Michael C Bonello: Overcoming the competitiveness challenge - Malta's economic imperative

Address by Mr Michael C Bonello, Governor of the Central Bank of Malta, to the Malta Chamber of Commerce National Competitiveness Conference, held in Qawra, 5 October 2001.

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That competitiveness is the key to survival is a maxim that applies as much to firms as to national economies. Countries tend to be competitive when they pursue sound macroeconomic policies and a market-oriented growth strategy. Indeed, it is difficult to imagine a firm, however efficient it might be, remaining competitive for long in a country which does not provide a congenial policy environment. The focus of my remarks will, therefore, be on how national competitiveness could best be promoted. For this purpose it is first necessary to enquire why it is that competitiveness has become such a vital issue and why we simply must not fail to overcome the challenge.

The imperative derives from a combination of exogenous and endogenous factors, both structural and cyclical. Perhaps the single most important structural factor is globalisation. Advances in information technology and communications have greatly reduced the costs of doing business internationally. The removal of barriers to the free movement of goods and also of some services has been followed by a large increase in cross-border trade. Firms are thus no longer guaranteed captive national markets.

The process of global economic integration has been driven even faster by foreign direct investment (FDI). Indeed, the volume of global FDI has almost quadrupled since 1980, a much faster progression than world trade, which barely doubled. For the FDI host countries this has meant not only an increase in output and employment, but often also a transfer of technology and know-how that has considerably strengthened their economies. In this respect, the experiences of Ireland and Portugal immediately spring to mind. Thus, failing to compete in a globalized world is likely to result not merely in lower sales but, more importantly, also in less investment and, therefore, in weaker growth prospects.

In sum, globalisation implies increased opportunities but also risks. The opportunities cannot be seized and the risks minimized, however, without an appropriate strategy. For this reason many countries are to-day actively engaged in improving their market positioning and their cost structures relative to their competitors in order to exploit opportunities for increasing their value added.

Some of the more interesting dynamics engendered by globalisation are taking place at the regional level. Economic integration is proceeding rapidly in Europe, Asia and the Americas and, as a result, the region rather than the nation state is gaining pre-eminence as the locus for policy-making in the political sphere and for investment in the economic sphere. Regional integration is, therefore, rapidly becoming a key vehicle for gaining access to world markets and for attracting foreign investment. There is a growing realization that countries which remain outside of regional alliances are likely to become increasingly marginalized.

The external dimension of the economic imperative is further reinforced by domestic considerations. These arise mainly out of the small size of the economy and its lack of natural resources, which translate into a high degree of openness. Malta depends heavily on imports for its consumption and investment needs, and equally critically on exports to generate the foreign exchange required to service its import bill. Imports and exports each account for around 100% of GDP. Such dependence on international trade is clearly a source of vulnerability.

Most business activities in Malta are thus inevitably exposed to the full force of international competition. Producers for the domestic market face import competition while export-oriented firms face an ever-tougher competitive environment as new countries enter the global market-place. In the export-oriented sector, there is a predominance of foreign direct investment that often provides the technical and marketing expertise which is a prerequisite for success. A loss of competitiveness would thus be doubly damaging. In the first instance, there would be a drop in domestic output in favour of imports and a contraction in export revenues. In the longer term, as Malta became a less profitable location, there would be a decline in new foreign investment and a consequently negative impact on growth prospects.

Apart from these structural factors, the need for competitiveness is accentuated by the current phase of the economic cycle. For most of this year the world economy has been on the brink of a recession. Following the recent tragic events in the United States, recessionary pressures are likely to intensify.

Some analysts are predicting that growth this year may be as low as 2.2%, with recovery likely to take over a year.

Against this backdrop of slowing global demand growth, competition will become even more intense, as buyers will be better able to pass the burden of cost reductions on to sellers, while investors will be ever more cautious about the risks they face and about securing reasonable rates of return. Indeed, there have already been widespread job losses in many countries as companies retrench and economise on costs. I need hardly point out that in these conditions competitiveness is critical for survival.

Given Malta's dependence on foreign markets, we need to understand the implications of these developments. And the more so since the Maltese economy is itself in the down phase of the economic cycle. Real economic growth dropped from an average of 5.5% between 1990 and 1995 to 4.2% thereafter. Given the deteriorating external environment, the growth rate for this year, and probably even for 2002, is unlikely to reach 4%. And yet, if Malta is to converge sufficiently rapidly to the level of development of its main trading partners, it will be necessary to achieve a consistently higher growth rate.

