Post-MPC Press Conference

29 April 2014

33rd Monetary Policy Committee

Interest Rate Decision: Key Repo Rate (KRR) at <u>4.65 per cent</u>

International Economic Developments

"Monetary Policy in the New Normal" – *Main theme of the 2014 IMF Spring Meeting*

What is it all about?

1. Implementation of both **Macro and Micro prudential measures** to deal with risks to financial stability
2. Building **Adequate Foreign Exchange Reserves** is a an important step towards protecting emerging markets from volatile capital flows and the impact of Fed Tapering
3. **Flexible Exchange Rates** shall allow Emerging Markets to better adjust to volatile capital flows
4. Central Banks must anchor inflationary expectations and protect **price stability.** Sustained periods of Negative Real Interest Rates can lead to dangerous risk-taking.

Date of last increase	COUNTRY	Cumulative Rate Hikes (bps) since June 2013 (no of hikes)	Policy Rate (%)	Inflation Rate (%)
	MAURITIUS		4.65%	4.5 [1]
	DEVELOPED ECONOMIES			
24-Apr-14	Denmark	**15 (1)**	0.05%	0.40
24-Apr-14	New Zealand	**50 (2)**	3.00%	1.50
	EMERGING MARKET ECONOMIES			
25-Apr-14	Russia	**200 (2)**	7.50%	6.90
25-Apr-14	Columbia	**25 (1)**	3.50%	2.51
02-Apr-14	Brazil	**300 (7)**	11.00%	6.15
29-Jan-14	South Africa	**50 (1)**	5.50%	5.40
28-Jan-14	Turkey	**550 (1)**	10.00%	7.71
28-Jan-14	India	**75 (3)**	8.00%	10.88
27-Dec-13	Tunisia	**50 (1)**	4.50%	6.00
14-Nov-13	Indonesia	**175 (5)**	7.50%	7.26
13-Nov-13	Pakistan	**100 (2)**	10.00%	7.36
	FRONTIER ECONOMIES			
14-Apr-14	Ukraine	**300 (1)**	9.50%	3.40
06-Feb-14	Ghana	**200 (1)**	18.00%	14.50

[1] *Year-on-Year inflation rate.*
Source: http://www.tradingeconomics.com; http://www.cbrates.com; The Economist.

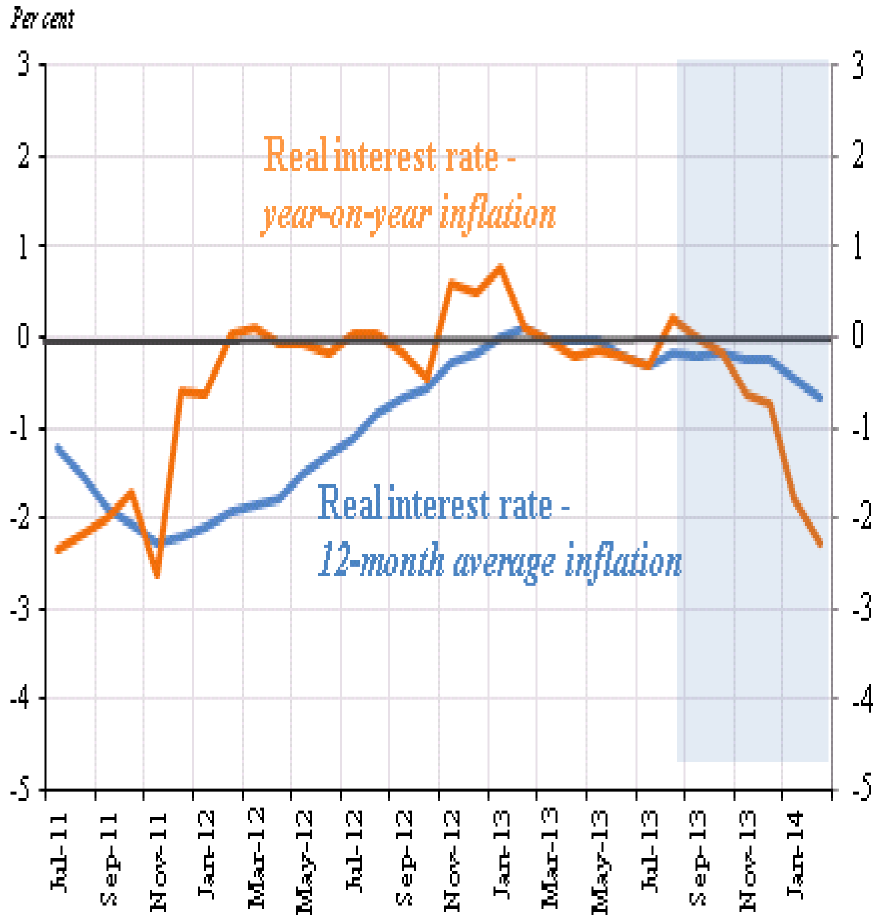
Where do we stand in terms of these measures?

1. **Macro prudential measures** – first set targeting the construction sector introduced in January 2014.

