BANK OF MAURITIUS

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Minutes of the 40th Monetary Policy Committee Meeting held on 20 July 2016

The 40th meeting of the Monetary Policy Committee (MPC) was held on Wednesday 20 July 2016 at 10:00 hours at the Bank of Mauritius and was chaired by Mr Rameswurlall Basant Roi G.C.S.K., Governor.

Members present: Mr Yandraduth Googoolye (First Deputy Governor); Mr Mahendra Vikramdass Punchoo (Second Deputy Governor); Mr Pierre Dinan, Mr Mohammad Mushtaq Namdarkhan, Dr Streevarsen Narrainen and Mr Guy Wong So (External Members).

Member absent with apologies: Mr Nishan Degnarain (External Member).

Summary of Staff Report on Economic and Financial Developments

The Bank's staff reported on economic and financial developments which took place since the 39th MPC meeting held on 17 February 2016.

Global economic and financial developments

1. **The MPC noted the revised 2016 and 2017 global economic projections, which showed that the global growth outlook remains anaemic and uneven.** Downside risks to growth remain elevated against the backdrop of sustained weakness in aggregate demand, sluggish investment, low commodity prices and financial market turbulences. The IMF's July 2016 World Economic Outlook Update downgraded global growth to 3.1 per cent for 2016 and to 3.4 per cent for 2017, 0.1 percentage point lower compared to the projections made in April 2016. The IMF highlighted the heightened uncertainty arising out of United Kingdom's decision to leave the European Union.

2. **Global inflation is expected to remain at low levels in 2016 and 2017**. According to IMF's latest projections, global inflation is estimated to stay below 2.0 per cent in advanced economies until 2017, reflecting tumbling prices of traded goods due to subdued global demand. In Emerging Market and Developing Economies (EMDEs), headline inflation is forecast to gradually decline to 4.4 per cent in 2017, from 4.6 per cent in 2015.

3. **Excess supply as well as reduced demand from major EMDEs have kept commodity prices somewhat under check**. Given subdued global growth prospects, demand pressures stemming from the price of oil are not expected to increase markedly in the near term but the price forecast remains subject to a significant margin of uncertainty. The Food and Agriculture Organisation food

price index reversed course during 16H1. From its lowest reading of 149.3 in January 2016, it rose to 163.4 in June 2016, mainly due to an increase in sugar prices.

4. **Following Brexit, volatility surged and several stock markets shed part of their earlier gains, while currency markets remained under the grip of risk aversion.** The result of UK's referendum released on 24 June 2016 sent shock waves across financial markets, pushing the VIX and VIX-Emerging Markets up by 49.3 per cent and 15.2 per cent, respectively. The MSCI World and MSCI Emerging Markets shed 4.9 per cent and 3.5 per cent before regaining some ground subsequently. Several currencies experienced sharp declines against the US dollar and Japanese yen mainly, seen as safe-haven currencies. In particular, the Pound sterling shed 11 per cent against the US dollar. Amid greater uncertainty about the global economic outlook, the US Federal Reserve System has put on hold its interest rate normalisation cycle, while the Bank of England warned that it would ease monetary policy further. The ECB and Bank of Japan were also expected to further ease their already accommodative monetary policy stances.

5. **EMDEs' central banks are being confronted with a diverse set of challenges**. India and China have cut interest rates to provide a fillip to growth. Russia, Australia, New Zealand and Indonesia have reduced interest rates amid sagging growth and weak inflation. As global interest rates continue to diverge, there is a risk that capital flow and exchange rate volatilities could intensify again, heightening financial risks and further dampening global economic prospects.

Domestic economic developments

6. **Statistics Mauritius expects GDP growth to pick up from 3.0 per cent in 2015 to 3.9 per cent in 2016, supported by increased investment and other government measures to support the economy**. Several major projects in the construction, tourism and manufacturing sectors are expected to begin this year. '*Construction*' is forecast to rebound by 1.6 per cent in 2016, after five consecutive years of contraction. '*Accommodation and food service activities*' is expected to grow by 6.9 per cent, based on expected tourist arrivals of around 1.24 million. '*Manufacturing*' is projected to expand by around 1.3 per cent, mainly due to higher output from *'sugar milling'*, expected diversification of markets and a higher production from *'textile manufacturing'*. '*Financial and insurance activities*' would grow by 5.4 per cent. '*Public administration and defence*' is projected to expand by 3.7 per cent, given the expected increase in public sector recruitments. Sustaining strong growth will, however, depend on the effective implementation of these projects while improving productivity and competitiveness. Persistence of skills mismatches, if not addressed, would also affect the growth dynamics of the economy.

