INTERNATIONAL MONETARY FUND

Staff Country Reports

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Malta: 2007 Article IV Consultation—Staff Report and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the Article IV consultation with Malta, the following documents have been released and are included in this package:

- the staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 28, 2007,** with the officials of Malta on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on July 12, 2007.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its August 24, 2007 discussion** of the staff report that concluded the Article IV consultation.

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INTERNATIONAL MONETARY FUND

MALTA

Staff Report for the 2007 Article IV Consultation

Prepared by Staff Representatives for the 2007 Consultation with Malta

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July 12, 2007

EXECUTIVE SUMMARY

Background: The Council of the European Union decided on July 10 to allow Malta to join the European Monetary Union (EMU) on January 1, 2008. Following a prolonged period of weak growth, a public investment boom, largely financed by EU grants, ignited a recovery in 2005 that is gaining traction. Amid rising domestic demand, staff forecasts GDP growth at 3 percent this year. The current account deficit remains elevated amid an overall weak competitive position. Buoyant tax revenues, in part owing to one-off measures, combined with further expenditure restraint, are expected to lower the fiscal deficit to 2 percent of GDP in 2007. Financial stability indicators continue to improve, but banks' loan portfolios are highly concentrated in real estate.

Challenges and staff views: Weak competitiveness within monetary union could—absent corrective policies—result in growth remaining weak for a prolonged period. Bolstering competitiveness requires enhancing productivity by shifting resources from the inefficient public sector to the private sector, and maintaining wage moderation. To prevent structural expenditure pressures from undermining medium-term fiscal consolidation, fiscal adjustment should aim to further reduce public consumption and enterprise subsidies. The risks posed to financial stability by the concentration of banks' portfolios could be mitigated by introducing tax deductibility for specific provisions and raising the risk weight for residential mortgages.

Authorities' views: The authorities agree that the dominant export sectors remain under appreciable competitive pressure, and that efficiency in the large public-enterprise sector needs to be improved. Nevertheless, they are optimistic about the potential gains in competitiveness resulting from ongoing structural changes, including in the financial services sector and remote gaming industry, which they see as enabling Malta to remain competitive within EMU. On fiscal policy, they emphasize that several initiatives are in place to curtail structural expenditures, while concurring that more measures are needed to advance medium-term consolidation. The authorities share concerns about concentration risks in the banking sector, and are considering the possibility of introducing tax deductibility for specific provisions. Raising the risk weight for residential mortgages is, however, not likely in the near future.

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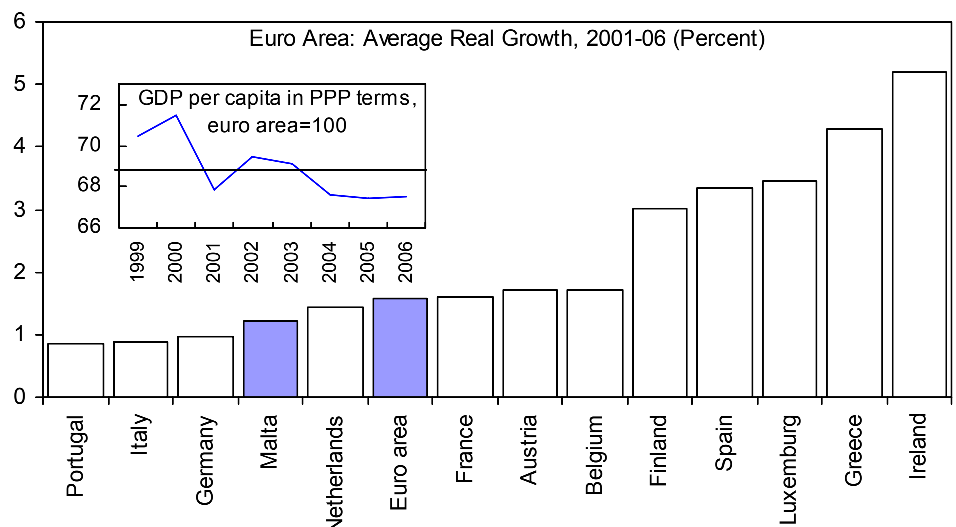
I. Introduction

1. **The Council of the European Union (EU) decided on July 10 to allow Malta to join the European Monetary Union (EMU) on January 1, 2008.** Upon entry, the Maltese lira will be converted at its current fixed exchange rate to the euro, the central parity of the exchange rate band that was adopted upon entry into the Exchange Rate Mechanism II (ERMII) in 2005. Preparations for EU Membership in 2004 spurred broad-based reform that helped mitigate structural impediments, especially by initiating the restructuring of the vast and inefficient public-enterprise sector (PES) and liberalizing the trade regime. However, saddled with high wage growth in the late 1990s and low labor productivity, the dominant exporters—a single, large electronics producer and the tourism sector—remained under competitive pressure (Figure 1). Consequently, real GDP growth averaged 1¼ percent per annum so far this decade, notwithstanding the recovery that began in 2005. Against this background, the discussions focused on policies to bolster competitiveness, advance fiscal adjustment, and enhance financial sector stability, all within a stable macroeconomic environment.



Source: Eurostat.

II. Background

2. **The economic recovery is gaining traction, owing in large part to cyclical strength and some structural change.** A public investment boom, financed largely by grants from the EU and Italy, reignited growth in 2005 (Table 1).[1] A modest recovery of exports, in addition to robust consumption growth, supported by rising employment and

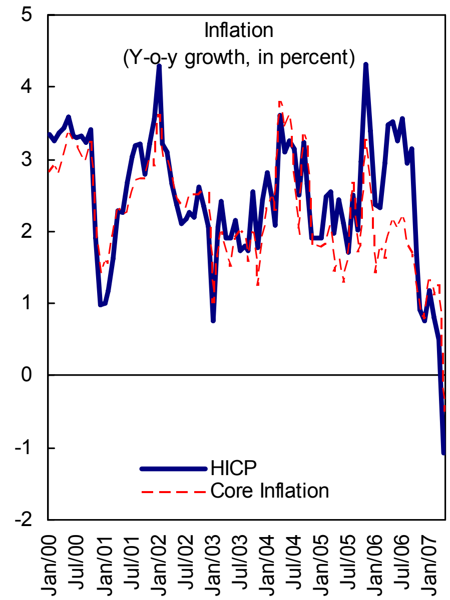
[1] There have been frequent and significant revisions to bring accounting in progressive alignment with ESA95, resulting in substantial changes, including for real GDP growth rates.

Malta: Fund Policy Recommendations and Implementation

Policy area	Fund recommendations	Implementation
Fiscal policy		
Fiscal consolidation	Expenditure-based adjustment through cuts in public employment beyond attrition and continued wage moderation; rationalization of welfare system.	Public employment declined mainly through attrition; anti-benefit-fraud unit generated tangible savings; more effective administration of benefits (e.g. pharmaceuticals) is planned. Public sector wage moderation ended in 2006.
Pension reform	Increase of statutory retirement age and establishment of second pension pillar.	Pension reform in 2006 mandates gradual increase of retirement age to 65 years beginning in 2015; increase of regular contribution period from 30 to 40 years; adoption of uniform formula for benefit adjustment; the introduction of a second pension pillar has been postponed.
Structural reform	Improve education services and attainment; increase female labor force participation; create a business friendly environment and cut red tape in public sector.	Significant expansion of vocational training. Reform of social security contribution schedule to accommodate part-time employment and pro-rating of mandatory benefits; the key port reform remains incomplete.
Financial sector	Limit exposure of financial sector to booming real estate sector by tying provisioning requirements to loan to value ratios.	No specific measures were taken in light of the pending implementation of pillar 2 of the Basel II accord.

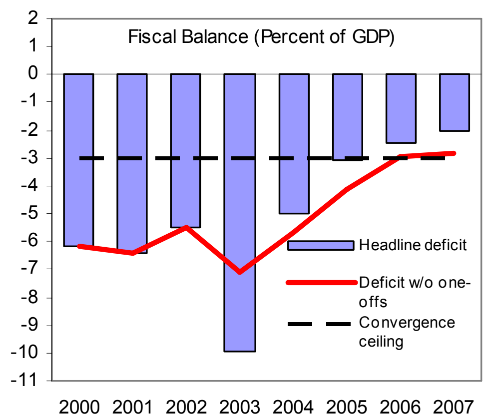
household borrowing, helped to sustain the upswing in 2006. At the same time, the emergence of higher-value-added service activities mitigated the adverse effects of continued restructuring in the manufacturing sector.

3. **Inflationary pressures proved temporary and the Maastricht inflation criterion was met.** Rising energy prices boosted headline inflation in 2005–06, but their unwinding caused a decisive decline in the harmonized index of consumer prices (HICP) in late 2006 to below the convergence criterion (Figure 2). Indicative of the competitive pressures on the tourism industry, inflation in the hospitality sector has declined steadily for almost two years, contributing to a fall in headline inflation to negative 1 percent year-on-year in May 2007.



Source: National Statistical Office.

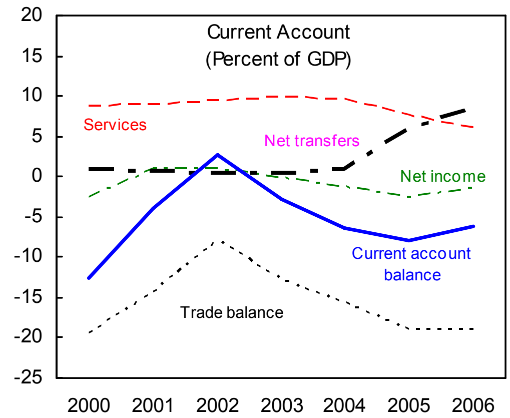
4. **The fiscal deficit nearly halved during 2004–06, with the adjustment reliant on one-off revenues as well as structural measures, but structural expenditure pressures loom large.** The general government deficit declined to 2½ percent of GDP in 2006 (Table 2), with broadly equal contributions from revenue and expenditure, and the EU's excessive deficit procedure was abrogated in early June 2007. Besides a substantial boost to capital revenue from EU and other grants, one-off revenue from land sales (1.0 percent of GDP over 2005–06) helped lower the deficit. Continued efforts to curtail the large public-sector wage bill reduced general government current expenditure by almost 1½ percentage point of GDP during 2005–06. Nevertheless, social expenditure has remained high, mainly owing to health care and pension outlays, and benefits fraud; considerable subsidies to the PES also weigh on the budget. Deficit reduction, in conjunction with substantial receipts from the privatization of Maltacom, lowered the government's debt-to-GDP ratio to 64 percent of GDP at end-2006.



Sources: Ministry of Finance and IMF staff estimates.

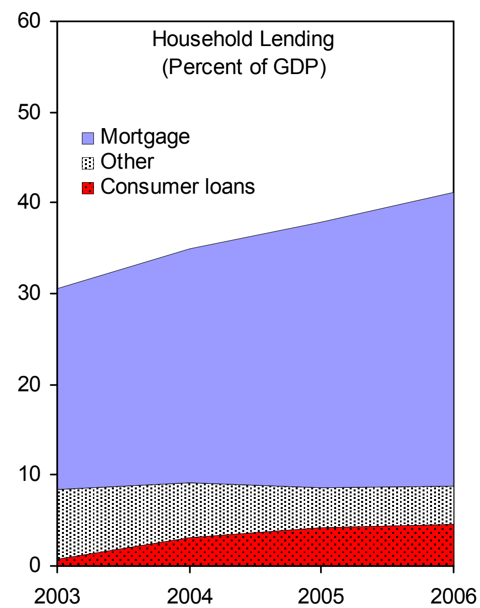
5. **The exchange rate has remained stable amid gradual monetary policy tightening.** Upon ERMII entry the fixed exchange rate regime—in place since 1968—was modified and the weight of the euro in the currency basket raised to 100 percent. Including its most recent move (May 2007), the Central Bank of Malta (CBM) has raised its policy rate by a cumulative 125 basis points since mid-2005, to 4.25 percent (Table 3 and Figure 3).

6. **Notwithstanding last year's improvement, the current account remains in a protracted deficit.** The trade balance, the service account, and the factor income balance have all deteriorated so far this decade (Tables 4 and 5). Nevertheless, the fast-growing remote gaming industry generated a substantial increase in net transfers, reflecting the difference between bets placed by foreigners and wins paid.[2] While these transfers reached almost 8 percent of GDP, the net contribution of the mostly foreign-owned industry to the external accounts is considerably smaller. Staff estimates that gaming-related service imports (e.g. marketing) and profit transfers reached almost 7 percent of GDP in 2006.



