EU ACCESSION CRITERIA – THE MACROECONOMIC DIMENSION: A CASE STUDY OF MALTA

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Abstract: This paper is a case study of the Maltese macroeconomic situation, within the context of Malta's accession negotiations with the European Union. The Maastricht Convergence Criteria and the Stability and Growth Pact relate to the Economic and Monetary Union, but are considered as benchmarks for member states, whether these form part of the EMU or not. Within this framework this article assesses Malta's economic situation vis-à-vis convergence with the European Union, taking into account both nominal and real convergence. The Maastricht convergence criteria are used for nominal convergence while Okun's discomfort index and the EMU indicator devised by Gros and Thygesen are used to analyse real convergence.

Introduction

This paper discusses the macroeconomic dimension of the criteria adopted by the European Union in accession negotiations with prospective applicant countries, with particular reference to the negotiations currently under way between Malta and the EU. Malta formally started accession negotiations in mid-February 2000 and the Government is confident that the country will be included in the next enlargement of the European Union.

The macroeconomic dimensions of the Copenhagen official accession criteria are spelled out in the Maastricht Convergence Criteria and the Stability and Growth Pact. While these may be viewed as strictly relating to Economic and Monetary Union (EMU) issues rather than to EU membership directly, the European Commission stated that,

"As membership of the EU includes acceptance of the global

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> goal of EMU, the convergence criteria will have to be fulfilled by Malta, although not necessarily upon accession. They remain key points of reference for stability oriented macro-economic policies, and must in time be fulfilled by Member States on a permanent basis." (European Commission 1999, Section 3.6)

Furthermore, Begg *et al* observe that "in whatever wave entry takes place, EMU entrants will still have to observe the Maastricht criteria" (Begg *et al.*, 1997:68-69).

In view of these considerations, this paper assesses Malta's standing in relation to the Maastricht convergence criteria and the Stability and Growth Pact. In discussing effective economic and monetary integration Lahmidi and Patterson (1998) distinguish between nominal convergence (referring to the official Maastricht criteria) and real economic convergence (relating to real GDP growth, unemployment rate and GDP per capita). The discussion is here extended beyond nominal convergence issues to encompass considerations of real economic convergence, which may at the end of the day prove to be just as important to Malta's eventual integration with the EU economy.

The Maastricht Criteria and the Stability and Growth Pact

An exposition of the role of the Maastricht criteria and the Stability and Growth Pact, within the recent developments regarding economic and monetary integration within the EU, sheds light on Malta's present position vis-à-vis the macroeconomic accession criteria.

> "[A]s real economic integration (through trade and movements of resources) proceeded, monetary integration became increasingly desirable." (Grahl, 1997:109)

With the single market in motion, a single currency appeared the next logical step in the process. The Delors Report of 1989 proposed a three stage process for economic and monetary union. It stressed the need for greater coordination of economic policies, the financing of national budgets and the need for an independent institution that would be responsible for the Union's monetary policy. In order to qualify for the third stage, envisaged for 1st January 1999, member states had to show

a high degree of durable convergence as measured by certain criteria entrenched in the Treaty. Member states were required to comply with the four convergence criteria set out in the Maastricht Treaty and the relevant protocol (No.6), Article109j(1). The four areas are: price stability; government finances; exchange rates; and long term interest rates.

Price stability is achieved by a convergence of the inflation rate, which much not be more than 1.5% higher than the average of the three lowest inflation rates in the European Monetary System (EMS). In 1997, the three countries were France, Ireland and Austria, whose average stood at 1.2%. Therefore, the limit of the inflation rate for the other countries was set at 2.7%. In 1999, this limit decreased to 1.3% since negative inflation was registered by one of the best performing countries. Price stability is assessed using harmonized price indices for the preceding twelve months.

Convergence in Government finances has two facets: the budget deficit and government debt, both as a ratio to GDP. Government budgetary deficit should not exceed 3% of GDP. If it does, it should be declining continuously and reaching the 3% level or it "should be exceptional and temporary and remain close to the reference value" [Art.104c(a)]. Government debt should not exceed 60% of the GDP. If this is not the case, it should "diminish sufficiently and approach the reference value (60%) at a satisfactory pace" [Art.104c(b)].

