THE ECONOMY OF COMMUNION IDEAL AND ITS RELEVANCE FOR THE MALTESE ECONOMY

1. *The emerging background*

Ideas are instrumental to inducing change if they are evaluated critically and allowed enough time to mature. In this way, they get adapted to the respective environment in which they are to take off. Such an evolutionary process of reflection, search for alternatives, and focusing of thought is an important input in all spheres of knowledge. It is perhaps more so in the domain of those factors that contribute to individual freedom and happiness and to social choice and cohesion.

Accepting the philosophical underpinnings of social paradigms does not automatically imply the immediate implementation of their policy prescriptions. The times and the social, political and economic environments have to be ready to accept the adoption of ideas. And given the speed with which views on social policy are spread worldwide nowadays, ideas could be accelerated to fruition by the adaptation of domestic policy measures to

Speech delivered at the Colloquium organised by New Humanity Movement on "Economy of Communion – A New Approach to Business and Enterprise", Thursday, 27 January 2000 international trends. The assimilation of a country's policies with global policy scenarios renders such measures politically and socially acceptable.

The debate on the utility of the Vision and the Means implied by the Economy of Communion model of social interaction encompasses ideas related to individual freedom, inter-personal support, an efficient production system, and a fair and person-directed redistribution of income. It has to be located within a temporal perspective of assessment-refinement-fruition of ideas. The paradigm is being proposed after many years of social experimentation in which the Collective, via the state, assumed an ever- widening range of responsibilities with regard to individual welfare.

Many countries, Malta included, have experimented with the Welfare State, that is, the creation of a society in which citizens are provided by the state with services that ensure economic security for themselves and their families. Welfare states start modestly, then commence growing in the size and the range of benefits they provide. Because of social and political constraints that render difficult substantial reductions or withdrawal of benefits once these are introduced, there does not seem to exist an equilibrating tendency that sets an upper limit to which welfare services may approach but not breach.

Experience demonstrates that rising unrequited transfers tend to encourage the abuse of publicly funded welfare schemes. Consequently, they raise unnecessarily the costs of the social welfare programmes. At the same time, citizens attempt to escape from paying the taxes and user charges that are raised to support these programmes. The end result is generally rising government sector deficits and public debts. The burdens of rising debts could be technically reduced through inflation. But rising prices hit the

expenditure potential of households with low and fixed incomes.

In many countries, rising or/and high unemployment rates and the intensification of competition in the exchange of goods and services have undermined the faith in economic management that relied on relatively heavy controls on domestic and international trade. In the past two decades, the world has seen a return to economic liberalism. Liberalism implies restricting the powers and functions of governments so as to give full scope for individuals, families and enterprises. Hence one of its leading principles is that of limited government in the economic domain as elsewhere.

But this movement is still potentially fragile. While people do not support full-blooded collectivism, yet they do not yearn for economic liberalism. They are after a sort of, what may be termed, "do-it-yourself economics" - often a batch of intuitively persuasive proposals all of which have a distinctively interventionist flavour.

Besides, doubts about the sustainability on a global scale of the economic development pattern that evolved in industrialised countries are also calling for an assessment of present trade and consumption trends. The core idea of sustainable development is based on inter-generational solidarity: meeting the needs of the present without compromising the ability of future generations to meet their own needs.

Malta is also going through this process of search and transition. After several decades of direct controls and intervention by state agencies, a decisive shift towards freer trade and capital movement has been recorded. There is presently a rising dominance of international market forces in everyday transactions within the constraints defined by the size of the respective domestic markets for goods and services. These emerging market forces will in time induce changes in resource allocation and prices of capital, land, labour and enterprise.

Even the tenets that inspire the state's welfare programmes are the subject of consideration. The universalist principle – all are entitled to receive benefits irrespective of recipients' income – is to be replaced by the principle of self-help, according to a government document entitled *A Caring Society in a Changing World* (Ministry for Social Policy, 1990). The four basic ideas behind the caring society concept are participation, solidarity, empowerment and decentralisation.

It is in this emerging political and economic context that the potential contribution of the Economy of Communion idea has to be evaluated.

2. *The tenets of the Economy of Communion*

The Economy of Communion model aims to give a human soul to the creation of wealth. It is directed to the humanisation of the system of production and distribution. It departs from the evangelical vision of a God, Father of Mankind, and all human beings are His children. It is this universal brotherhood which inspires the putting into practice of the moral value known to Christians as Charity (Christian Love) and to non-Christian believers as 'Benevolence'.

This vision rests on the tenet that all human beings are instinctively inclined to share or to give rather than to possess. The culture of sharing or communion is basic and lies 'deeper entrenched' in a person's psyche than the culture of possessing. All are called to respect and love others. This culture of communion is lived by those who are conscious of its merits for human fulfilment and happiness. Reciprocal

charity gives rise to solidarity. Solidarity can become durable only if one's egoism is suppressed and difficulties are faced and overcome. This communal solidarity demolishes barriers that separate social classes, political ideologies, and nation states.

The Economy of Communion upholds the efficiency of the market system and the drive towards wealth creation and the generation of profits. The important difference between this social and economic model and a typical firm described in a textbook on economics lies in value judgements. The economic theory of the fIrm is value free. The ranking of social priorities regarding personal welfare is transferred to the domain of politics which produces the legislation controlling production and distribution.

The theory of the firm leads to a classification of primary incomes arising from the exchange of services engaged in the production of commodities. And it stops there. It is then up to the government's intervention through the tax/appropriation-income transfer mechanism and to voluntary, non-profit organisations to redistribute the primary income into personal or households' income, thus creating a new configuration of the command over goods and services in a society. Personal consumption and saving depend on the secondary, personal or household income profile.

The Economy of Communion envisages the bypassing of this re-distributive mechanism. The actual personal or household command over goods and services emanates directly from the primary, functional or factor income distribution. The dividends are not entirely transferred to the entrepreneurs who combine labour and capital. Instead, they are distributed according to a set formula. A third goes to support the growth of the enterprise; another third is paid to those workers who are in need or allocated to generate new employment in the firm; and a third goes to finance the spreading of the vision of Economy of Communion.

Capital invested by 'entrepreneurs' in the Communion firm does not necessarily reap direct personal financial gains for contributors. These entrepreneurs earn a salary if they are also employed with the firm. The funds invested in the firm may be turned into a donation or contribution, although entrepreneurs are free to sell their equity at any time. The firm behaves like a non-profit organisation but with a major difference: the enterprise strives to generate profits and be at all times efficient. It will thus create its own supporting finance and render feasible its future growth. Profits are not all directed to personal gain, but rather to support others and to disseminate the ideal of an Economy of Communion.

A variant of this profit scheme allows shareholders in public limited companies to opt out of their right to dividends for some time and allocate their share of profits on the lines described above. In this case, the shareholder's participation in the Economy of Communion refers to a voluntary renunciation to the right to claim dividends, a decision that may be reversed.

Firms participating in the Economy of Communion are law abiding, avoid corrupt practices and are environment friendly. At the same time, they concentrate on the production of useful goods and services and create genuine value for society.

Those individuals who benefit from assistance do so with the specific intention of renouncing to such support once they no longer need it. Indeed, they themselves will seek to assist others in the best way they can.

The vision emanating from the Economy of Communion model is dynamic. It is not based solely on the underlying

solidarity principle, deriving its inspiration from theological sources. It is also forward looking. It foresees a global trade environment where the relocation of capital chasing low wages in search of profits could one day be difficult to attain. The non-profit firm will therefore assume greater importance especially in the sector of services. This phenomenon is already apparent in developed countries. Hence the need to reconsider the interpersonal relationships within firms, inter-industry and internationally.

3. *The Maltese Situation*

The Maltese Islands are not new to international solidarity. In the past half century, the Maltese people benefited from the moral and financial support given by various countries which received Maltese emigrants. Around 150,000 Maltese sought temporary or permanent settlement abroad. Their departure from Malta facilitated economic management for policy makers both pre- and post-independence. At the same time, the financial assistance received from the United Kingdom in relation to the military bases on the islands, and the support received from Italy since 1980 in grants and technical aid, increased the resources available for economic diversification and growth.

Also in the eighties, the Malta government set up a Posterity Fund that had as one of its objectives to seek investment in Less Developed Countries. But this objective never materialised and the funds were allocated for domestic uses. However, the Maltese do support people in need abroad. Such assistance remained primarily in the private sector domain effected through donations to the missions run by religious orders.

The vision and main characteristics proposed by the Economy of Communion model may be briefly addressed in the Maltese context under the following headings: Vision; Economic Efficiency; Participation in Decision Making; Law and Environment Friendly Institutions; Nationalism; and Life Skill Preparation.

3.1 *Vision*

The social contract that evolved over the past thirty years in Malta was based on an expanding, direct state control of economic activity, profits and employment generation, and, recently, a fairly constant Tax-GDP ratio. In return, the state bound itself to provide at zero-price a widening composite of services besides cash. Services included housing, medical aid, education and social security payments. Rising per capita incomes, smaller families, improved living standards, and higher economic expectations for the future, changed the interpersonal relationships in Maltese families and society. The Maltese want more and they want it now!

However, a combination of a fast-approaching ageing population, rising government budget deficits and unemployment, the changed role of women in a more individualised society and the emergence of lone-parenthood, are demanding a reconsideration of the entire welfare support set up. This means a re-assessment of the individual-collective relationship in an economic structure that is still heavily reliant on state intervention and the political market conditions that go with it. The economic market works in terms of the fittest; the political market operates in terms of alliances. The behaviour of the individual is bound to be different under the two scenarios.

With the redimensioning downward of government involvement in the economy, the role of the individual in the labour and welfare markets has to be re-defined. For a time, individual survival may become paramount in the minds of many especially if they fear that the material gains in the near future will be negative for some. Therefore, they may try to defend what they have acquired even at the expense of others.

The vision of the Economy of Communion is timely. But, notwithstanding the Christian culture which supposedly conditions the Maltese in their interpersonal behaviour it will not be evident to many where the long-lasting personal gains will arise from following the theological insight on international brotherhood. The self-help principle could be a useful starting point to turn the prevalent culture of possession into a culture of communion. It represents a halfway situation where the culture of receiving is replaced by self-help with the aim of freeing resources so that they could be transferred to those in need.

3.2 *Economic Efficiency*

Firms participating in the Communion model strive to be efficient. They adapt to the market in order to survive and be self – supporting. Only in this way can they be in a position to care for their dependents and assist others. Whenever they have to restructure, they adopt innovative ways in order to retain personnel, encourage initiatives, and improve supplier/customer relationships.

Firms in the private sector in Malta open to global market forces adapt to their changing environment. They are generally foreign-owned. Recorded gains are shared between the employees and the entrepreneurs. Again, those local firms operating behind trade barriers – now being phased out – generally transferred the rents arising from protection to their owners. But, employees did gain because local owners tend to invest in other activities thereby creating new employment opportunities. It may be claimed that a social conscience exists in the private sector organisations. Employers generally strive to be conscious of their responsibilities towards employees and, whenever they can, attempt to find alternative employment in their other businesses for those employees who become redundant following market changes.

The drive to efficiency in the public sector is weak. Even when enterprises record heavy annual losses, which are made good from public funds, the rate of restructuring is very slow. The public support that resulted in a rising national debt seemed to have entrenched the culture of receiving. This goes directly against the culture of communion. This culture implies a self-supporting system generating surpluses for financing its own growth and for the expansion of the capital base of other activities.

3.3 *Participation in Decision Making, Ownership and Rewards*

Forms of participation in decision-making through co-ops and worker participation have had a very restrictive response in Malta. Private sector organisations regard co-ops as mere tax-avoidance vehicles. They are not considered in terms of the spirit of collaboration that they are meant to represent. Members of co-ops seem reluctant to share their control with new members. Newcomers are generally hired labour and the original co-op founders reap the profits for themselves.

Worker participation was tried at the Malta Drydocks. The experiment failed to yield the results expected, and the corporation ended up massing a rising debt that is being financed from taxpayers' resources.

Workers-buyout has been tried in one instance. But, in general, ownership of firms rests with the owner/raiser of capital while labour is hired. The risk of capital loss is borne by the owner; the risk of income loss is borne by the owner and by the hired labour.

Non-profit organisations also operate with success. But the proliferation of such organisations and the sharp drop in religious vocations are rendering the running of such institutions more costly. Indeed, the non-rival atmosphere that prevailed in the past, with faith in Providence being supreme in the mind of those administering such institutions, could be dented and a rivalry for limited resources could emerge.

The underlying philosophy supporting the Communion model could help inspire a collaborative spirit among the various forms of organisations/networks. A culture of communion demands complementarity whenever possible in order to achieve an economic use of resources.

3.4 *Law and Environment Friendly Institutions*

Communion firms pay their tax dues and are conscious of the impact their production/distribution decisions have on the natural environment. Both these factors are under scrutiny in Malta.

Tax evasion has been a topic under discussion for many years. Trade union leaders have been voicing their concern about it, in particular in terms of the additional burden which workers have to carry as a result. Today, private sector organisations and the government are aware of this social problem and attempts at improving the administration of the income tax/VAT/social security contributions are under way. Successive Ministers of Finance have referred to fiscal morality and a Tax Compliance Unit will be set up in the year 2000. Indeed, one reason given for the introduction of the VAT in 1995, and its re- introduction in 1999, was its potential to curb tax evasion, expand the tax base, raise revenue, and contain the fiscal deficit. As regards the environment, a lot more is desired. Yet, again, there is already a corpus of legislation that refers to the principle 'who damages, pays'. The courts have applied this ruling in the past. Hence, a combination of education, enforcement of existing legislation and a speedier ruling by the courts could induce the desired attention for the environment in producers, distributors and consumers. (Delia, 1997)

3.5 *Nationalism*

An important development of the Communion model is in the political domain. The model is not hemmed in by man-made political boundaries that constrain the performance of solidarity. In this wider context, 'someone else's country is my country', thus extending the social, political and economic territory .

