1967 - 2012

45 YEARS OF CENTRAL BANKING

BANK OF MAURITIUS

Inflation Report

October 2012

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INFLATION REPORT

October 2012

This Inflation Report is published twice a year by the Bank of Mauritius in accordance with Section 33(2) of the Bank of Mauritius Act 2004. The Inflation Report is released to the public in April and October. It provides an assessment of factors underpinning monetary policy and concludes with an economic outlook. This issue of the Inflation Report refers to information for the period January to August 2012 unless otherwise stated.

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List of Acronyms

BDI	Baltic Dry Index
BoE	Bank of England
BoJ	Bank of Japan
BML	Broad Money Liabilities
CIF	Cost, Insurance and Freight
CPI	Consumer Price Index
CRB	Commodity Research Bureau
DXY	Trade Weighted Dollar Index
ECB	European Central Bank
EIA	Energy Information Administration (of the US Department of Energy)
FAO	Food and Agriculture Organisation
FOMC	Federal Open Market Committee
GBC1	Global Business Company (Category 1)
GDFCF	Gross Domestic Fixed Capital Formation
GDP	Gross Domestic Product
ICE	Intercontinental Exchange
IMF	International Monetary Fund
IPI	Import Price Index
MERI	Mauritius Exchange Rate Index
MPC	Monetary Policy Committee
MSCI	Morgan Stanley Capital International
NML	Narrow Money Liabilities
NYMEX WTI	New York Mercantile Exchange West Texas Intermediate
ODC	Other Depository Corporations
OECD	Organisation for Economic Co-operation and Development
OMT	Outright Monetary Transactions
ORR	Operations Reserves Reconstitution
PBOC	Peoples' Bank of China
PMI	Purchasing Managers' Index
PPI-A	Producer Price Index-Agriculture
PPI-M	Producer Price Index-Manufacturing
RBI	Reserve Bank of India
REER	Real Effective Exchange Rate
SEMDEX	Stock Exchange of Mauritius Index
WEO	(IMF's) World Economic Outlook
WRI	Wage Rate Index

Abbreviations and Definitions

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.

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.

CORE1 inflation excludes food, beverages and tobacco and mortgage interest on housing loan from the CPI basket. Both headline and y-o-y 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 y-o-y CORE2 inflation measures are available.

TRIM10 truncates 5 per cent of each tail of the distribution of price changes.

Dealt exchange rate is the weighted average rupee selling rate derived from transactions of US$30,000, and above, or equivalent.

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 index 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-classsified between short-term and long-term.

ISM activity indicators are manufacturing survey data collected in the United States by the Institute for Supply Management.

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

Y-o-y refers to year-on-year change.

Q-o-q refers to quarter-on-quarter change.

1. Overview

The global economy has slowed since the beginning of 2012, mainly as a result of the intensification of the euro area crisis and persisting public debt concerns in major advanced economies. While financial conditions in major markets, which have buttressed the weakening global economic environment, have eased recently following policy actions by the ECB and, to a lesser extent, by the US Federal Reserve, world growth is widely forecast to fall short of its long-term trend rate in 2012. Leading activity indicators have substantiated the sluggish growth outlook. Downside risks from the Eurozone crisis and the uncertain fiscal stance in the United States remain important. In its World Economic Outlook report released in October 2012, the IMF revised down its global growth projection to 3.3 per cent for 2012 and 3.6 per cent for 2013.

Economic activity in advanced economies moderated, with the IMF predicting growth of 1.3 per cent in 2012. Slow growth is expected to persist in the US, while the euro area and UK are projected to contract in 2012 before recovering somewhat in 2013. Growth in emerging economies, hit by reduced demand from their main export markets and past monetary policy tightening, is forecast to be weaker than expected in 2012 but to pick up slightly in 2013, in line with the expected recovery in advanced economies. In 2012Q2, China was estimated to have recorded its slowest growth in three years, while expansion in India was estimated to have fallen to its slowest pace since 2004.

As growing slack in advanced and emerging economies has reduced global inflationary pressures, central banks worldwide have signalled their determination to stimulate growth. The US Federal Reserve announced further quantitative easing while the ECB reduced its key refinancing rate by a quarter-point in July 2012 and unveiled a bond-buying plan in early September 2012. The Bank of England left its Bank Rate on hold at 0.5 per cent but extended its quantitative easing programme. Central banks in a number of emerging economies have also started to ease their monetary policy stance to support growth. More recently, increases in global food and energy prices have, however, exerted upside pressures on the global inflation outlook.

The domestic economy has held up relatively well to the soft external economic conditions although the growth momentum has slowed. Given muted business confidence and household consumption domestically, the output gap is assessed to have remained negative in 2012Q2, with the economy operating below trend. The Bank's central growth forecast for 2012 has been revised down to 3.3 per cent, from an earlier estimate of 3.8 per cent.

Since the start of 2012, headline inflation has declined steadily to 4.6 per cent in August 2012 and y-o-y inflation has trended down to 3.7 per cent. While underlying core measures of inflation have indicated a moderation in inflationary pressures, upside risks to the domestic inflation outlook have risen, partly reflecting higher world food and energy prices that may eventually be factored in the domestic price structure. Recently, a number of domestic factors have also contributed to raising upside risks to inflation, notably developments in the rupee exchange rate and, effective January 2013, the compensation for the cost of living across the economy and the salary increases in the public sector. The Bank's *Inflation Expectations Survey* of August 2012 has indicated that around 75 per cent of respondents expected prices to go up over the next 12 months, with the mean inflation rate one year ahead projected at 5.8 per cent.

In view of the global economic slowdown and developments on the inflation front, the Monetary Policy Committee decided to cut the Key Repo Rate by 50 basis points to 4.90 per cent in March 2012 to support economic activity. At its subsequent meetings in June 2012 and September 2012, the Committee decided to leave the Key Repo Rate unchanged. In June, the Bank implemented the Operations Reserves Reconstitution (ORR) programme to improve the country's import cover and announced a Special Foreign Currency Line of Credit aimed at reducing exporters' foreign exchange risks.

2. The Global Economy

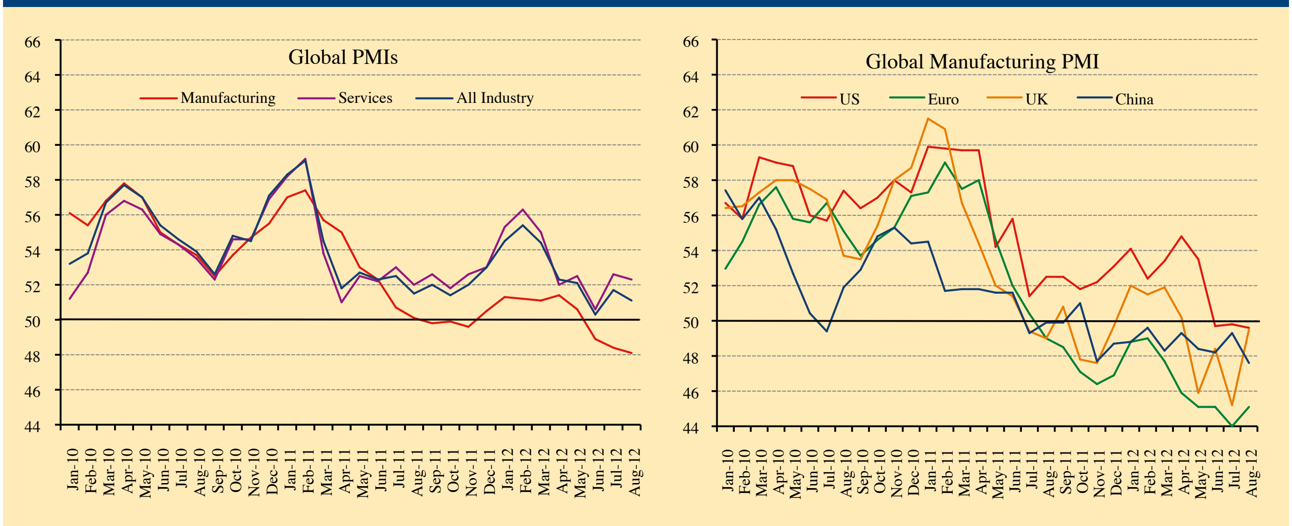
Global growth has slowed since the last Inflation Report, reflecting spillovers from the intensification of the euro area crisis. Growth in advanced economies has weakened significantly, with contraction expected in the Eurozone and United Kingdom in 2012 while the US would continue to recover modestly. Emerging economies are still projected to register higher growth than in advanced economies. Conditions in international financial markets have improved lately. Global inflationary pressures have declined but the recent increases in world food and energy prices constitute upside risks to the inflation outlook. To support growth, central banks in a number of economies have eased monetary conditions.

2.1 Demand and Output

The global economy has undergone a number of phases since the beginning of 2012. At the start of the year, a number of measures implemented by the ECB and euro area governments alleviated financial markets stresses and improved global funding conditions, thus increasing market confidence and contributing to lift the uncertainty prevailing in the global economy. Over 2012Q2, however, the Eurozone crisis intensified over significant concerns that Greece might choose to leave the monetary union and Spanish banking sector troubles. As conditions in international financial markets grew increasingly volatile, its effects on confidence as well as on trade and capital flows started to impact on the global economy. Real economic activity in most major advanced economies slowed down. In emerging economies including those in Asia, economic activity started showing signs of moderation amid sustained weakness in the external environment. While risks from the Eurozone crisis appear to have decreased recently following the announcement by the ECB to conduct Outright Monetary Transactions (OMT) to reduce distorted yields in exposed Eurozone sovereign bond markets, world growth is expected to remain below-trend in 2012.

Leading economic indicators have reflected the subdued outlook for the global economy. The JP Morgan Global All-Industry Output Index (Chart 2.1) has been on a downward trend since the beginning of 2012. After a slight pick-up between June and July 2012, it fell back by 0.6 point to 51.1 in August 2012, based on declines in both manufacturing and services activities. The JP Morgan Global Manufacturing PMI has declined consistently since April 2012 and crossed into contraction territory as from May 2012. In August 2012, the index fell to a 38-month low of 48.1, with output down to 47.4, reflecting declining levels of new business and weaker international trade flows. The global services PMI, which has continued to pull up the composite PMI in expansionary territory, has trended downwards up till June 2012

Chart 2.1: JPMorgan Global Purchasing Manager's Index



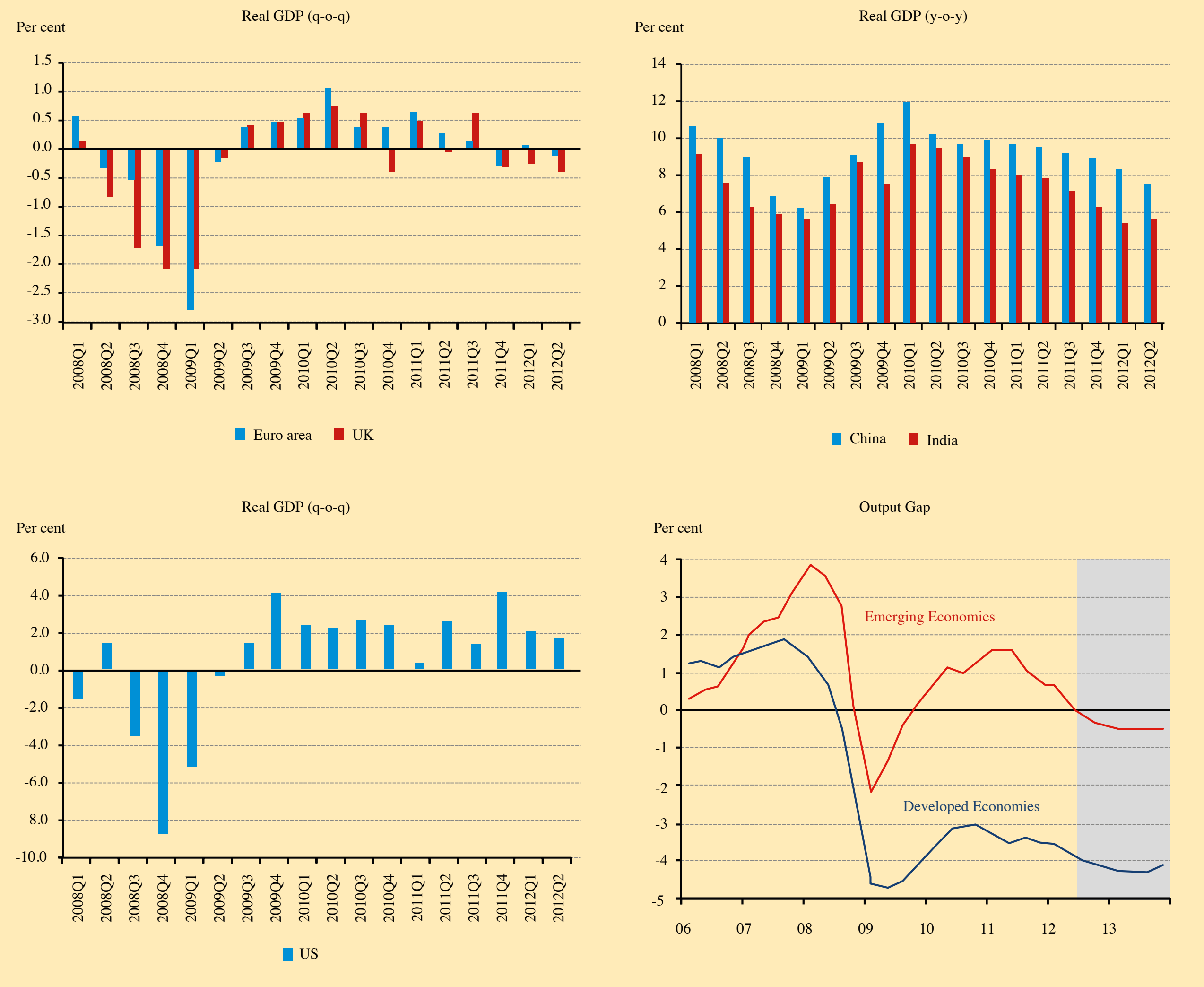
Source: JP Morgan.

before recovering in July 2012 and weakening slightly again in August 2012. Consistent with these readings, the outlook for global growth has generally been revised down by major forecasters since the start of the year.

After registering an annual growth of 2.0 per cent in 2012Q1, the US economy slowed to an annual pace of 1.3 per cent in 2012Q2 as private consumption and fixed investment decelerated. Labour market conditions remained weak, with lower job creation and a persistently high unemployment rate, which reached 8.3 per cent in July 2012. Consumer confidence trended downwards, reflecting the cautious outlook of households on the economy. Sentiment was also weaker in manufacturing where the latest Institute for Supply Management report on US manufacturing suggested a contraction in economic activity between June and August 2012. In contrast, the outlook for the housing sector appeared marginally better, with activity and prices starting to recover, albeit from very low levels. The uncertainty over the path of fiscal policy, which could tighten abruptly at the beginning of 2013, could contribute to constrain US growth in the foreseeable future.

The economic situation in the Eurozone continued to deteriorate during the period under review. While real GDP stagnated in 2012Q1, it fell by 0.2 per cent in 2012Q2. The contraction was contained by stronger-than-forecast growth of 0.3 per cent in Germany

Chart 2.2: Growth in Selected Advanced and Emerging Economies and Output Gap



Sources: OECD, IMF and JP Morgan.

while output continued to stagnate in France and grew at a negative pace in Italy. Most peripheral countries continued to record negative growth rates. The low pace of activity in the region led to another record high unemployment rate of 11.4 per cent in August 2012. Manufacturing activity experienced a deeper contraction in both the core and peripheral economies as private sector sentiment weakened. The leading Markit manufacturing PMI indicator, which receded for the thirteenth successive month in August 2012, showed that contraction was likely to continue for some time. Looking ahead, low business and consumer confidence generated by the uncertainty over the evolution of the sovereign debt crisis as well as the on-going recession in large parts of the periphery is expected to hold back Eurozone growth.

The UK economy has been in technical recession since the start of 2012. It contracted by 0.4 per cent in 2012Q2 compared to 0.3 per cent in 2012Q1, reflecting the impact of the Eurozone crisis and poor performance of production and services sectors. Domestic demand continued to be weighed down by fiscal austerity measures and weak private sector sentiment. The labour market, however, remained surprisingly resilient, with the unemployment rate edging down to 7.9 per cent in the three months to August 2012. Leading indicators showed signs of easing in the manufacturing sector in August 2012 as the rates of contraction of production, new orders and exports moderated. While the economy is expected to rebound in 2012H2, growth would not compensate for the contraction experienced in 2012H1.

Growth in emerging economies, significantly hit by the deepening euro area crisis and weaker export demand, declined over the period under review. Growth in China slowed to 7.6 per cent y-o-y in 2012Q2, its lowest in three years, from 8.1 per cent in 2012Q1. In India, y-o-y GDP growth of 5.5 per cent was recorded in 2012Q2 compared to 5.3 per cent in 2012Q1. Downside risks nevertheless remained important. While increasing domestic consumption and growing investment in manufacturing as well as accommodative monetary policies in some emerging economies are expected to support economic activity, the growth momentum in the near to medium term is likely to be less than in preceding years.

Chart 2.2 shows real GDP growth rates in selected advanced and emerging economies and an assessment of output gap.

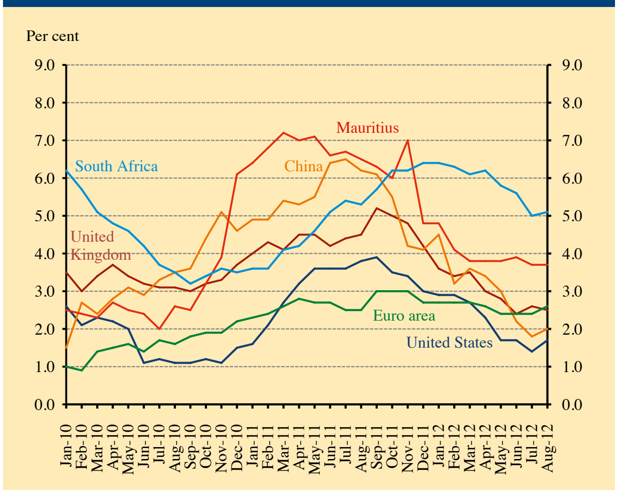
2.2 Cost and Prices

Inflation in Selected Countries

Annual rates of headline consumer price inflation in most OECD have remained at moderate levels since the April 2012 Inflation Report and have tended to move lower in a number of emerging economies. The inflation outcome in advanced economies has been largely driven by ample economic slack and well-anchored inflation expectations while slower growth and lower food price inflation in the first part of the year have influenced inflation in emerging markets.

