BANK OF MAURITIUS

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MONETARY POLICY STATEMENT

The Monetary Policy Committee (MPC) of the Bank of Mauritius decided to maintain the key Repo Rate at 5.75 per cent per annum at its regular meeting held on 22 June 2010. The interest rate chargeable on the Special Deposits Facility, set at 100 basis points below the key Repo Rate, remains at 4.75 per cent per annum while that on the Overnight Facility, set at 150 basis points above the key Repo Rate, is held at 7.25 per cent per annum. The interest rate payable on the Standing Facility, set at 400 basis points above the key Repo Rate, is 9.75 per cent per annum.

The MPC reviewed current international and domestic economic as well as financial developments and assessed the outlook for the global and domestic economy before reaching its decision.

International developments and outlook

The global economy was recovering faster than expected although at an uneven pace across countries and regions as evidenced by recent releases of economic data and reports from international organisations.[1] World trade had also continued to expand in the first quarter of 2010, largely on account of the rebalancing of Asian economies away from external demand. While the recovery in many advanced economies was still not firmly entrenched, almost all major emerging and developing economies were on track toward robust growth in 2010.

According to the International Monetary Fund's World Economic Outlook released in April 2010, real activity in many emerging and developing economies, particularly in Asia, had continued to rebound swiftly in the first quarter of 2010. After having been severely battered by the financial crisis, almost all Asian economies had experienced a "V-shaped" recovery by the end of 2009 with output back to pre-crisis levels. The growth dynamics in Asia had helped pull other regional economies along, in particular commodity-exporting Australia and New Zealand. Large capital inflows and

[1] *The OECD Economic Outlook of May 2010, and the G-20 Meeting of Finance Ministers and Central Bank Governors on 5 June 2010.*

more robust growth had led to increasing inflationary pressures and to the appreciation of Asian currencies.

Real economic activity data for the first quarter of 2010 revealed marked differences among major advanced economies. In the United States, although real GDP data for the first quarter of 2010 indicated that the US economy had expanded at a lower rate of 0.8 per cent compared to the preceding quarter, there were encouraging signs that autonomous private demand had started to contribute to economic growth more strongly than before.[2] Other encouraging signs of stronger growth ahead related to the positive job numbers in May 2010 - the first time, the US economy had been adding jobs since December 2007 - and the Beige Book released in June pointing to continuous but still moderate improvement in economic activity across all 12 Federal Reserve districts. In the Euro zone, the economy grew by 0.2 per cent in the first quarter of 2010, up marginally from 0.1 per cent in the preceding quarter. Household and business spending continued to be depressed while exports were seen as the key driver of economic growth. In the United Kingdom, the pace of economic activity slowed down by 0.1 percentage point to 0.3 per cent in the first quarter of the year on flat consumer spending and exports of goods and non-factor services. More recent data in both the United Kingdom and the Euro zone supported the view that the recovery was taking hold but at a very gradual pace. In the near to medium term, the growth outlook would remain undermined by a sluggish labour market, weak consumer demand and rising uncertainty following the announced implementation of austerity measures in both the Euro zone and the United Kingdom.

The sovereign debt crisis in Europe had also dented investor sentiment about the pace of the global economic recovery and contributed to increase risk aversion. Since the last MPC meeting in March, several indicators of risk sentiment such as the 3-month dollar LIBOR rate, the treasuries and bonds spreads, as well as the credit default swaps spreads for Euro zone countries had jumped to multi-month highs, adding greater stress to the financial markets. Although, risk sentiment had improved and debt spreads narrowed afterwards, investors' sentiment continued to remain fragile mainly on concerns about Europe's banking system and fears that the planned austerity measures would dampen European growth going forward.

