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"Tout l'art de la politique est de se servir des conjonctures." Louis XIV

Tough times ahead for the Bank of Mauritius

By Sameer Sharma

Excess liquidity in the banking system is generally defined as the banks' holding of reserves over and above what they need for transaction purposes. Excess liquidity can have a negative impact on monetary policy and price stability. Its impact on the yield curve for example can sometimes hinder monetary policy objectives. This article will attempt to examine excess liquidity from an economist's perspective and assess its impact on monetary policy and price stability in Mauritius in the short and medium term. In the current high inflation environment, such an assessment should be considered by all players of the Mauritian economy.

From an economist's point of view, the difference between the growth rate of the money supply and nominal Gross Domestic Product growth (a rough proxy of the demand for money) can be used as a measure of the excess liquidity that is created in a given year. When this is combined with the money supply M2 to GDP ratio, one can have a rough sense of the excess liquidity condition prevailing in an economy.

While Mauritius does not certainly have the alarming 160% M2/GDP ratio that China has, one cannot ignore the upward trend of this ratio over the past ten years. In fact if the growth of the money supply continues to exceed nominal GDP growth in the coming years, we may even join China in this undesirable category. There are of course many reasons why we find ourselves in this potentially dangerous situation but this article will stray away from the causes and concentrate more on the potential consequences of the apparent quasi permanent excess liquidity situation prevailing in the country.

Excess liquidity has both a direct and indirect impact on price stability. All economists know that money creates inflation and lots of it can create even higher inflation. Despite the recent pickup in GDP growth, monetary growth accelerated in 2007 despite the more conservative monetary stance adopted by the Bank of Mauritius (BoM). In general BoM research has shown that high growth in the money supply has a negative impact on the inflation rate with a one to two year lag. Hence the growth rates of narrow money M1 and broad money M2 in 2007 should be a cause of concern considering the current inflation rate.

Inflation has been pushed up by two years due to the M2 inflation impact lag. Furthermore two forecasts for inflation were made for 2008 and 2009. Inflation is assumed to stand at 7.7% in December 2008 and at 6.9% in December 2009.

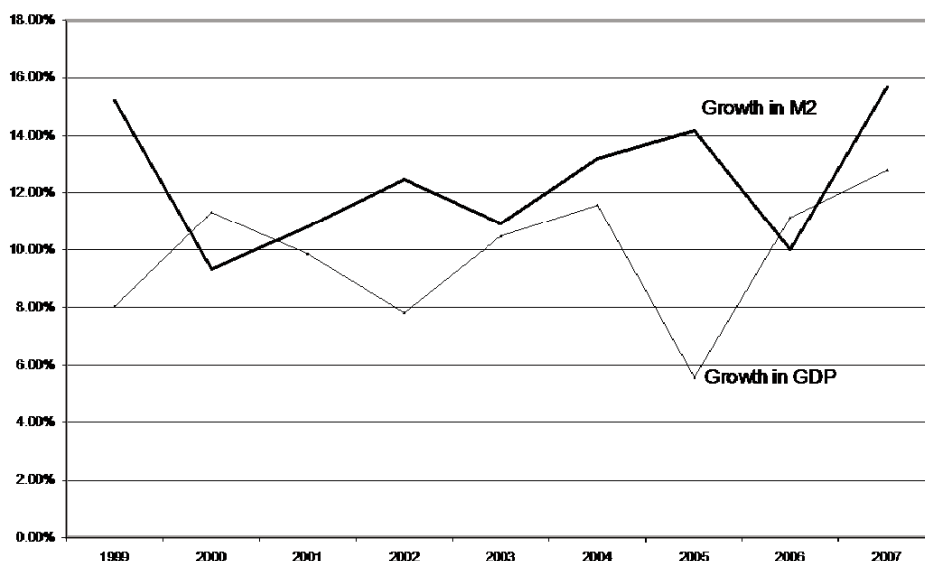
With the current inflation of 9% and negative interest rates, the Bank of Mauritius should limit foreign exchange purchases

People should be reminded that price inflation also includes asset inflation. Indeed low interest rates in the United States and lax lending standards to people who should not have qualified for loans in the first place eventually created the US real estate bubble characterized by low rental yields versus long term bond yields (measuring the opportunity cost). I have worked in Mauritius for almost two years and have observed the rental yields of many commercial properties (along with some very suspect valuations helped greatly by the lack of a proper supervisory body and the infamous bricks and mortar approach to valuation in a country where contractors, promoters and developers tend to be

role in "sucking in" some excess liquidity by getting more people to pay their fair share of taxes. Luckily though, the banking and hotel stocks were massively undervalued and excess liquidity did not result in a stock market bubble.