For exchange rate convergence, a country must have participated in the European Monetary System (ERM2) for the previous two years without having devalued its currency against the currency of any other member state.

Long-term interest rates must not exceed by more than 2% the average of the three best-performers of the price stability measure. The yield on government bonds with a maturity of 10 years is used as a measure, except in the case of Greece where a maturity period of 5 years is used. In 1997 the average nominal long-term interest rate of France, Ireland and Austria, was 5.8%. Therefore, the upper limit was set at 7.8%. In 1999, this limit decreased to 7.0%. According to the Treaty, while the inflation rate shows price stability convergence, long-term interest rates show the durability of such convergence.

Furthermore, in its assessments, the Commission also takes account of the integration of the local market with the EU markets, the situation and the development of the balances of payments on the current account, and the development of the unit labour costs and other price indices.

Who Qualified?

It is interesting to note the difference in the assessments between the 1996 and the 1997 convergence reports and how some member states were "allowed" to qualify through an abrogation. Furthermore, some countries were "creative" in how they managed to qualify.

The 1996 convergence report for the member states was not satisfactory. Spain, Greece, Italy, Portugal and the UK had inflation rates above the reference value. Only three member states (Denmark, Ireland and Luxembourg) qualified under the 3% government deficit/GDP ratio. Only three countries (France, Luxembourg and the UK) were below the 60% government debt/GDP ratio. Nine countries qualified under the exchange rate criterion, with Greece, Italy, Sweden and the UK, actually being out of the ERM2. Eleven countries qualified under the interest rate criterion.

The 1997 convergence report was promising and showed the countries' commitment to form part of the European monetary union. Commitment gave the countries political credibility because of their efforts to adjust "within a rules-based macroeconomic framework...embedded in EMU" (Jones *et al*, 1998:23). The euro was launched with eleven countries, with Denmark and the UK opting out of the EMU, Sweden not qualifying because it did not form part of the ERM2 and Greece not qualifying under any of the four criteria. However, in April 2000, Greece was accepted and will join the Eurozone in January 2001.

Some of the EU countries were "highly creative" to achieve the thresholds that apply to the convergence criteria (Seidel, 1998:1). For example, the French government assumed the future pensions obligations of the former telephone company employees, the Telecom, and in so doing accepted a lump sum of about eleven billion deutschemarks from the company. In order to raise additional revenue, Italy devised a new tax system. The German government rescheduled the repayments of unifi-

cation debts. These examples show that financial stretching and postponement of payments helped countries meet the criteria. An article by the Princeton Economic Institute (1997:1) suggested that "without 'cooking' the books, Germany would fail to meet its own Maastricht budget deficit criteria." There was also a possibility that the "tough convergence criteria...may be relaxed...as the deadline for EMU approaches" (Frank, 1992:17).

The Stability and Growth Pact

The Stability and Growth Pact is a means of exerting financial discipline on governments once the single currency was launched further to the excessive deficit criterion laid out in the Maastricht Treaty.

> "The credibility of the (ECB's) monetary policy is further supported by the budgetary provisions of the Treaty, which oblige Member States to avoid excessive budget deficits. The Stability and Growth Pact clearly defines the exceptional circumstances under which excessive deficits are allowed". (Duisenberg, 1997:2)

The Stability Pact defines when a deficit can be allowed and when it demands sanctions and fines. When the deficit exceeds 3% and the Ecofin Council rules that the case is not an exceptional one, the country in question would have to deposit with the ECB the amount of 0.2% of the GDP plus 10% of the percentage points by which the 3% limit has been exceeded. The maximum deposit is 0.5% of GDP, which is transformed into a fine if the deficit is not cut within two years. Since the Maastricht Treaty also contains a "no-bail-out clause", the country would have to adopt appropriate budget policies because there would be no help forthcoming from the other member states or the ECB. Therefore, countries will need a high degree of credibility to be able to raise resources from financial markets. Germany even proposed that governments reduce the budget deficit to 1% of GDP in times of normal economic growth so as to be able to handle a 3% deficit in recessions (Association for the Monetary Union of Europe, 1998:2).

