Michael C Bonello: Time for a reality check

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the annual dinner of the Institute of Financial Services, Saint Julian's, Malta, 20 November 2010.

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I would first of all like to thank the President and his Council for inviting me once again to address their annual dinner. Before I do so, I would like to commend IFS Malta for its unstinting efforts to promote higher levels of expertise in our financial community. The success of the foundation degree programme at MCAST and the new training programmes in Funds Administration, Anti-Money Laundering and Financial Crime Prevention are but two examples. I would also like to congratulate the Institute's nominee, Mr Peter Calleya, for his election to the EBTN Executive Committee.

The economic rebound should not give rise to complacency

Last year I said that an improving external environment could benefit the Maltese economy. And indeed it has. The recession proved short and shallow, with a peak-to-trough decline in GDP of 3.4%, as against 5.3% in the euro area, and the GDP contracted by just 2.1% in 2009. In the first half of 2010 the economy grew by 4%, which suggests that the outturn for the full year could top 3%.

This encouraging performance has prompted manifestations of the "Malta is different" syndrome, with suggestions that belt-tightening and structural reforms are for others, but not for us. For a country that, with one exception, has not had a current account surplus or a balanced budget for at least fifteen years, this attitude betrays a poor understanding of the growth dynamics in a small, open economy and of current world realities.

A more balanced assessment of the facts would recognize that the extent and speed of the turnaround demonstrate not only the undoubted resilience of the Maltese economy, but also its vulnerability. More specifically, since the rebound in good part reflects a recovery in the electronics and tourism industries, it underlines our dependence on the state of external demand. We ignore this reality at our peril.

Medium-term prospects will be conditioned by slow growth abroad

Now, given the pervasiveness of the recession abroad and the considerable uncertainty that still prevails today, we can expect only modest growth in export markets in the near future. According to the IMF, real GDP in the advanced economies will expand by only 2.2% in 2011 compared with 2.7% this year.[1] In Europe, the euro area is forecast to grow by just 1.5%.

Given these subdued global prospects, it would be naïve to assume that the current economic upswing in Malta will continue spontaneously without determined efforts to achieve faster growth. There is no other option if we aspire to converge to the higher living standards enjoyed elsewhere in Europe. The key to a better quality of life are rising incomes. In this respect, there is considerable potential for improvement. Malta's GDP per capita in PPS terms has been stuck at around 77% of the EU average since 2003.[2]

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[1] IMF, *World Economic Outlook*, October 2010.

[2] Source: Eurostat.

The focus must be on productivity and competitiveness

Faster sustainable growth will not, however, be possible unless we produce goods and services that meet the test of increasingly competitive and discerning markets. This, as the recent Pre-Budget Document acknowledged, requires, among others, higher productivity levels, which would then raise the rate of growth of potential output.

Productivity has been improving recently, but against the backdrop of a relatively poor long-term record, which leaves Malta well behind the best performers in the euro area.[3] Even more worrying, compensation levels have risen much faster than productivity.

The explanation for this relatively poor outcome should be sought in the way we use productive resources, principally labour and capital.

Malta's labour resources are underused…

To begin with, not enough people participate in the formal labour market. In 2009 the employment rate stood at 55%, compared with a euro area average of nearly 65%.[4] The activity rate among women and older workers in particular is especially low.

Furthermore, long-term demographic projections suggest that, over time, the labour force will shrink. According to the European Commission, the working-age population in Malta will contract by more than 20% by 2060.[5] In the light of these trends, raising participation rates should be a priority. Several measures have already been taken, including in the Budget for 2011, such as incentives for women to re-enter the labour market, and trying to remove "unemployment traps" that arise from the interaction of the tax and welfare system. The gradual increase in the retirement age will also help. But this will not be enough.

