Michael C Bonello: Growing the economy in the Euro area – a policy prescription

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the annual dinner of the Malta Institute of Financial Services, Saint Julian's, 30 November 2007.

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I would first of all like to thank the President and the Council of the IFS for inviting me once again to this annual dinner and also to commend the Institute for the valuable contribution it continues to make to the development of the financial services industry in Malta.

This is the ninth consecutive time that I have been given the opportunity to share my thoughts with the members of the Institute and their guests. It is also the last time I do so as my term of office expires in September next year. As this will, therefore, be my valedictory address, I propose to cast a look back to the prospects for the Maltese economy as I saw them in November 1999 upon taking up my post with a view to assessing how the economy has evolved since then and suggesting what remains to be done.

On that occasion, I dwelt upon the challenges of globalization arising from three emerging trends. First, it was becoming increasingly difficult for countries to insulate their economies from processes and decisions originating elsewhere. Globalization, moreover, was producing an environment in which success would only be achieved by countries that had the ability to anticipate change and the capacity to adapt their productive structures fast enough to seize the new market opportunities ahead of their competitors. Finally, the increasingly free movement of the factors of production entailed a relative loss of policy autonomy, even for large and relatively self-reliant economies. I suggested that these trends were especially relevant for a small, open economy like Malta's, and one that was clearly living beyond its means at the time.

As you might recall, less than two years later the vulnerability of our economy was clearly exposed by two external events: the collapse of the technology stocks bubble and the ensuing sharp decline in demand for electronic components; and the increased aversion to flying following the 9/11 terrorist attack in New York. The impact of these shocks on the electronics and tourism sectors combined with some long-standing domestic factors to produce a stagnation in economic activity in the period 2002–2004. This was a stark reminder that there is no escape from the realities of a globalized world, and that the only valid response to international competition is to make the economy more efficient and flexible.

From stagnation to sustainable convergence

Today, some six years after those destabilizing events, the Maltese economy has come a long way. Most importantly, it has achieved a high degree of sustainable convergence with the euro area and is about to adopt the euro, a feat many believed unachievable in such a short time span. Here I would like to express my gratitude to the entire banking community, including the staff of the Central Bank of Malta, for their hard work and commitment in preparing for a smooth currency changeover.

How did this marked change in fortunes come about? Three factors at least played a role. Like other small countries which leveraged their participation in regional economic groupings to overcome size and resource limitations, Malta has adapted its institutions and policies to the requirements of EU membership and is starting to derive the expected benefits. At the same time, under the pressure of globalization, polices have been implemented to start correcting endemic weaknesses. And finally, advantage has been taken of the cyclical upturn in external demand. As a result, the economy has grown by more than 3% in each year since 2005.

Recent measures have included the restructuring of the public and public-enterprise sectors, a wide-ranging privatization programme, the first stage of a pension reform, and the complete liberalisation of the trade and capital accounts. As a result, the public sector's profile in both product and resource markets has been reduced, and the price mechanism now plays a more prominent role in the allocation of resources.

Perhaps the most striking change has occurred in the fiscal situation. Having peaked at 48% of GDP in 2003, government expenditure declined to 42% of GDP in 2007. Similarly the fiscal deficit contracted from almost 8% of GDP in 1999 to below 2% this year, and the public debt/GDP ratio has gone from a peak of 73% in 2004 to 63% today. At the same time, the share of the public sector in total employment has shed five percentage points to 30%.

The private sector, meanwhile, has adjusted well to the changing composition of domestic and external demand. Between 2000 and 2006 the contribution of service providers to total employment rose from 65% to 70%, thanks largely to growth in financial and ICT-related services, while a leaner but more capital intensive manufacturing sector now employs 17% of all working persons, down from 23% in 2000. FDI has been instrumental in the development of this more diversified economy. As a proportion of GDP, in fact, net FDI inflows increased from 16% to 28% in the six years to 2006.

