Michael C Bonello: The challenges faced by the Maltese economy ahead of euro adoption and their implications for monetary policy

Interview with Mr Michael C Bonello, Governor of the Central Bank of Malta, by The Times, 2 March 2006.

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1. It has been reported that Malta needs a real growth rate of 4 per cent per annum if it is to reach the EU average per capita GDP in 20 years. Growth, in fact, only averaged about 0.5 per cent in real terms in the five years to 2005. Are you preoccupied?

More important than expressing concern is the need to understand the reasons for this slow growth. Since the turn of the century the economy has faced challenges of both external and domestic origin, and the recent period of weakness reflects the size of the task ahead.

The slowdown began in 2001 with external shocks to the key sectors of tourism and semi-conductors. Since then the relatively slow growth in Malta's main trading partners has been compounded by the competitive pressures unleashed by globalization and by our integration in the single European market, all of which has forced an acceleration in the pace of restructuring of the manufacturing sector. At the same time that we were opening up our markets, low-cost producers were undercutting our competitiveness, particularly in labour intensive sectors. These, along with the sharply higher price of imported oil since last year, are among the factors that have contributed to the slow down. In the long run the changes brought about by globalization and by the correction of the economy's structural imbalances should enhance growth prospects, but the coincidence of the same two events has made for a difficult transition.

It is also true that the economy could have been better prepared to cope with such shocks. That, however, would have required a greater degree of foresight and a timely reordering of priorities in the allocation of scarce resources. Regrettably, our national governance system is not conducive to the achievement of consensual solutions to issues having longterm implications. This explains why the process of reform tends to be rather slow and the outcome often less than ideal.

The persistence of rigidities in product and labour markets, a partial wage indexation system, failure to anticipate the consequences of demographic trends and insufficient investment in physical infrastructure and in human resources in earlier years are some of the reasons why the economy lacks the flexibility to react to external developments as successfully as some of its competitors.

This does not mean that the economy is not headed in the right direction. Appropriate policies are indeed in place in several key areas, policy coherence is improving and financing is available to implement the national reform programme. This much has been acknowledged by the EU Commission and the IMF. As the restructuring process moves on, moreover, the industrial sector is increasingly composed of more resilient firms producing higher value added products, while new, important sources of output growth are emerging, such as financial and ICT-related services. I, therefore, believe that there are grounds for cautious optimism, provided we persevere. It will, however, take time; there are no easy short cuts to faster growth.

2. EU accession was meant to boost our trade. In fact, exports were down by 11.3 per cent in 2005, although the EU's share edged up slightly to 51.5 per cent. Don't tell me the problem is the EU economy, not ours ...

First, let's get the facts right. While Malta's exports did fall by 11.3% last year, exports to the EU were only 5.2% lower. The drop, moreover, was entirely due to reduced sales of electronic goods and clothes. Sales of some other product categories to the EU increased. And do not forget that Malta is also increasingly an exporter of services, which are not included in these numbers.

Second, in the real world it is hardly ever the case that things are either black or white. For a start, it is a proven fact that membership of a single market, particularly in the presence of a monetary union, results in a marked expansion of intra-market trade. That has been the experience of existing EU and euro area members. It is not reasonable, however, to expect that to happen in the first full year after membership! Exploiting the new market opportunities takes time because institutional structures and operating practices need to be adapted. Some of the funds Malta is getting from the EU are being used precisely to strengthen the economy's export potential.

At the same time, it is also true that the EU economy did not grow as rapidly as anticipated in 2005. It expanded by 1.6 per cent, compared with 2.3 per cent in 2004. A higher proportion than ever of consumer demand, moreover, was satisfied by imports from more competitive producers at the expense of established suppliers.

Finally, as I have already observed, the persistence of sluggish growth in the Maltese economy cannot be explained exclusively in terms of a cyclical downturn. Delays in implementing effective competitiveness-enhancing reforms were also a factor. As a result, the economy was not fully prepared to exploit the single market.

