Part I – Key Issues and Lessons Learnt

2

Economy of Malta

Malta has been a fully integrated member of the European Union since 2004 and in January 2008, adopted the euro as its currency. In the build-up to entry into the EU, Malta had to implement a string of reforms in line with EU standards and practices. As a result, most of its major economic policies are guided by EU principles and regulations. Malta has had much to gain from its entry into the EU, particularly from its entry into the eurozone in January 2008, when it adopted the euro.

The benefits to a small open economy like Malta's with a vulnerability to external and sector-specific shock could be significant. From a monetary policy standpoint, eurozone membership implies eliminating the various risks associated in managing a small, vulnerable currency like the Maltese lira, with the greater security afforded by a major reserve unit such as the euro.

Malta's entry into the eurozone coincided with the global recession – a time of great uncertainty for the global economic outlook, characterised by business bankruptcies, bank closure, widespread loss of confidence and financial meltdown. This timely entry has surely saved the Maltese economy from the external and sector-specific shocks. Malta was partially spared from the global financial crisis thanks to the euro.

Besides the euro, another important factor that has contributed significantly to mitigating the impact of the global recession is the existence of a sound financial system. Malta's EU membership has brought renewed benefits to the small island economy. In the midst of the global recession, many central banks across the world adopted a slack monetary policy stance, especially with regard to interest rates (IR). The euro area was no exception as the European Central Bank (ECB) decided to act likewise by reducing the IR on its main financing operations gradually from its peak of 4.0 per cent in October 2007 to 1.5 per cent by March 2008. As a member of the Eurosystem[1] (European Monetary Union), Malta benefited from the rate reduction that was passed on to bank borrowers. Such a reduction in borrowing costs would have been improbable had Malta not been part of the Eurosystem.

An interesting – though surprising – outcome of the global economic downturn has been the return of government intervention in the economy through the use of fiscal policy to stimulate aggregate demand. Several governments, including those in the eurozone, announced huge fiscal stimulus packages to bail out their ailing financial institutions at the time when the world was experiencing one of the worst financial crises in history. Despite Malta's favourable economic condition, it would have been difficult to undertake such measures should the need arise due to its relatively high budget deficit and debt level. Fortunately, due to Malta's strong financial position, the government did not have to intervene.

Nevertheless, Malta was not completely insulated from the global economic downturn, although its impact was less severe than in other countries, including those in the eurozone. Malta depends a lot on foreign trade, so it would be very surprising if the country were utterly immune. The economy started quite well in 2008 but as time progressed, especially towards the second part of the year, things suddenly took a U-turn. It began with a significant drop in exports of goods and tourist arrivals followed suit. As the year closed during the fourth quarter, the global economic downturn was even more bleak. This time it was the manufacturing sector (in particular the electronics and automotive components industries) that was the victim. Both tourism and manufacturing were affected as a result of sharp decline in foreign demand, as both sectors depend on external markets. In consequence, it was not surprising to see growth in the last quarter being negative as investment spending was also on the decline. Although real growth recorded a positive value, it was less than for the previous year.

2.1 The productive sector

Like the Seychelles, the productive sector of Malta is largely dominated by two main industries: tourism and manufacturing. Financial services (including offshore) are also becoming an important sector contributing significantly towards the economy.

2.1.1 Tourism

Tourism is the mainstay of the Maltese economy and its share of GDP has continuously increased over the years, making a direct contribution of around 35 per cent towards the GDP. The tourism industry has experienced rapid growth since 1987 as a result of an increase in foreign exchange tourism-earnings and tourism arrivals (see Figure 2.1 below). Nonetheless the industry suffered some temporary setbacks after the 9/11 terrorist attack in the USA.

Figure 2.1 depicts the number of tourists visiting Malta over the period 1998–2007. The overall trend is increasing, except for 1996, which recorded a significant decline

Like Seychelles, Malta's heavy dependence on tourism makes the island highly susceptible to the vicissitudes of global economic conditions and changing tastes of tourists. The principal market for tourism in Malta is from four main European sources: the UK, Germany, France and Italy. The UK is by far the leading market accounting for almost one third of all international travellers.

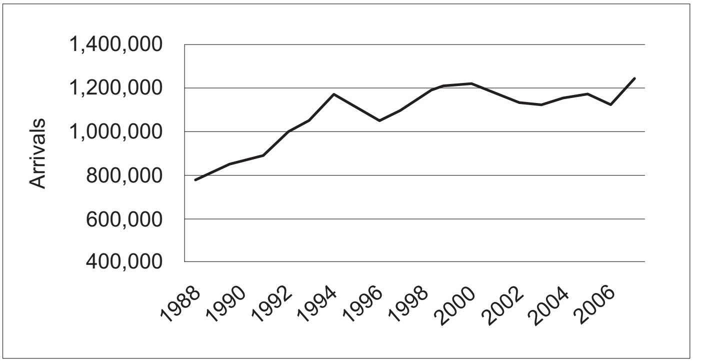

Figure 2.1 Malta tourist arrivals, 1998–2007

2.1.2 Manufacturing

The manufacturing industry accounts for some 25 per cent of GDP. This industry is dominated by the manufacturing of value-added products, namely electronics and pharmaceuticals. Most goods are produced for export and the manufacturing sector is supported by a strong presence of foreign-owned, export-oriented enterprises (over 250).

Today, many well-known ICT centres of excellence and training such as CISCO, Microsoft and Oracle are located in Malta. This is partly due to the country's outstanding communications infrastructure and highly-skilled human capital. Malta is classed highly among EU countries in most major indicators of ICT infrastructure and service provision. It is important to note that Malta's achievement in ICT development has become possible due to the well-established co-operation strategy between the government and the private sector. The Maltese government has been very instrumental and supportive with regard to major investment, providing the private sector with an enabling environment.

