



بنك المغرب
BANK AL-MAGRIB

◆ MONETARY POLICY REPORT ◆

Document prepared for
the Bank Board
December 19, 2006





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PREAMBLE

Bank Al-Maghrib has set inflation at the centre of its preoccupations since price stability has been confirmed by its new statutes as its main mission. Having put emphasis on monitoring a monetary aggregate, set in the beginning of the financial year by reference to M1, and to M3 since January 2006, the Bank has decided to ground its analysis on a diversified range of inflation-related indicators, in addition to the monetary aggregates and price indexes. Together, these indicators, which constitute the global diagnosis framework used as a basis for the monetary policy measures proposed to the Board of Bank Al-Maghrib, can be divided into two major categories:

- Monetary and financial indicators, which give information on the monetary and financial conditions characterising the economic situation at a given time and on the effects it may have on aggregate demand and, therefore, on prices (interest rates, monetary and credit aggregates, exchange rate, financial assets' prices, etc.)
- Indicators relating to the real sector, thanks to which one can detect the inflation factors linked to an excessive demand in comparison to supply or linked to pressures on production factors (labour in particular): demand, production, labour market, import prices, producer prices, consumer prices, etc.

This report is based mainly on the studies carried out by the staff of the Bank within the framework of the strategic plans aiming at developing its modelling and analysis capacities, especially as concerns prices. The main studies achieved in this regard concern demand for money, credit, inflation determinants in Morocco, and macroeconomic forecasting models. The two surveys made on credit conditions and on the industrial sector's situation have provided pertinent data. The other ongoing projects with the aim of developing a high frequency statistical database, the widening of the scope of the survey made with the economic operators, as well as the studies made with a view to deepening the understanding of the monetary policy's transmission mechanisms, will allow for the preparing of the analysis and modelling devices necessary for the possible transition to an inflation targeting strategy.

In addition to the forecasts on monetary aggregates, and on the basis of the data available a fortnight before the Bank's Board meeting of December 2006, this report gives a retrospective and forecasting economic analysis and shows a balance of risks likely to influence price stability at the short term, while taking the usual precautionary measures as to the data used and the methods adopted. This document, which will be published on a quarterly basis, ten working days after the Bank's Board meeting, is a first draft set to be improved according to the gradual refinement of the analysis and monitoring tools of prices and activity.

LIST OF ABBREVIATIONS AND ACRONYMS USED

BAM	:	Bank Al-Maghrib
CLI	:	Cost of living index
CNSS	:	National Social Security Fund
GDP	:	Gross domestic product
GFCF	:	Gross fixed capital formation
HCP	:	High Commission for Planning
HP	:	Hodrick-Prescott
IMF	:	International Monetary Fund
INAC	:	National Institute for Economic Condition Analysis
MASI	:	Morocco All Shares Index
NAIRU	:	Non-accelerating inflation rate of unemployment
TIC	:	Domestic consumer tax
UCITS	:	Undertakings for collective investment in transferable securities
VAT	:	Value added tax

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OVERVIEW

In the third quarter of 2006, annual inflation reached about 3.7%, compared to about 1.5% in the last quarter of 2005. In October 2006, inflation reached 4.1% year-on-year. This acceleration is also reflected by the underlying inflation indicator which increased by around 3.6% in October 2006. During the first ten months of 2006, inflation and underlying inflation increased by an annual rate of 3.3% and 3.2% respectively. In parallel, in this well anticipated context, the Board decided in April 2006 to favour the recourse to liquidity-withdrawal operations on call for tenders at 2.50%.

Beyond the effect of base of the VAT increase at the beginning of the year and the rise in the domestic oil price, inflation's acceleration also resulted from a dynamic economic activity. According to our estimates, the present growth rate of the non agricultural GDP is above its trend level. Many indicators tend to reveal the existence of tensions on output capacities, especially in the labour market. Our estimates show a positive output gap for 2006. This excess in demand, compared to the output capacities, may feed new inflationary pressures. However, recent developments indicate that the potential economic growth has apparently strengthened in the recent years.

In fact, the activity is still well-positioned. The acceleration of the global GDP growth, expected to exceed 7% in real terms in 2006, is stimulated by a very strong domestic demand. The increase in household consumption was mainly fostered by the good agricultural campaign. Investment growth, also, is on an upward trend, owing mainly to the expansion of real estate loans, big infrastructure projects and a renewed confidence. Consumption, and more particularly investment, are expected to pursue their increase on a sustained rate, maintaining growth at a pace above its tendency.

External conditions remain rather favourable, with yet a considerable risk of oil price increase in the coming months. Import prices relaxed at the third quarter of 2006 after a sustained increase at the beginning of the year, due to the surge in oil prices. The progressive and partial restoring of the indexation system during 2006 has favoured the transmission of these shocks to the domestic oil prices and to inflation. The relative moderation of world prices, started in September, in addition to the dirham's appreciation against the dollar, has contributed to the attenuation of inflationary pressures. This effect has been encouraged by the evolution of the import prices of consumer goods in 2006, which have continued on the downward trend observed for many years. Furthermore, the continuing process of tariffs' dismantling has amplified the drop in import costs and reinforced its disinflationary effect.

Within this context, a slight downturn of the inflation rate is expected for the next months. In the first quarter of 2007 inflation would reach between 1.8% and 2.4% year-on-year. Inflation rate would stand between 2.1% and 2.8%, for the whole year 2007, taking into account the following balance of risks:

- The economic activity is expected to remain dynamic during 2007 and the pressures already exerted on some segments of the labour market may favour an upward trend of wages. Additionally, the recent multiplication of wage claims may feed wage inflation.

- There remain considerable uncertainties as to oil price and the weakening of world inflation has not been confirmed.
- The substantial excess liquidities, accumulated during the last years, are expected to increase in 2007, thus reinforcing the spending potential of households and enterprises. This dynamic has already produced a strong effect on the share and real-estate prices.

Overall, the balance of risks tends to indicate that inflation rate in 2007 will probably reach a level within the high part of the bracket of prevision which is delimited by confidence intervals (2.1% and 2.8%).

1- GLOBAL DEMAND TREND

The speeding-up of the overall GDP growth, expected to reach more than 7% in real terms in 2006, was fuelled by a very dynamic domestic demand. The increase in household consumption has been essentially stimulated by the good agricultural campaign. Investment growth, also, is on upward trend, owing mainly to the expansion of real estate loans and the big infrastructure projects. Despite the good performance of exports, the trade balance has had a negative impact on GDP growth, owing to the rapid rise in imports.

1.1 Output

The buoyant activity in 2006, which translated into a GDP growth rate of over 7% in real terms (Chart 1.1), has concerned all market sectors (Table 1.1). Agricultural output benefited from a bumper farming season which pushed its growth up to 30%. In 2007, the forecasts based on the hypothesis of an average crop year suggest a drop in the agricultural output. Market non-agricultural GDP should reach a growth rate of over 5% in 2006, in continuation of the expansionary cycle started in 2004. In particular, the sector of building and public works has asserted its dynamism with a growth rate exceeding 7%. This trend is likely to be maintained in 2007 owing to the continuation of the big infrastructure projects and the dynamism of social housing constructions. After the slowdown witnessed in 2005, mainly due to the fall in the textile sector, industrial output has revived with a growth rate of around 4% in 2006. This industrial expansion rate is above the long term trend which is at 3.2% approximately.

1.2. Consumption

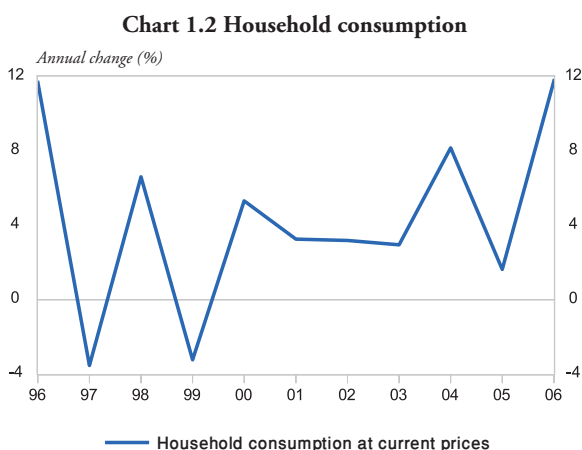
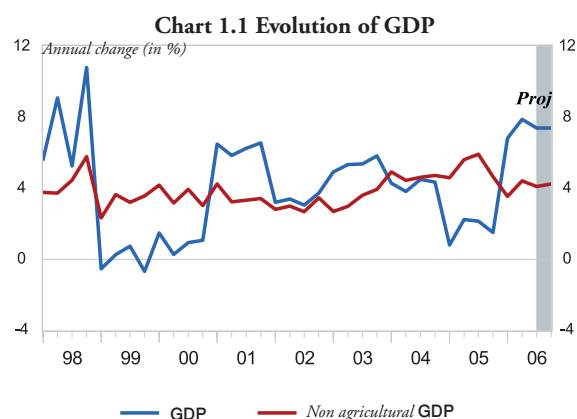
Household consumption is expected to increase by 11.7% in nominal terms in 2006, its highest growth rate since 1996 (Chart 1.2). This dynamism is mainly due to the very good agricultural campaign which has resulted in a more than 30% increase of the primary sector output. The fluctuations of the agricultural activity have a direct impact on household consumption through the appreciation in agricultural products consumption. It has also an indirect effect through the improvement of rural household income, which encourages the

Table 1.1. GDP evolution by sector

Year-on-year (in %)	2003	2004	2005	2006			
				T1	T2	T3*	T4*
GDP	5.4	4.2	1.7	6.8	7.9	7.4	7.4
Market non agricultural GDP	3.3	4.7	5.2	3.4	4.4	4.1	4.3
Non agricultural GDP	2.7	5.1	5.2	4.6	5.2	5.1	5.3
Agriculture	18.0	1.9	-17.8	30.7	32.2	30.9	29.1
Building and Public Works	3.7	3.5	5.9	7.7	6.0	8.3	7.4
Industry	3.7	3.0	2.6	3.9	5.1	3.0	3.8
General government	6.0	2.9	5.1	-1.4	1.2	0.2	0.3

Source: Previsions of the High Commission for Planning

(*) : Estimates



consumption of non agricultural products. In 2007, household consumption should increase more moderately, within a context characterized by the slowdown of agricultural growth after the strong rebound of 2006.

