Ten years in Economic and Monetary Union:

Malta's experience

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Policy Note

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[2] Material included in this Policy Note was presented at a conference organised jointly by the Central Bank of Malta and the School of Economics and Finance of Queen Mary University of London on 13 April 2018 as well as at a public lecture on the subject which was held in Malta on 3 July 2018 (available at https://www.centralbankmalta.org/file.aspx?f=71886). The cut-off date for statistics quoted in this note is 8 November 2018.

Abstract

This note compares Malta's economic performance after it adopted the euro in 2008 with developments in earlier years. It also examines how the Maltese economy's performance in relation to the euro area changed over time, with reference to selected macroeconomic indicators. The note documents how Malta transitioned from an average, or below-average performer, to one of the best performers in the euro area in economic terms.

It also tries to draw some lessons based on Malta's first ten years as a euro area Member State. It concludes that in Malta's case, participation in Economic and Monetary Union has been an enabling factor for economic growth. However, the absence of major financial and fiscal shocks that characterised several other countries in the euro area, as well as structural reforms aimed at enhancing the economy's efficiency and resilience to shocks through diversification were also important.

JEL Classification: F42, F43, F45

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Executive Summary

In 2018 Malta marked the first decade since it adopted the euro as its currency. Since this important decision represented a substantial policy shift for the Maltese economy, for instance by abandoning the possibility of an independent monetary and exchange rate policy, this policy note attempts to answer three questions.

- **How does the performance of the Maltese economy post-euro adoption compare with that in earlier years?**

The Maltese economy is very open and over time has evolved into a services-oriented economy. This partly reflects Malta's accession to the European Union (EU), which facilitated trade with other countries in a wider set of products and allowed Malta to participate in the Single Market for services. In contrast, before EU accession, trade facilitation arrangements were based on an Association Agreement that focused on selected goods. In more recent years, the shift towards services was also supported by substantial immigration flows of foreign workers. In the process, the economic base has become more diversified, allowing activity to grow at a fast pace and the closure of most of the gap, in income per capita terms, with the euro area average. The steady pace of economic expansion was reflected in a relatively fast pace of job creation and a significant decline in the unemployment rate. The post-euro adoption period also features significant shifts in Malta's fiscal balance and its external balance, with both swinging from deficit to surplus.

- **Is Malta's experience in line with that of other countries?**

Since adopting the euro, the Maltese economy transitioned from an average, or below-average performer, to one of the best performers in the euro area. For many years, annual consumer price inflation in Malta based on the Harmonised Index of Consumer Prices (HICP) stood above the euro area average. This has also been the case after Malta started to participate in the Economic and Monetary Union (EMU), possibly reflecting more rapid economic growth in Malta relative to the EU. That said, in both the euro area and in Malta, HICP inflation has recently fallen to levels that are low from a historical perspective.

Long-term government bond yields remained among the lowest in the EU, partly reflecting the improvement in Malta's fiscal situation as well as the absence of banking sector difficulties which elsewhere required government support and pushed sovereigns' financing costs significantly upwards. In contrast, the lending rates charged by local banks to the private sector in Malta, which previously were among the lowest in the EU, have recently been among the highest, clustering around levels reported in countries that have experienced banking sector difficulties.

This suggests that the private sector in Malta has benefited to a limited extent from the accommodative monetary policy stance of the European Central Bank (ECB). Domestically therefore, support from the accommodative monetary policy stance did not materialise through the bank lending channel, but rather from the depreciation of the euro and the more stable economic environment that the ECB's monetary measures fostered in Malta's trading partners.

In the area of public finances, Malta became one of the best performers based on the deficit and debt-to-GDP ratios. This also holds true on the basis of the structural fiscal balance, although on this basis

Malta's performance was, for most years, only marginally better than the euro area average. The years 2016 and 2017 show a more marked improvement.

As regards labour costs, on average, the post-2008 period features lower growth in unit labour costs (ULC) compared with the period 2000 to 2007, with ULC growth in the latter period converging to that of euro area countries which suffered from fewer economic imbalances in the last decade, such as Germany. However, those countries that were more severely affected by the financial and sovereign debt crises recorded a much more pronounced moderation in labour costs. As a result, Malta's ULC growth remained above the average for the euro area as a whole. Based on this metric, it seems that earlier losses in external competitiveness have not yet been offset, despite the recent moderation in wage costs in Malta.

- **What are the main lessons learned from Malta's experience in the euro area?**

An interesting feature of the Maltese economy during this period is the fact that faster GDP growth relative to the euro area materialised despite the fact that the transmission of the ECB's expansionary monetary measures to the real economy has lagged that in other countries.

This can be attributed to a number of factors that ensured a smooth integration in EMU, some of which were relevant in the run-up to euro adoption. These included the fact that the Government and the monetary authorities agreed at the outset on the benefits of the single currency and on the need to correct the economic imbalances prevailing before euro adoption. This helped garner consensus on the need for fiscal consolidation, a better utilisation of the country's human resources and wage awards that reflect more closely productivity developments, although progress in these terms was modest in the first years of Malta's EMU membership. Malta's positive experience in the euro area also owes to its long and positive track record with a fixed exchange rate regime and a high degree of economic convergence with the euro area already achieved at the time of EU accession.

Once in the euro area, policy making in Malta came under pressure to embrace the enhanced discipline associated with the EU's economic surveillance mechanisms, in particular in the area of public finances. Most of the improvement in this area materialised after 2013, as the authorities began to limit recourse to temporary revenue-raising measures and focus instead on revenue measures with a more lasting impact, launched expenditure reviews and established an independent Malta Fiscal Advisory Council (MFAC). The absence of banking sector stress and of Government support to the domestic financial sector avoided a sharp deterioration in public finances, which would have compromised fiscal consolidation to progress at a sufficiently ambitious yet socially acceptable pace.

Malta's solid performance in recent years also significantly reflects the pursuit of reforms which unlocked the economy's potential to attract private investment and increase labour supply to accommodate demand, also through the integration of a sizeable flow of foreign workers in the domestic labour market. This enabled a rapid pace of income convergence without undue cost and price pressures at a time when Malta's national population of working age was in decline.