Malta, like many other small island states, does not have vast natural resources, but has nonetheless been very successful. This success stems from the ability to exploit their technological base, geographical position and knowledge society. Malta's industrial strategy is centred on attracting foreign direct investment (FDI).

Due to its outstanding communication infrastructure and highly-skilled manpower, Malta has become an ideal place for a number of economic activities. This includes among others:[2]

- the manufacture of medium- and high-technology products requiring special skills;
- the manufacture of MSEi-customised small batch products requiring 'just-in-time' delivery;
- manufacturing activities that require a significant degree of quality control;
- operations requiring access to EU markets; and
- service companies seeking a location to meet international demand for their products.

To facilitate the establishment of businesses, strategic industrial estates have been created throughout the island. All the estates are equipped with purpose-built standard factories, readily available on demand to start business. In its endeavour to attract further investment, the government has built the Mosta Technopark, a purpose-built facility to house advanced technology companies.

To foster further investment in the manufacturing industry, the government has come up with a generous incentive package which includes:[3]

- ten-year tax holidays for new export-oriented companies;
- training grants for approved programmes offered to employees and soft loans offered to management;
- ready-built factories at subsidised rents;
- duty-free importation of plant, machinery and all materials;
- full repatriation of capital and profits;
- duty-free importation to the EU;
- liberal work permit policy.

Despite Malta's current success in creating a high-tech manufacturing base, its traditional manufacturing is struggling. Traditional manufacturing encompasses semiconductors, clothing and textiles. The textile industry has been hit particularly hard, with output and employment down by 60 per cent from 2004–2006 and factory closures. The misfortune of Malta's traditional manufacturing industries is a direct result of stiff competition from low-cost countries. To counter the downfall in those industries, some manufacturers, e.g. those of semiconductors, are trying to reposition themselves by moving to more technological products.

2.2 Government revenue and expenditure

Fiscal policy in Malta has for some years been geared towards reducing the budget deficits. Malta has persistently recorded budget deficits throughout the entire period as illustrated by Figure 2.2 below. From a low of almost -11 per cent of GDP in 1998 the deficit-to-GDP ratio has since progressively been reduced to -2 per cent in 2007. Since 2006 the deficit-to-GDP ratio has been kept below -3 per cent, in conformity with EU requirement for accession into the Eurosystem. However, the year 2008 recorded a worsening in the deficit-to-GDP ratio of -4.7 per cent.

Despite Malta's continuous effort to consolidate expenditure, public finances remain a challenge. As also indicated in the IMF Country Report 2008, public finances are under considerable pressure. This is in consequence to the large subsidies (about twice the EU average) and state aid (four times the EU average); health care costs; the public wage bill (13 per cent of GDP); pensions and other social spending (over 13 per cent of GDP). Apart from the aforementioned, public enterprise guarantees and other contingent liabilities are also contributing factors.

Figure 2.2 below (taken from IMF Country Report 2008), shows the fiscal development in Malta.

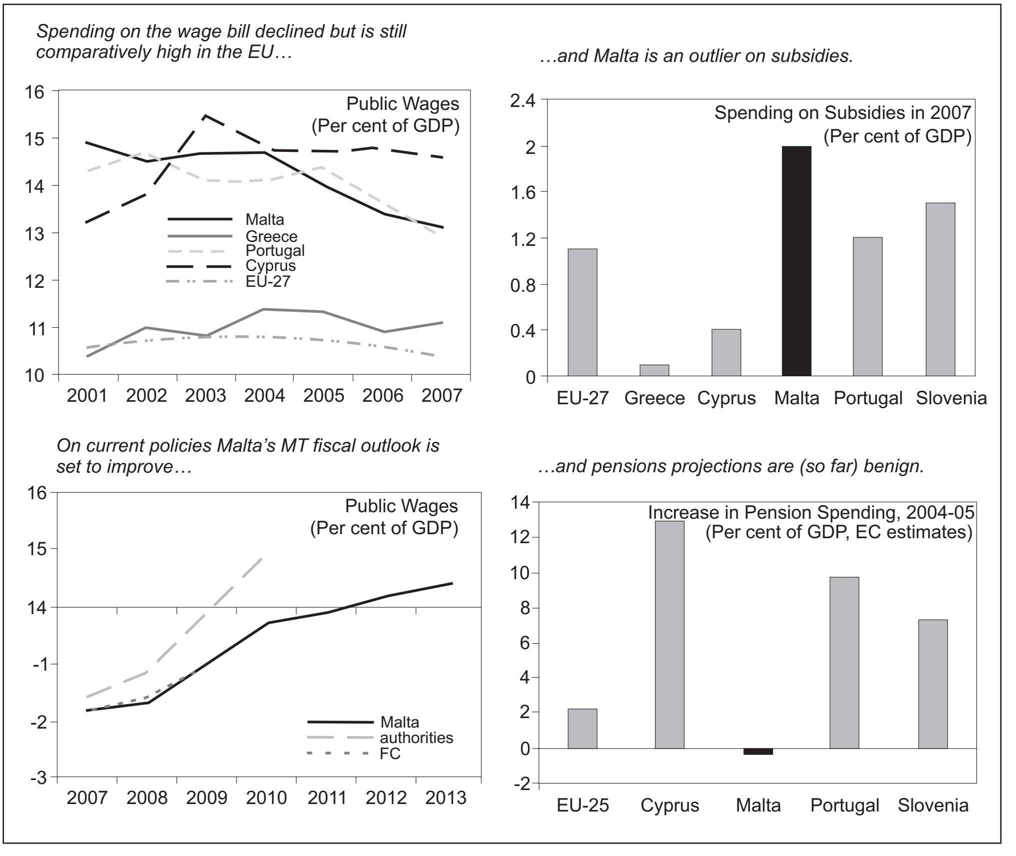

Figure 2.2 Malta's fiscal development

Sources: Eurostat; European Commission; EPC; and IMF staff calculations

2.2.1 Trend in revenue and expenditure

A further glance at Figure 2.3a below reveals that expenditure is the main culprit in exacerbating the fiscal deterioration over the years as manifested through the persistent budget deficit. While both revenue and expenditure appear to be trending upward, the former has always out-paced the latter. In consequence the budget has persistently remained in deficit, despite showing signs of improvement towards the latter part of the period. Coincidentally the upturn in the deficit-to-GDP ratio gathered momentum after 2003.

