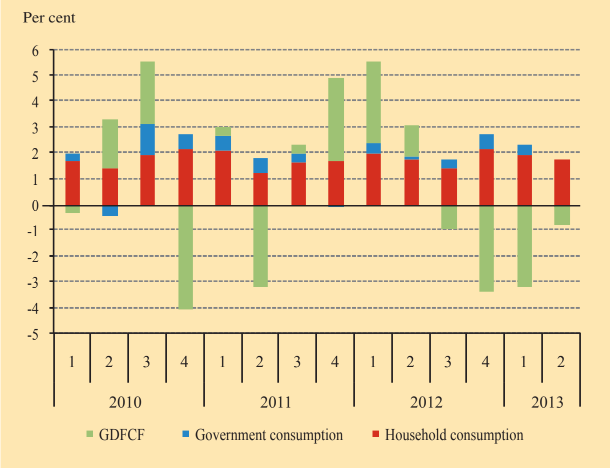
'Machinery and equipment' contracted at a significantly slower pace of 2.0 per cent in 2013Q2, compared with a decline of 28.1 per cent in 2013Q1. This was made possible by positive growth of 2.8 per cent in 'other machinery and equipment' whereas it had declined by 32.3 per cent in the preceding quarter and a lower decline of 16.7 per cent in 'other transport equipment'. In contrast, investment in 'passenger cars' recorded a higher contraction of 14.6 per cent in 2013Q2 (Chart 4.7).

Chart 4.5: Contribution of Domestic and External Demand to Growth



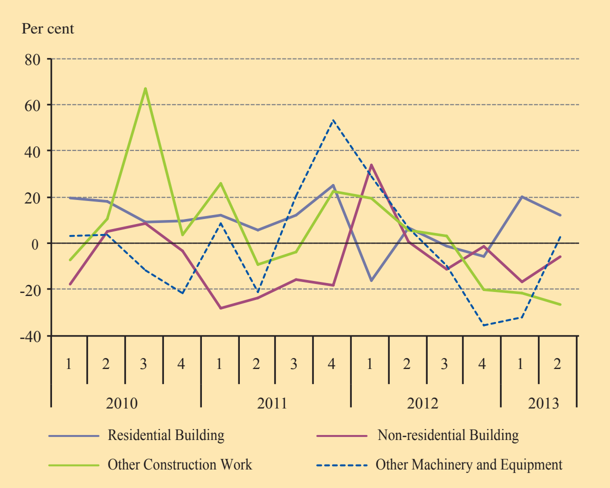
Source: Statistics Mauritius.

Chart 4.6: Contribution of Consumption and Investment to Growth



Source: Statistics Mauritius.

Chart 4.7: Growth Rates of GDFCF by Main Components



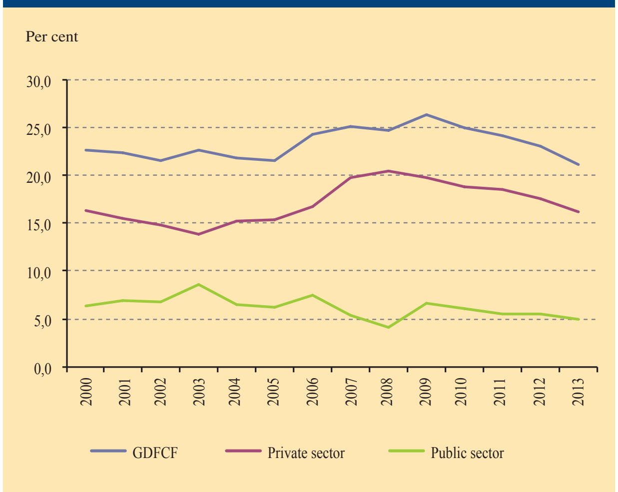
Source: Statistics Mauritius.

The persistently low levels of investment substantially contributed to the sluggish momentum in domestic demand. In 2013, GDFCF is forecast to contract by 3.1 per cent after a decline of 0.8 per cent in 2012. Excluding 'aircraft and marine vessel', GDFCF is forecast to contract by a higher rate of 5.7 per cent in 2013 maintaining its declining trend as a percentage of GDP at market prices (Chart 4.8)

The projected fall in GDFCF in 2013 can largely be attributed to a decrease of 2.8 per cent in private investment, following a decline of 1.9 per cent in 2012 as major projects were completed. As a ratio to GDP, private investment has declined steadily from around 20 per cent in 2007 to a projected 16 per cent in 2013. The continuing slowdown in the Eurozone and other trading-partner countries impacted negatively on the balance sheets of firms in key sectors of the economy, weighing on their capacity to increase capital expenditure. At the same time, some firms have become over leveraged partly as a result of the low interest rate environment. It is noted that in terms of industrial use, a much larger proportion of GDFCF was directed to the 'real estate activities' sector. In 2013, this share was estimated at 33.1 per cent compared with 8.8 per cent invested in the 'accommodation and food service activities' sector.

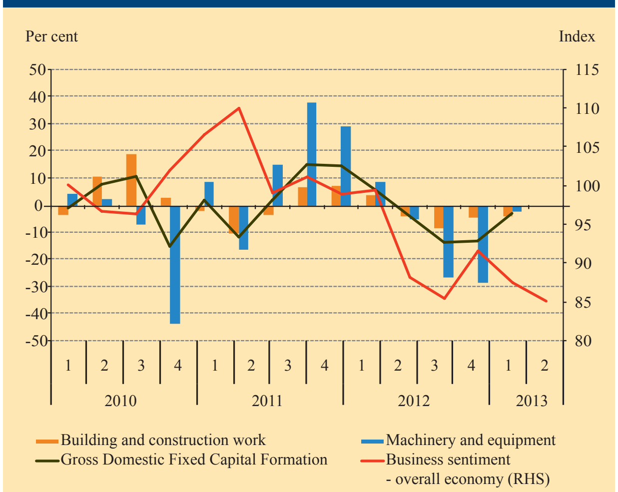
Business confidence remained muted. The latest Mauritius Chamber of Commerce and Industry (MCCI) business confidence survey carried out in September 2013 indicated that business confidence dropped by 2.4 points to 85.1 in 2013Q3, following a decline of 4.1 points in 2013Q2 (Chart 4.9). The main factors that had a negative impact on business performance during 2013Q3 were instability in the global environment and fierce competition in the local market. Whilst this could imply lower private investment in the near term, the survey showed that 12 per cent of respondents were planning to increase their investment level over the next twelve months while 9 per cent claimed that they would reduce investments further.

Chart 4.8: Public and Private Sector Investment as a share of GDP



Source: Statistics Mauritius.

Chart 4.9: Gross Domestic Fixed Capital Formation and Business Sentiment Index



Source: Statistics Mauritius.

Against the backdrop of falling private investment, public investment has also been contracting. In 2013, it was expected to record a negative growth rate of 4.1 per cent, as against an expansion of 2.9 per cent in 2012. This would mainly be attributable to the completion of major projects such as the airport extension and delays, or postponements, in the implementation of new projects.

After first rising in 2009 in the wake of the fiscal stimulus package, the trend of the rate of public investment has been downward to stand at around 5 per cent in 2013. The contraction in public investment in recent years has thus reinforced the decline in total investment in the economy, contributing to the slowdown in real GDP growth. Looking ahead, a pro-cyclical fiscal policy that focusses on the need to meet statutory debt targets as well as implementation delays may lead to sustained cutbacks in public investment. While public sector debt increased by 6.0 per cent at the end of June 2013, it was up only slightly by 0.5 percentage point to 58.1 per cent of GDP at market prices.