Consumer price inflation in the OECD area eased to an annual rate of 2.0 per cent in August 2012, from an annual rate of 2.9 per cent in December 2011. Amongst major economies, annual inflation in the UK fell from 4.2 per cent in December 2011 to 2.5 per cent in August 2012. Headline inflation in the US stood at 1.7 per cent in August 2012, down from 3.0 per cent in December 2011. Inflation in the euro area edged down from 2.7 per cent to 2.6 per cent in August 2012. Inflation in India rose significantly from 6.5 per cent in December 2011 to 10.3 per cent in August 2012 while inflation in China went down from 4.1 per cent to 2.0 cent over the same period (Chart 2.3). Table 2.1 shows the consumer price inflation in selected countries.

Chart 2.3: Y-o-y Inflation Rates in Selected Countries



Sources: Statistics Mauritius and Bank of Mauritius; central banks' and offices of national statistics' websites.

Commodity Prices

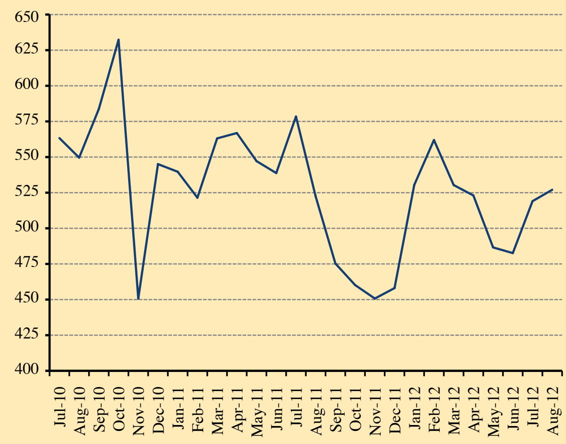
Global commodity prices have showed a mixed picture since the start of 2012. While food prices appeared to have been mostly contained during 2012H1 given weaker global demand, crude oil prices have held up as a result of geopolitical tensions as well as increasing interest of investors to go for riskier assets amid ample global liquidity. More recently, global food prices surged on supply concerns while oil prices showed signs of strengthening in both July and August 2012. The upward trend in global commodity prices as from the start of July 2012 is clearly apparent from the Thomson Reuters-Jefferies CRB index – a global benchmark for commodities (Chart 2.4).

The recent dynamics in food and oil prices amid major central banks' plans for a new round of quantitative easing have stoked upside inflationary pressures although the weak global economic environment may cap any rise in inflation. Additionally, there are concerns about the negative effect of quantitative easing on long-term inflation expectations, the more so that the exit strategy in most central banks is still quite vague.

Oil Prices

International oil prices generally moved to within a range of US$82.4 to US$124.5 a barrel in the first eight months of 2012, from a range of US$86.3 to US$123.1 a barrel in the corresponding period of 2011. ICE Brent Crude prices firmed to a peak of US$124.5 a barrel in March 2012, the highest since July 2008, mainly due to supply glitches in the North Sea and East Africa, further amplified by speculative activities. Crude oil price rises were not sustained in 2012Q2 amid revived fears about Europe's debt crisis, a weakening economic outlook and a steady rise in global crude stocks. Markets, however, rebounded in July and August 2012 and the spot price for Brent Crude climbed above $100 a barrel as geopolitical tensions and production

Chart 2.4: CRB Index



Source: Thomson Reuters.

Table 2.1: Consumer Price Inflation in Selected Countries

	(Annual percentage change)				Per cent	
	2008	**2009**	**2010**	**2011**	**December 2011**	**August 2012**
China	5.9	-0.7	3.3	5.4	4.1	2.0
Euro area	3.3	0.3	1.6	2.7	2.7	2.6
Hong Kong	4.3	0.6	2.3	5.3	5.7	3.8
Hungary	6.1	4.2	4.9	3.9	4.1	6.0
India	8.3	10.9	12.0	8.9	6.5	10.3
Indonesia	9.8	4.8	5.1	5.4	3.8	4.6
Philippines	8.2	4.2	3.8	4.7	4.2	3.8
Singapore	6.6	0.6	2.8	5.2	5.5	3.9
South Africa	11.5	7.1	4.3	5.0	6.4	5.1
South Korea	4.7	2.8	2.9	4.0	4.2	1.2
Thailand	5.5	-0.8	3.3	3.8	3.5	2.7
Turkey	10.4	6.3	8.6	6.5	10.4	8.9
United Kingdom	3.6	2.1	3.3	4.5	4.2	2.5
United States	3.8	-0.3	1.6	3.1	3.0	1.7

Sources: The Economist, OECD and IMF World Economic Outlook.

problems in the North Sea re-emerged. Expectations that the world's major economies would act to ease monetary policy to support their economies also exerted an upward pressure on global crude oil prices (Chart 2.5).

According to the U.S Energy Information Administration (EIA) report released in October 2012, Brent Crude, which averaged US$111.3 a barrel in 2011, would average US$111.8 a barrel in 2012 and US$103.4 a barrel in 2013.

Food Prices

Global food prices, as reflected by the FAO Food Price Index, which moderated during 2012H1 on weak macroeconomic conditions, surged to an average of 212.9 points in July 2012 and remained at an elevated level in August 2012 (Chart 2.6). The sharp rebound in July 2012 was mostly driven by a surge in grain and sugar prices. Extensive drought damage in the United States and in the Russian Federation severely deteriorated maize crop prospects, pushing prices up by almost 23 per cent in July 2012. The FAO Cereals Price Index, which includes prices of food staples such as wheat, rice and corn, edged up to an average of 259.9 points in August 2012, from 217.6 points in December 2011.

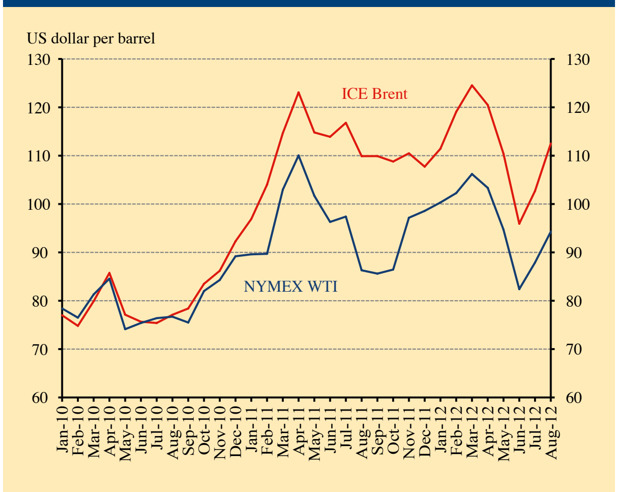
The FAO sugar price index declined from 326.9 points in December 2011 to 296.2 points in August 2012, reflecting improved production outlook amid more favourable weather conditions in Brazil, the world's largest sugar exporter, and monsoon rains in India. Meat prices rose to an average of 171.3 points in August 2012 after three consecutive months of decline but were below the level of 178.8 points reached in December 2011. The dairy price index decreased from 201.7 points in December 2011 to 172.9 points in July 2012 before rising to 175.6 points in August 2012 following increases in the prices of skimmed milk powder, casein, butter and whole milk powder, while cheese prices remained stable. Much of the recent strength stemmed from firming demand and production constraints in areas affected by drought and rising feed costs.

The OECD-FAO Agricultural Outlook 2012-2021 report issued in July 2012 focused on high and volatile agricultural commodity prices, stressing that prices would remain on a higher plateau, underpinned by continuing strong demand and rising costs for some inputs.

Other Commodity Prices

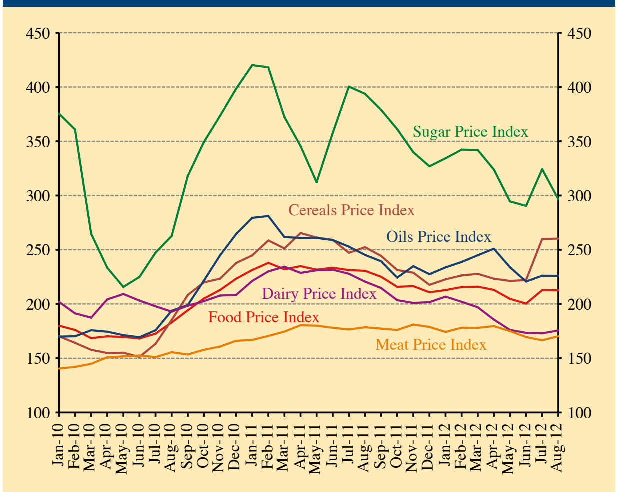
Prices of a number of non-energy commodities have eased since the April 2012 Inflation Report and are expected to remain subdued throughout 2012 (Table 2.2). Slowing growth in China and on-going concerns about the sovereign debt crisis in Europe should keep non-energy commodity prices – and base metal prices in particular – at moderate levels until the global economy starts picking up.

Chart 2.5: NYMEX WTI and ICE Brent (Monthly Average)



Source: Thomson Reuters.

Chart 2.6: FAO Food Price Index and its Components



Source: FAO.

Freight Costs

The Baltic Dry Index (BDI), which is the benchmark for tracking commodity shipping costs, is a useful economic indicator as it sheds some light on the actual usage of raw materials and, by extension, on the health of the global economy. The BDI fell to record lows in February 2012, from 1,869 points recorded in December 2011, partly reflecting the steep decline in demand for raw materials – and hence in utilisation rates – as a consequence of the global economic slowdown. The BDI, thereafter, trended upwards, albeit to moderate levels, but fell back to 703 points as at end-August 2012 (Chart 2.7). Looking ahead, with utilisation rates expected to remain muted, downward pressures on the BDI could be sustained.

Chart 2.7: Baltic Dry Index

Source: Hellenicshippingnews website.

2.3 Developments in Global Financial Markets

Financial markets, which had started the year on an optimistic note amid increased confidence following strong actions to provide additional liquidity and funding to the euro area banking sector by the ECB, deteriorated significantly thereafter. The possibility of a Greek exit from the Eurozone, which raised investors' fears on the reversibility of the euro, and concerns over the need for a recapitalisation of Spanish banks introduced significant uncertainty in financial markets. Yield spreads between bonds issued by troubled economies in the euro area and German bunds widened noticeably, while the VIX measure of market volatility moved above its six-month average and equity markets tumbled. More recently, statements by the ECB President and the effective announcement that the ECB would engage in OMT to restore confidence and address the severe distortions in distressed Eurozone sovereign bond

Table 2.2: Prices of Non-Energy Commodities

Commodity		Monthly Average					Percentage Change Between
	Unit	Dec-11	Mar-12	Jun-12	Jul-12	Aug-12	Dec 11 - Aug 12
Cotton A Index	c/kg	209.7	219.4	181.2	185.1	186.1	-11.2
Aluminum	$/mt	2,022	2,184	1,890	1,876	1,845	-8.8
Copper	$/mt	7,565	8,471	7,423	7,584	7,516	-0.6
Gold	$/toz	1,642	1,674	1,599	1,594	1,630	-0.7
Iron ore	c/dmtu	136	145	135	128	108	-20.6
Lead	c/kg	202	206	185	188	190	-5.9
Nickel	$/mt	18,267	18,661	16,549	16,128	15,735	-13.9
Silver	c/toz	3,013	3,293	2,798	2,743	2,880	-4.4
Tin	c/kg	1,938	2,299	1,927	1,855	1,877	-3.1
Zinc	c/kg	190	204	186	185	183	-4.2
Cocoa	c/kg	220	236	226	235	251	14.1
Plywood	c/sheets	615	611	608	608	608	-1.3
Tea, auctions (3) average	c/kg	270	242	297	303	312	15.6

$ = US dollar   c = US cent   bbl=barrel   mt = metric ton

kg = kilogram   dmtu = dry metric ton unit   toz = troy oz

Source: World Bank's Commodity Price Data.

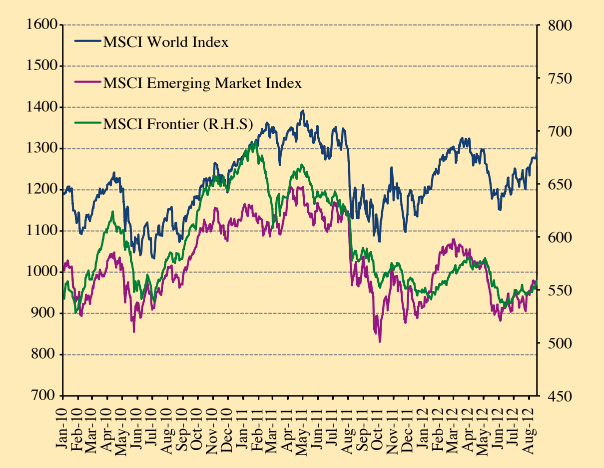
markets, helped sentiment in financial markets to recover. Global equities staged a strong rally while sovereign bond yield spreads narrowed.

Global Stock Markets

Following an impressive rally driven by robust US economic data and accommodative central bank policies in 2012Q1, global stock markets reversed course in 2012Q2, hurt by mixed data releases and a deepening Eurozone sovereign debt crisis. US equity markets weathered the negative developments relatively better than European markets, which suffered the heaviest losses on account of the shaky outlook in Europe. Since June 2012, global equity markets have posted significant gains, propped up by persistent expectations for more monetary stimulus from major central banks and some forecast-beating corporate results. As at end-August 2012, markets had generally risen back to their 2012 peaks registered in March 2012. As long as the Eurozone crisis is not completely resolved, a return to risk aversion cannot be discounted. Any further gains in global equities would thus likely be capped by the uncertainty in this region.

Since the beginning of 2012 through to end-August, the Dow Jones Industrial Average, NASDAQ, FTSE, CAC-40 and Nikkei gained 7.1 per cent, 17.7 per cent, 2.5 per cent, 8.0 per cent and 4.5 per cent, respectively. Among emerging stock markets, Shanghai SEC shed 6.9 per cent, while Bombay SENSEX and JALSH climbed 12.8 per cent and 10.6 per cent, respectively. Overall, the MSCI world index showed that global equity markets gained 7.8 per cent over the period January to August 2012, while the MSCI emerging markets index gained 3.3 per cent. The MSCI frontier index – of which Mauritius forms part – gained 2.1 per cent (Chart 2.8).

Chart 2.8: MSCI Indices



Source: Thomson Reuters.

Exchange Rates

Currency markets were principally influenced by developments in the Eurozone. The US dollar initially retreated at the start of 2012 as its safe haven appeal was dented by the massive intervention by the ECB to deal with the liquidity crunch and signs of stabilization in the Eurozone's bond markets. Better-than-expected economic data releases in some major economies and continued hopes of more monetary stimulus in the US economy also weighed on the US dollar. As events in the euro area took a turn for the worse in 2012Q2 and dampened investor sentiment, the US dollar turned back into a safe haven currency, such that it was able to recoup its earlier losses. However, this was short-lived. News on the ECB recent measures contributed to push the US dollar lower. Between January and August 2012, the trade-weighted US dollar index (DXY) appreciated by 2.3 per cent (Chart 2.9).

The euro, pressured by the region's sovereign debt crisis, reached a 17-month low of US$1.2624 on 13 January 2012 after the downgrade by Standard & Poor's of nine euro zone countries, including France, Spain, Italy and Austria. It briefly reversed its downtrend as risk appetite improved following better-than-expected German economic data, successful bond sales in Spain and France and the approval of a second rescue package for Greece. However, ensuing political deadlock that raised the spectre of insolvency in Greece together with the troubles encountered by the Spanish banking sector drove the euro down against the US dollar. It came very close to US$1.20 by end-July 2012 after the ECB cut its key refinancing rate to a record low of 0.75 per cent and no positive outcome to the Eurozone crisis appeared in sight. The downgrade of Italy's credit rating and fears that Spain would need a bailout added to the single currency's woes. The recent policy actions by the ECB have, however, helped the euro to recover.

The British currency generally tracked the euro versus the US dollar, initially losing ground on the lack of progress in resolving the Eurozone debt crisis. The dovish Bank of England (BoE) minutes that highlighted the possibility of more quantitative easing as well as uncertain prospects for the UK economy further added to the Pound's weak tone at the beginning of the year. As economic data releases in the UK improved and investors pared back expectations of further stimulus from the Bank of England, the Pound sterling reversed course, rising to its highest in eight months at above US$1.62 by end-April 2012. Fears that the Eurozone debt crisis would drag down the UK economy pressured the British currency in June and July 2012 but it thereafter turned around against a broadly weaker US dollar.

A number of emerging markets' currencies depreciated against the US dollar in the first eight months of 2012 as the greenback gained footing on international markets following an intensification of the euro area crisis which increased risk aversion. On a point-to-point basis, the Indian rupee depreciated against the US dollar by 4.7 per cent between January to August 2012 while the Tunisian Dinar and the Sri Lankan rupee depreciated by 6.7 per cent and 16.2 per cent, respectively. However, the Chinese yuan, the Malaysian ringgit and the Turkish lira appreciated by 0.3 per cent, 1.4 per cent and 3.5 per cent respectively (Chart 2.10).

2.4 International Monetary Policy

Monetary policy remained accommodative in advanced economies where historically low interest rates made it necessary for some central banks to increase quantitative easing to tackle continued weak growth prospects. In the US, the Federal Open Market Committee (FOMC) maintained the federal funds rate at 0-0.25 per cent and announced a continuation of its maturity extension programme through end-2012. The programme was aimed at reducing longer-term interest rates in order to ease financial market conditions and support the economic recovery. The FOMC also announced the adoption of an inflation target of 2 per cent. At its meeting on 13 September 2012, the FOMC decided to launch a third round of quantitative easing (QE3) through the open-ended purchase of mortgage-backed securities to the tune of US$40 billion per month in an effort to support economic recovery and ease labour market conditions.

