Rundheersing Bheenick: Three sinister traps we need to face up to

Address by Mr Rundheersing Bheenick, Governor of the Bank of Mauritius, at the Annual Dinner in honour of Economic Operators, Port Louis, 27 November 2010.

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First let me extend a warm welcome to you all here this evening at this annual dinner which the Bank hosts in honour of our economic operators.

We are specially privileged to have with us, tonight, the managing director of De La Rue, one of the most historic partners, not just of the Bank but of our country. Our association goes back one and a half century. It was in 1860 that Thomas De La Rue, as the nascent company was then known, bagged their very first banknote printing contract, to supply Mauritius with three denominations. Would you believe it, they took three whole years to deliver on that first order! They must have improved on that pretty fast as they are today the world's largest commercial printer. De La Rue is celebrating its 150th anniversary this year and we shall be screening a short video clip later to mark the occasion.

The year has been one of change. The Prime Minister came back at the head of a new Government. All our banks thrived, not just survived. A new bank opens for business next month in December. Another one, an Islamic bank, is slated to begin operations in the first quarter of next year. And, just to remind, in 2010 I came back too, after a little lacuna, in which we had first, as a sequel of that little business of the street theatre, a Supreme Court judgment, followed by a judicial Enquiry, and then a new Minister of Finance. To adapt what the writer H.H. Munro, better known by his pen name Saki, said after his cook had left his service,

> *The former minister was a good minister, but as ministers go… he went.*

Ah well, *Sic transit Gloria mundi!*

If I may say, as in so many aspects of the market place, the outcome of this fiscal and monetary *contretemps* seems just to have followed the predictions of Newton's third Law of motion, which you will recall, says that

> *every action has an equal and opposite reaction.*

It has been, frankly, at times, a rather confusing experience, but as Alan Clarke, British diarist and former minister of defence, put it more colourfully,

> *"If you have bright plumage, people will take pot shots at you."*

That, unfortunately, is the fate of central bank governors, regularly fired upon, and occasionally just simply fired. The current Federal Reserve Chairman, the avuncular Ben Bernanke, may have created a new precedent after QE2 last month, by actually drawing fire from other governors and foreign governments. The eponymous Uncle Ben enjoys a solid reputation by guaranteeing the quality of his product, long grain rice. "Helicopter Ben", critics allege, now flooding the world with liquidity, seems to be destroying his by becoming a serial debaser of his product, the greenback.

One sad event this year was the passing of Vice-president Angidi Chettiar, who lived to a sprightly 83, even after five decades in the hurly-burly of politics. He was our Chief Guest at an event which the Bank hosted in this self-same venue to launch our 40th anniversary commemorative coin. We mourn his passing.

Looking back over the past year we have much cause for satisfaction; but aren't we just perhaps overdoing it a little? Why this sense of smug self-satisfaction? Why this palpable air of complacency engulfing us? This reflects a syndrome which we must combat for our own good. We should not gloat on our success. What Graham Greene said of his own profession, writing, is equally applicable to the economic performance of countries:

> *"...success is always temporary, success is only a delayed failure; and it is incomplete."*

Everybody tells us how well we are looking. Well done the government; well done the private sector; well done the workers; well done our bankers; well done the Press. Let us distribute *satisfecits* all round. I do not want to sound like a spoilsport but I want to raise the alarm. It does not suffice to be on the right track, as we undoubtedly are. We must also move fast, faster than the competition, if we are not to be run over. I venture to suggest that we are running the risk of falling into three particular traps, which await to ensnare unwary countries in our position. I call these three traps MIT, ELT and BLT, respectively.

I shall turn to them in a minute. But, just to put us in a good mood for a moment, let us rehearse the good news, before we try to stomach the bad news. Our net international reserves have increased by a full third over the last three years, rising from Rs 75 billion in January 2007 and topping Rs 100 billion for the first time in November 2009. Rest assured that we took steps to reduce our exposure to the dollar, the euro and the pound sterling, which together accounted for over 97% of our portfolio in 2007. Now, this has fallen to a more prudent 70%, with our dollar and euro exposures having been reduced to 35% and 25%, respectively, from 40 and 41% previously. Our SDR allocation and gold holdings make up nearly 14% of the portfolio, the balance being commodity currencies like the Canadian, Australian and New Zealand dollars and the Japanese yen.

