FOR AGENDA

SM/07/259

July 13, 2007

To: Members of the Executive Board

From: The Secretary

Subject: **Malta—Selected Issues**

This paper provides background information to the staff report on the 2007 Article IV consultation discussions with Malta (SM/07/257, 7/12/07). At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of Malta indicating that they consent to the Fund's publication of this paper.

Questions may be referred to Mr. Chelsky (ext. 37362) and Mr. Danninger (ext. 34468) in EUR, and Mr. Perrelli, FIN (ext. 38782).

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the European Central Bank and the WTO Secretariat on Monday, July 23, 2007; and to the European Commission, the European Investment Bank, the Food and Agriculture Organization, and the United Nations Development Programme, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

MALTA

Selected Issues

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Approved by the European Department

July 12, 2007

Contents Page

MALTA'S COMPETITIVENESS CHALLENGE

With entry into the European Monetary Union imminent, Malta needs to address its competitiveness gap to reap the full benefits of integration. Traditional export sectors—tourism and semiconductors—have steadily lost market share this decade, resulting from a combination of external shocks, past wage hikes, and low productivity growth. In the absence of productivity enhancing reforms, regaining competitiveness within a monetary union could imply a protracted period of wage moderation and slow growth. However, there are some positive signs. A shift to higher value added activities is underway and new clusters are forming in the service sector, although their long-term potential remains uncertain.

I. INTRODUCTION

1. **Malta's economy is very open and heavily concentrated, and economic prospects are thus closely linked to competitiveness.** As a small island economy, Malta is greatly dependent on international trade, with export- and import-to-GDP ratios exceeding 80 percent. Despite its large export share, economic activity is narrowly based. Semiconductors and tourism together account for more than half of export earnings and generate more than one-third of GDP. Furthermore, Malta's small size implies that it is a price taker in international markets, and its economic fortunes are closely tied to its ability to maintain external competitiveness.

2. **A sequence of adverse shocks has seriously tested the economy's competitiveness over the past decade.** The bursting of the IT bubble in 2000 had adverse effects on the electronics sector, and the 9/11 terrorist attacks hit the tourism and travel industry. These challenges were exacerbated by a large public sector and inefficient parastatal enterprises, which have held back economy-wide productivity growth. Moreover, European Union (EU) accession in 2004, and the associated tariff reductions exposed previously sheltered domestic production to foreign competition and highlighted the negative effects of fast wage growth in the second half of the 1990s.

3. **Malta is at the doorstep of European Monetary Union (EMU) and its longer-term prospects are closely tied to its ability to regain competitiveness.** In the run-up to EU membership in 2004 and prospective EMU entry on January 1, 2008, Malta undertook broad-based reforms. Besides successful nominal convergence—the Maastricht criteria have been met—there has been progress in diversifying the economy, and businesses in new sectors, such as pharmaceuticals, business services and remote gaming, are emerging. However, the current account remains in a protracted deficit, and losses in world market share for traditional exports sectors are symptomatic of competitive pressures.

4. **This paper discusses the evolution of Malta's competitiveness.** Section II reviews competitiveness from a macroeconomic perspective and highlights how competitiveness

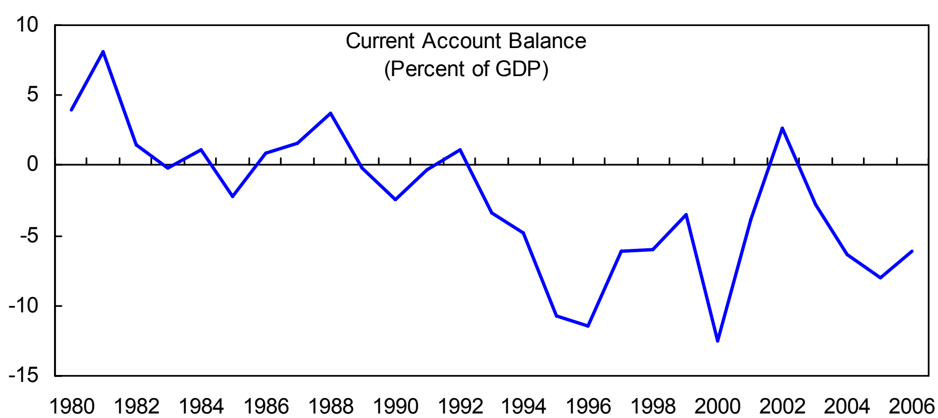
problems are related to the structure of the external sector. Section III reviews developments at the level of individual export sectors. Section IV concludes.

