OVERVIEW

International Developments

During August 2006, the US dollar, on average, depreciated against the euro and Pound sterling but appreciated vis-à-vis the Japanese yen. The US dollar started the month on a soft tone amid prevailing market expectations that the US Federal Reserve would pause its two-year string of interest rate rises. As expected, at its Federal Open Market Committee (FOMC) meeting on 8 August 2006, the US Federal Reserve kept its federal funds rate unchanged at 5.25 per cent, with members voting 9-1 for the rate decision. In its accompanying statement, the Fed, however, left the door open to more credit tightening if price pressures were to persist. While the Fed's uncertain outlook on rates triggered a wave of short covering thereby further undermining the US dollar, the release thereafter of relatively upbeat data, namely a narrower trade deficit and rising retail sales for June 2006, managed to recoup some of US currency's losses. However, with the release of declining headline and core producer price data, tame consumer price data as well as second quarter 2006 core personal consumption expenditure (PCE) price index, which is the Fed's preferred measure of inflation, all supporting the view that US inflation risks were subsiding, expectations that the Fed would keep on holding rates resurfaced. The release of further weak economic data relating to home sales, industrial production and consumer sentiment data, reinforced the view that US economic growth was slowing and weighed on the US currency. Minutes of the August 2006 FOMC meeting released towards the end of the month, which indicated that the decision to keep rates unchanged would allow time to judge whether more tightening would be needed to maintain price stability, further cemented market expectations that the Fed was in no rush to raise interest rates again.

The euro appreciated against the US dollar during August 2006, trading at an average of US$1.2810, from an average of US$1.2691 in July 2006. From its intra-month low of US$1.2734 on 1 August 2006, the euro moved higher after the ECB, at its governing council meeting on 3 August 2006, raised its key refinancing rate by a quarter percentage point to 3.00 per cent. Although the rate decision was largely priced in the market, the euro drew support from remarks made by ECB President Jean-Claude Trichet in the post-meeting conference that monetary policy in the euro zone remained accommodative and further tightening might be needed. On 10 August 2006, the euro hit its intra-month high of US$1.2879 but it could not hold on its gains as its failure to break above US$1.29 triggered a reversal. Against the backdrop of a weakening US dollar, the euro thereafter managed to recover, as it remained the currency of choice among investors due to expectations that the ECB would keep on raising rates. The release of strong German business climate sentiment data towards the end of August 2006 also suggested more euro zone interest rate hikes in the coming months. On 31 August 2006, the ECB held its key refinancing rate steady at 3.0 per cent. Speaking after the meeting, ECB President Trichet said that strong vigilance on inflation was needed, thereby signalling that a rate rise to 3.25 per cent was likely in October 2006. These remarks, however, did little to give a major boost to the euro as the market had already factored in such a move. The euro closed August 2006 trading at US$1.2817.

The Pound sterling, on average, strengthened against the US dollar during August 2006, trading at an average of US$1.8919 as against US$1.8436 in the preceding month. Starting August 2006 at an intra-month low of US$1.8635, the Pound sterling strengthened against the US dollar, helped by the release of solid UK housing market data as well as a report that the Bank of Italy had shifted part of its US dollar reserves to the Pound streling. The British currency also benefited from the surprise rate hike by the Bank of England (BoE) from 4.50 per cent to 4.75 per cent at the end of its two-day Monetary Policy Committee (MPC) meeting on 4 August 2006. Policymakers said that the hike was needed to ensure that inflation - already half a point above its 2.0 per cent target on the back of soaring energy costs - would come down as the economy was already operating close to capacity and growth had picked up. As the surprise UK rate rise led investors to brace for more tightening to come, the Pound sterling hit its intra-month high of US$1.9061 on 10 August 2006. The Pound thereafter shrugged some of its gains on news that London's Heathrow airport was closed to all incoming flights from Europe after police said that they had foiled a plot to blow up aircraft in mid-flight between the UK and the United States. The release of the relatively dovish minutes of the BoE MPC meeting also weighed on the Pound as UK policy makers highlighted the uncertainty surrounding their forecasts and raised the possibility of having to reverse the rate hike if warranted by economic conditions. The Pound sterling, by the end of the month, had resumed its uptrend, drawing support from the release of strong UK second quarter 2006 economic growth and August 2006 retail sales data and closed August 2006 trading at US$1.9034.

The Japanese yen moved lower against the US dollar during August 2006 trading on average at ¥115.75 per US dollar compared to ¥115.65 per US dollar in July 2006. The Japanese yen hit its intra-month high of ¥114.36 per US dollar on 2 August 2006, benefiting from comments by Bank of Japan Policy Board member Atsushi Mizuno, who said that it would be a mistake to think that there would be no additional rate rises this year. The yen thereafter lost ground against the US dollar amid weaker stock prices as well as expectations that the Bank of Japan would raise rates only gradually while interest rates in Japan remained ultra-low. As widely expected, on 11 August 2006, the Bank of Japan kept its overnight call rate unchanged at 0.25 per cent after its two-day policy meeting. The release of data showing that Japan's economy grew by less than expected in the second quarter of 2006 as well as soft inflation and industrial output figures reinforced expectations that the Bank of Japan would raise rates very slowly. The Japanese yen closed August 2006, trading at an intra-month low of ¥117.42 per US dollar.