Like many other peoples the world over, the Maltese are proud of their country and culture, a feeling accentuated after the attainment of Independence in 1964. Indeed, one argument against Malta joining the European Community as a member derives inspiration from this nationalistic trait.

Rivalry over saints, band clubs, sports and politics is apparently a characteristic of local culture. Rivalry

encourages a 'we-they' complex that goes against the suppression of egoism and the genuine identification of someone else's pleasure/gain as contribution to own satisfaction. Therefore, there is need for a conscious transformation to take place if the long term universal gains that the Economy of Communion promises are to materialise.

3.6 *Preparation for Life*

The communion model demands a preparation for life: the management of one's life, communication with others, leadership, decision taking, and consideration for others. Without life skills, the putting into practice of the Communion ideal will fail.

Life skills are in short supply in Malta! Employers repeatedly point out at the dearth of this ingredient in their employees; they have to invest to instil such skills. Research on the labour market and the educational sector confirm this position. Bullying in schools is not unknown, and child and spouse battering is not unheard of. For every bully and batterer there is at least someone else who suffers damage in self-respect. Two personal problems which are bound to render the enjoyment of life and mutual understanding and support impossible.

So unless the formal educational system is geared to countervail the shortcomings of the informal system -the upbringing in the homes, the task ahead of instilling comprehension for others and enjoyment in acting in such a manner will be difficult indeed. In such an environment, the ideals of the Communion model will become unrealisable, attractive and commendable though they may be.

4. *A Concluding Remark*

It may be claimed that the blocks of which the Economy of Communion model is built are spread throughout Maltese society and culture. But they are engulfed by other considerations that tend to distract attention from the altruistic aims of the model. However, Maltese society is being forced by circumstances to reconsider its social model, the relationships between the individuals, the family cells, the labour sub-markets, and the collective. This time of change could be ideal for a search for the long-term orientation of policies that contribute to a milieu where the culture of communion has a chance of prevailing over the present culture of possessing and receiving.

In doing so, one must be careful not to confuse end-results with the different inspirations that could induce them. Thus the Communion model departs from the vision of self-help: people try to be independent so that they could be of help to others. The principle of self - help as pronounced in the document *A Caring Society in a Changing World* (Ministry for Social Policy, 1990) was proposed as one way leading to cost-sharing and welfare planning for the future. In this case, however, the principle arose as an end-result rather than a point of departure. The point of departure in this case was the universalist rule, that all are entitled to benefit from state services irrespective of means, an objective which is proving to be unsustainable.

The Communion ideal expects a 'new human being', one that Christianity has been harping on for two millennia. It is the formation of this 'new being', more than the system of exchange, that needs to be addressed. Adhering to the Communion Culture is a deliberate decision to adopt a set of values, to render economic behaviour "non-value free", something which modern economic welfare theory abstains from.

This Colloquium could be the fruitful beginning of a serious, on-going discussion on this important aspect of personal well-being and social cohesion. (Delia, 1999)

References:

Delia, E.P., 'Rights, Compensation and the Market in Maltese Case Law', *Mediterranean Journal of Human Rights*, Vol. 1., No. 1: 151-166

Delia, E. P., 'Income Distribution, Social Cohesion and Sustainable Development: The Economy of Communion Model', *Mediterranean Journal of Human Rights*, Vol.3, No.2: 369-388, 1999

WHAT ARE THE ECONOMIC PROSPECTS FOR THE FUTURE OF SOCIAL HOUSING?

Economics teaches that static partial analyses are inadequate for drawing up policy prescriptions. While rendering an exercise manageable, they omit several factors with the result that the conclusions become critically dependent on the considerations made. It is necessary to take a holistic view of a situation especially if the phenomenon under discussion is widely diffused within a community's social and economic fabric and a radical change with the recent past is envisaged.

Malta is undergoing a major overhaul in its main economic and social policies. On the trade front, the protective levy system is being dismantled and liberalisation is increasing competition in areas like telecommunication where absolute monopoly control by state organisations has prevailed for several decades. In addition, the balance between the government and the private sector that evolved with regard to the ownership of productive assets is being redefined as the government divests itself of the controlling interests in various sectors. At the same time, the government is reconsidering the

Speech delivered at a National Conference on "Social Housing Now and in the Future", 13 April 2000 philosophy that has guided welfare provision and production. It is reassessing the universalist principle by which Maltese are entitled to some form of government support in housing, education, health and pensions, and seems inclined to move towards self-help, quasi-markets, and full market liberalisation.

Such a radical re-configuration of the personal and social responsibilities cannot be properly understood by a series of ad hoc partial assessments as has been happening to date. There has been 'national conferences' on privatisation, the national minimum curriculum, the financing of medical care, and the affordability of housing. In addition, national commissions were set up to review the former students' stipend scheme and the welfare provisions that fall under the Social Security Act. Such initiatives may render an understanding of the respective problems and potential partial solutions easier to absorb. But they have to be considered together with the generation of new employment outlets, the restructuring of the industrial sectors under protection, and the state of government's finances. Indeed, it was perhaps the deteriorating condition of the state's finances, with a public sector deficit/GDP ratio close to nine per cent, which gave rise to this extended exercise. But such entrenched systems cannot be meaningfully evaluated by a 'crisis management' approach . They have to be thoroughly assessed in an integrated manner. Partial analyses are not the correct tool to use in the circumstances.

Welfare policy in Malta focuses primarily on income delivery to households. Income support may be in cash or in kind. It includes the security of tenure in employment and the income arising therefrom; the protection given to selected industrial sectors and the employment income and profits that arise as a result; the pension income paid

to selected sub-groups and retirees; and the other income transfers to families, like children's allowances and maintenance grants paid to students. Besides, it incorporates the wide array of services delivered at partial or total subsidised rates for services provided by public utilities, and those supplied by the education, health, social welfare and housing authorities. Social housing is only one element in this long list of services. Any suggestion considered has to be assessed within this wide perspective.

Besides, such proposals have to be related to the globalisation process that is delimiting the policy tools which national governments have at their disposal to influence economic activity and hence personal incomes in their countries. They also have to account for the changing demographic profile of the Maltese Islands: initially an increase in the number of job seekers followed by a rising share of the sixty plus from 16% to 24% in twenty years time. Reference has to be made to the demands made by sustainable economic growth and the evolution of social networks.

This paper focuses on three interrelated issues. First, the objectives of Social Housing are defined. The outcome of past policy decisions is outlined in turn. Finally, the economic implications of potential social housing policies are introduced.

1. Defining the Objectives

Housing is a special kind of an economic good. Decent housing services are a basic necessity for the healthy physical and psychological development of an individual. However, the good that provides these services is long lasting in Malta. It could be considered as a consumer durable that depreciates or as an asset in terms of the land space occupied whose value increases with time. It is a commodity that is influenced by the demographic, economic, social and ecological environment over the long term. However, this interaction could possibly be conditioned by short or medium term political considerations regarding the timing and form of government intervention in the construction and housing markets, in particular, and in the economic, financial and land development sectors, in general. These factors render housing matters very complex indeed. They become more intricate still when decisions regarding the supply and the financing of housing are not thoroughly integrated.

According to the Structure Plan published by the Ministry for Development of Infrastructure in 1990, there had not been an overall strategy for development. The private rental sector was frozen at the time while generous subsidies of loans and free plots of land stimulated the demand for additional housing. Meanwhile, as new residential development took place, the older residential stock and related infrastructure deteriorated, while the quality of the environment grew significantly worse compared to what it used to be and to equivalent standards in Europe (Ministry for Development of Infrastructure, 1990: 5).

The Structure Plan envisaged the need for additional jobs, new dwellings and commercial outlets. It recommended, among other measures, the efficient use of land and buildings, a move away from subsidies and the amendment of rent regulation. The policies regulating housing schemes in place during the nineties could be said to have been inspired by these suggestions.

However, to date all measures have suffered from one basic shortcoming, namely, the absence of a clearly defined

objective for social housing that accounts for both equity and efficiency considerations. Social housing policies have become synonymous with a wide array of interventions in prices and supply of land and apartments. They included rent regulation, rent subsidies, the allocation of government-owned apartments at subsidised rents, the provision of land for building plus the free supply of the related public utility services, the financial assistance to extend or/and repair own residences, and interest rate subsidies on mortgages. These interventions over a sixty-year period render the term 'social housing' difficult to comprehend. The programmes are not meant to assist what may be considered a "homogeneous" group of welfare support recipients.

This loose definition that evolved for the social housing domain has not been rendered rationaliseable by the absence of a well-defined, integrated anti-poverty programme. Social welfare objectives have never been pinned down to specific targets with poverty limits per household category defined and re-assessed over time. Social housing objectives drifted along with loose talk on equity but hardly any reference to efficiency.

Consider the remark that housing is a necessity. It is correct to claim that some form of shelter is necessary to sustain life. This entails that there must be a minimum standard of accommodation that constitutes a 'decent home', say, in the year 2000 and beyond. But such a minimum is surely not equivalent to a three-bedroom, three-bathroom apartment that can be included in the "merit good" category worthy of enticing government's financial support (UNDP, 1996: 96-97).

Besides, this drive towards equity has got to the point where the shortage of dwellings in the past sixty years has been turned into a housing stock with about a third of dwellings vacant permanently or in Winter time. And forty percent of the same stock is either derelict or in urgent need of maintenance! Economic efficiency has been thrown to the wind.

Indeed, it may be claimed that Malta has overinvested in construction. The construction sector has always been regarded by public policy makers a prime economic mover. Its slow down was seen as heralding a period of economic stagnation. So, every time that the economy showed signs of slowing down, efforts were made to re-activate the building sector.

Yet, in encouraging the housing sector, no attention was given to the amount of housing consumed by those families above the minimum standard who were already adequately housed. This neglect of the efficiency objective has had its own consequences: dilapidated urban areas, large rural tracts consumed, a culture of speculation with practically minimal risks, and a public housing sector which cannot meet its social obligations on time especially with the shortage of resources at its disposal.

It is this efficiency criterion which has to be addressed. Simultaneously, for real equity's sake, the 'needy' have to be identified, a poverty limit or minimum income guarantee established, and a general framework for implementing welfare policies, including social housing schemes, put in place. These issues will be addressed below. But, it will be useful for analytical purposes to quantify first the outcome of past housing policies. This exercise is carried out in the next section.

2. The Outcome of Past Policy Decisions

Home ownership has been the prime objective of government's housing policy and of Maltese households.

Around 70% of households are homeowners; there were only 23% in 1948. Since homes are larger and families smaller, the occupancy ratio fell to 0.54 person per room in 1995, well below the 1.3 person per room reported in the 1957 census. This ownership is mirrored in the increase in the annual net mortgage lending rate as a share of national income: it rose from 9% in 1987 to 14% in 1994 and reached 18% in 1998.(Camilleri, 1999a:155)

At the same time, the prices of land and housing units accelerated. So did rents. These rapid increases have rendered housing units beyond the reach of many households. Land prices were considered cheap by European standards in 1980; they are now at par with the outer London region. The costs of house plots amounted to 7% of total costs of a house in 1970; they were 50% in 1995 and rose further to 58% in 1998. The Housing Affordability Index fell from 110 to 101 between 1992 and 1997 for a 2-bedroom apartment and from 74 to 65 for a 3-bedroom apartment. (Camilleri, 1999b: 197-208)

After changes were effected to rent legislation in 1996, rents for new apartments increased and now represent 29% of average household income, estimated at Lm6750, for a 2-bedroom apartment and 33% for a 3-bedroom one. They make up 30% and 39% for a 2-bedroom and 3-bedroom maisonette, respectively; and 58% for a three-bedroom terraced house. (Camilleri, 1999b: 202)

The controlled rental sector registers a marked contrast: 80% of private leases were built before 1959 with almost two thirds of them dating pre-1939. 53% of rents fall in the Lm31-Lm50 annually, with another 30% in the Lm51-Lm100. In total, 83% of the controlled rented apartments are let for less than Lm100 per annum.

Sixty per cent of the housing stock is considered of an acceptable standard. But around 30% are in need of substantial repairs and another 10% are derelict. A total 40% of the existing housing stock demands attention and, hence, resource injections to be rendered acceptable for modern housing needs. The challenge lies in reconditioning this stock in such a way as to provide a diversified supply of housing units that are affordable and that cater for the needs of a changing demographic structure and evolving social networks.

Future social housing policies have to account not only for these results but also for the economic realities represented by the rapid movement towards a liberalised economy. The Maltese economy has slowed down: the real rate of expansion is presently in the 2%-3% bracket, lower than the 4%-6% recorded in the early nineties. Unemployment stands at the relatively high of 5.5% of the labour supply and could rise further. And investment fell for the fourth consecutive year, households saving rates are lower, 9%-10%, down compared to the 12%-14% of the mid-nineties, and the government is dissaving: aggregate revenue falls short of recurrent expenditure and past savings are being run down.

The slowing down of economic growth will affect adversely the projected additional tax revenues over the next three years. By 2003, the government planned to reduce a 9% budget deficit/GDP ratio to 4%. Such a target may have to be revised or the privatisation programme accelerated.

The dismantling of the system of protective levies is expected to replace the demand for certain locally made goods by more competitive imports. Apart from the resultant loss of foreign exchange reserves, such a switch will mean the potential loss of several hundred jobs. This outcome will happen at a time when the demographic composition will be such that more Maltese will fall in the

working-age categories and a marked shift will occur in the age cohort 50 to 59 years. There will be 15000 more Maltese aged 50 to 59 in 2005 than there were in 1995, bringing the total in this sub-group to 56000. After the year 2005, the share of the 60 plus will start rising to reach about 24% of the population in 2020.