Having some leeway on the interest rate, the ECB further reduced its policy rate by 25 basis points to 0.75 per cent in July 2012 and cut the overnight deposit rate to zero per cent in order to further support bank lending activity. In parallel, the ECB adopted measures that continued to support the liquidity of the banking system. It extended, until the end of 2012, the unlimited short-term liquidity auctions and flexed its collateral policy to make it easier for banks to have access

Chart 2.9: Evolution of EURUSD, GBPUSD and DXY Indices

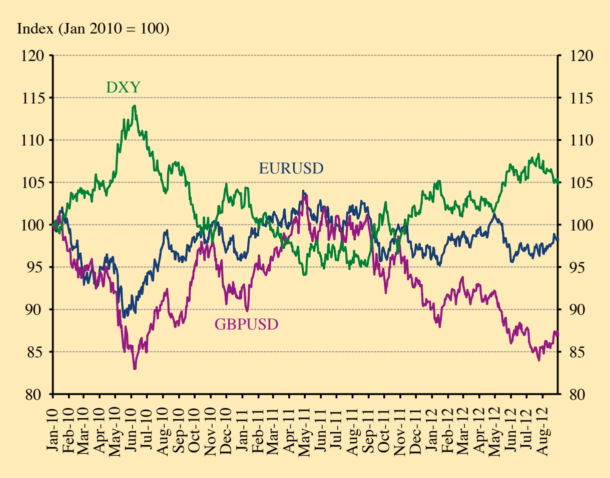
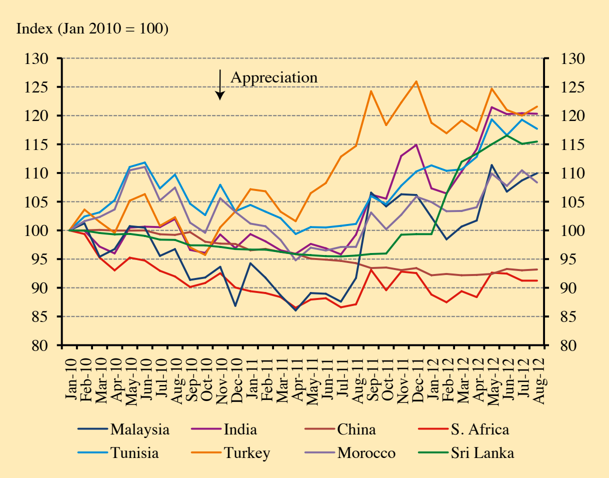


Chart 2.10: Evolution of Emerging Markets' Currencies Indices against the US dollar



Source: Thomson Reuters.

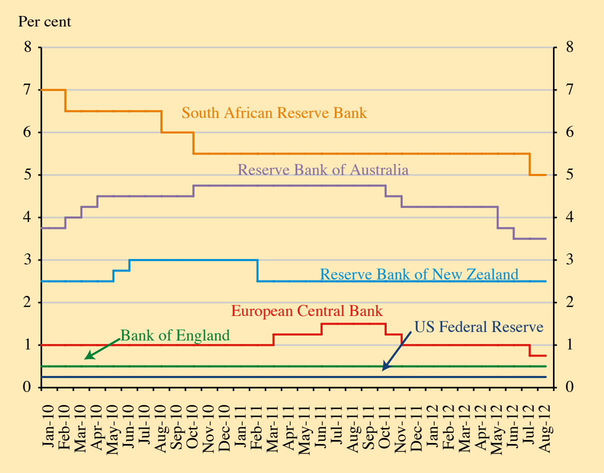
to liquidity with a broader array of assets. More recently, on 6 September 2012, the ECB indicated its willingness to conduct OMTs whereby it would buy sovereign debt securities of troubled sovereigns on the secondary market in an effort to reduce yield spreads. Nonetheless, the financial help would be conditional upon a government asking for financing support via the European Financial Stability Facility and the European Stability Mechanism (EFSF/ESM). In addition, countries that are already subject to a macroeconomic adjustment programme would be eligible for OMT once they regain access to the markets. Financial conditions have eased in the wake of the announcement by the ECB.

The Bank of England (BoE) kept its policy rate unchanged at 0.5 per cent but expanded its quantitative easing measures. It increased the size of its asset purchase programme by £50 billion in February 2012 to £325 billion and by a further £50 billion in July 2012 to £375 billion. In addition, the BoE and the British government jointly unveiled a £100 billion lending plan for households and businesses.

The Bank of Japan (BoJ) announced several measures to support the weak domestic economy. These included the expansion of its asset purchase programme, the setting of a formal inflation target of 1 per cent and an increase in the loan scheme targeting growth industries. In April 2012, the BoJ also extended the remaining maturity of Japanese government bonds to be purchased under the programme from "one to two years" to "one to three years".

Several central banks in emerging economies have eased monetary policy during 2012H1 given the continued uncertainties in the global economy. The Bank of Thailand reduced its key policy rate by 25 basis points to 3 per cent in January 2012 while the Bank Indonesia cut its benchmark interest rate by 25 basis points to 5.75 per cent in February 2012. Thereafter both central banks maintained their policy rates unchanged as they deemed monetary conditions accommodative enough to support continued expansion. The Reserve Bank of India (RBI) reduced its cash reserve ratio requirement by a cumulative total of 125 basis points to 4.75 per cent in March 2012 to ease liquidity in the banking system. In April 2012, the RBI lowered its key lending rate by 50 basis points to 8 per cent in an effort to support growth but, thereafter, maintained its policy rate at their level as it focussed on bringing down inflation. The People's Bank of China (PBOC) reduced its benchmark one-year lending rate for the first time since 2008 by a cumulative total of 56 basis points to 6 per cent in July 2012. This followed from the PBOC's decision to lower the banks' reserve requirement ratio by 50 basis points to 20 per cent in May 2012 to improve liquidity conditions. The South African Reserve Bank also cut its repo rate by 50 basis points to 5.00 per cent in July 2012 (Chart 2.11).

Chart 2.11: Selected Central Banks' Policy Interest Rates



Sources: Thomson Reuters and central banks' websites.

3. Recent Developments in Domestic Inflation

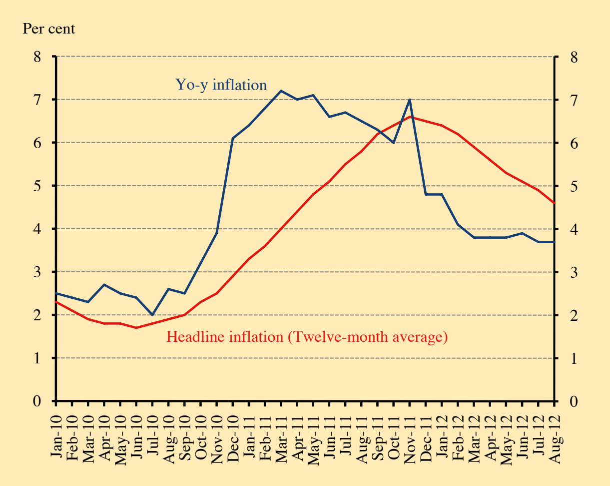
Both headline and y-o-y inflation have decreased to more moderate levels since the start of 2012 as base effects became absorbed and externally-generated inflationary pressures eased. Underlying core measures of inflation also indicated relatively benign inflationary pressures. Going forward, upside risks to the inflation outlook have risen following global commodity price increases and domestic developments particularly on the exchange rate and wages fronts while demand pressures are deemed to have remained contained in view of the negative output gap.

3.1 Inflation: Y-o-y, Headline and Core

Y-o-y inflation, defined as the annual percentage change in the Consumer Price Index (CPI), started to decline from December 2011 as base effects became absorbed and remained at moderate levels till August 2012. From 4.8 per cent in December 2011, y-o-y inflation remained flat in January 2012. It thereafter trended downwards to 3.7 per cent in August 2012, marking a sixth straight month of modest readings with inflation fluctuating between 3.7 per cent and 3.9 per cent. Concurrently, headline inflation, as measured by the change in the average level of prices during a twelve-month period, eased steadily from 6.5 per cent in December 2011, to 4.6 per cent in August 2012 (Chart 3.1).

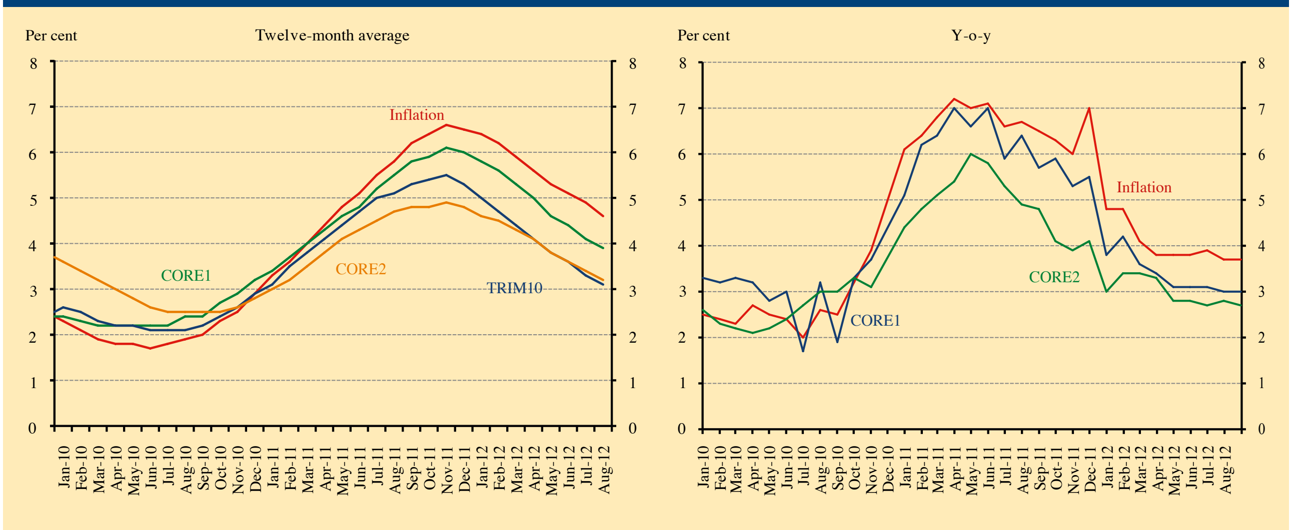
Underlying core measures of inflation indicated a moderation in inflationary pressures since the beginning of 2012. The twelve-month average core measures of inflation mirrored the path of headline inflation, decreasing consistently up till August 2012. CORE1 inflation fell from 6.0 per cent in December 2011 to 4.4 per cent in June 2012 and further to 3.9 per cent in August 2012 while CORE2 inflation decreased from 4.8 per cent in December 2011 to 3.6 per cent in June 2012 and further to 3.2 per cent in August 2012. TRIM10 inflation also remained on a downtrend, moving from 5.3 per cent in December 2011 to 3.1 per cent in August 2012.

Chart 3.1: Inflation Rate



Sources: Statistics Mauritius and Bank of Mauritius.

Chart 3.2: Inflation and Core Inflation Rates



Sources: Statistics Mauritius and Bank of Mauritius.

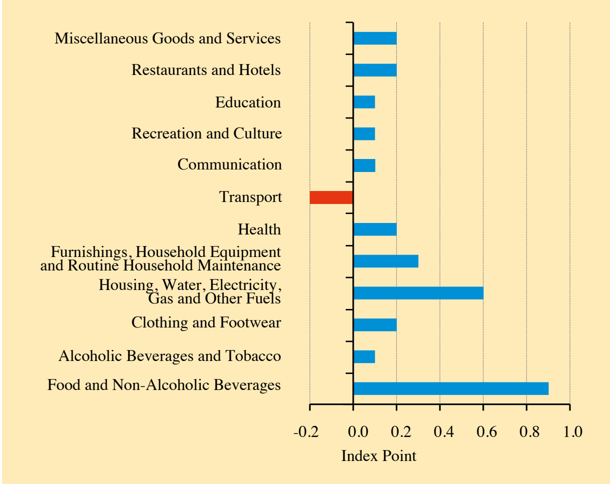
On a y-o-y basis, CORE1 inflation increased from 3.8 per cent in December 2011 to 4.2 per cent in January 2012 on account of increases in water charges and expenditure in restaurants and hotels but moderated thereafter to reach 3.0 per cent in August 2012. CORE2 inflation, which excludes food, beverages, tobacco, mortgage interest, energy and administered prices from the CPI basket, stayed flat at 3.4 per cent in the first two months of 2012 after it had risen from 3.0 per cent in December 2011. Thereafter, it continued to trend down to 2.7 per cent in August 2012 (Chart 3.2).

3.2 Evolution of Major Commodity Group Indices

The CPI rose from 130.4 in December 2011 to 133.2 in August 2012, driven by *food and non-alcoholic beverages*, which contributed 0.9 index point to the increase, and *housing, water, electricity, gas and other fuels*, which contributed 0.6 index point. The contribution of those two divisions to the CPI has been principally influenced by price increases in soft drinks, fish, meat, bread and other food products, cooking gas and water charges, respectively. Other divisions that contributed to the rise in the CPI were, among others, *furnishings, household equipment and routine household maintenance* (0.3 index point), *clothing and footwear* (0.2 index point), *health* (0.2 index point), *restaurants and hotels* (0.2 index point) and *miscellaneous goods and services* (0.2 index point). *Transport* made a negative contribution of 0.2 index point to the CPI over the period under review (Chart 3.3).

The contribution by each division to the y-o-y and headline inflation in August 2012 highlighted the significant addition of *alcoholic beverages and tobacco*, mostly as a result of the lingering effects of tax increases in the 2012 Budget. *Alcoholic beverages and tobacco* contributed 1.5 and 1.6 percentage points, respectively, to the y-o-y and headline inflation, while *food and non-alcoholic*

Chart 3.3: Weighted Contribution to the Change in CPI: December 2011- August 2012



Sources: Statistics Mauritius and Bank of Mauritius.

Table 3.1: Contribution to Inflation

	Consumer Price Index				Contribution to Inflation (Percentage point)	
DIVISIONS	**Aug-11**	**Aug-12**	**12-month average to Aug-11**	**12-month average to Aug-12**	**Y-o-y Inflation**	**Headline**
Food and Non Alcoholic Beverages	142.3	145.7	139.5	143.7	0.7	0.9
Alcoholic Beverages and Tobacco	138.2	160.6	133.5	156.9	1.5	1.6
Clothing and Footwear	131.4	137.9	128.4	135.0	0.3	0.3
Housing, Water, Electricity, Gas and Other Fuels	108.1	113.1	106.8	111.3	0.6	0.6
Furnishings, Household Equipment and Routine Household Maintenance	123.2	127.8	121.7	125.3	0.2	0.2
Health	129.3	134.4	126.5	131.0	0.1	0.1
Transport	128.6	126.8	124.2	127.3	-0.2	0.4
Communication	94.8	91.6	95.1	91.2	-0.1	-0.2
Recreation and Culture	106.4	109.5	105.5	108.5	0.1	0.1
Education	118.1	120.9	116.1	119.6	0.1	0.1
Restaurants and Hotels	141.5	151.5	137.4	148.6	0.3	0.4
Miscellaneous Goods and Services	125.9	128.8	124.0	127.0	0.1	0.1
Overall	**128.4**	**133.2**	**125.6**	**131.5**	**3.7**	**4.6**

Sources: Statistics Mauritius and Bank of Mauritius.

beverages was the second largest contributor with 0.7 and 0.9 percentage point, respectively. *Housing, water, electricity, gas and other fuels* added 0.6 percentage point to both y-o-y inflation and headline inflation (Table 3.1).

Food and Non-Food Inflation

On a 12-month average basis, food inflation declined steadily, from 5.7 per cent in December 2011 to 2.7 per cent in August 2012. Non-food inflation followed the same trend and fell from 6.9 per cent in December 2011 to 5.5 per cent in August 2012.

Based on the year-on-year methodology, food inflation declined from 3.9 per cent in December 2011 to 0.8 per cent in March 2012 before trending upwards to 2.0 per cent in August 2012. Non-food inflation rose to 5.7 per cent in January 2012, mainly on account of the hike in water and waste water charges, before retreating to 4.5 per cent in August 2012 (Chart 3.4).

Goods and Services Inflation

On a 12-month average basis, goods inflation fell continuously from 7.1 per cent in December 2011 to 4.9 per cent in August 2012, reflecting the softening of goods prices during the period under review. Services inflation remained unchanged at 5.3 per cent in January and February 2012 before subsiding to 4.1 per cent in August 2012.

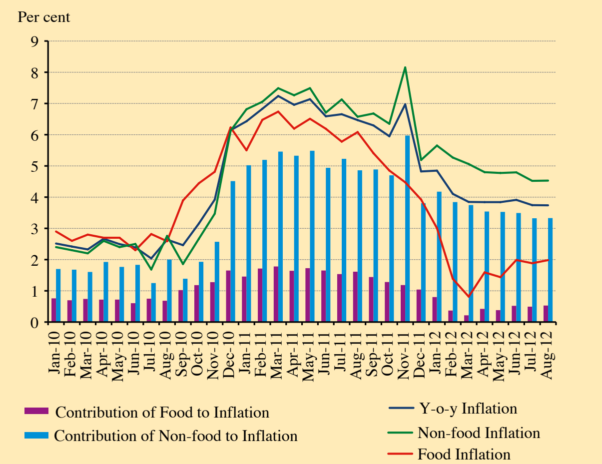
Y-o-y goods inflation remained volatile, initially falling from 5.5 per cent in December 2011 to 3.7 per cent in March 2012 before rising slightly to remain in the range of 4.0 per cent to 4.2 per cent up till August 2012. Services inflation picked up to 4.7 per cent in January 2012 but subsequently fell to more moderate levels, reaching 3.4 per cent in August 2012 (Chart 3.5).

3.3 Evolution of Other Price and Cost Indices

Import Price Index

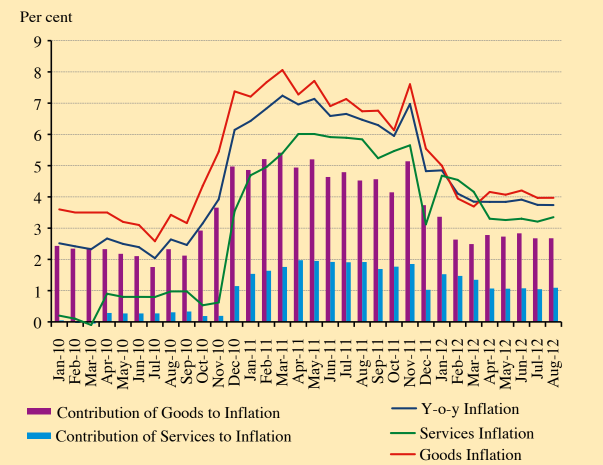
The Import Price Index (IPI), a key indicator of price movements of imported goods in Mauritius, has been on an upward trend since 2011Q4. In 2012Q2, the IPI reached 124.1, representing increases of 3.2 per cent and 5.3 per cent over 2012Q1 and 2011Q2, respectively. The growth in the IPI was mainly due to higher prices being recorded on the imports of *machinery and transport equipment, food and live animals* and *crude materials, inedible, except fuels*. *Mineral fuels, lubricants and related materials* recorded a decline of 4.9 per cent q-o-q as against a rise of 2.5 per cent y-o-y (Table 3.2).

Chart 3.4: Food and Non-Food Inflation



Sources: Statistics Mauritius and Bank of Mauritius.

Chart 3.5: Goods and Services Inflation



Sources: Statistics Mauritius and Bank of Mauritius.

