

CONJONCTURE

PluriConseil
THINKING OUT OF THE BOX!

Bilingual Journal of PluriConseil
N u m é r o 35- Octobre 2008

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

Ramesh Basant Roi:

"An economic recession caused by a financial crisis associated with the real estate is usually deep and lasts long"

(Cont on Pg 2,3,4)

For the first time, CONJONCTURE publishes an interview in this special edition focused exclusively on the global financial crisis. Ramesh Basant Roi, G.C.S.K., who was Governor of the Bank of Mauritius from October 1998 to December 2006, speaks to Eric Ng Ping Cheun.

- The sub-prime mortgage market crisis has been around for sometime. Broadly speaking what do you make out of it?

Views on the current financial crisis and its implications for the world economy run amok. I have said it elsewhere that when we go through our daily financial news, it's like reading a Russian novel. There are so many actors going out and coming in the play that you lose sight of the main plot. There are so many credible interpreters of the financial news from Nobel Prize Winners in Economics down to the last novice on financial matters that your confusion gets confounded. We need to focus our eyeballs on the main plot of the drama that has been unfolding for more than a year and derive lessons out of it.

The sub-prime mortgage market crisis was foreseeable. In fact, quite a few economists had sounded the alarm bell and even written books. One such book is *'The Coming Collapse of the Housing Market'* by John Talbott published in 2003. The party in Wall Street was in full swing and nobody cared to listen, nor even the Fed.

The party ended abruptly and central bankers and regulators of financial institutions woke up in the morning to find someone next to them with whom they did not go to bed last night. The world financial system got the wake up call last year.



Ramesh Basant Roi (left) and Antony Withers (right) pictured with Eric Ng Ping Cheun at a business forum on the global financial crisis organised by Junior Chamber International Port Louis on 24 September 2008

The famous Minsky moment had arrived. Hyman Minsky gave us this great quote, 'Stability is unstable.' The long term stability of economic and financial trends is the seedbed for asset and credit bubbles of all types. The depth of the current crisis is unfathomable.

The US Fed Chairman, Ben Bernanke, is reported to have privately uttered that the Fed has lost control of the situation. The world financial system has known several crises since the Great Depression of the 1930s. The present one is the most threatening one.

No one really knows how best to get out of this mess without too much hurting world economic prospects. You may have noted that the US has been trying all kind of remedial actions. None of them have met with success yet. We are all in for tough times.

- Hon Rama Sithanen has been saying that we need not be overly concerned. We should not be alarming about it. Do you share his views?

As Minister of Finance, I believe it's his duty to infuse public confidence in our financial and economic system. But it would be a gross mistake to be exceedingly confident.

The likely consequences of the global financial crisis

By Antony Withers (Cont on Pg 8)

The convulsions of the credit and equity markets have arisen out of concerns over asset values given the enormous growth over the last few years in sub-prime mortgage lending in the U.S. and the associated growth in securitisation and derivatives which transported and magnified these exposures and risks from U.S. commercial banks to a variety of financial market participants around the world. Quite simply, US sub-prime borrowers are defaulting on their borrowing to an unprecedented degree causing uncertainty as to loan losses and the marking down in value (mark to market) of the various categories of mortgage backed securities and credit default swaps linked to the enormous growth in mortgage lending.

This rise in the level of defaults has had profound knock-on consequences: 1) Huge loan losses and provisions by banks in many countries, 2) Drying up of inter-bank lending, 3) Cessation of wholesale capital markets fund raising, 4) Falling share prices, 5)

Rating downgrades. As Moody's and Standard & Poor's scramble to recover credibility lost on over-rating securitized products of various shapes and sizes and they react almost immediately to share price falls – which are sometimes the result of short-selling. It is the coincidence of all these factors that has led to the extreme state of volatility and illiquidity across almost all financial markets.

Some commentators have suggested that the blame for this "bursting" of the property asset bubble can be fairly laid at the door of central banks in general and the Federal Reserve in particular - notably under Alan Greenspan's watch. The Greenspan approach was that central banks should not try and spot asset bubbles but rather stand ready to sort out the mess when they burst.

This approach, I believe history will show, has been a profound error of judgement. We are currently

confronted with an extraordinary effort to save the financial system of not only the USA but in much of the developed world and it will likely be far more expensive both in actual costs and lost output than would have been the case if a more moderate monetary policy had been pursued preventing the build up of the property bubble.

In April 2005 Greenspan said: "Where once more marginal applicants would have been denied credit, lenders are now able to quite efficiently judge the risk posed by individual applicants and to price that risk appropriately. These improvements have led to rapid growth in sub-prime lending". He was certainly correct about the rapid growth in sub-prime lending.

There is, however, another aspect somewhat overlooked in this unfolding crisis, which is that if sober and sensible management had prevailed at many of the financial institutions that have either

Ramesh Basant Roi: "An economic recession caused by a financial crisis associated with the real estate is usually deep and lasts long"

(Cont from Pg 1)

I certainly am not alarmist – far from it. But as an economist I see things as they actually are and try to make some sense out of it. I do not claim to have the power of oracular utterances though.

You remind me of the Titanic. The captain of Titanic, a skilled mariner named J. Smith, is quoted to have said, 'I cannot conceive of any vital disaster happening to this vessel. Modern shipbuilding has gone beyond that.' But Capt. Smith did not realize that the steel used to in constructing the ship was brittle and that the steel became even more brittle when it was chilled to freezing point in the cold waters of the Atlantic. On April 14, 1912, a star of ill fate shone on the ship. Capt. Smith was heard to say something quite different. At around midnight he gave an order: 'Prepare for lifeboats.' Later in the early hours of the morning of April 15, he shouted as the water lapped over the bridge: 'Every man for himself.' The cold sea took Capt. Smith and he was never seen again.

Mankind still has that almost willful blindness to exercising the vision to forecast and avoid disaster in the making. And disaster takes time to erupt.

- You have been with the BoM for many years and Governor of the Bank, our regulatory and supervisory authority of our banking industry. Tell us where things have gone wrong with US policy?

Policy makers in the US have never believed in the regulation and supervision of financial institutions. They have always been guided by the philosophy that the least intervention the state has in the market, the more efficient is the market and the better is the outcome of the interplay of market forces. They cling tenaciously to the doctrine of laissez-faire – a kind of market fundamentalism asserting that the magic of marketplaces always assign risk correctly. Whatever little regulatory and supervisory mechanism is in place in the US is highly fragmented and balkanized so much so that financial institutions are left unregulated and unsupervised. Surprisingly, everybody discovered that investment banks in the US were never regulated and supervised.

You will recall that one of the first few banks that did object to the implementation of the regulatory principles underlying Basel II were American banks. Essentially, what Basel II says is that the greater the risk a financial enterprise takes the more capital the enterprise would need to maintain. Those banks that have failed and are currently in intensive care unit are the very institutions that historically have lobbied in Washington against regulation and supervision.

