From a Deficit to a Surplus Country – The Case of Malta

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Abstract

Malta's current account position has shifted dramatically in recent years, from one of the largest relative deficits in the euro area to one of the highest surpluses. Malta's external accounts have improved since 2009 by about four times the change seen in the euro area. This article argues that cyclical demand factors did not cause this, while lower oil prices and a better real exchange rate played a minor part. Structural developments, such as improving energy intensity and falling import content, were more important drivers. The improvement in the current account reflects a recovery in the national saving rate, driven by better fiscal performance, and rising corporate and household savings due to higher activity among export-oriented services firms. Conversely investment has declined, as these firms rely more on human capital.

Keywords: current account; savings; investment; Malta

Introduction:

The current account of the balance of payments is a key measure of economic activity and development (see Ghosh and Ramakrishnan, 2006), particularly important for small open economies, as these depend heavily on other countries as both a source of capital and consumer goods and also to provide markets for their own production. Malta, the smallest Member State of the euro area, is a case in point, with exports and imports both exceeding 100% of GDP, and with very significant dependence on foreign direct investment. Malta's current account position improved by nearly 12 percentage points after 2009, the largest change amongst euro area countries and about four times the movement seen on average.

Understanding the reasons underpinning this significant turnaround is particularly interesting, as it contrasts somewhat with the experience of neighbouring countries which are also part of the European Monetary Union. Thus, after reviewing trends in Malta's current account position and its

component parts, this article presents estimates of the cyclically adjusted current account position, to understand whether this improvement was driven by cyclical factors. The paper proceeds to evaluate the possible impact of lower oil prices and an improved real exchange rate. This is followed by an analysis of structural factors, such as the improvement in energy intensity and the broader change in Malta's import intensities, mainly due to the changing composition of its economy.

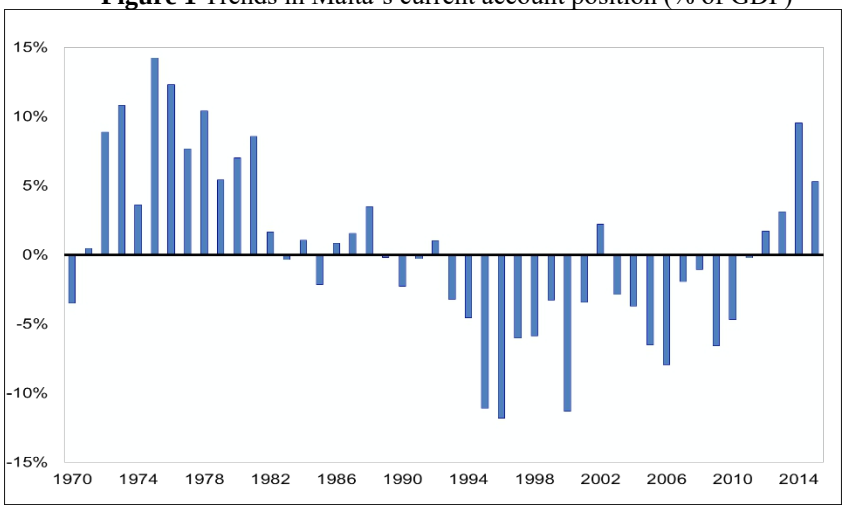
Trends in Malta's current account position

Edwards (2002) gives a very good overview of the changing views of economists on the current account since the late 1940s, with the literature initially stressing the monitoring of trade flows and the computation and comparison of import and export elasticities. This was followed by a focus on intertemporal saving and investment in the 1970s and 1980s, to the subsequent emphasis on current account sustainability and the current interpretation of current accounts as signs of economic imbalances.

Past research on Malta's current account has focused on assessments of sustainability (Demarco, 1999) and on the role of the private and public savings gaps in driving its development (Grech, 2000). More recently, the analysis has focused on the shift towards consistent current account surpluses, which is being attributed to the emergence of high value-added export-oriented services sectors (Grech, Micallef and Zerafa, 2016).

