



## **Monetary Policy in Small Financial Centres**

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Ladies and Gentlemen:

It is a great privilege for me to be here today and to participate in the 40<sup>th</sup> anniversary of the Bank of Mauritius, and in this way to celebrate the Bank's many achievements. While it is plain for all to see that the economy of Mauritius has undergone profound changes since 1967, it is not necessarily as obvious to the public that the monetary policy framework has been similarly transformed.

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\* The views expressed are solely my own and are not necessarily shared by the Bank of Mauritius, its Senior Management, Board, or Monetary Policy Committee.

Before 1967, the Board of Commissioners of Currency functioned as an issuing authority, *passively* adjusting monetary conditions in light of changes in the demand for money. By contrast, monetary policy is now pursued in an *active* manner, seeking to achieve the objectives specified in the 2004 Bank of Mauritius Act, that is, “to maintain price stability and to promote orderly and balanced economic development.” This gradual change from a passive to an active monetary policy strategy is of course a phenomenon that many countries have experienced, including my native Sweden. It may strike some as a minor change but it is in fact far reaching, a little bit like the difference between watching an opera and being the lead tenor.

The topic of my talk today is “Monetary Policy in Small Financial Centres.” By this I mean small and highly open economies that have a large financial sector. The reason for this choice of topic is, of course, that Mauritius is a small and highly open economy with a rapidly expanding financial sector. I should emphasise that I speak in a personal capacity and that the views expressed are not necessarily shared by my colleagues on the Monetary Policy Committee.

I will start by looking at the monetary policy experiences of two small and highly open economies with large financial sectors. For reasons that I will explain in a while, I will focus on Singapore and Switzerland. In thinking about how the monetary policy strategy here might evolve in the coming years, it seems natural to look at the experiences of other economies that also are small and have a large financial sector. Although the economies of Singapore and Switzerland are more advanced and differ in important respects from the economy here, I do think there are important lessons to be learned from their very successful conduct of monetary policy.

Next I will look at the monetary strategy of Mauritius. My main point is that monetary arrangements here are very good, but that further refinements may become desirable as the economy develops and its complexity increases. I will also briefly touch upon the costs and benefits of introducing inflation targeting.

But since we are celebrating the 40<sup>th</sup> anniversary of the Bank of Mauritius, let me first briefly review macroeconomic developments here since the establishment of the Bank in 1967. Forgetfulness of things past is not helpful when thinking about monetary policy.

### **Macroeconomic developments in Mauritius, 1967-2006**

Figure 1 shows the growth rate of real GDP and two measures of inflation, one constructed using the GDP deflator and one constructed using the consumer price index. The figure tells a story familiar from many countries: the 1970s were turbulent, with inflation rising sharply following the oil price shocks of 1973 and 1979. Inflation, as measured by the GDP deflator, reached almost 50 percent in 1974, and CPI inflation peaked at over 35 percent in 1980. Higher oil prices meant higher production costs and therefore lower output: real GDP growth fell to about 1 percent in 1975 and GDP in fact contracted by almost 11 percent in 1980.

Economic performance has been much better recently. Figure 2 focuses on the period between 1992 and 2006. Growth of real income averaged almost 4.5%. Since population growth averaged about 1% per year in this period, these were years of rapidly increasing real income for the people of Mauritius. At the same time, inflation was lower and more stable than before, averaging about 6% per annum, irrespectively of the choice of price index used to compute it. The figure

tells us something important: relatively low inflation and economic growth can occur simultaneously and there is no inherent conflict between them.

Most central banks conduct monetary policy by managing a short-term interest rate, changes in which impact on a whole range of other interest rates in the economy. Let me end this brief macroeconomic review by looking at the three-month interest rate. Of course, central banks impact on *nominal* interest rates, but the true cost of borrowing depends on the difference between the nominal interest rate and the rate of inflation, the *real* interest rate. I have therefore included a measure of it in Figure 3.

The figure shows that during the recent episode of sustained growth and stable inflation, nominal interest rates exceeded the rate of inflation by on average about 4 percentage points. The most recent years, in which nominal interest rates declined and – perhaps not surprisingly – inflation tended to rise, are exceptions.

