ECONOMIC CHALLENGES ON THE PATH TO THE EURO

THE MALTESE EXPERIENCE

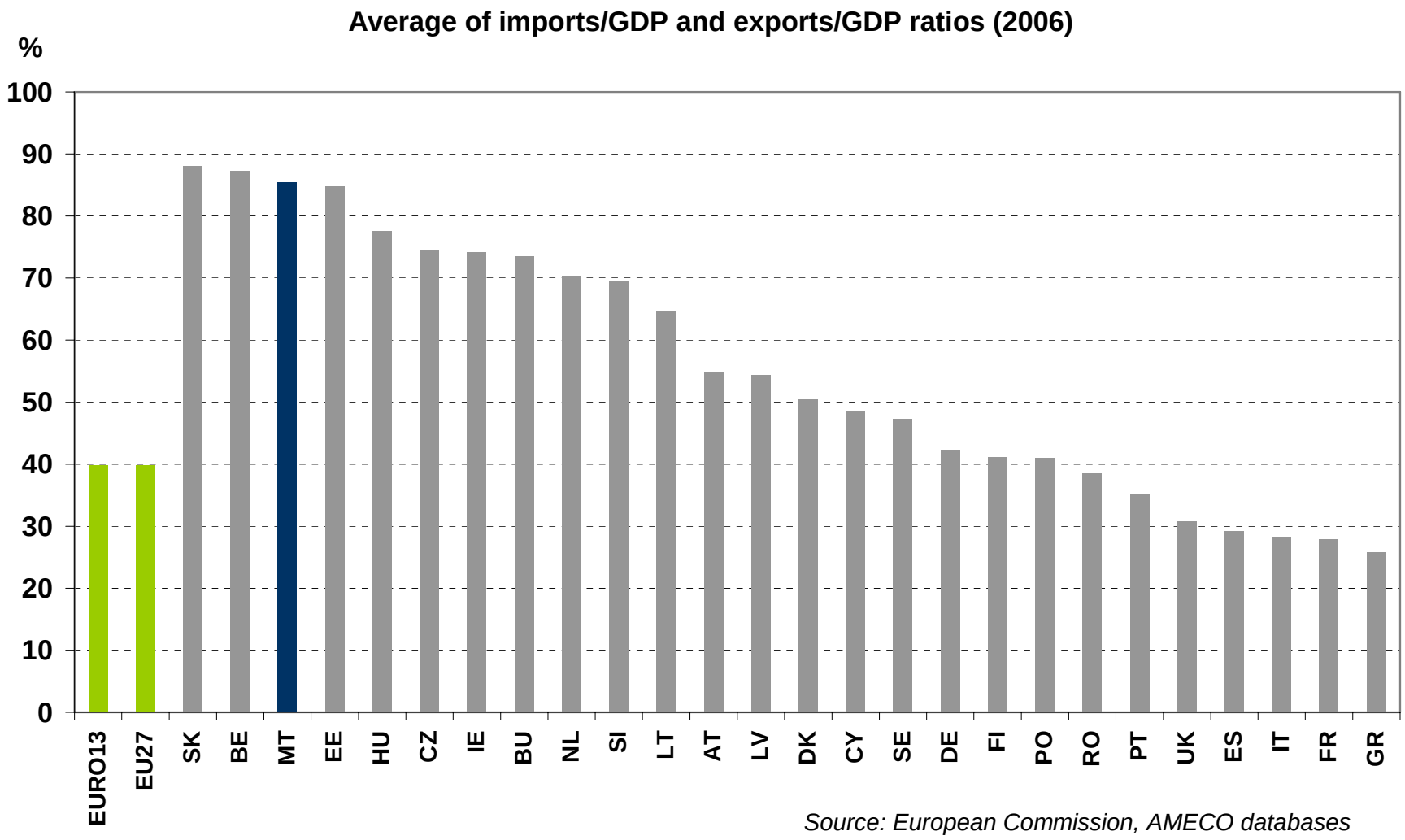
Vienna, November 2007

Central Bank of Malta

Malta has a small, but relatively developed economy:

