BANK OF MAURITIUS

Financial Stability Report

June 2009 | Issue No.3

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List of Acronyms

BoE	Bank of England
BoJ	Bank of Japan
BoM	Bank of Mauritius
CDS	Central Depository & Settlement Co. Ltd
COMESA	Common Market for Eastern and Southern Africa
CPI	Consumer Price Index
CRR	Cash Reserve Ratio
ECB	European Central Bank
EMES	Emerging Market Economies
FCL	Flexible Credit Line
FSB	Financial Stability Board
FSC	Financial Services Commission
FSF	Financial Stability Forum
GBCs	Global Business Companies
GDP	Gross Domestic Product
GFSR	Global Financial Stability Report
IFSB	Islamic Financial Services Board
ILO	International Labour Organisation
IMF	International Monetary Fund
MACSS	Mauritius Automated Clearing and Settlement System
MCIB	Mauritius Credit Information Bureau
MERI	Mauritius Effective Exchange Rate
MSCI	Morgan Stanley Capital International
MTSP	Mechanism for Transitional Support to the Private Sector
NBDTIs	Non-Bank Deposit-Taking Institutions
NPL	Non Performing Loans
PLACH	Port-Louis Automated Clearing House
PLCH	Port-Louis Clearing House
PRB	Pay Research Bureau
REPSS	Regional Payment and Settlement System
SDRs	Special Drawing Rights
SEM	Stock Exchange of Mauritius
SEMATS	Stock Exchange of Mauritius Automated Trading System
WAI	Weighted Average Interbank
WEO	World Economic Outlook

Overview

The global economy has started to crawl out slowly of a recession, unprecedented since the Great Depression of the 1930's. The exceptional macroeconomic and financial support applied worldwide helped to decelerate the pace of deterioration and stabilise economic activity to some extent. In April 2009, the G-20 leaders' commitment to increase the IMF's resources to weather the crisis, restore credit, growth and jobs triggered further hopes for recovery and reduced risk aversion. In its World Economic Outlook Update in July 2009, the IMF revised downwards world growth to a contraction of 1.4 per cent in 2009 from a previous 1.3 per cent contraction made in April 2009. Growth, below trend, is expected to return in 2010 but the recovery process is likely to be uneven and slow with some emerging economies poised to grow faster.

In its Global Financial Stability Report (GFSR) of July 2009, the IMF acknowledged that financial conditions have improved following unprecedented policy intervention which has reduced the risk of systemic collapse and expectations of economic recovery have risen. Thus, hope that the worst of the crisis may be behind us brought some confidence back into the system. However, the timing of exit strategies from various financial, monetary and fiscal supports is important to address uncertainty which is still present in the market. Overall therefore, systemic risks to global financial stability have subsided but vulnerabilities remain.

Global inflation rates have declined substantially in the wake of the severe downturn in economic activity. However, the massive fiscal and monetary easing may breed inflation as the global economy recovers.

In Mauritius, GDP growth has been revised upwards to 5.3 per cent in 2008 despite lower growth recorded in third and fourth quarters of 2008. The Central Statistics Office (CSO) forecast a meagre 2.5 per cent expansion in GDP in 2009 as our export-led sectors feel the pinch of the crisis. The textile and tourism sectors are projected to contract sharply in 2009 while growth in the construction and financial intermediation sectors are forecast to be significantly lower. Unemployment averaged 7.2 per cent in 2008 and is expected to reach 8.0 per cent in 2009. Deficit in the current account narrowed in the fourth quarter of 2008 and more significantly in the first quarter of 2009 as a result of reduced merchandise deficit, albeit lower surpluses in the services, income and transfers accounts.

Against the backdrop of deteriorating economic conditions, the Bank cut the key Repo Rate from October 2008 to March 2009 by a total of 250 basis points. The sharp drop in food and energy prices during the second half of 2008 and early 2009, which led to a decline in both the headline and year-on-year inflation, allowed the Bank enough space to ease monetary policy. Players in the domestic foreign exchange market traded without any intervention since November 2008 and pressures on the foreign exchange market are expected to be subdued in the near future. The Bank intervened in the money market to conduct repo and reverse repo transactions in the first six months of 2009 to the tune Rs 3.8 billion and introduced a Seven-Year Inflation-Indexed Government of Mauritius Bonds in June 2009 which bears annual interest at 150 basis points above the 12-months average inflation published by the CSO end-May, each year.

The banking laws were amended in 2008 with the view to introducing Islamic banking in Mauritius. The Bank, presently an Associate Member of the Islamic Financial Services Board (IFSB), has applied for its full membership. Islamic banking products have already been launched in the market this year.

The global financial crisis which indirectly impacted on the banking sector through a slowdown of the real sector led to lower growth in total profits of banks for the year 2008 compared to the previous year. Gross NPLs of banks were at a low of 2.4 per cent in March 2009, despite a slight increase as from December 2008. Banks remained well capitalised throughout the year 2008 and the first quarter of 2009 with an increase in the capital adequacy ratio to 17.1 per cent for the banking sector in March 2009 relative to the 15.3 per cent in December 2008. Banks adopted a prudent approach to risk-taking and at the same time have been pursuing profit-maximisation and efficiency gains. There are, for the time being, no indications of increasing risks of instability in the system that would warrant urgent or special actions by the Bank. However, a close watch, in collaboration with banks, is being kept on the developments in the banking sector through reinforced on-site and off-site surveillance. The Insurance sector and Non-Bank Deposit-Taking Institutions (NBDTIs) have so far been shielded from the effects of the international economic slowdown.

1. Global Economy

1.1 Overview

In the aftermath of the collapse of Lehman Brothers, the world economy headed towards an unprecedented slowdown since the Great Depression of the 1930's. Most major economies fell technically into recession with two successive contractions in quarterly GDP. In 2008, the world growth of 3.1 per cent was driven mainly by emerging and developing economies which grew by 6.0 per cent as compared to 0.8 per cent growth in advanced economies.[1]

Though in the first quarter of 2009 major economies were still experiencing negative growth in GDP, there were signs that economic conditions were deteriorating less rapidly. This dampened extreme risk aversion which had engulfed global financial markets as the crisis lingered. In its World Economic Outlook of July 2009, the IMF, which warned that the recession is not over yet even if the world economy had started to crawl out slowly, downgraded its projected contraction of world GDP to 1.4 per cent for 2009, from a previous estimate of 1.3 per cent contraction made in April 2009. However, it upgraded its outlook for 2010 by an additional growth of 0.6 percentage points over the previous estimate. While the global economy is expected to start expanding once again in the second half of 2009, the recovery process may be much more subdued.

1.1.1 International Initiatives

At the London Summit in April 2009, G-20 leaders have committed to make an additional USD 1.1 trillion available to help the world economy weather the economic crisis and to restore credit, growth and jobs. They also pledged to repair the financial global system, strengthen financial regulation, fund and reform international financial institutions, promote global trade and investment, fight protectionism and build an inclusive, green and sustainable recovery.

A strengthening of financial regulatory systems was called for. This could be achieved by: (i) promoting integrity and transparency; (ii) guarding against risks across the financial system; (iii) dampening rather than amplifying the financial and economic cycle; (iv) reducing reliance on inappropriately risky sources of financing; and (v) discouraging excessive risk-taking.

G-20 leaders issued a 'Declaration on Strengthening the Financial System', which includes, among other things, the establishment of a Financial Stability Board (FSB) with a strengthened mandate, as a successor to the Financial Stability Forum (FSF). The G-20 leaders took a number of decisions, including collaboration between the FSB and the IMF to provide early warning of macroeconomic and financial risks, reshaping of regulatory systems to identify and take account of macroprudential risks, extending regulation and oversight to all systemically important financial institutions, instruments and markets, including important hedge funds.

The G-20 summit showed that there was strong support for the IMF's analysis, economic forecasts, policy advice, and reforms to better serve the global community. There was agreement to dramatically strengthen the IMF's lending capacity by trebling its resources to USD 750 billion, and supporting the issuance of USD 250 billion equivalent of Special Drawing Rights (SDRs). Already, since last October 2008, the IMF has moved rapidly to provide about USD 50 billion in balance of payments support to some crisis-affected countries. These new IMF programmes have come with streamlined and more focused conditionalities, and have paid due attention to the need for social protection measures.

The Flexible Credit Line (FCL), initiated by the IMF aims at providing effective contingent liquidity support for emerging economies with proven good macro-financial track record. The market has reacted positively to the fact that three countries (Mexico, Poland and Colombia) had sought FCL support and had subsequently been granted credit lines for totalling USD 77 billion. Mauritius has also expressed interest in the FCL.

[1] *IMF World Economic Outlook, July 2009*

The IMF expects to treble its support to low-income countries over the next two years and double its medium-term concessional lending capacity.

Various actions have been taken by the FSB and its member bodies to enhance market and institutional resilience and implement the recommendations of the London Summit. These include strengthening the Basel II framework, enhancing supervisory guidance and establishing supervisory colleges for most global banks. Work is underway to mitigate procyclicality in the financial system and recommendations have been issued covering the bank capital framework, loan loss provisioning practices, and ways to dampen the adverse interaction between leverage and valuation. Critical work is being carried out by the FSB in collaboration with the Bank for International Settlements (BIS) and the IMF on macroprudential tools and on (i) accounting and valuation, (ii) hedge funds and (iii) other systemically relevant entities and products. The IMF and the BIS are advancing their work on methodologies to quantify systemic risk and identify systemically relevant institutions and activities.

1.1.2 Global Economic Developments

Intensification of the crisis in September 2008 triggered widespread concerns about counterparty risks, especially in financial institutions in the US and Europe. Banks reacted by hoarding liquidity and limiting credit growth through a combination of higher interest rates and tighter credit conditions. Liquidity dried up in financial markets and problems with the adequacy of bank capital came to the fore, driven by a general lack of confidence, increasing risk aversion and extensive deleveraging in many institutions. The slowdown in credit growth weighed on economic activity which led to a contraction of output in advanced economies mainly the US, UK and Europe. As economic activity weakened, asset quality deteriorated, reinforcing further pressure on banks' balance sheets which led to tighter credit conditions. The crisis led to a freeze-up in interbank liquidity with soaring interbank rates and demand for low-risk instruments increased significantly, pushing yields down sharply.

Central banks reacted with policies to support liquidity, insure deposits and recapitalise ailing financial institutions to mitigate risks to financial system stability though uncertainty remains over the long-term solvency of those institutions. Several governments also came forward with extraordinary measures to stimulate the economy. After several months of severe stress on the back of ongoing uncertainties about the depth and duration of the global economic downturn, there are signs that conditions in financial markets are improving.

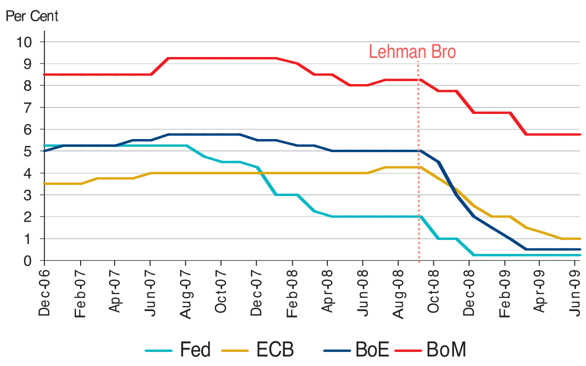
Market participants seem to focus on confidence and activity indicators in many countries, which suggested that economic conditions were deteriorating less rapidly than before or even stabilising in some cases. Risk premiums of interbank interest rates declined sharply from their record high levels in mid-October 2008, as major central banks intervened to ease the tensions through rapid interest rate cuts and liquidity-providing measures. Thus, the interbank markets have started to function more normally and liquidity has returned to credit markets. The improvement in investor sentiment is the outcome of several policy measures, including various fiscal stimulus packages which complemented the unconventional measures taken by central banks to ease monetary conditions.

Despite robust performances in previous years, emerging market economies (EMEs) were not immune to the effects of the sharp contraction of economic activity in developed countries. Emerging markets, many of which rely on exports for growth, experienced a rapid slowdown in export growth as international demand for manufactured goods tumbled. Both the IMF and the World Trade Organisation (WTO) predict sharp declines in trade volumes in 2009. Lower capital inflows and emigrant remittances also affected EMEs. However, this trend is expected to reverse as there are incipient signs that the EMEs are recovering rather rapidly.

