CONJONCTURE

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THINKING OUT OF THE BOX !

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

Why the Bank of Mauritius is behind the curve

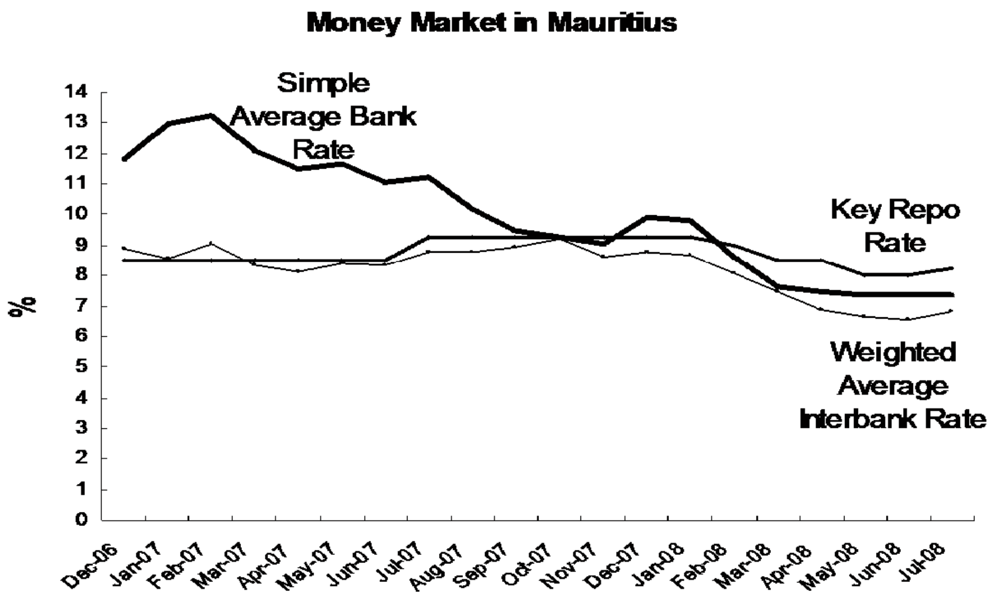
By Sameer Sharma - (Cont on Pg 5,6,7)

The month of July was certainly a rollercoaster ride for the financial market. It all started when the former St Louis Fed President was rumored to have argued that technically, both Fannie and Freddie, two leading mortgage lenders in the US were bankrupt. Within a week, shareholders made sure that the firms lost fifty percent of their market capitalization. Fannie and Freddie paper is owned by institutions and investors worldwide. And yes, if there had been a run on these banks, the global financial system would have titled precariously toward calamity. This led the US Treasury to backstop both lenders by increasing their lines of credit to USD 300 billion and leaving the door open for the US Government to buy an unlimited amount of shares.

All financial sector stocks got pummeled that week and most needed to raise capital. This chance came when various leading indicators confirmed that demand for commodities was slowing. The only place where large financial institutions had made any money was in commodities and as crude peaked at USD 145 a barrel, institutions booked profits. This forced traders who were long crude to short their positions which increased downward pressure on the commodity. Large sums of capital came out of the commodity space and rotated towards financials and the stock market bounced back.

The important Baltic Exchange Dry Index (BDI) fell below its short and medium term exponential moving averages, indicating to us that demand for commodities was beginning to slow on a global scale at these prices. This led to more selling pressure across the commodities space and crude oil fell below important resistance levels. It now appears that limited global oil demand destruction is taking place also that could be partly due to the temporary shutdown of various Chinese factories around Beijing.

Economic data in the Euro area has come in



The liquidity hangover

By Eric Ng Ping Cheun - (Cont Pg 4)

At last the Bank of Mauritius (BoM) decided to increase the cash reserve ratio (CRR) with effect from 15 August 2008. Just before announcing it, Governor Rundheersing Bheenick took great pains to make it clear that he would rather have liked to abolish the CRR altogether. This came as a surprising statement at a time when leaders in the world are harping on the monetary and financial abuses of the international banking system in the wake of the sub-prime mortgage crisis. In a recent editorial, the French daily *Le Monde* raised the question of *"the regulation of the regulator"*.

Fractional reserve banking is the root cause of inflation

So the CRR goes up from 4% to 6%. Along with the key interest rates and the banking prudential rules, the reserve requirement is one of the three tools which a central bank has at its disposal to control money creation depending on the quantity of liquidity in circulation. Having failed on two occasions to make the Monetary Policy Committee (MPC) accept an increase of 100 basis points in the Key Repo Rate, the Governor exercises his exclusive power as the regulator of the banking sector in imposing a hike in the CRR: banks are now required to maintain cash balances at the BoM equivalent to 6% of their average deposits and other liabilities in the two-week period preceding the maintenance period; and the minimum CRR on any day during the maintenance period is 4%.

The quarter point rise in the interest rate decided at the last MPC meeting left a bitter taste of "too little, too late". To correct it, albeit partially, the management of the BoM has been right to act on the reserve requirement ratio in order to avoid in the future bigger adjustments that could be more harmful to the banking industry.

Monetary tightening will be effective in so far as an increase in CRR goes hand in hand with a rise in the Repo Rate. But with the Repo Rate at 8.25%, the BoM monetary policy is still behind the curve. The Reserve Bank of India has moved up not only its Repo Rate by a half point to 9%, but also its CRR to 9% in a bid to stop inflation which has risen to 12.4%.

In Mauritius too, the year-on-year consumer price index jumped by 11.5% in July 2008. Double-digit inflation is likely to stay in view of the liquidity hang-over. Alarmingly, credit to the private sector has nearly trebled its annual growth rate to 24% in the year ended July 2008.

This figure makes a mockery of the notion of monetary stability. It is probable that the entry of new competitors in the banking sector has whetted bankers' appetite for risk-taking in their loan policy. The 100 billion rupees surge in the total balance sheet of our banks in just one year (March 2007 to March 2008) does not bode well for the quality of credit.

It is the role of the Governor to take a sanguine view on the soundness of our banking system, but the BoM needs to gear up its supervision vigilance on bad debts and defaults of payments.

Le textile mauricien a un avenir

Par Sylvain Boyer

Créée dans les années 1970, la zone franche mauricienne a attiré des investisseurs européens pour des raisons fiscales et économiques, une main d'oeuvre bon marché et la franchise de douane avec les pays de la Communauté économique européenne (CEE) suite à l'accord de Lomé. Elle a également attiré des investisseurs hongkongais, car ils bénéficiaient de l'absence de quotas pour leurs livraisons vers les État-Unis et la CEE. Ces entreprises ont prospéré et ont contribué au boom du textile mauricien dans les années 1980.