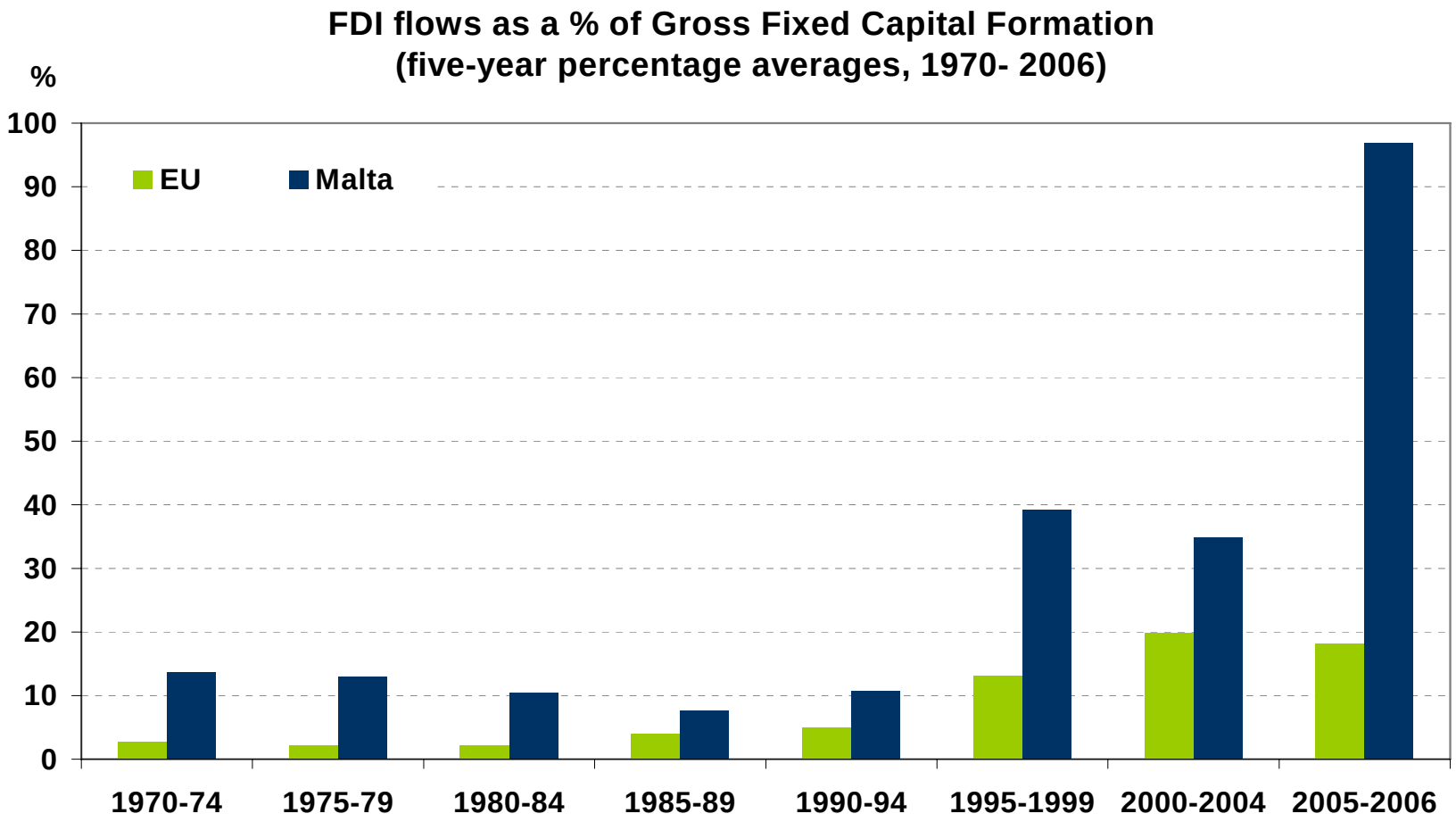
population	0.4 million
area	316 km^2
GDP	€5 billion
GDP per capita in PPS	73% of EU25 average
	69% of euro area average
price level	73% of EU25 average
	72% of euro area average
income inequality co-efficient	4.1
UNCTAD Inward FDI Performance Index	6th (2004-2006)
residents' deposits / GDP	126%
domestic credit / GDP	133%

The Maltese economy is also very open with an average trade-to-GDP ratio of 80% in recent years.



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

Economic situation in the late nineties

In 1999, when the EU membership application was re-activated, the economy was still characterised by:

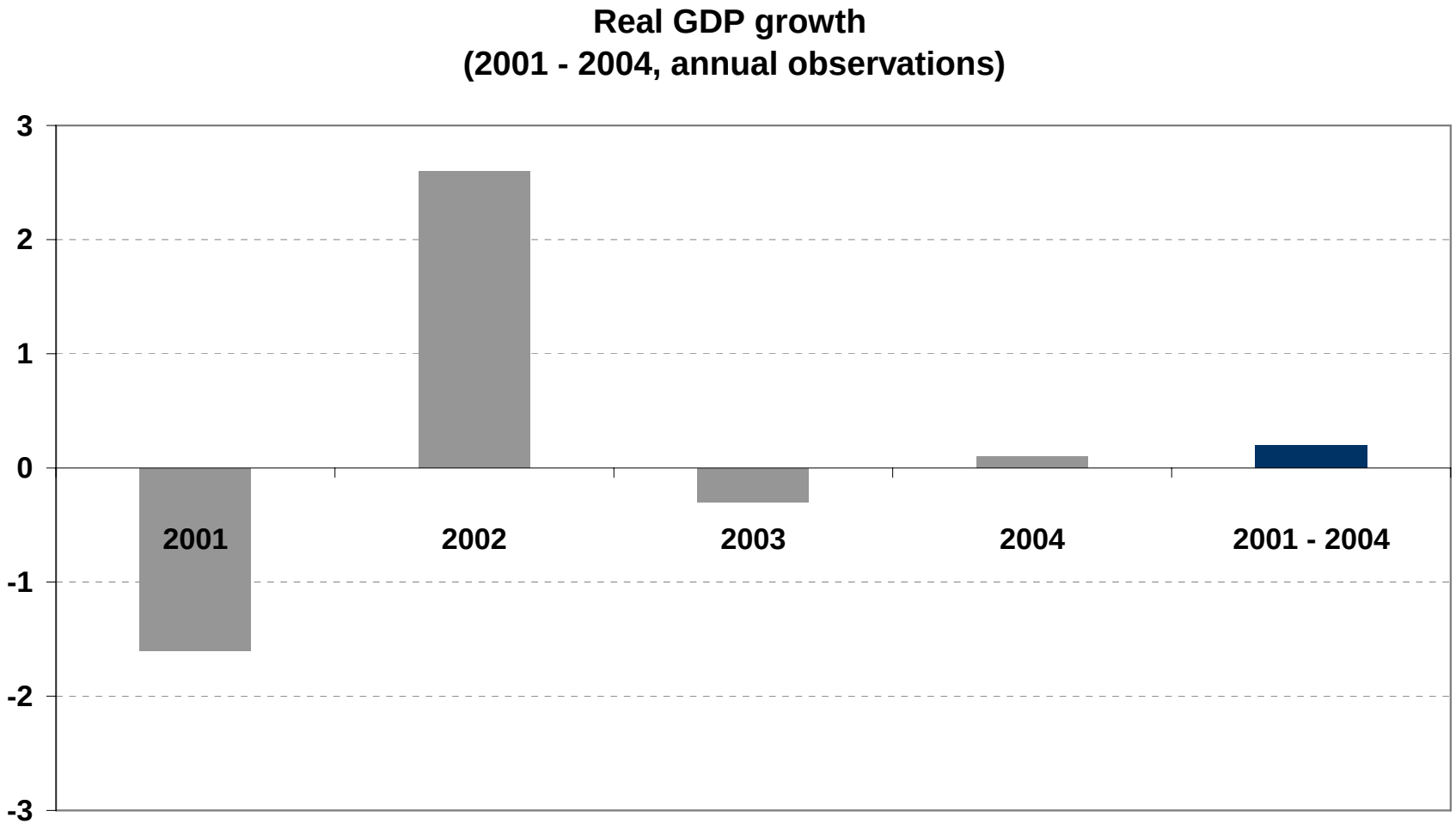
- a large public sector / substantial state ownership
- import levies and capital controls
- a central bank that was not fully autonomous
- structural rigidities which resulted in output and labour markets not being fully responsive to market forces

External shocks at the turn of the century

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



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.

