BANK OF MAURITIUS

Inflation Report

April 2011 | Issue No. 6

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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 31 December 2010 unless otherwise stated.

Acknowledgement

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The Report was cleared by the Publications Review Committee of the Bank of Mauritius.

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 publications.ead@bom.intnet.mu.

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List of Acronyms

APM	Automatic Pricing Mechanism
BDI	Baltic Dry Index
BoE	Bank of England
BML	Broad Money Liabilities
CIF	Cost, Insurance and Freight
CIPS	Chartered Institute of Purchasing and Supply
CPI	Consumer Price index
CSO	Central Statistics Office
ECB	European Central Bank
EIA	Energy Information Administration (of the US Department of Energy)
EU	European Union
FAO	Food and Agriculture Organisation
FFPI	FAO Food Price Index
GDFCF	Gross Domestic Fixed Capital Formation
GDP	Gross Domestic Product
ICE	Intercontinental Exchange
IES	Inflation Expectations Survey
IMF	International Monetary Fund
IPI	Import Price Index
ISM	Institute for Supply Management
MERI	Mauritius Exchange Rate Index
MPC	Monetary Policy Committee
NML	Narrow Money Liabilities
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
PPS	Petroleum Pricing System
REER	Real Effective Exchange Rate
SEMDEX	Stock Exchange of Mauritius Index
STC	State Trading Corporation
VIX	Volatility Index
WEO	(IMF's) World Economic Outlook
WRI	Wage Rate Index

1. Overview

1.1 International Developments

Global growth turned out better than expected in the second half of 2010. In its January 2011 World Economic Outlook (WEO) Update, the IMF revised world growth for 2010 up by 0.2 percentage point to 5.0 per cent. Growth remained uneven across regions, with buoyant growth in emerging economies and subdued economic conditions in advanced economies. Looking ahead, latest global manufacturing and services surveys point to sustained recovery in the world economy. The IMF, which had upgraded its forecast for 2011 to 4.4 per cent in the January 2011 WEO Update, maintained this outlook in the April 2011 WEO.

After losing momentum during the middle of 2010, the US economy regained some traction, supported by consumer spending as the US Fed decided to implement a second round of quantitative easing worth US$600 billion in November 2010. The Euro zone continued to expand in the second half despite renewed turbulence in peripheral economies. Largely driven by German growth, the Euro zone may consolidate its recovery in 2011 although the risks posed by large sovereign debt in peripheral regions will still be present. In the UK, a number of uncertainties surround the growth outlook on account of planned austerity measures to be implemented in 2011. Among emerging economies, China and India are expected to continue posting robust growth rates. However, concerns about the global economy have increased lately on heightened tensions in the Middle East and North Africa and the recent events in Japan.

Global inflation started to rise in the second half of 2010 on account of higher food, energy and other commodity prices. Inflation in advanced economies remained modest but is firming while inflation in emerging economies is already at high levels as real economic activity has been expanding rapidly. Recent geopolitical disturbances have increased the risks to the inflation outlook.

1.2 Domestic Developments

The domestic economy progressed at a faster pace than expected in 2010, with growth estimated at 4.4 per cent compared to 3.1 per cent in 2009. This performance underlined the rebound in growth led by resurgent external demand in the third and fourth quarters of 2010 in particular. Sectors that drove growth in the second semester of 2010 include *manufacturing, hotels and restaurants, construction, real estate, renting and business activities, financial intermediation and transport, storage and communication*. On the demand side, final consumption expenditure grew by 2.7 per cent while investment, exclusive of aircraft and marine vessel, increased by 3.7 per cent in 2010.

While inflation remained tame in the third quarter of 2010, it picked up noticeably in the fourth quarter, mainly as a result of higher food and energy prices on international markets. Headline inflation, which had steadily declined for more than two years and reached a trough of 1.7 per cent in June 2010, accelerated to 2.9 per cent in December 2010. Taking into consideration latest developments with regard to food and energy prices, inflation risks remain on the upside for 2011.

1.3 Monetary Policy

On the international front, divergent conditions in advanced and emerging economies resulted in different paths for monetary policy. While most central banks in advanced economies focused on stimulating the economy by keeping monetary policy loose, several central banks in emerging economies, and Asia in particular, started raising interest rates to keep inflation under control. Other liquidity management tools such as cash reserve requirements were also used in efforts to curtail the effects of capital inflows on the economy.

In Mauritius, the Key Repo Rate was cut by 100 basis points in September 2010 and left unchanged in December 2010.

Monetary policy decisions

At its meeting held on 27 September 2010, the Monetary Policy Committee (MPC) of the Bank noted that global growth momentum appeared to have moderated. Downside risks to the growth outlook had intensified amid increasing concerns of the sovereign debt crisis in the peripheral Euro zone economies spreading to core European countries while fiscal deficit and public debt in the United States were at worrying levels. Increasingly, possibilities of fiscal consolidation and austerity measures in UK and the Euro zone could depress the nascent fragile global recovery while the impact of earlier fiscal stimulus seemed to be fading. Data in emerging economies continued to suggest robust growth while those in advanced economies were disappointing, pointing towards slower growth.

On the domestic front, economic conditions in the first semester of 2010 had been better than expected, but real output growth was forecast to cool down in the second semester. Given the bleak global economic outlook, particularly in key traditional markets, domestic business sentiment worsened and uncertainty about economic prospects grew. Year-on-year GDP growth rate in the first quarter of 2010 was estimated at 3.7 per cent, but seasonally-adjusted quarter-on-quarter data suggested that the domestic economy was struggling. While discussing the inflation outlook, the MPC noted that domestic inflation had clearly bottomed out and was likely to start rising again to around 4.0 per cent by June 2011 on a no-policy change basis. The MPC, however, believed that inflation, at around 4.0 per cent over the following few quarters, would remain below trend.

The MPC weighed the risks to the growth and inflation outlook and debated alternative interest rate scenarios. With low inflation prevailing at that time and prospects in key traditional markets weak, the MPC unanimously decided that it had enough monetary policy space to cut the Key Repo Rate by 100 basis points to 4.75 per cent but cautioned that it stood ready to respond if the outlook for inflation and growth were to change. The move was also seen as providing further support to the on-going economic restructuring and opportunity for improving productivity and national competitiveness.

At its following meeting on 6 December 2010, the MPC noted that the global economy had evolved as expected at its previous meeting. While the underlying economic recovery was still progressing, the growth momentum had clearly dampened in the United States, Japan and several European economies, mainly laden by weak private demand. In its October 2010 World Economic Outlook, IMF had marginally upgraded its 2010 world GDP growth estimate but downgraded the outlook for 2011. The most recent data available at that time were mixed. While national accounts data suggested advanced economies were slowing, forward-looking indicators like purchasing managers' indices and confidence indicators suggested that these economies were not as weak as earlier anticipated.

The domestic economy was gradually recovering but growth appeared likely to remain below trend. However, the most recent data available up to October 2010 had surprised on the upside with the economy performing fairly well despite difficult international economic conditions. The MPC considered the slow pace of expansion of domestic credit to the productive sectors, in particular, the export manufacturing sector. Several MPC members observed that the prevailing bank liquidity overhang needed to be channelled in a way conducive to boosting economic activity.

The MPC took note of the latest wage developments and also assessed the impact of the recent budgetary measures as well as rising food and energy prices on the price level and economic growth. Several MPC members remarked that inflation might have risen faster than anticipated at the September 2010 meeting. However, with global economic prospects appearing uncertain, the balance of risks did not warrant a change in the Key Repo Rate. The MPC unanimously voted to maintain the Key Repo Rate unchanged at 4.75 per cent.

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
27 September 2010	100 basis points Cut	4.75	Unanimous
6 December 2010	Unchanged	4.75	Unanimous

2. The External Environment

During the second half of 2010, the global economy continued to consolidate, with better-than-expected growth in advanced economies and continued buoyant growth in emerging economies while forward-looking indicators in manufacturing and services improved gradually. In its January 2011 WEO Update, the IMF further upgraded global growth in 2010 by 0.2 percentage point to 5.0 per cent and revised the 2011 global growth forecast up by 0.2 percentage point to 4.4 per cent. This forecast was left unchanged in the latest release of the WEO in April 2011. However, uncertainties have increased recently due to higher food and energy prices that raised inflationary pressures. Geopolitical tensions in the Middle East and North Africa put further pressure on oil prices while the recent events in Japan raised some concerns about the near term global growth outlook.

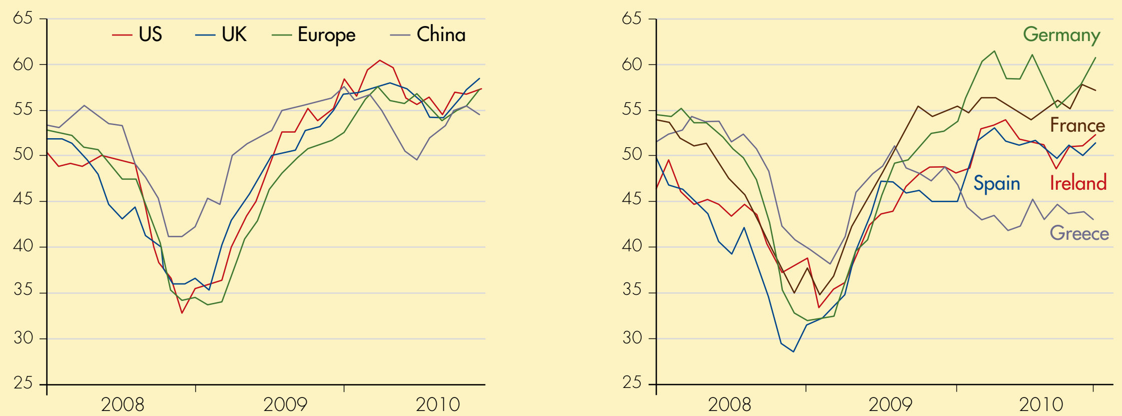
Chart 2.1 depicts the evolution of Global Manufacturing Purchasing Managers' Index (PMI).

2.1 Global Economic Activity

The US economy grew at an annualised rate of 3.1 per cent in the fourth quarter of 2010 compared to 2.6 per cent in the third quarter, partly driven by consumer spending while the labour market was showing increasing signs of recovery. Consumer spending increased by 4.0 per cent in the fourth quarter, climbing at the fastest rate since the fourth quarter of 2006 as households drew down on their savings to fund part of their purchases. The labour market was slower to improve but, with 121,000 jobs added in December, the unemployment rate edged down to 9.4 per cent in that month from 9.5 per cent in June. The housing sector remained weak as the market continued to be burdened by large stocks of unsold homes and households continued to experience difficulties in repaying mortgages. While forward-looking indicators improved – the ISM manufacturing index was up to 58.5 in December from 56.2 in June and the ISM non-manufacturing index rose to 57.1, from 53.5 in June – the US fiscal position continued to raise some worries with net liabilities swelling more than US$2 trillion in fiscal year 2010. According to the IMF's April 2011 WEO, the US economy is projected to grow by 2.8 per cent and 2.9 per cent in 2011 and 2012, respectively.

Real activity in the Euro zone continued to expand in the second half of 2010 as GDP grew by 0.4 per cent and 0.3 per cent in the third and fourth quarters of 2010, respectively. However, there were still considerable differences between the core and peripheral economies. While Germany was expanding at an impressive pace, Greece and Ireland were suffering deep recessions and economic growth was stagnating in Spain. Growth in Germany was led by a pick-up in manufacturing on account of buoyant external demand. Output growth in the Euro area services sector, however, slowed by the end of 2010 in part due to bad

Chart 2.1: Global Manufacturing Purchasing Managers' Index*



*A reading over 50 indicates expansion of activity in the manufacturing sector.
Source: Courtesy of Thomson Reuters.

weather in the Northern regions. Tough labour market conditions persisted in the second half of the year and the unemployment rate reached 10.1 per cent in October, the highest since the launch of the euro, before dropping to 10 per cent in December 2010. The Markit Euro zone Manufacturing PMI reached an eight-month high of 57.1 in December suggesting improved conditions going forward but concerns over Euro area sovereign debt still remained. In its April 2011 WEO, the IMF projects the Euro zone economy to grow by 1.6 per cent in 2011 and 1.8 per cent in 2012.

The British economy grew by a quarter-on-quarter rate of 0.7 per cent in the third quarter of 2010 but took a step back in the fourth quarter when real GDP contracted by 0.5 per cent, mostly due to the unusually severe winter weather, which impacted on construction activity and on the services sector. Manufacturing output, however, expanded by 1.1 per cent in the fourth quarter of 2010, supported by higher domestic and overseas demand. The labour market remained subdued in the second half, with the unemployment rate increasing to 7.9 per cent in December 2010, from 7.7 per cent in June. Consumer sentiment continued to be weak on worries about personal finances and job prospects. The December Markit/CIPS headline manufacturing PMI rose to 58.7, its highest since September 1994, indicating some impetus to the economy. The IMF projects the British economy to grow by 1.7 per cent in 2011 and 2.3 per cent in 2012 in its April 2011 WEO.

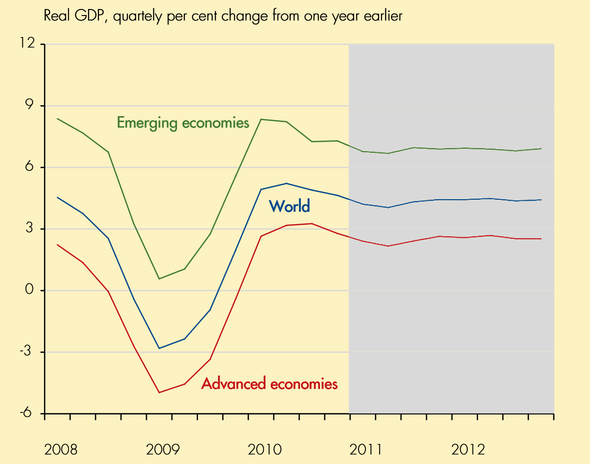
Emerging economies continued to register robust growth in the second half of 2010 but were increasingly concerned with the rapid surge in prices and excessive capital inflows. China's GDP growth unexpectedly quickened to 9.8 per cent year-on-year in the fourth quarter of 2010, from 9.6 per cent in the third quarter. Growth in private consumption firmed as a result of households' higher income levels while growth in credit maintained robust expansion. To prevent the economy from overheating, the central bank raised banks' required reserves six times during 2010. The HSBC Manufacturing PMI for China, which stood at 54.4 in December, pointed to marked improvement in this sector. The Indian economy also continued to grow at a relatively rapid pace in the second half of 2010, supported by upbeat services sector growth and enhanced agricultural output. Indian GDP expanded by 8.9 per cent and 8.2 per cent in the third and fourth quarters of 2010, respectively.

Table 2.1: Real GDP Growth Rates in Selected Economies

								Per cent
	Q1-2010	**Q2-2010**	**Q3-2010**	**Q4-2010**	**2009**	**2010**	**2011**	**2012**
	Quarter-on-quarter Growth Rates, seasonally adjusted						*Projections*	
World output					**-0.5**	**5.0**	**4.4**	**4.5**
Advanced economies					**-3.4**	**3.0**	**2.4**	**2.6**
of which								
United States	0.9	0.4	0.6	0.8	-2.6	2.8	2.8	2.9
Euro Area	0.4	1.0	0.4	0.3	-4.1	1.7	1.6	1.8
Japan	1.5	0.5	0.8	-0.3	-6.3	3.9	1.4	2.1
United Kingdom	0.2	1.1	0.7	-0.5	-4.9	1.3	1.7	2.3
	Q1-2010	**Q2-2010**	**Q3-2010**	**Q4-2010**				
	Year-on-year Growth Rates							
Emerging market and developing economies					**2.7**	**7.3**	**6.5**	**6.5**
Sub Saharan Africa					2.8	5.0	5.5	5.9
Developing Asia					7.2	9.5	8.4	8.4
of which								
China	11.9	10.3	9.6	9.8	9.2	10.3	9.6	9.5
India	8.6	8.9	8.9	8.2	6.8	10.4	8.2	7.8

Sources: IMF's April 2011 World Economic Outlook; offices of national statistics' websites, central banks' websites and OECD website.

Chart 2.2: Global Growth Outlook



Source: IMF's April 2011 World Economic Outlook.

According to the IMF's April 2011 WEO, China is expected to grow by 9.6 per cent in 2011 and 9.5 per cent in 2012 while India is forecast to grow by 8.2 per cent and 7.8 per cent in 2011 and 2012, respectively. Chart 2.2 and Table 2.1 show actual and projected real GDP growth rates.