With foreign investments expected to remain strong in 2008, further upward pressure on money supply growth could result for a consecutive year. I used to be of the view that the Bank of Mauritius should purchase as much foreign exchange as it can to limit short term foreign exchange volatility in a country that is expecting high foreign inflows in 2008. But considering the fact that this may add more

Growth Rates of GDP (Market Prices) & Broad Money M2



good friends). We should feel lucky to have well functioning banks (and a relatively less diversified economy that hinders them to lend more due to risk management purposes) that do not lend left, right and centre, or else we would have been in big trouble.

Excess liquidity and high growth in credit to the private sector is a danger sign in any country, just ask the Reserve Bank of India which has continuously increased the cash reserve requirements of banks while also raising interest rates to cool off high growth in credit to the private sector and soaring property prices. So far we do not seem to face this problem while new entrants in the banking sector may change this situation.

In any event excess liquidity can also make its way to the stock market and create stock price inflation. I was amazed at the amount of money people were taking out of banks last year and in 2006 due to the tax on interest on deposits. The Mauritius Revenue Authority can certainly play a

rupees in a system that may already have too much of it, I believe that it would be better for the BoM and its credibility to stick to inflation. We cannot in any event increase the supply of bonds forever to take some of this liquidity out of the system unless we plan to bankrupt our way out of our liquidity situation.

This reminds me of my recent visit to India where the foreign exchange dealers were no longer accepting my dollars at the airport but were very willing to give me Indian rupees. While I would not suggest that policy makers adopt such draconian measures in a country that needs to be friendly to tourists, better foreign inflow management will be paramount in 2008.

Excess liquidity can also affect price stability indirectly by hindering monetary policy objectives.

Tough times ahead for the Bank of Mauritius

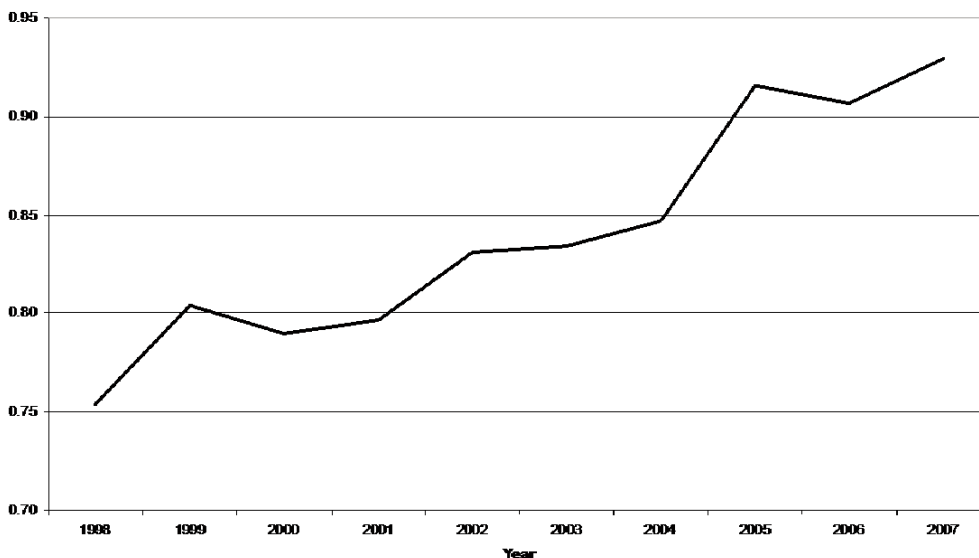
By Sameer Sharma (cont., from Pg 1)

The difference between short term treasury yields and the Repo Rate itself can be viewed in this light. This brings me to another observation about the Mauritian bond market: volatility!

Back in December when the 3-month annualized rate of inflation hovered at around the mid 7% range (as headline inflation fell from 10.7% in June to 8.9% in December), the real interest rate that investors were getting was quite high and partly reflected misaligned inflationary expectations.