3. In these circumstances, isn't this the worst time to be strait-jacketed by the conditions for euro adoption? Wouldn't a fiscal boost speed up economic growth, now that your already limited monetary policy tools have been put in the shed?

Allow me first to correct two misconceptions implicit in your second question. For a start, our monetary policy tools have not been put away but are available for use if needed, as was the case in April last year when the Bank's central intervention rate was raised by 25 basis points. The primary objective of our monetary policy, moreover, is not to influence the level of economic activity. It is to maintain price stability, which we pursue through the operation of a fixed exchange rate. We, therefore, use our monetary policy tools in the first instance to provide support for the currency.

Now your question echoes the view of those who argue that if only we were to delay adopting the euro, the government would be able to spend more and run a higher budget deficit because it would not have to meet the deficit criterion this year, and thereby help the economy grow faster. It sounds very attractive, but would it work?

First, the argument is based on the premise that increased government spending produces jobs and growth. In a small, open economy, things are not that simple. If more money is spent on infrastructure projects, there will be increased imports of raw materials and other inputs; and of the money that remains in Malta in the form of wages, a high proportion will also be spent on imports. These leakages will diminish the benefit to the economy from the multiplier effect of the increased spending.

Thus, for example, our calculations suggest that had the government invested Lm18.5 million more in 2005, keeping the deficit at the 2004 level, the GDP would have been around Lm14.5 million higher last year.

Against this benefit, moreover, one would have to set off the costs. For example, a higher deficit means an increase in the public debt of equal amount, and thus more annual interest to be paid out of recurrent revenue. Besides, for the reasons I gave earlier, a higher deficit translates into a wider trade gap (by an estimated Lm7.5 million in the above example).

Proponents of more government spending should also bear in mind that even in the absence of the euro adoption factor, Malta would still have to abide by the Stability and Growth Pact (SGP). You might recall that even the British Government, which has no immediate plans to adopt the euro, was called to order by the EU Council some time ago because of its growing budget deficit.

Then again, sound public finances are fundamentally a matter of economic common sense and prudence. So much so that in recent years there have been repeated calls on the government from all quarters to reduce the deficit and the public debt. Is it not strange, therefore, that just when headway is finally being made in this very direction, we hear calls for a reversal of this policy and for engineering what would at best be a short-term boost to growth?

One should also bear in mind that Malta's main challenge is to become more internationally competitive. In this respect, an increased fiscal deficit will not solve anything. Malta needs quality growth, preferably resulting from foreign direct investment, which brings with it capital, technology and markets. And that kind of investment tends to go to countries with sound economic fundamentals, including a budget that is balanced over the course of the business cycle.

More immediately, if we renege on the Convergence Programme targets, there would be a real risk of a drop in investor confidence. This is confirmed by recent developments in interest rates and in bond markets in central Europe, where markets have started to punish countries who risk delaying euro adoption. It is indeed relevant to point out that Malta's current 'A' rating is predicated upon the continued pursuit of fiscal consolidation.

There is an additional short-term gain from staying on course. As I have mentioned, fiscal restraint also helps to reduce the country's external imbalance, and this, in turn, could allow a cut in the interest premium that investors require in order to hold Maltese lira assets. This would mean lower interest rates.

On balance, therefore, the outcome of a u-turn on fiscal policy is unlikely to be positive.

4. Last year's entry in ERM II has been described as hasty and premature. Why the rush to join the euro? Does it not rule out any possible adjustments to the value of the lira?

One of the arguments made in support of this view is that our euro adoption calendar does not allow government to run a higher deficit and thus promote faster growth. I have just explained why I am not convinced by this argument.

As for the claim that the decision to enter ERM II was hasty and premature, that suggests recklessness! No, there was no rush. The decision was made after thorough consultations with the EU Commission and the European Central Bank (ECB) in the light of the progress achieved by Malta in fiscal consolidation and structural reforms. Their agreement was contingent on a firm undertaking by the Maltese authorities to continue to implement the Convergence Programme.

