Rundheersing Bheenick: Local currency bond trading and risk management

Opening address by Mr Rundheersing Bheenick, Governor of the Bank of Mauritius, at the Workshop on Local Currency Bond Trading and Risk Management, organized by the Financial Markets Association of Mauritius, Balaclava, 24 March 2008.

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It is a great pleasure for me to address you this morning at the opening of this Workshop. I consider the theme which you have chosen "**Local Currency Bond Trading and Risk Management**" quite topical at this juncture of the development of our domestic financial market. I salute the initiative of the Financial Markets Association and I would also like to add my own welcome to our resource person, Dr Graeme West.

I understand that this is the third workshop organized by the Association after those held in 2003 and 2006 which focused on Treasury and Risk Management, and Derivatives, respectively. Do I detect a slight increase in frequency here? Does this reflect the quickening pace at which things are happening in the financial sector these days? Be that as it may, such workshops help to enhance the skills of participants and enable them to keep up with the continuous innovations that characterize the changing financial landscape.

Skilled professionals and technicians are at the root of all innovations. A well-functioning bond market will help to create more growth and stability, not only in Mauritius, but also in the region.

As we all know, a deep and liquid bond market is a key component of a thriving financial centre. An efficient and mature bond market contributes directly to macroeconomic and financial stability. It constitutes an alternative source of funding which can help the corporate sector to reduce over-reliance on short-term foreign currency loans. Currently, in the absence of a properly functioning local bond market, issuers who qualify for bond financing must have recourse to international financial markets to finance their local projects and have to bear the attendant exchange rate risk. Local currency bonds can thus help to protect such issuers from foreign currency shocks. The improved financial intermediation resulting from an active bond market also brings such microeconomic benefits as efficiency gains and diversification of tools for both borrowers and savers.

Let me reaffirm that, as a trusted partner in economic development, the Bank of Mauritius is committed to promoting the development and efficiency of all markets, whether the foreign exchange market or the domestic money market and we keep a watchful eye on the stock market and other asset markets.

We see a need to add greater depth to the market. Central banks and governments share the responsibility to facilitate and promote the development of local bond markets, remove market friction and unnecessary restrictions, and provide an environment that is conducive to both supply and demand, that is to both the issuers and investors. Bond market development has been targeted by the central bank over the past years through various initiatives. This included the establishment of an appropriate market infrastructure that facilitates cost-effective and secure trading, and a transparent price discovery process. With regard to secondary market development, you all know that we set a Secondary Market Cell within the Bank in 1994. We established a Primary Dealer System in 2002. Treasury Bills have been listed on the Stock Exchange of Mauritius since 2003. We have re-introduced sales of Treasury Bills and Treasury Notes at the counters of the Bank of Mauritius last July.

The deepening of local currency bond market across a range of maturities will encourage increased participation by institutional investors. We have started issuing medium – to long – term bonds on a more regular basis to develop a benchmark yield curve for Government

securities across the whole spectrum. This will facilitate the development of a corporate bond market. In 2007, the European Investment Bank, with the State Bank of Mauritius and West LB from South Africa as lead managers issued Synthetic Mauritian Rupee debt in the international market. We are now considering a proposal from the World Bank for the Government to allow them to issue Mauritian rupee denominated or linked bonds

In the end, however, there is only so much that the authorities can – or should – do. Whilst these initiatives add up to the necessary conditions for market development, they are unlikely to prove sufficient on their own. However good the infrastructure may be, it is for the players themselves, that is the issuers, investors and the financial intermediaries to eventually determine the shape and size of the market. It is also of paramount importance that market players adopt a participative approach for the development of the money market, as the existence of trading limits are impeding the development of these markets.

Allow me now to dwell a little on the challenges that a small country like Mauritius is currently facing in the conduct of monetary policy. Today, the Bank of Mauritius finds itself confronted with the important challenge of reducing the rate of inflation, which stood at 9.0 percent at the end of February 2008, and preserving the competitiveness of the export-oriented sectors. And we must meet this challenge against a backdrop of unprecedented capital inflows which are driving up the exchange rate of the rupee.

With globalization, a small open economy receiving such large capital inflows faces the daunting task of managing these external flows to ensure macroeconomic and financial stability. Interventions by the central bank to purchase large amounts of foreign exchange from the market have an expansionary impact on the domestic money supply and pose severe challenges for the conduct of monetary policy.

