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Malta: 2008 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Malta

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 2008 Article IV consultation with Malta, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 30, 2008, 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 22, 2008. 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 6, 2008, discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Malta.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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MALTA

Staff Report for the 2008 Article IV Consultation

Prepared by Staff Representatives for the 2008 Consultation with Malta

Approved by Alessandro Leipold and Anthony R. Boote

July 22, 2008

EXECUTIVE SUMMARY

Outlook and competitiveness. Malta joined EMU on January 1, 2008: a key milestone in the authorities' strategy of boosting competitiveness through economic opening. Largely as a consequence of liberalizing reforms, Malta has experienced a three-year-long expansion reflecting strong foreign direct investment, export diversification, and value-added upgrading. Growth (3.8 percent in 2007) has been underpinned by fiscal adjustment, privatization, and public sector streamlining. Tourism and new high value-added exports supported cost and noncost competitiveness, trimming the current account (5½ percent in 2007) and trade deficits. Growth is expected to decelerate to 2¼–2½ percent in 2008–09 as the external environment weakens. There are some downside risks as traditional export sector declines could outpace the emergence of new export activities, especially if reforms slow down.

Policy issues. The authorities intend to press ahead with fiscal, financial, and structural reforms in the early period of the recently inaugurated legislature. Further fiscal consolidation and public sector streamlining will be key.

- *Fiscal policy.* The authorities are appropriately cutting spending to keep the 2008 budget on track—including passing through higher fuel import costs while protecting low-income households. Achieving the authorities' medium-term objective (MTO) of structural fiscal balance by 2010 based on expenditure retrenchment will require tackling the high cost of subsidies, payroll and entitlements, and reinforcing the fiscal framework.

- *Financial sector.* The banking system is well placed to weather global turmoil as banks have healthy liquidity and a good funding profile. However, exposure to the slowing housing market and low and uneven provisioning call for close supervisory vigilance. The authorities are reviewing mechanisms for crisis prevention and resolution in light of recent international experience, in collaboration with foreign supervisors.

- *Structural reforms.* Reform of the public enterprise sector and administered price-setting mechanisms will be essential to mitigate market distortions and redirect public spending toward growth-oriented investment. Enhancing the competition framework and wage-bargaining flexibility would help fight inflation and increase competitiveness.

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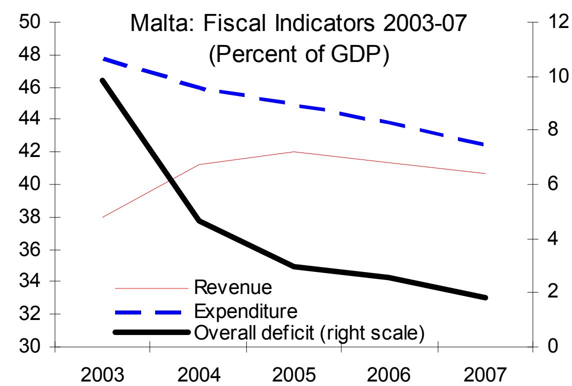
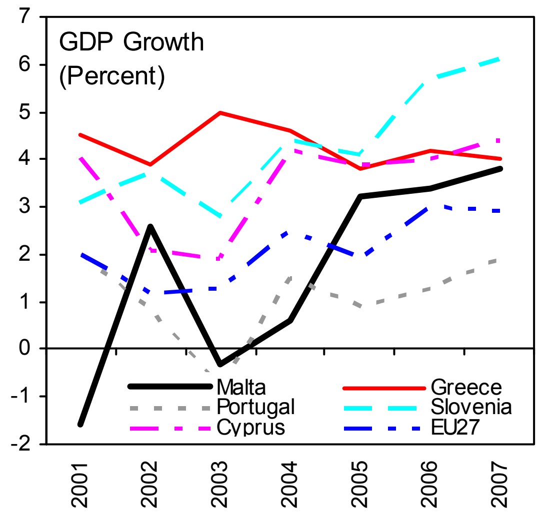
I. Introduction and Background

1. **Malta successfully adopted the euro on January 1, 2008: a crucial milestone in the authorities' growth-oriented reform agenda.** This agenda appropriately aims at leveraging Malta's strengths and income-generating potential through closer integration in the European and global economies. As the cost-competitiveness of traditional low value-added exports wanes, market liberalization and EU membership are intended to facilitate upward shifts in the value-added and quality export ladders. This is a promising but demanding strategy. It will require enhancing market-based flexibility and reducing the inefficiencies created by an overextended public sector. Robust fiscal savings are needed to provide a stable macroeconomic setting, reduce debt, and maintain the tax burden low—as the authorities intend—while investing in education and infrastructure.

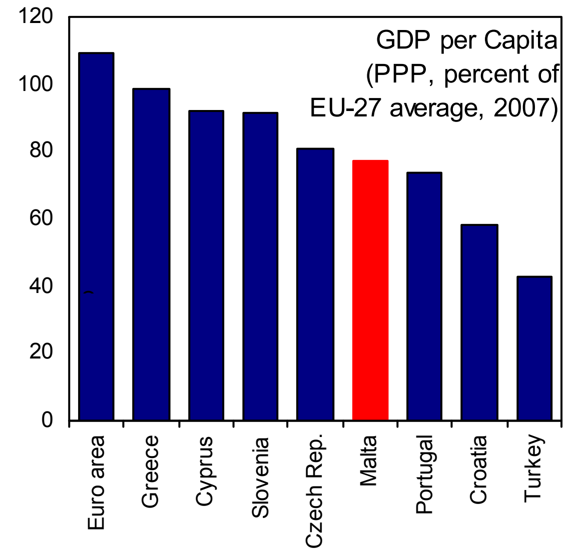
2. **Progress has already been made in this direction** (Appendix I)**.** Following sustained fiscal consolidation since 2003, the budget deficit was further reduced in 2007 to 1.8 percent of GDP, prompting the abrogation of the Maastricht Treaty's excessive deficit procedure in June 2007. Public debt fell to 62½ percent of GDP (from 72½ percent in 2004) helped by divestments. Also, direct public sector involvement in economic activities has been scaled down in the key areas of telecommunications, postal services, and airport and port services—though the public enterprise sector remains large, with subsidies and state aid among the highest in the EU.



3. **Largely as a consequence of liberalizing reforms, Malta has experienced a three-year-long expansion underpinned by foreign direct investment (FDI) and export diversification.** In the context of buoyant EU activity, growth accelerated to 3.8 percent in 2007 while the current account deficit declined to 5½ percent of GDP. Growth has been driven both by rising productivity and labor supply mobilization. Increased female participation helped raise the employment rate, while unemployment reached record lows. This reflected booming new manufacturing and services export activities, and a revival of tourism. Strong FDI (29 and 13 percent of GDP in 2006 and 2007, respectively) provided welcome know-how and global market access. Employment and income gains supported domestic demand.



Source: Eurostat.



4. **However, while economic liberalization has started to pay off, it is far from complete and a less favorable external environment will test the economy' resilience.** Despite recent positive economic performance, productivity is still low and the large public enterprise sector is a source of market distortions and budgetary strains—particularly since administered prices have lagged import price increases. The growth contribution of net exports became negative in the two quarters to 2008:Q1 as several export companies (textile and tobacco) closed down, and semiconductor sales (about half of goods exports) remained weak. During this latter period, activity was supported by domestic demand, notably government spending. Going forward, traditional manufacturing exports may experience further declines against the backdrop of softer external demand and an increasingly competitive global environment, despite subdued unit labor cost growth. Thus, Malta's competitiveness and economic prosperity will hinge on a stable macroeconomic framework and continued reforms to facilitate the reorientation toward high-growth export activities—buttressing FDI and investor confidence.

5. **The March 2008 general elections returned to office the ruling Nationalist Party with a narrow parliamentary majority.** During the preelectoral period, the authorities continued with important liberalizing initiatives and fiscal consolidation, but some controversial reforms were delayed—including restructuring of the loss-making public shipyards.

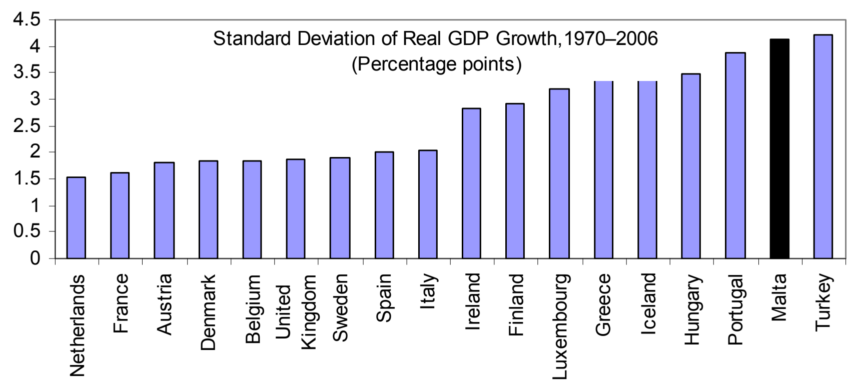
II. Report on the Discussions

6. **The authorities emphasized their determination to proceed with reforms.** They agreed that the initial period of the new legislature offered the opportunity to press ahead with crucial medium-term oriented reforms, thus anchoring investors' expectations. In this connection, they reiterated the 2008 budget deficit target of 1.2 percent of GDP (although

premised on a more favorable macroeconomic scenario than staff's), the MTO of structural budget balance by 2010 based on expenditure retrenchment, and the intention to meet remaining EU accession commitments. Regarding the latter, the authorities are unbundling and opening to private participation the fuel and LPG operations of the public energy company (Enemalta), and have recently announced their intention to restructure and privatize the shipyards shortly.

7. Policy discussions focused on the following areas, essential for success within EMU and economic stability.

- **Cementing fiscal consolidation.** Despite substantial fiscal retrenchment, the public finances remain fragile. Reinforcing the fiscal position is a core policy priority to ensure the domestic stability of Malta, highly vulnerable to external shocks and with volatile growth. In this vein, staff supported the authorities' target of structural budget balance by 2010 and argued for a surplus thereafter as a desirable policy buffer.



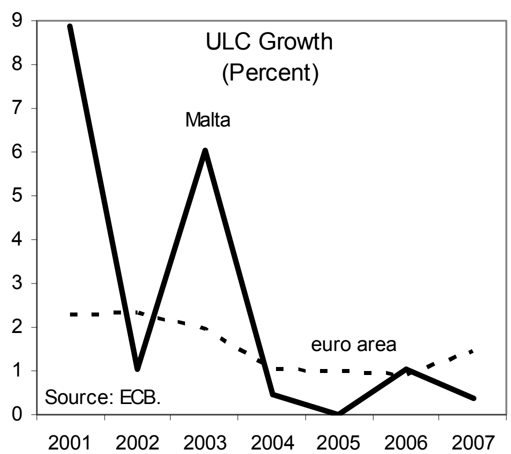
Source: World Development Indicators; and IMF staff calculations.

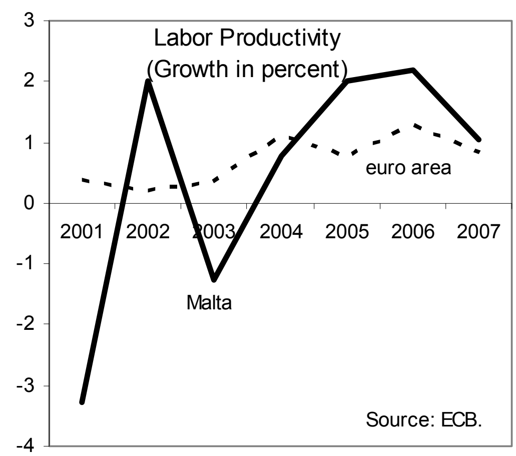
- **Strengthening the banking sector.** The impact of international financial turbulence on the domestic banking sector is assessed to be small. However, lending concentration, real estate exposures, and thin provisioning pose risks. Malta is actively participating in EU-wide efforts to strengthen mechanisms for crisis prevention and resolution.

- **Improving economic efficiency.** Reducing the role of the public sector is key. The authorities intend to reinvigorate, early in the legislature, their privatization and liberalization agenda, and reduce subsidies. The agenda could usefully be extended to competition policy and wage indexation, which however is not currently contemplated.

A. Outlook: Competitiveness and External Stability

8. **Improvements in cost fundamentals affecting competitiveness continued in 2007** (Figure 1, Box 1). After large competitiveness losses through 2004, ULC increases have generally been below trading partners' reflecting productivity gains and wage moderation. These trends continued in 2007, resulting in a ULC-based real depreciation of 1 percent relative to the rest of the euro area. On a multilateral trade-weighted basis, however, the ULC-based REER appreciated by 1.2 percent, highlighting Malta's vulnerability to euro appreciation—non-EMU countries account for 65 percent of goods exports. Labor cost growth has remained low (Figure 2) as the end of the agreed wage moderation period in the public sector appears not to have affected the private sector so far. Going forward, ongoing investment is likely to sustain productivity gains, while labor cost growth is expected to remain contained by slowing activity. All said, staff sees only a moderate competitiveness gap, based on CGER-type analyses, in the range 3–7½ percent.





9. **Noncost competitiveness trends—central to the authorities' strategy—have been particularly positive.** Terms-of-trade (TOT) gains and FDI-driven export diversification, especially into new services sectors, epitomize these trends.[1] The export structure is rapidly

[1] TOT gains averaged 0.9 percent annually in 2005–07, partly reflecting export quality and value-added upgrading. TOT-adjusted GDP grew 5.2 percent in 2007. TOT-adjusted GDP is computed by deflating exports by the import deflator and measures the volume of goods and services an economy can command.

Box 1. Competitiveness

Early this decade, Malta's narrow economic base (tourism, electronics) was shaken by the decline in tourism following the 9/11 events and the bursting of the dot-com bubble, while traditional manufacturing (e.g., textiles) came under pressure from low-cost competitors. Moreover, wage-inflation pressures led to large REER appreciation. EU entry in 2004 marked the start of a reversal (Figure 1). Updated national statistics show ULC growth below competitors (and euro area) during most of the 2004–07 period, stemming from sizable productivity gains and relatively subdued labor costs.

In recent years, FDI has driven the redeployment of resources toward new export activities (Figures 3, 4). Within manufacturing, airplane maintenance, and a tripling of generic pharmaceutics output helped cushion the decline of goods exports (Box Figure A below). Also, new services exports have emerged (Box Figure B), such as online gaming (9 percent of GDP), IT, call centers, and other business services (10 percent of GDP) and financial services (3 percent of GDP). Tourism rebounded recently owing to the airport opening to low-cost airlines, and harbor improvements enhanced cruise tourism. This reorientation has led to substantial terms-of-trade (TOT) gains (despite weak semiconductor prices), reflecting upward shifts in export quality and value-added. TOT gains are especially visible in services (Box Figure C), which exhibit high price elasticity relative to trading partners' income.

However, competitive pressures on traditional manufacturing remain, with output and employment losses of 60 percent in textiles through 2004–07 amid factory closures. Given the high import content of lower value-added manufactures, downsizing has caused a long-term downward trend in goods exports and imports (Box Figure D). Some manufactures (e.g., semiconductors) are counteracting competitive pressures by moving to higher skill and technology products. In the short run, the main risk lies in a faster-than-expected winding down in traditional manufacturing—adversely affected by euro appreciation, given the predominant weight of non-EMU export destinations (65 percent in goods).

The positive trends in Malta's competitiveness are partly captured by CGER-type estimates, which staff updated and extended in light of 2007 outcomes; new forecasts; and revised historical trade, current account, and international investment position (IIP) statistics.[2] [3]

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[2] Malta significantly revised its statistics in 2007–08 with assistance from Eurostat and the IMF to increase consistency with *ESA95* and SDDS, resulting in a more benign external competitiveness assessment than in the last Article IV consultation.

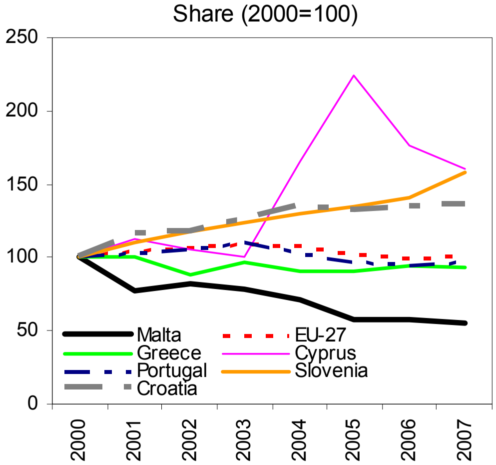
[3] The methodology follows *Exchange Rate Assessments: CGER Methodologies* (by Lee, et al, IMF Occasional Paper 261, 2008).