Progress has also been registered in other areas. Particularly significant was the narrowing of the inequality of income distribution ratio from 4.6 in 2000 to 4.1 five years later, well below the euro area average of 4.8. In education, the proportion of students having completed at least an upper secondary education increased from 41% of the relevant age group to 50% over the same period, and the proportion of students in tertiary education rose from 11% to 16%. There was also some improvement in the female participation rate, from 35% to 38%.

New challenges lie ahead

A sense of satisfaction is, therefore, justified. Complacency, however, is not, for much remains to be done. And any further progress will have to be pursued in an external environment that has become even more challenging. In the first place, competition, mainly from Asia, has eliminated any residual advantage in our labour intensive industries, and represents a growing threat even in more capital and knowledge intensive activities. Another worrying development is the increasing prospect of a slowdown in global economic activity, reflected in the recent downward revisions to GDP growth forecasts by leading central banks and multilateral institutions. The full impact of the chain of events set off by the sub-prime mortgage crisis in the United States has yet to be felt, and risks being compounded by the mounting inflationary pressures in commodity markets, especially for oil and agricultural products, with as yet unpredictable consequences.

Given the circumstances, while the adoption of the euro will undoubtedly enable Malta to face these challenges from a stronger position than if the convergence process had been slower, the euro alone will not be enough.

Against this background, I would be failing in my duty if I did not express concern at the insufficient recognition by public opinion of the risks that the evolving external scenario poses for the Maltese economy and of the need to improve the country's international competitiveness. The reaction to the budget for 2008 is a case in point. Attention has been focussed primarily on the perceived adequacy or otherwise of the proposed increases in incomes and benefits. The media regularly carry suggestions for still more handouts and other measures that would result in even higher consumption rather than investment. In contrast, little is said about where the "more" would come from. Neither has there been any serious discussion as to whether current levels of combined private and public consumption, at 87% of GDP in 2006, and of gross fixed capital formation, which was barely 20% of GDP last year, are appropriate. This imbalance is reflected in the persistent, if reduced, current account deficit, which suggests that consumption levels are indeed too high.

Mr. President, the members of the financial community, and the credit institutions in particular through their lending policies, can play a useful role in seeking to correct this bias towards consumption, which occurs at the expense of improving the economy's long-term growth potential and, therefore, weakens its ability to narrow the income gap with the more advanced members of the euro area. In this regard, we should be aware that despite the recent economic recovery, Malta's per capita GDP measured in purchasing power standards is still just below 70% of the euro area average.

Lessons from euro area country experiences

Policy prescriptions for bridging the remaining income gap are readily available. In this regard, the recent, widely different experiences of Ireland and Portugal are highly instructive.[1] Thus, whereas real per capita income in these two countries was not very different in the early 1990s, it had roughly doubled in Ireland by 2006 to 131% of the euro area average, but had only improved slightly in Portugal to 68%.

How can such divergent performances be explained? Before joining the euro area Portugal pursued a pro-cyclical fiscal policy, which reinforced domestic demand, while in Ireland the fiscal stance was more disciplined. Whereas unit labour costs and inflation rose fast in Portugal, cost and price pressures were more contained in Ireland. As a result, competitiveness declined in Portugal, reflected in a growing current account deficit, whereas Ireland remained competitive and enjoyed a roughly balanced current account.

These different policy approaches left their mark in the post-euro period. In Ireland, real output growth in the years 1999-2006 continued at a strong pace, 6.5% per year on average, and the fiscal balance was in slight surplus. In contrast, Portugal experienced an average growth rate of 1.7%, continued weak competitiveness and a substantial current account deficit. A major factor behind Ireland's success was a 3% average annual increase in labour productivity growth, compared to less than 1% in Portugal.

Another lesson that has emerged from the experience of these two countries, and is also widely documented in the literature, is that cost levels are not the only determinant of competitiveness. Constantly upgrading human and physical capital and freeing markets are as important as keeping unit labour costs under control. Portugal's apparent inability to compete as successfully as Ireland is indeed largely attributable to relatively rigid product and market regulation; insufficiently market-friendly policies; relatively low levels of educational attainment, of R&D expenditure and of information technology use; and not enough wage and price flexibility.

