Rundheersing Bheenick: Comprehensive reflections on economic and financial activities in Mauritius during 2007

Letter by Mr Rundheersing Bheenick, Governor of the Bank of Mauritius, to stakeholders, Bank of Mauritius, 28 December 2007.

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Dear Stakeholders

As you may be aware, in its endeavour to foster a rapid and sound development of the financial sector, and a stable macroeconomic environment, the Bank of Mauritius has heightened its interaction with stakeholders in 2007. I welcome the positive response of economic agents to the Bank's new communication strategy and wish to emphasise that the Bank is committed to pursuing this strategy, as transparent communication is crucial in enhancing the credibility and impact of its policy decisions.

The participative approach adopted by the Bank has permitted prompt handling of issues affecting the banking industry. The Bank hosted seven meetings of the Banking Committee in 2007, a marked departure from the previous quarterly schedule. Special meetings were convened to discuss specific issues for rapid implementation. I have to thank Chief Executives of banks for their collaboration and continued support in all the on-going projects.

As we close 2007, it is with pleasure that I review developments in the economic and financial landscape during this year, and look forward to some of the most important tasks awaiting us in 2008.

This year has seen a rebound in economic activity with real GDP growth rate forecast at 5.6 per cent compared to an estimated 5.0 per cent in 2006. This was mainly driven by the tourism and construction sectors where growth rates are forecast to jump from an estimated 3.5 per cent and 5.2 per cent, respectively, in 2006 to 13.1 per cent and 15.0 per cent this year. These high growth rates compensated for (i) the slowdown to 3.5 per cent, from 4.0 per cent in 2006, forecast in Manufacturing despite a significant recovery noted in Textile, and (ii) the contraction of 6.8 per cent forecast in Agriculture, including sugarcane.

Most economic indicators have improved during the year. Capital formation, excluding the purchase of aircraft and marine vessel, accelerated. The unemployment rate went down to an estimated 8.8 per cent in 2007 compared to 9.1 per cent in 2006. The budget deficit fell to 4.3 per cent of GDP, down from 5.3 per cent in 2006, as Government pursued its fiscal consolidation efforts. From January to October, broad money liabilities grew by 10.0 per cent while bank credit to the private sector increased by 5.2 per cent, compared to 8.6 per cent and 13.8 per cent in 2006. Inflation, which was at 8.9 per cent at end-2006, climbed to 10.7 per cent in June before gradually trending down to stand at 9.1 per cent in November and is now expected to fall to 8.8 per cent in December.

On the external front, during the first three quarters of this year, the current account registered a deficit of Rs8,659 million, with the deficit in the third quarter lower than the deficit recorded during the same period last year. Foreign direct investment (FDI) in the country from January to September, estimated at Rs9 billion, was already higher than the total of Rs7.2 billion recorded in 2006. FDI flowed mainly from the United Kingdom and the United States into Tourism, principally the Integrated Resorts Scheme. As a result of the improvement in the current account balance, reflecting combined higher surpluses on the services, income and current transfers accounts, and higher FDI and portfolio flows, the overall balance of payments showed a surplus of Rs12,114 million up to September, as against a deficit of Rs4,573 million in 2006.

Against this background, expansion of the Financial Intermediation sector was sustained with a growth rate of 7.3 per cent forecast this year. The banking industry has been particularly dynamic, with the entry of new participants and existing banks carrying on the expansion of their local and regional branch network. Three licences to newcomers in the industry were due to be delivered this year. However, only one new licence has been issued. The other two proposed licensees have instead taken over two existing banks. Three new branches opened in the country during the year and approval has been granted for the opening of a regional branch. In addition, 27 new Automated Teller Machines were installed by banks during the year.

Market players continued to broaden their offer of banking products and services with competition growing fiercer for market share. New segments are opening up in the industry and next year will see additional entrants as the Bank is contemplating the issue of licences to more moneychangers. In this respect, the Bank has reviewed the regulations and licensing procedures of money-changers and foreign-exchange dealers to encourage more competition and raise standards.

In general, the growth in banking stems not only from domestic operations but also from international business. In fact, business conducted with non-residents has increased by 30 per cent since last year, indicating that banking is surging beyond geographical boundaries, with our banks able to compete successfully both regionally and internationally. It may be highlighted that out of total growth of Rs135 billion in total banking assets during the year, over 80 per cent is attributed to business conducted with non-residents and Global Business Licence holders.

