BANK OF MAURITIUS

Inflation Report

OCTOBER 2014

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INFLATION REPORT

October 2014

The Inflation Report was prepared by a team from the Economic Analysis and Publications Division (EAPD), the Economic Research Division (ERD), the Statistics Division (STAT), the Middle Office and Risk Division (MO&R), and the Financial Markets Operations Division (FMOD).

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The Publications Review Committee of the Bank of Mauritius cleared the Report for publication.

The Report is available in PDF format on the Bank's website at https://www.bom.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.mu.

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PREFACE

The Bank of Mauritius publishes the Inflation Report twice a year as required by Section 33(2) of the Bank of Mauritius Act 2004. The Bank normally releases the Report in April and October. The Report includes the macroeconomic projections underpinning monetary policy decisions by the Monetary Policy Committee (MPC) as well as the risk factors that could make these projections deviate from the baseline macroeconomic scenario.

To maintain price stability, as mandated by section 4 of the Bank of Mauritius Act 2004, the MPC undertakes monetary policy decisions taking into account the orderly and balanced economic development of Mauritius.

The Monetary Policy Committee meets (in principle) every three months to decide on the level of the Key Repo Rate and the Bank of Mauritius regulates the supply of reserve money, through its Open Market Operations such that short term money market rates move, in principle, close to the Key Repo Rate.[1]

The MPC decides on the level of the Key Repo Rate based on an analysis of inflation projections and their determinants from within and outside the domestic economy. This takes into account inflationary factors beyond the control of the local authorities, such as global growth and volatility of international commodity prices that could lead to temporary deviations from the desired inflation path. At the same time, the Key Repo Rate affects the inflation rate through a number of channels and with different time lags.

The Bank of Mauritius also implements a number of policies to safeguard financial stability and ensure a robust transmission mechanism for monetary policy. Foreign exchange intervention seeks to reduce excessive exchange rate volatility and to build up official international reserves to address potential negative shocks affecting the economy. In addition, the Bank uses other instruments, such as the Cash Reserve Ratio Requirement, to affect the level of liquidity in the economy and foster a smooth provision of bank credit to the private sector.

1 *Bank of Mauritius, Communique, A New Framework for the Conduct of Monetary Policy by the Bank of Mauritius, dated 13 December 2006.*

1. SUMMARY

Monetary Policy

Since the April 2014 Inflation Report, the KRR has remained unchanged at 4.65 per cent due to the balance of external and internal risks affecting the outlook for growth and inflation. The international environment remains volatile, but favourable in terms of trends in international prices for food and energy, which have been declining in the recent past. The output gap has remained negative, with output growth below potential, while weak growth of final consumption and investment has been exerting limited demand-side inflationary pressures. Supply side factors affecting the inflation outlook also remain limited at this stage.

The Bank of Mauritius has continued to address the problem of excess liquidity using its monetary policy instruments and it has pursued strong policy coordination with the Ministry of Finance and Economic Development (MOFED). First, the Bank has continued open market operations using BoM securities so that the stock of BoM securities has increased significantly, from Rs16.7 billion to Rs24.0 billion, during the first half of 2014 as the monetary authorities sought to sterilise the impact of sizeable foreign exchange intervention during the period. Second, the BoM increased the cash reserve ratio on rupee deposits from 8.0 per cent to 9.0 per cent in May 2014. Third, policy coordination between the Bank of Mauritius and the MOFED is on-going to address the excess liquidity problem. Notably, the government has frontloaded the issue of its medium and long-term securities scheduled for this year to support the mopping up strategy. There is also agreement that co-operation in setting an explicit inflation target would effectively anchor inflation expectations, while acknowledging that other economic considerations, such as the orderly and balanced economic development, should be taken into account in monetary policy-making.

Short-term interest rates remain affected by the excess liquidity prevailing in the banking system, despite efforts by the fiscal and monetary authorities to address the problem. Indeed, the gap between the KRR and key short-term interest rates (i.e., the yields on Treasury Bills and the interbank rate) has widened since the beginning of the year, notwithstanding the sizeable issue of Bank of Mauritius securities and frontloading of government papers. The decline in short-term interest rates has coincided with a period of substantial BoM intervention in the domestic foreign exchange market that led to an increase in official reserves from about US$3,491 million by the end of December 2013 to US$4,052 million by the end of August 2014. Private sector credit growth has also remained subdued during the period.

International Economy

Global growth remains weak and uneven. This is evidenced by the renewed threats of recession and very low inflation in the Eurozone, persistent economic and financial weaknesses in some large emerging economies that may have reduced their potential output growth, and dampening confidence associated with geopolitical tensions in Russia and Ukraine. However, there are bright spots, with India sustaining rapid growth in exports and investment, and with continued growth in the US, Canada, Sweden, Norway, and the UK remaining rather solid. According to the October 2014 World Economic Outlook Update, global growth is expected to accelerate from 3.3 per cent in 2014 to 3.8 per cent in 2015.

Domestic Economy

During the first half of 2014, the domestic economy expanded at rates that were marginally higher than those achieved in the first half of 2013 with rapid growth of the services sector. The average real GDP growth rate for the first half of 2014 was 3.7 per cent, up from 3.6 per cent in the first half of 2013. Growth reflected brisk activity in the services sector, especially in public administration, accommodation and food service, financial and insurance, and other services. The secondary sector registered positive growth, although the key construction sector contracted in the first and second quarter of 2014. By contrast, manufacturing has shown an important recovery in recent months, echoing increased exports to the US, Asian, French and United Arab Emirates markets. Taxes on products (net of subsidies) have also shown average growth rates in the first half of 2014 that were higher than those registered in 2013.

In its update of national accounts in September 2014 Statistics Mauritius maintained its June forecast of annual GDP growth (at basic prices) of 3.5 per cent in 2014, although the sectors' contribution to growth changed between the two forecasts. In short, higher growth in public administration value added is projected to compensate for lower than earlier expected value added growth in construction, agriculture, arts and entertainment.

The Financial Developments

Since the last Inflation Report in April 2014, broad money grew by 7.7 per cent and 7.9 per cent y-o-y by the end of June and August, respectively, due to a rapid increase in transferable and savings deposits, while the growth of time deposits lagged behind. As such, velocity of circulation of broad money has remained broadly constant at around 1.0 for the last two/three years. In general, to date, the counterpart of a sluggish growth in the liquid assets of the banking sector has been a decline in the net foreign asset position of Other Depository Corporations (ODCs) and weak growth in total ODC credit to the private sector that together more than offset a sizeable accumulation of gross official reserves.

The SEMDEX reached an all-time high of 2,154.4 points during the third quarter of 2014. The stock market performance this year has been relatively broad-based. This is unlike recent post crisis years, when rallies were bank-stock driven, reflecting the fact that bank stocks are by far the most liquid and tend to be overweighted during more uncertain times in Mauritius. Local institutional investors continued to push the market higher while foreign investors remained net sellers to the tune of Rs451.2 million between August 2013 and August 2014.

The Exchange Rate

During the second half of 2013 through to the first quarter of 2014, the trade-weighted nominal exchange rate of the Rupee (NEER) appreciated largely on account of the depreciation of the Indian rupee and South African rand against the Mauritian rupee. In recent months, the NEER has depreciated along the appreciation of the US dollar against the euro. The currency-weighted nominal exchange rate (MERI1 or MERI2) has also depreciated marginally in recent months. In real effective terms (REER), the rupee remains appreciated compared to levels of late 2012.

Fiscal Policy

Prudent macroeconomic management continues to underpin fiscal performance in 2014, with the overall fiscal deficit (as a share of GDP) showing a decline between the first and second quarters of 2014, that is broadly on target with the 2014 Budget estimates. Since the issue of the last Inflation Report in April 2014, the overall central government deficit has dropped from an estimated 3.9 per cent of GDP in the first quarter of 2014 to 3.5 per cent of GDP in the second quarter. The primary balance (i.e., the overall fiscal deficit less the interest payments on the national debt) has also declined through the period. Trends in the overall fiscal deficit and primary balance are broadly on target, with the attainment of an overall fiscal deficit of 3.2 per cent of GDP and a primary deficit of 0.4 per cent of GDP expected by the end of 2014.

The Savings-Investment Balance

The Inflation Report assumes that domestic investment (as a share of GDP) will be largely financed by domestic savings, although the contribution of external savings will be lower than in earlier projections. The current account balance is likely to be lower than in 2013 due to a lower trade deficit. The contribution of public sector savings to the financing of domestic investment will remain negative, as in 2013. Consistent with recent trends, the level of domestic investment in 2014 has been revised downwards, from 23.2 per cent of GDP projected earlier in the year to 22.3 per cent of GDP now. A decline in private investment and inventories' accumulation explains the third-consecutive year drop in overall domestic investment.

Inflation & Expectations

Since March 2014, headline inflation has been virtually flat at about 4.0 per cent. While the measurement of inflation based on the 12-month average (i.e., headline inflation) suffers from statistical caveats, y-o-y inflation reflects more the dynamics of price movements. Thus, y-o-y inflation fell systematically from 5.6 per cent in February 2014 to 3.1 per cent in July 2014. It rebounded to 3.8 per cent in August 2014 on account of higher prices of vegetables and motor vehicles before dropping substantially to 2.9 per cent in September 2014. This decline is mainly attributed to subsiding food and transport prices.

Results of the August 2014 Inflation Expectations Survey pointed to lower inflation expectations for the different time horizons, compared with the previous survey. In the survey month of May 2014, the mean headline inflation rates expected by respondents were 4.1 per cent, 4.3 per cent and 4.5 per cent, respectively, for the twelve months ending December 2014, June 2015 and a year ahead, compared with 4.4 per cent, 4.6 per cent and 4.7 per cent respectively, for December 2014, a year ahead and June 2015.

The Bank's Inflation Forecast

Based on the Bank's short-term forecasting model, and under the baseline scenario, CPI inflation will decline marginally during 2014Q4 and 2015Q1, with respect to the annual inflation rate registered in 2014Q3, but will increase in the remaining quarters of 2015 due to seasonal and other exogenous factors. Y-o-y inflation in 2014Q4 and 2015Q1 is projected to average about 2.9 per cent (compared with 3.3 per cent in 2014Q3), reflecting the observed dynamics to date in food and non-food inflation, resulting from sluggish growth of domestic absorption (i.e., final consumption and investment), weak global growth (that lowers imported inflation), and an improvement in Mauritius' terms of trade along the stability of international prices for food and energy. Starting 2015Q2, however, seasonal and other exogenous factors would lead to a temporary acceleration of inflation through the end of 2015 (to an average of 4.8 per cent). During 2016, CPI inflation should gradually converge to 4 per cent.

The domestic output gap, which is also estimated using the Bank's forecasting model, is projected to remain negative throughout 2014-2017, albeit diminishing starting the second half of 2016. Over the medium-term, the output gap closes on account of low inflation expectations that support investment and economic activity. The model forecasts growth in the range of 3.4-3.6 per cent for 2014, with the upper bound of the growth projection reflecting the hike in the quarterly growth rate from 2.7 per cent in 2014Q1 to a high of 4.6 per cent in 2014Q2.

The Balance of Risks

Overall, the Bank of Mauritius staff assessment is that, for the first quarter of 2015, based on alternative model computations, the balance of risks to the inflation outlook is on the downside (i.e., there are no inflationary pressures arising). Specifically, in this Inflation Report, the balance of risks is negative: the probability that inflation will be higher than in the baseline (due to shocks in unit labour costs and enhanced exchange rate volatility) is less than the probability that inflation will be lower than in the baseline (due to a higher negative output gap in the Eurozone and lower domestic private investment in Mauritius).

Table 1.1: Mauritius – Selected Economic Indicators, 2011 - 2014

	2011	2012	2013	2014		
				Q1	Q2	Proj.
Nominal GDP (billions of Rupee)	323.0	343.8	366.2	88.3	95.7	388.3
Real GDP growth (basic prices; growth rate in %)	3.6	3.4	3.2	2.7	4.6	3.5
Inflation rate (y-o-y end period; growth rate in %)	4.8	3.2	4.0	4.5	3.3	2.9 [1]
CORE1 (y-o-y end period; growth rate in %)	3.8	3.2	3.3	2.7	2.7	2.3 [1]
CORE2 (y-o-y end period; growth rate in %)	3.0	3.0	3.2	3.1	3.2	3.3 [1]
Key Repo Rate (end December)	5.40	4.90	4.65	4.65	4.65	n.a.
Unemployment rate (in %)	7.8	8.0	8.0	8.0	7.8	7.8
Nominal exchange rate (Rs/US$)	30.0	31.0	30.6	30.6	30.7	31.7 [1]
Nominal Effective Exchange Rate (Indices; % change) [2]						
MERI1 (currrency weighted)	-4.8	4.1	-1.1	-0.8	-0.4	n.a.
MERI2 (currrency weighted)	-5.0	4.1	-1.1	-0.7	-0.2	n.a.
NEER (trade weighted)	-9.5	3.8	-5.1	-4.3	-1.2	n.a.
Real Effective Exchange Rate [2]	-9.8	4.8	-6.5	-6.8	-4.2	n.a.
Saving-Investment Balance (in % GDP)						
Investment*	26.0	24.8	24.0	n.a.	n.a.	22.3
Private [3]	20.5	19.3	19.0	n.a.	n.a.	17.0
Public	5.5	5.5	5.0	n.a.	n.a.	5.3
Total Savings*	26.0	24.8	24.0	n.a.	n.a.	22.3
External	13.8	7.3	9.9	n.a.	n.a.	8.3
Domestic	12.2	17.5	14.1	n.a.	n.a.	14.0
Private	13.4	17.1	14.9	n.a.	n.a.	14.7
Public [4]	-1.3	0.3	-0.8	n.a.	n.a.	-0.6
Public Finance (in % GDP)						
Revenue	21.4	21.5	21.3	20.9	21.5	22.1
Expenditure	24.6	23.2	24.8	24.8	25.1	25.4
Current	22.0	20.4	21.8	21.9	22.2	22.2
Capital	2.7	2.8	3.0	2.9	2.9	3.1
Overall Balance	-3.2	-1.8	-3.5	-3.9	-3.6	-3.2
Primary Balance	-0.2	1.2	-0.9	-1.3	-0.9	-0.4
Public Debt	58.5	57.9	60.0	57.8	60.8	59.6
Domestic	45.5	44.2	44.2	42.4	44.3	42.2
External	13.0	13.7	15.8	15.4	16.6	17.4
Monetary & Financial						
Private sector bank credit (growth rate in %)	8.3	12.8	6.0	5.2	3.6	n.a.
Velocity of circulation	1.03	1.03	1.03	1.04	1.04	n.a.
Balance of Payments						
Current account (in % GDP)	-13.8	-7.3	-9.9	n.a.	n.a.	-8.3
Trade balance (in % GDP)	-20.9	-21.5	-19.0	n.a.	n.a.	-17.1
Gross official reserves (in Rs million)	81,474	92,988	105,009	112,018	121,424	n.a.
Gross official reserves (in US$ million)	2,778	3,046	3,491	3,723	4,016	n.a.
Reserve import coverage [5]	4.6	4.9	5.2	5.6	6.0	6.2

[1] For period that ended September 2014.

[2] An increase in the index indicates depreciation of the index.

[3] Includes changes in inventories.

[4] Defined as the difference between government's total revenue and current expenditure.

[5] In months of imports of goods and services.

** Reflects accounting identity of investment equals savings (external plus domestic)*

Source: Bank of Mauritius.

2. INTERNATIONAL ECONOMY

2.1 Global Economic Activity

Global growth remains weak and uneven. This is evidenced by the renewed threats of recession and low inflation in the Eurozone, continuing economic and financial weaknesses in some large emerging economies that may have reduced their potential output growth, and dampening confidence associated with geopolitical tensions in Russia and Ukraine. However, there are bright spots, with India's growth sustaining along rapid growth in exports and investment, and growth in Canada, Sweden, Norway, and the UK remaining rather solid.[2]

Global growth is expected to accelerate from 3.3 per cent in 2014 to 3.8 per cent in 2015, mainly due to strong growth of the US economy. Overall, in advanced economies, growth is forecast to quicken from 1.8 per cent in 2014 to 2.3 per cent in 2015. The US economy is projected to maintain 3.0 per cent growth in the second half of 2014 and into 2015. Growth in emerging market economies is projected to slow to 4.4 per cent in 2014 (from 4.7 per cent in 2013) before accelerating to 5.0 per cent in 2015. The October 2014 World Economic Outlook (WEO) warns that threats to the world's moderate upswing have risen as heightened geopolitical tensions continue to endanger growth, the Eurozone's period of weak growth and very low inflation persists, and very low interest rates across the world that could possibly lead to excessive exuberance in financial markets. Moreover, emerging market economies, particularly those with domestic weaknesses and external vulnerabilities, may face a sudden worsening of financial conditions and a reversal in capital inflows in the event of a shift in financial market sentiments.

Advanced economies

Economic activity data from the advanced economies continue to show considerable divergence in countries' performance. Growth appears to be accelerating in the US, while recent economic indicators from the Eurozone and Japan have disappointed yet again, suggesting their central banks are likely to step in with additional monetary stimulus. As for the UK, broad-based consumer and business spending is enabling the economy to compete for leadership in growth among the industrialised nations.

In the US, recent economic data provide additional evidence that the pace of growth has picked up and remains solid. On a seasonally-adjusted basis, the US economy grew by 4.6 per cent in the second quarter of 2014, after a contraction of 2.1 per cent in the previous quarter, reflecting strong domestic demand and a swing in inventories. Labour market conditions remained favourable, with the unemployment rate falling to 5.9 per cent in September 2014. Notwithstanding rising house prices, activity in the housing sector remained sluggish. The Purchasing Managers Indices (PMIs) for manufacturing remained at a comfortable level in August. Forward-looking business sentiment and consumer confidence indicators are also higher compared to the second quarter of 2014, thus pointing to continued robust real-side activity in the third quarter of 2014. According to analysts, the US economy is likely to record a solid gain in the first half of 2014 with both households and businesses expected to increase spending. Business non-residential investment is expected to accelerate, albeit gradually, with a greater acceleration for 2015.