1.1.3 Monetary Developments

Major central banks continued to ease monetary policy to support the economy. Where room was available for rate cuts, policy rates were further reduced. Both the European Central Bank (ECB) and the Bank of England (BoE) cut interest rates by 100 basis points since the beginning of the year. However, in the US and Japan where interest rates were close to zero, unconventional measures of quantitative easing were adopted. The US Federal Reserve indicated that it would purchase USD 300 billion of long-term securities while the Bank of Japan (BoJ) expanded its programme to purchase JPY 4.8 trillion of Japanese government bonds. The BoE announced that it would increase its purchase of gilts and private sector assets to GBP 125 billion, from the GBP 75 billion announced earlier, to inject liquidity into the system. The ECB was the latest among major central banks to join the quantitative easing club when it announced the purchase of about EUR 60 billion of euro-denominated covered bonds issued in the euro area. The ECB also announced in June 2009 a special liquidity facility to the banking sector at the repo rate of 1.0 per cent for twelve months in order to ease strains on banks' balance sheets and stimulate the conditions for an economic recovery. Looking ahead, the easing cycle of central banks should come to an end on signs of sustained economic recovery as the large fiscal stimulus packages and the surge in commodity prices create inflationary pressures.

Chart 1.1: Key Policy Rates in Major Central Banks and Mauritius



Central Banks' websites

1.1.4 Unemployment

Large-scale job losses continue to be reported in many economies amid the sharp contraction in global economic activity. The unemployment rate in the US surged to a 26-year high of 9.5 per cent in June 2009. As at May 2009, the unemployment rate for the euro zone and Japan stood at 9.5 per cent and 5.2 per cent, respectively, while the UK recorded a three month-average unemployment rate of 7.6 per cent in May 2009. In its latest Global Employment Trends Update, the International Labour Organisation (ILO) presents a bleak picture of increasing job losses in every region of the world. The ILO also revised upwards its unemployment projections to levels ranging from 210 million to 239 million unemployed worldwide in 2009, corresponding to global unemployment rates of 6.5 and 7.4 per cent, respectively.

1.1.5 Commodity Prices

After having registered sharp increases up to July 2008 on account of substantial increases in oil, food and metal prices, international commodity prices declined in the second semester of 2008. However, commodity prices started to rise again since March 2009 as economic data from the US, Japan and India reinforced the perception that the global recession was abating and the price of crude oil reached a high of USD 72.7 a barrel on 11 June 2009. Rising global stock markets and the weakening of the US dollar also prompted an influx of investment into energy futures. The new bullish macroecomic sentiment has not yet produced signs of oil demand recovery and oil market fundamentals remain weak. Moreover, slower growth, spare capacity and higher stocks of many commodities are expected to keep rise in prices of non-oil commodities at bay throughout 2009.

1.2 Global Financial Environment

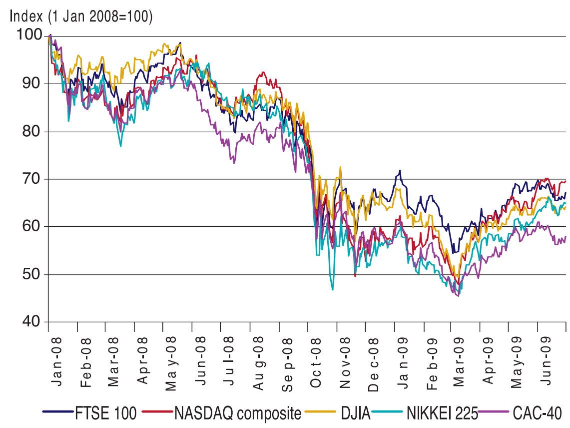
1.2.1 Major Equity Markets

The moderation in the decline of economic activity resulted in some signs of optimism in major equity markets which turned around early March to mid-June 2009. Glimmers of hope that the global recession and major systemic crisis might have bottomed out, reduced risk aversion. Moreover, the publication of US and UK bank rescue plans reduced uncertainty and the results of the stress tests of the largest 19 US banks improved visibility in the banking system. Better-than-expected corporate earnings in the first quarter also underpinned the pick-up in risk appetite. However, the sustainability of banks' profitability remains in doubt as it is perceived that the first quarter figures reflect a temporary boost from the new US guidelines on mark-to-market accounting, introduced in early April 2009 (but applicable retroactively to reporting periods ending 15 March 2009). Expectations of further credit losses in the coming quarters may also impinge on the profits of banks.

The FTSE 100 and the DJIA moved higher by 17.2 per cent and 24.9 per cent, respectively, from March to June 2009 while the NASDAQ and the NIKKEI-225 gained 38.7 per cent and 36.8 per cent, respectively, over the same period

However, in June 2009, some volatility was displayed reflecting the continued uncertainty in the markets. Most equity indices are now above the trough reached after the collapse of Lehman Brothers (Chart 1.2).

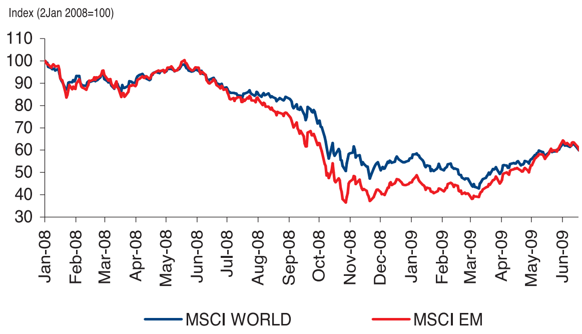
Chart 1.2: Equity Indices in Major Economies



Source: Reuters

Equities in emerging markets moved higher from early March 2009 as investors' risk appetite returned. Between March and June 2009, the MSCI EM index outperformed the MSCI World index which surged by 37.6 per cent while the MSCI EM index increased by 60.2 per cent on the back of strong macroeconomic fundamentals and improvement in commodity prices. Emerging markets were further supported by the April 2009 G-20 Summit Declaration which included measures to boost IMF's resources to help it better cope with the needs of emerging economies. In this context, the Fund initiated the FCL, which has been availed of by some eligible countries.

Chart 1.3: MSCI World and Emerging Markets

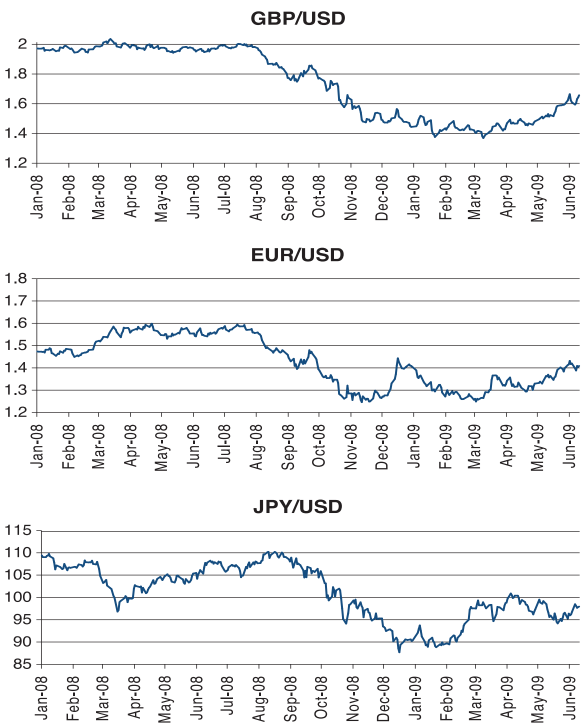


Source: Reuters

1.2.2 Evolution of Major Currencies

Volatility in currency markets heightened with the spread of the crisis. Despite a faltering US economy, the US dollar showed significant resilience as investors unwound risky carry trades and flew to quality. The US dollar and the Japanese Yen benefited from their safe haven appeal. As risk appetite picked up, investors diversified exposures away from the US dollar into other currencies.

Chart 1.4: Evolution of Major Currencies



Source: Reuters

1.3 Outlook and Risks

In its April 2009 GFSR Update, the IMF has underlined the need to clean banks' balance sheets of impaired assets, accompanied by restructuring and recapitalisation efforts in order to break the downward spiral in the financial system and the global economy. The IMF stressed the importance of maintaining the flow of credit to creditworthy borrowers. The Fund estimated write-downs on US-originated assets by all financial institutions over 2007 to 2010 at USD 2.7 trillion and total expected write-downs on global exposures are estimated at around USD 4 trillion. While the risk of a widespread banking crisis has eased and potential write-downs on securities are likely to be lower in the wake of the recovery in mark-to-market valuations, bank capitalisation remains a concern as further write-downs on loans are expected in the event of a deeper and more prolonged global downturn. Against this backdrop, the decision of many countries to assess their banking systems by performing stress tests can be an effective tool in rebuilding banks' balance sheets, if accompanied by measures to address any shortfall in capital.

Encouraging 'green shoots' of recovery suggesting the worst of the global recession is over, and unprecedented policy intervention have triggered a revival in market confidence as a result of which financing conditions have improved. Concerns over liquidity and counterparty risks in the banking sector have declined. Bank debt, interbank markets as well as corporate bond markets are functioning more normally. The risk of a widespread banking crisis has thus eased. However, overall financial conditions remain tight as reflected in the slowdown in growth in bank credit to the private sector in mature economies. As global growth is projected to remain below potential for several quarters ahead, the return of global financial markets to normal conditions would take some time. Although volatility continues to subside, financial markets still seem vulnerable to a resurgence of risk aversion. Notwithstanding the return of risk appetite for emerging market assets on the back of the recovery of commodity prices and improved growth prospects, the overall outlook for emerging markets remains mixed as their performance is vulnerable to lower-than-expected global growth and to constrained international bank lending.

The global economic outlook has somewhat improved but uncertainties remain, stemming mainly from rising unemployment, loss of confidence in the stability of the financial sector, falling housing markets and concerns over the sustainability of public debt in some countries. A sustained pick-up in global economic activity is not expected until the second half of 2010. The biggest risk to the outlook is undue delays by countries in cleaning toxic assets from their banking systems.

The threat of runaway inflation, as a result of the massive fiscal and monetary easing in several large economies, could pose a serious risk to financial stability as the global economy recovers (Box 1).

Box1: Price Stability and Financial Stability

Central banks are generally vested with a dual responsibility: maintaining price stability and financial stability. However, the primary objective for most central banks is price stability, which has been institutionalised around the world, with a growing number of countries adopting inflation-targeting regimes. The role of central banks in fostering the safety and efficiency of the financial system stems from their position as the country's monetary authority and thus the ultimate provider of liquidity to financial institutions. For a number of years financial stability was a secondary objective for central banks as their focus was primarily on the attainment of low and stable inflation. The intensification of the global financial crisis, which led to a major and synchronised downturn of the global economy, has placed financial stability on top of the agenda of central banks.

Policies directed towards achieving price stability could both reinforce and undermine financial stability. For instance, the reduction of output and inflation volatility under inflation-targeting frameworks minimises the macroeconomic risks to financial stability. On the other hand, expansionary policies pursued during a period of declining inflation could generate excessive credit expansion, fuelling asset-price bubbles, which enhance vulnerabilities of the financial system.

The current financial crisis has given rise to a significant debate on the formulation and implementation of monetary policy and its role in preventing financial crises. There have been persistent calls to broaden the scope of variables, which central banks usually consider when determining the future path of monetary policy, such as output growth, wages, inflation expectations and exchange rate. It has been argued that central bankers must also take into account other variables such as monetary aggregates and asset prices in their analysis, which have a bearing on future inflation while at the same time are important indicators of potential risks to financial stability. Inordinate growth in monetary and credit aggregates could signal that assets may be overvalued and financial markets are taking excessive risks, which would increase risks to financial stability.

Asset-price bubbles form when prices are pushed up artificially by factors other than fundamentals. The bursting of bubbles has an adverse impact on financial markets and on the real economy. However, bubbles are considered to be hard to identify and also difficult to affect through monetary policy and are thus ignored with the implicit understanding that the authorities would step in through injection of liquidity and interest rate cuts when they burst.

In its April 2009 World Economic Outlook and Global Financial Stability Report, the IMF has called upon central banks to adopt a better macroprudential framework for monetary policy, paying due attention to financial stability as well as price stability by taking into account asset-price movements, credit booms, leverage, and the build-up of systemic risks.