4.3 External Demand

The contribution of the net exports of goods and services to GDP growth has remained in negative territory for the first two quarters of 2013, indicating sustained vulnerabilities to adverse conditions in main export markets. Box III provides an indicator of external demand.

Box III
An Indicator of External Demand

To better assess the changes in external demand, this Box shows the computation of an external demand indicator. The indicator is constructed by weighting the real GDP growth of the countries that make up at least 70 per cent of Mauritian goods exports. The index is calculated as follows:

$$Y_t^* = \sum_{i=1}^{n} S_{i,t\text{-}1} \; Y_{i,t}^*$$

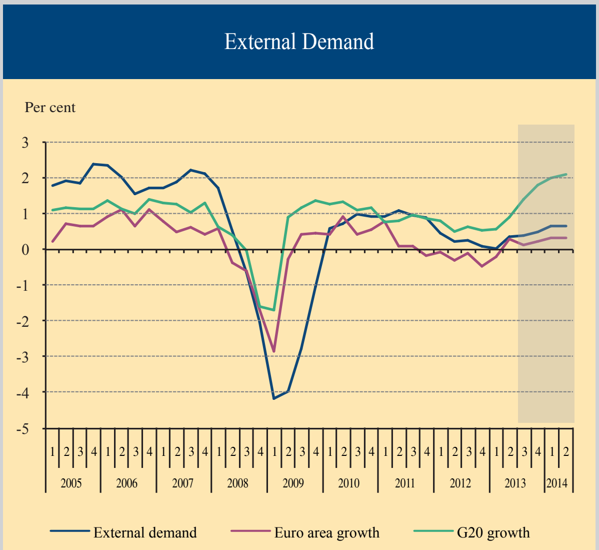
Where,

Y_t^* , is the annual rate of growth of foreign demand in quarter t

$Y_{i,t}^*$, is the annual rate of growth of the importing country i in quarter t

$S_{i,t\text{-}1}$, is the share of country i in exports in the previous quarter

The starting period for the analysis is 2004Q1. Growth rates for the countries included in the calculation of the index are computed as the q-o-q percentage change in real GDP for any quarter. Weights attributed to each country vary by quarter, depending on their import share. The computation of the indicator includes France, Italy, Spain, Belgium, UK, South Africa and the US as the major importing countries. The chart below illustrates the evolution of the external demand indicator over time.

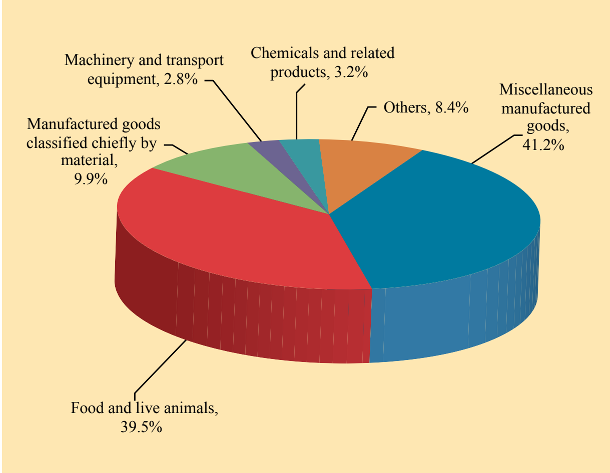


The external demand indicator includes both actual and forecast GDP growth rates up to 2014H1. For comparison, it is plotted against actual and projected euro area growth rate. Looking specifically at main trading partners, the computed indicator shows that foreign demand for domestic exports is likely to outpace euro area growth over the forecasting horizon mainly because the euro area is expected to recover at a very modest pace. However, the foreign demand for domestic exports is likely to fall behind G20 growth due to the higher weight of our exports to countries of the euro area.

4.3.1 Exports

In nominal terms, the total exports of goods, excluding ship's stores and bunkers, rose by 4.4 per cent to Rs34.0 billion in 2013H1. 'Food and live animals' exports, which went up by 17.7 per cent following significant growth in the exports of 'cane sugar' and 'fish and fish preparations', contributed to the increase in total exports. Exports were also influenced by an upswing of 9.9 per cent in 'manufactured goods classified chiefly by material' exports, whilst exports of 'machinery and transport equipment' and 'miscellaneous manufactured goods' fell by 12.0 per cent and 6.1 per cent, respectively (Chart 4.10). The rise in exports partly reflected some of the benefits of a weaker export-weighted nominal rupee effective exchange rate.

Chart 4.11: Exports by Main Commodities

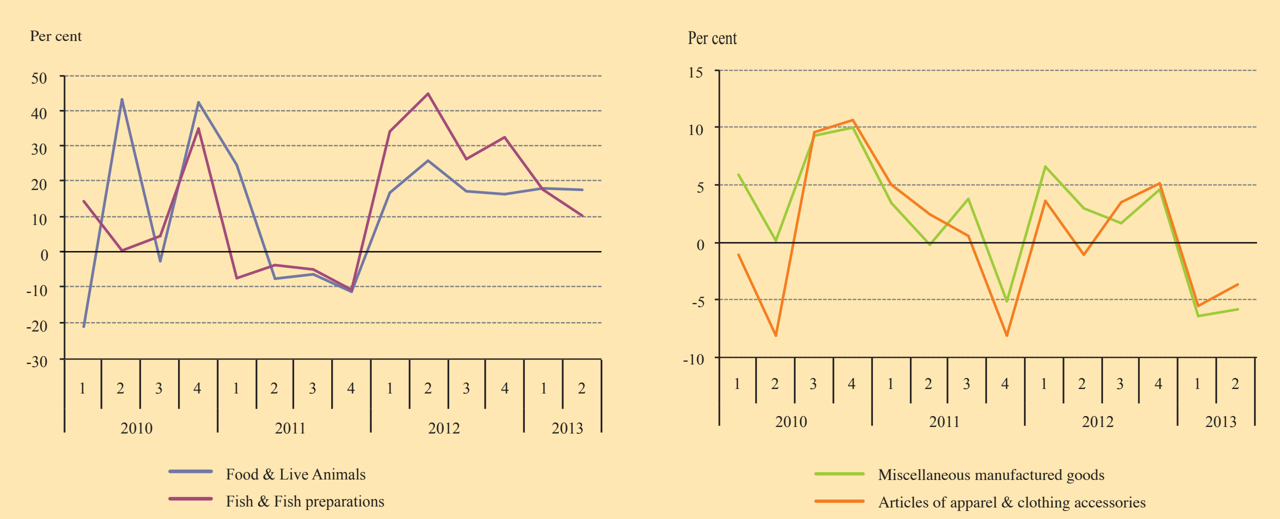


Source: Statistics Mauritius.

Exports of 'fish and fish preparations' grew by 13.6 per cent in 2013H1. Increases in prices led to a rise in export value, though there were delays in production, which reduced the actual export volume from 53,631 tonnes to 47,475 tonnes. The decline in the exports of 'articles of apparel and clothing accessories', which drove the fall in 'miscellaneous manufactured goods' exports, reflected the continued pressures faced by the textile sector as conditions in its main markets remained tight. Despite this, 'miscellaneous manufactured goods' still accounted for the major proportion of goods exports (41.2 per cent) in 2013H1, followed by 'food and live animals' (39.5 per cent) (Chart 4.11).

