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The Mediterranean economies in a changing world
Lessons learned in economic and financial instability:
what scenarios can we envisage?

The role of Central Banks at present.
Monetary policies and exchange rates in the Mediterranean countries

Address by Dr Mario Vella
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Dear Governor Linde, dear fellow Governors, ladies and gentlemen,

Thank you for the invitation to participate in this forum on monetary and exchange rate policy in Mediterranean countries. The Central Bank of Malta is both a Mediterranean central bank, which once pursued a monetary policy regime similar to that followed by many Mediterranean central banks today, as well as a member of the Eurosystem.

Since January 2008, when Malta adopted the euro, the Central Bank of Malta is an integral part of the Eurosystem. This comprises the European Central Bank and the national central banks of those EU member states that have adopted the euro as their currency. For us, therefore, our monetary and exchange rate policy is that of the euro area as a whole.

The primary objective of monetary policy in the euro area is price stability.[1] The Governing Council has defined price stability as an average annual rate of inflation of below, but close to, 2% over the medium term. This focus on price stability is based on the knowledge that money is neutral in the long run, meaning that it can affect nominal variables, such as the price level or the exchange rate, but not real variables, such as income and employment. It also reflects the historical experience of many countries, which clearly shows that inflation is ultimately a monetary phenomenon.

The existence of a single currency, the euro, entails a single exchange rate. This has both internal and external implications.

From an internal perspective, the single exchange rate means that the euro shields its member countries from exchange rate volatility between them. Indeed, the desire to eliminate such volatility was one of the main driving forces behind the creation of the euro itself. Prior to the existence of the

[1] See European Central Bank (2011) *The Monetary Policy of the ECB.*

euro, exchange rate arrangements in Europe were subject to the risk of destabilising currency crises. This instability was seen as incompatible with the existence of a single market and an integrated European economy.[2]

From an external perspective, like most major currencies, the euro is a freely floating currency. The external value of the euro is determined by the interaction of demand and supply in the foreign exchange market. Of course, the exchange rate remains an important indicator for the Governing Council, in so far as exchange rate movements affect developments in economic activity and inflation. At the same time, the monetary policy stance of the ECB, while fully oriented towards the price stability objective, does influence the exchange rate.

From a theoretical viewpoint, one can argue that the member countries of the euro area have chosen to go beyond a fixed exchange rate by adopting a single currency. The adoption of the euro implies the irreversible abolition of national currencies and, hence, of national exchange rates themselves.

This choice involves a trade-off. On one hand, a single currency, as we have seen, eliminates the volatility of exchange rates within the monetary union. The euro, as a freely-floating currency, helps protect the economies of its member countries from external shocks. The single currency also facilitates trade between them, deepening economic integration.

However, the elimination of national currencies implies that market signals regarding domestic economic imbalances are lost, allowing such imbalances to build up. More importantly, the absence of national currencies also implies that a valuable tool for stabilising the economy in the short term in the face of asymmetric shocks is no longer available. The sovereign debt crisis in the euro area has brought home the implications, both positive and negative, of membership of a single currency area. It remains my firm opinion, however, that the gains outweigh the losses. It is also my firm opinion that greater efforts need to be made to reduce and eventually eliminate internal imbalances within the monetary union in order to protect its sustainability.

I would now like to turn briefly to the experience of the Central Bank of Malta in dealing with these policy issues over almost 50 years of its existence.

Malta is an extremely small, open economy, highly dependent on international trade for its prosperity. The Bank's monetary policy objective was initially set as the promotion of *"the orderly and balanced development of Malta and a rising level of employment and income consistent with the maintenance of monetary stability in Malta and the external value of the currency"*.

