



MALTA

2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR MALTA

February 2015

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 2014 Article IV consultation with Malta the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 23, 2015, following discussions that ended on December 15, 2014, 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 February 5, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its February 23, 2015 consideration of the staff report that concluded the Article IV consultation with Malta.
- A **Statement by the Executive Director** for Malta.

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: <http://www.imf.org>
Price: \$18.00 per printed copy

International Monetary Fund
Washington, D.C.



MALTA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

February 5, 2015

KEY ISSUES

Malta has weathered the crisis well and its economic outlook is stronger than that of the euro area as a whole. Real GDP growth accelerated to 2.5 percent in 2013, and the external position remained strong. This reflects a relatively diversified economy and a stable banking sector, which withstood well the economic slowdown and shocks from international financial markets. The stronger than expected growth pushed the fiscal deficit in 2013 below 3 percent of GDP. Remaining vulnerabilities stem from high public debt, elevated non-performing loans, high cost of capital, and the need to maintain competitiveness.

To raise growth in a sustainable manner and reduce vulnerabilities, the policy priorities are:

- **Strengthening fiscal sustainability.** The budgetary targets for 2015–2017 are welcome but meeting them is subject to risks. The authorities need to continue the progress towards meeting the medium-term objective of a balanced budget in structural terms. In particular, broad based reforms of expenditures, pensions, healthcare, state owned enterprises (SOEs), and fiscal governance are the priorities.
- **Maintaining financial stability.** Bank regulatory and supervisory frameworks have been recently strengthened in several areas. The largest banks passed the ECB's recent Comprehensive Assessment (CA) without a need to raise additional capital. Priorities to preserve financial stability include: (i) vigilance over risks from the high concentration of core domestic banks' exposure to the property market and high NPLs; and (ii) further improving the bank regulatory, supervisory, and contingency frameworks.
- **Enhancing competitiveness and reducing the cost of capital.** The priorities include improving labor participation and productivity, and reforming the judicial system to enhance the business environment. Measures, such as developing and implementing a strategy for NPL resolution and implementing the planned credit registry, will help lower the cost of capital.

Approved By
**Aasim M. Husain and
 E. Dabla-Norris**

Discussions were held in Valletta during December 3–15, 2014. The staff team comprised P. Berkmen (head), L. Juvenal, V. Prokopenko, and S. Saksonovs (all EUR). U. Niman, J. Quarm, and D. Santos, assisted from headquarters. A. Bassanetti (OED) participated in discussions.

CONTENTS

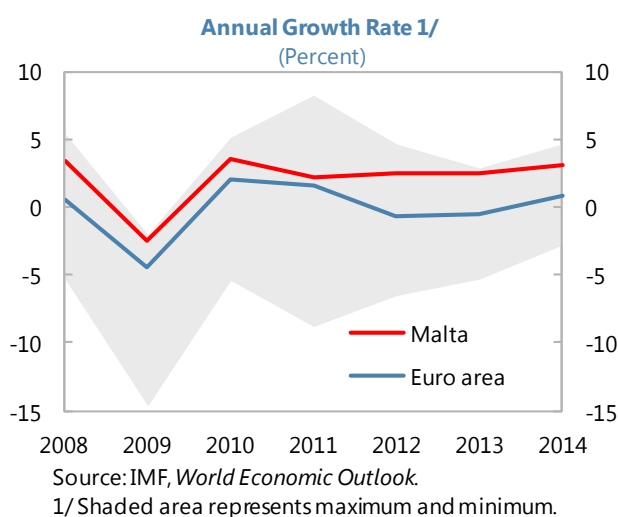
CONTEXT AND OUTLOOK: RESILIENT ECONOMY	4
POLICY DISCUSSIONS: SUSTAINING GROWTH AND REDUCING VULNERABILITIES	7
A. Strengthening Fiscal Sustainability	7
B. Financial Sector Policies	10
C. Structural Policies	15
STAFF APPRAISAL	18
BOXES	
1. Exchange Rate Assessment	6
2. Overview of the Financial Sector	11
3. Bank Regulatory and Supervisory Frameworks	12
FIGURES	
1. Non-Performing Exposures, 2014	13
2. Economic Indicators, 2003–2016	21
3. Short-Term Indicators, 2008–2014	22
4. Fiscal Developments, 2005–2014	23
5. External Sector, 2001–2014	24
6. Financial Soundness Indicators	25
TABLES	
1. Selected Economic Indicators, 2010–16	26
2. Fiscal Developments and Projections, 2010–16	27
3. Balance of Payments, 2010–16	28
4. General Government Financial Balance Sheet	29
5. Financial Soundness Indicators, 2010–13	30
ANNEXES	
I. Implementation of IMF Recommendations	31
II. Debt Sustainability Analysis (DSA)	32