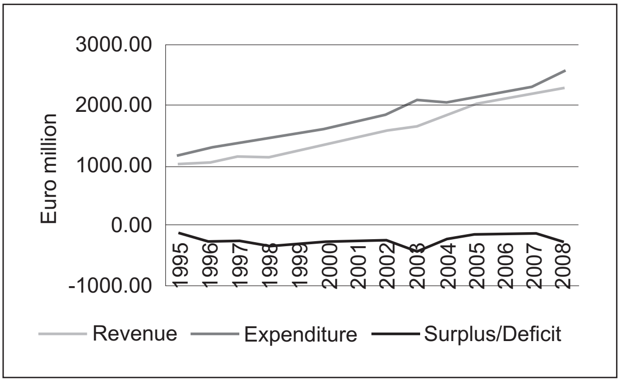

Figure 2.3a Government revenue v expenditure

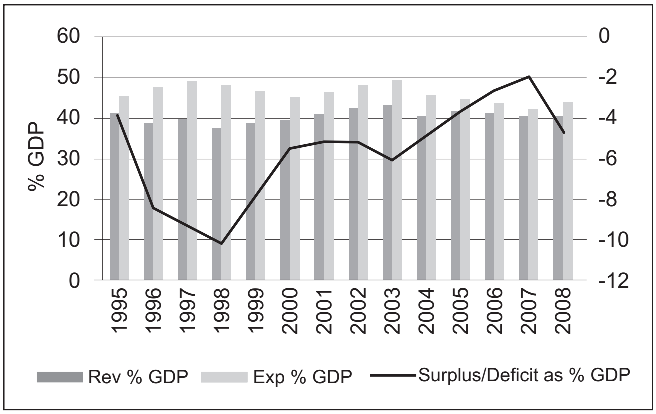

Figure 2.3b Revenue, expenditure and surplus/deficit as percentage share of GDP

Figure 2.3b depicts revenue, expenditure and surplus/deficit as percentage shares of GDP. Evidence (as demonstrated by Figure 2.3b) appears to suggest that the share of expenditure to GDP has remained high (above 40 per cent) despite a decline after 2003. Whilst the trend in expenditure as percentage of GDP appears to be sliding, the trend in revenue has remained more or less stagnant at around 40 per cent since 2004. A further glance at Figure 2.3 reveals a structural break at 2003 in the expenditure data series and surplus/deficit data series. A structural break indicates a change in regime; 2003 was a transition year for Malta in preparation for entry into the EU in 2004.

2.2.2 Net revenue composition

The main components of net revenue, i.e. revenue net of loans, sale of shares and other extraordinary receipts are: grants, customs and excise, value added tax, income tax and social security. Income tax and social security constitute the lion share of net revenue as depicted by Figure 2.4 below. On average they account for about 50 per cent of net revenue.

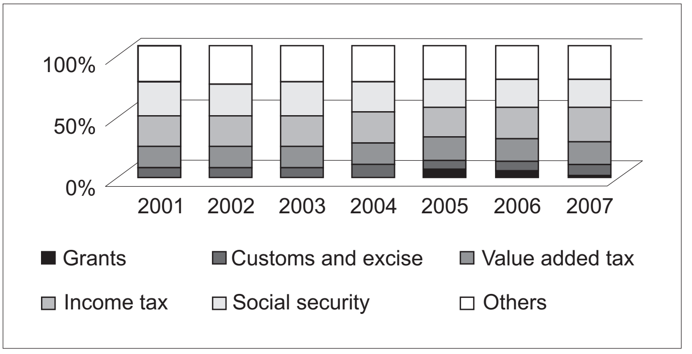

Figure 2.4 Net revenue composition

2.2.3 Tax revenue as a percentage of GDP

Whilst the share of revenue to GDP tends to fluctuate within the range of 35–40 per cent, tax revenue appeared to be trended upward. Tax revenue, which consists of direct and indirect taxes, has increased significantly over the entire period. Interestingly, Figure 2.5 below reveals a similar structural break in the tax revenue series at 2003.

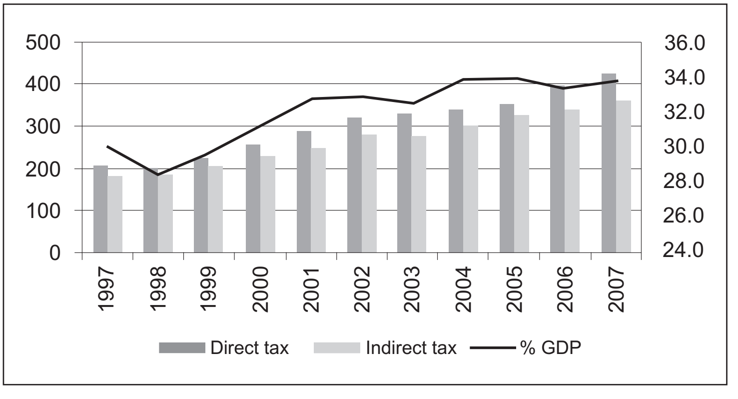

Figure 2.5 Composition of tax revenue v tax revenue as percentage of GDP

2.3 Budget surplus and deficit

As per EU requirement for joining the eurozone, Malta had to ensure a budget deficit-to-GDP ratio not exceeding 3 per cent by the end of 2007. The date set for Malta to enter the Eurosystem was 1 January 2008. This has necessitated a complete change in policy orientation with the main focus on curbing the fiscal deficit. Over the years, fiscal policy in Malta has been geared towards curbing the budget deficit.