The non-financing of fiscal deficits, the no-bail-out clause and the excessive deficits prohibition are regulatory constraints so that price stability is not undermined (Pelkmans, 1997:304-305). Applicant coun-

tries must also adhere to these restrictions even if they do not join the EMU upon accession.

The effectiveness of the Growth and Stability Pact at fostering fiscal discipline in EMU-member countries has been put to doubt. For instance, in an interview with the International Herald Tribune in November 1998, Massimo D'Alema (then Prime Minister of Italy) said that "governments should be free to 'interpret' the Stability and Growth Pact" (Cable News Network Inc., 1998).

Thus, the provisions of the Maastricht Treaty and the Growth and Stability Pact are intended to ensure an adequate degree of convergence between countries participating in the single European currency. Their interpretation and implementation may however fall somewhat short of the original intents, especially with regard to fiscal discipline. We now turn to analyse some implications of these developments for Malta's membership bid within the European Union.

The Maltese Macroeconomic Situation

Malta is a small, open economy with virtually no natural resources save for its human capital, a favourable climate, its sea and deep harbours. Its labour force stands at just under 150,000. The value of its imports are close to that of its GDP and exports typically fall short of imports by around 5%. Its economy depends on tourism and an assembly-type manufacturing. Within these sectors, there is strong concentration on a few core activities that is rendered necessary by the small scale of the economy. Socio-political motivations partly embedded in a colonial history have led the public sector to occupy a substantial role in economic activity. The public sector, comprising general government and public entities, account for almost 40% of employment in Malta. The economy's dependence on the government extends to the provision of many essential services such as housing, health and education, and to a generous welfare system whose sustainability is being questioned in view of population ageing.

Almost since its inception in the early seventies, the exchange rate of the Maltese lira has been determined by means of a peg to a basket of stable, low-inflation currencies. This has provided a nominal anchor for the

Maltese economy, linking domestic inflation to the average of the countries whose currencies compose the basket. Developments in the balance of payments and consequent movements in official external reserves thus bear the brunt of changes in economic conditions, and ultimately indicate the sustainability or otherwise of a given set of economic policies. Domestic interest rates would in these circumstances be expected to reflect interest rates on the currencies composing the Maltese lira peg adjusted by a risk premium typically applicable to a small, open economy. In practice, this link was for a number of years severed by means of exchange controls, which allowed domestic interest rates to be kept at artificially low levels by means of direct regulation. These restrictions were for a period of time complemented by controls on imports. It is suspected that these controls were only partially successful in restraining the outflow of capital from the country.

The macro-economic policy orientation has seen some important changes in recent years. The exchange rate peg remained an unchanged feature of economic policy, but controls on interest rates were virtually completely removed at the same time that the rudiments for a market-oriented monetary policy were laid down within the context of developing a financial infrastructure. At the same time, controls on imports were completely removed, while those on capital flows are being lifted gradually. These measures are in line with enhancing the efficiency of the domestic money and capital markets and bringing them closer to the requirements of EU membership.

At the same time, however, the fiscal deficit expanded substantially, creating a twin deficit on the external current account, which is financed by capital inflows or through a reduction in the country's official reserves. It is generally recognised that in a small, open economy as Malta, the exchange rate peg cannot be sustained durably in the face of these deficits. The symptoms of this unsustainability would be an excessively high level of interest rates, reflecting the risk of a Maltese lira devaluation, or outright strong outflows of capital motivated by the same reason.

The main targets of macroeconomic policy in Malta have been set out in the Budget Speech for 1998. These in part reflect the provisions of the Maastricht criteria, but add further dimensions peculiar to the economic situation of the country. The main targets indicated there include:

- *A 3% ceiling to the fiscal deficit to GDP ratio.* This target was in practice missed by a wide margin, as the deficit reached 12% of GDP by 1998. This has led government to redraw a plan to reduce the deficit to between 3% and 4% of GDP by 2004.
- *Inflation to be maintained at between 2% and 3%.* This target was achieved largely thanks to the currency peg and the general trend decline in inflation in Malta's main trading partner countries.
- *The unemployment rate to be maintained at under 4% and the share of public sector employment to drop to between 25% and 30%.* Neither of these targets has been achieved in practice, with unemployment hovering around 5% and the share of public sector employment just under 40%.
- *The supply-side economic fundamentals to be improved by enhancing the role of markets and the availability and productivity of resources.* Amongst other things, productivity growth was to become the main benchmark for wage increases. However, there still does not exist an index to measure productivity in Malta. Furthermore, Malta has some way to go to bring its competitiveness to the standards required by the European Single Market, as the *avis* on Malta's application for membership indicates.

