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# Malta's economy on the path to the Euro

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# MALTA'S ECONOMY ON THE PATH TO THE EURO

JULY 2007

CENTRAL BANK OF MALTA

# MALTA'S ECONOMY ON THE PATH TO THE EURO

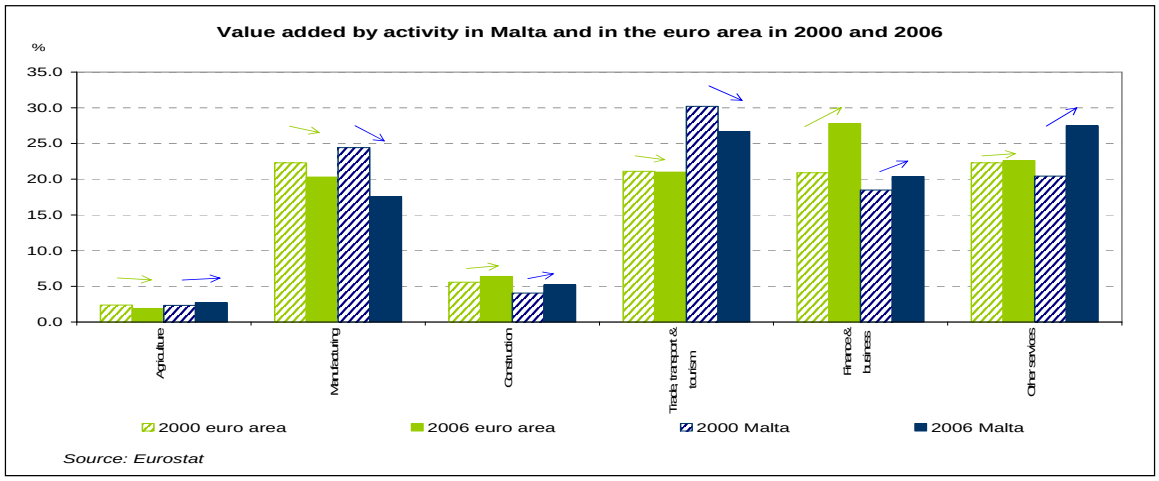
## Introduction

With a GDP of around €5.1 billion and a population of 400,000 living in an area of 316 km$^2$, Malta is the smallest and most densely populated EU Member State. In 2006 it had the fifth most open economy in the EU, and its average trade-to-GDP ratio hovered around 81% in recent years.[1] These characteristics constitute a challenge for both policymakers and analysts in that key economic variables are prone to volatility, being highly sensitive to external events and to shocks in specific sectors or individual enterprises which, though small in absolute terms, can have a disproportionately large impact in a small country context.

Such an economy clearly stands to benefit from closer economic and monetary integration with the euro area, particularly in terms of greater stability and policy credibility. The Maltese economy, moreover, is well suited to participate in the EU single currency area: it is already closely integrated with the EU 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;[2] it enjoys a relatively high level of development (per capita GDP in PPS stands at around 74% and 70% of the EU25 and Euro area averages[3], respectively); and the currency has a long history of stability, with a strong peg to the euro in recent years.

## An increasingly high value-added and services-oriented economy

Malta's response to the challenge of globalisation has been to promote higher value-added manufacturing and service activities. Reflecting this policy thrust, industrial output is predominantly made up of electronic products, while exports of pharmaceuticals are also growing rapidly. At the same time, the contribution of manufacturing to gross value added has fallen to around 18% in 2006 from 24% in 2000, as more labour intensive activities have been phased out. During the same period, the contribution of services increased from 69% to 75%. Apart from the hotels and restaurants sector, which remains a key service industry with a contribution to gross value added ranging between 5% and 7% in recent years, financial and ICT-related services have become increasingly important sources of employment and foreign exchange earnings.




