

**6th Meeting of Governors of the
Association of African Central Banks
Eastern Africa Sub-Region**

TOWARDS THE AFRICAN MONETARY UNION

Opening Address

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A very good morning to all of you.

And a very warm welcome to my Fellow Governors, former governors, central bankers and other overseas visitors who are with us this morning.

I feel very privileged and honoured to address you this morning at the opening ceremony of this Sixth meeting of Governors of the Eastern Africa chapter of the Association of African Central Banks.

For my colleagues and me at the Bank of Mauritius, this meeting assumes even greater significance as we prepare to celebrate the fortieth anniversary of the Bank in three months' time.

It is just twelve weeks since I was appointed Governor of the Bank of Mauritius. I am acutely conscious that I am very much the new boy on the block. It makes me understandably nervous to address such an august assembly of governors and high officials of central banks from the region. The novice in central banking that I am does, however, claim a passing familiarity with regional cooperation and regional integration, which constitute the backdrop for our meeting.

My involvement in regional integration dates back to the days when I was Director-General of the Ministry of Economic Planning and Development. With the assistance of a few very dedicated colleagues, I was able to position my former Ministry to play a leading role in various aspects of regional integration. It was under our impulse that Mauritius successively became a member of PTA, the Preferential Trade Area which was the precursor of the present COMESA, the Indian Ocean Commission of which I was a founder-member, SADC, the Cross Border Initiative and the Indian Ocean Rim-Association for Regional Cooperation. Indeed, I was instrumental in getting two of these agencies to set up their headquarters here in Mauritius.

Between 1997 and 2000, when I served as Minister of Economic Development, Productivity and Regional Cooperation, I had the privilege of chairing the Council of Ministers of the IOR-ARC, the COMESA Council of Ministers, and the CBI, which actually became the Regional Integration Facilitation Forum under my chairmanship. Somewhere along the line, I was also associated with the African Economic Research Consortium and, more recently, I got roped in to advise the East African Community on benefits asymmetry. I thought I should fill you in on this as regional cooperation looms large in the African Monetary Cooperation Programme that you have embarked upon.

Today, all countries - rich or poor, big or small, - are confronted with the various challenges thrown up by globalisation. Smaller countries face bigger challenges and even greater risks, as we know only too well. We have to reckon with unpredictable external shocks, such as oil price hikes, drop in the export price of our commodities, or of our manufactured exports. How should we react in the face of globalisation ? Should we, like one Latin American country did last week, pull out of the IMF and the World Bank ? It would be disastrous to envisage such a scenario on our continent as most of our countries are still indebted to these institutions, which for all their imperfections, have done a creditable job. Of course, we are not denying that there is considerable scope for achieving a better and more equitable international financial architecture more suited to the needs of our region.

Faced with the challenges stemming from globalisation, we have to build greater economic resilience into our economies. Turning our back on globalisation is not an option. Protecting our markets and insulating our labour force from competition can buy short-term peace and create the illusion of growth and welfare. Sustainable growth does not lie in that direction. Burying your

head in the sand was never a good strategy. Nations across the world are integrating their economies with those of their neighbours, to create larger and more competitive regional economic groups, and to engage in international trade - not as individual states but as regional powers. In Africa, now more than ever before, regional economic cooperation and integration has become a necessary condition for long-term sustainable development. It is in this context that we must focus on the objectives of the African Monetary Cooperation Programme.

This Programme requires us to adopt collective policy measures to achieve a harmonised monetary system and create a common management institution. The harmonisation of the monetary cooperation programmes of the various sub-regional groupings constitutes the first stage. These will then serve as building blocks for the single African monetary zone, which we expect by the year 2021, with a common currency and a common Central Bank. To move in this direction, the AACB has adopted a set of quantitative macroeconomic convergence criteria, that should be observed by at least 51 percent of AACB members, before we can launch the African Monetary Union.

