

MALTA'S EXPERIENCE IN THE EUROZONE

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Evaluating how national strategic choices have played out over the medium to longer term is not a straightforward business.

One needs to compare outcomes to the expectations originally set for a choice that is made, as well perhaps to the possible outcomes that could have resulted from alternative choices.

Also, unexpected events that have occurred since the choice was made, especially if major, would have changed the signposts for all available choices. Certainly in the case of the adoption by Malta of the euro, there was little awareness when the decision was taken that the financial crisis of 2008 and later was imminent.

There is another complication when assessing Malta's experience in the eurozone. The adoption of the euro came hard on the heels of Malta's accession to the EU. The later obligated the island to join the zone at a moment of its choice. Doing it so soon after EU accession means that it is difficult to really separate effects that occurred as a result of EU membership from those that happened as a result of adopting the euro.

If anything, the least that can be said is that the euro reinforced the economic consequences of EU membership, perhaps accelerated them. But that acceleration could also be considered a consequence of the 2008 financial crisis.

In general terms, Malta's experience over the last ten years confirms that the euro had been first and foremost a political project. It enjoyed, and continues to enjoy, wideranging popular support among Europeans, even if the economic and financial foundations for it were ramshackle right from the start.

These were laid out in the Stability and Growth Pact written in the nineties of the previous century. The pact, SGP for short, described how member states had to run budgetary and macroeconomic policies within stated parameters for their annual government deficits, national debt and inflation rates, among others. Before joining the eurozone, new entrants were expected to first achieve these performance ranges – which is what Malta did, with some huffing and puffing, not to mention some creative accounting.

At the time, I believed that it would have been more prudent to wait till the full consequences of EU accession were absorbed by the island before euro entry was attempted. Countries like Sweden, Poland and Hungary still believe this.

However, once the then government was determined to join the eurozone, it did not make much sense to contest this decision and create new tensions when the economy was already needing to digest the full application of EU regulations.

Moreover, in the middle of the last decade, it was clear that the European Commission was bullish to increase membership of the eurozone as fast as possible. That is the impression I got from an interview with the Commissioner then responsible for the eurozone Jouxquin Almunia. At the time, the EU appeared to be on a roll both economically and politically.

The original impetus to the political deal on which the eurozone was based came from German reunification. France was prepared to accept this only if a reunited Germany agreed to participate in a common European currency. The French believed that by doing so, Germany would have given up any aspiration to hegemonic dominance in the Europe of the future. They probably discounted the point that within eurozone structures, Germany would still end up in a dominant position purely by virtue of its economic strengths and success.

As a political construct, subject to the sway of national interests and bargaining between member states, the management structures devised for the eurozone lacked the cohesion of a federal arrangement with a centralised economic policy, central budgetary arrangements that could organise transfers within the zone to compensate for systemic imbalances, and a central bank that had truly overriding powers in all sectors of monetary policy. This happened because member states did not wish to relinquish their sovereignty, especially over economic policy – which is still the case at present.

The criticism was that the eurozone lacked the robust structures that could keep it going in a crisis. For quite some time during the initial years of this century, even the disciplines set out in the Stability and Growth Pact that were meant to ensure the cohesion of the zone were ignored, not least by France and Germany.

Moreover, powered by the optimism that was generated during the eurozone's first years, new members were added especially from the south, whose economic make up diverged substantially from those at the centre.

The eurozone came to satisfy less and less the requirements of an optimal monetary zone, one that in theory and in practice carried uniformly, all over its territory, roughly similar economic and social characteristics that would make usage of the same currency a desirable objective.

To the Cassandras who made these points, the natural response was: look at the political and economic success which the eurozone is enjoying.

The 2008 crisis changed that picture completely. It happened practically at the same moment that Malta became a eurozone member.

As the pressures accumulated, all the criticisms made by the Cassandras were validated. But then the biggest flaw at the heart of the euro project – that it was a political one – ensured it would not be allowed to fail. There was too much at stake politically.

Economic and financial meltdown in Greece first triggered the internal euro crisis. It continued with parallel developments in Ireland, Portugal, Italy, Spain and Cyprus, incidentally all countries in the south or at the periphery and thus among the greatest contributors to monetary suboptimality in the zone.