Following sustained fiscal consolidation since 2003, there has been consistent reduction in the budget deficit until 2007, where it hit a record low of 1.8 per cent of GDP. Figure 2.6 below can be referred to for further details. The Maltese authorities are determined to pursue further with the deficit reduction. In this regard, they have set a target for structural budget balance by 2010 and committed themselves for a budget surplus after 2010 as their main policy objective.

One area that Malta needs to address if it is to curb the budget deficit further is the large public enterprise sector. In its Country Report 2008, the IMF warned that the PES is a source of distortions and budgetary pressure for the Maltese authorities. The substantial subsidies to the PES are putting severe stress on the budget. Furthermore, one other area that requires reform is the administered prices, as it has been found to lag import price increases. Besides, the high social expenditure (predominantly due to health care, pension outlays and benefits fraud) is also taking its toll on the budget.

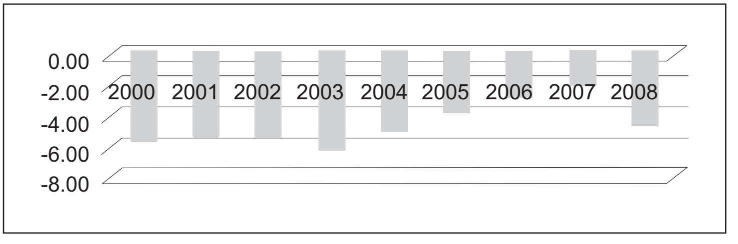

Figure 2.6 Government surplus/deficit as percentage of GDP

2.3.1 Current account balance

As demonstrated by Figure 2.7 below, the current account had persistently remained in deficit with the exception of 2002. While the services account balance had shown signs of improvement, the trade balance and current account have all deteriorated.

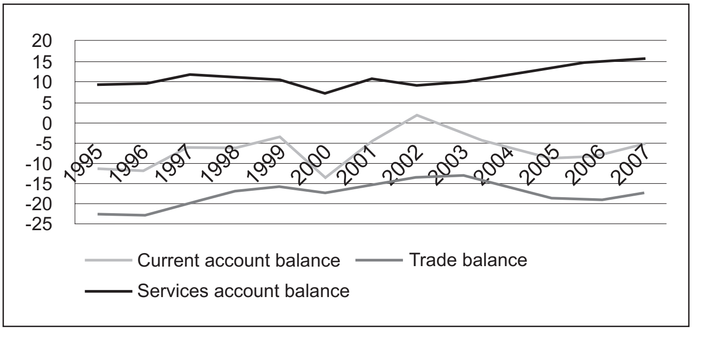

Figure 2.7 Current account (percentage of GDP)

2.4 Public debt

Public debt in Malta consists of treasury bills (TB), government stock, foreign borrowing, other debt assumptions and the Malta Government Stock (MGS) investments in government debt. Overall, the debt burden as a share of GDP has declined over the past couple of years after a peak in 2004 of 70.2 per cent, as illustrated by Figure 2.8 below. At the end of 2008, public debt stood at 63 per cent of GDP, an increase of 2.1 per cent from the previous year.

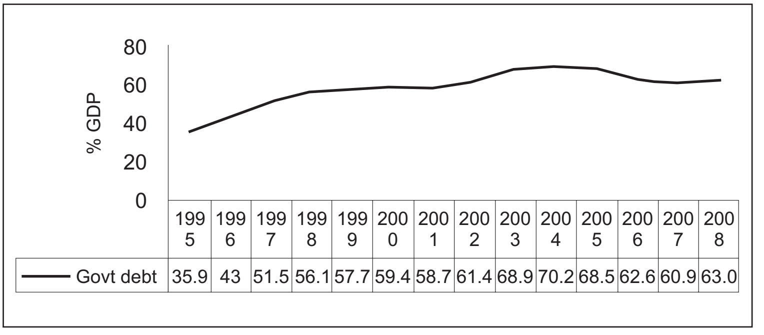

Figure 2.8 Government debt (percentage of GDP)

Figure 2.8 above shows government debt (domestic and foreign) as a share of GDP over the period 1995–2008. It is evident from Figure 2.8 that the trend is increasing, especially over the period 1995–2005.

Figure 2.9 below depicts the composition of government debt for the period 2001–2007. As indicated, the bulk of government debt (over 60 per cent) consists of government stock. This is followed by treasury bills, which account for less than 20 per cent.

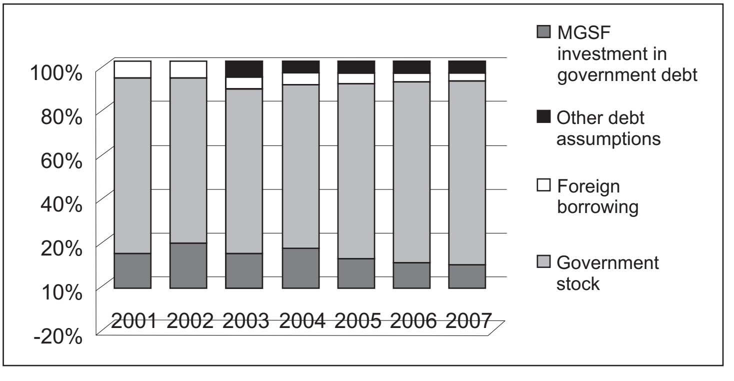

Figure 2.9 Composition of government debt, 2001–2007

By international comparison, Malta's external debt is quite low at less than 20 per cent of GDP. Figure 2.10 below gives an international comparison of external debt for the year 2007.