2.2 Financial Markets

During the second half of 2010, conditions in global financial markets remained generally accommodative while concerns over the vulnerable banking sector and fiscal positions of some European countries lessened. Equity prices rose strongly in main developed economies and risk premium eased while market volatility, as reflected by the Volatility Index (VIX), fell to pre-crisis levels.

Stock markets

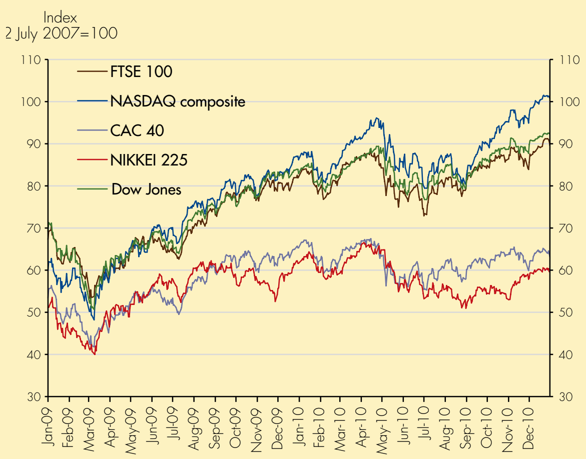
Global equity markets were on a general upward trend in the second half of 2010 on the back of heightened risk appetite as economic data releases around the globe pointed to recovery in major economies. An easing of European debt fears on successful auctions in Euro zone peripheral countries and new global banking rules that soothed worries about government funding further helped major stock markets. In December, a marked improvement in sentiment, as investors shrugged off the impact of Chinese tightening measures on global growth and bet on a strengthening of the US recovery, sparked a broad advance in equities.

The Chicago Board Options Exchange volatility index, a key measure of US stock market volatility, followed a general downward trend during the period under review. It moved slightly higher in August and November 2010 on the back of concerns that debt problems in the Euro zone peripheral countries might spread throughout the region but these fears were subsequently attenuated. Bond yield spreads of some Euro zone peripheral countries over Germany widened on funding uncertainties but firm commitments taken by EU policymakers and smooth bond auctions helped quell financial markets jitters.

Chart 2.3: Stock Market Volatility Index (VIX)

Source: Chicago Board Options Exchange.

Chart 2.4: Equity Indices of Selected Major International Stock Markets



Source: Thomson Reuters.

For the period July to December 2010, FTSE, Nasdaq, Dow Jones Industrial Average, CAC-40 and NIKKEI gained 22.8 per cent, 26.3 per cent, 19.0 per cent, 14.0 per cent and 11.3 per cent, respectively. Emerging stock markets followed the same uptrend with the JSE, Bombay SENSEX and Hang Seng moving up by 23.5 per cent, 17.1 per cent, and 14.4 per cent, respectively. Shanghai SEC increased by 18.3 per cent despite monetary policy tightening by the People's Bank of China.

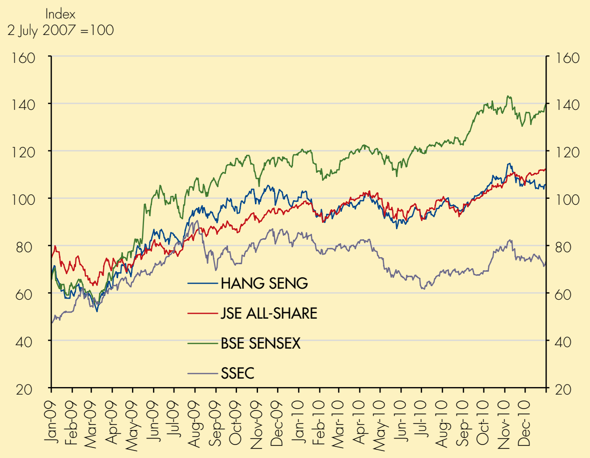
Exchange rate

The US dollar reversed its uptrend against the euro during most of the second half of 2010 on the back of concerns about the sustainability of US economic growth and expectations of further monetary policy easing, effectively announced by the Fed in November 2010. Moreover, the G20 pledge to shun competitive currency devaluation was interpreted as a green light to sell the US dollar. However, the US dollar managed to recoup some of its earlier losses in the last two months of 2010 on the back of positive US data releases that boosted confidence in the US recovery.

The euro strengthened against the US dollar during most of the second semester of 2010, supported by smooth bond auctions in the highly indebted Euro zone countries, better economic data releases and the conclusion that most Euro zone banks passed the stress tests. After a brief retreat in August 2010, the euro regained strength in September 2010 on the release of solid data from China that boosted investor confidence in the global economic recovery, thereby encouraging money flows into the euro. In November 2010, however, the euro started to lose momentum as European governments struggled to convince investors that they remained viable amid taxpayer resistance to budget cuts. Fears that the Irish debt crisis could spread to other Euro zone countries as well as possible and effective debt rating downgrades also weighed on the single currency.

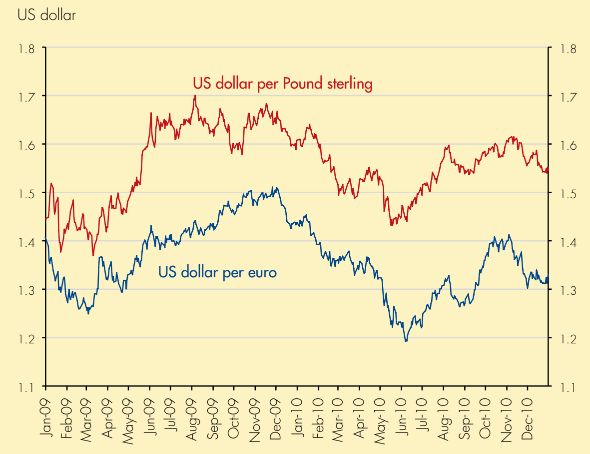
The Pound sterling appreciated against the US dollar during the period under review, benefiting from better-than-expected UK economic data and improved risk appetite on world markets. High UK inflation data, which raised expectations for higher interest rates, as well as a vote of confidence in the government's management of the economy from ratings agency Standard and Poor's provided further support to the British currency. The Pound rose as high as 1.6276 in early November 2010 against the US dollar before retreating on concerns about the UK's exposure to Euro zone debt and dovish comments in the BoE inflation report, suggesting a loose policy for the longer term. Chart 2.6 shows the evolution of the US dollar against the euro and Pound sterling.

Chart 2.5: Equity Indices of Selected Emerging Stock Markets



Source: Thomson Reuters.

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



Source: Thomson Reuters.

Monetary policy

In the second semester of 2010, central banks in developed economies generally maintained expansionary monetary policy stances and kept benchmark interest rates at historically low levels to support economic activity while several developing and emerging economies started increasing interest rates. The Reserve Bank of India raised its policy rate four times during the second half of 2010 while China's central bank raised its benchmark interest rate twice during the final quarter of 2010. Australia and New Zealand also raised interest rates as opposed to South Africa, which reduced its policy rate twice in the second semester of 2010.

The US Federal Reserve left the federal funds rate unchanged in the target range of zero to 0.25 per cent to prop up economic recovery amidst high unemployment and a depressed housing market. It pledged to keep interest rates low and, in November 2010, announced a plan to purchase an additional $600 billion in longer-term Treasury securities by the middle of 2011 to provide additional monetary policy stimulus to the economy.

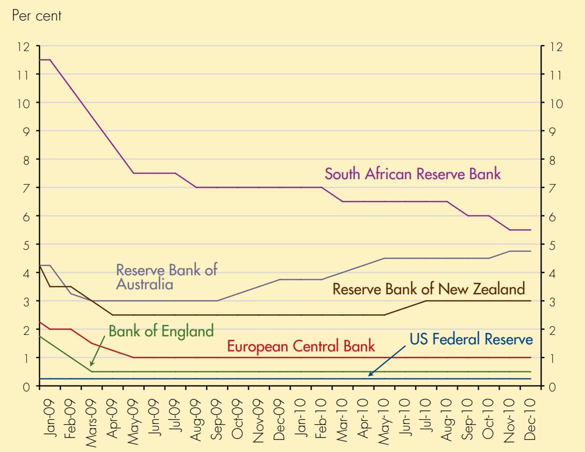
The European Central Bank (ECB) kept the interest rate on main refinancing operations on hold at 1.00 per cent as price developments were perceived to be of lesser concern compared to the risks to the growth outlook.

The Bank of England maintained the Bank rate at 0.5 per cent for the 21st month in a row in December 2010 as fears over the health of the UK economy continued to override concerns over inflation. The quantitative easing programme was also left unchanged at £200 billion. Although near-term inflation prospects had risen, the MPC's central view was that the persistence of spare capacity within the UK, which reduced underlying price pressures, was likely to cause CPI inflation to fall back as the impact of temporary factors waned.

Looking ahead, the US Fed is expected to keep monetary policy accommodative as it continued to support the recovery of the economy. In the UK and Euro area where inflation is rising faster than anticipated, the central banks are expected to face increasing pressures to raise interest rates. Central banks in most emerging markets are most likely to tighten monetary policy further as rising food and energy prices fed into other prices in the economy.

Chart 2.7 shows end-of-month policy interest rates of selected central banks.

Chart 2.7: Selected Central Banks' Policy Interest Rates



Source: Central banks' websites.

2.3 Inflation and Commodity Prices

During most of the second semester of 2010, inflation in advanced economies remained modest while inflation pressures were mounting in emerging and developing economies as a result of robust economic activity and continuously rising food and energy prices. All other primary commodities and raw materials also registered sharp price increases partly on account of weather-related events and strategic policy decisions at country level. By end-December 2010, inflation had become more entrenched globally.

Inflation in the United States, Euro area and UK rose from 1.1 per cent, 1.4 per cent and 3.2 per cent, respectively, in June 2010 to 1.5 per cent, 2.2 per cent and 3.7 per cent, respectively, in December 2010. Among emerging economies, China's inflation reached a 28-month high of 5.1 per cent in November 2010 before easing to 4.6 per cent in December while inflation in India stood at 9.7 per cent in December 2010.

However, inflation in South Africa declined to 3.5 per cent in December 2010, from 4.2 per cent in June. Chart 2.8 shows the paths of year-on-year inflation in selected countries, including Mauritius and Table 2.2 depicts inflation rates in selected countries.

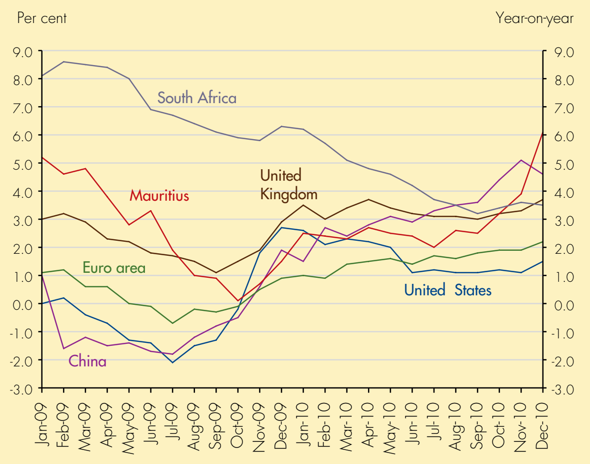
Commodity prices

Commodity prices, which remained subdued in the first six months of 2010, firmed in the second half in response to strong global demand and supply shocks.

Oil prices

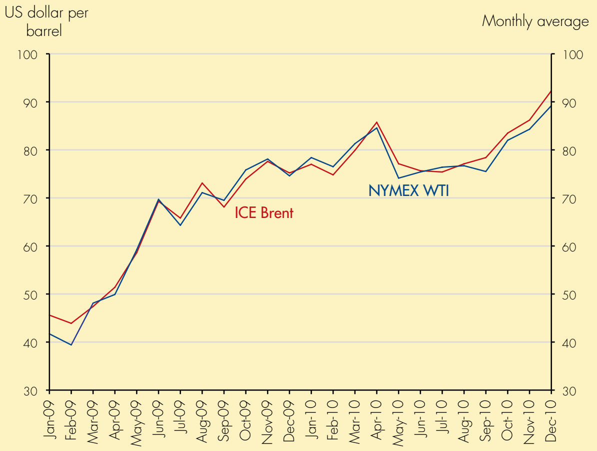
International oil prices, which had remained stable in the third quarter of 2010 on account of uncertainties about the global recovery, rose sharply in the last quarter of 2010 on growing demand from China and other emerging economies and expectations of further improvement in global economic conditions. NYMEX WTI crude rose from an average of US$75.4 a barrel in June 2010 to an average of US$89.2 a barrel in December 2010. Likewise, ICE Brent crude averaged US$92.3 a barrel in December 2010, up from US$75.7 a barrel in June 2010. Chart 2.9 shows movements in monthly average oil prices.

Chart 2.8: Inflation Rates in Selected Countries



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

Chart 2.9: NYMEX WTI and ICE Brent



Source: Thomson Reuters.

Table 2.2: Inflation Rates in Selected Countries

Per cent

	2005	2006	2007	2008	2009	January 2010	June 2010	December 2010
China	1.8	1.5	4.8	5.9	-0.7	1.5	2.9	4.6
Euro area	2.2	2.2	2.1	3.3	0.3	1.0	1.4	2.2
Hong Kong	0.9	2.0	2.0	4.3	0.5	1.0	2.8	3.1
Hungary	3.6	3.9	7.9	6.1	4.2	6.4	5.3	4.7
India	4.2	6.2	6.4	8.3	10.9	16.1	13.7	9.7
Indonesia	10.5	13.1	6.0	9.8	4.8	3.7	5.0	7.0
Philippines	7.6	6.2	2.8	9.3	3.2	4.3	3.9	3.0
Singapore	0.5	1.0	2.1	6.6	0.6	0.2	2.7	4.6
South Africa	3.4	4.7	7.1	11.5	7.1	6.2	4.2	3.5
South Korea	2.8	2.2	2.5	4.7	2.8	3.1	2.6	3.5
Thailand	4.5	4.6	2.2	5.5	-0.8	4.1	3.2	3.0
Turkey	8.2	9.6	8.8	10.4	6.3	8.2	8.4	6.4
United Kingdom	2.0	2.3	2.3	3.6	2.1	3.5	3.2	3.7
United States	3.4	3.2	2.9	3.8	-0.3	2.6	1.1	1.5

Sources: IMF's April 2011 World Economic Outlook, The Economist and central banks' websites.

Food prices

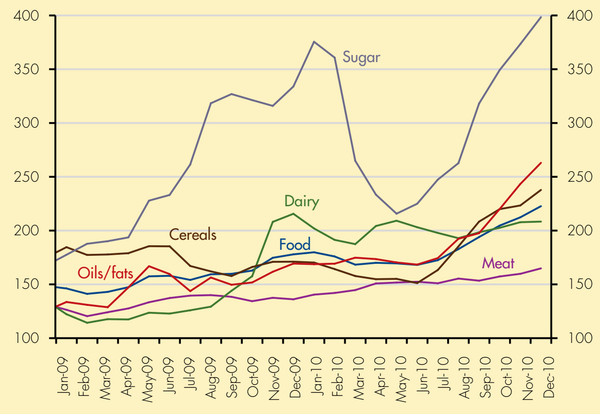
Global food prices, which remained subdued in the first half of 2010, rose continuously during the last six months of 2010 on unexpected shortfalls due to bad weather conditions and policy responses from some exporting countries that led to tighter global supply. The FAO Food Price Index (FFPI), which tracks agricultural commodities, surged to a record high in December 2010, driven by rising sugar, cereal and oilseed prices, surpassing its previous high of June 2008. The FFPI averaged 222.7 points in December 2010, up from 168.1 points in June 2010, compared to the previous peak of 224.1 recorded in June 2008. The FAO Sugar Price Index soared to a record high of 398.4 points in December 2010, from 224.9 points in June 2010. The Cereals Price Index, which includes prices of main food staples such as wheat, rice and corn, rose to an average of 237.8 points in December, the highest level since August 2008 and up from 151.2 points in June 2010. The Oilseed Price Index also jumped to 263.0 points in December, from 168.4 points in June. In the near term, global food prices are likely to stay high and even rise further until supply conditions start easing. The FAO Food Price Index and its components are shown in Chart 2.10.

Other commodity prices

Prices of most non-energy commodities and non-food commodities rose in the second half of 2010, reflecting increased demand and improved global economic conditions.

Table 2.3 shows the quarterly averages of selected non-energy commodities for the year 2010.

Chart 2.10: FAO Food Price Index and its Components



Source: FAO.

