Michael C Bonello: Central bankers' view of the new challenges

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at a conference entitled "The Challenges for Central Banks in an Enlarged EMU" organised jointly by the European Community Studies Association (ECSA Austria), Research Institute for European Affairs (IEF) and Oesterreichische Nationalbank, Vienna, 20-21 February 2004.

Mr Bonello was a panelist on the discussion regarding "Central Bankers' View of the New Challenges".

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When ten countries, including Malta, join the European Union (EU) on 1st May, they will assume the status of *"Member States with a derogation"*, meaning that they are exempt from the stricter rules of EMU. This may seem to imply that the transition to EMU is thereby rendered easier, but a careful examination of the conditions attached to the process reveals that the policy issues involved are anything but straightforward. This is particularly true of a small open economy like Malta's in which macroeconomic policy is strongly conditioned by the external environment, but which has nevertheless succeeding in reconciling a hard currency peg with relative exchange rate stability for over thirty years.

Malta has a population of only 400,000. Its nominal GDP of €4.5 billion, or less than 0.1% of that of the EU, translates into a per capita income which is around 69% of the 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 each almost as large as the GDP. The EU is Malta's main trading partner, accounting for over two-fifths of exports and two-thirds of imports in 2003. It is an even more important market for the tourism industry and is a major source of capital investment.

For Malta, therefore, the prospect of being anchored in the relative safety of the world's second largest economy and of using that economy's currency represents a considerable advantage. Perhaps the foremost benefit of euro area membership is being able to share in the credibility of a Europe-wide monetary policy. This will not only mean reduced exchange risks and less uncertainty for economic operators, but also the elimination of the risk premium on the Maltese lira. The resulting reduction in interest rates, moreover, would be of direct benefit in terms of price competitiveness, as would also be the lower currency conversion costs and the increased price transparency. The euro should also act to spur the integration process with the EU since it is known that trade and investment flows tend to increase in the absence of exchange rate volatility, and also that the trade of countries sharing a common currency can be as much as three times higher than that of countries with different currencies.

The Maltese economy is relatively well placed to secure these benefits of monetary union. For a start, the adoption of the euro should not involve any major regime shift. In fact, since the collapse of the Bretton Woods system the Maltese lira has been pegged to a basket of major currencies. Since then the lira was only devalued once, in the wake of the ERM crisis in 1992. Apart from that episode, the currency has enjoyed relative stability. In each of the past five years, for example, fluctuations in the euro/lira rate have moved within a band of between 1.4% and 3.3% around the average rate for the year. The fact that the currency peg has been successfully maintained for so long - as testified by the underlying upward trend in the external reserves, which today represent nine months of imports - suggests that this is a viable exchange rate regime for Malta.

The choice of a fixed exchange rate as the intermediate target of monetary policy is dictated by the key characteristics of the economy. First, Malta's size implies that it is a price taker 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 must take the exchange rate into account. This also means that the main cost of joining the euro area - the loss of monetary policy independence - has already been largely incurred as the euro carries a 70% weight in the currency basket and the progressive lifting of exchange controls has reduced the central bank's ability to set interest rates independently of world markets.

Second, the Maltese economy is already closely integrated with the euro area. This is borne out not only by trade patterns, but also by the similarity of Malta's sectoral distribution of value added and employment. Our business cycle, too, has become increasingly correlated with that of the euro area.

This synchronization is likely to grow further as exchange rate volatility declines and transactions costs fall and, if the correlation between business cycles is indeed endogenous in a monetary union, as our trade with the euro area intensifies. In addition, differences in productivity levels between Malta and the euro area in the traded goods sector appear to be minor, which suggests that the Balassa-Samuelson effect is unlikely to be strong. Similarities are also to be found in the financial system. For example, the degree of financial intermediation in Malta is comparable to that of the euro area, and the long-term interest rate is well within the Maastricht reference value.

Further evidence that the economy seems well prepared to join a monetary union is the fact that nominal wages have been sufficiently flexible to carry the burden of adjustment implicit in a fixed exchange rate regime. The absence of extended periods of high unemployment in the face of significant adverse developments suggests that labour markets have been able to adjust. Indeed, unemployment in Malta has been less volatile than in the euro area. The exchange rate peg has also been a valuable nominal anchor, restraining price increases. In fact, inflation has averaged just 2.4% in the past five years (1.3% in 2003), indicating a considerable measure of nominal convergence with our major trading partners, and with the euro area in particular.