The nominal value of that gold we controversially purchased from the IMF in November 2009, has risen by some Rs 570 million, perhaps the best investment the bank has ever made in its entire history; no wonder there is international talk about moving back to gold as a reference value, if no longer as actual backing, for paper currencies. The platinum coin we launched last year has increased 16% in terms of platinum value. The gold coin we launched here in 2007 did even better, its value increasing by 42%. That "*barbarous relic of a bygone age*", as Keynes dubbed gold, has not lost its shine over the centuries and may still be pressed into monetary service! So in this initiative we are ahead of the game, brickbats notwithstanding.

Our much-maligned exchange rate policy is another success story, to be celebrated, not decried. The MERI exchange rate index has been fairly stable, indicating that our policy has minimized volatility and maintained the stability of the exchange rate of the rupee. Had the Central Bank reacted, as many pressed us to do, and followed the euro in its wild gyrations, the economy would have suffered untold damage, with the poorest and most vulnerable strata of our countrymen taking the worst hits.

In the course of the year, the Bank ventured boldly in two complementary directions. We spent more than Rs 11 billion to purchase the equivalent of US$ 375 million in foreign currency, partly in an attempt to contain rupee appreciation. We sold less than half of this, only US$ 156 million, to the State Trading Corporation at favourable rates in a parallel attempt to finance food and fuel imports and thus to contain the impact of exchange rate rises on consumer prices. We were criticized for both of these moves, for doing ***too little*** in the first case – where some held that we should have driven down the rupee to the point where the worst-performing exporter could break even –, and for doing ***too much*** in the second case – where others took the view that the Bank had no business selling anything to the STC, in the first place! We were somewhat vindicated when, together with a supportive monetary stance, the inflation rate tumbled from double digits not too long ago (10.8%, year-on-year in September 2008) to an all-time low of 0.1 % in October last year, although it has picked up since and stood at 3.2% in October this year.

The domestic banking landscape has remained vibrant throughout, in stark contrast to the scene of distress and desolation in many other countries. While banks in much of the rest of the world are drowning in red ink, with bail-outs and nationalizations, our banks are thriving. Annual banking sector assets and banking deposits both grew by nearly 14% in Mauritius.

Advances increased by over 16%. And this happened while non-performing loans declined in the past two years from 2.4% to 2.1%. Banking profits over the twelve months, ending June 2010, were running at Rs 1 billion per month. Come to think of it, that's nearly Rs 50 million per working day. Quite an achievement for a population of less than 1.3 million, isn't it? And that, too, when the world economy is going through its worst crisis in a generation!

Little wonder, then, that the hard-pressed Minister of Finance couldn't resist dipping deeper into that kitty. When the Chairman of the Mauritius Bankers Association reacted to what his members no doubt thought was confiscatory overreach and retorted that banks constitute an easy prey, I was reminded of the story of Mr William Sutton. The name may not be familiar to many of you as by profession he was a bank robber. He enjoyed quite a reputation in that disreputable profession. When asked by a reporter after being sentenced for the umpteenth time for the same offence:

> *"Tell me, Willie, why do you rob banks?"*
>
> *"Because that's where the money is!"* was the classic reply.

Sutton is probably the only bank robber in history to give his name to a law. Sutton's Law states that in diagnosing a problem, start with the most obvious.

Apart from tempting Ministers of Finance, this kind of profit level may also indicate that our banks are perhaps overly conservative and could be a little bolder in fueling the economy. The sector where the growth of bank credit recorded its worst performance has been the manufacturing sector. There was actually a negative growth in credit to the EPZ. This tight banking posture may look good in the books of the banks, but it does not bode well for economic growth and innovation.

As many here will know, the G20 met earlier this month in Seoul to find ways of strengthening the global banking and financial system. Averting future crises is topmost on the agenda, neck to neck with stimulating and sustaining the recovery. The buzzword now is Basel III, whose tough capital requirements have got major international banks up in arms, lobbying furiously against the stricter provisions. Here in Mauritius, we have little to fear from Basel III as our banks are very well-capitalized. We have been proactive in this field with the imposition of a 10% capital adequacy ratio on our financial institutions, instead of the Basel II standard of 8%.