Although the primary objective of the Bank of Mauritius is to maintain price stability and to promote orderly and balanced economic development, the Bank is also entrusted with the responsibility to ensure the stability and soundness of the financial system. This mandate of the Bank provides a sound macroeconomic framework for maintaining financial stability. Regulatory and supervisory information are also important inputs in monetary policy formulation. The financial crisis has called for more concerted actions between Government and the Bank. Recent cuts in the key Repo Rate, in conjunction with fiscal stimulus measures to shore up the economy and preserve jobs, contribute to mitigate risks to financial stability by impacting positively on corporate and household indebtedness. The expansion of monetary and credit aggregates is closely monitored by the Bank to assess long-term risks to price stability. As far as stock market prices are concerned, their evolution is monitored, although the wealth effect is estimated to be relatively small in Mauritius. Recognising the importance of financial stability for overall economic development, Government has recently set up a high level Financial Stability Committee.

Material in this Box draws on insights on financial stability presented by the Governor of the Central Bank of Chile at a meeting in Santiago in November 2008 and a speech on ' Moral hazard, market discipline and self-regulation' by Professor Axel A Weber, President of the Deutsche Bundesbank, in Kuala Lumpur in February 2009.

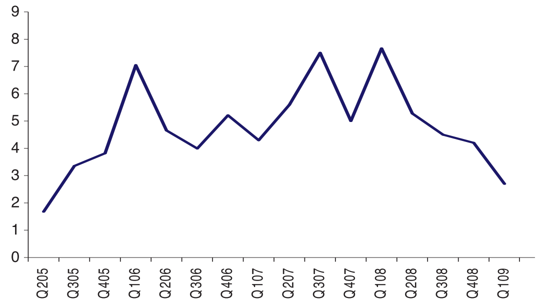
2. Domestic Economy

2.1 Real Sector Developments

The worsening of economic conditions in Western Europe, our main export market, impacted on the domestic economy, in the second semester of 2008 and first quarter of 2009, more particularly on external demand-led sectors. Some key sectors started to show signs of decelerated performance as from the third quarter of 2008 as the risk of a deeper and more prolonged downturn of the global economy increased.

According to the latest report on National Accounts issued in June 2009, the annual growth rate of the economy declined steadily from 7.7 per cent in the first quarter of 2008 to below trend rates of 4.5 per cent and 4.2 per cent in the third and fourth quarters of 2008, respectively. Growth is estimated to have slowed down sharply to 2.7 per cent in the first quarter of 2009. On a quarter-on-quarter basis, GDP grew by 0.1 per cent in the first quarter of 2009 compared to a growth of 0.6 per cent in the last quarter of 2008. The 'textile' sector contracted during four successive quarters while the 'hotels and restaurants' sector recorded negative growth rates in the last quarter of 2008 and the first quarter of 2009. Reflecting the severe downturn of the economy, the 'electricity, gas and water supply', 'construction' and 'distributive trade' sectors also contracted in the first quarter of 2009. The 'financial intermediation' sector, after registering robust growth in the four quarters of 2008, grew at a slower pace of 6.1 per cent in the first quarter of 2009. The main contribution to growth in the first quarter of 2009 came from the 'manufacturing', 'transport, storage and communications', 'financial intermediation' and 'real estate, renting and business activities' sectors.

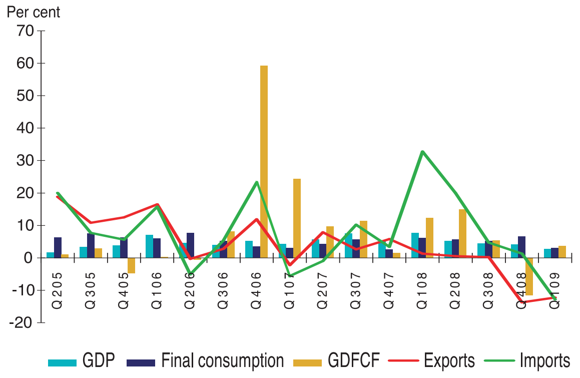
Chart 2.1: GDP Growth Rate (Percentage Change over Corresponding Quarter of Previous Year)



Source: CSO, Government of Mauritius

Quarterly GDP data by expenditure indicate a slowdown in consumption expenditure and investment activity as well as sharp contractions in both exports and imports of goods and services. After sustaining buoyant growth in 2008, partly on account of the implementation of the Pay Research Bureau (PRB) report in July 2008, household consumption expenditure growth moderated to 3.4 per cent in the first quarter of 2009. Investment somewhat improved by 3.6 per cent following a sharp contraction of nearly 12 per cent in the last quarter of 2008. The retrenchment by consumers in our main export markets is weighing heavily on exports of goods and services, which contracted by 13.7 per cent and 12.2 per cent, in the fourth quarter of 2008 and first quarter of 2009, respectively. After slowing sharply in the second semester of 2008, imports recorded negative growth of 12.8 per cent in the first quarter of 2009, reflecting weakening domestic demand.

Chart 2.2: GDP Growth and its Components (Annual Growth Rate)



Source: CSO, Government of Mauritius

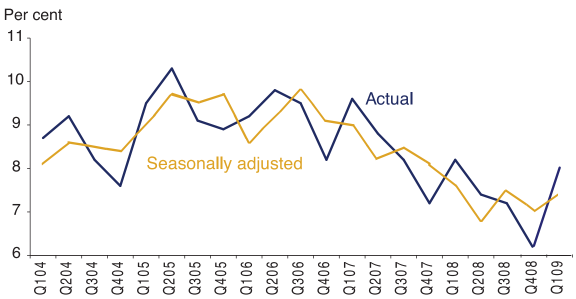
The growth rate is projected by the CSO to slow down sharply from 5.3 per cent in 2008 to 2.5 per cent in 2009, with contractions of 5.0 per cent and 8.8 per cent in the 'textile' and 'tourism' sectors, respectively and significant slowdown in the growth of the 'construction' sector to 2.0 per cent.

Weak economic prospects in key sectors of the economy have spillover effects on the rest of the economy. 'Financial intermediation' and the 'distributive trade' sectors are forecast to grow at a much slower pace in 2009. The 'agricultural', 'transport', 'storage and communications' and 'real estate' sectors are projected to sustain buoyant growth, notwithstanding weakening domestic growth prospects. The near-to-medium term outlook depends on the extent and duration of the global economic downturn, which would, in turn, impact on the demand for exports.

2.2 Labour Market Developments

The quarterly unemployment rate, as shown in Chart 2.3, is estimated at 8.0 per cent in the first quarter of 2009, sharply up from 6.2 per cent in the fourth quarter of 2008, but slightly lower compared to the rate of 8.2 per cent in the corresponding quarter of 2008. The unemployment rate is forecast by the CSO to rise from 7.2 per cent in 2008 to 8.0 per cent in 2009.

Chart 2.3: Unemployment Rate



Source: CSO, Government of Mauritius

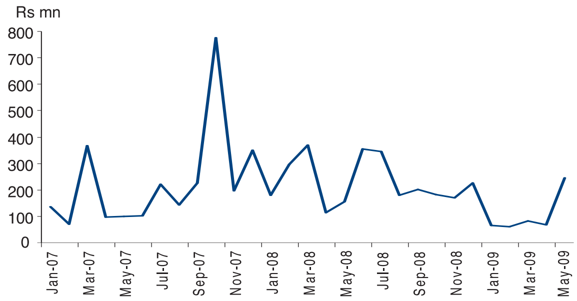
The employment outlook has weakened as a result of uncertainties over the future external and domestic economic conditions. With projected contraction in the 'textile' and 'tourism' sectors and the sharp slowdown in the 'construction' sector, these three key sectors of employment, are most likely to have a negative impact on the employment situation in the economy. Job losses, if sustained, may potentially reduce household income, which may in turn have adverse consequences on the level of non-performing loans and asset quality of banks.

With a view to mitigating the potential macroeconomic risks of rising unemployment, budgetary measures announced on 22 May 2009 included an amount of Rs 4 billion for minimising job losses. A rapid implementation of those measures may have a positive impact on employment in the coming quarters.

2.3 External Sector Developments

Exchange rate risks to financial stability have part of their roots in cross-border flows in the balance of payments. In the first quarter of 2009, the trade deficit narrowed by 35.2 per cent compared to the corresponding quarter of 2008, mainly on account of reduced imports outweighing the fall in exports, the former driven by the sharp reduction in commodity prices as well as slower economic activity. Lower surpluses were also recorded on the services[2], income and current transfers accounts. The current account deficit in the first quarter of 2009 was 66.5 per cent lower than in the corresponding period of 2008. Net inflows on the capital and financial account fell in the fourth quarter of 2008 compared to the third quarter of 2008, as the significant capital inflows directed towards the Integrated Resort Scheme (IRS) sector have decelerated due to uncertainties in the global economic environment.

Chart 2.4: Foreign Direct Investment in IRS



During the first quarter of 2009, the capital and financial account recorded a decline of 32.7 per cent in net inflows compared to the corresponding quarter of 2008. The overall balance of payments recorded a surpluses of Rs 4,624 million for the calendar year 2008 and Rs 154 million in the first quarter of 2009. On forecasted trend, the current account deficit for the year 2009 is projected to narrow to around 7.2 per cent of GDP from 10.5 per cent in 2008.

Portfolio investment in 2008 recorded net outflows of Rs 4,868 million as against net inflows of Rs 1,988 million in 2007. There were net outflows on the portfolio investment account as from the last quarter of 2007 and this trend continued up to the first quarter of 2009.

[2] *The surplus on the services account fell by 18.0 per cent in the first quarter of 2009 compared to the first quarter of 2008.*

International reserves act as a cushion to exchange rate risk and play a key role in financial system stability. Net international reserves, which consist of net foreign assets of the banking system, foreign assets of Government and the country's Reserve Position at the IMF increased to an average of Rs 93.5 billion for the period January to June 2009 compared to an average of Rs 85.3 billion in the corresponding period of the previous year. However, the import coverage, measured in terms of weeks, represented an average of 36.8 weeks in the first six months of 2009 compared to 33.6 weeks in the corresponding period of 2008.[3]

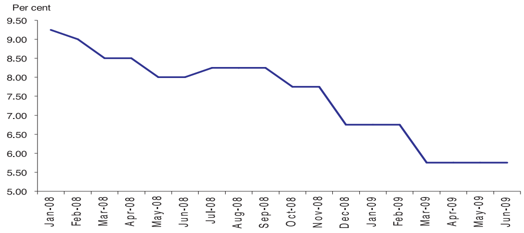
2.4 Fiscal Sector Developments

The budget deficit is estimated to have increased to 3.9 per cent of GDP in 2008/09 from an initial estimate of 3.3 per cent and would increase further until 2010 before the trend reverses in 2011. This would eventually result in rising public sector debt, which is forecast to reach 60.0 per cent and 60.8 per cent of GDP at the end of December 2009 and 2010, respectively, from 57.5 per cent as at June 2009. It is projected to subside to 59.8 per cent at the end of December 2011. However, notwithstanding some pressures on Government finances stemming from the fiscal measures, public sector debt is likely to remain below the ceiling of 60 per cent of GDP prescribed in the Public Debt Management Act 2008. In terms of composition, domestic public sector debt accounted for 84.6 per cent of total public sector debt as at 30 June 2009. This ratio is forecast to come down with the expected inflows emanating from the increased foreign financing of the budget deficit over the next two years.

2.5 Inflation Risks and Monetary Policy

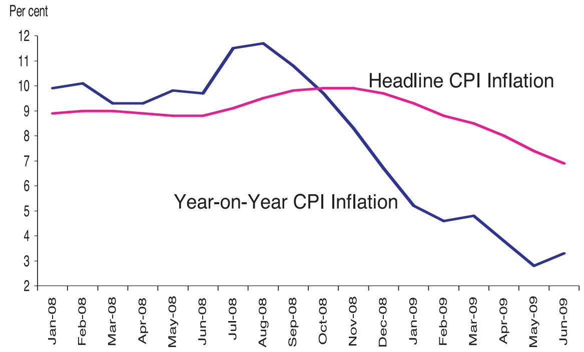
The Bank of Mauritius responded to the downside risks to growth by adopting an expansionary monetary policy from October 2008 to date during which period the key Repo Rate was reduced by a total of 250 basis points. Chart 2.5 shows movements in the key Repo Rate.

Chart 2.5: Movements in key Repo Rate



Headline and year-on-year CPI inflation rates have both maintained a downward trend since the fourth quarter of 2008 to reach 6.9 per cent and 3.3 per cent, respectively, in June 2009. This decline was essentially due to declining international commodity prices and increased slack in the domestic economy.

Chart 2.6: Year-on-Year and Headline CPI Inflation



In the near term, inflation is expected to remain at relatively low levels but the medium-term outlook could be marred by risks of higher commodity prices and the possibility of an earlier-than-expected and stronger global economic recovery. Movements in the rupee *vis-à-vis* major trading partners' currencies, increases in freight rates and the impact of government stimulus packages, both domestic and foreign, might also be sources of concern.

