Rundheersing Bheenick: Surfing the second wave of the crisis and major developments in the banking and financial landscape of Mauritius

Statement by Mr Rundheersing Bheenick, Governor of the Bank of Mauritius, in the Bank of Mauritius Annual Report 2009–10 transmitted to the Vice-Prime Minister, Minister of Finance and Economic Development on 29 October 2010, Port Louis, 12 November 2010.

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What a challenging and eventful year it has been! From my vantage point at the helm of the Central Bank during these stressful and extraordinary times, there is so much to say. But, confined by space, let me stick to the pattern of my previous Statements, briefly recapture highlights of the year in review, touch on the present outlook and share my thoughts on the very uncertain future that lies ahead.

The world economy in perspective

The global context exerted a determining influence on our small open economy and heightened our vulnerability to external shocks, originating far from our shores.

Governments in developed economies and their central banks responded to the global crisis, the worst since the Great Depression of the 1930's, by resorting to unconventional measures and embarking on fundamental financial sector reforms.

International financial institutions, and their governing bodies, having failed to be pro-active in anticipating and circumscribing the initial crisis, reacted with a plethora of initiatives while the economics profession, never a model of unity, polarised into opposing camps, with neo-Keynesians plugging the virtues of fiscal stimulus and monetary easing pitched against "austerians" sounding dire warnings about fiscal profligacy and debt sustainability, even as all agreed on the need to dump failing hypotheses on the efficiency of markets and the faulty models that had brought the world to the edge of financial Armageddon.

When the global economy showed signs of a gradual recovery in the second half of 2009, economists generally agreed that we had seen the worst of the crisis until the timid recovery hit another zone of turbulence in May 2010 with Europe's Sovereign Debt crisis. The Euro 750 billion package, assembled by the European Union and the International Monetary Fund, the austerity plans as well as the results of the European banking sector stress tests which indicated that the banking sector was in better shape than feared, appeased some of the worst fears and restored some calm on nervous markets.

As I write this Statement, the world economy is showing visible signs of recovery, with greater momentum coming from emerging-market economies. The exceptional stimulus from monetary and fiscal policies continues to prop up economic activity. There is growing concern that the recovery in the major advanced economies may stall as balance sheets are adjusted and the stimulus packages gradually withdrawn. As public debt, fiscal deficits and unemployment surge turning developed economies into "submerging economies", fears of a double-dip recession and of a Japanese-style deflation exercise the minds of policy-makers.

Considerable risks and policy challenges remain and central banks find themselves with a greater role in promoting financial stability and systemic oversight.

On the home front

Mauritius has faced formidable economic challenges this last year. Given our openness, we had very little lead time to respond to global challenges as they unfurled and this kept us on our toes all year round. As the Central Bank of the country, our role has probably never been more intense and our focus on macroeconomic issues never sharper. The challenge of maintaining a credible currency amidst difficult global conditions, coupled with the need to nurture the nascent signs of recovery of our economy, kept us on high alert.

My first term of office as Governor expired in February 2010 and I was entrusted a new mandate late in May 2010. In the interval, the country went through general elections, a feverish moment for our vibrant democracy, and our export-oriented enterprises were buffeted by the Euro crisis. Our vulnerability is such that it suffices for a European butterfly to flap its wings for the Mauritian export sector to be ablaze. In the days preceding my return to the Bank of Mauritius, not a single day passed by without the Euro crisis making headlines in the local press. The speed and virulence of the crisis caused much distress to our textile companies which suffered severe export revenue declines, igniting calls for a quick fix via currency depreciation failing which, it was claimed, they would have to envisage leaner structures and significant lay-offs to remain in business. I was very much alive to the potential dangers of this crisis for our export-driven sector and could not be oblivious to its ripple effects on the rest of the economy. During the first week that I was back in office, this issue monopolised the agenda. I intensified dialogue with private/real sector stakeholders, to assuage their fears on this latest and most direct threat to our economic prospects, the more so that the Euro crisis was coming on the heels of the global financial crisis from which we were still reeling.

It required a good dose of persuasion to appease markets and restore confidence. In December 2009, we had introduced a Short Term Foreign Currency Swap facility for the benefit of operators in the export and tourism sectors to reactivate the domestic foreign exchange market in the face of declining volumes of transactions. From December 2009 to June 2010, we conducted swaps for a total of USD89.2 million, or approximately Rs2.7 billion – a clear indication of the providential nature of this measure.

