BANK OF MAURITIUS

INFLATION REPORT

March 2009 | Issue No.2

The Inflation Report is published twice a year by the Bank of Mauritius in compliance with section 33(2)(b) of the Bank of Mauritius Act 2004. The Inflation Report is released to the public in March and September. It provides an analysis of inflation developments as well as the assessment underpinning monetary policy and concludes with the outlook for inflation. This issue of the Inflation Report refers to information for the semester ended 31 December 2008 unless otherwise stated.

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, Mr F. Sooklall and Mr K. Pitteea for the chapter on *Overview*; Mrs P. S. Hurree-Gobin and Mr G. Beegoo for the chapter on *Recent Developments in Inflation*; Mr A. Haulkory, Mr S. Jugoo, Ms M. Jhamna, Ms M. Mudhoo and Dr (Mrs) D. Mulliah-Hurchand for the chapter on *Demand and Output*; Mrs P. Lo Thiap Kwong, Mr C. Ellapah, Ms H. Nundoochan, Mr N. Daworaz and Mr M. Mohesh for the chapter on *Monetary and Financial Developments*; Mr J. N. Bissessur, Mr W. Khodabocus and Mr G. Beegoo for the chapter on *The Outlook for Inflation*.

The following officers contributed to the Boxes in the Report: Mr G. Beegoo – *Year-on-year CPI Inflation*, *Price Indices in Mauritius* and *Inflation Expectations Survey*; and, Mrs M. Heerah-Pampusa – *Exchange Rate Pass-Through to Prices*.

All rights reserved. No part of this publication may be reproduced, stored in any retrieval system or transmitted by any mechanical, electronic or digital means or otherwise without the prior permission of the publisher, the Bank of Mauritius.

The contents of this publication are intended for general information only and are not intended to serve as financial or other advice. While every precaution is taken to ensure the accuracy of information, the Bank of Mauritius shall not be liable to any person for inaccurate information or opinions contained in this publication.

The Report is available in PDF format on the Bank's website at *http://bom.intnet.mu* under the menu item *Research and Publications*. The Bank of Mauritius welcomes any comments or suggestions on this publication. You may send your emails to *mp.unit@bom.intnet.mu*.

Inflation Report March 2009 | Issue No. 2

© Bank of Mauritius 2009

Conception and Design by Khalil Muthy.

Printed by LOVELLS PRINTING AND ARTWORK LTD.

ISBN : 978-99949-27-59-3

INFLATION REPORT

March 2009 | Issue No.2

Contents

List of Tables, Charts and Boxes

List of Acronyms

APM	Automatic Pricing Mechanism
BML	Broad Money Liabilities
CPI	Consumer Price index
CRR	Cash Reserve Ratio
CSO	Central Statistics Office
ECB	European Central Bank
EIA	Energy Information Administration (of the US Department of Energy)
EPI	Export Price Index
FAO	Food and Agricultural Organisation
FDI	Foreign Direct Investment
FOMC	US Federal Open Market Committee
GDP	Gross Domestic Product
IES	Inflation Expectations Survey
IMF	International Monetary Fund
IPE	International Petroleum Exchange
IPI	Import Price Index
IRS	Integrated Resort Scheme
MERI	Mauritius Exchange Rate Index
MPC	Monetary Policy Committee
NYMEX WTI	New York Mercantile Exchange West Texas Intermediate
ODC	Other Depository Corporations
OECD	Organisation for Economic Co-operation and Development
PLR	Prime Lending Rates
PPI-A	Producer Price Index-Agriculture
PPI-M	Producer Price Index-Manufacturing
PRB	Pay Research Bureau
REER	Real Effective Exchange Rate
SEMDEX	Stock Exchange of Mauritius Index
TARP	Troubled Assets Relief Program
VAR	Vector Auto Regression
WEO	(IMF's) World Economic Outlook
WRI	Wage Rate Index

1. Overview

The international financial crisis intensified in the second half of 2008, particularly after mid-September 2008. Increased aversion to risk provoked by the financial turmoil constrained credit flows to households and businesses in most advanced economies. As a result, the adverse consequences on real economic activities were exacerbated and there was a significant and rapid deterioration of global economic growth prospects in the last quarters of 2008. These developments permeated from advanced economies to emerging and developing economies, further undermining the global growth outlook.

The sharp deterioration of global economic conditions bolstered a marked decline in energy and other commodity prices on international markets. From peaks attained in July 2008, oil prices by December 2008 had plummeted to levels seen in early 2005. Further, boosted by slowing global demand and bumper crops in food-producing countries, food prices declined substantially. As a result, inflationary pressures that characterised the first half of 2008 abated and inflation started falling across countries worldwide.

These developments impacted on the domestic economy, more so as they were most acute in the main export markets of Mauritius. Economic growth for 2008 was revised downward on account of weak economic performance in the third quarter of the year and growth prospects for 2009 are bleak. On the positive side, inflationary pressures receded at the end of 2008 on the back of the fall in domestic prices of petroleum products.

Against the backdrop of a deteriorating economic outlook and subsiding inflationary pressures, the government and the Bank coordinated their policy responses to ensure that appropriate measures were taken to shore up the economy. The government came up with a stimulus package, equivalent to 3.8 per cent of Gross Domestic Product (GDP), and the Bank eased monetary policy by reducing the key Repo Rate as well as the minimum Cash Reserve Ratio (CRR) in the last quarter of 2008.

1.1 THE EXTERNAL ENVIRONMENT

The international financial crisis and the global economic slowdown

The financial crisis, which first erupted with the US sub-prime mortgage collapse in August 2007, intensified as from mid-September 2008 following the bankruptcy of *Lehman Brothers* in the United States, the largest bankruptcy filing in US history. This created panic in financial markets, generating a tremendous increase in risk aversion and sharp declines in major stock markets. The deterioration in the health of financial institutions, particularly banks, coupled with heightened risk aversion which squeezed credit flows to households and businesses, severely affected consumer as well as business spending in major economies.

Indeed, the impact of the financial crisis on real economic activities, which started in August 2007, was more severely felt in the second semester of 2008. Recent data indicated that most G-7 economies were in recession in the second semester of 2008. Consumer as well as business confidence fell to historical lows. Job losses and unemployment rates in some advanced economies reached levels not seen in decades. Concurrently, shrinking demand in main export markets substantially undermined economic activity in emerging economies as well as in commodity producing economies.

Growth in emerging economies fell substantially to levels well below potential. These economies struggled with slower growth even though many had little direct exposure to the financial turmoil. Among emerging economies, commodity exporters were the hardest hit. Likewise, the growth outlook for poor developing economies, which depend on remittances and aid from donor countries, deteriorated as source economies faced challenging times. Further, capital flows to developing countries dried up and huge amounts of market capitalisation evaporated. Emerging market economies also experienced downward pressure on their currencies as global investors reduced exposure to them.

The policy reactions to support the international financial system and bolster economic activity came from both governments and central banks, as fears of a deep and prolonged global economic recession made headway. Various measures were taken to restore confidence in financial markets, including aggressive reduction of policy interest rates, massive injection of liquidity, expansion of the range of assets acceptable in central banks' refinancing operations, takeover of troubled assets, and recapitalisation and nationalisation of some financial institutions. In addition, various fiscal stimulus packages were announced by governments in an effort to stimulate economic activity.

In its World Economic Outlook (WEO) of 28 January 2009, the International Monetary Fund (IMF) downgraded its global economic outlook, citing rapidly slowing global activity and deteriorating global growth prospects on continuing financial sector deleveraging and falling producer and consumer confidence. Global growth is projected to decline to 0.5 per cent in 2009, the lowest since World War II. In advanced economies, economic activity is projected to contract by 2.0 per cent in 2009 after an estimated expansion of 1.0 per cent in 2008. The measures authorities worldwide have taken are expected to reduce the severity and duration of the crisis. However, the damage to global credit conditions is significant and recovery could take considerable time. The global economy is projected to gradually recover in 2010, with growth picking up to 3.0 per cent. Table 1.1 gives details on economic growth in selected economies.

The United States has been in recession since the last quarter of 2007. Its economy contracted at an

Table 1.1: Real Growth Rates in Selected Economies

Annual percentage change

	2006	2007	2008	2009 Projection	2010 Projection
World output	**5.1**	**5.2**	**3.4**	**0.5**	**3.0**
Advanced economies	**3.0**	**2.7**	**1.0**	**-2.0**	**1.1**
of which					
United States	2.8	2.0	1.1	-1.6	1.6
Euro area	2.8	2.6	1.0	-2.0	0.2
Japan	2.4	2.4	-0.3	-2.6	0.6
United Kingdom	2.8	3.0	0.7	-2.8	0.2
Emerging market and developing economies	**7.9**	**8.3**	**6.3**	**3.3**	**5.0**
Sub Saharan Africa	6.6	6.9	5.4	3.5	5.0
Developing Asia	9.8	10.6	7.8	5.5	6.9
of which					
China	11.6	13.0	9.0	6.7	8.0
India	9.8	9.3	7.3	5.1	6.5

Source: IMF's World Economic Outlook, October 2008, and Update released on 28 January 2009.

annual rate of 6.2 per cent in the fourth quarter of 2008. The US housing market continued to deteriorate further with falling house prices. The jobless rate in the United States rose to 7.2 per cent in December 2008, bringing job losses to 2.6 million in 2008. Moreover, leading indicators suggest the downturn would likely be prolonged despite massive monetary and fiscal policy boosts by the US Federal Reserve and the US government. In January 2009, the IMF projected a contraction of 1.6 per cent of the US economy in 2009.

The euro zone was in recession as well, after contracting in the last three quarters of 2008. Financial turbulence and significant house price declines in several euro zone economies led to greater uncertainty. Industrial production and retail sales had fallen significantly by the end of 2008. With the intensification of the financial crisis in September 2008, several economies including Germany and France took extraordinary measures to rescue their financial systems. Economic activity in these economies, however, is expected to decelerate further. The IMF projected in January 2009 that the euro zone economy would contract by 2.0 per cent in 2009.

The UK economy faces a serious recession, which began in the third quarter of 2008. The economic downturn has been deepening at an alarming pace. Manufacturing output, home sales, employment, investment, and consumer as well as business confidence hit record lows. Real GDP shrank by 0.7 per cent in the third quarter of 2008 relative to the previous quarter, the first drop since 1992, and further by 1.5 per cent in the fourth quarter of 2008. More declines in GDP over the next few quarters are anticipated. Unemployment rate rose to 6.3 per cent in the last quarter of 2008, raising the number of unemployed to 1.97 million in December 2008. In January 2009, the IMF indicated that the UK economy would contract by 2.8 per cent in 2009.

Economic growth in emerging economies continued to decelerate in the second half of 2008, as economic activity contracted in several major advanced countries. China's economic growth rate slipped into single digit in the third and fourth quarters of 2008 under the impact of the global credit crisis and shrinking export markets. Annual GDP growth slowed to 9.0 per cent in the third quarter of 2008 and to 6.8 per cent in the fourth quarter of 2008, from 10.1 per cent in the second quarter of 2008. The Indian economy also struggled. Industrial production dipped at a fast pace and foreign institutional investors pulled out billions of US dollars from the stock market. The Indian economy is estimated to have grown by 7.3 per cent in 2008. In January 2009, the IMF projected that growth in China and India would decelerate further to 6.7 per cent and 5.1 per cent, respectively, in 2009.

Inflation

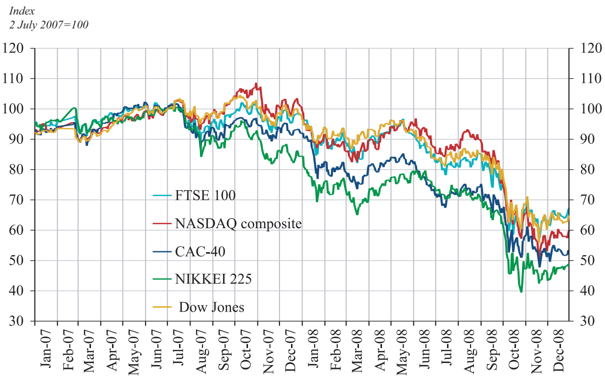
After rising rapidly in the first half of 2008 on the back of surging commodity prices, inflation subsided globally in the last two quarters of 2008. Inflation was down significantly in most economies in November and December mainly on account of the rapid fall in commodity prices, especially oil, and sluggish economic activity worldwide.

In the United States, inflation fell from 5.6 per cent in July to just 0.1 per cent in December 2008, while in the euro area inflation dropped from a peak of 4.0 per cent in June and July to 1.6 per cent in December 2008. Some advanced economies were even facing risks of deflation. Inflation also moderated in most emerging economies. However, in some countries such as Indonesia and Turkey inflation was still hovering close to or above 10 per cent. The inflation rates of selected economies are shown in Table 1.2.

International stock markets

Heightened risk aversion, deleveraging by institutions and investors and serious concerns about the global economic downturn increased volatility and uncertainty on stock markets, as shown in Chart 1.1.

Chart 1.1: Equity Indices of Selected Major International Stock Markets



Source: Reuters.

The culmination of the financial crisis around mid-September 2008, with the bankruptcy or close failures of several large financial institutions, was followed by a resumption of the general downward trend on stock markets. Equity markets plummeted further at the end of September 2008 when the US House of Representatives voted down the initial proposal of the US$700 billion Troubled Assets Relief Program (TARP) bail-out. The TARP aimed

Table 1.2: Consumer Prices

Annual percentage change

	2004	2005	2006	2007	July 2008	December 2008
China	3.9	1.8	1.5	4.8	6.3	1.2
Euro area	2.1	2.2	2.2	2.1	4.0	1.6
Hong Kong	-0.4	0.9	2.0	2.0	6.3	2.1
Hungary	6.8	3.6	3.9	7.9	6.7	3.5
India	3.8	4.2	6.2	6.4	8.3	9.7
Indonesia	6.1	10.5	13.1	6.4	11.9	11.1
Philippines	6.0	7.7	6.2	2.8	12.2	8.0
Singapore	1.7	0.5	1.0	2.1	6.5	4.3
South Africa	1.4	3.4	4.7	7.1	13.4	9.5
South Korea	3.6	2.8	2.2	2.5	5.9	4.1
Thailand	2.8	4.5	4.6	2.2	9.2	0.4
Turkey	8.6	8.2	9.6	8.8	12.1	10.1
United Kingdom	1.3	2.0	2.3	2.3	4.4	3.1
United States	2.7	3.4	3.2	2.9	5.6	0.1

Source: IMF's World Economic Outlook, October 2008, The Economist and central banks' websites.

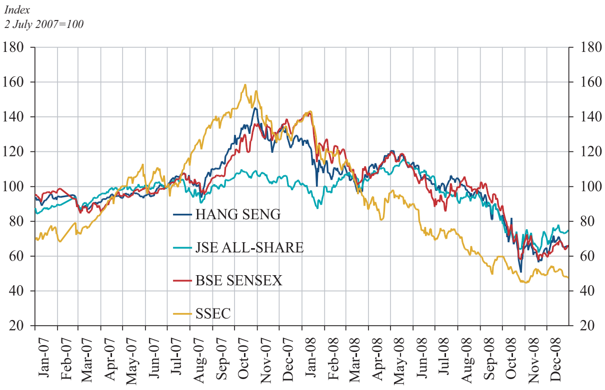
at purchasing assets and equity from financial institutions in the United States in order to support the financial sector. A revised TARP was subsequently agreed upon.

The sustained decline in equity prices on major international stock markets till November 2008 was comparable to the most severe historical episodes of financial stresses. Some marginal stock market recovery was observed in December 2008.

The intensification of the crisis in the United States spread to institutions in Europe, many of which had recourse to government support for survival. The loosening of monetary policy and injection of liquidity by major central banks, accompanied by fiscal stimulus packages, reassured stock markets to some extent.

Stock markets in emerging markets were affected by developments in advanced economies and suffered significant downturns, as shown in Chart 1.2. Increased risk aversion induced investors to move away from equity markets to liquid assets and safer havens, such as US dollar-denominated financial assets. In addition, share prices were hit by the weak outlook for corporate earnings as economic activity was affected by the crisis.

Chart 1.2: Equity Indices of Selected Emerging Stock Markets



Source: Reuters.

Monetary policy in selected economies

A number of central banks remained cautious about their monetary policy stance in the third quarter of 2008. The European Central Bank (ECB) raised its policy interest rate in July 2008 in a bid to mitigate inflationary pressures and anchor inflation expectations as well as contain second-round effects of price increases.