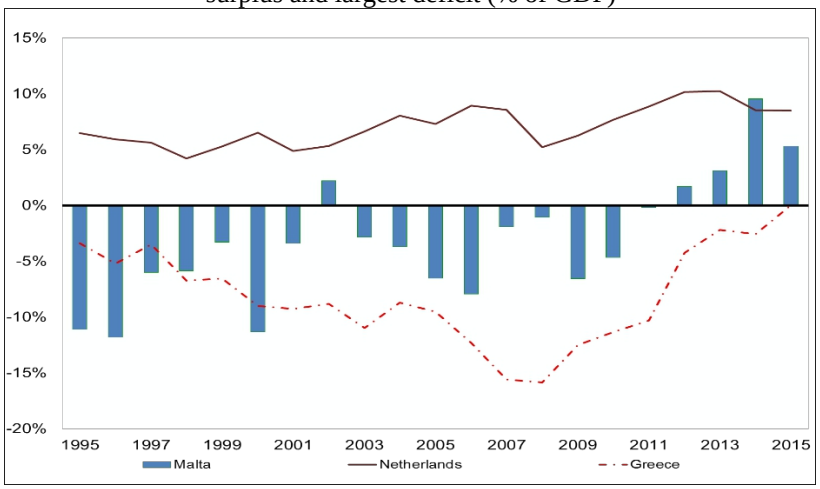
Figure 1 shows Malta's current account position as a share of GDP since 1970. Up to the early 1980s, the country had very high current account surpluses. This is diametrically opposite to the traditional view that developing countries run very high current account deficits as they invest heavily, while they still have low savings on account of their low income. In part, this reflected strong fiscal conservatism in Malta combined with financial repression and rigid controls on capital movement and imports (Findlay and Wellisz, 1993). Export growth also accelerated due to the rapid expansion of industry and tourism (Grech, 2015). The situation changed significantly in the 1980s when adverse international conditions resulted in a decline in exports of goods and tourist activity.

Figure 1 Trends in Malta's current account position (% of GDP)



Source: Author's calculations using https://www.centralbankmalta.org/historical-annual-database

Figure 2 Malta's current account position vis-à-vis that of EU countries with largest surplus and largest deficit (% of GDP)



Source: Author's calculations using https://www.centralbankmalta.org/historical-annual-database and AMECO database

As can be seen from Figure 2, which focuses on developments over the last two decades, the profile of Malta's current account position has shifted from having a very high deficit to moving closer to EU countries with the highest current account surpluses. Malta has seen its current account position improve by 11.9 percentage points since 2009, the largest improvement amongst euro area countries and about four times the change seen on average. On average, Malta has had a current account deficit of 3.2% of GDP since 1995, whilst the Netherlands, the EU country with the most consistently high

surplus, averaged a 7.1% surplus. Greece was the EU country with the worst performance over this period, and had a deficit that averaged 8.0% of GDP. However, even Greece has experienced a significant improvement in its current account position after the financial crisis, reflecting to a large extent the impact of a slowdown in activity on imports and lower wage growth on export competitiveness.

Distinguishing between cyclical and structural causes of changes in Malta's current account position

The calculation of cyclically adjusted current account positions helps understand better the causes of changes in external positions, as it enables one to study the impact of import compression during recessions and the influence of foreign demand (see European Central Bank, 2014; Bardakas, 2016). The European Commission has adopted the methodology of Salto and Turrini (2010), which involves adjusting levels of imports and exports to reflect respectively the potential domestic output level and that of a country's trading partners. While very intuitive, the Commission's approach suffers from a major defect, namely the assumption that income elasticities of exports and imports are both equal to 1.5 for all EU countries. Fabiani, Federico and Felettigh (2016) instead advocate calculating these elasticities empirically, similarly to the approach taken in Christodoulopoulou and Tkacevs (2014).

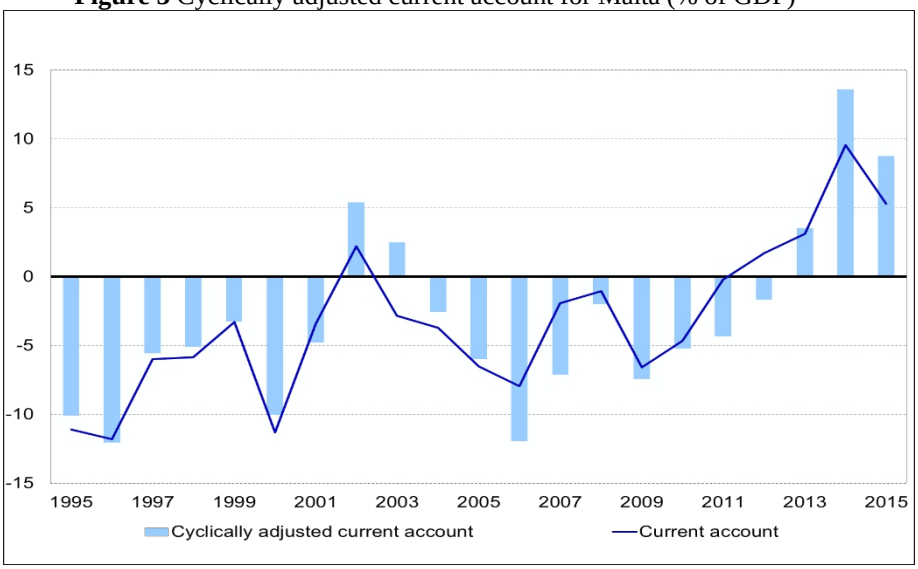
In this light, we estimate Malta's cyclically adjusted current account position using empirically derived elasticities. Using the measure for world demand for Malta's exports found in Grech and Rapa (2016), we find the long-term income elasticity for exports as 1.8, significantly higher than the measure adopted by the European Commission. To derive the import elasticity, Malta's imports were regressed against the measure of potential output for Malta derived from a production function as described in Grech and Micallef (2016). This yields a long-term income elasticity of imports for Malta, lower than that of exports, at 1.4.