The euro area was an ideal partner for Malta

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

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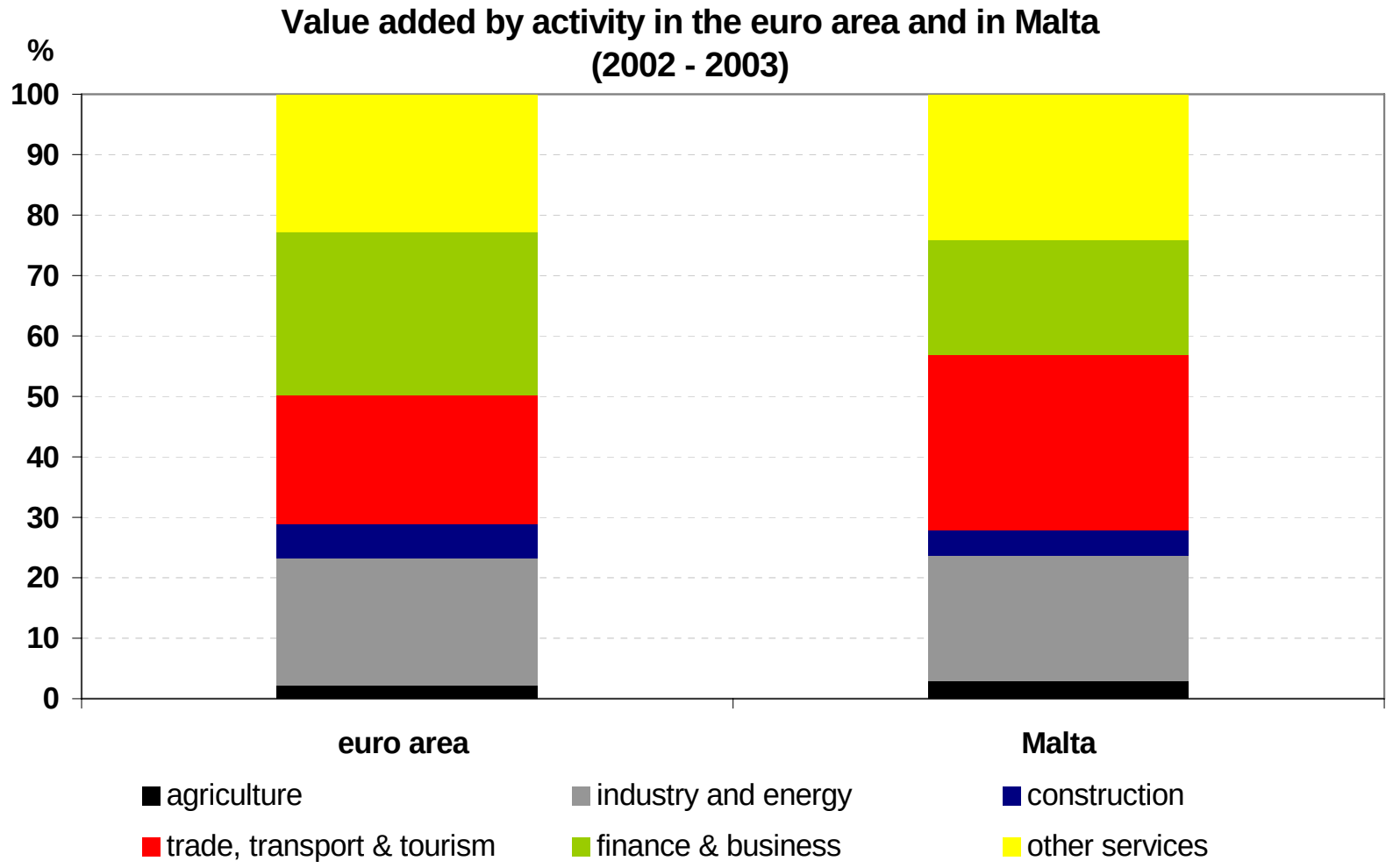
The euro would facilitate the process of further integration with the EU and enable Malta to reap the benefits of the single market

EU countries, including the larger euro area Member States, were among Malta's largest trading partners.

	2004	
	% EU	% euro area
imports of goods and services	71	54
exports of goods and services	59	35

Source: National Statistics Office

At the time of EU accession, the structure of the Maltese economy already resembled that of the euro area.



Source: Eurostat

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:

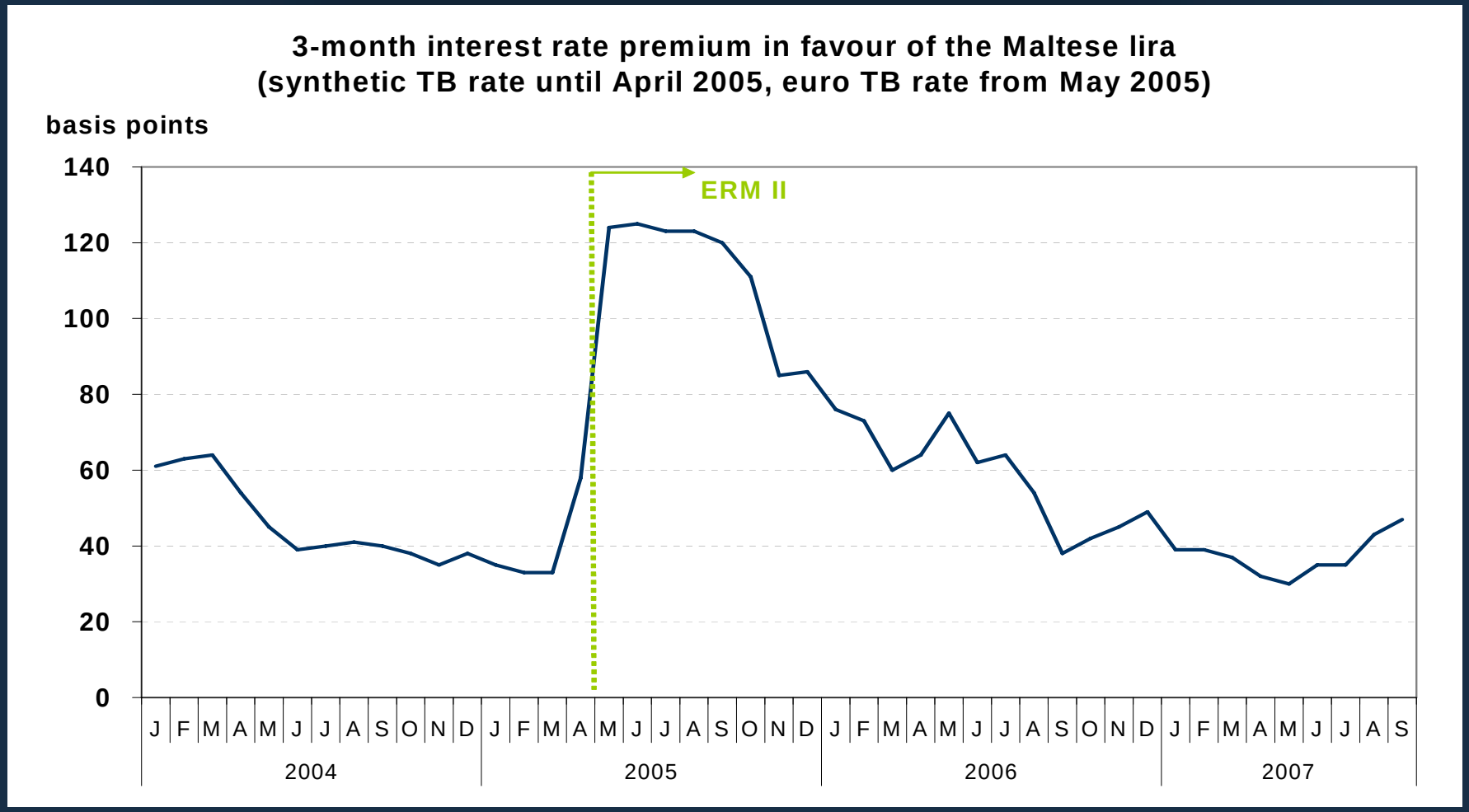
- adopt a medium-term programme of fiscal consolidation
- implement structural reforms

The exchange rate commitment

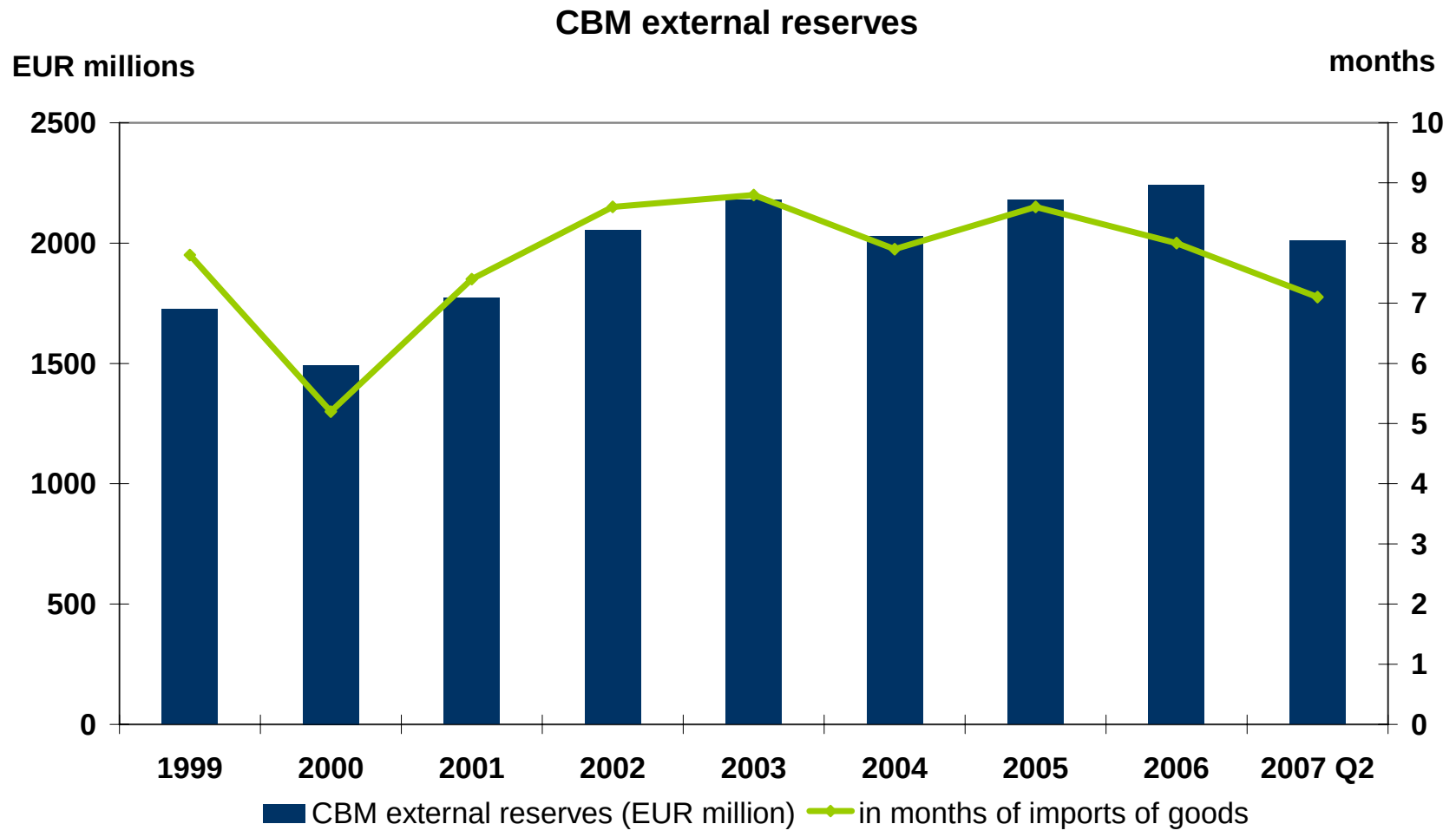
In pursuing its commitment with regard to the exchange rate the CBM:

- 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.

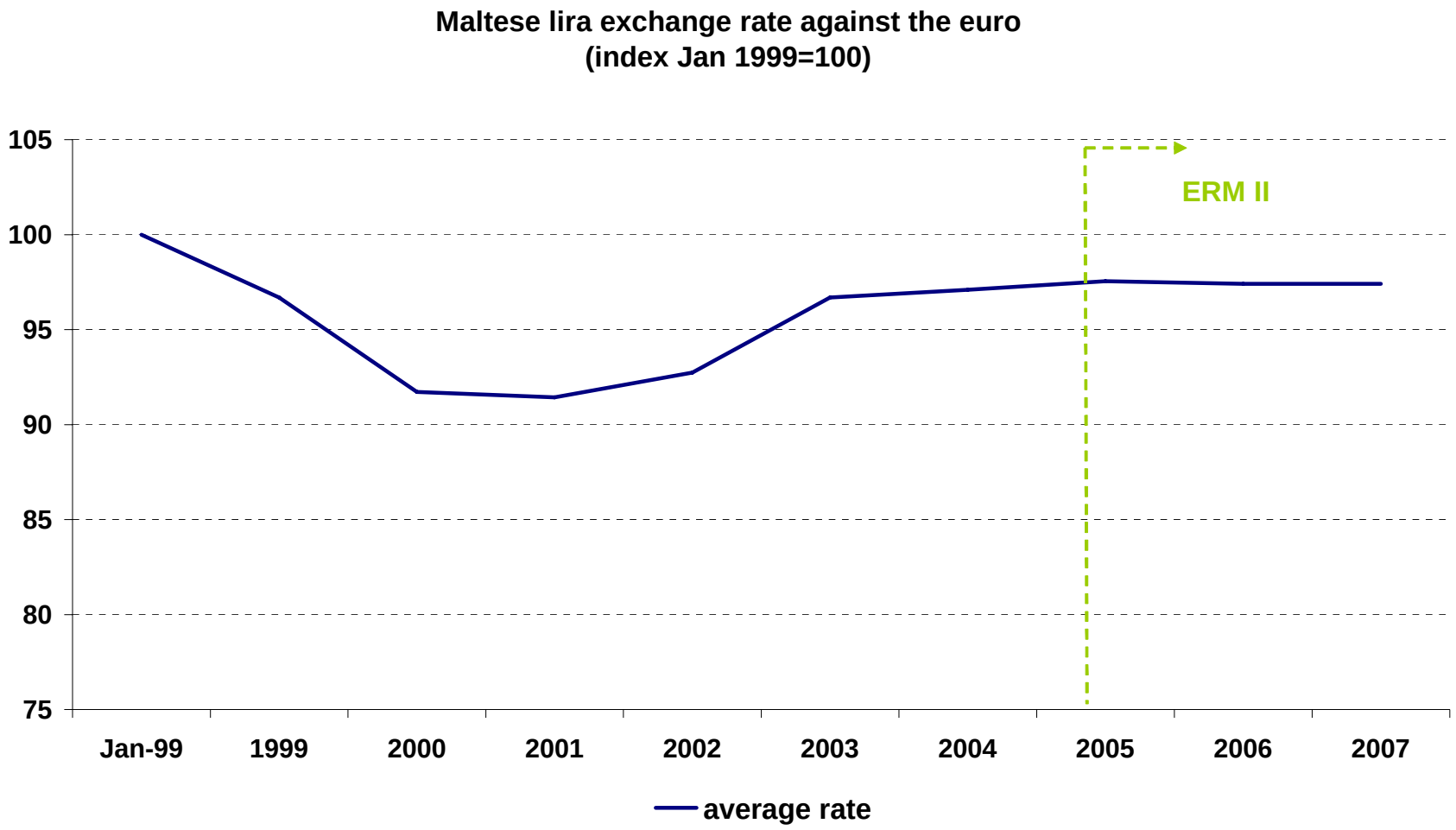


Source: Central Bank of Malta, National Statistics Office

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

Strengthening the financial structure

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

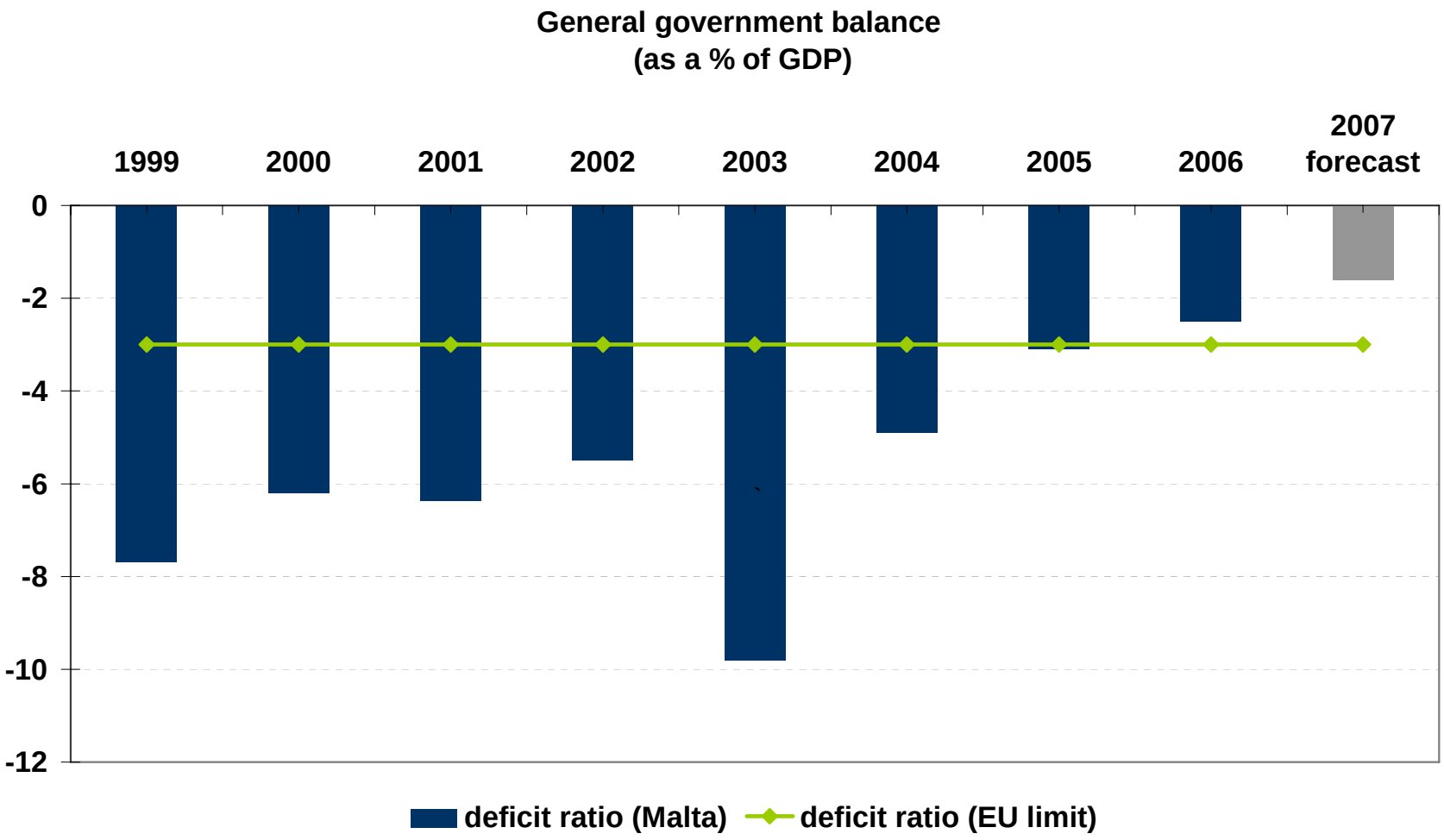
- amendments to CBM Act to formalize the Bank's independence
- the smooth transfer of banking supervision to the MFSA
- the further alignment of the legislative framework and of operational practices with those of EU jurisdictions
- the development of the financial infrastructure (e.g. payment and settlements 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.

