R Basant Roi: Present challenges of monetary policy in Mauritius

Address by Mr R Basant Roi, Governor of the Bank of Mauritius, at the annual dinner with major economic stakeholders, Sugar Beach Resort, 28 November 2003.

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Ladies and Gentlemen

Good evening

I am pleased to welcome you to the Bank of Mauritius Annual Dinner.

Right from the year I set the tradition of holding an annual dinner with the major economic stakeholders in the country I focused mostly on regulatory and supervisory issues in my addresses. Intentionally, I chose certain regulatory and supervisory issues as the leading themes of my addresses for reasons that I strongly believe should be clearer by now.

Tonight I shall briefly outline the present challenges of our monetary policy in the context of an external environment characterized by uncertainties. Before I proceed with the main theme of my address let me reiterate a few remarks I made in the post February 2003 months this year. The perceptions that emerged in the wake of the discovery of a fraud at the Mauritius Commercial Bank (MCB) inevitably make it compelling that I should re-emphasize some of the remarks. The guiding principle of any regulatory and supervisory authority in any economic and financial system is to first and foremost attempt to save troubled financial institutions. The legal frameworks of regulatory and supervisory authorities are designed to promote financial stability rather than to jeopardize financial stability. This is what is envisioned in the Bank of Mauritius and the Banking Acts. The Acts are an instrument that empowers the Bank of Mauritius to promote and sustain monetary and financial stability. Regulatory and supervisory authorities the world over do not use any of the provisions of their laws to defeat the very objective of the laws. Arbitrary decisions motivated by emotional or even personal considerations should be set aside in favour of a genuinely professional approach of sustaining the soundness of banks in situations similar to the one the Mauritius Commercial Bank found itself in. The regulatory and supervisory authority cannot but exercise its independence of mind. Without being presumptuous the MCB/NPF case was handled by the Bank of Mauritius in a manner that best serves the interests of our financial sector and of our economy. I should like to re-underline that supervision of banks is control and procedure oriented and not transaction oriented. Viewed in the light of determined steps taken by the MCB in the realm of risk management along with a number of other prudential measures taken in the months after the discovery of the fraud, the MCB/NPF case is expected to be over soon as far as the Bank of Mauritius is concerned. Regulatory issues relating to the Worldcom and Enron scandals in the US were dealt with and settled within a few months. Our banking industry is blessed in having to surmount only one tyranny: adverse publicity motivated by considerations that go beyond acceptable norms of conduct. The Bank of Mauritius will ensure that the steps taken by the MCB to fully revamp its internal controls and procedures are carried through to the finish and that internal controls are appropriately exercised and procedures are strictly followed. Suffice it to say that the MCB/NPF episode, despite the traumas associated with it, serves a good lesson to our financial industry.

Having said that let me turn to the main theme of my address tonight. As I explained in April last at a Seminar a full appreciation of the Bank’s monetary policy stance requires a perspective stretching beyond a few months or even beyond a single year. A few months or even a year is rather a short time to really gauge what monetary policies of central banks can accomplish on a lasting basis. Monetary policy tends to impact on economies with a long and variable lag. Unforeseen events having undesirable consequences for economies can take place in minutes. Predictability of the course of monetary policy is disturbed in such circumstances.

Policies in the post World War II were quite predictable. They were predictable because of the steady economic performance of the leading economies of the world in the context of a remarkably stable international socio-political and economic and financial environment. Central banks and governments all over the world enjoyed full sovereignty in policy making. In sharp contrast, the international socio-political and economic context is far from being that predictable today. Additionally, in the wake of financial liberalization across the world, with an estimated US$1.2 trillion being traded daily, capital moves in and out of countries with a remarkable ease and at a speed never witnessed before. The monetary policy stance of one country affects the monetary policy of another and in this process part of our sovereignty in monetary policy-making is thus lost. Central bankers necessarily have to constantly watch their radar screens and determine for themselves how to steer their monetary policy in the best interest of their economies. “The manner in which central bankers must operate can be compared to the decisions people make whenever they cross the street. If there is no traffic, there is little risk, and pedestrians don’t need to worry about the speed with which they cross the street. But if the road is heavy with fast moving traffic, it’s a different story, and safety demands that pedestrians wait until they are confident they can make it to the other side. The same holds true for central bank governors.”

