BANK OF MAURITIUS

Inflation Report

October 2010 | Issue No. 5

BANK OF MAURITIUS

INFLATION REPORT

October 2010

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. The Inflation Report is released to the public in April and October. 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 2010 unless otherwise stated.

Acknowledgement

The preparation of this Report was coordinated 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 for the chapter on *Overview*; Mr F. Sooklall, Mr C. Ellapah, Mr N. Daworaz, Mr I. Ramlall, Mr G. Beegoo and Mr W. Khodabocus for the chapter on *The External Environment*; Mr G. Beegoo and Mr M. H. Gendoo for the chapter on *Recent Developments in Inflation*; Mr W. Khodabocus, Ms M. Mudhoo, Ms M. Jhamna, Dr. D. Mulliah-Hurchand, Mr S. Jugoo and Mr M. Mohesh for the chapter on *Demand and Output*; Mrs P. Lo Tiap Kwong, Mr M. H. Gendoo, Mr J. C. Chamary, Mrs H. Nundoochand, Mr J. Pandoo, Mr C. Ellapah, Mr N. Daworaz, Mr I. Ramlall, and Mr M. Mohesh for the chapter on *Monetary and Financial Developments*; Mr J.N. Bissessur, Mr W. Khodabocus and Mr G. Beegoo for the chapter on *The Outlook for Inflation*.

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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, which may be sent to mp.unit@bom.intnet.mu.

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List of Acronyms

APM	Automatic Pricing Mechanism
BDI	Baltic Dry Index
BML	Broad Money Liabilities
BRIC	Brazil, Russia, India and China
CDS	Credit Default Swap
CIF	Cost, Insurance and Freight
CPI	Consumer Price index
CSO	Central Statistics Office
ECB	European Central Bank
ERCP	Economic Restructuring and Competitiveness Programme
EU	European Union
FAO	Food and Agriculture Organisation
FDI	Foreign Direct Investment
FOB	Free on Board
FFPI	FAO Food Price Index
GDFCF	Gross Domestic Fixed Capital Formation
GDP	Gross Domestic Product
IMF	International Monetary Fund
ICE	Intercontinental Exchange
IPI	Import Price Index
MERI	Mauritius Exchange Rate Index
MPC	Monetary Policy Committee
NYMEX WTI	New York Mercantile Exchange West Texas Intermediate
ODC	Other Depository Corporations
PMI	Purchasing Managers' Index
PPI-A	Producer Price Index-Agriculture
PPI-M	Producer Price Index-Manufacturing
REER	Real Effective Exchange Rate
SEMDEX	Stock Exchange of Mauritius Index
WEO	(IMF's) World Economic Outlook
WRI	Wage Rate Index

1. Overview

1.1 INTERNATIONAL DEVELOPMENTS

The global economy continued to improve in the first half of 2010 driven mainly by robust economic expansion in emerging economies. Activity in the global manufacturing and services sectors expanded further and world trade as well as financial flows rebounded strongly. The effects of the unprecedented expansionary economic policies, though diminishing, continued to be felt generally. As their domestic economic conditions strengthened, some countries began withdrawing the stimulus with a view to fostering macroeconomic stability. In July 2010, the International Monetary Fund (IMF) revised upward its global growth forecast for 2010 from 4.2 per cent to 4.6 per cent on better-than-expected growth in the first half of 2010 but leading indicators showing a deceleration in global manufacturing and services sectors in May and June 2010 suggested that economic activity could moderate after the first semester.

While the US economy appeared to be losing momentum, growth in both euro area and the United Kingdom surprised on the upside, particularly in the second quarter of 2010. In the United States, private demand was being held back by high unemployment, slow recovery of consumer and business confidence and tight credit standards. The euro area posted its fastest growth rate in the last four years but aggregated data masked the widening disparity among euro zone member countries, while Britain's economy grew at its fastest pace in nine years. Several emerging economies, including the BRIC economies, witnessed robust exports and private domestic demand in the six months to June 2010.

Inflation remained subdued globally in the first half of 2010 despite the turnaround towards late 2009. In the second quarter of 2010, expectations of a gradual rather than brisk recovery in global demand contributed to cap the trend increase in international commodity prices and helped curb domestic cost pressures. Most major advanced economies continued to witness low inflation prompting fears of deflation risks. In the United Kingdom, however, inflation remained persistently above 3.0 per cent. Faster-growing economies in South East Asia, Latin America, and Oceania were more concerned with inflation and began removing monetary stimulus by hiking their policy interest rates. Overall, monetary policy was anticipated to remain generally accommodative for some more time.

Beginning May 2010, markets became concerned over the elevated fiscal deficits and the sizeable sovereign debt after it emerged that Greece, a member of euro area, had a larger fiscal deficit than initially believed. Debt and fiscal deficit issues in the peripheral countries of the euro zone and the United Kingdom came under investors' close scrutiny. The Credit Default Swap (CDS) spreads relative to Bunds yield widened significantly on market fears and the recovery in financial markets suffered a setback. Stock markets retreated to some extent. As fiscal and monetary authorities responded quickly with measures to alleviate market tensions, the volatility in currency as well as equity markets tapered off gradually. The sovereign debt crisis led several countries mainly in Europe to consider withdrawing the fiscal stimulus sooner than initially planned and implementing austerity measures. Going forward, fiscal consolidation in these economies was foreseen to mitigate growth prospects.

1.2 DOMESTIC DEVELOPMENTS

Real activity in the Mauritian economy moderated in the first half of 2010 after having grown at a brisk pace in the second half of 2009. Exports of goods and services proved to be more resilient than expected and recovered from the contraction of a year ago but imports of goods and services, which are a leakage to Gross Domestic Product (GDP), also expanded. Overall, net exports made a higher positive real contribution to economic growth relative to a year earlier. Underlying the stronger performance of the export sector was the robust recovery in the tourism sector and to a lesser extent in the textiles sector. With regard to real domestic demand, final consumption expenditure and Gross Domestic Fixed Capital Formation (GDFCF) grew at a modest year-on-year rate of 1.7 per cent and 1.3 per cent, respectively, in the first semester of 2010.

Short-term growth dynamics, reflected in the behaviour of seasonally-adjusted quarter-on-quarter growth rate, showed that the economy had contracted by 3.7 per cent in the first quarter of 2010 compared to the fourth quarter of 2009 but recovered mildly in the second quarter of 2010 with a positive growth rate of 0.3 per cent. Most of the key sectors driving growth, which had witnessed a sharp contraction in real output in the first quarter of 2010, rebounded in the second quarter except for *Manufacturing* and *Transport, storage and communications,* where the rate of decline in real output was higher than in the first quarter. Largely on account of the economy's performance in the first semester of 2010, the initial growth forecast of 4.6 per cent for 2010 was scaled down to 4.1 per cent. Looking ahead, business confidence appeared to be deteriorating in many key sectors of the economy but the additional monetary stimulus in the September 2010 Monetary Policy Committee (MPC) meeting and the newly established Economic Restructuring and Competitiveness Programme (ERCP) should continue to support growth.

Inflation remained low by historical standards and moved within a narrow range of 1.7 per cent and 2.7 per cent in the first half of 2010, in line with the Bank's projections. Looking ahead, inflation is forecast to gradually rise to 4.0 per cent in the short-to-medium term but uncertainty about international commodity prices and higher inflation in key import markets would change the outlook.

1.3 MONETARY POLICY

The MPC maintained the key Repo Rate on hold at 5.75 per cent at its 23 March and 22 June 2010 meetings. The decision reflected the MPC's assessment of the balance of risks to growth and inflation. Whereas there were higher downside risks to the domestic growth outlook, upside risks to inflation were materially more significant. However, at the September 2010 meeting, the MPC considered the effects of faltering external demand and judged that downside risks to domestic growth prospects had increased and unanimously agreed to reduce the policy rate by 100 basis points to 4.75 per cent.

The slow pace of bank credit expansion well below nominal GDP growth rate in conjunction with net maturing Bills translated into an accumulation of excess liquidity in the banking system, effectively as from late February 2010. As a result, money market yields were depressed and fell to extremely low levels. In view of these developments, the Bank conducted a series of monetary operations using several instruments. In particular, the Bank issued Bills and Notes, conducted Special Deposits Facility as well as reverse repurchase transactions. The Bank also increased the minimum Cash Reserve Ratio by 0.5 percentage point to 5.0 per cent in June 2010.

Monetary policy decisions

When the MPC convened on 23 March 2010, there was further evidence of stronger global economic recovery. However, the pace of expansion differed across countries and regions and recovery still relied on the massive monetary and fiscal stimulus. Several major emerging economies were rebounding robustly. The pick-up in economic activity was faster in the United States than in Europe. Financial markets had been mending despite occasional jitters. Inflation had bottomed out globally and remained subdued.

Fourth quarter 2009 data suggested that the domestic economy had continued to improve and despite weak external demand, export-oriented sectors had been holding up better than expected. The MPC anticipated soft external demand to persist and real economic activity to stay below potential over the coming quarters. Inflation was still low by historical standards. The MPC judged that, on balance, inflation would remain benign in the short term with, however, potential upside risks to the inflation outlook stemming mostly from external sources over the medium to long term. The MPC unanimously agreed to continue supporting the economy with an accommodative monetary policy stance and decided to leave the key Repo Rate unchanged at 5.75 per cent per annum.

By June 2010, the global economy was recovering at a faster pace than initially anticipated, although economic revival in major trade partners was still not firmly anchored. The implementation of fiscal austerity measures in European economies following the sovereign debt crisis was expected to drag down the recovery process. Inflation remained generally subdued in most major advanced economies, but inflationary pressures had started building up in fast-growing emerging and developing economies and in commodity-exporting economies.

Domestic economic activity indicators pointed to sustained output growth across sectors in the first quarter of 2010. Despite persistently weak external demand, key export sectors were more resilient than expected. However, weaker recovery in major export markets had muted prospects of faster growth in outward-looking sectors and the overall pace of economic expansion was expected to be lower than the initial forecast. Inflation was still subdued in line with the Bank's projections, but the MPC judged that further risks to inflation had increased, driven mostly by external factors. After weighing the risks to the inflation outlook and the growth prospects, the MPC chose to maintain the policy rate at 5.75 per cent at its meeting held on 22 June 2010.

Decisions on the key Repo Rate are summarised in Table 1.1.

Table 1.1: 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**
23 March 2010	Unchanged	5.75	Unanimous
22 June 2010	Unchanged	5.75	Unanimous

2. The External Environment

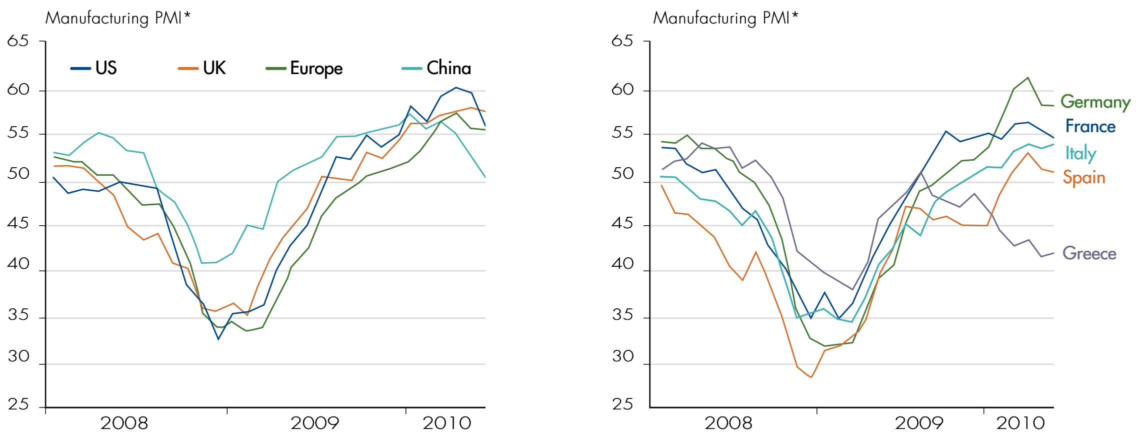
The recovery of the world economy in the first half of 2010 was stronger than initially expected. In its April 2010 World Economic Outlook (WEO), the IMF had revised upward its growth projections for 2010. However, towards May and June 2010, global leading indicators suggested that further out, economic activity could start moderating. Domestic demand in most advanced economies remained weak as unemployment was persistently high and both households' and the corporate sector's balance sheets continued to be seriously impaired. Tight credit conditions contributed to hold back demand. A gradual shift towards more rigid economic policies in key emerging economies to prevent the surge in capital flows creating asset bubbles was also seen as a damper on economic growth in these economies.

Financial markets' conditions improved initially but the sovereign debt crisis in many European countries amid signs of moderating growth gave rise to renewed volatility in markets. Inflationary pressures were relatively tame globally but were comparatively high in several emerging economies. Monetary policy remained generally accommodative although some central banks laid emphasis on a gradual process of interest rate normalisation to stave off threats to price stability as economic conditions strengthened. Concerns still prevailed on global economic prospects as major advanced economies were yet to see robust and sustained domestic demand. Further, implementation of fiscal austerity measures sooner than initially expected could slow the recovery process.

2.1 GLOBAL ECONOMIC ACTIVITY

The global economy continued to recover in the first half of 2010, with a pick-up in economic activity across regions worldwide. The IMF estimated world output to have grown at an annual rate of 5.25 per cent in the first half of 2010.[1] However, after a robust first quarter, leading indicators suggested an easing in real output growth in the second quarter. Industrial production decelerated in the United States and in Asia. The JP Morgan/Markit Global Manufacturing Purchasing Managers' Index (PMI) slowed to 55.0 in June, after reaching a peak in April, marking the lowest pace of expansion in 2010. The manufacturing PMIs of major countries are depicted in Chart 2.1. Nonetheless, major emerging economies continued to post pre-recession economic growth rates while output in advanced economies continued to expand but at a lower pace.

Chart 2.1: Global Manufacturing Purchasing Managers' Index



**A reading over 50 indicates expansion of activity in the manufacturing sector.*
Sources: Thomson Reuters, Markit, Institute for Supply Management, CLSA.
Courtesy of Thomson Reuters.

[1]*IMF's October 2010 World Economic Outlook.*

The US economy continued to expand in the first half of 2010. Real output grew at seasonally-adjusted quarter-on-quarter rates of 0.9 per cent and 0.4 per cent in the first and second quarters of 2010, respectively. The decline in the first quarter growth rate from the 1.2 per cent registered in the last quarter of 2009 primarily reflected slower growth in private inventory investment and exports, partly offset by higher growth in personal consumption spending. Economic expansion slowed further in the second quarter as companies invested heavily in imported equipment and private inventory investment decelerated sharply. The US manufacturing PMI, which fell from 60.4 in April to 59.7 in May and to 56.2 in June, could signal a renewed period of weak growth going further. The unemployment rate stayed elevated, despite falling to 9.5 per cent in June, from 9.7 per cent in January 2010. Persistently high unemployment remained a major concern for achieving sustainable growth. In its October 2010 WEO, the IMF revised downward its growth projections for the US economy to 2.6 per cent and 2.3 per cent in 2010 and 2011, respectively.

In Japan, economic growth slowed significantly in the second quarter of 2010 to 0.4 per cent, after a first quarter growth rate of 1.2 per cent, as the main forces supporting the economy – exports and consumption – lost some dynamism. Exports expanded for seven consecutive months until May and then dropped by 1.8 per cent in June 2010, as measured on a month-to-month basis. Domestic demand was quite supportive in the first semester. Retail sales grew by 0.1 per cent in the second quarter of 2010, after a robust increase of 2.7 per cent in the first quarter. Seasonally-adjusted unemployment rate rose to 5.3 per cent in June 2010, from 4.9 per cent in January 2010, as industrial production fell in some sectors of the economy. Deflation persisted in Japan's economy although the pace of decline in the Consumer Price Index (CPI) moderated in the first half of 2010: in June, inflation reached -0.7 per cent. Japan's economy was forecast to grow by 2.8 per cent in 2010 and 1.5 per cent in 2011, according to the IMF's October 2010 WEO.

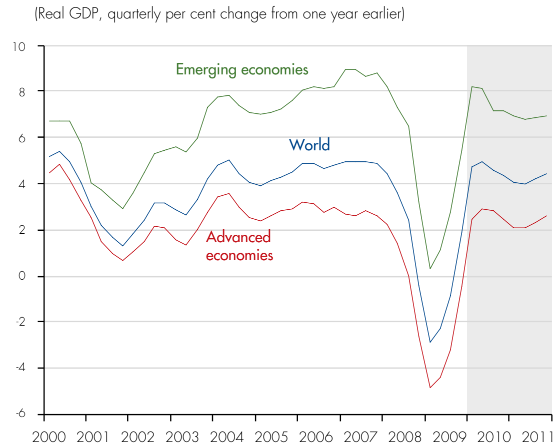
The euro area economy gathered pace in the first semester of 2010. Seasonally-adjusted quarter-on-quarter growth was 0.3 per cent in the first quarter of 2010, as real private consumption and investment contracted. Euro zone retail sales stayed anaemic as unemployment and tight credit conditions led consumers to cut down spending. However, higher household and investment spending drove euro zone growth to 1.0 per cent in the second quarter of 2010, the fastest pace in four years. The two largest economies namely Germany and France grew by 2.2 per cent and 0.7 per cent, respectively. On the production front, the construction and industrial sectors – the latter bolstered by higher demand for exports with the euro weakness – shored up output growth. Despite apprehensions over Europe's sovereign debt woes, sentiment and other indicators improved. By June 2010, the Markit Final Eurozone Composite Output Index – which covers the private manufacturing and services sectors – stood at 56.0: the index was marginally below that of May and down from the 32-month high achieved in April but stayed well above its long-run average of 53.4. Strong growth momentum in the core euro zone economies was likely to offset weakness in the peripheral economies. The IMF, in October 2010, upgraded its growth forecasts for the euro zone economy to 1.7 per cent in 2010 and 1.5 per cent in 2011.

After expanding by a fragile 0.4 per cent in the first quarter of 2010, real output in the United Kingdom grew at a robust 1.2 per cent in the second quarter. Growth was initially propelled by the inventory cycle and the strengthening of global trade. In the second quarter, an improvement in services output and the fastest rise in construction output in almost 50 years boosted real growth. The Pound's weakening also made UK exports more competitive. The manufacturing and services CIPS/Markit Purchasing Managers' Indices in June 2010 remained well above the level consistent with growth and the construction index increased further. Household spending grew at 0.7 per cent after contracting in the first quarter. The labour market remained weak and the unemployment rate for the three months to June 2010 was 7.8 per cent, the same as in January. According to the IMF, the UK economy was expected to grow by 1.7 per cent in 2010 and 2.0 per cent in 2011.

