Rameswurlall Basant Roi: Monetary and exchange rate policies, and challenging reforms undertaken by the Bank of Mauritius

Address by Mr Rameswurlall Basant Roi, Governor of the Bank of Mauritius, at the annual dinner for major economic stakeholders, Flic-en-Flac, 17 November 2017.

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Distinguished guests

Ladies and gentlemen

Good evening

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

Ever since I initiated this annual ritual of holding a dinner with major economic stakeholders way back in December 1998, I have often been told by a few that my speeches tend to be lengthy. I have a problem. And the problem is that short speeches take too long to write; it also requires an exhaustive use of my cerebral capacity. Long speeches take less time to write. This evening, I'll ask for your forbearance once again because the Bank of Mauritius is 50 years old.

There cannot be a more fitting occasion to travel back into 50 years of central banking policies than one of golden jubilee celebrations. In an address that I gave exactly two weeks ago on the occasion of the Inauguration of The Bank of Mauritius Museum, I focused on the institutional development aspects of the Bank over the 50-year period. This evening, I have chosen to give a very broad brush stroke of monetary and exchange rate policies as they have evolved in Mauritius and of the financial sector reforms and regulatory and supervisory reforms undertaken by the Bank over the years.

Against a backdrop of high unemployment rates and widespread poverty, the overriding need for leading the Mauritian economy into a self-sustained growth path had set the agenda for monetary, exchange rate and fiscal policies quite soon after independence. The rupee was then linked to the Pound sterling at the rate of £1 = Rs13.33. In view of the predominance of the United Kingdom in the trade and payments position of Mauritius, a fixed relationship between the pound sterling and the rupee was found to be favourable to the expansion of trade and capital flows between the two countries. In a global context of fixed par values, a single currency peg for Mauritius facilitated the mechanics of trade and payments both within the sterling area and with the rest of the world.

For any country in a dreadful state of underdevelopment seeking to foster economic growth, the link to the Pound sterling was clearly a major handicap. Because of the link to the Pound sterling, interest rates in Mauritius had to move synchronically with interest rate movements in the UK. The Bank's ability to pursue an independent monetary policy was thus severely constrained. In other words, the prevailing interest rates in Mauritius were unrealistic as they were not at levels consistent with the economic development objectives of the time. The pressing need for creating conditions conducive to sustained growth required financing at rates of interest affordable to risk takers, more so in an economy with a plethora of drawbacks and deficiencies, including investors having limited commercial skills. The Bank had thus purposively effected successive rounds of interest rate cuts in 1969 and 1970 that severed the connective relationship between its policy rate, that is, the then Bank Rate, and the Bank of England key policy rate. With an expansionary monetary policy stance combined with an expansionary fiscal policy stance, began an eventful chronicle of macro-economic policy making in Mauritius.

As opposed to a free market system, Mauritius had in place a regime of direct monetary control. The then Bank Rate, deposit rates, lending rates and yields on Government papers were all

administratively set by the Bank of Mauritius. Transfers and payments for international trade transactions and capital transfers required prior approval of the Bank of Mauritius. This regime of direct monetary control and exchange control, seen in the light of the then prevailing economic and financial conditions, were arguably a legitimate strategy.

In the early years of the 1970s, selective credit controls by economic sectors were introduced for channeling funds to priority economic sectors with limits set on the overall bank credit expansion with a view to containing the surge in aggregate demand in the economy. Quite expectedly, bank credit grew far above the desired rate. The inordinate bank credit expansion in a contextual excess liquidity situation largely attributed to the then sugar boom, the oil price shock of 1973 combined with an across-the-board increase in wages and salaries had given rise to double-digit inflation rates, thus putting a stop to a very long period of price stability. Rising cost of living had made it compelling for the Government to introduce what is today known as the annual cost of living compensation. Inflation had turned out to be a serious policy concern. In today's free market context, one would have ordinarily expected the cost bank credit to go up, meaning that interest rates would have had to be stepped up. Instead, the costs of bank credit to export promoting and import substituting enterprises were intentionally kept low, reflecting the authority's objective of creating an enabling environment for the expansion of the manufacturing sector.