7. **Domestic inflation continues to remain subdued, supported by moderate international commodity prices, weak global economic activity and broadly favourable domestic food supply conditions.** Headline inflation retreated from 1.3 per cent in January 2016 to 0.9 per cent in June 2016. Y-o-y inflation dropped to a historically low of -0.5 per cent in February 2016, before rising to 1.1 per cent in June 2016, on account of base effects and hike in the prices of non-food products. The various derived inflation indicators remained low and moderate. Inflation expectations assessed in the May 2016 Bank's survey remained skewed to the downside.

8. **Input cost pressures recorded mixed developments during 16Q1**. The ebbing of domestic input cost pressures was visible in the drop in producer price inflation (both Agriculture and Manufacturing). The import price index lost 10.9 per cent in 16Q1. The nominal wage rate index increased by 2.4 per cent, y-o-y, in 16Q1, more than the average y-o-y inflation rate recorded over the same period.

9. **Labour market conditions improved during 16Q1, as reflected by the decline in the unemployment rate due to a contraction in the labour force.** Quarterly estimates show an unemployment rate of 7.6 per cent in 16Q1 compared to 8.7 per cent in 15Q1 and 7.9 per cent in 15Q4. The unemployment rate is forecast to fall from 7.9 per cent in 2015 to 7.7 per cent in 2016.

10. **During 16Q1, the current account deficit was estimated to remain contained at about 2.5 per cent of GDP while sustained financial flows including direct investment flows from the non-GBC sector resulted in a balance of payments surplus of Rs5.8 billion.** For the year 2016, the current account deficit is forecast at about 3.9 per cent of GDP compared to 4.8 per cent of GDP in 2015. Various reserve adequacy metrics improved as a result of the build-up in gross official international reserves.

11. **On a point-to-point and dealt[1] basis, the rupee firmed against the three major currencies since the last MPC meeting, reflecting the continued inflow of foreign currencies in the domestic economy and developments in the major currency markets.** In nominal effective terms, the rupee appreciated by 0.14 per cent between 17 February and 14 July 2016. On a real effective exchange rate basis, the rupee depreciated by 2.9 per cent in 16Q2 but appreciated by 1.3 per cent during FY15-16.

12. **The Bank pursued active open market operations to prevent a disproportionate build-up in excess liquidity**. As a result, banks' average cash reserve ratio, which increased from 9.95 per cent at the end of April 2016 to 11.62 per cent for the period ended 9 June 2016, subsided to 10.11 per cent in the first week of July 2016. Total outstanding BoM and GoM securities issued for liquidity management purposes stood at Rs56.3 billion on 15 July 2016, of which the amount of deposits placed by banks on account of sterilised foreign exchange intervention amounted to Rs9.5 billion.

13. **Interbank money market rates and money market yields increased since the last MPC meeting.** The weighted yields for the 91-Day, 182-Day and 364-Day GMTBs rose to 2.88 per cent, 2.92 per cent and 3.10 per cent on 15 July 2016, from 2.46 per cent, 2.57 per cent and 2.64 per cent, respectively, on 19 February 2016. In general, yields on medium- to long-term maturities declined during most of the period under review.

14. **The pace in the expansion of broad money supply slowed somewhat since the last MPC meeting while private sector credit growth remained subdued.** The annual growth rate of Broad Money Liabilities declined from 10.2 per cent in December 2015 to 9.2 per cent in May 2016. The annual growth rate of depository corporations' loans to various sectors of the economy fell from

[1] *Calculated on spot transactions of USD20,000 and above, or equivalent, conducted by banks and forex dealers.*

8.1 per cent in December 2015 to 5.6 per cent in May 2016. The annual growth rate of banks' credit to the private sector (excluding credit to GBC entities) went down from 4.2 per cent in December 2015 to 2.7 per cent in May 2016, explained by a decline in both household and corporate credit. Y-o-y credit to the household sector dropped from 5.0 per cent to 4.3 per cent while y-o-y credit to corporates fell from 3.9 per cent to 2.0 per cent between December 2015 and May 2016.

