BANK OF MAURITIUS NINTH ANNUAL DINNER WITH MAJOR ECONOMIC STAKEHOLDERS

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Sugar Beach Resort, Flic-en-Flac
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Honourable Judges
Ladies and Gentlemen

Good evening

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

On this very occasion last year, I had sounded concerns about the evolution of our balance of payments. In particular, I had underlined that in a highly open economy like ours, overwhelmingly dependent on imports, rising levels of consumption expenditure unmatched by production for exports lead to deficits in the trade balance. Persistent current account deficits in our balance of payments would steadily erode our net foreign assets and this cannot continue indefinitely. Against a background of low growth rate of exports, Mauritian consumers must either reduce their spending and with it their imports that would correct the deficit or if the source of the deficit lies in government's own budget deficits then it will be for government to correct its own budget deficit by cutting spending or raising taxes or a combination of both. Do not rely entirely on monetary policy to do the job. Monetary policy alone cannot bring about the much-needed correction. In the case of a current account deficit arising from either consumer spending or government deficit or both, a tightening of monetary policy, that is higher interest rates, does not address the source of the current account deficit. It simply induces private

investors holding foreign currencies to buy rupee-denominated assets thereby reducing the need to finance the current account deficit from the Bank of Mauritius foreign reserves.

There is both theory and evidence that no firm in the private sector runs persistent deficits. Any such tendency would be self-correcting as its spending would reflect its wealth including its foreign assets. The household sector, too, cannot indefinitely run persistent deficits. Otherwise they will all go bankrupt. The source of persistent current account deficits in the present context cannot but be the government's own deficit. This also has to be corrected failing which Mauritius would eventually have to face a balance of payments crisis should we target a specific exchange rate. Those of us who are familiar with the history of balance of payments crises since the 1950s must be aware that the political process could delay the adjustment and precipitate an eventual crisis. One way to find out whether there exists a potential crisis is to look at government's own finances. Are government finances out of balance? Yes, very much indeed. Are corrections taking place? Yes, indeed.

The current account deficit for the preceding fiscal year reached a high of over Rs 10 billion, that is, over 5 per cent of GDP, representing an increase of over Rs4.0 billion in just one year. Had the world price of oil and the volume of imports of petroleum products remained unchanged the current account deficit would have been smaller, that is, in the region of Rs5 billion, implying that the pressures on the domestic foreign exchange market would have been much less.

Our balance of payments projections for the current fiscal year point towards the start of a containment of the current account deficit. Total imports on a c.i.f. basis, excluding exceptional purchase of aircrafts by Air Mauritius, are projected to grow by 6 per cent in the current fiscal year, way down from 20 per cent and 21 per cent in the preceding two years. In fact the current account deficit for the current fiscal year is expected to contract by nearly Rs 6.0 billion. The deficit is projected to be reduced to more than half the size of the deficit in the preceding year. Without any doubt, if the

present policy stand is maintained, the current account deficit in the near future should thin out with the result that the tightness in the foreign exchange market would ease to quite an extent.

A deficit in the current account reflects a deficiency of savings in the economy. Over the last few years consumption expenditure has been growing at a higher rate than the growth rate of GDP itself. Essentially, it means that the growth rate of consumption expenditure has been outpacing the growth rate of total value added by our active labour force in the economy. Although we are not through an economic boom period this phenomenon means what it means. After a period of economic prosperity, people get used to a certain level of income. They find it extremely difficult to adjust consumption expenditure downward when rationality calls for it. Those of us familiar with consumption theory will recall the Duesenberry effect. Simultaneously, we also face a disturbing phenomenon in the labour market. The labour market seems to be characterized by the "backward-bending supply curve". This suggests that higher wages or salaries do not produce more work but less and the way to increase work effort is to lower compensation per unit. Let me share with you a reflection of Andrew Carnegie: 'Years ago I distributed charity indiscriminately, and in doing so I committed perhaps the greatest evil in my life. Let a multi-millionaire take his millions to the slums and call the people together, saying: "There is a wrong distribution of wealth in the world; you have not got your share; I give to each one of you a share in my millions." Let that be done in the morning and let the millionaire return at night to see what good his action has done. He will find not happiness but pandemonium.' Many boards of directors in Mauritius must have faced this situation. To some extent, this is also my own experience at the Bank of Mauritius.