Had there been a coherent and effective regulatory and supervisory framework, the sub-prime mortgage market crisis would not have occurred. Banks and other financial enterprises are by definition very fragile and very vulnerable institutions. Failures of systemically important financial institutions impact brutally on the economy. The free market system has been abused and people defrauded. In a nutshell, the complete laissez faire US policy has failed with unpleasant consequences for the world economy. The US is finally recognizing the importance of regulation and supervision of its domestic financial institutions. Having said that let me tell you one more thing: the game is not yet over. Free market faith will continue to be tested as more bad news come in.

We must not forget the famous Ronald Reagan, a fanatical believer in laissez-faire, statement that the ten most dangerous words in the English language

are, 'We are from Government. We are here to help you.' He has been proved blatantly wrong. The US government is here to help the ailing financial institutions.

"Capitalism without bankruptcy is like religion without sin"

- If I get you right, do you mean to say that the free market and therefore capitalism has failed?

Yes, it has actually failed. There is no doubt about it. But failure in capitalism forms part of the package that go with a capitalist economic system. Let me share with you an anecdote: A young guy had asked Warren Buffet, until recently the richest person in the world, the question: 'What's the quickest way to become rich?' Buffet pressed his nose with both fingers of his right hand and pointed Wall Street with the other.

Since the 1950s, Americans have been made to believe that what's good for Wall Street is good for America in the same way that they were made to believe that what was good for GM was also good for America. But you don't have to have a Ph.D. in history to know that even in moments of irrational exuberance, Wall Street has never been popular among Americans. That's part of America's populist legacy and it runs deep in the electorate. Wall Street is one of the very few places in the world where some people ride in Rolls Royces to get advice from those who travel to office by subway.

Capitalism as an economic system has been abused by the capitalists. Capitalism now has to be saved from the capitalists. But we need to bear in mind that capitalism without bankruptcy is like religion without sin. Capitalism without bankruptcy is said to be like taking crucifixion out of Christianity. Bankruptcy allows purging of inefficient and rogue institutions. It's the failure of enterprises in capitalist system that finally makes of the capitalist system an efficient system. We observe today capitalism without Joseph Schumpeter's creative destruction. Capitalism is creative... and destructive, too. It's capitalism with seatbelts, helmets and air-bags.

Because laissez-faire policy in the US has failed, it does not mean that we should all happily don ourselves with Mao's jackets and wave the Little Red Book. To sum up, the present crisis however does signal the need for a good house-keeping of the capitalist system.

- How serious is the current financial crisis?

The crisis has been unfolding since August 2007. The more it's unfolding the more seriously threatening it looks like. The derivative market is a complex market. A single dollar of 'real' capital is found to support US\$20 to US\$30 dollar of loans. This spiral of borrowing in an increasingly thin base of real assets has ultimately created a world in which derivatives outstanding as at the end of last year stood at US\$475 trillion. – eight times total global GDP of US\$60 trillion. One of the wonders of leverage is that it amplifies profits on the way up and amplifies losses on the way down. The derivative based on mortgage market securities is a huge proportion of the US\$475 trillion. You can imagine how much of the derivative products must have been circulating around the world financial markets.

With the collapse of the housing market in the US, prices have been declining. In some States the decline has been as much as 40 per cent, and even

more by now. When the assets fall in value in the balance sheets of financial institutions, it wipes out equity capital. You have a small amount of capital controlling a large amount of assets. If you take a write off on the assets, it wipes out your capital. You're insolvent. That's the problem with most of the financial institutions holding derivative products relating to the mortgage market securities. Once the process of deleveraging is set forth, losses lead to collapse of financial institutions if they are not adequately recapitalized. Worst, no single financial institution has been willing to divulge the extent of their involvement in the derivative market for fear of creating a run on their own institutions.

Systemically important financial institutions around the world are holding the derivative products. A collapse of the systemically important financial institutions would of course trigger a bandwagon effect throughout the world. That would seriously clog the world economy into a severe recession or even a depression if the problem is not appropriately tackled.

- You said many financial institutions are holding those derivative products. Does an authority anywhere in the world have an idea of the extent to which other countries are in one way or the other involved with the derivative market?

I am not aware of any authority having an idea of the full list of holders of the derivative products as they have changed hands so many times. But the US Treasury Department does have an idea of the holding of what has come to be known as the toxic products by some countries. China through its Sovereign Wealth Funds holds US\$376 billion in securities issued by Fannie and Freddie. Japan holds US\$228 billion. European institutions hold more than US\$100 billion. The securities issued by Fannie and Freddie are just as good as the US Government's treasury bills and they do pay better.

Had Fannie and Freddie not been bailed out, all these investors would have lost their investment. Investors would have lost confidence in the US economy and in its ability to resolve financial crises that the capitalist economic system is prone to. That's why the US government has been relentlessly striving to bail out the systemically important financial institutions at any cost.

- The trillions of dollars of derivative products are held world wide by financial institutions. Do you think that it's possible for the authorities to bail out all the systemically important financial institutions?

The depth of the problem is not known. That is why I am a little sceptical about the success of the US authorities in restoring financial stability and preventing the US economy slipping into a recession. The US government injected US\$85 million in AIG. So far the Fed has made available some US\$700 billion to various financial institutions. Another bail out plan of US\$700 billion is in the pipeline.

These figures are in no way comparable to the size of the derivative products market I referred to earlier. We can expect further rounds of heightened crises in one form or the other.

"The US is an insolvent country bailing out insolvent financial institutions"

- It goes to say, according to you, that the US is not in a position to restore financial stability. Is it very likely for the world economy to go through a turbulent period of financial instability?

The US is busy catching the proverbial black cat in a dark room. We are in for quite a long period of instability. Do you still recall what the US Government did last year? Larry Summers, the former Treasury Secretary of the US, who has the ears of the Congress, suggested that the US economy needed a fiscal stimulus to prevent it from slipping into a recession. There came a chorus of views supporting the proposal. The US government went for a fiscal stimulus package of US\$150 billion that was approved by the Congress in February last, believing that the financial crisis was resolved already. A few of insightful economists like Stiglitz, Roubini, Kenneth Rogoff and even Anna Schwartz, the doyenne of monetarism, the economists who along with Milton Friedman, studied the Great Depression of the 1930s in the *Monetary History of the United States*, had laughed off the stimulus package. The depth and amplitude of the financial crisis was hardly visible in the radar screen of the authorities in the US. The fiscal stimulus package turned out to be a futile exercise.

Somehow I do entertain a mixed feeling that US might succeed in bringing back stability to its financial system... in the long run. I think it was Sir Winston Churchill who said that "The United States invariably does the right thing, after having exhausted every other alternative." The US has exhausted all the alternatives; it's time, probably after the election - for the politicians to do the right thing.

- Assume for a moment the US goes into an economic recession. How long is it going to be in your opinion?

The US is indeed slipping into a recession. It's going to last quite long but not longer than it was in the 1970s. All studies of financial crises and economic recession that have hit individual countries have a standard conclusion: an economic recession caused by a financial crisis associated with the real estate is usually deep and lasts long. The IMF has just come up with a Working Paper released by the IMF confirming this conclusion. Let's hope the resent crisis turn out to be a black swan event.