Cependant, il était logique et prévisible qu'avec l'abolition des quotas en 2005, l'implantation de ces entreprises hongkongaises soit remise en cause, ce qui a provoqué une première crise dans le secteur avec la fermeture de grosses usines et une perte d'environ 20 000 emplois. Ces entreprises sont retournées en Chine où se trouvaient, d'ailleurs depuis toujours, leur quartier générale ainsi que leurs bureaux d'achat, pour bénéficier des avantages d'une main d'oeuvre abondante et à très bon marché. Il reste maintenant à Maurice principalement des entreprises de grands groupes nationaux et quelques entreprises qui étaient les pilotes de l'implantation européenne des années 70 et qui ont réussi à s'adapter aux nouvelles données.

La capacité d'adaptation des PME

A mon avis, l'avenir du secteur textile et de la confection à Maurice est dans les mains de petites et moyennes entreprises (PME) pour les raisons suivantes :

1) Les patrons des PME ont appris à développer perpétuellement des capacités d'adaptation, à toujours trouver dans les meilleurs délais la solution tissu, et à placer leur planning de fabrication en court et moyen terme. Ces entreprises ont compris leur place sur l'échiquier international pour apporter du service, de la réactivité, cela de part leur taille réduite, une capacité à réaliser des séries courtes de modèles compliqués à un prix compétitif, la richesse des cotons, et la capacité à teindre en pièces finies.

2) Les prix mauriciens sont proches des prix turcs pour une expédition avion avec des minima moindres. Maurice a un avantage sur le marché français, car elle parle le français, et donc la communication est facile. Contrairement à la Chine, le décalage horaire n'est que de deux heures en été, pour l'instant.

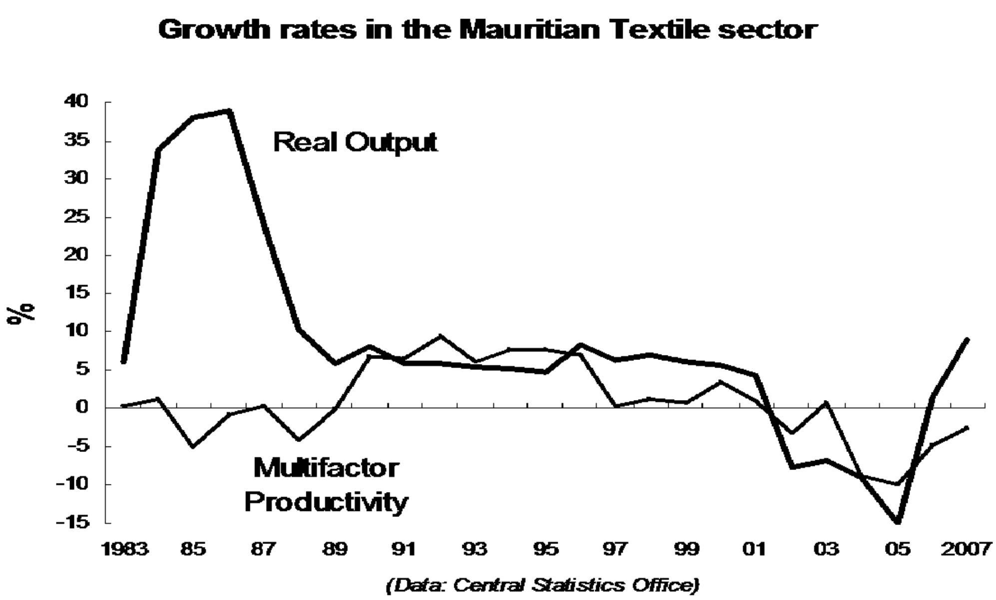
3) Dans une période où certains importateurs limitent leurs achats sur la Chine, échaudés par des risques de quotas, par des prix flottants croissants, à la recherche d'un *sourcing* différent et de qualité, sans droits de douane et avec des séries plus courtes, les entreprises mauriciennes ont la capacité de rester attirantes.

Dans une conjoncture difficile, qu'est-ce qui a poussé *First Confection Company* (FCC) à racheter les actifs de *Manupan* ? Quels sont les atouts de FCC ?

Tout d'abord, ce qui fait la force de cette entreprise, c'est que, en 34 ans d'existence, son personnel a été formé et conscientisé aux exigences du marché international, étant polyvalent et flexible. La compagnie aborde les marchés de la ville classique comme ceux du sportswear fantaisie de qualité. La production est aménagée en lignes courtes et spécialisées selon le type du produit, soit les pantalons classiques avec montage façon tailleur, soit les produits sportswear ou bien les vestes.

Puis, les équipes de marketing et des achats sont réactives et mobiles afin de pouvoir donner une réponse immédiate aux interrogations de la clientèle, que ce soit au niveau du choix des matières premières qui doivent présenter le meilleur rapport qualité/prix que sur le plan des livraisons en amont comme en aval. Ensuite, un soin particulier est mis sur le développement et la mise au point des produits afin de pouvoir échantillonner dans la semaine.

Enfin, FCC est une petite entreprise qui dispose d'une structure de coût légère. Ses capacités sont particulièrement bien adaptées à ses clients qui sont des chaines de magasins. 55 à 60 magasins ne disposent pas de structure import développée ni de bureaux d'achats délocalisés. Par temps de crise, FCC n'est pas à la recherche de longues séries dont les prix sont très bataillés et mis en concurrence dans le monde entier, pour remplir ses capacités.



Le prix n'est plus le seul critère principal

A mon avis, les entreprises mauriciennes auront du succès si elles essaient de sortir du prix comme critère principal. En effet, même si pour de nombreuses chaînes de magasin, le prix reste un critère important, il n'est plus le seul. La flexibilité, la rapidité des livraisons et la variété des produits importent de plus en plus, car dans le monde actuel, les clients veulent éviter les stocks pour pouvoir changer de produit si celui-ci se vend mal.

A force de rechercher les meilleurs coûts en délocalisant dans les pays à faibles salaires, certaines entreprises achètent la matière dans un pays, la teigne dans un second, la brode dans un troisième et la couse dans un quatrième. En utilisant des sous-contacteurs dans chacun d'eux, on a comme conséquence qu'une idée prend parfois jusqu'à huit mois pour aller du design aux entrepôts du client.

L'exemple le plus marquant est celui de Zara : elle achète 15% plus cher à proximité que ses concurrents en Chine, mais elle compense cela en évitant des surstocks et en s'ajustant aux tendances de la mode plus rapidement. Par ailleurs, elle évite les risques de publicités négatives véhiculées par des organisations occidentales qui dénoncent l'exploitation de la main d'oeuvre dans des pays à bas salaires. C'est ce qu'ont subi *Nike* et *Levi's*.

Opportunité en Afrique du Sud

Je viens de rencontrer en Afrique du Sud de nouveaux clients ambitieux et intéressés à bâtir une relation d'affaires durable grâce à une vision commune du business, des séries courtes, des livraisons rapides, des modèles variés et payés plus cher qu'en Chine. Ce type de client/partenaire existe, et il est important de les identifier et surtout de ne pas les décevoir en respectant les engagements professionnels pris.