There are some encouraging signs. Growth performance during the last three years in Sub-Saharan Africa has been the best in more than three decades, and higher oil revenues and increased debt relief have been used to make progress toward the Millennium Development Goals. Despite spending pressures, most countries have managed to preserve macroeconomic stability with policies intended to support and sustain the region's higher growth. However, while current growth rates in Africa are high by historical standards, they are not sufficient to have a decisive effect on poverty and help Africa attain the Millennium Development Goal of halving poverty by 2015.

One of the primary convergence criteria in terms of the African Monetary Cooperation Programme is the maintenance of an annual inflation rate of less than 3 per cent. The achievement of this inflation target is indeed a heroic challenge for many of our countries. Here in Mauritius, inflation has just nudged up into the very lowest of double digits, at 10.5 percent for the current fiscal year, for the first time in fifteen years. It is exercising our mind and causing some discomfort all round. We can hardly imagine what it must be like to grapple with quadruple-digit inflation, which is currently confronting a Fellow-Governor on the continent. This four-digit inflation rate certainly makes us extremely uncomfortable and underlines the need for continued vigilance in the fight against inflation. It is also a stark reminder of the very long road we still have to travel before we achieve our common vision of the African Monetary Union.

To paraphrase Lao-Tse, the longest journey begins with but a short step. We have taken many steps and we are well on our way. And, in our sub-region, we have made great strides since Governors last met. We are aware that much remains to be done to make a bigger dent on poverty and to raise living standards. We need to accelerate growth through more trade, more private sector development, more effective use of public resources and a deepening of our respective financial sectors.

There are wide disparities in the financial sector across Africa. Middle-income countries have a larger financial sector and broader institutional coverage than low-income countries. The latter typically have a narrow range of institutions. Many people do not even have access to basic payment services or savings accounts and cannot obtain credit. This inevitably handicaps economic transactions and impedes growth.

In low-income countries, banking transactions form the bulk of financial activity. In contrast, middle-income countries have a more diversified financial sector. This would normally include an insurance sector, a stock market, non-bank financial intermediaries and microfinance institutions. A country with a less diversified financial sector is more vulnerable to credit risk. A fall in commodity prices, with adverse impact on exports, can rapidly impair bank loans. Hence, the need to have a high capital adequacy ratio and prudential ratios on exposure to any single customer. Another characteristic of banks in our region is the high operating costs and high net interest margins. This reflects low efficiency. Banks with high operating costs need a high spread to cover these costs.

What can we do to make our financial sector more resilient? First and foremost, macroeconomic stability should be consolidated. If this is lacking, there is no growth, no rise in incomes and no reduction in the incidence of poverty. An increase in investment is also required. Gross domestic investment as a share of GDP is very low in Africa. We attract only a marginal share of world FDI to Africa, and it tends to go into extractive industries. Global investors will only be interested in the rest of our countries in Africa if we can offer peace, stability, good governance, the rule of law and the absence of corruption. Africa needs to strengthen its financial systems. Weak banks should be restructured through measures to address the stock of nonperforming loans and accumulated losses. Bank regulation and supervision should be improved through greater compliance with the Basel Core Principles for Effective Bank Supervision. Help is at hand as our own experience in Mauritius shows. The Financial Sector Assessment Program, initiated by the IMF and the World Bank, aims at strengthening financial systems and providing a comprehensive framework for identifying strengths and weaknesses in a country's financial system. I can confirm that we have used the FSAP to good effect to achieve institutional strengthening and to build a more robust financial and banking sector.

To stay within the theme of financial systems and financial stability, allow me to share with you some preliminary thoughts, not to say emerging preoccupations, on the quality of FDI. The volume of Foreign Direct Investment flowing into Mauritius has increased very fast in recent years, and stood at Rs 6.4 billion in 2006, having risen more than sixfold since 2002. We are doing nicely on this score and I certainly do not want to sound like a carping critic. Normally, one would have expected the Central Bank to busy itself with ways and means of sterilising these inflows. But – and I am not here talking only about Mauritius, - I am getting increasingly concerned on the economic repercussions and the systemic risk implications of unbalanced and poorly-conceived foreign direct investment policies. With the elimination of trade preferences in an increasingly global economy, countries sharing similar characteristics as Mauritius find it increasingly difficult to compete for foreign direct investment in traditional sectors.