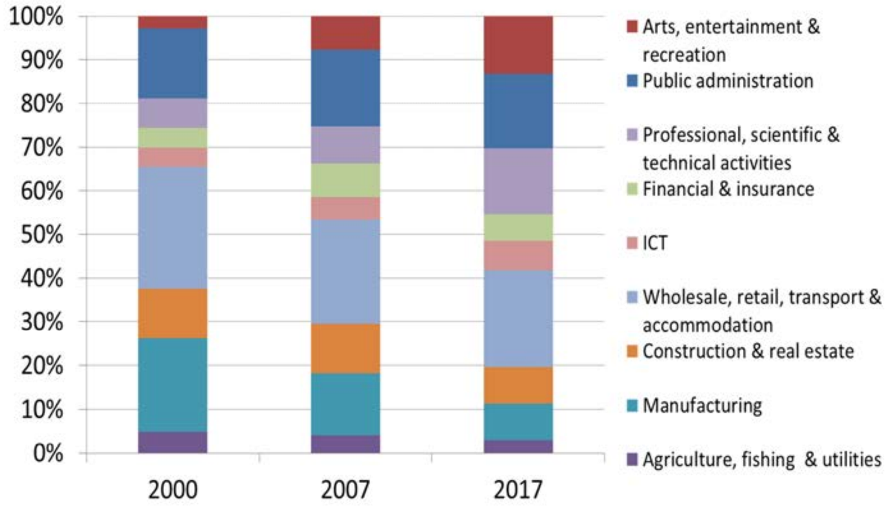
Overall, Malta's experience suggests that while participating in EMU carries with it significant growth opportunities, it alone cannot guarantee success. Economic performance is largely shaped by properly-paced and complementary reforms.

How does the performance of the Maltese economy post-euro adoption compare with that in earlier years?

The Maltese economy is the smallest in the EU. A lack of natural resources has conditioned economic activity to rely to a larger extent on services than on manufacturing activities, while also rendering the Maltese economy a very open one in terms of trade and investment linkages with trading partners.

The orientation towards services has become even more prominent in recent years, with the share of private market services in gross value added (GVA) exceeding 68% in 2017, up from around 52% in 2000 (Chart 1).

Chart 1
SECTOR SHARE IN GROSS VALUE ADDED
(%)



Source: National Statistics Office.

Most of this increase occurred over the period 2003-2007 and in the period 2011-2015. The increase between 2003 and 2007 was partly supported by Malta's accession to the EU and the country's ability to benefit from the Single Market in areas previously affected by trade restrictions. While Malta already benefited from facilitated access to trade with the EU in terms of a 1971 Association Agreement, the latter only covered trade in selected goods. As such restrictions were eliminated on a wider set of products and services, new industries developed and established firms were able to tap new markets and grow faster. In the more recent period, the continued shift to services reflected a deliberate effort to diversify activity in higher value added activities as well as the implementation of reforms which boosted the growth potential of the economy. In particular, this period was characterised by substantive reforms in the energy sector and enhanced labour activation policies. Steady growth in the number of foreign workers also supported the development of the services sector in Malta.[3]

Over time, the composition of services and manufacturing has also changed. In particular, the growth of professional and business services as well as the arts and entertainment sector reduced the

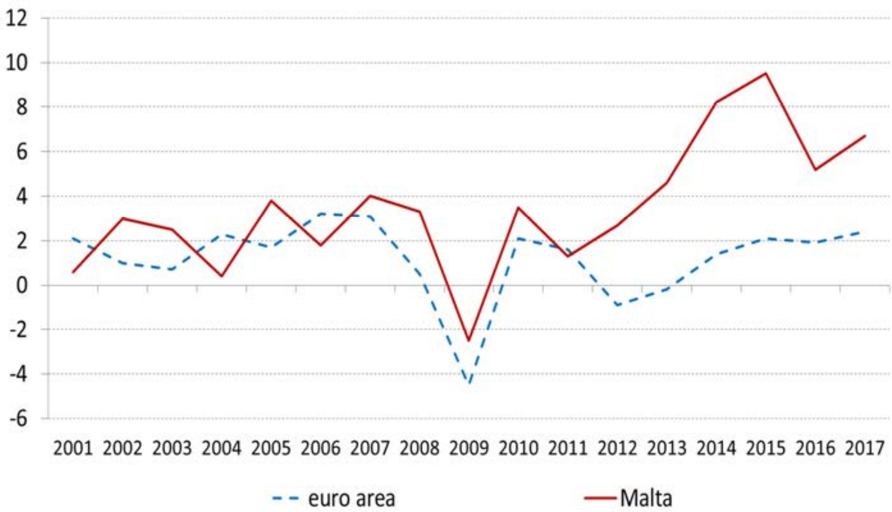
[3] For a more comprehensive review of these trends, see Grech, Micallef and Zerafa (2016).

economy's dependence on tourism and on wholesale and retail activities, achieving a more balanced composition of services activity.

Within the manufacturing sector, new activities have also emerged, including aircraft maintenance and design. Some pockets of industry became increasingly oriented towards capital and knowledge intensive activities, such as generic pharmaceuticals, while the share of traditional operations such as textiles and furniture continued to decline, as operators in these sectors consolidated their activities or even closed down. Several firms also adopted modern technology and made better use of sub-contracting.

The post-euro adoption period is also characterised by above-average GDP growth and a relatively fast pace of income convergence, though particularly in the second half of the decade post-euro adoption (Chart 2). Between 2008 and 2012, GDP growth in Malta averaged 1.7%, while in the euro area it averaged -0.2%. In the following five-year period, GDP growth in Malta averaged 6.8%, whereas it was only 1.5% in the euro area, as the latter recovered slowly from its second recent economic contraction in 2012. Moreover, while in the period 2013 to 2017 GDP growth in Malta exceeded the pre-crisis average by a wide margin, the pace of expansion in the euro area remained milder than that recorded between 2000 and 2007.