II. External Sector Developments and Competitiveness

5. **Developments in competitiveness are best understood by coupling exchange rate analysis with traditional analysis of external sector trends.** In Malta, quantitative competitiveness assessments are hampered by data constraints related to measurement issues (e.g., owing to past multiple exchange rate practices) and methodological breaks in macroeconomic data. For these reasons, the competitiveness analysis in this paper relies on both an interpretation of external sector trends and an analysis of the real effective equilibrium exchange rate.

A. External Sector: Structure and Developments

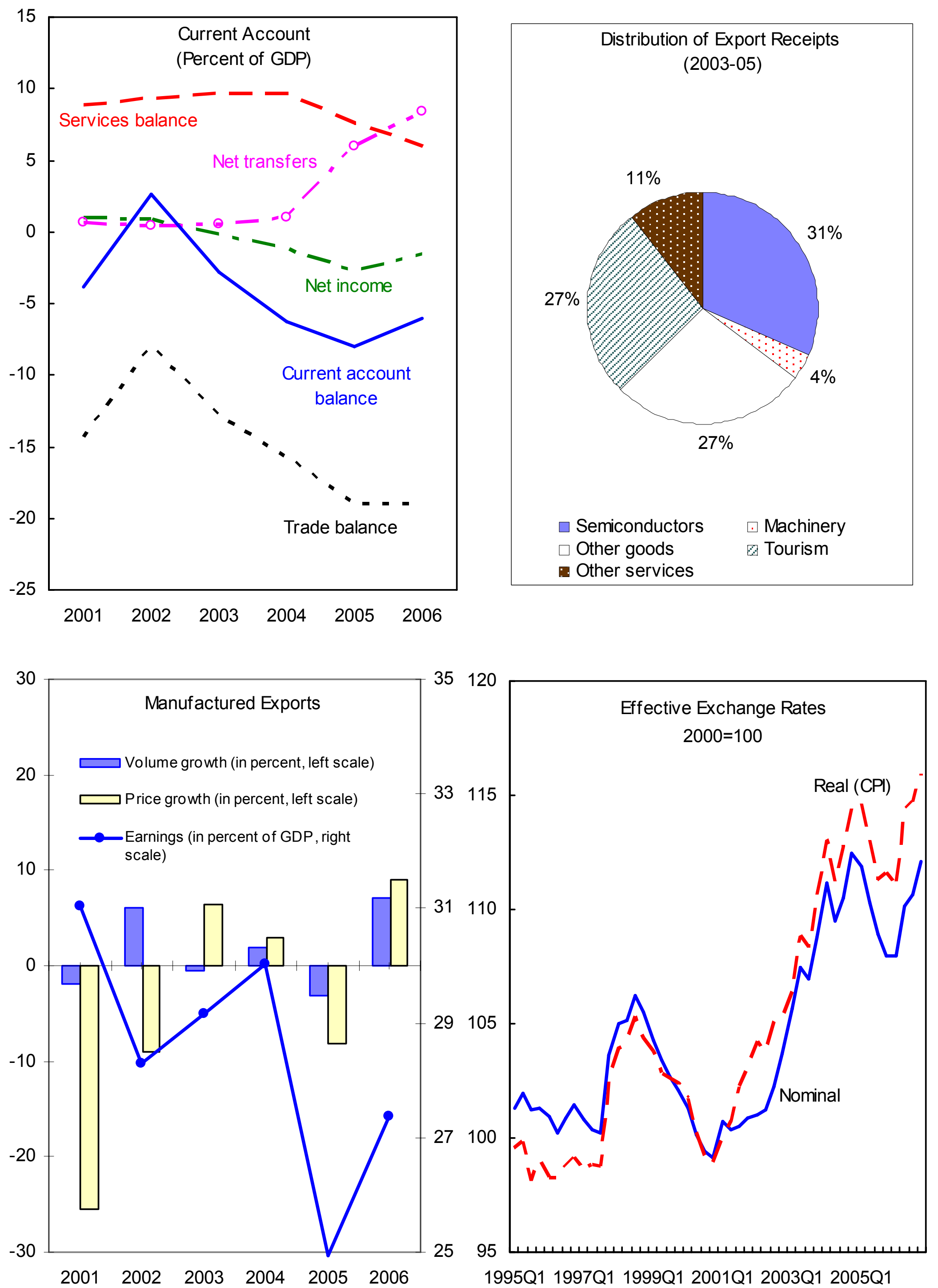
6. **After a decade of broadly balanced external accounts, the current account turned into deficit in the 1990s** (Figure 1). Since the mid-1980s, an ambitious public investment program, coupled with economic liberalization, stimulated domestic demand, leading to a gradual deterioration in the current account.[1] This deterioration was compounded by trend appreciation of the real effective exchange rate (REER) that began in the early 1990s. By the mid-1990s, tariff reform had begun to boost import demand, as financial sector and capital account deregulation encouraged banks to compete more aggressively for business lending. Initial efforts to address the growing fiscal imbalance were only partially effective, and structural reforms proceeded only gradually, so that the current account remained in deficit throughout the 1990s.