Source: National Statistical Office.

7. **The economic recovery has bolstered banking-sector earnings, but the concentration of loan portfolios in real estate has continued to rise.** Banking-sector earnings recovered in 2005–06, amid rising loan demand from the private sector (especially households), lower loan loss provisions, and an increase in banks' interest margins due to rising policy rates. Although nonperforming loans (NPLs) continued to decline, their levels remained high and provisioning uneven (Table 6). Moreover, the decade-long real estate boom fueled mortgage lending and raised banks' exposure to households and other real-estate-related sectors, including construction, with these sectors accounting for more than half of banks' portfolios.



Source: Central Bank of Malta.

8. **The outlook is overall positive.** Domestic demand continues to be boosted by public-sector investment and, increasingly, private consumption. After two years, wage moderation—especially in the public sector—is coming to an end. Consumption is also driven by employment growth, further credit extension, and the conversion of undeclared cash balances into euro (dehoarding). Against this background, staff forecasts growth in 2007 to remain broadly unchanged (3 percent), while HICP inflation is projected to decline to 1 percent, amid continued competitive pressures on the hospitality sector. The current account

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[2] The remote gaming industry facilitates internet-based gambling, including on sporting events.

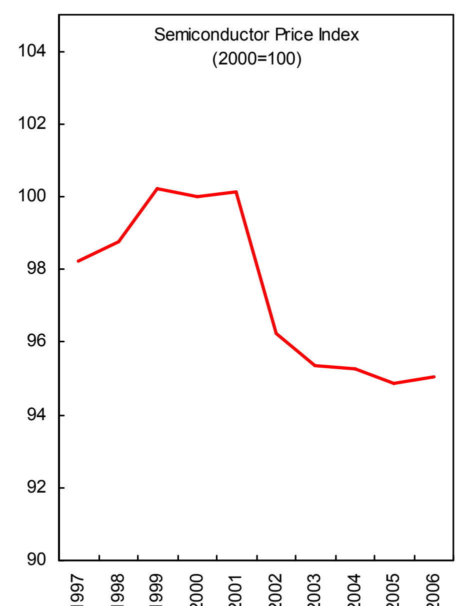
deficit appears set to reach 9¼ percent of GDP. Over the medium term, a broadening shift towards a more service-based economy is projected to support growth and contribute to a decline in the external imbalance.

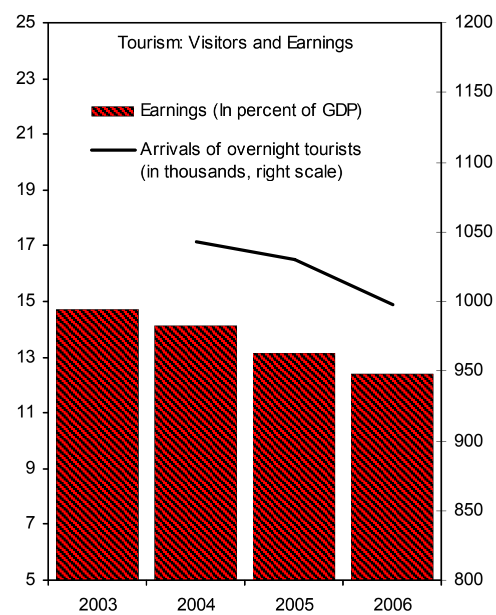
9. **Risks to the outlook are broadly balanced.** The authorities noted that the momentum generated by new service activities and the effects from dehoarding may surprise on the upside. However, they saw risks in rising interest rates and oil prices, especially given the economy's high energy dependency. Aside from such global factors, staff drew attention to the risks posed by a downturn in the domestic real estate market, and the risks to the medium-term outlook from weak competitiveness within monetary union. Unless durable measures to strengthen competitiveness are implemented, growth risks remaining weak for a prolonged period.

III. Policy Discussions

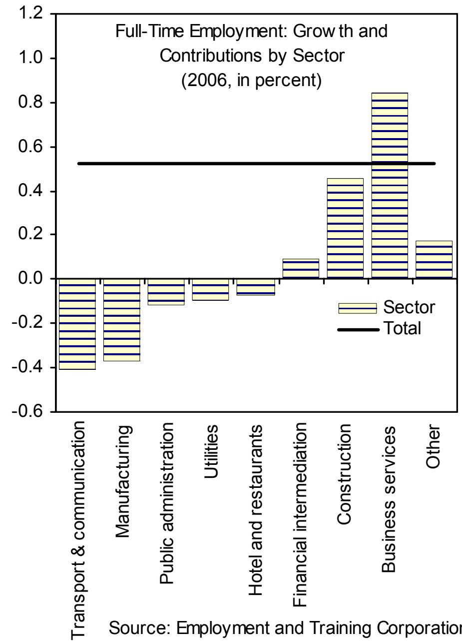
A. Bolstering Competitiveness

10. **There was agreement that the dominant export sectors remain under substantial competitive pressure.** In the tourism industry, following a period of significant weakness, there are indications that the contraction is ending, with the arrival of low-cost airlines and rebranding efforts. Nevertheless, increasing global competition continues to pressure profit margins in the industry. Separately, strong global demand is helping the electronics sector to emerge from years of difficulty. A shift to higher-value-added products appears to have been broadly successful, but risks could emerge as innovation continues to shorten product cycles.





Sources: US Bureau of Labor Statistics; Eurostat; and National Statistical Office.



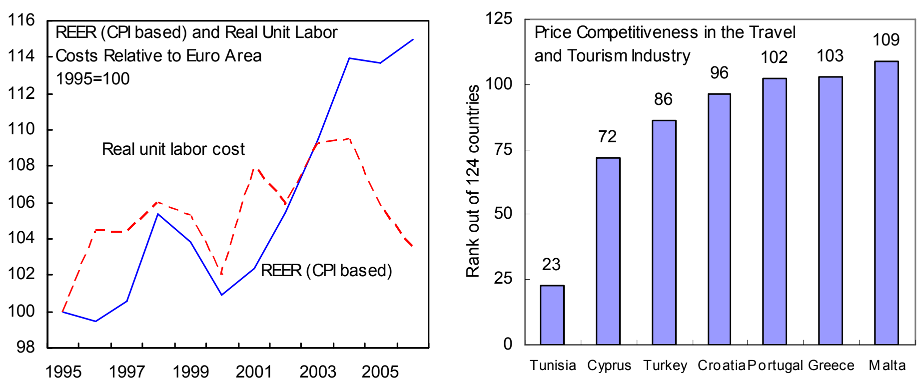
Source: Employment and Training Corporation.

11. **The authorities are of the view that emerging financial and business services could deliver important improvements in competitiveness.** They noted that EU entry had spurred interest in Malta as a location for service providers, including call centers, aircraft repair, and back-office operations. These activities were attracted by Malta's skilled work force, which benefited from significant public investment in technical and vocational training (particularly through the Malta College of Arts, Science, & Technology, MCAST). Staff welcomed the emergence of these new activities, but cautioned that their scale had so far remained relatively small.

12. **Notwithstanding diversification, staff expressed concern about weak competitiveness within monetary union.** The protracted external deficit, the steady appreciation of the REER, and the continued loss of export market share in several major sectors all point to weak competitiveness (Box 1). The authorities were mindful of the associated risk of a prolonged period of weak growth, but they stressed the difficulty in measuring competitiveness, especially for a small open economy such as Malta's. They viewed the competitiveness gap, if any, to be smaller than considered by the staff and in the process of being corrected by diversification and structural change in the economy. Furthermore, they considered exchange rate policy to be ineffective in restoring competitiveness, given wage indexation and the economy's high degree of openness, and consequently accepted the need to rely on productivity-enhancing structural reforms.

Box 1. Malta's Deteriorating External Competitiveness

Malta is a prototypical small open economy with a narrow economic base. It is a price-taker in international markets and, at 83 percent, the share of exports in GDP (2006) is high. Two major sectors—tourism and electronics—generate more than one third of GDP and half of exports. Underscoring the fragility of the economic base, a single semiconductor plant—belonging to a large multinational corporation—generates the bulk of electronics exports.



Source: Eurostat; IMF; Travel and Tourism Competitiveness Report 2007; and World Economic Forum.

Several indicators suggest rising competitive pressures. Deteriorating trade and services balances and an appreciating REER, are evidence of eroding competitiveness. Although increasing trade integration has contributed to a declining share of value added in output—including for the tourism and electronics sector—profit margins appear to be falling. Moreover, market share declines, including for the major exports, point to a possible loss of competitiveness.

13. **PES reform will need to be at the center of the strategy to bolster productivity.** While a significant reduction in public sector employment was achieved, staff noted that the PES remains large by international standards and is a drag on economy-wide productivity. There was agreement that, although restructuring was at an advanced stage, public-sector retrenchment remained incomplete and structural reforms needed to be intensified.

Public Enterprise Sector: Size and Performance 1/

	Public ownership	Staff	Operating balance 2005	Operating balance 2006
		(thousand)	(LM million)	
Enemalta	100%	1,611	-6.5	0.0
Malta Shipyards	100%	1,753	…	-8.0
Water Services Corporation	100%	1,645	-5.2	…
Air Malta	98%	1,134	-6.4	-3.8

Source: Ministry of Finance.

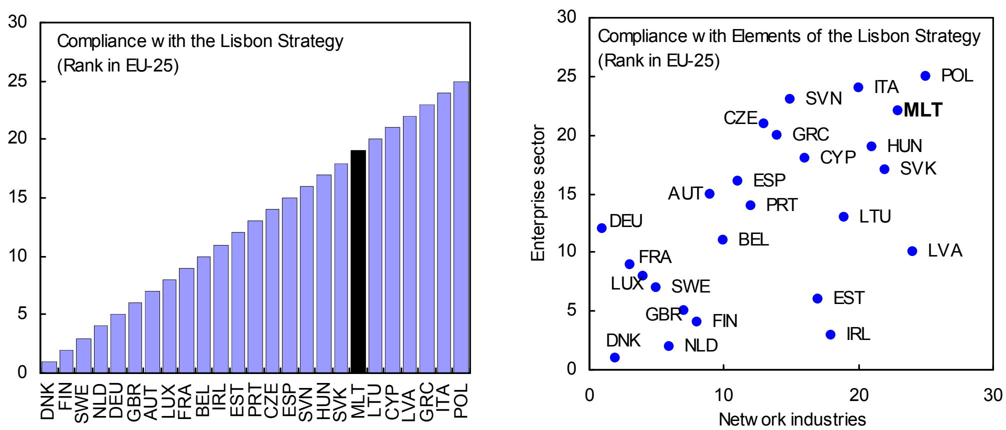
1/ Four largest public enterprises by employment.

- All agreed that port reform is key to lower high maritime transport costs. Following the award of the operating contract to a private company in 2006, the focus has shifted to improving work practices.

- The authorities recognized that further losses by Malta Shipyards could not be tolerated beyond the EU-required elimination of subsidies in 2008, but firm restructuring and privatization plans remain to be drawn up.

- The authorities concurred that there remain important inefficiencies in the energy sector. Labor hoarding in Enemalta, the electricity supplier, contributed to substantial loss-making, and cross-subsidization raised inefficiencies. Plans to privatize its gas and petroleum storage operations were progressing. Nevertheless, large investment requirements would frustrate efforts to return the core-electricity business to profitability.

- The financial state of Air Malta was improving, but continued losses necessitated further restructuring. However, the authorities considered the company of strategic importance and noted that losses were covered by asset sales. Staff noted that, at a minimum, the resulting costs to the public needed to be made more transparent.



Source: World Economic Forum.

14. **Staff stressed the importance of continued wage restraint to help lower unit labor costs (ULCs).** Amid efforts to curtail wage growth, real unit labor costs declined in recent years. Nevertheless, this decline did not keep pace with the adjustment in the euro area and, therefore, relative ULCs are still higher than at the beginning of this decade (Figure 4). A two-year period of wage moderation in Malta's public sector, however, came to an end last year: average wages are expected to increase by 3 percent this year and 4¼ percent per annum in 2008–10 (including wage indexation projected at around 2 percent per annum). The authorities explained that these increases were part of a six-year agreement, compensating for earlier wage restraint. They generally did not share staff concerns about the signaling effect for private sector wage setting, citing decentralized wage bargaining.

