Michael C Bonello: Malta's journey to the euro and beyond

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the European Economics and Financial Centre, London, 1 February 2008.

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A month has passed since the euro became Malta's new currency. Euro area membership is a major milestone for any country for there are clearly long-term benefits associated with participation in the world's second most important currency area. There is indeed much evidence that the macroeconomic framework which supports the euro has delivered price stability, job creation and economic growth.

For a small, open economy like Malta's with a heightened vulnerability to external and sector specific shocks, the benefits of the single currency can be expected to be even more valuable. From a central banker's perspective, moreover, euro area membership means replacing the manifold risks inherent in managing a small, vulnerable currency such as the Maltese lira by the greater security afforded of major reserve unit.

Where have we come from?

Although the Maltese economy had responded fairly well to the closure of the British military base in1979, it still suffered from considerable structural weaknesses when the authorities applied for EU membership in 1990. These were reflected in the dominant role of the public sector – which at the time provided 40% of all jobs – and in the extensive use of protective trade barriers that only served to entrench inefficient and uncompetitive practices. The extent of these deficiencies was such that in its first opinion on Malta, the European Commission called for *'a root-and-branch overhaul of the entire regulatory and operational framework of the Maltese economy'*[1].

Although the situation had improved somewhat by the time Malta's EU application was reactivated in1998, the economy was still not fully equipped to withstand the competitive pressures unleashed by globalization. While reforms were underway, they were not sufficiently ambitious. For example, while the re-introduction of VAT in 1999 was meant to broaden the tax base and reduce the extent of unrecorded activity, the list of exempt or zero-rated items was far longer than that of the other Member States. The role of different authorities having competence in the field of competition remained ambiguously defined, and in many sectors an insufficient distinction was made between the regulator and the service provider. The public sector was not only overmanned, but outdated practices and manual procedures were still pervasive.

These weaknesses became fully exposed around the turn of the century when the removal of trade restrictions and other protective measures gained momentum in anticipation of EU membership. This process, moreover, coincided with two external shocks that adversely affected two vitally important industries, electronic components and tourism. The former was hit by the sharp decline in demand as result of the global downturn in the high-tech sector, the latter by the increased travel aversion in response to the 9/11 terrorist attacks. The impact was of such magnitude that export receipts in these two industries, which together

[1] European Commission. 1993. *The Challenge of Enlargement – Opinion on Malta's Application for membership*, document drawn up on the basis of COM (93) 312 final. Bulletin of the European Communities, Supplement 4/93, p. 13.

had accounted for 60% of total exports, dropped by more than 26% between 2000 and 2002.[2]

The triggers

This cyclical setback was compounded by the economic restructuring induced by globalization and was soon reflected in a rising unemployment rate and large and growing fiscal and current account deficits. On the eve of EU membership, therefore, the authorities were faced with a choice between two strategies. They could either use the fact that Malta had a large fiscal imbalance to maintain the status quo or, at most, adopt a gradualist approach to fiscal consolidation, with the aim of minimising social disruption. This would have implied a delay in implementing much needed measures, with a consequent risk of slippage in the Government's commitment to reform that would have further undermined growth prospects. Worse still, this option carried the possibility of more painful adjustment at a later stage.

The alternative option was to highlight the urgent need for adjustments in the real economy given the vulnerability of the exchange rate peg in the context of capital account liberalization, while taking advantage of the fact that Malta was already closely integrated with the EU through trade and finance, and thus well suited to join the euro area at an early date.

The policy response

The authorities chose the second approach and launched an ambitious programme of fiscal consolidation and a comprehensive package of structural reforms. In the public sector, loss-making firms were liquidated, while others were privatised. Public finances were placed on a sounder footing through different measures, ranging from an increase in the VAT rate and the setting up of specialised units to investigate benefit fraud and tax evasion, to a revision of salary structures and a policy of natural attrition in the public service. The first stage of a pension reform has been implemented and cost-based pricing of public services introduced on a wider scale.