Apart from our export worries which caused us sleepless nights, the crisis was also an opportunity for Mauritians to show their mettle and for our economy to display unusual resilience as we played to our strength – a quick and flexible policy response capacity, anchored in social cohesion and consensus. We can safely say that Mauritius has weathered the first wave of the global crisis quite well. Our timely policy response helped lower domestic inflation, shore up employment, avert an economic crisis and fight off the spectre of recession. Well-timed and concerted measures by the Bank and the Treasury were instrumental in keeping the economy on track. International institutions, including the International Monetary Fund (IMF), and other observers commended the economic performance of Mauritius and even cited us as an example of resilience during the crisis. Growth remained positive at 3.1 per cent in 2009 and is forecast at 4.2 per cent in 2010.

Even as we remain cautiously optimistic about the future, we cannot escape the conclusion that the depressed growth prospects of our traditional export markets call for a strategic review of our export priorities in a world where the balance of economic power may be rapidly shifting.

The new modern global configuration with its deeply-woven interdependence is such that imported contagion and domino effects will always represent challenges for small open economies like ours. It has become imperative to develop a framework for *Contagion Management* to trigger the alarm at the least indication of distress in the economy.

Highlights of last financial year

From the kaleidoscope of events which have marked the year, let me focus on a few chosen scenes.

Performance of the banking sector

– Our banking sector remained in good shape, and showed commendable resilience, due mainly to our prudent regulatory and supervisory framework. Although the growth of 1.8 per cent in total assets recorded by the sector in the period under review did not match the performance of 10.9 per cent in the preceding year, it should still be considered quite robust, viewed against the backdrop of the gradual recovery of the global economy from the economic crisis and the sorry state of banking and finance in major economies.

– We did not relent in strengthening our regulatory and supervisory framework. We enhanced existing guidelines, e.g. on liquidity risk management, released new guidelines on country risk management, and finalised work on guidelines relating to fair valuation of financial instruments. All three pillars of the Basel II Capital Adequacy Framework have now been put in place with the issue of the Guideline on the Supervisory Review Process.

– We admitted new players in the banking sector and, in my next Statement, I hope to report on our new full-fledged Sharia-compliant banks as they start operations later this year.

– Preliminary work on the setting up a Deposit Insurance Scheme in Mauritius was initiated in consultation with the banks. I hope to elaborate further on progress in this area in our next Report.

– Savings mobilization continues to be an area where I feel that more effort is needed. We will relentlessly pursue efforts to improve the savings rate, to induce our citizens to save for the proverbial rainy day and to reduce our dependence on external financing.

Monetary policy

– At the core of the central bank, our Monetary Policy Committee (MPC) helped us to fulfill our mission of maintaining price stability.

– In the light of the conditions prevailing during FY 09/10, the MPC, which had reduced the key Repo Rate by 100 basis points in March 2009, considered it more appropriate to leave it unchanged at 5.75 per cent all through the five meetings convened from June 2009 to June 2010.

– I am happy to record that our monetary policy stance succeeded in maintaining price stability. The headline inflation rate which stood at 6.1 per cent in July 2009 declined steadily to 1.7 per cent in June 2010, which was low by historical standards.

– I take the opportunity here to express my appreciation to our two foreign Members, Prof Stefan Gerlach and Mario Blejer, whose extensive experience have greatly benefited the debate and enhanced the decision-making process at MPC meetings during these trying moments.

Exchange rate developments

– We can proudly say that we have been successful in maintaining monetary and financial stability in spite of uncertain and unusually volatile conditions.

– Despite sustained criticism from certain quarters, we remained steadfast in our duty to conduct exchange rate policy in the wider national interest. We felt vindicated when the IMF validated the monetary and exchange rate framework used by the Bank as being well-suited to the needs of the Mauritian economy. The last IMF Article IV mission of October 2009 commended our monetary and exchange rate policy framework, which they qualified as a “hybrid system of inflation targeting”. The

– Against the backdrop of high uncertainty in global financial markets, the rupee behaved well and, on a real effective basis, the rupee recorded a slight appreciation of 0.5 per cent over FY 09/10. We are satisfied that our free-float exchange rate regime worked well.

– Our close monitoring of the domestic foreign exchange market indicated that it was not functioning in a satisfactory manner during mid-May 2010. We had reason to suspect that there might have been some domestic currency manipulation in the wake of the Euro crisis. In such an environment when the rupee was being talked down, adding fuel to domestic uncertainty in a thin forex market, we thought it proper to probe further. We enlisted the services of a forensic consultancy firm to conduct a review.