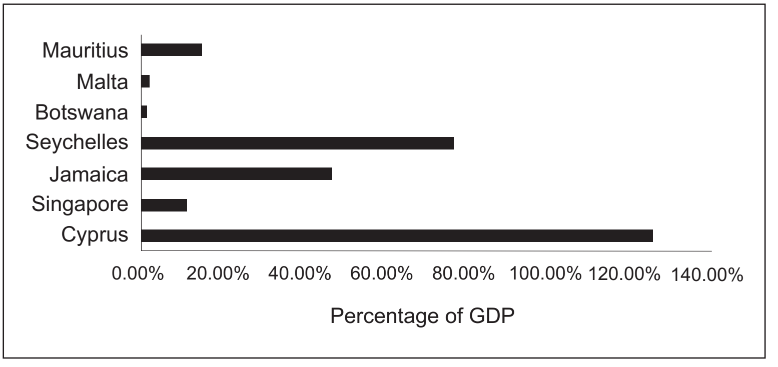

Figure 2.10 External debt (2007 estimates)
Source: http://www.nationmaster.com/graph/edu_edu_spe

2.4.1 Management of public debt

With the budget still running at a deficit, despite this showing significant reduction in recent years, Malta's fiscal situation still needs major revision. High on the agenda is the easing of public expenditure and improvement of the structural trade deficit. It is hoped that this will be achieved through the adoption of prudent fiscal policies. To ease pressure on public expenditure, the authorities have pledged to undertake reform aimed at curtailing spending and expect to achieve this by restraining three key elements, namely subsidies and state aid, the public wage bill, and the entitlement programmes.

The management of the public debt in Malta is undertaken by three principal government agencies. The agencies responsible are the Ministry of Finance, the Central Bank of Malta (CBM), and the Accountant General's Office. Though the activities surrounding the management of the debt stock are carried out by the three agencies, they are co-ordinated by the Public Debt Advisory Committee (PDAC). PDAC consists of senior representatives from each of these agencies and an additional one from the Malta Stock Exchange (MSE).

2.5 Economic growth

One aspect of vulnerability that Malta did not share with other small states such as Seychelles and Mauritius is remoteness from major markets. Its proximity to Europe and being a member of EU has brought a lot of benefit to Malta. Almost 50 per cent of Malta's total exports went to the EU, which is the principal market for Malta's exports as depicted in Figure 2.11 below.

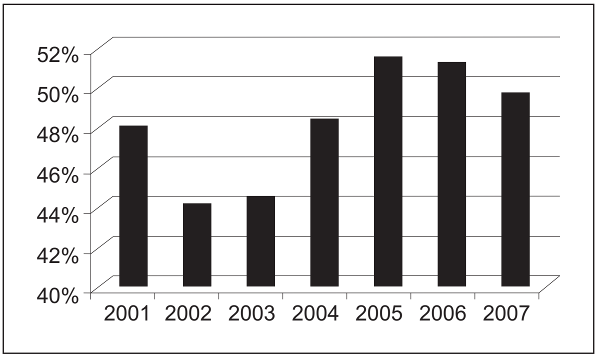

Figure 2.11 Percentage total export to EU

The export structure of Malta is undergoing brisk transformation owing in large part to robust expansion of niche exports and tourism. This has resulted in remarkable improvement in the trade deficit in goods and services from 5.3 per cent of GDP in 2005 to only 1.9 per cent in 2007.

The rejuvenation in export activities has been led by an upsurge in FDI that in turn has seen a redeployment of resources towards the export sector. While the export of goods has witnessed continuous decline over the years as depicted by Figure 2.12[4] below, this has been compensated by increase in manufacturing, aeroplane maintenance, and a tripling of generic pharmaceutics output. Alongside the increase in the above export-oriented industry, there is a host of new export services that have emerged. This includes: online gaming; IT, call centres, and other business services; and financial services. They account for 9 per cent, 10 per cent and 3 per cent of GDP[5] respectively. Figure 2.12[6] below, taken from the IMF Country Report 2008, helps to clarify the above statement.

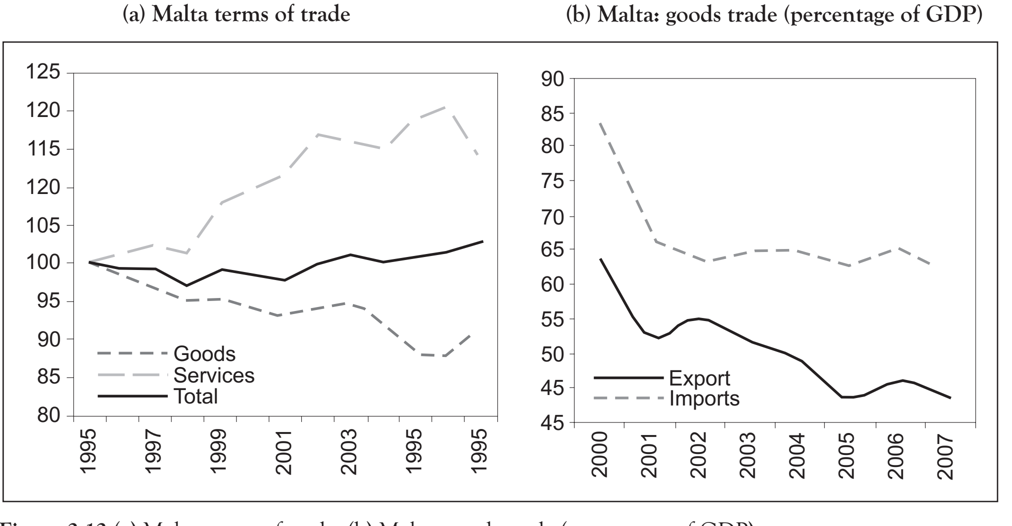

Figure 2.12 (a) Malta terms of trade; (b) Malta: goods trade (percentage of GDP)

