Malta's exchange rate arrangements - a medium-term perspective

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1. The Maltese economy

Malta has a population of around 380,000 living in a land area of just 316 square kilometres. Its GDP amounts to around US$ 3.5 billion in nominal terms, equivalent to about 0.04% of the GDP of the European Union. Because of its small size and lack of natural resources, the Maltese economy is highly open, with exports and imports amounting to approximately double GDP. The main industries are manufacturing and tourism, although the recently established financial services industry and port-related operations have assumed growing importance.

Malta applied for membership of the European Union in July 1990. It was officially recognised as a candidate country in December 1999 at the EU Summit in Helsinki, and has consistently met the Copenhagen accession criteria. The Government of Malta commenced negotiations with the EU Commission in March 2000 and by the end of June 2002 had closed 23 chapters including the one on economic and monetary union (EMU). As is the case with all other applicant countries, one of the requirements for EU membership is participation in EMU, initially with the status of "member with a derogation". Eventually, each new member state will be obliged to adopt the euro, after fulfilling all the necessary requirements, in particular the Maastricht convergence criteria. This obligation will entail a review of exchange rate strategies to ensure a smooth transition to the euro. In Malta it is the Central Bank of Malta that is responsible for recommending to the government any changes in exchange rate policy.

2. Historical background on Malta's exchange rate arrangements

As a British colony, Malta had a strong trading relationship with Britain, and the Maltese currency, known as the Malta pound at that time, was pegged at par to sterling at independence in 1964. However, after the breakdown of the Bretton Woods system in August 1971, and the continued depreciation of sterling in international markets, a decision was taken to peg the Malta pound to a basket of currencies which, besides sterling, included the major continental European currencies and the US dollar. The basket was designed to reflect Malta's international trading patterns in both goods and services. The inclusion of both exports and imports in the determination of the basket weights in part reflected the desire to seek, as much as possible, a balance between a weighting scheme aimed at controlling imported inflation, and one that tends to favour exporters.

Essentially this same exchange arrangement remains in effect today, with some modifications. For example, in the late 1980s the Special Drawing Right (SDR) was included in the basket for a brief period until 1989 when the component currencies were reviewed and reduced to three – the US dollar, sterling and the European currency unit (later replaced by the euro). The weights of the components were adjusted accordingly: the euro's weight was established at 56%, while the US dollar and sterling were assigned equal weights of 22%.

Up to the late 1980s the exchange rate peg was maintained successfully, though to a large extent supported by tight capital controls and restrictions on merchandise imports. From the late 1980s onwards the government adopted significant market reforms and liberalisation policies, including a privatisation programme. In the external sector all restrictions on current payments were removed and

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Malta accepted the obligations of Article VIII of the IMF's Articles of Agreement. Capital controls were gradually eased, though at present there still remain a number of restrictions on capital and financial transactions, particularly in respect of short-term flows. In spite of these far-reaching reforms, the fixed exchange rate policy was maintained successfully and there were no undue pressures on the currency. In fact the level of external reserves remained high and well in excess of the monetary base. The value of the currency was adjusted on only one occasion, in late 1992, when the lira was devalued by 10% in the wake of the ERM crisis and a number of currencies of competitor countries bordering the Mediterranean region also devalued.

3. Why Malta has opted for a fixed exchange rate arrangement

In theory, countries can choose from a wide range of exchange rate regimes. Studies based on the recent experience of emerging market economies seem to indicate, however, that in practice only the two most extreme forms of exchange rate arrangements are viable, namely a credible hard peg, usually associated with a currency board system, or a freely floating regime.

The criteria for exchange rate regime choice emerged from the theory of optimum currency areas, which essentially focuses on a comparison of the two main types of regimes, namely the fixed peg versus the floating exchange rate. The main criteria in this regard can be summarised as follows:

(i) the size and degree of openness of the economy to trade in goods and services;

(ii) the degree of labour mobility and nominal flexibility of wages and prices;

(iii) the similarity in national economic structures;

(iv) the degree of fiscal policy flexibility;

(v) the adequacy of external reserves.

These criteria are considered separately from a local perspective.

Size, openness and direction of trade

The determining factor that qualifies a country as "large" or "small" is the degree of market power it wields. Thus, a large country is one that has the ability to influence its external terms of trade and world interest rates, while a small country does not have such influence and may be defined as a price taker in world markets. A small country, therefore, cannot vary its nominal exchange rate to affect its international terms of trade. Malta belongs to the latter category of countries.