Meanwhile, initiatives have been taken in the context of the Lisbon Agenda, including public-private partnerships, a port reform and a liberalisation programme covering telecommunications and utilities. Vocational education institutions have been set up, school curricula substantially revised, a postgraduate bursary scheme introduced and mechanisms fostering synergy between educational institutions and the private sector put in place in order to meet the changing skill requirements of industry.

To encourage greater labour market participation, the disbursement of unemployment benefits was made conditional on the taking up of appropriate training, and fiscal incentives were introduced aimed at encouraging the return of women workers to the labour market and the employment of those over 40 years old.

In parallel, steps were taken to simplify administrative and business procedures and extensive investments were made in state-of-the art technologies and in broadening the outreach of the information society. This investment appears to have paid off, as Malta now ranks second in the EU in terms of the provision of online government services,[3] and two

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2 The deterioration was most significant in the electronics sector, which saw a 31% drop in 2001 and a further 9.5% drop in 2002. Tourist receipts fell by around 2% in 2001 but recovered by 4% in 2002, such that over the period at a whole it had grown by only 2%. This marginal increase notwithstanding, its share in total services exports had fallen from 54% to 49%.

3 Eurostat ICT indicators.

different sources suggest that it ranks among the 25 most technologically advanced countries in the world.[4]

Economic performance post-reform

Although the reform process is still underway, Malta's economy was judged by the EU Council in July 2007 to be sufficiently well equipped to operate within the policy parameters of monetary union. In the Commission's words, Malta had achieved *'a high degree of sustainable convergence'*.[5]

After four years of low or negative growth, the economy expanded by more than 3% in each year since 2005. At 6.5% the unemployment rate is at its lowest level in eight years, and the annual rate of change in productivity has returned to more acceptable levels after years of negative or marginal growth.

Reflecting this general improvement, macroeconomic imbalances have also declined. The fiscal deficit contracted from almost 8% of GDP in 1999 to an estimated 1.6% in 2007 and the public debt/GDP ratio has gone down to 63% from a peak of 73% in 2004. The other Maastricht criteria, of course, were all met in good time and in a sustainable manner. Meanwhile, the current account deficit dropped from the 6 - 8% range in the first years after EU accession to around 3% in 2007, and is expected to drop further as the fiscal consolidation programme continues to unfold.

At the same time, the private sector appears to have adjusted well to the changing composition of domestic and external demand. Not only has there been a shift away from public sector employment to private services - the share of the public sector in employment shed five percentage points to 30%since 2000 - but there has also been a move away from low value manufacturing activities to skills based services. Indeed, between 2000 and 2006 the share of the manufacturing sector in gross value added dropped by 5.5 percentage points, while the share of services other than public administration gained more than 6.5 points to 70%.

The composition of the services and manufacturing sectors has also changed. In manufacturing, for example, the share of the two largest sectors dropped from 52% in 2000 to 41% in 2006, suggesting that diversification is underway. Industry has also become leaner and increasingly oriented towards capital intensive activities such as generic pharmaceuticals and biomedicine. In the services sector, aircraft maintenance and repair, aviation engineering, software development, call centres and back office and financial services are gaining ground as are well-established activities such as tourism.

This change in Malta's productive structure reflects a conscious policy of moving away from labour intensive, low-value activities to others that use higher skills and have a potential to

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4 According to the 2007 e-rankings of the Economist Intelligence Unit, Malta is the 24th most technologically advanced country in the world. The Economist Intelligence Unit defines 'e-Readiness' as the 'state of play' of a country's information and communications technology (ICT) infrastructure and the ability of its consumers, businesses and governments to use ICT to their benefit. Rankings are based on a weighted collection of nearly 100 quantitative and qualitative criteria, organised into six distinct categories measuring the various components of a country's social, political, economic and technological development. The Intelligent Community Forum (ICF) recognises Malta as one of the Smart21 Communities of 2008. The rankings are based on nominations submitted by large and small communities from around the world that take into account indicators developed by the forum. The award goes to communities or regions with a documented strategy for creating a local prosperity and inclusion using broadband and information technology to attract leading-edge businesses, stimulate job creation, build skills, generate economic growth, and improve the delivery of government services.

