BANK OF MAURITIUS

INFLATION REPORT

November 2009

The Inflation Report is published twice a year by the Bank of Mauritius in accordance with section 33(2)(b) of the Bank of Mauritius Act 2004. 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 30 June 2009 unless otherwise stated.

Acknowledgement

The preparation of this Report was led by Mr W. Khodabocus, Chief-Monetary Policy Unit, with assistance from Ms M. Mudhoo, Analyst. Mr V. Punchoo, Head-Economic Analysis Division, edited the draft Report before it was cleared by the Publications Review Committee of the Bank of Mauritius. Substantive contributions were made by the following officers: Mr W. Khodabocus, Mr S. Ramrutton, Mr N. Daworaz, Ms M. Mudhoo, Mr I. Ramlall and Mr F. Sooklall for the chapter on *Overview*; Mr G. Beegoo and Mr M. H. Gendoo for the chapter on *Recent Developments in Inflation*; Mr A. Haulkhory, Ms M. Jhamna, Mr S. Jugoo and Ms M. Mudhoo for the chapter on *Demand and Output*; Mrs P. Lo Tiap Kwong, Mr C. Ellapah, Mr S. Ramrutton, Mr N. Daworaz, Mr M. H. Gendoo, Mr M. Mohesh and Mr I. Ramlall for the sections on *Monetary and Financial Developments*; 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 - *Evolution of the Prices of Mogas and Diesel Oil under the Automatic Pricing Mechanism* and *Inflation Expectations*; and, Mr F. Sooklall - *The Impact of the Global Crisis on Trade*.

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 e-mails to mp.unit@bom.intnet.mu.

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Boxes

List of Acronyms

APM	Automatic Pricing Mechanism
BML	Broad Money Liabilities
BSE	Bombay Stock Exchange
CPI	Consumer Price index
CSO	Central Statistics Office
ECB	European Central Bank
EIA	Energy Information Administration (of the US Department of Energy)
FAO	Food and Agriculture Organisation
FDI	Foreign Direct Investment

FPI	Food Price Index (FAO)
GDP	Gross Domestic Product
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 Rate
PPI-A	Producer Price Index-Agriculture
PPI-M	Producer Price Index-Manufacturing
SEMDEX	Stock Exchange of Mauritius Index
SSEC	Shanghai Stock Exchange
WEO	(IMF's) World Economic Outlook
WRI	Wage Rate Index

1. Overview

Global economic and financial conditions remained weak during the first semester of 2009. Most major economies were still in economic recession, although signs that they were pulling out of the recession started to emerge. The contraction of economic activity and trade had severely undermined labour market conditions as well as business and consumer confidence.

Financial markets conditions continued to worsen initially. Unprecedented interventions by governments and central banks worldwide and hopes of economic recovery in the second quarter of 2009 led to some gradual improvement. The supply of credit eased to some extent but overall financial conditions remained relatively tight. Major stock markets began recovering towards the end of the first quarter of 2009.

Global disinflationary pressures that had gathered momentum from late 2008 onwards partly as a result of the substantial economic slack gradually stabilised around the second quarter of 2009. Consequently, the synchronised fall in inflation in most advanced as well as emerging and developing economies slowed down. Rising oil and food prices on international markets in the second quarter of 2009 had but a limited impact on global inflation.

The global economic crisis adversely affected the Mauritian economy after September 2008. The export sector, specifically textile and tourism, was hard hit as demand from main export markets - chiefly the United Kingdom, the euro area and the United States - weakened significantly. The domestic economy is forecast to grow by 2.7 per cent in 2009, well below the trend growth of around 5 per cent in the past five years.[1]

Weaker economic prospects amid an improved inflation outlook in the first semester of 2009 led the Bank of Mauritius and the government to pursue expansionary economic policies further in a coordinated response to shore up the domestic economy. The government announced additional measures in its 2009 budget aimed at saving jobs, protecting people and preparing for recovery with a view to consolidating the fiscal stimulus package of December 2008. While the full effects of the fiscal stimulus and the easing of the monetary policy stance were yet to be felt, they may have contributed to upholding business as well as consumer confidence.

[1] *The CSO's latest growth projection for 2009 is around 2.8 per cent, as announced in the 2010 Budget Speech.*

1.1 THE EXTERNAL ENVIRONMENT

Global economic performance amid signs of recovery

During the first semester of 2009, large areas of the global economy continued to contract although the rate of decline had started to moderate significantly in the second quarter. A few advanced economies including Japan, France and Germany recovered in the second quarter, albeit moderately, while economic prospects brightened in major emerging economies. Financial markets conditions also improved. At this juncture, the global economy is still very much vulnerable and dependent on the extraordinary macroeconomic policy stimulus across the world. The global economy is expected to contract in 2009 but recover in 2010.

Real economic activity in G-7 countries as a group contracted further by 2.2 per cent in the first quarter of 2009 but recorded zero growth in the second quarter. Towards the end of the first quarter and during the second quarter of 2009, as financial strains and the pace of economic decline began to ease, an increasing number of developed and emerging economies had started to show signs of recovery. Developing economies were hit harder due to weaker external demand, falling commodity prices and lower capital flows amid rising concerns about national economic prospects, particularly in economies that had previously relied extensively on external financing. The global economic adjustment led to a broad-based deterioration of labour markets and unemployment worldwide rose significantly.

According to the forecast of the International Monetary Fund (IMF) released in its World Economic Outlook (WEO) of October 2009, world output is projected to contract by 1.1 per cent in 2009 but expand by 3.1 per cent in 2010. The IMF revised its growth forecast for 2010 upward by 0.6 percentage point compared to its previous forecast made in July 2009. With the exception of Japan, growth rates were marked up for all other G-7 economies. The growth rate of emerging and developing economies was projected at 0.4 percentage point higher than initially forecast. Table 1.1 provides details on growth rates in selected economies.

The contraction in real output in the United States slowed from an annual rate of 6.4 per cent in the first quarter of 2009 to a surprising 0.7 per cent in the second quarter. Private consumption, investment, exports and inventories continued to have negative contributions to growth in the second quarter, but their pace of contraction eased relative to the first quarter. Housing market conditions were improving: existing home sales rose for the third month in a row and house prices hit their highest level since October 2008 in June 2009. The labour market, which tends to lag the rest of the economy, remained undermined although the pace of deterioration moderated as the unemployment rate edged up slightly in June 2009 to 9.5 per cent from 9.4 per cent in May. Financial markets tensions and risk aversion eased and consumers felt less pessimistic about the economy. According to the IMF's October 2009 WEO, the US economy is projected to contract by 2.7 per cent in 2009 but will recover in 2010 growing at a rate of 1.5 per cent.

Japan's economy contracted by 3.3 per cent in the first quarter of 2009 compared to the previous quarter, but recovered in the second quarter to post a positive growth of 0.7 per cent. After falling in the first quarter of 2009, industrial production was bolstered in the second quarter, posting strong gains in May. Exports started to strengthen in the second quarter of 2009 and were expected to boost industrial production, as firms had almost completed their destocking cycle. However, public spending remained constrained by soaring public debt. Further export growth appeared increasingly unsustainable, given the degree to which deleveraging was stifling demand for foreign goods from the United States and Europe. In October 2009, the IMF projected that Japan's economy would contract by 5.4 per cent in 2009 but grow by 1.7 per cent in 2010.

The euro zone economy contracted as well, but the pace of contraction slowed as Germany and France unexpectedly pulled out of recession in the second quarter of 2009. Real output in the euro zone shrunk quarter-on-quarter by 2.5 per cent in the first quarter of 2009 and by 0.2 per cent in the second quarter aided by the still fragile recovery of its two largest economies in that quarter. Germany and France posted growth rates of 0.4 per cent and 0.3 per cent, respectively, in the second quarter of 2009 against contractions of 3.5 per cent and 1.4 per cent, respectively, in the first quarter of 2009. Economic conditions elsewhere in the euro zone also improved with lower rates of contraction and even small positive growth rates for a few member countries. Germany was the hardest hit in the first quarter of 2009 as its exports fell drastically on slumping global demand. Further signs of improvement emerged, such as slower declines in retail sales and

Table 1.1: Real Growth Rates in Selected Economies

Per cent

	Q3-2008	Q4-2008	Q1-2009	Q2-2009	2008	2009	2010
	Quarter-on-quarter Growth Rates					*Projections*	
World output					**3.1**	**-1.1**	**3.1**
Advanced economies					**0.6**	**-3.4**	**1.3**
of which							
United States [a]	-2.7	-5.4	-6.4	-0.7	0.4	-2.7	1.5
Euro Area	-0.4	-1.8	-2.5	-0.2	0.7	-4.2	0.3
Japan	-1.7	-3.0	-3.2	0.7	0.7	-5.4	1.7
United Kingdom	-0.7	-1.8	-2.5	-0.6	0.7	-4.4	0.9
	Q3-2008	**Q4-2008**	**Q1-2009**	**Q2-2009**			
	Year-on-year Growth Rates						
Emerging market and developing economies					**6.0**	**1.7**	**5.1**
Sub Saharan Africa					5.5	1.3	4.1
Developing Asia					7.6	6.2	7.3
of which							
China	9.0	6.8	6.1	7.9	9.0	8.5	9.0
India	7.9	7.6	5.8	6.1	7.3	5.4	6.4

[a] *Quarter-on-quarter, seasonally-adjusted annualised rate.*

Source: IMF's World Economic Outlook, October 2009; offices of national statistics' websites and central banks' websites.

industrial production. However, financial conditions remained weak and unemployment was on the rise hitting 9.4 per cent in June 2009. In October 2009, the IMF projected the euro zone economy to contract by 4.2 per cent in 2009 but grow by 0.3 per cent in 2010.

The economy of the United Kingdom contracted considerably in the first semester of 2009, with GDP contracting by 2.5 per cent and 0.6 per cent in the first and second quarters of 2009, respectively. The continuing contraction in global economic activity led to a fall in UK exports and further cutbacks in domestic spending. Household spending fell as consumers were confronted with rising unemployment, tighter credit conditions and falling real and financial asset prices. According to the IMF's estimates released in October 2009, the UK economy is expected to contract by 4.4 per cent in 2009 but grow by 0.9 per cent in 2010.

In emerging economies, export growth decelerated rapidly and capital inflows fell significantly. Lower international demand for manufactured goods had a particularly severe effect on the Asian region, with some countries recording double-digit percentage declines in exports and industrial production. Growth in China's economy slowed in the first quarter of 2009 to 6.1 per cent, but aggressive policy stimulus measures boosted domestic demand and growth accelerated to 7.9 per cent in the second quarter. In June 2009, manufacturing surveys indicated expansion, residential property market showed signs of stabilisation, and fixed investment started to surge. The Indian economy was estimated to slow down in 2009 in the wake of the prolonged global economic downturn, reflecting slowdown of growth in all its constituent sectors. In October 2009, the IMF estimated that China would register growth rates of 8.5 per cent and 9.0 per cent and India, growth rates of 5.4 per cent and 6.4 per cent in 2009 and 2010, respectively.

Inflation

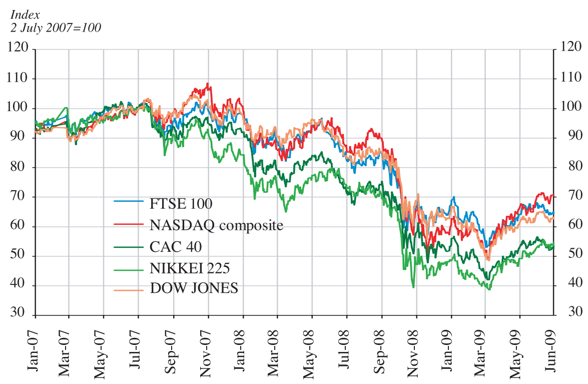
The decline in inflation that started in late 2008 was sustained in the first half of 2009 partly due to the economic slowdown and the relative stabilisation of oil and food prices at lower levels relative to a year ago. Several economies, especially advanced economies such as the United States, the euro zone and Japan, even entered deflation territory. Inflation in the euro area, the United Kingdom and the United States fell to -0.1 per cent, 1.8 per cent and -1.4 per cent, respectively, in June 2009.

Inflation also declined in emerging economies, with China and Singapore, whose economies were severely hit by falling exports, experiencing deflation. Likewise, Thailand had deflation for the sixth straight month to June 2009. Core inflation also continued to fall in most economies. The inflation rates in selected economies are shown in Table 1.2.

International stock markets

International equity markets posted, broadly, a V-shaped performance during the period January to June 2009. From the start of the year to the beginning of March, stock markets followed a downward trend amid mounting worries about the global economic outlook and reduced risk appetite. On 9 March 2009, markets recorded their lowest performance due to deepening concerns about the health of the world economy with rising fears of a collapse of banking systems worldwide. Thereafter, international stock markets both in advanced as well as in emerging market economies gradually climbed to higher levels. Chart 1.1 shows movements in major international stock market indices.

Chart 1.1: Equity Indices of Selected Major International Stock Markets



Source: Reuters.

Table 1.2: Consumer Prices

Annual percentage change

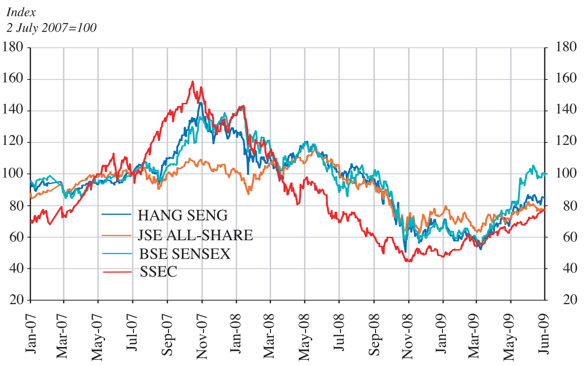
	2005	2006	2007	2008	January 2009	June 2009
China	1.8	1.5	4.8	5.9	1.0	-1.7
Euro area	2.2	2.2	2.1	3.3	1.1	-0.1
Hong Kong	0.9	2.0	2.0	4.3	3.1	-0.9
Hungary	3.6	3.9	7.9	6.1	3.1	3.7
India	4.2	6.2	6.4	8.3	10.4	9.3
Indonesia	10.5	13.1	6.0	9.8	9.2	3.7
Philippines	7.7	6.2	2.8	9.3	7.1	1.5
Singapore	0.5	1.0	2.1	6.5	2.9	-0.5
South Africa	3.4	4.7	7.1	11.5	8.1	6.9
South Korea	2.8	2.2	2.5	4.7	3.7	2.0
Thailand	4.5	4.6	2.2	5.5	-0.4	-4.0
Turkey	8.2	9.6	8.8	10.4	9.5	5.7
United Kingdom	2.0	2.3	2.3	3.6	3.0	1.8
United States	3.4	3.2	2.9	3.8	0.0	-1.4

Source: IMF's World Economic Outlook, October 2009, The Economist and central banks' websites.

The effects of fiscal and monetary policy measures taken to mitigate the global downturn, with interest rates dropping to very low levels, helped bolster investors' sentiment. The appetite of investors grew over the three-month period to June 2009. Further, broadly positive corporate announcements boosted stock markets with hopes that the worst might be over though growth prospects were still considered to be anaemic.