Sources: WEO; and IMF staff calculations.

[1] IMF (2001).

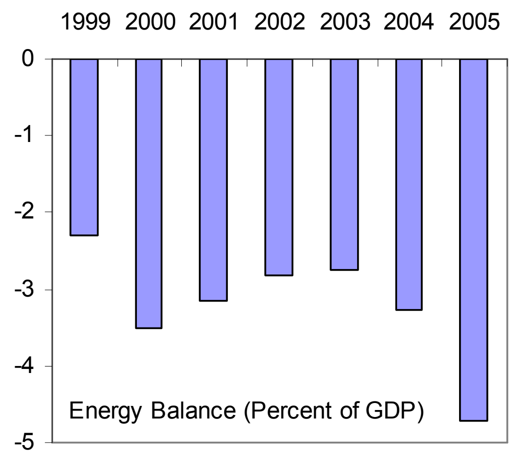
Figure 1. Malta: External Sector



Sources: Eurostat; National Statistics Office of Malta; IMF staff estimates; and UN Comtrade.

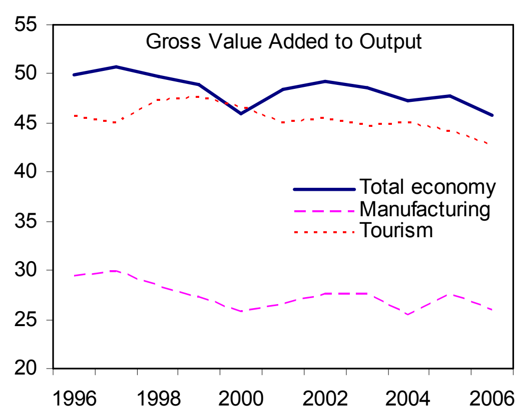
7. **Malta's export sector has become more diversified by product and destination.** The tourism sector has been the traditional mainstay of the economy for most of its recent history, with European tourists providing the bulk of visitors. However, since the 1980s, Malta has also been home to a manufacturing plant for a major, globally integrated, electronics firm. With a substantial expansion of production in the late 1990s, about one-third of all export earnings now come from semiconductors. This has contributed to a diversification of its export markets, with the share of goods exports to Asia rising from around 6 percent in the early 1990s to more than one quarter since 2002. However, this has also left the economy vulnerable to the vagaries of an increasingly competitive and volatile semiconductor industry.

8. **Notwithstanding diversification, external shocks and a pronounced dependency on oil weighed on the external accounts.** While Malta has a well developed export sector, vulnerabilities remain high due to the narrow export base. As a result, the economy was disproportionately affected by the dotcom bust and the recession in the travel industry following the 9/11 terrorist attacks. Moreover, given the economy's heavy dependence on energy imports—partly due to the need for desalination—the doubling of oil prices between 2003–06 led to a substantial increase in import costs and a growing energy deficit.



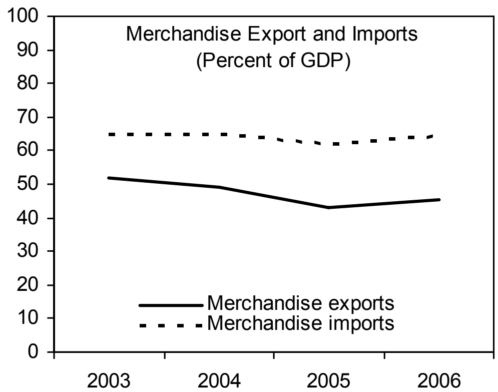
Source: National Satistical Office.