Since mid-December 2007 the Bank has purchased a total amount equivalent to US Dollars 193 million from the domestic foreign exchange market. To sterilize the excess liquidity stemming from these capital inflows, the Bank has to issue central bank paper as we now have a separation of debt management from monetary management. This entails the issue of a huge amount of Bank of Mauritius Bills for monetary policy purposes, which has a potentially adverse impact on the central bank's balance sheet. The Central bank, as regulator, has a different role and a slightly different perspective compared to commercial banks, Our mandate is price stability, financial stability and the promotion of economic development. In the pursuit of these objectives, profitability becomes a secondary issue and at times like the present, we have to dip into our reserves to meet the costs. When balance sheet considerations conflict with other public interest, there is no doubt in my mind which way the Central Bank should lean.

We must explicitly recognize that there are costs for the central bank in running monetary policy. That is why the central bank is required to strengthen its balance sheet in order to manage the shocks impacting on the economy. The central bank's capital and reserves have to be strong enough to be able to sustain repeated intervention in the money market. Given the uncertainty surrounding the nature of capital inflows, it would also be prudent for the central bank in a small open economy to build up reserves as a cushion against a possible reversal of capital flows.

Presently, we have Treasury and Bank of Mauritius Bills with maturities of 91 days up to 364 days. Treasury notes with maturities of 2, 3 and 4 years and bonds with maturities ranging from 5 years to 29 years are issued on a regular basis. Lately we have introduced a 14 day Special Deposit facility. We feel that there is a gap between the 14 day Special Deposit Facility and the 91 day bill and in order to close the gap and manage the persistent excess liquidity in the system, the Bank is contemplating the issue of Central Bank papers with maturities of 1 and 2 months.

Let me say a word about exchange rate, a subject of much interest right now. As a matter of policy, the Bank allows the free play of market forces to determine the exchange value of the rupee. Our intervention in the domestic foreign exchange market is not aimed at offsetting

market forces, or at targeting any specific exchange rate. Our only objective is to smooth out unwarranted volatility in the rupee exchange rate and improve the functioning of the market.

In a brief interview that I gave to the "**Business Standard**" newspaper in India last week, I said that even if our economy was suffering from a deluge of foreign exchange inflows, most of the foreign exchange operations were confined to the spot market. This is why we want to encourage the development of a vibrant futures and forward market that will help in creating an active foreign exchange market and introduce newer instruments for exporters and entrepreneurs to hedge and trade in the financial services sector.

As regards the issue of risk management, it is a correct practice these days to use derivatives to hedge against unwanted volatilities. Derivatives can bring substantial benefits to the commercial community, in facilitating hedging and business planning. Such instruments enable financial institutions to offer a progressively wider range of services and achieve greater efficiency in the intermediation process.

Unfortunately, this is one area where Mauritius is lagging behind. The market for derivatives has not picked up significantly compared to other emerging market economies. I strongly believe that the domestic financial market is mature enough to engage in derivatives trading under proper regulation. The Bank is now considering the necessary measures that need to be implemented to stimulate the development of this market. I know that. In many quarters, derivatives have a murky reputation. We do not believe that derivatives necessarily lead to market manipulation, which would be bad for a small market like ours. Rather, we see derivatives as enhancing the efficiency of financial markets and this is why we are determined to put in place in the near future the necessary building blocks for its rapid development.

We are conscious that derivatives involve multiple extra policy responsibilities for the Bank. Derivatives and derivatives-trading have the potential to bring disaster if not properly supervised. Therefore one of the areas that the Bank will concentrate upon therefore is to ensure that risks are properly identified, and managed, and that downside risks which might threaten systemic stability are avoided.

As we move into these new pastures designed to deepen the financial market and broaden the range of financial products and instruments, we feel that it is also the right time to encourage Rating Agencies to start operations in Mauritius. In any case this move will also be beneficial to the sector as we move on to implementation of Basle II. The Bank has already stated its intention to sell data held by the Mauritius Credit Information Bureau to accredited Rating Agencies. All these concerted initiatives will certainly take us in the direction of developing the local bond market.

We also welcome the recent initiative taken by the Mauritius Bankers Association to kick-start discussions relating to the netting of financial contracts and applicable law of securities, based on the Model developed by the International Swaps and Derivatives Association (ISDA).We hope to move rapidly in this direction at the level of the legislative support required.

The Bank is once again pleased to associate itself with events such as the present one. My predecessor, Governor Basant Roi initiated this arrangement with your Association and I am happy to follow. We believe that it is part of our role to develop the skills of our treasurers and we try to achieve this through our participation in events such as this one.

Finally, I would like once again to commend this initiative of the Financial Markets Association to organize this workshop and I am sure that participants will make the most of it.

I now have the pleasure to declare this Workshop open. I hope you will find it instructive and rewarding.

Thank you.