Michael C Bonello: Facing the challenge of today's economic realities

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the Institute of Financial Services Annual Dinner, St Julians, 14 November 2003.

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This being my first public statement since my reappointment, I should like to express my appreciation to the Government for the trust that has been placed in me. I am conscious of the magnitude of the task that lies ahead, but I am also comforted by the thought that I shall continue to be supported by a team of competent and dedicated professionals. I am, therefore, able to look forward with confidence to leading an independent Central Bank of Malta into membership of the European System of Central Banks next May, and to cooperating closely with the Government in creating a policy environment which would allow us to guide the Maltese lira smoothly into the euro area. I stress this point because it is only when the economy becomes anchored in the relative safety of the common currency area that the benefits of participation in the European single market can be enjoyed to the full. Early adoption of the euro is, therefore, in the national interest and must become our common objective.

Pursuing that goal successfully, however, will require a courageous effort to overcome the obstacles that stand in our way. This much was clear from the beginning. You might recall that in setting out the economic case for membership of the European Union (EU) on this occasion last year, I emphasized that the candidate countries needed to seriously question the way they had managed their economies in the past and to resolve to improve their performance. I warned against underestimating the entity of the task because the necessary changes were pervasive, affecting both institutions and mindsets, policies and work practices, and they also entailed costs.

It was this same realization of the difficult challenge implied by EU membership that lay behind the call I made, the day after the referendum result was confirmed at the April general elections, for an early mobilization of all the nation's resources. It is, therefore, somewhat disappointing that there persists today an insufficient awareness of the profound economic implications of that decision and of the need for all to work hard to secure the benefits of membership. This is all the more surprising given the threat posed by the continuing weakness in our major export markets.

The Major Challenges Facing the Maltese Economy

It is against this background that I propose to focus attention on four major challenges which I believe must be tackled with urgency if the economy is to return to a higher path of sustainable growth and development. These are the correction of macroeconomic imbalances, which I have often characterized as the need to live within our means; the need to respond to, and exploit the competitive forces unleashed by globalization; and the deleterious economic effects of population ageing and of environmental degradation.

These challenges are by no means unique to Malta. Economies all over the world at different stages of development are similarly affected. They can, and must, therefore, be transformed into opportunities, because economies which are more successful than others in overcoming them will enjoy a significant competitive advantage. In Malta's case the task is particularly difficult because all of these issues need to be tackled at the same time. Indeed, undue postponement of the necessary reforms could have serious consequences.

The Correction of Macroeconomic Imbalances

The Maltese economy has been devoting far too many of its relatively scarce resources to consumption. Household and government consumption have increased steadily over the past decade from 80% to 85% of GDP. The household savings rate has meanwhile declined from almost 16% to around 1.5% of disposable income during the same period.

These trends are a source of concern. First, because a reduced savings pool will compromise future economic growth by curtailing investment. Indeed, the share of resources devoted to productive investment has shrunk from almost 30% a decade ago to just over 20% today. Second, because excessive consumption threatens the sustainability of the economy given the high import content of domestic expenditures. The balance between exports and imports of goods and services has been consistently negative over the past decade, averaging 8% of GDP.

While in past these deficits have been made good through inflows of capital from abroad, there is no guarantee that external imbalances on this scale can persist without posing a serious threat to the country's external reserves and, ultimately, to the Maltese lira. And may I at this point remind you that the low and predictable inflation we have experienced in recent years is largely attributable to the pegged exchange rate regime. This has also significantly reduced pricing risks for exporters and investors. It should, therefore, be clear that undue and sustained pressure on the reserves would evoke a monetary policy response which would have pervasive repercussions.

There is no doubt that a primary factor behind these macroeconomic imbalances is the state of public finances. Malta's fiscal performance over the past decade has not been rigorously consistent with its intended objectives. Fiscal consolidation efforts based mainly on increasing taxation brought the deficit down from around 11% of GDP in 1998 to between 6% and 7% of GDP in the past three years. It is, however, clear that further attempts at consolidation, particularly in a weak growth environment, will have to focus on expenditure cutting.

