THE BANK OF MAURITIUS ANNUAL DINNER WITH ECONOMIC STAKEHOLDERS

Address by Mr. R. Basant Roi, Governor, Bank of Mauritius

29 November 2002

Honourable Judges
Fellow Bankers
Distinguished Guests

Welcome to the Bank of Mauritius annual dinner.

Just over three years ago when the Bank of Mauritius resolutely moved to revamp its regulatory and supervisory framework, it was thought that we would all see the trees better and have a good vision of the forest. Three years thence most of us do have a good vision of the forest. The pursuit of our supervisory policies, though viewed approvingly by many as the right kind of policies, seems to have given rise to a nagging sense of unease among a few practitioners in our financial sector. That sense of unease appears to have grown out of the practitioners' concern that public policy considerations regarding the stability of our financial system override the pursuit of their self-interests. In no financial system should standards of behaviour in financial enterprises start with the maximization of profits and end with the socialization of losses. I cannot help but repeat what Eugen von Bohm-Bawerk wrote several decades ago that *'we appreciate future pleasures and sorrows less merely because they occur in the future …. We systematically underrate our future needs and the means serving to satisfy them'*.

In March last the Bank of Mauritius revoked the banking licence of a bank. The revocation of the banking licence threw up infectious gossips and inelegant speculations that reminded me of the first day a new preacher went to the Church. *The preacher's first*

day at the Church happened to be a funeral day. He asked for someone in the gathering who cared for the eulogy, as he did not know the dead person. Someone at the far back seat shouted: 'I know very well this dead person. His brother is worse.' While it's not my intention to eulogize may I say that there was no brother worse than the dead person at the time the banking licence was revoked. What had followed made me realise for the nth time Ralf Hawtrey's observation in his celebrated book that "the art of central banking is a dynamic process placed at the core of the complex interactions between money, politics and the market-place."

Last year on this very same occasion I outlined the life cycle of a typical ailing bank. I underlined the rationale for the various supervisory measures and guidelines introduced by the Bank of Mauritius with a view to strengthening our banking industry. By now we have issued nine guidelines. Two new draft guidelines were issued to the banking industry for consultations bearing in mind that 'he who will not apply new remedies must expect new evils'. One of them that deals with public disclosure of information has been issued today. In this endeavour we have received invaluable technical assistance from the International Monetary Fund. I seize this opportunity to express my sincere appreciation to the Fund for the assistance.

Although our network of guidelines is becoming comprehensive, it will never reach the stage that will cover all the aspects of the industry's business. A bank in today's world has operations that are far too diverse and wide-ranging to permit that. Bank regulators and supervisors cannot afford to make the rules of the game so watertight as to choke the growth of the industry. Let me illustrate the point I want to make here:

If a lawyer gave you an orange, he would say to you, "I hereby give, grant and convey to you all my interest, right, title, and claim on this orange, together with all its rind, skin, juice, pulp and pips, and all rights and advantages therein with full power to bite, cut, suck or otherwise eat or consume the said orange, or give away or dispose of to any third party the said orange, with or without the rind, skin, juice, pulp or pips, subject

to any amendments subsequently introduced or drawn up to this agreement." However elegant, elaborate and comprehensive is the agreement, once you are in possession of the orange it is mind-boggling to decide what to do with it – to consume it, return it or destroy it. By contrast, the regulatory and supervisory authority cannot afford to be that elaborate and comprehensive. Over-regulation in the contemporary setting heightens the risk of stifling the growth of our financial industry. In the context of a market-oriented financial system, the approach is and should be to strengthen the stability and soundness of the system as a whole by providing greater scope for self and market discipline and also by enhancing the strength as well as the flexibility of the supervisory apparatus. I have to underline that, guidelines or not, financial institutions shall always remain totally responsible for the prudential conduct of their operations within appropriate norms. Financial institutions do have an absolute obligation to follow a prudent person approach to ensure their own safety and soundness. Let me stress that consumers of financial services in Mauritius, as anywhere else in the world, should never construe prudential supervision of financial institutions as a guarantee against failures. In every financial enterprise, the board of directors, the management and the auditors are equally responsible for the safety and soundness of the enterprise.

Notwithstanding the process of adjustment currently underway, our banking industry has made a genuine measure of progress over the last three years in building financial fundamentals that can best serve all of us in the years ahead. Assessors have observed that the Bank of Mauritius has attained advanced standards in various areas of prudential supervision of banks. The same assessors have noted that with the setting up of the Mauritius Automated Clearing and Settlement System and the automation of the Port Louis Clearing House in the very recent past, our payment and settlement system is one of the most technologically advanced, efficient and safest in the world. The Bank of Mauritius is continuing to strengthen certain institutional aspects of the banking industry. In this connection, the Bank is working on the setting up of a Credit Bureau.

