MALTA'S SMES IN THE EU: NEW REALITIES AND OLD STRUCTURES

The fourth of five principles on which the Maltese government plans to project its policies for the coming years, as expressed in the President's Address on the occasion of the opening of the tenth Parliament, focuses on work and the economy. It is the 'need for innovation and a spirit of enterprise that is geared towards the European market, though mindful of the specific responsibilities of all, Government included'. (p.4)

Government views a 'strong economy' as a prerequisite for the enhancement of education and culture, the environment, both natural and manmade, and social policy. 'The European single market and technological developments are simply means to achieving wealth in common in which all may share. Government's role in all this is merely that of regulator and strategist'. (ibid.,p.9)

Small and Medium sized Enterprises (SMEs) in Malta will have to bear the brunt of whatever policies are implemented. They will either flourish, wither away, or be reconstituted. The Maltese economy is made up of a

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relatively large number of establishments that employ few people. Out of 24,340 enterprises, only 47 establishments employed more than 200 persons in December 2000. On a sector basis, about 60% of micro units fall in the services sector. They are strongly represented in the wholesale and retail trade, transport, community and business services, personal services and catering and recreation. Small firms make up the agriculture and fisheries industry while nine out of ten units in the construction and manufacturing sector are classified as micro units. Distributions of sectoral contributions to the Gross Domestic Product, in absolute and relative terms, are given in Annex 1.

According to the Commission Recommendation 96/280/EC SMEs are units having less than 250 employees and a turnover not exceeding Euro 40 million or a total asset value not exceeding Euro 27 million. Small enterprises are those that have fewer than fifty employees and a turnover not exceeding Euro 7 million or a balance sheet value not exceeding Euro 5 million.

SMEs in the present fifteen EU member states represent around 99% of enterprises; there are 19 million units employing more than 74 million people. In the ten acceding countries, SMEs account for 72% of total employment. Therefore, after May 2004, small businesses will continue to be the source of economic growth, employment generation and competition in the enlarged European Union.

SMEs in Malta are said to 'face various obstacles as regards access to finance, in particular, the low availability of funds for start-ups, the capacity of currently uncompetitive enterprises to restructure and the growth of appropriate technology and innovation in small companies'.

(Ministry of Foreign Affairs, 2002: 205) It is government's industrial policy to back up entrepreneurial promotion and development. It is meant to support initiatives leading to increased international competitiveness in the consistent pursuit of additional value creation and enhancement (Ministry of Foreign Affairs, 2002:203)

At the same time it is acknowledged that larger companies may be the best placed to gain from the international division of labour that goes with single market membership as they can benefit from distance related transaction costs. But there are few large companies in Malta! In turn, the impact of membership on SME companies will depend on the kind of increased competition they face in the single market. They may profit from the secured enlarged markets provided that they have the capacity and the willingness to be innovative. They have to adapt their strategies to the new environment. This same survival criterion applies also, in the long run, for micro and small enterprises.(Metco, 2003: 11)

Similar ideas as those expressed in the official documents cited above are incorporated in the document *Prosperity in Change – The Way Forward: National Industrial Policy* published earlier this year by the Ministry for Economic Services. Therefore, one may claim that policy makers have a clear view of what lies ahead and so should individual operators and private sector organisations representing employers, employees or self-employed. All that they have to do is to read the said documents! But there is always a nagging thought that a miss may arise somewhere in the process of translating ideas expressed in official documents into everyday reality. Implementation is carried out within a historical framework that conditions attitudes, aspirations, operational manoeuvrability, and policy tools available for those who drew up the documents in the first instance.

After all, official policy documents regularly pronounce Malta's industrial objectives. Yet, private sector organisations keep repeating either that the policy and/or strategies are not well defined, or that such policy pronouncements notwithstanding Malta's competitive edge is being progressively eroded. This latter observation was the hallmark of a document entitled *Value 2000* published in 1998 by the Forum for a Better Economy, the predecessor of the present Malta Council for Economic and Social Development. *Value 2000* claims that:

"Malta's international competitiveness is being eroded. Urgent action is required to put all society's resources behind building superior competition. Malta needs to build on its strengths, its unique features, translating them into 'value' to its customers: Malta can no longer afford to compete on costs and lower wages".(Executive Summary, par.9,13.)

Five years later, in a press release announcing the closure of its plant in Malta, WET Automotive Systems AG indicated that 'the decision to relocate came after immense cost pressure from car manufacturers… The Malta operation was in fact the most efficient, flexible, productive and leanest of the Group with the highest quality standards. However, *the manufacturing costs were the highest and hence had become internationally uncompetitive*'.

The observations quoted from *Value 2000* were made at a time when the Maltese government was not seeking membership of the European Union. Malta will become a member of the EU on May 1, 2004 and will belong to the Single Market and adopt the EU's stability and growth pact

conditions. Hence, the present and future economic realities must be clearly spelled out and their connotations for profitable trade opportunities understood by all. As the EU's economic area grows and its political structure evolves, it will no longer make policy sense to talk of Malta's economy as if it were an independent entity but, rather, to think in terms of the EU economy with the Maltese Islands being a region within such an economic space. Malta's performance in the world economy will be heavily conditioned by the EU's role in world trade responding to global geo-political strategies and currency movements.

Two historical realities serve as a backdrop to the ensuing observations, one demographic and one fiscal. The Maltese population will grow over the coming two decades, reaching 400,000 in 2025 but will thereafter fall if the present fertility trends persist. The population is projected to be 360,000 in 2060! The Maltese aged 15 to 64 numbered 259,700 in 2001; projections see them falling to 250,700 in 2025. Therefore, there will be an ever-increasing dependence on productivity growth to support an expanding dependent group, especially those aged seventy-five years and over. (Delia, 2003) However, the total population including foreign residents is already close to 400,000. What it will be in two decades time will depend on intra-EU migration i.e. migration between the Maltese Islands and the rest of the then enlarged European Union, and, also, to international migration, especially immigration. Malta's labour supply is already being supported by the inflow of foreign manpower to meet the demand for workers in specific sectors like construction.

