Michael C Bonello: Opportunities and challenges of the euro for business

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the conference The Transition to ERM II, EMU Convergence & EURO Adoption - Implications for Enterprises, organised by the Malta Business Bureau and the Mediterranean Bank Network, Valletta, 15 October 2004.

*   *   *

The rationale for a common currency

In addressing this topic it is first of all important to understand that the adoption of the euro marks only the last stage in a much broader process which started with accession to the EU. At that point, Malta concurrently joined the Economic and Monetary Union (EMU), but its participation in EMU is for the time being limited. In particular, Malta has not yet entered ERM II. This means that both monetary and exchange rate policy are still under the control of the local authorities.

This is in line with the EC Treaty, which confers upon new members the status of *Member State with a derogation*, allowing them considerable discretion as to how and when they should proceed towards the euro. Such an approach builds on the premise that whereas a currency union offers the prospect of considerable benefits to its members, these can only materialise when a high level of convergence has been reached with the other participants in the union. When this point has been reached, a prospective new member is much less susceptible to asymmetric shocks, i.e. shocks which are not common to other members, and which would therefore require a monetary policy stance that differs from that which is appropriate to the currency union. The Treaty’s provision for a flexible time-table is grounded in this fundamental economic principle.

Now, while most of us are probably familiar with the fact that Malta has an obligation to adopt the euro at some point in the future, the rationale for doing so might be less obvious. Perhaps an appropriate way to put it is that EMU has come to play a central part of what the EU is today and of what it is expected to become in the future. This is because by significantly reducing transaction costs and intra-area exchange rate risk, the euro facilitates progress towards the completion of the Single Market and gives access to a large pool of financial resources. By increasing price transparency, moreover, the euro fosters a more competitive environment, which, in turn, is conducive to higher levels of efficiency.

In this sense, the euro also contributes to the achievement of the Lisbon Strategy’s goal of making the EU the most competitive and dynamic knowledge-based economy in the world. Indeed, the Strategy states explicitly that it is essential to exploit the potential of the euro to promote the integration of EU financial markets and also, therefore, SME growth and job creation.

With this one should factor in the other elements of EMU: the arrangements in place to promote fiscal discipline and economic policy co-ordination; and the pursuit of price and financial stability by the European Central Bank (ECB). These contribute to a stable macro-economic environment which, together with the climate of greater predictability ensuing from reduced exchange rate risk, support investment and growth.

It is with this perspective in mind that fellow central bankers and government officials in the other new Member States have expressed their preference for an early adoption of the euro. It also constitutes the motivation for the Maltese Government’s commitment to implement the necessary reforms that will prepare the economy for the heightened levels of competition ensuing from the Single Market, while providing businesses with a favourable environment in which they should be better able to profit from Malta’s entry in the euro area.

New opportunities for business

The benefits of the single currency for business could be substantial, and will occur along the various stages from EU entry through the ERM II period to entry in the euro area. They will, however, become more tangible when the euro is introduced as an accounting and physical currency. At that point, the value of the Maltese lira in terms of the euro will be fixed and foreign exchange risk in euro will be eliminated. The need for dual accountancy systems and software will likewise be reduced. The single currency will also minimize the need for maintaining separate cash floats, a widespread practice in the local tourist sector.

At the level of the individual firm, the single currency should also translate into a reduction in the risks and costs associated with managing exchange rate fluctuations. When Malta adopts the euro, currency risks will be hedged automatically for a large volume of transactions, allowing businesses to focus their resources on those activities which generate real value.

For locally-oriented SMEs in particular, the potential reduction in currency mismatches, and in the volatility in cash flows and profitability associated with them, can be substantial for whatever their dependence on foreign markets in terms of exports, they are all, in varying degrees, consumers of imports. The end result should be lower operating costs, higher levels of efficiency, improved profitability and healthier balance sheets, all of which should result in access to credit on more favourable terms.