B. Advancing Fiscal Adjustment

15. **Deficit reduction is continuing in 2007, albeit with continued reliance on one-off measures.** Staff projects the fiscal deficit to decline to 1.9 percent of GDP in 2007, in line with the latest official forecast, but 0.3 percentage points of GDP better than this year's original budget target. Besides the boost to tax revenue from the economic recovery and continued strides in tax administration, staff noted that the improved budget performance remains largely reliant on one-off measures, including from land sales (0.5 percent of GDP) and a further tax amnesty. On the expenditure side, the targeted reduction in the wage bill is ambitious, given renewed public-sector wage hikes. The authorities agreed that there are significant social expenditure pressures, while completion of the large Mater Dei hospital raises capital expenditures this year. They stressed that temporary measures would be phased out in their medium-term fiscal strategy.

Medium-Term Fiscal Projections

			Proj.					
	2005	2006	2007	2008	2009	2010	2011	2012
Authorities 1/				(Percent of GDP)				
Balance	-3.0	-2.4	-1.9	-0.9	0.1	…	…	…
Staff								
Balance	-3.0	-2.4	-1.9	-1.7	-1.7	-1.8	-2.1	-2.4
Memorandum items:								
Cumulative expenditure pressures				0.8	1.2	1.6	2.0	2.3
Parastatal restructuring	...	...	...	0.5	0.5	0.5	0.5	0.5
Health care operational costs (hospital)	...	...	...		0.1	0.2	0.2	0.2
Health care pressures (aging)	...	...	...	0.1	0.2	0.3	0.4	0.5
Pension benefit pressures (aging)	...	...	...	0.2	0.4	0.6	0.9	1.2
One off measures 2/	0.5	0.5	0.8	0.2	0.1	…	…	…

Sources: Ministry of Finance and IMF staff estimates.

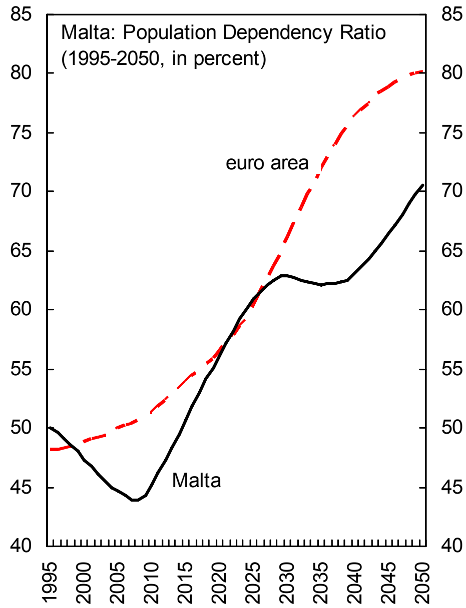
1/ Ministry of Finance estimates from May 2007.
2/ Land sales and asset registration.

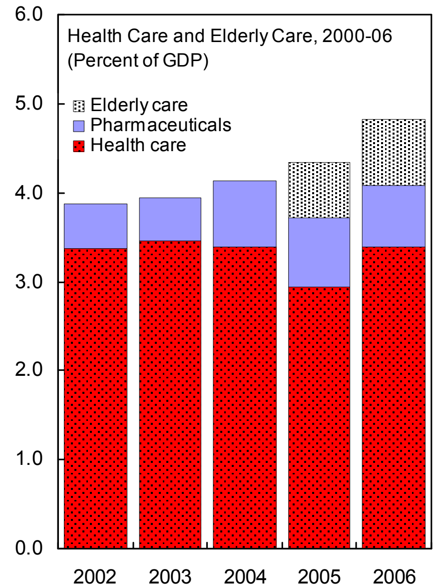
16. **However, medium-term budget pressures risk undermining progress.** While the completion of the domestically financed hospital will help lower spending and the deficit in 2008 (to around 1¾ percent of GDP), staff noted that structural expenditure pressures were on the rise. These include the potential restructuring costs for loss-making public enterprises, rising pension expenditures, and ballooning health care costs. The authorities concurred that aging-related expenditure pressures were increasing, but saw less of a risk of costly redundancies in the PES. Staff estimated that additional expenditures could reach 2¼ percent of GDP by 2012:

- The restructuring costs of the PES, including for redundancies in Malta Shipyards and Enemalta, could reach ½ percent of GDP per year.

- The 2006 pension reform mobilizes important savings, but these will begin to materialize only in the middle of the next decade. Cost pressures, from a pronounced increase in the dependency ratio in the interim, will gradually rise from 0.1 percent of GDP in 2008 to 1.2 percent of GDP by 2012.

- Aging-related increases in health care expenditures are estimated to rise from 0.1 percent of GDP in 2008 to 0.5 percent of GDP in 2012. Operating expenses from the expansion of hospital capacity remain to be budgeted and are estimated to amount to 0.2 percent of GDP.





Source: Ministry of Finance.

17. **There was agreement these challenges would be best addressed through expenditure restraint, following pronounced increases in the revenue ratio over the past decade.** Staff suggested priority should be given to further reductions in public consumption and subsidies (Figure 5), while the small notional surplus of the pension system should not be eroded. While demographic pressures would increase pension outlays over the medium term, the authorities stressed that excessive pressures would be addressed no later than in 2009, as part of the first review of the pension reform. Moreover, major initiatives were underway to introduce financial incentives to curtail health-care spending, including pilot projects for hospital budgeting and initiatives to address overprovision of medication. Against this background, the authorities did not see a need for introducing co-payments at this stage.

18. **The authorities concurred on the benefits of a more transparent medium-term fiscal framework.** Staff noted that Malta's commitment to the fiscal objectives in the Maastricht framework required a more proactive approach to policy making. Broad-based economic and fiscal analysis is needed to reduce the margin of error associated with budget projections—especially for tax revenue and social expenditures. The authorities agreed, and noted that improvements were underway, including by extending the budget planning horizon from three to five years. However, more significant improvements would require additional staff.

19. **Staff recommended targeting a budget surplus in the medium term.** Malta is a small open economy with a concentrated economic base and public debt above 60 percent of GDP and, hence, highly vulnerable to external shocks (Table 7). The authorities agreed that to absorb economic shocks a buffer would be advisable and, in this context, referred to the government's commitment to achieve its medium-term objective of a balanced structural budget, defined as cyclically adjusted balance net of one-off revenues, over the cycle.

C. Enhancing Financial Sector Stability

20. **Financial sector stability has continued to improve, though portfolio concentration could undermine progress.** Banks' regulatory capital remains comfortable, as earnings growth helped offset the impact of renewed risk-taking on capital adequacy (CA) in 2005–06. However, rising concentration of banks' loan portfolios in real estate and related sectors poses risks requiring close monitoring (Figure 6). With the stock of residential mortgages having tripled this decade, the loan-to-value ratio of half of the mortgage loans extended in 2006 remaining above 80 percent, and virtually all mortgage contracts based on floating rates, rising policy rates may test households' financial strength. In order to slow loan growth, staff advised that active consideration be given to raising the current 50 percent risk weight on *new* residential mortgages in the calculation of regulatory capital, especially for mortgages with associated loan-to-value ratios in excess of 80 percent.

21. **The authorities agreed that concentration risks were on the rise, but noted these were mitigated by households' financial strength.** Stress tests showed that CA of the domestic banks would fall below the regulatory minimum in case of a 30 percent decline in house prices. Moreover, CA would be severely compromised in the extreme scenario of a blanket default by households on residential mortgages. Although household balance sheets were not available, households' credit worthiness was viewed as being solid, with NPLs falling to 2½ percent of household loans in 2006. The authorities indicated that an increase in the risk weight for residential mortgages is not likely in the near future. In any event, concentration risks would be addressed by the regulator in the implementation of Basel II (pillar 2). Finally, the 2006 securitization law provided a framework for banks to reduce their balance sheet risks. Staff welcomed this development, but noted that the narrow economic base could limit banks' ability to diversify their portfolios.

22. **Staff called for improved incentives to bolster provisions.** While the level of provisions had risen, their uneven distribution was a cause for concern. NPLs more than halved during 2004–06, but NPLs net of provisions are highly concentrated in domestically controlled banks, owing to high levels of provisions of foreign-owned banks. In order to bolster provisions, staff called for the introduction of tax deductibility of specific provisions. The authorities were more sanguine than staff, underscoring that there was ample collateral securing the "unprovisioned share" of NPLs. In any event, they viewed the introduction of tax deductibility as a useful suggestion to be considered.

23. **Given that real estate is the dominant form of collateral, staff emphasized that prudent valuation requirements were needed.** The authorities explained that real-estate collateralized loans represented 59 percent of loans at end-2006. They indicated that banks tended to discount the collateral value by 30 percent. Staff recommended formalizing this practice and amending existing regulation to phase in collateral discounting (to 30 percent). Moreover, staff suggested that the absence of a reliable real-estate-price index created considerable uncertainty. While the existing offer-price-based index showed that residential-price growth had slowed significantly, purchase prices could already be declining. To improve transparency, staff recommended improving the existing index and complementing it with a volume indicator.

IV. Staff Appraisal

24. **Just three years after joining the European Union, Malta is at the doorstep of European Monetary Union.** EU membership spurred broad-based reform that helped mitigate structural impediments, especially by liberalizing the trade regime and exposing the economy to competition. Moreover, commitments under the Maastricht Treaty anchored policy and led to substantial fiscal consolidation, while also providing impetus to the restructuring of the vast public enterprise sector. Supported by these and other structural improvements, the cyclical upswing is expected to continue this year.

25. **Reaping the benefits of economic integration requires decisive policy action to sustain growth within a stable macroeconomic environment.** The economy's narrow base—tourism and a single electronics manufacturer generate more than one-third of output—and remaining structural rigidities leave it highly vulnerable to competitive pressures and external shocks. Indicative of these challenges, growth this decade has underperformed that of most EU member states, notwithstanding the recovery that began in 2005. A sustainable improvement in the standard of living requires a firm commitment to far-reaching reforms. In the prospective absence of monetary and exchange rate policy, priority should be placed on bolstering competitiveness via structural measures, advancing fiscal adjustment, and enhancing financial-sector stability.

26. **Persistent competitive pressures pose considerable challenges to growth and the standard of living over the medium term.** Large wage increases in the late 1990s, anemic labor productivity, and substantial and sustained adjustment among major trading partners, all contributed to an erosion in international competitiveness. The major export sectors, semiconductors and tourism, have both lost market share this decade, and the current account remains in protracted deficit, notwithstanding a narrowing of the deficit in 2006.

27. **With EMU entry agreed at the current central parity, restoring competitiveness will require the determined implementation of further structural reforms.** Recent growth in new activities is welcome and, to a considerable extent, reflects policy initiatives,

including regulatory efforts (e.g., remote gaming) and support to training. Nevertheless, many of the emerging service activities are at early stage of development and their growth potential remains highly uncertain. A commitment to rein in unit labor costs needs to be strengthened, particularly in the PES. In the absence of productivity-enhancing reforms, restoring competitiveness within monetary union may entail a prolonged period of slow growth. To reduce this risk, the government should set the following priorities:

- **Maintaining wage restraint.** While wage moderation helped to lower ULCs during 2005–06, wage growth should be held below labor productivity growth until competitiveness is adequate. There is a risk that public sector-wage increases in 2007–10 may ignite private-sector wage demands.

- **Shifting resources from the oversized public sector to the private sector.** Notwithstanding considerable privatization efforts, the PES remains large by international standards. Its weak financial performance is indicative of labor hoarding and low productivity, which restrains potential growth and raises costs to the private sector. With the EU deadline for the elimination of subsidies in 2008 approaching, priority needs to be assigned to returning Enemalta, Malta Shipyards, and Air Malta to profitability, or alternatively, to privatization.

- **Addressing the efficiency losses imposed on the economy by the public ports and energy networks.** Failure to complete the streamlining of port operations will continue to overburden the economy with expensive maritime transport costs. Similarly, cross-subsidization of energy tariffs undermines efficiency.

