# Michael C Bonello: Malta's experience of EU membership

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, to the European Documentation and Research Centre, at the Conference "Malta in the EU 2004-2009", Valletta, 15 May 2009.

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## Introduction

When I argued the case for membership of the European Union (EU) in November 2002,[1] the underlying premise was that given Malta's small size and lack of natural resources, wealth could only be created by adding value to imported inputs and transforming them into products for which there was a demand abroad. In a globalizing, increasingly competitive world economy Malta's only viable option, therefore, was to seek a more secure access to foreign markets. In this context I went on to argue that deeper integration with our major trading partner, with whom two–way trade was already equivalent to around 65% of GDP, represented a logical response to the challenge of creating a modern economy with the capacity to grow in a sustainable manner. I did emphasise, however, that this objective could only be met if we were prepared to question the way we had managed the economy in the past and resolved to make the necessary changes to institutions and mindsets, policies and work practices.

This explains why I was pleased to accept to participate in this conference, whose purpose is indeed to take stock of what has been achieved since Malta joined the EU in 2004 and, more importantly, to reflect on what still remains to be done.

## Where have we come from?

In order to appreciate the nature of the challenge that membership implied, it is first necessary to recall where we were coming from. Suffice it to point out that the European Commission's response in 1993 to Malta's application had been highly critical. It concluded that, "The adoption of the *acquis communautaire* … depends on a thoroughgoing overhaul of the Maltese economy's regulatory and operational systems."

The first steps in the reform process were taken in the mid-1990s. These included the liberalisation of the financial system and of the import tariff regime, the gradual easing of exchange controls, the partial deregulation of interest rates and the introduction of value added tax and of lower direct taxes. When the membership application was reactivated in 1998, however, the economy still needed significant restructuring.

Further reforms were, therefore, launched once accession negotiations commenced in 1999, including a further dismantling of trade restrictions and the privatisation of State-owned enterprises. This, however, was still not enough. The vulnerability of the Maltese economy was exposed in 2001 by the mounting competitive pressures from emerging economies and by two major external shocks, the bursting of the dot.com bubble and the events of 9/11, which together had an adverse impact on the manufacturing and tourism sectors.

By the time Malta was about to join the EU, the economy was emerging from a period of stagnation, with a widening output gap, a slow pace of productivity growth and a large current account deficit. 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

[1] *Regional economic integration: the options for Malta*, speech delivered at the Annual Dinner of the Malta Institute of Financial Services on 7 November 2002.

magnitude clearly presented considerable risks, not least because some fiscal tightening was already under way. The unemployment rate, for example, was edging upwards, partly in response to the ongoing restructuring process and the further liberalization of markets ahead of EU accession.

In these circumstances it soon became evident that the advantages of the single market needed to be complemented by those of monetary union. The Central Bank of Malta was an early advocate of this objective, particularly because of the greater stability and policy credibility that it promised. From the Bank's perspective a key advantage was the elimination of the risks inherent in managing a small, vulnerable currency. The irrevocable fixing of the exchange rate and the macroeconomic policy discipline of EMU, moreover, promised to offer a congenial environment for implementing the structural changes necessary for a lasting improvement in the country's international competitiveness.

This belief was shared by the Government and the rest is history. In 2005 the decision was taken to join ERM II with a unilateral commitment to maintain the exchange rate at its central parity. This was supported by a process of fiscal consolidation, driven both by revenue enhancing and expenditure cutting measures; the first stage of pension reform; the liquidation of loss-making State enterprises and the privatization of others; and further liberalization measures, including in telecommunications and the postal and port services. Measures were also taken in pursuit of the Lisbon Agenda objectives, especially to improve labour market participation and to enhance educational attainment levels. Finally, EU accession also saw the adoption of a new framework for product market regulation.

The decision to meet the Maastricht criteria at the earliest possible opportunity seemed overly ambitious to some at the time, but a combination of appropriate policies implemented within a clear strategic framework and an improvement in Malta's external environment led to the desired objective being achieved just three years after EU accession. In July 2007, in fact, the European Commission recommended to the EU Council that Malta be allowed to adopt the euro on the grounds that it had achieved the high degree of sustainable convergence required by the Treaty.

### Achievements of the past five years

The implementation of reforms began to pay dividends after 2004. Also with the help of stronger external demand, growth accelerated to an average annual rate of 3.4% between 2005-2008, compared with 0.5% in the preceding four years. Importantly, growth was driven by a pick up in labour productivity and by faster employment growth.

