Michael C Bonello: Policy challenges beyond the euro

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, 17 November 2006.

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I should first of all like to thank you, Mr President, and your Council for the opportunity to share my thoughts once again with such a distinguished audience. Before I do so, however, I would like to commend the Institute of Financial Services (IFS) for its admirable capacity to reinvent itself in response to the changing demands of the marketplace. This year, for example, the Institute has renamed itself as the IFS School of Finance. I have discovered that this apparently cosmetic change has a very significant meaning, in that the Institute in the UK is now empowered to award degrees. IFS Malta, on its part, has extended its reach beyond our shores and is cooperating with the Romanian Banking Institute in the delivery of one of its academic programmes in that soon-to-be EU member country. I am sure all your other guests will join me in wishing you and your Council every success in your continuing efforts to promote higher professional standards in the financial sector.

Since Malta joined the EU in 2004, and particularly since the Maltese lira entered ERM II last year, the Central Bank of Malta has been making the case for an early adoption of the euro. That goal now seems to be within reach, thanks in no small way to the Government's steadfast commitment to fiscal consolidation. The achievement of a political consensus on the euro is also a welcome development. The main remaining challenge is to meet the inflation criterion.

Tonight I shall argue that the euro is a necessary, but not a sufficient condition for faster growth. More specifically, unless we establish limits on how much we consume and, within limits set by the economy's earning capacity, allocate a greater proportion of the national income to investment, the advantages of euro area membership cannot be fully realized. It is time for the country to disown an unfortunate legacy of its colonial past that is best reflected in the notion that it is possible to spend more without first producing more. To this day, political discourse contains frequent references to tax reductions and subsidies, when it should be rallying popular support for the need to strengthen the country's capacity to generate wealth on a sustainable basis.

The benefits of euro area membership

As I have said, the adoption of the euro should enhance the economy's potential to grow faster. The elimination of exchange rate risk and currency conversion costs should result in increased trade, while the lower interest rate and inflation environment of the euro area should make for reduced business costs and greater macroeconomic stability. Combined with the fiscal discipline associated with monetary union, this is expected to translate into higher credit ratings and better investment prospects.

From a central banker's viewpoint, moreover, a key benefit of euro area membership will be the elimination of the costs inherent in managing a small, vulnerable currency like the Maltese lira and their replacement by the greater security and credibility afforded by a strong international currency.

Euro adoption necessary but not sufficient

Viewed from this perspective, therefore, the euro is but one element in a continuum of changes necessary to enhance the international competitiveness of the Maltese economy. The benefits of the single currency will not suffice, especially in the presence of downside risks to global growth such as higher oil prices, a potentially disorderly unwinding of current account imbalances and the rise of protectionism. Although the ongoing preoccupation with the level of the external reserves will cease once we join the euro area, moreover, any imbalance between what we buy and sell abroad will continue to cause the depletion of assets or the accumulation of liabilities, and be reflected in the country's international investment position. Any loss of competitiveness, therefore, will still result in slower growth.

Raising productivity a key challenge

In setting out to overcome this challenge, a primary objective should be the correction of existing macroeconomic imbalances. Output growth must, therefore, match spending growth more closely, and a key element in bridging that gap is increased productivity.

Put differently, since we are price takers in the markets that matter, notably those for electronics and tourism, we must have a cost structure that does not discourage investment. Domestic inputs, particularly labour, must be competitively priced. And since the cost of labour in Malta is relatively high, we must increase the value of output per employee. Once again, the only way forward is through productivity growth.

In this regard, there is much room for improvement. The level of productivity has remained roughly unchanged since 2001, while it is projected to increase at an annual rate of only 1% to 2% in 2007 and 2008. For a country that is highly dependent on exports, this is not good enough when many of our competitors are achieving faster productivity growth.

