GROWING WITH THE EURO

Central Bank of Malta
January 2007

OUTLINE

- Key dates and procedure
- Maastricht criteria
- Benefits of the euro
- Malta’s growth problem
- Conditions for successful monetary integration
- The need for further structural reforms

KEY DATES ON THE ROAD TO EURO ADOPTION

- 1 May 2004:
  - Malta joins the EU
  - assumes obligation to join ERM II and adopt the euro
- 2 May 2005:
  - Malta joins ERM II
  - unilaterally commits to maintain agreed central parity rate EUR1 = MTL0.429300
- 1 Jan 2008:
  - target date for euro adoption

ENTRY IN THE EURO AREA IS NOT AUTOMATIC

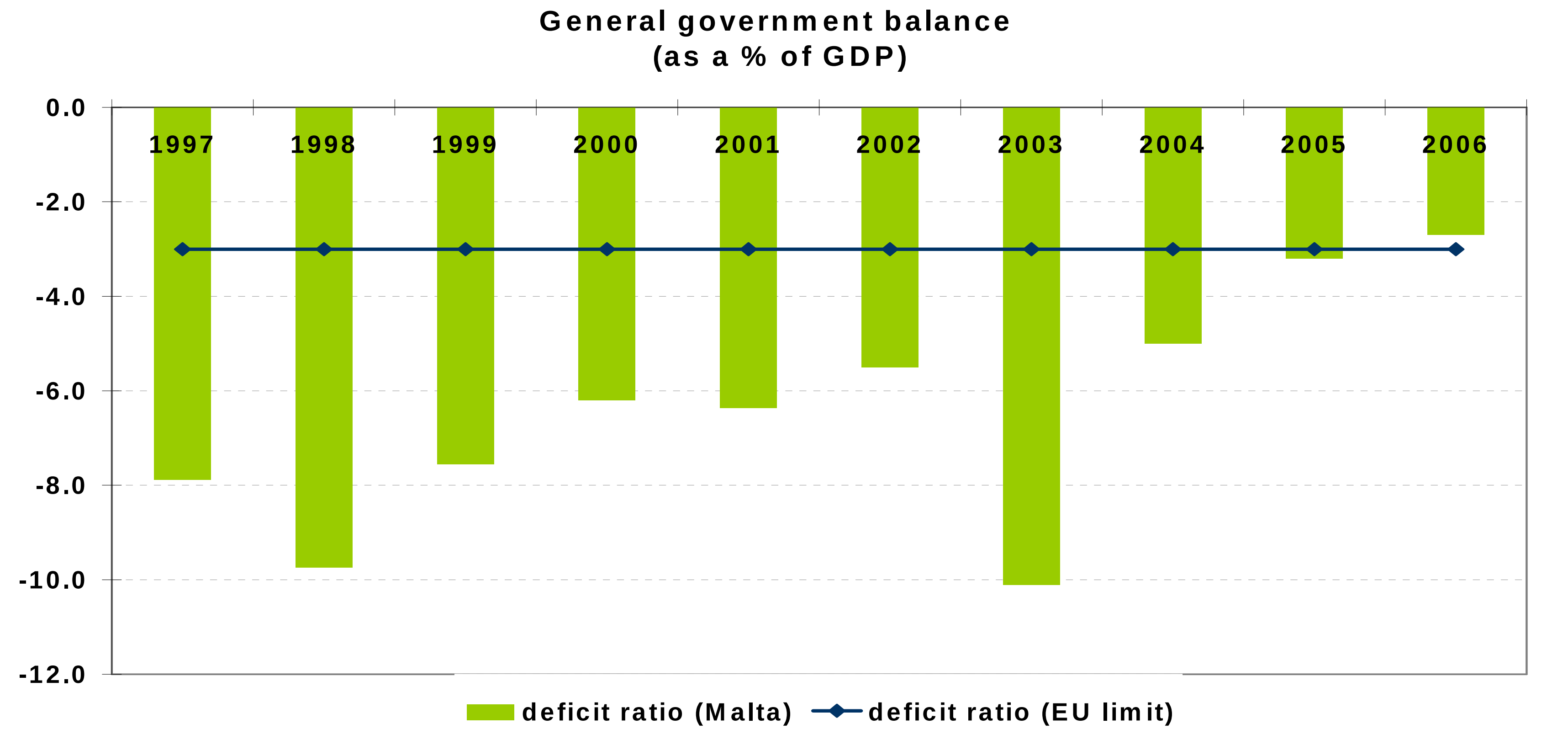
- ECOFIN decides on lifting Malta’s derogation
  - in euro area composition
  - based on a Convergence Report
  - published with a Council Regulation announcing irrevocable conversion rate and its effective date (euro area + Malta, unanimity)
- Malta will request an assessment once Maastricht criteria are met

- until 31 December 2007
  - EUR foreign currency, MTL the only legal tender
  - CBM interest rates continue to apply
  - EUR-MTL conversions need not occur at CPR
- from 1 December, banks will undertake all MTL/EUR exchanges at the conversion rate, without exchange charges (euro notes from business customers, 1 July)
- euro cash will be available to the public on demand from euro adoption date
- MTL notes and coins exchangeable at CBM for 10 years and 2 years, respectively, without charge