Table 2.3: Non-Energy Commodities

Commodity	Unit	Quarterly Averages Q1-2010	Q2-2010	Q3-2010	Q4-2010
Cotton A Index	c/kg	179	199	205	330
Aluminum	$/mt	2,163	2,096	2,090	2,343
Copper	$/mt	7,232	7,027	7,243	8,637
Gold	$/toz	1,109	1,196	1,227	1,367
Iron ore	c/dmtu	101	152	212	182
Lead	c/kg	222	195	203	239
Nickel	$/mt	19,959	22,476	21,191	23,609
Silver	c/toz	1,693	1,838	1,901	2,647
Steel (cold rolled) coilsheet	$/mt	725	838	850	850
Steel (hot rolled) coilsheet	$/mt	625	738	750	750
Tin	c/kg	1,721	1,786	2,055	2,601
Zinc	c/kg	229	203	201	231
Cocoa	c/kg	330	321	306	297
Plywood	c/sheets	557	566	572	581
Tea, auctions (3) average	c/kg	279	276	295	304

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

Source: World Bank.

Freight costs

The Baltic Dry Index (BDI), which is the benchmark for tracking commodity shipping costs, was quite volatile in the first few months of the second semester of 2010 before assuming a downward trend as from October 2010. The BDI, which averaged 1,910 points in July 2010, jumped to 2,456 points in August and further to 2,719 points in September. Thereafter, the BDI slowed to 2,693 points in October before tumbling to 1,773 points in December on account of weaker cargo activity – down to more than half of its peak in May 2010.

Chart 2.11 shows the evolution of the daily Baltic Dry Index between June 2009 and December 2010.

Chart 2.11: Baltic Dry Index

Source: Dowjonesclose.

3. Recent Developments in Domestic Inflation

From a trough of 1.7 per cent in June 2010, domestic inflation started rising in the second half of 2010, partly reflecting higher food and energy prices on international markets, the impact of budgetary measures, notably the increase in excise duties on cigarettes, alcoholic and non-alcoholic beverages, PET bottles and cans in December 2010, and hikes in the prices of electricity and transport. The Consumer Price Index (CPI) rose from 119.9 in June 2010 to 120.7 in September and reached 124.4 in December 2010.

3.1 Inflation and Core Inflation

Both headline inflation and year-on-year inflation clearly accelerated in the last quarter of 2010. Headline 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, turned around in July 2010 and remained on an uptrend throughout the rest of second half of 2010 to reach 2.9 per cent in December 2010. 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, hovered between 2.0 per cent and 2.6 per cent in the third quarter of 2010 before trending upwards in the last quarter of 2010 to reach 6.1 per cent in December 2010.

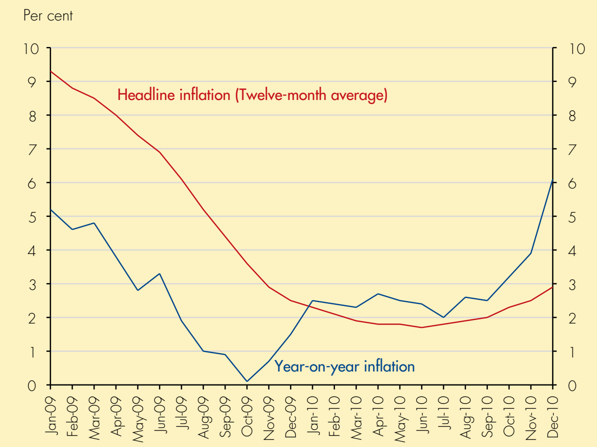
Chart 3.1 depicts the evolution of headline and year-on-year inflation.

The three measures of underlying inflation remained modest in the third quarter of 2010 before firming up in the last quarter. Based on the twelve-month average methodology, CORE1 inflation rose from 2.2 per cent in July 2010 to 2.7 per cent in October and further to 2.9 per cent and 3.2 per cent in November and December, respectively. CORE2 inflation remained flat at 2.5 per cent for three consecutive months before picking up to 2.6 per cent in November and 2.8 per cent in December 2010. TRIM10 inflation remained range-bound between 2 per cent and 3 per cent throughout the period under review and stood at 2.9 per cent in December 2010 compared to 2.1 per cent in June 2010.

On a year-on-year basis, CORE1 inflation showed some volatility in the third quarter of 2010 before picking up in the last three months of 2010 to reach 5.1 per cent in December 2010. CORE2 inflation moved higher to 4.4 per cent in December 2010, from 2.4 per cent in June 2010. The increase in CORE2 inflation, which removes food, beverages, tobacco, mortgage interest, energy prices as well as administered prices from the CPI basket, was a clear indication that price increases were becoming more broad-based and second-round effects were starting to feed through.

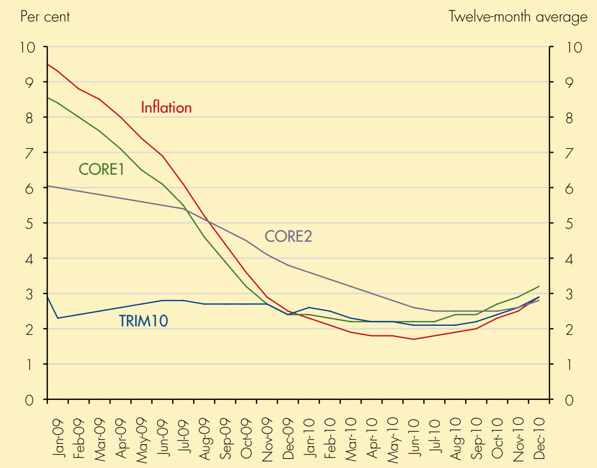
Charts 3.2 and 3.3 depict movements of core inflation.

Chart 3.1: Inflation Rate



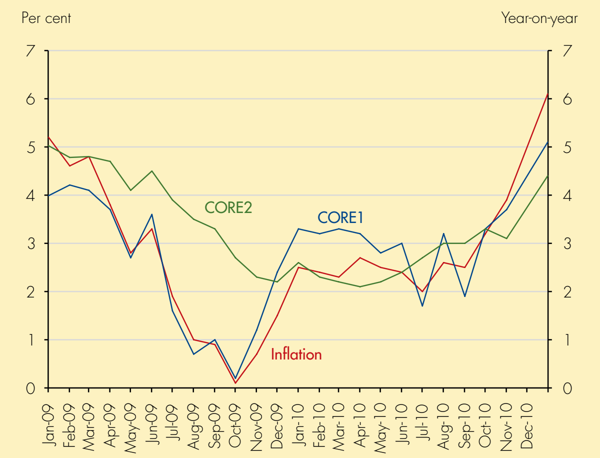
Sources: CSO, Government of Mauritius, and Bank of Mauritius.

Chart 3.2: Inflation and Core Inflation



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

Chart 3.3: Inflation and Core Inflation

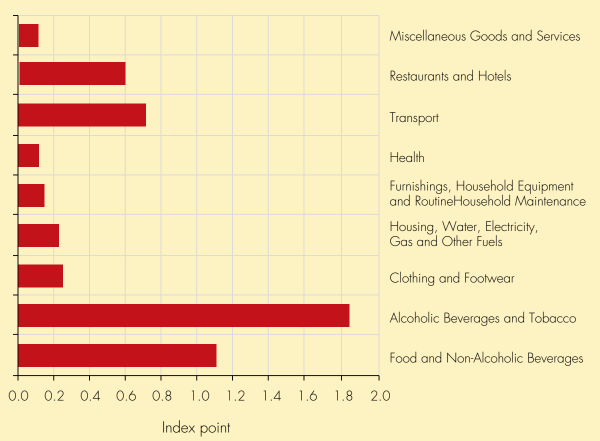


Sources: CSO, Government of Mauritius, and Bank of Mauritius.

3.2 Evolution of Major Commodity Group Indices

The CPI increased continuously from 119.9 in June 2010 to 124.4 in December 2010. The largest increase was registered in the division *Alcoholic beverages and tobacco*, which contributed 1.8 index points to the increase of the CPI.

Chart 3.4: Weighted Contributions to the Change in CPI: June – December 2010



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

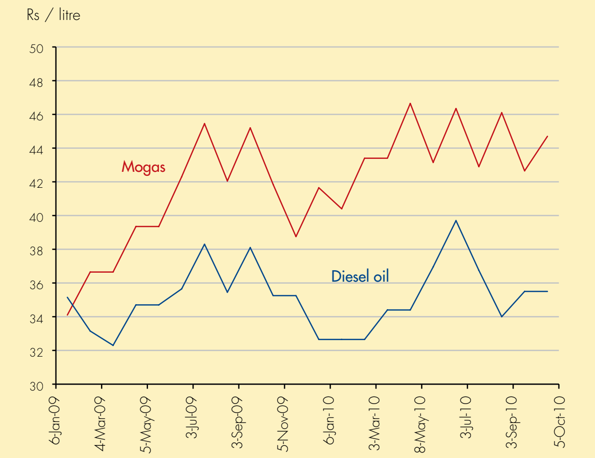
Food and non-alcoholic beverages accounted for 1.1 index points, *Transport* for 0.5 index point, *Restaurants and hotels* for 0.4 index point. *Clothing and footwear* and *Housing, water, electricity, gas and other fuels* contributed 0.2 index point each while three divisions, namely *Furnishings, household equipment* and *routine household maintenance*, *Health* and *Miscellaneous goods and services* recorded respective contributions of 0.1 index point. The remaining divisions recorded negligible positive contributions.

Chart 3.4 illustrates the weighted contribution of the main divisions of the CPI basket to the increase in the CPI between June 2010 and December 2010.

Domestic prices of mogas and diesel oil

The Automatic Pricing Mechanism (APM) Review Committee, which was replaced by the Petroleum Pricing Committee in January 2011, decided on a cumulative decrease in the domestic prices of mogas and diesel oil of 3.6 per cent and 11.8 per cent, respectively, in the second half of 2010. Chart 3.5 illustrates movements of retail prices of mogas and diesel oil since the introduction of the APM in April 2004.

Chart 3.5: Domestic Prices of Mogas and Diesel Oil



Source: State Trading Corporation.

BOX 1: Petroleum Pricing System

The Automatic Pricing Mechanism (APM), which was introduced in April 2004, was replaced by the Petroleum Pricing System (PPS) in January 2011 to determine the domestic selling price of petroleum products, with the exception of fuel oil. According to the State Trading Corporation (STC), the main objective of the new system was to mitigate the effects of world oil price movements on retail price on the domestic market. The new system makes provision for a Price Stabilisation Account (PSA), which aims at maintaining a single price over a longer period of time. Price revision for Gasoline and Diesel Oil will be carried out separately depending on the evolution of world prices and the balance in the PSA in respect of each product. The minimum/maximum allowable decrease would be between 7 per cent and 10 per cent while the minimum/maximum allowable increase would be in the range of 5 per cent to 15 per cent.

The Petroleum Pricing Committee is expected to meet as often as necessary, but at least once every four months, to monitor oil purchases and sales data as well as price trends on the world market, among others and decide whether there is a need to review domestic retail prices.

Source: State Trading Corporation.

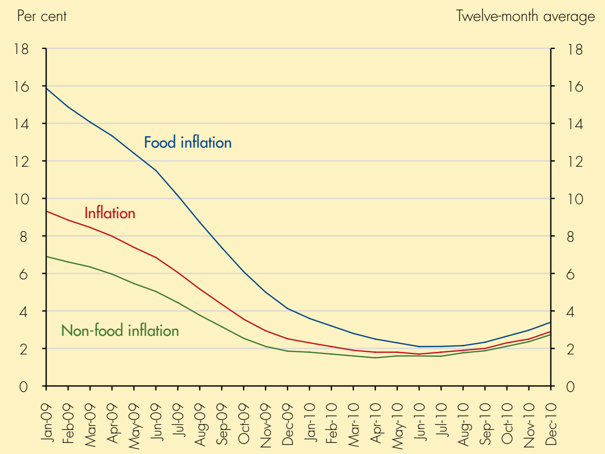
Food and non-food inflation

Reflecting surging international prices of agricultural commodities, food inflation that carries a weight of 26.5 per cent in CPI basket, went up from 2.1 per cent in June 2010 to 3.4 per cent in December 2010 on a 12-month moving average basis. Non-food inflation remained flat at 1.6 per cent in July 2010 before rising steadily to 2.7 per cent in December. A large part of the CPI non-food inflation resulted from increases in excise duties on a certain number of non-food items coupled with hikes in electricity tariffs and bus fares.

Based on the year-on-year methodology, food inflation surged from 2.3 per cent in June 2010 to 6.2 per cent in December 2010. Non-food inflation also picked up significantly from 2.5 per cent in June 2010 to 6.1 per cent in December 2010.

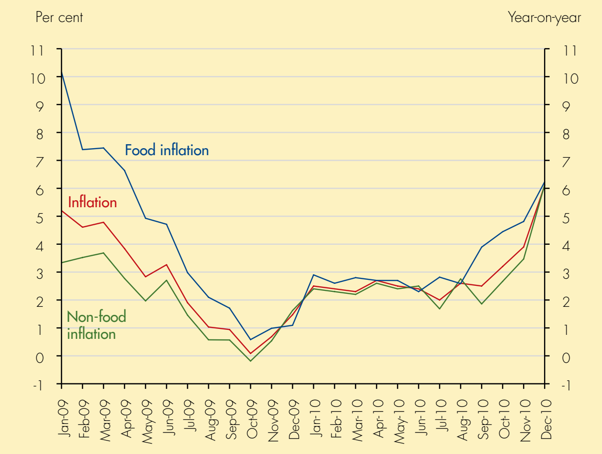
Charts 3.6 and 3.7 show movements in food and non-food inflation.

Chart 3.6: Food and Non-Food Inflation



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

Chart 3.7: Food and Non-Food Inflation



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

Goods and services inflation

On a 12-month moving average basis, goods inflation rose from 2.5 per cent in June 2010 to 3.9 per cent in December 2010, mirroring trends in food and non-food inflation in the last quarter of 2010. Services inflation remained moderate and stood at 0.8 per cent in December 2010, up from 0.1 per cent in June 2010.

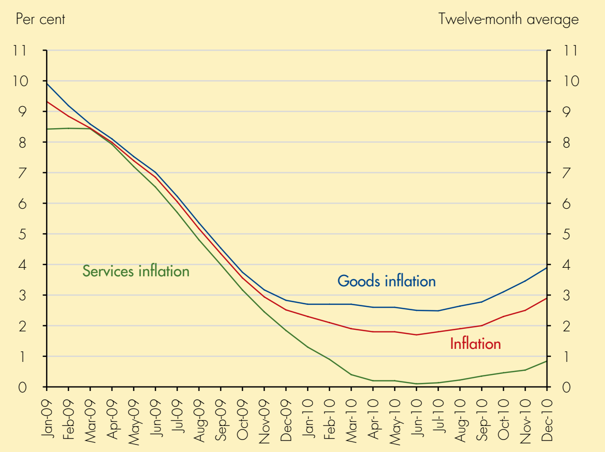
Based on the year-on-year methodology, goods inflation remained at moderate levels in the third quarter of 2010 but accelerated in the following quarter to reach 7.4 per cent in December 2010. Services inflation remained modest throughout most of the second half of 2010 but surged to 3.5 per cent in December 2010, following hikes in electricity tariffs and bus fares. Charts 3.8 and 3.9 illustrate movements in goods and services inflation.

3.3 Evolution of Other Price and Cost Indices

Producer Price Indices

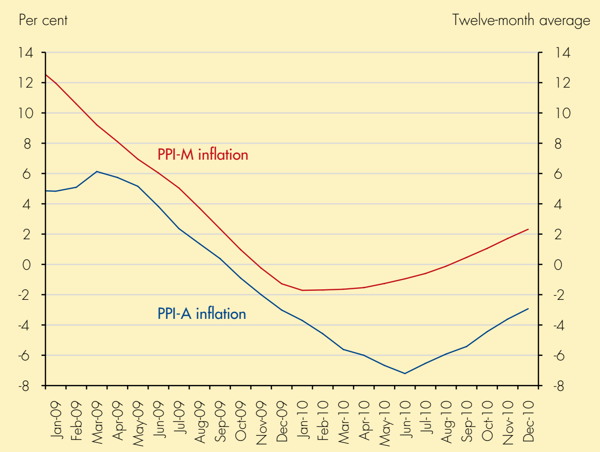
Price pressures at the production level showed signs of a pick-up in the second half of 2010. The Producer Price Index-Agriculture (PPI-A) twelve-month average inflation rose steadily from -7.2 per cent in June 2010 to -2.9 per cent in December 2010. On a year-on-year basis, PPI-A

Chart 3.8: Goods and Services Inflation



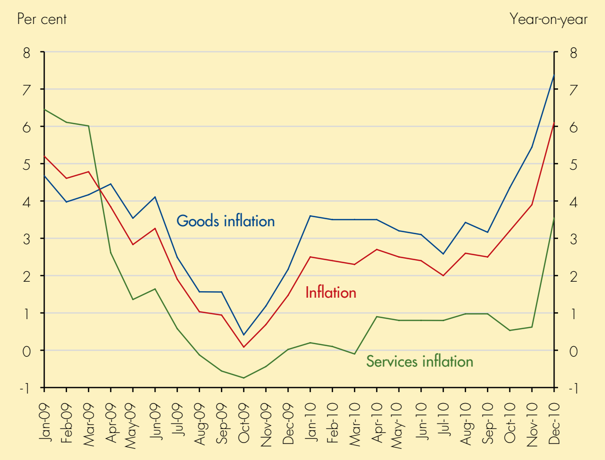
Sources: CSO, Government of Mauritius, and Bank of Mauritius.