A related objection is that before adopting the euro Malta should first satisfy tests similar to those set for the British economy by Chancellor Brown. This argument betrays an insufficient familiarity with the Chancellor's five tests. They are, in fact, not so different from the Maastricht criteria, which Malta, together with the six other new Member States currently in ERM II, is seeking to satisfy.

The five tests relate to convergence (like the Maastricht criteria); flexibility of labour, product and capital markets (being addressed in Malta's Convergence Programme); investment, i.e. whether euro will encourage more inward FDI (the British Treasury's 2003 report suggests that it does); financial services (this applies to the special case of the City of London); and growth, stability and employment. Malta's strategy document, published jointly by the Government and the Bank last year, argues that the euro would be beneficial in this respect (and so does the Treasury report).

The case for adopting the euro sooner rather than later is set out in the strategy document. I shall only reiterate here that for a small, open economy like ours with no trade or capital controls, keeping a separate currency leaves us exposed to external shocks and volatile capital flows. We are thus obliged to maintain a large amount of external reserves. These are financial assets that could perhaps earn higher rates of return if invested domestically. Instead, we invest them abroad, in effect promoting foreign, rather than domestic growth. That is the price we pay to have an independent currency.

This vulnerability is indeed one of the main reasons why some leading academics in this field believe that the small new Member States should have been allowed to lock themselves into the relatively greater security of the euro area as quickly as possible. The validity of this view was underscored by Malta's experience in late 2004/early 2005 when the Bank's external reserves declined as a result of uncertainty created by speculative comments on the exchange rate.

Your second question reflects the view that the fixed nature of the exchange rate as well as the level at which the lira was pegged to the euro in ERM II are both inappropriate and are stifling Malta's competitiveness.

Let me first address the issue of the fixed peg. This has been a mainstay of our monetary policy for over three decades. It is what Maltese traders and investors, and the public at large, have become accustomed to. The resulting exchange rate and price stability have made a vital contribution to the country's economic development. Opting for a new and unfamiliar regime, which is what the 15 per cent band arrangement amounts to, in the midst of the uncertainty prevailing early last year would not have been prudent.

The decision to opt for continuity by pegging the lira to the euro at the central parity rate, moreover, was also supported by our study on the equilibrium exchange rate, available on the Bank's website, which did not produce evidence of a significant misalignment; and by our conviction – which is shared by expert opinion in Malta and abroad – that given the openness of the economy and the speed of the nominal exchange rate pass-through to prices, a possible devaluation is anyway unlikely to have lasting beneficial effects. The 1992 experience proved that devaluation is not the correct antidote for structural problems. In less than three years, the inflationary pressures resulting from that decision wiped out whatever competitiveness gain had been achieved.

In the event, the commitment to keep the lira/euro peg at the central parity rate – which was also welcomed by the IMF - seems to have reassured both the business community and investors as calm returned to the financial markets. The downward trend in the reserves was first interrupted and then reversed, as capital inflows resumed, including a considerable amount resulting from the redenomination of domestic loans into euro to take advantage of the lower interest rate.

In these circumstances, had we allowed the exchange rate to adjust to market pressures within the 15 per cent band, the currency would have appreciated.

5. You seem to be playing down the efficacy of the fiscal deficit and of exchange rate adjustment as a means of jump starting the economy. What would you suggest instead?

As I have already pointed out, the domestic factors which are contributing to the economy's anaemic growth record are largely microeconomic in nature. I have also explained why deficit financing and changes in the nominal exchange rate cannot correct these weaknesses, still less produce sustainable growth. Policy orientation must eschew short-term palliatives. Like our competitors we must learn to come to terms with globalization. Reflecting on one simple fact should help in understanding what this means: the hourly cost of labour of an electronics operative in Malta is around $11, compared with $7 in Singapore and $2 in China. Neither more government spending nor a devaluation can narrow that gap.

Against this background, maintaining external competitiveness in the long run depends on continued moderation in wage growth, faster increases in labour productivity and sustainable budget positions. I make no claim to originality in proposing this prescription; it is shared by the EU Commission, the ECB and the IMF.