We, therefore, need to ask ourselves whether strong growth in Malta is sustainable. To the extent that it is generated by an expansion in the fiscal deficit, growth is potentially reversible as fiscal deficits and growing public debt cannot be sustained indefinitely. The deficit averaged 4.5% of GDP in the first half of the 1990s, but surged to 8.4% of GDP in the second. Substantial progress to consolidate public finances has recently been made and the deficit has dropped to around 6% from a peak of 11% in 1998. While this fiscal restraint may curb demand growth in the short run, it is restoring the long-run viability of the economy that would be threatened by a growing public debt. Suffice it to say that the cost of servicing this debt has reached levels comparable to expenditures on health and education. In this context the planned use of privatization proceeds to reduce the public debt is commendable.

By stimulating aggregate demand, budget deficits also encourage consumption at the expense of saving, thereby leaving fewer resources to finance investment, the only lasting source of long-term growth. Expenditure on foreign goods and services would rise, leading to a deficit on the current account of the balance of payments. The current account deficit averaged 2% of GDP in the first half of the 1990s, worsening to 8% of GDP in the second. Protracted deficits on the external current account are clearly not sustainable in view of their impact on the external reserves and the extent of foreign borrowing. In the long run, this could necessitate drastic reductions in consumption levels or curtailed investment.

These developments in the growth rate and in the twin deficits highlight the need to critically evaluate the economy's overall performance and its prospects. The recent IMF mission has done just that and we at the Central Bank concur with its findings. The IMF team concluded that while there do not yet appear to be clear signs of a loss of competitiveness, there are warning signals. What then are we to do? What viable strategic options are available to seek to overcome the obstacles that threaten the continued enjoyment of current living standards?

In difficult times such as these some might be tempted to seek shelter from external shocks by pursuing an inward-looking growth policy. Numerous experiences of countries far larger than ours have shown that this course of action only serves to promote inefficiencies that would defeat the original purpose. Malta's own experience during the early 1980s amply confirms this fact. The fastest-growing economies have been those who faced international competition head-on and pursued outward-oriented policies designed to achieve integration into a globalizing world economy. Malta itself recently reaped the benefits of a similar approach when the removal of protective levies last year was followed by an increase in output and employment in the hitherto protected sectors.

Others advocate fiscally-led growth through an expansion in expenditure or a reduction in taxes. In this context, it must be understood that government expenditure puts money in people's pockets without necessarily expanding the economy's supply capabilities. Aggregate demand would thus grow at the expense of higher inflation or an increase in imports. This policy would be appropriate if the economy were in a situation of severely depressed demand relative to its supply capabilities. In an economy operating at relatively high employment levels with a deficit in the external current account, however, a fiscally-driven expansion in aggregate demand would only produce short-lived growth. At this juncture, therefore, the best contribution that fiscal policy can make to the economy's growth prospects lies in the further consolidation of public finances, a policy stance that has already contributed positively to Malta's standing with credit rating agencies and the IMF.

Some commentators think it is possible to stimulate the economy via monetary policy, that is through the lowering of interest rates. As I have often had occasion to explain, the intermediate objective of monetary policy in Malta is to maintain a stable exchange rate by pegging the lira to a basket of currencies of low inflation countries. This restrains volatility in import and export prices, thereby contributing to lower costs; mitigates domestic inflationary pressures and contributes to export price competitiveness. If we are to continue enjoying the benefits of the exchange rate peg, our interest rates will have to shadow those prevailing in the currency basket countries, especially as restrictions on international capital flows are being lifted. The alternative would be to risk outflows of funds and a possible financial crisis.

There will, of course, be circumstances when a cut in interest rates is compatible with the sustainability of the peg. When this is the case, the Central Bank will not hesitate to reduce interest rates, as it did recently. But those who argue in favour of pursuing growth through monetary expansion should remember that investment is not interest-rate sensitive. Investment decisions are based on a range of factors of which the cost of money is but one. Similarly, bank interest represents only a small fraction of production costs.

Finally, some people would have us devalue the currency in an attempt to stimulate growth by improving export price competitiveness. This option carries with it the real prospect of higher import prices and, therefore, a significant cut in real wages and wealth. To the extent that this is not followed by compensatory measures, it would indeed help to increase exports and restrain consumption demand and hence, imports. But it would also imply a decline in living standards. The extent to which the benefits of improvements in cost competitiveness would be reaped in a situation where the export sector is already operating close to full capacity is also doubtful. Past experience, however, suggests that a devaluation would be followed by a nation-wide rise in wage levels as the partial wage indexation system came into play, and this would generate price inflation and erode competitiveness. In Malta, therefore, devaluation would impose immediate costs and leave no long-term benefits, besides weakening the credibility of the lira. It is for these reasons that changes in the exchange rate level are only a last resort option for an economy like ours.