Malta's growing services orientation is in line with trends in the euro area, resulting in the similarity apparent in the accompanying chart. The few variations, particularly Malta's heavier dependence on tourism and on transport services (both included in the category 'trade, transport and tourism' in the chart) are largely explained by the country's insularity and location.

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1 AMECO database. The trade-to-GDP ratio is the average of the ratios of imports and exports of goods and services to GDP

2 Government of Malta, Central Bank of Malta. 2005. *Malta's Strategy for Participating in Economic and Monetary Union and Adopting the Euro*, page 17.

3 These percentages refer to the position in 2006.

**Recent growth performance**

After four years of low or negative growth – mainly attributable to the slowdown in the electronics and tourism industries – real GDP growth recovered to 3.3% in 2005 and 2006 and to 3.5% in the first quarter of 2007.

*Investment*

Since 2003 economic growth was to a large extent driven by domestic demand, as the contribution of net exports only turned positive in 2006. The latter mainly reflected higher exports, although imports declined marginally. Net exports have also contributed positively so far in 2007, on account of a reduction in (real) imports.

As for the domestic drivers of growth, private consumption contributed positively each year since 2003. The contribution of investment was uneven, being particularly strong in 2005. This reflected an increase in infrastructure investment financed by EU funds, private start-ups in the pharmaceutical, aviation, ICT and financial sectors, as well as a number of expansions by long-established foreign-owned firms. The contribution of investment fell in 2006 and turned negative in the first quarter of 2007.

The importance of foreign investment as a source of economic growth is reflected in the ratio of the FDI stock to GDP, which stood at about 70% in 2005, among the highest in the EU and the second highest among the new Member States that joined the EU in 2004.[4]

The ratio of FDI flows to gross fixed capital formation has similarly been among the highest in the EU and, with a few exceptions, has been above the EU average for more than twenty years.[5] This position is expected to be maintained as foreign investors continue to respond favourably to the stable macroeconomic environment, the ongoing structural reforms and Malta's enhanced position as a financial and ICT hub in the Mediterranean. In 2005, in fact, FDI inflows amounted to around 55% of gross fixed investment, up from 37% in 2004. This ratio rose to 142% in 2006, but this largely reflected the privatisation of the national telecommunications company.

The sustained inflows of FDI should further enhance the economy's labour productivity, which in 2006 stood at around 90% of the EU average.[6]

*Productivity and the labour market*

According to a study by the European Commission, the recovery in 2005 was to a large extent underpinned by improved productivity levels.[7] This contrasts with developments between 2001 and 2004, when both productivity and labour utilisation on average contributed negatively to growth.[8] Productivity growth was also strong in 2006 and this positive momentum is expected to be maintained both in 2007 and 2008, in the range of 2%.[9]

Against a background of moderate increases in the average compensation per employee, the gains in productivity registered since 2005 contributed to restrain unit labour cost (ULC) growth. For the first time in several years, labour productivity growth in 2005 exceeded the rate of increase in wage awards. This development recurred in 2006. The latest European Commission economic forecasts, for example, suggest that nominal ULCs dropped by 0.1% and 0.7% in 2005 and 2006, respectively, and the trend is expected to continue in 2007.[10] Real unit labour costs followed a similar trend.

Reflecting the need for wage moderation, and in particular the need for wage awards to mirror productivity gains, cost-of-living adjustments have been increasingly subsumed into public sector wage agreements. At the same time, since the relatively low labour participation rate appears to be a major impediment to higher growth and income levels, females and older workers are being encouraged to enter or remain longer in the labour force. Measures introduced towards this end include incentives for

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4 NSO News Release 19/2007 and UNCTAD, World Investment Report Databases.

5 UNCTAD. World Investment Report Databases.

6 Eurostat Databases. Productivity is measured as productivity per person employed.

7 European Commission. 2006. *Labour market and wage developments in 2005, with special focus on labour market adjustment in the euro area*. European Economy Special Report No. 4.

