The Framework of Monetary Policy in Malta

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Introduction

Due to its small size, lack of natural resources and geographical position in the middle of the Mediterranean Sea, the Maltese economy has always been very reliant on international trade and investment flows[2]. Prior to independence, this dependence centred on revenues from the British military naval base. The gaining of political sovereignty in 1964 led to the successful restructuring of Malta from a fortress economy to a well-diversified manufacturing and tourism centre[3]. Starting in the late 1980s, the role of the public sector began to be rolled back, trade barriers were steadily removed and many sectors of the economy were liberalised. Thus, in 1994, the Central Bank of Malta (CBM) was granted operational independence from the Ministry of Finance and given complete autonomy as regards the formulation and implementation of monetary policy. Subsequently, in view of Malta's accession to the European Union (EU) in May 2004, the Central Bank of Malta Act was amended further so that price stability was established as the Bank's primary objective[4]. The CBM pursues this aim by using a fixed exchange rate as its intermediate target or nominal anchor[5].

A Successful Fixed Exchange Rate Regime

When the CBM was established in 1968, the Maltese currency, the lira was fixed at par with sterling. The floating of sterling after the collapse of the Bretton Woods system prompted the Maltese authorities to break this direct link and, instead, peg the lira to a trade-weighted basket of currencies, which included sterling and the major European currencies. In this way, the Maltese lira was insulated from external pressures arising from a binding relationship with

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[2] In 2002 exports and imports amounted to 174% of the gross domestic product (GDP). The latter stood at approximately $3.9 billion.

[3] Market services, including tourism, account for nearly two-fifths of GDP, while manufacturing, which is mainly export-oriented, contributes almost a quarter. GDP per capita stands at nearly $9,200.

[4] The original objectives of the CBM were "*to promote the orderly and balanced development of Malta and a rising level of employment and income consistent with the maintenance of monetary policy stability in Malta and the external value of the currency*". The amended Act also individuated other roles such as financial stability, the payment system and financial statistics. See CBM (2002).

[5] The Minister of Finance, however, may adjust the exchange rate, after consulting the Bank and upon the consent of the Prime Minister.

a single foreign currency. This original basket was afterwards modified to include the US dollar, in order to dampen the effects of the first oil price shock. Several alterations were made in the late 1970s and early 1980s in light of the establishment of the European Monetary System (EMS) and the second oil price shock. During this period the main emphasis was on combating imported inflation by favouring hard currencies in the basket. The subsiding of inflationary pressures, together with a spike in unemployment, prompted the removal of this bias, so to reinvigorate export competitiveness. In 1985 and 1987 the weighting scheme was revised to also reflect trade in services. Two years later, the number of component currencies was reduced to three, as the European Currency Unit (ECU) was included instead of the individual EU currencies. No further changes were effected in the following decade, until the advent of European Monetary Union (EMU) led to the replacement of ECU by the euro. In 2002, the weight of the euro was boosted from 56% to 70%, in view of deepening trade relationships. The weights of the dollar and sterling were set at 10% and 20%, respectively.

The adoption of a fixed exchange rate system implies that monetary authorities are prepared to forgo completely the use of monetary policy for stabilisation purposes[6], unless they set up rigorous capital controls. Liberalised capital flows emasculate any autonomous interest rate policy, as investors react to changes in the interest rate differential and through their actions force a readjustment of the domestic nominal interest rate back to its original position[7].

Maintaining a credible exchange rate peg is inherently difficult, as the speculative attacks that hit the EMS, Latin America and Asia in the 1990s attest. Yet, Malta is one of the few countries to have successfully operated a fixed exchange rate regime since its inception. The lira was, in fact, devalued only once in 1992. This impressive track record may in part be explained by the presence of capital controls, which were gradually removed only recently, and the associated imperfect substitutability of Maltese for foreign financial assets[8]. Thus during the 1970s and 1980s, the strict enforcement of controls may have allowed the authorities to maintain very low domestic interest rates in order to aid industrialisation, while building up credibility and reserves. The effectiveness and comprehensiveness of capital controls, however, diminished progressively, as Government pursued trade and financial sector liberalisation in the 1990s. In fact, in 2002, foreign financial holdings to the tune of 17% of GDP were registered by taxpayers following a special Government scheme.

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[6] Obstfeld & Rogoff (1995).
[7] The CBM, thus, monitors closely this differential so that it always incorporates an appropriate risk premium.
[8] See International Monetary Fund (1999).

