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Achieving Sustainable Growth after the Recession

An improving external environment

At this time last year the global economy was entering a severe recession as a result of the shock waves transmitted from the financial markets after the collapse of Lehman Brothers in September. It was only the resolute and timely interventions by governments and central banks that prevented a repeat of the catastrophic consequences of a 1930s-style depression.

The worst of the recession now thankfully appears to be behind us. Financial conditions worldwide have improved. Risk premia in money and credit markets have dropped to pre-crisis levels and equity markets have registered strong gains. Although at a slow pace, growth has resumed, boosted by the strong performance of Asian economies and a degree of stabilization in industrialized countries.

The euro area economy, too, has been improving, and finally emerged from recession in the third quarter on the back of stronger external demand. A word of caution is warranted, however, because the experience of recessions that followed financial crises suggests that the recovery will only be gradual. Both the IMF and the European Commission expect the world economy to expand by only about 3 per cent next year, compared with an average of 5 per cent in 2004 - 2007.¹ This expansion, moreover, is expected to be led by emerging economies, especially in Asia, because growth in the industrialised economies is forecast to average below 2 per cent

The recovery in the euro area is similarly expected to be modest. The Commission forecasts growth rates of 0.7 per cent in 2010 and 1.5 per cent in 2011. Foreign demand is seen as the main engine of growth, while the required de-leveraging of balance sheets in the financial sector, along with excess capacity and unemployment heading for double digit levels will continue to weigh on domestic demand.

In short, a recovery that will be both weak and protracted by historical standards, and characterised by credit constraints and reduced levels of consumption and investment, as both consumers and firms seek to repair balance sheets. In the process, export markets will become more competitive.

.... could benefit the Maltese economy

Although euro area membership cushioned the domestic impact of the global crisis, the economy's resilience has come under strain. As expected in an open economy, the shock was transmitted primarily through the trade channel as external demand shrank. Following average annual growth of almost 4 per cent in 2005-2007, the pace slowed to 2.1 per cent last year. The contraction was particularly pronounced in the manufacturing and tourism sectors, though ongoing expansion in the services sector mitigated the overall decline. The government measures targeted to support affected companies, moreover, served to contain job losses, such that the unemployment rate has remained below that of the euro area. Until very recently, inflation, however, has failed

¹ The IMF's forecasts, published in the *World Economic Outlook (October 2009)*, cover 2009 and 2010. The forecasts in the European Commission's *Autumn 2009 Economic Forecasts* extend to 2011.

to drop as fast as in the euro area, acting as a drag on purchasing power. These trends produced a sharp drop in output in the first half of the year and the Bank expects annual real GDP to shrink by about 2.2 per cent.

Looking ahead, we expect economic activity to pick up over the next two years, but growth, while positive, will likely remain below trend. Exports will be conditioned by weak growth prospects abroad and by unfavourable cost trends in the price-sensitive electronics and tourism sectors. Private consumption should remain relatively subdued on account of continuing high unemployment and slow income growth.

In this scenario, the risks to the domestic macroeconomic outlook could tilt to the downside if the expected revival abroad fails to materialize and if investment falters. So while the impact of the recession has not been severe and seemingly effective counter measures have been, and continue to be, taken, there is clearly no room for complacency. Today more than ever, Malta's heavy reliance on external demand underscores the importance of strengthening competitiveness. Sustainable growth will not be possible unless we consistently produce goods and services that meet the test of competitive and increasingly sophisticated markets.

This represents a major challenge, particularly for an economy that is burdened by both internal and external imbalances. I shall return to the former, and specifically to the fiscal imbalance, later on. On the external front, the current account has, with the exception of 2002, been in deficit since the mid-1990s. This could be a sign of structural weaknesses that limit the economy's ability to expand its productive capacity and exports. In other words, the external deficit may reflect an insufficient degree of international competitiveness.

A medium-term analysis of the relationship between productivity, wages and unit labour costs suggests that this is indeed the case. Between 2000 and 2008, productivity grew by 3.6 per cent but nominal wages increased seven times faster, by almost 28 per cent. As a result, unit labour costs rose by more than 23 per cent during this period, compared with 15 per cent in the euro area. Thus, despite the more moderate pace of relative cost growth during the last few years, Malta must still recover the ground lost in the early years of this decade. In the absence of relevant data, a sectoral diagnosis is not possible, but given that the export sector is a price taker and continues to attract investment, it is likely that the greatest effort must be made by other, mainly non-traded, sectors, including the public sector.

To a large extent, Malta's weak productivity record explains why per capita GDP in relation to the euro area average has stagnated at around 70 per cent since 2003. It is true that this subdued productivity performance was partly offset by higher labour utilisation in the past two years, but the latter is still some 88 per cent of the euro area level. This analysis suggests that the economy's growth potential can indeed be raised. This should be a key objective. As things stand, for example, should the Commission's growth projections prove accurate, in 2011 Malta's real GDP would only have recovered to its 2008 level.

