THE MALTESE ECONOMY
A Brief Overview

This booklet is essentially a summarized version of *The Maltese Economy - A Marcoeconomic Analysis* by the same author, with updated data. It was prepared for the course "The Structure and Performance of a Small Open Economy - Model Malta", organized by the Malta Federation of Industry in May 1989.

As its name implies, the publication briefly outlines the Maltese economy, and covers the most important macroeconomic variables including Output, Employment, Money Supply, and the Balance of Payments. It contains eight chapters, which are more or less self contained, and can be read in any order.

THE AUTHOR

Lino Briguglio is senior lecturer in the Faculty of Economics, Management and Accountancy at the University of Malta. He is a doctor of Philosophy in Economics (Exeter University) and the author of several publications on the Maltese economy. He has also published a number of articles on Labour Economics and International Trade in academic journals in Malta and abroad.

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A BRIEF OVERVIEW

LINO BRIGUGLIO

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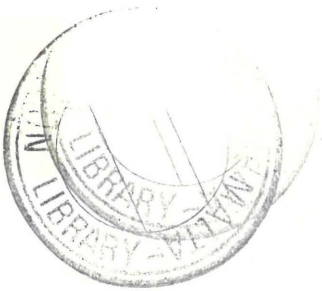

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1

AGGREGATE OUTPUT, INCOME AND EXPENDITURE

The aggregate domestic product of a country can be measured by summing the ***value added*** of all domestic private firms and of the government in a given period of time. This method ensures that all goods and services produced are only measured once, thereby avoiding double counting.

The following table gives the gross domestic product (GDP) for Malta in 1987 and the contribution made by the value added of different economic sectors.

The Maltese GDP at Factor Cost (1987)

Sectors	Lm Million	%
Agriculture and fishing	21.4	4.3
Construction and quarrying	21.1	4.3
Manufacturing	136.4	27.5
Retail and wholesale trades	70.8	14.3
Transport and communications	30.2	6.1
Banking and insurance	23.9	4.8
Private services	41.7	8.4
Government enterprise	42.1	8.5
Public administration	68.9	13.9
Property income (domestic)	38.9	7.9
GDP at Factor Cost	**495.5**	**100.0**

Source: National Accounts of the Maltese Islands, Table 11.

The table measures value added of the sectors ***gross***, that is before deducting depreciation, and ***at factor cost***, that is, covering only the rewards that go to the factors (labour, capital, land and entrepreneurship) participating in the production of the goods and services of which GDP is composed.

As stated, the table just presented utilises data on value added. The same aggregate result would be obtained by the ***factor income*** method which involves summing all the incomes arising from the domestic production of goods and services. These incomes include wages, self-employment income, profit, dividends, interest and rent.

Measuring at factor cost. This means measuring the value of output in terms of factor incomes only i.e. disregarding expenditure taxes. If expenditure taxes are included in the value, than the measurement would be *at market prices.*

	At Market Prices	minus	Net Expenditure Taxes	equals	At Factor Cost
GDP	549.2	-	53.7	=	495.5
GNP	579.8	-	53.7	=	526.1

Non-market activity. Many economic activities are carried out within the household. These include housekeeping, child rearing, cooking, gardening, furniture making, car repairing etc. These do not form part of GDP or GNP since they are not bought or sold on the market.

Non-productive transactions. These include grants, purely financial transactions (such as financial gains in the value of property or shares) and second hand sales. Such transactions are excluded from GDP and GNP.

The underground economy. Economic activity is sometimes concealed, probably for tax evasion motives, and the GDP data presented above may underestimate the actual domestic production of goods and services. Those economic activities which should be included, but are not actually included because they are concealed, constitute what is known as the underground economy.

Further Subdivisions

The data presented above pertains to the economy as a whole, divided in terms of sectors. Economic sectors are groups of industries having broadly similar characteristics. Two important sectors in the Maltese economy are the manufacturing sector and the market services sector, which can be further subdivided into industries. Industries are groups of firms producing broadly similar products.

The **manufacturing sector** is composed of a number of industries. The most important export oriented industries are the clothing industry , the machinery industry and the transport equipment (including ship building and ship repair) industry. The most important domestically oriented manufacturing industries are the food/beverages and furniture ones.

The **market services sector** has four main sub-divisions, namely retail and wholesale trades, transport and communications, banking/ finance and personal services. Some of these services are domestically oriented, while others, such as the tourist industry, are export oriented. The tourist industry is not a very large one considered by itself, but it has a very important impact on the Maltese economy, because it generates considerable income and employment in other industries.

2

THE LABOUR MARKET

The demand for labour for the economy as a whole may be measured by the number of persons employed, including hired employees and self-employed persons. Labour supply, on the other hand, may be measured by the labour force, which includes those who are actually employed and those registering as unemployed. The number of registered unemployed persons may be regarded as an index of involuntary unemployment, which in turn, can be regarded as an index of excess labour supply.

Maltese Labour Market Data

Year	Males			Females			Total		
	Emp-loyed	Unem-ployed	Labour Force	Emp-loyed	Unem-ployed	Labour Force	Emp-loyed	Unem-ployed	Labour Force
1960	73520	2464	75984	15170	1308	16478	88690	3772	92462
1970	79370	4007	83377	21790	955	22745	101160	4962	106122
1980	87744	3455	91199	31088	584	31672	118832	4039	122871
1987	91133	4631	95764	30788	999	31787	121921	5630	127551

Note: More recent and more detailed labour data is given at the end of this booklet.
Source: Annual Abstract of Statistics

Employment

The most important factors affecting employment are output of firms, wage rates, technological advance and weekly hours of work.

Output. In studies on aggregate labour demand, output is often measured by the gross domestic product in real terms. In Malta, a large proportion of GDP is exported, and therefore export competitiveness and economic conditions in Malta's "client" countries affect domestic output and employment to a large extent. However the domestic market is also of great importance, since many firms depend on domestic demand for goods, such as furniture and beverages, and on domestic demand for services, such as retailing, transport and personal services.

Wage Rates. Wages are at the same time costs to the firm employing labour, and income to the persons employed. An increase in wage rates therefore may give rise to an increase in production costs, and this may have adverse effects on employment. On the other hand, wage rate increases may stimulate consumption, and this may have a positive effect

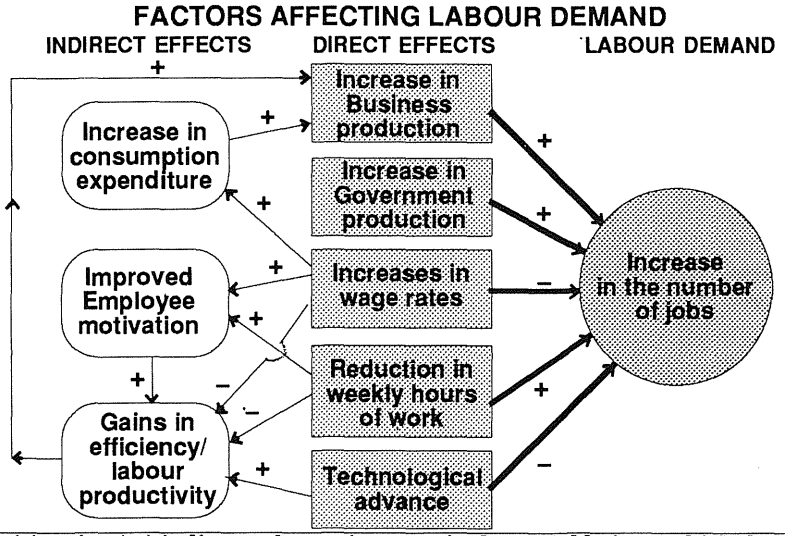
on aggregate demand and on employment. Wage rate increases therefore may have a simultaneous negative and positive effect on employment.

Technological advance. Technology has more than one effect on employment. On the one hand, it can be argued that modern methods of production are labour replacing, everything else remaining constant. However, by employing modern technology, firms may be able to improve their competitiveness and increase business production. This in turn would generate employment.

Hours of work. If the statutory average weekly hours of work decrease from say 40 to 35, firms are likely to need more workers to produce a given output, everything else remaining constant. This would stimulate labour demand. However, here again, there is an adverse side-effect on employment, since a reduction in weekly hours without a wage reduction may increase per unit costs, thereby reducing the competitiveness, and therefore adversely affecting business production of firms.

Workers' motivation. An important factor to consider when analysing labour demand is the effect on the workers' motivation following a change in the conditions of work, including increases in wage rates and a reduction in the weekly hours of work.

The effects on labour demand just discussed are be summarised in the following diagram. It can be seen that the direct effects give rise to a number of indirect effects. The end result depends on the relative strengths of positive and negative impacts on job creation.



A positive sign (+) indicates that an increase in the variable from which the arrow leaves causes an increase in the variable in which the arrow enters, keeping other things constant. A negative sign (-) indicates that an increase in the variable from which the arrow leaves gives rise to a decrease in the variable it affects.

The preceding diagram states that labour demand depends on government production which is shown separate from business production. The reason for this is that employment in this sector may increase or decrease due to factors other than economic ones. It should be noted that in Malta, over 40% of the gainfully employed are directly or indirectly employed with the government (see data at the end of the last chapter).

The Labour Force

The most important factors influencing the size of the labour force are the size of the working age population, short run employment opportunities and attitudinal changes affecting female employment.

Population. When the working age population increases, the size of the labour force is expected to increase by approximately the same proportion, everything else remaining constant.

Short run factors. Lack of employment opportunities in the shor t run may give rise to a reduction in the size of the labour force as a result of what is known as the **discouraged worker effect.**

Attitudinal changes . Changes in attitudes (mostly affecting female employment) have changed. Social attitudes in this respect are influenced by such factors as the availability of labour saving devices in housework, the existence of child nurseries, movements in favour of sexual equality, suitable employment opportunities for females and improved education. Because of these factors, the **female participation rate** has increased substantially during the past thirty years and is expected to increase further.

Participation rates measure the labour force as a percentage of the population as shown in the following table.

Participation Rates in Malta for 1986

	Males	Females	Total
Labour Force (Thousand)	95.7	31.8	127.6
Total Population (Thousand)	170.4	175.3	345.6
Participation Rate (total)	**56.2%**	**18.1%**	**36.9%**
Population (age 15-60)	105.9	107.1	213.0
Participation Rate(age 15-60)	**90.4%**	**29.7%**	**59.9%**

Source: Annual Abstract of Statistics (Sections II and VI)

The male participation rate in Malta, with respect to the 15-60 age group, is approximately 90%, and this percentage has changed only marginally during the past thirty years. This is possibly due to the fact that males are institutionally expected to participate in the labour force. On the other hand, the female participation rate, as already noted, has tended to increase over the years.

The Interaction of Labour Supply and Demand

In the coming years, the Maltese economy must grow to generate new jobs to meet developments in labour demand and labour supply. With regards to labour demand, technological advance is likely to increase labour productivity, in which case a given level of GDP would in future be produced by fewer gainfully employed persons than is the case at present. Hence to maintain the present level of employment in the coming years, the economy must expand. As to the labour supply side, the economy must grow to absorb future increases in the labour force due to population increases and due to an increase in the participation rate of females.

Unemployment

Involuntary unemployment occurs when, in an economy, labour supply exceeds labour demand. In this sense, policies to stimulate product demand may be suitable to reduce unemployment. However, unemployment may occur also as a result of **market frictions**, including skill mismatches, lack of information or lack of mobility. In this case, unemployment would not be due to deficient demand, and therefore an increase in aggregate demand may not be appropriate.

In the case of Malta, for example, the high rates of unemployment during the first half of the eighties could have been partly caused by deficient demand for Maltese products. However, at the same time, there were instances where employers needed workers and could not find suitably skilled ones. Hence unemployment and unfilled job vacancies existed at the same time. This indicates that some unemployment was **frictional**, resulting from skill mismatches.

Unemployment and Wage Rate Changes

It has been observed that wage rates tend to increase even when unemployment exists. This would seem to contradict the theoretical prediction that excess supply would bring about a decrease in prices (the wage rate may be considered at the price of labour services).

Theoretically, unemployment, if it really reflects excess labour supply, should give rise to a reduction in wage rates, which would stimulate labour demand, correcting the imbalance. In practice, this may not happen due to the fact that wage rates tend to be inflexible in the downward direction. In Malta, for example, trade unions tend to resist wage cuts, even during periods of high unemployment rates. The minimum wage legislation also works against wage flexibility.