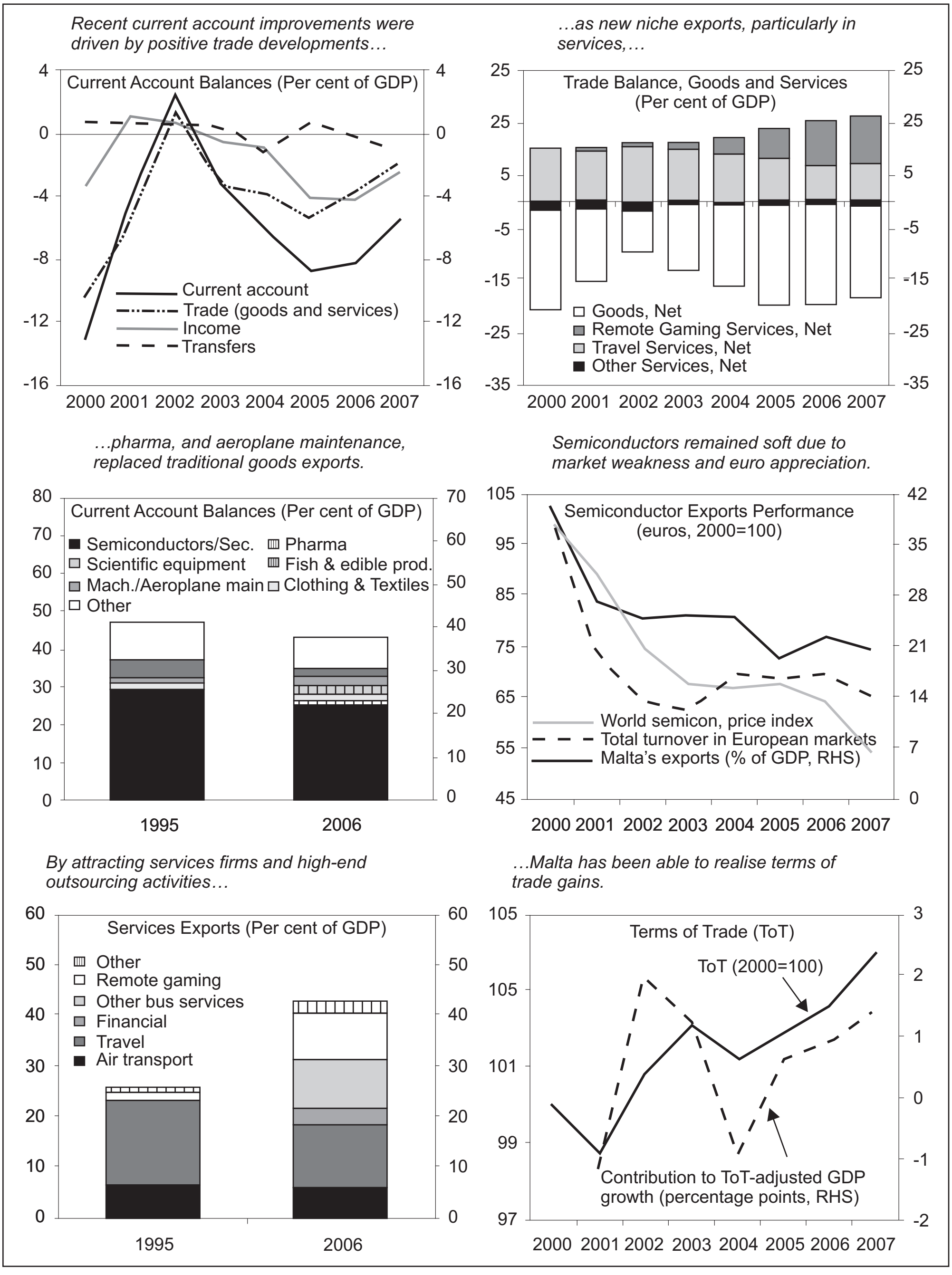

Figure 2.13 External current account development

Sources: National Statistics Office; European Commission; Eurostat; MSEiconductor Industry Association; IMF Direction of Trade Statistics; IMF Balance of Payments Statistics; and IMF staff calculations

Figure 2.12a depicts Malta's terms of trade. It is evident that the trend in trade in goods and trade in services appear to move in opposite directions over the period of study. Given Malta's fast growing service industry, it is no surprise therefore to see trade in services out-pace trade in goods. In addition, Figure 2.13[7] above, also taken from the IMF Country Report 2008, provides an overview of the trade performance of Malta over the period 2000–2007.

2.5.1 Real GDP growth

Malta's economic situation has been strengthened by the favourable international economic climate, mainly in the EU, and the government industrial policies, which are geared towards foreign export-oriented investment. As a result Malta's economy has experienced a period of sustainable growth, especially during the periods 1995–2000 and 2005–2007 as illustrated by Figure 2.14a and Figure 2.14b respectively. In 2008 the economy suffered some setbacks with a growth rate of 1.6 per cent, reflecting the dwindling global economic conditions. Economic growth over the entire period has been modest and somewhat volatile, with the exception of the year 2000 which recorded a growth rate of 6.3 per cent. The period 2001–2004 was turbulent from Malta's economic point of view. From a peak of 6.3 per cent in 2000, economic growth plummeted to rock bottom in 2001 with a recorded negative growth of -1.6 per cent. It was not until 2005 that the economy recovered fully.