Let me emphasise that, despite these observations, I am not necessarily saying that monetary policy must be tightened in order to return real interest rates in Mauritius to a level closer to their historical average. It could be that because of changes in the economy the equilibrium level of real interest rates in Mauritius has fallen in recent years. Or it could be that the inflation rate will decline in response to the interest rate increases we have already seen. Or it could be that higher interest rates are in fact needed. These are questions that the Monetary Policy Committee has to consider and until it has done so I will refrain from commenting on them.

So overall, the last 40 years have been a period in which real income in Mauritius has been growing steadily. After a turbulent episode in the 1970s with gyrations in growth and high and volatile inflation, the more recent period has seen more economic stability with nominal interest rates generally a few percentage points above the rate of inflation.

### **Monetary policy strategies in Singapore and Switzerland**

Next, let me turn to the monetary policy strategies of Singapore and Switzerland, both of which are small and highly open economies and are large financial centres. These are very advanced economies and one might think that their experiences are of little relevance to Mauritius. But, interestingly, their monetary policy strategies, although of course much more refined, are in some important ways similar to that of Mauritius. Since they have been very successful in achieving low and stable inflation, which seems essential for a financial centre, it may serve us well to consider their approaches to monetary policy and see whether there are useful lessons for us to learn.

So what are the critical features of the monetary policy strategies of Singapore and Switzerland? Four are readily apparent.

First, both the Monetary Authority of Singapore (MAS) and the Swiss National Bank (SNB) gear monetary policy to maintaining low and stable inflation. In this regard they have been very successful, as evidenced by Figure 4. Inflation in Singapore averaged 2.9% percent between 1967 and 2006; in Switzerland the average inflation rate in the same period was 3.0%. Between 1992 and 2006 the average inflation rates were even lower: 1.1% and 1.3%, respectively. More importantly, although inflation rose in both these countries in the 1970s for much

the same reason as it rose in Mauritius, policy makers quickly took measures to reduce it to lower levels. Thus, aiming for low and stable inflation, and returning inflation to the desirable level if a shock occurs, seems to be important for central banks in financial centres.

It is easy to see why this is so. High and unstable inflation creates random wealth transfers between creditors and debtors. Of course, since financial centres are characterised by large stocks of assets and liabilities, these effects are likely to be particularly large in them and so low and stable inflation becomes all the more important.

Second, in both countries the public has come to understand that the main objective of monetary policy is price stability. The authorities have achieved this the hard way – by maintaining low and stable inflation for a very long time. The strong track record of price stability means that inflation expectations respond little to economic disturbances, something that makes it easier to maintain low inflation, as I will discuss in a little while.

Third, the MAS and the SNB both use active monetary policy strategies in which exchange rate flexibility plays an important role. The reason for this choice of approach is simple: if the central bank was to fix the exchange at a specific level, it would have to move interest rates to stabilise the market exchange rate. In doing so the central bank would lose direct control of inflation, as there can be no guarantee that the fixed exchange rate, and the level of interest rates that is needed to sustain it, would also lead to an appropriate rate of inflation.

That said, being highly open, policy makers in both countries do worry about the level and movements of the exchange rate, since a large change in it would have a direct impact on inflation and the economy more broadly. But while they may at times seek to influence the exchange rate, they do not have a specific target for it: instead, the authorities' views of the appropriate exchange rate level evolve over time in response to macroeconomic developments.

Interestingly, while both the MAS and the SNB pay attention to the exchange rate, its precise role in monetary policy differs between the two countries. In Switzerland monetary policy is implemented by affecting short-term market-controlled interest rates and the exchange rate is left to adjust. This is a common operating strategy. In Singapore, by contrast, policy makers impact directly on the exchange rate and let interest rates adjust accordingly. While Singapore has been very successful in its conduct of monetary policy, this approach is somewhat unusual. It is not clear to me whether it can be replicated easily elsewhere.

Fourth, in both countries monetary policy is seen as a technical undertaking outside the realm of politics. This reflects the by now firm consensus among central bankers and academic researchers across the world that only by keeping interest rate decisions insulated from day-to-day politics can low inflation be achieved and maintained.

Such insulation is frequently achieved by having an independent central bank. This is the approach taken in Switzerland, where the SNB historically has enjoyed a very high level of independence. Singapore seems to be the exception that proves the rule that central bank independence is essential for good

monetary policy. But I would argue that the MAS is in a rare and fortunate situation in which the government truly understands the benefits of sound money, something that is readily apparent from Singapore's enviable track record of inflation control. In this happy situation, of course, the question of central bank independence does not arise.