Moreover, due to the market frictions just described, shortage of (i.e. excess demand for) certain types of employees may exist simultaneously with unemployment. For example, a large number of unskilled workers

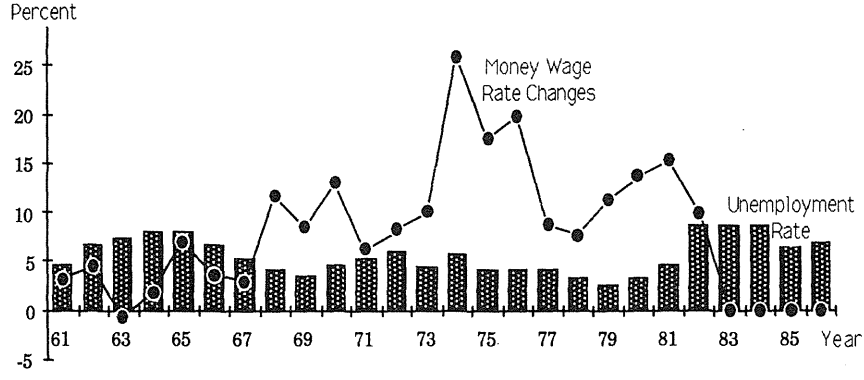
may be unable to find a job, while a large number of job opportunities remain unfilled due to skill shortages. Such shortages would give rise to increases in wage rates as employers bid up their offers to attract suitable employees. This is one reason why unemployment and wage rate increases may co-exist.

The Phillips Curve

The *Phillips curve* prediction is that money wage rates would increase faster as the rate of unemployment decreases. It may be depicted as a backward bending curve, with wage inflation on the horizontal axis and unemployment rates on the vertical axis, as shown in the diagram next page. The curve suggests that attempts to reduce unemployment would push up money wage rates. One implication of this is that governments may be in a position to choose suitable trade-offs between unemployment and inflation figures. Does this theory apply to Malta?

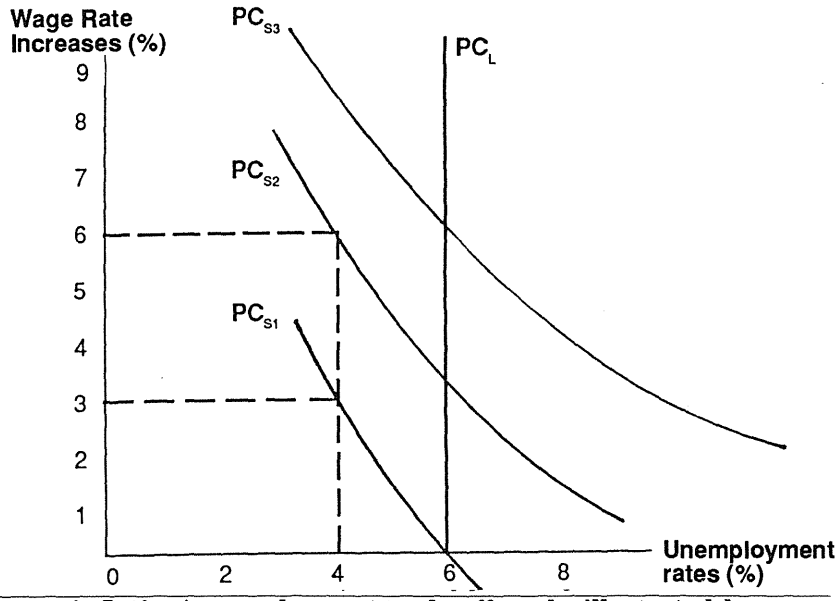
Wage rates in Malta tended to increase at relatively fast rates when the rate of unemployment was relatively low. This happened during the second half of the sixties and the second half of the seventies. On the other hand, wage rates tended to increase at slow rates when the rates of unemployment were relatively high. This happened during the first half of the sixties and the first half of the eighties. However during the first half of the seventies, unemployment and wage rates changes were both relatively high, as shown in the following diagram.

ANNUAL WAGE RATE CHANGES AND UNEMPLOYMENT



Econometric tests, carried out by the present author, with respect to the Maltese economy , would seem to indicate that wage rates tend to increase as unemployment rates decrease. However this relationship is not stable, and may not be suitable for the policy maker to choose acceptable trade-offs between the two variables.

IS THERE AN INFLATION-UNEMPLOYMENT TRADE-OFF?



The wage-inflation/ unemployment trade-off can be illustrated by means of the movement along one of the curves, say along the PC_{S1} curve. When the rate of unemployment is , for example, 6%, wage rate changes are zero, and when the rate of unemployment is 4%, wage rate increases are 3%.

The Phillips curve relation has ushered in considerable controversy in economic literature. **Monetarists** challenge the implications that there is a trade-off between wage rate increases and unemployment, stating that this can only happen in the short run. According to the monetarists' argument, this position cannot persist since wage rate increases would push up final prices and this would bring about demands for further wage increases as compensation for the rising cost of living. In turn, this would create expectations of future inflation. As a result, a given rate of unemployment, say 4%, which previously co-existed with a 3% inflation (as shown in PC_{S1}) becomes compatible with, say, a 6% rate of wage rate increases (as shown in the PC_{S2}). These shifts in the Phillips Curve would usher in expectations of higher inflation rates, and further shifts in the Phillips Curve, as shown in the diagram, and the wage-price spiral gathers momentum. According to monetarist theory, the points in the shifting short-run Phillips Curves, trace the **long run Phillips Curve,** also called **the natural rate of unemployment** shown as PC_L, which does not have a negative slope. In other words the monetarist point of view is that there is no long run trade-off between inflation and unemployment.

3

DOMESTIC EXPENDITURE

There are three broad categories of *domestic expenditures*, namely private consumption, government current expenditure and investment. If export expenditure is added to domestic expenditures, the *total final expenditure* would be obtained.

Consumption Expenditure

Private consumption expenditure accounted for about a third of the total final expenditure in Malta during the past few years. Since consumption expenditure has a domestic value added content, changes in consumer expenditures give rise to demand in domestic production and employment.

Consumption covers a variety of expenditures, including those on non-durable goods (such as food, beverages and tobacco, clothing, footwear and fuel), on durable goods (such as household and transport equipment) and on services (such as recreation, education and medical care).

Economists are interested in consumption expenditure because the relationship between changes in consumption and changes in disposable personal income yields information about what is known as ***marginal propensity to consume*** (MPC), which is the amount of consumption induced by an additional amount of personal disposable income and, in turn, this has implications regarding the multiplier process, as will be explained at a later stage.

The relationship between Maltese consumption expenditure and disposable personal income for selected years is shown in the following table:

Consumption and Disposable Income 1973 - 1987 (Lm Millions)

Year	Consumption Expenditure	Personal Income	Personal Tax	Disposable Income	Average Propensity to consume
1973	90.6	110.4	11.5	98.9	91.1%
1976	135.7	194.9	18.8	176.1	77.1%
1979	206.0	285.2	41.1	244.1	84.4%
1982	305.7	425.5	63.7	362.1	84.5%
1985	333.2	435.7	62.2	373.5	89.2%
1987	358.3	477.6	55.5	422.1	84.9 %

Sources: National Accounts of the Maltese Islands

Investment Expenditure

Investment may be defined as expenditures on fixed capital assets (plant, equipment and buildings) and changes in inventories (unsold finished goods, work in progress, etc.). Thus the term investment, as used here, does not describe the deposit of money in banks, the purchase of company shares and similar transactions which earn interest or dividend.

The following table classifies total fixed investment for 1987, according to whether it was purchased by the private sector or by the public sector.

Investment By Asset and Purchases – 1987 (Lm Millions)

	Private	Government	Total
Dwellings and Other Construction	25.6	23.5	49.1
Transport Equipment	41.4	0.1	41.5
Machinery and Other Equipment	53.4	9.5	62.9
Gross Fixed Investment	**120.4**	**33.1**	**153.5**
Changes in Stocks	-1.8	-0.6	-2.4
Gross Total Investment	**118.6**	**32.5**	**151.1**

Sources: National Accounts of the Maltese Islands

The sources of finance for investment are shown below.

Financing Investment – 1987 (Lm Millions)

	Private	Government	Total
Savings	94.8*	14.9	109.7
Capital Transfers from Abroad	17.4	0.0	17.4
Total Finance Available	**112.2**	**14.9**	**127.1**
Provision for Depreciation	18.4	7.6	26.0
Less Transfers to Abroad	n.a.	n.a.	2.0
Total	**130.6**	**22.5**	**151.1**

* Private Savings consisted of Lm55.4 million personal and Lm39.4 million corporate.

Sources: National Accounts of the Maltese Islands

These two tables show that the private sector saved more than was necessary for private sector gross investment, whereas the public sector saved less than was required for public investment. There was a net lending flow of around Lm12 million from the private sector to the public sector.

In macroeconomics, it is hypothesised that, everything else remaining constant, investment tends to increase as the rate of interest decreases, and tends to increase as output increases. This latter relationship is known as the ***accelerator principle.***

Like any other expenditure, investment has a multiplier effect, depending, amongst other things, on the import content of the expenditure. For example, in Malta, a Lm1000 expenditure on construction is likely to have a higher multiplier effect than a Lm1000 expenditure on a machine.

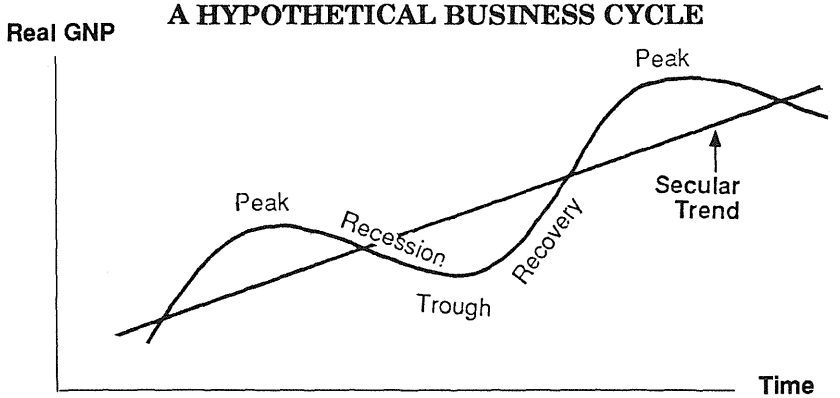
Investment is also associated with business fluctuations. The term ***business cycle*** refers to the ups and downs in the level of economic activity, extending over a period of years (see diagram below).

It is thought that these cycles are to a very large extent influenced by investment behaviour through the interaction of the ***multiplier*** and the ***accelerator*** processes. This occurs when, as the economy grows, investment is undertaken to produce additional output (the accelerator process), which when interacting with induced expenditures (the multiplier process), would in theory generate a boom.

Eventually a full employment peak is reached. Beyond this stage, a downswing is thought to occur, giving rise to a ***recession***. At some point, the floor, at the bottom of the trough, is reached. Following this point a recovery sets in. The interaction between the multiplier and the accelerator would then generate another cycle.

Business cycles have occurred in the Maltese economy, as will be explained in the last chapter. It is doubtful, however, whether the theory of the multiplier/accelerator interaction just referred to, can provide a complete explanation of the ups and down of the Maltese economy, which depends to a very large extent on the ups and downs in the rest of the world.

A HYPOTHETICAL BUSINESS CYCLE



Business cycles are associated with short-term fluctuations, as distinguished from the long-run *secular* trend. The real ups and downs of an economy are generally not as smooth and as regular as those shown in the diagram. In reality the economy tends to fluctuate during shorter-run time spans due to, for example, seasonal factors. Again, in reality, some recessions last longer than others and develop into what are known as *depressions*, and some peaks are higher than others, and develop into what are known as *booms*.

Government Expenditure

Government expenditures on goods and services and on capital formation constitute an important proportion of total final expenditure. The following table gives the most important categories of government expenditure:

Government Expenditure for Selected Years (Lm Million)

	Goods and Services	Sub-sidies	Grants to persons	Capital Forma-tion	Net Lending	Other	Total
1972	19.8	2.4	7.8	6.3	11.0	2.3	49.6
1976	35.9	8.6	18.6	31.0	-10.6	2.7	86.2
1982	85.2	2.8	59.1	39.7	22.2	2.5	211.5
1987	98.2	4.9	68.1	32.5	-10.7	4.7	197.7

Source: National Accounts of the Maltese Islands

In general, government expenditure is undertaken:

- to provide ***public goods.*** Public goods, such as traffic signs are available to anyone whether one pays for them or not. Since users would not, as a general rule, be willing to pay for them (unless forced to do so by means of, for example, taxation) private business is not usually interested in producing them, and they are normally supplied by the government.
- to produce goods and services which private business would not produce either because of the ***large outlay*** or because of the risks involved.
- to reap the benefits of ***externalities.*** In some instances, the social benefit of producing a certain service, such as free education, exceeds the amount of benefit by individuals receiving it. Private business, being guided by private profit rather than by social profit, would not, in these circumstances, supply an adequate amount of such a service. On the other hand, the government, if guided by social profit, would invest in free education and provide such a service to as wide a section of the population as possible, for the benefit of society in general.
- to promote an ***even distribution*** of income and wealth. Government expenditures have an income and wealth distribution effect in that they may be directed at increasing the real income of poorer families, or at increasing their access to such important services as education, health and housing. Expenditures on welfare programmes fall in this category.
- to ***counteract cyclical fluctuations.*** Government expenditure may act as *automatic stabilizer* to reduce the adverse effects of a slowdown in economic activity. For example, unemployment benefits automatically increase personal incomes of job seekers during periods of high unemployment rates. *Discretionary* use of government expenditure, such as direct wage subsidies to firms, may also help to reduce certain undesirable effects

of business fluctuations.