28. **Substantial fiscal deficit reduction will likely extend into 2007–08, with reliance on one-off measures in 2007 declining significantly in 2008.** With adjustment appropriately focused on cuts in public consumption, the general government deficit was halved during the last two years to 2½ percent of GDP in 2006. The deficit seems set to fall to 1.9 percent of GDP this year, but a large part of the decline is due to one-off measures. At the same time, solid revenue growth from the economic recovery and improved tax enforcement are helping to offset high investment expenditures for the large Mater Dei hospital. The completion of this project, and the related decline in domestically financed investment, are expected to further lower the deficit in 2008.

29. **However, structural expenditure pressures risk undermining medium-term consolidation.** Continuing losses in the PES, rising pension expenditures, and ballooning health care costs stand to add 2¼ percent of GDP to expenditures by 2012. More generally, meeting the fiscal targets under the Maastricht framework requires a more transparent approach to medium-term planning. Devising and monitoring such a framework, and making the necessary improvements in statistics, require the allocation of additional, professional staff.

30. **Further adjustments needs to be expenditure based and target a surplus over the medium term.** Competitive pressures suggest that Malta can ill-afford to rely on revenue measures, although improved tax administration can provide further relief. Priority should be given to further reductions in subsidies and public consumption, while the small notional pension surplus should not be eroded. The public health care system needs to adopt financial incentives to contain ballooning costs. With output volatility high and demographic pressures on the rise, the budget should aim for a surplus over the medium term.

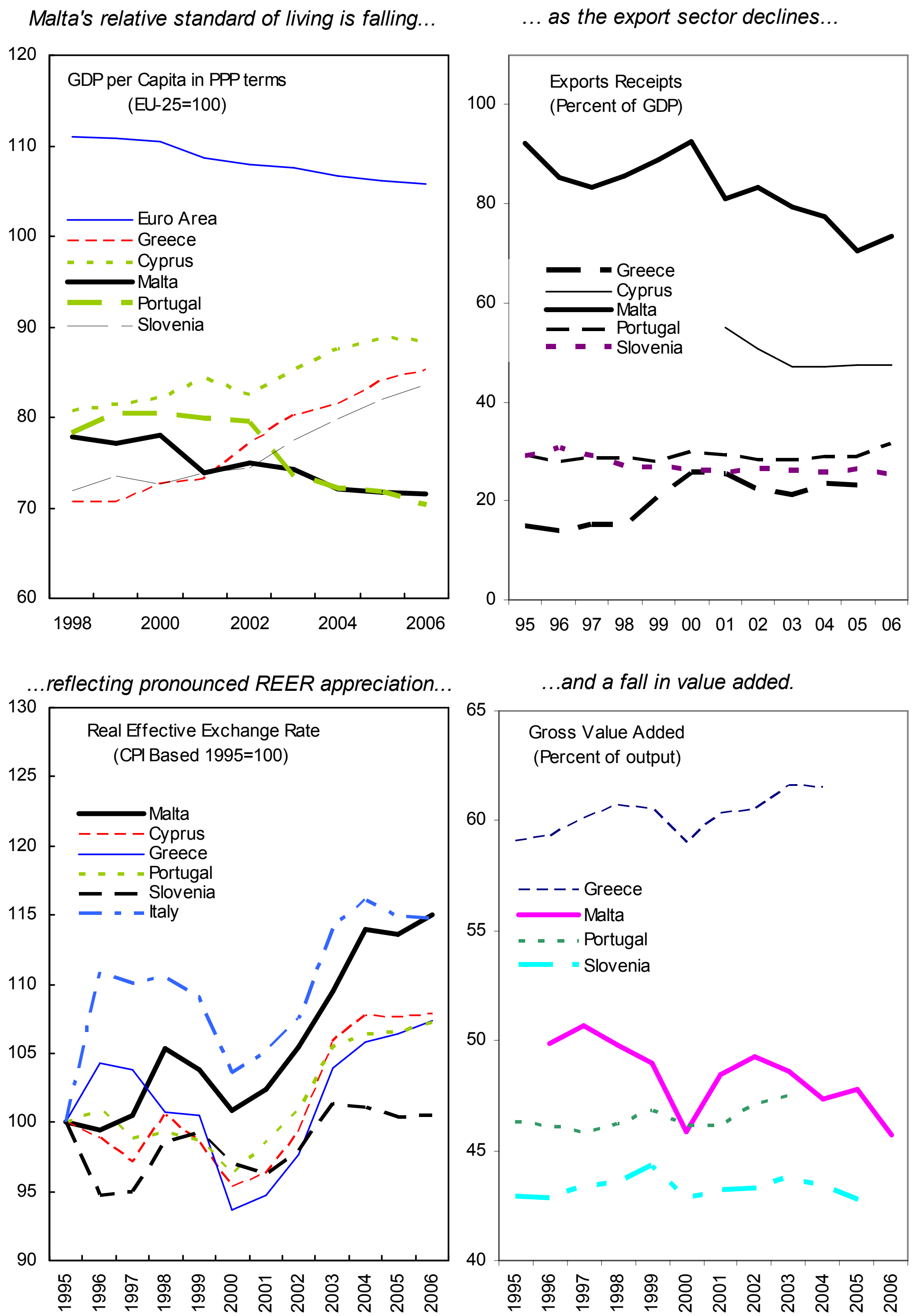
31. **Financial sector stability has improved, but concentration risks are on the rise.** The economic recovery, rising interest margins, and a reduction in provisions buoyed earnings of the domestically oriented banks in 2005–06. Capitalization remained adequate, and nonperforming loans continued to decline. Nevertheless, exposure to the real estate market—via residential and commercial mortgages and business loans, including to the construction sector—has continued to increase, with more than half of banks' loan portfolios in April 2007 concentrated in real estate.

32. **In light of these risks, supervisors need to remain vigilant.** Last year's securitization law provides a welcome framework for banks to reduce their balance sheet risks. Nevertheless, the high concentration of loan books reflects the narrow base of the economy. Banks have so far refrained from securitizing real-estate-related assets in the absence of alternative lending opportunities. In order to slow mortgage lending, serious consideration should be given to raising the risk weight for new residential mortgages.

33. **Incentives need to be improved to bolster provisioning.** Regulation allows the netting of the full collateral value against impaired loans in calculating provisions. Although banks tend to discount the collateral value, it would be prudent to phase in collateral discounting as a regulatory requirement. Moreover, to enhance financial incentives, tax deductibility of provisions should be introduced, in line with best international practice.

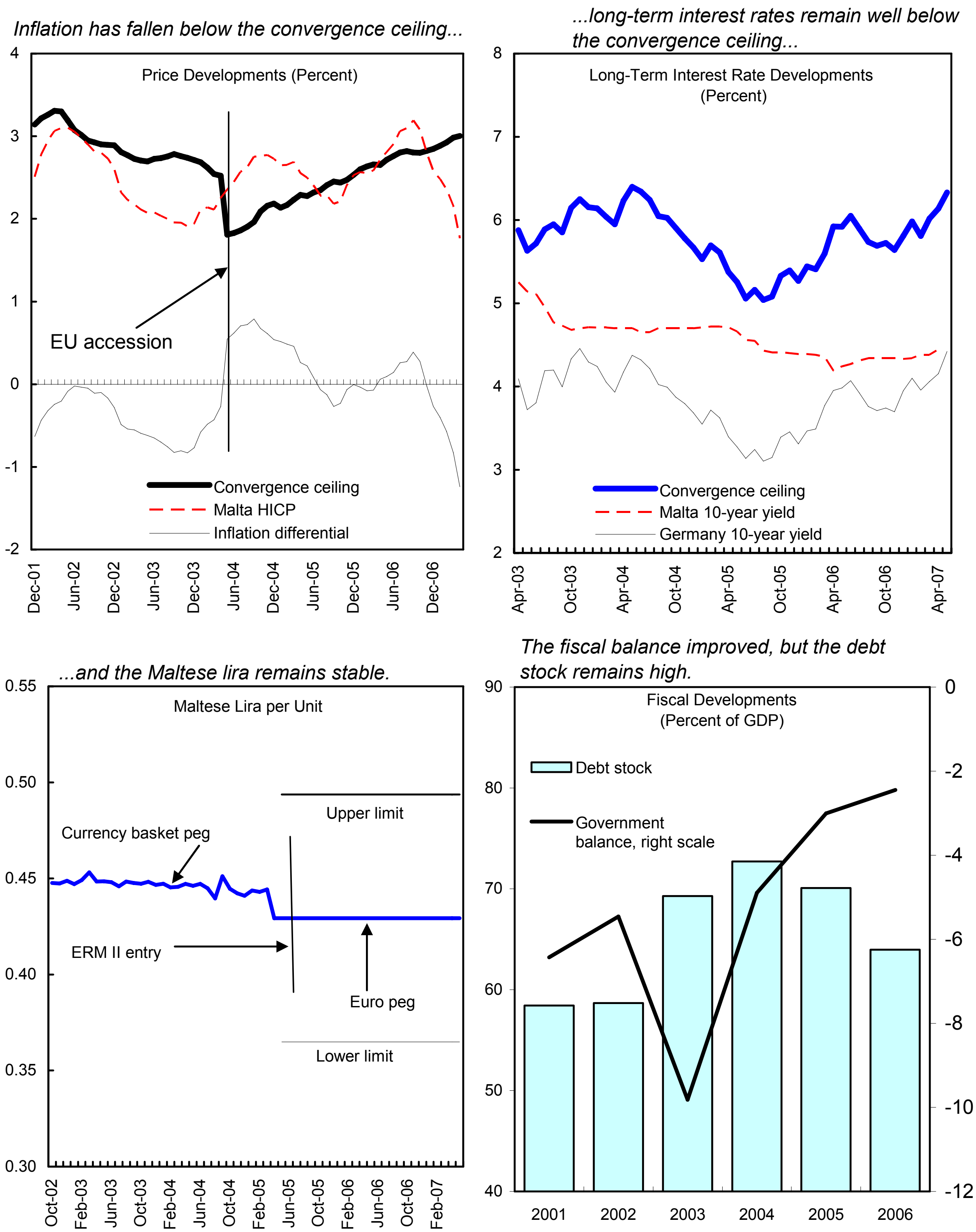
34. To provide the opportunity for a timely assessment of progress in restoring competitiveness, it is proposed to move the next Article IV consultation to the standard 12-month cycle.

Figure 1. Malta: Economic Performance in a Regional Perspective



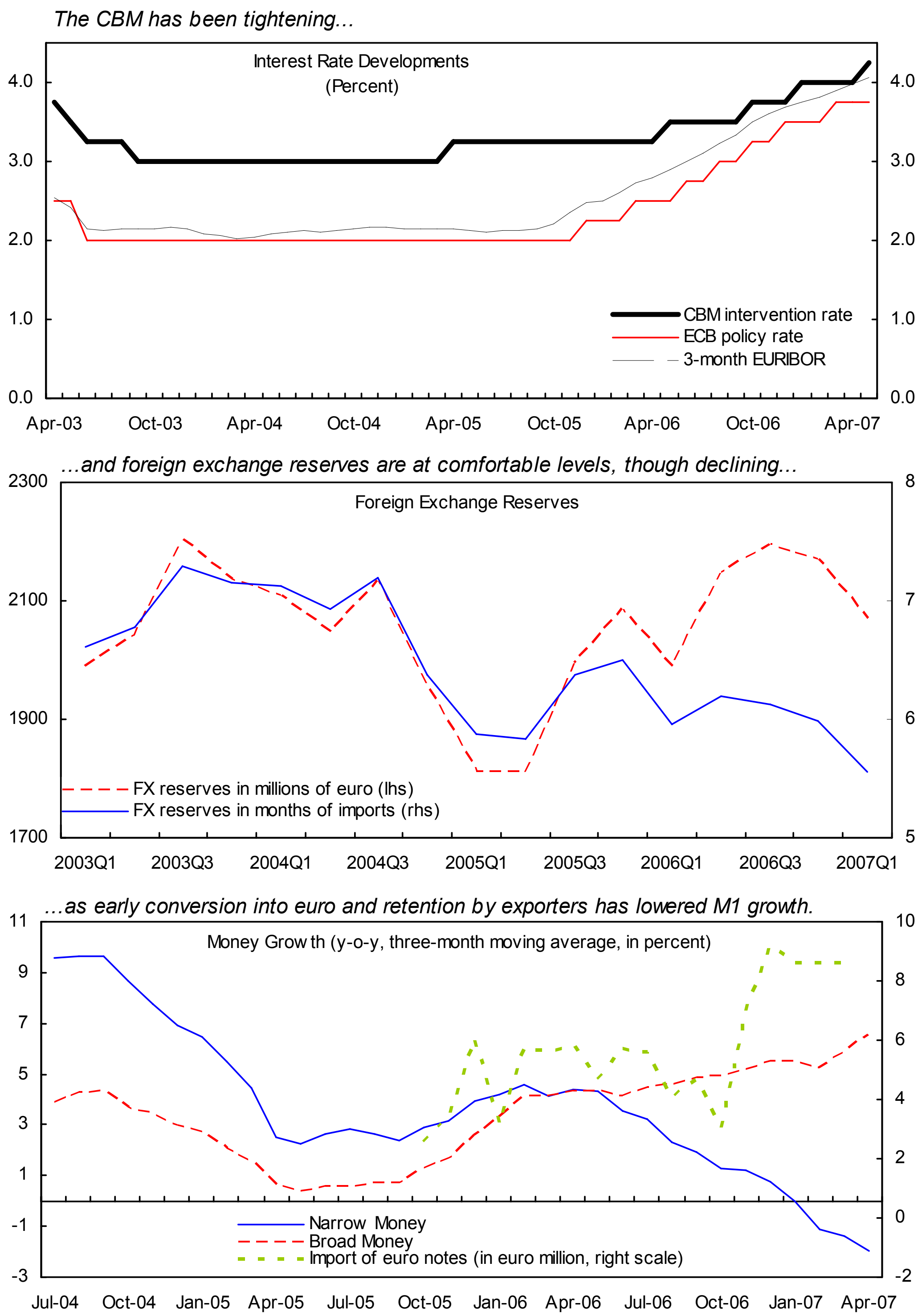
Source: Eurostat.

