The Governor of the Bank of Mauritius, Mr. Rundheersing Bheenick

BoM Governor R. Bheenick:

"For activity to be sustained, confidence needs to be sustained"

The Governor of the Bank of Mauritius (BoM), Mr. Rundheersing Bheenick, sheds some light on the impact of economic fluctuations on Mauritius and elaborates measures to be taken to palliate the effects of the consecutive crises that have shaken the world's financial structure.

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1. History has witnessed several business cycles, bringing in their strides several booms and crises, varying in their magnitude and density. Based on your long and illustrious career in the economic sphere, has the recent events changed your views on economic cycles?

Business cycles have been there throughout history.

Despite being termed cycles, these fluctuations in economic activity do not follow a mechanical or predictable periodic pattern. It is virtually impossible to predict the precise timing and intensity of future busts. It is nonetheless during a recession that inefficiency is replaced by newer and efficient firms shifting capital and labour to where they are most highly valued, ultimately creating the preconditions for long-term economic growth.

In the present case, neither economists nor market participants, nor indeed macroeconomic policymakers and regulators were able to foresee a financial crisis of the type and magnitude we have had. Booms and slumps are the result of the interplay of demand and supply. Crises, however, are the result of abuse, where essentially confidence in the economy has been lost because a few economic agents have taken undue advantage of the trust placed on them.

Two main factors have been shaping business cycles in recent decades: (i) The forces of globalization have increased cross-border economic interdependence and led to the convergence of business cycle fluctuations; and (ii) emerging markets (e.g. India and China and other Asian economies) have to some extent "decoupled" from industrial economies, in the sense that their business cycle dynamics are less linked to advanced economies' business cycles, mainly because of two reasons, first, the intra-regional trade and trade among emerging countries have significantly increased; second, as a result of rising middle-class in these emerging countries, domestic demand has gone up.

2. How was the past different from the current situation?

During the golden era i.e. from early 1980's and early 2000's, business cycles have been artificially long – each business cycle threatening incident was dealt with using aggressive intervention by the authorities. This, coupled with the lower and lower interest rates, led to previously unthinkable levels of public and private leverage. Along with loose monetary policy pursued by the US Fed between 2000 and 2007, the multiplicity of regulators, combined with growing supervisory laxity, – remember the Glass-Steagall Act which abolished the distinction between retail banking and investment banking –, underscored by too much faith in the efficiency of markets, were the main culprits in causing the global financial crisis.

Post global financial crisis, policymakers have used fiscal stimulus and excessively loose monetary policy to revive the global economy. Because these policies have been overused before the crisis, they became less effective after the crisis. Authorities seem now to be out of ammunition and they will be less able to prolong the cycle.

What distinguishes the current crisis from the previous crises is that trust in the two most important foundations of an economy, banks and government, has been shaken. Rebuilding that trust, which took ages to be forged, cannot happen overnight; it requires more efforts and firm actions by all stakeholders.

3. What is being done to palliate the effects of cyclical fluctuations?

Post global financial crisis, there have been concerted efforts worldwide. New regulations are being put in place; banks are becoming more cautious when they recruit people; regulators are adopting new supervisory approaches; more central banks are now understanding the importance of financial literacy; and banking and financial product end-users, themselves, are becoming more prudent in their dealings.

What we need to do is to work harder at strengthening the countercyclical features of fiscal, monetary, and financial policies, both to reduce the intensity of future business cycles and lower the likelihood of a global crisis like the current one happening again. We need sound and prudent macroeconomic policies as well as responsible central banks and fiscal authorities to ensure the stability of the economy. Essentially what I am saying is that we will continue to have crises in future. However, we should draw lessons from past crises to reduce the frequency and severity of future crises.

4. Arguably, 2008 was a year of slump, followed by a recession in 2009 where the world output actually did contract. 2010, and perhaps early 2011, gave much hope of recovery, however shaky it was. However, it appears that we are now backpedalling on the cycle, drifting further away from the boom we were supposed to achieve. How do you view the current global economic situation, and how long do you think this current state of affairs is expected to prevail?

The current global economic conditions are certainly weak and uncertain, but a lot of progress has been made. There are signs of stabilisation in the euro zone after the implementation of recent measures by European authorities to address the sovereign debt crisis. The fears of a global recession seem to have receded and the US economic outlook is improving. In Europe, while we are coming out of the Greek crisis and talks about the possible collapse of the Euro have dissipated, some important challenges persist. The Spanish and Irish problems have yet to be solved; >

unemployment is at historical high; Governments have to implement fiscal reforms and adhere to prudent fiscal rules, and the firewall has to be strengthened considerably to minimize contagion risks.

