BANK OF MAURITIUS

# INFLATION REPORT

November 2008

*Acknowledgement*

The preparation of this Report was led by Mr W. Khodabocus, Chief-Monetary Policy Unit. The draft has benefited from the comments of a number of officers before being cleared by the Publications Review Committee of the Bank of Mauritius. Substantive contributions were made by the following officers: Mr W. Khodabocus and Mr F. Sooklall for the chapter on *Overview*; Mrs P. S. Hurree-Gobin, Ms M. Jhamna and Ms M. Mudhoo for the chapter on *Demand and Output*; Mrs P. S. Hurree Gobin and Mr G. Beegoo for the chapter on *Recent Developments in Inflation*; Mrs P. Lo Tiap Kwong, Mr G. Beegoo, and Mr C. Ellapah for the sections on *Monetary and Credit Developments* and *Interest Rates*; Mr K. Pitteea and Mr N. Daworaz for the sections on *Money Market* and *Foreign Exchange Market and Exchange Rates*; Mr J. N. Bissessur, Mr W. Khodabocus and Dr H. Kasseeah for the chapter on *The Outlook for Inflation*. The Boxes in the Report were contributed by the following officers: Ms M. Mudhoo and Mr N. Daworaz - *Price Stability*; Dr H. Kasseeah - *The Neutral Real Interest Rate*; Mr C. Ellapah - *Summary of Findings of the Household Budget Survey 2006-07*; and, Mr J. N. Bissessur - *Inflation Fan Chart*.

Inflation Report November 2008

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The Bank of Mauritius welcomes any comments or suggestions on this publication.
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# INFLATION REPORT

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## List of Tables, Charts and Boxes

*Boxes*



## List of Acronyms

| | |
|---|---|
| **BML** | Broad Money Liabilities |
| **COICOP** | Classification of Individual Consumption by Purpose |
| **CPI** | Consumer Price index |
| **CSO** | Central Statistics Office |
| **ECB** | European Central Bank |
| **FAO** | Food and Agriculture Organisation |
| **FDI** | Foreign Direct Investment |
| **GDP** | Gross Domestic Product |
| **HBS** | Household Budget Survey |
| **IMF** | International Monetary Fund |
| **IPE** | International Petroleum Exchange |
| **MPC** | Monetary Policy Committee |
| **NYMEX WTI** | New York West Texas Intermediate |
| **OPEC** | Organisation of the Petroleum Exporting Countries |
| **SEMDEX** | Stock Exchange of Mauritius Index |

# Foreword

It is with great pleasure that I present the first issue of the Bank's *Inflation Report*.

The *Inflation Report* is released in compliance with section 33(2)(b) of the Bank of Mauritius Act 2004. The Bank will henceforth publish the *Inflation Report* twice a year to meet the statutory requirement.

The primary object of the Bank is to "maintain price stability and to promote orderly and balanced economic development". As part of its functions, the Bank is required to "conduct monetary policy and manage the exchange rate of the rupee, taking into account the orderly and balanced economic development of Mauritius". Price stability has important economic and welfare implications and makes the fight against inflation an important goal of economic policy. It is certainly an overarching objective of the Bank as given in its mandate.

The formulation and determination of monetary policy is entrusted to the Monetary Policy Committee, as laid down under sections 54 and 55 of the Bank of Mauritius Act 2004. The Monetary Policy Committee meets to set the key Repo Rate with a view to achieving the primary object of price stability. It regularly reviews domestic as well as international economic and financial developments before taking monetary policy decisions.

Since the establishment of the Monetary Policy Committee in April 2007 – and in line with requirements of the central bank legislation on transparency – the Bank has adopted a communication strategy aimed at clarifying its monetary policy stance for the benefit of stakeholders and wider public. In addition to the press conference which I give, generally on the day following the Monetary Policy Committee meeting, to explain the monetary policy decision, the assessment motivating the decision is further elaborated in the *Monetary Policy Statement* which is released one week after each meeting.

The *Inflation Report* analyses more extensively the information already disseminated. It aims to enhance the public's understanding of the policies applied to achieve the objective of price stability and provide further insight into price developments.

Each bi-annual *Inflation Report* will normally focus on price developments and the assessment underpinning monetary policy for the two quarters ending June and December. Exceptionally, the coverage of the first issue spans over the year to June 2008. The first issue of the *Inflation Report* is being released in November 2008 and the next issue is planned for release in March 2009. As we move ahead, forecasts and empirical analyses will be included to allow for better understanding of the basis of monetary policy decisions.

We welcome your views and comments on this inaugural edition of the *Inflation Report*.

Rundheersing Bheenick
*Governor*

26 November 2008

# 1. Overview

Driven by increases in food and energy prices on international markets, consumer price inflation breached historical averages in a large number of countries in 2007 as well as in the first half of 2008. Soaring prices of these commodities have impacted to varying degrees on individual country's inflation rate. In emerging economies, their relatively larger weights in the consumption basket of goods and services have resulted in substantial increases in inflation rates.

Mounting global inflationary pressures have evidently not spared Mauritius. As a highly open small economy, prices of imported commodities have important implications in domestic price formation. As a consequence, the rate of inflation in Mauritius has hovered around relatively high levels in the year to June 2008. Based on preliminary assessments, however, inflationary pressures originating from domestic supply and demand factors were subdued.

The *Inflation Report* provides an analysis of inflation developments. It first assesses the external and domestic economic environment and elaborates on the monetary policy stance of the Bank of Mauritius. The analysis thereafter focuses on recent developments in inflation and how demand and output as well as monetary and financial developments have evolved. The outlook for inflation is presented in the last section.

## 1.1 THE EXTERNAL ENVIRONMENT

### Growth

In the second half of 2007, besides the prevalence of strong inflationary pressures, the world economy faced downside risks to growth stemming principally from the turmoil in international financial markets, triggered by the United States sub-prime mortgage crisis. Global economic prospects were projected to deteriorate markedly in 2008 after several years of robust growth, mainly on account of subsiding consumer sentiment and as the global financial market turbulence was expected to be protracted. Economic prospects in Western Europe, which constitutes Mauritius' main export market, were undermined by the financial strains, a weaker external demand due to the economic downturn in the United States and housing cycles trending downward in some countries.

According to the International Monetary Fund's World Economic Outlook released in October 2008, global output growth would decline from 5.0 per cent in 2007 to a projected 3.9 per cent in 2008. In advanced economies, growth would fall from 2.6 per cent to an estimated 1.5 per cent in 2008.

Emerging and developing countries were expected to post a moderate but fairly strong growth of 6.9 per cent in 2008 compared to 8.0 per cent in 2007. Relatively high growth rates in some of the economies were driven by productivity gains, commodity price boom and improved macroeconomic policy-making. The impact of the economic slowdown in the United States on Asia was to some extent offset by growing domestic demand, intra-regional trade and accommodative policies. Table 1.1 provides details on growth in selected economies.

Table 1.1: Real Growth Rates in Selected Economies

*Annual percentage change*

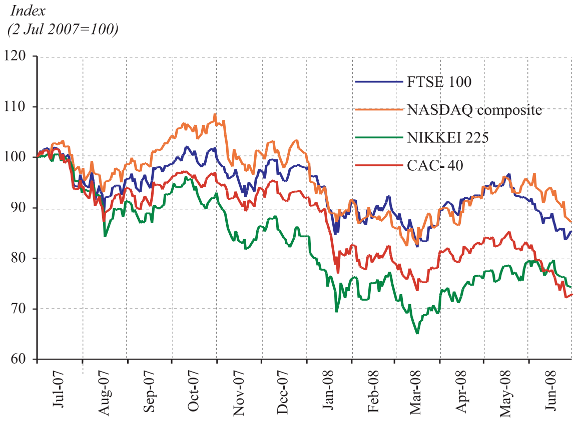
| | 2004 | 2005 | 2006 | 2007 | 2008 *Projection* |
|---|---|---|---|---|---|
| **World output** | **4.9** | **4.5** | **5.1** | **5.0** | **3.9** |
| **Advanced economies** | **3.2** | **2.6** | **3.0** | **2.6** | **1.5** |
| *of which* United States | 3.6 | 2.9 | 2.8 | 2.0 | 1.6 |
| Euro area | 2.1 | 1.6 | 2.8 | 2.6 | 1.3 |
| Japan | 2.7 | 1.9 | 2.4 | 2.1 | 0.7 |
| United Kingdom | 2.8 | 2.1 | 2.8 | 3.0 | 1.0 |
| **Emerging market and developing economies** | **7.5** | **7.1** | **7.9** | **8.0** | **6.9** |
| Sub Saharan Africa | 5.9 | 6.0 | 6.6 | 6.9 | 6.1 |
| Developing Asia | 8.6 | 9.0 | 9.9 | 10.0 | 8.4 |
| *of which* China | 10.1 | 10.4 | 11.6 | 11.9 | 9.7 |
| India | 7.9 | 9.1 | 9.8 | 9.3 | 7.9 |

*Source: Various issues of the International Monetary Fund's World Economic Outlook.*

## International stock markets

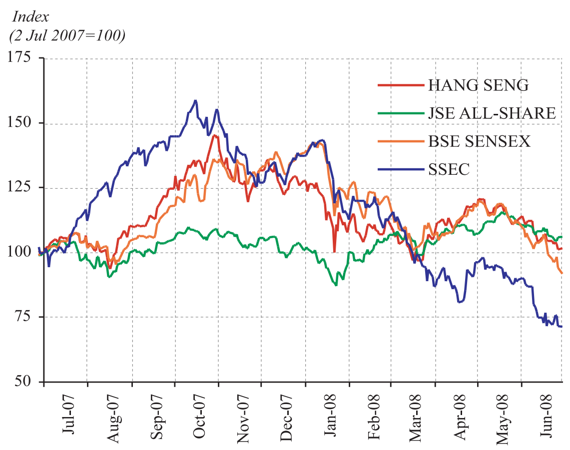
The international financial crisis triggered in August 2007 spread throughout global financial markets and led to significant volatility in major international stock markets. Major equity markets, concerned about the adverse repercussions the turmoil could exert on corporate earnings, plummeted from November 2007 till early 2008. The slight recovery observed in April and May 2008 was short-lived. As credit concerns resurfaced and inflationary pressures intensified on rising food and energy prices, economic growth slowed in major economies and global stock markets pared away gains by June 2008. The movements of major stock market indices are shown in Chart 1.1.

Chart 1.1: Equity Indices of Selected Major International Stock Markets




*Source: Reuters.*

Chart 1.2: Equity Indices of Selected Emerging Stock Markets




*Source: Reuters.*

Contrasting with earlier episodes of financial disruption, emerging stock markets showed significant resilience initially. The outbreak of the sub-prime crisis in August 2007 was accompanied by an upsurge in most emerging market equities as investors fled to safer assets. But as the financial markets turmoil deepened by late 2007, these stock markets became nervous and lost momentum. Chart 1.2 shows the evolution of indices of selected emerging stock markets.

## Inflation

Inflation increased globally, sparked off mainly by rising food and energy prices. In almost all economies, actual consumer price inflation overshot targets or historical averages. Bad weather conditions tightened supply of cereals while, on the demand side, biofuels programmes exerted upward pressure on cereal prices. The price of crude oil recorded unprecedented increases largely due to geopolitical tensions in supplier countries and OPEC's decision not to increase supply. Moreover, unabated growing demand from China and India and speculation in commodity markets led to further price increases. The inflation rates of selected economies are shown in Table 1.2.

Table 1.2: Consumer Prices

*Annual percentage change*

| | 2004 | 2005 | 2006 | 2007 | July 2007 | June 2008 |
|---|---|---|---|---|---|---|
| United States | 2.7 | 3.4 | 3.2 | 2.9 | 2.4 | 5.0 |
| Euro area | 2.1 | 2.2 | 2.2 | 2.1 | 1.8 | 4.0 |
| United Kingdom | 1.3 | 2.0 | 2.3 | 2.3 | 1.9 | 3.8 |
| Hungary | 6.8 | 3.6 | 3.9 | 7.9 | 8.4 | 6.7 |
| Turkey | 8.6 | 8.2 | 9.6 | 8.8 | 6.9 | 10.6 |
| China | 3.9 | 1.8 | 1.5 | 4.8 | 5.6 | 7.1 |
| India | 3.8 | 4.2 | 6.2 | 6.4 | 6.5 | 7.7 |
| Hong Kong | -0.4 | 0.9 | 2.0 | 2.0 | 1.5 | 6.1 |
| Indonesia | 6.1 | 10.5 | 13.1 | 6.2 | 6.1 | 11.0 |
| South Korea | 3.6 | 2.8 | 2.2 | 2.5 | 2.5 | 5.5 |
| Philippines | 6.0 | 7.7 | 6.2 | 2.8 | 2.6 | 11.4 |
| Singapore | 1.7 | 0.5 | 1.0 | 2.1 | 2.6 | 7.5 |
| Thailand | 2.8 | 4.5 | 4.6 | 2.2 | 1.7 | 8.9 |
| South Africa | 1.4 | 3.4 | 4.7 | 7.1 | 7.0 | 12.2 |

*Source: IMF's World Economic Outlook, The Economist and central banks' websites.*

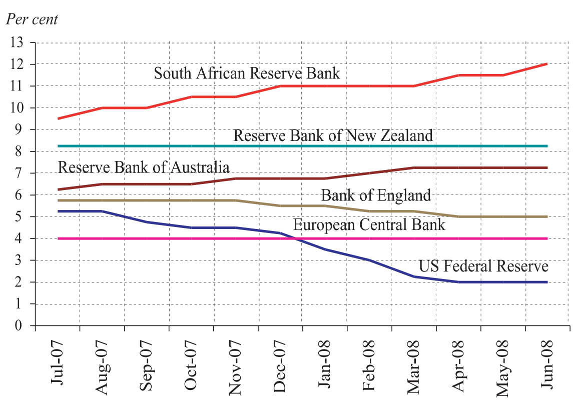
## Monetary policy in selected economies

Central banks in most major economies remained concerned in 2007 about potential upside risks to inflation and monetary policy was tightened in several countries such as Australia, Canada, euro area, India, New Zealand, Norway, South Africa, Switzerland and United Kingdom.