These demographic and labour market conditions are bound to affect personal well being and incomes, especially in a society which is considered to be living for the 'Here and Now' (Tonna, 1997). The Maltese are becoming impatient. They want to improve their living standards fast and do not appear prepared to wait.

In the past the Maltese turned to their families in time of need. The Maltese family believed in the institution of marriage. Support for the individuals was family centred. However, the family in Malta has undergone major economic, social and cultural changes that have shaken its foundations. Today, one in every three Maltese families is reported to face marital problems. Protracted disputes render Maltese families the breeding place of conflict and low self-esteem. As a result, families become centres that demand social welfare support, both psychological and financial. (Delia C, 1998) At the same time, such units would be considered poor financial risks by loan-giving institutions.

Marital breakdown results in economic deprivation. Single parent families often headed by the wife experience a lower standard after the family splits. They may find it difficult to combine raising children with securing an adequately remunerative job. Women who never worked previously or who left the labour market to take on family responsibilities are worst hit. Besides, single parents are large welfare recipients and the welfare system may not be geared to bring families above the poverty line. For example, research suggests that the national minimum wage fell below the relative poverty limit in 1994. This limit was estimated to be Lm49.5 weekly while the minimum wage was Lm38.13 in that year. (Delia, 1998: 15)

Cultural changes will affect the demand for welfare support and housing. They also condition a person's ability to earn income and pay for housing needs. Hence social housing policies should account for such changes in the cultural milieu and demographic composition and be specifically directed to address them.

3. Social Housing Policies and Economic Implications

As observed already, social housing policies in Malta have highlighted 'equity' at the expense of efficiency. And equity has been restricted to the interests of tenants and home occupiers. It was unfavourable to landowners. Intervention in rent controls, first introduced as a temporary measure during the 1939-45 world war, were retained for too long. An attempt to ease rent-control in 1959 was counter remanded in 1979 when tenants were once more granted protection from eviction even with regard to decontrolled dwellings. As a result, policy makers were deemed by developers to be inconsistent in their regard leading government, finally, to prohibit the requisition of property in 1995 (Delia, 1996: 95-96). The end result of this policy thrust was registered in the supply of rental housing. Only 11% of new dwellings constructed in the eighties were offered for rent and most of these were government built and subsidised.

Since 1925, the British model of tenants'security inspired Maltese law on house controls. At the same time, there was a deliberate drive to encourage home ownership as the various development plans for Malta and recent official

reports demonstrate (e.g. Economic Division, Office of the Prime Minister, 1981: 189-191; The Housing Authority, 1999: par.4.1). Presently, owneroccupiers are a main voting force in Malta. If changes in welfare programme financing, including social housing, are regarded as neutral to their self-interest they will probably be willing to support such reforms.

However, if the easing of rent control and the rise in property prices render any social housing initiative a tax bearing measure, even though taxes are not yet earmarked in Malta, then public support may not be readily forthcoming. The income and rent support systems currently in place have to be assessed with a view of transforming them into a real equitable transfer programme that attracts the backing of the greatest possible section of the population.

The anomalies observed in the outcome of past land use and housing policies are known to all. They were expounded in the Structure Plan and in a conference on Land Use and Housing Markets held in 1995 (Ebejer, 1996). Yet, the prices of land and apartments, as well as rent, accelerated in the past five years, and housing affordability became more burdensome for the median family. These results render a short-term remedy to social housing issues unrealisable.

Still, attempts have to be made to address seriously these integrated matters in the long term interest of urban renewal, rural conservation, economic development and an equitable redistribution of resources, including housing services. The surge in property prices increased the net worth of households and especially of developers. Hence there are many interested 'economic rent seekers' who have committed themselves financially in terms of certain values for property. Social policy makers have to contend with these rent-seeking groups, namely, developers, second time homebuyers, and the institutions financing property development. They also have to account for the fact that the economic growth rates recorded in the early nineties may not be repeated in the medium term and, personal real incomes could actually fall. In a situation like this, cash flow problems could affect negatively the households' spending and saving potential thereby increasing the number of social cases.

A revamped social housing programme has to be integrated with a comprehensive welfare support system. This objective is recognised by the Housing Authority (Housing Authority, 1999: par.2.2). A long-term effective housing policy will introduce a wide degree of flexibility in the supporting schemes and render them adaptable to the financial means of the beneficiaries. To operate efficiently, such schemes must encourage a positive application of the principle of self-help, rather than the practice prevalent to date to drive personal gains at the expense of present and future generations. It is reported that dwellings under the Home Ownership Scheme were sold at the high prices obtained in the property market, with the owners registering hefty profits having secured the land for free in the eighties! (UNDP, 1996: 98)

Past social housing programmes may not have been entirely motivated by the desire to empower the tenants by facilitating their social integration. Indeed, other forces seem to have been at work. The allocation of government apartments seems to have been driven by a re-allocatation of votes in the context of a general election rather than the total development of the individual tenant accomodated on a housing estate. New comers found it difficult integrating in the new home in the midst of 'political adversaries' (UNDP, 1996: 92).

If a workable set of propositions regarding social housing are to be made, then these have to be inspired by the idea that social housing is above all a factor in an extensive dynamic empowerment programme that enables individuals to develop their personality in a healthy social, and home, environment. This empowerment should continue all the time, irrespective of the age and the social background of the individual. The present housing support schemes may be considered as static programmes. They identify persons at risk and aim to provide them with decent homes. But home ownership remains high on the Housing Authority agenda (Housing Authority, 1999: par. 2.2, par. 4.1). Lm2.4 million are projected for subsidies for financial year 1999-2000 and another Lm5.1 million are directed for construction. The Housing Authority plans to finance Lm4 million of its outlay from the sale of government owned property.

A pragmatic approach to a general social housing policy may be implemented by establishing the guidelines described below.

1. Set a ranking of objectives for social action: rented dwellings or home ownership to be considered the main driving force in a social housing programme. An ambivalent set of objectives will merely prolong the present situation. The Housing Authority may be turned into an estate developer, independently or in conjunction with private interests, with the aim of catering for social cases, however these cases are defined. Rents would be charged in relation to the changing financial circumstances of the tenant.
2. Such flexible subsidised rates depend on two policy benchmarks, namely, a level of income that renders eligibility for state income support and an amount of reversible rent grant per time period. The former

value refers to the Poverty Limit or Minimum Income Guarantee (MIG); the second defines the Rent Gap.

3. A Poverty Limit or MIG will be based on income distribution by household size. It will be revisable and will establish a set of officially determined and accepted income criteria. Presently, poverty limits are estimated from data that were not compiled with the identification of a social policy benchmark in view. Besides, some researchers use the mean values, others the median values creating different measuring yardsticks and thus varying conclusions with regard to households living in poverty. (Delia, 1986; 1998). Income data on applicants for social housing schemes indicate a median annual income of Lm1921 for those whose income falls in the Lm0-Lm4000 range, while a median of Lm4769 is recorded for those whose income exceed Lm4000. Other income distributions could be resorted to, for example, the income data given by the Household Budgetary Survey. But the larger the number of benchmarks proposed, the more obscure will become the identification of the 'representative' beneficiary in need of social support. Such situations will render indefinite the estimation of costs and the evaluation of potential pool of beneficiaries.
4. The rent gap is the difference between the total rents that buildings should theoretically receive to cover such elements as operating and maintenance costs, debt service costs, taxes and return on investments, and the actual rent. If an apartment costs Lm20000 and a 4% rate of return is determined as a fair rate, given an appreciation of property over time, then the imputed rent will be Lm800. If a social tenant, for various reasons specified in the social housing scheme,

is charged Lm300 annully, then the revisable rent gap subsidy will be Lm500.

5. Such an approach could apply to private rented apartments. For such subsidies to be containable, the costs of apartments and land – reflecting size and quality - have to be maintained at reasonable levels. Otherwise, the subsidy could become too heavy for a public agency to support or few beneficiaries will gain.
6. The withdrawal of requisition from the statute book did not have the desired effect so far. It did not increase in any significant way the number of apartments that may be considered affordable for Maltese in the income strata indicated in point 3 above. Indeed the thrust of the building sector has been focused more on second time buyers and foreign investors rather than on the provision of a mixture of apartments that meets the respective market demands representing various home buyers or rent seekers. A few tens of apartments placed annually by the Housing Authority on the market will not affect prices or rents of private estates. Not as long as developers eye the foreign markets and second time buyers will expect to fetch market related prices for their homes in order to minimise their future financial burden on their second home.
7. Subsidies in cash are explicit. So should be subsidies in kind. They reveal the costs to both the policy maker and to the beneficiary. A balance will have to be possibly struck between the pervasive income in kind approach adopted in the past and a direct cash injection to a recipient's income that is more compatible with a self-help position. Transfers could be integrated with income tax as is presently the case with children's

allowances. Households whose incomes exceeds Lm10000 annually are not eligible for children's allowances. A streamlined tax-benefit structure will be desireable if such an integrated approach to welfare support is implemented on a wide scale.

8. Such an integrated system is bound to induce a radical change in the way in which welfare recipients consider welfare support schemes. An additional Lm100 in own income would not only mean a marginally higher income tax payment but also a potential loss of income in cash or kind under a social welfare programme. At present the latter includes, for example, the subsidies on interest rate paid for mortgages or the cash paid to families who carry out extension works in their homes (Scheme W). The presence of such Implicit Marginal Tax Rates (IMTRs) will encourage the underdeclaration of own income. It encourages welfare fraud. The IMTR is measured by the reduction in benefits received following an increase in own income.

9. A combined tax-transfer schedule must identify the basic unit to be considered for tax and income transfer purposes. The traditional family set up in Malta is changing. So the new forms of stable relationships that constitute 'households' will have to be identified for tax and income transfers. Legal recognition will also condition the affordability of repayment programmes of house loans.

10. The supply of government housing should not be seen as a potential for the eventual emergence of a slum area. So training in life skills will ideally accompany housing schemes. Such training will not only be of benefit to the individuals involved and all those who come in contact with them, but also enhance

the value of the property and its environment. Failure to instill such skills will not reward the individual by the contribution that a decent home set up can make to one's personality.

11. Finally, the overall macroeconomic policy package and industrial/trade policy should be devised in such a way as to improve the earnings' potential of households in gainful employment. In this way households will be financially better off and as a result would ease their claims on public sector welfare support. The funds thus relieved could be utilised to assist others. For this social collaborative spirit to prevail, the culture of receiving associated with the welfare state will have to change to a culture of sharing (Delia, 1999). A mismanagement of economic policies will not maximise the creation of wealth and militates against the positive effects that decent homes could generate on the development of an individual.

References:

Camilleri, D. H., *"Maltese Housing Characteristics in an EU Perspective"* in Chamber of Architects and Civil Engineers et al., 1999: 149-156, 1999a

Camilleri, D. H., *"Main Findings of the 1999 Conference Housing Affordability in Malta"* in Chamber of Architects and Civil Engineers et al.: 183-208, 1999b

Chamber of Architects and Civil Engineers and Building Industry Consultative Council, *Housing Affordability in Malta*, 1999

Delia, Carmen, "The Maltese Family", *Melita Theologica*, Vol.XLIX, No.1: 19-41, 1998

Delia, E. P., "A Contribution to Income Distribution Analysis in Malta", in Faculty of Management Studies, The University of Malta, *Economic and Social Studies: New Series* Vol 3: 33-48, 1986
Delia, E. P., "Neglected Issues in Malta's Housing Policies and Their Impact on Rental Housing in Malta", in Ebejer. J, editor, 1996.
Delia, E. P., *Towards Sustainable Welfare Programmes and Pensions in Malta*, The Malta Chamber of Commerce, *Research Monographs* No.1., 1998
Delia, E. P., "Income Distribution, Social Cohesion and Sustainable Development: The Economy of Communion Model", *Mediterranean Journal of Human Rights*, Vol.3, No.2: 369-388, 1999
Ebejer, John, editor, *The Land and Housing Markets in Malta: The Economic, Social and Environmental Dimensions*, The Planning Authority, 1996
Economic Division, Office of the Prime Minister, *Malta: Guidelines for Progress*, 1981
Housing Authority, Malta, *Report for the Year 1998-1999 and Estimates for 1999-2000*, 1999
Ministry for Development of Infrastructure, Malta, *Structure Plan for the Maltese Islands*, 1999
Tonna, B., *The Sign of the Here and Now Criterion*, *Discern Institute for Research*, Media Centre Publications, 1997
United Nations Development Programme, *Malta Human Development Report 1996*, Malta, Media Centre, 1996

FREE MOVEMENT OF CAPITAL: ECONOMIC IMPLICATIONS OF THE REMOVAL OF FOREIGN EXCHANGE CONTROLS IN MALTA

Entrepreneurial decisions regarding the location of enterprise and the composition of inputs used in the process of production and the provision of services are based in part on the availability of resources at the 'right' price. In principle, therefore, one cannot consider the economic impact of a liberalisation drive on the allocation of capital without evaluating the volume and the distribution of resources in the commodity and labour markets. The costs of inputs condition the offer prices, which in turn affect the flow of goods and services traded, and thus the demand for the inputs that go into their production. In turn, prices reflect the respective market structures in which commodities are traded.

The same efficiency criteria influence the decision making of financial investors seeking the highest attainable yield for a given level of risk and cost, and for choices regarding the purchase of property for own use or for investment purposes.

Such decisions are taken at a point in time. They are conditioned by several factors representing the past

Speech delivered at a conference organised by the Malta Chamber of Commerce on "Understanding the Four Freedoms", Friday, 10 November 2000 economic, financial, social and political environment as well as the factors that are envisaged to prevail in the foreseeable future. Economic decisions are dynamic in nature. They evolve and adapt to the various policy measures – on trade, money, taxation and government expenditure, and industrial development, among others - that are taken by authorities in various countries. Altogether, such measures induce the behaviour of the many transactors in the multitude of markets for commodities and factors of production.