With the exception of Shanghai Stock Exchange (SSEC), major emerging stock markets posted a negative performance in the period January to March 2009, reaching their lowest in the second week of March 2009. Thereafter, their performance improved consistently till the end of June. India and China were the best performers among emerging economies, recording performances of 63.0 per cent and 50.0 per cent, respectively, in the six months to June 2009. Chart 1.2 shows the evolution of selected emerging stock market indices.

Chart 1.2: Equity Indices of Selected Emerging Stock Markets



Source: Reuters.

Monetary policy in selected economies

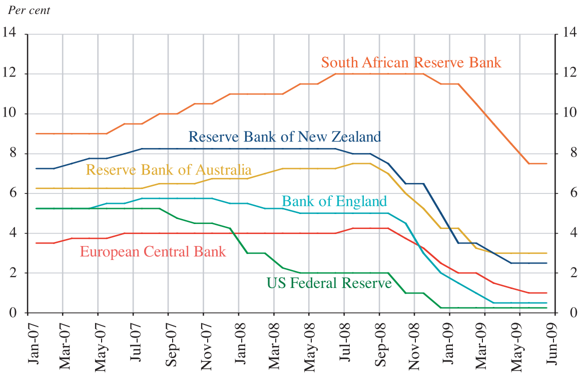
Central banks in a large number of advanced as well as emerging and developing countries continued to loosen their monetary policy stance in the first semester of 2009, as global financial and economic conditions remained severely undermined. Policy interest rates were further reduced to new historical lows, close to zero in a number of cases. Where key interest rates had reached near-zero levels, central banks were applying quantitative easing by purchasing securities and bonds to ease monetary conditions and support credit markets. As a consequence, the credit crunch in advanced economies gradually eased by June 2009. Simultaneously, risk appetite of financial investors, in general, improved. However, growth in bank credit continued to slow in advanced economies.

The US Federal Reserve maintained the federal funds rate in the target range of zero to 0.25 per cent but continued to ease monetary conditions by purchasing securities and lending to depository and other financial institutions. However, as financial markets showed signs of stabilising, the US Federal Reserve outlined a series of specific requirements for banks to exit the Troubled Asset Relief Program in order to promote a smooth transition in markets.

The European Central Bank (ECB) and the Bank of England aggressively reduced their respective policy interest rates by 150 basis points to 1.0 per cent and 0.5 per cent, respectively, in the first semester of 2009. The Bank of England had been simultaneously injecting liquidity into the monetary system by purchasing securities and bonds from the market. In June 2009, the ECB announced, among non-standard measures, the purchase of euro-denominated covered bonds issued in the euro area. The aim was to improve liquidity in the private debt security markets and encourage a further easing of credit conditions.

Central banks in other advanced as well as emerging and developing economies - such as in Australia, Canada, India, Malaysia, New Zealand, Norway, Sweden and Thailand - also reduced their key interest rates significantly to support their economies. Chart 1.3 shows end-of-month policy interest rates of selected central banks.

Chart 1.3: Selected Central Banks' Policy Interest Rates



Source: Reuters and central banks' websites.

The outlook on monetary policy in most major economies is likely to stay focused on low level interest rates for some time as economic prospects and labour markets remain vulnerable. However, while a few central banks already started tightening monetary policy as from August 2009, some other central banks are expected to begin adjusting their key interest rate upward early in 2010. The implementation of an exit strategy at the appropriate time remains an important consideration for monetary policy in order to prevent the resurgence of inflationary pressures following the low interest rate environment over a protracted period and the increase in global money supply.

1.2 THE DOMESTIC ENVIRONMENT

Growth

Economic conditions in Mauritius were weak in the first semester of 2009. Seasonally-adjusted data showed that the quarter-on-quarter real output growth rate contracted by 0.8 per cent in the first quarter of 2009 before recovering to 0.6 per cent in the three months to June 2009. Disaggregated and unadjusted expenditure data indicate that the contraction in real output in the first semester of 2009 relative to the second semester of 2008 was attributable to the marginal contraction in domestic demand - reflecting lower real spending on final consumption expenditure and on gross fixed capital formation - and to a sharp deceleration in net external demand of goods and non-factor services.

On the supply side, output growth in the first semester of 2009 was dragged down by the contraction in real activity of several key sectors namely manufacturing, construction, distributive trade, and hotels and restaurants and the deceleration of financial intermediation and real estate, renting and business activities. The recovery of the sugar sector and robust performance of transport, storage and communications helped contain the downside risks to the growth picture. Within the manufacturing sector, textile, which had started to shrink as early as in the second quarter of 2008, witnessed a sharper contraction in the period under review. Output in food processing slowed down while activity in other manufacturing declined significantly.

Quarterly data, however, indicated that the textile and hotels and restaurants sectors may have passed their trough in the second quarter of 2009 as the pace of contraction of real output in these sectors has slowed down and the outlook in the second semester of 2009 is improving. In contrast, the decline in real output in other manufacturing and construction aggravated in the second quarter of 2009.

Amid improving global conditions, the domestic economic outlook for the remaining of the year brightened up but the recovery to trend growth will be slow. Trade-exposed sectors like textile and hotels and restaurants could recover much faster than others as these sectors have already undertaken the necessary adjustment efforts to stay competitive. Sectors dependent on domestic demand may, however, take longer to return to 'normal' conditions. For 2009, the Central Statistics Office (CSO) has revised upwards its forecast for overall growth rate to 2.7 per cent from an initial forecast of 2.5 per cent.

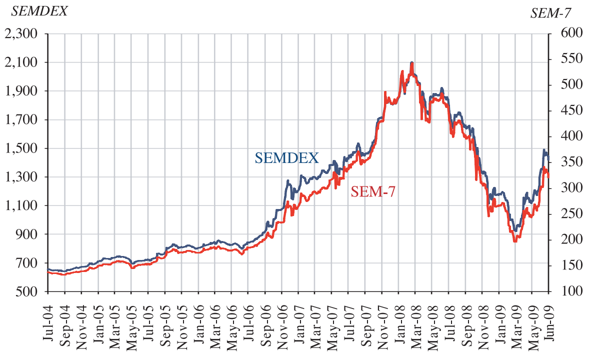
The coordinated approach by government and the central bank in the last quarter of 2008 favouring an expansionary fiscal and monetary policy continued during the six months to June 2009. The government consolidated the fiscal stimulus measures it announced in December 2008 in its May 2009 Budget, which made provision for an estimated total amount of Rs14.2 billion to be spent on infrastructure works, structural adjustment measures and financial aid to the private sector over a period of eighteen months. The key Repo Rate was reduced by another 100 basis points to a historical low 5.75 per cent in March 2009.

Stock market

The local stock market lost considerable ground in the early months of 2009, reflecting growing uncertainty about the domestic economic outlook amid heightened risk aversion in international markets and reversal of capital flows. The SEMDEX and the SEM-7 fell by 22.2 per cent and 26.6 per cent, respectively, reaching troughs of 919.83 and 196.24 on 3 March 2009. Share prices of blue chip companies dipped as foreign investors fled towards safe-haven assets and domestic investors reassessed the outlook of hotel and bank sectors mainly in the light of cautionary announcements and lower corporate earnings. However, from March to June 2009, the local stock market picked up on the back of positive international news and both SEMDEX and SEM-7 recouped their previous losses to rise by 54.1 per cent and 63.7 per cent, from 3 March to 30 June 2009, respectively.

Over the period January to June 2009, foreign investors disinvested on the local stock market, with total net sales of Rs1.2 billion. The decline was mainly driven by sales of banking and hotels sector stocks. Chart 1.4 depicts the evolution of the local stock market indices.

Chart 1.4: SEMDEX and SEM-7



Source: Stock Exchange of Mauritius Ltd.

Exchange rate

With the foreign exchange market broadly in balance, the exchange rate of the Mauritian rupee reflected essentially movements of major currencies on global markets in the first semester of 2009. The rupee lost some ground against the US dollar in the first quarter of 2009 after the US currency appreciated due to international investors' appetite for safe haven assets. Thereafter, the rupee recouped some of its losses against the US currency benefiting from the latter's broad-based weakness on global markets. Overall, the rupee depreciated vis-à-vis the US dollar, the euro and the Pound sterling on a point-to-point basis in the six months to June 2009.

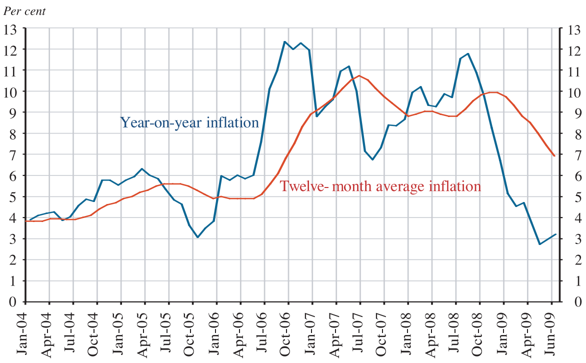
Inflation

As widely expected, inflation declined steadily in the first semester of 2009 in line with the general trend worldwide. A number of factors, both external and internal, contributed to the decline in inflation. The combination of a drop in oil and commodity prices on international markets earlier in the year translating into lower domestic prices for these commodities, the relative stability of the rupee against the US dollar, on average, in which imports are predominantly denominated, subdued domestic demand, and receding inflation expectations were the main contributors to the decline in inflation.

Inflation, measured on the twelve-month moving average basis, reached a high of 9.9 per cent in October and November 2008 but declined consistently thereafter to 6.9 per cent in June

2009. The drop in year-on-year inflation was sharper, falling from 6.7 per cent to 3.3 per cent from December 2008 to June 2009. The evolution of inflation is depicted in Chart 1.5.

Chart 1.5: Inflation Rate



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

1.3 MONETARY POLICY

The central bank further eased monetary policy against the backdrop of a rapidly declining inflation rate and weak economic conditions.

There were two important developments in the formulation of monetary policy during the period under review. First, the Governor announced during a press conference held on 23 June that section 5(2)(a) of the Bank of Mauritius Act 2004 would be considered for implementation. The law provides that the Bank shall "*... determine, with the concurrence of the Minister* [Minister of Finance and Economic Empowerment], *the accepted range of the rate of inflation during a given period consistent with the pursuit of the price stability objective*". The fulfilment of this requirement will foster the anchoring of inflation expectations. The wide-ranging benefits of well-anchored inflation expectations over the medium to long term will accrue to businesses, households as well as the government and, ultimately, favourably influence economic progress.

Second, the May 2009 Budget made provision for the Monetary Policy Committee (MPC) to be strengthened by expanding its membership to bring in more expertise.[2] The number of external members was raised to four from three previously. Since its establishment on 23 April 2007, the MPC has been striving to improve the quality of its evaluation of the international and domestic environment and the outlook as well as the communication of the assessment underpinning its decision.

Monetary Policy Committee meetings

The MPC of the Bank of Mauritius held two regular meetings during the first semester of 2009, the thirteenth on 26 March and the fourteenth on 22 June 2009.

There was no change in the communication policy for announcing the decision and assessment of the MPC. However, a new feature is the announcement of the subsequent meeting of the MPC in the Monetary Policy Statement released a week after a meeting as per the established practice.

Monetary policy decisions

The global economic and financial situation had further weakened when the MPC met on 26 March 2009. Economic contraction, poor consumer and business confidence, rising unemployment, financial markets strains and wealth destruction had been afflicting major economies. The IMF had downgraded its global growth outlook in its WEO Update of January 2009 and was about to downgrade it further in the April 2009 WEO to a global economic slump that was going to be deep and protracted.

Preliminary data suggested that domestic economic conditions had worsened significantly on account of weakening external demand for textiles and tourism services. The economic slowdown, which started in 2008, was expected to continue in the first half of 2009. Meanwhile, the rapid decline in global inflation and the near stabilisation of food and oil prices had led to a reduction of domestic inflationary pressures as well as to a marked fall in domestic inflation. The MPC decided to further ease the monetary policy stance with a view to further supporting the Government's policy to stimulate the domestic economy. The MPC reduced the policy interest rate by 100 basis points on 26 March 2009 to an all-time low of 5.75 per cent per annum.

[2] *The Bank of Mauritius Act 2004 stands amended effective 30 July 2009 providing for four external members to sit on the MPC.*

Since the March 2009 MPC meeting, leading indicators in major economies suggested that global economic conditions were stabilising although the global growth outlook remained vulnerable. The unparalleled fiscal stimulus and monetary policy easing implemented in a large number of countries together with the support to major financial systems were seen as a catalyst. Global inflation was stabilising at a low level.

Domestically, exports of goods and services had contracted further in the second quarter of 2009 and overall economic conditions had remained weak while the inflation rate had continued to decline. The economic slowdown was expected to have worsened in the second quarter of 2009 given the weight of exports of goods and services in the domestic economy. Amid a great deal of uncertainty, the MPC considered that the full effects of the coordinated expansionary economic policies were yet to be felt and anticipated a reversal of the declining trend in quarterly growth rate in the second half of 2009. The MPC, however, assessed that the inflation outlook was clouded by uncertainties regarding the future direction of commodity prices, particularly oil, on international markets and exchange rate movements and judged that, on balance, the current stance of monetary policy remained appropriate. It decided to leave the key Repo Rate on hold.

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**
26 March 2009	Reduce by 100 basis points	5.75	5 - 2	1 - reduce by 50 basis points 1 - reduce by 75 basis points
22 June 2009	Unchanged	5.75	Unanimous	-

2. Recent Developments in Inflation

As the international prices of most commodities drifted downwards in the wake of lower demand emanating from the global economic slowdown, pressure on prices originating from imported items continued to ease during the first half of 2009. As a result, domestic inflation, both in terms of year-on-year and twelve-month average, fell rapidly also benefiting from the base effect from past upswings in these prices and developments in domestic demand conditions.

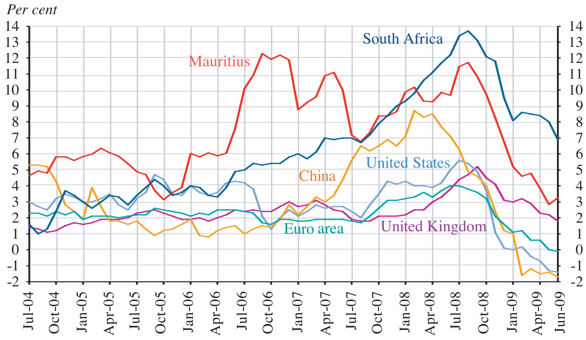
2.1 GLOBAL INFLATION AND COSTS

The global disinflationary process that began in the second half of 2008 gathered momentum in the six months to June 2009 in most economies after food and fuel prices markedly declined compared to levels prevailing in the first half of 2008 and increasing economic slack.[3] In addition, the significant deterioration in labour market conditions in most economies led to a sharp easing of wage pressures. The rapid fall in prices stoked fears of deflation, which became an important concern of policymakers in developed economies in particular.

Since reaching 3.7 per cent in December 2008, inflation in Organisation for Economic Co-operation and Development (OECD) countries declined to -0.1 per cent in June 2009. Inflation in the United States fell sharply from 0.1 per cent in December 2008 to -1.4 per cent in June 2009. In the United Kingdom, inflation declined from 3.1 per cent to 1.8 per cent over the same period. In the euro area, inflation fell from 1.6 per cent in December 2008 to -0.1 per cent in June 2009. Inflation in South Africa declined from 9.5 per cent in December 2008 to 6.9 per cent in June 2009 while that in China dropped markedly to -1.7 per cent in June 2009. Chart 2.1 shows the evolution of year-on-year inflation in some selected countries, including for Mauritius.

