Michael C Bonello: The institutional, economic and monetary policy implications of EMU on countries applying for accession to the EU

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at a workshop organised by the University of Malta, Gozo Centre, Gozo, 16 November 2002.

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I guess we are by now all too familiar with the fact that a country's eligibility to join the European Union (EU) rests on satisfying the Copenhagen criteria, including the obligation to achieve compliance with the EU acquis and to show a commitment to the aims of the Union, including those relating to EMU. Indeed, unlike Denmark and the United Kingdom, the current wave of accession countries are all expected to join EMU eventually. This implies that they will also have to join the Exchange Rate Mechanism (ERM II). Participation in ERM II is in fact one of the Maastricht criteria which must be met before admission to the euro area. This requires the national currency to remain within the fluctuation margins of this mechanism for at least two years without resorting to a devaluation against the euro.

What makes ERM II more important than the other Maastricht criteria?

Participation in ERM II is not the only criterion which the accession countries will have to meet before being able to join EMU. Prospective members of the euro area are in fact also required to satisfy the other four Maastricht criteria, which relate to inflation, the interest rate, the fiscal deficit and the public debt. I propose to focus on the ERM II criterion for two reasons.

First, the timing of EMU membership is conditioned by the two-year period embedded in the exchange rate criterion. In Malta's case, if it is part of the next enlargement in May 2004 and even if it fulfils the other Maastricht criteria, the earliest that it will be technically able to participate in EMU is mid-2006. Earlier adherence to the other criteria, therefore, becomes almost irrelevant.

Second, the obligation to participate in ERM II has implications in terms of the preparations which a national central bank has to make in view of its eventual entry into EMU. This is because it impinges directly on some of the central bank's main functions – such as the formulation of monetary and exchange rate policy and the management of external reserves – something which is not true, for example, of the fiscal criteria. ERM II is thus of particular interest to central bankers.

Against this background, I will now review some issues which eventual participation in ERM II, and later in EMU, raises for policy makers in Malta.

No significant change in the parameters governing monetary and exchange rate policy

EMU entails the adoption of the euro and the surrender of autonomy in the area of monetary policy to the European Central Bank (ECB). At this point, however, it is relevant to mention that the additional loss of independence which EMU would represent for the formulation of monetary policy in Malta is minimal. This is so because the Central Bank of Malta already has limited freedom of action since it operates a fixed exchange rate regime and exchange controls have been almost entirely removed. This means that the Bank must adjust domestic interest rates in response to movements in capital flows in a way which is consistent with the peg. Too low an interest rate would encourage investors to move out of domestic assets, creating downward pressures on the currency, whereas too high a rate could attract interest-sensitive capital flows which could create upward pressures on the exchange rate.

To a large extent, these conditions already govern monetary policy and reserves management in Malta. While the Monetary Policy Advisory Council does take domestic economic conditions into account, decisions on official interest rates are, in fact, primarily conditioned by trends in the official reserves and in the interest rates on the currencies which make up the basket to which the Maltese lira is pegged. Malta's eventual participation in EMU, therefore, would not involve any significant departure from the current situation in terms of the degree of autonomy enjoyed by the Central Bank of Malta in setting interest rates.

In view of the incompatibility of monetary policy autonomy, full capital account liberalisation and a fixed exchange rate, EMU participants have given up independent national monetary polices in favour of the free movement of capital and the adoption of a single currency. The main driving force behind this decision was the desire to overcome the obstacles to the completion of the Single Market and to progress towards monetary and, eventually, economic union. A single currency was a logical step in this regard.

Given the constraints which the adoption of the single currency entails, the emphasis which the Treaty puts on containing fiscal deficits and on labour mobility is understandable. In this set-up, in fact, the adjustment to asymmetric shocks has to take place through fiscal policy and the labour market. Since labour mobility within the Union is still weak, however, in practice this means that the onus of adjustment falls on fiscal policy. Fiscal consolidation thus remains a necessary precondition for the success of EMU. Indeed, whereas it could be argued that the Stability and Growth Pact precludes fiscal policy from responding to short-term domestic needs, it is equally true that the constraints arising from that Pact are meant to ensure that governments in the euro area have the necessary room for manoeuvre over the medium-term. The presumption here is that by achieving close to balance or surplus positions, governments would be in a better position to deal with normal cyclical fluctuations. In addition, the commitment to refrain from excessive deficits is also a necessary condition for the success of EMU itself. This is the case because if such a deficit occurs in one of the larger euro area members, the inflationary pressures resulting from that deficit could instil an upward bias in ECB interest rates.