Another important consideration is the degree of openness of an economy to trade. A fixed exchange rate regime tends to reduce transaction costs for countries with a high level of trade. In this regard, Malta's share of trade in GDP is one of the highest in the world, and is likely to become even higher as its economy integrates further with the global economy. This is another argument for maintaining a fixed exchange rate system.

Labour mobility and nominal wage and price flexibility

Another important condition for an optimum currency area is a high degree of labour mobility, both across sectors within a country, and also between partner countries, as this would be an effective substitute for nominal exchange rate adjustment to counteract asymmetric shocks. Past experience has shown that labour mobility in the European Union has been rather low, particularly when compared with the United States. This is not the case with Malta, given its small physical size, although retraining programmes and other institutional changes are sometimes necessary to encourage labour mobility across sectors. Malta's experience of emigration during the 1950s and 1960s has shown that significant net emigration to countries with higher per capita income levels does occur if job opportunities in these countries are available. Thus, EU membership is likely to increase further labour mobility in Malta, given the differences in per capita incomes between Malta and current EU members.

Nominal price and wage flexibility would be necessary if the exchange rate is prevented from adjusting by the type of arrangement adopted. Furthermore, it has often been observed that a high degree of openness tends to increase the responsiveness of prices and wages to changes in the real exchange rate. Since the drive towards EU membership is likely to increase the degree of openness of the Maltese economy, the arguments for maintaining or strengthening the peg are reinforced by this condition.

Similarity in economic structures

A high degree of openness makes an economy more vulnerable to trade shocks if the exchange rate instrument is abandoned. This vulnerability is reduced the more a country's production base and exports are diversified. Thus, in the face of symmetric shocks, similarity in the economic structure of a country to that of its trading partners makes a fixed exchange rate more attractive since it reduces adjustment costs.

In this regard, a comparison of Malta's economic structure, in terms of sectoral distribution of value added and employment, to that of the European Union does not reveal any striking divergences. Even the sectoral distribution of exports and imports does not present glaring differences, except in respect of electronic components, which are somewhat higher for Malta, and chemicals, which have a relatively low share in Malta's trade. On the other hand, the share of private services, excluding wholesale and retail trade, in total employment is somewhat lower than the EU average, partly as a result of a large public sector and perhaps the stage of economic development in Malta. This notwithstanding, the available evidence seems to indicate that a fixed peg arrangement is more appropriate in the face of symmetric shocks.

Degree of fiscal policy flexibility

Under a fixed exchange rate system autonomy over monetary policy is forgone once capital controls are removed. There would therefore be a need for greater flexibility in the fiscal policy stance. The credibility of the exchange rate peg is crucial during an economic reform process, and this necessitates a disciplined approach to fiscal policy. This would strengthen confidence in the peg and discourage speculative attacks on the currency. Under a flexible exchange rate system fiscal policy would not be conditioned to the same extent. Yet a flexible rate may in effect provide a disincentive for change in the fiscal stance even though this may be an underlying cause of macroeconomic instability.

Until fairly recently fiscal deficits in Malta were very high. In 1999, however, a five-year plan was launched with a view to reducing the deficit to 3-4% of GDP by 2004. Since then the preset targets have been achieved. To a large extent, therefore, the fiscal policy stance in Malta appears to be flexible and consistent with the workings of a fixed exchange rate system.

Adequacy of external reserves

Empirical evidence shows that countries with exchange rate regimes that lie between the two extremes of a pure float and a completely fixed exchange rate have become more exposed to exchange rate pressures, particularly in the presence of increased capital mobility. Thus an adequate level of external reserves is an important factor in support of a fixed exchange rate arrangement. In Malta, the gradual easing of capital controls has had some effect on the level of reserves. However, as stated earlier, the stock of reserves has remained high, both in relation to imports and the monetary base, and so far there have been no significant pressures on the exchange rate.

From the foregoing discussion, it appears that a fixed exchange rate is the most appropriate choice for Malta.

4. Future exchange rate policy options

The key question concerns the appropriate exchange rate regime for Malta as it proceeds along its course to Economic and Monetary Union (EMU). The choice lies between further strengthening the peg to the currency basket through a larger euro weight, or adopting a more flexible arrangement before finally shifting once again to a fixed exchange rate regime in its most permanent form, that is, a currency union when Malta adopts the euro.

Three options are available:

(i) a currency board, which would imply a stronger commitment compared to a simple exchange rate peg;

(ii) an exchange rate peg to the euro with a zero band, before participation in the Exchange Rate Mechanism (ERM 2), which is a necessary condition for eligibility to EMU; and

(iii) a more flexible arrangement in the form of an exchange rate peg to the euro, but with a fluctuation margin ranging up to ±15%, which is the maximum permissible under the ERM 2 arrangement.

