BANK OF MAURITIUS

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Minutes of the 29th Monetary Policy Committee Meeting 11 March 2013

The 29th meeting of the Monetary Policy Committee was held on 11 March 2013 at 09.30 hours at the Bank of Mauritius, with Mr Rundheersing Bheenick, Governor, in the chair.

Members present: Mr Yandraduth Googoolye, First Deputy Governor; Mr Mohammed Iqbal Belath, Second Deputy Governor; Mr Nishan Degnarain, Mr Pierre Dinan, Mr Hemraz Oopuddhye Jankee and Professor Silvana Tenreyro, External Members.

Professor Jeffrey Frankel, External Member, attended the meeting via video-conference.

Observers: Dr Streevarsen Narrainen, Senior Economic Adviser, Ministry of Finance and Economic Development, and Mr Neetyanand Kowlessur, Chief-Economic Analysis Division, Bank of Mauritius.

Summary of Staff Reports on Economic and Financial Developments

The Staff reported on economic and financial developments since the 28th MPC meeting held on 26 November 2012.

The International Economic Environment

1. The global economic environment had remained weak since the November 2012 MPC meeting. Leading economic indicators had been volatile and, in the near to medium term, lingering uncertainty about the duration of the Eurozone recession and the US debt ceiling appeared likely to curb the pace of growth in the world economy.

2. The US economy had recorded marginal expansion of 0.1 per cent q-o-q in 2012Q4, reflecting drops in inventory investment, federal government spending and exports. Progress in the labour market had been slow, with a relatively high unemployment rate of 7.7 per cent recorded in February 2013. Looking ahead, activity indicators pointed to an improvement in the manufacturing sector although output growth risked being curtailed by fiscal tightening.

3. The Eurozone economy had slipped deeper than expected into recession in 2012Q4, with a contraction of 0.6 per cent q-o-q. Output had fallen in the core economies while the unemployment rate had struck another record high of 11.9 per cent in January 2013. Leading indicators suggested that the growth momentum in both core and peripheral economies would continue to be affected by tight lending conditions and fragile confidence.

4. After a brief expansion in 2012Q3, Britain's economy had contracted by 0.3 per cent q-o-q in 2012Q4. While the unemployment rate had declined to 7.8 per cent in December 2012, a recent string of bleak data releases indicated that the UK might be on the brink of its third recession in four years.

5. Emerging economies had continued to outperform advanced economies but remained at risk from uncertain global economic conditions. For 2013, China and other emerging Asian economies were expected to lead the recovery in the world economy.

6. Global commodity prices had remained at elevated levels since the November 2012 MPC meeting. While the FAO Food Price Index had stabilised at around 210, it continued to be extremely vulnerable to shocks induced by weather-related disturbances. Geopolitical tensions had increased crude oil price volatility and driven a rise in prices at the start of 2013, which could be sustained in the foreseeable future by emerging markets demand.

7. Global consumer price inflation had been generally subdued though inflationary pressures remained in some emerging market economies faced with better growth prospects.

8. Conditions in global financial markets continued to improve as worries about the euro area sovereign debt crisis receded. Investors' risk appetite recovered significantly, driving bond and equity markets higher and putting the US dollar somewhat under pressure.

Domestic Economic Developments

9. Latest national accounts data released in December 2012 indicated continued positive momentum in the domestic economy. In 2012Q3, the domestic economy had expanded at a seasonally-adjusted q-o-q pace of 1.3 per cent compared to 1.1 per cent in 2012Q2, partly driven by a recovery in **'manufacturing'**.

10. Over the year to 2012Q3, the domestic economy had grown by 3.9 per cent compared to 3.7 per cent in 2011Q3. Activity had rebounded in **'manufacturing'**, **'transport and storage'**, **'information and communication'**, **'financial and insurance activities'** and **'wholesale and retail trade'** but had slowed down in **'accommodation and food service activities'** and **'real estate activities'**. Within **'manufacturing'**, *'food'* had recovered significantly to post growth of 11.3 per cent while *'textile'* and *'sugar'* had contracted by 1.0 per cent and 6.3 per cent, respectively. **'Construction'** had contracted by 4.5 per cent while **'export-oriented enterprises'** had expanded by 0.8 per cent.

11. In December 2012, Statistics Mauritius had slightly upgraded the GDP growth estimate for 2012 to 3.3 per cent, from 3.2 per cent previously, and had forecast growth for 2013 at around 3.7 per cent.