2.6 Household and Corporate Indebtedness

One of the key risks in financial stability is credit risks associated with household and corporate indebtedness. In the absence of exhaustive data, household and corporate sector indebtedness are estimated solely from banking sector data. On-going efforts are being made to enhance data coverage to facilitate better estimation of household and corporate indebtedness.

3 Import cover is based on the value of import for the respective years, exclusive of purchase of aircrafts and marine vessels.

2.6.1 Household Credit

Household indebtedness, estimated by exposures to the housing and personal sectors including credit card facilities, as a ratio to total private sector credit, has declined slowly over the past twelve months ended June 2009 to reach 21.4 per cent against 22.7 per cent a year earlier. Credit growth in the household sector increased during the period September to November 2008 on a month-on-month basis. Thereafter, it declined despite the on-going attractive housing loan products offered by banks. Household behaviour tends to reflect, to a large extent, the effects of the economic slowdown as well as the bleak economic outlook due to growing uncertainties. As potential risks of a decline in household incomes are not insignificant, risks of higher probability of defaults in the household sector should not be ignored.

The Bank has initiated a Survey of Housing Market Conditions to enhance understanding of the domestic housing market and awareness of latest developments therein. The Survey revealed, among other things, that the housing market was characterised as being in a situation of excess supply during the first quarter of 2009 by 60 per cent of the respondents. Moreover, for 55 per cent of the respondents, the price at which a residential property was sold in the first quarter of 2009, was generally lower than its initial asking price. Other details of the Survey findings are available on the Bank's website.

2.6.2 Corporate Credit

As at 30 June 2009, the ratio of corporate sector credit to GDP was 48.5 per cent compared to 44.5 per cent a year ago. In the last quarter of 2008, the broadening of the global crisis adversely impacted local corporates vulnerable to international developments. Credit to the corporate sector as a percentage of total private sector credit, which stood at 71.9 per cent in June 2008, peaked at 73.4 per cent in October 2008 to subsequently fall to 71.5 per cent in June 2009. This may be attributed to lower demand for credit due to pessimism in some key economic sectors.

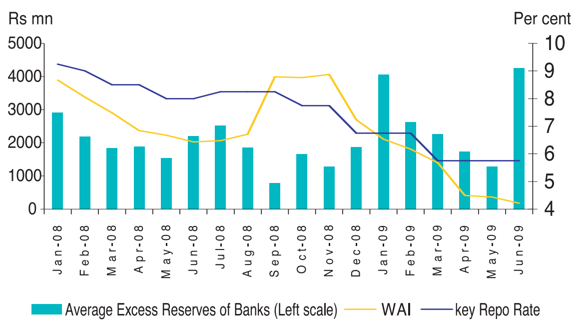
Corporate credit growth is likely to remain subdued in the coming months with the bottoming out of the recession but is expected to improve once global economic activity gathers momentum. Against the backdrop of growing uncertainties in the market, banks may adopt a more cautious approach to lending - both short-term and long-term - to companies. However, the advances that have been and would be granted under the Mechanism for Transitional Support to the Private Sector (MTSP) initiated by Government are likely to minimise defaults of the concerned borrowers.

2.7 Domestic Financial Markets

2.7.1 Domestic Money Market

During the period July 2008 to June 2009, the Bank intensified its monitoring of the developments and liquidity situation on the money market. Despite the contraction of liquidity on the international financial markets, the domestic banking system remained relatively liquid with banks operating above the minimum CRR, which was hiked from 4.0 per cent to 6.0 per cent in August 2008. However, this induced some temporary tightness in the market and the Bank of Mauritius intervened to conduct 16 repo transactions to the tune of Rs 26.9 billion from August 2008 to January 2009. Following the hike in the CRR, the weighted average interbank (WAI) rate increased remarkably in August 2008.

Chart 2.7: Banks' Excess Reserves and Interbank Rates



Subsequently, when downside risks on domestic economic growth became more apparent, the Bank brought down the CRR to 5.0 per cent in November 2008 and further down to 4.5 percent in December 2008 which resulted in a Rs 3.7 billion injection of liquidity into the system. This led to some building-up of excess reserves and allowed the interbank market to continue to function normally. Two reverse repo transactions were carried in the months of February and March 2009 to the tune of Rs 1.3 billion. Excess liquidity increased to an average of Rs 2.5 billion in the period January to June 2009 compared to Rs 1.7 billion in the second half of 2008.

Movements in yields on Treasury Bills reflected the successive changes in the key Repo Rate and the high liquidity situation. The adequate liquidity led to a fall in yields well below the key Repo Rate. Yields on other government instruments, namely, Treasury Notes and Long-term Government of Mauritius Bonds generally followed the trend in Treasury Bills yields.

The Bank introduced a Seven-Year Inflation-Indexed Government of Mauritius Bonds in June 2009 which bears annual interest at 150 basis points above the 12-months average inflation published by the CSO end-May, each year.

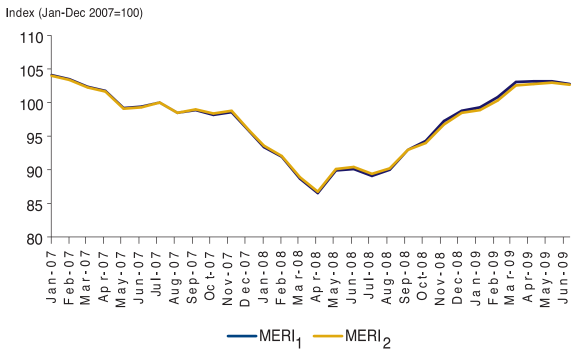
2.7.2 Domestic Foreign Exchange Market

The Bank of Mauritius intervened, in a bid to reduce excessive volatility and to ease tight conditions, on the domestic foreign exchange market and sold around USD 172 million during the period August to November 2008. Banks' average foreign exchange position increased significantly in the first six months of 2009 to USD 77.9 million compared to USD 41.2 million for the period July to December 2008. Transactions on the interbank forex market, on a monthly average, fell to USD 68.4 million in the period January to June 2009 compared to USD 90.0 million in the second semester of 2008.

The evolution of the rupee in the domestic foreign exchange market was driven by the interplay of local and international factors. During the period January to June 2009, the rupee depreciated against the US dollar, the euro and the Pound sterling by 1.7, 2.8 and 10.9 per cent, respectively. The significant depreciation of the rupee against the Pound sterling reflected the latter's broad-based recovery in international markets.

On a nominal effective basis, both $MERI_1$ and $MERI_2$ have been on a depreciating trend since the second half of 2008 though some stability was observed as from March 2009 (Chart 2.8). For the period January through June 2009, the $MERI_1$ depreciated by 3.4 per cent while the $MERI_2$ moved lower by 3.7 per cent. [4]

Chart 2.8: Movements of $MERI_1$ and $MERI_2$



2.8 Local Stock Market

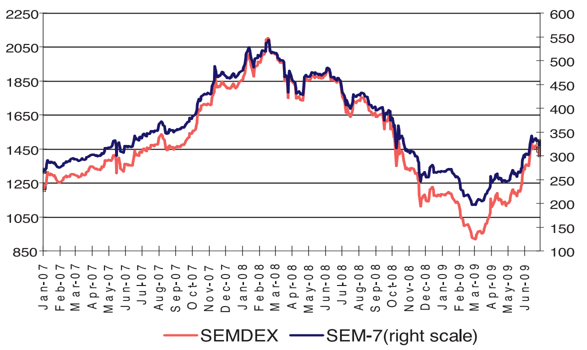
The local stock market maintained its uptrend in 2007 and early 2008 despite the outbreak of the US sub-prime crisis in August 2007. However, as the crisis deepened in September 2008 with the collapse of Lehman Brothers, massive sell-offs took place although local fundamentals stayed reasonably sound. The intensification of the crisis in September 2008 was mirrored by further deterioration in the local stock market indices. Share prices of banks and companies operating in the tourism sector witnessed the steepest decline.

The SEMDEX hit a low of 919.8 in March 2009, a level last seen in September 2006. The subsequent rise in the local market index, driven by the surge in global equities, was further supported by timely policy responses and big expenditure projects announced in the May 2009

[4] The Mauritius Exchange Rate Index (MERI) is a summary measure of the rupee's movements against the currencies of important trading partners. $MERI_1$ uses the currency distribution of trade as weights while $MERI_2$ includes the currency distribution of tourism receipts combined with the currency distribution of trade as weights.

Budget. For the period March through June 2009, the SEMDEX and the SEM-7 moved higher by 56.3 per cent and 62.7 per cent, respectively although it witnessed sporadic declines. Over the same period, banks' share prices, on average, surged by 68.5 per cent while those of hotels, on average, increased by more than 100 per cent. Consequently, while in the later part of June 2009, mature equity indices moved lower, the SEMDEX continued to increase at a slower pace.

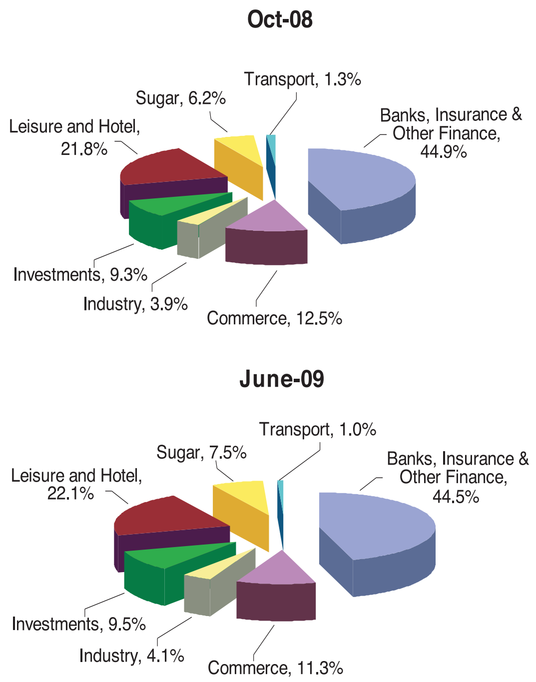
Chart 2.9: Evolution of SEMDEX and SEM-7



Source: Stock Exchange of Mauritius

Market capitalisation, which went below the Rs 100 billion level in February 2009, increased by about 53.3 per cent from March to June 2009. Foreign investors disinvested a total of Rs 665.7 million over the same period. For the period October 2008 to June 2009, the share of 'Banks, Insurance and Other Finance' out of total market capitalisation moved down while that 'Leisure and Hotels' increased slightly.

Chart 2.10: Sectoral Composition of the SEM



Source: Stock Exchange of Mauritius

3. Financial Sector

3.1 Vulnerabilities in Financial Systems

Financial systems which are dominated by banks face vulnerabilities originating from the undiversified on-balance sheet and off-balance sheet items of banks. These vulnerabilities take the form of credit, liquidity, market and operational risks which are amplified as a result of their inter-relationships. The financial system as a whole also faces systemic vulnerabilities such as contagion risks whereby weaknesses in one institution or market spill over into other markets and institutions. Generally, a financial system is considered vulnerable when it is not readily able to absorb shocks. These shocks include price shocks (interest rate, exchange rate and commodity price, etc.), liquidity shocks (access to market), and deterioration in credit quality and macroeconomic environment.

The financial sector is vulnerable to developments in various market segments through inter-sector and intra-sector linkages. Mauritius, being a small open economy, such linkages are strong and therefore there is a need for greater vigilance. The chart in Box 2 illustrates the main linkages in the Mauritian financial sector.

3.2 The Domestic Financial System

The financial landscape in Mauritius is dominated by banks which play a major role in asset allocation mainly through the provision of credit. Banks represent a growing percentage in total financial sector assets followed by insurance companies while other financial institutions held a small share in the sector. The number of players in the more important segments in the financial sector has remained unchanged over the last two years. (Table 3.1)

The primary activity of the banking sector remains deposit-taking and the provision of loans. Within the framework of traditional banking, banks are diversifying their businesses and enlarging the range of banking products they offer. The amendments brought to the banking laws in 2008 to enable banks to offer Islamic financial products as a full-fledged activity or through an Islamic window within conventional banking have opened up new opportunities for existing banks and possibilities for new players to enter the market. The financial sector landscape is likely to change as Islamic banks commence operations this year. Some Islamic financial products have already been introduced in the market.