In these circumstances, FDI in the property and real estate sector can be a rather interesting and viable alternative. However, policy-makers and regulators have to perform a fine balancing act between, on the one hand, the imperatives of economic and financial sector growth and, on the other, concerns about a potentially disruptive speculative property bubble which could defeat the very purpose the policy was meant to fulfil. Specifically, we have to reckon with the fact that poor implementation of such policies can lead to an increase in banks' exposure should foreign investors have recourse to domestic bank financing instead of bringing in their own funds. Should this happen, the host country could eventually not only end up with lower-than-expected foreign exchange inflows but also find itself stuck with an unbalanced investment programme heavily skewed towards a sector with a very limited capacity to sustain growth. Still another negative fallout from increased lending to high-net-worth foreigners would be its crowding-out effect on domestic investment, either denying local investors adequate access to bank finance, or hardening their terms. It is abundantly clear that the quality of FDI does matter. FDI should be

strongly linked to local enterprise development and not confined to small enclaves as the benefits of FDI do not accrue automatically and are not uniform across sectors and countries. Experience shows that the authorities need to go beyond traditional liberal FDI policies. They need to pay more attention to the broad set of regulatory and institutional frameworks conducive to an enabling environment both for foreign investment and for domestic entrepreneurship.

Perhaps a few words about the local banking and financial sector could provide some useful context. Ours is a small middle-income economy, with a population of only 1.2 million, but we have an economy which is fully monetised. Financial intermediation, overwhelmingly banks and NBFIs', will make up nearly 11 percent of GDP this year. Let us pause a moment to reflect on this percentage contribution. It is higher than almost all the real sectors. It is higher than the tourism sector, where Hotels and Restaurants are expected to contribute a little less than 9 per cent of GDP. It is higher than the Export Processing Zone, which will account for 7.4 per cent. And it is of course much higher than the sugar sector, whose contribution to GDP is forecast at 3.3 per cent.

How has the sector come to occupy such an important place in the local economy? How is it structured to play such a leading role? There are 19 banks and 13 non-bank financial institutions licensed to transact deposit-taking business. Three new banks should open by the end of this year as the banking licenses granted at the end of last year are operationalised. There are currently nearly 160 branches and 329 ATM's, which leads some observers to jump to the erroneous conclusion that we are overbranched and overbanked.

The sector is marked by a very high degree of market dominance, with the two largest banks, both domestically-owned, controlling around 70% of rupee deposits, with the next two, both among the top ten international banks, accounting for slightly above 20%. There are also many other international banks who are relatively new to Mauritius, and who have brought in their own special expertise and financial sophistication, and are busy carving out a lucrative niche for themselves in this allegedly overbanked country. They are playing a very welcome role. They increase competition. They give the established players a run for their money. This is good for the domestic consumer. It dampens any tendency towards cartelisation which could otherwise be encouraged by the market dominance I referred to earlier, with the smaller players slipping comfortably into "follow-the-leader" mode. Internationally, the presence of these foreign banks raises the profile of the country, enhances its reputation and reinforces its role as an offshore financial centre. I look forward to the three new bank licensees entering this dynamic financial landscape, with their own business models and their complementary financial products and services. All in all, we should have a very interesting year!

Let me now touch briefly on how the Mauritian economy is coping with the challenges of globalisation and adapting to life in the post-Lome and post-Cotonou world. A less resilient country would no doubt have been tottering under the impact of the triple shocks that have hit the economy, namely the dismantling of the preferential price for our sugar exports under the Sugar Protocol, the erosion of trade preferences in textiles, and the surge in oil prices. The factor-intensive, export-oriented growth strategy, based on comparative advantage and fuelled by trade preference, with sugar, textiles and tourism as the three main pillars of the economy, has given way to a new strategy. We are now building competitive advantage in targeted sectors. The new strategy is based on

- the development of a high-tech, innovative financial and business services hub, with new activities such as ICT, BPO, biotechnology, as well as financial and medical services,
- manufacturing activities such as printing and publishing and light engineering and

- restructuring and consolidating the existing sectors, which can adapt to the Brave New post-WTO World.