Wage Rate Index

The Wage Rate Index (WRI) remained subdued in 2012H1 and did not indicate undue cost pressures within the domestic economy. It rose by 2.9 per cent, from 143.5 in 2011Q2 to 147.6 in 2012Q2. On a quarterly basis, the WRI registered an increase of 1.0 per cent between 2011Q4 and 2012Q1 but thereafter slowed by 0.3 per cent between 2012Q1 and 2012Q2.

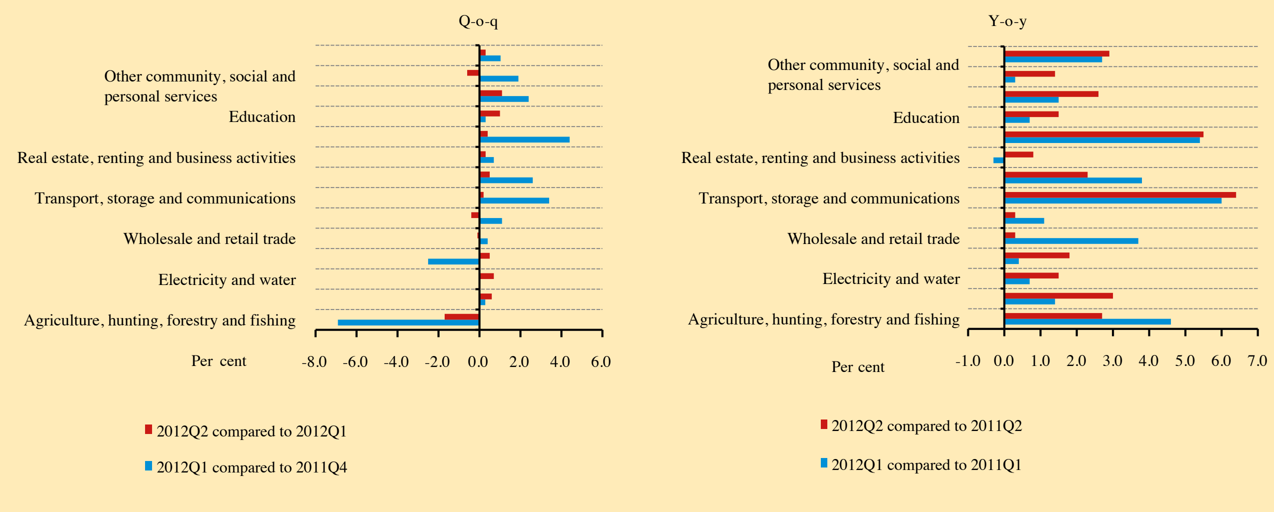
All industry groups registered positive y-o-y increases in their WRI in 2012Q2. The rise in the overall WRI was led by *transport, storage and communications* and *public administration and defence*, which recorded increases of 6.4 per cent and 5.5 per cent, respectively. On a quarterly basis, the growth in the overall WRI in 2012Q2 reflected mainly increases in the WRI of *health & social work* (1.1 per cent), *education* (1.0 per cent), *electricity and water* (0.7 per cent) and *manufacturing, mining and quarrying* (0.6 per cent). In contrast, the following sectors recorded q-o-q decreases: *agriculture, hunting, forestry and fishing* (-1.7 per cent), *other community, social and personal*

Table 3.2: Import Price Index

Description	Weights	Quarterly Percentage Change			Annual Percentage Change	
		2011Q4 compared to 2011Q3	2012Q1 compared to 2011Q4	2012Q2 compared to 2012Q1	2012Q1 compared to 2011Q1	2012Q2 compared to 2011Q2
Food and live animals	1,808	-1.1	-2.7	7.8	0.7	4.6
Beverages and tobacco	138	1.1	-1.0	1.9	0.8	1.7
Crude materials, inedible, except fuels	288	1.3	-0.3	4.2	7.2	5.2
Mineral fuels, lubricants and related materials	2,004	-3.4	10.8	-4.9	19.7	2.5
Animal and vegetable oils, fats and waxes	104	-0.6	-1.7	2.1	-8.3	-6.5
Chemical materials & related products, n.e.s	851	-0.3	0.1	1.3	4.5	5.8
Manufactured goods classified chiefly by material	2,141	0.3	2.0	2.4	6.2	3.5
Machinery and transport equipment	1,800	11.8	-10.7	14.9	-10.7	13.9
Miscellaneous manufactured articles	866	4.4	-0.4	0.8	5.5	6.1
Overall Index	10,000	1.1	0.5	3.2	4.8	5.3

Source: Statistics Mauritius.

Chart 3.6: Wage Rate Index by Industry Group



Source: Statistics Mauritius

services (-0.6 per cent), *hotels and restaurants* (-0.4 per cent) and *wholesale and retail trade* (-0.1 per cent) (Chart 3.6).

Producer Price Indices

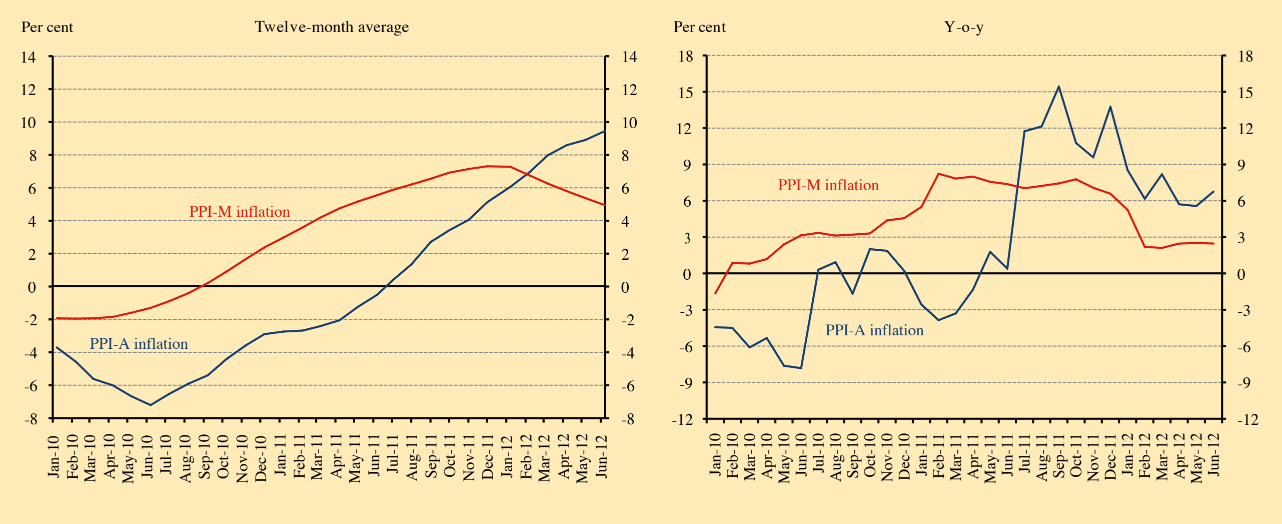
Price pressures at the production level showed a mixed picture in 2012H1. On a 12-month average basis, the Producer Price Index-Agriculture (PPI-A) inflation rose significantly, from 5.1 per cent in December 2011 to 9.4 per cent in June 2012. On a y-o-y basis, however, PPI-A inflation declined from 13.8 per cent in December 2011 to 6.8 per cent in June 2012.

On a twelve-month average period, the Producer Price Index-Manufacturing (PPI-M) inflation went down almost consistently from 7.3 per cent in December 2011 to 5.0 per cent in June 2012. Y-o-y PPI-M inflation moderated considerably at the start of 2012, from 6.6 per cent in December 2011, but stabilised thereafter to stand at 2.5 per cent in June 2012, reflecting modest dynamics in its largest activity group *Manufacture of food products and beverages* (Chart 3.7).

3.4 Inflation Expectations

Inflation expectations remained more or less anchored over the year to August 2012 insofar as the mean inflation rate was expected to go down. According to Inflation Expectations Surveys carried out by the Bank since August 2011, the proportion of respondents who perceived inflation to be high had come down significantly since February 2012. However, most respondents still thought that inflation had gone up over the past 12 months, driven mostly by external factors followed by a change in aggregate demand and monetary policy. Over the next twelve months, inflation was mostly expected to go up but the mean projected inflation rate was down to 5.2 per cent by December 2012 and 5.6 per cent by June 2013.

Chart 3.7: Producer Price Inflation



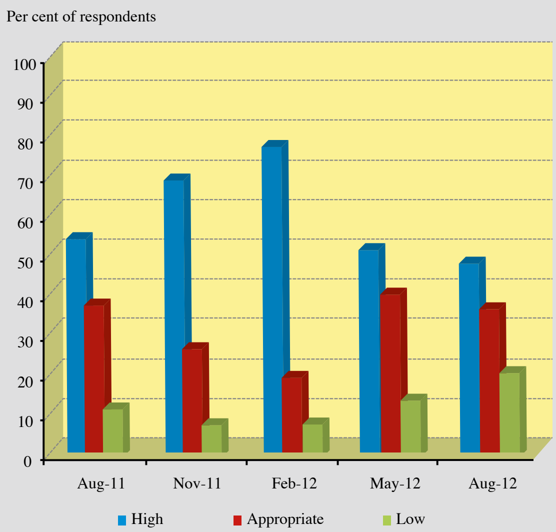
Sources: Statistics Mauritius and Bank of Mauritius.

BOX 1: EVOLUTION OF INFLATION EXPECTATIONS

The evolution of the results of the five inflation expectations surveys carried out by the Bank between August 2011 and August 2012 are described below.

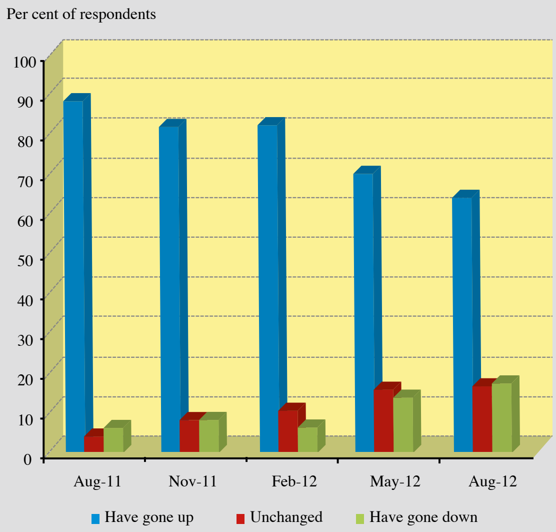
Q.1. How do you perceive the inflation rate in the twelve-month period ending in the month preceding the survey [*Note: at 5.5 per cent in July 2011, 6.4 per cent in October 2011, 6.4 per cent in January 2012, 5.6 per cent in April 2012 and 4.9 per cent in July 2012?]*

With headline inflation increasing continuously between May and November 2011 and standing at 6.4 per cent in December 2011 and January 2012, the proportion of respondents perceiving inflation to be high maintained an uptrend to reach 77 per cent in February 2012. Thereafter, as inflation started coming down, the share of respondents perceiving inflation to be high decreased to 46 per cent in August 2012. Concurrently, share of respondents that perceived inflation to be low increased from 6 per cent in February 2012 to 19 per cent in August 2012.



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

For the survey months August 2011 to August 2012, the share of respondents that described prices as having gone up during the past 12 months trended downward to reach 65 per cent in August 2012. In parallel, the share of respondents that were of the opinion that prices had gone down increased from 7 per cent in August 2011 to 19 per cent in August 2012. 17 per cent of respondents were of the view that inflation had remained unchanged over the past 12 months, in August 2012.



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

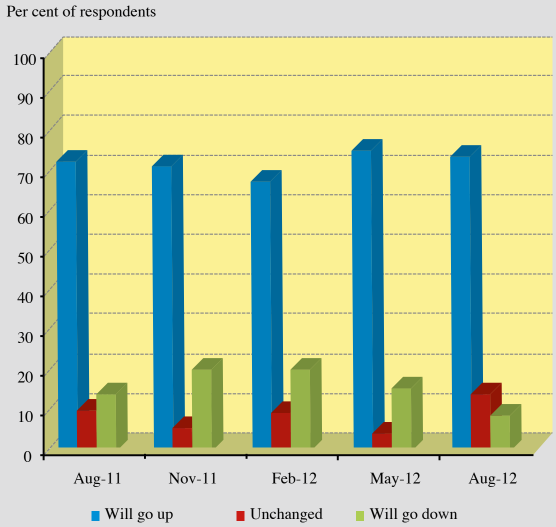
An overwhelming majority of respondents continued to perceive external factors as being the most important cause of inflation in the five surveys carried out since August 2011, although the share had gone down from 87 per cent in August 2011 to 73 per cent in August 2012. With the exception of the August 2011 survey, which showed monetary policy (MP) as the second most important factor affecting inflation, the surveys carried out thereafter indicated that respondents viewed the change in aggregate demand (AD) as the second most important factor explaining inflation. MP was perceived by respondents as the third most important cause for inflation in the last three surveys carried out.

Ranking of Factors by Order of Importance	Aug-11		Nov-11		Feb-12		May-12		Aug-12	
	Factor	% of Respondents	Factor	% of Respondents	Factor	% of Respondents	Factor	% of Respondents	Factor	% of Respondents
First	External	87	External	83	External	79	External	80	External	73
Second	MP	33	Change in AD	30	Change in AD	30	Change in AD	36	Change in AD	42
Third	Change in AD	30	FP	28	MP	32	MP	36	MP	40

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

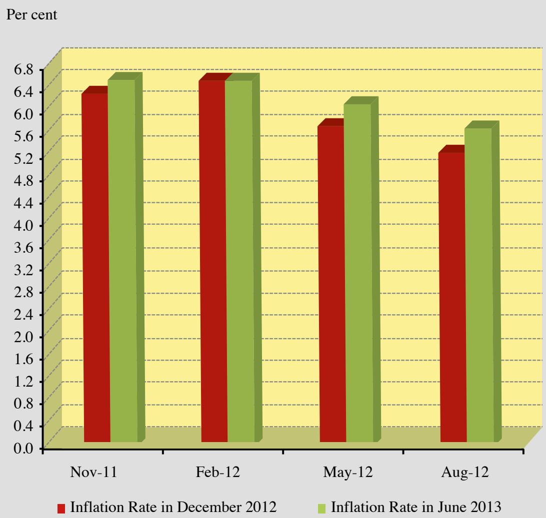
Q.4. Which of the following would best describe the movement of prices over the next 12 months?

The proportion of respondents who had expected inflation to go up decreased between August 2011 and February 2012 but rose thereafter to reach about 75 per cent in May and August 2012. The share of respondents that expected prices to go down initially increased from 15 per cent in August 2011 to 21 per cent in November 2011 before coming down to 10 per cent in August 2012. Concurrently, a higher proportion of respondents (15 per cent) expected prices to remain unchanged in August 2012.



Q.5 Mean expectation of inflation in December 2012 and June 2013

The mean inflation rate expected by respondents in December 2012 increased from 6.2 per cent in the November 2011 survey to 6.4 per cent in the February 2012 survey before receding to 5.2 per cent in August 2012. The mean inflation rate expected by respondents in June 2013 fell from 6.4 per cent in August 2011 to 5.6 per cent in August 2012.



4. The Domestic Economy

The domestic economy withstood the global headwinds reasonably well but major export sectors remain at risk from economic and financial developments in the Eurozone. Growth dynamics have slowed and the economy is forecast to continue operating below trend. Growth in final consumption expenditure and investment is expected to be relatively muted in 2012, while labour market conditions would remain relatively stable. Looking ahead, diversification efforts and a fair performance of emerging sectors are expected to continue supporting the domestic growth outlook.

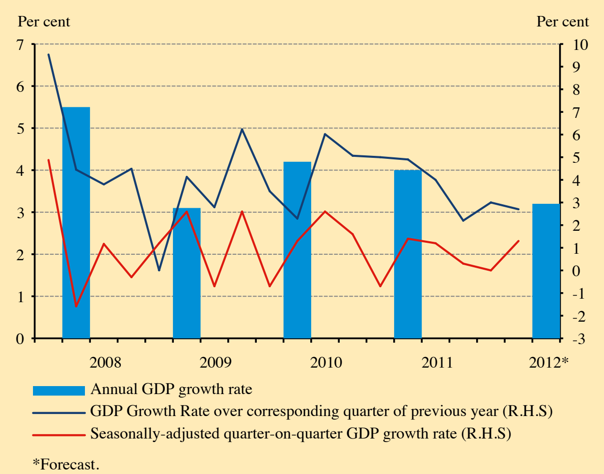
4.1 Economic Activity

The domestic economy continued to hold up well to the prolonged crisis although the pace of economic activity, especially in the export-led sectors, was affected by the escalating global headwinds. The annual pace of growth decelerated to 2.7 per cent in 2012Q2, from 3.0 per cent in 2012Q1 and 4.9 per cent in 2011Q2. However, the underlying growth momentum, as reflected by seasonally-adjusted q-on-q data, picked up to 1.3 per cent in 2012Q2 compared to zero growth in 2012Q1. In its September 2012 national accounts data release, Statistics Mauritius revised downwards the growth projection for 2012 to 3.2 per cent, from an earlier estimate of 3.5 per cent. This growth projection compares with growth of 3.9 per cent estimated for 2011 (Chart 4.1).

Over the year to 2012Q2, a number of sectors recorded positive growth rates. 'Wholesale and retail trade' and 'real estate, renting and business activities' expanded at higher rates of 3.6 per cent and 5.7 per cent, respectively, compared to 3.4 per cent and 5.1 per cent, respectively, in 2012Q1. 'Construction', 'transport, storage and communications', and 'financial intermediation', however, recorded lower growth of 1.0 per cent, 3.4 per cent and 4.9 per cent, respectively, during 2012Q2.

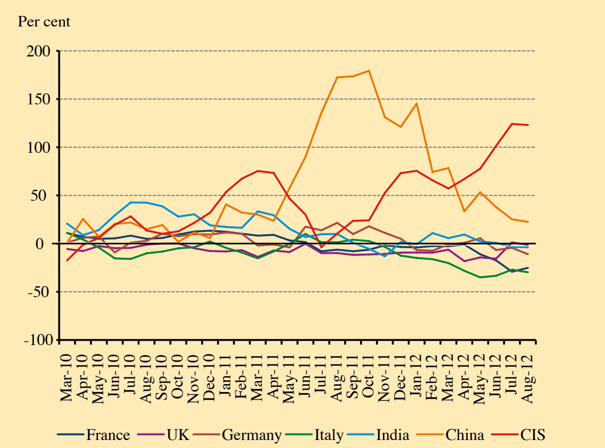
After expanding throughout 2011, 'hotels and restaurants' contracted by 1.2 per cent in 2012Q1 and stagnated in 2012Q2, reflecting the weak economic environment in main source markets. The performance of this sector was affected by the subdued growth in total tourist arrivals, which increased by 0.5 per cent y-o-y in 2012H1. A drop in arrivals from several key European markets was noted, compensated to some extent by significant growth from emerging source countries (Chart 4.2). As at end-June 2012, a total of 113 hotels were registered in Mauritius, of which 107 were in operation and 6 were undergoing renovation works. During 2012H1, total tourist nights were estimated at 4.96 million, representing an increase of 0.5 per cent over the corresponding period of 2011. The bed and room occupancy rates for all hotels in operation in 2012H1 decreased to 55 per cent and 62 per cent, respectively, from 57 per cent

Chart 4.1: Real GDP Growth Rate



Source: Statistics Mauritius.