8 Productivity refers to GDP/hours worked. Labour utilisation is defined as (hours/employment) X (employment/working age population) X (working age population/population) X (population).

9 European Commission Economic Forecasts, Spring 2007.

10 ibid.

continued employment, education and retraining; public investment in human capital and in tertiary-level and vocational institutions; and reforms to the income tax and social benefits system.

These measures have started to deliver results. The female employment rate increased from 33% in 2000 to around 35% in 2006. During the same period, the employment rate of older workers edged slightly upwards from 28.5% to 30%. Raising employment rates remains nevertheless one of the key policy challenges, particularly as current levels remain low in relation to the relevant Lisbon Agenda targets.

The dynamics of the labour market in recent years have largely mirrored developments in output, with employment shifting gradually towards the private sector, in particular to services. Reflecting efforts to disengage from business activities that could be provided more efficiently by the private sector, the share of the public sector in total employment dropped from 35% in 2000 to around 30% in the last quarter of 2006. Over the same period, the share of employment in services rose from 65% to 71%. These shifts were accompanied by an increase in the unemployment rate from 6.4% in 2001 to 7.6% in 2003. It then levelled off at a slightly lower level in 2004 and 2005. In 2006, the unemployment rate averaged 7.3%, but declined to 6.8% in the first quarter of 2007.[11]

*The balance of payments*

Reflecting factors such as the growing importance of FDI and the emergence of substantial fiscal deficits, the latter partly occasioned by heavy expenditures on infrastructure projects, the current account has been in deficit for most of the past decade, with the balance fluctuating between 2.5% and -13% of GDP. The current account deficit was at its highest in 2000. It declined to 3.1% in 2003, before increasing again to 6.2% in 2004 and 9.0% in 2005. In 2006, the current account deficit stood at 6.5% of GDP.

For most of the period since 2001 the current account balance has been negatively impacted by a fall in the demand for, and in the prices of, electronic products – which account for more than half of domestic merchandise exports – following the downturn in the international IT cycle. This was compounded by a decline in tourism – the other main source of foreign exchange earnings – after 9/11 and in response to growing competition from cheaper destinations. Other, more recent, contributory factors have been the liberalisation of trade movements and an increase in imports linked to EU-funded projects, which are masking the positive impact on the external balance of the marked contraction in the fiscal deficit during the past three years.

In 2005 and 2006 higher oil import costs also contributed significantly to the widening of the external imbalance, reflecting Malta's total dependence on oil for electricity generation and on an energy-intensive desalination process to augment the water supply from natural sources. In these two years, the share of oil imports in GDP exceeded its 2004 level by 3 percentage points and 2 percentage points, respectively.

While sizeable, Malta's current account deficits have generally been covered by net inflows on the capital and financial account of the balance of payments. In 2005 and 2006, for example, net inflows on the capital and financial account, excluding changes in official reserves, amounted to 10% and 9% of GDP, respectively.

Furthermore, anecdotal evidence and the existence of large, positive 'errors and omissions' in the balance of payments suggests that unrecorded transactions, particularly connected with the income and other services accounts, may be responsible for an overestimation of the deficit in most years since 2001.

Malta also enjoys a substantial net external creditor position. The net international investment position (IIP) has in fact been positive since it was first recorded in 1994, and stood at around 38% of GDP in 2006.