One of the most dramatic events that marked the first half of the 1970s was the breakdown of the Bretton Woods system on the 15th August, 1971. Overnight, the world financial system had moved from a fixed exchange rate regime to a floating exchange rate regime. Exchange rates of the world's major currencies had ceased to be linked to gold, directly or indirectly. Their determination was thereafter left to the inter-play of market forces. Many developing countries had adopted some kind of a pegged exchange rate regime which meant pegging the national currency to such a major reserve currency that best served the country's economic and financial interests. The Mauritian rupee had continued to be pegged to the Pound sterling. Since the Pound sterling floated as did other major currencies in the wake of the breakdown of the Bretton Woods system, the rupee floated along with.

A flush of liquidity, unsterilized, that had swelled aggregate demand side-by-side with an ever growing fiscal deficit also heavily financed by the central bank money had triggered a tension in the exchange rate of the rupee. The tension was exacerbated by a weakening of the Pound sterling as from May 1975. Weeks later, on the 30th June, the Pound sterling suffered one of its sharpest falls. The effective depreciation of the pound sterling against other leading currencies compared with the Smithsonian agreement of 1971 was nearly 30 per cent. It meant that along with the Pound sterling, the rupee also had depreciated significantly thus adding further pressures on domestic prices. The double digit inflation rates had turned out to be a major policy concern.

Inevitably, the exchange rate regime had to be reviewed. On the 5th January, 1976, the rupee was de-linked from the pound sterling and pegged to the Special Drawing Right (SDR) of the International Monetary Fund at the central rate of SDR1 = Rs7.713759. Seen in the light of the trade pattern of Mauritius, the SDR, a basket of currencies with the US dollar having the preponderant weight, was obviously an import-biased basket. The principal objective of the new peg, while intended to help minimize volatility of the exchange rate of the rupee, was to ward off pressures on internal prices stemming from the external front. So much was the Government concerned about the inflationary conditions in the economy that the new peg was decided upon even at the expense of deteriorating external payments position. The economic development objective was not adequately reflected in selection of the peg. Whereas the peg to the SDR favoured imports on the one hand, the qualitative and quantitative controls on imports were designed to check imports on the other. It did not make much harmonic sense in policy making. Because of the preponderance of the US dollar in the SDR basket, the peg of the rupee to the SDR could only stabilize the exchange rate of the rupee against the currencies of its major trading partners during a period of relative stability in the US dollar. In a world economy where

authorities were desperately grappling with the problems arising out of the breakdown of the Bretton Woods system and the unprecedented oil price shock of 1973, the resulting volatility of exchange rates of major currencies seemed to have been taken lightly in deciding on the appropriateness of the new peg. Given an export-oriented strategy, the appropriateness of the new peg has remained a moot question.

In spite of a relatively tight monetary policy stance, demand conditions, fueled by an expansionary fiscal policy, had continued to be buoyant with the result that the balance of payments posted successive years of deficits. There was a clear and persistent gap between the level of import demand and the country's foreign exchange earning capabilities. The basic causes of the deficits were the adverse terms of trade, the high level of public expenditure and deficit financing, the excessive growth in wages and salaries and the distortions in the domestic cost price structure. All the policy sins committed by decision makers were ultimately disastrously reflected in the balance of payments position of the country. The ill-effects of unchecked fiscal deficits year in and year out on the economy via excessive monetary expansion were conveniently left at the doorstep of Bank of Mauritius for resolution. The emerging precarious situation was indicative of an urgent need for bold measures. Instead, Government had recourse to foreign borrowings in an attempt to postpone painful adjustment measures. Humans, being what they are, the moment for under-spending almost never comes. Like fat people at a wedding feast, fiscal policy makers told to themselves they would eat less after the party was over, to make up for it. But in public finance, there is never a good time for fasting. The die was already cast. Bold measures, as always, need bold political courage. The second oil price shock of 1978 gave yet another blow to the economy. The foreign exchange reserves of the Bank of Mauritius had dwindled. The situation was desperate.