Progress towards fulfilling the formal criteria for euro adoption

PROGRESS TOWARDS MAASTRICHT CRITERIA

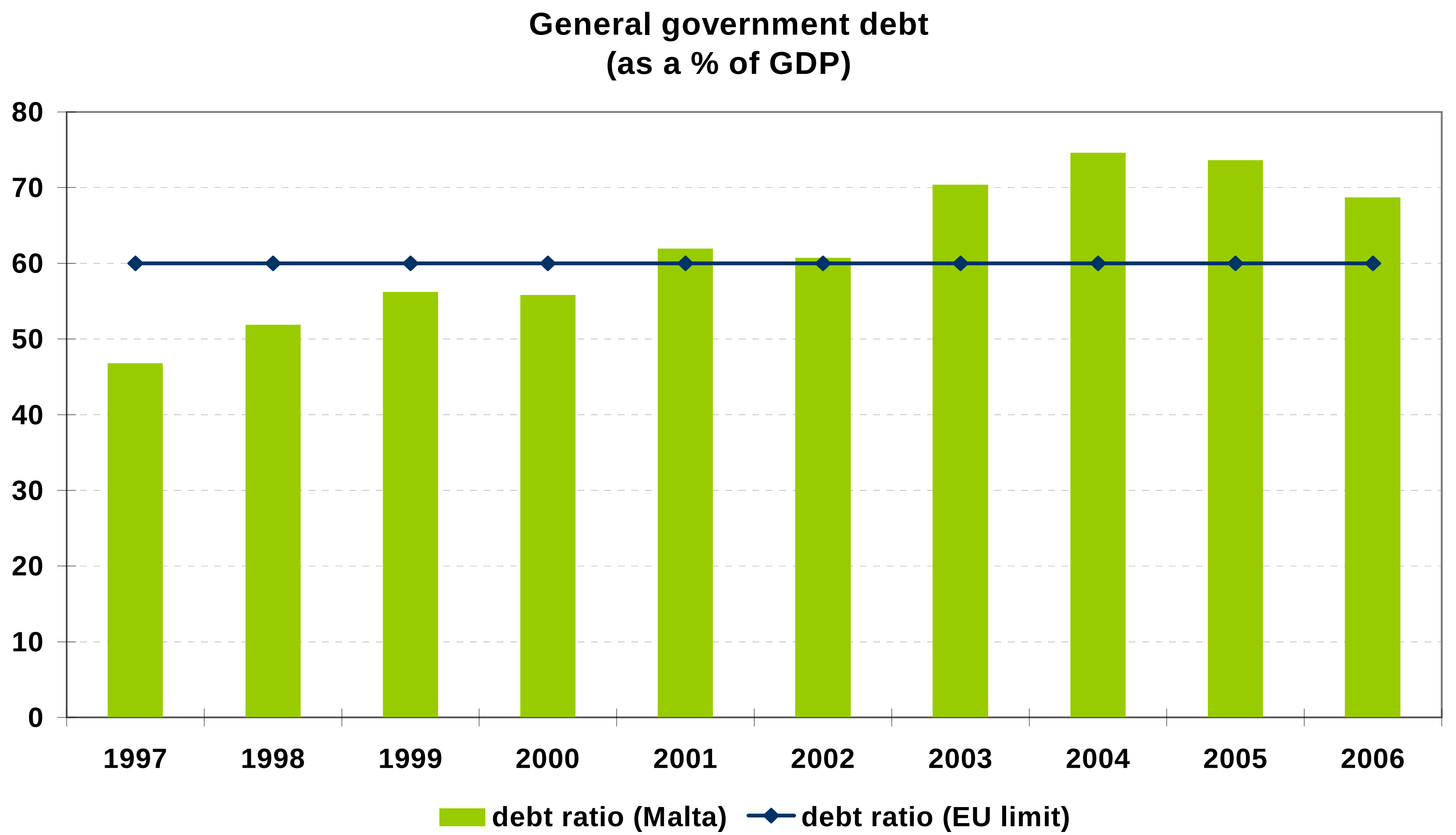
The deficit/GDP ratio has been gradually reduced and is expected to fall below the 3% limit in 2006. Government plans further reductions



Source: National Statistics Office

PROGRESS TOWARDS MAASTRICHT CRITERIA

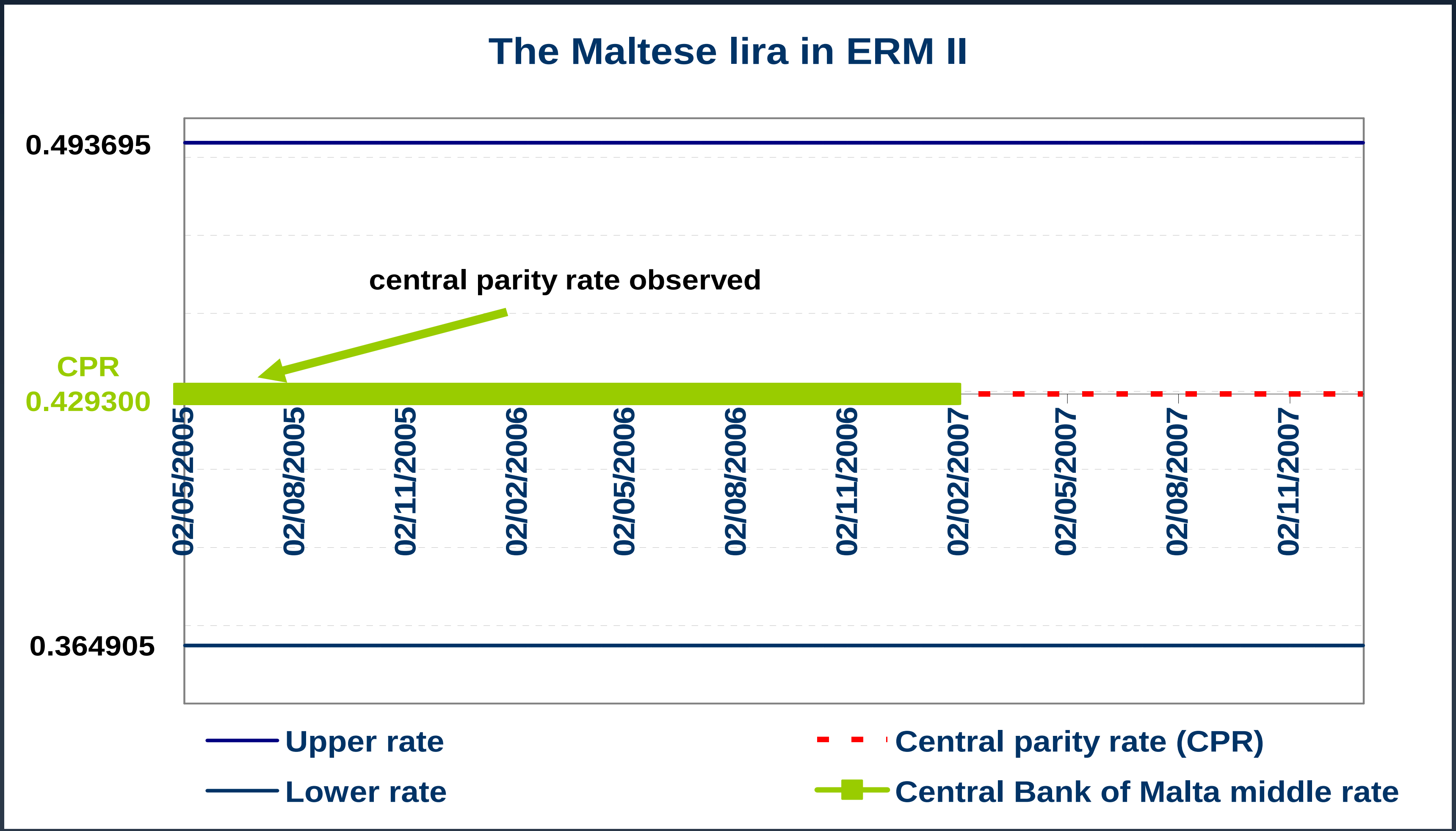
The debt ratio is also approaching the reference value