However, towards the end of 2007 through March 2008, a few central banks reduced their policy interest rates as the financial markets crisis intensified and consumer sentiment deteriorated, thereby increasing the risk of a recession. The US Federal Reserve cut its policy interest rate as from September 2007. The Bank of Canada followed suit by cutting its policy interest rate. With the crisis spilling over to the financial system of the United Kingdom and posing downside risk to economic growth, the Bank of England decreased its policy interest rate as from December 2007 despite the fact that inflation was above the 2 per cent target.

The European Central Bank (ECB) raised its policy interest rate on two occasions in 2007 to 4.00 per cent on a worsening inflation outlook. The financial market turmoil, however, spawned downside risks to economic activity, constraining further interest rates increases. In June 2008, however, the ECB indicated it could hike its policy rate to contain second-round effects and risks to price stability over the medium-term.

Chart 1.3: Major Central Banks' Interest Rates




*Source: Central banks' websites.*

A number of central banks continued tightening monetary policy in the first half of 2008 in the light of threats of higher inflation. In New Zealand, however, there was a shift to an easing bias against the backdrop of an economic slowdown and as domestic cost of funds reacted to higher borrowing costs abroad. Chart 1.3 depicts movements in interest rates of selected central banks.

## 1.2 THE DOMESTIC ENVIRONMENT

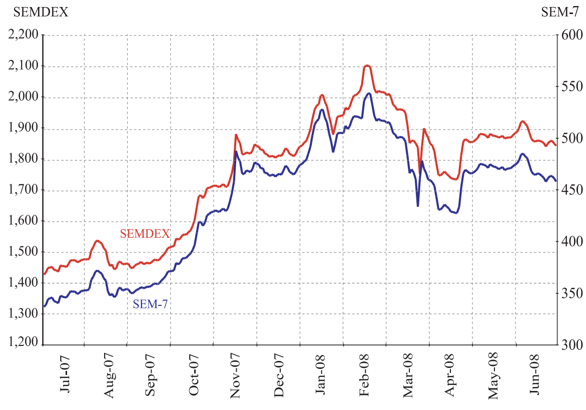
### Growth

The domestic economic environment was characterised by robust growth although some downside risks were anticipated as from the first half of 2008, falling unemployment rate, and declining but persistently high inflationary pressures emanating mainly from higher food and energy prices on the international market. The economy grew at a real rate of 5.4 per cent in 2007 and was forecast to grow by 5.6 per cent in 2008. Growth was being driven principally by the services industry, a trend that is likely to persist. The economic downturn in Mauritius' main export markets, if protracted, could enhance downside risk to growth in the short-term.

### Stock market

Despite uncertainty surrounding financial markets internationally, the local stock market remained bullish throughout 2007 supported by a booming economy.

Chart 1.4: SEMDEX and SEM-7




*Source: Stock Exchange of Mauritius Ltd.*

The SEMDEX rose to an all-time high of 2,101.34 points on 18 February 2008 before undergoing a correction between March and mid-April 2008, partly explained by a fall in net foreign purchases due to profit-taking. The stock market recovered thereafter on the strength of mainly blue chip stocks in the banking and hotel industry but registered mixed performance in June 2008. The SEMDEX gained 29.1 per cent in the year to June 2008 while the SEM-7 went up by 34.0 per cent.[1]

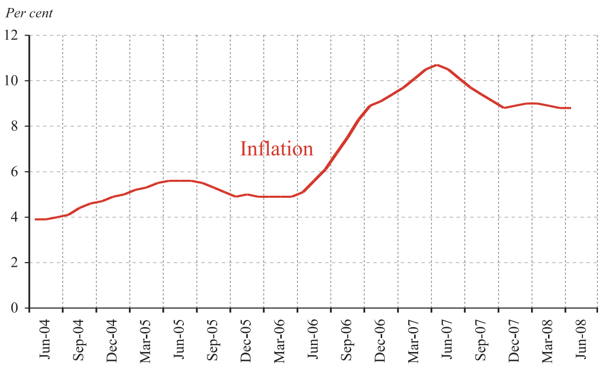
## Exchange rate

Strong inflows of foreign exchange, emanating mainly from Foreign Direct Investment (FDI), caused the rupee to appreciate on average vis-à-vis major international currencies from early 2007 through April 2008. Thereafter, the exchange rate of the rupee recorded some volatility up to the end of June 2008, with a slight depreciation noted in May and June 2008. Overall, the appreciation of the rupee helped to some extent to mitigate the impact of rising prices of imported commodities on inflation.

## Inflation

Reflecting food and energy price increases to staggering levels on the world market, the sub-index of food and energy within the overall Consumer Price Index (CPI) remained on an increasing path driving inflation to 10.7 per cent in June 2007, an all-time high in over a decade and a half.[2] Thereafter, inflation gradually subsided to reach 8.8 per cent in December 2007 before picking up moderately in the first quarter of 2008 to 9.0 per cent in March 2008.

Chart 1.5: Evolution of the Inflation Rate




*Source: CSO, Government of Mauritius.*

Inflation retreated slightly to 8.8 per cent in June 2008. Chart 1.5 illustrates the evolution of the inflation rate.

## 1.3 MONETARY POLICY

The role of the Bank of Mauritius in monetary policy-making has evolved significantly over the past decade or so. The process of economic diversification and integration of the economy with the rest of the world, which have concurrently increased its vulnerability to external shocks, have imparted greater significance to the conduct of monetary policy.

The Bank of Mauritius currently uses the key Repo Rate as the policy interest rate to signal its monetary policy stance.[3] The two main channels through which changes in the key Repo Rate affect economic activity and, ultimately, inflation are through the effects on lending and deposit activities, and through the exchange rate of the rupee. In terms of implementing monetary policy decisions, once the level of the key Repo Rate has been set, the Bank of Mauritius would then initiate measures to ensure that market interest rates move coherently with the new level of the policy interest rate. The interest rates chargeable on the Special Deposits Facility, the Overnight Facility as well as the Standing Facility of the Bank of Mauritius are simultaneously adjusted with the changes in the key Repo Rate.

Nowadays, monetary policy decisions in the majority of central banks around the world are increasingly taken by committees whose mandate is well specified in their legislation. The committees generally comprise experts familiar

1 *The SEM-7 comprises the seven largest Mauritian companies, measured in terms of market capitalisation, whose shares are on the Official List.*

2 *Consumer Price Index (CPI) inflation, also known as headline inflation, refers to the rate of change in the overall CPI published by the Central Statistics Office (CSO). Headline inflation thus captures the changes in the cost of living based on the movements of the prices of items in the basket of commodities and services consumed by the typical Mauritian household. The rate of inflation is calculated as the percentage change between the average CPI during a twelve-month period and the average CPI during the corresponding previous twelve-month period.*

3 *The key Repo Rate was introduced on 18 December 2006.*

## Box 1: Price Stability

The primary objective of most central banks is to safeguard the value of the domestic currency in terms of what it can purchase at home. Price stability plays a very important role in central banking and is the primary objective of monetary policy. It is a means by which policy can achieve its other objectives, such as promoting a stable macroeconomic environment conducive to economic growth.

According to Alan Greenspan, former Chairman of the Board of Governors of the US Federal Reserve System, *"… for all practical purposes, price stability means that expected changes in the average price level are small enough and gradual enough that they do not materially enter business and household decisions".*

A number of central banks usually define price stability relative to a certain numerical target. The table that follows summarises the inflation objective of selected central banks. Broadly defined, price stability is a low and stable rate of change in the aggregate price level in an economy.

### Inflation Targets of Selected Central Banks

| Country | Target | Underlying Index |
|---|---|---|
| Australia | 2 to 3 per cent on average | CPI |
| Canada | 1 to 3 per cent, with monetary policy aiming at the 2 per cent midpoint | CPI; operational guide is core CPI (excludes 8 volatile components and indirect taxes) |
| Euro area | Below but close to 2 per cent | Harmonised Index of Consumer Prices (HICP) |
| New Zealand | 1 to 3 per cent over the medium-term | CPI |
| South Africa | 3 to 6 per cent | CPI excluding mortgage interest cost |
| Thailand | 0 to 3.5 per cent | Quarterly Average core CPI (excludes raw food and energy) |
| United Kingdom | 2 per cent | CPI |

*Source: Central banks' websites.*

The Bank of Mauritius Act 2004 states that the primary object of the Bank of Mauritius is to maintain price stability and to promote orderly and balanced economic development. The Act also stipulates that the Bank of Mauritius will determine, with the concurrence of the Minister of Finance and Economic Empowerment, the accepted range of the rate of inflation during a given period consistent with the price stability objective. The price stability objective is guided by developments in consumer price inflation as measured using the CPI. However, the Bank of Mauritius also monitors core inflation *(see footnote 4 for a definition)* as part of broad inflationary indicators in the economy.

Price stability promotes efficiency and long-term growth by providing a monetary and financial environment in which economic decisions can be made and markets can operate without concern about unpredictable fluctuations in the purchasing power of the domestic currency. High and variable inflation degrades the quality of signals coming from the price system. Producers as well as consumers find it difficult to distinguish price changes arising from changes in product supplies and demands from changes arising from general inflation.

High inflation complicates long-term economic planning, creating incentives for households and firms to shorten their planning horizons. They then tend to spend resources in managing inflation risk rather than focusing on more productive activities. When prices are stable, people can hold money for transactions and other purposes without having to worry that inflation will erode the real value of their money balances. Equally important, stable prices act as a measure of value when making long-term contracts, engaging in long-term planning, or borrowing or lending for long periods.

Recent evidence has shown not only that low and stable inflation is beneficial for growth and employment in the long-term but also that it contributes importantly to greater stability of output and employment in the short- to medium-term. In addition, higher inflation may lead to loss of international competitiveness and balance of payments deterioration.

Price stability also contributes to the objective of moderate long-term interest rates. As first pointed out by the economist Irving Fisher, interest rates will tend to move in tandem with changes in expected inflation, as lenders require compensation for the loss in purchasing power of their principal over the period of the loan. When inflation is expected to be low, lenders will require less compensation, and thus interest rates will tend to be low as well. In addition, because price stability and the associated macroeconomic stability reduce the risks of holding long-term bonds and other securities, price stability may also reduce the premia that lenders charge for bearing risk, lowering the overall level of rates.

with the economy and monetary policy. Decision-taking by committees introduces greater transparency and enhances credibility in the monetary policy-making process. Ultimately, this mechanism helps to better anchor inflation expectations.

## Monetary Policy Committee

As laid down in section 4(1) of the Bank of Mauritius Act 2004, the primary object of the Bank of Mauritius is to maintain price stability and to promote orderly and balanced economic development. The Bank of Mauritius Act 2004 provides under sections 54 and 55 for the establishment of the Monetary Policy Committee (MPC). Initially, the MPC was required by law to submit its findings and recommendations to the Board of Directors of the Bank of Mauritius which took the final monetary policy decision. The Bank of Mauritius Act 2004 was, however, amended in August 2007 to empower the MPC to formulate and take the final decision on the monetary policy to be conducted by the Bank of Mauritius.

The MPC was launched on 23 April 2007. The law stipulates that the MPC shall comprise eight members, namely, the Governor of the Bank of Mauritius as chairperson, the two Deputy Governors, two Board Directors and three external members. Two observers and one honorary adviser have also been appointed to sit on the MPC.

The MPC met every two months at the outset. Effective September 2007, it agreed to meet on a quarterly basis but to convene interim meetings as and when the need arose. The MPC announces its decision by issuing a communiqué immediately after a meeting and a *Monetary Policy Statement* a week later to explain its decision. The voting pattern is also disclosed.

## Monetary policy decisions

The MPC was established at a time of rising inflation. Consumer price inflation had reached peak levels in over more than a decade and a half, driven by rising oil and food prices, the pass-through of the depreciation of the rupee that occurred in the second half of 2006 into prices of consumer products and the increase in excise duties. Given upside risks to inflation and inflationary expectations becoming entrenched, the monetary policy stance was tightened following the meeting of the MPC on 30 June 2007. The key Repo Rate was increased by 75 basis points effective 2 July 2007, from 8.50 per cent to 9.25 per cent per annum.

At its meeting on 21 August 2007, the MPC assessed that the pace of economic growth was strong, the trade-weighted exchange rate of the rupee had stabilised and money growth was moderate. Upside risks to inflation were viewed as subdued. Consequently, following the unanimous recommendation of the MPC, the key Repo Rate was kept unchanged at 9.25 per cent per annum.

Domestic macroeconomic conditions had strengthened and both headline and core inflation rates had trended downwards from their peaks attained in June 2007 by the time the MPC met on 5 December 2007.[4] The rupee had appreciated in nominal terms against a basket of major trading partners' currencies, thereby contributing to dampen pressures on prices. However, upside risks to inflation stemming from persistently higher oil and food prices continued to weigh on the inflation outlook. The global economic outlook remained positive in spite of some downside risks emanating from the turbulence in international financial markets. Against this backdrop, the MPC

[4] *Core inflation measures the change in average consumer prices after excluding from the CPI certain items with volatile price movements. The Bank calculates three measures of core inflation by using the exclusion and statistical approaches. The first measure, CORE1, is obtained using the exclusion-based approach and strips "Food, Beverages and Tobacco" and mortgage interest on housing loan from headline inflation. The second measure, CORE2, also an exclusion-based approach further excludes energy prices and administered prices from the overall CPI. The third measure, TRIM10, truncates 5 per cent of each tail of the distribution of price changes. The methodological note on core inflation published by the Bank is available at* http://bom.intnet.mu/pdf/Research_and_Publications/Research_Papers/WRITEUP.pdf.

unanimously voted to leave the key Repo Rate unchanged at 9.25 per cent per annum.

A special meeting of the MPC was convened on 6 February 2008 to principally review the implications of the reductions in policy interest rates by a number of major central banks. Also, in the wake of the turmoil in international financial markets, the International Monetary Fund (IMF) had projected global output growth to slow down in 2008. The potential downside risks to domestic economic growth arising from the slowdown of economic activity in major trading partners were a cause for concern. On the other hand, the domestic rate of inflation had declined from 10.7 per cent in June 2007 to 8.8 per cent in December 2007 and the inflation outlook had improved marginally. Given these considerations, the MPC was unanimous in its decision to cut the policy interest rate with a majority voting in favour of cutting the key Repo Rate by 25 basis points to 9.00 per cent per annum. The interest rate cut also underscored the need to have interest rate differentials that were compatible with the maintenance of domestic financial and monetary stability.