The Irish experience during the 1980s is most telling. The first half of the decade was characterised by increasing taxation, which often had to be followed by higher expenditure to satisfy economic, political and social demands. During this period the deficit to GDP ratio only shed two percentage points to 12%. In contrast, the second half of the 1980s featured an emphasis on reducing expenditure. In the process the deficit was slashed to 2% of GDP. A perceptible dividend of this policy was an acceleration in the growth rate to an annual average of 8.6% in the 1990s.

At this stage, therefore, there can be no doubt about the urgent need to reduce the fiscal deficit primarily through better expenditure management. Broad policy statements of intent will no longer do. The budgetary allocation process must be radically changed so as to ensure that expenditure is minimised and delivers value for money.

Perhaps the greatest obstacle to an effective implementation of such an approach is the negative short-term economic impact which expenditure cuts are likely to entail. It is thus crucial that the private sector be in a position to take up the slack as the State reduces its role in the economy. And for this to happen, there have to be the best possible conditions for the attraction of local and foreign investment.

There are indications, however, that our performance is not quite up to standard in this regard. In a speech I delivered last year, I had shown how Malta's competitiveness lags behind that of EU member States, mainly because of restrictive practices and other labour market inflexibilities; the maintenance of monopolistic situations in economically strategic areas such as transportation and inland freight; and insufficiencies in our educational system and innovation efforts. These conclusions have been supported by a number of studies since then and remain valid today.

Problematic as it is, however, the budget deficit is by no means the only determinant of macroeconomic imbalances. Certain systems and practices which create demand without generating output have equally harmful consequences. A typical example is the welfare system. It has become so entrenched that its benefits are mistakenly considered to be immutable rights; but, as the rapidly growing welfare gap shows, it is a system which carries the seeds of its own destruction. For while the welfare state was born from the noble premise that care for the weak and the needy is the responsibility of society as a whole, in Malta the terms "weak" and "need" are defined very liberally. In so doing, we overlook the fact that generous welfare depends on two details of demography and politics: that there are enough people of working age to fund the claims of those defined as being weak and in need; and that working people are indeed willing to pay the necessary taxes. If these conditions are not met, there can be no other solution but to redesign the welfare system according to the funds available.

Globalisation and Increased International Competition

Such considerations lead us to another major challenge, that of globalisation and increased international competition. Malta is particularly susceptible because it has a very open economy. Developments in the international market place are indeed likely to become even more relevant because the process of globalisation continues unabated. Facilitated by the progressive dismantling of trade barriers, this process has been characterised by a rapid growth in factor mobility and cross-border investment, and has given rise to harsh competition based on innovation, dynamism, improved quality and low cost. It has also become easier for new entrants to gain access to global markets, including the countries of Central and Eastern Europe, many of which are now our competitors.

Globalisation has, therefore, brought more uncertainty because there will be winners and losers. Although the process probably involves more than simply a zero-sum game, it is also true that countries which adapt to the new competitive conditions more rapidly will grow at the expense of those which are slower to react. This is a crucial consideration for Malta, which is a very small player in the global market place, and therefore a price taker, but which depends heavily on exports to maintain the living standards of its people.

While there are many enterprises in Malta which are rising effectively to this challenge, the cost pressures associated with the macroeconomic imbalances and the inefficient practices described earlier are proving to be too much of a burden for some others. As a result, they are finding our country no longer profitable to operate in, especially when compared to locations in Eastern Europe, North Africa and Asia. For them, as the recent painful examples of plant closures have shown, Malta fails to offer the right combination of productivity, skills, innovative ability and cost to justify their investment.

There are other early warning signals. The economy's 0.2% average real growth rate over the past two years is the lowest of all the acceding countries. It is also low compared to that of the existing EU member States. The experience of those two years may well have been exceptional, but it nevertheless serves to remind us that the economy needs to grow consistently much faster if Malta is to catch up with average EU per capita income levels within a reasonable period of time.