Source: National Statistics Office

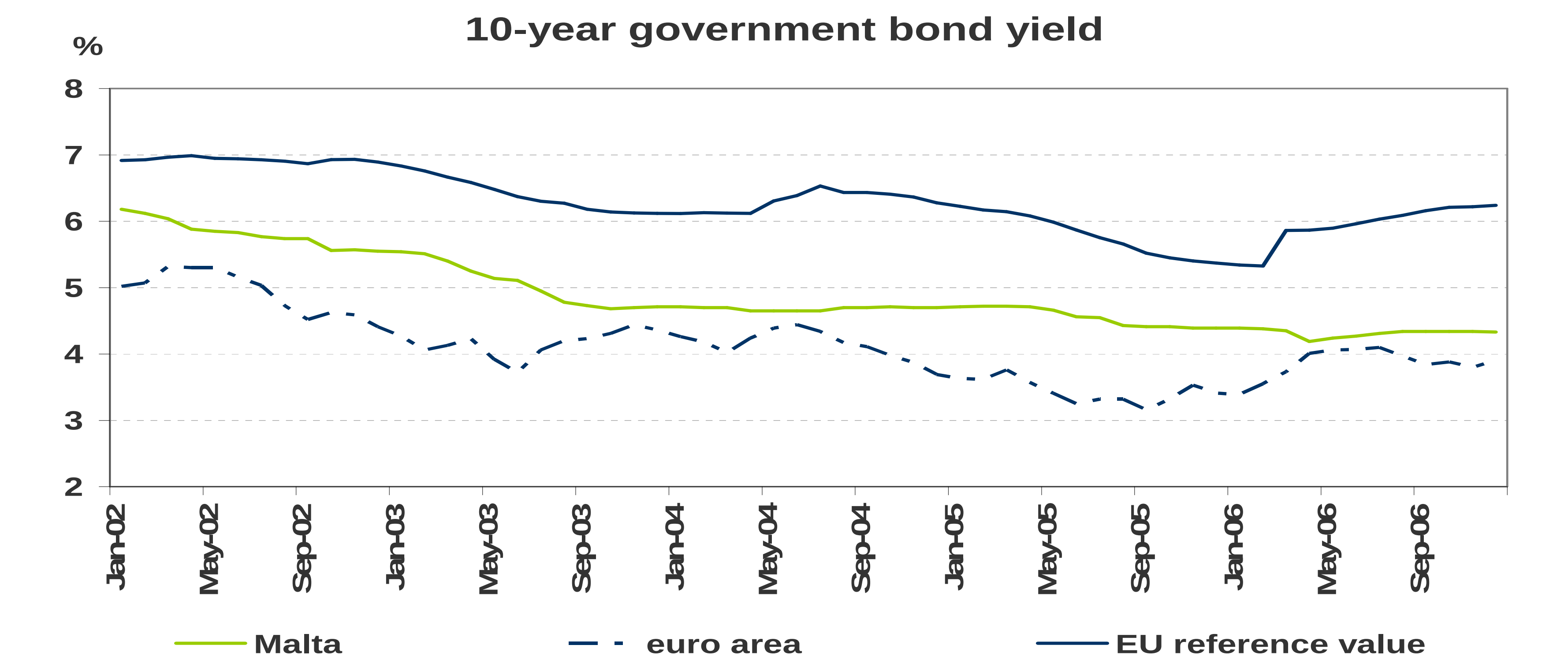
PROGRESS TOWARDS MAASTRICHT CRITERIA

Malta's unilateral commitment to maintain the central parity rate has been observed since entry in May 2005



PROGRESS TOWARDS MAASTRICHT CRITERIA

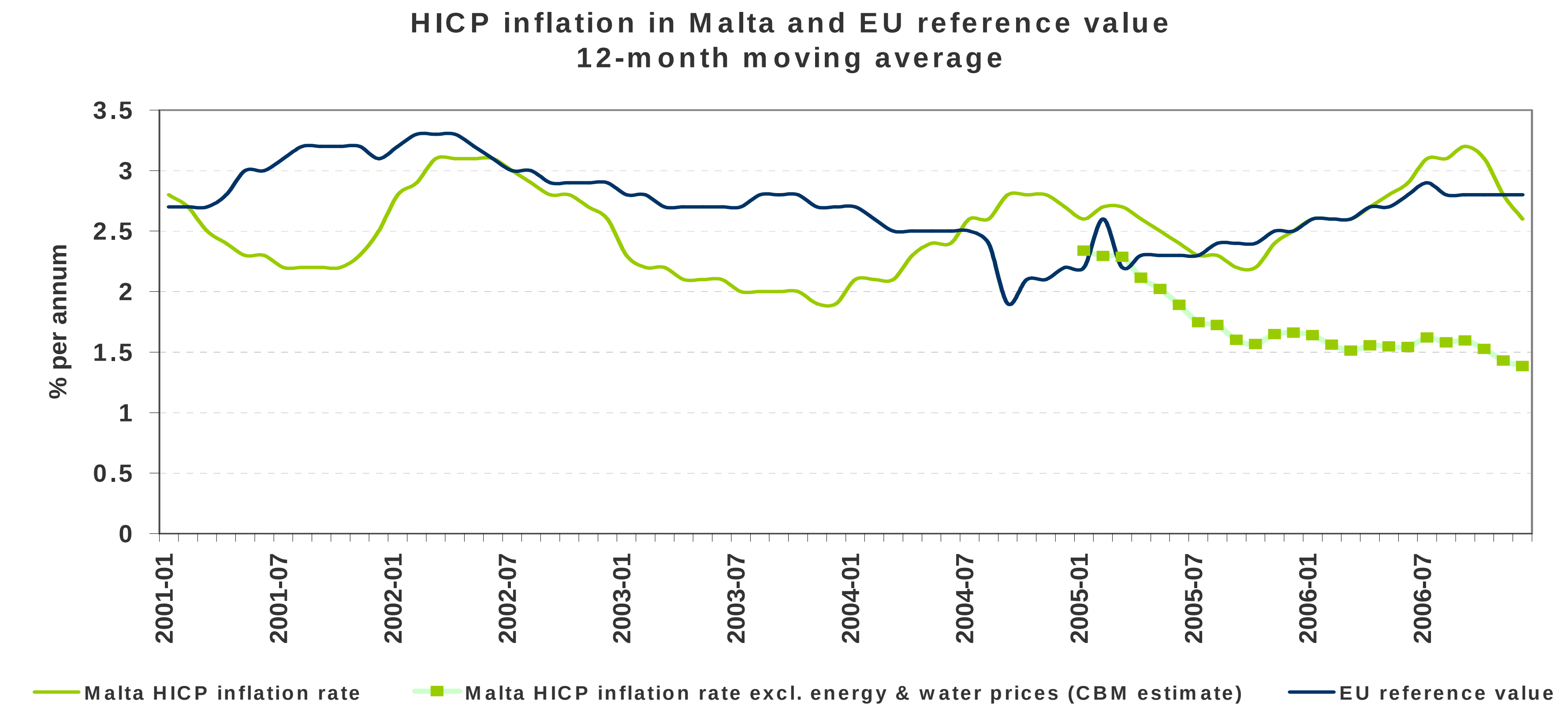
The long-term interest rate has been shadowing the euro area interest rate, at a slightly higher level, but it has remained well below the reference value



Source: ECB, Central Bank of Malta

PROGRESS TOWARDS MAASTRICHT CRITERIA

HICP inflation generally below EU reference value, except for some periods in 2004 (VAT increase) and 2005 and 2006 (energy-related costs)



Source: Eurostat New Cronos Database and National Statistics Office, Malta.