Europe remained the main export market, with its share in exports of goods increasing slightly to 60.6 per cent in 2013H1 compared with 60.1 per cent in 2012H1. While the share of exports to the UK, France and Spain, declined to 18.4 per cent, 13.0 per cent and 6.1 per cent, respectively, the share of exports to Italy increased to 10.8 per cent. Export shares to the US and South Africa went down to 10.1 per cent and 8.3 per cent, respectively.

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

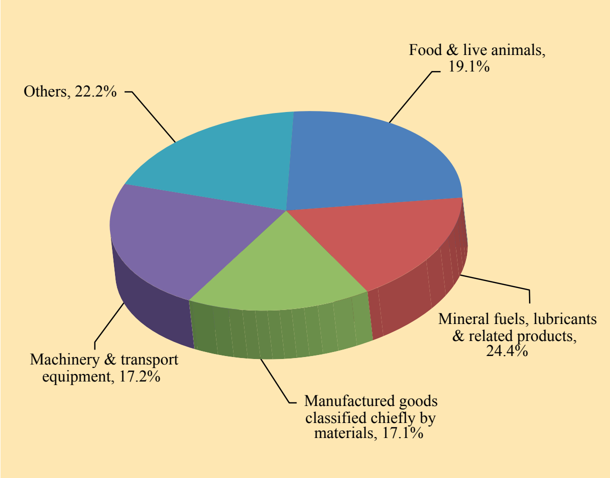


4.3.2 Imports

Imports of goods c.i.f. went down by 1.8 per cent y-o-y to reach Rs75.9 billion in 2013H1. This mainly reflected a decline of 22.4 per cent in 'machinery and transport equipment' whereas increases of 6.7 per cent, 2.4 per cent and 0.9 per cent were noted in 'food and live animals', 'mineral fuels, lubricants and related products' and 'manufactured goods classified chiefly by material', respectively (Chart 4.12).

In 2013H1, 'mineral fuels, lubricants and related products' represented the bulk of imports (24.4 per cent) followed by 'food and live animals' (19.1 per cent) (Chart 4.13). The Asian continent remained the major source of total imports with a share of 55.9 per cent. Within Asia, the share of imports from India increased to 26.4 per cent but the proportion of Chinese imports fell to 14.0 per cent. The share of imports from France also dropped to 7.9 per cent, while import shares from South Africa and Spain went up to 6.5 per cent and 4.2 per cent, respectively.

Chart 4.13: Imports by Main Commodities



Source: Statistics Mauritius.

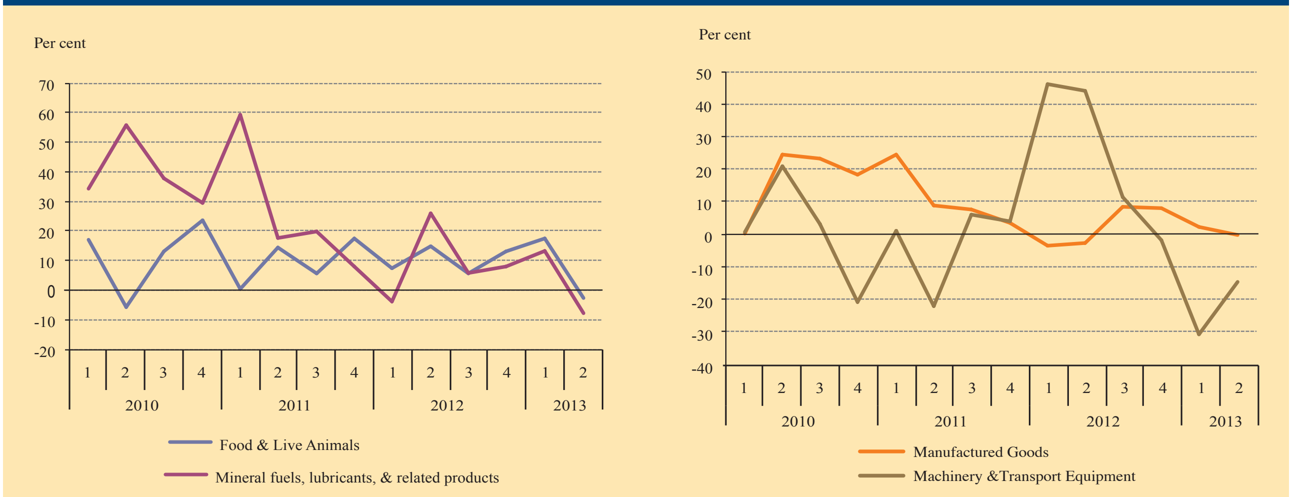
4.4 Balance of Payments Developments

The country's external sector imbalances persisted through 2013H1. As a percentage of GDP at market prices, the current account deficit remained at a persistently high level of 8.3 per cent reinforcing concerns about its sustainability. The country's overall balance of payments for the first two quarters of 2013, as measured by the change in reserve assets excluding valuation change, recorded a surplus of Rs15.7 billion.

The current account deficit widened to Rs14.3 billion in 2013H1, from Rs12.9 billion recorded in the corresponding period of 2012. The deterioration was largely due to a worsening trade balance, which was to some extent offset by the combined surpluses in services and current transfers. The trade balance in the first six months of 2013 fell by 14.6 per cent y-o-y to Rs30.2 billion.

During 2013H1, an improvement in the merchandise trade deficit was noted as it moderated by 14.6 per cent y-o-y, reaching Rs30.2 billion. The trade gap

Chart 4.12: Y-o-Y Growth in Imports by Selected Commodity Groups



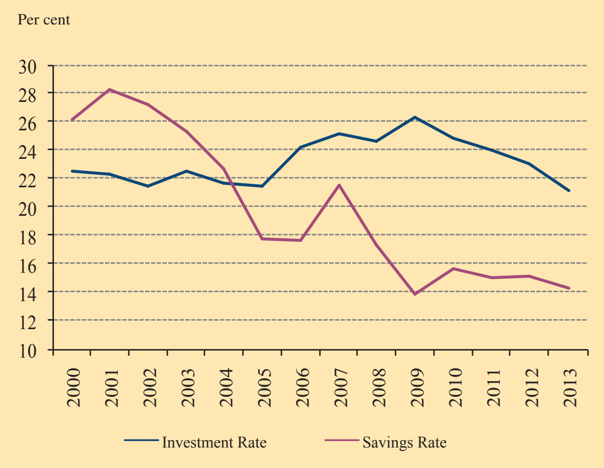
Sources: Statistics Mauritius

narrowed, with exports picking up, while imports of goods, *f.o.b* fell by 2.5 per cent. The services account registered a surplus of Rs12.8 billion in 2013H1, representing a y-o-y fall of 24.9 per cent, from Rs17.1 billion. Net travel receipts registered a fall of 14.1 per cent in 2013H1 to reach Rs15.8 billion, while inbound tourism registered a marginal rise of 1.0 per cent.

The income account, inclusive of GBC1 transactions, posted a surplus of Rs2.3 billion in 2013H1 compared with Rs3.2 billion in the same period the previous year. The lower surplus was largely attributed to a fall in net inflows of direct investment income and other investment income which more than offset the fall in net outflows from other portfolio income. The current transfers account posted a lower surplus of Rs0.7 billion in 2013H1 compared with 2012H1 mainly on account of lower private net inflows.

