

**BANK OF MAURITIUS ANNUAL DINNER WITH MAJOR
ECONOMIC STAKEHOLDERS**

Address by Mr. R. Basant Roi, G.C.S.K., Governor of the Bank of Mauritius

(2 December 2005, Sugar Beach Resorts, Flic-en-Flac)

Honourable Judges
Ladies and Gentlemen
Good Evening

I am once again pleased to welcome you all to the Bank of Mauritius Annual Dinner.

In my last seven end-of-the-year addresses, I persistently focused more on regulatory and supervisory issues than on monetary policy issues. The repeated emphasis on the desirability of a sound and strong banking industry was motivated by several critical important considerations. Against the backdrop of recent developments in our export markets and the evolution of our balance of payments position I find it quite appropriate to briefly look back in order to throw some light on future orientation of our macro-economic policies.

The 1980s witnessed a rapid process of financial sector liberalization in most parts of the world. The long repressed financial sector in developing countries underwent a process of gradual deregulation. Layers upon layers of direct controls in the financial sector, fashionable in the 1950s, 1960s and in the early years of the 1970s, were gradually removed. Decision makers in Mauritius rightly bent with the then prevailing wind of change. Direct controls on interest rate determination, ceilings on bank credit expansion and exchange control were

done away with. With hindsight, it appears that the wide-ranging implications of the move from a system of direct controls to a fully liberalized financial system have not been fully appreciated.

Financial sector liberalization imperatively requires monetary discipline, fiscal discipline, financial market discipline, labour market discipline and very importantly a sound and solid financial industry. These requirements are all, in one way or the other, closely related. The lack of appreciation of the complexity of the relationships among them seems to trigger the on and off criticisms against the Bank of Mauritius regulatory and supervisory policy and other policy stance.

The emphasis on regulatory and supervisory issues relating to the banking industry has been driven by four principal considerations:-

1. Financial sector liberalization intensifies competition. Obviously, banks operating in the country necessarily have to be sound and strong, as otherwise competitive forces would drive out of the market the inefficient ones. I need not overstate that it takes only one small bank to fail to undermine confidence in our banking system and threaten financial stability in a small economy like ours;
2. The process of financial sector liberalization, throughout the world in the 1980s, was quite likely to be followed by a process of trade liberalization at the level of individual countries, regional level as well as the global level. Having taken the view that, at some stage, trade liberalization might eventually affect the balance sheets of banks thereby undermining their soundness, the Bank of Mauritius far-sightedly intensified its regulatory and supervisory activities in a bid to stave off as far as possible its adverse impact;

3. There exists a solid body of research strongly suggesting that improvements in financial arrangements precede and contribute to economic performance. Developing countries with relatively deep and efficient financial markets in the 1960s and the 1970s grew faster than those with relatively shallow markets. The Bank of Mauritius has thus been committed to initiate credible regulatory and supervisory measures with a view to strengthening the banking industry; and
4. The efficacy of monetary policy implementation in a liberalized financial system depends greatly on the strength and efficiency of the players in the financial marketplace. We have a bank-centered financial system. In other words, banks are at the epicentre of our financial system. Evidently, the players in our market are banks and bankers. Banks are the medium through which the monetary policy impulses of the Bank of Mauritius are transmitted to the rest of the economy. The weaker the medium for transmission of monetary policy impulses the lesser is its efficacy in achieving the desired objectives. The medium, that is banks, had to be strengthened and hence the repeated emphasis on the need for a sound and solid banking industry.

These have been the inter-related objectives envisioned in the approach adopted by the Bank of Mauritius in the last seven years with regard to the banking sector. Despite a number of hurdles and unforeseen happenings, the Bank of Mauritius relentlessly pursued its objectives, for it is in the best interests of the economy to have a banking industry sufficiently strong to meet emerging

challenges. All through the road traveled so far, the Bank of Mauritius has not been short of criticisms from commentators.

In January 1992, the Financial Times carried a headline “Man bites Watchdog”. The man was Robert Maxwell. In the list of watchdogs, pension fund trustees, external auditors and accountants, institutional shareholders, the Bank of England and a number of other regulators were identified as potential scapegoats. In private conversations and in the media everyone had his favourite scapegoat. Some carefully avoided including themselves in the list of potential candidates for the scapegoats, as is the case in Mauritius.