- And how deep is the recession likely to be?

The US has very large trade deficit. This is a country that requires over US\$2 billion per day to finance its trade deficit. This is also the country that has a very huge fiscal deficit that is unlikely to narrow in the foreseeable future. This is also a country with rising inflation rate and unemployment rate. The US is by any standard an insolvent economy. It's an insolvent country bailing out insolvent financial institutions.

The UK also has a huge budget deficit and a huge trade deficit. Consumers in these two countries shop till they drop.

Household debt in the US has attained a staggering level of 85 per cent of GDP. Total debt of the US, both public and private, is US\$62 trillion. This debt cannot be repaid by their children's children. To fully refund such debt, the US requires an average of 10 per cent growth rate every year for 75 years. Household debt in the UK stands at 103 per cent of its GDP. More than 80 per cent of Britons admit to overspending regularly with 26 per cent using retail therapy or using shopping as means to cheer themselves up.

America's recession is likely to shift from homebuilding activity, its least global sector, to

consumer demand which is its most global sector. Unemployment rate in the US is rising. Manufacturing order has after a long time registered a steep decline.

The US cannot indefinitely have a huge trade deficit and a huge fiscal deficit. The billions and billions of dollars being injected into the US economy and the European economy will have adverse impact. Macro-economic adjustment will be painful for the American and European and British consumers. And if it's going to be painful for them it's going to be painful for us too.

With such a state of the US economy coupled with the high-voltage financial crisis one should ordinarily expect the recession to be deep and long lasting.

- But China and India have a rapidly rising number of rich middle-class consumers. A decline in consumer spending can be matched by consumer spending in these two countries. Isn't it?

No way. Some have indeed argued along this line. But statistics go against this possibility. American consumers spent close to US\$9.5 trillion last year. Chinese consumers spent US\$1 trillion and Indian consumers spent US\$650 billion. It's arithmetically impossible for China and India to offset the contraction in American consumer spending. The US remains the most important consumer country in the world.

"Oil will on average stay at above US\$100 per barrel"

- What would be the fate of the US dollar and petrol prices in this bleak scenario that you have painted?

Let me again tell you that I am not alarmist. I am just looking at figures and events face to face. With the poor economic fundamentals one cannot normally expect the US dollar to be strong.

There are two ways of looking at it. If the US dollar weakens, against which currency is it going to weaken? Since the financial crisis is also affecting the economies with reserve currencies though less seriously, the other reserve currencies are going to be weak at around the same time. If that would be the case, the US dollar parity would be maintained at around the same level where it stands right now. But I am inclined to believe that since the US economy would be in greater troubles, the US dollar would be relatively weaker for quite sometime.

If the dollar weakens we should expect an increase in the price of oil. Since 2001 the dollar price of oil and gold has moved in tandem. Gold price has risen by about 250 per cent while oil price has risen by some 280 per cent. This means that if the dollar had remained as good as gold since 2001, oil would be selling at US\$35 a barrel today and not at over US\$100. We cannot remove the gold from the standard. Nor can we remove the standard from the gold.

I have one caveat here. Commonsense tells us that if the US economy slips deeper and deeper into recession, demand for oil in the US and elsewhere would go down. This could lead to a decline in the price of oil. But given that the oil-exporting countries collectively now have huge import bills to settle, would they be prepared to accept a fall in oil prices over a protracted period of time? I wonder. Anyway, my best guess is that oil will on average stay at above US\$100 per barrel.

Sure, prices could decline temporarily because of

slackening demand conditions. But they will certainly go up over the medium term.

- It is said that when the US sneezes the rest of the world catches cold. The US economy is going through a crisis phase. Are we in Mauritius going to catch a cold?

Prof Kindleberger, a trade theorist who has also studied financial crises in-depth said that in the 1960s. It was as much valid in those days as it is today. Until three months ago, much had been said about the de-coupling theory meaning that if the US sneezes the rest of the world would not sneeze. It was nonsense. Anybody who still says that the crisis in the US and in the UK and Europe is not likely to eventually affect the Mauritian economy needs to re-educate himself on what globalization means. One cannot believe in Sir Issac Newton's laws of gravity and still see water running uphill. If one does see water running uphill he must be having fundamental problems. Yes, the risk of us eventually catching the cold, if we have not already caught it, is high.

"Our banking sector is sound and solid"

- A variety of views has been expressed in the market place about the possible impact of the crisis on our economy. How in your view is the crisis likely to affect our financial industry?

First and foremost, we need to appreciate the fact that the crisis has not yet fully unfolded. The first wave of the crisis reared its head in August 2007. The Japanese, Chinese, Singaporean and the Middle Eastern helped inject capital into the ailing Merrill Lynch and Citicorp. What we are witnessing right now is the second wave of the crisis. I am inclined to go along with the views of Prof. Kenneth Rogoff, the former Director of Research of the IMF and now Professor at the Harvard University that the US is half-way through the crisis. The probability of other waves of the crisis re-emerging is high. But so far, we are left more or less untouched by the crisis.

Because the crisis has yet to reach its lowest point, we can only surmise. Clearly, our banking industry, as I said in an interview with *l'express* in January last has nothing to do with the toxic instruments that are at the origin of the crisis. I do not have information about our insurance sector and keeping in view of the difficulties of AIG despite the US\$85 billion injection I cannot make a firm statement. The Financial Services Commission is best placed to comment on the insurance sector. With regard to our Stock Exchange we have seen some nervousness recently.

Globally, the financial industry seems to be in good stead. One thing I should tell you though. Towards the end of 2006 when Wall Street began to feel the foul smell, there was a flight of capital from the US to emerging market economies. An estimated amount of US\$ 700 billion moved to emerging market economies in 2007. The amount for 2008 was initially estimated at US\$620 billion but was subsequently raised to US\$1 trillion.

A tiny amount which I had estimated way back in January last at US\$250 million moved to Mauritius. I suspect total short-term net capital flows to Mauritius as of today must be in the region of US\$350 million. This represents as high as 17 per cent of the Bank of Mauritius foreign currency reserves. In terms of capital flows, this is how the crisis has so far impacted on our financial industry. This is where the Bank of Mauritius would have to pull the magical white rabbits from its black policy hat should there be flight of capital out of Mauritius.

Ramesh Basant Roi: "An economic recession caused by a financial crisis associated with the real estate is usually deep and lasts long"

(Cont from Pg 1,2,3)

- Do you mean that there might some sort of problems with our insurance sector?

I do not mean that. What I want to tell you is that I have some inside knowledge, though not up to date, of our banking industry. I can confidently tell you that the banking industry is safe because of the regulatory and supervisory framework put in place under my Governorship. You will recall the repeated emphasis I placed on the regulatory and supervisory guidelines I had introduced and how emphatic was I on the question of soundness of banks under my tenure of office. Sure I was disliked for putting emphasis on the regulatory and supervisory issues from within and outside the Bank. But we did a good job. We can afford to derive pride that our banking sector is sound and solid and I am happy to see that the latest survey of the Global Competitive Index of the World Economic Forum ranks our banking industry among the best in terms of soundness. You may have noted that out of 10 our banking industry has scored 6.2 whilst the highest has been scored by Canada with a score of 6.4.