Reflecting the difference between domestic savings and investment, the current account deficit over the recent years can be explained by the significant fall in national savings from over 25 per cent of GDP in the early 2000s. For 2013, Statistics Mauritius has revised down the projected savings rate to 14.2 per cent from an earlier projection of 14.8 per cent, compared with 15.1 per cent in 2012 (Chart 4.14).

Chart 4.14: Investment and Savings Rates

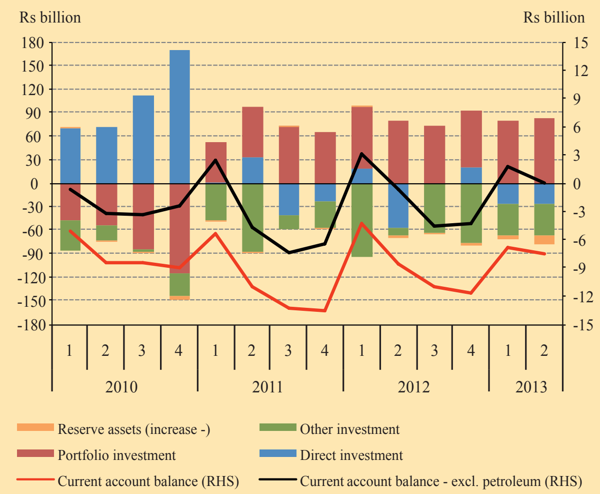


Source: Statistics Mauritius.

4.4.1 Capital and Financial Account

The capital and financial flows which were lower in 2013H1 relative to the corresponding period in 2012 remained adequate to finance the current account deficit. Inclusive of cross-border transactions of GBC1s, the capital and financial account posted a surplus of Rs13.2 billion in 2013H1 (Chart 4.15).

Chart 4.15: Financing of the Current Account Deficit



Direct investment, inclusive of cross-border transactions of GBC1s, posted net outflows of Rs53.0 billion in 2013H1 compared with Rs37.9 billion recorded in the corresponding period of the previous year. Excluding the cross-border transactions of GBC1s, foreign direct investment in Mauritius, net of repatriation, reached Rs3.9 billion in 2013H1 compared with Rs3.4 billion in the corresponding period of 2012. Residents' direct investment abroad, excluding cross-border transactions of GBC1s, increased to Rs1.7 billion in 2013H1 compared with Rs1.3 billion registered in the corresponding period of 2012.

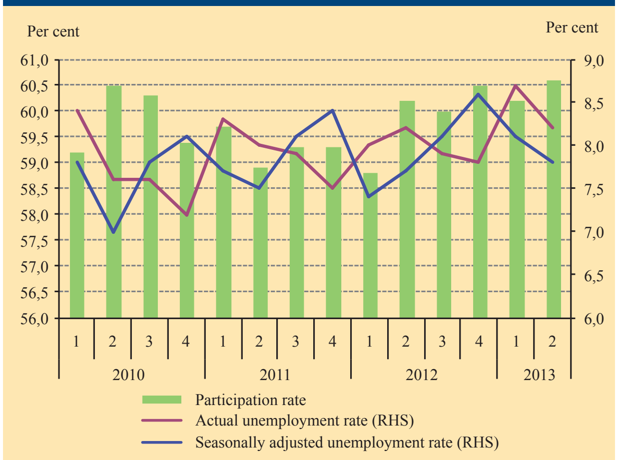
Portfolio investment, inclusive of GBC1s, recorded higher net inflows of Rs163.1 billion for the first six months of 2013 compared with Rs160.1 billion a year earlier. Excluding the cross-border transactions of GBC1s, portfolio investment posted higher net inflows of Rs4.0 billion compared with Rs3.3 billion in the previous corresponding period. Substantial repatriation of residents' portfolio assets from abroad largely drove the overall expansion in the net portfolio inflows. On the liabilities side, non-residents carried out net purchases of Rs0.8 billion on the Stock Exchange of Mauritius, including the Development Enterprise Market, in 2013H1 as against net sales of Rs0.1 billion in the same period of 2012.

Other investment, inclusive of GBC1s' cross-border transactions, posted lower net outflows of Rs81.2 billion during 2013H1, down from the net outflows of Rs105.1 billion in the corresponding period of 2012. The smaller deficit was largely attributable to banks' higher fall in foreign assets relative to their drawdown in foreign liabilities.

4.5 Labour Market Developments

The unemployment rate stood at 8.2 per cent in 2013Q2, down from 8.7 per cent in 2013Q1 but unchanged from 2012Q2. On a seasonally-adjusted basis, the unemployment rate was 7.8 per cent in 2013Q2, down from 8.1 per cent in 2013Q1 but slightly up from 7.7 per cent in 2012Q2 (Chart 4.16).

Chart 4.16: Unemployment Rate and Participation Rate

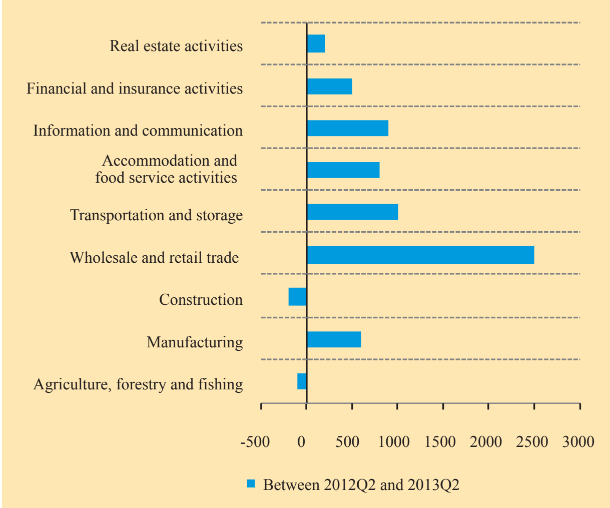


Source: Statistics Mauritius.

Gender imbalances continued to prevail in the labour market in 2013Q2, with the female unemployment rate (13.3 per cent) outpacing the male unemployment rate (4.9 per cent). However, while the male unemployment rate has remained almost unchanged since 2005, the female unemployment rate has declined. Further, among the 49,700 unemployed, 42 per cent were below the age of 25 years. Within the unemployed, 35.5 per cent had not obtained the 'School Certificate', while 20.3 per cent had reached tertiary level.

Over the year to 2013Q2, 9,700 jobs were created in the domestic economy. Among the main sectors, the highest number of jobs was created in 'wholesale and retail trade' (+2,500) followed by 'transportation and storage' (+1,000), 'information and communication' (+900), 'accommodation and food service activities' (+800), 'manufacturing' (+600) and 'financial and insurance activities' (+500) (Chart 4.17).

Chart 4.17: Change in Employment by Main Sectors



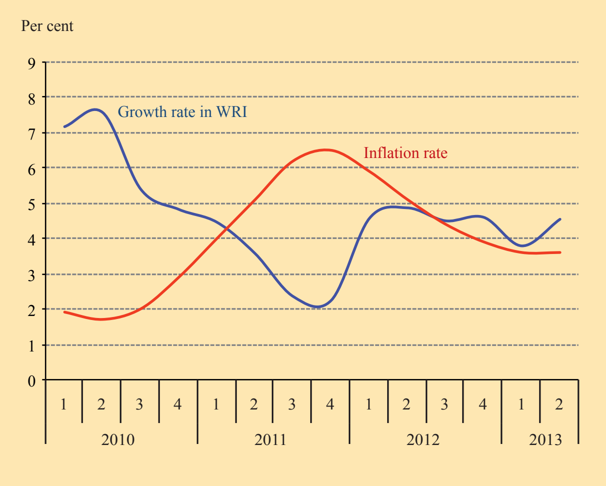
Source: Statistics Mauritius.