Banks are growing not only in size to meet the growing demands of a buoyant economy, but also in sophistication. Needless to say, increased activity in the sector has heightened competition for skilled manpower, giving rise to lateral staff movement and even staff poaching in many cases. Consequently, the sector has seen a sharp rise in salaries at middle-management and higher levels.

The continuous evolution of the domestic financial environment and the need for domestic banks to keep up with competitors in an increasingly globalised economy has led the Bank to formulate appropriate strategies in various domains to shape the Bank for the future, and review its internal organisation structure.

In 2007, the Bank implemented a number of changes to its policy-making process and operations. The Monetary Policy Committee (MPC) was set up on 23 April. Following the amendment of the Bank of Mauritius Act 2004 in August, the MPC is empowered to formulate and determine the monetary policy of the Bank. The MPC consists of the Governor as Chairperson, the two Deputy Governors, two Board Directors, and three external persons having recognised experience in the field of economics, banking or finance, one of whom is a Professor of Monetary Economics at the University of Frankfurt, Germany. The MPC also benefits from the wide-ranging experience of an Adviser, a former Governor of the Bank of Argentina and the current Director of the Centre for Central Banking Studies of the Bank of England. In the current setup, there is a possibility that the Bank's executives may find themselves in a minority position in the MPC.

The MPC met three times this year to decide on the stance of monetary policy. The key Repo rate was increased by 75 basis points at the June meeting as inflation was hovering in the double-digit region, and there were significant upside risks with regards to international commodity prices. The two subsequent meetings of the MPC maintained the tight stance of monetary policy taking into consideration domestic developments and the potential downside effects on the US economy of the sub-prime crisis. The outlook is that, barring any potential shocks stemming from high oil and commodity prices, inflation will continue on its downward trend.

An important prerequisite in the fight against inflation is for the central bank to disseminate information effectively on monetary policy issues. As provided in the Bank of Mauritius Act 2004, the Bank publishes a Monetary Policy Statement after each MPC meeting to explain the main assessments and findings of the MPC. The Statement also discloses the voting pattern of the MPC members.

In the implementation of monetary policy, the Bank has as far as possible limited its market interventions and allowed free play of market forces. In the domestic foreign exchange market, the Bank intervened to sell foreign currencies for an amount of US$48.8 million to alleviate excess demand in the first two months of the year before purchasing an amount of US$252.8 million between February and April as the situation turned around and the rupee stabilised. With an appreciation in the rupee exchange rate of about 9.4 per cent against the US dollar from January up to November, the Bank intervened again in early December to purchase Euros 40.5 million from the market. In the same vein, the net foreign assets of the Bank are estimated at around Rs51 billion as at end-December, that is, an increase of some 16 per cent since the beginning of January.

In the domestic money market, this year provided the first occasion to test the new monetary policy framework introduced in December 2006. To reduce excess liquidity prevailing in the system and to keep the overnight interbank interest rates within the corridor around the key Repo rate, the Bank conducted a number of reverse repos and issued some Rs14 billion of Bank of Mauritius Bills. As participation at the weekly auctions did not always reflect the forecast excess liquidity positions of banks, and there seemed to be a risk that the Bank's intervention would actually lead to more volatile yields, the Bank became reluctant to use reverse repos after May.

There seemed to be a wedge between effective excessive liquidity, as showed in the bidding behaviour of banks, and liquidity levels forecast by the Bank's models. In an attempt to tackle this, a new facility in the form of a Special Deposit was established in November whereby banks were invited to deposit their excess funds with the Bank for a period of 14 days at a rate that was below the lower bound of the corridor. It is expected that further adjustments will be required in 2008 to the monetary policy framework to take into account the apparently quasi-permanent excess liquidity conditions in the domestic money market.

In an effort to enhance market liquidity, improve the price-discovery process, and develop a more effective transmission of policy decisions, the Bank re-introduced over-the-counter sales of Bills and Treasury Notes on 24 July. The number of primary dealers was also increased from five to eight to spur more competition in the secondary market. A total of Rs306 million of Bills and Notes have been sold over the counter to date. For comparison, since January, Bills sold on the Stock Exchange totalled Rs118 million. Generally, the outcome of the measures to develop the secondary market has been fairly moderate but it constitutes a basis to build upon in the coming year.

With a view to assisting the Bank to achieve its objectives, and given that real sector issues play an important part in monetary policy decisions, the Bank embarked in September on a series of consultations with private/real sector stakeholders to gauge their perceptions with regard to specific issues, such as the evolution of the main macroeconomic indicators, labour market developments, access to finance, and to identify the domestic and external constraints they face. The Bank intends to maintain regular contact with stakeholders of the real sector as we need to weigh real sector issues more adequately in our policy decisions.