Besides, the Maltese economy has been run for many years under a system of artificial prices. It had dual exchange rates; subsidised interest rates; sticky prices for water, electricity and gasoline; subventions for the construction and repair of ships; subsidised welfare programmes, and income support through employment in the public sector and in those sectors that depend exclusively for their earnings on government contracts. Subventions even distort the 'meaning' of key economic parameters: Lm31.9 million out of a projected capital outlay of Lm97.7 million for fiscal year 2002, Lm31.3million out of Lm106.3 million for 2003, and an estimated Lm20.6 million out of a projected Lm 126.7 million for 2004, are actually subventions that support industrial activity, often loss making firms. Such resource injections do not add to the capital stock of the country. (Budget Office, Malta, 2003: 28, 33, 38)

Of course, such a price support structure is not unique for Malta; most countries have similar set up. Witness the EU's Common Agricultural Policy, for example, or the support by the US government given to the steel industry or agriculture. But it implies that many prices of intermediate inputs and final services have to be changed before it may be claimed that micro and macro decisions are conducive to sustainable economic growth and to the diversification of the economy in accordance with market forces.

This presentation is made up of four sets of observations: a review of the evolving world trade order, ideological underpinnings and currency considerations; the significance of the terms 'competition' and 'enterprise'; a review of the economic/financial developments related to the move towards the single market that will condition traders and consumers in the coming three years and beyond; and, finally, some remarks regarding possible behaviour by local or locally based entrepreneurs.

1. An evolving world trade order, ideological underpinnings and currency considerations

The main trading blocs, the USA, the EU and Japan, altogether representing around 60% of the world's production, have been searching for a global trade order that, in theory, should one day lead to a more open trade environment for all supported by an international foreign exchange market that responds fairly quickly to the envisaged future trade and capital flows. Multilateral rather than bilateral trade arrangements were encouraged. Yet the recent failure to advance on such front at the World Trade Organisation meeting in Cancun will possibly reinforce bilateralism based on wide-ranging free trade associations hovering around the EU, the USA and China and spanning across wide geographical areas rather than growing in wider concentric circles around a particular economic nucleus. Thus, the United States is seeking to extend free trade arrangements beyond the American continent. Yet, at the same time, US policy makers are giving in to domestic pressure groups in industry and have been imposing tariffs – say, on steel from the EU – and quotas – on several types of textiles and clothing from China – in order to protect the home producers.

The growing importance of China in world trade following the massive inward surge of foreign direct investment could trigger a return to wide protectionism in the triad EU-USA-Japan at a time when these three economies seem to be relatively weak to stimulate global aggregate demand. China seems to be an ideal location for labour-intensive manufactures; it can be regarded as a competitive new supplier with large labour resources.

China is a low-inflation country, with fast rising productivity and huge foreign exchange reserves. It is being urged by the main world economies to assume a global leading economic role starting by allowing its currency to float rather than keep it pegged to a soft US dollar.

The EU is not considered to be for the time being a prime booster of global demand. Worse, with a weakening dollar and the pegged yuan renbimbi, and with repeated intervention by the Japanese monetary authorities to keep the yen low, the euro and the British pound could become stronger than desirable stalling the resurgence of export growth particularly for Germany, which makes up around 30% of the value added of the present fifteen member states

The EU's reaction to this emerging trade-currency situation is now Malta's reaction. And any trade decision by, say, the USA directed at the EU will be also directly addressed to Malta's trade. As long as Malta retains its currency and the present currency basket composition, there could be a temporary respite in carrying out trade strategies in so far as prices are involved. But this respite period is measured in months. As explained below, the continued life of the present currency basket composition is bound to be short and Malta based economic activity will be constrained by this wide international trade canvas and a floating euro.

The EU itself is still growing up to the idea of one 'internal' single market, the focus of all policy thinking of the 'technocrats' in Brussels. In principle, the single market is merely an offshoot of the liberal view of a multilateral free world trade vision. The EU's single market represents one of the world's free trade blocs going further because it encourages the movements of personnel and capital. In

reality, the member states continue to think in terms of 'domestic' markets and 'local' producers and plan resource allocation accordingly. Indeed, some analysts are even proposing the formation of a global Free Trade Association with the United States and the United Kingdom as charter members. Such a plan requires the UK to shift its politico-economic focus from Europe and focus on its 'special relationship' with the United States. (Hudsman, 2001)

Such a frame of mind contributes to an economic anomaly: while movements of capital and people in, say, the USA and China – with its 1.3 billion citizens– are fairly freely unrestricted, such movements are 'circumscribed' in the EU through certain members' vetos on labour movements or the adoption of currency units other than the euro. Indeed, Mr. Gordon Brown, the British Chancellor of the Exchequer was quoted as claiming that 'the old road going from the single market to single currency through tax harmonization to a federal fiscal policy won't yield the success we want to see'. (*Financial Times*, November 5, 2003:2) implying that every member state may adopt whatever policies may suit it. In such an environment, a 'protectionist' mentality will not refer to the expanding EU market but rather to a particular 'national' market, say, the Italian or French, which will go against the very idea of a single market.

Maltese SMEs have to 'adjust' to this seemingly unclear economic vision of what constitutes "the single market", as if there are not enough problems already clarifying the role of different market structures with the aim of stimulating competition in the interest of all – producers, traders and consumers. At the same time, there are conflicting signals regarding the future role of the State in the EU countries and the concomitant role of different legal forms that private sector industries could profitably adopt. The long debate on maintaining a balance between economic efficiency/growth and the distribution of income and wealth is getting longer for several reasons.