For accession countries, contained public spending and flexible labour markets are also necessary from the point of view of achieving nominal and real economic convergence. Excessive deficits would not only accentuate inflation differentials, undermining the ability of these countries to fulfil the Maastricht criteria, but could also crowd out private sector investments, delaying progress in structural reforms and convergence in income levels. Given that large deficits and labour market rigidities tend to weaken a country’s ability to achieve both nominal and real economic convergence, policies to address these issues are an integral part of the preparations which accession countries are making in advance of EMU.

The rationale behind ERM II

ERM II is a fixed exchange rate regime, involving the adoption of a central exchange rate against the euro in agreement with the ECB. This rate is then allowed to fluctuate within specified margins, normally +/- 15%, but narrower bands may be adopted subject to mutual agreement.

The rationale behind ERM II is that, if a country succeeds in maintaining the value of its currency against the euro within the fluctuation bands for a period of two years, then it would be reasonable to assume that the country would be able to deal with the binding constraints of EMU. During this phase, accession countries will have to prove that they are able to put up with the disciplines inherent in a fixed exchange rate without imbalances arising in other sectors of the economy. That is why accession to EMU is conditional on prior participation in ERM II. Furthermore, it would be unfair on the twelve euro area countries if the EU were to demand less stringent conditions of the present wave of accession countries.

Upon EU accession and during the ERM II phase, Malta, like the other accession countries, would have the status of a “country with a derogation”. Since ERM II neither entails the formal transfer of monetary policy responsibilities to the ECB nor the replacement of the domestic currency by the euro, it will not, as I have already indicated, involve any significant departure from current practice, although it offers more flexibility than our current fixed exchange rate regime, which does not involve any fluctuation band. Another difference is that the obligation to defend the central exchange rate under ERM II would be binding on both the ECB and the Central Bank of Malta. Both institutions would be expected to intervene to preserve that value. This in turn explains why both the central rate and the fluctuation bands will have to be fixed by mutual agreement.

The current regime also differs from the conditions governing ERM II in terms of the anchor currency. Strategies based on free floats, pegs to currencies other than the euro and crawling pegs are not compatible with ERM II. Consequently, Malta’s exchange rate, which apart from the euro is also linked to the US dollar and Sterling as anchor currencies, will have to be revised. The question we then have to answer is, “What exchange rate strategy should Malta pursue in the run-up to ERM II?”

Experience suggests a move to more flexible regimes prior to ERM II

Whereas the strategy to be pursued during EMU is prescribed in the Treaty, and while the institutional framework governing ERM II limits the strategies which would be compatible with that arrangement, in principle any exchange rate regime is permitted during the phase preceding ERM II. What matters is that the selected regime should contribute to real economic convergence with the economies of EU member countries, macroeconomic stabilisation and the transition to a functioning market economy capable of dealing with the competitive pressures within the EU.

Indeed, accession countries are currently pursuing very different strategies. This diversity of exchange rate regimes can be explained in terms of the progress made thus far by these countries in disinflating their economies; their degree of openness; the extent of capital account liberalisation; and the adequacy of their reserves.

Generally speaking, during the early phase of transition when many accession countries were faced with the task of disinflating their economies and restoring the credibility of monetary policy, fixed exchange rate regimes were the norm. Then, a credible anchor in the form of the currency of a low-inflation trading partner was viewed as the best strategy for meeting these objectives. The rationale is not difficult to understand. The persistence of inflation differentials under a fixed exchange rate regime would lead to an appreciation of the real exchange rate, undermining a country's external competitiveness. The mere adoption of a fixed exchange rate indeed signals the intention to subordinate monetary policy to exchange rate policy, adding to the credibility of anti-inflationary monetary decisions.

As these countries progressed with disinflation and as the emphasis shifted towards integration with the EU, the continuation of structural reforms and attracting sufficient capital flows to enhance real convergence, a gradual move to more flexible regimes become feasible.

At first sight, such a shift would also seem to be indicated for Malta, particularly as the capital liberalisation programme approaches full implementation. Moreover, a flexible regime has the additional benefit of yielding exchange rates that reflect market forces and economic fundamentals, enabling the authorities to gauge the proper level of the equilibrium exchange rate as the date of entry of ERM II draws closer. A more thorough examination of the facts, however, suggests otherwise.