Les entreprises mauriciennes peuvent également bénéficier de la zone de libre échange qui se met en place au sein de la *Southern African Development Community*. C'est une opportunité pour Maurice de pénétrer un marché sud-africain de 50 millions d'habitants.

L'avenir du secteur textile et de la confection à Maurice est dans les PME qui ont appris à se mouvoir dans un secteur extrêmement concurrentiel et diversifié, et capables de se remettre en cause quand le marché le demande.

Il faut dire tout de même que les PME n'ont pas une capacité financière à toute épreuve pour faire face à des accidents de parcours. Il faut donc les aider par des plans qui leur permettent de restructurer leurs capacités, de les perfectionner, d'encourager la création, de rester mobile et d'être commercialement agressives. Le succès passe par la volonté.

Sylvain Boyer est le directeur général de *First Confection Company*.

Les nouvelles voies du textile mauricien

Par Yusuf Sooklall

Regardons d'abord le contexte dans lequel évolue le textile mauricien. Les productions en quantité se sont orientées vers des pays à bas coût de main d'œuvre comme la Chine, le Madagascar et le Maroc. Donc ceux qui ne font que du basic licencient.

La faiblesse commerciale des entreprises mauriciennes est une réalité : il y a donc peu ou pas de marque mauricienne. Il existe très peu d'investissement dans les compétences du personnel de production : il y a ainsi peu ou pas de compétences spécifiques. Les intérêts bancaires rendent difficile l'investissement : il y a ainsi peu ou pas de renouvellement des machines.

La fin des régimes spéciaux des douanes en entrée et en sortie a enlevé toute protection. La *Southern African Development Community*, dont Maurice est membre, met fin au protectionnisme pour Maurice.

Il existe peu d'outils de garantie de paiement qui sont promus afin que l'exportation soit encouragée. Il n'y a pas de chaîne de magasin ou de « fair distribution mark » permettant de faciliter l'export.

De plus, les acteurs locaux sont refroidis et le crédit a disparu. Le financement de chaque production devient problématique. L'export est donc un risque total et la concurrence des pays exportateurs est forte.

Apprendre les ouvriers à travailler différemment

Que doit-on faire ? Premier axe : il convient de revoir la production. Au niveau des échelles, il faut disposer d'unité spécialisables sur des productions en faible quantité. Les conditions spécifiques de la Chine commencent à 5 000 pièces alors que nous devons pouvoir faire 10 fois 500 pièces dans le même temps.

Au niveau des produits, le tee shirt basic est mort. Grâce à Mario Guillot ou lida O'reilly, le produit haut de gamme a sa place sur le marché local et encore plus à l'étranger. D'où l'importance du deuxième axe : la formation.

Formation technique couture : nous devons former nos ouvriers à l'efficience, non pas en exigeant qu'ils travaillent plus vite mais en leur apprenant à travailler différemment. Il faut aussi éduquer le middle management à la décomposition des gestes et des étapes d'assemblage.

Formation dynamique du secteur : les approches du design et de la vente doit être renforcées au sein des entreprises mauriciennes afin qu'elles cessent de dépendre des contrats, mais qu'elles commencent à produire pour leur propre compte sur leur propre marque. Elles ne doivent pas faire uniquement de l'assemblage, mais doivent être une force de proposition.

Formation Management : l'approche du développement d'entreprise ne s'est faite que sur le model de l'ISO afin de rassurer les clients. Il faut réinventer un entreprenariat mauricien, conquérant, agressif, novateur, empreint des cultures qu'il côtoie et qu'il visite.

Recherche et développement : des unités devraient être dépêchées de par le monde (via internet si nécessaire pour une maitrise globale des coûts) afin de connaître les évolutions des besoins, des techniques des méthodes et des machines permettant de restructurer ce secteur.

Que Maurice devienne une marque de qualité

Troisième axe : les outils financiers. Ainsi de la garantie locale : un fonds de garantie doit être mis en place. Des unités de redressement d'entreprise doivent pouvoir intervenir dès les premiers signes de déséquilibre. Actuellement, l'intervention d'un liquidateur arrive trop tard. Le processus de redressement devrait être légalement sécurisé

Pour ce qui est de la facilitation à l'export : les exports doivent pouvoir être garantis, comme le fait l'Agence française de développement pour les sociétés françaises. Enfin, un plan d'investissement ou un produit financier d'encouragement à l'investissement doit être mis en place pour le renouvellement des machines.

Dernier axe : le marketing. Le pays est connu pour ses plages et le sourire de sa population. Mais il est urgent que Maurice devienne une marque de qualité synonyme d'élégance, de produits fashion, et de prêt-à-porter de faible quantité mais à haute valeur ajoutée.

Toutes ces actions sont aussi nécessaires qu'urgentes. Je sais que beaucoup d'emplois seront perdus lors de cette restructuration. Mais le textile mauricien a un avenir sous certaines conditions.

Il est important que les entreprises parviennent à mettre en place des équipes d'accompagnement dans les unités du textile. Cela afin que les ouvriers et ouvrières qui ont travaillé 10, 15 ou 20 ans dans ces usines ne soient pas dégoûtés par le traitement parfois inhumain qu'ils vivent lors de leur licenciement, qu'ils comprennent le processus de restructuration et qu'ils l'accompagnent. Ainsi lorsque ce secteur sera restructuré et aura trouvé les outils et les débouchés lui assurant un avenir, les ouvriers viendront lui apporter la force de leur passion pour leur métier.

Yusuf Sooklall est le président de *Free Democratic Union Federation*.

Competence in conflict with Caste

By Kris Seeburn

We still live in wonderful Mauritius, don't we? Then why are Mauritians so angry and frustrated with the situation that is going on in the country? There is a massive brain drain of competent professionals. They came back home after their studies overseas but had nothing to grab on. Here they were treated as non-professionals

What is happening? Well, many people would agree with me that knowledge, competence, caste and colour are part of the main problem Mauritius is facing. First, having a vast knowledge is a great quality to possess, but unfortunately not having enough will not get you anywhere in Mauritius.

Second, competence is another good quality to have but is regrettably not enough. It is ideally good if you have a limited competence, which surely will get you somewhere. Third, come to think of caste. The Indians from India take too much importance in it. But Mauritius is not better now and I am even wondering why everyone should change into the right caste that the government obliges us.

Last and not least, colour does not help but hurt us a lot as well. We live in a society which can never accept competent people to be in the right place. This is because we are all influenced by socio-political societies or the likes. Every political party and every government are under their influence.

Competence should prevail everywhere

I know someone who recently went to an interview. It was obviously a masquerade as usual, because the top jobs were reserved to a certain caste, and the guy was not from the right caste. The moment the job was advertised, someone was already selected. So why make a call for candidates? Someone competent enough could have had the job. But he should have been from the right ethnic group or supported by the right people.

It is time that Mauritius recognises all those who are really working with integrity and passion for the country, leaving aside the incompetent. The trouble is that Mauritius is so entangled in the veins of ego, incompetence, caste, and colour that it will never enjoy real success. Mauritius is said to be a reference for Africa, but has not yet evolved into a great and respected country.