The United Kingdom has also displayed good performance, with GDP expanding by around 0.8 per cent in the first two quarters of 2014. Both consumption and investment contributed to the strengthening of economic activity. The economic recovery has led to a steady decline in the unemployment rate, which was 6.0 per cent in August 2014. Leading indicators point to a continued strong momentum. The PMI for manufacturing remained at a high level of 52.5 in August. Considering the trend from the beginning of the year, GDP growth is expected to remain high while weakening exports and housing market could pose some downside risks to the growth outlook.

Unlike the US or the UK, the Eurozone continues to struggle for a broad-based recovery. The economy stagnated in the second quarter of 2014, dragged lower by the contraction in Europe's three largest economies despite reasonable gains in other countries in the north and south. Overall demand conditions remained weak amid high unemployment, tight credit conditions and on-going balance sheet adjustments by both the public and private sectors. The unemployment rate in August 2014 remained

[2] *IMF Survey Magazine – World Economic Outlook October 2014.*

at a high level of 11.5 per cent, while the recent PMI numbers showed output growth slowing in both the manufacturing and service sectors. Nevertheless, higher external demand continued to benefit export performance, while domestic demand was supported by more accommodative monetary conditions and a slower pace of fiscal consolidation. The challenges the Eurozone faces include slipping into deflation from the current low inflation numbers, a persistent recession in Italy and a decline in manufacturing orders from the traditionally strong German economy.

Emerging markets

Among the emerging markets, economic growth remains relatively healthy in selected Asian countries, such as China and India, while South Africa and several Latin American countries led by Brazil are experiencing slow or negative growth.

- **China's** national accounts data indicate that the economy has stabilised following the slowdown earlier this year. GDP growth in the second quarter of 2014 bounced back to 2.0 per cent quarter-over-quarter after 1.5 per cent in the first quarter of 2014, mainly on account of a recovery in exports and the mini-stimulus on infrastructure spending. Growth in industrial production and fixed assets investment accelerated, retail sales growth remained strong, and business confidence rose further in July. Growth momentum is expected to be moderate in the near-term amid a slowdown in residential investment, but the economic policies point to low risk of a sharp deterioration in the outlook.
- In **India**, confidence and spending have improved during the first half of 2014, as a result of measures taken to control inflation and the perception that the new government will increase growth-oriented reforms. Growth is expected to pick up in both 2014 and 2015.
- **South Africa** avoided falling into a recession after GDP figures showed the economy grew by 0.6 per cent in the second quarter of 2014. However, with declining growth in both consumption expenditure and investment, and low confidence, the outlook for growth has deteriorated further. Growth in **Brazil** contracted by 0.9 per cent y-o-y in the second quarter of 2014, due to sluggish investment and a fall in industrial production. Investment decreased by 11.2 per cent y-o-y in the second quarter of 2014 and activity in the manufacturing sector actually contracted by 5.5 per cent over the same period.

Table 2.1: Real Growth Rates in Selected Economies

Per cent

				April 2014 WEO Projections		October 2014 WEO Projections		Difference from April 2014 WEO Projections	
	2011	2012	2013	2014	2015	2014	2015	2014	2015
World Output	**4.1**	**3.4**	**3.3**	**3.6**	**3.9**	**3.3**	**3.8**	**-0.3**	**-0.1**
Advanced Economies	**1.7**	**1.2**	**1.4**	**2.2**	**2.3**	**1.8**	**2.3**	**-0.4**	**0.0**
of which									
United States	1.6	2.3	2.2	2.8	3.0	2.2	3.1	-0.6	0.1
Euro Area	1.6	-0.7	-0.4	1.2	1.5	0.8	1.3	-0.4	-0.2
Germany	3.4	0.9	0.5	1.7	1.6	1.4	1.5	-0.3	-0.1
France	2.1	0.3	0.3	1.0	1.5	0.4	1.0	-0.6	-0.5
Italy	0.4	-2.4	-1.9	0.6	1.1	-0.2	0.8	-0.8	-0.3
Spain	0.1	-1.6	-1.2	0.9	1.0	1.3	1.7	0.4	0.7
United Kingdom	1.1	0.3	1.7	2.9	2.5	3.2	2.7	0.3	0.2
Japan	-0.5	1.5	1.5	1.4	1.0	0.9	0.8	-0.5	-0.2
Emerging Market and Developing Economies	**6.2**	**5.1**	**4.7**	**4.9**	**5.3**	**4.4**	**5.0**	**-0.5**	**-0.3**
Sub Saharan Africa	5.1	4.4	5.1	5.4	5.5	5.1	5.8	-0.3	0.3
South Africa	3.6	2.5	1.9	2.3	2.7	1.4	2.3	-0.9	-0.4
Emerging and Developing Asia	7.7	6.7	6.6	6.7	6.8	6.5	6.6	-0.2	-0.2
of which									
China	9.3	7.7	7.7	7.5	7.3	7.4	7.1	-0.1	-0.2
India	6.6	4.7	5.0	5.4	6.4	5.6	6.4	0.2	0.0

Source: IMF

2.2 Global Inflation Developments

The subdued world output growth and sluggish demand have so far kept global inflation at moderate levels, with the potential risk of deflation in the Eurozone. Inflationary pressures are expected to remain contained in an environment of negative output gaps in advanced economies and relatively well-anchored inflation expectations. The October 2014 WEO projected consumer price inflation in the advanced economies to rise from 1.4 per cent in 2013 to 1.6 per cent and 1.8 per cent in 2014 and 2015, respectively. In emerging market and developing economies, it is projected to fall from 5.9 per cent in 2013 to 5.5 per cent in 2014 before rising marginally to 5.6 per cent in 2015.

Advanced economies

Amongst major advanced economies, US inflation stabilised further in August 2014, reflecting the unwinding of some temporary factors which had accounted for the pick-up in CPI inflation earlier this year. Inflation in the Eurozone is very low and steadily declining in recent months. In the UK, annual CPI inflation in August remained below the Bank of England's target for the eighth month in a row.

Emerging markets

Inflation developments in emerging market economies have been mixed, with CPI inflation since the beginning of the year showing an upward trend in Brazil, but stabilising in China and India, albeit at different levels.

2.3 Monetary Policy Stances

Central banks are facing different challenges given the unevenness of the economic recovery across economies and inflation movements with respect to target levels. In the US and the UK, where the recovery is stronger, the challenge is to manage their exit from the accommodative monetary policies. However, the loose monetary policy stance is expected to continue in the Eurozone and Japan to boost economic activity and fight the threat of deflation.

Advanced economies

Although the overall monetary policy remained highly accommodative in advanced economies, the direction diverged in the second quarter of 2014. In the US, the Federal Reserve (Fed) kept interest rates unchanged but altered its asset purchases in response

Table 2.2: Consumer Price Inflation in Selected Economies

Per cent

				April 2014 WEO Projections		October 2014 WEO Projections		Difference from April 2014 WEO Projections	
	2011	2012	2013	2014	2015	2014	2015	2014	2015
Advanced Economies	**2.7**	**2.0**	**1.4**	**1.5**	**1.6**	**1.6**	**1.8**	**0.1**	**0.2**
of which									
United States	3.1	2.1	1.5	1.4	1.6	2.0	2.1	0.6	0.5
Euro Area	2.7	2.5	1.3	0.9	1.2	0.5	0.9	-0.4	-0.3
Germany	2.5	2.1	1.6	1.4	1.4	0.9	1.2	-0.5	-0.2
France	2.3	2.2	1.0	1.0	1.2	0.7	0.9	-0.3	-0.3
Italy	2.9	3.3	1.3	0.7	1.0	0.1	0.5	-0.6	-0.5
Spain	3.1	2.4	1.5	0.3	0.8	0.0	0.6	-0.3	-0.2
United Kingdom	4.5	2.8	2.6	1.9	1.9	1.6	1.8	-0.3	-0.1
Japan	-0.3	0.0	0.4	2.8	1.7	2.7	2.0	-0.1	0.3
Emerging Market and Developing Economies	**7.3**	**6.1**	**5.9**	**5.5**	**5.2**	**5.5**	**5.6**	**0.0**	**0.4**
Sub Saharan Africa	9.5	9.3	6.6	6.1	5.9	6.7	7.0	0.6	1.1
South Africa	5.0	5.7	5.8	6.0	5.6	6.3	5.8	0.3	0.2
Emerging and Developing Asia	6.5	4.7	4.7	4.5	4.3	4.1	4.2	-0.4	-0.1
of which									
China	5.4	2.6	2.6	3.0	3.0	2.3	2.5	-0.7	-0.5
India	9.6	10.2	9.5	8.0	7.5	7.8	7.5	-0.2	0.0

Source: IMF

to an improvement in labour market conditions and contained inflation. The Fed cut its bond purchase program to US$25.0 billion in July 2014. In August 2014, it purchased US$10 billion of agency mortgage-backed securities and US$15 billion of longer-term Treasuries. At its September meeting, the Fed also said that it was likely to maintain the current target range for the federal funds rate for a considerable time after ending the asset purchase programme, especially if projected inflation continues to run below the Committee's 2 per cent longer-run goal, and provided that longer-term inflation expectations remain well anchored. The Fed has announced that beginning in October 2014, it would add to its holdings of agency mortgage-backed securities at a pace of $5 billion per month and add to its holdings of longer-term Treasury securities at a pace of $10 billion per month, rather than $15 billion per month.

The European Central Bank (ECB) implemented further monetary easing to boost the economy, support credit conditions and reduce the risk of deflation. In addition to lowering the repo and deposit rates to all-time lows of 0.05 per cent and -0.2 per cent, respectively, ECB President Mario Draghi announced at the ECB's meeting in September 2014 that the ECB would engage in a form of monetary easing that includes purchasing asset-backed securities and covered bonds. Looking forward, it is expected that monetary policy would remain accommodative for an extended period of time to stimulate economic activity and reduce the risk of deflation and raise the expectation of inflation towards the target level.

In the UK, the Bank of England (BoE) kept the bank rate at 0.5 per cent and maintained the size of the Asset Purchase Program at £375 billion. Nevertheless, the central bank signalled the potential for a review of its monetary policy instruments, should economic activity continue to gain momentum.

Emerging markets

In emerging and developing economies, policy settings were mixed with some countries changing their policy stance, while others kept it unchanged. In China, monetary policy is consistent with achieving an orderly slowdown in growth. By contrast, higher inflation in countries like India and Brazil means that monetary policy will need to remain restrictive.

Highlights for China, India and South Africa are as follows:

- The People's Bank of **China** (PBoC) appeared to have eased monetary policy recently. It cut the required reserve ratios for targeted financial institutions, and there has been a stable growth in reserve money in recent months.

- In **India**, the central bank raised interest rate by 25 basis points to 8.0 per cent in January, while the **Brazilian** central bank increased the policy rate by the same amount in April. Both central banks kept their policy rates unchanged afterwards to support economic activities in their economies.

- The **South African Reserve Bank** (SARB) increased its interest rate by 25 basis points to 5.75 per cent in July to curb the risks of rising inflation at over 6 per cent arising from strong wage increases and a weaker currency. It has continued to keep its repurchase rate unchanged in view of the slightly improved outlook for inflation and expectations of inflation, and the risk of declining economic growth.

2.4 Global Equity Markets

Global share prices have continued to increase in recent months, albeit remaining volatile to news. The gains have occurred mainly due to the widespread view that the US economy improved further and the official interest rates in major economies would remain exceptionally low for a long time. In advanced economies, higher share prices were underpinned by modest gains in the US and strong increases in Japan. In contrast, European share prices fell quite sharply recently due to the economy's greater exposure to Russia and renewed concerns about the economy. Emerging economies' equity indices have risen significantly after a decrease at the start of 2014. Share prices in India, Indonesia, Thailand and Turkey have all risen, reflecting a return of foreign capital to emerging equity markets since mid-February 2014, particularly in India and Indonesia. Share prices in China have also increased, driven by better-than-expected Chinese data and increased confidence in its economy.

2.5 Exchange Rates

Currency markets were mainly influenced by the difference between the major central banks' policy outlook and rising geopolitical tensions. The US dollar rallied over the period on better-than-expected

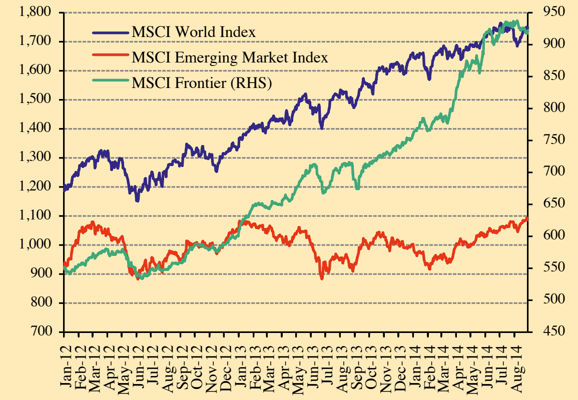
US economic data releases and the Fed's conviction to continue with the reduction in bond purchases. Rising US Treasury yields and widening interest rate differentials attracting more and more capital inflows also supported the US dollar. Moreover, risk aversion on escalating geopolitical tensions in Ukraine added support to the safe haven appeal of the US currency. The Japanese yen came under pressure as Japan's economy shrank in the second quarter of 2014, paving the way for further expansionary policies in coming months.

The euro tumbled against other major currencies on the back of weaker-than-expected economic data releases and the threat of dangerously low inflation. The predicament of the ECB with continued pressure on the viability of the single currency, led the ECB to cut its policy rates to near zero and embark on a new stimulus plan. The euro continued its declining trend on increasing tensions in Ukraine and the potential impact on the fragile euro zone economic growth.

The Pound sterling gained momentum on the back of robust UK data releases and jumped to a high of around US$1.72 in July 2014 on growing expectations that the BoE would tighten monetary policy sooner than later.

Major emerging market currencies came under renewed pressure, rekindling memories of heavy selloffs driven by shifts in US interest rate policy. For example, the Turkish lira and South African rand declined against the US dollar. Growing expectations that the Fed could raise rates in the first half of 2015 are driving the decline in emerging market currencies.

Chart 2.1: Stock Market Indices



Source: Reuters

Table 2.3: Monetary Policy Stance				
		Change since (basis points)		Forecast (Per cent)
	Current rate *(Per cent p.a)*	2005-07 avg	July 2011	December 2014
Developed economies	**0.26**	**-323**	**-58**	**0.27**
of which				
United States	0.125	-438	0.0	0.125
Euro Area	0.05	-293	-145	0.05
United Kingdom	0.50	-444	0.0	0.50
Japan	0.05	-17	0.0	0.05
Emerging Market and Developing Economies				
South Africa	5.75	-254	75	6.00
Emerging and Developing Asia				
of which				
China	6.00	-14	-56	6.00
India	8.00	113	0.0	8.00

Source: JPMorgan

3. DOMESTIC ECONOMY

3.1 GDP by Sector

During the first half of 2014, the domestic economy expanded at rates that were marginally higher than those achieved in the first half of 2013 on account of rapid growth of the services sector (Table 3.1). The average real GDP growth rate for the first half of 2014 was 3.7 per cent, up from 3.6 per cent in the first half of 2013. Growth in 2014 reflects brisk services sector activity, especially for public administration, accommodation and food service activities, financial and insurance activities, and other services.[3] The secondary sector registered positive growth in the first half of 2014, although the key construction sector registered negative growth in the first and second quarters of 2014.[4] By contrast, manufacturing has shown an important recovery in recent months, echoing an improved export performance to the US and Asian markets as well as the French and United Arab Emirates markets. Taxes on products (net of subsidies) have also shown average growth rates in the first half of 2014 that are higher than those registered in 2013.

In its September 2014 national accounts update, Statistics Mauritius maintained its June forecast of annual GDP growth (at basic prices) of 3.5 per cent in 2014, although the sectors' contribution to growth changed between the two forecasts (Table 3.2). In short, higher growth in public administration is projected to compensate for lower than earlier expected growth in construction, agriculture, arts and entertainment. This 2014 real GDP growth rate projection is, roughly, above the mid-point of growth projections by analysts, including the IMF (Table 3.3).

Disaggregated leading economic indicators show a mixed picture in economic activity through the second quarter of 2014. Yet, further analytical work and monitoring of these indicators is warranted to identify/extract the right "signal" (i.e., the trend) from these volatile high-frequency data (Chart 3.1). These short-term data include:

- building permits
- job vacancies
- electricity production
- tourist arrivals
- industrial production index
- money supply M1

[3] *Data for the second quarter showed an important recovery in 'accommodation and food service activities,' with tourist arrivals from Europe – Mauritius' main market – picking up. According to Statistics Mauritius, tourist arrivals are expected to exceed the one-million mark in 2014, owing to diversification efforts and additional flights put in place this year. Also, initiatives by the sector's authorities are on-going to strengthen Mauritius' image and visibility.*

[4] *Negative growth of construction activities reflects an apparent excess supply of residential and non-residential buildings. The construction sector is projected to decline for the fourth consecutive year by 6.7 per cent in 2014, mainly due to a drop in the number of major private construction projects.*

Table 3.1: GDP - Sectoral Growth Rates, Volume Terms (Annual growth rates, in per cent)

	2013			2014		
	Q1	Q2	Avg.	Q1	Q2	Avg.
Primary Sector						
Agriculture forestry & fishing	-4.6	-0.1	-2.4	8.4	7.2	7.8
Mining & quarrying	-2.4	-6.6	-4.5	-15.0	-4.8	-9.9
Secondary Sector						
Manufacturing	6.0	4.8	5.4	-1.9	4.1	1.1
Electricity, gas, steam & AC	6.3	2.6	4.5	2.3	6.4	4.4
Water supply	3.2	1.3	2.3	2.2	2.5	2.4
Construction	-2.0	3.1	0.6	-4.7	-6.2	-5.5
Tertiary Sector						
Wholesale & retail trade	3.7	3.1	3.4	3.2	3.1	3.2
Transportation & storage	2.8	-1.0	0.9	2.7	2.6	2.7
Accommodation & food service activities	1.4	0.3	0.9	-1.0	10.0	4.5
Information and communication	7.2	8.1	7.7	6.0	6.9	6.5
Financial & insurance	5.1	5.3	5.2	5.7	5.5	5.6
Real estate	2.9	3.0	3.0	2.6	2.9	2.8
Professional, scientific & technical activities	7.4	7.2	7.3	6.9	7.2	7.1
Administrative & support service activities	7.2	7.1	7.2	7.2	7.3	7.3
Public administration	1.2	1.8	1.5	3.2	6.7	5.0
Education	2.7	2.7	2.7	3.3	2.5	2.9
Health	6.3	5.9	6.1	6.3	6.6	6.5
Art, entertainment & recreation	8.1	8.2	8.2	6.9	7.0	7.0
Other service activities	5.1	5.9	5.5	5.6	5.5	5.6
GDP at basic prices	**3.8**	**3.4**	**3.6**	**2.7**	**4.6**	**3.7**
Taxes on products (net of subsidies)	-0.4	4.1	1.9	2.5	4.7	3.6
GDP at market prices	**3.3**	**3.5**	**3.4**	**2.7**	**4.6**	**3.7**

Source: Statistics Mauritius and BoM staff estimates.

