Rundheersing Bheenick: Coping with uncertainty – a central banker's perspective

Address by Mr Rundheersing Bheenick, Governor of the Bank of Mauritius, at the Chartered Institute of Management Accountants Southern African Regional Conference, Pointe aux Piments, 5 November 2009.

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It is a pleasure for me to be here with you this morning on the occasion of the Chartered Institute of Management Accountants (CIMA) Southern African Regional Conference. I thank the Mauritius Branch of CIMA for its kind invitation. The theme of the Conference – *Surfing the waves: Coping with uncertainty in the global village* – conjures up images of how the great upheavals of the last two years have taken us straight from the Great Moderation to the Great Recession. The Goldilocks economy – and, for that matter, much of the global economy – has been brought crashing down by a lethal combination of three G's:

- First, Glass-Steagall – which abolished the distinction between retail banking and investment banking.
- Second, Greenspan – who would not recognise a bubble if it was staring at him in the face, to say nothing about not doing anything about it until the bubble had actually burst.
- Third, Greed – sheer, naked, money-grubbing greed that seized savers, investors, bankers, brokers, advisers, indeed everybody involved in finance.

These upheavals have created a very uncertain world. Central bankers have of course always had to deal with uncertainty. By definition, bankers must live with uncertainty. In fact, uncertainty is at the very heart of the financial intermediation business. The measurable uncertainty is often termed risk. Risks arise because banks convert short-term liabilities into long-term assets. Uncertainty does not occur only because of this maturity transformation, but there is also uncertainty about depositors' behaviour, about the sustainability of the business of the clients to whom banks have lent, and so on. In this new era where it seems that many deep beliefs have been challenged, central bankers are faced with an even greater degree of uncertainty. The sustainability of the timid global recovery, the sustainability of the new world economic order that is still unfolding and indeed the sustainability of the new international financial architecture that is being jerry-built in response to the crisis – these are so many challenges confronting us if we are to reduce uncertainty to manageable levels. Personally, my life-long career in policymaking has provided me with plenty of experience in attempting to predict the next wave and to position our own small economy to profit from it by purposeful actions. Unfortunately, these days, as the wag put it, it is difficult to make forecasts, especially about the future!

This morning as I stand in front of an audience comprising largely members of the accounting profession, I intend to remain firmly in the shoes of the central banker. I propose to tell you how we have surfed the waves during the recent crisis. I shall focus my remarks on six key themes:

- First, the need for vigilance
- Second, the way we have coped with macroeconomic challenges
- Third, the conduct of monetary policy in an uncertain world
- Fourth, the resilience of our banking sector
- Fifth, the orderly functioning of the market

- And sixth, and last, – but certainly not least, especially in front of an audience comprising CIMA members – the responsibility of the accounting profession.

1. Need for vigilance

First, the need for vigilance. By and large all of us know that banking is a public good and therefore there is little need to look for additional justification for prudential banking supervision. Because we are committed to provide banking and other financial services through the markets, we need to have a very strong regulator. There is a price to pay if we don't have a strong regulator – as indeed there is a price to pay if we have too many regulators with their attendant regulatory overlaps or regulatory gaps. There is still a heavy price to pay if we have regulators and regulations, but regulators fail to enforce the regulations. For all these reasons, and particularly because banking is a public good, there is an overwhelming case for the central bank, or for whoever is regulating the banking sector, to do what no other body is allowed to do, namely regulate, inspect, and supervise the business of banks. Once the crisis started unfolding, we at the Bank of Mauritius saw the need to step up our vigilance and to take prompt action to sustain investor confidence and buttress long-term financial stability. We set up in the Bank a special multi-divisional cell, comprising senior officers from various disciplines, to monitor closely the evolution of the crisis and react quickly and appropriately to any sign of stress in the banking sector which, if left unattended, could lead rapidly to distress in the economy.

We initiated close monitoring of the operations of banks through scrutiny of enhanced and granular data. These returns are analysed on a weekly basis and information submitted to management regularly. These reports, in conjunction with feedback on market activity generated by the multi-disciplinary cell, enable us at the Bank to keep a close tab on the financial systems' activities. As the crisis developed, we began sharing some of the data with the Treasury as part of the coordinated response that we felt was warranted.