In parallel with the good agricultural campaign, the evolution of household income in 2006 has benefited from the increase in remittances by Moroccans living abroad (estimated at 12.2% in 2006), the fall in unemployment rate and wage increase (see Section 2). Nonetheless, in 2006, the purchasing power's increase has been slightly eroded by the rise of inflation, which may probably have a negative impact on consumption.

Moreover, household consumption was also stimulated by favourable monetary conditions. The low level of interest rates have encouraged households to increase their demand for consumer credits which increased by 16.5% year-on-year in the third quarter of 2006 (Chart 1.3).

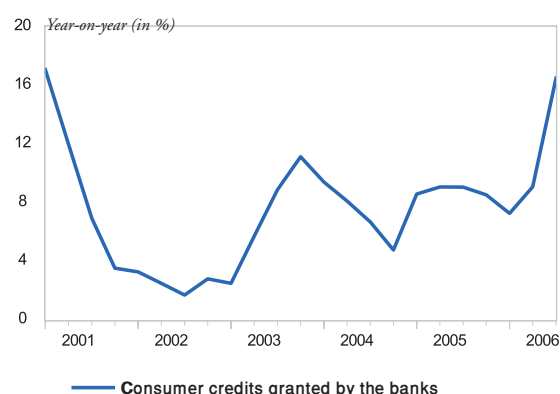
Unlike household consumption, public consumption increased moderately in 2006, owing to the 3% decrease in current expenditure, after a considerable increase of 25% in 2005 (Table 1.4). In 2007, the draft finance law foresees a 3% growth of current expenditure.

1.3 Investment

The growth of investment in nominal terms speeded up in 2006 to reach 9.5% against 6% in 2005 (Chart 1.5). In continuation of the trend observed for many years, the investment rate (GFCF/GDP) saw a new increase in 2006 (Chart 1.6). In one decade (1996-2006), the investment rate has gone from 20% to 25.5%, reflecting mainly the effort made by enterprises as regards equipment and the dynamism of building and public works expenditure.

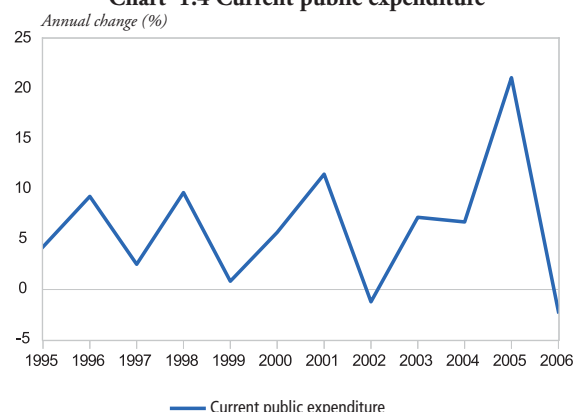
Boosted by the big infrastructure works and housing purchase by households, investment

Chart 1.3 Consumer Credit



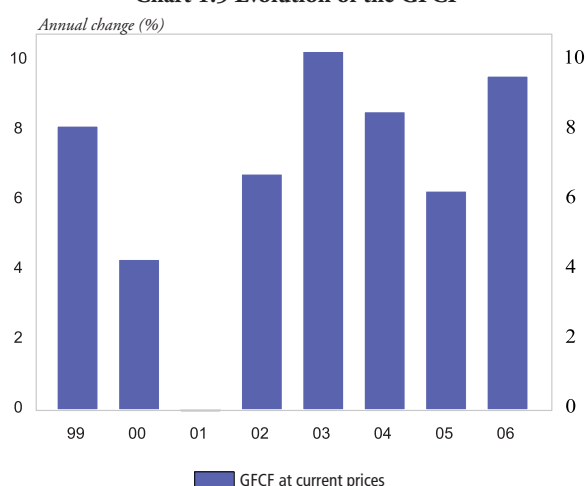
Source: Bank Al-Maghrib

Chart 1.4 Current public expenditure



Source : Ministry of Finance and Privatisation

Chart 1.5 Evolution of the GFCF



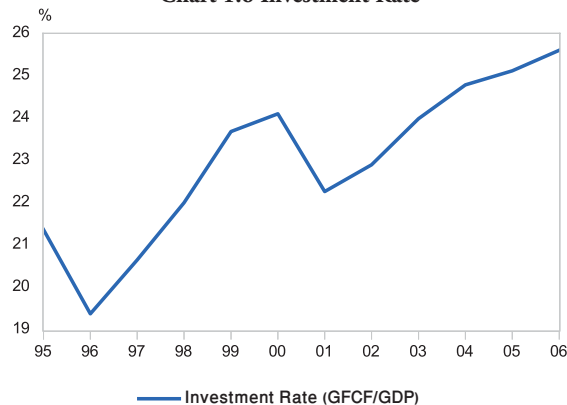
Source : HCP

in building and public works has continued its expansion cycle started in 2005. Recent indicators show that this trend might be confirmed in the last quarter of 2006 and continue over the whole year 2007. At present, real estate loans are witnessing a very strong expansion which reached 25.6% on a year-on-year basis in the third quarter of 2006 (Chart 1.7). The significant decline of debtor rates, credit maturity extension and social housing development have, to a great extent, contributed to reinforcing households' housing purchase capacity. Furthermore, it is noticed that the banks' propensity to grant real estate loan tends to increase as a result of the abundant bank liquidities and the appreciation of the collateral's value.

On the other hand, investment in plant and equipment also witnessed a sustained increase in 2006. In the third quarter, capital goods' imports increased by about 16% on a year-on-year basis (Chart 1.8).

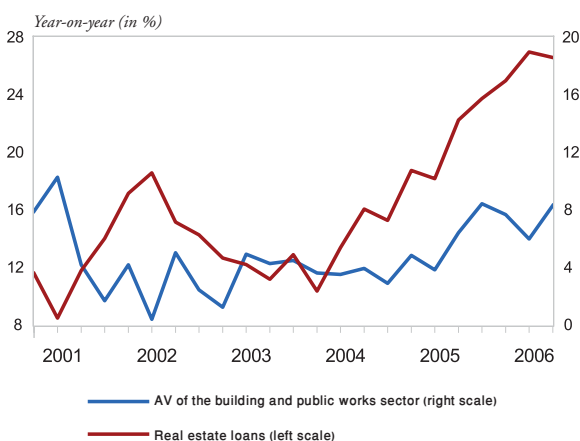
Public investment strongly contributed to the growth of the GFCF in 2006. Capital expenditure under the State budget is expected to increase by 7% in 2006 after the 8% contraction of the previous year. On the other hand, public enterprises' investments, which constitute about one third of the total GFCF¹, should witness a very sustained expansion in 2006, from 32.3 billion dirhams in 2005 to 52.3 billion dirhams in 2006.

Chart 1.6 Investment Rate



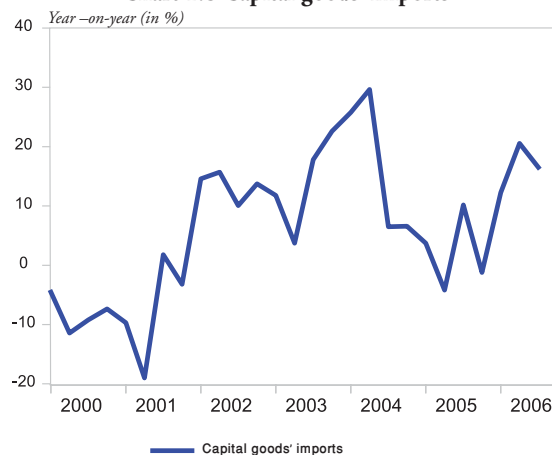
Source : HCP

Chart 1.7: Real estate loans and the added value of the building and public works' sector



Source: HCP; Bank Al-Maghrib.

Chart 1.8 Capital goods' Imports



Source: Foreign Exchange office

1 Source : «Report on public corporations and enterprises sector», Draft finance law for the fiscal year 2007, Moroccan Ministry of Finance and Privatisation. It should be noted that, given the different accounting methods, the amount of public investments should carefully be compared with the GFCF".

