A NEW FRAMEWORK FOR THE CONDUCT OF MONETARY POLICY BY THE BANK OF MAURITIUS

13 January 2022

The Bank is introducing its new Monetary Policy Framework (MPF) effective 16 January 2023.

The new framework is expected to address the deficiencies of the existing one and help to further strengthen monetary policy operations and the monetary policy transmission mechanism.

The existing framework lacked a clearly defined nominal anchor and needed to be aligned with best practices at other central banks so as to be able to address shifting economic and financial conditions. Successive rounds of economic setbacks, in particular, the COVID-19 pandemic, also prompted the Bank to take a fresh look at its repertoire of policy instruments and incorporate unconventional instruments as well to deal with emergency exceptional scenarios. Revamping the MPF had thus become timely.

New Monetary Policy Framework

The new MPF will continue to rely on the interest rate channel to steer economic variables and expectations, while focusing on a number of key operational and strategic elements, such as a well-defined and flexible inflation target; prominent role for inflation forecasts as intermediate targets; review of the operational target; greater clarity on the foreign exchange and money markets nexus; and appropriate institutional design for different aspects of the monetary policy decision-making process, as detailed below.

The Bank will be explicitly adopting an inflation target, providing a benchmark against which members of the public can gauge inflationary pressures and assess the Bank's success in keeping inflation under control. This will contribute towards the formation of inflation expectations and facilitate decision-making in financial markets, by providing a concrete indication as to the future direction of policy actions. The framework will also promote greater transparency on the monetary policy decision-making process, while adopting a forward-looking approach. Additionally, the framework will embed stronger communication about the stance of monetary policy and the operations undertaken by the Bank.

(i) **Flexible inflation target (ultimate target):** In addition to the explicit price stability commitment, the flexible inflation targeting regime allows the central bank to pursue other objectives, such as attempting to stabilise real economic conditions by promoting stable output and employment growth or limiting exchange rate volatility. The Bank will adopt an inflation target ranging between 2 to 5 per cent, with the aim of achieving the mid-point of 3.5 per cent over the medium-term.

(ii) **Inflation forecast (intermediate target):** The Bank will forecast inflation over the policy horizon using its medium-term policy model. The projections will serve as a basis for MPC policy deliberations to formulate monetary policy to achieve the inflation objective.

(iii) **Policy interest rate:** The MPC will continue using a key policy interest rate to signal its monetary policy stance. Monetary policy signals would be transmitted to the overnight interbank interest rate and through various channels to the real economy when market interest rates are adjusted in line with changes to the policy rate.

(iv) **Exchange rate:** The exchange rate of the rupee will continue to be subject to market forces under a floating exchange rate regime. The Bank will aim to smooth out excessive volatility of the rupee exchange rate.

(v) **Communication:** The Bank's communication will put emphasis on medium-term prospects for both inflation and growth.

New Operational Framework

A. Policy Rate

1. Under the new framework, the "Key Rate" will replace the Key Repo Rate as the policy rate used to signal the stance of monetary policy. The Monetary Policy Committee will continue to determine the level of the new policy rate, consistent with the inflation and growth outlook.

2. The level of the "Key Rate" will be set at the same level as the Key Repo Rate.

B. Operational Target

3. The overnight interbank rate will replace the yield on the 91-Day Bill as the operational target for monetary policy.

4. The Bank will undertake open market operations as required to steer the overnight interbank rate close to the "Key Rate".

C. Main Instrument of Monetary policy

5. The main instrument of monetary policy will be the 7-Day BoM Bill, which the Bank will issue every Friday. The 7-Day BoM Bill will be issued at a fixed-rate equal to the "Key Rate" and on full allotment basis.

6. This will ensure that the amount of liquidity remaining in the system is in line with the demand for reserve money by banks, thus helping to anchor short-term money market rates at around the "Key Rate".

D. Width of the Interest Rate Corridor and Standing Facilities

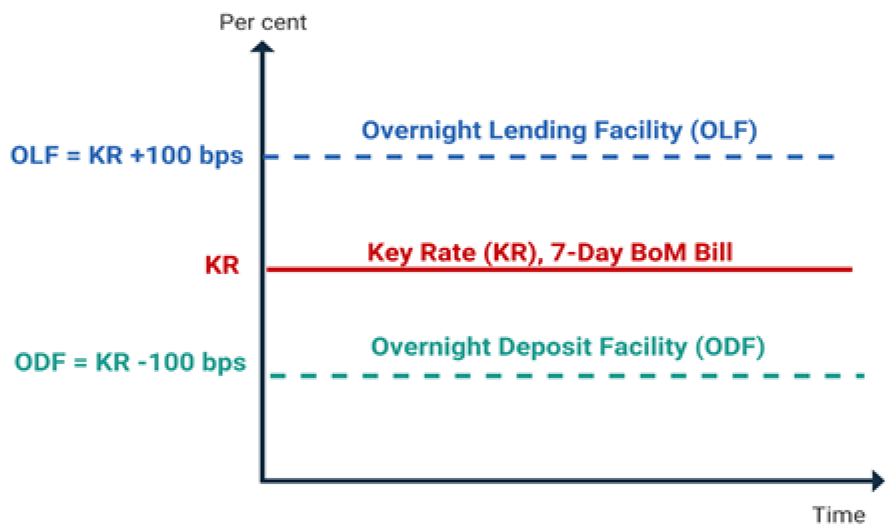
7. The Bank will maintain a symmetric interest rate corridor of 200 basis points around the "Key Rate" through standing facilities. Banks with excess liquidity or shortage of liquidity may use the standing facilities to clear their liquidity positions.