The strategy also provides for the development of Mauritius into a regional platform for a variety of activities, ranging from the storage, processing and distribution of seafood, and the repair and maintenance of fishing vessels, to warehousing and distribution.

As regards the traditional sectors, their restructuring is in full swing. The sugar industry, hit by a 36 per cent cut in the price of sugar exported to the European Union, is undergoing a complete transformation into a “cane cluster” producing special sugars, bagasse for electricity generation, and molasses for distillation into ethanol and value added spirits. The dismantling of the Multi-fibre Agreement in 2005 forced the textile and apparel sector to downsize. This sector now revolves around a core of firms that have invested heavily in sophisticated design and fabrication machinery which enable Mauritian products to reposition away from the commodity end of the market. As for tourism, which was always built on its underlying competitive strength, the strategy is to double its bed capacity to capitalise on the liberalisation of air access. The objective is to attract two million tourists in the next 10 years. This multi-pronged strategy is expected to inject still greater resilience into our economy to enable us to face further external shocks that are beyond the horizon.

Allow me to dwell briefly on monetary policy in Mauritius. Over the years, the Bank of Mauritius, like most central banks on the continent, went through a phased programme of monetary policy reforms. It switched from direct to indirect monetary control. This was in line with the general move towards increased reliance on market forces, economic liberalisation and regulation and away from directives, controls and subsidies. Exchange controls disappeared more than twelve years ago. After using Reserve Money Programming and liquidity forecasting as its framework for the conduct of monetary policy for more than ten years, the Bank introduced a new framework in December last year. The Lombard Rate was replaced by the Repo Rate as the key policy rate to signal changes in the monetary policy stance of the Bank.

Just over two weeks ago, I had the privilege of launching the Monetary Policy Committee as a statutory committee of the Bank of Mauritius, in the presence of the Deputy Prime Minister, and Minister of Finance and Economic Development. This marked the start of a new era in monetary policymaking in Mauritius. It was the culmination of a long reforming process that began nearly four decades ago. I am looking forward to the next meeting of the MPC which should take place in the second fortnight of June, just after the Deputy Prime Minister has handed down his budget.

So much for monetary policy! Let me say a few words about the Bank’s involvement in regional integration activities. I can vouch that it dates back at least to the early 1980’s when, wearing a different hat, I managed to persuade the then Governor to support our economic and trade overtures to Madagascar. In the early 1980’s, when exchange controls had yet to be dismantled, we entered into a bi-lateral agreement with Madagascar which provided for payments settlement in respect of bilateral trade between the two countries to be effected through a compensatory mechanism agreed between the central banks of the two countries.

Subsequently, the Bank hosted in succession a Meeting of the Preferential Trade Area, followed immediately by a Meeting of the AACB. When we joined SADC in August 1995,- after some private behind-the-scenes bargaining with my friend Kaire Mbuende who was then the Executive Secretary, - I requested the Finance and Investment Sector to be allocated to us. Had our request found favour, the Finance and Investment Sector Coordination Unit would have been located in Mauritius. However, the decision was taken to reallocate the Tourism sector away from Lesotho

to us while the Finance and Investment Sector went to South Africa. In 1998, the Bank hosted the 6th Meeting of the Committee of Central Bank Governors of SADC. The Bank has just participated in the 24th Meeting of the CCBG in Tanzania last month (April 2007) and, at that meeting, we have been assigned the Permanent Chair of the SADC Committee of Banking Supervisors.

To conclude, let me assure all of you, Fellow-Governors, that we are firm believers in regional cooperation and integration. We go further; we believe that economic salvation for small countries like ours lies definitely in that direction. The African Monetary Cooperation Programme, and its ultimate objective of the African Monetary Union, hold considerable appeal for us. On what better note could I end my address than by re-dedicating the Bank of Mauritius to this noble cause?

I thank you for your attention.