At Microsoft, competence prevails everywhere. If Bill Gates or the senior management were to always favour a certain category of people, Microsoft would not have been what it is today. An open company policy to competence brings enthusiasm among employees and breeds success. Proper Management exists only when the company is open to competence and knowledge and does not discriminate.

Kris Seeburn is a lecturer at the University of Technology, Mauritius.

The liquidity hangover

By Eric Ng Ping Cheun - *(Cont from Pg 1)*

While the central bank issues fiduciary (fiat) money in the form of notes, a commercial bank too creates money, called deposit money, at the very moment that it grants a loan to a borrower. The loan is credited by a simple accounting entry to the account of the debtor who, in turn, draws cheques. Hence, the money circulates into other several banks and becomes their deposits, thereby increasing their capacity to lend. By virtue of this money multiplier effect, credit money is being created ex-nihilo (out of nothing).

This is how credit fuels an inflationary process thanks to a banking system based on fractional reserve: banks constantly keep a fraction of their deposits and they lend the rest against collateral and remuneration. The whole structure of the contemporary banking system hinges on the trust of depositors that they will recover their initial money, for they can withdraw their deposits at any moment. In that respect, the method of calculating the reserve requirement ratio is crucial. The BoM defines the CRR as a percentage of total deposits, which comprise demand deposits, savings deposits and time deposits.

Controlling money requires one hundred percent reserve

The problem of fractional reserve banking system is that it will always tend towards a more or less uncontrolled expansion of money. If the BoM is seriously concerned about controlling it, it should consider establishing the condition that banks keep, at all times, a reserve of one hundred percent of the amount of money obtained as demand deposits. The rationale behind it is simple: money received in a current account is fungible money (also called irregular deposit) as it can be withdrawn at any moment through a cheque.

It is unacceptable that a bank considers the funds deposited in a current account as belonging exclusively to itself. If banks were not allowed to lend something which had been deposited with them as a demand deposit, then they would give credits on the basis of real savings according to the relative scarcity of capital. This would put a stop to banking abuses and, consequently, to high inflation.

The old Roman Law had a long standing principle that custody, in irregular deposits, consists precisely of the obligation to have always an amount equal to that received at the depositor's disposal. This means that all acts that grant credits against fungible money are a violation of that principle and an illegitimate act of undue appropriation.

The eighteenth century witnessed a convergence of theory and practice on the one hundred percent reserve requirement. David Hume defends it in his essay "Of Money" (1752) where he affirms that *"no bank could be more advantageous than such a one that locked up all the money it received, and never augmented the circulating coin, as is usual, by returning part of its treasure into commerce."*

At that time, the prestige of the Bank of Amsterdam was based on the belief that it held a reserve of one hundred percent. Adam Smith reported that in chapter 3, book 4, volume 2 of *The Wealth of Nations* (1776): *"The Bank of Amsterdam professes to lend out no part of what is deposited with it, but for every gilder which it gives credit in its books, to keep in its repositories the value of a gilder, either in money or bullion."*

The proposal to establish a banking system with a one hundred percent reserve was mooted by Ludwig von Mises, founder of the Austrian School of Economics, in the first edition of *The Theory of Money and Credit* (1912) written in German. In the English edition, published in 1953, Mises expressly states that *"the main thing is that the government should no longer be in a position to increase the quantity of money in circulation and the amount of checkbook money not fully – that is, one hundred percent – covered by deposits paid in by the public."*

Mopping up liquidity is a sine qua non for a return to monetary stability

The Austrian business cycle theory describes how the fractional reserve banking system generates economic recessions endogenously and recurrently. When a central bank sets short-term interest rates at such a low level that it causes credit to expand artificially, businesses overestimate the value of long term investments and generate a boom led by what Friedrich Hayek calls *"malinvestment"*.

Such an investment-led boom, where a plethora of money is locked into excessively capital intensive projects, sows the seeds of its own destruction. It ends in bankruptcies, a crash in capital spending and an inability for producers to increase prices. Banks call in bad loans and are reluctant to extend credit. Firms liquidate wrongly induced investment projects while households scramble for cash and government securities. Overall, investment and consumption fall.

The Mauritian economy appears to be experiencing this artificial boom. That is why the authorities must take further corrective actions to remove liquidity out of the banking system. The severe correction of the Mauritian stock market over the past months, after a long bubble phase, constitutes an eye-opener.

Mopping up liquidity is a sine qua non for a return to monetary stability. The BoM can achieve it only if the CRR becomes a function of one hundred percent reserve on demand deposits. Since the latter represent 9% of total deposits, the CRR should be raised further to 9%. At the same time, the BoM should regularly conduct repurchase transactions to keep the market buoyant.

Hardly had the BoM raised the CRR to 6% when our commercial banks inched up their prime lending rate by 25 basis points. Instead of reducing their profit margin, they compensate for the incremental operational cost due to the hike in the CRR. They have actually widened their interest spread as deposits rates remain the same. They also keep non-interest charges high.

While I reckon that greed is a natural feature of capitalism, what worries me is the apparent reliance of our banks on the greed motive for the successful workings of their industry. True, a bank cannot engage in a cost-cutting exercise that dents the quality of its services. But it will reap efficiency gains in applying lean management techniques rather than poaching staff with a handsome salary package.

As the Governor of the BoM is not a firm believer in cash ratio, he would support additional increases in the Repo Rate instead of the CRR. He had argued for 100 basis points but got only 25 last time. As a two percentage point hike in CRR is equivalent to a quarter point rise in the lending interest rate, he is likely to propose 50 basis points at the next MPC meeting on 29 September. The quantum seems justified to me although I would prefer to have it in two consecutive steps.

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Why the Bank of Mauritius is behind the curve

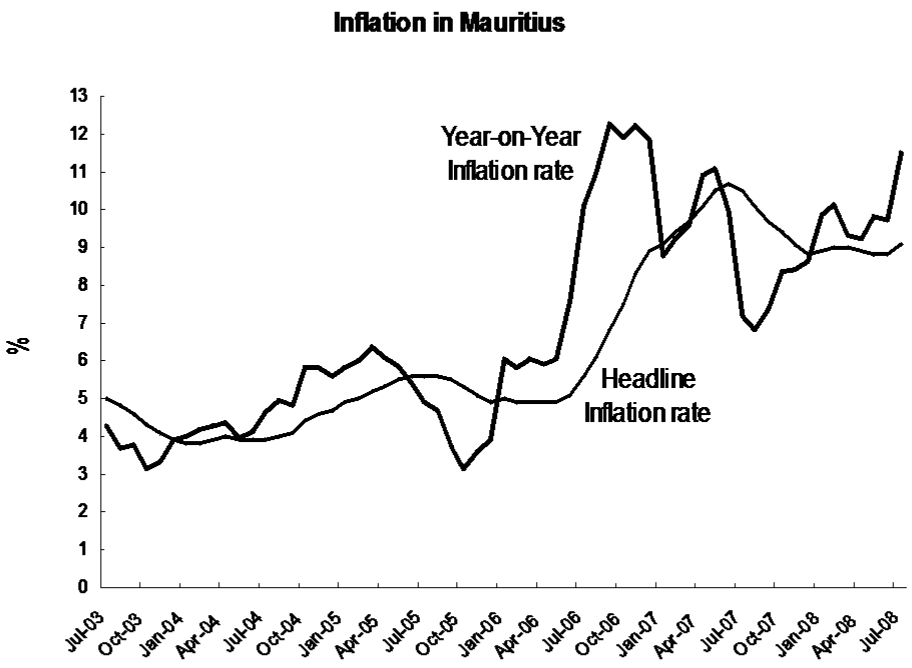
By Sameer Sharma- *Cont form Pg 1 - cont.,Pg 6-7*