5 European Commission. 2007. *Report from the Commission - Convergence Report 2007 on Malta*, COM(2007) 258 final, p.7.

generate more value. The ongoing improvement in the quality of the infrastructure and other facilities available to investors has induced many foreign investors to locate, or expand existing operations, in Malta and thus take advantage of market access and cost-saving opportunities created by Malta's status, first as an EU Member State and eventually also as a euro area member. This is reflected in the FDI figures when expressed in terms of additions to the capital stock in any one year. Since 2003, for example, the ratio of FDI inflows to gross capital formation was on average 83%, compared to 14% in the EU25.

In manufacturing alone, since the first year of EU membership a total of 127 new projects or expansions with foreign participation have been approved, with an estimated potential value equivalent to 1% of nominal GDP.[6]

The role of the Central Bank of Malta

The Central Bank of Malta has been present at every stage of Malta's journey to the euro. In the early years it provided the intellectual underpinnings for the project as well as policy advice. For example, it was at the fore in highlighting the long-term benefits for Malta's small, open economy of EU membership and of an early adoption of the single currency. It also cautioned, however, that these benefits would only materialise if the existing macroeconomic imbalances were addressed through the implementation of appropriate reforms. The Bank also emphasized that these reforms were not only necessary to ensure eligibility for adopting the euro, but also in view of the strong competitive pressures that were emerging in the global economy.

On the operational level, the Bank's monetary policy remained oriented towards delivering a low and stable level of inflation. The fixed exchange rate regime has indeed been a cornerstone in the country's euro adoption strategy. The policy discipline it promoted had served the country well for over three6 decades as it had come to be recognised that imbalances and structural deficiencies must be addressed through targeted reforms and not through exchange rate adjustment.

When, therefore, the time came for the Maltese lira to enter ERM II in May 2005, the Bank's advice was that the exchange rate should remain fixed throughout the ERM II period. This would ensure continuity and so assure operators that stability would continue to prevail notwithstanding the lira's participation in a mechanism that permitted relatively wide daily fluctuations. This decision was also dictated by the need to counter harmful speculation at the time about the appropriate level of the exchange rate.

Lessons learned

One lesson that could indeed be drawn from Malta's experience is that the discipline imposed by the currency peg was probably the factor that contributed most to the relatively smooth transition to euro area membership, not only in terms of the achievement of the exchange rate criterion, but more so because it helped to focus attention on macroeconomic and structural policies.

There was, however, one factor that remained constant as the journey to the euro progressed. That was the small size of the economy and, thus, its vulnerability to shocks. This was compounded by the risk of a speculative attack of the currency, given the combination of still weak economic fundamentals and the dismantling of the capital controls regime which had protected the lira for decades. These realities made the transition from a basket peg to a full euro peg even more challenging. The potential exposure to capital outflows was also a source of preoccupation because the Bank was aware that the typical

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[6] Malta Enterprise.

interest-sensitive Maltese investor was likely to be attracted by the availability of a wide choice of financial products overseas offering attractive yields.

Long before EU accession the Bank had anticipated this challenge by adopting a sequenced programme of capital account liberalisation to test investor reactions. In fact, capital controls were only fully lifted on the eve of EU membership in 2004. During the experimental phase, the liberalisation of direct investment and other long-term flows preceded that of flows with a shorter maturity. At this time in particular the Bank ensured that its policy interest rate contained a sufficient premium over euro rates so as to make Maltese lira assets relatively more attractive. As a result, and despite the persistence of a relatively high current account deficit, the Maltese lira did not experience undue selling pressures.

