"Risk Mitigation in Futures Market v/s Exposure to Market Forces: The EDGE for Mauritius Exporters"

Address at the Inaugural Seminar of GBOT EDGE organized jointly with the Mauritius Export Association

By Rundheersing Bheenick, Governor, Bank of Mauritius,
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It is an honour for me to have been invited this afternoon to address you on an issue that is close to my heart. Let me begin by congratulating the organizers, the Global Board of Trade (GBOT), for yet another excellent initiative, and the Mauritius Export Association (MEXA) for hosting this event. Any initiative that helps to develop our foreign exchange and derivatives market will of course receive the full support of the Bank of Mauritius. And for those of you who may be inclined to believe that dabbling in derivatives by Central Banks is a risky business, let me assure you that promoting the development of the foreign exchange market and derivatives is very much part of the remit of the Bank.

On a previous occasion when I had the honour to address a GBOT audience – it was on the occasion of the Seminar on Currency Derivatives in July 2009 – I had emphasized that financial development in Mauritius was incomplete and had a long way to go if we are to be reckoned as an international financial centre. I had then borrowed Randall Dodd's image of a four-legged table to depict the financial system and argued that our table had one leg missing. I then welcomed the launch of GBOT, the first Pan-African Derivatives Exchange, which I believed would play a role in the development of our financial sector and help us to find that missing fourth leg. Today, I am very glad to note that GBOT has done some brisk business since its start of operation and its daily trading volume crossed the 50 million dollar-mark two weeks ago. I congratulate GBOT for this achievement and wish them continued perseverance in the pursuit of their trading volume target of USD 1 billion a day, which I think is achievable.

On several occasions, in previous addresses and during meetings with various stakeholders, I have stressed the importance of foreign exchange hedging instruments in helping domestic corporates, particularly our exporters to manage currency mismatches in their balance sheets. A typical reaction was: we know how to produce textile products for the markets that we know – that is our job. We need the dollar at Rs35, the euro at Rs45, and the UK pound at Rs55 – that's your job! Now, among the tools I discovered when I joined the Central Bank, unfortunately there was no magic wand… But I believe the debate has moved on a little. I am very pleased to see that I am no longer a lone voice in the wilderness. I understand that many of you have started active treasury operations for a more efficient management of your foreign exchange exposures and the attendant risks that go along. Indeed, GBOT's EDGE programme aims to support these efforts. The acronym is self-explanatory: Empowerment and Development through Global financial markets' Education.

I am also aware of GBOT's efforts to familiarize operators with *hedging*. Much ink has been spilt on this issue of hedging in the local press in the wake of the unfortunate events at Air Mauritius and the State Trading Corporation. The airline ran into some unexpected turbulence, almost bankrupted itself in the process, and ejected management and board-level executives to claw its way back to solvency. Our State Trading Corporation found fuel

imports to be an explosive issue which led to the premature departure of its former Chief Executive. But abuse, or misuse, of a tool does not make the tool useless. It only underlines the necessity of perusing the User's Manual very carefully and familiarizing yourself with any health warning that comes with it, which is the object of this exercise this afternoon. It gives me great pleasure therefore to reiterate my full support to the EDGE initiative.

As Governor, I have become used, if not inured, to the periodic recriminations of our exporters on the value of the rupee. There have been times when these were accompanied by direct threats to phase down operations, to lay off thousands of workers, and cause other mayhem, if we did not provide relief via currency depreciation. And my unfaltering answer to them has always been that we are in a free market with no capital controls and the foreign exchange market is also free. The Central Bank is non-interventionist and when we do intervene, it is only to smooth out unwanted volatilities, not to achieve any particular exchange value of our rupee vis-à-vis any particular currency. Hence, taking exchange risk is very much part and parcel of the game of our economic operators. Since the revolutionary idea that risk can be managed – which literally transformed the world – man is no longer left to the whims of the gods. The concept of management of risks actually drives modern society, and much of the progress made by man would not have been realized without the notion that risk not only can be managed, but can actually be rewarding. Indeed, risk and reward are the two faces of the same coin.

The exporters' outcries show their extreme vulnerability to the vagaries of global financial markets. At the same time they reflect a certain inability, or should I say reluctance, to seize the opportunity that modern risk management tools offer to mitigate their risk. I do understand your fears – trading in derivatives is quite complex and involves many risks. The memories of the collapse of Barings in 1995 and the more recent scandal at Société Générale in 2008 are still fresh in the minds of many people. These scandals have nourished the myth surrounding derivatives and their potential for leading to catastrophe. In both these cases, as indeed in the more recent cases like Bear Sterns and Lehman Brothers, the problem was not with the derivatives but with the controls those banks failed to put in place. And there was also a failure of regulation and supervisory oversight.

