EPZ'S FINANCIAL ISSUES REVISITED

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Keynote Address by Mr. R. Basant Roi, Governor of the Bank of Mauritius

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President of MEPZA

Ladies and Gentlemen

Good morning

I am pleased to be here with you this morning. I am equally pleased to have been given the opportunity to speak on an aspect of economic policy that has been for one reason or the other the subject of recurring sound-biting criticisms. Let me at the outset put it clearly that I am not here to reply to the criticisms that have been leveled against the Bank's policy. Criticisms do provide opportunities for central bankers to come out and explain their policy stands. Criminologists claim that few acts of violence are committed after a good meal. This prolongs the lives of speakers. I have had a hearty breakfast this morning. I do not intend to deliver a long speech on account of my throat. The risk is that one of you might cut it. Central bankers are accustomed to saying the right thing at the right moment and to leave unsaid the wrong thing at the most tempting moment.

Central banks, anywhere in the world, are never short of criticisms. The Bank of Mauritius has never been exempt of vitriolic remarks. Before July 1994 when the Exchange Control Act was suspended repeated releases of repressed emotions through random shootings of caustic remarks against the Bank's policies were quite common. In the wake of the liberalization of our financial system the monetary policy stance of the Bank has received less appreciation than it deserves. While the objective of the monetary policy of the Bank is well appreciated by some of us it is less so by others presumably because of considerations driven by self-interest. A short-term view or rather a myopic view of the Bank's monetary policy stance in a world economy that is highly demanding in terms of economic and financial efficiency is tantamount to losing sight of the forest because of the trees.

I shall attempt to give a perspective to the monetary policy of the Bank for your benefit. I view this as being important simply because a full appreciation of the Bank's work and results does require a perspective beyond a few months or even beyond a single year. A single day, a few months or even a year is rather a short time to really gauge what monetary policy of the Bank can accomplish on a lasting basis. Monetary policy takes time to make its beneficial effects felt in any economic society. But I do also reckon that a few months or even a single month or a single day may sometime appear to be a long time. Events having undesirable consequences for the economy can take place in minutes.

We live in an economic society wherein the role of money is taken for granted. The basic importance of money in the economy is unwittingly overlooked. Buyers and sellers, savers and investors and borrowers and lenders are, as you are aware, linked through money. It goes to say that money which links them should have our confidence if our economy has to perform well. Money that keeps its value will have the confidence it deserves. As is usually said among central bankers it is the democratic right of every citizen to see that the length of a metre or the weight of a kilogramme does not vary over time. Why then should the value of money change over time? Clearly, the basic objective of monetary policy of the Bank, which is the sole issuer of currency in the country, should be to preserve the value of money.

The Bank of Mauritius is the nucleus in the process of money creation in the economy. It is mistakenly believed that the Bank has the intrinsic power of simultaneously achieving a multiplicity of objectives. This is a gross misconception. Paradoxically, there is also a common tendency for some in the exporting community to believe that inflation need not be the prime consideration of the Bank. This is also an incorrect view of what should be the objective of our monetary policy. Our business community and the public at large would be badly served if the Bank's monetary policy stance irresponsibly fuels inflation. Suffice to say that inflation creates uncertainty, breeds inefficiency and makes the economy less productive. Worst, it creates inequity. Those who gain from inflation necessarily gain at the expense of others. In fact, the Bank's power to print money is limited by the leverage available to monetary policy. The Bank uses this leverage to enhance the economic performance of our country. In simple terms, the Bank manages liquidity in the economy - which in turns affects expenditure – in such a manner that is consistent with the capacity of the economy to grow but, as far as possible, without giving rise to inflationary pressures. Monetary policy would not be doing justice to all of us if it unleashes forces that create inflation.

What is the 'ideal' rate of inflation then? Ours is a small economy and highly open to international exchange and international economic and financial influences. As such it is quite inflation-prone. There is no such thing as an 'ideal' rate of inflation. The best policy outcome can only be price stability. Taking into consideration the character of our economy, an inflation rate of 3 to below 5 per cent sustained over time is believed to be tolerable. A rate of inflation in this range may be kept in sight as an anchor for the monetary policy of the Bank of Mauritius. The sustained policy effort in the last few years underpinned by the absence of a consequential increase in wage bill in the economy helped bring down the rate of inflation. For the current fiscal year the rate of inflation is expected to be around 5 per cent. Importantly, the pressure behind inflation appears to have lost some of its intensity.

I wish to underscore that the problem of inflation would have been greater today had not the Bank of Mauritius progressively pursued a restrictive monetary policy stance in response to the intensified inflationary pressures following the rapid depreciation of the rupee in 1996, 1997 and 1998. Beginning 1999 we pursued a policy of monetary tightening with a view to arresting the rapid depreciation of the rupee thereby stopping the flight of capital. Had the depreciation of the rupee and the resulting flight of capital not been arrested the foreign exchange reserves of the Bank would have dwindled to only a few weeks of imports. Inflation rate would have eventually risen to double digits. Seldom do we realize that with the least policy mistake in 1999 we would have subsequently knocked at the door of the IMF for a Stand-by Arrangement. Monetary tightening, that is, the high interest rate policy relentlessly pursued over time helped stabilize the foreign exchange market and also check monetary expansion to a rate consistent with the objective of reducing the rate of inflation.

It is therefore a misconstrued view that the Bank of Mauritius is pursuing a high interest rate policy. This is not how I would like to put it. The Bank is pursuing an inflation fighting policy. All of us know it well. Savers do demand higher interest rates to protect themselves from higher inflation rates. A monetary policy stance that eventually brings about sustained low and stable inflation rate creates conditions for sustained low interest rates. We are all well aware that it is only in those countries that have a good track record of confidence in their money through policies that generate low and stable inflation that we find low interest rates. A good track record of low inflation does set the ground for low interest rates. Low inflation rates precede low interest rates. The converse is invalid.

