BANK OF MAURITIUS ANNUAL DINNER WITH MAJOR ECONOMIC STAKEHOLDERS

Address by Mr Rameswurlall Basant Roi, G.C.S.K.,

Governor of the Bank of Mauritius

Sugar Beach Resort, Flic-en-Flac, December 3, 2004.

Honourable Chief Justice
Distinguished Guests
Ladies and Gentlemen

Good Evening

I am pleased to welcome you all to the Bank of Mauritius Annual Dinner. In my last six addresses I dealt mostly with regulatory and supervisory issues that the business community and the public at large need to be aware of. The addresses are purported to enhance transparency in the Bank's policy decision-making. The theme for my address this evening is: A perspective of our monetary policy objective and the evolution of its operational framework since 1994 when our Exchange Control Act was suspended.

Let me start with a remark – a remark that is generally valid. Often, commentators make observations that are so framed, either unwittingly or intentionally, as to lend the impression that monetary policy, on its own, should be capable of achieving all economic objectives at the same time and all the time. This is indeed an unrealistic demand on monetary policy. Monetary policy, though a very important arm of macro-economic policy, is only one of several elements in the economic panorama. We need to have a realistic appreciation of what monetary policy or any other policy in any other field can be reasonably expected to deliver. It's a fact of life that we cannot have all that we want at the same time, all the time and under all circumstances. Whether it's monetary policy, fiscal policy or social policy, choices are made between conflicting or potentially conflicting objectives in the short term. Between the choices made in the short term and the choices available in the long run there is what economists call the long run opportunity cost. Policy choices made today do often constrain the range of choices available in the longer run.

Those of us outside the economics profession and even those in the economics profession frequently tend to overlook the long run opportunity cost when it suits them. Whenever expectations of a particular sector are not met, there emerges pressing demand to intervene and set right sectoral problems while dismissing the long run adverse implications of the intervention for the economy as a whole. In any dynamic society with ever changing priorities, the relative importance of any single objective varies over time. A switch from one policy to another as demanded by particular economic sectors out of unrealistic expectations to best serve their exclusive interests is likely to cause unintended damage to other longer term objectives.

High level of employment is a desired policy objective. But we simultaneously want low and stable inflation rate. Consumer protection is warranted in the same way as investor protection is warranted. But we also want free-market competition. The rupee depreciates. Exporters are silently happy. Consumers are not. The rupee appreciates. Exporters are angry. Consumers are silent. And so goes the story on interest rate changes. We will have 'expectations gaps' all the time. There are 'trade offs'. However, policy makers constantly strive to strike the right balance between competing ends. Sound minded people cannot reasonably expect conflicting objectives to be met at the same time. If the Bank of Mauritius were to meet everybody's expectations, its policy would swing, quite often violently, from one extreme to the other. The end result would be much less success in the achievement of its longer-term objective.

Prior to the 1980s, monetary policy did not have a precisely defined role in an overwhelming majority of countries across the world. Monetary policy was expected to achieve a number of objectives: price stability, balance of payments equilibrium, promotion of economic growth and full employment. These objectives are conflicting in the short term. With one major policy instrument, central banks were expected to achieve the conflicting objectives simultaneously. As priorities changed following pressures from politicians, industry and commerce, monetary policy shifted legs from one to the other, frequently at short intervals. The monetary policy stance of central banks swung from one extreme to the other giving rise to business cycles and higher and higher inflation rates as also higher and higher unemployment levels - an excellent way of sharing misery but not of creating solid wealth.

Central bankers became increasingly disappointed. What should central banks systematically aim at to finally achieve the ultimate goals of growth and high employment levels? Academics and central bankers debated the question. Researchers emphasized the monetary nature of inflation. Lasting price stability came to be accepted as a necessary condition for sustained growth and high employment levels. Country experiences supported this perception. Those countries with a history of low and stable inflation had also performed well in terms of growth and employment.

Over the years, lasting price stability as a policy goal for central banks won broad-based support. Monetary policy came to be assigned the specific objective of achieving and sustaining price stability. Rather than pursuing different policy stances depending on the exigencies of the day to meet the expectations of different pressure groups, it is best to consistently pursue policies with a precisely defined objective that best serve society as a whole in the medium and long-term.

There is a general tendency to believe that the Bank of Mauritius is not concerned with growth and employment. This is a mis-perception. The Bank is not insensitive to the unemployed. Indeed, the Bank does take into account these considerations in policy-making, not with a short term but with a medium and long-term view. Monetary policy does not **directly** promote growth and help create employment; it does it **indirectly** through the achievement of sustained price stability. Durable growth can only be achieved, inter alia, within a framework of monetary stability. This is what central banks can be reasonably expected to deliver. In the Bank of Mauritius Act 2004 this is what is expected of the Bank.