[3] *In this section, official inflation figures cited represent year-on-year inflation.*

Chart 2.1: Inflation in Selected Countries



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

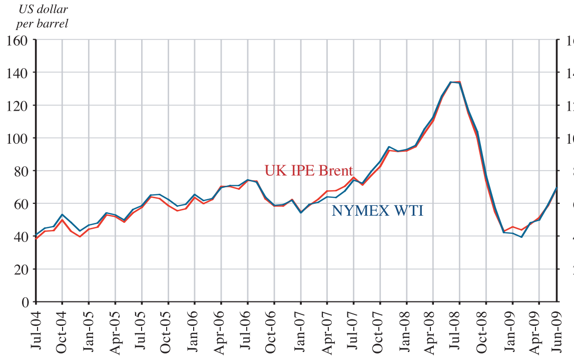
Oil prices

Among the main primary commodity markets, oil markets were the most affected by the rapid decline in global economic activity and the sharp deterioration in economic prospects. The price of crude oil on the New York Mercantile Exchange (NYMEX) WTI (West Texas Intermediate) collapsed to US$44.6 a barrel by the end of December 2008.

Oil prices broadly stabilised in the range US$35 to US$50 a barrel in the first four months of 2009, with occasional spikes outside the range. Subsequently, oil prices recovered and the NYMEX WTI traded around US$70 a barrel through most of June 2009. Oil prices NYMEX WTI averaged US$69.7 a barrel in June 2009, up from US$42.1 a barrel in December 2008. Likewise, IPE Brent figures averaged US$69.3 a barrel in June 2009, up from a trough of US$43.0 a barrel in December 2008.

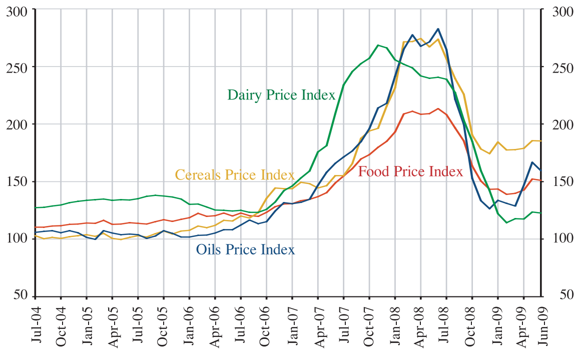
The bottoming-out of oil prices around late 2008 and early 2009 is likely to be followed by a rebound in the medium term, as per projections by major international forecasters. However, a rapid recovery to the record price levels seen in the first half of 2008 seemed improbable given prospects of more moderate growth over the next global expansion cycle. Chart 2.2 shows movements in monthly average oil prices.

Chart 2.2: Oil Prices



Source: Reuters.

Chart 2.3: FAO Food Price Index and Other Food Commodity Price Indices



Source: FAO website.

Food prices

Food prices on the global market eased significantly following slowing demand and improved supply prospects particularly for oilseeds and grains in major producing countries, as shown in Chart 2.3. The easing of market conditions was reflected in the benchmark Food Price Index (FPI) compiled by the Food and Agriculture Organisation (FAO), which fell by around 71 per cent in June 2009 from highs attained a year earlier.

The FPI dropped in the first quarter of 2009, reaching nearly a two-year trough of 139 points in February 2009, but recovered thereafter to 151 points in June 2009. The rise in the FPI in the second quarter reflected renewed surge in international prices of several major agricultural commodities composing the FPI against the backdrop of strong demand for grains, weather concerns and cultivation delays.

Growing linkages between the agricultural, energy, financial and currency markets rendered food prices increasingly exposed to external shocks. Thus, a weak US dollar and a rebound in energy prices could exert renewed upward pressure on international food prices. However, with world staple food stocks at more comfortable levels than in 2008 and barring any setback in crop production as well as a sharp rebound in energy prices, market conditions for food appear less vulnerable to shocks than was the case in 2008.

Other commodity prices

Prices of non-energy commodities – such as cotton, timber and metals and minerals – declined in the first six months of 2009 owing to the global economic downturn. Table 2.1 shows the annual averages of selected non-energy commodities for the years 2007 and 2008 and the first six months of 2009.

Table 2.1: Non-energy Commodities

Commodity	Unit	Averages *Jan-Dec 2007*	*Jan-Dec 2008*	*Jan-June 2009*
Cotton A Index	c/kg	139.5	157.4	126.5
Aluminum	$/mt	2,638	2,573	1,422
Copper	$/mt	7,118	6,956	4,046
Gold	$/toz	697	872	915
Iron ore	c/dmtu	84.7	140.6	101.0
Lead	c/kg	258	209.1	132.8
Nickel	$/mt	37,230	21,111	11,696
Silver	c/toz	1,341	1,500	1,321
Steel (cold rolled) coilsheet	$/mt	650	966	867
Steel (hot rolled) coilsheet	$/mt	550	883	767
Tin	c/kg	1,454	1,851	1,227
Zinc	c/kg	324.2	187.5	132.3
Cocoa	c/kg	195.2	257.7	259.2
Plywood	c/sheets	640.7	645.5	569.1

$ = US dollar   c = US cent   mt = metric ton
kg = kilogram   dmtu = dry metric ton unit   toz = troy oz

Source: World Bank's Commodity Price Data.

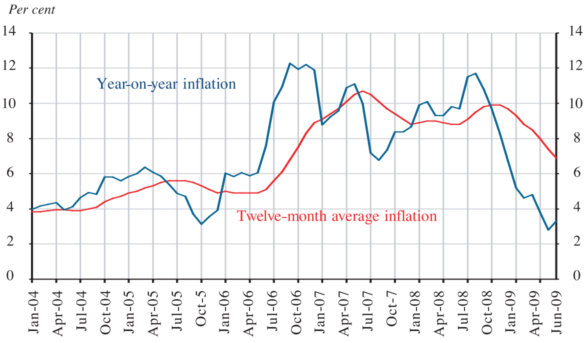
Freight costs

The London-based Baltic Dry Index (BDI), which is the benchmark for tracking commodity shipping costs, bottomed out early in 2009 and started rising by end-June 2009. The BDI hit a low of 774 points on 24 December 2008 and thereafter, rose to 1,786 points on 30 April 2009 and further to 3,757 points on 30 June 2009. Given that the BDI is a measure of shipping rates, the increase in the BDI is regarded as an important indicator of an improving global economy.

2.2 INFLATION: HEADLINE AND CORE

In the six months to June 2009, headline inflation, both year-on-year and twelve-month average, as well as core inflation have been moderating rapidly, as shown in Charts 2.4, 2.5 and 2.6. The year-on-year inflation, defined as the percentage change in the Consumer Price Index (CPI) in a given month compared to the same month of the preceding year, was on a clear downtrend up to June 2009 although it increased on two occasions in between but remaining well below the rate of December 2008. From 6.7 per cent in December 2008, the inflation rate declined to 4.6 per cent in February but edged up to 4.8 per cent in March. In April and May, it resumed its downward trend but rose again in June to 3.3 per cent. The cumulative effect of administered price cuts in government imported flour, reduction in the price of bread and in cooking gas in early January 2009 were partly offset by the subsequent hikes in domestic fuel prices under the Automatic Pricing Mechanism (APM).[4]

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



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

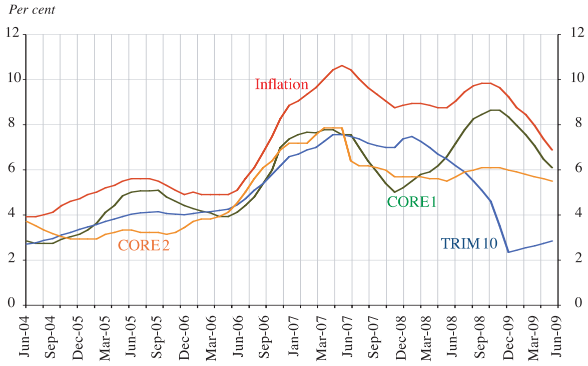
Inflation, as measured by the percentage change between the average CPI during a twelve-month period and the average CPI during the corresponding previous twelve-month period, also declined but not to the same extent as year-on-year inflation. It maintained a steady downward path falling from 9.7 per cent in December 2008 to 8.5 per cent in March 2009 and further to 6.9 per cent in June 2009.

Core inflation

The measures of underlying inflation mirrored the paths of headline inflation. The decline in CORE1 and CORE2 inflation suggested a turning point in underlying price pressures.[5]

Based on the twelve-month average methodology, CORE1 inflation dropped from 8.7 per cent in December 2008 to 8.4 per cent in January 2009 and further to 6.1 per cent in June 2009. CORE2 inflation fell from 6.1 per cent in December 2008 to 6.0 per cent in January 2009 and further to 5.5 per cent in June 2009. In contrast, TRIM10 inflation also fell from 3.5 per cent in December 2008 to 2.3 per cent in January 2009 but edged up to 2.8 per cent in June 2009.

Chart 2.5: Inflation and Core Inflation - twelve-month average



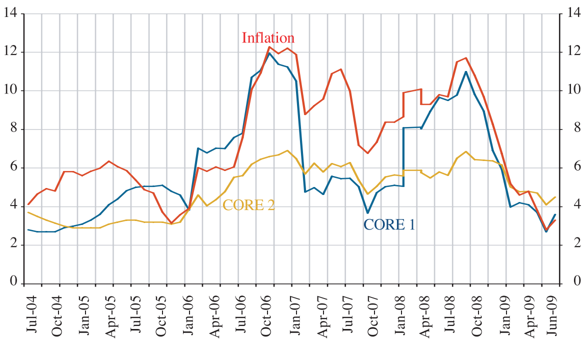
Source: CSO, Government of Mauritius, and Bank calculations.

On a year-on-year basis, CORE1 inflation dropped from 5.9 per cent in December 2008 to 4.0 per cent in January 2009 and further to 3.6 per cent in June 2009, while CORE2 inflation declined further to 4.5 per cent in June 2009, from 6.2 per cent in December 2008 and 5.0 per cent in January 2009.

[4] *Refer to Box 1 on page 16.*

[5] *Core inflation measures the change in average consumer prices after excluding from the CPI basket 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 the CPI basket. 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.*

Chart 2.6: Inflation and Core Inflation - year-on-year



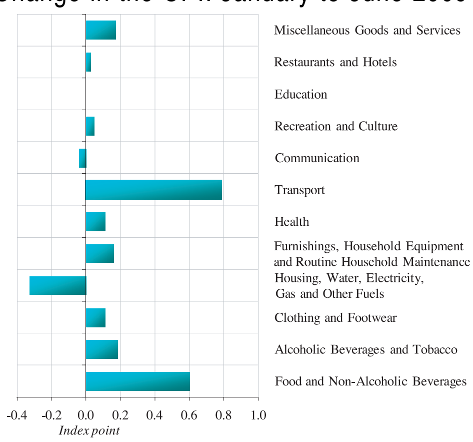
Source: CSO, Government of Mauritius, and Bank calculations.

2.3 EVOLUTION OF MAJOR COMMODITY GROUP INDICES

The CPI rose from 115.3 in January 2009 to 117.1 in June 2009, that is, by 1.8 index points. The largest increase was registered in the CPI division *Transport*, which increased by 4.8 per cent between January and June 2009, thus contributing 0.8 index point to the increase in the CPI. *Food and non-alcoholic beverages* recorded the second largest contribution of 0.6 index point, mainly as a result of hikes in the prices of fresh vegetables and sugar in the earlier months of 2009. The increase in the CPI was partially offset by a weighted decline of 0.3 index point in the *Housing, water, electricity, gas and other fuels* division.

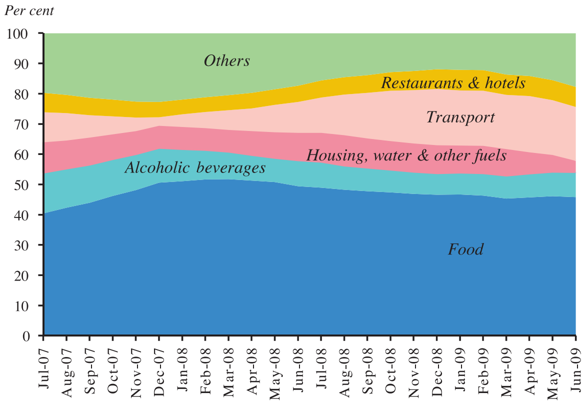
Chart 2.7 illustrates the weighted contribution of the main divisions of the CPI basket to the increase in the CPI between January 2009 and June 2009. Chart 2.8 depicts the monthly weighted contribution of the main components of the CPI basket to twelve-month average inflation.

Chart 2.7: Weighted Contribution of Main Divisions to the Change in the CPI: January to June 2009



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

Chart 2.8: Weighted Contribution of the Main Divisions of the CPI Basket to Inflation



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

Food and non-food inflation

The food component in the CPI basket carries a weight of 26.5 per cent. As a result of the stabilisation of food prices on the international markets leading to price cuts of some key food items early in the year, food inflation declined steadily from a peak of 17.2 per cent in September 2008 to 14.1 per cent in March 2009 and further to 11.5 per cent in June 2009. Food inflation accounted for around half of headline inflation, more or less in line with the trend in the second half of 2008.

On a twelve-month average basis, non-food inflation gradually fell from 7.2 per cent in December 2008 to 5.0 per cent in June 2009. Table 2.2 and Charts 2.9 and 2.10 show movements in food and non-food inflation.

Table 2.2: Food and Non-food Inflation

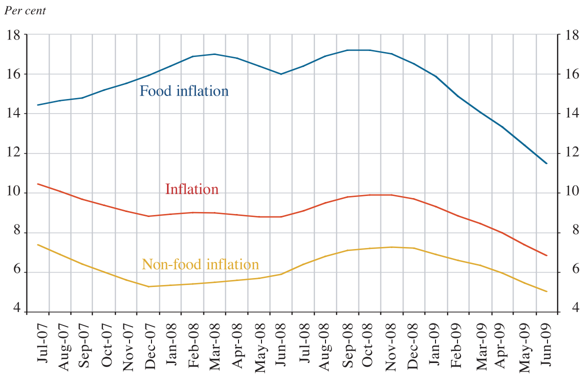
Per cent

	Food	Non-Food	Food	Non-Food
	12-month average		*Year-on-year*	
Dec-08	16.5	7.2	12.0	4.7
Jan-09	15.9	6.9	10.2	3.3
Feb-09	14.9	6.6	7.4	3.5
Mar-09	14.1	6.3	7.4	3.7
Apr-09	13.3	6.0	6.6	2.8
May-09	12.4	5.5	4.9	2.0
Jun-09	11.5	5.0	4.7	2.7

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

Based on the year-on-year methodology, the steady decline in food inflation was more pronounced. Food inflation fell from 12.0 per cent in December 2008 to 10.2 per cent in January 2009 and further to 4.7 per cent in June 2009.