Taken together, these features of the Maltese economy suggest that the likelihood of experiencing an asymmetric shock is small; and they lead us to believe that the exchange rate peg provides a suitable framework for joining ERM II and that the country should be able to adopt the euro sooner rather than later. We are also aware, however, that the peg will have to be maintained during the lira's passage through what is essentially uncharted territory. Professor Eichengreen's words of admonition to last November's East-West Conference here in Vienna readily come to mind, *"… prescribing bands for the new EU members for an extended period is the worst form of macroeconomic malpractice. Bands are fragile and difficult to manage. Their fragility is clear from Europe's own experience in 1992."*

In order to ensure a smooth transition towards, and through ERM II, therefore, it will be necessary to convince the markets that ERM II is indeed a natural culmination of the lira's currency basket regime. In this regard, given our track record and assuming a strong national commitment to the convergence process, our strategy should also benefit from the added credibility which the prospect of support by the ECB and other NCBs would confer on it. On the basis of similar considerations, a leading credit rating agency has concluded that ERM II participation can be a rating strength.

While we believe this to be a viable approach to euro area membership, it is clear that new, and possibly uncomfortable situations cannot be ruled out. International capital movements, for example, may well present a challenge for monetary policy during the ERM II phase. While econometric evidence and recent experience since the liberalization of capital controls suggest that the Maltese economy has already coped successfully with significant capital outflows, it must nevertheless be clear that monetary policy will have to stand ready to neutralise any pressures on the exchange rate should these develop. Higher interest rates, of course, would not be helpful for economic activity; and they could compromise progress towards the achievement of the convergence criteria.

Successfully managing the exchange rate will thus be a major challenge. And it is not the only one. There are others at the broader, macroeconomic policy level and which arise because the tools available for economic adjustment are limited compared to the many reforms that need to be undertaken. Many of the tasks to be accomplished, moreover, are subject to tight deadlines. As a result, tradeoff situations will inevitably arise, and this will complicate the simultaneous pursuit of nominal and real convergence.

One such case is that of public finances. Here the task is to achieve further convergence in economic structures and income levels without endangering fiscal sustainability. The recent experience of some existing Member States suggests an inherent incompatibility between these two objectives. On the one hand, the acceding countries must undertake the structural reforms necessary to create a congenial business environment and achieve an efficient allocation of resources, which would facilitate the implementation of the single monetary policy. On the other hand, they have to ensure that the expenditure associated with such reforms does not drive up fiscal imbalances beyond a level which is sustainable, or which in any case is considered excessive in terms of the Stability and Growth Pact (SGP).

In Malta's case another factor to be considered is the persistent weakness in our major export markets and its impact on the growth rate. Subdued growth does not only constrain the tax base, but through its negative effect on employment could generate opposition to the necessary structural reforms. The pursuit of fiscal balance is further burdened by the co-financing requirement built into most of the EU's funding programmes; by demographic trends which are beyond the control of policy makers, especially population ageing; and by the implementation of acquis-related obligations.

I dwell at some length on this issue because the state of public finances is currently the only significant impediment to Malta's membership of the euro area. While it is encouraging to know that we have been able to reduce the fiscal deficit/GDP ratio from 11% in 1998 to its current level of around 6%, getting to the Maastricht reference value of 3% by 2006, as the Government plans to do, will require unrelenting efforts and a greater emphasis on expenditure-cutting.

This is not only because taxation levels are already relatively high for an economic downturn, but also because of the tradeoffs involved in pursuing further fiscal consolidation. Indeed, the Government's resolve to trim the deficit will be a key determinant of the degree of exchange rate stability that it will be possible to achieve during ERM II. This, in turn, will depend on how much economic operators, taxpayers and recipients of social benefits and other transfer payments are prepared to give up today in exchange for sustainable public finances tomorrow.

In the final analysis, therefore, the success of the euro strategy will hinge on consensus being reached on the implementation of the necessary reforms. In this context, discussions are underway in the Malta Council for Economic and Social Development with a view to reforming the pension and health systems, currently two major sources of pressure on public finances. If the social partners do indeed take ownership of the reforms, the credibility of the country's overall economic strategy will be considerably enhanced.

Agreement on the reforms is also important because in an ERM II context the room for manoeuvre available to central banks is restricted. The implied commitment to a high degree of exchange rate stability - and for countries like Malta which have experienced limited day-to-day exchange rate movements, the concept of stability has taken on a very specific meaning - means that monetary policy cannot be used for demand management purposes. The onus of adjustment must then fall on fiscal and structural policies.

The implementation of effective policies must also be ensured because the financial markets will be quick to spot any incoherence between a country's exchange rate and its underlying economic condition. Since market behaviour, however, also has the potential to produce volatility to a degree unwarranted by the economic fundamentals, the exchange rate stability assessment at the end of the ERM II phase should take appropriate account of country-specific circumstances.