Faced with this situation, we would do well to reflect on the experience of others. In France, a recent McKinsey report showed how industrial productivity gains slowed sharply in the last five years, causing the country to miss the opportunity to create an estimated 700,000 jobs. As for the reasons, a report by the Camdessus expert group in 2005 identified two major obstacles to growth: first, not enough people work, and those who do work, do not work long enough, due in part to the introduction of a 35-hour working week; second, the heavy State has become a costly drag on the economy.

Malta faces a similar predicament for much the same reasons. For example, the labour participation rate is still low at 58% compared with an EU average of 70%; and the Maltese will have worked seven fewer days this year than the Dutch, who work longest, and three days fewer than the EU average, despite the abolition of the practice of compensation for a holiday that falls on the weekend. Since independence, moreover, successive governments have bequeathed a legacy of welfare schemes and free public services that have not only distorted incentives and encouraged waste and abuse, but are also largely unsustainable. It is no wonder, therefore, that the Government absorbs almost half of the GDP, the tenth highest percentage in the EU. The concept of value for money, moreover, does not always prevail in public sector procurement[1].

Let me mention just two examples of resource misallocation. The first is the absence of fees for government-supplied health care. One can, for example, obtain expensive medicines or have a heart by-pass operation for free, regardless of one’s capacity to pay. Not surprisingly, the budgetary allocation for medicines and surgical materials alone is forecast to increase by 13% next year to Lm21.5 million. The sustainability of the public health system is imperiled by the very manner in which it is financed. Sooner or later, the ability to provide free services to those who truly deserve them will itself come under threat. In this context, the parallel commitments of the major political parties to the continued provision of free health services for all and to prudent fiscal policies are not easy to reconcile.

Much the same can be said of higher education, which is characterized by a student subsidy system that is probably unique. The University of Malta and MCAST have together been allocated Lm15.5 million for 2007, compared with no less than Lm8 million budgeted for students’ maintenance grants. Funds that would permit these institutions to offer better quality programmes, and in the process hopefully raise the number of science and technology graduates from its current inadequate level, are instead paid to students regardless of their financial means.

Changes needed in the pattern of resource allocation

This generous approach to the management of public finances has meant that recurrent revenue, although higher year after year, has often not been able to keep up with recurrent expenditure. For example, in 2005 expenditure amounted to 41% of GDP, roughly matching revenue at 42%. As a

[1] A recent paper on public sector efficiency in the new EU Member States gives Malta a relatively high score in terms of public sector performance that measures outcomes. However, when performance is related to the inputs used to gauge the efficiency of the State, Malta ranks 21st in a pool of 24 countries including all 10 new Member States, Greece, Portugal, Ireland and a number of emerging market economies. Antonio Afonso, Ludger Schuknecht and Vito Tanzi, *Public Sector Efficiency: Evidence for New EU Member Sates and Emerging Markets*. ECB Working Paper No 581 (2006).

result, the 6% of GDP allocated to capital spending had to be funded almost entirely by additional borrowing, which gives rise to further debt-servicing costs. Repeated year after year, this pattern pushed the debt/GDP ratio steadily upwards to a peak of 75% in 2004.

This tendency for recurrent revenue to be matched by recurrent expenditure in the context of fiscal retrenchment has had a crowding-out effect on investment, and partly explains why the country's investment/GDP ratio has been static at best in recent years. A more telling indicator of the relatively small investment in productivity-enhancing activities is the share of GDP devoted to R&D, 0.6% in 2004, compared with an average EU ratio of about 2%.

It is doubtful whether the existing pattern of resource allocation is conducive to the desired improvement in Malta's international competitiveness. The latter can only be achieved by increasing the size, flexibility and skill level of the labour force, while simultaneously creating an institutional and physical infrastructure more likely to attract high value-added foreign direct investment. And since the State must play a leading role in this effort, the question of financing arises spontaneously.

Now in the context of a fiscal consolidation process that has not yet run its full course, increasing recurrent spending beyond the natural creep caused by existing commitments such as pensions is clearly not an option. Such spending is already equivalent to 47% of GDP. The same applies to taxation, which stands at 36% of GDP. The only way forward is to pursue the medium-term objective of a balanced budget over the business cycle by reducing recurrent expenditure, by redistributing the resources available and by making the most efficient use possible of both domestic and EU funds.