• to promote ***long term growth*** and development. Incentive packages to attract foreign investment and expenditures on infrastructural development fall in this category.

The expenditures shown in the previous table were financed as follows:

Sources of Government Revenue for Selected Years(Lm million)

	Total Taxes	Profits	Income From Property	Transfers From Persons	Grants From Abroad	Other	Deprec-iation Provision	Total
1972	23.3	0.8	5.8	2.2	15.9	0.9	0.6	49.6
1976	45.8	0.4	18.3	3.3	14.8	1.0	2.6	86.2
1982	127.6	5.3	58.3	4.6	9.1	1.7	5.0	211.5
1987	130.7	21.2	30.5	5.7	0.0	2.0	7.6	197.7

Source: National Accounts of the Maltese Islands

In Malta, taxation takes three main forms, namely personal income tax (which is **progressive**) company income tax (which is **proportional**) and expenditure tax (which tends to be **regressive**).

Taxation in Malta for Selected Years (Lm millions)

	Personal Income Tax	Net Expenditure Tax	Company Income Tax	Total Tax*	Percent of National Income
1972	6.3	12.6	2.4	21.3	22.6 %
1976	18.8	14.3	4.1	37.2	18.5 %
1982	63.7	44.0	17.1	124.8	27.5 %
1987	55.5	53.7	16.6	125.8	25.2%

* The difference between total taxes in the previous and this table is that this table measures taxes net of subsidies.

Source: National Accounts of the Maltese Islands

An important reason why economists are interested in analyzing ***fiscal policy***, which is related to government revenue and expenditure, is that this may be used to regulate economic activity.

As stated, certain types of government expenditures can serve to counteract business fluctuations. Taxation may also have this effect. For example, proportional or progressive income tax tends to increase during periods of economic growth and to decrease during periods of recession, thereby acting as an automatic stabilizer.

Government taxes and expenditure play an important part in the multiplier analyses. Taxes are leakages from the domestic income flow. Thus an

increase in tax rates would theoretically reduce the magnitudes of spending and respending associated with the multiplier process. Taxation may also serve as a disincentive to entrepreneurship and/or an incentive for participation in the underground economy.

An increase in government expenditure is normally considered as an independently determined injection, which has a multiplied impact on the economy, depending on the magnitude of the induced leakages. A characteristic of government expenditure, especially on public administration, is that it has a very small import content compared to other exogenous expenditures, and it therefore has a relatively high multiplier effect.

Government and Market Forces

Government participates directly in the economy as a producer of goods and services and as buyer of investment and consumer goods from the private sector. Economies, such as that of Malta, are called ***mixed economies,*** because the means of production are partly owned by the private sector and partly by the state.

An economy which is purely capitalistic would be based on ***laisser-faire*** and unbridled competition between private producers of all sorts of goods and services. In the modern world there is not one single country with pure capitalism, since in all countries governments take action to regulate the economy. For example, in the United States of America, a country which is associated with capitalism, government regulation and direct government participation in production are widespread.

The debate on the extent of government intervention sometimes focuses on the advantages and disadvantages of relying on market forces.

The ***market mechanism*** performs two main functions, namely (a) allowing households and producers to determine the choices to be made regarding supply and demand of goods and services and (b) allowing the price mechanism to eliminate excess demand or excess supply, bringing about a tendency towards equilibrium. One major advantage of this process is that it tends to allocate resources automatically.

Some major disadvantages associated with reliance on the market system are that it does not operate in the case of public goods, that certain social investments would not be undertaken on the basis of private profit alone, that certain profitable activities are socially undesirable (such as drug trafficking), that spontaneous demand and supply forces sometimes need to be harnessed to ensure, for example, that enough resources are available for investment, and that it sometimes takes a very long time to correct imbalances, because of the lags involved in market adjustment.

It is for such reasons that governments never rely exclusively on market forces, and exercise a degree of direct control on economic activities.

4

MONEY BANKING AND INFLATION

There are many definitions of money depending on which function of money one is focusing on. For example, if one is interested in money as a medium of exchange, the most appropriate definition would seem to be notes and coins in circulation, plus private current account deposits . This quantity of money is sometimes referred to as **M1**. On the other hand, if one is interested in money as a store of value, then deposits in savings and fixed accounts (which are sometimes referred to as *quasi-money*) could be considered as forming part of money supply.

Money Supply

The following table presents data on the Maltese money supply and total monetary assets for selected years since 1962.

Money Supply in Malta for Selected Years (Lm Millions)

	Currency in Circulation	Demand Deposits	Total Money Supply	Savings Deposits	Time Deposits	Total Quasi Money	Total Monetary Assets
1962	23.9	6.0	29.9	17.7	31.9	49.6	79.5
1966	30.0	9.0	39.0	21.7	35.7	57.4	96.3
1972	62.4	11.8	74.2	36.9	78.5	115.4	189.6
1976	119.6	21.6	141.2	60.7	114.3	175.0	316.2
1982	259.6	35.0	294.6	100.3	172.3	272.6	567.1
1988	314.3	47.9	362.2	178.1	308.2	486.3	848.5

Source: Central Bank Quarterly Review

It can be seen that money supply as defined in the table has increased considerably since 1962.

Money supply may increase or decrease in response to demand by households and firms. For example, people demand more currency for christmas shopping, either by drawing from past savings, or by borrowing from the banks.

Credit activities by banks are important sources of money supply growth. Banks have an incentive to lend money to make profit, and new deposits permit banks to create money through credit facilities. They cannot lend all the deposits since they have to keep some form of liquidity

to meet cash demands from clients. These banks are expected to lend only a proportion of their deposits, and to keep what is known as a liquidity ratio. In general, the lower the liquidity ratio required by the monetary authorities, the higher would be the proportion of total deposits that commercial banks are able to lend and, as a result, the greater is their ability to expand money supply.

As a general rule, the Central Bank supplies notes and coins to the Commercial Banks according to their needs to meet withdrawals, cashing of cheques and credit arrangements. But the Central Bank may influence the money supply by making it easier or more difficult for commercial banks to extend credit, or for firms or households to borrow money.

Demand for Money

Firms and households need money for several reasons. One motive is to pay for the goods and services they require. This is called the ***transactions demand for money,*** and is associated with the function of money as a medium of exchange. In general, the money balances that households or firms hold increase as the value of transactions increases. Thus, for example, a household would be expected to require more money in order to support transactions in goods and services worth Lm100 a week than another family whose transactions are worth Lm50 a week. This type of reasoning also applies to firms that require money to pay for the inputs needed for production.

In general, the amount of money held for transactions purposes is less then the value of transactions during a given period. For example, a household earning Lm2400 a year, may use its income to buy goods and services of an equivalent amount by holding only an average of Lm100 a month in the form of cash if its income is received monthly. The holding of cash is likely to be lower if the household's income is received weekly. In general, the more frequently people get paid, the lower is the amount of money held to finance a given amount of transactions during a given period.

The ratio of the total spending to a given amount of money supported by it is referred to as the ***velocity*** of money. It may defined as the average number of times that a unit of currency (say Lm1) changes hands in a given period, usually a year.

It is often argued that money balances are held for reasons other than transactions. One explanation for this is that money has attractions as an asset because of its liquidity characteristic. Thus, for example, the going rate of interest may be perceived by certain households as being too low to compensate for the loss of liquidity associated with the buying of government bonds or depositing money in savings or fixed accounts. In macroeconomics, this type of ***asset demand*** is assumed to decrease as the rate

of interest increases.

In countries where the money market is developed, and responds to the forces of supply and demand, households may hold "idle" money in expectation of a future increase in the rate of interest so as to improve the rate of return from buying of bonds. This is called the ***speculative demand*** for money, implying that a large amount of speculative balances are held when the rate of interest is low, and these balances are reduced as the rate of interest rises. Liquidity preference for such speculative purposes is not of much relevance in the case of Malta since fluctuations in the rate of interest are minimal, and there is no active bond market.

In all probability however, Maltese households do hold money over and above that required for ***formal*** transactions. The ratio of currency in circulation to the Gross National Product in Malta tends to be extremely high when compared to the same ratio in other countries. For example, in 1985, Maltese currency in circulation amounted to over 50% of GNP, whereas in industrialised countries, this ratio ranged from 5% to 10%, during the same year. In Cyprus, which is a small Mediterranean island like Malta, the ratio for 1985 was just 7%.

An important reason for the relatively large cash holdings in Malta is probably related to the ***underground economy***, where underground transactions are settled in currency so as to evade taxation. In this sense it is not, strictly speaking, correct to refer to such balances as "idle" holdings of money, since cash in this case is being used to finance transactions which are not officially recorded. A distinction could be made in this case, between *formal* and *informal* transactions demand for money.

Monetary Policy

Monetary policy refers to action taken by the monetary authorities to stabilize the economy by adjusting or controlling money supply. The most commonly used instruments of monetary policy are (a) open market operations, involving the buying and selling of government bonds (b) measures which influence the rate of interest and (c) qualitative and quantitative controls on bank credit.

In Malta, monetary policy has played a very minor role in the control and direction of the economy. Policies relying on the operation of the money market have hardly ever been used. One reason for this is that in Malta the market for government bonds is insignificant, and open market operations would not therefore have the desired effect on bank liquidity. Also, even had an active bond market existed, open market operations, as well as changes in the commercial bank liquidity requirements, would not have had the expected effect on the banks' ability to lend, since these institutions

normally hold vast amounts of liquid assets, which by far exceed the ratio required by the Central Bank. Moreover, as already noted, the non-bank sector normally holds a large volume of cash, which may be utilised to finance the formal and the underground economy, independently of commercial banks liquidity requirements.

Some direct controls, related to the extension of credit by commercial banks have been made in terms of the Banking Act in the past. For example, for a time, commercial banks were not free to lend money to the Maltese tourist and clothing industries, because the government considered that the uncontrolled expansion of these industries was undesirable.

Banking in Malta

The **Central Bank** of Malta is the most important institution in the banking system. It was established in 1967 with the following functions:

- issuing legal tender currency notes and coins
- controlling and administering external reserves so as to safeguard the international value of the domestic currency
- influencing the volume and supply of credit in order to promote economic development, consistent with monetary stability
- fostering the development of a capital market and promoting a sound financial structure
- acting as banker to the government and to commercial banks
- advising the government on financial matters

Commercial banks are those institutions with which the general public mostly comes into contact. These banks are essentially borrowing and lending institutions. They borrow money from the general public at a given rate of interest and re-lend a proportion of it at a higher rate of interest, with the aim of making profits.

In Malta there are three commercial banks, namely Mid-Med Bank Ltd., Bank of Valletta Ltd., and Lombard Bank Ltd. These accept current, savings and fixed deposits. They also offer a number of services to the business community and to private households including currency exchange, issuing of travellers' cheques, forward exchange facilities, letters of credit, investment advice and safe custody of valuables.

Commercial Bank Assets and Liabilities

The proportion of commercial bank assets to be held in liquid form is established by the Central Bank and this amounts to 25% of total deposits (see Banking Act, 1970). These liquid assets include notes and coins, which are perfectly liquid, and on which no profit is made. Commercial banks also hold liquid assets at the Central Bank of Malta in call accounts, on which

an interest of around 5% is earned. Other liquid assets include Malta Government Treasury Bills and inland bills of exchange, rediscountable at the Central Bank. These are short term loans and constitute a promise that the loans involved will be repaid at some future date, generally within three months or earlier.

A characteristic of the Maltese commercial banks is excessive liquidity as shown in the following table.

Commercial Banks Liquid Assets for Selected Years since 1972

Year	Actual Amount (Lm Million)	Actual Per Cent of Deposits	Required By Law (25%) (Lm Million)	Excess (Lm Million)
1972	48.3	44.5%	27.2	21.2
1976	101.4	58.8%	43.1	54.1
1982	118.7	47.3%	62.8	55.9
1988	234.8	43.4%	135.1	99.7

Source: Central Bank of Malta – Quarterly Review

In general the more liquid an asset is, the lower would be the rate of return on it. Thus commercial banks earn no interest on cash, they earn about 5% on money at call at the Central Bank, and around 8% on longer term loans and advances.

In Malta, commercial bank derive considerable income by investing a proportion of their liquid assets abroad. This proportion cannot exceed 50% of the liquid assets, subject to approval by the Central Bank.

The liabilities of commercial banks are mostly demand, savings and time deposits. In recent years, about 60% of the operating expenses of Maltese commercial banks consisted of interest paid on these deposits.

There are two other institutions which also accept deposits. These are the Apostleship of Prayer Savings Bank Ltd. which accepts savings and time deposits from small savers, and the Melita Bank International Ltd, an offshore bank set up in 1981.

There are institutions, other than commercial banks, which carry out banking activities. In developed economies one finds specialised institutions, such as the discount houses in Britain, which operate in the short-term money market. In Malta, the money market is not so developed and these types of institutions do not exist as a separate entity.

