BANK OF MAURITIUS

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MONETARY POLICY STATEMENT

The Monetary Policy Committee (MPC) of the Bank of Mauritius decided by a majority vote to raise the Key Repo Rate by 50 basis points to 5.25 per cent per annum at its regular meeting held on 28 March 2011. The interest rate chargeable on the Special Deposits Facility, set at 100 basis points below the Key Repo Rate, is 4.25 per cent per annum while the interest rate on the Overnight Facility, set at 150 basis points above the Key Repo Rate, is 6.75 per cent per annum. The interest rate payable on the Standing Facility, set at 400 basis points above the Key Repo Rate, is 9.25 per cent per annum.

The MPC reviewed 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 had continued to improve since the MPC December 2010 meeting although the pace of growth across regions remained uneven. While real economic activity in advanced economies had been stronger than anticipated, growth was still subdued. Emerging and developing economies had maintained robust expansion, reflecting sustained strength in domestic demand, rising global demand for commodities, accommodative monetary policies, and resurgent capital flows.

In its January 2011 World Economic Outlook Update, the International Monetary Fund (IMF) had raised the global growth estimate for 2010. It had also slightly upgraded the global growth forecast for 2011 to 4.4 per cent after having reduced it in its last assessment. Growth prospects had been revised up for several major advanced and emerging economies, and the outlook for the United States had been substantially upgraded by 0.7 percentage point. Reflecting the strengthening of global economic activity, world trade volume had increased by 2.6 per cent in the fourth quarter of 2010 after a slowdown in the third quarter.

The US economy had been at the forefront of the quickening pace of global growth. Real annualised GDP growth accelerated from 2.6 per cent in the third quarter of 2010 to 3.1 per cent in the fourth quarter, driven mainly by growth in private consumption. Conditions in the labour market had also improved, with the unemployment rate declining to 8.9 per cent in February.

The euro area had continued to grow steadily while unemployment had stopped rising. In the final quarter of 2010, real GDP was up 0.3 per cent compared to the third quarter although large differences persisted among the various economies, with the core region led by Germany outperforming the debt-burdened peripheral economies. German growth had slowed somewhat from 0.7 per cent in the third quarter to 0.4 per cent in the fourth quarter, mainly as a result of harsh winter conditions, but this should not signal an end to the upturn that continued to be driven by external demand and corporate investment. Growth stabilised at 0.3 per cent in France, increased to 0.2 per cent in Spain but decelerated to 0.1 per cent in Italy in the fourth quarter.

In the UK, real GDP contracted by 0.5 per cent in the fourth quarter of 2010 as the unusually severe winter weather impacted on the service sector and on construction activity. Survey data at the beginning of 2011 pointed to a rebound in economic activity supported by improving global economic conditions, expansionary monetary policy and past depreciation of the Pound sterling. However, high uncertainty surrounded the UK growth outlook.

Strong manufacturing and services surveys underlined the global economy's positive momentum. Global Purchasing Managers' Indices (PMI) for manufacturing and services sectors expanded significantly in February, signalling resilient economic conditions and broad-based recovery. In the US, PMI surveys demonstrated the strong upturn of the economy while Euro zone PMI suggested that the economy had made a strong start in 2011. UK services PMI declined in February while manufacturing PMI posted strong growth.

Looking ahead, fresh concerns about global growth prospects had emerged with the sharply rising food and energy prices threatening to fan inflationary pressures and raise inflation expectations. Oil prices, in particular, could rise on geopolitical concerns in North Africa and the Middle East, a major oil-producing region. In the United Kingdom, where economic conditions were still fragile, higher inflation could lead to a faster withdrawal of monetary stimulus while in the euro area, the risks of a major debt crisis had faded but were still present.

The MPC noted that global inflation had increased broadly across regions mainly on higher food and energy prices. Many central banks, in both advanced and emerging economies, had either already tightened monetary policy or were considering starting the process of normalisation soon.

The outlook for food prices remained bullish due to strong fundamentals: poor weather affecting supply, strong demand from emerging economies and inventory declines. The Food and Agriculture Organisation Food Price Index had risen for the eighth consecutive month to an all-time high of 236 points in February 2011 and was likely to stay high and even rise further until supply conditions started easing. Global oil prices had also firmed since the December 2010 MPC meeting, with both NYMEX WTI and ICE Brent rising to their highest levels in March 2011 since September 2008. While stronger global economic conditions continued to be the main driver of oil prices, the levels reached recently were also due to supply disruptions amid political unrest in the Middle East and North Africa and events in Japan, which is the world's third biggest oil consumer.

Domestic developments and outlook

In Mauritius, the latest available data pointed to more buoyant than expected growth in 2010, at an estimated 4.4 per cent. Looking ahead, the real economy was forecast to grow by around 4.6 per cent in 2011.

National accounts data for the third quarter of 2010 showed that the seasonally-adjusted real growth rate had rebounded by 2.8 per cent quarter-on-quarter following growth of 1.7 per cent in the second quarter and a contraction of 0.6 per cent in the first quarter.[1] Economic expansion had been broad-based with a strong recovery noted in manufacturing, which grew by 1.5 per cent following a contraction of 4.9 per cent in the second quarter. Within manufacturing, the textile sector expanded significantly by 13.6 per cent after contracting in the first two quarters of 2010 while other manufacturing growth turned slightly positive. The growth momentum slowed somewhat in the hotels and restaurants and construction sectors but remained at appreciable rates. While agriculture, transport, storage and communications, financial intermediation and real estate, renting and business activities continued to register fairly buoyant growth, real activity continued to contract, albeit at a slower rate, in the food sector and in distributive trade.