Chart 3.10: Producer Price Inflation



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

Chart 3.9: Goods and Services Inflation



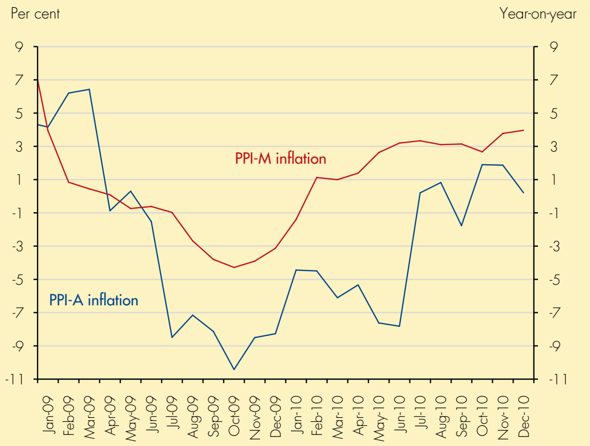
Sources: CSO, Government of Mauritius, and Bank of Mauritius.

inflation stood at 0.2 per cent in December 2010 compared to -7.8 per cent in June 2010. The Producer Price Index-Manufacturing (PPI-M) inflation for the twelve-month period ended December 2010 stood at 2.3 per cent, up from -1.0 per cent in June 2010. The year-on-year PPI-M inflation went up from 3.2 per cent in June 2010 to 4.0 per cent in December 2010.[1]

The producer price inflation for manufacturing and agricultural products based on twelve-month average and year-on-year methodologies are shown in Charts 3.10 and 3.11.

[1] *The PPI-M inflaion data have been re-calculated in line with the change in base period undertaken by the CSO: from base period (2003=100) to base period (2007=100).*

Chart 3.11: Producer Price Inflation



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

Import Price Index

The Import Price Index (IPI), a key indicator of price movements of imported goods in Mauritius, edged down from 112.5 in the second quarter to 111.3 in the third quarter of 2010, before rebounding to 112.5 in the fourth quarter. The easing of IPI between the second and third quarters of 2010 reflected mainly import price decreases in *Mineral fuels, lubricants and related materials, Food and live animals, Crude materials* and *Manufactured goods classified chiefly by materials* while the rebound of the IPI in the fourth quarter was driven by increases in the prices of *Food and live animals* and *Mineral fuels, lubricants and related materials*.

Year-on-year, the IPI was up by 7.1 per cent in the third quarter of 2010 and by 9.4 per cent in the fourth quarter, as shown in Table 3.1, reflecting mainly growth in *Mineral fuels, lubricants and related materials* and *Manufactured goods classified chiefly by material*.

Wage Rate Index

The Wage Rate Index (WRI), which measures changes over time in labour cost, rose by 2.6 per cent between the second and the third quarters of 2010, mainly as a result of the sugarcane peak harvest period, and further by 0.1 per cent in the fourth quarter. Compared to the corresponding period in 2009, the WRI was 5.3 per cent and 4.7 per cent higher in the third and fourth quarters of 2010, respectively.

In the third quarter of 2010, *Agriculture, hunting, forestry and fishing* registered the highest increase of 10.9 per cent while in the fourth quarter of 2010, *Real estate, renting and business activities* registered the highest growth of 14.5 per cent after accelerating from 10.2 per cent in the third quarter of 2010, relative to the corresponding quarters of 2009.

Table 3.1: Import Price Index

Description	Weights	Quaterly Percentage Change				Annual Percentage Change	
		Between Q4-2009 and Q1-2010	Between Q1-2010 and Q2-2010	Between Q2-2010 and Q3-2010	Between Q3-2010 and Q4-2010	Between Q3-2009 and Q3-2010	Between Q4-2009 and Q4-2010
Food and live animals	1,808	0.3	10.7	-6.0	3.9	2.0	8.4
Beverages and tobacco	138	-2.7	-0.2	-3.1	1.3	-3.4	-4.6
Crude materials, inedible, except fuels	288	4.1	6.1	-4.1	3.4	3.7	9.5
Mineral fuels, lubricants and related materials	2,004	6.6	11.4	-3.8	3.7	14.9	18.4
Animal and vegetable oils, fats and waxes	104	9.3	-1.0	0.4	6.8	6.6	16.0
Chemical materials & related products, n.e.s	851	3.9	2.0	-2.2	1.7	-2.0	5.5
Manufactured goods classified chiefly by material	2,141	5.1	7.4	-2.2	-1.2	12.0	9.0
Machinery and transport equipment	1,800	0.2	-1.4	11.3	-3.0	6.8	6.7
Miscellaneous manufactured articles	866	1.7	3.6	-0.7	0.0	3.8	4.6
Overall Index	**10,000**	**3.1**	**6.2**	**-1.1**	**1.0**	**7.1**	**9.4**

n.e.s: not elsewhere specified.

Source: CSO, Government of Mauritius.

Table 3.2 shows the quarterly change in WRI by industry group.

Table 3.2: Wage Rate Index by Industry Group

INDUSTRY GROUPS	2010 Q1	2010 Q2	2010 Q3	2010 Q4	Weighted contribution between Q2-2010 and Q3-2010 (Index point)	Weighted contribution between Q3-2010 and Q4-2010 (Index point)	Percentage change between Q2-2010 and Q3-2010 (Per cent)	Percentage change between Q3-2010 and Q4-2010 (Per cent)
1 Agriculture, hunting, forestry and fishing	134.5	133.6	170.5	155.0	2.3	-0.9	27.6	-9.1
2 Manufacturing, mining and quarrying	127.5	131.1	133.7	136.1	0.4	0.4	2.0	1.8
3 Electricity and water	135.6	136.9	138.7	141.7	0.0	0.1	1.3	2.2
4 Construction	129.4	137.6	138.7	139.5	0.0	0.0	0.8	0.6
5 Wholesale and retail trade repair of motor vehicles, motorcycles, personal and household goods	133.5	132.3	128.7	131.8	-0.2	0.2	-2.7	2.4
6 Hotels and restaurants	140.2	137.3	141.4	144.1	0.3	0.2	3.0	1.9
7 Transport, storage and communications	138.4	138.9	139.1	139.4	0.0	0.0	0.1	0.2
8 Financial intermediation	125.3	126.5	126.8	130.0	0.0	0.2	0.2	2.5
9 Real estate, renting and business activities	155.0	154.8	157.8	169.2	0.2	0.6	1.9	7.2
10 Public administration and defence compulsory social security	143.7	146.9	146.8	146.5	0.0	-0.1	-0.1	-0.2
11 Education	143.5	143.6	147.8	142.7	0.5	-0.6	2.9	-3.5
12 Health and social work	138.3	140.2	139.9	141.0	0.0	0.1	-0.2	0.8
13 Other community, social and personal services	134.1	133.7	137.0	140.4	0.1	0.1	2.5	2.5
ALL GROUPS	**137.2**	**138.6**	**142.2**	**142.4**	**3.6**	**0.2**	**2.6**	**0.1**

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

4. Demand and Output

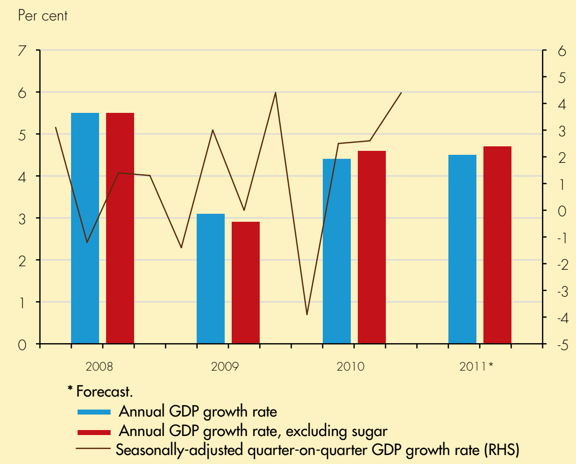
The domestic economy rebounded strongly in the fourth quarter of 2010, growing by a seasonally-adjusted 4.4 per cent quarter-on-quarter rate following growth of 2.5 per cent and 2.6 per cent in the second and third quarters and a contraction of 3.9 per cent in the first quarter. Compared to the corresponding quarter of the preceding year, real output accelerated to 5.4 per cent and 5.5 per cent in the third and fourth quarters of 2010 compared to growth rates of 3.4 per cent and 2.8 per cent in the first and second quarters, respectively. In 2010 as a whole, real output expanded by 4.4 per cent compared to 3.1 per cent in 2009.

Latest data clearly revealed the upbeat performance of external-led sectors although all key sectors recorded positive growth rates in the second semester of 2010. Real output of export-oriented enterprises grew at a robust pace of 12.4 per cent and 12.9 per cent in the third and fourth quarters of 2010 respectively, after more moderate growth of 2.8 per cent in the first quarter and a contraction of 2.6 per cent in the second quarter. Growth in *manufacturing* surged to 6.4 per cent in the fourth quarter of 2010, from 2.1 per cent in the third quarter and a contraction of 2.6 per cent in the second quarter. Within manufacturing, *textile* expanded significantly by 11.9 per cent and 10.8 per cent in the last two quarters of 2010 after contracting in the first two quarters, reflecting the recovery in main export markets and higher demand. *Other manufacturing* growth was mixed with an expansion of 4.4 per cent in the fourth quarter and a contraction of 3.7 per cent in the third quarter. *Hotels and restaurants* also recorded stronger growth of 8.5 per cent in the fourth quarter compared to 5.7 per cent in the third quarter and 3.8 per cent in the second quarter. Increased tourist arrivals and earnings as global economic conditions improved accounted for this relatively positive performance.

Real activity in *construction*, which had accelerated by 11.1 per cent in the third quarter of 2010, slowed to 5.0 per cent in the fourth quarter mainly on the completion of major infrastructure projects. Other sectors that decelerated over the second semester were *transport, storage and communications* and *agriculture*, which was dragged down by negative growth in sugar. *Financial intermediation* and *real estate, renting* and *business activities* maintained buoyant growth in the second half of 2010 with the former growing at 6.0 per cent and 6.4 per cent and the latter expanding by 6.6 per cent and 6.7 per cent in the third and fourth quarters, respectively.

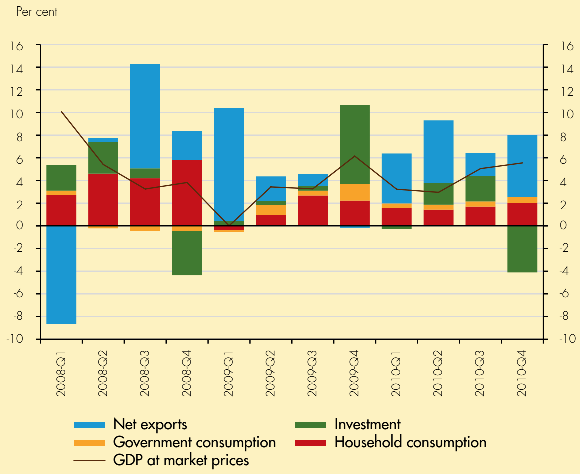
Chart 4.1 illustrates annual and seasonally-adjusted quarterly GDP growth rates. Chart 4.2 shows the contribution of selected aggregate demand components to growth of GDP at market prices.

Chart 4.1: Real GDP Growth Rate



Source: CSO, Government of Mauritius.

Chart 4.2: Contributions to Growth of GDP at market prices



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

Risks to growth prospects

The global growth outlook perked up as from the second semester of 2010, with the IMF forecasting global growth at 4.4 per cent in 2011. According to the April 2011 WEO, advanced economies were projected to grow at 2.4 per cent while emerging and developing economies were forecast to expand at 6.5 per cent in 2011. However, downside risks emanating mainly from high food and energy prices remain. Oil prices, in particular, could increase on geopolitical tensions in the Middle East and North Africa, and coupled with potential demand pressure from Japan's reconstruction needs later this year, these could lead to an increase in global inflation expectations. Risks that huge sovereign debt in certain Euro area countries could affect growth are still present but have diminished.

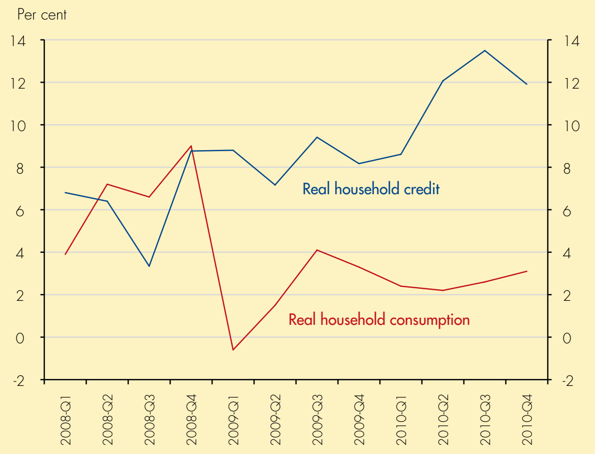
With regard to the domestic economy, latest data suggested continued improvement in the second half of 2010, driven by key export sectors. Reflecting better economic conditions, it is estimated that the output gap, which is measured as the difference between actual and trend output and which is negative, is rapidly closing. Looking ahead, improved business confidence and market reports of upbeat activity in the export sector led to an upward revision in domestic growth to around 4.6 per cent in 2011. But downside risks to the growth outlook stemming mainly from high food and energy prices feeding into the entire cost and price structure of the economy remain.

4.1 Consumption

Final consumption expenditure picked up pace in the second semester of 2010, increasing by 2.7 per cent and 3.3 per cent in the third and fourth quarters of 2010, respectively, while it grew by 2.5 per cent and 2.4 per cent in the first and second quarters of 2010, respectively. The acceleration in final consumption growth was driven by both household and government consumption expenditure.

Consistent with improved consumer sentiment prevailing in the relatively low inflation environment of much of 2010, household consumption expenditure, which contributes to around 84 per cent of final consumption expenditure, increased by 3.1 per cent in the fourth quarter of 2010 compared to 2.4 per cent, 2.2 per cent and 2.6 per cent in the first, second and third quarters of 2010, respectively. Real Household consumption expenditure was also supported by real bank credit to households, which picked up in 2010 as illustrated in Chart 4.3.

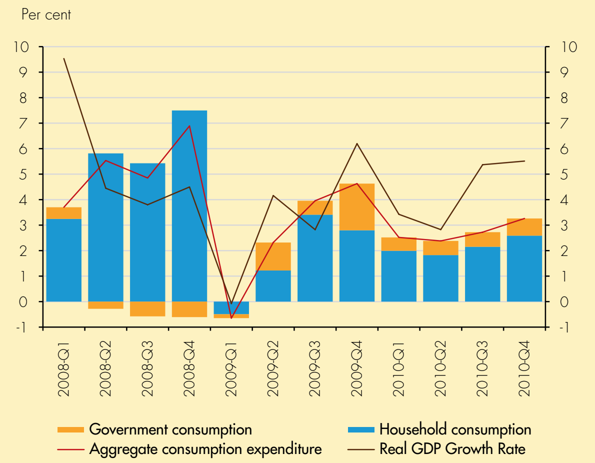
Chart 4.3: Real Household Consumption and Credit Growth Rates



Note: The CPI is used to deflate nominal credit.

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

Chart 4.4: Real GDP and Consumption Growth Rates



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

Government consumption expenditure accelerated to 3.5 per cent and 4.1 per cent in the third and fourth quarters of 2010, after growing by 3.1 per cent and 3.0 per cent in the first and second quarters. Chart 4.4 illustrates the evolution of real GDP growth rate and contributions of household and government consumption in aggregate consumption growth.

With monetary and fiscal policies remaining accommodative, both household and government expenditure are expected to remain well supported over the next few quarters. However, this picture may be clouded by inflationary pressures, which have re-surfaced. The recent spate of price hikes in the wake of surging international food and energy prices and the possibility of further price increases in coming months can lead to a drop in purchasing power and slow the growth in household consumption although, as seen in Box 2, it is possible that real consumption could continue to grow.