In practice, among these multiple objectives, the Bank gave priority to maintaining stability in the external value of the Maltese lira (or pound as it was initially known). An exchange rate peg was seen as necessary to support foreign trade and inward investment from abroad. Moreover, given Malta's

[2] For an account of the euro area's exchange rate policy during the first decade of its existence, see Lorenzo Bini Smaghi, "The euro area's exchange rate policy and the experience with international monetary co-ordination during the crisis". Speech delivered on 6 April 2009 in Brussels.

dependence on imported goods to satisfy domestic consumer demand, the peg was also seen as a prerequisite to safeguard domestic purchasing power.[3] Throughout its existence, therefore, the Bank's monetary policy orientation was always focused on a fixed exchange rate as the nominal policy anchor.

When the Bank was founded in 1968, Malta formed part of the sterling area, reflecting its past as a British colony and its strong ties with the United Kingdom. When the Bretton Woods system collapsed in 1972, the Maltese monetary authorities decided to break the exclusive link with the pound sterling and to peg the lira to a trade-weighted basket of currencies. During the 1980s the composition of the basket was revised on several occasions until, in 1989, the number of component currencies was reduced to three, the ECU - which had replaced several European currencies - the pound sterling and the US dollar. In 2002, the weight of the euro was raised to 70%, while those of the dollar and the pound were set at 20% and 10%, respectively.

Following Malta's accession to the European Union, in May 2004, the authorities resolved to move swiftly to adopt the euro. A year later, the Maltese lira entered Exchange Rate Mechanism Mark II (ERM II) with a unilateral commitment by the Maltese authorities to maintain its value unchanged at the central parity rate. This central parity rate then became the conversion rate between the Maltese lira and the euro when Malta adopted the single currency at the beginning of 2008.

In effect, Malta has moved from a currency union with the pound sterling to membership of the euro area, with a period characterised by a basically fixed exchange rate in between.

Maintaining an exchange rate peg over such a long time span is hard, though changes to the composition of the currency basket allowed some flexibility. Throughout this period, the lira was only devalued once, in 1992, in the wake of the turbulence seen in Europe, which saw the pound sterling ejected from the Exchange Rate Mechanism (ERM) and the devaluation of the Italian lira among others. Otherwise, the Bank's determination to maintain the peg never wavered. We never blinked.

The ability to maintain the peg may have been partly due to restrictions on trade and stringent controls on capital movements, at least in the early decades. By the mid-1990s, however, trade and financial market liberalisation meant that these factors became less and less important. Instead, major reforms in 1994 brought about fuller independence for the Central Bank and a gradual liberalisation of interest rates amid increasing recognition that, in the absence of capital controls, monetary policy had to be more actively oriented towards maintaining the peg.

Throughout, the lira was buttressed by a healthy stock of external reserves. The Central Bank of Malta was legally bound to maintain reserves equivalent to at least 60% of the monetary base, but in

[3] For a review of Malta's monetary and exchange rate policy over the years, see Anton Caruana Galizia (1989) "Malta's exchange rate policy since the breakdown of the Bretton Woods system" in the *Central Bank of Malta Quarterly Review*, June 1989 and Aaron G Grech (2003) "The framework of monetary policy in Malta". MPRA Paper No 33464.

practice this ratio normally exceeded 100%. As capital controls were eased, interest rate policy was increasingly set with an eye on the spread vis-à-vis interest rates offered on the basket currencies (and, later, the euro).

More profoundly, maintaining the exchange rate peg required discipline in domestic wage and price setting to safeguard Malta's external competitiveness. Despite an element of wage indexation, the labour market was fairly flexible, with relatively low coverage of collective bargaining in the private sector and with wage negotiations being handled at the level of the individual firm. Broadly speaking, fiscal discipline was also maintained. The government debt to GDP ratio remained below 60% until the late 1990s, peaked at around 72% in 2004, and is now just at about the 60% threshold again.

This discipline helped establish the credibility of the exchange rate peg, which became embedded in the decision-making process across the economy. For this reason, the Bank never adopted policy options that would have entailed greater exchange rate flexibility, even when this became possible, for instance in ERM II.