Growth in major emerging economies rebounded to pre-crisis levels, spurred mainly by robust exports and rising domestic demand, particularly in China and India. Real output growth was strong in China, although it slowed to 10.3 per cent in the second quarter of 2010 from 11.9 per cent in the first quarter. Domestic demand was vigorous in the first half of the year, with retail sales increasing by 18.2 per cent relative to the corresponding period of 2009. Growth slowed in the second quarter of 2010 as measures were taken to cool the economy given risks of overheating. In June 2010, industrial production, retail sales, lending and investment increased but at slower rates. In India, real output grew by 8.6 per cent in the first quarter, bolstered by industrial production and services, and by 8.8 per cent in the second quarter of 2010. Economic stimulus measures supported domestic demand significantly, but these were being retrenched. The rate of growth of manufacturing output rose in India for the fifteenth consecutive month in June. The PMI for the service industries, which accounts for about 55 per cent of output, hit a two-year high of 64 in June. In October 2010, the IMF estimated China to grow by 10.5 per cent and 9.6 per cent and India by 9.7 per cent and 8.4 per cent in 2010 and 2011, respectively.

Chart 2.2 and Table 2.1 show real growth rates, actual and projected.

Chart 2.2: Global Growth Outlook



Source: IMF's October 2010 World Economic Outlook.

The global economy was expected to continue growing in the second half of 2010, albeit moderately compared to the first semester. In October 2010, the IMF revised upward its global growth forecast for 2010 from 4.6 per cent made in July 2010 to 4.8 per cent.

2.2 FINANCIAL MARKETS

The perception of risk gradually abated on financial markets worldwide in the first four months of 2010. There were fairly widespread increases in stock market indices but they were still lower than the pre-

Table 2.1: Real GDP Growth Rates in Selected Economies

Per cent

	Q3-2009	Q4-2009	Q1-2010	Q2-2010	2008	2009	2010	2011
	Quarter-on-quarter Growth Rates, seasonally adjusted						*Projections*	
World output					**2.8**	**-0.6**	**4.8**	**4.2**
Advanced economies					**0.2**	**-3.2**	**2.7**	**2.2**
of which								
United States	0.4	1.2	0.9	0.4	0.0	-2.6	2.6	2.3
Euro Area	0.4	0.2	0.3	1.0	0.5	-4.1	1.7	1.5
Japan	-0.1	0.9	1.2	0.4	-1.2	-5.2	2.8	1.5
United Kingdom	-0.3	0.4	0.4	1.2	-0.1	-4.9	1.7	2.0
	Q3-2009	**Q4-2009**	**Q1-2010**	**Q2-2010**				
	Year-on-year Growth Rates							
Emerging market and developing economies					**6.0**	**2.5**	**7.1**	**6.4**
Sub Saharan Africa					5.5	2.6	5.0	5.5
Developing Asia					7.7	6.9	9.4	8.4
of which								
China	8.1	10.7	11.9	10.3	9.6	9.1	10.5	9.6
India	8.6	6.5	8.6	8.8	6.4	5.7	9.7	8.4

Sources: IMF's October 2010 World Economic Outlook; offices of national statistics' websites, central banks' websites and OECD website.

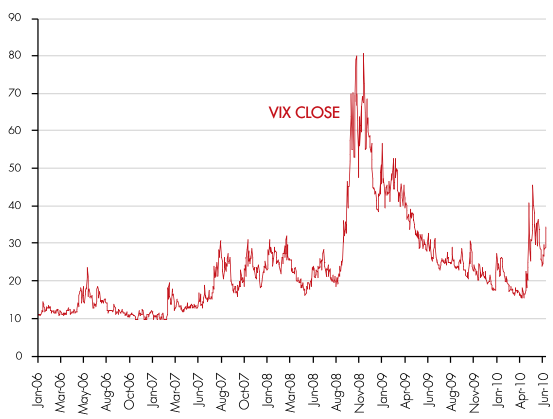
crisis levels. However, Europe's sovereign debt crisis of May 2010 brought renewed volatility on financial markets which receded to some extent by the end of June. Financial conditions improved further in emerging economies as they continued to record net capital inflows.

Credit conditions remained relatively tight in most major advanced economies despite efforts by major central banks to ensure adequate liquidity conditions in the financial system. As banks endeavoured to improve their balance sheets to absorb impaired credit and cover for lower asset prices, credit growth to the corporate sector and households in major advanced economies was persistently constrained.

Stock markets

Stock markets were volatile in the first half of 2010, particularly in May 2010. The Chicago Board Options Exchange volatility index, a key measure of US stock market volatility, rose steadily as from the third week of April to peak in May 2010 on growing fears that the euro zone's sovereign debt crisis could jeopardise global economic recovery. The volatility measure declined thereafter as concerns eased but picked up again at the end of June 2010 due to renewed worries over the global economic outlook, as shown in Chart 2.3.

Chart 2.3: Stock Market Volatility - Chicago Board Options Exchange Volatility Index

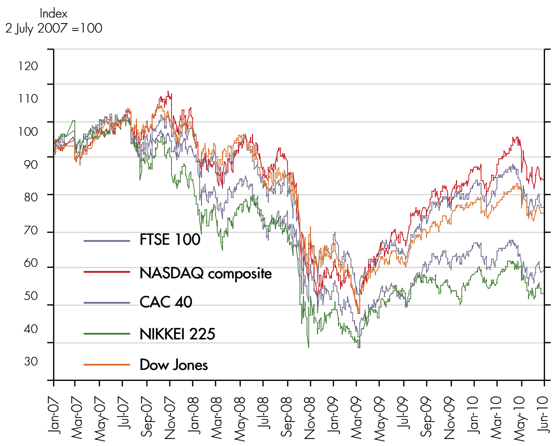


Source: Chicago Board Options Exchange's website.

Global equity markets started the year 2010 with optimism but retreated thereafter until mid-February on the back of apprehensions over weaker-than-expected US consumer sentiment survey data, US banking sector reform proposals, policy tightening in China and escalating sovereign debt problems in Europe, amongst others. Stock markets recovered up to the end of April as the European Union (EU) and the IMF envisaged sharing the burden for debt-stricken Greece. In the ensuing period to June 2010, negative news, including credit ratings downgrades of Greece, Portugal and Spain, concerns about the viability of the EU/IMF aid package and downgrading by the US Federal Reserve of its assessment of US economic recovery, generated an equity sell-off.

Overall, from January to June 2010, major stock markets posted negative performances. FTSE, Nasdaq and Dow Jones Industrial Average recorded negative returns of 9.16 per cent, 7.05 per cent and 6.27 per cent, respectively. Similarly, NIKKEI and CAC-40 fell by 11.04 per cent and 12.54 per cent, respectively. Chart 2.4 shows movements in major international stock market indices.

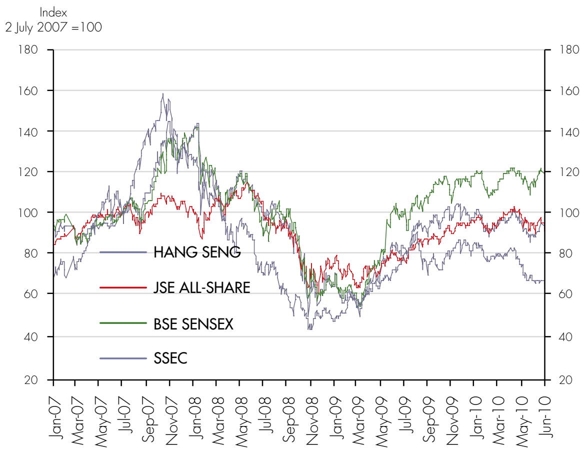
Chart 2.4: Equity Indices of Selected Major International Stock Markets



Source: Thomson Reuters.

Major emerging stock markets, with the exception of BSE which posted a positive return of 1.35 per cent, retreated in the first half of 2010. JSE, Hang Seng and Shanghai SEC generated negative returns of 5.09 per cent, 7.97 per cent and 26.81 per cent, respectively. Shanghai SEC posted the worst performance on the back of government policy measures initiated to tame speculation in the property market. Chart 2.5 shows movements in major emerging stock market indices.

Chart 2.5: Equity Indices of Selected Emerging Stock Markets



Source: Thomson Reuters.

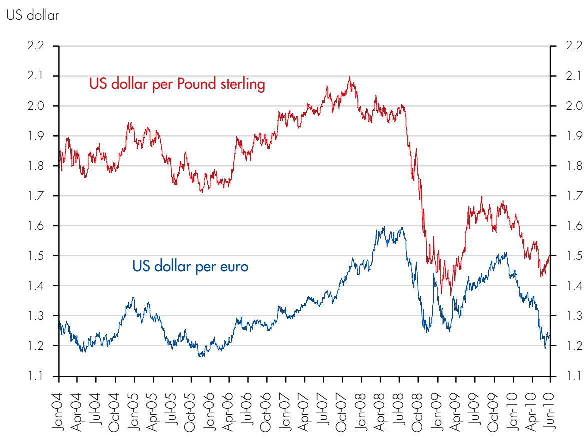
Exchange rate

The US dollar initially gained ground as the US economy appeared on a stable path to recovery and stronger inflation data fuelled speculation that the US Federal Reserve might begin to raise interest rates in 2010. A surprise move by the US Federal Reserve in February 2010, namely the hike in the discount rate from 0.50 per cent to 0.75 per cent, gave further support to the US dollar. The US dollar continued on an upward trend in subsequent months on persistent investor anxiety regarding the euro zone's debt woes. The Federal Open Markets Committee minutes for June 2010, however, showed that the US Federal Reserve had softened its view on the US economy, pointing out weakness in certain sectors and warned against volatile financial markets stemming from the euro zone debt crisis. The downward revision in US first quarter economic growth suggesting that recovery was not picking up pace in addition to a raft of weak reports led the US dollar to pare some gains in June 2010.

The euro tumbled against the US dollar between January and June 2010. The euro was heavily sold after renewed risk aversion from euro zone sovereign debt crisis and general economic weakness. The fall in the euro accentuated on widening CDS spreads and credit ratings downgrades of Greece, Portugal and Spain in April 2010. Despite the joint European Union and IMF bailout package of US$1 trillion in May 2010, fears that the debt problems could have contagion effects across borders heightened risk aversion and increased market volatility. The announcement of fiscal austerity measures by several euro zone governments also added to fears that the fragile recovery might be hampered. The single currency reached a low of US$1.19 on 7 June 2010. It recovered slightly thereafter following solid demand at European debt auctions and ended the period under review at US$1.22.

The Pound depreciated against the US dollar, weighed by increased risk aversion arising from European debt woes and political uncertainty in the United Kingdom about a hung parliament following the May 2010 general elections. Towards the end of June 2010, however, some better economic figures coupled with hawkish comments from policymakers as well as tough fiscal measures outlined in the Emergency Budget of the new coalition government on 22 June 2010 brought some support to the UK currency, which ended the month at US$1.51. Chart 2.6 shows the evolution of the US dollar against the euro and the Pound sterling.

Chart 2.6: Evolution of the US dollar against the Pound sterling and the Euro



Monetary policy

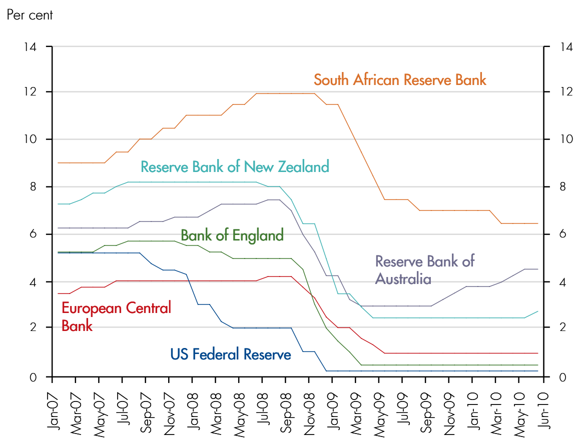
Central banks generally maintained the accommodative monetary policy stance with a view to continue supporting economic recovery. Central banks in Hungary, Czech Republic, Romania, Russia, Columbia and South Africa reduced interest rates further to prop up their economies amid low inflation. In the euro zone, the European Central Bank (ECB) reintroduced liquidity operations early June 2010 to ease financial markets tensions on increasing concerns over the sovereign debt issue. Central banks in faster-growing economies – such as Canada, Norway, Australia, New Zealand and Brazil and in South East Asia – increased their policy interest rates in a bid to withdraw the exceptional monetary stimulus and normalise interest rates.

The US Federal Reserve left its federal funds rate unchanged in the target range of zero to 0.25 per cent. In February 2010, the Federal Reserve surprised markets by raising the discount rate by 25 basis points. The US central bank completed its asset-purchase schemes and closed most of the special liquidity-providing facilities, which had resulted in a massive jump of around US$1.4 trillion in total assets held by the US Federal Reserve since September 2008. It, however, re-affirmed its commitment to keep the federal funds rate at the current low levels for an extended period.

The ECB kept its interest rate on the main refinancing operations on hold at 1.00 per cent. Severe tensions in financial markets stemming from the euro area sovereign debt crisis prompted the ECB to announce a number of measures in June 2010. Acquisitions of euro area public and private debt securities as well as provision of liquidity to banks were key measures. The covered bond purchase programme – which began in July 2009 to support financial markets – for the pre-determined amount of EUR60 billion was completed on 30 June 2010. Overall, despite nervousness, the euro area credit markets continued to recover. Inflation expectations remained firmly anchored.

The Bank of England maintained its Bank Rate unchanged at 0.5 per cent. The quantitative easing programme – which aimed at supporting lending and, thus, boost nominal demand – requiring the purchase of assets worth £200 billion financed by the creation of central bank reserves was completed in February 2010. Credit conditions, which had started to ease, were likely to remain tight for some more time. The MPC was of the view that actual inflation, which had been persistently well above the target of 2 per cent, would move back towards the target over the medium term at the current level of Bank Rate. Chart 2.7 shows end-of-month policy interest rates of selected central banks.

Chart 2.7: Selected Central Banks' Policy Interest Rates



Sources: Thomson Reuters and central banks' websites.

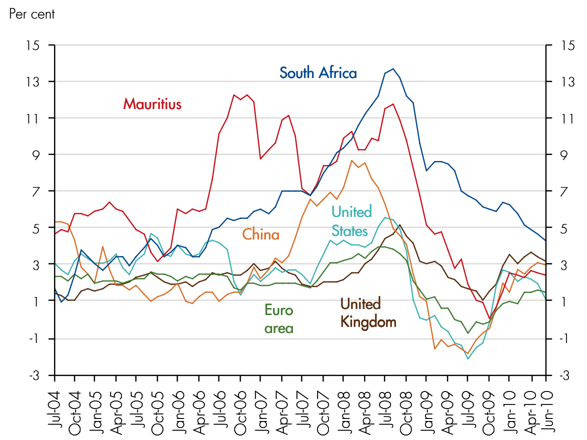
Many central banks were expected to keep monetary policy accommodative for an extended period while those that had begun raising interest rates were expected to slow the pace of monetary policy tightening. The outlook for global growth on the one hand and the resurgence of inflation on the other would be the main considerations that were going to guide monetary policy decisions in the near future. Although the world economy was recovering, uncertainty had also significantly increased. The enormous amount of global liquidity as central banks in advanced economies inflated their balance sheets to gear their economies out of recession remained an important challenge to global inflation looking ahead.

2.3 INFLATION AND COMMODITY PRICES

Consumer price inflation was on multi-speed paths in advanced and emerging economies in the first half of 2010. In most major advanced economies, inflation was generally mild and core inflation measures stayed persistently low given the extent of economic slack and well-anchored inflation expectations. In contrast, inflation rose in several major emerging economies as economic activity intensified. Inflation developments were also shaped by international commodity price pressures. After picking up earlier in 2010, international commodity prices eased to some extent in May and early June 2010 as global economic expansion was widely expected to stay moderate in the second half of 2010.

Inflation in the United States, the euro area and the United Kingdom was at 1.1 per cent, 1.4 per cent and 3.2 per cent in June 2010, respectively. In South Africa, inflation fell to 4.2 per cent in June 2010. Among emerging economies, China's inflation picked up to 2.9 per cent while inflation in India declined to 13.7 per cent in June 2010. Chart 2.8 and Table 2.2 show year-on-year inflation for selected countries.

Chart 2.8: Inflation in Selected Countries



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

The global inflation outlook suggests subdued inflation to stay for a while mainly on account of the industrial slack. The IMF projected inflation pressures to stay curbed in advanced economies. In October 2010, the IMF forecast inflation in advanced economies to move around 1.4 per cent and 1.3 per cent in 2010 and 2011, respectively. Inflation in emerging and developing economies was projected to escalate to 6.2 per cent in 2010 before dropping to 5.2 per cent in 2011.

Commodity prices

The rebound in commodity prices that started at the beginning of 2009 continued into the first few months of 2010 as the global economy recovered but eased in May and June as recovery was expected to moderate.

Oil prices

Crude oil prices hovered between US$74.1 and US$85.7 a barrel in the first half of 2010 compared to a range of US$64.3 to US$78.1 a barrel in the last six months of 2009. Oil prices rebounded to around April 2010 in tandem with signs of strengthening world economic activity and higher oil demand expectations but fell thereafter.