Malta likely to maintain a fixed exchange rate regime

Whereas the liberalisation of capital flows could indeed lead to upward pressures on the exchange rate in some countries, such pressures are unlikely to be overwhelming in the case of Malta, not least because a functioning market economy already exists. Econometric evidence in fact suggests that because of its openness, the Maltese economy has already been exposed to significant capital flows, such that the impact of full capital account liberalisation is likely to be significantly smaller than that in some other accession countries . To some extent, the Bank's external reserves, which have always remained well above 60 per cent of its liabilities as required by law, can also act as a cushion against external shocks. In addition, the structure of the Maltese economy is already very similar to that of its main trading partner, the EU, which makes a fixed peg arrangement more appropriate in the event of a symmetric shock.

Empirical evidence also shows that the fixed exchange rate has been a valuable nominal anchor in restraining price and wage increases. Inflation has in fact remained below 3% during the past five years. This has been confirmed in an ECB assessment of Malta's monetary and exchange rate policy in connection with the Pre-Accession Economic Programme Report for 2002, where it is noted that the current regime has served Malta well in promoting real and nominal convergence. In view of these considerations, and given the importance which exchange rate stability has for trade and investment, the current regime remains the preferred arrangement for Malta.

Taken together, therefore, the institutional arrangements governing ERM II and the successful experience with the current fixed exchange rate regime suggest that the way forward will consist of a gradual reduction in the weight of the US dollar and sterling in the currency basket, such that by the time Malta will be ready to join ERM II the euro will be the sole reference currency. If the United Kingdom were to join EMU in the meantime, this would automatically raise the proportion of the euro in the currency basket, making the approach to ERM II that much easier. Consistently with this objective, the weight of the euro in the basket was increased from 56.8% to 70% last August.

Given that Malta's optimal exchange rate strategy in the run-up to ERM II has been identified, the next question concerns the choice of the central exchange rate and the fluctuation bands.

The choice of the central exchange rate and fluctuation bands

Some might argue that the choice of the central rate is not vitally important. After all, the central rate can be re-aligned if necessary, although such a move would require the agreement of the ECB and the other national central banks participating in the euro area. In practice, however, the initial central rate chosen is important because it conveys a signal to the market about what the ECB and the national authorities consider to be the equilibrium exchange rate. The determination of the central rate is also crucial because if the selected rate turns out to be incompatible with economic fundamentals, market intervention by the ECB and the Central Bank of Malta could become too frequent in relation to the resources available.

Determining the appropriate central rate, however, is not an easy task. Nevertheless, though the available evidence suggests that in the current economic climate the Maltese lira exchange rate is sustainable at prevailing levels, work is being undertaken in order to estimate an equilibrium rate.

The second choice concerns the fluctuation band. It is a matter of choosing between the lower degree of uncertainty and volatility associated with a narrow fluctuation band and the flexibility inherent in a wider fluctuation band. On the one hand, the flexibility necessitated by the absence of capital controls would strengthen the case for a wider band. On the other hand, Malta's dependence on foreign trade and investment, the country's track record with a fixed peg as well as the Central Bank's commitment to price stability would seem to justify the adoption of a narrow band. As real convergence is progressively achieved and as structural reforms proceed, the case for a narrow band would also become stronger.

Should this latter path be followed, the burden of adjustment to external shocks would, of course, have to be borne by the real economy. In the first instance, this means pursuing a prudent fiscal policy. The current aim of fiscal policy is indeed to reduce the deficit to GDP ratio to around 2.5% by 2004, from 5.3% last year and over 10% in the late 1990s. By restraining domestic absorption, tighter fiscal policy should enhance the credibility of the exchange rate peg. Moreover, a smaller borrowing requirement also frees up resources for the private sector and helps to contain upward pressure on interest rates, thereby stimulating economic growth. Finally, bringing the budget deficit closer to balance will then give fiscal policy the leeway to respond in the event of adverse shocks or cyclical downturns.

The response to shocks will also depend on the degree of flexibility in the economy as a whole. Unlike most accession countries, Malta has a long experience of 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.

As is the case with any exchange rate strategy, the sustainability of the central rate and, with that, the fulfilment of the Maastricht criteria, will hinge on whether that rate is compatible with economic fundamentals. Fulfilling this criterion requires an unconditional willingness to defend the external value of the currency. For policy makers that means a commitment to abstain from practices that could be in conflict with the objectives of exchange rate policy. For participants in foreign exchange markets, including the central bank, it implies the need to intervene in the market without hesitation.