Box 1. Competitiveness (Concluded)

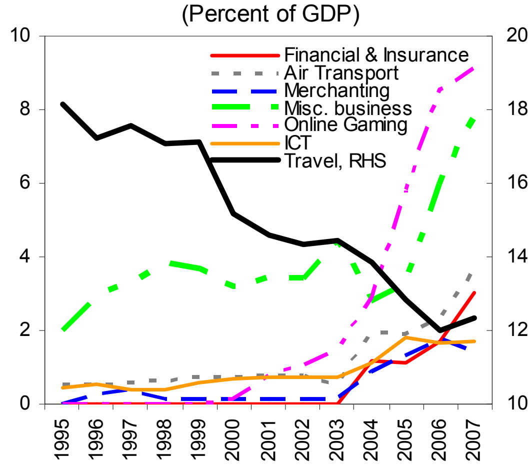
- The *macroeconomic balance approach* indicates a competitiveness gap of around 3 percent, versus 10–15 percent last year—reflecting better-than-expected current account outturn and data revisions. Closing this gap would bring the underlying current account (estimated at -2.4 percent of GDP) to an estimated long-run equilibrium level of -0.8 percent of GDP.

- The *external sustainability approach* indicates that stabilizing the net international investment position at current levels would require a competitiveness improvement of 7½ percent.

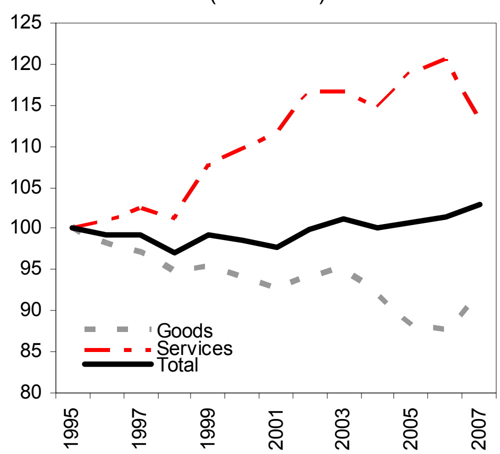
Box Figure A: Goods Exports World Trade Share (2000=100)



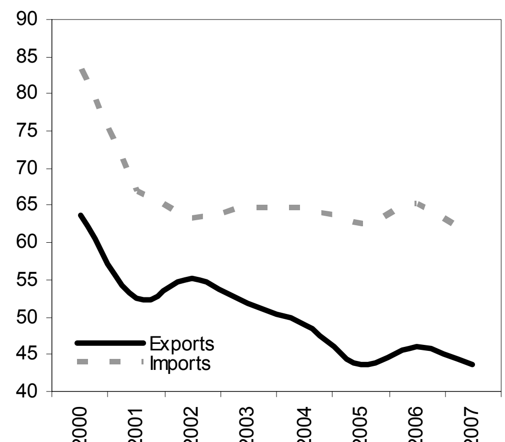
Box Figure B: Malta: Services Exports (Percent of GDP)



Box Figure C: Malta: Terms of Trade (1995=100)

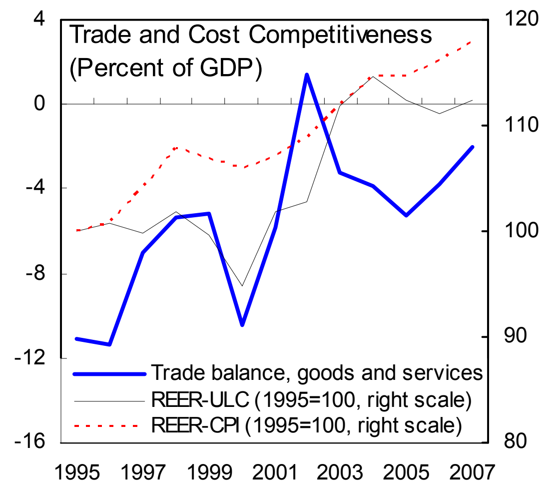


Box Figure D: Malta: Goods Trade (Percent of GDP)



Sources: Ameco; NSO; Central Bank of Malta; IMF Direction of Trade Statistics; and IMF staff estimates.

changing due to strong expansion of niche exports and tourism (Figure 5). As a consequence, the trade deficit in goods and services narrowed to 1.9 percent of GDP in 2007 (from 5.3 percent in 2005). Thus, the authorities felt that traditional aggregate cost-based competitiveness analyses should be complemented with micro-based angles—particularly in small economies. Staff's research also shows that quality upgrading and trade-specialization shifts have supported export performance in several neighboring euro area economies.[4] Indeed, there was broad consensus among the mission's interlocutors that changes in export structure were an equilibrium response to a higher REER—a hypothesis supported by sustained improvements in the goods and services trade balance despite a broadly stable ULC-based REER (after a large appreciation early in the decade).



Sources: National Statistics Office; and European Commission.

10. **Staff's central scenario envisages growth decelerating temporarily to 2¼–2½ percent in 2008–09 reflecting unfavorable external conditions** (Table 1)**; the authorities see a shallower slowdown.** Staff does not project a growth contribution of the external sector in the short term on account of weak foreign demand and further traditional manufacturing export contraction. This, coupled with high import prices will temporarily widen the current account deficit to close to 7 percent of GDP—partly reflecting high dependence on oil and food imports. Domestic demand, in turn, will be dampened by relatively high inflation during 2008 (annual average of about 4 percent, Figure 6), sluggish employment and real income growth, and tighter credit conditions. Inflation is expected to ease in 2009 as food and oil prices stabilize, the pricing power of the tourism sector weakens with the global environment, and base effects from the recent electricity price hike fade. Output is estimated to have reached its trend level in 2007, although the envisaged slowdown will reopen a modest gap in 2009, contributing to moderate inflation. The authorities envisage a more supportive external environment and thus project

Dependence on Food and Fuel Imports

	Oil equivalent consumption/ GDP 1/	Net imports (Percent of GDP) 2/		
		Fuel	Food	Fuel and Food
Malta	147.2	6.8	4.5	11.3
euro area	100.0	2.4	0.0	2.4
EU-27	113.5	n.a.	n.a.	n.a.
Europe 3/	n.a.	2.2	0.1	2.4

Sources: Eurostat; IMF.

1/ In kg/€ '000 (euro area=100) for 2005.
2/ Average of 2006 and 2007.
3/ Excludes Norway and Russia

[4] See *France, Greece, Italy, Portugal, and Spain -Competitiveness in the Southern Euro Area* (IMF Country Report No. 08/145), Chapters I, II, VI, and IX.

better export performance. There is broad consensus that investment will support activity, reflecting planned FDI projects.[5] There was also agreement that, over the medium term, activity will recover swiftly toward trend, sustained by FDI, emerging export activities, and terms-of-trade gains.

11. **In staff's view, the decline of traditional export sectors poses short-term risks, underscoring the need to maintain cost competitiveness and reform momentum.** The authorities see this decline as having largely run its course; any tail effects would likely be offset by the ongoing rapid growth of new exports. Staff, on the other hand, saw the risks to its scenario somewhat tilted to the downside. In the short term, given the small size of the economy, even modest additional export losses in some individual companies subject to intense international competition could significantly disrupt output and employment. Staff emphasized the need to prevent wage growth from running ahead of productivity, while accelerating reforms that foster the ongoing economic transformation. Competitiveness pressures within EMU might otherwise lead to a period of lackluster growth as has occurred in some euro area countries.

Main Economic Projections, 2008–09
(Percent)

	GDP		Inflation		CA balance		Fiscal deficit	
	2008	2009	2008	2009	2008	2009	2008	2009
IMF staff (June 08)	2.5	2.3	4.1	2.7	-6.7	-6.2	1.7	1.0
Stability Program (Nov. 07)	3.1	3.2	2.5	2.3	-2.6	-1.9	1.2	0.1
Central Bank of Malta (June 08)	2.5	2.6	4.0	2.7	-6.2	-6.3	1.6	0.7
European Commission (Apr. 08)	2.6	2.5	3.4	2.2	-5.9	-5.6	1.6	1.0

12. **Long-term external sustainability risks are tempered by envisaged large FDI inflows and a strong net international investment credit position** (Tables 2 and 3). The authorities pointed out that the current account deficit had been amply overfinanced by FDI, supported by Malta's history of stable institutions and internationally harmonized business environment—enhanced by EU and EMU membership. Staff's external sustainability analysis also points to a robust external balance sheet (Table 4). However, staff emphasized the need for fiscal and financial policy buffers given the volatility associated with the economy's small size and its reliance on continued positive investor sentiment.

[5] Projects include the construction of an IT park by TECOM—strategic investor from Dubai in GO (former Maltacom)—starting at end-2008 and ongoing harbor investments by the private operator (a large French maritime transport company).

B. Cementing Fiscal Consolidation

13. **Expenditure-based consolidation continued in 2007, though the public finances remain fragile** (Figure 7)**.** Tight spending control achieved the first recorded current surplus in recent years while allowing some tax cuts. The structural deficit (net of one-offs, mainly land sales) improved by almost ½ percentage point of GDP (Table 5). However, the public finances are under endemic stress from sizable subsidies (about twice the EU average) and state aid (four times the EU average); health care costs; the public wage bill (13 percent of GDP); and pensions and other social spending (over 13 percent of GDP). Also, public enterprise guarantees, and other contingent liabilities remain high.

14. **The authorities are adopting additional measures to meet the 2008 budget target (1.2 percent of GDP).** 2008 data show a significant increase in outlays. The authorities indicated that there had been frontloaded expenditures that they planned to claw back within the year. They anticipated, however, that given higher-than-projected oil prices and other costs, the budget would be substantially overrun if prevailing policy parameters were maintained through year end. Thus, the authorities were planning offsetting cuts in discretionary spending, including prioritization and sequencing of capital projects, additional hiring controls, and other savings in current spending. They also have raised electricity prices by about one-third since the mission (although staff estimates that they remain some 25 percent below cost recovery). This latter measure will limit electricity subsidies to 0.7 percent of GDP (0.25 percent in the original budget). In staff's view, the measures in train will limit overall 2008 underperformance to ½ percentage point of GDP relative to budget—partly due to the play of automatic stabilizers, given lower growth assumptions. The structural balance, however, is forecast to improve by ¾ of a percentage point of GDP—making a sizable contribution toward the MTO.

Medium-term Fiscal Targets in the Stability Program
(Percent of GDP)

	2007	2008	2009	2010
Structural balance	-1.9	-1.2	-0.6	0.1
Overall balance	-1.6	-1.2	-0.1	0.9
Memorandum items:				
Staff overall balance (current)	-1.8	-1.7	-1.0	-0.3
European Commission overall balance (April 08)	-1.8	-1.6	-1.0	n.a.

15. **The authorities anchor their medium-term strategy in further spending retrenchment, which will require expenditure reforms.** The authorities intend to continue reducing subsidies and still-high public employment (about 30 percent of full-time employees). In particular, they have announced the elimination of shipyard and bread subsidies in 2009, and are identifying savings on other subsidies and health costs—although delivery-point health care charges have been ruled out. The mission encouraged early

formulation of detailed and more explicit multiyear measures to reduce current spending.[6] This would minimize uncertainty and the encroachment, forced by events, on growth-enhancing capital spending—especially, in view of upside risks to expenditure plans, including unbudgeted potential costs of public enterprise restructuring. Staff suggested complementing attrition with proactive personnel redeployment and selection based on training and performance; and consideration of market-based measures to rationalize public services demand and increase supply efficiency, including in health care, if administrative cost control measures prove ineffective. There was agreement that 2009–10 revenue projections were appropriately conservative—given authorities' indications that tax cuts would be implemented prudently, as cost savings materialized.

16. **The authorities are reinforcing the fiscal framework with a medium-term orientation.** They are pursuing more structured multiyear fiscal planning and the introduction of performance budgeting methods. Evaluation procedures for investment projects (crucial for optimizing reduced EU funds) and hospital performance are being improved. Staff recommended extending spending reviews to all major areas (particularly education, given its competitiveness-enhancing role), and parliamentary agreement on aggregate expenditure limits before starting budget appropriation discussions. On longer-term issues, the EU pensions working group projects age-related spending to be relatively benign, though revised estimates of the 2006 pension reform impact still need to be finalized.

C. Strengthening the Growing Financial System

17. **The financial sector appears to be resilient to international developments, though it has experienced some adverse effects** (Box 2)**.** The authorities and private sector analysts considered the banks well-placed to weather the global turmoil. Banks have strong liquidity positions (Table 7) and no exposure to subprime-related assets. They are also profitable, although some banks' financial results were affected by markdowns in security portfolios, and equity valuations saw substantial declines in 2008—possibly accentuated by local stock market thinness (Figure 8). The internationally oriented financial sector (now fully under uniform regulation) is expanding rapidly.

[6] A point also made by the EC in its assessment of Malta's Stability Program (ECFIN/REP50669/08). Staff's medium-term scenario (Table 5) assumes an underlying expenditure-based effort (public employment, subsidies and other spending reductions) similar to 2004–06. The pace of spending reduction would be however slower reflecting the expiration of the public wage moderation agreement and increasing demographic pressures on social spending.

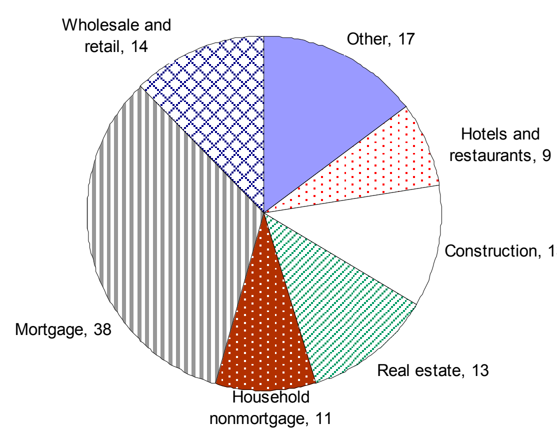
Box 2. Spillovers from International Financial Turmoil

Malta's domestic banks, as elsewhere, have seen some fallout from the turmoil, including mark-downs in the security portfolios, trading losses, and increased funding costs. Lending surveys indicate tightening credit conditions, and securities valuation losses could increase in case of prolonged international market turbulence. But overall, the following factors indicate **low risk of direct contagion**.

- **Strong domestic franchises.** The systemically important banks have robust brand recognition and a solid presence and expertise in key domestic sectors.
- **Good funding profile.** Domestic banks rely mainly on resident deposits and little on wholesale market funding—being generally net lenders in cross-border interbank money markets. Hence, higher funding costs affect profits only moderately.
- **High liquidity.** Liquidity ratios are well above the 30 percent prudential requirement. This buffer should permit the banks to recover valuation losses by holding securities (generally highly rated and with maturity under five years) to maturity.
- **Negligible subprime exposures.** Main agencies have confirmed bank ratings with stable outlooks and reported very limited exposure to structured and similar instruments—a point confirmed by Central Bank of Malta's surveys.

18. **The housing market remains overall broadly stable, although some market segments have recently experienced real price declines as credit conditions tightened** (Box 3)**.** Banks' exposure through mortgages and corporate lending, at 57 percent of resident loans, is large and has been growing quickly (Figure 9). Recently, banks have become more cautious in extending high loan-to-value mortgages and are reducing exposures to construction, while using opportunities for asset diversification created by EMU entry. The housing market has remained generally stable since 2005, and staff concurred with the authorities that there is probably little, if any,

Banks' Loan Portfolio, end-2007
(Percent of GDP)



Source: Central Bank of Malta.

overvaluation relative to fundamentals. Nonetheless, some market segments could experience additional real price declines if credit tightens further.

Box 3. Housing Market

Real house prices increased by 54 percent during 2002–05 but have since been broadly stable (Figure 6). Staff's regression analysis, based on the Spring 2008 *WEO* methodology, indicates that most of these price dynamics reflect changing fundamentals in the run up to EU accession (Box Figure A). In particular, lower interest rates on predominantly variable-rate mortgages and financial development during 2001–07 are identified as the main drivers (Box Figure B).

In recent months, interest rate and credit tightening also explain the observed decline in real prices, which could continue for some time if credit conditions remain restrictive—despite the estimated absence of significant overvaluation relative to fundamentals. The authorities and private analysts pointed out that the market was highly fragmented, with pent-up supply concentrated in certain segments, where the real price falls had occurred (e.g., apartments).

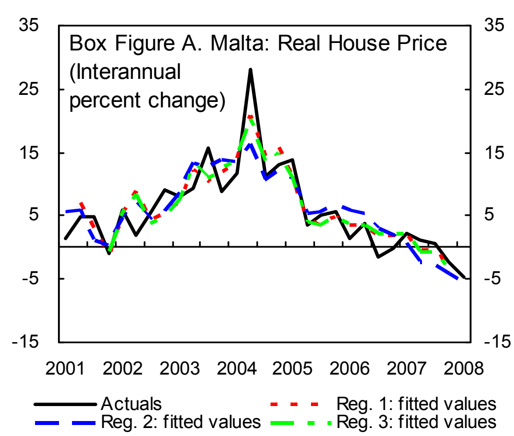
Empirical Results

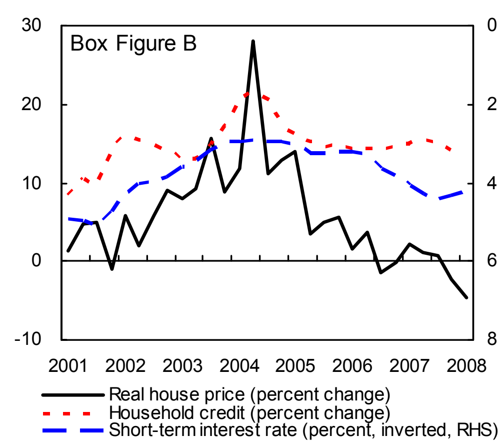
Explanatory Variables 1/	Reg. 1	Reg. 2	Reg. 3
	Dependent Variable Real House Price (Growth)		
Affordability ratio (lagged)	-0.464	-0.335	-0.513
	(0.000)	(0.001)	(0.001)
Short-term interest rate	-0.059	-0.085	-0.064
	(0.000)	(0.000)	(0.001)
Household credit growth (lagged)	0.928		0.728
	(0.008)		(0.088)
Working age population (growth)	74.124	45.297	86.290
	(0.003)	(0.054)	(0.015)
Constant	-1.826	-0.979	-2.018
	(0.000)	(0.024)	(0.007)
Memorandum items:			
Adjusted R squared	0.748	0.648	0.753
Number of observations	27	28	25
Implied current over (+) / under(-) valuation (percent)	-0.03	0.58	-0.05
Method	OLS	OLS	2SLS

Source: IMF staff estimates.