We all know the importance of trade channels for a small open economy like ours which basically relies on inward and outward trade to survive. By and large, the availability or non-availability of trade credit was not directly under the purview of the Central Bank in as much as this was taken care of by the commercial banks and their network of correspondent banks in all the major countries. But as the crisis began to pinch and as banks became nervous about lending to one other, we saw some signs of potential difficulties for some local banks due to the non-availability, or inadequacy, of foreign exchange credit facilities from their usual sources. The Bank immediately decided to make available to commercial banks operating in Mauritius a Special Foreign Currency Line of Credit, aggregating USD125 million, to finance the country's requirements in trade. That line of credit represented more than 5 per cent of the total resources available to the central bank. This showed how concerned we were and how prompt we were to react to emerging financing difficulties which would have made it impossible for us to keep our economy on an even keel.

There were a few other things that we did even before the crisis unfolded. We at the Bank were the first to warn about a possible real-estate bubble in the Integrated Resort Scheme sector which prompted a few well-targeted attacks on the Governor but did lead to greater caution on the part of banks. Similarly, well before the sub-prime crisis had assumed the dimensions it took, the Bank had debated the efficacy of allowing all mortgage-related exposures of banks being allowed the lower risk weight of 35 per cent under Basel II.

2. Coping with macroeconomic challenges

Let me now move on to the 2nd theme, Coping with macroeconomic challenges. Mauritius, as a small open economy, has of course not been immune to the effects of the global crisis. Although we weathered fairly well the first-round effects of the global financial crisis and the ensuing economic downturn, the global financial crisis began to impact on economic activity in the country in the second half of 2008, hitting the export-oriented sectors, with spill-over effects on the rest of the economy.

This new situation required greater cooperation and a higher level of understanding between policy makers at the national level, in particular between the Treasury and the central bank. The last quarter of the last year saw an unprecedented level of concerted action by the Bank of Mauritius and the Treasury in an attempt to shore up economic activity and restore confidence in the economy. As a preventive measure to mitigate the adverse effect of the crisis on the economy, the Bank reduced the Key Repo Rate by a cumulative 250 basis points since October 2008 to stand at 5.75 per cent at the end of March 2009. In parallel, the Treasury unveiled an Additional Stimulus Package to the tune of Rs10.4 billion, equivalent to about 3.8 per cent of GDP, in mid-December 2008 to boost economic growth, protect jobs and maintain purchasing power. The Bank also reduced its Cash Reserve Ratio, from 5 per cent to 4.5 per cent, with effect from the fortnight beginning 19 December 2008, which led to an immediate injection of an estimated Rs1.2 billion of extra liquidity in the system.

Our relentless efforts to contain the adverse impact of the crisis on our economy have borne fruit. Economic growth for 2008 stood at 5.0 per cent, slightly below the 2007 level of 5.5 per cent. At the beginning of this year, it appeared that our GDP growth rate would be closer to 2 per cent. As the crisis began to be addressed effectively, we revised this forecast and our GDP growth rate is now expected to be around 2.7 per cent in 2009, despite our major export markets being in recession.

The need to sustain the growth momentum requires us to come up with the right policies to build up and maintain resilience even in the current challenging times characterised by an unusually high degree of uncertainty and very poor visibility beyond a couple of quarters, if not a couple of months. Our Vice Prime Minister and Minister of Finance and Economic Empowerment has already set the tone by announcing “Shaping the Recovery” as the main theme of his forthcoming Budget, which he will present later this month.

We at the Bank will remain focused on the primary object of the Bank which is to maintain price stability and to promote orderly and balanced economic development. We believe that the enhanced coordination with the Treasury, without sacrificing the Bank’s policy autonomy and independence, has reduced the uncertainty confronting economic operators and households and added to policy predictability. That, briefly, is how we coped with the macroeconomic challenges thrown up by the crisis.