The Maltese Economy and Nominal EMU Convergence

It is against this backdrop that Malta aspires to become a full member of the European Union. Even though the aspiring new member states are not likely to be in a position to join the EMU area upon accession,

> "they must conform to the rules governing prospective members of the EMU which means granting independence to their central banks, coordination of economic policies, adherence to the relevant parts of the Stability and Growth Pact and abandoning any direct central bank financing of public sector deficits." (European Commission, 1998:9)

It is further considered that the window-dressing and special arrangements made by larger "veteran" members of the European Union to qualify for EMU will not be applicable to a new entrant with a potentially more vulnerable and riskier economic set-up. It is thus interesting to compare Malta's economic performance with that required by the EMU convergence criteria, subject to the qualifications that the economy is

Table 1
Maastricht Convergence Criteria Applied to Malta
1980-1999

Year	Inflation Rate	Govt. Budget Deficit/ Surplus	Govt. Debt	Interest Rate	Lm/ECU (Euro) Exchange Rate
1980	15.76	0.06	24.6	6.250	2.0821
1981	11.50	2.19	27.1	6.250	2.3169
1982	5.80	-1.69	31.5	6.375	2.4740
1983	-0.87	-2.25	30.0	6.375	2.5956
1984	-0.44	-2.42	28.9	6.500	2.7526
1985	-0.24	-2.22	28.1	6.500	2.8057
1986	2.00	-3.08	25.5	6.500	2.5969
1987	0.42	-7.75	26.1	6.500	2.5107
1988	0.95	-0.87	27.5	6.500	2.5565
1989	0.86	-5.26	28.1	6.750	2.6048
1990	2.98	-6.01	31.1	7.000	2.4733
1991	2.54	-5.59	29.7	7.750	2.4979
1992	1.64	-3.41	28.5	7.750	2.4287
1993	4.14	-3.37	32.9	7.750	2.2347
1994	4.13	-4.32	33.5	7.750	2.2296
1995	3.98	-3.10	35.9	7.750	2.1669
1996	2.49	-9.00	41.9	7.500	2.1852
1997	3.27	-9.90	52.6	7.620	2.2921
Reference Value 1997	*2.7%*	*-3%*	*60%*	*7.8%*	*ERM2*
1998	2.43	-11.10	56.2	6.86	2.2640
1999	2.13	-8.60	54.0	6.14	2.4114
Reference Value 1999	*1.3%*	*-3%*	*60%*	*7.0%*	*ERM2*

Source: Adapted from various issues (1980-1988) of the *Quarterly Review* and the *Annual Report* (Central Bank of Malta) and *National Accounts of the Maltese Islands* (Central Office of Statistics)

still undergoing fundamental restructuring towards EU membership which could have an important impact on macroeconomic developments. The data in Table 1 shows Malta's position vis-à-vis all the criteria save for the exchange rate. The latter is not considered because the Maltese

lira remained relatively stable against European currencies due to the heavy weight of these currencies in the basket. Thus, the exchange rate for the Maltese lira cannot be regarded as a fair market-based test of convergence.

Table 1 indicates that at present, Malta qualifies for EMU convergence under the interest rate and government debt/GDP ratio criteria, but fails narrowly the inflation criterion, and very widely the fiscal deficit criterion. Some comment on each of these is warranted.