Efforts to get more people to work must, moreover, be accompanied by measures to raise their productivity. We need to invest more, and more efficiently. Malta's educational attainment levels in particular, though improving, remain low. In 2009 just over one quarter of adults aged between 25 and 64, much less than half the EU average, had completed at least an upper secondary level of education.[6]

The solution here does not lie solely in allocating more resources. It is also a question of how the money is spent. According to a recent study, public spending on education in Malta amounts to around 5.5% of GDP, which is above the EU average.[7] But the study also shows that this spending is not very efficient, especially in the case of tertiary education. Despite the significant amounts spent, Malta's tertiary educational attainment level, at 21.1%, is well below the EU average of 32.3% and the Europe 2020 target of 40%.[8]

This situation must be reversed because well-remunerated jobs cannot be created in the absence of high-quality post-secondary education. As the recent Browne report in the UK

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[3] Source: Eurostat.

[4] Source: Eurostat.

[5] European Commission, *The 2009 Ageing Report: economic and budgetary projections for the EU-27 Member States (2008–2060), European Economy* 2/2009, page 47.

[6] Source: Eurostat.

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

[8] The tertiary educational attainment level is defined as the share of the population aged between 30–34 years who have successfully completed university or university-like education with an International Standard Classification of Education 1997 of 5–6.

stresses, higher education drives innovation and economic transformation.[9] The University of Malta, however, is short of funds. One way of tackling this deficiency would be to limit stipend support to students who are truly in need. This would ensure that access to a university education remains open to everyone with the potential to benefit from it, while releasing funds for improving its quality. It would also address an issue of equity: since a tertiary level education is the key to better-paid jobs and higher lifetime incomes, it is appropriate that those who benefit most from it should contribute at least part of the costs involved.

… while investment has not been sufficient

But enhancing the supply and quality of labour is still not enough. To produce output, labour has to work with capital. Now a country's capital stock can only grow through investment. The recent performance in this regard has been inadequate. As a share of GDP, private investment amounted to 16% on average between 2000 and 2009, among the lowest ratios in the euro area. Given Malta's track record in attracting foreign direct investment, this shortfall is probably more a reflection of a relatively low level of domestic private investment.

The latter is unlikely to be related to the cost and availability of finance. Interest rates are at historic lows and, contrary to the experience elsewhere, credit to the private sector continued to expand during the recession. As for possible structural factors, the diversification of the economy away from manufacturing towards services is also unlikely to have been a factor. Similar sectoral shifts elsewhere did not result in a declining investment share.

Rather, the relatively low level of private investment could, in part, be a legacy of the past, when firms in protected sectors could survive without the need to invest to face up to competition. In addition, in key sectors such as tourism and the wholesale and retail trades, the operating surplus has fallen, on average, over the past decade. Weak profitability, which is partly due to labour costs rising faster than productivity, reduces both the incentive to invest and the internal funds available to do so. Hence the emergence of a perverse cycle of weak profitability, low investment, poor productivity growth and a loss of competitive strength.

These weaknesses are reflected in persistent current account…

These structural weaknesses show up in a persistent deficit on the current account of the balance of payments. Shortfalls have been recorded in every year but one since at least 1995. The deficit widened again in 2009 to 6.9% of GDP from 5.7% the previous year.

A current account deficit indicates that we spend more than we produce. It also implies that domestic savings are insufficient to finance investment, even though, as we have seen, the rate of investment is relatively low. The only way in which current consumption levels can be sustained, therefore, is by raising incomes. This, in Malta's case, requires a more dynamic export performance.

For a start, this means that efforts to attract foreign direct investment, much improved in recent years, need to become even more focussed and supported with a strengthened infrastructure. The domestic private sector, meanwhile, needs an incentive to switch to producing for markets abroad. This incentive is relative profit. Export-oriented activity must become relatively more profitable than production for the domestic market alone.

In a small island economy, where transport costs impose natural barriers to trade, it is easier to set up and defend monopolies. This was especially true before the liberalisation of product markets at the time of EU accession. But this is not to say that elements of monopoly power – and the attitudes this engenders – have not survived. For example, a survey carried out by

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[9] *Securing a sustainable future for higher education*, 12 October 2010, http:// www.independent.gov.uk/browne-report.

the Bank on price and wage setting in Malta shows that although just over half of respondents would cut prices if their competitors did so, 36% would not. Unsurprisingly, the most flexible firms were those in the manufacturing and tourism sectors, where foreign competition is strong.