2. **Building adequate foreign exchange reserves** – introduced Operation Reserve Reconstitution since June 2012, with a target for import cover of 6.0 months. We are presently at <u>5.8 months</u>.

3. **Exchange rate Arrangement -** The de jure exchange rate arrangement for Mauritius is floating (Annual Report on Exchange Arrangements and Exchange Restrictions IMF 2013).

4. Sustained Periods of **Negative Real Interest Rates** can lead to dangerous risk-taking – **this is where we need to act.**



Recent IMF's growth forecasts and Public Information Notice released on 21 April 2014, at the conclusion of the IMF Article IV Consultation on Mauritius

April 2014 World Economic Outlook - growth forecasts

			April 2014 WEO Projections		Difference January WEO Update	
	2012	2013	2014	2015	2014	2015
World Output	3.2	3.0	3.6	3.9	-0.1	-0.1
Advanced economies	1.4	1.3	2.2	2.3	0.0	0.0
of which						
United States	2.8	1.9	2.8	3.0	0.0	0.0
Euro Area	-0.7	-0.5	1.2	1.5	0.1	0.1
United Kingdom	0.3	1.8	2.9	2.5	0.4	0.3
Japan	1.4	1.5	1.4	1.0	-0.3	0.0
Other						
Emerging market and developing economies	5.0	4.7	4.9	5.3	-0.2	-0.1
Sub Saharan Africa	4.9	4.9	5.4	5.5	-0.7	-0.3
Developing Asia	6.7	6.5	6.7	6.8	0.0	0.0
of which						
China	7.7	7.7	7.5	7.3	0.0	0.0
India	4.7	4.4	5.4	6.4	0.0	0.0

Extracts of the IMF Article IV Consultation

1. …encourage the authorities *"to consolidate recent macroeconomic gains, strengthen policy buffers, and pursue greater economic diversification through structural reforms to enhance the resilience of the economy".*
2. *"…the **current monetary stance is broadly appropriate,** but cautioned that a withdrawal of accommodation might be necessary if inflationary pressures intensify".*
3. *"…proposed a mechanism to share the cost of monetary policy and provide incentives to eliminate the structural excess liquidity".*
4. *"…reserves levels appear comfortable when measured against the traditional thresholds and adequate relative to the IMF composite indicator".*
5. *"…reducing excess liquidity in the banking sector is necessary to improve the monetary transmission mechanism despite likely but justifiable losses for the Bank of Mauritius".*

Taylor Rule and its application to Monetary Policy

- In 1993, John Taylor postulated the idea of employing econometric policy evaluation research to set monetary policy rules in policymaking environment.

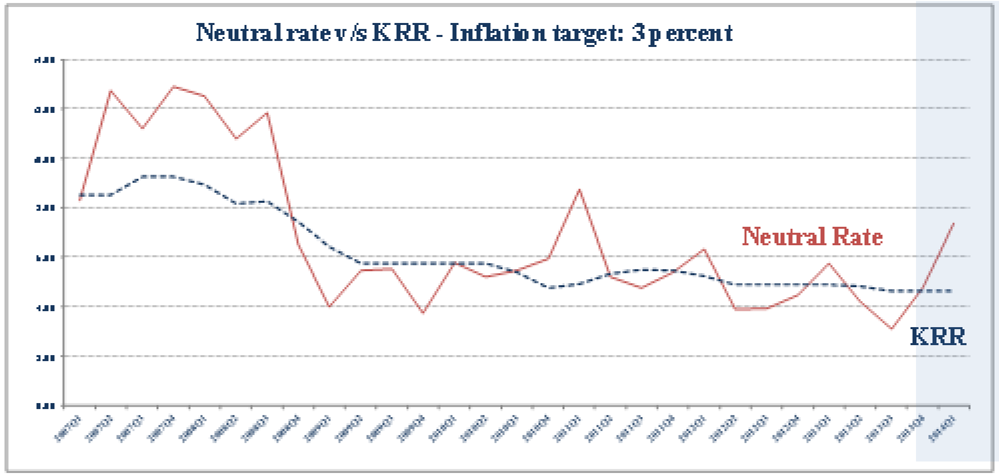
- Monetary policy decision making relies partly on the discretion of policymakers. However, the Taylor rule emphasizes the importance of a policy rule-like behaviour on part of central banks as a key conceptual framework in an environment committed to transparency and independence.

- The policy rule entails changing the KRR, according to whether the inflation rate is on target and whether growth is on target.