APPENDICES

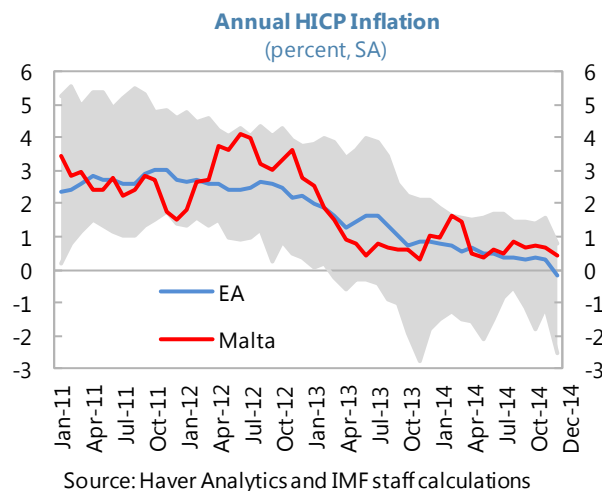
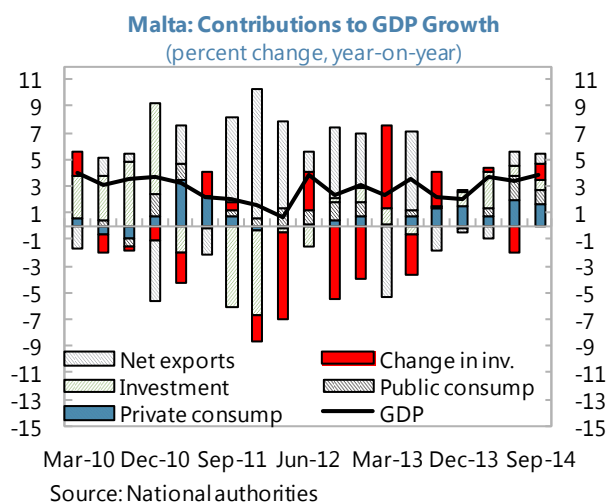
I. Developments in Malta's Competitiveness in Goods Sector	39
II. Interest Rate Pass-Through in Malta	43
III. Small and Medium Enterprises in Malta	49

CONTEXT AND OUTLOOK: RESILIENT ECONOMY

1. Malta's economy has remained resilient since the global crisis. Spillovers from turmoil in financial markets have been contained because of low reliance on external finance by domestic banks and the government. Real GDP has increased at one of the highest rates in the euro area since the crisis, supported by relatively diversified exports and, more recently, by domestic demand. At the same time, unemployment has declined close to its historical lows—among the lowest in the euro area—despite increasing labor participation rates.

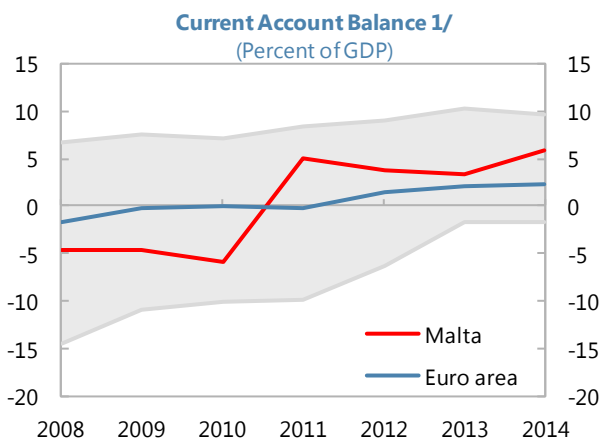


2. Growth is strong while inflation has declined along with the euro area trend (Table 1). The economy expanded by 2.5 percent in 2013, driven by domestic demand. Growth further accelerated to 3.6 percent (y-o-y) in the first nine months of 2014, supported by investment in large scale energy infrastructure projects and consumption. Inflation remained subdued at around 0.75 percent, reflecting lower oil prices, a decline in electricity tariffs, and low inflation in the euro area. Core inflation has been running higher, at about 1.5 percent, reflecting a closed output gap.

