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 25 basis points to 5.50 per cent per annum at its regular meeting held on 13 June 2011. The interest rate chargeable on the Special Deposits Facility, set at 100 basis points below the Key Repo Rate, is 4.50 per cent per annum while the interest rate on the Overnight Facility, set at 150 basis points above the Key Repo Rate, is 7.00 per cent per annum. The interest rate payable on the Standing Facility, set at 400 basis points above the Key Repo Rate, is 9.50 per cent per annum.

The MPC reviewed economic and financial developments in the international and domestic economies before reaching its decision.

International developments and outlook

Although the global economic recovery had slowed since the last MPC meeting, mainly as a result of high energy prices and the disruptive effects of the Japanese earthquake on production and spending, it was likely to be sustained for the year 2011 with uneven progress across regions. Growth had remained subdued in advanced economies but was rapid in emerging and developing countries.

In its April 2011 World Economic Outlook, the International Monetary Fund had maintained the global growth projection for 2011 at 4.4 per cent. It had marginally downgraded the output growth forecast for advanced economies by 0.1 percentage point to 2.4 per cent and left that of emerging and developing economies unchanged at 6.5 per cent. Reflecting the underlying upturn in global economic activity, world trade volumes had increased by 3.6 per cent quarter-on-quarter in the first quarter of 2011, with a strong rebound in US trade while Japanese exports had collapsed.

The US economy had continued to improve, albeit at a slower pace. It grew at an annualised rate of 1.8 per cent in the first quarter of 2011, down from 3.1 per cent in the last quarter of 2010, mainly on declines in real consumption, construction activity and federal spending. Reflecting the muted US recovery, the unemployment rate had edged up to 9.1 per cent in May 2011. Going forward, however, the stabilisation in oil prices and the payroll tax cuts introduced at the start of 2011 were expected to boost consumer spending and output growth.

The euro zone had fared better in the first quarter of 2011, with real GDP expanding by 0.8 per cent compared to a growth of 0.3 per cent in the last quarter of 2010. Wide divergences, however, persisted among the euro area countries. Growth in Germany and France, driven by domestic and external demand, had jumped to 1.5 per cent and 1.0 per cent, respectively, in the first quarter of 2011, from 0.4 per cent and 0.3 per cent in the fourth quarter of 2010. Activity had remained sluggish in Spain at 0.3 per cent while Italy had underperformed with a growth rate of 0.1 per cent.

Real output growth in the UK had rebounded to 0.5 per cent in the first quarter of 2011, offsetting the weather-related contraction of 0.5 per cent experienced in the fourth quarter of 2010. While growth performance had been positively affected by net exports, which benefited from the relatively more favourable international economic environment and the depreciation of the Pound sterling, it had suffered from contractions in private consumption and gross fixed capital formation.

Manufacturing and services survey data in May 2011 were consistent with the decline in global growth. The Global Purchasing Managers' Index (PMI) for manufacturing fell as new orders and inventory accumulation moderated significantly following the major supply and demand shocks to Japan's economy while the global services PMI remained well below the levels reached at the beginning of the year. PMI surveys for the US, euro area and UK all predicted slower rates of expansion in these economies in the second quarter of 2011.

Looking ahead, however, real economic growth is expected to rise during the second half of 2011 as global manufacturing improves. The global economic recovery is thus anticipated to remain broadly on track for the year as a whole despite significant downside risks in a few specific economies. In the euro zone, in particular, sovereign debt sustainability problems in the periphery continue to weigh on the growth outlook while in the UK, prolonged high unemployment, the erosion of purchasing power and on-going fiscal consolidation are likely to keep the household sector weak.

The MPC noted that global inflationary pressures had receded lately as commodity prices moderated. The Food Price Index of the Food and Agriculture

Organisation had declined from the all-time high of 237.2 reached in February 2011 to 232.1 in April 2011 as decreases in dairy, sugar and rice price indices more than offset the sharp increase in international grain prices. Global oil prices had fallen sharply in recent weeks from the higher levels reached in April and early May 2011 as investors fled for safety amid concerns about the slower global growth and geopolitical risks in the Middle East.

However, global inflation had remained high. Headline inflation in the US, euro area and UK had continued to increase since the last MPC meeting but was still subdued compared to inflation in fast-growing emerging economies. Many central banks in emerging economies are engaged in monetary policy tightening.

While seasonal and geopolitical factors are expected to affect global food and energy prices in the short-term, the underlying strength of the global economy, especially in emerging and developing economies, supports the view that commodity prices would remain at elevated levels and even resume their uptrend in the medium term.

Domestic developments and outlook

In Mauritius, the economy had evolved as broadly anticipated at the last MPC meeting, driven by buoyant activity in key sectors of the economy. Over the year ending in the fourth quarter 2010, the domestic economy had grown by 5.5 per cent compared to 5.4 per cent in the third quarter. On current conditions, the GDP growth forecast was maintained at 4.6 per cent in 2011 but could end up higher if the uncertainties clouding the economic prospects of some of the country's trading partners abate.