Firstly, the economic space and, therefore, the ultimate beneficiaries of wealth creation, is not known: one refers to a single market that spans international frontiers but still thinks 'national". Thus, the basis for resource allocation is not the *entire* EU economic space but rather a *specific* region, for example, the Island of Malta with its present set up of production units and services providers. This point of departure often leads to an exercise in supporting and enhancing the status quo. Such an approach may be realistic in the medium term, especially if reforms lag behind, but it is not in the interest of the long-term development of the wider economic space with its resources. It could be that the obfuscated economic vision that is guiding decision making in the European Union has led to the observed result of 'Europe growing so slowly over the last few years' against the more robust performance of the United Kingdom, a fact noted by the UK's minister of finance. (*Financial Times,* November 5, 2003:2)

Secondly, policy makers want to assume a role of regulators but remain "mindful of their specific responsibilities"- as the quotes from the Maltese President's address indicate. This ambivalence, perhaps, is an offshoot of the dual objectives given to public corporations under an asset-ownership system in which public ownership was a specific policy objective – be profitable but at the same time generate work.

Thirdly, a liberal vision of world trade keeps clashing with an interventionist attitude rendering progress in trade talks slow both at international fora and even between members of free trade areas and customs unions. International cooperation in world fora is dictated by the thrust and pace determined by government officials. These generally favour multilateral approaches that involve slow decision-making, free riders, hazy goals and a strong fervour for national sovereignty.

Finally, the effectiveness of stakeholding capitalism is being reconsidered: managers are evolving into strong power wielding forces compared to a company's shareholders, especially after part remuneration in shares is in place. In the absence of transparent and reliable recording of decision making in capitalist firms, this form of ownership vehicle that was meant to spearhead economic growth and enlist the support of thousands of small savers is seen faltering in achieving its desired objective. The true owners of the firm, the shareholders, will be 'deprived' of their power and, possibly, wealth by those engaged to administer the day to day business. The role of executive board members is under scrutiny as well as the role of financial and company regulators. Moreover, with the collective involvement of many small savers, via pension / saving funds, the power of capitalist support is being taken from the actual providers of capital to those relatively few that manage the accumulated funds.

The legal form and the place of registration that Maltese SMEs will adopt for their survival in the future will depend on the social vision and economic/financial incentives that will prevail in the 'single market'. Sole traders, cooperatives, private companies, public companies seeking listing in

Malta and/or elsewhere – these unit format will be influenced by whatever trade and fiscal measures are in operation in the entire EU space. Even the official registration of the unit will be influenced by the legislation that prevails in the respective member states. For example, it is being observed that more German entrepreneurs are setting up under UK company law with a UK address. They are adopting the British 'Limited' as a legal shell for their SMEs. The attraction of the British model is that it does not carry a minimum equity requirement while the German GmbH – short for Gesellschaft mit beschrankter Haftung, or limited liability company – must have at least euro 25,000. In addition, the German companies will benefit from lighter British bureaucracy and lower registration costs and, at the same time, look forward to tax savings. (*Financial Times*, November 4, 2003:9)

In turn, the company format chosen may influence the units' abilities to relate to the myriad sub-markets in which they can potentially operate. The smaller the unit, the quicker it could act but the weaker could be the response: technical or/and financial clout will be limited.

In sum, the way in which Maltese operators consider the local (Maltese) market and the entire 'single market' will condition the future search for trade segmentation and collaboration with partners in the EU and outside. Besides, the role of the state and the legal economic unit preferred, in terms of which trade is carried out, will also influence future production alliances and direction of trade. It is on these two basic tenets that the roles of competition and entrepreneurship have to be addressed.

2. Competition, Entrepreneurship and the Evolution of Malta's SMEs

For a country, competitiveness implies the viable, profitable production and sale of goods and services in an open trade environment. Sustaining an economy's output through tariff and non-tariff barriers gives rise to weak economic positions that have to be addressed before economic growth can be achieved. Output and the derived demand for factor inputs can only be regenerated if an economy successfully faces the challenge of "free and fair market conditions". Otherwise a false sense of economic security creeps into the production and distribution system and will demand the continuous support of regulations, including import control, for the system's survival.

It is not easy to identify the factors that induce competition. Various explanations have been proposed to describe the success of some countries in international trade. These include: macroeconomic phenomena, such as depreciating exchange rates, low interest rates and low government budget deficits; labour market factors, namely, cheap and abundant labour supply; bountiful natural resources, government industrial policies which target certain industries for development and assist them through protection, export promotion and subsidies; and, management practices, including labour-management relations.

The variety of explanations suggests that the search for competitiveness may be futile, because the notion itself eludes a general explanation. Reasons behind the success of industrial sectors in particular countries change over time. To avoid vain searches for the competitiveness of countries it is best to focus on people and their productivity.

Productivity may be defined as the change in output per unit of factor input: it refers to labour, capital and land. It is the main determinant of a country's living standard and income per head. The productivity of human resources determines their wages, while the productivity with which capital or land is employed determines the return it earns for its holders. High productivity supports high levels of income for workers, capitalists and rentiers, expands output and thereby the tax bases on which state provided welfare programmes can be supported, and allows all producers to choose between work and leisure. Data for the manufacturing sector in Malta do not suggest high productivity gains per worker over the past decade. They show erratic productivity behaviour with the result for 2003 estimated to be 105 with 1995=100. (See Annex 2)

The attainment of high productivity demands a large market and, therefore, international trade. Trade increases the welfare of all participants, even those with lower productivity than their trading partners. A country that is less productive than its trading partners across the board will be forced to compete on the basis of low wages instead of superior productivity. Therefore if a country does not want to compete on low wages, as seems to be the case for Malta, it must compete on productivity, on added value.