I strongly believe that the factors making for high costs and weak growth rates should be addressed as a priority. As I have observed on other occasions, strategies to improve competitiveness in a globalising world can be devised. Other countries have shown the way. What is needed is the political will and the effective collaboration of all the parties concerned.

Population Ageing

Perhaps there exists no clearer example to illustrate the kind of challenge the country faces than the issue of population ageing. The impact of a rapidly ageing population in the context of a generous welfare system is inevitably a dramatic rise in spending on pensions and health care. Expenditure on welfare, including on health, is already absorbing close to one-fifth of the economy's annual income, or about Lm300 million, and almost two-fifths of government revenue. Retirement pensions alone account for more than one-fourth of this, and are the cost item which is likely to register the strongest growth in the years ahead. Over the next twenty-five years it is expected that the number of workers supporting one pensioner will drop from the present 4 to just over 2, partly reflecting the fact that the proportion of pensionable age persons in the population will rise from 16.7% today to over 28%.

An ageing society will also further aggravate existing national saving and investment trends. The impact on private consumption and savings patterns is a result of the 'life cycle hypothesis', which holds that a rise in the proportion of the elderly in the population tends to be accompanied by a decline in national savings.

Indeed, the effect of population ageing on public finances is nothing but a reflection of a wider economic problem involving a reduced productive capacity. Reforms to pre-empt this impact must, therefore, be implemented without delay. Here again, Malta need not re-invent the wheel. The World Bank model involving funded pension schemes is being applied successfully in many countries. Equally interesting is the Open Method of Co-ordination of Pension Reform operated by the European Commission with the aim of promoting sustainability of pension systems across the EU without imposing uniformity. This method places a strong emphasis on social acceptability coupled with supply-side reforms designed to ensure that the pension system is sustainable.

A society like ours that is devoting more resources to welfare payments than it can afford, is saving and investing too little and is spending more than it is earning - while financing these excesses with borrowed money - stands in blatant contradiction with its professed commitment to social justice, because it is bequeathing to its children an inheritance of debt in selfish rejection of the principle of inter-generational equity. This prospect is clearly unacceptable. It is time for all to recognise this and to shoulder what has become a moral responsibility.

Environmental Degradation

It is in a similar spirit that I approach another important challenge, namely that of environmental degradation. There is no question that a significant part of our economic achievements in recent years have been attained at the cost of the environment. It is doubtful whether this constitutes real progress, as it is eroding the welfare of current and future generations and depleting the productive potential of an economy that is highly dependent on quality tourism.

From a more practical economic viewpoint, environmental sustainability, involving the conservation of existing amenities and resources for an indefinite time period, will entail significant resource outlays. This is in addition to the resources necessary to finance the investment needed to face the competitive pressures of globalisation and to meet the costs of population ageing. This requires us to produce more, and more intelligently, and to devote a larger share of the nation's resources to fund the investments which are vital for its continued economic development.

Policy Dimensions

I have often stressed that the solution to such problems lies in the implementation of a coherent reform strategy that enjoys as wide a measure of support as possible. Today I would like to dwell on two considerations arising directly out of EU membership, which should in themselves help to promote progress in this direction. These are Malta's expected contribution to the realisation of the Lisbon Agenda and its participation in the Economic and Monetary Union (EMU).

Malta and the Lisbon Agenda

The central objective of the Lisbon Agenda is to address supply-side impediments to growth. The Agenda states:

"The Union has today set itself a new strategic goal for the next decade: to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion"

As from May next year, Malta will automatically be part of a process which presents opportunities for improving supply capabilities through focused policies and for which specific funding is available. It, however, also involves a greater degree of competition, and thus constitutes a driving force for countries to move ahead rapidly with the required structural reforms.