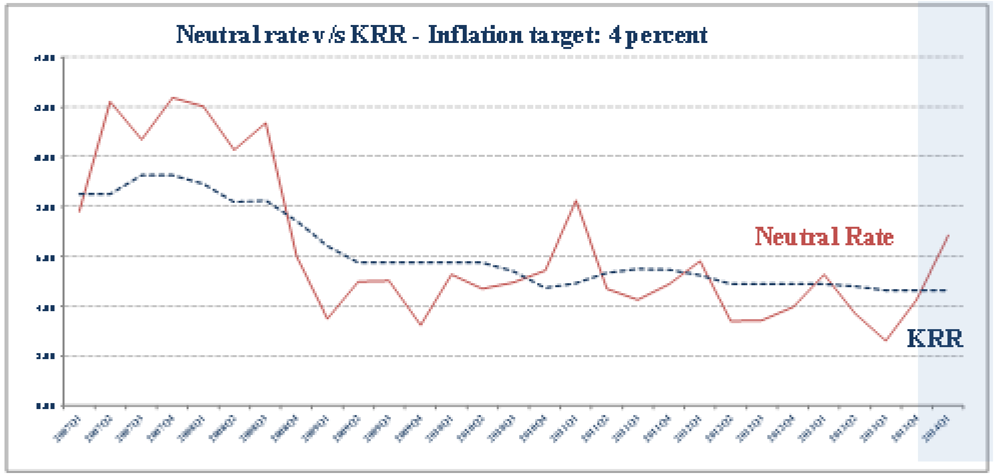
- The Taylor rule has gained widespread influence because it can be implemented in policy regimes with a dual mandate for price stability and growth or in regimes where inflation is the primary target. As such, the Taylor rule is being used by the FED, ECB, BOJ, BOE, RBI and IMF.

- Since 1993, the Taylor rule has been widely used in many central banks for policy making and has also been incorporated in macroeconomic forecasting models.

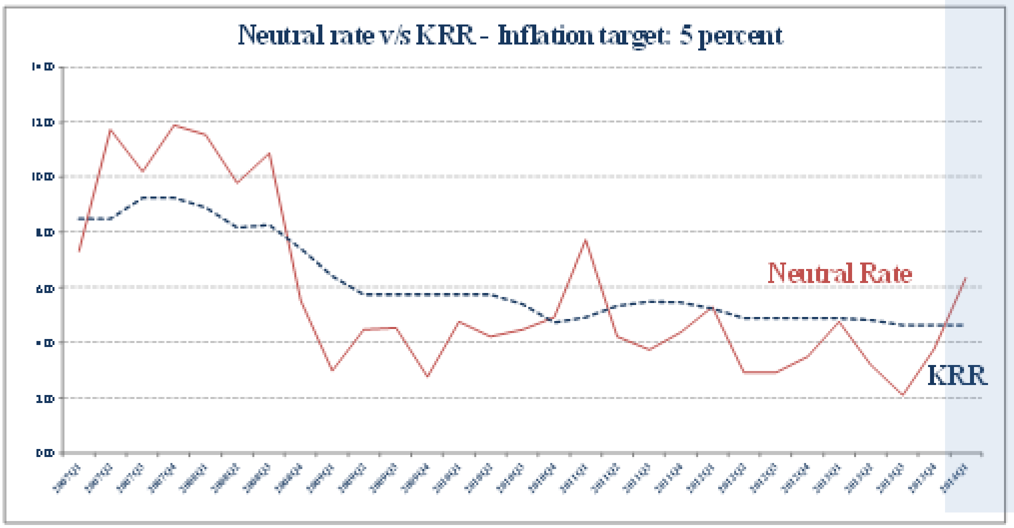
Has the KRR fallen behind the neutral rate?