A backward-bending supply curve in the labour market side by side with high rates of consumption expenditure and three successive years of current account deficits necessarily have serious labour market and macro-economic policy implications should we desire to survive in this globalized world.

Against the backdrop of a huge current account deficit and expectations that sugar export receipts will decline, the domestic foreign exchange market has remained tight. The Bank of Mauritius intervened on the market as and when required. In fact, during the last seventeen months the Bank sold US$ 207 million with a view to easing market conditions. Several factors have contributed to the tight conditions in the foreign exchange market. Firstly, the current account deficit has been seen expanding at too rapid a pace and hence viewed as being unsustainable in the medium term. Secondly, the budget deficit was perceived as being too big for government to be able to contain it in the short term as well as the risk of government debt ballooning to a point of explosion. The deficit was unsustainable. Thirdly, shortfall in sugar export proceeds as a result of the announced sugar export price reduction has given rise to wild expectations about the poor prospects of adequate supply of foreign currencies on the domestic foreign exchange market. Exporters have since been holding on to their export proceeds and traders have quickened payments for their imports thereby exacerbating the already existing gap between demand and supply of foreign exchange. And fourthly, projects with large import contents that would otherwise have been either partly or wholly financed through borrowings from external sources are being financed by borrowings in rupees from local banks. These are in my view the four most important factors that have given rise to nervousness in the domestic foreign exchange market.

I need not overstate that in a turbulent foreign exchange market speculators go out for a kill. The stock of foreign exchange held by residents, individuals as well as institutions, in Mauritius amounts to Rs80 billion. These are official figures. The actual figure could be much more than Rs80 billion. Anyway the known stock of foreign currencies held by residents and the Bank of Mauritius account for 60 per cent of the rupee deposit liabilities in the financial industry. There should not be such a shortage of foreign currencies unless some players are intentionally holding back their foreign currency receipts with a view to making speculative gains. Indeed, exporters are holding on to their export proceeds. One may argue that it is rational behaviour.

Rational action in economics does not imply that all actors have the same information, the same insight, the same experience and purposes. Moreover, the fallacy of composition brings about from time to time that individual actors all act rationally but in combination produce an irrational result, such as spectators of a soccer match standing to get a better view as spectators of sport or theatre goers running for the exit in the event of a fire. The irrational result thus produced could defeat policy efforts being made to restore both internal and external balances in the economy. The projected substantial reduction in the size of the current account deficit is already a positive sign that quite some progress has been made in the correction of external imbalance. The exchange rate of the rupee has gone down to a level that is impacting on the rate of growth of imports. The exchange rate of the rupee has sufficiently borne the brunt of adjustment. Enough is enough. Speculators are warned.

Ideally a competitive market, be it for goods and services or for financial services or foreign exchange, serves best the interest of an economy when all conditions for healthy competition are met. Perfect competition requires that no single or a limited group of sellers or buyers on the market is powerful enough to dictate prices. In the domestic foreign exchange market we have observed a few powerful sellers of foreign currencies dictating the prices. They defy the rules of competition.

It is true that from Adam Smith to Marshall and Pigou a hundred years later and still later, Joan Robinson and E.H. Chamberlain, economists underlined circumstances in which competitive *laissez-faire* would not produce maximum efficiency. Their simplified leading ideas became widely absorbed as *laissez-faire* ideology. The technical qualifications that vitiate *laissez-faire* in many real world situations, though extremely important, were disregarded. The physiocrats, most of whom were medical doctors, used the term laissez-faire in arguing for the removal of their mercantilist government's restrictions on the export of grain. They were Frenchmen, writing before the Revolution of 1789, who invented and inspired economic ideology relating it to the circulation of blood in the human body. They drew a diagram showing the interaction and interdependence of the several sectors of the French national economy as goods

circulated among them. The physiocrats' medical analogy went further. Just as the medical doctor should interfere only to remove those obstacles which prevent the self-healing properties of the body from working, so too should government interfere in the economic body of the nation only in circumstances which prevent the self-regulating supply and demand forces of markets from working towards equilibrium. To interfere otherwise is to create more bodily harm than good. We are all familiar with the analogy used by Adam Smith to make the same point: that the invisible hand of God has so arranged things that individuals in the competitive market, pursuit of their own maximum material interests also inadvertently serve best the public good. Most of us have come to agree with Lord Keynes that the invisible hand some of the time suffers from arthritis. The remedial action is Government intervention. A note of caution to speculators: the adjustment process has started. The current account deficit is narrowing in a big way. Let not the authorities have recourse to unorthodox measures.