However, the escalation of the financial crisis around mid-September 2008 and rapid deterioration of economic conditions and prospects compelled most central banks worldwide to embark on a generalised loosening of monetary policy. The credit crunch was a serious source of concern, particularly in advanced economies.

In a coordinated move, several central banks – namely in Canada, United Kingdom, the euro area, United States, Sweden and Switzerland – acted jointly and reduced interest rates by 50 basis points on 8 October 2008. The Bank of Japan strongly supported the policy action. The measure aimed at easing global monetary conditions against the backdrop of elevated downside risks to global growth. The decline in the prices of energy and other commodities as from July 2008 had moderated inflation and an improvement in the inflation outlook ensued. Thus, heightened growth concerns against the backdrop of an improved inflation outlook led to an aggressive loosening of monetary policy.

The intensification of the financial crisis led to a generalised and sharp reduction in policy interest rates in advanced as well as emerging and developing countries. As financial markets reeled under the crisis, central banks also injected liquidity to alleviate severe financial market strains. The combination of expansionary monetary policy and fiscal stimulus measures was expected to mitigate the economic meltdown and shore up recovery.

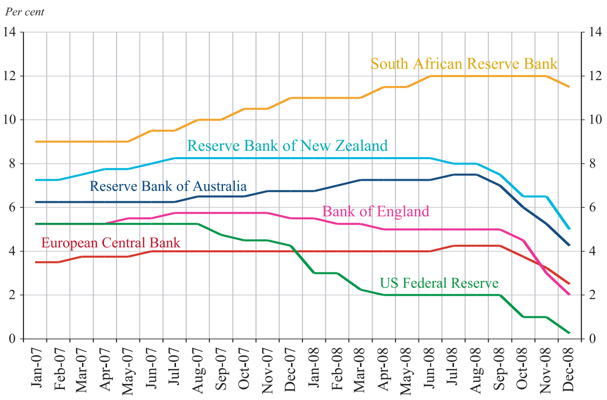
The ECB adopted an easing stance as from October 2008 and reduced its policy interest rate on three successive occasions by December 2008. The US Federal Reserve and the Bank of England aggressively cut their policy interest rates in the last quarter of 2008. Central banks in other countries, such as Australia, India, Malaysia, Sweden, Thailand, New Zealand, Norway and Canada, also reduced interest rates significantly in an attempt to prop up their economies.

By the end of December 2008, policy interest rates reached historical lows in a number of countries. In the United States, the federal funds rate was reduced to the target range of 0 to 0.25 per cent. The official Bank Rate in the United Kingdom was decreased by the Bank of England to 2.00 per cent, reaching a 50-year low. The interest rate on the main refinancing operations in the euro area was cut to 2.00 per cent. Chart 1.3 shows end-of-month policy interest rates of selected central banks.

In contrast, in the period under review – particularly around October 2008 – some central banks namely in Hungary, Iceland and Denmark raised their policy interest rates in a move to protect their respective national currencies. Thereafter, however, they had to gradually lower their policy interest rates.

The outlook for global monetary policy suggests that, given the significant deterioration in growth prospects and the major improvement in the inflation outlook, further loosening is expected to take place though at a less aggressive pace as policy interest rates are already at very low levels. In addition, some central banks would likely go for quantitative easing by injecting liquidity into the monetary system.

Chart 1.3: Major Central Banks' Interest Rates



1.2 THE DOMESTIC ENVIRONMENT

Growth

The domestic economy is estimated to have grown at a lower pace of 5.2 per cent in 2008, compared to 5.4 per cent registered in 2007, but still above the trend growth rate of close to 4.5 per cent for the present decade. As a small and highly open economy, this rate of economic expansion indicates that, overall, the economy demonstrated some degree of resilience to the global economic downturn and financial turmoil.

Overall for 2008, the downward revision of the initial growth forecast was mainly due to lower growth anticipated in the manufacturing, especially textiles and hotels and restaurants sectors, which are particularly dependent on external demand. The banking sector was, however, expected to post higher growth than initially estimated. Financial intermediation, transport, storage and communications, real estate, construction and distributive trade sectors were projected to register relatively strong growth rates. In terms of expenditure, the salary increase in the public sector, effective as from July 2008, was expected to sustain household consumption expenditure.

Nonetheless, there is evidence of a deceleration in economic activity in the second half of 2008 due to the global economic slump. Clear signs that the export-oriented tourism and textile sectors were being negatively affected emerged. Output and domestic demand decelerated in the third quarter of 2008 and the slowdown was likely to have persisted in the fourth quarter of 2008 as well.

Growth prospects for 2009 are expected to be clouded by heightened uncertainty given the anticipated contraction of main export markets. Economic growth for 2009 is forecast by the Central Statistics Office (CSO) at 4.0 per cent, with zero growth expected in the textile and tourism sectors. The impact of weak economic conditions in Mauritius' main export markets is a serious cause for concern. The government implemented a fiscal stimulus package in December 2008 to prop up the economy and the Bank eased monetary policy in the last quarter of 2008.

Preliminary estimates of the output gap – measured as the difference between actual and potential output – suggest that, reflective of downside risks to growth, it would likely turn negative in 2009.

The fiscal stimulus package has been designed to be targeted, flexible and temporary. It will lapse at the end of 2010. Broadly, the measures aim at increasing public sector investment by principally fast-tracking and frontloading infrastructure projects, removing bottlenecks to boost private sector investment, providing support to businesses for them to continue operations, thereby protecting employment. In terms of sectoral initiatives, export-oriented firms will be provided with assistance to face falling demand in export markets, such as marketing back-up and marketing intelligence. Overall, the fiscal stimulus represents around 3.8 per cent of GDP.[1]

Stock market

Reflecting mounting economic gloom and heightened risk aversion in international markets,

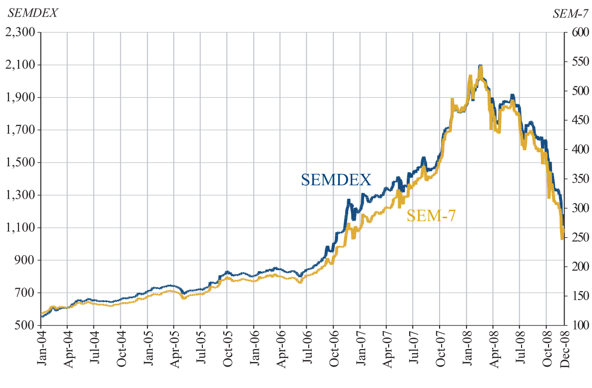
1 *Additional Stimulus Package, Shoring up Economic Performance,* Ministry of Finance and Economic Empowerment, Government of Mauritius, http://www.gov.mu/portal/goc/mof/files/minibud1208.pdf.

the local stock market lost considerable ground in the second half of 2008. The SEMDEX and the SEM-7 fell by a hefty 35 per cent and 41 per cent, respectively, reaching lows of 1,112.17 and 245.90 on 24 November 2008.[2]

The sharp drop in the stock market indices to levels last seen in November 2006 caused the SEM to shed all gains made throughout 2007 and beginning of 2008, as shown in Chart 1.4. With the focus on the economic weakness of major export markets and the potential impact on export-oriented enterprises amid the revised domestic economic outlook, share prices of blue chip companies dipped following aggressive selling by both local and foreign investors.

Foreign investors disinvested significantly from the local stock market. Net sales by foreign investors in the second half of 2008, which mostly occurred in the last quarter of 2008, stood at Rs308 million as against inflows of Rs1,091 million in the first half of the year. The decline was mainly driven by sales of banking and hotels stocks. Despite investors remaining cautious and trading at low levels, a slight pick-up was noted in December 2008. Risk aversion for emerging equity markets might persist for some time, which might be reflected in transactions by foreign investors on the local stock market.

Chart 1.4: SEMDEX and SEM-7



Source: Stock Exchange of Mauritius Ltd.

Exchange rate

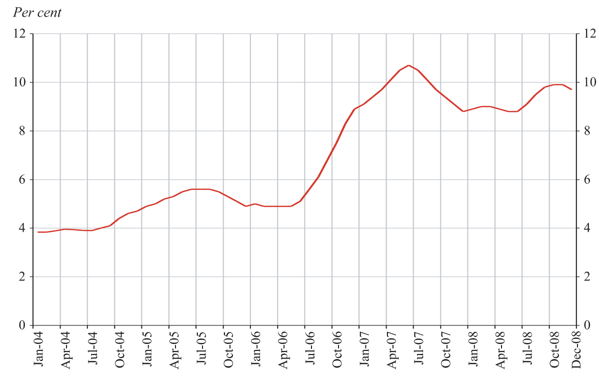
In the second half of 2008, the exchange rate of the rupee was driven mostly by international economic developments whilst local factors had rather mitigated effects. The intensification and deepening of the crisis, which enhanced risk aversion, pushed investors towards safe havens like the US dollar and the Japanese yen. These currencies remained well-supported as a result. This was mirrored in a depreciation of the rupee on the local foreign exchange market. The rupee depreciated against major currencies from July to December 2008, with the exception of the Pound sterling which tumbled to multi-year low on international markets.

Inflation

Downward adjustments in domestic prices of imported commodities were seen in the last quarter of 2008. Administered prices – such as for petroleum products and flour – were brought down markedly. Market prices of imported foodstuffs registered declines, although the pass-through was slower due to a number of factors, such as downward price stickiness, stocks acquired at high prices and exchange rate movements. It is, however, expected that prices would come down more prominently in early 2009, enhanced by declining inflation expectations.

The movement in the inflation rate, as measured by the twelve-month average change, is depicted in Chart 1.5. After hovering at 9.1 per cent in July 2008, inflation rose to 9.9 per cent in November 2008 but fell to 9.7 per cent in December 2008. Inflation is foreseen to come down further in 2009.

Chart 1.5: Evolution of the Inflation Rate



Source: CSO, Government of Mauritius.

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

1.3 MONETARY POLICY

At the beginning of the second semester of 2008, there was a reassessment of domestic monetary policy after an easing stance in the first semester during which the key Repo Rate was reduced by a cumulative 125 basis points. Thus, in July 2008, against the backdrop of intensifying upside inflationary pressures, there was a hike in the policy interest rate.

However, towards the end of September 2008, the sharp decline in energy and other commodity prices internationally subjugated inflationary pressures and the significant deterioration in the global economic outlook – in particular, in Mauritius' main export markets – became a source of concern. Enhanced downside risks to domestic economic growth were perceived by the Monetary Policy Committee (MPC) as serious. Consequently, the monetary policy stance adopted in July 2008 was short-lived and monetary policy was eased in the last quarter of 2008, with successive reductions in the policy interest rate totalling 150 basis points. The assessments and decisions of the MPC are detailed in the following sections.

Monetary Policy Committee meetings

The MPC convened four times in the second half of 2008. Of the four meetings, two were specially convened to deal with exceptional developments.

The communication policy for announcing decisions and assessments of the MPC was maintained. All decisions to change the policy interest rate became effective at the time of announcement. The monetary policy decision was announced at 1800 hours on the same day the MPC met and the Governor, Chairperson of the MPC, held a press conference on the following day to elaborate on the monetary policy decision. Exception was made for the special MPC meeting held on 31 October 2008 when the decision was made public at 1400 hours and the Governor met the media on the same day. The Monetary Policy Statement, expounding the assessment made by the MPC as well as the voting pattern, continued to be released a week after each meeting.

Monetary policy decisions

The MPC convened specially on 21 July 2008 and unanimously decided to raise the key Repo Rate, with a majority supporting a 25 basis points hike that took the key Repo Rate to 8.25 per cent per annum. The MPC judged that the monetary policy stance had to be reviewed to avoid the economy falling into an inflation spiral. The outlook for domestic inflation had deteriorated after domestic prices of petroleum products and public sector salary were hiked in July 2008. It was feared that inflationary pressures could permeate to the broader economy and second-round effects of high inflation could serve as a basis for anchoring inflation expectations at high level.[3] On the growth front, the likelihood for domestic growth to be adversely affected by faltering consumer spending in Mauritius' main export markets remained high. The MPC determined that downside risks to economic growth and upside risks to inflation were both serious, but the relatively higher upside risks to inflation required a tightening of monetary policy.

The economic and financial environment, both locally and internationally, had deteriorated by the time the MPC met on 29 September 2008. The economic downturn had spread rapidly to G-7 economies, several of which represent main export markets for Mauritius. Weakening demand in export markets had worsened growth prospects of domestic export-oriented sectors. Consequently, the MPC judged that the downside risks to growth had intensified considerably. Signs of a deceleration in the domestic economic growth and the likely impact of the decline in oil and food prices on international markets on domestic inflation convinced the majority of MPC members to leave the key Repo Rate unchanged. The MPC took note that the increase in the minimum CRR from 4.0 per cent to 6.0 per cent, with effect from 15 August 2008, had led to a rise in short-term market interest rates, thus tightening monetary conditions.

As the global financial crisis intensified from September 2008 onwards, accompanied by severe consequences on global economic activity, it was imperative for the government to shore up the domestic economy to mitigate the adverse effects of the global economic downturn. Many central banks were loosening monetary policy and providing liquidity to money markets. The Bank proposed to support and complement the efforts of government. Accordingly, the MPC met exceptionally on 31 October 2008 and took note of the policy of government to prop up the economy.

3 Box 4 elaborates on inflation expectations.

Domestic inflation was projected to decline as global inflation rapidly receded due to sharp declines in food and energy prices and weaker prospects for global economic activity. Alongside, the MPC noted a further intensification of downside risks to growth in domestic export-oriented sectors, as demand conditions in the country's main export markets were foreseen to weaken further. These risks could spill over to the rest of the economy and negatively affect overall economic activity. In the light of the expected decline in inflation and government's policy stance to support the domestic economy, the MPC decided by consensus to adopt an accommodative monetary policy stance and reduced the key Repo Rate by 50 basis points to 7.75 per cent per annum. The MPC also took note of the decision to reduce the minimum CRR by 1 percentage point to 5.0 per cent in order to ease monetary conditions.

The global economic and financial situation had aggravated further when the MPC met again on 8 December 2008. The international financial crisis continued to unfold and a deeper and protracted global economic downturn was anticipated. Economic activity in advanced economies was projected by the IMF to contract significantly in 2009. Most central banks had been cutting interest rates aggressively and injecting liquidity to mitigate the worldwide financial crisis and stimulate their economies. Depressed economic conditions in Mauritius' main export markets were already affecting the domestic export-oriented sectors. Consequently, downside risks to domestic growth had further intensified. Inflation was falling worldwide, as food and crude oil prices plummeted. While being concerned about the widening current account deficit and the slowdown in private capital flows, the MPC determined that monetary policy could be eased further which would support the government's policy to stimulate the domestic economy. The MPC decided by consensus to cut the key Repo Rate by 100 basis point to 6.75 per cent per annum.

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

Table 1.3: Decisions of the MPC on the Key Repo Rate

Date of MPC meeting and effective date of decision	Decision on the key Repo Rate	Key Repo Rate *(post-decision level, per cent per annum)*	Voting pattern	Details on voting pattern
21 July 2008	Increase by 25 basis points	8.25	4 - 3	2 - hike by 100 basis points 1 - hike by 50 basis points
29 September 2008	Unchanged	8.25	5 - 2	2 - hike by 25 basis points
31 October 2008	Reduce by 50 basis points	7.75	Consensus	-
8 December 2008	Reduce by 100 basis points	6.75	Consensus	-

2. Recent Developments in Inflation

Inflation in Mauritius hovered around high levels in both 2007 and 2008 mainly on account of external factors, particularly the acute increase in oil and food prices. Such levels were last seen in 1994.

As from July 2008, the retreat in oil and other commodity prices on international markets, together with weaker economic conditions worldwide, significantly reduced inflationary pressures. Domestic prices were favourably affected by these developments. The pass-through of international price developments became more perceptible in the last quarter of 2008. The drop in local prices of a number of imported commodities generated a fall in the Consumer Price Index (CPI) in both November and December 2008 leading to a decline in inflation in December 2008. Developments in inflation over the period July to December 2008 are elaborated in ensuing sections.