FORECASTS

Forecasts suggest that Malta could meet all the Maastricht criteria by Spring 2007

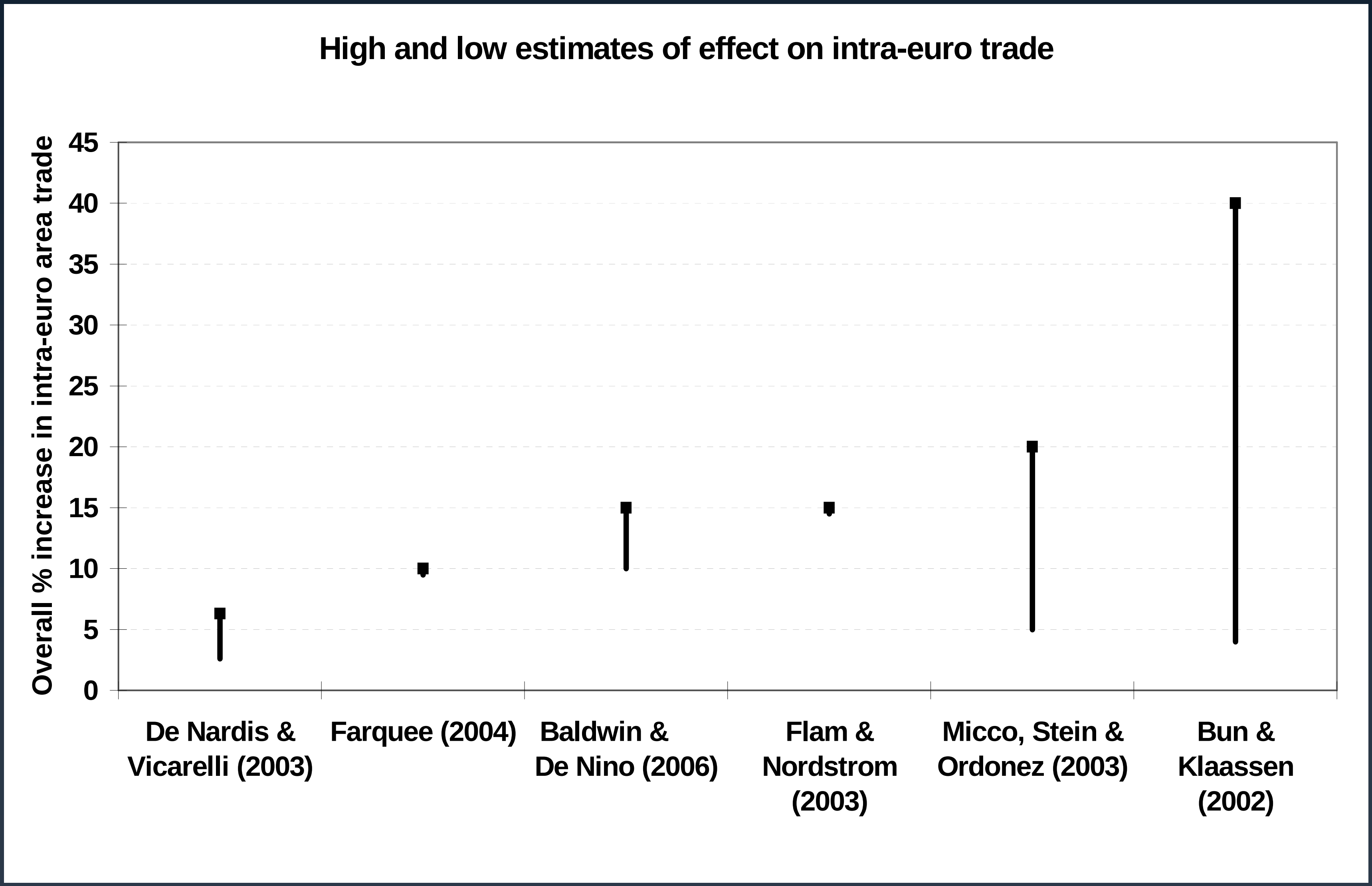
	EU Commission		CBM	
	2006	**2007**	**2006**	**2007**
government deficit (% of GDP)	**-2.9**	**-2.7**	**-2.7**	**-2.4**
government debt (% of GDP)	**69.6**	**69.0**	**68.0**	**67.2**
LT interest rate (% per annum)	**4.3**	**-**	**4.8**	**5.3**
HICP inflation rate (% year-on-year)				
headline figure	***3.0***	***2.6***	***2.8***	***1.6***
excluding energy	***-***	***-***	***2.0***	***1.9***
ERM II (% deviation from CPR)	**0.0**	**0.0**	**0.0**	**0.0**