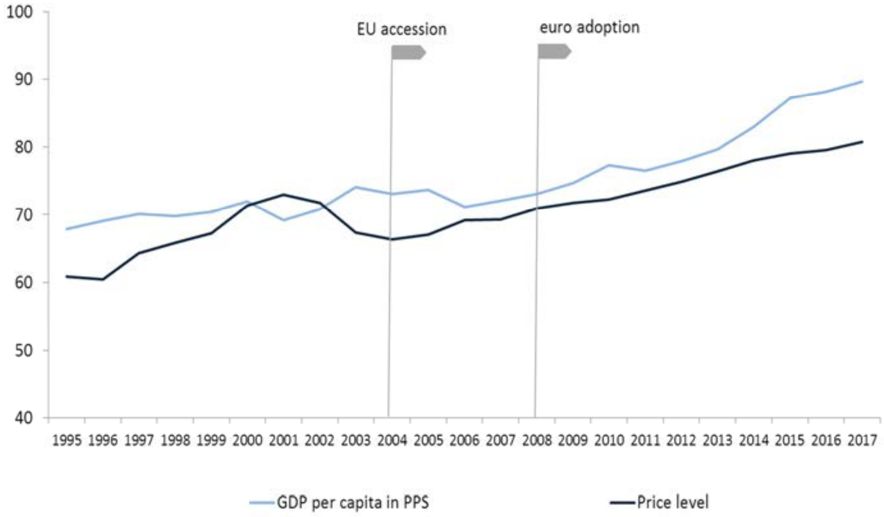
Chart 2
REAL GDP GROWTH IN MALTA AND IN THE EURO AREA
(annual % change)



Source: Eurostat.

As the rate of economic expansion in Malta outpaced the euro area average by a wide margin, income per capita - measured on the basis of GDP in purchasing power standards (PPS) - rose from just below 70% of the euro area average in 2000, to 72% in 2008, before reaching around 90% by 2017, with most of the increase arising since 2012 (Chart 3).   The price level has also converged further, though at a much more gradual pace.

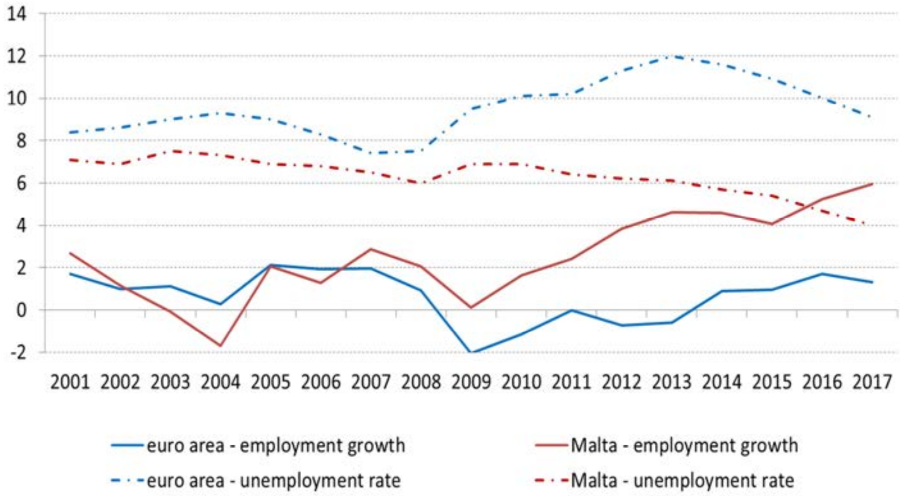
Chart 3
INCOME AND PRICE CONVERGENCE
(euro area = 100)



Source: Eurostat.

The faster economic momentum in recent years was in turn reflected in the labour market, with Malta consistently recording faster growth relative to the euro area average according to the Labour Force Survey. The unemployment rate fell from rates of between 7.0% and 8.0% during most of the period 2000 to 2012, to 5.7% in 2014 and 4.0% in 2017, less than half the average rate for the euro area as a whole. The unemployment rate fell despite an increase in the labour supply, as the number of jobs created through economic diversification was more than sufficient to meet the increase in the number of persons available to work.

Chart 4
EMPLOYMENT AND UNEMPLOYMENT
(annual % change, % of labour force)



Source: Eurostat.

The favourable development of the labour market was supported by new active labour market policies aimed at lifting the long-term unemployed and other disadvantaged groups from inactivity, as well as programmes that encourage re-skilling and entrepreneurship. Such measures included fiscal incentives for single parents and women, schemes that taper welfare benefits, an extension of vocational learning programmes as well as enhanced co-ordination between industry and academia. A pension reform was also launched, along with incentives to postpone retirement.

The post-euro adoption period also features significant shifts in Malta's fiscal situation and in its external balance. For many years, fiscal policy in Malta served as the major economic stabilisation tool, given that monetary policy focussed on preserving a sustainable level of external reserves to ensure credibility in the pegged exchange rate. This in turn resulted in an accumulation of national debt and a relatively large interest rate burden. This trend, however, reversed in recent years.

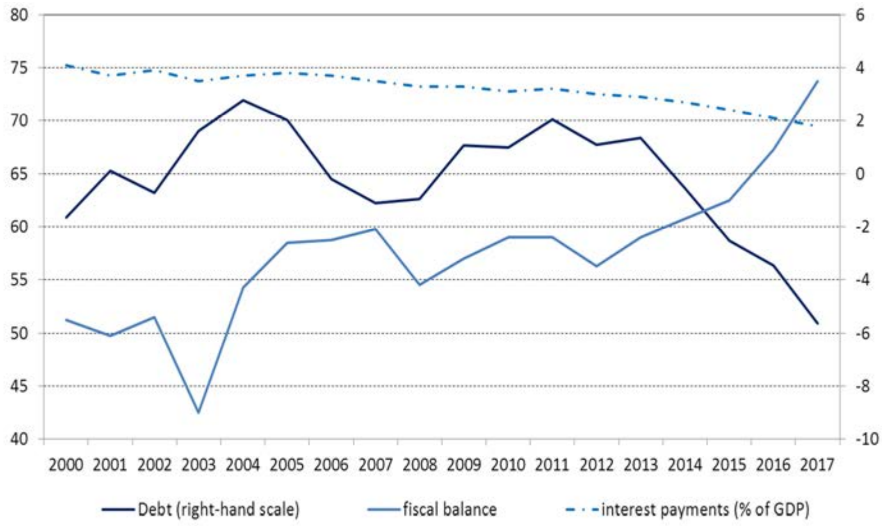
In 2016, general government recorded a surplus for the first time in several years. The fiscal balance improved further in 2017, with both the European Commission and the Government expecting that a surplus will also prevail in the coming years. The debt ratio has meanwhile decreased below the 60% Treaty reference value, to levels that are closer to 50%, and is projected to fall to below 40% by 2021.