Notes: P-values in parentheses. Reg. 1 applies the Spring 2008 WEO methodology to Malta. The other two regressions aim to avoid reverse causality between credit growth and house prices by (i) excluding credit growth (Reg. 2) and (ii) instrumenting it with its own lags in a two stage least squares regression (Reg. 3). Over-/undervaluation calculated over the period from 2001Q4 to 2007Q4 (Regressions 1 and 3) and 2001Q4 to 2008Q1 (Regression 2).

1/ In all specifications, the variance of the explanatory variable is overwhelmingly explained by interest rates.





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

19. **Domestic asset quality remains weak due to relatively high—and thinly provisioned—NPLs.** Despite substantial reduction in recent years, the NPLs in domestically controlled banks are high (7.6 percent of loans at end-2007)—and edging up in construction. The authorities partly shared staff concerns over the low and declining provision-coverage ratio (below 30 percent before collateral at end-2007). Staff recommended that the supervisor discuss with banks means to increase provisioning, while enhancing incentives by introducing tax deductibility of specific provisions. The authorities noted, however, that unprovisioned loans are fully backed by high-quality collateral.

20. **Malta is making good progress in introducing Basel II and other EU prudential standards.** The authorities saw merit in staff's recommendations to introduce more frequent (quarterly) public reporting by the main banks and improve consistency in NPL reporting. Regarding the former, however, they observed that more frequent reporting may also cause a higher noise-to-information ratio.

21. **Malta is actively strengthening its national and cross-border crisis management framework in the light of lessons from the financial turmoil.** The Domestic Standing Group was established last year and Memoranda of Understanding have been signed among key agencies and with relevant foreign jurisdictions—increasingly important due to rising internationally oriented bank presence. The authorities are also participating in various EU and ECB cross-border reviews, as well as conducting simulations and stress tests. In staff's view, Malta's preparedness to engage in bank resolution is satisfactory but could be improved in some respects. In this regard, the authorities were receptive to staff recommendations to review the legal means and procedures to act expeditiously—including systemic solvency support provision—should it ever be necessary. They were also introducing initiatives to buttress deposit insurance coverage based on recent international experience.

D. Improving Economic Efficiency

22. **The authorities have made remarkable gains in strengthening the business environment and improving education outcomes, but rigidities in product and labor markets hinder growth.** Policies seek additional improvements in educational attainment and labor market participation, particularly among females. Staff suggested reconsideration of the existing across-the-board mandatory inflation adjustment of wages (COLA), which, although partial, may hinder productivity-based wage increases and help entrench inflation.[7] The authorities, however, thought that COLA's impact was limited and facilitated consensus in wage negotiations. Staff also recommended granting institutional independence to the

[7] See ECB Monthly Bulletin, 5/2008, Box 5 "Wage Indexation Mechanisms in Euro Area Countries" and ECB Occasional Paper No. 90, 7/2008, "Wage Growth Dispersion Across the Euro Area Countries: Some Stylised Facts" (Andersson, et al).

competition authority (currently part of the Ministry of Finance). The authorities thought this premature, while agreeing that a proactive stance was crucial in fostering price flexibility and efficient markets, hampered by the economy's small size. They also viewed implementation of the EU services directive as an opportunity in this regard.

23. **Renewed momentum in public enterprise reform would also improve economic efficiency, while freeing public resources.** Privatization and outsourcing has continued in several areas (harbor services, post, energy), soon to include the shipyards—but the public sector remains large (Table 9). Although not opposed in principle, the authorities have no immediate plans to privatize Bank of Valletta[8] partly because they consider current market conditions unfavorable. Staff agreed with the latter point but argued for a more active search of a suitable strategic investor as the sale would crowd in FDI and have positive spillovers within the financial system.

24. **The authorities are increasing the pass-through of fuel prices to avoid derailing budget plans and prevent distortions while exploring means to shield vulnerable groups.** The authorities already increased the price of electricity in July 2008, although a significant gap relative to costs remains. They also intend to introduce a water and electricity tariff reform by the fall aiming to protect low-income households and progress toward cost recovery. In this connection, staff advocated the introduction of rule-based mechanisms to regularly update administered prices—according to market conditions and aiming to reach cost recovery over a reasonable period. This would avoid the need for discretionary government decisions, which have often been protracted and unnecessarily controversial.

25. **Provision of economic statistics has improved substantially but remains below international best practices** (Appendix II)**.** Progress has been made toward SDDS subscription (expected shortly). The authorities indicated their intention to reinforce the National Statistics Office, including by filling essential management-level vacancies and improving further national accounts and business statistics.

III. Staff Appraisal

26. **Malta's EMU membership in January 2008 is an important step forward in seizing the opportunities of a global marketplace.** The authorities' strategy of boosting competitiveness through liberalization, export diversification, and value-added upgrading is beginning to pay off. Growth averaged 3½ percent in 2005–07, underpinned by fiscal adjustment and economic liberalization, and driven by FDI and new niche exports. Export reorientation, rising productivity, and terms-of-trade gains supported cost and noncost

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[8] One of the two dominant banks in the domestic market (by deposits). The government is the main shareholder with a 25 percent stake.

competitiveness, trimming the current account and trade deficits. However, competitiveness gaps remain, and Malta is particularly vulnerable to euro strength given its trade orientation. These factors are intensifying the decline of traditional exports despite subdued ULC growth.

27. **Growth is expected to decelerate to 2¼–2½ percent in 2008–09 due to unfavorable external developments before reverting back to trend of some 3 percent.** Import-price-driven inflation will curb domestic demand this year, while a weaker external environment eliminates the growth contribution of net exports. Risks are on the downside: traditional export sector declines could outpace the emergence of new activities, especially if complacency over reforms were to dent investor sentiment and FDI.

28. **Seizing the potential of new growth niches will require improvements in economic efficiency and market-based flexibility.** Further fiscal consolidation and public sector streamlining will be key. The start of the new legislature is an opportunity to reinvigorate the necessary fiscal, financial, and structural reforms.

29. **The authorities' MTO of structural fiscal balance by 2010 based on expenditure retrenchment will require tackling the high cost of subsidies, payroll, and entitlements.** The authorities are appropriately identifying and implementing immediate spending cuts to address expenditure overruns—partly caused by higher-than-budgeted fuel prices. This should ensure a continuation of good progress toward the medium-term objective. Reinforcing the fiscal framework with a medium-term orientation would help preserve the benefits of fiscal consolidation and prioritize spending. Vulnerabilities inherent to Malta's small economy argue for targeting a surplus beyond 2010.

30. **The banking system is well placed to weather the current global turmoil but is weakly provisioned and exposed to Malta's narrow economic base.** The supervisory framework is rapidly improving in the wake of EU membership and further steps would enhance resilience and market discipline. Banks have healthy liquidity and a good funding profile. But exposure to the slowing housing market, and low and uneven provisioning call for close vigilance. Recent international experience offers an opportunity to review mechanisms for crisis prevention and resolution, including the needed authority and flexibility to act expeditiously.

31. **Further public sector streamlining and market-oriented reforms are key to realizing Malta's growth potential.** Reform of the public enterprise sector and administered price-setting mechanisms will be essential to mitigate market distortions and redirect public spending toward growth-enhancing investment. Enhancing the competition framework and wage-bargaining flexibility would help to fight inflation and increase competitiveness.

32. It is proposed that the next Article IV consultation be held on the 12-month cycle.

Table 1. Malta: Selected Economic Indicators, 2004–13

					Proj.					
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Real Economy					(Change in percent)					
Real GDP	0.6	3.2	3.4	3.8	2.5	2.3	2.7	3.0	3.2	3.4
Domestic demand	2.2	5.5	2.3	2.9	2.3	2.2	2.4	2.8	3.0	3.1
Consumption	2.0	1.4	1.8	1.2	2.3	2.0	2.2	2.6	2.9	3.0
Private consumption	2.4	1.9	0.7	1.6	2.3	2.2	2.6	2.8	3.1	3.2
Public consumption	0.6	-0.5	6.0	-0.1	2.6	1.1	0.8	2.0	2.1	2.3
Fixed investment	-3.2	8.2	3.8	3.8	2.6	3.5	3.7	3.7	3.7	3.7
Inventory accumulation 1/	1.1	3.1	0.2	1.3	0.0	0.0	0.0	0.0	0.0	0.0
Foreign balance 1/	-1.7	-2.6	0.9	0.7	0.0	-0.1	0.1	0.1	0.1	0.2
Exports of goods and services	2.2	-0.8	10.0	-0.6	-0.3	1.1	1.7	2.1	2.3	2.5
Imports of goods and services	3.8	1.8	8.4	-1.3	-0.2	1.1	1.5	1.9	2.1	2.2
Output gap (percent)	-3.1	-1.7	-0.6	0.4	0.1	-0.5	-0.6	-0.5	-0.2	0.1
CPI (harmonized)	2.7	2.5	2.6	0.7	4.1	2.7	2.4	2.4	2.4	2.4
Unemployment rate EU stand (percent)	7.4	7.3	7.3	6.4	6.5	7.0	6.7	6.4	6.2	6.1
Gross national savings (percent of GDP)	10.7	11.7	12.4	16.1	15.3	15.9	17.3	18.0	18.6	19.2
Gross capital formation (percent of GDP)	16.7	20.4	20.7	21.6	22.0	22.1	22.0	21.9	21.7	21.6
Public finance					(Percent of GDP)					
General government balance	-4.6	-3.0	-2.5	-1.8	-1.7	-1.0	-0.3	-0.1	0.2	0.4
Revenue	41.0	42.0	41.3	40.6	40.8	40.7	40.7	40.6	40.5	40.4
Expenditure	45.6	45.0	43.8	42.4	42.5	41.7	41.1	40.7	40.3	40.0
General government debt	72.4	70.3	64.1	62.4	60.9	59.0	56.0	52.6	49.1	45.5
Money and credit					(Change in percent)					
International Investment Position (millions of euros)	1,814.9	1,778.9	1,496.7	…	…	…	…	…	…	…
Broad money (M3) growth	2.4	4.2	5.2	11.1	…	…	…	…	…	…
Domestic credit	5.5	1.3	9.2	10.7	…	…	…	…	…	…
o/w private sector	-1.3	9.0	15.3	10.2	…	…	…	…	…	…
Balance of payments					(Percent of GDP)					
Current account balance	-5.9	-8.8	-8.2	-5.4	-6.7	-6.2	-4.8	-3.8	-3.1	-2.4
Trade balance (goods and services)	-3.8	-5.3	-3.9	-1.9	-3.9	-3.5	-2.0	-1.0	-0.1	0.7
Exports of goods and services	79.2	77.6	87.4	87.4	86.9	86.3	85.4	84.5	83.6	82.8
Imports of goods and services	83.1	82.9	91.4	89.3	90.8	89.8	87.4	85.4	83.8	82.1
Goods balance	-15.6	-18.7	-18.9	-17.4	-20.2	-21.1	-20.8	-20.7	-20.2	-19.8
Services balance	11.8	13.3	15.0	15.5	16.3	17.6	18.8	19.7	20.1	20.5
Exchange rates										
Exchange rate regime				Joined EMU on January 1, 2008						
Nominal effective rate (2000=100)	110.9	109.8	110.2	114.7	…	…	…	…	…	…
Real effective rate, CPI-based (2000=100)	112.9	112.7	113.8	117.3	…	…	…	…	…	…
Real effective rate, ULC-based (2000=100)	122.7	120.2	119.8	120.8	…	…	…	…	…	
Memorandum item:										
Nominal GDP (millions of euros)	4,488.9	4,770.4	5,075.1	5,398.5	5,651.4	5,941.3	6,311.3	6,724.4	7,172.3	7,664.4

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

1/ Contribution to growth.

Table 2. Malta: International Investment Position, 2002–06

	2002	2003	2004	2005	2006
			(Millions of euros)		
International Investment Position	1,501.9	1,783.7	1,814.9	1,778.9	1,496.7
Direct investment	-1,989.4	-1,880.8	-2,158.6	-2,805.2	-4,061.8
Assets	252.6	736.8	823.1	840.5	868.8
Liabilities	-2,242.0	-2,617.6	-2,981.7	-3,645.7	-4,930.6
Portfolio investment	3,700.3	5,271.4	6,789.8	9,640.9	10,963.8
Assets	4,043.3	5,600.6	7,144.4	10,053.9	11,371.6
Liabilities	-343.0	-329.2	-354.6	-413.0	-407.8
Financial derivatives	0.0	-21.1	-27.4	-1.9	-14.9
Other investment	-2,261.1	-3,786.1	-4,817.8	-7,243.8	-7,631.0
Assets	5,623.8	5,803.4	6,745.2	9,595.7	12,328.2
Liabilities	-7,884.9	-9,589.5	-11,563.0	-16,839.5	-19,959.2
Reserves	2,051.8	2,200.3	2,029.0	2,188.9	2,240.7
			(Percent of GDP)		
International Investment Position	35.1	40.6	40.4	37.3	29.5
Direct investment	-46.5	-42.9	-48.1	-58.8	-80.0
Assets	5.9	16.8	18.3	17.6	17.1
Liabilities	-52.4	-59.6	-66.4	-76.4	-97.2
Portfolio investment	86.5	120.1	151.3	202.1	216.0
Assets	94.6	127.6	159.2	210.8	224.1
Liabilities	-8.0	-7.5	-7.9	-8.7	-8.0
Financial derivatives	0.0	-0.5	-0.6	0.0	-0.3
Other investment	-52.9	-86.3	-107.3	-151.8	-150.4
Assets	131.5	132.2	150.3	201.2	242.9
Liabilities	-184.4	-218.5	-257.6	-353.0	-393.3
Reserves	48.0	50.1	45.2	45.9	44.1
Memorandum items:					
Gross external debt (millions of euros)	8,179.0	9,881.1	11,799.5	17,070.8	20,180.6
Gross external debt (percent of GDP)	191.3	225.2	262.9	357.8	397.6

Sources: Eurostat; and Maltese authorities.