Closer economic integration with the EU led to increased business cycle synchronization, which meant that Malta was better placed to benefit from the common monetary policy of the ECB. Between 2005 and 2008, economic activity displayed an average bilateral correlation of over 82% with the euro area, up from 45% in the previous four years.[2]

While EU funds also played an important role, economic expansion since 2005 has been largely driven by foreign direct investment (FDI), as the economy shifted towards higher value-added activities and exploited new niche markets opened up by EU membership. As a proportion of gross fixed capital formation, FDI inflows increased from an average of 56% in the period 2001-2004 to 93% during 2005-2007. Meanwhile, the stock of FDI stood at around 100% of GDP, an increase of more than half since 2003.

[2] Business cycle synchronization is measured by the contemporaneous correlation of de-trended GDP levels in Malta and the euro area. The data were obtained from Eurostat and de-trended using the Hodrick-Prescott filter on quarterly statistics that were seasonally adjusted and adjusted by working days.

At the same time, industry became increasingly oriented towards more capital intensive activities, such as generic pharmaceuticals, while the share of labour intensive operations such as textiles continued to decrease. In the services sector, the importance of tourism, which rebounded in 2007 following the introduction of low-cost airlines and growth in cruise ship business, has been complemented by growth in a broad range of new activities, including financial services, aircraft maintenance and repair, online gaming, ICT, call centres and back office operations. The more diversified supply of services and the shift towards higher value-added manufacturing helped to cushion the negative impact on traditional manufacturing activities of the competitive pressures from low-cost countries.

The changed structure of the economy, which is now service oriented to the extent of 77% of gross value added, led to an improvement in the balance of trade in goods and services and to gains in the terms of trade. The deficit on the former fell from more than 10% of GDP in 2000 to 3.7% of GDP in 2008, while the terms of trade went up by almost 2% during this period, driven by a strong increase in the services sector, which outweighed the steady deterioration in merchandise trade. Gains in the terms of trade can result either from higher export prices or from lower import prices, or a combination of both. Achieving favourable terms of trade is vital for an open economy where real income depends not only on the volume of output produced, but also on the value of that output in international markets.[3]

Positive changes in non-cost competitiveness were complemented by a favourable trend in cost competitiveness. Unit labour cost growth declined to an annual average of 0.6% during 2005-2007, compared to 3.9% during 2001-2004. This improvement was driven by a pick-up in productivity and moderate wage awards. Wages and productivity drifted significantly apart in 2008, however, a divergence which will have harmful consequences if allowed to persist.

Progress has been registered in other areas too, though at times not to the same extent as in other EU countries. In the labour market, the employment rate increased from 54% in 2004 to 55.2% in 2008, driven by a steady rise in the female employment rate, while the unemployment rate fell to a record low of 5.9% in 2008. In education, early school leavers declined from 42% in 2004 to 37.3% in 2007, although this is still well above the 15% average EU ratio.[4] Education attainment levels increased from 51% to 55% during the same period.[5] Since the start of this decade, the student population pursuing further and higher education has increased by an annual average of over 5%.[6] An improvement in human capital goes hand in hand with greater employability. In 2008, the employment rate of those with a tertiary level of education stood at 86%, compared to 46% for those with only a secondary level of education.

On the social level, one indicator that captures the considerable advances made in recent years is the inequality of income distribution ratio, which fell from 4.6 in 2000 to 3.8 in 2007, well below the average of 4.8 in the EU and the euro area.

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3 A broad treatment of this subject is contained in Duguay, Pierre, *Productivity, terms of trade and economic adjustment*, remarks by the Deputy Governor of the Bank of Canada to the Canadian Association for Business Economists, 28 August 2006.

4 Early school leavers are defined as the percentage of the population aged 18 - 24 with at most a lower secondary education and not in further education or training.

5 The education attainment level is defined as the percentage of the population aged 20 - 24 having completed at least upper secondary education.

6 Data obtained from National Commission for Higher Education *NCHE Further and Higher Statistics 2008,* December 2008.

## The challenge ahead

Despite this encouraging start to EU membership, much clearly remains to be done. An indication of the challenge ahead is provided by the gap between income levels in Malta and the EU. Measured in terms of real GDP per capita in purchasing power standards (PPS), this gap has not been narrowing of late and in 2008 was still about 21% and 29%, respectively, below the EU and euro area averages.