The single currency:
economic benefits and limitations

THE ECONOMIC RATIONALE BEHIND THE EURO

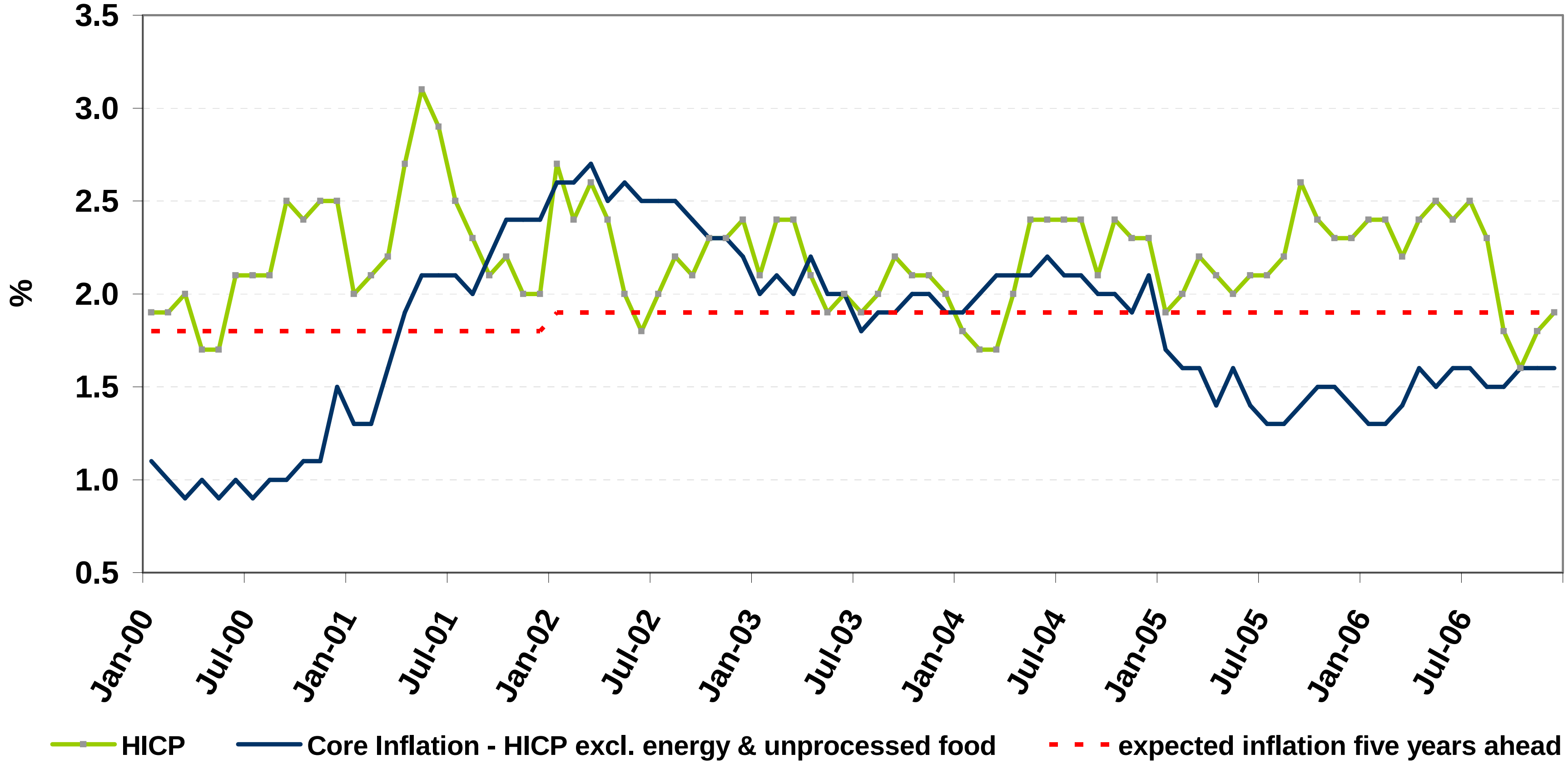
- an EU perspective
  - a single currency is the natural complement of a single market
  - supports achievement of Lisbon Agenda
- a national perspective
  - trade, efficiency and investment
  - signalling effects
  - protection

SOME EVIDENCE



SOME EVIDENCE

The euro has delivered price stability and anchored inflation expectations at around 2%



Source: ECB and Eurostat

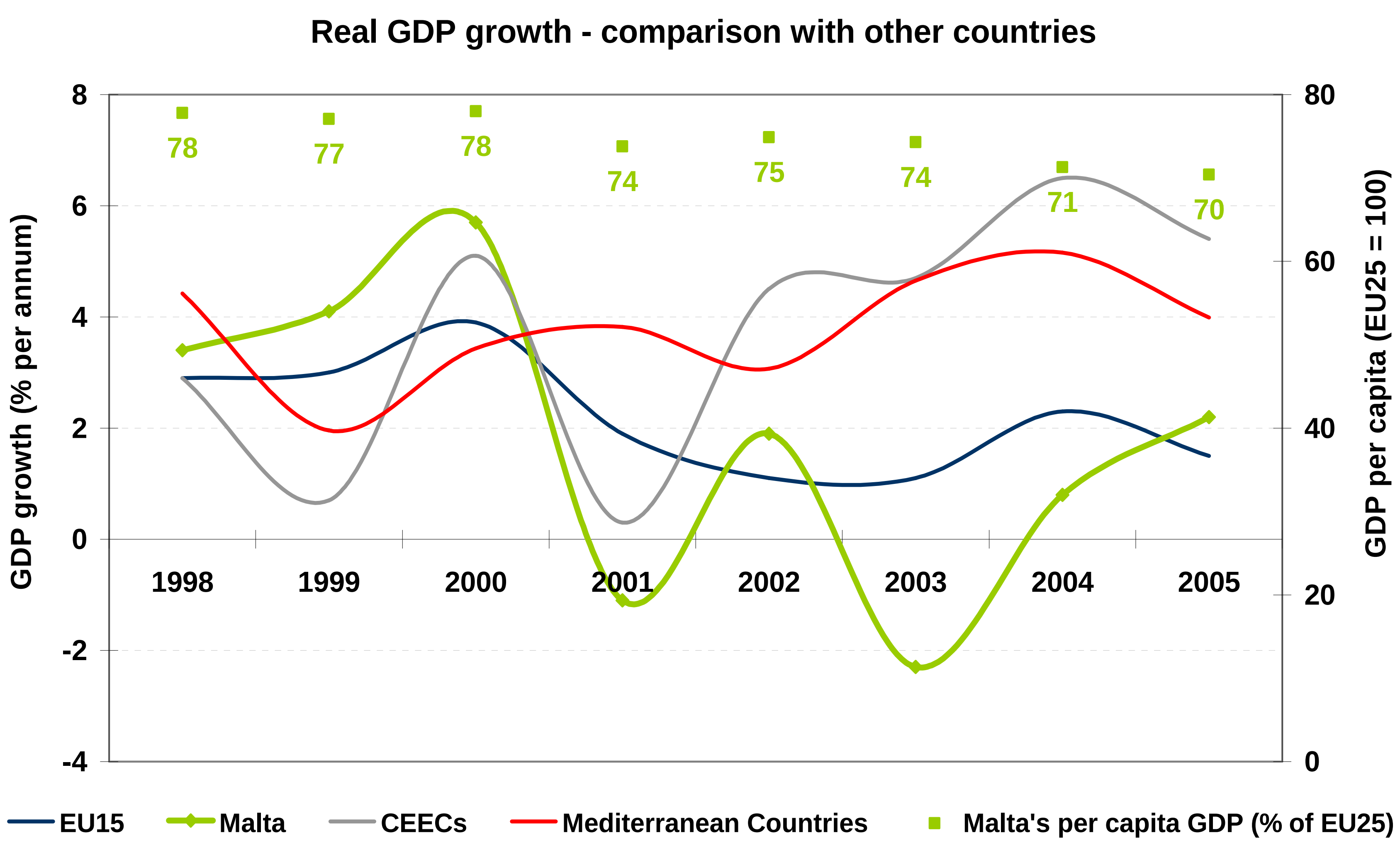
... HOWEVER

- euro adoption is not sufficient for faster growth
- single currency benefits can only be realised with:
  - ability to take advantage of growth opportunities
  - flexibility to respond to external shocks
  - tools to address country-specific developments (asymmetric shocks limited but not negligible)

WHY IS THIS RELEVANT FOR MALTA?