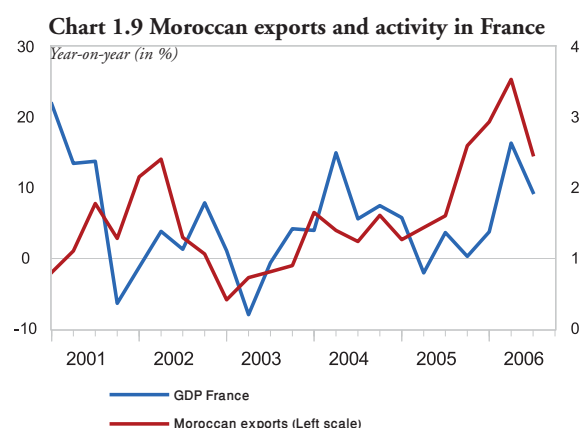
1.4 Foreign Trade

Trade exchanges between Morocco and its partners stepped up in 2006, owing to a strong expansion of world trade. Following many years of stagnation, the Moroccan exports witnessed a strong rise in 2006, with a growth rate of more than 14% in the third quarter on a year-on-year basis.

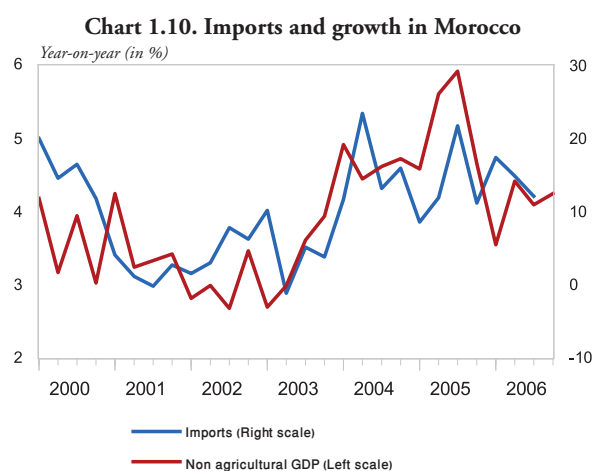
The analyses made by Bank Al-Maghrib show that the Moroccan exports are very sensitive to the Euro zone economic situation, especially the French economy (Chart 1.9). Hence, the positive evolution of exports in 2006 can be explained by the speeding-up of growth in the partner countries, which has contributed to the reinforcement of world demand towards Morocco.

In 2006, the economy of the Euro zone is expected to grow by 2.1% in comparison to 1.3% in 2005. In France, growth should rise from 1.2% in 2005 to 2.2% in 2006. The Moroccan exports have also benefited from an improvement in the competitiveness/price ratio, due to the depreciation of the dirham's effective exchange rate against the euro which continues since 2001. Finally, textile industry exports, which were severely affected by the dismantling of the textiles and clothing agreements in 2005, benefited from the establishment of temporary quotas for Chinese exports. In 2007, the Moroccan exports' growth may weaken, as a result of the expected slowdown of the European growth and the possible removal of quotas on Chinese exports.

Since the start of 2006, imports have shown a very dynamic profile (Chart 1.10). In the third quarter, they recorded a 13% increase on a year-on-year basis. The expansion of imports may be explained by the acceleration of economic growth and the strengthening of domestic demand. As imports have increased more rapidly than exports, the trade deficit is expected to widen out by about 15% in 2006, thus producing a negative effect on growth.



Source: IMF and Foreign Exchange Office



Source: Foreign Exchange Office and the HCP

2- PRESSURES ON OUTPUT CAPACITY

Based on our estimates, the present growth rate of non-agricultural GDP is above its trend level. Many indicators tend to reveal some tensions on output capacity, especially in the job market. The output gap, which measures the difference between actual output and potential output, seems positive in 2006. This excess demand, as opposed to the output capacity, may fuel new inflationary pressures. Nonetheless, some recent developments point out that the potential growth of the economy has likely strengthened over the recent years.

2.1 Pressures on capacity

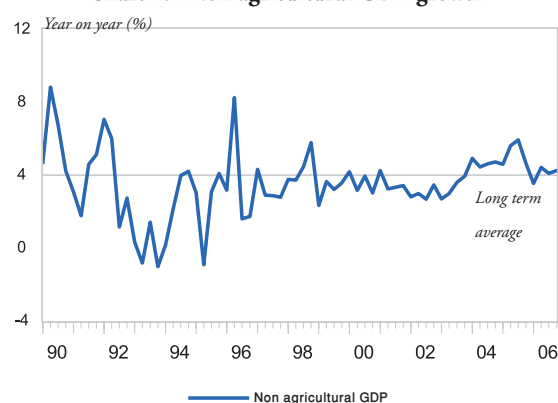
The acceleration of non-agricultural growth, started in 2004, continues in 2006 at sustained rates thanks to a very dynamic domestic demand (Chart 2.1). The present expansion cycle has proved to be longer for more than 15 years. In the second quarter of 2006, the non-agricultural GDP has shown an increase of 5% on a year-on-year basis. Short-term forecasts reveal that non-agricultural growth could keep on this expansionary upward trend in the third and fourth quarters. The growth level registered in non-agricultural growth is above the long-term average which is close to 4%.

According to the Bank estimates, based on the quarterly data of the HCP, the present growth should in fact exceed the potential growth of the economy (Box 2.1). The global output gap, which measures the gap between potential and effective output, would hover around 1.3% in 2006, while the market non-agricultural output gap would stand at around 1%.

The studies carried out by Bank Al-Maghrib have shown the positive correlation between the output gap and the increase of the underlying inflation in Morocco (Charts 2.2 and 2.3). Furthermore, it seems that this relationship tends to get reinforced over the last few years. Both the global and non agricultural output gaps were positive in 2006, which may be interpreted as a risk of the existence of pressures on output capacity, likely to fuel, on their turn, new inflationary pressures.

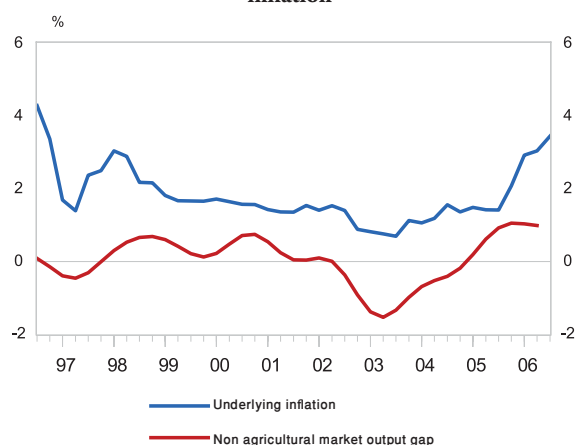
Given the uncertainties surrounding the output

Chart 2.1 Non agricultural GDP growth



Source: HCP, BAM calculations

Chart 2.2. Non agricultural market output gap and underlying inflation



Source: HCP, BAM calculations

gap estimates, it proves necessary to study other indicators for a complete assessment of the pressures linked to the output capacity.

The rate of output capacity utilisation in the industrial sector, measuring the degree to which enterprises use their equipments, fell back in the two first quarters of 2006, after a considerable increase in 2005 (Chart 2.4). According to the data of the new monthly survey of Bank Al-Maghrib on the economic situation among industrial enterprises, the rate of output capacity utilisation in November 2006 was around 77%. At present, this indicator is in line with the long term average. Consequently, the pressures on output capacity seem, on the whole, moderate in 2006 in spite of the economic recovery. Hence, industrial enterprises have unused capacities at their disposal which allow them to meet the growing demand with no excessive pressure on their production tool.

The existence of this capacity is a result of the productive investment effort made during the last years, the dynamism of which was confirmed in 2006.

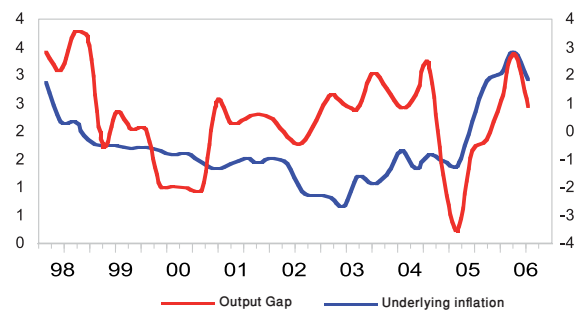
This sustained increase of the productive capital stock is likely to enhance the potential growth and is expected to attenuate the inflationary pressures caused by a strong demand.

The development of labour productivity, calculated through a simple method as being the non-agricultural GDP/ urban employment ratio, also highlights the pressures on productive capacities. In the long run, productivity gains seem relatively weak in Morocco. Several studies carried out recently on growth in Morocco show that the overall factor productivity² stagnated since early 1980's³. Starting from 2004, and particularly in 2005, a steady increase has been observed in apparent labour productivity in the

² The total factors productivity measures the combined efficiency of labour factor and capital factor. It is measured as the part of output growth which can neither be explained by the increase of the amount of work nor by the rise in stock capital.