These contrasting outcomes clearly demonstrate that joining the euro area does not on its own provide a guarantee of sustainable growth and that the full benefits of monetary union can only be enjoyed if a country adopts appropriate economic structures and policies.

Bridging the income gap with the euro area

In a Maltese context the pursuit of excellence implicit in the Irish model requires in the first place a change in mindsets and behaviour that would allow us to arrive first at a common diagnosis of the obstacles to faster growth, and then at an equally consensual identification

[1] L. Bini-Smaghi, Real and nominal convergence: policy challenges, speech delivered at the Conference on European Economic Integration 2007 – Currency and Competitiveness, Oesterreichische Nationalbank, Vienna, 20 November 2007.

of the means to overcome them. The ability to achieve a social compact was incidentally another no less vital ingredient of the Irish success story. In the absence of a consensus, however, strong leadership would be required in order to explain the need for hard measures to the population and to isolate vested interests standing in the way of the needed reforms.

Whatever the approach adopted, maximizing the benefits of Malta's participation in monetary union will require the removal of the remaining impediments to growth. In the public sector, fiscal consolidation must henceforth involve a greater emphasis on expenditure reduction, particularly in view of rising pressures caused by aging-related factors such as pension and health care costs, and on securing more "value for money" and greater accountability in the use of public funds. The provision of free public goods and services regardless of the beneficiary's ability to pay needs to be reassessed as it leads to waste and to a higher tax burden, besides being inequitable. The same applies to subsidies, whether implicit or explicit. The resulting distortion of incentives and inefficiencies is both unsustainable and incompatible with the fiscal discipline required in a monetary union.

An important contribution to enhancing the economy's competitiveness can also be made by new forms of employment security and by further improvements in labour market flexibility. With regard to the former, there remains scope for more innovation in terms of employment-friendly labour laws, labour market practices and social protection systems. As for the cost of labour, while it is true that since 2004 wages have been growing more in line with productivity, it also the case that not all the loss in competitiveness experienced before 2004 has been reversed. In 2006, in fact, unit labour costs were still 18% higher than in 2000. And although wage growth has been moderate in recent years, it has been even more so elsewhere. Indeed, when compared to those in the euro area, Malta's relative unit labour costs have risen since 2000. There is little doubt that external competitiveness has deteriorated and that continued wage restraint, therefore, remains an essential ingredient in the recipe for achieving faster export-led growth.

Productivity can also be boosted by making education and training systems better attuned to the needs of a competitive economy, by further reducing compliance costs and simplifying administrative procedures, and by improving the quality of the business infrastructure. Together with those suggested above, these measures can make a substantial contribution to strengthening the economy's capacity to deal successfully with globalization.

Lastly but no less importantly, it also needs to be realized that action on all these fronts is essential for preserving a social model that has reduced income inequality and secured wide access to education, health and pensions.

Conclusion

Mr. President, at this critical juncture in the country's economic development on the eve of joining the euro area, the national interest calls for a strong sense of realism. Failure to understand under which conditions an economy works best in today's world to make possible concrete improvements in welfare can be very costly. There is, therefore, a need to foster a greater public awareness of developments in our external environment and of the appropriate policy responses. There is also a need for a wider acceptance of some basic truths, for example that it is an illusion to believe that something can be had for nothing, or that governments can fix any problem or grievance. On the contrary, policy makers and opinion shapers alike have a responsibility to explain that the expectation of ever increasing entitlements and higher living standards must be balanced with the recognition that these expectations cannot be satisfied sustainably through the redistribution of national income. In the long run, the expected improvements can only be financed through productivity gains and economic growth. And since nobody owes Malta a living, the responsibility for shaking off our ambivalent attitude to change and for turning globalization from a threat into an opportunity is ours and ours alone.