An additional advantage of lower spending commitments is that this would make further tax cuts possible that would, in turn, stimulate private initiative and investment.

The course of action I am suggesting, therefore, would bring the country's spending priorities more closely into line with its Lisbon Strategy goals. If Malta is to move up the value chain, it must acknowledge global realities. It is clear, for example, that there are increasing rewards from innovation; and that ICT has become a major driver of economic growth. A growing proportion of world manufactured products, moreover, are in the high-tech category, 28% in 2000, double the percentage twenty years earlier; and knowledge intensive services are the largest source of employment growth in the EU15, with over 7 million new jobs created between 1997 and 2002[2]. These trends should leave us in no doubt as to the direction in which the wind is blowing.

Financing the necessary investment

So where is the money to be found to promote improved higher education and ICT-related skills, entrepreneurship and innovation, or to be able to offer foreign investors custom-built premises at relatively short notice and of the standard they have come to expect, when almost 80% of recurrent Government expenditure goes on transfer payments and wages? As for the remainder, there is no room for discretionary cuts either: almost 9% represent interest payments on the public debt, and the balance is spent on essential supplies. Since EU funds alone will not be sufficient, the solution must encompass a further contraction of the public sector and a rethinking of the philosophy behind social spending programmes and other transfer payments.

Compensation of public sector employees has been stable at 36% of recurrent expenditure. As a proportion of GDP, it peaked at just over 15% in 2004 and is projected to decline to 13% in 2008, reflecting moderate wage increases and a declining workforce. It is important that these trends continue.

As for transfer payments, these account for some 40% of total recurrent expenditure. Social spending alone absorbs a third of the total. Growth in this area over time has been driven by the perceived need to preserve the social fabric and by demographic pressures. In the process, however, sight has been lost of the original objective. We have to ask whether today's blanket approach to welfare, higher education and health is promoting a culture of reliance on the State rather than the encouragement of private initiative. Our system does not focus exclusively on those who are truly in need, but also provides a cushion for higher income earners, at the cost, however, of a heavier fiscal burden.

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[2] Swedish Ministry of Finance and H. M. Treasury *Social Bridges: Meeting the Challenges of Globalisation*, London and Stockholm, April 2006.

Social programmes must be sustainable

The time has, therefore, come for a radical reform that reconciles the objective of social cohesion with financial sustainability. Non-essential transfer payments should be reduced, especially those that are of a universal nature and do not address a proven need. The introduction of means testing must be seriously considered, accompanied by continued efforts to reduce tax evasion. The criteria for the granting of certain benefits should be tightened further. The underlying objective should be to promote a culture of self-help and efficiency.

In the field of higher education, for example, since an academic qualification enhances the student's income-earning potential, I believe a strong case can be made for at least the partial replacement of grants with loans for students from a better-off financial background, with a repayment schedule that provides for moratoria to suit the post-graduation realities of the particular student. What the typical student expects from higher education in terms of quality will increase once he or she is contributing to its financing, and higher expectations are known to be one of the drivers of an improvement in standards.

Anyone who perceives something sinister in these proposals might look up a recent study by economist Andre Sapir. Using a fairly well-established typology, Sapir grouped the EU15 into four main social models, the Continentals, Nordics, Mediterraneans and the Anglo-Saxons, and then estimated the efficiency and equity of each. He shows that there does not need to be a trade-off between efficiency and equity. Just as importantly, however, he underlines that efficiency is always necessary for sustainability[3].

How do other countries approach this challenge? The experience of Singapore, which is twice as well off as Malta on a per capita GDP basis, is instructive. There, undergraduate education is heavily subsidized by the government, but the remaining cost is borne by the student. The student's annual contribution ranges from the equivalent of Lm1,300 for an engineering degree to Lm3,800 for a medical degree.