While the current upward trend in the 3-month annualized rate of inflation (and headline inflation) may not last for more than another month, if we assume that inflation will stand at 7.5-7.7% this December, you do not even need to calculate the 3-month annualized rate of inflation to realize that current yields on the 3-month Treasury Bills are yielding negative real interest rates or at best near zero real interest rates. Only those who believe that the GDP deflator rather than the 3-month annualized rate of inflation should be used may disagree but the 3-month annualized rate of inflation is a widely used figure, and this

M2/GDP Ratio



rather than the deflator is the first thing that most investors think of when thinking about real interest rates.

With inflation at current levels, near zero or negative interest rates are not helpful! This is another reason why the BoM should limit further foreign exchange purchases. The Bank of Canada has achieved wonders in terms of maintaining price stability and credibility by only sticking to inflation in recent years despite intense pressure from the business community to tackle the CAD/USD exchange rate. The Bank of Canada has only intervened when it felt that inflation was around target. Even the European Central Bank has kept its Refinancing rate on hold so far despite the appreciation of the Euro versus the US Dollar (while the market does expect them to eventually give up the fight which by the way should lead to a short lived dollar rally by the end of the year).

The central bank needs to stick to inflation and take liquidity out of the system

The BoM should do the same and worry about the rupee only when it feels inflation is under control. I do not think that anyone can claim that inflation in Mauritius is under control so far especially when one considers the current rise in commodity prices around the world. A favourable base will in any event not last forever. In any event the base effect seems to be loosing its grip on inflation. With yields going down and with more rupees entering the system, we should not be surprised why forecasts are not being met.

The BoM should conduct reverse Repo transactions within the 1% corridor. So far it has preferred not to because it feels that this may create more volatility based on its models. This view needs to be reexamined when one considers the recent evolution of the yield curve and expected inflows into the economy. It is however encouraging to note that the central bank has recently launched a special deposit facility whereby banks can deposit their excess liquidity at the central bank for a two week period.

The BoM will need to use all means at its disposal to remove excess liquidity out of the system in

order to face a very challenging year and it should maintain interest rates on hold. This is after all also the year when the Pay Research Bureau recommendation will be announced. If the Government engages in the printing of money to finance these compensations (we could certainly also live with less Government debt), it may only serve to benefit the politicians but not the people because high growth in the money supply will eventually lead to inflation and the net gains will be near zero or negative.

Labour unions and politicians need to show more responsibility and the opposition needs to stop playing the socialist card to please the masses and misguide them. The entire world is facing higher inflation because of rising food and energy prices. This is the worst possible year for a high compensation package! The latest PluriConseil survey indicates that most analysts expect inflation to either remain high or rise to double digit figures in the coming months. Worryingly,

they also expect that the BoM will lower the Repo Rate in order to stabilize the rupee. However, the 3-month Treasury Bills rate has already gone down by more than 2% since December 2007 and is probably yielding negative interest rates at the moment while the Repo rate was reduced by only 25 basis points.

Excess liquidity in the system (read lots of rupees lying around) has already affected monetary policy objectives and is probably feeding into money supply growth at the moment. This when combined with further expected foreign inflows spell trouble for the BoM.

From the survey, it appears that most analysts do not believe that the BoM is credible anymore when it states that it is concerned about inflation. Loose anchoring of inflationary expectations along with low credibility is danger signs for any central bank and will only make inflation targeting even more difficult.

The central bank is not Merlin the wizard and cannot resolve all problems. It needs to stick to inflation and take liquidity out of the system rather than putting more of it in by buying foreign exchange. A lower fiscal deficit and a change in the maturity pattern of Government debt (for a more optimal mix and a lower weighted average cost of debt) will make for lower supply of short term bills and hence sterilization has and will not be enough to maintain yields at a level where real interest rates are positive.

Only when inflation is under control should the central bank worry about GDP growth

The situation in Mauritius is potentially alarming and the BoM needs to get on top of the situation quickly. Mauritians need to be concerned with the interest rates they are getting at banks at the moment because in real terms they are not getting much and may even be losing money.

Upside risks to inflation are logically much higher than the downside risks to GDP growth at the moment. The central bank's main job is to target inflation; only when this is under control should it worry about growth! We should not be feeding the fire of inflation (caused by rising food and energy prices) by adding more rupees into the system! Let us pay less attention to the lobbies and more attention to inflation. Companies will need to adapt to a higher rupee versus the US Dollar just like they do in Canada, in Europe, in India and most other countries that are faced with a higher interest rate differential. Even the Reserve Bank of India, despite strong pressure from giant multi-billion dollar companies, has kept rates constant and controlled inflationary expectations, and today Indian inflation is quite manageable.