With regard to the insurance sector I do not hold any privileged knowledge. This sector did not fall under my purview. But given the worldwide ramifications of AIG I just wondered the latter might have something to do with our insurance sector. I do not believe that AIG is anymore healthier with the injection of US\$85 billion.

"A drastic slowdown in the pace of economic activities would impact badly on our balance of payments position"

- Much has been said about the impact of the crisis on the real sector of the Mauritian economy. Do you share the same views?

Broadly yes. We are an export oriented economy and we are bound to be affected if the US slips into recession. We do not need to be rocket scientists to have a first feel of how the crisis might affect our economy. I see that even before the US and Europe get into recession our tourism sector seems to have already caught cold. From information gleaned in some reports I note that there is clearly a deceleration in the sector.

I am ill at ease with the evolution of our balance of payments. Let me lift the cap on an 'Inconvenient Truth'.

Statistics published by the Bank of Mauritius show that the excess of our imports over exports is swelling at a rapid rate. The deficit, that is excess of imports over exports, deteriorated from Rs38 billion in 2006-07 to Rs55 billion in 2007-08. The current account of our balance of payments posted a deficit of Rs22 billion in 2007-08, higher than the deficit of Rs17 billion in 2006-07. They are by any standard huge deficits and unsustainable. As I said earlier, the best scenario for the US economy is a significant slowdown in its economic activities and the worst scenario is deep and long lasting economic recession. In either case exports sector and tourism will be seriously affected. These deficits will further aggravate. This reminds me of the current account situation of the late 1970s.

These growing deficits are being financed from capital inflows comprising mostly short-term speculative capital, proceeds from IRS projects, borrowing from abroad. Short term capital inflows can quit the country anytime. Proceeds from IRS projects are certainly not unlimited. External

borrowings have to be repaid with interests.

My question is: how long can we sustain the deficit in an increasingly difficult international economic and financial context? The music will stop at some stage. How then would we finance the deficits?

Forget recession. Even a drastic slowdown in the pace of economic activities would impact badly on our balance of payments position.

- But the Bank of Mauritius has the foreign currency reserves. Isn't it?

Before I reply to your question, let me stress that the current account of the balance of payments is an extremely important indicator of the economic health of a country. The overall balance of payments position is an economic indicator of lesser importance.

To come back to your question, I should say, yes, the Bank does have the foreign currency reserves. Iceland also had huge reserves and a strong currency until very lately. I can safely say that the foreign exchange reserves of the Bank have stopped growing. It stood at US\$2 billion in August last. In fact, the reserves level seems to have a perceptible tendency to decline. Should the US slip into a deep and long or even a short and shallow recession, the expanding deficit would absorb a huge proportion of our foreign currency reserves. It sounds farfetched just like it did in the 1970s. But the chicken came home to roost and it turned out to be painful.

It really has been a good move to contain the budget deficit. But what we have to be concerned about is the impact of the crisis on an already precarious state of the current account of our balance of payments. It cannot be taken lightly. The outlook is far from a promising one. This is a pressing concern. It's dangerous to live with deficits of this magnitude in an uncertain world. In the event of a deep recession abroad our export performance would take a buffetting and receipts from tourism would drop. These would widen the deficit further and take a toll of our foreign exchange reserves – a repetition of the 1970s.

- But is not the growth rate of the economy which is estimated at 5.6 per cent for 2008 sufficient for us to withstand economic shocks resulting from a possible recession in the US?

I have been having a problem understanding the various estimates that have been put forward in recent months. You will recall the IMF mission visited Mauritius some months ago and came up with a growth forecast of around 8 per cent for 2008. Honestly, I trusted this growth forecast and I felt happy with it. Let me tell you why I trusted the IMF forecast.

Since January 2007 to the end of August last, the foreign exchange reserves of the Bank of Mauritius have risen by about US\$700 million. This increase in reserves is obtained after financing an estimated current account deficit of roughly US\$800 million in the last 18 months. It means that during the 18 months period total capital inflows amounted to US\$1.5 billion or roughly US\$1.0 billion for a period of 12 months. This represents as much as 11 per cent of our latest GDP figure.

We have been made to understand that the economy is being flushed with FDI. One would ordinarily expect the FDI to stimulate activities and boost up

growth. The IMF guys must have plugged this figure in their equation to obtain the growth rate of 8 per cent. Mauritius ought to have been a buoyant economy today. But the Central Statistics Office is now estimating a growth rate of only 5.6 per cent which is the usual trend growth rate of the economy in the 1990s. There is something incomprehensible here.

I have two possible explanations: the first is that we may be having lots of portfolio investment including investment in Treasury bills which by definition is short term. They are fickle and frightened capital having fled from the US and elsewhere. The second is that we are now using more capital to produce less output. The first possibility indicates a clear and present danger of capital outflows. The second tells us that we are making an inefficient use of capital.

"Independence of the Bank of Mauritius has been thrown out of the window"

- What do you think needs to be done to mitigate the unfavourable impact of a possible recession in the US?

We are a small and highly vulnerable economy. As such, we do not determine prices on the world market. We do not determine demand in the world market. We do not determine supply in the world market. We are so small that we can determine neither. In the economists' jargon, we say that we are a 'price taker' in the world economy, not a 'price maker'. In such a tricky and difficult situation, the authorities in Mauritius do not have much leeway to invent new rules in their policy playbook. But they can only endeavour to minimize the adverse impact of an economic recession abroad. I do however recognize that the problems we are facing have a global character and as such we need global solutions. We do not have to be impotent observer either.

Monetary policy, by definition, acts on the demand side of our macro-economic equation. Fiscal policy, by definition, acts on the supply side of the equation. That is why we generally say that there should be an appropriate monetary and fiscal policy mix if the authorities of any country are to strike some degree of macro-economic balance. In the immediate future, the private sector needs to discover gaps in export markets and take advantage of them.

I listened to Hon Rama Sithanen in the radio sometime back. I got a clear, precise and unmistakable impression that he is in full command of monetary policy decisions in Mauritius. He is also the fiscal policy decision maker in the country. With the two arms of macro-economic policy making in the same hand, we should expect a good sweet and sour policy mix to mitigate the adverse impact of a possible economic recession in the US.

The economic recession in the US is here to stay for some time. Such policy decisions take years to fructify. In this business the public at large cannot expect calves jumping around after you put the bull to the cow. But we would at least expect to see some contented cows around.

- You have been the Governor of the Bank of Mauritius for eight years. How did you react when Hon Rama Sithanen said he is responsible for monetary policy?

If I were still Governor of the Bank I would personally not have liked to be in such a soup. Nor did I ever deserve to be in. I would rather again face situations like the MCB/NPF, Delphis and IOIB all

over again than being successively outvoted at the MPC meetings. It's a question of dignity. I had a brief and pleasant chat with the Governor recently at an official function. He reminded me of a conversation I had with the Governor of the central bank of Sierra Leone during the civil war. He had said to me, 'You live a month and it's probably ten years in a condensed time.'