3. Conducting monetary policy in an uncertain world

Let me move on to my third theme. Almost by definition, central banks operate in an uncertain world since monetary policy works with a well-known lag – a long and variable lag. Conducting monetary policy against the backdrop of the global financial crisis and the ensuing economic downturn is a challenging task, particularly for small open economies like Mauritius. The Bank had to react appropriately and in a timely manner. Here again, extreme vigilance was the order of the day. As I mentioned earlier, we reduced the Key Repo Rate by a cumulative 250 basis points over a period of six months. There were extraordinary Monetary Policy Committee Meetings. The recent IMF Article IV Consultation Mission which left over the weekend qualified the monetary and exchange rate framework applied by the Bank as “hybrid-inflation targeting” and declared it well-suited to the needs of the Mauritian economy. The IMF has gone further and concluded that, in its view, the Mauritian regime can be usefully considered as a model for other emerging market countries. We are much encouraged by this high-level positive endorsement – which stands in sharp contrast to the brickbats thrown at us regularly in the local press, the business press as well as the popular press.

While there are some positive signs of a budding recovery in our major export markets, the global economic outlook is still subject to a very high degree of uncertainty. The cycle of monetary easing by major economies appears to have bottomed out and increasing attention is now being focused on so-called "exit strategies" without, however, jeopardizing the nascent recovery. In the Mauritian context, we do not really have an "exit" problem: the magnitude of fiscal adjustment required is not all that significant as the budget deficit is under control and our debt-to-GDP ratio is within normal prudential limits. The headline inflation rate has declined significantly from 9.7 per cent at the end of December 2008 to 3.6 per cent at the end of October 2009. However, over the medium term, the inflation outlook remains uncertain. Potential risks stem from the future course of oil and food prices on international markets, which are factors beyond the reach of domestic policy-makers.

On this score, too, policy has been very supportive by lowering inflation and stabilising inflation expectations. Our much-maligned stewardship of the Bank, including our monetary policy – with accusations of policy zig-zagging, questions about why the Governor was still in post, and in one notorious editorial in a major local daily, in November 2008, calling the Governor the chief putschist who would no doubt meet the same fate in the "ides of December" as befell Caesar in the ides of March, a near-incitement to murder the incumbent – that policy has earned kudos from knowledgeable observers who have examined the evidence and have pronounced that it can serve as a model for others in our situation.

4. The resilience of our banking sector

In an economy whose financial system is largely dominated by banks, major uncertainties in the market can emanate from the banking sector itself. While intermediation by banks necessarily involves risk-taking, the regulation and supervision of the system should ensure that: first, banks clearly know the risks they are exposed to and second, banks take steps to measure, control, manage and mitigate those risks effectively.

The question is how do we achieve this? How do we ensure that the banking system is stable and sound and thus does not generate any excessive uncertainties in the market? We may not agree with banks about the extent and reach of regulation. But we need adequate regulation and supervision. We need a regulatory framework that encourages prudence, requires maintenance of adequate capital in relation to the risk in the balance sheet, and that deals with issues in liquidity management. And this must be coupled with close off-site and on-site monitoring of compliance with the regulatory requirements.

In Mauritius, the banking system continues to be sound, stable, well-capitalised, liquid and profitable. This has been possible because of seven key factors. Let me enumerate these one by one.

First, banks in Mauritius have stuck to the basics of lending out of stable customer deposits. The advances to deposits ratio has remained at around 70 per cent. There is virtually no reliance on inter-bank or volatile wholesale deposits for meeting funding needs. Volatile deposits represent only 1.6 per cent of total deposits. The average daily turnover in the interbank market is as low as 0.2 per cent of the total assets of the banking system. The quality of the deposit base has a bearing on the ability of a bank to meet its funding requirements in a crisis situation. This, combined with a strong capital adequacy ratio, is reflected in the resilience of the banking sector.

Second, domestic banks did not have a huge trading book. The Bank recently issued the final guideline on Market Risk Management after analysing the trading book of commercial banks over a period of more than a year. Our analysis revealed that the trading book accounted for only 2 per cent of the balance sheet of banks. Banks did not have any large exposure to assets prone to asset price bubble valuations. Even their liquid assets comprise largely investments in Government securities and paper with no credit risk.

Third, the Bank adopted a prudential approach to regulation, not only from the viewpoint of financial system stability but also to protect the interest of depositors. This prompted the review of several guidelines to enhance prudence in an environment of increasing uncertainty. The transition from Basel I to Basel II was effected seamlessly in March 2009, after a year-long parallel run. While applying the Basel II risk-weighting system, the domestic scenario and market conditions were always borne in mind. Banks were not given the option of moving over to advanced approaches because of serious reservations and uncertainties regarding the reliability of models built on a thin database. The lower risk weight of 35 per cent on residential mortgages was only allowed to be applied very restrictively. Moreover, considering the importance of liquidity management, the guideline was revised to address new concerns that the crisis threw up. Banks have been advised to net-off deposits received by them from corporates and parastatal entities which are part of their customers' treasury operations given that such deposits tend to be highly volatile.

