DETERMINING THE UNDERLYING CAUSES BEHIND THE RECENT SHIFT IN MALTA'S CURRENT ACCOUNT POSITION

BOX 5: DETERMINING THE UNDERLYING CAUSES BEHIND THE RECENT SHIFT IN MALTA'S CURRENT ACCOUNT POSITION[1]

The current account of the balance of payments is a key economic indicator closely followed by policymakers. There are two broad ways of conceiving it: either as the difference between what a country exports and what it imports, or else as the difference between national savings and investment. Past research on Malta's current account has focused on assessments of sustainability[2] and on the role of the private and public savings gaps in driving its development.[3] More recently, the analysis has focused on the impact on the current account of the emergence of high value-added export-oriented services sectors.[4]

Over the last two decades, the Maltese economy has shifted from having a very high current account deficit to forming part of the group of above-average surplus European Union (EU) countries. Malta's current account position has improved by 11.9 percentage points of GDP since 2009, the largest improvement amongst euro area countries and about four times the change seen on average. In 2014, Malta's surplus even surpassed that observed in the Netherlands, the EU country with the most consistently high surpluses since 1995. This is quite a turnaround given that in the late 1990s, the Maltese economy tended to have higher deficits than Greece, the EU country with the worst average current account performance over the last two decades. That said, as can be seen in Chart 1, even Greece has experienced a significant improvement after the financial crisis. However the rebalancing in the external accounts in the case of Malta differs significantly, and appears to be mostly of a structural, rather than a cyclical nature.

The change in Malta's current account was, in fact, mainly driven by the rapid growth of exports, which resulted in the services surplus rising by 11.0% of GDP since 2009. On the one hand, the traditionally strongest services sector – tourism – has experienced a steady increase, accounting for nearly half of this improvement. On the other hand, the financial services sector, after exceptional surpluses between 2008 and 2011, appears to have settled to much lower levels. This development was offset by other services sectors, notably remote gaming, maintenance & repair, telecommunications and computer & information

Chart 1
MALTA'S CURRENT ACCOUNT POSITION VIS-À-VIS THAT OF LARGEST SURPLUS AND DEFICIT COUNTRIES IN THE EU
(% of GDP)
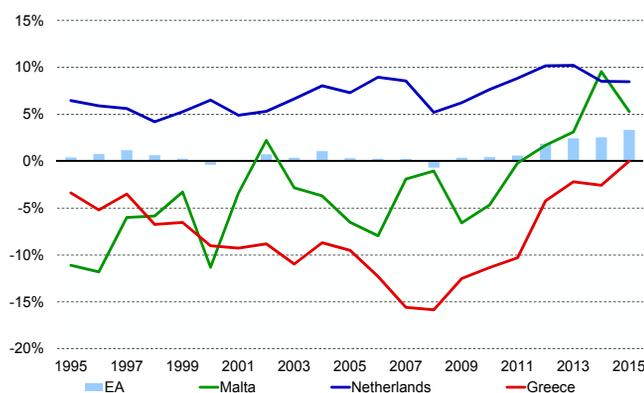
Source: Author's calculations using Central Bank of Malta macroeconomic time series database and AMECO.

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[1] Prepared by Dr Aaron G. Grech, Chief Officer – Economics. The views expressed in this Box, which are a summary of a broader article by Grech, A.G. and Rapa, N. (2016), Trends in Malta's current account and their underlying causes, *Policy Note*, Central Bank of Malta, are the author's own and do not necessarily reflect the views of the Bank.

[2] Demarco, A. (1999), Measuring current account sustainability. *Quarterly Review*, Central Bank of Malta March 1999.

[3] Grech, A.G. (2000), The private and public saving gaps in Malta and their impact on the current account. *Quarterly Review*, Central Bank of Malta March 2000.

[4] Grech, A.G., Micallef, B. and Zerafa, S. (2016), Diversification and structural changes in the Maltese economy, in A. G. Grech (ed.) *Understanding the Maltese Economy*, Central Bank of Malta, Valletta.
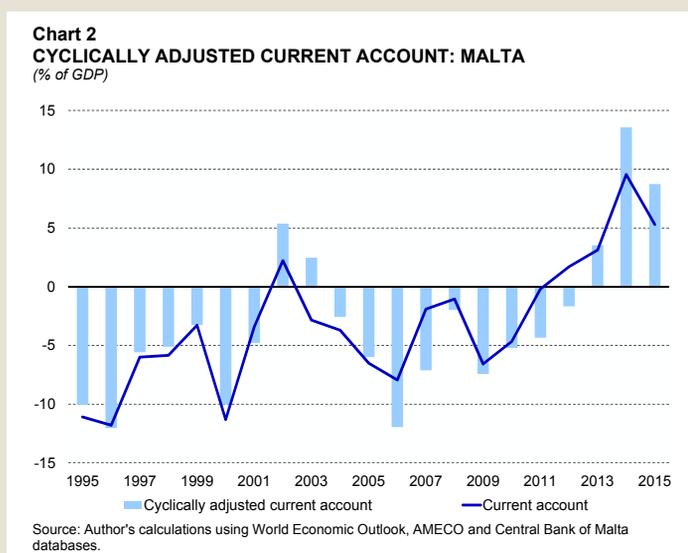
services. These sectors, as evidenced by the continued rise in their employment, are now generating substantial export revenues.