Figure 2. Malta: Convergence Criteria, 2001–07



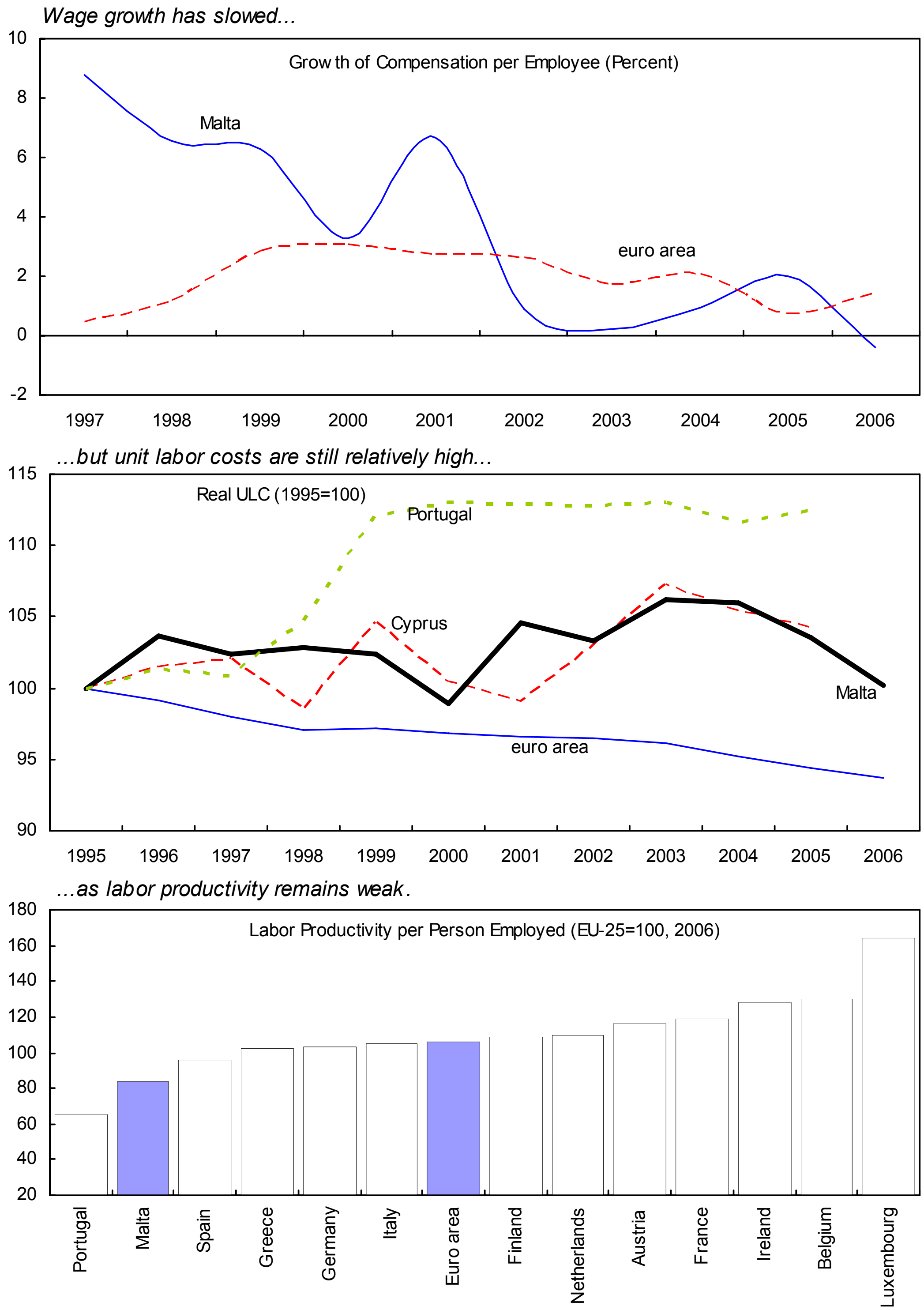
Sources: Bloomberg; CBM; IMF staff calculations.

Figure 3. Malta: Interest Rate and Monetary Developments



Sources: CMB; ECB; Haver Analytics; IFS; and IMF staff calculations.

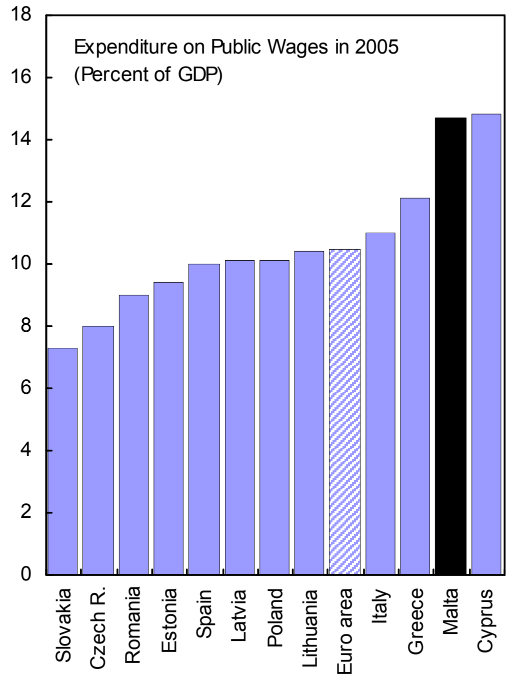
Figure 4. Malta: Labor Productivity



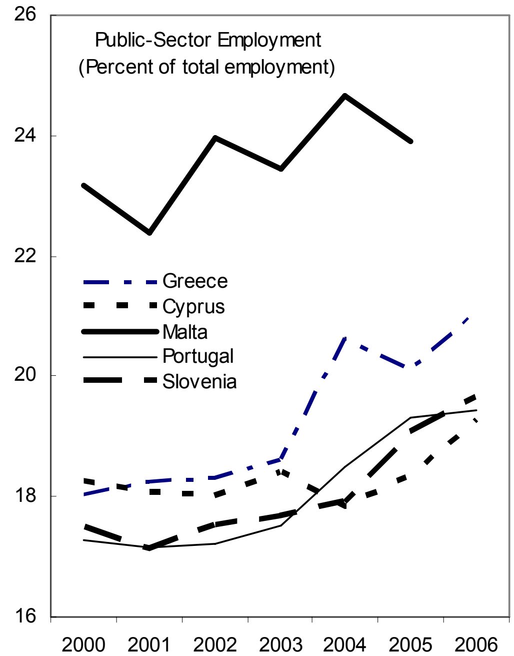
Sources: Eurostat; and IMF staff calculations.

Figure 5. Malta: Public Sector

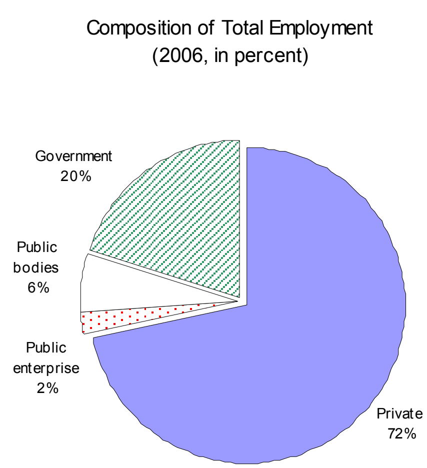
The wage bill is high...



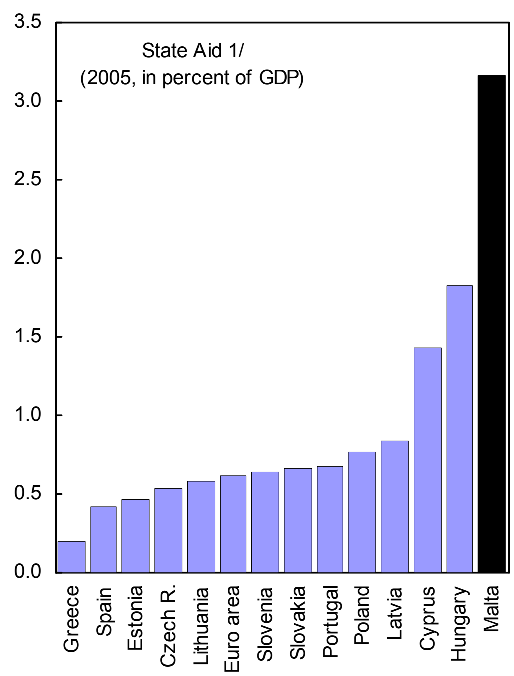
....and public employment large...



...exceeding a quarter of total employment.



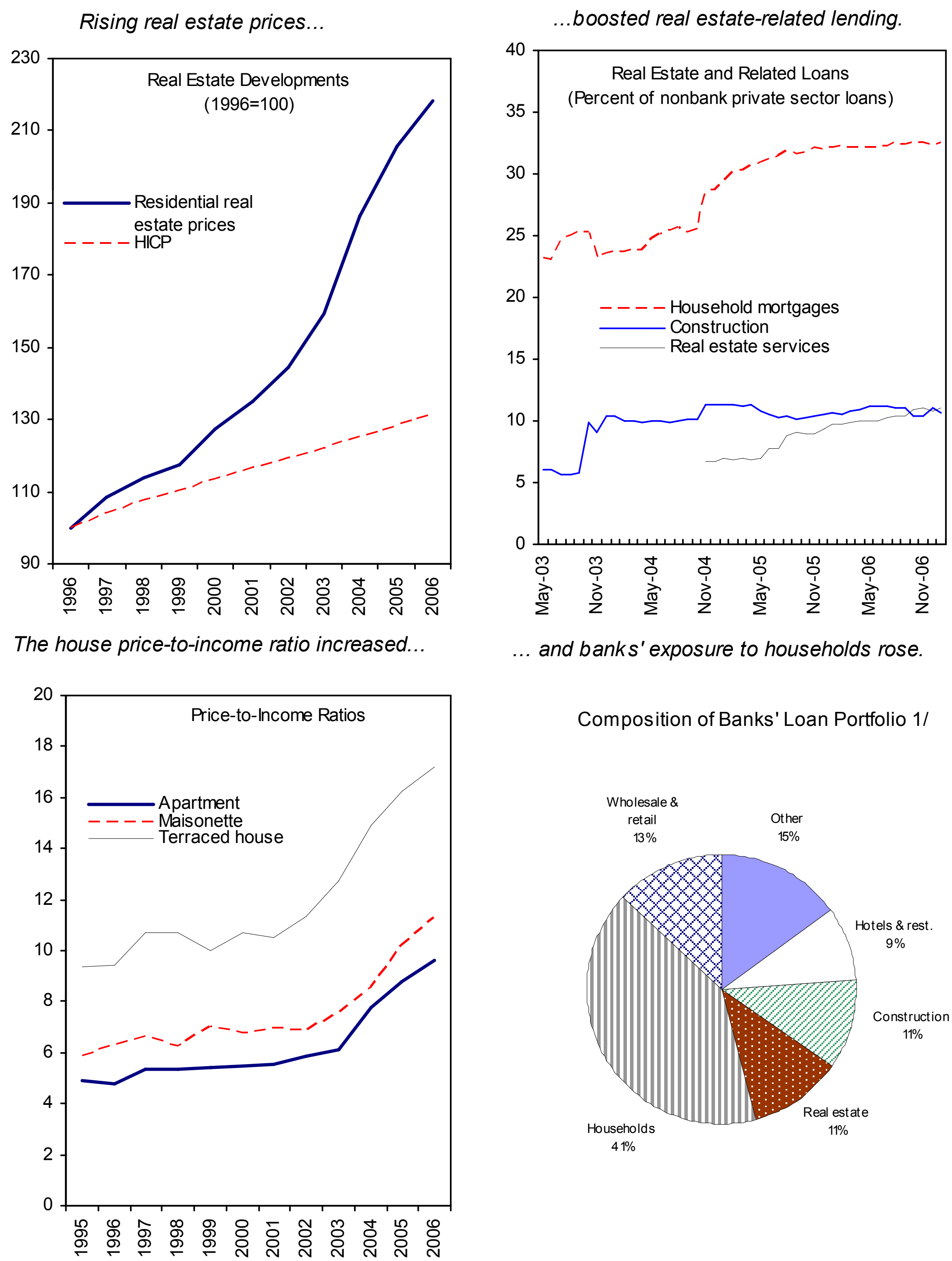
State aid to enterprises is highest within the EU25



Source: Eurostat; EU commission; and Ministry of Finance.