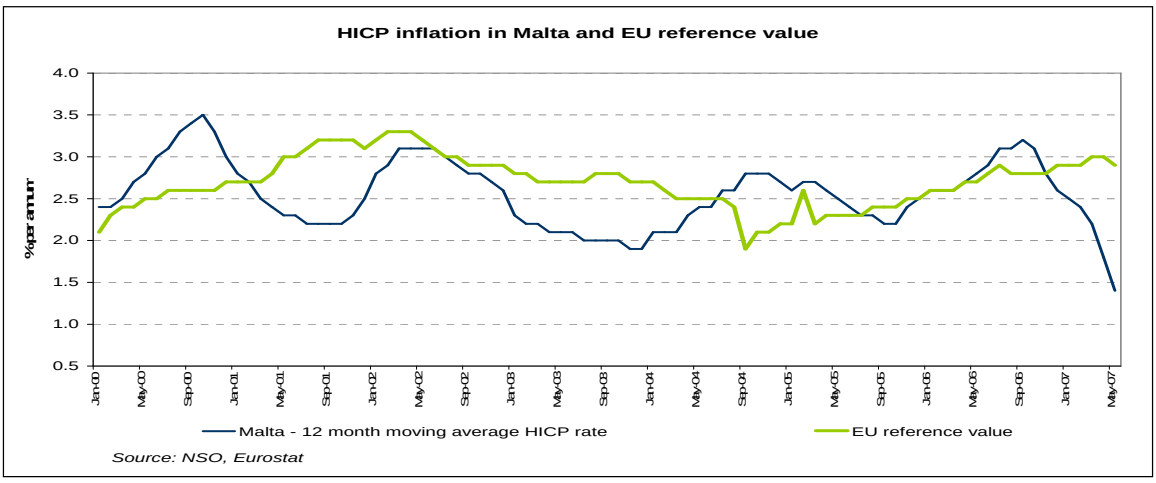
[11] Employment figures according to LFS data published by the National Statistics Office.

## The convergence criteria

*Inflation*

Given the Maltese economy's high dependence on foreign trade, inflation trends are mainly determined by factors beyond the control of domestic policy. This was particularly the case during 2005 and most of 2006, when the HICP inflation rate rose largely under the impact of higher oil prices. The sensitivity of Malta's HICP inflation to oil prices can in turn be explained by Malta's high dependence on oil for electricity generation and water production, as well as the additional transport costs implied by the country's island status and location.

For most of the period between 2001 and the second half of 2004, the 12-month moving average HICP inflation rate was below the corresponding EU reference value. It rose above it in July 2004, reflecting the impact of the increase in the VAT rate that became effective in January of that year. Thereafter, it stabilised somewhat. The Government introduced a 17% electricity and water surcharge in January 2005. This was raised to 55% in November of the same year. In the meantime, the Government also introduced measures establishing a closer link between domestic fuel prices and the international price of oil. As a result, the HICP moving average started to edge up again towards the end of 2005, and remained above the EU reference value for most of 2006, reaching a peak of 3.2% in September 2006.




However, as international oil prices started to stabilise and the statistical base effect came to an end, the 12-month moving average HICP inflation rate began a downward trend in October 2006. It fell below the EU reference value in November, and remained there through May 2007, when it dropped to 1.4%. Inflation is expected to continue below the EU reference value in 2007, as underlying inflationary pressures in the non-energy components remain contained.

In 2005, the HICP inflation rate excluding the energy component stood at 2.0%, and was thus above the corresponding euro average of 1.4%. This trend has been reversed since the end of 2006. In May 2007, the HICP inflation rate excluding the energy component stood at -0.4%, below the 2% registered in the euro area. The dynamics in core inflation followed a similar path. [12] This declined from 2% in 2005 to -0.5% in May 2007.

*ERM II*

On 2 May 2005 the Maltese lira joined ERM II at a central parity rate of MTL/EUR 0.429300. In order to retain the same stability of a fixed exchange rate enjoyed in the past, the monetary authorities committed themselves to maintain the exchange rate of the lira against the euro unchanged at the central parity rate. There have, in fact, been no deviations from the central parity rate since then.

[12] Source: Eurostat. Core inflation is defined as the overall HICP index excluding energy and unprocessed food.

