

## Michael C Bonello: The euro and beyond

Welcome address by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the Conference "EMU Governance and Euro Changeover – Malta on the Path to the Euro", Valletta, 1 October 2007.

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Prime Minister, President of the European Central Bank, Mr. Jean-Claude Trichet, Commissioner for Economic and Monetary Affairs, Mr. Joaquin Almunia, Excellencies, Distinguished Guests, Ladies and Gentlemen,

Malta's forthcoming adoption of the euro represents the final step in the country's integration in the European Union (EU) and is clearly a major milestone in its economic history. The presence here today of such a distinguished gathering indeed testifies to the importance of the occasion. I therefore would like to start by joining the Prime Minister in extending a warm welcome to President Trichet, Commissioner Almunia and our other guests from abroad, including the Governors and other senior officials of twenty-two national central bank members of the European System of Central Banks.

Reaching this milestone has by no means been an easy task. At the level of macroeconomic policy, difficult decisions were called for, and taken, to start addressing existing imbalances and other impediments to growth in order to satisfy the Maastricht criteria. As for the logistics involved in preparing for the change of currency, a wide-ranging effort has been undertaken during the past two years to mobilise both the public and private sectors and to coordinate preparations at a national level. It is, therefore, appropriate on this occasion to acknowledge the valuable work carried out by the National Euro Changeover Committee and its Steering Committee. I would also like to pay tribute to the staff of the Central Bank of Malta for their contribution in preparing the Bank for its role as a member of the Eurosystem and in planning and executing the currency changeover.

During more than two millennia the Maltese people have used many different currencies in circumstances often dictated by the changing balance of power in the Mediterranean, and reflective of Malta's status as a dependency of some larger and more powerful nation. The adoption of the euro, however, is a change of currency with a difference. This time it will occur because Malta, out of its own choice, will join fourteen other sovereign Member States of the EU in an economic and monetary union designed to complement the Single European Market, a venture that could rightly be described as an epoch-making development in the history of our continent.

Since Malta joined the EU in 2004, and particularly since the Maltese lira entered ERM II in 2005, the Central Bank of Malta has been making the case for an early adoption of the euro. And for good reason. For a start, the economy was clearly well suited to participate in Economic and Monetary Union (EMU): it has a long history as a market economy; it is already closely integrated with the euro area through trade and finance; it has close similarities with the euro area in the sectoral composition of output and employment as well as in terms of business cycle synchronisation; it enjoys a relatively high level of development, with a per capita GDP close to the euro area average; and its currency has a long history of stability.

The euro, furthermore, offered the prospect of enhancing the economy's potential to grow faster. The elimination of exchange rate risk and currency conversion costs should result in increased trade, while the low 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 improved investment prospects. From a central banker's perspective, moreover, a key benefit of euro area membership will be the elimination of the risks inherent

in managing a small, vulnerable currency and their replacement by the greater security afforded by the world's second most important currency.

Finally, the object of our quest, that is participation in EMU, was desirable for another reason. We were aware that we would thus become part of a framework that has been successful in fostering economic growth and employment creation. Much of the credit for this belongs to the European Central Bank (ECB), whose steadfast commitment to price stability has created an environment conducive to investment, reflected in the fact that interest rates are low across the yield curve. The ECB's credibility in fighting inflation is now so well established, moreover, that long-term inflation expectations are well anchored at around 2%. Price stability clearly yields important welfare benefits.

So there are both advantages and opportunities for policy makers and economic agents in the euro area. But in setting out on this new phase of Malta's economic development, we must be aware that, while the ECB can, and indeed has, delivered low and stable inflation, it cannot use the interest rate to permanently increase growth. From Malta's perspective, therefore, the adoption of the euro must be viewed as but one in a continuum of challenges to be faced. The purpose of this conference is precisely to focus attention on the policy choices that need to be made in the years ahead.

Put simply, the task that Malta faces is to bridge the remaining income gap with the more advanced members of the euro area. The success of this endeavour will depend importantly on how effectively the public and private sectors work together, both in assimilating the lessons learned during these first years of EU membership and in implementing appropriate policies. In this regard it is helpful that in a monetary union the parameters within which action can be taken are defined in the sense that the interest rate and the exchange rate instruments are not available to governments, and fiscal policy can only be used for adjustment purposes within the limits set by the Stability and Growth Pact. Given the limited room for manoeuvre, therefore, any adjustments necessary in order for the Maltese economy to achieve the growth rates that will ensure a more rapid pace of convergence and to respond successfully to asymmetric shocks will have to take place in the real economy. And since in a resource-poor and open economy like Malta's, growth must be predominantly export-led, the focus of policy must be on increasing the country's international competitiveness.

The starting position for addressing this challenge is relatively favourable. In the words of the Commission's Convergence Report, Malta has achieved a high degree of sustainable convergence; and more recently, the IMF Article IV Mission Report concluded that The economic recovery is gaining traction, owing largely to cyclical strength and some structural change. The economy has indeed been growing at more than 3% for almost three years and broad-based reforms have helped to mitigate structural impediments in a number of areas. After the upgrading of the physical infrastructure during the past two decades, recent reforms have included the restructuring of the public and public-enterprise sectors, a wide-ranging privatization programme, port reform and the first stage of a pension reform, and the full liberalisation of the trade and capital accounts. As a result, the public sector's profile in both product and resource markets has been reduced, and the price mechanism now has an increased role in the allocation of resources. At the same time, and this is arguably the most impressive development, the fiscal deficit has been reduced to a quarter of its size in 2003.

Looking beyond the introduction of the euro, therefore, the task is to maximize the benefits of participation in monetary union by making further progress on the path of reform. The National Reform Programme provides a good basis for this purpose, as do the recent reports by the Commission, the ECB and the IMF. A common conclusion of these reports, and one which is shared by the Central Bank of Malta, is that further fiscal consolidation is necessary in order to achieve a balanced budget by the set date. In this regard, there needs to be a greater emphasis on expenditure-based adjustment, particularly in view of rising pressures caused by ageing-related factors such as pension and health care costs. It will be equally

important, in both the private and public sectors, for wage growth to be compatible with productivity growth, labour market conditions and cost developments in competitor countries. The further strengthening of competition in both product and resource markets and the creation of more incentives to work are also necessary in order to raise the participation rate.

It also needs to be realized that these reforms are essential for safeguarding our social model. In recent decades we have been successful in reducing income inequality and in securing universal access to all levels of education, to health care and to pensions. These benefits, however, can only continue to be enjoyed by future generations if today's generation implements the necessary reforms.

The next phase in Malta's economic history, therefore, promises to be a challenging one, but it should also be an exciting time. For a country with a population of 400,000 and a GDP of just four-and-a-half billion euro, having a major reserve unit as its domestic currency is indeed a significant advantage. We thus have good reason to feel encouraged and, as a people that has suffered repeatedly as a consequence of divisions on the European mainland, also reassured that we are about to reinforce our integration in Europe with full economic and monetary union. For, while the EU has for fifty years brought peace and stability to the peoples of Europe, the Single Market and Economic and Monetary Union have created a congenial environment in which economies can grow and people prosper.