Michael Bonello: The challenge of the Euro

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the Second International Summit organised by The Economist/Caja Madrid, Madrid, 8 July 2002.

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It is a pleasure and an honour to be in Madrid today to participate in this discussion on challenges related to the adoption of the euro and to share a platform with such distinguished speakers. Since I have been invited to present the perspective of a small candidate country, I propose to start by briefly recalling some key facts about Malta and its economy.

Malta is a micro-state, with a population of nearly 400,000 living in an area of just over 300 km2. In 2001 nominal GDP amounted to €4 billion, or less than 0.1% of that of the euro area. This translates into a level of income per capita estimated at around half the European Union (EU) average. Market services, including tourism and finance, account for nearly two-fifths of GDP, while manufacturing contributes almost a quarter.

Given its size and lack of natural resources, it is not surprising that Malta has one of the most open economies in the world, with imports and exports combined amounting to nearly double GDP. The EU is Malta’s main trading partner, accounting for two-fifths of its exports and nearly two-thirds of its imports during 2001. It is an even more important market for the tourist industry and is a major source of capital inflows.

These strong economic links are expected to deepen once Malta accedes to membership of the EU. Malta was officially recognised as a candidate country at the 1999 Helsinki summit and has consistently met the Copenhagen accession criteria, which include the existence of a functioning market economy able to withstand competitive pressures within the Union. Negotiations began in March 2000 and since then 23 chapters have been provisionally closed, including those on Economic and Monetary Union (EMU) and on the free movement of capital. Accession is expected in 2004, subject to the outcome of a referendum to be held early next year.

Apart from its political and social dimensions, EU membership offers Malta the opportunity to become fully integrated into the world’s largest regional economy. Membership will guarantee unimpeded access to our major market and requires the implementation of internationally recognised norms and standards, both of which would increase Malta’s attractiveness as an investment location. Moreover, as in the case of other candidate countries, the accession process has spurred market-oriented reforms. As a result, EU accession should contribute to faster economic growth, leading to an acceleration of the process of real convergence and to a steady improvement in living standards.

EU membership also entails a commitment to participate in EMU. Before accession, Malta will, therefore, have to adopt key elements of the acquis communautaire related to EMU. This process is well underway. For example, legislation currently before Parliament will explicitly make price stability the primary objective of monetary policy, strengthen the legal and operational independence of the Central Bank of Malta and formally prohibit central bank financing of public sector deficits. In practice, the Central Bank has been formulating monetary policy independently since 1994, using market-based instruments, including open market operations and reserve requirements, which are similar to the ones currently used by the Eurosystem.

The adoption of the euro would be the final step in a process linking the Maltese economy and the euro area. Compared to the current regime it offers a number of additional advantages, which are highlighted in the literature on optimum currency areas. Specifically, it should reduce transaction costs; result in lower interest rates in Malta; ease access to the growing European financial market; and lead to more transparent pricing of goods and services. It should also act as a spur to the integration process with the EU since countries with the same currency tend to trade more with each other.

From an institutional point of view, it should allow Malta to be represented in the decision-making processes of the European System of Central Banks (ESCB) that affect it even today. Here I would like to support the view put forward recently, among others by Governor Wellink of De Nederlandsche

Bank[1], about the need for adequate representation of national central bank governors in the decision-making bodies of the ESCB. Their participation confers a degree of legitimacy on the decisions of supra-national bodies such as the Governing Council, and can improve the quality of the policy debate as well as communications with the public in the various member states.

From our perspective, the adoption of the euro should not involve any major regime shift. In fact, since the collapse of the Bretton Woods system three decades ago, the Maltese lira has been pegged to a basket of major currencies. Although the composition of the basket has been changed on a number of occasions, mainly in response to shifting trade patterns, the exchange rate was only devalued once, in the wake of the ERM crisis in the autumn of 1992. The fact that Malta has successfully maintained a peg for so long suggests that this is a viable exchange rate arrangement.

The choice of a fixed exchange rate as the intermediate target of monetary policy was dictated by key characteristics of the economy. First, Malta's size implies that it is a price taker on international markets and cannot hope to influence its terms of trade through nominal exchange rate movements. In addition, because of the economy's openness, the conduct of monetary policy has to take the exchange rate into account, whatever the overall policy strategy adopted. In fact, our experience after the 1992 devaluation showed the ineffectiveness of the exchange rate as a policy instrument, given the rapid pass-through from import prices to the general price level, and the consequent loss of competitiveness in export markets.

Second, the economy is already highly integrated with that of the EU. This is borne out by trade flows, as well as by a comparison of Malta's economic structure in terms of the sectoral distribution of value added and employment with that of the Union. In addition, differences in productivity levels between Malta and the EU in the traded goods sector have been found to be small, which suggests that the Balassa-Samuelson effect is unlikely to be strong. Moreover, economic integration will deepen as barriers to the movement of goods, services and factors of production are removed as part of the accession process. These factors, which attest to a significant degree of real convergence, support an exchange rate regime based on a peg to the euro.