Following the meeting of the MPC on 24 March 2008, the key Repo Rate was further reduced by 50 basis points to 8.50 per cent per annum. The MPC judged that, against the backdrop of weakening global economic prospects, the downside risks to the domestic growth outlook outweighed the upside risks to inflation. The preliminary economic growth forecast of the CSO was 6.0 per cent for 2008. Although inflation picked up marginally to 9.0 per cent in February 2008, the short-term outlook was marred by high inflation expectations. Inflation was, however, projected to ease over the medium-term. The rupee has also appreciated in nominal effective terms as a result of strong and sustained capital inflows. However, the MPC expressed concern that exchange rate gains did not appear to have been fully reflected in consumer prices.

At the special MPC meeting convened on 2 May 2008, monetary policy was further eased with an additional 50 basis points reduction taking the policy interest rate to 8.00 per cent per annum. The global economy was losing momentum with accompanying potential adverse implications for the domestic export-oriented sectors. Concern was expressed that Mauritius, as a highly open small economy, might not be as resilient as larger emerging economies in withstanding external shocks. It was recognised that, backed by high oil and food prices, inflationary pressures still remained strong. The downside risks to growth were thus viewed as outweighing the upside risks to inflation. The MPC reiterated its call to economic operators in the import and distributive trade sectors to exercise restraint and reflect purely economic factors in pricing their products.

The 2008-09 budgetary measures coupled with the salary award in the public sector were foreseen to give a boost to consumption and, therefore, aggregate demand. In addition, monetary and credit conditions were viewed as accommodative. It was anticipated that the fiscal-monetary policy mix could intensify upside risks to inflation. Domestic economic growth prospects were uncertain given weak growth prospects in major export markets: but the easing of monetary policy in the past few months was likely to alleviate downside risks to growth. In its overall assessment of the growth and inflation outlook at the meeting held on 20 June 2008, the MPC concluded that, though inflationary pressures had intensified, downside risks to economic growth remained a major concern. It decided with a majority of votes to maintain the key Repo Rate unchanged at 8.00 per cent per annum. However, the view was expressed that the policy interest rate should be increased to combat inflationary pressures. The MPC concurrently recognised that the balance of risk between inflation and growth might change, which might warrant a reassessment of the monetary policy stance.

The decisions on the key Repo Rate are summarised in Table 1.3.

Table 1.3: Decisions on the Key Repo Rate [a]

| Date of MPC meeting | Decision on the key Repo Rate | Effective date of decision | Key Repo Rate (post-decision level, per cent per annum) | Voting pattern | Details on voting pattern [b] |
|---|---|---|---|---|---|
| 30 June 2007 | Increase by 75 basis points | 2 July 2007 | 9.25 | 6 - 3 | See Note 1 |
| 21 August 2007 | Unchanged | - | 9.25 | Unanimous | See Note 2 |
| 5 December 2007 | Unchanged | - | 9.25 | Unanimous | - |
| 6 February 2008 | Reduce by 25 basis points | 6 February 2008 | 9.00 | 5 - 3 | 3 - reduce by 50 basis points |
| 24 March 2008 | Reduce by 50 basis points | 24 March 2008 | 8.50 | 6 - 2 | 1 - reduce by 25 basis points<br>1 - unchanged |
| 2 May 2008 | Reduce by 50 basis points | 2 May 2008 | 8.00 | 6 - 1 | 1 - unchanged |
| 20 June 2008 | Unchanged | - | 8.00 | 5 - 2 | 1 - hike by 100 basis points<br>1 - hike by 50 basis points |

a : *The key Repo Rate was introduced at 8.50 per cent per annum on 18 December 2006.*

b : *The final decisions on the key Repo Rate for the June and August 2007 MPC meetings were taken by the Board of Directors of the Bank of Mauritius. The MPC took the final decision on the key Repo Rate as from the December 2007 meeting.*

***Notes:***

1 : *6-3 represents the voting pattern of the Board of the Bank of Mauritius. The MPC voting pattern on the key Repo Rate was as follows: 3 members voted for a 75 basis points hike; 3 members voted for a 50 basis points hike; and, one member voted for a reduction of 50 basis points.*

2 : *The MPC unanimously recommended to leave the policy interest rate unchanged and the Board of the Bank of Mauritius agreed with the recommendation.*

## Box 2: The Neutral Real Interest Rate

The concept "neutral interest rate" is generally associated with the real interest rate level. The neutral real interest rate (NRI) is defined as the level of real interest rate consistent with stable inflation and a closed output gap. Output gap is the difference between actual and potential output, which is the output level consistent with stable inflation over time.

The NRI is a benchmark for evaluating monetary policy stance as it provides a broad indication of the level of interest rates where monetary policy is neither expansionary nor contractionary. A central bank generally uses its policy interest rate to influence short-term market interest rates. When short-term real market interest rates are above the NRI, monetary policy is set to restrain economic growth. On the other hand, when short-term real market interest rates are below the NRI, monetary policy aims at stimulating economic activity. Hence, the NRI can be thought of as a benchmark, where a contractionary real interest rate is sometimes referred to as ‘above neutral’ and a stimulatory real interest rate is ‘below neutral’.

The NRI can change over time. The NRI is influenced by a host of factors which can make it time-varying. These include anything that might affect the risk premium for a country, the level of economic development, trend productivity growth, a credible monetary policy framework, structures of financial markets, and stability of inflation expectations.

### Estimation of the neutral real interest rate

The NRI cannot be observed and has to be estimated. Various methods can be used to estimate the NRI. Techniques include simple averaging of real interest rates over a long time period, the use of information contained in the market yield curve and the use of a multivariate filter in an economic model using the method of Kalman filtration. However, there are limitations to any methodologies used in the estimation.

Extensive research has been undertaken in the literature to estimate the NRI for a number of countries using a multivariate filter but the process always involves a number of assumptions and calibrations which result in a great deal of uncertainty attached to the estimates. Blinder (1998) states that: *"... the neutral real rate of interest is difficult to estimate and impossible to know with precision ...".* [*]

As part of on-going research, the Bank undertakes to estimate the neutral real interest rate that would provide a benchmark against which the monetary policy stance of the Bank can be evaluated.

[*] Blinder, A. S. (1998), *Central Banking in Theory and Practice, MIT Press*.

# 2. Recent Developments in Inflation

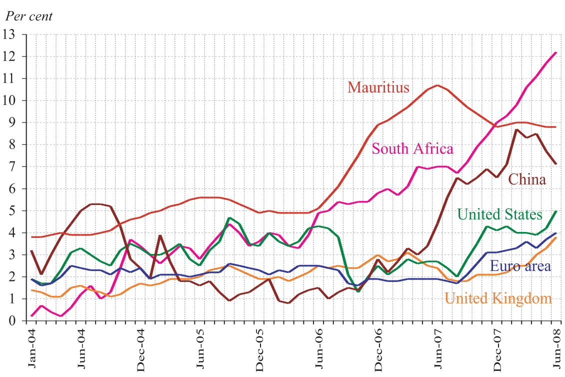
The acceleration of inflation has been a generalised worldwide phenomenon since 2007 with rising food and energy prices feeding into higher inflation rates. In Mauritius, domestic inflation reflected, to a large extent, price developments abroad. The analysis that follows examines recent trends in global and domestic inflation, and reviews developments in the indicators of inflation in Mauritius.

## 2.1 GLOBAL INFLATION AND COSTS

Commodity prices maintained their rapid ascent during the period under review. Against this background, most countries around the world experienced rising production cost pressures as a result of which inflation rose to high levels.

Inflation picked up significantly in some of the major trading partner countries of Mauritius, as shown in Chart 2.1. For instance, the euro area recorded an inflation rate of 4.0 in June 2008 compared to 1.8 per cent in July 2007, while in the United Kingdom it rose to 3.8 per cent from 1.9 per cent. In the United States, inflation went up substantially from 2.4 per cent in July 2007 to 5.0 per cent in June 2008. Inflation in South Africa rose markedly from 7.0 per cent in July 2007 to 12.2 per cent in June 2008. In China, inflation went up from 5.6 per cent to 7.1 per cent over the same period.

Chart 2.1: Evolution of Inflation in Selected Countries

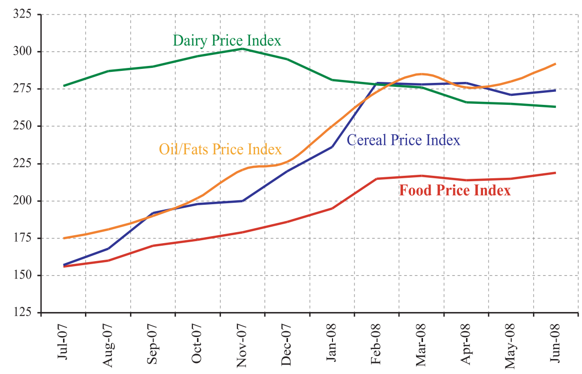



*Source: CSO, Government of Mauritius; central banks' and offices of national statistics websites.*

### Food prices

International prices of most agricultural commodities, which have risen sharply over the past two years, remained at high levels. As a result, increases in food prices have been dramatic in the year to June 2008. The food price index compiled by the Food and Agriculture Organisation (FAO) went up on average by 23.8 per cent in 2007 compared to 2006. From July 2007 to June 2008, the index rose by 40.4 per cent. The FAO food price index is shown in Chart 2.2.

Chart 2.2: FAO Food Price Index

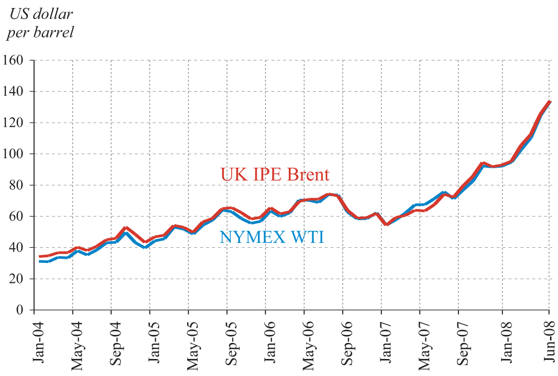



*Source: FAO website.*

### Oil prices

Oil prices maintained their upward trend, as shown in Chart 2.3. NYMEX WTI (West Texas Intermediate crude oil) averaged US$134.0 a barrel in June 2008, up from US$74.2 a barrel in July 2007. IPE Brent figures averaged US$133.8 a barrel in June 2008, up from US$75.8 a barrel in July 2007. Oil prices climbed to high levels due to a combination of factors including rising world oil consumption, low surplus production capacity, speculative activities, geopolitical tensions and a weaker US dollar. Oil markets, according to the Short Term Energy Outlook of the US Energy Administration Information, were likely to remain fundamentally tight, despite downside risks to global economic growth.

Chart 2.3: Movements in Monthly Average NYMEX WTI and IPE Brent




*Source: Reuters.*

## 2.2 HEADLINE AND CORE INFLATION

The CSO conducted the 8th Household Budget Survey (HBS) from July 2006 to June 2007.[5] With effect from July 2007, a new series for the CPI was introduced, which is computed on the basis of the updated basket of goods and services derived from the 2006-07 HBS. The base period for this new CPI series is the twelve-month period July 2006 to June 2007.

### Headline inflation

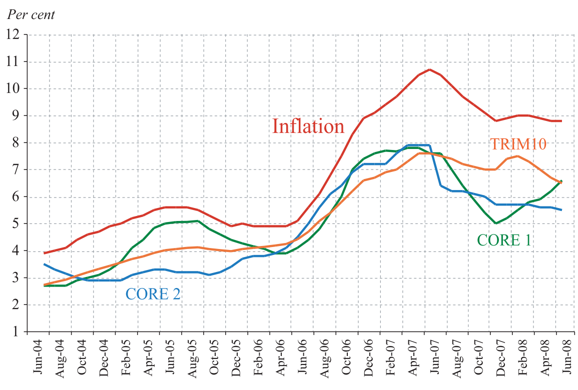
Inflation in Mauritius rose systematically as from mid-2006 to reach an all-time high in over a decade and a half in June 2007.[6] Inflation since July 2007 was driven mainly by supply-side factors, led by high and rising imported food and energy prices and the increase in freight rates. On the demand side, inflationary pressures stemming from domestic supply and demand factors appeared muted in the four quarters ended June 2008. The pass-through of the appreciation of the rupee vis-à-vis major trading partner countries' currencies as from the beginning of 2007 mitigated the impact of rising prices of imported commodities on prices of consumer goods.

Inflation reached a peak of 10.7 per cent in June 2007. It gradually subsided to 8.8 per cent in December 2007, with the decline partly reflecting the base effects of the CPI. Inflation rose to 9.0 per cent in February and March 2008 before dropping to 8.8 per cent in June 2008.

### Core inflation

Core inflation, an indicator of the underlying long-term trend of inflation, mirrored the movements of headline inflation. The three measures of core inflation rose consistently from mid-2006 to June 2007 but declined from July 2007 to June 2008 on a point-to-point basis.[7] From July 2007 to June 2008, CORE1 inflation dropped from 7.6 per cent to 6.6 per cent. CORE2 inflation declined from 6.4 per cent in July 2007 to 5.5 per cent in June 2008. TRIM10 inflation went down from 7.5 per cent in July 2007 to 6.5 per cent in June 2008. The evolution of headline and core inflation rates is shown in Chart 2.4.

Chart 2.4: Headline and Core Inflation Rates




*Source: Bank of Mauritius and CSO, Government of Mauritius.*

## 2.3 EVOLUTION OF MAJOR COMMODITY GROUP INDICES

From July 2007 to June 2008, the most significant increase in major commodity group indices was recorded in *Food and non-alcoholic beverages* which rose by 16.1 per cent, largely due to increases in the prices of government imported flour, milk and milk preparations, traders' rice,

5 *The main findings of the 8th Household Budget Survey are highlighted in Box 3.*

6 *For a theoretical and empirical analysis of inflation and core inflation, refer to "A Primer on Inflation" by M. Heerah-Pampusa, W. Khodabocus and V. Morarjee, and "A Primer on Core Inflation" by J. N. Bissessur and V. Morarjee, in the Bank of Mauritius Occasional Paper Series 2006, Number 1, which is available at* http://bom.intnet.mu/pdf/Research_and_Publications/Research_Papers/Occasional_Paper_Series.pdf.