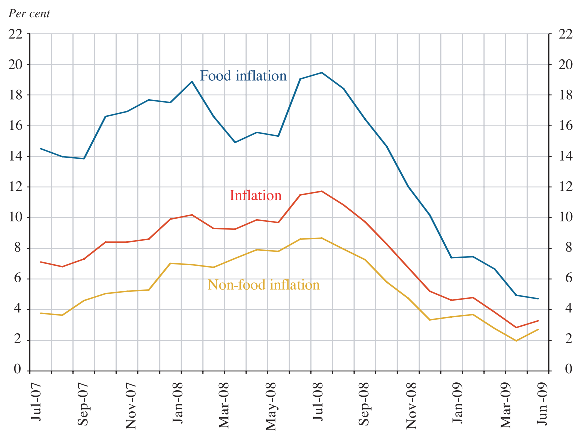
Chart 2.9: Headline, Food and Non-food Inflation - twelve-month average



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

Year-on-year non-food inflation declined from 4.7 per cent in December 2008 to 3.3 per cent in January 2009 and further to 2.7 per cent in June 2009. However, non-food inflation was volatile recording increases in February and March 2009 and again in June 2009.

Chart 2.10: Headline, Food and Non-food Inflation - year-on-year



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

Goods and services inflation

Goods inflation, which stood at 10.5 per cent in December 2008, fell to single digit in January 2009 and declined steadily thereafter to reach 7.0 per cent for the twelve-month period ended June 2009. Services inflation also eased in the first semester of 2009. For the twelve-month period ended June 2009, services inflation stood at 6.5 per cent, down from 8.4 per cent for the twelve-month period ended December 2008.

Based on the year-on-year methodology, goods inflation remained subdued declining from 6.4 per cent in December 2008 to 4.1 per cent in June 2009. Services inflation fell from 7.6 per cent in December 2008 to 1.6 per cent in June 2009, reflecting smaller increases in the price indices of *Restaurants and hotels* division and in the sub component 'mortgage interest on housing loan' in the division *Housing, water, electricity, gas and other fuels*. Table 2.3 and Charts 2.11 and 2.12 show movements in goods and services inflation.

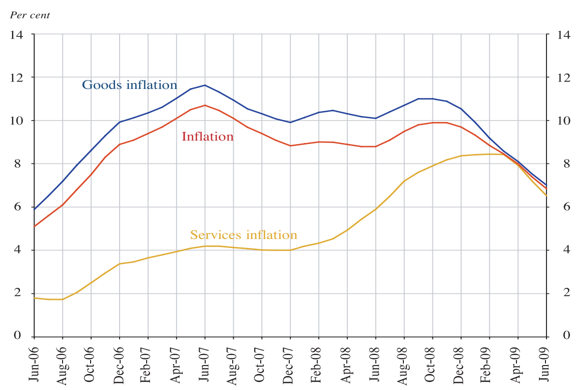
Table 2.3: Goods and Services Inflation

Per cent

	Goods	Services	Goods	Services
	12-month average		*Year-on-year*	
Dec-08	10.5	8.4	6.4	7.6
Jan-09	9.9	8.4	4.7	6.5
Feb-09	9.2	8.4	4.0	6.1
Mar-09	8.6	8.4	4.2	6.0
Apr-09	8.1	7.9	4.5	2.6
May-09	7.5	7.2	3.5	1.4
Jun-09	7.0	6.5	4.1	1.6

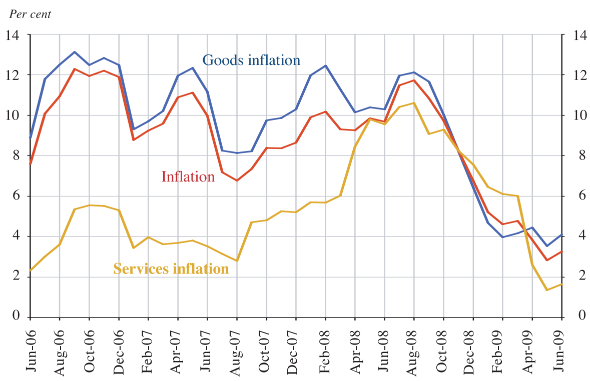
Source: CSO, Government of Mauritius, and Bank calculations.

Chart 2.11: Goods and Services Inflation - twelve-month average



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

Chart 2.12: Goods and Services Inflation - year-on-year



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

2.4 EVOLUTION OF OTHER PRICE/COST INDICES

Import Price Index

The Import Price Index (IPI), computed on a quarterly basis, measures the transaction prices of goods and services imported into Mauritius. The majority of prices used in calculating the IPI, quoted Free On Board (fob), thus exclude duties, insurance and other extra charges. It is an essential indicator for tracking changes in the prices paid for goods imported to Mauritius. The IPI fell by 7.4 per cent between the last quarter of 2008 and the first quarter of 2009 largely as a result of falling oil and food prices on international markets. In contrast, there was an increase of 0.9 per cent in the IPI between the first and the second quarter of 2009. The IPI dropped from 109.3 in the second quarter 2008 to 104.5 in the second quarter 2009 representing a decline of 4.3 per cent, as shown in Table 2.4.

Producer Price Index

The Producer Price Index-Manufacturing (PPI-M) and the Producer Price Index-Agriculture (PPI-A) are the two measures of producer prices computed by the CSO.[6] PPI-M inflation for the twelve-month period ended June 2009 stood at 9.2 per cent, down from 15.9 per cent in December 2008. The mitigated growth in the sub-components *Manufacture of food products, beverages and tobacco* index contributed to the moderate growth in PPI-M inflation. PPI-M, based on the year-on-year methodology, dropped markedly from 14.5 per cent in December 2008 to zero per cent in the second quarter of 2009.

PPI-A inflation picked up in the earlier months of 2009, but declined subsequently during the second quarter of 2009. PPI-A inflation reached 6.1 per cent in March 2009 before declining to 3.8 per cent in June 2009. On a year-on-year basis, PPI-A rose to 6.4 per cent in March 2009 before declining markedly to -1.7 per cent in June 2009.

The producer price inflation for manufacturing and agriculture based on twelve-month average and year-on-year methodologies are illustrated in Table 2.5 and Charts 2.13 and 2.14.

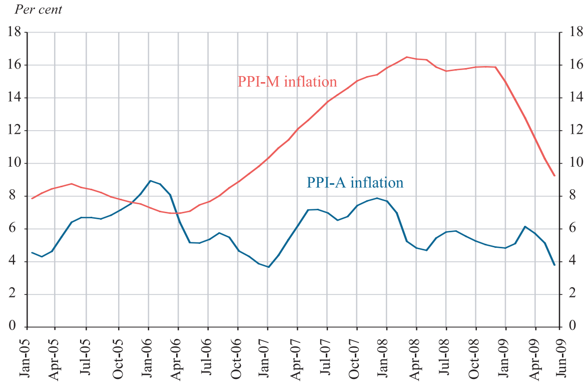
Table 2.5: Producer Price Inflation

Per cent

	PPI-A	PPI-M	PPI-A	PPI-M
	12-month average		*Year-on-year*	
Dec-08	4.9	15.9	4.5	14.5
Jan-09	4.8	15.0	4.2	7.6
Feb-09	5.1	13.9	6.2	5.1
Mar-09	6.1	12.8	6.4	4.5
Apr-09	5.7	11.6	-0.9	1.1
May-09	5.1	10.3	0.1	0.1
Jun-09	3.8	9.2	-1.7	0.0

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

Chart 2.13: Producer Price Inflation for Manufacturing and Agriculture - twelve-month average



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

Table 2.4: Import Price Index

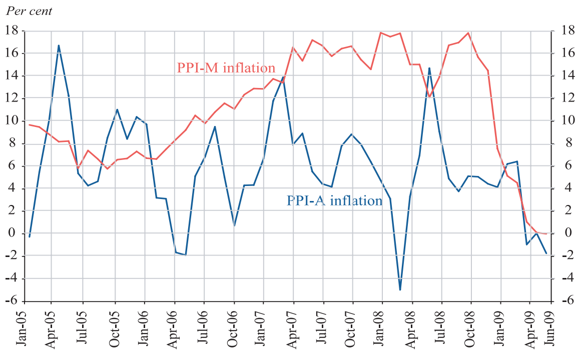
	2008				2009		Percentage change	
	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Quarter 1[1]	Quarter 1[2]	Between 2nd Quarter and 1st Quarter 2009	Between 2nd Quarter 2009 and 2nd Quarter 2008
Food and live animals	113.4	114.1	121.8	129.9	110.0	109.4	-0.5	-4.1
Beverages and tobacco	103.6	103.5	112.3	110.9	116.4	137.9	18.4	33.1
Crude materials, inedible, except fuels	91.3	115.7	132.5	147.4	153.6	135.6	-11.7	17.1
Mineral fuels, lubricants and related materials	110.7	144.7	166.8	100.4	78.5	82.1	4.5	-43.3
Animal and vegetable oils, fats and waxes	126.2	153.2	150.8	144.9	109.7	96.4	-12.2	-37.1
Chemical materials and related products, n.e.s.	93.8	93.8	103.6	110.9	112.5	113.7	1.1	21.1
Manufactured goods classified chiefly by material	89.7	93.0	105.4	108.8	102.7	106.0	3.2	13.9
Machinery and transport equipment	93.9	91.7	93.5	102.0	105.4	104.3	-1.1	13.7
Miscellaneous manufactured articles	94.2	102.5	104.0	113.2	118.2	119.5	1.1	16.6
Overall Index	**100.3**	**109.3**	**119.6**	**111.8**	**103.6**	**104.5**	**0.9**	**-4.3**

n.e.s.: not elsewhere speficied. [1] *Revised.* [2] *Provisional.*

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

[6] *The PPI-M measures changes in the effective prices received by producers for that part of their output sold on the domestic market. The PPI-A measures the average change in the selling prices which producers receive for their agricultural products. The indices are measured on a monthly basis and released quarterly.*

Chart 2.14: Producer Price Inflation for Manufacturing and Agriculture - year-on-year



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

Wage Rate Index

The measure of cost of labour, the Wage Rate Index (WRI), edged up by 0.6 per cent in the second quarter of 2009 relative to the first quarter of 2009. A comparison of changes in wage rate indices by economic activity between the first quarter and the second quarter of 2009 showed a significant rise of 4.8 per cent in *Wholesale and retail trade*, followed by 3.9 per cent in *Construction* while *Agriculture and fishing* and *Hotels and restaurant*s recorded increases of 3.3 per cent and 3.1 per cent, respectively. Table 2.6 shows the quarterly change in the wage rate index by industry group.

Table 2.6: Changes in the Wage Rate Index by Industry Group

	INDUSTRY GROUPS	First Quarter 2009	Second Quarter 2009	Weighted contribution between 1st Quarter of 2009 and 2nd Quarter of 2009 *(index points)*	Percentage change between 1st Quarter of 2009 and 2nd Quarter of 2009 *(Per cent)*
1	Agriculture and fishing	115.5	119.3	0.2	3.3
2	Manufacturing, mining and quarrying	121.5	122.5	0.2	0.8
3	Electricity and water	119.9	119.7	0.0	-0.2
4	Construction	117.6	122.2	0.2	3.9
5	Wholesale and retail trade; repair of motor vehicles, motorcycles, personal and household goods	128.5	134.7	0.4	4.8
6	Hotels and restaurants	123.3	127.1	0.2	3.1
7	Transport, storage and communications	125.9	126.4	0.0	0.4
8	Financial intermediation	117.7	117.2	0.0	-0.4
9	Real estate, renting and business activities	130.9	132.3	0.1	1.1
10	Public administration and defence; compulsory social security	137.2	136.9	-0.1	-0.2
11	Education	138.1	137.7	0.0	-0.3
12	Health and social work	136.6	128.8	-0.5	-5.7
13	Other community, social and personal services	128.2	131.8	0.1	2.8
ALL GROUPS		**128.0**	**128.8**	**0.8**	**0.6**

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

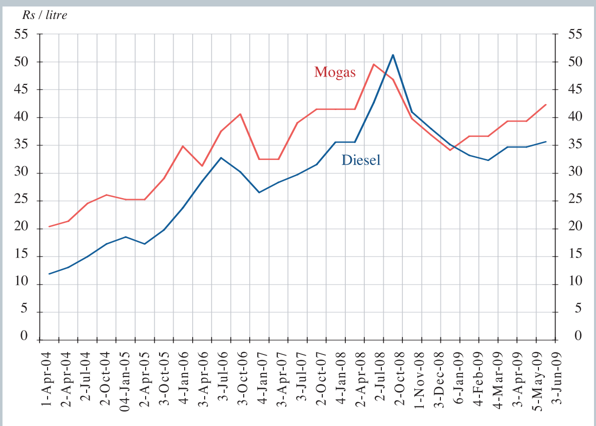
Box 1: Evolution of the Prices of Mogas and Diesel Oil under the Automatic Pricing Mechanism

The Automatic Pricing Mechanism (APM) was established in April 2004 for the determination of domestic prices of motor gasoline (mogas), gas oil (diesel oil) and fuel oil on a quarterly basis. Prior to January 2006, the APM Review Committee adjusted prices either way by a minimum/maximum allowable of 2.5 per cent to 15 per cent. The maximum allowable increase was then adjusted up in January 2006 to 20 per cent. Effective December 2008, the APM Review Committee meets every month to carry out price adjustment, if any, and the maximum allowable increase/decrease is 7.5 per cent. The determination of the prices of Mogas, diesel oil and fuel oil is based on the combined effect of the following factors: (i) changes in international oil prices, (ii) exchange rate movements, (iii) adjustments due to differences between the volume estimated and actually sold by the State Trading Corporation to local oil companies, (iv) windfall gain/loss on stock of petroleum products held by local oil companies and retail outlets on the effective date of change in prices and (v) any recovery of past loss.

Since the beginning of 2009, the price of mogas was adjusted down on one occasion, up on three occasions, while there were three downward adjustments and two upward adjustments in the price of diesel oil. The price of mogas and diesel oil remained unchanged on two occasions and one occasion, respectively. The price of mogas was reduced by 7.46 per cent in January 2009 but was subsequently increased by 7.48 per cent, 7.37 per cent and 7.50 per cent in February, April and June 2009, respectively. As at the end of June 2009, the retail price of mogas stood at Rs42.30/litre compared to Rs36.85/litre in December 2008.

In contrast, the price of diesel oil was brought down in the first three months of 2009 before being raised by 7.43 per cent in April 2009 and by a further 2.74 per cent in June 2009. At the close of the fiscal year 2008-09, the retail price of diesel oil was at Rs35.65/litre compared to Rs37.95/litre in December 2008. The chart below depicts movements in the prices of mogas and diesel.

Prices of Mogas and Diesel



3. Demand and Output

Effects of the global economic crisis

The continued deterioration of the international economy caused the domestic economy to slow down further during the first quarter of 2009. In the second quarter, GDP growth picked up to 2.3 per cent, up from 1.1 per cent in the first quarter, but lower than 4.7 per cent registered in the second quarter of 2008. Seasonally-adjusted quarterly GDP data showed that the growth rate in the second quarter of 2009 was 0.6 per cent, as opposed to a contraction of 0.8 per cent in the preceding quarter.

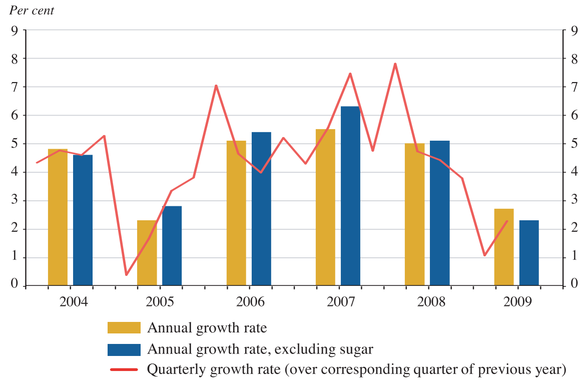
As anticipated, persistently falling demand in our main export markets intensified the strains in the external demand-led sectors, namely the textile and tourism sectors, thereby mitigating overall economic activity. The textile sector contracted for five consecutive quarters. The sharpest contraction of 5.0 per cent was recorded in the first quarter of 2009 and the textile sector continued to contract in the second quarter, though at a slightly slower pace of 4.0 per cent.