Interest rates in Malta have been rather stable over the years. This is because "monetary policy in Malta has been traditionally based on direct regulation...using selective credit controls, administered interest rates and exchange controls" (Demarco, 1999:35). In 1994 interest rates were liberalised and exchange controls were gradually lifted throughout the nineties. These developments have however hardly produced any movements in domestic interest rates, due to the strong cushion of official foreign reserves that absorb the impact of adverse balance of payments movements. It may thus well be that Malta has never been submitted to the "market-test" of interest rates, involving the determination of an appropriate risk-premium on Maltese lira assets that correctly reflects the perceived threat of a devaluation. It may well be that these market considerations will have a stronger impact in future as exchange controls are further liberalised and the threat of capital outflows becomes more significant. Malta may in such circumstances well fail to qualify on the interest rate criterion, especially if the substantial fiscal deficit continues to fuel the demand for imports.

The currency peg, and during the 1980s, price controls, have kept the inflation rate in Malta relatively low during the past decades. Still, the Maltese inflation rate currently narrowly fails to the meet the Maastricht convergence criterion mainly because of domestically-generated price pressures induced primarily by the expansionary fiscal stance. This consideration is of primary importance, since "among indicators of convergence, inflation had pride of place" (Dyson, 1994:345). Moreover, this situation could result in a further erosion of the country's competitiveness in the international market-place, putting further pressure on the country's external imbalance.

The final criteria to be analysed regard Government finances. In the Maastricht Protocol, government is defined as "general government, that is central government, regional or local government and social security funds" (Treaty Article 104c(14) quoted in Patterson, 1997:4). Parastatal organizations are therefore excluded. In the case of Malta if one takes this definition of government debt the figure remains under the 60% limit, albeit fast approaching that benchmark. However, if one includes debt due by parastatal enterprises the figure increases to 92% of GDP, for the year 1997. (European Commission, 1999). The main problem for Malta is however the budget deficit. "A major challenge is to put the budget on a sounder footing" (European Commission 1999, Section 2.1).

> "Upon accession, Malta will be required to respect the stability and growth pact, to renounce any direct central bank financing of the public sector deficit and privileged access of public authorities to financial institutions and to have completed liberalisation of capital movements."
> (European Commission 1999, Section 3.6)

Since 1986, the government fiscal deficit has tended to increase and in recent years has been well above the 3% limit (see Table 1) and has also caused other economic ills that compromise Malta's convergence with the EMU criteria. In view of these issues, Government has announced financial targets aimed at reducing its deficit to between 3% and 4% of GDP by 2004. The specific policies to be implemented have at this stage only been hinted at, but they would include increased taxation, more efficient revenue collection, improved efficiency in expenditure and privatisation.

On the other hand, it is not enough that the Government achieves a 3% fiscal deficit to GDP target. By virtue of the Stability Pact, it is essential that this deficit ratio be sustainably maintained, as the "excessive deficit" criterion "will continue to apply to participating and non-participating countries alike" (Patterson, 1997:3). Even though 'outs' cannot be fined for excessive deficits, the no-bail out clause and non-financing of deficits still apply. Furthermore, the 3% limit is "to be seen as an upper limit in normal circumstances" and national policies regarding government budgets should "create room for manoeuvre in adapting to exceptional and cyclical disturbances" (quoted in Patterson, 1997:7). Hence, in normal economic circumstances the budget should be "close to balance

or surplus" *(ibid.)*. The last year the Maltese government budget showed a surplus was in 1981.

The Maltese Economy and Real EMU Convergence

During a "Seminar on the Accession Process" held on the 11 and 12 November 1999 in Helsinki it became more evident that nominal and real convergence should be pursued in parallel, i.e. nominal convergence (Maastricht criteria) should be accompanied by real convergence, that is structural reform. Real convergence is analysed in terms of real GDP growth rate, the unemployment rate and GDP per capita. This assessment is typically carried out using the discomfort index as devised by Arthur Okun and by the EMU indicator devised by Gros and Thygesen (1992:468-471).

Table 2 presents data on unemployment, inflation, real GDP growth and the discomfort index for 1980-1999. The discomfort index shows the degree to which overall economic conditions are improving or deteriorating.

In the period 1980-1999, the unemployment rate has always been below the EU 1998 average of 10.8%. However, this has in significant part been driven by public sector demand for labour, which may in future not be sustainable in view of the demands for the reduction in the fiscal deficit. In fact, the last three years have seen a slight increase in unemployment, as Government did not continue to generate new employment at the historical rates. The unemployment situation may even aggravate further in the coming years as the economy restructures to become more efficient and the remaining protective measures for local industries are removed.