– As we took these bold steps, exchange rate volatility subsided and the market returned to a fairly normal pattern, aided in this by our decision to meet the currency requirements of the State Trading Corporation, the largest local forex buyer.

Open market operations

Our money market remained liquid throughout FY 09/10. The build-up of excess liquidity towards the end of 2009 accentuated downward pressure on money market rates. We thus raised the minimum Cash Ratio by 0.5 percentage point in June 2010 and, despite severe balance sheet constraints, we undertook a series of open market operations, namely special deposits, reverse repo transactions, and the issue of Bank of Mauritius Bills, in an attempt to normalize liquidity conditions.

Bank's balance sheet

Traditionally, the Bank has been very conservative in managing its foreign exchange reserves. Our foreign reserves are mainly invested with major central banks.

– In the wake of the global crisis, these central banks systematically reduced the rate of interest payable on deposits. We suffered a drastic decline in our income derived from interest on foreign investments and this severely affected our profitability. Our operating profit for FY 09/10 has nosedived to Rs72.4 million, compared with Rs1.4 billion in the previous year.

– This development only served to place in sharper focus the concern which I had expressed when times were better over the state of the Bank's balance sheet and the severe constraints this might place on our ability to conduct monetary policy. It will be recalled that I had advocated dynamic provisioning during the last financial year. Dynamic provisioning is forward-looking and consists inter alia in making provisions out of profits in good times to meet expected losses in future years. It is an approach that is increasingly favoured by many central banks to finance open market operations. I am somewhat dismayed that our balance sheet has borne the predictable consequences and registered a significant hit during the year in review because my call went unheeded.

– However, the current state of our balance sheet has strengthened my resolve to press for the early adoption of dynamic provisioning to preserve the integrity of the Central Bank's balance sheet – to emulate the farsighted and hardworking Ant preparing for wintry times and not the laid-back Grasshopper enjoying the country's sun and sand, to paraphrase Aesop slightly.

Foreign exchange reserves management

Last year we announced a review of our Foreign Exchange Reserves Management Strategy along with peer reviews conducted by the Bank for International Settlements (BIS) and the Reserves Advisory and Management Program of the World Bank's Sovereign Investments Partnership (SIP).

– We completed our review exercise and decided to entrust a fresh mandate for euro instruments to the BIS and a new mandate to the SIP. These arrangements still awaited finalisation at the time of writing.

Purchase of gold

We purchased two metric tons of gold from the IMF in November 2009 under the Fund's Limited Gold Sales Programme to diversify our portfolio of foreign assets and to mitigate the impact of currency volatility. Our holdings of gold, as a percentage of the Bank's total foreign exchange reserves, rose from 2.3 per cent to around 6 per cent after the purchase.

Net international reserves

The net international reserves of the country breached the Rs100 billion-mark for the first time in November 2009. Gross official international reserves stood at USD2.2 billion at end-June 2010. Our net international reserves represented roughly 48 weeks' import cover – more than adequate to meet unexpected short-term external shocks.

Public debt management

Now that we have taken over debt management functions from the Government, we want to promote the development of an active secondary market for government securities in order to generate a yield curve that could be used as a reference for the pricing of corporate bonds. The Bank has started issuing benchmark Government of Mauritius bonds as well as auctioning single maturity instruments for the medium and long term.

– We have also embarked on a project to modernise and streamline the auction process. The on-line auctioning system which is being run on a pilot basis is expected to go live this year, while the review of the primary dealers system is on course.

Financial stability

Let us rewind a little in time: an economic crisis surfaces, a financial institution – little-known beyond financial circles – fails, triggering a string of counterparty defaults across financial systems. The shock ripples across oceans and rapidly spreads globally. The contagion spreads at epidemic rates, threatening market functioning and financial stability – and the blame game begins. It was perhaps inevitable that central banks and regulators would be blamed after the crisis for having had a narrow and segmented vision of their mandate.

– Financial Stability moved centre stage for central banks and became the main item on the agenda at Governors' Meetings.

– At the Bank, we embraced this new role well before it became fashionable. I set up a Financial Stability Unit at the Bank three years ago to identify vulnerabilities and risks in the system and develop tools and policies to incorporate financial stability in our policy framework. We introduced semi-annual Financial Stability Reports.