12. **'Final consumption expenditure'** had expanded at a slightly higher pace of 2.4 per cent in 2012Q3, compared to 2.2 per cent in 2012Q2, driven by a pick-up in *'general government consumption expenditure'* growth while *'household consumption expenditure'* had decelerated. **'Gross domestic fixed capital formation'** (GDFCF) had deteriorated markedly in 2012Q3, with negative growth of 3.8 per cent, reflecting a contraction of investment by 2.8 per cent and 6.5 per cent in *'building & construction work'* and *'machinery & equipment'*, respectively. Excluding *'aircraft and marine vessel'*, GDFCF was estimated to have contracted by 1.8 per cent in 2012.

13. Most recent available information showed that exports, excluding *'ships, stores and bunkers'*, had increased by 11.9 per cent y-o-y in 2012Q4 while imports *c.i.f.* had risen by 6.2 per cent. For 2012, exports were estimated to have grown by 9.2 per cent y-o-y, mainly led by higher exports of *'food and live animals'*. Total imports *c.i.f.* had expanded by 8.9 per cent y-o-y, driven by greater *'food and live animals'*, *'manufactured goods'* and *'machinery and transport equipment'* imports, which offset a decline in *'mineral fuels, lubricants and related materials'* imports.

14. Although sluggish conditions in the global economy continued to impact negatively on export-oriented industries, both the textile and tourism sectors had drawn support from the diversification of markets in 2012. Tourist arrivals had increased marginally by 0.1 per cent y-o-y while tourist earnings had risen by 3.9 per cent. Latest data for January 2013 showed that tourist arrivals had fallen by 6.0 per cent y-o-y, led by declines in key markets, while gross tourist earnings had amounted to Rs4.7 billion. Statistics Mauritius forecast tourist arrivals to reach 1 million this year, with gross tourist earnings totalling around Rs47 billion.

15. Preliminary estimates of the balance of payments indicated that the current account deficit had declined to Rs11.6 billion in 2012Q4, from Rs14.1 billion in 2011Q4, driven by a higher net invisibles surplus, which had partly offset the widening trade deficit. The current account deficit had been financed by net inflows of Rs13.5 billion on the capital and financial account. *'Direct investment'*, inclusive of GBC1s, had recorded net inflows of Rs148.6 billion while *'portfolio investment'* and *'other investment'* had posted net outflows of Rs93.7 billion and Rs37.7 billion, respectively. For 2012, the current account deficit as a percentage of GDP had fallen to 10.2 per cent, from 13.3 per cent in 2011.

16. The unemployment rate had fallen to 7.9 per cent in 2012Q3, from 8.2 per cent in 2012Q2. On a seasonally-adjusted basis, the unemployment rate had climbed by 0.4 percentage points to 8.1 per cent.

17. Following revisions brought to monetary data in accordance with international guidelines, the annual growth rate of broad money liabilities had gone up slightly to 7.1 per cent in January 2013, from 6.9 per cent in September 2012. Over the same period, the annual growth of claims on the private sector had picked up pace to 17.4 per cent, from 14.8 per cent.

18. The CPI had increased by 3 points to 136.6 between October 2012 and February 2013. While headline inflation had continued to trend downward to reach 3.6 per cent in February 2013, y-o-y inflation had initially declined to 2.9 per cent in January 2013, from 4.2 per cent in October 2012, before rising to 3.6 per cent in February 2013. *'Alcoholic beverages and tobacco'* (+1.1 percentage points) and *'food and non-alcoholic beverages'* (+1.0 percentage point) had been the largest contributors to y-o-y inflation over the year to February 2013.

19. Underlying inflationary pressures had remained moderate. Y-o-y CORE1 inflation had dropped from 3.6 per cent in October 2012 to 2.2 per cent in February 2013 while CORE2 inflation had decreased to 2.6 per cent, from 3.5 per cent in October 2012.

20. The Bank's *Inflation Expectations Survey* carried out in February 2013, that is, before the petrol price hike, revealed that 79.2 per cent of respondents expected prices to go up over the next 12 months. Most respondents expected headline inflation to be within a range of 4.5-6.5 per cent over the forecast horizon. Mean headline inflation rates were projected at 4.5, 5.0 and 5.2 per cent, respectively, for the twelve months ending June 2013, December 2013 and a year ahead.

21. In line with the amendment to the Bank of Mauritius Act 2004 requiring the MPC to take into account the views of the Bank, the Finance Ministry and such other institution or organisation as it considers appropriate in the discharge of its functions, the MPC benefited from a presentation by the Financial Secretary, Mr Ali Mansoor. Members noted that, from the standpoint of the Finance Ministry, the Eurozone was likely to perform less well in 2013. In this context, and considering a loss in global competitiveness, the challenge for the domestic economy would be to accelerate growth. However, given the significant amount of structural reforms already undertaken, the Ministry believed that there was little room left for fiscal policy to further support the expansion of the economy. Fiscal policy was expected to end up neutral or even contractionary in 2013 because of implementation capacity constraints and the need to control the total amount of Government debt. Economic growth would thus require an expansionary monetary policy to compensate for the tight fiscal policy, even if it entailed greater risks to the inflation outlook.

