Part II – Monetary Policy Strategies, Targets, Instruments, Transmission Mechanisms for Addressing the Most Common Shocks Facing Small States

6

Independence and transparency of the institution

6.0.1 Central Bank

The Central Bank of Malta is an independent institution and a fully-functioning member of the Eurosystem. It has as its major functions the regulation and supervision of banks and financial institutions, and the conduct of monetary policy. These powers are vested in the bank under the Banking Act 1994 and the Financial Institutions Act 1994. It also has, as mandated by the Malta Stock Exchange Act 1990, the responsibility of supervision of the exchange to protect investors and promote a sound securities market.

The regulatory and supervisory role which entails policy formulation is the responsibility of the Joint Banking Committee as per the Banking Act 1994. Apart from policy formulation, the committee also monitors and ensures soundness of the banking system, which is its main role. The committee has as its chairman the governor, assisted by four other bank officials.

The primary objective of the bank is however to foster good economic practice and maintain price stability. Maintenance of price stability is the core requirement prescribed by the Central Bank of Malta Act 1994. Under the act, the bank is also mandated to 'promote the orderly and balanced economic 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.' Besides its main function and objective as mentioned above, the CBM also assists in the formulation of exchange rate policy, a joint responsibility with the government.

In 2002, there was an amendment to the CBM Act 1994. Following the amendment, the primary objective of the bank was defined formally as the maintenance of price stability. This is in accordance with the ECB recommendation.[1] As per the CBM Annual Report

2002, under the amended act of 2002, the bank's independence was reinforced. It was given the operational flexibility required to implement its functions in a liberalised financial environment, whilst at the same time providing for more accountability and transparency. To further consolidate the bank's authority under the amended act, full power to undertake decision on monetary policy was vested to the governor. The Monetary Policy Advisory Council was given a statutory basis, responsible for advising the governor on matters related to monetary policy.

Despite this amendment, the CBM retained its responsibility to foster good economic practice. During the past years, the bank continued with its prime objective, by pursuing policies aimed at containing inflation. Pursuing policies aimed at maintaining price stability helped create a platform for attaining balanced economic development and sustainable growth in employment and income. This was achieved through transparent monetary policy based on a system of exchange rate peg. Having a system of exchange rate peg (i.e. prior to entering the Eurosystem) helped to control cross-border inflation by linking domestic inflation to that of Malta's key trading partners.

In 2002, as part of the amendment to the CBM Act, a framework governing payment systems was established, the first formal system for Malta in accordance with international standards. The establishment of the Malta Real-time Interbank Settlement System (MaRIS) came into effect in October 2002. MaRIS represents an initial step in the integration of Malta's payment systems with other cross-border payment systems, including the TARGET system that operates in the eurozone.

It is important to note that since 1 January 2008, the CBM no longer holds responsibility for monetary policy in Malta. This is because Malta is now a fully-integrated member of the Eurosystem whereby monetary policy formulation is done at EU level, through the governor's participation in the Governing Council of the ECB. The CBM's new role is to implement the common policy decision as devised by the ECB Governing Council. Despite the changing role of the CBM, its prime objective remains and that is the maintenance of price stability.

6.1 Supervision of credit and financial institutions

As the authority that was responsible for the supervision of credit and financial institutions until 2002, the CBM still has to ensure compliance with the provisions of the relevant acts and directives. Supervision is carried out on a regular basis by a team of inspectors. This involves both on-site inspection and off-site supervision, applying a risk-management approach. As part of their supervisory activities, the bank also meets with the institutions' external auditors.

Since January 2002, the responsibility for licensing, regulating and supervising credit and financial institutions as per the Banking Act 1994 and the Financial Institutions Act 1994 was transferred to the MFSA. The same applies to the MSE, which has since October 2002 transferred to the MFSA, as per the new Financial Markets Act 2002.

A number of issues are covered by on-site inspection, amongst which are; credit risk and asset quality, internal audit functions, adherence to licensing requirements and internal controls at financial institutions, and accuracy of reporting. As for the off-site inspection this basically involves the examination by off-site supervisors of the statutory returns that credit and financial institutions regularly submit to the CBM. Besides the regular inspection of the structure of the institutions' balance sheets, other aspects of the inspections focus on market risk and profitability and assessing the management and organisation of each institution.