Some financial institutions such as building societies operate in the long-term money market. In Malta we have an institution, called Lohombus Corporation, which acts as a building society, in that it specialises in providing long-term funds (up to 25 years) for house building and for certain types of commercial properties.

Inflation

Inflation may be broadly defined as a rapid increase in the general level of prices. Often the word inflation is applied to refer to an *unhealthy* or *excessive* increase in the price level. There is no general agreement as to what price increase is undesirable, but in recent times, a rate of increase of up to 4% per annun has been considered as acceptable in some countries.

Apart from the question of definition, there is also the problem of measuring inflation. In official statements by the Maltese government the retail price index is often used as an index of inflation. Another indicator is the consumer price index, which covers a wider selection of goods and services than the retail price index. These two indices are constructed in such a way as to reflect changes in prices of a number of goods and services purchased by the average family. Each good and service is weighted according to its importance in a chosen basket of goods and services. The weights are occasionally changed to take account of updated information. Generally speaking, the weights assigned in the retail price index are derived from a survey of consumer expenditure.

Price indices are computed in relation to a *base year* weighted average price of all the goods and services included in the chosen basket, and this is then assigned a value of 100. The average current price of the goods and services for other years is then expressed as a percentage of the base year weighted average price. For example, the Maltese retail price index with 1983 as base year takes a value of 100 in 1983 and a value of 101.3 in 1986. The latter figure shows the yearly price level with respect to that of 1983.

When considering inflation, economists are interested in measuring price changes rather than price levels. The annual changes in the retail price index (RPI) and in the consumer price index (CPI) are given in the table shown in the next page.

Another useful index of prices is the Gross Domestic Product Implicit Deflator. This index is called *implicit* because it is not constructed directly but is obtained as a ratio between GDP at current prices and GDP at constant prices. The GDP Implicit Deflator therefore measures the average price of goods and services produced domestically. Changes in this price index are also given in table and shown as GID.

In an open economy such as Malta, import prices are likely to have an important effect on the general price level. The imports price index is therefore useful as an indicator of the extent to which imported inflation affects the final prices of consumption and exports. Changes in this index are also shown in the table as MPI.

On the other hand, if one is interested in measuring changes in Malta's export competitiveness (in Maltese liri) the export price index would be more relevant. Changes in this index are shown as XPI in in the next table.

Annual Rates of Change (Percent) in Price Levels

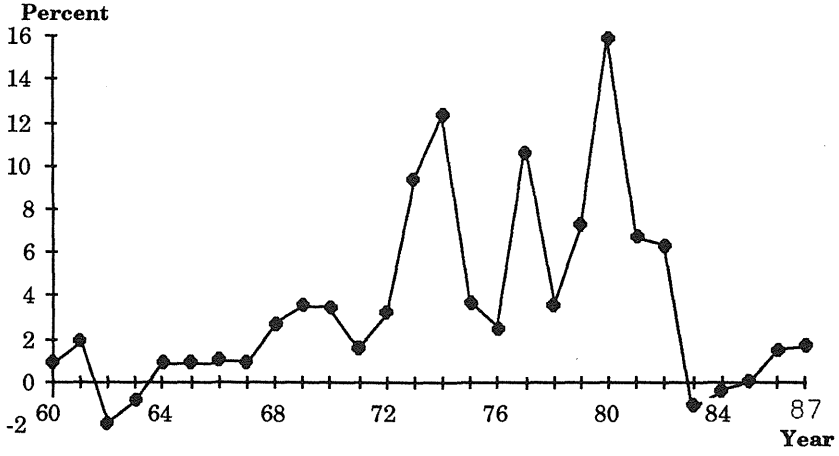
YEAR	RPI	CPI	GID	MPI	XPI
1973/74	+ 7.2	+11.3	+ 3.4	+ 3.6	+ 2.5
1974/75	+ 8.8	+ 4.7	+ 5.3	+ 6.0	+ 3.8
1975/76	+ 0.6	+ 2.5	+ 5.1	+ 9.0	+ 8.4
1976/77	+10.0	+10.6	+ 4.9	+ 9.2	+ 5.0
1977/78	+ 4.7	+ 3.6	+ 4.2	+ 7.2	+ 5.5
1978/79	+ 7.1	+ 7.3	+ 6.2	+12.4	+ 8.4
1979/80	+15.7	+15.9	+12.3	+ 9.9	+ 9.6
1980/81	+11.5	+ 6.7	+ 7.8	+12.4	+12.6
1981/82	+ 5.8	+ 6.3	+ 3.4	+ 2.6	+ 4.3
1982/83	- 0.9	- 1.0	- 0.3	+ 2.7	- 2.0
1983/84	- 0.4	- 0.4	- 0.2	+ 0.6	+ 1.1
1984/85	- 0.3	+ 0.0	+ 0.0	- 2.2	- 0.6
1985/86	+ 2.6	+ 1.6	+ 3.4	- 0.2	+ 0.3
1986/87	0.0	+ 1.7	+ 2.9	+ 1.5	+ 3.0

Sources: National Accounts of the Maltese Islands and Annual Abstract of Statistics.
All indices, with the exception of RPI have the year 1973 as base year.

It can be seen from the table that prices have tended to rise at very fast rates during the seventies, especially between 1977 and 1981, and to decrease or increase by very small percentages after 1982.

The following diagram shows the annual rates of change in the consumer price index. The rapid increases during the seventies can be contrasted with the low rates of change in the sixties and the eighties.

Percentage Change in the Consumer Price Index



Control of Inflation

Generally speaking governments take action to control persistent and appreciable rises in the general price level because inflation gives rise to a number of disadvantages including that:

- it erodes the purchasing power of personal incomes, especially those of persons with a fixed income, such as pensioners.
- it generates demands for wage increases to compensate for price increases, and this, apart from creating industrial unrest, would also generate expectations of further inflation in the future. As noted in chapter 2, this would tend to give rise to wage-price spiralling inflation.
- it gives rise to a loss in export competitiveness, and in an open economy such as Malta, this is likely to have a marked effect on employment.

Inflationary sources are usually classified under two broad headings, namely ***demand-pull*** and ***cost-push***. Demand-pull inflation occurs as a result of excess demand which may be brought about, for example, by excessive government spending and increases in money supply, which inflate the economy at a faster rate than it can grow in real terms.

Cost-push inflation, on the other hand, occurs as a result of increases in the cost of production brought about, for example, by increases in wages, profits or prices of industrial supplies, imported or otherwise.

The control of demand pull inflation and of cost-push inflation may necessitate different policies. For example, restrictive fiscal policies, aimed at reducing aggregate demand, and restrictive monetary policies, aimed at reducing the money supply, are more suited for demand pull inflation.

Cost-push inflation is a supply side phenomenon, and controlling it may require a different set of tools. In Malta, for example, a major source of price increases are changes in the cost of imported consumer goods and industrial supplies. In some years, exchange rate policy had, as one of its objectives, the control of imported inflation.

It is sometimes argued that cost- push inflation would not continue to exist in the long run independently of demand-pull inflation. According to this argument, an autonomous increase in costs of production would give rise to an increase in the final price, but the ensuing decrease in demand would, through market forces, bring back prices to their equilibrium level. This suggests that unless sustained by shifts in demand (caused for example by polices to reduce unemployment) cost-push inflation would not persist. If this line of reasoning is correct, the basic source of inflation is excess demand.

In Malta, especially during periods of rapid growth, cost-push and demand pull inflation occurred simultaneously, and tended to reinforce each other.

5

THE BALANCE OF PAYMENTS AND THE MALTESE LIRA

The balance of payments is a statement of the financial transactions of a country with the rest of the world during a given period, normally a year. It may also be regarded as a report of the outflows and inflows of foreign exchange from and into a country, during a given period. The most important sources of foreign exchange inflows are exports, and the most important use made of foreign exchange is to buy imports.

Like many other small countries, Malta has a relatively large foreign sector. Final sales have a 50% import content (imported consumer goods and imported industrial supplies) and around 40% of such sales are exported.

As will be explained later on, exports are not the only source of foreign exchange inflows in Malta.

Exports

Malta depends to a very large extent on exports of goods and services for its foreign exchange requirements. Before the sixties, Malta's exports consisted mainly of services connected with the British military and naval base. The share of merchandise exports was relatively very small.

With the growth of the manufacturing sector and the expansion of the tourist industry, the volume of Maltese exports grew at a very fast rate. During the sixties and the seventies, there was a marked change in the composition of exports, since the share of merchandise exports increased, reaching about 60% of total exports during the eighties. Exports of services now consist mostly of tourist and transport related services, rather than activities connected with the British military presence.

Another notable change with respect to exports is that during the fifties and the sixties, the United Kingdom was Malta's most important buyer of Maltese merchandise exports, but during the seventies and the eighties, West Germany became Malta's most important client for such goods.

The two tables in the next page give a breakdown of Malta's exports of goods and services for 1987. It can be seen that the bulk of merchandise exports were finished manufactures, and the bulk of services exports were travel related.

Maltese Merchandise Exports (1987)

Category of exports	Lm Million	%
Food (mostly processed food)	4.2	2.0
Beverages and Tobacco	4.5	2.2
Crude Materials (mostly scrap metal)	1.6	0.8
Chemicals	2.9	1.4
Semi-manufactures (mostly textiles, rubber and leather)	23.1	11.1
Machinery and equipment (mostly electrical components)*	55.0	26.4
Other finished manufactures (mostly clothing)	99.4	47.6
Re-exports	17.9	8.6
Total merchandise exports	**208.6**	**100.0**

* This excludes ship repair and building, where exports amounted to about Lm18 million.
Source: Economic Survey 1988, Table V.3.

These merchandise exports were mostly directed to West Germany, followed by the United Kingdom and Italy. Around 75% of these exports go to the European Community.

Maltese Exports of Services (1987)

Category of Exported Service	Lm Million		%
Tourist related exports:	**113.0**		**55.3**
Tourist personal expenditure		68.2	
Hotel expenses		43.5	
Transit/cruise passengers		1.3	
Transport related exports:	**62.9**		**30.8**
Freight/Insurance on foreign trade		6.9	
Passenger fares		19.0	
Port services		4.6	
Ships/aircraft repairs, bunkering		8.3	
Charter hire and miscellaneous		24.0	
Other exported services:	**28.5**		**13.9**
Government (eg diplomatic missions)		7.0	
Other private services		21.5	
Total exports of services	**204.4**		**100**

Source: National Accounts of the Maltese Islands, Tables 31-35.

It can be seen from the preceding table that the bulk of Malta's exports of services are related to travel (mostly personal and hotel expenses by tourists), and to transportation (mostly revenues from Air Malta and port dues).

Imports

Most of Malta's imports are merchandise, and only a small proportion are services. A large proportion of merchandise imports are industrial supplies . A more detailed description of merchandise imports is given in the following table.

Maltese Merchandise Imports (1987)

Imports of Merchandise	Lm Millions	%
Consumer goods	**86.4**	**22.0**
Food and beverages for consumption	35.0	
Durable consumer goods	35.4	
Other consumer goods	16.0	
Industrial Supplies	**201.6**	**51.3**
Primary industrial supplies	10.8	
Semi-finished manufactures for production	176.6	
Finished industrial supplies	14.2	
Capital goods (eg. machinery)	**70.2**	**17.9**
Fuel	**24.4**	**6.2**
Other	**10.2**	**2.6**
Total merchandise imports	**392.8**	**100.0**

Source: Economic Survey 1988, Table V.2.

The following table shows the composition of Malta's imports of services. It can be seen that the bulk of such imports are related to transport and tourism.

Maltese Imports of Services (1987)

Type of imported service	Lm Millions	%
Travel related imports:	**35.3**	**28.4**
Tourist and business travel abroad	35.0	
Other expenditure overseas	0.3	
Transportation related imports:	**60.6**	**48.8**
Freight and insurance on imports	39.2	
Passenger fares	5.4	
Port disbursements	13.9	
Charter hire and miscellaneous	2.0	
Other services:	**28.3**	**22.8**
Government transactions	3.2	
Private imported services	25.1	
Total imports of services	**124.2**	**100.0**

Source: National Accounts of the Maltese Islands, Tables 31-35.

Note: Freight and Insurance enters both tables above, and the total of both tables therefore amounts to more than total imports of goods and services.

The Maltese Balance of Payments

The table below gives the main inflows and outflows of foreign exchange in the Maltese balance of payments for 1987, together with the negative or positive balances associated with these flows.

It can be seen from the table that the balance of payments has three main sections, namely the ***current account***, the ***capital account***, and ***official financing***.

Let us look at the current account first. The ***balance of trade*** i.e. the difference between imports and exports of merchandise, was negative. This has always been the case in Malta since 1954, the first year for which the National Accounts were published. The balance between imports and exports of all services taken together was positive, the only unfavourable balance being that with respect to freight and insurance.

When taking goods and services together, however, the overall balance, called the ***resource gap***, was negative due to the large deficit in merchandise trade. Malta has had a deficit in its resource balance since 1954.