Table 3.1: Structure of the Financial Sector

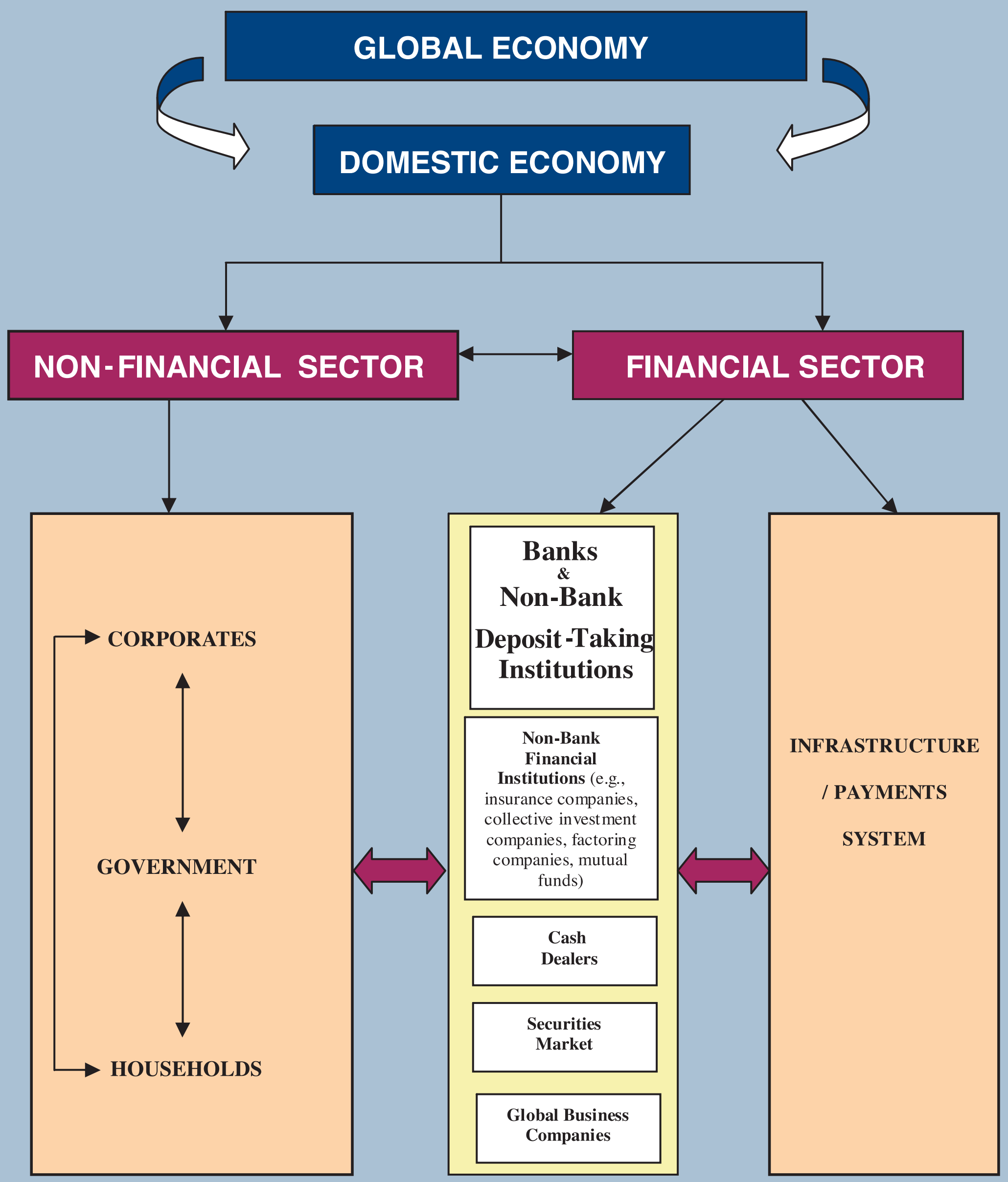
Types of Institutions	2008	2007
Banks	18	18
Companies operating under the Insurance Act 2005		
Insurers: Long Term and General Insurance Business	10	10
Long Term Insurance Business	3	3
General Insurance Business	4	4
Insurance Service Providers [5]	996*	1927
Financial Services other than Global Business	151	193
Companies operating under the Securities Act 2005	51	106
Global Business Companies	33,586	29,766
Non-Bank Deposit Taking Institutions	13	13
Cash Dealers	12	8

Source- FSC Statistical Bulletin 2009

[5] includes Insurance Agents (Com pany), Insurance Agents (Individual), Insurance Brokers and Insurance Salespersons

*significant reduction in the number of individual insurance agents.

Box 2: Linkages in the Mauritian Financial System



The Bank is working on an operational, supervisory and regulatory framework for Islamic banks to address the specificities and ramifications for financial stability risks. Liquidity management instruments that are Sharia'h compliant will be introduced shortly.

So far, Islamic banks are reported to have shown resilience to the global financial crisis which can be attributed to the nature of their activities. However, financial stability issues associated with Islamic financial activities should not be totally ignored as Islamic finance gathers momentum in Mauritius.

3.3 Banks

The banking sector remained heterogeneous in terms of activities, with Segment A and Segment B activities unequally distributed on banks' balance sheets. Some domestic banks remained focused on the Segment A line due to established market share and customer loyalty while other banks maintained their preferences to conduct business with non-residents. As a result, the impact of the global crisis on banks differed depending on the sectoral composition of their balance sheets. Although banks, on average, recorded a slight decline of 0.2 per cent in total assets from January to June 2009, Segment A activities which are dependent on domestic economic conditions experienced a less pronounced deceleration than Segment B activities as these are more closely connected to global economic conditions.

Credit granted to borrowers operating in the key economic sectors showed some sporadic growth on a month-on-month basis in the first quarter of 2009. However, the Additional Stimulus Package initiated by Government in December 2008 and the budgetary measures of May 2009 relating to Small and Medium Enterprises (SMEs) would undoubtedly assist such companies to sustain their activities and minimise risks of job losses which otherwise would have impacted more seriously on banks' balance sheets through higher non-performing loans (NPLs) in linked sectors. Moreover, for capital adequacy purposes, a zero per cent risk-weight will be applicable on 50 per cent of the facilities that would be granted under the May 2009 budgetary measures and guaranteed by Government.

Banks' main source of funds remains deposits raised from the public. As at 30 June 2009, the share of rupee deposits and foreign currency deposits in total deposits stood at 35.9 per cent and 64.1 per cent, respectively, compared to 32.6 per cent and 67.4 per cent, respectively, a year earlier. Total deposits remained rather stable over the first six months of 2009. The evolution of deposits in the banking sector might depend on customers' expectations on the savings rate which is pegged to the key Repo Rate as well as alternative investment instruments.

Over the years, asset quality has significantly improved in the banking sector. The setting up of the Mauritius Credit Information Bureau (MCIB) has been an important development contributing to better-informed credit appraisals and thus lowering the level of NPLs. With other financial institutions like NBDTIs, insurance companies, etc. joining the platform, the coverage of credit information is poised to widen and deepen in the near future.

In March 2009, gross NPLs for the sector were as low as 2.4 per cent but there are risks that the quality of credit exposures granted to the sectors susceptible to the crisis, namely tourism, export, construction and personal[6] may deteriorate in the coming months. However, given that banks have built up strong capital buffers over the years, they are more likely to sustain the impact of defaults, if any.

Liquidity in the banking sector is quite comfortable as banks held 40.4 per cent of their assets in liquid form and their credit/deposit ratios were around 74.4 per cent. Moreover, banks comfortably maintained the CRR prescribed by the Bank throughout 2008 and in the first semester of 2009. Interbank transactions,in terms of amounts and frequency, continued nomally, and repos and reverse repos were conducted during the period January to June 2009 to meet the short-term liquidity needs of banks and to mop up excess liquidity, whenever necessary.

[6] *Comprises housing loans and personal loans including credit cards.*

Banking business continued to be profitable in 2008 and early 2009 in both Segment A and Segment B activities on the back of lower loan delinquencies, although profits from these two sources grew at a lower pace in 2008 compared to the previous year. Income was generated mainly from interest bearing assets which constituted more than 82.4 per cent of total income in 2008 against 85.4 per cent a year earlier.

Banks are well capitalised with most of them maintaining capital adequacy ratios well above the minimum requirement of 10 per cent prescribed by the Bank. In March 2009, the Basel II Capital Adequacy Framework was implemented and banks were required to maintain capital according to the Standardised Approach to credit risks. The capital adequacy ratios which encompassed both credit and operational risks ranged between 10.0 per cent and 98.1 per cent in March 2009.

Overall therefore, there are for the time being no financial stability concerns emanating from the banking sector. However, given the possible adverse impact of a slowdown in the economy, a close watch, in collaboration with banks, is being kept on the developments in the sector through reinforced on-site and off-site surveillance.

3.4 Insurance Companies

The insurance sector has so far been shielded from the effects of the international economic slowdown and remained profitable in 2008. Insurance companies diversify their assets in various risk-bearing activities with the highest percentage parked in Government Debt Securities followed by investment in equities listed locally, and investment in related companies. In 2008, only 8.7 per cent of insurance assets were in the form of residential mortgage loans.

Credit risks in the banking sector are sometimes transferred to insurance companies through insurance debt cover on credit facilities granted by banks. In Mauritius, such credit risk transfers are limited only to loans granted to individuals to cover defaults on death or permanent disablement of the borrower. Generally banks ensure that the insurance cover is obtained from well established and sound companies.

There are no visible indications of adverse performance in the insurance sector. However, the possibility of a deceleration in activities and performance this year as a result of the economic slowdown, cannot be altogether ruled out. Such potential adverse results are unlikely to undermine the stability of the financial system given the relatively low significance of the sector in the financial system.

3.5 Non-Bank Deposit-Taking Institutions (NBDTIs)

The Non-Bank Deposit-Taking sector which comprised 13 operators in June 2009, experienced a remarkable 22.4 per cent growth in total assets in 2008 compared to 10.7 per cent growth a year earlier. However, in the first quarter of 2009 total assets grew by 2.9 per cent against a 8.0 per cent increase in the corresponding period in 2008. This is likely to have resulted from the slowdown in some key sectors of the economy.

NBDTIs recorded credit/deposit ratio in excess of 100 per cent to some extent because of the increase in own funds to comply with the statutory minimum capital of Rs 200 million that was implemented in 2008. Part of the funding gap was met by borrowings from banks. Credit granted was channelled to all economic sectors with more than 65 per cent allocated to the personal and construction sectors. These two sectors also held the largest share in total NPLs in the NBDTI segment. The ratio of non-performing assets rose from 7.3 per cent in June 2008 to 8.3 per cent in March 2009 mainly on account of growth of NPLs in facilities granted to operators in the construction sector.

Banks and NBDTIs are both governed by the same legal framework enacted in November 2004. However, some provisions applicable to NBDTIs had not been proclaimed until August 2008. To create a level playing field as envisaged by the legislation, the Bank is taking steps to bring the regulatory framework applicable to NBDTIs on par with that of banks in a gradual manner. Although

NBDTIs represent a small segment of the financial sector, they are being closely monitored by the Bank because of the stability concerns arising from the inter-linkages with banks and the need to safeguard depositors' interest.

3.6 Global Business Companies (GBCs)

Global Business activities remain an attractive offshore segment for investors due to the various fiscal benefits associated with them as well as the conducive legislative environment that has been created to promote such activities. Global Business Companies (GBCs) are licensed by the Financial Services Commission (FSC) and are involved in activities including among others, investment holdings, collective investment schemes and financial business activities.

By the nature of their activities, GBCs are more exposed to the international economic environment. However, despite the intensification of the global crisis, the number of licensed GBCs increased by 3,820 in the year 2008. Furthermore, banks' exposures to such companies have been on the rise up to February 2009 after which those exposures remained rather stagnant. According to available information, there are some indications of a slowdown in certain international businesses which are channelled through our offshore segment.

3.7 Other Financial Institutions

The remaining institutions such as Cash Dealers, Investment Dealers, Asset Management Companies, Factoring Companies and Registrar and Transfer agents which provide financial services are of relatively small significance in the financial sector, in terms of size but they have a role to play in making the financial sector complete. So far, no indications of financial stability concerns have been visible from these segments of the sector.