On the regional front within COMESA, we scored another success with the Regional Payment and Settlement System which will be run by the Bank of Mauritius and will be aggressively promoted by all participating central banks. The COMESA Monetary Institute, which will be hosted by the Central Bank of Kenya, will become operational by January 2011.

Now that is all pretty good news in anyone's book. Hey didn't we do well; we have survived. But where, as economic operators, is our vision beyond that? What legacy are we leaving for our children? I'm afraid the truth is, we find ourselves in a new third world of jobbing middle-income countries prone to be stuck with a future of uncertainty, volatility, and like many other SIDS, heightened economic and environmental vulnerability. As we face the coming decade, the awkward decade as yet without a name, the teenies perhaps, I fear we are likely to be overwhelmed by the three seemingly inescapable traps I mentioned earlier. MIT, ELT and BLT.

Just to titillate your curiosity, MIT here does not stand for the famous seat of learning in Cambridge, Massachussets, familiar to the academic boffins. ELT has a key role in avionics and air safety where it stands for Emergency Locator Transmitter but our ELT is much less benign. As for BLT, no I was not referring to the bacon, lettuce, and tomato sandwich you had for lunch. What on earth could I mean by MIT, ELT and BLT? And why should I be so scared of them, singly or in combination?

That's enough titillation for now! Let me clarify the mysterious acronyms: MIT stands for the middle income trap; ELT is the extended life trap; and BLT is the banking liquidity trap. I hope that, by the time I resume my seat, some of you will begin to share my concern that this formidable trio packs a very powerful punch indeed, and constitutes a veritable trifecta of challenge confronting our country.

This is not just my diagnosis of our current predicament. It is a recurring feature across the globe, especially common among middle-income countries. Hence the MIT label, the middle income trap. Nations from East to west, from Vietnam to Barbados, and from north to south, from Estonia to Botswana, suffer the same dilemmas. At the heart of MIT, we find the complacency which I alluded to earlier. A particularly virulent feature of MIT is the fact that those very factors that aided middle-income countries to effect the transition from low-income and underdeveloped status to their present more comfortable position in the middle income order, seem to undergo a genetic mutation and turn into factors which actually hold middle-income countries back, preventing their next transition to higher income.

Educated, broad-minded and subtle government leaders, a small set of second-generation wealthy bright local business monopolies, a pool of educated but none-too-skilled workers, creaking infrastructure and utilities unable to keep pace with development, policy inertia when not downright policy paralysis, accompanied or not by flows of aid, remittances and foreign direct investment, will not facilitate the new transition.

Prof Paul Collier reminded us the other day when he gave a lecture at the Bank of the tremendous pressure in slow-growing middle-income countries, which find themselves unable to keep pace with either the more dynamic developing countries fast catching up on them or the fast-growing middle-income countries getting further and further ahead of them. In the 2009 Industrial Development Report of UNIDO, Mauritius shows signs of becoming exactly such a slow-growing middle-income economy: we occupy the 55th position, far behind Malaysia (16th), Turkey (43rd), Tunisia (49th), and not that far ahead of Bangladesh at 87th position. In the “logistics performance index”, we do much worse, trailing in 132nd out of 150 countries.

Something has clearly gone wrong here, don’t you think? The report offers a generic explanation. Middle-income countries that developed a niche for themselves some years ago are now facing intense competition from new lower-income countries, eager to move up the ladder to middle-income category. The dynamic ones have enhanced the diversity and sophistication of the products they produce. The laggards are competing with low-income countries for space at the bottom of the export sophistication ladder. Joining in a race to the bottom is hardly an appealing prospect.

To avoid such a catastrophic outcome, we must spare no effort to reengineer, to plug the knowledge and skill gap with our Asian competitors, and do whatever it takes to restore our competitive advantage so that our exporters become once again a dynamic force of economic transformation. This calls for profound changes in the way we conduct our business; but therein lies the rub. We seem to have become deeply averse to change. To paraphrase Jean Monnet, the architect of the EU, when he observed the resistance to the formation of the European community and blind protectionism of their national interest by sovereign states in divided post-war Europe all heading for disaster:

> *“Man has a natural instinct to resist change until it becomes a necessity, and he won’t recognise necessity until he’s faced with a crisis.”*

But, let’s ask ourselves, do we really need a crisis to jolt us out of the Middle Income Trap?