Besides the issue of having different income elasticities for imports and exports, the other key determinant of the cyclically adjusted current account position is the difference in the relative cyclical position. Malta's economic cycle broadly tracks that of its main trading partners, even though it is somewhat more volatile. In recent years there appears to have been a break in this relationship, with Malta experiencing a smaller drop in activity in 2009 and its output gap turning into a significant surplus in recent years, whereas it remains negative in many other countries. The fact that Malta's economy is performing better than that of its trading partners implies that its cyclically adjusted current account position should exceed the unadjusted position. On the one hand, Malta's exports would be higher if its trading partners were not operating below capacity. On the other, its imports would be lower if GDP

were closer to potential. The impact of the first factor is higher than the impact of the second, because exports are a larger share of GDP, while the income elasticity of exports is higher than that of imports.

These considerations are borne out by the data depicted in Figure 3, which plots the cyclically adjusted and the unadjusted current account position for the Maltese economy over the period 1995 to 2015. The two measures track closely each other. While European Commission (2015) estimates that between 2007 and 2015, under unchanged cyclical differences, Malta's current account position would have improved by an additional 6.9 percentage points compared to its observed change, our estimates suggest the improvement stood at 8.7 percentage points. This suggests that cyclical demand factors are not the main drivers of the improvement in Malta's current account position.

Figure 3 Cyclically adjusted current account for Malta (% of GDP)



Source: Author's calculations using Eurostat database

That said, other temporary factors, such as changes in real exchange rates and oil prices could be nearly as big a cause of external rebalancing (see Brissimis et al, 2016). To study this, Haltmaier (2014) regresses changes in current account balances on current and lagged values of changes in the output gap differential (defined as trading partner output gap minus home country output gap), on changes in the log of the real exchange rate, on changes in the log of oil prices and on the lag of the current account balance for 35 countries from 1980 onwards. These estimates are compared with those derived applying the same regression to Maltese data (see Table 1).

Table 1 The impact of cyclical differences, exchange rates and oil prices (1980 to 2013)

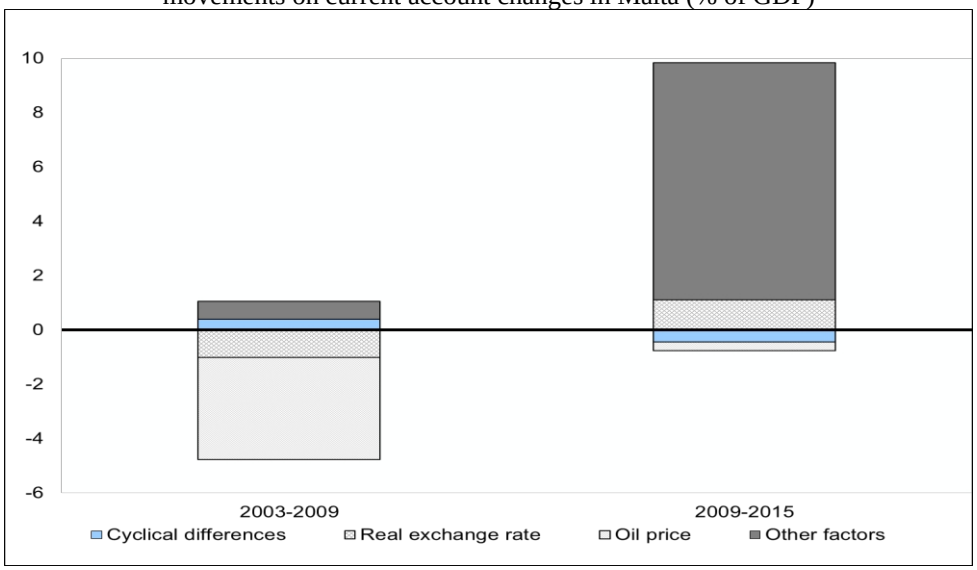
	Estimated coefficient		***Long-run effect***	
	35 countries (Haltmaeir, 2014)	*Malta*	*35 countries (Haltmaeir, 2014)*	*Malta*
Change in cyclical differential	0.44	0.44	0.28	0.31
Real exchange rate	-0.06	-0.15	-0.04	-0.11
Oil price	-0.02	-0.06	-0.01	-0.04
Lagged current account	-0.57	-0.41		

