Address of Mr. Y Googoolye, Acting Governor, Bank of Mauritius on 24 April 2010 at the Gala Night Dinner of the South Asian Capital Markets Conference, held in Mauritius by the South Asian Federation of Exchanges

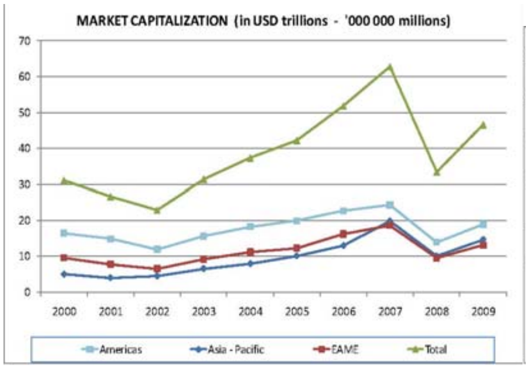
It gives me immense pleasure to be amongst you all on the occasion of what I consider the final closing ceremony of the South Asian Capital Markets Conference held by the South Asian Federation of Exchanges. Ladies and gentlemen, since this is a dinner address, I will keep it short so that it does not come in the way of your enjoying your meal.

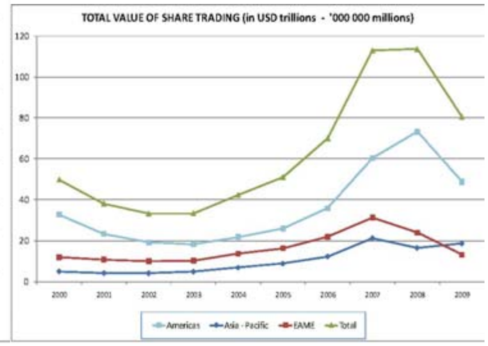
At the outset, I congratulate the organisers for choosing to hold the conference in Mauritius. As a gateway to Asia and Africa, with a well established financial services industry contributing nearly 11 per cent of GDP, an upcoming commodity and currency exchange, and Islamic banking added to the repertoire of financial services being offered, Mauritius is poised to be one of the most favoured destinations in the region for financial sector players.

Going through the conference brochure, I noticed that the entire gamut of issues concerning capital markets and their relevance for economic development have been addressed over the last two days by a galaxy of speakers and analysts who are experts in their own fields. I will try to give a central banker’s perspective.

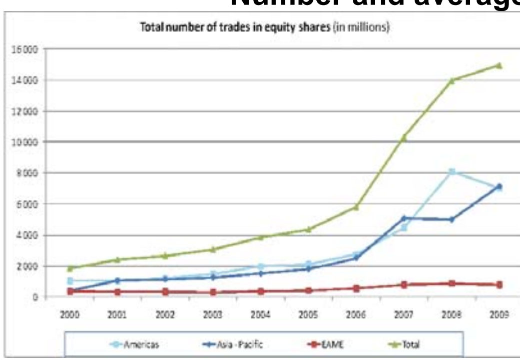
Stock and commodity exchanges play a critical role in enhancing the efficiency of the financial system. As a platform for bringing together investors and savers, the stock exchange provides liquidity to capital market offerings of economic operators. A well developed capital market therefore is as relevant for economic development as is an efficient and sound banking system.

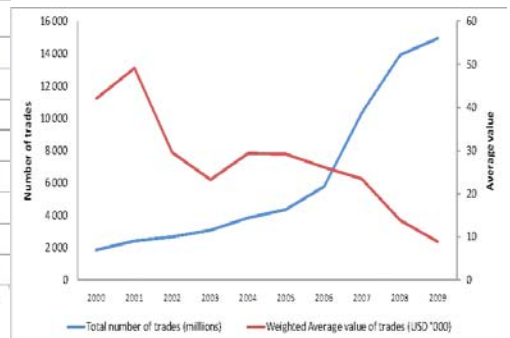
Stock market activities across the world have grown by leaps and bounds over the last decade and the Asia Pacific region has been the epicentre of this growth. To put things in perspective, global market capitalisation of shares went up from about USD31 trillion to nearly USD48 trillion between 2000 and 2009. This would have been much higher but for a fall in market capitalisation from nearly USD62 trillion in 2007 to USD30 trillion in 2008, due to the global economic crisis. But what is more significant is the fact that the share of Asia-Pacific region in global capitalisation went up from 16 per cent in 2000 to 32 per cent in 2009. More spectacular growth was witnessed in the value of share trading, which went up by 61 per cent, number of trades in equity shares which witnessed a seven-fold growth and the number of shares listed that vaulted by 41 per cent during this period. Only the average size of trade declined, perhaps pointing to a greater bias towards smaller trades and the growing significance of the Asian markets. These are shown in the graphs below.