### **Lessons for Mauritius**

So what lessons of relevance to Mauritius can be drawn from the MAS's and the SNB's conduct of monetary policy? I can think of four: aim for low inflation; make the public understand that this is the focus of monetary policy; let the exchange rate be free to move; and see monetary policy as a technical undertaking which is not to be influenced by short-term political developments. Let me discuss in inverse order these lessons and how they apply to Mauritius.

According to the 2004 Bank of Mauritius Act, the Bank enjoys legal independence, much like the SNB. The power to set interest rates here rests with the Monetary Policy Committee, whose members are selected because of their expert knowledge about the economy of Mauritius, gained from long public service or while working in the private sector, or of monetary economics. The Monetary Policy Committee can set interest rates freely, subject only to the requirements specified in the Bank of Mauritius Act.

In the meetings, members debate how the economy is evolving and what measures are needed to achieve the statutory objectives of monetary policy. This is an entirely technical discussion. Having the Monetary Policy Committee set interest rates in this way enables the government to focus on the issues it is best placed to handle, in particular, on promoting economic growth and



development, and on determining how the fruits of that growth should be shared by the citizens of Mauritius.

Turning to the exchange rate, I note that while it is free to vary, the Bank of Mauritius does keep an eye on it. This seems appropriate: changes in exchange rates can impact on inflation and economic conditions and may be particularly large in periods of financial strains in which the foreign exchange market can become one-sided and lack liquidity. But the exchange rate is an integral part of the price mechanism through which the economy adjusts to shocks. Fixing it would thus not be desirable.

That leads me to the last two lessons from the monetary policy experiences of Singapore and Switzerland: aim for low inflation and promote public understanding that that is the focus of policy.

To meet these goals, many central banks have recently adopted inflation targeting by announcing a numerical objective for inflation. If inflation deviates from the target, the argument goes, the public will expect interest rates to be changed in order to return inflation to the objective. Once the central bank has established a track record of delivering on the target, the public's expectations of future inflation will stabilise at the appropriate level.

To understand the benefits of this, suppose that a temporary shock occurred so that inflation rises unexpectedly. In the absence of an inflation target, workers may come to believe that the central bank will not return inflation to target, so wage demands may go up as workers want compensation in advance of expected price increases. Firms may also not believe that the central bank will

take action, and therefore agree to wage increases in the expectation that future inflation will enable them to raise their own prices without becoming uncompetitive. Thus, high inflation expectations are likely to be reflected in higher wages and price pressures.

In this situation the central bank is presented with two unenviable choices. It could tighten monetary policy to reduce the level of demand in the economy, which reduces firms' scope to raise prices. With higher wages but without the possibility to raise prices, inflation will be kept under control but at a cost of a policy-induced recession. The second option is not to tighten monetary policy. But this means that the central bank accepts that the inflation rate may be higher permanently.

Suppose instead that the public knows that the central bank will not let inflation move away from the targeted level, so that their inflation expectations are firmly anchored and are unaffected by the initial rise in inflation. In this case, the increase in inflation will not lead to higher wages, as firms and workers know that a purely transitory shock has occurred which the central bank will offset. Without secondary wage increases or responses by firms, it is of course much easier for the central bank to return inflation to the target. Thus, engendering low and stable inflation expectations is a key task for any central bank.

However, while inflation targeting has desirable features, neither the MAS nor the SNB have found it necessary to introduce it, although the SNB has defined price stability, its dominant objective, as annual inflation of less than 2%. One reason for this may be that by the time inflation targeting became widely used, Singapore and Switzerland already had a long history of low inflation and the

public had come to understand that this is the goal of policy. With little to gain and with central banks naturally being hesitant to change something that works well, it is not difficult to understand that these central banks saw no reasons to change their policy frameworks.

But do the experiences of Singapore and Switzerland suggest that adopting inflation targeting makes sense for Mauritius? In commenting on this question, let me again emphasise I am expressing my own views and that, in the absence of thorough review of the costs and benefits of such a policy change, they are necessarily speculative.

