Michael C Bonello: Malta's economy on the path to the euro

Remarks by Mr Michael C Bonello, Governor of the Central Bank of Malta, at a Round Table organised by the Austrian National Bank, Brussels, 13 June 2007.

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This Round Table is being held shortly after the release of the Convergence Reports which the European Commission and the European Central Bank prepared at the request of Cyprus and Malta, and the recommendation of the Commission to the EU Council to allow these two countries to adopt the euro on 1 January 2008 on the grounds that they have achieved a high degree of sustainable convergence.

And yet, only four years ago as Malta was preparing to accede to the EU, qualifying for euro area membership seemed a distant and uncertain prospect. This evening I propose to illustrate the nature of the challenge that Malta faced, how the task has been approached and what measures are being taken to ensure a smooth integration into the euro area.

The Central Bank of Malta has been at the forefront in advocating an early adoption of the euro, and for good reason. With a GDP of around €4.9 billion and a population of 400,000 living in an area of 316 km2, Malta is the smallest and most densely populated EU Member State. It has no natural resources and is one of the most open economies in the EU, with average import and export-to-GDP ratios of over 80%. These characteristics constitute a challenge for policymakers in that key economic variables are prone to volatility, being highly sensitive to external events and to shocks in specific sectors or individual enterprises which, though small in absolute terms, can have a disproportionately large impact in a small country context.

Such an economy clearly stands to benefit from joining a monetary union, particularly in terms of greater stability and policy credibility.[1] From a central banker's viewpoint, moreover, a key advantage is the elimination of the risks inherent in managing a small, vulnerable currency. Permanently fixing the Maltese lira / euro exchange rate, moreover, did not appear to be a radical change. The ECU, and since 1999, the euro, had in fact been the main reference currency in the exchange rate baskets since 1989. By 2002 the euro already carried a weight of 70%.

Furthermore, Malta's only devaluation, which took place in 1992, confirmed that exchange rate adjustments are not the most effective means for safeguarding an open economy's competitiveness. The initial advantage derived from the devaluation was soon reversed, owing to the inflationary impact of compensatory wage increases resulting from a partial wage indexation mechanism and the high import content of inflation.

If anything, the irrevocable fixing of the exchange rate and the economic policy co-ordination and monitoring procedures of EMU seemed to offer a congenial environment for implementing the structural changes necessary for a lasting improvement in the country's international competitiveness.

The benefits of the euro for individuals and businesses, its contribution to a more effective participation of Maltese enterprises in the Single Market and the possibility of using the euro as a means of competing on international markets were also important considerations.

But while there were many compelling reasons for an early adoption of the euro, there was also an understanding of the need to avoid the economic costs of a premature entry. Consequently, there was some hesitation in adopting an ambitious reform programme.

These concerns were well-founded. At the time Malta was preparing to join the EU, the economy was emerging from a period of stagnation, a widening output gap and a slow pace of productivity growth. In addition, while the Government planned to reduce the budget deficit from almost 10% of GDP in 2003 to below 3% by 2006, an adjustment of that magnitude clearly presented considerable political risks, not least because some fiscal tightening was already underway. The unemployment rate, meanwhile, was edging upwards in response to the ongoing restructuring process and the further liberalisation of markets as a result of EU accession, making any further retrenchment painful for most households.

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[1] For a fuller treatment of Malta's case for adopting the euro, see Malta's Strategy for Participating in Economic and Monetary Union and Adopting the Euro, Government of Malta, Central Bank of Malta, April 2005.

At the same time, many indicators suggested that Malta was well suited to participate in the EU single currency area. The economy was already closely integrated with the EU through trade and finance; it had close similarities with the euro area in the sectoral composition of output and employment, as well as in terms of business cycle synchronisation; and it also enjoyed a relatively high level of development (the price level and per capita GDP both stood at around 70% of the euro area average). Furthermore, the large euro area countries had long been among Malta's most important trading partners and sources of foreign direct investment.

As for the Maastricht criteria, the only serious doubts centered on the fiscal criteria. As noted previously, exchange rate stability was never an issue and the strong presence of the euro in Malta's currency basket had also fostered convergence in interest rates. In fact, the interest rate criterion had been met long before EU accession. Fulfilling the inflation criterion was not considered an obstacle either, as the inflation rate had been generally below the EU reference value, and the upward risks were largely related to the impact of the VAT increase planned for January 2004. Although inflation continued to exceed the EU limit for most of the period from the second half of 2004 until the autumn of 2006, this mainly reflected the introduction of measures aimed at aligning energy and fuel prices more closely with market rates at a time of spiralling oil prices. Malta is totally dependent on oil, not only for electricity generation but also for water production.

