Michael C Bonello: EU membership - the challenge of change

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the conference "EU Accession, One Year On - Quo Vadis Malta?", organised by the Malta Business Bureau, St Julians, 6 May 2005.

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When I argued the economic case for Malta's accession to the EU in November 2002 I described membership as a concrete, long-term response to the challenge of developing a modern economy with the capacity to generate wealth in a sustainable manner. The experience of countries like Ireland, Portugal, Spain and Greece showed that the EU had indeed proved to be a most effective mechanism for this purpose.

A year after Malta's accession it is clear that membership has indeed opened up new opportunities. The economy now enjoys wider access to export markets, increased competition at home and a greater availability of financial resources under EU funding programmes. While it is too soon to draw definitive conclusions, it has become equally evident, however, that the successful exploitation of the Single Market will depend on our ability to adjust both institutional structures and operating practices to this novel environment and to implement effective competitiveness-enhancing reforms. The intensification of competition in world markets and the growing diversion of both consumption demand and investment to lower-cost countries adds urgency to this challenge.

These developments cannot fail to have an impact on the Maltese economy given its small size and openness and its position as a price taker in international trade. While exporters are experiencing acute competitive pressures, the magnitude of this challenge from abroad, and the threat it represents for employment levels, has not, however, been adequately reflected in the results of the high-level social dialogue taking place in the country. It is in part for this reason that Malta appears less prepared than its competitors to face international competition.

Against this background I shall review some of the more important changes brought about by EU membership and the attendant opportunities for Malta. Subsequently, I shall analyse the current economic performance in terms of the country's ability to adjust to, and capitalise on, the new operating environment. Finally, I shall outline some policy orientations that could be useful in facing up to this challenge.

The consequences of EU membership

The main consequences of EU accession for Malta can be broadly categorised under five headings. These are:

- a better access for exports to EU Member States and to other countries with whom the EU has negotiated trade agreements;
- heightened competition in the domestic market due to the removal of protectionist measures;
- the free flow of factors of production, including labour and capital, between Malta and other EU Member States;
- a greater availability of external financial resources; and
- an enhanced degree of policy co-ordination between Malta and the other EU Member States, especially in the area of macroeconomic stabilisation, the promotion of economic growth and trade policy.

Of these, the free flow of goods, services and capital are the factors that are most likely to have an impact in the short term. They have, indeed, already left their mark on the Maltese economy over the past year. The freedom of movement of labour, together with funding programmes and policy co-ordination are more likely to have medium- to long-term impacts. I shall therefore focus initially on the main opportunities and threats attendant upon the first set of factors. The longer-term consequences of EU accession will be dealt with in the context of the proposed policy orientations.

The free movement of goods and services offers new opportunities for exporters, not least among them an enhanced access to an internal market of almost 500 million consumers accounting for one-fifth of world trade and one-quarter of global incomes, with a single set of trade rules and administrative procedures and free of tariff and non-tariff barriers. Maltese exports no longer need to adhere to the country of origin principle, which requires a minimum amount of value added to be produced in Malta, in order to benefit from preferential access to the EU. This creates opportunities for manufacturing and distribution operations, and opens up the possibility for Malta to serve as a hub for trade between the EU and North Africa.

In addition, exporters can now benefit from all preferential third country arrangements which the EU has with major trading blocks around the world. Malta also stands to gain in international trade negotiations when the EU acts to stave off threats of unfair competition originating from activities such as dumping. The sourcing of cheaper imported raw materials is another advantage, though this would to an extent be eroded by the application of the common external tariff, especially in agricultural products. As an EU Member State, Malta is now also automatically included in the common Pan-Euro Mediterranean system of cumulation of origin for industrial products. This means that Malta can still retain activities associated with higher-value added components of products, such as textiles, which are more cost-effectively produced elsewhere.

The free flow of goods in import-competing sectors such as agriculture implies unrestricted access for Maltese products to EU markets, while allowing reciprocal access to imported products. This represents both an opportunity and a threat, however, so that it should be met with appropriate restructuring of the sector so as to enable it to face foreign competition. In this regard Malta can obtain considerable market and development assistance from the EU for the agricultural and fishing sector, including for processing activities. As an EU Member State, Malta can also benefit from programmes aimed at promoting industrial restructuring, particularly with regards to SMEs.