1/ As defined by the EU Commission, including direct subsidies, tax expenditures, soft loans, and guarantees.

Figure 6. Malta: Financial Sector and Real Estate



Sources: CMB; ECB, Falzon (University of Malta); and IMF staff calculations.

1/ Loans to the nonbank private sector, April 2007.

Table 1. Malta: Selected Economic Indicators, 2003–12

				Est.	Proj.					
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Real economy				(Change in percent)						
Real GDP	-0.3	0.1	3.3	3.3	3.2	2.8	2.7	2.7	2.5	2.4
Domestic demand	5.8	1.8	7.0	2.6	2.9	2.2	1.9	2.2	2.1	2.1
Consumption	3.7	1.9	2.0	2.8	2.7	2.3	2.2	2.2	2.0	2.0
Private consumption	3.9	2.2	2.4	2.6	3.1	2.4	2.2	2.2	2.0	2.0
Public consumption	3.3	0.8	0.4	3.3	1.7	1.8	2.4	2.0	2.1	2.0
Fixed investment	23.1	0.5	6.5	0.3	4.1	1.9	0.6	2.6	2.6	2.8
Inventory accumulation 1/	-1.1	0.1	4.3	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Foreign balance 1/	-6.0	-1.7	-4.1	0.4	0.0	0.4	0.6	0.3	0.3	0.2
Exports of goods and services	-0.6	2.0	-3.1	7.1	4.4	4.4	4.2	3.1	3.0	2.6
Imports of goods and services	5.9	3.7	1.1	6.0	4.0	3.6	3.3	2.6	2.5	2.2
CPI (harmonized)	1.9	2.7	2.5	2.6	0.9	1.9	1.8	1.8	1.8	1.8
Unemployment rate EU stand. (percent)	7.6	7.4	7.3	7.3	7.5	7.5	7.3	7.2	7.0	6.8
Gross national savings (percent of GDP)	13.8	10.3	12.9	14.7	11.8	13.0	13.3	13.8	14.3	14.6
Gross capital formation (percent of GDP)	16.5	16.6	21.0	20.8	21.0	21.0	20.6	20.5	20.5	20.6
Public finance				(Percent of GDP)						
General government balance	-9.8	-4.9	-3.0	-2.4	-1.9	-1.7	-1.7	-1.8	-2.1	-2.4
Revenue	38.0	41.2	41.6	41.0	41.5	41.4	40.4	40.2	40.2	40.1
Expenditure	47.8	46.1	44.6	43.4	43.4	43.1	42.1	42.1	42.2	42.5
General government debt	69.3	72.7	70.1	64.0	63.0	62.2	61.2	60.3	59.8	59.7
Money and credit				(Change in percent)						
Net foreign assets (growth)	8.9	14.7	11.3	13.9	…	…	…	…	…	…
Broad money (M3) growth	2.4	2.4	4.2	5.2	…	…	…	…	…	…
Credit to economy	10.1	-1.7	1.3	9.2	…	…	…	…	…	…
o/w private sector	…	-1.3	9.0	15.3	…	…	…	…	…	…
Balance of payments				(Percent of GDP)						
Current account balance	-2.8	-6.3	-8.0	-6.1	-9.2	-8.0	-7.2	-6.7	-6.2	-6.0
w/o current transfers	-3.3	-7.3	-14.0	-14.5	-19.6	-19.4	-19.2	-19.2	-18.7	-18.6
Exports of goods and services	79.4	77.2	70.3	73.7	73.9	74.6	74.9	74.4	74.0	73.2
Imports of goods and services	-82.5	-83.3	-81.6	-86.7	-86.2	-86.9	-86.5	-85.5	-84.6	-83.7
Trade balance	-12.9	-15.8	-19.0	-19.0	-18.9	-19.4	-19.2	-18.9	-18.6	-18.5
Services balance	9.7	9.6	7.7	6.0	6.5	7.1	7.6	7.8	8.0	8.1
Exchange rates										
Exchange rate regime			Euro peg (ERM II)							
Lira per euro			0.43							
Nominal effective rate (2000=100)	107.2	110.9	109.8	110.2	…	…	…	…	…	…
Real effective rate (2000=100)	108.5	112.9	112.7	114.0	…	…	…	…	…	…
Memorandum item:										
Nominal GDP (Million of Lm)	1,884	1,918	2,056	2,188	2,292	2,385	2,492	2,608	2,725	2,838

Sources: Central Bank of Malta; National Statistical Office; Eurostat; and IMF staff calculations.

1/ Contribution to growth, in percent.

Table 2. Malta: Medium-Term Fiscal Projections, 2003–12
(Percent of GDP)

				Est.	Budget 1/	Proj.					
	2003	2004	2005	2006	2007	2007	2008	2009	2010	2011	2012
Revenue	38.0	41.2	41.6	41.0	42.1	41.5	41.4	40.4	40.2	40.2	40.1
Current revenue	37.6	39.5	38.3	38.3	38.9	39.3	38.8	38.5	38.5	38.5	38.5
Tax revenue	24.8	26.4	26.1	26.9	27.5	27.9	27.9	27.8	27.8	27.8	27.8
Indirect taxes	12.9	14.6	14.6	14.9	…	15.3	15.1	15.0	15.0	15.0	15.0
Direct taxes	11.8	11.6	11.2	11.8	…	12.4	12.5	12.6	12.6	12.6	12.6
Other taxes (capital taxes)	0.1	0.2	0.4	0.3	…	0.3	0.3	0.3	0.3	0.3	0.3
Social security contributions	8.0	8.1	8.3	7.7	7.9	7.8	7.8	7.7	7.7	7.7	7.7
Other current revenue	4.8	5.1	3.8	3.7	3.5	3.6	3.1	3.0	3.0	3.0	3.0
Capital revenue	0.4	1.7	3.3	2.7	3.2	2.2	2.7	1.9	1.7	1.7	1.6
Expenditure	47.8	46.1	44.6	43.4	44.3	43.4	43.1	42.1	42.1	42.2	42.5
Current expenditure	39.5	41.1	39.4	38.8	37.6	38.1	38.5	38.7	38.9	39.2	39.6
Wages and salaries	14.7	14.7	14.0	13.3	12.9	12.8	12.5	12.3	12.1	12.1	12.0
Goods and services	4.7	5.4	4.9	5.6	5.4	5.6	5.6	5.7	5.9	5.9	5.9
Social transfers	13.2	13.4	13.1	13.0	12.8	13.1	13.9	14.2	14.5	14.8	15.2
Subsidies	2.2	1.9	2.1	1.9	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Interest payments	3.4	3.7	3.7	3.5	3.3	3.3	3.1	3.1	3.1	3.1	3.1
Other current expenditure	1.2	2.0	1.6	1.5	1.3	1.5	1.6	1.6	1.6	1.6	1.6
Capital expenditure	8.3	5.0	5.1	4.6	6.7	5.2	4.6	3.4	3.1	3.0	2.9
Overall balance	-9.8	-4.9	-3.0	-2.4	-2.2	-1.9	-1.7	-1.7	-1.8	-2.1	-2.4
Overall balance w/o one offs	-7.0	-5.6	-3.5	-2.9	…	-2.7	-1.8	-1.7	-1.8	-2.1	-2.4
Public debt											
Official	69.3	72.7	70.1	64.0	…	63.0	62.2	61.2	60.3	59.8	59.7
Government guaranteed debt	14.5	15.8	15.0	12.8	…	…	…	…	…	…	…
Memorandum items:											
Primary balance	-6.4	-1.2	0.7	1.1	…	1.4	1.5	1.5	1.2	1.0	0.7
One-offs	-2.8	0.7	0.5	0.5	…	0.8	0.2	0.1	0.0	0.0	0.0
Government grants					…						
Privatization receipts	0.0	1.9	1.2	4.3	…	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Central Bank of Malta; National Statistical Office; Eurostat; and IMF staff calculations.

1/ Budget 2007 estimates reflect revised GDP data.

Table 3. Malta: Monetary Developments, 2003–07

	2003	2004	2005	2006	2007 Apr.
	(Millions of Maltese liri, end of period)				
Central bank balance sheet					
Base money	623	652	656	681	681
Net foreign assets	919	870	933	951	894
Net credit to general government	-76	-94	-139	-77	-35
Other items, net	-220	-124	-138	-193	-178
Financial survey					
M3	2,849	2,918	3,042	3,199	3,268
Net foreign assets	1,417	1,626	1,809	2,061	2,049
Domestic credit	2,649	2,603	2,637	2,879	3,018
Net credit to general government	568	545	443	365	436
Credit to parastatal and private sectors	2,080	2,058	2,194	2,514	2,582
Credit to parastatal sector	190	182	150	157	153
Credit to private sector	1,900	1,876	2,044	2,356	2,428
Other items, net	-1,217	-1,311	-1,405	-1,741	-1,800
	(Percentage change, year over year)				
Base money	0.9	4.6	0.6	3.9	-0.1
M3	2.4	2.4	4.2	5.2	7.2
Domestic credit	10.1	-1.7	1.3	9.2	10.4
Net credit to general government	14.1	-4.0	-18.8	-17.6	-2.7
Credit to the parastatal and private sectors	9.0	-1.1	6.6	14.6	12.9
Credit to the parastatal sector	…	-4.3	-17.7	5.0	-7.9
Credit to the private sector	…	-1.3	9.0	15.3	14.6
	(Millions of euros, end of period)				
Net foreign assets	3,754	4,717	5,233	6,045	5,181
Central bank	2,436	2,525	2,697	2,789	2,557
Banks	1,318	2,192	2,536	3,256	2,624
Interest rates	(Percent; end of period)				
Central bank intervention rate 1/	3.00	3.00	3.25	3.75	4.25
Three-month treasury bill	2.94	2.96	3.22	3.90	4.18
Weighted average rate on resident loans	5.31	5.33	5.50	5.90	6.10

Sources: Central Bank of Malta; and IMF staff estimates.

1/ Last column refers to May 2007.

