Michael C Bonello: The Maltese economy – the recession and the challenges beyond

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, to the Committee on Economic Affairs and Development of the Parliamentary Assembly of the Council of Europe, Attard, 28 May 2010.

*   *   *

With a GDP of €5.7 billion and a population of around 400,000 living in an area of 316 km^2, Malta is the smallest and most densely populated country in the EU. With an average trade-to-GDP ratio of 82% since membership in 2004, it has the second most open economy in the Union. Malta's business cycle is closely synchronized with that of its main trading partner, the EU, which accounts for 61% of its exports of goods and services. The small size of the country necessarily implies a narrow export base and a dependence on strategic imports, such as fuels and industrial supplies. These characteristics constitute a challenge for policymakers in that the economy's performance is highly sensitive to external events and to sector specific shocks.

The impact of the recession

It was thus inevitable that the headwinds unleashed by the global recession would test the resilience of the Maltese economy. Although euro area membership helped to cushion the impact, as expected in such an open economy the shock was transmitted primarily through the trade channel as external demand shrank. The downturn was particularly pronounced in tourism and manufacturing, two sectors that are highly dependent on demand abroad. Tourist arrivals declined by 8.4% in 2009 while the manufacturing industry's gross value added fell by more than 18%. On the upside, several service activities that have expanded thanks to access to the Single Market have proved quite resilient to the global recession and their performance helped the external balance on goods and services to move into surplus for the first time since 2002.

As a result, the domestic recession was less severe and shorter than elsewhere. Malta's GDP fell by 1.9% in 2009, compared to 4.1% in the euro area, while the peak-to-trough drop in GDP is estimated to have been similarly less pronounced, 3% against 4.7%. A sharp decline in investment acted as a major drag on demand in 2009, but private consumption held up. The reduction in exports was less marked than might have been expected given the severe contraction in world trade such that, together with a steeper drop in imports, net exports contributed positively to GDP.

This limited slowdown in economic activity was in turn reflected in labour market trends. The unemployment rate rose moderately in the first half of the year from 6% at the end of 2008 and has stabilized at around 7% since then.

On the inflation front, consumer price trends in 2009 again did not fully mirror those in the euro area, converging only during the second half of the year when energy and food prices, which had risen sharply in the early part of the year, decelerated substantially. As a result, inflation in Malta was lower than in the euro area for most of the last six months, partly compensating for the higher rates registered previously.

In the context of an economic recession, Malta's public finances performed relatively well in 2009, although the country is still subject to an Excessive Deficit Procedure. The deficit-to-GDP ratio declined from 4.5% to 3.8% in spite of an outlay of some 0.7% of GDP by way of targeted assistance to manufacturing firms and other stimulus measures.[1] To a large extent, however, the fall in the deficit ratio is explained by the presence of one-off expenditure items in 2008.[2] The general government debt ratio rose by around five percentage points to end the year at 69.1% of GDP, still below the estimated 78.7% euro area average.

These developments helped to underpin confidence in Maltese government bonds, which are primarily held by domestic residents. In fact, all the government and corporate bond issues launched in 2009 were oversubscribed, in spite of the fact that the issuance volume doubled compared with 2008. Credit rating agencies have confirmed Malta's sovereign credit standing, with Moody's giving an A1 rating with a stable outlook. Spreads over the German benchmark ten-year bond yield have remained stable over the past year at around 123 basis points.

Sources of economic resilience

The relative resilience of the Maltese economy is mainly attributable to four factors. The first is the adoption of the euro. The single currency has provided a valuable anchor during the intensification of the financial turmoil as Malta did not have to carry the risks inherent in a small and vulnerable national currency.

The threat posed by the financial crisis was further mitigated by the strength and stability of Malta's banking system. Our banks benefited from an approach based on traditional intermediation between retail depositors and borrowers. Their funding model, in fact, eschews reliance on wholesale markets. Exposures to asset-backed securities or failed institutions were small, while lending in foreign currency to residents was limited. Throughout the crisis, moreover, capital and liquidity ratios remained well above the regulatory minimum, which helped to retain investor confidence. Malta's banking system was ranked as the 13th soundest in the world in the World Economic Forum's Global Competitiveness Report 2009–2010.