The improvement in public finances was neither immediate nor consistent. It was especially marked in two phases. The first phase constitutes the period immediately following Malta's entry in the EU, as the country was engaged in an effort to fulfil the Maastricht criteria. Progress was uneven and almost halted in the period 2009–2013, with the headline deficit during the period ranging between 2.5% and 3.5% of GDP. In fact, during this period, the European Commission launched the Excessive Deficit Procedure with Malta twice.

The second phase started in 2014, when the deficit narrowed to 1.7% of GDP, and continued to progressively improve in the immediate years. A number of factors contributed to this improvement. These include the very favourable domestic economic environment and dynamic labour market, which supported tax revenue growth, as well as efforts to tap new sources of financing, notably the Individual Investor Programme (IIP) since 2014.

Public finances in Malta also benefited from the low-interest rate environment engendered by the accommodative monetary policy of the European Central Bank (ECB), with interest payments by government decreasing from 3.5% of GDP in 2007 to around 2% recently (Chart 5).

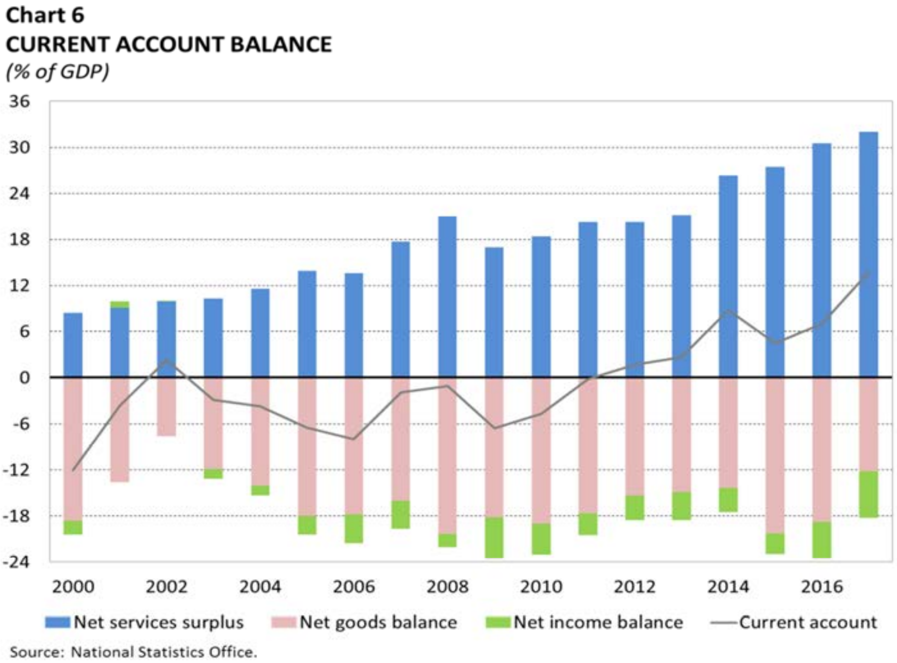
Chart 5
GENERAL GOVERNMENT BALANCE, INTEREST PAYMENTS AND DEBT
(% of GDP)



Source: Eurostat.

The current account of the balance of payments has meanwhile swung from a deficit to a surplus (Chart 6). Apart from the amelioration in government finances, the improvement in Malta's external balance since 2007 also reflects a recovery in the savings rate of the private sector as well as structural changes which had the effect of lowering import intensities. For example, the diversification of energy sources and greater efficiency in the generation of electricity have reduced the reliance on oil imports. At the same time, the shift from capital-intensive industries to more labour-intensive sectors reduced the need for capital goods imports. The development of new services activities in Malta also supported faster growth in exports of services and in the surplus on services.[4]

[4] A fuller account of developments affecting Malta's current account balance is available in Grech (2016) and in Grech and Rapa (2016).



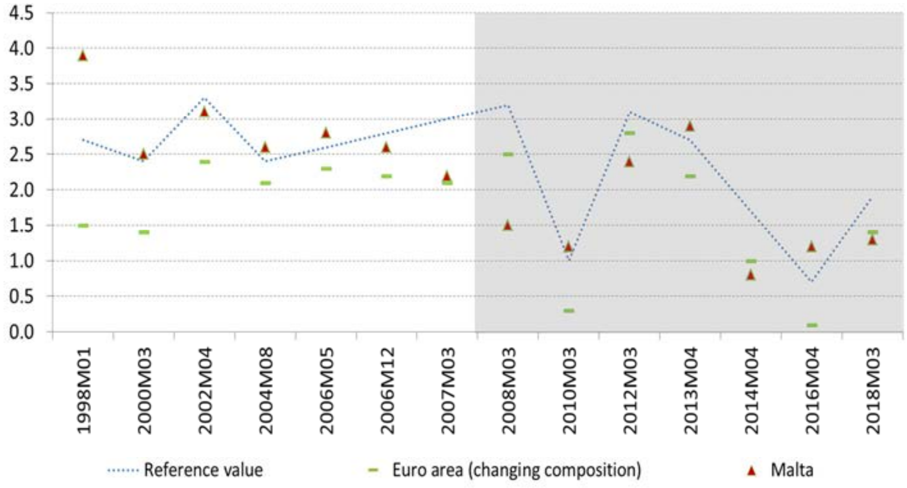
Is Malta's experience in line with that of other countries?

Since it adopted the euro, Malta has gradually transitioned from an average, or below-average performer, to an above-average performer in economic terms.

HICP inflation, which is the basis for the ECB’s price stability definition, typically exceeded the euro area average and this remained the case, though to a lesser extent, in recent years. As was the case in other euro area countries, since 2014 HICP inflation in Malta has moderated to levels that can be considered very low from a historical perspective. From this point of view, Malta’s experience was similar to that of other euro area countries, as the disinflation process is a feature that has been also observed in other countries (Chart 7).

Inflation developments in Malta can also be cast in terms of an ex post, hypothetical assessment of the official inflation criterion specified under Article 140 (ex article 121.1) of the Treaty on the Functioning of the European Union, which gauges inflation in relation to that prevailing in the three best performing EU countries. This broadly suggests continued convergence with the other countries. In particular, Malta’s HICP inflation rate remained consistently below the reference value applied in official convergence assessments until 2012. Subsequently, HICP inflation in Malta exceeded that in the euro area in two instances, with the more significant deviation occurring in 2016. Such deviation seems justified on economic grounds.

