

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

Interview with Mr Michael C Bonello, Governor of the Central Bank of Malta, by The Sunday Times (of Malta), published on 17 November 2008.

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### **If I had spoken to you at the beginning of the year, would you have envisaged this financial mess worldwide?**

I do not think anybody, anywhere, could have fully anticipated the devastating consequences of the sub-prime mortgage crisis in the US. We are learning a sobering lesson about the downsides of liberalisation and globalisation. For almost a decade the world economy had experienced rapid growth. Now we are seeing the other face of globalisation. This is a systemic crisis and it will therefore take longer to resolve than other recent crises. The challenge for policymakers is both complex and unprecedented. It is, however, somewhat reassuring that it is being tackled in a determined and coordinated manner at both political and technical levels.

### **When do you think we'll be out of this dark tunnel?**

I do not think anybody is in a position to answer to that. It is still unfolding.

### **Do you think there was a belated political response to the financial crisis? Were the warning signs ignored?**

This problem did not happen overnight. It was precipitated by the Lehman Brothers failure, but we had preliminary signs in August 2007, which culminated in the Northern Rock (UK bank) failure. The ECB and other central banks started injecting liquidity into the markets then. The gravity of the situation only became fully apparent a year later.

### **The government is insisting the local banks are under no threat from the international financial crisis because of their conservative lending. Do you concur with this point of view?**

Maltese banks are not directly threatened by the financial crisis. Our banks do not hold asset-backed securities associated with the sub-prime crisis. And as the International Monetary Fund confirmed last summer, they are well capitalised and have high liquidity ratios. Maltese banks do not generally borrow from the international money markets to fund lending operations but rely on customers' deposits.

It is significant that at the end of September, deposits by Maltese residents amounted to €8.6 billion, which is equivalent to one-and-a-half times Malta's GDP. That was an increase of €239 million since the end of 2007. Our banks, moreover, have very prudent lending policies. They have diversified portfolios and appropriate risk management systems. This explains why the fallout from the crisis has been fairly limited.

Like investors everywhere, however, all our banks and other investors are seeing the value of their investment portfolios decline as a result of the generalised decline in asset prices. This will result in lower profits, but since our banks are well capitalised they are able to cope with it.

This does not mean there should be room for complacency, particularly at times of unprecedented market dysfunctionality and a looming global recession. A small banking system like ours is inevitably characterised by a degree of concentration risk and, because of a typical Maltese idiosyncrasy, our banks are heavily exposed to the construction and property sectors. Since our economy is likely to be affected by the oncoming recession and will experience a slowdown next year, it would be advisable for the banks to strengthen their balance sheets further.

**Would you say that the worst is over for local banks? Can you envisage a scenario where one of the banks will go down?**

There is no direct threat from the crisis – they are not directly exposed. If the economy slows down, certain borrowers might be overextended and there might be an increase in non-performing loans.

**During a press conference in Frankfurt last week, ECB President Jean-Claude Trichet said he did not exclude further interest rate cuts. Why the need for further cuts and are you optimistic that these cuts are the solution?**

During the ECB Governing Council of November 6, we concluded that the outlook for price stability had improved further because inflation rates are expected to continue declining. Market expectations about medium-term inflation based on information extracted from the bond markets have fallen to just over two per cent.

While the Governing Council does not pre-commit itself, should the data available at our December meeting point to a further alleviation of upside risks to price stability, then the conditions would be ripe for another cut in interest rates. Lower interest rates should contribute to easing current tensions in the financial markets and also to facilitating the flow of credit.

But monetary policy alone cannot resolve the financial and economic crisis. Corrective actions at other levels of policy are required, and these have indeed been taken by national governments and central banks as well as by international institutions. It will, however, take a while for confidence to return to a level that would permit the financial system to fully service the needs of a globalised economy.

**So why did the ECB increase rates in the first place in July?**

Consistently with its interpretation of the mandate, at that time the ECB perceived that there were strong upside risks to price stability. Decisions are always based on the latest information available and on a full analysis at a given point in time. The slowdown in economic activity has been very sudden, and projections for inflation have in the meantime been revised downwards.

**Do you think the cuts should always be passed on to the customer? In some cases the local banks have refused to do so, or they didn't reduce them to the full extent.**

In Malta, banking practice has generally been to set interest rates with reference to the official policy rate. Where such is the case, we would expect most of the ECB's interest rate cuts, one percentage point in the past month, to be passed on to customers, particularly at a time of weakening growth prospects. I have just seen that our two main banks are moving in this direction and are also giving preferential treatment to mortgages.

You also have to remember that a bank manages two sides of the balance sheets. It collects interest from borrowers but it pays interest to depositors. It is the efficient management of the difference between interest earned and interest paid that earns a bank its profits. Given that both lending and deposit books may differ from one bank to the other, there could be various reasons why the full interest rate cut is not passed on to the customer straight away.

**Are you optimistic that these interest rate cuts are enough to stave off recession?**

Monetary policy is just one instrument available for macroeconomic adjustment, so it has a limited capacity. It just tries to achieve price stability, because without price stability you cannot have long-term investment plans plus economic growth and employment. The problem is deeper than that. We need a coordinated effort at the political, central banking and regulatory levels.

**There is talk of a looming recession in Malta. Do you agree with this argument?**

I have not seen any economic indicators which at this point in time suggest that this scenario is imminent. I would rather wait to see the figures as they come out. So far we have an average growth rate of over three per cent for the first half of the year. The figures for the third quarter are unlikely to be dramatically different from what we have seen so far. Unemployment is still rather stable at a relatively low level. We have, of course, started to see the first signs of a slowdown in our major markets with some companies reducing the number of work days and letting go of some employees. We are a very open economy, we depend on external demand and it is only natural that we will be affected.