Some of these benefits will indeed materialise ahead of entry in the euro area. You will recall that in ERM II the Maltese lira will be fully pegged to the euro, so that the variability, albeit limited, in the lira/euro exchange rate associated with the fact that the euro has a weight of 70% in the Maltese lira currency basket will disappear. On the other hand, some variability could nevertheless manifest itself to the extent that the currency fluctuates within the ERM II band.

The advantages of pegging fully to the euro area should nonetheless be considerable, as the euro area already accounts for more than half of Malta's external trade in non-primary products. For the EU as a whole, the share is even higher. This share is set to increase as Malta integrates further with the EU and as more of the current non-euro area Member States join the euro area.

While prospects for the UK's entry in the euro area remain uncertain, the analysis does not change much, as a large number of companies operating in the UK have already switched to the euro as an accounting currency to gain exposure on international markets and to preserve their competitiveness. This trend is set to continue and is likely to spread to other countries as the euro continues to establish itself as an international currency. This means that the local business community could face pressures to make payments in euro even while Malta is outside the euro area, acquiring new currency mismatches in the process. There comes a point, therefore, when delaying adoption of the euro results in more pain than gain.

Membership of the euro area will also present considerable financing opportunities associated with the large size and liquidity of financial markets in euro. Businesses will be in a better position to shop around for the cheapest terms and the highest return. These advantages are an inevitable outcome of the presence of a large number of market participants and the further unfolding of the Financial Services Action Plan, which will enhance the tradability of euro assets in the euro area and beyond.

Participation in the single currency area provides scope for further cost savings in the form of lower risk premia resulting from adherence to the EU's strict macroeconomic policy framework. This aspect is particularly relevant in the Maltese context, as the small size of the country and the prevalence of micro-enterprises make the economy highly susceptible to developments abroad. Foreign banks and suppliers seek to cover this perceived risk by building a higher risk premium into the prices quoted to Maltese businesses. The insurance provided by the discipline of EMU, and the high level of intra-EU integration should reduce this perceived vulnerability and, with that, the risk premium. This is conducive to lower interest rates and to access to financing on more favourable terms.

A related advantage is the improved marketability and acceptance of collateral. Maltese lira assets are not considered sufficiently liquid by foreign lenders in view of the thinness of domestic financial markets. Many SMEs are consequently either denied foreign financing altogether, or offered prohibitive rates. This constraint should ease considerably with the adoption of the euro, as the redenomination of domestic assets into euro will improve the marketability of the collateral offered by local businesses.

Further benefits should accrue to business from the eventual linkage of the domestic payment system to the EU's TARGET system. By linking together the national systems of Member States with the payment mechanism of the ECB, TARGET allows payments in euro to be effected much faster, potentially improving liquidity conditions in the financial sectors of participating countries while lowering the processing costs of cross-border payments in euro.

The challenges posed by the single currency

Thus far we have reviewed the opportunities inherent in membership of the euro area. As might be expected, however, membership will also present new challenges. For example, while it places the economy in a better position to compete internationally, it exposes businesses to additional competitive pressures. For a start, customers will be better able to compare local prices with comparable prices abroad and will increasingly question price differentials. Some operators will, of course, benefit from lower procurement costs, but others might find it difficult to survive. It is, therefore, advisable for pricing strategies to be reassessed well in advance of the date of the actual euro changeover, especially where price is an important variable in marketing strategies.

In the same manner that the euro will facilitate price comparisons, other monetary variables such as cost per unit, average wage, annual sales volumes, administrative expenses and profits will also become easier to compare across countries. In other words, the single currency will expose the performance of Maltese businesses to a much more detailed scrutiny than they are accustomed to.