Another precondition for maintaining the exchange rate peg and ensuring a smooth transition to the euro is financial sector stability. In this respect, a regulatory and supervisory framework based on best international practice is already in place in Malta, and the legislation incorporates almost all the features of the corresponding EU directives. 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 of Malta, which is charged with ensuring the financial stability of the system and is also responsible for the domestic payment system. In this regard it is reassuring that the recently concluded IMF/World Bank FSAP exercise found Malta's financial system to be healthy and well supervised, with a comprehensive legal framework and strong adherence to most international standards and codes.

An issue of special significance for central bankers is the need to preserve the integrity of their institutions. Although the experience of current euro area Member States already provides useful insights into the appropriate exchange rate strategies to be pursued prior to, and during ERM II, the acceding countries will have to arrive at this judgment on the basis of expectations of the future path of the economy. Expectations, however, are just that.

This means having to stand ready to give satisfactory accounts of the rationale for the policy choices made, to explain deviations from targets and to ensure that governments introduce corrective measures without undue delay. Unfortunately, however, the information reaching economic operators, and financial markets in particular, is not always accurate. And yet, with only a few months to go to EU accession, the markets will be looking out for indications regarding the strategies we intend to pursue with respect to ERM II and entry in the euro area. It will be important, therefore, to be constantly on guard against any imprecise information which could provoke untoward market reactions. This highlights the importance of an effective communications strategy and of appropriate coordination between central banks and governments. In Malta the joint working committee established to elaborate the strategy for adopting the euro fulfils this role.

Simultaneously with the need to contribute to the promotion of economic convergence within the EMU parameters, our central banks are engaged in the task of integrating themselves into the European System of Central Banks (ESCB). The challenge here is multifaceted in that it involves infrastructural and organisational changes that profoundly affect not only the central bank and the financial markets, but also the players in those markets.

The technical aspects of ESCB membership represent a special challenge for small acceding countries like Malta. The domestic financial markets in most of our countries are small and less liquid that those of existing EU members, and typically less sophisticated. And yet, upon membership we will be expected to function on the same level as the long-standing and, in most cases, larger members of the System. Ensuring that the transition takes place with the least possible disruption has entailed a comprehensive reform of institutions and operating systems.

For example, a real time gross settlement payment system (RTGS) has been put in place instead of the existing payment infrastructure. The standards of the securities settlement system have been upgraded to a fully ESCB-compliant 'delivery versus payment' system, which ensures the risk-free transfer of collateral and, where necessary, of securities. Cross-border payment systems have been adapted to ensure that they meet today's 'straight through processing' standards. Similarly, with regard to statistics there has been an overhaul of methodologies and databases. The development of systems capable of delivering the quality-assured statistics necessary for the successful participation in EMU has understandably been a priority of the reform process.

But the challenge of EMU extends beyond the Bank's operational framework. For example, while we aim to participate effectively in the operational structures and decision-making bodies of the ESCB alongside much larger central banks, we only have some 250 people to perform the tasks involved. We are, therefore, undertaking a critical analysis of each of the Bank's areas of operation in order to devise ways of coping with the increased workload. The development of new skills in work areas that will become key to the Bank's operations as a member of the ESCB is another objective.

The Bank's management structure, too, is being reviewed. The policy-making process has been reinforced in order to respond to the growing need to analyse issues and take decisions in a more timely fashion. Line management has been strengthened and authority delegated more extensively to allow the managerial and technical staff to dedicate more time to ESCB-related activities. It has additionally been felt necessary to introduce a more efficient and rapid exchange of information across the Bank, particularly information acquired through participation in ESCB committees and working groups.

While it is helping the Bank to become a more focused and efficient institution, effective participation in the ESCB undoubtedly represents a heavy claim on its limited human and financial resources. We do appreciate that the System is still in a developmental phase and has yet to reach its ideal configuration. The arrival of ten new members, moreover, will not make things any easier for a time. I would nevertheless like to suggest that a collective effort be undertaken to rationalise the work of the ESCB, not least by containing the number of meetings in Frankfurt and elsewhere.

The challenges posed by EMU are clearly diverse and vary from country to country as well as across time, depending on a host of factors ranging from the extent of catching-up that needs to be done and the tools available to policymakers, to the degree of cross-sectoral linkages and of consensus on the respective national strategies. In practice, however, the underlying economic causes are probably quite similar across countries, often being manifestations of macroeconomic imbalances and structural inefficiencies. As such they must be addressed sooner rather than later. Only in this way will it be possible for our countries to derive full benefit from EU membership.

That probably hardly needs emphasizing in this forum because central bankers understand the importance of coherent policies designed to achieve a more efficient allocation and use of resources. At the same time, however, we are also conscious of the difficulties involved in reconciling what is conceptually desirable with what is feasible in practice. It is to be hoped, therefore, that our countries' considerable efforts to integrate successfully and without undue delay into EMU will receive a sympathetic response and not be perceived as a potential source of instability.