- one of the slowest growth rates in EU in recent years
- failure to return to past growth rates amid favourable global economic conditions
- neighbouring countries experienced:
  - less prolonged recessions
  - earlier and more sustained recovery in good times
- result:
  - widening income gap viz. euro area
  - narrowing income advantage viz. NMS

GROWTH DEFICIT REFLECTS STRUCTURAL FACTORS



Source: World Bank, Eurostat

ADDRESSING THE ECONOMY'S STRUCTURAL WEAKNESSES

- need for rapid implementation of comprehensive reforms

…HOW?

- range of policy options available is limited by EMU constraints, particularly in a Maltese context

THE POLICY CONSTRAINTS OF EMU

- exchange rate permanently fixed
- interest rate decisions centralised + inflation oriented
- output stabilisation depends on fiscal policy, but scope for fiscal stimulus in EMU is limited

monetary and fiscal policy, therefore, have limited capacity to address country specific problems

realisation of EMU's benefits depends on structural flexibility and supply-side policies

SOME EMU CONSTRAINTS ALREADY APPLY

- limited utility of monetary and exchange rate tools
  - small size + openness warrant a stable exchange rate
  - stability commitment + free capital flows condition interest rates to follow rates of anchor country
  - devaluation is costly (inflation)
- fiscal policy has limited effectiveness as an adjustment tool
  - high import propensity means effect is lost abroad

POLICY PRIORITIES FOR GROWTH

- a prudent fiscal framework
  - more room for manoeuvre during downturns
  - increased resources for investment
  - stronger support to private sector
  - better prospects to attain medium-term objective
- step up pace of structural reforms
  - economy still lacks the necessary flexibility to adjust to external and country-specific developments

Comparisons that matter

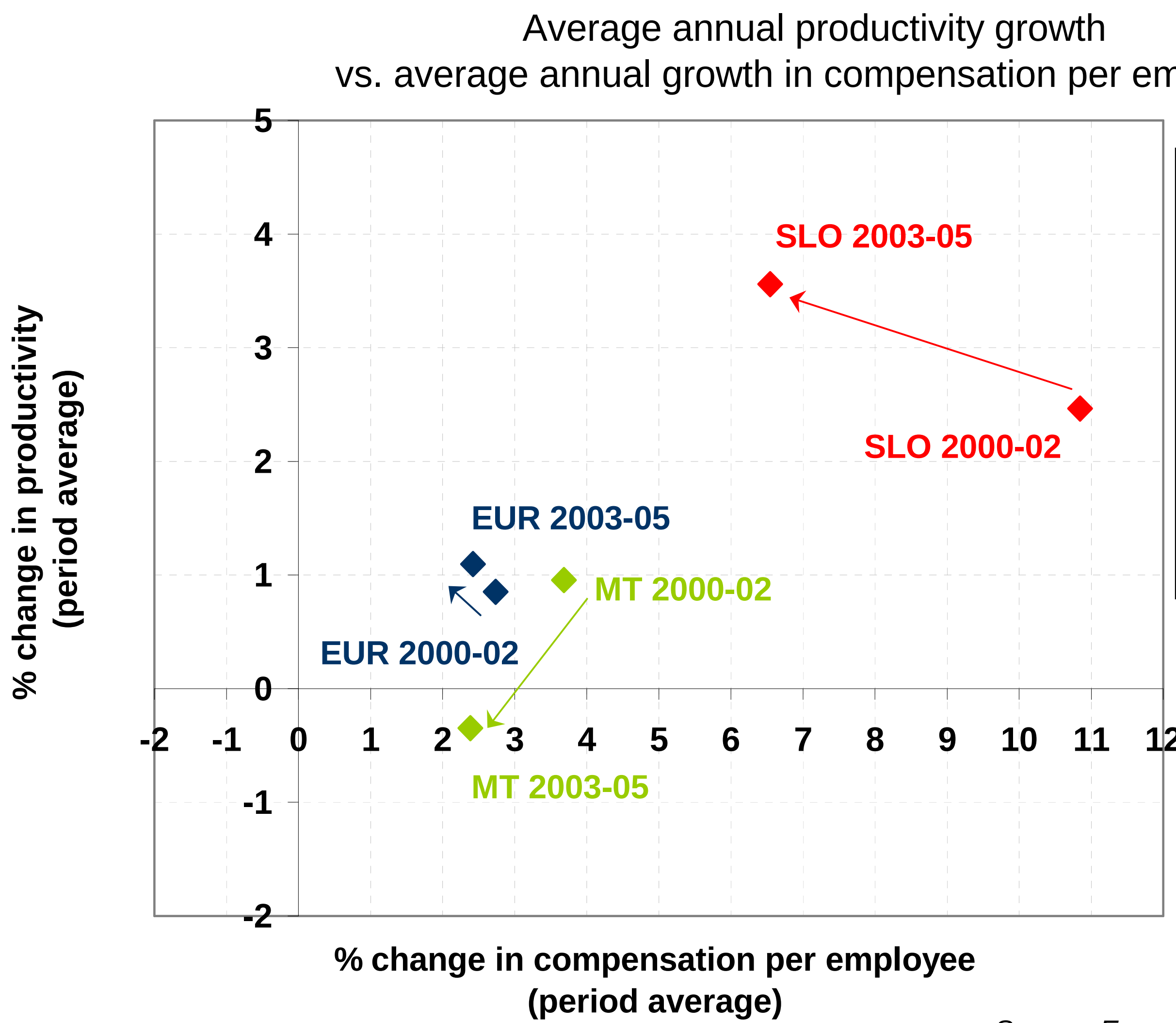
	euro area	Slovenia	Malta
private savings rate (% of GDP)	20.1	21.2	11.4
private investment (% of GDP)	17.4	20.9	14.8
state aid (% of GDP)	0.6	1.0	3.1
percentage of R&D expenditure funded by domestic industry (% of total R&D exp.)	56.3	60.0	18.6
government appropriations of R&D (budgeted provisions as % of GDP)	0.8	0.6	0.2
female employment rate (% of population aged 15-64)	55.2	61.3	33.7

Source: Eurostat data for 2004 or 2005, as available, except domestically funded R&D

	euro area	Slovenia	Malta
science and technology graduates (per 1000 pop.)	12.7	8.7	3.6
early school leavers (% of pop.)	18.0	5.2	41.6
youth education attainment level	73.5	90.5	53.7
public expenditure on human resources (% of GDP)	5.0	6.0	4.8
nominal unit labour costs *cumulative change 2000-2002* (%)	5.6	24.5	8.5
cumulative change 2003-2005 (%)	3.9	8.7	8.4

Source: Eurostat, refers to 2004/2005. ECB (unpublished) for nominal unit labour costs.