Table 3. Malta: Summary Balance of Payments, 2004–13

					Proj.					
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
	(Millions of euros)									
Current account balance	-263.7	-418.2	-418.6	-292.3	-379.2	-369.2	-299.9	-257.6	-222.3	-182.8
Trade balance (goods and services)	-171.5	-254.6	-200.3	-100.7	-221.0	-207.6	-126.9	-65.3	-8.5	54.8
Goods balance	-700.4	-891.1	-960.6	-937.1	-1,141.6	-1,253.6	-1,312.7	-1,391.9	-1,448.8	-1,517.5
Exports	2,188.2	2,083.1	2,333.7	2,347.8	2,379.2	2,430.0	2,530.8	2,656.1	2,804.4	2,966.1
Imports	-2,888.6	-2,974.3	-3,294.3	-3,284.9	-3,520.8	-3,683.6	-3,843.6	-4,048.1	-4,253.2	-4,483.6
Services balance	528.9	636.6	760.3	836.5	920.6	1,046.0	1,185.8	1,326.7	1,440.3	1,572.3
Exports	1,369.0	1,617.2	2,104.0	2,370.1	2,530.6	2,697.7	2,856.1	3,023.2	3,195.0	3,383.7
Imports	-840.0	-980.6	-1,343.7	-1,533.6	-1,610.0	-1,651.7	-1,670.3	-1,696.5	-1,754.7	-1,811.4
Current income, net	-43.5	-199.6	-212.7	-129.5	-152.6	-154.5	-164.1	-181.6	-200.8	-222.3
Current transfers, net	-48.7	35.9	-5.6	-62.1	-5.7	-7.1	-8.8	-10.8	-12.9	-15.3
Private	-60.4	14.2	-48.3	13.2	-6.6	-8.1	-9.9	-11.9	-14.1	-16.6
Public	11.7	21.7	42.8	-75.3	1.0	1.0	1.1	1.1	1.2	1.3
Capital account, net	66.6	155.6	149.4	49.3	68.9	89.1	116.2	127.0	136.1	157.6
Financial account, net	140.3	300.2	326.1	107.7	310.3	280.1	183.7	130.5	86.2	25.3
Direct investment	312.0	560.4	1,481.8	684.4	401.7	528.2	544.9	556.7	579.7	577.8
Portfolio investment	-1,681.1	-2,137.3	-1,980.8	365.9	-503.0	-1,027.8	-1,268.6	-1,499.5	-1,728.5	-1,931.4
Other investment	1,348.3	2,064.9	908.2	-616.2	411.6	779.8	907.4	1,073.4	1,235.0	1,378.9
Reserves (- inflow; + outflow)	161.1	-187.8	-83.1	-326.5	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	56.8	-37.5	-56.9	135.3	0.0	0.0	0.0	0.0	0.0	0.0
	(Percent of GDP)									
Current account balance	-5.9	-8.8	-8.2	-5.4	-6.7	-6.2	-4.8	-3.8	-3.1	-2.4
Trade balance (goods and services)	-3.8	-5.3	-3.9	-1.9	-3.9	-3.5	-2.0	-1.0	-0.1	0.7
Goods balance	-15.6	-18.7	-18.9	-17.4	-20.2	-21.1	-20.8	-20.7	-20.2	-19.8
Exports	48.7	43.7	46.0	43.5	42.1	40.9	40.1	39.5	39.1	38.7
Imports	-64.4	-62.3	-64.9	-60.8	-62.3	-62.0	-60.9	-60.2	-59.3	-58.5
Services balance	11.8	13.3	15.0	15.5	16.3	17.6	18.8	19.7	20.1	20.5
Exports	30.5	33.9	41.5	43.9	44.8	45.4	45.3	45.0	44.5	44.1
Imports	-18.7	-20.6	-26.5	-28.4	-28.5	-27.8	-26.5	-25.2	-24.5	-23.6
Current income, net	-1.0	-4.2	-4.2	-2.4	-2.7	-2.6	-2.6	-2.7	-2.8	-2.9
Current transfers, net	-1.1	0.8	-0.1	-1.2	-0.1	-0.1	-0.1	-0.2	-0.2	-0.2
Private	-1.3	0.3	-1.0	0.2	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2
Public	0.3	0.5	0.8	-1.4	0.0	0.0	0.0	0.0	0.0	0.0
Capital account, net	1.5	3.3	2.9	0.9	1.2	1.5	1.8	1.9	1.9	2.1
Financial account, net	3.1	6.3	6.4	2.0	5.5	4.7	2.9	1.9	1.2	0.3
Direct investment	7.0	11.7	29.2	12.7	7.1	8.9	8.6	8.3	8.1	7.5
Portfolio investment	-37.4	-44.8	-39.0	6.8	-8.9	-17.3	-20.1	-22.3	-24.1	-25.2
Other investment	30.0	43.3	17.9	-11.4	7.3	13.1	14.4	16.0	17.2	18.0
Reserves (- inflow; + outflow)	3.6	-3.9	-1.6	-6.0	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	1.3	-0.8	-1.1	2.5	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Official reserves, end of period										
(Millions of euros)	2,193.2	2,081.5	2,360.2	2,753.1	…	…	…	…	…	…
(Millions of U.S. dollars)	2,733.9	2,578.7	2,980.9	3,798.4	…	…	…	…	…	…
(Months of imports of goods and services)	7.1	6.3	6.1	6.8	…	…	…	…	…	…

Sources: Eurostat; Central Bank of Malta; and IMF International Financial Statistics.

Table 4. Malta: External Debt Sustainability Framework, 2003–13
(Percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2003	2004	2005	2006	2007	10-Year Historical average	10-Year Standard deviation	2008	2009	2010	2011	2012	2013	Debt-stabilizing noninterest current account 6/
								I. Baseline projections						
1 External debt 1/	-26.3	-36.7	22.6	-53.5	-55.5			**-54.1**	**-55.1**	**-56.9**	**-58.9**	**-61.3**	**-63.7**	**-14.3**
2 Change in external debt	2.0	-10.4	59.3	-76.1	-2.1			1.4	-0.9	-1.8	-2.1	-2.4	-2.4	
3 Identified external debt-creating flows (4+8+9)	-4.0	0.3	0.3	-20.9	-2.5			2.6	0.6	0.1	-0.2	-0.5	-0.3	
4 Current account balance, excluding interest payments	3.1	9.7	13.3	13.8	11.9			14.0	14.3	13.7	13.6	13.6	13.7	
5 Deficit in balance of goods and services	3.2	3.8	5.3	3.9	1.9			3.9	3.5	2.0	1.0	0.1	-0.7	
6 Exports	79.9	79.2	77.6	87.4	87.4			86.9	86.3	85.4	84.5	83.6	82.8	
7 Imports	83.2	83.1	82.9	91.4	89.3			90.8	89.8	87.4	85.4	83.8	82.1	
8 Net nondebt creating capital inflows (negative)	-7.9	-6.2	-10.7	-27.8	-11.1			-6.6	-8.3	-7.9	-7.5	-7.2	-6.7	
9 Automatic debt dynamics 2/	0.8	-3.3	-2.4	-6.9	-3.3			-4.8	-5.5	-5.7	-6.2	-6.9	-7.4	
10 Contribution from nominal interest rate	0.0	-3.9	-4.5	-5.6	-6.5			-7.3	-8.1	-8.9	-9.7	-10.5	-11.3	
11 Contribution from real GDP growth	-0.1	0.1	1.1	-0.7	1.9			1.3	1.2	1.4	1.6	1.8	1.9	
12 Contribution from price and exchange rate changes 3/	0.8	0.4	1.1	-0.6	1.3			1.2	1.5	1.8	1.9	1.9	2.0	
13 Residual, including change in gross foreign assets (2–3)	6.1	-10.6	59.0	-55.2	0.4			-1.2	-1.5	-1.8	-1.9	-1.9	-2.1	
External debt-to-exports ratio (percent)	-32.9	-46.3	29.1	-61.2	-63.6			-62.3	-63.8	-66.6	-69.8	-73.3	-76.9	
Gross external financing need (billions of euros) 4/	…	-0.5	-0.9	1.2	-1.8			-2.1	-2.2	-2.4	-2.7	-3.1	-3.5	
Percent of GDP	…	-10.3	-19.0	22.8	-33.2			-37.6	-36.9	-38.7	-40.9	-43.2	-45.7	
Key macroeconomic assumptions						10-Year Historical average	10-Year Standard deviation							Projected average
Nominal GDP (billions of euros)	4.4	4.5	4.8	5.1	5.4			5.7	5.9	6.3	6.7	7.2	7.7	
Real GDP growth (percent)	-0.3	0.6	3.2	3.4	3.8	1.8	2.1	2.5	2.3	2.7	3.0	3.2	3.4	2.9
GDP deflator (change in domestic currency)	3.0	1.7	3.0	2.9	2.5	3.4	2.6	2.2	2.8	3.5	3.4	3.3	3.4	3.3
Nominal external interest rate (percent)	-0.1	15.0	13.1	-26.2	13.0	1.2	11.8	13.8	15.8	17.2	18.2	19.1	19.8	18.0
Growth of exports (euro terms, in percent)	-6.2	1.4	4.0	19.9	6.3	7.3	11.4	4.1	4.4	5.1	5.4	5.6	5.8	5.3
Growth of imports (euro terms, in percent)	-0.8	2.2	6.1	17.3	3.9	6.7	12.6	6.5	4.0	3.3	4.2	4.6	4.8	4.2
Current account balance, excluding interest payments	-3.1	-9.7	-13.3	-13.8	-11.9	-7.5	5.6	-14.0	-14.3	-13.7	-13.6	-13.6	-13.7	-13.8
Net nondebt creating capital inflows	7.9	6.2	10.7	27.8	11.1	10.2	10.0	6.6	8.3	7.9	7.5	7.2	6.7	7.5
								II. Stress tests for external debt ratio						Debt-stabilizing noninterest current account 6/
A. Alternative scenarios														
A1. Key variables are at their historical averages in 2008-2013 5/								**-54.1**	**-56.3**	**-58.7**	**-61.1**	**-63.4**	**-65.9**	**-7.7**
B. Bound tests														
B1. Nominal interest rate is at baseline plus one-half standard deviation								**-54.1**	**-58.1**	**-63.4**	**-69.7**	**-77.1**	**-85.7**	**-21.7**
B2. Real GDP growth is at baseline minus one-half standard deviations								**-54.1**	**-55.8**	**-58.5**	**-61.7**	**-65.5**	**-69.7**	**-16.2**
B3. Noninterest current account is at baseline minus one-half standard deviations								**-54.1**	**-52.3**	**-51.0**	**-49.6**	**-48.0**	**-46.0**	**-12.2**
B4. Combination of B1–B3 using 1/4 standard deviation shocks								**-54.1**	**-55.6**	**-58.0**	**-60.8**	**-64.2**	**-68.0**	**-17.3**
B5. One time 30 percent real depreciation in 2009								**-54.1**	**-89.2**	**-99.3**	**-110.6**	**-123.4**	**-137.6**	**-26.5**

1/ External debt in this table relates to net external debt.

2/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in U.S. dollar terms; g = real GDP growth rate; e = nominal appreciation (increase in dollar value of domestic currency); and a = share of domestic-currency denominated debt in total external debt.

3/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both noninterest current account and nondebt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and nondebt inflows in percent of GDP) remain at their levels of the last projection year.

Table 5. Malta: Fiscal Developments and Projections 2004–13
(Percent of GDP)

					Proj.					
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Revenue	41.0	42.0	41.3	40.6	40.8	40.7	40.7	40.6	40.5	40.4
Current revenue	39.2	38.7	38.2	39.6	39.5	39.5	39.4	39.3	39.2	39.1
Tax revenue (o/w)	26.2	26.9	27.0	28.3	28.3	28.4	28.6	28.5	28.4	28.3
Indirect taxes	14.5	14.6	14.9	14.7	14.7	14.7	14.7	14.6	14.5	14.4
Direct taxes	11.5	12.0	11.8	13.3	13.3	13.4	13.6	13.6	13.6	13.6
Social security contributions	8.0	8.1	7.7	7.4	7.4	7.2	7.1	7.1	7.1	7.1
Other current revenue	5.0	3.7	3.5	4.0	3.8	3.8	3.7	3.7	3.7	3.7
Capital revenue	1.8	3.3	3.0	1.0	1.3	1.2	1.3	1.3	1.3	1.3
Expenditure	45.6	45.0	43.8	42.4	42.5	41.7	41.1	40.7	40.3	40.0
Current expenditure	41.1	40.0	39.2	38.6	38.7	38.2	37.5	37.2	36.8	36.6
Wages and salaries	14.7	14.0	13.4	13.0	12.9	12.6	12.2	12.0	11.7	11.5
Goods and services	5.6	5.0	5.8	5.6	5.5	5.5	5.4	5.4	5.4	5.4
Social transfers	13.3	13.5	13.1	12.9	13.1	13.2	13.4	13.5	13.7	13.8
Subsidies	1.9	2.1	1.9	2.0	2.3	2.1	2.0	1.9	1.8	1.8
Interest payments	3.7	3.7	3.5	3.4	3.2	3.1	3.0	2.8	2.7	2.5
Other current expenditure	2.0	1.7	1.6	1.7	1.7	1.7	1.6	1.6	1.6	1.6
Capital expenditure	4.5	4.9	4.6	3.7	3.9	3.5	3.5	3.5	3.5	3.5
Overall balance	-4.6	-3.0	-2.5	-1.8	-1.7	-1.0	-0.3	-0.1	0.2	0.4
Structural balance (net of one-offs)	-4.3	-4.0	-3.0	-2.6	-1.9	-1.0	-0.2	0.0	0.2	0.4
Public debt	72.4	70.3	64.1	62.4	60.9	59.0	56.0	52.6	49.1	45.5
Government guaranteed debt	13.6	13.2	11.4	11.6	...	...	...	...	...	...
Memorandum items:										
Primary balance	-1.0	0.8	1.0	1.6	1.5	2.1	2.7	2.8	2.9	3.0
One-offs	0.8	1.6	0.7	0.7	0.2	0.2	0.1	0.1	0.1	0.0
Privatization receipts	0.0	1.2	4.4	0.5	0.2	0.0	0.0	0.0	0.0	0.0

Sources: NSO; Eurostat; and IMF staff estimates and projections.

Table 6. Malta: Public Sector Debt Sustainability Framework, 2005–13

(Percent of GDP, unless otherwise indicated)

		2005	2006	2007	Projections 2008	2009	2010	2011	2012	2013	**Debt-stabilizing primary balance** 8/
1	Baseline: public sector debt 1/	70.3	64.1	62.4	**60.9**	**59.0**	**56.0**	**52.6**	**49.1**	**45.5**	**-0.6**
	Of which: foreign-currency denominated	1.4	1.2	1.0	0.8	0.6	0.4	0.2	0.1	0.1	
2	Change in public sector debt	-2.1	-6.2	-1.7	-1.5	-1.9	-3.0	-3.4	-3.5	-3.6	
3	Identified debt-creating flows (4+7+12)	-2.5	-6.1	-2.7	-1.3	-2.0	-3.1	-3.4	-3.5	-3.6	
4	Primary deficit	-0.8	-1.0	-1.6	-1.5	-2.1	-2.7	-2.8	-2.9	-3.0	
5	Revenue and grants	42.0	41.3	40.6	40.8	40.7	40.7	40.6	40.5	40.4	
6	Primary (noninterest) expenditure	41.2	40.3	39.0	39.3	38.6	38.1	37.9	37.6	37.5	
7	Automatic debt dynamics 2/	-0.5	-0.7	-0.5	0.4	0.1	-0.5	-0.6	-0.6	-0.6	
8	Contribution from interest rate/growth differential 3/	-0.5	-0.7	-0.4	0.4	0.1	-0.5	-0.6	-0.6	-0.6	
9	*Of which:* contribution from real interest rate	1.7	1.6	1.8	1.9	1.4	1.0	1.0	1.0	0.9	
10	*Of which:* contribution from real GDP growth	-2.2	-2.2	-2.3	-1.5	-1.3	-1.5	-1.6	-1.6	-1.6	
11	Contribution from exchange rate depreciation 4/	0.0	0.0	-0.1	...	...	...	...	...	...	
12	Other identified debt-creating flows	-1.2	-4.4	-0.5	-0.2	0.0	0.0	0.0	0.0	0.0	
13	Privatization receipts (negative)	-1.2	-4.4	-0.5	-0.2	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/	0.5	-0.1	1.0	-0.2	0.1	0.1	0.0	0.0	0.0	
	Public sector debt-to-revenue ratio 1/	167.4	155.3	153.7	149.1	145.0	137.4	129.4	121.1	112.5	
	Scenario with key variables at their historical averages 6/				**60.9**	**63.6**	**66.3**	**68.9**	**71.6**	**74.2**	**0.5**
	Scenario with no policy change (constant primary balance) in 2008-2013				**60.9**	**59.3**	**57.5**	**55.3**	**53.2**	**51.0**	**-0.6**
	Key macroeconomic and fiscal assumptions underlying baseline										
	Real GDP growth (percent)	3.2	3.4	3.8	2.5	2.3	2.7	3.0	3.2	3.4	
	Average nominal interest rate on public debt (percent) 7/	5.5	5.3	5.6	5.4	5.4	5.4	5.4	5.4	5.5	
	Average real interest rate (nominal rate minus change in GDP deflator, percent)	2.5	2.4	3.2	3.2	2.6	1.9	2.0	2.1	2.2	
	Nominal appreciation (increase in U.S. dollar value of local currency, percent)	-0.4	1.0	9.1	...	...	...	...	...	...	
	Inflation rate (GDP deflator, percent)	3.0	2.9	2.5	2.2	2.8	3.5	3.4	3.3	3.4	
	Growth of real primary spending (deflated by GDP deflator, percent)	1.4	1.0	0.4	3.4	0.3	1.3	2.5	2.6	3.0	
	Primary deficit	-0.8	-1.0	-1.6	-1.5	-2.1	-2.7	-2.8	-2.9	-3.0	

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 - π (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 six 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.