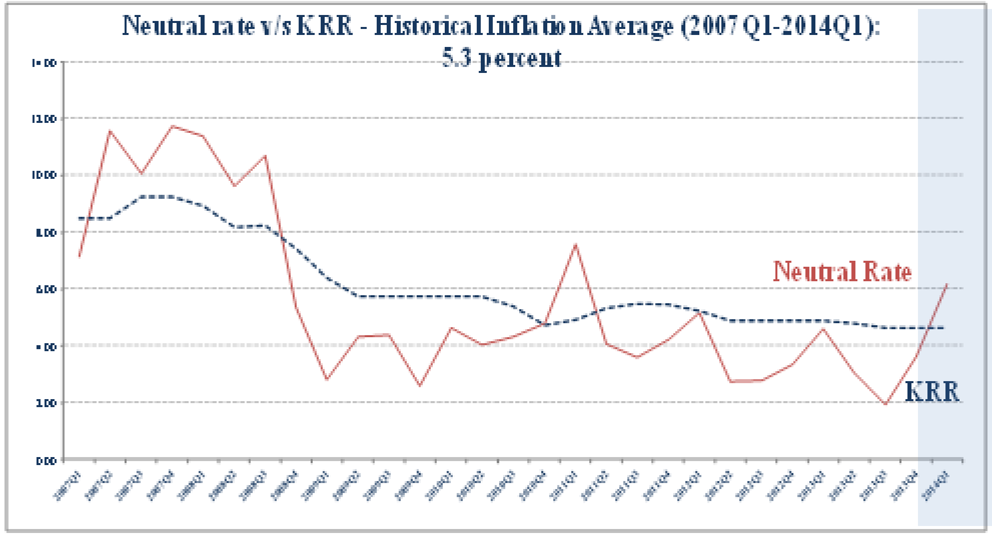
Scenario 1(a): Inflation Target: 3%



Scenario 1(b): Inflation Target: 4%

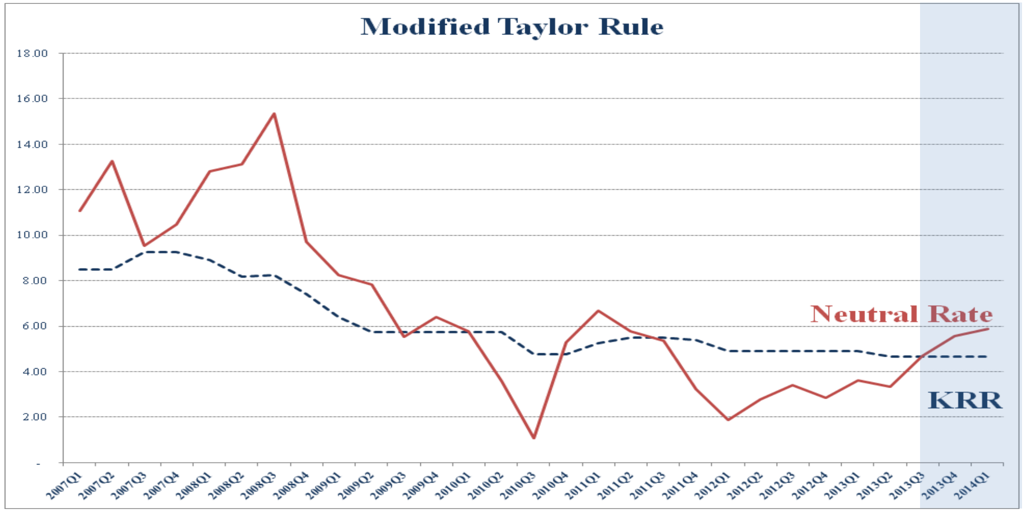


Scenario 1(c): Inflation Target: 5%

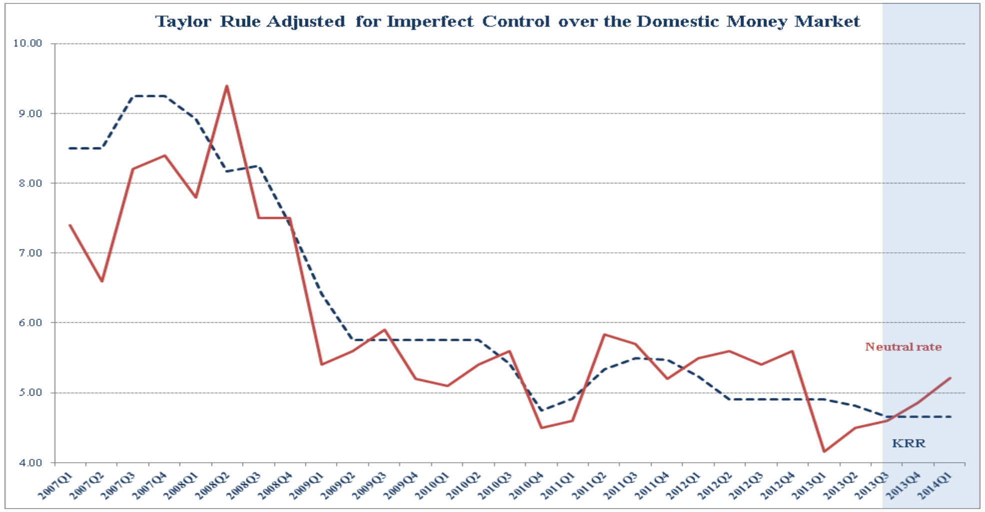


Scenario 1(d): Historical Inflation Average (2007Q1-2014Q1): 5.3%

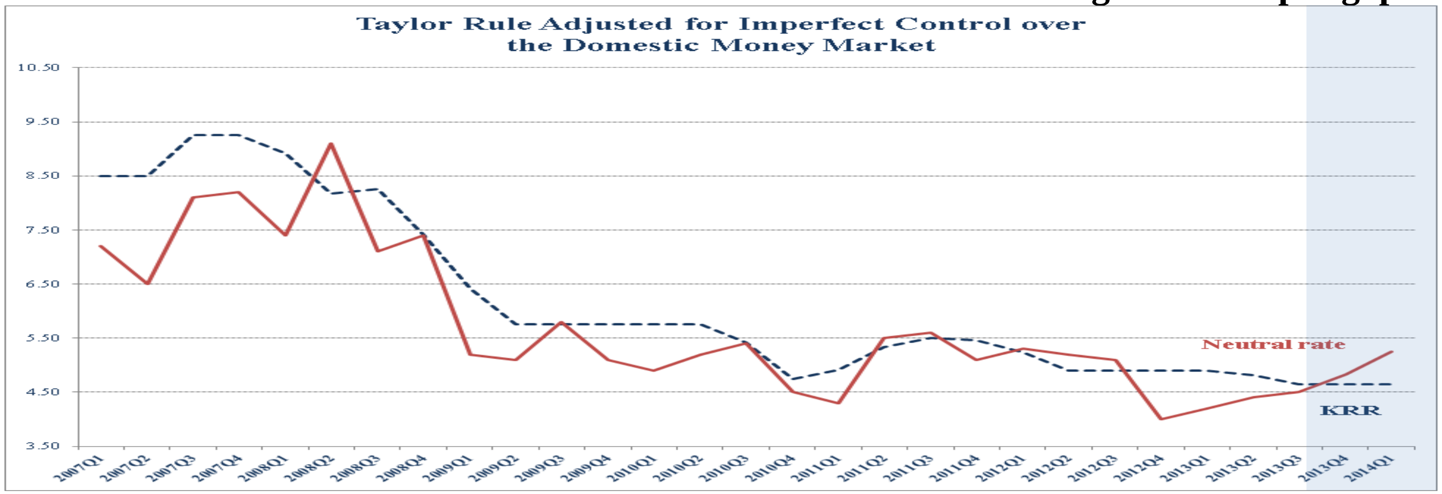
Since the 2013Q4, the gap between KRR and neutral rate has been widening…