The labour market outlook has remained mostly unchanged since the last Inflation Report. The domestic economy is still characterised by labour market rigidities, namely the structural mismatch between available jobs and skills of the labour force. The unemployment rate is likely to remain at around current levels in the short to medium term as firms continue to be cautious of expanding capacity and employing more people in the present challenging economic environment. Additional cost pressures from higher transport prices coupled with potential demand for higher wages and actual wage compensations for the cost of living may also play a role in keeping employment down. The September 2013 MCCI business confidence survey showed that 11 per cent of entrepreneurs were planning to recruit in the coming months while 13 per cent were contemplating to lay off workers. Statistics Mauritius projects that the unemployment rate will increase to 8.3 per cent in 2013, from 8.1 per cent in 2012.

Wage Rate Index

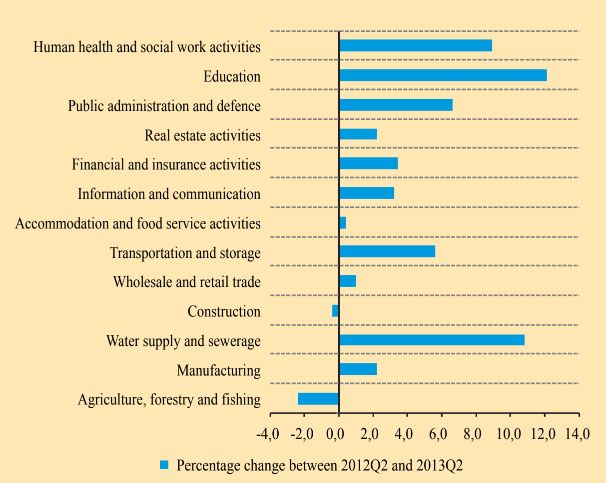
The Wage Rate Index (WRI) increased by 4.5 per cent y-o-y to reach 108.1 in 2013Q2. The increase in the WRI was higher than the y-o-y inflation rate of 3.6 per cent during the same period (Chart 4.18). The highest wage increases were recorded in 'education' (12.1 per cent), 'water supply, sewerage, waste management and remediation activities' (10.8 per cent), 'human health and social work activities' (8.9 per cent) and 'public administration and defence; compulsory social security' (6.6 per cent). Main decreases in wages were noted in 'agriculture, forestry and fishing' (-2.4 per cent) and 'construction' (-0.4 per cent) (Chart 4.19). On a q-o-q basis, the WRI rose by 1.2 per cent in 2013Q2.

Chart 4.18: Growth in Wage Rate Index and Inflation Rate



Source: Statistics Mauritius.

Chart 4.19: Change in Wage Rate Index



Source: Statistics Mauritius.

Productivity and Compensation

Wage developments in excess of inflation and productivity gains continued to pose the main upside risk to inflation in the medium term. Latest available data on productivity and compensation show that labour productivity grew at a lower rate of 1.6 per cent in 2012 compared with the 3.2 per cent recorded in 2011 while average compensation went up by 4.8 per cent relative to 7.6 per cent in 2011. The drop in productivity in 2012 was the result of a lower GDP growth of 3.4 per cent, coupled with a growth of 1.6 per cent in labour input. Unit labour cost increased by 3.1 per cent in 2012 compared with 4.3 per cent in 2011. In 2012, capital productivity declined by 0.9 per cent compared with a drop of 1.3 per cent in 2011. Multifactor productivity stagnated in 2012 compared with a marginal growth of 0.3 per cent in 2011. Both labour and capital productivity in export-oriented enterprises went up by lower rates of 4.3 per cent and 9.7 per cent, respectively, in 2012 compared with 2011 while unit labour cost increased by a higher rate of 1.7 per cent (Chart 4.20).

Chart 4.20: Average Compensation of Employees, Labour Productivity and Unit Labour Cost

Source: Statistics Mauritius.

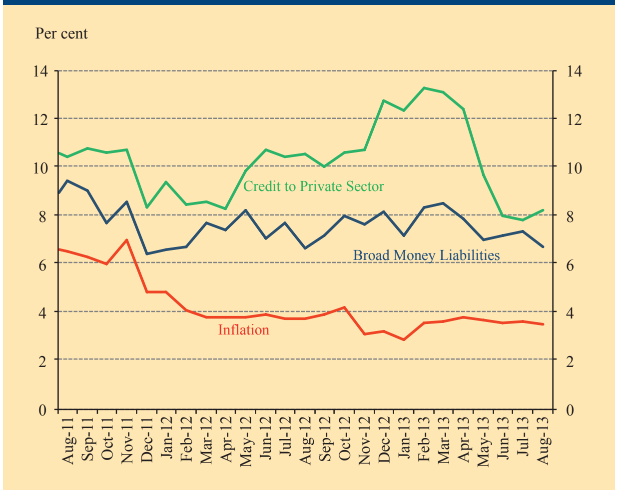
5. MONETARY AND FINANCIAL DEVELOPMENTS

Both monetary and credit developments have remained subdued since the April 2013 Inflation Report, reflecting continuing weak economic activity. Credit was largely channelled to the construction, personal and financial and business services sectors. While overall excess liquidity in the money market was higher, interbank interest rates and yields on Government securities increased. Transactions on the domestic foreign exchange market remained active. On a weighted average dealt basis, the rupee depreciated against the US dollar, euro and Pound sterling.

5.1 Monetary and Credit Developments

Reflecting continuing weak economic activity, monetary and credit developments have remained subdued since the April 2013 Inflation Report and have exerted mild pressures on inflation. Since late 2011, y-o-y growth in Broad Money Liabilities (BML) has moved within a narrow range. It stood at 6.7 per cent in August 2013 and when adjusted for inflation, was at 3.6 per cent (Chart 5.1).

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



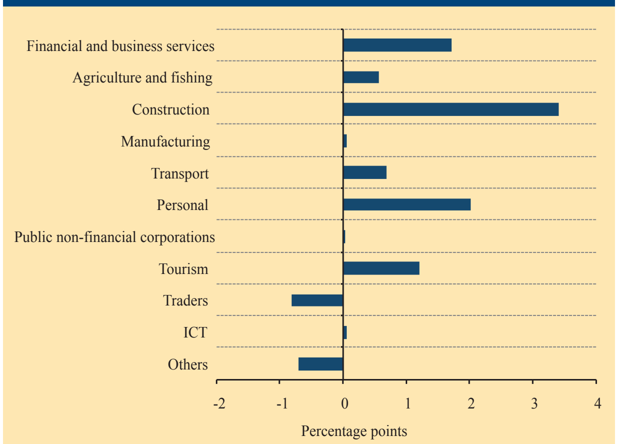
Among the components of BML, quasi-money liabilities grew by 5.5 per cent y-o-y, down from 8.3 per cent in February 2013, as savings and time deposits expanded by 13.1 per cent and 0.2 per cent, respectively, and foreign currency deposits fell by 1.9 per cent. Narrow money liabilities grew by 8.3 per cent, as a result of higher growth in transferable deposits. Securities other than shares increased by 126.6 per cent, up from 17.8 per cent in February 2013.