Table 7. Malta: Financial Soundness Indicators, 2004–07
(Percent)

	2004	2005	2006	2007
Banking sector (unless noted, includes internationally-oriented banks)				
Regulatory capital to risk-weighted assets	21.3	20.4	22.0	23.2
Domestically oriented banks 1/	...	...	15.1	16.1
Domestically controlled banks 2/	15.4	17.3	15.5	14.8
Regulatory Tier 1 capital to risk-weighted assets	18.2	19.0	20.8	21.7
Domestically oriented banks 1/	...	...	13.6	13.9
Domestically controlled banks 2/	12.7	14.1	13.2	13.0
Nonperforming loans net of provisions to capital	30.0	20.1	12.5	10.3
Domestically oriented banks 1/	...	...	28.8	24.5
Domestically controlled banks 2/	77.7	49.4	42.0	38.7
Nonperforming loans to total gross loans	6.5	3.9	2.8	1.8
Domestically oriented banks 1/	10.1	7.7	6.0	5.1
Domestically controlled banks 2/	17.5	12.0	9.2	7.6
Return on assets	1.4	1.4	1.3	1.0
Domestically oriented banks 1/	...	...	1.8	1.5
Domestically controlled banks 2/	1.2	1.4	1.5	1.4
Return on equity	13.2	14.3	11.7	10.7
Domestically oriented banks 1/	...	...	15.3	13.6
Domestically controlled banks 2/	15.9	20.8	20.7	18.9
Interest margin to gross income	45.3	48.6	56.3	58.5
Domestically oriented banks 1/	...	...	63.4	76.5
Domestically controlled banks 2/	68.9	68.1	65.8	66.1
Noninterest expenses to gross income	47.8	41.3	44.4	51.9
Domestically oriented banks 1/	...	...	45.0	45.0
Domestically controlled banks 2/	49.8	45.9	50.3	50.1
Liquid assets to total assets	24.3	21.7	19.5	21.8
Domestically oriented banks 1/	...	...	21.9	24.2
Domestically controlled banks 2/	24.4	26.8	24.9	30.5
Liquid assets to short-term liabilities	49.9	55.7	52.2	52.5
Domestically oriented banks 1/	...	...	50.7	49.1
Domestically controlled banks 2/	54.1	50.7	50.8	54.9
Net open position in foreign exchange to capital	…	-1.6	0.2	...
Domestically oriented banks 1/	...	...	2.0	14.3
Domestically controlled banks 2/	...	4.4	2.3	0.8
Capital to assets	7.9	6.8	8.6	...
Domestically oriented banks 1/	...	...	9.1	8.7
Domestically controlled banks 2/	7.3	8.0	7.4	7.6
Gross asset position in financial derivatives to capital	37.2	83.1	21.3	...
Domestically oriented banks 1/	...	...	2.8	3.4
Domestically controlled banks 2/	1.2	1.1	0.9	0.9
Gross liability position in financial derivatives to capital	39.4	82.5	21.9	...
Domestically oriented banks 1/	...	...	3.2	2.2
Domestically controlled banks 2/	3.4	3.7	1.3	1.7
Trading income to total income	…	3.5	19.9	...
Domestically oriented banks 1/	...	...	0.2	-4.9
Domestically controlled banks 2/	...	0.1	0.0	-12.9
Personnel expenses to noninterest expenses	38.8	40.8	37.6	...
Domestically oriented banks 1/	...	...	53.5	55.6
Domestically controlled banks 2/	59.8	58.8	55.9	55.8
Spread between reference lending and deposit rates (in basis points)	…	340.7	345.2	...
Customer deposits to total (noninterbank) loans	92.1	100.1	70.3	...
Domestically oriented banks 1/	...	...	129.2	140.0
Domestically controlled banks 2/	167.0	164.3	154.6	156.0
Net open position in equities to capital	38.5	34.6	25.0	...
Domestically oriented banks 1/	...	...	5.6	6.7
Domestically controlled banks 2/	9.5	17.0	9.5	12.0
Real estate markets				
Residential real estate prices (annual percentage increase)	20.3	9.9	3.5	1.1
Residential real estate loans to total loans	12.9	14.2	12.9	...
Domestically oriented banks 1/	...	...	26.9	30.3
Domestically controlled banks 2/	26.2	29.0	29.8	31.7
Commercial real estate loans to total loans	6.9	9.5	...	...
Domestically oriented banks 1/	...	...	32.3	32.6
Domestically controlled banks 2/ 3/	7.5	10.2	33.0	33.1

Source: Central Bank of Malta.

1/ Domestically oriented banks are those that predominantly work with Malta's residents.
2/ Banks that on a group consolidated basis are regulated by Malta's Financial Services Authority.
3/ A sharp break in the time series in 2006 is due to a change in methodology.

Table 8. Malta: Indicators of External and Banking Sector Vulnerability, 2004–08
(Percent of GDP, unless otherwise indicated)

	2004	2005	2006	2007	2008	Latest observation date
Financial indicators						
Government debt	72.4	70.3	64.1	62.4	...	
Broad money (percent change, 12-month basis)	2.4	4.2	5.2	11.1	...	
Credit to nonbank private sector (percent change, 12-month basis) 1/	-1.3	9.0	15.3	10.2	...	
Three month T-bill yield (percent)	3.0	3.2	3.9	4.4	4.9	Jul
Nonperforming loans (all banks)	6.5	3.9	2.8	1.8	...	
External indicators						
Exports of G&NFS (percent change, average in U.S. dollars)	11.2	3.3	21.8	16.4	16.3	Q1
Imports of G&NFS (percent change, average in U.S. dollars)	12.1	5.3	19.0	13.9	21.4	Q1
Current account surplus	-5.9	-8.8	-8.2	-5.4	...	
Capital and financial account balance	4.6	9.6	9.4	2.9	...	
Of which						
Capital account	1.5	3.3	2.9	0.9	...	
Inward portfolio investment (debt securities, etc.)	-37.4	-44.8	-39.0	6.8	...	
Other investment (loans, trade credits, etc.)	30.0	43.3	17.9	-11.4	...	
Inward foreign direct investment	7.0	11.7	29.2	12.7	...	
Gross official reserves (millions of US dollars; e.o.p.)	2,734	2,579	2,981	3,798	...	
Official reserves in months of imports GNFS	7.1	6.3	6.1	6.8		
Ratio of foreign reserves to base money (percent)	133.7	143.3	141.3	143.4	...	
Ratio of foreign reserves to broad money (percent)	29.8	30.9	30.1	31.0	...	
Exchange rate (per U.S. dollar, period average)	2.9	2.9	2.9	3.2	3.6	Jun
REER appreciation, CPI-based (period average)	4.1	-0.2	1.0	3.1	...	
Change in stock market index (percent, year-to-date)	44.4	62.3	-2.2	1.3	-13.4	Jun

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

1/ Excludes credit to public nonfinancial enterprises.

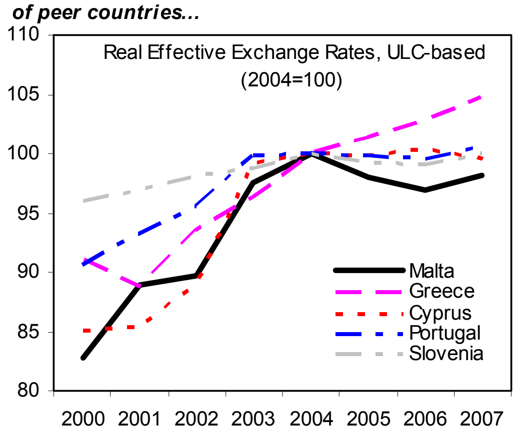
Table 9. Malta: Privatizations and Remaining Public Enterprises

Privatizations:	
Maltacom (telecom)	Successful privatization of 40 percent through floatations until 1998. Sale of remaining 60 percent to TECOM investments in 2006 (which will also develop the SmartCity).
Malta International Airport	Successful privatization through sales of 40 percent to private operator in 2002 and a further 40 percent through floatations in 2002 and 2005. The government retains a 20 percent stake.
Tug Malta (harbor towage)	In July 2007, the authorities sold their 73 percent stake to the Italian Rimorchiatori Riuniti SpA.
Malta Freeport (main cargo harbor)	Concession to operate and develop extended in 2008 to 65 years to French shipping company CMA-CGM, in return for future expansion/modernization worth 130 million euros and 500 jobs over the next five years.
Maltapost (postal service)	Successful privatization through sales of 60 percent to Lombard Bank plc (2003 and 2005) and 40 percent through a highly oversubscribed floatation in February 2008.
Remaining public enterprises:	
Malta shipyards	Privatization is now envisaged. Subsidies are scheduled to end in 2008 (an EU accession commitment) and recent government statements point to interest by several bidders. The process can be expected to require a considerable downsizing of the current 1700-strong workforce. Until now there had been persistent losses, despite a 7-year restructuring plan including 700 million euro debt write-offs and 148 million euros in operating aid.
AirMalta (airline)	No privatization plans for 98 percent government stake. AirMalta's losses were reduced from 30 million (2004) to 5 million euros (2007) in a restructuring program. Funding for the restructuring emanated from sales of AirMalta's hotel properties, so that no subsidies were paid. Recently AirMalta has expanded into intra-Italian routes.
Enemalta (energy)	Consists of three divisions. For the two smaller ones - Petroleum (profit of 20 million euros in 2005) and LPG Gas bottling and distribution (0.4 million euros profit in 2005) - privatization/long-term leasing is currently underway. The larger electricity division recorded a loss of 20 million euros in 2005, mainly attributable to its pricing not keeping pace with costs. Since then the introduction of a surcharge to cover rising fuel costs had alleviated the problem somewhat, until the strong rise of oil prices at end-2007. The government guarantees 70 percent of Enemalta's debt.
Water Services Corporation (water)	Privatization is not envisaged, but some efficiency-enhancing reforms have been undertaken. The tariffs WSC charges are set by the government. High subsidies ensue (25 million euros in 2006) as water prices to end users are kept artificially low.
Bank of Valletta (largest bank)	The authorities sold 15 percent to the Italian bank Unicredit and 60 percent in floatations up to 1995. However, the state retains a 25 percent stake. The bank is run on a commercial basis with no government interference in day-to-day decisions.

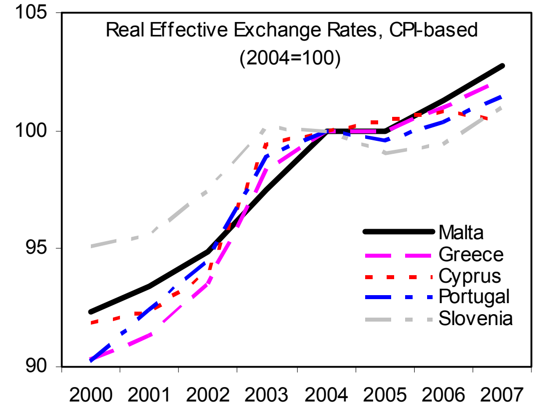
There are another 36 (fully or partially) public enterprises in the sectors of waste management, ferry services, air traffic control, culture and broadcasting, amongst others.

Figure 1. Malta: Cost Competitiveness

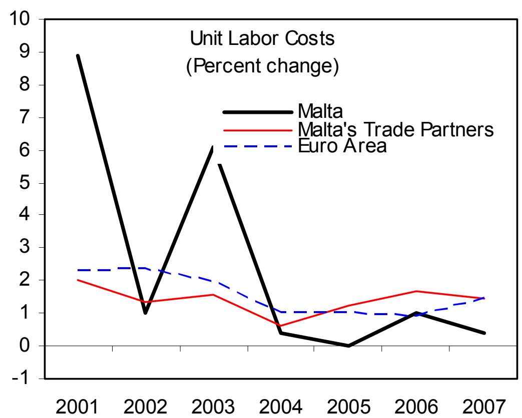
Since EU entry in 2004, Malta's labor cost competitiveness has improved more strongly than that of peer countries...



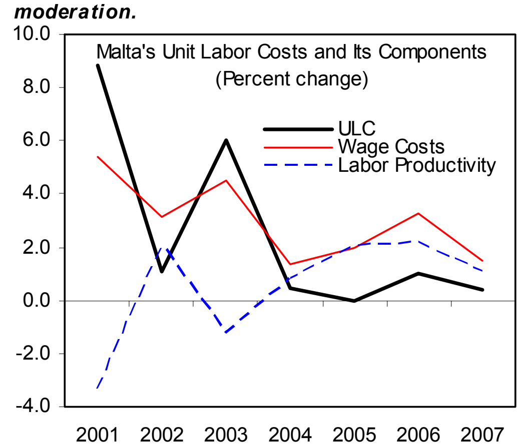
...however, less so when using CPI-based competitiveness measures.



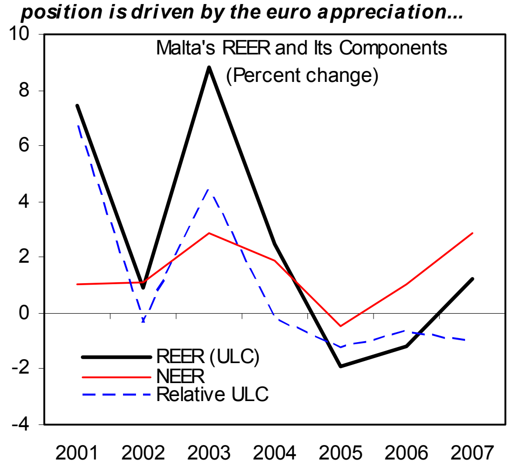
Malta's unit labor costs have remained low...



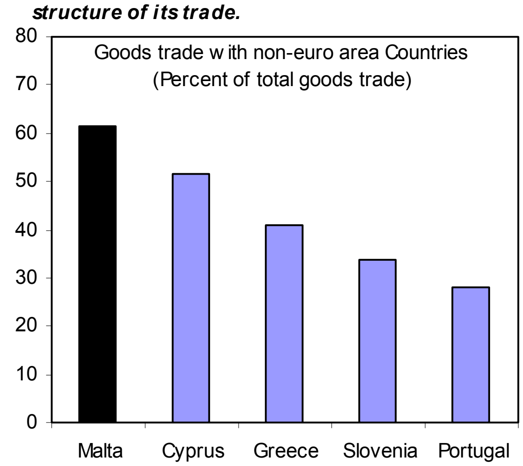
...due to a pick up in productivity and wage moderation.



The recent slight weakening in Malta's competitive position is driven by the euro appreciation...

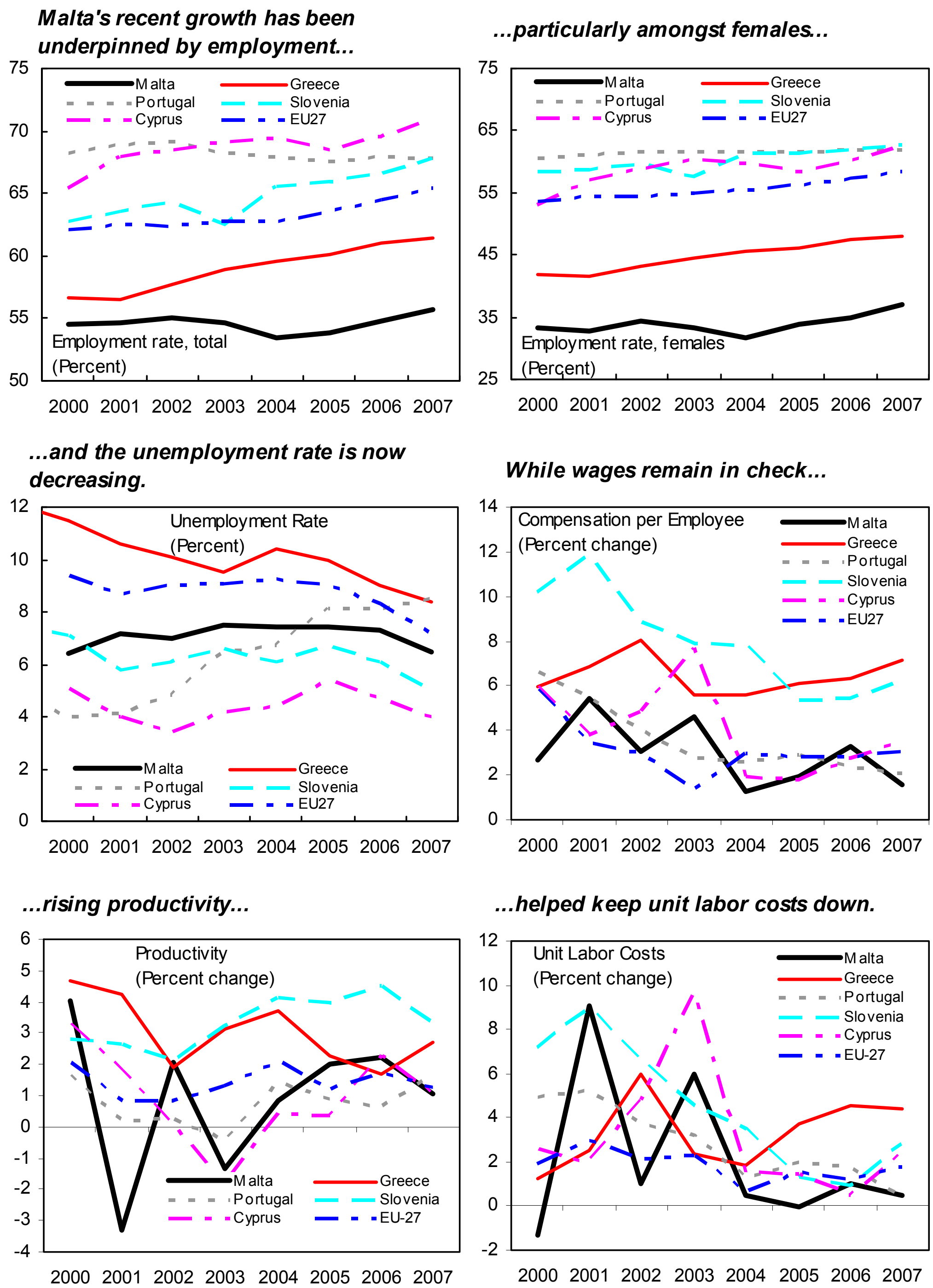


...to which Malta is more exposed due to the structure of its trade.



