Michael C Bonello: Pursuing faster growth in a stable macroeconomic environment

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the Annual Dinner of the Institute of Financial Services, St. Julians, 10 November 2005.

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Prime Minister, Parliamentary Secretary, Excellencies, Ladies & Gentlemen,

I should first of all like to thank the President and Council of the Institute of Financial Services for inviting me once again to their annual dinner. Over the past six years I have been able to observe with satisfaction how the Institute has successfully adapted itself to the steady expansion of Malta's financial services industry, and to the demand this growth has generated for a diversified range of professional expertise. One planned innovation which I consider most appropriate is the Certificate in Mortgage Advice and Practice that is partly based on Maltese law.

This annual occasion also affords me a welcome opportunity to share with a distinguished audience of bankers and their corporate guests the Bank's thinking on a subject of topical interest. In today's complex global environment several issues spontaneously present themselves as likely candidates for further analysis. For us in Malta, the major policy challenge at this time is to return the economy to a path of higher and sustained growth. The facts speak for themselves. In the five years to 2004, the annual growth rate averaged only 1.2 per cent in real terms, well below that of many of our EU partners; and while this year's growth rate up to September, at 1.7 per cent, may be encouraging, it is too early to know whether the implied acceleration will be sustained.

And yet the need to achieve a faster pace of economic growth has probably never been as urgent as at the present time. Growth is not only necessary in order to satisfy society's legitimate aspirations for higher living standards. Beyond that, an expansion in the economy's supply capacity and an enhanced degree of international competitiveness are essential to overcome the daunting challenges the country is currently facing.

A threefold challenge: globalization and its implications

The first challenge derives from the pervasive process of globalization, which, powered by rapid advances in technology and trade liberalization, has given rise to an unprecedented mobility of resources between countries in pursuit of the best cost-quality combinations. Suffice it to say that over the past two decades exports and foreign direct investment have been growing twice and three times faster than global output, respectively. Globalization is undoubtedly creating numerous profitable business opportunities.

At the same time, however, it represents a potential threat for open economies like Malta's because of the concurrent intensification of competition. Behind recent trends, in fact, lies the emergence of countries like China and India, who have doubled their share of global output over the past twenty years and are now also competing in markets for high technology products. China alone manufactures half of the world's cameras and its share of world exports of computers increased tenfold, to almost 20 per cent, in the ten years to 2003! We, too, must find a way to participate actively in globalization and gain from it.

... compounded by a sharply higher oil price ...

The second challenge derives from the sharp increase in oil prices. There is a silver lining to this dark cloud in the sense that the price rise is not expected to have a significant effect on world output. The IMF, for example, anticipates global growth to average 4.3 per cent both in 2005 and 2006. This is mainly because it is due to an expansion in demand that is underpinned by economic growth, particularly in Asia. It is still the case, however, that a massive redistribution of wealth is underway from countries which consume oil to those which produce it.

Malta is inevitably on the losing side of this process. The estimated increase in the fuel bill for 2006 arising from the production of electricity and the consumption of liquid fuels is not far from the expansion in nominal GDP forecast for 2005. It would seem, therefore, that no significant growth could be expected next year if the underlying pace of economic activity does not accelerate from this year's level.

The increase in Malta's fuel bill is also roughly equivalent to the narrowing of the fiscal deficit achieved over the past seven years. In the circumstances, it would be foolish to allow the progress made at considerable cost to be blown away by this external shock. An attempt to cushion the increase in the oil price through borrowing may be economically justifiable in terms of sustaining the incipient recovery suggested by recent GDP data. On the other hand, any borrowing would have to be serviced; and, because it would constitute interference with market signals, it could also retard the process of economic adjustment.

The only long-term remedy to counteract the effects of higher fuel prices is to expand productivity and output, and therefore incomes. Indeed, the oil price shock is another compelling reason, if one were needed, for redoubling our efforts to energize the economy.