Chart 7
HICP INFLATION
(annual % change, 12-month moving average)



Sources: Eurostat, European Commission Convergence Report 2018.
Dates in this chart correspond to the cut-off months considered in Convergence Reports.

In particular, at the time the 2016 convergence assessment was concluded, 11 Member States had a negative inflation rate. The three countries selected for the determination of the reference value for the inflation criterion had inflation rates of between -0.6% and -1.0%, with the reference value set at 0.7%.[5] This is well below the ECB's definition of price stability and it is arguable whether this is an ideal benchmark to aim for.

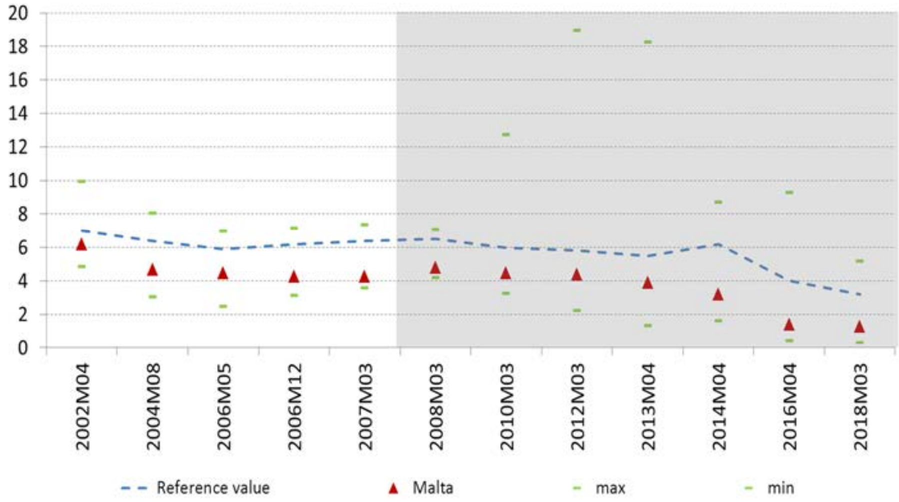
Malta's relatively high inflation outcome in recent years also reflected an exceptionally fast pace of growth that was not observed in other countries. Indeed, one may have expected even higher inflation than that recorded, given the tight economic conditions in Malta in the last three years, though the extent of the low inflation environment abroad and the high import content of domestic consumption have restrained inflation.

Long-term interest rates, based on yields on ten-year government bonds, have also evolved in line with the relevant Maastricht criteria (Chart 8). Such rates have traditionally hovered towards the lower bound of the range of values for other countries. This remained the case also post-2008, with the ten-year yield in Malta remaining comfortably below the applicable reference value applied in convergence assessments and only a touch above the lowest rates recorded in the rest of the EU. This partly reflects the fact that Malta was spared from the increase in spreads triggered by the financial market tensions that characterised several other Member States since 2008. It may also reflect progress with fiscal consolidation and the progressive reduction in the debt-to-GDP ratio. Indeed, the negative spread between the domestic ten-year government bond yield and the reference value widened in 2014. This marked the first year since 2000 with a fiscal deficit of less than 2% of GDP. Another factor that may have contributed to contain borrowing costs for the Maltese Government, was the further gradual reduction in the share of short-term debt in total government debt, along with an unremitting willingness

[5] ECB (2018) and European Commission (2018).

of households and domestic monetary and financial institutions to subscribe to Malta Government Stocks. This is in contrast to the situation in a number of other euro area countries where concerns about debt sustainability often translated into higher risk premia on government debt securities in attempts to stave off investor sell-offs.

Chart 8
LONG-TERM INTEREST RATE
(% per annum, 12-month moving average)



Sources: Eurostat, European Commission Convergence Reports 1998 - 2018.
Dates in this chart correspond to the cut-off months considered in Convergence Reports.

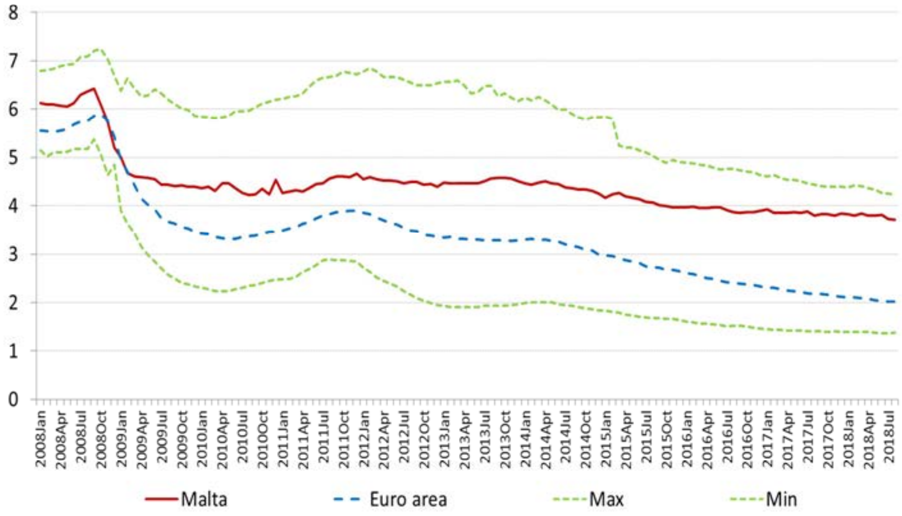
A different picture emerges from the lending rates charged by local banks to the domestic private sector. While retail rates in Malta initially stood in the middle of the range of values recorded in other countries, they have recently moved closer to those prevailing in countries which experienced banking sector difficulties (Charts 9 and 10).[6] This suggests that households and firms in Malta have not benefited to the same extent as their counterparts in other euro area countries from the low policy rates of the ECB and confirms other evidence that the pass-through of the ECB's policy rates to domestic interest rates has been weaker than in the euro area.[7]

[6] ECB (2013) assesses differences in interest rate pass-through in the four largest euro area economies based on pass-through models that account for the impact of sovereign tensions and risk factors that affect interest rate setting behaviour. It finds evidence that risk factors and sovereign debt spreads have had a strong upward impact on bank lending rates in Italy and Spain, while illustrating the higher cost of borrowing in these countries relative to the euro area average.
[7] See Micallef, Rapa and Gauci (2016).