Oil markets experienced a turbulent month in May as markets were unnerved over Europe's debt woes and prices tumbled US$18 per barrel in the first three weeks of the month. NYMEX WTI futures prices hit a 19-month high of US$86.19 a barrel on 3 May before plummeting to US$68.01 a barrel by

Table 2.2: Consumer Prices

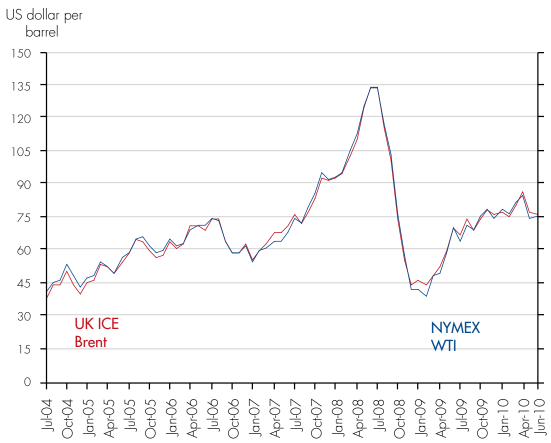
Annual percentage change

	2005	2006	2007	2008	2009	January 2009	June 2009	January 2010	June 2010
China	1.8	1.5	4.8	5.9	-0.7	1.0	-1.7	1.5	2.9
Euro area	2.2	2.2	2.1	3.3	0.3	1.1	-0.1	1.0	1.4
Hong Kong	0.9	2.0	2.0	4.3	0.5	3.1	-0.9	1.0	2.8
Hungary	3.6	3.9	7.9	6.1	4.2	3.1	3.7	6.4	5.3
India	4.2	6.2	6.4	8.3	10.9	10.4	9.3	16.1	13.7
Indonesia	10.5	13.1	6.0	9.8	4.8	9.2	3.7	3.7	5.0
Philippines	7.7	6.2	2.8	9.3	3.2	7.1	1.5	4.3	3.9
Singapore	0.5	1.0	2.1	6.6	0.6	2.9	-0.5	0.2	2.7
South Africa	3.4	4.7	7.1	11.5	7.1	8.1	6.9	6.2	4.2
South Korea	2.8	2.2	2.5	4.7	2.8	3.7	2.0	3.1	2.6
Thailand	4.5	4.6	2.2	5.5	-0.8	-0.4	-4.0	4.1	3.2
Turkey	8.2	9.6	8.8	10.4	6.3	9.5	5.7	8.2	8.4
United Kingdom	2.0	2.3	2.3	3.6	2.1	3.0	1.8	3.5	3.2
United States	3.4	3.2	2.9	3.8	-0.3	0.0	-1.4	2.6	1.1

Sources: IMF's October 2010 World Economic Outlook, The Economist and central banks' websites.

20 May. In June, the market turned bearish on mixed economic data clouding the strength of the economic recovery. Equities and exchange rate fluctuations also impacted on crude oil prices. NYMEX WTI oil prices averaged US$75.4 a barrel in June 2010, up from US$74.6 a barrel in December 2009. Likewise, ICE Brent prices averaged US$75.7 a barrel in June 2010, marginally up from US$75.2 a barrel in December 2009. Chart 2.9 shows movements in monthly average oil prices.

Chart 2.9: NYMEX WTI and ICE Brent - monthly average



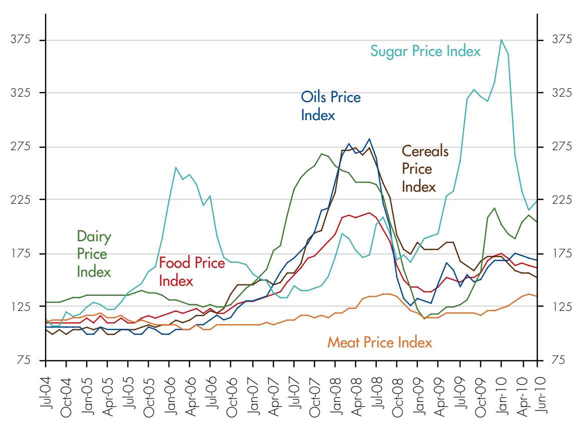
Source: Reuters.

Food prices

Price pressures from agricultural commodities were generally absent in the first semester of 2010. The Food and Agriculture Organisation Food Price Index (FFPI), which tracks prices of agricultural commodities, declined by 6.6 per cent between January and June 2010 driven by the drop in international prices of sugar and cereals.[2] The FFPI averaged 162.6 points in June 2010, down from 174.0 points in January 2010 and significantly lower than its peak of 214 in June 2008.

Sugar prices dropped by 40 per cent from their peak at the beginning of the year on expectations of a substantial rise in production. Similarly, international prices for all major cereals fell since the start of the year, primarily on account of ample export supplies and bumper crops anticipated in 2010. Oilseeds prices resisted a major downturn as demand remained strong. However, dairy markets were tight as milk production stayed sluggish against robust demand. Meat prices had been rising due to falling production set against rebounding world demand. The FFPI and other food commodity price indices are shown in Chart 2.10.

Chart 2.10: FAO Food Price Index and Other Food Commodity Price Indices



Source: FAO website.

Other commodity prices

The recovery in the global economy and brighter prospects fuelled optimism on other commodity markets. Prices of non-energy and non-food commodities had generally firmed up in the first half of 2010 compared to the second half of 2009. The increases reflected an upward adjustment in demand for these commodities.

Table 2.3 shows the quarterly averages of selected non-energy commodities for the second half of 2009 and the first six months of 2010.

Freight costs

The Baltic Dry Index (BDI), the benchmark for tracking commodity shipping costs, was volatile in the first half of 2010 but ended lower from December 2009 levels, despite the continuous rise in world trade. The BDI averaged 3,168 points in January 2010, dropping in February 2010 before rising in March 2010. The BDI fell in April 2010 but bounced back in May 2010, recording its first

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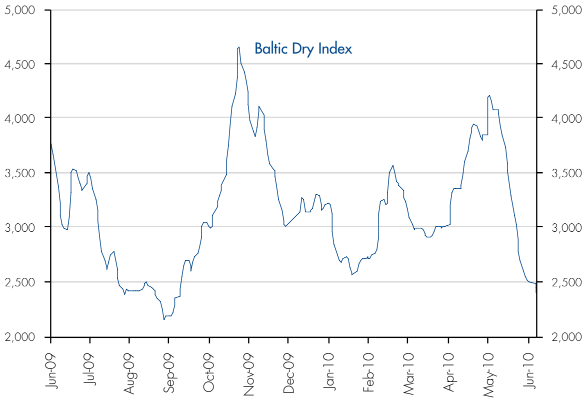
[2]The FAO FPI consists of the average of six commodity group price indices, namely, meat, dairy, cereals, oil and fats, and sugar, weighted with the average export shares of each of the groups for 2002-2004.

semester high on 26 May 2010 at 4,209 points. The BDI plunged in June 2010 to close at 2,406 points on account of weak cargo activity. Chart 2.11 shows the daily Baltic Dry indices as from 30 June 2009 to 30 June 2010.

Chart 2.11: Baltic Dry Index



Source: Dowjonesclose website.

Table 2.3: Non-Energy Commodities

Commodity	Unit	Quarterly Averages Jul-Sep 2009	Oct-Dec 2009	Jan-Mar 2010	Apr-Jun 2010
Cotton A Index	c/kg	142	158	179	199
Aluminum	$/mt	1,812	2,003	2,163	2,096
Copper	$/mt	5,859	6,648	7,232	7,027
Gold	$/toz	960	1,102	1,109	1,196
Iron ore	c/dmtu	101	101	101	167
Lead	c/kg	193	229	222	195
Nickel	$/mt	17,700	17,528	19,959	22,476
Silver	c/toz	1,477	1,760	1,693	1,838
Steel (cold rolled) coilsheet	$/mt	700	700	725	838
Steel (hot rolled) coilsheet	$/mt	600	600	625	738
Tin	c/kg	1,459	1,517	1,721	1,786
Zinc	c/kg	176	221	229	203
Cocoa	c/kg	296	342	330	321
Plywood	c/sheets	562	558	557	566
Tea, auctions (3) average	c/kg	304	302	279	276

$ = 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.

Box 1: Austerity Measures in the Euro Area

In order to deal with the drastic fall in output that resulted from the global financial crisis, several governments in the euro area resorted to fiscal stimulus. As world trade picked and financial markets conditions eased, market players started scrutinising sovereign debt levels. Surprisingly higher sovereign debt and fiscal deficit levels than previously reported in Greece turned market focus onto the euro area, in particular the 'peripheral' PIIGS (Portugal, Italy, Ireland, Greece and Spain) economies. In the wake of the euro zone sovereign debt crisis, credit spreads on these economies' Government bonds relative to Bunds yields skyrocketed and there was a general loss of confidence in the euro, which fell sharply across the board. In a bid to restore fiscal balance, authorities in several of these countries started implementing wide-ranging austerity measures.

Public Debt to GDP and Fiscal Deficit to GDP for Euro Area Member Countries: 2007-2009

Per cent

	Public Debt to GDP			Fiscal Deficit to GDP		
	2007	**2008**	**2009**	**2007**	**2008**	**2009**
Austria	59.5	62.6	66.5	-0.4	-0.4	-3.4
Belgium	84.2	89.8	96.8	-0.2	-1.2	-6.0
Cyprus	58.3	48.4	56.2	3.4	0.9	-6.1
Finland	35.2	34.2	44.0	5.2	4.2	-2.2
France	63.8	67.5	77.5	-2.7	-3.3	-7.5
Germany	65.0	66.0	73.2	0.2	0.0	-3.3
Greece	95.7	99.2	115.1	-5.1	-7.7	-13.6
Ireland	25.0	43.9	64.0	0.1	-7.3	-14.3
Italy	103.5	106.1	115.8	-1.5	-2.7	-5.3
Luxembourg	6.7	13.7	14.5	3.6	2.9	-0.7
Malta	61.9	63.7	69.1	-2.2	-4.5	-3.8
Netherlands	45.5	58.2	60.9	0.2	0.7	-5.3
Portugal	63.6	66.3	76.8	-2.6	-2.8	-9.4
Slovakia	29.3	27.7	35.7	-1.9	-2.3	-6.8
Slovenia	23.4	22.6	35.9	0.0	-1.7	-5.5
Spain	36.2	39.7	53.2	1.9	-4.1	-11.2

The EU and the IMF were ready to bail-out Greece only if it implemented austerity measures that will get it back on sustainable public debt track. Greece came up with a plan to scrap bonus payments for the public sector, freeze public sector salaries and pensions for at least three years, increase value added tax from 19 per cent to 23 per cent and raise taxes on fuel, alcohol and tobacco by 10 per cent. The harsh measures met with a wave of public sector strikes and protest. Italy cut public sector pay by up to 10 per cent and froze new recruitments. In Spain, some planned public sector investments were abandoned, a 5 per cent cut in public sector pay was introduced and a freeze of public sector salaries thereafter was applied. France considered reforming its pension and tax systems and raising the retirement age from 60 to 62 years. The new UK coalition government announced GBP6.2 billion savings by delaying or stopping government projects, cutting consultancy and travel costs and slimming public sector agencies. German's austerity drive included a cut in subsidies to parents, 10,000 government job cuts over four years and higher taxes on nuclear power.

In spite of several announcements of austerity measures, financial markets were not convinced. The EU together with the IMF set up a joint fund of EUR750 billion (out of which EUR500 billion would be funded by the EU) to bail-out member countries that faced acute public debt problems. Out of those EUR500 billion, EUR440 billion were to be used to help countries using the euro that might face borrowing costs that were unusually high for reasons beyond their control. This was called the European Financial Stability Facility. The other EUR60 billion was meant to ensure the whole European Bloc's financial stability.

European banks were also stress-tested to assess whether they could withstand future economic shocks. The tests did provide some comfort to financial markets and confidence over the single currency was restored to some extent.

Will the austerity measures work?

With all these unpopular austerity measures being put in place amid high and rising unemployment and lower consumer wealth, the big question is whether fiscal discipline would provide the necessary condition for private investment to pick up and support the economic recovery? Increasingly, however, many analysts view that the austerity measures had come too early and would weigh down on consumer and business confidence, creating a vicious circle of low demand, and higher unemployment, penalising growth in the medium term.

3. Recent Developments in Inflation

Inflation in the domestic economy remained subdued in the first semester of 2010, amid low price pressures from both external and domestic sources. Consumer price inflation stayed moderate and well below historical trend, underpinned by lacklustre domestic demand, fairly low global inflation and modest global commodity prices. The pass-through of the depreciation of the rupee exchange rate, on a nominal effective basis, produced modest effects on inflation dynamics. While the twelve-month average inflation maintained its downward momentum, the year-on-year inflation picked up in January 2010 and moved in the range of 2.3 per cent to 2.7 per cent up to June 2010.

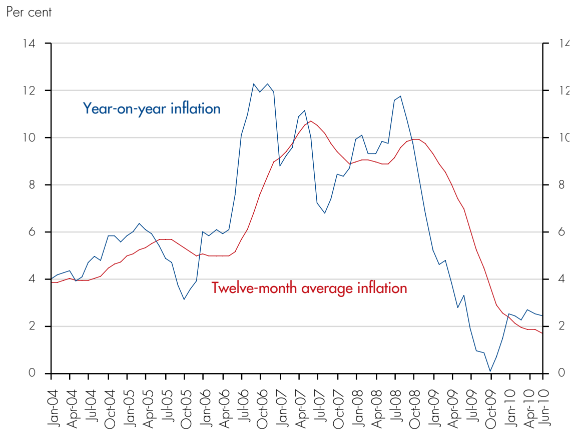
After rising consecutively during the first four months of 2010 from 117.2 in December 2009, the CPI fell in May to 119.1 before going up to 119.9 in June 2010 on account of increases in the domestic prices of petroleum products, food products and motor vehicles.

3.1 INFLATION: HEADLINE AND CORE

Consumer price inflation, as measured by both twelve-month moving average and year-on-year methodologies, showed a mixed trend in the first half of 2010, albeit with moderate movements, as depicted in Chart 3.1. Year-on-year inflation, defined as the percentage change in the CPI of a given month compared to the same month of the preceding year, remained range bound between 2.3 per cent and 2.7 per cent. It picked up by one percentage point in January to 2.5 per cent and declined marginally to 2.4 per cent in June 2010.

The twelve-month average inflation – 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 – maintained its downward trend. It fell from 2.3 per cent in January 2010 to 1.8 per cent in April and May and further to 1.7 per cent in June.

Chart 3.1: Inflation – twelve-month average and year-on-year



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

Core inflation

The three measures of core inflation also remained at modest levels in the first half of 2010, with barely any divergence from headline inflation.[3] Charts 3.2 and 3.3 depict movements of core inflation.

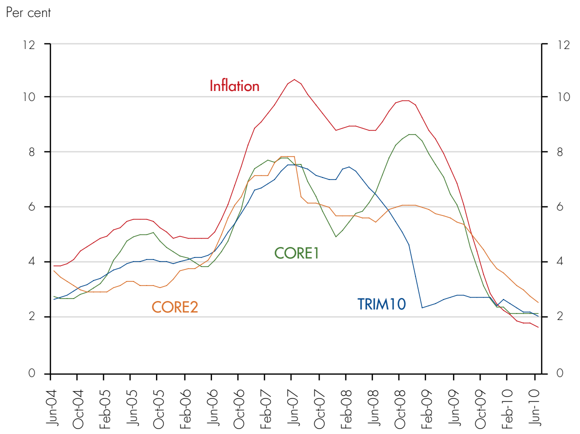
On the twelve-month average basis, CORE1 inflation stood unchanged at 2.4 per cent in January 2010 and subsequently declined to 2.3 per cent in February and further to 2.2 per cent in March. It stood flat for three consecutive months before closing at 2.2 per cent in June. CORE2 inflation declined continuously to reach 2.6 per cent in June, from 3.8 per cent in December 2009. As at June 2010, TRIM10 inflation stood at 2.1 per cent, compared to 2.4 per cent in December 2009.

On a year-on-year basis, CORE1 inflation picked up from 2.4 per cent in December 2009 to 3.3 per cent in January 2010 principally due to base effects and the rise in the price of motor gasoline. It moved between 3.2 per cent and 3.3 per cent in the following three months before dropping to 2.8 per

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

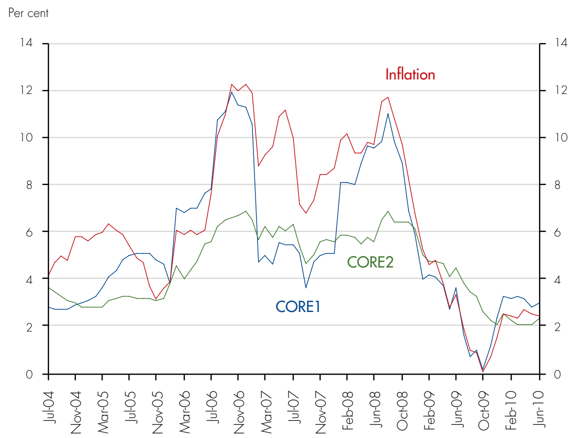
cent in May and rising to 3.0 per cent in June. CORE2 inflation declined from 2.6 per cent in January to 2.1 per cent in April, picking up subsequently to 2.4 per cent in June.

Chart 3.2: Inflation and Core Inflation - twelve-month average



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

Chart 3.3: Inflation and Core Inflation - year-on-year



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

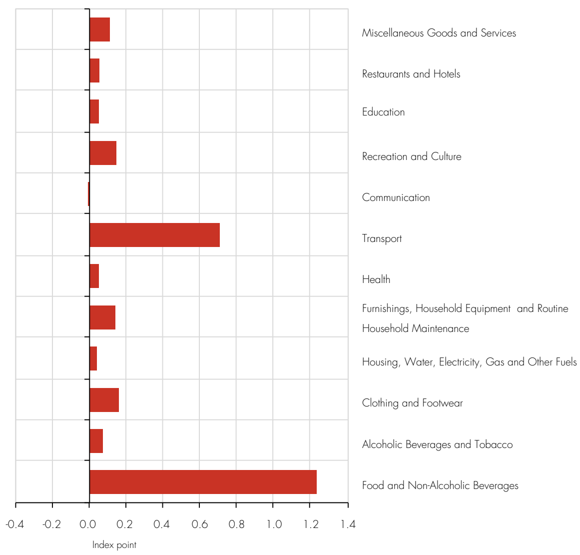
3.2 EVOLUTION OF MAJOR COMMODITY GROUP INDICES

The CPI was subject to some upward price pressures in the first semester of 2010. The CPI rose from 117.2 in December 2009 to 119.9 in June 2010, that is, by 2.7 index points. Almost all of the CPI divisions recorded increases in their sub-indices.

The division *Food and non-alcoholic beverages* was the largest contributor to the rise in the CPI with 1.2 index points. *Transport* and *Clothing and footwear* accounted for 0.7 index point and 0.2 index point to the increase in the CPI. *Alcoholic beverages and tobacco*, *Furnishings, household equipment and routine household maintenance*, *Recreation and culture*, *Education*, *Restaurants and hotels* and *Miscellaneous goods and services* contributed 0.1 index point each. The other divisions recorded negligible contributions.

