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ANALYSIS

Monetary pumping

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Imagine you were sitting comfortably in a flying airplane without any turbulence. Suddenly you got startled by the microphone and the captain made this unexpected announcement: “Don't panic!” No doubt you would feel less at ease than before. The minister of Finance is bullish on the Mauritian economy. The minister of Industry repeats proudly in every meeting that our textile is expanding. The minister of Tourism boasts that tourist arrivals will achieve near double digit growth this year. Nobody is concerned about investment or growth, but everybody is complaining about inflation. So what does the Bank of Mauritius (BoM) do? It slashes interest rate by 50 basis points and states at a press conference: “There is no panic on board.”

There is no better way to instill doubt in people’s mind.

I myself am now less sanguine about the possibility of recession following this decision of the central bank. Maybe the BoM knows something, which the markets don’t know. The fact is that Mauritius is not heading towards a recession. According to the Central Statistics Office, our economy will be growing at a healthy 6% in 2008, with output of export-oriented enterprises progressing at the same rate. Even if balance sheets get squeezed, it will clock more than 5% this year.

At company level, Ciel Textile made foreign exchange losses in 2007, but still showed big profits. It could have used the money in its international subsidiary by investing in other currencies or reinvesting in rupees to partly hedge. In the hotel sector, Sun Resorts enjoyed a 36% increase in operating profit in 2007.

At last week’s news conference, the BoM Governor, Rundheersing Bheenick, assured us that the 50-basis-point rate cut would not fuel inflation. Economics textbook tells the contrary, and even the layman is aware that, when banks bring down interest rates on savings and lending, he will prefer to spend and borrow rather than save. And he is able to think in terms of real interest rates, knowing that he is earning interests less than the expected inflation rate. The BoM says that headline inflation, barring the impact of eventual fuel price increases and of the Pay Research Bureau award, would stay at 9% for year 2008. But you don’t make forecasts assuming that everything else remains constant. Forecasters factor in events that are certain to happen.

Now the BoM justifies the rate cut on the basis that Core2 inflation (which strips food, energy and administered prices from headline inflation) has remained stable at 5.7% over the past three months. But this is misleading. Firstly, a 3-month period does not make a trend. A rise in energy prices has an impact on Core2 inflation in the medium term as input costs rise. Secondly, a Core2 inflation of 5.7% is still very high and signals that the economy is overheating… The BoM should aim at lowering it to 3%, which would get headline inflation somewhere around 6%. This is possible over a 2-year period. But to achieve this target, the BoM needs to tighten its monetary policy in line with the present high inflation expectations.

Thirdly, Trim10 inflation (which truncates 5% of each tail of the distribution of price changes) has not been constant but actually rose from 7% in December 2007 to 7.5% in February. One cannot talk about core inflation being stable when a measure is contradicting the other! Since inflation as measured by the trimmed mean approach is up, core inflation is not conclusively stable. Fourthly, no central bank can afford to ignore the upward pressure of money supply on core inflation. The BoM pumps rupees into the economy not only through an easing in interest rate (loans make deposits which make loans, and so on), but also through purchase of foreign currencies. Money was plentiful even when the monetary stance was tight in 2007.

In the year to January 2008, the monetary base excluding Bank of Mauritius Bills jumped by Rs 3 billion (+14%). Therefore, with a minimum cash ratio of 4%, banks could expand credit and money supply by Rs 75 billion (that is Rs 3 billion divided by 0.04). Actually, domestic credit of depository corporations went up by Rs 22 billion (+11%). Broad money liabilities shot up by Rs 34 billion (+17%).

It will take years to rid the system of excess liquidity. Hopefully, the BoM will resume repurchase transactions with a larger Repo rate corridor. It will lengthen the maturity of its Special Deposit Facility to 14-21 days, will introduce 1-month and 2-month Treasury Bills, and will set up a futures market. But the private sector must be innovative. Hedging does not only involve using forward contracts. In the absence of a derivatives market, companies can buy existing Exchange-Traded Funds that will allow them to hedge against the falling dollar and commodities.

The new BoM instruments are only reactive measures that are unlike to circumvent the serious repercussions of a loose monetary policy. Entrepreneurs will attempt to exploit the pool of newly created money to get into non-productive activities, with the result that real savings will be diverted from wealth-generating activities. When the growth momentum of money supply strengthens, this will increase the number of rupees paid per unit of a good or service produced by a particular activity, i.e. prices will go up.

It is worrying to see the BoM focus on core inflation when the US Federal Reserve targets overall inflation and emphasises core inflation only as a predictor of future headline inflation. The trouble is that the price movements of oil and food are not volatile, but unidirectional. This means that core inflation indicators may persistently underestimate the true inflation rate. The danger of core inflation is that the BoM fails to spot the breadth of emerging inflationary pressures throughout the economy. It has opened the money spigots in a big way and is flooding the economy with money. When you are piloting the economy from the sky, you can't gauge the consequences of flooding. But I will have peace of mind as long as the captain doesn't take the microphone.

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