2.1 GLOBAL INFLATION AND COSTS

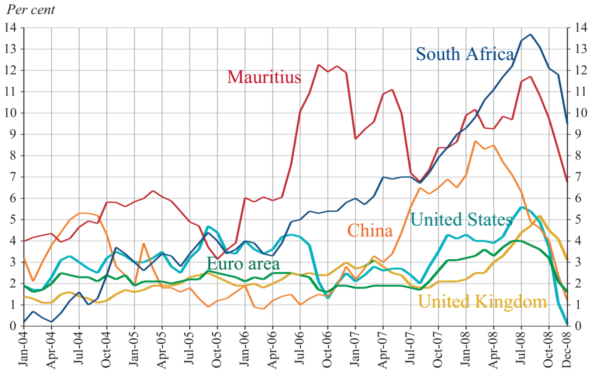
Inflation started moderating in most major economies in the second half of 2008, with the decline becoming more pronounced in the third quarter of 2008.[4] The marked decline in energy and commodity prices on international markets, concurrent with weaker aggregate demand in major economies, had considerably reduced inflationary pressures. Alongside, measures of core inflation in major economies recorded declines. Global inflation is expected to fall further in 2009, with risks of deflation rising in some economies, such as in the United Kingdom and the United States.

The rise in inflation, which characterised the first half of 2008, initially persisted in most of the major trading partner countries of Mauritius. Inflation reached a peak of 5.6 per cent and 4.0 per cent in the United States and euro area, respectively, in July and 5.2 per cent in the United Kingdom in September 2008. Thereafter, inflation fell at a rapid pace against the backdrop of fast declining energy and other commodity prices. In the United States, inflation fell to 0.1 per cent while in the euro area and the United Kingdom it dropped to 1.6 per cent and 3.1 per cent, respectively, in December 2008. In South Africa, inflation declined to 9.5 per cent in December, after attaining a high of 13.7 per cent in August 2008. Inflation in China dipped to 1.2 per cent in December, from 6.3 per cent in July 2008.

Inflationary pressures in the US economy are expected to remain subdued during 2009. Similarly, in the United Kingdom and euro area, inflationary pressures are expected to subside, reflecting waning contributions from retail energy and food prices amid a major slowdown in economic activity. The ECB expects inflation to fall to levels in line with price stability over the policy-relevant horizon.

In most emerging market economies, inflation, after firming up during the first half of 2008, eased thereafter, influenced by the same set of factors as for advanced economies including the generalised slowdown in economic activity arising from the spill-over effects of the global financial crisis. Consequently, the monetary policy responses of most central banks in emerging market economies switched from containing inflation and inflationary expectations to easing monetary conditions to support the recovery of economic activity. Chart 2.1 shows the path of (year-on-year) inflation in some selected economies, including Mauritius.

Chart 2.1: Evolution of Inflation in Selected Countries



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

Oil prices

Oil prices dropped considerably as from July 2008 on the back of the slump in global demand, after systematically climbing to elevated levels for an extended period since early 2007. The NYMEX WTI (West Texas Intermediate) crude oil prices dipped sharply from its intraday historical high of US$147.3 a barrel on 11 July 2008 to US$44.6 a

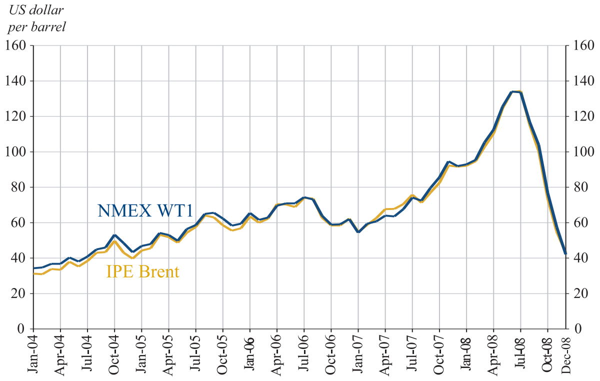
4 In this section, official inflation figures cited represent year-on-year inflation computed as the percentage change between the CPI in a given month compared with the same month of the preceding year.

barrel on 31 December 2008. The decline was induced by falling demand in the Organisation for Economic Co-operation and Development (OECD) countries as well as some developing countries.

NYMEX WTI averaged US$42.1 a barrel in December 2008, down from US$133.5 a barrel in July 2008. IPE Brent figures averaged US$43.0 a barrel in December 2008, down from a peak of US$134.3 a barrel in July 2008. Chart 2.2 shows the rapid decline in both NYMEX WTI and IPE Brent oil prices.

The outlook for crude oil prices, as per projections by major international forecasters, indicates that oil prices would remain close to US$50 a barrel during 2009, principally on account of the global economic downturn. According to the US Energy Information Administration Short-Term Energy Outlook of January 2009, NYMEX WTI crude oil prices per barrel would average US$43 in 2009 and US$55 in 2010. The IMF, in its WEO Update of 28 January 2009, projected the price of crude oil at US$50 a barrel for 2009 and US$60 a barrel for 2010.

Chart 2.2: Movements in Monthly Average NYMEX WTI and IPE Brent



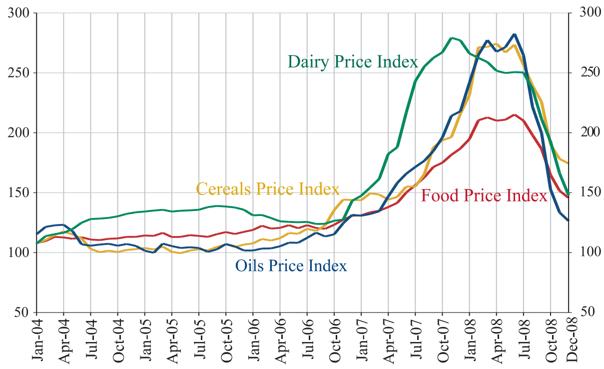
Source: Reuters.

Food prices

Food prices eased during the second half of 2008. According to the Food and Agricultural Organisation (FAO), the primary factor behind falling agricultural prices was slowing demand.[5] A number of other important factors contributed to the fall in food prices, notably an improvement in global supply such as for oilseeds, grains and dairy products in major producing countries, a strengthening of the US currency and the international financial crisis. However, food prices still remained above their long-term trend levels. The outlook for food prices is mired in uncertainty over the medium term on account of both supply and demand conditions.

Following the rapid decline in food prices worldwide, the Food Price Index, compiled by the FAO, declined by 32.9 per cent from June 2008 to December 2008. The FAO Food Price Index and other food commodity price indices are shown in Chart 2.3.

Chart 2.3: FAO Food Price Index



Source: FAO website.

Freight costs

The severe decline in global economic activity brought down freight rates markedly in the last two quarters of 2008. The London-based Baltic Dry Freight Index, the benchmark for commodity shipping costs, which reached its record peak level of 11,793 points on 21 May 2008, dropped by 93 per cent to 774 points, six months later, on 24 December 2008.

2.2 HEADLINE AND CORE INFLATION

Inflation is measured by computing the average change over time in the cost of a fixed basket of consumer goods and services. The jump in domestic inflation since the second half of 2006, which persisted throughout 2007 and most of 2008, thereby breaching historical average levels over a sustained period, was caused primarily by surging prices of energy and food on international markets.

The reversal in movements of these commodity prices as well as in freight rates subjugated inflationary pressures substantially. Despite the general persistence of a lag in the pass-through from externally falling prices onto domestic prices, a decline in domestic prices of some imported commodities, including energy products and

5 *Food Outlook, Global Market Analysis,* November 2008, FAO, FAO website.

foodstuffs, was seen in the last quarter of 2008. Consequently, the continuous rise in inflation observed as from July 2008 onwards was reversed in December 2008.

Headline inflation

Headline inflation, measured as the percentage change between the average CPI during a twelve-month period and the average CPI during the corresponding previous twelve-month period, gathered some momentum in the third quarter of 2008 mainly due to increases in domestic prices of petroleum products and some non-oil commodity prices, accompanied by an increase in freight cost in July 2008. Inflationary impulses, of both external and domestic origins, were most clearly felt in terms of rising consumer prices of food and transport, with these two categories accounting for three-quarters of the increase in consumer prices. Consequently, domestic inflation remained high primarily reflecting the first-round and, to some extent, second-round effects of the adjustments in energy and food prices.

The impact of falling prices of oil and food commodities on the global market started to be felt during the fourth quarter of 2008. The sustained decline in oil prices led the Automatic Pricing Mechanism (APM) Review Committee to revise downwards the domestic price of fuel in November 2008 and December 2008.[6] Furthermore, declining global food prices and lower freight rates were important factors contributing to an easing of inflation towards the end of 2008.

After rising continuously from 9.1 per cent in July 2008, inflation peaked at 9.9 per cent in October and November 2008 before falling slightly to 9.7 per cent in December 2008.

6 The APM Review Committee carries out any adjustment in the prices of petroleum products on a monthly basis as from 1 December 2008 and the maximum allowable increase/decrease is 7.5 per cent. Previously in 2008, the APM Review Committee adjusted prices on a quarterly basis with a maximum allowable increase/decrease of 20 per cent.

Box 1: Year-on-Year CPI Inflation

In terms of 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 growth. Price stability relates to a low and stable rate of inflation. Inflation can be described as a persistent rise in prices, that is, a series of rises over a fairly long period, e.g. one year as compared to a single month. Inflation refers to the average price of goods and services, not the price of an individual good or service and it is widely measured using the Consumer Price Index.

There are usually two ways of calculating the annual rate of change in the CPI. The first way is to calculate the year-on-year percentage change in the index, that is, comparing the CPI in a particular month with the CPI in the same month of the preceding year. The second method is based on the change in the average index; for instance, by comparing the average CPI during a twelve-month period with the average CPI during the corresponding previous twelve months. In Mauritius, the CSO uses the second method to calculate the rate of inflation. However, it is recognised that this measure is not without flaw in that it is backward-looking and it does not reflect the dynamics of price changes.

Both the twelve-month average and the year-on-year methodologies have their merits and demerits. While the twelve-month average method smoothes out fluctuations over a time period, the year-on-year methodology captures the dynamics of inflation movements over a period of time and is more appropriate from the central bank's point of view for monetary policy purposes. Accordingly, the Bank proposes to use the year-on-year methodology for monetary policy decisions. This is in line with international best practices.

The table below shows a list of countries (non-exhaustive) that are using the year-on-year methodology for monetary policy decisions.

Argentina	India	Thailand
Australia	Indonesia	Turkey
Bangladesh	Israel	United Kingdom
Brazil	P.R China	United States
Canada	Philippines	
Euro Zone	South Africa	

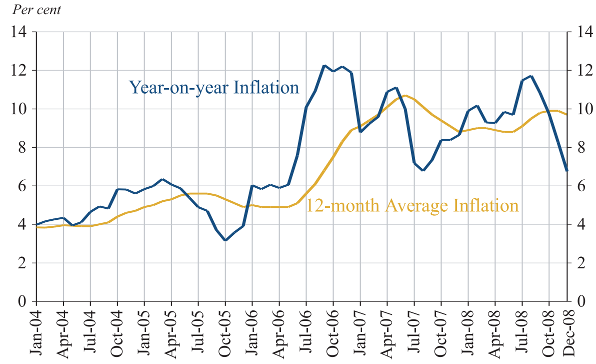
Year-on-year inflation

For policy to react in a timely and appropriate manner to changing inflationary pressures, the use of an inflation measure that provides better information on inflation dynamics is important. Central banks, in general, formulate and determine monetary policy on the basis of inflation measured by the year-on-year methodology. Year-on-year inflation is computed as the percentage change in the CPI for a given month compared with the same month of the preceding year.

The MPC, while deciding on monetary policy, also considers movements in year-on-year inflation to better gauge inflation dynamics. The MPC thus relies on a more accurate and comprehensive picture of the inflation process for policy formulation. By focusing exclusively on the twelve-month average inflation, there could be a risk for the MPC, when prices move rapidly, to fall behind the curve in terms of policy reaction.

The year-on-year inflation shows that inflationary pressures had indeed receded significantly. Year-on-year inflation rose from 9.7 per cent in June 2008 and 11.5 per cent in July 2008 to peak at 11.7 per cent in August 2008. With domestic prices of some commodities beginning to drop, the effect on year-on-year inflation was seen in a timely manner as from September 2008 onwards, as shown in Chart 2.4. Year-on-year inflation moved back to single digit in the last three months of 2008, with the primary factor pulling inflation down being the decrease in fuel prices. In December 2008, year-on-year inflation fell to 6.7 per cent, clearly indicating inflationary pressures were subsiding rapidly.

Chart 2.4: Inflation – twelve-month average and year-on-year

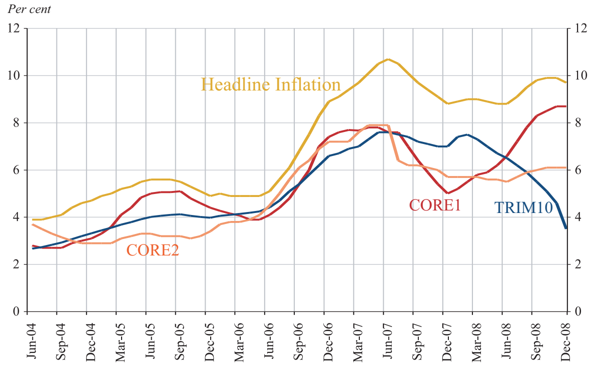


Source: CSO, Government of Mauritius, and Bank calculations.

Core inflation

Of the three measures of core inflation, which are indicators of the underlying long-term trend in inflation, CORE1 and CORE2 moved in line with headline inflation while TRIM10 declined over the period July to December 2008.[7] CORE1 inflation rose from 7.2 per cent to 8.7 per cent, while CORE2 inflation increased from 5.7 per cent to 6.1 per cent over the period under consideration. In contrast, TRIM10 inflation dropped continuously from 6.2 per cent to 3.5 per cent. Movements in headline and core inflation are shown in Chart 2.5.

Chart 2.5: Headline Inflation and Core Inflation



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

2.3 EVOLUTION OF MAJOR COMMODITY GROUP INDICES

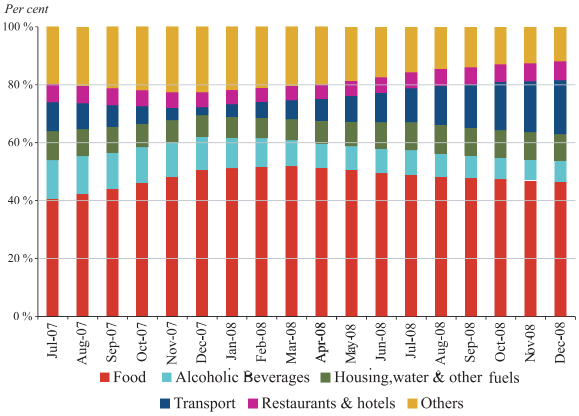
The CPI declined marginally from 115.6 in July 2008 to 115.5 in December 2008, that is, by 0.1 per cent. The most significant decrease in major commodity group indices was recorded in *Transport* which fell by 5.1 per cent, largely due to consecutive decreases in domestic fuel prices under the APM effective in November and December 2008.

Housing, water, electricity, gas and other fuels recorded the second largest decrease of 2.2 per cent, mainly as a result of the decline in interest rate on housing loans, followed by a decline of 1.2 per cent in *Recreation and culture* and 0.3 per cent

7 Core inflation measures the change in average consumer prices after excluding from the CPI certain items with volatile price movements and using statistical approaches. CORE1 is obtained using the exclusion-based approach and strips "Food, Beverages and Tobacco" components and mortgage interest on housing loan from headline inflation. CORE2 also an exclusion-based approach further excludes energy prices and administered prices from the overall CPI. TRIM10 truncates 5 per cent of each tail of the distribution of price changes.

in *Communication*. The decrease in the CPI was partially offset with increases ranging from 0.5 per cent for *Miscellaneous goods and services* to 3.7 per cent for *Restaurants and hotels*. Chart 2.6 depicts the weighted contribution of the main components of the CPI basket to inflation.

Chart 2.6: Weighted Contribution of the Main Components of the CPI Basket to Inflation

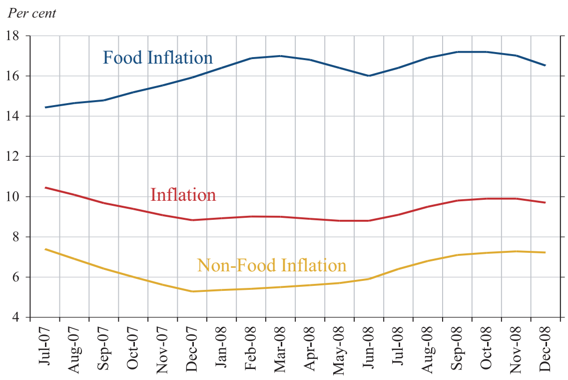


Source: CSO, Government of Mauritius, and Bank calculations.