There are, however, means for the student to finance this co-payment through borrowing from the Central Provident Fund. This is a social security savings plan funded by contributions from employers and employees, and which go into three accounts. Let me mention two of them. One is the Ordinary Account, which can be drawn upon to pay for the family's educational expenses, or to buy a house. Another account, the Medisave Account, can be used for hospital and other medical expenses, or to participate in the MediShield insurance programme. Under this scheme the patient pays a deductible amount and is required to make a co-payment. The system encourages efficiency, because medical practitioners and hospitals must compete for patients.

Other areas susceptible to reform

As these examples show, it only takes some imagination and a clear sense of purpose to devise mechanisms that promote a more efficient use of resources. But it is not just in the areas of welfare, higher education and health that a policy review is needed. Take transportation, for example. Restrictive practices at the harbour raise costs by pushing up the price of imports and lower our competitiveness by increasing the cost of exports. It is rather ironic that decades after the abolition of hereditary titles, and at a time when the merits of free markets and competition are widely acknowledged, Malta sanctions the inheritance of licences and protects monopolies not only in the harbour, but throughout the public transport system.

More generally, if investment is to be channelled to productive activities that generate the highest return, profit signals should not be distorted by monopolistic market structures, subsidies or protection.

The need for a consensual approach to reforms

Mr President, I am aware that the thrust of my remarks challenges the continued existence of what have come to be perceived as acquired rights. They might have been acquired, but they are often

[3] Sapir, A. "Globalisation and the reform of social models". Background document for a presentation at ECOFIN Informal Meeting in Manchester, 9 September 2005.

neither economically viable nor affordable. Trying to persuade public opinion to come to terms with such economic realities is, however, a central bank governor's responsibility. My concern is not without foundation, for the challenge to the sustainability of our current ways comes with a precise timeline. It is likely that Malta's eligibility for EU structural funds will decline after 2013, and the burden of an ageing population in terms of health and pension expenditures will be much heavier than it is today. It will, therefore, be imperative to have invested massively and wisely in the meantime such that the economy will be generating sufficient wealth and, therefore, tax revenues to bridge any budgetary shortfall.

My conclusions are supported by both theory and experience. In the neo-classical growth model the rates of saving and investment are the fundamental determinants of living standards in the long run. In other words, countries that save or invest more than others will enjoy a higher per capita income. Newer growth theories go beyond this and distinguish between two types of capital, physical and human. Empirical evidence clearly shows that differences in living standards across countries can be explained by differences in investment in human capital. Unfortunately, advice on the importance of saving and investment often goes unheeded because higher saving entails lower consumption. In other words, prosperity tomorrow can only be achieved by making sacrifices today.

Even if this lesson is not fully taken on board, the need for continued fiscal prudence will ensure that choices between alternative uses of public funds will have to be made more frequently, and spending cuts made in sensitive areas. Such decisions would be taken much faster and more effectively if a bipartisan approach were adopted. Other countries in Europe have taken this road, but there are precedents in Malta too. The financial services legislation, for example, was adopted unanimously by Parliament. The impressive growth of the financial sector indeed testifies to what a bipartisan approach to strategic economic choices can achieve. The national consensus on the adoption of the euro is another example. It would greatly strengthen the economy's capacity to benefit from membership of the euro area if this consensus were extended to a recognition of the need to increase the share of government revenue devoted to investment in the country's future.

Mr President, I make no claim to originality in voicing these concerns. In a recent letter to a local newspaper, a Mr V. Spiteri wrote,

"Vague promises and assurances that if we vote for one side instead of the other we can retain free medical care, retire at 61, afford to eat out more often, take at least one holiday abroad and drive a new car, is a dream we would do well to wake up from".

How very true! Higher living standards cannot be created by politicians out of thin air. As one of my predecessors, Mr Lino Spiteri, wrote recently,

"They don't make magic wands that work any more."

In the real world, a key precondition for prosperity is higher productivity. It should, therefore, be our common task, but particularly that of the political class, to promote policies and practices that are conducive to a more efficient use of the nation's scarce resources.