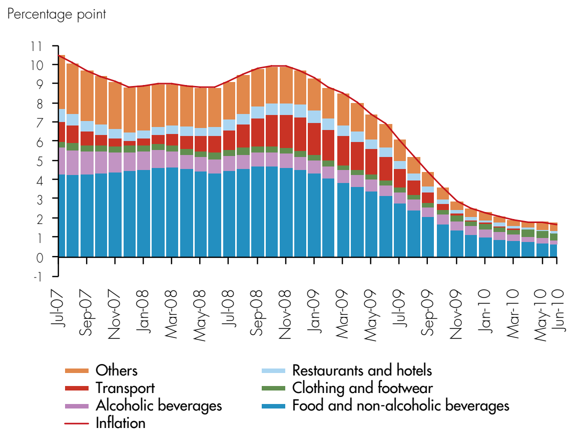
Chart 3.4 illustrates the weighted contribution of the main divisions of the CPI basket to the increase in the CPI between December 2009 and June 2010. Chart 3.5 depicts the weighted contribution of the main divisions of the CPI basket to the twelve-month average inflation rate.

Chart 3.4: Weighted Contribution of Main Divisions of the CPI Basket to the Change in CPI: December 2009 – June 2010



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

Chart 3.5: Weighted Contribution of Main Divisions of the CPI Basket to Inflation

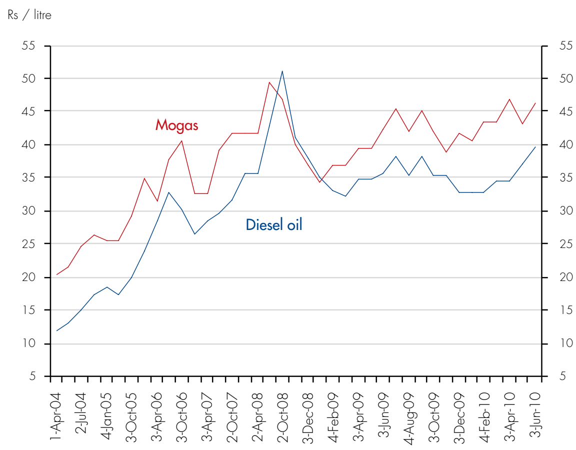


Sources: CSO, Government of Mauritius, and Bank calculations.

Domestic prices of mogas and diesel oil

The domestic prices of motor gasoline (mogas) and diesel oil, as determined by the Automatic Pricing Mechanism (APM) Review Committee in the first week of every month, rose by 11.3 per cent and 21.6 per cent, respectively, in the first half of 2010. The retail price of mogas was adjusted downward on two occasions, upward on three occasions and kept unchanged on one occasion by the APM Review Committee. In contrast, the retail price of diesel oil was increased on three occasions and kept unchanged at the three other meetings. Chart 3.6 depicts movements of retail prices of mogas and diesel oil since the introduction of the APM in April 2004.

Chart 3.6: Domestic Prices of Mogas and Diesel Oil



Source: State Trading Corporation's website.

Overall, the net contribution of adjustments in mogas and diesel oil prices to the increase in the CPI stood at 0.6 index point.

Food and non-food inflation

Food inflation – with food carrying a weight of 26.5 per cent in CPI basket – maintained a declining trend. It fell from 4.1 per cent in December 2009 to reach 2.1 per cent in June 2010. Non-food inflation dropped to 1.5 per cent in April 2010 before edging up to 1.6 per cent in May and June 2010.

Based on the year-on-year methodology, food inflation picked up quite rapidly, mainly as a result of increases in several local and imported food items. It rose from 1.1 per cent in December 2009 to 2.9 per cent in January 2010. It remained range-bound between 2.3 per cent and 2.8 per cent in the remaining months to June 2010. Non-food inflation also picked up in January 2010 to 2.4 per cent, from 1.6 per cent in December 2009, and fluctuated between 2.2 per cent and 2.6 per cent thereafter. Table 3.1 and Charts 3.7 and 3.8 show movements in food and non-food inflation.

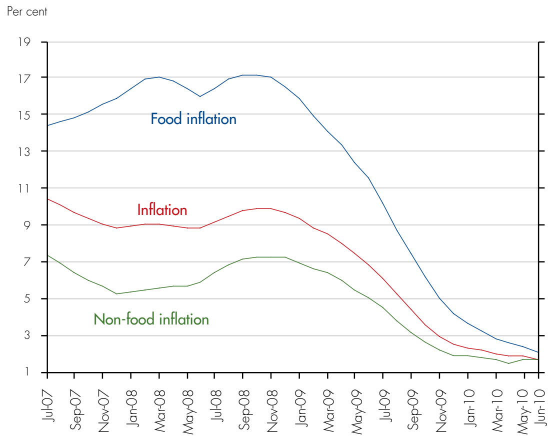
Table 3.1: Food and Non-Food Inflation

Per cent

	Food	Non-Food	Food	Non-Food
	12-month average		*Year-on-year*	
Dec-09	4.1	1.9	1.1	1.6
Jan-10	3.6	1.8	2.9	2.4
Feb-10	3.2	1.7	2.6	2.3
Mar-10	2.8	1.6	2.8	2.2
Apr-10	2.5	1.5	2.7	2.6
May-10	2.3	1.6	2.7	2.4
Jun-10	2.1	1.6	2.3	2.5

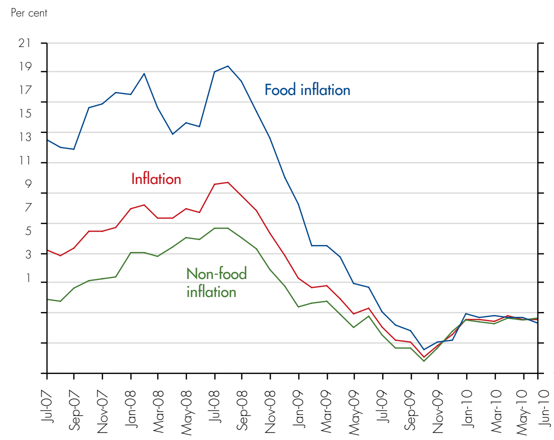
Sources: CSO, Government of Mauritius, and Bank calculations.

Chart 3.7: Food and Non-Food Inflation – twelve-month average



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

Chart 3.8: Food and Non-Food Inflation - year-on-year



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

Goods and services inflation

Goods inflation, on a twelve-month average basis, continued to moderate in the first half of 2010. It dropped from 2.8 per cent in December 2009 to 2.5 per cent in June 2010. Services inflation also showed a significant downturn partly reflecting still subdued domestic demand conditions. In June 2010, services inflation stood at 0.1 per cent, down from 1.8 per cent in December 2009.

Based on the year-on-year methodology, goods inflation rose from 2.2 per cent in December 2009 to 3.6 per cent in January 2010, driven by higher food and non-food prices. Goods inflation settled lower at 3.1 per cent in June 2010. Services inflation remained low throughout the first half of 2010, reaching -0.1 per cent in March 2010. It increased to 0.8 per cent in June 2010. Table 3.2 and Charts 3.9 and 3.10 illustrate movements in goods and services inflation.

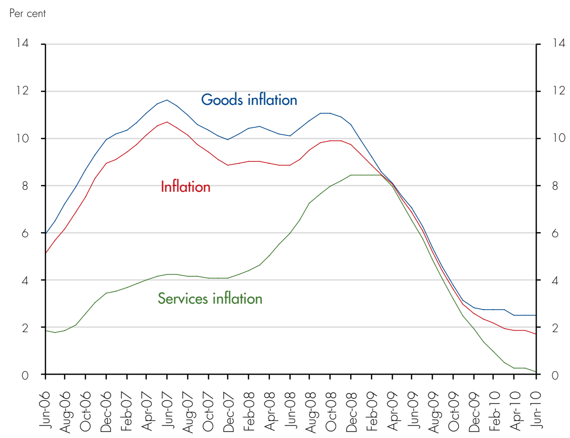
Table 3.2: Goods and Services Inflation

Per cent

	Goods	Services	Goods	Services
	12-month average		*Year-on-year*	
Dec-09	2.8	1.8	2.2	0.0
Jan-10	2.7	1.3	3.6	0.2
Feb-10	2.7	0.9	3.5	0.1
Mar-10	2.7	0.4	3.5	-0.1
Apr-10	2.6	0.2	3.5	0.9
May-10	2.6	0.2	3.2	0.8
Jun-10	2.5	0.1	3.1	0.8

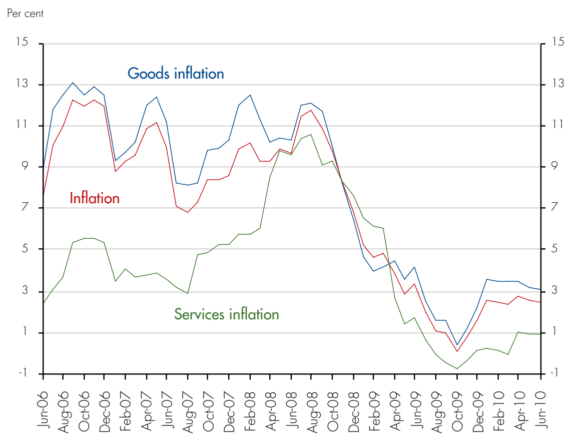
Sources: CSO, Government of Mauritius, and Bank calculations.

Chart 3.9: Goods and Services Inflation – twelve-month average



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

Chart 3.10: Goods and Services Inflation - year-on-year



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

3.3 EVOLUTION OF OTHER PRICE AND COST INDICES

Import Price Index

The Import Price Index (IPI), a key indicator of price pressures as it measures prices of goods imported in Mauritius inclusive of exchange rate movements, was on an upward trend in the first half of 2010. The IPI increased by 3.1 per cent between the fourth quarter of 2009 and the first quarter of 2010, reflecting mainly the rise in international prices of fuel and crude materials. It further rose by 6.1 per cent between the first and second quarters of 2010 mainly on account of an increase in international oil prices.

The IPI went up from 103.5 in the second quarter of 2009 to 112.4 in the second quarter of 2010, representing a significant increase of 8.5 per cent, as shown in Table 3.3. Between the second quarters of 2009 and 2010, the growth in the indices of the sub-components *Mineral fuels, lubricants and related materials, Animal and vegetable oils, Crude materials, inedible, except fuels* and *Food and live animals* contributed to the rise in the IPI.

Producer Price Indices

Price pressures at the production level showed signs of moderation in the first half of 2010 except in the manufacturing sector where upward pressures emerged in the second quarter. The Producer Price Index-Agriculture (PPI-A) inflation remained in negative territory. PPI-A inflation for the twelve-month period declined steadily from -3.0 per cent in December 2009 to -7.6 per cent in June 2010. On a year-on-year basis, PPI-A inflation was -8.8 per cent in June 2010 compared to -8.3 per cent in December 2009.

Movements in the Producer Price Index-Manufacturing (PPI-M) showed upward pressures in the second quarter of 2010. The rise in the PPI-M was largely driven by increases noted in the sub-component *Manufacture of food products, beverages and tobacco*. On the twelve-month average basis, PPI-M inflation eased from -0.7 per cent in December 2009 to -2.3 per cent in March 2010 but recovered to -1.5 per cent by June 2010. The year-on-year PPI-M inflation moved up from -4.2 per cent in December 2009 to 2.0 per cent in April 2010 and further to 5.5 per cent in June 2010, which could potentially propel inflation in the quarters ahead.

The producer price inflation for manufacturing and agricultural products based on twelve-month average and year-on-year methodologies are illustrated in Table 3.4 and Charts 3.11 and 3.12.

Table 3.4: Producer Price Inflation

Per cent

	PPI-A	PPI-M	PPI-A	PPI-M
	12-month average		Year-on-year	
Dec-09	-3.0	-0.7	-8.3	-4.2
Jan-10	-3.7	-1.5	-4.4	-2.1
Feb-10	-4.7	-1.9	-5.5	-0.4
Mar-10	-5.8	-2.3	-7.1	-0.5
Apr-10	-6.3	-2.2	-6.3	2.0
May-10	-7.0	-1.9	-8.6	4.2
Jun-10	-7.6	-1.5	-8.8	5.5

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

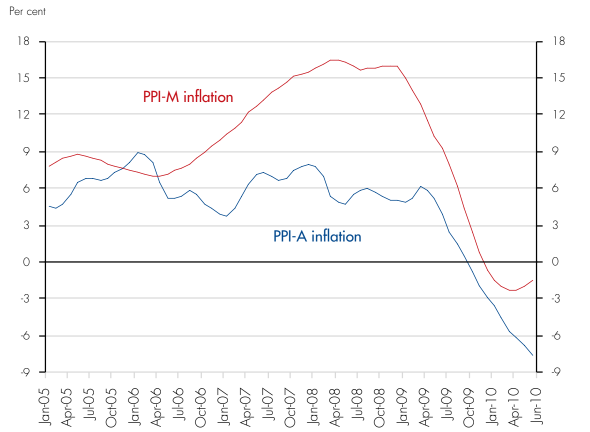
Table 3.3: Import Price Index

Description	Weights	2009[1] Quarter 1	2009[1] Quarter 2	2009[1] Quarter 3	2009[1] Quarter 4	2010[2] Quarter 1	2010[2] Quarter 2	Weighted Percentage Change: Between Quarter 4 2009 and Quarter 1 2010	Weighted Percentage Change: Between Quarter 1 2010 and Quarter 2 2010
Food and live animals	1,808	110.0	109.4	111.5	108.9	109.2	119.9	0.1	1.8
Beverages and tobacco	138	116.4	137.9	140.5	144.2	140.3	140.1	-0.1	0.0
Crude materials, inedible, except fuels	288	153.6	135.6	138.4	135.5	141.1	149.7	0.2	0.2
Mineral fuels, lubricants and related materials	2,004	78.5	82.1	97.3	98.0	104.4	116.3	1.3	2.3
Animal and vegetable oils, fats and waxes	104	109.7	96.4	101.7	99.8	109.1	108.0	0.1	0.0
Chemical materials and related products, n.e.s	851	112.5	113.7	108.6	102.6	106.6	108.8	0.3	0.2
Manufactured goods classified chiefly by material	2,141	102.7	106.0	94.8	96.3	101.3	107.4	1.1	1.3
Machinery and transport equipment	1,800	105.4	104.3	103.3	100.4	100.6	101.1	0.0	0.1
Miscellaneous manufactured articles	866	107.0	107.9	106.1	105.3	107.1	110.3	0.2	0.3
Overall Index	**10,000**	**102.6**	**103.5**	**103.9**	**102.8**	**105.9**	**112.4**	**3.1**	**6.1**

[1] Revised. [2] Provisional. n.e.s: not elsewhere specified. Figures may not add up to totals due to rounding.

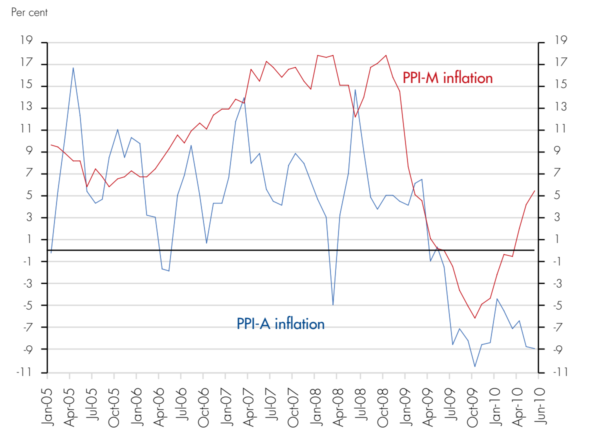
Sources: CSO, Government of Mauritius, and Bank calculations.

Chart 3.11: Producer Price Inflation for Manufacturing and Agriculture – twelve-month average



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

Chart 3.12: Producer Price Inflation for Manufacturing and Agriculture – year-on-year



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

Wage Rate Index

The Wage Rate Index (WRI), a measure of labour cost, was on an uptrend in the first half of 2010. The WRI rose by 0.9 per cent in the first quarter relative to the last quarter of 2009 and by 1.2 per cent in the second quarter of 2010 relative to the first quarter of 2010 largely due to higher wage and new contracts across certain industry groups.

A comparison of wage rate increases by industrial groups shows that the largest rise of 11.4 per cent in the second quarter of 2010 relative to the first quarter was recorded in *Electricity and water*, followed by 6.3 per cent in *Construction*. Other industry groups namely *Manufacturing, mining and quarrying, Public administration and defence; compulsory social security, Health and social work,* and *Financial intermediation* registered increases of 3.0 per cent, 2.2 per cent, 1.4 per cent and 1.0 per cent, respectively. In contrast, the wage rates of *Hotels and restaurants* fell by 2.1 per cent followed by 0.9 per cent in *Wholesale and retail trade; repair of motor vehicles, motorcycles, personal and household good,* and by 0.7 per cent in *Agriculture, hunting, forestry and fishing*. Table 3.5 shows the quarterly change in WRI by industry group.