A useful exercise for policy purposes decomposes this income gap in terms of labour productivity and labour utilisation.[7] In turn, labour utilization can be broken down into the employment rate, the average number of weekly hours worked and the share of the population in the 15-64 age bracket. This decomposition facilitates the identification of appropriate measures for improving growth prospects and, therefore, for narrowing the income gap. It also helps to demonstrate that living standards can only be raised in a sustainable manner though a combination of a greater mobilization of human resources and higher productivity levels.

Given the similarities of the EU and euro area averages, I will focus on the income gap relative to the EU. In 2008 this gap was attributable to both lower productivity and labour utilization in Malta. Lower productivity can be the result of either a smaller capital stock, both physical and human, or an inferior level of technology, or some combination of the two. Malta's labour productivity has been declining over time, dropping from around 90% of the EU average in 2003 to 87% in 2008. On the other hand, labour utilization has improved, increasing from around 88% to 91% of the EU average over the same period. Malta's lower labour utilization rate is entirely attributable to a low employment rate, as both the average working week and the share of persons of working age in the total population are higher in Malta than in the EU. Since 2003, in fact, Malta's employment rate declined from around 87% to 84% of the EU average. This reflected a steadily falling male employment rate, the lowest female employment rate in the EU, a declining rate among older workers and the lowest average exit age in the EU of workers from the labour market.

Apart from such supply-side considerations, there are other factors which may hinder the ability of the economy to generate sustainable growth. For instance, despite the widespread recognition that exports should be the engine of growth in a small open economy like Malta's, insufficient attention has been devoted to the fact that between 2005 and 2008 GDP growth was largely driven by domestic demand. The average level of combined private and public consumption was around 85% of GDP during this period, against 78% in the EU. Consumption at this level cannot be sustained unless substantially more resources are allocated to investment and to other growth-enhancing activities.

At this point it is necessary to extend the analysis to two important dimensions of membership of a monetary union, namely the role of price and cost competitiveness and fiscal policy.

Persistently faster increases in prices and costs in Malta relative to the euro area average lead inevitably to a loss of competitiveness. Since the interest rate and exchange rate policy tools are not available to euro area members, the necessary adjustments have to take place through domestic price and wage levels or in real variables such as output and employment. It is, therefore, important to avoid any such divergencies.

The failure of domestic food prices to decline in line with trends abroad in recent months is a case in point and suggests the presence of market imperfections. The harmful effect of such

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7 A similar analysis is presented by Papademos, Lucas, *Determinants of growth and the role of structural reforms and macroeconomic policies in Europe,* a speech delivered at the 2004 Ludwig Erhard Lecture on the State of the European Economy at the Lisbon Council's Board of Economists in December 2004 and in a box entitled *Labour utilization and economic convergence,* published in the Central Bank of Malta, Quarterly Review 2008:2, pages 46-48.

rigidities is magnified when nominal wages are partly indexed to consumer prices, as they are in Malta, because temporary price shocks can lead to permanent wage and price deviations from the euro area average. The wage determination process must, therefore, give equal importance to achieving offsetting gains in productivity in order not to jeopardize competitiveness and employment creation. This is a vital requirement because Malta is already at a disadvantage given that since 2000 unit labour costs have risen by some 22% compared with an average of 15% in the euro area.

Failure to maintain low levels of inflation is also detrimental in the short term. Consumers in several euro area economies are currently experiencing increases in real purchasing power as a result of falling price levels. This is not the case to the same extent in Malta, where the HICP inflation rate is well above the euro area average.

Let me now turn to the role of fiscal policy, which in the context of monetary union is the only national policy tool available for short-term adjustment. In Malta, however, in spite of the remarkable fiscal consolidation achieved in the run up to euro adoption, deficit and debt to GDP ratios are still at a level that allows limited scope for using fiscal measures to support economic activity. I shall elaborate on the implications of this constraint later on.

Fiscal prudence is also necessary to safeguard the country's credit rating and maintain investor confidence. There is indeed growing evidence that investors are increasingly discriminating among euro area countries on the basis of their fiscal outlook. From a budgetary standpoint, moreover, risk premia on long-term interest rates will increase, and the debt servicing burden will therefore grow, if the perception gains ground of a departure from the path of fiscal consolidation. Finally, from a longer-term perspective, a prudent budgetary policy is also required to cater for the growing costs of Malta's ageing population, as was vividly pointed out in a recent report published by the European Commission,[8] and the still unidentified costs associated with climate change.

## The way forward

Going forward, therefore, it must be realized that in a monetary union the effects of institutional rigidities, inappropriate policies and inefficient practices on prices, costs and competitiveness will inevitably become visible in the shape of lower income levels relative to the other members of the union. Given that a sizeable income gap already exists with the euro area, removing the remaining impediments to faster growth is, therefore, a policy imperative.