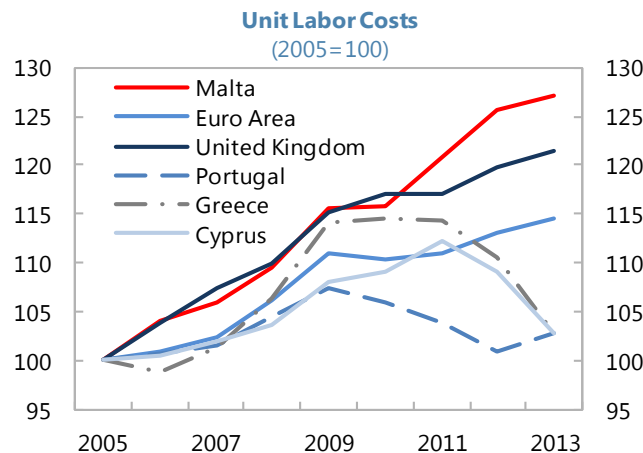


3. Malta has made impressive strides in improving its external balances, but unit labor costs are rising faster than in trading partners (Figure 5, Appendix 1). The trade balance reverted from a deficit of 2.5 percent of GDP in 2009 to a surplus of 9.2 percent of GDP in the first three quarters of 2014. Robust export growth after the crisis has reflected a diversified export base, both geographically and across sectors, and rapidly growing exports of services. Exports, however, grew

only marginally in 2014, partly reflecting a drop in the semiconductor sector. The current account remained positive at 8.1 percent of GDP, mainly driven by lower goods imports and a shrinking deficit in the primary income account. At the same time, unit labor costs have been increasing at one of the fastest rates in the euro area, posing risks for competitiveness when many euro area neighbors are undertaking structural reforms and internal devaluations.

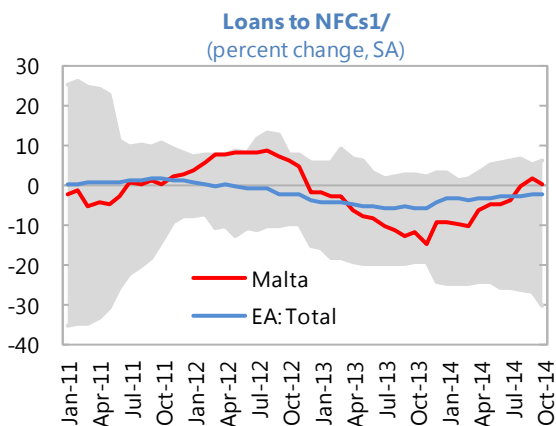


Source: IMF, *World Economic Outlook*.
1/ Shaded area represents maximum and minimum.

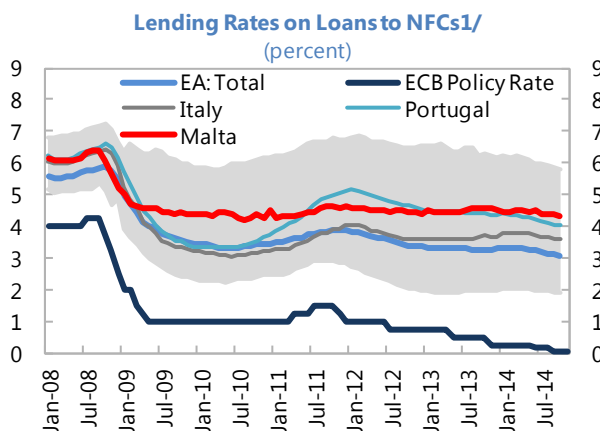


Source: Eurostat

4. Despite a growing economy, credit to corporations has remained weak, and the cost of capital has remained relatively high. Loans to non-financial corporations (NFCs) had been declining and only recently have stabilized at around a zero growth rate. At the same time, NFCs' lending rates have remained high relative the euro area average—despite the decline in ECB policy rates and a sound banking system—making it difficult for viable firms, particularly smaller ones, to access credit. High lending rates could reflect various factors, including higher funding cost of banks (relative to the ECB policy rates), limited competition, high level of NPL ratios, and relatively high corporate sector leverage, particularly for smaller firms and in certain sectors (Appendices 2 and 3).