The net foreign assets of depository corporations increased by 11.2 per cent y-o-y, mainly as a result of an increase of 14.3 per cent in the net foreign assets of the Bank of Mauritius. The latter can be partly explained by the implementation of the Operation Reserves Reconstitution (ORR) programme as from June 2012.

The monetary base increased by 11.4 per cent y-o-y in August 2013, while the reserve deposits held by ODCs at the Bank increased by 10.6 per cent. The positive growth in the monetary base was mainly due to contributions of the Bank's net foreign assets and domestic claims.

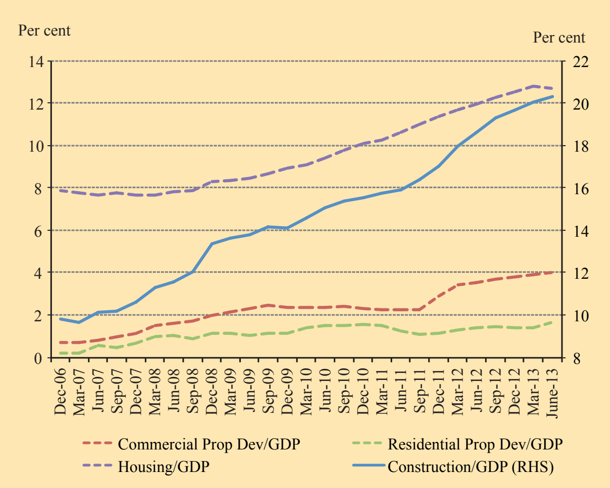
Credit to the private sector increased by 8.2 per cent y-o-y in August 2013 compared with 13.3 per cent in February 2013. The growth in banks' credit to the private sector over the year was mostly channelled to the construction sector (3.4 percentage points), followed by the 'personal' (2.0 percentage points) and 'financial and business services' (1.7 percentage point) sectors. Credit to 'traders' contributed negatively to total credit growth (Chart 5.2).

Chart 5.2: Sectoral Contribution to the Change in Banks' Credit to the Private Sector – end-August 2012 to end-August 2013



The increase in credit to the 'construction' sector and to 'residential housing' was sustained. As a percentage of GDP, the share of credit extended to 'construction' reached 20.3 per cent in June 2013 while the share of credit to 'housing' stood at around 12 per cent. There was a notable increase in credit extended to 'commercial and property development' as a percentage of GDP over the period under review (Chart 5.3). It is estimated that these increases may have had a significant impact on property prices. They have also increased vulnerabilities in the banking system by raising firms' indebtedness which, going forward, may constrain investment and growth. The Bank has recently issued guidelines on the implementation of a number of macro-prudential measures to deal with those issues.

Chart 5.3: Credit to the Construction Sector as a percentage of GDP as at June 2013

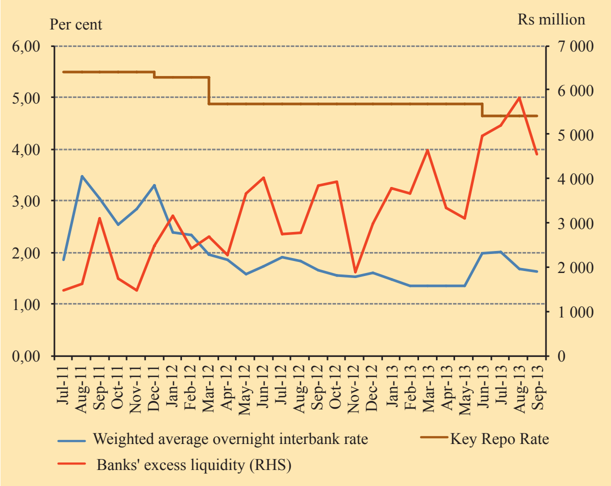


5.2 Money Market

Since the publication of the last Inflation Report to August 2013, the overall excess liquidity in the banking system has increased to an average of Rs4.5 billion. Net redemption of Government securities, higher Government expenditure, the placement of public funds with banks and net intervention by the Bank on the domestic foreign exchange market contributed to the overall excess liquidity in the money market. The Bank issued its own instruments to the value of Rs10.5 billion to mop up some of the excess liquidity during the same period.

With banks allowed to keep part of their cash reserve requirements in foreign currency, a decrease in rupee balances held at the Bank of Mauritius resulted in a rise in overnight interbank interest rates to above 2 per cent in July 2013, notwithstanding the reduction in the KRR in June 2013. Thereafter, the weighted average interbank rates fell to an average of 1.64 per cent in September 2013 (Chart 5.4).

Chart 5.4: Banks' Monthly Average Excess Reserves, Weighted Average Overnight Interbank Rate and Key Repo Rate



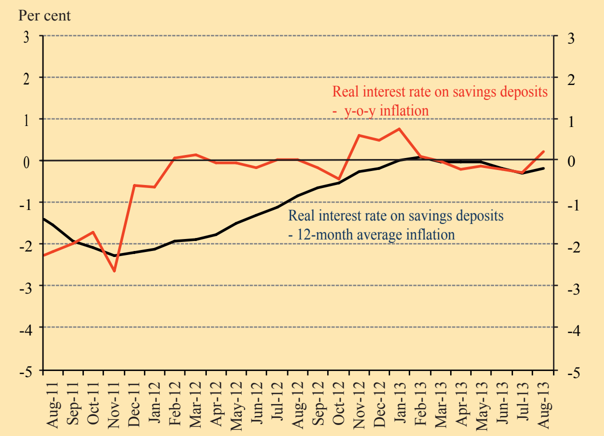
For the same reasons, the overall weighted yield on Government of Mauritius Treasury Bills increased from 2.67 per cent in February 2013 to 2.73 per cent in September 2013. The weighted yield on Three-Year Government of Mauritius Treasury Notes, however, declined from 4.06 per cent in February 2013 to 3.88 per cent in September 2013.

Yields on longer-term instruments have fallen since the April 2013 Inflation Report. The weighted yield on Five-Year Bonds declined from 4.34 per cent at the end of February 2013 to 4.28 per cent at the end of September 2013. The weighted yield on Ten-Year Government of Mauritius Bonds decreased from 7.06 per cent to 6.22 per cent over the same period. While the weighted bid margin on the Fifteen-Year Inflation Indexed Bond stood at 2.39 per cent at the end of September 2013.

5.3 Deposit and Lending Rates

Following the 25 basis point reduction in the KRR in June 2013, banks have revised their Savings Deposits Rate (SDR) downward by the same quantum. They have also eased financing conditions by adjusting their Prime Lending Rates (PLR) accordingly. The SDR fell to within a range of 2.75-3.40 per cent at the end of August 2013, from 3.00–3.65 per cent, and the PLR decreased from 7.00-8.50 per cent to 6.75-8.50 per cent. The banks' modal SDR and modal PLR also came down by 25 basis points to 3.40 per cent and 7.15 per cent, respectively. The weighted average deposits rate stood in a range of 3.21-3.47 per cent while the weighted average lending rate stood in a range of 8.18-8.42 per cent (Chart 5.5). Using the y-o-y measure of inflation, which dropped substantially in August 2013, a marginal increase in the real interest rate on savings deposits, from 0.1 per cent in February 2013 to 0.2 per cent in August 2013, was observed. However, based on headline inflation, the real interest rate on savings deposits continued to be negative.

