



Mauritius

*2014 Article IV Consultation
Martin Petri, February 2014*

Strengthening the Monetary Transmission Mechanism



Summary and Outline

- Key repo rate (KRR) pass-through to lending works
- Pass-through to interbank rate (IR) is not effective
- Excess liquidity causes the disconnect
- Excess liquidity has other negative consequences
- Excess liquidity can be removed with T-bills
 - BOM does not have enough T-bills to remove liquidity
 - BOM would need to pay interest on deposits to share costs
 - Removing excess liquidity is contractionary
 - Using T-bills instead of BOM paper helps T-bill market
- Moving to formal flexible Inflation Targeting (IT) would improve the effectiveness of monetary policy

Economic Outlook For 2014

- Growth at 3.7 percent
- Investment expected around 23 percent of GDP
- Year-on-year inflation at 4.5 percent, average 3.8%
- Consolidate budget deficit 4.5 percent of GDP, compared to 4.5% in 2013 but only 2.1% in 2012
- Government debt 59.9 percent of GDP at end-2013
- External current account deficit 8.7 percent of GDP relative to 9.1% in 2013, but with stable financing
- Reserves are comfortable at 4.4 months of imports; authorities could continue to build buffers

Monetary Transmission Mechanism in Two Steps

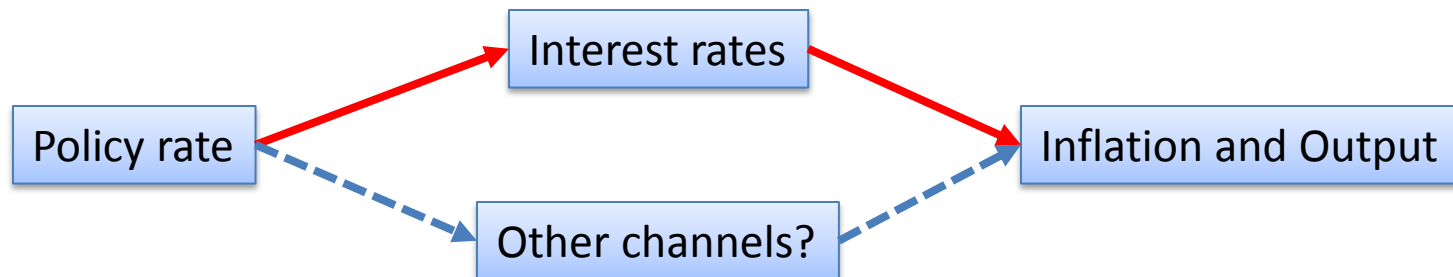
→ Step 1: Policy rate pass-through to interest rates

- Partially effective

→ Step 2: interest rates to inflation and output

- Depends on structural factors of the economy

→ Will focus on interest rate pass-through



Transmission Mechanism Empirically

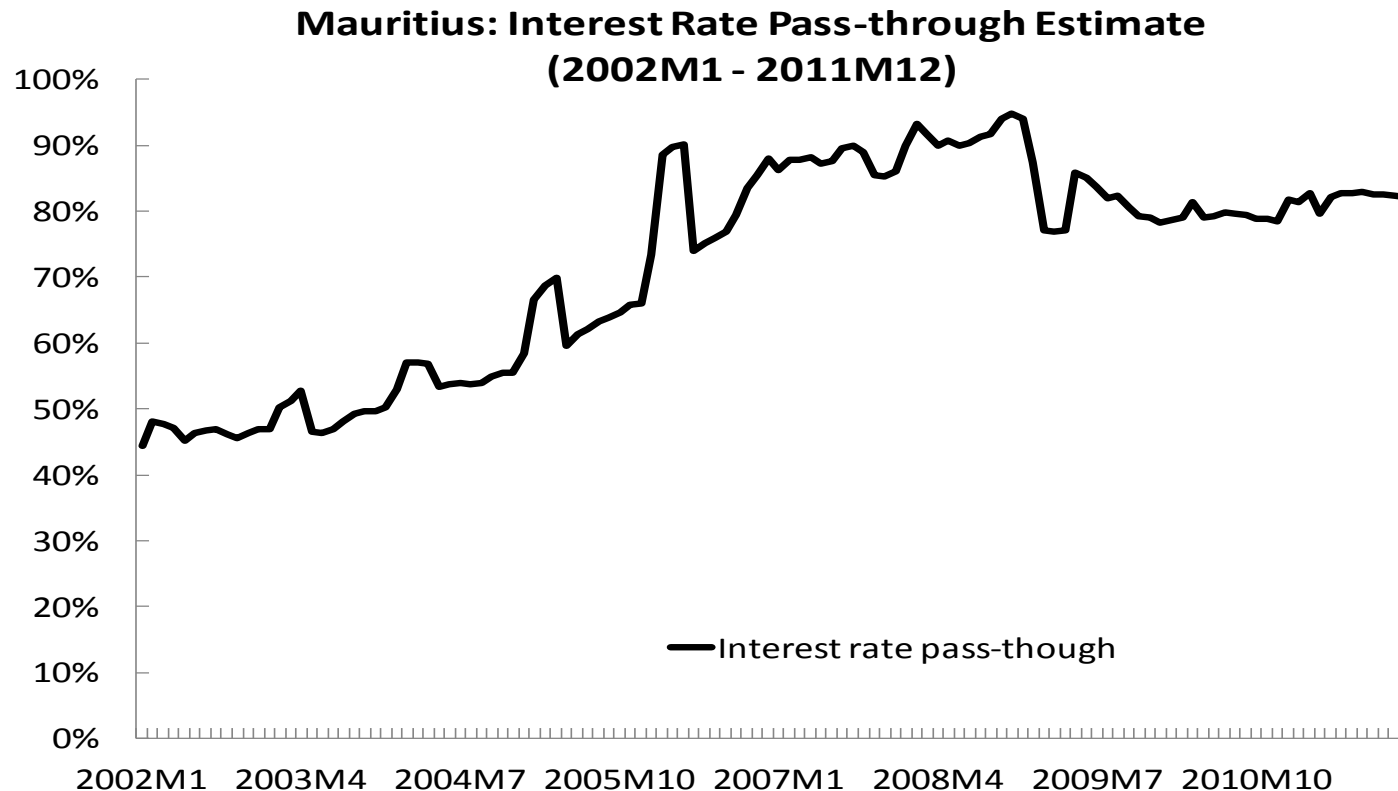
- ...describes how *monetary policy* affects
 - The price level
 - *Real* variables such as aggregate output and employment