The Lisbon Agenda establishes numerous competitiveness indicators, as well as a set of targets to be achieved by 2010. I do not intend to dwell on these here. The Federation of Industry recently held a national seminar on this very issue and I am sure that these indicators and targets will continue to attract the necessary attention, not least within the Malta Council for Economic and Social Development (MCESD).

Allow me, however, to make a few observations about how Malta is performing in this regard. I shall do so by comparison with the international best practice benchmarks upon which most of the Lisbon Agenda criteria were built. So how does Malta fare, especially when compared to the peer group of the new EU member States?

Based on data relating mainly to 2002, Malta's GDP grew by 1.5% compared to 2.5% in the other new member States. And this is not simply because less advanced economies than Malta's need to grow faster in order to catch up. Indeed, the two acceding countries which are richer than Malta, namely Cyprus and Slovenia, grew by 2.0% and 2.9%, respectively.

Turning now to possible reasons for Malta's slower growth rate, a first observation is that our unit labour costs are relatively high. On average, other new member States have labour productivity and price levels which hover around 50% of the current EU average. In Malta labour productivity is relatively higher, at 70% of the EU average, but the price level is higher still at almost 90%. This suggests that Malta needs to increase its productivity to match its price level.

A second measure relates to public finances. On average, the other new member States have fiscal positions ranging from close to balance to deficits of around 7% of GDP. Malta's deficit is close to the latter figure and thus acts as a drag on the productive use of resources, and hence also on economic growth.

Other new member States on average spend 0.8% of their GDP on innovation, research and development. This compares with almost 2% for the present EU members and with a target of 3% to be achieved by 2010. The comparable figure for Malta is not yet known, but preliminary indications suggest that the research and development expenditure undertaken here is even lower than the average for the other new members. And Malta is only now preparing to adopt a specific innovation policy as part of its programme of economic reform.

Business investment in the other new member States amounts to almost 20% of GDP. The comparable figure for Malta is not available, but it is known that the combined public and private investment to GDP ratio in 2002 was 21%. This suggests that the ratio of business investment to GDP in Malta is significantly lower than that in other countries.

On the other hand, Malta compares relatively well in terms of its educational expenditure which, at almost 5% of GDP, is equivalent to that in other new members and indeed in the EU member countries. Malta also compares favourably on social cohesion, with income dispersions being comparable to those in other acceding countries and with the long-term unemployment rate being significantly lower.

In summary, it appears that Malta has costs which do not reflect productivity levels and a highly expansionary fiscal stance. There is also a need for more spending on innovation activities and business investment. For while our economic system is successful in delivering social cohesion and stability, these factors cannot alone sustain the economy's growth rate at sufficiently high levels. This suggests a need to question existing priorities and to re-direct policies to activities which can support higher income levels in future.

Malta and EMU

Malta's participation in EMU will eventually lead to the adoption of the euro, a step which holds out the prospect of significant benefits. Perhaps the foremost of these is that Malta would share in the strength and credibility of a single, Europe-wide monetary policy. This would not only mean reduced exchange rate risks and less uncertainty for economic agents in Malta and for their foreign business partners, but also the elimination of the risk premium on the Maltese lira. The reduction in interest rates consequent upon the introduction of the euro would be of direct benefit in terms of price competitiveness, as would also be the reduction in currency conversion costs and the increased price transparency.

On the other hand, if a country is to benefit fully from adopting the single currency, then its economic structures must be compatible with those of the countries that are already using that currency. It is for this reason that the EU Treaty sets a series of eligibility tests, known as the Maastricht criteria. These include convergence of inflation and interest rates, sustainable fiscal positions and exchange rate stability.

