ECONOMIC CHALLENGES
ON THE PATH TO THE EURO
THE MALTESE EXPERIENCE

Vienna, November 2007
Central Bank of Malta
Malta has a small, but relatively developed economy:

<table>
<thead>
<tr>
<th>Metric</th>
<th>Value</th>
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<tbody>
<tr>
<td>population</td>
<td>0.4 million</td>
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<tr>
<td>area</td>
<td>316 km²</td>
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<tr>
<td>GDP</td>
<td>€5 billion</td>
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<tr>
<td>GDP per capita in PPS</td>
<td>73% of EU25 average</td>
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<tr>
<td>price level</td>
<td>69% of euro area average</td>
</tr>
<tr>
<td>income inequality co-efficient</td>
<td>4.1</td>
</tr>
<tr>
<td>UNCTAD Inward FDI Performance Index</td>
<td>6&lt;sup&gt;th&lt;/sup&gt; (2004-2006)</td>
</tr>
<tr>
<td>residents’ deposits / GDP</td>
<td>126%</td>
</tr>
<tr>
<td>domestic credit / GDP</td>
<td>133%</td>
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</table>
The Maltese economy is also very open with an average trade-to-GDP ratio of 80% in recent years.

Source: European Commission, AMECO databases
The contribution of foreign direct investment is relatively large and has been increasing over time.

FDI stock 92% of GDP (2006) 3rd in EU

Source: UNCTAD World Investment Report Databases
In 1999, when the EU membership application was reactivated, the economy was still characterised by:

- a large public sector / substantial state ownership
- import levies and capital controls
- a central bank that was not fully autonomous
- structural rigidities which resulted in output and labour markets not being fully responsive to market forces
The formulation of a strategy aimed at preparing the economy for EU membership coincided with two major external shocks:

- the 9/11 terrorist attacks on the US, which impacted negatively on the tourism industry
- the global downturn in the high-tech industry, which had severe repercussions on the domestic electronics sector
These shocks and the process of restructuring resulted in an economic slowdown in 2001 - 2004

Real GDP growth
(2001 - 2004, annual observations)

Source: Eurostat
Challenges ahead of EU accession

- reversing the downward trend in economic growth
- strengthening external competitiveness in the light of a widening current account deficit
- reducing the fiscal deficit, which by 2003 had reached a peak
- improving resource allocation by diminishing the role of the state in the economy
- completing the restructuring process in the private and public sectors
- strengthening the institutional framework for the development of financial services and their regulation
### Policy options to meet the challenges

While the ultimate objective was to achieve convergence with the EU, the authorities had a choice between two options:

**Option 1**
- a gradualist approach
- with minimal social disruption
- a delay in implementing much needed measures
- risk of reform slippages
- painful adjustment later on

**Option 2**
- build on the existing degree of integration with the EU by adopting bolder reforms
- heavier social burden
- faster convergence with euro area
- earlier realisation of benefits of EU accession

The decision was taken to pursue the second option.
Malta’s small size + openness vulnerable to internal and external shocks, including sector-specific shocks. This vulnerability could be mitigated by integration into a larger, stable economic area. Evidence that the single currency and the policy framework of the euro area produce benefits, since Malta had already achieved a high degree of integration with the euro area, these benefits appeared achievable in the short-term. The euro would facilitate the process of further integration with the EU and enable Malta to reap the benefits of the single market.
EU countries, including the larger euro area Member States, were among Malta’s largest trading partners.

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<th></th>
<th>2004</th>
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<tbody>
<tr>
<td></td>
<td>% EU</td>
<td>% euro area</td>
</tr>
<tr>
<td>imports of goods and services</td>
<td>71</td>
<td>54</td>
</tr>
<tr>
<td>exports of goods and services</td>
<td>59</td>
<td>35</td>
</tr>
</tbody>
</table>

Source: National Statistics Office
At the time of EU accession, the structure of the Maltese economy already resembled that of the euro area.
Implementation of the chosen strategy

In pursuing the strategy implied by the second option, the authorities made the following broad commitments:

The Central Bank of Malta (CBM):
- continue to pursue a fixed exchange rate policy
- promote further reforms in the financial sector

The Government:
- adopt a medium-term programme of fiscal consolidation
- implement structural reforms
The exchange rate commitment

In pursuing its commitment with regard to the exchange rate the CBM:

- maintained an adequate risk premium in favour of the Maltese lira
- continued to implement a sequenced capital account liberalisation programme
- advised the Government to enter ERM II as soon as practicable after EU accession
- advocated entry in ERM II in May 2005 with a unilateral undertaking to maintain the Maltese lira / euro exchange rate at the central parity rate
Except during a brief period of speculation about the possible level of the exchange rate in ERM II, a relatively low risk premium has been sufficient to support the currency peg.
The commitment to maintain a fixed exchange rate was made against the background of a strong external reserves position.
Gradual liberalisation of the capital account

- outward direct foreign investment and real estate
- long / medium-term outward portfolio investment, within specified limits
- lending to non-residents / borrowing by residents from overseas, within specified limits
- opening of bank deposit accounts by non-residents permitted subject to obligation on banks to cover the foreign currency exposure
- short-term outward portfolio investment by residents was restricted until EU accession in May 2004
- reporting requirements retained after liberalisation for monitoring and statistical purposes
Since Malta joined ERM II on 2 May 2005, there have been no deviations from the central parity rate.

Source: Central Bank of Malta
In pursuing its commitment with regard to the upgrading of the financial sector, the CBM contributed to:

- amendments to CBM Act to formalize the Bank’s independence
- the smooth transfer of banking supervision to the MFSA
- the further alignment of the legislative framework and of operational practices with those of EU jurisdictions
- the development of the financial infrastructure (e.g. payment and settlements systems, data reporting capacity, risk management practices)
The Government’s commitments (i)

With the Government committed to early euro adoption, policy measures were aimed at achieving the nominal convergence criteria and a high degree of real convergence.

- a fiscal consolidation programme to reduce the deficit to below 3% of GDP by 2006
- pension reform
- further downsizing of the public sector
- a five-year public sector wage agreement
- measures against tax evasion and abuse of welfare benefits
- an increase in the VAT rate and a broadening of the VAT base
- greater recourse to cost-based pricing of publicly provided services
- liquidation of loss-making firms and privatisation
By 2006 the deficit / GDP ratio had dropped to below 3%.

General government balance
(as a % of GDP)

Source: National Statistics Office, Budget 2008
The public debt / GDP ratio remains above the 60% threshold but is on a declining trend.

Source: National Statistics Office, Budget 2008
Other measures were aimed at meeting the Lisbon Agenda targets. These included:

- ‘make work pay’ initiatives
- measures to encourage labour market participation
- improved access to retraining and life-long education
- investment in ICT infrastructure, e-government and the information society
- streamlining of public administration procedures
Reforms are ongoing, but implementation is already delivering results

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<tr>
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<th>2003</th>
<th>2005</th>
<th>2007</th>
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<tbody>
<tr>
<td>real GDP growth</td>
<td>-0.3%</td>
<td>3.1%</td>
<td>3.5%</td>
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<tr>
<td>unemployment rate (LFS)</td>
<td>7.6%</td>
<td>7.2%</td>
<td>6.6%</td>
</tr>
<tr>
<td>fiscal balance</td>
<td>-9.8%</td>
<td>-3.1%</td>
<td>-1.6%</td>
</tr>
<tr>
<td>share of public sector in employment</td>
<td>34%</td>
<td>33%</td>
<td>30%</td>
</tr>
<tr>
<td>share of services in employment</td>
<td>41%</td>
<td>43%</td>
<td>46%</td>
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<tr>
<td>inflation rate</td>
<td>1.9%</td>
<td>2.5%</td>
<td>0.4%</td>
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<tr>
<td>change in productivity</td>
<td>-1.3%</td>
<td>1.3%</td>
<td>2.1%</td>
</tr>
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Some lessons from the Maltese experience

- The reactivation of Malta’s application to join the EU served to focus attention on the need for more ambitious reforms.

- The CBM pronounced itself unequivocally on the long-term benefits of EU membership and of an early adoption of the single currency.

- Hence the importance of a strong research capacity and of a structured public information campaign to deliver the message.
The importance of a shared vision between the government and the central bank on policy objectives and the need for a holistic approach to achieve them:
- fiscal consolidation and public sector downsizing
- structural reforms to enhance competition, efficiency and flexibility
- a monetary policy focussed on its primary objective
- an appropriately sequenced capital account liberalisation programme

Commitment to join ERM II must be credible.

A clear target date for euro area membership.
THANK YOU