**Address by Mr Rundheersing Bheenick, Governor, Bank of Mauritius, at the Seminar on Currency Derivatives organised by the Global Board of Trade, 16 July 2009, Mauritius**

Ladies and Gentlemen

It is a great pleasure for me to be with you this morning at the opening ceremony of this Seminar on Currency Derivatives, organised by the Global Board of Trade. The launch of the first Pan-African Derivatives Exchange — which is what GBOT is — here in Mauritius marks a milestone in the development of our financial sector. The waves of financial sector liberalisation first touched our shores in a big way in 1994 with the suspension of exchange control which was how we had kept our external accounts in balance until then, supported much of the time by steep import tariffs, administrative controls, lending ceilings and directed interest rates.

Our financial sector has attracted favourable reviews from international financial institutions and has emerged over the past few years as an important contributor to the economy. It has also been a key driver in our efforts to participate fully in globalisation, supported by other measures such as tariff reduction and fiscal consolidation. In 2008, the financial sector was the second-fastest growing area of activity, just after the booming construction sector, with a growth rate of 10.1 per cent, against 7.5 per cent in 2007. It employed 12, 500 persons, and its share in GDP was just below 11 per cent. And this year, when the global economy has stalled as Western economies have nosedived in what has been called the Great Recession, our financial sector continues on its growth path. Its contribution to GDP is predicted to rise to 11.5 per cent in 2009 and to keep rising thereafter as the contributions of traditional sectors to GDP continue on their declining trend.

Although our financial sector witnessed an impressive development over the last decade following the suspension of capital controls, the focus remained on sound bank lending, securities issuances and trading, and foreign direct investment. We relied on domestic retail deposits, not foreign wholesale

money markets. We, as regulator and supervisor, did not fall asleep at the wheel and our banks have continued to be profitable and have not become wards of the state! Our financial system is of course far from perfect and suffers from several deficiencies – e.g. markets for bonds, currency and derivatives are thin!

In a brief interview I had given to the 'Business Standard' newspaper in India in March last year, I said that even if our economy was suffering from a deluge of foreign exchange via Foreign Direct Investment inflows, most of the foreign exchange operations were confined to the spot market. I added that I wanted to encourage the development of a vibrant currency futures and forward market. I took the view that such a development would help in creating an active foreign exchange market and introduce newer instruments for exporters and entrepreneurs to hedge and trade in the financial services sector.

Forward transactions accounted for less than one-fifth of total reported foreign exchange transactions during the last two financial years. Of this, options comprised only a tiny fraction. This was the prevailing situation despite the fact that, the Bank had authorised one bank to engage in cross-currency options in major currency pairs with corporates as far back as 2003. Clearly, some more robust action was called for if we were to dampen the volatility arising from over-reliance on a fairly thin forex spot market with too few players.

I have underscored on various occasions the importance of an efficient financial system to sustain our growth as a small export-oriented economy, situated far from its main markets, and forced by globalisation and trade liberalisation to compete without the protection of the preferential trading arrangements which we relied on earlier to pay our way. It is a truism to say that the financial system can be efficient only in so far as it has efficient financial markets to support it. Let me borrow the image of a four-legged

table from Randall Dodd[1], Director of the Financial Policy Forum and Derivatives Study Centre, in Washington DC, to illustrate this notion. His four-legged table is made up of (i) securities markets, which issue and trade bonds and equity shares, (ii) banks, which issue loans and provide payment and settlement services, (iii) insurance and pension funds, which provide future income and collateral for lending, and (iv) derivatives markets, which facilitate risk management and price discovery. Dodd concludes: "All four legs serve to support the table, and it is no more stable than its weakest leg." Indeed! No wonder our table proved rather wobbly: one leg has been missing all along!

Measures such as the elimination of centralised controls over prices and resource distribution, trade liberalisation, freeing nominal interest rates and abolishing exchange controls fundamentally alter the economic and financial risk exposures of financial institutions and companies. They generate a demand for effective risk management products that cover both liquidity and price risk. As the financial system develops, the sophistication of financial products increases. Borrower and investor choice is widened; and products that better match their specific requirements are more likely to be on offer, thus encouraging greater use of the financial sector. In addition, financial products, like instruments with market-determined returns (for example, government bonds), derivatives (for example, financial futures), and foreign exchange products facilitate arbitrage that links prices across time, markets, and countries.