7 *See footnote 4 for definitions of the three measures of core inflation.*

## Box 3: Summary of Findings of the Household Budget Survey 2006-07

The CSO conducted the 8th Household Budget Survey (HBS) from July 2006 to June 2007 in Mauritius. The survey studied the consumption pattern of the Mauritian population with a view to updating the basket of goods and services used for the computation of the monthly CPI. The representative consumer basket is updated by the CSO every five years.

The main findings of the survey as well as the weights for the new basket are outlined below.

### Main findings

1. After adjusting for inflation between 2001-02 and 2006-07, average monthly household income was virtually unchanged. In nominal terms, it went up by 33.7 per cent from Rs14,232 in 2001-02 to Rs19,025 in 2006-07.
2. A slight deterioration in the income distribution was noted.
3. Income inequality increased between 2001-02 and 2006-07, with the Gini coefficient rising from 0.371 to 0.389.[a] In1996-97, it stood at 0.387. The share of total income going to the 20 per cent of households at the lower end of the income range decreased from 6.4 per cent in 2001-02 to 6.1 per cent in 2006-07, while the share of the upper 20 per cent of households increased from 44.0 per cent to 45.7 per cent.
4. The number of poor households increased from 23,700 to 26,900. The proportion of poor households below the relative poverty line - set at the half median monthly household income per adult equivalent - was 8.0 per cent in 2006-07 up from 7.7 per cent in 2001-02.
5. Wages and salaries remained the principal source of household income accounting for 69.4 per cent of total gross income in 2006-07 against 69.8 per cent in 2001-02. Transfer income comprising mainly pensions and other social security benefits was the next most important source of income, accounting for 13.2 per cent of total gross income in 2006-07 compared to 10.6 per cent in 2001-02.
6. The average monthly household consumption expenditure increased by 33.3 per cent from Rs11,390 in 2001-02 to Rs15,188 in 2006-07. Adjusting for inflation and the decrease in household size between 2001-02 and 2006-07, a real increase of nearly 5 per cent in the consumption expenditure of private households was noted.
7. Education registered the largest increase in household expenditure mainly due to higher importance of university fees. Communication recorded the next largest increase in household expenditure.

### Weights for the new basket of consumption goods and services

8. *Food and non-alcoholic beverages* remained the largest broad category of household expenditure accounting for 28.6 per cent of total household consumption expenditure in 2006-07, down from 29.9 per cent in 2001-02. The weight for *Food* in the CPI basket fell from 27.4 per cent to 26.5 per cent.
9. *Transport* was the second largest category accounting for 14.7 per cent compared to 13.9 per cent in 2001-02. Households increased expenditure on gasoline, diesel and air transport which was partly offset by a significant decline in expenditure for bus fare due to the introduction of free bus transport for students and the elderly. The weight for gasoline and diesel increased to 3.6 per cent and 0.8 per cent from 2.7 per cent and 0.4 per cent, respectively.
10. The weight for the third largest category, namely, *Housing, water, electricity, gas and other fuels*, rose from 9.6 per cent in 2001-02 to 13.1 per cent in 2006-07, following the inclusion of interest on housing loans for the first time which carries a weight of 3.7 per cent.
11. The share of *Alcoholic beverages and tobacco* in total household expenditure increased from 8.6 per cent in 2001-02 to 9.2 per cent in 2006-07.
12. After taking into account that the weight for *Housing, water, electricity, gas and other fuels* went up due to the inclusion of interest on housing loans, *Transport* registered the largest increase in CPI weights followed by *Education*.
13. The largest decreases in CPI weights were registered in *Furnishings, household equipment and routine household maintenance*, which fell from 8.0 per cent to 6.4 per cent.

Changes in Weights of Major Commodity Groups of the CPI basket of goods and services

| | Division | 2001-02 HBS[i] per cent | 2006-07 HBS[i] per cent |
|---|---|---|---|
| 1. | Food & non alcoholic beverages | 29.9 | 28.6 |
| 2. | Alcoholic beverages & tobacco | 8.6 | 9.2 |
| 3. | Clothing & footwear | 6.0 | 5.1 |
| 4. | Housing, water, electricity, gas & other fuels | 9.6 | 13.1 |
| 5. | Furnishings, household equipment & routine household maintenance | 8.0 | 6.4 |
| 6. | Health | 2.8 | 3.0 |
| 7. | Transport | 13.9 | 14.7 |
| 8. | Communication | 3.1 | 3.6 |
| 9. | Recreation & culture | 5.3 | 4.8 |
| 10. | Education | 2.4 | 3.2 |
| 11. | Restaurants & hotels | 5.0 | 4.3 |
| 12. | Miscellaneous goods & services | 5.4 | 4.0 |
| | **Total** | **100.0** | **100.0** |

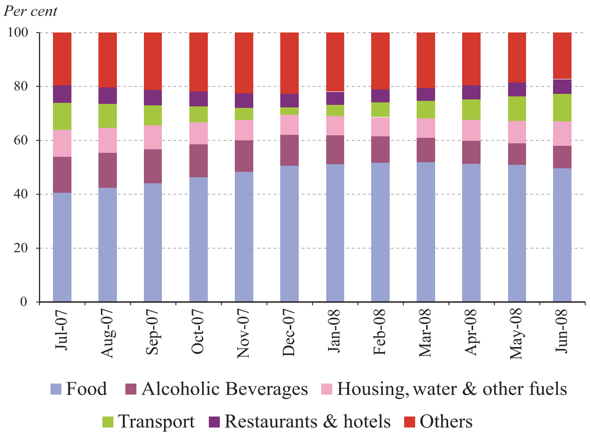
*Source: CSO, Government of Mauritius.*

[i] *The data are not strictly comparable as the items consumed in the two reference period differ.*

[a] *The Gini coefficient is a measure of inequality of income distribution or wealth distribution. It is defined as a ratio with values between 0 and 1. A low Gini coefficient indicates more equal income or wealth distribution. In contrast, a high Gini coefficient indicates more unequal distribution.*

fresh vegetables and other basic food items. *Restaurants and hotels* recorded the second largest increase of 14.0 per cent, mainly as a result of higher charges for food and drinks, some prepared foods, and for hotels and bungalows. With the exception of *Communication*, which registered a drop of 3.5 per cent, the remaining nine divisions registered increases ranging from 0.9 per cent for *Recreation and culture* to 8.7 per cent for *Housing, water, electricity, gas and other fuels*. Chart 2.5 depicts the weighted contribution of the main components of the CPI basket to inflation.

Chart 2.5: Weighted Contribution of the Main Components of the CPI Basket to Inflation

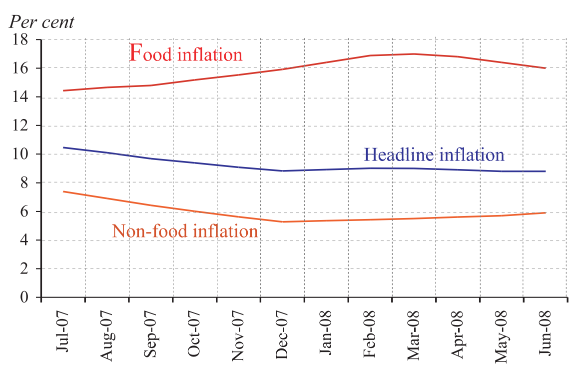



*Source: CSO, Government of Mauritius.*

## Food and non-food inflation

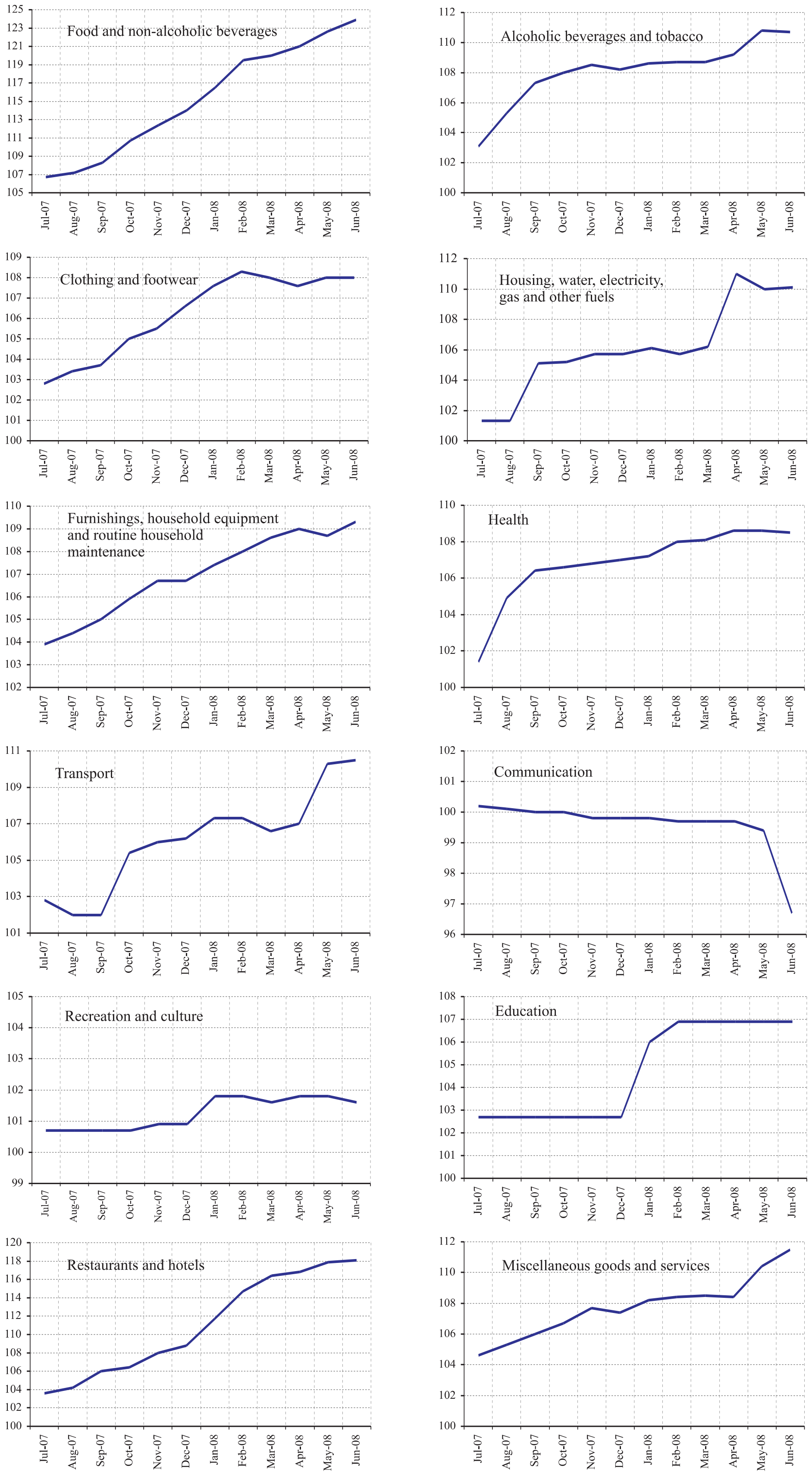
Food, which carries a weight of 26.5 per cent in the CPI basket of goods and services, recorded strong price increases. Food inflation went up consistently since mid-2006, reaching 14.7 per cent in June 2007 before gaining further momentum to 16.0 per cent in June 2008. Food inflation accounted for around half of headline inflation. In contrast, non-food inflation gradually declined up to December 2007 before picking up thereafter to June 2008. Chart 2.6 illustrates movements in food and non-food inflation while Chart 2.7 depicts movements in major commodity group indices.

Chart 2.6: Headline, Food and Non-food Inflation




*Source: CSO, Government of Mauritius.*

Chart 2.7: Movements in Indices of Major Commodity Groups of the CPI Basket of Goods and Services




*Source: CSO, Government of Mauritius.*

## 2.4 EVOLUTION OF OTHER PRICE/COST INDICES

Movements in the CPI are also generally preceded by changes in either import costs or producer prices or labour costs or a combination of all these factors. These changes could obviously be the result of exogenous shocks and/or monetary policy decisions and are eventually reflected in the final prices of consumer goods and services.

The evolution of indicators of inflation is outlined below. The pressure on consumer prices exerted by higher prices of manufactures produced locally for the domestic market and by higher wages remained high. However, the deceleration in the growth of prices of importable commodities, as measured by the Import Price Index (IPI), and the drop in prices of agricultural products contributed to some extent in containing the upward pressure on the general price level.

### Import Price Index

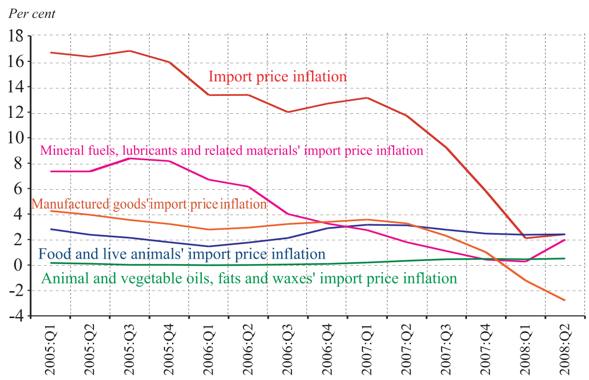
Import prices are an important domestic inflation indicator given the high degree of openness of the Mauritian economy and its significant reliance on imports. The IPI provides an overall measure of pure price changes in the domestic currency of goods imported into the country.[8]

The IPI, which rose systematically to 156.2 in the first quarter of 2007, declined to 153.7 in the first quarter of 2008 after going up in the final quarter of 2007. However, there was a rapid increase in the IPI in the second quarter of 2008. Overall, between the second quarters of 2007 and 2008, the IPI went up by 8.3 per cent.

When the methodology for computing CPI inflation is also used to measure import price inflation, it becomes evident that there has been a deceleration in import price inflation as from the second quarter of 2007.[9] A key factor behind the deceleration in the growth of import prices was the continuing appreciation of the exchange rate of the rupee vis-à-vis major currencies. Import price inflation decelerated from 11.7 per cent in the second quarter of 2007 to 2.1 per cent in the first quarter of 2008 before going up slightly to 2.4 per cent in the second quarter of 2008, as shown in Chart 2.8.