weaker than expected with second quarter growth coming in negative although that comes off a high base. The next 6 quarters are likely to be challenging for the Euro area economies which should have a dampening impact on inflationary expectations in the medium term. Emerging market growth (including Mauritius) will continue to moderate but should remain relatively more robust. While the US economy has posted a 1.9% growth rate during the last quarter, the contribution of exports was high (75%). With the Euro area now expected to grow below trend next year (with some economies expected to contract during 1-2 quarters) coupled with a slowing Asia, US exports are likely to come under some pressure.

The recent dollar strengthening has more to do with weakening Euro area economic activity than US economic strength. While short term inflationary expectations of US consumers have crossed the important 5% mark, their 3 year expectations remain at the 3% range as per the latest University of Michigan survey. Hence considering the weaker outlook on the export front coupled with the fading impact of the already paid out stimulus package, growth in the US economy should be near zero over the next two quarters in line with expectations.

Near recession level economic activity coupled with an easing commodity price outlook mean that the Fed is likely to hold off from increasing rates until next year. Medium term inflationary expectations remain contained as below trend economic activity should minimize second round effects. Central Banks that have tightened earlier this year will be in a position to ease next year. The Bank of Mauritius (BoM) is of course well behind that curve.

While long term supply constraints in the oil market remain a reality, in the short to medium term, the outlook on the commodities play has turned relatively bearish provided that geopolitical tensions do not flare up. There is strong resistance for crude at USD 100-110/bbl however (55 week moving average at USD 103 with strong support) and many traders are beginning to call the bottom. The risk of stagflation has fortunately eased in recent weeks.



Lower oil prices should provide some relief to the slowing global economy and could be exactly what the doctor ordered as it allows time for firms to adjust and improve on their battered margins. The dollar's direction will depend on relative Euro area weakness versus that of the US, a difficult scenario to forecast. From a technical standpoint, the recent rally has been overbought with a 14 day RSI of 20.6 although Goldman Sachs believes that the dollar will peak at 1.45 per euro. Bloomberg mean forecasts of 37 analysts (for the US/EUR exchange rate) stand at 1.50 by December 2008 and at 1.40 for 2009. Dollar appreciation has a negative effect on commodity prices.

Real estate bubble is a concern

The long term growth outlook for the Mauritian economy remains rather grim. Since the beginning of this year, I and a few others have been warning against the dangers of excess liquidity and inflation and its impact on long term growth. Narrow money has continued to accelerate to an annual growth rate of 15.1% as at June 2008 while Broad Money Liabilities have grown by a worrying 17.1%. Domestic credit growth has continued to soar to new heights (22.9%) as banks continue to increase lending. The gap between the demand for money (nominal GDP growth) and money supply continues to create even more excess liquidity in the system, thereby making the monetary policy transmission mechanism quasi sterile.

Consequently interbank lending rates have continued to fall well below the recently increased Repo corridor. Excess liquidity growth and a powerless Governor remain the biggest challenge to financial stability in Mauritius and yes the BoM had no choice but to hike the cash reserve ratio (CRR). Despite an easing outlook on the commodities front, the domestic environment remains rather inflationary considering the empirical link between money supply and inflation.

Inflation is always and everywhere a monetary phenomenon. Furthermore, commercial banks in Mauritius have relatively low loans to deposit ratios (66% versus 71% just three years ago) which does not bode well for a deceleration in credit growth anytime soon. A CRR hike was hence necessary.

The potential of a bubble in the commercial real estate sector in particular, a sector that could already be characterized by low rental and cash on cash yields relative to the 7 year bond yield in 2007, should be a concern. The less said about the developers and super rich valuers and contractors, the better! It is high time to set up various real estate indices in Mauritius and have better oversight on valuers.

Negative real interest rates and real estate bubbles go hand in hand and unfortunately Mauritians view real estate as the best hedge against inflation. It would be interesting to calibrate total commercial real estate debt relative to nominal Gross Domestic Product and compare this figure to vacancy rates, something similar to the Wharton Real Estate Index. The cap rates used for discounting the stabilized net operating income (EBITDA minus Operating costs) such as CAPEX during valuation is also a big problem.

With the Pay Research Bureau award, itself a function of inflation coupled with wage pressures in the private sector, second round effects are alive and kicking. In fact, the latest quarterly results of New Mauritius Hotels clearly indicate that payroll increases and general price increases have also hurt the bottom line. My updated econometric model indicates that inflation should continue to remain high ranging between 9.30% and 10.41% in December and between 7.95% and 10.40% by next June. Hence, despite a certain degree of deflationary pressure emanating from a slowing global economy, and a projected gradual easing in year on year inflation towards the 6.3-8.8% range, overhead inflation (along with an unfavorable denominator) should remain alarmingly high well into 2009.

Consequently the negative real interest rate situation will persist for a while yet while inflationary expectations will remain loosely anchored. Such volatility in prices and such a high rate of inflation will continue to destroy the poor and the middle class and distort balance sheets. There is no long term tradeoff between growth and inflation for high inflation is not supportive of the high savings and investment rates needed to sustain high growth in the long term. Companies cannot make rational investment decisions when the weighted average cost of capital remains so volatile. That is how it works in the rest of the world and this is why most central banks have been tightening.

Negative real interest rates are by definition inflationary

The Monetary Policy Statement of July 2008 is a confusing farce. Only in Mauritius will four members of the Monetary Policy Committee (MPC) think that they can signal their concern about inflation by raising the Repo by a mere 25 basis points. After all one learns at a rather early stage in economics that negative real interest rates are by definition inflationary!

In my view, most of the politically appointed members of the MPC are incompetent for the job and must be replaced. If they cannot understand what negative real interest rates are (and that there

Why the Bank of Mauritius is behind the curve

By Sameer Sharma- *Cont form Pg 5*

is no balance between growth and inflation when rates are negative!), then I would be hard pressed to believe that they can comprehend econometric forecasts and a more advanced framework that we will eventually have to adopt. As I have said many times, politicians and vested interests have too much of an influence in the decision making process of the "independent" central bank.