… and by a higher dependency ratio due to population ageing.

The third challenge is the demographic shift caused by population ageing, such that the ratio of the working age to the dependent population is expected to shrink from almost four- to just over two-to-one by the late 2020s. Some effects of this trend are already being felt this year as the first cohorts of the baby-boom generation reach retirement age. This has produced a significant acceleration, by some Lm7 million or 10 per cent of the budget deficit, in the rate of increase in pension expenditures. Pension reform clearly cannot be delayed any longer.

Population ageing also represents a broader threat to the sustainability of living standards and to social cohesion because the burden of supporting a growing number of dependent persons will, at some point, become unbearable for the productive sectors of the economy. This burden consists not only of pension and other welfare payments, but also of services provided in kind, most notably by the public health system. This is another reason why reducing government recurrent commitments should be a priority objective.

A better understanding of the magnitude of these challenges can be obtained by synthesising their effects in terms of the growth rate necessary for the economy to deal with them effectively. For example, in order just to compensate for the increase in the dependency ratio associated with population ageing, the economy would have to grow by around 1 per cent per annum over the next twenty years. At this rate of growth, which is more or less what Malta averaged over the past five years, there would not be any improvement in per capita GDP, that is in living standards. As for hopes of raising the activity rate by ten percentage points to around 70 per cent over twenty years, the economy would have to grow by an average annual rate of at least 3 per cent. This growth rate, in turn, would still not be sufficient to ensure convergence with the average per capita GDP of the EU twenty years from now. For this latter objective to be achieved, a real growth rate of some 4 per cent would be required.

The way forward: a concerted push for faster growth

These scenarios underline the urgency of achieving more rapid, sustainable growth. The longer it takes to expand the productive base of the economy, the more onerous the challenge will be. The prospects for a significant recovery in the short term, moreover, are doubtful since oil prices are expected to remain at their current high level, and the dynamic benefits of fiscal consolidation and EU membership are unlikely to exercise a marked impact on growth in the coming months. Growth forecasts for 2006 vary between 1% and 2%.

The current economic situation, therefore, requires decisive action designed to produce early results. I, therefore, feel obliged once again to make a strong appeal to all the social partners not to underestimate the threat which today's realities represent for the wellbeing of their own members, and to cooperate in the search for real, long-term solutions in the national interest. The alternative is a slow, but depressing process of stagnation.

The way forward towards faster growth lies in the first instance in striving to maintain the competitive advantage of traditional sectors – which typically rely heavily on cost advantage and where market share is being lost -, while promoting the development of new activities that exploit the potential offered by Malta's strategic assets. These include EU membership, a modern technological infrastructure and a skilled and flexible labour force. The current, encouraging expansion in new activities such as financial services, software development and pharmaceuticals attests to the competitive edge which our economy indeed enjoys in these areas. This advantage must, however, also be supported by a stable operating environment that is responsive to changing market conditions.

Elements of a coherent policy framework

Such an environment requires a coherent policy framework on three levels: the first is the macroeconomic level, where a sound financial system and prudent fiscal and monetary policies should combine to provide favourable conditions for the restructuring of the productive base. At the microeconomic level, resources must be more efficiently allocated and managed by enterprises so as to obtain the maximum possible degree of cost-effectiveness and market penetration. The third involves what may be termed as meso-level policies, involving specific sectors. Policy at this level should primarily avoid distorting the mechanisms that facilitate economic activity.

Supportive macroeconomic policies are already in place …

At the macroeconomic level, the recent track record has been largely positive. Fiscal consolidation is progressing in line with the projections of the convergence programme. Despite weak growth, the fiscal balance improved significantly in 2004 and again this year. This has not escaped the attention of international observers. The recent assessment of the Maltese economy by the IMF, for example, commends the progress achieved in strengthening macroeconomic management, including the substantial reduction in the fiscal deficit.