Oil prices moved lower during August 2006. Although around 500,000 barrels per day (bpd) of Nigerian crude oil output were still not available due to militant unrest, news that part of the supply that was disrupted due to a leak was restored after repairs and the easing of the conflict between Israel and Lebanon helped lower oil prices. Moreover, US stock reports from the US Energy Information Administration, released in the last two weeks of August 2006 were satisfactory. However, the US's biggest oilfield that produces 400,000 bpd was supplying only part of its output due to a damaged pipeline. While UN requested Iran to halt its nuclear work by 31 August 2006, the latter called for more talks with the West over the issue. In the weeks ahead, oil prices will most likely trade between US$65 - US$70 a barrel, as the market remains sensitive to supply disruption fears.

NYMEX WTI (West Texas Intermediate benchmark crude oil) averaged US$73.1 a barrel in August 2006, down from US$74.4 a barrel in July 2006 and up from US$65.0 a barrel in August 2005. IPE Brent futures averaged US$73.9 a barrel during the period under review, down from US$74.3 a barrel in July 2006 and up from US$63.8 a barrel in August 2005.

COMEX gold futures, on average, moved higher during August 2006, trading in an intra-month closing range of US$619.1/Oz-US$645.8/Oz compared to a range of US$613.2/Oz-US$668.0/Oz in July 2006. Gold prices continued to be influenced more by speculative moves rather than fundamental demand and supply factors, with geopolitical issues, oil prices and the value of the US dollar acting as stimulating factors. COMEX averaged US$640.4/Oz during August 2006, compared to an average of US$635.5/Oz in July 2006.

Domestic Developments

Tourist arrivals increased by 0.1 per cent, from 65,462 in July 2005 to 65,540 in July 2006, while gross tourism receipts went up by 20.9 per cent, from Rs1,596 million in July 2005 to Rs1,929 million in July 2006. Cumulatively, over the period January to July 2006, tourist arrivals reached 425,677, representing an increase of 2.6 per cent on the 414,773 arrivals recorded in the corresponding period in 2005. Tourism receipts for the period January to July 2006 grew by 22.6 per cent to reach Rs17,380 million from Rs14,180 million recorded over the corresponding period of the previous year.

The Consumer Price Index (CPI) increased from 129.9 in July 2006 to 130.9 in August 2006. Except for "Alcoholic Beverages and Tobacco" which registered a decline of 0.3 per cent in its sub-index and "Housing, Water, Electricity, Gas and Other Fuels" and "Education", which recorded no change in their sub-indices, all the remaining nine Divisions recorded increases in their sub-indices. The largest rise of 1.8 per cent was noted in "Transport", followed by "Food and Non-Alcoholic Beverages" (+1.1 per cent)

The remaining Divisions registered increases in their sub-indices in the range of 0.2 per cent and 0.8 per cent. The main contributors to the change in the index between July and August 2006 were other food products (+0.2 index point), taxi fare (+0.2 index point) and fresh vegetables, fresh fruits, eggs, airfare, catering services and other goods and services, each registering an increase of 0.1 index point. The rate of inflation for the twelve-month period ended August 2006 stood at 6.1 per cent, up from 5.6 per cent for the twelve-month period ended July 2006.

With effect from 11 September 2006, the Bank of Mauritius increased the Lombard Rate by 100 basis points, from 12.00 per cent to 13.00 per cent per annum. The hike in the Lombard Rate was effected taking into account the intensification of upside risks to inflation, the worsening external sector outlook and monetary expansion, in particular the growth of money supply and credit. The increase in the Lombard Rate is also expected to restore the attractiveness of rupee-denominated financial assets. The restoration of internal and external balance remains an overriding concern of the Bank.

Money supply M2 went up by Rs414 million or 0.2 per cent, from Rs177,527 million at the end of June 2006 to Rs177,941 million at the end of July 2006 reflecting the increase in quasi money offsetting the fall in narrow money supply. Narrow money supply M1 contracted by Rs549 million or 2.2 per cent to Rs24,520 million while quasi-money increased by Rs964 million or 0.6 per cent to Rs153,422 million.

Net foreign assets of the banking system grew by Rs1,822 million or 3.0 per cent, from Rs61,435 million at the end of June 2006 to Rs63,257 million at the end of July 2006. Net foreign assets of Bank of Mauritius increased by Rs848 million or 2.0 per cent to Rs43,302 million while net foreign assets of banks went up by Rs974 million or 5.1 per cent to Rs19,955 million over the same period.