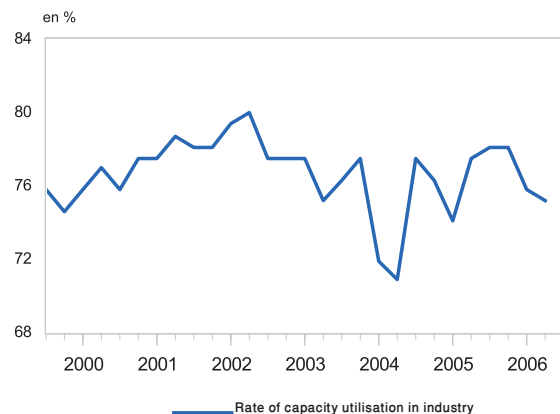
³ See World Bank "Kingdom of Morocco: Promoting growth and employment by productive diversification and competitiveness" Economic memorandum, World Bank, Washington, D.C., March 2006

Chart 2.3. Underlying inflation and lagged global output gap



Source: HCP; BAM calculations

Chart 2.4. Rate of capacity utilisation in the industrial sector



Source: HCP; BAM calculations

Box 2.1 Output gap and inflation

The output gap is a variable which captures tensions on the economy. It is defined as the relative difference between the actual output Y_t and the potential output Y_t^{POT} :

$$\text{Output Gap} = \frac{Y_t - Y_t^{POT}}{Y_t^{POT}}$$

The potential output level equals the level of activity compatible with a normal use of output factors. In case the activity exceeds its potential level, the output gap is positive, thus indicating an economic expansion. On the contrary, in the case of an economic recession, output factors seem to be underused, which leads to a negative output gap. The output gap is an important concept for the economists of the central bank. It is a baseline tool used to make a diagnosis of the economic situation and to position economy in the cycle. Furthermore, it is considered as an indicator of inflationary pressures. A sustainably positive output gap reflects an excess demand in the economy likely to generate inflationary tensions through wage increases or through the widening of enterprises margins. Conversely, inflation will tend to decelerate if the output gap is negative, and to remain stable if the output gap is close to zero.

Not directly observable, the output gap should be calculated on the basis of the data available. Among the methods commonly used by central banks, we distinguish between the structural and statistical methods. The structural approach is based on the assessment of an output function, where all the factors are measured at their full utilisation capacity (capital, work and technical progress). The use of this method requires the existence of sufficient data with a view to ensuring an adequate measurement of the capital stock and the Non Accelerating Inflation Rate of Unemployment (NAIRU). Alternately, the statistical approach rests on the use of univariated or multivariated filters which allow dividing the activity into two components: a cyclical component and a trend component. The main filters used are Hodrick-Prescott and the pass-band. These methods are simple to use, transparent and parsimonious in terms of data. Nonetheless, the weakness of these statistics smoothing instruments lies in the absence of any economic foundation and in the fact that they provide frail projections at the tails of the sample. Despite these shortcomings, authors like De Masi (1997) recommend the use of statistical filters in emerging countries where data are either unavailable or of poor quality.

To study the relation between inflation and the business cycle, the works made by the staff of BAM have focused on the consideration of many alternative indicators of the output gap, including the multivariated filters such as Hodrick-Prescott filters increased by a Philips' curve, or the multivariated Kalman filter, also constrained by a Philips' curve. These multivariated approaches include constraints in the shape of equations which give a more economically interpretable output gap series. However, given the similarity of the outcome of the simple and multivariated approaches, and for the purpose of simplicity, the univariated methods have been adopted, particularly the pass-band filter suggested by Christiano-Fitzgerald (2003) and the Hodrick-Prescott univariated filter which allow for a clear identification of the different economic stages and seem closely linked to underlying inflation in Morocco.

non-agricultural sector which, nonetheless, seems to have decreased in 2006 due to the rapid labour expansion (Chart 2.5). Beyond these cyclical fluctuations, it seems that labour productivity is fundamentally improving. The structural reforms undertaken for many years (trade openness, privatisation, improvement of governance and business climate) in addition to the increase of public and private investment may explain this positive evolution.

By reinforcing companies' supply, productivity gains contribute to alleviating pressures on capacity and curbing pressure on prices.

2.2. Tensions on the labour market:

Since early 2006, the labour market situation in Morocco has considerably improved both in rural and urban areas (Table 2.1). Urban unemployment rate fell from 17.6% in the third quarter of 2005 to 15.8% in the third quarter of 2006 (Chart 2.6). In the second quarter of 2006, unemployment rate had reached its lowest level for more than 10 years. Urban labour rose at a rate much higher than the long term trend, reaching, at the third quarter of 2006, 7.8% on a year-on-year basis. The considerably rapid decline of unemployment rate raises questions on how accurate employment statistics are. The change in the methodology adopted in 2006 in job survey may have contributed to these exceptional performances. Nonetheless, the general trend of the available indicators seems also to reflect an effective improvement in the job market situation.

Within this economic situation characterised by a historic decline of the unemployment rate, wages in the private sector increased by more than 7% on a year-on-year basis in the second quarter of 2006, while the upward movements recorded previously stood on average at around 3% (Chart 2.7)⁴. If

⁴ This indicator should be interpreted with caution as it concerns only private sector employees affiliated to the CNS and as the basic data used for its preparation are frequently revised

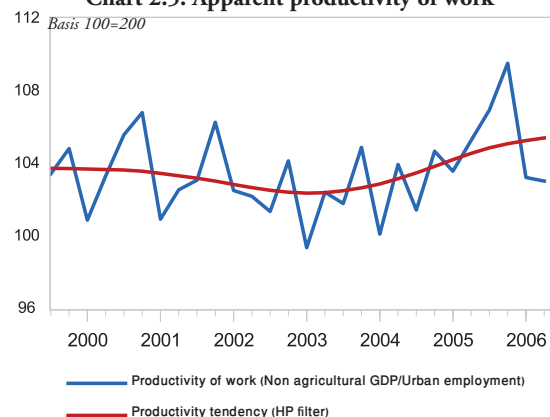
Table 2.1: Labour market indicators

	2004	2005	2006	
			T2	T3
National working active population ⁽¹⁾	3.7	1.1	6.1	5.7
Urban working active population	4.7	1.5	7.5	7.8
National employment rate	46.7	46.2	48.3	46.8
Urban employment rate	37.1	36.7	38.5	38.3
National unemployment rate	10.9	11.2	7.7	10.9
Urban unemployment rate	18.6	18.6	13	15.8
National working rate	52.5	52	52.3	52
Urban working rate	45.6	45.1	44.2	45.5

Source : HCP

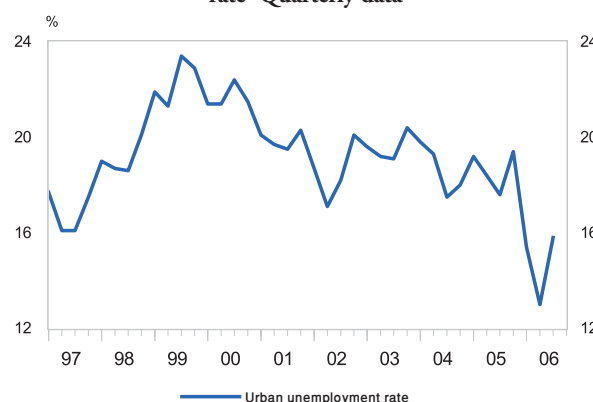
(1) : Year-on-year change

Chart 2.5: Apparent productivity of work



Source: HCP, BAM calculations

Chart 2.6 Urban unemployment rate- Quarterly data

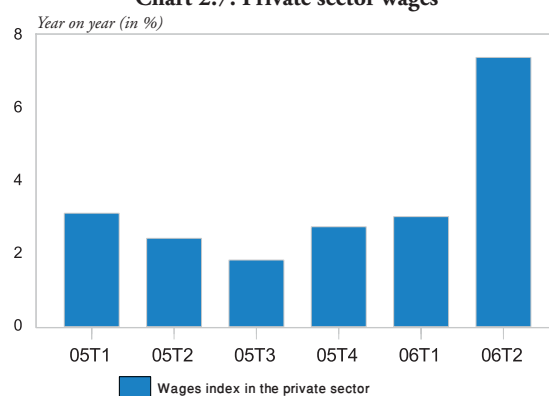


Source : HCP

the rapid wages increase was confirmed in the next quarters, this might suggest that important pressures are underway in the job market and that the present level of unemployment is below its equilibrium level.

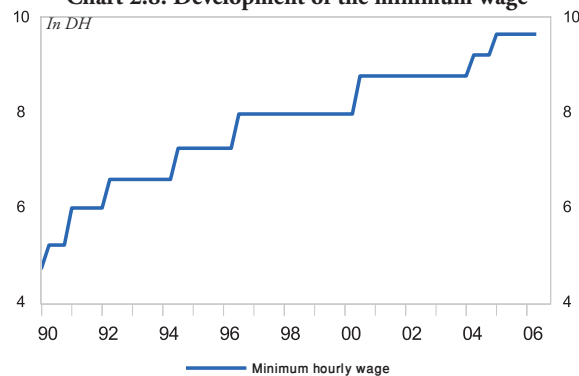
Furthermore, taking into account past experiences, the risk of increase in the minimum staff wage in 2007 is high and may fuel wage inflation (Chart 2.8). The analyses made by Bank Al-Maghrib show that the wage restraint observed since the mid 1990's has considerably contributed to the disinflationary trend that Morocco has been witnessing for a decade. A sustained wages acceleration exceeding the productivity gains may present a risk for price stability.

Chart 2.7: Private sector wages



Source: HCP

Chart 2.8: Development of the minimum wage



Source: Ministry of employment

Box 2.2. Wage negotiations and minimum wage adjustment

Since 1936, Morocco has adopted a law on the minimal wage defining different wage levels for the urban and rural job markets and for different age groups. Minimum wages are revised on the basis of a formal method of price indexation, especially when consumer price index increases by 5%. In practice, however, the adjustments are irregular and independent of this indexation rule. In fact, they result from political and discretionary decisions due to significant trade unions' pressures. The few studies available suggest that the regulation of the urban minimal wages (especially as concerns unqualified workers) is generally observed in the formal private sector owing to the active role played by the general government and trade unions. Also, these studies show that only 13% of formal private sector employees earn a wage below the required minimum.