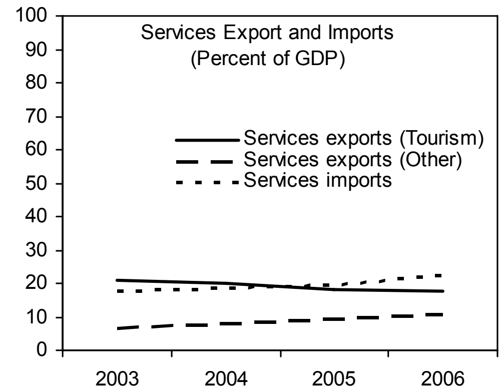
9. **Globalization and European integration also had a dampening effect on traditional exports.** EU entry in 2004 exposed exporters to new competition from low-cost producers in other accession countries. The tourism sector saw some of its demand diverted to Southern and Eastern Europe, and traditional manufacturers, especially in shoemaking and textiles, lost market share and eventually shut down production. Adding to these pressures was the coming on stream of low-cost electronics producers in Southeast Asia, notably the Philippines, and the emergence of alternative tourist destinations. All of these developments contributed to a decline in profit margins, as indicated by the falling share of gross value added in total output.



Source: National Statistical Office.

10. **As a result of these developments the current account remained in deficit and has improved only recently with the emergence of new services exports.** The current account deteriorated during most years since 2000, and the deficit narrowed only in 2006, at 6 percent of GDP. Both merchandise trade and services balances contributed to the deterioration, falling 2001–06 from -14 to -20 percent of GDP and 9 to 6 percent of GDP, respectively.





Source: National Statistical Office.

- **Merchandise trade.** Goods exports declined by 10 percentage points of GDP since 1995 and began to recover only in 2006 to 45 percent of GDP. The weakness was broad based (see section III). At the same time, the import-to-GDP ratio remained high, as EU funding boosted investment and, more recently, private consumption rebounded.

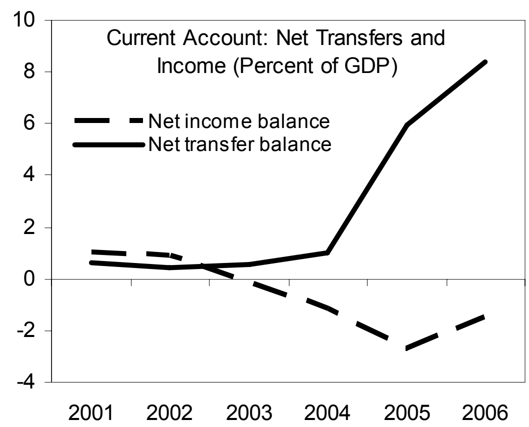
- **Services trade.** The services surplus declined by 3 percentage points since 1995 to 6 percent of GDP in 2006. The deterioration reflects falling tourism and transportation sector revenue, although other service exports increased, including through growth in professional services (e.g., call centers) and business services (e.g., airplane maintenance). At the same time, service imports grew steadily due to increased travel abroad by residents and marketing activities of the remote gaming industry.[2]

11. **The sharp increase in the net transfer balance since 2004 is related to the fast growth of the remote gaming industry.** Since 2003, an increasing number of foreign-owned remote gaming operators set up in Malta given its sound regulatory environment.[3] Due to the large scale of operation relative to Malta's economic size, the international

[2] The remote gaming industry facilitates mainly internet-based gambling, including betting on sporting events.

[3] Several remote gaming enterprises intend to list on capital markets and, hence, desire to operate in a well-regulated environment.

transactions of this sector have had a growing effect on the balance of payments. This is visible in the transfer balance, which records the net betting revenue of operations (i.e., bets placed minus wins paid out) and has grown to a net surplus of 8 percent of GDP in 2006.[4]

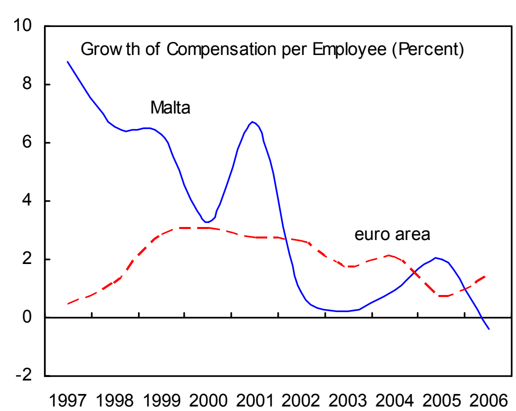


Source: National Statistical Office.