Two elements of an appropriate response to this challenge emerge spontaneously from an analysis of the current macroeconomic situation. Attention has already been drawn to the over reliance on consumption as a driver of growth since 2005, highlighting the need to devote more resources to investment. In Malta's case, this must continue to take the shape predominantly of FDI because of the implied technology transfer and access to markets. Attracting further FDI, however, will require a determined effort because when the current recession is over the global marketplace will be characterised by fewer, but more cost-efficient suppliers and a slow-growing demand; a large pool of unemployed labour, implying downward pressures on wages; and an increased tendency for investment to shy away from relatively expensive locations. A review of Malta's investment promotion strategy should, therefore, be undertaken that takes this scenario fully into account.

Private investment must be supported by appropriate levels of public investment, mainly of an infrastructure nature. For reasons already explained, progress towards the attainment of a balanced budget over the medium term must at the same time also be a priority. Financing

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[8] Report entitled *The 2009 Ageing Report: Economic and budgetary projections for the EU27 Member States (2008-2060)*, published by the European Commission and the Economic Policy Committee.

the necessary investment, therefore, represents a complex task. This is because some 65% of budgetary revenues come from cyclically-sensitive sources, essentially direct and indirect taxes, and current projections show that the recovery in Malta's export markets, and therefore also in the domestic economy, is likely to be very slow. This means that the tax base will expand only moderately. As a result, the need to allocate more public funds to investment while at the same time reducing the deficit can only be satisfied if a major effort is made on the expenditure side.

Here too, however, the task is complicated. This is mainly because about 69% of total budgetary outlays are in the shape of fixed commitments such as wages and salaries, interest on the public debt and welfare payments. Since increased taxation must be ruled out as an option, the solution must be centered on efficiency improvements in the use of budgetary resources and a reordering of spending priorities. In this context it should be noted that beyond 2013 Malta is unlikely to be eligible for EU funds to the same extent as at present.

Two areas which have been identified as having the potential for efficiency gains are the education and healthcare systems. Together, these absorb around 25% of general government expenditure. A recent study by the European Commission suggests that, as far as tertiary education is concerned, the same level of output could be attained with 44% of the present level of expenditure per student.[9] The equivalent figure for the healthcare sector stands at 38%. On this basis the study concludes that even incremental efficiency gains in these two areas can lead to substantial savings. No doubt, other spending categories offer similar possibilities.

As for spending priorities, the choice needs to be guided by some important criteria, such as the delivery of a minimum social safety net for those who are genuinely in need; the ending of benefits that discourage participation in the labour market; the elimination of excess demand for, and waste of, free public goods and services; and a greater focus on policies and programmes that would promote innovation and encourage entrepreneurship and investment, and thus generate long-term economic growth. The room for retrenchment may be limited in the short-term, but in the long-term all expenditure categories should come under close scrutiny. Since the outcome of such an exercise will inevitably entail a departure from established practices and the loss of acquired rights, it should ideally be based on a broad consensus among the social partners.

## Conclusion

In conclusion, the economy has come a long way since 2004, and is now much more diversified and market-oriented. There is, however, no room for complacency because narrowing the income gap with the other euro area countries during a recession and a likely slow recovery will be a formidable task. This calls for a renewed impetus in the implementation of the structural reforms contained in Malta's Lisbon Agenda programme, particularly the removal of remaining labour and product market rigidities and anti-competitive practices.

It has also become clear that in spite of the undoubted protection they offer, neither EU nor euro area membership is a panacea for deep seated problems. The global financial crisis has put a premium on sound economic policies and the efficient use of scarce resources. A reordering of public expenditure priorities and an overhaul of the welfare system would be a major step in this direction. The implementation of the necessary structural and fiscal

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[9] Ebejer, Ivan and Mandl, Ulrike, *The efficiency of public expenditure in Malta*, published in February 2009 as ECFIN Country Focus (Volume 6, Issue 2).

reforms, however, can only be achieved through a combined effort involving all the social partners.

Finally, the current recession also serves as a poignant reminder of a basic truth in economics: living beyond your means – and particularly borrowing to finance consumption even in good times – is not sustainable. We would do well to heed the advice Cicero gave the citizens of Rome in 55 BC.

*"The budget should be balanced, the treasury should be refilled, public debt should be reduced, the arrogance of officialdom should be tempered and controlled … lest we become bankrupt. People must again learn to work, instead of living on public assistance."*