Looking ahead, I am pleased to note that the Budget for 2006 bears the hallmark of continuity. Operating within the constraints represented by the natural upward creep in spending on health, pensions and welfare programmes, on the one hand, and the need to avoid increasing the burden of taxation on a slow moving economy, on the other, the Government has charted a course which envisages a continuation of the process of fiscal consolidation, leading to a further reduction in the deficit to GDP ratio to below 3 per cent. This is an ambitious target whose attainment will depend crucially on a rigorous implementation of all the Budget measures, together with an intensification of efforts aimed at cutting costs and collecting taxes.

On the monetary front, the financial markets have so far considered the level of domestic interest rates as appropriate and inflation remains moderate. Monetary stability is also being promoted by participation in ERM II, which is proceeding smoothly.

Allow me at this point, Mr. President, to reiterate the reasons behind the Bank’s advice to the Government to maintain the value of the Maltese lira constant against the euro within ERM II at the rate prevailing prior to entry in the Mechanism.

First, it is generally acknowledged that Malta’s pegged exchange rate regime has in the past served the economy well, in that it kept inflation and inflationary expectations at bay. As for the level of the central parity rate of the lira in ERM II, studies conducted by the Central Bank of Malta found no evidence of a significant exchange rate misalignment, a conclusion which was not contested by the competent EU institutions. There being no compelling reasons for change, therefore, the exchange rate level prevailing prior to entering the Mechanism was retained in the interests of continuity and stability.

As for the unilateral commitment to maintain the currency at its central parity rate during the ERM II phase, I would remind the proponents of a flexible exchange rate regime of Malta’s high dependence on foreign trade. For such an open economy, the resultant volatility and consequent uncertainty would entail additional costs associated with insuring against exchange risk, thereby inflating both retail and export prices.

Changes in the nominal exchange rate, moreover, are not likely to have a significant impact on competitiveness via adjustments in the real exchange rate. This is because a weakening of the currency is typically followed by a rapid pass-through in the shape of higher prices of imports and wages, as the 1992 experience proved. On the other hand, due to downward rigidities, a strengthening of the Maltese lira cannot be expected to be followed by commensurate reductions in price and wage levels.

Finally, advocates of flexibility should note that if the Maltese lira were allowed to fluctuate within the ERM II bands, the exchange rate would reflect developments in the balance of payments as a whole, including those in the capital account, and would not, therefore, necessarily adjust in response to export trends. Indeed, had the Bank opted for the bands, market forces would have exerted upward pressure on the exchange rate. This is because since ERM II entry in May there has been a steady market demand for the lira, such that the Bank has been a net buyer of foreign exchange and the external reserves have increased substantially.

It is very important that these basic facts be well understood before public pronouncements are made that might affect the credibility of monetary and exchange rate policy. You will recall that when negative perceptions about the exchange rate took hold towards the end of 2004, they eventually led the Bank to defend the currency by raising interest rates. This is a responsibility that the Bank cannot, and will not, abdicate.

… as are progressive policies at the enterprise level …

At the microeconomic level, a measure of progress is being registered in spite of the failure to adopt a social pact. There are indications that productivity-enhancing measures are being introduced at the enterprise level under the pressure of competitive forces. These range from more flexible working practices and wage restraint to improved management techniques and more focussed marketing efforts. Some areas, however, remain susceptible to further efficiency gains, particularly the services sector.

… but the public sector still lags behind.

At the meso or sectoral level, some important measures were announced in the Budget for 2006, including the decision to intensify efforts to improve efficiency in the public service. Hopefully this will also involve the adoption of output-, rather than input-oriented management practices. The recently-signed collective agreement for the public service, moreover, is an example of what a responsible social dialogue aimed at balancing competing interests can achieve.