3. IMPORT PRICES

Import prices eased off in the third quarter of 2006 after a sustained rise at the beginning of the year, due to the surge in oil prices. The progressive restoring of the indexing system in the year 2006 helped to transfer these shocks to the oil prices and to inflation. The moderation of world prices, which started in September, combined with the appreciation of the dirham against the dollar, contributed to easing inflationary pressures. This effect was reinforced by the increase of consumer goods' import prices in 2006, which follow their downward trend maintained for several years.

3.1 Inflation in the world

The year 2006 was characterized by an increase in world inflation rate (Table 3.1). The emergence of these pressures results from the explosion of oil prices linked to an acceleration of economic growth. However, in the third quarter of 2006, a very slight easing of inflationary pressures is observed, mainly due to the fall in the prices of raw materials as well as to the impact of tightened monetary policies conducted in numerous industrialized and emerging countries. This very relative drop in inflation is expected to continue in the fourth quarter of 2006 and in the year 2007.

Table 3.1: Recent evolution of inflation in the world

Change in %	2004 2005 2006 2007			
	2004	2005	2006	2007
Industrialized countries	2.0	2.3	2.5	2.2
France	2.3	1.9	1.9	1.8
Spain	3.1	3.4	3.6	3.1
Emerging countries	5.6	5.4	5.2	5.0
Euro zone	2.1	2.2	2.2	2.2

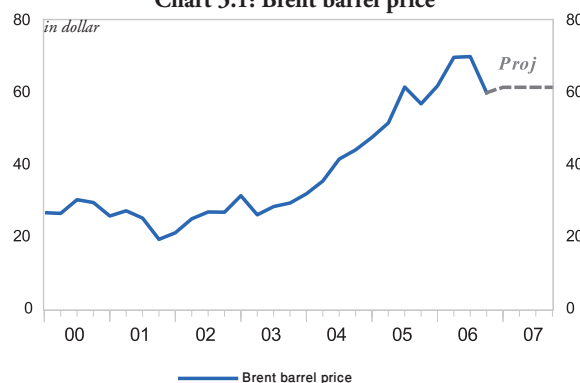
Source: IMF

3.2 Oil price

The upward trend of oil price, which started in the year 2003, has significantly increased during the first eight months of 2006. The Brent barrel price has fluctuated around \$70 until August 2006, reaching peaks of more than \$80 (Chart 3.1).

The main causes put forth to explain this sharp rise refer to the geopolitical tensions in the Middle East, to the successive hurricanes in the Mexico Gulf and to the global demand strengthening, in a context of strong economic growth. As from September 2006, a changing of trend becomes apparent, leading to a drop in world prices, which fluctuate now around \$60. This inflection is explained by the relatively calm situation in the Middle East and the expectations of a fall in global demand. According to the World Economic Outlook⁵, the relaxation

Chart 3.1: Brent barrel price



Source: IMF

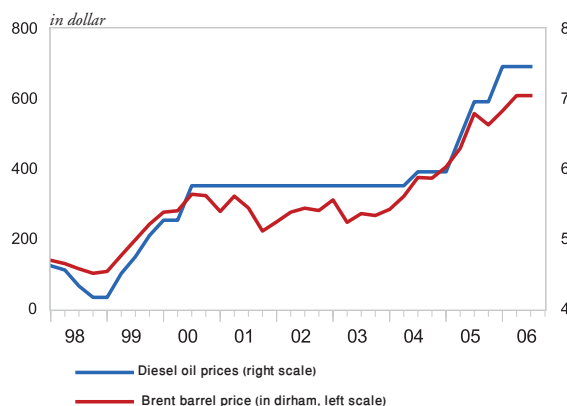
⁵ World Economic Outlook, International Monetary Fund, September 2007.

trend is expected to continue in 2007, while prices would stabilize around an average of \$61.5.

In Morocco, on account of the existence of a subsidization system, the increase in oil world prices, which started in 2002, did affect but partially and in an irregular manner oil prices starting from 2004 (see Box 3.1 and Chart 3.2). Indexing mechanism, suspended in 2000, was reintroduced in September 2006. From then on, every downward or upward variation of world price which is above 5% passes on to the oil prices at the rate of two reviews a month. According to Bank Al-Maghrib estimates, an increase of 15% in oil world price brings about a rise by 10% in diesel oil prices in Morocco, taking account of the taxes and subsidies in force (see Box 3.1). On the basis of the forecasts of oil international price and the euro-dollar parity, oil prices are expected to remain stable in the year 2007.

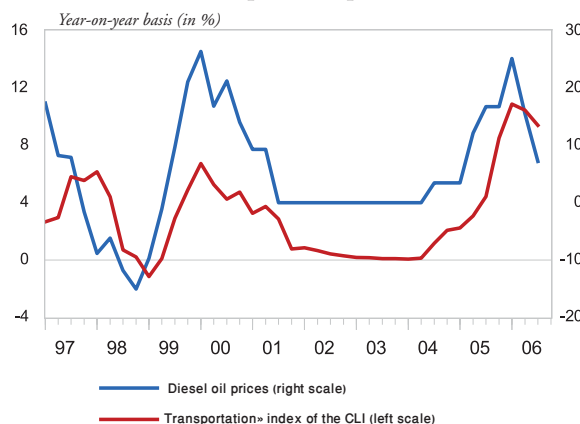
According to the Bank's analyses, fluctuations of oil prices are transmitted to total inflation mainly through the «transportation» component, given that the effects of the second turn⁶ seem to this day relatively limited (Chart 3.3). Rises in fuel price in the years 2005 and 2006 have led to an increase by more than 10% in transportation fares in the first quarter of 2006. This component has contributed for about a quarter to the total inflation noticed in the first three quarters of the year.

Chart 3.2: world oil price and oil prices in Morocco



Source: Ministry of Energy and Mining Industry, IMF

Chart 3.3: fuel oil prices and transportation price



Source: Ministry of Energy and Mining Industry, HCP

⁶ Second turn effects occur when a rise in oil price spreads to the whole components of general price index, following a compensatory increase in salaries.

Box 3.1 Oil world price and fuel price in Morocco

Since 1995, regulations provide for the indexing of oil prices in Morocco on Rotterdam's quotations of petroleum products. According to this system, the price fluctuations in the international market that exceed 2.5% must affect the final consumer, by means of two reviews a month. Nonetheless, this indexing mechanism was suspended in 2000 to alleviate the effects of the soaring barrel price on the national economy. The Subsidization Fund was hence called to cover the difference between the blocked domestic prices and the real prices that indexing would have required. As from 2004, several price rises were made to reduce the gap between the world price and oil prices, and lightening thus the subsidization burden. In 2006, the indexing mechanism was gradually reintroduced (in February and in September), despite the maintenance of a significant subsidized part. The structure of the oil prices of diesel, which represents more than 50% of the consumption of petroleum products in Morocco, can be broken down as follows:

$$\text{Oil prices} = \text{selling price} + \text{Domestic Consumer Tax (TIC)} + \text{VAT} - \text{Subsidy} + \text{margins and miscellaneous}$$

The selling price refers to the price at which refiners sell their products. They are perfectly indexed on Rotterdam's market quotation. The Domestic Consumer Tax (TIC) is applied on a fixed basis to each diesel litre, irrespective of its price. The amount of this tax is rarely reviewed, and totals today 2.42 dirhams a litre, which is a third of the selling price at the pump. The VAT is an ad valorem tax of 7% that is applied to the wholesale price. Tax deductions (TIC + VAT) represent about 40% of the oil prices of a litre of diesel. However, this burden tends to decrease as international prices increase. The subsidy granted by the state covers the gap between the price resulting from the indexing and the regulated price. In October 2006, it amounted to 0.45 dirhams a litre of diesel.

Structure of diesel price in October 2006

	price at the pump	selling price	TIC	VAT	subsidy	margins and miscellaneous
Dirhams by diesel litre	7.46	4.34	2.42	0.46	-0.45	0.69
% of diesel price at the pump	100	60	30	6	-7	10

On account of the mechanism of compensation and the dirham's appreciation against the dollar, diesel oil prices has increased by only 40% between 2000 and 2006, while the price of oil barrel has more than doubled during this period. Starting from September 2006, the mechanism of indexation has been restored. Fluctuations of the barrel price, both upward and downward, pass on henceforth in the oil prices. Considering the structure of prices as noted in 2006, it is believed that an increase by 10% in the world price of oil barrel should entail an automatic rise of about 6% in diesel price at the pump.

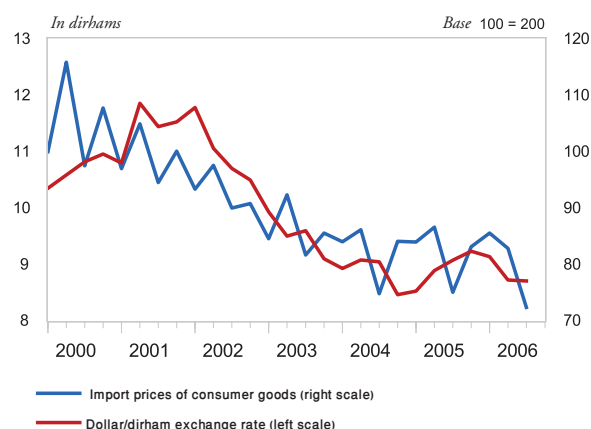
3.3 Import prices

The analyses of Bank Al-Maghrib have made it possible to establish a medium-term relationship between inflation in Morocco and the prices of imported consumer goods. Their downward trend since the mid-nineties constitutes one of the main factors which explain disinflation in Morocco (Chart 3.4). This phenomenon has increased in intensity since 2000 due to the dirham's appreciation against the dollar and the increase of the share of imports from China in the overall imports. Besides, the continuing process of tariffs removal increases the fall in import prices and reinforces its disinflationary effect.