Against this background, the authorities had two options: either to use the fact that Malta did not meet the fiscal criteria to maintain the status quo and delay the implementation of sensitive reforms, with the risk of undermining growth prospects; or to use the adverse impact of globalization on Malta's current account and the vulnerability of the fixed exchange rate regime to highlight the urgent need for a faster pace of reform, while holding out the promise of the expected benefits of the euro.

The authorities chose the latter approach, including a rather ambitious programme of fiscal consolidation and a unilateral commitment to maintain the Maltese lira/euro exchange rate at the central parity rate in ERM II. This appeared a natural way to buttress the economy's long record of exchange rate stability, though it was also dictated by the need to counter harmful speculation at the time about the level of the exchange rate.

Three years after EU accession, that bold decision appears to have paid off. Economic growth rose to 3.3% in 2005 and 2006, and is expected to stay around that level; the unemployment rate stabilised, then eased slightly; and FDI flows, which have always been important, strengthened further. The gap between productivity growth and wages narrowed to the point that unit labour costs are now increasing negligibly or falling, depending on the measure used.

In 2006 the fiscal deficit ratio dropped below the 3% reference value for the first time in several years, with the structural balance net of temporary measures shedding around 3.7 percentage points since 2003. The debt ratio also trended downwards and is expected to fall below the 60% limit by 2009.

As the base effect of the energy price hikes started to abate, moreover, the HICP inflation rate has stayed below the EU reference value since last November. Meanwhile, the Maltese lira continued to trade at the central parity rate against the euro in ERM II and the long-term interest rate converged further towards the reference value.

As for the economic recovery, although this partly reflects stronger demand in Malta's main trading partners, it also owes something to the reforms implemented in recent years. These included measures aimed at increasing participation in the labour market and improving its functioning. School curricula have been modified and training opportunities broadened. There has also been heavy investment in ICT infrastructure and education, as well as better targeted financial and technical support to SMEs, including a privately-managed venture capital institution. On the fiscal front, steps have been taken to reform the pension system and to avoid abuse of the social benefit system and tax evasion.

In some areas, however, the pace of reform has been modest and the Central Bank of Malta has repeatedly called for the remaining weaknesses to be addressed. In particular, more effort is required to ensure that domestic inputs are priced competitively, and hence the need for continued wage moderation; to raise productivity levels; and to ensure faster progress towards key Lisbon Agenda objectives such as educational attainment and innovation. Measures aimed at strengthening the economy's physical infrastructure and the quality of its human capital, a more efficient delivery of support services by the public and private sectors, and enhanced competition both in product and resource markets are crucial in this regard. This is the only way to increase the economy's capacity to respond flexibly and competitively to new challenges and opportunities, and thus derive the full benefits of EMU.

A high level of economic convergence and flexibility, however, are not sufficient for a successful transition to the euro. This also requires both careful logistical planning and public acceptance of the single currency.

As for the former, the necessary structures have been in place for two years and they seem to be working well. At the apex stands the National Euro Changeover Committee (NECC), which has drawn up a national Master Plan. The Central Bank of Malta is represented on the Steering Committee which oversees the work of the NECC, it participates in the financial sector committee of the NECC and it is also present on a task force responsible for co-ordinating national training activities related to the euro. On a daily basis, moreover, the Central Bank of Malta liaises closely with the NECC, the Malta Bankers' Association and other entities which for years now have been participating in joint technical meetings covering key operational areas, including the functioning of money and capital markets, payment systems and the gathering of statistical data.

The Bank also has an internal plan, encompassing some 200 different tasks as well as time frames within which they need to be completed, for an orderly transition to the euro. This plan was drawn up using a bottom-up approach, with each department developing its own programme for adapting structures and procedures to the policy and operational requirements of EMU.

Plan implementation is on track. Steps have already been taken to align the monetary operations, accounting and financial reporting frameworks with those of the Eurosystem. The Bank has also completed most of the necessary upgrades to its IT hardware and operating systems to ensure that it can exchange information and settle transactions with the Eurosystem in a seamless fashion.

As far as the Cash Changeover Plan is concerned, this too is on schedule. The physical facilities for the storage and distribution of cash have been completed, the test run for the minting of Malta's euro coins has commenced and arrangements for the procurement of euro notes are about to be finalised.