The health of the domestic banking system is also reflected in its uninterrupted ability to respond to the demand for credit in 2009. The annual rate of increase in bank loans to the private sector, at 8.3%, was only slightly slower than in 2008.[3] This contrasts with the euro area, where private sector credit outstanding has been contracting. It is significant that according to a recent survey, the majority of small and medium-sized enterprises, which form the backbone of the Maltese economy, did not consider access to finance as a main source of concern.[4]

The third source of resilience in the face of the global downturn was the ongoing diversification of the economy towards higher value-added services such as financial services and various business-related activities. The combined share of these services in total gross value-added has increased from 25% in 2004 to 35% in 2009.[5] Success has also been registered in attracting new manufacturing activities such as pharmaceuticals and aircraft maintenance, although these have not reversed the declining role of manufacturing, as traditional sectors like textiles and clothing continue to shrink in the face of competition from low-cost producers.

---

[1] European Commission *Malta: Macro Fiscal Assessment: An analysis of the February 2010 update of the Stability Programme*, April 7, 2010, pages 6, 10.

[2] For example, the voluntary redundancy schemes offered to the workers of Malta Shipyards Ltd.

[3] Latest figure, for March 2010.

[4] Flash Euro Barometer No. 271.

[5] These services include NACE categories J (financial intermediation), K (real estate, renting and business activities) and O (other community, social and personal service activities).

Finally, the provision of direct budgetary assistance to manufacturing companies that found themselves in difficulty helped to limit the impact of the weaker external demand on the labour market. This approach was deemed more appropriate than a broad-based fiscal expansion, which would have mostly leaked out through imports. This stimulus was complemented by the initiation of a number of infrastructure and environmental projects.

The economy today and near-term prospects

The Maltese economy emerged from recession in the fourth quarter of last year and is currently in a moderate cyclical upswing underpinned by more favourable external conditions. Merchandise exports increased markedly in the first quarter of this year and survey indicators point to a sustained improvement in economic sentiment. Tourism activity also seems to be recovering. The latest unemployment rate – 6.9% in March 2010 – is one of the lowest in the euro area, where the average stands at 10%.

Looking ahead, forecasts by the Central Bank of Malta and the European Commission (EC) anticipate GDP growth of 1.1% and 1.2%, respectively this year, followed by 1.7% and 1.8% in 2011.[6] Domestic demand is expected to be the main engine of growth, mainly driven by a pick-up in investment, but the contribution of net exports is thought to be negative in both years, as imports are projected to grow at a faster pace than exports.

Labour market conditions are expected to remain soft, reflecting the usual lagged response to the recovery in output. The unemployment rate is thus foreseen to stay slightly above 7% in both years. Inflation is also projected to remain subdued at around 2%, but it will still be somewhat higher than the euro area average. Similarly, compensation per employee is forecast to rise by around 2%. As this increase in nominal wages is more reflective of inflation developments rather than productivity gains, it could put pressure on cost competitiveness.[7]

Forecasts are of course subject to uncertainty at the best of times. In the present period of renewed crisis, the risk to the projections is clearly on the downside, mainly because of the clouded outlook for demand in Malta's main trading partners and the likely spillover from the deflationary fiscal policies being adopted in many countries. The recovery in Europe is also constrained by the deleveraging process currently underway in the banking sector and in the private sector generally. Together with the fiscal tightening, this balance sheet consolidation largely explains why the EC is forecasting only a modest recovery in the euro area and the EU this year, with growth rates of 0.9% and 1.0%, respectively.

Lessons learned and the way forward

Several lessons can be drawn from the crisis, but two come to mind more readily. The first is that those countries which entered the recession already burdened with imbalances – both internal and external – have performed more poorly than those with sounder economic fundamentals. The second is a universal law that often tends to be forgotten: like individuals, countries cannot afford to live beyond their means indefinitely. Sooner or later, the excesses of the past have to be paid for, often at a high economic and social cost.

The recent proposals by the EC to strengthen economic policy coordination and fiscal discipline are grounded in precisely such thinking.[8] They call for improvements in both the preventive and corrective arms of the Stability and Growth Pact, more emphasis on debt

---

[6] European Commission *European Economic Forecast*, Spring 2010.

[7] European Commission *European Economic Forecast*, Spring 2010, page 118.

[8] EC Document COM (2101) 250, entitled *Reinforcing economic policy coordination published* on 12 May 2010.

sustainability and the extension of peer surveillance beyond the budgetary dimension to other macroeconomic imbalances, such as losses in competitiveness, asset price booms fuelled by excessive credit growth and rigidities in product and labour markets.

While Malta's situation is clearly less worrisome than that of some of the peripheral euro area countries, these proposals would benefit our economy as well. The persistence of current account deficits, for example, suggests an erosion of competitiveness and, therefore, the need for higher productivity, the removal of remaining constraints on market efficiency and increased investment in high value added, export-oriented activities.