Food and non-food inflation

The food component in the current CPI basket of goods and services, which carries a weight of 26.5 per cent, recorded strong price increases. Food inflation increased consistently from July onwards, reaching a peak of 17.2 per cent in September, before subsiding to 16.5 per cent in December 2008. Similar to the trend in the first half of 2008, food inflation explained around half of headline inflation. Likewise, non-food inflation, after averaging less than 6.0 per cent in the first half of 2008, jumped from 6.4 per cent in July to 7.3 per cent in November before moderating marginally to 7.2 per cent in December 2008. Chart 2.7 illustrates movements in food and non-food inflation.

Chart 2.7: Food and Non-food Inflation



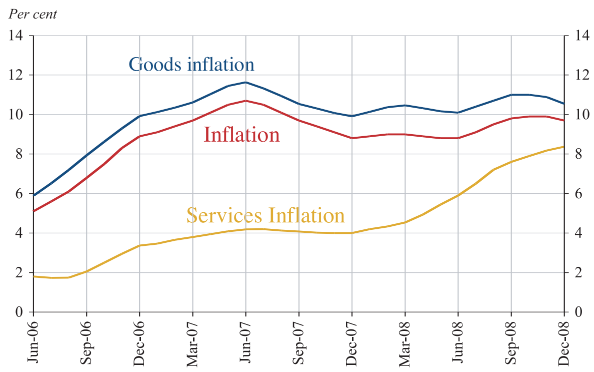
Source: CSO, Government of Mauritius and Bank calculations.

Goods and services inflation

The decomposition of inflation into goods inflation and services inflation reveals more information on the type of inflation and the extent to which the two components influence each other. Second-round effects of inflation can be assessed as inflation permeates from tradable commodities to non-tradables, such as services, with a certain lag generally. Goods mainly refer to goods that can be used or consumed, such as food items, textile products, medical goods, household appliances and so forth. On the other hand, services include fees, charges, taxes and expenditures on services such as restaurants and hotels, and dentist fees among others.

Goods inflation persisted at high levels, moving close to 10 per cent in both 2007 and 2008. Goods inflation rose from 10.4 per cent in July to peak at 11.0 per cent in September before marginally subsiding to 10.5 per cent in December 2008. The second-round effects of a high level of goods inflation manifested, to some extent and with a time lag, by the gradual rise in services inflation during 2008. After increasing from 4.2 per cent in January 2008 to 5.9 per cent in June 2008, services inflation surged from 6.5 per cent in July to 8.4 per cent in December 2008. For instance and to some degree, the rise in the index of the major commodity group *Restaurants and hotels*, which is classified as a service, was generated by higher prices of imported goods. Chart 2.8 illustrates movements in goods and services inflation.

Chart 2.8: Goods and Services Inflation



Source: CSO, Government of Mauritius and Bank calculations.

2.4 EVOLUTION OF OTHER PRICE/COST INDICES

Changes in domestic consumer prices are generally preceded by developments in prices of manufactures produced locally, in wages and in

Box 2: Price Indices in Mauritius

There are six price indices that are computed and disseminated by the Central Statistics Office in Mauritius. These six prices indices are discussed below.

1. Consumer Price Index

The Consumer Price Index (CPI) is a measure of changes over time in the general level of prices of goods and services, which a private consumer buys or pays for. The composition of the local CPI basket is based on the expenditure pattern of private Mauritian households and is derived from the Household Budget Survey, which is carried out by the CSO every 5 years to keep track of changes in consumption patterns and to re-evaluate the weights attached to each item in the basket. The CPI is used to measure the rate of inflation in Mauritius.

The CPI is disseminated monthly within 5 working days of the end of the reference month.

2. Producer Price Index–Agriculture

The Producer Price Index-Agriculture (PPI-A) provides information on trends in producer prices of agricultural products and purchase prices of the means of agricultural production. It gives a measure of the average change in the selling price which producers receive for their agricultural products that comprise “Crop Products” and “Animals and Animals Products”.

The PPI-A is calculated on a monthly basis but disseminated on a quarterly basis.

3. Producer Price Index–Manufacturing

The Producer Price Index-Manufacturing (PPI-M) measures changes in the effective selling prices received by manufacturers for their output on the domestic market. It reflects the price trends of a constant basket of goods, representative of the total output of an industry. The PPI-M covers all large manufacturing establishments, that is, those employing 10 or more persons.

The PPI-M is calculated on a monthly basis but disseminated on a quarterly basis.

4. Export Price Index

The Export Price Index (EPI) is a measure of pure price changes of domestically produced Mauritian products exported to other countries. It is an indicator of price trends for exported commodities and is based on actual price measurements of relatively more homogeneous group of products. The EPI covers all domestic exports, the most important commodities being sugar, textile fabrics and articles of apparel and clothing accessories produced by export-oriented enterprises.

The EPI is computed and disseminated on a quarterly basis.

5. Import Price Index

The Import Price Index (IPI) provides an overall measure of pure price changes in Mauritian Rupees of goods imported into the country. It is based on the actual price measurements of a fixed basket of imported goods and takes into account all the main price determining factors, such as country of origin and quality. The IPI, directly or indirectly, covers about 99 per cent of the value of merchandise imports.

The IPI is computed and disseminated on a quarterly basis.

6. Construction Price Index

The Construction Price Index measures the change in the level of construction prices. It measures the change in the level of prices of construction works and is used as deflator for the measurement of real growth in the construction sector. Specifically, it is an input cost index for the construction of a single storey house that is, it reflects an index for residential buildings only.

The index is calculated on a monthly basis but disseminated on a quarterly basis.

prices of imported commodities. Recent evolution of these underlying indicators of inflation tends to suggest that some upside inflationary pressures would continue to prevail over the medium-term.

Import Price Index

The Import Price Index (IPI), which is published on a quarterly basis by the CSO, provides an overall measure of pure price changes in the domestic currency of goods imported into the country and is based on actual price measurements of a fixed basket of imported goods.

In the third quarter of 2008, higher import prices had a strong unfavourable impact on domestic price dynamics as the IPI recorded a large and faster increase. Based on changes in the indices of components of the IPI, upward price pressures were significantly higher for imported energy products, food and live animals and manufactured goods. The depreciation of the rupee also exerted upward price pressures.

The IPI rose significantly from 150.2 in the third quarter of 2007 to 180.1 in the third quarter of 2008 - that is, by 19.9 per cent. Compared to the second quarter of 2008, the IPI registered an increase of 8.3 per cent. Import price inflation, which is calculated as the percentage change between the average IPI during a four-quarter period and the average IPI during the preceding four-quarter period, gathered significant momentum in the third quarter of 2008.

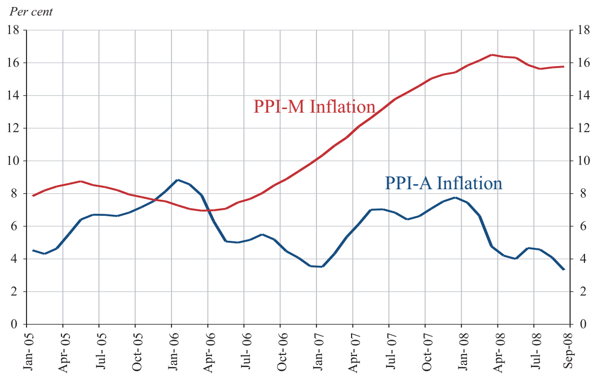
Producer Prices

Movements in the two measures of producer prices computed by the CSO – namely, the Producer Price Index-Manufacturing (PPI-M) and the Producer Price Index-Agriculture (PPI-A) – did not suggest any additional pressures on underlying inflation in the third quarter of 2008. This is explained by PPI-A inflation, measured as the percentage change in the yearly average PPI, trending downward while PPI-M inflation remaining more or less stable albeit at a persistently high level during that period.

From a peak of 16.5 per cent in March, PPI-M inflation dropped to 15.6 per cent in July and rose marginally to 15.8 per cent in September 2008. The sustained rise in the sub-component *Manufacture of food products, beverages and tobacco* maintained PPI-M inflation at such high level.

In contrast, PPI-A inflation dropped from 4.9 per cent in July to 4.2 per cent in September 2008, reflecting mainly an improvement in the prices of fresh vegetables on account of seasonal factors. Movements in producer price inflation for manufacturing and agricultural products are depicted in Chart 2.9.

Chart 2.9: Producer Price Inflation for Manufacturing and Agricultural Products



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

Wage Rate Index

The Wage Rate Index (WRI), which measures the cost of labour, went up by 17.0 per cent in the third quarter of 2008 relative to the second quarter of 2008. The implementation of the Pay Research Bureau (PRB) salary increase in the public sector effective July 2008 principally accounted for the increase in labour cost in the third quarter of 2008.[8] A review of changes in industry-wise wage rate indices shows that all industry groups simultaneously registered large increases in wage rates. This might suggest that the public sector salary increase spread broadly, albeit to varying degrees, to economy-wide industrial sectors.

In terms of weighted contribution to the increase in the WRI between the second and third quarters of 2008, the industry group *Public administration and defence; compulsory social security* contributed 29.4 per cent to the rise. Table 2.1 shows the weighted contribution to the increase in the WRI between the second and third quarters of 2008.

On the basis of trends observed over the past few years, the unfavourable gap between the growth in labour productivity and average compensation of employees for the whole economy appears to

8 The Pay Research Bureau is responsible for reviewing pay levels and conditions of service at regular intervals in the public sector.

persist. Gains in multifactor productivity, if any, had been marginal. Consequently, the persisting gap between the growth in productivity and average compensation signifies higher unit cost of production, which could suggest upward pressure on underlying inflation over the medium term, particularly for consumer products manufactured domestically.

Table 2.1: Change in Wage Rate Index by Industry Group

INDUSTRY GROUPS	Second Quarter 2008	Third Quarter 2008	Weighted contribution between 2nd and 3rd Quarters of 2008 *(index points)*	Percentage change between 2nd and 3rd Quarters of 2008 *(Per cent)*
1 Agriculture and Fishing	106.7	129.8	1.4	21.6
2 Manufacturing, Mining and Quarrying	113.7	120.1	1.1	5.6
3 Electricity and Water	107.0	118.7	0.2	10.9
4 Construction	113.4	124.8	0.4	10.1
5 Wholesale & Retail Trade; Repair of Motor Vehicles, motorcycles, personal and household Goods	116.5	131.6	1.0	13.0
6 Hotels and Restaurants	116.2	128.2	0.8	10.3
7 Transport, storage and communications	114.1	126.2	1.1	10.6
8 Financial Intermediation	112.6	117.8	0.3	4.6
9 Real Estate, renting and business Activities	111.3	122.6	0.6	10.2
10 Public administration and defence; compulsory Social Security	103.3	135.6	5.5	31.3
11 Education	104.6	137.4	4.1	31.4
12 Health and social Work	102.9	136.3	2.0	32.5
13 Other community, social and personal Services	109.0	120.0	0.2	10.1
ALL GROUPS	**109.7**	**128.4**	**18.7**	**17.0**

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

3. Demand and Output

Overall, in 2008, the domestic economy remained fairly resilient to the global economic and financial crisis. Economic growth was estimated to be above trend level at 5.2 per cent. The financial sector had not been adversely affected by first-round effects of the global financial turmoil and there was no sign of a credit crunch affecting businesses and households. The domestic banking system remained sound and stable, and was not afflicted with the same liquidity and risk-aversion problems as faced by financial institutions in some advanced economies.

Nonetheless, an analysis of seasonally-adjusted quarterly GDP data showed that the economy started slowing down in the second and third quarters of 2008. Quarter-on-quarter seasonally-adjusted growth rates for the second and third quarters of 2008 decelerated to 0.2 per cent and 1.7 per cent, respectively, from 1.7 per cent and 3.2 per cent in the corresponding quarters of 2007. The Bank's projections indicate that growth in the fourth quarter of 2008 slowed down as well. The impact of the economic downturn was also felt on domestic demand, which decelerated in the third quarter of 2008. Inflationary pressures arising from domestic supply and demand conditions had, however, remained subdued in the period under review.

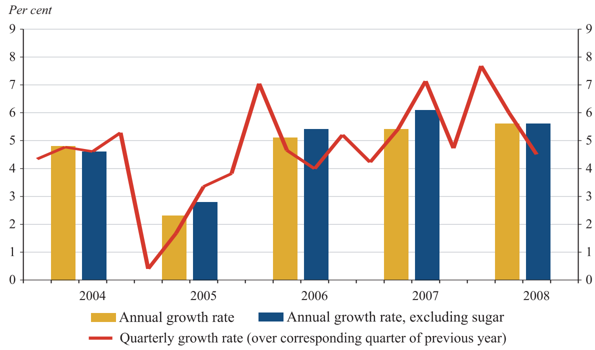
There was evidence that export-oriented sectors, particularly tourism and textile, started to bear the brunt of weak economic conditions in main export markets in the second half of 2008. Relative to the corresponding quarter of the previous year, growth in the textile sector was negative at 3.2 per cent in the third quarter of 2008 as compared to a high growth of 11.9 per cent. Similarly, the *Hotel and restaurant* sector registered a growth of 2.6 per cent in the third quarter of 2008 as compared to 13.6 per cent in the corresponding quarter of 2007.

Among the key drivers of economic activity, the hardest hit would be the textile and clothing industries, and tourism in subsequent quarters. The textile and tourism sectors are projected to record zero growth in 2009 while growth in the financial intermediation sector would drop to 6.5 per cent, from 10.1 per cent in 2008. The easing of monetary policy in the last quarter of 2008 was undertaken against the backdrop of heightened downside risks to growth and subsiding inflationary pressures.

Risks to economic growth

With key export-led sectors inevitably slowing down, the spill-over effects to the rest of the economy could pull down overall economic growth over the next few quarters. Growth prospects for 2009 have clearly weakened as the global economy is expected to face more dire economic conditions with most of G-7 countries in recession. According to the CSO, the economy would slow down to 4.0 per cent in 2009. The near- to medium-term outlook depended on the extent and duration of the global economic downturn: this would, to a large extent, determine demand for exports. Chart 3.1 depicts movements in real growth rate.

Chart 3.1: Real Economic Growth Rate



Source: CSO, Government of Mauritius.

Fiscal and monetary stimulus

In view of the potential downside risks to growth, macroeconomic policies were made expansionary in the last quarter of 2008. Monetary policy was loosened, with a cumulative decrease of 150 basis points in the policy interest rate. Further, the government came up with the *Additional Stimulus Package* of Rs10.4 billion in December 2008, representing 3.8 per cent of GDP, to shore up the domestic economy. Mauritius thus prepared itself to face potential repercussions of the global economic slump.

In parallel, the Bank took a series of additional measures in the last quarter of 2008. The minimum CRR was reduced from 6.0 per cent to 4.5 per cent thus releasing liquidity equivalent to around Rs3.3 billion into the monetary circuit.[9] Second, in view of the difficulties faced by some local banks to access foreign exchange facilities from their usual sources, the Bank made available a Special Foreign Currency Line of Credit aggregating US$125 million, equivalent to Rs4 billion approximately, from its own reserves as from 20 December 2008.

9 The minimum CRR was hiked from 4.0 to 6.0 per cent effective 15 August 2008.

3.1 CONSUMPTION

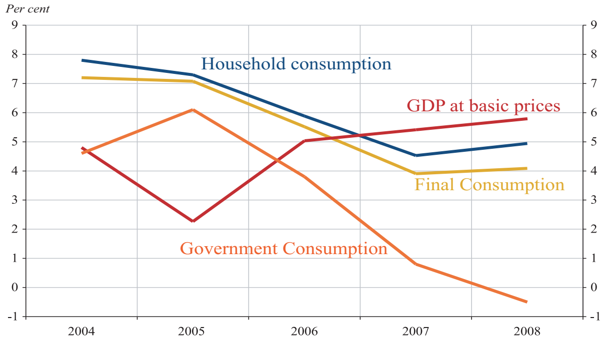
Final consumption expenditure is estimated to have grown, in real terms, at a slightly higher rate of 4.1 per cent in 2008 compared to 3.9 per cent in 2007. This was due to higher growth in household consumption expenditure, which more than offset the decline in government expenditure. Despite buoyant consumption growth, domestic demand decelerated in the second semester of 2008.