Empirical evidence indeed shows that the exchange rate peg has been a valuable nominal anchor, restraining price and wage increases. In fact, inflation has averaged just 2.6% in the past five years, indicating a considerable measure of nominal convergence with our major trading partners, and with the euro area in particular. By reducing the costs associated with international trade and investment, the peg has also contributed to Malta's orientation as an open economy. Price stability and openness have been key factors contributing to the country's economic growth record, which averaged 3.3% in real terms during the same period.

Between now and the adoption of the euro, therefore, Malta intends to maintain a fixed exchange rate regime based on a currency basket centred on the euro. The Central Bank is aware that it will have to maintain the peg and manage a smooth transition to membership of the ERM and the single currency area in a rapidly changing economic environment. This will not be easy, but we should be able to rely on the well-established institutional and policy framework of the acquis and anchor our strategy to a clear end-point, the adoption of the euro. We, therefore, believe this to be a credible approach to euro area membership.

In conducting monetary policy during this period, we recognize that international capital movements may present a growing challenge. For a long time, Malta's exchange rate peg was backed by controls on inward and outward capital flows but these are now being gradually phased out. In theory, full capital account liberalisation may lead to large and volatile capital flows which, in turn, may put pressure on the peg. In practice, econometric evidence suggests that, because of its openness, the Maltese economy has already been exposed to significant capital flows. This, together with recent experience with a partially liberalised capital account, suggests that the impact of full liberalisation may turn out to be less than might have otherwise been the case.

It is clear, nevertheless, that the Central Bank will have to adjust short-term interest rates – its key policy tool – to neutralise any pressures on the exchange rate. In other words, interest rates will not be able to respond to domestic economic developments, but will have to move in line with those abroad.

[1] Nout Wellink, 'The Role of National Central Banks within the Europeans System of Central Banks: The Example of De Nederlandsche Bank', 30th Economics Conference, Oesterreichische Nationalbank, June 13 – 14, 2002.

This would not, however, represent much of a change because already today the Bank has only limited autonomy in the conduct of monetary policy.

As far as the transition to the euro is concerned, therefore, the path that Malta should follow seems fairly straightforward, given the starting point of the existing exchange rate regime. Today, the basket consists of the euro, the US dollar and sterling, with weights of around 52%, 26% and 22%, respectively. There is no fluctuation band. The peg is backed by official external reserves, which have comfortably exceeded the monetary base over the years and are equivalent to a fifth of broad money.

The first step would be to increase the weight of the euro in the currency basket at the expense of either or both of the other component currencies. If the United Kingdom were to join EMU, this would automatically raise the proportion of the euro in the currency basket, making Maltese entry into ERM II that much easier. On accession, the timing for joining ERM II, as well as technical questions relating to the entry level and the fluctuation band will be up for discussion.

If the Maltese lira were to join ERM II with the normal fluctuation band of ±15%, this would inject more flexibility into the system. The exchange rate would be able to move in response to the balance of payments, allowing monetary policy some latitude in reacting to domestic economic developments. In this framework, the real exchange rate appreciation that is a corollary of economic convergence could take place via nominal exchange rate appreciation. However, the introduction of a relatively wide fluctuation band could lead to unprecedented exchange rate volatility. In turn, this could jeopardise the Bank’s price stability objective. It may, therefore, be preferable to enter ERM II without a fluctuation band at all.

This exchange rate strategy of course implies that the burden of adjustment to shocks will 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, a tighter fiscal stance will enhance the credibility of the exchange rate peg. Moreover, a smaller borrowing requirement will also free up resources for the private sector and 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 it lacks today to respond to adverse shocks or cyclical downturns.

The response to such disturbances will also 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, while the restructuring of the shipyards – a key employer - has begun to yield positive results. The pace of reform must, however, be sustained if we are to secure the productivity gains that would increase competitiveness in the tradable sector, buttress the exchange rate peg and bring about real convergence.

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 legislative amendments currently before 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 payments system, which is being upgraded in line with developments in the euro area.

According to a recent background paper prepared by the European Central Bank(ECB)[2], Malta already has a domestic financial intermediation mechanism that broadly mirrors the composition of different financial market segments in the euro area member states. While there has been considerable growth of non-bank financial intermediaries and development in the 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% in March of this year.

Although there are concerns about the quality of loan portfolios after a recent period of rapid credit expansion, the banks have reinforced their capacity to assess and contain risk. In this regard, the sale of one of Malta's two large banks to a major foreign banking group in 1999 was particularly important. Prudential controls also limit bank exposures to exchange rate risk, thereby reducing a source of instability in the context of a pegged exchange rate regime with international capital mobility.

In conclusion, EU accession and, in particular, the adoption of the euro would cement the strong links that already exist between Malta and the Union. From the Central Bank's point of view, the prospect of EMU membership will reinforce the current commitment to price stability through the use of an exchange rate peg. Overall, the adoption of the euro would represent a logical step for an economy already closely integrated with that of the EU and influenced by the monetary policy of the ECB. We are, however, under no illusions: achieving this goal will require the continued pursuit of fiscal consolidation, structural reform and financial stability. But we are confident that these challenges can be met.

[2] European Central Bank, 'Financial Sector Developments and Convergence in Accession Countries: An Overview', December 2001