Michael C Bonello: Interview with The Times (of Malta)

Interview with Mr Michael C Bonello, Governor of the Central Bank of Malta, appearing in The Times, 10 May 2007.

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You have long argued for structural reforms and the same message emerges from your Statement in the Bank's recently published Annual Report for 2006. With an election due in the coming year or so, is there any point in repeating your plea?

The Central Bank of Malta has a statutory responsibility to advise the Government on economic and financial matters. In performing this advisory role the Bank cannot be conditioned by considerations of electoral expediency or feasibility. Central bankers must take a long-term view of the economy's best interests; and it is clear that in the long run the remaining rigidities and inefficiencies which burden the Maltese economy are unsustainable.

Although it is true that the economy has entered a recovery phase, it is also a fact that Malta has not benefited to the same extent as other countries at a similar level of development from the favourable global conditions of the past three years. This suggests that structural factors prevented the economy from responding effectively to the cyclical upswing. That partly explains why per capita GDP in Malta has fallen against the EU average, from 74 per cent in 2001 to 72 per cent last year.

This relative decline cannot be corrected unless productivity growth accelerates. Wage increases have been moderate and cannot, therefore, be blamed for the recent setback in competitiveness. The cause is weak productivity growth, averaging just 0.1% between 2001 and 2005, compared with 0.5% in the euro area. So that while wage moderation remains essential in today's competitive environment, higher productivity levels are indispensable to sustain economic growth and living standards.

As I emphasized in my Statement, the response to this challenge must, sooner rather than later, include measures designed to influence *all* the determinants of productivity growth. The needs here are well known. Key among them are policies to further improve the quality of human capital and to attract even more high-value added foreign direct investment; the need to reorder priorities in public spending to align them better with the Lisbon Agenda goals; a more cost-effective delivery of support services to exporters by both public and private sector suppliers; the adoption of more efficient work practices; and policies to raise the labour participation rate, especially for women.

In your statement you also call for means testing. Aren't you treading through a political minefield?

It is only a political minefield because we have allowed it to become one. Generations of politicians have fostered the belief that governments have the means to provide all citizens, irrespective of their financial means, with an extensive range of free services and benefits.

With expectations rising faster than the ability of governments to meet them out of available resources, however, the norms of prudent financial management were put aside and growing resort was made to deficit financing. Understandably, politicians are wary of asking citizens to give up any of the rights they have acquired in the process, especially on the eve of elections.

The problem is that there comes a time – and that time is now in Malta as in some older EU members – when the financial burden of an extensive welfare system (itself compounded by the effects of an aging population) and of a large, and relatively inefficient public sector becomes too heavy to bear. It also deprives the economy of both the resources and the flexibility necessary to respond successfully to the competitiveness challenge coming from low-cost or more efficient producers.

This is a challenge which cannot be ignored. The people need to be told that certain attitudes and practices are unsustainable, and that the only effective response to the relentless march of globalization, to EU membership and other sources of competitive pressures is nothing less than a culture change, a complete break with the past. I believe it is possible to build an alternative, more efficient system for managing the economy and which nevertheless reconciles the objectives of social cohesion and financial sustainability.

It is in this broader context that I have often called for a wider application of means testing. It is hardly equitable to provide free health care and medicines to all irrespective of income levels. Means testing would, moreover, help to ensure that essential health and welfare services could be provided free of charge in the years to come to those who truly deserve them. The provision of stipends to all students in higher education is even more difficult to justify. For apart from equity considerations, stipends draw funds away from other uses, such as the provision of better library and laboratory facilities and the recruitment of more full-time teaching staff instead of part-timers.

I acknowledge that it is not easy to implement means testing fairly because those who under-declare their income, and thus evade taxes, would qualify for benefits undeservedly. The answer, however, is not to rule out means testing in principle, but to wage a more effective campaign against tax evasion.

I also recognize that a wider application of such testing might make only a relatively small contribution to the correction of the fiscal imbalance. But it would be highly symbolic in that it would send a powerful message about the need for change to a citizenry which firmly believes that public goods and services can be had for "free".

The truth is that there is no free lunch – somebody must pay for it! Let me give you two topical examples. First, take the Park and Ride scheme. The popular impression is that it is free. This, however, is not correct. What is happening is that people who use the scheme are getting a free ride at the expense of those who do not use it. Had the latter been consulted, they might well have preferred to see their taxes put to a different use.