We know we inhabit one of the most densely-populated countries in the world. We face a continued increase in population of some 5–7,000 people a year. Over the next ten years, this means an addition close to the size of the total population of the Seychelles. This increase is arising, not from increasing fertility which has been steadily declining from 2.05 to 1.5 over the last ten years, but rather from our longer life expectancy which has increased by 2 years for both males and females to stand at 69.5 and 76.6, respectively, over the same period. This is the ELT, the Extended Life Trap, the second leg of the trifecta to which I referred.

It has some very serious social, economic, and financial implications, which are not self-evident. We are living longer, healthier lives and surely that is a good thing, isn't it? Our very good performance on the Human Development Index is built on it. It is a feature we share with some advanced countries in the western world and surely that's a good thing too! Nothing to worry about there, one would be tempted to say! Where's the trap I'm going on about?

It all boils down to a question of affordability. As baby-boomers move into a long and well-deserved retirement, the pensioner support ratio is worsening, which means there will be fewer and fewer people in employment per pensioner. The median age has risen by nearly four years in the last decade from 28.5 to 32.1 years. By 2019, our population pyramid will look more like one of the gleaming tower blocks going up all over the place and less like a pyramid. Unfunded old age pensions and universal health care providing costly high-tech medicine to a growing number of senior citizens in the last years of their life may rapidly outstrip our capacity to finance them.

The recent experience of some countries such as France is there to remind us of the risks to which we expose ourselves if we do not undertake the appropriate reforms in time. The street demonstrations which followed in the wake of the French government's attempt to extend the retirement age also explain why policy-makers are so reluctant to grasp this particular nettle. Why incur the wrath of an unbridled electorate today to tackle a problem which is building up to explode only some time in the future? The Extended Life Trap, which brings a panoply of problems relating to fiscal sustainability and intergenerational transfers, may overwhelm middle-income countries if the underlying problems remain unaddressed.

Let me now come to the third component of my sinister trinity: BLT. This is the Banking Liquidity Trap. I do not need to tell an audience such as the one we have tonight of the importance of money and finance to a modern economy. With the global financial and economic crisis, there's scarcely anybody around the country who has not been touched in one way or another by its after-effects. The problem there at the epicentre of the crisis was a credit crunch arising from a *lack of liquidity* in the system. The problem here is an *excess of liquidity*, coexisting back-to-back with a credit crunch affecting some sectors. There, governments have overborrowed, or are doing quantitative easing, making financial markets and bondholders nervous and demanding higher returns and *driving up yields*. Here, Government is not rolling over all its domestic maturing debt, making banks awash with cash, and *driving down yields* on treasuries. That is why solutions applicable there cannot and should not be transposed here.

We have been cutting back the excess liquidity in the system. We did not panic when it hit nearly Rs 8 billion in mid-August this year when it equated to over 43% of the currency in circulation. This excess was partly driven by FDI inflows which we were forced to mop up in an attempt at partial sterilisation. We issued a rapidly-escalating volume of Bank paper during the year. In addition to short-term bills of maturity of up to a year, we found ourselves forced to issue notes of longer-term maturities, ranging from two to four years, to pick up the slack created by net redemption of Government paper. The amount of Bank of Mauritius paper outstanding now totals Rs 7.3 billion, comprising bills of Rs 3.8 billion and notes of Rs 3.5 billion. In spite of all these efforts, we still had an excess liquidity of nearly Rs 4.2 billion at the close of business yesterday.

Now, it is quite possible, indeed very likely, that the demand for loanable funds has fallen off as a result of the knock-on effects of the global economic crisis and the timid recovery. There is a famous law in economics to the effect that supply creates its own demand. They say a certain *Monsieur* Say said it. That law has been suspended, it seems. Whether in the vaults of commercial banks or at the central bank, excess liquidity is idle money. It is equivalent to keeping money under the mattress and not using it to put people to work and help business to thrive. If we take that together with the low net non-performing loan levels we have achieved, currently standing at just above 2%, and the profits of our banks, now running at Rs 50 million per day, we have some difficulty in understanding why the flow of credit to the export manufacturing sector has fallen so steeply.