The implementation of Basel II by the March 2008 deadline constituted another major challenge for the Bank this year. Substantial progress was made in 2007 towards the implementation of the standardised approach to credit, market and operational risks. The Bank has tried to adapt the Basel II framework to the specificities of the Mauritian banking sector, which is set to benefit substantially from the new capital adequacy framework. The Bank adopted a collaborative approach with commercial banks for the implementation of Basel II, with working groups comprising both central bank and commercial bank Officers. A special Banking Committee meeting was held in September to review the implementation of Basel II by banks, which seem well poised to meet the set deadline. Although we are still at an early stage on this long journey, improvements in the risk management systems of banks have already been noted as the requirements of Basel II are gradually being applied by banks.

It is expected that Basel II compliance will create the required platform for improving business decisions and increasing competitiveness in the sector. In this perspective, and taking into consideration changes in international accounting standards and the legal framework, the Bank has been reviewing its Guidelines to enable a more effective capture of risk management and market disclosure.

The challenge of Basel II has necessitated the training of staff in Basel II compliance. The Bank has deployed the necessary resources to that effect. The Bank, jointly with Deutsche Bank (Mauritius) Limited, organised a training course aimed at the Bank's staff as well as staff of commercial banks on Basel II implementation. The Bank's staff also attended courses offered by the Financial Stability Institute and the Bank for International Settlements (BIS) in Switzerland. It goes without saying that such training is on-going to ensure that our staff acquire specialised knowledge for successful implementation of Basel II.

Still on the supervisory side, and as part of the process of promoting a more structured collaboration and co-ordination between the two domestic regulatory and supervisory bodies, a *Protocole D'Accord* was signed on 12 July. A Joint Bank of Mauritius / Financial Services Commission Co-ordination Committee was set up to activate and expand on the existing Memorandum of Understanding between the two bodies with a view to consolidating the supervision of the financial sector and harmonising the regulatory framework.

The modernisation of the cheque-clearing system in Mauritius has reached an advanced stage, with the cheque truncation project expected to go live next year. Cheque truncation refers to the process by which cheques are cleared electronically without any physical movement. Banks can also utilise this technology to facilitate the clearing of cheques over the counter to provide a better service to their customers. Cheque truncation represents a paradigm shift in the processing and clearing of cheques and is a milestone in the modernisation of the cheque clearing and settlement process started in November 2002. Currently, it takes two days to clear a cheque after its presentation for clearing. Some 21,000 cheques for an amount of Rs900 million are presented for clearing every day; this gives an indication of the scope for faster and more efficient cheque clearing.

In its endeavour to enhance credit quality in the banking sector, the Bank is progressively lowering the reporting threshold for credit facilities at the Mauritius Credit Information Bureau (MCIB). The threshold, which stood at Rs100,000 for individuals and Rs500,000 for corporates, was reduced to Rs25,000 for all categories in November, and as from 1 March 2008, the threshold will be abolished altogether. In 2008, non-bank deposit taking institutions, in particular leasing companies, the Mauritius Housing Corporation, and possibly insurance and finance companies, will be joining the MCIB to enable a wider capture of credit data for better decision-making. It is expected that improving overall credit quality in the financial sector will contribute to lower costs and narrow interest rate spreads, a subject of concern to us. As regards the MCIB itself, it should be noted that early this year, the Bank turned down the offer of a reputed rating agency to acquire the MCIB.

During the year, the Bank has been actively setting the pace for the implementation of Islamic banking services in Mauritius so as to enrich the panoply of services already offered by the industry. The Banking Act 2004 was amended in August to accommodate the setting up of Islamic banking. In November, the Bank has been admitted as an Associate Member of the Islamic Financial Services Board, an international standard-setting organisation whose prime objective is to promote and enhance the soundness and stability of the Islamic financial services industry worldwide.

The Bank is presently finalising the regulatory and supervisory framework that will govern institutions offering Islamic financial services. Existing banks can opt to offer such services through a window, or alternatively, such services could be provided through a full-fledged Islamic bank. Draft guidelines will be issued to the industry for consultation early next year.