UNIT LABOUR COSTS EXPLAINED

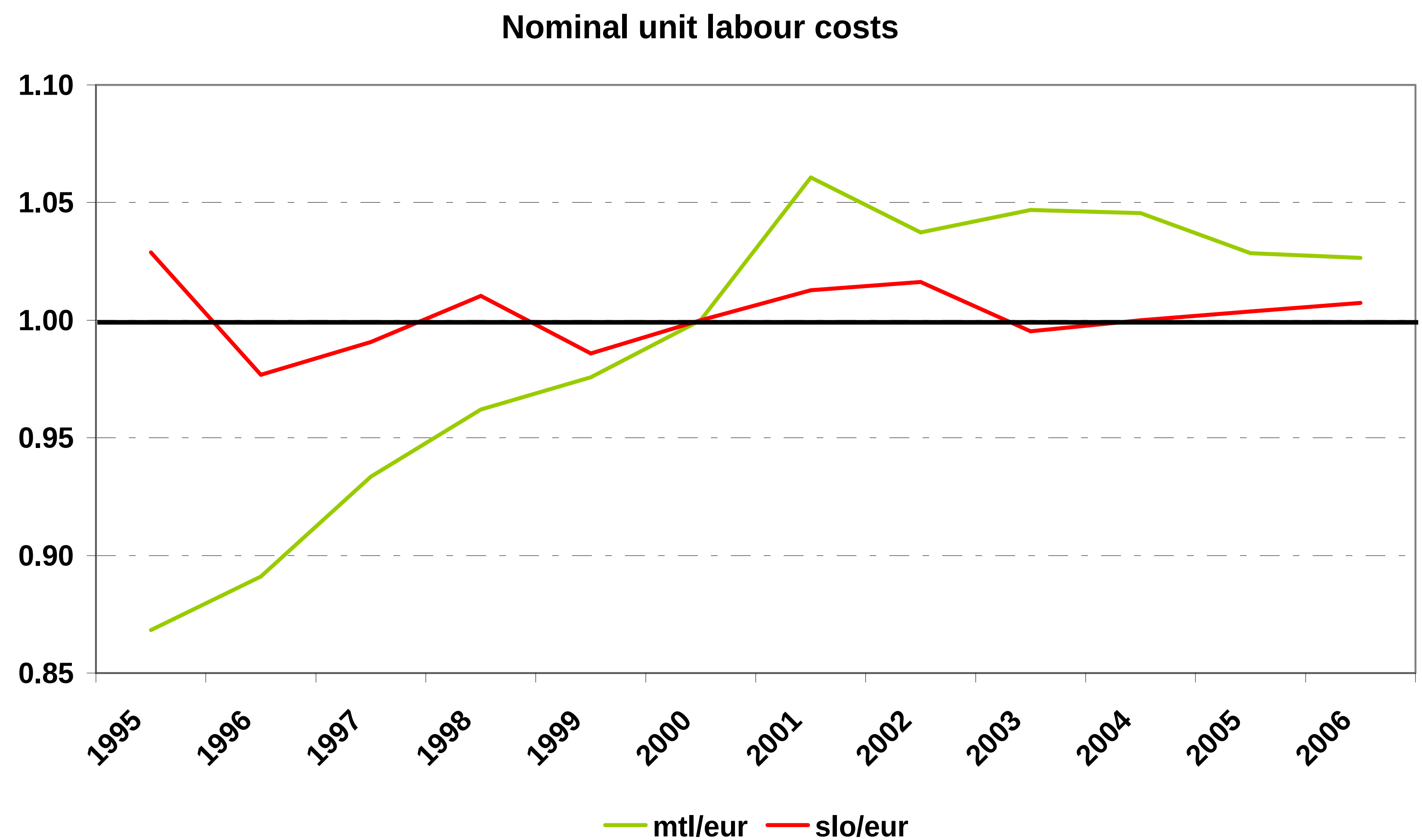


ULC =

$$\frac{\text{COMPENSATION PER EMPLOYEE}}{\text{OUTPUT PER EMPLOYEE (productivity)}}$$