Estimating Malta's cyclically adjusted current account position
To understand better the causes of external accounts rebalancing, economic literature has focused on the calculation of cyclically adjusted current account positions.[5] This involves adjusting a country's level of imports and exports to reflect respectively its potential domestic output and that of its trading partners by means of given elasticities. This is done to account for the influence on the current account of import compression during recessions and the impact on exports of foreign demand cycles.

Besides issues relating to the calculation of potential output estimates, debate on cyclically adjusted current account positions has focused on the assumed income elasticities. For instance, the European Commission's methodology assumes a common income elasticity of exports and imports equal to 1.5 for all countries.[6] While this has all the benefits of a harmonised approach, a number of studies have instead advocated calculating these elasticities separately and empirically.[7] In fact, if one adopts the latter stance, Malta's long-term income elasticity for exports stands at 1.33, while that for imports is 1.25. These estimates were applied to measures of the output gap for Malta and its trading partners.[8] While Malta's economic cycle broadly tracks that of its main trading partners, in recent years there was quite some difference in the relative cyclical position, with Malta experiencing a smaller drop in activity in 2009 and its output gap turning into a significant surplus in the last few years. This implies that the cyclically adjusted current account position should exceed the unadjusted position. On the one hand, Malta's exports would be higher if its trading partners were not currently operating below capacity. On the other, imports would be lower if Malta's demand were closer to its potential level, rather than being substantially above. The impact of the first factor is, of course, higher than the impact of the second, because exports are a larger share of GDP, while the income elasticity of exports is higher than that of imports.

Chart 2 plots the cyclically adjusted and the unadjusted current account position for the Maltese economy over the period 1995 to 2015. The two measures track closely each other, with only

Chart 2
CYCLICALLY ADJUSTED CURRENT ACCOUNT: MALTA
(% of GDP)

Source: Author's calculations using World Economic Outlook, AMECO and Central Bank of Malta databases.

[5]   For instance, see European Central Bank (2014), To what extent has the current account adjustment in the stressed euro area countries been cyclical or structural? *Monthly Bulletin* Box 5, ECB January 2014.
[6]   Salto, M. and Turrini, A. (2010), Comparing alternative methodologies for real exchange rate assessment. Economic Papers 427, European Commission.
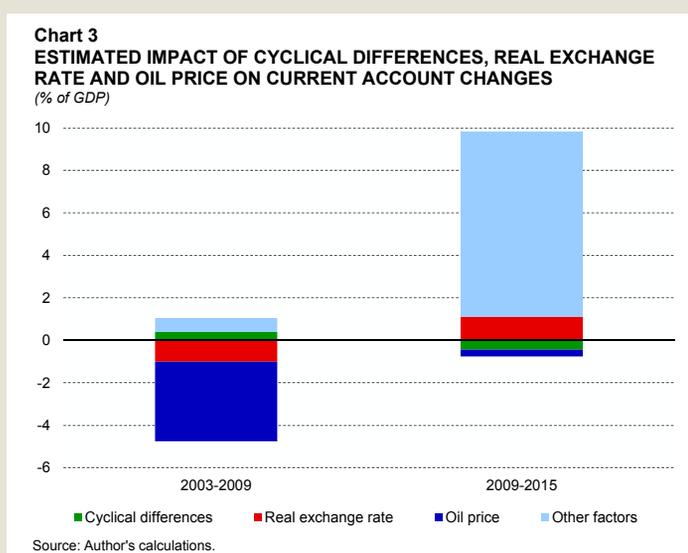[7]   For example, Fabiani, S., Federico, S. and Felettigh, A. (2016), Adjusting the external adjustment: cyclical factors and the Italian current account. *Questioni di Economia e Finanza* No. 346, Banca d'Italia.
[8]   The Maltese output gap estimates are derived using the method described in Grech, A.G. and Micallef, B. (2016), Assessing potential output growth of the Maltese economy using a production function approach, in A.G. Grech (ed.) *Understanding the Maltese economy*, Central Bank of Malta, Valletta. The estimates for Malta's trading partners are derived as a composite of output gaps for EU countries derived from the AMECO database and those for non-EU countries taken from the World Economic Outlook database. The individual country cyclical positions are then combined using weights reflecting the relative share of that country in Malta's total exports of goods.

some minor exceptions. In view of the assumptions that needed to be taken when computing the cyclically adjusted measure, such as relying on estimates of unobservable variables such as output gaps and assuming time-invariant income elasticities, an attempt was made to compare these findings with those of other institutions. The European Commission estimates that between 2007 and 2015, under unchanged cyclical differences, Malta's current account position would have improved by an additional 6.9 percentage points compared to its observed change.[9] This is similar to the results in Chart 2, where over the same period the adjusted current account improved by 15.9 percentage points, as against nearly 7.2 percentage points in the unadjusted position.