The other example comes from New York. Defending his proposal to introduce a congestion charge for vehicles entering Manhattan, Mayor Bloomberg is reported to have said that the question was not whether people wanted to pay, but how they wanted to pay: whether through a higher incidence of respiratory and other diseases and increased health care costs, or by reducing the number of polluting vehicles in the city and using the money collected through the charge to improve public transport.

The Central Bank of Malta raised its central intervention rate twice last year and again in January. Wasn't this risky for an economy finally showing growth?

The primary objective of the Bank's monetary policy is price stability. As is typical for small, open economies, however, the Bank does not target inflation directly. Instead, the Bank pursues this objective by using the exchange rate as its intermediate target and the level of the external reserves as its operational target. In the absence of capital controls, interest rates on the Maltese lira are inevitably influenced by those offered by the currency to which it is pegged, the euro.

It follows, therefore, that in an environment of rising interest rates abroad, domestic rates must also rise in order to maintain a premium over euro rates, and thus protect the Maltese lira by making domestic financial assets more attractive, thus discouraging capital outflows. That is why under fixed exchange rate regimes, the state of the economy cannot be a primary consideration.

Having said that, it must be pointed out that the two objectives are not mutually exclusive. Indeed, since a prudent monetary policy stance contributes to macroeconomic stability, it indirectly creates favourable conditions for sustainable economic growth.

It should also be noted that the recent increases in domestic interest rates – after a long period at historically low levels, it must be said – are unlikely to have slowed down the economy unduly. The sensitivity of the economy to interest rates is, in fact, thought to be relatively small. Higher rates will have some impact on growth and employment only if they are sustained over a long period of time. Our estimates show that a half-percentage point rise in interest rates, for example, will reduce the GDP by only 0.06% in the first year, reaching 0.1% by the third year.

At the micro level, of course, higher interest rates raise borrowing costs for businesses and households. On the other hand, depositors benefit from higher interest income. Once again, however, monetary policy decisions cannot be based exclusively on such considerations. Exchange rate stability must take precedence over the cost of money in a small, open economy.

You have implied that higher interest rates were necessary to defend the exchange rate. Has the recent declining trend in the Bank's external reserves been mostly due to the premature conversion of Maltese lira to euro?

With an open capital account and the growing integration of the Maltese financial system with that of the EU it is becoming increasingly difficult to clearly identify the impact of the different factors affecting movements in the external reserves. Some factors, moreover, are interest sensitive, others less so and yet others not at all.

One major factor belonging to the latter category that has exerted downward pressure on the reserves since the latter part of 2006 has been the improved prospect of euro adoption in 2008. This has induced some firms and individuals who receive foreign income denominated in euro not to convert such income into domestic currency.

Others are converting their Maltese lira deposits into euro deposits. In addition, holders of Maltese lira assets, particularly cash, have been buying up euro currency notes. It is significant that since the external reserves started to decrease in November, currency notes in circulation have declined by about Lm35 million, almost entirely in the form of Lm10 and Lm20 notes, the preferred medium for cash hoarding. At the same time, the importation of euro notes, mainly high denomination notes, has increased.

Movements in the external reserves are also influenced by the performance of the current account of the balance of payments. This account has been persistently in deficit, although there was a marked improvement in the deficit in 2006 to 6.3% of GDP. In the long run, however, this imbalance needs to be further reduced to a more sustainable level. This can only be achieved to the extent that growth is driven more by export-oriented activities and less by consumption.

In view of the large amount of currency in circulation and your interest in ensuring a smooth changeover to the euro, what advice would you give to the public in this regard?

As I said earlier, the amount of currency in circulation has been contracting and there is evidence that cash hoards and bank deposits are being converted into euro. We are trying to discourage this premature conversion because portfolio diversification at this stage is expensive and makes little sense. In the case of Maltese lira bank deposits, these will be converted automatically, and at no cost, into euro on the changeover date.

As for cash conversions, people who are buying euro currency notes from banks and other financial institutions are having to pay exchange commissions; those who obtain euro notes outside the banking system are being offered an even more unfavourable exchange rate, besides running the risk of receiving counterfeit notes. These early conversions, moreover, constitute a drain on the Bank's reserves.