It would appear, therefore, that as the economy responds to a gradual improvement in external demand, it may still be constrained by its own rigidities. Removing these obstacles and correcting the resultant imbalances is, therefore, a precondition for achieving more rapid growth, which in turn is the key to accelerating convergence with euro area income levels.

Faster growth is achievable but depends on

The Roman writer Ovid said that times change and we change with them. That may be so, but what really matters in today's circumstances is how rapidly we read the signs of the times and adapt to them. I will focus on three directions of necessary change. The first is towards greater competitiveness. The second, and related thrust, would be to promote higher productivity. The third focuses on fiscal consolidation and the pursuit of sound public finances. Before proceeding, however, I should stress that none of these objectives is attainable without further structural reforms, debunking the popular notion that the State has an unlimited capacity to satisfy demands for free goods and services and an end to inefficient practices that involve subsidies.

..... greater cost competitiveness

First of all, in Malta's case sustained economic growth depends largely on our ability to attract export-oriented foreign direct investment. Given the past increases in unit labour costs, the only way of maintaining a competitive edge is by ensuring that these costs rise by less than those of our competitors. The magnitude of the task is compounded by the fact that a high proportion of Malta's exports go to non-euro area countries whose currencies have tended to depreciate against the euro.

In this regard, the example of Germany is significant. Despite the appreciation of the euro, the real effective exchange rate based on unit labour costs actually declined by almost 2 per cent in 2000-2008, primarily because wage growth was moderate and was, in any case, accompanied by productivity gains. The resulting strong competitive position enabled Germany to take full advantage of the global rebound, becoming one of the first, and few, countries to register positive growth in the second quarter of this year.

There is a clear message implied here, that wage adjustments not accompanied by more efficient production methods result in a gradual erosion of a country's competitiveness, especially when inflation is driven by internal cost pressures as in Malta today. A priority task, therefore, should be to change market structures and practices that tend to distort prices. A parallel endeavour should be to foster a culture where wage increases reflect higher productivity.

The first challenge then is inflation. We cannot compete successfully in export markets if prices rise faster here than abroad. For instance, despite the downward correction in global food commodity prices since mid-2008, prices in Malta have continued to rise. Last year, a similar movement in restaurant prices reinforced the upward inflation trend. This suggests that some markets do not function efficiently. In this regard, the recent decision to scrutinise the operations of the wholesale fruit and vegetable market is most welcome. The relevant authority should also ensure, however, that the lower cost of imports from outside the euro area resulting from the appreciation of the euro is passed on to the consumer.

Another factor contributing to domestic cost pressures is the mechanism for the partial indexation of wages, or COLA. It is estimated that the COLA accounted for one-half of the increase in the average wage in 2004 - 2008. While its impact on public sector pay is limited up to 2010 by the terms of the collective agreement, this is not necessarily the case in the private sector. Any benefit that this mechanism may be perceived to have in terms of stable industrial relations must be weighed against its potential to ratchet price levels upwards, so that the initial improvement in earnings may prove to be short lived. This is because the higher wage costs that employers incur tend to be passed on in higher end prices, with the resulting inflationary impact feeding into the following year's indexed wage adjustment. Thus, an attempt to restore consumers' purchasing power feeds a wage-price spiral in which there are no winners, only a possible loss of competitiveness.

Experience shows that in a currency union it is only if accompanied by productivity gains that wages can increase without being harmful in the long run. Furthermore, recent studies indicate that wage indexation is a major factor amplifying the transmission of oil shocks to the prices of non-energy products.² Considerable welfare gains could be achieved, therefore, if agreement were reached by the social partners to gradually phase out COLA and replace it with a productivity-linked wage mechanism negotiated at enterprise level.

..... higher productivity

Competitiveness is not only about keeping costs down. It is also about higher productive efficiency and increasing the value added content of exports. Encouraging progress in this direction has been made, especially since Malta joined the EU. One need only mention the expanding pharmaceuticals and aircraft maintenance sectors, as well as the steadily increasing surplus in the services component of the current account, which has remained quite resilient during the recent turmoil.

² *Structural Issues Report 2010*, which focuses on the impact of the energy markets on the macroeconomy. A detailed report is to be published next year in the form of an ECB Occasional Paper.

We cannot, however, rest on our laurels for the record shows that overall labour productivity has declined from more than 90 per cent of the euro area average in 2000 to 79 per cent last year. A key consideration here is the extent to which resources are allocated to capital formation rather than consumed. Between 2000 and 2008 the share of gross fixed capital formation averaged 19 per cent of GDP in Malta, compared with 21 per cent in the euro area. In 2008 the share fell to 15 per cent for Malta. There is clearly scope for improvement. In this regard, the Budget for 2010 provides several incentives that are conducive to a stronger productivity performance, particularly concerning SMEs and research and development.

Beyond capital deepening, improved prospects for productivity growth also require a heightened awareness that inefficient work practices, including over manning, slow down output growth and threaten the sustainability of employment and income levels. The concept of value for money that is increasingly determining consumer behaviour should be given equal importance in the workplace.