Today, we are here to talk about risk mitigation through the futures market. Some corporates in Mauritius, as well as the Mauritius Sugar Syndicate, have traditionally hedged their foreign exchange exposure using forward instruments traded in the over-the-counter market. It is good to know that futures and forwards contracts are both contracts to deliver an asset on a future date at an agreed price but they differ in some respects. Futures are standardized and exchange-traded, while forwards are customized and traded over-the-counter. Thus futures face an exchange, while forwards face a non-exchange counterparty. Furthermore, futures are often margined, while forwards are not. They have significantly less credit risk, and their funding is different.

Like the forward contract, a futures contract is a guarantee that a certain product will be sold at a fixed price at a certain date. Although the proliferation of mysterious-sounding acronyms and the complex trade jargon may indicate a recent origin, the concept is certainly not new. In fact the idea of entering into agreements to guarantee a fixed return in the future is mentioned by Aristotle. Gillian Tett, in her fascinating book "Fool's Gold", drawing on the

aforesaid Randall Dodd, tells us of rudimentary futures and options contracts having been found on clay tablets in Mesopotamia, dating back to 1750 BC. The first futures exchange market was the *Dōjima* Rice Exchange in Japan in the 1730s, to meet the needs of samurai, who were being paid in rice and needed a stable conversion for the value of their currency which was the rice. The first-ever standardized 'exchange traded' forward contracts, called futures contracts, were listed in 1864 by the Chicago Board of Trade, or C-BOT – surely the inspiration for G-BOT, our host today. Soon there were contracts created on a number of commodities, and futures exchanges developed all over the world. This was the birth of our modern futures market as we know it. Today, there are more than 90 futures and futures options exchanges and these include the London International Financial Futures Exchange (now *Euronext.liffe*), Deutsche Terminbörse (now *Eurex*) and the Tokyo Commodity Exchange (*TOCOM*).

With the breakdown of the Bretton Woods system of fixed exchange rates, deregulation, and the advent of new technologies, the environment, in which banks and other financial intermediaries evolved, changed drastically. They responded by developing financial risk management products designed to better control exchange risk. They started with simple foreign exchange forwards that obligated one counterparty to buy, and the other to sell, a fixed amount of currency at an agreed date in the future. By entering in such contracts, customers could offset the risk that large movements in exchange rates could adversely impact the economic viability of their transactions. The World Bank, one of the Bretton Woods twins, concluded the world's first swap deal in 1981, with IBM as the counterparty and Salomon Brothers as the arranger. Where Salomon Brothers led, others followed, piling innovation on innovation. An ever-increasing number of novel products designed to manage and control financial risks more effectively were gradually offered to customers. There is today an impressive array of financial risk management products available.

When we compare the stage of development of our financial sector with that of the developed economies, or even with a few other emerging economies, it is evident that we are trailing quite far behind. India, for example, has a deep and liquid equity spot and derivatives market, a liquid forex OTC spot and derivatives market, an exchange traded currency futures, a market for Government securities, an interest rate swap market, a securitization market, a primary market for corporate bank and money market instruments, and a repo market in Government securities and corporate bonds. We are indeed trailing very far behind, aren't we? But, by way of mitigation, I have to point out that the Indian exchanges remain largely domestic given that capital controls still exist there. Our banks deal very little in forward transactions and even less in options. We only have a thin spot market that does not offer adequate protection to our operators against the volatility of the dollar and the euro.

If our system is still deficient, it is certainly not through want of trying. We have spared no effort to put in place the appropriate infrastructure to deepen the financial system. The enabling legislation has been put in place; there are continuing efforts at the Bank to develop a secondary market for Government paper; there are other initiatives by the Stock Exchange of Mauritius; and we have GBOT, the exchange which is hosting this event this evening. In December 2009, the Bank initiated foreign currency swaps tailor-made for the needs of our export operators when there was evidence that the volume of transactions on the domestic spot foreign exchange market had declined, and was causing some undue volatility

in the market. This measure had a two-fold objective: first, to cater to the needs of the operators temporarily, and second, to encourage them to have greater recourse to hedging instruments for securing their rupee earnings. Although we maintained the swaps throughout 2010, they have not been used since July of that year. Participants still show reluctance to hedge their exposures – it is not easy to get rid of old habits.

Most of the time, our exporters have evolved in a fairly well-protected market; they have developed a reliant client-base in Europe, and they relied on the expected depreciation of the rupee to sustain their operations. There was no need for them to have recourse to hedging instruments to control their risks. Well, as you all know, that era is over. Today, there is not a single exporter in this room who does not believe that the economic viability of his enterprise depends on the proper management of its risks, or to put it differently, there is not a single exporter who believes he can ignore developments on the currency front and his business will still flourish. Let me bring up some statistics to highlight the importance of the export-oriented sector in the Mauritian economy and the extent to which they are exposed.