– The domestic economic landscape is characterised by concentration of economic power, with a web of companies and local conglomerates operating across different sectors, and relatively large complex financial institutions. These raise a host of

Payments system

We modernised our payments infrastructure by switching to new-generation software for the Mauritius Automated Clearing and Settlement System.

– Real-time interbank payments can be made in three major foreign currencies, the US dollar, the pound sterling and the euro, in addition to the Mauritian rupee – a *première* in Africa.

– Central banks in the region are avid for placements and visits to study our payments and settlement system. The Bank thus hosted delegations from the central banks of Kenya, Rwanda, Uganda, Ethiopia, Seychelles and Nigeria during the year.

Mauritius Credit Information Bureau

We have extended the coverage of the Mauritius Credit Information Bureau to have a complete picture of the problem of multi-borrowing and over-indebtedness in the country.

Memorandum of Understanding

We extended our network of Memoranda of Understanding with other institutions, namely with the Financial Intelligence Unit and the Mauritius Revenue Authority, in an effort to combat money laundering and terrorist financing and fiscal evasion. By the end of the review period, we were at an advanced stage of discussion with the Competition Commission of Mauritius.

Regional cooperation

We hosted the 14th Meeting of the COMESA Committee of Governors of Central Banks in October 2009. The chairmanship of the COMESA Committee of Governors of Central Banks passed to the Bank of Mauritius.

– To mark the event, we invited two renowned speakers to make presentations on two issues of critical importance for central bank Governors – "The evolving structure and role of Monetary Policy Committees" and "Issues of Governance in Central Banks". This initiative to invite external parties to meetings of Governors was so well received and appreciated that the COMESA Committee decided that it would become a permanent feature in future meetings.

– We marked our presence in regional and international fora and participated actively in the SADC Committee of Central Bank Governors, the meeting of Governors of the Association of African Central Banks and the Commonwealth Central Bank Governors Meeting, which I had the honour of chairing.

Extending regional footprint

The dynamism, with which the Bank has gone regional, has heightened our visibility on the international front and has earned us much respect. With the support of COMESA Governors, our country was successful in its candidature to host AFRITAC (South), one of the two new African Technical Assistance Centres which the IMF is establishing in Africa, in the face of strong regional contenders.

– The Bank offered to house AFRITAC (South) on one of the floors of the old Bank of Mauritius Building which would be refurbished for the purpose.

Membership of Islamic Financial Services Board

During the year, we moved from being an Associate Member to full membership of the Board, with a seat on the Governing Council of the Islamic Financial Services Board (IFSB).

– To support our plans to develop Islamic banking and finance in Mauritius, we joined IFSB initiatives to develop Islamic liquidity management instruments with other participating countries. We participated fully in the preparatory work for the launch of a Special Purpose Vehicle and envisage participation in its share capital.

Bank's admission to the Irving Fisher Committee

We were admitted as a full institutional member of the Irving Fisher Committee (IFC) on Central Bank Statistics. Mauritius is the second country in sub-Saharan Africa, after South Africa, to become a full institutional member of the IFC, which has a total of 66 members.

– Our membership of the IFC comes at a time when our efforts are currently being directed towards improving the coverage and quality of our data to enable us to graduate to the Special Data Dissemination Standards of the IMF.

Platinum commemorative coin

Mauritius joined the select list of countries that have issued platinum coinage. Three beautifully-crafted platinum coins constitute the "Father of the Nation" Platinum Series. The first coin was launched on 30 October 2009 by Dr the Honourable Navinchandra Ramgoolam, our Prime Minister. The second coin in the series will be launched later this year.

Training

The financial turmoil undeniably posed new challenges for central banks and imposed new demands and new burdens on them. The leadership of central banks are under pressure to ensure that their institution is equipped to deal with the challenges which this crisis brought – and ready to face the next one.

– We put a lot of emphasis on training our key staff, expose them to new thinking and raise their professional competence and skills to enable them to deal with a rapidly-changing external environment.

– In the course of the year, our Staff members benefited from 124 training opportunities in different areas of central banking from reserve management to talent building, an increase of 33 per cent on the previous year.

– The credibility of our central bank rests on the quality of its Staff, its work culture and its leadership abilities. I wish here to thank the Governor of the South African Reserve Bank (SARB) who has graciously agreed to assist us in our endeavour to enhance the skills-set of our middle management with a dedicated programme on effective leadership and executive management. We were also delighted to have had the Honourable Tito Mboweni, former Governor of SARB, as a special guest to our Annual Dinner in honour of Economic Operators in December 2009.