Table 3.2: Sectoral Growth Rates, Volume Terms (Annual growth rates, in per cent)

	2014 Projections		
	June (1)	September (2)	Changes (2) - (1)
Primary Sector			
Agriculture forestry & fishing	7.4	6.4	-1.0
Mining & quarrying	0.0	0.0	0.0
Secondary Sector			
Manufacturing	1.7	1.9	0.2
Electricity, gas, steam & AC	5.0	5.3	0.3
Water supply	3.0	3.0	0.0
Construction	-4.8	-6.7	-1.9
Tertiary Sector			
Wholesale & retail trade	3.3	3.2	-0.1
Transportation & storage	2.7	2.7	0.0
Accommodation & food service activities	3.5	3.5	0.0
Information and communication	6.5	6.5	0.0
Financial & insurance	5.3	5.4	0.1
Real estate	2.7	2.7	0.0
Professional, scientific & technical activities	7.1	7.1	0.0
Administrative & support service activities	7.5	7.5	0.0
Public administration	2.0	3.1	1.1
Education	3.1	2.9	-0.2
Health	6.4	6.4	0.0
Art, entertainment & recreation	8.3	7.1	-1.2
Other service activities	6.3	5.7	-0.6
GDP at basic prices	**3.5**	**3.5**	**0.0**
Taxes on products (net of subsidies)	2.5	3.0	0.5
GDP at market prices	**3.4**	**3.4**	**0.0**

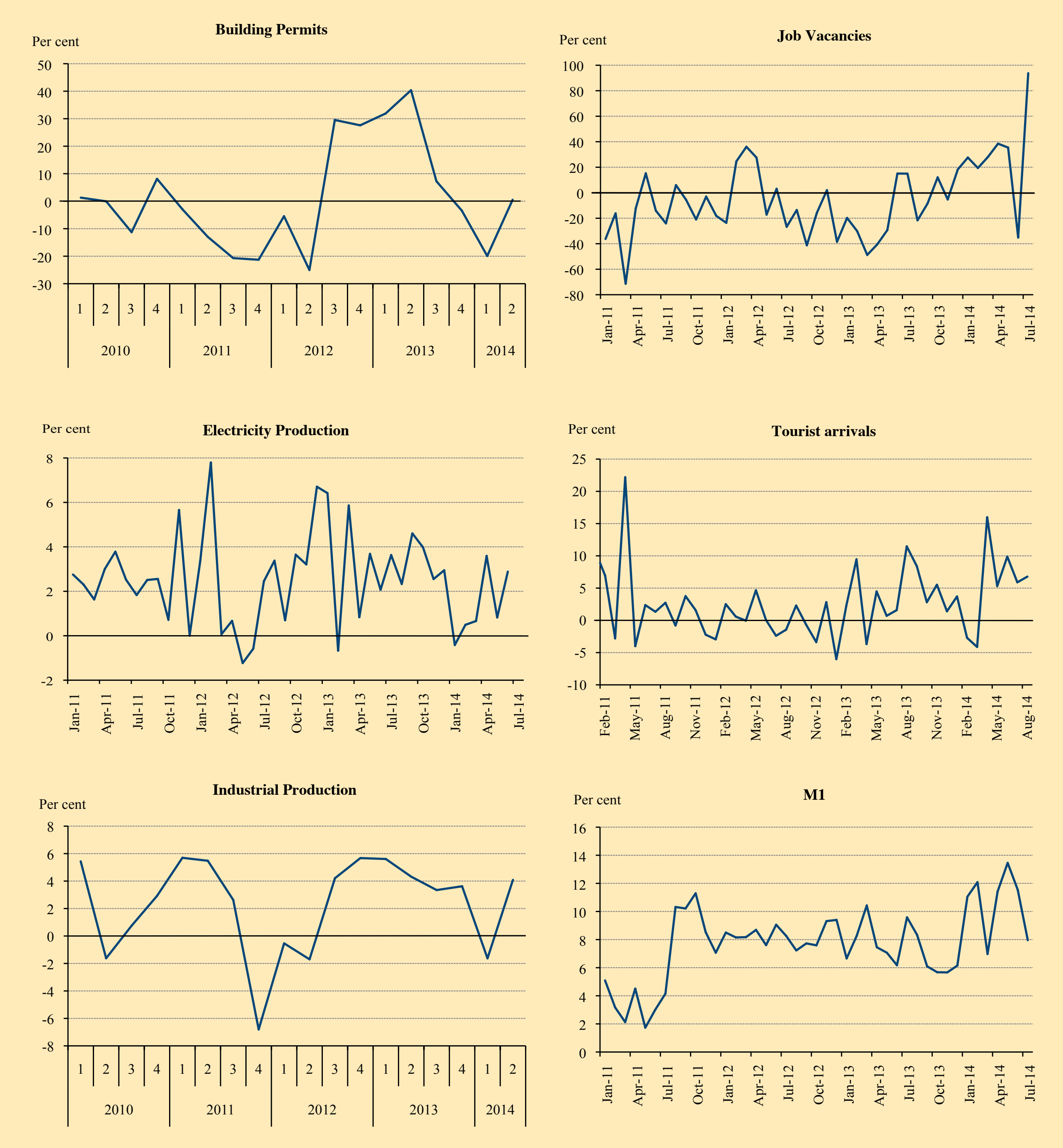
Source: Statistics Mauritius and BoM staff estimates.

Table 3.3: Comparison of 2014 Real GDP Growth Rate Projections (in per cent)

	Real GDP Growth Rate Projections
Statistics Mauritius [1]	3.5
IMF [2]	3.3
MCCI [3]	3.4
MCB Focus [4]	3.3
Pluriconseil [5]	3.3 - 3.6
Bank of Mauritius [1]	3.4 - 3.6

[1] *Real Growth Rate of GDP at Basic Prices*
[2] *Based on Staff Projections - April 2014 Article IV Consultation*
[3] *MCCI Perspectives Economiques 2014 - May 2014*
[4] *MCB Focus - July 2014*
[5] *Baromètre Economique de PluriConseil - July 2014*

Chart 3.1: Y-o-y Growth Rates of Leading Indicators of Economic Activity



Source: Statistics Mauritius and Bank of Mauritius

3.2 GDP by Expenditure

Real GDP growth in the first half of 2014 reflects a positive contribution of external demand and final consumption to output growth, while growth of gross domestic fixed capital formation (GDFCF) has remained negative (Table 3.4). The growth of net external demand echoed a strong growth of exports of goods and services, while imports grew at a significantly lesser pace. Final consumption grew at an average rate of 2.3 per cent, which is marginally lower than the growth rate registered in the first half of 2012 and 2013. During the first half of 2014, the growth rate of GDFCF was negative. A contraction of demand for investment in building and construction work was the main factor explaining this development.

3.3 Labour Market and Unit Labour Costs

Labour market conditions remained stable during the period 2013-2014, although the relatively high unemployment rate for the youth and the women suggests that the country continues to operate inside its production possibility boundary. All in all, the unemployment rate went down slightly to 7.8 per cent in 2014Q2, from 8.0 per cent in 2014Q1. On a seasonally-adjusted basis, the unemployment rate, however, remained unchanged at 7.4 per cent in 2014Q2 from the previous quarter. Total employment rose by 5,900 in the year to 2014Q2, compared with an increase of 6,700 in the corresponding period of 2013.

Subdued economic conditions and a structural mismatch between available jobs and skills, continue to weigh on labour market conditions. The construction sector – a major employer of manual labour and a potential growth stabilizer – has experienced negative growth for four years in a row. Statistics Mauritius forecasts that the unemployment rate for 2014 will fall slightly to 7.8 per cent, from 8.0 per cent in 2013.

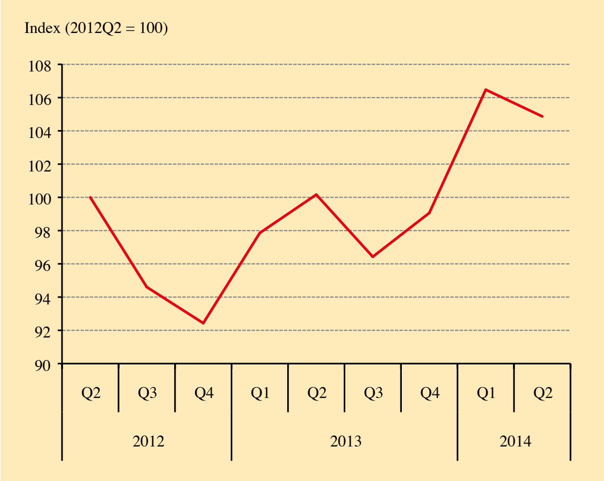
Table 3.4: Domestic and External Demand

	2012					2013					2014		
	Q1	Q2	Avg.	Q3	Q4	Q1	Q2	Avg.	Q3	Q4	Q1	Q2	Avg.
I. Domestic Demand													
Final consumption	2.9	2.4	2.7	2.2	3.5	2.8	2.0	2.4	2.6	1.8	1.4	3.1	2.3
Households	2.9	2.7	2.8	2.1	3.3	2.8	2.5	2.7	3.0	2.2	1.6	2.7	2.2
General Government	3.1	1.0	2.1	2.9	4.6	2.9	-0.5	1.2	0.5	-0.1	0.7	5.6	3.2
GDFCF	14.4	5.6	10.0	-4.1	-13.8	-10.7	-4.3	-7.5	-0.6	1.9	-1.5	-0.2	-0.9
Building & construction work	7.2	4.0	5.6	-3.9	-8.3	-4.1	-4.1	-4.1	-11.4	-19.1	-4.4	-5.7	-5.1
Machinery & equipment	29.4	9.1	19.3	-4.8	-26.1	-21.6	-4.4	-13.0	25.8	59.7	4.2	11.1	7.7
II. Net External Demand													
Exports of G & S	2.8	13.9	8.4	-4.0	1.5	-2.0	3.8	0.9	5.4	10.4	-0.1	6.3	3.1
Exports (goods)	-1.9	5.6	1.9	-2.2	2.1	4.3	0.1	2.2	6.4	7.9	6.9	13.4	10.2
Export (services)	6.2	21.3	13.8	-5.5	1.1	-6.1	6.6	0.3	4.5	12.4	-5.3	1.0	-2.2
Imports of G & S	4.8	11.3	8.1	-8.2	-1.0	0.2	0.2	0.2	11.3	12.3	-3.4	2.2	-0.6
Imports (goods)	3.2	10.4	6.8	-2.1	-0.8	-1.2	-2.9	-2.1	10.8	12.3	-1.9	11.7	4.9
Imports (services)	8.1	13.1	10.6	-18.8	-1.6	2.8	6.5	4.7	12.5	12.2	-6.2	-15.1	-10.7
III. GDP at market prices	**2.9**	**3.0**	**3.0**	**3.6**	**3.5**	**3.3**	**3.5**	**3.4**	**3.4**	**2.8**	**2.7**	**4.6**	**3.7**

Source: Statistics Mauritius and Bank of Mauritius

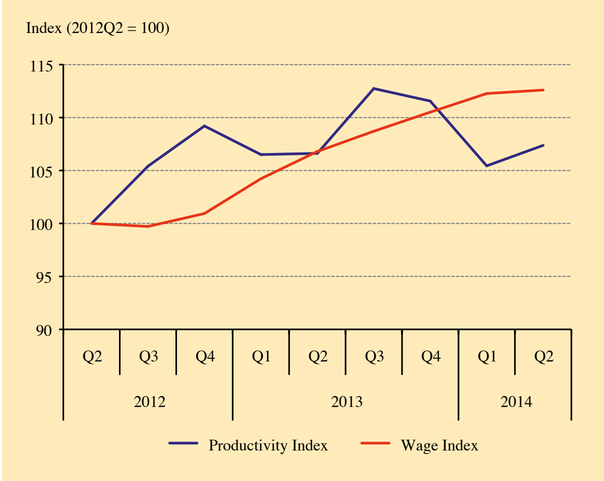
After declining significantly in 2012, unit labour costs (ULCs) confronting export-oriented enterprises have been increasing, albeit due to different reasons (Charts 3.2 & 3.3). The recorded ULCs' decline in 2012 was largely due to an increase in labour productivity that surpassed the increase in wages. During 2013, ULCs recovered to their early 2012 levels, although the increase in costs was somewhat contained by a sustained (albeit volatile) increase in productivity. During 2014, ULCs increased rapidly as labour productivity dropped, while wages continued to rise.

Chart 3.2: Export-Oriented Enterprises, Unit Labour Costs



Source: Bank of Mauritius.

Chart 3.3 Export-Oriented Enterprises, Labour Productivity & Wages



Source: Bank of Mauritius.

4. PUBLIC FINANCE

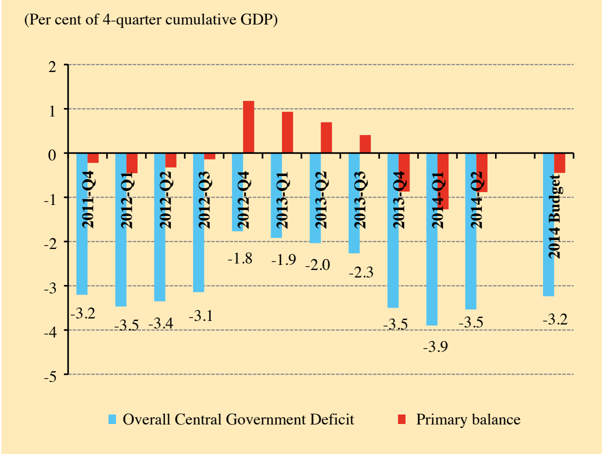
4.1 Developments and Outlook

Prudent macroeconomic management continues to underpin fiscal performance in 2014, with the overall fiscal deficit (as a share of GDP) showing a declining trend between the first and second quarters of 2014, that is broadly on target with the 2014 Budget estimates (Chart 4.1). Since the issue of the last Inflation Report in April 2014, overall central government deficit has declined from an estimated 3.9 per cent of GDP in 2014Q1 to 3.5 per cent of GDP in 2014Q2. The primary balance (i.e., the overall fiscal deficit less the interest payments on the national debt) has also declined through the period. Trends in the overall fiscal deficit and primary balance are broadly on target with the attainment of an overall fiscal deficit of 3.2 per cent of GDP and a primary deficit of 0.4 per cent of GDP by the end of 2014.

Revenue performance remains strong, supported by robust growth in taxes on goods and services, despite the economy's performance during the year, to date (Chart 4.2). Total revenue (as a share of GDP) recovered between the first and second quarters of 2014 largely on account of policy measures introduced in the Budget 2014 and on-going tax administration reforms. Hikes in excise duties and tobacco introduced in December 2013, together with strong collections in taxes on goods and services, are supporting the recovery in tax receipts. Tax administration reforms, such as the increased number of tax collectors and invigorated efforts to tackle tax evasion and underreporting of gambling taxes and VAT, are also starting to yield dividends to the tax revenue authority.

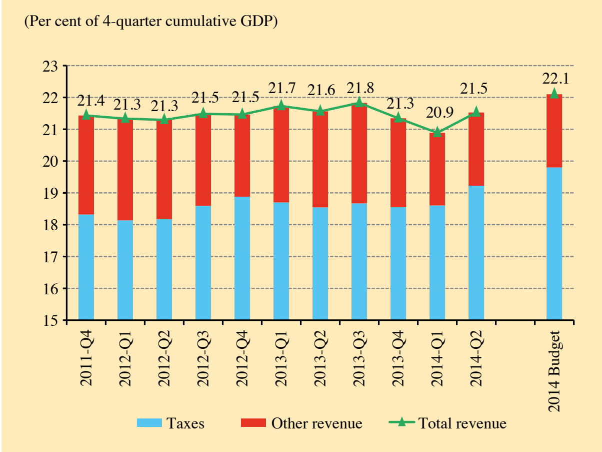
Total government expenditure has remained constant (as a share of GDP) during the first and second quarters of 2014 (Chart 4.3). To date, the level and composition of total expenditure reflect the Budget 2014 commitments. On the one hand, current expenditure, particularly spending on wages and salaries, pensions and social benefits, reflects budgeted spending commitments along a full year implementation of the Pay Research Bureau report,with some allocations (e.g., basic retirement pensions and other social transfers) increasing by just above the inflation rate. As such, current expenditure hovered around 22 per cent of GDP during the first half of 2014, up from about 21 per cent of GDP in the first half of 2013. On the other hand, capital expenditure has remained at around 3 per cent of GDP during 2014, which is roughly the level (as a share of GDP) of the last three years. Main infrastructure projects supporting the dynamics of capital expenditure include: (i) investment in consolidating the aviation hub and expanding the cargo and freeport facilities at the airport; (ii) construction of a cruise terminal building and extension of quay at the Mauritius Container Terminal; and (iii) investment in the utility sector to expand capacity, in line with rising demand.

Chart 4.1: Overall Central Government Deficit and Primary Balance



Source: Ministry of Finance and Economic Development.