Domestic credit expanded by Rs2,885 million or 1.7 per cent, from Rs164,958 million at the end of June 2006 to Rs167,843 million at the end of July 2006. Net credit to Government from the banking system fell by Rs134 million or 0.3 per cent, from Rs45,487 million at the end of June 2006 to Rs45,353 million at the end of July 2006. Net credit to Government from the Bank of Mauritius declined by Rs64 million or 3.9 per cent to Rs1,577 million while net credit to Government from banks edged down by Rs70 million or 0.2 per cent to Rs43,776 million. Credit to the private sector grew by Rs3,019 million from Rs119,471 million at the end of June 2006 to Rs122,490 million at the end of July 2006 or 2.5 per cent. Between end June 2006 and end July 2006, additional credit was directed to “Agriculture & Fishing” (Rs670 million), “Tourism” (Rs522 million), “Traders” (Rs509 million), “Financial and Business Services” (Rs316 million), “Construction” (Rs246 million), “Infrastructure” (Rs224 million), “Personal” (Rs171 million), “Manufacturing” (Rs158 million) and “Transport” (Rs139 million). Over the same period, a decline of Rs30 million was recorded at “Freeport Enterprise Certificate Holders”.

Reserve money contracted by Rs258 million or 1.1 per cent, from Rs24,543 million at the end of June 2006 to Rs24,285 million at the end of July 2006.

The Bank issued Government of Mauritius Treasury Bills/Bank of Mauritius Bills for a total amount of Rs3,025 million through the Primary Market in August 2006. No repurchase transaction was undertaken by the Bank.

During August 2006, total transactions in Government of Mauritius Treasury/Bank of Mauritius Bills effected through primary dealers amounted to Rs228.7 million. There was no trading of Treasury Bills on the Stock Exchange of Mauritius.

At the monthly auction of Treasury Notes held in August 2006, a total nominal amount of Rs1,500 million of Treasury Notes with maturities of 2, 3 and 4 years and with interest payable semi-annually at the rates of 8.10, 8.40 and 8.65 per cent per annum, respectively, were put on tender. Bids were received for a total amount of Rs1,937.8 million, of which an amount of Rs1,500 million was accepted. The weighted average yields on bids accepted were 8.28, 8.44 and 8.76 per cent per annum, respectively.

The first issue of Five-Year Government of Mauritius Bonds for 2006-07 took place on 18 August 2006, through an auction held on 16 August 2006. Bonds bearing interest of 8.90 per cent per annum were put on tender for a total nominal amount of Rs500 million. Bids were received for a total amount of Rs660.2 million, of which Rs500 million were accepted. The weighted average yield on bids accepted was 9.07 per cent per annum.

In August 2006, the Bank intervened and sold US dollars for a total amount of US$31 million on the interbank foreign exchange market.

Between July and August 2006, the rupee, on average, depreciated against all major currencies. The weighted average dealt selling rates of the rupee, which are calculated on the basis of transactions of US$30,000 and above, or the equivalent in other foreign currencies, effected by banks, also showed that the rupee, on average, depreciated against the US dollar, Euro and Pound sterling between July and August 2006.

At the end of July 2006, the net international reserves of the country amounted to Rs63,805 million. The end-July 2006 level of net international reserves of the country, based on the value of the import bill for calendar year 2005, exclusive of the purchase of aircraft, represented 35.6 weeks of imports, up from 34.6 weeks of imports at the end of June 2006. The gross foreign exchange reserves of the Bank of Mauritius increased from Rs43,306 million at the end of July 2006 to Rs44,191 million at the end of August 2006.

Core Inflation

Inflation is defined as a rise in the general price level and is generally measured by changes in the Consumer Price Index (CPI). This measure of inflation is termed headline inflation. However, it is universally accepted that the consumer price index reflects the impact of some factors that are beyond the control of the monetary authority such as the adjustments in administered prices, taxes, adverse weather conditions or oil market shocks. From a policy point of view, it is useful to decompose headline inflation into a transient component on the one hand, and a trend component on the other hand. This trend component is referred to as “core” inflation and reflects persisting sources of inflationary pressures. Core inflation typically excludes certain items in the overall CPI index whose price movements are generally characterized by short-term volatile movements.

The most common approach used by many countries to calculate core inflation is the exclusion method, which estimates the core inflation by taking out the prices of a fixed, pre-specified set of items from the CPI basket. The excluded components are considered to be either volatile or susceptible to supply disturbances and would typically consist of food and energy items. Another widely used measure of core inflation is the trimmed mean approach, which consists of trimming a certain percentage of the tail of the distribution of price changes.

Three measures of core inflation have been worked out for Mauritius based on the following approaches: (i) exclusion method (CORE1), which strips “Food, Beverages and Tobacco” from headline inflation, (ii) exclusion method (CORE2), which apart from excluding “Food, Beverages and Tobacco” also strips energy prices and administered prices and (iii) trimmed mean approach (TRIM10), which truncates 5 per cent of each tail of the distribution of price changes and estimates core inflation by taking the weighted average of price changes of the rest of the components.

While headline inflation for August 2006 stood at 6.1 per cent, CORE1, CORE2 and TRIM10 inflation rates are estimated at 4.8 per cent, 5.6 per cent and 5.1 per cent, respectively. Consequently, for August 2006, core inflation was between 0.5 and 1.3 percentage points lower than the headline inflation.

These core inflation rates nonetheless have to be interpreted with caution as the methods used to calculate core inflation rates have their limitations, the most obvious ones being that part of the information in the official measure is disregarded each month and that the derivation of these rates involves some degree of subjectivity.