Changing financial systems in open economies: The Central Bank of Malta's recent experience

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1. The objectives of financial system reforms

Serious efforts to bring about change in the Maltese financial system commenced at the beginning of 1994. The aims of the reforms were: (i) to gradually liberalise interest rates; (ii) to create a properly functioning money market (a stock exchange was set up in 1992); (iii) to strengthen the role of the Central Bank by giving it the statutory power to formulate monetary policy and providing it with the necessary instruments to implement a market-oriented monetary policy; (iv) to improve and upgrade the banking structure and strengthen the supervision of banking and other financial services (given the need to monitor the activities of financial institutions more closely as the liberalisation programme gathers pace); (v) to allow market forces a bigger role in establishing the level of the exchange rate; and (vi) to complete the removal of all restrictions on capital movements.

2. The measures introduced

With regard to **interest rate liberalisation,** all ceilings on deposit rates were lifted in early 1994. More uniformity was introduced in lending rates with the abolition of special rates to priority sectors (excluding residential construction). In November 1995 the ceiling on bank lending rates was raised to 10 percentage points above the discount rate, effectively freeing bank lending rates.

A number of initiatives were taken to **develop the money market.** These were focused chiefly on the development of the Treasury bill market, with a view to making operations in this market the main instrument of monetary policy. A proper auctioning system was introduced at

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the beginning of 1994, with the Central Bank playing a dominant role in the initial stages in order to encourage the active participation of the banks and ensure that the discount yield on bills was market-determined. The tenor of bills was also increased, with new maturities of six months, nine months and one year being issued. In addition, the Bank introduced the concept of repurchase agreements, and by the end of 1994 weekly auctions in repos and reverse repos had become a regular feature of the Bank's open market operations. At the same time, interbank trading in money market instruments also started to develop. This year, the Bank has established a separate market-making function for Treasury bills in order to improve liquidity in the secondary market.

All the necessary amendments to the Central Bank of Malta Act aimed at enhancing the Bank's **monetary policy role** were approved by Parliament before the end of 1994. These gave the Bank the power to set interest rate levels or influence their movement through-market oriented methods. Before the legislation was changed it was the Minister of Finance who was responsible for setting maximum levels of bank lending rates. The legislation gave the Bank the authority to issue its own securities and to enter into repurchase agreements with the banks. It also gave the Bank greater flexibility with regard to the assets it held in its portfolio. Most importantly, the new legislation abolished the provision enabling the Government to borrow short-term funds (in the form of an overdraft facility) from the Bank. This amendment, however, will only come into effect from the beginning of next year.

With regard to the **development of the banking and financial structure,** a new Banking Act to regulate banking activity in Malta was also passed by Parliament at the end of 1994. The Act brings Malta's banking legislation closely into line with the European Union's First and Second Banking Directives. It also adopts most international recommendations on bank supervision regarding solvency, capital adequacy and large exposures.

Under the Act the Central Bank was confirmed as the competent authority responsible for banking supervision. A new, separate authority has been established with responsibility for the supervision of other financial services and also for the promotion of Malta as an international financial centre. In this regard it is pertinent to mention that a number of laws on financial services, taxation, money laundering, insider dealing, professional secrecy and the recognition of trusts were approved by Parliament during 1994. The Bank and the new authority actively cooperate in the development and supervision of financial services.

To allow a more competitive environment to develop in the banking sector, the Government privatised one of the smaller banks in April 1994 and one of the larger banks in March last year. Also in 1995, a full banking licence was granted to a major international bank, which is expected to begin operating in Malta later this year. In addition, the Bank has issued banking licences to four foreign-owned banking institutions. These are currently only permitted to carry out offshore operations, although they will be authorised to participate in domestic activities in the near future.

The daily **exchange rate** of the Maltese lira is currently not allowed to deviate from its basket-determined level. Accordingly, the Central Bank provides the banks with their foreign exchange requirements at the stated selling rate and purchases any excess holdings from them at the stated buying rate. However, over the last 18 months a number of measures have been introduced to lay the foundation for the establishment of a properly functioning foreign exchange market. These measures have included real-time quotations for the Maltese lira, greater scope for interbank foreign exchange transactions, a widening of margins around the mid-rate quoted by the Bank for the Maltese lira, a reduction (to three) in the number of currencies used by the Bank for intervention purposes and, finally, the issue of forward exchange quotations for the Maltese lira based on interest differentials.