The EOE sector plays a key role in our economy and its sustainability and competitiveness are a matter of national interest. To take 2010 figures, the EOE sector represents around 6 per cent of GDP, accounts for 58 per cent of total export of goods, and provides employment to nearly 56,000 persons, which in turn represents a little over 10 per cent of total employment.

However, the EOE sector and external demand-led sectors as a whole are subject to some structural weaknesses which make them particularly vulnerable to external shocks. A full two-thirds of our total export of goods was directed to European markets in 2010. This pattern of dependence on Europe is also evident on the services front. Two-thirds of our tourists also come from Europe. To complete the picture, half of total FDI inflows into Mauritius came from Europe in 2010.

This geographical concentration on Europe for exports of goods and services, and inward investment, is not replicated on the import side. Europe provided only one quarter of our imports of goods. We are not only highly exposed to the European market; we also have to cope with the imbalance in the currency in which our trade is conducted. On the one hand, it is estimated that 41 per cent of our export proceeds is denominated in euros. The share of the US dollar and pound sterling stands at 39 per cent and 14 per cent, respectively. On the other hand, our imports are invoiced mainly in US dollars, with a share of 67 per cent. The euro represents 21 per cent and the pound sterling less than 2 per cent of imports.

At one point in time, the combination of a downward slide of both the euro and the pound sterling on global currency markets, coupled with a stronger US dollar, raised serious concern in view of the negative implications of such a trifecta on a wide spectrum of economic activity in the country, including the sugar, textiles, tourism and BPO sectors. Today, fortunately the rupee has stabilized. We cannot, however, pretend that we are protected from all external instability, as the value of our currency in the domestic foreign exchange market is largely driven by the interplay of domestic and international factors. After almost 84 weeks of non-intervention in the foreign exchange market, the Bank started intervening again to correct emerging distortions in the market. So while we, as regulator are playing our part to stabilize the market, you exporters, who are the active participants, are also expected to play

yours. You cannot continue to take one-way bets on the exchange rate or continue to try to pull the rug in your direction. It will come as no surprise to close observers of the Mauritian economic scene that, in its last Article IV Consultation Mission conducted early this year, the IMF finds that our currency is broadly in line with economic fundamentals. So let's stop griping about rupee strength or weakness and take action to minimize currency risks.

I have every reason to believe that our operators are beginning to appreciate fully the importance of managing their foreign exchange risk – the organization of this seminar with the support of MEXA, the exporters' association, and the high turnout, are ample evidence of this. 2010 has been a very good year for our exporters in spite of the fragile recovery in our main export markets. Exports by EOEs rose by 11 per cent in 2010, nearly four times faster than the 2.8 per cent growth of 2009. The seafood sub-sector is said to be hauling in a very good catch and the textile sector remains stable, with full order books and recovering markets.

However, we are conscious that the export sectors are facing daunting challenges in the wake of the uncertainty still surrounding the global economic environment, and, in particular, our main export markets. From our perspective, risks of subdued growth surround these traditional partners, although there are new opportunities arising in other parts of the world. But it is evident that now is the time, more than ever, for our export operators to rethink their business models to adjust to the new economic order. Now, more than ever, is the time for them to re-engineer their operations, achieve sustained rises in productivity and move into new products and new markets! Salvation can only come from diversification. Geographical diversification, sectoral diversification, and product diversification. Diversify, Diversify, Diversify – that should be our new mantra. This is more of a medium-term challenge though; the simplest way to start is to learn how to properly manage your foreign exchange risk and this is what you are here for today.

Let me briefly comment on some misconceptions on the use of derivatives. There are indeed many old wives's tales about derivatives, and believing in the fairly widespread myths may lead people to avoid them altogether. That would be a mistake. It is true that the tremendous growth of the derivatives market and the reports of major losses associated with derivative products have created a lot of confusion about those complex instruments. Derivatives have been considered as the villains in the collapse of the global financial system. In fact, companies and countries that bought derivatives in the form of mortgage-backed securities, credit default swaps and synthetic collateralized debt obligations as insurance, discovered, to their dismay, that the insurance cover was only as good as the counterparty at the other end of the contract. Some were of the view that the problem was not so much with the exotic nature of some of the products, or their volume, as with the fact that the derivatives were traded over the counter, that is, outside a transparent and regulated exchange. That is how the value of OTC derivatives reached ten times global GDP. Others blamed the lax regulation of financial derivatives and perverse incentives. This is why there are proposals on the table on either side of the Atlantic for the better regulation of all derivatives trading.