There remains, nevertheless, ample room for further progress. The country needs to undergo a culture change so as to realise the fallacy inherent in the perception of unlimited government power to levy taxes, which leads to the assumption of jobs for life regardless of performance or need, and of universal and free welfare services irrespective of their sustainability and of equity considerations. Such thinking is incompatible with an ethic based on efficiency and accountability, and with the need to reduce the burden of taxation, foster initiative and encourage investment. Social dialogue can, and should play a crucial role in promoting acceptance of the policies necessary to bring about this change.

The attainment of greater efficiency in the public sector is a key objective because it provides vital support services to the productive sectors of the economy. It must, therefore, become better geared to ensure that the intentions of policy-makers are implemented rapidly and effectively. Determined efforts must be made to streamline bureaucratic procedures, eliminate outdated regulations and generally reduce the cost of engaging in any economic activity. The Better Regulation Unit in the Office of the Prime Minister must meet the expectations its creation has raised. Failure to do so risks compromising all the efforts being undertaken at both the macro and microeconomic levels to create a modern, dynamic economy.

At the national level, moreover, we need to understand that the simultaneous pursuit of economic growth and a high degree of social protection can only be achieved by making our product and labour markets more flexible; by investing more in people, refining their skills and helping them into work, while introducing an obligation to take up jobs; and by giving more importance to developing our scientific and technological base.

We do not need to look far to see how this can be done. Faced with high labour costs in the late 1990s, German companies started restructuring and downsizing. The government meanwhile introduced social security reforms aimed at making the welfare state less expensive, as well as labour market reforms that created incentives for the jobless to work. An awareness developed that the solution to chronic deficits and unemployment could no longer be to cut public investments. As a result, Germany’s unit labour costs have fallen by 12 per cent since 1999 against those of France. The payoff was significant: the volume of German exports rose by 47 per cent over the same period, compared with 25 per cent in France.

The French were not unaware that they, too, had a competitiveness problem. A commission of independent experts led by the former Managing Director of the IMF, Michel Camdessus, was set up in 2003. Reporting earlier this year, the experts concluded that without a change of direction, decline was a real threat for France. They identified two obstacles to growth: first, not enough people worked, and those who did failed to work long enough; second, the heavy State had become a costly drag on the economy.

Our own country faces a similar predicament. Malta's labour participation rate is among the lowest in the EU at 58 per cent; as for hours worked, during 2004 the Maltese worked 72 fewer hours than the hardest working people in the EU, the Estonians, Lithuanians, Poles and Slovenes, mainly because we enjoyed 13 public holidays, the most in the EU, whereas the countries just mentioned had only 8; as for the cost of the State, the public sector in Malta absorbs just over half of the GDP, the fourth highest percentage in the EU.

Conclusion

Mr. President, we are indeed facing an unprecedented challenge. The consequences of our inherent vulnerability to external events, and of a large State apparatus which subsidizes inefficient public corporations and offers its citizens notionally free services irrespective of income levels as well as generous welfare benefits are catching up with us very rapidly. In the meantime, the world has changed beyond any expectation. For those of us who remember the days when famines and inefficient state-controlled economies were endemic in Asia, today's realities are not easy to comprehend or to accept. The former EU Internal Market Commissioner, Fritz Bolkenstein, captured the momentous nature of this change most strikingly when he observed recently that "The true heirs of the capitalist revolution now live in Asia."

We in Malta, too, need to change if, like them, we want to turn globalization from a threat into an opportunity. We must shake off our ambivalent attitude to reform: we know that the status quo is unsustainable, but it is also comfortable, and so we are reluctant to bear the cost of change. Hence the slow pace of reform, characterized by the commissioning of reports followed by long drawn-out consultations in search of a consensus, which frequently proves elusive. But time is running out faster than many appreciate. For a start, let us stop blaming others for our woes and, as Brutus was enjoined to do, let us accept that "The fault …… lies not in our stars but in ourselves." We should then work together to build on our past achievements, which are not negligible, in order to secure the objectives of greater material wellbeing and social cohesion which, after all, we all profess to share.