It should be clear, therefore, that isolationist policies and expansionary fiscal, monetary and exchange rate measures cannot be relied upon to generate sustainable economic growth. There are indeed no easy fixes. The only viable option is to compete successfully in the global market-place. I believe that this objective should be approached by pursuing a virtuous triangle of mutually-reinforcing policies:

i) increasing the amount of resources available in the economy and the efficiency with which they are employed, by cutting costs and raising productivity;

ii) focusing on the market niches in which we can excel;

iii) ensuring the best international market access for our products and services.

On the last of these points, there is at present a lively debate on the pros and cons of different arrangements with our main trading partner, the EU. While not wishing to enter the debate at this point, I cannot fail to observe that the uncertainty surrounding this issue is causing considerable harm to Malta’s economic prospects. It is in our common interest that the direction the country is to take be clarified as soon as possible. And this within a realisation that with Malta’s main competitors themselves seeking closer trade ties with the EU, we cannot afford to fall behind. It is also well to remember that some of the losses resulting from closer trade arrangements with the EU would be incurred in any case since Malta would have to give up trade protection measures by virtue of its existing and impending WTO obligations. As I mentioned earlier on, isolationism is counter productive in the presence of the growing wave of globalization and regional integration.

As for seeking profitable market niches, this task is best left to the private sector itself provided that it is allowed to operate in a congenial business environment, unfettered by excessive costs or bureaucratic red tape, and where resources can find their most productive use through a properly operating price mechanism. Apart from promoting such an environment, the State can assist through the provision of information and assistance in the taking and sharing of business risks. This would involve the undertaking of appropriate restructuring and business promotion measures by State agencies in collaboration with the private sector, as is being done by the MDC, METCO and IPSE among others.

Gone, however, are the days when policy-makers would make the decisions that should rightfully be made by the private sector based on efficiency, productivity and profit considerations. Excessive interference by the State has bred inefficiency and a string of unsustainable corporations. Indeed, State intervention aimed at rectifying some kind of market failure has often resulted in welfare losses that are greater than those associated with the failure it was meant to correct. The Maltese taxpayer is still paying the price of past mistakes in this respect.

On the other hand, the private sector must do its utmost to become more competitive without relying on subsidies, protection or unsustainable monopolistic positions. In the past, business used to agglomerate around what were perceived to be the safest and most profitable propositions, such as real estate development and importation. These activities have, unfortunately, also proved to be less productive than others. A fresh, export-oriented approach based on investment, innovation and higher value added is necessary for survival in today's competitive global environment.

This ties in very closely with the third factor involved in sustaining competitiveness, namely the need to increase the amount of resources in the economy and the productivity with which they are used. Productivity growth is perhaps the single most important objective for it determines how fast the economy can grow. And faster growth not only lifts living standards, but it also boosts tax revenues and makes it easier to do many socially desirable things, such as paying for tomorrow's pensions.

Turning first our attention to the labour market, human capital is the most valuable resource this country possesses. We must nurture it and use it as productively as possible. Towards this end, our labour supply and our work practices must be flexible enough to rapidly adapt to changing market needs. Training and development must be an on-going process, especially in the skills that are most in demand. In this respect, there are significant synergies that are potentially exploitable through better co-operation generally between Government, employers and unions, and specifically between the new MCAST and the private sector.

In Malta's case particularly, being competitive means above all ensuring that production costs do not exceed those of our competitors. And because the cost of labour represents a major proportion of total costs, it is important that increases in its cost are matched by improvements in productivity. Moody's latest report on Malta observes that "Productivity gains (in Malta) are lagging behind (those) in Malta's trading partners, partly because a backward-looking wage adjustment system puts a floor under inflation". Automatic wage increases across the board awarded through indexation and not matched by productivity gains can be very harmful because, by tending to reduce cost competitiveness, they put existing jobs at risk and also weaken Malta's attractiveness as a location for investment.

Labour market behaviour can also be distorted by over-generous social security systems that may encourage a culture of dependence rather than one of self-help. Unemployment schemes, for instance, could benefit from less emphasis on cash handouts and an increased focus on retraining and on improving employability. Loose contributory rules may entice workers to seek underground employment to avoid making contributions without necessarily having to renounce to pension and other entitlements.