Besides cyclical demand factors, some studies[10] argue that temporary changes in real exchange rates and oil prices can be big causes of external rebalancing. While both of these factors are very important in Malta's case, reflecting the economy's stronger reliance on imported oil and the relatively higher price elasticity of foreign trade, they do not explain most of recent developments. Chart 3 illustrates the impact of these factors in explaining the change in the current account during two distinct periods, namely the years between Malta's EU accession and the onset of the financial crisis, and the years following the financial crisis.[11] In the first period, Malta's current account position deteriorated by 3.7 percentage points of GDP. This mostly reflected rising oil prices, though the appreciation in the real exchange rate also contributed to widen the deficit. On the other hand, cyclical differences reduced the current account deficit slightly during this period. Other (structural) factors also contributed positively to the current account, but were the third most important factor during this period. By contrast, these factors appear to account for nearly the entire improvement in the current account position in the post-financial crisis years. Changes in the oil price and in cyclical differences, in fact, offset most of the impact induced by the improvement in the real exchange rate.

One of the structural factors driving the change in the current account appears to be the improvement in the energy intensity of the Maltese economy. Whereas in 2005 it took 162.8 kg of oil equivalent to generate €1,000 of GDP, by 2014 this had fallen to 118.7, or more than a quarter less.[12] In fact, while in 2005, Malta required nearly 9% more oil than the EU average to generate the same amount of economic output, it now needs 3% less than the EU average. This turnaround reflects a number of developments, notably the reduced importance of exports of goods (which fell by nearly 17% in their relative significance over the same period) and the improvement in the efficiency in the generation of electricity.

Chart 3
ESTIMATED IMPACT OF CYCLICAL DIFFERENCES, REAL EXCHANGE RATE AND OIL PRICE ON CURRENT ACCOUNT CHANGES
(% of GDP)

Source: Author's calculations.

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[9]   European Commission (2015), Rebalancing in the euro area: An update. *European Economic Forecast,* Spring, Box 1.3.

[10]   Haltmaeir, J. (2014), Cyclically adjusted current account balances. *International Finance* Discussion Papers No. 1126, Board of Governors of the Federal Reserve System.

[11]   For a technical discussion of this decomposition, see Grech, A.G. (2016), Trends in Malta's current account and their underlying causes. *Policy note*, Central Bank of Malta December 2016.

[12]   Eurostat (2016), *Energy, transport and environment indicators: 2016 edition.*

More broadly the changing composition of the Maltese economy, with the strong shift to services, is leading to a general reduction of Malta's import intensities; while at the same time, the local work force is being used more in export-oriented businesses. For instance, while the share of the workforce employed in public administration fell from 10.0% in 1995 to 8.2% in 2015, that of the arts, entertainment and recreation sector (which includes remote gaming) rose from 0.8% to 3.2%. This shift towards export-oriented high value-added activities has led to a significant improvement in corporate and household saving, with the national saving rate rising by nearly 9 percentage points since 1995. About a third of the latter increase also reflected a recovery in Government saving.

These trends, combined with the lesser reliance on gross fixed capital formation of the growing sectors of the Maltese economy, appear to be the main causes behind the recent improvement in the current account position. Table 1 compares sectoral changes between 2006 and 2015 in ratios to GDP of investment, gross value added and gross operating surplus. Industry and transportation & storage are the only two sectors to have seen a significant increase in their investment ratio, and in both cases their gross value added is lower in relative terms than it was in 2006. This could imply that the sectors are restructuring towards more capital-intensive modes of production. Accommodation & food services and, to a certain extent, information & communications have increased investment in line with developments in their activity; while agriculture and financial services have lowered investment less than the relative drop in their value added and operating surplus. The services sectors which are increasing their share of economic activity, such as remote gaming, professional services and administrative support, are doing so without significant changes in gross fixed capital formation.

This suggests that if these export-oriented services sectors continue to grow, while national savings stay stable, it is highly likely that Malta's current account could remain in surplus over the coming years. While this surplus could be invested abroad, another potentially more welfare-enhancing option would be to increase investment in education and other activities that improve Malta's human capital, while also boosting spending on infrastructure. This would help sustain the pace of economic growth seen in recent years.

Table 1
CHANGE IN RATIO TO GDP (%) OF SELECTED NATIONAL ACCOUNTS COMPONENTS BY SECTOR (2006 to 2015)

	Gross fixed capital	Gross value added	Gross operating
Agriculture and fisheries	-0.18	-0.82	-0.48
Industry	2.51	-4.46	-0.21
Construction and real estate	-3.41	-2.50	-1.32
Wholesale and retail	0.04	-1.17	-0.14
Transportation and storage	3.42	-0.25	0.18
Accommodation and food services	0.32	0.12	0.84
Information and communication	0.48	0.84	0.36
Financial and insurance services	-0.11	-1.26	-1.92
Professional, technical and administrative support	-0.40	3.34	1.19
Public administration, education, health and social work	-0.60	-0.06	-0.19
Arts, entertainment and recreation; other services	0.06	7.19	6.00

Source: Author's calculations.