There are however several underlying and fundamentally important assumptions for monetary policy to succeed. Rather than enumerating the assumptions, let me set a few questions and leave them to you for reflections. Are there serious imperfections in the determination of prices of goods and services in the domestic market? Why prices of goods and services do not positively respond in both directions to movements in the exchange rates of the rupee? How rational are consumers in making decisions? Is the labour market flexible? How many traders, producers, exporters and importers have reliable annual balance sheets on the basis of which banks make decisions to lend? Have our financial markets attained a level of development that facilitates transmission of monetary policy impulses readily? Years ago we had less national savings and more investment. Today we are flushed with funds but investment is sluggish despite a panoply of investment incentives. Indeed, national savings exceed investment by far. Haven't we overstretched the 'welfare state' for too long a time to a point that has suppressed entrepreneurial instinct, blunted creativity, inventiveness, and undermined work effort? Hasn't the 'welfare state' been overstretched to a point that has given rise to a society of free riders? The more free riders there are in a 'welfare state' the heavier is the burden on Government finance and the more difficult is the task of monetary policy in achieving the desired objective.

The point I want to make here is that monetary policy does not operate in a vacuum, independent of a host of other critical factors, and it alone cannot perform miracles. Deprived of a number of allied factors, the achievement of monetary policy objective and ultimately durable growth could be rendered difficult. Lasting price stability is, as I stated earlier, a **necessary**

condition but not a **sufficient condition** for growth and employment. A number of catalytic factors should imperatively accompany monetary policy for it to succeed.

Along with the change in the aims of monetary policy in the last fifteen years, the operational framework for the conduct of monetary policy underwent several stages of evolution across the world. Here, in Mauritius, since 1994 the operational framework for the conduct of our monetary policy was based on monetary programming, with broad money as an intermediate target and inflation as the final target with a time horizon of 18 months on a running basis. The first Monetary Policy Committee under the Chairmanship of the then Minister of Finance was established in 1994. The monetary programming exercise ought to have produced the desired results. The only snag - a critical one indeed - was the issue of independence of the Bank with regard to interest rate policy decisions. Notwithstanding this snag, the first operational framework for indirect monetary control was at least set. In 1996 the monetary programming was given a different twist. In essence, both exercises had the same objective. The framework changed in its form but not in substance. The first was the top-down and the second is the bottom–up approach of operating in the balance sheet of the Bank of Mauritius. In the following two and a half years, the Bank was at the helm of the ship but could not control the storm for reasons that I suspect you may already be aware of.

The Bank had the powers to pursue a realistic interest rate policy but it did not. Even if the Bank had decided to change its interest rate policy, it would have taken several weeks to do so with no meaningful impact on the interest rate structure of the system. The Bank Rate, which is the predecessor of the Lombard rate, used to be determined by the market at the weekly auctions of Treasury bills since 1994. The Bank Rate moved weekly like flotsam and jetsam without signalling any definite direction to the market. This system of determining the Bank Rate was anathema to the financial system of a small highly open economy that had passed the post of financial liberalization. Despite the liberalization of exchange control, which by definition allowed for the free movements of capital, the 'flotsam-jetsam' Bank Rate was retained.

Towards the end of 1998, the systematic pursuit of a realistic interest rate policy along with an imaginative and well-crafted strategy, that is, the sale of Treasury bills over-the-counter to individuals re-established a number of equations in our system. This strategy remedied to some extent the inadequacies of our money market. In 1999, our operational framework was again reviewed. This framework encapsulated repurchase operations between the Bank of Mauritius and commercial banks along with the concept of a key interest rate, the Lombard rate for signalling the interest rate policy decisions. Admittedly, the connection between the Lombard rate and the money market is not sufficiently strong. This is not because the concept of the key rate itself is wrong but because our money market has not attained the desired level of development and sophistication. The link between the Lombard rate and the money market has to be robust for any shift in the interest rate policy stance to be instantly transmitted. However, as you may have observed, changes in the Lombard rate have been having the intended impact on our interest rate structure. In time to come our operational framework for the conduct of monetary policy will be refined with the progress in the development of our money market. Depending on the pace of development of our money market in 2005, the Lombard rate will be replaced by a Repurchase rate, commonly referred to as the Repo rate.

As an aside, let me say that monetary policy making has never been and can never be a purely mechanical process; it is basically an interpretative and therefore a judgemental process requiring a battery of information collected from every available source, including the on-site inspection of banks carried out by our Banking Supervision Department. The judgemental process is what makes monetary policy decision-making difficult. I need not overstate that what is judgemental is susceptible to mis-judgements. The Bank, however, does its best to avoid erring on the wrong side.

It sounds simple. But it isn't. Central bankers endeavour to have a clear view of its monetary policy transmission mechanism. Our policy decisions involve a good understanding of the roles of short-term interest rates, exchange rate, and money and credit in the economy. The Bank heavily counts on dependable inflation forecasts. A fan chart for probabilistic outcomes on the inflation front, duly supported by a highly reliable inflation forecasting model, plays a decisive role in our policy-making process. This is a key element since our monetary policy framework is necessarily forward-looking. Academics and central bankers agree that there is no such thing like an 'ideal' rate of inflation. The specificities of our economy coupled with the weak predictable relationships between certain key monetary and other economic variables have not made targeting a specific inflation rate that easy at this stage. I suspect you must be aware of the saying: 'To be sure of hitting the target, shoot first and call whatever you hit the target.' Price stability will continue to be given central importance and will be kept clearly in sight as the anchor for monetary policy. Precisely, this is what the Bank of Mauritius Act 2004 expects us to deliver.