Chart 4.2: Central Government Revenue



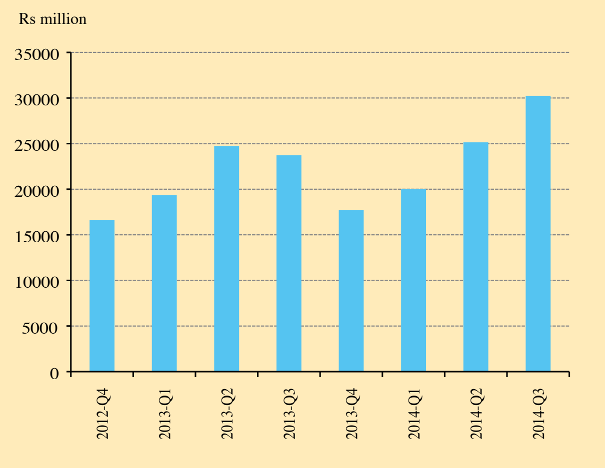
Source: Ministry of Finance and Economic Development.

Striking the right balance between the government's recourse to domestic and external finance is an on-going pursuit of the fiscal authorities (Table 4.1 and Charts 4.4 & 4.5). While the Budget 2014 targets a ratio of 60/40 of foreign to domestic financing, latest available data suggest on-going efforts by the central government to build up its deposits at the Bank of Mauritius in an effort to address the excess liquidity problem affecting the banking system. Deposit accumulation with the central bank comes on top of the frontloading of government paper (mostly 3-year Treasury notes and 10-year government bonds) during the year and early repayment of government external loans to dampen excess liquidity conditions in the economy.[5] Going forward, some of the referred accumulation in government deposits are likely to decline, depending on the performance of government revenue and expenditure, and the issue of alternative (additional) sources of domestic financing (i.e., Treasury Bills and/or government bonds).

4.2 Public Sector Debt

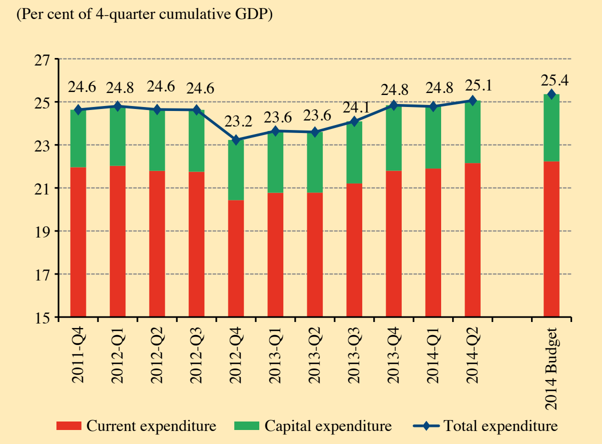
Public sector debt increased by 10.2 per cent, from Rs207.4 billion by the end of June 2013 to Rs228.6 billion by the end of June 2014 (Tables 4.2 & 4.3; Chart 4.6) As a percentage of GDP, total public sector debt increased by 2.4 percentage points to 60.8 per cent in June 2014. The increase has been broadly evenly distributed between external and domestic debt, with the latter showing a lengthening of its maturity profile. Most external debt is at variable interest rates.

Chart 4.4: Government Deposits with BoM



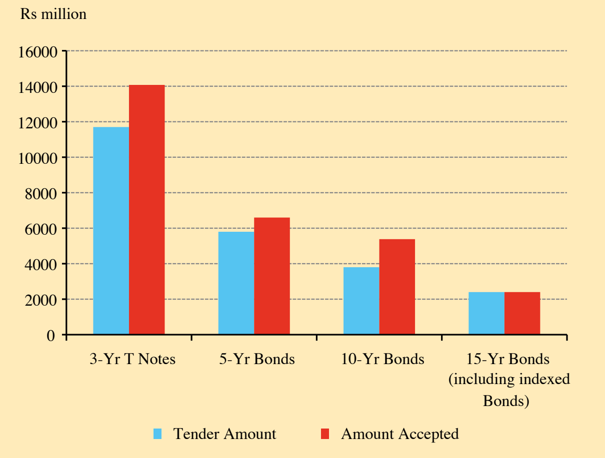
Source: Statistics Division, Bank of Mauritius

Chart 4.3: Central Government Expenditure



Source: Ministry of Finance and Economic Development.

Chart 4.5: Frontloading of Public Debt Issue (in millions of Rupees)



Source: Statistics Division, Bank of Mauritius

[5] *Frontloading refers to the issue of government securities ahead of the planned issuance calendar.*

Table 4.1: Statement of Budgetary Central Government Operations

	2011	2012	2013	2014 [1]	Jan - Jul 2013	Jan - Jul 2014
	(Actual)	*(Actual)*	*(Prov. Actual)*	*(Estimates)*	*(Actual)*	*(Estimates)*
	(Rs million)					
1. Revenue	**69,223.2**	**73,793.7**	**78,224.2**	**86,270.0**	**43,978.7**	**44,852.2**
Taxes on income, profits, and capital gains	13,619.7	14,634.2	15,919.6	17,048.0	8,510.4	9,351.6
Taxes on goods & services	38,817.9	43,007.8	44,964.0	48,682.0	25,503.3	26,134.5
2. Expense	**79,569.9**	**79,871.3**	**91,047.5**	**98,891.0**	**46,903.1**	**48,730.9**
Current	70,937.5	70,255.3	79,886.4	86,709.9	42,237.7	44,436.5
of which Interest	9,629.2	10,129.3	9,629.4	10,870.0	5,606.8	5,900.3
Capital	8,632.5	9,616.0	11,161.1	12,181.1	4,665.4	4,294.4
3. Gross Operating Balance/Overall Balance (1-2)	**-10,346.8**	**-6,077.6**	**-12,823.3**	**-12,621.0**	**-2,924.4**	**-3,878.7**
Primary Balance	**-717.6**	**4,051.7**	**-3,193.9**	**-1,751.0**	**2,682.4**	**2,021.6**
Net Lending	**2,458.2**	**1,032.1**	**4,967.4**	**1,655.3**	**24.4**	**-200.6**
Overall borrowing requirement	**-12,805.0**	**-7,109.7**	**-17,790.7**	**-14,276.3**	**-2,948.8**	**-3,678.1**
Financing	**12,805.0**	**7,109.7**	**17,790.7**	**14,276.3**	**2,948.8**	**3,678.1**
Domestic	7,774.7	4,493.3	7,283.1	6,193.0	-2,965.3	-597.5
Monetary Authority 1/	4,731.7	-5,946.3	-656.5	…	-8,000.9	-10,112.0
Banks	-5,529.8	5,384.0	2,835.6	…	2,202.1	8,294.1
Non-Banks	8,572.8	5,055.5	5,104.1	…	2,833.5	1,220.4
Foreign	5,564.2	2,981.4	10,805.1	8,195.3	5,964.8	4,304.7
Other	-533.8	-365.0	-297.5	-112.0	-50.7	-29.1
	(In per cent of GDP)					
1. Revenue	**21.4**	**21.5**	**21.3**	**22.1**		
Taxes on income, profits, and capital gains	4.2	4.3	4.3	4.4		
Taxes on goods & services	12.0	12.5	12.3	12.5		
2. Expense	**24.6**	**23.2**	**24.8**	**25.4**		
Current	22.0	20.4	21.8	22.2		
of which Interest	3.0	2.9	2.6	2.8		
Capital	2.7	2.8	3.0	3.1		
3. Gross Operating Balance/Overall Balance	**-3.2**	**-1.8**	**-3.5**	**-3.2**		
Primary Balance	**-0.2**	**1.2**	**-0.9**	**-0.4**		
Net Lending	**0.8**	**0.3**	**1.4**	**0.4**		
Overall borrowing requirement	**-4.0**	**-2.1**	**-4.9**	**-3.7**		
Financing	**4.0**	**2.1**	**4.9**	**3.7**		
Domestic	2.4	1.3	2.0	1.6		
Monetary Authority 1/	1.5	-1.7	-0.2	…		
Banks	-1.7	1.6	0.8	…		
Non-Banks	2.7	1.5	1.4	…		
Foreign	1.7	0.9	2.9	2.1		
Other	-0.2	-0.1	-0.1	0.0		

[1] *Includes government deposits with the Bank of Mauritius.*

Source: Ministry of Finance and Economic Development and BoM staff estimates.

According to the Budget 2014, the aim is to reduce the discounted public sector debt from 54.8 per cent of GDP by the end of 2013 to 54.0 per cent of GDP by the end of 2014.[6] The Public Debt Management Act (PDMA) 2008 sets a target for the reduction in the discounted public sector debt to 50 per cent of GDP by 2018.

Table 4.2: Public Sector Debt

Rs million

	Dec-12	Jun-13	Dec-13	Jun-14 *Provisional*
1. Short-term Domestic Obligations [1]	**31,093**	**29,880**	**27,497**	**22,984**
o/w: Treasury Bills	29,486	29,861	27,497	22,984
2. Medium-term Domestic Obligations [1]	**40,174**	**40,697**	**43,251**	**50,692**
o/w: Treasury Notes	40,157	40,680	43,251	**50,692**
3. Long-term Domestic Obligations [1]	**69,539**	**73,309**	**79,212**	**83,301**
o/w: MDLS/Government of Mauritius Bonds	39,892	42,287	46,062	49,079
Five-Year Government of Mauritius Bonds	29,647	31,022	33,150	34,222
4. Domestic Central Government Debt (1+2+3)	**140,806**	**143,886**	**149,960**	**156,977**
	(41.0)	(40.5)	(40.9)	(41.8)
5. External Government Debt	**35,918**	**42,106**	**47,133**	**51,427**
	(10.4)	(11.9)	(12.9)	(13.7)
(a) Foreign Loans	31,134	37,434	42,214	46,483
(b) Foreign Investment in Government Securities	241	157	427	418
(c) IMF SDR Allocations	4,543	4,515	4,493	4,525
6. Extra Budgetary Unit Domestic Debt	**105**	**105**	**24**	**24**
7. Extra Budgetary Unit External Debt	**180**	**171**	**160**	**147**
8. Local Government Domestic Debt	**2**	**1**	**0**	**0**
9. Public Enterprise Domestic Debt	**11,130**	**10,175**	**12,062**	**9,319**
10. Public Enterprise External Debt	**10,888**	**10,994**	**10,569**	**10,657**
11. Domestic Public Sector Debt	**152,043**	**154,167**	**162,046**	**166,320**
	(44.2)	(43.4)	(44.2)	(44.3)
12. External Public Sector Debt	**46,986**	**53,271**	**57,862**	**62,231**
	(13.7)	(15.0)	(15.8)	(16.6)
13. Total Public Sector Debt (11+12)	**199,029**	**207,438**	**219,908**	**228,551**
	(57.9)	(58.4)	(60.0)	(60.8)

[1] *By original maturity.*

Notes: (i) Short-term: Up to 12 months; Medium-term: Over 1 year but less than 5 years; Long-term: 5 years and above.
(ii) Figures in brackets are percentages to GDP.
(iii) Figures may not add up to totals due to rounding.

Source: Financial Markets Operations Division, Bank of Mauritius; Ministry of Finance and Economic Development, Government of Mauritius.

[6] *Discounted public sector debt evaluates/adjusts total public sector debt for the fiscal risks associated with debt of parastatals and state-owned enterprises. Accordingly, this debt is discounted whenever the fiscal risk is small. For operational purposes of adherence to the provisions of the PDMA 2008, it is the discounted public sector debt that is relevant.*

Table 4.3: Government External Debt by Interest Rate Mix

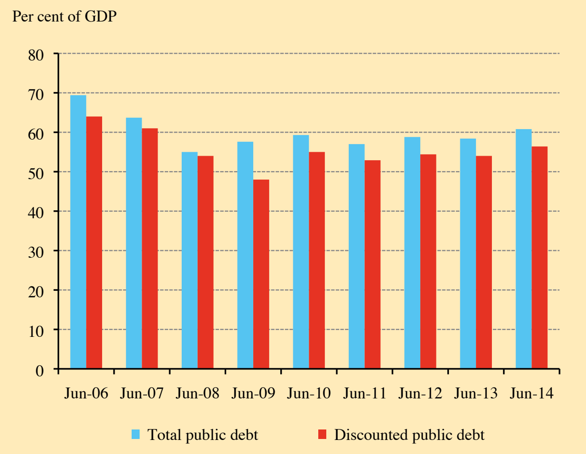
(Per cent)

	Dec-12	Jun-13	Dec-13	Jun-14 *Provisional*
Fixed Rate	21.7	19.1	19.5	17.1
Floating Rate	74.1	76.9	77.0	79.8
Interest-Free	4.2	3.9	3.5	3.1

Note: Figures may not add up to totals due to rounding.

Source: Ministry of Finance and Economic Development, Government of Mauritius.

Chart 4.6 Public Debt



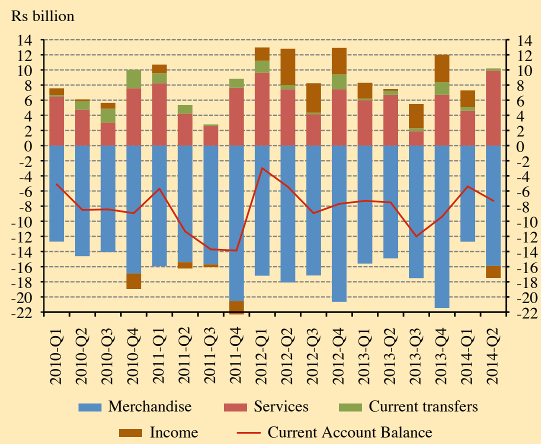
Source: Ministry of Finance and Economic Development.

5. BALANCE OF PAYMENTS

5.1 Overall Trends and Outlook

According to latest available information, the current account deficit narrowed from Rs14.8 billion in the first half of 2013 to Rs12.7 billion in the first half of 2014 on the back of a lower trade deficit, combined with a growing surplus on the services account, that more than offset a marked deterioration in the income account balance (Table 5.1 & Chart 5.1). Barring re-exports and 'ships, stores and bunkers', the improvement in the trade balance mirrored a restricted growth in imports of intermediate and final consumption goods. Indeed, during the first half of 2014, the annual growth rate of commodity imports (net of re-exports) was negative (-3.8 per cent; Table 5.2 & Chart 5.2). The deterioration in the income account echoed a drop in net inflows of 'other investment income' and an extraordinary hike in net outflows of portfolio investment income by a resident bank. An improved services account balance reflected lower net outflows on the 'transportation' and 'other services' accounts.

Chart 5.1: Components of the Current Account, 2010Q1-2014Q2



Source: Statistics Division, Bank of Mauritius.

Table 5.1: Balance of Payments Summary, 2012-2014H1

Rs million

	2012 [1]		2013 [1]		2014 [2]
	Semester 1	Semester 2	Semester 1	Semester 2	Semester 1
Current Account	**-8,435**	**-16,624**	**-14,782**	**-23,350**	**-12,700**
Exports (f.o.b)	38,274	41,384	42,107	46,041	45,272
Imports (f.o.b)	-74,161	-79,310	-72,719	-84,680	-73,854
of which: aircrafts/marine vessels	-	-	-	-1,732	-
Trade balance	-35,887	-37,926	-30,612	-38,639	**-28,582**
Services, net	17,083	11,753	12,833	6,638	14,518
*of which:*travel, net	18,341	15,041	15,762	11,407	15,677
Income, net	8,244	7,415	2,297	6,575	623
Current transfers, net	2,125	2,135	700	2,076	741
Capital and Financial Account	**32,553**	**2,911**	**14,349**	**25,933**	**9,393**
Capital account, net	-113	-128	-55	-68	-43
Direct investment, net	82,134	88,069	30,641	36,010	40,203
Portfolio investment, net	24,415	17,643	40,576	26,287	20,221
Other investment, net	-72,528	-97,988	-41,163	-35,366	-34,565
Balance of Payments Surplus (-)/ Deficit (+)	-1,356	-4,685	-15,650	-930	-16,423
Net Errors and Omissions	**-24,118**	**13,713**	**433**	**-2,583**	**3,307**

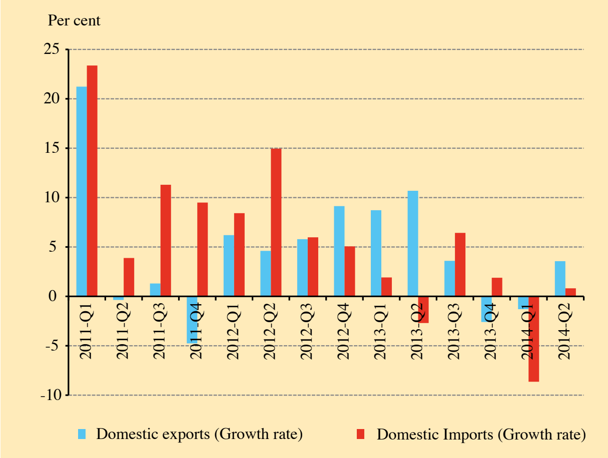
[1] *Revised.* [2] *Provisional.*

Figures may not add up to totals due to rounding.

Source: Statistics Division, Bank of Mauritius.

For the year 2014 as a whole, the current account projection developed in January 2014 has been revised to reflect emerging trends in international trade and finance (Table 5.3). The trade deficit has been reduced to reflect lower import volumes, while the earlier assumption of unchanged international terms of trade remains intact. The projected income account surplus, inclusive of GBC1 transactions, has also been reduced to reflect trends in outward profit remittances (through 2014H1) affecting the portfolio investment income envelope. Transportation costs are lower than before alongside a deceleration of commodity imports, whilst the earlier projection of current transfers from abroad remains unchanged. All in all, the current account deficit is projected to decline from 9.9 per cent of GDP in 2013 to 8.3 per cent in 2014.

Chart 5.2: Domestic Exports and Imports (Annual growth rates)



Source: Statistics Mauritius and BoM staff estimates.