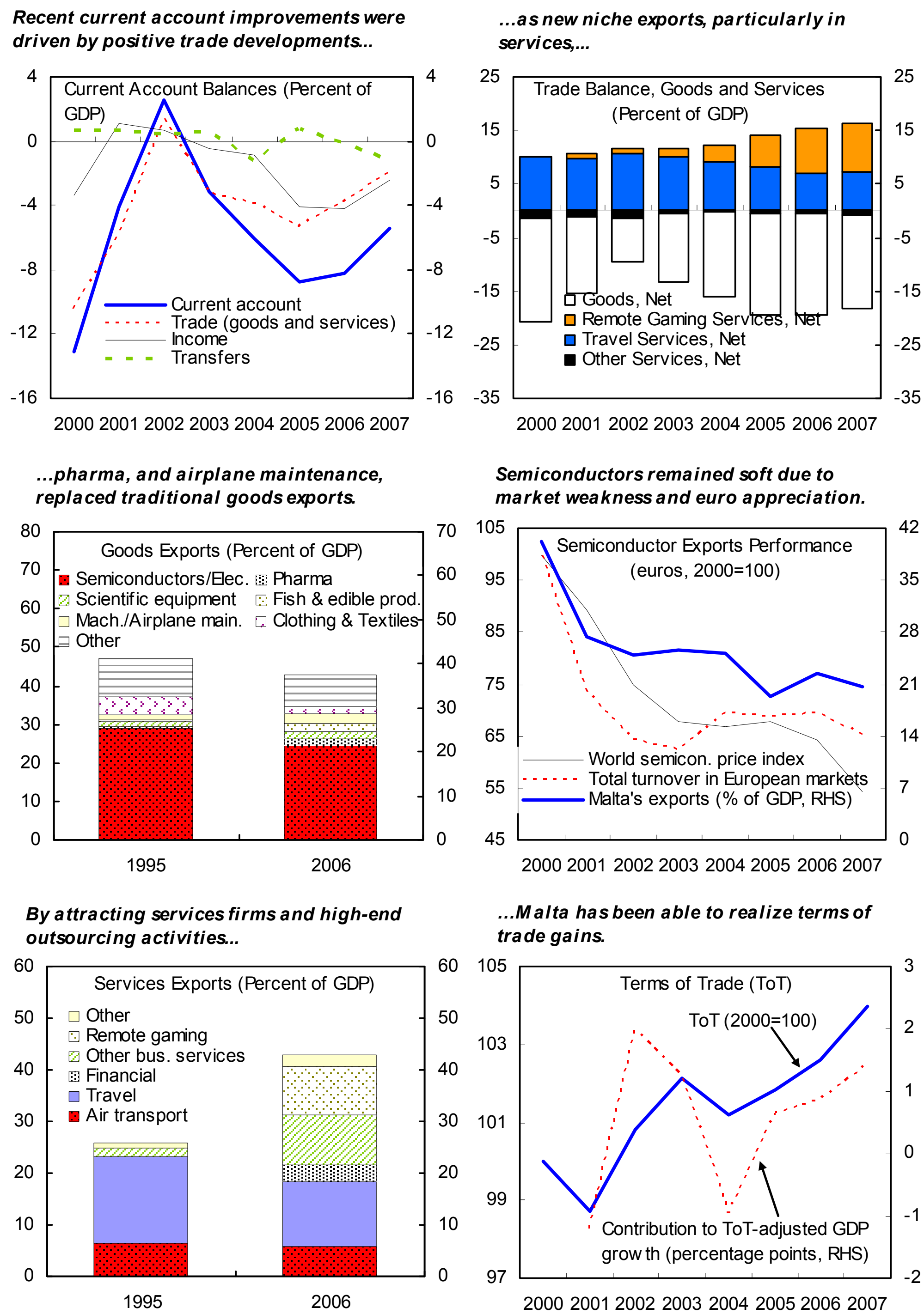
Sources: European Commission; ECB; Eurostat; INS; and IMF staff calculations.

Figure 2. Malta: Labor Market Developments



Sources: Eurostat; and Ameco.

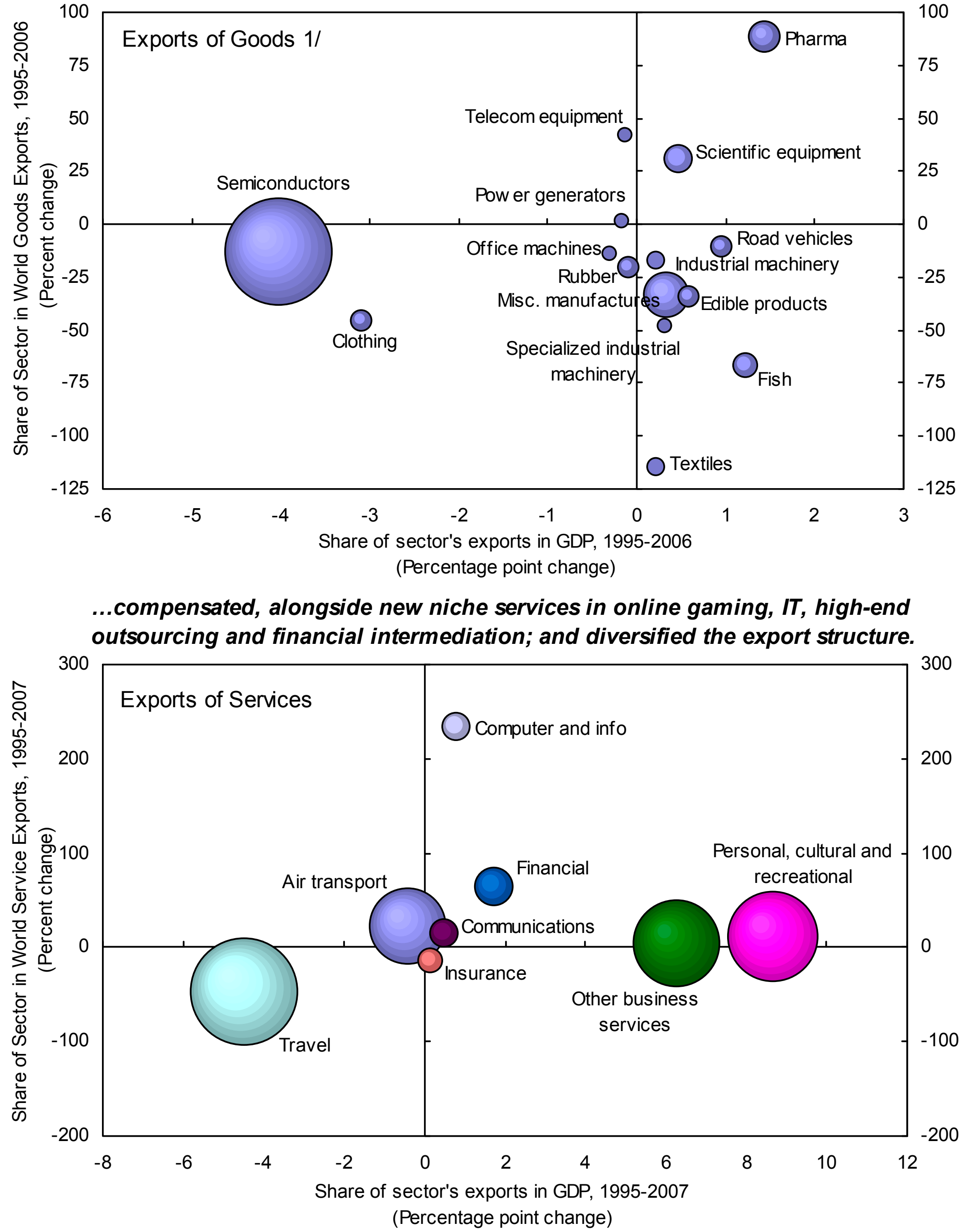
Figure 3. Malta: External Current Account Developments



Sources: National Statistics Office; European Commission; Eurostat; Semiconductor Industry Association; IMF Direction of Trade Statistics; IMF Balance of Payments Statistics; and IMF staff calculations.

Figure 4. Malta: External Competitiveness, 1995–2007

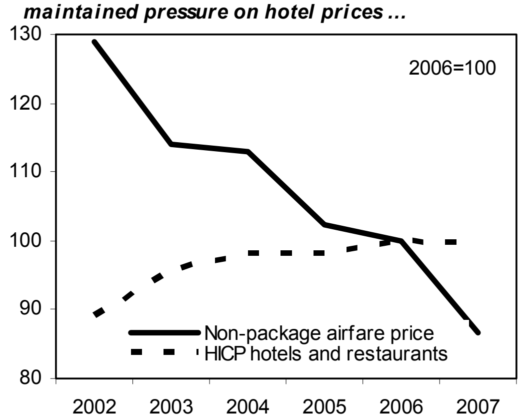
Traditional clothing exports have declined, while important semiconductors experienced price pressures. Emerging pharmaceuticals, however, have...



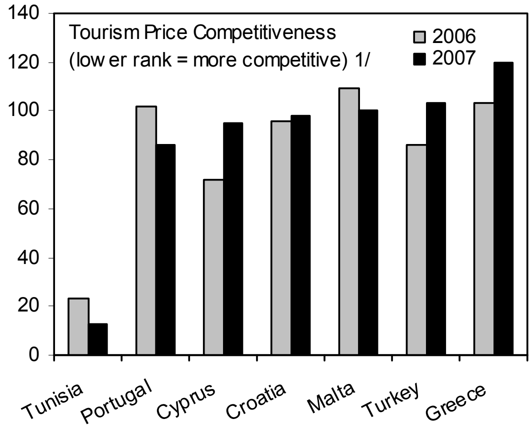
Sources: NSO; IMF Balance of Payments Statistics; and IMF Direction of Trade Statistics.
1/ Size of spheres depicts the size of exports as a percentage of GDP in last available year.

Figure 5. Malta: Tourism Services Exports

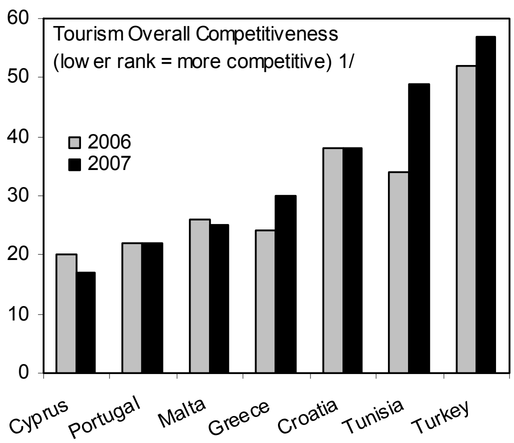
Arrival of low-cost airlines in mid-06 led to a further fall in airfare prices, while intense competition maintained pressure on hotel prices ...



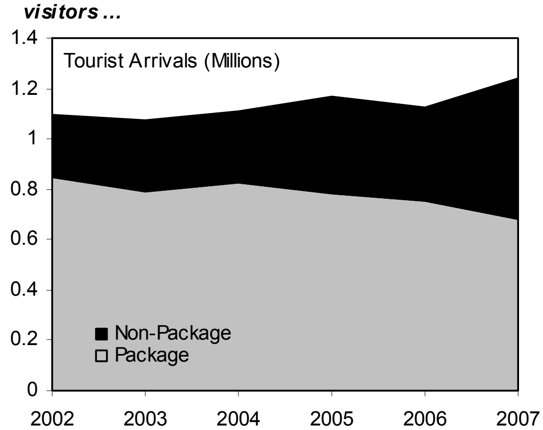
...thus improving Malta's price competitiveness among its immediate competititors.



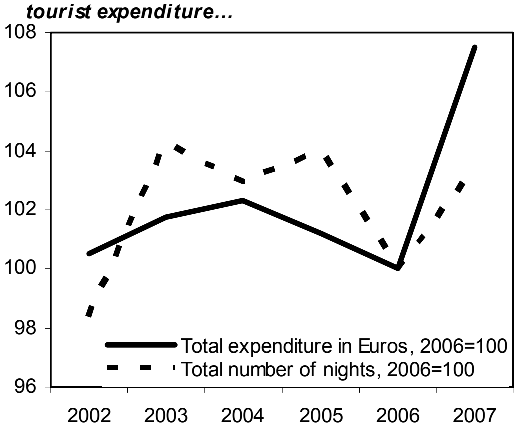
Malta's overall tourism product remains attractive.



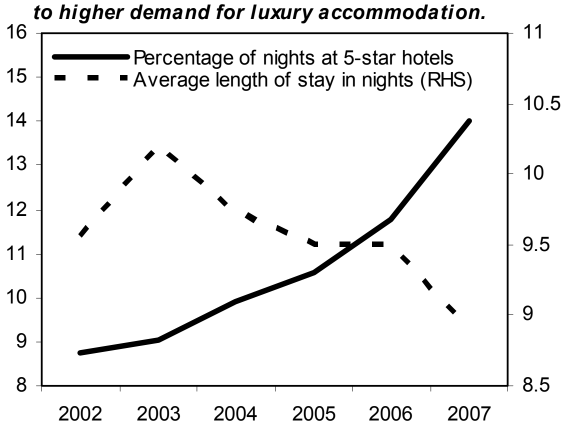
Low-cost carriers have led to a reorientation away from packages and substantially increased the number of visitors ...



...leading to a rebound in nights stayed and total tourist expenditure...

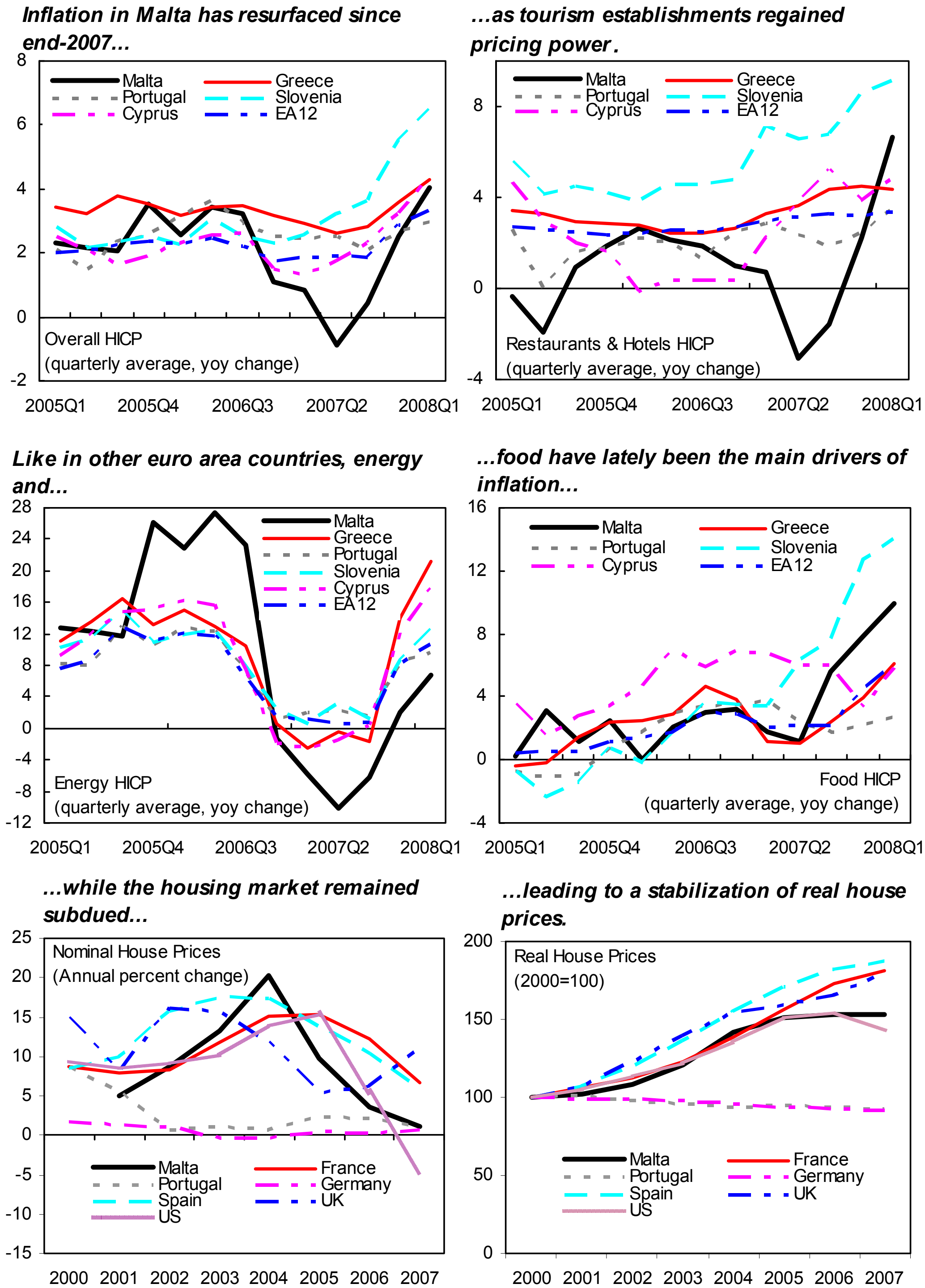


...despite shorter average stays, latter partially due to higher demand for luxury accommodation.