This suggests that there is still scope for increasing the degree of domestic market competition. Sometimes, the connection between market liberalisation and exports may be indirect. As the recent experience in the communications sector has shown, liberalisation drove down costs and prices. This opened up new export opportunities outside the communications sector itself, for example, in financial services and remote gaming.

The importance of keeping costs under control cannot be overemphasized. Malta's inflation performance over the last ten years illustrates this point. Whereas the euro area inflation rate averaged 2.1% between 2000 and 2009, domestic inflation averaged 2.5%. The record for inflation excluding energy prices shows a similar unfavourable trend. It is an established fact that in a currency union rates of inflation consistently above the average result in a loss of competitiveness.

Apart from more competitive markets, containing domestic inflation implies a need for wage moderation. For many years employee compensation has grown faster than real labour productivity. Whereas the former increased by around 31% since 2000, productivity rose by only 2.5%. The resulting rapid growth in unit labour costs, more than 28%, compares with an average of 20% in the euro area.

In order to make up for this lost ground, the wage determination process needs to be reformed. While wage bargaining at the enterprise level provides flexibility, the automatic indexation mechanism through which current wages are adjusted to past inflation, even if partially, increases the downward rigidity of real wages and thus represents a permanent drag on Malta's competitive position.

...and government budget deficits

The current account deficit is mirrored not only in the shortfall in private savings but also in the budget deficit. Government expenditure has exceeded revenue in every year at least since 1995, resulting in a steady rise in the public debt from less than 40% of GDP in the mid-1990s to 69% today.

The thrust of the recent Budget, and particularly the projected cut in the deficit ratio from 3.9% of GDP in 2010 to 2.8% next year, is therefore a welcome development. Continued vigilance is, however, necessary. Given the uncertain prospects for Malta's export markets, for example, the assumed nominal GDP growth rate of 5.6% on which the tax revenue forecast for 2011 is based could turn out to be optimistic. The medium-term objective of a balanced budget, moreover, must be kept well in mind.

EU rules stress the importance of achieving a balanced budget over the cycle precisely because fiscal prudence responds to a clear economic logic. In the long run, a persistent budget deficit contributes not only to a dangerous debt dynamic, but also to price pressures, a loss of market share and a trade imbalance. Only through the achievement of surpluses during a cyclical upswing can there be room for countercyclical deficits in a downturn. The retrenchment currently being experienced in many countries highlights the consequences of leaving fiscal imbalances unaddressed.

Fiscal consolidation is also necessary to bring the debt ratio below the 60% limit. For example, if the deficit ratio does not shed one percentage point in 2011 as planned, the deficit would be some EUR65 million higher than the projected amount. At current interest rates, this would imply an addition of about EUR3.3 million to the annual interest charge on the debt, which at EUR 198 million this year is considerably more than government

investment in the infrastructure; and the debt ratio would rise by an additional percentage point to 70%.

Improving the long-term sustainability of public finances assumes additional importance in view of the expected doubling of the share of the elderly in the Maltese population by 2060. As a result, age-related spending is set to increase by more than 10% of GDP. Partly because of these demographic trends, Malta is among the group of EU countries facing the greatest challenge in terms of fiscal sustainability.[10]

Since this task can only be addressed gradually, we have to start now. Completing the planned reform of the pension system must be part of the solution. In particular, introducing funded pensions promises to deliver benefits on several fronts. First, by boosting incomes in retirement it will help support a large share of the population as it ages, reducing the burden that currently falls on the unfunded pay-as you-go system. Second, if individual contributions are linked more closely to individual payouts, this will encourage private saving, which, as we have seen, is necessary to close the saving/investment gap. Finally, if individuals perceive a closer link between their contributions and their retirement income, this should help curb the evasion of social security payments.

