Michael C Bonello: The Maltese lira

Interview with Mr Michael C Bonello, Governor of the Central Bank of Malta, by The Malta Business Weekly, 9 December 2004.

* * *

I must first of all point out that decisions regarding the external value of the Maltese lira can only be taken by the Minister of Finance on the recommendation of the Central Bank of Malta and with the consent of the Prime Minister. Decisions on such a complex, technical issue can have far-reaching economic and social implications and are understandably not taken lightly. They must, for that same reason, be made on the basis of facts not supposition.

Having said that, I must make it equally clear that at this point in time the Bank cannot responsibly make a recommendation in this sense for the simple reason that it has no conclusive evidence that such a change is warranted, still less that it would deliver the expected benefits. Nor is the Bank aware that anybody else has made a credible case for changing the value of the currency.

The conclusions of the Bank's study on the equilibrium exchange rate have been shared with several local and foreign experts, including the IMF mission that was in Malta last May. Subject to the caveat that the equilibrium exchange rate of a currency cannot be estimated very precisely, there is common agreement that the exchange rate of the Maltese lira does not appear to be significantly misaligned and that the reasons for the economy's slow growth lie elsewhere and should be addressed directly.

Indeed, I cannot detect an economic rationale for the sudden attention being given to the exchange rate. The exporting community, the sector most directly concerned, has not to my knowledge made a formal proposal through the FOI. It is also significant that a change in the exchange rate did not feature among the 55 MCESD recommendations for the restoration of competitiveness.

Devaluation to improve competitiveness does not work. Unless it is accompanied by a cut in real wages, it serves only to raise inflation. This is borne out by the experience of several countries, including Malta's after 1992.

As for the concept of a "gradual depreciation", which has not been clearly defined, the nearest instrument known to economic theory is a crawling peg. Since this involves a change in the exchange rate regime, it requires an announcement that the currency will be depreciated at given intervals dictated by movements in some anchor, such as the retail price index. This method creates uncertainty and offers speculators a one-way bet. Experience has indeed shown that crawling peg regimes have often ended in crisis.

The lessons of recent economic history should not be ignored. Changes in the exchange rate should only be resorted to when everything else has failed. They should be a measure of last resort. Besides, they only produce the desired results if they are accompanied by a comprehensive set of complementary policies implemented in a controlled environment.

Speculating about the exchange rate without producing conclusive proof that it is the root cause of the economy's difficulties is, therefore, inappropriate and can have serious repercussions. The national interest requires all of us to concentrate rather on the more immediate, and well documented, reasons for the economy's slow growth. I have elaborated on this aspect in a recent interview carried by another local newspaper.