Consequently, capital account liberalisation[9] was not seen as posing any threat to the Bank's capability to continue defending the external value of the lira.

The regime is now, in fact, backed by a healthy stock of reserves[10], which are legally required to cover at least 60% of base money. More importantly the credibility of the peg is buttressed by a three-decade long track record during which political and monetary authorities have agreed on the primacy of the fixed rate commitment. Under various administrations, both the Minister of Finance and the CBM Governor have repeatedly stressed that devaluation is a rather ineffective policy, in that it imposes "*immediate costs and leaves no long-term benefits*" [11]. As a result, visiting International Monetary Fund (IMF) missions have always concurred with the retention of the pegged regime[12].

The Rationale behind the Exchange Rate Peg

In a speech in 1997, the then CBM Governor, Mr. E. Ellul, had explained why the Bank has always considered "*some form of fixed exchange rate to be the most suitable arrangement for Malta*" and effectively agreed to "*accept to have its hands tied in this way*". First of all "*the exchange rate peg reduces exchange rate volatility and thus contributes positively to foreign trade and investment*", a particularly important consideration for "*a small, open economy with relatively underdeveloped financial markets*" like Malta. Secondly this arrangement "*may serve to instil greater discipline in the operation of monetary and fiscal policies*", thereby helping "*in achieving long-term economic goals*". Finally, the Governor had stressed that the peg "*is one manner of ensuring that inflation in Malta does not diverge significantly from inflation abroad so that Malta's export competitiveness is maintained*".

Malta's dependence on imports of consumer goods implies that inflation in trading partners plays an important part in domestic price dynamics. Furthermore, even domestically produced goods are to a large extent affected by foreign inflation, as most raw materials and capital goods are imported. As a result, core inflation tends to mirror movements in imported inflation[13]. By pegging the lira to a basket of stable currencies belonging to Malta's main trading partners, exchange rate movements are prevented from boosting imported inflationary pressures. In this regard the peg arrangement has served the country well. With the exception

[9] The last formal controls were removed this year.
[10] In May 2002, external reserves amounted to 152% of the monetary base, and provided 6 months of import cover.
[11] In 2001, the Governor indicated that internal studies had revealed that following a devaluation, the real effective exchange rate (REER) index reverts to its original level within two years.
[12] See IMF (1999), IMF (2001).

of the oil price shock of the early 1980s, inflation has remained low throughout the post independence period. Over the past five years, it has averaged 2.4%, never departing from the basket-weighted foreign inflation rate by more than 0.8 of a percentage point.

The Monetary Policy Advisory Council (MPAC)

The MPAC, which meets every month, is responsible to advise the Governor on matters relating to monetary policy. However, the responsibility for taking decisions is vested in the Governor alone.

Usually the meeting starts with a review of the effects on financial markets of the decision taken in the previous MPAC. The latest financial market trends are then looked into, in order to detect any market expectations. Thereafter the Council proceeds to analyse local and international economic developments and forecasts. Given the nature of the intermediate target, economic analysis focuses on the individuation of current and potential pressures on the exchange rate. These are primarily reflected by movements in foreign currency reserves and the interest rate premium. International developments play a very important part in the determination of these movements. Hence the performance of Malta's main trading partners is monitored extensively. Malta's balance of payment transactions, due to the openness of the economy, are studied in detail, focusing on merchandise trade, tourism and capital flows. The CBM has also constructed CPI-based NEER and REER indices to appraise the economy's competitiveness. Turning to the domestic sector, the MPAC assesses the state of aggregate demand, on account of the substantial import content of consumption. Credit growth and fiscal developments are given close attention in this regard. Labour market activity is also reviewed so as to determine pressures on labour costs. The Council looks at price developments, including movements in house prices. On a regular basis the MPAC is also given economic forecasts derived from the Bank's structural model, together with business sentiment assessments from a survey carried out amongst major economic operators.

Conclusion

Following EU accession, Malta will eventually adopt the euro. This should benefit the Maltese economy as "*from a monetary policy point of view, the surest way to overcome the disadvantages of small economic size is to adhere to a larger currency area*[14]". EMU participation will eliminate currency conversion costs and exchange rate risk. Greater price

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[13] With a lag of two to three quarters and moving on a less volatile path. See CBM (2000).

transparency could also induce more competition and lower inflation. The adoption of the euro, in essence, will consolidate the present exchange rate arrangement and monetary policy framework, whilst removing the need to maintain a large stock of reserves to safeguard against speculative attacks.

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[14] CBM (2002).