In 2006, import prices of consumer goods followed their downward trend. The data of the third quarter show a drop by 4% compared with the preceding year.

In the event of the dirham's appreciation against the dollar, this trend is expected to continue during the next quarters, exercising a moderating effect on inflation in Morocco.

Chart 3.4: Import prices of consumer goods and exchange rates



4. MONETARY CONDITIONS AND ASSETS PRICES

Economic activity benefited in 2006 from a favourable development of monetary and financial conditions. Money supply rose by 13.5% and interest rates, except those applied on time deposits with banks, were marked down, hence extending the trend noticed for several years. The effective nominal exchange rate remained almost stable on average, just as the bilateral rate against both the euro and the dollar. Also, prices of financial and real-estate assets have strongly appreciated.

4.1 Monetary conditions

4.1.1 Liquidity

The implementation of monetary policy continued in 2006 in a context marked by excess liquidity, in connection with the accelerating increase in exchange reserves. Actually, with the exception of very short periods of tightening, the Bank had to mop up surpluses by means of the 24-hour deposit facility at a rate of 2.25%, before starting to favour 7-day liquidity withdrawal operations at a rate of 2.50% on calls for tenders, pursuant to the decision of the Bank's Board dated 27 April 2006.

In this respect, it is worth mentioning that the Bank, with a view to refining its operational framework, was granted in August the possibility to mop up surpluses via the deposit facility according to the market situation and not in an automatic way.

4.1.2 Interest rate

The interbank rate fell from 2.81% on average during the eleven first months of 2005 to 2.58% for the corresponding period of 2006.

As for interest rates applied on Treasury bills, they underwent a drop, more noticeable for medium and long term maturities. Rates of 26-week bills registered a drop limited to 9 basis points, while those of 5-year, 10-year and 20-year bills respectively fell by 83, 124 and 191 basis points, considering that a first issuing of 30-year bonds had been made in December at a rate of 3.98%.

Chart 4.1: Monthly impact of bank liquidity factors

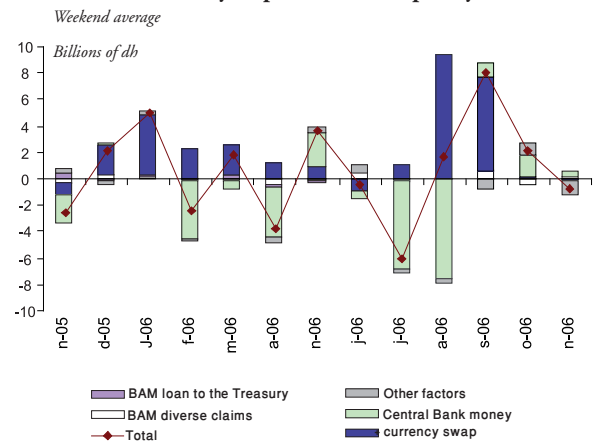


Chart 4.2: Interbank market rate

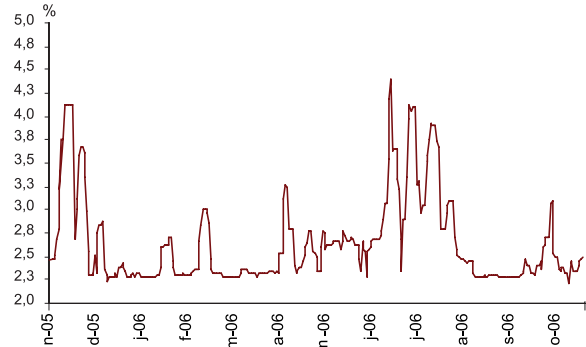
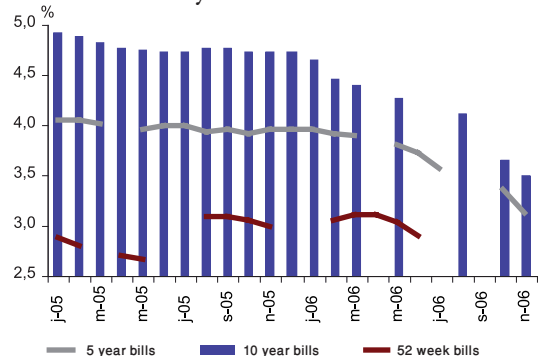


Chart 4.3: Rates of Treasury bills issued by calls for tenders



The conditions of the economy's financing have been improving, as witnessed by the fall in the average loan cost by 154 basis points. In addition to the creation of a competitive context between banks and the provision of alternative funding mechanisms, the easing of financing terms was favoured, on the one hand, by the reinforcement of risk evaluation systems and the reduction of bank risks cost, and on the other hand by the improvement of enterprises' transparency, especially small and medium-sized ones. In this respect, it should be noted that the campaign on small and medium-sized enterprises, launched in November 2006, constituted an opportunity to assess the outcome of these actions and, more particularly, to evaluate the transmission of monetary policy to this category of businesses.

On the other hand, rates on bank deposits have increased by 22 basis points for 6-month deposits and by 8 basis points for those of one year, respectively amounting to 3.51% and 3.69%. This inflection, in a context that is still marked by excess liquidity, seems to reflect a change of banks' behaviour, who appear to take renewed interest in this category of investment.

4.1.3 Money and credit

Money creation generally acts on inflation which may be equally influenced by factors of a real nature. As shown in chart 4.6, the increase in prices seems to be partly determined by the money surplus accumulated during the previous periods.

In the last quarter of 2006, M3 would show a year-on-year increase of 15%, its growth in the whole year should reach more than 13% on average, above the norm set in a range between 7.5% and 8.5%, despite the rise of liquid investment aggregates by about 42%. Money creation during 2006 resulted in a new surplus that came to increase the previously constituted liquid cash in hand pending allocation.

Under these circumstances, the velocity of money

Chart 4.4: Average cost of bank credit in half-year data

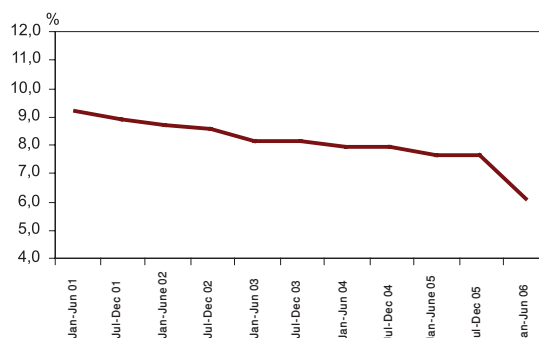


Chart 4.5: Short-term creditor interest rates in half-year data

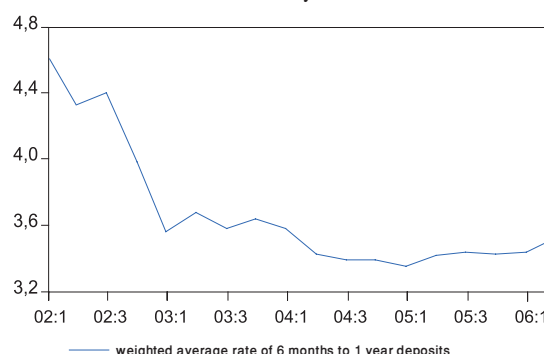
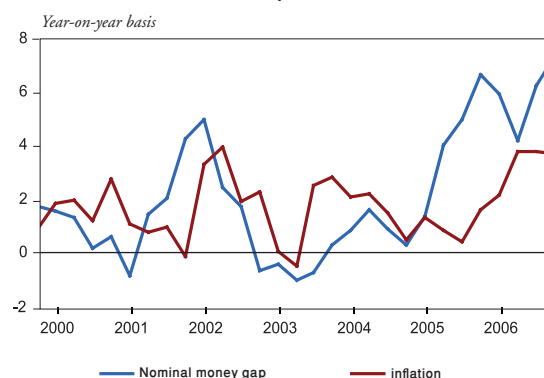


Chart 4.6: Inflation and money growth in half-year data



circulation fell again by 3%, a rate less intense than that of 2005, on account of the good orientation of economic activity, whose nominal growth is expected to reach 10.3% in 2006.

Lending to the private sector rapidly increased in 2006, following its expansion phase initiated in 2003. At the last quarter of 2006, it should grow by more than 12% on a year-on-year basis, taking no account of the effect of writing off an important portfolio of pending claims.

All credit categories largely increased, more particularly real estate loans whose year-on-year growth should exceed 25%, as well as cash facilities and equipment credits which would increase by more than 18%.

As far as demand is concerned, this dynamic continues to reflect the effect of the same factors as in 2005 and the beginning of 2006, namely the good orientation of economic activity and of the generally low levels of interest rates, especially for medium and long term loans.

Besides, credit growth represents a coincident and advanced indicator respectively for economic activity and inflation (see chart 4.8). On the basis of the development registered in 2006 and the forecasts for 2007, the continuing credit expansion still fuels excessive money growth and might give rise to inflationary tensions whose scale would depend on the moderating effect of supply factors.