Scenario 2: Model-based inflation forecast & Output gap



Scenario 3(a): Weights on inflation gap = 1.5
Weights on Output gap = 0.3



Scenario 3 (b) Weights on inflation gap = 0.5 Weights on Output gap = 0.5

Results of Taylor rule for all scenarios

<table>
<tr><th colspan="2">Scenario</th><th>Does the neutral rate exceed the KRR?</th><th>When does the neutral rate exceed the KRR?</th><th>By how much does the neutral rate exceed the KRR?</th></tr>
<tr><td rowspan="4">Scenario 1:
Backward Looking Taylor Rule</td><td>Inflation target - 3%</td><td>Yes</td><td>2014Q1</td><td>270 bps</td></tr>
<tr><td>Inflation target - 4%</td><td>Yes</td><td>2014Q1</td><td>220 bps</td></tr>
<tr><td>Inflation target - 5%</td><td>Yes</td><td>2014Q1</td><td>170 bps</td></tr>
<tr><td>Historical Inflation Average</td><td>Yes</td><td>2014Q1</td><td>150 bps</td></tr>
<tr><td colspan="2">Scenario 2:
Modified Taylor Rule</td><td>Yes</td><td>2013Q4 - 2014Q1</td><td>110 bps : 120 bps</td></tr>
<tr><td rowspan="2">Scenario 3:
Taylor Rule adjusted for imperfect control over the domestic money market</td><td>Weights Inflation= 1.5
Weights GDP = 0.3</td><td>Yes</td><td>2013Q4 - 2014Q1</td><td>21 bps : 56 bps</td></tr>
<tr><td>Weights Inflation= 0.5
Weights GDP = 0.5</td><td>Yes</td><td>2013Q4 - 2014Q1</td><td>18 bps : 60 bps</td></tr>
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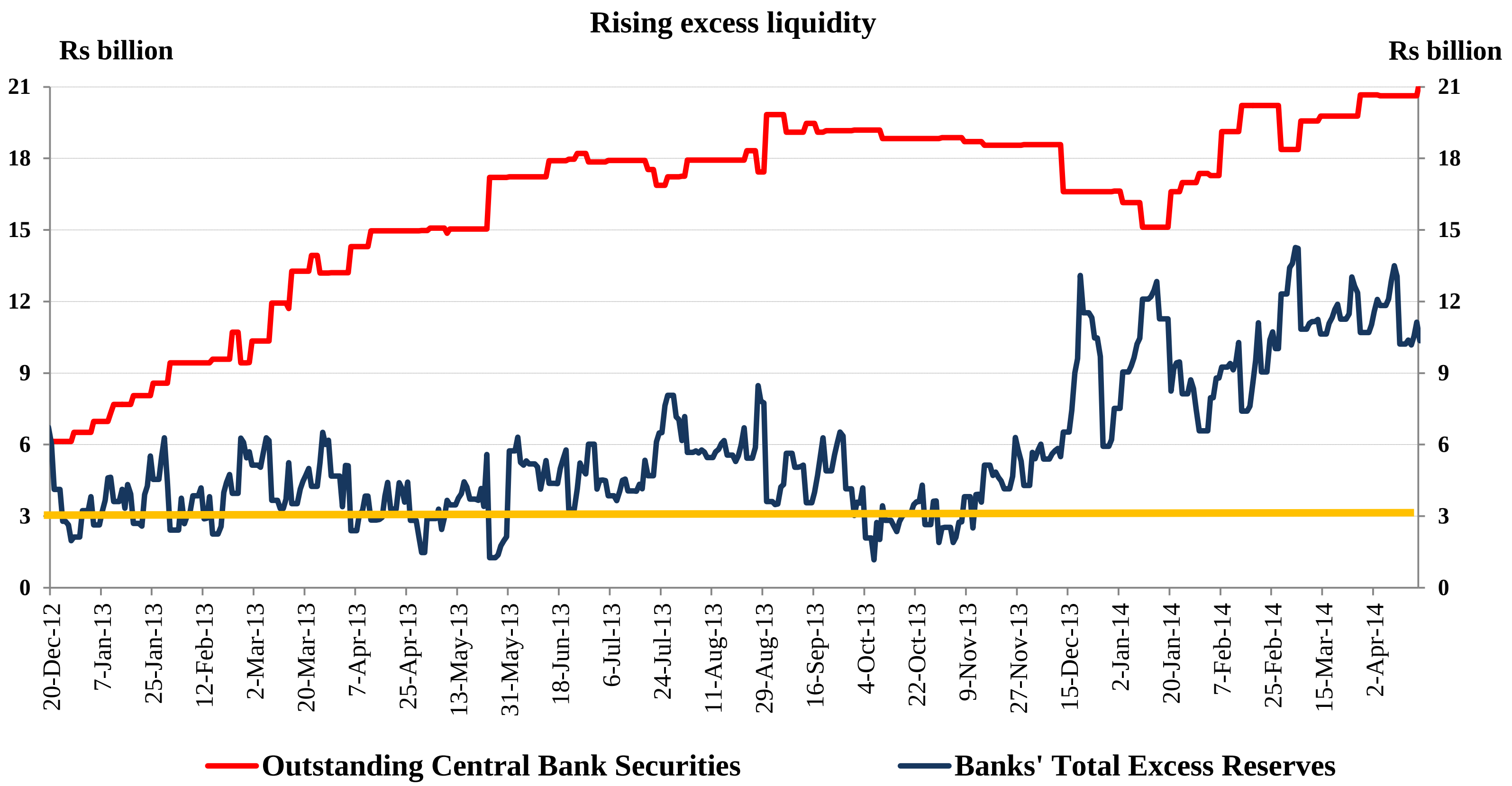
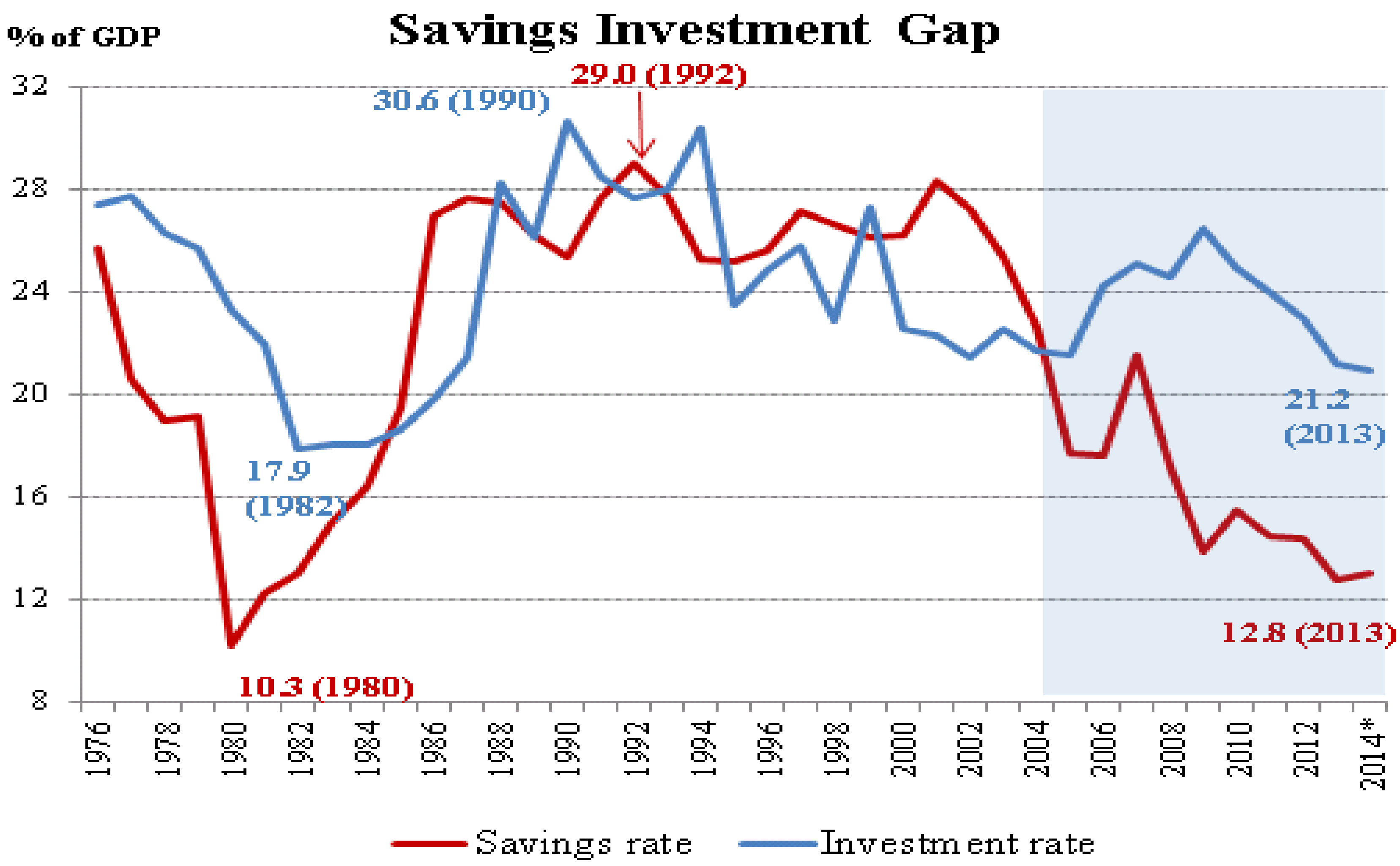
Emerging Vulnerabilities (i)