3.8 Conclusion

The financial system in Mauritius has so far shown resilience to the global financial crisis due to the non-existence of complex structured financial products as well as non-exposure to toxic assets in the domestic banking system. The latter remained focused on conventional banking and traditional activities where risks are properly identified, measured and mitigated according to international best practices. The sound regulatory and supervisory framework in place also played a major role in that respect. The simple structure of the financial system acted as a cushion against the effects of the global crisis and most financial institutions continued to operate in a sound manner although some mild effects of the crisis started to be felt in the banking sector as from the beginning of this year. Even though most soundness indicators continued to be within comfortable levels in the first semester of 2009 and there are, at present, no threats to financial system stability, some key sectors would require closer monitoring.

4. Banking Sector

4.1 Overview

The banking sector plays a dominant role in the financial sector as it accounts for more than 70 per cent of total assets of the financial sector. The growth in size and volume of activities in the banking sector also entails the intensification of risks which, if not properly managed and mitigated, could impact on the stability of the financial system. The nature and magnitude of the linkages which exist between banks and other segments of the financial sector also have key implications for financial stability. As part of its mandate to ensure the stability and soundness of the financial system, the Bank has subscribed to international prudential and regulatory standards but adapted them to the domestic specificities. This approach has, over the years, contributed significantly to mitigate the level of risks in the banking system without affecting economic development.

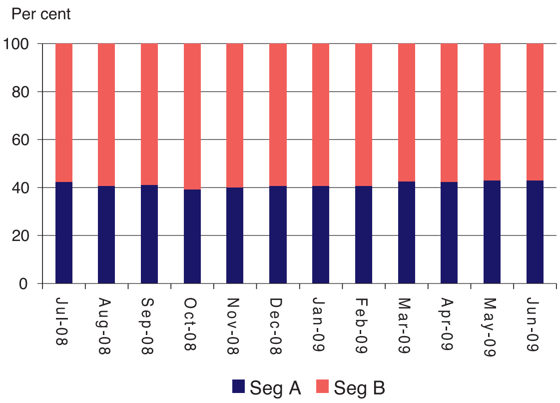
On-going on-site examination of banks complemented by close off-site surveillance plays a major role in detecting early warning signals that would require prompt corrective action by the Bank. The application of CAMEL ratings as an off-site monitoring tool for the individual assessment of banks on a quarterly basis enables the Bank to monitor risk parameters more closely. Furthermore, the Bank has been adopting a proactive role by examining all financial institutions under its purview more frequently than the law requires. The Bank is also studying issues arising from fair value accounting in deposit taking institutions (Box 3).

In light of the global financial turbulence which has already started to impact, though not seriously yet, on the banking system, banks have been required to provide more granular data on certain types of exposures which carry higher probabilities of defaults in the coming months as a result of weak performance in some key economic sectors. Recognising the possibility of deterioration in asset quality, the Bank is more intensely monitoring the evolution of financial soundness indicators.

4.2 Total Assets in the Banking Sector

Total banking sector assets recorded an average decline of 0.2 per cent in the first six months of 2009 compared to average increase of 0.2 per cent in the corresponding period of 2008 as a result of the slower economic activity. The slowdown in total assets in 2009 was due to slowdown in the growth of both Segment A and Segment B assets. Movements in banking sector assets were driven by Segment B assets which accounted for more than 60 per cent of the total. Over the period January to June 2009, Segment A assets grew on average by 1.2 per cent compared to an average growth of 2.0 per cent in the corresponding period of 2008 while Segment B assets recorded an average decline of 1.1 per cent from January to June 2009 compared to a lower average decline of 0.6 per cent in the same period of 2008.

Chart 4.1: Total Assets in the Banking Sector



4.3 Credit

Credit remains the major source of banks' income and its growth is dependent on the overall level of economic activity. From January 2008 to June 2009, lending activities, on average, represented more than 50 per cent of total assets, resulting in high credit risk in banks' balance sheets.

Credit growth has been relatively slow since November 2008 mainly as a result of the second round effects of the global economic slowdown which were more pronounced in certain sectors such as traders, tourism, construction, manufacturing and personal sectors. To facilitate credit flows, the Bank pursued monetary easing and supported the Additional Stimulus Package initiated by Government.

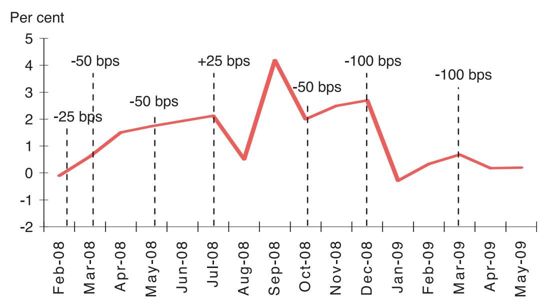
The decline in credit growth can be attributed to demand and supply factors such as as lower credit off-take by the private sector as well as banks' more cautious approach to lending.

Segment A credit recorded an average growth of 0.3 per cent during the first six months of 2009 compared to an average growth of 1.1 per cent in the corresponding period of 2008. The evolution of Segment A credit in the coming months is uncertain but encouraging monetary and fiscal measures have been taken to support industry operators to deal with the present situation.

Segment B advances, which are more susceptible to the global economic developments fell by 1.2 per cent on average during the first six months of 2009 compared to an growth of 0.8 per cent recorded during the corresponding period of 2008. The evolution of Segment B credit in the coming months is also uncertain but will definitely depend on the pace of recovery of the global economy.

Domestic credit growth and changes brought to the signalling rate are shown in Chart 4.2.

Chart 4.2: Changes in key Repo Rate and Credit Growth



4.4 Deposits

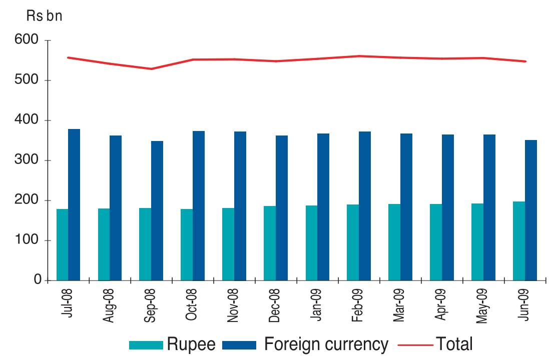
Banks mobilised deposits both in the domestic currency and in foreign currencies, with the latter representing more than 64.1 per cent of total deposits as at 30 June 2009. A significant portion of foreign currency deposits are drawn from outside Mauritius and held mainly by banks operating in the Segment B line. These deposits are mostly held in the major currencies, namely the US dollar, euro and Pound sterling. Deposits represented 77.3 per cent of total foreign currency funds of banks of which 84.5 per cent were raised from non-residents and the remaining from residents. The remaining foreign currency funds are either borrowed from banks locally and abroad or are raised through subordinated loans outside Mauritius.

Total deposits in the banking sector remained stable, on average, from January to June 2009 against a slight average growth of 0.8 per cent in the corresponding period of 2008. Despite the fact that inflationary pressures have subsided since the beginning of 2009, the several cuts brought to the key Repo Rate limited the improvement in the real interest rate which could make deposits more attractive.

Foreign currency deposits declined by 0.5 per cent, on average, in the first semester of 2009 compared to an average decline of 0.2 per cent in the corresponding period of 2008.

The evolution of Segment A and Segment B deposits is depicted below.

Chart 4.3: Banking Sector Deposits

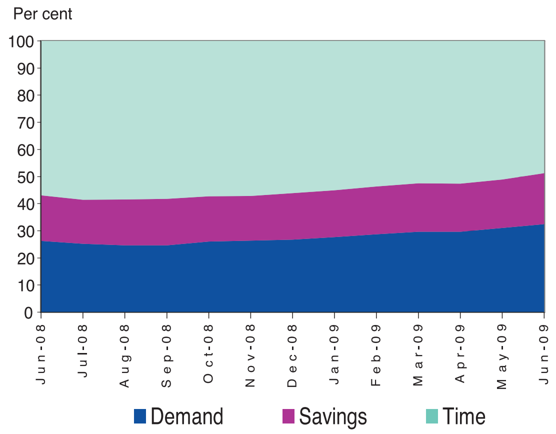


4.4.1 Maturity Preferences

Depositors hold their funds in demand, savings and time deposits. They have generally shown a preference for time deposits which accounted for more than 60 per cent of total deposits throughout the year 2008 and the first six months of 2009.

Following changes brought to the key Repo Rate, a sporadic movement in depositor preference across demand, savings and time deposits was observed. However, no clear pattern of depositor preference could be discerned from the data. This is an area for in-depth study as it has ramifications for financial stability.

Chart 4.4: Maturity Preferences of Deposits



4.5 Market Concentration

Competition in the banking industry reduces market concentration and in the process minimises the consequences of systemic risks. Prior to 2004, Segment A assets, deposits and loans were concentrated in a few large banks which enjoyed economies of scale, making them systemically important financial institutions. With the single licensing regime, banks which were previously limited to Segment B activities were permitted to undertake Segment A activities i.e. domestic retail and business banking markets, and thus provided an effective competitive counterweight to these large banks.

The Herfindahl-Hirschmann Index[7] which is a measurement of market share concentration, has been computed for the years 2005-2008 and June 2009. The results indicate that the concentration of total assets, deposits and loans pertaining to Segment A activities have slightly diluted but remained high. The penetration of banks into Segment B activities was reflected in a decrease in concentration from 'high' (0.28) in 2005 to moderate (0.14) in Segment B deposits in June 2009. However, domestic banks continue to have predominance in raising Segment A deposits resulting in the concentration index remaining high even if it declined marginally from 0.25 in December 2005 to 0.22 in June 2009.

With regard to lending activities, concentration of Segment A loans has been improving but remained in the high concentration (0.24) category, indicating hesitation of some banks to lend in Segment A. Table 4.1 indicates how market concentration has evolved over the past years.

Table 4.1: Market Concentration

SEGMENT A	Market share percentage				
	Dec 05	Dec 06	Dec 07	Dec 08	Jun 09
ASSETS					
2 largest banks	62.7	61.6	58.2	57.8	55.5
4 largest banks	86.5	83.7	85.8	82.3	78.1
LOANS					
2 largest banks	67.8	65.3	64.0	61.2	59.8
4 largest banks	90.3	87.0	87.2	83.3	81.1
DEPOSITS					
2 largest banks	61.9	59.1	57.9	57.4	57.9
4 largest banks	86.9	85.5	85.1	82.0	80.3

4.6 Credit Risks

The Bank subscribes to international standards with regard to capital requirements for credit risks. In this pursuit, the Basel II framework for capital adequacy requirement was implemented as from March 2009. Banks are required to maintain a minimum capital adequacy ratio of 10 per cent on their risk-weighted assets comprising credit risk under the Standardised Approach, operational risk, and foreign exchange risk. Even after the implementation of the new framework in March 2009 the capital adequacy ratios of banks ranged from 10.0 per cent to 98.1 per cent.

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[7] The Herfindahl-Hirschman Index (HHI) is a measure of the size of firms in relationship to the industry and is an indicator of the amount of competition among them.

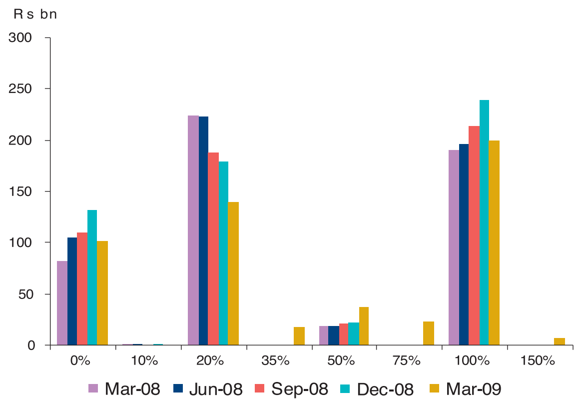
A HH Index below 0.1 indicates no concentration.

A HH Index between 0.1 to 0.18 point indicates moderate concentration.

A HH Index above 0.18 point indicates high concentration.

The global crisis has led to increased risk aversion in most economies where banks have shifted most of their investments from high risk-weight activities to low ones. In Mauritius, however, this tendency was not apparent over the last four quarters. Banks operating mainly in Segment A maintained almost the same pattern in the risk allocation of their assets, most of which are parked in 100 per cent risk-weight and zero per cent risk-weight buckets. On the other side, banks which operate mainly in the global business activities sector have over the past four quarters ended March 2009, held most of their assets in the 20 per cent risk-weight bucket followed by those bearing 100 per cent risk-weight.

Chart 4.5: Risk Diversification Matrix for Banks Operating in Segment A



4.7 Concentration of Risks

Concentration risk is one of the key risks which can pose serious stability concerns in the banking sector. A small open emerging economy has a tendency to have a few large conglomerates with interests spread over several lines of business. This tends to create large concentrated risks in banks' balance sheets.