Box 2: Consumption Expenditure

Final consumption expenditure refers to expenditure incurred by residents - household and General Government - on final goods and services. Together with investment and net exports, final consumption expenditure makes up the Gross Domestic Product (GDP) of the country from a demand-side perspective. This box analyses the trends in consumption expenditure over the period 1991-2010.

During the period under review, three broad phases in the evolution of final consumption expenditure can be identified. In the sub-period 1991-2003, final consumption expenditure grew at an average of 4.6 per cent annually before accelerating to an annual average of 5.9 per cent during 2004-07 and easing to an average growth of 3.4 per cent over 2008-2010. As a percentage of GDP, final consumption expenditure was rather stable at an average of around 75 per cent in the period 1991-2003 against a background of declining interest rate on savings deposits. As consumption growth accelerated - despite increasing interest rates to counteract rising inflation - and the economy had slowed somewhat relative to 1991-2003, the final consumption expenditure to GDP ratio rose to an average of around 81 per cent over the period 2004-07. Thereafter, the consumption growth rate was negatively impacted by the economic crisis although, as a percentage of GDP, consumption reached a higher average of around 87 per cent over the period 2008-2010.

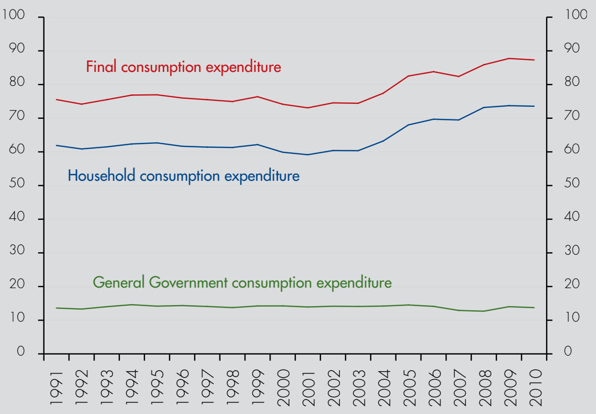
From Chart 1, it can be seen that most of final consumption expenditure was made up of household consumption expenditure. Movements in the latter thus determined the trends described above for final consumption expenditure as General Government consumption expenditure was mostly flat. The mean household consumption expenditure to GDP ratio climbed from 61.2 per cent in the period 1991-2003 to 68.0 per cent in the period 2004-07 and further to 73.5 per cent in 2008-10. The ratio of General Government consumption expenditure to GDP averaged about 13.9 per cent during the whole period under review.

Reflecting increasing consumption expenditure to GDP, the savings rate – defined as the ratio of Gross National Savings to GDP at market prices - fell from 26.7 per cent in the period 1991-2003 to 19.7 per cent in the period 2004-2007 and further to 15.7 per cent over 2008-2010.[1] An essential prerequisite for a higher savings rate going forward would be that the growth rate of GDP should exceed the growth rate of consumption.

The relationship between consumption and inflation is not clear-cut. It would usually be expected that when the general price level rises, each unit of the currency would buy fewer goods and services – or the purchasing power of money would erode – thereby reducing consumption. However, inflation and consumption have usually been found to be positively correlated. The role of inflation expectations in household consumption could partly explain this inconsistency: if increases in inflation rate persist, inflation expectations may be driven higher and may cause households to consume more to avoid being faced with higher prices at a later stage. This excessive consumption may itself, in turn, translate into higher inflation when supply of goods and services is not flexible enough. From Chart 2, it can be seen that real household consumption expenditure growth and the inflation rate have been moving fairly closely together, which would tend to suggest that anticipated higher inflation over 2011 could be matched by higher real consumption growth and thus lower savings.

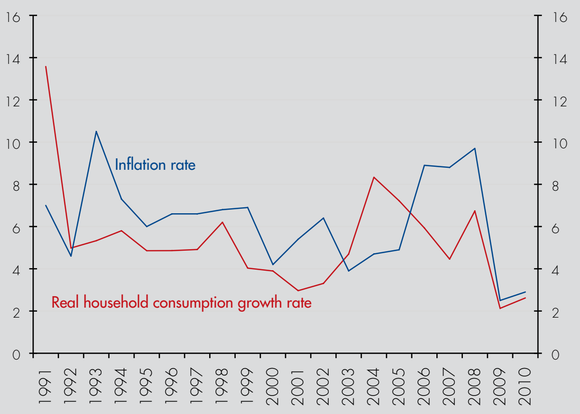
Table 1 shows the average annual growth of GDP and consumption expenditure, the savings rate and inflation rate.

Chart 1: Consumption Expenditure to GDP Ratio



Source: CSO, Government of Mauritius.

Chart 2: Growth in Real Household Consumption Expenditure and Inflation Rate



Source: CSO, Government of Mauritius.

Table 1: Average Annual GDP and Consumption Growth Rates, Savings and Inflation

	1991-2003	**2004-2007**	**2008-2010**
Average Annual Real Growth Rate:			
GDP at basic prices	5.3	4.6	4.3
Final consumption expenditure	4.6	5.9	3.4
Households	*5.3*	*6.5*	*3.8*
General Government	*4.5*	*3.4*	*2.4*
Savings Rate	**26.7**	**19.7**	**15.7**
Inflation Rate	**6.3**	**6.8**	**5.0**

Source: CSO, Government of Mauritius.

[1] *Gross National Savings is measured by deducting final consumption expenditure from Gross National Disposable Income.*

4.2 Investment

Investment excluding aircraft and marine vessel expanded by 3.7 per cent in 2010, lower than the growth of 5.5 per cent recorded in 2009. After shrinking by 1.2 per cent in the first quarter of 2010, investment growth strongly rebounded to 7.6 per cent in the second quarter and to 9.3 per cent in the third quarter, supported by the implementation of major infrastructure projects. However, investment fell back sharply in the last quarter and recorded negative growth of 14.4 per cent on completion of some projects.

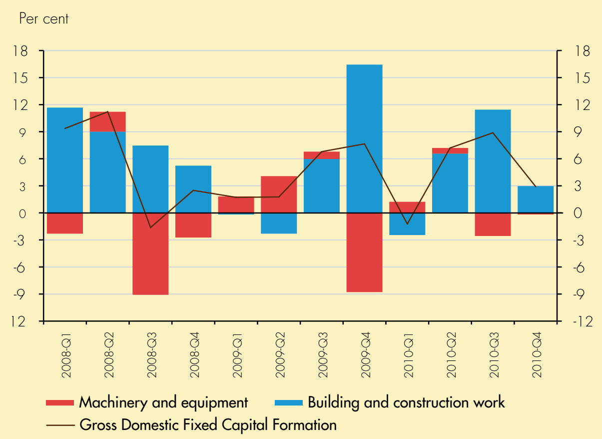
The increase in investment spending in the third quarter of 2010 was mostly led by a jump of 17.0 per cent in *building and construction work*. *Residential building and non-residential building* registered growth rates of 9.3 per cent and 4.7 per cent, respectively, while growth in *other construction work* surged to 67.1 per cent, driven by public infrastructure projects. In contrast to *residential building*, which continued to grow at 9.7 per cent in the fourth quarter, *non-residential building* was almost stagnant.

Investment in *machinery and equipment* contracted by 7.1 per cent in the third quarter and 43.5 per cent in the fourth quarter compared to positive growth of 4.9 per cent and 2.4 per cent in the first and second quarters, respectively. This poor performance was to some extent due to the contraction of 11.9 per cent and 21.7 per cent in *other machinery and equipment*, in the third and fourth quarters respectively, offsetting the growth of 22.6 per cent and 13.4 per cent in *other transport equipment* excluding aircraft and marine vessel.

Chart 4.5 shows the growth rate of GDFCF and the contributions made by its two components, namely *building and construction work* and *machinery and equipment* exclusive of aircraft and marine vessel.

The outlook for investment in coming quarters is mixed. With the improvement in business confidence amid a better global economic environment, it is expected that private investment, which has been very subdued lately, could pick up. However, there is still the risk that higher inflation and demand for higher wage compensation may hold back investment to some extent. In addition, there are increasing concerns that the completion of major projects with regard to shopping malls and office spaces in particular may have created excess capacity, causing planned future construction to be curtailed. According to latest CSO releases, investment, exclusive of aircraft and marine vessel, is forecast to grow at a lower rate of 3.1 per cent in 2011. Table 4.1 gives details on real growth in the components of aggregate demand.

Chart 4.5: Contributions to Growth in Gross Domestic Fixed Capital Formation



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

Table 4.1: Real Growth in the Components of Aggregate Demand

(Per cent, year on year)

	2008	2009[1]	2010[1]	2011[2]	Q3-2009[1]	Q4-2009[1]	Q1-2010[1]	Q2-2010[1]	Q3-2010[1]	Q4-2010[3]
Final Consumption Expenditure	5.2	2.4	2.7	3.2	4.0	4.6	2.5	2.4	2.7	3.3
of which:										
Household consumption	6.7	2.1	2.6	3.2	4.1	3.3	2.4	2.2	2.6	3.1
Government consumption	-1.4	5.1	3.4	3.2	3.3	12.0	3.1	3.0	3.5	4.1
Investment	1.3	8.9	-0.7	3.2	1.6	30.1	-1.2	7.6	9.3	-14.4
Investment *(exclusive of aircraft & marine vessel)*	4.6	5.5	3.7	3.1	n.a	n.a	n.a	n.a	n.a	n.a
Exports of goods and services	4.0	-3.5	15.9	3.9	-4.1	2.4	15.7	19.8	11.3	17.1
Imports of goods and services	1.8	-9.1	7.5	7.6	-6.1	2.7	7.6	8.0	7.7	6.8

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

Source: CSO, Government of Mauritius.

4.3 Foreign Trade and External Demand

In the last two quarters of 2010, the country's balance of payments was characterised by a year-on-year widening in the current account deficit, which was mostly financed by long-term financial and other investment flows. The worsening merchandise trade deficit and lower support from net services and current transfers led to the higher current account deficit. As a percentage of GDP at market prices, the current account deficit widened to 8.4 per cent in the second semester of 2010, from 7.4 per cent a year ago.

Current account

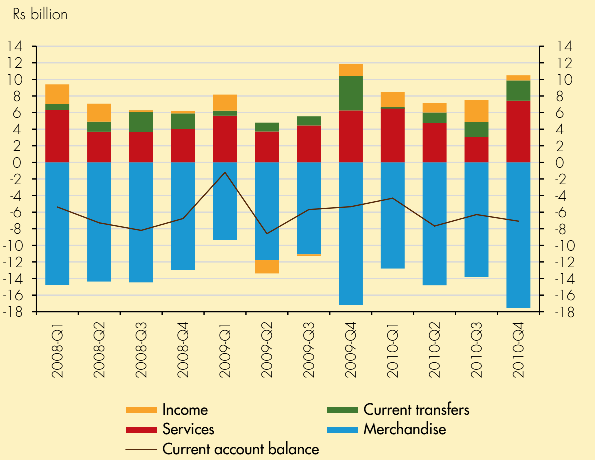
The current account recorded a deficit of Rs13.4 billion in the last six months of 2010. The deficit worsened by Rs2.3 billion year-on-year, mostly on account of the deteriorating merchandise account deficit and lower surpluses on the services and current transfers accounts that more than offset the increase in the surplus on the income account.

Even though export growth surged in the second semester of 2010 relative to the corresponding period of 2009, the more robust import demand, resulting from a pick-up in domestic growth and higher food and energy prices, led to the marked expansion in the merchandise trade deficit. In absolute terms, the merchandise trade deficit widened by Rs3.1 billion.

The services account showed a lower surplus of Rs10.5 billion in the second half of 2010, compared to Rs10.7 billion in the second half of 2009. The decline was mostly on account of a decreased in *other services*, from a surplus of Rs1.7 billion in the second semester of 2009 to a shortfall of Rs0.9 billion in the corresponding period of 2010. Net receipts on the travel account, however, registered a significant growth of 17.8 per cent in the second half of 2010 to reach Rs13.9 billion, as tourist arrivals expanded by 8.3 per cent.

The income account posted a higher surplus of Rs3.3 billion in the second semester of 2010, an increase of Rs1.9 billion compared to the same period in 2009. The improvement was mostly attributed to significantly lower direct investment income payments and higher net income earned by banks on external assets. Current transfers recorded a lower surplus of Rs4.3 billion as government net transfers witnessed a fall in the second semester of 2010 relative to the corresponding period of 2009. The components of the current account are depicted in Chart 4.6.

Chart 4.6: Components of the Current Account



Capital and financial account

The capital and financial account ended the second semester of 2010 posting a surplus of Rs11.7 billion, representing a year-on-year increase of Rs7.1 billion. Compared to the corresponding semester of 2009, buoyancy in financial flows were driven by higher *other investment* inflows and steady *net direct investment* flows.

Private long term net capital inflows associated with foreign direct investment amounted to Rs4.2 billion, an increase of 42.8 per cent relative to the second semester of 2009. The bulk of inflows were mostly the result of large investment made by foreign parent companies into their domestic subsidiaries. Mauritian direct investment abroad also witnessed a higher year-on-year rise of nearly Rs0.8 billion to reach Rs1.5 billion in the second semester of 2010.

Portfolio investment recorded net outflows of Rs0.7 billion as against net inflows of Rs0.4 billion a year earlier. *Other investment* recorded net inflows of Rs12.7 billion during the second semester of 2010, up from Rs9.4 billion in the corresponding period of 2009. The inflows were due to higher external loans contracted by the Government and non-residents' balances held with resident banks exceeding to the rise in banks' foreign assets.

The country's overall balance of payments for the last two quarters of 2010, as measured by the change in reserve assets excluding valuation change, recorded a surplus of Rs4.5 billion. The financing of the current account deficit is depicted in Chart 4.7. Details on the balance of payments are provided in Table 4.2.

Net external demand

Net exports of goods and services registered a smaller decline of 0.9 per cent in the second semester of 2010 compared to a fall of 3.8 per cent in the first half of 2010 and an increase of 1.3 per cent in the second semester of 2009. Export of goods and services grew by 14.4 per cent while imports of goods and services expanded by 15.3 per cent in the second half of 2010. Chart 4.8 depicts the growth in external trade.

Chart 4.7: Financing of the Current Account

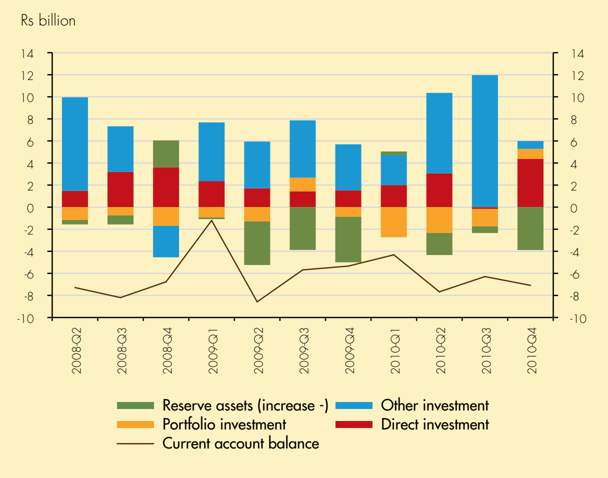


Chart 4.8: Growth in External Trade

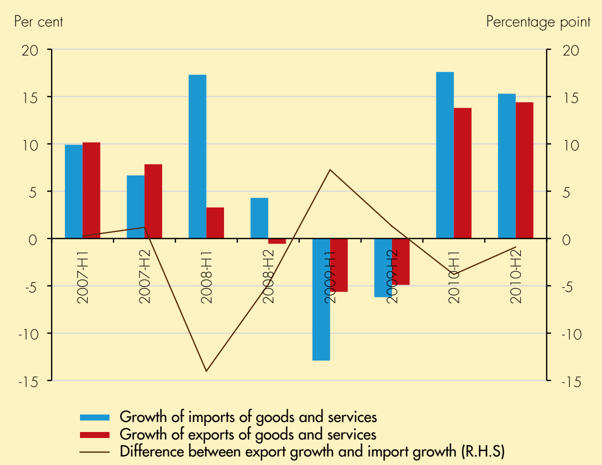


Table 4.2: Balance of Payments Summary

Rs million

	2009[1]		2010[2]	
	Semester 1	Semester 2	Semester 1	Semester 2
Current Account	**-9,805**	**-11,031**	**-11,992**	**-13,379**
Exports (f.o.b)	29,013	32,668	31,461	37,405
Imports (f.o.b)	-50,190	-60,964	-59,076	-68,793
of which: aircrafts/marine vessels	-	*2,862*	-	-
Trade balance	-21,177	-28,296	-27,615	-31,388
Services, net	9,347	10,703	11,328	10,472
of which:travel, net	*12,564*	*11,822*	*13,294*	*13,928*
Income, net	344	1,334	2,937	3,265
Current transfers, net	1,681	5,228	1,358	4,272
Capital and Financial Account	**7,292**	**4,634**	**8,220**	**11,699**
Capital account, net	-5	-54	-115	-33
Direct investment, net	4,076	2,948	5,063	4,211
Portfolio investment, net	-2,225	388	-5,060	-669
Other investment, net	9,545	9,356	10,022	12,678
Balance of Payments Surplus (-)/ Deficit (+)	-4,099	-8,004	-1,689	-4,488
Net Errors and Omissions	**2,513**	**6,397**	**3,772**	**1,680**

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

Figures may not add up to totals due to rounding.