There is little room for tax increases

Fiscal consolidation, therefore, is desirable to help correct the economy's external imbalance; to put public finances on a sound footing while coping with the costs of population ageing; and, above all, to maintain credibility and investor confidence, which are prerequisites for growing the economy.

Now deficit reduction is typically achieved through a combination of increased revenue and expenditure cuts. As for the former, relying mainly on higher taxation cannot be an option at this juncture; besides, it generally distorts the efficient allocation of resources. Higher indirect taxation tends to push up the price level and, hence, harms competitiveness, while higher taxes on income depress economic growth. Neither, of course, is this a time for cutting taxes. An option which is at once fiscally beneficial and socially desirable is to close remaining tax loopholes and to engage in a more aggressive pursuit of tax evasion and benefit fraud.

We need to cut spending, while rebalancing it

The only real alternative, however, is to cut public spending. There is a near-consensus in the literature that expenditure cuts have a smaller adverse impact on the economy than revenue increases.[11] Fiscal consolidation, moreover, produces long-term benefits since a smaller debt stock results in lower interest payments, and thus can eventually create room for growth-enhancing tax cuts.[12]

General government expenditure amounted to EUR2.5 billion in 2009, or almost 44% of GDP. The largest single item was the wage bill, equivalent to 14.5% of GDP. It was followed by spending on benefits, mainly old age pensions, which amounted to some 13% of GDP. Health care, excluding wages, absorbed a further 2%. These three items together account for more than two-thirds of government spending. In contrast, an amount equal to only 2.2%

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[10] See European Commission, *Public Finances in EMU 2010, European Economy* 4/2010.

[11] For example, according to the IMF, "spending-based deficit cuts, particularly those than rely on cuts to transfers, have smaller contractionary effects than tax-based adjustments". See IMF *World Economic Outlook* October 2010, Chapter 3, p. 113.

[12] See also European Central Bank "The effectiveness of euro area fiscal policies" *Monthly Bulletin* July 2010.

of GDP was dedicated to investment. A substantial increase in productive investment, particularly in physical and human capital, is clearly necessary.

The Budget for 2011 recognizes this need, projecting a marked increase of 15% in capital spending. This is encouraging because in recent years growth has mainly occurred in recurrent spending. Between 2004 and 2009, this expanded at an annual average of 5.3%. On the other hand, government investment remained broadly unchanged during this period and declined in the last two years, in part because actual outlays often fell short of targets.

The dual challenge of maintaining a high level of investment spending while reducing the budget deficit, therefore, implies that it is recurrent expenditures that must be cut. Progress has already been made by reducing subsidies, through the privatisation of the shipyard and by aligning utility rates more closely to production costs. For next year, however, while an increase of less than 1% in recurrent spending is planned, few specific cuts have been identified. In this context, the latest Annual Report of the National Audit Office suggests there is ample scope for controlling expenditures more effectively and for improving revenue collection.[13]

While taxpayers have every right to expect value for their money, a substantial, durable fiscal correction requires a fundamental reappraisal of the role of the state in providing services. The need to prioritize expenditure programmes has not been fully addressed. As a result, the most difficult challenges, such as how to ensure sustainable funding for tertiary education, pensions and health services, remain to be tackled.[14]

Domestic consumption must return to a sustainable level. It is an inevitable adjustment for economies like ours that have lived beyond their means for far too long. Fortunately, we need to adopt much less drastic measures than those countries that have had to make deep cuts in public sector staffing levels, wages and social benefits in order to stave off the financial collapse of the state itself.

And yet, people in Malta continue to expect the Government to hand out money it does not have. This attitude must change, for not only can it lead to bankruptcy, but it is also indefensible on moral grounds. Politicians, trade unions, NGOs and other opinion shapers must explain that we do not have money for everything and that you cannot have gain without pain. The intelligent thing to do is to work together so as to minimize the pain and then ensure that it is equitably shared.