Before addressing credit developments in our economy and issues relating to monetary policy, let me dwell briefly on one specific aspect of the Bank's determination

to vigorously push forward its agenda on the safety and soundness of our financial system as well as on the urgent need for strengthening the system. There is a perception that the Bank of Mauritius is excessively obsessed with this agenda of action. It's true we are obsessed with the idea of building a safer, sounder and stronger financial system. This obsession – a magnificent one indeed - stems from one fundamental consideration and that is the need for improving the transmission vehicle for the effective and efficient conduct of the Bank of Mauritius monetary policy. Let me clarify the point. The banking and financial system serves as the transmission vehicle through which the monetary policy of the Bank of Mauritius influences overall economic activity in the country. The more defective, the more rigid, the more inefficient and the weaker is the banking and financial system, the less effective will be the transmission vehicle. An ineffective transmission vehicle blunts the efficacy of monetary policy of the central bank and fails to influence the overall economic activity. In other words, the weaker the medium through which monetary policy affects economic activity the less effective will be the monetary policy of the Bank of Mauritius. This is one of the several reasons why the Bank is so persuasive with regards to its supervisory policies. Rather than serving as a conduit for monetary policy to influence economic activities, a weak and ailing banking and financial system would itself pose as a serious impediment and deaden monetary policy.

Our supervisory responsibilities have made us a better monetary policy maker. Conversely, our responsibilities for monetary policy-making have made us a better bank supervisor. This cross-fertilization between monetary policy-making and bank supervision fosters monetary and financial stability. While designing and implementing our supervisory policies we do strike a balance between our concerns for safety and soundness of banks on the one hand and our concerns for possible adverse impact on the economy of over-regulation on the other. While I am on this specific issue, I cannot resist but quote one paragraph from one of a series of reflections made by leading central bankers across the world. "The central bank, in my experience, needs direct hands-on involvement in the supervision and regulation of a broad cross-section of banks in order to carry out the Fed's core responsibilities of conducting monetary policy, ensuring the

stability of the financial system, acting as the lender of the last resort, protecting the payments system and managing a financial crisis. Meeting all these responsibilities is not just an academic exercise; it requires practical knowledge of financial institutions and markets, knowledge that comes with being deeply involved in supervising individual banking organizations. Without such involvement, the Federal Reserve would be much less able to maintain its practical knowledge of banking and other financial markets, and the influence and authority necessary for macroeconomic policy and crisis management. Ivory towers are great for universities, but they are not desirable for central banks." It's a reflection made by Lawrence Meyer, a distinguished member of the Board of Governors of the Federal Reserve System. The European System of Central Banks and the European Central Bank share this reflection. I also do share this reflection. Hundreds of millions of rupees do flow in and out of our financial system by just a simple 'click of the mouse'. In a small, highly open and vulnerable economy like ours, it is compelling for the Bank to have real time information on financial flows and on so many other areas that do affect our policy stance. Monetary policy has never been and will never be as simple as buying and selling of foreign exchange, Treasury bills and other Government papers on the markets. Good formulation of a monetary policy stance also requires good judgement on prevailing conditions in financial markets and financial institutions as well as an incisive knowledge of the working of the markets and institutions. The symbiosis between monetary policy making and supervision of financial institutions is indeed very strong. Amputate the supervisory arm of the central bank there goes away with it efficient and effective monetary policy-making.

Let me now turn to credit developments in the economy and monetary policy against the backdrop of a faltering world economy. Mauritius is not insulated from the unusual countervailing forces against economic growth. Over the last four years, bank credit to the private sector has expanded at an annual rate of over 11 per cent. The annual rate of expansion of money supply has been 13 per cent. This rate of expansion in money supply is deemed to be consistent with the annual rate of growth of over 6 per cent of the economy and an annual rate of inflation of over 5 per cent.

The pursuit of a fairly tight monetary policy in the past few years has positively yielded good results. Inflationary pressures are less apparent as the best latest forecast gives an inflation rate of quite less than 6 per cent for the current fiscal year. The volatility of the exchange rate of the rupee has been significantly reduced. The net international reserves of the country have risen to record levels. Broadly speaking, monetary conditions are far better than they have been in the 1990s.

To better understand the unusual forces working in the credit markets, it would be helpful to look back several years. In the 1980s, our economy went through a long period of expansion - indeed the longest expansion in its history. Led by the euphoria of good times some banks relaxed their credit standards. Bank credit to the private sector grew at an annual rate of as high as 24 per cent over the period 1985 to 1995. In 1997, the liquid assets ratio that banks were required to maintain was reduced overnight from 20 per cent to zero per cent. Overnight, banks found themselves with potentially loanable resources running into billions of rupees. Another festive round of lending started. Competing banks further relaxed their lending standards – this time much beyond prudential limits.