Lending rates of commercial banks are often said to be on the high side. There is no doubt an element of truth in this contention. However, it does not necessarily go to say that commercial banks alone are to be blamed for the high lending rates. Often borrowers too share the blame. You might recall I have since 1999 pressed upon banks to reduce their non-performing loans to a tolerable level. Non-performing loans are one of the reasons that explains the tendency to charge high lending rates to borrowers. In any banking system the ‘free lunch’ has to be paid by someone. Generally depositors and honest borrowers are made to pay for the bad and doubtful debts through lower deposit rates and higher lending rates respectively. I do not see any justification for rogue borrowers to clamour for low rates of interest. Banks need to make good credit appraisals while making lending decisions failing which lending rates would continue to be prohibitive even to honest borrowers. The good news is that banks have seriously undertaken to bring down their non-performing loans to acceptable limits.

Let me now turn to the exchange rate of the rupee. Exchange rate is evidently important. Its movements and levels have a strong bearing on medium and long-term growth prospects of our economy. As such the exchange rate of the rupee has a lot to do with monetary policy. Monetary policy is effective only in a market based financial system. In any capitalist system the financial markets are the most market-oriented. Undue intervention in such markets over a protracted period of time will most likely turn out to be counterproductive. In such a framework confidence is fundamentally an important ingredient that the Bank of Mauritius can provide to financial markets in the formation of judgements regarding interest rate and exchange rate. It goes without saying that the Bank of Mauritius should constantly seek to build confidence in the rupee. Confidence in the external value of the rupee cannot be maintained if confidence in the internal value of the rupee is not maintained. This is what price stability is basically all about. Let me stress that it does not go to say that we should have an exchange rate target.

As you are well aware, the exchange rate of the rupee reflects international as well as domestic market conditions. Over the 12-month period ended March 2003, it may be observed that the US dollar has weakened significantly on international financial markets. The Japanese yen, Pound Sterling and the Euro have appreciated against the US dollar. The rupee depreciated on average by 10.2 per cent against the Euro, 6.7 per cent against the Pound sterling and 1.7 per cent against the Japanese yen but appreciated by 0.5 per cent against the US dollar. In trade-weighted nominal effective terms, the exchange rate of the rupee depreciated by about 8 per cent. In real effective terms, the rupee recorded a depreciation of about 5 per cent. There is nothing to suggest that the exchange rate of the rupee is in any way responsible for the erosion of international competitiveness.

Once again concern has recently been expressed about the appreciation of the rupee vis-à-vis the US dollar. In pressing their claim for a higher rate of depreciation of the rupee, some have even leaned on the Turkish case. What is not mentioned, however, is that the double digit rate of depreciation of the Turkish currency has also been served with a helping of high inflation rate of 27 per cent and high short-term interest rate of 42 per cent. Let me say once again that this is far from being a Turkish delight!

It is more appropriate to view exchange rate developments over a period of time. The more we integrate with international financial markets, the more we have to allow markets work their way through. The exchange rate of the rupee has recently been likened to price determination in a specific market. Well, in so far as we are trying to promote a competitive foreign exchange market, the Bank of Mauritius is quite comfortable with this reference. Indeed, we welcome it because the market under reference is the only market in Mauritius that is closest to the textbook model of perfect competition.

Currency appreciation or depreciation cannot be a panacea for all our economic ills. We should not forget that appreciation or depreciation of a currency could be a mixed blessing. In terms of macroeconomic policies, the authorities usually have to make a policy trade-off between the extent of exchange rate adjustment and the inflation rate. It must, however, be emphasized that the way forward for Mauritius is for it to become competitive through the achievement of real productivity gains. A deliberate policy to depreciate the rupee can only be a temporary solution and not a permanent one. A lasting solution to long-term competitiveness depends not on exchange rate changes but on productivity growth. Short-term exchange rate accommodation can only serve to postpone the need to address the real issues relating to restructuring, good management and productivity improvement. Any attempt to rescue employment in the Export Processing Zone through the depreciation of the rupee cannot but be a temporary one.

Finally, let me reassure firms in the Export Processing Zone that the Bank of Mauritius will continue with the pursuit of a monetary policy stance that does not jeopardize the maintenance of low and stable inflation keeping in view certain short-term considerations. The monetary scene in Mauritius today does not at all support the view that the economy is in a state of ‘fundamental disequilibrium’. There is no precise definition of ‘fundamental disequilibrium’. The IMF has a working definition to judge whether or not an economy is in a state of 'fundamental disequilibrium'. Of the six broad criteria that define the presence of fundamental disequilibria in an economy none of them is palpably present in the current state of the Mauritian economy. Instead, Mauritius is for the first time in its history recording four successive years of current account surpluses in its balance of payments. The overall balance of payments surpluses are significant. The foreign exchange reserves position of the Bank of Mauritius has attained unprecedented level. Inflationary pressures in the economy are contained. Inflation is on a declining trend. Although the rupee has in the past months appreciated against the US dollar partly due to the surpluses generated in the current account of the balance of payments there is no evidence that the exchange rate is mis-aligned. The Bank of Mauritius is pretty conscious that persistent appreciation of the rupee over a protracted period of time could potentially lead the economy to a state of 'fundamental disequilibrium'.

While guided principally by the objective of sustaining low and stable inflation, monetary policy will continue to strike the desired balance between short-term and long-term considerations in the best interest of the economy. Once I likened the conduct of monetary policy to drawing a heavy paperweight with a piece of elastic – either the heavy paperweight does not move or it flies across the table and hits you in the face. This analogy seems closer to reality than the organized sound-biting criticisms.

I wish you well.

Thank you.

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