The exchange rate criterion requires participation in ERM II for a minimum period of two years prior to the adoption of the euro. This is an arrangement whereby the European Central Bank (ECB) and participating national central banks would not allow any currency to fluctuate beyond a given margin from its central euro rate. This margin at present can be as wide as 15%, but significantly narrower margins are being contemplated, with an often-cited reference value of 2.25%. Thus, participation in ERM II does not necessarily imply increased currency volatility. Indeed the rationale of this mechanism is to test the stability of a currency. As you know, the Maltese lira is pegged to a weighted average of three currencies, whose individual exchange rates against the lira can vary. In this regard, it is noteworthy that the fluctuations in the Maltese lira/euro rate over the past few years on average have not exceeded 3.5%.

As for the inflation and interest rate criteria, Malta is well within the reference values. The fiscal deficit, on the other hand, represents a significant hurdle as it is currently about double the 3% of GDP limit. Related to the deficit is the size of the public debt, which exceeds the 60% threshold.

The main determining factor in the timing of the adoption of the euro, therefore, is the speed with which fiscal consolidation can be achieved, bearing in mind that the euro area will not technically be in a position to accept newcomers before 2007.

If the Government embarks on the relatively fast track of fiscal consolidation implied by Malta's Pre-Accession Economic Programme, we would need to enter ERM II in 2005. Should this track be chosen, however, it would be vital that the planned pace of consolidation be maintained. In this way the benefits of an early adoption of the euro would be reaped, and the lira's stay in ERM II would be smooth, with no noticeable shocks in the transition from the current basket system to the single currency.

If, on the other hand, there are slippages in the rate of fiscal consolidation, the stay in ERM II would have to be prolonged and the adoption of the euro postponed. This would attract negative attention from the international financial markets, resulting in a reduced credibility of our economic policy and in pressures on the exchange rate and the interest rate. The country would then probably also face difficulties in meeting the other Maastricht convergence criteria, further complicating the task of economic management.

If the risk of this happening is considered unacceptably large, a slower pace of fiscal consolidation, entailing a smaller risk of slippage, could be chosen. The late adoption of the euro would, however, imply that the enjoyment of the relative benefits would be postponed, and that the country could lose competitiveness if other new member States successfully adopt the euro at an earlier date.

In summary, the best case scenario is the one where a relatively fast pace of fiscal consolidation is both planned and achieved. The worst case scenario is the one where fiscal policy fails to deliver on a planned fast process of consolidation. The scenario featuring a slower pace of consolidation can be described as intermediate in terms of its degree of preference. However, this could turn into a worst case scenario if fiscal policy fails to deliver even on a planned slower consolidation process.

It is for these reasons that medium-term fiscal planning should be adopted, detailing concrete objectives and measures to be implemented over a number of years. It is equally important that such a programme enjoy the support of the social partners. The consensus-building approach being followed in the MCESD is a welcome, positive development in this regard, one that could facilitate an early adoption of the euro.

Conclusion

Throughout a long and, at times, turbulent history, our people have faced repeated threats to their livelihood, but our forefathers always rose to the challenge. In a commendable demonstration of courage, solidarity and vision they were able to put aside narrow political and sectoral interests and unite in the pursuit of the common good. Indeed, if we are here today, in control of our destiny as a free and independent people, it is because they found the inner strength to put country first. In recognition, we justly recall their achievements with pride.

The challenge we face today is no less serious than any the country has had to deal with in the past. If this generation of policy makers and policy shapers wishes to earn a similarly favourable judgement of history, they must have the courage of their convictions and lead from the front. It must be understood that we are all in the same boat. Tackling our common problems means that we must fight together against inertia and embrace change in the pursuit of progress. For this alone is the key to job creation and higher living standards.

In this context I would like to conclude by making my own the message which the recently retired President of the ECB, Wim Duisenberg, gave to ECOFIN Ministers at a farewell dinner they organised for him last month in Venice. Speaking of the reform objectives contained in the Lisbon strategy, he said:

"There has been some progress. I do not need to tell you that there is still a lot to be done. You have said so yourselves many times. These good words must be transformed into actions, and soon, because time is running out. It is no good having the right diagnosis if you don't apply the medicine and cure the disease."