On the basis of quarterly data, growth in household consumption was relatively stable during the first three quarters of 2008. Real household consumption grew by 4.5 per cent in the third quarter of 2008, slightly above the growth rate of 4.4 per cent registered in the preceding quarter. Factors that positively influenced consumption included nominal wage increase in the public sector and reductions in interest rates earlier in 2008, while offsetting factors comprised increases in the food and energy prices.

In contrast, government consumption expenditure, after recording positive growth in the first two quarters of 2008, dropped markedly by 4.5 per cent in the third quarter. The contribution of government spending to domestic demand had been on a declining trend in recent years, in line with fiscal consolidation efforts. The data for 2008 confirms this underlying trend.

The evolution of final consumption expenditure and its components and real economic growth since the first quarter of 2004 is depicted in Chart 3.2. Table 3.1 shows real growth rates in components of aggregate demand.

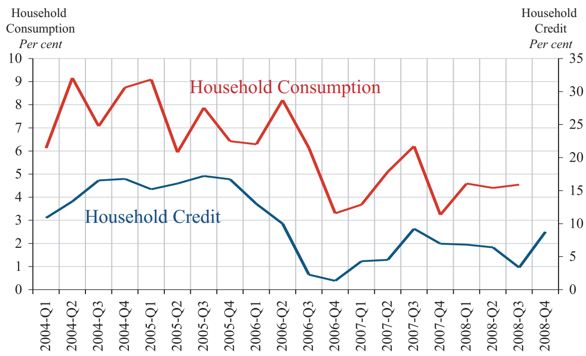
Chart 3.2: Real Economic and Consumption Growth Rates



Source: CSO, Government of Mauritius.

A combination of factors could maintain buoyancy in household consumption expenditure in forthcoming quarters. These include the expected decline in inflationary pressures in the wake of plummeting global commodity and energy prices, the macroeconomic stimulus and the easing of monetary policy. Moreover, as shown in Chart 3.3, the flow of credit to the household sector, in real terms, was on average sustained in the second half of 2008 and the easing of monetary policy should contribute to support household consumption.

Chart 3.3: Real Household Consumption Growth and Real Growth in Credit to Households



Note: The CPI has been used to deflate nominal credit data.
Source: CSO, Government of Mauritius, and Bank of Mauritius.

Table 3.1: Expenditure Components of 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]				2008		
						Quarter 1	*Quarter 2*	*Quarter 3*	*Quarter 4*	*Quarter 1* [1]	*Quarter 2* [1]	*Quarter 3* [2]
Final Consumption Expenditure	7.2	7.1	5.5	3.9	4.1	3.1	4.2	5.6	2.5	4.2	3.7	3.0
of which:												
Household consumption	7.8	7.3	5.9	4.5	4.9	3.7	5.1	6.2	3.2	4.6	4.4	4.5
Government consumption	4.6	6.1	3.8	0.8	-0.1	0.6	0.8	2.9	-0.9	2.6	0.6	-4.5
Investment	2.2	-1.9	19.0	8.6	3.0	24.3	9.7	11.3	1.5	11.1	13.8	3.5
Investment *(exclusive of the acquisition of aircraft & marine vessel)*	4.8	-1.6	5.5	17.0	6.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Exports of goods and services	-0.3	10.6	7.7	3.5	4.4	-3.3	6.9	2.4	7.9	2.1	1.1	7.2
Imports of goods and services	2.8	6.4	9.3	2.1	3.1	-3.2	1.5	10.2	-0.4	20.4	5.6	-7.4

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

Source: CSO, Government of Mauritius.

3.2 INVESTMENT

Investment growth is projected to have decelerated to 3.0 per cent in 2008 after a strong growth of 8.6 per cent in 2007. This slowdown in investment growth was triggered by lower private sector investment growth, which is estimated to have fallen to 9.2 per cent in 2008 compared to 24.0 per cent in 2007. On a quarterly basis, investment grew by 3.5 per cent in the third quarter of 2008 in compared to 11.3 per cent in the third quarter of 2007. The deceleration in investment growth reinforced the slowdown in domestic demand.

Investment was propelled by building and construction works, whose share in total investment activities is estimated to have surged from 59 per cent in 2007 to 67 per cent in 2008. Private sector investment comprised mainly investment in commercial and office building, hotels and Integrated Resort Scheme (IRS) projects.

Exclusive of the acquisition of aircraft and marine vessel, investment is estimated to have grown by 6.5 per cent in real terms in 2008 as compared to 17.0 per cent in 2007. Public sector investment, exclusive of the acquisition of aircraft and marine vessel, increased marginally by 0.4 per cent while private sector investment grew by 7.9 per cent in real terms, higher than real growth.

The outlook for private investment, which has been particularly robust in preceding years, is uncertain and would depend on the depth and duration of the economic recession in main markets. Planned investments may still go ahead as investors would want to have the capacity when the economic recovery kicks off. However, a long and painful recession could delay and even freeze planned investments. Regarding public investment, it is expected that the measures taken by government under the additional stimulus package would give a boost to public infrastructural projects in 2009.

3.3 FOREIGN TRADE AND EXTERNAL DEMAND

In the second semester of 2008, the weakening of demand for exports of both goods and services from major markets – mostly advanced economies – accompanied by the continuous increase in imports contributed to a further widening of the current account deficit. As a percentage to GDP, the current account deficit continued to hover at high levels, standing at 10.9 per cent in the second half of 2008. The current account deficit was mostly financed by sustained inflows of foreign direct investment (FDI), net inflows from other investment and a drawdown in foreign assets of the country.

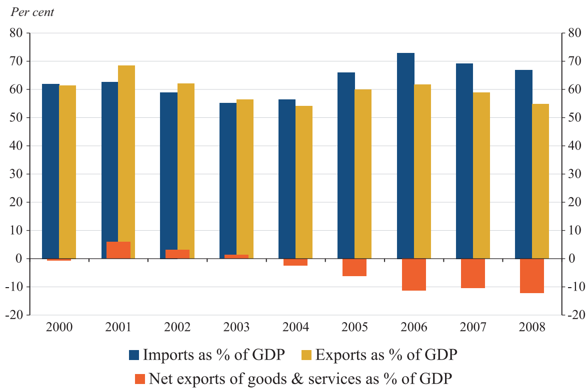
Current account balance

In the second semester of 2008, provisional estimates show that the current account deficit of the balance of payments widened further to Rs15,081 million compared to Rs9,760 million over the same period in 2007. This deterioration was induced by the worsening merchandise trade deficit – as imports continue to outpace exports of goods – and a significant fall in the surplus recorded on both the services and income accounts. The merchandise account generated a deficit of Rs27,414 million, higher than the Rs26,170 million shortfall recorded in the second semester of 2007.

The surplus on the services account registered a sizeable decline of 26.6 per cent to Rs7,657 million in the second semester of 2008, from Rs10,427 million in the same period of 2007. Gross tourism earnings declined to Rs19,047 million in the second semester of 2008 from Rs20,935 million for the corresponding period of 2007, mainly due to the appreciation of the rupee vis-à-vis the euro and Pound sterling, and as the domestic tourism industry started to feel the pinch of waning global travel demand.

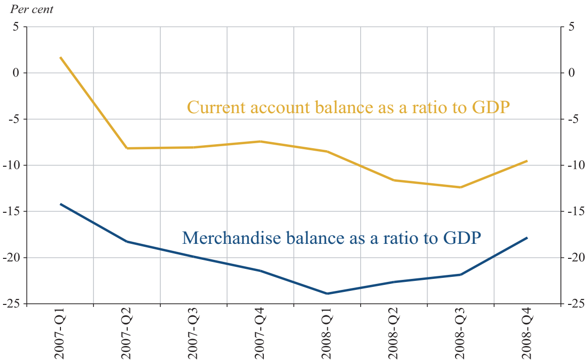
A major source of concern continues to be the sustained deterioration in the contribution of net exports of goods and services to GDP, which worked out to -12.2 per cent in 2008. Part of this deterioration could be attributable to high import prices of energy products and food earlier in 2008. The impact of a worsening negative contribution of net exports to GDP was reflected in the broadening of the current account deficit. Chart 3.4 depicts the evolution of annual imports, exports and net exports as a percentage to GDP. The evolution of quarterly current account and merchandise account balance as a percentage of GDP is depicted in Chart 3.5.

Chart 3.4: Imports, Exports and Net Exports of Goods and Services as a Percentage of GDP



Source: CSO, Government of Mauritius.

Chart 3.5: Quarterly Current Account and Merchandise Account Balance as a Percentage of GDP



Higher direct investment income remitted abroad led to a considerable drop in the surplus of the income account to Rs343 million in the second semester of 2008, from Rs3,785 million in the corresponding period of 2007. In contrast, the surplus on the current transfers account nearly doubled to Rs4,333 million in the second semester of 2008, mainly due to European Union monetary compensation for the sugar sector reform.

Capital and financial account

The capital and financial account of the balance of payments, inclusive of reserve assets, recorded net inflows of Rs7,233 million during the second semester of 2008 as against net outflows of Rs1,035 million in the second semester of 2007. This improvement in the capital and financial account was induced by sustained inflows of FDI and a reversal in other investment.

FDI registered higher net inflows of Rs7,374 million in the period under review compared to Rs5,076 million in the corresponding period of 2007, reflecting the positive investment climate in spite of the global economic downturn. The bulk of the capital was channelled to the *Financial Intermediation* sector and the *Hotels and Restaurants* sector, with respective shares of 50 per cent and 28 per cent. Net outward direct investment flows during the second semester of 2008 amounted to Rs568 million, lower than Rs1,470 million registered in the corresponding period of 2007.

Portfolio investment in the second semester of 2008 recorded higher net outflows of Rs2,437 million compared to Rs788 million a year before mainly on account of maturing debt instruments held by non-residents. These instruments were not renewed subsequently because of lower long-term returns. Net disinvestments in money market instruments amounted to Rs857 million in the second semester of 2008 as against an inflow of Rs137 million in the corresponding period 2007. Furthermore, net sales of shares by foreign investors on the stock exchange amounted to Rs308 million in the second half of 2008 as against net purchases of shares amounting to Rs934 million in the corresponding period of 2007, reflecting bearish conditions prevailing in the stock market and slowdown in the global economy.

Other investment registered net inflows in the second semester of 2008 in contrast to net outflows in the corresponding period of 2007. Details on the balance of payments are given Table 3.2.

The continuing imbalance between saving and investment was reflected in the current account of the balance of payments remaining persistently in

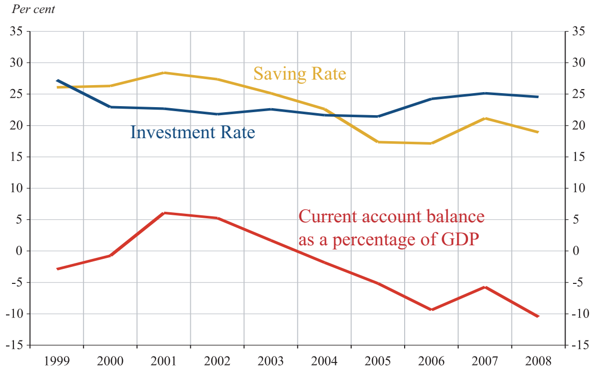
Table 3.2: Balance of Payments Summary

	2007 [1]		2008 [2]	
	3rd Quarter	4th Quarter	3rd Quarter	4th Quarter
Current Account	**-4,810**	**-4,950**	**-8,188**	**-6,893**
Exports (f.o.b)	17,580	20,036	18,249	19,932
Imports (f.o.b)	-29,453	-34,333	-32,709	-32,886
of which: marine vessels /aircraft		2,730	583	
Merchandise trade balance	-11,873	-14,297	-14,460	-12,954
Services	3,550	6,877	3,654	4,003
of which: travel	5,878	9,170	5,377	6,949
Income	2,418	1,367	22	321
Current transfers, Net	1,095	1,103	2,596	1,737
Capital & Financial Account	**131**	**-1,166**	**5,798**	**1,435**
Capital account	-5	-15	-1	-10
Direct investment	2,085	1,521	3,194	3,612
Portfolio investment	1,259	-2,047	-743	-1,694
Other investment	-2,103	1,141	4,172	-2,912
Balance of payments Surplus (-) / Deficit (+)	-1,105	-1,766	-824	2,439
Net Errors and Omissions	4,679	6,116	2,390	5,458

[1] Revised estimates.
[2] Provisional estimates.

deficit since 2004, as illustrated in Chart 3.6. Consequently, the need to boost saving has become imperative in order to bridge the saving-investment gap. Otherwise, the current account deficit would persist and would require greater reliance on non-residents' savings as a source of finance. This could exert pressure on the external position of the country and, eventually, on the exchange rate.

Chart 3.6: Saving Rate, Investment Rate and Current Account Balance as a Percentage of GDP



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

Exports

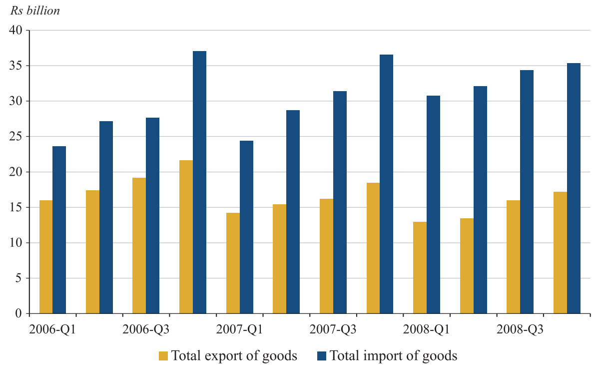
Excluding ship's stores and bunkers, total nominal exports of goods registered a decline of 4.3 per cent, explained largely by a significant drop in exports of *Articles of apparel & clothing accessories* and *Textile yarns, fabrics, and made up articles*. The slowdown in main export markets stemmed demand for textile exports which, along with the appreciation of the domestic currency against the Pound sterling, led to the fall in nominal exports of goods in the second semester of 2008.

Imports

Total nominal imports grew moderately by 2.5 per cent in the second semester of 2008 compared to the corresponding period of 2007. This was largely attributed to slower growth of 8.0 per cent and 15.4 per cent in imports of *Food and live animals* by and in *Mineral fuels, lubricants, & related products*, respectively. Lower prices of these products impacted on the value of imports of these products.

Imports of *Manufactured goods classified chiefly by material* rose modestly by 4.0 per cent, largely on account of a considerable drop of 18.7 per cent in imports of textile yarn, cotton fabrics and other textile fabrics. The decline in imports of these materials confirms a slowdown in the export-oriented enterprises sector. Quarterly nominal imports and exports are depicted in Chart 3.7.

Chart 3.7: Quarterly Nominal Exports and Imports



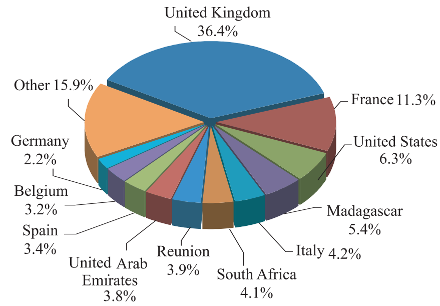
External demand

Latest external trade data indicate that, in the second semester of 2008, Europe remained the main export market for Mauritius, accounting for 67.3 per cent of total exports, although its share fell from 71.8 per cent in the second semester of 2007. The United Kingdom continued to be Mauritius' most important market, with a share of 36.4 per cent, despite a fall of 11.3 per cent in nominal exports in 2008. The other major destinations for our exports were France, United States, Madagascar, Italy and South Africa with shares of 11.3 per cent, 6.3 per cent, 5.4 per cent, 4.2 per cent and 4.1 per cent, respectively.

Compared to the second semester of 2007, total nominal exports to France, United States, Madagascar and Italy declined by 16.9 per cent, 8.6 per cent, 7.6 per cent and 28.0 per cent, respectively. However, exports to regional markets, namely, Seychelles, Reunion Island and South Africa increased by 42.7 per cent, 37.2 per cent and 26.4 per cent, respectively.

The main export destinations in the second semester of 2008 are illustrated in Chart 3.8.