These general observations apply to the performance of domestic savers and investors in Malta, in so far as the disposal of financial and real assets by Maltese are involved. They also apply to the decision of foreign investors in transferring financial assets or direct investment to Malta and in transferring them again elsewhere. The volume of funds and the prices of financial and real assets are thus determined in the process.

This presentation examines several issues related to policies on capital flows into and out of Malta. It outlines the economic conditions that first gave rise to exchange controls and the additional objectives that were targeted once such controls were in place. In turn, it examines the implications of free movement of capital in the present economic and financial context given the expected time frame for further 'restructuring' of the economy, the containment of public sector deficit, and the implications of an eventual membership of the European Monetary Union (EMU).

1. The Emergence and Outcome of Capital Controls in Malta

Foreign exchange controls have been in place for the past thirty years. They were introduced to check the outflow of domestic savings at a time when the Malta government was constrained to borrow locally in order to bridge the budget gap following disputes with the British government on the implementation of the phasing down of the military bases on the islands.

In the late sixties, Malta's monetary regime operated a currency board set up inherited from the British: cash in circulation and bank deposits were hundred percent backed up by foreign currency reserves, namely, assets denominated in British pounds. The Lira was pegged to the Pound and the presence of a British bank, Barclays Bank, rendered the Maltese conversant with financial investment options in the UK currency. The foreign exchange controls were meant to regulate the outflow of domestic private savings that were attracted by a higher rate of interest obtained on the UK bond market. The Maltese monetary authorities introduced controls in order to facilitate the selling of local government stock and, thus, keep the economic development programme on course. Foreign exchange controls were primarily directed to attain a fiscal objective, namely, the financing of public expenditure through borrowing.

Balance of payments considerations were not paramount in policy makers' minds at that time. The wages of Maltese personnel employed with the UK defence establishments were in Maltese liri but originated in Britain. This same condition applied for works carried out by Maltese contractors for the British Services. These factors eased pressure on the external account balance just as the grants received under the financial protocols with the UK in the sixties and seventies and with Italy since 1980 offset in part the payments for imports.

Foreign exchange controls were introduced under the following conditions: a pegged rate of exchange; a hundred percent back up by foreign exchange reserves for the local currency and bank deposits; the presence of foreign financial institutions in Malta which rendered Maltese familiar with foreign financial products, mainly bonds and bank deposits; a surplus of private sector saving; a deficit in the public sector account; and an active emigration programme that contributed to stabilise labour flows in the various sub-markets. The controls were meant to make local private sector savings available for the public sector at a price established by the Treasury. It was a public sector demand for funds approach coupled to the ability to create an environment in which the cost of capital could be regulated by the borrower.

The outcome of such controls over the ensuing thirty years reflected the developments in the financial sector that followed. These were primarily characterised by the emergence of a strong public sector control over a wider area of economic activity. Government became the major or sole shareholder in the two commercial banks, the National Bank of Malta and Barclays Bank, and government direct investment in productive activities was extended as a matter of policy. Monetary and foreign exchange controls, together, became a relatively powerful fiscal tool. The interest rates obtained abroad were higher than those paid in Malta by the banks whose interest rate policy was dictated by the Monetary Authorities. The interest income accruing on the official foreign exchange reserves, which backed the currency in circulation and bank deposits, accrued eventually to the government via the profits registered by the Central Bank of Malta.

In the eighties, exchange controls spread to the current flows of foreign exchange transactions. Import controls were implemented in an attempt to defend the country's trade performance and job creation. As a result they hedged foreign exchange reserves and, thus, the value of the Malta Lira, which had terminated its one-to-one link with the British pound, and was set daily, in terms of the US dollar, via a basket of currencies. This basket changed its composition over the three decades reviewed and remained the point of reference for money matters. Throughout, interest rate levels, wage increases for public sector employees, who accounted at one time for forty percent of the gainfully occupied, and prices of public utility services and basic commodities remained subjected to government decree.

Controls were gradually eased, initially on trade and then on money and capital, in the second half of the eighties and throughout the nineties. All restrictions on current payments were removed in 1994 when Malta accepted the obligations of Article VIII of the IMF'S Articles of Agreement. Furthermore, import protection measures, like levies on industrial imports, are scheduled for phasing out in the years 2000-2003 while capital controls are to be eased further and eventually withdrawn by the year 2002, except for those provisions that could still be deemed necessary.

But controls still circumscribe the use of capital transfers to Malta by foreigners and return Maltese migrants for the purpose of purchasing a second property for own use or property for speculation. It has been a social policy priority to encourage home ownership in Malta. Presently 70% of Maltese households are homeowners compared with 28 % in 1948. This shift in the ownership of property became possible through the supply on the housing market by the government and the Catholic Church of plots of land at affordable prices or annual rates. Besides, property developers were encouraged by appropriate legislation to attract foreign buyers, who decided to reside in Malta provided that they abide by the conditions of the Immovable Property Act and the exchange controls when it comes to the sale of their property and the transfer abroad of the proceeds from such sale.

The outcome of the capital controls had a dual effect on Maltese savers and investors. As ***savers*** they saw their rate of return on savings kept low during years when corresponding rates were higher in the United Kingdom, the 'traditional' deposit base for Maltese savings abroad in the postwar years. They saw their capital taxed and the gains that could have been made by the private sector 'transferred' to the government through the profits of the Central Bank of Malta. But Maltese capital still found its way abroad! The amount of Maltese accumulated assets abroad is unknown, but these assets are estimated to exceed the billion Liri.

However, as ***investors*** the Maltese gained from the relatively low real rates charged by the banks for investment in the secondary and tertiary sectors. Besides, they gained as potential homeowners from the subsidized housing schemes. Foreign direct investors also benefited from relatively cheap finance for government as these obtained the use of government-owned industrial estates. They also gained from comparatively competitive cost of borrowing from local financial institutions.

But these fixed rates of interest for a long time -the Central Bank discount rate remained set at 5.5% throughout the seventies and nineties; it edged up to 6.5% or 6% between 1982 and 1987 - could have had ***complementary negative side effects***. The country could

have over-invested in housing stock, while the government could have over-invested in capital capacity in certain sectors that require large amounts of capital, e.g., the shipbuilding industry, because interest rates were not considered to be at the time an obstacle for public sector borrowing. Presently, out of the Lm900million worth of national debt, external debt amount only to Lm42 million. These data exclude the borrowing of public corporations and companies in which government is a major shareholder. These liabilities amount to around Lm500 million.

Overall, fiscal policy remained fairly tight up to the early eighties, with government amassing savings in the Consolidated and Posterity Funds even at the cost of neglecting the development of the infrastructure. However since 1982, public sector budget deficits have become a regular feature. In a sense we have gone a full circle since the introduction of foreign exchange restrictions in 1970. Public sector deficits presently represent about 8% of GDP, with interest on the debt now exceeding Lm50million annually and projected to grow to around Lm74million in four years' time. The Malta Lira is still determined, in real time, through a basket of currencies comprising 58% Euro, 21% the US dollar, and 21% the British Pound. Currency in circulation and bank deposits are still backed by more than 100% by foreign exchange reserves, even though the Central Bank Act sets a 60% cover limit. What are the implications of freedom of capital movement in such an environment, given the knowledge and expertise the Maltese saver and investor gained over the past three decades? Again, how does a euro zone and membership of such zone affect capital movements and related fiscal and labour market policies?

2. Freedom of Capital Movement:
The Evolving Legal and Economic Scenario

The National Programme for the Adoption of the Acquis outlines the medium term programmes for the attainment of free movement of capital, the further development of the payment system and measures to prevent money laundering (Ministry of Foreign Affairs, Malta, 1 September 2000: 49-55). Government plans to retain restrictions on land ownership by non-residents. This condition has critical social connotations unless "a permanent derogation" is accorded by the European Union "in respect to the free movement of capital for secondary residence purposes and for the acquisition of real estate for speculative purposes" (Ibid: 50)

The implications of free movement of capital may be examined in terms of entities that could be affected. These refer to the public sector and policy makers, households and firms.

2.1 Implications for the Public Sector and Policy Making

Exchange controls are being removed during a period when the Treasury still plans to record a deficit: in the year 2004 the government's budget will be showing a gap of Lm77million representing 3.93% of the projected GDP at the time. The state of government's finances may be said to be in an identical position to the one that induced the introduction of exchange controls thirty years back. If this decision is being reconsidered, therefore, it means that the Treasury feels confident that it can raise the funds required without affecting negatively the pattern of yields on government paper. At the same time, the Central Bank

assesses the situation as being tenable and sustainable in terms of its policies on money and rate of exchange. The national debt is projected to grow to Lm1.12 billion in 2004, up from the Lm900 million at present, and interest payments on this borrowing are scheduled to rise from Lm53 million to Lm74million. Besides, such decision is not deemed to affect negatively the volume of foreign exchange reserves. Reserves reached a high of Lm690 million in 1994, then fell to Lm554 million in 1996, edging up again to Lm742 million in November 1999, falling since then to Lm685million in July 2000.

There is a tri-partite relationship between the public sector debt increase and rolling over, the cost of borrowing, and the external value of the Lira. The Central Bank has so far taken the value of the Lira as 'given' and adopted its monetary policy, via the repurchase agreements, with a sight of a set of variables including inflation, credit creation and changes in official reserves. The domestic performance of these economic parameters – falling inflation, reasonable rate of credit increase and rising reserves – led to a fall in the rates of interest. This position was reinforced by the fact that the synthetic rate of interest i.e. a numeraire derived by weighting rates of interest obtained for paper denominated in the euro, US dollar, and the British pound in the same proportions that these are recorded in the basket of currencies that determine the value of Lira/US dollar, was for several years lower than the weighted rates of return obtained on Maltese paper securities.

But such position has changed bringing in its wake the possibility of a strategic choice between 'defending' the Lira position and free the cost of borrowing, or 'defending' the cost of borrowing (the desired cost of borrowing capital) and letting the Lira float. Following this second option would be new territory for the Central Bank. It implies having to learn how to intervene in the foreign exchange market in the absence of tools for control.

Moreover, such a position will be implemented during a time when the Treasury's tax departments, for Income Tax and Value Added Tax, are improving their administrative set up in order to collect taxes due. This implies a higher actual burden on the private sector, firms and households, which had been accustomed to relate to an accommodating tax collector! The aggregate tax ratio, measured as the ratio of aggregate tax revenue to GDP, hovered around the 30% mark for many years. What will be the reaction of the private sector under such changing circumstances is anybody's guess. But given the past experience under a regime of controls, it could well be that Maltese capital will not go out as capital seeking investment elsewhere, unless it is in direct foreign investment. Capital outflows will not be affected much, at least not in the short run. What will be affected, instead, are the returns on exports recorded in the current account. Foreign exchange earnings could be diverted before they arrive into Malta! Therefore the official reserves could be affected on several fronts: capital investments seeking higher rates of return abroad, over-invoiced imports, under-invoiced exports, and non-repatriated investment incomes.

Capital outflows will also grow following a pension reform programme that promotes funded pensions and that encourages the search for the best rates of return by allowing such funds to seek investment possibilities abroad. Such institutional transactions, already permissible under the present exchange controls, will complement the transfer of savings into investment schemes denominated in foreign currency. The number

of collective investment funds, listed on the Malta Stock Exchange, has increased rapidly in the past five years. The reappearance of financial institutions whose majority interests are controlled by foreigners could accentuate such an outflow.

One position clearly stands out: with the loss of a policy tool – exchange controls – policy autonomy, capital mobility and a managed-pegged exchange rate do not mix. With a 'pegged' Lira and capital mobility, interest rate levels will have to be determined by the market. It is no use insisting on cheaper borrowing costs by the government so that the rate of growth of the national debt will be held in check.

2.2 Private Investors

In theory, freedom of capital movement contributes to an efficient sourcing for funds. It leads to a convergence of the cost of funds especially in a monetary union with a single monetary authority responsible for policy decisions. But, it may be claimed that 'cheap' financing was available for investors in Malta. Foreign Direct Investment geared for exports benefited from a series of benefits at a time when, often, interest rates were relatively high abroad. Capital controls shielded such effects. Under a free capital regime, when monetary policies aim primarily to check price increases and interest rates hikes, such a positive factor can be extended without the need for direct controls by authorities in Malta.

Maltese who already had savings to back up their investment needs could have obtained similar benefits. Such savings, locally and abroad, could be used as a backup to raise funds domestically, decisions on the most efficient funding methods depended on several considerations not least ones related to the tax regime in place at the time. But, again, such investors will be no more dependent on local decisions but rather be more explicitly seen as deciding after they account for the financial packages on offer. The freedom of service provision will see to that!

A relatively new player in the fund-investment sector is the institutional investor, especially if retirement pension schemes are transferred from the present Pay As You Go system to a funding base. Such funds would complement the recent surge in collective investment schemes that already concentrate large amounts of funds in the hands of a few decision makers. More than twenty SICAV companies have registered in Malta in the past five years.

This issue leads to a related consideration regarding the saving propensities of the Maltese. The average saving ratio for Maltese households, measured as the share of savings out of disposable income, fell from 15.8 % in 1993 to 8.1% in 1997 rising to around 10% thereafter. These saving ratios refer to the ability of a household to save. But in future the liberalisation drive and a greater reliance by the state on the provision of market driven welfare support programmes could mean that a greater share than at present of households' saving will be of a 'forced' kind. Mortgage payments, pension provisions, and health insurance will absorb a greater share of households' committed allocations.

Thus, for example, the combined drive to homeownership and a dichotomized rental market has resulted in a sharp rise in the demand price for accommodation rendering housing for the average income family less affordable. The Housing Affordability Index fell from 110 to 101 between 1992 and 1997 for a 2-bedroom

apartment and from 74 to 65 for a 3-bedroom apartment. Furthermore, the changes effected to rent legislation in 1995 resulted in rents for new apartments reaching 29% of an average household income, estimated at Lm6750 annually, for a 2-bedroom apartment and 33% for a 3-bedroom apartment. For a three-bedroom terrace house, it represents 58% of the same income.