The crisis activated what the euro was politically intended to prevent: the emergence of Germany as the European driver, even if on the whole while being hard to very hard on major policy issues, this new power was deployed with prudence. Moves to contain and overcome the crisis depended right through on whether Germany was slamming the brakes on or pressing the accelerator.

Initially Germany insisted that in line with the SGP, Greece had to overcome its financial crisis on its own. When it became clear that this would lead to Greece's bankruptcy and damage hugely the euro project, Germany moved in favour of organizing a salvage operation.

The crisis played along two main tracks. Ultimately both led to public finances. Big banks too big to fail needed to be rescued for their demise would wreck economies. Because they had overspent and overborrowed over the years and/or because they needed to rescue their big banks, governments risked bankruptcy as the costs of servicing their international borrowings rocketed.

In return for strict, contractual commitments about how to run their budgets that implied huge cuts in public expenditures, the members in crisis were given loans initially by the other member states individually but acting jointly; later, on a pooled arrangement.

On this basis, by mid-2012, Malta was already committed for over 1 billion 200 million euros by way of loans and guarantees to other members states, plus the institutions being established to shore up the euro zone. The main building block here was a so-called European Stability Mechanism designed to provide backup finance to governments facing up to unsustainable deficits. In parallel with this, scrutiny and backup arrangements were set up to bolster big banks that were heading towards bankruptcy, under ongoing moves to establish a banking union within the eurozone.

Malta did not need to access any of these loan and backup arrangements. However, the argument has been made that we avoided being negatively affected by the 2008 crisis because we belonged to the eurozone. Frankly, I find this argument to be at best specious.

Most government borrowing in Malta is funded in the country itself. The banks which have overriding significance for the Maltese economy have most of their exposures in Malta. We were therefore up to a degree insulated from the 2008 fallout in so far as the financial system covering the local economy was concerned.

Actually, the main danger for Malta in the eurozone arose from the risk that the eurozone itself would collapse. This therefore gave us a vested interest to see that rescue packages were launched successfully.

To be sure, one could refer to our experience during the seventies of the previous century, when a global economic crisis prevailed, arguably much deeper than that of 2008. Malta had just launched its own national currency, the lira. It came out of that crisis with flying colours.

Actually, in reaction to the crisis, euro membership came to imply new controls on economic and financial management that were not there when we joined or that were slackly implemented. Mainly at the insistence of Germany, the introduction of rescue

mechanisms was linked to the setting of new rules for all, that enforced the strictures of the Stability and Growth Pact. Indeed they went beyond that. Among other things, they set as an objective for member states the short to medium term attainment of a balanced budget.

For Europe as a whole, at a time of recession, when banks had to adopt increasingly prudent policies, this austerity was a recipe for further stagnation. The eurozone and the EU as a whole embarked on a long period of great unemployment, deflation and low investment. Though growth has now finally emerged, Europe is still experiencing part of the fallout from these overprudent approaches.

For instance, a strict implementation of SGP rules regarding the public deficit has led to an all-round decline in public investment. In aiming to cut deficits and secure a balanced budget, the rules do not discriminate between recurrent and capital investment. Politically governments have found it much easier, more convenient, to cut investment outlays than recurrent expenses.

Also, inputs from the EU budget – which is basically an investment budget – have become more salient in ensuring the continuation of government investment projects. Governments have come to rely more on EU inputs in order to leverage their trimmed investment outlays. This has enhanced the jagged investment performance in the European public sector. During the initial phase when EU funded projects are being set up, disbursements are minimal till the actual implementation begins. Then project outlays tend to bunch together towards the end of the EU's multiannual budgetary cycle.

No wonder that since 2008, one main worry in Europe has been the decline of investment, both public and private.

It is clear that the general conditions resulting from developments in the eurozone have conditioned the economic situation and performance in Malta, not least by way of investment. Situated at the periphery of Europe, it has always been a challenge to attract toward the island significant longterm direct foreign investment. The efforts of recent years to achieve such a goal via say, private public partnerships, must also be evaluated against this background.