12. **The full impact of remote gaming on the current account is not yet well understood but is likely substantially smaller than indicated by the transfer balance.** The transfer balance captures only part of the activities of the industry. The net-credit entry is offset by debit entries in the services balance related to substantial imports for marketing and consulting services. In addition, the repatriation of gaming profits leads to further outflows. Due to the fast growth of the industry and a lack of accurate data, the net impact s on the current account balance is not well understood. Balance of payments statistics show a large positive impact of remote gaming on the transfer balance for 2006 but only a small outflow of factor income. It is conceivable that profit outflows have been delayed or were not recorded. Based on estimates of service imports (e.g., advertising), profit transfers derived from balance of payment data, and discussions with the authorities, staff estimates that gaming-related current account debits reached almost 7 percent of GDP in 2006, limiting the net positive impact on the current account to approximately 1 percent of GDP. This estimate appears broadly in line with preliminary data on employment in the sector (estimated at around 700 at end 2006) and the sector's overall low capital intensity.

B. Real Exchange Rate Developments and Competitiveness

13. **While the extent of the competitiveness gap is difficult to gauge, there is little doubt that external competitiveness deteriorated over the last decade.** Rapid wage increases in the late 1990s, inefficiencies imposed by a large public enterprise sector, and modest productivity gains have all undermined competitiveness. These pressures have continued into this decade and coincided with increased competition and, most importantly, intensified adjustment in competitor countries. Although wage growth in Malta has been moderate in recent years, it has been even

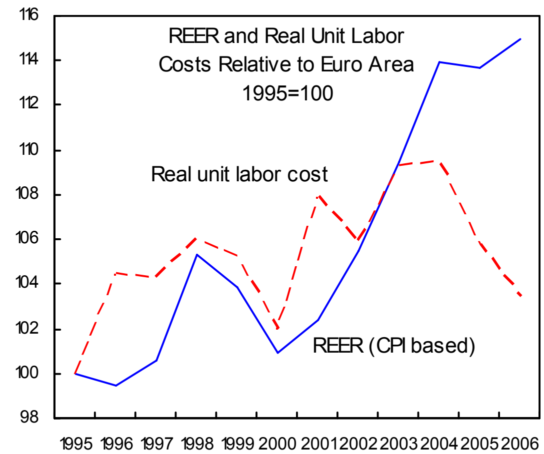


Sources: Eurostat; and IMF staff calculations.

[4] Central Bank of Malta (2007).

more moderate in European competitor markets.[5] These developments have resulted in substantive REER appreciation this decade.

14. **An extension of the results of a study of the equilibrium real exchange rate suggests moderate overvaluation.** A recent study by the Central Bank of Malta[6] used a broad range of estimation methods and found that the real effective exchange rate was roughly in equilibrium in 2002. Results for 2004 were more mixed, and two approaches indicated overvaluation between 4 and 6 percent. The case for overvaluation appears to have firmed, given REER appreciation of 9 percent since 2002.



15. **More formal analysis indicates overvaluation of between 10 and 15 percent although these estimates have a high variance.** This analysis is based on two different estimation approaches, which quantify the degree of REER adjustment necessary to bring the projected medium-term current account balance into line with its estimated equilibrium or "norm" level (Box 1).

III. Sectoral Developments and Competitiveness

Merchandise exports

16. **Underlying the worsening of the trade deficit has been a steady and broad-based loss of export market share for several of Malta's major exports.** Indicative of high export concentration, the 13 largest export categories have generated more than 80 percent of merchandise export revenues, on average, since 1996. While approximately one-half of the categories have registered market share increases and one-half declines over the past decade, the revenues generated by the products that lost market share have exceeded those generated by the products that gained market share by a factor of two.[7] Where market share has been lost, it has tended to shift to lower-cost producers, such as China (apparel), Romania (shoes), and Philippines (semiconductors).

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[5] The dynamics of the REER differs with the choice of the base year, and direct measures of unit labor costs are only available at an aggregate level.

[6] Central Bank of Malta (2006).

[7] Nuclear reactors, boilers, and machinery, (approximately 5 percent of merchandise exports) registered little change in world export market share between 1996 and 2005.

Box 1. Assessments of the Maltese Lira Equilibrium Exchange Rate

The analysis is based on the Macroeconomic Balance (MB) approach developed by the IMF Consultative Group on Exchange Rate Issues (CGER).1/ The approach calculates the current account (CA) gap, measured as the distance between the projected medium-term CA balance at prevailing exchange rates and an estimated equilibrium CA balance—referred to as the CA norm—for 2011. The exchange rate adjustment necessary to close the gap between the projected CA and its norm is obtained as the ratio of the CA gap to the CA elasticity with respect to the real exchange rate.