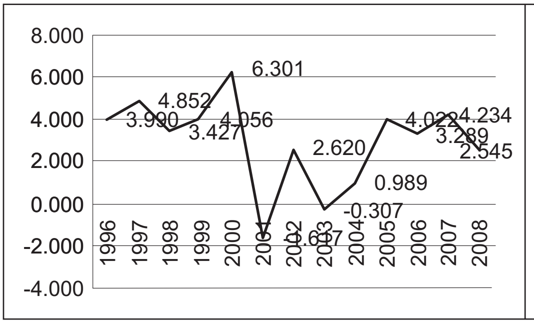

Figure 2.14a Real GDP growth rate

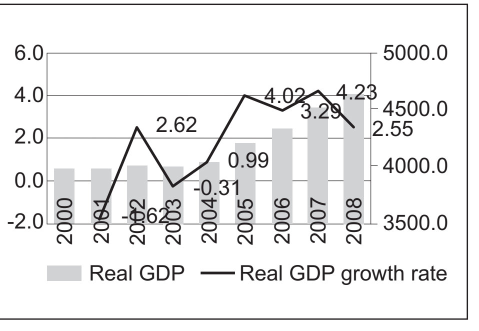

Figure 2.14b Real GDP and GDP growth rate, 2000–2008

Figure 2.14 above depicts real GDP and GDP growth rate for the period 2000–2008. Real GDP growth rate appears to be more rapid during the second half of the period, i.e. after 2003.

The economy regained momentum after 2003 as manifested by real GDP growth (see Figure 2.14b). The year 2004 is important and perhaps noteworthy as it marked Malta's entry into the EU. Presumably it is no coincidence that Malta's economy gathered some strength after 2003. Entry into the EU has surely given Malta the upper hand and the impetus to salvage its economy from further downfall. This came in the wake of criticism that the Maltese economy was performing below its full potential. It is important to note that Malta's economy has been under constant competitive pressure, especially during the late 1990s due to high wage growth and low labour productivity.

2.5.2 Aggregate demand

Malta's economic recovery was supported in part by strong domestic demand (mainly consumption), which started picking up in 2005 and resulted from major increases in government spending (see Figure 2.15 below), and exports of goods and services. The hefty public investment financed largely by grants from the EU and Italy was vital in supporting Malta at a time of weak economic growth. All these have further boosted Malta's favourable economic performance, especially after 2003. In addition, domestic demand supported by an increase in private consumption remained robust in 2008, despite the deteriorating global economic conditions.

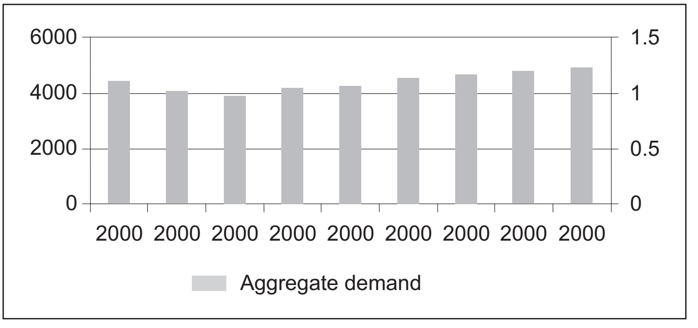

Figure 2.15 Aggregate demand, 2000–2008

2.6 Public involvement in the productive sector

Until recently, the Maltese government was very much active in the economy, owning a number of businesses spanning the whole spectrum of the economy and employing a large labour force. The type of business owned by the government included telecommunications, postal services, port services, shipyards and banks. It is worth noting that with the reform programme in place, the government has scaled down its involvement in those key business areas.

Despite the significant reduction in government participation in the economy, they still have a pervasive presence. At the end of 2008 there were some 40 public enterprises in the field of banking, waste management, aviation, energy and public utilities amongst others that are fully-owned or partially-owned by the government.

Furthermore by the end of 2008 the public enterprise sector was employing about 30 per cent of the labour force. The large public sector enterprise is a drain on government resources, accounting for a substantial amount of subsidies and state aid, the highest in the EU. There are widespread criticisms that the large public sector employment is putting pressure on the government budget, thus making them underperform. On the basis of an international comparison, the size of the public sector in Malta is identical to that of the Seychelles at 30 per cent.

2.6.1 Employment by sector

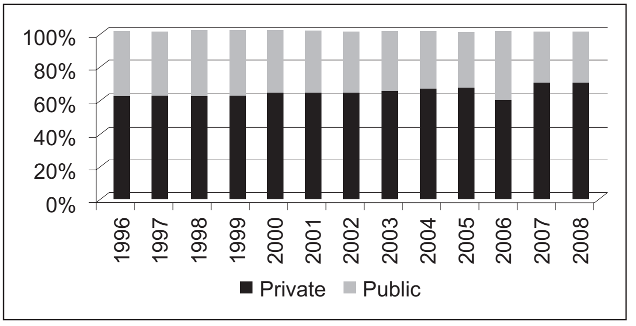

Figure 2.16 below shows the public/private sector employment for the period 1996–2008

The Maltese government was a major employer with some 40 per cent of the labour force during the 1990s, but has since reduced to about 30 per cent in 2008. The reduction in public sector employment is an indication of the ongoing privatisation programme.