What people tend to forget is that we have been hit by several successive crises, and not by one: The sub-prime crisis in the US led to the global financial crisis and a global recession. This brought to the forefront vulnerable balance sheets of banks, households and government, creating the conditions for the intensification of the Euro sovereign debt crisis. The latter spurred the Arab Spring paving the way for political crises in several parts of the world. On top of all this, there have been natural disasters in Japan and oil prices trading over US$100 barrel, longer than anyone could have expected. All this has been blurring the good news and we are not being able to rebuild confidence. Getting back business and consumer confidence to normal levels is what is required.

Predicting the shape of the business cycle in such circumstances is difficult. The recoveries nowadays tend to be long flat U's or W's rather than the V-shaped recoveries of yesteryears. It is clear that engineering a recovery from postmodern recessions is much harder than engineering a recovery from a recession in past years. The balance sheets of households and companies which have been badly hit by the global financial crisis will take time to recover.

Monetary policies are near the zero-bound and fiscal policies have been used to its maximum such that fiscal debt is a major constraint. Intervention appears to have pushed a culmination of business cycle and long wave into a global 2012-13 transition period that will set the stage for future economic growth. In 2012, global growth is projected to grow at 3.5 per cent, then accelerate somewhat to 3.6 per cent from 2013-2016.

Nowadays we hear much talk about recovery. I do not see many signs of a sustained economic recovery. We have to bear in mind that post-financial crises' recovery takes much longer than normal. Against the backdrop of globalization and rapid improvements in technology, pre-crisis jobs in the US and Europe might no longer be available. An important lesson for us is that attempts to save jobs across all chains of production where we might not be globally competitive may weigh on the long-term growth potential of the economy.

5. Crises have come and gone several times. This particular one seems to be lasting, with policymakers unable to find sustainable solutions. What do you believe are the factor, or factors, that define this particular one from the others?

The particularity of the current crisis is that it combines a financial crisis originating in the world's largest economy, the US, with a global downturn. As we all know, the financial crisis started in the US during summer 2007. Given the interconnected nature of financial markets, the crisis spread rapidly through the financial sector and spilled over to other industrialized and emerging market economies, leading to the deepest global downturn since the Second World War. To a large extent, lack of proper regulation and blind belief in the market mechanism for resource allocation accounted for the mess.

As I said earlier, the best way to get out of this bad phase is by rebuilding business and consumer confidence. Producers and consumers are postponing hiring and consumption decisions given still weak labour and housing market conditions in some countries. That is why recent economic data do not show a clear trend. They show low levels for two or three quarters, then an abrupt significant rise and then back again to two or three quarters of slumps. Global uncertainty is at an unprecedented level and its persistence has made things worse.

For activity to be sustained, confidence needs to be sustained. This requires the collaboration of every stakeholder of the economy and a long-term approach, certainly not the short-term speculative ill. As far as Mauritius is concerned, our Euro-centricity has been a significant factor influencing the impact of the crisis on our economy.

6. Given the openness of our economy, Mauritius is bound to be affected by the situation in other economies. What does 2012 and beyond reserve for Mauritius?

Mauritius has so far demonstrated a fairly good degree of resilience. Our economy posted a positive growth rate despite the uncertain economic conditions prevailing in our main markets. The unemployment rate was fairly stable at 7.9 per cent. We scored good points with the IMF and we are currently on the positive watch for an upgrade of our ratings by Moody's. But past performance cannot always be an indication of the future.

Like it or not, our euro-centric economy will be affected by the fall out of the euro crisis. Europe represents around 60 per cent of our export market, both goods and services. We are very much dependent on imports to meet our consumption and raw material needs. Europe is expected to have sluggish economic conditions in 2012 and oil price, which is currently over US$125 per barrel and projected to hover above US$100 for most of 2012, will certainly have adverse spillover effects on our small open economy.

Our oil import bill today represents around 19 per cent of our total import bill compared to less than 10 per cent a decade ago. In the meantime, the goods import bill has doubled from around Rs70 billion to around Rs140 billion. This increase has been principally driven by price effect with less important volume changes.

These two factors along with the ongoing global uncertainty will continue to weigh on our economy in 2012 and 2013. GDP growth may thus be below average at around 3.8 per cent and inflation will be around 5 per cent since both fiscal and monetary authorities are doing what it takes to maintain confidence in the economy. Risks from the external side have certainly increased, but, there are a lot of things that we can do to avert the worst if we are united and if each stakeholder of the economy put in an honest effort.

Beyond that, I believe we are operating well below our potential. There are many opportunities that we are missing because we are not bold enough to capitalise on them. Our own history gives us many insights. We moved away from a monocrop economy to develop other sectors. And we succeeded in our development path.

Our call to diversify production and find alternative markets two years ago, which had seemed to fall in deaf ears when we first mooted the idea, is increasingly finding a favourable echo among real-sector operators and decision-makers. I think we must step up our diversification drive and look for what we may be best at. The economy can only develop through, as Schumpeter puts it, a perennial gale of creative destruction. So, we need to keep on trying.