Notes: This table shows the equation results of a regression of changes in current account balances on changes in the relative cyclical position of trading partners and a home country, changes in the real exchange rate and in the oil price and the lagged current account position of the home country. The long-run effect shows the cumulative effect of changes in the explanatory variables. Thus for instance, whereas a one-percentage point increase in the output gap differential improves the current account balance by 0.28 percentage points on average across the 35 countries studied by Haltmaeir (2014), it leads to a 0.31 percentage points improvement in Malta. The impact of the real exchange rate and of oil prices is, on the other hand, much stronger in Malta than in the countries studied by Haltmaeir (2014).

Source: Author's calculations, Haltmaeir (2014)

This suggests that the impact of oil prices on the current account position is more pronounced in Malta, reflecting our economy's stronger reliance on imported oil. A 1% rise in the oil price, in fact, induces in the long run a 0.04% deterioration in Malta's current account, as against a 0.01% change in the countries studied in Haltmaier (2014). The real exchange rate also plays a more pronounced role in Malta. In the long run a 1% appreciation in the real exchange rate brings about a 0.11% worsening in the current account position for Malta, as against a 0.04% deterioration, on average, across the 35 countries surveyed in Haltmaier (2014). This greater influence of the real exchange rate is in line with the results for Malta shown in Christodoulopoulou and Tkacevs (2014). Cyclical differences are the strongest determinant of the current account position for Malta, similarly to the results for other economies, though again the long run elasticity is stronger.

Figure 4 Estimated impact of cyclical differences, real exchange rate and oil price movements on current account changes in Malta (% of GDP)



Source: Author's calculations

The long-run elasticities derived from this regression can be used to assess the contribution of changes in oil prices, real exchange rates and cyclical differences towards Malta's current account position during different periods. Any change that cannot be attributed to these three factors is considered as due to structural changes. This decomposition is shown in Figure 4 for two periods: the years between Malta's EU accession and the onset of the financial crisis and the years following the financial crisis. In the first period, Malta's current account position had deteriorated by 3.7 percentage points of GDP. This mostly reflected rising oil prices, though the appreciation in the real exchange rate also contributed to widen the deficit. On the other hand, cyclical differences reduced the current account deficit slightly during this period. Other (structural) factors also contributed positively to the current account, but were the third most important factor during this period. By contrast, these factors appear to account for nearly the entire improvement in the current account position in the post-financial crisis years. Changes in the oil price and in cyclical differences, in fact, offset most of the impact induced by the improvement in the real exchange rate.

Understanding the structural causes of changes in Malta's current account position

Grech (2000) indicated that Malta's external accounts did not exhibit stationary behaviour up to 1997, and the current account position was deteriorating by 0.6 percentage points of GDP every year. This finding,

together with econometric tests that showed that this was being driven by worsening public finances, was worrying as stationarity is a necessary (although not a sufficient) condition for avoiding sustainability problems in external accounts (see Trehan and Walsh, 1991; Quintos, 1995). By contrast, running the same econometric tests on data spanning to 2016 indicates that the current account position is stationary. In fact, in recent years most external account sustainability indicators have registered a strong positive upturn. For instance, the net international investment position has grown from 28% of GDP in 2006 to nearly 49% in 2015, the third highest ratio in the EU, while the government's external loans declined from 3% of GDP to 2%, the lowest in the EU. The analysis presented in the previous section indicates that the change in Malta's current account position was mostly of a structural nature. Understanding these structural factors is therefore important, as they are highly likely to persist in the coming years.