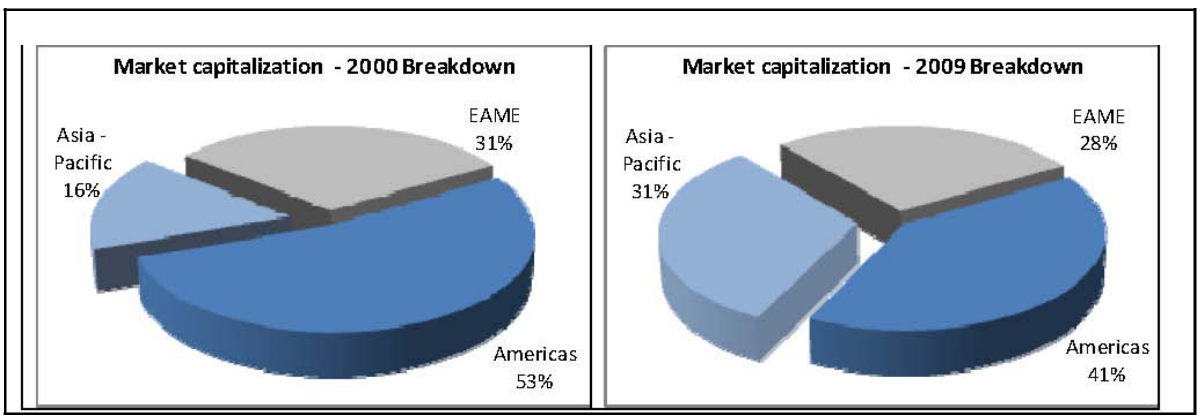




Number and average value of trades







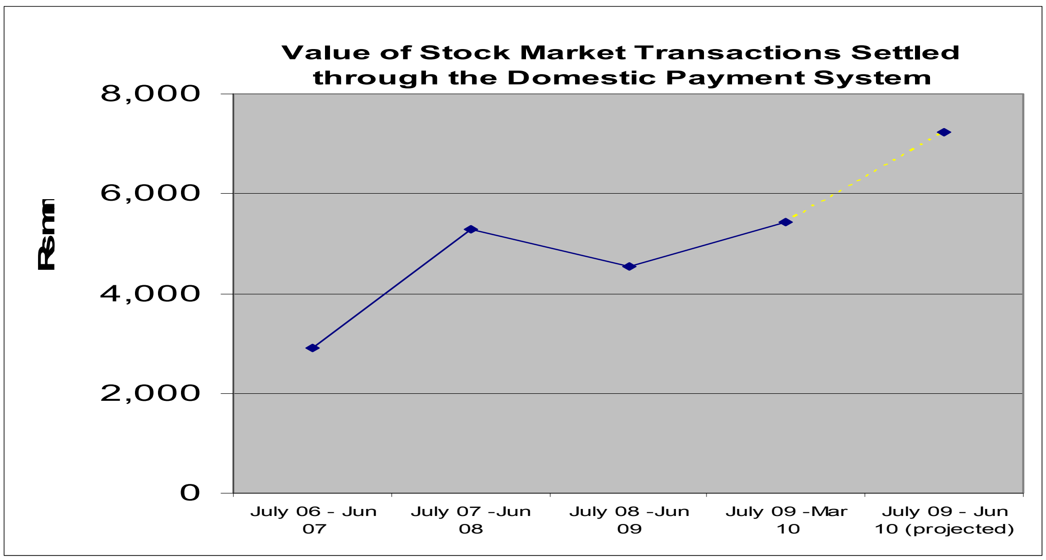
Note: EAME stands for Europe, Africa and Middle-east

Source: World Federation of Exchanges

In Mauritius as in most of the countries, the exchanges are not regulated and supervised by the central bank but by the market regulator, namely the Financial Services Commission (FSC). However, developments in the stock exchange are critical inputs for various policy interventions of the Bank of Mauritius (Bank). Similarly, many institutions regulated by a central bank are direct or indirect participants in the stock exchange. Let me examine the areas of stock market and other exchange activities that cross the Bank's concern.

First, the two domestic banks namely Mauritius Commercial Bank and State Bank of Mauritius, account for nearly 40 per cent of the market capitalisation of stocks listed on the Stock Exchange of Mauritius and for more than 50 per cent of the transactions taking place on many days.

Second, the ultimate financial settlement of the transactions at the stock exchange is reflected in the payment and settlement system which is managed by the Bank. In fact, the value of stock market transactions settled through the domestic payment system increased from Rs2.9 billion in the year ended June 2007 to Rs5.3 billion for the year ended June 2008 but came down to Rs4.5 billion in last financial year reflecting the impact of the global economic crisis. In the nine months to March 2010, the figure had reached Rs5.3 billion indicating greater buoyancy. This is reflected in the graph below.



Source: Bank of Mauritius

Third, there are differing views on the causal relationship between the stock market activity and economic growth. But it is clear that stock market functioning can have several implications for financial stability. An erratically functioning stock market without a proper regulatory framework can result in failure of counterparties to honour commitments and this could have serious adverse consequences for financial stability which could spill over to real economy as well. As the integration of the various segments of the financial system intensifies, their interrelationship is strengthened resulting in the developments in one market impacting the other. This does not mean that a segregated market is the alternative, but that the coordination among different regulators needs to be strong. In Mauritius we have put in place a mechanism for structured coordination between the Bank and the FSC to take care of this requirement. The Finance (Miscellaneous Provisions) Act 2009 also provided for a Financial Stability Committee of which both the Governor of the Bank and the Chief Executive of the FSC are members.