Mauritius seems to be confused as to what to do, inflation or foreign exchange, when the economy is not even facing a recession or a major slowdown. If Chief Finance Officers cannot hedge against currency risk properly, then replace them or get them better trained in the field of non accounting related finance and economics. Do not expect the central bank to bail the company out all the time when inflation is so high!

Sameer Sharma is a financial analyst working in Canada.

Gearing up the capital market

By Bilal Sassa

The capital market in Mauritius is intricately linked to the Stock Exchange of Mauritius (SEM) and, though highly limited to equity, has developed quite a bit since the first trading day back in July 1989. Not only has the number of companies increased over time, but the infrastructure has witnessed considerable improvement.

The first trading sessions where traders would gather around the 'basket' on the trading floor to match their orders is now part of our capital market history and traders now trade from their office on a terminal that is connected to a central terminal at the SEM where orders are matched through the Stock Exchange of Mauritius Automated Trading System (SEMATS). No more do we deal with share certificates, but the advent of the Central Depository & Settlement Company (CDS) now makes life much easier for both the investor and the broker by avoiding possible risks of loss of certificates to high administrative burden respectively.

All these development now makes the SEM a highly respected place on the African continent and has even given it a highly respectable position. The SEM is now considered as a reference exchange in Africa having been the first to move to a fully automated infrastructure. The SEM and the CDS have played a very active role in expanding services to other exchanges in Africa and has been ranked No 2 Exchange in Africa in 2007 after the Johannesburg Stock Exchange (JSE) by Africa Investor in terms of infrastructure, modern and flexible regulatory environment and innovative initiatives to develop capital markets.

The limited liquidity on specific stocks may limit the possibility of creating derivative instruments on specific counters

Let us now have a look at the various constraints and challenges facing the local capital market. In the wake of increased globalization, it is becoming more and more important to position the market in such a way that will allow us to better face the increased competition we already face and that will keep on increasing. Moreover, as Africa has become very much in the limelight, Mauritius is well positioned to take advantage of increased trade flows both through portfolio investments but also by acting as a central hub for accessing the under exploited continent.

In my view, we are ready for this challenge. Our regulatory framework, which has been updated with the promulgation of the Securities Act 2005 in October 2007, caters for a more proper environment for financial activities. But what do we do to get there?

There are four constraints.

First, the local capital market is essentially a single asset class market. Our market is highly equity based. The listing of debentures back in the 1990s came to a sudden halt after the removal of the tax free status of the interest paid on these instruments. We have some Treasury Bills that are traded on the market but trading on these instruments is very thin.

Second, capital raising by listed companies have been fairly muted in spite of strong market appetite for equity (controlling shareholders do not wish dilution). Whilst companies have invested substantially in new projects over the years, financing have been primarily through bank lending and equity financing has not been on the agenda.

Third, capital market activities are intricately linked to fortunes of local economy or local companies. The companies listed on the market are mainly local companies. The listing of offshore funds on the local market is an obvious way of giving added visibility to the local market place. As other jurisdictions offer listing facilities, Mauritius as a destination of substance for financial services should be able to address this issue. Adequate rules along this line are awaiting the regulatory blessings.

Fourth, free-float of large companies has substantially increased over the years but those of the smaller ones are still very low.

It is always good to be aware of one's weaknesses but one should not stop at this as complacency may set in and we see ourselves being caught up by competition and we would have lost the chance of spearheading the capital market development in Africa. Of course, speaking of Africa here does not make reference to South Africa which is comparable to the developed economies in terms of capital market structure.

I strongly believe that there is a case for the introduction of new assets classes to improve our product offering. It is a fact that the limited liquidity on specific stocks may limit the possibility of creating derivative instruments on specific counters, but the possibility of derivative contracts on indices is a possibility that is worth considering.

We should leverage on the presence of global funds and global companies to position Mauritius as a centre for the listing of funds

Moreover, creating an active debt market is long overdue especially in a place where companies prefer to finance new projects through debts rather than equity issues. Maturity structure on government papers are now long enough to create a risk-free benchmark from which corporate papers could be traded. Along this same line, the creation of a credit rating agency to provide independent and reliable rating on issues will be instrumental to improving our image vis-à-vis international agencies looking at Mauritius as an international financial centre.