Banks in Mauritius are somewhat exposed to risks arising from credit concentration. The guidelines issued to banks require them to monitor this risk and subject the large exposures to stress tests.

The recent downward revision of the sectoral growth by the CSO for 2009 might indicate the possibility of some impact on the asset quality arising from such concentrated exposures. However, due to the adequate capital buffer of banks and the well-diversified nature of the business of the conglomerates, the risk of threat to financial stability is highly insignificant.

Nevertheless, the Bank is pursuing its efforts to establish the inter-linkages between the business groups either through their shareholdings or management with a view to better evaluating the potential risks.

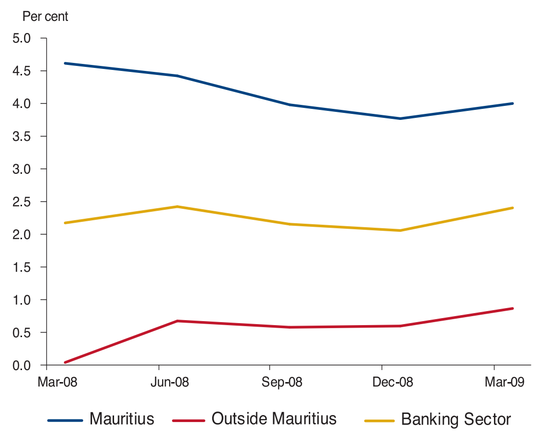
4.8 Asset Quality

The level of NPLs is an important element when assessing the strength of financial systems which are dominated by banks. In times of economic stress, asset quality tends to deteriorate requiring banks to make additional provisions which in turn impact on banks' capital.

Loans granted in and outside Mauritius followed a similar pattern in terms of default rate over the period March 2008 to March 2009. As at 31 March 2009, NPL ratio in the banking sector stood at 2.4 per cent from 2.1 per cent as at 31 December 2008.

As depicted in Chart 4.6, from June to December 2008, the overall NPL ratios followed a downward trend for both Segment A and Segment B exposures. However, NPL ratios took an upward trend in the first quarter of 2009, which could be explained by a faster growth in NPLs compared with that of total loans.

Chart 4.6: Non-Performing Loans Ratio



A review of the share of impaired loans to total respective sectoral loans revealed some minor signs of stress in the manufacturing, construction, and tourism sectors. The share of NPL arising from exposures to those sectors in total NPL has slightly increased during that period. However, NPL associated with traders sector recorded a declining share in total NPL from September 2008 to March 2009.

Changes in the share of sectoral NPLs in banking sector's NPL over the last four quarters are shown in Table 4.2.

Table 4.2: Sectoral NPL as a Ratio to Total NPL

per cent

Sectors	June-2008	Sept-2008	Dec-2008	Mar-2009
Manufacturing	22.2	20.4	19.5	22.7
Construction	19.4	19.6	20.9	21.1
Tourism	2.8	3.1	2.9	3.0
Personal	20.7	21.7	22.0	20.9
Traders	21.2	21.8	21.1	19.7

Although the current levels of NPL across all sectors, including those affected by the downturn, as a ratio to total loans in the banking sector are not alarmingly high, a close watch is being kept on the banks' exposures to the most vulnerable sectors to determine the relevant responses, if warranted.

4.9 Cross Border Exposures

Facilities granted outside Mauritius carry not only credit risks which are inherent in all credit exposures but an additional risk element namely country risk which amplifies the overall risks in such exposures. Several countries have been directly hit by the crisis and others have been downgraded by rating agencies as a result of deterioration in their economies resulting from the global turbulence. Such downgrades usually amplify country risk and can create potential risks to the banking sector if exposures to such countries are significant. One of the channels through which the global economic crisis has infiltrated the domestic banking sector is the exposures arising from credit granted to customers who are residents in the economies which are hit by the crisis.

As at end of March 2009, banks were exposed to the tune of Rs 203 billion to borrowers in countries outside Mauritius compared to Rs 221 billion in December 2008. This decline could be explained by the reduced exposure to customers in Asia which moved from Rs 141 billion to Rs 125 billion in March 2009.

The countrywise/regionwise share of exposures to borrowers in different geographical areas as well as the ratios of impaired loans as a percentage of such exposures are given in Table 4.3

Table 4.3: Cross Border Exposures

Region	DECEMBER 2008		MARCH 2009	
	Percentage of total loans in banking sector	Percentage of impaired loans by country*	Percentage of total loans in banking sector	Percentage of impaired loans by country**
USA and Canada	0.30	0.01	0.33	0.01
Africa	3.89	7.42	4.05	8.36
Europe	7.31	0.19	7.10	1.27
Middle East	4.16	-	4.12	-
Asia	33.80	0.07	31.37	0.08
Australia	0.11	0.22	0.09	0.30
Others	3.52	0.04	3.98	0.05

** Ratio of impaired loans by region to total loans granted to that region*

The ratio of impaired assets outside Mauritius to total banking sector loans amounted to 0.5 per cent. The cross-border exposures are unlikely to undermine the soundness of the banking sector given that a large part of such exposures is either backed by cash collaterals or guaranteed by banks abroad. Furthermore, a major part of such exposures is on the balance sheet of subsidiaries or branches of strong foreign banks and form a minuscule portion of their global balance sheets.

4.10 Household Exposures

Lending to households remains an important activity to banks but over-exposure of banks to households in periods of economic stress can result in adverse consequences with severe repercussions on banks' balance sheets.

Historical data show that banks' exposures to households which include housing loans and personal loans increased steadily over the past few years and ranged between 20 and 22 per cent of total private sector credit.

Credit card facilities, excluding those to corporates, have been on the declining trend from June 2008 to December 2008 but rose by 25 per cent in the first quarter of 2009. The ratio of impaired credit card facilities increased from 13.5 per cent for the quarter ended June 2008 to 20.4 per cent at the end of December 2008. However, this ratio declined to 17.1 per cent as on 31 March

2009, largely because of a huge rise in the credit card oustandings. Specific provisions on credit card NPL grew by 11.8 per cent and 13.3 per cent in the last two quarters of 2008 respectively, indicating an increase in the non-performing credit card exposures as well as a worsening of grade within the non-performing credit card exposures. Specific provisions, again, increased by 8.2 per cent in the first quarter of 2009. The growth in credit card facilities in the first quarter of 2009, despite this, can be attributed to banks tapping this credit segment both due to excess liquidity and the high returns associated with such exposures.

Traditionally and in line with global trends, interest rates applicable on credit cards exposures in Mauritius are relatively high ranging between 15 and 26 per cent. The interest rates on those facilities did not seem to have responded adequately to the several cuts in the signalling rate over the past months. However, pegging the interest rate applied on credit card exposures to the Prime Lending rate is one way to ensure that the pass-through of changes in the key Repo Rate is more visible. To improve disclosure on household indebtedness, additional quantitative information on credit cards will be published regularly in the Bank's Monthly Statistical Bulletin in the near future.

4.11 Profitability of Banks

The slowdown of the domestic economy resulting from second round effects of the global crisis impacted on the banking sector's financial results in 2008.

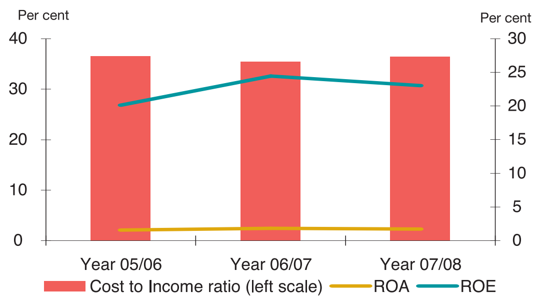
Banks derive income mainly from interest bearing assets and loans and advances constituted the main contributor to banks' earnings. Other sources of earnings are securities, placements, fee-based income and profits arising from dealings in foreign currencies. Banking sector's pre-tax profit is driven by Segment B activities which generated 62.4 per cent of total banking sector profit in 2008 compared to 62.2 per cent in the previous year.

In the year ended 31 December 2008, banking sector pre-tax profits grew by 13.6 per cent while the year ended 31 December 2007 recorded a higher growth in pre-tax profits of 28.2 per cent. Segment A pre-tax profits grew by 12.9 per cent in 2008 against 38.4 per cent the previous year while Segment B profits increased by 14.0 per cent in 2008 compared to 22.6 per cent in 2007. Banks' operating income grew by 20.6 per cent in the financial year ended 31 December 2008 compared to 26.5 per cent a year earlier. Operating expenses of banks increased by 23.9 per cent in 2008 against 22.7 per cent in 2007.

Preliminary data indicate that banks achieved Rs 3.0 billion profits for the first quarter of 2009 against Rs 3.3 billion in the corresponding period in 2008.

Performance indicators declined in 2008 with Return on Assets dropping from 1.8 per cent to 1.7 per cent while Return on Equity moved from 24.4 per cent to 23.0 per cent. Cost to income ratio worsened slightly from 35.5 per cent in 2007 to 36.5 per cent in 2008 as shown in Chart 4.7.

Chart 4.7 Efficiency and Performance Ratios



4.12 Financial Strength Indicators

Financial Strength Indicators show some slight deterioration in the two quarters ended 31 March 2009. It may be noted that some mild deterioration occurred in some of the indicators. These are being closely monitored in light of domestic and global economic developments and their impact on the banking sector is constantly being assessed.

Table 4.4: Financial Strength Indicators

			Dec-08 (per cent)	Mar-09 (per cent)
Asset Quality	Gross NPLs/Gross Loans		2.1	2.4
	Net NPLs/Shareholders Equity	*NPLS net of specific provision*	7.7	8.6
	Fixed Assets/Total Assets		1.9	1.9
Liquidity	Liquid Assets/Total Assets	*Cash and Foreign notes, Balances with Bank of Mauritius, Govt papers, Due from banks in and outside Mauritius*	36.1	40.4
Exchange Rate risk	FX net General Position/Own Funds	*Net open position of banks reporting FX exposure/core capital of those banks (11banks)*	8.3	8.5
Profitability	Net Profit/Total Assets	*Net profit for quarter/average assets of financial year (annualised)*	1.6	1.5
	Net Profit/Shareholders Equity	*Net profit for quarter/shareholders equity (annualised)*	19.8	17.9
Capital Adequacy	Free Capital/Total Assets	*Shareholders equity less fixed assets*	6.1	6.4
	Capital Adequacy Ratio		15.3	17.1

Box 3: Fair Value Accounting

The financial turmoil which intensified in September 2008 is due to numerous factors but, in many respects, it is about valuation and uncertainties on the 'true' value of complex financial instruments. As confidence in global markets fell and uncertainty about counterparty risk grew, this led to contagion across asset classes, financial markets and economic regions. The present crisis has highlighted that valuation of financial instruments has financial stability implications as it is about risk management and reporting issues related to bank valuations of complex or illiquid financial instruments, and the implications for prudential issues such as regulatory capital requirements and bank supervision. The application of fair value accounting to a wider range of financial instruments coupled with experiences from the recent market turmoil, have emphasised the critical importance of robust risk management and control processes around the measurement of fair values and their reliability. The valuation frameworks which were in place when the crisis amplified in the second half of 2008 were the results of several years of efforts to improve risk measurement and financial reporting for financial institutions as well as solvency regulations for regulated entities. These efforts were extensively driven by experience of the previous crises which occurred as far back as in the 1990s. The new valuation methods created a move to mark-to-market accounting in financial reporting with the aim to foster more transparency and timely recognition of risk exposures as well as improved market discipline. As the mark-to-market method provides a true reflection of the value at which balance sheet items could be bought or sold in current transactions, it has enabled market participants, investors and supervisors to have a better understanding of the actual risk profiles of financial institutions. Mark-to-market accounting works best when financial markets operate perfectly in the way that the models used by financial institutions usually assume. In such cases, market prices accurately reflect the future earning power of assets. Hence if the market value of an institution's assets falls below the market value of its liabilities, that institution would not be able to meet all of its obligations. The present crisis has caused serious market imbalances and imperfections such that prices no longer reflect fundamentals. Policy makers recognise that the valuation of complex and illiquid financial instruments has not been thoroughly understood and measured and assumptions underlying mathematical models were found to be irrelevant. The need to address divergences between accounting practices, prudential regulation and management is found to be urgent.