Indeed, the economy's strong performance up to 2006 owed more to domestic consumption than to exports. Export growth, upon which the sustainability of a small, open economy depends to a large extent, has been insufficient over the past decade, and the consequent loss of market share partly explains why Malta's income gap with the euro area has not narrowed in recent years.

With regard to the internal imbalance, the events of the last two years have brought to a halt the substantial fiscal consolidation that was achieved in the run-up to euro adoption. While the deficit had been reduced from almost 10% of GDP in 2003 to 2.2% in 2007, it widened in the following two years and the latest projections, those of the EC, suggest that the shortfall will increase further to 4.3% this year, before declining to 3.6% in 2011.[9] These projections imply that the debt-to-GDP ratio in 2011 will stand at roughly the same level as in 2004, around 72%. These ratios are higher than those contained in the Government's Stability Programme since the EC follows the "no policy change" rule and also because of differing macroeconomic assumptions.

A credible fiscal consolidation strategy involves achieving a primary surplus that is sufficiently large to place the public debt on a stable, and eventually declining, path. For this purpose, additional measures beyond those announced in the latest Stability Programme would be required in order to comply with the recommendation under the Excessive Deficit Procedure to bring the deficit below 3% by next year. This accelerated consolidation is also necessary in view of the anticipated increase in spending on health care and pensions associated with an ageing population. Life expectancy in Malta in 2008 was 76 years and 81.1 years for men and women, respectively, and the population aged 65 or over as a proportion of the working age population is expected to rise progressively from 21.2% today to 59.1% in 2060.[10]

Looking ahead, the ability of the economy to benefit from the incipient recovery in external demand through export growth hinges on its competitiveness. This is a multi-faceted concept incorporating both higher product quality and lower costs than those of competitors. The erosion in competitiveness experienced since the start of this decade is partly explained by relatively higher prices and unit labour costs than in our trading partners.

This process needs to be reversed. One way of addressing this challenge would be to ensure more competition in certain product markets. Another would be to replace the national wage indexation mechanism with a productivity-linked wage adjustment system at the enterprise level. Yet another would be to step up efforts to ease the bottlenecks that are constraining the country's growth potential. The revamped EU2020 Agenda could be a useful guide in this respect since it focuses on a number of supply-side initiatives in areas where Malta has lagged behind in the past, such as employment rates, spending on R&D, education-related indicators and clean sources of energy.

The achievement of such goals does not depend only on releasing substantial resources through a reordering of fiscal spending priorities. It also requires the adoption of micro-level

---

9 European Commission Forecasts.

10 Sustainable Report 2009, pp. 23, 125.

policies that create incentives to encourage private initiative and risk taking, that make work pay and that help to change the still prevalent culture of dependence on the State.

Conclusion

To sum up, Malta has not been unduly affected by the global financial crisis and the subsequent recession, and the latest forecasts suggest that it is recovering, albeit modestly. This is encouraging and suggests that the reforms implemented in recent years have made the economy more resilient to external shocks.

There is, however, no room for complacency, particularly at this time of renewed financial market turmoil. It is clear that further difficult policy choices remain to be made. The lessons from the ongoing sovereign debt crisis should serve as a stark reminder that the benign neglect of accumulating imbalances, especially in the context of a monetary union, will have serious economic and social repercussions, sooner rather than later. Allowing short-term considerations to delay the timing of reforms, therefore, only serves to make the inevitable corrections more painful.

This challenge should be faced with pragmatism. Rigorous fiscal consolidation and structural reforms may well cause some pain and even keep growth subdued, but this is a temporary phenomenon as the ensuing gains in efficiency and competitiveness should improve the economy's ability to take fuller advantage of new export opportunities. On their part, businesses need to respond flexibly to changes in global demand, especially in a likely scenario in which foreign markets will be characterized by more efficient competitors and more cost conscious consumers. In these circumstances, innovation and the quality of human capital will be of paramount importance. Malta's ability to compete internationally will depend increasingly on a more cost-effective use of human and physical resources and sustained efficiency gains in both the public and the private sectors.

Finally, at an EU level, the efforts of individual countries to correct macroeconomic imbalances – and Malta is not alone in facing such a challenge – would be greatly facilitated by an early completion of the Single Market project, particularly in the area of services, and by a strengthening of the economic component of EMU, including the Stability and Growth Pact. In this regard, it should not be forgotten that the economic rationale of a monetary union foresees an important role for surplus countries as well in redressing imbalances within the Union.