No country can be competitive or net exporter in everything. Its human and capital resources are limited. The ideal, therefore, is to use those resources in the most productive way possible. The export success of industries

with a competitive advantage will push up the cost of labour inputs and capital making other industries uncompetitive. As a result market positions in some segments and industries will be lost if the national economy is to prosper. Saving the existing system of production will not work forever. Intervention through subsidies maintained for an indefinite period will only slow down the upgrading of the economy and curbs the country's long-term standard of living.

The answers to queries on productivity are not found at the national level. They are obtained from industries and industry segments. The human resources most decisive in international competition must possess specialised skills. These are not the outcome of the general level of education but of a process closely connected to competition in particular industries. Producers learn how to gain competitive advantage if they live in a dynamic and challenging environment that stimulates and prods firms to upgrade and widen their advantages over time.

It need hardly be pointed out that operating in an economic environment where political patronage could be conducive to the artificial creation of monopolies or collusive practices, especially in a very restricted home market which a community of 400,000 would represent, will not lead to the maximisation of productivity growth. It leads to short term calculus, to situations where profits and asset appreciation are maximised as fast as possible ignoring long-term considerations. New conditions have to be created wherein firms could seek competitive advantage with a chance of success. It is the operating environment that forces firms to change. Producers seldom change spontaneously.

Porter (1990) defines the conditions which induce competition as follows: a home base which allows and supports the most rapid accumulation of specialised assets and skills; a home base which affords better ongoing information and insight into product and process needs; situations when the goals of the owners, managers, and employees support intense commitment and sustained investment.

For Malta, the "home" base will now become synonymous with 'the single market'. With the liberalisation of trade, more sectors will be exposed to pressure from competitors forcing decisions relating to the form in which sectoral activity could survive. Again, an environment in which production decisions are totally absent, as has been the case of public sector organisations in Malta, cannot be considered conducive to an "intense commitment" to investment programmes directed to improve value added per worker over time. It will merely represent higher commitments, higher wage bills and therefore either higher charges or higher subsidies. Higher charges mean increased input costs for users; higher subsidies demand a rise in taxes or public sector borrowing.

A country's comparative advantage in specific sectors may change over time, or it may be consolidated. Thus, research on the Manufacturing sector suggests that the growing internationalisation of the production process and trade means that manufacturers sell products to foreign markets, use foreign made inputs, and compete with foreign manufacturers in domestic markets through imports. Even defining 'external orientations'- a country's industrial reliance on international markets – is becoming a complex issue. However, it seems that export shares in the main

industrial producing countries tend to be high in the same industries irrespective of the country in which they are produced: these industries are electrical machinery, non-electrical machinery, transportation equipment and instruments related products. Besides, industries that rely heavily on imported inputs differ sharply from country to country: in this case industrial success is country specific. (Campa and Goldberg, 1997).

Besides, exports may be sustained over time or change significantly their composition. Local entrepreneurs may exploit the opportunity to acquire foreign inputs and know-how in order to improve product quality, thereby expanding their export markets. Studies on the role of investment in manufacturing industry suggest that a region's output growth will have to rely heavily on indigenous or 'naturalised' entrepreneurial initiative and capital rather than on foreign direct investment (FDI). (Hoekman and Djankov, 1997)

Another observation refers to the services sector and related productivity. Services are generally considered to be labour intensive, with wages making up the major share of total costs. Employment in services is thought to be less vulnerable to cyclical fluctuations than employment in manufacturing. But services display on average a lower productivity than manufacturing. If this happens a growing services sector would imply a lower overall productivity growth unless productivity is injected in the sector through the best use of technology and scale economies. An emerging free trade area in the Mediterranean could offer scope for such opportunities.

The productivity growth potential of the services industries remains a challenging issue with several unresolved puzzles. Conceptual problems defining and measuring output and price deflators may have contributed to the prevailing research indicating 'weakness' in labour productivity growth in the services industries. However, recent studies of various services industries in the United States seem to suggest that Information Technology capital deepening has contributed to an enhanced labour productivity in the nineties. (Triplett and Bosworth, 2003)

Tourism dominates the services sector in Malta. The industry's ability to sell accomodation seems to have been surpassed by its ability to build quality accomodation. Like labour, capital has to be used efficiently. Low occupancy rates represent a waste of resources in plant and equipment. Inefficiency increases when value added is lower than the optimal because of price cuts arising from excess capital or lower spending visitors. This situation results in higher plant-output ratios than desired. This fact is often overlooked in discussions on the competitiveness of the sector since comments on the performance of tourism are often restricted to nominal earnings flows. Per capita expenditure, at 1995 prices, declined from Lm208.6 in 1995 to Lm186.9 in 1999, the last year for which data are available, and from Lm21.3 to Lm19.5 per day stayed over the same period. (See Annex 3).

In sum, competitiveness is the outcome of continuous improvement in factor productivity. There is nothing dramatic about it. It goes on all the time as long as producers of goods and services are exposed to international competition where quality standards, price and profits levels are established. EU membership implies that a significant share of Malta's international trade will become 'internal' subject to EU trade laws and emerging trade

customs. Trade advantages could be sensitive to several factors, including culture – which also refers to the accumulation of skills and the institutional structure which condition competition; chance – breakthrough in basic technologies, major shifts in 'foreign' market demand; and government – competition policy, investment in education, public sector employment and purchases.

2.1 Enterprise and Profits

'A spirit of enterprise that is geared towards the European market' is a "need" according to government. Implicit in this statement is the idea that the activity that emerges from this 'enterprise' will be carried out from a Malta base, generates income and employment in Malta, and be recorded thereby expanding the tax base. However, Maltese entrepreneurs may be actively searching for profitable opportunities in the EU economic space and elsewhere without generating income and employment opportunities for other Maltese nationals and without recording such transactions in Malta.