Salary review and staff matters

In August 2009, a Report on the Review of Salary and Terms and Conditions of Service was implemented, following a majority decision (mostly external directors) of the Board of Directors of the Bank, with the Governor, the First Deputy Governor, and Me Kader Bhayat, external Director, dissenting.

– This Report was commissioned by the Board after an earlier report by the Hay Group, a well-known pay and remuneration consultancy selected by the Bank after an open competitive tender, was rejected *in toto* by the Board. It followed the first report from the consultant proposed by the Board, which the Board also found unacceptable. The second report of the consultant was prepared along lines acceptable to the Board.

– This last report was based on the organisation structure prevailing before the 2007 restructuring exercise. Predictably, its implementation led to much litigation in Court as well as to a string of cases before the Labour Tribunal, charging the Bank amongst others of breaching a fundamental tenet of labour law relating to "equal pay for equal work". The Bank could have done without the strained industrial relations that resulted from this imbroglio. Following the judgment of the Supreme Court (see below), this matter is now taking a different course. The latest development at the time of writing is that the Bank has now been declared non-compliant by the Labour Tribunal. I shall come back to this in the next Report.

– The introduction of new technology and new work processes – as well as the need to change the competency mix at the Bank to enable it to deliver effectively on its widening mandate – necessitated the introduction of a Voluntary Retirement Scheme. Fifteen long-serving officers of the Bank opted to proceed on early retirement under the Scheme. This will enable the Bank to recruit extra staff with a different profile without increasing our head count.

– Well beyond the Salary Review exercise, it is my earnest resolve to channel more effort towards achieving operational excellence. We shall strive to align our business processes with international standards and best practices. We propose to implement a Performance Review system tagged to productivity. I believe strongly in periodically reviewing our scorecards.

– We will also push for innovative approaches to manage and develop our people, fortify our management team, and continuously restructure in order to adjust to the requirements of an ever-evolving financial landscape.

Landmark Supreme Court judgment and Fact Finding Committee

Pursuant to an enduring feud between a majority of (external) Members of the Board of Directors of the Bank and the Executive Management, the Supreme Court delivered a significant judgment in March 2010, finding in favour of management.

– The Supreme Court clarified that the Board's statutory remit is to formulate general policy and not to be involved in the day-to-day administration of the Bank. This judgment not only helps to clearly situate responsibilities but also paves the way for much healthier deliberations in the Boardroom.

– The year was also marked by the establishment of a Fact-Finding Committee, chaired by a highly-respected retired Chief Justice, Sir Victor Glover, Kt, GOSK. Coming just after the Supreme Court judgment, the report of the Fact-Finding Committee put paid to the smear campaign against the Governor and confirmed that he had acted *intra vires*, without any abuse of power or authority as charged by his detractors.

Words of appreciation

I wish to express my gratitude to Dr the Honourable Navinchandra Ramgoolam, Prime Minister, for his support and the confidence he has placed in me by entrusting me this second term of office. I also thank Honourable Pravind Kumar Jugnauth, Vice Prime Minister and Minister of Finance and Economic Development, for his support and an excellent working relationship. I am happy that we are guided by a shared commitment to serve the general good and by a common desire to build on the country's strong fundamentals and make things better for our fellow-citizens.

I extend my appreciation to the Chairman and the Chief Executive of the Mauritius Bankers Association, the Chief Executives of banks, the representatives of the various business chambers and associations and other stakeholders with whom I have a regular dialogue, and the members of the various committees and sub-committees at the Bank for their active collaboration during the past year.

My sincere appreciation also goes to Mr Yandraduth Googoolye, First Deputy Governor, for his unflinching support during very difficult times. I extend a warm welcome to Mr Iqbal Belath, the new Second Deputy Governor, who assumed office in July this year.

Looking forward

If the past three years have taught us anything, it is that things are never static and we can never bank on the continuation of the status quo. Looking ahead, we need to continuously improve, strengthen our frameworks and re-engineer if we are to achieve greater levels of efficiency and promote financial stability.

As Governor, I will ensure that as one team, we at the Bank – the Deputy Governors, the Senior Management team, and all our Staff – spare no effort in furthering the objectives of the Bank, that is improve the economic and financial well-being of all our countrymen, keep inflation well under check at low and predictable levels and participate in promoting strong, balanced, equitable and durable economic growth.