Drastic measures could no longer be delayed by having continued recourse to foreign borrowings. In October, 1979, the IMF agreed to an economic and financial programme under a Stand-by Arrangement. On the 23rd October, 1979, the Mauritian rupee was devalued by 22.9 per cent against the SDR basket to foster, *inter alia*, export-led growth. The devaluation was expected to restore the profitability and external competitiveness of Mauritian exports and to encourage import substitutions in the economy. The economic and financial programme was designed to stabilize the economy by bringing about a balance between the demands for and the supply of resources and to correct the balance of payments disequilibrium in the medium term. The measures under the programme included an exchange rate depreciation supported by restrictive budgetary, incomes and credit policies. The objective was to depress the demand for imports by way of the resulting higher rupee import prices. But, against all principles of good economics, the government had decided to grant a massive across-the-board increase in wages and salaries thus mitigating the positive outcome expected of the devaluation of the rupee. A central banker's job, it's often said, is to take away the punch bowl just as the party gets going. Way back in 1979, Government had decided to keep the bar open. Bad politics destroyed good economics.

The economy continued to face a number of difficulties which were caused by factors beyond the authorities' control. Adverse weather conditions which prevailed in early 1980 had led to a heavy shortfall in sugar exports in 1980–81. A fall in the rupee price of sugar exports which was due to the weakening of the pound sterling weakened the country's external payments position. A realignment of the external value of the rupee became inevitable and the rupee was devalued once more – not to use the euphemism "re-adjustment" – on the 27th September, 1981, by 16. 7 per cent in terms of the SDR. Two massive devaluation in six years reflected badly on the fiscal policy performance of the Government.

But we do have to recognize that the world economy was facing numerous challenges throughout the 1970s. The external economic environment was far from being hospitable to countries in a state of under-development. The breakdown of the Bretton Woods system had given rise to serious disturbances. The unprecedented oil price shocks of 1973 and 1978 had

unleashed destabilizing forces the world over. Authorities were learning for the first time since the end of World War II how to cope with a situation never seen before and resolve new problems posed by the two traumatizing events. The world economy had dipped into its worst economic recession since the end of the post-World War II. Stagflation, a state of high inflation rates and no growth, characterized the world economy. Governments and central banks the world over were having a very hard time resolving problems never known before. In Mauritius, recurrent strikes by trade unions, demands for higher wages and salaries, recurrent inclement weather conditions, high inflation rates fueled by high prices of oil and high unemployment rates were certainly not ideal conditions for a take-off to self-sustained growth. It was a decade of restlessness and crises in many respects. Admittedly, the economy did however undergo meaningful transformation. Policy mistakes were made. Right policies would have lessened the pains economic adjustment later. There are great lessons that all of us need to draw from the policy mistakes of the past. If we don't learn from our experience, we'll never learn at all. I was dismayed to see how the honest economist became a lonely voice of reason, and thus, a very valuable voice, but ignored most of the time arrogantly rather than nonchalantly. Ultimately, society, in particular the less privileged class, paid the price of the policy mistakes and arrogance of the charlatans.

It cannot but be appropriate – indeed very appropriate – at this juncture of my address this evening, to underline that the then Bank of Mauritius Act had an abhorrent sentence that read as follows: *"The Minister may from time to time give such directions to the Bank as, after consultation with the Governor of the Bank, he considers necessary in the public interest."* Even where directives were not formally issued, the Bank was required to seek the nodding approval of the Minister on many policy matters. Obviously, the Bank was not an independent organization. Having gone through the trials and tribulations in the field of monetary policy making for years and spent a greater part of my life in the central banking community, I have to say that it's the responsibility of one and all to preserve and protect the independence of the Bank of Mauritius in policy making and implementation from deplorable baskets of fake economists, self-seeking advisers and imposters in the veiled pursuit of self-interests. It's in the best interest of society to have a central bank that is truly independent. Independence of the central bank must be treated as sacrosanct. Never ever forget how a mafia-infested Italy was saved in the not so distant past from catastrophic situations. Two institutions are said to have saved Italy: the Vatican and the central bank of Italy.