From a broader macroeconomic perspective, it could also be argued that just as the euro will enable domestic operators to reap the full benefits of the Single Market, a higher level of integration with the EU could also make the Maltese economy more susceptible to developments abroad. This applies in particular to the financial sector. Thus, for example, while participation in European financial markets will present unprecedented opportunities for risk diversification, this also carries with it an increased danger of contagion should weaknesses develop in specific segments of the market. Furthermore, the TARGET payment system will facilitate the transmission of financial risks between different institutions operating within Member States, calling for extreme vigilance on the part of the Central Bank of Malta and the MFSA.

While most sectors of the Maltese economy have been exposed to international competition for a number of years now, and while the financial sector incorporates adequate safeguard measures, there is clearly no room for complacency. As Hari Vittas, Alternate Executive Director for Malta's constituency in the IMF aptly put it during a recent IMF Economic Forum, "The potential benefits of monetary integration may be large, but they are not automatic and can easily be wasted in the absence of good policies."[1]

On balance, however, the benefits of participation in the euro area should more than outweigh the costs, such that over a sufficiently long time span the growth potential of an economy should be higher than it would have been outside the union. This expectation is supported by the results of recent research. An extensive study by Andrew K Rose of the University of California at Berkeley, for example, concludes that a currency union results in approximately a doubling of trade. Within the euro zone, moreover, it is estimated that trade volumes have increased by 15 per cent, beyond what can be explained by growth and other factors.

Recognizing such benefits of EMU, many credit rating agencies foresee an upgrade in the ratings of those new Member States that are among the first to adopt the euro,[2] although they generally emphasize that what matters is establishing a track record with respect to the implementation of reforms, especially fiscal consolidation.[3]

The broader macroeconomic challenge

These observations notwithstanding, premature participation in a currency union is nevertheless associated with some potential pitfalls. These result from the loss of monetary and exchange rate policy as a tool for stabilisation purposes. As I will shortly explain, however, the arguments typically advanced against participation in a currency union are not very strong in Malta's case.

It is sometimes argued, for example, that the Maltese economy might be on a different point on the business cycle relative to the euro area, warranting a different monetary policy stance from that of the

---

1 IMF Survey. *Adopting the Euro.* Vol. 33. Number 10. May 31 2004.

2 In July, for example, while noting that "credible convergence towards adoption of the euro was likely to be a positive driver of foreign currency ratings over the coming years", Fitch Ratings only upgraded the ratings for the Baltic States and Slovenia. They refrained from making other EMU related changes for those Member States where the size of the fiscal deficit is such that it is likely to delay entry in the euro area, noting that further changes are still premature.

3 Thus, for example, Moody's latest credit opinion on Malta notes that "*far-reaching structural reforms - most of which are guaranteed by compliance with EU requirements - will support the country's A3 rating over the medium term.* " Similarly, Standard and Poor's note that "*being a member of EMU is not a direct rating factor in our analysis. Once Malta is an EMU member, the foreign currency and local currency rating will be equalised but at what level will depend mostly on the fiscal account.*"

ECB; and that even if the degree of business cycle synchronisation with the euro area is already significant, national economic and financial structures might respond to the ECB's monetary policy stimuli differently from the average euro area Member State. While this might not matter much when other tools of adjustment such as the exchange rate are available, the argument continues, the use of these tools is thwarted in a single currency area such as EMU. On the one hand, exchange rate flexibility is conditioned by the maximum allowable bands in ERM II, and is given up altogether upon the irrevocable fixing of the exchange rate at the point of euro adoption. Additionally, the Stability and Growth Pact constrains the use of fiscal policy for fine tuning the economy. Consequently, any underlying imbalances in the economy are bound to persist.

While based on sound theoretical principles, this argument is largely not applicable to Malta. In particular, the business cycle is already fairly synchronised with that of the euro area, and the degree of trade integration is also quite significant. At the same time, sectoral GDP and employment data both reveal a strong correspondence with euro area economic structures, after allowance is made for the relatively more dominant role of tourism in Malta. Moreover, the small size of the domestic labour market and the extent of migration in and out of the country in past years suggest that in the event of an external shock specific to Malta, the labour market is sufficiently flexible to adapt. On a number of counts, in fact, labour market indicators are already comparable to those of the euro area. The resemblance is not complete, but further progress in this regard is to be expected as public sector employment is downsized further and as the structural reform programme continues to unfold. A similar conclusion emerges from a comparison with the euro area of the structure of the domestic financial sector and indicators of real convergence; the degree of similarity is already significant, although there remains scope for some catching up with respect to income and price levels.