In the mid-70’s, credit to the manufacturing sector accounted for 42 % of total bank credit. In the mid-80’s, this had halved to about 20%. In the mid-90’s, it fell to around 15%. In the last five years, this rapid decline continued and averaged a little less than 5%. What is still more disturbing than the relative decline is the fall in the actual volume of credit, which contracted from Rs 8.2 billion in June 2008 to Rs 6.6 billion in June 2010. The picture is not that dismal when we look beyond manufacturing at overall credit growth to the private sector. Here, absolute volumes are still rising, having more than doubled between June 2005 and June 2010, from Rs 102 billion to Rs 217 billion. But the rate of overall credit growth has also been decimated in this period, from an annual 26% to only 8%.

All this gives us cause for serious concern. Are our banks perhaps becoming too risk-averse? Is there an unmet demand for loans in parallel with excess liquidity in the system? If so, aren’t we failing to tap our full growth potential? By becoming too conservative, are our bankers doing us a disservice? It would be foolish to suggest that the bottom line of banks does not matter and we are not saying that. We certainly do not want to add our island to the list of states such as Iceland and Ireland, coincidentally island-states, with a sad experience of what happens when banks become reckless and take excessive risks. Here, we are far from that kind of situation. I think it is legitimate to ask ourselves if our banks are just possibly focusing too much on their bottom line, to the detriment of the top line for the country as a whole? And if so, we should examine what measures we could take to get credit flowing again to the sectors in need. We should put our money to work for the people. That is the business of banks: fuelling business.

So, there we are facing this sinister trinity of MIT, ELT and BLT. If we become complacent with our recent success, and rest on our oars, if we end up believing the picture-perfect image of our island of our tourist brochures, we run the risk of being swept downstream. If we do not carefully navigate our way out of the troubled waters that these traps generate, we may put at risk, not just our progress, but also our hard-earned gains in the economic sweepstakes if not our very survival in the global economy. We may be staring at nothing less than the perpetual and progressive impoverishment of our people if we don’t extricate ourselves from these traps.

To escape these traps, we need to face up to the multiple challenges they pose. Most of them go well beyond monetary policy and the narrow remit of central banks. Some intensive soul-searching is called for. Is it healthy for many of us to continue to worship at the altar of a weak rupee? Should we saddle our poorer compatriots with the additional burden of paying for currency depreciation? A sliding rupee will push up prices in our import-dependent economy, reduce disposable incomes of consumers, and result in a net transfer of national wealth to richer exporters. Ultimately, what is at issue here is a question of social choice. To address it, a strong leadership is a must. But so is a clear and agreed framework for action in a context of continuing policy analysis. I hesitate to call it a five-year plan for fear that one of our honourable guests present here tonight might just find in it, with a little further stretch of the imagination, the confirmation of his recent startling observation that the Bank of Mauritius Tower is now leaning in a Leninist direction!

Voltaire, the pre-revolutionary writer, political scientist and wit, observed that:

> *“Governments need both shepherds and butchers.”*

We have got the shepherds. Bring on the butchers! Let’s be done with the sacred cows standing in the way, sapping our vitality! We need new champions to propel us to the next stages of development, which is about achieving fresh integrated economic, social and environmental harmony. Let us not just sit back and say well done the government, hurrah for our visionary Prime Minister and a pat on the back for the Minister of Finance. We need to snap out of our complacency. Above all we must escape our own hubris.

But this is a celebratory dinner and I have somewhat wandered off course trying to foretell the future of our nation and provide some guidance through our troubled waters ahead. So I shall just leave you with a new law for survival. On similar occasions in the past, I have given you the Maradonna theory of interest rates, and the Einstein theory for success. I have this evening already made reference to Newton's third law of motion and Sutton's Law, a law grounded in solid bank robbing experience. So let me now offer, for your digestion, Winston Churchill's law for survival in public office: "*It is*", he declared,

> *"…the ability to foretell what is going to happen tomorrow, next week, next month and next year; and to have the ability afterwards to explain why it did not happen."*

Let me conclude, Distinguished Guests, Ladies and Gentlemen, with some wise words from a former chief executive of Shell Oil, which serve as a golden rule in his industry. Although couched in the language of the oilman drilling for oil, it is sound advice, readily applicable to public speaking, as you will appreciate:

> *"If you are not striking, stop boring!"*