4.1.4 Liquid investment aggregates

Concerning liquid investment aggregates, they would show an expansion of over 40% at the end of 2006, which should concern in particular securities of bond UCITS, on account of the combined effect of the rise of demand and the revaluation of portfolios linked to the fall of interest rates, as well as securities of share UCITS at the same time as the appreciation of stock exchange prices.

Chart 4.7: Money circulation velocity in yearly data

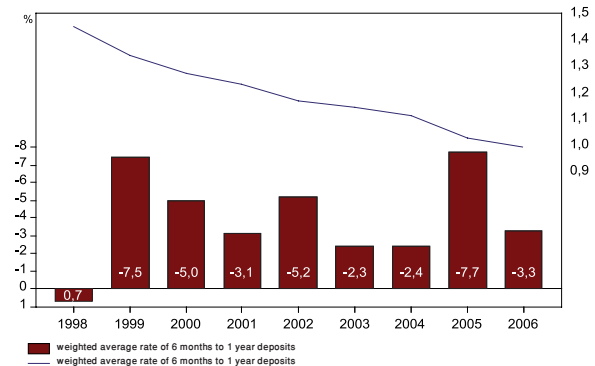
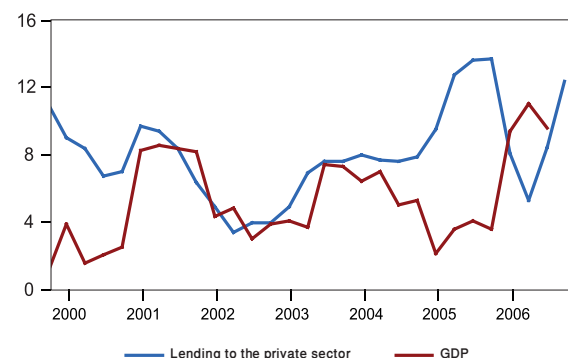


Table 4.1: Lending to the private sector in 2006

	Year-on-year evolution (%)						
	Dec. 03	Dec. 04	Dec. 05	Mar 06	Jun 06	Sept. 06	Oct. 06
Lending to the private sector	8.7	6.8	11.1	8.6	7.8	7.9	9.1
Total banks' lending	8.3	7.2	13.1	10.3	8.1	8.2	9.4
. Debtor accounts and cash credits	-1.3	3.3	17.5	19.6	7.7	8.2	12.0
. Equipment loans	13.5	-1.1	13.9	3.5	5.3	14.2	10.6
. Real-estate loans	12.3	15.5	24.9	23.1	28.0	7.9	26.3

Chart 4.8: Growth of lending to the private sector and of economic activity



4.1.5 Other counterparts of money supply

The strong money growth of 2006 has been achieved for almost the two thirds of it during the second semester, as a result of the accelerating distribution of loans and the currency flows in this period.

Net foreign assets would show, at the end of the year 2006, an increase by 30 billion dirhams, of which 20 billion just for the months of July and August, at a rate of 18% instead of that of 14.5% recorded in 2005. This is attributed to the ongoing growth of private unrequited transfers and tourist earnings, as well as to the consolidated recovery of exports and foreign direct investments.

On the other hand, net claims on Government are expected to decrease by 5 billions or 6.5%, in relation to the improved net position of the Treasury with regard to Bank Al-Maghrib, and especially with regard to the banks.

4.1.6 Exchange rate

On the average, the dirham's exchange rate remained practically unchanged in 2006, both against the euro and the dollar, as well as in terms of the nominal and real effective rates.

From one period-end to the next, the dirham's exchange rate, in parallel with the behaviour of the two main currencies on exchange markets, has depreciated by 1.69% against the euro and appreciated by 7.41% against the dollar.

4.2 Assets prices

At the level of financial assets listed on the stock exchange, the volume of transactions has increased by 29.2% to reach about 130 billion dirhams, representing almost the third of market capitalisation that has gone up from 252.5 to 400.5 billion dirhams in 2006. This progress indeed reflects the introduction of six new companies (+10% of the market capitalisation), but especially the effect of prices appreciation, the MASI index

Chart 4.9 : Counterparts contribution in percentage to the annual growth of money supply

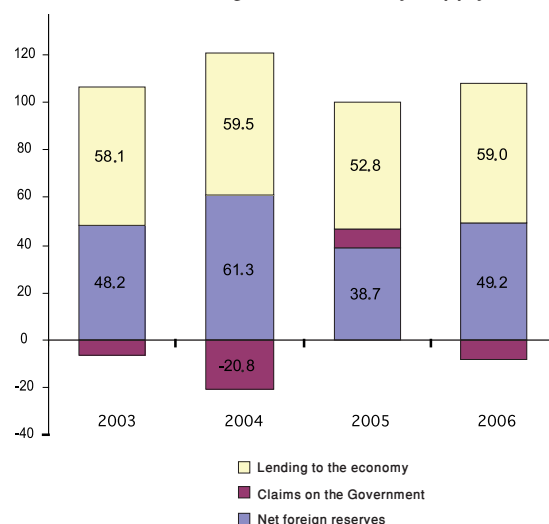
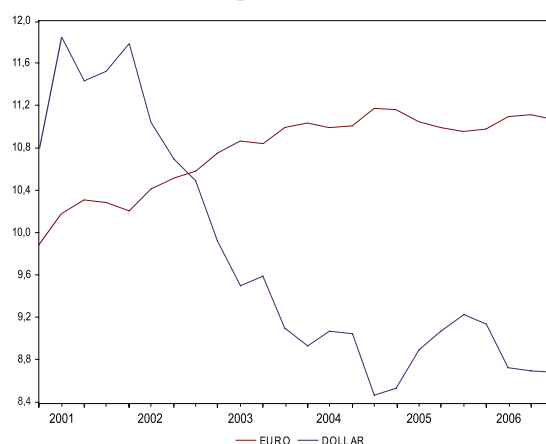


Chart 4.10: The dirham's exchange rate in quarterly data



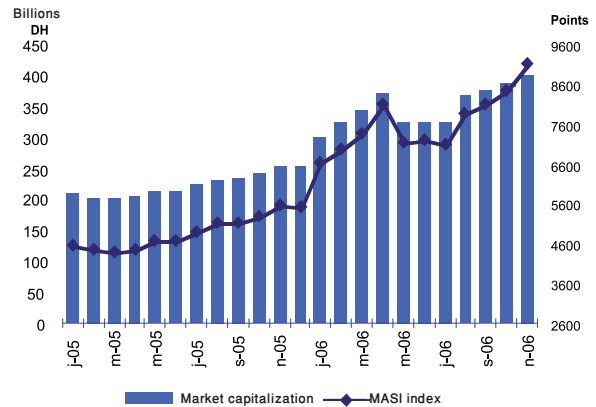
having risen by 64.7%.

The appreciation trend did concern also debt securities, whose prices have markedly risen, in parallel with the increase of demand and especially the revaluation of portfolios, linked to the fall of interest rates, particularly for medium and long-term maturities.

Concerning the prices of real estate assets, in light of fragmented data, their rising evolution would be accentuated, corroborated, among others, by the accelerating growth of real estate loans during the last years.

These loans are certainly intended to go hand in hand with the governmental policy aimed at facilitating real-estate acquisition as part of the «social housing» programme. They seem to contribute also to financing the purchase of medium and high standing housing, including by non residents, and the acquisition of plots of land. In a context of excess liquidity, banks display a growing interest in this segment of activity offering tangible securities.

Chart 4.12: Stock-exchange indexes evolution
in monthly data



Source: Casablanca Stock-exchange

5. MONETARY FORECASTS FOR THE YEAR 2007

5.1 Scenario 1: baseline scenario

The referential value for the growth of money supply M3 can be fixed at around 10%, considering a non-agricultural GDP growth of around 5%, an increase of prices up to 2%, and a drop of the speed of money circulation by 3%, in accordance with the past trend.

Money creation would result from a reinforcement of foreign exchange reserves by about 24 billions, corresponding to the estimated balance of payments, and from a rise in loans to the private sector by 28 billions or 8.5%, sufficient to support the growth of economic activity. Net claims on the Government should, as a result, register a limited increase.

The development of liquidity factors arising from this scenario would exercise an expansive effect of one billion dirhams, which would bring the outstanding surplus to more than 23 billion dirhams.

5.2 Scenario 2: the resulting money

Money growth would reach more than 13%. It would result from a flow of foreign currency corresponding to the estimated total balance of payments (+24 billions), as well as from a growth of loans, according to the needs of the economy as expressed by banks (+45 billions or 13,7%), and from a money financing of the Treasury reaching up to 2 billions (10% of the cash deficit).