The Central Bank of Malta's preparatory process for integration in the Eurosystem has undoubtedly benefited from its participation in ESCB committees and from the bilateral contacts established with many Eurosystem central banks, including the Oesterreichische Nationalbank and the Central Bank and Financial Services Authority of Ireland, our partner in the Twinning Arrangement on communication strategy in which we participated with Cyprus. Some Eurosystem central banks, moreover, have responded favourably to requests for entering into cooperative arrangements with the Bank for the implementation of specific operations, such as in the field of reserve management.

As for the public mood, price perceptions will probably remain a source of apprehension, at least in the immediate period ahead. Although 68% of Maltese respondents who participated in the latest Eurobarometer survey said that they are in favour of a relatively early euro adoption, some responses to the other questions suggest that the Maltese are not indifferent to what they hear about the possible negative effects of the single currency.

The percentage of respondents who consider that the euro will be of personal or national benefit,[2] for example, is smaller than that of those who favour early adoption. And the main concern is not unlike that in the current euro area Member States. It is not about the ability of the ECB to deliver price stability over the medium-term. It is primarily about a temporary increase in price levels after the changeover, a fear which has been reinforced by what is reported in the Italian media. Indeed, 65% of Maltese respondents believe that the euro will result in a one-time increase in prices. And this despite the fact that around 60% considered that the euro will deliver price stability in the medium-term; and that a large majority are aware of the various initiatives that are being taken to limit price abuse and consider that the dual display of prices[3] is helping people get used to the new currency.[4]

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[2] 53% and 43%, respectively.

[3] According to the April 2007 NSO survey, 91.4% of respondents.

[4] The first observation is based on the results of Flash Eurobarometer Survey No. 207. The second and third observations are based on the National Statistics Office survey which was conducted a few weeks after the completion of fieldwork for the Eurobarometer survey. While corroborating many of the findings reported in the Eurobarometer survey, including the same level of concern about potential price abuses, the NSO survey reveals some facts which are not discernible through the questions featuring in the Eurobarometer survey, including the two reported here.

What is equally striking is the fact that while a high level of education and young age are correlated with a positive attitude towards the euro, there is no discernible pattern across age groups or education levels when it comes to expectations about the potential inflationary impact of the changeover. Apprehension is widespread.

These findings suggest the need for a communications campaign that gives the issue of inflation perceptions priority attention, as well as for effective price monitoring mechanisms. Measures are being taken on both fronts.

Inflation perceptions are being addressed in TV slots, newspaper articles and official statements. These messages will be intensified in the coming months.

As far as pricing abuses are concerned, the national euro Master Plan has invited businesses to adopt dual display from January 2007 and makes it mandatory from the day the irrevocable conversion rate is fixed until the end of June 2008. The dual display of prices has gained momentum since the introduction of the Fair-pricing Agreements in Retailing (FAIR) initiative towards the end of last year as a voluntary, self-regulating mechanism whereby businesses commit to refrain from increasing prices simply as a result of the changeover. They, in turn, benefit from nationwide publicity recognising their commitment to adopt a code of conduct.[5] In addition, consumers are constantly encouraged to use the national telephone helpline not only to seek information, but also to report cases of suspected non-compliance with the guidelines.

With the assistance of international experts, including the Austrian Price Commission, a Euro Observatory has also been set-up to monitor and analyse pricing trends during the changeover period. The unit is supported by 70 Euro Assistants who carry out fieldwork in towns and villages across the island. Separately, one of the two largest trade unions in Malta has been running an independent price monitoring exercise, to be followed soon by a name and shame campaign. This exercise involves the participation of mystery shoppers who monitor an extensive list of products and services.

More recently, a special deposit scheme was launched to provide residents with a one-time opportunity to regularise their position in respect of cash and deposits not previously declared for income tax purposes. The objective is to mitigate the risk of inflationary pressures arising from the sudden conversion of these financial assets into real assets, which would reinforce the view that the euro creates inflation.

If I had to draw any conclusions from Malta's experience, I would first say that the prospect of euro adoption has served as an additional, and welcome, impetus to fiscal consolidation and to structural reform. As a result, the economy should not only be more prepared for take on the policy disciplines of EMU, but also be better equipped to deal with an increasingly challenging global economic environment.

Second, while a successful integration in the euro area demands, apart from solid economic foundations, public acceptability of the single currency, opinion surveys in Malta seem to confirm that public perceptions do respond to a targeted information campaign. Such a campaign is in hand, but the adjustment process is slow and is occasionally fraught with perceptions that are seemingly in conflict with each other. Myths are not easily dispelled!

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[5] Around a half (5000) of all Maltese outlets have already applied and around 3250 have been awarded the FAIR mark, meaning that around 25% of all eligible outlets are actually participating. (Figures from May edition of Euro Times).