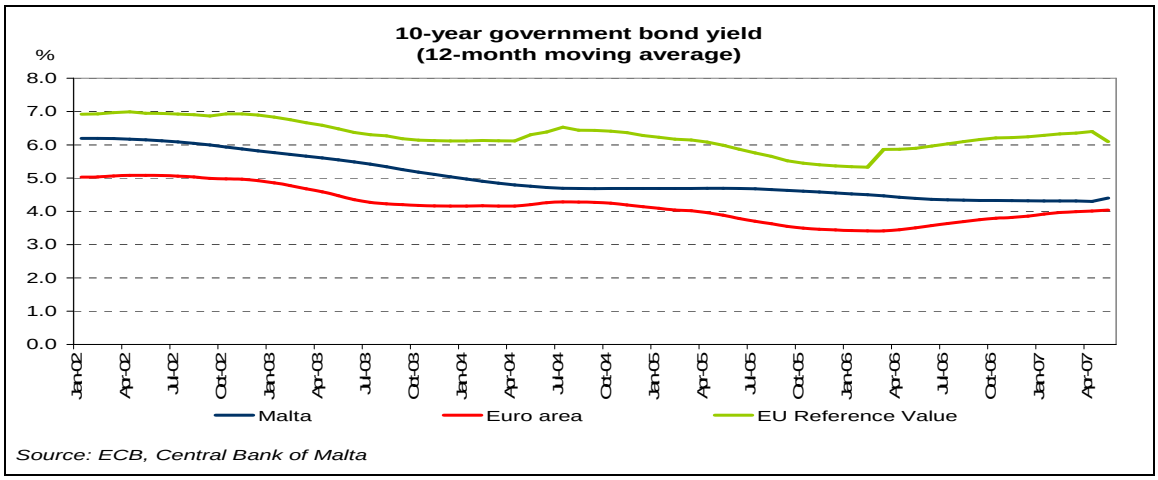
In line with established patterns, the country's external reserves, which are the main indicator of the sustainability of the exchange rate, have tended to fluctuate around a rising secular trend. During the last decade, external reserves have been equivalent to between 7.5 and 9 months of imports.

A number of special factors have influenced this trend of late. These include sharply higher payments for oil imports; the substitution of locally produced consumer goods, especially food and furniture, by foreign products following the removal of import levies consequent upon EU membership; and a growing trend towards portfolio diversification into euro assets by both personal and corporate investors in anticipation of euro adoption. These movements, however, have been partly offset by the receipt of privatisation proceeds and corporate borrowings in euro.

Compared to a level of €1.9 billion at the time of entry into ERM II in 2005, the net foreign assets of the Central Bank of Malta amounted to around €2 billion at the end of June 2007.[13]

*Long-term interest rates*

Since the liberalisation of interest rates and the creation of money and capital markets in the 1990s, and the more recent removal of capital controls, long-term interest rates in Malta have become a more meaningful indicator of financial market perceptions with regard to domestic economic conditions and inflation expectations. In recent years the 10-year Malta government bond yield has generally moved in line with corresponding yields in the euro area, albeit on a higher path reflecting the risk premium on the Maltese lira. The convergence towards euro area levels continues nevertheless, and the domestic long-term interest rate, at 4.4% in May 2007, remains below the EU reference value of 6.1%.[14] Commercial bank interest rate spreads have also been converging.




*The fiscal criteria*

Malta's commitment to fiscal consolidation is spelled out in the *Update of the Convergence Programme 2006 – 2009*. The record shows that the deficit and debt targets established in the previous programme have been exceeded. Despite unfavourable cyclical conditions, reflected in average real GDP growth of only 1% in the period 2003 – 2005, the general government deficit fell from 9.0% of GDP in 2003, when the shortfall was boosted by a one-off expenditure item, to 3.0% in 2005. The fiscal deficit declined to 2.5% in 2006, dipping below the 3% reference value for the first time in more than a decade. Since 2003, moreover, the structural balance[15] lost 3.7 percentage points cumulatively, with each year's structural adjustment exceeding the recommended minimum benchmark of 0.5 percentage points.