If one were to add the saving put aside for pensions and health insurance, which would complement the 10% of wages and salaries up to the capped level paid in weekly social security contributions by employees, then the share of households' incomes 'trapped' in own welfare support payments will be higher than that recorded to date. A new consumption/saving configuration is bound to emerge. The impact such aggregated funds would produce on the local capital and equity markets will be evident. Unless opportunities for attractive returns are available locally such funds will have to find their way abroad. What will represent 'abroad' will depend on Malta's membership bid for the EU. But the complete liberalisation of capital movement will already open the way for an efficient management of own and collective funds.

In addition, the relevance of the derogation requested by the Maltese government vis-à-vis property ownership in Malta by non-Maltese is understandable given the performance of the income-rental-accommodation price movement registered in recent years. Whether such derogation will be forthcoming is another matter. After all, if persons have a right to move and seek employment or establish business, they must live somewhere. Freedom of labour movement in an enlarged economic space may be turned into effective labour mobility only through resilient housing markets. A prime factor that renders people immobile geographically is generally the housing market and the various constraints attached to selling and buying one's property, especially in conditions where the rental accommodation sector is not attractive for developers and/or tenants. The housing issue is compounded by two factors, namely, the rapidly ageing population in Malta, with the share of the sixty-plus rising from around 16% at present to 23% in two decades time; and, the rapidity with which the traditional family set up, made up of parents and children, is changing. Single parent households are on the increase. Together with the ageing phenomenon, they render the housing issue in Malta a complex one indeed!

Finally, one has to consider the fiscal impact of capital outflows. A reduction of the official exchange reserves will result in lower income for the Central Bank of Malta. In turn, this will be reflected in lower profits and, hence, a lower transfer to the Treasury. The Central Bank of Malta contributed Lm30 million in 1999 and Lm27 million in 2000 to government revenue. Alternative sources of finance will have to be found to replace a shortfall in CBM profits. The Bank's income will be affected by the introduction of the euro in two years time. Gains arising from existing foreign exchange transactions in currencies to be substituted by the euro will not arise any more. These, too, have to be substituted by other income if the CBM profits are to be sustained.

In sum, free movement of capital has wider connotations than the cost of capital and return on savers' funds that are generally mentioned. It affects government revenue through the impact capital flows could have on the profits of the Central Bank of Malta. It could also affect the price and supply of apartments. These effects will be happening at a time of a relatively rapid demographic transition and transformed family networks.

3. The European Monetary Union (EMU)

The drive to liberalisation may be a desirable objective per se. But in Malta's case it is also being undertaken because of Malta's application for membership of the European Union. Membership implies an eventual adoption of a single currency.

The EMU project is unique in the history of monetary unions. A group of monetary and politically independent countries have surrendered their national currencies to form a common monetary union based on a new unit of account under the leadership of a common monetary authority while still retaining political independence. But experience suggests that a complete monetary union remains functional in the long run when combined with far reaching political integration.

The EMU, unlike the monetary unions of the nineteenth and twentieth centuries, is based on a fiat and not specie standard. Therefore, a nominal anchor has to be created by member countries through some form of common and political agreement to pursue and enforce a rule such as monetary and inflation targeting. European monetary unification will be based on a commonly accepted, politically decided commitment mechanism as opposed to the gold standard in the past that had gold convertibility as a common focal point and commitment mechanism.

The statutes of the European Central Bank set out price stability as its principal objective. It remains to be seen how this goal will be attained. It requires that the individual members of the EMU will display forever a commitment to their common goal. This is what the advanced nations to the gold standard did more than a hundred years ago. And this is a major challenge facing the EMU. It has to succeed in creating such a convergence in policy purposes in the future without putting strain on the relationship between the major and minor member countries. Judging from past experience of monetary unions, peripheral countries may not have a major influence in the decision-making. Small countries may enlarge their influence by forming coalitions within the EMU, but coalition-construction is generally a costly process. It implies 'quid pro quos' or logrolling whereby one country's support today will be exchanged for another country's support tomorrow!

For Malta, joining the EMU will not merely imply a substitution of the monetary policy objective – from defending the external value of the Lira to overall price level targeting; or from moving away from a 'specie' (gold and foreign exchange reserves) backed currency to fiat money. It implies much more. It means a political decision to collaborate with the other members of the EMU on specifying monetary targets and to abide by their economic implications. It implies adjusting 'regional' economic fundamentals in relation to the parameters dictated for the much larger economic space. It, therefore, demands a constant will to adapt to the macro parameters and continually strive for economic efficiency that follows from the four freedoms on which the single market is constructed.

The EMU is bound to be an evolutionary process. Its implications are too widespread and far-reaching and it demands adjustments in the search for economic efficiency, i.e. low production cost, at all levels. Such an objective can only be achieved gradually but it demands a political resolve to cooperate. It constantly evokes a changing world trade/power scenario that seeks to locate the role of Europe in such an environment.

4. The Outcome

Ultimately, this is what freedom of capital with an eye on the EMU means for Malta. By itself, the liberalisation of capital already has a political connotation for Malta. Fiscal and monetary policy makers have to learn how to create the best set of policies that will encourage economic growth while safeguarding the internal and external values of the Malta Lira in the absence of external account controls. That is already a big challenge. The re-action time of policy makers will have to swerve to one of pro-active behaviour, judging the steps to be taken in terms of the needs of the economy over the medium term.

But joining the EMU means much more. It implies adopting the economic base to a set of decisions taken collectively in the interest of the entire economic space. The leadership skills required have to be at the same time both sharper and more diverse than at present. Policy makers will have to foresee the overall economic and political conditions that will ultimately influence the setting of the economic control parameters in the future.

The 'four freedoms' have to be understood and assessed simultaneously. Every one of them has its peculiar characteristics that have to be considered. As direct controls give way to market forces, the need to influence economic behaviour over a longer time frame becomes more apparent. This approach will be accentuated in a monetary union. The loss of the two policy tools, the rate of exchange and the rate of interest, will mean that the economy will have to adapt to whatever monetary and exchange rates are set responding by the appropriate fiscal and labour market parameters. In single markets even these two policy areas are defined. So the manoeuvrability of policy makers in particular member parties of the union is bound to be restricted. A longer-term view than that historically taken will have to be undertaken. Switching the time horizon and doing it successfully may require time. But in the present circumstances, the learning curve will have to be quite short!

THE SOCIAL ASPECT IN THE NEW ECONOMY

1. Introduction

The manufacturing sector in Malta accounts for 24.4% of total domestic value added at factor cost. This sector used to be the main contributor to Malta's economic diversification, output growth and exports. That role has now been taken over by the services sector, which presently accounts for almost 50% of the Gross Domestic Product. The leisure industry and financial services are important contributors to income generation and foreign exchange earnings.

Manufacturing sales amounted to Lm834million in the first nine months of 2000, of which Lm688million, representing 82% of the total, were exported. The primary contributor to this value added is the sector of Communication Equipment and Apparatus, which recorded Lm490million in sales and Lm489million, i.e. 99.9% of sales, in exports.

The CEA sector represents one component of the growing array of activities that fall under the Information

Speech delivered at the Union Ħaddiema Magħqudin XXVII General Conference on "F'Malta u fl-Unjoni Ewropea b'Impenn Soċjali", Tuesday, 6 February 2001

Technology area. This comprises both the production of hardware components or assemblage and software writing apart from the many IT related management services. The CEA sector follows the fortunes of the rapidly expanding use of communications technology that has become the hallmark of economic development in those world regions that enjoy relatively high and rising per capita incomes, namely, North America, Japan and the European Union. It belongs to the so-called 'New Economy'.

The economic features of the CEA sector in Malta point at the relative attraction that the sector has for all those involved in it. Value added per head is more than twice the average for the whole manufacturing sector, with net margins per capita being almost three times those obtained in manufacturing, and wages and salaries amounting to one and a half times those for the average wage in the sector. The data also suggest that productivity growth, represented by value added per head in real terms, need not necessarily be always positive. In the past five years, the rate of productivity changes in the CEA sector altered between plus 10.2% for the years 1998/1999 and a fall of 14.6% for the two years 1996-1997. Several of these features are summarized in the table below.

Sector of Communications Equipment and Apparatus: January-September 2000

	(1) CEA Sector	(2) Manufacturing	(1)/(2) %
Value Added Per Capita	Lm26, 304	Lm 11,638	226
Wages And Salaries Per Capita	7,096	5,049	141
Net Margin Per Head	19,208	6,589	292
Value Added/Head in Real Terms	24,435	10,811	226
Sales	489.6mill.	834.2mill.	58.7
Exports	488.9mill.	687.8mill.	71.1

Source: Ministry for Economic Services, Economic Policy Division: ***Economic Survey January-September 2000***: Tables, 4.1, 4.2, 4.3, and 4.4

However, the economic impact of the New Economy is not restricted solely to the performance of hardware producers or to the output of software houses. It is much wider felt throughout the organisational structure of an economy and affects directly the way in which market operations are planned and executed.

The larger the number of users, and the better the quality and competitive the pricing of the services on offer by Internet Service Providers and IT support firms, the more effective can such an integration become. In Malta there is presently a growing network of facilities and users. It includes 186,000 fixed telephone lines, 120,000 mobile phones, 30,000 Internet subscribers, 8,200 voice mails, 4,600 pagers, 1,200 two-way radio licenses, 77,000 cable TV subscribers, 3,400 satellite dish receivers, and 70,000 personal computers. And the list keeps growing!

This presentation focuses upon several social issues that emanate from the economic connotations of the New Economy as these are manifested in Malta. A description of the main features of the New Economy is presented first. This is followed by a series of observations regarding the impact of technology and the fast distribution of knowledge at lower costs on output growth, market structures and the labour market. Finally, the implications for Malta of the characteristics of the New Economy are examined in terms of the generation of wealth (production and growth) and income distribution.

2. The New Economy

The term 'New Economy' refers to a system of production and exchange that is particularly based on information and knowledge. Economies are becoming increasingly more reliant on knowledge: a greater share of economic activity in modern economies is arising from the exploitation of ideas rather than materials. They are tending to the so-called “weightless economy” with the sector of services absorbing a greater share of the gainful employment. Even in the manufacturing sector, a greater volume of goods is absorbing a bigger share of knowledge embedded in their value added, through design and customer services.

Knowledge, like entrepreneurship, is not a scarce resource. Suppliers of ideas still retain the ideas to themselves even though they pass them on to others. This characteristic is unlike the effect that results in the transaction of goods, when the exchange of a good involves the loss of the good for the seller, who gets the monetary worth of resources exchanged in return. Irrespective of the number of times ideas are exchanged, they do not get used up in the process. The impact ideas will have on the way in which goods and services are produced, distributed and consumed will depend on the abilities of those who receive them to understand their utility within the context of the organization or system/network in which these ideas may be implemented. Entrepreneurs need to demonstrate the ability to translate knowledge into new ways of doing business.

The rapid global deployment of ideas is supported effectively by the on-going burst of innovation in information technology – computers, software, telecoms and the Internet. The ability to distribute information faster, more reliably, and at falling costs over a wider geographical territory is being enhanced at an exhilarating rate. This speed demands constant adaptation to new operating and trading environment, which implies, in turn, a recurrent need for the evaluation of organisational

setups, investments, and personal skill development.

The Internet will assist economic diversification. But it is not a magic formula for inducing economic growth. The Internet has the potential to be a global service for communications and possibly entertainment. But it is not a medium for exchange or a product in itself. It cannot bring people and goods physically together. It can only transmit messages and orders for commodities that will have to be delivered locally.

Increasing competition sensibly, controlling abuses of monopoly power, and sustaining education are more important for economic growth than the Internet. The New Economy thrives on the free flow of goods and capital, which enables the benefits of IT to be maximised.

The New Economy is not immune either to business cycles or international politics. The fact that markets may operate more efficiently, being better informed and obtaining information at lower costs, does not result in a business cycle-less economic environment. Indeed, post-1996 experience in the United States, which saw historically high rates of growth around 6% abating abruptly to rates in the 0% region suggests that economic booms are in part the result of over investment when a sentiment of ‘fear of falling behind’ rather than educated strategies will condition decisions to invest. A similar behaviour appeared on the international stock exchanges where valuations of stock of IT related companies have been pushed fast by market sentiment and not by dispassionate medium/long term profit consideration.

New Economy companies have to look beyond their native base and the regulations enacted by their governments. They have to ensure uniformity in the diffusion of international technological standards. The more varied are such standards the harder it will be for companies in these sectors to maximise revenue worldwide. But international cooperation in world fora is dictated by the thrust and pace determined by government officials. These favour multilateral approaches that involve slow decision making, free riders, hazy goals, and a strong fervour for national sovereignty. Such behaviour tends to lead to the formation of regional or group cooperation rather than the formation of global markets.

In fact, it may be claimed that globalisation, defined as a system of free trade with fully integrated world markets, is not in evidence. Instead, evidence indicates that multinational enterprises that are supposed to benefit from world free trade are actually regionally based. They organize their production, marketing and other business in relation to regional boundaries. Of the world's largest 500 multinational enterprises, 434 are based in the triad USA, EU, and Japan, accounting for 90% of the world's stock of foreign investment.

3. The New Economy, Productivity, Returns to Labour, and Market Structures

3.1. Productivity and the New Economy

The real contribution of IT to productivity growth per head is still under examination. Research on the impact of new technologies, like the railways or electricity, on a country's output growth suggests that the technology has to be extensively introduced and adopted before it can make itself really felt. A 50% penetration rate is deemed 'necessary' for the effects to be unmistakably identified.

Productivity considerations may refer either to the increase in output per man-hour – referred to as Labour Productivity – or to the effect on total output arising from the most efficient organisation of all factor inputs, say labour and capital. This second effect is known as Total Factor Productivity (TFP) and refers to a costless way of boosting economic growth without increasing scarce inputs. Faster total factor productivity increases also labour productivity.