One of the structural factors driving the change in the current account appears to be the improvement in the energy intensity of the Maltese economy. Whereas in 2005 it took 162.8kg of oil equivalent to generate €1,000 of GDP, by 2014 this had fallen to 118.7, or more than a quarter less (Eurostat, 2016). This turnaround reflects a number of developments, notably the reduced importance of exports of goods (which fell by nearly 17% in their relative significance over the same period) and the improvement in the efficiency in the generation of electricity. Given that Malta imports all of its fuel, these developments undoubtedly generated an underlying improvement in Malta's structural current account position.

Another factor responsible for driving the recent improvements registered in Malta's current account is the general reduction of Malta's import intensities. Grech and Rapa (2016) calculate that Malta's overall dependence on imports fell by around 8 percentage points between 1995 and 2011, with reductions registered in the import intensities of all GDP expenditure items. Most of the fall in import intensities occurred between 2010 and 2011, a period characterised by a marked increase in the share of services in Maltese output, suggesting that the changing structure of the Maltese economy is underpinning the improvement in the country's external accounts.

Table 2 Change in the ratio to GDP of selected national accounts components by sector (2006 to 2015)

	Gross fixed capital formation	*Gross value added*	*Gross operating surplus*
Agriculture & fisheries	-0.18	-0.82	-0.48
Industry	2.51	-4.46	-0.21
Construction & real estate	-3.41	-2.50	-1.32
Wholesale & retail	0.04	-1.17	-0.14
Transportation & storage	3.42	-0.25	0.18
Accommodation & food services	0.32	0.12	0.84

Information & communication	0.48	0.84	0.36
Financial & insurance services	-0.11	-1.26	-1.92
Professional & administrative	-0.40	3.34	1.19
Public sector	-0.60	-0.06	-0.19
Arts, entertainment & other	0.06	7.19	6.00

Source: Author's calculations

Table 2 indicates that over recent years there have been interesting trends in the ratios to GDP of gross fixed capital formation, gross value added and gross operating surplus of the various sectors. Industry and transportation & storage are the only two sectors to have seen a significant increase in their investment ratio, and in both cases their gross value added is lower in relative terms than it was a decade ago. This could imply that the sectors are restructuring towards more capital-intensive modes of production. On the other hand, the decline in construction & real estate gross fixed capital formation exceeds the relative drop in their gross value added and operating surplus. Accommodation & food services and, to a certain extent, information & communications have increased investment in line with developments in their activity; while agriculture and financial services have lowered investment less than the relative drop in their value added and operating surplus. The main trend evident in Table 2 is that the services sectors which are increasing their share of economic activity, such as remote gaming, professional services and administrative support, are doing so without significant changes in gross fixed capital formation.

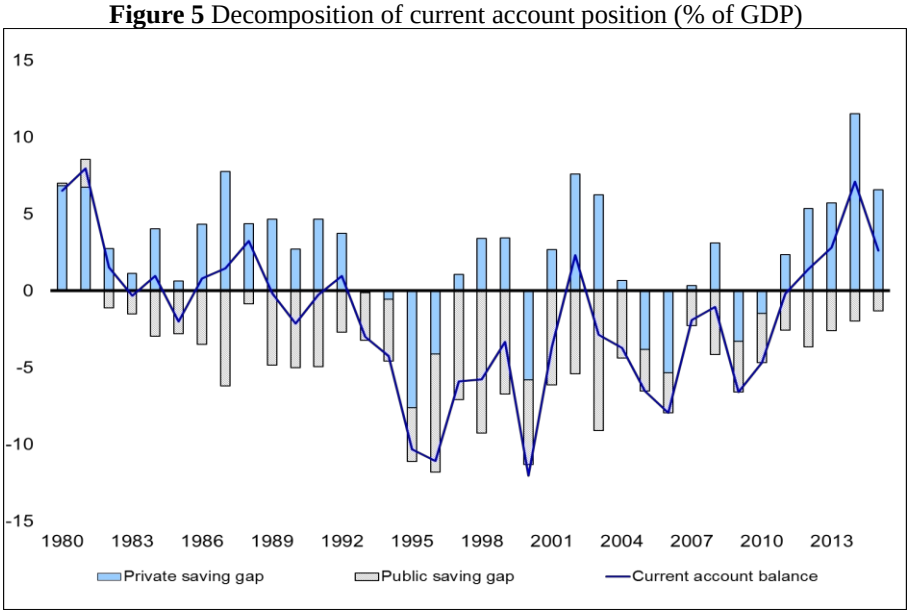
There is a negative relation between sectors that have a higher propensity to invest and the growth in their share in overall gross value added. Sectors which have traditionally contributed significantly to total investment, such as industry (which on average contributes to around 40% of total investment), and wholesale and retail (whose investment on average makes up around 10% of total investment), have experienced a significant decline in their relative economic share. On the other hand, industries which tend to play a smaller role in investment dynamics (mainly in the services sector) have expanded rapidly in the last years. Therefore Malta's shift from capital intensive industries to the more labour intensive sectors is likely to have led to a compositional effect that has weighed negatively on total investment growth.

