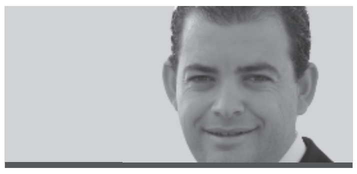


Edward Rizzo

Mr Rizzo is director of Rizzo, Farrugia & Co. (Stockbrokers) Ltd.

The market in Malta Government Stocks

The Rizzo Farrugia MGS Index was launched in December 2010 to help investors gauge the movements in prices of Malta Government Stocks. The changes in this index (especially recently as a result of wide price fluctuations from one day to the next) provides a useful insight into current developments across local and international financial markets.

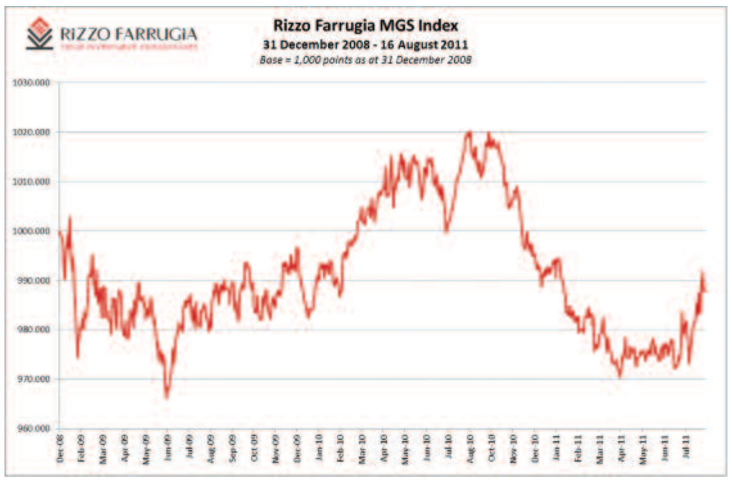
The MGS Index tracks movements in the bid prices of all Malta Government Stock issues quoted by the Central Bank of Malta and due to the inverse relationship between bond prices and yields, an increase in the index represents a decline in yields and vice versa.

After closing at 992.63 points on December 31, 2010 (representing a 0.7 per cent rise for the year), the MGS Index was on a clear downward trend during the first few months of the year as eurozone yields edged upwards in anticipation of a widely expected increase in official interest rates in the euro area. In fact, the Rizzo Farrugia MGS Index dropped by 2.23 per cent to 970.537 points on April 11, 2011 and traded within a narrow range during the subsequent three months.

However, the steady upward movement in yields (and downturn in prices) that was evident at the start of 2011 began to quickly reverse in June as renewed fears on the worsening eurozone sovereign debt crisis surfaced once again. As talks on the second Greek bailout dragged on, and fears spread towards Italy and Spain, the search for safer sovereign assets caused German bund prices to rise sharply. As a result, the eurozone benchmark yield (which is one of the indicators used by the Central Bank of Malta to establish daily bid prices for Malta Government Stocks), dropped sharply below the three per cent level, sending MGS prices to higher levels.

Last week, German bund yields dropped below the 2.20 per cent level, and the resultant sharp rise in MGS prices caused the Rizzo Farrugia MGS Index to touch a seven-month high of 991.856 points on August 11. Yields in Europe previously touched an all-time low of 2.09 per cent when the Rizzo Farrugia MGS Index had climbed to a peak of 1,020.209 points.

Although the eurozone benchmark yields once again approached their all-time lows registered almost one year ago, the Rizzo Farrugia MGS Index was however still 2.8 per cent below the high of 1,020.209 points registered on August 31, 2010. This may be explained by a widening of spreads between the yields on Malta Government Stocks and those in Germany as well as the fact that the Central Bank of Malta recently purchased substantial quantities of MGS on the secondary market and such a development normally causes a dampening effect on prices.