The official inflation rate in Mauritius is a smoothed figure (a moving average) that in itself lags year on year inflation. Year on year inflation is in itself a lagging indicator since it is already in the bag so to speak. Hence if one is to follow the past evolution of a lagging indicator of a lagging indicator, monetary policy itself is likely to be, well, lagging. Core inflation is, of course, one important remedy (although we smooth that too and hence it lags!) but central banks are supposed to be forward looking and must make forecasts of core and overhead inflation (forecasts of growth relative to trend too) before making any monetary policy decision.

The standard approach to forecasting inflation is rooted in the ideas associated with the Phillips curve, the statistical changes between inflation and overall economic activity. The generalized version of the Phillips curve involves variables that are supposed to summarize a large number of inflation indicators. A simple example of a generalized Phillips curve then can be defined as follows:

$$\pi^{12}_{t+J} - \pi^{12}_{t} = \alpha + \beta(L)(\pi_t - \pi_{t-1}) + \sum_{i=1}^{K} \theta_i(L) d_{it} + \varepsilon_{t+J},$$

The above model simply defines changes 12 month (year-on-year) inflation as a function of a constant and changes in monthly inflation lagged back x times and the sum of various lagged diffusion indices (all in continuous time). The obvious problem in the case of Mauritius is the lack of indices/data that can be used as indicators of inflation or economic activity for that matter. It is almost impossible to conduct Principal Component Analysis (PCA) and reduce dimensionality because we have almost nothing to work with.

One can also consider using ARMA models where a "stationarized" inflation variable would be regressed with ARMA terms and other relevant variables (money supply, producer prices, employment, expectations). Such a procedure is also problematic and also suffers from the lack of a large sample size (and also low adjusted R^2 and other statistical issues). For example, if one were to conduct augmented Dickey Fuller tests on the continuous time monthly rate of change of the CPI since January 2003, one would find that the variable in question is a stochastic trend. The problem is that when you work with small samples, you are more likely than not to be finding trends that you may or may not find if you had a larger sample.

In Canada and in many other western countries for example, forecasters take the second difference of the CPI (unit root of the second order). While some may argue that increasing the sample size is the obvious solution, one would need to use the latest CPI basket weights (comparable sample) and properly adjust previous figures. This increases the risk of putting garbage in and getting garbage out (GIGO) but we are forced to try. We must also properly account for monetary policy shifts during the sample period. Canada for example adopted an inflation targeting regime in 1998 and so we must always account for that when forecasting (cut the sample or use Dummies).

Ideally you also want to be forecasting Core inflation and not overhead inflation. For all these reasons, despite the fact that there are many models out there to forecast inflation, we have a problem in Mauritius wherein we do not have sufficient indices to properly model many things. Furthermore we have problems with our monetary policy transmission mechanism due to excess liquidity, and the CPI basket has a high energy and food component.

In such a volatile environment, forecasting is error prone. One way to limit the margin of error is to provide a range of possible inflation rates (confidence interval) which is what I have done but without the necessary data, not much else can be done. It is important for people to realize that forecasts evolve over time as uncertainty turns to certainty. No forecast can however beat good judgment. Negative real interest rates are meant to help stimulate inflation when an economy is close to a recession. Whatever the MPC seems to be practicing these days, it is certainly not economics!

The neutral real interest rate is ever changing

Once policy makers are comfortable with their inflation forecasts, they must determine an appropriate Repo rate that will maintain price stability in the medium term and hence foster sustainable economic growth beyond the five year election cycle. The Governor of the BoM recently talked about the neutral rate of interest which, while positive, if implemented, does have some important limitations. The difficulty policy makers face is that it is not obvious exactly what the level of the neutral real rate is. It cannot be observed directly and it changes over time. The neutral rate, it is held, is one that is consistent with stable prices and a balanced economy and is consistent in the medium term with a closed output gap. According to economic theory, the neutral real interest rate will depend on unobservable variables such as time preferences and growth in potential output.

Econometricians estimate the neutral real interest rate by the Kalman filter. This filter is a computational algorithm that uses imprecise data on a linear system with Gaussian errors to update the best estimate of the system's past, current and future states on a continuous basis and is superior to the rolling window method. This is similar to least squares fitting although it provides real time updates to the fit. A highly simplified model is showcased below (borrowing from Gerdrup 2007).

Assume that the real interest rate ([r.sub.t]) can be split into a trend component ([r.sub.t.sup.*]) and a cyclical component ([e.sub.t]) (see equation (1)):

(1) [r.sub.t] = [r.sub.t.sup.*] + [e.sub.t] where [e.sub.t] ~ N(0, [[sigma].sub.e.sup.2])

The trend component above is defined as the neutral real interest rate. We can also assume that the trend component is itself equal to a constant (mu) which represents the long term equilibrium and a disturbance term which allows the rate to deviate from its equilibrium.

(2) [r.sub.t.sup.*] = [mu] + [z.sub.t]

(3) [z.sub.t] = [rho][z.sub.t-1] + [[epsilon].sub.t] where [[epsilon].sub.t] ~ N(0, [[sigma].sub.[epsilon].sup.2])

The disturbance term itself is defined as following what we call an AR1 process in this example although this can of course vary. These three equations are regarded as a one sided Hodrick-Prescott filter. We of course need a relationship to other economic variables such as the output gap.

(4) [x.sub.t] = [alpha][x.sub.t-1] - [beta]([r.sub.t-1] - [r.sup.*.sub.t-1] + [[eta].sub.t] where [[eta].sub.t] ~ N(0, [[sigma].sub.[eta].sup.2]

The fourth equation essentially tells us that the output gap (x sub t) is a function of itself lagged by one period (AR1) and the real interest rate gap. After imposing the required restrictions, we can use these four equations to get what we are looking for! While actual models are exponentially more complicated than the one presented above, it showcases to the readers that modeling is highly complex and fraught with challenges. Because of data and model uncertainty, results can be off by a couple of percentages. When you are trying to set the right rate, a couple of percentages can be a problem.

In sum you need to have a really good model and a good team of modelers, and policy makers must be able to properly understand the advantages and limitations of such a framework. Furthermore, since the neutral real interest rate is ever changing, there is a danger that policy makers adopt an over active stance in order to follow it along. This can increase the potential for boom bust cycles and create even more economic instability. Econometric modeling is widely used by central banks to set the appropriate rate of interest but no model can beat sound judgment which has sadly been lacking so far.

CRR and Repo Rate should be raised further

The BoM has more pressing needs though. It must continue to raise the CRR to the 7-8% range and then raise the Repo to 9.50% and keep these rates unchanged for 12 months or more if need be. Imported inflation should stabilize and could even be quite deflationary in the coming quarters and hence, a lot can still be done to cool inflation to more acceptable levels by 2010. While the outlook for the export sector remains challenging, it is the state and not the central bank that needs to help them.