The Maltese Balance of Payments for 1987
Lm Millions

	(Credit) Inflow	(Debit) Outflow	Balance
Current A/C			
Merchandise Exports and Imports	218.1	349.5	- 131.4
Gold (Non Monetary)		7.3	- 7.3
Insurance/Freight on Merchandise	6.9	39.2	- 32..3
Transportation	56.0	21.4	+ 34.6
Travel	113.0	35.3	+ 77.7
Investment Income	39.5	8.9	+ 30.6
Other Private Services	21.5	25.0	- 3.5
Other Government Services	7.0	3.2	+ 3.8
Private Transfers	32.8	2.8	+ 30.0
Government Transfers	0.1	0.3	- 0.2
Current Account Total	**494.9**	**492.9**	**+ 2.0**
Capital A/C			
Net Direct Investment	6.7		+ 6.7
Private Financial Investment	3.1	4.8	- 1.7
Bank/Financial Institutions Flows	20.4	23.4	- 3.0
Government Loans	2.0	2.6	- 0.6
Capital Account Total	**32.2**	**30.8**	**+ 1.4**
Net Errors and Omissions		5.9	- 5.9
Decrease in Official Reserves	**2.5**		**+ 2.5**

Investment income from abroad covers interest and other earnings which Maltese residents and institutions make on their foreign investments or which arises from the ownership of foreign assets. The outflows of investment income arises from similar earnings made by non-residents on their investment in Malta. ***Transfers*** from abroad include flows of foreign exchange for which nothing direct is received in return.

The balance of payments table shows that the net inflows from investment income and transfers just cover the deficit on the resource gap, and the balance on current account shows a surplus of Lm2.0 million. Malta has enjoyed a surplus on current account for most years since 1954. The years with a current account deficit were 1964, 1969, 1970, and 1983 and 1985.

The ***capital account*** covers changes in net foreign assets. In 1987, Malta had additional foreign exchange inflows from direct investment. Direct investment involves some form of ownership of domestic enterprise by non-residents. Financial outflows and inflows deposits, loans and portfolio securities. Government loans on the debit side cover repayments. There was an overall surplus on capital account in 1987.

Net errors and omissions allow for statistical discrepancies arising from mistakes in recording, or from non-recording, of foreign exchange inflows and outflows due to oversights or to secret capital transfers.

In 1987, the balances on current and capital accounts taken together (after allowing for net errors and omissions) show that for that year, the amount of foreign exchange earned or obtained in some other way, was not enough to cover the amount of foreign exchange required. This was not typical in the Maltese balance of payments, since in most years since 1954, foreign exchanges inflows exceeded outflows, and a surplus was recorded.

Official External Reserves

When a surplus in the overall balance of payments is recorded, official external reserves increase by the amount of the surplus. This increase is entered as a debit, because it may be regarded as an official capital outflow. The financing of balance of payments deficits and the accumulation of external reserves resulting from balance of payments surpluses is referred to as ***official financing.***

Over the past years, the Balance of Payments surpluses have enabled the Maltese monetary authorities to accumulate millions of Maltese liri worth of foreign exchange reserves, which, in 1987, amounted to an average of about 15 months worth of imports. This figure is one of the highest in the world.

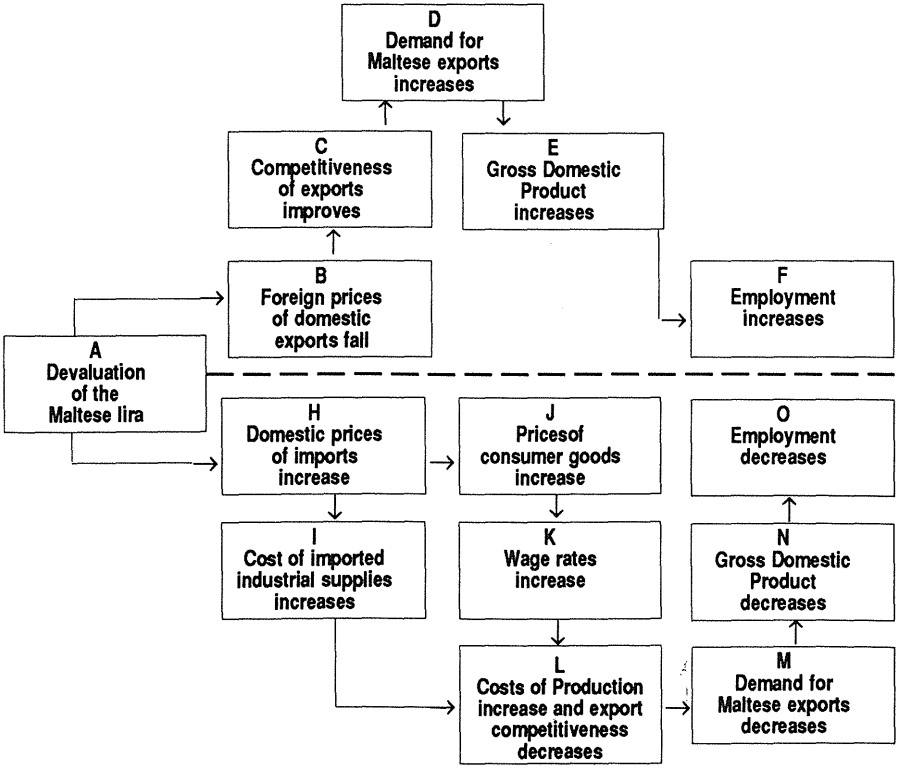
These reserves serve as a backing for currency in circulation and Central Bank demand deposits. They also yield considerable income (in the form of interests, etc.) to the Central Bank itself. However, whether or

not the amount of official external reserves is an indicator of economic well being is a matter of debate. It may be argued that such an accumulation of reserves was mainly the outcome of the rigid foreign exchange control legislation prevailing in Malta. One question to ask in this regard is whether or not it was wise on the part of the monetary authorities, to reinvest abroad all those foreign exchange inflows, when such funds, or a proportion of them, could have been utilized to upgrade Malta's productive capacity.

The Exchange Rate of the Maltese Lira

The exchange rate of the Maltese lira is established on the basis of a formula, which pegs the lira to a number of foreign currencies according to pre-specified weights. Changes in the external value of the Maltese lira are likely to have important effects on the Maltese economy, as shown in the following diagram , where the effects of a devaluation are considered.

THE EFFECT OF A DEVALUATION OF THE MALTESE LIRA ON EXPORTS, OUTPUT AND EMPLOYMENT



The diagram shows that the effects of a decrease in the Maltese lira exchange rate (a devaluation) can be divided into two, namely direct and and indirect effects. The direct effects, shown in the movement from A to F (top section of the diagram) are that with a devaluation, competitiveness would improve, thereby increasing exports, output and employment.

The indirect effects, shown in the movement from A to O (bottom section of the diagram) are known as ***price reversal effects***. With a devaluation costs of production are pushed up, and adversely affecting exports, output and employment. It should be noticed that costs of production are affected through increases in the prices of imported industrial supplies (H to I) and through increases in the prices of consumer goods, which are likely to generate demands for wage increases (H to K).

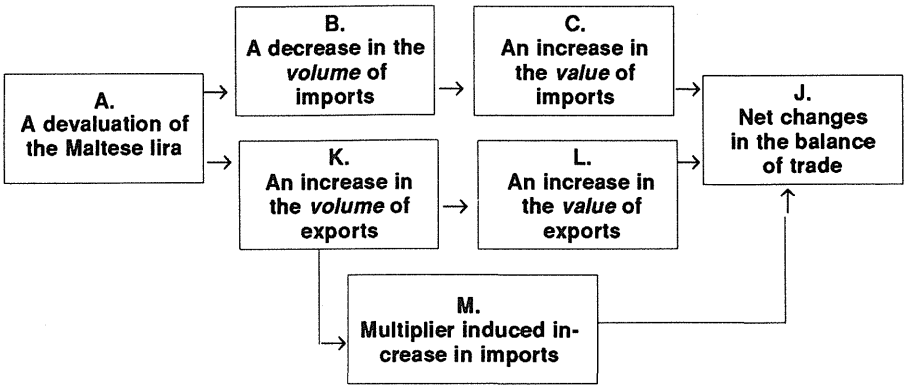
The final outcome on employment depends on the relative strengths of the effects shown in the top and bottom sections of the diagram.

Exchange Rates and the Balance of Trade

The analysis of exchange rate movements is very important especially for a country with a relatively large foreign sector, like Malta. In general, an increase in the external value of the Maltese lira would render exports cheaper and imports more expensive.

The following figure explains the effect of a change in the value of the exchange rate on the Maltese balance of trade. The figure shows that the effects of a devaluation on the volume of trade may be divided into three, namely (i) an increase in the volume of exports arising from a decrease in export prices in foreign currency, shown in the movement from A to K (ii) a decrease in the volume of imports arising from an increase in import prices in domestic currency, shown in the movement from A to B and (iii)

THE EFFECT OF A DEVALUATION OF THE MALTESE LIRA ON THE BALANCE OF TRADE ON GOODS AND SERVICES



an increase in imports induced by the increase in exports, shown in the movement from K to M.

These changes in volume have to be translated into money in order to assess the impact on the balance of trade, since this balance is normally measured in value terms. The final effect normally depends on the magnitude of what are known as ***import and export price elasticities***, and on the ***marginal propensity to import.***

In the case of Malta, a devaluation is likely to increase the volume and value of exports as shown in the movement from K to L, since the export price elasticity is probably higher than unity, i.e. a given percentage decrease in export prices arising from a devaluation would bring about a more than proportionate increase in export volume, even after allowing for the price reversal effects discussed earlier.

It is likely to decrease the volume and to **increase** the value of imports as shown in the movement from B to C, since the magnitude of the import price elasticity is probably less than unity. This means that when the price of imports increases by a given percentage, say 5%, as a result of a devaluation, the volume of imports would decrease by a smaller percentage, say 1%, so that in the end total expenditure on imports would increase with an increase in import volume at a higher per unit price.

The value of imports would also increase via the multiplier process as shown by the movement from K to M.

The final outcome of all these changes in the case of Malta, shown in rectangle J, would probably be a marginal improvement in the balance of trade.

The results just described are based on an emprical economic study by the present author. However , it should be stressed that the effects of a devaluation depend on a number of factors other than those shown in the preceding two diagrams. For example one has to consider whether or not productive capacity in Malta can expand to meet an increase in demand for exports. Another factor in this respect is the extent to which the increase in domestic prices ushers in a wage-price spiral. There are also factors which are not purely economic in nature, such as for example the reaction of trade unions following a devaluation.

6

MALTA IN AN INTERNATIONAL CONTEXT

Malta and World Development

Countries may be grouped into two broad categories namely (1) **developed countries**, also known as **industrial market economies**. These include most Western European countries, Canada, USA, Australia, New Zealand and Japan and (2) developing countries, of which there are over a 100, mostly in South America, Africa and Asia. These are sometimes also referred to as **less developed countries** or **third world countries**. Somewhere in between these two categories lie the **socialist countries** of Eastern Europe, and the **high-income oil exporting countries**.

Malta is usually classified as a developing country. This category includes low income countries, lower middle-income countries and upper middle-income countries. This classification, which follows that used by the *World Development Report* is somewhat arbitrary, but it is convenient for grouping countries in terms of economic development.

Average GNP per capita for different country groupings are given in the following table. The table shows that in 1984 Malta's GNP per capita was approximately US$3360. This means that Malta belonged to the upper middle-income countries. In fact, among the countries classified as developing, Malta is one of the richest in terms of GNP per capita. For this reason, classifying Malta with the under-developed world may be misleading since Malta's income per capita is much higher than that of many countries in Asia, Africa and Latin America.

GNP per Capita and Structure of Production (1984)
Weighted average for Country Groupings and for Malta

Country Grouping	GNP (dollars) per capita	Manufacturing as % of GDP	Agriculture as % of GDP
Low income economies	260	15	36
Lower middle-income economies	740	17	22
Upper middle-income economies *	1950	25	10
Developed market economies*	11430	25	3
Malta	3360	30	6

* excluding high income oil-exporting countries and Eastern European Socialist Countries.

Source: World Development Report (1986, World Bank)

GNP per capita has a number of shortcomings as an indicator of development . It may not be perfectly comparable across countries, since there are differences in national accounting procedures. Moreover, certain biases arise from the fact that only goods and services provided through the market are counted in GNP. Another consideration to make in this respect is that comparisons of GNP per capita of different countries necessitate the conversion into a common currency, such as the US dollar, and therefore the gross national product of a given country may increase or decrease, in dollars, with an appreciation or a depreciation of the domestic currency. Finally, there is yet another shortcoming associated with the fact that a unit of currency in one country may buy different amounts of goods and services in another country.

In spite of these and other shortcomings, data on GNP per capita is very often the best available indicator of development for purposes of international comparisons. However, other indicators are sometimes also utilised.

One such indicator is related to the contribution made by the manufacturing and the agricultural sector to the gross domestic product. Developed countries tend to have a relatively large manufacturing sector and a relatively small agricultural sector. On these two counts, Malta is similar to developed countries (see preceding table).