This was reassuring, but it was not enough. When it was time to decide on the strategy to pursue in ERM II, therefore, the Bank only put forward its proposal to eschew the use of the 15% fluctuation bands after it had carried out the necessary studies to assess the level of the equilibrium exchange rate. These studies, based on different methodologies, showed that the Maltese lira exchange rate was not significantly out of line with its estimated equilibrium level, and so promised to be broadly sustainable. The ECB and the EU Commission reached a similar conclusion. Hence the decision to enter ERM II at the market rate prevailing the previous day and the commitment not to allow the lira to move from its central parity rate in ERM II.

Such a commitment, of course, could only be made against the background of a strong external reserves position. There was, moreover, no departure from the Bank's prudent approach to reserve management and the reserves remained well above the minimum statutory level. This was the case even during periods of rising international oil prices, which inflated the import bill, and in 2007 when the public started to convert Maltese lira holdings into euro and to hold on to euro earnings in anticipation of the change to the euro.

Another favourable element during the ERM II phase was the comfortable surplus position on the capital and financial account, which more than offset the current account deficit. A combination of substantial inflows of FDI and inward portfolio investment flows provided strong support to the Maltese lira.

The Central Bank of Malta's credibility - based on its track record in delivering exchange rate and price stability - as well as the small size of Malta's financial market probably also helped to ward off any unwanted attention. The absence of volatile short-term capital flows into and out of the country during this period supports this impression.

Finally, Malta's experience points to the importance of a shared vision between the government and the central bank on policy objectives, as well as of a holistic approach to achieving them. In this regard, the continued acceptance by economic operators of the need to support the fixed exchange regime facilitated the authorities' task in imposing the fiscal and monetary discipline necessary to meet the nominal convergence criteria.

The way forward

Becoming a member of the euro area does not represent the end of a process, but rather the beginning of a new era in which the burden of adjustment will have to be carried entirely by the real economy and in which the harmful effects of inefficient institutions and practices on costs and final prices will become more visible. The policy challenge, therefore, is to maximize the benefits of participation in monetary union and so bridge the remaining income gap with the euro area. Malta's per capita income level is still around 70% of the euro area average.

Among other things, this means that further fiscal consolidation is necessary in order to achieve a balanced budget by the set date of 2010. There must also be more emphasis on expenditure-based adjustment, particularly in view of rising pressures caused by ageingrelated 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.

These ambitious objectives clearly allow no room for complacency. In this regard, it is a positive sign that the Budget for 2008 promises policy continuity. It contains a commitment, for example, to reduce the burden of public sector expenditure on the productive areas of the economy, and targets a 6 percent reduction this year. It also provides new incentives for investment in R&D by the private sector and more generous allocations for the development of industrial areas.

As far as the labour market is concerned, new training and placement programmes are envisaged for persons who lack skills and for the long-term unemployed, especially those interested in setting up their own business. There are also plans to establish a register for those seeking part-time employment, along with incentives that should encourage a greater take up of temporary employment as well as labour market participation after pension age.

In the education sector, a wide range of measures are envisaged aimed at improving the quality of education. There are also plans to offer land to international educational institutions interested in developing campuses in Malta. This year will also see a record amount of funds allocated for higher education, including for the creation of an ICT faculty, the modernisation of science and engineering laboratories and additional investment in e-learning facilities.

In this same area, a new ICT strategy has been launched which aims to establish Malta among the top ten Smart Islands by 2010. The strategy aims at improving further the ICT infrastructure, the diffusion of next generation applications and at creating the right environment for large projects that are in the pipeline, including the Smart City by Tecom Investments of Dubai. The strategy also provides for further enhancements to e-government services, and sets new targets aimed at raising the broadband connectivity ratio and computer literacy rate among households.

Malta’s investment promotion efforts meanwhile have been refocused to exploit the island’s strategic location as a bridge between two continents, as well as its potential to serve as a hub for international business in areas such as health care, software development and education.

Conclusion

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 under five 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.