Chart 4.2: Growth in Tourist Arrivals from Key Markets



Source: Statistics Mauritius.

and 65 per cent in 2011H1. Over the period January to July 2012, tourist earnings totalled Rs26,618 million, an increase of 9.3 per cent compared to the corresponding period in 2011. Statistics Mauritius revised downwards the initial forecast of 980,000 tourist arrivals for 2012 to 960,000, which would represent a decrease of 0.5 per cent in tourist arrivals compared to 2011. Tourist earnings for 2012 are forecast to be around Rs42,542 million, that is, 0.4 per cent lower compared to earnings in 2011.

'Manufacturing' recorded its third consecutive quarter of negative growth, with a contraction of 1.6 per cent in 2012Q2 following negative growth of 0.5 per cent in 2012Q1 and 5.2 per cent in 2011Q4. Within 'manufacturing', '*textile*' contracted by a higher rate of 7.3 per cent compared to a decline of 0.7 per cent in 2012Q1 as global headwinds constrained activity despite diversification away from European markets. '*Other manufacturing*' declined by 0.9 per cent compared to a contraction of 6.9 per cent in 2012Q1 while '*food*', driven by the expansion of the seafood industry, was the only sub-sector where positive, albeit lower, growth of 3.4 per cent was recorded in 2012Q2. Following positive growth in the four preceding quarters, 'agriculture' and 'electricity, gas and water supply' turned around to record negative growth rates of 0.4 per cent and 1.9 per cent, respectively, in 2012Q2. Real output in export-oriented enterprises contracted by 2.4 per cent in 2012Q2 after expanding by 3.4 per cent in 2012Q1 (Chart 4.3).

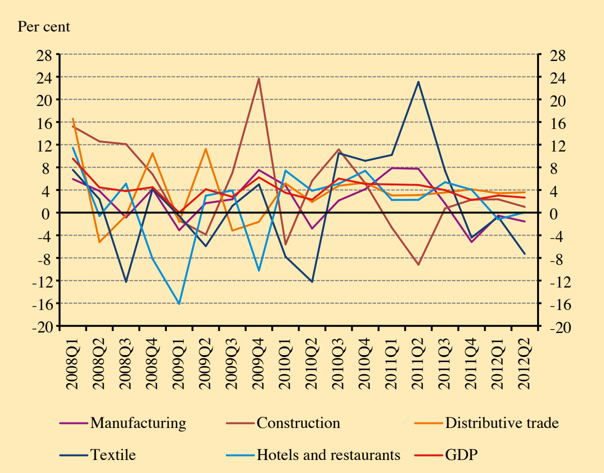
The major contributors to GDP growth in 2012Q2 were 'Real estate, renting and business activities' (0.7 percentage point) followed by 'Transport, storage and communications' (0.5 percentage point), 'Financial intermediation' (0.4 percentage point) and 'Wholesale and retail trade' (0.4 percentage point). 'Manufacturing', which removed 0.3 percentage point from the 2012Q2 growth rate, was the only sector that made a negative contribution (Chart 4.4).

Consumption

Although households and government continued to spend cautiously relative to pre-crisis trends, an improvement in final consumption expenditure was noted in 2012Q2 when it expanded by 2.5 per cent compared to 2.2 per cent in 2012Q1. Household consumption expenditure, which accounts for around 84 per cent of final consumption expenditure, grew by 2.8 per cent in 2012Q2 compared to 2.1 per cent in 2012Q1. General government consumption expenditure growth decelerated to 1.0 per cent in 2012Q2 following growth of 2.7 per cent in 2012Q1 (Chart 4.5).

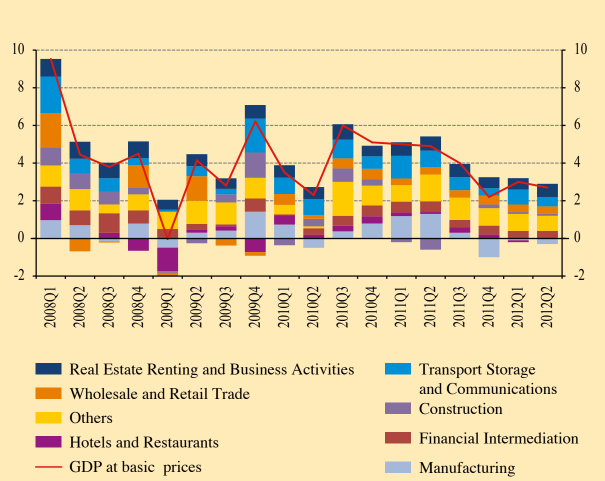
For the year 2012, Statistics Mauritius has estimated that final consumption expenditure growth would increase slightly to 2.6 per cent, from 2.5 per cent in 2011, mainly as a result of higher general government consumption expenditure growth of 2.8 per cent compared to 2.3 per cent in 2011. Household consumption expenditure growth is

Chart 4.3: Y-o-y Sectoral Growth Rates



Source: Statistics Mauritius.

Chart 4.4: Contribution of Major Sectors to Real GDP Growth Rate



Sources: Statistics Mauritius and Bank of Mauritius.

expected to remain flat at 2.5 per cent in 2012, constrained by fragile consumer sentiment amid on-going uncertainty in main export markets.

Investment

Following growth of 13.9 per cent and 10.5 per cent in 2011Q4 and 2012Q1, respectively, Gross Domestic Fixed Capital Formation (GDFCF) expanded by a mere 2.8 per cent in 2012Q2. This reflected a lower expansion of 5.3 per cent in 'machinery and equipment' compared to growth of 34.2 per cent and 27.0 per cent recorded in 2011Q4 and 2012Q1, respectively, on account of the acquisition of a power generating plant. Among the components of 'machinery and equipment', '*other transport equipment*' registered a higher expansion of 19.2 per cent in 2012Q2 compared to 11.3 per cent in 2012Q1 while '*other machinery and equipment*' grew at a lower rate of 4.7 per cent compared to 31.7 per cent in 2012Q1 and '*passenger car*' contracted by 0.3 per cent as against a growth of 14.6 per cent in 2012Q1.

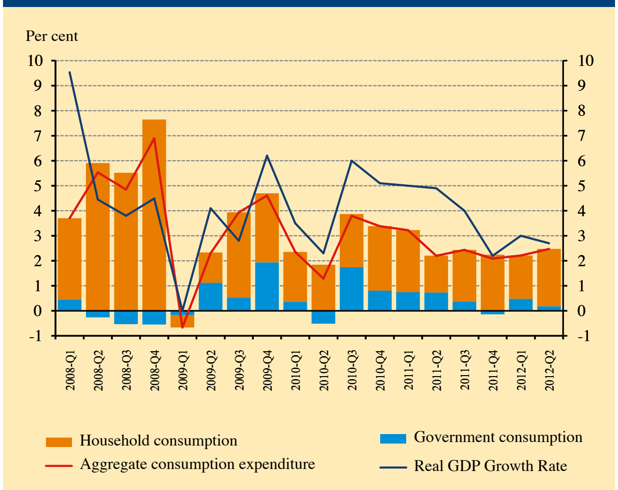
'Building and construction work' expanded at a lower rate of 1.6 per cent in 2012Q2 compared to 2.8 per cent in 2012Q1, mainly as a result of a contraction of 3.5 per cent in '*non-residential building*' as against a growth of 19.9 per cent in 2012Q1 and a marked deceleration in '*other construction work*' to 5.9 per cent, from 18.9 per cent in 2012Q1. '*Residential building*' grew by 3.5 per cent in 2012Q2 after declining by 15.9 in 2012Q1 (Chart 4.6).

In September 2012, Statistics Mauritius maintained its forecast of a contraction of 0.7 per cent in GDFCF for 2012 as against growth of 0.3 per cent in 2011. The projected contraction in GDFCF in 2012 is attributable to a decline of 3.3 per cent in private investment, partly offset by public investment growth of 7.7 per cent. Excluding a*ircraft and marine vessel*, the same rate of contraction in GDFCF is projected for 2012.

Business Confidence

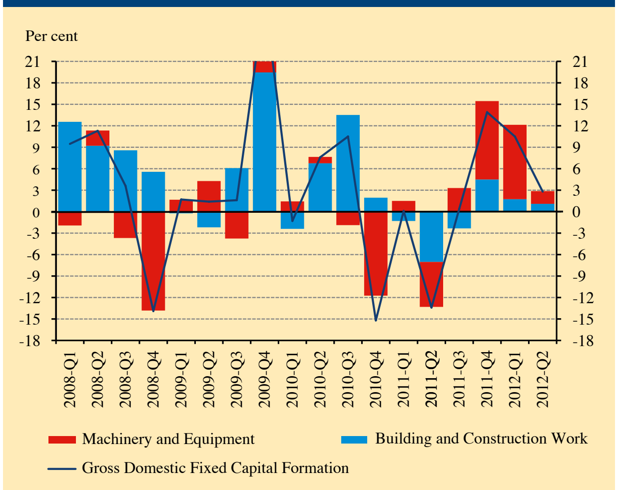
After an increase of 0.6 point in 2012Q2, the MCCI business confidence indicator decreased significantly by 11.3 points in 2012Q3 to 88.1, its lowest level since its launch in 2010. The fall in the index was driven by declines in confidence in all the three sectors covered: services (-20.2 points), manufacturing (-11.0 points) and distributive trade (-5.9 points). The major factors that reportedly led to the marked deterioration in the index were the perceived strength of the rupee, increased number of taxes and unfair competition. While about a third of the respondents to the business confidence survey foresee deterioration in the business climate during 2012Q4, some 48 per cent do not expect any improvement in their business situation. Entrepreneurs generally remained concerned about the level of their order books, the evolution of their

Chart 4.5: Real GDP and Consumption Growth Rates



Sources: Statistics Mauritius and Bank of Mauritius.

Chart 4.6: Contribution to Growth in Gross Domestic Fixed Capital Formation



Sources: Statistics Mauritius and Bank of Mauritius.

businesses, and the level of finished goods stocks. Hiring prospects were also viewed to have worsened (Chart 4.7).

4.2 Output Gap

Against the weak global economic backdrop, the domestic output gap was assessed to have remained negative. The economy was thus likely to have remained below trend, operating with some degree of spare capacity. The output gap was estimated using a number of different methods that provided a consistency check. In addition to the Hodrick-Prescott (HP) filter, the band-pass filter - which uses the statistical properties of the data to separate trend from cycles - and the Kalman filter - which uses an economic structure to yield an assessment of potential output and deviations therefrom - were also utilised (Chart 4.8).

4.3 Balance of Payments Developments

The country's balance of payments recorded a surplus of Rs1.4 billion in 2012H1, lower than the surplus of Rs3.9 billion recorded in the corresponding semester of 2011. The sustained surplus in the country's external position remained supported by net inflows in the capital and financial account (Table 4.1).

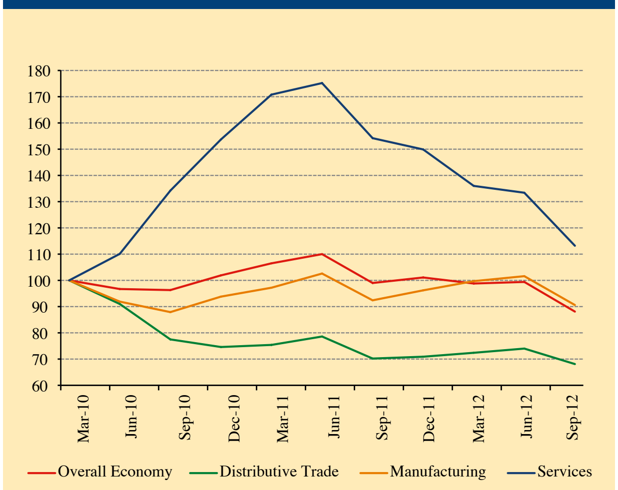
Current Account

The current account recorded a deficit of Rs13.1 billion in 2012H1, representing a decrease of Rs0.7 billion y-o-y as higher net receipts in services and income had to a larger extent offset the growing merchandise trade deficit. As a percentage of GDP at market prices, the current account deficit is estimated to have come down to 8.0 per cent, from 9.0 per cent in 2011H1.

The merchandise trade deficit worsened to Rs35.7 billion, from Rs29.9 billion a year ago. The 19.4 per cent deterioration of the trade-in-goods deficit was due to the expansion in nominal imports *f.o.b* of 12.2 per cent, which outpaced the modest growth in exports of goods of 6.2 per cent.

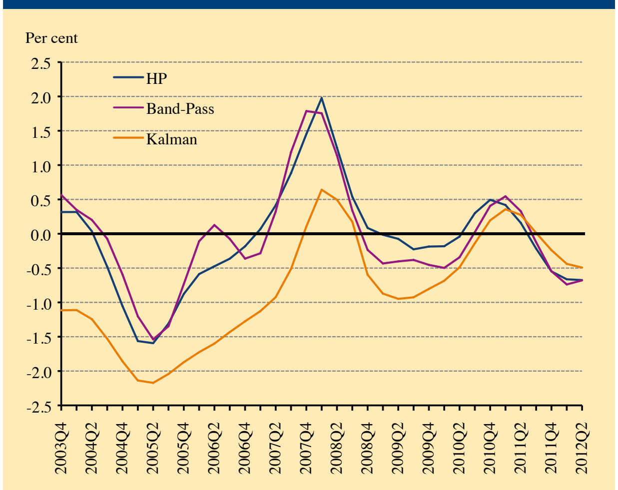
In 2012H1, the surplus on the services account went up by 37.0 per cent y-o-y to Rs17.1 billion. The growing surplus resulted largely from net travel receipts, which posted a rise of 16.6 per cent to reach Rs18.3 billion and a turnaround in other services, which shifted from a deficit of Rs0.6 billion in 2011H1 to a surplus of Rs1.2 billion. At the same time, transportation account registered a lower deficit of Rs2.5 billion in 2012H1.

Chart 4.7: MCCI Business Confidence Indicator



Source: The Mauritius Chamber of Commerce and Industry.

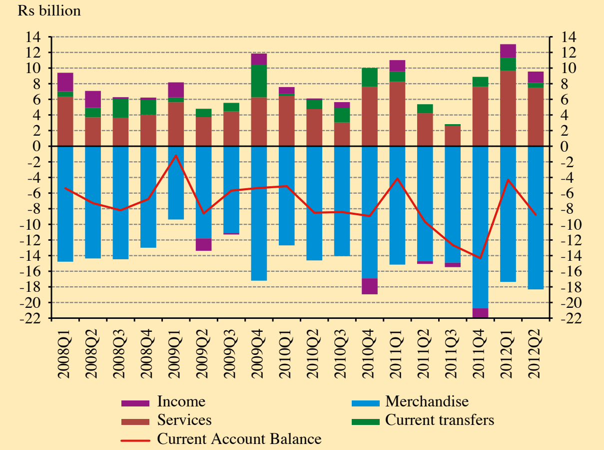
Chart 4.8: Domestic Output Gap



Sources: Statistics Mauritius and Bank of Mauritius.

The income account, inclusive of cross-border transactions of GBC1s, posted a higher surplus of Rs3.2 billion in 2012H1 compared to Rs1.1 billion in the same period of last year. The y-o-y increase in the surplus was due primarily to higher net portfolio income. In contrast, net direct investment income posted a lower deficit in 2012H1 relative to 2011H1, while net other investment income recorded a lower surplus. The current transfers account posted a surplus of Rs2.3 billion in 2012H1, down by Rs164 million a year earlier, reflecting lower net private transfers receipts (Chart 4.9).

Chart 4.9: Components of the Current Account Balance



Capital and Financial Account

The capital and financial account, inclusive of cross-border transactions of GBC1s, posted higher net inflows of Rs15.7 billion in 2012H1 compared to Rs10.8 billion in the same period of 2011. The rise in financial flows was largely driven by the combined effect of steady direct investment inflows and significantly lower other investment outflows, which offset the growing outflows recorded in portfolio investment.

Table 4.1: Balance of Payments Summary

(Rs million)

	2010		2011 [1]		2012 [2]
	Semester 1	**Semester 2**	**Semester 1**	**Semester 2**	**Semester 1**
Current Account	**-13,624**	**-17,361**	**-13,826**	**-26,982**	**-13,083**
Exports (f.o.b)	31,801	37,749	36,194	39,722	38,438
Imports (f.o.b)	-59,105	-68,734	-66,072	-75,332	-74,125
of which: aircrafts/marine vessels	-	-	-	-	-
Trade balance	-27,304	-30,985	-29,878	-35,610	-35,687
Services, net	11,328	10,621	12,469	10,369	17,084
of which:travel, net	13,294	13,928	15,725	15,509	18,341
Income, net	994	-1,268	1,117	-3,070	3,218
of which:global business, net	-1,943	-4,534	-2,186	-5,101	17
Current transfers, net	1,358	4,271	2,466	1,329	2,302
Capital and Financial Account	**-18,647**	**44,785**	**10,833**	**24,137**	**15,656**
Capital account, net	-115	-33	-25	-28	-113
Direct investment, net	142,312	281,346	167,459	217,031	212,965
of which:global business, net	129,378	271,565	164,254	214,930	210,840
Portfolio investment, net	-101,551	-199,132	-93,101	-215,486	-185,898
of which:global business, net	-82,820	-193,247	-93,173	-217,402	-189,174
Other investment, net	-57,604	-32,908	-59,589	23,956	-9,942
of which:global business, net	-15,319	-36,174	-13,039	-30,425	-23,353
Balance of Payments Surplus (-)/ Deficit (+)	-1,689	-4,488	-3,911	-1,336	-1,356
Net Errors and Omissions	**32,271**	**-27,424**	**2,993**	**2,845**	**-2,573**

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

Figures may not add up to totals due to rounding.

Direct investment, inclusive of cross-border transactions of GBC1s, posted net inflows of Rs213 billion in 2012H1, up by 27.2 per cent y-o-y. Excluding the cross-border transactions of GBC1s, foreign direct investment in Mauritius, net of repatriation, lost pace to reach Rs3.4 billion in 2012H1 compared to Rs4.3 billion in 2011H1. Outward direct investment excluding cross-border transactions of GBC1s, registered higher net outflows of Rs1.3 billion compared to Rs1.1 billion in the first six months of 2011.