I do not know if I should say that monetary policy making has been hijacked, with or without justification. If I had to speak the correct 'tongue', I should unhesitatingly say that independence of the Bank has been thrown out of the window. Hon Rama Sithanan could defend by saying that independence of the Bank has been abused in which case his intervention as Minister of Finance at the level of monetary policy making and decision is justified. The fact remains that the Bank of Mauritius does no longer have the 'instrument independence' it otherwise would have deserved.

Unless corrective action is initiated, I see two paths for central banking in the country in the immediate future: one leads to the past and the extinction of our central bank and the other leads to the future when our central bank will be dead. We have to choose the right path – and wisely! The Governor seems to favour a high interest rate policy. The Ministry of Finance is clearly supporting a different policy stand. We are in a phase in the history of monetary policy making in Mauritius in which we are driven to consult a medical doctor who is also running a funeral parlour on the side. Like Conservative Chancellor of the Exchequer, Norman Lamont, I would say the Governor is in office but not in power.

The one thing I should tell you is that the Bank has not succeeded in re-discovering the 'neutral rate of interest' for Mauritius since January 2007.

“The Governor should be made accountable to a select committee of the National Assembly”

- More precisely how do you react to the fact that the Ministry of Finance directly or indirectly has a say in the monetary policy Committee of the Bank of Mauritius?

The rate of interest has been kept on hold in the last MPC meeting. The reason for holding the rate on hold is the ever present threat to growth. The balance of risk weighed more on the growth side than on the inflation side. I hope it is a sincere version of considerations that led to the decision for keeping the rate on hold. There is however a flip side to the Ministry of Finance hijacking monetary policy making. I am however not at ease with the Ministry having a say either directly or indirectly on the MPC platform. The risk is that the Ministry of Finance could twist arguments in favour of holding the rate or even reducing interest rate for purposes of reducing the servicing Government debt. I have worked with all the Ministers of Finance since Independence. I can tell you this risk is ever present.

- What is the alternative, then?

Well I have always believed that since the Governor is not an elected representative of the people, he should be made accountable to a select committee of the National Assembly. A new mechanism for keeping out politicians from the monetary policy picture can be devised. The wheel exists; it does not have to be invented.

The ultimate arrangement is to have a competent Governor, who will be in office as well as in power, with a long term vision for the domestic financial sector.

The real growth challenge *By Sameer Sharma (Cont on Pg 6,7)*

When the US Treasury and the Federal Reserve were able to save both Fannie and Freddie, two of the largest and most financially unsound mortgage lenders in the United States back in July 2008, most of us thought that the worst was over. We knew that Lehman Brothers had a balance sheet that was worth a fraction of the paper it was written on and we knew that American International Group (AIG) had made some very bad bets over the years. We even knew that the Lehmans of the world would probably not survive for long and that other regional banks would most certainly disappear or be bought out by larger banks. So then how could most of us have thought that the worst had passed when we have been a ticking time bomb away from total disaster? Being so far away from it all, Mauritians have read with amazement about this crisis as the financial system of the world collapsed all too easily but as bad as you think it was two weeks ago and even now, it is much worse and the problem is that all the analysts and traders of the western world never realized that they would be the ones to finally pull the trigger.

How the global financial crisis happened?

Short selling is a perfectly viable and sound investment policy. In the not so recent past, before you would short a stock (sell high and buy low strategy), you had to borrow it from someone who actually owned the stock. You also had to wait for an uptick of the said stock before you could short it.

About ten years ago however, in the name of 21st century capitalism, a few Princeton professors (who later made their way to the Securities and Exchange Commission) concluded that the old way to short sell a stock was outdated and in the name of price discovery, naked shorting would be much more effective.

In the world of naked shorting, you do not have to borrow a stock or wait for the stock to uptick before you can short it. Shorting a stock is as easy as buying a stock. The simplest strategy to short a stock can be summed up as follows. Buy the stock when it crosses its 30 day moving average; sell the stock when the latter crosses below its five day moving average and short the stock when it crosses its 30 day moving average and continue to do so until it crosses above its five day moving average.

Now traders also look at other technical signals such as the RSI, MACD and so on, but the basic rule remains the same. You can even program this rather easily on MATLAB or even Visual Basics and the computer can do it for you. In the world of the naked shorts, shorting became easier than being long a stock especially when one considers the amount of money hedge funds have been blessed with in recent years. Now Lehman Brothers badly managed the situation and it was simply not transparent enough. Eventually the company, as expected by the market, got downgraded and its stock price plummeted. The price first crossed the five day moving average and all the traders and investors of the world began to sell the stock which pushed the price even lower until it crossed its 30 day moving average. Once that happened, in a systematic way so to speak, everybody shorted it.

This happened on the 9th of September 2008 when Lehman Brothers was trading at USD 12.92 a share.

By the 15th of September 2008, naked shorting had enabled investors to take the stock down to USD 0.26 cents a share. In finance, this phenomenon is

known as beta expansion risk or crowded shorting. This is what created the panic and the credit market which is not to be confused with the stock market completely frozen. Other Investment Banks such as Goldman Sachs and Merrill Lynch could not even fund their operations anymore because no one wanted to lend to them. Once investors realized that, they began to short these stocks too.

That same week AIG got a downgrade and as usual, the computers shorted the stock like there was no tomorrow and of course this created even more panic in the credit market. Investment banks do not have a deposit base. If they cannot get funding through the credit market, they go down. The problem with naked shorting is that it never gave any time for Lehman and others who fell to find buyers or do anything to gain confidence back. Despite a downgrade, a large insurance company like AIG should not have had to pay LIBOR + 8% to get credit from the Federal Reserve to fund its operations. AIG had a less than stellar balance sheet with all those credit default swaps but it was not that bad. Merrill Lynch had to scramble to find a buyer in two days or risk collapse for no good reason beyond a stupid shorting rule. Goldman Sachs was fortunate enough to get a USD 5 billion preferred stock purchase (and warrants too) from legendary Warren Buffet.

The funny thing is that it was not only investment banks and insurance companies that could not get funding, nobody could and even today credit spreads are enough to make you want to stay home. The state of California could not get any short term credit to fund operations. Triple A rated companies like General Electric were issuing short term bonds at between 8-9%. That may not sound too high in 9.8% inflation suffering Mauritius but that is very high in the US. If you were in the export sector and needed short term credit, you had to pay a ridiculously high interest rate. Whatever liquidity that was being provided by the Federal Reserve and later by the European Central Bank was being stored in the vaults of banks, only to be leant at very high interest rates.

It took decades to build a modern financial system but it took two days to bring it down to its knees. Historians will look at the implementation of the now banned (at least temporarily) naked shorting rule as one of the dumbest rules in world financial history. Now it is true that when you get a downgrade, it tends to act as a trigger event on the default swap but that was not the main problem, naked shorting was. Credit derivatives also suffer from high and often underestimated counterparty risk. We are likely to see the setup of a credit derivatives market in the coming years.