Domestic Financial Markets Developments

22. Staff indicated that overall excess liquidity in the banking system had averaged around Rs3.5 billion following the November 2012 MPC meeting, largely driven by the net redemption of Government securities and deposits by the National Resilience Fund with commercial banks.

23. At the primary auctions of Treasury Bills, the weighted yields on the 91-Day 182-Day, 273-Day and 364-Day Treasury Bills had declined by 56, 62, 31 and 62 basis points, respectively, to reach 2.41 per cent, 2.34 per cent, 2.74 per cent and 2.55 per cent.

24. The weighted average interest rate on rupee deposits and rupee advances had fallen to 3.35 per cent and 8.42 per cent, respectively, as at end-January 2013. The real interest rate on savings deposits, using the y-o-y inflation rate, had reached 0.7 per cent in January 2013.

25. Under the Special Line of Credit in Foreign Currency of €600 million made available to operators in the export sector, the Bank had disbursed funds totalling €26.3 million as at end-February 2013, mainly to operators in the tourism sector.

26. Reflecting the movements of key currencies on international markets as well as domestic demand and supply conditions, the dealt rupee exchange rate had appreciated against the US dollar and Pound sterling but depreciated against the euro. In nominal effective terms, the trade-weighted rupee, as measured both by MERI1 and MERI2, had appreciated since the November 2012 MPC meeting.

Staff Economic Outlook

27. Staff estimated that the output gap had narrowed a little in 2012Q4 but that the domestic economy was still operating with spare capacity. Looking ahead, while the underlying growth momentum was likely to stay positive, the challenging external environment was expected to impact on the pace of economic activity and keep the output gap negative over the forecast horizon. Growth was nevertheless expected to be supported by the diversification efforts undertaken to boost the textile and tourism sectors as well as the consolidation of the ICT and seafood industries. Bank staff forecast 2013 growth to be within a range of 3.4-3.9 per cent, compared to an estimate of 3.3 per cent for 2012. Significant downside risks arising from the threat of a prolonged recession in the euro area remained.

28. Although the negative output gap pointed to moderate demand pressures on prices, risks to the domestic inflation outlook remained skewed to the upside following the implementation of the wage award to compensate for the cost of living and the PRB award to the public sector. The recent increase in administered fuel prices and its expected second-round effects had also increased the upside risks to inflation. On a no-policy change basis, Bank staff forecast y-o-y inflation within a range of 5.5-5.9 per cent by December 2013, equivalent to a headline inflation forecast of 4.7-4.9 per cent.

The Monetary Policy Decision

29. The MPC took the view that economic conditions among developed economies of export interest to Mauritius had remained fragile. The Eurozone recession was expected to persist in 2013, with the outlook subdued in the largest economies and France having had a credit

downgrade. While the US economy was projected to perform relatively better, failure to extend the debt ceiling could reduce the growth forecast in 2013. The UK, which also had a credit downgrade, faced bleak growth prospects and might be on the brink of a triple-dip recession. Concurrently, global inflationary pressures had remained contained but commodity prices, in particular food prices, still represented a major upside risk to the inflation outlook.

30. Members assessed that despite the underlying positive growth momentum, domestic activity in 2013 was likely to be dampened by disappointing global economic developments. Together with muted domestic consumption and negative investment growth, they were likely to keep the output gap negative and sustain the downside risks to the domestic growth outlook. Although the diversification of markets had contributed to prop up economic growth, it was deemed necessary to increase the pace of diversification going forward to compensate for dismal external demand conditions.

31. The Committee discussed the consequences of a prolonged accommodative monetary policy stance. Some members drew attention to the decline in the savings rate over the recent years, as well as the relatively large increase in credit to the private sector, in particular to the construction and tourism sectors, and the rise in non-performing loans. They were of the view that these developments required a more prudent approach to monetary policy-making, with interest rates set at such levels that they would provide strong inducement to savers to step up savings while containing speculative activities. Although other members agreed on the need to promote savings, they held diverging views on the correlation between the savings rate and interest rate changes.

32. The MPC noted that there had been a rise to 3.6 per cent in y-o-y inflation in February 2013, from the January 2013 reading of 2.9 per cent. Upside risks to the inflation outlook had persisted as a result of elevated global commodity prices, the impact of the recent PRB award to the public sector and the latest rise in retail petroleum prices. The expected second-round effects of these increases, as well as the projected rise in administered prices, could amplify inflationary pressures in the foreseeable future although some members observed that historical data showed mixed evidence of the extent of second-round effects. Members further took note of the Bank's February 2013 *Inflation Expectations Survey*, which projected increasing inflation during the year ahead.