Table 3.5: Wage Rate Index by Industry Group

INDUSTRY GROUPS	2009				2010		Weighted contribution between (Index point)		Percentage change between (Per cent)	
	Quarter 1	Quarter 2	Quarter 3	Quarter 4	Quarter 1	Quarter 2	Quarter 4 2009 and Quarter1 2010	Quarter 1 and Quarter2 2010	Quarter 4 2009 and Quarter1 2010	Quarter 1 and Quarter2 2010
1 Agriculture, hunting, forestry and fishing	115.5	119.3	153.8	145.7	134.5	133.6	-0.7	-0.1	-7.7	-0.7
2 Manufacturing, mining and quarrying	121.5	122.5	126.1	125.7	127.5	131.3	0.3	0.6	1.4	3.0
3 Electricity and water	119.9	119.7	138.2	135.3	135.6	151.1	0.0	0.3	0.2	11.4
4 Construction	117.6	122.2	128.1	131.0	129.4	137.6	-0.1	0.3	-1.2	6.3
5 Wholesale and retail trade; repair of motor vehicles, motorcycles, personal and household goods	128.5	134.7	130.6	132.1	133.5	132.3	0.1	-0.1	1.1	-0.9
6 Hotels and restaurants	123.3	127.1	134.8	139.4	140.2	137.3	0.1	-0.2	0.6	-2.1
7 Transport, storage and communications	125.9	126.4	132.4	135.0	138.4	138.7	0.3	0.0	2.5	0.2
8 Financial intermediation	117.7	117.2	120.4	123.7	125.3	126.5	0.1	0.1	1.3	1.0
9 Real estate, renting and business activities	130.9	132.3	143.2	147.8	155.0	154.8	0.4	0.0	4.9	-0.1
10 Public administration and defence; compulsory social security	137.2	136.9	140.5	140.8	143.7	146.9	0.5	0.5	2.1	2.2
11 Education	138.1	137.7	140.4	142.3	143.5	143.6	0.1	0.0	0.8	0.1
12 Health and social work	136.6	128.8	136.8	136.2	138.3	140.2	0.1	0.1	1.5	1.4
13 Other community, social and personal services	128.2	131.8	130.7	133.1	134.1	133.7	0.0	0.0	0.8	-0.3
ALL GROUPS	**128.0**	**128.8**	**135.0**	**136.0**	**137.2**	**138.9**	**1.2**	**1.7**	**0.9**	**1.2**

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

4. Demand and Output

Moderating growth pace

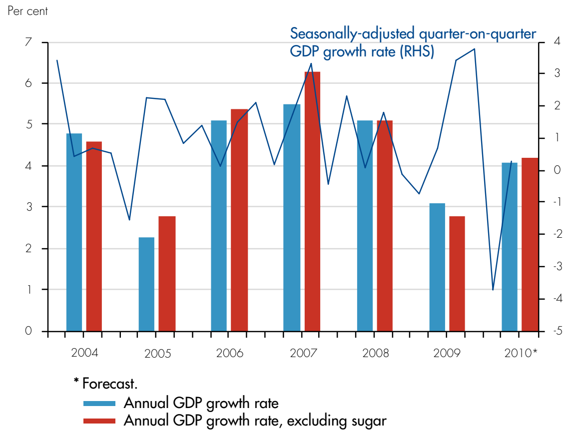
The economy continued to grow in the first half of 2010 but the pace of growth moderated relative to the second semester of 2009. Real output grew by 4.2 per cent in the first quarter of 2010 and at a lower rate of 3.8 per cent in the second quarter, compared to the corresponding quarters of 2009. These growth rates were, however, higher compared to the rates recorded in the first two quarters of 2009 when the domestic economy reeled under the effects of the global economic downturn. Short-term growth dynamics as revealed by seasonally-adjusted quarter-on-quarter growth rate showed a contraction of 3.7 per cent in the first quarter of 2010 and a growth of 0.3 per cent in the following quarter. In the first quarter, real output contracted in all strategic sectors of the economy except in the *Sugar* and *Real estate, renting and business activities* sectors, with the *Construction* and distributive trade sectors contracting at the highest pace. Output in *Textiles* as well as *Hotels and restaurants* sectors also contracted after expanding in the fourth quarter of 2009.

External demand was the main engine of growth in the first half of 2010 compared to domestic demand that grew at a moderate rate of 1.6 per cent. Real output of export-oriented enterprises expanded at a significant rate of 7.1 per cent in both the first and second quarters of 2010. Net exports, thus, rose at a robust pace compared to the contraction in the first and second semesters of 2009. Final consumption expenditure grew softly in the first and second quarters of 2010, reflecting a combination of tepid household consumption growth and a contraction of general government consumption in the second quarter after it rose marginally in the first quarter. Investment rebounded in the second quarter of 2010 following a contraction in the first quarter of 2010.

The main sectors contributing to growth in the first quarter of 2010 were *Manufacturing*, *Transport, storage and communications* and *Hotels and restaurants*. In the second quarter, *Construction*, *Manufacturing* and *Real estate, renting and business activities* sustained economic growth. The manufacturing sector grew close to its average rate in the first semester of 2010 and, within that sector, textiles output expanded by a flat rate of 1.3 per cent in the first two quarters of 2010. The *Transport, storage and communications* sector expanded robustly. *Hotels and restaurants*, supported by higher tourist arrivals, and the distributive trade sectors also grew at commendable rates. Growth rates in the *Agricultural*, *Financial intermediation* and *Real estate, renting and business activities* sectors slowed in both the first and second quarters of 2010. Construction activities contracted in the first quarter of 2010 but rebounded sharply in the second quarter.

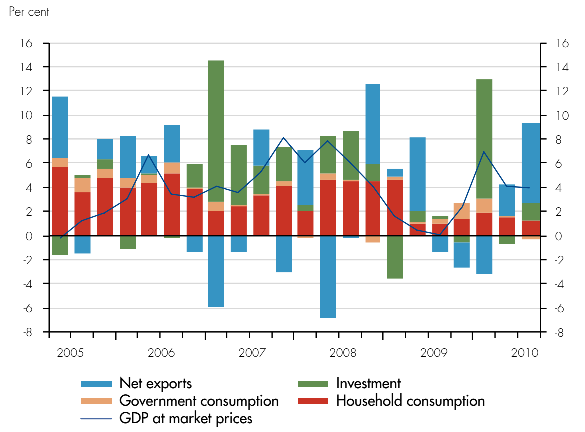
Subdued growth, which maintained the output gap – measured by the difference between actual and potential output – in negative territory, curbed domestic inflationary pressures. Chart 4.1 depicts annual and seasonally-adjusted quarterly GDP growth rates and Chart 4.2 shows the contribution of selected aggregate demand components to growth of GDP at market prices.

Chart 4.1: Real GDP Growth Rate



Source: CSO, Government of Mauritius.

Chart 4.2: Contribution of Selected Aggregate Demand Components to Growth of GDP at market prices



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

Risks to growth prospects

The global growth outlook had become more vulnerable with downside risks remaining elevated, as the IMF highlighted in its October 2010 World Economic Outlook. While underscoring the risks on both sides of its growth forecasts, the IMF estimated slightly higher world output growth for 2010 at 4.8 per cent relative to its previous forecast due to better economic performance in the first half of the year. It, however, revised its 2011 world growth projection marginally downward to 4.2 per cent.

Major revisions were made to US growth projections for both this year and the next. In contrast, the growth forecasts for the euro area were upgraded for 2010 as well as 2011 to 1.7 per cent and 1.5 per cent, respectively, while growth in the United Kingdom was revised upward for this year and marginally downward for 2011. Fiscal consolidation following the sovereign debt crisis in Europe and slow recovery in labour markets in most major advanced economies were a drag on the global economy. The IMF underlined that global recovery could slow in the near term but reaccelerate during 2011. However, growth in advanced economies might remain sluggish.

The domestic economic growth forecast for 2010 was revised downward by the Central Statistics Office (CSO) to 4.1 per cent as export-oriented activities were expected to moderate with softer external demand. Outward-oriented sectors remained vulnerable to growth prospects in Europe, particularly in the United Kingdom, the single most important market for Mauritius where the effects of the fiscal austerity measures could mitigate spending. Further, large volatility in currencies of main export markets could adversely affect short-term competitiveness of export-oriented enterprises. Growth of domestic demand was estimated to decline in 2010 compared to the preceding year, thus providing little impulse to economic activity. Quarterly growth could remain below trend for a prolonged period.

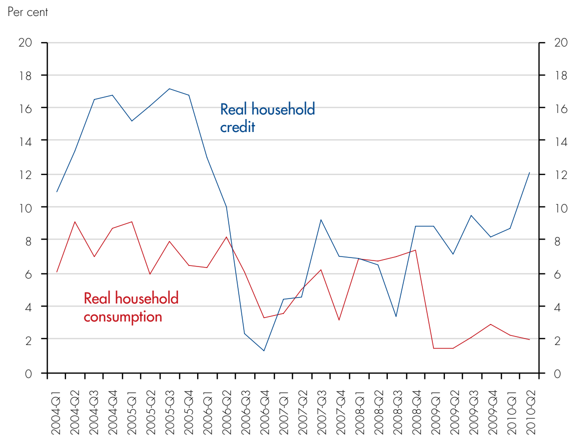
Concerns over listless recovery in main export markets weighed on business confidence and caused the private sector to be cautious in its investment plans. Lower growth in government consumption expenditure and tepid household consumption growth would restrain the expansion of final consumption growth. Looking ahead, sluggish growth in main export markets compounded by diminishing effects of public sector investment spending in infrastructure potentially raised downside risks to the domestic growth outlook.

4.1 CONSUMPTION

Final consumption expenditure growth moderated to 2.1 per cent year-on-year in the first quarter of 2010 and further to 1.4 per cent in the second quarter, compared to the vigorous growth pace of the last two quarters of 2009. The slowdown was mainly attributed to a marginal growth of 0.9 per cent in the first quarter, followed by a contraction of 1.2 per cent in the second quarter in general government consumption.

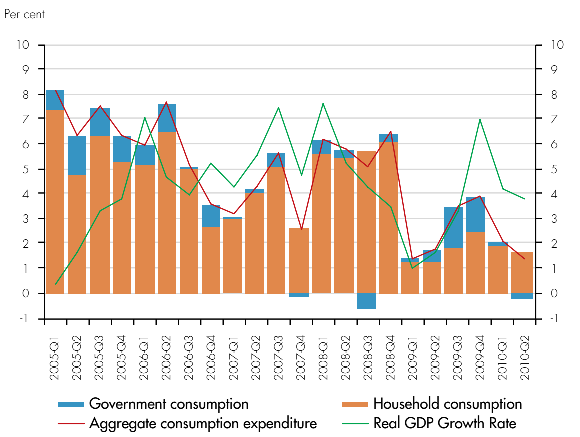
Household expenditure, which contributes around 75 per cent to total aggregate spending, grew at a stronger pace than government expenditure as economic expansion, a low inflation environment and rising bank credit to households upheld consumer confidence. It rose by 2.3 per cent in the first quarter of 2010 and slowed to 2.0 per cent in the second quarter , higher than in the first semester of 2009 but slightly lower than in the fourth quarter of 2009. Real bank credit to households, which eased in the last quarter of 2009, picked up in the first quarter of 2010 and rose sharply in the second quarter, as shown in Chart 4.3, reflecting improved consumer sentiment. Chart 4.4 illustrates the evolution of real GDP growth rate and contributions of household and government consumption in aggregate consumption growth.

Chart 4.3: Real Household Consumption and Credit Growth Rates



Note: The CPI is used to deflate nominal credit.
Sources: CSO, Government of Mauritius, and Bank of Mauritius.

Chart 4.4: Real GDP Growth Rate and Contributions of Household and Government Consumption in Aggregate Consumption Growth Rate



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

With efforts on the part of the fiscal and monetary authorities to sustain economic activity, both household and government expenditure are expected to progress positively in coming quarters.

Firmer household credit in the first half of 2010 was expected to support household spending. Overall, household consumption expenditure was estimated to grow by 2.5 per cent and government expenditure by 2.8 per cent in 2010, implying faster growth in the second half of 2010. The CSO estimated that final consumption expenditure would expand by 2.5 per cent in 2010, slightly lower than the 2009 rate of 2.6 per cent.

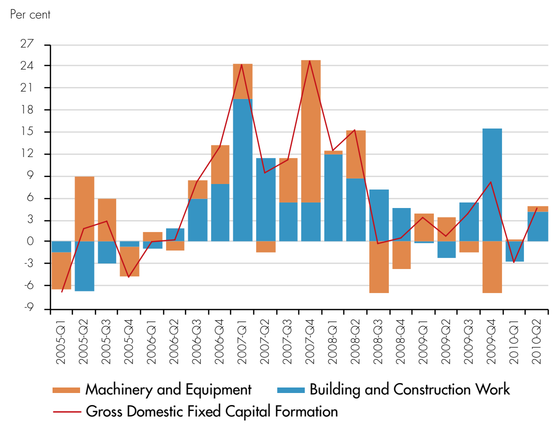
4.2 INVESTMENT

Investment spending contributed modestly to economic growth in the first half of 2010. It contracted by 2.5 per cent year-on-year in the first quarter of 2010 and grew by 4.7 per cent in the second quarter. A major deceleration befell real investment expenditure compared to the last quarter of 2009.

The contraction of 4.4 per cent in *Building and Construction* Work, the main component representing around two-third of capital outlay, stifled investment in the first quarter of 2010. The decline in construction activity was mostly attributed to completion of several public and private sector projects in the final quarter of 2009 as well as delays in the implementation of other public sector road infrastructure projects. The private sector completed most of its outstanding projects, namely construction of commercial and office buildings as well as renovation of hotels, and also exercised caution on investment plans following soft demand from main export markets. Activity was, however, buoyant in residential construction works. The other component of investment, namely *Machinery and Equipment,* grew at a lower year-on-year rate of 0.8 per cent in the first quarter of 2010 compared to solid growth in the first and final quarters of 2009.

The investment rebound in the second quarter of 2010 was largely driven by a recovery in *Building and Construction Work*. In particular, a robust pick-up in residential and non-residential construction activities propped up growth of *Building and Construction Work* to 7.0 per cent. Simultaneously, higher spending on *Machinery and Equipment*, more specifically on passenger cars which more than offset the contraction of spending on *Other* *transport equipment,* also bolstered investment growth. Passenger cars recorded positive growth in the first two quarters of the year after five consecutive quarters of contraction. Chart 4.5 depicts the growth rate of GDFCF and the contributions of the two components namely *Building and Construction Work* and *Machinery and Equipment* exclusive of aircraft and marine vessel to the GDFCF growth rate.

Chart 4.5: Contribution of Building and Construction Work and Machinery and Equipment exclusive of aircraft and marine vessel to the Growth Rate of GDFCF



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

The outlook for investment for the remaining quarters of 2010 appeared lacklustre. Clouded by uncertainties in view of the slow recovery in advanced countries, business sentiment was still low with regard to investment decisions. Investment, exclusive of the acquisition of aircraft and marine vessel, was expected to expand by 2.0 per cent in 2010, with the growth in public sector investment offsetting the contraction of 1.2 per cent in private sector investment. However, fiscal stimulus measures announced under the ERCP presented by the government in August 2010 as well as the easing of monetary policy in September 2010 may give a fresh boost to investment.

Table 4.1 gives details on real growth rates of components of aggregate demand.

4.3 FOREIGN TRADE AND EXTERNAL DEMAND

In the first two quarters of 2010, the balance of payments were characterised by a worsening merchandise trade deficit, resulting from a recovery in domestic demand that led to higher growth in imports of goods relative to exports, and significantly higher financial flows. The impact of the higher trade deficit on the current account balance was to some extent mitigated by higher surpluses on both the income and services accounts. As a percentage of GDP at market prices, the current account deficit widened to 8.7 per cent in the first semester of 2010, from 7.6 per cent in the corresponding period of 2009. In the financial account, notable inflows were registered in private long-term capital flows associated with net foreign direct investment and other investment due to increasing non-residents net balances with domestic banks.

Table 4.1: 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)

	2005	2006	2007	2008[1]	2009[1]	2010[2]	2009[1]				2010	
							Quarter 1	*Quarter 2*	*Quarter 3*	*Quarter 4*	*Quarter 1[1]*	*Quarter 2[3]*
Final consumption expenditure	7.1	5.5	3.9	6.0	2.6	2.5	1.4	1.8	3.5	3.9	2.1	1.4
of which:												
Household consumption	7.3	5.9	4.5	7.0	2.1	2.5	1.5	1.6	2.2	2.9	2.3	2.0
Government consumption	6.1	3.8	0.8	0.7	5.4	2.8	0.8	2.4	10.2	8.5	0.9	-1.2
Investment	-1.9	19.0	8.6	3.6	9.1	-2.8	3.5	1.0	-1.7	39.2	-2.5	4.7
Investment *(exclusive of the acquisition of aircraft and marine vessel)*	-1.6	5.5	17.0	7.2	5.0	2.0	n.a	n.a	n.a	n.a	n.a	n.a
Exports of goods and services	10.6	7.7	3.4	2.3	-4.8	13.6	-5.2	-10.7	-5.5	1.2	14.6	22.8
Imports of goods and services	6.4	9.3	2.0	1.8	-4.6	5.8	-15.7	-8.4	-1.8	7.1	10.9	9.1

[1] : Revised estimates. [2] : Forecast. [3] : First estimates. *n.a.: not available.*

Source: CSO, Government of Mauritius.

The current account deficit is expected to rise marginally above 9 per cent in 2010 owing to higher merchandise trade deficit as growth of imports, partly reflecting higher international prices, would outpace that of exports. Exports growth is foreseen to be restrained by muted growth in the United Kingdom and the euro zone. Capital inflows are expected to continue to finance the current account deficit.

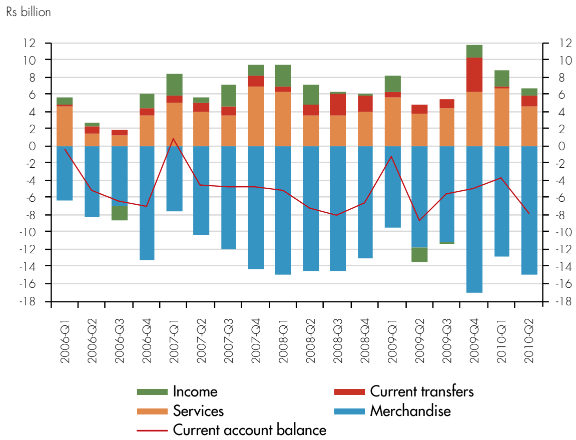
Current account

The current account posted a higher deficit of Rs11.9 billion in the first six months of 2010 compared to Rs9.9 billion in the first half of 2009. Reflective of the higher impulse from economic activity, imports grew at a more robust pace relative to exports in the first semester of 2010. As a consequence, the merchandise trade deficit of the current year deteriorated further to Rs27.6 billion, from Rs21.3 billion in the first half of 2009.

The surplus on the services account reached Rs11.7 billion, representing a substantial increase of 24.8 per cent from Rs9.3 billion registered in the first semester of 2009. The higher surplus is largely attributed to positive balances on the *Travel* and *Other Services* accounts. Net travel receipts grew by 5.8 per cent in the first half of 2010, boosted by strong growth in tourist arrivals. Other services account posted a net surplus of nearly Rs1 billion as against a net deficit of Rs0.4 billion in the first semester of 2009, a turnaround resulting mainly from continuing growth in other business services.

The income account posted a significantly higher surplus of Rs2.7 billion in the first two quarters of 2010, compared to the surplus of Rs344 million recorded in the first semester of 2009. The lower surplus on current transfers was mainly on account of the drop in net private transfers inflows. The components of the current account are shown in Chart 4.6.

