1. Executive Summary

Since the issue of the February 2014 FSR, economic and financial conditions in advanced and emerging markets have continued to improve and financial stability risks have moderated. The global economy appeared on track for sustained growth though there are increasing divergences in the pace of recovery across countries and regions. Faster growth in the US and UK contrasts with sluggish prospects in the euro area, where the enduring effects of the crisis recently compounded by geopolitical risks limit the growth potential. Market turbulence in some vulnerable emerging market economies, brought by the beginning of the US Fed asset-purchase tapering programme, abated. However, the outlook for emerging economies remains subdued relative to past developments.

Monetary policy remains accommodative in major advanced economies but there are widespread expectations that the normalisation of interest rates in the US and UK will start in the near future. The process entails risks to financial stability, particularly since the low interest rate environment coupled with subdued volatility in financial markets appears to have given rise to excessive risk-taking, rising debt levels, and has led to over-pricing of various financial assets. A tightening of monetary policy stance could affect repayment capacity and bring increased volatility as well as significant price adjustments. Decoupling among advanced economies may further exacerbate vulnerabilities through its potential impact on major currencies, which could affect fragile emerging economies.

The domestic economy withstood global headwinds and continued to record positive growth. Statistics Mauritius projected growth to be slightly higher at 3.5 per cent in 2014, in line with a general pick-up in global economic activity. Unlike several emerging market economies, the impact of the US Fed tapering on domestic financial markets has been limited. The rupee exchange rate has been stable and the domestic stock market has performed well. External vulnerabilities arising from the large current account deficit prevail, especially as a large portion of the deficit is financed by debt-creating flows. There is also a concern that normalisation abroad may lead to a reallocation of foreign investors' portfolios. To partly mitigate those risks, the Bank has, through the Operation Reserves Reconstitution programme initiated in June 2012, accumulated gross official international reserves to Rs121.4 billion at end-June 2014, equivalent to six months of import cover.

Fiscal consolidation is on-going to meet the statutory debt-to-GDP ratio of 50 per cent by 2018, and efforts are being pursued to lengthen Government debt maturity profile and reduce rollover risks and costs. Financial stability risks from Government finances appear low although there are some interest rate and exchange rate risks regarding debt.

The banking sector was resilient, well-capitalised and generally profitable during the year ending March 2014 while activity grew appreciably. Banks operated with ample funding from domestic and international sources. Liquidity risks were low, but significant excess liquidity on the domestic money market led to worries about the effectiveness of the monetary policy transmission mechanism. Based on stress tests conducted by the Bank, the banking sector appeared to be resilient to adverse shocks affecting the credit quality of banks' loan portfolios. It is estimated that a majority of banks would not require additional capital injection under the tested scenarios.

Since banks can have a systemic impact on financial stability and the real economy because of their size, interconnectedness, and complexity, the Bank initiated action to identify domestic-systemically important institutions and determine an applicable capital surcharge. The Bank also started the implementation of Basel III to reinforce the regulatory framework, improve banks' soundness and strengthen financial stability. As a first step, banks need to maintain higher capital standards and capital conservation buffers are being introduced in a phased manner.

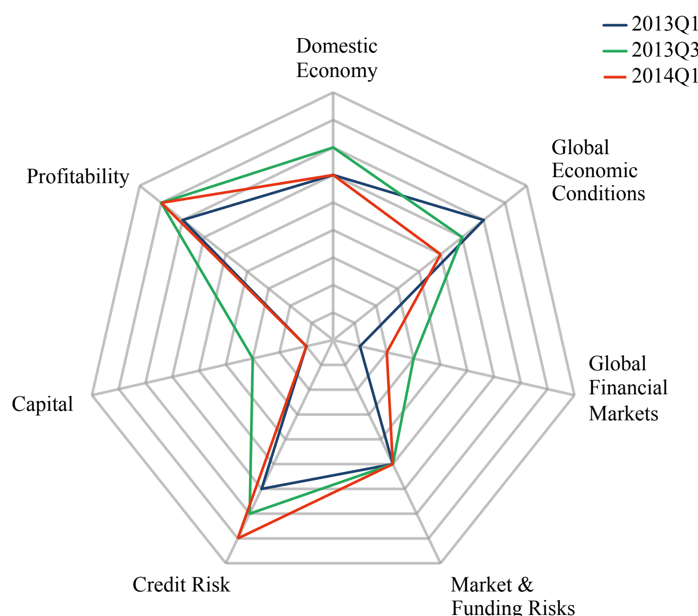
Credit remained an important area of risk. Although credit expansion slowed recently, the high growth rates recorded in previous quarters led to a large accumulation of debt in the household and corporate sectors. The Bank is vigilant over the shift towards consumption loans by households. Banks' asset quality deteriorated, with rising NPL recorded in some sectors. Excess liquidity could accentuate credit risk in the banking sector if banks lower their credit standards. There are sustained concerns about the construction sector where NPL increased to 8.2 per cent as at end-March 2014. The implementation of macroprudential measures induced banks to adopt a more cautious approach to lending to this sector. Cross-border exposures, mainly to India, also need to be carefully monitored due to concerns about declining asset quality in the Indian banking sector.

Large credit concentration suggests another potential source of risk to which the Bank remains vigilant, the more so as the balance sheets of some corporates have shown some signs of vulnerabilities. The introduction of sectoral limits, effective July 2014, is expected to mitigate those risks gradually.

Non-bank deposit-taking institutions remained sound and were well-capitalised. Their activities grew steadily, with total assets recording growth of 10.0 per cent as at end-March 2014. The insurance sector also recorded sound performance in 2013, with latest data from the FSC showing total assets growing by 13.0 per cent.

Overall, the financial system is assessed to be sound and resilient. Looking ahead, a key challenge for the domestic financial system will be related to the process of interest rate normalisation in some advanced economies and its spillover effects on global financial markets. Excess liquidity in the banking system, decline in asset quality, and rising indebtedness of some large corporates will also be carefully monitored to ensure financial stability.

Financial Stability Map



Note 1: Lower vulnerability closer to the center.

Note 2: For further information on the methodology used in the financial stability map, see Financial Stability Report February 2014.