BANK OF MAURITIUS

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MONETARY POLICY STATEMENT

The Monetary Policy Committee (MPC) of the Bank of Mauritius unanimously decided to maintain the Key Repo Rate unchanged at 5.50 per cent per annum at its regular meeting held on 12 September 2011. The interest rate chargeable on the Special Deposits Facility, set at 100 basis points below the Key Repo Rate, remains 4.50 per cent per annum while the interest rate on the Overnight Facility, set at 150 basis points above the Key Repo Rate, remains 7.00 per cent per annum. The interest rate payable on the Standing Facility, set at 400 basis points above the Key Repo Rate, remains 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

At the last MPC meeting, it had been expected that the global economy would rebound in the second semester of 2011 as the adverse impact of the Japanese disasters and commodity price surge unwound. However, global economic activity deteriorated and global output growth is now expected to recover more slowly than had been anticipated due to heightened uncertainty. Growth had moderated to a greater extent in advanced economies compared to emerging and developing countries.

In its June 2011 World Economic Outlook Update, the International Monetary Fund had revised slightly downward the global growth projection for 2011 by 0.1 percentage point to 4.3 per cent. It had downgraded the growth projection for advanced economies by 0.2 percentage point to 2.2 per cent and marginally upgraded that of emerging and developing economies by 0.1 percentage point to 6.6 per cent. More recent forecasts made by other institutions had, however, downgraded expected growth rates much more significantly. Reflecting the downturn in global economic activity, world trade volumes had decreased by 0.6 per cent quarter-on-quarter in the second quarter of 2011, with declines in most regions except Africa, the Middle East and Japan.

In the US, revised data showed that the economy had come close to contracting in the first quarter of 2011 while it was estimated to have expanded at an annualised rate of 1.0 per cent in the second quarter. Along with persistently high unemployment, weak consumer spending and the prospect of significant fiscal tightening in 2012 had continued to weigh on business sentiment. Forward-looking indicators pointed to deteriorating manufacturing activity and a faltering US economic outlook even though declining energy prices and an extremely accommodative monetary policy might cushion some of the weakness in the economy.

The euro zone economy nearly came to a halt in the second quarter of 2011, growing by a mere 0.2 per cent quarter-on-quarter compared to growth of 0.8 per cent in the first quarter, held back by the underperformance of core economies. Growth had stagnated in France and had slowed to 0.1 per cent in Germany as consumer and investor confidence were negatively affected by the intensification of the euro area sovereign debt crisis. Comparatively, real activity had grown by 0.2 per cent in Spain and 0.3 per cent in Italy. Forward-looking indicators signalled euro area growth would likely remain sluggish in the quarters ahead as fallouts from the sovereign debt crisis spread across the region.

In the UK, real output growth had fallen to a modest 0.2 per cent in the second quarter of 2011, from 0.5 per cent in the first quarter, as foreign trade did not manage to compensate for weak domestic demand against the backdrop of slow real income growth and uncertainty over employment prospects. Consumer and investor confidence had remained low and looked prone to be further affected by the turmoil in financial markets and the dim global growth outlook.

Growth in emerging economies had stayed generally robust in the second quarter of 2011 although there were signs of moderation as global economic activity softened. Persistent high inflation, which had necessitated continuous tightening of monetary policy, had also contributed to slow the expansion of emerging economies.

Manufacturing and services survey data pointed to sustained fragile global economic conditions. The Global Purchasing Managers' Index (PMI) for manufacturing had continued to fall due to the near-stalling of the manufacturing sector, with a decline in the new orders component to 49.4 in August 2011, from 51.0 in June 2011, suggesting increased vulnerability to the subdued aggregate demand environment. The global services PMI had also declined to levels well below those reached at the beginning of the year. PMI surveys for the US, euro area and UK had all predicted slower rates of expansion in these economies in the third quarter of 2011.

The MPC noted that global commodity prices had eased to more sustainable levels since its last meeting. 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 231.1 in August 2011, driven by decreases in dairy, and oil & fats price indices. Global oil prices had remained volatile, dropping sharply in August 2011 on renewed pessimism about the global economic outlook before picking up to some extent subsequently.

Global inflation, which had emerged as a key policy concern at the start of 2011, fuelled by strong commodity prices and strong pace of economic growth in emerging economies, had shown signs of slowing down in several economies. However, it was still higher in emerging economies compared to advanced economies. Against the background of weakening global growth prospects, a number of central banks in advanced and emerging economies had maintained interest rates at current levels.

Given lower optimism about the pace of growth in the US and the euro zone, the risk of a new round of rapidly rising international commodity prices had lessened. However, there were still significant concerns that supply constraints could continue to pose upside risks to the inflation outlook, especially in fast-growing emerging economies.

Domestic developments and outlook

In Mauritius, the underlying growth momentum had remained broadly positive although it had eased on a sharp contraction in the construction sector and a slowdown in the distributive trade and hotels and restaurants sectors. The Mauritian economy was expected to continue on its growth path even though the growth projection for 2011 had been revised slightly downwards by 0.2 percentage point to 4.4 per cent.

Over the year ending in the first quarter 2011, the domestic economy had expanded by 3.8 per cent compared to 5.1 per cent in the preceding quarter. Output growth in manufacturing had improved to 4.7 per cent, led by strong activity in the textile and other manufacturing sub-sectors, but had slowed to 3.1 per cent and 3.6 per cent in distributive trade and hotels and restaurants, respectively. Transport, storage and communications had expanded at a moderate pace of 4.4 per cent while financial intermediation and real estate, renting and business activities both continued to register robust growth rates of 6.6 per cent. Construction and agriculture had contracted by 11.7 per cent and 2.3 per cent, respectively, in the first quarter.