Chart 3.8: Main Export Destinations in the Second Semester of 2008

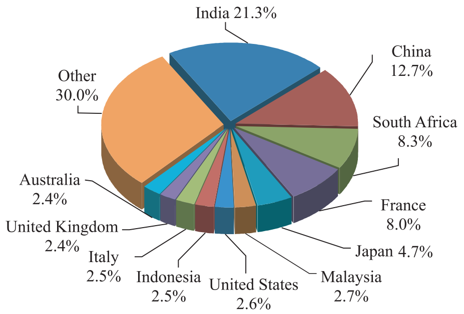


Source: CSO, Government of Mauritius.

Sources of imports

Imports originated mainly from India, China, South Africa, France and Japan, with shares of 21.3 per cent, 12.7 per cent, 8.3 per cent, 8.0 per cent, and 4.7 per cent, respectively. The relatively high share of India in our import bill can be attributed to the fact that India is the main supplier of petroleum products. Chart 3.9 shows the main sources of imports in the second semester of 2008.

Chart 3.9: Main Sources of Imports in the Second Semester of 2008



Source: CSO, Government of Mauritius.

3.4 LABOUR MARKET AND WAGES

Unemployment maintained a downward trend despite uncertainty about short-term economic prospects. The rate of unemployment was expected to drop to 7.8 per cent in 2008, from 8.5 per cent a year earlier. Even quarterly data showed a marked decline in the unemployment rate to 7.2 per cent in the third quarter of 2008, from 8.2 per cent in the corresponding period of 2007. Jobs were principally created in the tourism, and transport and communications sectors, which more than offset declining employment in the manufacturing sector.

Notwithstanding the increase in the seasonally-adjusted unemployment rate from 6.8 per cent in the second quarter to 7.5 per cent in the third quarter of 2008, the unemployment rate is yet lower compared to the third quarter of 2007. Table 3.3 shows movements in the unemployment rate.

Labour market outlook

External demand-led sectors are highly vulnerable to the downturn in the main export markets. Employment in the export-oriented enterprise sector declined by around 4,300 in the year to September 2008, essentially due to job losses in wearing apparel following the contraction of the textile industry in the second and third quarters of 2008.

A prolonged recession in the main export markets could lead export-oriented firms to cut down on operational costs to maintain already tight profit margins. They might start shedding jobs more than they create, which could generate a reversal of the declining unemployment trend in 2009. Potential spill-over effects on other enterprises directly or indirectly related to export-oriented firms would further jeopardise the employment situation. The government, however, expressed its commitment to preserve jobs and maintain household income as domestic growth momentum slows down on the back of the global economic downturn.

Table 3.3: Unemployment Rate

	2005	2006	2007	2007				2008		
				Quarter 1	Quarter 2	Quarter 3	Quarter 4	Quarter 1	Quarter 2	Quarter 3
Actual	9.6	9.1	8.5	9.6	8.8	8.2	7.2	8.2	7.4	7.2
Seasonally adjusted	9.6	9.1	8.5	9.0	8.2	8.5	8.1	7.6	6.8	7.5

Source: CSO, Government of Mauritius.

4. Monetary and Financial Developments

4.1 MONETARY AND CREDIT DEVELOPMENTS

In the conduct of monetary policy, developments in monetary and credit aggregates are given appropriate consideration as they provide valuable information on the inflation process over the medium to long term. This monetary policy strategy ensures that various indicators are utilised to detect and assess inflationary pressures upfront. Overall, monetary developments in the second half of 2008 were not viewed as jeopardising the attainment of price stability over the medium term.

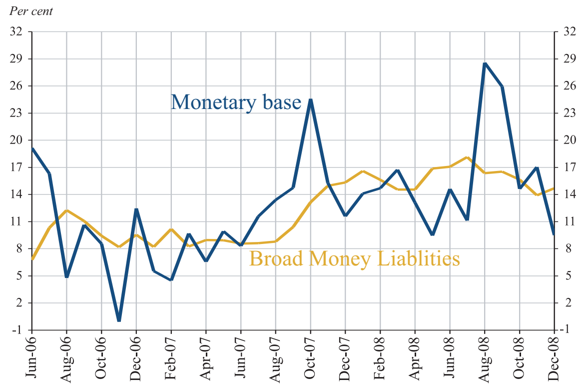
Monetary base

Changes in the monetary base provide the foundation for changes in broader measures of money supply.[10] The monetary base rose by 9.5 per cent in the year to December 2008, compared to an increase of 14.6 per cent recorded in the year to June 2008. The rate of growth of reserve deposits held by other depository corporations (ODCs) at the Bank decelerated to 5.4 per cent from 25.9 per cent in the year to June 2008.

Broad Money Liabilities

A striking feature of monetary developments has been the deceleration in the growth of Broad Money Liabilities (BML), the broadest measure of money supply, during the second semester of 2008.[11] Growth in both components making up the BML also slowed down. It can be partly explained by the deceleration in economic activity, the more so as inflation remained high during that period. Chart 4.1 illustrates movements in monetary base and BML.

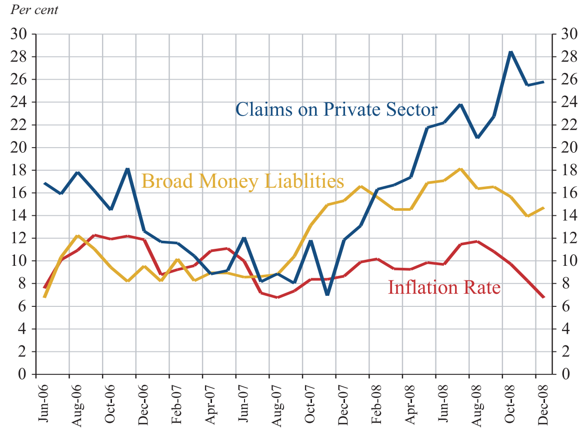
Chart 4.1: Growth Rate of Monetary Base and Broad Money Liabilities



Percentage change over corresponding month of previous year.

BML growth slowed from 17.1 per cent in the year to June 2008 to 14.7 per cent in the year to December 2008, as shown in Chart 4.2. The main drivers of monetary expansion continued to be claims on the private sector and on central government by depository corporations.

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



Percentage change over corresponding month of previous year.

Components of Broad Money Liabilities

Narrow money liabilities rose by 13.0 per cent in the year to December 2008, lower than the increase of 15.1 per cent in the year to June 2008. Narrow money growth might reflect current downside demand pressures in the economy.

Quasi-money went up by 15.1 per cent in the year to December 2008 compared to an increase of 17.9 per cent in the year to June 2008. Savings and time deposits rose by 15.9 per cent and 12.7 per cent, respectively, in the year to December 2008 as compared to respective growths of 17.5 per cent and 16.0 per cent in the year to June 2008. Foreign currency deposits increased by 18.3 per cent in the year to December 2008, lower than the 21.8 per cent expansion recorded in the year to June 2008.

The last component of BML, Securities other than Shares, increased by 14.0 per cent in the year to December 2008.[12] Table 4.1 provides details on growth rates in components of BML and credit.

10 The monetary base, also termed high-powered money and reserve money, comprises central bank liabilities that support the expansion of broad money and 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 size and stability of the money multiplier.

11 Broad Money Liabilities include deposits of banks and non-bank deposit-taking institutions.

12 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	Sep-08	Dec-08
Broad Money Liabilities	**8.6**	**10.4**	**15.3**	**14.5**	**17.1**	**16.5**	**14.7**
Narrow Money Liabilities	10.4	10.7	17.3	14.8	15.1	18.5	13.0
Currency with public	*11.2*	*11.0*	*9.5*	*9.9*	*11.4*	*12.7*	*14.5*
Transferable deposits	*10.0*	*10.5*	*21.0*	*16.9*	*16.6*	*21.0*	*12.4*
Quasi-Money Liabilities	8.7	10.5	15.0	14.7	17.9	16.5	15.1
Savings deposits	*6.3*	*5.5*	*8.6*	*13.9*	*17.5*	*17.4*	*15.9*
Time deposits	*8.0*	*12.1*	*20.5*	*20.3*	*16.0*	*15.6*	*12.7*
Foreign currency deposits	*14.0*	*15.9*	*15.5*	*6.3*	*21.8*	*16.7*	*18.3*
Securities other than shares	-24.8	-5.2	-0.4	-6.2	-16.3	-19.8	*14.0*
Domestic Credit	**6.0**	**4.2**	**9.0**	**16.2**	**22.9**	**21.6**	**21.2**
Credit to private sector	12.1	8.3	11.9	16.7	22.2	22.7	25.8
Net Foreign Assets	29.5	19.2	9.6	1.3	0.6	-6.2	4.7

Sources of Broad Money Liabilities

Foreign assets

The growth of 4.7 per cent in net foreign assets in the year to December 2008 reflects solely the increase in net foreign assets held by the Bank. ODCs registered a decline in net foreign assets, despite interventions by the Bank by way of sales of foreign exchange on the domestic foreign exchange market. The fall in net foreign assets held by ODCs is explained by a higher increase in liabilities to non-residents, primarily on account of loans taken from non-residents, which more than offset the increase in claims on non-residents.

Domestic credit

Growth in domestic credit by depository corporations decelerated from 22.9 per cent in the year to June 2008 to 21.2 per cent in the year to December 2008, chiefly reflecting a slowdown in net credit to central government partly offset by the expansion in credit to the private sector.

Net credit to central government rose by 3.2 per cent in the year to December 2008, essentially reflecting ODCs interest in government securities. Credit to the private sector by ODCs increased by 25.8 per cent in the year to December 2008 compared to the rise of 22.2 per cent in the year to June 2008. Credit growth to the private sector remained buoyant particularly in the last three months of 2008.

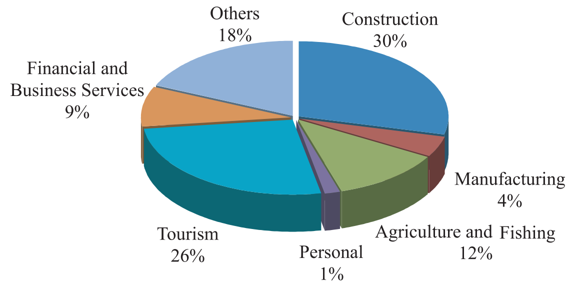
Sector-wise distribution of credit by banks

Bank credit expansion to the private sector has been relatively high for the year ended December 2008. Construction and tourism sectors continued to drive the increase in bank credit, representing respective shares of 32.3 per cent and 25.9 per cent to total credit expansion.

Credit to the household sector expanded by 17.7 per cent in the year to December 2008 compared to a rise of 16.6 per cent recorded in the year to June 2008. Total lending to households continued to grow strongly, bolstered by the reduction in interest rates. In terms of currency composition of credit, rupee loans and advances expanded by 18.4 per cent, while foreign currency loans and advances grew by 53.9 per cent in the year to December 2008 compared to 10.9 per cent and 85.7 per cent, respectively, in the year to June 2008.

The distribution of the increase in bank credit to the private sector from the end of June 2008 to the end of December 2008 is shown in Chart 4.3.

Chart 4.3: Distribution of the Increase in Bank Credit to the Private Sector



4.2 MONEY MARKET

Liquidity management

During the period July to December 2008, the Bank closely monitored developments and liquidity situation on the money market in order to avert any adverse impact of the global financial crisis. It, however, continued to limit its interventions to allow for efficient functioning of markets. Two key developments were changes brought to the minimum CRR, which impacted on liquidity in the banking system, and the introduction of the Special Foreign Currency Line of Credit for US$125 million.

Impact of changes of the minimum Cash Reserve Ratio on excess reserves

The CRR is one of the policy tools available to the central bank to control the supply of money and, hence, credit creation in the economy. With a view to tightening liquidity conditions in the money market, the Bank raised the CRR from 4.0 per cent to 6.0 per cent with effect from the fortnight beginning 15 August 2008. The minimum CRR, which banks must maintain on any particular day, was also increased from 2.0 per cent to 4.0 per cent.

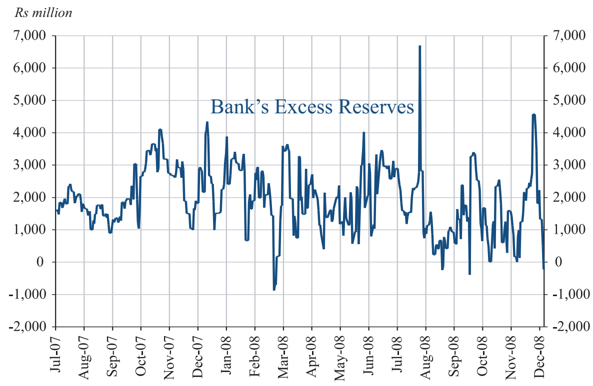
Average excess reserves in the banking system dropped in the period August to September following the increase in the minimum CRR.[13] Accordingly, the Bank proceeded with early redemption of Bank of Mauritius Bills for Rs1.7 billion and purchased Treasury Bills for Rs2.3 billion on 14 August 2008 to help banks meet their minimum CRR.

However, with a view to alleviating liquidity conditions concurrently with the easing of monetary policy in the fourth quarter of 2008, the Bank lowered the minimum CRR from 6.0 per cent to 5.0 per cent with effect from the fortnight beginning 7 November and further down to 4.5 per cent with effect from the fortnight starting 19 December 2008. The minimum CRR on any particular day remained unchanged at 4.0 per cent in the first instance but was reduced to 3.0 per cent effective 19 December 2008. These initiatives formed part of the exceptional measures taken to counter possible adverse impact of the global economic and financial crisis on Mauritius and to support the measures taken by the government to stimulate the economy.

The Bank did not have recourse to the issue of Bank of Mauritius Bills after July 2008 to mop up liquidity. Instead, with tightness emerging in the money market, the Bank intervened by conducting repo transactions with banks for a total of Rs24.2 billion during the period September to December 2008 so as to provide greater flexibility to banks to manage their day-to-day cash balances. Conditions prevailing on the money market became tighter when the Bank, in a bid to ease difficult conditions on the domestic foreign exchange market, intervened on several occasions to sell a total of US$172 million. These interventions absorbed the rupee counterpart equivalent to Rs5.2 billion from the system. The two successive reductions in the CRR in November and December 2008, respectively, contributed to relieve the resulting liquidity tightness.

Overall, banks' excess reserves declined from an average of Rs2.5 billion in July to Rs0.8 billion in September. Thereafter, excess reserves rose from an average of Rs1.8 billion in October to Rs2.0 billion in December 2008, since during the last month of the year banks normally keep high excess reserves to meet high seasonal demand for cash. The evolution of banks' daily excess reserves is shown in Chart 4.4.

Chart 4.4: Banks' Daily Excess Reserves



Interbank interest rates

Movements in interest rates on the interbank money market reflected changes in the level of excess liquidity in the banking system. Relative to the corridor set at 125 basis points around the key Repo Rate, overnight interbank interest rates jumped within the corridor after the hike in the CRR in August 2008 after persistently straying below the lower bound of the corridor. They momentarily breached the threshold of the corridor given liquidity tightness towards the end of October and beginning of November 2008.

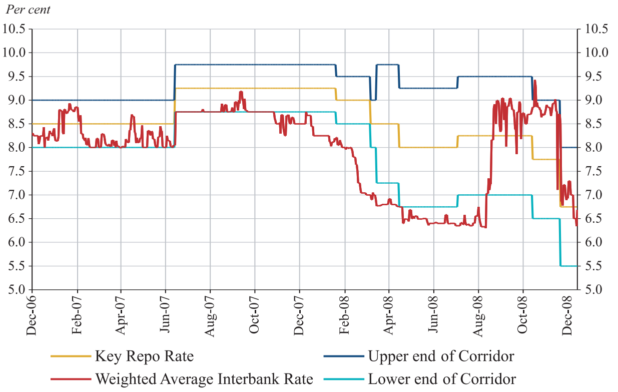
The weighted average overnight interbank interest rate went up significantly towards late August 2008 with the rise in the CRR. Thereafter, interbank interest rates remained high and varied in a range of 7.11-9.43 per cent between September to early December 2008. Despite the 1.0 per cent reduction in the CRR in November 2008, overnight interbank

13 Excess reserves are defined as the excess funds held by banks over and above the amount required to maintain the minimum CRR.

interest rate remained high. It subsequently fell after the CRR was further reduced and as liquidity conditions improved in December 2008.

The weighted average overnight interbank interest rate fluctuated within the range of 6.30-6.75 per cent in July and 6.25-9.25 per cent in December 2008. Its evolution is depicted in Chart 4.5.