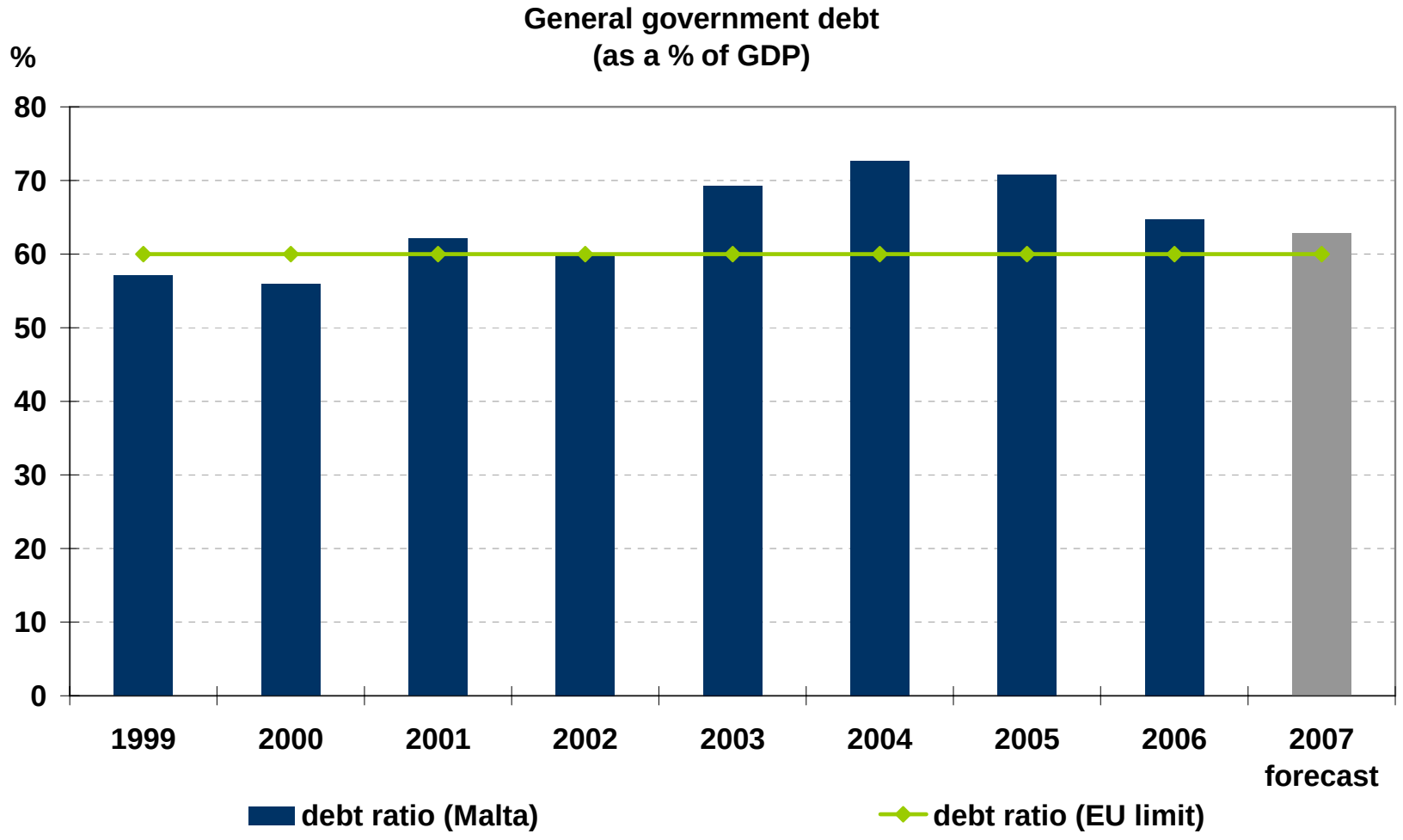
- a fiscal consolidation programme to reduce the deficit to below 3% of GDP by 2006
- pension reform
- further downsizing of the public sector
- a five-year public sector wage agreement
- measures against tax evasion and abuse of welfare benefits
- an increase in the VAT rate and a broadening of the 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%.



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

The Government's commitments (ii)

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

	2003	2005	2007
real GDP growth	-0.3%	3.1%	3.5%
unemployment rate (LFS)	7.6%	7.2%	6.6%
fiscal balance	-9.8%	-3.1%	-1.6%
share of public sector in employment	34%	33%	30%
share of services in employment	41%	43%	46%
inflation rate	1.9%	2.5%	0.4%
change in productivity	-1.3%	1.3%	2.1%

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.

Some lessons from the Maltese experience

- 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