Bank of Mauritius

Released at 13.00 hours on 4 October 2010

MONETARY POLICY STATEMENT

The Monetary Policy Committee (MPC) of the Bank of Mauritius unanimously decided to cut the key Repo Rate by 100 basis points to 4.75 per cent per annum at its regular meeting held on 27 September 2010. The interest rate chargeable on the Special Deposits Facility, set at 100 basis points below the key Repo Rate, is 3.75 per cent per annum while the interest rate on the Overnight Facility, set at 150 basis points above the key Repo Rate, is 6.25 per cent per annum. The interest rate payable on the Standing Facility, set at 400 basis points above the key Repo Rate, is 8.75 per cent per annum.

The MPC reviewed current international and domestic economic as well as financial developments and assessed the outlook for the global and domestic economy before reaching its decision.

International developments and outlook

The global economy had continued to recover since the MPC last met but the growth momentum appeared to be moderating. The Global Manufacturing Purchasing Managers Index (PMI), a leading indicator of future economic conditions, had been decelerating from June 2010 onwards. In August, it fell to its lowest level since November 2009, while the Global Services PMI data highlighted strong divergence across countries, with some economies, United States and Britain included, slowing down and others namely, China and Germany, still expanding. Credit expansion to non-household private sector in many advanced economies continued to be slow and concerns about the health of the banking system, especially in Europe, had been increasing.

Downside risks to the growth outlook had intensified amid increasing risks of the sovereign debt crisis in the peripheral Euro zone economies spreading to core European countries and the United States, where fiscal deficits and public debt were worryingly high. Furthermore, fiscal consolidation in Europe mainly and possibly in the United States could become a drag on growth going forward. Already, the end of fiscal stimulus measures in some countries had contributed to depress economic conditions that were slowly improving.

In line with the recovery in global economic activity, world merchandise trade rose sharply in the first two quarters of 2010. However, there were wide divergences across regions. While

Asia's international trade and to a lesser extent, Latin America's, had been booming partly due to intra-regional trade, in the United States and Europe, with the exception of Germany, trade was still below pre-crisis levels. Going forward, the pace of global trade expansion was likely to be restrained reflecting lower projected global output growth in the second half of 2010 and well into 2011. Looking ahead, there is increasing uncertainty about whether emerging economies and the Euro area's leading economies can continue to grow even if the US economy and other Euro zone economies are slowing down.

National data pointed to slower rates of expansion for the United States, the Euro zone and the United Kingdom in the second quarter while economic growth in key emerging economies still remained strong.

The US economy slowed down to a quarter-on-quarter rate of 0.4 per cent in the second quarter of 2010 from a growth rate of 0.9 per cent in the first quarter as the contribution of the US Government stimulus package and the rebuilding of inventories faded. Weak housing market, worsening consumer sentiment and high unemployment were seen holding back real household spending in the United States. Business spending, although rising, was growing less rapidly than earlier in the year. The pace of US economic recovery was likely to be modest in the near term amid persistently low inflation and the Federal Reserve Bank was considering additional stimulus measures to boost the flagging economy.

Real GDP in the euro area increased, by 1.0 per cent in the second quarter of 2010, the fastest pace in four years. But aggregated data masked the widening disparity among Euro zone member countries. While the German economy was picking up strongly and French business expansion accelerated, Italy and Spain were struggling to recover. The main concern in the Euro zone was the continued dependence on France and Germany, which were expected to pull the rest of Europe along. More recent data on industrial new orders suggested a slump in demand ahead. Britain's economy grew at its fastest pace for nine years in the second quarter of 2010 at a revised 1.2 per cent. However, the growth momentum may be tailing off as the August 2010 British PMI data for manufacturing, construction and the services sector showed lower-than-expected orders. Latest unemployment data highlighted the weak economic recovery under way in the UK. The near to medium term outlook for the British economy continued to be marred by fiscal austerity plans, which were likely to slow activity further over the medium term.

Elsewhere, key emerging economies continued to witness strong manufacturing and services activity supported by resilient domestic and external demand within the region and advanced economies.

The MPC also assessed recent international price developments. Global inflation outlook remained subdued but inflation, in some parts of the world, had started to pick up again. Energy prices had been less of a concern as crude oil prices stayed range-bound and current conditions were foreseen to persist well into 2011 amid uncertainty about the strength of demand. Global food prices, however, rose in August 2010 mainly due to surging wheat and higher sugar and oilseeds prices. The United Nations Food and Agriculture Organisation Food Price Index increased for the third month in a row, rising from 167 points in the previous month to 176 points in August, the highest since September 2008 but way below its 2008 peak. Unfavourable climatic conditions in major supplier countries and the subsequent export bans in some others causing supply disruptions largely explained the surge in food prices.