Table 5.2: Exports and Imports by SITC

	2013			2014			Growth rate (Year-on-Year)		
	Q1	Q2	Semester 1	Q1	Q2	Semester 1	Q1	Q2	Semester 1
	(Rs million)						*(Per cent)*		
Total Exports (f.o.b.)	**20,361**	**21,746**	**42,107**	**21,385**	**23,887**	**45,272**	5.0	9.8	7.5
Domestic exports	13,799	15,036	28,835	13,620	15,572	29,192	- 1.3	3.6	1.2
Re-exports	2,692	2,517	5,209	3,597	5,455	9,052	33.6	116.7	73.8
Ship's Stores and Bunkers	3,870	4,193	8,063	4,168	2,860	7,028	7.7	- 31.8	- 12.8
Exports by section									
Food and live animals	6,624	6,818	13,442	6,196	6,555	12,751	- 6.5	- 3.9	- 5.1
Machinery and transport equipment	497	467	964	1,008	2,743	3,751	102.8	487.4	289.1
Miscellaneous manufactured goods	6,731	7,296	14,027	7,032	8,032	15,064	4.5	10.1	7.4
of which: Articles of apparel & clothing accessories	5,427	5,840	11,267	5,650	6,488	12,138	4.1	11.1	7.7
Manufactured goods classified chiefly by material	1,527	1,828	3,355	1,857	2,299	4,156	21.6	25.8	23.9
Total Imports (c.i.f)	**37,744**	**38,679**	**76,423**	**35,620**	**41,912**	**77,532**	- 5.6	8.4	1.5
Domestic Imports	35,052	36,162	71,214	32,023	36,457	68,480	- 8.6	0.8	-3.8
Imports for re-exports	2,692	2,517	5,209	3,597	5,455	9,052	33.6	116.7	73.8
Imports by section									
Food and live animals	7,346	7,135	14,481	6,832	7,171	14,003	- 7.0	0.5	- 3.3
Mineral fuels, lubricants, & related products	9,963	8,592	18,555	8,244	8,361	16,605	- 17.3	- 2.7	- 10.5
Machinery & transport equipment	5,889	7,287	13,176	6,955	9,809	16,764	18.1	34.6	27.2
Miscellaneous manufactured articles	2,781	3,407	6,188	2,639	3,741	6,380	- 5.1	9.8	3.1
Manufactured goods classified chiefly by material	6,477	6,908	13,385	5,900	6,931	12,831	- 8.9	0.3	- 4.1

Source: Statistics Mauritius and BoM staff estimates.

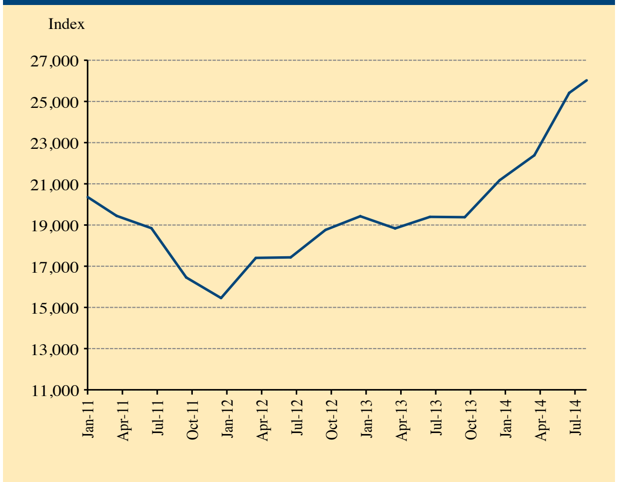
Table 5.3: Balance of Payments, 2010 – 2014

	2010	2011	2012	Preliminary 2013	2014 Projection	
					Jan. 2014	Revised
			(Rs million)			
Current account	**-30,985**	**-44,630**	**-25,059**	**-36,187**	**-33,862**	**-32,261**
Trade balance	-58,289	-67,585	-73,813	-69,590	-79,298	-66,526
Service balance	21,949	22,869	28,838	21,493	25,297	26,912
Income balance	-274	-3,389	15,659	9,134	14,583	4,406
o/w GBC1 net inflows	-6,478	-7,179	11,273	5,282	10,407	2,924
Current transfers	5,629	3,475	4,260	2,776	5,557	2,947
Capital and Financial account	**26,138**	**39,188**	**35,463**	**33,173**	**33,862**	**29,202**
Capital account	-148	-53	-241	-123	-123	-150
Financial account	26,286	39,241	35,704	33,296	33,984	29,352
FDI (net)	423,658	-29,009	170,204	67,213	56,816	75,911
Portfolio investment	-300,682	256,972	42,059	59,760	37,178	43,405
Other investment	-90,512	-183,475	-170,518	-77,098	-48,681	-68,273
o/w Banks (net)	-56,096	-7,911	-24,971	46,892		41,408
Reserve assets	-6,177	-5,247	-6,041	-16,580	-11,328	-21,691
Errors and omissions net	**4,847**	**5,442**	**-10,404**	**3,015**	**0**	**3,058**
			(In Per cent of GDP)			
Current account	**-10.4**	**-13.8**	**-7.3**	**-9.9**	**-8.7**	**-8.3**
Trade balance	-19.5	-20.9	-21.5	-19.0	-20.3	-17.1
Service balance	7.3	7.1	8.4	5.9	6.5	6.9
Income balance	-0.1	-1.0	4.6	2.5	3.7	1.1
o/w GBC1 net inflows	*-2.2*	*-2.2*	*3.3*	*1.4*	*1.4*	*0.7*
Current transfers	1.9	1.1	1.2	0.8	1.4	0.8
Capital and Financial account	**8.7**	**12.1**	**10.3**	**9.1**	**8.7**	**7.5**
Capital account	0.0	0.0	-0.1	0.0	0.0	0.0
Financial account	8.8	12.1	10.4	9.1	8.7	7.5
FDI (net)	141.6	-9.0	49.5	18.3	14.6	19.5
Portfolio investment	-100.5	79.6	12.2	16.3	9.5	11.1
Other investment	-30.3	-56.8	-49.6	-21.0	-12.5	-17.5
o/w Banks (net)						
Reserve assets	-2.1	-1.6	-1.8	-4.5	-2.9	-5.6
Errors and omissions net	**1.6**	**1.7**	**-3.0**	**0.8**	**0.0**	**0.8**
Memo items:						
Nominal GDP (millions of Rs)	299,173	323,011	343,835	366,479	…	389,999
Gross official reserves (millions of Rs)	78,011	80,054	91,409	103,258	110,080	126,700
Import coverage (in months of Goods & Services)	5.0	4.6	4.9	5.2	4.8	6.2

Source: Statistics Division, Bank of Mauritius.

The financing of the 2014 current account deficit has also been updated along with recent financial developments. The change in reserve assets (excluding valuation changes) has been updated to reflect trends to date, which include a sizeable increase in gross official reserves in the second quarter of this year (from US$3.5 billion at end-December 2013 to US$4.0 billion by end-June 2014). Also, compared with 2013, the net GBC1 portfolio inflows have been reduced to capture recent trends with these cross-border financial flows (excluding valuation changes, as those registered in the Indian stock exchange during 2008/09 and 2012, onwards; Chart 5.3) into the domestic economy.[7] The revised projection also includes net inflows on account of long-term government foreign borrowing (estimated at about Rs690 billion). Net errors and omissions are projected to remain at around the same level as in 2013.

Chart 5.3: India Stock Market Index (SENSEX)

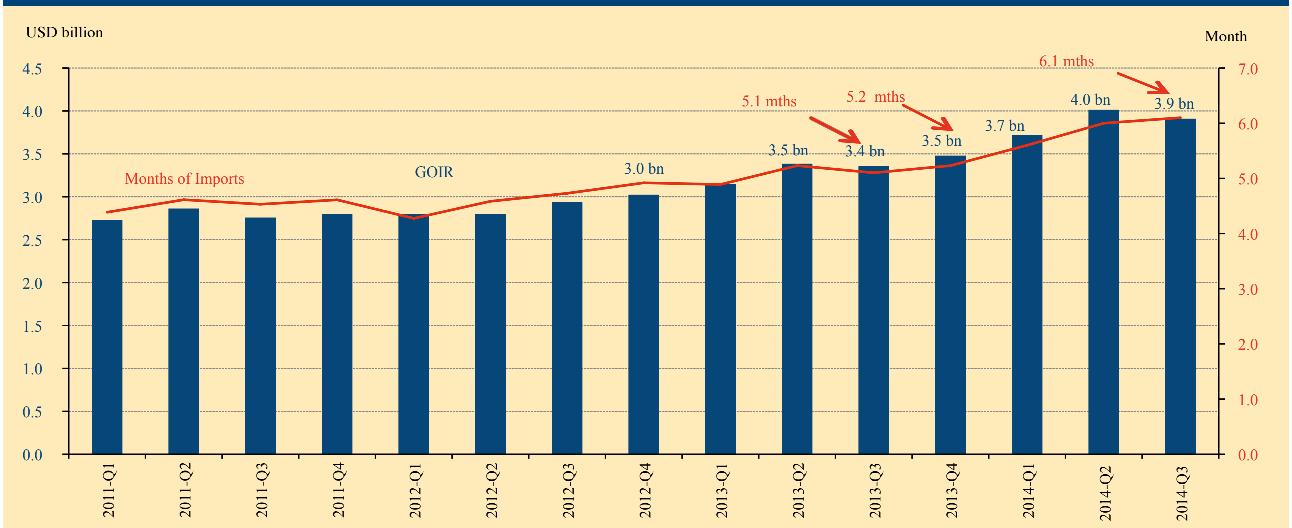


Source: Reuters

5.2 Gross Official International Reserves

The revised balance of payments projection assumes international reserves import cover of 6.2 months by the end of 2014 (Table 5.3 and Chart 5.4). Gross official international reserves have grown rapidly since the Bank embarked on the Operation Reserves Reconstitution (ORR) programme in June 2012. A sizeable accumulation of gross international reserves arose in the first half of 2014 on account of net purchases in the foreign exchange market, coupled with Government's net external borrowing.

Chart 5.4: Gross Official International Reserves and Import Coverage



Source: Statistics Division, Bank of Mauritius

[7] *Only stock data as those reported in the country's International Investment Position include valuation adjustment of debt and equity. Balance of payments data exclude valuation adjustments.*

5.3 International Terms of Trade

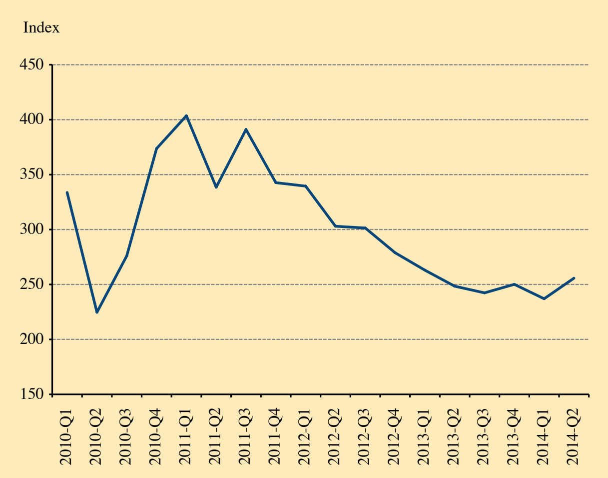
During the first half of 2014, there was a further improvement in the terms of trade that was in line with the overall trend in place since 2011 (Table 5.4). While the export price index declined against the average in 2013, the import price index fell significantly in 2014Q1, alongside a substantial easing of food import prices and that of miscellaneous imports. The terms of trade index has been broadly improving since 2011, mainly on account of hikes in export price indices for fish (through 2013), apparel and clothing, while price increases for imported food and energy prices have remained contained, albeit volatile.

For 2014 as a whole, the current Inflation Report assumes that the trend in the terms of trade will remain unchanged with respect to 2013. The Report assumes that the overall import price index will continue to decline due to on-going reductions in international food and energy prices. Export price indices are also projected to decline (mainly due to drops in sugar and fish prices). The decline in export and import price indices will broadly offset each other.

Sugar price

The FAO Sugar Price Index averaged 244.3 points in August 2014, down by 14.8 points from July 2014, but still 2.2 points higher than in August 2013. The large drop in prices was triggered by improved production prospects in India, the world's second largest sugar producer, as well as in the European Union and the Russian Federation. In addition, reports of lower-than-expected import demand by China weighed on international prices. The downgrading of production in Brazil, the world largest sugar producer, was not sufficient to offset the downward price pressure. According to the FAO food outlook for the 2014-15 season, the world sugar market is likely to be more balanced, or even display a small deficit, as producers adjust to lower international sugar prices by reducing production.

Chart 5.5 Sugar Prices



Source: FAO

Table 5.4: International Terms of Trade (Index; 2007 = 100)

	Weights	2007	2008	2009	2010	2011	2012	2013	2014Q1	2014Q2
Export price index	**1.0000**	**100.0**	**97.2**	**96.7**	**93.7**	**97.2**	**103.9**	**108.6**	**107.3**	**105.2**
Apparel & clothing	0.5389	100.2	91.3	94.5	90.8	91.9	93.5	96.0	101.1	101.6
Sugar	0.1904	100.0	94.2	87.3	84.6	94.6	109.9	108.0	94.3	91.4
Fish	0.1262	100.0	117.5	93.1	92.7	96.0	115.7	127.1	114.5	100.0
Other exports	0.1445	99.0	105.2	120.5	117.0	121.8	124.7	139.9	141.1	141.3
Import price index	**1.0000**	**100.0**	**109.6**	**103.2**	**110.6**	**117.6**	**124.6**	**122.7**	**118.7**	**119.4**
Food	0.1808	100.0	119.8	109.9	115.5	122.8	131.5	138.2	122.5	128.7
Petroleum	0.1725	100.0	128.4	86.1	110.0	135.0	148.5	146.6	142.6	141.1
Manufacturing	0.2141	100.0	99.2	99.9	105.2	109.4	115.1	112.4	113.7	112.3
Other	0.4326	100.0	102.9	108.8	111.4	112.5	116.9	111.8	110.1	110.3
Terms of trade		100.0	88.7	93.7	84.7	82.7	83.4	88.5	90.4	88.1

Source: Statistics Mauritius and Bank of Mauritius

Crude oil prices

Geopolitical tensions in Iraq and Ukraine/Russia and supply outages put upward pressures on global oil prices in 2014H1 before subsiding in July and August 2014 as the crude oil market became complacent about the risk of supply disruptions. The September 2014 US Energy Information Administration (EIA) report expects Brent crude oil price to weaken as non-OPEC supply growth exceeds growth in world consumption. Brent crude oil price is projected to average US$106 per barrel and US$103 per barrel in 2014 and 2015, respectively.

International oil prices have, in general, remained range-bound, between US$96.0 and US$112.0 per barrel, during the period under review (Chart 5.6). ICE Brent rose from US$107.7 per barrel in March 2014 to US$111.9 per barrel in June 2014 before subsiding to US$103.6 a barrel in August. Likewise, NYMEX firmed to US$105.1 per barrel in June 2014 before moving downwards to US$96.0 per barrel in August 2014.

Food Price Index

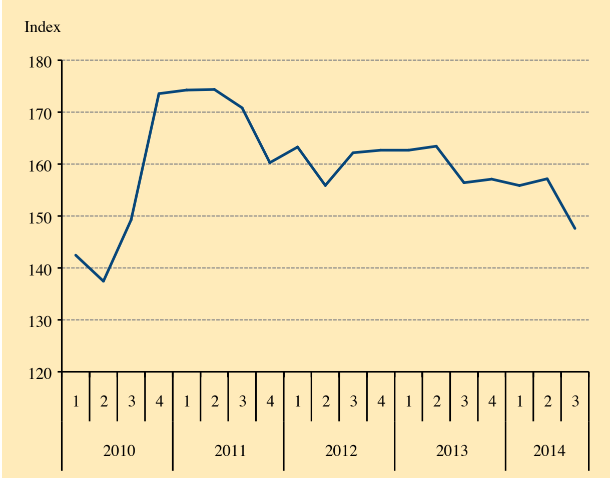
The Food and Agriculture Organisation's (FAO) food price index decreased for a fifth consecutive month in August 2014. The lingering decline of food prices reflects much better expectations over supplies in the current and forthcoming seasons. The index's August 2014 average of 196.6 points represented a decrease of 17.2 points (8.0 per cent) from March 2014. With the exception of meat, prices for all of the commodities measured by the index have dipped markedly since March 2014.

According to the July 2014 World Bank Commodity Markets Outlook, agricultural prices are projected to moderate further in 2014 under the assumptions that current crop conditions will be along the normal trends and there are ample inventories.

Wheat and maize

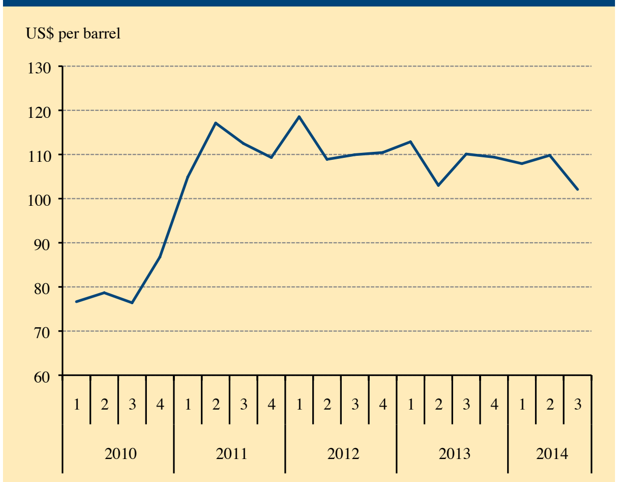
The price for maize decreased by 27 per cent between the second quarter of 2013 and the second quarter of 2014 mainly on account of bumper harvests in key producing economies, especially the US, while wheat prices strengthened. The wheat market is reportedly still tight, as farm yields are projected to retreat from last year's record, causing production declines in the world's key suppliers (U.S. Canada, and Australia). According to the July

Chart 5.7: FAO Food Price Index



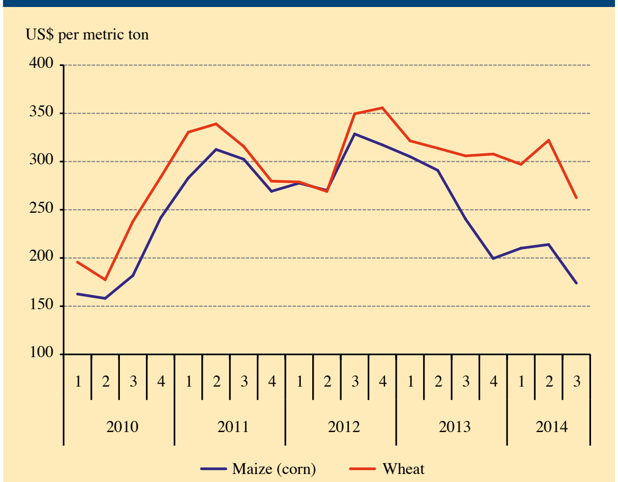
Source: FAO.