Other indicators are related to the rates of population growth, and education/health indices. Developed countries tend to have low population growth rates, higher life expectancy, fewer persons per doctor of medicine and higher school enrolment ratios than developing countries. Malta is very similar to developed countries with respect to these variables.

Malta as a Small Nation

A distinguishing feature of the Maltese economy is its size in terms of its total GNP, land area and population. Smallness does not necessarily render a country underdeveloped, since there are small countries, such as Luxemburg, the Bahamas, Iceland, Bahrain and Cyprus that have done rather well in terms of economic development. However there are a number of drawbacks associated with small size.

One drawback is that small economies tend to depend on international trade more than large economies do, and therefore they are more dependent on developments outside their control. This dependence may be measured in terms of the ratio of imports to GDP or the ratio of exports to GDP, as shown in the table next page.

One reason for the high dependence on foreign trade is that small countries tend to lack natural resources, and hence their import bill tends to be relatively large. The need for foreign exchange to finance this import bill forces small countries to export a large proportion of their output.

Selected 1985 Data for a Sample of Countries Classified by Population Size in Descending Order

Country	Population (Million persons)	Area (Thousand Sq. Km.)	GDP (Million US$)	Exports as percentage of GDP
China	1042.59	9561	265.5	10
India	758.93	3288	196.9	6
USA	238.02	9363	3959.6	8
Brazil	135.56	8512	226.8	12
Japan	120.74	372	1325.2	15
Mexico	79.00	1973	177.5	18
Canada	25.43	9976	348.3	29
Switzerland	6.37	41	92.8	39
Denmark	5.12	43	58.1	37
Norway	4.14	324	58.4	47
Cyprus	0.67	9	2.3	52
Luxemburg	0.36	3	3.6	78
Malta	0.34	0.3	1.0	72
Barbados	0.25	0.4	1.2	65

Source: Handbook of International Trade Statistics (UNCTAD, 1987)

Another reason is that in small countries, the size of the domestic market is small. Because of this, these countries find it impossible to support efficient production in domestically oriented industries, and are therefore forced to expand their production via exports of goods and service

Another drawback associated with small size is concentration on a few categories of products and services in export trade. This imposes serious disadvantages on a small country. Most of all, it may lead to excessive fluctuations in exports receipts. If demand for a particular product-group decreases, the country exporting that particular product would be faced by a large decline in its foreign exchange earnings.

Malta and the EC

The European Community (EC) was established in 1957 with the aim of setting up a **Common Market** so as to progressively promote the harmonisation of economic policies and economic expansion of member states. To achieve this aim, customs duties and quantitative restrictions within the community have been gradually reduced, and a ***Common External Tariff*** (CET) on imports from non-member countries was adopted by member states. A ***Common Agricultural Policy*** (CAP) was also established, and many institutions were developed with the aim of eventually creating a single European market.

The EC consists of twelve members, namely Italy, Germany, France, Belgium, the Netherlands, Luxemburg, the U.K., Ireland, Denmark, Greece, Spain and Portugal. It is the largest trading block in the world, although it occupies a relatively small surface area. It has not yet attained full integration, in that for example, taxation and monetary institutions are not yet harmonised, and non-tariff trade barriers still exist. But steps have been taken to create a truly border-free space within the EC, by 1992.

Advantages and Disadvantages of Joining the EC

The present government is committed to seek full-membership in the EC. At the time of writing, there is considerable debate as to whether or not full EC membership is advantageous to the Maltese economy.

Arguments against Malta becoming full EC member include:

- import controls against EC members would have to be dismantled with full membership and this would give rise to a loss of output and employment in firms enjoying protection. In Malta, a large number of firms produce for the domestic market, and depend on import controls to remain in existence.
- food prices are likely to increase because of the EC Common Agriculture Policy (CAP).
- the Maltese government would lose revenue due to the fact that goods from EC members would enter Malta duty free.
- there will be a new tax on expenditure called the *value-added tax* (VAT)
- there will be a loss of sovereignty since Malta would cease to be able to act independently in a number of political and economic areas.

Arguments in favour of Malta becoming full EC member include:

- Malta is already tied to Europe politically and economically, but not being a full member, Malta cannot reap the benefits that full members enjoy, such as the unrestricted access of exports to the EC market.
- the completion of the EC internal market, scheduled by 1992, is likely to make it difficult for a non-member country to maintain, let alone improve, its ability to penetrate EC markets, even if it is assumed that the existing concessions and preferences remain in force.
- by becoming a full member, Malta would be in a better position to attract investment (a) from EC countries because of improved legal and other forms of harmonization and (b) and from non-members wanting to use Malta as a platform from which to penetrate the European market.
- Malta would benefit through transfers from the EC Regional Development Fund and the Social Fund, which are mainly intended to decrease disparities between countries and regions in the EC.
- Malta would be forced to adopt a more competitive strategy, which would promote efficiency and generate wealth.

7

THE MULTIPLIER PROCESS

In macroeconomics, the income multiplier process describes how a change in any expenditure gives rise to a series of spending and respending on purchases of domestically produced goods and services. To estimate multiplier magnitudes, one needs information on the marginal withdrawals from the income flow, in the form of taxation, savings and imports.

The following estimates were calculated by the present author in a study on the multiplier process in Malta.

Estimates of Induced Propensities in the Maltese Economy

INDUCED VARIABLES	PROPENSITIES	ESTIMATED MAGNITUDE
Consumption (CNS)	Marginal Propensity to Consume	84% of Disposable Personal Income
Personal Savings (SVG)	Marginal Propensity to Save	16% of Disposable Personal Income
Personal Tax (TXP)	Marginal Personal Tax Rate	23% of Personal Income
Expenditure Tax (TXE)	Marginal Expenditure Tax Rate	17% of Consumption or 8% of GNP
Corporate Leakages (CLK)	Marginal Company Tax + Savings	16% of GNP
Imports (MPT)	Marginal Propensity to Import	32% of Cons. + Exports + Invest.

Source: Briguglio L., Multiplier Effects in the Maltese Economy.

The two tables presented in the next page give numerical examples of the multiplier process using the estimates of the marginal propensities just described. The first table shows the estimated effect of an initial Lm100 increase in ***government current expenditure***, whereas the second table shows the effect of an initial increase of Lm100 in ***export expenditure***.

The multiplier process shown in the first table works as follows. In round 1, a Lm100 increase in government expenditure would increase GNP by Lm100, which would induce a Lm16 increase in company savings and taxation (termed company leakages or CLK). It would also induce an increase of Lm8 in expenditure taxes (TXE) . The remaining increase in income goes to households as personal income (PRS), which in this case would increase by Lm76. This would induce a Lm17.7 increase in personal tax (TXP), leaving Lm58.3 as disposable income (DSP). This change in disposable personal income would increase consumption (CSM) by Lm49, and personal savings (SVG) by Lm9.3. The increase in consumption would induce a Lm15.7 increase in imports (MPT), so that consumer expenditure on domestic value added would amount to Lm33.3 which is consumption net of imports.

Changes in Lm in the Induced Macroeconomic Variable arising from a Lm100 change in GOVERNMENT EXPENDITURE

Round	GNP	CLK	TXE	PRS	TXP	DSP	CSM	SVG	MPT	Increase in next round GNP
1	100.0	16.0	8.0	76.0	17.7	58.3	49.0	9.3	15.7	33.3
2	33.3	5.3	2.7	25.3	5.9	19.4	16.3	3.1	5..2	11.1
3	11.1	1.8	0.9	8.4	2.0	6.4	5.4	1.0	1.7	3.7
4	3.7	0.6	0.2	2.8	0.6	2.2	1.8	0.3	0.6	1.2
5	1.2	0.2	0.1	1.0	0.2	0.8	0.6	0.2	0.2	0.4
6	0.4	0.1	0.1	0.3	0.1	0.2	0.2	0.0	0.1	0.1
7	0.1	0.0	0.0	0.1	0.0	0.1	0.1	0.0	0.0	0.1
8	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Final Change:	150	24.0	12.0	114.0	26.5	87.4	73.4	14.0	23.5	
Multiplier:	**1.50**	**0.24**	**0.12**	**1.14**	**0.26**	**0.87**	**0.73**	**0.14**	**0.23**	

All estimates shown in this and the following table are based on a model presented in Briguglio L. Multiplier Effects in the Maltese Economy.

In the second round, the process is repeated again, but this time the increase in GNP is Lm33.3, which comes from consumption expenditure in the first round. This would induce further changes in all the other variables. The process is repeated in subsequent rounds, but with every round, the induced changes become smaller and smaller, and by the 8th round they become negligible. If the GNP changes in all the rounds are summed, the final change brought about by an initial change in government expenditure of Lm100, would be an increase of Lm150. This implies a GNP multiplier of 1.5 with respect to government expenditure. The bottom line of the table shows the multipliers of all the induced variables with respect to government expenditure. To take one example, an initial increase of Lm100 in government expenditure gives rise to an estimated increase of Lm114 in personal income (PRS), so that the multiplier effect on personal income is 1.14, as shown in the bottom line of the PRS column.

The following table shows the estimated multiplier effects of a Lm100 increase in exports expenditure. The basic difference between the previous and the following table is that government expenditure is assumed to have an induced marginal propensity to import of zero, whereas the marginal propensity to import, associated with **exports** is taken to be 32%.

Changes in Lm in the Induced Macroeconomic Variables arising from a Lm100 change in EXPORT EXPENDITURE

Round	GNP	CLK	TXE	PRS	TXP	DSP	CSM	SVG	MPT	Increase in next round GNP
1	68.0	10.9	5.4	51.7	12.0	39.6	33.3	6.3	42.7	22.6
2	22.6	3.6	1.9	17.2	4.1	13.2	11.1	2.1	3.5	7.6
3	7.6	1.2	0.6	5.7	1.3	4.4	3.7	0.7	1.2	2.5
4	2.5	0.4	0.2	1.9	0.4	1.5	1.2	0.3	0.4	0.8
5	0.8	0.1	0.1	0.7	0.2	0.5	0.4	0.1	0.1	0.3
6	0.3	0.1	0.0	0.2	0.0	0.1	0.1	0.0	0.1	0.1
7	0.1	0.0	0.0	0.1	0.0	0.1	0.1	0.0	0.0	0.0
Final Change:	101	16.3	8.2	77.5	18.0	59.4	49.9	9.5	48.0	
Multiplier	**1.019**	**0.163**	**0.082**	**0.77**	**0.18**	**0.59**	**0.50**	**0.09**	**0.48**	

Thus, an initial effect of a Lm100 increase in exports would immediately increase GNP by Lm68, and imports by Lm32. This is shown in the first round value of imports of Lm42.7, of which Lm32 are induced by exports and Lm10.76 by consumption expenditure.

The exports multiplier table just presented shows that the GNP multiplier with respect to exports is lower than that for government expenditure, the former taking a value of 1.5 whereas the latter taking a value of 1.019. The reason for this is, as already noted, that exports are assumed to have a 32% import content.

As in the case of government and other expenditures, a change in exports would give rise to multiplier effects on GNP, consumption, imports and other induced variables. For example, the export-import multiplier is 0.48, indicating that after all multiplier rounds are considered, a Lm100 in exports would increase imports by Lm48.

The two tables illustrate the multiplier process with respect to two types of expenditures, namely government expenditure and exports. Similar tables can be constructed to show the multiplier process associated with other expenditures, such as private and public investment expenditures.

Disaggregated Results

It should be noted that the estimates shown in the two multiplier tables just presented pertain to aggregate macroeconomic variables, and show overall tendencies. For example the marginal propensity to import of 32% applies to consumption, investment and exports considered together. These three types of expenditures can be further disaggregated.

Let us for example take exports. Exports of merchandise, such as clothing, tend to have a higher import content than exports of services, such as tourism. This means that Lm100 spent by tourists generates more domestic value added, and therefore more income, when compared to a Lm100 spent on exported clothing. This suggests that the multiplier effects of a given expenditure on tourism are higher than an equivalent expenditure on clothing. The multiplier estimates shown in the last table, therefore, can be regarded as some form of weighted average of the multiplier effects with regard to exports of goods and services taken together.

Similarly, if one were to calculate multiplier effects with respect to investment, one can disaggregate the results to allow for the different import contents of different investment items. In Malta, there are items of investment expenditure with a high import content such as, for example, machinery. Thus a Lm100 spent on machinery would tend to have a low

multiplier effect. On the other hand there are investment expenditures with a relatively low import content, such as construction of dwellings. An expenditure on a dwelling in Malta, therefore, tends to have a high multiplier effect.

Of interest in this respect, is that in Malta the second half of the sixties was characterized by rapid increases in expenditure on construction and the second half of the seventies was characterised by rapid increases in expenditures by tourists. As noted, these expenditures tend to have a relatively low import content and therefore high multiplier effects. It is possible, therefore, that such expenditures were to a very large extent responsible for the fast rates of growth of GNP and of employment registered during these two periods.