Chart 9

MFI INTEREST RATES ON LOANS TO NON-FINANCIAL CORPORATIONS

(outstanding amounts, all maturities, % per annum)

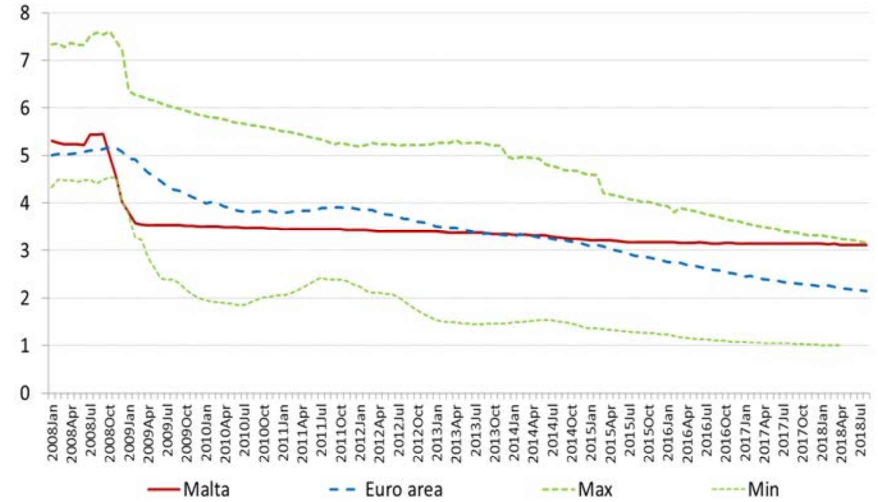


Source: ECB SDW.
Last observation: August 2018.

Chart 10

MFI INTEREST RATES ON LOANS TO HOUSEHOLDS FOR HOUSE PURCHASE

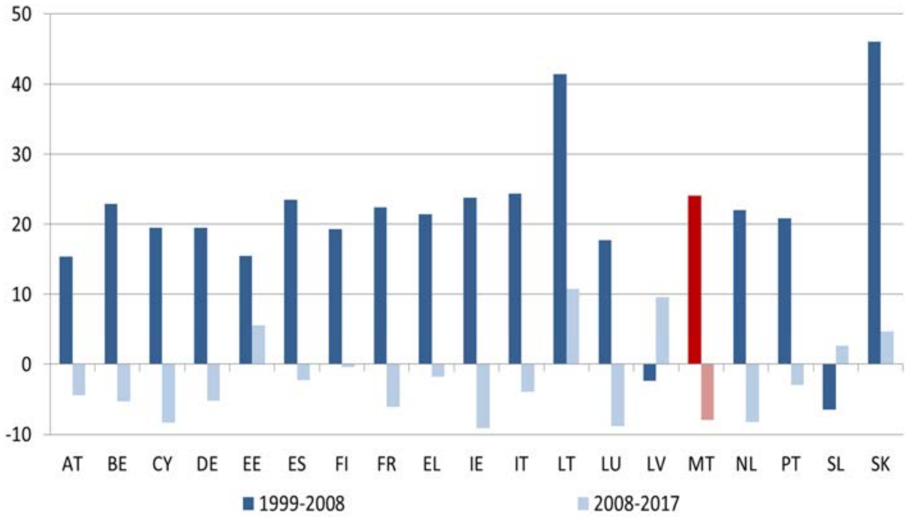
(outstanding amounts, all maturities, % per annum)



Source: ECB SDW.
Last observation: August 2018.

In Malta's case, the private sector appears to have benefited to a larger extent from the fact that the ECB's accommodative monetary policy steered a more stable and growth-friendly environment in trading partners and from the weakening of the euro that followed the latest monetary policy easing cycle of the ECB. While retail interest rates may not have responded fully to the ECB's policy rate cuts, the effective exchange rate, which is a measure of a country's competitiveness and one of the indicators typically assessed in Convergence Assessment has developed broadly in line with that in other countries; mostly appreciating between 2000 and 2008, before weakening in more recent years (Chart 11). The weaker euro contributed somewhat to the emergence of a surplus on the current account of the balance of payments, although other factors such as the structural shift to services and lower energy intensity played a more significant role.

Chart 11
NOMINAL EFFECTIVE EXCHANGE RATE
(cumulative % change, 38 trading partners)



Source: ECB SDW.

Another feature of the Maltese economy since euro adoption is the containment of labour costs. For several years preceding the adoption of the euro, growth in ULC in Malta exceeded that in the euro area and was skewed towards the relatively high rates recorded in countries that subsequently were hit hardest during the crisis. In contrast, during the period 2000–2007, countries like Austria, Germany and Finland, which had fewer imbalances, recorded negative or very modest growth in ULC (Table1). Over the period 2008 - 2017, ULC growth in Malta converged to that of these countries. Moreover, while pre-crisis ULC growth in Malta was almost double that in the euro area, since euro adoption only a moderate difference can be detected.

The countries hit hardest by the sovereign and financial crises in Europe, such as Greece, Ireland and Spain, have recorded an even more significant moderation in ULC growth. These countries have hardly recorded any increase in labour costs measured on this basis, as their economic adjustment programmes with official institutions typically mandated widespread restrictions on wage awards aimed at restoring fiscal sustainability and external competitiveness. On balance, this suggests that labour costs in Malta are evolving more in line with those in the euro area as a whole. At the same time, ULC growth in Malta continues to exceed that in the euro area indicating that any past losses in external price competitiveness based on this metric have not reversed yet.[8] Moreover, the deceleration in ULC growth since 2008 was concentrated in the post-2014 period and largely driven by stronger gains in productivity, as the moderation in wage growth progressed more gradually over time.

[8] ULC figures should be interpreted with caution. ULC growth is only one measure of external competitiveness. Other indicators of competitiveness, including non-price measures are also relevant, and should be considered when gauging a country's external competitiveness. The figures presented in Table 1, moreover, are based on total economy figures and need not be representative of price competitiveness in the business economy sector.