The BoM completely misjudged the inflation picture earlier this year and has allowed money supply and credit growth to go out of control and now it is time to act much more harshly. The BoM is behind the global curve and misjudgment has left it with no choice. Capitalism is not about privatizing the gains while socializing the losses. The BoM must also impose more capital controls on foreign speculative money that would make its way towards the bond market if the differential is increased further.

The BoM must also set intermediate inflation targets. For example an 8- 9% inflation target by next June is achievable The BoM can then progressively lower the target over a two to three year period to the 5% mark. The best forecast for inflation in the medium term is the inflation target. Inflation targeting is about setting the right interest rate to achieve the inflation target (via modeling and judgment), thereby enhancing the bank's credibility. In order for Mauritius to have low interest rates in the long term (read low cost of debt), we must achieve low and stable inflation first and that is another reason why there is no long term tradeoff between growth and inflation.

Ironically, we need higher rates now in order to have much lower rates in the future. Year on year inflation will cool down and we can get to a 6% intermediate target sometime in 2010 (bar any major exogenous shock). Central banks cannot control transitory shocks, but they can minimize a generalized increase in prices over a 2-3 year period by controlling demand and credit. Despite what some self proclaimed economists in Mauritius have been telling you, if this was not the case, Central Banks would not exist. The whole world is not wrong and so naïve after all to have tightened months ago! Lobbies can certainly pervert economics.

Recently the Mauritius Export Association (MEXA) called for a more competitive Rupee which is a nice way of saying "depreciate our currency". One of the main reasons why the Rupee has appreciated so much has not only been due to the interest rate differential but also the capital inflows that have made their way to the Integrated Resorts Scheme projects, something the private sector was happy about just two years ago. The biggest mistake policy makers made was to give so many licenses in such a short span of time.

Of course when billions worth of capital enter a small open economy over a short period, the pace of appreciation will increase. If MEXA wants a "competitive" Rupee, something that has no economic foundation, then they need to knock at the door of the Government and the sugar companies for help. Furthermore it makes no sense to make the entire population suffer from high inflation just to keep alive many companies that do not have a comparative advantage in producing the goods that they manufacture.

The fact is that over the last ten years, the average multifactor productivity growth rate of the export oriented sector has stood at a dismal negative rate of -2.1% despite consistent Rupee depreciation. In fact our entire economy is largely unproductive with a decadal average growth of 0.2%. It would have perhaps been better for some exporters to move up the value chain and produce goods where Mauritius has a comparative advantage, and to improve management rather than constantly harp about depreciating the currency, so that their flawed business models can remain viable. If your return on capital employed cannot realistically be brought above your cost of debt (let alone the weighted average cost of capital), it is time to change your line of work.

The BoM and the politically appointed members of the MPC should not be subsidizing such companies while subjecting the population to high inflation. If the state wants to, then let them spend tax payers money to do so and let the tax payers decide at the polls. The BoM should only aim to control capital inflows so that exchange rate volatility is minimized in order to allow viable firms enough time to adjust. Currency appreciation/depreciation occurs too quickly in Mauritius. The foreign currency market needs more participants in order to limit volatility.

More speculation, less volatility

This brings me to a misunderstanding of speculation. If Mauritius wants to have a futures market for the currency (or a commodities exchange), it needs to understand speculation. Without speculation, the futures market cannot work because they add liquidity to the market and allow price discovery to take place. The more the better, but if you have too few, it can be very problematic. The futures market is not meant for the average Joe and margin requirements must cater to this tradeoff. In the oil futures market, if it were not for speculators, hedgers would not be able to, well, hedge and the global economy would most certainly collapse. Speculators do not need prices to rise in order to make money. They can be long, short or take positions in between with complex structured products that can be created.

While "speculation" (are pension funds speculators?) was probably worth some 800 billion dollars, this was spread out in various positions. Some unnamed economists came up with a figure a few months ago saying that around USD 40 dollars of the market price of crude was based on "speculation". That was picked up by politicians in the US Senate (mainly democrats) and soon enough the media picked up on it too. Eventually the unnamed economists' valuation became fact in the media.

Recently the CFTC and the Fed have clearly showcased that this was not the case. Anyone who understands how futures markets work knew that but then again politicians needed someone to blame. At worse speculation can temporarily amplify trends when there is genuine supply-demand uncertainty but they cannot possibly set the trend. Right now, net short positions have amplified the downward trend.

In the commodities market, goods get consumed so there has to be underlying demand! If speculation is strong, one would expect a rise in inventories somewhere, which did not happen. The Mauritian media and the regulators themselves need to be properly educated about contangos and backwardized curves before the setup of a futures market on currencies. If you have too few speculators, then the big institutions will make a killing from arbitrage, and volatility will be high. Mauritius wants to be reducing foreign exchange volatility. Also all hedgers will need to find a speculator to hedge! In sum, the market will not work properly.

The failures of pegging

Now some still dream about a Rupee peg to the dollar or a basket of currencies. They should know that Saudi Arabia, the largest source of oil to the world, is battling an inflation rate of 10.1%, the highest in almost three decades. Flush with record sums of inflows, management of money supply has become an issue rarely encountered by its central bank. Worse, the Saudi central bank is constrained in its fight against surging prices due to the Riyal's peg to the dollar. This becomes a critical issue in today's scenario, when the economies of Saudi Arabia and the US are inversely related. Had we been pegged to the dollar, our inflation rate would have been in the mid teens by now and rising!

In March 2008, the Saudi Central Bank was forced to cut interest rates by three-quarters of a percentage point in tandem with the US Fed despite inflationary pressures. Monetary policy being rendered hapless, the government has had to resort to subsidies and wage hikes to compensate angry Saudis which have made inflation even worse. Can a balance be found? Can a certain level of the exchange rate be set?

The Russian economy is another interesting case. High oil prices have enabled the country to register a growth rate of 8.5%. That would have thrilled Russians if it were not accompanied by 15.1% inflation, far higher than the high 7.8% registered a year ago. Energy prices have made possible $13 billion of extra government spending on items like pensions and state wages, boosting domestic demand and money supply growth.

The Central Bank of Russia's dilemma is a policy that targets both the exchange rate and inflation. It uses the reserves to manage the rouble (sounds familiar?), pumping money into the economy to weaken the currency and stoking inflation. Battling inflation, the Bank of Russia has now been forced to allow the rouble to strengthen twice with indications of further measures to come.

High inflation eventually kills growth

Normally you want to learn from the mistakes of others so that you do not make them yourself, but in Mauritius, some policy makers are bent on trying out failed policies anyway! I do not really understand what the MPC means by upside risks to inflation when it is already at 9.1% (smoothed figure) unless they use Zimbabwean inflation as a benchmark. These "benchmarkless upside this and downside that" statements that take one week to come out are getting rather ridiculous now. That upside risk materialized almost two years ago.