Revised national accounts data for the fourth quarter of 2010 indicated that the seasonally-adjusted pace of economic expansion had accelerated to 4.4 per cent quarter-on-quarter compared to 2.6 per cent in the previous quarter. The main boost to growth had come from manufacturing, which surged by 17.4 per cent in the fourth quarter, up from 3.6 per cent in the third quarter. Within manufacturing, the food subsector had strongly recovered by 17.0 per cent following a contraction in the previous quarter while other manufacturing had jumped by a remarkable 25.3 per cent. Growth in the textile subsector and in construction had slowed but remained robust at 9.4 per cent and 6.0 per cent, respectively. A slowdown was also noted in real estate, renting and business activities whereas growth in transport, storage and communications and financial intermediation gathered speed and distributive trade, mining and quarrying and electricity, gas and water supply bounced back into positive territory. Agriculture and hotels and restaurants contracted in the fourth quarter of 2010 while growth in export-oriented enterprises accelerated to 15.0 per cent.

Household consumption expenditure growth had picked up in the fourth quarter of 2010 while gross domestic fixed capital formation, excluding the purchase of aircraft and marine vessel, improved modestly. By type of capital goods, moderate growth was recorded in building and construction work, driven mainly by investment in residential building, but investment in machinery and equipment had contracted. The MPC noted that private sector investment had been stagnant in 2010 following a contraction in the previous year while public sector investment, excluding aircraft and marine vessel, had expanded at a slower rate than in 2009.

The current account deficit of the balance of payments improved to 5.0 per cent of GDP in the first quarter of 2011 as robust net travel receipts in the services account contributed to offset the larger deficit of the merchandise account caused by higher import prices. However, the capital and financial account closed the first quarter of 2011 with a lower surplus as foreign direct investment in Mauritius slowed significantly to Rs1.0 billion, from Rs4.0 billion a year ago.

The most recent available information showed that key export sectors remained the main drivers of growth. Year-on-year nominal exports *f.o.b* growth had outpaced nominal imports *f.o.b* growth by about 3.4 percentage points in the first quarter of 2011. Against an overall improvement in business confidence, market reports suggested that manufacturing was being propped up by sustained external demand given the global recovery and rising costs of production in some competitor countries. In the tourism sector, activity continued to improve amid growing signs that the sector was gradually regaining pre-crisis momentum. Tourist arrivals kept growing at appreciable rates, with encouraging signs of market diversification, while tourist earnings in the first four months of 2011 surpassed 2008 levels.

The MPC noted the latest price developments and discussed the inflation outlook. While external price developments had continued to influence domestic prices, administrative measures taken by Government to cut prices of selected food items and reduce petroleum prices in April 2011 had contributed to limit the gains in the Consumer Price Index (CPI) in that month. Largely as a result of the temporary negative price shock, year-on-year inflation had slowed a little from 7.2 per cent in March 2011 to 7.0 per cent in April 2011 but it had thereafter increased marginally to 7.1 per cent in May 2011. Headline inflation had, however, maintained its uptrend, rising to 4.4 per cent in April and further to 4.8 per cent in May 2011 from 3.6 per cent in February 2011 and 4.0 per cent in March 2011.[1]

There was clear evidence that underlying inflation pressures were still present in the economy. The year-on-year CORE2 measure of inflation, which strips the CPI basket of food, beverages, tobacco, mortgage interest, energy and administered prices, and reflects second-round effects, was down slightly to 5.8 per cent in May 2011 after it had increased to 6.0 per cent in April 2011 from 5.4 per cent in March 2011. Year-on-year CORE1 inflation had increased to 7.0 per cent in May 2011 following a 0.4 percentage point dip to 6.6 per cent in April 2011. On a 12-month average period, both CORE1 and CORE2 inflation had sustained the vigorous pace of the previous months, rising to 4.6 per cent and 4.1 per cent, respectively, in May 2011.

The MPC noted that the Inflation Expectations Survey carried out by the Bank in May 2011 had shown that expectations for higher prices one year ahead had risen.

While external developments would continue to be a key driver of domestic inflation dynamics in the short to medium term, domestic factors were gaining importance. On the basis of Staff's estimates, the negative domestic output gap was estimated to close gradually in the coming quarters, indicating that inflationary pressures might be building up from the demand side. A determining element in the future course of inflation remains the evolution of the rupee exchange rate. While the rupee had broadly appreciated since January 2011, thus contributing to contain increases in prices, lower private capital inflows could potentially change the exchange rate outlook and hence the inflation outlook.

On current conditions, the Bank forecast headline inflation to remain strong until the end of this year. Subsequently, it is projected to decline to around 5.4 per cent by June 2012, much above the level reached during the first half of 2010, while year-on-year inflation is expected to reach 4.4 per cent.

The MPC weighed the risks to the growth and inflation outlook over the policy relevant horizon and discussed alternative interest rate scenarios. Although risks to the growth outlook continued to exist over the medium term, the MPC judged that the balance of risks remained tilted towards the inflation outlook as underlying

[1] *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.*

inflationary pressures showed no signs of abating. A view was expressed that the current economic slowdown could justify a pause in the tightening of monetary policy. However, taking into consideration the expected improvement in global growth and the domestic output gap nearing zero, the MPC judged it important to continue the process of normalising the Key Policy Rate to further anchor inflation expectations and prevent the high 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.

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 25 basis points to 5.50 per cent per annum. The other three members voted to keep the Key Repo Rate unchanged.

Date for Regular Meeting

The MPC will convene its next quarterly meeting on 12 September 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
20 June 2011