6.1.1 Financial Intelligence Analysis Unit

In Malta, the functions of financial intelligence which include anti-money laundering (AML) and countering the financing of terrorism (CFT) are carried out by the Financial Intelligence Analysis Unit (FIAU). Unlike Seychelles and Mauritius, the FIAU is not directly under the authority of the CBM. It is governed by a board whose members are appointed by the Minister of Finance as per the Anti-Money Laundering Act 1994.

Under Article 2 of Anti-Money Laundering Act 1994 it states that:

> 'The Minister shall appoint the four members referred to in sub-article (1)(a) by selecting one member from each of four panels, each of at least three persons, nominated respectively by the Attorney General, the Governor of the Central Bank, the Chairman of the Malta Financial Services Authority and the Commissioner of Police.'

The FIAU is the focal point for requesting, receiving, analysing and disseminating reports of transactions or attempted transactions relating to the offence of money laundering or financing of terrorism, to the appropriate law enforcement agencies and supervisory agencies. It is also the unit responsible for ensuring compliance with any legislation on AML and CFT.

To enforce its jurisdiction so as to ensure full compliance with the new legislation on AML and CFT, Malta participates actively in meetings at EU level, for example the Council of Europe Select Committee of Experts on the Evaluation of Money Laundering. Malta's law on AML and CFT is a directive of EU legislations.

6.2 Transparency in monetary policy operations

The transparency with which the operation of monetary policy is conducted has so far been very open. The bank has made it its obligation to be transparent and publicly accountable. This is achieved through the publication of its financial statements, effective communications and announcements through its website, other publications and regular reporting to parliament on its policies and operations.[2] In addition, the CBM operates and maintains a very informative and comprehensive website with very detailed statistics and other information, including quarterly reviews, annual reports and monthly statistical release on monetary aggregates and their determinants.

Furthermore, under the Central Bank of Malta Act 2004, the bank was granted total legal independence. As a member of the Eurosystem, the CBM subscribes to the Eurosystem's mission, strategic intents and organisational principles. The CBM is also reported to be making good progress in implementing the Basel II Core Principles and other EU prudential standards.

6.2.1 Monetary Policy Council

In Malta all decisions regarding monetary policy stance is taken by the CBM Monetary Policy Council, whose members are top bank officials. The council is chaired by the governor, assisted by the board of directors and senior officials of the bank. Usually the council meets on a regular basis on the last Thursday of each month.

6.2.2 Contribution of CBM towards the stability of the financial system

As of January 2008, Malta became a full member of the eurozone after adopting the euro as its legal tender. Being a fully-integrated member of the Eurosystem implies that the CBM objective has to be in line with the EU directives.

Financial stability is one of the core principles, especially given that Malta's entry into the eurozone has coincided with a time when the world has been going through financial turbulence. With regard to financial stability, the objective of the bank states that:

> 'The bank contributes to the stability of the financial system through ongoing macro-surveillance of the infrastructure, financial institutions and markets and by monitoring and assessing the implications for financial stability of economic and financial developments, both domestically and in the euro area.'

In its quest to ensure a sound financial sector and safeguard it against eventual adversities, the bank has set up an early warning system. This system makes use of available information, based on data analysis to detect sources of peril, and tests the resilience of the financial sector to withstand eventual shocks. In recognising the importance of such a system, the bank has also developed a sound framework for the management of crisis situations and emergency procedures. To further assume its commitment as caretaker of the financial sector and hence safeguard its stability, the bank acts as lender of last resort.

6.2.3 Reserve requirements

This is a requirement imposed on the banking system by the CBM for all domestic banks to maintain reserve deposits equivalent to a percentage[3] of their deposit liabilities. The CBM allows certain flexibility with regard to holding these reserves provided that, on average, over the month, the ratio is maintained. This implies that the banks can go below the ratio at times as long as they satisfy the ratio on average.