IT may boost labour productivity in several ways. As firms invest in IT, they increase the capital per worker thereby enabling output per man to rise. Or, by speeding up total factor productivity growth in IT producing industries following technical advances, IT will automatically increase output per man-hour. Besides, IT may increase the total factor productivity in those sectors that use IT. While there seems to be agreement among economic analysts regarding the beneficial effect of accelerating TFP, there is still a lack of consensus regarding the enabling facility of IT following an increase in Capital/Labour ratios or the output gains that emerge from higher TFP growth in sectors using IT.

Investment in IT will continue generating output per man-hour in the future only if the price of IT equipment continues to fall. This price behaviour implies continuous technological progress in the IT sector. Only in this way can the rate of investment throughout the economy be sustained in the future.

Measuring productivity growth was never an easy task, especially in the services sector. IT and the Internet have rendered the productivity issue harder still. Their main benefits come in terms of enhanced product quality, convenience and customer service rather than in terms of net cost savings. Product quality or convenience is very rarely accounted in aggregate value added statistics.

Productivity growth will not result automatically following the purchase of technology but more so from the efficient and extensive use of technologies. The ultimate test of IT-induced and sustained economic growth is the manner in which IT permits businesses to re-organise their production processes: whether IT allows existing purchases to be made more efficiently or by creating entirely new products.

The former channel demands supportive complementary policies in labour market legislation and in the supply of skills in the necessary quantities. The second channel presupposes rising real incomes and/or expanding markets - hence access to markets that could have been untapped – in order to continue generating rising demand for new goods and services. Trade liberalisation and macroeconomic policies that contribute to growing personal incomes are therefore also desirable. Economic booms are still potentially related to inflation, especially if they are in part the result of either overconfidence or 'over-fear' and lead to over-investment. In turn, booms could still be followed by economic slowdowns and possibly recessions. The performance of the United States economy in recent years and in the coming months could be an eye-opener on this economic profile.

3.2 Returns to scale and market structure

Information products, such as software, financial services and websites, and books are subject to increasing returns to scale. They have fixed costs – hence they are expensive to produce – but low variable costs – hence they are cheap to reproduce. This feature does not follow traditional

economic theory of production that assumes diminishing returns at some stage, when unit costs start to increase.

Firms operating under returns to scale tend to monopoly structures. In the case of knowledge products this supply phenomenon is reinforced on the demand side through network 'externalities' and 'lock-in' effects: the value of such products increase, the wider they are used. And once customers become familiar with computer systems, they will hesitate, and feel reluctant, to change. Network and lock-in effects, therefore, can create strong barriers to entry. In such markets, there will be a tendency for one firm to become dominant.

This line of argument does not mean that monopolies will mushroom in the knowledge industries. Competition could also be tough as the constant search for profits and the recouping of the original investment goes on. Where network and lock-in effects are not strong, competition will thrive. Where they are high, competition tends to be contained and national regulators will have to find ways to encourage as much competition as markets warrant. Such a search for competitive measures will have to be undertaken through a 'trial' approach.

3.3. Job creation and Wage Inequalities

The introduction of new technologies has historically given rise to a sense of alarmism among the employed and trade union officials. In the case of the developments in IT, workers were preoccupied that computers and robots would replace their jobs. However, the success recorded by the American economy in creating jobs while absorbing the impact of IT driven investment could have relieved somewhat the negative attitudes that employees could have towards innovation. Although many skills and jobs have been lost over time, an even larger number of new jobs have replaced them.

Experience in the USA suggests that most of the jobs lost as a result of IT are concentrated among the low skilled, whereas many of the new jobs require sound education and skill development. The demand for brains has risen in relation to the demand for brawn.

In the process, wage differentials have widened in favour of the better educated. Low skilled, routine jobs carried out by clerical and production workers, are easier to automate and replace by computers than jobs performed by professionals and managers. Therefore, in routine occupations, such as cashiers and clerks, pay is likely to become more uniform as technology reduces sectorial and regional differences. At the same time, computers complement skilled workers, thereby increasing the return on the creative use of information, whether in designing products, trading financial instruments, or managing companies. Besides, as the Internet expands the market for individuals with special talents, small differences in ability will lead to high differences in rewards. IT expands the market for such skills to a global scale and thus spreads the incidence of the so-called 'superstar effect' or 'winner takes it all'. In some occupations, like acting or sports, being slightly ahead of the contestants will reap large rewards.

But wage differentials do not rely solely on demand. They also reflect supply conditions. Hence, if an increased demand for skilled workers is not matched by the generation of educated workers the wages of the group in demand will rise higher than otherwise warranted. But, in this case, the impact recorded on wider wage bands will not primarily reflect the rapid increase in

demand, but the lack of foresight in boosting up the supply of the skills in demand. The successful improvement of educational and training facilities will be a key factor in conditioning the spread of wage differentials and their corresponding effect on production costs.

A corollary of the above is the possible growing divide between the information-haves and the have-nots. Richer and better-educated people are more likely to own computers and keep updating the software to improve their access to the Internet. Households that are less well off will therefore find themselves at a disadvantage. Without access to information, they are shut out of electronic technology, commerce and the opportunity to act fast in changing commodity, labour and capital markets.

3.4 Summary

Several issues stand out from the above analysis. Information technology is an industry in its own right. It generates employment, wage income, sales and profits. It boosts economic performance directly. Besides, technology has an even more extensive effect depending on how it is adopted in the economy, how it enables businesses to re-organise their productive processes. This effect will be entirely beneficial if complementary trade and macroeconomic policies are implemented simultaneously with the technology induction.

The knowledge industry is subject to increasing returns to scale through network externalities and lock-in effects. It tends to the concentration of power in the market and leads to monopoly situations. IT will destroy 'traditional' jobs. But like other technologies before it, IT helps create new ones. A skill imbalance could therefore lead to structural unemployment and wider wage distribution. To alleviate such negative labour market impacts on personal welfare and, possibly, social cohesion, the supply of workers has to match demand. In addition, the wider use of technology will ensure that the potential gap in the skill/consumer command between those who own the technology and those who do not, via access to the Internet for example, will be minimised.

The above features are examined within the context of the Maltese economy along four lines of enquiry, namely, market structures and value for money; adaptation to market changes; adaptation to cultural changes; and adaptation to demographic changes.

4. The implications of the New Economy for Malta

4.1 Market Structures and Value for Money

A small market always presents its own peculiar demand and supply characteristics. This is especially so if supply conditions have been characterised by monopolistic features, which arise directly from state ownership. In this case the regulator and the regulated entity are both state controlled. The liberalisation of such services via deregulation or/and privatisation, complemented by an independent regulator – a state agency or/and an industry's own board responsible for the imposition of a code of conduct – will raise the number of producers, expand the options on offer and result in a more attractive price-quality package for consumers.

But for this situation to materialise, several effective supervisory authorities, possibly operating in conjunction

with other supervisory bodies abroad, have to be in place. Their task will be to understand correctly the potential market configuration and to encourage the provision of services that are timely, economical, and do not distort competitive pricing structures. Such services span the IT range of products, Internet providers, financial services and transport. It is only in this way that a healthy competitive environment may be generated throughout the economy. Such trade arrangements will benefit from a speedier flow of information and, in the case of merchandise, a quicker delivery process at reduced real costs per unit. Otherwise, the gains in time recorded as a result of technology advances in communications will not be matched by gains in delivery. The expected speed will generate frustration and the full rewards from the enhanced communications system will not be realised.

The containment of unit costs of information and goods delivery will encourage the diffusion of the knowledge-distribution network. In this way the existing gap between the knowledge haves and the have-nots will be reduced. A wider access to information will enable a better use of resources and contribute to a wider sharing of the newly created national wealth.

Maltese society is presently re-assessing the social contract. It is seeking to redefine the relationship between the individual as a taxpayer and the individual as a recipient of state benefits in cash and kind. The Maltese are being asked to resort more than in the past to the principle of self-help rather than on collective sharing of tax-financed services. At the same time, the fifty year old rules that protected domestic production are being withdrawn and a free trade regime or membership of a single market are imminent. Membership of the EU will redefine the role of agencies and redraw the market boundaries thus enabling foreign suppliers to sell directly to Maltese buyers. The least one wants to have under such an evolving trade scenario is an uneven distribution of the means to chart one's way in life at a time of rapid social and technological change. An uneven distribution of such means at this moment in time will be socially divisive and will induce unnecessary personal hardship.

Appropriate legislation, targeted social programmes and enlightened regulators have a lot to contribute to the diffusion of the IT tools to the greatest number of people. Witness the role that the law and regulators had in the pricing of local telephony and mobile calls, and the 'uneasy' relationship that exists between wired and mobile voice, word and image service providers. The less expensive are the costs per unit, and the wider the interconnection between one network and another the more effective can a 'service' become. But sectorial interests based on network and lock-in strategies may go against the objective of the maximum diffusion of a service thereby affecting negatively the quality of the service itself. In this case, the maximum advantage that may be had from the technology will not be attained. Consumers and intermediate producers will suffer as a result.

4.2 Adaptation to Market Conditions

All have to adapt to a changing trade, production and service environment. Producers will rely more on electronic business-to-business transactions. Therefore, if there exist efficient distribution networks, both domestically and internationally, procurement and selling systems as well as production time frames and stock keeping will adapt accordingly. Such a set up will reduce the costs of stock

holding, speed up production but at the same time be exposed to the performance of the distribution system. An unreliable distribution network, arising from, say, industrial unrest or political instability anywhere along the route of delivery of materials or finished products, will bring businesses to a halt.

This phenomenon is doubly important for Maltese manufacturers. Local production depends critically on the regular inward flow of raw materials and semi-finished goods and on the outward delivery of the goods. A greater reliance on knowledge of market conditions and costs will enable the fine-tuning of production systems especially in markets where local producers are price takers.

Producers will also have to match their skill requirements with supply at prices that the industry can bear and register profits. Skills do not refer solely to technical knowledge and after sales services. They also condition the ability of a firm to adapt technology to its production, distribution and service provision so as to meet rising buyers' expectations. Buying hardware and software is only one step in a process that envisages the successfully absorption of the technology into a revamped organisation. The skill to select the right type of personnel and to provide the training needed to integrate information in the organisational set up is independent of the technology introduced.

Technological adaptations are bound to be more demanding when they take place at times of major policy changes. Malta's manufacturing sector has been characterized by a dualistic set up. Duality refers to the large number of very small firms catering exclusively for the domestic market and a number of few relatively large firms employing 250 and over operating primarily, if not exclusively, for export. The export-oriented firms have been exposed to international competition and have been on a constant adaptation state. Those domestically oriented firms that survived because of the nature of their trade or because of protection will have to face competition from foreign production and imports.

The impact of the IT drive under way is taking place simultaneously with the drive towards the liberalization of trade, money, capital and foreign exchange. At the same time a greater reliance is being placed on market forces, taxes and self-help in the acquisition of welfare services. So, several forces are being released at one go! Many entrepreneurs, self-employed and workers may be unaware of the true significance of these changes is so far as they affect self-development, skills distribution, and personal fulfillment. A labour market driven by a wider information network may suffer negative setbacks emanating from the movement of skilled persons in short supply who will be attracted by better working conditions elsewhere – pay, opportunities to develop one's skills, and personal satisfaction. Unless opportunities are forthcoming locally, Malta stands to lose personnel to the information and communication technology sectors abroad. The EU alone is predicted to register a shortage of 1.7 million workers is such sectors by 2003!

And yet, employers in Malta do not allocate enough funds for training, although the situation could be improving as the awareness to train and retrain becomes more widespread among both employers and employees. A flexible skill deployment policy, on an enterprise and economy scale, effectively supported by training opportunities is doubly important for Malta. Firstly, Malta's population is ageing, and the rate of this ageing process accelerates after the year 2005. The present 16%

of the population aged 16 years and over are projected to rise to 24% twenty years hence.

Besides, the distribution of labour skills and employability of workers is not geographically uniformly distributed. Some areas are more skill-rich than others. The ability to adapt to changing labour market conditions, where brains are replacing brawn, is not evenly distributed with the result that the economic gains that go with a better use of technology will not be uniformly distributed. There are already income gaps by areas: per capita incomes are very unevenly distributed. These divergences will become more pronounced if the differences in skill endowment get wider.

A decisive break with the past has to be registered in this area. A country that keeps quibbling over its national minimum curriculum and the availability of resources allocated for education and training will not be contributing to closing the skill gap. This is especially so when the new technology points at knowledge and the ability to use that knowledge in the respective markets. The gap between the knowledge-haves and the have-nots will get wider with the negative personal and group connotation that it implies.

4.3 Cultural Adaptations

A cultural change is called for. A society responding to the new technology emphasizes speedy and correct decision-making, quick response to changing social and economic conditions, and a sharp foresight that anticipates the signs of the times. These features apply to individuals and to groups in relating one to the other socially and in trade.

Fast change expects fast responses. And many may be lethargic to respond because traditionally they were brought up to assume set patterns of behaviour that did not include a speedy response among them. Thus workers operating for many years in 'sheltered' industries or in the public sector may take some time to comprehend the real meaning of the IT revolution with its fast-moving delivery environment. They will become disoriented, caught between static behavioural patterns belonging to the past and the dynamic performance of the future.

This disorientation could get compounded if leadership skills are in short supply. It applies to all levels of relationships: among relatives, friends, colleagues and competitors. It affects personal and social interactions and trade relations. Those who live in a competitive trade environment expect to be freed from unnecessary bureaucracy, but bureaucracy does not adapt to changing conditions overnight. Hence the inherent dialectic between slow-moving, free-riding bureaucracy – characteristic of state controlled institutions – and fast Internet browsing, profit searching entrepreneurs.