I believe that in the near future it would be desirable to think carefully about the potential costs and benefits of taking such a step. One likely benefit of introducing inflation targeting is that it would clarify what exactly “maintaining price stability” means, which may stabilise inflation expectations more rapidly than merely aiming for low and stable inflation would. If so, it would facilitate the setting of monetary policy. I note that introducing inflation targeting would be compatible with the Bank of Mauritius Act, which says that the Bank, with the concurrence of the Minister, shall determine the accepted range for the inflation rate which, in a given period, is consistent with the price stability objective.<sup>1</sup>

While I thus think there are reasons in favour of introducing inflation targeting, most countries that have recently done so have taken this step in situations in which inflation was close to the steady state level. Since the rate of inflation in Mauritius is relatively high by the standards of the last 15 years, I am sensitive to

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<sup>1</sup> See Section (5), subsections (1)(a) and (2)(a).

the argument that this may not be an opportune time to do so. Furthermore, central banks that have recently adopted inflation targeting have done quite a bit of preparatory work, in particular, they have developed statistical models to forecast inflation and to predict the effects of monetary policy actions. This is an area in which building expertise takes time. Thus, good arguments can be made for why the time for inflation targeting, however desirable in the longer term, may not yet have come for Mauritius.

### **Conclusions**

Let me conclude. My brief review of the macroeconomic history of Mauritius indicated that after some economic volatility during the first 25 years after the establishment of the Bank of Mauritius in 1967, the last 15 years have been marked by much greater economic stability. In particular, inflation has been lower and less variable, notwithstanding the developments since the middle of 2006.

My review of the monetary frameworks and economic developments in Singapore and Switzerland led me to conclude that monetary policy in small financial centres is typically focussed on achieving price stability, since the costs of inflation are likely to be particularly large in such economies. I also noted that while the conduct of monetary policy is more advanced in these economies than here, there is quite a bit that can be learned from their highly successful records of safeguarding price stability.

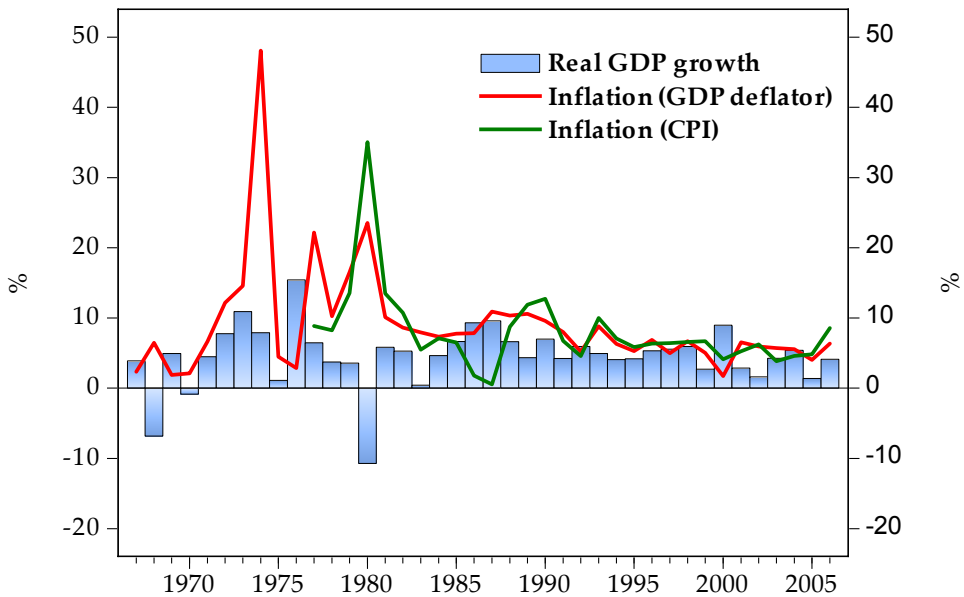
Finally, in reviewing the monetary policy strategy here in Mauritius, I sought to argue that while it is well suited to the circumstances, the continued development and increasing complexity of the economy suggests that over time

it may be desirable to consider if greater clarity about the objectives of policy can be achieved by adopting inflation targeting. While a definitive answer to that question will have to await a comprehensive review of the costs and benefits of doing so, I am cautiously in favour.