Following EU membership, Maltese will have a wider range of potential economic and financial possibilities for profit seeking supported by a new set of legislation. This scenario applies also to other EU citizens who will henceforth consider Malta as a possible entry point or exit on the southern flanks of the Union.

This means that from now on Maltese policy makers have to compete for Maltese capital and human resources if they wish to succeed to implement whatever social/ cultural vision they have. Otherwise capital will move out; people will search for a fortune elsewhere as employees and as investors. Massive emigration was the hallmark of these Islands in the postwar decades; and the capital repatriation programme in place over the past two years is a reminder of the Maltese owned financial assets harboured in other jurisdictions!

Entrepreneurship is not a scarce resource, since all individuals are capable of exercising judgements that can lead them to financial and non-monetary gains. However,

entrepreneurial vision is not uniformly and continuously activated to take advantage of all opportunities. Hence, society must identify those factors that switch on entrepreneurial vision and discovery.

Therefore, there has to be set up an institutional environment that can be expected to evoke those qualities of entrepreneurial alertness on which the search for efficiency in decision-making necessarily depends. This context may be best met by competition

In this context, competition may be seen as a procedure that allows the discovery of the various tastes and preferences that individuals in the market place possess and of the various mixes of inputs that will enable these decisions to be met at the lowest possible cost. It is competition that instigates producers to seek out and experiment with new ideas of demand and to satisfy the tasks and demands that may not have been recognised by other competitors. The presence of many potential competitors should stimulate an entrepreneur to move quickly and to explore new and untapped markets.

Profits have a critical role to play in the discovery of new and untapped opportunities. The benefits and rewards for market activity stimulate people to serve the needs of others to the maximum extent possible without actual coercion. Profit is a strong means that induces people to act. Rewards have to exist; it is not possible to make believe 'as if' rewards exist when they do not. Suppliers have to learn through the process of acting competitively what consumers will pay for or what alternative productive methods will work most efficiently.

An enterprise that is insulated from market conditions is unable to act 'as if' it will be competitive, and is unable to learn the changing facts of the market that will enable it to serve its customers more efficiently and cheaply. How profits are, in turn, allocated will depend on the ownership structure of the firm and the underlying philosophy that guides its owners. Cooperatives are inspired in their relationships among the members by a different philosophy from that which binds shareholders of a joint-stock company.

The fiscal scenario that prevailed in Malta for many years, described in the introduction above, - trade controls, monopoly structures, subsidised costs, relatively high public sector subventions for a long time for certain economic activities like ship repair and ship building, transshipment, and inter-island transport – is being gradually removed. Such decision is bound to induce a reassessment of future economic activity. Prices have to reflect a new reality, one that is based on transparency within the EU economic space, especially after Malta adopts the euro. The EU is still made up of a series of national economies, every one striving to create a non-level playing ground favouring its 'nationals'. And there is still an absence of a Union based policy cum strategy for basic infrastructure, e.g. transport on land, sea and air; or transshipment. But in time a consolidated policy based on the single market concept will emerge.

In the meantime, entrepreneurs will be seeking profitable opportunities arising within this evolving scenario. And it is up to Maltese policy makers to generate the 'right' environment, disseminate timely reliable information, and provide at reasonable prices the basic utilities without which competitive production of goods and services will suffer. Now that they are citizens of the EU as well as

Maltese, local entrepreneurs will only operate from Malta if it is profitable to do so.

In this delicate transition phase – from a sheltered economy to a differently sheltered wider economic space in competition with the rest of the world – the economic/legal environment has to be charted to the minutest detail. Costs are bound to rise to account for stringent standards; these have to be offset by a rediscovery or redefining of products, markets, and alliances. The worst one can do is to rely on periods of transitions as if these last for eternity; they pass faster than many hope for as other countries are learning at their own expense - see, for example, the experience of the farming community in Portugal where those engaged in agriculture remained slow in adapting to a changing economic scenario and stuck to old habits as derogative periods dragged on! Besides, the rules of the 'emerging' single market are to be anticipated. The current debate on a 'safeguarding clause' for local trade is a subject of contention among agricultural producers. Other similar issues will definitely arise in other markets. A long term guiding rule will have to be unequivocally given, otherwise enterprise will search for 'rewards', whether financial or non-monetary, elsewhere.

3. New Macroeconomic Parameters

New conditions will regulate the operation of levies, subsidies and the implementation of quality standards. These will lead to new compliance costs, as, for example, waste management plants for animal breeders, insurance for farmers and fishermen, quality standard for machinery operated in the construction sector, or new data compilation on regular basis. Besides, two main macroeconomic considerations have to be determined.

One, monetary, refers to the move to adopt the euro as Malta's currency. This switch will possibly take place in 2007. The second is a fiscal issue. It refers to the condition that governments' budget deficits should be lower than 3% of GDP. At present the ratio is higher than that, closer to 7% than to 3%! This statistic will have to be reviewed following the revised (probably higher) GDP values that account for new data classification and statistical methodologies.

Malta's foreign exchange mechanism belongs to the fixed but adjustable category. Malta adopted a currency basket system for the past thirty years. Prior to that, the Malta Lira was pegged, one for one, to the British pound and it was backed up hundred percent by foreign, pound sterling, reserves. The basket weights are presently as follows: Euro 70%; British Pound 20%; and US Dollar 10%.

The currency basket system allows for decision regarding the exchange rate level to be altered in line with deliberate policy objectives. The present legal requirement is for foreign reserves to make up at least 60% of currency in circulation and bank deposits. But the hundred percent backing 'rule' remains to this day.

In the past, the Central Bank of Malta implemented its interest rate strategy to reflect movements in official reserves in relation to currency in circulation and bank deposits: interest rates were raised in the mid-nineties when the ratio started falling away from the 100% level.