We should also leverage on the presence of a number of global funds and global companies to position Mauritius as a centre for the listing of funds. I strongly believe that at a time when substance in the global business sector is becoming more and more important, listing of offshore funds could help tackle this issue. The necessary amendments to the listing rules are ready and await the necessary regulatory blessings.

The point about increasing liquidity on the local market is one that is easier to identify than to find a solution. However, the creation of the Development & Enterprise Market (DEM), which allows for startups to seek listing on the market if they have a good business plan, is an important step in the right direction. At a time when the government is putting a lot of emphasis on entrepreneurship, the DEM provides an important conduit for Small and Medium Enterprises seeking to raise finance. Furthermore, the DEM allows for an interesting exit route for private equity fund, the creation of which should be further encouraged.

All in all, I strongly believe that the capital market in Mauritius so far is well poised for an important gearing up in terms of substance in the context of globalization. The onus remains on the operators and the regulator to work hand in hand to achieve the standard that we have so far been using as benchmark. It is important that operators become also an integral part of the development process and be ready to embrace changes that the challenges of globalization pose for the stock exchange and the economy.

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L'Etat impotent

EDITORIAL – Par Eric Ng Ping Cheun

Il peut paraître incongru de cibler l'Etat dans un pays que la très libérale *Heritage Foundation* qualifie de "Mostly Free" et classe à la 18ème place au tableau de la liberté économique. Et pourtant, on a le sentiment que l'Etat est omniprésent dans la vie quotidienne des Mauriciens. Il n'y a pas un seul journal ou une seule radio privée qui ne consacre ses premières nouvelles à une actualité qui implique un ministre quelconque. Qu'il provienne de la société civile ou du monde des affaires, chaque problème, petit ou grand, est porté à la connaissance du gouvernement. Cet appel permanent à l'Etat fait que les Mauriciens deviennent dépendants de lui.

Maurice est certainement une économie de marché, une économie libre, où le secteur privé contribue largement au produit intérieur brut (PIB). La contribution du secteur public au PIB a diminué, passant de 12,6% en 2000 à 11% en 2007. C'est une part bien faible par rapport aux pays développés (entre 40% et 50%).

L'administration publique, la sécurité sociale, l'éducation et la santé sont quatre grands secteurs étatiques qui produisent. On constate toutefois une régression des deux derniers secteurs au profit du privé : entre 2000 et 2007, la part du public dans la production de l'éducation passe de 53% à 48%, et celle dans la production de la santé de 66% à 55%.

Sous la pression de la dette, l'Etat a investi de moins en moins ces dernières années pour laisser la place au secteur privé. L'investissement public, excluant l'aviation, était à un niveau record en 2003 lorsqu'il représentait 37% de l'investissement total et 8% du PIB. Aujourd'hui, les taux ont baissé respectivement à 18,8% et à 4,4%.

Davantage que par le volume de sa production, il faut évaluer l'Etat par la qualité de ses services. Dans les activités où l'Etat est présent, il doit être efficace au sens où il offre le maximum de bénéfices au moindre coût. Par ailleurs, même là où l'Etat est absent, il exerce une grande influence sur les décisions des opérateurs. Il ne joue pas toujours bien son rôle de facilitateur qui est d'enlever des obstacles administratifs inutiles.

Des biens collectifs médiocres

On confère à l'Etat la mission de produire des biens de consommation collective (éducation, santé, infrastructure, police). Mais toute production comporte des coûts. Ces coûts peuvent être justifiés moyennant que les biens produits soient de bonne qualité et satisfassent ceux qui les consomment. Or c'est loin d'être le cas, à voir le niveau élevé de l'échec scolaire, l'incurie dans les hôpitaux, la faillite de la gestion routière et l'insécurité rampante.

On entend souvent dire que l'Etat ne peut pas être géré comme une entreprise privée qui est motivée par le seul souci du profit. Si l'Etat n'a pas pour vocation de faire des profits, il ne peut toutefois pas se permettre d'être en déficit. Car

tout déficit doit être financé par les impôts des contribuables.