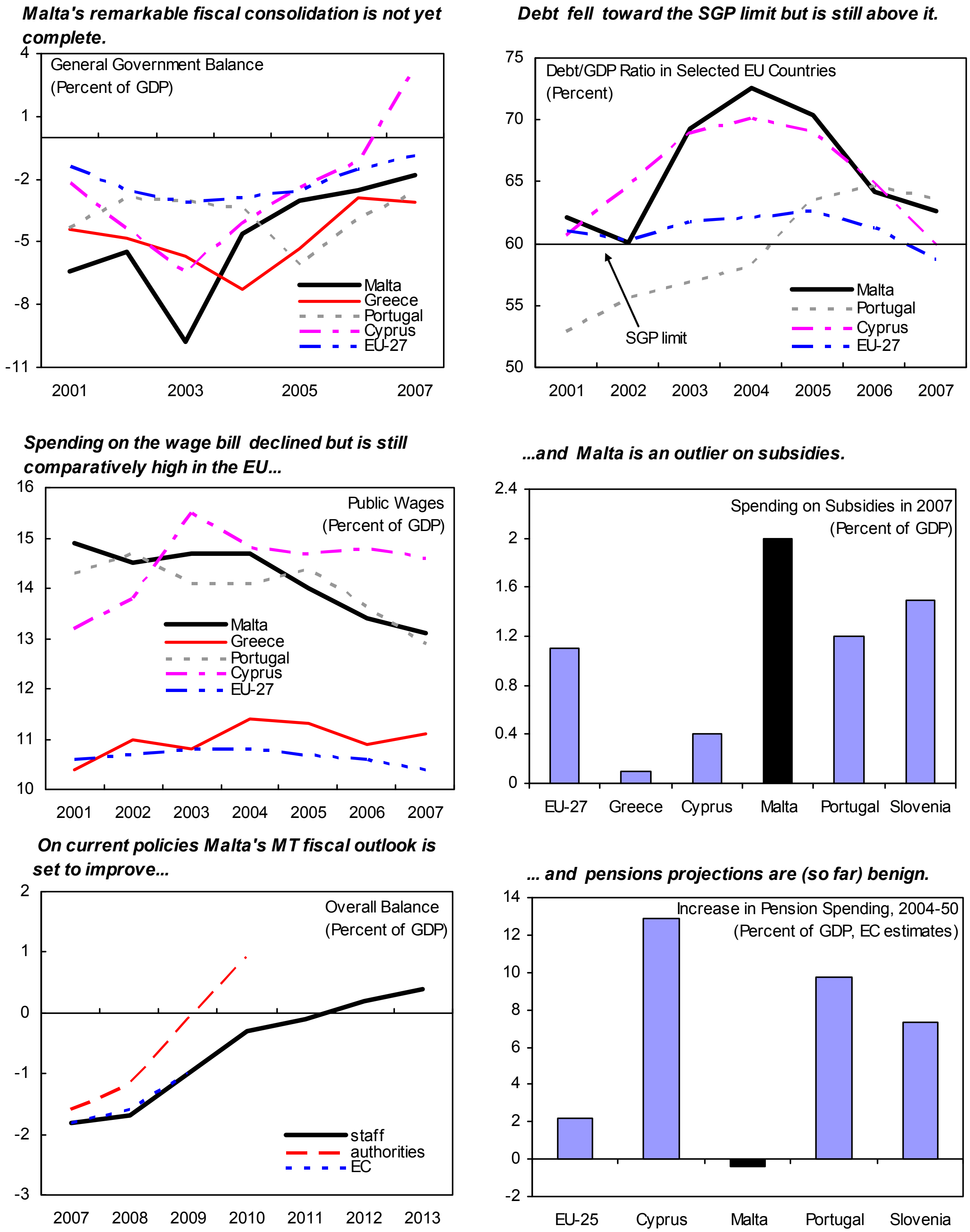
Sources: NSO; Eurostat; World Economic Forum Travel; and Tourism Competitiveness Reports.
1/ Rank out of 130 countries.

Figure 6. Malta: Price Developments



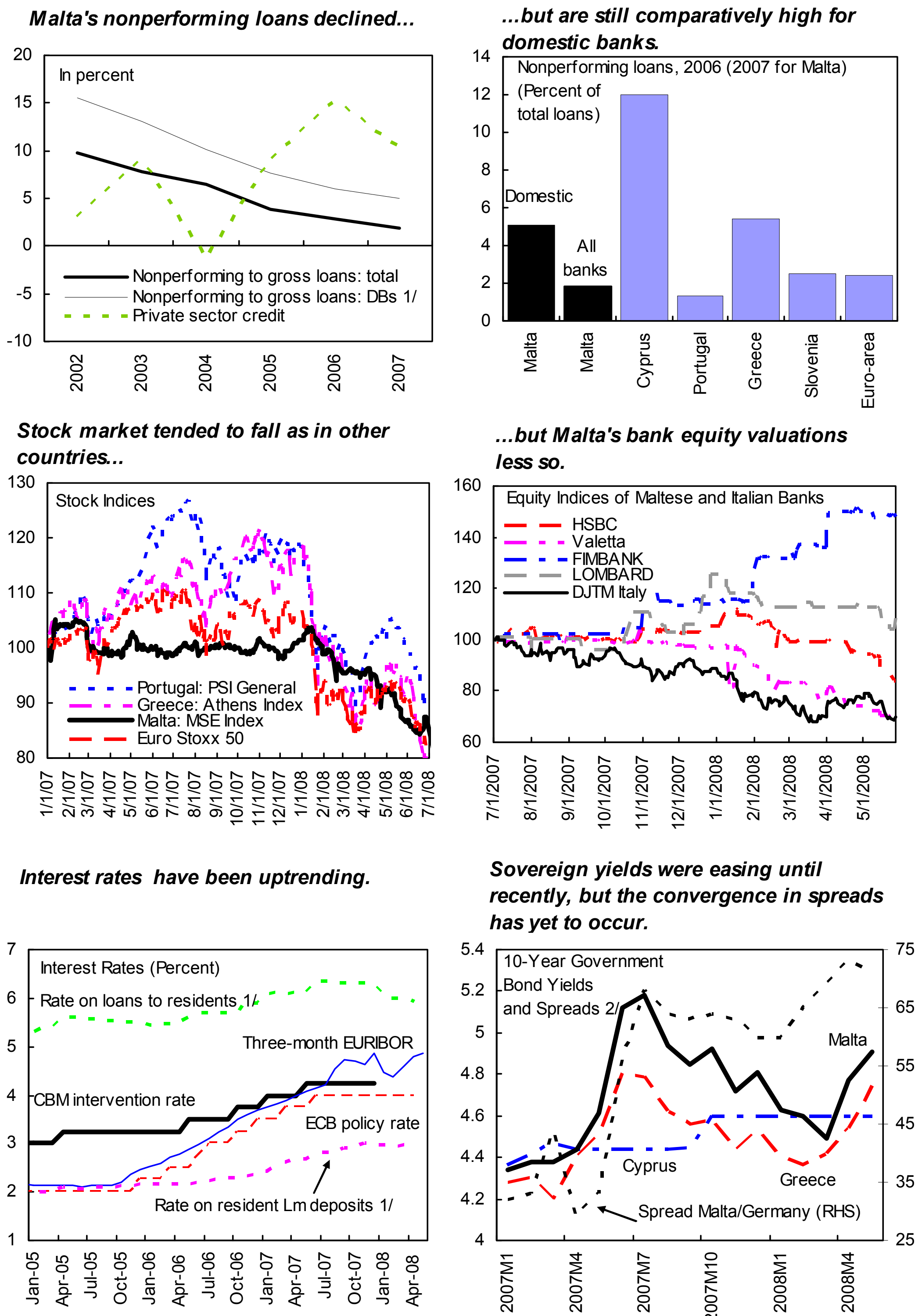
Sources: Haver; Central Bank of Malta; Bank of Spain; and Eurostat.

Figure 7. Malta: Fiscal Developments



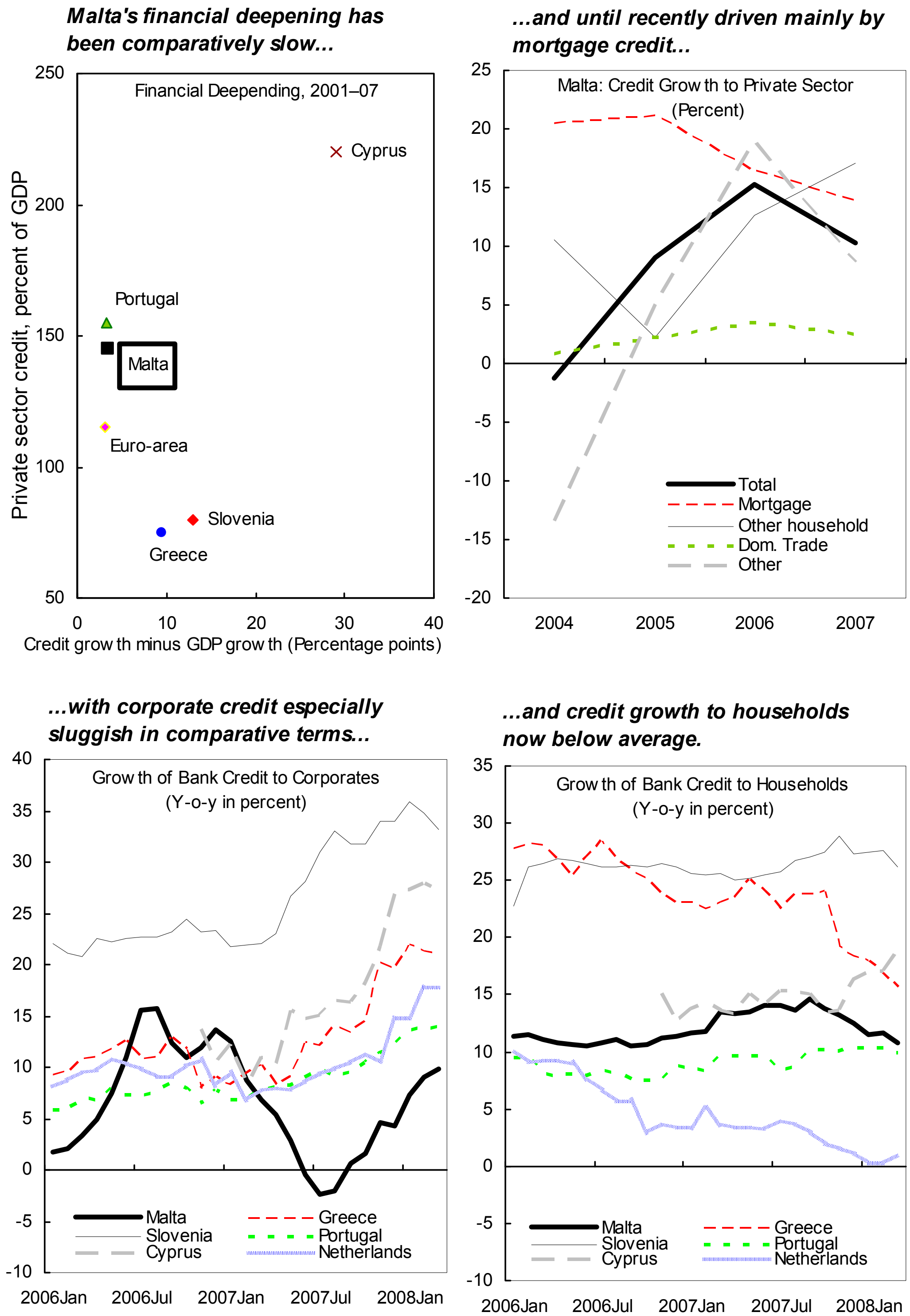
Sources: Eurostat; European Commission; EPC; and IMF staff calculations.

Figure 8. Malta: Financial Sector Developments



Sources: Bank of Malta; Datastream; and IMF staff estimates.
1/ For domestically oriented banks (DBs).
2/ Bond yields are measured in percent and spreads are in basis points.

Figure 9. Malta: Credit Developments



Sources: Central Bank of Malta; ECB; and Eurostat.

Appendix I. Malta: Fund Policy Recommendations and Implementation

Policy Area	Fund Recommendations	Implementation
Fiscal policy	Pursue expenditure-based consolidation, further reducing subsidies and public consumption. Improve medium-term budget planning. Adopt financial incentives in healthcare.	Fiscal adjustment continued in 2007 and 2008. After delays, substantial progress in curbing subsidies is being made since mid-2008. Effort to improve budget planning is ongoing; new procedures for capital projects are being implemented. Performance budgeting in hospitals is being introduced, but co-payments have been ruled out.
Financial sector	Monitor non-performing loans (NPLs) and concentration risks, notably exposure of financial sector to the real estate sector. Bolster provisioning by introducing tax deductibility of specific provisions.	NPLs have continued to decline but provisioning has remained thin, with no tax deductibility. While exposure to the real estate sector remains high, good progress has been made in introducing Basel II standards and upgrading the crisis management and resolution framework.
Structural reforms	Bolster competitiveness by improving the flexibility of the economy and rationalizing the public sector. Enhance productivity by raising the efficiency of energy and maritime transportation networks and streamlining of loss-making public enterprises; thereby reduce ensuing subsidies.	The authorities have continued streamlining the public sector with renewed momentum. Long-term lease of port operations and post privatization have been completed. Privatization process was initiated for shipyards to stop subsidies by end-2008. Unbundling and privatization of LPG and gasoline distribution operations is underway. Retail electricity prices were increased and the subsidy reduced, although prices remain below cost recovery. Reforms of the electricity pricing system and domestic transportation have been announced. The independence and profile of the competition authority remains low. Partial indexation of wages hampers the alignment of wage and productivity increases and could sustain inflationary pressures.

INTERNATIONAL MONETARY FUND

MALTA

Staff Report for the 2008 Article IV Consultation—Informational Annex

Prepared by the European Department

July 22, 2008

Contents | Page

Appendix I. Malta: Fund Relations

(As of May 31, 2008)

Article IV mission: Discussions were held in Valletta, May 20–30, 2008.

Staff team: Messrs. Escolano (head), Henn, and Lissovolik (all EUR).

Country interlocutors: The mission met with Minister of Finance, Mr. Tonio Fenech; Central Bank of Malta Governor, Mr. Michael Bonello; and other senior officials. It also met with representatives of financial institutions, the private sector, employers and labor unions, opposition, and academics. The authorities agreed to publish the concluding statement.

Data: Malta participates in the IMF's General Data Dissemination System and is at an advanced stage to reach subscription to the Special Data Dissemination Standard.

I. **Membership Status**: Malta became a member of the IMF 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.

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

III. **SDR Department**:	**SDR Million**	**Percent Allocation**
Net cumulative allocation	11.29	100.00
Holdings	38.81	343.82

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

V. **Latest Financial Arrangements**: None

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

VII. **Exchange Rate Arrangement and Restrictions**: Malta joined EMU on January 1, 2008 at the central parity of Maltese lira 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 IMF pursuant to Executive Board Decision No. 144-(52/51).

VIII. **Article IV Consultation**: The last Article IV consultation was concluded on August 24, 2007. Malta is on a 12-month consultation cycle.

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

- An expert visited Valletta in November 2006, and April and December 2007 to assist with the preparation of a producer price index, which was first published in May 2008 and constituted one of the last remaining criteria for future SDDS subscription.

- ROSC Data Module mission visited Malta in June 2007.

- 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. Significant progress in improving macroeconomic statistics has been made in close cooperation with the ECB and Eurostat while upgrading statistical systems to meet the euro area standards. However, national accounts and balance of payments data have remained subject to substantial revisions, often affecting several years. Most macroeconomic statistics can now be accessed through Eurostat. The country has been a participant in the GDDS since September 11, 2000, with the metadata posted on the IMF's Dissemination Standards Bulletin Board. In 2007, the IMF has continued to provide technical assistance to the authorities in order to develop a producer price index. Its first release in May 2008 fulfilled one of few remaining requirements to achieve SDDS standards. Given progress as of July 2008, reaching SDDS subscription status will necessitate the appointment of an SDDS coordinator. In collaboration with IMF staff, the coordinator will facilitate completion of the remaining steps toward SDDS subscription, such as the finalization of the metadata, setting up a National Summary Data Page and Advance Release Calendar, and finalization of the Reserves Template. The authorities are currently in the process of taking these steps.

Real sector statistics: Data on retail and consumer prices, labor market indicators, and tourism arrivals are released monthly, usually with a short lag. These data are available through the Internet via the National Statistics Office (NSO) website. Presently the NSO releases national accounts data in euros with one quarter lag. Statistical discrepancies (captured under stock building) are often large, particularly on the first release, and typically lead to sizable revisions. Supply side GDP estimates by type of economic activity are not available, but the recently published producer price index will facilitate their compilation. National accounts import and export data are not disaggregated into goods and services. The harmonized index of consumer prices was first published in May 2004.