Government Expenditure

Government expenditure is of special significance in multiplier analysis. since it is sometimes argued that a government may generate economic growth simply by spending money on goods and services. Therefore some comments on this type of expenditure are warranted here.

It can be seen from the first multiplier table that although government expenditure is assumed not to have an immediate import content, it tends to induce changes in consumption which contain an import content. For example, with respect to the first table, a Lm100 increase in government expenditure induces Lm23.5 in imports, after all multiplier rounds are considered.

Of interest also is that an increase in government expenditure gives rise to an increase in personal, corporate and expenditure taxes. The first table shows that an increase of Lm100 in government expenditure increases personal income tax by Lm27, and expenditure tax by Lm12. It is estimated also that a Lm100 increase in government expenditure gives rise to an increase of Lm4 in company tax, (marginal company tax is not shown separately in the table for simplicity, and is incorporated in the company leakages). This means that a Lm100 government expenditure tends to increase total tax revenue by Lm43, so that the post-tax net government expenditure is about Lm57.

Keynesians and Monetarists

The multiplier process is associated with **Keynesian economics** where the basic policy implication is that increases in exogenous expenditures (such as government expenditure) induce a chain reaction which ultimately lead to increases in economic activity and employment.

This issue is very hotly debated. The most influential opponents of Keynesian economics are the so called **Monetarists** . These take a long-run view of the economy, and disagree with the type of short-run remedies proposed by Keynesians. They believe that in the long run market forces would , by themselves, act as corrective influences on the economy and, if allowed to operate, they would eliminate inflation and unemployment. The most important prescription advocated by monetarists is that money supply should be allowed to expand at a controlled rate, in keeping with the rate at which the economy can grow, but otherwise, government should intervene as little as possible.

This debate is further enhanced by those known as **supply-side** economists. Proponents of the view that output is induced by increased expenditures, are called **demand-side** economists. Supply siders believe, among other things, that tax reductions are the best way to promote long-run economic growth, since this method would stimulate more work effort, and more savings for capital formation.

Expenditures and Excess Demand

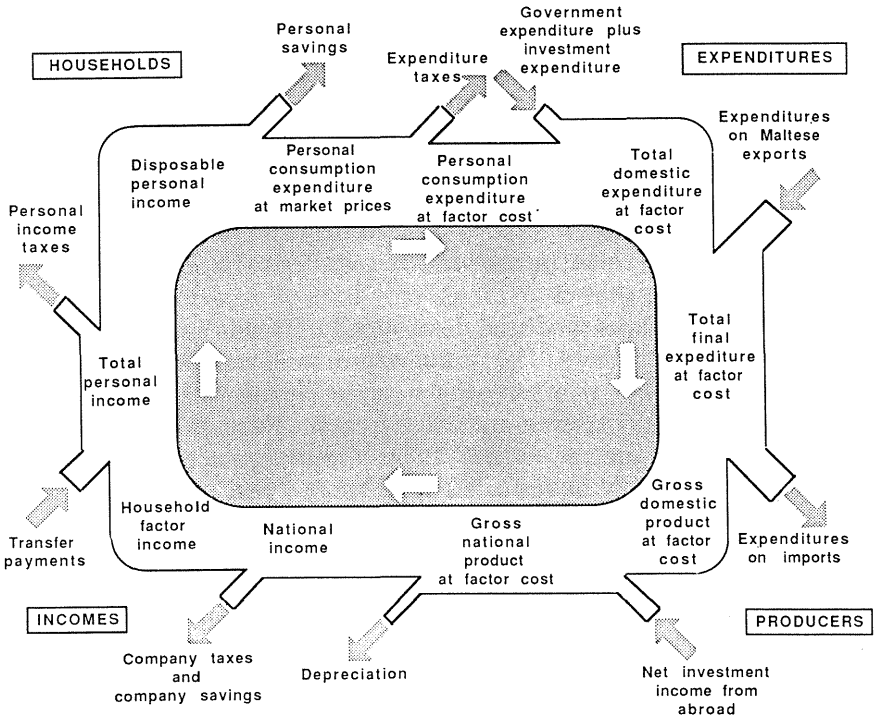
The controversy as to whether or not expenditures are to be resorted to for the promotion of economic growth is not likely to be resolved on a theoretical level. On a practical level, there is some evidence that policies based on generating output and employment through increased expenditures have worked in Malta and elsewhere, especially in periods characterised by unused production capacity.

Such policies, however, may not always have the desired results for at least two reasons. Firstly an increased expenditure may generate more imports than domestic demand. To take the example given in multiplier table shown above, government expenditure would have a GNP multiplier lower then 1.5 if an increase in such expenditure induces additional purchases of cars and other goods with a high import content. In such a case, the marginal propensity to import of 32% would understate the real import leakage, and the multiplier effects would be much lower than those shown in the table.

Secondly, one has to consider the effects that an increase in government expenditure might have on the general price level. If, for example, the increase in demand is not matched by an increase in supply, the end result could well be an inflationary spiral.

In many parts of the Western world, for example, during the seventies there were rapid increases in government expenditures when the economies were already at or nearing full-employment. Some economic analysts attribute the fast inflation rates during that period to the excess demand generated by excessive government expenditures.

THE CIRCULAR FLOW OF INCOME



The diagram summarizes the multiplier flows within an economy. We can start from the left hand side with *personal income*. This is income received by households in the form of wages, dividends, welfare receipts, and so on. A proportion of personal income "leaks" away in the form of *personal taxes* and *personal savings*, and what remains is spent on *consumption* of goods and services at market prices. Subtracting *net expenditure taxes* we get personal consumption expenditure at factor cost. Apart from consumption expenditure by households, we have other expenditures namely *government expenditure, investment expenditure* (on capital goods such as machinery and construction) and expenditure by non-residents on Maltese *exports*. All these expenditures constitute the *total final expenditure*. These expenditures are at the same time income to employees, employers and others involved in the production of goods and services. Not all income receipts remain in Malta's income flow since a proportion of them "leak" away on *imports* of goods and services from abroad. What remains is the *Gross Domestic Product*. This represents what is actually produced by the domestic economy and what is earned by all those participating in domestic production. Part of this is retained by business to pay *taxes* and to *save* for new investment. The remainder is distributed to households in the form of personal income, such as wages, dividends and so on. Households also receive *transfer payments*. from the government and from abroad. Thus we arrive again at personal income. The flow then repeats itself and grows or diminishes according to the size of the leakages or injections within the economy.

8

ECONOMIC CHANGES OVER TIME

The most important structural change in the Maltese economy during the past 30 years was related to the expansion of the manufacturing sector and the phasing out of the British forces bases in Malta.

During the second half of the fifties, it became manifestly obvious that changes in the British defence policies were going to result in massive rundowns of the British presence in Malta, and the need was felt to implement a co-ordinated development plan to diversify Malta's economy.

Development Planning

Between 1959 and 1986, six development plans were launched. Although during this time Malta had governments of different ideologies, the basic objective of successive plans was essentially the same, namely that of making Malta a viable economic unit, which by its own efforts would provide jobs for those who sought them.

To achieve this aim, measures were taken to increase the share of manufacturing, tourism and agriculture in the Domestic Product. Since Malta's internal market is very small, industrial expansion had to be sustained through increased reliance on the export market, and therefore the importance of competitiveness for attaining the plan objectives was always stressed. All plans insisted on the need for adapting of attitudes and of methods of production to the changing structure of the Maltese economy.

The major differences between the planning approaches under different governments were related to the role of the state in directly productive activities. The Nationalist governments believed that state organs should only take a backing role in such activities, whereas the Labour governments held that the state should participate directly, especially where the private sector failed to take the initiative.

The planning process in Malta was beset by a series of difficulties, which were not all of Malta's own making. These included the successive and sometimes unexpected decreases in the British defence expenditures during the sixties, the international energy crisis and unprecedented inflationary pressures during the seventies and the international recession during the early eighties. A satisfactory measure of success has however-

been achieved, and this is evidenced by the growth in the number of the gainfully occupied persons, the expansion of the manufacturing sector, the rise in real national income and the phasing out of dependence on British military services.

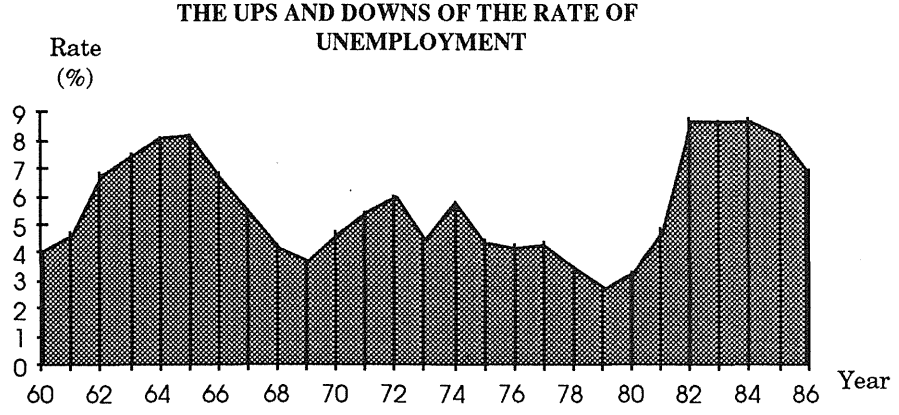
Cyclical Changes

During the past thirty years the Maltese economy experienced a cyclical pattern of change.

The economy performed relatively badly during the first half of the sixties. During this sub-period, emigration and unemployment reached very high rates. The trend was however reversed during the second half of the sixties, a sub-period characterised by very fast growth rates in GDP and employment.

The economy slowed down again during the first half of the seventies. Although between 1970 and 1974, GDP tended to grow, the number of persons employed did not grow significantly, and had employment not been created in government labour corps, the number of persons employed would have actually decreased. Again , this sub-period of unsatisfactory economic performance was followed by another - the second half of the seventies - when fast growth rates in output and employment were registered.

The performance of the Maltese economy between 1982 and 1986 was perhaps the worst during the past thirty years. The rate of growth if GDP was a very slow one. Employment decreased at a very rapid rate – the fastest decline when all sub-periods are considered. Unemployment, on the other hand, increased and reached very high rates. Had the labour force (i.e. the number of people willing to work) not decreased, the official unemployment figures would have been much higher.



The economy therefore performed at its best during the second half of the sixties and of the seventies. The most rapid increase in GDP occurred between 1975 and 1979 and the fastest increase in employment occurred between 1965 and 1969. Probably the most important factors which accounted for the satisfactory performance of the Maltese economy during these sub-periods, were the so-called construction boom during the second half of the sixties, and the rapid increase in tourism during the seventies. These two types of expenditures have relatively low import contents and therefore high multiplier effects on domestic value added and employment.

Structural Changes

The patterns of change just described have been accompanied by changes in the composition of GDP. The following table presents data on the contribution of major sectors during the sub-period under consideration.

It can be seen from this table that the fastest growing sector was manufacturing, which accounted for just 17% in the early sixties and increased to about 33% during the late seventies.

There was a small decline in the percentage share of this sector during the first half of the eighties. A further breakdown of this sector would indicate that the manufacturing sector itself experienced structural changes during the twenty-five year period, with the textile, clothing and machinery industries expanding their relative shares.

The British military establishments on the other hand, reduced their share of GDP from an average of 15% in the early sixties to zero during the eighties. As already explained, this was in line with the development strategy adopted in the Maltese development plans.

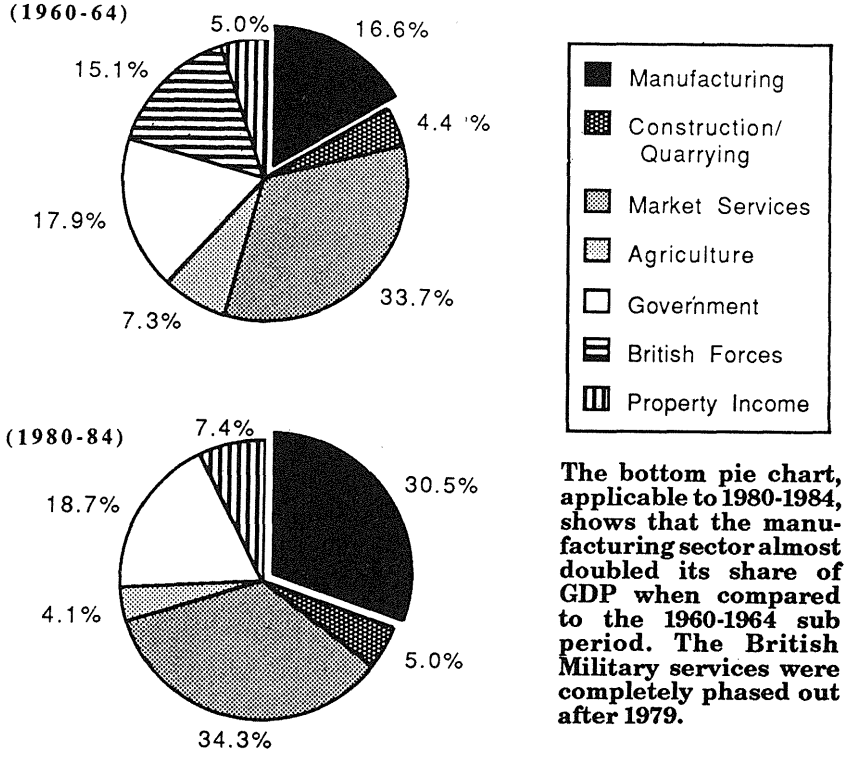
Sectoral Net Output as a Percentage of GDP at Factor Cost. Averages for 1960-1986 and for five-yearly sub-periods.