Chart 5.6: Crude Oil Prices



Source: IMF.

Chart 5.8: Maize and Wheat Prices



Source: FAO.

2014 World Bank Commodity Markets Outlook, the US Department of Agriculture has maintained its outlook for next season with global production of wheat and maize expected to decline.

5.4 Savings-Investment Gap

The macroeconomic framework used in this Inflation Report for projecting inflation for the whole of 2014 assumes that domestic investment (as a share of GDP) will be largely financed by domestic savings, although the contribution of external savings will be lower than in earlier projections (Table 5.5). As noted above, the external current account deficit is expected to be lower than in 2013 due to a lower trade deficit. The contribution of public sector savings to the financing of the domestic investment envelope is expected to remain negative, as in 2013. Consistent with recent trends in the national accounts, the projection for 2014 level of domestic investment has been revised downwards from 23.2 per cent of GDP projected earlier in the year to 22.3 per cent of GDP. The expected decline in private investment and inventories' accumulation explains the drop in overall domestic investment.

Table 5.5: Saving-Investment Balance

	2011	2012	2013	2014 Proj.	
				Jan. 2014	Revised
			(Rs million)		
Investment	**83,905**	**85,162**	**87,892**	**91,479**	**86,784**
Private (GDFCF)	59,667	60,175	59,266	57,943	58,413
Public	17,898	19,010	18,352	21,620	20,702
Change in inventories	6,340	5,977	10,274	11,916	7,669
Savings	**83,905**	**85,162**	**87,892**	**91,479**	**86,784**
External	44,630	25,059	36,187	33,862	32,261
Domestic	39,275	60,103	51,705	57,616	54,523
Private	43,334	58,962	54,770	…	56,963
Public	-4,059	1,141	-3,065	…	-2,440
			(In per cent of GDP)		
Investment*	**26.0**	**24.8**	**24.0**	**23.2**	**22.3**
Private (GDFCF)	18.5	17.5	16.2	14.7	15.0
Public	5.5	5.5	5.0	5.5	5.3
Change in inventories	2.0	1.7	2.8	3.0	2.0
Total Savings*	**26.0**	**24.8**	**24.0**	**23.2**	**22.3**
External (with global business)	13.8	7.3	9.9	8.6	8.3
Domestic	12.2	17.5	14.1	14.6	14.0
Private	13.4	17.1	14.9	…	14.7
Public	-1.3	0.3	-0.8	…	-0.6
			(In per cent of GDP)		
Savings	**26.2**	**23.6**	**23.4**	**22.9**	**22.0**
External (with global business)	13.9	7.0	9.7	8.5	8.2
Domestic	12.3	16.7	13.8	14.4	13.8
Private	13.5	16.4	14.6	…	14.4
Public	-1.3	0.3	-0.8	…	-0.6
Memo item:					
GDP (millions of Rs)	323,010	343,833	366,476	394,200	388,297
GNDI	320,145	360,490	374,966	399,413	394,430

** Reflects accounting identity of investment equals savings (external plus domestic)*

Source: Statistics Mauritius and BoM estimates and projections.

6. Monetary Policy

6.1 Overview

Since the April 2014 Inflation Report, the KRR has remained unchanged at 4.65 per cent due to the balance of external and internal risks affecting the outlook for growth and inflation. The international environment remains volatile, but favourable in terms of trends in international prices for food and energy, which have been declining in the recent past. The output gap has remained negative, with output growth below potential, while limited (albeit positive) growth of final consumption and investment has been exerting limited inflationary pressures from the demand side. Supply side factors, such as shocks affecting the availability of goods and services, also remain limited at this stage.

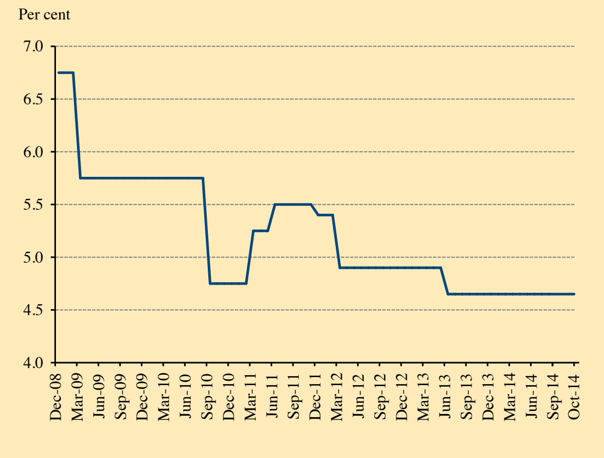
The Bank of Mauritius has continued addressing the problem of excess liquidity using its monetary policy instruments and pursuing strong policy coordination with the Ministry of Finance and Economic Development (MOFED):

- First, open market operations using BoM securities have continued, although the stock of BoM securities declined in the last quarter of 2013 due to the maturing of Bills. However, during the first half of 2014, the stock of BoM securities increased significantly, from Rs16.7 billion to Rs24 billion, as the Bank of Mauritius sought to sterilise the impact of sizeable foreign exchange intervention during the period. During August 2014, the stock of BOM securities declined mainly on account of maturing BOM bills (182-day Bills and 364-day Bills).

- Second, the BOM increased the cash reserve ratio requirement for banks to hold on Rupee deposits to address the liquidity problem: the ratio was increased from 8.0 per cent to 9.0 per cent in May 2014.[8]

- Third, there is also agreement that co-operation in setting an explicit inflation target would effectively anchor inflation expectations, while acknowledging that other economic considerations, such as the orderly and balanced economic development, should be taken into account in monetary policy-making.

Chart 6.1: Key Repo Rate



Source: Bank of Mauritius

8 *The CRR that banks are required to maintain has been increased five times: from 4.5 per cent to 5.0 per cent in June 2010; from 5.0 per cent to 6.0 per cent in October 2010; from 6.0 per cent to 7.0 per cent in February 2011; from 7.0 per cent to 8.0 per cent in October 2013, and further to 9.0 per cent in May 2014.*

Two MPC meetings (July and October 2014) were held since the last Inflation Report (April 2014).

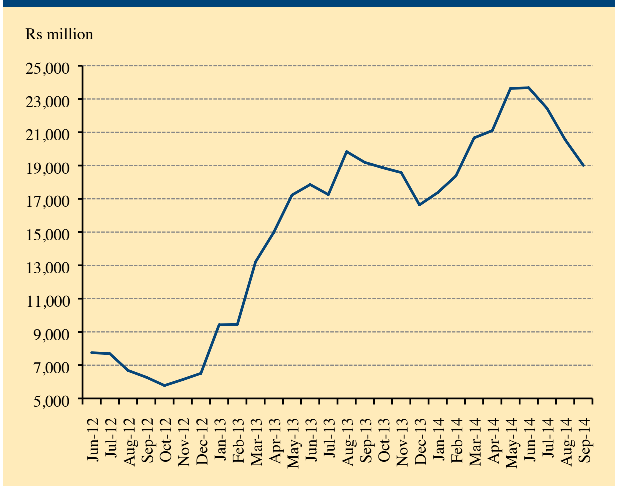
- The July 2014 Monetary Policy Communiqué noted the risks of a decline in the growth of output, while inflation remained low and declining. The Communiqué also noted that the MPC foresaw maintaining the stance of monetary policy up to the end of 2014 on the assumption that headline inflation would stay at or below 4 per cent and y-o-y inflation at or below 3.5 per cent, assuming no unexpected disruption in the supply of goods and services.

- The October 2014 Monetary Policy Communiqué kept the KRR unchanged at 4.65 per cent per annum noting that economic conditions were broadly unchanged from the previous MPC meeting.

6.2 Short-term Interest Rates and Monetary Operations

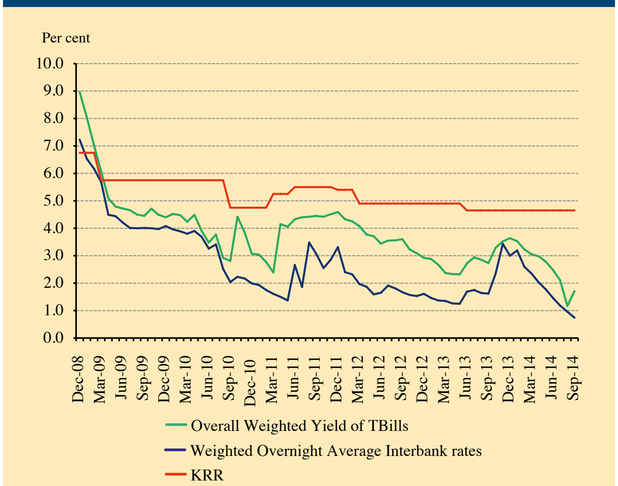
Short-term interest rates remain affected by the excess liquidity prevailing in the banking system, despite efforts by the authorities to address the problem (Chart 6.3). Indeed, the gap between the KRR and key short-term interest rates (i.e., the yields on Treasury Bills and the interbank rate) has widened since the beginning of the year, notwithstanding the sizeable frontloading of government papers. The decline in short-term interest rates[9] has coincided with a period of sizeable BoM intervention in the foreign exchange markets that led to an increase in official reserves from about US$3,491 million by the end of December 2013 to US$4,052 million by the end of August 2014 (Chart 6.4). During the second half of 2013 through the first quarter of 2014, the trade-weighted nominal exchange rate for the Mauritian Rupee (NEER) appreciated largely due to the depreciation of the Indian Rupee against the Mauritian Rupee (Charts 6.5). In recent months, the Mauritian Rupee has depreciated in nominal effective terms (as measured by the NEER) along the appreciation of the US dollars against the euro. The currency-weighted nominal exchange rate (MERI1 or MERI2) has also depreciated marginally in recent months. The recent depreciation of the NEER has partly offset some of the appreciation of the real effective exchange rate (REER) since the second half of 2013 (Chart 6.6).

Chart 6.2 Outstanding BOM Securities



Source: Bank of Mauritius

Chart 6.3: KRR, Money Market and Interbank Interest Rates



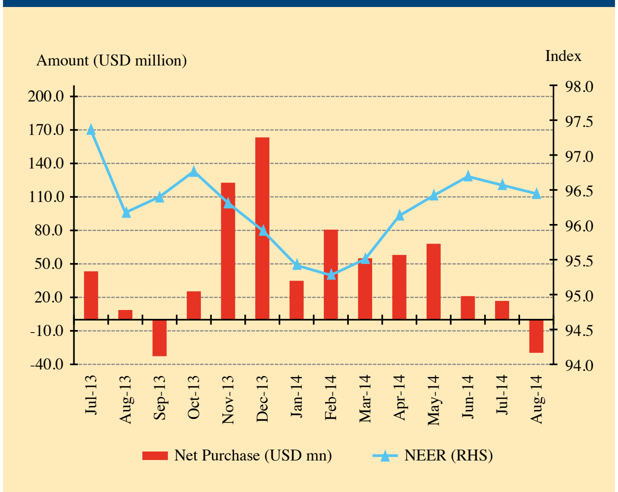
Source: Bank of Mauritius

9 *The weighted overnight interbank interest rate reached a low of 0.96 per cent by the end of August 2014 while the weighted yields on the 91 day, 182 day, 273 day and 364-Day Government of Mauritius Treasury Bills moved to 1.43 per cent, 0.92 per cent, 1.12 per cent and 1.30 per cent, respectively.*

Banks' lending rates have been stable for long, notwithstanding the volatility of interest rates in the interbank money market and the yields on Treasury Bills (Chart 6.7). Lending rates for key sectors in the economy (i.e., construction, traders, and tourism) have been higher than inflation, in the range of 7.45 to 8.91 per cent in the recent past. Rates on consumer or personal credit are higher than those for productive purposes. Since the beginning of 2014, there has been a marginal decline in lending rates to the tourism sector, possibly reflecting efforts to boost tourism activities in the low season. All lending rates show a marginal decline following the June 2013 reduction in the KRR.

Rupee deposit interest rates have been consistently lower than the inflation rate, although deposit rates have increased marginally since April 2014 (Chart 6.8). The recent increase in the weighted average deposit rate reflects marginal changes in the BoM estimation methodology used to compute this indicator.

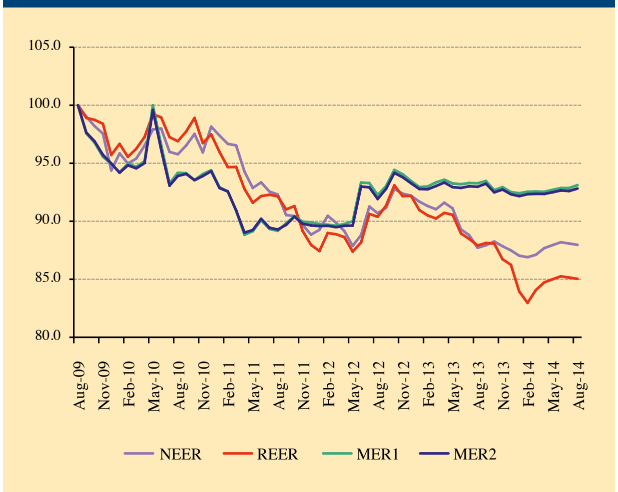
Chart 6.4 BoM Forex Intervention and NEER[1]



[1] *An increase in the NEER index indicates a depreciation of the NEER. The NEER is a trade-weighted index.*

Source: Bank of Mauritius

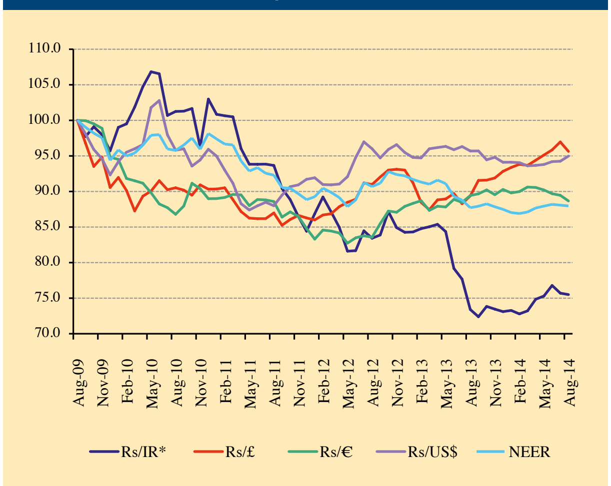
Chart 6.6 NEER, MERI1, MERI2 and REER Indices (August 2009 = 100)[1,2]



[1] *An increase in the NEER index indicates a depreciation of the NEER.*
[2] *The NEER is a trade-weighted index. The MERI1and MERI2 are based on the currency distribution of merchandise trade and services, excluding transactions in Rupees.*

Source: Bank of Mauritius

Chart 6.5 Cross Rates for the Rupee & NEER Index (August 2009 = 100)[1]

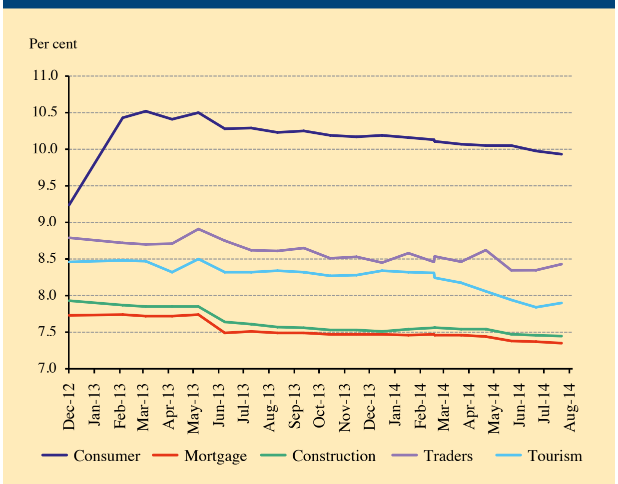


[1] *An increase in the NEER index indicates a depreciation of the NEER. The NEER is a trade-weighted index.*

* *IR stands for Indian Rupee.*

Source: Bank of Mauritius

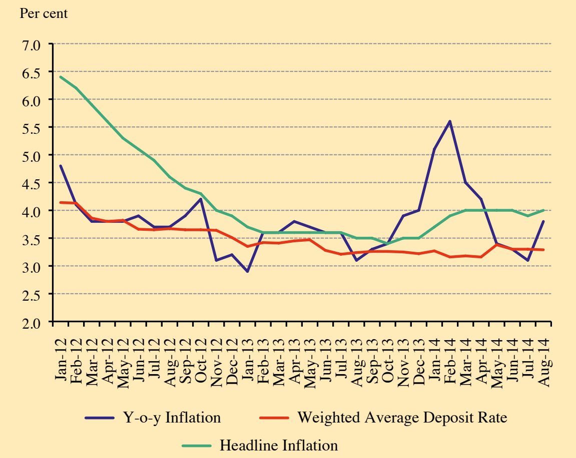
Chart 6.7: Lending Rates by Sector



Source: Bank of Mauritius

BoM intervention in the money market has been implemented using an array of instruments, whose yields have been generally the same as those of government paper (Table 6.1). From the beginning of 2014, the central bank has intervened using instruments with maturities ranging from 91-day maturity to 15-year maturity. The issue of BoM securities has been concentrated in the 273-day and 3-year maturities (Chart 6.9). Most of the BoM securities remain in the hands of domestic banks, although social security funds also hold a significant portion of these instruments (Table 6.2). The issue of BoM instruments has reduced the growth of the monetary base.