While the medium-term current account balance is projected, the CA norm involves out-of-sample estimates from econometric models, based on a panel of 54 industrial and emerging market economies for the period 1973–2004. The equilibrium relationship between current account balances and a set of macroeconomic fundamentals is estimated via pooled and fixed effects panel data regressions. The main difference between the pooled and the fixed effects regressions is that the former assumes a common intercept for all countries, while the latter allows for country-specific intercepts. Once computed, the distance between the norm and the projected CA balances is divided by the CA elasticity, yielding the level of real exchange rate adjustment necessary to eliminate the difference.

Seven fundamentals are considered to be robust determinants of the CA balance over the medium term and thus are included in the regression estimating the CA norm. These are: fiscal balance, old-age dependency ratio, population growth, initial net foreign assets, oil balance, output growth, and relative income. All else equal, fiscal surpluses, net foreign assets, oil surpluses, and higher relative income, are positively associated with the CA norm, while the other variables exhibit negative correlation. In addition, the approach controls for banking and currency crises, as well as for economies hosting financial centers.

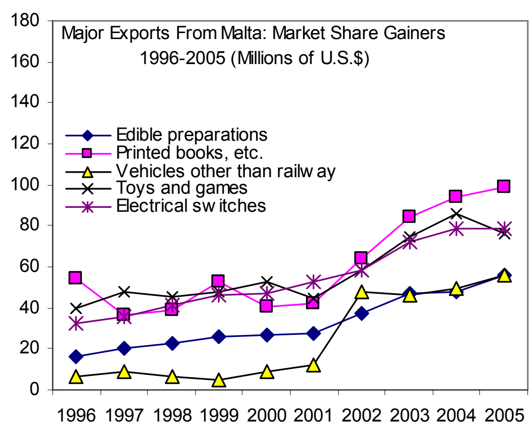
In the case of Malta, the medium-term CA norm is estimated to range between -1.6 (fixed effects regression) and +0.6 (pooled regression) percent of GDP, while the projected 2011 CA balance is -6.2 percent of GDP. The CA gap, therefore, is -4.6 and -6.8 percent of GDP, respectively. Given the computed CA elasticity of -0.5 for Malta, the exchange rate depreciation required to close this gap is 10.1 and 14.8 percent, depending on the econometric model. At this elasticity, a deterioration (improvement) in the projected CA balance of 1 percentage point of GDP would correspond to an incremental depreciation (appreciation) of 2.2 percent.

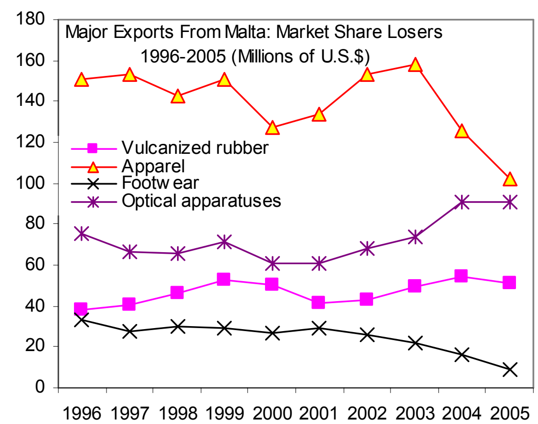
To account for the potential impact of shocks in the estimated CA elasticity for Malta, sensitivity analysis was conducted replacing the CA elasticity by the Maltese historical average plus/minus twice its standard deviation. The results indicate a confidence band for the overvaluation ranging between 7.4 and 11.5 percent in the case of the fixed effects regression, and between 10.9 and 16.9 percent in the case of the pooled regression.

1/ Data requirements allow estimates for only one of the Fund's standard methodologies to assess equilibrium exchange rates.

17. **In the electronics sector, competitive pressures have been exacerbated by the dotcom bust.** Increasing global competition has put pressure on semiconductor exports. Following a shift to higher value-added products, exports began rising again in 2003. Nonetheless, the share of value added in output of the electronics sector has declined and, as a result, profit margins appear to have fallen.

18. **However, exporters have made inroads into new markets.** Malta has been successful in gaining market share, including for printed books, toys, and games. Moreover, pharmaceutical exports, which only accounted for 1 percent of total exports on average between 2000–05, quadrupled in value in 2006. While these advances are important, to date, they have not been large enough to offset revenue losses in other sectors.





Source: UN Comtrade.