In my view, the priority of the welfare state should be to provide equal opportunities for all, but a safety net only for those who need it most. Universality – dispensing free goods and services to all irrespective of income – is a wasteful and unaffordable principle. In the words of the renowned economist, Jeffrey Sachs, *"Even playgrounds should collect tolls, when it is billionaires who are playing in the sandpit."*

The social welfare system, including health care, has long been identified, including by the European Commission and the IMF, as offering the greatest potential for savings. Effective measures implemented elsewhere which could be adopted range from user fees for certain public services to policies designed to make work pay. We should also reassess the scope of

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[13] See National Audit Office (NAO), *Annual Audit Report by the Auditor General: Public Accounts 2008*, December 2009. Examples of inefficiencies and improper practices range from 28,810 cases of social security contributions worth EUR 4.5 million being in arrears, to the number of hospital meals charged in one hospital consistently exceeding the number of in-house patients, to cases of payments to government suppliers not supported by VAT receipts.

[14] The welfare gap, i.e. the difference between all items of expenditure and contributions made in terms of the Social Security Act, 1987 has more than doubled in the last five years to EUR381.2million in 2010. The cost of pensions and related benefits is estimated at EUR 564 million and that of free hospitalisation and community care EUR 306.5 million. See, Ministry of Finance, the Economy and Investment *Financial Estimates* 2010, p. 294.

social benefits, to distinguish between those that truly help to combat poverty and social ills and others that are not so effective in achieving the desired outcomes.

Finally, I believe the time has also come to consider how to strengthen the budget process, drawing on models tested successfully abroad. These typically involve fiscal rules providing for limits on supplementary budgets, multi-annual expenditure ceilings and more transparency in fiscal policy making, as well as an independent monitoring agency. The pursuit of fiscal sustainability along such lines requires a broad political consensus.

Conclusion

Mr. President, this evening I have argued that while the Maltese economy is headed in the right direction – a fact that has been recently confirmed by its 33rd place in the Human Development Index –, we must look beyond the current upturn to examine structural weaknesses that are preventing the economy from exploiting its full potential, and thus from closing the income gap with our European peers.

I have therefore suggested that we need to raise labour force participation, improve the quality of the work force and increase the efficiency of public spending, particularly in education. We also need to invest more, to upgrade the capital stock. Here, monetary policy is playing an important role: interest rates are at historic lows and bank credit continues to flow. The Eurosystem's commitment to deliver price stability in the medium term is also a key factor in sustaining investor confidence and supporting economic expansion.

Market mechanisms, underpinned by appropriate legal frameworks, must be allowed to work better. In general, we need to open up domestic markets to an even greater degree of competition.

In addition, fiscal tightening is necessary to correct current imbalances and begin to reverse the trend increase in public debt. This objective acquires added importance in the context of population ageing. Above all, durable consolidation requires a reappraisal of the role of the state and the tightening of fiscal rules.

Finally, we need to further improve the economy's resilience to external shocks. Over the past decade unit labour costs and prices have shown a marked tendency to deviate from the euro area average, thereby eroding competitiveness. It is a law of economics that the adjustment necessary to regain competitiveness inside a monetary union must take place in the real economy by ensuring that prices, wages and profit margins fall, or at least increase by less than the average, for a number of years. This requires the introduction of productivity-enhancing measures and a wage-setting process in which wage increases reflect efficiency gains at the enterprise level rather than past inflation.

In concluding, let me emphasize that what I am advocating is not austerity but enlightened self-interest. It is a commonsense appeal for a closer alignment of our priorities with the economy's strategic objectives and for a more efficient allocation of resources. Against a backdrop of weak and uncertain global growth prospects, the policy focus must be on releasing resources to make the long-term investments needed for sustainable growth. There is indeed not much that economic policy can do to create well paid jobs in the short term. These are the combined outcome of high education standards, modern technology and an efficient infrastructure. This, in turn, depends on farsighted policies and years of wise investment by both the public and private sectors. That, I believe, is the path we should follow.