The role of the Central Bank of Malta in the MGS market is very well explained on the website of the Central Bank. This role is described as that of a 'market maker' on the secondary market for Malta Government securities. The Central Bank reveals that this role has been performed since the inception of the Bank in 1968 and it is undertaken "because, to date, there are no private market makers or primary dealers in Malta who are prepared to take on this role due to the small size of the market".

The Central Bank of Malta correctly states that by carrying out this function, it has contributed to the development of the domestic money and capital markets and has enhanced the liquidity of Malta Government securities. However, the bank's statement that no private market makers or primary dealers are prepared to take on this role may not be the case at this point in time. It may well be that some institutions are interested in a market making role for MGS and possibly also corporate bonds, however, the legislative changes required to allow private market makers to operate are taking far too long to be introduced.

In my view, the role of the Central Bank can be better described as a 'buyer of last resort' rather than a 'market maker'. Market makers are obliged to quote *continuous* two-way prices in the market and this function is not really being fulfilled by the Central Bank. In fact, the bank quotes "indicative bid prices" on a daily basis but does not quote any offer prices indicating the price level at which the bank is willing to sell given quantities of stocks available on its books. This only happens on rare occasions usually in response to specific requests for largish quantities by market participants.

In view of the limited role being performed by the Central Bank, it is worth highlighting some recent developments that took place on the secondary market. The longest-dated MGS, the 5.25 per cent MGS 2030, is one of the most actively traded on a daily basis due to the very high retail and institutional participation in recent issues of this stock. However, while it was customary in the past to see MGS prices close the trading session at a price equal to the bid price quoted by the Central Bank, the price in recent weeks has very often traded below the CBM bid price of the day due to the large amount of offers coming out of the market. In fact, during the first week of August, a total of €6.2 million was traded in this particular issue alone with the Central Bank on the buying side for a large part of this volume.

This is due to the fact that as indicated on the website of the Central Bank, the bank is only committed to purchase at its initial indicative price up to €250,000 in those stocks having a total issued amount of €70 million and above and only up to €100,000 in those stocks with an issue amount below a level of €70 million. Naturally, depending on the level of supply in the market, the Central Bank adjusts its bid price accordingly during the trading session.

In view of this capacity constraint, the role of the Central Bank as the sole 'market maker' or 'buyer of last resort' should be re-visited. The changing dynamics and requirements of the MGS market especially since Malta joined the euro area is such that the Ministry of Finance, the Central Bank, the MFSA, the MSE and interested market intermediaries should be working hard to allow private market makers to operate.

Back to market developments, the recent upturn in the MGS Index reflects a lower risk appetite by investors due to the growing tensions across the global equity and currency markets. Yields and MGS prices, however, also reflect expectations on the future direction of interest rates. Until a few weeks ago, it was widely viewed that the European Central Bank will continue to gradually increase interest rates following the two hikes of 25 basis points each in April and July, while the Federal Reserve in the US and the Bank of England were expected to also start tightening monetary policy in late 2011/early 2012.

However, following the weak economic data coming out from both the US and the UK bringing renewed fears that both economies will drop back into recession, last week both central banks in the US and the UK indicated that rates will remain at current historically low levels for an extended period of time. The Federal Reserve also provided an indication that rates will remain at close to zero per cent for another two years.

The European Central Bank continues to state that it will maintain a strong vigilance to price stability and the bank's next policy meeting due on September 8 may follow the US lead and give a clearer indication on timeframes as a result of the currently fragile market sentiment. Weaker economic performance was confirmed on Tuesday when the German economy reportedly only grew by 0.1 per cent in the second quarter of the year.

Statements following monthly monetary policy meetings of the Fed, the ECB and the Bank of England are always eagerly awaited by the market.

These statements are also keenly followed in Malta especially in proximity to the offer of new MGS issues by the Treasury. The Malta government raised a total of €401.6 million in February and May 2011 and according to the announcement by the Treasury earlier on in the year, a further €168.4 million remains to be raised this year to fulfill the government's programme in this respect.

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