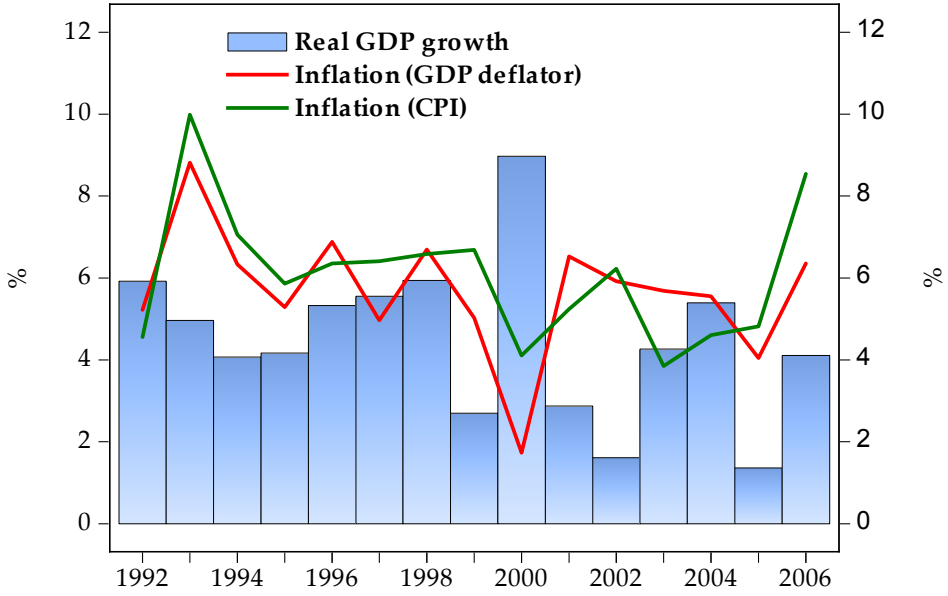
In ten years from now the Bank of Mauritius will turn fifty and will have reached adulthood as a central bank. As we hopefully all then gather again to participate in the various celebrations, it will be interesting to see how the framework for monetary policy in Mauritius will have developed in the intervening years. My guess is that it will have continued to undergo a series of improvements, and that the average rate of inflation will be clearly below the rates we have experienced in the last 15 years. Time will tell.

Thank you.

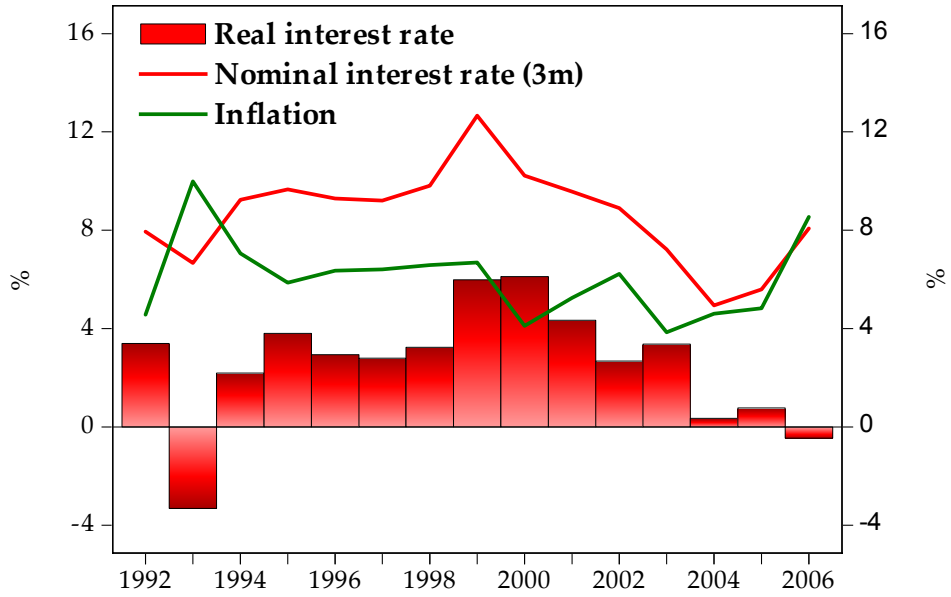
**Figure 1:**  
**Economic Growth and Inflation in Mauritius**



**Figure 2:**  
**Economic Growth and Inflation in Mauritius**



**Figure 3:  
Real and nominal interest rates in Mauritius**



**Figure 4:  
Inflation in Switzerland and Singapore**