Portfolio investment, inclusive of GBC1s, recorded net outflows of Rs185.9 billion for the first six months of 2012 compared to Rs93.1 billion a year earlier. Excluding the cross-border transactions of GBC1s, portfolio investment posted a net inflow of Rs3.3 billion. While net non-residents' transactions in shares traded on the Stock Exchange of Mauritius were sluggish in the first half of this year, amounting to net sales of Rs0.1 billion as against net purchases in the same period of 2011, non-residents' interest in domestic money market instruments increased.

Other investment, inclusive of GBC1s' cross-border transactions, posted significantly lower net outflows of Rs9.9 billion during the first semester of 2012, down from the net outflows of Rs59.6 billion in the corresponding period of 2011. The smaller deficit was largely attributable to banks' higher increase in foreign liabilities relative to foreign assets (Chart 4.10).

Net External Demand

The y-o-y growth in net exports of goods and services slowed to 6.9 per cent in 2012H1 after expanding by 9.0 per cent in 2011H1. Export of goods and services grew by 14.0 per cent, higher than the imports of goods and services at 12.6 per cent (Chart 4.11).

Exports

Y-o-y growth in nominal exports of goods, excluding Ship's Stores and Bunkers, slowed by 2.2 per cent to Rs32.2 billion in 2012H1. Domestic exports, which accounted for 82.0 per cent of total exports, recorded virtually no growth in 2012H1 in contrast to the robust growth of 15.4 per cent achieved in 2011H1. Re-exports of goods grew by 13.4 per cent after contracting by 2.3 per cent in 2011H1.

A breakdown by commodity group showed that the rise in exports was mainly driven by '*machinery and transport equipment*' and '*food and live animals*', which rose by 39.6 per cent and 13.9 per cent, respectively. Growth in exports in those categories was partly offset by declines of 10.4 per cent in '*manufactured goods classified chiefly by material*', 8.2 per cent in '*articles of apparel & clothing accessories*', and 3.5 per cent in '*miscellaneous manufactured goods*'.

Chart 4.10: Financing of the Current Account Balance

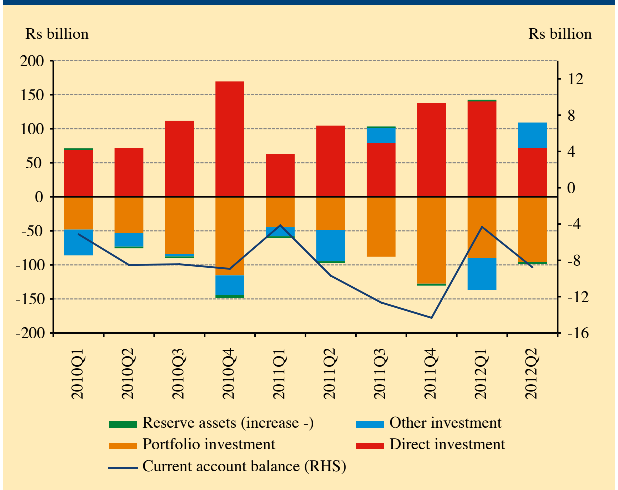
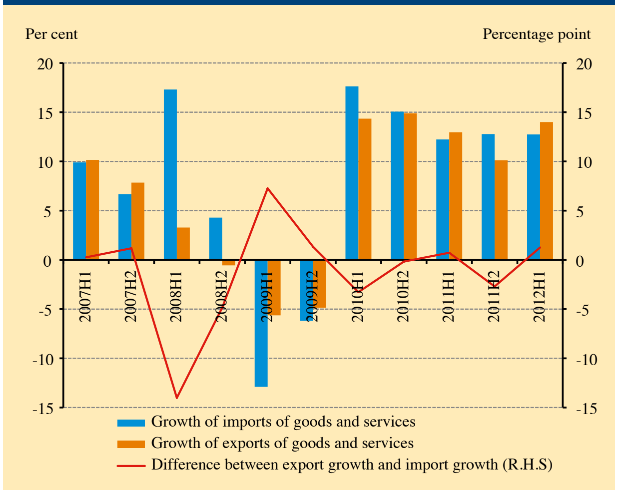


Chart 4.11: Growth in Exports and Imports of Goods and Services



While Europe remained our main export market, its share in total exports dropped to 59.6 per cent in 2012H1, from 64.3 per cent in 2011H1. The share of exports to the United Kingdom and France, the two major European export markets, decreased to 19.8 per cent and 14.3 per cent, respectively, and that of Italy fell to 6.6 per cent, while that of Spain remained constant at 7.7 per cent. The share of exports to the US also decreased to 9.6 per cent in 2012H1. In contrast, the share of exports to the African continent increased to 22.4 per cent as exports to South Africa went up by 35.1 per cent, reflecting to some extent the diversification of textiles into the Southern African market. Similarly, the share of exports to the Asian continent rose to 7.2 per cent, mainly on account of higher exports to Japan (Chart 4.12).

Imports

Imports of goods *c.i.f.* grew by 11.8 per cent to Rs77.3 billion during 2012H1. The growth in imports reflected mainly increases of 45.1 per cent in 'machinery & transport equipment' on account of the purchase of a power generating plant, 14.2 per cent in 'miscellaneous manufactured articles', 11.3 per cent in 'food and live animals' and 9.4 per cent in 'minerals fuels, lubricants and related materials'. In contrast, there was a decline of 2.8 per cent in 'manufactured goods classified chiefly by material' imports, with a more pronounced decrease of 40.6 per cent recorded in '*textile yarn*'.

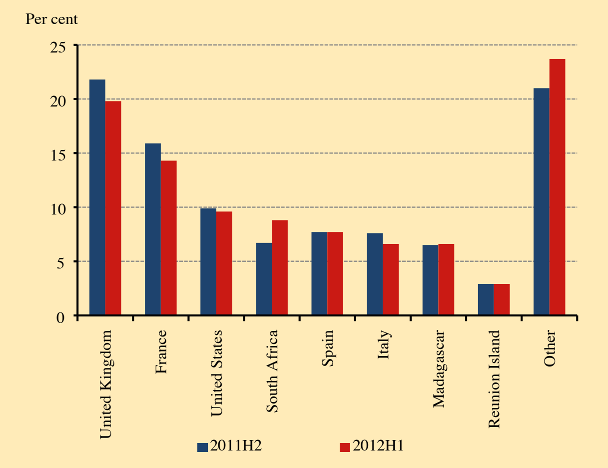
The Asian continent remained the major source of total imports. In 2012H1, 56.5 per cent of total imports were from Asia, up from 53.6 per cent in 2011H1. Within Asia, imports from India and China represented 24.5 per cent and 15.0 per cent of total imports. With the exception of China where a rise of 2.1 percentage points in import share was noted, all countries registered a decline in their import share. The share of imports from France, South Africa and Spain declined to 8.0 per cent, 6.3 per cent and 2.8 per cent, respectively (Chart 4.13).

4.4 Labour Market Developments

The unemployment rate increased to 8.2 per cent in 2012Q2, from 8.0 per cent in both 2011Q2 and 2012Q1. During 2012H1, an increase in the labour force was noted, partly because of school leavers joining the market. On a seasonally-adjusted basis, the unemployment rate remained quite volatile, falling from 8.4 per cent in 2011Q4 to 7.4 per cent in the 2012Q1 before rising to 7.7 per cent in 2012Q2. For the year 2012, the unemployment rate is forecast to be marginally higher at 8.0 per cent compared to 7.9 per cent in the previous year (Chart 4.14).

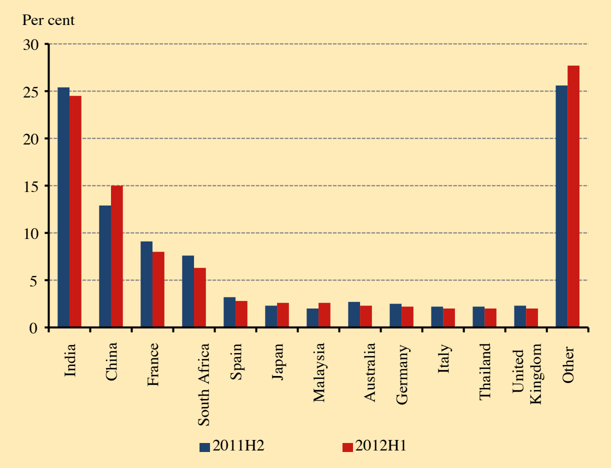
Over the year to 2012Q2 and on a sectoral basis, the highest number of jobs was created in 'transport and storage' (+6,400), followed by 'wholesale and retail trade' (+6,000), 'agriculture, forestry and fishing' (+1,400) and 'accommodation and food service activities' (+1,400) while the '*other manufacturing*'

Chart 4.12: Main Export Destinations



Source: Statistics Mauritius.

Chart 4.13: Main Sources of Imports



Source: Statistics Mauritius.

sub-sector recorded a gain of 2,100 new jobs. Jobs were lost in 'textiles' (2,200), 'construction' (800), 'real estate activities' (200) and 'education' (100).

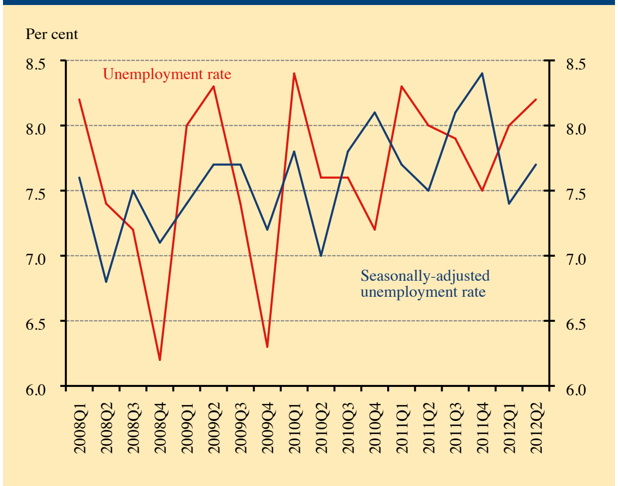
Q-o-q data indicate that in 2012Q2 the highest number of jobs were created in 'wholesale and retail trade' (5,000), 'transport and storage' (3,700) and the '*other manufacturing*' sub-sector (1,600). In several other sectors, growth in employment was flat. Only '*textiles manufacturing*' recorded losses in employment (600).

Employment in export-oriented enterprises decreased by 1,956, from 56,520 as at end-June 2011 to 54,564 as at end- June 2012. The largest decline in employment was registered in the '*wearing apparel*' group to the tune of 2,130 to 36,110.

Latest data available on productivity and compensation show that labour productivity grew by 3.7 per cent in 2011 compared to 1.9 per cent in 2010 while average compensation progressed by 7.8 per cent relative to 3.7 per cent in 2010. The higher growth in productivity in 2011 was the result of a GDP growth of 3.9 per cent coupled with a lower growth of 0.3 per cent in labour input. Higher average compensation growth relative to labour productivity growth resulted in unit labour cost advancing by 3.9 per cent in 2011 compared to 1.8 per cent in 2010. In 2011, capital productivity declined by 0.8 per cent, same as in the previous year. Multifactor productivity grew slightly by 0.1 per cent in 2011 compared to zero growth in 2010. Both labour and capital productivity in export-oriented enterprises registered sizeable increases of 11.3 per cent and 16.7 per cent, respectively, in 2011 while unit labour cost decreased by 1.2 per cent (Chart 4.15).

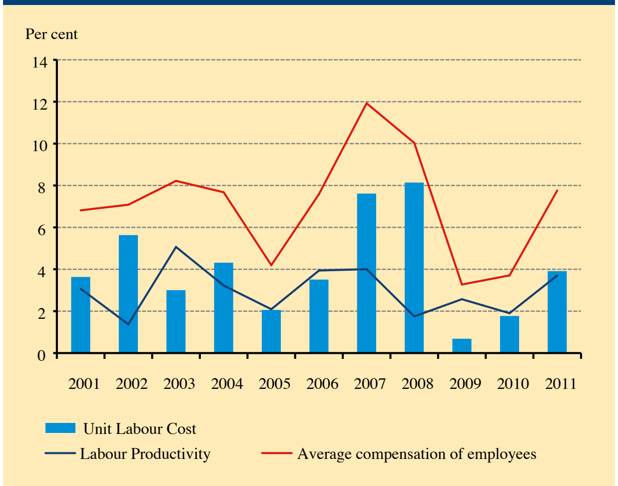
The labour market outlook has not changed significantly since the previous Inflation Report. The structural mismatch between available jobs and skills of the labour force persisted in the domestic economy.

Chart 4.14: Quarterly Unemployment Rate



Source: Statistics Mauritius.

Chart 4.15: Average Compensation of Employees, Labour Productivity and Unit Labour Cost



Source: Statistics Mauritius.

5. Monetary and Financial Developments

Since the beginning of 2012, the growth rates of broad monetary liabilities and claims on private sector appear to have picked some momentum, with the latter growing at a more vigorous pace than the former. Additional credit was largely channelled to the construction sector. Excess liquidity in the domestic money market has fallen, while yields on Government instruments generally declined. Reflecting international developments and the implementation of the ORR, the exchange rate of the rupee has been on a depreciating trend since June 2012.

5.1 Monetary and Credit Developments

Despite a decline in August 2012, the growth rate of broad monetary liabilities (BML) and claims on the private sector have picked up some momentum since the beginning of the year, with the latter showing more vigorous pace than the former.

Monetary Base

The monetary base declined by 4.2 per cent between end-December 2011 and end-August 2012 compared to a contraction of 1.4 per cent registered in the corresponding period of the previous year (Chart 5.1). Currency in circulation fell by 7.8 per cent over the same period compared to a drop of 4.2 per cent in the corresponding period of 2011. Reserve deposits held by other depository corporations (ODCs) at the Bank decreased by 0.5 per cent as against an increase of 1.0 per cent in the same period of 2011.

On the sources side of the monetary base, net foreign assets of the Bank rose by 8.7 per cent in the first eight months of 2012 compared to a moderate rise of 2.7 per cent in the corresponding period of 2011. Domestic claims by the Bank went down mainly on account of a rise in liabilities to the central government.

Broad Money Liabilities

BML grew at a higher pace of 3.0 per cent between end-December 2011 and end-August 2012 compared to 1.4 per cent in the corresponding period of the previous year (Chart 5.2).

Components of Broad Money Liabilities

The growth in BML was mainly due to an acceleration in the growth of quasi-money liabilities, which rose by 4.1 per cent in the first eight months of 2012 compared to an increase of 1.5 per cent in the corresponding period of the previous year. The expansion of quasi-money liabilities reflected an increase in the growth of rupee time deposits and foreign currency deposits. Rupee time deposits, which had contracted by 0.7 per cent in the eight months ended August 2011, reversed to positive growth of 4.7 per cent in the eight months ended August 2012. Foreign currency deposits also shifted from a contraction of 0.2 per cent in the first eight months of 2011 to a growth of 6.5 per cent in the first eight months in 2012. Over the same period, saving deposits growth slowed from 4.5 per cent to

Chart 5.1: Y-o-y Growth in Monetary Base and Broad Money Liabilities

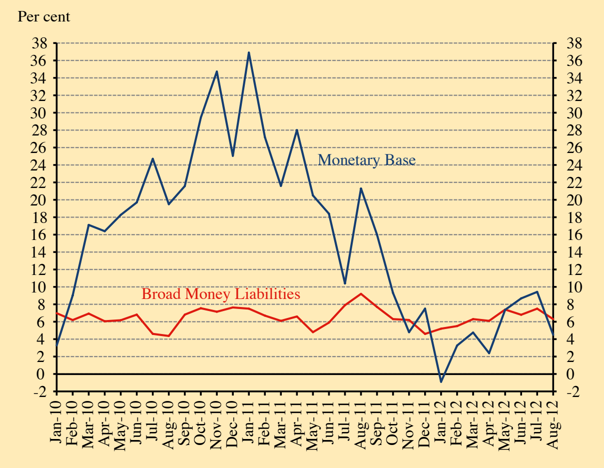
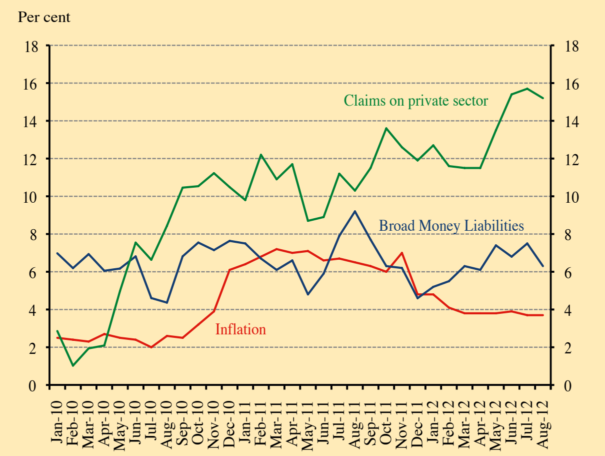


Chart 5.2: Y-o-y Growth in Broad Money Liabilities, and Credit to Private Sector and Inflation Rate



2.4 per cent. Securities other than shares fell by Rs362 million compared to a rise of Rs1.5 billion in the preceding year (Table 5.1).

Narrow Money Liabilities (NML) decreased by 0.3 per cent in the eight months ended August 2012 compared to a fall of 1.2 per cent in the eight months ended August 2011, reflecting contraction in currency with public.

Foreign Assets

The net foreign assets of depository corporations contracted by 5.8 per cent between end-December 2011 and end-August 2012 compared to a decline of 7.3 per cent in the corresponding period of 2011. This was due to a fall in net foreign assets held by ODCs. The net foreign assets of the Bank went up by 8.7 per cent while those of ODCs decreased by 9.7 by per cent between end-December 2011 and end-August 2012.

Domestic Credit

The rate of growth in domestic credit by depository corporations increased from 5.0 per cent in the first eight months of 2011 to 8.7 per cent in the corresponding period of 2012, reflecting mainly higher credit to the private sector. Net credit to budgetary central government contracted by 10.0 per cent between end-December 2011 and end-August 2012 compared to a fall of 8.3 per cent in the corresponding period of 2011. The rate of growth of credit to the private sector by ODCs went up from 7.6 per cent to 11.6 per cent over the same period.