Chart 4.5: Overnight Weighted Average Interbank Interest Rate



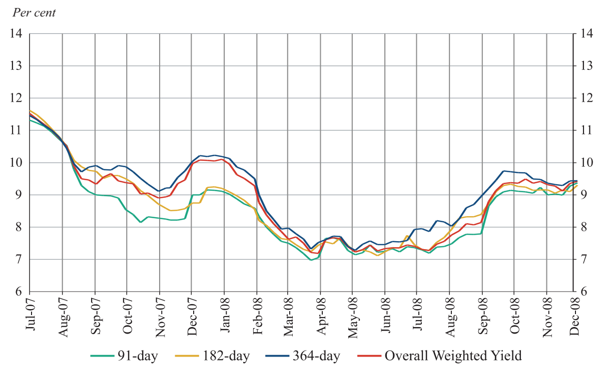
Yields on Government debt instruments

The decision of the MPC to tighten monetary policy in July 2008 and the increase in the minimum CRR in August 2008 impacted on movements of short-term yields. Short-term Treasury Bill yields drifted upwards from July to October 2008. Weighted yields on all three maturities of Treasury Bills sustained their upward momentum till October 2008, reaching a high of 9.37 per cent on the 91-day, 9.33 per cent on the 182-day and 9.74 per cent on the 364-day Bills, respectively.

Subsequent to the easing of monetary policy as from 31 October and the decrease in the minimum CRR shortly after, yields assumed a generally declining trend that continued to the end of December 2008, as shown in Chart 4.6. In general, primary auctions of Treasury Bills remained oversubscribed during July to December 2008 with an average bid-cover ratio of 1.7.

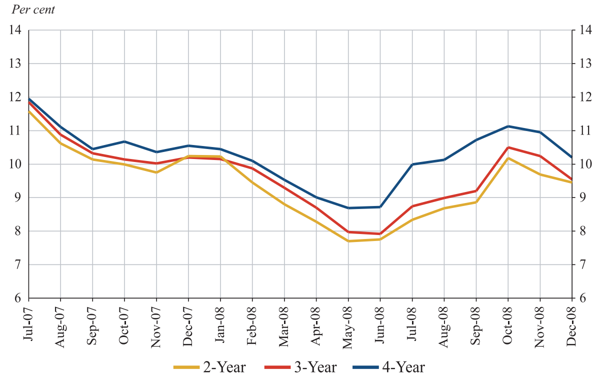
Market bidding preference was skewed towards the 91-day and 182-day maturities from July to October 2008, indicating investors' unwillingness to lock up funds for longer term. Thereafter market sentiment changed and marked preference for the 364-day maturity persisted till the end of 2008.

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



The auctions of other government instruments – namely, Treasury Notes and Long Term Government of Mauritius Bonds – were on average oversubscribed over the period July to December 2008 with the exception of the Five-Year Government of Mauritius Bonds. The weighted average yields on these instruments followed the same trend as short-term market interest rates. Chart 4.7 exhibits movements in yields on Treasury Notes.

Chart 4.7: Evolution of Yields on Treasury Notes



Non-residents' holdings of government and central bank securities fell from Rs1.2 billion at the end of June 2008 to Rs0.3 billion at the end of December 2008. Resident holders of Government and central bank securities comprised principally banks and pension funds.

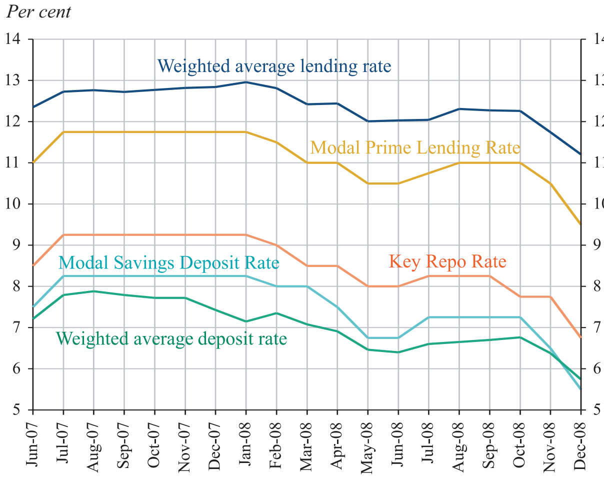
4.3 INTEREST RATES

Interest rates offered on savings deposits and charged on credit were adjusted following changes made to the key Repo Rate, as shown in Chart 4.8. Banks altered their interest rate structures with varying but relatively short time lags. Thus, changes brought to the monetary policy stance through adjustments to the policy interest rate were effectively and in a timely manner transmitted by financial intermediaries to market interest rates. In addition, lending rates also responded to changes brought to the minimum CRR.

The net cumulative decrease in the key Repo Rate of 125 basis points in the second semester of 2008 was followed by an adjustment of similar magnitude in the modal interest rate offered on savings deposits. Overall, from 6.75 per cent at the end of June 2008, the modal savings deposit rate rose to 7.25 at the end of July 2008 following the hike in the key Repo Rate and remained at that level over the following three months before falling to 6.50 per cent at the end of November 2008 and further down to 5.50 per cent at the end of December 2008. Interest rate on savings deposit moved from a range of 6.25-7.25 per cent at the end of June 2008 to a range of 5.00-5.75 per cent at the end of December 2008.

Banks adjusted their Prime Lending Rates (PLR) in conjunction with changes in the key Repo Rate as well as in the minimum CRR. The modal PLR stood at 10.50 per cent, 10.75 per cent and 11.00 per cent, respectively, at the end of June, July and August. It went down to 10.50 per cent at the end of November 2008 and further down to 9.50 per cent at the end of December. Banks' PLR range moved from 10.15-11.50 per cent at the end of June to the range of 9.05-10.00 per cent at the end of December 2008.

Chart 4.8: Movements in Deposit and Lending Rates



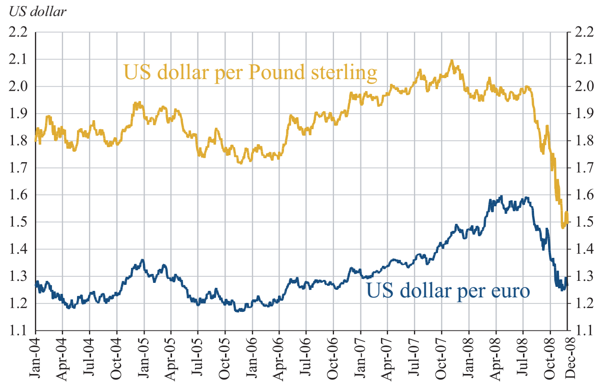
From a negative figure of 1.9 per cent at the end of June 2008, the real interest rate on savings deposits deteriorated gradually to reach a negative figure of 3.9 per cent at the end of December 2008, reflecting the combined effects of relatively high inflation and cuts in the key Repo Rate.

4.4 FOREIGN EXCHANGE MARKET AND EXCHANGE RATES

Major international currencies

The US dollar enjoyed broad-based rally in the second half of 2008 as growth projections for other major economies deteriorated more rapidly than for the US economy. Overall, the US currency appreciated against the euro and the Pound sterling but depreciated vis-à-vis the Japanese yen. Moving away from near record lows against the euro in mid-July 2008, the US dollar also benefited from the sharp drop in oil prices. Chart 4.9 shows evolution 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



Severe financial problems in several major economies brought considerable volatility in foreign exchange market. Risk aversion engulfed financial markets and investors shunned risky assets for safe haven currencies like the US dollar and Japanese yen, which underpinned the appreciation of the Japanese yen and brought further support to the US dollar in the second half of 2008. Despite the US Federal Reserve slashing interest rates to a historical low of between zero to 0.25 per cent in December 2008, the rally to the US currency was sustained.

Another key feature on the international foreign exchange market was the marked weakness of the Pound sterling since October. The UK economy was foreseen to face a much more severe and prolonged recession than thought earlier. The sharp weakening of the Pound sterling was also explained by rising unemployment, deteriorating public finances and aggressive interest rate cuts by the Bank of England. The Pound sterling continued its downtrend, hitting a six-and-a-half year low against the US dollar in

December and approached parity versus the euro as investors braced themselves for the Bank of England to cut interest rates further to support the struggling UK economy.

On a point-to-point basis, the US dollar appreciated against the euro and the Pound sterling by 11.8 per cent and 37.8 per cent, respectively but depreciated by 17.0 per cent against the Japanese Yen.

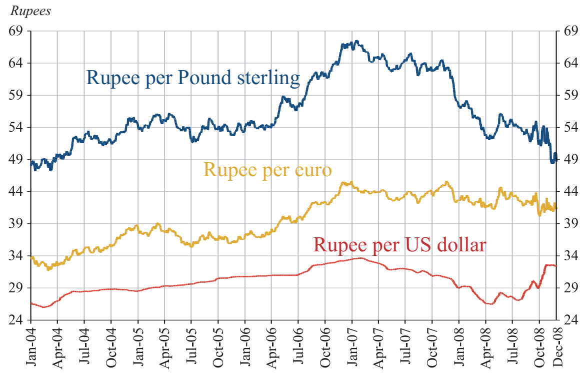
Domestic currency

On the domestic market, the rupee depreciated, on a point-to-point basis between 1 July to 31 December 2008, against the US dollar and the euro by 14.6 per cent and 4.8 per cent, respectively, but appreciated vis-à-vis the Pound sterling by 17.4 per cent. In the first weeks of July, the rupee appreciation was backed by positive market sentiment locally and the broad-based weakness of the US dollar on international markets. Thereafter, the rupee reverted to a depreciating trend as the US currency made a dramatic recovery from record lows on international markets.

Intensification of the credit crisis by mid-September brought significant volatility in the US dollar which was reflected in a slight rupee appreciation. Early in October, the rupee resumed its depreciating trend following a sharp recovery in the US dollar fuelled by large unwinding of carry trades. Demand pressures on the domestic foreign exchange market, partly relating to end-of-year seasonal pattern, also accentuated the rupee depreciation in October 2008. In the last two months of 2008, the rupee remained rather stable despite some weakness in the US dollar following aggressive easing by the US Federal Reserve.

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



Activity on the domestic foreign exchange market

Activity on the domestic foreign exchange market was sustained in the second half of 2008. There was a deterioration in the foreign exchange liquidity position of the market as, overall, banks sold more foreign exchange than they purchased.

On the interbank foreign exchange market, the volume of transactions fell slightly to a monthly average of US$15 million for the period July to December 2008 compared to a monthly average of US$18.7 million between January and June 2008.

Interventions by the Bank

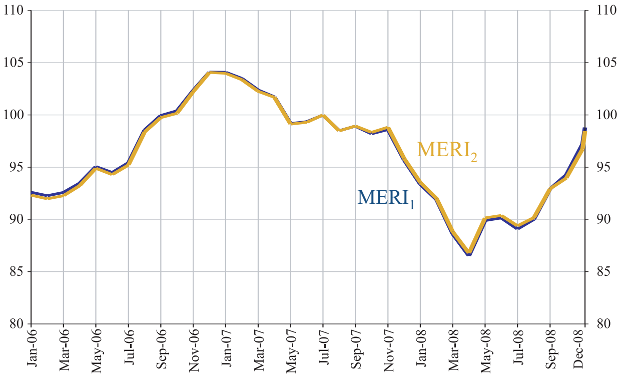
In an attempt to smooth out the increased volatility prevailing on the domestic foreign exchange market, driven mostly by international factors, the Bank intervened on eight occasions between August and November 2008 to sell a total of US$172 million. Transactions were carried out at exchange rates ranging from Rs27.95 to Rs31.90. This was synonymous to mopping up around Rs5.2 billion from the money market.

Furthermore, with a view to countering possible adverse effects of the ongoing global economic crisis on the domestic economy and to support the initiatives taken by the government to stimulate the economy, the Bank, on 20 December 2008, introduced a Special Foreign Currency Line of Credit for US$125 million equivalent to approximately Rs4 billion. The objective was to support banks which might be facing non-availability, or inadequacy, of foreign exchange credit facilities from their usual sources, which may adversely affect banks' ability to finance the country's requirements in trade. On 24 December 2008, one bank was granted a loan of US$5.0 million under the facility.

Effective exchange rate

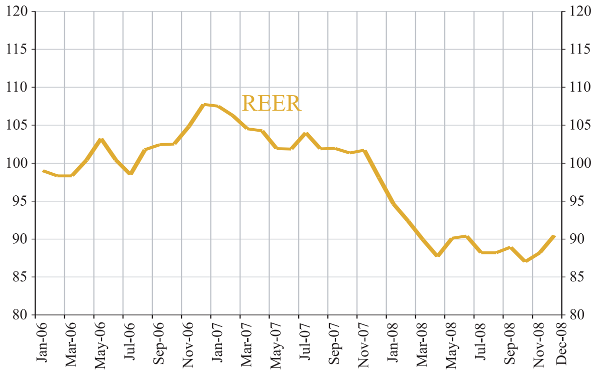
On a nominal effective basis, both $MERI_1$ and $MERI_2$ followed a depreciating trend in the second semester of 2008. $MERI_1$, which uses the currency distribution of trade as weights, showed a depreciation of 9.8 per cent. $MERI_2$, which combines currency distribution of trade and tourism receipts as weights, recorded a depreciation of 9.2 per cent. Chart 4.11 depicts the evolution of the $MERI_1$ and $MERI_2$

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



The Real Effective Exchange Rate (REER) is often used as an indicator of the international competitiveness of a country as it takes into account both nominal exchange rates and inflation. The REER for Mauritius is derived as a geometric average of exchange rate and consumer price data for selected countries with weights based on each country's relative importance as a trading partner. The chosen countries make up at least 80 per cent of Mauritian trade, and revisions are effected on a fiscal year basis to capture changing trade patterns, which occasionally give rise to changes in the currency composition of the basket. The base year is 2005-06, which is a period of relative stability in the rupee exchange rates. The REER showed a depreciation of 2.5 per cent from July to December 2008. Chart 4.12 shows movements in REER.

Chart 4.12: Evolution of the Real Effective Exchange Rate



Box 3: Exchange Rate Pass-Through to Prices

Exchange rate pass-through, broadly defined as the responsiveness of prices to movements in the nominal exchange rate, is a complex mechanism. Any appreciation or depreciation of the exchange rate is expected to impact not only on the prices of imported finished goods but also on the prices of imported inputs that affect the cost of finished goods and services. Knowledge of the degree and timing of exchange rate pass-through is considered essential for a proper assessment of the monetary policy transmission as well as for inflation forecasting.

Using a VAR approach, an internal study has been carried out to examine the extent of exchange rate pass-through in Mauritius over the period 1994Q3 to 2008Q3. This approach allows the quantification of exchange rate pass-through directly from the data in terms of impulse responses that trace the speed and extent of the pass-through of an exchange rate shock to other variables in the model. The study has also assessed whether estimates of pass-through are symmetric or not.

Variables used in the VAR include a recursive distribution chain of pricing, which maps out the dynamic effect of an exchange rate shock along three pricing stages in the following order: (i) import prices, (ii) production prices, and (iii) consumer prices. The ordering and choice of the price variables are motivated by the idea that prices are set at each of three different stages – import, production and consumption – which together make up a stylised distribution chain for goods and services.

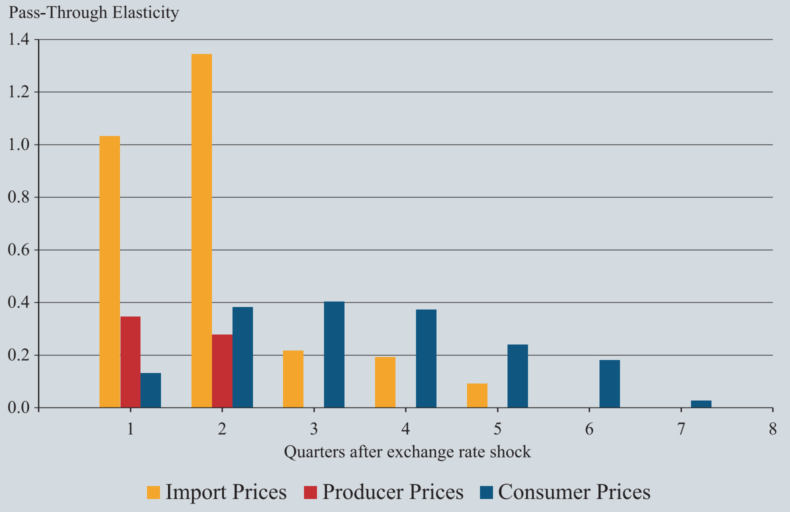
In addition to the distribution chain of pricing, variables such as oil prices, output gap and broad money or interest rates have been incorporated in the VAR model to estimate exchange rate pass-through. These variables act as proxies for supply and demand shocks, and for monetary policy, respectively.