Import prices of *Animals and vegetable oils and fats* and *Food and live animals* recorded faster annual growth between the second quarters of 2007 and 2008, but the appreciating rupee partially dampened the magnitude of the growth. The substantial decline in prices, denominated in terms of rupees, of imported manufactured goods – again reflecting the appreciation of the rupee – contributed to a large degree in the deceleration of import price inflation.

Chart 2.8: Import Price Inflation and Contributions of Selected Components




*Source: CSO, Government of Mauritius.*

### Producer prices

Two measures of producer prices are computed by the CSO, namely, the Producer Price Index-Manufacturing (PPI-M) and the Producer Price Index-Agriculture (PPI-A). PPI-M measures changes in the effective prices received by producers for that part of their output which is sold on the domestic market. It reflects the price trends of a constant basket of goods, representative of the output of the manufacturing industries. PPI-A measures the average change in the selling prices which producers receive for their agricultural products. The indices are measured on a monthly basis and released quarterly.

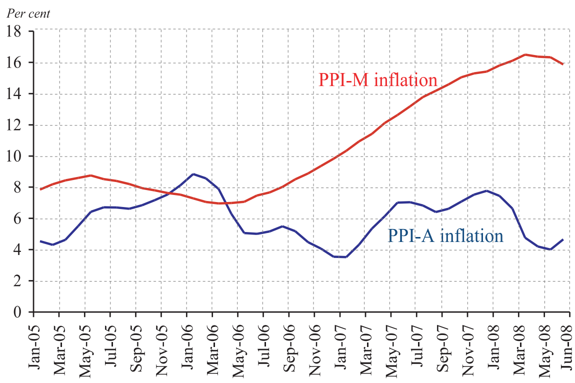
8 *The IPI, which is published on a quarterly basis by the CSO, is based on actual price measurements of a fixed basket of imported goods.*

9 *Import price inflation is calculated as the percentage change between the average IPI during a four-quarter period and the average IPI during the corresponding previous four-quarter period.*

PPI-M inflation, measured using the same methodology as for computing inflation, maintained a general upward trend. It rose from 13.8 per cent in July 2007 to 16.5 per cent in March 2008 before receding marginally to 15.9 per cent in June 2008.[10] Underlying this increase was the sustained rise in *Manufacture of food products, beverages and tobacco*.

PPI-A inflation, on the other hand, dropped from 6.8 per cent in July 2007 to 4.7 per cent in June 2008, reflecting mainly an improvement in the prices of fresh vegetables on account of seasonal factors. The producer price inflation for manufactures and agricultural products are depicted in Chart 2.9.

Chart 2.9: Producer Price Inflation for Manufactures and Agricultural Products




*Source: CSO, Government of Mauritius.*

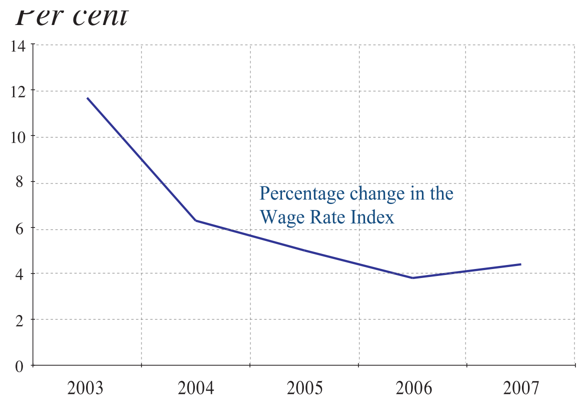
## Wage Rate Index and Unit Labour Cost

The Wage Rate Index (WRI) measures the cost of labour and rose by 4.4 per cent in 2007 relative to 2006, largely due to higher wage rates across all industry groups. Chart 2.10 shows movements in the annual WRI.

On the basis of quarterly data, the WRI rose by 7.9 per cent in the first quarter of 2008 compared to the first quarter of 2007.[11] A comparison of wage rate increases by industrial groups over the same period shows that the largest rise of 15.3 per cent was registered in *Transport, storage and communication* followed by 12.3 per cent in *Wholesale and retail trade, repair of motor vehicles, motorcycles, personal and household goods* while *Hotels and restaurants* recorded a rise of 11.5 per cent. The lowest increase of 2.3 per cent was registered in *Electricity and water*. In the most important industry group in terms of weight, which is *Manufacturing, mining and quarrying* with a weight of 17.1 per cent, the wage rate index registered an increase of 7.7 per cent.

In 2007, the gap between labour productivity and average compensation of the whole economy widened further. Labour productivity and average compensation grew by 3.7 per cent and 10.5 per cent, respectively, in 2007 compared to increases of 3.3 per cent and 6.6 per cent, respectively, in 2006. Multifactor productivity inched up by 0.1 per cent in 2007 against a decline of 0.7 per cent in 2006. Thus, the wide gap between the growth in productivity and average compensation implies higher unit cost of production. This could lead to rising prices of consumer products manufactured domestically.

Chart 2.10 Wage Rate Index




*Source: CSO, Government of Mauritius.*

[10] *Producer price inflation is measured as the percentage change in the twelve-month average PPI in a particular month relative to the corresponding previous twelve-month average.*

[11] *A new series of the Wage Rate Index, based on the occupational structure of the working population, was introduced by the CSO in September 2006. As from 2007, the WRI is disseminated on a quarterly basis.*

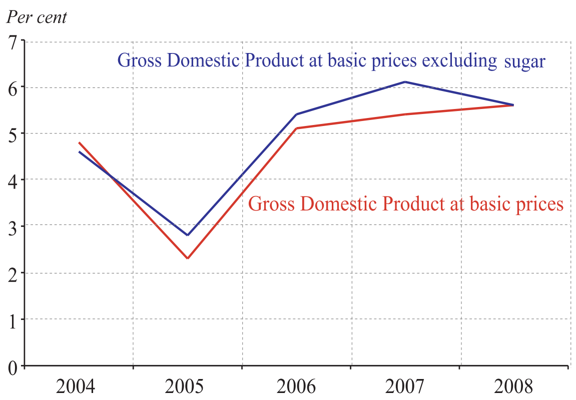
# 3. Demand and Output

The economy grew at a strong pace of 5.4 per cent in 2007 after a downward revision of the initial estimate due to lower manufacturing output and a larger contraction in agricultural output. Economic growth is forecast at 5.6 per cent for 2008, but the export sector remains vulnerable to the global economic downturn.

Domestic demand appears to have lost momentum in 2007, as evidenced by national accounts data on economic activity, particularly in sectors dependent on consumption. For instance, output growth in the distributive trade sector declined to 4.4 per cent in 2007 due to falling consumers' real disposable income after the series of price hikes in food and energy products. However, the estimates for 2008 indicate higher real consumption growth, accompanied by a slightly higher growth of 4.7 per cent in the distributive trade sector.

Overall, domestic economic prospects still appear positive even though the global economy was slowing down. Inflationary pressures originating from domestic supply and demand factors appear to have been subdued in the four quarters ended June 2008. Chart 3.1 depicts movements in real economic growth rate. The following sections assess changes in the main components of demand and output as well as labour market conditions.

Chart 3.1: Real Economic Growth Rate




*Source: CSO, Government of Mauritius.*

## 3.1 CONSUMPTION

Growth of final consumption expenditure eased in 2007 to 3.9 per cent from 5.5 per cent in 2006. Both components of final consumption expenditure – that is, households and government – slowed down significantly in 2007. The deceleration was evident in the fourth quarter of 2007. The prevalence of high inflation rates eroded the purchasing power of households and curtailed real consumption growth. When compared to trend growth rates over the past few years, consumption growth was relatively subdued in the first two quarters of 2008. However, consumption growth may pick up in the second half of 2008 on account of nominal salary increases.

Household consumption expenditure grew by 4.5 per cent in 2007 and is forecast to grow by 4.9 per cent in 2008 in real terms. As part of efforts by government to reform the income tax regime, the effective rate of income tax was reduced to 15 per cent as from July 2007. In spite of the increase in after-tax income, real household consumption growth slowed in 2007. Tighter credit conditions resulting from the hike in interest rates coupled with high inflation appear to have hurt consumption growth.

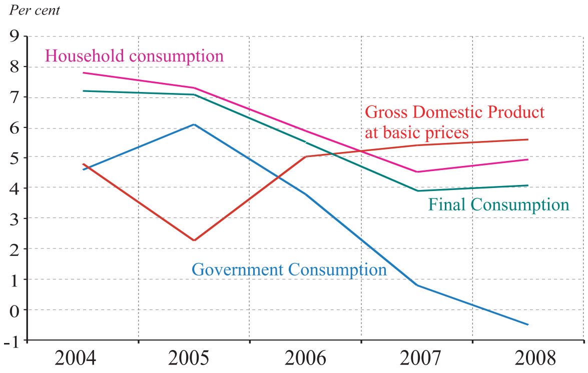
However, with the salary review in the public sector, effective as from July 2008, household consumption expenditure would likely boost domestic demand, as has been observed in the past following salary awards.

In line with fiscal consolidation efforts, the contribution of government spending to domestic demand had been declining in recent years. Government spending is estimated to have grown by 0.8 per cent in 2007 but is forecast to recede by 0.5 per cent in 2008.

The evolution of final consumption expenditure and its components as well as Gross Domestic Product (GDP) growth since 2004 is depicted in

Chart 3.2. Table 3.1 shows real growth rates of the components of aggregate demand.

Chart 3.2: Real Economic and Consumption Growth Rates




*Source: CSO, Government of Mauritius.*

## 3.2 INVESTMENT

Investment growth, in particular private sector investment, has been buoyant in 2007 but is projected to decelerate in 2008. Investment is essentially being driven by building and construction work, which is expected to contribute a higher share of 64 per cent of total investment activities in 2008. The wholesale and retail trade sector continues to invest massively in order to tap a growing consumer market. The composition of investment tends to indicate a rise in the productive capacity mainly in construction-related activities and wholesale and retail trade.

Exclusive of the acquisition of aircraft and marine vessel, investment increased by 17.0 per cent in real terms in 2007 and is projected to expand at a lower rate of 10.2 per cent in 2008, as shown in Table 3.1. Public sector investment, exclusive of the acquisition of aircraft and marine vessel, has declined in real terms while private sector investment continues to grow at a much higher rate than real GDP.

The relatively tight credit conditions throughout 2007 accompanied by some moderation in the first half of 2008 did not appear to have adversely affected business investment decisions. Relatively stable macroeconomic conditions despite vulnerabilities to external shocks, attributable to monetary policy and government policy, appear to have significantly improved the business and economic environment over the medium- to long-term.

## 3.3 FOREIGN TRADE AND EXTERNAL DEMAND

It is evident that the high degree of openness of the Mauritian economy has increased its vulnerability to external price and demand shocks.[12] Rising food and energy prices on the international market have not spared Mauritius and have exerted significant pressures on import prices as well as on the import bill. Further,

[12] *The degree of openness is measured as the ratio of total trade to GDP. The ratio stands at 1.3 in 2007 for Mauritius.*

Table 3.1: Components of Aggregate Demand – Real Growth Rates

*(Percentage change over previous year for annual data and over corresponding quarter of previous year for quarterly data)*

| | 2004 | 2005 | 2006 | 2007[1] | 2008[2] | 2007[1] Quarter1 | 2007[1] Quarter2 | 2007[1] Quarter3 | 2007[1] Quarter4 | 2008[2] Quarter1 | 2008[2] Quarter2 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Final Consumption Expenditure | 7.2 | 7.1 | 5.5 | 3.9 | 4.1 | 3.1 | 4.2 | 5.6 | 2.5 | 3.7 | 3.1 |
| *of which:* | | | | | | | | | | | |
| Household consumption | 7.8 | 7.3 | 5.9 | 4.5 | 4.9 | 3.7 | 5.1 | 6.2 | 3.2 | 4.2 | 3.9 |
| Government consumption | 4.6 | 6.1 | 3.8 | 0.8 | -0.5 | 0.6 | 0.8 | 2.9 | -0.9 | 1.6 | -0.4 |
| Investment | 2.2 | -1.9 | 19.0 | 8.6 | 6.5 | 24.3 | 9.7 | 11.3 | 1.5 | 14.4 | 21.9 |
| Investment (exclusive of the acquisition of aircraft & marine vessel) | 4.8 | -1.6 | 5.5 | 17.0 | 10.2 | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Exports of goods and services | -0.3 | 10.6 | 7.7 | 3.4 | 4.2 | -3.3 | 6.9 | 2.6 | 7.6 | 7.9 | 9.1 |
| Imports of goods and services | 2.8 | 6.4 | 9.3 | 1.9 | 5.1 | -3.2 | 1.5 | 10.5 | -0.9 | 20.5 | 7.1 |

[1] *: Revised estimates.* [2] *: Forecast.*
*n.a.: not available.*

*Source: CSO, Government of Mauritius.*

expected weak growth in Mauritius' main export markets in 2008 could adversely affect the performance of the export sector.

Overall, net exports of goods and services are estimated to contribute negatively to GDP both in 2007 and 2008, even after excluding the acquisition of aircraft and marine vessel.

## Current account balance

Provisional estimates for the second quarter of 2008 indicate that the current account of the balance of payments recorded a higher deficit of Rs7,531 million compared to a deficit of Rs4,627 million over the same period in the previous year. This shortfall was mostly attributable to the worsening deficit on the merchandise account, which almost doubled in the second quarter of 2008 largely on account of higher nominal import growth.

The deficit on the merchandise account of the balance of payments worsened significantly to Rs55,272 million in 2007-08, mostly as a result of rising imports against a decline in exports in nominal terms. Nonetheless, combined higher surpluses on the services account – mostly attributable to the surge in gross tourism receipts – and current transfers account as well as a more than moderate growth in the income account in 2007-08 have partly offset the growing merchandise account deficit.

As a result, the current account of the balance of payments recorded a higher deficit of Rs21,964 million in 2007-08. Chart 3.3 shows movements of the current account deficit in relation to GDP in 2007-08 which rose to 8.8 per cent compared to 7.9 per cent in 2006-07.