The tourism sector, which had until the third quarter of 2008 recorded positive albeit slowing growth rates, was seriously hit in the fourth quarter, contracting by 1.6 per cent. With demand from main markets weakening significantly, the contraction was even more alarming at 9.5 per cent in the first quarter of 2009, plunging the tourism sector as well into recession. The sector contracted at a lower pace of 6.2 per cent in the second quarter.

Growth in the *Financial intermediation* and *Real estate, renting and business activities* sectors remained positive in spite of the economic slump, but moderated in the first and second quarters of 2009, thereby contributing to the overall lower GDP growth in those quarters. The *Financial intermediation* sector grew by 6.1 per cent and 5.7 per cent in the first and second quarters of 2009, respectively. The *Real estate, renting and business activities* sector grew by 3.6 per cent in the first quarter of 2009 and picked up to 4.4 per cent in the second quarter. Chart 3.1 illustrates movements in the real growth rate.

With the deceleration in overall economic activity, preliminary estimates show that the output gap - measured as the difference between actual and potential output - has moved into negative territory. Thus, the disinflationary momentum triggered by price developments on international markets was further enhanced by domestic demand and supply conditions. The magnitude of the negative output gap is, however, projected to diminish as from the second half of 2009.

Chart 3.1: Real Economic Growth Rate



Source: CSO, Government of Mauritius.

Risks to growth prospects

Signs that the global economy was gradually stabilising had become increasingly visible towards the end of the second quarter of 2009. The pace of decline in economic activity in several major advanced economies had slowed and some of them such as France and Germany resumed with positive growth in the second quarter of 2009. Real output growth in major emerging economies had started to gather momentum. According to latest IMF projections, the global economy is expected to contract by 1.1 per cent in 2009 before growing by 3.1 per cent in 2010. Global recovery was still weak and vulnerable at this juncture. Although a double-dip recession can be ruled out, downside risks to growth still prevailed.

These favourable developments were expected to alleviate the downside risks to the domestic growth outlook and positively influence economic activity in coming quarters. In line with this renewed optimism, the 2009 growth forecast for the Mauritian economy has been recently upgraded from an earlier figure of 2.5 per cent to 2.7 per cent signalling a better economic performance in the second half of 2009 than previously estimated.

Fiscal and monetary stimulus

With a view to stimulating economic growth and mitigating the adverse effects of the global economic downturn on the domestic economy, an expansionary macroeconomic policy was pursued in the first semester of 2009. In March 2009, the key Repo Rate was cut by another 100 basis points bringing the cumulative rate reduction since October 2008 to 250 basis points.

The action plan of the 2009 Budget of the government, amounting to Rs14.2 billion and spanning over a period of eighteen months, reinforced measures announced in the Additional Stimulus Package in December 2008. The Budget focused on massive infrastructural projects and the preservation of jobs by shoring up the performance of enterprises.

To achieve the objectives of the Budget, an action plan had been set up focusing on saving jobs, boosting project realisation capacity, launching the largest investment programme in the history of Mauritius, protecting people and maintaining expansionary macroeconomic policies. Targeted measures for key economic sectors like Small and Medium Enterprises, tourism, construction and Integrated Resort Scheme (IRS), which have been the hardest hit by the crisis, were expected to help safeguard employment and prepare for recovery. While the positive effects of the additional spending under the fiscal stimulus plan and the easing of the monetary policy stance were yet to be fully felt, they had helped in upholding business as well as consumer confidence.

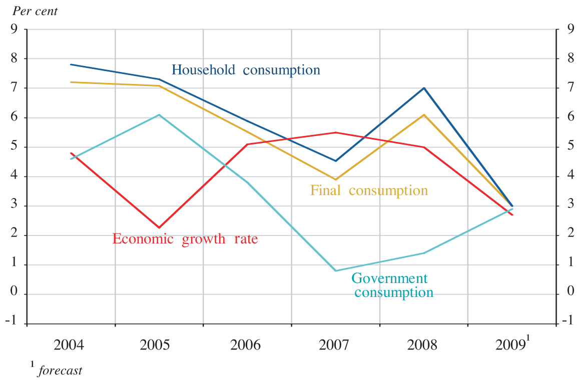
3.1 CONSUMPTION

Final consumption expenditure is estimated by the CSO to have grown, in real terms, by 2.4 per cent and 4.0 per cent in first and second quarters of 2009, respectively, lower than in the first two quarters of 2008. Government consumption expenditure rose by a mere 0.2 per cent in the first quarter of 2009 but surged to 7.8 per cent in the second quarter. Household consumption expenditure slowed down to 2.9 per cent in the first quarter of 2009, reflecting uncertainties about the economic outlook but recovered to 3.2 per cent in the second quarter.

Consumption growth ahead will depend on the evolution of prices and the economic outlook. For instance, if there is a rebound in commodity prices and/or unfavourable exchange rate developments, leading to a rise in inflation in subsequent quarters, consumption growth may remain subdued. The CSO has forecast a lower growth of 3.0 per cent for consumption expenditure for 2009 compared to 6.1 per cent in 2008. The key driver of this lower growth is the relatively large fall in the growth of household consumption to 3.0 per cent compared to an average of slightly above 6 .1 per cent in the last five years.

The evolution of final consumption expenditure and its components is depicted in Chart 3.2.

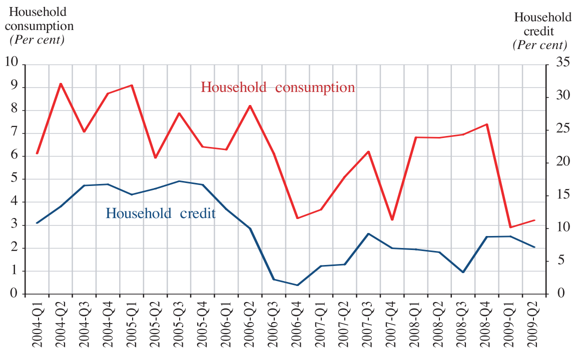
Chart 3.2: Real Economic and Consumption Growth Rates



Source: CSO, Government of Mauritius.

The flow of bank credit to households, in real terms, was sustained in the first semester of 2009, as depicted in Chart 3.3, and was relatively stronger than a year earlier. Real household consumption growth is estimated to have picked up in the second quarter of 2009 even though there was a drop in real household credit growth, reflecting renewed consumer confidence in the economic outlook.

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



Note: The CPI has been used to deflate nominal credit.

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

3.2 INVESTMENT

Investment growth declined from 3.8 per cent in the first quarter of 2009 to 2.6 per cent in the second quarter. While there were notable increases in *Machinery and equipment* of 12.5 per cent and 9.8 per cent in the first and second quarters respectively, overall investment was stifled by contractions of 0.6 per cent and 1.9 per cent in *Building and construction work*. The level of inventories also fell in the first two quarters of 2009.

The deceleration in investment growth was mostly attributed to the completion of private sector projects comprising mainly construction of commercial and office buildings, hotels as well as villas under the IRS and Real Estate Scheme. Delays in implementation of public sector projects announced in December 2008 in the Additional Stimulus Package had also contributed to pulling down investment in the first semester of 2009.

The outlook for investment for the second semester of 2009 is clouded by uncertainties for the private sector, given the slow recovery in advanced countries, which may be offset by the implementation of major infrastructural projects in the public sector.

Table 3.1 gives details on real growth rates of components of aggregate demand.

3.3 FOREIGN TRADE AND EXTERNAL DEMAND

The decline in global output and demand severely affected world trade. This drop has been felt in economies whose exports contain a large durable or capital goods component, which fortunately is not the case for Mauritius. Compared to the first semester of 2008, total nominal exports declined by 3.6 per cent in first semester of 2009. The prices of imports showed a downward correction in the first semester of 2009, which together with the effect of lower domestic demand for imports, brought about a reduction of 15.1 per cent in total nominal imports.

Consequently, the merchandise trade deficit improved and ultimately narrowed the current account deficit. However, the improvement in the merchandise trade deficit was somewhat negatively offset by significant decreases in surpluses on the services, income, and net

Table 3.1: Components of Aggregate Demand - Real Growth Rate

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

	2004	2005	2006	2007 [1]	2008 [1]	2007 [1]				2008 [1]				2009 [2]	
						Quarter 1	Quarter 2	Quarter 3	Quarter 4	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Quarter 1	Quarter 2
Final consumption expenditure	7.2	7.1	5.5	3.9	6.1	3.1	4.2	5.6	2.5	6.5	5.2	5.3	6.5	2.4	4.0
of which:															
Household consumption	7.8	7.3	5.9	4.5	7.0	3.7	5.1	6.2	3.2	6.8	6.8	6.9	7.4	2.9	3.2
Government consumption	4.6	6.1	3.8	0.8	1.4	0.6	0.8	2.9	-0.9	5.3	-1.8	-2.7	2.4	0.2	7.8
Investment	2.2	-1.9	19.0	8.6	3.9	24.3	9.7	11.3	1.5	12.3	15.0	6.2	-11.3	3.8	2.6
Investment *(exclusive of the acquisition of aircraft & marine vessel)*	4.8	-1.6	5.5	17.0	7.5	n.a.	n.a.	n.a.	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	3.4	2.3	-3.0	7.1	2.6	7.2	4.6	6.8	6.7	-6.7	-8.0	-12.7
Imports of goods and services	2.8	6.4	9.3	2.0	1.8	-0.8	1.2	8.2	-0.4	18.7	6.7	-5.7	-8.3	-17.1	-8.8

[1] : Revised estimates. [2] : First estimates.
n.a.: not available
Source: CSO, Government of Mauritius.

current transfers accounts. The services account was affected by a contraction in tourism receipts as a result of economic crisis in our major tourist markets.

As a percentage of GDP, the current account deficit in the first half of 2009 dropped to 8.0 per cent from 10.1 per cent in the first half of 2008. Looking ahead, even if weakness in import demand is likely to persist, the current account deficit might not necessarily narrow down at a fast pace given that, at the current juncture, global commodity prices have started moving up again. Provided that foreign financial flows remain sustained to finance the current account deficit, the pressure on the exchange rate would remain mitigated, thus helping to keep inflationary pressures in check.

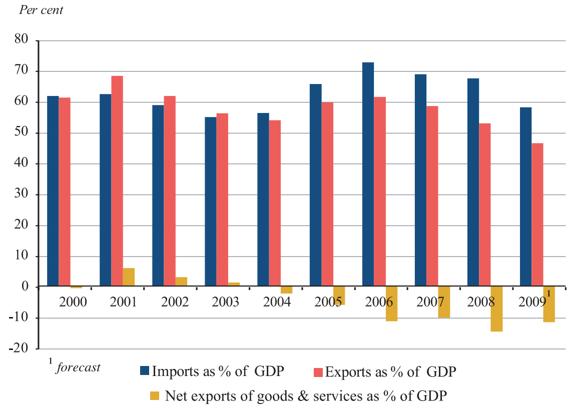
Current account balance

Provisional estimates for the first semester of 2009 indicated that the current account deficit narrowed substantially to Rs10,500 million, from Rs12,667 million in the corresponding period of 2008.

The contraction in the current account deficit was mostly due to a correction in the external imbalance, consequent to the global economic crisis. The merchandise trade deficit improved as nominal imports decreased at a faster pace than nominal exports. The merchandise account during the first semester of 2009 experienced a 27.1 per cent reduction in its deficit, from Rs29,141 million to Rs21,257 million.

The downturn in global economic conditions also had a bearing on the services account. The surplus on the services account witnessed a sharp decrease of 12.5 per cent from Rs10,002 million in the first semester of 2008 to Rs,8,748 million in the first semester of 2009, largely driven by significant decline in tourism receipts associated with lower revenue from passenger fares. Furthermore, the surplus on the income account decreased substantially from Rs4,555 million in the first semester of 2008 to Rs335 million in the first semester of 2009 on account of substantial amount of profits and dividends remitted abroad. The surplus on the current transfers account moderated to Rs1,674 million in the first semester of 2009, from Rs1,917 million in the corresponding semester of 2008. Chart 3.4 depicts the evolution of annual imports, exports and net exports of goods and services as a percentage of GDP.

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



Source: CSO, Government of Mauritius.

Capital and financial account

The capital and financial account, inclusive of reserve assets, recorded lower net inflows of Rs3,891 million in the first half of 2009 compared to Rs13,816 million in the first half of 2008. This followed from a significant decline in other investment net inflows due to a considerable decrease in non-residents' deposits.

Foreign Direct Investment (FDI) registered higher net inflows of Rs2,704 million in the first semester of 2009 compared to Rs2,605 million in first half of 2008. Despite the global slowdown, the Mauritian economy displayed some resilience and continued to attract direct investment inflows. Net inward FDI remained buoyant at Rs3,194 million during the first two quarters of 2009 and the bulk of capital was mainly channelled into *Hotels and restaurants* and *Real estate, renting and business activities* sectors with respective shares of 38.8 per cent and 37.5 per cent.

Among debt-creating flows, portfolio investment in the first half of 2009 recorded net outflows of Rs2,225 million, lower than the Rs2,431 million noted in the first half of 2008. While portfolio investment assets showed a decline of 43.5 per cent, portfolio liabilities increased from Rs1,060 million to Rs1,450 million. Non-resident transactions in domestic money market instruments and on the stock market reflected the falling domestic interest rates and bearish market conditions. Foreign investors purchased a meagre Rs29 million of securities in the first two quarters of 2009 compared to Rs272 million during the same period last year. Disinvestment in money market instruments in the first half of 2009 amounted to Rs259 million, lower than the Rs2,513 million registered in the first semester of 2008. Net sales of shares by foreign investors on the stock market amounted to Rs1,220 million in the first half of 2009, a shift from net purchases of Rs1,181 million recorded in the first half of 2008.

The first half of 2009 was marked by a drop in net inflows of the other investment account from Rs19,910 million to Rs7,516 million. Disbursements of general government external loans increased nearly two-fold from Rs2,308 million during the first half of 2008 to Rs5,524 million in the first half of 2009. The overall balance of payments, measured by the change in reserve assets excluding valuation changes, recorded a surplus of Rs4,099 million in the first semester of 2009 compared to a surplus of Rs6,239 million in the first semester of 2008. Details on the balance of payments for the first two quarters of 2008 and 2009 are shown in Table 3.2.