Malta accepted the obligations of Article VIII of the IMF's Articles of Agreement in November 1994. As a result, there are no restrictions on current payments. Controls on **capital movements** are virtually non-existent so far as non-residents are concerned. Indeed, recently a restriction on non-resident investment in Treasury bills was abolished, so that non-residents are now permitted to move in and out of almost all types of domestic financial assets. There are still limits on the amount of capital which residents may invest in overseas assets, but annual allowances are being increased every year until all limits are removed, possibly over the next two years.

3. The experience of the Central Bank over the period of change in the financial system

The financial system reforms are certainly contributing to greater efficiency in the system and a deepening of financial markets. The Central Bank is now in a position to pursue a monetary policy that relies more and more on indirect methods of control. Whereas prior to the reforms it had to resort exclusively to direct controls and reserve requirements to exert monetary control, it now intervenes regularly in the money market through repo transactions.

Over the last year the Bank has been concerned about price pressures in the economy and the relatively high rate of annual monetary growth, which at one time exceeded the upper limit of its monitoring range (8–12%). The Bank's ultimate monetary policy objective continues to be a stable price level, which it achieves by maintaining an exchange rate peg. Its principal intermediate target is therefore the net foreign assets, which are also measured in relation to base money. The Bank's main operating target is currently the money market rate, more precisely the seven-day repo rate.

After taking developments in monetary conditions and the external reserves into consideration, the Bank tightened monetary policy from the middle of 1994. Initially (that is, prior to the above-mentioned changes in the legislation governing the Bank) it absorbed liquidity from the banking system by auctioning term deposits of various short-term maturities. Subsequently it launched the system of repo auctions which it currently uses to supply or remove liquidity. The Bank has also provided lending facilities at a penal rate to the banks and continues to impose reserve requirements. However, the latter are implemented more flexibly insofar as the banks are allowed to maintain reserve balances on an average basis. Over the last year the Bank has left its discount rate unchanged, relying on the repo rate to give signals to the market.

4. The problem areas

In the light of the Central Bank's experience over the last year, it may be said that the Bank has generally been successful in its efforts to implement a more market-oriented monetary policy. However, attention should be drawn to a number of problem areas in the present situation which will have to be addressed in the future to enable the benefits of a market-oriented financial system and an effective monetary policy to be transmitted to the economy. These problems may be summarised as follows:

(i) The **danger of cartelisation** due to the fact that two major commercial banks dominate the banking sector: there is concern that, notwithstanding the efforts of the authorities to encourage competition, the banks may collude to push interest rates higher even if conditions in the market indicate that they should move lower. This danger has been reduced by the entry of a major international bank into the market.

(ii) A still rather **slow response of banking institutions** to the changes that are taking place in the financial sector, particularly when the Central Bank sends monetary policy signals through the money market: bank management still needs to become more sensitive to market developments, and to the implications for interest rates and the pricing of loans.

(iii) The **thinness of the financial markets** due to the small number of banks and financial institutions making up the sector: the Central Bank has been forced to play the role of market-maker in both the capital and the money market, which may at times have led to some conflict with its monetary policy role, although this situation is expected to improve with the development of a separate market-making structure in the money market.

(iv) The **fiscal deficit** which is still partly financed by borrowing from the Central Bank via primary market purchases of Treasury bills: this restricts the Bank's scope for maintaining monetary control.

(v) The **stance of fiscal and monetary policy** as viewed by the Ministry of Finance and the Central Bank: while both agree that the control of inflation is a major policy objective, senior officials at the Ministry appear to give priority to keeping the cost of government borrowing as low as possible; the Bank's determination to pursue a tight monetary policy has thus created some friction with the Ministry.

(vi) The need to strengthen the **foreign exchange market** and broaden participation: this will allow the exchange rate to be determined by market forces, subject to market intervention by the Central Bank aimed at maintaining the currency within a specified trading range.