Sector-wise Distribution of Credit by Banks

While the expansion of real BML is more or less commensurate with the subdued pace of real economic activity, the expansion of the depository corporation claims' on the private sector appears to be quite significant. Banks' credit to the private sector rose by 7.4 per cent over the eight months to August 2012 compared to a growth of 5.2 per cent in the corresponding period of 2011. The 'construction', 'public non-financial corporation', 'personal', 'traders', and 'financial and business services' sectors drove the increase in banks' credit with respective shares of 57.5 per cent, 8.8 per cent, 8.6 per cent, 8.0 per cent, and 4.2 per cent in total credit expansion (Chart 5.3).

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

(Rs million)

	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Aug-12
Broad Money Liabilities	**302,944**	**300,567**	**319,124**	**315,401**	**320,818**	**323,565**	**333,905**	**335,118**	**342,702**	**344,006**
Narrow Money Liabilities	59,262	57,086	63,835	60,012	61,402	63,157	68,117	65,796	67,912	67,901
Currency with public	15,905	16,242	18,975	17,492	17,517	17,958	20,308	18,979	19,014	19,287
Transferable deposits	43,357	40,844	44,860	42,519	43,886	45,199	47,809	46,818	48,898	48,614
Quasi-Money Liabilities	242,841	240,519	252,420	251,912	255,371	256,269	261,744	265,207	270,880	272,422
Savings deposits	90,513	96,748	102,349	106,417	106,470	107,097	112,381	115,981	115,865	115,046
Time deposits	94,073	91,399	94,150	90,280	92,196	94,644	95,885	95,039	96,971	100,417
Foreign currency deposits	58,255	52,372	55,921	55,215	56,705	54,528	53,478	54,187	58,045	56,959
Securities other than shares	842	2,962	2,869		4,045	4,139	4,044	4,114	3,910	3,683
Domestic Credit [1]	**313,963**	**314,866**	**324,592**	**322,979**	**333,439**	**343,956**	**351,782**	**356,246**	**378,455**	**382,250**
	261,558	266,543	271,714	275,790	285,630	297,829	303,604	308,539	332,398	338,879
Net Foreign Assets [2]	**385,176**	**370,289**	**392,018**	**358,700**	**394,927**	**368,459**	**367,086**	**396,815**	**354,770**	**345,616**

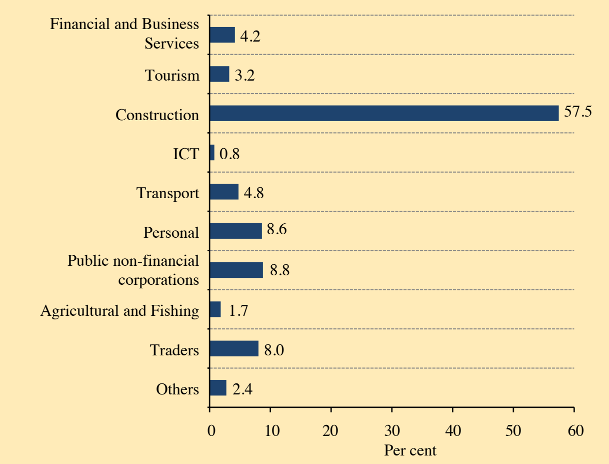
Figures may not add up to totals due to rounding.

[1] With effect from January 2010, claims on other sectors are no longer adjusted for claims on GBL holders.

[2] With effect from January 2010, net foreign assets of other depository corporations(ODCs) are no longer adjusted for foreign currency deposits of global business entities.

On a y-o-y basis, credit to the household sector went up by 17.2 per cent in August 2012 compared to a rise of 15.1 per cent in August 2011. Credit to '*housing*' grew by 21.1 per cent, lower than the rise of 21.7 per cent in the previous year. Corporate credit went up by 10.0 per cent compared to a rise of 10.6 per cent in August 2011. The growth in credit to the tourism sector declined steadily to 1.0 per cent in August 2012, while credit growth to the manufacturing sector retreated to 1.9 per cent as at end-August 2012, from 2.6 in August 2011. Credit to the construction sector expanded to 25.3 per cent as at end-August 2012, up from 15.1 per cent in August 2011 (Chart 5.4).

Chart 5.3: Sectorwise Contribution to the Change in Banks' Credit to the Private Sector – End-December 2011 to End-August 2012

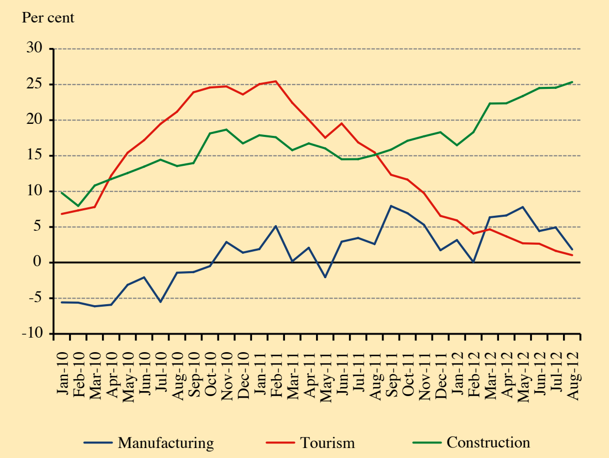


5.2 Money Market

Liquidity Management

Over the period January to August 2012, overall excess liquidity in the banking system declined to an average of Rs2.9 billion from an average of Rs3.5 billion for the same period in 2011, as a result of the net issue of Government securities to the tune of Rs2.3 billion (Chart 5.5). The Bank intervened to withdraw liquidity on the domestic money market by issuing Bank of Mauritius Bills of 273-Day and 364-Day maturities for a total amount of Rs0.7 billion between January and March 2012. Subsequently, as overall excess liquidity trended down, there was no other issue of Bank of Mauritius securities although the Bank kept open the option of a buy-back for Bank of Mauritius Notes.

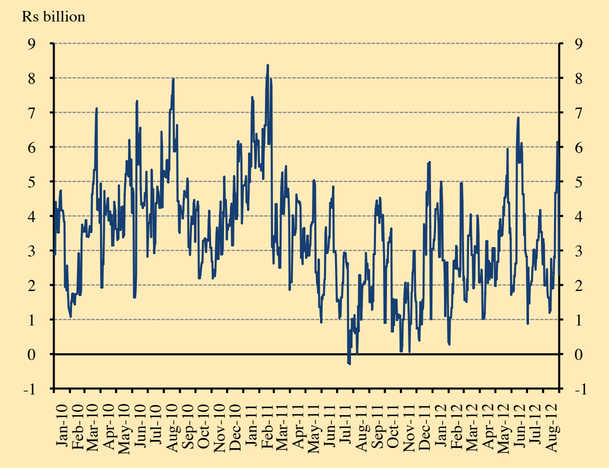
Chart 5.4: Growth in Credit to Manufacturing, Tourism and Construction Sectors



Interbank Interest Rates

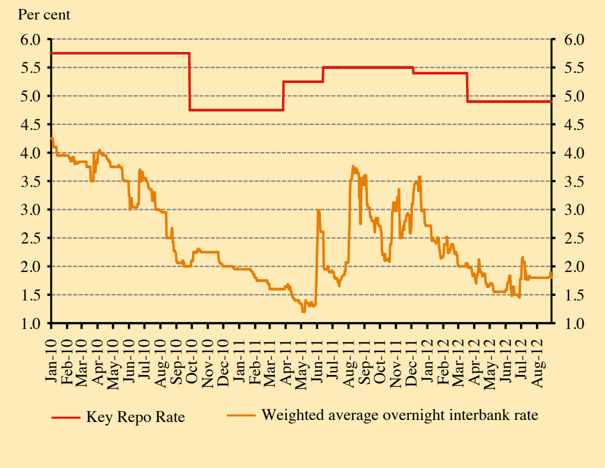
Over the period January to August 2012, interbank interest rates were mainly influenced by the 50 basis points cut in the Key Repo Rate in March 2012 and by the supply and demand conditions on the interbank money market. The overnight weighted average interbank interest rate drifted downwards, from 2.72 per cent in early January 2012 to a low of 1.45 per cent at the end of June 2012 before trending up to reach 1.80 per cent as at end-August 2012. Interbank interest rates hovered in the range of 1.45 - 3.20 per cent during the period under review compared to a range of 1.20 - 4.15 per cent in the corresponding period of 2011. The overnight weighted average interbank interest rates fluctuated between 1.45 and 2.75 per cent, while interest rates

Chart 5.5: Banks' Daily Excess Reserves



on short notice and term transactions were within a range of 1.55 per cent to 3.20 per cent (Chart 5.6). The overall weighted average interbank interest rate ranged from 1.59 per cent to 2.40 per cent compared to a range of 1.40 per cent to 3.58 per cent over the period January to August 2011.

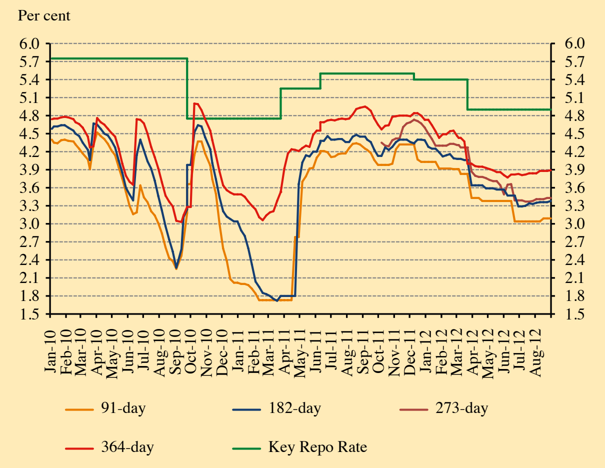
Chart 5.6: Overnight Weighted Average Interbank Interest Rate



Yields on Government debt instruments

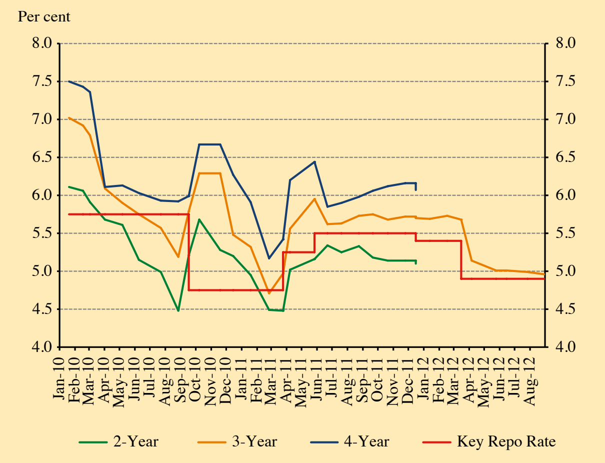
The weighted average yield on 91-Day and 182-Day Government of Mauritius Treasury Bills (GMTBs) decreased from 4.03 per cent and 4.39 per cent, respectively, as at end-2011 to 3.09 per cent and 3.38 per cent as at end-August 2012. The weighted average yield on the 273-day GMTB went down by 117 basis points to 3.43 per cent and the weighted average yield on the 364-Day GMTB lost 87 basis points to reach 3.88 per cent (Chart 5.7).

Chart 5.7: Yields on Treasury Bills



During the period under review, the Bank discontinued the issuance of the 2-Year and 4-Year Treasury Notes but maintained the monthly issues of 3-Year Treasury Notes in an effort to build a significant pool of those instruments for future trading on the Stock Exchange of Mauritius. The coupon rate on the 3-Year Treasury Notes declined from 5.40 per cent at the beginning of 2012 to 4.90 per cent, in line with the cut in the KRR in March 2012. The weighted average yield on the 3-Year Treasury Note went down from 5.69 per cent as at end-January 2012 to 4.96 per cent as at end-August 2012 (Chart 5.8). All auctions of Treasury Notes were oversubscribed during the period under review.

Chart 5.8: Yields on Treasury Notes



With regard to long-term instruments, five auctions of Five-Year Government of Mauritius Bonds were held during the period January to August 2012. The coupon rate on the Five-Year instrument, which is market-determined, declined from 6.75 per cent in February 2012 to 6.00 per cent in August 2012. During the period under review, Five-Year Government of Mauritius Bonds were issued for a total amount of Rs6,842 million. The weighted average yield on the Five-Year Bonds declined from 6.77 per cent as at end-December 2011 to 6.11 per cent as at end-August 2012.

At the primary auction of a 7.75 % Ten-Year Government of Mauritius Bond on 27 June 2012, bids received and accepted amounted to Rs4,579.1 million and Rs1,451.0 million, respectively, against a tender amount of Rs1,000 million. The highest yield accepted on the Bond stood at 8.05 per cent while the weighted average yield was at 7.94 per cent.

Two auctions of the Fifteen-Year Government of Mauritius Bonds were held in January and August 2012 for an amount of Rs1,500 million each. At the auction held in January 2012, bids received and accepted amounted to Rs3,369.5 million and Rs1,709.0 million, respectively, whilst at the auction held in August 2012, bids received and accepted amounted to Rs4,643.3 million and Rs1,029.8 million, respectively. Partly reflecting the decrease in the KRR, the coupon rate on the Fifteen-Year Bond was reduced from 9.25 per cent to 8.29 per cent while the weighted average yield on bids accepted declined from 9.81 per cent in January 2012 to 8.38 per cent in August 2012.

Overall, the yield curve shifted downwards as at end-August 2012 compared to end-December 2011 as yields went down across the maturity spectrum (Chart 5.9).

5.3 Interest Rates

During the first eight months of 2012, all banks in general adjusted their deposits and lending rates in line with the reduction of 50 basis points in the KRR. The savings deposits rates (SDR) fell to a range of 3.00 - 3.65 per cent as at end-August 2012, from a range of 3.50 - 4.25 per cent as at end-December 2011. The prime lending rates (PLR) went down to a range of 7.00 - 8.50 per cent, from a range of 7.50 - 9.00 per cent. The magnitude of the cut in the policy rate was also mirrored into banks' modal SDR and PLR, which stood at 3.65 per cent and 7.40 per cent as at end-August 2012, respectively, compared to 3.90 per cent and 8.00 per cent as at end-December 2011. The weighted average deposit rate and the weighted average lending rate were in a range of 3.64 - 4.15 per cent and 8.52 - 9.09 per cent, respectively, compared to a range of 9.12 - 9.66 per cent and 3.56 - 4.37 per cent during the corresponding period of 2011 (Chart 5.10).

Deflated by the y-o-y inflation rate, the real interest rate on savings deposits remained in negative territory.

5.4 Stock Market

The Stock Exchange of Mauritius was mostly decoupled from international stock markets over the eight months to August 2012. As global equities recovered on the back of improved investors' confidence in 2012Q1, the local stock market trended downwards but then rallied in contrast to the downturn in global markets as the Eurozone crisis intensified. With the return of risk appetite in the wake of the ECB announcements, major international stock markets reversed course but the domestic stock market lost ground. Overall, the SEMDEX posted a negative performance in the first eight months of 2012, declining by 10.7 per cent and hitting its lowest level since July 2010, while the SEM-7 fell by 6.2 per cent (Chart 5.11).

Chart 5.9: Yield Curve

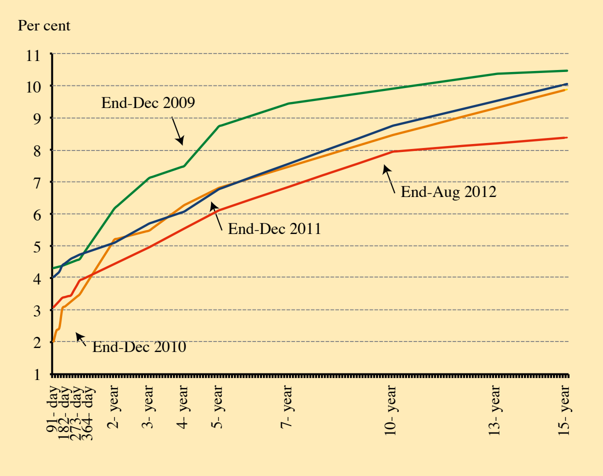
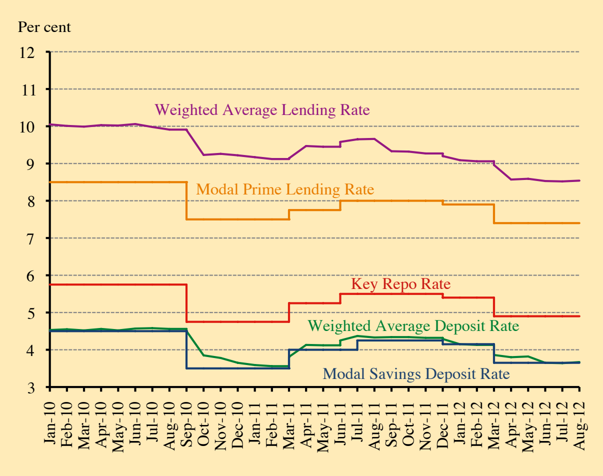


Chart 5.10: Key Repo Rate and Deposit and Lending Rates



Hotel shares were the most affected, recording a drop of around 15.0 per cent during the period under review. Comparatively, the shares of the two largest banks dropped by 3.0 per cent and 2.4 per cent, respectively.

The domestic stock market recorded net disinvestments of Rs183.8 million by foreigners, largely driven by a disinvestment of Rs336.6 million from a conglomerate. The market Price Earnings ratio dropped from 11.28 at the beginning of January 2012 to 10.25 at the end of August 2012.

5.5 Foreign Exchange Market and Exchange Rates

Activity on the Domestic Foreign Exchange Market

Activity on the domestic foreign exchange market remained buoyant during the period January to August 2012. The total turnover of spot and forward transactions amounted to US$5,683 million, representing a daily average of US$34.4 million compared to a daily average of US$30.0 million recorded in the corresponding period of the preceding year. Monthly average transactions on the interbank foreign exchange market amounted to US$77.4 million during the period under review, higher than the average of US$41.6 million registered over the same period in 2011.

Between January and beginning of June 2012, banks maintained a daily average overbought position of US$16.9 million compared to US$34.4 million over the corresponding period of 2011. However, following the announcement of the Operation Reserves Reconstitution (ORR) programme by the Bank on 09 June 2012, banks started to build up their foreign exchange position, which surged to a peak of US$66.3 million towards the end of the month. Meanwhile, the Bank stepped up its purchases of foreign exchange from the domestic market. Over the period January to August 2012, the Bank purchased a total amount of US$312.3 million and €46.1 million from banks and foreign exchange dealers. Banks' overbought position swung to an oversold position of US$14.6 million by end-August 2012.