Striking the right balance between regulation, supervision and market discipline is a big challenge for all regulators. While overregulation may impede the development of the financial system and slow down growth, deregulation may bring about banking fragility. Therefore, it is also the duty of all market players to act in a responsible manner. The financial system of Mauritius was evaluated by the joint IMF/World Bank Financial Sector Assessment Programme (FSAP) mission during 2007. A first FSAP mission that assessed the overall financial sector in February has already submitted its *Aide Memoire* as well as an action plan. A second mission conducted a thorough examination of the Anti Money Laundering/Combating the Financing of Terrorism (AML/CFT) framework and practices in Mauritius in September/October and has already submitted its draft report. The recommendations of the FSAP missions should serve as a basis to foster sound development of the financial sector.

The Bank has also received Technical Assistance missions from the IMF on Balance of Payments statistics and on the functioning of the foreign exchange market. In addition, a "Report on the Observance of Standards and Codes" mission of the IMF conducted a review of Mauritius' statistical systems and assessed its data dissemination practices against the prescriptions of the Special Data Dissemination Standards in early December. Following discussions with data producing agencies, and responses from data users, the mission has developed a set of recommendations designed to increase our adherence to internationally accepted statistical practices and enhance the analytical usefulness of produced statistics. The Bank intends to implement these recommendations early next year.

One area where progress has been limited during the year relates to the designation of an Officer to be the Ombudsman for banks, as provided by Section 96 of the Banking Act 2004. According to the Act, one of the functions of the Ombudsman would be to deal with complaints against financial institutions by their customers. Consultations are on-going with the Commissioner for the Protection of Borrowers and the Mauritius Bankers Association to find a way forward on this issue.

In 2007, the Bank continued its active involvement in regional and international fora. The 6th meeting of Governors of the Eastern Africa Sub-Regional Committee of the Association of African Central Banks (AACB) was held in Mauritius from 9 to 10 May 2007. On that occasion, the chairmanship of the Committee was passed on to the Bank for one year. The Bank has also been deeply engaged in the Southern African Development Community (SADC) and the Common Market for Eastern and Southern Africa (COMESA) committees and workshops to achieve macroeconomic convergence, among other goals. The Bank holds the permanent chair of the Sub-Committee of SADC Banking Supervisors.

The relationships with other central banks in the region were further reinforced on the occasion of our 40th anniversary when the Bank had the honour to receive Governor Y.V. Reddy from the Reserve Bank of India and Governor P. Acquah from the Bank of Ghana to deliver memorial lectures. We expect even more co-operation next year with the visits of Governors from the central banks of Kenya, Belgium, and France.

During the year, the Bank was represented at a number of meetings held by regional and international organisations. I attended the World Bank Group and the International Monetary Fund 2007 Spring and Annual Meetings held in Washington DC, USA. I also represented the Bank at several meetings of Governors of central banks, notably the BIS Annual General Meeting in Switzerland, the BIS Roundtable of Governors in South Africa, and the meetings of Governors of francophone countries, of the Commonwealth, and of the AACB. I was also privileged to attend the Pre-Monetary Policy Committee Meeting of the Bank of England in November as a special guest of Governor King.

The First Deputy Governor attended the meetings of the Offshore Group of Banking Supervisors on two occasions, in London and in Macao. He also represented the Governor at the FICCI – IBA Conference on "Global Banking Paradigm Shift" in India, and led a delegation of ten officers from the Bank of Mauritius and commercial banks to Hong Kong and Singapore on a fact-finding mission in connexion with the implementation of cheque truncation in Mauritius.

The Second Deputy Governor attended the Meeting of the SADC Committee of Central Bank Officials and Governors in Tanzania, as well as the AACB meetings in Ethiopia. He also attended two conferences on Financial System Strategy and Opportunities and Challenges on Development for Africa in the Global Arena in Nigeria and Ethiopia, respectively. He represented the Governor on two occasions, at the 50th Anniversary Celebrations of the Bank of Ghana, and at the Board Meeting of the African Export-Import Bank in South Africa.

The Chief Economist represented the Bank twice during the year in the SADC and COMESA Committees of Central Bank Governors. He also attended the Ad-Hoc Expert Group meeting of the UN Economic Commission for Africa-Southern Africa Office, and the COMESA Committee of Central Bank Experts on Finance and Monetary Affairs. The Head of Corporate Services represented the Bank at a Symposium on Central Bank Independence.

This year, the Bank celebrated its 40th anniversary and we used this event as a good opportunity to revamp the Bank's corporate image. A number of activities were undertaken to this end, amongst which a Charity Dinner to aid Epilepsy and Alzheimer associations, sponsorship of the Inter-Clubs Youth Championships for boys and girls, a blood donation day, and the turning of the first sod for the establishment of a bamboo garden in the Midlands region.