Exports

After contracting by 13.8 per cent in the second semester of 2009, total nominal exports of goods grew by 14.5 per cent to Rs37.4 billion in the second semester of 2010. Excluding ships' stores and bunker, exports of goods increased at a slightly higher pace of 14.6 per cent. The high rate of expansion in nominal exports can be largely accounted for by volume growth than price increases. In terms of commodity structure, the rise in domestic exports was driven by 28.6 per cent increase in exports of *Manufactured goods classified chiefly by materia*l and 18.0 per cent increase in *Food and live animals*.

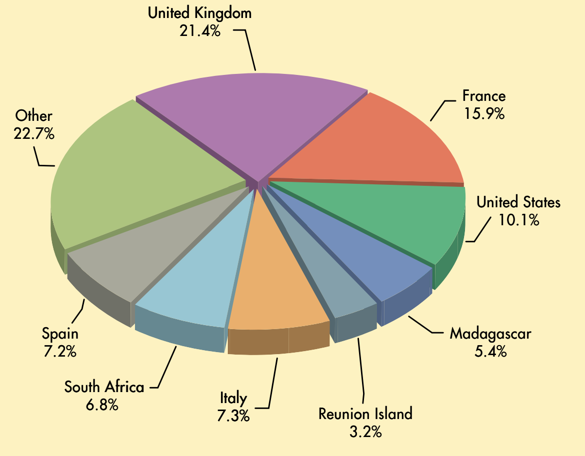
By country of destination, Europe remained our main export market during the second semester of 2010, with a share of 63.1 per cent. Within Europe, the United Kingdom continued to be the primary destination with a share of 21.4 per cent, followed by France (15.9 per cent), Italy (7.3 per cent) and Spain (7.2 per cent). Other important destinations for exports were the US (10.1 per cent), South Africa (6.8 per cent) and Madagascar (5.4 per cent) as shown in Chart 4.9.

Imports

Total nominal imports of goods *c.i.f.* registered growth of 12.3 per cent in the second half of 2010 as against a contraction of 7.0 per cent in the corresponding period of the previous year. Growth in nominal imports is largely driven by higher import prices rather than volume growth. The higher import bill stemmed mainly from increases of 32.7 per cent in *Mineral fuels, lubricants and related materials*, 20.7 per cent in *Manufactured goods classified chiefly by material* and 18.4 per cent in *Food and live animals*. The expansion in the import bill of *Mineral fuels, lubricants and related materials* was mainly as a result of higher crude oil price, which rose from an average of US$72.2 in the second semester of 2009 to an average of US$80.7 in the second semester of 2010.

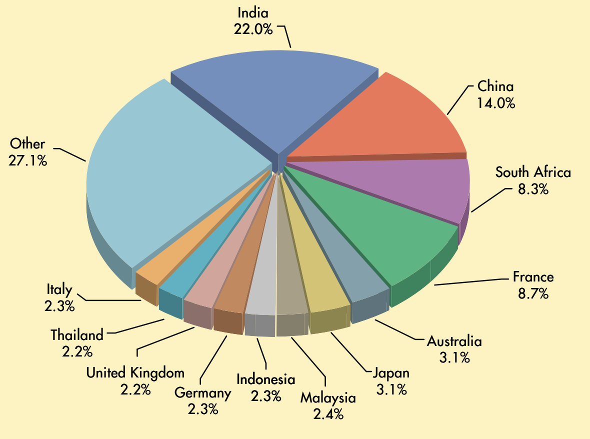
The Asian continent accounted for 53.0 per cent of total imports in the second half of 2010 compared to 50.9 per cent in the corresponding semester of 2009. Imports originated mostly from India (22.0 per cent), China (14.0 per cent), France (8.7 per cent), South Africa (8.3 per cent) and Australia (3.1 per cent), as depicted in Chart 4.10. The relatively high share of India in our import bill is attributable to the fact that India is the main supplier of petroleum products to Mauritius.

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



Source: CSO, Government of Mauritius.

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



Source: CSO, Government of Mauritius.

Box 3: External Indicators

		Dec-09	Dec-10
		Rs million	
Gross External Debt [1]	as at end	33,511	39,311
External Debt Service	year ended	4,650	5,827
Export of Goods	year ended	61,681	68,866
Export of Goods and Services	year ended	132,877	151,632
Import of Goods and Services	year ended	162,300	188,835
Gross Official International Reserves [2]	as at end	69,761	79,064
GDP at market prices	year ended	274,496	304,916
Broad Money Liabilities	as at end	296,480	319,124

Indicators	*Per cent*	
I. Solvency		
Gross External Debt/GDP	12.2	12.9
Gross External Debt/Exports	54.3	57.1
Gross External Debt/Exports of Goods and Services	25.2	25.9
External Debt Service/Exports	7.5	8.5
External Debt Service/Exports of Goods and Services	3.5	3.8
II. Reserve Adequacy		
Reserves/Import of Goods and Services	43.0	41.9
Reserves/ Broad Money Liabilities	23.5	24.8
Reserves/Gross External Debt	208.2	201.1

[1] *Gross External Debt outstanding as at end of period comprises central government, public corporations, monetary authorities and private sector gross external debt.*

[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.*

The gross external debt of the country rose by Rs5,799 million or 17.3 per cent to Rs39,311 million at the end of December 2010, largely driven by the increase in central government external debt. Inclusive of valuation changes, central government external debt increased by Rs5,371 million in 2010.

As a percentage of GDP at market prices, gross external debt of the country went up from 12.2 per cent at the end of 2009 to 12.9 per cent at the end of 2010. Outstanding gross external debt as a ratio to exports of goods and services also edged up from 25.2 per cent to 25.9 per cent over the same period. The ratio of external debt service to exports of goods and services rose from 3.5 per cent in 2009 to 3.8 per cent in 2010 indicating the higher debt service relative to growth in the exports of goods and services.

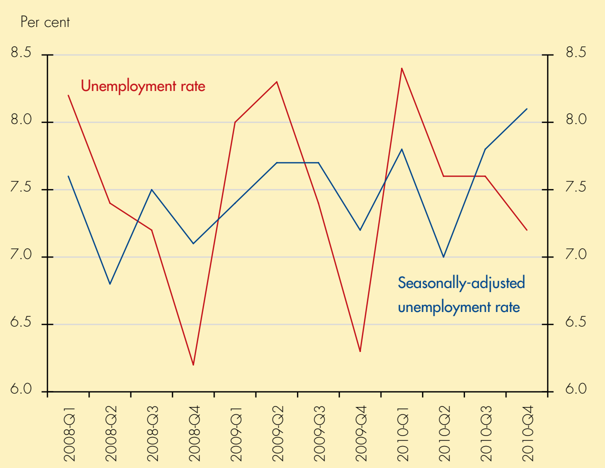
With regards to reserves adequacy ratios, the ratios of reserves to imports of goods and services and reserves to gross external debt dropped over the period under review, reflecting higher increases in imports of goods and services and higher external loan disbursements.

4.4 Labour Market

In the fourth quarter of 2010, the unemployment rate stood at 7.2 per cent compared to 7.6 per cent in the second and third quarters of 2010 and 8.4 per cent in the first quarter of 2010. Compared to a year ago, the unemployment rate was up by 0.9 percentage point in the fourth quarter of 2010. After adjusting for seasonal factors – the unemployment rate tends to be higher in the first half of the year because of school leavers joining the labour market and lower in the second half as more casual jobs are available mainly in the trade sector towards year-end – the unemployment rate declined markedly from 7.8 per cent in the first quarter of 2010 to 7.0 per cent in the second quarter before rebounding to 7.8 per cent in the third quarter and to 8.1 per cent in the fourth quarter. For 2010 as a whole, the unemployment rate is estimated at 7.8 per cent, up from 7.3 per cent in 2009. Chart 4.11 shows the evolution of the quarterly unemployment rate.

Between the third and fourth quarters of 2010, job losses were recorded in *Manufacturing, Wholesale and retail trade; repair of motor vehicles, motorcycles and personal household goods, Construction* and *Hotels and restaurants* while marginal gains in employment were recorded in other sectors. On a year-on-year basis, most sectors of the economy registered gains in employment, with the highest increases being recorded in *Other community, social and personal service, Health and social work, Construction* and *Transport, storage and communications*. However, *Manufacturing, Wholesale and retail trade; repair of motor vehicles, motorcycles and personal household goods,* and *Hotels and restaurants* shed jobs.

Chart 4.11: Quarterly Unemployment Rate



Source: CSO, Government of Mauritius.

Employment in the export-oriented enterprise sector declined by 2,738, from 58,566 at the end of December 2009 to 55,828 at the end of December 2010, mainly as a result of a decline in employment in *Wearing Apparel*. Within the latter, employment fell by 203 and 3,428 in *Pullovers* and *Other Garments*, respectively.

Labour Market Outlook

While there is a time lag in employment adjustment to business cycles, some of the current unemployment may be structural as some jobs may have become obsolete following some firms' strategic decision to restructure and re-engineer part of their operations. Latest surveys by the private sector on the business situation in the country painted a relatively stable employment outlook, with job creation nonetheless expected in certain expanding sectors like manufacturing and construction. The main challenges in the near to medium term, according to those surveys, remain the scarcity of skilled labour, absenteeism, lack of proper attitude and work ethics among employees and labour turnover that can have a bearing on productivity growth. The uncertain global economic environment and the potential impact on external demand are also factors that can influence job creation.

5. Monetary and Financial Developments

5.1 Monetary and Credit Developments

Reflecting improving economic conditions, credit and money growth accelerated in the second half of 2010. Credit to both the corporate and household sectors picked up noticeably. The additional lending was mainly channelled to the tourism, construction, financial and business services, traders and household sectors.

Monetary base

The monetary base grew by 25.7 per cent between end-June 2010 and end-December 2010 compared to an increase of 20.3 per cent registered in the corresponding period of 2009. Reserve deposits held by other depository corporations (ODCs) at the Bank expanded by 34.0 per cent during the second semester of 2010, significantly higher than the growth of 15.5 per cent registered in the second half of 2009.

On the sources side of the monetary base, net foreign assets of the Bank rose by 13.7 per cent during the second semester of 2010 compared to a moderate increase of 2.8 per cent in the second semester of 2009. Domestic claims by the Bank expanded by 61.5 per cent in the second half of 2010 compared to an increase of 8.4 per cent registered in the corresponding period of 2009, driven mainly by a 50.8 per cent rise in net claims on central government.

Broad Money Liabilities

Broad Money Liabilities (BML) went up by 5.3 per cent between end-June 2010 and end-December 2010 compared to a growth of 4.5 per cent registered during the corresponding period of 2009. Chart 5.1 shows the evolution in the growth rates of the monetary base and BML and Chart 5.2 depicts the evolution in the growth rates of BML and credit to private sector as well as the inflation rate.

Components of Broad Money Liabilities

The higher growth in BML was mostly due to higher growth in quasi-money liabilities, the most important component of BML. Quasi-money liabilities increased by 3.9 per cent in the second semester of 2010 compared to a rise of 2.9 per cent in the second semester of 2009, reflecting a surge in the growth rate of rupee savings deposits to 13.1 per cent, from 6.1 per cent. Rupee time deposits edged up by 0.1 per cent compared to an increase of 2.4 per cent in the second half of 2009 while foreign currency deposits contracted by 4.0 per cent compared to a marginal fall of 0.7 per cent in the corresponding period of 2009. Taking into consideration the low interest rate environment and expectations that interest rates would start rising in the near future, it could be inferred that depositors' preference was biased towards rupee savings deposits.

Chart 5.1: Growth in Monetary Base and Broad Money Liabilities

(Percentage change over corresponding month of previous year)

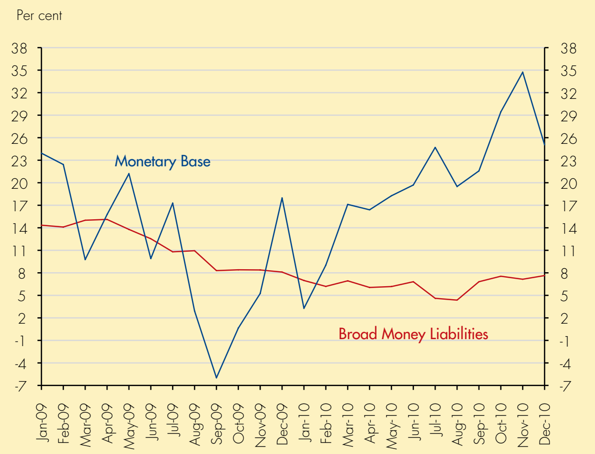
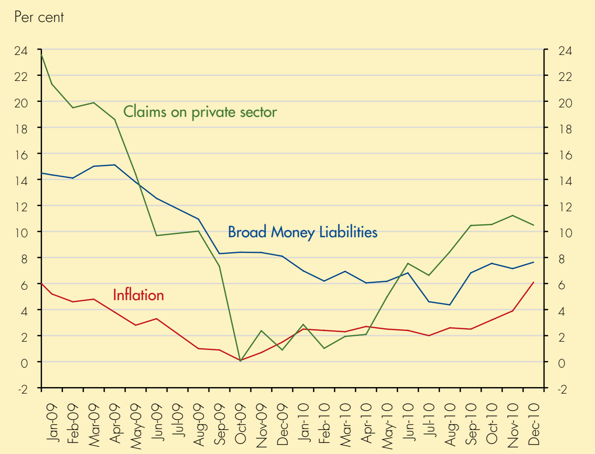


Chart 5.2: Growth in Broad Money Liabilities and Credit to Private Sector and Inflation Rate

(Percentage change over corresponding month of previous year)



Narrow Money Liabilities (NML) expanded by a much lower rate of 7.7 per cent in the second half of 2010 compared to 13.0 per cent during the corresponding period of 2009. The deceleration in NML was mainly on account of the slowdown in the growth of transferable rupee deposits.

Securities other than shares, the third main component of BML, increased significantly by more than Rs2 billion in the second half of 2010 compared to a fall of Rs0.8 billion in the second half of 2009. Table 5.1 provides details on the components and sources of BML.

Sources of Broad Money Liabilities

The net foreign assets of depository corporations went up by 5.1 per cent in the second semester of 2010 compared to a rise of 8.2 per cent in the corresponding period of 2009, mainly as a result of an increase in the Bank's net foreign assets that more than offset the fall in ODCs' net foreign assets. The net foreign assets of the Bank rose by 13.7 per cent, driven by net purchases of foreign exchange from the market, valuation changes and external loan disbursements to government, while those of ODCs went down by 10.0 per cent in the second semester of 2010.

Domestic credit by depository corporations accelerated from 0.8 per cent in the second semester of 2009 to 3.2 per cent in the second semester of 2010, reflecting the increase in both net credit to central government and credit to the private sector. Net credit to budgetary central government edged up by 0.9 per cent in the second half of 2010 compared to a marginal rise of 0.1 per cent in the corresponding period of 2009. Credit to the private sector by ODCs increased by 3.7 per cent compared to a marginal increase of 0.9 per cent recorded in the second semester of 2009.

The contributors to the 5.3 per cent increase in BML in the second semester of 2010 were: domestic credit with 3.1 percentage points - of which credit to other sectors contributed 3.0 percentage points and net claims on central government contributed 0.1 percentage point; and net foreign assets with 1.7 percentage points. Other items net contributed negatively 0.5 percentage point to BML growth.

Sector-wise distribution of credit by banks

Bank credit to the private sector rose by 5.9 per cent in the second half of 2010 compared to a moderate rise of 1.1 per cent in the corresponding period of 2009. The tourism, construction, and financial and business services sectors contributed significantly to the increase in bank credit to the tune of 43.1 per cent, 25.1 per cent and 24.7 per cent, respectively.