Fiscal adjustment has been pursued through revenue enhancing measures, including increases in indirect taxation; rigorous efforts to combat tax evasion; strict enforcement of expenditure limits;

[13] As at 26 June 2007.

[14] The long-term interest rate is defined as the 12-month moving average of the monthly 10-year government bond yield.

[15] This is defined as the cyclically-adjusted balance net of one-offs and other temporary measures.

restrictions on the size of the public service; and a close monitoring of eligibility for welfare and other benefits.

| **Fiscal Indicators** (% of GDP) | | | | |
|---|---|---|---|---|
| | **2003** | **2004** | **2005** | **2006** |
| General government balance | -9.9 | -4.9 | -3.0 | -2.5 |
| General government debt | 69.3 | 72.7 | 70.1 | 63.8 |
| Source: Data for 2003 - 2006, National Statistics Office | | | | |

The debt/GDP ratio has been on an upward trend for most of the past decade, peaking at 72.7% in 2004. It started to decline in 2005, dropping to 63.8% in 2006. According to the Convergence Programme, the debt ratio is projected to drop below the 60% reference value by 2009. The improvement foreseen by that date is partly attributable to favourable assumptions about future growth prospects and stock-flow adjustments,[16] but it also reflects a commitment to pursue further structural adjustment towards the medium-term objective of a balanced budget. The Programme projects a small surplus in 2009.

The Government is committed to ensure the long-term sustainability of public finances and took the first steps towards this objective last year with the introduction of new legislation[17] providing for the implementation of a number of measures as part of a pension reform. These include a gradual rise in the pension age to 65 years and an increase in the contributory period for eligibility to a two-thirds pension from 30 to 40 years. The legislation also allows for the introduction of second and third pillar pensions.

The structure of the debt, moreover, poses only a limited risk to external sustainability: foreign currency debt constitutes only around 4% of the total, while approximately 88% of total government debt is of a medium to long term maturity.

## Other aspects of convergence

*Financial market integration*

Malta's financial integration with the EU gained further momentum following the liberalisation policies of the last decade. The main channel of integration has been the growing extent of foreign ownership of the banking system, with foreign-owned credit institutions now accounting for 78% of total assets. Compliance with the *acquis communautaire* in the field of financial services had already been broadly achieved on EU accession, and good progress has been made in transposing the legislation adopted under the Financial Services Action Plan.

*Product market integration*

At around 85% in 2006, Malta's degree of openness exceeds the EU average. Trade is highly integrated with the EU, accounting for 52% of merchandise exports and 69% of merchandise imports during the first four months of 2007. The larger euro area economies are also important trading partners. During the same period, the euro area accounted for around 37% of merchandise exports and 52% of merchandise imports.

## Conclusion

For Malta's small, open economy the early adoption of the euro is a vital objective. Apart from enabling the economy to exploit more fully the opportunities presented by the EU single market, and thus to achieve higher levels of growth and prosperity, membership of the euro area would mean replacing the costs and the vulnerability inherent in managing a small, national currency in an increasingly competitive external environment with the greater security and credibility afforded by an international currency. At the same time, by providing a more stable macroeconomic framework and by increasing price transparency, the adoption of the euro should spur reform efforts and allow

[16] See Malta Update of the Convergence Programme 2006-2009.

[17] Act No. XIX of 2006.

policymakers to focus more effectively on the pursuit of the Lisbon Agenda goals in accordance with the National Reform Programme.

While Malta has made good progress in this regard, this has not been uniform across all the major priority areas identified for reform. Improvement has been most notable in relation to fiscal sustainability. The continued implementation of the fiscal consolidation programme and the redirection of tax revenue towards activities with a potential to generate efficiency gains and growth are indispensable to attain the other targets. In this regard, efforts need to focus on a review of health care expenditure and on the introduction of additional measures aimed at improving the employability of the work force and creating an environment more conducive to business innovation and competition. This is the context for Malta's commitment to secure membership of the euro area.