I shall first address the last objective. Given that taxation levels are already high, fiscal consolidation should be achieved by cutting recurrent spending. Here I would focus on reducing the public sector wage bill, mainly by lowering employment levels, as government is currently doing; reforming the provision of pensions and health care; rationalizing social welfare schemes, including by eliminating benefits that have outlived their usefulness and extending means testing; and transforming the unemployment benefit system into an effective instrument of employment creation rather than of social dependence.

With regard to competitiveness-related problems, there is a need to address remaining rigidities in the labour market – including by ensuring that wage costs reflect productivity levels; investing more in education and providing suitable incentives to unleash the potential inherent in the country's human resources; and improving the business environment, in particular by lowering the costs of operating in Malta.

While it is beyond dispute that the country has undergone significant change for the better in these first years of the new century, it is equally true that the world around us has become a much more dynamic place in the meantime, and competitive pressures are such that unless we adapt to them rapidly, we will have to accept lower living standards.

6. Euro yields have risen yet you have left the central intervention rate unchanged…

This proves that our limited monetary policy tools have not been put in the shed, as you put it in an earlier question! We still have a degree of autonomy. As I said earlier, the exchange rate is the nominal anchor of our monetary policy. The rationale of our regime, i.e., providing support to the currency, does indeed require us to mirror interest rates offered by other currencies – primarily the euro since we moved to a full peg last May – , but in addition we also need to offer a premium to holders of Maltese lira assets to compensate for the small size and vulnerability of our economy. Our judgement on the appropriate size of that premium at any point in time, complemented by considerations relating to financial market sentiment and economic conditions generally, determines our decisions on the Bank's central intervention rate. The markets have so far judged the interest rate premium on the lira as being appropriate.

7. It would be ironic if the government were to meet the fiscal criterion for euro adoption, but fail because of the inflation rate. What interest rate policy will the Bank adopt in this regard?

I have already explained that the focus of monetary policy in a fixed peg regime is the exchange rate. Unlike most countries with a floating regime, we are not inflation targeters. The Bank's ability to influence price levels directly through its power to change short-term interest rates in the money market is, therefore, rather limited. To the extent, however, that a rise in inflation is associated with developments that are putting pressure on the exchange rate in the shape of a persistent loss of external reserves, such as a surge in consumer imports financed by credit creation, then a higher interest rate could have a cooling effect.

In Malta's open trading environment, one would expect prices to respond more effectively to market forces than seems to be the case. The relatively small number of importers of essential commodities and of providers of some services that have a significant weight in the retail price index is a disadvantage in this respect. There are governmental agencies whose responsibility it is to ensure that competition and price transparency prevail. Containing local costs, including government-induced costs, should also be a priority in this crucial ERM II phase. In its capacity as advisor to the government, the Bank takes every opportunity to express any concerns that it may have in this regard.

8. In addition to the short-term pressure of the Maastricht criteria, there is the longterm reality of the welfare gap. Are you frustrated with the pace of pension reform?

A sense of disappointment best sums up my feelings. I am all for consultation and consensus building, but the time comes when decisions need to be taken if further damage is to be avoided. This applies equally to the social welfare and health systems as it does to pensions. Last year the first cohorts of the baby-boom generation reached retirement age. This produced an acceleration of some Lm7 million in the rate of increase of pension expenditures.

Pension reform, which is vital for the long-term sustainability of public finances, should be implemented this year. Everybody has had a say and there is now a comprehensive, balanced set of proposals which answer to the widest possible range of concerns compatibly with having a viable system. It is time to move on to other pressing issues.

9. Property values continue to increase against a background of a rising volume of bank credit that is being channeled into construction and house purchase. Are there grounds for concern?

Property values are estimated to have increased by about 9% in 2005. Although this represents a slowdown from previous years, it is still in excess of recent inflation and occurred despite a continuing high vacancy rate.