Source: European Commission, AMECO database

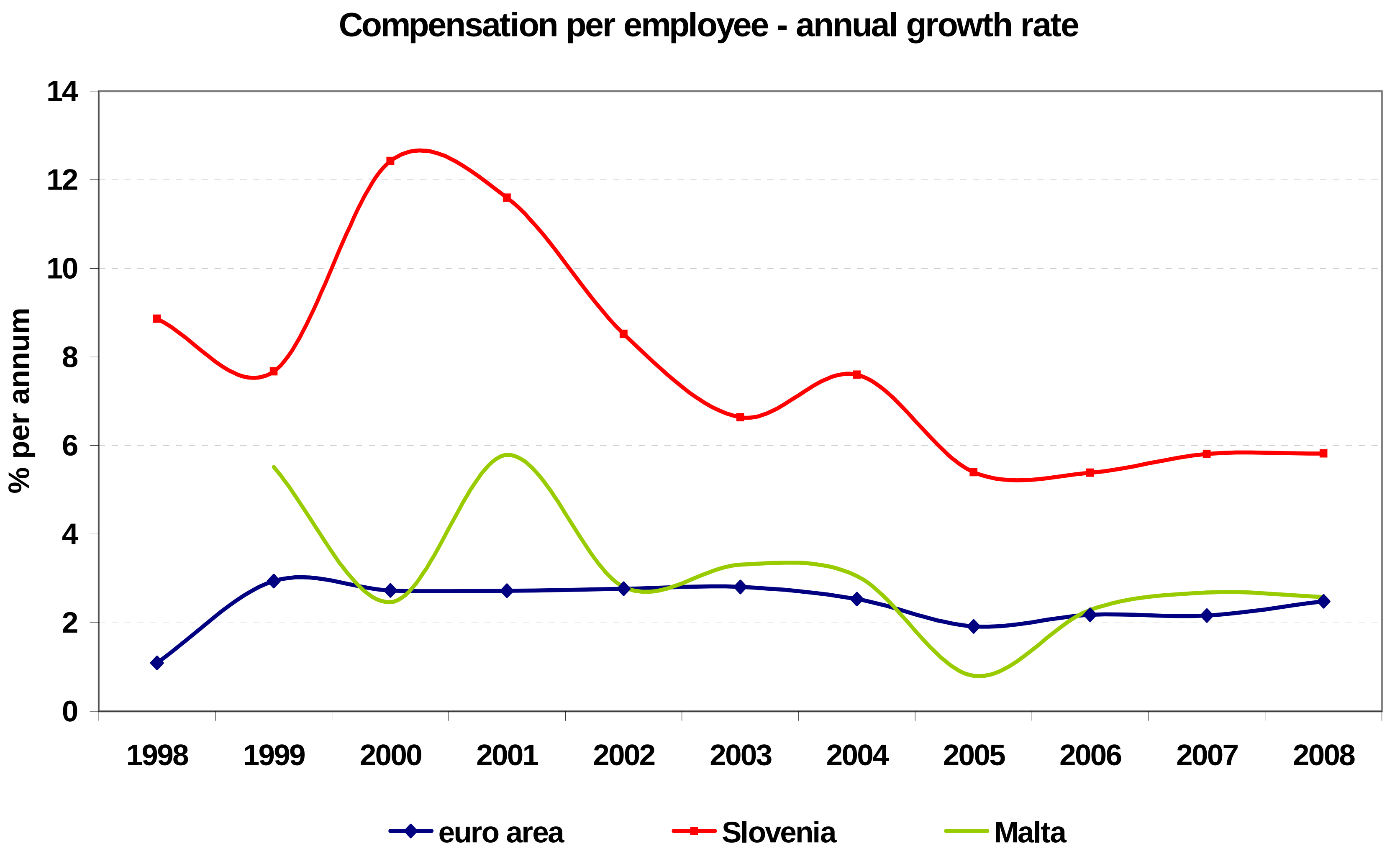
UNIT LABOUR COSTS RELATIVE TO EURO AREA



Source: AMECO database

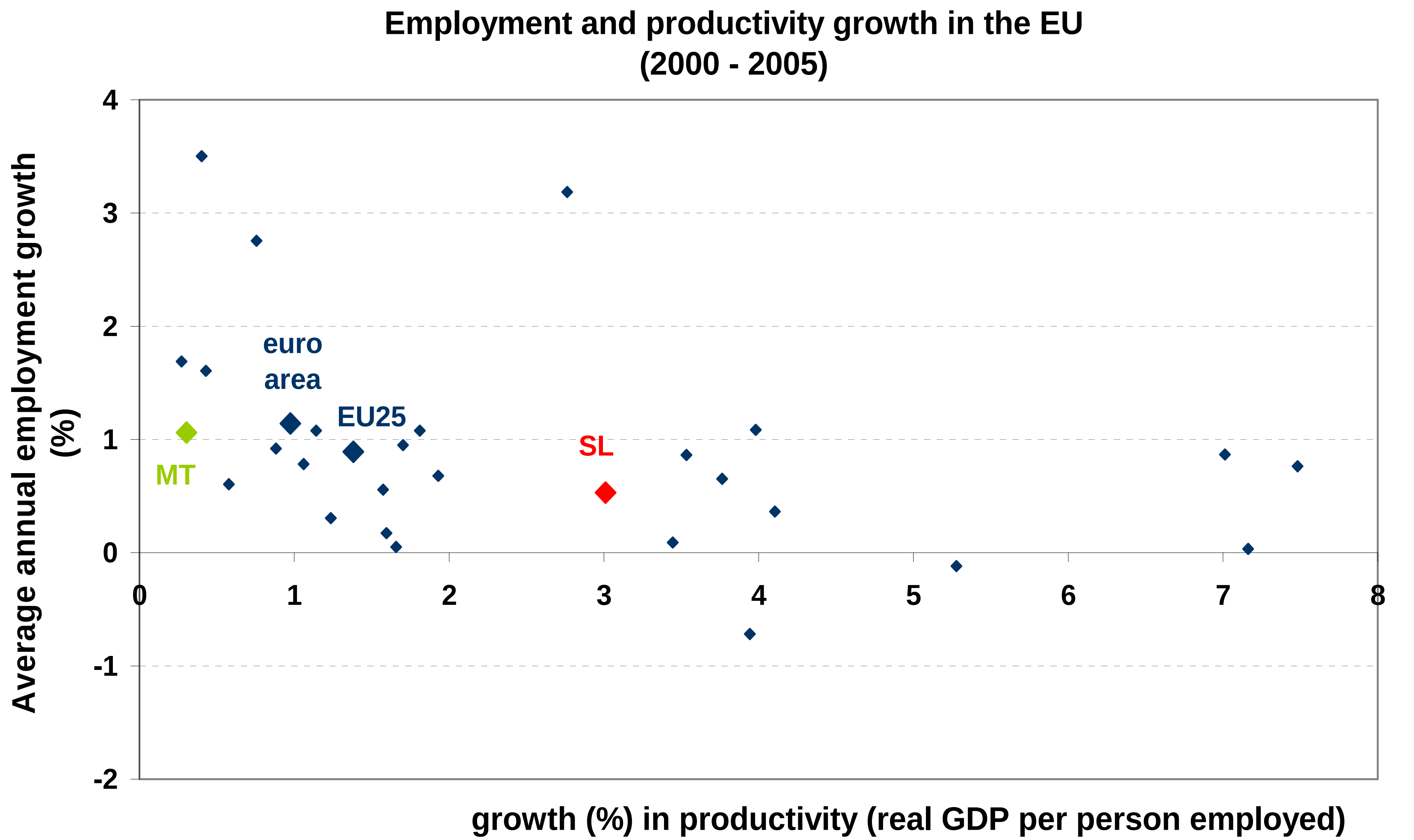
Reducing ULC growth: slower wage growth or faster productivity?

WAGE MODERATION SHOULD CONTINUE BUT MUST BE SUPPORTED BY PRODUCTIVITY GAINS



Source: Slovenia and euro area: AMECO Database. Data for Malta: National Statistics Office and CBM forecasts.

PRODUCTIVITY GAINS AMONG THE LOWEST IN THE EU



Source: European Commission, AMECO Database

THE ROAD AHEAD

- deliver more value for money
  - public and private sector, goods and services
- a more investment friendly environment
- expenditure-driven fiscal consolidation with incentives for self-help
- co-operation of social partners

DELIVER MORE VALUE FOR MONEY

- better use of resources to generate more output
  - in public sector

ensure employees achieve performance standards equivalent to those in private sector

  - in private sector

capital accumulation and technology transfer

ACHIEVING AN ENVIRONMENT THAT IS BUSINESS FRIENDLY

- education and training relevant to industry
- better regulation
- simpler administrative procedures
- longer availability (hours) of key public services
- port reform
- lower taxes

FISCAL CONSOLIDATION MUST BE EXPENDITURE DRIVEN

- pension reform (first pillar is not enough)
- apply means testing more widely
- subcontract to private sector
- ensure it is done well first time
- incentive structure
- penalise tax evasion, undeclared income and inefficiencies

A ROLE FOR THE SOCIAL PARTNERS

the case of Finland

“*established social dialogue has been helpful in the implementation of some reforms … although challenges still remain*”

“*as a small open economy Finland has adopted a pragmatic approach to economic policy issues and often been less resistant to economic reform and deregulation than some of the larger EU countries*”

Erkki Liikanen (2006) Finland, EMU and euro

CONCLUSION

- euro is delivering benefits to current ‘ins’
- in 2007 Malta stands a good chance of fulfilling the criteria for euro adoption
- benefits of euro area membership are not automatic
- the euro is not the answer to all Malta’s problems
- more structural reform is indispensable
- the responsibility to deliver is national: it must be shared by the public sector, business and the social partners

Thank you