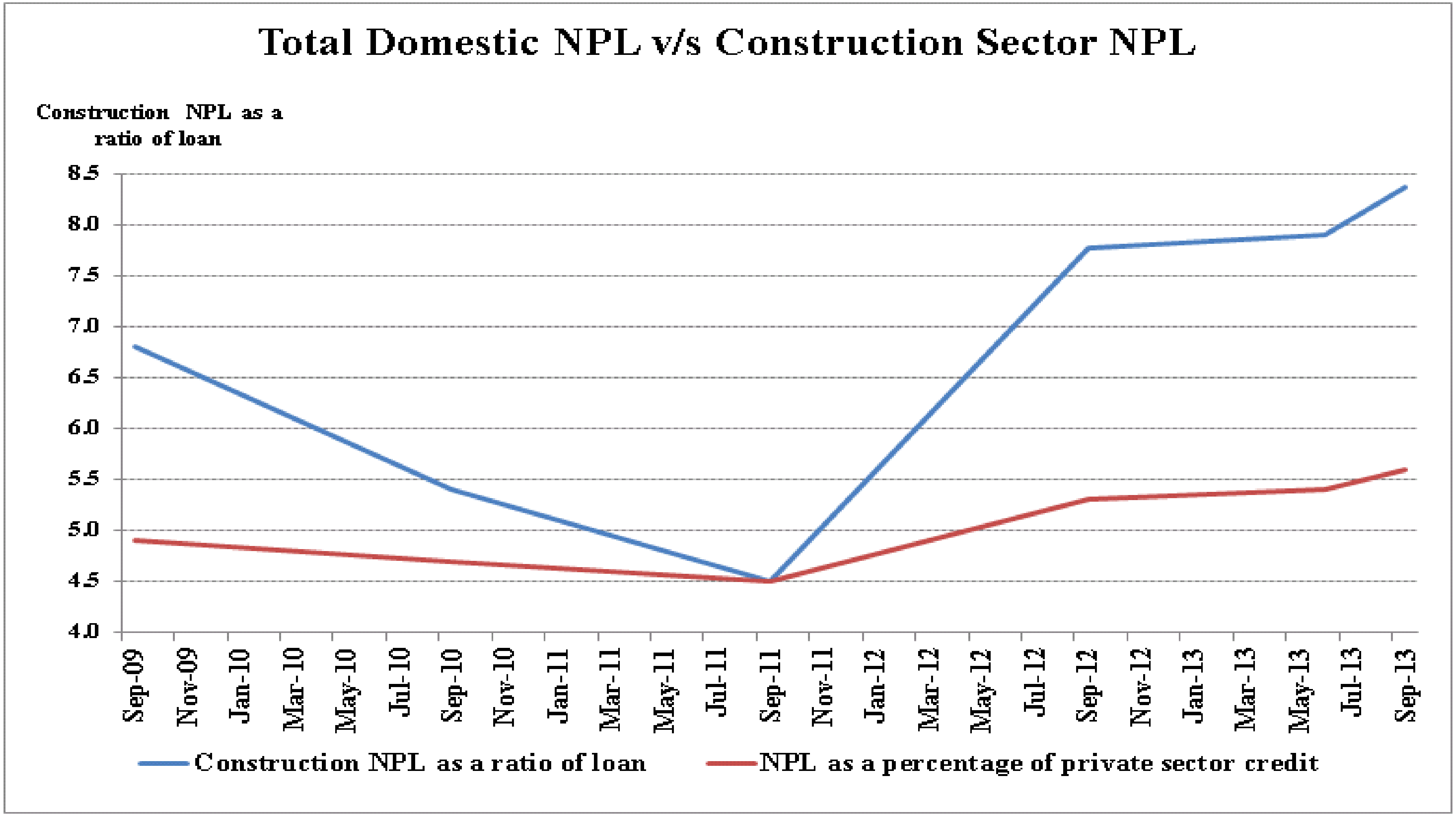


1. Excess liquidity has been consistently above Rs3bn (acceptable level)
2. Excess liquidity has been building up since 2012 on account of:
    a. Net redemption of Treasury Bills;
    b. Increasing recourse of Government to foreign borrowing; and
    c. Intervention of BoM to combat currency appreciation causing rupee excess liquidity.