Table 4. Malta: Summary Balance of Payments, 2003–12

				Est.	Proj.					
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
					(Millions of euros)					
Trade balance	-568.7	-705.3	-904.5	-969.0	-1,009.8	-1,078.6	-1,118.2	-1,150.1	-1,181.7	-1,228.1
Exports, f.o.b.	2,285.7	2,186.6	2,055.1	2,308.8	2,412.5	2,521.3	2,631.3	2,719.8	2,807.3	2,865.3
Imports, f.o.b.	-2,854.3	-2,891.8	-2,959.7	-3,277.8	-3,422.3	-3,599.9	-3,749.5	-3,869.9	-3,988.9	-4,093.4
Balance on services	428.7	430.9	365.5	304.2	350.0	396.0	443.3	474.1	506.5	536.6
Exports	1,219.1	1,269.4	1,301.4	1,456.9	1,542.9	1,635.6	1,731.6	1,812.5	1,901.0	1,991.7
Imports	-790.4	-838.5	-935.9	-1,152.7	-1,192.9	-1,239.6	-1,288.3	-1,338.4	-1,394.5	-1,455.1
Current income, net	-6.8	-53.4	-128.2	-76.5	-387.8	-400.3	-443.7	-493.3	-516.7	-541.5
Current transfers, net	25.1	45.7	285.2	430.1	555.1	636.0	696.9	758.3	796.4	834.8
Private	4.2	38.7	263.6	390.6	531.7	606.9	665.3	729.4	765.6	803.5
Public	20.9	7.0	21.6	39.5	23.4	29.1	31.6	28.9	30.7	31.3
Current account balance	-121.7	-282.1	-382.0	-311.2	-492.5	-446.9	-421.7	-411.0	-395.5	-398.2
Capital account, net	15.5	66.7	155.1	151.4	244.8	254.7	266.2	278.5	291.0	303.2
Financial account, net	224.9	-3.8	412.2	381.7	187.7	223.3	236.1	247.1	257.0	280.3
Direct investment	370.0	325.4	487.0	1,342.9	350.4	257.0	257.0	257.0	257.0	280.3
Portfolio investment	-1,382.5	-1,698.3	-2,147.7	-2,159.8	-1,627.4	-1,681.9	-1,044.6	-986.8	-885.9	-973.1
Other	1,237.3	1,369.2	2,072.9	1,198.7	1,464.7	1,648.2	1,023.7	976.9	885.9	973.1
Errors and omissions	9.6	57.8	1.8	-138.6	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	128.3	-161.4	187.1	83.3	-60.0	31.2	80.6	114.6	152.5	185.3
					(Percent of GDP)					
Current account balance	-2.8	-6.3	-8.0	-6.1	-9.2	-8.0	-7.2	-6.7	-6.2	-6.0
Merchandise	-12.9	-15.8	-19.0	-19.0	-18.9	-19.4	-19.2	-18.9	-18.6	-18.5
Services	9.7	9.6	7.7	6.0	6.5	7.1	7.6	7.8	8.0	8.1
Exports	27.6	28.4	27.3	28.5	28.8	29.4	29.7	29.8	29.9	30.0
Imports	-17.9	-18.7	-19.6	-22.6	-22.3	-22.2	-22.1	-22.0	-21.9	-21.9
Current income, net	-0.2	-1.2	-2.7	-1.5	-7.2	-7.2	-7.6	-8.1	-8.1	-8.2
Current transfers, net	0.6	1.0	6.0	8.4	10.4	11.4	12.0	12.4	12.5	12.6
Capital account, net	0.4	1.5	3.2	3.0	4.6	4.6	4.6	4.6	4.6	4.6
Financial account, net	5.1	-0.1	8.6	7.5	3.5	4.0	4.1	4.1	4.0	4.2
Direct investment	8.4	7.3	10.2	26.3	6.5	4.6	4.4	4.2	4.0	4.2
Portfolio investment	-31.3	-37.9	-45.0	-42.3	-30.4	-30.2	-17.9	-16.2	-13.9	-14.7
Other	28.0	30.6	43.4	23.5	27.4	29.6	17.6	16.0	13.9	14.7
Errors and omissions	0.2	1.3	0.0	-2.7	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	2.9	-3.6	3.9	1.6	-1.1	0.6	1.4	1.9	2.4	2.8
Memorandum items:										
Official reserves, end of period										
(Millions of euros)	2154.4	2030.9	2165.0	2221.4	…	…	…	…	…	…
(Millions of U.S. dollars)	2683.3	2732.1	2571.2	2919.0	…	…	…	…	…	…
(Months of imports of goods and services)	7.1	6.5	6.7	6.0	…	…	…	…	…	…

Sources: Central Bank of Malta; National Statistical Office; and IMF staff calculations.

Table 5. Malta: Indicators of External and Banking Sector Vulnerability, 2003–07
(Percent of GDP, unless otherwise indicated)

					Latest Observation	
	2003	2004	2005	2006	2007	*Date*
Financial indicators						
Government debt	69.3	72.7	70.1	64.0	…	
Broad money (percent change, 12-month basis)	2.4	2.4	4.2	5.2	7.2	*Apr.*
Private sector credit (percent change, 12 month basis) 1/	…	-1.3	9.0	15.3	14.6	*Apr.*
Three-month T-bill yield	2.9	3.0	3.2	3.6	3.5	*May*
Nonperforming loans to gross loans	...	6.5	3.9	2.8	...	
External Indicators						
Exports of G&NFS (percent change, average in euros)	-6.1	-1.4	-2.9	12.2	…	
Imports of G&NFS (percent change, average in euros)	-0.8	2.3	4.4	13.7	…	
Current account surplus	-2.8	-6.3	-8.0	-6.1	…	
Capital and financial account balance	5.4	1.4	11.9	10.4	…	
Of which						
Capital account	0.4	1.5	3.2	3.0	…	
Inward portfolio investment (debt securities, etc.)	-31.3	-37.9	-45.0	-42.3	…	
Other investment (loans, trade credits, etc.)	28.0	30.6	43.4	23.5	…	
Inward foreign direct investment	8.4	7.3	10.2	26.3	…	
Gross official reserves (euros; e.o.p.)	2,154	2,031	2,165	2,221	2,071	*Apr.*
Official reserves in months of imports GNFS	7.1	6.5	6.7	6.0	...	
Ratio of foreign reserves to base money (percent)	147.6	133.5	142.3	139.6	137.2	*Apr.*
Ratio of foreign reserves to broad money (percent)	32.3	29.8	30.7	29.7	27.1	*Apr.*
Exchange rate (per U.S. dollar, period average)	2.7	2.9	2.9	2.9	3.1	*May*
REER appreciation (+) (e.o.p. basis)	3.8	4.1	-0.2	1.2	...	
Change in stock market index (percent)	13.6	44.4	62.3	-2.2	-21.8	*Apr.*

Sources: Central Bank of Malta; Central Office of Statistics; and IMF staff estimates and projections.

1/ Claims on private sector excludes credit to public nonfinancial enterprises.

Table 6. Malta: Financial Soundness Indicators, 2004-06 (Percent)

	2004	2005	2006
Banking sector			
Regulatory capital to risk-weighted assets	21.4	20.4	22.0
Regulatory Tier 1 capital to risk-weighted assets	18.5	17.6	20.8
Nonperforming loans net of provisions to capital	29.4	20.2	12.5
Nonperforming loans to total gross loans	6.5	3.9	2.8
Return on assets	1.3	1.4	1.1
Return on equity	16.6	20.8	12.6
Interest margin to gross income	44.9	44.7	57.3
Noninterest expenses to gross income	47.7	38.4	45.8
Liquid assets to total assets	17.1	13.9	13.5
Liquid assets to short-term liabilities	53.4	58.3	58.1
Net open position in foreign exchange to capital	…	-1.6	0.2
Capital to assets	7.9	6.8	8.6
Total exposure of 5 largest banks to 5 largest resident entities to capital	62.8	145.4	121.2
Gross asset position in financial derivatives to capital	37.2	83.1	21.3
Gross liability position in financial derivatives to capital	39.4	82.5	21.9
Trading income to total income	…	3.5	19.9
Personnel expenses to noninterest expenses	38.8	40.8	37.6
Spread between reference lending and deposit rates (in basis points)	…	340.7	345.2
Customer deposits to total (non-interbank) loans	92.1	100.1	70.3
Foreign-currency-denominated loans to total loans	52.9	60.0	65.4
Foreign-currency-denominated liabilities to total liabilities	69.4	75.8	77.3
Net open position in equities to capital	38.5	34.6	25.0
Real estate markets			
Residential real estate prices (annual percentage increase)	24.2	10.4	6.0
Residential real estate loans to total loans	12.9	12.9	12.9
Commercial real estate loans to total loans	6.0	5.0	6.3

Source: Central Bank of Malta.

Table 7. Malta: Public Sector Debt Sustainability Framework, 2003–12
(Percent of GDP, unless otherwise indicated)

				Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	**Debt-stabilizing primary balance 8/**
1 Baseline: public sector debt 1/	72.7	70.1	64.0	**63.0**	**62.2**	**61.2**	**60.3**	**59.8**	**59.7**	**0.7**
Of which foreign-currency denominated	3.6	2.9	2.5	2.0	1.5	1.0	0.6	0.4	0.2	
2 Change in public sector debt	3.4	-2.6	-6.1	-1.0	-0.8	-1.0	-0.9	-0.5	0.0	
3 Identified debt-creating flows (4+7+12)	1.4	-3.1	-6.1	-1.0	-0.8	-1.0	-0.9	-0.5	0.0	
4 Primary deficit	1.2	-0.7	-1.1	-1.4	-1.5	-1.5	-1.2	-1.0	-0.7	
5 Revenue and grants	41.2	41.6	41.0	41.5	41.4	40.4	40.2	40.2	40.1	
6 Primary (noninterest) expenditure	42.4	40.9	39.9	40.1	39.9	39.0	39.0	39.2	39.4	
7 Automatic debt dynamics 2/	2.1	-1.1	-0.8	0.4	0.7	0.4	0.4	0.5	0.7	
8 Contribution from interest rate/growth differential 3/	2.4	-1.1	-0.7	0.4	0.7	0.4	0.4	0.5	0.7	
9 *Of which* contribution from real interest rate	2.5	1.1	1.4	2.4	2.4	2.0	1.9	1.9	2.1	
10 *Of which* contribution from real GDP growth	-0.1	-2.2	-2.1	-2.0	-1.7	-1.6	-1.6	-1.5	-1.4	
11 Contribution from exchange rate depreciation 4/	-0.3	0.0	0.0	...	...	...	...	...	...	
12 Other identified debt-creating flows	-1.9	-1.2	-4.3	0.0	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	-1.9	-1.2	-4.3	0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2–3) 5/	2.0	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	176.4	168.5	156.2	151.8	150.1	151.3	150.0	148.8	148.8	
Scenario with key variables at their historical averages 6/				**63.0**	**67.0**	**71.1**	**75.3**	**79.6**	**83.9**	**1.3**
Scenario with no policy change (constant primary balance) in 2007-2012				**63.0**	**62.3**	**61.3**	**60.3**	**59.4**	**58.7**	**0.7**
Key macroeconomic and fiscal assumptions underlying baseline										
Real GDP growth (percent)	0.1	3.3	3.3	3.2	2.8	2.7	2.7	2.5	2.4	
Average nominal interest rate on public debt (percent) 7/	5.4	5.5	5.3	5.4	5.2	5.2	5.3	5.3	5.3	
Average real interest rate (nominal rate minus change in GDP deflator, percent)	3.7	1.7	2.3	3.9	4.0	3.4	3.4	3.4	3.6	
Nominal appreciation (increase in US dollar value of local currency, percent)	9.4	-0.3	1.1	...	...	...	...	...	...	
Inflation rate (GDP deflator, percent)	1.7	3.8	3.1	1.5	1.2	1.8	1.9	1.9	1.7	
Growth of real primary spending (deflated by GDP deflator, percent)	-4.3	-0.6	0.8	3.8	2.4	0.2	2.7	3.0	3.1	
Primary deficit	1.2	-0.7	-1.1	-1.4	-1.5	-1.5	-1.2	-1.0	-0.7	

1/ General government and gross debt.

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ For projections, this line includes exchange rate changes.

6/ Last 6 years. The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

7/ Derived as nominal interest expenditure divided by previous period debt stock.

8/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

INTERNATIONAL MONETARY FUND

MALTA

Staff Report for the 2007 Article IV Consultation—Informational Annex

Prepared by the European Department

July 12, 2007

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Appendix I. Malta: Fund Relations
(As of April 30, 2007)

Mission: Valetta, May 17–28, 2007

Staff team: Messrs. Odenius (head), Chelsky, Danninger, (all EUR) and Perrelli (FIN). Mr. Landi (Advisor to the Executive Director) also attended most meetings.

Country interlocutors: The mission met with the Bank of Malta Governor, Mr. Michael Bonello; the Parliamentary Secretary to the Minister of Finance, Mr. Tonio Fenech; other senior officials; employers and labor unions; opposition and private sector representatives.