**Has personal debt in Malta increased in the last years?**

As you would expect in a growing economy, household debt has been rising. It is currently estimated at €2.6 billion or 48 per cent of Malta's GDP. It was 31 per cent in 2002, but the ratio remains below the euro average of 60 per cent. The interest burden on Maltese households arising from this debt as a proportion of disposable income is comparable to the euro area average at three per cent.

**Are we saving more?**

It is unlikely. There has been a declining trend because habits and cultures change. The existence of a very extensive social safety net has acted as a disincentive to save for one's old age.

It is appropriate for households to borrow funds to smooth their consumption patterns as long as this is backed by reasonable income expectations. The number of non-performing loans has been coming down for some years in the household sector though it has risen slightly recently to 2.5 per cent. On the positive side, net financial wealth of households has increased by 15 per cent since 2003 – it was estimated at €8.2 billion in June. On average, households have considerably more assets than liabilities, which suggests that household debt is within sustainable levels.

**So do you disagree with claims that we've started living beyond our means?**

As long as people can manage their finances, if they do not keep accumulating debt and repay their debts to banks, there does not seem to be a problem at the level of households.

At a national level, the picture is different – we still have a tendency to spend more than we earn as evidenced by the current account of the balance of payments and the fiscal position, which both show a deficit year after year. The prospects for changing this behaviour, at least at this point in time, do not seem very encouraging. These days we are seeing a growing chorus of people calling on the government to run an even larger deficit and to increase the public debt further.

**During a seminar last June, you said that automatic compensation for inflation, especially at the national level, was counterproductive. The government has calculated its COLA at over €4.09 a week. What do you make of it?**

When you have countries with wage indexation schemes that link wages to past inflation, there is always a danger of the two feeding on themselves and the creation of a wage-price spiral. At the ECB Governing Council, we repeatedly point out the dangers of allowing a one-time spike in prices of exogenous origin to affect wage levels in this way because it becomes a self-perpetuating increase harming competitiveness. In Malta the indexation scheme is partial, but nevertheless it contains the potential for creating higher costs. We have to sell our products and services abroad and so we need to remain competitive.

**So do you think it was wrong to give workers a €4.09 increase?**

That is an agreement reached with the social partners. If we accept that it is a priority for us, then we need to make sure we increase our productivity to match the increase in wages.

**Nearly one year on, do you think the euro was to blame for the rising inflation and would you describe its phasing in as successful?**

A Eurobarometer survey last April showed that 90 per cent of Maltese citizens considered that the change to the euro was smooth and efficient. A Eurobarometer survey in February said that 84 per cent of Maltese citizens believed that the price conversions into euro were "always, or mostly" fair. A Eurostat assessment in April found that the total one-off impact of the euro changeover was between 0.2 and 0.3 percentage points. According to the European Commission, the perceived inflation index for Malta fell from 51 points in December 2007 to 40.5 points in January to 34 points in February. This is evidence that we have not experienced a spike in inflation directly attributable to the euro.

**A lot of people would tell you that everything went haywire after March...**

Yes, we have since had an increase in inflation but this is largely attributable to the delayed higher international energy prices and the spike in food and cereal prices. We have been importing inflation, and the way we have administered prices in the energy sector has not helped. We have tried to protect ourselves for too long from market prices, and then when you make changes they tend to be bigger than if you had allowed the gradual movement of prices to take place.

**To what extent has the introduction of the euro helped to cushion the impact of the financial crisis? Where would we be with the Maltese lira?**

I was one of those who always expressed the belief that Malta's small open economy in a liberalised global environment and with its own currency was becoming increasingly vulnerable. That is why I was an advocate of EU membership and of early euro adoption. We only need to look at the example of Iceland, which stayed out of the EU, and the financial disaster it is now experiencing. Look at Denmark – an advanced stable country which is also pegged to the euro. Because of this turmoil, the Danish central bank has had to increase interest rates. This is the price of going it alone in times of stress.

**How much Maltese lira remains in circulation?**

There is still a considerable amount of Maltese currency which has not been presented for redemption. There is about Lm11 million (€25.6 million) in coins and something like Lm28 million (€65.2 million) in notes. Holders of coins have two years to present them at the

Central Bank of Malta and in the case of notes it is 10 years. Money is still coming in, but at a very slow pace.

**Do you think this Lm39 million will ever be returned?**

The experience of other countries suggests there is always a considerable proportion of currency issued which is never returned. It depends on how long the currency has been in circulation. Many coins which were issued up to 30 years ago have probably left the country through tourism or have been lost. It is the same with notes, especially the small denomination notes – they might have been lost or deteriorated. Some of the higher denomination notes might still be hidden away, and maybe forgotten.

**Has the euro hoarding started?**

I do not suppose all those who had that habit have adopted a new way of doing things. In 2007 there was considerable activity with people exchanging Maltese lira notes for euro on the kerb market – and that probably represented mainly hoarded money. We had people who were hoarding money because of habit – these were persuaded to open bank accounts. Last year we saw a sharp increase in bank deposits when the banks targeted these people with very attractive interest rates on short-term deposits to take them over the end of the year to save them the trouble of having to exchange cash. What we know is that we have not reached the same level of currency issued that we had before. There is a caveat here as the currency is shared with 14 other countries.

**Do you believe that the international financial crisis is prompting more people to become reluctant about depositing their money into banks?**

There is no evidence. Across the Eurosystem, in September, after the Lehman Brothers collapse there was an increased demand for currency notes in some countries, especially those whose banks were exposed to emerging economies. It seems to have largely subsided since then.