The introduction of the Euro, the September 11 attacks that impacted seriously on the US economy which is an importer of the last resort, the ever growing instability in the Middle East, the disagreements over trade policies and tendencies for countries to resort to protectionist measures in one form or the other, volatility in the exchange rates of major currencies in the international exchanges as well as the weak performance of most economies across the world have not made monetary policy making here and abroad a plain sailing endeavour. Successive years of uncertainties intensified by events beyond the control of central banks have increasingly blurred visibility. Central banks have to constantly chart a safe way forward in this world of unexpected twists and turns of events.

Five years ago, substantial capital outflows triggered by a loss of confidence in the rupee had brought down the foreign reserves of the Bank of Mauritius to unacceptable levels. The rapid weakening of the Euro in the international exchanges following its introduction in January 1999 translated into a significant appreciation of the rupee. And that appreciation of the rupee was a quick reversal of the preceding three years of rapid depreciation of the rupee. The mood of pessimism that emerged in the wake of the September 11 attacks brought down the world economy to the throes of deflation. Central banks around the world effected a series of cuts in interest rates in a bid to revitalize their respective economies. Notwithstanding the policies adopted by central banks, the leading world economies entered a period of balance sheet recession in recent years. In the wake of drastic fall in equity prices, many companies the world over could no longer afford to maximize profits. They chose to restructure their balance sheets for corporate governance so demanded. However, the household sector continued to save money and the business community almost stopped borrowing money even at low rates of interest. This is a peculiar situation or rather a fallacy of composition problem that exacerbated the recessionary trend in the world economy. Monetary policy becomes much less effective when only few companies are willing to borrow in this type of a recession. Fiscal policy takes over as an absolutely important instrument to boost up aggregate demand as well as to keep money supply from shrinking.

In such troubled waters the navigational hazard is impaired visibility, which is quite often the case. Monetary policy judgments become a question of balancing risks more so in a small open economy like ours with all its vulnerabilities. Observers from outside the walls of the central banks may find monetary policy making a mechanical process as described in textbooks hardly realizing that in such circumstances policy decisions are more about weighing probabilities. This is an area in policy making where even thinking people do differ in the judgments regarding the course of policy actions. I cannot claim divine insight. Nor do I think anyone of us here may claim having been gifted with such an insight. However, it would be surprising if all of us always agreed in the judgments. When everyone agrees with each other all the time no one is really thinking enough. Criticisms of the Bank of Mauritius policy stance are profoundly appreciated so long as the criticisms are educated criticisms.

The hazard posed by troubled waters abroad and the third party threat to the competitiveness of our Export Processing Zone has rendered the conduct of our monetary policy quite a puzzling exercise. Basically, the conduct of monetary policy in recent years has aimed at bringing down the rate of inflation. The informal inflation targeting approach of monetary policy making has paid good dividends. The average inflation rate in the first five years of the 1990s was 6.8 per cent, 6.1 per cent in the second half of the 1990s and 5.2 per cent in the last five years. For the current year the rate of inflation is forecast at close to 4 per cent. Clearly, the tendency is for the rate of inflation to either post a further marginal decline or to stay at the current rate of around 4 per cent. That excessive monetary tightening could adversely affect growth performance of our economy is a consideration that is well borne in mind.

The successive cuts in interest rate like in several other countries have induced borrowings but not to the desired extent. The pace of bank credit expansion is currently subdued. Some corporate bodies are borrowing in foreign currencies substituting for borrowings in rupees. While the rates of interest on foreign borrowings are lower compared to the rates of interest charged by local banks, borrowers need to be mindful of the risks involved. Risks associated with external borrowings could turn out to be high. With the upside risk of inflation being minimal in the foreseeable and the need for re-aligning interest rate parity being felt in order to prevent a built up of short-term foreign liabilities, the Bank of Mauritius effected a further cut in the rate of interest yesterday.