In the area of social security especially, the country is faced with hard choices. The resources devoted to this area have a high opportunity cost in terms of foregone spending on, say, education and health. I believe the time has come to redefine the concept of need and reschedule our social priorities because it is clear that we can no longer afford to provide such a wide range of services for free to all irrespective of income levels. Moreover, we must ensure that whatever programmes are implemented, these are done in the most efficient and cost-effective manner possible.

Which brings us to another important labour market issue that needs to be tackled, namely employment in the public sector, where the extent of human capital absorbed is excessive and where, consequently, productivity is on average lower than in other sectors. Apart from imposing a tax burden on the rest of the economy, this is effectively reducing the supply of potential skills to the private sector, thereby not only limiting its growth but also increasing the cost of its labour input.

Turning next to the product markets, competitiveness can only be hurt if goods and services are not properly priced to reflect the demand for them and the use of resources in providing their supply. This may take place, for instance, through excessively high prices engendered by monopoly situations and cartel pricing. High inland freight costs, for instance, are contributing to erode the competitiveness of our exporters as well as to inflate domestic price levels. Another example is the provision of free goods and services by the State. This may encourage an excessive demand which, in turn, can only be accommodated through higher expenditure, which then absorbs resources that could otherwise be productively used by the private sector.

I think it should by now be clear that enhancing the economy's competitiveness is in everybody's interest. As I have suggested, securing this objective requires a number of wide-ranging reforms to the labour market, the wage indexing mechanism, the educational system, the social security system, public sector employment levels and bureaucratic procedures, the provision by the State of free goods and services and monopoly practices. These involve making difficult choices between, on the one hand, a *status quo* that shelters categories of individuals to the detriment of the growth, and indeed the sustainability and livelihood, of the rest of the economy and ultimately even of the sheltered individuals themselves; and, on the other, reforms that may cause pain in the short run, but which could secure the entire community's livelihood by ensuring the economy's competitiveness. A short-term oriented approach would likely lead to bad choices which we and future generations would come to regret.

And this brings me to my concluding point, which is in the form of two questions. If there seems to be such a wide consensus regarding the presence of inefficiencies in our economy and about the need to eliminate them, why has Maltese society been so lethargic in undertaking this vital task? Are we doomed to end up like the ancient civilisation dwelling on Easter island, which prospered for hundreds of years, living off a tree whose reproductive cycle exceeded the life-time of an individual, and for which reason no one had ever bothered to replant as existing trees died off?

The second question probably provides a clue towards understanding the issue surrounding the first. If a section of society makes a sacrifice to reform, the benefits derived in the process may accrue to the rest of society in a greater proportion than to the people making the sacrifice. The obvious solution to this dilemma would be for all sectors of society to share in the costs and benefits of reform in an equitable manner. And this is where Government and all the other social partners have a crucial role to play. It is to take the lead in agreeing on a programme of reforms and carrying their respective constituencies with them. The Malta Council for Economic and Social Development could, I believe, provide a congenial forum for this purpose.

But try we must because the challenge is a formidable one and we should not labour under any illusion that it can be wished away. This is not a time for carrying on as usual. Nor is it a time for behaving as though the universal laws of economics or current world realities do not apply to us. Least of all should the impression be given that it is somehow possible to have all the gain without any of the pain. We all know, for instance, that virtually all public sector expenditures are in the nature of fixed charges to revenue in the form of wages, social benefits and other handouts, subsidies and debt-servicing costs, leaving relatively few discretionary items of expenditure. This probably explains why we hear many calls for cuts in Government spending, but no specific proposals on where and how much to cut. Likewise, the rigidities which pervade the labour market and work practices have become so fundamentally ingrained in the behavioural patterns of society that they have assumed the status of acquired rights. A number of institutions remain characterised by outdated cultures and practices, while a sizeable part of the population remains stubbornly dependent on subsidies and artificial protection.

Under such circumstances it is clear – and recent electoral experience has underscored the fact – that the quest for competitiveness cannot, and indeed should not, be attempted by the Government alone. The change in culture and behaviour that this requires can only be successfully undertaken through the joint efforts of all the interested parties. Faced with similar circumstances, other countries have successfully injected a new dynamism into their economies on the strength of a broad consensus on reform measures among the political and social forces. I sincerely hope that we in Malta can similarly find the inner strength and conviction to put aside our differences and unite on these vital issues that are clearly our common concern.