To derive impulse responses, variables in the model have been ordered in a particular sequence so that those placed higher in the ordering have contemporaneous impact on those placed lower in the ordering, but not vice-versa. The most exogenous variable, oil prices, has been placed first on the premise that oil price shocks affect all other variables in the system contemporaneously but oil prices are not themselves affected contemporaneously by any of the other shocks. The next variables in the system are the output gap and the exchange rate. With this ordering, a contemporaneous impact of the demand shocks on the exchange rate is implicitly assumed while a certain time lag on the impact of exchange rate shocks on output is also recognised. The price variables have been ordered next and are thus contemporaneously affected by all of the preceding variables. Following the pricing chain, import prices have been placed before producer prices and consumer prices implying that pricing decisions at the import and production stages can have a contemporaneous impact on consumer prices, but not vice versa. The interest rate has been ordered last, allowing for the money market, and in particular monetary policy, to react contemporaneously to all variables in the model.

Over a ten-quarter horizon, it has been found that the maximum impact of the exchange rate shock is immediately felt in the case of import prices and producer prices while it takes two quarters for the maximum impact of the exchange rate shock to be reflected onto consumer prices. Thereafter, the effect of the shock on all price variables diminishes substantially, turning negative after 2-4 quarters partly reflecting the adjustment process by consumers in the domestic economy to the shock.

Pass-through to import prices amounts to about 100 per cent of the exchange rate shock in the first two quarters after the shock, meaning that the elasticity of import prices with respect to the exchange rate is approximately unity. The extent of pass-through to producer prices is considerably less but still significant, with 35 per cent of the exchange rate shock reflected in producer prices after one quarter and 28 per cent after two quarters. The response of consumer prices is also quite significant and persistent as well. From about 13 per cent at the end of the first quarter pass-through rises to some 38 per cent in the second quarter, and peaks at around 40 per cent three quarters after the shock before gradually subsiding. The chart below shows the pass-through elasticities of a one per cent shock in the exchange rate.

Pass-Through Elasticities



In order to test whether pass-through is asymmetric two dummies have been added to the baseline model to distinguish between periods when exchange rate changes are above the mean – when the rupee tends towards appreciation - and when they are below the mean – when the rupee tends towards depreciation. As expected, results show that the extent of pass-through to the CPI is greater and more persistent when the rate of change of the rupee is lower than the mean than when it is higher. While the impact of a lower-than-mean shock increases up to the 8th quarter before falling gradually, it takes more time for a higher-than-mean shock to even start having an effect on consumer prices and the impact is in any case of much lower magnitude.

The results tend to suggest that besides a possible degree of inflation persistence, domestic factors may also be important in explaining consumer price inflation. This implies, as a result, a significant role for monetary, wage and fiscal policies in containing inflationary pressures in the economy and puts into perspective the sensitiveness of monetary policy making in Mauritius to exchange rate fluctuations.

5. The Outlook for Inflation

While the duration of the economic and financial crises is quite uncertain and the repercussions on the global economy are still unfolding, there has been a decisive improvement in the global inflation outlook. The reversal in the evolution of oil and food prices on international markets in the second half of 2008 has led to a rapid decline in inflationary pressures worldwide. Inflation dropped rapidly after reaching peak levels in the third quarter of 2008 in many advanced as well as emerging and developing economies.

The lingering credit crunch, crumbling stock markets, and record low consumer and business sentiments in most major economies have severely affected global economic prospects. Advanced economies might not come out of the economic recession in the near-term, with most of them projected to register economic contraction in 2009. The monetary and fiscal stimulus deployed by central banks and governments worldwide are aimed at propping up the global economy and speeding up recovery. However, uncertainty still prevails as to the timing of the recovery from the economic slump. A likely but gradual economic recovery is nonetheless foreseen in the course of 2010.

The economic downturn and the slump in aggregate demand globally have generated a lot of spare capacity. Rising unemployment in major economies in the second half of 2008 further reduced pressure on capacity utilisation. Taken together, these factors have substantially lowered upside risks to inflation over the medium-term. Further, oil prices are projected to hover between an average of US$43 to US$60 during 2009 and 2010, suggesting reduced likelihood of higher oil prices fuelling inflation over the policy-relevant horizon. However, the trend in commodity prices, including for food and oil, is shrouded in some degree of uncertainty owing to a number of factors that could adversely affect price movements over the medium-term.

5.1 RISKS TO THE INFLATION OUTLOOK

The impact of the global economic slump on the domestic economy was felt in the third quarter of 2008, as indicated by the deceleration in quarterly GDP growth. Both output and domestic demand are expected to be adversely affected, the more so as the global economic downturn is foreseen to persist during 2009 with probable mild recovery in 2010. External demand-led sectors – such as tourism, textile and free port – would remain undermined by weak consumer spending in main export markets, generating spill-over effects on the remaining sectors of the economy. The monetary and fiscal stimulus is expected to support domestic demand, although the latter is foreseen to grow at a pace below potential.

Economic growth has been forecast, in December 2008, by the CSO to fall below trend to 4 per cent in 2009. The CSO has assumed zero growth for the tourism and textile sectors. Reflecting higher pessimism, the IMF has projected domestic growth at 2.0 per cent for 2009.[14] The outlook for unemployment is uncertain, contrasting with the steadily declining unemployment rate from 2007 onwards. Preliminary estimates show that the output gap will become negative in 2009. Overall, against the backdrop of weak growth prospects, upside risks to inflation emanating from domestic demand conditions appear to be highly mitigated.

The pass-through of energy and food price decline on international markets into domestic prices was seen as from the last quarter of 2008. Foodstuffs and fuel prices have fallen markedly. However, upside wage pressures when combined with relatively low productivity growth remain a threat to inflation over the medium-term, although subdued economic activity over forthcoming quarters could mitigate the potential impact over the policy-relevant horizon.

As regards monetary developments, the relatively high rate of monetary expansion over the past year or so could be attributed to high inflation characterising the domestic economic environment. A deceleration in money growth has already been taking place since September 2008. Bank credit to the private sector has remained buoyant, sustained by credit expansion to the construction and tourism sectors. Thus, monetary developments are not expected to jeopardise the attainment of price stability over the medium-term.

14 IMF Staff Statement at the Conclusion of a Staff Visit to Mauritius, Press Release No. 09/43, 20 February 2009.

An important factor determining price pressures is exchange rate developments. In the second half of 2008, investors' rally into safe haven currencies led to an appreciation of the US dollar and the Japanese yen. However, volatility remained a dominant feature of currency markets at the current juncture: stabilisation of financial markets could restore investors' confidence which could contain the flight to safe haven currencies. Following the appreciation of the US dollar on currency markets in the second half of 2008, the rupee depreciated against the US dollar. In real effective terms, the rupee depreciated by 2.5 per cent in the second semester of 2008. The combination of a well-supported US dollar over the near term, lower capital inflows and a large current account deficit might exert pressure on the exchange rate of the rupee.

Thus, in terms of internal risks to the inflation outlook, adverse developments on the exchange rate front could mitigate the pass-through of the decline in commodity prices internationally to domestic prices and exert upward price pressures with a lag. Productivity growth relative to wage growth also mars the inflation outlook over the medium term. On the other hand, depressed economic activity is expected to subjugate upward price pressures.

On balance, stronger downward pressures on inflation over the foreseeable period have improved the inflation outlook significantly. Inflation is, therefore, projected to fall closer to historical average levels in 2009 and over the policy-relevant horizon with a relatively high probability. The forecasts of inflation support the finding of the survey of inflation expectations, with slightly above two-thirds of respondents expecting a decline in inflation by the end of 2009. In all probability, as depicted in the fan chart, inflation is forecast to fall below 6 per cent by December 2009.

Overall, there is lesser uncertainty at the current juncture on the domestic inflation outlook than when the assessment in the first issue of the Inflation Report was made. Two important variations in the assessments need to be highlighted. First, there is lower uncertainty regarding the inflation forecast as illustrated by the narrower probability distribution of the forecasts by December 2009. Second, the inflation outlook has improved markedly chiefly attributable to favourable commodity price dynamics, as depicted by a drop of nearly 3 percentage points in the central projection.

Inflation fan chart

The risks to the inflation outlook over the forecast horizon are presented graphically in the fan chart, as shown in Chart 5.1. The fan chart depicts the probability distribution of different outcomes of inflation forecasts. The central projection corresponds to the darkest band in the fan chart. The uncertainty around the central projection of inflation is depicted as additional bands surrounding the central projection.

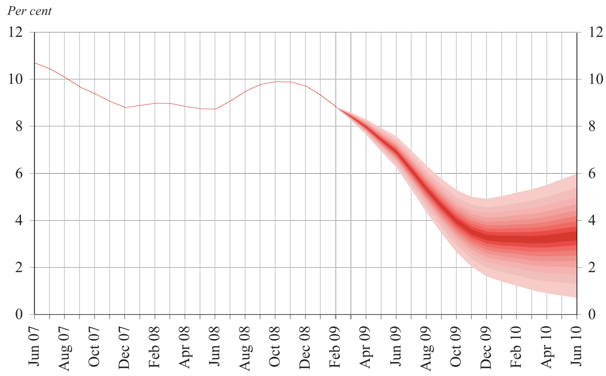
If current economic circumstances were to prevail, the probability that inflation over the next twelve months or so would lie within the darkest central band would be 10 per cent. The fan chart is so constructed that the likelihood for inflation outcomes to lie within each pair of the lighter bands bears a probability of 10 per cent. Consequently, inflation is expected to lie somewhere within the entire fan chart with a probability of 90 per cent. The bands widen as the time horizon is extended, indicating increasing uncertainty about outcomes.

Main assumptions made for constructing the fan chart

The major uncertainties induced by the global financial turmoil, in terms of the nature and expected duration of its effects on the world as well as on the domestic economy, have serious consequences both on the layout of the baseline scenario of the current projection and the identification and quantitative assessment of the effects of risk factors that are deemed as the most likely to manifest during the current forecasting round. The risks regarding the dynamics of oil and commodity prices, as well as the risks associated with the exchange rate dynamics are relatively symmetrically distributed around the forecasted path of inflation from the baseline scenario. In other words, on the basis of latest available data, each of the above-mentioned factors is perceived as having equal probabilities to deviate upward or downward from the hypotheses regarding their dynamics in the baseline scenario.

The forecast is conditional on strict assumptions regarding the external economic environment, regulated domestic prices and the fiscal stance. Nonetheless, expectations regarding the external environment are one of the key assumptions of the forecast.

Chart 5.1: Inflation Fan Chart



Box 4: Inflation Expectations Survey

Inflation expectations are considered as an important determinant of inflation itself. They play an important role in economic decision making and are crucial to monetary policy management, since expectations bear considerable influence on inflation dynamics, acting as one of the major components in the setting of prices, wages and contracts in the economy. At the same time, expectations define the real yield curve, thus affecting private consumption and investment decisions.

From a theoretical viewpoint, inflation expectations result from past values of inflation and from a rational assessment of all factors influencing inflation. Changes in demand (for instance, arising from an exogenous rise in household consumption expenditure that reduces the output gap) and supply conditions (such as a sharp rise in commodity prices) usually are the initial cyclical causes of an increase in inflation. This higher level of inflation, then, is mostly sustained by amongst other inflation expectations – that is, expected future values of the inflation rate. Consumers, trade unions, producers and so forth build these higher inflation expectations into wage demands, asset prices and selling price.

The idea that expectations of inflation are important in linking the nominal values to real decisions can be traced to the seminal work of Fisher (1896). Inflation expectations were a cornerstone of early theories of macroeconomic dynamics, notably the work of Keynes (1936). Alan Greenspan, the former US Federal Reserve Board Chairman, once defined price stability as “an environment where economic agents do not take into account uncertainty about future inflation in their decision-making”. The current US Federal Reserve Board Chairman, Ben Bernanke, noted that “accurate and consistent measurements of inflation expectations therefore represent an important source of information for appropriately calibrating monetary policy and deepening our understanding of economic behaviour”.

In line with international practice, the Bank is paying special attention to monitor private sector inflation expectations. In this respect, the Bank conducted its first Inflation Expectations Survey (IES) towards the end of November 2008 to find out the outlook on inflation by stakeholders. Out of the 50 stakeholders chosen from the financial and real sectors of the economy, 40 responded to the survey, thereby giving a response rate of 80 per cent. The survey findings are based on these 40 responses.

Findings of the IES

1. With respect to how respondents perceived the 9.9 per cent inflation rate for the twelve months ended October 2008, 50 per cent of respondents considered this rate to be too high while 40 per cent judged it to be high. 7.5 per cent of respondents deemed this rate as being appropriate and 2.5 per cent viewed this rate as being low.

2. With regard to their best description of the movement of prices over the preceding 12 months, 87.5 per cent of respondents indicated that prices of goods and services had gone up while 7.5 per cent were of the opinion that they had gone down. 5 per cent of respondents viewed that prices had remained unchanged.

3. With respect to the three main factors accounting for the prevailing inflation pattern, external factors were viewed by 90 per cent of respondents as the primary source of inflation in Mauritius. Wage policy and monetary policy were each regarded by 40 per cent of respondents as the second most important factor. The third most important factor was identified by 40 per cent of respondents as monetary policy, 22.5 per cent of respondents as fiscal policy and 20 per cent of respondents as wage policy.

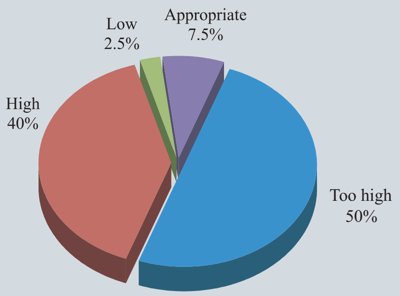
4. In relation to movement of prices over the following 12 months, 67.5 per cent of respondents expected prices to go down, while 25 per cent of respondents anticipated an increase in prices. 7.5 per cent of respondents expected that prices would remain unchanged.

5. Finally, respondents were requested to provide their expectations of the rate of inflation for fiscal year 2008-09, calendar year 2009 and fiscal year 2009-10. 72.5 per cent of respondents expected an inflation rate of 8.0 per cent or higher for fiscal year 2008-09, while 37.5 per cent of respondents thought that it would be 9.0 per cent or higher. 45 per cent of respondents anticipated an inflation rate of below 8.0 per cent for calendar year 2009, while 32.5 per cent of respondents thought that it would be 9.0 per cent or higher. 52.5 per cent of respondents expected an inflation rate of below 8.0 per cent for fiscal year 2009-10, but 32.5 per cent of respondents believed that it would be 9.0 per cent or higher.

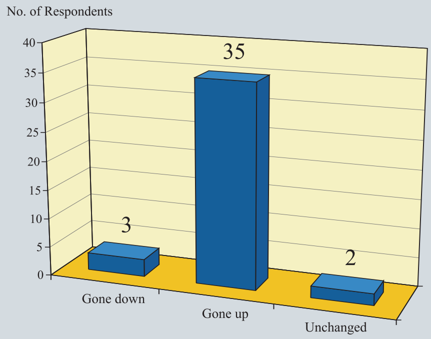
6. The mean inflation rate expected by the respondents was 8.5 per cent for fiscal year 2008-09, 7.9 per cent for calendar year 2009 and 7.4 per cent for fiscal year 2009-10. Respondents, thus, expect a drop in the inflation rate in the near term.

Graphical Representation of Responses

QI.1. Inflation for the twelve-month period ended was 9.9 per cent. Do you perceive this rate to be…



QI.2. Which of the following best describes the movement of prices over the past 12 months?



QI.3. Which of the following factors account for the current inflation pattern? (*Ranking in order of importance starting with 1 for most important*)

Factors	1	2	3
Fiscal policy	2	6	9
Monetary policy	1	16	16
External factors	36	1	1
Wage policy	1	16	8
Increase in investment	0	1	1
Other	0	0	5

QI.4. Which of the following would best describe the movement of prices over the next 12 months?