The history of troubled financial institutions is littered with eventful episodes of “Men biting Watchdogs”. “Watchdogs biting watchdogs” is however an uncommon happening. I guess you must be familiar with the story of the man who discontentedly wailed, “We were so poor in our childhood, we could not afford a dog; we ourselves had to do the barking.” Certain recent remarks against the regulator of the banking industry gave an incorrect perspective of the role of regulators. Some smart – pretentiously smart - but not necessarily persons of enviable integrity and probity have attempted to advertise colossal untruths. I refer to them as smart persons, for they are fully conversant with the laws that bind the Bank of Mauritius with regard to its duty of confidentiality of banking transactions. They are equally aware that the Bank of Mauritius has certainly no interest in street fighting with “respected” delinquent borrowers however provocative the unpleasant and unfair remarks. Any form of public retaliation against certain “law-abiding” delinquent borrowers is obviously not the business of any regulator. The Bank of Mauritius wisely chose to take the aspersions leveled against it cool headedly – with an elevated sense of respect to the laws governing the banking industry. They have talked the talk. We have walked the walk.

In the last six years the Bank of Mauritius has been involved in clearing the banking system, through thick and thin, of outdated practices. We are today at the tail end of the clearing process. And we have had a rich experience in tackling problematic banks and ‘gentlemen’ delinquents – I mean habitual delinquent borrowers making a good, open and public show of piety - of monks in monasteries.

It is generally wondered why the Bank of Mauritius does not aggressively resolve problems that afflict certain financial institutions, whether at the board of directors level or the managerial levels. Ailing financial institutions can never be brought back on rail by simply applying mechanical procedures to complex operational problems. It’s like a man undergoing several medical procedures simultaneously. One physician is in charge of the head injury, someone else is setting the broken leg, another physician is working on the displaced shoulder and still another one is getting rid of the gallstone. Each operation is perfect and is indeed a success. But to the dismay of the physicians the patient dies - dies of shock. It is certainly not in the interest of any regulator - nor is it in the interest of society - to give shocks and kill financial institutions; its primary concern is rather to rescue ailing institutions, help restore their financial soundness and sustain overall financial stability. Breaking problems into small pieces and then managing the pieces, more so if the problems stem from the highest level of decision-making in a financial institution, is the surest way to a crash. The regulator’s responsibility in such cases is to manage the dynamics, not the pieces. No regulator would ever envy the plight of an ambulance crew at the scene of a car crash. I regret having to use metaphors for I am bound by a duty of confidentiality even in respect of the ‘gentlemen’ delinquent borrowers.

Institutional shareholders or any individual shareholder in any enterprise, be it a financial institution or a non-financial enterprise, are expected to be the first

and foremost watchdog of its operations. The watchdogs are supposed to look after the best interests of the enterprise rather using their authority to advance their own agendas. As is generally observed the sinews of good behaviour can hardly be reinforced by regulation. Financial regulations are not designed to catch deceit but to create markets and promote good corporate habits - habits that are indeed transparent to savers and investors who can vote with their money and why not with their feet, if the need arises.

The dissemination of reliable information to the public at large and the ability to trust each other are the pillars of market-based economies. A former professor at Harvard rightly observed that trust constitutes a decisive ingredient of a society for it to be a successful capitalist society. People, who do not trust their neighbours, do not trust other groups, do not trust distant people, cannot trade among themselves. The economy is reduced to the level of a bazaar economy. The regulator needs to be trusted. I am absolutely certain that none of us would ever wish our economy to be reduced to a bazaar economy. As I said earlier, we have reached the tail end of the clearing process. We are now in the process of constructing a framework for the implementation of Basel II, taking into account the specificities of our economy. The year 2006 will quite likely be marked by acquisitions in the banking industry. We have had a number of expressions of interest for take-overs from several banks of good reputation. Despite a few consequential setbacks beyond our control, business confidence in the economy is not as bad as is being painted.

Once an economic system is on a path of financial sector reform, the process is self-reinforcing; it cannot be stopped as one measure of reform engenders other reforms. The Mauritius Credit Information Bureau launched on Wednesday last is an innovative step that is expected to go a long way towards imposing discipline in the credit market. In the longer term this Bureau will

definitely play a catalytic role in improving the quality of our financial sector. Let me clear one misconception. The Bureau is a repository of credit information on borrowers. When processing application for loans banks are required to consult the Bureau through an electronic network before deciding whether or not to approve the application for the loans. The decision whether or not to approve the loans however rests with the banks themselves, not with the Bank of Mauritius.