6.3 Exchange rate policy

The Maltese lira was pegged to a basket of low inflation currencies like Seychelles and Mauritius prior to their exchange liberalisation.[4] The basket of currencies consisted of the euro, the US$ and GBP. Evidence appeared to suggest that the fixed exchange rate regime that was in place until the adoption of the euro in 2008 proved to be effective in containing inflation. As illustrated by Figure 5.3, domestic inflation has remained pretty much under control over the years (i.e. below 5 per cent). Furthermore, as also commented in the CBM Annual Report 2002, domestic inflation managed to stay within an acceptable range of the average inflation rate in the respective countries in the currency basket.

Figure 6.1 below shows the exchange rate of Malta's lira against the euro. Further scrutiny of the diagram reveals that there is a dichotomy at 2003. Prior to 2003 the exchange rate appears to be volatile and trended, while for the period starting 2003, which coincides with Malta's entry into the EU, the exchange rate appears to be stable and the fluctuation within a narrow band.

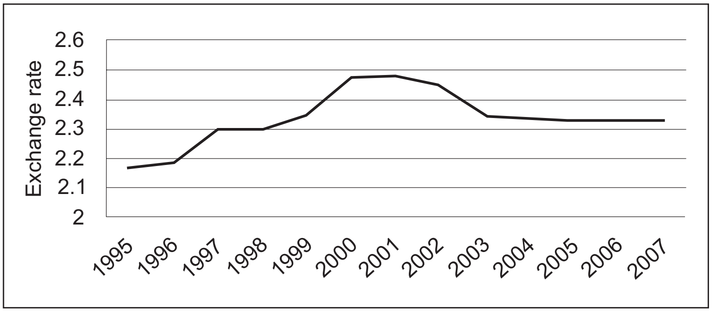

Figure 6.1 Exchange rate – Malta's lira v euro

From Figure 6.1 above, the period 1995–2001 was characterised by a sharp appreciation of the exchange rate. The period 2001–2003 saw a significant decline in the exchange rate, which then stabilised.

Exchange rate stability is vital for Malta, in view of the economy's dependence on external trade and on inflows of foreign investment.[5] Upon the launching of the euro in January 1999, the CBM reacted by revising the weight allocation of the currencies in the basket, favouring the euro. The new weights for the three currencies, i.e. euro, US$ and GBP, were initially set at 56.8 per cent, 21.6 per cent and 21.6 per cent respectively. In 2002 the Monetary Authority made a substantial revision to the currencies basket, to reflect current trends and likely future patterns in Malta's external trade more closely. The new revision saw the euro share increase to 70 per cent while the US$ and GBP were each allocated 20 per cent and 10 per cent respectively. It is interesting to note that since 2004, Malta's exports to the EU have increased significantly.

In order to maintain the fixed exchange rate, the bank uses a variety of instruments. One such instrument is the buying and purchasing of foreign exchange at the official rate. The bank has also utilised IR to manage movements in its external reserves by adjusting the official rates. Altering the official IR has been an important tool in dampening upward pressure on the Maltese lira. Other mechanisms used by the bank as monetary policy instruments, but less frequently, are reserve requirements, standing facilities and controls on capital movements.

6.4 Interest rates

Altering the official IR has been widely used as a means to regulate pressure on the exchange rate. It is important to note that the movements in the official IR impacted on returns in domestic money and capital markets as well as retail bank deposit and lending rates. Malta's fixed exchange rate regime,[6] coupled with the gradual liberalisation of capital movements, implies that domestic IR are greatly subjected to rates abroad.

To ensure compatibility with its monetary policy stance and the short-term IR, the bank made use of the open market operations[7] tool to regulate liquidity in the banking system. As a means to facilitate this process, the bank introduced an overnight deposit facility in 1999. This facility was put in place to mop up excess liquidity from the banking system. The IR offered on this facility was set at 295 basis points below the bank's central intervention rate. This rate acts as a floor for the inter-bank rates.