- Transmission in Mauritius: Tsangarides (2010), VAR model
 - Policy rate has a statistically significant but small impact on CPI inflation
 - Policy rate impact on output is weak
 - Possibly because of many administered prices
 - Results are subject to data and empirical methodology limitations

- How to improve the monetary transmission mechanism?

Interest rate pass-through: Mauritius

- Policy rate to lending rate pass-through improved over the period
 - BOM Switching from Lombard rate to Key Repo rate



Sources: Saborowski and Weber (2013)

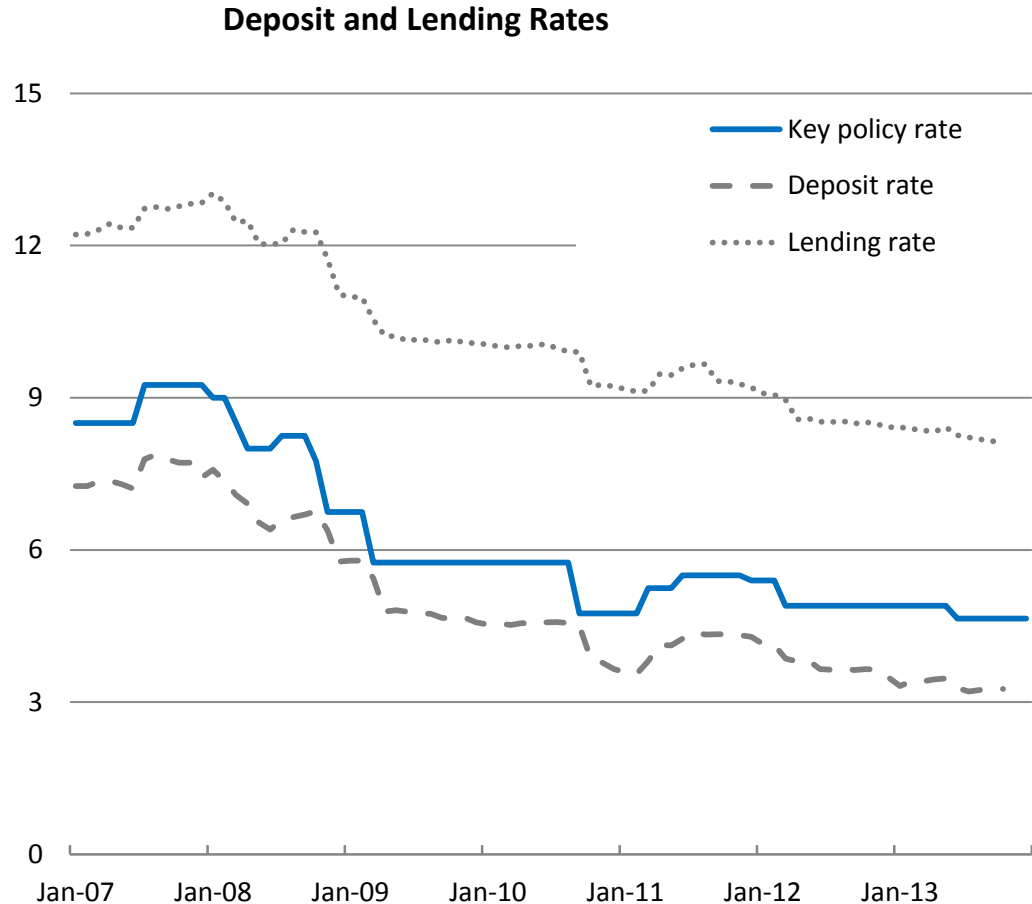
KRR Pass-Through to Bank Interest Rates

→ Deposit and lending rates appear to respond to policy rate changes...