Chart 3.3: Current Account and Merchandise Account Balance as a Ratio to GDP

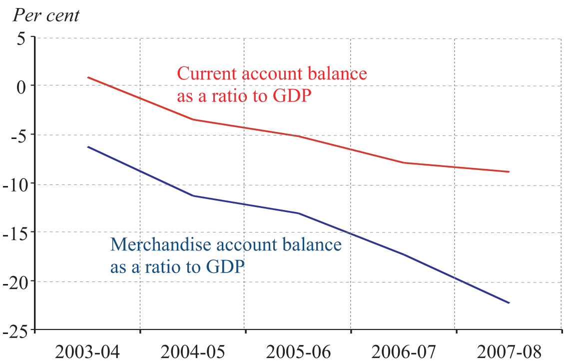



Table 3.2: Balance of Payments Summary

*Rs million*

| | 2005-06 | 2006-07 | 2007-08[1] |
|---|---|---|---|
| **Current Account** | **-10,188** | **-17,404** | **-21,964** |
| Exports (f.o.b) | 68,959 | 72,840 | 67,844 |
| Imports (f.o.b) | -94,492 | -110,847 | -123,116 |
| *of which:* aircrafts | 146 | 6,700 | 2,730 |
| Merchandise trade balance | -25,533 | -38,007 | -55,272 |
| Services | 12,363 | 14,079 | 20,753 |
| *of which:* travel | 28,571 | 36,243 | 43,106 |
| Income | 1,341 | 3,499 | 8,774 |
| Current transfers, Net | 1,641 | 3,025 | 3,781 |
| **Capital & Financial Account** | **4,141** | **6,212** | **12,571** |
| Capital account | -98 | -50 | -49 |
| Direct investment | 578 | 7,084 | 6,211 |
| Portfolio investment | -1,679 | 2,949 | -3,220 |
| Other investment [2] | 2,321 | 2,832 | 18,739 |
| Balance of payments Surplus (-) / Deficit (+) | 3,019 | -6,603 | -9,110 |
| Net Errors and Omissions | 6,047 | 11,192 | 9,393 |

[1] : *Provisional.*

[2] : *Data on certain components of 'Other Investment' for the fiscal year 2007-08 are not strictly comparable to previous fiscal years on the basis that banks' foreign assets and liabilities for 2007-08 have been derived using the Depository Corporations Survey.*

The current account deficit in 2007-08 was partly financed by higher inflows in the financial account. Foreign direct investment registered net inflows of Rs6,211 million in 2007-08 while portfolio investment recorded net outflows of Rs3,220 million. On account of the fairly strong capital inflows, the overall balance of payments, measured by the change in reserve assets excluding valuation changes, posted a surplus of Rs9,110 million, as shown in Table 3.2.

The imbalance between saving and investment – with the ratios of gross national saving and investment to GDP stagnating around 17 per cent and 24 per cent, respectively, for the last three years – has contributed to sustain the current account deficit. There is thus a dire need to boost domestic saving that could be utilised to finance investment. This can be achieved either by a rise in personal saving, corporate saving and surpluses on the public sector's recurrent budget or any combination of the three. On current trends, continued reliance on non-residents' financing of the current account deficit may exert pressure on the exchange rate. The external position of Mauritius may also become more vulnerable to a sharp reversal in market sentiment in respect of capital flows.

## Exports

Total exports of goods fell, in nominal terms, by 6.9 per cent in 2007-08. A slowdown in our main export markets as well as the appreciation of the rupee somewhat explain the dim performance of exports. Domestic exports – that is, total exports adjusted for re-exports (freeport exports) – which account for 72.0 per cent of total exports registered a decrease of 3.7 per cent. In the second quarter of 2008, total exports of goods fell by 4.2 per cent compared to the second quarter of 2007.

An analysis of external trade statistics for 2007-08 shows that the decline in total exports of goods was largely on account of a significant reduction in re-exports and a drop in the value of both sugar exports and exports of export-oriented enterprises. Exports of sugar went down by 14.1 per cent mainly as a result of the drop in sugar prices, due to the phased reduction in prices obtained on sugar exports to the European Union.

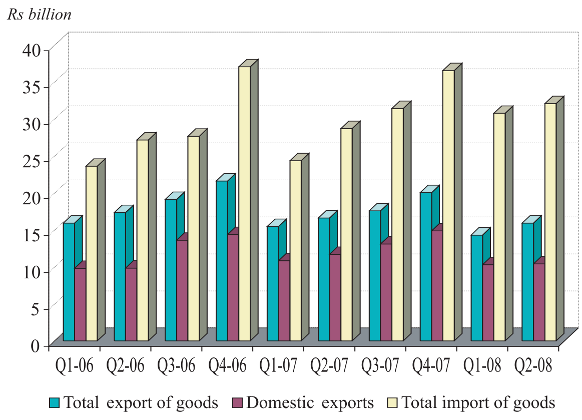
## Imports

Total nominal imports, excluding the acquisition of aircraft and marine vessel, went up by 15.3 per cent in 2007-08. This high growth was mostly driven by a sharp increase in the import bill for rice, flour, wheat, dairy products, and petroleum products on account of soaring food and energy prices on the world market. Imports of food and live animals soared by 23.1 per cent. Concurrently, the record high level of oil prices led to a 29.6 per cent rise in import of refined petroleum products. Imports by export-oriented enterprises expanded by 7.0 per cent.

Further, a notable increase was registered on the import bill of certain goods, namely, prefabricated buildings, sanitary plumbing, heating and lighting fixtures and fittings, and iron and steel. High growth in the construction sector, including construction projects related to the Integrated Resort Scheme, accounted to a large extent for the increase.

Quarterly nominal exports and imports are depicted in Chart 3.4. The significance of the price increase of some selected commodities is indicated in Table 3.3.

Chart 3.4: Quarterly Exports and Imports




*Source: CSO, Government of Mauritius.*

## External Demand

The United Kingdom remained Mauritius' main export market, accounting for 35.7 per cent share of total exports in 2007-08, despite a fall of 3.1 per cent in exports to that market. Other main markets are France and the United States. South

Table 3.3: Percentage Change in Quantity, Price and Value of Selected Imported Commodities between 2006-07 and 2007-08

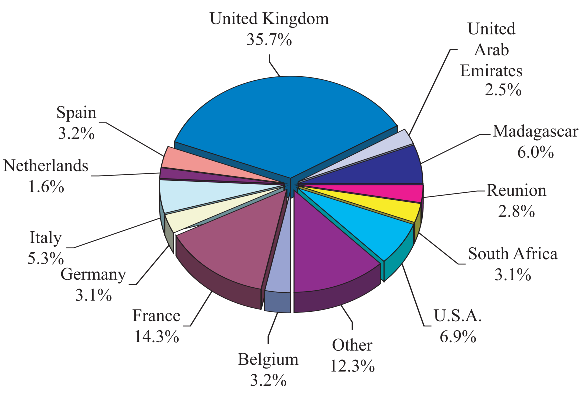
| Commodity | Percentage Change in Quantity | Percentage Change in Price | Percentage Change in Value |
|---|---|---|---|
| Rice | 20.3 | 24.3 | 49.5 |
| Wheat | -40.3 | 95.2 | 16.6 |
| Dairy Products | 14.3 | 35.7 | 55.1 |
| Edible Oil / Fats | 40.7 | 39.4 | 96.2 |
| Medical / Pharmaceutical products | 0 | 10.6 | 10.6 |
| Fertilisers | 25.0 | 45.5 | 81.9 |
| Cotton Fabrics | -12.5 | 26.6 | 10.8 |
| Cement | -0.3 | 9.9 | 9.6 |
| Iron and Steel | 29.6 | -0.3 | 29.1 |

*Source: CSO, Government of Mauritius.*

Africa's importance as a market for Mauritian exports has also been rising recently. Exports to South Africa, consisting mostly of garments, rose by 8.2 per cent.

The main exports destinations in 2007-08 are illustrated in Chart 3.5. The economic slowdown in Mauritius' main export markets does signify downside risks to domestic exports.

Chart 3.5: Main Export Destinations in 2007-08

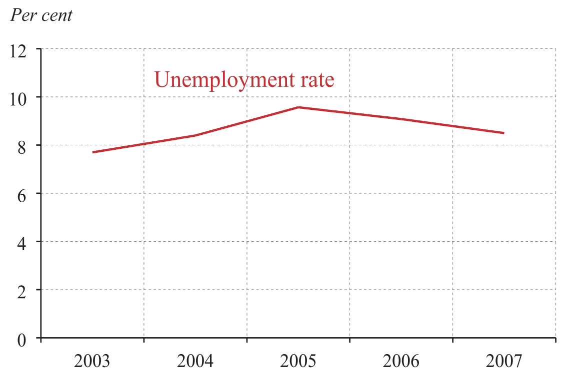



*Source: CSO, Government of Mauritius.*

## 3.4 LABOUR MARKET AND WAGES

The overall positive economic outlook in the year to June 2008 coupled with the Government's efforts to enhance the job matching process had a positive impact on the labour market. Job fairs organised in various regions were instrumental in reducing the asymmetry of information in the labour market. There was a marked decline in the unemployment rate from 9.6 per cent in the first quarter of 2007 to 7.4 per cent in the second quarter of 2008. Table 3.4 and Chart 3.6 depict movements in the unemployment rate.

Chart 3.6: Unemployment Rate




*Source: CSO, Government of Mauritius.*

### Labour market outlook

Overall, labour costs are expected to rise following the increase in public sector salaries as from July 2008 which could be accompanied by demand for higher wages across industrial sectors. Further, tighter labour market conditions, as indicated by the general decline in the unemployment rate, and relatively slower rise in productivity would imply higher unit labour costs.

Table 3.4: Unemployment Rate

*Per cent*

| | 2005 | 2006 | 2007 | 2007 | | | | 2008 | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | Quarter 1 | Quarter 2 | Quarter 3 | Quarter 4 | Quarter 1 | Quarter 2 |
| Actual | 9.6 | 9.1 | 8.5 | 9.6 | 8.8 | 8.2 | 7.2 | 8.2 | 7.4 |
| Seasonally adjusted | 9.6 | 9.1 | 8.5 | 9.0 | 8.2 | 8.5 | 8.1 | 7.6 | 6.8 |

*Source: CSO, Government of Mauritius.*

Export-oriented enterprises, especially in the manufacturing sector, are currently facing some key challenges. The increase in prices of energy and raw materials already negatively impacted on the operating costs of these enterprises. Higher labour costs could dent their competitiveness if unaccompanied by productivity gains.

Positive growth prospects in the wider economy could offset the adverse impact of higher labour costs on the demand for labour. Economic sectors which have been outperforming others would continue to hire labour.

# 4. Monetary and Financial Developments

## 4.1 MONETARY AND CREDIT DEVELOPMENTS

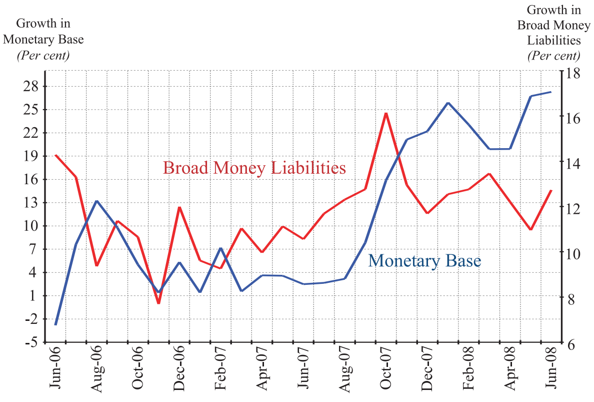
Money and credit developments provide valuable information on the inflation process and are important for formulating monetary policy.[13] In the long run, persistently high rates of money growth have been associated with high nominal demand growth and inflation.

### Monetary base

The central bank has monopoly in the creation of money and, hence, on the monetary base. The close link that monetary base bears with money supply – through the money multiplier concept – implies that excessive expansion in the monetary base provides the foundation for high money supply growth. As a corollary, the current high growth in monetary base through its probable effect on broad money supply could enhance inflationary pressures over the medium-term. Chart 4.1 illustrates movements in monetary base and broad money liabilities.

The monetary base expanded by 14.6 per cent between the end of June 2007 and the end of June 2008 compared to an increase of 8.3 per cent recorded in the year to June 2007.[14] The rate of growth of reserve deposits held by other depository corporations (ODCs) at the Bank of Mauritius accelerated from 4.8 per cent to 25.9 per cent, reflecting a huge build-up of reserves at the central bank.

Chart 4.1: Growth Rate of Monetary Base and Broad Money Liabilities




### Broad Money Liabilities

Growth in Broad Money Liabilities (BML), the broadest measure of money supply, surged to 17.1 per cent in the year to June 2008 – that is, from the end of June 2007 to the end of June 2008.[15] In comparison, BML had increased by 8.6 per cent in the year to June 2007 – that is, from the end of June 2006 to the end of June 2007. The current strength of BML growth might imply some build-up of inflationary pressures over the medium-term. However, this high pace of money supply expansion could also be interpreted as accommodative to the high inflation environment. The evolution of BML and credit to private sector year-on-year growth rate and inflation rate is shown in Chart 4.2.

The main drivers of monetary expansion were the sustained increase in claims on the private sector and on budgetary central government by depository corporations and the steady, though slower, rise in net claims on non-residents.

### Components of Broad Money Liabilities

Higher levels of time deposits and, to a lesser extent, narrow money liabilities contributed to the growth of BML.