Fourth, enforcement. Given the systemic importance of the banking system as a whole in a small country as ours, the Bank tightened the supervisory process by increasing the frequency of on-site examination of banks, enhancing the levels of exchange with the regulated entities and more intensive analysis of off-site prudential returns.

Fifth, unlike many other countries, we did not have the problem of transmission of the crisis through foreign banks. Although the banking system in the country would appear to be dominated by foreign banks at least in terms of numbers, with 12 of the 18 banks being either subsidiaries or branches of foreign banks, the important positive factor has been the larger share of the domestic financial intermediation business that rests with local banks. In fact, more than 60 per cent of domestic banking assets are held by these banks. Moreover, none of the parents of the foreign banks having a presence in Mauritius have had to avail of support from their respective governments for shoring up their capital in their home jurisdiction. None of them have become wards of state.

Sixth, even in the absence of credit ratings, banks have been able to gauge their clients' creditworthiness. This has been made possible because of intensive knowledge of their clients and their businesses resulting from the small size of the country and the prevalence of relationship banking in a context of great customer loyalty. The establishment of the Mauritius Credit Information Bureau (MCIB) under the aegis of the Bank increased the ability of banks to assess their borrowers and thus contributed to enhance the quality of their assets. For instance, the non-performing loans ratio of the banking sector to domestic borrowers which was 8.4 per cent in June 2004 declined to 3.8 per cent in December 2008. Even in the crisis situation, NPL's have gone up only marginally to 4 per cent in June 2009. We anticipate a further improvement in credit quality as we extend the coverage of the MCIB database.

Seventh, the limited role of ratings agencies. In Mauritius, banks did not have a large portfolio of loans extended to domestic borrowers on the basis of dubious ratings by the rating agencies. We now know that a part of the added uncertainty can be attributed to the quality of ratings and the doubtful ethics of the credit rating agencies in their conduct of business. While these ratings are supposed to help investors take decisions without their having to do too much due diligence of their own, over time rating agencies have come to play too important a role in the system while they themselves went largely unsupervised.

But, in spite of their limited role in domestic financial intermediation, ratings agencies have not been all that benign in our part of the world. With the worst possible timing, based on doubtful data and faulty analysis, they added to the nervousness and uncertainty on our small domestic stock market. I am referring here to the inexplicable decision of Moody's to place on watch the ratings of two of the largest banks in Mauritius for a possible downgrade, on concerns that we fail to understand. I don't need to tell you the importance of these two banks in Mauritius. They hold 60 per cent of assets in the banking sector. They account for 40 per cent of the domestic stock market capitalisation. They generate a full 60 per cent of the average daily share transactions on the local stock exchange, if I take last week as a reference. And you have this credit rating agency threatening to put these two banks on watch for a possible downgrade and, to add insult to injury, going further to warn that the country was facing unsustainable debt dynamics.

In our view, these seven points are key to the resilience of our banking sector. The sector obviously also has certain characteristics which add to its vulnerability, thus warranting vigilance and close monitoring. First, although the small number of clients enables banks to have a good knowledge about their businesses, concentration of credit in a few groups of closely-related borrowers accentuates credit risk. This could have serious potential consequences for financial stability. The Bank is therefore watching with keen interest developments in other parts of the world with regard to macro-prudential supervision to cope with the impact of such inter-linkages. Secondly, the two large banks to which I referred earlier and a few others as well would readily qualify as "too big to fail" and thus raise issues of moral hazard. The complex structures of banks, the need for the larger banks to write down their "living will" are matters receiving attention world-wide. We are closely following these developments.

5. The orderly functioning of the market

This brings me to my fifth key theme. In conditions of uncertainty, the orderly functioning of the market is a major prerequisite. In the domestic foreign exchange market, the Bank has allowed the free play of market forces to determine the exchange value of the rupee. Our intervention has not been aimed at offsetting market forces or at targeting any specific exchange rate. Our objective has been rather to smooth out any unwarranted volatility in the rupee exchange rate and to improve the functioning of the market. This has resulted in greater stability in the exchange value of the rupee.