The ready availability of credit contributes to rising property prices. While the volume of bank credit to the construction industry was more or less flat last year, borrowing to finance the construction or purchase of housing went up by 21% to Lm653 million. These numbers, moreover, must be viewed in the context of total household borrowing. Consumer credit, including through credit cards, increased by 13% in 2005 to Lm91 million. This is an area where the banks are marketing their products rather aggressively, encouraging borrowing for consumption rather than for investment purposes.

One has to be concerned about this, particularly at a time of slow growth in household disposable income, and about the resulting increase in the consumer debt burden. For while the default rate of household borrowing, particularly mortgage loans, remains low, much lower in fact than that of the corporate sector, existing and prospective borrowers may not be factoring into calculations of their repayment capacity the possibility that interest rates might not remain at their current low levels indefinitely.

While the exuberance which took hold of the property market in recent years appears to have moderated somewhat, a similar phenomenon has emerged in the equity market. The optimism that is driving up share prices is supported by strong corporate profitability in a few cases. Current trends, however, are taking prices into territory where the connection with intrinsic values becomes less obvious, and suggest caution.

10. Economic analysts can sound gloomy warnings to keep pushing the authorities in the right direction, or ring the bells proclaiming good news and risk undermining the sense of determination needed. Which approach would you advocate?

Neither of the two. There is already so much spin created by purveyors of pessimism and optimism alike that it is becoming increasingly difficult to get a balanced reading of the economic situation. Independent economic analysts, therefore, shoulder a heavy responsibility. It is to bring together all the relevant information, subject it to a critical but objective assessment, and be prepared to support their conclusions with well documented arguments. This is a role the Bank has endeavoured to play consistently, and for good reason. The more people understand how our economy works, the challenges it is facing and the limited options available to overcome them, the greater the likelihood that policymakers will feel comfortable to take the required decisions promptly, leading to a faster pace of wealth creation, which is one thing we all want.

11. The adoption of the euro will greatly reduce the role of the Central Bank of Malta. What will you be doing in January 2008?

Your question reflects a perception that is commonly held but which is not borne out by the experience of the current members of the euro area. It would be more correct to say that the Bank's role will be greatly changed rather than reduced. Some existing functions will become less important, others more so, and yet others created.

On the institutional level, the transfer of responsibility for monetary policy to the ECB would be replaced by the Governor's participation in the Governing Council where interest rates are set for the euro area. For this purpose, we will need to strengthen our capacity in the areas of economic research, forecasting and statistics and redirect its focus. This also applies to our activities in support of monetary policy, such as open market operations, which would be conducted within the parameters set by the ECB.

In the area of foreign exchange, there would no longer be a need to provide marketmaking facilities once the euro becomes our domestic currency, or to retain the current foreign exchange facilities offered to government at their existing level. Our reserve management role, however, would remain; not only to manage our own reserves, but also to manage part of the ECB's portfolio.

Likewise, the Bank would retain its function as issuer of notes and coins and would thus have to meet the local demand for euro. It would also need to analyse suspected counterfeit euro notes and coins.

Particularly important will be the Bank's role in providing a channel for both domestic and cross border, high value payments by linking our payment system with the Eurosystem's TARGET, as well as in operating a mechanism for the cross border delivery of assets for collateralisation purposes.

The adoption of the euro will also integrate further Malta's financial system with that of the euro area, so that the Bank's financial stability and internal audit responsibilities will assume a cross border dimension because weaknesses in any one Member State could impact directly on the stability of the entire system. For example, we will have to cooperate closely with other central banks and the ECB to prevent the emergence of systemic crises. This will involve strengthening our institutional and analytical capacities to detect potential vulnerabilities in our own financial system. As for the audit role, we will have to provide internal control assurances to the ECB on all the functions we will be carrying out on their behalf.

All of this, of course, has important implications for essential support functions such as information technology and human resources. I need only mention the fact that euro area membership entails considerable electronic reporting obligations and the maintenance of several statistical databases.

The Bank is gearing up to take on these new, more specialized functions, and I would like to note that it is only able to do so with confidence because it has a substantial core of qualified and dedicated professionals in all these areas.