15. **The domestic banking sector remained sound and resilient as banks continued to strengthen their capital positions.** The capital adequacy ratio maintained by the banking sector improved further from 17.9 per cent as at end-December 2015 to 18.1 per cent as at end-March 2016, reflecting an increase of 0.4 percentage point in the capital base. Credit quality suffered somewhat during 16Q1, as the ratio of impaired credit to total credit worsened from 6.4 per cent as at end-December 2015 to 7.1 per cent as at end-March 2016. However, banks' overall coverage ratio (ratio of specific provision to impaired credit) improved from 48.7 per cent to 49.8 per cent over the same period.

Staff economic outlook

16. **Bank staff have estimated that headline inflation would remain low and contained in the near term, conditional on a set of external and domestic assumptions.** Headline inflation is projected at around 1.5 per cent for 2016 and around 3.0 per cent in 2017. Inflationary impulses would be generated out of the gradual pick-up in global inflation and a boost in domestic demand, notwithstanding base effects.

17. **Bank staff project that domestic economic growth would remain below potential but supported.** Overall, subject to assumptions made, real GDP growth for 2016 is forecast at 3.6 per cent and at 3.8 per cent for 2017. The anticipated improvement in the implementation capacity of public infrastructure projects and expectations that private sector investment would get a boost from the Budget Speech measures would be key contributing factors supporting the pick-up in the domestic economy. Nonetheless, downside risks to the domestic growth outlook persist, especially if global growth suffers out of the outcome of the unanticipated shocks from Brexit.

Monetary Policy Decision

18. **Members discussed the recent international and domestic developments and projections.** They also examined the potential impact of the UK's referendum results. Members noted that in view of strong trade and financial linkages between the UK and the EU, Brexit has accentuated downside risks to global growth. Given that the UK is an important trade partner for Mauritius, members discussed the various channels through the domestic economy may potentially be affected. The MPC observed that the UK accounted for around 12 per cent of our total exports and that around 6 per cent of our exports is denominated in Pound sterling. They noted that projections at this stage were clouded with uncertainty. Against a backdrop of subdued global demand and commodity prices, global inflation risks are also expected to remain low in the near to medium term.

19. **Notwithstanding a commendable performance of the domestic economy in 16Q1, the MPC viewed that the domestic economy continued to operate below potential and that latest global developments, especially in the aftermath of Brexit, on a no policy change scenario, pointed to further downside risks to the domestic growth outlook**. Members reiterated the presence of structural bottlenecks that have been a major drag on growth prospects. Domestic productivity levels and trends and wage developments in the economy continue to diverge. The MPC argued that the deleveraging process of the corporate sector, high perceived lending risks by banks and weak demand for credit could explain the deceleration in private sector credit.

20. **MPC members noted the continued decline in externally-generated inflationary pressures as well as in various inflation indicators**. They viewed that the inflation outlook was relatively moderate and that, at the current juncture, inflation did not pose any serious risk. In the absence of any major shock, they viewed that headline inflation would remain contained at relatively low levels.

21. **Members also took note of the evolution of excess reserves in the banking system, the Bank's sterilised interventions and active liquidity management since the last MPC meeting as well as the interest rate differential between Mauritius and major partner countries**. They viewed that this would help in the monetary policy transmission mechanism.

22. **The MPC weighed the risks to the growth and inflation outlook and considered that the downside risks to the domestic growth outlook outweighed the risks to the inflation outlook.** Taking into account the uncertainty created by Brexit and potential for the US November elections to increase market volatility, the MPC deemed it important to support investment activity in the country and raise the growth potential of the economy.

Voting Pattern

23. **At the conclusion of the discussion, the Committee unanimously voted to cut the Key Repo Rate by 40 basis points to 4.00 per cent per annum**.

24. **The MPC would continue to monitor economic and financial developments.** The MPC would also stand ready to meet in between its regular meetings, if the need would arise.

25. **The next MPC meeting is scheduled on Thursday 10 November 2016**.

Editor's Note

According to the Bank of Mauritius Act 2004, the primary object of the Bank shall be to maintain price stability and to promote orderly and balanced economic development. The Act gives the Monetary Policy Committee (MPC) responsibility to formulate and determine the monetary policy to be conducted by the Bank. The MPC meets on a regular quarterly basis.

When the MPC met on 20 July 2016, the last available data on national accounts, employment and external trade were for 16Q1. The last data available on CPI and inflation were for June 2016.

Abbreviations and Definitions

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.

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

CORE1 inflation excludes food, beverages and tobacco and mortgage interest on housing loan from the CPI basket. Both headline and y-o-y 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 y-o-y CORE2 inflation measures are available.

Y-o-y refers to year-on-year changes.

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

GMTBs refer to Government of Mauritius Treasury Bills.