Narrow money liabilities, the first component of BML, rose by 15.1 per cent in the year to June 2008, higher than the increase of 10.4 per cent noted in the year to June 2007.[16]

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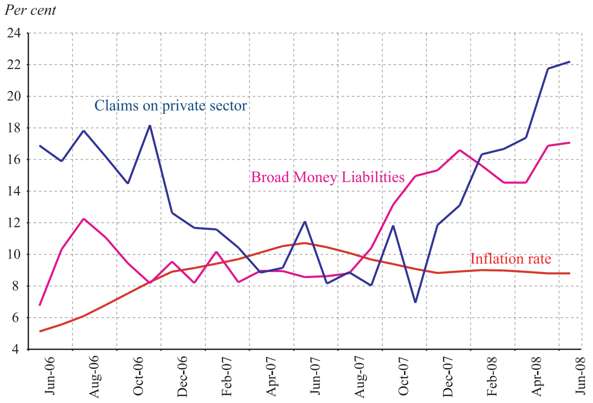
13 *The IMF's Monetary and Financial Statistics Manual provides the methodology for compiling monetary statistics in Mauritius.*

14 *The monetary base, also termed high-powered money or reserve money, comprises central bank liabilities that support the expansion of broad money and, thus, credit. Changes in the monetary base usually lead to increases in money and credit that are larger than the changes in the monetary base, due to what is termed the money multiplier effect. The final impact of a change in monetary base on money supply also depends on stability of the money multiplier.*

15 *Broad Money Liabilities include deposits of banks and non-bank deposit-taking financial institutions.*

16 *Narrow money liabilities comprise currency with public and transferable deposits.*

Chart 4.2: Annual Growth Rate of Broad Money Liabilities and Credit to Private Sector, and Inflation




The second component of BML, quasi-money liabilities, registered an expansion of 17.9 per cent in the year to June 2008 compared to an increase of 8.7 per cent in the year to June 2007. Time and savings deposits rose significantly by 16.0 per cent and 17.5 per cent, respectively, while foreign currency deposits rose by 21.8 per cent in the year to June 2008.

Growth rates of financial corporations, households' and private non-financial companies' deposits have been high. But the sharp pick-up in money growth over the past year or so was driven largely by an increase in deposits held by other financial corporations, which registered a rise of nearly 60 per cent between the end of June 2007 and the end of June 2008.

Favourable developments in corporate deposits were mainly attributable to (i) signs of improvement in companies' financial operations, (ii) a decline in the securities portfolio of financial corporations resulting from non-renewal of maturing government and central bank securities, and (iii) higher average interest rates on new time deposits.

The final component of BML, *Securities other than Shares*, dropped by 16.3 per cent in the year to June 2008.[17] Table 4.1 provides details on growth rates in components of BML.

[17] *The component* Securities other than Shares *comprises essentially certificates of deposits.*

Table 4.1: Growth Rate of Broad Money Liabilities and Domestic Credit

*Percentage change over corresponding month of previous year*

| | Jun-07 | Sep-07 | Dec-07 | Mar-08 | Jun-08 |
|---|---|---|---|---|---|
| **Broad Money Liabilities** | **8.6** | **10.4** | **15.3** | **14.5** | **17.1** |
| Narrow Money Liabilities | 10.4 | 10.7 | 17.3 | 14.8 | 15.1 |
| *Currency with public* | *11.2* | *11.0* | *9.5* | *9.9* | *11.4* |
| *Transferable deposits* | *10.0* | *10.5* | *21.0* | *16.9* | *16.6* |
| Quasi-Money Liabilities | 8.7 | 10.5 | 15.0 | 14.7 | 17.9 |
| *Savings deposits* | *6.3* | *5.5* | *8.6* | *13.9* | *17.5* |
| *Time deposits* | *8.0* | *12.1* | *20.5* | *20.3* | *16.0* |
| *Foreign currency deposits* | *14.0* | *15.9* | *15.5* | *6.3* | *21.8* |
| Securities other than shares | -24.8 | -5.2 | -0.4 | -6.2 | -16.3 |
| **Domestic Credit** | **6.0** | **4.2** | **9.0** | **16.2** | **22.9** |
| Credit to private sector | 12.1 | 8.3 | 11.9 | 16.7 | 22.2 |
| **Net Foreign Assets** | 29.5 | 19.2 | 9.6 | 1.3 | 0.6 |

## Sources of Broad Money Liabilities

### *Foreign assets*

The marginal increase in the net foreign assets must be set against the background of an appreciating domestic currency. There was a drop in net foreign assets held by ODCs which reflects the sale of foreign currencies to the Bank of Mauritius and also conversion of foreign currency deposits into rupee deposits by corporates. During the period under review, the Bank of Mauritius was a net purchaser of foreign exchange on the domestic market following its interventions on a number of occasions.

### *Domestic credit*

Growth in domestic credit by depository corporations accelerated from 6.0 per cent in the year to June 2007 to 22.9 per cent in the year to June 2008, reflecting increases in both net credit to central government and to the private sector.

Net credit to budgetary central government increased by 25.9 per cent in the year to June 2008 against a fall of 13.0 per cent registered in the year to June 2007. The rise in net claims on government essentially reflected ODCs investment in government securities. Credit to the private sector by ODCs increased by 22.2 per cent in the year to June 2008 compared to a rise of 12.1 per cent recorded in the year to June 2007.

### Sector-wise distribution of credit by banks

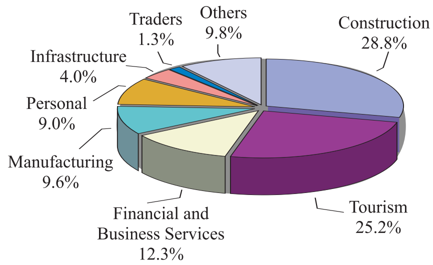
Credit to the private sector by banks remained buoyant resulting in an increase in the ratio of private sector credit to GDP. The construction and tourism sectors continue to drive the increase in bank credit, representing respective shares of 28.8 per cent and 25.2 per cent of total credit expansion.

Credit to the household sector expanded by 16.6 per cent in the year to June 2008 compared to a rise of 15.7 per cent recorded in the year to June 2007. Total lending to households continued to grow strongly.

In terms of the currency composition of credit, between the end of June 2007 and the end of June 2008, rupee loans and advances expanded by 10.9 per cent, while foreign currency loans and advances increased by 85.7 per cent.

The distribution of the increase in bank credit to the private sector of 18.6 per cent in the year to June 2008 is shown in Chart 4.3.

Chart 4.3: Distribution of the Increase in Bank Credit to the Private Sector - June 2007 to June 2008




## 4.2 MONEY MARKET

### Liquidity management

The Bank of Mauritius minimised its intervention on the market in the second half of 2007 and allowed the money as well as the foreign exchange markets to play a more prominent role in resource allocation and price determination. The Bank of Mauritius reduced its intervention on the money market in order not to mop up funds that did not structurally affect liquidity in the system. However, the central bank remained vigilant and monitored closely the increased inflow of foreign exchange – such as FDI and short-term portfolio investment.

With the build-up of excess reserves held by banks towards the end of September 2007, the Bank of Mauritius started to issue Bank of Mauritius Bills again and, in November 2007, introduced the 14-day Special Deposits Facility to enhance its management of excess reserves.[18] Banks were allowed to deposit funds with the central bank at a fixed interest rate of 8.00 per cent. With the Bank of Mauritius having recourse to a number of instruments to manage rupee liquidity, the level of average excess reserves for November and December 2007 declined after peaking in October 2007.

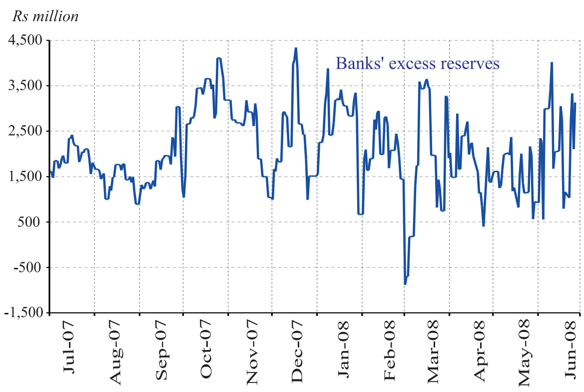
[18] *Excess reserves are defined as the excess funds held by banks over and above the amount required to maintain the minimum Cash Reserve Ratio of 4 per cent. These funds are maintained in current accounts at the central bank.*

As from December 2007 and during the first half of 2008, the excess foreign exchange supply situation in the market prompted the Bank of Mauritius to intervene and buy an equivalent of US$300.2 million from the market. Concurrently, the rupee counterpart was injected into the monetary system thereby boosting the volume of excess reserves. During May and June 2008, however, the Bank of Mauritius sold a total of US$45 million to ease conditions on the foreign exchange market, which enabled the absorption of around Rs1.2 billion worth of excess reserves.

On 1 April 2008, the Bank of Mauritius implemented further operational changes in its liquidity management. The Special Deposits Facility was extended to 21 days. Further, the issue of Bank of Mauritius Bills was completely separated from the issue of Treasury Bills: Bank of Mauritius Bills of only 28-day and 56-day maturities were issued during auctions held on Wednesdays, while auctions for Treasury Bills of 91, 182 and 364 days continued to be held on Fridays.

Overall, average excess reserves held by banks were higher in the first half than in the second half of 2007-08. With the Bank of Mauritius' continued monitoring of money market conditions and regular money market operations, average excess reserves declined from an average of Rs2.7 billion in January 2008 to Rs2.2 billion in June 2008. The evolution of banks' daily average excess reserves is shown in Chart 4.4.

Chart 4.4: Banks' Daily Average Excess Reserves

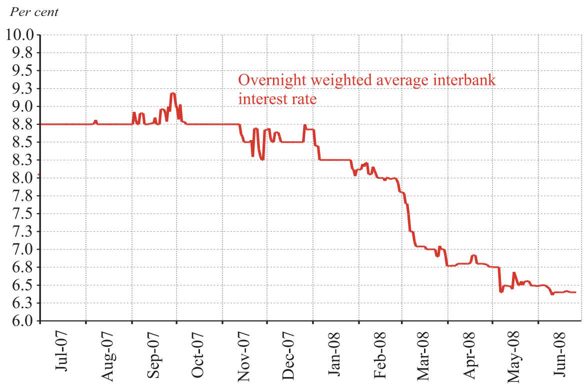



## Interbank interest rates

Interest rates prevailing on the interbank money market were influenced downwards by the prevalence of excess liquidity in the banking system.

The weighted average interbank interest rate was more or less stable from July to December 2007 but, thereafter, started to decline and reached a low of 6.36 per cent by mid-June 2008, as depicted in Chart 4.5. From a range of 8.05-8.75 per cent in July 2007, interbank interest rates declined to a range of 6.36-6.50 per cent in June 2008.

Chart 4.5: Overnight Weighted Average Interbank Interest Rate




## Yields on Government debt instruments

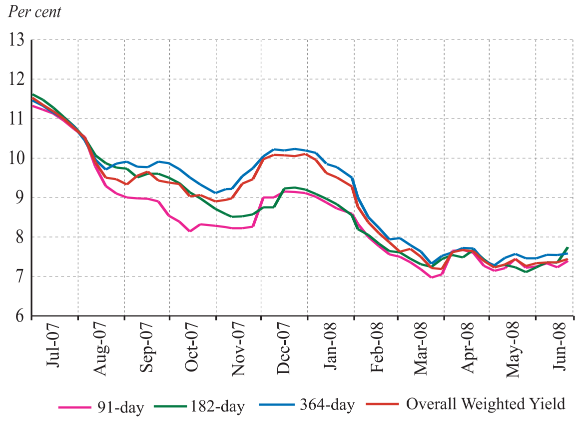
Yields on short-term Treasury/Bank of Mauritius Bills assumed a generally declining trend from July 2007 to March 2008 and stabilised thereafter, as shown in Chart 4.6. In general, primary auctions of Treasury/Bank of Mauritius Bills remained oversubscribed with an average bid-cover ratio of 2.3.[19]

Though weighted yields on all three maturities had started trending downwards since May 2007, they stayed above 10 per cent till mid-August 2007. Reflecting the three successive reductions in the key Repo Rate, weighed yields declined to

[19] *Bid-cover ratio is the ratio of the value of bids received to the tender amount.*

reach a low of 7.05 per cent on the 91-day Bill, 7.11 per cent on the 182-day Bill, and 7.28 per cent on the 364-day Bill during the last quarter of 2007-08.

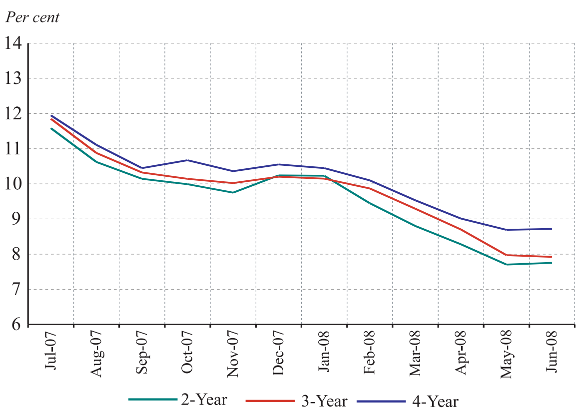
Chart 4.6: Movements of Yields on Treasury/Bank of Mauritius Bills




Market showed preference for the 364-day maturity for most of 2007 and early 2008. As from March 2008, preference became marked for 91-day and 182-day maturities, probably indicating investors' unwillingness to lock up their funds for longer term.

The auctions for the other Government securities – namely, Treasury Notes, Five-Year Government of Mauritius Bonds and Long-Term Government of Mauritius Bonds – were oversubscribed. The downward trend in short-term market interest rates was reflected in the weighted average yields of these instruments as well. Chart 4.7 exhibits movements in yields on Treasury Notes.

Chart 4.7: Evolution of Yields on Treasury Notes




Non-residents' holdings of Government securities and central bank bills fell from Rs5.7 billion in July 2007 to Rs3.5 billion in December 2007. In the first half of 2008, purchases by foreigners declined further and the outstanding amount reached a low of Rs1.2 billion at the end of June 2008. Resident holders of Government and central bank securities comprised principally banks and pensions funds.

## 4.3 INTEREST RATES

Banks responded to changes in the key Repo Rate by adjusting their deposit and lending interest rates. Table 4.2 gives details of the changes in lending and deposit interest rates in the banking sector.

Following the 75 basis points hike in the key Repo Rate as from 2 July 2007, banks' increased their prime lending rates (PLR) from a range of 10.70-11.75 per cent to 11.25-12.25 per cent in July 2007. Likewise, banks raised their savings deposits rates (SDR) from the range of 7.20-7.60 per cent to 8.00-8.60 per cent in July 2007. The minimum PLR was increased to 11.40 per cent in October 2007 following adjustment by one bank. These ranges of interest rates remained unchanged up to January 2008.

After the three consecutive cuts in the key Repo Rate in February, March and May 2008, banks' SDR varied between 6.25-7.25 per cent while their PLR varied between 10.15-11.50 per cent in June 2008.