2.6.2 Unemployment

Historically, unemployment has been relatively high in Malta despite the sustainable rapid growth of the economy. Nevertheless, unemployment is mostly confined to the unskilled work force. In contrast, rapid growth coupled with the knowledge-based economy has put additional pressure on the market for skilled labour. In consequence Malta is now suffering from an acute skilled labour shortage despite illegal immigration, and a significant increase in real earnings. This emerging gap between the skilled and unskilled labour markets was so pronounced that in 1999, it was reported that there were on average three times as many unemployed people for each vacancy in the unskilled job category as there were for job vacancies generally.

The rising trend of unemployment in Malta dates back to 1996 and has since remained high. This rising trend is to a large extent caused by weaker domestic demand, which as a consequence impacted negatively on the demand for labour, particularly in the construction and service industries. Moreover there were attempts by the government to reduce public sector workers further.

Figure 2.17 below depicts the quarterly (Q) unemployment rate for the period 2000 (Q2) to 2009 (Q1). For most of the entire period, unemployment has remained above 6 per cent, with the exception of the third quarter (Q3) of 2007 and 2008 respectively. The unemployment rate for 2007 (Q3) and 2008 (Q3) was 5.98 per cent and 5.84 per cent respectively, but had risen again to above 6 per cent in 2009.

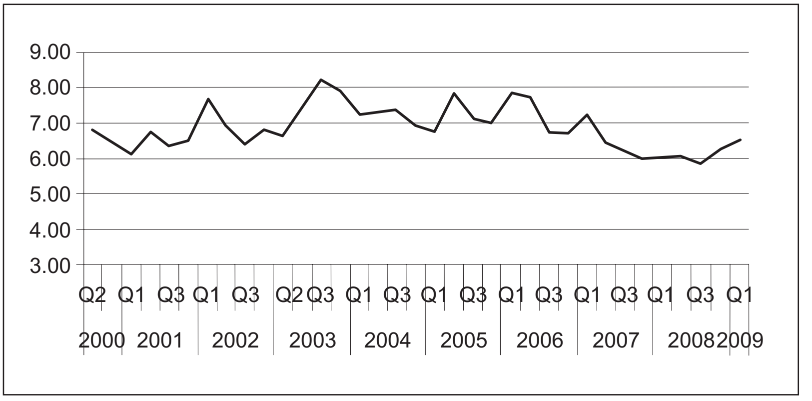

Figure 2.17 Unemployment rate, 2000–2009

Figure 2.17 above shows that the unemployment rate has consistently remained above 5 per cent over the entire period. The highest rate was recorded in 2003 (Q3) standing at 8.24 per cent.

2.7 Economic vulnerability

2.7.1 Pollution

The greatest challenge faced by Malta is the controlling of pollution, which appears to be on the rise. Among the polluting activities are waste generation, energy generation and development. The existing legislations are ineffective in making the polluters account for the full cost of their activities on the environment. Nonetheless there are efforts on the part of the government to mitigate the impact of pollution. Two main areas have already been earmarked by the government for immediate action; biodiversity and climate change. In the case of biodiversity there are a number of pressures arising from ongoing development. Biodiversity, both on land and in the marine environment, is under constant pressure and risk of degradation. The other taxing area is climate change. Despite the commitment from the government to address the issue of climate change, this could be a daunting task. Malta is partly responsible for contributing towards climate change (though not on a large scale) through greenhouse gas emissions arising from electricity generation and transport.

2.7.2 Climatic change

Over the past few years, global climate change has emerged as one of the major threats of this century. Flooding in Asia, hurricanes of various magnitudes, droughts in Africa, a rise in sea level, ice melting in the North Pole and heightened global temperatures are all realities of today's world. All these occurrences are directly related to global climate change. Malta, the Seychelles and other SIDS are very much the victims, but unfortunately have to share in the consequences.

A paper entitled 'The First Communication of Malta to the United Nations Framework Convention on Climate Changes 2004', published by Malta's Ministry of Rural Affairs and Environment, highlighted some of Malta's main challenges to global climate changes:

> 'The main characteristics that make the Maltese islands particularly vulnerable to climate change are the following:
>
> 1. Malta has one of the smallest populations in the world. Smallness tends to increase vulnerability to climate change (Briguglio, 1995).
> 2. Malta is one of the most densely populated countries, with over 1,200 inhabitants per square kilometre. This increases vulnerability and hampers adaptation to climate change (Attard et al., 1996).
> 3. Tourists raise the effective population, especially during the summer months when an increase of about 10 per cent is typical. The tourism sector is highly susceptible to climate change (Bijlsma et al., 1996).
> 4. The demography of Malta is similar to that of other developed countries, with very low birth and death rates and an ageing population. This exacerbates socio-demographic vulnerability to climate change and costs of adaptation.'

Malta's direct exposure to climatic changes does pose serious threats to economic sustainability. A potential source of economic vulnerability according to the authors is the disruption of productive and expenditure activities. Sectors most prone to climate changes are agriculture, manufacturing and tourism. The latter two sectors are worrying as they account for a significant share of GDP in Malta.

In analysing the above threats posed by climate change to the Maltese economy, a similar pattern can be witnessed in Seychelles and Mauritius. All three of these island states share a common economic characteristic that directly relates to climate changes: tourism.

Notes

1. The Eurosystem consists of the European Central Bank and the National Central Bank (NCB)
2. http://www.focusmm.com/malta/ma_manif.htm [last accessed May 2011]
3. http://www.focusmm.com/malta/ma_manif.htm [last accessed May 2011]
4. IMF Country Report 2008.
5. GDP as at 2007.
6. IMF Country Report 2008.
7. IMF Country Report 2008.