These are examined separately.

Currency board

The popularity of currency boards arose from the need to address specific economic challenges, in particular historically high rates of inflation. The introduction of currency boards in some central European countries, for example, was mainly underpinned by the need for a relatively smooth transition away from a centrally planned economic system, while in other countries, such as Argentina, it was adopted to control hyperinflation. Indeed, the main objective of currency boards is that of providing credibility to the monetary system and achieving low inflation, as well as preventing monetary financing of government budget deficits.

Malta’s economic circumstances are very different, particularly in respect of inflation and the extent to which a market-oriented economic structure is in place. Over the past 20 years inflation has been maintained at relatively low levels, while the fixed exchange rate has never been exposed to undue downward pressure. In fact, inflation has averaged just 2.6% in the past five years, indicating a considerable measure of nominal convergence with Malta’s major trading partners, and with the euro area in particular. Furthermore, the prohibition of monetary financing of fiscal deficits, which has been in force for a number of years, has now been written into the Central Bank of Malta Act. Given these circumstances and the purpose for which a currency board is normally established, there does not seem to be a compelling argument for Malta to switch to such a regime.

Link to the euro without a band

In deciding on the type of exchange rate regime to be adopted prior to and after accession it should be borne in mind that during this period Malta’s economic policies will be focused more and more on convergence with those of the European Union. Both real and nominal convergence will have to be pursued. Difficulties may, however, be encountered in achieving, simultaneously, the targets set by the Maastricht criteria. For example, the criteria on nominal interest rates and inflation clearly imply a constraint on real interest rates. Similarly, the criteria on the nominal exchange rate and inflation restrict movements in the real exchange rate.

Consequently, one of the major factors influencing the choice of exchange rate regime during the ERM 2 phase is the productivity level in the tradable sector. For an open economy like Malta, the Balassa-Samuelson effect is unlikely to be strong, since about 80% of manufacturing output is exported and, therefore, already competes in international markets, and the tourism sector has long been exposed to international competition. This implies that these sectors may have already achieved the high productivity levels that are necessary to compete in the markets of EU member states. Furthermore, it is estimated that the difference between real GDP measured at respectively market exchange rates and PPP exchange rates is very small. This indicates that the relative price of non-traded goods to traded goods in Malta is similar to that of the European Union, and therefore differences in productivity levels in the traded goods sector are small. In this regard, a fixed exchange rate arrangement with a zero band appears to be a feasible option for Malta.

Link to the euro within an established band

An argument often put forward in favour of a more flexible arrangement, such as the adoption of the ±15% band, is that this would provide a test for the sustainability of the exchange rate, particularly during the ERM 2 phase prior to full monetary union. Furthermore, this would ensure that a country does not enter the euro area at the wrong parity. Even with an exchange rate peg, such tests are still possible, although perhaps not directly observable in terms of exchange rate movements. Other economic and financial indicators do throw light on whether the exchange rate is at the appropriate level. Such indicators normally include current account performance, monetary aggregates, trends in GDP growth, and more importantly the level of reserves and interest rates.

As noted earlier, the level of Malta's external reserves as a proportion of the monetary base has remained relatively stable over the past 20 years, and still remains well in excess of the monetary base, indicating that there is no undue pressure on the exchange rate. Furthermore, the differential between long-term market interest rates in Malta and a synthetic rate based on the Maltese currency basket has remained relatively stable, with a premium of well below 100 basis points on the Maltese lira rate. This is an acceptable country risk premium. These arguments support the view that a fixed exchange rate system without a band still remains a viable proposition for Malta once it enters the ERM 2.

5. Economic policies necessary to support the fixed exchange rate

For the reasons stated above, it is the intention of the Maltese authorities to retain the fixed exchange rate arrangement based on a currency basket centred on the euro. The authorities are clearly aware that the ability to preserve this arrangement depends on the simultaneous implementation of an appropriate mix of monetary and fiscal policies and of the necessary structural reforms. These policies are discussed briefly below.

Monetary policy

The Central Bank of Malta pursues its price stability objective by using the fixed exchange rate as its intermediate target or nominal anchor. The Bank is, therefore, constantly on the lookout for any signs of incipient pressures on the exchange rate in the form of persistent, large movements in its external reserves. Since changes in the reserves reflect developments in the balance of payments, high and continuing current account deficits are usually indicative of an unsustainable payments position. If this translates into downward pressure on the currency, the Bank stands ready to raise interest rates to defend it. Moreover, as capital controls are gradually dismantled, the Bank's ability to pursue an independent monetary policy will be diminished further. It is also understood that as long as Malta maintains a fixed exchange rate arrangement, monetary policy will be inevitably influenced by that of its major trading partners, in other words the European Union.

