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Actualités

ANALYSIS

Raise rates now

By Eric NG PING CHEUN

If you want to shock market operators, say something unfashionable. I think the next move of the Bank of Mauritius (BoM) would be another rise in the Repo rate from the current level of 9.25%. This is not wishful thinking. On the contrary, I hope this prediction will not happen.

The Monetary Policy Committee (MPC) will meet on December 5. For the first time, the MPC will not need the approval of the Board of Directors of the BoM to set the key interest rate. One recalls that when the MPC decided on an interest rate tightening on June 30 th last, it was split evenly on the extent of the increase. As Chairman of the MPC, the Governor of the BoM, Rundheersingh Bheenick, did not choose to exercise his casting vote, but left the final decision to the Board of Directors which then voted in his favour, that is a hike of 75 basis points.

Speaking on the occasion of the 40th anniversary of the Mauritius Bankers Association, the Governor expressed some discomforts at the idea of finding himself again in minority on future interest rate decisions. He thus urged MPC members to look in the same direction. The question is not whether he was right or wrong to say it so publicly. What matters is that he made his appeal stand out by stating that inflation has not come down “quickly enough”.

Imagine Ben Bernanke, Jean-Claude Trichet or Mervyn King making such a statement. Markets would have intrepreted it as a hint to a near interest rate hike. Even more, Mr Bheenick was sounding hawkish in his speech and he had made the same comments the day before, on the occasion of Prof. Persaud’s lecture.

Special attention to price stability

The primary object of the BoM is “to maintain price stability and to promote orderly and balanced economic development”. In a context where economic growth is firmly on track, it appears normal that the BoM pays special attention to price stability. Even if they were told that annual inflation would decline from 10.7% last June to 8.8% this December, people are concerned about oil and food prices. Their inflationary expectations remain too high: to quash them is precisely the aim of monetary policy.

Mr Bheenick makes no secret of being a firm believer in inflation targeting.

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He does not care about exchange rate targeting, making it clear that “we intend to allow the market to operate fully, whether it’s the interbank market or the foreign exchange market”.

A common argument against further monetary tightening is that the rupee’s bilateral exchange rate against the dollar is rising. But what is relevant for monetary policy purposes is the real effective exchange rate (REER). According to the International Monetary Fund, the rupee’s REER depreciated by 5.5% in 2004-05 and 1.2% in 2005-06. For 2006-07, BoM figures suggest that the relative price increase (Mauritius’ inflation rates are 5 percentage points above those of its main trade partners) has been more than offset by nominal depreciation: the rupee depreciated against the dollar, the euro and the pound sterling by 6.3%, 13.3% and 14.3% respectively.

If one accepts inflation targeting as a policy, then there is a strong case for another rise in the Repo rate. What matters here is not the direction but the level of inflation. In the last budget, the Finance Minister has set the inflation target at 7% for the year ended June 2008. Actual inflation, at 9.4% in October 2007, is clearly above target. On present trends and benefiting a high base effect, inflation might reach the target rate. However, inflationary pressures are not easing, but quite possibly increasing.

The biggest upside risk to inflation is oil price. One can expect constant increases in the price of fuel next year. As the economy will be growing at its cruising speed, rising wages will also become an important source of inflationary pressures. The labour market has already begun to tighten in the textile, construction, tourism, ICT and financial services sectors.

It is no secret that Mr Bheenick is concerned about the savings-investment gap which has widened to 7% of gross domestic product. This deterioration is reflected in our current account deficit as the additional domestic consumption and investment goods have to be imported. That is why the Governor has emphasised “the urgency of the promotion of savings”. It is noteworthy that savings deposits fell by Rs 2.3 billion during the third quarter of 2007 as people withdrew their money to invest on the stock market. An increase in interest rate may not be sufficient to counter asset inflation, but it can help encourage people to return their savings to banks.

Technical disagreement

A very rough calculation suggests that the neutral interest rate would be around 11%. The Mauritian economy has potential growth of 6%, and a medium-term inflation target of 5%. Add them together, you get to 11%. This is the rate at which the Repo rate should have been introduced last year. It would have reflected a neutral monetary stance, for the mid-rate between the interbank rate and the previous Lombard rate was 11% at that time.

My own guess is that the MPC will raise the Repo rate by 50 basis points next week. If I were a voting member, I would opt for the status quo. My disagreement is technical too.

First, at 5.8%, economic growth is still below, albeit close to, potential growth. Second, although personal credit has expanded at a blistering pace of 21% for the twelve-month period ended September 2007, growth in overall credit to the private sector has been rather subdued at a clip of 8%. Third, the next three years will see the country receiving large capital flows

which will cause real exchange rate overvaluation which, in turn, will hurt export industries and overall productivity. And fourth, as long as the BoM does not conduct repurchase transactions, it will be no use changing the Repo rate.

The problem is that the MPC meets on a quarterly basis. If he waits until March 2008, it will be difficult for the Chairman to argue in favour of a rate rise. But he stands a chance now.

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