By 1982, the world economy had bottomed out of one of its worst recessions since the end of World War II. A new era in monetary and fiscal policy making began. On the fiscal side, the sales tax that evolved into what we refer to as VAT (Value Added Tax) was introduced as part of a well-meaning and determined effort to curb the budget deficit. On the Bank of Mauritius side, a fundamentally important strategic policy move was made. As I mentioned earlier, the rupee had been linked to the SDR with a view to reducing the exchange rate variability of the rupee. With the steady strengthening of the US dollar especially since 1981, the SDR had appreciated against other major currencies which in turn resulted in an appreciation of the rupee on a trade weighted basis. More or less the same problems were baked in the SDR peg as in the Pound sterling peg. The time was up to do away with the SDR peg. With effect from the 28th February, 1983, the rupee was delinked from the SDR and pegged to a trade-weighted basket of currencies, which was more representative of the external trade pattern of Mauritius. The pegging of the rupee to the new and a much simpler basket of currencies was expected to be more effective in stabilizing its exchange value. It was a heavily export-biased basket designed to be a perfect fit for an export-oriented growth strategy.

Concomitantly, a number of key measures was announced for implementation decidedly. Government had given its unwavering political commitment to pursue the measures to the finish. Never in the history of Mauritius were monetary and exchange rate policies so harmoniously orchestrated and finely tuned with a host of fiscal and trade liberalization policies for the achievement of a common economic goal. In the scheme of things, trade liberalization

meant, *inter alia*, elimination of quota on imports, removal of import licenses, gradual reduction of tariffs and customs duties etc. On the fiscal side, the pre-eminent measures were a planned reduction of the then high corporate tax and income tax. A prudent wage policy was deemed a key element in the overall policy package to beef up the competiveness of the Mauritian economy. On the central banking side, a few policies aimed at complementing measures for strengthening competiveness and financial sector reforms were set as an agenda for immediate execution. The export sectors were the first policy target. The Bank's exchange rate policy was immediately geared towards one prime objective: achieve and maintain the competitiveness of the export sectors. Following the introduction of the new currency peg, the Bank of Mauritius monitored the exchange rate of the rupee on a daily basis. Corrective steps were taken as and when they were deemed necessary. In this exercise, constant attempts were made to keep the exchange rate of the rupee (I mean real effective exchange rate of the rupee) stable. The exchange rate of the rupee, deftly managed, in an imperfect financial market eventually enabled exporters to better predict costs and prices of their products.

The previous two currency pegs had not permitted the re-alignment of the exchange rate of the rupee on a regular basis. The new peg did. Investment in the economy shot up. The manufacturing sector, in particular the export sectors, underwent an unprecedented expansion. The economy fired in all its cylinders. Entrepreneurs mushroomed. Like boats in the rising tide of economic prosperity, new enterprises floated profitably. Exports shot up. The economy attained a state of full employment conditions. The foreign exchange reserves of the Bank of Mauritius rose to levels never attained before. Economic prosperity reached the lowest strata of the population. Government revenue collections improved substantially despite cuts in corporate and personal income tax rates and reduction in tariffs and customs duties. It's certainly not my intention to claim that the unprecedented economic prosperity of the second half of the 1980s is attributable solely to the Bank of Mauritius. Far from it.