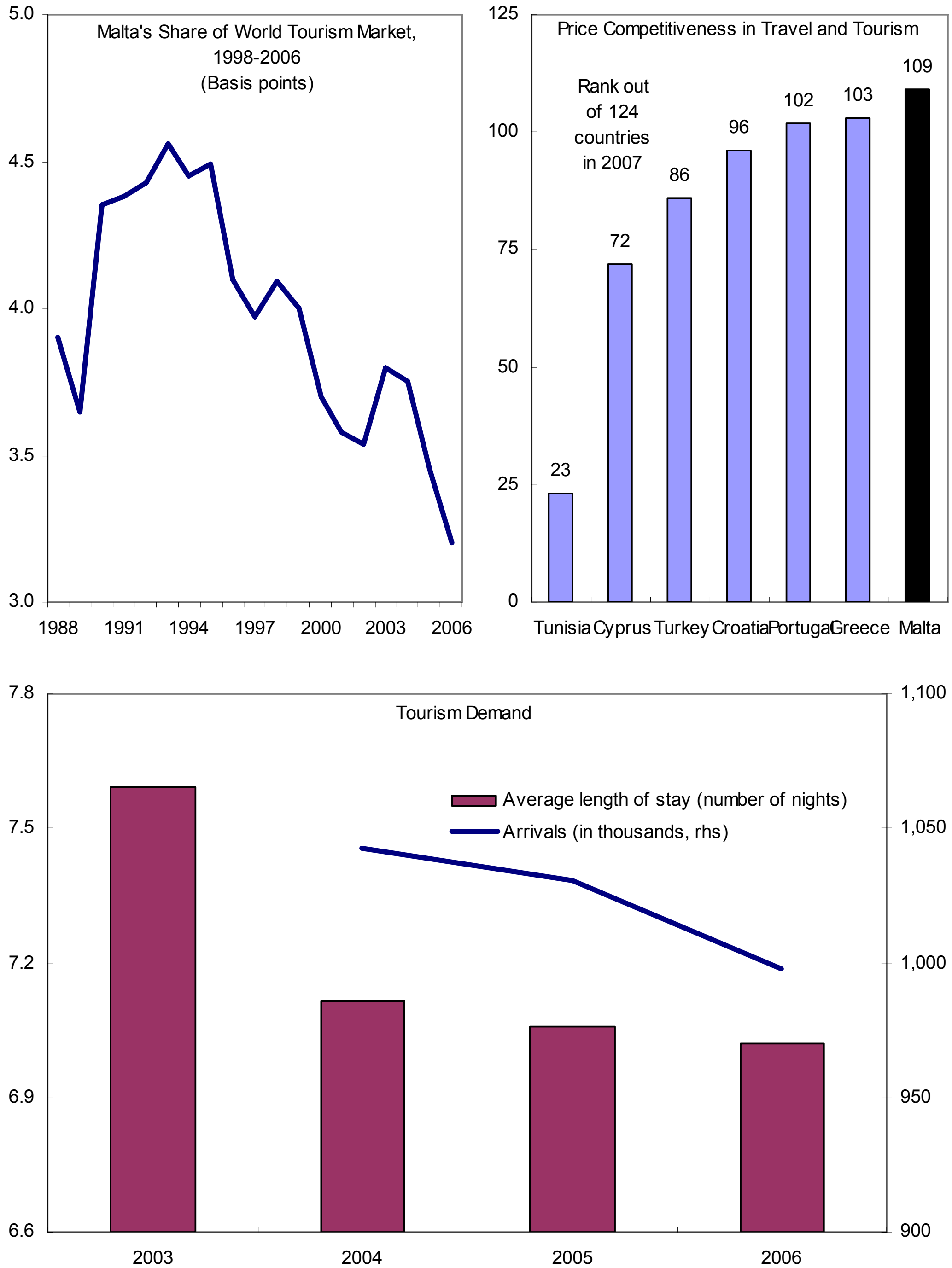
Tourism exports

19. **Eroding competitiveness is also evident in the tourism sector.** Tourism dominates the services sector and contributed about three-fourths of services export receipts during 1996–2005. Since the mid-1990s, Malta has steadily lost world tourism market share—as the REER experienced trend appreciation—and the sector remains under competitive pressure (Figure 2).

20. **Malta is at a significant disadvantage relative to other tourist destinations in terms of price competitiveness.** Part of the reason for this erosion is reflected in the World Economic Forum's *2007 Travel and Tourism Competitiveness Report*.[8] According to the

[8] World Economic Forum (2007). The report measures the "factors and policies that make it attractive to develop the travel and tourism sector in different countries." See also World Travel and Tourism Council (2007).

Figure 2. Malta: Tourism Indicators



Sources: Eurostat; World Economic Forum; and World Travel and Tourism Council.