The MPC needs to do the right thing and raise the Repo rate, and the BoM must constrain liquidity enough so that Treasury bill yields move upwards too (more CRR hikes). There is no long term tradeoff between growth and inflation, for high inflation eventually kills growth! I understand fully well that Mauritius has a high trade openness ratio but the problem is that many of our export companies are not productive enough. In fact this indirect subsidy of Rupee depreciation has allowed unviable firms to survive for far too long and has discouraged viable firms from quickly adapting to a competitive global economy.

In last November, I wrote about how our near zero productivity growth record is the single biggest challenge facing our economy (due to the decreasing returns to scale nature of capital input led growth) and the more I listen to the calls for exchange rate targeting, the more I realize why we are in such a mess in the first place. In the end, the poor and the middle class are the biggest losers, but their lobbies are just not that powerful. I too wish that I was wrong seven months ago when I first warned against excess liquidity growth, negative real interest rates and cutting the Repo rate so quickly.

With a slowing (read more deflationary than inflationary) global economy, central banks that had tightened earlier this year could be in a position to ease their stance sometime next year, but our venerable central bank is well behind that curve and must tighten and that is indeed unfortunate. Everyone seems to be talking about a second economic miracle these days. With a near zero total factor productivity growth record, middle class killing inflation, out of control monetary and credit expansion, and a very lagging MPC to boot, we are certainly going to need one.

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En défense des spéculateurs...

Par Jean-Yves Naudet

La faim dans le monde, c'est de la faute aux spéculateurs ; l'inflation aussi ; la hausse de l'euro également ; le prix du pétrole, celui du blé ou du lait encore plus. La pire, c'est la spéculation financière sur les marchés à terme de marchandises : spéculer sur « la faim des autres », quel crime en effet ! Comme toujours, *Le Monde*, fidèle baromètre de l'anti-libéralisme, ouvre le bal : *« La spéculation sur les matières premières affole le monde agricole »*.

En cause : l'instabilité des cours, déconnectés des réalités et une hausse artificielle des prix. Il y a quelques années, on accusait les spéculateurs de ruiner le tiers-monde en poussant à la baisse des prix ; maintenant, on les accuse du péché inverse. Le directeur de l'Office national interprofessionnel des grandes cultures, F. Bova, précise : *« Les matières premières agricoles se banalisent en tant qu'objets de marché »*. L'association générale des producteurs de blé s'inquiète : *« Si on laisse les fonds de pension investir dans l'alimentaire, où va-t-on ? »*.

Le contrat à terme joue le rôle d'assureur

Tout cela marque une méconnaissance des marchés à terme. Ceux-ci existent depuis plus d'un siècle. Ils ont été créés pour les besoins des producteurs ou des acheteurs. Ils n'existent que sur des marchés dont les prix des produits varient fortement. Si un marché a spontanément des prix stables, parce qu'offre et demande s'y adaptent en permanence, il n'y a pas besoin de marché à terme.

En revanche il est des secteurs où le prix varie fortement d'une période à l'autre. C'est le cas dans l'agriculture, on le sait depuis au moins le XVII° siècle avec la loi de King : le prix s'effondre en cas de bonne récolte, et c'est la ruine des paysans, tandis qu'il fait la prospérité des mêmes paysans en cas de disette. Pour ces secteurs, un marché à terme se justifie, et la « spéculation » a des effets positifs.

Prenons le cas d'un fabricant de chocolats. Il doit envisager, un an avant, de discuter avec ses clients, pour fixer le prix des œufs qu'il livrera à Pâques de l'année suivante. Or il ignore tout du prix du cacao qui lui servira à fabriquer les œufs à cette date. Il ne peut évidemment l'acheter un an avant, cela lui coûterait trop cher, et c'est impossible pour des produits périssables. Il doit donc acheter des contrats à terme de cacao, à un an.

Si le prix monte, il ne prendra pas livraison de la marchandise (qui n'est pas forcément de la qualité ou du lieu voulus), mais il vendra son contrat, et avec le gain pourra payer la différence du cours réel. Si le prix baisse, il vendra son contrat moins cher, mais en contrepartie il achètera le cacao moins cher aussi. Le contrat à terme joue ici le rôle d'assureur, garantissant le prix un an à l'avance par exemple. C'est comme une prime d'assurance : si la maison brûle on est content de s'être assuré, si elle ne brûle pas, on a perdu la prime.

En sens inverse, un producteur de blé peut vendre sa récolte à terme, en vendant des contrats, avant même qu'elle ne soit plantée, de façon à en garantir le prix de vente ; c'est ainsi qu'on a des marchés à terme d'œufs frais, alors que la poule elle-même n'est pas née…C'est donc à la demande des acheteurs ou des producteurs que ces marchés existent : c'est une protection contre le risque sur la variation du prix.

Evidemment, le système fonctionne bien parce qu'il existe un lien avec le réel, c'est à dire qu'une minorité de contrats donne lieu à livraison ou achat de la marchandise, pour garantir le lien entre le marché financier des contrats et le marché du physique, ce qui fait qu'à l'échéance les deux prix coïncident.

Sans spéculateurs, pas de marché à terme

Si les entreprises se protègent contre le risque-prix, il faut que quelqu'un assume ce risque ; et c'est là qu'interviennent les « spéculateurs ». Sans eux, pas de marché à terme. Eux font des paris sur les évolutions des prix futurs. S'ils se trompent, ils perdent beaucoup d'argent ; mais s'ils gagnent, ils peuvent en gagner beaucoup ; voilà ce qui choque les bonnes âmes. Mais si les Français ont moins d'accidents, les assureurs font plus de profits. Il n'y a pas de marché à terme protecteur sans spéculateurs nombreux.

Toutes les études montrent qu'il y a toujours une corrélation avec le réel : si le blé ou le pétrole monte, c'est parce que la demande réelle augmente ; la spéculation ne fait qu'anticiper, accroître la tendance à court terme, mais on ne spécule pas durablement contre la réalité. Enfin, ces marchés représentent la meilleure estimation possible des cours réels à long terme, supérieure à toutes les prévisions des experts.

Des simulations précises montrent que sans marché à terme, les fluctuations seraient plus grandes : ils limitent les variations. Les pays du tiers-monde eux-mêmes auraient pu se protéger en intervenant sur les marchés.

Tout cela n'est pas facile à comprendre ; il faut savoir ce qu'est un marché ; c'est sans doute trop subtil pour le lecteur moyen du journal *Le Monde*. La plupart des gens ne sauraient admettre qu'un marché fait toujours mieux qu'un expert : quel désaveu pour les technocrates ! Sérieusement, qui pense que sans marché à terme, le pétrole serait encore à trois dollars au lieu de 120 ?

Mais il est gênant de chercher les vraies causes, donc d'accuser l'Organisation des Pays Exportateurs de Pétrole ou encore de prendre acte de ce que le tiers-monde se développe et achète du pétrole. Il est plus facile de dire « c'est la faute aux spéculateurs » ! Soutenir que les spéculateurs rendent un vrai service, ce n'est pas politiquement correct, mais c'est scientifiquement prouvé.

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