Centeno (1995) shows that the current account position of a country, conceived as the difference between saving and investment can be broken down into a private saving gap (private saving less private investment) and a public saving gap (public saving less public investment). This redefinition allows one to study whether there is a correlation between the saving and investment decisions made by the private sector and fiscal policy. For instance, the Ricardian equivalence hypothesis posits that the private sector neutralises any increase in the fiscal deficit through higher saving, as agents

expect future rises in taxes. Similarly the crowding-out theory implies that a fiscal deficit, especially when an economy is operating at full capacity, could reduce private investment and lead to higher saving.

Figure 5 decomposes the current account into a private saving gap and a public saving gap. At first glance, this seems to invalidate the hypothesis that they are inversely related. Regressing the current account on the fiscal balance and the real exchange rate (as in De Castro and Fernandez, 2009) indicates a strong positive relationship between the external and the fiscal position. This suggests that it is more likely that the Maltese economy exhibits patterns more consistent with the Keynesian twin deficit framework.

Figure 5 Decomposition of current account position (% of GDP)



Source: Author's calculations using https://www.centralbankmalta.org/historical-annual-database

While private saving and private investment in Malta are positively correlated, in recent years the relationship seems to be weakening. On the other hand, the relationship between government saving and government investment appears to have strengthened substantially, particularly since EU membership. This suggests that while public investment is increasingly being financed internally by Government (primarily through the use of EU funds), private investment is going in the opposite direction, with the rise in private saving not inducing a commensurate increase in private capital formation.

Grech and Rapa (2016) shows that in the decade prior to EU accession, Malta's national saving rate practically halved. The main cause was a significant deterioration in public savings, as government started running substantial primary deficits. However there was also a notable decline in private saving, reflecting in part the restructuring of the Maltese economy that

preceded EU membership. Grech (2014) shows that from growth rates of over 5%, household disposable income fell to slightly negative in the same period. Gatt (2014) suggests that bank lending was another important cause for developments during this period, as bank lending was growing at nearly 20%. Reductions in credit constraints may have led households to save less.

By contrast, the national saving rate has been on a consistent upward path since 2006. On the one hand, public saving has improved by some 5 percentage points in recent years. On the other, the emergence of new services sectors, combined with the impact of greater competition and restructuring, has led to a much higher growth in profits. This led to a significant improvement in corporate saving. Furthermore, the strong economic growth registered in recent years, combined with higher dependence on labour in the new economic sectors, has contributed to raise disposable income. While consumption has increased, the household saving rate is estimated to have returned to levels last seen in the late 1990s. On the other hand, private investment has not risen by as much, on account of the sharp decline in capital intensity of production.

Conclusion

The shift of Malta from a deficit to a surplus country appears to be firmly linked to structural changes induced by EU membership. The latter resulted in the emergence of new export-oriented services sectors that boosted national saving considerably, while reducing the import content, particularly of gross fixed capital formation, of the Maltese economy. Combined with the successful fiscal consolidation, this structural change has made Malta's external account position sustainable, marking a significant turnaround from the conditions that characterised the late 1990s and early 2000s. That said, there still remain significant issues that need close attention.

While in the past, Malta's production was reliant on imports of capital goods, in recent years it has become dependent on imports of labour, with the share of the foreign workforce rising from a fiftieth to a fifth of total employment since EU membership. The new services sectors are more labour-intensive, and while some sectors, such as manufacturing, are becoming more productive and thus are freeing up skilled labour for use in other sectors, the unfulfilled demand for labour remains high. In the context of a rapid ageing transition, this is unlikely to change unless there is considerable investment to upskill the labour force and boost its productivity. At the same time, the success of Malta's new economy depends on the country having the right infrastructure, particularly in the areas of digital networks and communications, links with the main trading partners and, increasingly, internal transit. Whereas traditionally investment in human capital and infrastructure were the remit of the public sector, in future years the role of the

private sector will need to take a more central role, as government needs to maintain its finances in order. This implies that sustaining the recent shift in Malta's current account position requires further structural changes in the Maltese economy.

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