Household consumption expenditure growth had decelerated to 2.5 per cent year-on-year in the first quarter of 2011, after growth of 3.1 per cent in the last quarter of 2010, underlining the loss in output growth momentum. Gross domestic fixed capital formation had declined by 4.7 per cent as a strong rebound in machinery and equipment had not been enough to offset a significant fall in building and construction work as a result of weakening non-residential investment. Excluding aircraft and marine vessel, private sector investment was expected to grow at 0.3 per cent in 2011 following zero growth in 2010 while public sector investment was projected to expand at 11.0 per cent compared to 18.9 per cent in 2010.

The current account deficit of the balance of payments had deteriorated to Rs8.5 billion in the second quarter of 2011, from Rs3.4 billion in the previous quarter, largely explained by a marked quarter-on-quarter decline of 48.4 per cent in net invisibles surplus. However, the capital and financial account had recorded a higher surplus of Rs5.7 billion compared to Rs1.2 billion in the previous quarter as foreign direct investment picked up to Rs1.2 billion in the second quarter of 2011 and portfolio investment recorded a net inflow of Rs1.3 billion.

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 *c.i.f* growth by about 4.4 percentage points in the first semester of 2011. Activity in manufacturing and in textile, in particular, had been sustained. The sector was supported by a number of factors, of which the rise in production costs in some competitor countries that had contributed to shift orders to domestic enterprises. The tourism sector had continued to perform well. Tourist arrivals had risen by 5.1 per cent over the period January to July 2011 compared to the same period in the preceding year, with significant increases recorded from non-traditional markets, while tourist earnings had expanded by 8.4 per cent.

The MPC noted the latest price developments and discussed the inflation outlook. Year-on-year inflation had slightly eased from 7.1 per cent in May 2011 to 6.5 per cent in August although between June and July, it had crept up 0.1 percentage point. Headline inflation had continued to rise to reach 5.5 per cent in July 2011 and 5.8 per cent in August 2011, from 4.8 per cent and 5.1 per cent in May and June 2011, respectively. Base effects reflecting lower inflation in the preceding twelve months as well as substantial increases in the CPI in December and in early 2011 accounted for the average increase in inflation.[1]

While the three core measures of inflation showed a mixed picture in August 2011, they broadly suggested that underlying inflation pressures were still present in the economy. Year-on-year CORE1 inflation declined from 7.0 per cent in May 2011 to 5.9 per cent in June 2011 before rising again to reach 6.4 per cent in July 2011. It fell back to 5.7 per cent in August 2011. Year-on-year CORE2 fell for the fourth month running to ease to 4.8 per cent in August 2011. On a 12-month average period, both CORE1 and CORE2 inflation continued to rise. CORE1 picked up to 5.5 per cent in August 2011, from 4.6 per cent in May 2011 while CORE2 rose to 4.7 per cent, from 4.1 per cent in May 2011. TRIM10 inflation stood at 5.1 per cent in August 2011 compared to 4.4 per cent in May 2011.

The MPC noted that the Inflation Expectations Survey carried out by the Bank in August 2011 had shown that the mean inflation expectation one year ahead had risen.

External factors were expected to remain a major driver of domestic inflation dynamics in the short to medium term against the backdrop of rather tame domestic demand and muted wage pressures. On the basis of Staff's estimates, the domestic economy had continued to operate below its trend capacity. While the negative output gap was expected to close gradually, it might be at a slower pace than previously projected, reflecting developments in major export markets. Much of the future course of inflation would depend on the domestic exchange rate outlook, which for now appeared relatively stable. Private capital inflows were considered adequate but should they fall short of financing the current account deficit, some inflationary pressures could arise from the exchange rate channel.

On current conditions, the Bank forecast headline inflation to reach 6.6 per cent by the end of this year while year-on-year inflation would reach 5.1 per cent. Subsequently, on a no-policy-change basis, headline inflation is projected to decline to around 5.1 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 4.3 per cent.

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[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.*

The MPC weighed the risks to the growth and inflation outlook over the policy relevant horizon and discussed alternative interest rate scenarios. The risks to the growth outlook were seen to have increased in the light of recent developments in the global economy although the MPC did not fully share the mood of pessimism that seemed to prevail among certain economic operators. While the risks associated with the inflation outlook had evolved slightly more favourably since the last MPC meeting, reflecting a gradual moderation in global commodity prices, underlying inflationary pressures still existed. The MPC considered it important to anchor inflation expectations and minimise the risk of second-round effects. The need to achieve a positive real rate of interest in the current environment was also underlined. However, taking into consideration the increased uncertainty generated by the euro area debt crisis and the worsening growth prospects in the country's main trading partners, the MPC decided to put on hold the process of normalising the Key Repo Rate, started in March 2011.

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 unanimously voted to keep the Key Repo Rate unchanged at 5.50 per cent per annum.

Date for Regular Meeting

The MPC will convene its next quarterly meeting on 5 December 2011. It will, however, maintain strong vigilance over unfolding economic developments and 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.

Change in MPC Proceedings

With a view to enhancing transparency and accountability in the decision-making process of the MPC, the MPC will start publishing the minutes of its meetings and the votes of its individual members as from the December 2011 meeting.

Bank of Mauritius
19 September 2011