Exchange Rates

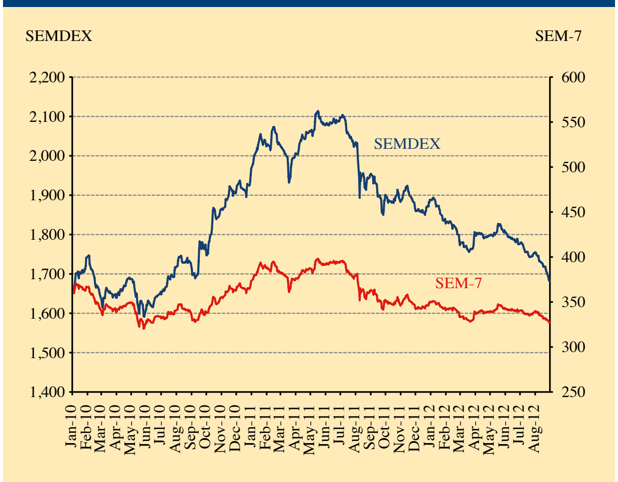
The exchange rate of the rupee vis-à-vis the three major currencies reflected both international developments and demand and supply conditions on the domestic market (Chart 5.12). During the first two months of 2012, the rupee strengthened against the US dollar to Rs29.49 in late February but subsequently lost ground against the greenback, falling to Rs31.75 in late July 2012. Thereafter, however, the local currency reversed course somewhat, trading at around Rs31.10 as at end-August 2012.

The Rs/euro exchange rate appreciated from Rs38.99 at the beginning of January 2012 to a high of around Rs37.70 at the start of June 2012. However, in the following two months, the local currency lost some grounds against the euro and closed the month at around Rs38.93. The movements of the rupee against the single currency reflected, to a large extent, the international movements of the euro.

The rupee depreciated noticeably against the Pound sterling during the period January to July 2012, sliding from Rs46.63 at the start of January 2012 to Rs49.63 towards the end of July 2012. During the month of August 2012, however, the rupee appreciated slightly to close at around Rs49.10.

On a point-to-point consolidated indicative selling basis, between end-December 2011 and end-August

Chart 5.11: SEMDEX and SEM-7



Source: Stock Exchange of Mauritius.

2012, the rupee depreciated against the US dollar, euro and Pound sterling by 3.4 per cent, by 0.1 per cent and 5.7 per cent, respectively. The weighted average dealt rupee exchange rate depreciated by 3.6 per cent, 0.6 per cent and 5.7 per cent against the US dollar, euro and Pound sterling.

Movements in MERIs and REER

MERI1, which is a nominal effective exchange rate measure based on the currency distribution of trade as weights, registered a depreciation of 3.1 per cent over the period January to August 2012. MERI2, which includes currency distribution of trade combined with that of tourism receipts as weights, showed a depreciation of 3.0 per cent. The Real Effective Exchange Rate (REER), with weights based on trade distribution with countries that make up at least 80 per cent of total trade and adjusted for price differentials between the Mauritian economy and its trading partners, depreciated by 2.3 per cent (Chart 5.13).

Chart 5.12: Rupee Exchange Rate Movements

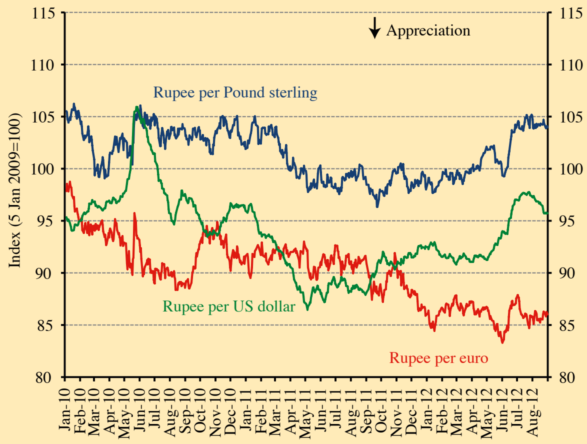
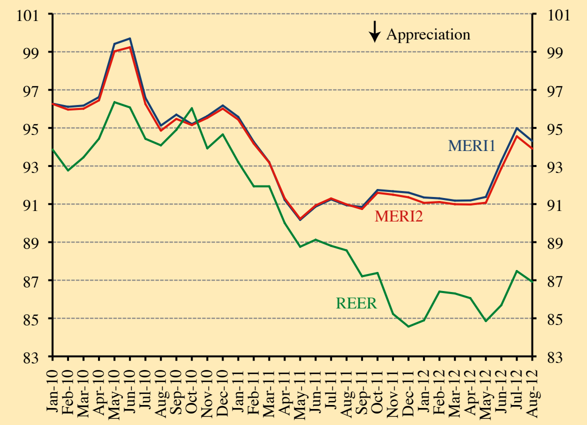


Chart 5.13: MERI1, MERI2 and REER

(Base year: Jan-Dec 2007=100)



6. Monetary Policy Decisions

Monetary policy has stayed accommodative by historical standards. In March 2012, at the first MPC meeting of the year, the MPC voted with a majority of 5-4 to cut the KRR by 50 basis points to 4.90 per cent in view of the higher downside risks to the domestic growth outlook. Subsequently, at the June 2012 meeting, the KRR was left unchanged considering the high uncertainty surrounding the global economic landscape and the potential pass-through of the recent measures initiated by the Bank to inflation. In September 2012, the resurgence of upside risks to the inflation outlook and the uncertainty surrounding the future evolution of the Eurozone crisis and the fiscal stance of the forthcoming Budget prompted the MPC with a majority of 6-3 to maintain the KRR at its current level.

At its meeting on 19 March 2012, the MPC noted that downside risks to the global growth outlook were still important although there were signs of stabilisation in the Eurozone following measures implemented by European authorities to address the sovereign debt crisis. Fears of global recession had receded and the US economic outlook had improved. Emerging economies had continued to record appreciable growth, albeit at a slower rate. The domestic economy had been resilient to the euro area crisis although growth had slowed in some key export sectors. The domestic growth momentum was expected to slow a little before the signs of recovery in target markets began to change the outlook for exports. Growth for 2011 was estimated at 4.0 per cent and the Bank's staff forecast a growth rate of 3.8 per cent for 2012. Headline inflation had eased steadily, from 6.6 per cent in November 2011 to 6.2 per cent in February 2012 while y-o-y inflation had declined from 7.0 per cent in November 2011 to 4.1 per cent in February 2012. The MPC noted that global inflationary pressures had eased but acknowledged increased upside risks to the inflation outlook from rising commodity prices. The MPC weighed the risks to the growth and inflation outlook and observed that the global backdrop had reduced the risks to the domestic growth outlook although they remained skewed to the downside. The Committee concurred that a cut in the KRR was warranted, but was divided with regard to the magnitude of the decrease. After a second round of voting, the Committee voted with a majority of 5-4 to cut the KRR by 50 basis points to 4.90 per cent.

At its next meeting held on 11 June 2012, the MPC noted that, since its March 2012 meeting, risks to the global growth outlook had intensified, along with growing uncertainty about the unfolding of the euro area debt crisis. Both advanced and emerging economies were slowing down. Concurrently, global commodity prices had eased and moderating global inflationary pressures had allowed a number of advanced and emerging economies to maintain accommodative monetary policies to support growth. The domestic output gap had been assessed as slightly negative in 2012Q1, indicating that the economy was operating with some degree of excess capacity. Going forward, the domestic growth momentum was expected to stay positive, but subdued, as headwinds from the Eurozone crisis continued to affect main export industries. Growth was still projected at 3.8 per cent in 2012 though there were clear downside risks to this scenario. On the inflation front, y-o-y inflation was expected to reach just below 5.0 per cent by December 2012 while headline inflation was projected at 4.5 per cent. The MPC judged that the significant risks surrounding the global economy had clearly shifted the balance of risks in the domestic economy to the growth outlook, the more so that the risks around the most likely path for inflation appeared skewed to the downside in the near term, largely reflecting the risks arising from depressed global demand conditions. The main upside risks to inflation were seen to emanate from a possible resurgence in global oil prices and the potential impact of the Operation Reserves Reconstitution (ORR), which had been announced by the Bank. The MPC noted that, in addition to the ORR, the Special Foreign Currency Line of Credit was expected to provide a breather to the export sector. Considering the high uncertainty surrounding the global economic landscape and the potential pass-through of the recent measures initiated by the Bank to inflation, the Committee concurred that the monetary policy stance was broadly appropriate and unanimously voted to keep the Key Repo Rate unchanged at 4.90 per cent.

At the meeting held on 24 September 2012, the MPC considered that growth prospects had remained moderate in the US but had deteriorated further in the euro area, UK and emerging economies. Despite measures announced by the ECB and the US

Federal Reserve, members considered that risks for prolonged sub-par growth in main export markets had remained significant. Meanwhile, global inflationary pressures had resurfaced following the increase in food and energy prices. The domestic economy had continued to hold up well to the prolonged crisis although the pace of economic activity had been affected by the escalating external headwinds. The output gap was assessed to have remained negative, with the economy operating below trend level. Given that the downside risks identified at the previous MPC meeting in June 2012 had largely materialised, domestic growth in 2012 was projected at 3.3 per cent, as against 3.8 per cent projected earlier. The MPC judged that considerable uncertainty remained with regard to the domestic economic outlook. The MPC also noted that headline inflation had steadily declined from 5.3 per cent in May 2012 to 4.6 per cent in August 2012 while y-o-y inflation had remained modest at 3.7 per cent in August 2012. However, members observed that upside risks to the domestic inflation outlook had risen, partly reflecting higher global food and energy prices. Quantitative easing by major foreign central banks could exert further upward pressures on commodity prices. The MPC considered that the recent rupee depreciation, public sector wage increases expected from the forthcoming Pay Research Bureau (PRB) salary review, the possible upward pull of the PRB award on the private sector wage bill and the expected adjustment in retail petroleum prices could influence the inflationary outlook on the domestic front. The majority of MPC members considered that there was need to remain cautious on the monetary policy front given prevailing uncertainties in the global economy, persistent negative real interest rate in the economy and its potential impact on savings deposits, asset prices and corporate indebtedness. The Committee voted with a majority of 6-3 to keep the Key Repo Rate unchanged at 4.90 per cent per annum (Table 6.1).

Table 6.1: Decisions of the MPC on the Key Repo Rate

Date of MPC meeting and effective date of decision	Decision on the Key Repo Rate	Key Repo Rate (post-decision level, per cent per annum)	Voting pattern
19 March 2012	Cut of 50 basis points	4.90	Majority of 5-4
11 June 2012	Unchanged	4.90	Unanimous
24 September 2012	Unchanged	4.90	Majority of 6-3

7. Growth And Inflation Outlook

7.1 Growth Outlook

The sovereign debt situation in Europe continues to pose significant downside risks to the global economy even though the latest policy action by the ECB, reinforced by further quantitative easing by the US Federal Reserve, could provide a breather to markets by clearly signaling the commitment of the authorities to support growth. A high degree of uncertainty regarding the timing and probability of a complete resolution to the Eurozone crisis still remains, constraining the global growth outlook. In addition, debt issues persist in advanced economies. Austerity measures in Europe to tackle high government debt together with an expected tightening of fiscal policy in the United States, where tax-relief measures implemented in efforts to boost the recovery are due to end at the beginning of 2013, represent additional drags on global growth prospects. Sub-par growth in the world economy is therefore expected to continue in the foreseeable future.

In its latest World Economic Outlook (WEO) released in October 2012, the IMF has been quite alarmist, noting that the global economy has suffered new setbacks and uncertainties weighed heavily on the outlook. The IMF has downgraded its global growth forecast by 0.2 percentage point and 0.3 percentage point to 3.3 per cent and 3.6 per cent in 2012 and 2013, respectively, compared to the previous forecast of July 2012 (Table 7.1). Risks to this forecast are skewed to the downside, with the crisis in the euro area and the US fiscal cliff viewed as major threats to the global economic recovery. On the upside, greater and more effective policy action could deliver a better global growth outcome.

Growth in advanced economies has been cut by 0.1 and 0.3 percentage point to 1.3 per cent and 1.5 per cent, respectively, for 2012 and 2013 as public spending cutbacks and the still-weak financial system weigh on prospects. Continued slow recovery is projected in the United States where real output is forecast at 2.2 per cent in 2012 and 2.1 per cent in 2013 given weak household balance sheets and confidence, relatively tight financial conditions, and sustained fiscal consolidation. Projections for the euro area have been revised downwards, with a contraction of 0.4 per cent expected in 2012 before a pick-up to growth of 0.2 per cent in 2013. Most peripheral economies are likely to suffer sharp contraction in 2012, constrained by tight fiscal policies and financial conditions.

Low growth and uncertainty in advanced economies affect emerging market and developing economies through trade and financial channels. In its October 2012 WEO, the IMF has marked down growth in emerging market and developing economies by 0.3 percentage point and 0.2 percentage point, respectively, to 5.3 per cent for 2012 and 5.6 per cent for 2013. The pace of expansion in most emerging and developing countries remain significantly higher than in advanced economies although decelerations

Table 7.1: IMF World Economic Outlook Projections

	January 2012 Update		April 2012 Outlook		July 2012 Update		October 2012 Outlook	
	2012	**2013**	**2012**	**2013**	**2012**	**2013**	**2012**	**2013**
World	**3.3**	**3.9**	**3.5**	**4.1**	**3.5**	**3.9**	**3.3**	**3.6**
United States	1.8	2.2	2.1	2.4	2.0	2.3	2.2	2.1
Euro area	-0.5	0.8	-0.3	0.9	-0.3	0.7	-0.4	0.2
Germany	*0.3*	*1.5*	*0.6*	*1.5*	*1.0*	*1.4*	*0.9*	*0.9*
France	*0.2*	*1.0*	*0.5*	*1.0*	*0.3*	*0.8*	*0.1*	*0.4*
United Kingdom	0.6	2.0	0.8	2.0	0.2	1.4	-0.4	1.1
Japan	1.7	1.6	2.0	1.7	2.4	1.5	2.2	1.2
China	8.2	8.8	8.2	8.8	8.0	8.5	7.8	8.2
India	7.0	7.3	6.9	7.3	6.1	6.5	4.9	6.0
Brazil	3.0	4.0	3.0	4.1	2.5	4.6	1.5	4.0
Russia	3.3	3.5	4.0	3.9	4.0	3.9	3.7	3.8

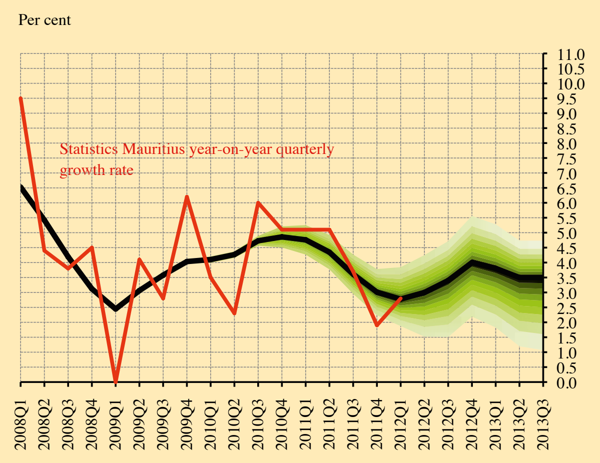
Source: IMF World Economic Outlook.

are expected. Among the main emerging economies, China is projected to grow at 7.8 per cent in 2012 and 8.2 per cent in 2013, while India would expand at 4.9 per cent and 6.0 per cent over the same period.

Notwithstanding efforts undertaken to diversify export markets, the domestic economic outlook continues to be to a large extent vulnerable to developments in the euro area. However, despite escalating headwinds from this region and other parts of the world, the domestic economy has been fairly resilient so far, registering positive growth rates. Weaker external demand for goods and services has weighed on export growth and is likely to affect the pace of economic activity, particularly in the textile and tourism sectors, in the near to medium term. Fragile business confidence in the major sectors of the economy as well as low private and public investment prospects are further expected to restrain the domestic growth outlook. As a result, the economy is projected to continue operating with excess capacity as growth stays below potential.

Taking into consideration the precarious global economic backdrop and the difficulties faced by major sectors, especially textile, hotel and construction, the Bank's central growth forecast for 2012 has been downgraded to 3.3 per cent, from an earlier estimate of 3.8 per cent. Emerging sectors, like seafood and ICT/BPO, maintain reasonably good prospects despite the global downturn and the economy is expected to be supported by diversification policies and the accommodative monetary policy. However, significant downside

Chart 7.1: Growth Projections



risks to the central growth forecast exist and are expected to persist so long as consumer confidence in the Eurozone is not restored and a long-term solution to the crisis not found.

Growth projections over the next six quarters are shown in Chart 7.1. The most likely outcome is depicted by the central band, which is the darkest shaded area in the fan chart while the red line represents the y-o-y estimated growth rates by Statistics Mauritius. The downside risks to the central growth forecast are captured by the asymmetric probability distributions (the green bands) around the central scenario.

7.2 Inflation Outlook

While global and domestic inflation has gradually turned milder since the beginning of the year, upside risks to the inflation outlook have increased recently and warranted caution on monetary policy.

On the external front, the recent firming of global food and crude oil prices largely as a result of supply shocks and geopolitical factors while global demand has remained relatively weak have increased inflationary risks. While concerns about a deterioration of crop prospects – particularly cereals – as a result of severe drought conditions in the United States have eased somewhat, prices remain at elevated levels. According to the FAO, the evolution of food prices in the future is likely to depend on how the weather develops for US crops and on demand in coming months. Price volatility remains a concern, with weather-related yield variability the main threat as long as stocks remain low. Meanwhile, crude oil prices remain at risk from the fragile geopolitical situation in the Middle East.

Lately, additional quantitative easing by a number of major central banks in advanced economies to support their economies has added to the upward pressures on global commodity prices. Depending on demand and supply developments abroad, external price pressures could be strong enough to steer the domestic inflation path on an uptrend. There is some likelihood that retail petroleum prices may be revised upward by the Petroleum Pricing Committee. Any potential increase in domestic retail prices would likely feed into the domestic price structure, increasing the risk for higher inflation.

In the domestic economy, excess capacity and moderate growth may have tempered demand pressures. However, upside risks to domestic inflation have risen following the wage awards across the economy to compensate for the cost of living and salary increases to the public sector. The possible feedback from public sector wages to private sector wages may lead to wage costs growing faster than productivity and, eventually, entail second-round effects on inflation.

Since the implementation of the ORR in June 2012, the behaviour of the rupee exchange rate vis-à-vis major trading partners' currencies and the pass-through to import prices of food and non-food commodities have added to the inflationary risks. While the full impact of changes in the rupee exchange rate on domestic prices may yet be felt, there is a large possibility that higher input costs may be reflected into domestic prices.

Overall, the main factors that are likely to affect the inflation path are external supply shocks such as higher food and energy prices and on the domestic front, higher input costs of raw materials and eventually wages. There is a certain degree of uncertainty with regard to the inflation outlook in the near to medium term, which could be underpinned by the fiscal stance. Risks are nevertheless perceived to be skewed to the upside.

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