The MPC also assessed the recent international price developments of food and energy. Latest trends of agricultural commodity prices indicated sustained strength between the beginning of the year and May 2010. Reflecting the uncertainty about the global economic recovery, average crude oil prices had weakened in May 2010 before

[2] *The data refers to the US Bureau of Economic Analysis (BEA) second estimate of real GDP growth rate. At the time the MPC met, the BEA third estimate of 0.7 per cent had not been released.*

rising again beginning of June. It was noted that the International Energy Agency (IEA) had revised upward its estimate of global oil demand growth this year due to increased fuel use in the United States and on robust Chinese oil consumption.

The MPC reviewed the latest batch of global inflation data. While headline inflation remained subdued in most major advanced economies with the exception of Britain where inflation at 3.4 per cent in May 2010 was way above the target of 2.0 per cent, inflationary pressures had started to pick up relatively strongly in fast-growing emerging and developing economies as well as in commodity-exporting economies. Price developments in international commodity markets and higher inflation in source markets particularly in Asia were seen as key drivers of inflation worldwide. Several economies had been surprised by higher inflation and this has raised concerns about the extent of the output gap. In the United Kingdom and Australia, measures of consumer inflation expectations had also surged but in the United States and the Euro zone, inflation expectations remained well-anchored for now. Core measures of inflation were still tame in many advanced economies. Reflecting the diverging inflation paths, several central banks had raised interest rates while the accommodative monetary policy stance was expected to be maintained in many advanced economies for a longer period than had initially been thought.

Domestic developments and outlook

The MPC discussed recent economic developments and assessed the risks to the growth outlook. Fourth quarter 2009 national accounts data released by the CSO at end-March 2010 showed that the domestic economy had evolved broadly as the MPC anticipated at its last meeting on 23 March. Year-on-year growth rate in the fourth quarter of 2009 posted an impressive 6.4 per cent, which was partly explained by the base effect after the economy had started slowing down in the fourth quarter of 2008. In the third quarter of 2009, year-on-year real growth rate of the economy was at a lower positive figure of 3.5 per cent. Key export sectors namely, textiles and hotels and restaurants witnessed strong positive year-on-year growth rates after several quarters of contraction. The expansion was broad-based with equally robust growth in food, other manufacturing, utilities, construction, distributive trade, transport, storage and communications as well as public services. It was also noted that labour productivity in the textile sector had gained 7.7 per cent in 2009 outpacing the average for the total economy and the increase of 6.9 per cent in the sector's unit labour cost.

For the first quarter of 2010, economic activity indicators pointed to sustained economic growth across sectors. Despite persistently weak demand in key export markets, both the textiles and tourism sectors had been more resilient than expected in the first three months of the year and had been able to sustain sales albeit at lower prices. For the remaining nine months to end-December 2010, weaker-than-expected recovery in the Euro area and the United Kingdom could adversely affect clothing exports and tourist arrivals, while other sectors of the domestic economy should continue to record positive growth rates. On account of the renewed weakness expected in export markets, the pace of expansion of the domestic economy is expected to slow down to around 4.1 per cent from a previous forecast of 4.6 per cent made in March.

The MPC was concerned about the difficult export environment created by the unusual volatility of the exchange rate of the US dollar and the euro. This raised a range of very real sectoral concerns that impact on the economic health of the country and that need to be addressed by tailor-made measures which fall beyond the scope of monetary policy.

The MPC was also concerned about the significant slowdown in the annual growth rate of credit to the private sector in the final quarter of 2009 and in the first four months of 2010, well below the real growth rate of domestic output. While the expansion of broad money liabilities has also declined, it has been less drastic than private sector credit growth. On account of slow growth in private sector credit, banks' liquid balances have also risen markedly. The MPC took note that the central bank had recently raised the minimum Cash Reserve Ratio by 0.5 percentage point to 5.0 per cent and had also conducted monetary policy operations with a view to reducing this excess liquidity to reasonable levels.