Table 3.2: Balance of Payments Summary

Rs million

	2008 [1]		2009 [2]	
	Quarter 1	*Quarter 2*	*Quarter 1*	*Quarter 2*
Current Account	**-5,379**	**-7,288**	**-1,743**	**-8,957**
Exports (f.o.b)	14,157	15,900	14,262	14,714
Imports (f.o.b)	-28,934	-30,264	-23,733	-26,500
of which: aircrafts/marine vessels	-	-	-	-
Trade balance	-14,777	-14,364	-9,471	-11,786
Services, net	6,306	3,696	5,174	3,607
of which:travel, net	*8,862*	*7,190*	*7,311*	*5,253*
Income, net	2,389	2,166	1,933	-1,598
Current transfers, net	703	1,214	621	820
Capital and Financial Account	**5,233**	**8,391**	**3,523**	**-1,533**
Capital account, net	-28	-1	-1	-4
Direct investment, net	1,134	1,471	1,015	1,689
Portfolio investment, net	-1,266	-1,165	-928	-1,297
Other investment, net	11,234	8,484	3,591	2,024
Balance of Payments Surplus (-)/ Deficit (+)	-5,841	-398	-154	-3,945
Net Errors and Omissions	**146**	**-1,103**	**-1,780**	**10,490**

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

Exports

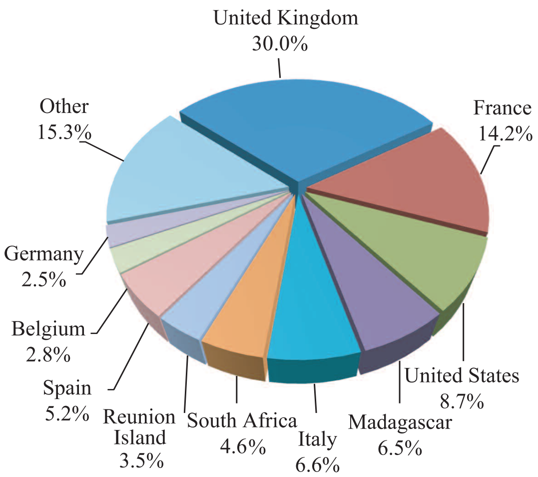
Compared to the first semester of 2008, total nominal exports decreased by 3.6 per cent to stand at Rs28,976 million in the first semester 2009. However, excluding ships, stores and bunkers, total exports registered a rise of 1.5 per cent to reach Rs26,556 million in the first semester of 2009. An increase in exports by export-oriented enterprises was noted for the first semester of 2009, driven mostly by increasing external demand for *Fish and fish preparations*. Overall, export proceeds in rupee terms also benefited from the depreciation of the domestic currency vis-à-vis major trading currencies.

Latest external trade data indicated that, in the first semester of 2009, Europe remained the main export market for Mauritius, accounting for 67.4 per cent of total exports despite a fall in its share from 68.8 per cent in the corresponding semester of the previous year. The United Kingdom continued to be Mauritius' most important market, with a share of 30.0 per cent. The other major destinations for our exports were France, United States, Italy, Madagascar and Spain, with shares of 14.2 per cent, 8.7 per cent, 6.6 per cent, 6.5 per cent and 5.2 per cent, respectively.

Compared to the first six months of 2008, total nominal exports to France, United Kingdom and Madagascar declined by 10.0 per cent, 1.8 per cent and 0.7 per cent, respectively. In contrast, exports to Spain, Italy and United States increased substantially by 60.5 per cent, 33.2 per cent and 24.1 per cent, respectively. Nominal exports to regional markets, namely South Africa, Reunion Island and Seychelles increased by 57.8 per cent, 26.7 per cent and 25.9 per cent, respectively.

The main export destinations in the first semester of 2009 are illustrated in Chart 3.5.

Chart 3.5: Main Export Destinations in the First Semester of 2009



Source: CSO, Government of Mauritius.

Imports

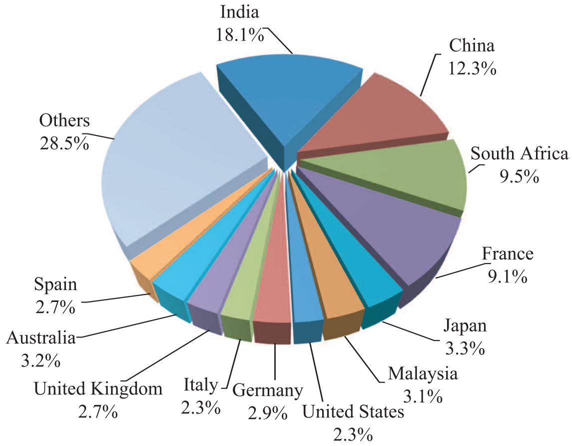
Total nominal imports (cif) amounted to Rs53,890 million in the first semester of 2009, down by 14.1 per cent from the corresponding period in 2008. This significant drop in aggregate imports has been the result of a combination of declines in both import volume and import prices.

While contraction in domestic consumer and business spending has flowed through into sharp declines in import volumes, considerable reductions in oil and non-oil commodity prices have brought down import prices. The NYMEX WTI price of crude oil averaged US$51.3 during the first semester of 2009, more than half the average of US$110.9 a barrel in the corresponding period in 2008.

As regards the commodity structure, the negative growth in nominal imports stemmed mainly from three main commodity groups, namely, *Mineral fuels, lubricants and related materials* at -44.3 per cent, *Manufactured goods classified chiefly by material* at -11.2 per cent, and *Food and live animals* at -8.5 per cent.

The Asian continent accounted for 48.6 per cent of total imports in the first semester of 2009, down from 54.7 per cent in the corresponding semester of the previous year. Imports originated mainly from India, China, South Africa, France and Japan, with shares of 18.1 per cent, 12.3 per cent, 9.5 per cent, 9.1 per cent and 3.3 per cent, respectively. The relatively high share of India in our import bill could be attributed to the fact that India is our main supplier of petroleum products. Chart 3.6 shows the main sources of imports in the first semester of 2009.

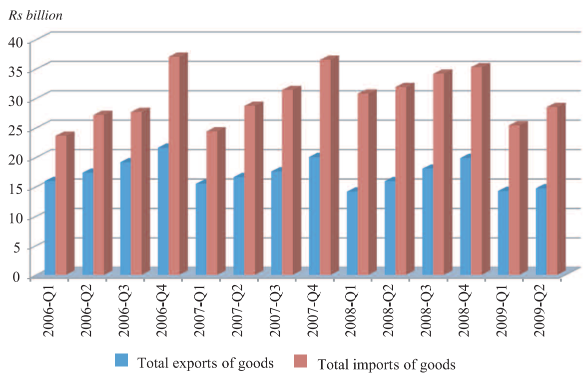
Chart 3.6: Main Sources of Imports in the First Semester of 2009



Source: CSO, Government of Mauritius.

Quarterly value of nominal exports and imports of goods are depicted in Chart 3.7.

Chart 3.7: Quarterly Value of Nominal Exports and Imports of Goods



Source: CSO, Government of Mauritius.

3.4 LABOUR MARKET

The declining trend in the unemployment rate since the first quarter of 2007 was reversed in early 2009. The rate of unemployment increased sharply from 6.2 per cent in the fourth quarter of 2008 to 8.0 per cent in the first quarter of 2009 and further to 8.3 per cent in the second quarter. The seasonally-adjusted unemployment rate also increased from 6.9 per cent in the second quarter of 2008 to 7.9 per cent in the second quarter of 2009. Table 3.3 shows movements in the unemployment rate.

Job losses were significant in the textile sector, which was adversely affected by weak external demand in the main export markets and the lifting of quota restrictions by the European Union and the United States on China's exports as from 2008. The excess supply over demand exerted downward pressure on prices as firms competed to retain market share and cost-cutting measures had inevitably led to the lay-off of workers.

Labour market outlook

Employment in the export-oriented enterprises sector declined by 6,582 in the year to June 2009, mainly as a result of a fall in employment by 5,271 in the wearing apparel sub-sector. In the tourist industry, employment as at end March 2009 was estimated at 26,922 compared to 28,764 as at end March 2008.

Labour market developments are likely to reflect trends in the broader economy with some lag, although the labour market is not expected to weaken much further. The economic downturn has been followed by fewer job losses than initially expected partly due to the fiscal stimulus package, which ties down job preservation with the financial and operational help the government gives to viable firms in difficulty. The anticipation that the economic slowdown would be short might have also induced businesses to retain labour although there were indications of working hours being reduced.

In the short-term, prospects for job creation to regain the momentum it had prior to the global crisis have diminished. The anticipated economic recovery to below trend growth could be accompanied by moderate job creation as it is likely that activity pick-up encourages employers to initially choose to increase working hours for incumbents and bring part-time workers back to full-time. Targeted active labour market programmes would be instrumental in promoting a quick reintegration of job losers into employment and prevent the risk of long-term unemployment.

Chart 3.8 shows the evolution of the quarter-on-quarter seasonally-adjusted GDP growth rate and the quarter-on-quarter growth rate of employment.

Chart 3.8: Quarter-on-quarter Seasonally-adjusted GDP and Employment Growth Rates

Source: CSO, Government of Mauritius.

Table 3.3: Unemployment Rate

	2006	2007	2008	2007				2008				2009	
				Quarter 1	Quarter 2	Quarter 3	Quarter 4	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Quarter 1	Quarter 2
Actual	9.1	8.5	7.2	9.6	8.8	38.2	7.2	8.2	7.4	7.2	6.2	8.0	8.3
Seasonally adjusted	9.1	8.5	7.2	9.0	8.2	8.5	8.1	7.6	6.9	7.5	7.0	7.4	7.8

Source: CSO, Government of Mauritius.

Box 2: The Impact of the Global Crisis on Trade

The global economic crisis had a direct dampening impact on global trade flows. All countries, and mostly emerging and developing countries, have already been heavily hurt by the crisis through falling exports, rising unemployment and, thus, falling income. Output and trade growth of developed economies were already slowing during the first three quarters of 2008, but the worsening of the global financial crisis in the fourth quarter of 2008 and the first quarter of 2009 accelerated this trend. The World Trade Organisation recently forecast that the collapse in global demand brought on by the economic crisis will drive exports down by roughly 9 per cent in volume terms in 2009. Other international organisations, such as the United Nations Conference on Trade and Development, also estimate world merchandise trade to fall between 6 and 8 per cent in 2009, while the IMF forecasts world trade volume to shrink by around 12 per cent in 2009.

Although the current crisis was initially a financial crisis and has been transmitted through the financial channel internationally, it has an impact on both the supply-side and demand-side of trade. On the supply-side, trade has collapsed due to the drying up of trade finance, collapse of vertical integration and the disruption in international capital markets. On the demand-side, the considerable fall in demand from advanced economies has had a significant impact on emerging market economy exports.

The decrease in merchandise trade has had a negative impact on all developing regions and most types of goods. Moreover, South–South trade, which has been the most dynamic component of world trade for over a decade, continues to decline, especially intra-Asian trade. The quick contraction of developing countries' manufacturing trade is largely due to today's highly globalised production and marketing schemes. Among the most affected sectors are automotive products, office and telecommunications equipment, and electronics, as well as textiles and clothing.

The global crisis has affected not only manufacturing trade, but also trade in services. Maritime transport is particularly affected, as are tourism and construction services. There is also a growing reduction in the employment levels of migrant workers from developing countries. This is expected to lead to a further fall in remittance inflows to developing countries, which began to slow down in 2008. Conversely, trade in ICT-enabled services appears to be less influenced by the economic downturn, as companies see the offshoring of services as one method of enhancing competitiveness.

Implications of the fall in world trade for the Mauritian economy

The sharp slowdown in demand for highly-traded manufactured items has weighed on Mauritian exports, which fell by 7.5 per cent in the second quarter of 2009 compared to the corresponding quarter of the previous year. The outlook for these exports will partly depend on the severity and persistence of the slowdown in the global demand for traded goods. The outlook for overall export growth for the Mauritian economy will also depend on exports of services.

4. Monetary and Financial Developments

4.1 MONETARY AND CREDIT DEVELOPMENTS

Monetary and credit developments reflected the slowdown in domestic economic activity during the first half of 2009. The moderate growth in money supply and credit was not viewed as jeopardising the attainment of price stability over the medium term. The banking sector remained robust and availability of credit was not a cause for concern.

Monetary base

The monetary base fell by 2.1 per cent in the first six months ended June 2009 as compared to a fall of 3.0 per cent in the previous corresponding period in 2008.[7] The rate of growth of reserve deposits held by other depository corporations (ODCs) at the Bank increased by 22.7 per cent, higher than the growth rate of 21.0 per cent registered in the corresponding period in 2008.

On the sources side of the monetary base, net foreign assets of the Bank grew by 13.0 per cent in the first semester of 2009 compared to 12.1 per cent in the first semester of 2008. Domestic claims by the Bank continued to contract as its net claims on budgetary central government declined significantly.

Broad Money Liabilities

The slowing growth of Broad Money Liabilities (BML) that began in the second semester of 2008 persisted in the first half of 2009.[8] BML growth fell to 3.4 per cent in the first semester ended June 2009, from 5.3 per cent in the first semester ended June 2008. Further moderation in money supply growth continued to be attributed to the slowdown in the expansion of claims on the private sector as well as in net claims on central government.

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

[8] *Broad Money Liabilities include deposits of banks and non-bank deposit-taking institutions.*

Chart 4.1 illustrates movements in the monetary base and BML. The evolution of BML and credit to private sector and the inflation rate is shown in Chart 4.2.

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

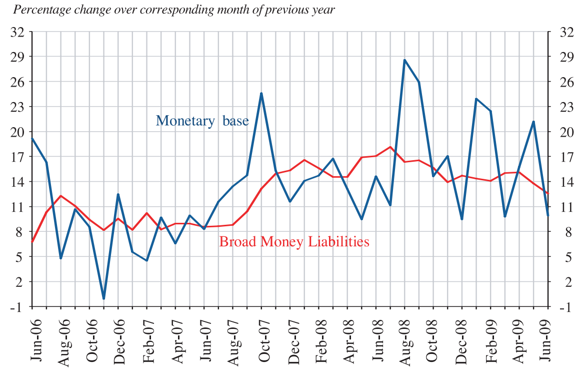
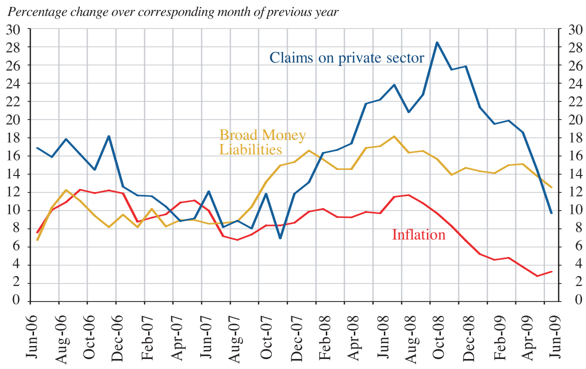


Chart 4.2: Growth Rate of Broad Money Liabilities and Credit to Private Sector and Inflation



Components of Broad Money Liabilities

Narrow Money Liabilities rose by 1.4 per cent for the six months ended June 2009 as opposed to a fall of 2.6 per cent for the six months ended June 2008.

The slowdown of BML growth over the six months to June 2009 was mainly on account of a moderation in the components of quasi-money liabilities. Quasi-money liabilities grew by 3.9 per cent in the first semester ended June 2009, lower than the 7.2 per cent recorded in the first semester ended June 2008. The moderation in the growth of quasi-money liabilities reflected the slowdown in the growth of savings and time rupee deposits, which could be partly attributable to the lower average interest rates on time deposits and savings. Savings and time deposits rose by 5.0 per cent and 3.0 per cent, respectively in the first semester of 2009 compared to 12.2 per cent and 4.8 per cent in the first semester ended June 2008. Foreign currency deposits went up by 4.0 per cent compared to 4.2 per cent in the corresponding period in 2008.

The last component of BML, Securities other than Shares, increased by 1.4 per cent in the first semester of 2009 as compared to 14.3 per cent in the first semester in 2008.[9] Table 4.1 provides details on growth rates of the components of BML and credit.