Chart 5.5: Real Interest Rate on Savings Deposits



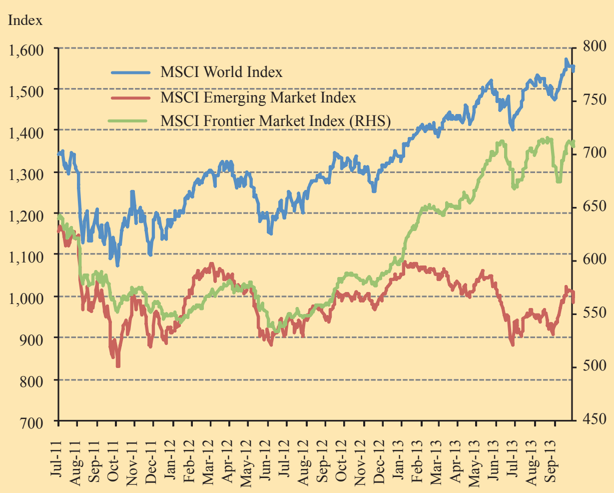
5.4 Stock Market

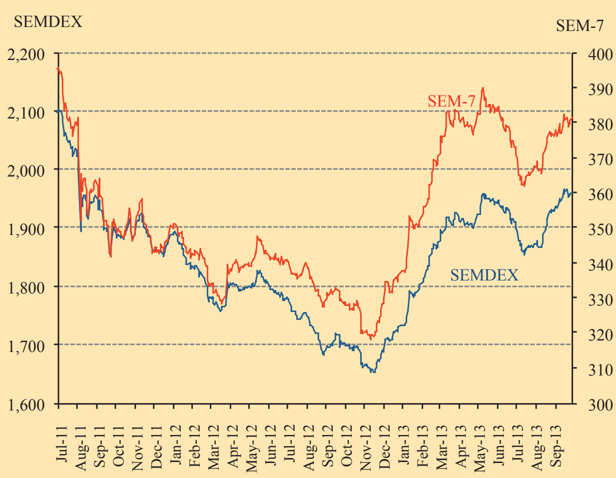
Since the April 2013 Inflation Report, the local stock market drifted lower for some time, reflecting to some extent the evolution of emerging market indices but managed to recoup some of its losses in 2013Q3 on better investor sentiment. Recent inflation rates do not appear to have had any major impact on stock market returns. During the period under review, the SEMDEX and the SEM-7 have increased by 5.1 per cent and 3.6 per cent, respectively, with total market capitalisation as a ratio to GDP at 54 per cent at the end of September 2013 (Chart 5.6).

The market price-earnings (PE) ratio increased from 12.23 at the end of February 2013 to 13.51 at the end of September 2013, mainly driven by an increase in the PE ratio of the "Leisure and Hotel", "Industry" and "Property Development" segments, while the PE ratio of the "Investment" segment dropped.

Foreign investors' exposure to the Official and DEM markets in terms of net investment (purchases-sales) as at 30 September 2013 amounted to Rs747 million since the beginning of the year. Net investment was largely driven by net inflows in the "banking" and "hotel" sectors.

Chart 5.6: Stock Market Indices



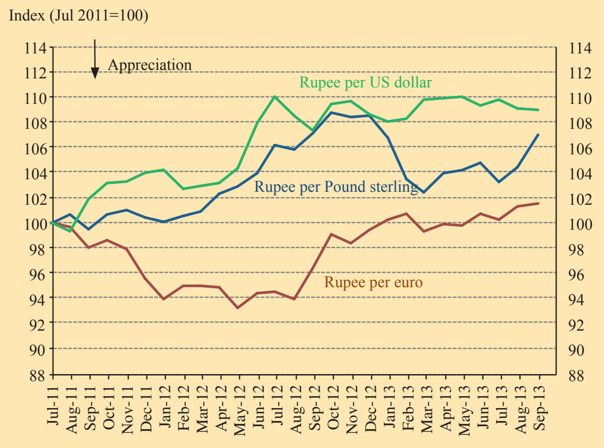


5.5 The Domestic Foreign Exchange Market

Between the April 2013 publication of the Inflation Report and August 2013, the total turnover of spot and forward transactions amounted to US$3,082 million, representing a daily average of US$29.1 million. The daily average transaction on the interbank foreign exchange market amounted to US$5.0 million. The Bank maintained its ORR program and purchased an aggregate amount of US$32.0 million and EUR178.8 million from banks and foreign exchange dealers. The demand and supply conditions on the domestic market as well as developments on international currency market influenced the weighted average dealt rupee exchange rate.

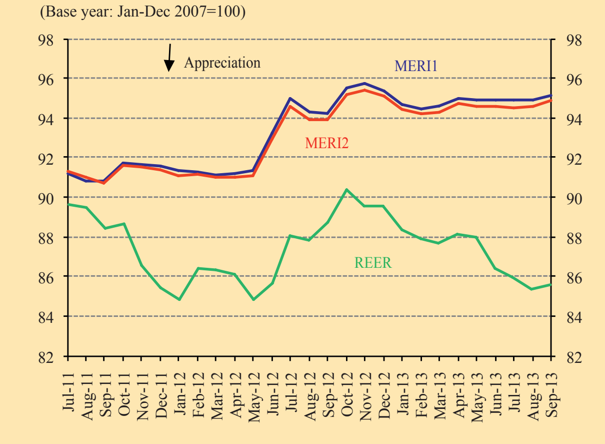
The rupee initially depreciated against the US dollar as the latter gained on the FED's announcement that it might scale back its monetary stimulus programme. Subsequently, the rupee recouped its losses as a result of the greenback's broad-based weakness on international markets. The rupee continued on a broad depreciating trend against the euro over the period under review on the back of positive economic data releases in the Eurozone. Against the Pound sterling, the rupee started to appreciate after the April 2013 Inflation Report but thereafter lost ground with the gains in the GBP as the UK economy showed signs of recovery (Chart 5.7).

Chart 5.7: Rupee Exchange Rate Movements



The nominal effective rupee exchange rate, as measured by MERI1 which is based on the currency distribution of trade, remained mostly stable since the April 2013 Inflation Report although a slight depreciation was registered in September 2013. Weighed by trading-partner countries, the real effective rupee exchange rates appreciated quite substantially during the period under review, mainly on account of a depreciation of the South African rand and the Indian rupee against the Mauritian rupee (Chart 5.8).

Chart 5.8: MERI1, MERI2 and REER



6. MONETARY POLICY DECISIONS

Since the April 2013 Inflation Report, the MPC has eased its monetary policy stance by cutting the Key Repo Rate by 25 basis points to 4.65 per cent per annum at the MPC meeting held on 17 June 2013. At the September 2013 meeting, the Key Repo Rate was left unchanged at 4.65 per cent per annum as a majority on the Committee viewed that downside risks to growth in the domestic economy remained important.

At its meeting on 17 June 2013, the MPC noted that global economic conditions had remained weak and uneven since the March 2013 MPC meeting. While the US economy had continued to recover slowly, activity in the UK had remained lacklustre and output in the euro area had fallen for the sixth consecutive quarter in 2013Q1, with France back in recession. Growth had slowed in a number of emerging economies as a result of persistent external headwinds.