Credit to the household sector went up by 8.2 per cent in the second half of 2010 compared to a rise of 6.4 per cent in the corresponding period of 2009. Credit growth in housing sector grew by 11.3 per cent in the second semester of 2010

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

Rs million

	Jun-08	Dec-08	Jun-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10
Broad Money Liabilities	**252,007**	**274,314**	**283,613**	**296,480**	**297,312**	**302,944**	**300,567**	**319,124**
Narrow Money Liabilities	45,981	53,186	53,920	60,904	58,847	59,262	57,086	63,835
Currency with public	*12,746*	*16,156*	*14,683*	*17,153*	*15,845*	*15,905*	*16,242*	*18,975*
Transferable deposits	*33,234*	*37,030*	*39,237*	*43,751*	*43,002*	*43,357*	*40,844*	*44,860*
Quasi-Money Liabilities	204,487	219,592	228,137	234,805	237,659	242,841	240,519	252,420
Savings deposits	*73,444*	*75,850*	*79,604*	*84,477*	*87,452*	*90,513*	*96,748*	*102,349*
Time deposits	*83,164*	*89,409*	*92,051*	*94,251*	*93,113*	*94,073*	*91,399*	*94,150*
Foreign currency deposits	*47,878*	*54,334*	*56,482*	*56,077*	*57,093*	*58,255*	*52,372*	*55,921*
Securities other than shares	1,540	1,535	1,556	772	806	842	2,962	2,869
Domestic Credit	**258,704**	**272,426**	**275,223**	**277,412**	**280,145**	**294,721**	**294,963**	**304,164**
Credit to private sector	205,533	225,468	225,439	227,569	229,303	242,449	246,778	251,432
Net Foreign Assets	**83,628**	**89,520**	**97,146**	**105,124**	**103,539**	**101,733**	**96,509**	**106,951**

compared to a rise of 7.6 per cent in the previous corresponding period.

Following the 100 basis points cut in the Key Repo Rate in September 2010, credit growth accelerated to 4.1 per cent in the fourth quarter of 2010 compared to 1.8 per cent in the third quarter of 2010 and 1.6 per cent in the fourth quarter of 2009.

The sectorwise contribution to the change in bank credit to the private sector over the period June 2010 to December 2010 is shown in Chart 5.3.

5.2 Money Market

Liquidity management

During the second half of 2010, excess liquidity in the domestic banking system increased significantly and reached a peak of nearly Rs8 billion towards mid-August 2010. On average, excess liquidity rose to Rs4.3 billion during the second semester of 2010, from Rs1.7 billion in the corresponding period of 2009, mainly due to the net redemption of government securities.

Chart 5.4 depicts excess reserves in the banking sector.

The Bank undertook a number of monetary policy operations between July and December 2010 to try to contain the growing level of excess reserves in the system. Two reverse repurchase transactions for 14-day periods were carried out at the rate of 4.50 per cent per annum in July 2010 for a total amount of Rs2.9 billion. Moreover, the Bank revisited its approach to liquidity management and introduced new instruments of longer maturities than those normally issued for liquidity purposes, namely Bank of Mauritius Bills of 91-Day, 182-Day and 364-Day maturities and Bank of Mauritius Notes of 2-Year, 3-Year and 4-Year maturities to withdraw excess liquidity for a longer time period. During the second half of 2010, the Bank issued Bank of Mauritius Bills and Notes for Rs4.2 billion and Rs3.5 billion, respectively. The Bank also raised the Cash Reserve Ratio requirement from 5.0 per cent to 6.0 per cent with effect from the fortnight beginning 8 October 2010, thus lowering excess liquidity in the system by around Rs2.8 billion.

Interbank interest rates

During the second semester of 2010, interest rates on the interbank market continued to decline due to excess liquidity conditions. The overnight weighted average interbank interest rate remained well below the lower bound of the corridor during the period under review, gradually falling from 3.56 per cent to 1.95 per cent. Interest rates on short notice and term transactions hovered in the range of 2.10 per cent to 3.75 per cent.

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

Chart 5.3: Sectorwise Contribution to the Change in Bank Credit to the Private Sector – End-June to End-December 2010

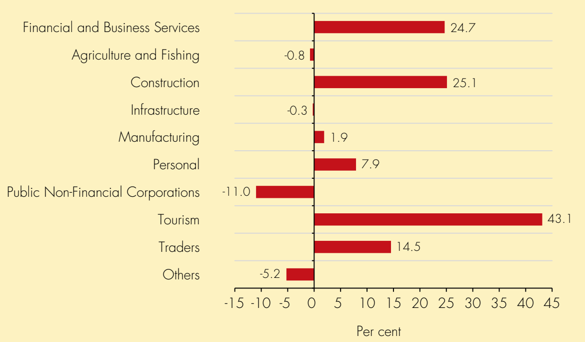


Chart 5.4: Banks' Daily Excess Reserves

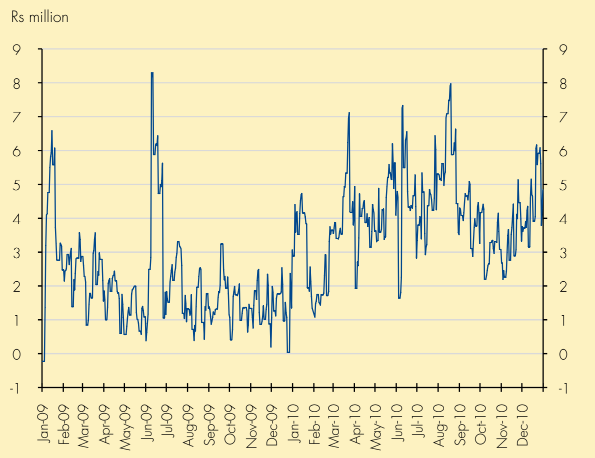
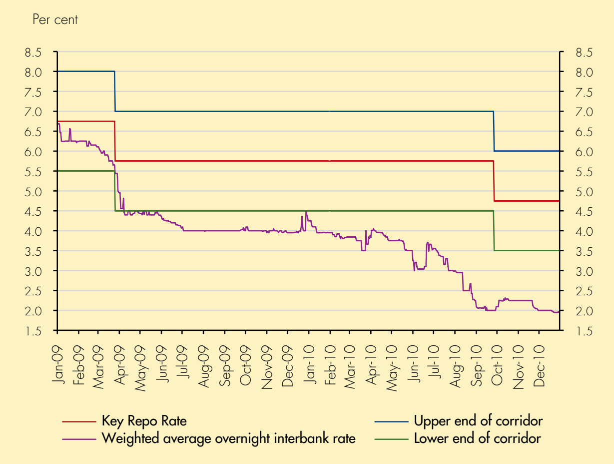


Chart 5.5: Overnight Weighted Average Interbank Interest Rate



Yields on Government debt instruments

Except for a temporary hike recorded in October 2010, yields on Government of Mauritius Treasury Bills generally trended downwards during the period under review, reflecting the build-up in excess liquidity and market participants' aggressive bids at primary auctions. The latter were mostly oversubscribed with an average bid-cover ratio of 3.01.

The weighted average yield on 91-day Treasury Bills decreased from 3.39 per cent at end-June 2010 to 2.01 per cent at end-December 2010 while the weighted average yield on 182-day and 364-day Treasury Bills decreased by 136 basis points and 124 basis points, respectively, from end-June 2010 to reach 3.04 per cent and 3.49 per cent at end-December 2010. Consequently, the monthly overall weighted average yield on Treasury Bills, which stood at 3.96 per cent at end-June 2010, fell to 2.89 per cent at end-December 2010. The market bidding preference was skewed towards the 91-day maturity, showing investors' preference for shorter-term instruments. Chart 5.6 illustrates movements in Treasury Bills yields.

At the monthly auctions of 2-, 3- and 4-Year Treasury Notes, the coupon rates remained unchanged from their September 2009 levels at 5.50 per cent, 5.75 per cent and 6.00 per cent per annum, respectively, till September 2010. Thereafter, coupons decreased to 4.50 per cent, 4.75 per cent and 5.00 per cent per annum, respectively, in line with the decrease in the Key Repo Rate. Between end-June 2010 and end-December 2010, the weighted yield on bids accepted increased by 5 basis points and 24 basis points, respectively, for the 2- and 4-Year tenors while it decreased by 27 basis points for the 3-Year tenor. Chart 5.7 depicts movements in Treasury Notes.

At the re-opening of the 6.69 per cent Five-Year Government of Mauritius Bond due on 04 June 2015 in November 2010, the weighted yield declined to 6.81 per cent, from 7.05 per cent at its first issue in June 2010.

The Bank also issued an 8.75 per cent Ten-Year Government of Mauritius Bond in July 2010 at a weighted yield of 9.66 per cent. This issue was later

Chart 5.6: Yields on Treasury Bills

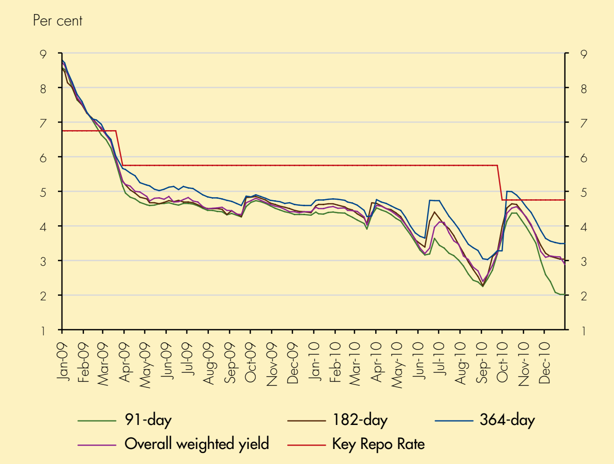
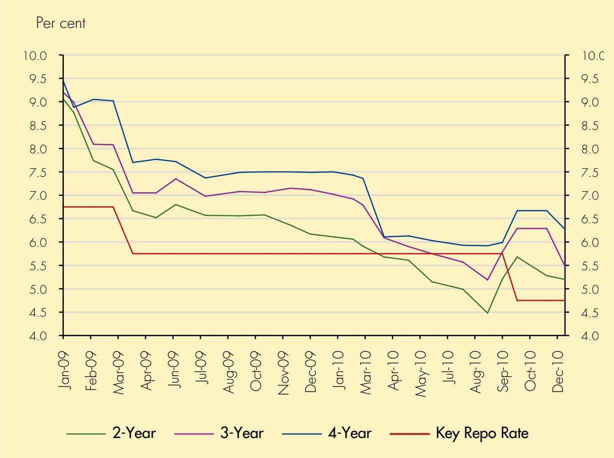


Chart 5.7: Yields on Treasury Notes



re-opened in December 2010 and the weighted yield declined to 8.46 per cent. Other instruments issued during the second half of 2010 included a 9.25 per cent Fifteen-Year Government of Mauritius Bond issued in August at a weighted yield of 9.88 per cent and a Fifteen-Year Inflation-Indexed Government of Mauritius Bond issued in December at a weighted bid margin of 2.50 per cent per annum.

5.3 Interest Rates

Following the 100 basis points cut in the Key Repo Rate effective as from 27 September 2010, all banks had adjusted their deposits and lending rates by October 2010. The savings deposits rates went down to a range of 3.00-4.00 per cent, from a range of 4.00-4.75 per cent, while prime lending rates fell to a range of 7.05-8.50 per cent, from a range of 8.05-9.00 per cent. The magnitude of the cut in the policy rate was also mirrored into banks' modal savings deposits rate and modal prime lending rate, which fell to 3.50 per cent and 7.50 per cent, respectively. Consequently, the weighted average interest rate on rupee deposits fell below 4.00 per cent while the weighted average interest rate on rupee advances fell to a range of 9.22-9.26 per cent compared to a range of 9.90-10.08 per cent during the period December 2009 to September 2010. The real interest rate on savings deposits remained in positive territory but was declining. It stood at 0.6 per cent at the end of December 2010. Deposits and lending rates as well as the Key Repo Rate are shown on Chart 5.8.

5.4 Stock Market

In the second half of 2010, the domestic stock market generally tracked developments abroad. The SEMDEX and SEM-7 moved up by 18.9 per cent and 11.8 per cent, respectively, with the SEMDEX outperformance mainly caused by the rise in the share prices of a number of non-blue chip domestic-oriented companies. After a subdued start in the second half of 2010, banking and hotel stocks picked up rather strongly thereafter, reflecting improving domestic and global economic conditions and a setback in risk aversion. The decrease of the Key Repo Rate in September 2010 has also contributed to enhance the attractiveness of equities relative to bank deposits and Government instruments. At the end of December 2010, the SEMDEX reached a peak of 1,967.45, while the SEM-7 attained 373.22, a level not seen since November 2009, as shown in Chart 5.9.

For the period July to December 2010, net foreign investment on the domestic stock market amounted to Rs816.7 million. With the lift in sentiment towards financial shares internationally and relatively better earnings in the domestic banking sector, foreigners mainly bought banking stocks, which cumulatively made up around 93 per cent of total net foreign purchases on the stock market during the second half of 2010.

Chart 5.8: Key Repo Rate and Deposits and Lending Rates

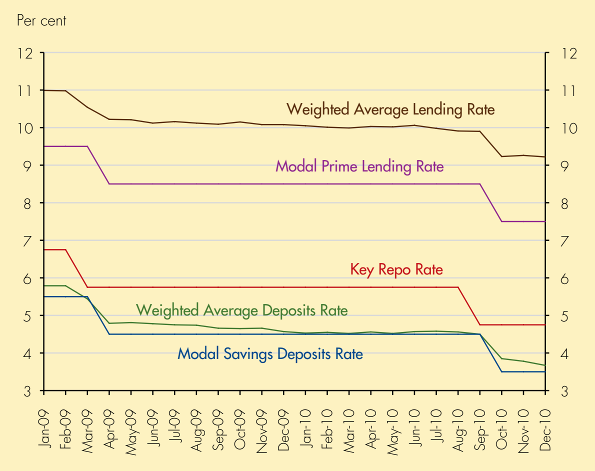
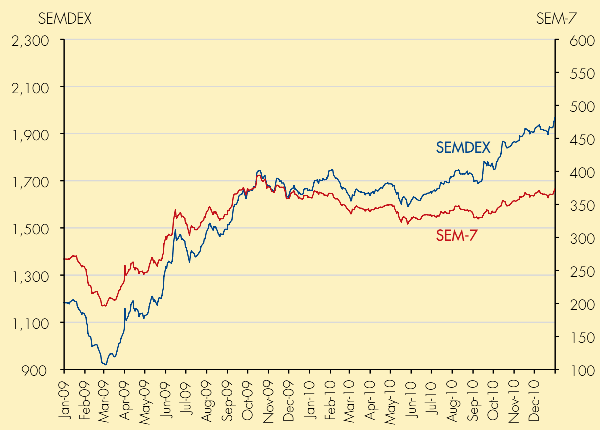


Chart 5.9: SEMDEX and SEM-7

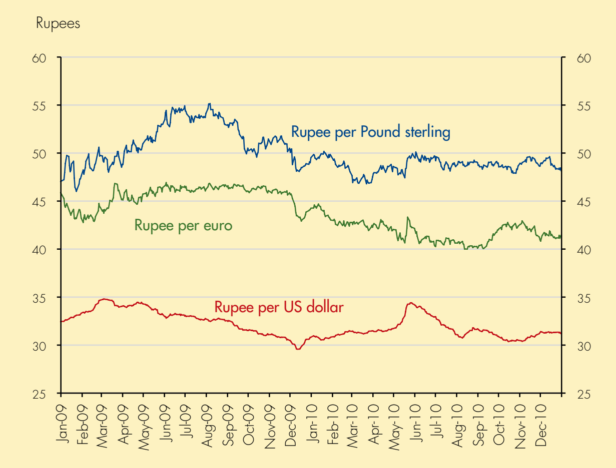


Source: Stock Exchange of Mauritius.

5.5 Foreign Exchange Market and Exchange Rates

During the second half of 2010, the exchange rate of the rupee continued to reflect movements of major currencies on international foreign exchange markets as well as domestic demand and supply conditions. The volatility of the US dollar against major currencies thus translated into a volatile rupee exchange rate against the US dollar on the domestic foreign exchange market. After strengthening in July on broad-based US dollar weakness on international markets, the rupee briefly weakened against the US currency in August, reflecting safe-haven buying of the US dollar on concerns about the global economic recovery before broadly gaining ground and reaching a ten-month high of Rs30.42 in October 2010. Thereafter, the rupee weakened vis-à-vis the euro between July and early November 2010, hitting a six-month low of Rs42.94, but it subsequently reversed its losses as the euro was undermined by renewed debt concerns. The rupee broadly appreciated against the Pound sterling in the second half of 2010 given mixed signals about the UK economy. On a point-to-point basis, between July and December 2010, the rupee depreciated by 2.9 per cent against the euro but appreciated by 5.7 per cent against the US dollar and 2.2 per cent vis-à-vis the Pound sterling. The evolution of the rupee exchange rate against the US dollar, Pound sterling and euro is shown in Chart 5.10.