Chart 4.6: Components of the Current Account



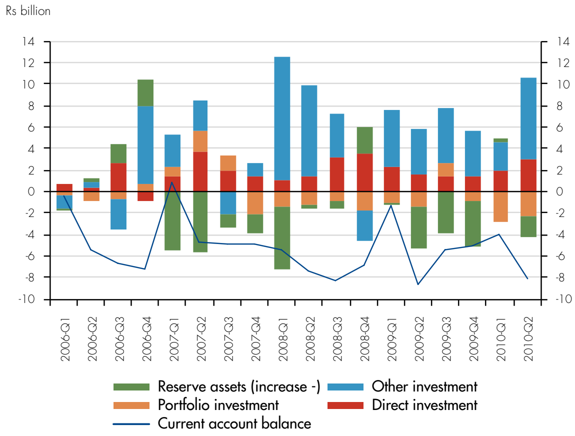
Capital and financial account

The larger surplus of Rs8.5 billion on the financial account in the first semester of 2010, with net inflows of Rs1.2 billion compared to the first half of 2009, was due to significant inflows in foreign direct investment (FDI) and other investment, which helped finance the growing current account deficit. Private long-term net capital inflows associated with FDI rose by 24.2 per cent relative to the first semester of 2009. FDI into the Mauritian economy gathered momentum attaining Rs7.6 billion in the first two quarters of 2010, with the bulk of inflows mostly due to large investments by foreign parent companies into their domestic subsidiaries. Mauritian direct investment abroad rose to Rs2.5 billion in the first semester of 2010.

Portfolio investment recorded higher net outflows of Rs5.1 billion in the first semester of 2010, compared to net outflows of Rs2.2 billion in the first semester of 2009, explained mainly by large acquisitions of assets abroad made by resident private administrators of equity. Reflective of positive global investors' sentiment, non-residents' net purchases on the domestic stock market amounted to Rs0.8 billion, a shift from net sales of Rs1.2 billion in the corresponding period of 2009. In contrast, non-residents' disinvestment in domestic money market instruments reached Rs0.2 billion. Transactions in *Other Investment* account of the balance of payments showed net inflows of Rs10.2 billion in the first semester of 2010, up from Rs9.5 billion in the first semester of 2009.

The country's overall balance of payments for the first two quarters of 2010, as measured by the change in reserve assets excluding valuation changes, recorded a lower surplus of Rs1.7 billion compared to Rs4.1 billion in the first two quarters of 2009, as shown in Table 4.2. The financing of the current account deficit is depicted in Chart 4.7.

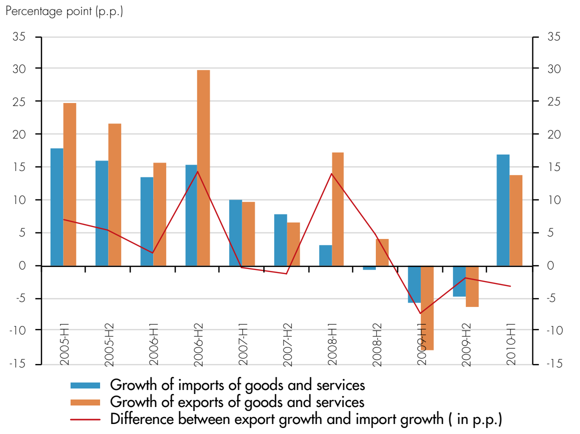
Chart 4.7: Financing of the Current Account



Net external demand

The favourable trend in net exports of goods and services in nominal terms, visible since the first semester of 2009, reversed in the first semester of 2010. The marked strengthening of growth in nominal imports of goods and services by 17.0 per cent compared to the lower expansion of 13.9 per cent in nominal exports of goods and services explained the turnaround. Chart 4.8 depicts the external trade turnover.

Chart 4.8: External Trade Turnover



Exports

After contracting successively since the first semester of 2006, nominal exports of goods recorded an increase of 8.6 per cent to Rs31.5 billion in the first semester of 2010 relative to the corresponding period last year. Excluding ships' stores and bunkers, domestic exports – that is, total exports of goods adjusted for re-exports (freeport exports) – registered a lower growth of 5.9 per cent. According to provisional estimates from the CSO, the expansion in nominal exports would be mainly on account of volume growth since exports prices remained rather stable despite the appreciation of the rupee vis-à-vis the euro and Pound sterling.

The commodity breakdown showed exports of *Food and live animals* rose by 5.3 per cent mainly due to higher sugar proceeds as sugar production was

Table 4.2: Balance of Payments Summary

Rs million

	2009[1]		2010[2]
	Semester 1	Semester 2	Semester 1
Current Account	**-9,883**	**-10,706**	**-11,880**
Exports (f.o.b)	28,976	32,808	31,461
Imports (f.o.b)	-50,233	-60,774	-59,027
of which: aircrafts/marine vessels	-	*2,862*	-
Trade balance	-21,257	-27,966	-27,566
Services, net	9,349	10,698	11,672
of which:travel, net	*12,564*	*11,822*	*13,294*
Income, net	344	1,334	2,652
Current transfers, net	1,681	5,228	1,362
Capital and Financial Account	**7,292**	**4,598**	**8,403**
Capital account, net	-5	-54	-115
Direct investment, net	4,076	2,948	5,063
Portfolio investment, net	-2,225	389	-5,061
Other investment, net	9,545	9,320	10,205
Balance of Payments Surplus (-)/ Deficit (+)	-4,099	-8,005	-1,689
Net Errors and Omissions	**2,591**	**6,108**	**3,477**

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

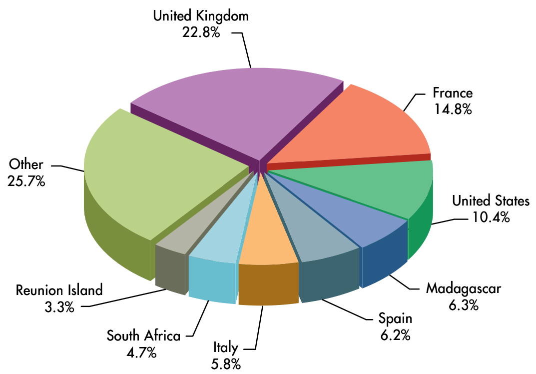
Figures may not add up to totals due to rounding.

geared more towards higher-value added refined sugar. Proceeds from export-oriented enterprises increased by 6.4 per cent, albeit the decline registered in the value of export of *Articles of apparel and clothing accessories*. Exports of *Jewellery, goldsmiths' and silversmiths' wares* picked up significantly in the first semester of 2010.

Europe remained the key market for Mauritius during the first semester of 2010, although its share of total exports of goods fell to 63.8 per cent, from 67.4 per cent in the first half of 2009. Demand from the United Kingdom fell steeply with a drop in its share of total demand for exports from 30.0 per cent in the first semester of 2009 to 22.4 per cent, but the UK economy remained the most important market. The other main destinations for exports were France, United States, Italy, Madagascar and Spain, as shown in Chart 4.9.

Total nominal exports of goods to the United States, France, Spain and South Africa rose by 21.1 per cent, 32.0 per cent, 17.4 per cent and 5.7 per cent, respectively, compared to the first semester of 2009. On the other hand, exports to United Kingdom declined significantly by 21.1 per cent resulting in the drop in its share of total exports. Exports to regional markets, that is, Seychelles and Reunion Island also declined by 11.1 per cent and 6.1 per cent, respectively.

Chart 4.9: Main Export Destinations in the First Semester of 2010



Source: CSO, Government of Mauritius.

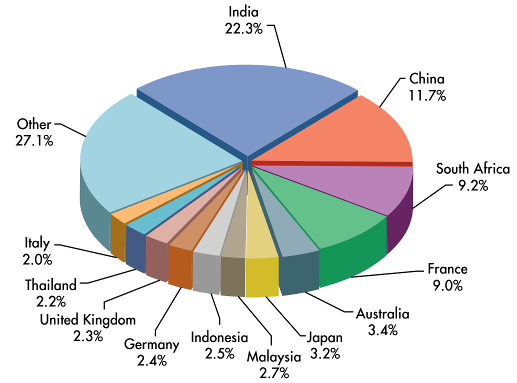
Imports

Total nominal imports of goods rose by 16.5 per cent to Rs62.8 billion during the first semester of 2010 relative to the first semester of 2009. Estimates of the price-volume breakdown of nominal imports for the second quarter of 2010 would indicate an increase of around 5.5 per cent in import prices and a rise of 11 per cent in volume terms. The rise in imports cut across various sectors of the economy and reflected both a pick-up in domestic economic activity as well as a rise in international commodity prices.

The higher import bill stemmed mainly from an increase of 48.3 per cent for *Mineral fuels, lubricants and related materials*, 12.8 per cent for *Manufactured goods classified chiefly by material* and 11.7 per cent for *Machinery and transport equipment*. The expansion in the import bill for *Mineral fuels, lubricants and related products* hinged upon a higher average price per barrel of crude oil on world market which stood at US$78.4 in the first semester of 2010 relative to a lower price of US$51.3 in the first semester of 2009. The rise in *Manufactured goods classified chiefly by material* was driven mainly by increases in the imports of pearls, precious and semi-precious stones, reflective of higher external demand for our jewellery products, and iron and steel owing to a pick-up in construction. Imports of *Machinery and transport equipment* went up largely due to higher imports of road vehicles and other machinery.

The Asian continent accounted for 53.0 per cent of total imports in the first semester of 2010, compared to 48.6 per cent in the corresponding semester of 2009. Imports originated mostly from India, China, France, South Africa, Japan and Australia. The main sources of imports in the first semester of 2010 are shown in Chart 4.10.

Chart 4.10: Main Sources of Imports in the First Semester of 2010



Source: CSO, Government of Mauritius.

BOX 2: External Indicators

		June 2009	June 2010
		Rs million	
Gross external debt[1]	as at end	27,200	33,385
External debt service	year ended	5,486	4,890
Exports of goods	year ended	66,889	64,269
Exports of goods and services	year ended	136,411	141,703
Imports of goods and services	year ended	168,122	174,865
Gross Official International Reserves[2]	as at end	63,957	70,105
GDP at market prices	year ended	269,944	282,155
Broad Money Liabilities	as at end	283,613	302,944

Indicators	*Per cent*	
I. Solvency		
Gross external debt to GDP	10.1	11.8
Gross external debt to exports of goods	40.7	51.9
Gross external debt to exports of goods and services	19.9	23.6
External debt service to exports of goods	8.2	7.6
External debt service to exports of goods and services	4.0	3.5
II. Reserve Adequacy		
Reserves to imports of goods and services	38.0	40.1
Reserves to Broad Money Liabilities	22.6	23.1
Reserves to gross external debt	235.1	210.0

[1] *Gross External Debt outstanding as at end of period comprises central government, public corporations, monetary authorities and private sector.*
[2] *Gross Official International Reserves as at end of period comprise gross foreign assets of the Bank of Mauritius, reserve position in the IMF and the foreign assets of Government.*

As at end-June 2010, the country's gross external debt reached Rs33.3 billion, that is, 21.9 per cent higher relative to the outstanding level a year earlier. The expansion was led mainly by an increase in external debt of the monetary authorities equivalent to Rs4.0 billion on account of the Special Drawing Rights allocations made by the IMF, a rise in private sector external debt of Rs1.1 billion and an increase in public corporations' debt of Rs1.9 billion. Central government external debt, however, recorded a reduction of Rs1.1 billion, largely on account of valuation gain.

The ratio of external debt to GDP at market prices rose from 10.1 per cent as at end-June 2009 to 11.8 per cent as at end-June 2010. Similarly, the ratio of gross external debt outstanding to exports of goods as well as exports of goods and services went up, indicating a higher debt burden in relation to earnings. The ratio of debt service to total exports fell as at end-June 2010 as a result of significantly lower principal payments relative to the growth rate of exports which slowed down for the period ended June 2010.

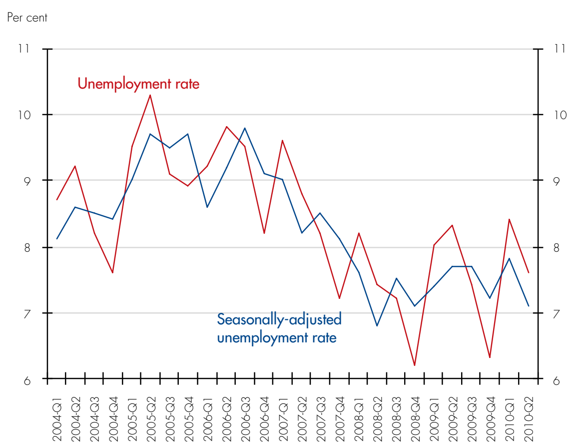
With regards to reserve adequacy indicators, an improvement was noted in two ratios for June 2010 relative to June 2009 except for the ratio of reserves to gross external debt. The latter ratio dropped by 23.7 percentage points on account of significant external loan disbursements throughout the year ended June 2010 compared to the growth in reserves.

4.4 LABOUR MARKET

The labour market showed a mixed picture in the first semester of 2010, with the unemployment rate increasing sharply from 6.3 per cent in the fourth quarter of 2009 to 8.4 per cent in the first quarter of 2010 but declining to 7.6 per cent in the second quarter. On a seasonally-adjusted basis, the unemployment rate also rose to 7.8 per cent in the first quarter of 2010 but dropped to 7.1 per cent in the second quarter. Chart 4.11 shows the evolution of the quarterly unemployment rate.

Gains in employment in the domestic economy on a year-on-year basis were broad-based notwithstanding some job losses in the *Manufacturing* and *Public administration and defence; compulsory social security* sectors. Quarter-on-quarter data showed that most sectors created jobs in the second quarter of 2010, while employment in the remaining sectors was flat. The highest increase in employment was recorded in the *Wholesale and retail trade; repair of motor vehicles, motorcycles and personal household goods* followed by *Construction* and *Transport, storage and communications*. Employment in the export-oriented enterprises fell marginally in the first half of 2010, with the *Wearing apparel* group recording the largest drop.

Chart 4.11: Quarterly Unemployment Rate



Source: CSO, Government of Mauritius.

The unfavourable gap between labour productivity and average compensation of the whole economy narrowed significantly in 2009 compared to the previous year. Labour productivity and average compensation grew by 2.6 per cent and 6.6 per cent, respectively, in 2009 compared to increases of 1.4 per cent and 10.1 per cent, respectively, in 2008. Largely as a result of the restructuring of enterprises, labour productivity gains in the textile sector were higher than the increase in labour costs in 2009: unit labour cost grew at a rate of 6.9 per cent in 2009 compared to an increase of 7.7 per cent in labour productivity. Further, multifactor productivity in the textile sector rose by 4.5 per cent in 2009, enhancing gains in competitiveness. For the whole economy, however, multifactor productivity fell by 0.9 per cent.

Labour market outlook

The pace of expansion in key export sectors, namely textile and tourism, if sustained could impact favourably on employment in these sectors. Further, the acceleration in public infrastructure as announced in the ERCP could add more jobs in the construction sector. The relative commendable performance of the sectors catering to domestic demand and emerging sectors of the economy could lead to more job creation that could outweigh any potential job losses in outward-oriented sectors owing to subdued economic prospects in the main export markets. Further, the ERCP is expected to provide any retrenched workers with sufficient income protection, to promote new activities and employment opportunities and to impart required training.

5. Monetary and Financial Developments

5.1 MONETARY AND CREDIT DEVELOPMENTS

The declining trend in credit growth was reversed in the first half of 2010, reflecting the pick-up in economic activity and better economic prospects. Money growth remained subdued, although it picked up in May and June 2010. After falling as from the end of 2008, household and corporate credit soared in the first semester of 2010. Further, credit extension was well spread among both inward and outward-oriented sectors of the economy. The construction sector secured a dominant share of bank credit followed by the tourism sector.

Monetary base

The monetary base contracted marginally by 0.5 per cent between the end of December 2009 and the end of June 2010, compared to a decline of 2.1 per cent registered in the corresponding previous period.[4] Reserve deposits held by other depository corporations (ODCs) at the Bank expanded by 12.4 per cent, lower than the growth rate of 22.7 per cent in the first half of 2009.

The drop in monetary base was mainly driven, on the sources side, by the contraction of 0.1 per cent in the net foreign assets of the Bank, as against the significant increase of 13.0 per cent in the first semester of 2009. Domestic claims by the Bank went up mainly as a result of an increase in net claims on central government.

Broad Money Liabilities

Broad Money Liabilities (BML) grew at a slower pace in the first semester of 2010 compared to the same period of 2009.[5] BML rose by 2.2 per cent between the end of December 2009 and the end of June 2010 compared to 3.4 per cent registered in the first semester of 2009. Chart 5.1 shows movements in the monetary base and BML. The growth rates of BML and credit to private sector and the rate of inflation are depicted in Chart 5.2.

Chart 5.1: Growth Rates of Monetary Base and Broad Money Liabilities

(Percentage change over corresponding month of previous year)

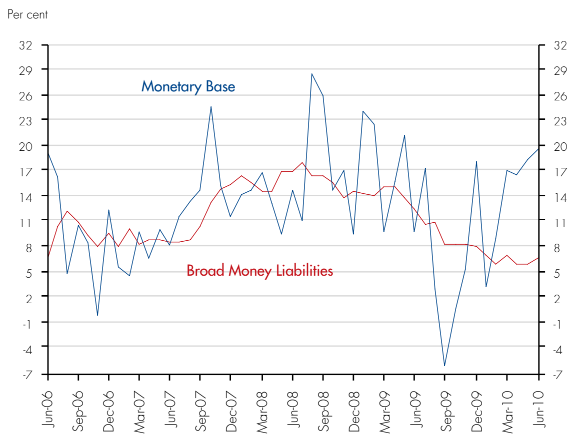
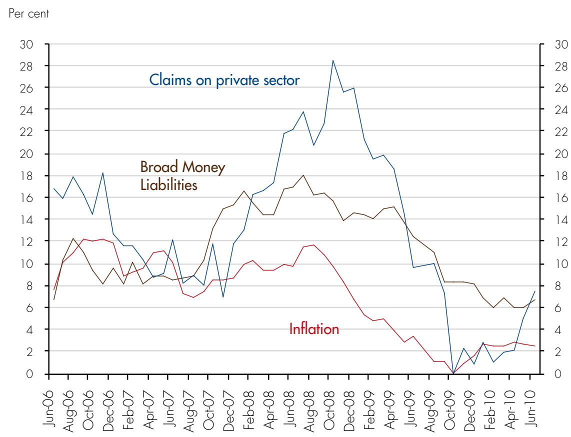


Chart 5.2: Growth Rates of Broad Money Liabilities and Credit to Private Sector and Inflation

(Percentage change over corresponding month of previous year)



Components of Broad Money Liabilities

Subdued growth of BML was mainly due to a drop in narrow money liabilities and lower growth in quasi-money liabilities. Narrow money liabilities fell by 2.7 per cent in the six months to June 2010, compared to a rise of 1.4 per cent for the six

[4] *The monetary base, also termed high-powered money and 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 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.*

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

months to June 2009, largely reflecting lower demand for currency by the public.