L'Etat ne résoud pas son problème de déficit simplement en ne faisant payer les impôts qu'à ceux qui en ont les moyens. Les contribuables qui portent le fardeau fiscal sont précisément ceux qui sont les plus productifs au travail et font ainsi progresser l'économie. Il serait injuste de pénaliser leurs efforts individuels pour leur proposer, en retour, des biens collectifs médiocres.

L'Etat est un mauvais gestionnaire : malgré une croissance économique soutenue d'environ 5%, il est prévu que son budget affichera pour l'année 2007-2008 un déficit de Rs 9,5 milliards, en augmentation de Rs 100 millions par rapport à 2006-2007. Les déficits s'accumulent chaque année, portant la dette publique à Rs 122 milliards au 30 juin 2007. Le service de la dette publique sera cette année de Rs 12 milliards, soit un cinquième du budget des dépenses.

L'Etat consacre Rs 7,8 milliards au budget de l'éducation et Rs 4,8 milliards au budget de la santé. Imaginons un instant qu'on abolisse le ministère de l'Education et celui de la Santé, et qu'on distribue ces sommes directement aux 230 000 élèves du primaire et du secondaire ou aux 300 000 familles mauriciennes. Chaque élève aura droit à un chèque-éducation de Rs 34,000 pour payer ses frais de scolarité, et chaque famille bénéficiera d'un chèque-santé de Rs 16 000 pour prendre un plan d'assurance privé. Devant une aussi forte demande, les fournisseurs des services d'éducation ou de santé baisseront drastiquement leurs prix. Ceux capables d'offrir de tels services entreront sur le marché et seront poussés par la compétition à assurer la meilleure qualité-prix.

Actuellement, l'Etat est un mauvais producteur. Chaque année, un tiers des élèves participant aux examens du *Certificate of Primary Education* échouent. Parmi les 18 000 jeunes qui entrent au primaire, un peu plus de 6 000 parviennent plus tard à décrocher un *Higher School Certificate*. Un véritable désastre.

La santé publique ne fait pas mieux. Le ministère de la santé est administré par un fonctionnaire plutôt que par un praticien. Les hôpitaux publics peinent à offrir un service décent aux patients. Pour masquer sa mauvaise gestion, l'Etat embauche sans faire partir les incompetents ! Les fonctionnaires justifient toujours leur défaillance en invoquant l'insuffisance des budgets et le manque de personnel. Ainsi, tout échec appelle un grossissement de la structure.

Pas de subventions à l'entreprise d'Etat

Maintenant, il se trouve que l'Etat veut aussi produire des biens non collectifs, des biens qui peuvent être fournis par des entreprises privées. C'est ce que tente de faire la *State Trading Corporation* en créant une compagnie commerciale subsidiaire. Celle-ci ne serait pas un monopole d'Etat, mais qu'est-ce qui garantit

qu'elle ne le deviendrait pas ?

Un monopole d'Etat est contestable dans une économie libre, car il s'arroge le droit exclusif de fournir un service quelconque. Il convient de le distinguer d'une entreprise d'Etat qui, elle, est légitime à condition que l'Etat ne la subventionne pas. A moins que ce dernier donne les mêmes subventions aux entreprises privées concurrentielles de la même industrie. Mais allouer ainsi des ressources publiques est économiquement inefficace.

C'est la fourniture des biens et services, et non la nature publique ou privée des institutions dispensatrices de ces biens, qui détermine la liberté économique. Les consommateurs ne sont pas moins libres lorsqu'ils achètent des biens non collectifs à une entreprise d'Etat. Mais seulement, l'Etat doit s'engager dans une activité sur les mêmes bases que les entrepreneurs.

La méfiance qu'inspire toute entreprise d'Etat aux entrepreneurs est très justifiée. Car rien ne dit que la première sera traitée par l'Etat sur un pied d'égalité avec les seconds. Si l'Etat use de son pouvoir fiscal pour aider ses entreprises, il peut à tout moment les transformer en monopoles de fait.

Il est difficile de gérer un pays quand sa population attend tout de l'Etat. Comme celui-ci ne peut pas résoudre tous les problèmes, les gens sont constamment déçus, et cette déception influe sur le moral de la nation. On croit l'Etat omnipotent, il est en fait impotent. Par conséquent, un gouvernement ne peut jamais être populaire dans ses fonctions. C'est pourquoi, pour citer Tocqueville, "le plus grand soin d'un gouvernement devrait être d'habituer peu à peu les peuples à se passer de lui".