Two crucial decisions will have to be taken. First, at what time will the Lira be initially pegged to the euro, meaning a currency basket make up 100% of the euro? In turn, the Lira will be replaced by the euro. Secondly, at what level is the Lira to be pegged to the euro: at the rate prevailing on the day the decision is taken to substitute the 100% euro basket for the existing tri-currency formula or at a new level? The former value is the outcome of the basket weights and the international movements of the three currencies. A new value will have to be determined and based on a judgement about the relative suitability of the present value of the Lira, that is, whether decision makers judge the present value to be truly representative of the 'worth' of the Lira in trade.

This judgement is bound to reflect the model used and the data introduced to test whatever economic scenarios are considered. For example, movements registered in the Real Effective Exchange Rate Index for the Malta Lira, which is in effect a series of price indices weighted by a series of exchange rates, indicate that in recent months Malta has been 'regaining' its price competitiveness when compared to countries with which we trade. Such a conclusion depends on price indices applied; if one adopts a different price index series the results could differ and therefore the policy conclusions would vary accordingly. Refer, say, to the sector of tourism and consider the recorded price movements. One notes that, according to the National

Statistics Office, prices of goods and services purchased by visitors to Malta rose by 19 percent between 1995 and 1999 (1995 = 100; 1999=119.61) whereas the corresponding increase in Consumption Expenditure was lower: 110.37 in 1999 with 1995=100. Therefore, one could blame an 'overvalued' Lira when the real issue will be an undervalued particular price index!

A move to a euro peg implies that the countervailing factors that tended to 'neutralise' movements on international foreign exchange markets for the currencies in the Malta Lira basket will be no more. The Lira will be allowed to vary within a specified range - which could be the present +/- 15% or another, smaller value - from the set value until a final decision is made on 'conversion day', possibly three years down the line. The Maltese government and Monetary Authorities seem to favour a quick adoption of the euro.

It is in the interest of the single currency to have the largest number of member states adopting the euro. Hence it makes tactical sense to implement the conversion of the currencies of the ten new member states at one go. Failure to do so may generate the mentality of the single currency being 'a la carte': if it 'suits' you take it, if not leave it. There is already the precedent of Sweden opting not to adopt the euro prior to, say, 2012. If the UK, Denmark, and the new member states decide to postpone until 2012 a two tier Europe could develop giving another twist to the term 'single market'.

Once Malta adopts the euro, local operators have to learn to adapt to a floating currency whose values would not necessarily reflect economic fundamentals in the region at any one point in time. A hardened euro may make no

difference in an area where it is the unit of account, although the import content could differ among industries and service producing units and profits could be hit. But it will surely render the imports of goods and services more attractive and render exports of goods and services more expensive. A movement away from products or services that are highly price sensitive is desirable if fluctuating demand is to be managed. Besides, management will require an efficient costing system to ensure perfect knowledge of costs and identify potential economies.

One corollary to the above currency arrangement arises from the way monetary policy is implemented in the European Monetary Union. The European Central Bank has price stability as its principal objective. It bases its assessment on a harmonised index of prices. It requires that individual members of the EMU display a total, permanent commitment to this common goal. There has to be a successful convergence in policy purposes in the future without putting strain on the relationship between the major and the minor member countries. This is a laudable objective, but life is showing that this task is not an easy one at all.

Again, once the euro is adopted, there has to be a political commitment to collaborate with the other EMU members on specifying monetary targets and to abide by their economic implications. This means that the local economic fundamentals will have to be tuned to the macroeconomic parametric values dictated by the much larger economic space. This decision reflects the will to constantly adapt to changing world economic scenarios and strive for economic efficiency that follows from the four freedoms – of goods, services, labour and capital – on which the single market is constructed. Unless 'local' costs are synchronized with the floating euro, competitiveness will be lost. The experience following unit labour costs changes in the wake of the 1992 devaluation of the Maltese Lira shall act as a witness to the process where productivity growth, wage increases and loss of competitiveness are seen to be closely intertwined. The potential gains in competitiveness that followed a devaluation of the Lira in 1992 were eroded by 1995. (See Annex 4)

This observation leads to the second corollary. Since the monetary unit and the cost of capital are being surrendered, then economic management has to come about from the fiscal and labour segments. An accelerated switch to the euro, though desirable from an EU perspective, will mean a sharp rethinking on the local Treasury. The commitment to meet the identified targets will have to be seen by all. So the manner in which the approach to the 3% target in the deficit/GDP ratio in the coming years will outline the fiscal environment in which operators – producers, traders, savers, workers – will reach their mind on future behaviour. One awaits the coming government budget to start gauging this move.

4. Behaviour by Local or Locally Based Entrepreneurs

Several remarks may be derived from the above observations.

Firstly, every entrepreneurial decision will reflect the context in which it is taken. Such behaviour applies to all markets – for goods and services, labour, and finance. It is a common base for decision making for employees, land users/developers, producers and service providers, and savers.

Providers of labour services will continue to seek markets for their services whether in Malta, in the new EU domain, and elsewhere. The facility to work in the EU region will encourage them to seek new opportunities; this will merely represent an extension to the present labour market scenario. After all, emigration was a common labour market phenomenon up to two decades ago. How this consideration will affect labour costs in Malta will have to be seen. If labour considers the new potential outlets for services as a factor that turns local remuneration from work into a relative work perspective, then they could resist the wages offer, expect improved work packages and decide accordingly. Locally based SMEs and small industry will have to account for this element. Future capital/labour relationships will be established accordingly to ensure profitable output.

Savers will have to adapt to money and capital markets that will reflect the costs of capital requirements of the entire EU region. Moreover, following the adoption of the euro, interest rates in Malta, especially for government bonds and debentures, will have to reflect the credit rating Malta based debt is given once it is denominated in euros.