The current account deficit for the first quarter of 2010 widened to Rs3.9 billion, higher than the deficit of Rs1.3 billion registered a year ago but significantly lower from the deficit of Rs5.6 billion recorded in the previous quarter. Faster growth in nominal imports compared with exports led to a worsening merchandise trade deficit of Rs12.8 billion, which was nearly 35 per cent higher than the deficit of Rs9.5 billion registered a year earlier. The higher merchandise trade deficit more than offset the combined surpluses on the services, income and current transfers' accounts. Year-on-year, the surplus on the services account rose by nearly 23 per cent to Rs6.9 billion in the first quarter 2010, up from Rs5.6 billion, largely driven by an increase in 'other services' coupled with higher travel receipts reflecting higher tourist arrivals in the three months to March 2010. Net inflows on foreign direct investment and other investment for a total amount of Rs4.7 billion contributed to offset net outflows on portfolio investment of Rs2.7 billion in the first quarter of 2010. Based on current trends, the current account deficit, as a percentage of GDP, would widen to 8.8 per cent in 2010 from 7.8 per cent in 2009.

Members examined exchange rate developments. They concurred that the domestic foreign exchange market had returned to more orderly conditions and movements in the exchange rate of the Mauritian rupee on a nominal effective basis were more reflective of market fundamentals as well as developments on the international foreign exchange market. The level of foreign exchange reserves remained high and comfortable.

Inflation has remained subdued amid easing pressures on both external and domestic front up to now. Headline consumer price inflation, as measured by the change in the average level of prices during a twelve-month period, remained flat at 1.8 per cent between April and May 2010 after having steadily declined since December 2008. Year-on-year inflation receded to 2.5 per cent in May 2010 following an increase to 2.7 per cent in April from 2.3 per cent in March. Since January 2010, year-on-year inflation has moved little. Base effects were still playing out but monthly adjustments in domestic fuel prices were adding to the volatility in the CPI. All core measures showed moderate inflation in May 2010. On current trends, the MPC judged that inflation had bottomed out and should start rising again towards its historical average level.

Looking ahead, the MPC gauged that higher imported inflation could turn out be a major upside risk. Faster growth in Asia and Oceania, which accounts for roughly 53 per cent of the country's imports, implying rising inflation, rising wages and stronger currencies, as well as higher international food and energy prices - fuelled partly by Asia's rapid growth - could significantly change the domestic inflation outlook from moderate to high. Largely as a result of the exchange rate appreciation of the Mauritian rupee by nearly 8.5 per cent vis-à-vis the US dollar in the first quarter of 2010 over the corresponding quarter of the preceding year, the import price index had gone up by only 3.3 per cent over the same period. Further, the consolidation of sectors in the economy had increased the uncertainty about the magnitude of the negative output gap, which had contributed to contain inflationary pressures arising from domestic sources. In the near term, given the outlook for the Mauritian economy, a shift in inflation expectations could be a more serious upside risk to the inflation outlook. The Bank's sixth Inflation Expectations Survey, carried out in March 2010, reveals that a greater number of respondents, 82.6 per cent as against 76.1 per cent in December 2009, expected prices to go up over the following 12 months. Domestic wage awards and the expected change in the wage-setting mechanism could also represent domestically-generated sources of inflation, if not managed properly.

The MPC weighed the risks to the growth and inflation outlook over the policy relevant horizon and discussed alternative interest rate scenarios. Though downside risks to the growth outlook have increased, the MPC judged that on balance, given the risks to the inflation outlook over the medium term, it was appropriate to maintain the key Repo Rate at its level of 5.75 per cent. The MPC reiterated that monetary policy remained focused on promoting sustainable growth and low inflation.

The MPC will continue to monitor economic and financial developments and remains committed, as per its mandate, to formulate and determine monetary policy, taking into account the orderly and balanced economic development of Mauritius.

Voting Pattern

The MPC voted unanimously to maintain the key Repo Rate at 5.75 per cent per annum.

Date for Regular Meeting

The MPC will convene its next quarterly meeting on 27 September 2010. It stands ready to meet outside regular meetings as and when required to assess the evolution of the economic situation and, if needed, take appropriate policy measures.

Bank of Mauritius

29 June 2010