6.4.1 Open market operation

Open market operations are common, particularly in countries with advanced financial systems. It is an effective method used as a primary instrument by central banks to regulate the degree of liquidity within the economy. In the case of Malta, when the CBM wants to absorb liquidity temporarily from the banking system, it uses weekly auctions of term deposits with a maturity of 14 days. On the other hand, when the CBM wants to inject liquidity into the banking system, it uses auctions repos.

In the repo, the CBM agrees to purchase government securities from the banking system in exchange for liquidity. However the agreement is only temporary, as the bank will re-sell the same securities after a predetermined period of time (usually 14 days). Despite the CBM's active support to the market for government securities through the buying of TB and government stocks, it only operates in the secondary market. The bank does not participate in the primary market.

6.4.2 Discount window and other standing facilities

When the CBM finds it necessary, it discounts TB and other eligible securities to provide liquidity for the banking system. Apart from the discount window, the CBM also offers a collateralised loan facility to the banking system to help them in a situation of temporary shortage of liquidity. To help banks meet their liquidity requirement, an overnight credit facility is on offer. The basic IR on this facility has been set at 55 basis points above the CBM's central intervention rate.

6.5 Exchange control

Like Seychelles prior to the exchange liberalisation, Malta also used to have a system of exchange control. As per the Exchange Control Act 1972, the CBM was appointed as the government agent for this purpose. In 1999 the CBM implemented a series of liberalisation measures to ease the control further. Among the measures implemented are[8] an increase in the limit on direct investment abroad by residents of Malta to Lm300,000 from Lm150,000. In addition, there was a rise of Lm3,000 in the annual ceiling on personal portfolio investment abroad from Lm5,000 to Lm8,000. The period during which local companies could retain export proceeds in foreign currency was extended from four to six months. Furthermore, the bank issued guidelines to authorised dealers on lending in foreign currency to residents. Ultimately, all restrictions on the amount that authorised dealers could lend to non-residents in connection with the acquisition of property in Malta were removed.

A second round of liberalisation took place in November 1999. The measures taken included[9] a complete removal of restrictions on direct investment abroad by companies resident or domiciled in Malta, the limit on personal portfolio investment abroad by residents was raised further to Lm15,000 and restrictions on the surrender of foreign currency receipts by export-oriented companies in the services sector were eased.

In January 2002 a number of liberalisation measures came into effect. This was part of the government's plan to completely remove all controls by beginning 2003, with the exception of those that apply to capital transactions with a maturity period of less than six months. This was in line with Malta's entry into the EU in 2004. The Exchange Control Act 1972 was replaced by the External Transactions Act in 2003. This new piece of legislation, according to the Central Bank Annual Report 2002, would provide the infrastructure for the total liberalisation of capital controls. It would also allow the government power to impose controls in the event of a financial or balance of payments crisis.

6.6 Relationships with other international institutions

In addition to the IMF, Malta is also a member of the World Bank Group, the European Bank for Reconstruction and Development (EBRD) and the European Central Banks (ECB).

6.6.1 Malta and the WTO

Malta became a WTO member on 1 January 1995. Under EU regulation, all its member States are WTO members, for legal reasons known as the European Communities in WTO matters.

Malta has much to gain as a WTO member, as also echoed by its Minister for Commerce in a WTO conference in 1996. Being a small island economy with limited resources, Malta depends heavily on international trade for its livelihood and wellbeing.

Malta is a net food importing country, producing only about 20 per cent of its food needs. Apart from food, Malta also imports nearly all the raw materials and capital goods required for manufacturing industries. Furthermore, the island imports virtually all of its energy needs. Its main exports are electronic products.

Notes

1. Promoting price stability in the euro area is one objective of the CBM and this is done through the participation of the governor in the Governing Council of the ECB.
2. CBM Annual Report 2007.
3. The percentage is not fixed so has a tendency to change subject to the Central Bank of Malta decision.
4. Both Seychelles and Mauritius now have a floating exchange regime.
5. CBM Annual Report 1999.
6. That is prior to Malta joining the Eurosystem in 2008.
7. These are transactions in the domestic financial markets to regulate the level of liquidity in the banking system.
8. CBM Annual Report 1999 p.72.
9. CBM Annual Report 1999 p.72.