Derivatives perform two economically-useful purposes: (i) risk shifting, also known as risk management or hedging, and, (ii) price discovery, which is the process of determining the price level for a commodity, asset or other item, based on supply and demand factors. Derivatives provide excellent opportunities to hedge risk for different kinds of participants, importers, export-oriented enterprises etc. Here, I have particularly in mind our dear exporters, relentless and unabashed champions of sustained depreciation of our Rupee.

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[1] See Dodd (2002): Consequences of Liberalizing Derivatives Markets

I am sure that once GBOT would have explained the complexities and risks of currency derivatives and how those risks are mitigated, our economic operators and other market players will appreciate that there would be commensurate reward for those who are willing to assume the risk as for those who are seeking to shift the risk. A market for foreign exchange hedging instruments can help domestic corporates in managing currency mismatches in their assets and liabilities. Our banks can also become members of the exchange in the foreign currency segment. In spite of the fact that forex futures, like all futures, are in the nature of a zero-sum game, differences in risk appetites mean that there is a potential for win-win outcomes all round.

Let me comment briefly on the evolution of the derivatives markets worldwide just to provide some context. The latest BIS Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity shows that derivatives markets worldwide witnessed explosive growth during the period covered, that is the three years from May 2004 to April 2007. The OTC derivatives segment, the average daily turnover of interest rate, as well as non-traditional foreign exchange contracts increased by 71 percent to USD 2.1 trillion over the three-year period, maintaining an annual compound growth of 20 percent witnessed since 1995. Turnover of foreign exchange options and cross-currency swaps more than doubled to USD 0.3 trillion per day, outpacing the growth in "traditional" instruments such as spot trades, forwards or plain foreign exchange swaps.

In the wake of the financial crisis, it has been found that the explosion of the derivatives markets was partly due to speculation and an abuse and misuse of derivatives. The ballooning of trade in derivatives across all categories to a staggering total of USD 596 trillion in December 2007 was driven by strong speculative interest and did not reflect economic fundamentals. In the two years to December 2007, currency derivatives grew by 78 per cent to reach USD 56 trillion. The semiannual statistics on OTC derivatives of the BIS indicate that currency derivatives had fallen to USD 50 trillion by December

2008. The growth in the market for currency derivatives is likely to decline further as regulators contemplate limits on trade in view of large losses which drove the South Korean won to a decade low; led to lawsuits in India; and caused shares of China's Citic Pacific Ltd. to collapse. So, there is a downside and it is as well that we should be aware of the potential dangers that lie ahead and that we should guard against.

I must say that I have seen lately the first encouraging signs of the maturity of our exchange arrangements: the recognition of the greater role assigned to market forces in determining the exchange value of the Rupee. I have already mentioned recently the proposal of the IMF to reclassify our exchange rate regime from “managed float” to “free float”, based on our performance in the recent past. We have come a very long way indeed since the collapse of the Bretton Woods system of fixed exchange rates in 1971. Countries of our size were paralysed by the fear of floating. They did not have the credibility to have independent monetary and currency regimes. By being recognised as a free-floater, we have truly come of age as an independent nation, with an independent currency.

As an aside, let me recall that currency futures, which we are discussing this morning, were also made possible by the collapse of the system of fixed exchange rates. The Chicago Mercantile Exchange launched the first forex future in 1972.

Let me make a few comments on our Exchange Rate Policy! Over the past year, the Bank has limited its interventions in the foreign exchange market but we have nevertheless ensured that the Rupee did not suffer from any undue volatility despite the spillover effects of the financial turbulence in other parts of the world. If we are upgraded to the category of “free floater”, this would mean a continuation of our policy of limited intervention and would imply a greater role for the market in managing the exchange rate. We expect that trade in currency derivatives can assist this area, by relieving pressure on the spot market and contributing to eradicate erratic and opportunistic behaviour, and thus reducing volatility.

The launch of a global derivatives exchange in our jurisdiction is yet another indication of the growing sophistication of our financial system. I strongly believe that the domestic financial market is now mature enough to engage in derivatives trading under proper regulation. I would like to mention in the same breath the efforts of the Bank to develop a secondary market for Treasury Bills and Bank of Mauritius Bills. This will add greater depth and liquidity to the official paper segment of the market and perhaps pave the way for a bond and interest rate futures market. Another initiative worth mentioning is the introduction of Islamic financial services and the need for Islamic Treasury Products. Discussions have been ongoing with GBOT for several months now to provide a platform for launching and trading such products. Yesterday itself, the press reported that the Stock Exchange of Mauritius (SEM) and the Central Depository & Settlement Co Ltd had approached the Financial Services Commission to launch index futures trading, targeting the SEM-7 Index.