	1960-64	1965-69	1970-74	1975-79	1980-84	1960-86
Manufacturing	16.6	20.8	24.3	32.7	30.5	25.3
Construction/Quarrying	4.4	4.4	4.2	2.9	5.0	4.2
Market Services	33.7	33.3	30.4	30.9	34.3	32.7
Agr. & Fishing	7.3	7.2	7.2	5.3	4.1	6.1
Public Sector*	17.9	19.8	21.8	19.8	18.7	19.5
British Forces	15.1	9.5	6.3	2.3	-	6.2
Property Income	5.0	5.0	5.8	6.1	7.4	6.0
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

* This covers public administration and public enterprise, but not companies with MDC majority shareholding.

Source: National Accounts

SECTORAL VALUE ADDED AS A PERCENTAGE OF GDP



The bottom pie chart, applicable to 1980-1984, shows that the manufacturing sector almost doubled its share of GDP when compared to the 1960-1964 sub period. The British Military services were completely phased out after 1979.

The changes in the shares of other economic sectors were not as dramatic as those pertaining to manufacturing and the British bases. During the twenty five year period, construction and quarrying contributed an average of 4.2%, market services an average of 32.7% and the public sector an average of 19.5% of GDP. The share of agriculture and fishing averaged 6.1% but tended to decrease during the 25 year period.

The next table shows the changing pattern of the distribution of employment in different sectors. In general, with the notable exception of the public sector, the changes in employment shares reflected the changes in the shares of GDP. For example, the increasing share of the manufacturing output has increased employment in manufacturing from just over 18% of the gainfully occupied in the first half of the sixties to about 32% in the eighties.

Another finding presented in the next table is that female employment as a percentage of total employment increased from just over 18% in the first half of the sixties to about 26% in the second half of the seventies.

The percentage has decreased slightly during the eighties, reflecting the fact that most of the jobs lost since 1981 related to female employment.

Sectoral Employment as a Percentage of Total Employment. Averages for 1960 - 1986 and for five-yearly sub-periods.

	1960-64	1965-69	1970-74	1975-79	1980-84	1960-86
Manufacturing	18.2	21.3	27.0	31.3	31.8	26.3
Construction/Quarrying	8.6	10.7	8.0	4.2	5.8	7.5
Market Services	28.4	29.8	30.4	30.8	31.7	30.6
Agr.& Fishing	8.9	7.3	6.3	6.4	6.4	6.7
Public Sector*	19.6	20.6	22.9	25.2	24.3	22.7
British Forces	16.2	10.3	5.3	2.1	-	6.2
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Male	81.8	79.6	76.0	74.0	75.0	77.3
Female	18.2	20.4	24.0	26.0	25.0	22.7

* This covers public administration and public enterprise, but not companies with MDC majority shareholding.
Source: National Accounts

Female employment tended to increase at a faster rate than male employment between 1960 and 1980. The bulk of the increases in female employment occurred in the manufacturing sector, mostly in the clothing, textile, and electrical machinery industries.

Changes in Total Final Expenditure

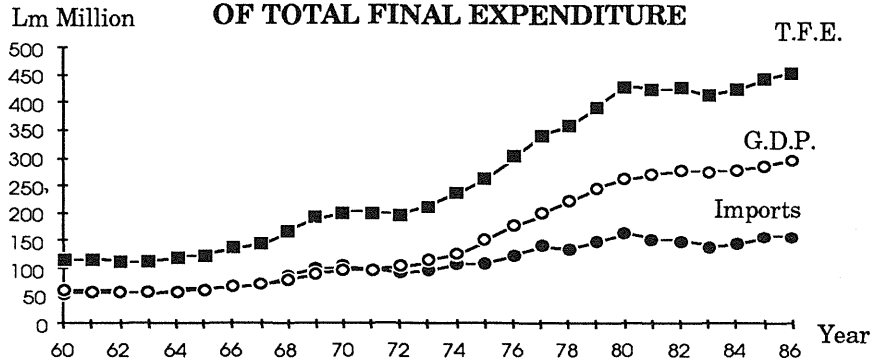
Total Final Expenditure is composed of consumption, investment, exports and government current expenditure. These represent all the possible expenditures on goods and services sold by domestic firms. Total Final Expenditure is composed of an ***imported*** content and a ***domestic value-added*** content. The latter is called the ***Gross Domestic Product.***

Aggregate expenditures in Malta have also tended to follow a cyclical pattern of change. In general, these tended to increase rapidly during the second half of the sixties and of the seventies, and to increase slowly or even decline during the other sub-periods. The type of expenditure that fluctuated most was investment expenditure. Exports, which is an expenditure by foreigners, has tended to increase rapidly during the second half of the sixties and the seventies. This expenditure has tended to decrease during the early sixties and the first half of the eighties.

Over the same period, imports, measured in real terms, tended to grow at a slower rate than total final expenditure during the seventies and the eighties. This means that the import content of total final expenditure

tended to decrease and the domestic value added content tended to increase during these two decades. This tendency has been brought about by the policy of **import substitution** and import controls which have been resorted to with increased intensity since the seventies and up to 1987.

THE IMPORT CONTENT AND THE GDP CONTENT OF TOTAL FINAL EXPENDITURE



The Maltese Balance of Payments

The balance of payments gives a picture of a country's transactions with the rest of the world. It is usually divided into three parts, namely the current account, the capital account and official financing account.

The following table gives a summary of the main entries in the balance of payments during the 1960 – 1986 period. The data is presented as five-yearly averages.

Briefly, Malta has always experienced a relatively large deficit in its merchandise trade, as shown by the trade gap in the table, and a positive but smaller surplus in its services trade. Thus the balance between exports and imports of goods and services taken together (the resource balance) was negative during all sub-periods.

Some Statistics Pertaining to the Maltese Balance of Payments (Averages for six sub-periods)

	1960-64	1965-69	1970-74	1975-79	1980-84	1985-1986
Merchandise Trade	-22.9	-27.1	-42.9	-61.4	-116.5	-113.3
Services Trade	16.6	13.3	15.9	37.8	62.2	47.6
Merchandise + Services	-6.3	-13.8	-27.0	-23.6	-54.3	65.7
Net Investment Income	3.7	5.2	8.6	17.1	41.4	33.4
Transfers	4.2	11.2	24.6	30.6	28.8	26.5
Balance on Current A/C	2.8	2.6	6.1	24.1	16.1	-5.4
Balance on Capital A/C	-1.9	3.7	8.8	18.0	18.6	-11.3

Source: National Accounts of the Maltese Islands.

The bulk of merchandise exports consisted of clothing and textiles, and in recent years electrical machinery has had a major share also. As regards services, the most important sources were expenditures connected with the British forces bases during the sixties. However, during the seventies and the eighties, with the development of the tourist industry, foreign travel and transportation have accounted for a large proportion of foreign exchange inflows from exported services.

The deficits which Malta experienced on trade in goods and services tended to be partially offset by investment income from abroad, the net inflows from which are shown in the table.

Another source of foreign exchange on current account are transfers which consist of remittances and pensions to households and foreign exchange grants to the Maltese government. Considering all these inflows and outflows of foreign exchange, the overall balance on current Account was generally a surplus, as shown in the table.

With the exception of the first sub-period, the capital account has tended to be in surplus, indicating that, on average, capital inflows from abroad offset capital outflows to foreign countries. It should be noted that the outflows of foreign exchange on capital account do not include those by the monetary authorities.

If we add the net surpluses (or deficits) of foreign exchange from the current account to the net surplus (or deficits) in the capital account we obtain the total net surplus (or deficits) in the balance of payments. This residual is computed after all foreign exchange transactions, with the exception of official financing, are considered.

During any one year, this residual constitutes the net additions (or reductions) of foreign exchange holdings of the monetary authorities. As stated, in the case of a deficit, the amount of foreign currency reserves of the monetary authorities decrease in order to finance this deficit. In the case of a surplus, the foreign currency reserves of the monetary authorities increase by the amount of the surplus. Official external reserves of the monetary authorities have tended to grow rapidly during the seventies.

Malta has, in general, enjoyed an overall surplus of foreign exchange inflows. A closer look at the balance of payments statistics would indicate that, in many years, this surplus would not have been possible without official transfers (grants) and borrowing from abroad by the government. This notwithstanding, Malta's external debt is not excessive by international standards.

Major Problems of the Maltese Economy

One disturbing feature of the Maltese economy is its **very small size**. For this reason, it has to rely on exports to produce on a sufficiently large scale.

The smallness of Malta's economy, therefore, renders it completely exposed to what happens abroad. This is why the international recession during the early eighties has had a very large impact on the Maltese economy.

Another weakness of the Maltese economy is its relatively **high import requirements**, particularly in the export oriented industries. One reason for this is that Malta lacks natural resources.

Malta's dependence on imports has, during the seventies and the first half of the eighties, prompted the government to embark on a policy of **strict import controls**. This policy brought about a marked reduction in the import content of total final expenditure, but it has in many instances encouraged inefficient production. At present, there is still a considerable amount of employment which would disappear if import controls are dismantled.

An area of concern is that a very high percentage of exported goods consist of textiles and clothing. In this regard, the advantages of specialisation arising from concentration on a few products has to be weighed against the **disadvantages of having too many eggs in one basket.**

A related problem is that a very large percentage of exported services are connected with tourism. Tourism has had an important beneficial effect on the Maltese economy, in terms of foreign exchange earnings and employment. However, past experience has shown that excessive reliance on this type of service presents a danger in that **the tourist industry tends to be quite volatile.**

As regards exports in general, the major recurrent problem is the need to maintain competitiveness vis-a-vis foreign countries. This touches upon the question of **exchange rate policy**. As is well known, Malta has in the past adopted a policy of tying the Maltese lira to relatively strong foreign currencies. This policy has had beneficial as well as adverse effects on Malta's economy. It has helped to contain the disadvantages associated with imported inflation. But at the same time, it has adversely affected export competitiveness.

On the monetary side, the Maltese economy is characterised by an excessive amount of currency in circulation, in relation to the formal GNP. This is probably due to the tendency to settle certain transactions in cash to evade taxation. This suggests that the **underground economy** is relatively large in Malta. This would seem to indicate also that marginal tax rates in the personal sector are relatively high.

Again, as regards the monetary sphere, the personal sector, the commercial banks and the monetary authorities tend to invest considerable amounts of **funds abroad**. Thus while Malta craves for investment, the Maltese people and their financial institutions look elsewhere to invest

their money.

There are also a number of problems directly associated with the labour market. The major problem in this respect appears to be that of **lack of skills.** This will cause severe bottlenecks in the coming years, unless steps are taken to upgrade the skills in keeping with the development needs of the Maltese economy.

Another problem is that a large proportion of the gainfully employed are in the **public sector**. The public sector tends to be characterised by low labour productivity and its relatively large size in the Maltese economy is probably giving rise to inefficient use of resources. Many economic analysts are of the opinion that the Maltese public sector needs trimming down.

Overall Assessment

Everything considered, the Maltese economy did not fare very badly during the period of time covered in this chapter. An important conclusion that emerges from the trends presented above is that attempts by successive Maltese governments to expand local production, generate more employment opportunities, and to phase out the dependence on British military expenditure were by and large successful.

EMPLOYMENT AND POPULATION IN MALTA
(June 1989)

Labour Force and Population (Persons)

	Total	Males	Females
Labour Force	129773	97444	32329
Employment	125427	93617	31630
Unemployment	4526	3827	699
Population	350394	172865	177529

Number of Persons Employed by Sector

Private Direct Production	**36484**		**29.1%**
Agriculture and Fishing		3117	
Quarrying and Construction		5025	
Manufacturing		28342	
Private Market Services	**32486**		**25.9%**
Wholesesale and Retail		12384	
Insurance and Real Estate		980	
Transport and Communication		5399	
Hotel and Catering		7217	
Others		6506	
Public Sector	**47181**		**37.7%**
Government Departments		25523	
Armed Forces and Airport		1754	
Public Corporations		8910	
Govt/MDC Controlled Coys.[1]		10994	
Temporary Employment[2]	**9096**		**7.3%**
TOTAL	**125247**		**100%**

Source: Economic Trends, June 1989

[1] Employment in Goverment/MDC controlled companies includes Direct Production employment (4735 persons) and Market Services employment (6259 persons). In some official publications, such employment is included with the private sector.

[2] Temporary employment includes Apprentices and Trainees, Pupil and Student Workers, Auxiliary Workers, and members of Dejma. It is therefore essentially public sector employment.