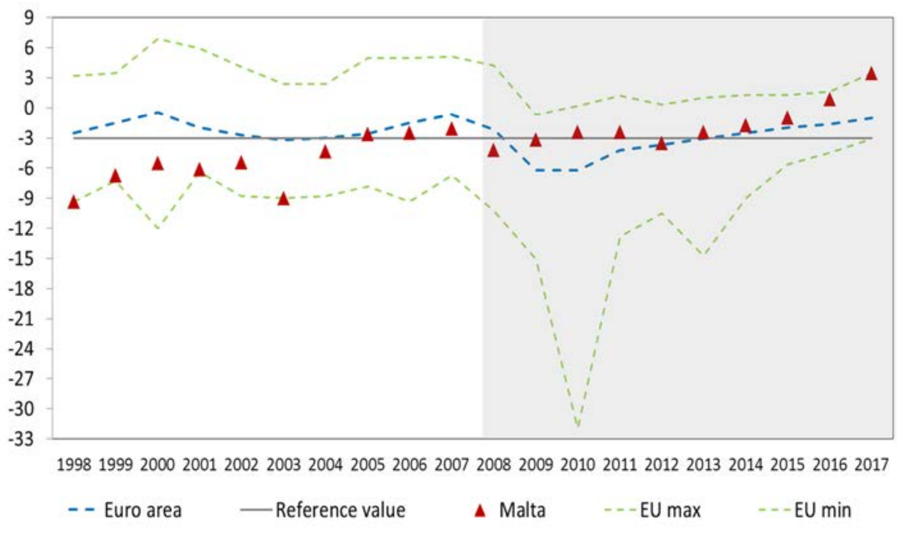
Table 1

GROWTH IN UNIT LABOUR COSTS *(Annual percentage changes, period averages)*	2000-2007	2008-2017
Euro area	1.5	1.4
Germany	-0.1	2.0
Ireland	3.8	-3.1
Greece	3.5	0.0
Spain	3.2	0.1
France	1.8	1.4
Luxembourg	2.9	3.2
Malta	2.6	1.9
Austria	0.8	2.1
Slovenia	4.5	1.8
Slovakia	3.6	1.9
Finland	1.1	2.1

Source: Eurostat

As regards fiscal developments, while Malta's fiscal performance pre-euro adoption undershot that in the euro area as a whole, more recently fiscal outturns outperformed the euro area average. In 2017, Malta recorded the highest surplus in the European Union (Chart 12).

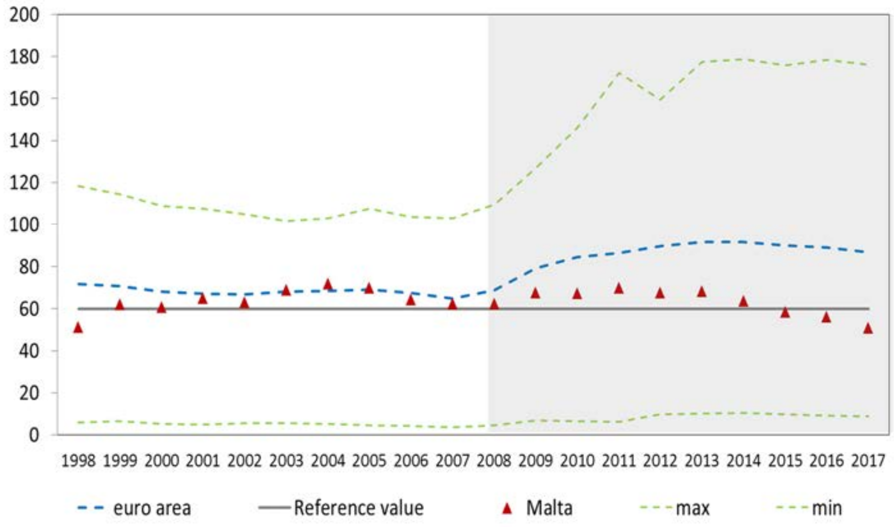
Chart 12
GENERAL GOVERNMENT BALANCE
(% of GDP)



Source: Eurostat.

The paths of the debt-to-GDP ratio have also diverged. In particular, since 2007, the government debt-to-GDP ratio in the euro area edged up faster than that in Malta. In the more recent period 2014 to 2017 although the debt ratio fell in both economies, it fell faster in Malta. While in Malta the debt ratio had fallen below the 60% Maastricht reference value already in 2015, in the euro area the ratio continues to exceed 80% (Chart 13).

Chart 13
GENERAL GOVERNMENT DEBT
(% of GDP)



Source: Eurostat.

This difference in debt trajectory partly reflects the swing to a fiscal surplus in Malta. In contrast, the euro area as a whole continues to record a deficit, with the latter equivalent to 1.0% of GDP in 2017. Another important factor is the absence, locally, of banking sector interventions by the Government. Support to the financial sector weighed on the debt position of a number of other euro area sovereigns in recent years. In the fiscal domain, Malta has thus effectively transitioned from being one of the worst performers to one of the best performers in the EU.

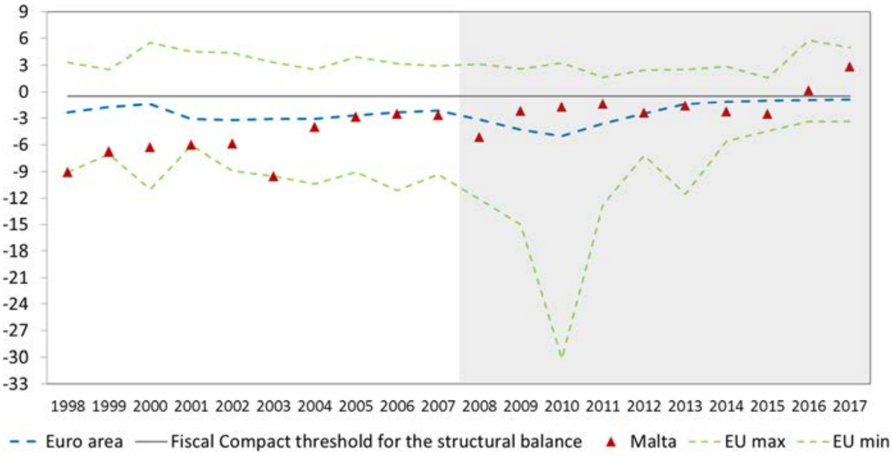
The amelioration in the headline fiscal balance has also been reflected in the cyclically-adjusted fiscal balance. In particular, while ahead of euro adoption, this measure showed a deficit, in 2016 and 2017 Malta recorded a close-to-balance and a surplus, respectively, in cyclically-adjusted terms. The corresponding measure for the euro area as a whole has also improved over time, with a cyclically adjusted deficit of 0.9% of GDP in 2017, which is, however, short of the limit of 0.5% for the structural deficit imposed by the Fiscal Compact for countries with a debt-to-GDP ratio that is not significantly below 60% (Chart 14).[9]