The freedom of movement of capital which Malta is experiencing as a Member State of the EU has significant implications. For one, it signals to investors that Malta is a developed market economy with a well regulated financial system where financial resources can find profitable employment. This contributes to the development of the sector, including of its intermediation function of transforming savings into productive investment. It also encourages the inflow of capital from abroad. For these same reasons, however, international investors will maintain a close scrutiny of developments in the local economy, and move capital according to their evaluation of prospective risks and returns. Freedom of movement of capital thus implies the need for more vigilance by the Central Bank of Malta not only to protect the exchange rate but also to preserve financial stability.

The current state of the Maltese economy

The prospects for the creation of new economic activities opened up by EU membership come at an opportune moment. For while Malta’s growth rate in 2004, estimated at around 1.5%, registered a marked turnaround since 2003, it was low compared to the rates achieved by other new EU members whose level of development is comparable to Malta’s. This relatively weak performance, moreover, did not suddenly materialise last year, but has now been persisting since 2001.

A relatively sluggish pace of export activity underpinned the low growth rate in 2004, while imports rose at a faster pace, partly in response to the removal of tariffs on certain products. This wider trade gap led to a current account deficit of over 10% of GDP, a development that was to a certain extent anticipated. For, while it is possible to absorb larger volumes of imports at short notice, penetrating new export markets is a medium-term project. It is nevertheless imperative that the country manages to exploit the new market openings, because the current account deficit experienced in 2004 is not sustainable.

The economy’s relatively subdued performance last year can also be attributed to the short-term effects of the process of fiscal consolidation aimed at narrowing the budget deficit. Malta is still one of the EU Member States with the highest levels of general government deficit and debt expressed as percentages of GDP. The Government plans to satisfy the Maastricht criteria for fiscal performance by 2006, but this means that the short-term effects on GDP growth of this fiscal adjustment will continue to be felt at least until then.

Sound public finances are also critical to the role played by the Central Bank of Malta in the economy. Through its monetary policy, the Bank remains committed to safeguarding the exchange rate peg against possible threats to the external reserves, whether they arise from changes in the international trading or financial environment, or from a lack of competitiveness, which adversely affects the balance of payments.

This commitment has now taken on an added dimension with Malta's participation in the ERM II. As you are no doubt aware, in order to retain the same stability and benefits of a fixed exchange rate regime enjoyed over the past three decades, we have decided to maintain the EUR/MTL rate unchanged during the ERM II phase at the central parity level of 0.429300. The Bank's recommendation to the Government was, however, premised on the assumption that fiscal consolidation is assiduously pursued and that a steady pace of structural reform is maintained.

This cursory review of the recent performance of the Maltese economy suggests that it was not sufficiently well prepared to exploit the opportunities that became available upon accession to the EU, so that the costs of adjustment are for the time being outweighing the positive effects. In this context it is important to note that these opportunities are now also available to the other nine new Member States, so that the benefits of membership cannot be taken for granted. On a macro level, success in this endeavour will depend on the overall competitiveness of the economy; and, on a micro level, on the efficiency with which the country's resources are utilised and on the ability of the business community to identify profitable opportunities and exploit them in the new operating environment.

It is to these issues that I next turn my attention.

Policy orientations for growth

There are no easy or short-cut solutions to promote economic growth in Malta. Measures aimed at stimulating demand, through fiscal or monetary expansion, can only be effective in the short term. And in any case, their impact is limited. This is because they do not help to expand the economy's supply capabilities, which is a prerequisite for sustained growth. In the current situation characterised by high fiscal and external deficits, moreover, the stimulation of aggregate demand would do more harm than good to the country's economic prospects. Living standards can only be raised on a sustained basis if we succeed in adding value to imported inputs and by providing services in a manner that is cost-effective in relation to our competitors.