Against a backdrop of four successive years of surpluses recorded in the current account of our balance of payments and less than buoyant aggregate demand in the economy, the Bank faces a policy dilemma. The market is flushed with liquidity for quite sometime. Excess supply of foreign exchange has given rise to a situation of excess rupee liquidity. In the last two years the Bank of Mauritius purchased foreign currencies on the domestic market for an amount equivalent to over US$500 million. The rupee counterpart of the purchases amounted to around Rs14 billion that has ultimately landed in the balance sheet of the Bank of Mauritius as well as in the balance sheet of Government. The interest burden on this rupee counterpart of the foreign currencies purchased by the Bank is indeed heavy. To what extent the Bank can keep buying foreign currencies on the market remains a complex policy question should the considered view that the current exchange rate level have to be maintained.

Given the volatility of exchange rates on the international foreign exchange markets should we take the exchange rate of the rupee as a given price to us ignoring all considerations regarding domestic economic fundamentals? Economics textbooks teach us that in a market economy, the invisible hands of the market promote economic efficiency. Do we systematically take what the international financial markets decide as given to us despite the common belief that the invisible hands of the market often suffer from arthritis? Sometime back a Council member of the European Central Bank likened the behaviour of currency markets to herds that all ran in the same direction. He had this to say, “I have met a lot of sheep who know they are running in the wrong direction. But they only want to run in the opposite direction if they are certain the rest of the herd will follow.” The problem is how best the determination of the exchange rate of the rupee in our foreign exchange market reconciles domestic economic fundamentals with what the international financial markets dictate to us. The Bank’s policy concern is about the need for stemming excessive foreign exchange inflows while sustaining the current exchange rate levels. This is a policy dilemma not only specific to Mauritius but also to giant economies like China and others. The Bank of Mauritius has but only one instrument to strike an appropriate balance and that is interest rate.

In the last 30 months the Bank of Mauritius reduced interest rate on 9 occasions. The Lombard rate was reduced step by step from 12.5 per cent to 9.75 per cent. The Prime lending rates of banks fell from 11 per cent to 8.5 per cent; it will be further reduced as a result of yesterday’s cut. However, borrowers with default risk pay a premium over the Prime lending rates of banks. The higher the default risk the higher is the premium. Monetary policy has its limits; it cannot influence the premium in either direction. In this policy scenario savers face the vicissitudes of interest rate not only in Mauritius but the world over. Our household sector has traditionally placed its savings with banks. Risk averse investors, particularly those depending on their pensions for a living, have not had the benefit of risk-free investment avenues. In December 1998 the Bank of Mauritius started with the sale of Treasury bills over-the-counter to individuals. Over Rs4 billion from more than 11,000 individual investors were soaked up by the Bank of Mauritius. Evidently the market for Government debt instruments has a growth potential in Mauritius.

The sale of bills was subsequently suspended in view of our decision to develop a secondary market for Government debt instruments. There have been many requests from the public to the Bank of Mauritius for the regular sales of Treasury bills over-the-counter. Though helpful as a rudimentary method of conducting open market operations in a less developed market, the sale of Treasury bills over-the-counter by the Bank of Mauritius is not the way forward. We have decided that Treasury bills and over time other Government debt instruments be traded on the Stock Exchange of Mauritius. Our Stock Exchange has good operating characteristics for trading in Government papers. We expect the market to eventually develop into a bond market with an efficient system of good price discovery. The Bank of Mauritius, the Stock Exchange of Mauritius and Stockbrokers have made united efforts to start trading sometime in the next few weeks. The Stock Exchange of Mauritius and stockbrokers will come up with more details this December.

The Bank of Mauritius has a keen interest in the development of the market for Government debt instruments. Such a market would provide the Bank with a good medium for the conduct of its monetary policy.

Ladies and gentlemen, my address tonight is based on a decision to make the monetary policy stance of the Bank of Mauritius increasingly more transparent. It is an adopted practice among central banks in most countries to move for transparency in the area of monetary policy making. I for one do really believe in it and will move further in this direction. Before concluding may I say that the Bank of Mauritius will live up to the challenges of monetary policy in the years ahead. In an uncertain external environment the Bank has so far charted the best possible course to support non-inflationary growth. The Bank will pursue the course in the same spirit.

May I on behalf of the Board of Directors of the Bank of Mauritius and on my own behalf wish you and your family Merry Xmas and a Happy New Year.