7. In your opinion, what strengths does our economy have in dealing with the adverse economic situation?

It is not the first time in our history that we are confronting a challenging environment. We have been through worse episodes in the past. But we have shown we can rise up to the challenges. In the past, we may have undertaken policies which were potentially sub-optimal. But sustained policy and institutional reforms over the years have enabled us to reach where we are

today. We have to combat the creeping pessimism so evident in other parts of the world. Crises provide opportunities as well. We should reorient our business strategies to tap new opportunities in growing markets. A case in point is the sugar sector which has reinvented itself to survive the drastic 36 per cent cut in sugar prices following the reform of the EU Sugar Protocol. Prior to the reforms, the sugar sector consisted of 14 factories and generated, directly and indirectly, some 40,000 jobs. As a result of centralization and modernization, today there are only 7 enterprises but the sugar sector still generates some 30,000 jobs. Sugar is better described today as the cane industry – in fact, there is much more than sugar in sugar cane. Mauritius is now known as a successful and respected exporter of refined sugar to Europe.

I think our most effective and immediate strength is our current fiscal and monetary space that allows us to act with much less constraint than several advanced economies. The coordinated actions of Government and the Central Bank during the crisis reinforced the effectiveness of our policy actions. And this did not happen overnight. We have all been working hard for that in spite of all the ill-conceived critics thrown at us.

Another of our strength, as I mentioned in my Letter to the Stakeholders, is our smallness that allows us to remain flexible and adapt to the changing environment. This permits us to concentrate in niche markets and avert the disastrous impact of crises. Our political stability and strong institutions provide the comfort that allows businesses to operate peacefully and without disruption.

Moody's Investors Service, which has recently placed Mauritius on a watch for a possible upgrade at a time when ratings of stronger economies in the West are being downgraded, has underscored the strengths of our small open economy in times >

of crisis. These strengths are based on three main factors: (1) the country's resilience to shocks, supported by positive growth in recent years; (2) the foreign direct investment (FDI) into the high-value-added service sector and successful diversification of the economic base; and (3) Government's significant progress in reducing its debt-servicing burden and improving its debt structure by lengthening maturities.

Mauritius has undertaken various steps to diversify its economy, transitioning from a comparatively low-skilled sugar and textile exporter to that of a higher-skilled services economy. The country has been able to attract significant FDI flows over the past five years and develop new sectors to diversify the economy.

The IMF in its Public Information Notice (PIN) released recently commended the authorities' skillful policy response to the global crisis, which has enabled a strong economic recovery and contained inflationary pressures.

8. And, what weaknesses need to be addressed to come out of this turmoil relatively unscathed?

Paradoxically, our greatest weaknesses are the rampant complacency that still plagues a number of public sector institutions and private companies, and our lack of unity that makes the decision-making process much too rusty and at times unfortunately jeopardizing our own chances. For this to change, it is important that many of our politicians and future ones get out of their many hidden agendas and come out clear when they propose alternatives to what is being done, in a holistic manner.

There are structural weaknesses that need to be addressed.
i. There is an absence of strategic planning capacity which needs to be remedied urgently; **ii.** We are too much dependent on certain markets EU accounts for two thirds of Mauritius's export market, implying that the country is significantly exposed to the crisis in Europe; **iii.** We need to invest more in Research & Development the culture of innovating is almost absent. We tend to be 'copy cats' rather than forging our own identity. **iv.** We lack technological preparedness: In all economies, it is the private sector that keeps on pushing the technology level higher and higher. But this is not happening here. **v.** There is a real mismatch between skills required and the jobs – skilled human capital deficit in certain key sectors: The training and skilling of the labour force is left too much to the public institutions whereas the private sector can help reduce this mismatch to a large extent by providing experience and exposure to fresh school leavers.
vi. Our proverbial low productivity is more a question of mindset – one solution: provide the labour force with proper tools and training and the space to be the source of innovation. **vii.** We need also to curb excessive leverage through recapitalization and restructuring measures; to ensure social cohesion and address growing inequality; and increasing savings and investment is crucial for our future growth.

In sum, we need all stakeholders to collaborate — public, private sector, the civil society at large. We need continued efforts to secure more inclusive and diversified growth. In addition to social protection and state-owned enterprise reform, we need investments in human and physical infrastructure (water, electricity, transport) as well as further improvements in the business environment.

9. Any other comments?

Apart from the things you have been asking me about the crisis, you have omitted a very important issue, which is one of the major concerns for Central Banks – INFLATION. For a central bank, our very reason to exist is related to inflation, so I get puzzled that you didn't talk about it. That's partly because we have delivered quite efficiently on our mandate in the recent past, in spite of all external shocks endured by the economy. Had we had inflation of the kind of Zimbabwe, then your first question would have been about inflation.

The fact that you didn't even bother to talk about it means that it's not a problem. But it doesn't mean that we must not be prepared for the battle because it can rear its ugly head anytime, especially because we depend so much on imports.

We do not have much control over external factors. But we should not complicate things by following the wrong policies domestically. To me inflation is an ever-present danger, so we should always be on the look out for it. ■