The festivities also had another dimension. The Bank initiated a Financial Literacy Programme (FLP) aimed at raising the level of awareness among the public about the roles and functions of the Bank and of the financial system in general. The FLP, which is expected to be an on-going programme, comprised such activities as an Essay-writing Competition, a Monetary Policy Challenge, a series of memorial lectures with key guest speakers on money, banking and finance, and a Consumer Education week. A banknote design competition was launched in preparation for a new family of banknotes, and a special commemorative coin marking our 40th anniversary as well as a new twenty-rupee coin was launched.

As it reached its 40th year, and in order to meet the challenges ahead with greater efficiency, the Bank engaged in a major restructuring of its internal organisation with the help of resource persons from Bank Negara Malaysia. The structure is now flatter, with the creation of Divisions within the Bank that are responsible for particular focused areas. The Bank has adopted an open and transparent staffing strategy, with the promotion of thirty-nine existing staff and recruitment of fourteen additional staff from outside to ensure necessary competencies to build a workforce that would ultimately add value to the organisation and contribute directly towards the attainment of our organisational goals.

The Bank has also enhanced its training strategy to develop the full effectiveness of our most important resource, our people. Sixty members of staff have followed training courses or seminars worldwide at, or under the auspice of, such institutions as the World Bank and the IMF, the United Nations, the BIS, SADC, and other central banks.

The Bank's communication strategy has been reviewed. Its website has been re-designed in line with latest developments in technology and information dissemination engines. The new website was launched in October 2007. It provides timelier information on a broader range of subjects.

In 2008, the Bank intends to revisit its approach to the dissemination of data and other publications. The concept of a centralised database was introduced during the year and work has already started to that effect. We are being guided in that project by the Reserve Bank of India, and the central database should be operational towards the end of next year.

As part of good corporate governance practices, thirteen statutory Board meetings were held during the year. For the first time, a two-day retreat regrouping Board Directors, our external legal counsel, and top Bank management was organised to discuss corporate governance issues. The event was held in Rodrigues, and we were pleased to have among us the

Secretary-General of the Central Bank Governance Forum of the BIS as resource person to share his experience of other central banks on governance matters generally.

For the year ended 30 June 2007, the Bank realised an operating surplus of Rs1,763 million. It remitted Rs900 million to Government, a 50 per cent increase over the amount transferred the preceding financial year, after making adequate provision for open market operations and effecting necessary statutory transfers.

The move to the Bank Tower, our new premises, has almost been completed. The old building will be refurbished to accommodate a Knowledge Management Centre, an Auditorium, a Conference Room, and a Museum. The development of the Rodrigues branch was also a priority for the Bank during this year as we explored better ways of serving the community there. The foundation stone for a new building for the Rodrigues branch was laid on 24 November.

While the international economic outlook may be marred by the recent sub-prime crisis, we expect Mauritius to withstand the effects of the crisis reasonably well. Strong growth in tourism and a well-behaved currency augur well for 2008. Of course, we do not expect the sailing to be plain. The Bank has already expressed its concerns about the financing arrangements for the Integrated Resorts Scheme and highlighted the need to guard against speculative asset bubbles. Several challenges, notably on the inflation front, and those arising from the erosion of our trade preferences and growing global competitiveness, will provide a severe test for the resiliency of our economy, and of our financial sector in particular, and indeed of our society and country as well.

As this year closes, I wish to express my thanks to all those who have contributed in one way or another to the fulfilment of our mission throughout the year. In particular, I wish to thank Chief Executives of banks and the Mauritius Bankers Association for their collaboration and continued support in all the on-going projects, the Institute for Consumer Protection and the *Association des Consommateurs de l'Ile Maurice* for their help during the Consumer Education week, the Honourable Minister of Agro Industry & Fisheries who leased a plot of land for the establishment of our bamboo garden, and the Island Commissioner of Rodrigues who leased the plot of land for the construction of our Rodrigues branch.

In closing, I must record my gratitude to the Prime Minister for his constant support since he called upon me to take up the position of Governor of the Bank in mid-February. I must also extend my thanks to the Deputy Prime Minister and Minister of Finance and Economic Development, Board members, and members of the MPC for their help during the year. A special “thank you” to members of the staff of the Bank at all levels, and in particular to my Deputy Governors.

I am pleased to note that we have moved forward on many fronts during this year. I am confident that we will pursue our mission in the coming year with even greater dedication. May I wish you and your family a very happy New Year 2008.