Sources of Broad Money Liabilities

Foreign assets

The net foreign assets of depository corporations increased by 8.5 per cent in the first semester ended June 2009 against a fall of 2.2 per cent in the first semester ended June 2008, mainly on account of a higher growth of net foreign assets held by the Bank and ODCs.

The net foreign assets of the Bank rose by 13.0 per cent for the first semester of 2009 as compared to an increase of 12.1 per cent in the semester ended June 2008. Valuation changes in addition to foreign exchange proceeds received on behalf of Government from Agence Française de Développement during the first six months of 2009 and significant foreign currency purchases from Government were among the factors contributing to the rise.

Net foreign assets held by ODCs rose by 1.1 per cent in the first six months ended June 2009 as opposed to a fall of 23.2 per cent in the same period in the previous year.

Domestic credit

Growth in domestic credit by depository corporations slowed from 15.1 per cent in the first semester of 2008 to 1.0 per cent in the first semester of 2009, reflecting mainly a slowdown in both net credit to central government and to the private sector.

Net credit to budgetary central government rose by 6.0 per cent in the first semester ended June 2009 compared to 16.8 per cent in the previous corresponding period in 2008. Credit to the private sector by ODCs contracted by 0.01 per cent in the first semester of 2009 against the significant rise of 14.7 per cent recorded in the first semester of 2008.

Overall, the contributors to the 3.4 per cent increase in BML for the first semester ended June 2009 were net foreign assets with 2.8 percentage

Table 4.1: Broad Money Liabilities, Domestic Credit and Net Foreign Assets

Rs million

	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09
Broad Money Liabilities	**215,408**	**223,103**	**239,318**	**241,748**	**252,007**	**259,834**	**274,314**	**278,029**	**283,613**
Narrow Money Liabilities	40,101	40,923	47,219	44,128	45,981	48,344	53,186	50,788	53,920
Currency with public	*11,597*	*12,081*	*14,260*	*12,735*	*12,746*	*13,451*	*16,156*	*14,800*	*14,683*
Transferable deposits	*28,503*	*28,843*	*32,959*	*31,393*	*33,234*	*34,893*	*37,030*	*35,987*	*39,237*
Quasi-Money Liabilities	173,467	180,321	190,753	196,128	204,487	210,000	219,592	225,802	228,137
Savings deposits	*62,480*	*62,706*	*65,461*	*69,218*	*73,444*	*73,615*	*75,850*	*79,777*	*79,604*
Time deposits	*71,663*	*75,876*	*79,346*	*83,124*	*83,164*	*87,685*	*89,409*	*90,139*	*92,051*
Foreign currency deposits	*39,325*	*41,740*	*45,945*	*43,786*	*47,878*	*48,700*	*54,334*	*55,886*	*56,482*
Securities other than shares	1,840	1,859	1,346	1,491	1,540	1,490	1,535	1,439	1,556
Domestic Credit	**210,443**	**212,479**	**224,683**	**236,527**	**258,704**	**258,438**	**272,426**	**274,420**	**275,223**
Credit to private sector	168,207	169,603	179,167	187,623	205,533	208,166	225,468	224,939	225,439
Net Foreign Assets	**83,162**	**85,373**	**85,520**	**81,479**	**83,628**	**80,050**	**89,520**	**88,509**	**97,146**

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

points and domestic credit with 1.0 percentage point - of which claims on other sectors contributed negative 0.01 percentage point and net claims on central government contributed positive contribution of 1.0 percentage point.

Sector-wise distribution of credit by banks

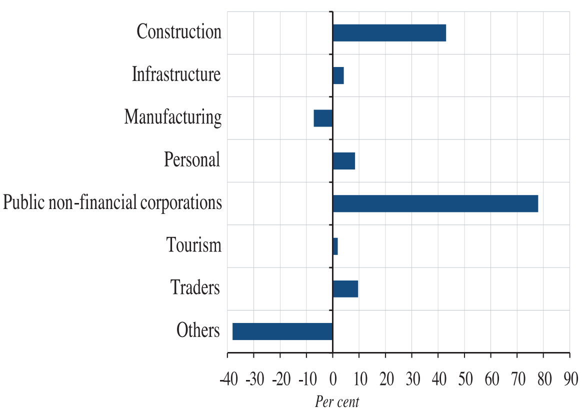
Total credit to private sector by banks rose by 2.1 per cent for the six months ended June 2009, down from 7.2 per cent recorded in the first six months of 2008. Construction and public non-financial sectors drove the increase in bank credit, representing respective shares of 43.0 per cent and 78.0 per cent to total credit expansion in the first semester ended June 2009.

Credit to the household sector expanded by 2.4 per cent in the six months ended June 2009 compared to 8.9 per cent recorded in the first six months of 2008. Total lending to households slowed down.

In terms of currency composition of credit, between the end of December 2008 and the end of June 2009, rupee loans and advances expanded by 1.2 per cent, while foreign currency loans and advances increased by 6.6 per cent as compared to 3.8 per cent and 29.8 per cent, respectively in the corresponding period in 2008.

The distribution of the increase in bank credit to the private sector over the period January 2009 to June 2009 is shown in Chart 4.3.

Chart 4.3: Distribution of the Increase in Banks' Credit to the Private Sector - January to June 2009



4.2 MONEY MARKET

Liquidity management

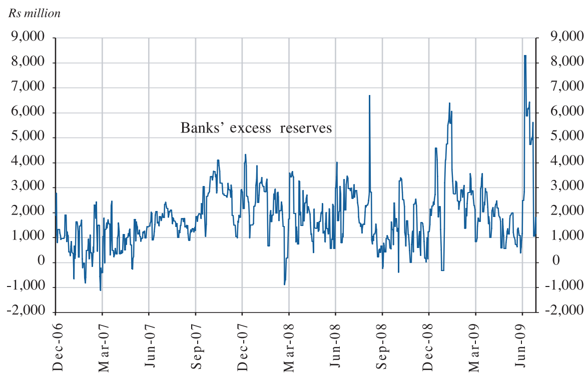
To avert any potential impact of the global financial crisis on the economy, the Bank stepped up its monitoring of the money market and the daily liquidity position of banks. Key developments affecting money market liquidity conditions in the first half of 2009 were the reduction of 0.5 percentage point in the minimum Cash Reserve Ratio to 4.5 per cent with effect from the maintenance period ended 1 January 2009.

Overall, banks' average excess reserves gradually fell over the period January to June 2009, as shown in Chart 4.4. Average excess reserves surged around mid-January following the combined effects of a drop in currency in circulation and net maturing securities. The Bank conducted a repurchase transaction for an amount of Rs2.5 billion for a 14-day period in January 2009 to maintain orderly conditions on the money market.

Thereafter, however, average excess reserves declined due to the cumulative effects of net issue of securities and tax receipts accruing to government. The Bank conducted two 7-day period reverse repurchase transactions, one in February and another in March, totalling Rs1.3 billion to alleviate liquidity conditions. Liquidity increased significantly as from the second week of June but declined towards the end of the month following the net issue of securities.

Broadly, liquidity in the money market remained at comfortable levels. Average excess reserves rose from Rs1.7 billion in the period June to December 2008 to Rs2.5 billion in the period January to June 2009.

Chart 4.4: Banks' Daily Excess Reserves

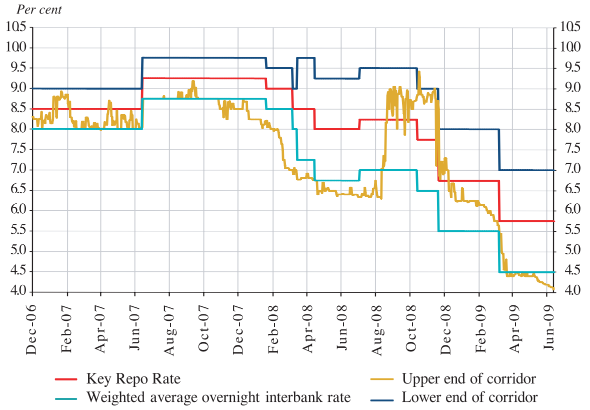


Interbank interest rates

The interest rates on the interbank money market were predominantly influenced by changes in the level of excess liquidity in the banking system and the reduction in the key Repo Rate. The weighted average interbank interest rate (WAI) was on a downtrend from January to June 2009, declining steeply until March and more gradually in the three months to end-June 2009.

Overnight interbank interest rates moved from a range of 6.00-7.25 per cent in the period January to February 2009 to 4.00-4.95 per cent between April and June 2009, more than fully reflecting the 100 basis points cut in the key Repo Rate in March 2009. The weighted average overnight interbank interest rate moved below the lower bound of the interest rate corridor, a situation last seen in August 2008, with the gap widening to 43 basis points at the end of June 2009. The evolution of the weighted average overnight interbank interest rate is depicted in Chart 4.5.

Chart 4.5: Overnight Weighted Average Interbank Interest Rate

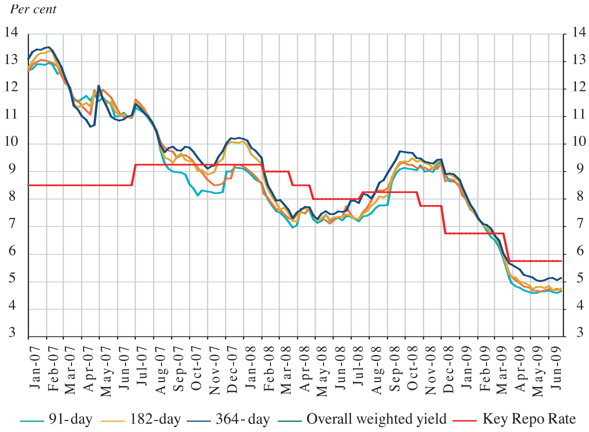


Yields on Government debt instruments

Yields on short-term Treasury Bills steadily drifted downwards throughout the period January to June 2009, as shown in Chart 4.6. In general, primary auctions of Treasury Bills remained oversubscribed with an average bid-cover ratio of 1.92.[10]

Reflecting the cut in the key Repo Rate in March 2009, the weighted yields on all three maturities of Treasury Bills continued to fall until May 2009 and thereafter started to stabilise. The unchanged key Repo Rate on 22 June was fully reflected in the weighted yields, which remained stable. From beginning of January to end-June 2009, yields fell from 8.52 per cent to 4.65 per cent on the 91-day Bills, from 8.45 per cent to 4.69 per cent on the 182-day Bills and from 8.71 per cent to 5.14 per cent on the 364-day Bills.

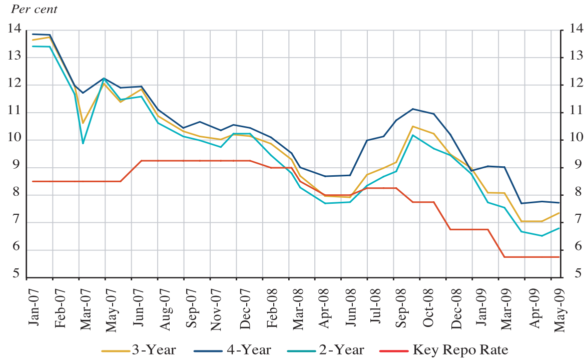
Chart 4.6: Movements in Yields on Treasury/Bank of Mauritius Bills



The market exhibited preference for 364-day maturities from January to March 2009, indicating investors' initial desire for longer term instruments. However, from March to June 2009, market sentiment shifted as investors switched increasingly to 91-day maturities.

The auctions for the other government instruments, namely Treasury Notes, Five-Year Government of Mauritius Bonds and Long Term Government of Mauritius Bonds were, on average, oversubscribed in the period January to June 2009. The trend in the weighted average yields of these instruments reflected the evolution of short-term market interest rates. Chart 4.7 shows movements in yields on Treasury Notes.

Chart 4.7: Evolution of Yields on Treasury Notes



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

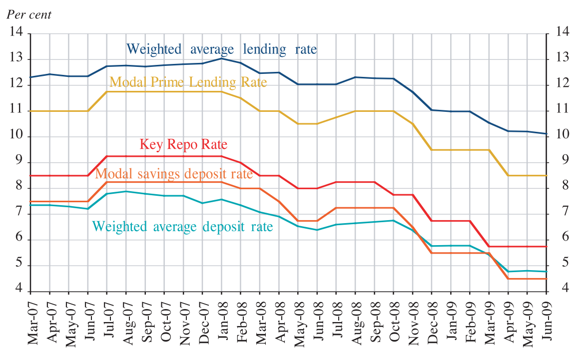
Non-residents' holdings of government and central bank securities fell from Rs0.3 billion at the end of December 2008 to Rs0.06 billion at the end of June 2009. Resident holders of government and central bank securities comprised principally banks and pensions funds.

4.3 INTEREST RATES

Following the reduction of 100 basis points in the key Repo Rate on 26 March 2009, banks adjusted downwards their lending and deposit interest rates by similar magnitudes within a relatively short time lag, as depicted in Chart 4.8. From 5.50 per cent at the end of January 2009, the modal savings deposit rate declined to 4.50 per cent by the end of April 2009 and remained unchanged thereafter. The interest rate on savings deposits moved from a range of 5.00-5.75 per cent at the end of January 2009 to a range of 4.00-4.75 per cent at the end of June 2009.

The modal Prime Lending Rate (PLR) moved from 9.50 per cent at the end of January 2009 to 8.50 per cent at the end of April 2009 and was unchanged until the end of June 2009. Banks' PLR moved from a range of 9.05-10.00 per cent at the end of January 2009 to a range of 8.05-9.00 per cent at the end of June 2009. Chart 4.8 depicts movements in deposit and lending rates as well as the key Repo Rate.

Chart 4.8: Key Repo Rate and Deposit and Lending Rates



The real rate of interest on savings deposits improved gradually from -3.5 per cent at the end of January 2009 to -2.2 per cent at the end of June 2009, reflecting the effect of the decline in inflation which offset the drop in the key Repo Rate.

4.4 FOREIGN EXCHANGE MARKET AND EXCHANGE RATES

Major international currencies

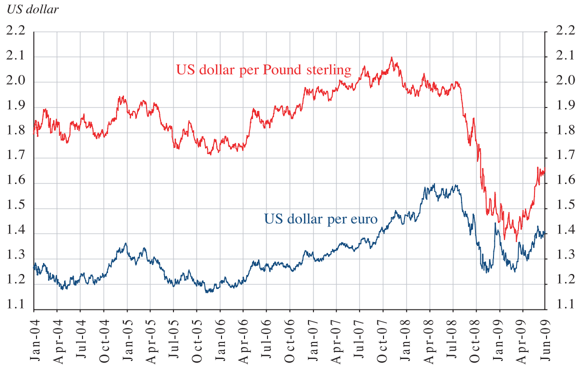
The US dollar strengthened in the first two months of 2009 on increased risk aversion. Weak economic data releases undermined investors' confidence as they moved their assets and currency holdings into US dollar denominated assets. The market focused on the stimulus package of the new US administration and rescue plans for the US financial industry.

The US dollar reached a high of 1.2487 against the euro on 4 March 2009. This trend was reversed thereafter and the US dollar lost momentum amid signs of stabilisation of the global financial crisis and scattered evidence that the economic slowdown was bottoming out. With investors' confidence back, there was a reversal of capital flows from US dollar and US dollar denominated assets to riskier assets namely, stocks and higher-yielding currencies such as euro, Pound sterling and the Australian dollar. As a result, the US dollar depreciated in the second quarter of 2009. Overall, for the six months to June 2009, the US currency depreciated against the euro and the Pound sterling but appreciated vis-à-vis the Japanese yen on a point-to-point basis.