Ladies and gentlemen, right at the outset I mentioned that financial sector liberalization necessarily requires monetary discipline, labour market discipline and fiscal discipline. Wages and salaries levels over and above productivity levels persistently lasting for a protracted period of time combined with unsustainable budget deficits are bound to influence monetary policy-making. I have to reiterate the point I stressed here, during previous annual dinners, and elsewhere that the Bank of Mauritius does not operate in isolation, irrespective of developments in the domestic economy and of developments in our major trading-partner countries. Its policies are designed in the light of the dynamics of the domestic economy and developments in foreign exchange markets abroad.

In most large and resourceful economies, economic growth is to quite an extent driven by consumption expenditure. Consumption expenditure, amongst other things, is a propelling force to investment that, in turn, generates economic growth. In small economies like ours it is investment that propels economic growth that, in turn, gives rise to consumption expenditure. Ours is an investment driven economy and is not a consumption driven economy. The point I wish to make here is that in a highly open economy like ours, overwhelmingly dependent on imports, rising levels of consumption expenditure, not matched by production for exports, rather leads to deficits in the trade balance.

After four successive years of surpluses, the current account of our balance of payments posted a deficit of over Rs5 billion in fiscal year 2004-05 - close to 3 per cent of GDP. The Goods Account, commonly understood as the Merchandise account, posted a deficit of over Rs20 billion, roughly twice the deficit recorded in the preceding year. May I underline that the rupee value of petroleum products imported in fiscal year 2004-05 amounted to Rs11 billion, twice the value recorded only three years ago. It is projected to attain over Rs13 billion in the current fiscal year. For every Rs100 worth of imports, Rs13 account for petroleum products.

Only in a society that embraces self-criticisms can decision-making processes produce real facts to cope with real problems. A back-of-the-envelope arithmetic shows that in certain organizations, employees, after making allowances for week-ends, vacation leave, casual leave and sick leave entitlements, are at work for only 200 days in a year; I do not wish to say that they consume during 400 days in a year. Household consumption expenditure grew by 8 per cent in 2005, twice the average growth rate of 4 per cent in the four years ended 2003.

Fortunately, the incisiveness of the Bank of Mauritius led to an accumulation of net international foreign currency reserves amounting to Rs54 billion today. We cannot lean against the wind for long. The policy implications of these developments are fiscal rectitude and strong demand management policies. Why fiscal rectitude? Let me explain. Two different hypotheses exist in regard to the relation between trade deficits and budget deficits. One of them is the twin deficit hypothesis postulating that budget deficits cause trade deficits. The policy implication of this theory is that budget deficits need to be reduced to restore trade balance. The other hypothesis is what economists refer to as the Ricardian Equivalence hypothesis: an increase in government expenditure is absorbed by a

rise in private savings and therefore no increase in consumption expenditure, which in our case, means no increase in imports and therefore no impact on the balance of trade. Contrarily, our consumption rate has gone up meaning that savings rate has gone down. Trade deficit has widened. The first hypothesis seems to be more valid in the case of our economy. Although there is no one to one relationship between budget deficits and trade deficits in our context, the case for a reduction in budget deficit is strong. Fiscal dentistry needs to be carried out; the cavities need to be filled in. On the monetary policy side, stringent demand management policy is the order of the day.

Finally, let me share with you the reflections made in the 1980s by a former Prime Minister of the U.K. on the state of mind of the British public, “I think we’ve have been through a period where too many people have been given to understand that if they have a problem, it’s the Government’s job to cope with it. ‘I have a problem, I’ll get a grant.’ ‘I’m homeless, the Government must house me.’ They are casting their problems on society. And you know there is no such thing as society. There are individual men and women, and there are families. And no Government can do anything except through people, and people must look to themselves first. It’s our duty to look after ourselves and then, also, to look after our neighbours. People have got their entitlements too much in mind, without obligations. There is no such thing as entitlements, unless someone has first met an obligation.” Aren’t these reflections equally valid for Mauritius?

Ladies and gentlemen, the way forward is to carry out a really big and rapid change rather than proceeding with small gradual changes. A plunge in cold water is less painful than a slow submersion. We have to open up the economy, without any form of deleterious barriers. Problems do exist and will continue to exist. They exist to be redefined and transformed. They exist to be tackled and overcome. A problem shared is a problem halved.

Let me on behalf of the Board of Directors, the staff of the Bank of Mauritius and on my own behalf wish you and your family a Merry Xmas and a very prosperous New Year 2006.

Thank you.

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