But also, the wider macroeconomic implications of eurozone dynamics need to be taken into account. One notes the wide divergence of economic endowments and standards across the eurozone, as well as between its centre and the periphery. As a result, within the zone, the output of the centre is undervalued and it therefore enjoys a strong competitive advantage. That of the periphery is overvalued and suffers a competitive disadvantage.

Outside the zone, the output of the centre doubles its competitive edge due to the momentum it already has resulting from the scale economies it has acquired, grounded on EU markets. The output of the periphery loses yet more ground.

So there occurs a transfer of resources from periphery to centre. Meanwhile, given the fixed rate of exchange within the zone, adjustments to relative competitiveness within it, have to be carried out through internal devaluation, otherwise named – austerity. This brings with it political trouble and social dislocations.

So Germany has been accumulating huge external trade and budgetary surpluses. But up to now, it has declined to recycle them back into the eurozone economy, via say, new investment that would have stimulated growth. And it refuses any notion that the eurozone should function as a transfer union to balance out discrepancies in economic performance across the zone.

All this has had an overhang for Malta.

It was claimed for membership of the EU that it would boost economic growth rates and new investment.

This did not happen. At best, growth rates remained at the modest levels of the early years of this century when they had already dipped, contrasted to previous decades. Since Malta joined the eurozone, industry has declined by over 30 per cent; the much smaller farm sector by double that. What compensated for these losses, were on the one hand, EU funds in financial terms; on the other hand, an ongoing expansion of the services sectors – tourism, financial services and later gaming activities.

However, these sectors all benefitted from factors that fell outside the purview of the eurozone, indeed the EU.

Terrorism and political crises knocked out major tourist destinations that competed with ours, so that Malta along with Spain and Portugal increased their market shares hugely.

Financial services and then gaming grew in the absence of any Europe wide policies to regulate them. Eventually they reached the take off point that has fuelled the record growth of recent years.

But the last two are vulnerable sectors. They depend on the maintenance of tax flexibility within the European Union. This is under attack amid claims that it allows tax evasion and similar sins to proliferate. In the continental media, as well as with European governmental authorities, Malta has acquired the reputation of being a tax haven. Whether true or false, the reputation is there and has to be taken into account.

What is true is that since we have become a euro member, foreign investment flows reaching us are in their great majority, getting parked here for onward transfer to somewhere else. The flow at present is sufficiently plentiful for our scale and well renewed to make a net significant and favourable impact on our finances.

Providing garage services for international financial movements is a useful function but it does not have the same permanence as greenfield productive investment. This, Malta always found difficult to attract and retain. Under eurozone operating conditions I would argue that the problem has become greater. Solving it has indeed become more costly, as the Crane project seems to show.

To sum up: The conclusion to arrive at on the basis of Malta's experience as a member of the euro zone is a very obvious one. But it needs to be hammered home and needs to be understood in terms of the arising questions about the future of the eurozone that sooner or later will be coming up for decision.

It is this: Within the eurozone, Malta can only be a policy taker, certainly not a policy maker. I believe that we are not much better than when we were when an integral part of the sterling zone up till some years after Independence. This does not mean that we are paralysed as we face the choices that will be coming up. It means that our future economic success will depend on how well we are able to interpret arising situations and how correctly we succeed in predicting outcomes within the eurozone decision making structures.

Secondly, regarding the array of decisions that will come up in the short to medium term, we need on the basis of the acquired experience to have an opinion as to whether it is in our interests:

--That the European Stability Mechanism which has been used to support the failing finances of governments, be turned into a kind of IMF for Europe? – I believe yes.

--That such a new IMF for Europe should be used for an initial period, to backstop the Authority which watches over the resolution of European banks? –I believe yes.

--That there should be a eurozone finance minister with budgetary clout? – I think not.

--That a banking union within the eurozone should include as soon as possible a Europe wide deposit insurance scheme? – I think yes.

--That the EU budget should contain as of now a revenue and expenditure line covering the eurozone? – On this one, best postpone.

Being a policy taker in the eurozone, Malta has no alternative but to be cautious about new policy initiatives covering the zone. For these could serve in future to emphasize further its policy taking role, while reducing the margins for autonomous action that would reflect the special circumstances facing these islands.