33. The Committee weighed the risks to the growth and inflation outlook over the policy-relevant horizon and discussed alternative interest rate scenarios. While members generally acknowledged the upside risks to inflation, a majority considered that it was too early to start tightening monetary policy. With domestic and external economic conditions still subdued, and possibly capping upward inflationary pressures, the threats to the growth outlook were seen to continue outweighing inflation worries. The case was also made that monetary policy could not insulate the public from an increase in the cost of living and decrease in real income if they originated from an exogenous rise in world oil or food prices or other deterioration in

the country's terms of trade. The level of the Key Repo Rate, which was still positive in real terms, was judged to be broadly appropriate at the current economic juncture.

34. The remaining members took the view that the balance of risks had clearly shifted to the inflation outlook and that it was time to signal an end to the easing cycle. While the performance of the domestic economy was expected to be relatively satisfactory against the muted global backdrop, the inflationary pressures highlighted at the November 2012 MPC meeting were materialising and expected second-round effects were contributing to move inflation into uncomfortable territory. Given the strong concerns about the deteriorating inflation outlook, and the need to offer a positive real rate of return on savings while restricting undue credit growth in some sectors and anchoring inflation expectations, it was considered essential to be proactive in normalising interest rates. It was also noted that the 2013 IMF Article IV Consultation Mission to Mauritius had recommended a tightening of monetary conditions if inflation accelerated.

35. The Committee reviewed developments in monetary policy elsewhere and lengthily debated about the Bank's mandate and monetary policy framework. It noted that, in line with the provisions of the Bank of Mauritius Act 2004, a hybrid approach, focusing on both price stability and orderly and balanced economic development, had been followed so far. However, maintaining the balance between the two objectives was a delicate exercise. Some members felt that it was important to clarify the Bank's mandate and proposed that a study be undertaken to explore the merits and demerits of different targets for monetary policy. The Committee took note that nominal GDP targeting was a possible framework that was receiving increased attention among central bankers around the world.

Voting Pattern

36. At the conclusion of the discussion, the Committee voted with a majority of 5-3 to keep the Key Repo Rate unchanged at 4.90 per cent per annum. The three dissenting members voted to increase the Key Repo Rate within a range of 10-25 basis points. It was argued that a 10 basis point increase would be the minimum required to signal the strong concerns about the inflation outlook whereas a 25 basis point increase would place the Committee ahead of the curve in containing second-round inflationary pressures.

37. The MPC will maintain strong vigilance in monitoring economic and financial developments and stands ready to meet in between its regular meetings if the need arises.

38. The meeting adjourned at 17.20 hours. The next MPC meeting is scheduled on Monday 17 June 2013.

39. **Voting for the MPC action:** Mr Nishan Degnarain, Mr Pierre Dinan, Professor Jeffrey Frankel, Mr Hemraz Oopuddhye Jankee and Professor Silvana Tenreyro.

40. **Voting against the MPC action:** Mr Rundheersing Bheenick, Mr Yandraduth Googoolye and Mr Mohammed Iqbal Belath.

Bank of Mauritius
25 March 2013

Editor's Note

According to the Bank of Mauritius Act 2004, the primary object of the Bank shall be to maintain price stability and to promote orderly and balanced economic development. The Act gives the Monetary Policy Committee (MPC) responsibility to formulate and determine the monetary policy to be conducted by the Bank. The MPC meets on a regular quarterly basis.

In line with amendments brought to the Bank of Mauritius Act 2004 in December 2012, the MPC was reconstituted in March 2013. Members of the MPC now comprise the Governor (Chairperson), the 2 Deputy Governors, 2 other persons appointed by the Prime Minister and 3 other persons, not being Directors or employees of the Bank, appointed by the Finance Minister.

When the MPC met on 11 March, the last available data on national accounts and employment were for 2012Q3 while the last data on external trade and the balance of payments were for 2012Q4. The last monetary data available was for January 2013 while the last data available on CPI and inflation were for February 2013.

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.

Output gap is the difference between the actual level of GDP and potential GDP.

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

MERI 1 is the Mauritius Exchange Rate Index, a nominal effective exchange rate introduced in July 2008, based on the currency distribution of merchandise trade.

MERI 2 is the Mauritius Exchange Rate Index, a nominal effective exchange rate introduced in July 2008, based on the currency distribution of merchandise trade and tourist earnings.

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

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

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

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