All these initiatives aim at remedying the deficiencies of our financial system to which I alluded earlier and which need to be addressed to achieve greater financial system efficiency and realise our ambition to become an international financial centre. The development of a vibrant market for trading currency derivatives, not just for the domestic market but for the region, is another element that would contribute to position Mauritius as a world-class financial centre. It would help in forging deeper economic ties and strengthen our commitment to regional integration. Such ties are mutually beneficial – for Mauritius they can help to overcome the constraints posed by the small size of our domestic market and for our regional partners in Africa, they can contribute to accelerate the pace of development and financial liberalisation. Perhaps there can be no better testimony to our commitment to regional integration than the determined drive by some of our major banks to expand their operations in the region. As the process gathers momentum, others will follow suit; and currency derivatives are set to take on greater importance in the risk management toolkit of our banks.

This seminar comes at a time when policy-makers across the world are reflecting deeply on the role of the financial crisis in the global recession and the necessary changes to be made to the financial system to make it more resilient. Amid the chaos and confusion surrounding the debacle of the global financial system, it is important to remind ourselves of the role of the financial sector in allocating resources and risks. We may disagree about the precise role which complex financial instruments played in the financial crisis, but there is broad agreement that the way forward is not a turning back of the clock of global finance, but for better understanding by all market-players, including regulators, about the nature of sophisticated financial instruments. This seminar is therefore both timely and pertinent in enhancing our collective understanding of complex financial products, and in dispelling misconceptions, as we prepare for recovery and transition to a new world order.

*A word of caution: the regulator's perspective*

One word of caution before concluding my remarks – while currency derivatives are hedging products, and therefore, risk mitigating instruments, the absence or inadequacy of robust risk management practices and oversight surrounding this activity could have disastrous consequences. Our banks should therefore ensure that their dealers are well-trained, that there are clear-cut controls on their operations, and that the activities are audited on a concurrent basis, at least in the initial stages. While the exchange has the responsibility to ensure against settlement risks, it is the institution concerned that must address the internal procedural issues. Let us not forget that the scandals that affected such venerable institutions as Barings and Société Générale, although related to derivatives, had their origin in a failure of the internal controls of the banks.

As much as the Bank of Mauritius recognises the wealth of opportunities which the development of a currency derivatives market can bring, we are also mindful of its potential implications for financial stability. Derivative

activities can contribute to build up vulnerabilities and adverse market dynamics, particularly if the necessary supporting financial and legal infrastructure is not in place. We would not have been here this morning, if the new Insolvency Act had not made provision for the netting of financial contracts drawing on best international practice in this area. This set the stage for the development of the derivatives market in Mauritius. The mechanisms in place to ensure that these instruments are used to hedge risks and not for speculative purposes must also be there.

To conclude, let me refer to the Bond-Currency-Derivatives nexus that Percy Mistry, Director of Oxford International Group, had laid emphasis on in his Committee Report on converting Mumbai into an International Financial Centre. He had indeed taken a similar position earlier when he led a Commonwealth Secretariat team to Mauritius to examine ways and means to dynamise the export of tradeable services. He concluded that Mauritius needed to "develop the ability to provide such specialised international financial services with the knowledge and skills set necessary to give it an added advantage in developing suitable financial derivative (risk-hedging) contracts for African securities markets….and over time……Mauritius might develop the ability to offer and trade more sophisticated derivative contracts…..".

Mistry provides the script for the derivatives play. We at the Bank of Mauritius consider the development of a futures market one of our priorities to further our financial sector development agenda, in collaboration with our sister-regulator, the Financial Services Commission (FSC). The Bank and FSC have a major role which – to stay in the theatrical world – may be likened to that of Lord Chamberlain – producer, controller and censor! So, here we are with all the elements falling in place: the stage is set; the playwright's script has been passed; the Lord Chamberlain is watching over everything; the players are busy rehearsing their roles and learning their lines (which is what the seminar is all about); and the curtain will soon go up. Excited and expectant, I say to all of you: let the show begin. I wish GBOT and all players every success in this endeavour. Thank you for your attention.