The depreciation of the euro from January 2009 to early March 2009 was mainly due to the ECB slashing its key refinancing rate and investors favouring US assets. Thereafter, the euro recovered against the weak US dollar on the revival of investors' risk appetite and on better-than-expected data releases in the euro zone. Amid hopes of a global recovery, the euro rebounded against major currencies in the second quarter of 2009.

The Pound sterling hovered in the range of US$1.3676 and US$1.5182 in the first quarter of 2009 as the severe recession and aggressive loosening of monetary policy pressurised the currency. However, general bullish sentiment for the Pound supported by increasing signs of the UK economy stabilising and investors' perception of the Pound being undervalued led to an appreciation of the currency during the second quarter of 2009. Chart 4.9 shows the 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



Domestic currency

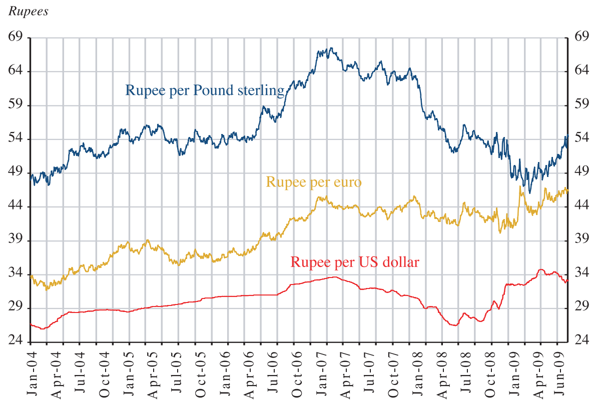
On the domestic market, the rupee depreciated, on a point-to-point basis, between 1 January 2009 and 30 June 2009, against the US dollar, the Pound sterling and the euro by 1.8 per cent, 14.4 per cent and 1.4 per cent, respectively.

The rupee hovered within the range of Rs32.48-Rs34.80 against the US dollar in the six-month period ended June 2009. In the first quarter, the rupee lost some ground vis-à-vis the US dollar as the latter appreciated on international markets, reaching a trough of Rs34.80 on 4 March. Thereafter, the rupee recovered on the back of improving domestic market sentiment and broad-based weakness of the US dollar on global markets, attaining a peak of Rs32.80 on 3 June 2009.

The rupee was volatile against the Pound sterling and the euro, following more or less the same pattern in both cases. However, the depreciation of the rupee was more pronounced against the Pound sterling as from February 2009 on the back of the deteriorating outlook for the euro zone economies while the United Kingdom seemed more resilient supported by proactive decisions to rekindle growth.

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

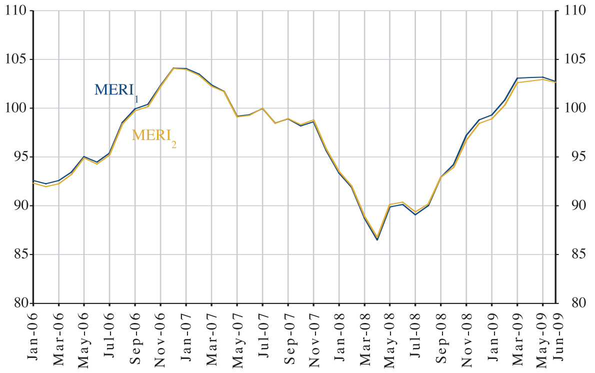
There was no evidence of demand or supply pressure on the domestic foreign exchange market in the first half of 2009. Banks maintained comparatively higher overbought foreign exchange position of US$77.9 million compared to US$39.3 million in the period July to December 2008. The Bank did not intervene to buy or sell foreign exchange from the foreign exchange market.

The volume of transactions on the interbank foreign exchange market fell to a monthly average of US$11.4 million in the first semester of 2009, lower than the monthly average of US$15.0 million in the period July to December 2008.

Effective exchange rates

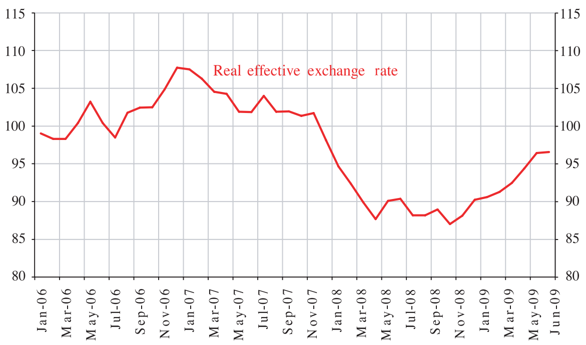
The nominal effective exchange rates, as measured by $MERI_1$ and $MERI_2$, sustained their depreciating trend in the first three months of 2009 but remained rather stable afterwards. The $MERI_1$, which uses the currency distribution of trade as weights, showed a depreciation of 3.4 per cent over the period January to June 2009. The $MERI_2$, which combined currency distribution of trade with that of tourism receipts as weights, depreciated by 3.6 per cent over the same period. Chart 4.11 illustrates the evolution of $MERI_1$ and $MERI_2$.

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



The real effective exchange rate with weights based on trade distribution with countries that make up at least 80.0 per cent of total trade and adjusted for price differentials between the domestic economy and its trading partners, showed a depreciation of 6.5 per cent. Chart 4.12 illustrates the evolution of the real effective exchange rate.

Chart 4.12: Movements in Real Effective Exchange Rate



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5. The Outlook for Inflation

There are encouraging signs that the global economy is moving out of recession, as suggested by the latest batch of economic reports and the IMF October 2009 WEO. The pace of economic contraction has slowed in some of the major advanced economies while in other economies, the recovery seemed to have already started. At this juncture, however, the recovery is still fragile and the global economy remains vulnerable to continuing strains in the financial system, weak labour market conditions, gradually rising commodity prices and massive liquidity resulting from the unprecedented fiscal and monetary stimulus. The latest IMF projections indicate that the rate of decline of world output would be lower in 2009 than envisaged in the July 2009 WEO Update and for 2010 the global economy would record a higher positive growth rate at 3.1 per cent, up by 0.6 percentage point from the July 2009 figure of 2.5 per cent.

With the recovery expected to be sluggish due to the significant economic slack and weak demand pressures over the next few quarters, the short-to-medium term inflation outlook should remain benign, dissipating any short-term threat of a resurgence of inflationary pressures at the global level. In October 2009, the IMF projected inflation in advanced economies at 0.1 per cent in 2009 and 1.1 per cent in 2010, while inflation for emerging and developing economies is projected at 5.5 per cent and 4.9 per cent in 2009 and 2010, respectively.

Oil prices are likely to rebound in the medium term, although a rapid recovery to the record price levels seen in the first half of 2008 is unlikely, given prospects of more moderate growth in emerging and developing economies in the next global expansion. According to the US Energy Information Administration Short Term Energy Outlook released on 6 October 2009, the price of NYMEX WTI crude oil is expected to average about US$70 per barrel until the first quarter of 2010. Average oil prices are projected to rise gradually to around US$75 per barrel by December 2010, as world economic conditions improve.

Looking further ahead, however, the global inflation outlook is clouded by uncertainties regarding the evolution of commodity prices, particularly oil, on international markets as well as the second-round effects of the massive fiscal and monetary stimulus implemented across countries. Reflecting improved market expectations, commodity prices - especially oil - have surged from a trough ahead of sustained economic recovery.

5.1 RISKS TO THE INFLATION OUTLOOK

There are both downside as well as upside risks to the domestic inflation outlook. On the downside, they relate to the outlook for economic activity particularly, while on the upside, they pertain to commodity price pressures stemming from external sources and exchange rate movements.

After declining steadily from the second quarter of 2008 onwards, preliminary estimates of quarterly economic growth suggest that growth will gradually recover but will remain weak. Demand pressures are foreseen to stay subdued, the more so as the pick-up in overall economic activity is expected to be held back by the slow recovery in external-demand led sectors namely the tourism and textile sectors. The full effects of the fiscal and monetary stimulus are yet to be felt and, at this juncture, the expansionary economic policies are not expected to generate undue domestic demand pressures. As a result, the output gap is estimated to remain in negative territory up to around the second half of 2010 although the magnitude is forecast to diminish as from the second half of 2009. Thus, risks to the inflation outlook emanating from domestic economic conditions should remain moderate over the forthcoming quarters.

Monetary developments have been characterised by a general deceleration in the growth of money and credit, indicative of the slowdown in economic activity. Overall, the rate of monetary expansion is not foreseen to threaten the attainment of low inflation over the short to medium term.

The US dollar depreciated over the past few months and could remain undermined in the longer run. However, while financial markets gained relative stability, global currency markets are still quite volatile. Consequently, volatility on international currency markets coupled with lower capital inflows and a large current account deficit might exert pressure on the exchange rate of the rupee in the medium to long term. Already in real effective terms, the rupee depreciated in the first half of 2009. Any unfavourable exchange rate development remains a source of upward price pressures over the medium term.

The disinflationary momentum triggered by commodity price developments on international markets has stabilised. The risks to the inflation outlook are broadly balanced over the next few quarters. However, looking further ahead and on balance, upside risks could outweigh downside risks. The countervailing pressures could arise from increases in commodity prices and freight rates in the medium term.

In comparison to the previous inflation forecast, there is a slight increase which is symmetrically distributed around the baseline projection. This upward revision stems from the degree of uncertainty regarding future commodity price developments, which has already risen since the last projections were made.

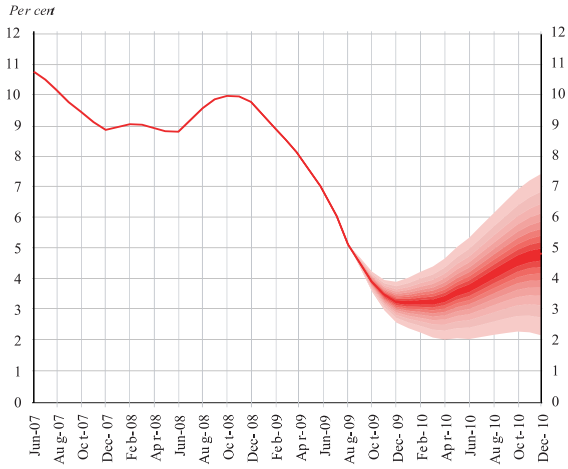
Inflation fan chart

The risks to the inflation outlook up till December 2010 are graphically represented in the inflation fan chart, as shown in Chart 5.1. The fan chart depicts the probability of different inflation outcomes based on the central projection illustrated by the darkest band in the chart. The uncertainty around the central projection of inflation is shown as additional bands above and below the central projection.

The fan chart continues to show a deceleration in inflation up till the end of 2009 and a pick-up thereafter. This may be attributed to the combined impact of the base effects and the impact of lower-than-expected inflation outturn.

In a context of high uncertainty about the evolution of the global economy, weighing the above-mentioned risks against the baseline scenario shows a neutral balance for the inflation forecast. This implies a projection of symmetric density for inflation throughout the forecast horizon, which means that there is the same probability inflation will fall below or rise above the level considered in the baseline scenario.

Chart 5.1: Inflation Fan Chart



Box 3: Inflation Expectations

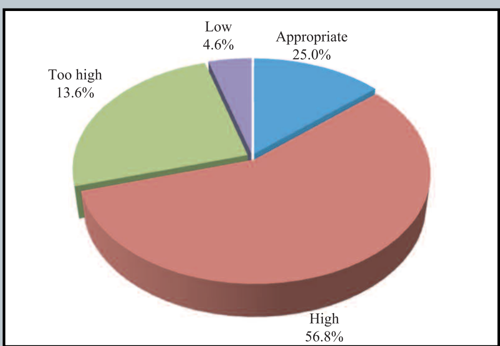
The third Inflation Expectations Survey was carried out in June 2009. Out of the 50 stakeholders chosen from the financial and real sectors of the economy, 44 responded to the survey. The survey findings are based on these 44 responses.

Findings of the Inflation Expectations Survey

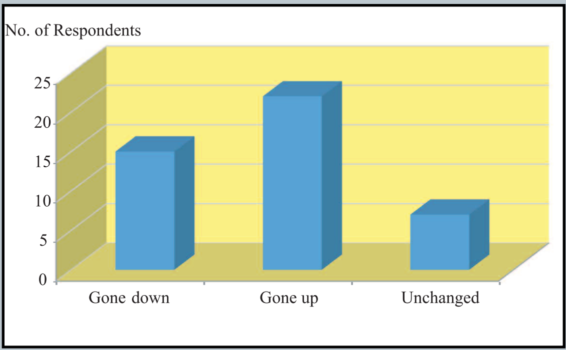
1. With respect to how respondents perceived the 7.4 per cent inflation rate for the twelve months ended May 2009, 56.8 per cent of respondents considered this rate to be high while 13.6 per cent judged it to be too high. 25 per cent of respondents deemed this rate as being appropriate and 4.6 per cent viewed this rate as being low.
2. With regard to their best description of the movement of prices over the preceding twelve months, 50 per cent of respondents indicated that prices of goods and services had gone up while 34.1 per cent were of the opinion that they had gone down. 15.9 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 68.2 per cent of respondents as the primary source of inflation in Mauritius. Wage policy and monetary policy were regarded by 36.4 per cent of respondents as the second and third most important factors, respectively.
4. In relation to the movement of prices over the following twelve months, 47.8 per cent of respondents expected prices to go up, while 38.6 per cent of respondents anticipated a decrease in prices. 13.6 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 the twelve months ending December 2009, June 2010 and December 2010. 56.8 per cent of respondents expect inflation in December 2009 to be less than 7.4 per cent while 50 per cent of respondents are of the opinion that inflation will be less than 7.4 per cent in June 2010. 43.2 per cent of respondents anticipate an inflation rate of less than 7.4 per cent in December 2010.
6. The mean inflation rates expected by respondents were 6.9 per cent, 7.2 per cent and 7.5 per cent, respectively, for the twelve months ending December 2009, June 2010 and December 2010. Respondents thus expect a drop in inflation rate in the short-term but anticipate a pick-up in the medium-term.

Graphical Representation of Responses

QI.1. Inflation for the twelve-month period ended May 2009 was 7.4 per cent. Do you perceive this rate to be ...



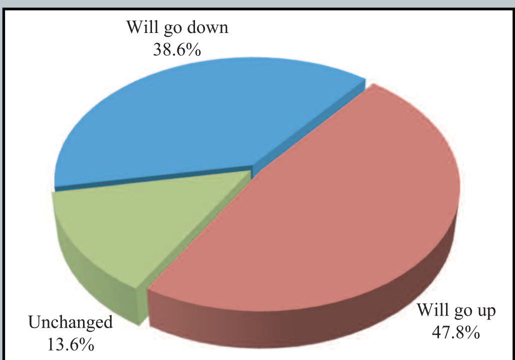
QI.2. Which of the following best describes the movement of prices over the past 12 months?



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

	(Ranking in order of importance starting with 1 for most important.)		
Factors	**1**	**2**	**3**
Fiscal policy	3	4	12
Monetary policy	5	7	16
External factors	30	7	2
Wage policy	3	16	5
Fall in aggregate demand	2	7	6
Other	1	3	3

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



QI.5 What is your expectation of inflation in (a) December 2009; (b) June 2010; and (c) December 2010?