Subsequently, this internal discipline also served in good stead after euro adoption, which, as we have seen before, entails the loss of the exchange rate and interest rates as a policy tool. Despite the several shocks that have hit the euro area since 2008, the Maltese economy has performed well. Malta has taken full advantage of the opportunities offered by EU accession and euro adoption to diversify its economic base, from an economy driven mainly by export-oriented manufacturing industry to one characterised by the increasing importance of export-oriented services. It also engaged in structural reforms to increase competition in key markets and to encourage labour market participation. Malta now enjoys rapid growth, full employment and moderate inflation.

The latest Economic Forecast by the European Commission, that of Winter 2017, shows that Malta's economy is expected to remain on a sustained positive trajectory. According to the Commission:

"Malta's economic growth has settled down from the exceptional levels of 2014 and 2015 but is forecast to remain well above the EU average. Unemployment is set to remain at record lows while productivity gains contain unit labour costs and preserve competitiveness."

Malta's real GDP growth is estimated to remain robust. For both 2017 and 2018, the Maltese economy is estimated to expand at the rate of 3.7%. This places Malta amongst the top performers in the EU. During 2017, GDP in the euro area and the EU is expected to grow at the rate of 1.6% and 1.8% respectively. For 2018 growth in the euro area is expected to increase to 1.8% whilst average growth in the EU will remain as in the previous year (1.8%).

Malta's historical low unemployment rates are envisaged to be maintained over the coming period. The EC forecast shows that both for 2017 and 2018, Malta's unemployment rate will be 4.9%, which is extremely low when compared to the both the euro area and the EU. During 2017, it is expected that unemployment in the euro area and the EU will be 9.6% and 8.1% respectively. For 2018, unemployment in the euro area is expected to go down to 9.1% whilst that in the EU will also decline to 7.8%.

Malta's general government deficit as a percentage of GDP is also expected to continue on the positive trajectory it has embarked on the in the previous years. It is expected to narrow further to 0.6% in 2017 and remain at this level in 2018. This figure is also compares favourably to the average deficit ratios projected in the euro area19 (2017 and 2018: -1.4%) and the EU (2017:= -1.7% and 2018= -1.6%).

For the first time in many years, Malta's gross government debt to GDP is expected to fall below the 60% threshold. In fact, for 2017 the debt ratio is expected to be 58.0% and to decline even further in 2018 (55.6%).

In my view, the main lesson to be learnt from this half a century of experience is that while a flexible exchange rate policy may afford some leeway in the short term, allowing the economy to withstand economic shocks, it is no substitute for structural reforms that achieve greater flexibility in product and labour markets. This is especially the case for small open economies. In such economies the internal market is far too small for firms to enjoy sufficient economies of scale that enable them to be competitive internationally. Moreover, these economies wield little market power in the global economy. Ultimately, the realities of rigid labour and product markets and unsound fiscal policies always catch up. Exchange rate adjustment alone is unable to restore or improve living standards.

Therefore, a fixed exchange rate policy provides incentives for prudent fiscal behaviour as well as for policies that promote productivity and competitiveness. These policies are crucial to avoid large current account deficits, depletion of foreign exchange reserves, and currency depreciation. Depreciation increases inflation and deters investment if market-oriented reforms in product and labour market policies remain absent and fiscal discipline is missing. Diversification of an economy's production base and of the markets it targets insulate an economy from shocks more effectively than exchange rate flexibility.

In conclusion, I hope I have shown how the Central Bank of Malta has journeyed from a monetary and exchange rate policy based on a currency peg – an arrangement common to many Mediterranean central banks today – to membership of a single currency area. I contend that we have managed this transition successfully. At the same time, we cannot afford to lose the focus on internal discipline and external competitiveness that served us so well over the last five decades. The former exchange rate peg policy, as well as our current membership of the euro area, are not ends in themselves, but are a means to ensure the economic well-being of our citizens.