Fourth, the relationship between stock market and the banking sector development can also be varied. At one level, we can say that they are alternative sources for corporate finance and therefore there might be a temptation to believe that one would grow at the expense of the other. But that is not exactly how it pans out in real life situation because there is interplay of several other factors as well. Very often it is found that the interrelationship between stock markets and the banking sector is mutually reinforcing. Increased stock market capitalisation is likely to be accompanied by an increase in the volume of bank business (not necessarily an increase in lending) as financial intermediaries may provide complimentary services to issuers of new equity, such as underwriting. A sound capital market may itself boost capital formation leading to higher economic activity, which will result in growth in banking business. Therefore it has been argued that at the aggregate level the development of the stock market goes hand in hand with the development of the banking system. Empirical studies have in fact found that countries with well developed stock markets also have well developed banks and non-bank financial intermediaries and vice-versa. In Mauritius, the larger volume of activities in the stock market has not affected the growth of banks and non-bank deposit taking institutions. It is a fact, though, that in Mauritius banks continue to be the largest source of funds for economic operators.

Fifth, stock prices can have an impact on banks' balance sheets. The extent of impact will depend on how much they are exposed to shares directly or indirectly, the former representing equity holdings of banks and the latter the lending against the security of shares. In Mauritius, the Banking Act 2004 places certain restrictions on the acquisition of shares by banks and thus contains the possible impact of loss arising from fall in share prices. Banks' lending against security of shares has also been negligible.

Sixth, stock market behaviour can be influenced by central bank's policies. Very often stock prices react adversely or favourably to changes in the interest rates set by the central bank. The changes can be short term or sustained. The stock prices can also be influenced by the quantum of money supply in the economy. Similarly, exchange rates have a bearing on the stock prices through changes in behaviour pattern of foreign investors. It is equally a fact that capital flows will have an effect on exchange rate.

Seventh, the development of a liquid market for government securities is another area of interest to the Bank. A well developed capital market can provide a secondary market for gilts. This will in turn provide greater liquidity to these instruments which will help Government raise funds at finer yields. While the Government of Mauritius Bonds are listed on the stock exchange, we are discussing with banks on the way forward to developing a buoyant secondary market for the securities and I am confident that sooner than later we would have the right framework.

Eighth, at a fundamental level, an exchange is a place/or a forum, in today's IT-enabled world, for buyers and sellers to determine the price at which they want to buy or sell a financial instrument or a right to buy or sell goods. Therefore we have today commodity and currency exchanges that deal in futures and options for goods and currencies. Several derivative products are now available to hedge different types of risks. In the exchange-traded products, the counter party risks are largely avoided. We at the Bank believe that making proper use of these products would ultimately result in better price discovery and risk management, which is for everybody's good.

You would all be aware however that due to lack of proper control over their operations, some financial institutions in other countries had to face huge losses on account of frauds in their derivative transactions. The problem was neither at the exchanges nor with the products but with the risk management and control functions of the financial institutions themselves. Therefore, apart from a proper regulatory framework to govern the exchanges, and the exchanges themselves putting in place sound systems for ensuring against counterparty failures through margin calls, the counterparties dealing in such hedge instruments should also have robust controls surrounding the dealing operations. The Bank would therefore be keen to ensure that the banks as counterparties have the right risk management and control systems in place for this activity

Lastly, the presence of a commodity exchange in Mauritius has an additional dimension for us. We have embarked on offering Sharia-compliant banking services. Even non-bank deposit taking institutions can accept such deposits with the Bank's approval. Since Islamic banking requires that financial products are backed by a tangible underlying, the banks offering Sharia-compliant banking facilities would benefit from such an exchange for their liquidity management.

You can thus see that although the Bank does not regulate the exchanges directly, the activities in the exchanges have a bearing on many institutions and economic variables which are the concern of the central bank. In the same vein the policy choices of the central bank would have an effect on the activities in the exchanges. It is in national interest that this interaction yields best results for the economy as a whole. That is what we should all strive for.

Before I conclude, let me digress to a somewhat related issue. According to OECD, trade within Africa amounted to only 9.5 per cent of the continent's total exports valuing US$ 424 billion in 2007. Moreover Africa is a leading provider of commodities. African reserves are 80 per cent or more of world total for some commodities: 90 per cent of platinum, 80 per cent of Chromites, 85 per cent of Manganese for example. However, this potential is not fully utilised by local companies. For instance Africa has only 48 companies listed in the area of minerals and energy with a market capitalisation of US$ 67 billion, whereas despite having less than 10 per cent of the reserves in many commodities, Australia and Canada had about 400 and 850 companies listed with a market capitalisation of about USD130 billion and USD556 billion respectively at end June 2009. We need to reflect why this is so and take measures as a group to realise our full potential.

Let me then conclude by once again congratulating the hosts of this conference for their decision to hold it in Mauritius and thank them for giving me an opportunity to share some thoughts with you. I am confident that the outcome of the deliberations over the last couple of days would help all stakeholders achieve their objectives in a mutually reinforcing manner to the best advantage of their respective economies.

Thank you for your attention.