As a result, headline inflation in some parts of the world, mostly Asia, had surprised on the upside given the weight of food in their CPI basket. In several advanced economies, inflation had remained tame and concerns about deflationary risks had risen. In the United Kingdom, however, inflation had been sustained at higher-than-target level. Although food price increases were still way below pre-crisis levels and had not yet fed through core inflation, the recent surge, especially in Asia, had ignited fears of a bigger risk of a rise in inflation expectations and claims for higher wages.

Against this backdrop, several central banks, mostly in Asia and Latin America as well as in a few advanced economies, had raised their policy interest rates and started removing monetary stimulus with a view to curbing inflationary pressures.

Domestic developments and outlook

Domestic economic conditions have been better than expected in the first semester of 2010 but real output growth was forecast to cool down in the second semester. External demand-dependent sectors were holding up despite difficult international trading conditions but lower domestic demand reflecting weak investment and a slowdown in household consumption were seen as an economic drag going forward. Business sentiment was likely to worsen further.

Year-on-year growth rate of real economic activity in the first quarter of 2010 was estimated at 3.6 per cent – partly reflecting favourable base effects on account of the significant weakness of the domestic economy in the corresponding period a year ago – down from an upwardly revised 6.7 per cent in the fourth quarter of 2009.[1] Real final consumption spending expanded at a slower pace while real investment expenditure in almost all capital goods, except for residential building, passenger cars, and other transport equipment excluding aircrafts and marine vessels, contracted in the first quarter of 2010.

Seasonally-adjusted quarter-on-quarter data, however, suggested that the domestic economy was struggling in the first quarter of 2010 to sustain momentum after a buoyant second half in 2009. In the first quarter of 2010, much of the late 2009 momentum appeared to be fading away across almost all sectors except for patchy positive quarter-on-quarter growth rates in sugar, other manufacturing, insurance, and owner-occupied dwellings. Effectively, all key sectors of the

[1] At the time the MPC met, the Central Statistics Office had not yet published its quarterly national accounts estimates for the second quarter of 2010.

economy posted negative seasonally-adjusted quarter-on-quarter growth rates with the largest contraction in construction and distributive trade. Real activity in textiles as well as in hotels and restaurants also contracted by 1.5 per cent and 4.8 per cent, respectively, after having expanded by 4.3 per cent and 11.6 per cent in the fourth quarter of 2009.

External trade and tourism data for the second quarter of 2010 were supportive of the view that external demand-led sectors would continue to grow, albeit moderately. Going forward, more downside risks to textiles exports had recently emerged while international travel seemed to be picking up again. With regard to international travel, the International Air Transport Association foresees a faster than expected recovery in the industry but with sharp regional differences. Europe was lagging behind Asia. Other reports confirmed that the leisure market was beginning to display renewed vigour but travellers were keeping a tight rein on their budget with shorter stays. Long-haul travel destinations were likely to take longer to return to pre-crisis levels. Quarterly growth could remain below trend for a prolonged period. The domestic economy was forecast to grow at roughly 4.1 per cent in 2010.

The MPC discussed the inflation outlook. Year-on-year inflation had firmed up from 2.0 per cent in July 2010 to 2.6 per cent in August 2010 while the 12-month average inflation increased for the second consecutive month in August 2010 to 1.9 per cent from 1.8 per cent in the preceding month. Although, domestic inflation had remained subdued, it had clearly bottomed out and was likely to start rising again to around 4.0 per cent by June 2011 on a no-policy change basis. Until now, the rupee exchange rate has been an important factor contributing to the low inflation environment. However, the MPC continues to believe that inflation, at around 4 per cent over the next few quarters, will remain below trend.

The MPC weighed the risks to the growth and inflation outlook over the policy-relevant horizon and discussed alternative interest rate scenarios. Although the risks to the inflation outlook over the medium term still remain, the MPC judged that the balance of risks has tilted towards the growth outlook as the downside risks have increased. With inflation at currently low levels and the weakening prospects in economies of partner countries, the MPC gauged that it had the monetary policy space to cut the key Repo Rate by a full one percentage point to 4.75 per cent but cautioned that it stood ready to respond if the outlook for inflation and for economic activity were to change.

This substantial monetary easing will give further support to the on-going economic restructuring and provide the opportunity for embarking on a major drive to improve productivity and national competitiveness.

The MPC will continue to monitor economic and financial developments and remains committed, as per its mandate, to formulate and determine monetary policy with a view to maintaining price stability and promoting the orderly and balanced economic development of

Mauritius.

Voting Pattern

The MPC voted unanimously to cut the key Repo Rate by 100 basis points to 4.75 per cent per annum.

Date for Regular Meeting

The MPC will convene its next quarterly meeting on 6 December 2010. It stands ready to meet outside regular meetings as and when required to assess the evolution of the economic situation and, if needed, take appropriate policy measures.

Bank of Mauritius

4 October 2010