Chart 6.8 Inflation and Weighted Average Rupee Deposit Rate



Source: Bank of Mauritius

Table 6.1 : Yield on BoM Securities

Per cent

	Key Repo Rate	91-day	182-day	273-day	364-day	3-year	5-year	15-year
2012M1	5.40			4.30				
2012M3	4.90				4.37			
2012M9	4.90					4.73		
2012M11	4.90		2.96		3.22			
2012M12	4.90		2.80					
2013M1	4.90		2.72	2.88	2.87			
2013M2	4.90		2.62	2.74				
2013M3	4.90		2.34	2.35	2.47			
2013M4	4.90			2.34	2.38	3.65		
2013M5	4.90			2.28	2.30	3.62		
2013M6	4.65			2.81	2.91		4.29	
2013M7	4.65			2.88	2.96			
2013M8	4.65		2.62		3.08	3.88	4.28	
2013M9	4.65	2.51		2.77	3.04			
2014M1	4.65		3.42	3.44	3.70	4.54		
2014M2	4.65	3.04			3.46	4.33		
2014M3	4.65	2.78	3.07	3.05	3.30			7.60
2014M4	4.65			2.93	3.00			
2014M5	4.65		2.79	2.79	2.90	4.12		
2014M6	4.65	2.43	2.32	2.56				
2014M8	4.65						4.28	

Source: Bank of Mauritius.

Table 6.2: Bank of Mauritius: Balance Sheet, 2011-2014

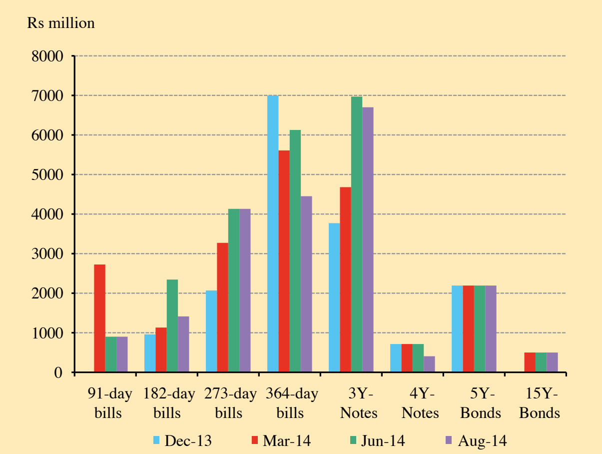
	2011	2012	2013				2014		
			March	June	September	December	March	June	August
(In millions of Rupees)									
Net Foreign Assets	80,100.9	91,559.8	96,754.8	103,579.9	100,933.4	103,497.9	110,343.1	119,619.6	123,260.4
Net Domestic Claims	**(23,223.7)**	**(32,414.4)**	**(31,563.7)**	**(32,620.7)**	**(31,551.3)**	**(24,504.0)**	**(27,227.8)**	**(33,925.2)**	**(36,260.4)**
Claims on ODCs	1,138.7	1,804.6	2,108.1	1,546.1	2,973.9	2,715.7	3,529.4	2,414.3	2,049.4
Net Claims on Central Government [1]	(5,754.7)	(9,721.1)	(8,902.4)	(13,237.6)	(12,545.6)	(6,903.8)	(9,566.7)	(14,427.2)	(16,493.9)
Claims on Other Sectors	187.7	184.5	144.7	198.1	162.7	172.7	154.8	159.6	129.5
Other items (net)	(18,795.4)	(24,682.3)	(24,914.1)	(21,127.3)	(22,142.3)	(20,488.5)	(21,345.3)	(22,071.9)	(21,945.3)
Monetary Base	**48280.9**	**52622.9**	**51963.3**	**53094.0**	**50185.2**	**62350.0**	**62483.5**	**62137.0**	**66521.8**
Currency in circulation	24469.8	26961.3	24955.0	24405.0	24906.3	30127.7	26769.0	26344.9	26980.2
Liabilities to ODCs	23811.1	25661.6	27008.3	28689.0	25279.0	32222.4	35714.5	35792.1	39541.5
BoM securities	**8596.3**	**6522.5**	**13227.8**	**17865.2**	**19196.9**	**16644.0**	**20631.8**	**23557.3**	**20478.2**
(Contribution to Monetary Base growth; in per cent)									
Net Foreign Assets	**4.9**	**23.7**	**38.9**	**40.1**	**27.5**	**22.7**	**26.1**	**30.2**	**46.6**
Net Domestic Assets/Claims	**9.3**	**-19.0**	**-12.8**	**-2.9**	**4.1**	**15.0**	**8.3**	**-2.5**	**-16.1**
Claims on ODCs	0.3	1.4	2.1	2.4	4.7	1.7	2.7	1.6	-0.1
Net Claims on Central Government	5.4	-8.2	-3.6	-8.9	-5.4	5.4	-1.3	-2.2	-15.4
Claims on Other Sectors	-0.2	0.0	-0.2	0.1	-0.1	0.0	0.0	-0.1	0.0
Other items (net)	3.8	-12.2	-11.2	3.5	4.9	8.0	6.9	-1.8	-0.6
Monetary Base	**7.4**	**9.0**	**16.4**	**15.6**	**6.2**	**18.5**	**20.2**	**17.0**	**29.3**
Currency in circulation	4.2	5.2	6.9	5.8	5.2	6.0	3.5	3.7	3.2
Liabilities to ODCs	3.3	3.8	9.5	9.9	1.0	12.5	16.8	13.4	26.1
BoM securities	**-6.7**	**4.3**	**-9.6**	**-21.6**	**-25.4**	**-19.2**	**-14.2**	**-10.7**	**-1.2**
(Growth Rate in per cent)									
Net Foreign Assets	**2.8**	**14.3**	**21.8**	**21.6**	**14.8**	**13.0**	**14.0**	**15.5**	**22.1**
Net Domestic Assets/Claims	**-15.2**	**39.6**	**22.2**	**4.2**	**-5.7**	**-24.4**	**-13.7**	**4.0**	**14.9**
Claims on ODCs	14.8	58.5	78.7	243.5	289.4	50.5	67.4	56.2	-31.1
Net Claims on Central Government	-29.7	68.9	21.8	44.4	25.7	-29.0	7.5	9.0	31.5
Claims on Other Sectors	-35.1	-1.7	-36.7	39.2	-12.8	-6.4	7.0	-19.4	-20.5
Other items (net)	-8.3	31.3	25.0	-7.0	-9.4	-17.0	-14.3	4.5	-0.9
Monetary Base	**7.4**	**9.0**	**16.4**	**15.6**	**6.2**	**18.5**	**20.2**	**17.0**	**32.6**
Currency in circulation	8.3	10.2	14.1	12.2	10.9	11.7	7.3	7.9	8.3
Liabilities to ODCs	6.6	7.8	18.6	18.7	1.9	25.6	32.2	24.8	56.4
BoM securities	**54.1**	**-24.1**	**48.0**	**124.6**	**166.9**	**155.2**	**56.0**	**31.9**	**6.7**
Memo item:									
End-period exchange rate (Rs/US$)	29.3	30.5	31.2	31.0	30.5	30.1	30.1	30.2	30.9

[1] *Excludes BOM securities holdings by social security funds*

Source: Statistics Mauritius and BoM estimates and projections.

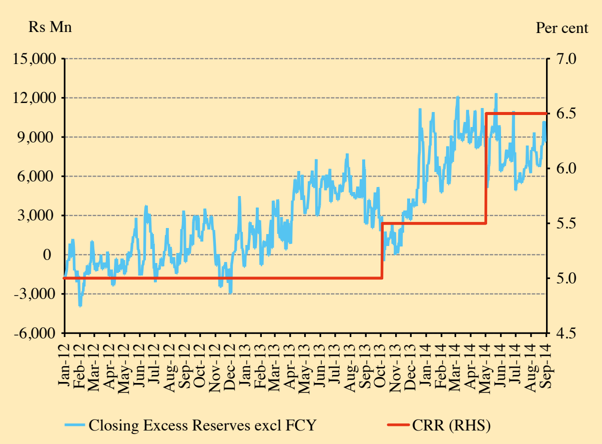
Despite efforts by the BoM to mop up liquidity through the issue of BoM instruments, there still remains excess liquidity in the banking system, as measured by the difference between cash reserve requirements held at the central bank and actual bank reserves (Chart 6.10). Since the beginning of the year, excess reserves have hovered around Rs9 billion. The stock of excess reserves generally declined following increases in the CRR (in October 2013 and May 2014), although the observed declines unwound soon after.

Chart 6.9: BOM Securities by Maturity



Source: Bank of Mauritius

Chart 6.10: Banks' Excess Liquidity and CRR



Source: Bank of Mauritius

6.3 Monetary and Credit Developments

Since the last Inflation Report, broad money grew by 7.7 per cent and 7.9 per cent y-o-y by the end of June and August 2014, respectively, due to a rapid increase in savings and transferable deposits, while the growth of time deposits lagged behind. As such, velocity of circulation of broad money has remained broadly constant at around 1.03 during the last two/three years.

In general, through August 2014, the counterpart of the sluggish growth in banking sector liquid assets has been a decline in the net foreign asset position of Other Depository Corporations (ODCs) and weak growth in total ODC credit to the private sector that more than offset a sizeable accumulation of gross official reserves (Table 6.3). Since December 2013, the decline in ODCs' net foreign assets positions has broadly mirrored the decline in GBC deposits held with domestic banks, with banks' gross foreign assets showing an important decline through June. By August, however, both foreign assets and liabilities have declined by broadly the same amounts. At the same time, the declining trend in annual growth rates of total bank credit to the private sector ("loans to various sectors of the economy") continued (since late 2012). By contrast, Bank of Mauritius' intervention in the foreign exchange market through its Operations Reserves Reconstitution programme supported a build-up of gross official reserves to an equivalent of 6 months of imports of goods and services by the end of June 2014. Intervention in the foreign exchange market picked up from November 2013 to July 2014, but has since then declined. Banking sector net claims on the Central Government increased on a y-o-y basis through the end of August, although, in nominal terms, the value of these claims (Rs33.7 billion) was lower than that reached by the end of December 2013 (Rs34.8 billion).

Table 6.3: Mauritius: DCS*, 2011-2014

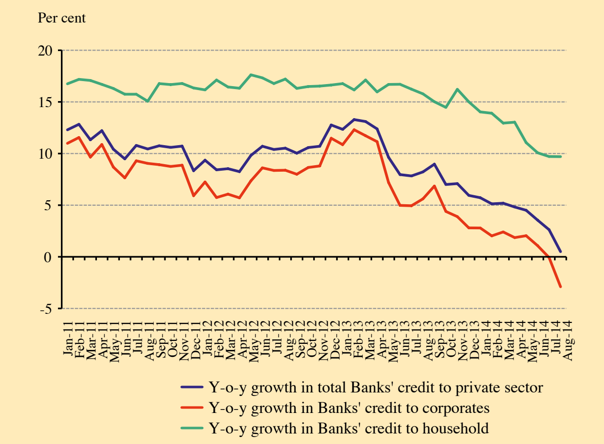
	2011	2012	2013	2014		
				March	June	Aug
(Rs million)						
Net Foreign Assets	**370,755.1**	**401,320.9**	**396,299.9**	**371,676.9**	**382,241.5**	**409,256.2**
BOM (net)	80,100.9	91,559.8	103,497.9	110,343.1	119,619.6	123,260.4
ODCs (net)	290,654.2	309,761.1	292,802.0	261,333.9	262,621.9	285,995.8
Domestic Claims	**207,767.5**	**214,348.0**	**242,531.1**	**235,803.6**	**228,878.2**	**229,531.4**
Net Claims on Central Government	**30,173.4**	**26,748.3**	**34,759.0**	**35,853.6**	**34,504.0**	**33,649.0**
Claims on Central Government	60,487.7	61,251.3	65,605.5	68,621.4	74,354.5	73,327.2
Liabilities to Central Government	-30,314.2	-34,503.0	-30,846.5	-32,767.8	-39,850.5	-39,678.1
Claims on Other Sectors	**311,128.6**	**364,273.6**	**413,415.5**	**402,940.8**	**391,977.3**	**389,133.1**
of which						
Loans	**272,268.8**	**306,043.5**	**336,942.4**	**336,684.6**	**338,473.8**	**341,676.6**
Other claims (net)	**-133,534.5**	**-176,673.9**	**-205,643.5**	**-202,990.7**	**-197,603.1**	**-193,250.7**
Broad Money Liabilities	**319,536.7**	**345,617.2**	**365,608.7**	**371,778.4**	**378,456.3**	**379,201.6**
Currency Outside DCs	20,307.8	22,169.7	23,316.7	22,090.4	21,685.0	22,196.1
Transferable Deposits	69,425.5	74,630.8	80,391.4	80,761.7	85,000.1	82,539.6
Savings Deposits	114,277.7	123,940.2	137,028.6	143,389.4	145,274.2	146,609.3
Time Deposits	113,563.8	122,902.1	121,803.1	122,623.4	123,269.5	124,673.5
Securities other than Shares	1,961.8	1,974.3	3,069.0	2,913.5	3,227.4	3,183.1
GBC deposits	**258,985.9**	**270,051.7**	**273,222.3**	**235,702.2**	**232,663.4**	**259,586.0**
(Annual growth rate; in per cent)						
Net Foreign Assets	**-6.4**	**8.2**	**-1.3**	**-6.2**	**-3.0**	**5.4**
BOM (net)	2.8	14.3	13.0	14.0	15.5	24.1
ODCs (net)	-8.6	6.6	-5.5	-12.8	-9.6	-1.1
Domestic Claims	9.7	**3.2**	**13.1**	**11.1**	**6.7**	**2.5**
Net Claims on Central Government	**1.1**	**-11.4**	**29.9**	**27.8**	**40.9**	**6.5**
Claims on Central Government	-4.3	1.3	7.1	8.7	17.6	11.2
Liabilities to Central Government	-9.1	13.8	-10.6	-6.6	2.9	15.6
Claims on Other Sectors	**11.5**	**17.1**	**13.5**	**9.0**	**5.5**	**-3.5**
of which Loans to various sectors of the economy	**...**	**12.4**	**10.1**	**8.4**	**7.7**	**6.2**
Other claims (net)	**11.7**	**32.3**	**16.4**	**9.4**	**8.9**	**-8.4**
Broad Money Liabilities	**6.4**	**8.2**	**5.8**	**6.8**	**7.7**	**7.9**
GBC deposits	**-9.2**	**4.3**	**1.2**	**-9.5**	**-9.6**	**-0.5**
Memo items:						
Nominal GDP (market prices)	**323,011.0**	**343,835.0**	**366,228.0**	**370,154.0**	**376,298.0**	**...**
BML + GBC deposits	**578,522.6**	**615,668.9**	**638,831.0**	**607,480.6**	**611,119.7**	**638,787.6**
Velocity of Broad money (BM)	1.04	1.03	1.03	1.04	1.04	...
Velocity of BM plus GBC	0.56	0.58	0.58	0.60	0.61	...
Money multiplier	6.1	6.6	5.9	6.0	6.1	5.7

** Includes the accounts of Banks and Non-bank deposit taking institutions*

Source: Bank of Mauritius

The growth rate of bank credit to the private sector (excluding credit to GBC entities) declined from 5.9 per cent by the end of 2013 to 3.6 per cent by the end of June 2014 and to 0.5 per cent by the end of August 2014 (Table 6.4 & Charts 6.11). The slowing in credit mainly reflected a deceleration in the growth of corporate credit, while growth in household credit has also declined. The observed slowing in corporate credit is broad-based. Sectors contributing to the deceleration have been construction, financial and business services, tourism, and traders. Consumer credit to households, which accelerated in 2013, has now slowed down.

Chart 6.11: Y-o-y Growth in Banks' Credit to Private Sector [1]



[1] *Excludes loans to GBC entities.*

Source: Bank of Mauritius

Table 6.4 Bank Credit to Private Sector [1]

	2005-2011	2012-14	2013-14
(Average annual growth rates; in per cent)			
Total credit to private sector	12.0	5.6	3.8
Corporates	**11.2**	**3.0**	**0.8**
Construction	26.9	10.6	5.3
Tourism	18.3	5.3	5.5
Traders	9.5	2.8	1.3
Financial services	14.3	-2.8	-5.0
Manufacturing	3.7	1.1	0.5
Agriculture & Fishing	12.9	7.6	6.5
Other	1.9	-3.4	-10.0
Households	**14.9**	**12.9**	**11.9**
Personal credit	11.4	15.0	15.3
Mortgages	17.6	11.6	9.9
(Contribution to growth of total credit to private sector; in per cent)			
Total credit to private sector	12.0	5.6	3.8
Corporates	**8.7**	**2.2**	**0.6**
Construction	1.6	1.0	0.6
Tourism	2.8	0.9	1.0
Traders	1.2	0.3	0.1
Financial services	1.5	-0.3	-0.5
Manufacturing	0.4	0.1	0.0
Agriculture & Fishing	0.8	0.5	0.4
Other	0.3	-0.3	-0.9
Households	**3.3**	**3.4**	**3.2**
Personal credit	1.1	1.5	1.6
Mortgages	2.2	1.8	1.6

[1] *Data up to August 2014*

Source: Bank of Mauritius

6.4 Domestic Stock Market

The SEMDEX reached an all-time high of 2,154.4 points during the third quarter of 2014 (Chart 6.12). This was led by strong performances from the hotel sector's Lux Island Resorts Ltd (50 per cent growth from late 2013 to date), the insurance sector's Mauritius Union Assurance Ltd (33.33 per cent growth from late 2013 to date), the diversified construction and leisure sector's Gamma group (25.97 per cent growth from late 2013 to date), the non-bank financial sector's FinCorp (28.38 per cent growth from late 2013 to date) and BMH Ltd (23.40 per cent growth from late 2013 to date). Lux Island Resorts accounted for more than 30 per cent of the SEMDEX point move this year due to a continued profit margin and improvements in free cash flow indicating that parts of the tourism industry are currently engaged in a moderate recovery.