There also exists potential for creating a more congenial business climate to reinforce Malta Enterprise's investment promotion strategy. In a recent survey of corporations, a reduction in bureaucracy topped the list of measures that were considered necessary to further enhance Malta's attractiveness as a location for foreign direct investment.³ Education policies, too, can play a role by strengthening the country's human capital, particularly by promoting greater synergies between educational institutions and industry.

In assessing the role of productivity, it is well to reflect on the words of the Nobel laureate Paul Krugman, who said "productivity is not everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker".⁴

.....and sound public finances

The third policy priority is to achieve sustainable public finances. The process of fiscal consolidation must resume in earnest once the recovery materialises. For a start, each year's deficit translates into higher debt and debt-servicing burdens, which already stand at 67 per cent and 3.4 per cent of GDP, respectively.⁵ Put differently, the 196 million euro in interest due on the debt next year is equivalent to what the Government would spend on medicines in three years at today's prices. To complete this perspective, despite the reduction planned from 2011, the general government deficit in that year is still expected to remain just above the 3 per cent benchmark, and the forecast reduction to 2.9 per cent in 2012 is contingent on seemingly optimistic nominal growth assumptions.

What are the options for reducing the deficit? Since any increase in the tax burden, already high at around 40 per cent of GDP, would have a negative impact on competitiveness, expenditure restraint seems to be the only possibility. This option is more complex than it might seem, however, because of the structure of recurrent government spending. Fixed commitments in the form of wages, social transfers and interest on the public debt absorb more than two-thirds of the total. Furthermore, these expenditures are destined to grow autonomously. This is because, while the ongoing reduction in the public service headcount may restrain growth in wage costs, the impact of the slow pace of planned fiscal consolidation on the debt servicing burden and, in the longer term, of population ageing on the health and pensions budgets, cannot be easily avoided. In these circumstances, cutting the deficit while at the same time rebalancing the thrust of fiscal policy towards investment in growth-enhancing projects will be difficult. A determined effort must nevertheless be made.

Areas which offer scope for rationalisation include health care and education, which have both been identified as producing relatively less efficient outcomes in terms of output compared with the EU average. Further savings could also be realised in the areas of social transfers to households and subsidies to enterprises. The latter are still equivalent to about 3 per cent of recurrent expenditure even after substantial recent cutbacks. Subsidies not only aggravate the fiscal burden, they also distort the price-signalling mechanism.

³ *Weathering the challenges*, in Ernst & Young's 2009 *Malta Attractiveness Survey*.

⁴ Paul Krugman, *The Age of Diminished Expectations: US Economic Policy in the 1980s*, MIT Press, 1992

⁵ Estimates taken from the Budget speech 2010.

The implications of this fiscal scenario are far reaching. Two recent reports, one by the Today Public Policy Institute and another by the European Commission, conclude that in the long run Malta's welfare system is unsustainable.⁶ The projected reduction in the working-age population will translate into slower economic growth and will, therefore, negatively impact tax revenues, at the same time as the fiscal burden of a larger population of elderly people increases. The Commission calculates that by 2015 the share of age-related spending in GDP is expected to reach 20.1 per cent, two percentage points up from 2007, mainly due to the increased cost of pensions and healthcare, and will continue to rise thereafter.

The fiscal correction required to bridge the implied sustainability gap clearly cannot be achieved without a culture change regarding the welfare state. Put simply, it needs to be understood that you cannot give away what you do not have. We must, therefore, adopt a more cost-efficient approach to the provision of public goods and services, whereby only those demonstrably in need would benefit. Access to social benefits, healthcare and subsidies should be streamlined through a combination of means testing and market-based mechanisms. In addition, the benefits structure could be further refined beyond the recent Budget measures with a view to making work pay and reducing the disincentives to enter the labour market.

Conclusion

The Maltese economy is experiencing its first major test since it adopted the euro. While membership of the euro area has provided a degree of protection during the crisis, in particular exchange rate stability, the road ahead is still fraught with challenges. Rigidities, whether in institutions, markets or work practices, that impede progress towards cost competitiveness and higher productivity are incompatible with enduring membership of the currency union. They also render the common objective of raising living standards less likely to be achieved.

Needed structural reforms are being implemented, but given the uncertain growth prospects in export markets, the change process needs to be accelerated and given greater focus. The directions for change I have suggested are by no means original because they emerge spontaneously from an analysis of the current state of the economy. They do, however, imply difficult policy choices, not least because they often entail a departure from established practices and the loss of acquired rights. This is undoubtedly a major challenge, but it is also one that cannot be avoided if we want Malta's boat to be lifted by the rising tide, when it comes, along with those of other countries.

⁶ *The Sustainability of Malta's Social Security System: A Glimpse at Malta's Welfare State and Suggestions for a Radical Change of Policy*, Today Public Policy Institute, July 2009 and *Sustainability Report 2009*, European Commission.