I am sure, you will agree with me that entrepreneurship and industrial success do not occur from a void. They thrive in the soil of political structure and a culture comprising many essential elements. Those combined elements give rise to synergy and to a mood of optimism. A critically important element in addition to the ones I mentioned earlier, was the decision to go for financial sector liberalization. The objective of doing away with exchange control was announced in 1984 and accordingly measures were taken to gradually do away with the regime. By the mid-1980s, the foreign exchange reserves level of the Bank of Mauritius had reached more than comfortable levels and the budget deficit drastically curbed to a point that Government repaid quite a chunk of its external repayment obligations ahead of due dates. In August 1986, the Stand-by Arrangement with the IMF was over. Economic recovery was well under way. The balance of payments position for Mauritius had improved considerably. The then prevailing economic conditions did not warrant yet another Stand-by Arrangement with the IMF.

The launch of offshore banking in August 1989 portended an acceleration of the elimination of exchange control. Proper sequencing of financial sector liberalization required that the inter-play of market forces be promoted in the financial industry. It was a strenuous walk away from the era of financial repression. Ceilings on bank credit expansion – the long established method of containing bank credit expansion – began to give way to market forces. The Bank gradually let go the administrative determination of interest rates in the economy. Effective open market operations imperatively required market determination of the prices of Government debt instruments. In 1992, the Bank moved away from a rule-of-thumb method of determination of prices for Government papers to a method of weekly auctioning. While the process of financial sector liberalization was well under way, Mauritius adopted Article VIII of the Articles of Agreement of the IMF in September 1993. Prior approval of the Bank of Mauritius was no longer required for transfers and payments of international trade transactions. By July 1994, the Exchange Control Act was suspended.

A new framework for monetary policy making was adopted and a Monthly Monetary Policy

Committee Chaired by the Minister of Finance with the support of late Prof. Maxwell Fry of the University of Birmingham was set up. Mauritius was among the very few countries in the world to have had a Monetary Policy Committee in 1994. In subsequent years, the monthly meetings were held in house under the chairmanship of the Governor.

With the suspension of exchange control, began a full-fledged market based financial services industry in Mauritius. Normally, a market based financial industry presupposes fiscal discipline and, more importantly, rigors in public finance if monetary and financial stability has to be maintained, particularly, in relatively smaller jurisdictions. In the years just after abolition of exchange control, government borrowings from the central bank had reached very high levels because of expanding budget deficit. Excess demand for foreign exchange on the domestic foreign exchange market invited the Bank to more than frequently intervene on market up to a point it no longer was willing to proceed with intervention for fear of depleting its foreign exchange reserves. It was a typically monetary economics textbook illustration of what happens to the financial markets via the current account balance of payments when the fiscal position of Government is persistently out of line with economic realities. The end result was a chaos in the domestic foreign exchange market. The market ran short of foreign exchange. The rupee depreciated at an accelerated pace and the Bank of Mauritius, for some reasons, failed defend the rupee. The market desperately needed a shock therapy.

In the dying days of 1998, the Bank of Mauritius gave a counter shock to the money market by causing yields on treasury bills to shoot up and selling them directly to the public. Central bank financing of the fiscal deficit was soon completely replaced by financing from the public. The Bank regained its lost credibility and equilibrating forces worked their ways into the market. Order in the market was restored. The tight monetary policy stance of the Bank along with the “massaging” of the exchange rate of the rupee in a highly imperfect market gave the country, for the first time in its history, four successive years of current account surpluses in the initial years of the new millennium.

Both the domestic money market and the foreign exchange market were still in their fledgling state of development. Even five years after the suspension of exchange control, players in the money and foreign exchange markets were still operating with the same frame of mind as in the days prior to the abolition of exchange control. They shied away from such elementary operations as forward sales and purchases of foreign currencies. The risk-averse attitude was worryingly pervasive. Since the Mauritius Sugar Syndicate (MSS) was the single largest seller of foreign currencies in the market, the Bank forcefully drove the MSS to actively engage in forward sales of sugar export proceeds. It had required the CEO and the accountant of the MSS the gall and guts, the audacity to persuade their very conservative Board of Directors to be innovative. The then treasurer of Barclays Bank, a forward-looking young professional in finance, with the explicit support of the Bank of Mauritius threw his weight in the game and gave the kick-start for an innovative approach of treasury management. The domestic money and foreign exchange markets wherein millions of US dollars are traded today started right then and there. It’s in the best interests of our financial industry and, by extension, to the economy as a whole that these two markets grow healthily at a sustainable gait, without which the effectiveness of monetary policy transmission mechanism is seriously impaired.