Data: Malta participates in the Fund's General Data Dissemination System.

I. **Membership Status**: Malta became a member of the Fund on September 11, 1968. It eliminated all remaining restrictions under Article XIV of the Articles of Agreement, and accepted the obligations of Article VIII (Sections 2, 3, and 4) of the Articles of Agreement on November 30, 1994. Malta maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, except for restrictions maintained for security reasons and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

II. **General Resources Account**:	**SDR Million**	**Percent Quota**
Quota	102.00	100.00
Fund holdings of currency	61.74	60.53
Reserve position in Fund	40.26	39.47

III. **SDR Department**:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	11.29	100.00
Holdings	34.63	306.79

IV. **Outstanding Purchases and Loans**: None

V. **Latest Financial Arrangements**: None

VI. **Projected Payments to the Fund**: None

VII. **Exchange Rate Arrangement and Restrictions**: Malta participates in the ERM II. The Maltese lira is currently pegged to the euro in a conventional peg arrangement. The central rate of the lira vis-à-vis the euro is Lm 0.429300 per €1. Malta maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, except for restrictions maintained for security reasons

and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

VIII. **Article IV Consultation**: The last Article IV consultation was concluded on October 14, 2005. Malta is on a 24-month consultation cycle.

IX. **Technical Assistance**: (1999–present)

- ROSC Data Module mission visited Malta in June 2007.
- An expert visited Valetta in November 2006 and again in April 2007 to assist with the preparation of a producer price index.
- FSAP missions in October 2002, and January 2003.
- STA mission on money and banking statistics visited Malta in March 2001.
- An MAE mission addressed monetary operations and liquidity forecasting (February 1999).

X. **Resident Representative**: None.

Appendix II. Malta: Statistical Issues

Data provision is adequate for surveillance purposes. The 2006 IMF Report on the Observance of Standards and Codes finds that Malta has made significant progress in improving its macroeconomic statistics. The National Statistics Office (NSO) was created in March 2001 as an autonomous and independent institution, superseding the Central Office of Statistics (COS). The NSO is in the process of developing procedures to ensure its coordinating role, as required by the Statistical Act 2000. The authorities have been in close contact with the ECB and Eurostat to upgrade their statistical systems to meet euro-area standards, and most of Malta's statistics can be accessed through Eurostat. Malta has been a participant in the GDDS since September 11, 2000, and the authorities are taking steps to subscribe to the SDDS. Data are posted on the Fund's Dissemination Bulletin Board on the Internet. http://dsbb.imf.org/Applications/web/gdds/gddscountrycategorylist/?strcode=MLT

Real sector data: Data on retail prices, labor market indicators, and tourism arrivals are released monthly, usually with a short lag; access to these data is available through the Internet via NSO's web site. The NSO completed the project to improve the coverage of GDP in accordance with *ESA95*, with estimates published on the NSO web site, with a three-month lag, since August 2004. Past data going back to 1995 were recently revised based on this methodology. Volume GDP estimates by type of economic activity are not available. Work is underway to prepare a producer price index which will enable the authorities to produce constant price output data by sector. Separate deflators for goods and services exports and imports are not available. The harmonized index of consumer prices (HICP) was first published in May 2004.

Fiscal data: Fiscal statistics are timely and of a high quality. The NSO published monthly statistics on the cash operations of the central government in line with the guidelines set out in the European System of Accounts (*ESA95*) Manual on Government Deficit and Debt. In addition, quarterly general government account are published on accrual basis in accordance with the *ESA95* methodological framework. The general government comprises data from the consolidated fund of government adjusted to include other accounts of government, the accruals elements, and the financial performance of the Extra Budgetary Units (EBUs) and of the Local Councils. Malta has no extrabudgetary funds.

Money and Banking Statistics: Monetary statistics are timely and of good quality. Malta participates in the Fund initiative to publish Financial Soundness indicators: http://www.imf.org/external/np/sta/fsi/part.asp?iso=MLT

External sector: Nonrecording of the transactions of special purpose entities is a factor behind the large errors and omissions. Summary data (merchandise trade, current account balance, and selected capital account data) are released on a quarterly basis with a lag of about three months. More detailed BOP data, as well as those on the international investment position, are released annually, the latter with a lag sometimes exceeding one year. Summary trade statistics are released monthly with a lag of about 40 days.

Malta: Table of Common Indicators Required for Surveillance

(As of June 14, 2007)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality – Accuracy and reliability[8]
Exchange Rates	6/14/07	6/14/07	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	5/07	6/07	M	M	M		
Reserve/Base Money	6/07	6/07	M	M	M	…	…
Broad Money	6/07	6/07	M	M	M	…	…
Central Bank Balance Sheet	4/07	4/07	M	M	M	…	…
Consolidated Balance Sheet of the Banking System	12/06	7/07	M	M	Q	…	…
Interest Rates[2]	5/07	5/07	W	W	W		
Consumer Price Index	5/07	6/14	M	M	M	O/LO	O/LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	5/07	6/07	M	M	M	O/LO	O/LO
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	5/07	6/07	M	M	M	O/LO	O/LO
Stocks of Central Government and Central Government-Guaranteed Debt[5]	5/07	6/07	M	M	M		
External Current Account Balance	2007:Q1	6/07	Q	Q	Q	O/LO	O/LO/LNO
Exports and Imports of Goods and Services	2007:Q1	6/07	Q	Q	Q	O/LO	O/LO/LNO
GDP/GNP	2007:Q1	6/07	Q	Q	Q	O/LO/LNO	O/LO
Gross External Debt	n/a	n/a	n/a	n/a	n/a		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[7] Reflects the assessment provided in the data ROSC (published on August 18, 2006, and based on the findings of the mission that took place during June 2005) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[8] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment, and revision studies.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 07/109
FOR IMMEDIATE RELEASE
September 7, 2007

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2007 Article IV Consultation with Malta

On August 24, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Malta.[1]

Background

The Council of the European Union decided on July 10 to allow Malta to join the European Monetary Union (EMU) on January 1, 2008. Malta's economic recovery is gaining traction, owing in large part to cyclical strength and some structural change. A public investment boom, financed largely by grants from the EU, reignited growth in 2005. A modest recovery in exports and robust consumption growth, supported by rising employment and household borrowing, helped sustain the upswing in 2006. Rising energy prices boosted headline inflation in 2005–06, but their unwinding caused a decisive decline in consumer price inflation in late 2006 to below the Maastricht convergence criterion. While social expenditure and subsidies to the public-enterprise sector remain high, the general government deficit declined to 2½ percent of GDP in 2006, largely on account of a substantial boost to capital revenues from EU grants and land sales combined with a decline in the wage bill. Notwithstanding last year's improvement, the current account remains in a protracted deficit. The trade balance, the service account, and the factor income balance have all deteriorated so far this decade. These developments reflect weak competitiveness, in large part owing to the legacy of high wage growth in the late 1990s

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

and a still inefficient public enterprise sector. The latter continues to stifle economy-wide labor productivity, notwithstanding structural reform.

While financial stability has continued to improve, the concentration of loan portfolios in real estate has continued to rise. Although nonperforming loans (NPLs) declined further, levels remain high and provisioning uneven.

Executive Board Assessment

Executive Directors congratulated the Maltese authorities for the decision of the Council of the European Union to accept Malta as a member of the European Monetary Union (EMU) on January 1, 2008. They commended the authorities for the substantial fiscal consolidation that has been achieved and their implementation of broad-based structural reforms, which were central to Malta's entry into the EMU. They observed that structural change is supporting the cyclical upswing, and expected the expansion to continue this year.

At the same time, Directors noted that growth so far this decade has trailed that of most other EU members, notwithstanding the recovery that began in 2005. They therefore recommended that decisive policy actions be taken to enable Malta to reap the full benefits of economic integration with the EU.

Directors agreed that the determined implementation of productivity-enhancing structural reforms and a commitment to rein in labor costs will be essential to strengthen Malta's competitiveness, export base, and growth within the monetary union. In this context, several Directors noted the loss of market share by the main export sectors and the protracted current account deficit—driven by a number of factors, including large wage increases in the past and low labor productivity—suggesting competitiveness pressures. At the same time, Directors pointed to the emergence of new export sectors as a promising sign of diversification which could mitigate vulnerabilities.

Against this background, Directors recommended that the moderation of public sector wages should continue in 2007–10, also to avoid igniting demands for private sector wage increases. Welcoming the considerable privatization efforts, Directors encouraged the authorities to press on with the restructuring of public enterprises and the shifting of resources to the private sector to enhance productivity. They took note of the progress made in improving the operations of the public ports, and recommended that focus be placed next on improving the efficiency of the energy networks to enhance the competitiveness of the economy.

Directors welcomed the prospect of further deficit reduction in 2007–08, and the objective of reducing reliance on one-off revenue measures in 2008. Structural improvements in tax enforcement and the economic recovery have raised revenue growth. Directors stressed that, in the medium term, structural expenditure pressures, notably pension and health care costs and public enterprise losses, will need to be reduced to safeguard and advance the progress made

in fiscal consolidation. Further fiscal adjustment needs to be expenditure based, with emphasis on a reduction in subsidies and public consumption, which are large by international standards. Directors advised that the budget aim for a surplus over the medium term given the high volatility of output and demographic pressures.

Directors welcomed the continued improvement in financial sector stability, with strengthened banking sector performance, comfortable levels of regulatory capital, and declines in nonperforming loans. At the same time, as loan concentration is rising with increasing exposure to the real estate market, Directors recommended that consideration be given to raising the risk weight for new residential mortgages to maintain mortgage lending soundness. Directors also noted the scope for strengthening provisioning by allowing tax deductibility of specific provisions and introducing collateral discounting as a regulatory requirement.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2007 Article IV Consultation with Malta is also available.

Malta: Selected Economic Indicators

	2003	2004	2005	2006	2007 1/
Real economy (percentage change; constant prices)					
Real GDP	-0.3	0.1	3.3	3.3	3.2
Private consumption	3.9	2.2	2.4	2.6	3.1
Public consumption	3.3	0.8	0.4	3.3	1.7
Fixed capital formation	23.1	0.5	6.5	0.3	4.1
Exports of goods and services	-0.6	2.0	-3.1	7.1	4.4
Imports of goods and services	5.9	3.7	1.1	6.0	4.0
HICP inflation	1.9	2.7	2.5	2.6	0.9
Unemployment rate (percent of labor force)	7.6	7.4	7.3	7.3	7.5
Public finances (percent of GDP)					
Government budget balance	-9.8	-4.9	-3.0	-2.4	-1.9
Revenues	38.0	41.2	41.6	41.0	41.5
Expenditures	47.8	46.1	44.6	43.4	43.4
General government debt	69.3	72.7	70.1	64.0	63.0
Money and credit (end period; percentage change)					
Base money	0.9	4.6	0.6	3.9	...
M3	2.4	2.4	4.2	5.2	...
Domestic credit	10.1	-1.7	1.3	9.2	...
Net foreign assets of the central bank	4.3	-5.3	7.2	2.0	...
(Percent of the monetary base)	147.5	133.5	142.3	139.6	...
Interest rates (percent; end period)					
Central bank intervention rate	3.00	3.00	3.25	3.75	...
Three-month treasury bill	2.94	2.96	3.22	3.90	...
Government bonds (10-year)	5.01	4.69	4.56	4.32	...
Balance of payments (percent of GDP)					
Trade balance	-12.9	-15.8	-19.0	-19.0	-18.9
Services balance	9.7	9.6	7.7	6.0	6.5
Current account balance	-2.8	-6.3	-8.0	-6.1	-9.2
Official reserves (end period)					
(Millions of euro)	2,154	2,031	2,165	2,221	...
(Months of imports of goods and services)	7.1	6.5	6.7	6.0	...
Exchange rate					
Nominal effective exchange rate (2000=100)	107.2	110.9	109.8	110.2	...
Real effective exchange rate (2000=100)	108.5	112.9	112.7	114.0	...
Regime (Pegged to the euro since ERM2 entry on May 2, 2005)					
Current rate (July 5, 2007) 0.4293 Maltese liri per euro					
Memorandum items:					
Nominal GDP (millions of Maltese liri)	1,884	1,918	2,056	2,188	2,292

Sources: National Statistics Office; Central Bank of Malta; Ministry of Finance; IMF *International Financial Statistics*; and IMF staff estimates.
1/ IMF staff projections.