In Mauritius, statutory auditors are expected to vet the process of fair valuation adopted by banks given that auditors have the responsibility to certify the accounts. Generally auditors would ensure that banks comply with the provisions of the Companies Act 2001 and those of the International Financial Reporting Standards (IFRS). HoweverΔ, in light of the developments that came out during the crisis, the Bank is considering various options to ensure that banks do not face the adverse consequences of inaccurate fair valuation. The Bank is presently working on a Guideline based on the principles of fair value accounting issued by the Basle Committee on Banking Supervision. Other areas that are being studied for possible reviews include the distribution of profits from unrealized gains and the immediate reflection of losses in banks' balance sheets. The inclusion of fair value gains in distributable profits may also warrant some revisions.

5. Settlement Risk in the MACSS

Settlement risk arises when a settlement in a transfer system does not take place as expected. This may happen when one party defaults on its clearing obligations to one or more counterparties. As such, settlement risk comprises both credit and liquidity risks. Credit risks arise when a counterparty cannot meet an obligation for full value on due date and thereafter because it is insolvent. Liquidity risk refers to the risk that a counterparty will not settle for full value at due date but could do so at some unspecified time thereafter; causing the party which did not receive its expected payment to finance the shortfall at short notice. Sometimes a counterparty may withhold payment even if it is not insolvent (causing the original party to scramble around for funds), so that liquidity risk can be present without being accompanied by credit risk.

The Mauritius Automated Clearing and Settlement System (MACSS) which works on the principle of Real Time Gross Settlement System (RTGS) is the medium through which all payments and settlements are carried out and as such is the Systemically Important Payment System of Mauritius. It links participating banks operating in Mauritius and Government to the Bank of Mauritius via a secure, reliable and efficient payment network. The objectives of MACSS are to enhance the efficiency of the payment system, eliminate large floats and the concomitant risks, and pave the way for the financial infrastructure to fall in line with the norms of the international payments mechanism. Currently, apart from inter-bank transactions, the MACSS handles settlement for the Cheque Clearing, Central Depository System, payment for Value Added Tax (VAT), and Customs. Moreover, the Government, through its accounts with the Bank of Mauritius carries out payments and collect revenues in real time through the MACSS. On average, transactions aggregating Rs 5 billion are settled through the MACSS daily. The MACSS system is therefore built on the Core Principles for Systemically Important Payment Systems as a prolonged failure of the MACSS system could pose financial stability concerns.

In order to eliminate risks related to settlement, MACSS operates on the principle of 'credit push'. A transaction is initiated by the paying party and payment takes place only if funds are present in the accounts of the payer. However, settlement of cheque clearing transactions at the Port-Louis Clearing House (PLCH) and settlement of stock exchange transactions through the Central Depository & Settlement Co. Ltd (CDS) take place on a net basis in the MACSS.

Settlement of CDS transactions are carried out daily on the MACSS upon instructions from the CDS and participants whose accounts are to be debited. A defaulting party in the CDS has direct implication on financial stability because participating banks in the CDS are also participants in the MACSS. However, the risk of non-settlement does not arise in the MACSS as it is managed by the CDS which operates strictly on a Delivery versus Payment basis.

5.1 Reducing Risks with Two Cheque Clearing Cycles

Cheque clearing transactions do represent a risk as participants are not aware of their settlement obligations prior to clearing. In Mauritius, cheques represent 20 per cent of the total value of transactions put through MACSS. In order to mitigate this risk, clearing is carried out twice a day. Moreover, settlement is carried out immediately after clearing through a standing agreement where banks authorise their accounts to be debited for cheque clearing purposes. In the event that these banks are in need of funds during the day, they may have recourse to intra-day facility from the Bank of Mauritius against eligible collateral securities. These facilities should be repaid by the end of the day. However, so far, banks' accounts were adequately funded and as such, the need did not arise for them to avail the intra-day facility.

The distribution of cheques in the two cycles is not uniform with 60 per cent of the total value of cheques being cleared in the first cycle (Chart 5.1 and Chart 5.2). The first cycle has a higher volume and value due to the fact that cheques also collected from branches of banks on the previous day are presented for clearing in that cycle.

Chart 5.1: Number of Cheques Cleared

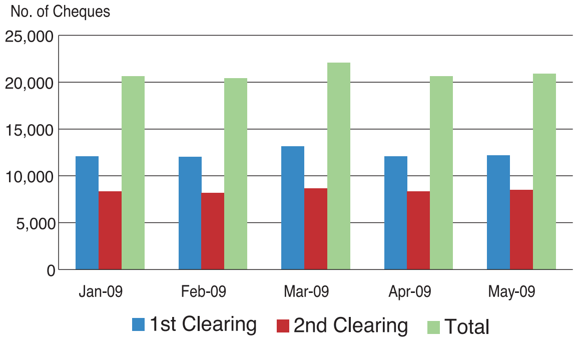
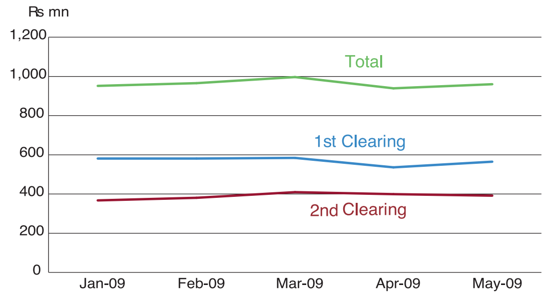


Chart 5.2: Value of Cheques Cleared



The two cycles have the effect of sharing the settlement risk. Participants thus have more room for liquidity management as the interbank market is open for funding purposes.

5.2 Continuous Net Settlement

As increasing the number of cycles reduces the risk for default, the Bank will consider implementing Continuous Net Settlement with the introduction of the Cheque Truncation System. Cheque images and code line data will be scanned and sent in electronic format to the clearing house where items will be netted continuously. The system may then be configured to carry out higher number of settlements or identify high value items for special clearing.

5.3 New Developments in the Payment Systems

5.3.1 Multi-currency Support in MACSS

With a view to further modernise the payment systems in Mauritius, the Bank launched, in January 2009, a new application for the Mauritius Automated Clearing and Settlement System (MACSS). This new application has support for multi-currency transactions and this feature will be operationalised for payments in three main currencies, namely US dollar, euro and Pound sterling. Commercial banks will be invited to open accounts in the above currencies at the Bank and fund transfer will be carried out in real time and at much lower cost compared to the present situation where such fund transfer may take a few days depending on the number of correspondent banks involved.

5.3.2 Multi-currency Cheque Clearing

Presently, cheques drawn in foreign currency are sent to foreign correspondent banks and clearing and may take up to 21 days. As settlement of cheques take place through the MACSS, the Port-Louis Automated Clearing House (PLACH) will also be enhanced to carry out settlement of cheques drawn by local banks in foreign currencies. Foreign currency cheques will therefore be cleared locally following the same principles for the PLACH. Discussions will be held shortly with stakeholders and PLACH and MACSS rules will be amended accordingly.

5.4 Cross Border Payments

The Regional Payment and Settlement System (REPSS) was officially launched at the thirteenth summit of the COMESA Authority of Heads of State and Government, held in Victoria Falls Town, Republic of Zimbabwe, on 7-8 June 2009. Heads of States also expressed appreciation to the Bank of Mauritius for acting as the Settlement Bank to REPSS and urged all Central Banks to aggressively promote REPSS and commercial banks and stakeholders to make full use of this facility for the benefit of the region.

The Bank will allow participants of the MACSS to use this infrastructure to carry out cross border payments to the COMESA region using the REPSS. For this purpose, participant banks are required to open US dollar and euro accounts with the Bank and payments will be carried out in a seamless manner.

6. Risk and Outlook for Financial Stability

In view of strong economic and financial linkages, recessionary conditions in Western Europe have a pronounced impact on the domestic economy, in particular, on external demand-led sectors. Growth rate is projected by the CSO to slow down sharply from 5.3 per cent in 2008 to 2.5 per cent in 2009, with contraction of 5.0 per cent and 8.8 per cent in the textile and tourism sectors, respectively and significant slowdown in the construction sector growth to 2.0 per cent. The near-to-medium term outlook depends on the extent and duration of the global economic downturn, which would, in turn, impact on the demand for exports. Inflation, measured by both the average and year-on-year methodologies, is projected to converge to around 4.0 per cent in 2009, amid below potential growth in the quarters ahead.

On the external front, the retrenchment by consumers in our main export markets would impact on exports of goods and tourism receipts. Nominal imports are projected to register a relatively sharper decline on the back of weaker domestic demand conditions. As a result, the current account deficit as a percentage of GDP is forecast to narrow from 10.5 per cent in 2008 to 7.2 per cent in 2009. Against the backdrop of the narrowing current account deficit, some slowdown in portfolio and direct investment flows and increasing recourse by Government to external funding, pressures on the foreign exchange market and on the level of foreign reserves are expected to be subdued.

On the fiscal front, lower tax buoyancy stemming from the slowdown of the economy together with fiscal measures to stimulate the economy and preserve jobs would exert some pressure on Government finances. However, the fiscal deficit is projected to decline from 5.0 per cent of GDP in 2010 to 3.3 per cent in 2011 while public sector debt as a percentage of GDP would be contained at 60 per cent. The noticeable increase in external debt of Government poses some risks relating to adverse movements in exchange rates, although external debt accounts for a relatively small proportion of total Government debt. In sum, public finances in Mauritius remain on a sound footing and debt levels are sustainable.

As the economy loses some momentum, downward pressures on employment and household income together with risks of a tightening of credit conditions have potential adverse impact on household consumption and indebtedness. The corporate sector might respond to significant declines in demand in export markets by cutting production, employment, wages and investment which might impact on profitability in the corporate sector. As a result, there are risks of a deterioration in the quality of banks' exposures to households and corporates so that banks could face some write-downs and increases in loan-loss provisions.

Inflationary pressures are projected to ease further. The level of foreign reserves is comfortable in terms of our import coverage and the level of short-term external debt, and provides adequate buffer to contain excessive exchange rate movements and any emerging pressures on the balance of payments.

The recent announcement by Moody's of possible downgrades of two largest banks, had brought some unwarranted volatility in the stock market, albeit for a very short period. The financial position of both banks is sound despite the global economic crisis and looks likely to remain robust, judging from their earnings and profitability outlook.

Banks in Mauritius are well-capitalised, they have a good liquidity base, and the NPL ratio is very low at 2.4 per cent. Credit growth remains robust, notwithstanding a slowdown noted in recent months. Banks are well supervised and closely monitored. The Bank undertakes a quarterly review exercise of individual banks to determine their respective CAMEL rating. This rating exercise is based on balance sheet data, supplemented by information gathered during the on-site examination. The Bank is presently in the process of improving the current rating system by incorporating new criteria to make it more risk-sensitive. Overall, it is observed that the ratings of banks have been stable and are likely to remain so.

The risks posed to soundness of financial institutions due to a deterioration in the asset quality of banks are mitigated by the strong capital buffers and other counter-cyclical measures such as the Capital Adequacy Ratio of 10 per cent, and the maintenance of a portfolio provision/general reserve of 1 per cent on the standard assets portfolio of banks. Risks for a disruption in the flow of credit to the productive sectors of the economy are low as banks have adequate liquidity. The outlook for the banking sector therefore remains positive.

From the macroeconomic perspective, the combined impact of the Additional Stimulus Package, significant reductions in the key Repo Rate and the expansionary May 2009 Budget have to a large extent reduced the vulnerability of the Mauritian economy. The authorities are closely monitoring global and domestic economic conditions and are committed to take necessary actions should there be a marked deterioration in the growth outlook.

The G-20 Declaration has highlighted the need to strengthen financial sector supervision by moving towards macroprudential surveillance. As mentioned in the Report, banks in Mauritius are somewhat exposed to credit concentration risks arising from a few large conglomerates having interests in several sectors of the economy. In this regard, the Bank intends to upgrade its oversight mechanism by moving towards macroprudential analysis to capture the impact of the inter-sector and intra-sector linkages on financial stability at an early stage and take appropriate actions, where warranted.

Government has set up a Financial Stability Committee which comprises the Minister of Finance and Economic Empowerment, the Governor of the Bank of Mauritius, the Financial Secretary and the Chief Executive of the Financial Services Commission. The functions of the Committee will be to regularly review and ensure the soundness and stability of the financial system. The Committee will also meet as often as is necessary and regulate its meetings and proceedings as it deems fit.

Some moderate risks to financial stability may stem from the deteriorating global financial and economic outlook in 2009. However, macroeconomic fundamentals of the economy are sound and the financial system is robust enough to cushion any increase in risks.

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