One of the most important contributions made by the Bank of Mauritius in the past seventeen years finds its roots in a fundamentally important amendment to the Bank of Mauritius Act in 2004. The dual licensing regime, one for offshore banking and the other for domestic banking, introduced in 1988 before the launching of offshore banking in Mauritius in 1989, was done away with; it was replaced by a single banking license regime. The removal of the regulatory wall between offshore banking activities and domestic banking activities was a turbo-charged enabler of the widening and deepening of the domestic money and foreign exchange markets. Isn’t awesome that the foreign exchange reserves of the Bank of Mauritius have gradually risen to a record level of about US$5 billion despite consequential declines in export proceeds over the past

several years? No importers, no Mauritian travelling abroad, no student studying abroad has had any problem of foreign exchange for ten years unlike it often used to be in the past. The Mauritian economy has had ten years of enduring stability in the domestic foreign exchange market. We often take this for granted and insult the man, the institution that gave the country this precious gift of stability. That stability, indeed a very rare gift to any economic system for so long a time, ought to have been taken full advantage of for purposes of durable social and economic development. There are risks of instability in the offing that hopefully will be effectively tackled by the Bank and other agencies in the years ahead.

Thus far, the Bank has taken the stand that if the risk-taking behaviour of financial institutions cannot be regulated perfectly, it must impose some kind of prudential ratios to curb the volume of transactions. Otherwise the Bank would commit the same fallacy as gun control opponents who argue that “guns do not kill people, people do”. As we are unable to regulate fully the behaviour of gun owners, we have no choice but to restrict the circulation of guns more directly.

In an ever changing technological environment, new risks, new threats and greater regulatory challenges keep emerging. They intensify the regulatory burden for achieving financial stability. Our current regulatory and risk management systems are designed to retrospectively identify at what point in time a thief stole your money, not to alert you when he is actually stealing it. They are expected to change soon with the Bank’s risk-based supervision approach. Regulation and supervision of financial institutions is fast moving to a state of things where you might possibly beat the system but not the house. It does not necessarily go to say that the Bank will be regulating for zero failures. Such an approach would of course stifle financial innovation.

Human nature. I come back to an important element in Hyman Minsky’s financial instability hypothesis. The longer people make money by taking risk, the more imprudent they become in risk-taking. It’s self-fulfilling when the going is good. If everybody is simultaneously becoming increasingly more risk-seeking, the value of things like, say, privately issued cryptocurrencies, goes up. This increases the ability to lever and the game keeps going. Human nature is inherently pro-cyclical. Human beings are not inherently given to equilibrium; they’re inherently given to manic depression.

Once the process of financial sector liberalization was over, the Bank of Mauritius threw its weight on setting in place the building blocks for financial stability towards the end of the 1990s. The Bank came up with a completely new regulatory and supervisory framework for deposit-taking institutions.

The Bank of Mauritius has since made relentless efforts to improve the jurisdiction’s institutional set up and constantly update its regulatory standards. A successful regulatory authority needs independence in the exercise of its powers. The Bank of Mauritius was made legally independent in the Bank of Mauritius Act 2004. Along with the independence, the Act made allowance for the setting up of a Monetary Policy Committee. In the great spirit of responsible central banking, I have done what could possibly be done to maintain the independence of the Bank.

Ladies and gentlemen, on behalf of the Board of Directors of the Bank, myself included, my wife, Meera, and the staff of the Bank, I wish you all Happy Holidays and the very best for 2018.

Thank you.