Chart 5.10: Rupee Exchange Rate Movements



Activity on the domestic foreign exchange market

Activity on the domestic foreign exchange market remained buoyant. Total turnover of spot and forward transactions amounted to US$3,808 million, representing a daily average of US$29.5 million during the period July to December 2010 compared to a daily average of US$25.3 million in the previous six months. Activity on the interbank foreign exchange market increased to a monthly average of US$42.1 million during the period under review compared to a monthly average of US$37.2 million in the first semester.

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 €4.55 million only in July 2010 compared to US$87.2 million over the period January to June 2010.

Banks maintained an average overbought foreign exchange position of US$58.3 million during the second half of 2010 compared to US$60.3 million over the period January to June 2010. The Bank intervened in the domestic foreign exchange market to buy US$219.5 million and €18.8 million from banks and foreign exchange dealers and sell US$180.5 million. Moreover, the Bank purchased US$299.2 million, €109.2 million and £12 million from the Government.

Movements in MERIs and REER

On a nominal effective basis, both MERI1 and MERI2 appreciated in the six months to December 2010. The MERI1, which uses the currency distribution of trade as weights, appreciated by 0.4 per cent while MERI2, which uses currency distribution of trade combined with that of tourism receipts as weights, appreciated by 0.3 per cent. The Real Effective Exchange Rate – with weights based on the distribution of trade with countries that make up at least 80 per cent of total trade – which adjusts the nominal effective exchange rate for price differentials between Mauritius and its trading partners, showed a depreciation of 2.0 per cent.

Chart 5.11 shows the evolution of MERI1 and MERI2 and Chart 5.12 depicts the movements of the REER.

Chart 5.11: MERI1 and MERI2

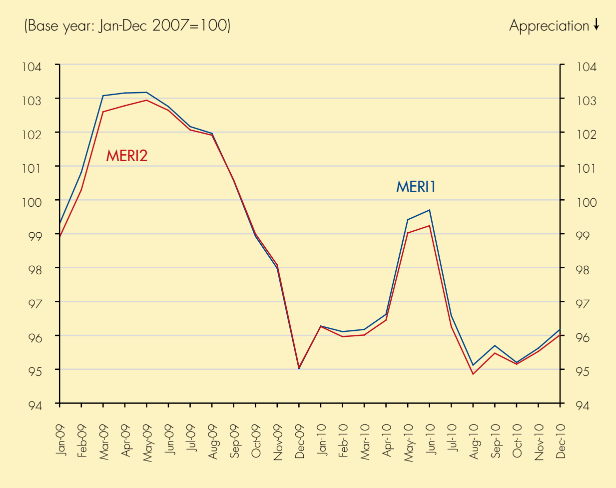
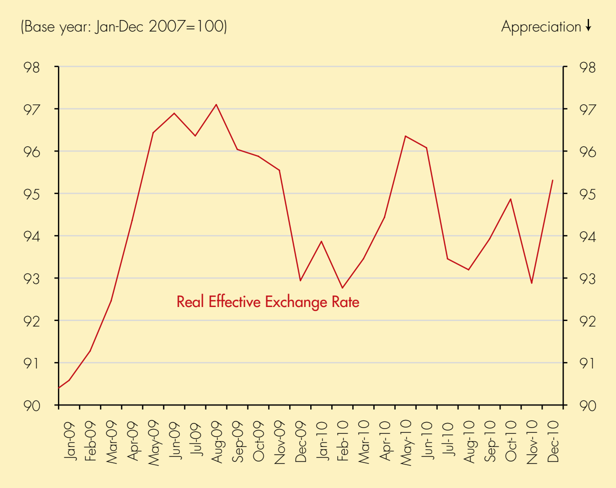


Chart 5.12: Real Effective Exchange Rate



6. The Outlook For Inflation

Global inflation is expected to become a major source of concern in 2011 mainly on elevated food and energy prices, which are expected to rise further.

The global outlook for food prices is bullish in the near to medium term due to supply concerns amid unfavourable weather, stockpiling by importers and higher demand from emerging markets. In its latest report, the FAO warned that food prices worldwide might harden during 2011, intensifying global inflationary pressures.

While global oil prices have been fundamentally driven by robust demand from emerging economies and firming recovery in advanced economies, supply disruptions as a result of tensions in the Middle East and North Africa are expected to continue exercising significant upward pressures on prices. Recent events in Japan, which is the world's third biggest oil consumer, could also add to price pressures as the country embarks on reconstruction projects and tries to supplement the loss of nuclear power. The latest projections from the US Energy Information Administration (EIA) point to firmer oil prices in 2011 and 2012 on continued tightening of world oil markets.

The IMF, in the January 2011 WEO Update, had projected consumer price inflation in advanced and emerging economies to stand at 1.6 per cent and 6.0 per cent, respectively, in 2011. However, recent developments with regard to commodity prices prompted the IMF to significantly revise up the consumer price inflation forecasts for advanced and emerging economies by 0.6 percentage point and 0.9 percentage point to 2.2 per cent and 6.9 per cent, respectively in the April 2011 WEO.

On the domestic front, while external developments are likely to be the main drivers of inflation in 2011, the expected narrowing of the output gap could also lead to an increase in domestic demand pressures in the near future. On a no-policy change basis, it is expected that headline inflation could exceed 5 per cent by June 2011 and reach around 8 per cent by December 2011 while year-on-year inflation was projected to reach 7.8 per cent by June 2011 and 7.0 per cent by December 2011.

6.1 Risks to the Inflation Outlook

Risks to the domestic inflation outlook have moved on the upside since the last quarter of 2010. The main risks originate from the supply side, where the pick-up in inflation in source markets, especially Asia, and the increase in international commodity prices could be higher than anticipated. On the demand side, domestic activity could pick up faster than expected as global economic conditions improve, thus closing the output gap and bringing the economy nearer to its potential more rapidly than forecast.

As the core measures of inflation rise, indicating increasing underlying inflationary pressures, there is the risk of a pick-up in inflation expectations which can ultimately be reflected in price-setting behaviour and demand for higher wage compensation. Inflation expectations surveys carried out by the Bank since June 2010 suggest that an increasing proportion of respondents expected inflation to go up over the next twelve months, as detailed in Box 4. In the near to medium term, the interplay between inflation expectations and actual price-setting policies and wage compensation will be a key determinant to inflation.

With regard to monetary developments, both broad money supply and credit appear to be expanding at a pace consistent with the current level of nominal spending and do not yet constitute major risks to the inflation outlook. Looking ahead, though, the large outstanding balance of high-powered money, which in the absence of strong private sector demand for credit, is sitting idle in banks' balances with the central bank, may become a major source of easy money once expectations about the economic outlook change.

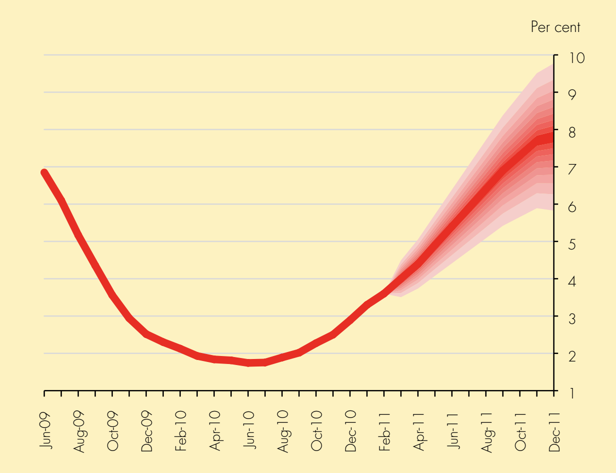
So far, inflation risks stemming from the exchange rate pass-through have to a certain extent been contained by a well-supported rupee. However, rupee appreciation alone may not be able to offset the surge in imported inflation from higher global commodity prices.

Inflation fan chart[2]

The risks to the inflation outlook over the forecast time horizon are presented graphically in the inflation fan chart as illustrated in Chart 6.1. A fan chart depicts the increasing uncertainty surrounding the central projection of twelve-month average inflation as the time horizon is extended up till December 2011. The central projection corresponds to the darkest band in the fan chart. The uncertainty around the central projection of inflation is depicted as additional bands surrounding the central projection. 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.

The inflation fan chart shows that the central projection for inflation rises throughout the forecast horizon based on the assumptions of the baseline scenario with regard to the external economic environment, domestic economic conditions, administered prices and the fiscal stance. It is notably assumed that international commodity prices will rise on account of a pick-up in global demand and supply disruptions in major exporting countries. Since Mauritius is a net importer of food and energy products and international commodity prices strongly influence domestic price dynamics, the baseline scenario assumes increasing price pressures going forward.

Chart 6.1: Inflation Fan Chart



The fiscal stance is assumed unchanged and the negative output gap is expected to close by the middle of 2011 as the economy picks up speed.

Compared to the forecast published in the October 2010 Inflation Report, the inflation outlook for 2011 is now much higher. The uncertainties surrounding the inflation outlook, which principally stem from the future development of exogenous variables and the evolution of domestic underlying inflation pressures as the recent price increases feed into the broader economy and inflation expectations rise, are reflected in the widening bands on both sides of the central projection as the year 2011 proceeds.

Inflation expectations

The Bank carried out the tenth Inflation Expectations Survey (IES) in February 2011. Results revealed that 89.2 per cent of respondents expected prices to go up over the next twelve months. The mean inflation rates expected by respondents were 4.7 per cent, 5.6 per cent, 5.8 per cent and 6.2 per cent respectively, for the twelve months ending June 2011, December 2011, a year ahead and June 2012. External factors were viewed by 89.1 per cent of respondents as the primary source of inflation in Mauritius in February 2011. The evolution of inflation expectations over the four surveys carried out by the Bank between June 2010 and February 2011 is presented in Box 4.

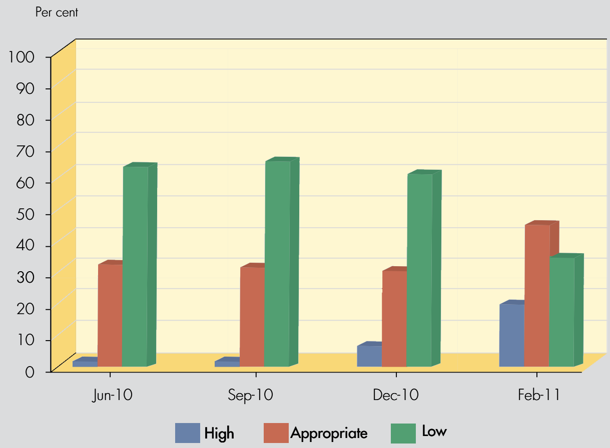
[2] *The inflation fan chart does not incorporate the MPC's decision taken on 28 March 2011.*

Box 4: Evolution of Inflation Expectations

The Bank of Mauritius carried out Inflation Expectations Surveys in June, September and December 2010 and in February 2011. This Box describes the evolution of inflation expectations between June 2010 and February 2011.

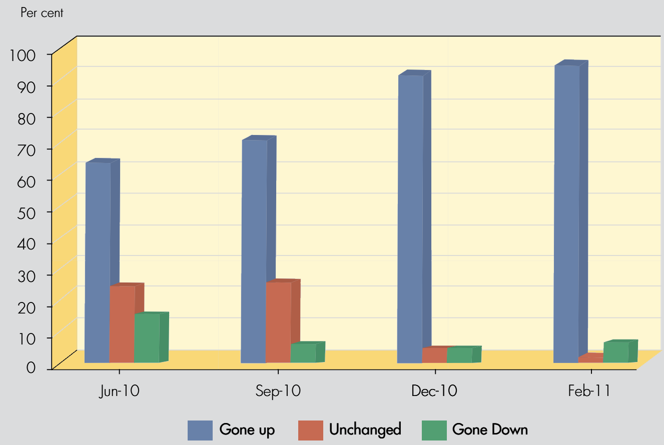
Q.1. How do you perceive the inflation rate in the twelve-month period ending in the month preceding the survey.
[Note: at 1.8 per cent in May 2010, 1.9 per cent in August 2010, 2.5 per cent in November 2010 and 3.3 per cent in January 2011]?

The proportion of respondents who perceived inflation to be high increased from 2 per cent in June 2010 to 20 per cent in February 2011. Conversely, in February 2011, only 35 per cent of respondents thought inflation was low compared to 65 per cent in June 2010. Respondents who perceived the inflation rate to be appropriate climbed from an average of about 30 per cent in the second half of 2010 to 46 per cent in February 2011.



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

Between the June 2010 and February 2011 surveys, respondents who described prices as having gone up during the past 12 months increased from 64 per cent to 94 per cent. In February 2011, no respondent was of the view that inflation had gone down.



Q.3. How do you rank the factors accounting for the current inflation pattern?
[Note: factors to be ranked were External Factors, Fall in Aggregate Demand, Monetary Policy, Fiscal Policy, Wage Policy and Other]

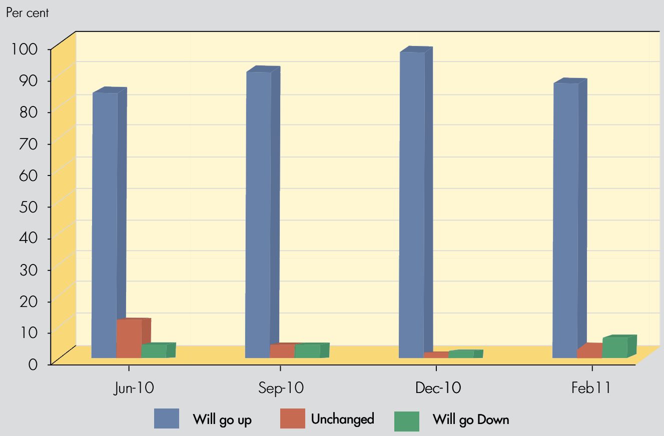
External factors were perceived as the most important cause of inflation in the four surveys carried out since June 2010. The second most important factor explaining inflation had been the change in aggregate demand in June and September 2010 but in the later surveys, fiscal policy was gradually seen as being the second most important cause of inflation. Throughout the four surveys, monetary policy was regarded as the third most important factor accounting for inflation by a majority of respondents.

Ranking	Jun-10		Sep-10		Dec-10		Feb-11	
	Factor	% of respondents	Factor	% of respondents	Factor	% of respondents	Factor	% of respondents
First most important factor	External	84%	External	70%	External	79%	External	89%
Second most important factor	Fall in AD	38%	Fall in AD	32%	FP	29%	FP	35%
					Fall in AD	29%		
Third most important factor	MP	42%	MP	34%	MP	40%	MP	33%

Note: AD - Aggregate Demand, MP - Monetary Policy, FP - Fiscal Policy

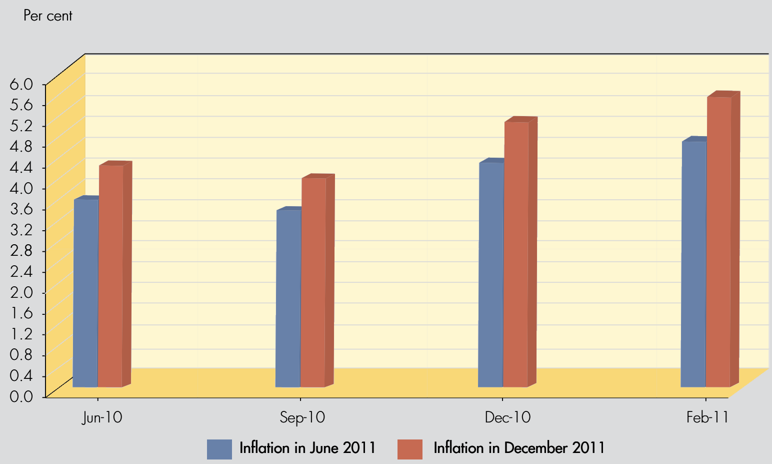
Q.4. Which of the following would best describe the movement of prices over the next 12 months?

The proportion of respondents who believed prices would go up increased from 85 per cent in June 2010 to 98 per cent in December 2010 before easing to 89 per cent in February 2011. About 7 per cent of respondents anticipated a decrease in prices in February 2011 compared to 4 per cent in June 2010.



Q.5. Mean expectation of inflation in June 2011 and December 2011:

Mean inflation rates expected by respondents for June 2011 eased from 3.6 per cent in June 2010 to 3.3 per cent in September 2010 before increasing to 4.2 per cent in December 2010 and further to 4.7 per cent in February 2011. The mean inflation rates expected by respondents for December 2011 eased from 4.3 per cent in June 2010 to 4.0 per cent in September 2010 before increasing to 5.1 per cent in December 2010 and further to 5.6 per cent in February 2011.



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