→ But, deposit rates are declining.

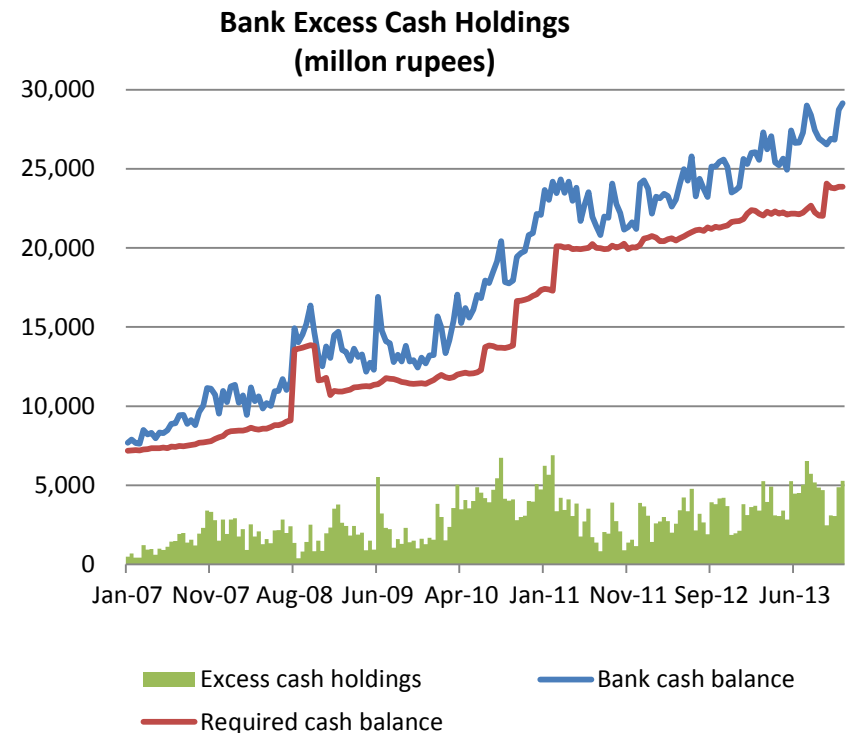
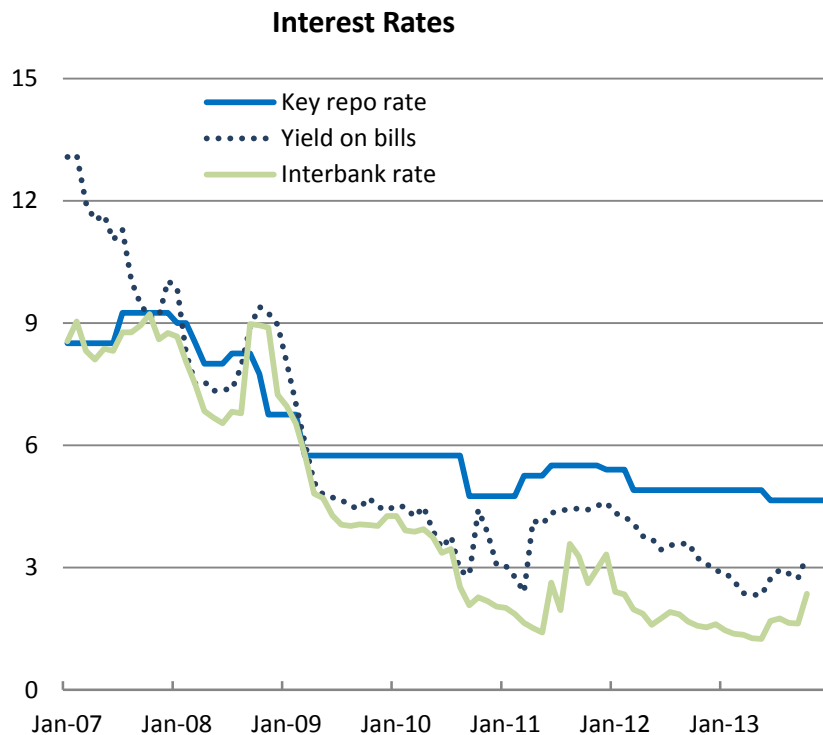
→ Spreads seem to be increasing.