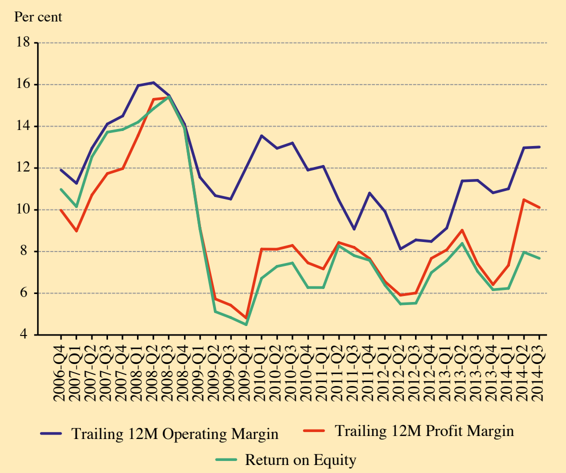
The stock market performance this year has been relatively broad-based. This is unlike recent post crisis years, when rallies were driven by purchases of banks' stocks, as these stocks are by far the most liquid and tend to be overweighted during more uncertain times in Mauritius. Local institutional investors continued to push the local market higher while foreign investors remained net sellers to the extent of Rs451.2 million between August 2013 and August 2014.

Overall, the operating and net profit margins of all listed companies on the main index were still below their high levels before the financial crisis, but the trend has remained largely positive since the 2009. (Chart 6.13). Also, with the demand from investors rising, the gross dividend yield of the market maintained its declining trend as prices outweighed the corresponding increases in dividend. The moderate domestic improvements indicate that the market has had a continued mild recovery over the past two years following improvements in the major global equity markets.

Chart 6.12: SEMDEX

Source: Stock Exchange of Mauritius

Chart 6.13: Margins and Return on Equity for SEMDEX Listed Corporations



Source: Bloomberg

7. Inflation: Recent Developments and Outlook under the Baseline Scenario

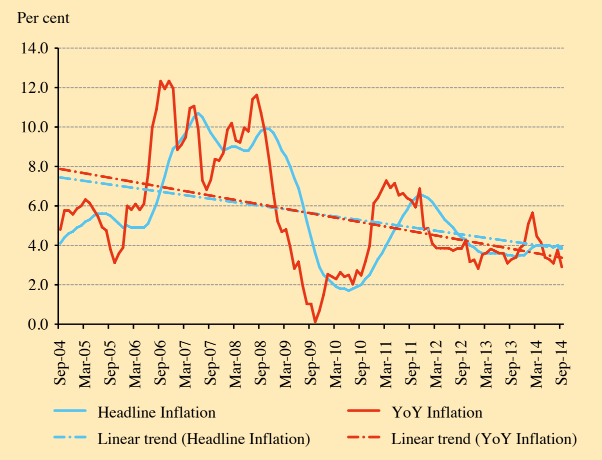
7.1 Recent trends

Since March 2014, headline inflation has been virtually flat at about 4.0 per cent. While the measurement of inflation based on the 12-month average suffers from statistical caveats, y-o-y inflation reflects more the dynamics of price movements. Thus, y-o-y inflation fell systematically from 5.6 per cent in February 2014 to 3.1 per cent in July 2014. It rebounded to 3.8 per cent in August 2014 on account of higher prices of vegetables and motor vehicles before dropping substantially to 2.9 per cent in September 2014. This decline is mainly attributed to declining prices of food and transport.

Chart 7.1 maps the dynamics of inflation using the two measures and it shows that inflation has declined with reduced volatility. In the short term, stable domestic economic conditions coupled with low inflation in major trading partners, as well as lower international commodity prices in general, are likely to keep inflation at current levels in Mauritius.

"Food and non-alcoholic beverages", which carries the largest weight in the CPI basket, remained the principal factor behind overall CPI inflation in September 2014 (Table 7.1). Between June and September 2014, "food and non-alcoholic beverages" contributed significantly to overall CPI while remaining sub-indices made negligible contribution.

Chart 7.1: Inflation Dynamics



Source: BoM staff calculations.

Table 7.1: Contribution to Inflation

DIVISIONS	Weights	Consumer Price Index		Contribution to Inflation(%):
		Sep-13	Sep-14	
Food and Non Alcoholic Beverages	273	103.0	106.7	1.0
Alcoholic Beverages and Tobacco	96	110.1	116.5	0.6
Clothing and Footwear	45	104.6	110.3	0.2
Housing, Water, Electricity, Gas and Other Fuels	120	100.3	101.3	0.1
Furnishings, Household Equipment				
and Routine Household Maintenance	61	103.0	102.5	0.0
Health	40	104.0	109.8	0.2
Transport	151	103.0	105.4	0.4
Communication	39	99.8	99.4	0.0
Recreation and Culture	44	103.1	105.0	0.1
Education	45	101.9	103.7	0.1
Restaurants and Hotels	45	106.8	111.7	0.2
Miscellaneous Goods and Services	41	102.5	105.2	0.1
Consumer Inflation (%)	**1000**	**103.5**	**106.5**	**2.9**

Source: Statistics Mauritius and BoM staff calculations.

While the majority of the inflation measures depicted stability and subdued price pressures, the movements in food price inflation and goods inflation were noteworthy (Table 7.2). The dynamics in these two measures were reflected through the volatilities in price of vegetables on the domestic market, food products and motor vehicles.

Y-o-y core inflation measures mirrored more or less CPI inflation trends; albeit the two measures charted different paths. Y-o-y CORE1 inflation declined further to 2.3 per cent in 2014Q3 while Y-o-y CORE2 inflation dropped to 3.3 per cent. The higher CORE2 inflation rate compared to CORE1 and CPI inflation rates points to downward rigidity of prices other than administered energy prices in the CPI basket.

Results of the August 2014 Inflation Expectations Survey pointed to lower inflation expectations for the different time horizons, compared with the previous survey period. The mean headline inflation rates expected by respondents were 4.1 per cent, 4.3 per cent and 4.5 per cent, respectively, for the twelve months ending December 2014 and June 2015, and for a year ahead compared with 4.4 per cent, 4.6 per cent and 4.7 per cent respectively, for December 2014, a year ahead and June 2015 for the survey month of May 2014.

7.2 Inflation Projection and Output Gap in Baseline Scenario

Using the Bank's forecasting model (Box 1) and under the baseline scenario, CPI inflation is expected to decline marginally during the fourth quarter of 2014 and the first quarter of 2015, from its third quarter level, but it will temporarily rise over the following 3 quarters. Y-o-y inflation is projected at 3.1 per cent in the fourth quarter of 2014 and 2.8 per cent in the first quarter of 2015, compared with 3.3 per cent in the third quarter of 2014. The projected inflation dynamics reflects trends with food and non-food inflation, resulting from sluggish growth of domestic absorption, weak global growth (that lowers imported inflation), and an improvement in Mauritius' terms of trade along the stability of international prices for food and energy. Starting 2015Q2, however, seasonal and other exogenous factors would bring about an acceleration of inflation through the end of 2015 (to an average of 4.8 per cent). During 2016, CPI inflation should gradually converge to 4 per cent.

The domestic output gap, which is also estimated using the Bank's forecasting macro model, is projected to remain negative through 2016 (Chart 7.2). The model's estimate is consistent with the information arising from: (i) the national accounts (moderate growth of final consumption's and investment's weak growth, and volatile leading economic indicators); (ii) the balance of payments (measured growth of import commodity volumes that are improving the trade balance); and (iii) the slowdown in bank credit to corporations and households.

Table 7.2: Measures of Inflation

(Per cent)

Period	Food price inflation	CPIX_M*	Imported inflation	Goods inflation	Services inflation	Core1	Core2	TRIM10 inflation
Jun-14	4.0	3.4	3.4	3.3	3.2	2.7	3.2	3.2
Jul-14	3.6	3.2	3.0	3.4	2.6	2.7	3.2	2.3
Aug-14	6.1	3.9	3.3	4.5	2.5	2.7	3.5	3.1
Sep-14	3.7	3.0	2.5	3.1	2.5	2.3	3.3	3.1

** Refers to CPI excluding mortgage payments in inflation.*

Source: Bank of Mauritius

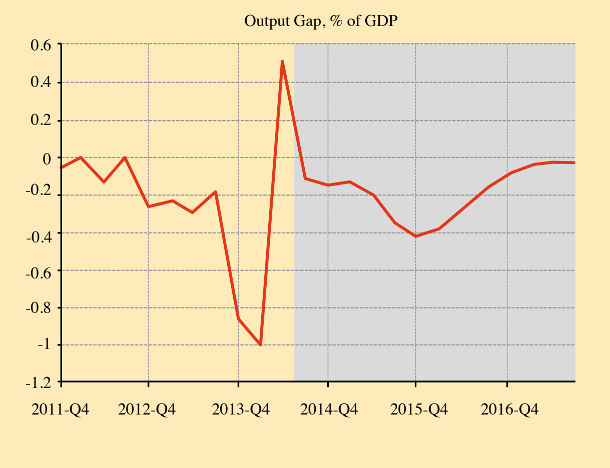
Box 1. Bank of Mauritius Output Gap and Inflation Forecasting Model

The BoM's model is a New Keynesian Model for an open economy, formulated in terms of differences between the actuals or projected macro variables against the value of those variables in the "steady state." The latter could be broadly interpreted as smooth filtered values for historic variables used in the model. In terms of levels (rather than in terms of differences from the steady state values), the model could be summarized as containing:

- An IS curve,[10] where output is a function of the expected domestic output, expected output in main trading partners, the real interest rate, and the real effective exchange rate;
- A Phillips curve, where domestic current inflation is a function of past and expected domestic inflation, imported inflation, domestic output, and output in trading partners;
- An interest rate rule, or "Taylor Rule," where the real interest rate is a function of the lagged real interest rate, expected inflation deviation from the target, and output, and;
- An interest parity condition equation, where the level of the exchange rate is a function of the expected exchange rate, the nominal interest rate differential between Mauritius and the rest of the world, and the domestic risk premium.

While some parameters of the model have been estimated using e-views and other standard statistical packages, certain parameters estimations have been (are) done using the Matlab software platform.

Chart 7.2: Output Gap



Source: BoM staff calculations.

10 *The IS curve relates changes in real interest rates on output growth (i.e., lower interest rates increase investment and growth). In an open economy, the IS curve adds the impact on the real exchange rate on output growth (i.e., a more depreciated real exchange rate improves the external balance and fuels growth).*

8. Inflation Outlook: Balance of Risks against the Baseline Scenario

Main risks that could trigger a deviation of the inflation rate from that assumed in the Bank's baseline scenario relate to: (i) weaker-than-expected global economic growth; (ii) unforeseen demand and supply shocks, and (iii) increased volatility in international financial flows.

a. Weaker-than-expected global growth

The baseline scenario assumes a gradual, undisturbed, recovery of the world economy. The October 2014 WEO puts global growth rates at 3.3 per cent, and 3.8 per cent in 2014 and 2015, respectively. However, weaker global growth (i.e., a larger negative output gap in the Eurozone than that included under the baseline) would affect Mauritius' exports. This would impair the external sector's contribution to domestic growth, increase the economy's negative output gap, and, possibly, lead to a lower inflation rate than in the baseline.

b. Unforeseen demand-pull factors

The pace of domestic economic activity would be lower than in the baseline scenario, if private investment during 2015 (as a share of GDP) declines faster than projected under the baseline. This would create a more negative output gap and thus lower inflation against the baseline scenario.

c. Unforeseen cost-push factors

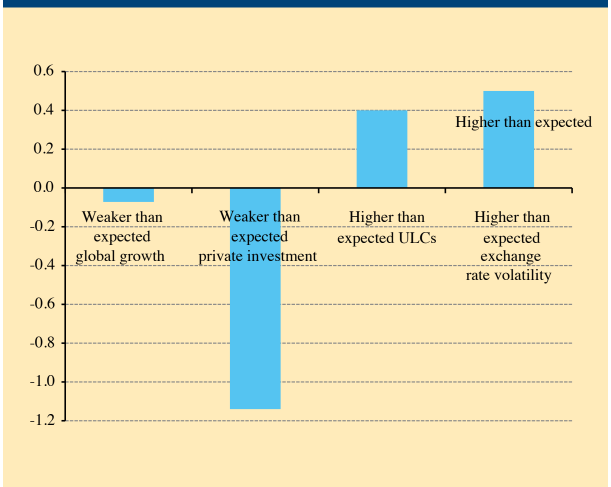
A higher-than-expected growth in unit labour costs than in the baseline would affect investment plans and create inflationary pressures arising from such higher costs. This would affect the output gap and lead to higher inflation than in the baseline.

d. Increased volatility volatility of international capital markets

The baseline scenario assumes a gradual retreat of the US monetary stimulus in terms of quantity easing and adjustments of the Federal Funds rate. However, there is a risk of high interest rate volatility as it happened in mid-2013. In that event, there would be sharp movements in capital flows and ensuing nominal exchange rate depreciations in emerging economies. In that scenario, increased pressures in the foreign exchange market would translate in a more depreciated exchange rate for the Mauritian Rupee than in the baseline and ensuing inflationary pressures.

Overall, the Bank of Mauritius staff assessment is that, for the first quarter of 2015, based on alternative model computations, the balance of risks to the inflation outlook is on the downside (i.e., there are no inflationary pressures arising). Specifically, in this Inflation Report, the balance of risks is negative: the probability that inflation will be higher than in the baseline (due to shocks in unit labour costs and enhanced exchange rate volatility) is less than the probability that inflation will be lower than in the baseline (due to a higher negative output gap in the Eurozone and lower domestic private investment in Mauritius). Chart 8.1 shows the impact of the individual risk factors on inflation in the first quarter of 2015, measured as the difference between the inflation projection under the baseline and the inflation projection subject to the specific shock, adjusted (i.e., multiplied) by the probability that such specific shock does occur. The sum across of the various impacts—the balance of risks—indicates how these factors, taken as a whole, would deviate the inflation projection from that included in the baseline scenario.

Chart 8.1: Balance of Risks vis-à-vis the Baseline Inflation Outlook



Source: BoM staff calculations.

9. Concluding Remarks

The inflation projection, based on the Bank's short-term forecasting model, is that, under the baseline scenario, CPI inflation will marginally decline during the fourth quarter of 2014 and the first quarter of 2015 (to an average of 2.9 per cent) with respect to the annual inflation rate registered in the third quarter of 2014 (3.3 per cent), although there will be some temporary (seasonal) inflationary pressures arising during the last three quarters of 2015. During 2016, CPI inflation should gradually converge to 4 per cent.

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List of Acronyms

BoE	Bank of England
BoJ	Bank of Japan
BML	Broad Money Liabilities
CIF	Cost, Insurance and Freight
CPI	Consumer Price Index
DXY	Trade Weighted Dollar Index
ECB	European Central Bank
EMDE's	Emerging Market and Developing Economies
FAO	Food and Agriculture Organisation of the United Nations
FED	Federal Reserve Bank
FOB	Free on Board
FOMC	Federal Open Market Committee
GBC1s	Global Business Companies with a Type 1 Licence
GDFCF	Gross Domestic Fixed Capital Formation
GDP	Gross Domestic Product
GMTB	Government of Mauritius Treasury Bills
HP	Hodrick-Prescott
ICE	Intercontinental Exchange
IMF	International Monetary Fund
IPI	Import Price Index
KRR	Key Repo Rate
MCCI	Mauritius Chamber of Commerce and Industry
MERI	Mauritius Exchange Rate Index
MPC	Monetary Policy Committee
NYMEX WTI	New York Mercantile Exchange West Texas Intermediate
ODCs	Other Depository Corporations
OECD	Organisation for Economic Co-operation and Development
OPEC	Organisation of the Petroleum Exporting Countries

List of Acronyms

ORR	Operation Reserves Reconstitution
PE	Price Earnings
PLR	Prime Lending Rate
PMI	Purchasing Managers' Index
PPI-A	Producer Price Index-Agriculture
PPI-M	Producer Price Index-Manufacturing
REER	Real Effective Exchange Rate
SDR	Savings Deposits Rate
SEM	Stock Exchange of Mauritius
SEMDEX	Stock Exchange of Mauritius Index
SITC	Standard International Trade Classification
VIX	Volatility Index
WRI	Wage Rate Index

Glossary

CORE1 inflation excludes food, beverages and tobacco and mortgage interest on housing loan from the CPI basket. Both headline and year-on-year CORE1 inflation measures are available.

CORE2 inflation excludes food, beverages and tobacco, mortgage interest, energy prices and administered prices from the CPI basket. Both headline and year-on-year CORE2 inflation measures are available.

Fiscal consolidation is a policy aimed at reducing government deficits and debt accumulation.

GBC1s are resident corporations which conduct business outside Mauritius. The law has recently been amended to allow them to transact with residents provided that their activities in Mauritius are ancillary to their core business with non-residents.

Headline inflation is measured by the change in the average Consumer Price Index (CPI) over a twelve-month period compared with the corresponding previous twelve-month period.

Key Repo Rate is the key policy rate used by the Bank of Mauritius to signal changes in its monetary policy stance.

MERI1 is the Mauritius Exchange Rate Index, a nominal effective exchange rate introduced in July 2008, based on the currency distribution of merchandise trade.

MERI2 is the Mauritius Exchange Rate Index, a nominal effective exchange rate introduced in July 2008, based on the currency distribution of merchandise trade and tourist earnings.

Other investment, which is a category in the Balance of Payments, includes all debt liabilities between unaffiliated non-residents and residents, which are not securitised. It can be classified by institutional sector: general government, monetary authorities, banks, and other sector, and sub-classified between short-term and long-term.

PMI refers to the Purchasing Managers' Index of financial activity, reflecting purchasing managers' acquisition of goods and services.

Seasonally-adjusted data are derived by removing the seasonal component of a time series in order to understand the underlying trends of the series.

Y-o-y change compares the value of a variable at one period in time to the same period the previous year.

Y-o-y inflation is measured by the change in the CPI for a given month compared with the corresponding month of the preceding year.

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