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ÉCONOMIE & business

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ANALYSIS

Monetary see-sawing

After the cut in the interest rate argued for in May, it seems that the BOM has decided to change tack. Rundheersing Bheenick is now apparently in favour of a rise in key Repo rate...

There is panic on board. Less than two months after arguing for a third consecutive cut in the interest rate, the top management of the Bank of Mauritius (BoM) changes tack. The monetary policy statement released in connection with the last Monetary Policy Committee (MPC) meeting reveals that "two dissenting members were in favour of a rise in the key Repo Rate, with one voting for a 100 basis points and the other for a 50 basis points hike". It is easy to guess that the former was the Governor of the BoM while the latter was his First Deputy.

In the second half of 2007, Governor Rundheersing Bheenick had built up an inflation-fighting reputation with some success in the wake of the 75 basis points increase in July. Eight months later, he decided a rate-cutting strategy in a bid to calm down the export lobbies. Now he tries to reposition himself from export-supporting dove to bona fide inflation hawk. With such a see-sawing in monetary policy, the hawk will lose some feathers. Future interest rate tightening will look as a credibility-bolstering exercise rather than as an inflation-killing job.

Mr Bheenick would have rapidly cleared up a confused situation if he had admitted his lack of judgment. But in his press conference, he expressed no sympathy with observers who were against the decision to cut rates in May. He even went on casting some doubt on the independence as well as the competence of the MPC members appointed by the Finance Minister.

Contradictions

The Governor contradicts what he said a few weeks ago. Whereas he assured the population that the last rate cut was taken for the benefit of the overall economy, he now indicates that it was intended for the export sector. Whereas he accused his critics to be "obsessed by inflation", he now puts inflation at the heart of monetary policy. Whereas he tolerated negative real interest rates, he now wants to make them positive.

One would expect from a central bank a minimum foresight over three months. Everybody, except the BoM, knew beforehand that the Pay Research Bureau award would lead to the injection of several billions of rupees and that the 2008-2009 budget would concentrate on infrastructure spending. It has been known since March that 24 out of the 25 major central banks have discarded the rate-cutting option despite export problems. But it is now that the BoM realises that central banks have changed focus from growth to inflation.

The BoM made the mistake of relying on core inflation indicators as they are biased towards the past. Our official method of calculating inflation in terms of 12-month averages creates a favourable statistical effect and does not totally capture changes occurring over the last 12 months. All three measures showed different directions in May: Core1 inflation rose to 6.2 %, Core2 inflation was stable at 5.6 %, but Trim10 inflation fell to 6.7 %!

The most reliable indicator is money supply: in the year to April 2008, broad money liabilities shot up by 14.5 %, well above economic growth, while domestic credit jumped by 16.3 %. The real problem is the liquidity glut, which MCB Focus fails to mention. Given that the average loans to deposits ratio of commercial banks stood at 66 % compared to 71 % a few years back, and that yields on bills are unattractive in real terms, it makes sense why banks do not wish to see the BoM curtail the high credit growth through an increase in either the Repo Rate or the cash reserve ratio. How-ever, strong credit expansion is likely to create a real estate bubble in a negative real interest rate environment.

MCB Focus suggests that the MPC keeps rates on hold, but there is no question about that elsewhere as the spectre of inflation has returned to haunt the global economy. Although the Central Statistics Office has revised our economic growth for 2008 down to 5.7 %, such a performance is still highly commendable. Also, unemployment will recede to 8 % this year compared to 9.6 % in 2005. On the other hand, consumer inflation will verge on the 10 % mark by next year, leading to second-round effects as workers demand higher wages. The corporate sector is reeling from elevated



inflationary pressures as witnessed by the 18 % increase in the producer price index of manufacturing for the year ended March 2008.

It is obvious that upside risks to inflation override downside risks to growth. In fact, this dichotomy between risks is spurious, for persistent high inflation rates have a dampening impact on long-run growth. Letting an inflation psychology take hold of the population is damaging to monetary policy. As to the problem of capital inflows, it is not so much related to interest rate differential as to insufficient regulation of our bond and stock markets.

Bound to suffer

Mr Bheenick has spoken so openly that he has cornered the other MPC members into voting for a rate rise at the next MPC meeting. He will stick to 100 basis points or compromise himself by agreeing to 75 basis points. He will not accept less than that to keep his self-respect, knowing that the MPC will appear ridiculous if the Governor is in minority for the second time.

Personally, I would prefer a 50 basis points hike in several steps, with the BoM giving a clear signal that it is setting the pace of a tightening cycle. A gradual approach will allow time for companies to adjust, and it will firmly anchor consumers' inflation expectations. However, for banks to raise savings interest rate, the authorities must increase the supply of government securities and BoM Bills to push yields higher. But since the government is constrained by a 3.3 % budget deficit target and has rebalanced its debt portfolio, it cannot issue bills galore. So the BoM will have no other choice than to hike the cash ratio to take out liquidity and reduce demand on the bond market.

The banking sector is bound to suffer for a while. The BoM took too long to tweak its monetary policy tools, allowing excess liquidity to swell and create imbalances in the financial system. These distortions, if left unchecked, could bring the economy into a state of cyclone warning class 4.

By Eric NG PING CHEUN



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