→ Spreads are related to cash ratio, special banking levy, and excess liquidity



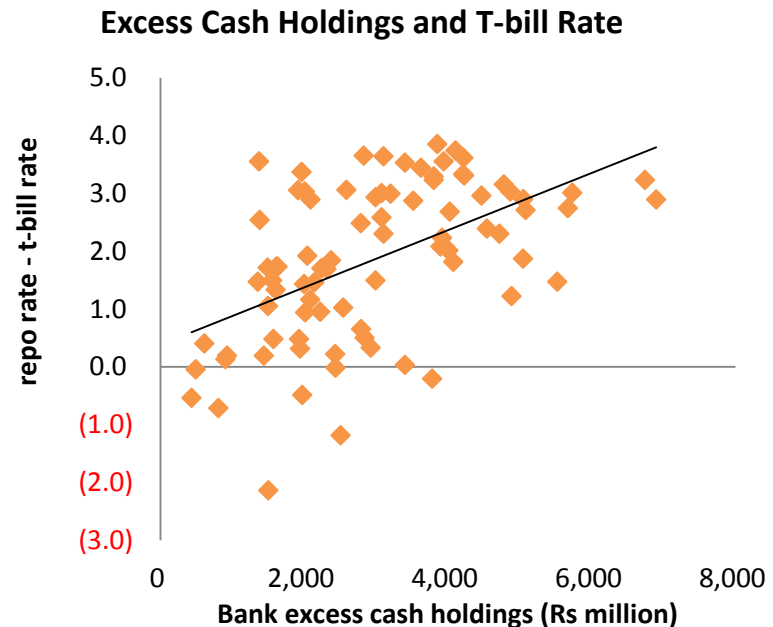
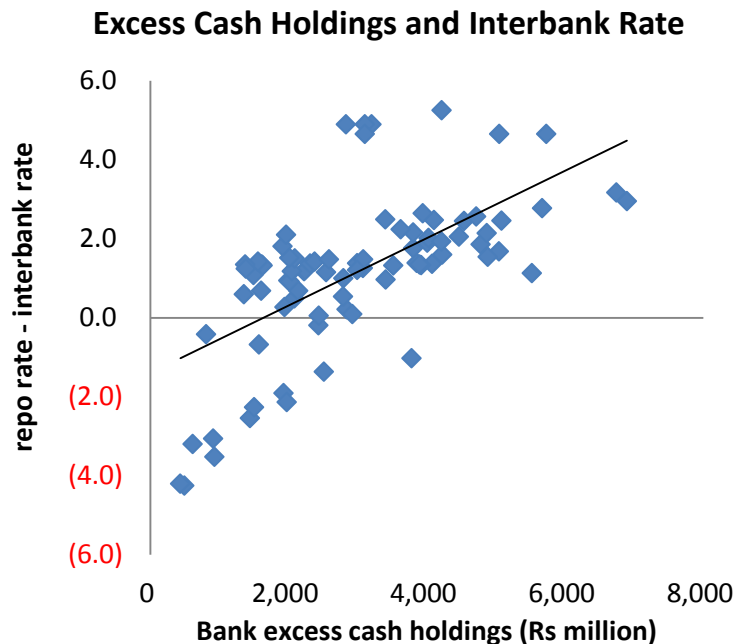
KRR Pass-Through to Market Interest Rates

- Banks have excess cash since 2007; Rs 6 billion end-2013.
- BOM has issued BOM bills and increased cash ratio.
- There are two transmission mechanisms.



Excess Liquidity and Monetary Policy

- There is a positive correlation between excess cash and repo/interbank interest rate gap...
- Excess liquidity is harmful for MP and the financial system
 - Loss of control over monetary transmission mechanism
 - Financial disintermediation because banks do not want deposits
 - Banks have an incentive to engage in potentially risky business



Improving the Transmission Mechanism

- MOFED issues government paper for MP purposes
 - BOM decides on quantity; MOFED on maturities
 - BOM pays interest on government deposits to share costs
 - Total to be issued around Rs 30 billion (almost 8% GDP)
 - BOM's balance sheet can support losses
- Helps develop government securities market
 - One instrument instead of two
 - Banks forced to use interbank market
- Removing excess liquidity is contractionary
 - Could simultaneously decrease KRR for neutrality
 - Would need to be communicated carefully

Moving to Flexible Inflation Targeting (IT)

- Most requirements for IT are in place
 - Forecasting capacity needs to be improved
 - Objectives could be clarified (medium-term price stability and short-term output stabilization)
- MP likely more effective with IT than discretion
 - Increased credibility leaves more room for stabilization
 - Decreased inflation risk premia help the overall economy
- Considerations before moving to flexible IT
 - Choice of inflation target and range
 - Accountability and communications mechanisms
 - Consider medium-term inflation-indexed notes