But adaptation will have to happen. What has to be determined is the form adaptation will take, the speed of adjustment, and the institutional and personal support that can be expected while individuals and systems respond to change. Thus, for example, large capital outlays may demand shorter working weeks per worker in order to induce the maximum turnover of the capital capacity. Such a measure will not primarily be taken in the interest of the worker but in the interest of the large amount of funds 'sunk' in capital. Three or four shift systems may be warranted. These work procedures demand adaptation at the personal level to flexible working time commitment, to personal well- being and

to family life. Stress will follow unless countervailing attitudes are adopted.

This holds both for manufacturing and for the leisure industry. If the 'family' unit is to be supported, as seems to be a re-emerging trend in high-income countries, then life skill training is a necessary, though not sufficient, condition for healthy personal and social relationships. Life skill training, unfortunately, is deficient in Malta at work and at the educational institutions. Surveys among employers and secondary school students suggest that there is a deficiency of life skill formation at all levels of formal and informal education. This includes the homes, schools and the places of work. (Delia et. al 1997)

4.4 Adaptation to Demographic Changes

Reference was made above to Malta's ageing population. One in four, close to 100,000 Maltese, will be over sixty in 2020. This demographic phenomenon demands supportive economic and social policy measures that entice total factor productivity. There has to be an enhancement of human resources, organizational networks, social infrastructure, and plant in the manufacturing and service industry. Ageing is a natural fact of life. But retirement from work at a given age is man-made and, in a sense, an artificial measure that has to be assessed from time to time.

Retirement will have a strong impact on people's lives. It comes as a shock for many, wherein some try to keep occupationally active by working part time, while others try to extend employment elsewhere. Employment delivers psychological benefits: it confers an identity, structures time, gives access to social interaction and a sense of creativity and control, and keeps people absorbed. Forced retirement through redundancies and mismatch of skills, as seems to be an emergent trend in the labour market in Malta, is a matter of concern. So is forced retirement at a pre-determined age through mandatory rules.

Retirement affects also social welfare schemes that are financed through payroll taxes on the Pay As You Go formula. It indirectly influences unit labour costs and, in turn, the comparative advantage of allocating a plant in or providing a service from Malta. A welfare funding system based on the self-help principle will therefore in time ease the pressure on the existing social welfare support network in Malta. But it will disturb the personal provision plans of all those who are unprepared to continue supporting their way of life if unemployed or retired.

Forced retirees from work could find IT fulfilling if they are taught to handle the medium. It may boost the probability of earning an income and at the same time be a means to attaining cultural aspirations and social commitments. This combined producer/consumer facet of IT services, particularly the Internet, implies that retirees are technology literate and enjoy themselves using the medium for leisure or for profit. By spreading the use of the IT media, a society will potentially enhance the quality of life of retirees, of the groups to whom they belong, and of the economy in general. A knowledge-based society can lead to a fulsome life.

The demographic transition also implies that skill mismatches will continue, especially if young Maltese emigrate in search of more rewarding opportunities abroad. Malta will have to consider seriously a migration strategy whereby it accepts that young IT literate Maltese will emigrate, some will return, and skill gaps in the various service sectors will have to be filled by foreign

workers. In the early nineties, it was government's policy to fill the expected increase in employment by relying primarily on domestic labour. This policy strategy will have to be assessed in the wake of the ageing process Malta is going through.

In part, such a migration policy will depend on Malta's relation with the EU. Membership will be automatically associated with freedom of movement of EU nationals. But the entry of non-EU citizens will equally mean freedom of movement for them throughout the EU. Malta could become a stepping-stone to Europe. Non-membership will keep controls on freedom of persons from the EU and elsewhere. But it does not exclude the need for a clearly specified migration policy.

Freedom of personal movement in a work environment where life tenure is no longer assured will imply the portability of a worker's contribution to a pension. There cannot be a true worker movement without the transferability of pension rights, especially under Pay As You Go, defined benefit schemes. Personal welfare is truly intertwined with the social welfare network in place in the place of origin and the place of adoption. (Delia, 1998) The New Economy may be encouraging social policy planners to examine the social welfare systems in place and to assess how these could be adapted to a working environment that has a global dimension and speed of adjustment as its fundamental elements.

5. Concluding Remarks

Maltese society is living a challenging experience. Demographically, it is witnessing the transition from a young community to an elderly one: the share of the sixty plus in the population will rise from 16% to 24% in two decades time, pulling up the median age of the population in the process. This shift will have profound effects of the labour market, social welfare support systems, and individual welfare.

Meanwhile, the rate of economic growth per head of population has been slowing down. Future economic growth will have to arise from initiatives that improve the productivity of all factors of production. This growth has to be generated by activity exposed to competitive forces in the markets for labour, capital and goods and services. This is a relatively new scenario for many producers and traders in Malta.

In terms of technology, there is greater reliance than hitherto on information. Collating, screening and assessing such information with the aim of making profits and discovering self-fulfillment is a challenge that is facing all Maltese irrespective of age and gender. By itself, an economy that trades knowledge in a larger volume than in the past will be able to assist economic diversification. And a freer trade environment will enable the benefits of IT to be maximized.

However, the New Economy is not immune to business cycles or to the interference by governments in international trade. Hence Maltese society will have to adapt to these conflicting forces made up of speedy responses to potentially growing global trade and slowing down processes based on multilateral arrangements and free riders. The Maltese have to adapt to such contrasting factors on the personal, social group and industry level. Policies that regard income creation, production and distribution costs, training, life skill support, welfare programmes and migration will have to be coordinated and made to work effectively.

The aim of such policies will be the development of multi-skilled individuals who can respond fast to changing global trade signals in order to secure a living while developing their personality. Such policies will be conditioned by the type of relationship that Malta has with the European Union. This relationship will define the macroeconomic policy tools available to policy makers to attain the desired socioeconomic objectives and the conditions ruling the freedom of movement of persons, capital and trade between Malta and the EU and between Malta and the rest of the world.

Responding to these challenges at one go is not an easy task. But it is this condition that makes the times exciting.

References:

Delia, E. P., Ghirlando, R., Vassallo, M., *Human Resources in Malta – Trends and Challenges*, Volume One, Malta University Services Ltd. for The Employment and Training Corporation, 1997

Delia, E. P., *Towards Sustainable Welfare Programmes and Pensions in Malta*, The Malta Chamber of Commerce, Research Monographs No. 1., 1998

EXCHANGE RATE ARRANGEMENTS: FROM AN EXCHANGE RATE UNION TO AN ECONOMIC AND MONETARY UNION

Monetary systems are an expression of national sovereignty. Hence governments, the embodiment of national sentiment, control the supply of money. This control is not only sought for nationalistic purposes but also because an over valued money is a prime fiscal resource. Indeed some economists propose the denationalisation of the money supply in order to impose discipline in the issue of this commodity (Hayek, 1990; Issing, 2000).

Monetary control is, additionally, a factor that conditions a country's competitiveness and personal welfare. Responsible governments and monetary authorities, therefore, gain from the seignorage attached to the supply of money but they also aim to reasonably sustain its purchasing power through a monetary set up that incorporates an efficient foreign exchange rate mechanism. The rate of exchange is the instrument through which domestic prices are converted into international prices, and vice versa, thereby affecting in multifold ways a country's flows of trade and capital.

These observations apply to Malta as they do to other sovereign states. Prior to independence in 1964, Malta had

Speech delivered at The Charter Institute of Bankers, Malta, 22 May 2001 its own currency that was pegged, one for one, to the British pound and was backed up hundred percent by foreign, pound sterling, reserves. The sterling peg remained until the early seventies, when Malta switched to a currency basket exchange rate mechanism but to date retained the full back up of currency by gold and foreign exchange holdings. The legal requirement is for foreign reserves to make up at least 60% of currency in circulation and bank deposits. In March 2001, the latest figures for the assets and liabilities of the Central Bank of Malta, the reserve backup amounted to 99.19%, having been 97.79% in February 2001 and 109.53% in November 2000.

Malta's foreign exchange mechanism belongs to the fixed but adjustable category. A currency basket system falls within this exchange rate arrangement that allows for decisions regarding the exchange levels to be altered in line with deliberate policy objectives. If Malta adopted a hundred percent currency back up rule, against the 60% condition that prevails at present, the exchange rate arrangement will turn to a Currency Board condition that will render the exchange rate arrangements truly fixed. The Central Bank of Malta has implemented its interest rate strategies to reflect movements in official reserves in relation to currency and deposits: interest rates were raised when the ratio started falling way from the 100% mark in the mid-nineties at a time of the liberalisation of interest rates. In a sense, a *de facto* currency board scenario has been created even though *de jure* a 60% back up position still stands.

This presentation outlines the policy implications of the exchange rate regime chosen by the Maltese monetary authorities and identifies the additional constraints on policy choices if Malta were to opt for an exchange rate regime that locks the exchange rate of the Malta Lira in terms of other currencies – as for example by joining the Exchange Rate

Mechanism (ERM) of the European Union – and eventually joining the European Monetary Union (EMU). By joining an economic and monetary union, and adopting the currency of that union, - in the case of the EU it will be the euro in circulation in 2002 -, Malta will bind herself to an irrevocably fixed exchange rate arrangement and will have to abide by the economic consequences of such a regime. When this happens, Malta will have moved from a foreign exchange union to a monetary union, which represents an extreme form of fixed exchange rate arrangements.

1. The Rate of Exchange and International Competition

The rate of exchange is the price of one currency in terms of another: how many US dollars will be given in exchange for one Maltese Lira. It is a monetary factor with no 'real' or volume counterpart. And contrary to what many may believe the 'desirable' value of a country's currency in terms of other currencies - the so-called 'equilibrium rate of exchange' – cannot be identified with conviction. Disagreement on its level is bound to persist.

In theory, consistency among a country's desired production, consumption, trade and payments structure, including tariffs, subsidies and exchange controls, may be established through a general equilibrium model of the economy. Such a model integrates over time the real productive sectors with financial transactions and arrives at optimal levels for the rate of exchange and other variables including the government's budget components and the money supply. However, such an approach will be difficult to implement empirically, future targets are not easily identified and data may not be readily available to the model builder.

The appropriateness of an exchange rate can be determined on the basis of a country's competitiveness and the degree of imbalance in the external sector. One method used to assess the adequacy and track movements in a country's competitiveness is the construction of Effective Real Exchange Rate Indices (REER); these are in effect price indices weighted by exchange rate indices. The REER index for Malta was 100 in 1995; it recorded 108 in December 2000, meaning that Malta's competitiveness in international markets has been eroded by eight percent as a dual result of an overall appreciation of the Lira and a faster rate of growth in the average price level in Malta compared to the average price levels in competitive countries (Central Bank of Malta, 2001: 42-43). The nominal value of the Lira is influenced by the components of the currency basket that determines its level. The basket is composed of three currencies: the euro (58%), the US dollar (21%), and the British pound (21%). Although the euro weakened in the period under survey, thus tending to bring down the value of the Lira, yet the US dollar and the British pound got stronger. The end result was a stronger Lira and comparatively more costly exports. Also more expensive are the imports of goods denominated in the US dollar, like fuel.

Underlying these indices is the Purchasing Power Parity (PPP) doctrine. This postulates that the equilibrium rate of exchange between any pair of currencies is equal to the rate between domestic and foreign prices (the absolute version) or that the equilibrium changes in exchange rates match inflation differentials (the relative version). The PPP theory is based on the law of one price and the neutrality of money: if identical goods originating in two countries are priced identically by the market, and all relative prices are fixed in the long run, then overall price indices must obey the PPP condition.

One difficulty faced by researchers in testing for PPP theory is the identification of a suitable price index to measure price movements over time. Different price indices could lead to different results and consequently confound policy making. The Central Bank of Malta uses the Retail Price Index to construct the REER index. But other deflators, such as the implicit GDP deflator or a Unit Labour Cost Deflator, will yield a different impression of Malta's competitive standing from the present REER index. However, the GDP deflator or the Labour Index is not available on a monthly basis. Hence they cannot be incorporated in a regular timely assessment exercise. It is with such analyses in mind that the National Statistics Office is compiling a Purchasing Power Parity Index.

The validity of such indices for policy formation is readily apparent: the policy objective and the instruments used to influence the rate of exchange of a country's currency have to be examined in the wider context of the array of policy tools available to condition over the short or the long term the composition of output and prices in the respective markets for goods, labour and capital. Involved are, among others, decisions regarding the determination of absolute and relative prices of goods and services, wages and interest rates. In turn these prices imply decisions regarding taxation and subsidies, import controls, export support, and other regulations in the many markets for goods and services. These decisions, together, influence households' consumption, saving and investment propensities, the supply of effort and the organisation of production.

Hence, the exchange rate mechanism has to be seen as a component of an economic policy that seeks to establish a country's competitiveness and, in the process, determine the value of a country's currency in terms of other currencies.

These complementary policy packages have to be assessed as a country moves from one exchange rate regime to another. This examination is carried out below.

2. The Policy Implications of a Foreign Exchange Union

Countries seek to eliminate the transactions cost of exchange in international trade. They aim to take away exchange risks in order to allow producers to focus on what they can do best, namely, generating goods and services. However, a fixed rate system based on fiat money may not provide a nominal anchor of specie convertibility unless a participating country defines its currency in terms of the currency of a dominant country.

Throughout the postwar years, both pre- and post independence, Malta pegged the Lira to the British pound and formed part of the sterling area. Indeed, following the devaluation of the pound in 1967 Malta sought, and was given, safeguards against eventual future devaluations for financial assets that formed part of the official reserves. The commercial banks in Malta were thus encouraged to transfer their private holdings to the official foreign reserves account that was administered by the newly founded Central Bank of Malta.

A pegged currency implies that the cost of money in the participating state must match the cost obtained in the dominant country. This means that the freedom to follow an independent interest rate policy is given up. With no exchange risks, deposits in the participating country must yield the same rate of return as in the dominant country. Interest rate differentials for identical monetary and capital instruments will entice capital movements between the two countries.