Mauritians should be safe with their capital guaranteed investment products

Today the era of the investment bank is over. The remaining investment banks have fused with traditional banks with deposit bases. There were two ways in which investment banks made money. Firstly they bought and sold credit derivatives and they also wrote notes on the more famous capital guaranteed investment products. During this crisis, we have finally learnt that these capital guaranteed products are not so guaranteed after all.

A typical capital guaranteed product, a product that has become quite popular in Mauritius, works as follows.

The real growth challenge

By Sameer Sharma (Cont from Pg 5)

Suppose you invest 1 million dollars in a capital guaranteed product with an option on oil for example. The Investment Bank will take around 75-80% of your money and put it in a bond that will permit it to reach 100% of the capital in x years. It will then sell this bond which offers a fixed rate to a bank in a swap agreement in exchange for cash flows from a mortgage pool that pays even more interest.

Now all this is in theory supposed to be guaranteed by the investment bank to you the investor. With the remaining 20%, the investment bank can for example take a call on oil with a strike price of USD 110. They can reduce their costs further by simply selling a call at a much higher strike price and coolly collect the premium. This is the main reason why you always see return limits in those products. If after year X, the price of oil stands at USD 150 a bbl, then the profit, as you can imagine for a USD 20 investment (say you bought 10,000 call contracts at USD 20 each) is enormous especially when you consider the fact that the investment bank had also sold a call at a higher strike price. You may end up with 10-15% on top of your invested capital but the investment bank will make a lot of money with your money.

When this crisis erupted, all those protected notes were in danger of collapsing because no investment bank could guarantee them as we all thought they could. It is hard to guarantee something when you are about to go bankrupt. The good news for Mauritians who have invested in such products is that the remaining investment banks have fused with traditional banks and can at least guarantee these products again and you should be safe.

Much has been said about the USD 700 billion dollar US Government Wall Street bailout plan and many have been against the Government interfering with the free market. The fact is that there was no other alternative. When banks have failed in other parts of the world in large numbers, capital infusion and the market have tended to solve the problem. What critics fail to realize is that since January of this year, investors have been busy delevering and if anyone has seen the credit markets lately, nobody was lending. The savings rate in the US is near 0% of GDP and it is not stellar in Europe either. Unless a bunch of Arab Sheiks wanted to skinny dip their petrodollars in the financial markets, there was no capital in such large amounts for risky investments. If the market were to come up with the funds, investors would have had to borrow but banks were not lending and so a private bailout could not have possibly happened.

Only Governments can after all print money. So the US Government will buy some billions worth of bad debt, mostly mortgages, keep them for a long time as only a Government can and then when the prices of homes eventually recover sell it for a yet to be determined profit. The US Government will be buying these mortgages at a relatively high discount and the asset is real, it's not a stock but there is an actual home in California or Florida (the most troubled states) behind it. Most of the bad mortgages were leant during the period 2005-2007. Those were the years when negative real interest rates (sounds familiar?) encouraged banks to offer high loan to value packages to borrowers the most. If the Government sits on these loans for long enough, it can break even adjusted for inflation and maybe even make some money.

We still need the private sector though. The first USD 700 billion is only meant to take the worst forms of debt and also reduce panic and credit spreads in the credit market. If the credit market can begin to function with less spectacular spreads again, there is an urgent need for a further USD 1 trillion capital infusion in the US banking sector alone. This is why the Federal Reserve, in a coordinated fashion with four other central banks, has lowered interest rates. The Fed Funds Rate is forecast to be lowered to 1.25% in the not so distant future. There is a need for battered banks to rebuild balance sheets and start to lend again so that the private sector can leverage up cheaply enough to buy more bad debts. All this liquidity that will eventually be pumped in will probably come back to haunt us in the form of higher money supply growth and inflation in three years or so but right now there is no other choice. In such an environment gold may be more king than cash for an investor.

Negative real interest rates end up creating financial crises

There is no doubt that the global economy will now slow down more than previously forecast. The Europeans do not have a system to even pass a bailout package. Most of the revenues of the European Union are destined to subsidies for farmers in socialist like fashion and also infrastructure development for rural areas. There is no budget and more importantly no mandate yet for the bailout that the Europeans will need to pass.

Until there is more clarity, stock markets are going to test new multi year lows. Make no mistake, the Government bailouts may save the patient from certain death but it will take a long time to get out of the intensive care unit, let alone the hospital. The US and Europe are hence now expected to experience recession over the next three to four quarters before a slow recovery sometime in 2010. Emerging market growth should hence continue to slow but will still remain relatively more robust considering the consumption factor as a percentage of GDP in many of these countries despite falling export demand. Bar gold, which could spike, commodity prices are not expected to emulate their 2008 performance next year.

In fact, emerging economies that depended on commodities to boast growth have seen large capital outflows from their respective equity markets in recent weeks. China which through monetary tightening has been able to largely control domestic inflationary pressures is now in a position to increase fiscal spending to stem the negative pressure of capital outflows on growth and lower interest rates. Chinese inflation now stands at around 4.9% and is expected to slow down to 2% by the end of next year. Money supply growth has fallen for four consecutive months.

The Chinese understood that real interest rates are normal and beneficial to an economy while negative real interest rates end up creating financial crises when real estate bubbles, sustained by high credit growth, go bust. The Chinese should come out of this crisis, scared but alive. I often hear people in Mauritius talk about subprime loans in the US but few talk about the fact that it was negative real interest rates that induced excessive leveraging and today the US is paying far more than it gained when Greenspan thought it simple to keep rates negative to "protect American jobs" in the post 9/11 world. In every single country of the planet where rates have

been kept negative for a while, it has ended up creating more harm than good.

When I listen to the speeches of the lobby groups in Mauritius about the health of the Mauritian banking sector, I cannot but remember when Alan Greenspan would say the same things about US banks just five years ago. At least in the US, we could see the bubble coming because unlike in Mauritius, we have various indices that allow us to track the price evolution of real estate. In Mauritius of course, we have the construction price index!

India is also an interesting case. Because the export lobby and big corporations were able to convince power hungry politicians that growth was more important than inflation, the Reserve Bank of India's now former Governor Dr Reddy was pressured to keep rates steady. Today, despite the fact that the world is slowing, India cannot cut rates yet. Ten years ago, Dr Reddy came in as the monetarist hero but in the end politicians made him the scapegoat.

The government of India cannot also increase fiscal spending drastically because since elections are near, the Government has just given out massive and very inflationary wage hikes to the public sector (politicians are the same everywhere they breed) and it is also still reeling from the fiscal cost of high oil subsidies. Come the wedding season, the curry is not likely to be that spicy for the Indian economy but growth should remain above 7% because India is a big country. At least the Indians are responsible enough to have established various indices and benchmarks to better track economic activity, real estate prices and inflation. India, unlike China is behind the curve and will suffer from an economic slowdown a bit more.

The Russians have found themselves embroiled in a financial crisis of their own. Builders and owners in overpriced Moscow and St Petersburg have suddenly not been able to sell their properties and those high Loan to Value ratios no longer look too pretty. So the Russian bear is likely to freeze up a bit more than expected come this winter.