Emerging Vulnerabilities (ii)

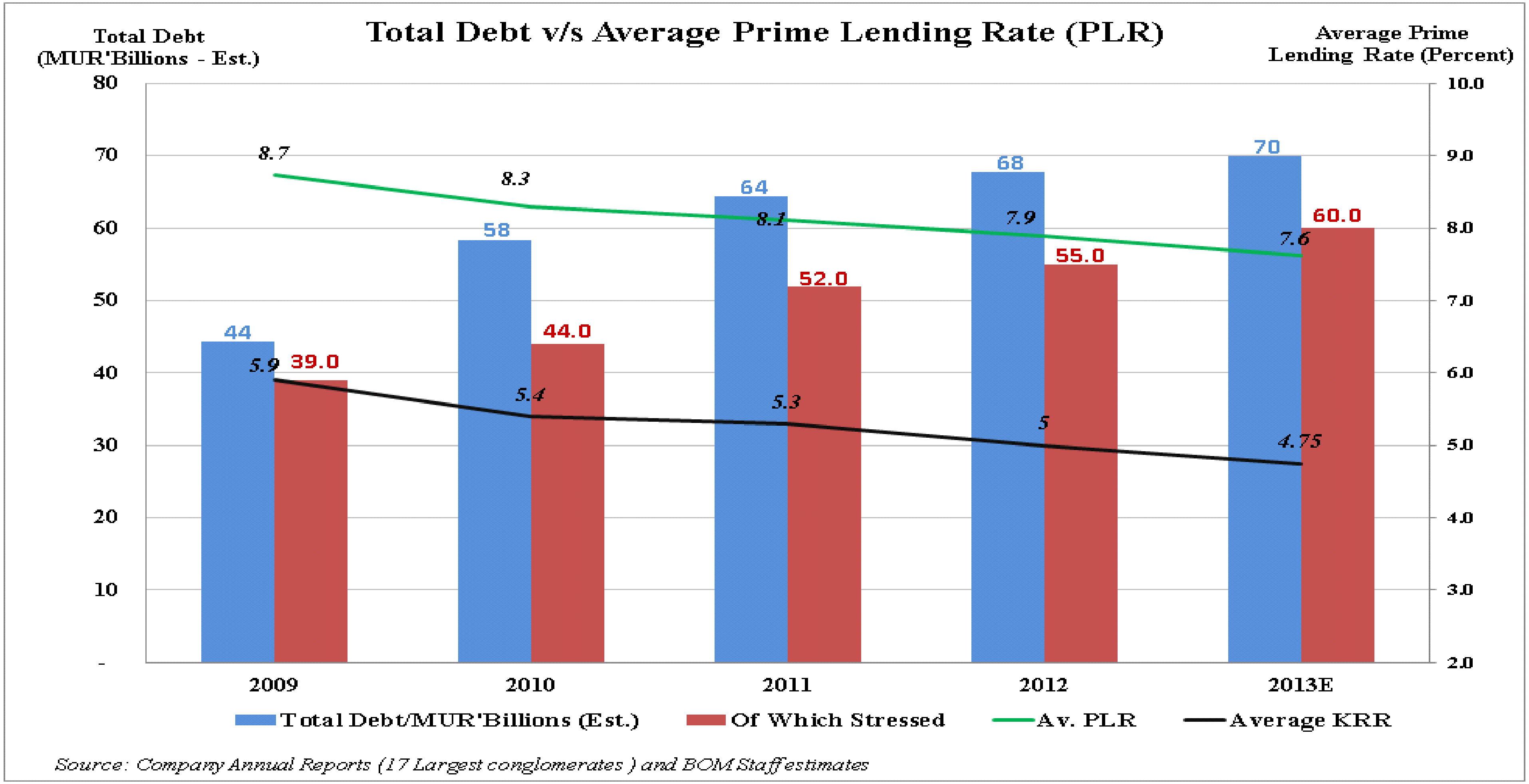


Emerging Vulnerabilities (iii)



NPL: Non-Performing Loan

Emerging Vulnerabilities (iv)



Key Take-Aways

1. Monetary policy needs to be proactive. It is high time to start the process of normalising, so says the IMF globally. Growth in Mauritius is projected to strengthen close to its potential level in 2014.

2. Although inflation is muted, it is almost 10 times above the inflation prevailing in the Eurozone, our main trading partner and we cannot be comfortable about that. Mauritius has taken commitment under SADC and AACB Macroeconomic Convergence Criteria for an inflation target of 3 per cent.

3. The KRR has fallen behind the neutral rate since 2013Q4, under various scenarios, as per the Bank's estimates of the neutral rate of interest using Taylor Rule, and the gap is widening. Monetary policy needs to be ahead not behind of the curve.

4. Emerging vulnerabilities: Where is the long term trade - off between growth and inflation when engaged in ultra loose monetary policy?
    - Misallocation of resources hurts growth.
    - Rising NPLs especially in construction hurts growth.
    - Emerging bubbles from mal-investment hurts growth
    - Corporate indebtedness poses continued risks to financial stability.

5. The persistence of excess liquidity in the banking system and its potential impact on the Bank's Balance Sheet remains a source of grave concern to the Bank and hurts the transmission mechanism of monetary policy.
   "… proposed a mechanism to share the cost of monetary policy and provide incentives to eliminate the structural excess liquidity", IMF Staff Report for the 2014 Article IV Consultation