Under such a regime, the freedom to chose between exchange rate parity and the cost of capital is surrendered. Macroeconomic management will have to be exercised through fiscal policy – government taxation and expenditure – and labour market policies concerning wages, hours of work, and productivity inducements. The international difference in the prices of traded goods and services will be reflected, in the end, in the external account balance: if exports exceed imports foreign exchange reserves will increase, thereby leading to an increase in the money supply and domestic credit unless the increase is sterilised, that is, withdrawn from the monetary system, by the Monetary Authorities. Conversely, if exports fall short of imports, the country will pay for the excess either from its foreign reserves, or by adding to its international debt, or, if fortunate enough by receiving grants that match up the foreign exchange deficit. In Malta's case, grants from the UK government and emigrants' remittances complemented investment income and direct investment and made up for the trade deficit.

The important element in this policy scenario was the reliance of economic adjustment through fiscal and labour market policy, including in the latter an orgnanised emigration movement on a large scale. All the time the Lira was pegged and the quantity of money in circulation and bank deposits were backed up hundred percent by foreign exchange and gold holdings. When the government wanted to gain leeway in monetary and incomes policies, it had to follow one of two paths. It introduced exchange controls, which it did in 1970 to free itself to follow the interest rate and fiscal policies it deemed suitable for Malta. And it stopped pegging the Lira to the British pound, thus gaining independence in administering the exchange rate and in the process 'influencing' the value of the Lira even though the Lira was not 'quoted' in international foreign exchange markets. This autonomy was achieved by the introduction of a currency basket in 1971.

Following the collapse of the Bretton Woods monetary system in August 1971, steps were taken to break the direct link with the British pound and the Lira was set at £1.05 on 25 August 1971. In June 1972, following the British government's decision to float the pound for an indefinite period until it found its own level, the Central Bank of Malta decided to break completely the link with the pound, and the Lira began to be determined in relation to a basket of currencies of Malta's main trading partners. The currency basket base remains effective to date (Delia, 1986).

Macroeconomic management in Malta in the past twenty years has been charaterised by these three important policy tools: a managed pegged exchange rate, a hundred percent backed money supply and bank deposits, and a wide array of controls on money and capital flows, wages and prices of goods and services. Direct controls tended to support or countervail macroeconomic policies and microeconomic initiatives taken at different points in time. These controls created a set up wherein resource allocation was not attained through price movements alone but also through quantity rationing or adjustment. Thus, for example, in the capital market, the supply of funds was channeled according to priority sectors that were considered deserving from a national point of view – say, the export sector or agriculture. If the monetary authorities judged that a sector had been over lent, as happened at some time in the hotel sector, the commercial banks were directly instructed not to direct capital to projects in the accommodation segment of the tourism industry.

Imports of goods were also put under controls in order to save foreign exchange, once, for various reasons, export

earnings fell short of the projected. Similarly, control on foreign travel allowances were introduced to check for the outflow of foreign exchange. In a similar vein, controls were imposed on wage and price movements at a time when the total domestic value added faltered in the early eighties.

Such constraints on the freedom to trade and capital flows were introduced because a primary macroeconomic policy target was the value of the Lira. The external value of the Lira became a prime policy tool around which the other complementary policy tools were enlisted as the economic needs demanded. In fact, changes in the level of the Lira – re/devaluations – took place only three times in a thirty-year period. They happened twice in 1980, with a revaluation on the 7 of April followed by a devaluation of the Lira three weeks later. This abrupt change emerged from the high volatility of the US dollar at the time. The Lira was devalued for a second time in November 1992. Macroeconomic management relied on controls of prices and volumes of goods and services to meet the economic conditions prevailing at the time. It was in this way that foreign exchange reserves and the monetary supply that was tied to them were safeguarded in the absence of an active monetary policy and in the wake of a fiscal policy that relied on balancing the budget even at the cost of curtailing investment in infrastructure.

With the easing of controls in trade and capital movements, throughout the second half of the eighties and the nineties, the economic environment gradually changed. And, by 2002, capital will be free to move in search of the highest returns anywhere, inward directed funds will be entirely freed except for the purchases of speculative property titles, protective tariffs will all but be gone except for the agro-industrial sector. With controls withdrawn, the monetary and fiscal authorities cannot continue to enjoy the autonomy to pursue an independent fiscal regime and an independent monetary policy. Without controls, the fiscal and monetary scenarios will have to meet the conditions imposed by the rate of exchange level as this evolves from the performance of the international foreign exchange markets. Once these markets determine the value of the lira, the fiscal, monetary and labour market policies must be such as to ensure an external account balance. Failure to achieve this objective will imply that either the domestic price level will have to be deflated or, if a differential inflation persists, the external value of the lira will have to be adjusted.

Such an adjustment is still possible under the existing exchange rate regime. But what will be the macroeconomic policy implications if Malta were to join the Exchange Rate Mechanism of the European Union, a step Malta will have to take in the first two years of membership, and, more important perhaps, what is the meaning for policy of joining the Monetary Union, the Economic and Monetary Union (EMU) of the European Union? The ERM, established in 1979, was modeled on Bretton Woods: fixed parities with bands within which currencies could float. Though not based on gold the ERM incorporated flexibility and great financial resources. It broke down in 1992-1993 for the same reasons that the Bretton Woods collapsed; namely, pegged exchange rates do not live with capital mobility and policy autonomy. The policy constraints that emerge from such exchange rate arrangements for Malta are examined in the following section.

3. On Joining the ERM and the EMU

In theory, Malta should not find inordinate difficulties adapting to an exchange arrangement whereby the value of the Lira is fixed with a variance of 15% in terms of the euro, in circulation after January 2002. Malta had followed rigorously for many years a policy of tuning its economic policies in relation to the stock of foreign exchange reserves without resorting to policy changes in the external level of the Lira. The managed pegged arrangement served Malta well. So, if the Lira were to be locked to the euro, it will imply that policy makers will have to be explicit in their complementary policy targets – fiscal balances, average wage levels, and average aggregate price levels, nominal GDP growth rates - and consistent in their pursuit. Time consistency may not have been the hallmark of macroeconomic policy in Malta in the past. It was thanks to the tightness of controls that the recorded fiscal results could be attained. This degree of control is no more, and it will be eliminated in the coming months. Because of this major policy tool change, the past performance cannot be taken as sure guide to the future.

An examination of the mechanics of the existing exchange rate arrangements will reveal several important features. Firstly, the existing basket of currencies tends to countervail ‘extreme’ movements in the external value of the Lira. The basket includes three of the main world currencies, the euro, the US dollar, and the British pound. The last two currencies tend to fluctuate inversely to the euro or to its predecessor the ecu that reflected the fortunes of the German mark. Since the Pound is bound to remain outside the EMU in the foreseeable future, and since the US dollar will continue to be the global reserve currency – even reinforcing its future trade role following the setting up of the pan-

American free trade zone after 2006 – the euro will rely on the evolutionary monetary, economic and political development in Europe in the coming years. If it remains a relatively soft currency, pegging to the euro will result in a weaker Lira.

The domestic economic fundamentals will have to account for that condition. Exports will benefit. But Maltese exports rely to different degrees on imports, including fuel and raw material. Gains in competitiveness arising from the export price will be affected by import prices, including the costs of non-European merchandise. Hence the locally generated costs of services and labour will have to counterbalance the increase in the cost of imports; otherwise any export gains through a weaker Lira will be eroded fast. The 1992 devaluation experience, when productivity gains failed to match wage increases, stand as a stark reminder to this phenomenon. The gains from devaluation were dissipated within three years: a Unit Labour Cost Index for local manufacturing that registered 109.85 immediately pre-devaluation fell to 97.85 in 1993 and rose again to 114.66 by 1995 (Delia, 1992, 1998:50)!

Secondly, the value of the lira in relation to the euro will have to be determined. Today's exchange rates are the outcome of the currency basket in place and of the international movements of the currencies that constitute it. They are not the outcome of 'independent' market forces. Hence a judgement will have to be made regarding the suitability of the Lira-euro rate of exchange. Once a value is 'locked in' in the two-year transition period for the ERM, the economy will have to adapt to the value established. It will be an irrevocable decision in the sense that there has to be an economic commitment to abide by the 'rules' of economic management, with the result that the relevant macro-variables – interest rates, average price

level, average wage increases and productivity growth – will have to comply to the external parameter thus established. With freedom of capital movement, interest rates will be internationally determined and local decisions will be restricted to the fiscal and labour market domain.

Productivity considerations will become paramount. No amount of lip service to factor efficiency, a hallmark of the past, will be to any avail. The economy will have to assess its organisational network with the aim of achieving Total Factor Productivity, that is, a costless way of boosting economic growth without increasing scarce inputs. Such restructuring and factor gains have to be achieved in a liberalised and deregulated market environment for goods, services and factor inputs. In sum, economic diversification and growth will have to take place within parametric constraints without the support of the control tools with which Maltese policy makers are familiar.

Under the ERM the Lira will still be the unit of account and medium of exchange. Seignorage will therefore accrue to the issuer, namely, the Central Bank of Malta and eventually the Maltese government. However with membership of the EMU a further political step will have to be accomplished: money control will be transferred to a 'foreign' body.

A monetary union is intrinsically a form of exchange rate arrangement. It represents an irrevocably fixed exchange rate arrangement with high credibility rating. But, in the case of the EMU it also means a strong political commitment to abide by the economic follow up that emerges from decisions taken by the Central Monetary Authority, the European Central Bank.

The EMU stands out in the history of monetary unions. A group of monetary and politically independent countries have surrendered their national currencies to form a common monetary union based on a new unit of account under the leadership of a common monetary authority while still retaining political independence.

The EMU is based on a fiat and not specie standard. Therefore a nominal anchor has to be created by member countries through some form of common and political agreement to pursue and enforce a rule such as monetary and inflationary targeting. European monetary unification will be based on a commonly accepted, politically decided commitment mechanism. This is a distinct difference from the gold standard of past monetary unions that had gold convertibility as a common focal point and commitment mechanism.

The European Central Bank has price stability as its principal objective. This requires that the individual members of the EMU will display a total, permanent commitment to this common goal. This was what the advanced nations of the gold standard did a century ago. The EMU, therefore, has to successfully create a convergence in policy purposes in the future without putting strain on the relationship between the major and the minor member countries.

For Malta joining the EMU will imply several commitments. Firstly, it means switching from targeting the Lira as a policy anchor to the overall price level. The euro is a floated currency; its value depends on the Union's economic fundamentals and on the perception of foreign exchange dealers of how economic and financial management in the Union will be exercised. As a result, the floating value of the euro will be given for Malta and the Maltese economy will have to adapt to the resulting price structure by channeling resources and adjusting productivity accordingly.

Secondly, it implies a political commitment to collaborate with the other members of the EMU on specifying monetary

targets and to abide by their economic implications. Again, this means that the local economic fundamentals will have to be tuned to the macroeconomic parametric values dictated by the much larger economic space. This decision reflects the will to constantly adapt to changing world economic scenarios and strive for economic efficiency that follows from the four freedoms – of goods, services, labour and capital- on which the single market is constructed.

Thirdly, EMU membership demands a series of reliable data sets that can guide policy makers on the performance of prices and quantities in the respective sub-markets.

Fourthly, it envisages consistency in policy making whereby one policy supports another. There have been too many policy inconsistencies in the past, both as regards to the timing and as regards the nature of the policy set. Policy targets, though not infallible policy prescriptions, have to be synchronised and pursued with vigour. The synchronisation of policy objectives and strategies has not been a characteristic of policy implementation in Malta!

Fifthly, economic targets are simply numeric guidelines. But economic policies refer to people. Several major European countries, like Germany and France, are ageing regions. So are the Maltese Islands. Whenever and whatever reference is made to economic policies, this demographic factor has to be kept in perspective. The age and gender distribution characteristics of a population have an important bearing on the labour supply, its response to change and its willingness and ability to face a more economically demanding future.

Finally, the EMU is bound to be an evolutionary process. Its effects are too widespread to be considered solely in economic terms. A political evolution is therefore expected. Europe will have to locate itself in a wider global trade and power distribution as a step towards global cooperation.

This world vision could emerge through regional cooperation, where the term 'regional' will encompass enlarged geographical spaces, like an extended European Union and a pan-American Free Trade Area. The role of the nation state will have to be rediscovered and redefined in this evolving scenario.

The challenges arising from a freer global trade environment are greater than many may expect. Understanding these complex phenomena is a start to a better evaluation of the intricacies of the issues involved and, possibly, to a search for a fair system of global wealth creation and distribution. Financial institutions, as the intermediaries in the global movement of capital resources, have an important role to fulfill: the maximising of return of savings from capital rich zones to capital poor areas which promise a higher rate of return to all involved. But these massive flows demand an evolution in international monetary systems. The EMU is one such development that focuses on monetary stability, eliminates transactions costs in exchange and encourages production in terms of economic efficiency.

References

Central Bank of Malta, *Annual Report 2000*, 2001.

Delia, E.P., *The Currency Basket*, Confederation of Private Enterprise, Malta, 1986.

Delia, E. P., 'Malta's Trade Account, Labour Costs and the Rate of Exchange of the Maltese Lira:; An Overview', Central Bank of Malta, *Quarterly Review*, Vol.25,3:48-67, 1992.

Delia, E.P., *Towards Sustainable Welfare Programmes and Pensions in Malta*, The Malta Chamber of Commerce, Research Monograph 1, 1998.

Hayek, F. A., *Denationalisation of Money – The Argument Refined*, Third Edition, The Institute of Economic Affairs, Hobart Paper Special, 70, 1990.

Issing, Otmar, *Hayek, Currency Competition and European Monetary Union*, Institute of Economic Affairs, Occasional Paper 111, 2000.