If the market demands a premium, once Malta eurobonds will have to compete with all other euro paper floated, then the cost of capital will reflect this expectation! SMEs will have to assess their projected rates of return from investment activity in relation to the (higher) cost of capital at that time.

Manufacturers will react in relation to their present degree of integration in world markets. The dual characteristic of the Maltese manufacturing sector will induce such behaviour. Duality refers to the large number of very small firms catering for the domestic market and a number of few large firms operating primarily, if not exclusively, for the export market.

Exporting firms have survived, diversified their products and markets, and even expanded over time because of their success in meeting international consumer demand, either directly or indirectly by supplying components to firms that had to compete in a more aggressive free trade environment. Some firms had to wind up their operations completely and locate elsewhere. There remains the core of the large number of small and micro firms that still have to seek a re-orientation within the expanded trade domain.

Foreign ownership contributes the bulk of Maltese exports. Foreign enterprises contribute more to the economy than the domestic operators in the sector. They are heavily represented in the electrical machinery, mechanical manufacturing, and professional scientific instruments. Foreign owned firms undertake the largest share of investment. It is this relationship between a constant upgrading of production and the system that supports it which contributes to export competitiveness.

Domestic producers have operated for a long time behind protective barriers. Under such a trade regime, competition

among them reflects more the individual financial strength of the operators than quality-price conditions. Oligopolistic and imperfectly competitive markets generally compete through non-price measures emphasizing discounts or credit. Labour market policies and marketing of ideas and goods and services will be the crucial elements in the survival process for these units.

Regarding the tourist sector, it has already been pointed out above that the accommodation plant is underutilized and a lower spending tourist is being attracted to the islands. With reference to past strategies, using dual exchange rates to support the tourist trade from the UK, one may point out that the favourable exchange rate mechanism did not stop a decline of tourism from Britain; for a time, unsupported sectors like the German tended to perform better. But recently, strained demand appeared on several fronts. Price, by itself, is therefore not a conditional factor. One has to look elsewhere for identifying the way ahead for this sector. The diversification of tourist trade by season and category of visitors should account for the fact that the Maltese population is ageing and account of this fact may be made when delineating the population complement on a monthly basis.

A second remark refers to timely information on the significance of the corpus of rules adopted on membership. The true significance of these regulations will become apparent in the course of trade. But two recent episodes suggest that entrepreneurs need to be told in uncertain terms what is the true meaning of 'free and fair trading', dumping, and the single market! One incident referred to the granting of a trading license to a ship – the MV Doulos – selling books at a bargain, the Union representing retailers

(Association of General Retailers and Traders, GRTU) protested with government and a license to sell was not granted. The other case referred to the interpretation given to the so-called 'safeguarding clause' for the import of agricultural products. There are contrasting interests between importers and local producers vis-a vis imports of agri-produce. Sometimes, uncertainty arising from gray areas in legal matters may be a lucrative position if one knows how to exploit it. But it could also lead to unnecessary indecision in which case it will be detrimental to investment and economic growth.

The educational and monitoring role of regulators is apparent at this transition stage. Regulators have to anticipate the uneasiness of respective market players and clarify issues. Indecision on their part will be adverse to investment. Only if the future market environment is clearly charted can potential investors make informed decisions and assume market risk.

Thirdly, agencies that promote Malta as a location for future investments have to support would be entrepreneurs, irrespective of origin. Malta is now part of the EU markets lying at the southern flank, and it can develop this role as a point of entry or exit. To do this, its telecommunications and financial systems have to be strengthened, a clear EU policy has to be enunciated on transshipment facilities, the profitable air transport network ensured. The newly instituted organisation, Malta Enterprise, which absorbs the operations carried out in the recent past by four agencies, has a challenge ahead. It still has to build up its respective units and, hopefully, get on with its work. There is a challenging world waiting to be approached!

Fourthly, it remains to the individual units to consider

how best to reorganise so that they can better sustain the trade shocks that are bound to appear in the domestic scene and to benefit from the opportunities arising from membership. Surely, consolidation of capital and expertise would help. Consolidation was never the hallmark of Maltese business. Fragmentation was more common, whether through succession following a death in a family or internal family issues. The fairly rapid business expansion by certain firms over the past three decades means that the question of smooth succession must be looming in the minds of the founders. Family businesses can thrive, as many large companies abroad indicate. But they need the injection of new ideas and, often, the injection of new blood not necessarily from within the family compound. This issue has to be considered carefully by local business groups if their future is to be secured.

Besides, other forms of organisations, like cooperatives, have to do a serious soul searching exercise to assess their future. New legislation and the formation of new agencies/ regulators do not of their own self inject new life in a stale organisational environment. The worse thing that could happen is to assume that a form of business organisation is alive simply because it exists at law. For example, the cooperative movement needs to critically assess its future role in markets that are becoming increasingly trade aggressive. The future of business in several economic sectors depends on such an exercise.

Finally, policy makers have to ensure that the new challenges are not affronted with old structures of thought, perspectives, organisations and rewards. This observation applies primarily to public administration for which they are responsible, but also to the now-popular 'civil society' that is supposed to assess important issues and come out, reasonably fast, with workable proposals. It is not an easy task, but one that has to be undertaken successfully if the transition from a sheltered economy to a more competitive environment is to be achieved with the least cost in personal welfare.