Much progress has been made in the recent past in the achievement of price stability. Wide fluctuations in the rate of inflation have been drastically reduced over time. Inflation rate in the 1980s reached a peak of 44 per cent and a low of less than 1 per cent. In the 1990s, it attained a high of 14 per cent and a low of 3 per cent. In the last 5 years the highest rate was 7 per cent because of the introduction of VAT coupled with an increase in the VAT rate and the lowest was 4 per cent. These figures are the headline inflation rate as published by the Central

Statistical Office. It captures changes in the cost of living based on a typical household consumption basket.

Central banks have gone deeper into statistical analyses of inflation. For quite some years they have come up with the concept of core inflation - an indicator of the underlying movements in consumer prices. Core inflation irons out the effect of temporary disturbances and shocks to prices that are not attributable to economic and monetary policy. For instance, the impact of the current increase in world price of oil on our inflation rate is a disturbance for which monetary policy is not responsible. That part of inflation due to such disturbances and shocks are statistically isolated from the headline inflation rate. The resultant rate of inflation provides a measure of and an indicator of underlying long-term inflation. We have carried out this exercise for Mauritius. We have had some difficulties in arriving at a specific core inflation rate for Mauritius because the prices of around one-third of the items in our consumption basket are set by Government. Having used two different methods, we obtained a range for our core inflation. For the 12-month period ended September 2004, the core inflation ranged between 2.9 per cent and 3.3 per cent lower than the headline inflation rate of 4.1 per cent as published by the CSO. On average, our core inflation is likely to be between 1 and 1.5 percentage points below the headline inflation rate. We expect the core inflation for the current fiscal year to be in the region of 4 per cent. I may say that we have made considerable headway in achieving price stability in recent years.

The operational framework for the conduct of monetary policy combined with an increasing degree of transparency has led to a higher level of appreciation by the market of policy decisions of the Bank. This has clearly aided expectations building. In the past central bankers believed that unanticipated changes in their policies were more effective. Contrary to this perception, experience demonstrated that policy induced shocks rather harmed economic agents than helped sharpen the effectiveness of the policy. Central bankers have thus adopted a stand – not that much palpable - that allows market players to formulate a view and anticipate their likely policy moves. We have growing evidence of this phenomenon in Mauritius in the last few years. Let me use an anecdote to express what I mean. In the 19th century a leading newspaper in France announced the death of a famous ailing French author. The author, upon hearing the news about his own death, said, ‘ Eh! I have started living again.’ A week later the author actually died. The day after, the same newspaper came with a headline: ‘We were the first to announce the death of the author.’ We have observed such capabilities emerging among our market players and commentators. And that augurs well for the stability of our financial industry.

Ladies and gentlemen, so strong is the weakness of mankind to fall into mutual animosities, that the most fanciful artefacts have been sufficient to excite unfriendly passions. Let me conclude with two observations: the first is about profits of the banking industry. In our type of an economic system profit making is not regarded as a sin. Banks make fat profits. But banks also take high risk. Banks also make fat provisions for debts that have gone bad. Banks also need to build reserves and strengthen their balance sheets. Strong and sound balance sheets make strong banks. The rate of growth of pre-tax profit of commercial banks is observed to be lower than the growth rate of their total assets. Moreover, in the last ten years profits of the banking industry have grown at about the same rate as the nominal growth rate of the economy.

My second observation relates to the idiosyncratic view that commercial banks in Mauritius operate as a cartel. No; that is not simply barking up at the wrong tree, but being in a different forest altogether. It's a view that is distilled badly, blended poorly, and bottled upside-down. Deposit and lending rates do vary from bank to bank. Fees, charges and commissions also vary from bank to bank. This is what we have seen during our on-site inspections of banks. Now, let me assume for a moment that, for instance, the same rates of interest were offered on deposits by some banks. Should it be necessarily seen as an evidence of collusion among banks? Even elementary economics textbooks on the theory of competition teach us that the inter-play of forces in a competitive market drives down prices of goods and services to the same level. Over time one price for the same product prevails throughout the market not because of necessarily a monopolistic situation but because of competition within the industry. The contention that commercial banks operate as a cartel simply because some of the rates applied by them are the same does not make commonsense. And Mr. Sneer-well said:

"I went to the pictures next Tuesday
And took a front seat at the back
I said to the lady behind me
I cannot see over your hat."

Seated in an armchair, I cannot feel the fire of competition underneath.

Ladies and gentlemen, on behalf of the Board of Directors and staff of the Bank of Mauritius and on my own behalf I wish you and your family a Merry Xmas and a Happy New Year.

Thank you.