Two definitions of excess liquidity

Let me get to the "economic miracle" that is Mauritius. Since the beginning of this year, I have been warning against inflation and central bank inaction and time has proven me right. I have tried to explain in vain that economic wellbeing is not about socializing the losses while privatizing the gains. Economic wellbeing is not just about a six percent GDP growth target but about increasing the real wealth of all citizens. Annual inflation was up to 9.8% in September 2008.

Much has been made in recent weeks about excess liquidity's apparent disappearance from the banking system. Certainly, the 2% cash reserve ratio (CRR) hike has had a positive impact in terms of controlling liquidity and the mere fact that the Bank of Mauritius (BoM) has been able to conduct Repo transactions is excellent news for anyone who cares about the well being of a central bank. It is no longer a mere spectator and can now act with open market operations because liquidity has been tightened.

We must however differentiate between the macroeconomic definition of excess liquidity which essentially looks at the difference between money supply growth and nominal GDP growth and the microeconomic definition. The latter can simply be defined as the bank's holding of liquidity in excess

of what is required for risk management purposes. If we stick to the macroeconomic definition of excess liquidity, it has not disappeared at all. M2 money supply has exceeded nominal GDP growth for most of the past ten years and the new definition of money supply, Broad Money Liabilities (BML) has been growing well above nominal GDP since last year.

This excess stock of money is very much still here but we must entertain the microeconomic definition of excess liquidity to understand what has been happening in recent weeks. There is firstly a seasonal factor, many in Mauritius have been withdrawing money to pay their taxes. We also know that excess liquidity in the banking sector is concentrated with a smaller number of banks. Some have talked about Mauritius being overbanked but I will stay away from such a discussion. When you hike the CRR, the banks that do not have as much "excess liquidity" may suffer more than others. There was also a need to instill confidence in the banking sector in the very short term and make sure that there was not a perception of a "lack of liquidity".

Negative real interest rates have fuelled credit growth that in my opinion is quite dangerous, especially in a country that lacks any real estate indices, and so the CRR hike came at a bad time, at least if you were a bank. Hence some banks have lots of liquidity and others do not. It does not mean that on the aggregate, our problems are over by any means. Now the latest monetary policy statement tries to tackle this excess liquidity issue and talks about BML growth but money supply has not only been above nominal GDP growth since last year, that is a mere definition issue from M2 to BML. Bar the Monetary Policy Committee (MPC) decision, I have been encouraged by the performance of the Bank of Mauritius and its Governor in recent weeks. Short term Treasury Bill yields and interbank lending rates are up and as someone who does not work for a lobby and cares about how inflation affects the middleclass and the poor, I am very happy but much work still needs to be done.

Economic growth should slow down to 4.5-5% in 2009

I know all too well that most of the politically appointed members of the MPC would have never voted for a rate hike, crisis or no crisis, because let us face it, politicians do not like it when monetary policy is tightened when elections are near. Once Mauritians begin to understand that there are two ways in which you can increase any revenue such as budget revenue (real growth and inflation), they will quickly understand why both major parties in Mauritius have maintained such tight control over the BoM for decades.

Then there are the lobby groups who have their own vested interests in mind. In the name of "protecting jobs", they can get front page news slots galore and engage in their daily dose of economic mumbo-jumbo. That does not mean that there is no real crisis because there is one in some sectors and a fiscal response is needed. The tourism sector will be impacted, perhaps much more than people think come this December and well into next year. The unproductive export sector will also suffer for both external and internal reasons. I do not think that a middle income economy can be selling T-shirts and sweaters forever but that's another issue.

Growth across all sectors should slow down in 2009 and GDP growth should hover between 4.5-5%. If you think that this is bad figure, don't! Unless policy

makers have been suffering from head in the sand syndrome as they so often do and have been ignoring those money supply and credit growth numbers, the Mauritian economy was overheating. That 4.5-5% growth figure is by the way around our 14 year trend line rate of growth. Until I see some total factor productivity growth figures that are a bit above zero for a change in 2008, I will not believe that Mauritius can sustain growth above that trend figure without that growth being inflationary.

The reforms were good and a welcomed break from the failed policies of the previous government, but you cannot improve near zero productivity growth in three years time. Our problem is that we have been declaring victory too early. Populist budgets that may win you votes in the short term do not help in resolving the inflation issue in the medium term. Second round effects across the economy are rampant. Anyone who has looked at those much delayed June 2008 financials of listed companies would notice that.

Three months ago, I talked about how capital inflows can be volatile. The government will need to increase spending in order to stem the negative impact that this could have on growth but it will need to work closely with the BoM because this could also prove to be inflationary. Therein lies the

months before gradually easing during the second half of 2009. The world economy will be more deflationary than inflationary in the medium term but we should not let the world do our inflation job for us because we have domestic factors too that keep inflation high.

Inflationary expectations remain loosely anchored and even this 4.5-5% trend line growth rate remains in danger if we do not control inflation. So yes, the Repo rate does need to go higher still mainly because most people in Mauritius are still earning around 7% in their savings deposits while banks are at least buying up Treasury Bills at around 9%. We need not give everything to the private sector and nothing to the people all the time. That is not capitalism in my book. The lobby groups may be powerful, and their propaganda via the media effective, but policy makers have an obligation towards the population that put them into office, not the lobbies that fund the election campaigns. It is fiscal policy, and not monetary policy, that needs to tackle the real growth challenge that lies ahead.

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Bank Rate (Overall Weighted Average Yield on 91-day, 182-day and 364-day Treasury Bills)



problem when you are behind the global curve. If the lobbies that dot the land were not so powerful, we would certainly have lower inflation today even if we consider those commodity prices.

The Repo rate needs to go higher

While growth is expected to fall towards its trend line rate of growth in 2009 and while money supply and credit growth are expected to cool down to a certain degree, negative real interest rates remain inflationary in Mauritius. If there is one thing that I hope policy makers have learnt from this crisis, it should not be an excuse to keep rates on hold but to realize that negative real interest rates cost more in the long term.

On this note, I am encouraged by the fact that the BoM has begun to give out inflation forecasts. I think that September was the best month for the Bank of Mauritius in a very long time. The inflation outlook however is not that encouraging and the June 2010 5.6% forecast is a bit on the optimistic side. Inflation should continue to rise for another two to four

The likely consequences of the global financial crisis

By Antony Withers (Cont from Pg 1)

failed or been rescued, then we would very likely not be in the mess we are in today.

will undoubtedly be repercussions from the poor decisions made by many banks and institutions.

Mauritius is a “niche market” economy on the global economic stage

Responsibility for executing low risk strategies for growth lies on the shoulders of management and boards

Consumer demand to “live the American Dream” is of course unquenchable at source, but that is simply no excuse for the aggressive pursuit by banks and other institutions of “ill-judged” financial strategies involving significantly higher risks. Placing undue reliance on regulation to have prevented the current crisis also misses the point. Responsibility for executing low risk strategies for growth lies squarely on the shoulders of management and boards and investors/shareholders, not on regulators. There is also the aspect of individual responsibility in not taking on too much debt – this has also been overlooked by many commentators.