Overall for the year ending in the third quarter 2010, real growth rate of the domestic economy surged to 5.4 per cent compared to 2.8 per cent in the second quarter with all key sectors of the economy expanding. Strong expansion was expected to be maintained in the fourth quarter.

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[1] *At the time the MPC met, the Central Statistics Office had not yet published its quarterly national accounts estimates for the fourth quarter of 2010.*

By main expenditure categories, household consumption expenditure growth accelerated in the third quarter of 2010 while growth in gross domestic fixed capital formation also picked up in the third quarter. By type of capital goods, building and construction work made sizeable progress, driven by a surge in other construction work on account of public infrastructure projects, while investment in machinery and equipment contracted.

The higher growth rate combined with higher import prices translated into a higher deficit of the current account of the balance of payments in the final quarter of 2010 to 8.5 per cent of GDP.

The most recent available information indicated a relatively strong recovery in key export sectors but some domestic oriented sectors remained weak. Adjusted for nominal effective exchange rate effects, the increase in exports was more evident. Business confidence, overall, was improving and market reports suggested increased external demand for manufacturing, resulting mainly from higher labour costs in competitor countries. In the tourism sector, international tourist arrivals were on the rise and although tourist earnings lagged behind as heavy price discounting continued, prospects were optimistic for 2011. Domestic data broadly matched international trends with a sustained increase in tourist arrivals and earnings, which adjusted for exchange rate effects, were close to 2008 levels.

While the pace of economic growth had firmed, the MPC observed that downside risks, arising mainly from high food and energy prices amid geopolitical uncertainty, remained significant.

The MPC took note of the latest price developments and discussed the inflation outlook. External price developments had strongly influenced domestic prices and domestic inflation had risen much faster than anticipated at the September and December 2010 MPC meetings. Headline inflation had risen from 2.5 per cent in November 2010 to 2.9 per cent and 3.6 per cent in December 2010 and February 2011, respectively. The MPC's preferred year-on-year measure of inflation had surged from 3.9 per cent in November 2010 to 6.1 per cent in December 2010 and further to 6.8 per cent in February 2011.[2]

[2] *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. 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.*

There was clear evidence that underlying inflation pressures had accentuated as reflected in the rapid rise of core measures of inflation. Year-on-year CORE1 and CORE2 inflation had risen to 6.4 per cent and 5.1 per cent, respectively, in February 2011 from 3.7 per cent and 3.1 per cent in November 2010 while the 12-month average CORE1 and CORE2 had increased to 3.7 per cent and 3.2 per cent in the same month. The increase in CORE2, in particular, which strips the CPI basket of food, beverages, tobacco, mortgage interest, energy prices as well as administered prices, signals that second-round effects were developing.

The course of domestic inflation in the near term was likely to be conditioned by international commodity prices, inflation in supplier countries, the extent of pass-through of import prices to consumer prices and exchange rate developments. Higher growth in emerging markets had been pushing up demand for commodities, in particular food and energy, and might shift prices upward permanently. The prospect of oil prices increasing to levels reached in 2008 and perhaps beyond over a prolonged period would add to inflationary pressures. Recent market indicators had suggested that international commodity prices were likely to rise further.

On the basis of Staff's estimates, the negative output gap had been closing down rapidly and domestic market conditions that had largely induced firms to keep prices stable to sustain market share might no longer hold in the near term. The MPC took note of the Inflation Expectations Survey carried out by the Bank in February, which had revealed that expectations for higher prices by June 2011 had risen, and was of the view that extreme prudence in price-setting behaviour and wage compensation policies was warranted to prevent cascading price effects. Over the medium term, how inflation expectations and wage demands to compensate for higher cost of living would develop were key factors determining the future course of inflation.

On a no-policy change basis, the Bank forecast year-on-year inflation to reach 7.8 per cent by June 2011 and 7.0 per cent by December 2011 while headline inflation could exceed 5 per cent by June 2011 and reach around 8 per cent by December 2011.

The MPC weighed the risks to the growth and inflation outlook over the policy relevant horizon and discussed alternative interest rate scenarios. Although the risks to the growth outlook over the medium term remained, the MPC judged that the balance of risks has tilted towards the inflation outlook as the upside risks have increased. While some concern was expressed that the recovery was not entrenched enough to warrant tightening of monetary policy, the MPC, taking into consideration the expected narrowing of the output gap, gauged it important to start the process of normalising the Key Policy Rate to anchor inflation expectations and prevent the recent rise in consumer price inflation from generating second-round effects. The need to maintain a positive real rate of interest in the current environment was also underlined. It was noted that a co-ordination of monetary and fiscal measures could help in better containing inflationary pressures.

The MPC will continue to monitor economic and financial developments and remains committed, as per its mandate, to formulate and determine monetary policy with a view to maintaining price stability and promoting the orderly and balanced economic development of Mauritius.

Voting Pattern

The MPC voted with a majority of 5 to 3 to raise the Key Repo Rate by 50 basis points to 5.25 per cent per annum. Of the other three members, two voted for a rise of 25 basis points and one voted to maintain the Key Repo Rate unchanged.

Date for Regular Meeting

The MPC will convene its next quarterly meeting on 13 June 2011. It, however, 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
5 April 2011