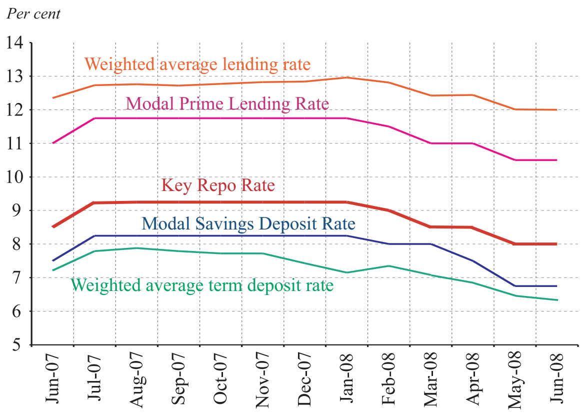
Table 4.2: Changes in Interest Rates

*End of period, per cent*

| | Key Repo Rate | Savings Deposit Rate | Prime Lending Rate |
|---|---|---|---|
| Jun-07 | 8.50 | 7.20-7.60 | 10.70-11.75 |
| Jul-07 | 9.25 | 8.00-8.60 | 11.25-12.25 |
| Feb-08 | 9.00 | 7.75-8.25 | 11.15-12.00 |
| Mar-08 | 8.50 | 7.00-7.75 | 10.65-11.75 |
| Apr-08 | 8.50 | 6.75-7.75 | 10.65-11.75 |
| May-08 | 8.00 | 6.25-7.25 | 10.15-11.50 |
| Jun-08 | 8.00 | 6.25-7.25 | 10.15-11.50 |

Over the period under review, the modal PLR declined by 50 basis points in line with the key Repo Rate while the modal SDR fell by a greater magnitude of 75 basis points, as depicted in Chart 4.8. Overall, interest rates in the banking sector moved more or less in line with movements in the key Repo Rate.

Chart 4.8: Movements in the Deposit and Lending Rates



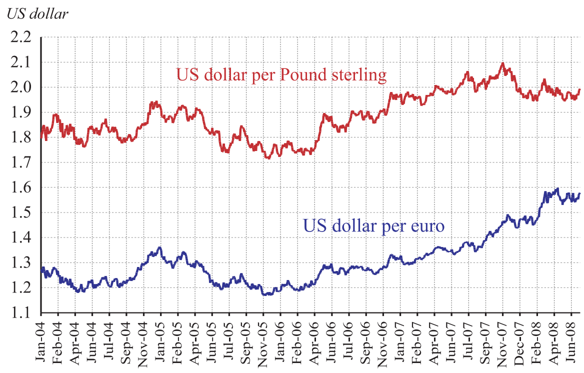

With high inflation, the real rate of interest on savings deposits remained negative throughout the period under review. In June 2008, the real rate of interest on savings deposits turned out to be negative 1.9 per cent compared to negative 2.9 per cent in July 2007.

## 4.4 FOREIGN EXCHANGE MARKET AND EXCHANGE RATES

### Major international currencies

Over the period July 2007 to June 2008, the US dollar depreciated against the euro and Japanese yen but appreciated marginally against the Pound sterling. The US currency maintained a sustained depreciating trend against the euro during the period under review. While the depreciation was moderate up to August 2007, the onset of the sub-prime crisis and associated turbulence in the financial sector contributed to accelerating the pace of the US currency depreciation. Ongoing fears of a recession in the United States kept the US dollar on a generally depreciating trend in the first quarter of 2008 although some stability was observed by June 2008. The Pound sterling, however, appreciated against the US currency as from July 2007 but lost ground from November 2007 onwards, which more than offset the earlier gains. Chart 4.9 shows the movements of the US dollar against the euro and the Pound sterling.

Chart 4.9: Evolution of the US dollar against the Pound Sterling and the Euro




### Domestic currency

Overall, on a point-to-point basis between 1 July 2007 and 30 June 2008, the rupee appreciated vis-à-vis the US dollar and Pound sterling but depreciated slightly against the euro. The rupee appreciation was mainly due to capital inflows and positive market sentiment. As from fourth quarter 2007, the rupee appreciation trend was further reinforced by the weakness of the US dollar on international markets.

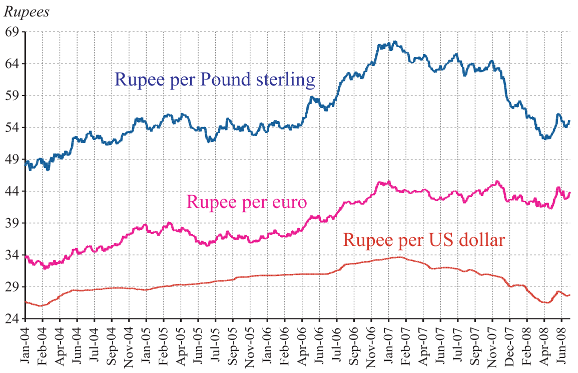
On a point-to-point basis between July 2007 and April 2008, the rupee appreciated against the Pound sterling, US dollar and euro by 23.4 per cent, 19.4 per cent and 5.3 per cent, respectively. However, the exchange rate of the rupee recorded some volatility from the end of April to the end of June 2008. Over that period, the rupee depreciated by 5.6 per cent, 4.0 per cent and 5.8 per cent against the Pound sterling, US dollar and euro, respectively.

Overall, the domestic foreign exchange market remained characterised by an excess supply situation. Banks have, on average, maintained a higher overbought position of US$34.4 million between January to June 2008 compared to an average of US$32.7 million in the period July 2007 to December 2007. Similarly, foreign exchange interbank activity remained buoyant with a higher monthly average turnover equivalent to US$18.7 million between January and June 2008 compared to a monthly average of US$8.4 million for the period July to December 2007.

In a bid to smooth out excessive volatility of the rupee, the Bank of Mauritius intervened on the domestic foreign exchange market. Over the period December 2007 to April 2008, the Bank of Mauritius purchased foreign currencies equivalent to US$300.2 million.  In May and June 2008, a total of US$45.0 million was sold on the market.

The evolution of the rupee exchange rate against the US dollar, the Pound sterling and the euro is shown in chart 4.10.

Chart 4.10: Exchange Rate Movements

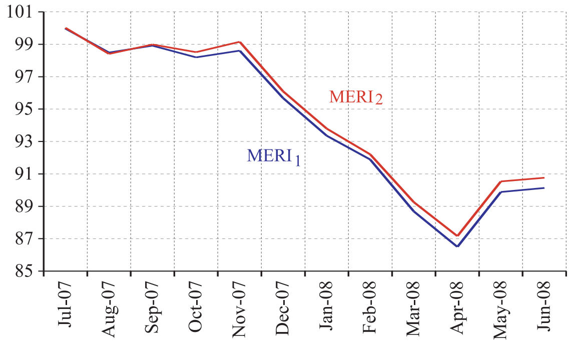



## Mauritius Exchange Rate Index (MERI)

On a nominal effective basis, $MERI_1$, which uses the currency distribution of trade as weights, appreciated by 10.9 per cent from July 2007 to June 2008. $MERI_2$, which includes the currency distribution of tourism receipts combined with the currency distribution of trade as weights, appreciated by 10.2 per cent over the same period.[20] The evolution of the exchange rate indices are illustrated in Chart 4.11.

[20] *The Mauritius Exchange Rate Indices are explained in the Financial Stability Report available at* http://bom.intnet.mu/pdf/FSU/Financial_Stability.pdf *on pages 24 and 25.*

Chart 4.11: Evolution of $MERI_1$ and $MERI_2$




## Exchange rate pass-through

The dynamics and structure of markets in Mauritius have made consumer price adjustments in the economy asymmetric. Consumer prices are adjusted more rapidly in the face of a depreciating rupee while a much longer and uncertain pass-through occurs in the case of an appreciating rupee. Strong persistence of this observed practice could be attributed to the fact that stakeholders view an appreciation of the rupee as only temporary. As a result of this and owing to lack of competition, traders generally refrain from adjusting prices of consumer products when the rupee appreciates.

However, in the current economic environment the exchange rate could depreciate as well as appreciate for prolonged periods. The appreciation of the rupee exchange rate against the major international currencies since the beginning of 2007 is a clear example of the changing environment. It follows that a change in pricing behaviour becomes imperative. Timely adjustments in prices of consumer products should contribute towards better price formation in the economy and help in the fight against inflation. Accordingly, importers and traders were urged in the March 2008 *Monetary Policy Statement* to reflect the gains from the appreciation of the rupee into the prices of imported consumer products.

# 5. The Outlook for Inflation

Inflationary pressures intensified across countries worldwide in the year to June 2008. In most advanced as well as emerging and developing economies, inflation breached historical average levels. In emerging and developing economies, food and fuel constitute a larger share of the consumption basket as a result of which the jump in inflation was relatively more prominent.

However, although the inflation outlook remains highly uncertain, there are expectations in many advanced economies that inflation will gradually subside in the second half of 2008 which will continue in 2009. Recent developments in commodity prices tend to support this expectation. Food and oil prices on the world market have already plummeted from record levels attained in June and July 2008. However, amid increasing uncertainty, the evolution of commodity prices internationally would depend on supply conditions as well as on how deep and protracted the global economic slowdown would be.

Some major economies are now confronted with both problems of high inflation and depressed economic conditions. The economic slowdown in advanced economies is expected to have a dampening effect on inflation. Moreover, economic growth in emerging and developing countries is also projected to decelerate.

Mauritius, as an export-led economy, could suffer from the economic slowdown in its main export markets and the pace of economic expansion could be undermined. As a result, exports of goods and services, which account for a substantial share of output, could be dented by faltering demand in advanced economies. On the domestic demand side, although there has been a slowdown in consumer spending in recent years, the rise in public sector salary in the second half of 2008 is expected to keep aggregate demand on firm footing. Thus, higher public sector wages could potentially generate increased consumer spending. Overall, however, demand pressures are not seen as an important contributor to inflation under current circumstances.

On the domestic supply side, food and energy prices – which directly account for around 40 per cent of the representative consumer basket – could moderate deriving support from international price developments. However, labour cost pressures are on the upside and, if not accompanied by gains in productivity, they could adversely impact on inflation.

Monetary and credit developments reflect a fairly strong underlying pace of expansion which could jeopardise medium-term price stability. However, the high rate of monetary expansion could be due to higher demand for nominal money balances to accommodate current high inflation.

Exchange rate developments in the first half of 2008 have so far contributed to limit producer and retail price increases on a number of consumer items, although the gains from the appreciation of the rupee appeared not to have been fully passed on to consumers. The expected decline in commodity prices internationally could impact favourably on the inflation outlook but the final impact remains conditional upon exchange rate movements.

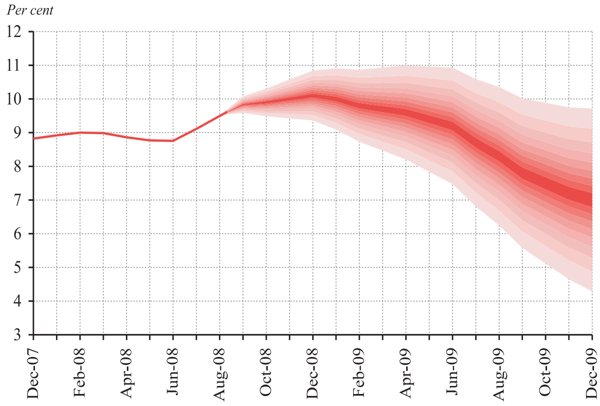
As regards economic growth prospects, business confidence remains relatively strong and is expected to continue supporting expansion of the economy's productive capacity.

## 5.1 INFLATION OUTLOOK

Inflation continues to be a major macroeconomic challenge for policymakers. The assessment of the inflation outlook entails greater ambiguity than has been the case so far and remains highly uncertain. Given the outlook on international markets for food and energy prices, imported inflation – a key factor behind rising domestic inflation – is expected to decline over the medium-term.

As illustrated in the fan chart on inflation in Chart 5.1, it needs to be highlighted that short-term inflationary pressures are forecast to be sustained and inflation is expected to hover around high levels in the next few months.[21] However, the inflation outlook is expected to gradually improve during 2009.

Chart 5.1: Inflation Fan Chart




[21] *A comprehensive description of the inflation fan chart is provided in Box 4.*

## Box 4: Inflation Fan Chart

An inflation fan chart provides information about the uncertainty surrounding a central or baseline forecast of inflation. The inflation fan chart is a probability distribution of the likely outcomes for the forecasts of inflation and gives more information on the projected future path of inflation than a simple point forecast. Along with the central projection of inflation, corresponding to the darkest band on the chart, the fan chart reflects the degree of uncertainty around the central projection as additional bands. The fan chart also displays the balance of risks to the baseline projection.

The inflation fan chart constructed for Mauritius, as shown in Chart 5.1, graphically exhibits the probability associated with the inflation projection over the forecast horizon; that is, up to December 2009. The baseline projection principally assumes there will be no major supply or demand shocks as well as no change in the monetary policy stance.

The darkest band in the fan chart indicates that the central projection of inflation can occur with a probability of 10 per cent. Each additional band above and below central projection covers a further 10 per cent of probability, until 90 per cent of the probability distribution is covered. The bands widen (i.e. “fan out”) as the time frame is extended, indicating increasing uncertainty about the inflation forecast. The bands above the central projection continue to be wider than those below, indicating that the balance of risks remains generally tilted towards higher inflation.

While fan charts are primarily used to illustrate the general uncertainty surrounding the central projection, the charting of alternative paths is one of the most frequently used methods to display risks with a direct impact on decision making. This is a very useful tool for examining the way the projected baseline scenario will change for the specific period if the most probable assumptions do not prevail. On the whole, the inflation forecast for Mauritius is subject to upside risks, implying that actual inflation could exceed the initial forecast rather than fall short of them. The baseline projections describe the most probable outcome on the basis of basic assumptions and the current information available. Obviously, various unforeseen events may affect the economy, and the macroeconomic impacts of potential shocks are also uncertain.

It is important to bear in mind the assumption that there will be no change in the current monetary policy stance over the forecast horizon in order to correctly interpret the probability distributions and the risks facing the baseline inflation projections. The probability distribution reflects the probability of changes in inflation projections, not actual inflation, since it does not take into account the monetary policy response to the latter.