As far as fiscal policy is concerned, this has rarely been used for fine tuning purposes in Malta. If anything, the disciplinary mechanisms of EMU should serve to reverse the current trend of negative balances, allowing fiscal policy to respond to the needs of the economy and leaving monetary policy to focus more on price stability.

As for the exchange rate, by pegging the Maltese lira to a basket of currencies, which is recognized as being the preferred regime for a small, open economy, the monetary authorities have long since given up the exchange rate as a tool of adjustment. Although the lira fluctuates on a daily basis against the euro and other foreign currencies, it is fixed in terms of the basket. The use of a fixed exchange rate in which the euro is the main reference currency, moreover, already requires our interest rates to shadow those of the euro area. In practice, therefore, Malta has already largely relinquished monetary independence, so that entry in the euro area will not represent a major loss in this regard.

Overall, therefore, the evidence suggests that neither ERM II nor the irrevocable fixing of the Maltese lira/euro exchange rate at a later stage involve a radical shift in policy regime. And since the Maltese economy already possesses many of the characteristics required for a smooth transition to a complete peg with the euro and full participation in EMU, the adoption of the euro does not only carry with it the prospect of substantial benefits, but is also an objective which can be pursued without fear of serious economic repercussions.

Entry in the euro area, however, is not automatic but is subject to the fulfilment of a number of conditions. In this respect, since the legal, institutional and operational preparations are on track, the only significant challenge is represented by the Maastricht criteria. As for the inflation rate and the long-term interest rates, these have generally been within, or close to, the reference values in recent years. As far as ERM II is concerned, the minimal exchange rate movements observed over the past few years suggest that Malta would have kept within a hypothetical ERM II band. The indications are, therefore, that this criterion, too, is achievable. Indeed, this should not be any more difficult than the current task of maintaining a hard peg with a currency basket.

This leaves the fiscal criteria as the major outstanding problem since the budget deficit is well above the 3% limit and the debt ratio likewise exceeds the 60% reference value. The need to curb the deficit is widely acknowledged and is a central objective of the Government's Convergence Programme 2004-2007. This is most welcome because progress in the area of fiscal consolidation and structural reforms is desirable not only because of the need to satisfy the Maastricht criteria. It is also required to support the exchange rate as long as Malta continues to pursue a fixed exchange rate regime.

Progress in this direction is certainly also necessary if we want to have a smooth passage through ERM II. Indeed, the size of the fiscal deficit is a determinant of the degree of exchange rate fixity which a country can afford, and thus also has implications for the width of the band which will apply to the Maltese lira in ERM II. On the one hand, Malta's successful experience with a peg in terms of price stability, coupled with the importance of exchange rate fixity for a small open economy that is heavily dependent on foreign trade and investment, suggest that it would be desirable if the features of the present exchange rate regime - predictability and stability - were preserved while Malta participates in ERM II. On the other hand, the appropriate width of the bands in ERM II is inversely related to the degree of convergence achieved with the euro area, but positively related to the size of the fiscal deficit. Whether the continuation of the features of the current regime will remain possible or not, with all the advantages that it brings to the business community, thus depends on the extent of progress with structural reforms and fiscal consolidation.

It is, therefore, vital that the reform agenda remains on track. It is in the common interest to ensure that the economy converges faster towards the high levels of efficiency and living standards of the euro area. The business community clearly has an interest in contributing to the achievement of this objective, both by modernizing its structures and operational practices so as to be better placed to seize the opportunities and also by participating constructively in national fora such as the MCESD.