On this basis, on average since 2008, the Maltese economy seems to have performed only marginally better than the rest of the euro area. It only outperformed the euro area average by a significant margin between 2009 and 2011 and again in 2017. In 2017 government revenue (adjusted for the economic cycle) was partly boosted by intakes from the IIP, and substantial increases in labour participation mostly driven by structural reforms. Thus, while the record so far indicates compliance with the minimum requirements of the Fiscal Compact, as regards the structural balance, adherence to its requirements in future rests on the implementation of measures that can compensate for a potential

[9] The cyclically-adjusted balance differs from the structural balance, as apart from the economic cycle, the latter also takes into account temporary measures. Cyclically-adjusted balances were used in this note, as data on the structural balance data are only available since 2010. The cyclically-adjusted balance provides a reasonable approximation for the structural balance as long as temporary measures are small.

decrease in IIP flows while maintaining the momentum in reducing economic inactivity and dependence on social benefits.[10]

Chart 14
CYCLICALLY-ADJUSTED GENERAL GOVERNMENT BALANCE
(% of potential output)



Source: European Commission AMECO datbase.

The swing from a fiscal deficit to a surplus was also reflected in the current account of the balance of payments. Since 2007, Malta's current account position improved by more than 15 percentage points, which is one of the largest improvements recorded across the EU. In 2017, in fact, Malta recorded the largest current account surplus in the European Union.

What are the main lessons learned from Malta's experience in the euro area?

An interesting feature of the Maltese economy since 2008 is that it has recorded very fast growth in parallel with the correction of fiscal imbalances and thus limited support from fiscal policy. Moreover, Malta benefited only to a limited extent from the accommodative monetary policy of the ECB.

Malta's smooth integration in the euro area can be attributed to a number of factors.

In the run-up to euro adoption, the country benefited from clear target dates and a shared vision between the Government and the monetary authorities on the desirability of participating in the single currency area as early as possible. The Central Bank of Malta pronounced itself unequivocally on the long-term benefits of EU membership and on the benefits of an early adoption of the single currency.[11] This made it easier to garner the necessary support among the social partners to pursue fiscal consolidation and better utilise the country's human resources, The post-2008 period is characterised by several measures aimed at discouraging reliance on social benefits, encouraging labour market participation and re-skilling and supporting entrepreneurship through targeted advice and financial support. Some loss-making public corporations, including the national airline, were also restructured

[10] The Draft Budgetary Plan 2019 targets both a headline surplus net of IIP and a structural surplus net of IIP.
[11] See Bonello (2002) and Bonello (2007).

during this period. The implementation of such reforms was necessary for a correction of the economic imbalances that prevailed before euro adoption and for preventing their recurrence.

In Malta's case a long history of trade links with the euro area, a track record with a fixed exchange rate and a high degree of real economic convergence at the time of EU accession permitted a relatively short stay in the Exchange Rate Mechanism II and enabled a smooth transition to an environment in which the authorities had to relinquish completely the discretion to use the exchange rate and monetary policy as economic adjustment tools.

Once in the euro area, the country benefited from a reduction in exchange rate uncertainty and the policy discipline embedded in the institutional arrangements surrounding EMU. In particular, the changes in the budgetary process triggered by the EU's surveillance mechanisms in the context of the Stability and Growth Pact, with their emphasis on multi-annual programming, the cyclically-adjusted balance and long-term sustainability assessments were very important, as was the setting up of the Malta Fiscal Advisory Council in 2015.[12]

The EU's economic surveillance framework did not only engender greater transparency and discipline, but also brought a significant change in mind set, as it led the authorities to look beyond headline indicators and quick-fix revenue-raising schemes, and focus instead on measures with a more long-lasting effect on public finances.

At the same time, the absence of banking sector stress and of Government financial support to the domestic financial sector did not inhibit fiscal consolidation from progressing at a sufficiently ambitious yet socially acceptable pace.

Overall, Malta's experience also shows that while the euro carries significant growth opportunities, on its own it cannot guarantee success. Economic performance is largely shaped by properly-paced and complementary reforms and a determined response to long-standing challenges. For example, Malta's fiscal position only improved tangibly when fiscal consolidation was accompanied by reforms aimed at boosting the economy's productive capacity and labour utilisation and when the orientation of fiscal policy itself shifted from temporary revenue-raising measures to measures with a more lasting impact. Similarly, the benefits of the Single Market materialised in a more visible way as the business environment improved and new industries emerged, offering new opportunities for outsourcing and networking.[13]

In Malta's case, the positive spill-overs from economic migration also proved much greater than anticipated. Although the influx of foreign labour, facilitated by the EU's freedom of movement of

[12] Bongardt and Torres (2013) provide an account of some of the important reforms introduced after the onset of the recent sovereign crisis to improve economic surveillance mechanisms in the EU, amid signs that the earlier framework had allowed macroeconomic imbalances in some countries to persist and threaten EMU's sustainability.

[13] ECB (2015) also argues that there are no automatic mechanisms to ensure that the process of nominal convergence which occurs before adoption of the euro produces sustainable real convergence thereafter. Several other factors matter in this regard. These include macroeconomic stability, a sound fiscal policy, flexible product and labour markets; favourable conditions for an efficient use of capital and labour, supporting total factor productivity growth; economic integration within the euro area; and a more active use of national policy tools to prevent asset price and credit boom-bust cycles.

workers, did contribute to some pressure on house prices and the rental market in Malta, the integration of foreign nationals in the labour market complemented efforts to diversify economic activity and attain faster growth. This additional supply of labour enabled a rapid pace of income convergence without undue cost and price pressures at a time where the national population of working age was in decline.

Moreover, being part of the euro area is probably a safer option for a small country like Malta. The counterfactual, that is, pursuing a fixed exchange rate regime as a non-euro area Member State without capital controls could have exposed the country to unwarranted speculative attacks, particularly during the financial crises period.

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