Within this context, the importance which the acquis assigns to the independence of central banks is understandable. Whereas the Central Bank of Malta has been formulating monetary policy independently since 1994, there is no doubt that the recent amendments to the Central Bank of Malta Act have put the Bank in a better position to defend the peg. The amended Act, in fact, not only establishes price stability as the primary objective of the Bank, but it also protects the Bank from any external interference and provides it with the operating flexibility necessary for effective and prompt intervention in foreign exchange markets. With the coming into force of these amendments, Malta has achieved a high degree of compliance with Chapter 11 of the acquis on EMU.

Another 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 the legislative amendments I have just referred to have brought about almost total harmonisation. Institutional responsibilities are divided between the Malta Financial Services Authority, 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 Bank is also responsible for the domestic payments system, which is being upgraded in line with developments in the euro area.

According to a recent background paper prepared by the ECB , Malta already has a financial intermediation mechanism that broadly mirrors the composition of different market segments in the euro area member states. Despite the growth of non-bank financial intermediaries and the development of money and capital markets, the banks remain the key financial institutions. Total bank assets amount to more than double GDP, whereas the ratio of domestic credit to GDP is broadly in line with the EU average. More importantly, the banking system is generally healthy, enjoying ample liquidity and a broad capital base, with the ratio between own funds and risk-weighted assets standing close to 14%.

Some institutional aspects of EMU preparations

I shall conclude with some remarks on preparations of a more operational nature for eventual integration within the ESCB. An important area in which central banks will have obligations towards the ECB is that of statistics. This is because the formulation of monetary policy in the euro area rests on the timely availability of standardised economic, monetary and financial data from participating national central banks. In recognition of this future obligation, the Central Bank of Malta established a Technical Committee on Financial Statistics in 2000 to identify the changes required to the way statistics are classified and reported by the Central Bank and other financial sector reporting agents in order to comply with ECB and Eurostat requirements. This committee, which includes representatives of all the interested institutions, has already agreed on the necessary changes to the reporting forms through which credit and financial institutions submit data to the Central Bank and the Malta Financial Services Authority. Monetary and financial data are in fact already being reported to the ECB and Eurostat. In the meantime, significant progress has also been made with respect to the establishment of a common direct reporting database between the Central Bank and the National Statistics Office for the dissemination to the ECB and Eurostat of balance of payments data and data relating to Malta's investment position.

In the area of payments, a new settlement system has been established for the handling of large inter-bank payments in line with EU and other international standards. This system, called the Malta Real-time Inter-Bank Settlement System (MARIS), provides for the immediate delivery and settlement of wholesale financial payments in line with the principle of finality adopted in the acquis and will eventually be integrated with the EU's TARGET system.

In the meantime, the Central Bank has already set up two committees to identify the changes which need to be made to the instruments, contracts and control procedures which the Bank uses for monetary and foreign exchange operations. In both cases the necessary changes have been identified and are in the course of implementation. With the cooperation of the Malta Police, the Central Bank is also strengthening its capacity to detect cases involving counterfeit notes and to report such cases to the ECB and Europol. Finally, the Bank is analysing ways in which the composition of its official reserves could be revised as Malta progresses towards EMU membership.

As noted above, a key aspect of the smooth operation of EMU is fiscal discipline. Earlier on, I made reference to the Stability and Growth Pact. This, however, is but one element in the framework which applies to the co-ordination of economic policy and fiscal surveillance in the euro area. In particular, euro area members are also required to submit reports outlining their policy intentions over the medium-term. As part of the preparations for their eventual participation in EU surveillance efforts in this area, accession countries have already started to submit Pre-Accession Economic Programmes (PEP). The Central Bank of Malta has been collaborating with the Ministry of Finance and the Ministry of Economic Services in the preparation of the necessary documentation. To date, like all other accession countries, Malta has submitted two PEPs.

Conclusion

The road to EMU is clearly not an easy one as the tasks involved are both numerous and difficult. For a small central bank with limited resources they represent a formidable challenge. On a policy level, there are reasons to believe that the current fixed exchange arrangement should ideally be maintained until Malta adopts the euro. It should also be clear, however, that the Government's commitment to contain the fiscal deficit and to pursue structural reforms is a vital prerequisite for the sustainability of the fixed exchange rate regime. The importance of fiscal discipline and of product and factor market flexibility will indeed increase as Malta progresses towards EMU.