It is very easy to give in to pressures from various sectors in conditions of uncertainty. Central banks have a natural tendency to intervene anyway. It is not easy to turn a deaf ear to incessant appeals from export lobbies and their friends in high places to play around with the domestic currency. The Bank has resisted these pressures. For a full year now, the Bank has not intervened in the foreign exchange market – in sharp contrast to what central banks in many other countries have been busy doing. Perhaps the domestic forex market has now matured and learned to function in an orderly manner without the intervention of the central bank. This track record of non-intervention by the Bank since November 2008 has recently led the IMF to reclassify our exchange rate regime from "managed floating" to "free floating" in the 2009 issue of the Fund's Annual Report on Exchange Arrangements and Exchange Restrictions. I believe that this hands-off attitude of the Bank has reduced idiosyncratic behaviour and empowered market-players. The possibility of Central Bank intervention at any time and the increasing firepower we wield, should we wish to do so, keeps the market well-behaved.

6. The responsibility of the accounting profession

Let me now come to my sixth and last theme, which directly concerns your own profession. Accountants and auditors play a key role in contributing to the level of trust required for the proper functioning of a modern market economy. They prepare financial statements and audit them so that various stakeholders of the economy are able to make informed decisions. In the aftermath of the crisis, bankers and regulators have paid a very heavy price and they have been in the front line, incurring the wrath of the public. But we all know that we, bankers and regulators, are basing our actions on your accounts and that accounting principles have played a major part in accentuating the crisis.

Let's just look at what the mark-to-market valuation principles have led to. By definition, mark-to-market valuation principles are procyclical since they inflate the value of an asset in an upswing and bring it down in a downturn. Thus, they accentuate the volatility of bank balance sheets. Issues relating to accounting practices have become the focus of recent

G-20 meetings. In the context of the financial sector, there is a need for juxtaposing fair valuation principles with prudence. The accounting profession may wish to reflect on the need for provisioning for potential loss based on Full Fair Value Accounting within the Current Accounting Framework. It used to be said that war was too important to be left to the generals. Is it not possibly the case that accountancy has now become too important to be left to accountants?

Let me digress here for a moment to bring up an issue that the Bank faced with accounting principles. In a year when we were deluged with FDI inflows and the Bank had to intervene in the market to mop up excess liquidity through the issue of Bank of Mauritius Bills in exchange for foreign exchange assets that we purchased, we felt the need for dynamic provisioning because of very clear "negative carry" in these transactions. However, our pioneering attempt to apply this approach had to be undone in the midst of much incomprehension and recrimination. The proposal did not meet the approval of our accountants and auditors because of their steadfast adherence to their accounting principles, to the great delight of our single shareholder who thus got an unusually large second transfer of profit from the Bank in a year when it would have been more prudent to provide for expected losses on the horizon. There is therefore in a world of uncertainty a need for everyone to be a bit less hide-bound by current practice and to be a little more forward-looking.

Let me conclude by mentioning that bankers, accountants, regulators and for that matter, all of us, function in a world of increasing uncertainty. As Keynes put it, "anticipating what average opinion expects the average opinion to be.." leads to herding behaviour. We cannot altogether eliminate uncertainty but we should certainly use our judgment to anticipate, even act pre-emptively and respond with alacrity to emerging situations. I have detailed how we at the Bank through various actions and measures have endeavoured to ensure the stability of the domestic financial system. To recapitulate, we were vigilant and took anticipatory measures where possible and responded with promptitude to emerging situations. A banking system working on sound principles, aided by prudent regulation and close supervision, ensured that the sector remained sound and stable. We concerted our action increasingly with Government initiatives. We facilitated the orderly functioning of the market. We adopted an appropriate monetary policy and exchange rate management framework. All this contributed to Mauritius weathering the storm.

As a parting remark, let me add that for policy-makers in a small island state, situated quite far from its major trade partners, and surrounded by a sea of uncertainty, an ocean of threats and perils, the price to pay to ensure our continued economic salvation is eternal vigilance. It is a price that we are prepared to pay. It is a price that we pay everyday.

Thank you for your attention.