Towards the end of the 1990s pessimism regarding the prospects for sustainable high growth rates firmed up. Businesses, and households also, had taken on more debt in the 1990s than they could comfortably service under less buoyant economic conditions. They were bound to reach the limit at which further debt-financed expansion of their respective balance sheets was no longer safe. Heavily indebted borrowers began to default in large numbers. *Indebted householders realised the hard way that bankers are people with one glass eye, which they can distinguish from the real eye because the glass eye is the one with a spark of humanity, albeit a barely discernible one. We are all familiar with the joke that bankers will always lend to you an umbrella when the sun is shining; they take it away, sometimes forcefully, when it starts raining.* Loan delinquencies reared their heads and loan losses increased. Asset quality of banks involved in lending competition deteriorated. Sales by levy gathered momentum.

Rightly so, banks tightened their credit standards with a view to minimising possible future losses. The tightening of credit standards by banks as well as by other lenders is obviously a healthy trend. Lending attitudes of banks have undergone quite some improvement. As opposed to bankers' generosity of the past, the constriction of credit supplies, engendered largely by banks and other financial institutions striving to protect their capital positions in the last three years, aided the reduction in the rate of overall credit expansion. However, most of the decline in the rate of credit expansion appears to reflect more a slackening of credit demand and some firms favouring foreign currency borrowings because of the low interest rate levels than a tightening of credit supplies. The lower pace of lending and borrowing also reflects a scaling down of expectations about the likely rates of asset price inflation, particularly that of real estates. Seen from this perspective, some lenders ought not to have extended credit on the basis of the expectation that asset prices would keep going up. We all bear witness to the episodes of loan delinquencies, defaults, insolvencies and bankruptcies in recent times. They confirm this impression.

May I digress a little here to say that those firms favouring foreign currency borrowings should bear in mind at all times the risks associated with it. Foreign exchange markets often hit back and quite often with disastrous consequences. I would like to urge borrowers of foreign currency to take calculated decisions regarding the inherent risks. As I have just said foreign exchange markets often punish without mercy even the most artful and seasoned players.

The situation in the household sector is quite cryptic. The dearth of disaggregated statistics for this sector does not permit refined analyses. Income inequality is generally more volatile than consumption inequality. Our aggregate household data mask key information on consumption expenditure of the various income classes in the country. We can only draw some inferences that may be conclusive.

It's indisputable that, in the household sector, purchases of motor vehicles – duty-free, duty paid or with duty and leased cars - and other consumer durables ran at

historically high levels in the last fifteen years. Consumer spending attained remarkably high levels – to such levels never seen before in our economic history. If I may use a Keynesian jargon, the marginal propensity to consume in the 1980s stood at 0.60, that is, 60 cents were spent for every rupee of extra income. In the 1990s, this coefficient increased to 0.70, that is, 70 cents were spent for every rupee of extra income. Until a few years ago consumer spending was buoyant. An overwhelming proportion of the purchases of motor vehicles and other consumer durables was and is still being paid for in instalments or in other form of debt that carry extended maturities. The household-spending spree in the second half of the 1980s that spilled over into most of the 1990s extended to the acquisition of homes and apartments in mostly the prime regions of the country. Those homes and apartments were not for essential shelter but either for speculative purposes or as investment for encashment later to meet projected future spending or still as an asset portfolio diversification. We should not overlook the fact that our society also faces the problem of an ageing population. To sustain the current level of spending after retirement householders in certain income groups seem to have invested in real estates thereby stretching their budgets to an extreme. The basic point is that most of the purchases involved borrowing from banks or from other sources and that has constituted a heavy call on current and expected family incomes. This story leaves us with an impression of a considerable degree of financial stress in the household sector, largely due to an overstretching of household budgets. Debt-income ratios may have gone up as a result of which they seem to be impinging on consumer spending. The perceived state of the household balance sheet needs not be construed as an area of excessive concern because, at the aggregate level, savings in the economy far exceed investment.

To sum up, we are currently going through a cyclical situation. Households and business balance sheets are rather weak, with the smaller and inefficient firms being the most affected. Households may be indebted but we have no evidence that they are credit constrained at the moment. The indebtedness of quite a few firms has resulted in higher borrowing costs and reduced investment incentives. Higher borrowing costs are the result of part of the future earnings of borrowers having been pledged towards the repayment of debt. Debtors can only borrow against a smaller proportion of future earnings. Reduced

investment is partly the result of less proceeds of new investment accruing to the investor due to debt repayment obligation.