The domestic economy continued to be vulnerable to the subdued external environment. Economic performance had been below trend, with slow growth recorded in major export sectors despite diversification efforts, while a significant contraction was noted in the construction sector. Given the generally softer conditions in main trading-partner countries and downside risks to the economic outlook, the Bank's growth forecast for 2013 had been revised downward to a range of 3.2-3.7 per cent as against a range of 3.4-3.9 per cent forecast at the previous MPC meeting.

The MPC noted that the global inflation outlook had been benign as a result of significant economic slack and slower growth in commodity prices. On the domestic side, inflation indicators had remained broadly unchanged since the March 2013 MPC meeting. However, upside risks to the inflation outlook arising mainly from the public sector wage award and possible spillovers to private sector wages remained significant. On a no-policy change basis, y-o-y inflation was forecast within a range of 5.3-5.8 per cent by December 2013, equivalent to headline inflation of 4.1-4.3 per cent. In the light of the continuing weak economic conditions, the Committee voted with a majority of 5-3 to cut the KRR by 25 basis points to 4.65 per cent per annum.

At their meeting on 30 September 2013, the MPC noted that the global economy had improved slightly. Growth was expected to remain moderate in the US although the outlook remained clouded by the fiscal deadlock. The UK was picking up some momentum and the euro area and Japan had returned to positive growth. However, in several major emerging economies, including China and India, growth had slowed and looked unlikely to return to previous highs.

In September 2013, Statistics Mauritius revised its growth forecast downward for the year from 3.3-3.2 per cent. The Bank also revised its forecast downward from a range of 3.2-3.7 per cent to 3.1-3.5 per cent.

The MPC noted that global inflation had continued to be broadly benign and below target inflation rates in developed economies although some emerging economies had recorded an increase in inflation as a result of their depreciating currencies. Domestic inflation had declined sharply to 3.1 per cent in August 2013 after hovering around 3.6 per cent since February 2013, helped by stable food and fuel prices. Wage developments in excess of inflation and productivity gains remained the main upside risk to inflation in the medium term.

A majority on the Committee believed that the risks to growth outweighed the upside risks to inflation. Some members, however, were of the view that it was time to start normalizing interest rates to address the vulnerabilities facing the Mauritian economy and offer attractive rates of interest to savers.

The Committee voted with a majority of 5 to 3 to keep the KRR unchanged at 4.65 per cent per annum (Table 6.1).

Table 6.1: 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
17 June 2013	Cut of 25 basis points	4.65	Majority of 5-3
30 September 2013	Unchanged	4.65	Majority of 5-3

7. GROWTH AND INFLATION OUTLOOK

7.1 Growth Projection

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

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

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

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

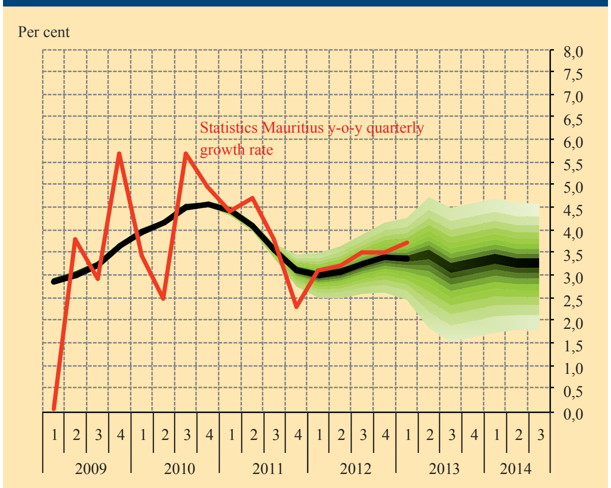
The uncertain economic outlook is also affecting consumer confidence, which combined with high debt levels and relatively high unemployment, is expected to contain household appetite for spending, especially in the low to middle-income groups. Households faced with a tight budget tend to spend on essential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

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

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

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

Chart 7.1: Y-o-Y Growth Forecast



7.2 Inflation Outlook

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

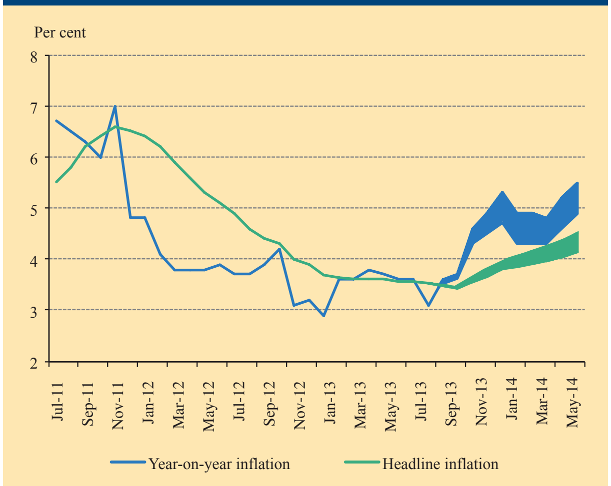
On the domestic front, the inflation rate has moderated amid a persistently negative output gap and a rise in the unemployment rate, which together contributed to some extent to subdued wage and domestic demand pressures. Looking ahead, however, wage developments in excess of inflation and productivity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

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

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

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

Chart 7.2: Inflation Forecast



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List of Acronyms

BoE	Bank of England
BoJ	Bank of Japan
BML	Broad Money Liabilities
CIF	Cost, Insurance and Freight
CPI	Consumer Price Index
DXY	Trade Weighted Dollar Index
ECB	European Central Bank
EMDE's	Emerging Market and Developing Economies
FAO	Food and Agriculture Organisation of the United Nations
FED	Federal Reserve Bank
FOB	Free on Board
FOMC	Federal Open Market Committee
GBC1s	Global Business Companies
GDFCF	Gross Domestic Fixed Capital Formation
GDP	Gross Domestic Product
GMTB	Government of Mauritius Treasury Bills
HP	Hodrick-Prescott
ICE	Intercontinental Exchange
IMF	International Monetary Fund
IPI	Import Price Index
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

List of Acronyms

ORR	Operation Reserves Reconstitution
PE	Price Earnings
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
SEMDEX	Stock Exchange of Mauritius Index
VIX	Volatility Index
WRI	Wage Rate Index

Glossary

Basis point is a unit equal to one hundredth of a percentage point.

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.

Dealt exchange rate is the weighted average rupee selling rate derived from transactions of US$30,000, and above, or equivalent.

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.

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.

MERI2 is the Mauritius Exchange Rate Index, a nominal effective exchange rate introduced in July 2008, based on the currency distribution of merchandise trade and tourist earnings.

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.

Q-o-Q calculates the change in a variable between one quarter and the previous quarter.

Quantitative Easing is a mechanism by which central banks increase the money supply by buying government securities or other securities from the market.

Recession is typically defined as a decline in GDP for two or more consecutive quarters.

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

SEMDEX is an index of prices of all listed shares on the Stock Exchange of Mauritius, with each stock weighted according to its share in the total market capitalisation.

SEM-7 is an index launched by the Stock Exchange of Mauritius on 31 March 1998. It comprises the seven largest eligible shares of the Official Market, measured in terms of average market capitalization, liquidity and investibility criteria.

Shorting refers to the practice of selling securities or other financial instruments that are not currently owned, with the intention of subsequently repurchasing them at a lower price.

Stocks-to-Use Ratio indicates the level of carryover stock for any given commodity as a percentage of the total demand or use.

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

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

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