I mentioned earlier that monetary policy cannot be entirely relied upon to restore current account balance that is a major source of pressure on the domestic foreign exchange market. It is well established that short-term interest rate is a monetary phenomenon; it cannot be made too high in relation to the needs of growth and full employment. A substantial hike in the rate of interest could possibly help bring in foreign exchange through short-term portfolio investment by foreigners to finance the current account deficit but would not correct the deficit. A higher rate of interest, while helping to ease the domestic foreign exchange market, would at the same time stifle growth of those sectors that are emerging. In the macro-economists language, the rate of interest required for external equilibrium to finance deficits and/or to stop the currency from taking a beating on the domestic foreign exchange market may be way above that rate of interest required for internal equilibrium.

Two years ago I said on this same occasion that the Lombard rate I introduced in 1999 would be replaced by a Repo rate depending on the evolution of the domestic money market. We have since studied a framework that would best meet the specificities of our banking industry. The key rate of interest in the new Monetary Policy Framework

will be the Repo rate for signaling the Bank's monetary policy stance. Basically the Repo rate will be the rate at which the Bank will intervene on the overnight inter-bank market to supply or absorb liquidity. As lender of the last resort, the Bank will continue to provide collateralized overnight advances to banks under a new Standing Facility. The rate of interest thereon will be above the Repo rate. The operation of the new Monetary Policy Framework will enable the Bank to conduct monetary management more effectively than the present framework. In the new framework the Bank will be guided by the objective of achieving and maintaining low and stable inflation in the medium and long term without jeopardizing growth prospects.

Monetary policy is doing its job. Fiscal policy is doing its best. Growth of imports is decelerating. The current account deficit is projected to contract by over 50 per cent. Signs of a restoration of external balance are positively emerging. Barring any major setback, the rate of inflation is forecast to decline to marginally below 5 per cent by the end of the next fiscal year. Do not overplay on the domestic foreign exchange market. I repeat do not push the authorities against the wall.

Many of us, particularly those outside the business sector, do not seem to really grasp what the struggle for economic survival in an era of globalization imposes on us all. The story of the lion and the gazelle in the jungle is worth recalling. Every night the lion goes to sleep bearing in mind that when the sun rises the next morning if it cannot outrun the slowest gazelle it will go hungry for the day. Every night the gazelle goes to sleep bearing in mind that if it does not run fast enough when the sun rises the next morning the fastest lion will have it for breakfast. One thing both the lion and the gazelle know: when the sun rises the next morning they had better start running. This is a struggle for economic survival that cannot be met with success should we, in the day-to-day management of institutions and enterprises, stick to old moulds of thinking. Someone said it at the World Economic Forum in Davos that we have moved from a world where the big eat the small to a world where the fast eat the slow. Don't want to run fast; don't blame your neighbour if he wins the race.

Suffice it to say that the Bank of Mauritius has been the fastest institution in the last eight years. The Bank, not to say I, has been the first in sub-Saharan Africa to have a Real Time Gross Settlement System. The Bank has been the first to have a Credit Information Bureau in sub-Saharan Africa. The Bank has given Mauritius an unprecedented level of foreign exchange reserves despite difficult economic circumstances. The Bank has given Mauritius the lowest average rate of inflation in the last eight years. The Bank has been the first in sub-Saharan Africa to embark with full cooperation from all the bankers on the project for implementation of Basel II. The Bank has been the first in a few other areas. The Bank has successfully pushed private enterprises to go for efficient treasury management in the last eight years. All the Chief Executive Officers in the banking industry understood in 1999 the way forward. They have been running fast. And they are winning. The banking industry is far sounder and resilient today than it was eight years back.

Ladies and Gentlemen, may I, on behalf of my wife and my two daughters and on my own behalf, wish you and your family a Merry Xmas and a Happy New Year.

Thank you.