What can monetary policy do about the present conditions? Taking into account the fact that there is no apparent upside risk of inflationary pressures, the Bank of Mauritius relaxed the tight policy stance with a judicious approach to interest rate cuts and the suspension of sales of Treasury bills over the counter at the Bank of Mauritius. We are all aware that the net worth of an entity is directly proportional to the business cycle – rising in good times and falling in less buoyant conditions. When times are good, profit figures are at a peak and internal funds abound. Good times also entail lenient credit conditions. In bad times, we see the opposite. The pool of internal funds shrinks and external funds become scarce as agency costs rise.

There is asymmetry in the strength of the financial accelerator with respect to the state of borrowers' balance sheets. The effects of financial accelerator are stronger when balance sheets are weak which implies that monetary policy is then much more effective. A change in interest rate triggers a major quantity effect when balance sheets are weak. Monetary policy is faced with the need for establishing conditions that will tend to promote sustainable economic growth without putting at risk the progress that has been made against inflation. As I mentioned earlier the Bank effected a cut in the rate of interest. Under the present conditions, the Bank believes that a hike in interest rate is a distant possibility, more so as the inflation outlook for the current fiscal year is brighter than expected.

I seize this opportunity to re-emphasise that our monetary policy is not formulated and executed irrespective of what takes place elsewhere in the economy. Fiscal developments constitute an important input in monetary policy decision-making. One of the greatest challenges for monetary policy today is how best to sustain in the years ahead the stability of monetary conditions achieved in the past few years. The synergy between monetary policy and fiscal policy is of critical importance in our endeavour to sustain macroeconomic stability. Fiscal policy makers are concerned, as much as many of us,

about the size of the fiscal deficit. Seldom do we realize that part of the blame resides in our own attitudes towards the fiscal authority. Several years ago I narrated during a forum in Port Louis a short story about a US Congressman. Let me re-narrate it.

Late in the evening, the US Congressman dons himself with a sleeping gown imported from Hong Kong. Goes to bed that is made of timber imported from Canada. Wakes up in the morning and goes to the bathroom fitted with sanitary wares imported from Italy. After the morning shower, he dons himself with haute couture from France and a silk tie imported from Thailand. Takes coffee imported from Brazil in cups imported from China. Takes his briefcase bought at Selfridges from UK. Gets into his car imported from Sweden using petrol imported from the Middle East and travels to his office. Sits down at his office table imported from a Latin American country. A laptop on his table assembled in the Far East. Asks for a cup of Darjeeling tea imported from India. Picks up a cigar from Havana. Puffs out a ring of heavy smoke and wonders why on earth the United States is running a trade deficit for so many years.

We also do wonder about and question the size of our fiscal deficit. Sometime back the Bank of Mauritius carried out a study on The Extent of Tax Evasion in Mauritius: An Estimation of the Underground Economy. The study reveals that tax revenue foregone, both direct and indirect taxes, amounted to over Rs 1 billion in 1990. It went up steadily to nearly Rs3 billion in 1995 and further to over Rs4 billion today. As a percentage of GDP, tax revenue foregone remained over 4 per cent until 2000; it has since declined to just under 4 per cent. These figures are estimates and are however subject to errors of estimation. Such a magnitude of revenue foregone is not good for exchange rate and price stability, for a level of interest rate that would otherwise have been desirable and for monetary and financial stability. The central bank cannot but welcome all initiatives aimed at improving revenue collection at all collection points in our tax collection system. Enhanced revenue collection should help reduce Government's dependence on bank financing as well as help reduce the level of its debt. And that would obviate the need for an otherwise too restrictive a monetary policy stance. The nexus

between monetary policy and fiscal policy, as all economists are aware, is inextricable. Our monetary policy is not formulated in a vacuum as is often believed.

We, all of us present here in this very dining room, are fully aware that it is within our capacity to craft policies to materially enhance prospects for success. We cannot afford to be expedient. We cannot concern ourselves for today only. If we do so prospects for success would turn out to be elusive. In closing, let me say that in the recent past our financial markets have moved quite far ahead and are too overpowering for us to take it for granted that central bankers alone have the wisdom to control them. The private sector is not always wrong. Markets are never perfect. Public servants are not always wrong. Even a broken clock is right twice a day. Consultations between the private sector and public servants are not a guarantee for consensus. But they do help produce the best possible results for society. We, at the Bank of Mauritius, do maintain constant dialogue with market participants with an open door and an open mind. But we do also keep our eyes – of course, not the typical bankers' eyes – on our society's interest. I may confidently say that we have given it the best shots under very difficult circumstances. We look forward to the years ahead with the same tenacity and in the same spirit.

May I on behalf of the Board of Directors of the Bank of Mauritius and on my own behalf wish you and your families a merry Xmas and a Happy New Year.

May God Bless You

Thank you.