Essentially what derivatives do is to hedge risks by reducing future uncertainties and managing them more effectively. Derivatives help to improve market efficiency because risks can be isolated and sold to those who are willing and able to accept them at least cost. But using derivatives requires a firm understanding of the tradeoff of risks and rewards, and the

decision to use them should be driven by the participant's strategic objectives. It is important that all users understand how their contracts are structured, the unique price and risk characteristics of those instruments, and how they will perform under stressful and volatile economic conditions. Derivatives users should establish a framework for effectively managing and controlling derivative activities. The dark side of derivatives is that, if they are used improperly or without a plan, they can inflict serious losses. So without a clearly defined risk management strategy, the use of derivatives can be dangerous. When used wisely, they can increase shareholder value by providing a means to better control a firm's risk exposures and cash flows. A firm should be clear about the risks it is comfortable with, and the risks it does not want.

Now that we have an exchange where currency futures can be traded, new opportunities are opened to investors. Besides offering better price discovery and lower transaction costs, the futures market is a major financial hub which provides an outlet for intense competition among buyers and sellers and, more importantly, a center to manage price risks. It is also a very liquid market. Currency prices are based on objective considerations of supply and demand and cannot be easily manipulated because the size of the market does not allow even the largest players, to move prices at will. Futures market prices depend on a continuous flow of information from around the world and thus require a high amount of transparency.

It is an indeed very exciting time – watching the developments, albeit small, that are taking place in our financial system. We hope that after a few such training sessions we will soon see our exporters proactively seeking ways to hedge their risks. We have an exchange in Mauritius which is properly licensed and regulated, where there is price transparency. I can only encourage our operators to participate in it. GBOT currently offers gold and silver contracts and futures in five currency pairs: EUR/USD, GBP/USD, JPY/USD, ZAR/USD as well as USD/MUR. I have no doubt the exporters will find among these, the instruments that would most suit their needs. May I add that the Central Bank is also closely monitoring the currency trading. Since the start of operations until the end of April, the total turnover of transactions in the various currency pairs conducted by GBOT add up to nearly USD 1.4 billion. So far, so good, one may be tempted to say. But what is far from good is that trading in the rupee-dollar currency pair came to a grand total of less than USD 1 single million! There is considerable room for improvement, isn't there?

We will continue to support the development of professional training courses and investor education programmes to deepen expertise in the sector. One example of such training is the OptionsXpress® Investor Education Series of the Chicago Mercantile Exchange on futures options and which had the slogan: *"Get your feet wet before you take the plunge"*. I do believe this is what our exporters are precisely here for – to get their feet wet. It is important that you have a proper knowledge of the product and an understanding of the arithmetic of its leverage – which I am sure, should help dispel much of the mystique surrounding the world of derivatives. You should not overlook your treasury operations. This reminds me of General Motors (GM), the renowned US car maker which founded in 1919 the General Motors Acceptance Corporation (GMAC) to provide financing to automotive customers. Over the years, GMAC expanded to include insurance, online banking, treasury operations and so forth; it was at some point in time making more profits than GM itself. Eventually it applied to the FED to become a bank holding company and changed its

name to Ally Financial Inc in 2010. I am not telling you that you need to go that far – by all means, do not stray too far from your core competencies or, put differently, stick to your knitting! But you should not overlook the importance of proper treasury operations and greater use of derivatives products that are now available to you. It might bring in some additional profits.

Let me now conclude with a word of caution for the banks and foreign exchange dealers who are to be the main players in this game - the absence of robust risk management practices and adequate oversight surrounding this activity could have disastrous consequences. Banks and foreign exchange dealers should therefore ensure that their dealers are well trained, that there are clear-cut controls on their operations, and at least in the initial stages that the activities are audited on a concurrent basis. While the exchange has the responsibility to ensure against settlement risks, it is the institutions concerned that have to address internal procedural issues. We, the regulator, expect to see among all participants unrelenting emphasis on efficient risk management infrastructure. We encourage the ongoing development of a qualified talent pool with deep knowledge in the area, who will uphold proper market conduct. We intend also to maintain a close dialogue with all relevant stakeholders to ensure a robust and conducive regulatory environment for the development of a vibrant futures market in Mauritius.

Whether you are reaching out to new markets, branching out into new products, or envisaging greater recourse to derivative products, it is change that is the order of the day.

And I am reminded of Charles Darwin's conclusion from his great study of species: *"It is not the strongest of the species that survives, nor the most intelligent, but the one that is the most responsive to change"*.

I wish you all a very fruitful seminar.

Thank you for your attention.