According to Agenda 2000 (European Commission 1998), the EU anticipates that applicant countries maintain a 4% real GDP growth. Between 1986 and 1996, growth in Malta is reported to have exceeded this figure – but significant doubt can be placed on the measurement of real GDP growth in the Maltese economy, which up to some years ago was based on 1973 deflators, and which may suffer from some conceptual deficiencies. In any case, growth was over the period significantly prodded up by an expansionary fiscal stance, whose maintenance over the coming years

is both unlikely and undesirable. In fact, economic growth slowed down perceptibly over the past four years when government started to rein in the rate of expansion of its deficit.

Table 2
Unemployment, Inflation and Real GDP Growth
1980-1999

Year Rate	Unemployment Rate	Inflation	Real GDP Growth	Discomfort Index
1980	3.3	15.76	3.2	19.06
1981	4.7	11.50	3.3	16.20
1982	8.6	5.80	2.3	14.40
1983	8.5	-0.87	0.8	7.63
1984	8.6	-0.44	0.6	8.16
1985	8.1	-0.24	1.8	7.86
1986	6.9	2.00	4.0	8.90
1987	4.4	0.42	4.2	4.82
1988	4.0	0.95	5.4	4.95
1989	3.7	0.86	5.5	4.56
1990	3.8	2.98	6.0	6.78
1991	3.6	2.54	4.4	6.14
1992	4.0	1.64	4.5	5.64
1993	4.5	4.14	5.7	8.64
1994	4.1	4.13	5.8	8.23
1995	3.7	3.98	6.2	7.68
1996	4.4	2.49	3.8	6.69
1997	5.0	3.27	3.7	8.27
1998	5.2	2.40	3.1	7.43
1999	5.3	2.13	3.1	7.43

Source: Data for unemployment, inflation and real GDP growth from *Central Bank of Malta Annual Reports* 1980 to 1999.

Table 2 also shows the discomfort index which is the summing up of the unemployment and inflation rates. The index has gone down from 19.06 in 1980 to 4.56 in 1989 and gone up again to 7.43 in 1999. Taking Okun's interpretation, this indicates that over a time-period of nineteen years

economic conditions have overall improved but in recent years there has been some deterioration.

The EMU indicator assesses the overall economic performance of a country by adding up inflation, the budget deficit, public debt, unemployment and the current account balance (Gros and Thygesen, 1992). In their analysis Gros and Thygesen gave figures for EU countries based on 1991 data. The Netherlands had the best rate at 11.6 while Greece had the worst at 51.8. For the year 1991, Malta's rate was calculated at 12.9. However, this indicator shot up to 32.13 in 1999. Although the indicator is "only suggestive....it is useful in discussing the need for convergence in individual member countries" (Gros and Tygesen, 1992:471).

Conclusion

This paper analyses the macroeconomic dimension of the Maltese economy in the context of the EU's accession criteria, by considering nominal, as postulated by the Maastricht Treaty and the Stability and Growth Pact, and to some extent real convergence issues.

It has been shown that the main difficulty encountered in Malta's macroeconomic situation at present relates to the excessive fiscal deficit and a consequent lack of competitiveness. Malta qualifies for only two of the nominal convergence criteria – and this position may not be sustainable if the country were to be further exposed to international capital flows in the face of a substantial fiscal deficit. In terms of real convergence, it has been shown that the need for the country to rectify its fiscal imbalance is gradually revealing the economy's true lack-lustre performance regarding economic growth and employment generation.

These considerations highlight the need for far-reaching changes in the way in which the Maltese economy operates in order to compete within the globalised trading environment. The country needs a push to engage in a much-needed industrial restructuring programme and to rationalize better and more efficiently its operations. At this point in our history the prospect of EU membership seems to be the lever that is pushing us towards this. This need not necessarily be the issue since in any case the restructuring programme is inevitable in view of the globalisation

process currently taking place. Some reforms will carry deep social as well as economic impacts, and will need the support of all the social partners, so that welfare losses can be partially alleviated by sensible forward planning, and to ensure an optimum spread of the relative burdens.

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