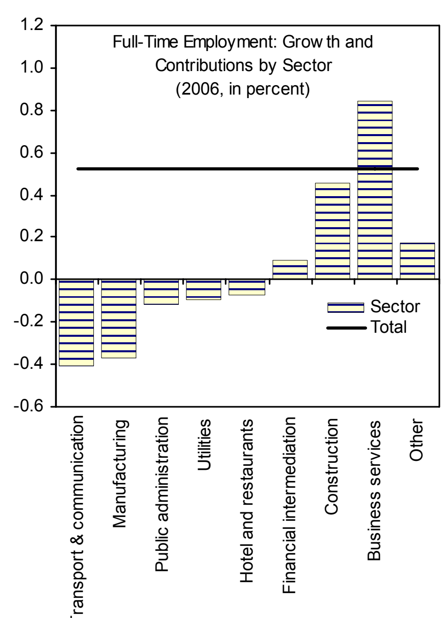
report, Malta ranks 26th out of 124 countries in overall competitiveness. While this is a relatively favorable overall ranking, it masks poor relative performance in terms of price competitiveness (109th), labor quality (90th), and ground transport infrastructure (60th). These serious deficiencies have undermined Malta's attractiveness as a tourist location.

21. **However, a rapid increase in cruise ship tourism, consolidation in the hotel sector, and an opening of Malta's skies to low-cost airlines offer room for optimism,** although it is too early to tell whether the following developments will be sufficient to reverse the decline in market share.

- Between 2004 and 2006, tourist arrivals via cruise ships increased by 37 percent, offsetting some of the revenue losses from the stagnation in package tourism. While this is a positive development, cruise ship tourism is considerably less lucrative than overnight visitors. Malta is attempting to improve this situation by marketing itself as a "cruise hub" rather than a "port of call" but so far with only limited success.

- Rationalization in the tourism sector has led to fewer, but larger, establishments. The number of hotels has declined by 9 percent since 2003 and the number of tourist beds by 2 percent. There has also been a modest shift up the value chain, with the share of two-star hotels declining, while that of five-star hotels has increased. This appears to have been the result of price reductions by higher-end hotels, which have put pressure on lower-end establishments.[9]

- The tourism sector is benefiting from efforts to reduce travel costs. Aided by government incentives, low-cost airlines began flying to Malta in late 2006, leading to an increase in tourist arrivals. However, to date, these gains have been at least partially offset by an industry-wide trend toward shorter (albeit more frequent) trips.



Exports of other services

22. **Emerging services have partially offset declines in other exports, but their potential remains uncertain.** Besides remote gaming, new business services, such as call centers and back-office management, have been attracted to Malta because of its

[9] Recent data indicate a large year-over-year decline in consumer prices in the hospitality sector (-4.1 percent in April), further evidence of the severity of the competitiveness pressure face by this sector.

good telecommunications infrastructure and the English language proficiency of its population. These activities have generated significant employment growth, which has helped offset job losses in traditional sectors. However, these activities tend to be mobile and their long-term potential remains uncertain.

IV. Conclusions

23. **Malta is widely expected to join EMU in 2008, highlighting the importance of restoring competitiveness.** After a decade of broadly balanced external accounts, the current account turned into deficit in the 1990s. Languishing growth during this decade and a sequence of adverse shocks seriously tested the economy's competitiveness. Malta's traditional export industries—semiconductors and tourism—gradually lost market share and have only recently begun to recover.

24. **External weakness could trigger a period of prolonged adjustment and slow growth.** A formal analysis of Malta's overall competitiveness based on estimates of equilibrium real exchange rates indicates that the REER is overvalued by between 10 and 15 percent. While assessments of equilibrium exchange rates are subject to wide margins of error, this estimate is not out of line with earlier estimates by the Central Bank of Malta showing overvaluation of no more than 6 percent in 2004, given REER appreciation since. The experience of other countries shows that regaining competitiveness within monetary union can trigger a prolonged period of slow growth, especially in the absence of far-reaching structural reforms.

25. **Structural change in the export sector and the emergence of new activities are possible signs of a turnaround, but it is too early to judge whether they herald a permanent improvement.** New activities in business services, pharmaceutical production, and remote gaming have supported growth in the last two years. In the tourism sector, a rapid increase in cruise ship traffic, consolidation of hotel capacity, and an opening of Malta's skies to low-cost airlines also offer new opportunities for growth. These are important developments, but they are at an early stage so that it is difficult to assess whether they indicate a lasting structural improvement.

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