Quasi-money liabilities, with a share of around 80 per cent in BML, rose by 3.4 per cent in the first semester of 2010 compared to 3.9 per cent recorded in the first semester of 2009. The moderation in the growth of quasi-money liabilities reflected mainly the contraction of rupee time deposits at the rate of 0.2 per cent, as against an increase of 3.0 per cent in the first semester of 2009. Rupee savings deposits grew by 7.1 per cent compared to 5.0 per cent in the first semester of 2009. Foreign currency deposits rose by 3.9 per cent, marginally lower than the increase of 4.0 per cent in the first half of 2009. The fall in the growth rate of time deposits could imply depositors preferred more liquid savings deposits than less liquid and longer term deposits. The third component of BML, Securities other than shares, increased by 9.0 per cent in the six months to June 2010 compared to 1.4 per cent in the first half of 2009. Table 5.1 provides details on the components of BML, domestic credit and net foreign assets.

Sources of Broad Money Liabilities

Net foreign assets

The net foreign assets of depository corporations declined by 3.2 per cent in the first semester of 2010 compared to a rise of 8.5 per cent in the same period of 2009, mainly as a result of decreases in both net foreign assets held by the Bank and by ODCs. The net foreign assets of the Bank fell by 0.1 per cent while those of ODCs dropped by 8.3 per cent.

Domestic credit

Domestic credit by depository corporations expanded at a faster pace of 6.2 per cent in the first semester of 2010 as against a small increase of 1.0 per cent in the corresponding period of 2009, mainly as a result of higher credit to the private sector.

Net credit to budgetary central government grew by 4.9 per cent in the first half of 2010, lower than the rise of 6.0 per cent recorded in the corresponding period of 2009.

Reflecting domestic economic recovery, credit to the private sector by ODCs rose by 6.5 per cent contrasting with the marginal contraction of 0.01 per cent recorded in the first semester of 2009. Demand for loans picked up sharply in the first quarter of 2010 and remained above past years' trend in the second quarter, as suggested by data on monthly credit reports drawn from the Mauritius Credit Information Bureau.

The contributors to the 2.2 per cent increase in BML in the first semester of 2010 were domestic credit with 5.8 percentage points – of which credit to other sectors contributed 5.0 percentage points and net claims on central government 0.8 percentage point – which was partly offset by the negative contributions of net foreign assets of 1.1 percentage points and 2.5 percentage points of Other items net.

Table 5.1: Broad Money Liabilities, Domestic Credit and Net Foreign Assets

Rs million

	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10
Broad Money Liabilities	**252,007**	**259,834**	**274,314**	**278,029**	**283,613**	**281,387**	**296,480**	**297,312**	**302,944**
Narrow Money Liabilities	45,981	48,344	53,186	50,788	53,920	54,760	60,904	58,847	59,262
Currency with public	*12,746*	*13,451*	*16,156*	*14,800*	*14,683*	*15,013*	*17,153*	*15,845*	*15,905*
Transferable deposits	*33,234*	*34,893*	*37,030*	*35,987*	*39,237*	*39,747*	*43,751*	*43,002*	*43,357*
Quasi-Money Liabilities	204,487	210,000	219,592	225,802	228,137	225,884	234,805	237,659	242,841
Savings deposits	*73,444*	*73,615*	*75,850*	*79,777*	*79,604*	*81,072*	*84,477*	*87,452*	*90,513*
Time deposits	*83,164*	*87,685*	*89,409*	*90,139*	*92,051*	*92,697*	*94,251*	*93,113*	*94,073*
Foreign currency deposits	*47,878*	*48,700*	*54,334*	*55,886*	*56,482*	*52,115*	*56,077*	*57,093*	*58,255*
Securities other than shares	1,540	1,490	1,535	1,439	1,556	742	772	806	842
Domestic Credit	**258,704**	**258,438**	**272,426**	**274,420**	**275,223**	**273,468**	**277,412**	**280,145**	**294,721**
Credit to private sector	205,533	208,166	225,468	224,939	225,439	223,411	227,569	229,303	242,449
Net Foreign Assets	**83,628**	**80,050**	**89,520**	**88,509**	**97,146**	**93,271**	**105,124**	**103,539**	**101,733**

Sector-wise distribution of credit by banks

Bank credit to the private sector expanded by 7.1 per cent in the first half of 2010, higher than the increase of 2.1 per cent in the corresponding period of 2009. The inclusion of ABC Banking Corporation Ltd in banks – formerly a non-bank deposit-taking institution – led to the inclusion of its outstanding credit, which contributed to a one-off increase in overall bank credit to the private sector. Even adjusting for this increase, credit to the private sector expanded by 6.0 per cent in the first semester of 2010.

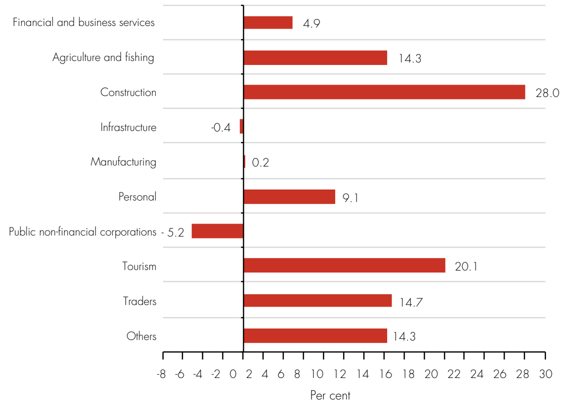
Construction, tourism, traders and agriculture and fishing sectors drove the increase in bank credit, representing respective shares of 28.0 per cent, 20.1 per cent, 14.7 per cent and 14.3 per cent to total credit expansion. The extension of credit to the construction sector increased by Rs3.7 billion, to tourism by Rs2.6 billion, to traders by Rs1.9 billion, to the agricultural and fishing sector by Rs1.9 billion, and to the personal sector by Rs1.2 billion. Outstanding credit fell by Rs0.7 billion for public non-financial corporations and by Rs0.05 billion for infrastructure.

Reflecting improved consumer confidence and economic outlook, bank credit to households grew at a solid pace in the first half of 2010. Household credit, which includes loans for housing as well as for other purposes, expanded at a robust 7.9 per cent, compared to a tepid rise of 2.4 per cent in the first semester of 2009. The growth rate of bank loans to households for housing purposes, which attained a trough in December 2009, picked up sharply in the first half of 2010, partly driven by favourable price developments in the construction sector. Credit extended to the personal sector also grew strongly by 6.9 per cent in the first semester of 2010 as against 2.0 per cent in that of 2009.

In terms of currency composition of credit, between the end of December 2009 and the end of June 2010, rupee loans and overdrafts rose by 5.8 per cent while foreign currency loans increased at a higher rate of 14.9 per cent which maintained the trend observed in the first semester of 2009 with respective growth rates of 1.2 per cent and 6.6 per cent.

The distribution of the change in bank credit to the private sector over the period December 2009 to June 2010 is shown in Chart 5.3.

Chart 5.3: Distribution of the Change in Bank Credit to the Private Sector – end-December 2009 to end-June 2010



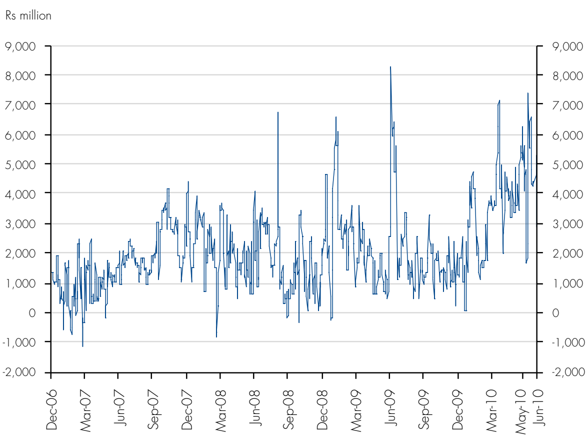
5.2 MONEY MARKET

Liquidity management

Excess reserves of banks averaged Rs3.8 billion in the first semester of 2010, higher than the Rs2.7 billion prevailing in the first semester of 2009, with a trough of Rs1.1 billion on 2 February 2010 and a peak of Rs7.3 billion on 10 June 2010, mainly due to net redemption of government securities and a relatively low growth in bank credit. Out of the Rs2.7 billion proceeds of swap transactions conducted by the Bank, Treasury Bills for Rs1.5 billion were issued on tap during the period under review. Chart 5.4 depicts excess reserves in the banking sector.

The Bank initiated a host of monetary operations to manage the high level of excess reserves. Three Special Deposits Facility operations were conducted – namely, in March, April and June 2010 – for a period of 14 to 21 days for an aggregate amount of Rs6.7 billion. In June 2010, one reverse repo transaction was conducted for a period of seven days for Rs1.0 billion. Bank of Mauritius Bills were also issued in May 2010 for 28-day maturity for a total of Rs700 million. The minimum Cash Reserve Ratio was raised by 0.5 percentage point to 5.0 per cent in June 2010, which helped sterilise around Rs1.4 billion of excess liquidity.

Chart 5.4: Banks' Daily Excess Reserves

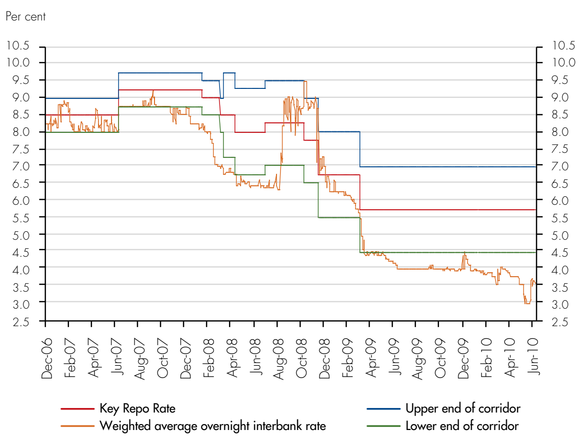


Interbank interest rates

Interest rates on the interbank money market were largely influenced by the level of excess liquidity in the banking system. The weighted average overnight interbank interest rate remained well below the lower bound of the corridor set at 4.50 per cent, ranging from a low of 3.00 per cent to a high of 4.25 per cent in the first semester of 2010. Interest rates for short notice and term money market transactions hovered in the range of 3.25 per cent to 5.50 per cent.

The evolution of the overnight weighted average interbank interest rate is depicted in Chart 5.5.

Chart 5.5: Overnight Weighted Average Interbank Interest Rate

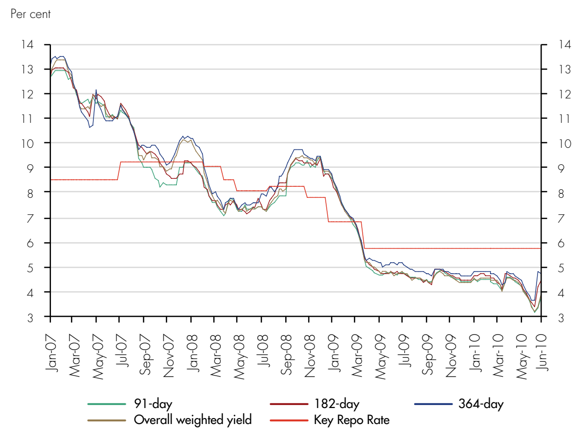


Yields on Government debt instruments

Yields on Government of Mauritius Treasury Bills for the three maturities generally followed a downward path except in April 2010 when they went up temporarily. With high liquidity in the banking system, market participants bid aggressively at primary auctions for risk-free Government papers which were mostly oversubscribed with an average bid-cover ratio of 2.32.[6]

The monthly weighted average yield on 91-day, 182-day and 364-day Bills fell by 107 basis points, 63 basis points and 47 basis points to 3.30 per cent, 3.99 per cent and 4.29 per cent, respectively, in June compared to January 2010. Bidding preference was skewed towards the 91-day maturity showing investors' preference for short-term instruments. Chart 5.6 illustrates movements in Treasury Bills yields.

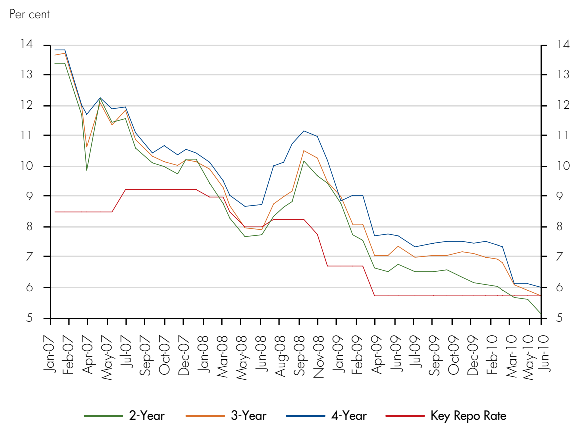
Chart 5.6: Yields on Treasury Bills



Auctions for Treasury Notes and Five-Year Government Bonds were, on average, oversubscribed. Interest rates on the 2-Year, 3-Year and 4-Year Treasury Notes, which were fixed at 5.50 per cent, 5.75 per cent and 6.00 per cent per annum since September 2009, remained unchanged over the period January to June 2010. However, the weighted yields of bids accepted for the three maturities fell continuously: the weighted yields for the 2-Year, 3-Year and 4-Year tenors dropped by 50 basis points, 112 basis points and 137 basis points to 5.61 per cent, 5.90 per cent and 6.13 per cent, respectively, in June compared to January 2010. Chart 5.7 depicts movements in yields on Treasury Notes.

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

Chart 5.7: Yields on Treasury Notes

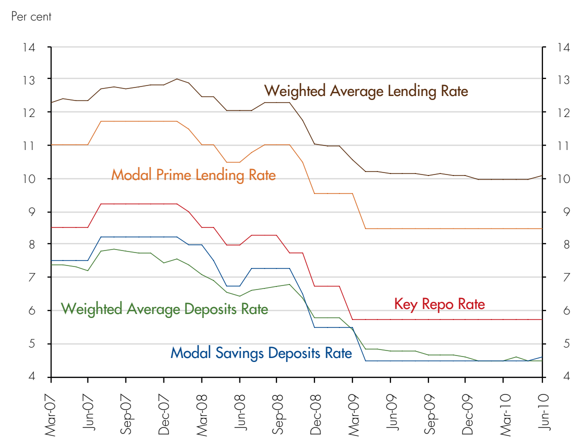


The coupon rate for the issue of Five-Year Government of Mauritius Bonds dropped to 6.69 per cent per annum at the auction held on 2 June 2010, from 8.08 per cent per annum for the preceding auction held in November 2009. The weighted yield declined to 7.05 per cent from 8.73 per cent in November 2009.

5.3 INTEREST RATES

The savings deposits rates (SDR) and prime lending rates (PLR) remained in the range of 4.00-4.75 per cent and 8.05-9.00 per cent, respectively, in the first semester of 2010. The modal SDR and PLR were also unchanged at 4.50 per cent and 8.50 per cent. The weighted average deposits rate as well as the weighted average lending rate remained range-bound at around 4.5 per cent and 10.0 per cent, respectively. Deposits and lending interest rates as well as the key Repo Rate are shown in Chart 5.8.

Chart 5.8: Key Repo Rate and Deposits and Lending Rates



The real rate of interest on savings deposits was positive throughout the first semester of 2010. It rose steadily from 2.0 per cent at the end of December 2009 to 2.8 per cent at the end of June 2010, as the inflation rate declined continuously.

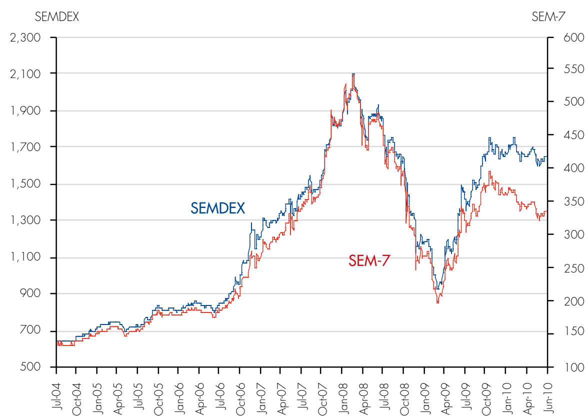
5.4 STOCK MARKET

The stock market retreated in the first semester of 2010, as shown in Chart 5.9, due to the spill-over effects of the debt crisis that hit Europe on the performance of companies exporting to European economies. The SEMDEX and SEM-7 fell by 0.23 per cent and 7.20 per cent, respectively. The SEM-7 reached a low of 320.43 on 26 May while the SEMDEX attained a low of 1,591.20 on 27 May.

Earnings reports, for hotels stocks in particular, indicated that local companies felt the pinch of the crisis not only from dwindling exports but also from a stronger rupee against the euro, both of which gnawed at the profitability levels of hotels' stocks. The SEMDEX gained some support from non-blue chips stocks as some companies benefited from large infrastructural projects.

With the crisis buffeting the financials of the hotels sector, foreigners consolidated their investments mainly in banks and insurance stocks. Net foreign investments stood at Rs765.73 million in the first half of 2010, with foreigners buying Rs1,895.15 million but selling Rs1,129.42 million worth of stocks.

Chart 5.9: SEMDEX and SEM-7



Source: Stock Exchange of Mauritius.