1/ Outstanding amounts.
Source: Haver Analytics and IMF staff calculations.



1/ Outstanding amounts; EA, Total: EA16, excluding Estonia and Latvia.
Source: Haver Analytics.

5. Overall, the baseline outlook is strong. In particular:

- Growth is projected to remain robust, at around 3 percent in 2015–16. The output gap is slightly positive and is expected to close over the next two years. Domestic demand is supported by large scale investment projects in the energy sector and strong household income from rising wages and employment. Lower oil prices are expected to raise growth marginally in 2015. Over the medium-term growth is projected at 2.6 percent, slightly higher than the average since the EU accession on account of increased labor force participation.
- Inflation is projected to rise slowly as upward pressures from a small positive output gap and higher unit labor costs are expected to be dampened by planned reduction in energy tariffs, the pass-through of lower global oil prices and euro area inflation.
- The current account surplus will persist, supported by lower oil prices in 2015, the projected gradual recovery in external demand, Malta's continued competitiveness in the services sector, and the planned transfers of EU structural funds, despite the uncertainty surrounding the primary income account reflecting transactions of international banks (Table 3).

6. Risks to the outlook are balanced (Risk Assessment Matrix). In the short-term, prolonged stagnation and deflation in the euro area would reduce external demand and make fiscal adjustment more challenging. Medium-term risks of delays in implementing energy infrastructure projects and restructuring state-owned enterprises are balanced by the possibility of positive spillovers to private investment and consumption from ongoing large scale investment projects. Broader than expected changes in the EU regulatory framework and tax reforms could erode Malta's competitiveness especially if implementation of structural reforms in Malta is delayed while many other euro area countries continue to reduce their unit labor costs. Fiscal slippages and a further increase in public debt could feed into higher financing costs, crowding out private investment.

Box 1. Exchange Rate Assessment

Since the last Article IV consultation, the real effective exchange rate (REER based on INS), is depreciated by about 1.5 percent. Real effective exchange rates remain elevated relative to trading partners, and the gap between the ULC and CPI based REER persists (Figure 5).

Nevertheless, estimates of exchange rate valuation are broadly in line with fundamentals. While the macro balance and external sustainability approaches show a small undervaluation, the equilibrium exchange rate approach points at an overvaluation of about 6 percent.

	Estimates of Exchange Rate Valuation 1/		
	(Percent)		
	Art IV 2012	Art IV 2013	Current
Macro Balance	-1.7	-1.2	-3.0
Equilibrium RER 2/	5.9	-0.5	6.4
External Sustainability	5.6	5.0	-1.5

Sources: IMF article IV staff reports; and IMF staff estimates.

1/ +/- indicates exchange rate over/undervaluation; see IMF Occasional Paper No. 261 for details on the methodology underlying the estimates in this table. Numbers are not comparable with previous Art IV due to data revisions.

2/ To compute the medium term RER we use data up to October 2014.

Authorities' views

7. The authorities broadly agreed with the outlook and risks. Staff's growth projections are marginally more optimistic than the Central Bank's, reflecting recent oil price and exchange rate developments, while the Ministry of Finance expected higher growth rates in 2015 and 2016 (3.5 and 3.4 percent, respectively) on account of more favorable external assumptions. Continued strong performance of the tourism industry was also expected to support growth. The authorities saw the external environment as one of the main sources of downside risks, including for the recovery of semiconductor exports. They noted that the downside risk of investment project delays is balanced by the possibility of stronger than expected consumption due to improved confidence and labor market conditions. The risk of loss of competitiveness from changes in regulation and tax reform was seen as modest as the authorities emphasized still-relatively-low labor costs, flexibility and availability of skilled labor, and Malta's overall diversification and dynamism as the main sources of competitiveness.

POLICY DISCUSSIONS: SUSTAINING GROWTH AND REDUCING VULNERABILITIES

8. Despite the broadly favorable outlook, Malta faces important challenges: public debt is still high; non-performing loans are elevated; the cost of capital is relatively high despite abundant liquidity; and maintaining competitiveness is increasingly difficult. To raise growth in a sustainable manner and reduce vulnerabilities, the policy agenda should focus on: 1) strengthening fiscal sustainability; 2) maintaining financial stability; and 3) enhancing competitiveness and reducing the cost of capital.