   (a) The corridor will be operated as follows:

      (i) an Overnight Lending Facility (OLF) will be made available to banks at their discretion at the "Key Rate" plus 100 basis points; and

      (ii) an Overnight Deposit Facility (ODF) will be offered to banks at their discretion at the "Key Rate" minus 100 basis points.

New Operational Framework



8. Collateral will be required from banks whenever they wish to avail of the Overnight Lending Facility. The type of collateral and applicable haircuts will be at the discretion of the Bank. The Bank will not provide any collateral for the Overnight Deposit Facility.

E. Fine-Tuning Operations

9. Fine-tuning operations may be conducted to either absorb liquidity from the market or inject liquidity into the market in between auction days.

10. The purpose of these operations will be to prevent significant and abrupt changes in the level of the overnight interbank rate in case of liquidity shocks.

11. Fine-tuning operations will be conducted at the "Key Rate" and on full allotment basis. They will be conducted overnight and will be at the discretion of the Bank.

F. Longer-Term Operations

12. Longer-term issues of BoM instruments will remain part of the monetary policy toolkit to remove structural liquidity and/or to support market development.

13. Auctions of longer-term BoM instruments will be conducted in pre-specified tender amounts at rates determined through competitive bidding. The auction dates will be at the Bank's discretion with the corresponding prospectus communicated one week prior to the auction.

14. The Bank may also conduct buybacks of BoM securities in case the liquidity in the system turns short. These buybacks will be carried out through competitive auctions.

G. Other Operations

15. The Bank will retain the use of other instruments, such as foreign currency swaps and bilateral operations, as part of its monetary policy toolkit. The Bank will retain discretion on the modus operandi, pricing, method of auction and timing of these operations.

H. Reserve Requirements

16. Effective 27 January 2023, the computation of the Cash Reserve Ratio (CRR) on both the rupee and foreign currency deposits will be lengthened from 14 to 28 days to enable banks to better manage their liquidity. The maintenance period will thus run from 27 January 2023 to 23 February 2023.

17. Banks will be required to maintain reserve balances at the Bank equivalent to 9.0 per cent of their average deposit liabilities held over the preceding 28-day period starting on 30 December 2022 and ending on 26 January 2023.

18. The daily requirements on both the rupee and foreign currency CRR, currently standing at 6.5 per cent and 4.5 per cent, respectively, will be discontinued with effect from maintenance period starting 27 January 2023.

19. Effective 27 January 2023, the foreign currency CRR will be increased from 6.0 per cent to 9.0 per cent.

20. The remuneration on the foreign currency CRR will be terminated as from 1 January 2023.

I. Eligible Counterparties

21. All banks, which are members of the Port Louis Automated Clearing House, will have access to the Bank's monetary operations.

22. The Guideline on the Operational Framework of Primary Dealers will, as from 16 January 2023, only apply to issuances of government securities.

J. The Standing Facility

23. The Standing Facility, which currently acts as the lender of last resort facility, will no longer be part of the new monetary policy framework.

Implications of the New Monetary Policy Framework

Under the new framework, the Bank will be removing excess liquidity from the system, mainly through the 7-Day BoM Bill issued at the "Key Rate". Banks will therefore be remunerated at a higher rate than has been the case under the current framework.

It is expected that banks will pass on this higher remuneration to their customers through a higher Savings Deposit Rate, which will benefit savers.

In parallel, the Prime Lending Rate (PLR) is also expected to be adjusted accordingly.

Going forward, the intention is to improve the transmission mechanism of monetary policy, anchor inflation expectations and enable the Bank gain more traction on inflation. Leaving inflation unaddressed can lead to highly volatile and destabilizing price pressures which may have severe long-term impact on the purchasing power of individuals, labour market and ultimately, economic growth.

The costs of not undertaking bold reforms now, through the introduction of the new monetary policy framework, may be more painful for the population in the long-term. The central bank, however, strives to act in the best interest of the population.

Bringing inflation under control in the medium-term is a priority for the Bank, in line with its price stability mandate. Price stability is necessary for a healthy economy and is beneficial for the public over time. The introduction of the new monetary policy framework will largely help attain this objective and its benefits will overwhelm the short-term pains associated with higher rates now.