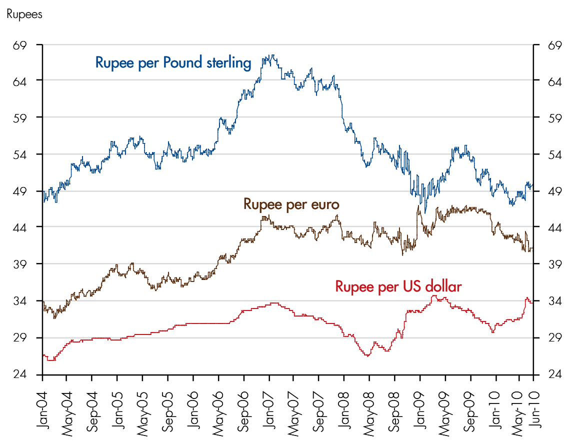
5.5 FOREIGN EXCHANGE MARKET AND EXCHANGE RATES

The exchange rate of the rupee continued to reflect movements of major currencies on international markets. The extent of excess supply in the domestic foreign exchange market narrowed, mitigating the appreciating trend of the rupee. The rupee weakened vis-à-vis the US dollar from January to May 2010 against the latter's broad-based recovery on international markets. The rupee depreciation accelerated in May 2010, with the rupee reaching a low of Rs34.41 against the US dollar as the latter gained ground on international markets. Thereafter, the rupee recouped part of its losses against the US dollar on weak indicators for the US economy and return of confidence in the euro area.

The rupee appreciated vis-à-vis the euro, amidst significant periodic volatility, driven by the euro's weakness on international markets. The consolidated selling rate of the rupee moved between Rs40.30 and Rs44.69 against the euro. The rupee appreciated against the Pound sterling in the first quarter of 2010 and touched a high of Rs46.80 on 22 March 2010 as slow growth prospects in the UK economy and political uncertainty weighed on the Pound. However, the rupee weakened against the UK currency in the second quarter of 2010 as the Pound sterling was supported by reassuring UK data as well as fiscal consolidation measures put forward by the new coalition government. On a point-to-point basis between 4 January and 30 June 2010, the rupee depreciated against the US dollar by 6.0 per cent but appreciated vis-à-vis the euro and the Pound sterling by 9.9 per cent and 0.4 per cent, respectively.

The evolution of the rupee exchange rate against the US dollar, the Pound sterling and the euro is shown in Chart 5.10.

Chart 5.10: Exchange Rate Movements



Activity on the domestic foreign exchange market

The Bank did not intervene on the spot foreign exchange market in the first half of 2010, reflecting the relatively comfortable foreign exchange liquidity position of banks. Banks maintained a daily average overbought foreign exchange liquidity position of US$60.3 million during the first half of 2010 compared to US$69 million in the period July to December 2009.

Activity on the interbank foreign exchange market increased to a monthly average of US$37.2 million in the period January to June 2010 compared to an average of US$31.5 million in the period July to December 2009.

Transactions on the domestic foreign exchange market remained buoyant. Total turnover of spot and forward transactions amounted to US$3,113.6 million, representing a daily average of US$25.3 million during the period January to June 2010 compared to a daily average of US$25.8 million for the period July to December 2009.

Under the Bank of Mauritius short-term foreign currency swaps facility, which was introduced in December 2009 in order to reduce volatility and inject liquidity in the market given supply pressures in the market, the Bank conducted foreign exchange swaps for an equivalent of US$87.2 million in the period January to June 2010.

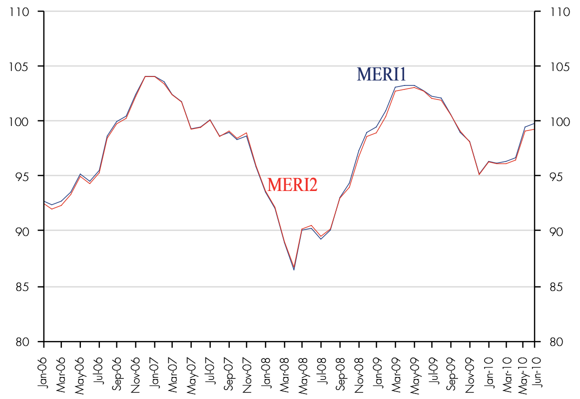
Movements in MERIs and REER

On a nominal effective basis, both MERI1 and MERI2 depreciated in the six months to June 2010. MERI1, which uses the currency distribution of trade as weights, depreciated by 3.4 per cent while MERI2, which includes currency distribution of trade combined with that of tourism receipts as weights, depreciated by 3.0 per cent.

Chart 5.11 shows the evolution of the MERI1 and MERI2.

Chart 5.11: MERI1 and MERI2

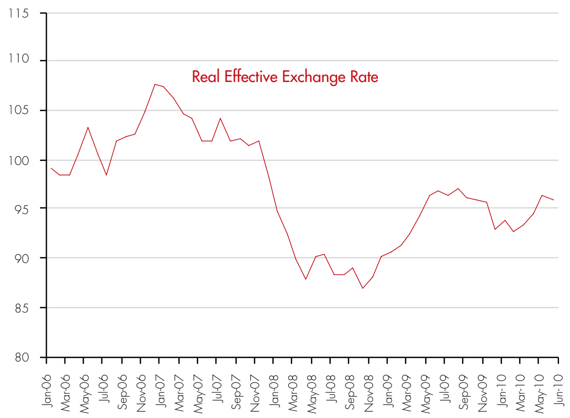
(Base year: Jan-Dec 2007=100)



The Real Effective Exchange Rate (REER), with weights based on trade distribution with countries that make up at least 80 per cent of total trade and adjusted for price differentials between the domestic economy and its trading partners, showed a depreciation of 2.3 per cent in the first half of 2010. Chart 5.12 depicts the movements of the REER.

Chart 5.12: Real Effective Exchange Rate

(Base year: Jan-Dec 2007=100)



6. The Outlook for Inflation

Rising international commodity prices earlier in 2010 increased inflationary pressures in many economies, but had limited impact on core inflation. Thereafter, subdued pressure on international commodity prices kept inflation generally low. Going forward, persistent excess capacity and low demand pressures at the global level are expected to mitigate increases in international commodity prices. Protracted recovery of the world economy currently heralds low inflationary pressures at the global level for some more time to come.

Recent projections by international organisations reveal that commodity price pressures could emanate more from the supply side than from global demand. The October 2010 US Energy Information Administration Short-Term Energy Outlook projected oil prices to rise gradually as world oil demand picked up. The spot price of West Texas Intermediate crude oil was estimated to rise from an average of US$77 per barrel in 2009 to US$78 per barrel in 2010 and further to US$83 per barrel in 2011. Upward pressures on oil prices from rising oil demand in emerging and developing economies are expected to be dampened by soft demand from advanced economies.

The IMF, in its World Economic Outlook released in October 2010, forecasts inflation in advanced economies to converge to around 1.3 per cent in 2011 compared to 1.4 per cent in 2010. In emerging and developing economies, the IMF projects inflation to ease to around 5.2 per cent in 2011, from 6.2 per cent in 2010.

6.1 RISKS TO THE INFLATION OUTLOOK

Inflation, computed using both the year-on-year and the twelve-month average methodologies, has bottomed out and remained range-bound in Mauritius. The gradual rise in inflation is forecast to continue over the policy-relevant horizon to reach around 4 per cent in the baseline scenario, a level below the pre-crisis average.

The uncertainties surrounding the inflation outlook are conditioned by assumptions on both external and domestic factors. Through its influence on international commodity prices as well as external demand conditions, the pace of global economic activity is an important factor that would drive inflation dynamics. As of now, market indicators suggest that international commodity prices would be quite stable in the short term. On the other hand, inflation has been high in major emerging economies, some of which, such as India and China, are main sources of imports for Mauritius.

On the domestic front, real output growth is likely to stay below potential for several quarters ahead. The negative output gap is, thus, expected to persist and exert downward pressure on inflation. The increase in downside risks to growth basically emanate from slower recovery in main export markets with likely adverse effects on net exports. Consequently, given the linkages between outward- and inward-oriented economic activities, weak export sector activity combined with diminishing effects of the exceptional high public spending are expected to be a drag on domestic demand. Also, despite strong recovery in household credit, household consumption growth is expected to remain below the pre-crisis average for several quarters. Concurrently, prevailing uncertainty is not helping private sector investment spending.

Though credit growth has been picking up since the beginning of 2010, monetary developments do not, as yet, constitute a threat to the maintenance of low inflation over the short to the medium term.

Nonetheless, there are upside risks to the short- to medium-term inflation outlook. International commodity prices could overrun short-term expectations should the pace of global economic recovery rise sooner rather than later during 2011. Mauritius, being a major importer of commodities, would be more exposed to such a scenario. This scenario, however, seems more plausible in the medium term as global economic conditions normalise. Higher inflation forecast in major trading partner countries would also help shaping up the domestic inflation path. Domestic wage pressures remain quite mild but rising producer prices for manufactured products reveal some pressure on prices. Further, the combination of higher growth of unit labour cost and loss in overall productivity could generate upward pressure on underlying inflation over the medium term, particularly for consumer products manufactured locally. The increase in freight rates in August 2010 would potentially be passed on to consumers in the form of higher prices of various food and non-food products, thus inducing some volatility in the CPI in the short term. Overall, several factors are expected to exert some upward pressures on inflation over the forecast horizon.

The recent appreciation of the rupee in effective terms should provide some buffer to increases in global commodity prices. However, it has been observed that some prices usually tend to be sticky downwards and the extent to which economic agents factor such appreciation in their pricing behaviour would be instrumental in weighing the near-term inflation outlook.

Inflation fan chart

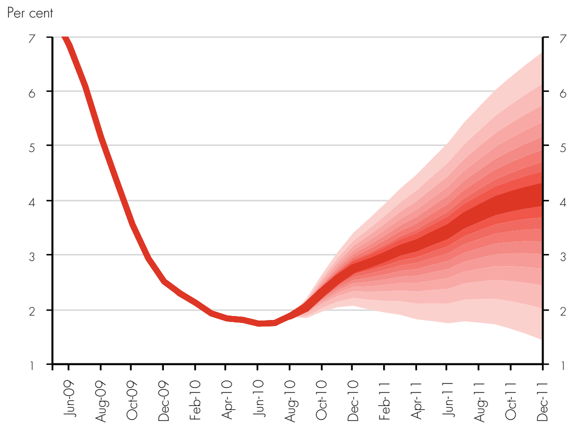
The forecasts of the twelve-month average inflation up to December 2011 are shown in Chart 6.1 which also depicts the degree of uncertainty around the central projection. The central forecast is denoted by the darkest band in the chart and the risks surrounding it are represented by lighter bands. The central projection covers 10 per cent of the forecast and each successive pair of bands are drawn to cover a further 10 per cent probability until 90 per cent of the probability distribution is covered. Therefore, there is a 10 per cent probability that actual inflation will be in the central and darkest band. The bands widen as the time frame is extended, indicating increasing uncertainty around the forecast.

Inflation is forecast to rise based on the assumptions that make up the baseline scenario, as illustrated in the fan chart. Assumptions are made regarding the external economic environment, domestic economic conditions, regulated prices, and the fiscal stance. It is assumed that oil and food prices will increase on account of a gradual pick-up in global demand which will be transmitted to domestic prices. Local food production is assumed not to witness any setback, implying no supply shock to prices of these products. The fiscal stance is assumed unchanged and the output gap is estimated to remain in negative territory notwithstanding that it might shrink as growth picks up gradually over the forecast period. Inflation will also rise as the base effects drop out.

The inflation fan chart shows a moderate inflation environment up to around the second quarter of 2011. Potential risks to the inflation outlook thereafter stem from external sources mostly. The central inflation projection goes up to reach around 4 per cent by December 2011 but with a larger degree of uncertainty around the forecast. The widening of the bands on both sides of the central projection as from mid-2011 represents the substantial uncertainties clouding the inflation forecasts given lack of visibility on external as well as domestic demand conditions that would potentially affect inflation pressures.

The outlook has changed slightly in comparison to the previous forecast published in the Inflation Report of April 2010. In particular, the central projection of inflation has declined slightly and there is a drop of more than a percentage point in the upper forecast for December 2011. The narrowing of the probability distribution around the central forecast in December indicates slightly lower uncertainty regarding domestic demand conditions, costs pressures and international commodity prices.

Chart 6.1: Inflation Fan Chart



Inflation expectations

The seventh Inflation Expectations Survey, which the Bank carried out in June 2010, revealed that 84.5 per cent of respondents expected prices to go up, while 4.4 per cent of respondents anticipated a decrease in prices over the next twelve months. 11.1 per cent of respondents expected that prices would remain unchanged over the next twelve months. The mean inflation rate expected by the respondents was 3.1 per cent for December 2010, 3.6 per cent for June 2011 and 4.3 per cent for December 2011. Moreover, external factors were viewed by 84.4 per cent of respondents as the primary source of inflation in Mauritius.

BOX 3: Inflation Expectations

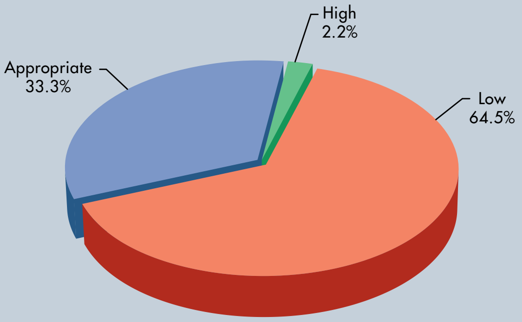
The seventh Inflation Expectations Survey was carried out in June 2010. Out of the 50 stakeholders chosen from the financial and real sectors of the economy, 45 responded to the survey. Consequently, the findings are based on these 45 responses.

Findings of the Inflation Expectations Survey

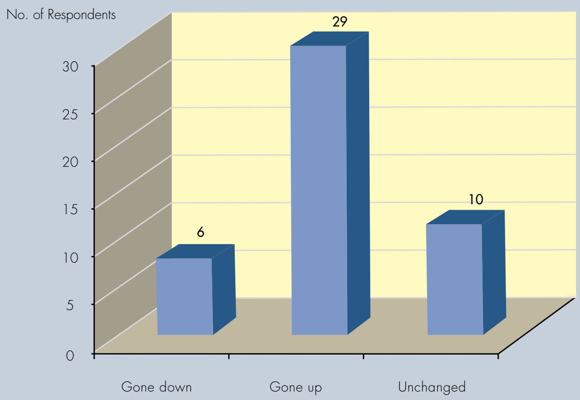
1. With respect to how respondents perceived the 1.8 per cent inflation rate for the twelve months ended May 2010, 64.5 per cent of respondents considered this rate as being low while 33.3 per cent of respondents judged it to be appropriate. 2.2 per cent of respondents viewed that this rate was high.
2. With regard to their best description of the movement of prices over the preceding twelve months, 64.5 per cent of respondents indicated that prices of goods and services had gone up while 13.3 per cent were of the opinion that prices had gone down. 22.2 per cent of respondents viewed that prices were unchanged.
3. Concerning the three main factors that accounted for the prevailing inflation pattern, *external factors* were viewed by 84.4 per cent of respondents as accounting for the primary source of inflation in Mauritius. 37.8 per cent of respondents viewed *fall in aggregate demand* as the second most important factor and *monetary policy* was regarded by 42.2 per cent of respondents as the third most important factor.
4. In relation to movement of prices over the next twelve months, 84.5 per cent of respondents expected prices to go up, while 11.1 per cent of respondents expected that prices would remain unchanged. 4.4 per cent of respondents anticipated a decrease in prices.
5. Respondents were also requested to provide their expectations of the rate of inflation for the twelve months ending December 2010, June 2011 and December 2011.
   - *December 2010:* 57.8 per cent of respondents were expecting inflation to be 3 per cent or less while 33.3 per cent of respondents were expecting inflation to be between 3.1 per cent and 4 per cent. 8.9 per cent of respondents were anticipating inflation to be higher than 4 per cent.
   - *June 2011:* 28.9 per cent of respondents were expecting inflation to be 3 per cent or below and 40.0 per cent of respondents were expecting inflation to range from 3.1 per cent to 4 per cent. 31.1 per cent of respondents were anticipating inflation to be above 4 per cent.
   - *December 2011:* 22.2 per cent of respondents were expecting inflation to be 3.0 per cent or less while 28.9 per cent of respondents were expecting inflation to be within 3.1 per cent and 4 per cent. 48.9 per cent of respondents were anticipating inflation to be higher than 4 per cent.
6. The mean inflation rates expected by respondents were 3.1 per cent, 3.6 per cent and 4.3 per cent respectively, for the twelve months ending December 2010, June 2011 and December 2011.

Graphical Representation of Responses

QI.1. Inflation for the twelve-month period ended May 2010 was 1.8 per cent. Do you perceive this rate to be ...?



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

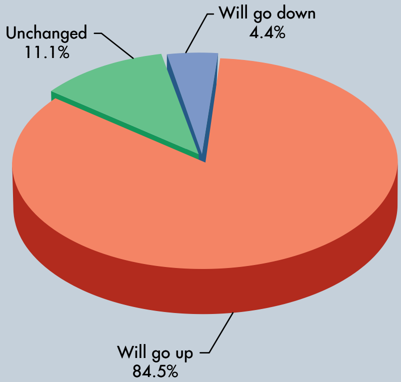


QI.3. Which of the following factors account for the current inflation pattern?

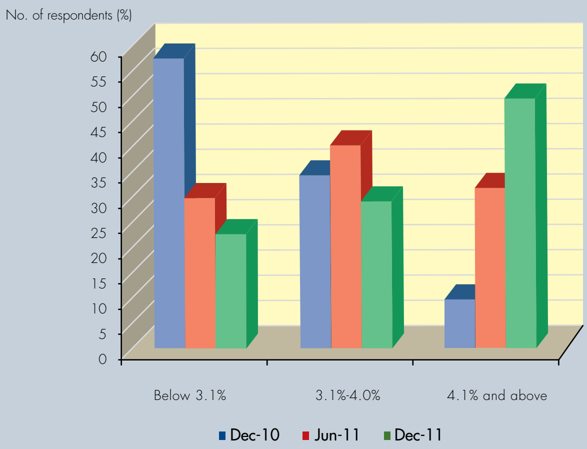
(Ranking in order of importance starting with 1 for most important.)

Factors	1	2	3
Fiscal policy	3	3	5
Monetary policy	0	12	19
External factors	38	3	4
Wage policy	0	10	6
Fall in aggregate demand	3	17	8
Other	1	0	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 2010; (b) June 2011; and (c) December 2011?



'The reported survey findings represent the views of respondents and not necessarily those of the Bank of Mauritius.

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