With regard to growth-oriented policies, inspiration can be obtained from a number of EU programmes, including the Lisbon Agenda for Competitiveness and the Stability and Growth Pact. Although most Member States have fallen behind in meeting the targets of the Lisbon Agenda, Malta must make even more pronounced efforts to achieve them, particularly in the areas of human resource development and innovation. The National Action Plan for Employment is a step in the right direction, but it can only produce the desired results if all social partners take ownership of it.

With regard to macroeconomic stabilisation, the successful achievement of the Convergence Programme objectives would restore the use of fiscal policy as an instrument of economic management and lead to a better allocation of resources in the economy. It would also contribute to a smooth transition through ERM II and towards the adoption of the euro. As a small and highly open economy, Malta stands to benefit significantly from the introduction of the single currency, mainly through the elimination of exchange rate risk and uncertainty and lower interest rates and transaction costs.

On the microeconomic level there are a number of issues which need to be tackled to improve the efficient allocation and use of resources and to raise productivity. Unlike macroeconomic policies, which tend to yield results only in the medium-term, efficiency improvements at the micro level are likely to produce more immediate benefits in terms of new economic activity and job creation. The truth is that sustained improvements in the country's economic fundamentals cannot be attained without enhanced efficiency and productivity in both the public and private sectors.

The achievement of such improvements requires efforts on a number of fronts. First, it must be understood that the quest for competitiveness can only succeed if it takes the form of a collective effort whose sole purpose is to boost the economy's value added. Without the latter, higher wages and profits cannot be paid. It cannot be an exercise in which one of the parties attempts to crowd out the other. It is clear, therefore, that a more focused social dialogue is needed that takes a stronger leadership role in identifying the policies and measures needed to improve Malta's international competitiveness and to ensure their implementation.

Second, there is absolutely no guarantee that the standard of living the country has been enjoying so far can be maintained in the face of increasing global competition. The threats that Malta is facing cannot be simply wished away or averted through quick fixes. What is required is a more flexible and cost-conscious attitude towards work practices and the setting of generally higher standards of performance across the board.

Third, we must accept that subsidies, transfers and services provided for free by Government do not come at zero cost, but must be paid for through resources generated by the economy. Their provision at zero cost often induces excess demand and waste, and imposes unacceptable burdens on the productive sectors of the economy, thereby compromising their competitiveness and the very generation of income through which such benefits must be financed. It is possible, and indeed desirable, to introduce the concept of co-payment by beneficiaries at the widest possible level without compromising the satisfaction of genuine needs.

Fourth, there must be acceptance of the need for everyone to contribute to the development of the economy, including through the payment of taxes due. It is highly probable that unless these community values are inculcated in to-day's rising generations, the economy's growth prospects will not improve because the resources necessary to undertake the required investments will simply not be available.

Fifth, there must be a more effective and focused approach through which Government and its entities support existing export industries and the establishment of new foreign direct investment in Malta. The provision of business advisory and support services must be improved and bureaucratic procedures reduced to a minimum so as to make the most of the opportunities available in a more difficult international trading environment. This new approach would also require a more active participation by Malta in international trade fora at an EU level. It also calls for better co-ordination on these matters within the public administration, and also between Government and the constituted bodies representing the exporting community, whether in industry, tourism or financial and other services.

Conclusion

Malta's accession to the European Union has opened up undoubted scope for economic and social advancement. The potential for Malta to successfully exploit this opportunity has been given a clear endorsement by the EU Member States and institutions with this week's entry of the Maltese lira in ERM II. These momentous developments place on both policy makers and the social partners a heavy responsibility for doing what is necessary to bring this promise to fruition.

We must all re-double our efforts within the context of the Lisbon Agenda in order to enhance the economy's competitiveness. With the cooperation of the social partners, the Government must pursue the targets set for fiscal consolidation, upon which sustained economic growth and the eventual adoption of the euro are premised. Equally importantly, a series of reforms at the microeconomic level are also overdue so as to enhance efficiency and productivity.

These challenges are not being faced exclusively by the Maltese economy, but also by larger and more advanced countries who are meeting them by adopting measures - which often appear to be painful in the short run - to sustain the standard of living of their people over the medium term. It is up to all the components of Maltese society to rise to the challenge so as to defend the economic and welfare gains achieved in the past and improve on them in the coming years.