Concerning more particularly claims on the private sector, banks' forecasts relating to the progress of credit reveal a growth of 14% in total outstanding amount, two percentage points of which are attributed to the expected increase in financial loans. As in 2006, real estate loans, with an expected annual growth of 23%, will continue to significantly contribute to the dynamics of

Table 5.1: Monetary forecasts for 2007

<i>In billions of dirhams</i>	dec. 06/ dec. 05		dec. 07 (S1)/ dec. 06		dec. 07 (S2)/ dec. 06	
		%		%		%
Net foreign reserves	30	18	24	12	24	12,3
- Bank Al-Maghrib	27	18	20	11	20	11,3
- Banks	3	19.1	4	21	4	21.4
Claims on Government	-5	-6.5	2	2.8	2	2.8
- Bank Al-Maghrib	0	0	-5.5	76	-5.5	75.5
- Banks	-5.6	-7.4	7.5	11	7.5	10.7
Lending to the economy	36	12	28	8.5	45	13.7
- Bank Al-Maghrib	-0.2	-2.7	0	0	0	0
- Banks	36.2	12.7	28	8.7	45	14
M3 aggregates	64	14	54	10	71	13.2

Table 5.2: Credit in 2007: banks forecasts

<i>In billions of dirhams</i>	2005		2006		Change 2006/2005		2007		Change 2007/2006	
						%				%
Credits¹ outstanding amounts	278 132	319 012	40 880	14,7	362 374	43 362	14			
Of which:										0
. Privatization operations	11 961	12 340	379	3.2	9 400	-2 940	-24			
. Other financial operations	3 567	3 334	-233	-6.5	3 600	266	8			
. New financial operations in 2007			0		10 000	10 000				
			0			0				
Total excluding specific operations	262 604	303 338	40 734	15,5	339 374	36 036	12			

Source: BAM, investigation among banks

bank loans. For the other loans, forecasts show that equipment credit will rise in 2007 due to the realisation of large-scale investment projects in the fields of tourism, petroleum and infrastructures.

excess liquidities to 19 billion dirhams by the end of December 2007.

This scenario would result in a restrictive effect of more than 3 billion dirhams, which will bring

6. INFLATION EVOLUTION

6.1 Evolution up to the end of October

On a year-on-year basis, the cost of living index (CLI) showed in October 2006 a rise of 4.1% against 1% during the same period of the year 2005. This increase is mainly attributed to a rise in food products price index by 5.1% caused essentially by a growth of the prices of fats, fruits and fresh vegetables respectively by 15.2%, 9.4% and 3.2%. As for the index of non-food prices, it went up by 3.4% against 1.6% a year earlier, largely because of the 8.5% increase in «transportation and communication» prices.

The indicator of the underlying inflation, which excludes fresh products, private transportation and some administered products, has registered a year-on-year increase of 3.6%, against 1.6% in the previous year.

During the first ten months of the year 2006, the average cost of living index has risen by 3.3% against 0.8% in 2005. This accelerating increase in prices is mainly attributed to the rise in fats prices by 16.7%, in meat by 3.6%, in fresh vegetables by 5.6%, in tobacco by 6%, as well as in the increased tariffs of transportation and communication by 10.1% instead of 3.5%.

6.2 Estimates for the year 2006

According to the evolution of both the cost of living index and the underlying inflation indicator, prices in 2006 registered an acceleration compared with the trend noticed in the recent years.

In fact, the rise of the cost of living index would move up to 3.2% instead of 1% in 2005. This accelerating pace is justified in part by the reorganization of the VAT for some products, food in particular, whose direct mechanical impact is estimated at 0.5%, as well as by the partial implementation of the indexing system, domestic prices of hydrocarbons having been raised in February and September

Table 6.1: Inflation and underlying inflation in 2006

	Year-on-year evolution for 2006				Annual rate			
	1st quarter	2nd quarter	3rd quarter	4th quarter	2003 2002	2004 2003	2005 2004	2006 ^F 2005
Inflation¹	2.1	3.7	3.7	3.3	1.2	1.5	1.0	3.2
Underlying inflation²	2.8	3.0	3.4	2.8	0.8	1.3	1.6	3.1

(E) BAM Estimates

(1) Source : HCP

(2) BAM Calculations

before being reduced in October.

At the same time, underlying inflation is expected to go up from 1.6% to 3.1% mainly owing to the increase of the tariffs of some services; such as public transportation, telephone calls, health care

and articles of personal use as well as water and electricity.

Box 6.1: The underlying inflation indicator

In Morocco, the evolution of consumer prices is monitored by means of a cost of living index that is very sensitive to the fluctuations of food prices. As part of fine-tuning the instruments it uses to analyze prices for the purposes of monetary policy, Bank Al-Maghrib, like the other central banks, has elaborated an underlying inflation indicator.

The construction principle of this indicator consists in making, on the basis of the consumer price index, another index that does not take account of the transitory shocks on the prices and retraces therefore the fundamental trend of inflation.

The underlying inflation indicator has been chosen on the basis of a comparative study taking into consideration a set of standards (robustness and absence of bias, availability of this index at the same time as the CLI, credibility and verifiability). It is calculated according to the exclusion method. Hence, were excluded from the cost of living index calculated by the High Commission for Planning (HCP) the prices of meat, fresh fish, fresh vegetables and fruits, as well as those of sugar, tobacco and private transportation.

7. INFLATION OUTLOOK

In the first quarter of the year 2007, the forecasts for the rise of the cost of living index reveal a rise which would revolve around 1.8% and 2.4% compared to the same period of the previous year.

Taking into consideration the following risks implies that, for the whole year 2007, inflation would very likely stand between 2.1% and 2.8%.

Economic activity would remain dynamic during 2007, and the pressures that have already weighed on some segments of the labour market could favour an upward trend of wages. Moreover, the recent multiplication of wage claims could fuel wage inflation.

Significant uncertainties remain about oil prices, and the easing of global inflation is not confirmed.

The substantial excess liquidities, accumulated during the last years, would increase in 2007, thus reinforcing the potential of households and firms' expenditure. This dynamic already produces powerful effects on share and real-estate prices.

Table 7.1: Inflation forecast for 2007

	Year-on-year evolution for 2006				2007 2006
	1st quarter	2nd quarter	3rd quarter	4th quarter	
Range of inflation forecast	1.8 2.4	2.6 3.6	2.0 2.9	1.9 2.8	2.1 2.8

ANNEX

بنك المغرب
بنك المغرب

بنك المغرب
بنك المغرب

THE CALCULATION METHOD OF PRICE CHANGES

The analysis of retail price is made on the basis of the cost of living index and its changes, as published by the HCP Statistics Department in the rough (not seasonally adjusted). It is completed by the analysis of seasonally adjusted indexes and the underlying inflation indicators made by the Bank staff.

The monthly change of prices is calculated and published by the High Commission for Planning by drawing the change in percentage from the general index of cost of living of the month under review compared to the index of the preceding month. In the absence of seasonally adjusted official series, the main correction brought to the price indexes published by the HCP Statistics Department deals with the rectification of seasonal changes which allows drawing the evolution of price trend. These seasonally adjusted indexes are internally calculated and used in our analysis but not published.

For the analysis of prices at the end of the year, two main methods are used by the central banks:

1- Change on a year-on-year basis: ratio between the December index of a given year and the December index of the previous year.

In principle, this method excludes the effect of the seasonality linked to the civil year calendar but not that linked to the lunar calendar which is mobile compared with the civil year (religious days and Ramadan in particular).

2- Average change of the year: year-on-year average of the 12 months of the year (average of the monthly ratios): for each month of the year calculation is made of the year-on-year change (index of the month compared with the same month of the previous year) as well as of the average of the whole year. Even more: ratio between the average of the monthly indexes of the year under consideration and the average of the previous year (ratio of the average of the two years).

The last method, the most frequent, presents the following advantages:

- In comprehending the change of price level for the whole year and not in comparison with the sole month of December, it better translates the analysis in terms of the year's balance sheet.
- The annual change is not strongly influenced by a brutal trend reversal during the last months of the year or by step and passing changes during the sole month of December (at the numerator or at the denominator). As an example, on account of the sharp increase of prices in November 2005, the CLI saw a rise of 2.1% on a year-on-year basis (December 2005/December 2004) while the change on annual average did not go beyond 1%. For the year 2004, the changes calculated according to the two methods were respectively of 0.5% and 1.5%.

	CLI changes in %			
	2002	2003	2004	2005
On average	2.8	1.2	1.5	1.0
Year-on-year basis	1.4	1.8	0.6	2.1

For Morocco, the use of this last method, defined for several years in coordination with the staff of the High Commission for Planning, is justified by the fact that the official CLI is not rectified from seasonal changes linked to the civil calendar and those linked to the lunar calendar. Moreover, the index is influenced by the strong volatility that affects the prices of some products, notably the agricultural one, especially as the number of articles to which they refer is relatively more reduced than that of consumer price indicators calculated in other countries.

Concerning the follow up of prices in the course of the year, most central banks analyze the indicators by using the year-on-year change (the index of the month under consideration against that of the same month of the previous year). Some central

banks take the index of the end of the quarter as a basis for their analysis.

In Morocco, the HCP Statistics Department publishes both the year-on-year change and the change of the averages calculated as from the first month of the year (ratio between the average of n months of the ongoing year and that of the same period of the previous year). However, it is this last method which is taken as reference in the appreciation and communication over prices evolution compared with the previous year. It is also the case for Bank Al-Maghrib, the National Institute for Economic Condition Analysis (INAC) affiliated to the HCP, and the Department of Research and Financial Forecasts of the Ministry of Finance.

These different methods are complementary and non exclusive, and are all used by economists in their analyses and price forecasts. Nonetheless, it is crucial that the central bank's communication be carried out on the basis of a constant and clarified method in methodological notes. To that end, the two methods, year-on-year (M/M-12)

and the average of n months of the year, may be published.

Focus will be put on the average for analysis in terms of the ongoing balance sheet and at the end of the year. However, the year-on-year method (M/M-12), which gives more weight to the recent trend, seems the most appropriate to be taken into consideration in monetary policy decision making.

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