Government finance statistics: Fiscal statistics meet basic requirements, but timeliness is below the general practice in the EU. The NSO publishes monthly statistics on the cash operations of the central government. In addition, quarterly general government accounts are published on an 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 and of the Local Councils.

Monetary and financial statistics: Monetary statistics are timely and of good quality. Since the entry into the euro area in January 2008, monetary data for IMF statistical publications are now obtained through a gateway arrangement with the ECB, thus reducing the reporting burden of the country. The country participated in the pilot project—Coordinated Compilation Exercise—for Financial Soundness Indicators and submitted indicators as of end-2005 along with metadata, which are now available to the public through the IMF's website (http://www.imf.org/external/np/sta/fsi/part.asp?iso=MLT).

External sector statistics: Summary data (merchandise trade, current account balance, and selected financial 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 July 11, 2008)

	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]	Data Quality – Accuracy and reliability[8]
Exchange Rates	7/11/08	7/11/08	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	5/08	6/08	M	M	M		
Reserve/Base Money	4/07	6/07	M	M	M	…	…
Broad Money	4/08	6/08	M	M	M	…	…
Central Bank Balance Sheet	4/08	6/08	M	M	M	…	…
Consolidated Balance Sheet of the Banking System	4/08	6/08	M	M	Q	…	…
Interest Rates[2]	4/08	6/08	W	W	W		
Consumer Price Index	5/08	6/08	M	M	M	O, LO, O, O	O, O, LO, LO, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	4/08	6/08	M	M	M	O, LO, O, LO	O, O, O, LO, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	4/08	6/08	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	12/07	5/08	M	M	M		
External Current Account Balance	2008:Q1	6/08	Q	Q	Q	O, LO, O, O	LO, O, O, O, LNO
Exports and Imports of Goods and Services	2008:Q1	6/08	Q	Q	Q		
GDP/GNP	2008:Q1	6/08	Q	Q	Q	O, LNO, O, LO	LO, O, LO, LO, LO
Gross External Debt	n/a	n/a	n/a	n/a	n/a		
International Investment Position[6]	2006	2/08	A	A	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] Includes external gross financial asset and liability positions vis a vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[8] 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).
[9] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment, and revision studies.

Public Information Notice (PIN) No. 08/104
FOR IMMEDIATE RELEASE
August 11, 2008

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

IMF Executive Board Concludes 2008 Article IV Consultation with Malta

On August 6, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Malta.[1]

Background

Malta joined the European Monetary Union (EMU) on January 1, 2008 and has implemented broad liberalizing economic reforms since EU accession in 2004. The economy has experienced a three-year-long expansion with average annual growth of over 3½ percent during 2005–07, driven by productivity gains, foreign direct investment, and export diversification into new dynamic sectors. Domestic demand was supported by rising employment and incomes. The external current account deficit fell to 5½ percent of GDP in 2007 due to the revival of tourism, new niche service and pharmaceutical exports, and sustained terms of trade gains. Traditional manufacturing exports, however, continued a prolonged decline in the face of intense competition. Recently, Malta has been adversely affected by the euro appreciation reflecting its predominant export orientation toward non-EMU countries. High dependence on fuel and commodity imports has pushed inflation—subdued until late 2007—above 4 percent.

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[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.

Expenditure-based fiscal consolidation continued in 2007, with the fiscal deficit falling to 1¾ percent of GDP in 2007. However, subsidies and state aid, the public wage bill, and entitlement spending are comparatively high, exerting significant pressure on the budget. The authorities have recently adopted several expenditure retrenchment measures, including adjustments in the subsidized retail electricity tariff, aiming to keep the 2008 budget on track and continue progress toward their medium-term objective of structural balance.

Financial soundness indicators held up in 2007 despite unfavorable international developments. The banking sector's liquidity and funding profile are healthy, and banks have remained profitable despite markdowns in security portfolios. Nonperforming loans fell further but are still comparatively high and thinly provisioned. Loan portfolios remain concentrated in the real estate sector, which is cooling down.

Privatization and restructuring of public enterprises in key sectors (harbor services, post, energy) continued during 2007. The authorities are unbundling and opening to private participation the fuel and gas operations of the public energy company, and have announced their intention to privatize the shipyards shortly.

Executive Board Assessment

Executive Directors congratulated the authorities for Malta's successful EMU entry on January 1, 2008. The authorities' strategy of boosting growth and external competitiveness through closer regional and global integration, supported by fiscal adjustment and liberalizing reforms, has catalyzed foreign direct investment, the emergence of dynamic new export sectors, and attendant productivity gains. Malta's three-year-long expansion in employment and activity largely reflects economic opening and public sector rationalization. Directors also noted the recent favorable trends in Malta's price and non-price competitiveness, which have contributed to reducing the current account deficit.

Looking ahead, Directors stressed that the economy will face some challenges from a weakening global economy, higher food and fuel prices, and possible risks in the financial sector. Also, the decline in traditional sectors could accelerate and outpace the emergence of new export activities. In the absence of independent monetary and exchange rate policies, Directors underlined the importance of continuing to pursue sound fiscal policies, increasing the flexibility of the economy, bolstering productivity growth, and monitoring developments in the financial sector closely.

Directors praised the authorities' fiscal performance, and welcomed measures to contain public spending in 2008 as necessary for continued progress in reducing the budget deficit. In particular, Directors viewed the increase in retail electricity tariffs as instrumental in limiting expenditure overruns, and encouraged the authorities to follow through with further steps toward full cost recovery while supporting efforts to protect low-income households. The announced elimination of certain subsidies—notably those to public shipyards—in 2009 are also important steps in putting the public finances on a sound footing.

Directors stressed that reinforcing the budget framework with a medium-term orientation would help preserve the benefits of consolidation while better prioritizing spending. They supported the authorities' objective of structural balance by 2010, and reiterated the desirability of targeting a surplus thereafter, given the vulnerabilities inherent in the economy's small size and prospective demographic pressures on spending.

Directors observed that Malta's banking system appears well-positioned to weather the global financial turmoil, as banks have healthy liquidity and a good funding profile. At the same time, Directors noted that the banks' still-high level of nonperforming loans, relatively thin provisioning, and concentrated exposures in the cooling housing sector called for increased supervisory vigilance aimed inter alia at augmenting provisioning buffers. Directors welcomed the upgrading of the supervisory and crisis management frameworks, and recommended more frequent public reporting by the main banks. It would also be useful to review the existing legal authority and institutional mechanisms to act expeditiously in a crisis situation in light of recent international experiences.

Directors stressed the importance of strengthening labor and product market flexibility, and further streamlining the public sector, to realize Malta's growth potential and maintain competitiveness within the EMU. They suggested introducing stable rules-based mechanisms for setting administered prices, aiming at cost recovery over the medium term. Directors recommended implementation of the EU Services Directive to foster competition in sheltered markets, and reinforcing the competition and statistics authorities. They encouraged the authorities to consider means to relax the price indexation of wages, which could entrench inflationary dynamics and hinder alignment between wage and productivity increases. Directors pointed out that that further privatization in the banking sector would help to strengthen economic resiliency and seize new growth opportunities.

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 2008 Article IV Consultation with Malta is also available.

Malta: Selected Economic Indicators

	2004	2005	2006	2007	2008 1/
Real economy (constant prices)	(Change in percent)				
Real GDP	0.6	3.2	3.4	3.8	2.5
Domestic demand	2.2	5.5	2.3	2.9	2.3
Consumption	2.0	1.4	1.8	1.2	2.3
Private consumption	2.4	1.9	0.7	1.6	2.3
Public consumption	0.6	-0.5	6.0	-0.1	2.6
Fixed investment	-3.2	8.2	3.8	3.8	2.6
Inventory accumulation 2/	1.1	3.1	0.2	1.3	0.0
Foreign balance 2/	-1.7	-2.6	0.9	0.7	0.0
Exports of goods and services	2.2	-0.8	10.0	-0.6	-0.3
Imports of goods and services	3.8	1.8	8.4	-1.3	-0.2
Output gap (percent)	-3.1	-1.7	-0.6	0.4	0.1
CPI (harmonized)	2.7	2.5	2.6	0.7	4.1
Unemployment rate EU stand (percent)	7.4	7.3	7.3	6.4	6.5
Gross national savings (percent of GDP)	10.7	11.7	12.4	16.1	15.3
Gross capital formation (percent of GDP)	16.7	20.4	20.7	21.6	22.0
Public finance	(Percent of GDP)				
General government balance	-4.6	-3.0	-2.5	-1.8	-1.7
Revenue	41.0	42.0	41.3	40.6	40.8
Expenditure	45.6	45.0	43.8	42.4	42.5
General government debt	72.4	70.3	64.1	62.4	60.9
Money and credit	(Change in percent)				
International Investment Position (millions of euros)	1,814.9	1,778.9	1,496.7	…	…
Broad money (M3) growth	2.4	4.2	5.2	11.1	…
Domestic credit	5.5	1.3	9.2	10.7	…
o/w private sector	-1.3	9.0	15.3	10.2	…
Balance of payments	(Percent of GDP)				
Current account balance	-5.9	-8.8	-8.2	-5.4	-6.7
Trade balance (goods and services)	-3.8	-5.3	-3.9	-1.9	-3.9
Exports of goods and services	79.2	77.6	87.4	87.4	86.9
Imports of goods and services	83.1	82.9	91.4	89.3	90.8
Goods balance	-15.6	-18.7	-18.9	-17.4	-20.2
Services balance	11.8	13.3	15.0	15.5	16.3
Exchange rate					
Exchange rate regime	Joined EMU on January 1, 2008				
Nominal effective rate (2000=100)	110.9	109.8	110.2	114.7	…
Real effective rate, CPI-based (2000=100)	112.9	112.7	113.8	117.3	…
Real effective rate, ULC-based (2000=100)	122.7	120.2	119.8	120.8	…
Memorandum item:					
Nominal GDP (millions of euros)	4,488.9	4,770.4	5,075.1	5,398.5	5,651.4

Sources: Central Bank of Malta; National Statistics Office; Eurostat; and IMF staff calculations.
1/ IMF staff projections.
2/ Contribution to growth.

**Statement by Arrigo Sadun, Executive Director for Malta
and Francesco Spadafora, Senior Advisor to Executive Director
August 6, 2008**

On behalf of the Maltese authorities, we thank staff for the well-written and informative report, which is a testament to the fruitful and close cooperation with the authorities.

Overview

Since the beginning of the year, Malta has been a member of the Euro Area, a landmark achievement in the authorities' strategy of fostering an open economy fully integrated into the global economy.

Malta has enjoyed a three-year long economic expansion underpinned by strong foreign direct investment, rising productivity, export diversification, and value-added upgrade, all largely induced by structural reforms. Fiscal adjustment, privatization, and public sector streamlining have also contributed to the positive performance.

Growth accelerated to 3.8 percent in 2007 and unemployment reached record lows. Inflation was limited to 0.7 percent, but it is expected to accelerate to 4.1 percent in 2008, before easing to 2.7 percent in 2009, as food and oil prices stabilize. The trade deficit in goods and services declined to 1.9 percent of GDP in 2007, from 5.3 percent in 2005, as a result of a revival of tourism and exports of higher value-added products and services.

Substantial improvements in cost and noncost competitiveness have been key in this regard. The former reflects productivity gains and wage moderation while the latter results from FDI-driven export diversification, especially into new services, as well as terms-of-trade gains, originating from upward shifts in export quality and value-added.

Malta's history of stable institutional and business environment has attracted large FDI inflows, which have so far amply overfinanced the current account deficit; this pattern is expected to continue in the near future. Staff's external sustainability analysis points to a robust external balance sheet. However given the economy's small size and openness and its reliance on positive investor sentiment, there is a continuing need for prudent fiscal and financial policies.

The positive trends in Malta's competitiveness are partly captured by CGER-type estimates: for example, the macroeconomic balance approach indicates a competitiveness gap of around 3 percent, versus 10-15 percent last year.

Staff expect growth to decelerate to around 2.5 percent in 2008 and 2.3 percent in 2009 as a result of a weakening external environment that is testing the resiliency of the economy. The authorities envisage a shallower slowdown on account of better export performance. There is however agreement that, over the medium term, activity will recover rapidly toward trend, sustained by FDI, emerging exports activities, and terms-of-trade gains.

The authorities recognize that the early period of the new legislation provides the opportunity to advance fiscal, financial, and structural reforms, and are determined to make progress in this regard.

Fiscal policy

The authorities are aware that market liberalization and EU membership have to be supported by a low tax burden and robust fiscal savings in order to allow for public investment in education and infrastructure that would boost productivity.

Progress in fiscal consolidation over the last few years has resulted in a reduction of the overall budget deficit from 4.6 percent in 2004 to 1.8 percent in 2007, prompting the termination of the Maastricht Treaty's excessive deficit procedure. In the same period, public debt as a percentage of GDP fell from 72.4 to 62.4 percent.

For 2008, the authorities are targeting, in their stability program, a budget deficit of 1.2 percent of GDP; they are also pursuing a medium-term objective (MTO) of a balanced structural budget by 2010 in order to ensure domestic stability and reduce vulnerability to external shocks.

However, because of anticipated overruns for the 2008 budget, partly arising from higher than projected oil prices, the authorities are identifying and implementing offsetting cuts in discretionary spending and have already raised electricity prices to close the gap with costs.

In staff's view, the 2008 budget deficit will stand at 1.7 percent of GDP, as the planned measures limit the overall underperformance to 0.5 percent of GDP. This notwithstanding, the structural balance should mark a substantial step toward the MTO, improving from -2.6 percent of GDP in 2007 to -1.9 percent.

To safeguard the budget and prevent distortions, the authorities are increasing the pass-through of fuel prices while exploring means to shield vulnerable groups. They also intend to introduce a water and electricity tariff reform by the fall, aiming to protect low-income households and progress toward cost recovery.

To ease pressures on public finances, the authorities' medium-term strategy is anchored in further expenditure reforms aimed at containing spending in three main areas: subsidies and state aid, the public wage bill, and the entitlement programs. They are also reinforcing the fiscal framework by pursuing more structured multi-year fiscal planning and by introducing methods of performance budgeting. Staff has recommended extending spending reviews to all major areas and parliamentary agreement on aggregate expenditure limits before starting budget appropriation discussions. In order to optimize the access to EU funding, evaluation procedures for investment projects are being improved.

Financial sector

The resiliency of the financial sector has been tested by the recent international developments, whose impact has so far been small.

According to the authorities and private sector analysts, a strong liquidity position and a good funding profile, which relies mainly on resident deposits, place the banking system in a good position to weather the global turmoil. Banks are profitable and have negligible exposure to subprime-related assets. Some banks' financial results were affected by markdowns in security portfolios, while equity valuations saw substantial declines in 2008.

Banks are using opportunities for asset diversification created by EMU entry. More generally, the internationally oriented financial sector (now fully under uniform regulation) is expanding rapidly.

Close supervisory vigilance is needed in light of the banks' large and growing exposure to the housing market. This remains broadly stable overall, although tightening credit conditions have resulted in real price declines in some market segments. Staff and the authorities concur that there is probably little, if any, house overvaluation relative to fundamentals.

Staff highlight that domestic asset quality remains weak due to relatively high, and thinly provisioned, non-performing loans (NPLs). The authorities partly shared staff concerns over the low and declining provision-coverage ratio, while noting that unprovisioned loans are fully backed by high-quality collateral.

The authorities are making good progress in introducing Basel II and other EU prudential standards, and, in light of lessons from the financial turmoil, are actively participating in EU-wide efforts to strengthen the national and cross-border framework for crisis prevention and resolution.

Memoranda of Understanding have been signed among key agencies and with relevant foreign jurisdictions, and, based on recent international experience, deposit insurance coverage is set to be strengthened.

Structural reforms

The authorities are aware that Malta's competitiveness and economic prosperity hinge on a stable macroeconomic framework and are determined to proceed with reforms in the product and labor markets to improve economic efficiency and facilitate the reorientation toward high-growth export activities.

This is important in light of the potential further declines that the traditional manufacturing sector may experience, despite subdued unit labor cost growth, as a result of a weakening external environment and competition from low-cost economies. The authorities, however, see this decline as having largely run its course.

While remarkable progress has been made in strengthening the business environment and improving education outcomes, additional policies would contribute to enhance still low productivity and increase competitiveness. The authorities are seeking additional improvements in educational attainment and labor market participation, particularly among females.

The authorities acknowledge staff's remarks on the existing across-the-board mandatory inflation adjustment of wages (COLA), but point out that its impact is limited and facilitate consensus in wage negotiations.

As for the public enterprise sector, despite significant divestment in several areas over the last few years, it remains large and its administered price-setting mechanisms are a source of market distortions as well as take a toll on the public budget. To mitigate such distortions and, more generally, to further scale down the role of such a sector, the authorities are reinvigorating the liberalization agenda and the reform of public enterprises. They have announced their intention to restructure and privatize, shortly, the loss-making shipyards.

The authorities consider premature staff's recommendation to grant institutional independence to the competition authority (currently part of the Ministry of Finance), but agree that a proactive stance is crucial in fostering price flexibility and efficient markets. They view implementation of the EU services directive as an opportunity in this regard.