Fiscal policy

Apart from a flexible monetary policy, the adoption of a fixed exchange rate system within an environment of a liberalised capital account necessitates a prudent approach to fiscal policy. Sound fiscal policies are crucial for macroeconomic stability. Indeed, monetary policy by itself, irrespective of the nominal anchor variable selected, will inevitably fail to deliver low inflation in the absence of fiscal discipline.

A responsible fiscal policy approach is even more crucial for the credibility of an exchange rate peg when the economy is highly open. This can be illustrated by reference to recent experience. For a number of years Malta has run large fiscal deficits. Since government expenditure largely takes the form of wages, salaries and social security benefits, it inevitably gives rise to substantial spending on imports. Unless the private sector compensates for excessive government consumption by saving more, the fiscal deficit thus aggravates the current account deficit, leading to downward pressures on the Maltese lira. Thus, by restraining domestic absorption, tighter fiscal policy will enhance the credibility of the exchange rate peg.

The current aim of the government's fiscal policy is indeed to reduce the deficit-to-GDP ratio to around 3% by 2004 from 5.3% in 2001 and over 10% in the late 1990s. Perhaps equally important, the deficit reduction is now being pursued through measures aimed at seeking efficiency and stimulating economic activity by enhancing the productive capabilities of the economy.

The evidence, therefore, suggests that both monetary and fiscal policies are on track to produce the more sustainable degree of internal and external balance required to sustain the exchange rate peg. But that does not necessarily mean that the overall policy framework is robust enough to guarantee durable economic growth. The latter also requires the implementation of structural policies aimed at raising the productivity of the economy and hence its growth potential, at the same time as international competitiveness is improved.

Structural reform policies

To support the fixed exchange regime, not only should a sound macroeconomic framework be in place but the economy should be in a position to respond to external shocks. This will depend on the degree of flexibility in the economy as a whole. Unlike most accession countries, Malta has always had a functioning market economy, driven by private ownership of productive assets and with much of it exposed to international competition. In general, therefore, the private sector has already proved that it can cope with adverse shocks. In this regard, the flexibility of the labour market has been especially important. This flexibility must, however, be enhanced in order to safeguard competitiveness.

The EU accession process itself has stimulated important structural reforms in product and factor markets, ranging from the removal of barriers to trade to the liberalisation of the telecommunications industry. The privatisation of state-owned firms has also triggered important inflows of foreign direct investment. This notwithstanding, the pace of reform has to be sustained to enable the economy to secure the productivity gains that would increase competitiveness in the tradable sector, buttress the exchange rate peg and bring about real convergence.

A final crucial precondition for maintaining the exchange rate peg and ensuring a smooth transition to the single currency is financial sector stability. In this respect, a regulatory and supervisory framework based on high international standards is already in place. Maltese legislation in this area in fact incorporates almost all the features of the corresponding EU directives, and legislative amendments currently before the parliament will bring about almost total harmonisation. Institutional responsibilities are divided between the Malta Financial Services Centre, which is responsible for the regulation and supervision of banking, insurance and investment services, and the central bank, which is charged with ensuring the stability of the system as a whole. The central bank is also responsible for the domestic payment system, which is being upgraded in line with developments in the euro area.

6. Conclusion

There is strong evidence to suggest that Malta should maintain its fixed exchange rate regime, though increasing its link to the euro before participating in ERM 2. The current exchange rate strategy has made a valuable contribution to the economy in the shape of stable prices and a predictable trading environment. Stability also enhances the country's attraction as a centre for business and investment, which, in turn, facilitates growth and a more rapid integration into the global economy. However, it is clearly understood that this exchange rate strategy cannot succeed if it is not supported by strong macroeconomic fundamentals. These can only be delivered by a monetary policy that is consistent with the exchange rate target and by a prudent fiscal stance. An equally vital ingredient in the policy mix is the implementation of structural reforms designed to raise productivity levels throughout the economy and thus strengthen its competitive edge. Finally, the maintenance of a sound financial system remains a necessary ingredient for macroeconomic balance and a stable exchange rate.

It is also relevant to mention that the prospect of EMU membership will reinforce the Central Bank of Malta's current commitment to price stability through the use of an exchange rate peg. The adoption of the euro would thus represent a logical step for an economy already closely integrated with that of the European Union and influenced by its monetary policy. This goal, however, will not be achieved without a clear commitment to the continued pursuit of fiscal consolidation, structural reform and financial stability.