Perhaps a few examples of “ill-judged” financial strategies will illustrate the point:

1) The US investment banking model evolved in recent years into one of excessively high leverage. Bear Stearns and Lehmans had leverage ratios approaching 30 to 1, i.e. capital ratios of just over 3 per cent. Lehmans had total assets of US\$ 600 billion and capital of \$ 20 billion, which was akin, as one commentator observed “to playing Russian Roulette with 5 out of the 6 chambers loaded in the pistol.”

2) The over-high dependency of many banks and institutions on wholesale funding through the Repo market, Interbank Lending, Securitisations and other capital market issues meant there was no back-up plan when these sources of finance started to diminish or disappear due to concern about values of assets and solvency. The loan to deposit ratio of HBOS, for example, had reached 177% when it was rescued by Lloyds TSB last week. It was facing the near impossibility of renewing its wholesale funding sources of renewing some GBP 198 billion of funding obligations.

3) Lax underwriting and risk management practices including over-reliance on sophisticated financial models and off-balance sheet vehicles (and the urge to use these to get round regulatory capital requirements) by many institutions have contributed to the disappearance of wholesale funding.

For example granting 100 per cent, 120 per cent or “exploding” mortgages (an initial low teaser interest rate which then escalated significantly) on ever higher income multiples, and on the basis of self-certified statements of income and dubious collateral valuation, eventually undermines the credibility of those lending institutions that indulged in such practices – and which no amount of financial modelling, parking in off balance sheet vehicles, or use of credit insurance can ever mitigate.

4) Quite what possessed AIG Financial Products to write US\$440 billion of credit default swaps to banks on a variety of Mortgage Backed Securities and Collateralised Loan Obligations will make a good book one day as this enormous exposure effectively led to the demise of the company. It found itself unable to post cash-collateral in the required amount as the securities fell in value. Hence, the \$ 85 billion rescue by the Federal Reserve.

The point from these four examples is that all were deliberate management decisions which ultimately led to the rescue or failure of their institutions. Such strategies were foolhardy and thus avoidable. There

Mauritian banks remain soundly based and asset quality good

How the Mauritian banking system is faring in the context of the stresses that are causing such turmoil?

1) Firstly I believe the banking system here has avoided making the key errors of judgement outlined above. Business strategies remain generally soundly based and asset quality good.

2) The banking sector is well capitalised with minimum Tier 1 (equity + retained profits) capital ratios of 10 per cent. Leverage ratios are therefore moderate. Regulation has played a role in setting minimum capital ratios at 10 per cent but conservative management always operates with a cushion, especially in an emerging market economy, so in practice leverage is lower than 10 to 1.

3) The banking sector here, generally speaking, has little if any dependency on wholesale funding in that it makes loans based on deposits. The Mauritian Rupee loan to deposit ratio of local banks currently stands at 74.2% - which leaves a comfortable liquidity cushion. As bankers we are only too aware that there is no Repo Market to speak of and very little inter-bank lending – and, whilst this may be perhaps more by accident than by design, it means that banks' business models here are predominantly based on lending off customer deposits.

4) Risk Management standards are already high and improving further, particularly in the context of Basel 2, which imposes on banks uniform standards of disclosure. The recently augmented scope of the Credit Information Bureau has a key role to play as regards compiling as complete as possible a picture of the total indebtedness of a borrower - so important in determining a borrower's ability to service debt.

5) Availability of finance will always be an issue in an emerging market economy but it seems to me that banks' lending practices have not been lowered here in the way observed in the US and the UK. Regulation carried out by the Bank of Mauritius through its inspections is also quite demanding for information in this area - and rightfully so.

6) There is no derivatives market of any depth yet in Mauritius and to my knowledge, banks here have not purchased or traded US sub-prime mortgage backed securities or associated credit default swaps.

7) Bank Managements are by and large experienced and capable and thus not “fashion-conscious” in the sense that led the relatively young and inexperienced CEO of HBOS, a former consumer goods retailing executive, to chase volume growth - “sell them cheap and pile them high” - financed from the wholesale markets instead of from customer deposits. Perhaps he succumbed too easily to the stock market wishes for accelerated growth.

Banks are always potentially “fragile” creatures by virtue of being typically geared on their capital at levels of 10 to 1. This level of gearing carries with it a high degree of responsibility towards depositors, customers and counterparties as well as shareholders and in my view imposes on executive management and boards of banks a strong duty of care when setting out strategies for growth.

The importance of having robust checks and balances, i.e. good governance cannot be emphasized strongly enough as regards decision making.

The likely consequences of the financial crisis will be that we will be seeing the consolidation of the banking market as a result of the mergers and acquisitions of a number of banks. The highly leveraged independent investment banking business model has probably had its day. Wholesale funding dependencies will be significantly reduced as banks return to lending based predominantly on customer deposits. Significant de-leveraging can be expected as the banking industry shrinks assets and trading volumes. The international bond and capital markets are likely to remain virtually closed, and certainly very expensive to access for the banking community for quite some time until bank balance sheets are repaired and trust is restored. Longer term capital market funding will therefore remain a very scarce as well as costly resource.

Greater transparency in financial reporting and more regulation will become a part of the landscape. Regulation will likely become much more intrusive as regulators look to examine in ever greater detail asset quality, liabilities and capital structures as well as revenues and profitability. The cavalry invariably arrives late however and it would seem that the less foolhardy will, in future, be regulated to the standards that should have applied to the more foolhardy that had to be rescued or went bust.

Uncertainty will remain in the U.S. as property prices have yet to stabilise. The large cost to U.S. taxpayers due to the \$700 billion bail will inflate government borrowing, enlarge the fiscal deficit and likely put downward pressure on the U.S. dollar exchange rate. Lastly there will also be extensive litigation in the U.S. from those shareholders that have suffered significant losses.

This is not to say that Mauritius is “free and clear” of the consequences of the global financial turmoil. It would be to my mind surprising if, as the developed world (individuals as well as banks) lowers its levels of leverage and saves more, consumption and growth do not fall to lower levels for a while. This will likely mean that foreign direct investment and perhaps tourism may plateau for a period of time. Mauritius is, though, a “niche market” economy on the global economic stage and may therefore be less affected than might be surmised.

Maintaining an “even keel” will require sustained both thoughtful economic management as well as regulation in the years ahead for Mauritius to continue its growth path. The good news is that the banking system here is currently well capitalised, generally profitable, enjoys solid levels of liquidity, is pursuing sensible growth strategies and has experienced management i.e. the necessary aspects to finance, and therefore underpin, continued economic expansion.

Much progress has been made over the last few years and, without being complacent in any way, I remain optimistic that the success story that is Mauritius can be continued, despite the challenges posed by the global financial turmoil. If the consequences of low rates of interest are inflationary asset bubbles followed by financial turmoil then it would imply interest rates need to be higher rather than lower. This is therefore a deeply challenging time to be a central banker, let alone a commercial banker.

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