5. Concluding remark

SMEs are Malta's entrepreneurs, as producers or as labour. Like all people with initiative, the Maltese will adapt. They have done so in the past; they will do so again in the future. But the present Maltese entrepreneurial 'class' was expected by history to adapt to a military economy, witness massive emigration, see the State expand rapidly, operate under protecting umbrella of tariffs and quotas thus sheltered from a gradually more competitive world, and is now asked by the majority of Maltese voters to go ahead and integrate the Maltese economy into a wider, single market region that is still writing and implementing the rules of trade. Adaptation is the answer. But this adaptation has to be undertaken while the State is withdrawing from production, the population will start ageing faster after 2005, and a new social contract is being written: there is a move from the universalist, zero-price provision of a wide array of public services to a selective help, positive price (charges) scenario. These changes will induce stress and can only be surmounted with a large dose of personal initiative and collective effort. These are the hallmark of enterprise! (Delia, 2002: 27 – 46)

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Annex 1

Gross Domestic Product by Industry

Lm000s

Period	Agriculture & Fishing	Construction & Quarrying	Manufacturing	Transport & Communication	Wholesale & Retail Trade	Insurance, Banking & Real Estate	Government Enterprises	Public Administration	Property Income	Private Services	**Gross Domestic Product at factor cost**
1993	25,094	26,211	200,946	59,428	115,704	59,638	63,432	135,048	64,363	84,233	834,097
1994	25,661	33,717	223,051	65,806	120,399	60,991	70,635	147,993	81,060	90,029	919,342
1995	28,341	35,326	240,944	65,622	131,848	72,916	60,673	164,486	89,868	98,919	988,943
1996	30,687	35,722	248,116	67,736	132,921	88,564	59,023	182,426	101,230	106,494	1,052,919
1997	32,539	37,092	250,960	71,687	134,973	95,585	78,668	181,619	117,435	116,901	1,117,459
1998	32,605	36,073	271,334	75,819	136,096	96,941	93,663	186,224	134,869	134,308	1,197,932
1999	31,270	32,880	290,262	86,596	140,098	99,953	99,838	190,767	141,976	146,282	1,259,922
2000	31,336	37,106	343,196	87,009	147,936	119,696	81,264	198,853	140,320	155,090	1,341,806
2001[p]	35,792	42,004	320,155	90,734	153,090	133,048	86,147	226,747	143,531	161,289	1,392,537
2002[p]	39,297	48,315	326,468	88,704	155,319	132,182	92,893	233,368	138,088	170,235	1,424,869

P = provisional

Source: National Statistics Office, Malta

Sectoral Percentage Contribution to the Gross Domestic Product

Lm000s

Period	Agriculture & Fishing	Construction & Quarrying	Manufacturing	Transport & Communication	Wholesale & Retail Trade	Insurance, Banking & Real Estate	Government Enterprises	Public Administration	Property Income	Private Services	**Gross Domestic Product at factor cost**
1993	3.01	3.14	24.09	7.12	13.87	7.15	7.60	16.19	7.72	10.10	100.00
1994	2.79	3.67	24.26	7.16	13.10	6.63	7.68	16.10	8.82	9.79	100.00
1995	2.87	3.57	24.36	6.64	13.33	7.37	6.14	16.63	9.09	10.00	100.00
1996	2.91	3.39	23.56	6.43	12.62	8.41	5.61	17.33	9.61	10.11	100.00
1997	2.91	3.32	22.46	6.42	12.08	8.55	7.04	16.25	10.51	10.46	100.00
1998	2.72	3.01	22.65	6.33	11.36	8.09	7.82	15.55	11.26	11.21	100.00
1999	2.48	2.61	23.04	6.87	11.12	7.93	7.92	15.14	11.27	11.61	100.00
2000	2.34	2.77	25.58	6.48	11.03	8.92	6.06	14.82	10.46	11.56	100.00
2001[p]	2.57	3.02	22.99	6.52	10.99	9.55	6.19	16.28	10.31	11.58	100.00
2002[p]	2.76	3.39	22.91	6.23	10.90	9.28	6.52	16.38	9.69	11.95	100.00

P = provisional

Source: National Statistics Office, Malta

Annex 2

Labour Productivity Index for the Manufacturing Sector (1995=100)

Year	*AVAFC*	*Index of productivity*
1999	Lm 9090	102
2000	11341	127
2001	8812	99
2002 *	9267	104
2003 **	9397	105

AVAFC = Average Value Added at Factor Cost at Constant Prices

** Provisional*
*** Estimate*

Source: Economic Survey January-September 2003 (Ministry of Finance and Economic Affairs, Malta): 100, Table 4.5

Annex 3

Expenditure by Tourists, at Constant Prices, per Head and per Day

(1)	(2)	(3)	(4)	(5)	(6)
Year	Expenditure (Lm000)	No. of Tourists (000)	Days Stayed (000)	Expenditure Per Head (1/2)	Expenditure Per Day (1/3)
1995	232,804	1116.0	10919	Lm208.6	Lm21.3
1996	219,622	1053.8	10665	208.4	20.6
1997	227,724	1111.2	10939	204.9	20.8
1998	224,215	1182.2	11326	189.7	19.8
1999	226,890	1214.2	11658	186.9	19.5

Source: Column (2) – National Accounts of the Maltese Islands, 1999, National Statistics Office, Malta, 2001: Table 15.

Annex 4

Unit Labour Cost Index for the Manufacturing Industry

Year	(1) MHLC	(2) RVA	(3) Lm/$	(4) (1)x(3) $	(5) ULC (4)/(2)	(6) ULCI 1990=100
1990	Lm1.67	Lm1.53	3.1527	5.2650	3.4412	100.00
1991	1.79	1.56	3.1002	5.5494	3.5573	103.37
1992	1.85	1.54	3.1462	5.8205	3.7795	109.95
1993	2.02	1.57	2.6171	5.2865	3.3672	97.85
1994	2.11	1.61	2.6486	5.5885	3.4711	100.87
1995	2.27	1.63	2.8333	6.4361	3.9485	114.66

Notes:
MHLC = Mean Hour Labour Compensation
RVA = Real Value Added per Man-hour
ULC = Unit Labour Cost
ULCI = Unit Labour Cost Index

Source: Delia, E.P., 1998: Table 4.2