We are, therefore, encouraging the public to deposit Maltese lira cash holdings into the banking system and retain them in Maltese lira denominated deposits, thereby earning interest. In this regard, some of the domestic banks have launched special deposit schemes to attract such funds. Those who already hold lira deposits, bonds and similar assets do not need to do anything. Such assets will be automatically converted into euro when the changeover takes place, and free of any charges.

For those who own Maltese lira and euro assets that represent income previously not declared for income tax purposes, the recently launched Special Registration Scheme represents a timely opportunity for such persons to regularize their holdings in terms of the law.

In summary, therefore, I would say that there is no advantage to be gained by converting Maltese lira assets into euro before the changeover date. From that date onwards, there will be an ample supply of euro notes and coin to satisfy the needs of the public. More importantly, euro currency will be provided at the official conversion rate without any changes or commissions.

Still on the euro, do you think that people are as worried about inflation as they were?

According to the Eurobarometer poll taken in September 2006, some 70% of Maltese respondents said they feared the euro would give rise to inflation and over 80% were afraid of abuses and cheating on prices. This fear is largely based on sometimes inaccurate reports in the local media of what happened in some of the countries that introduced the euro in 2002.

Since then many lessons have been learned and, with the help of the EU Commission, the ECB and twinning agreements with Ireland, Austria and France, a big effort is being made by the NECC to avoid the repetition of past mistakes. Some four-and-a-half thousand businesses have applied to enrol in the FAIR initiative. Dual pricing will become mandatory on July 1, and in fact many sellers have already started to display prices in both currencies.

Consumers, therefore, have reason to feel reassured. At the same time, it must be understood that a low-inflation changeover will depend on a number of factors. Competitive pressures keep sellers honest; but for competition to work, buyers must be vigilant and assertive, taking advantage of dual price displays and other information material that will be available. Moreover, there must be zero inflation on all government-supplied products/services. In fact, the national master plan requires public sector entities that want to smoothen monetary amounts in euro to submit a business case to the Ministry of Finance showing that it is to the consumer's advantage.

One advantage Malta has compared to a country like Italy, for example, is that any Maltese lira amount will translate into a larger number of euros, and for that reason there will be less justification for sellers to round euro prices up. Exact conversions that will leave the cost of living unchanged will always be possible, also because very low denomination euro cent coins exist. The one-cent euro coin is in fact equivalent to less than the Maltese five mils coin, a unit of such a low value that it is no longer in circulation.

Property price inflation has finally started to slow down but the pace of construction activity has not – and there are no indications that it will this year. What are your forecasts?

The Bank's residential property price index indeed shows a marked deceleration from a peak of almost 20% in 2004 to 3% in the first quarter of this year. A major contributing factor is surely the marked increase in the supply of residential units, both in the shape of large up-market developments and of smaller apartment complexes. Given this situation of over supply, we expect property price inflation to remain low in 2007.

At the same time, one should not overlook the fact that in a country where land is scarce and substitute locations do not represent a competitive alternative, property remains a popular component of investment portfolios because of the widespread anticipation of large capital gains. Developers, therefore, are willing, and indeed seem able, to hold on to vacant property in the expectation of a rebound in prices. This prevents prices from finding their true level.

Reference is made in your Statement in the Bank's Annual Report to the independence of the institution. Will this change with the entry into the euro area?

If anything, the importance of the Bank's independence, which is already enshrined in Maltese law and has been duly respected by successive governments, will be even greater once the Bank becomes a member of the Eurosystem. First of all, the autonomy of national central banks is mandated by the Maastricht Treaty. Reflecting this requirement, the Central Bank of Malta Act now fully guarantees the institutional, functional, financial and personal independence of the Bank and of the members of its decision-making bodies.

As for the ECB, it has adopted low inflation as its overriding objective, and its independence helps to guarantee its ability to deliver on this commitment. As I said earlier, the governors who sit on the Governing Council of the ECB do so in a personal capacity and must be guided only by euro-area wide considerations. As members of this Council, therefore, governors of national central banks must not only be persons of recognized professional competence and personal integrity, but they must also be prepared to defend their own bank's as well as the ECB's ability to act independently of political and other pressures.