A. Strengthening Fiscal Sustainability

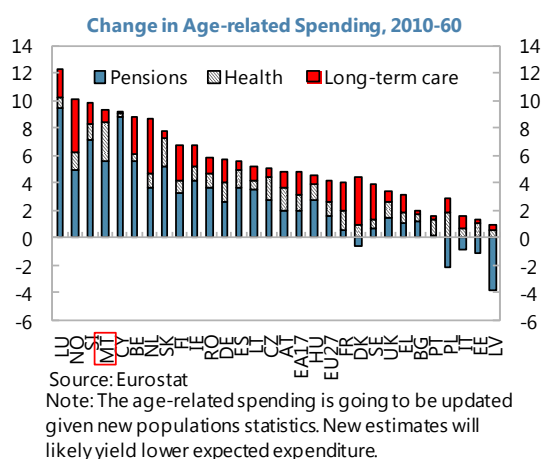
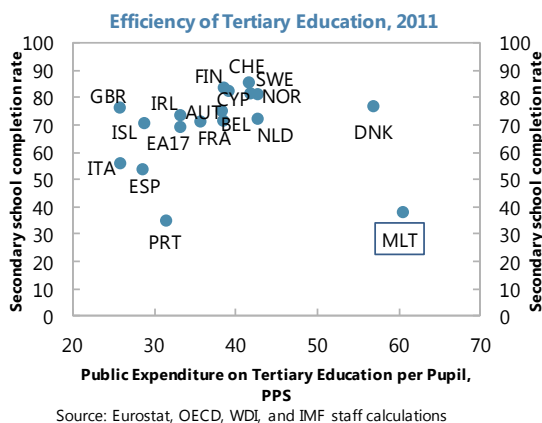
9. Malta has made significant progress in reducing its overall deficit and strengthening fiscal governance since the last Article IV consultation. Stronger than expected growth helped lower the fiscal deficit by almost 1 percentage point to 2.7 percent of GDP in 2013, and debt reached 69.5 percent of GDP, partly reflecting stock-flow adjustments. Fiscal consolidation has continued in 2014, despite rapidly growing current expenditures, financed by stronger-than-expected revenues. Staff estimates the fiscal deficit to decline to 2.2 percent in 2014. The authorities enacted the Fiscal Responsibility Act (FRA) over the summer, introducing i) a balanced-budget rule and a debt rule in line with EU requirements; ii) an independent fiscal council to monitor fiscal rules; iii) the Medium Term Fiscal Policy Statement and the Fiscal Policy Strategy; iv) a fiscal risk statement; and v) a contingency reserve to be built over the next five years.

Staff's views

10. The budgetary targets for 2015-2017 are welcome but meeting them will be challenging. The authorities aim at bringing the structural deficit to -0.4 percent in 2017, implying

an annual average fiscal consolidation of about 0.6 percent of GDP. The implied pace of adjustment strikes an appropriate balance between adjusting towards the MTO of balanced budget in structural terms and limiting its impact on growth. However, the authorities' target for 2015 (-1.6 percent of GDP) is based almost entirely on revenue measures, and the underlying growth projections rely on favorable external assumptions. To ensure that the proposed fiscal targets are met, additional expenditure measures should be considered. These measures should be designed to contain the fast growth in current spending— including through prudent wage agreements and further restraint on public sector employment— while preserving incentives for labor participation and education, and capital spending. Given weaker growth assumptions, possible slippages in the wage bill and subsidies relative to the targets, and lack of specific measures beyond 2015, staff project an overall deficit of 1.9 percent of GDP in 2015 and 1.5 percent for 2017 (Table 2). Staff project debt to reach 69.8 percent in 2015, gradually declining to around 62 percent of GDP by 2020. Low inflation and growth, and contingent liabilities are the key risks (DSA Annex).

11. Broad-based reforms—on expenditures, pension, and healthcare— are critical to contain fiscal pressures going forward. The authorities have started a Public Expenditure Review (PER) process, and the main progress has been made in social security spending. Building on this initiative, a comprehensive spending review would help prioritize and contain spending. In addition, such a review would facilitate improvements in the efficiency of spending, for example on education and health, where outcomes remain weak despite high spending levels. On pension reforms, while a private third pillar pension scheme was introduced in 2014, progress has been limited. Further measures—such as accelerating the planned increase in the retirement age and linking pensionable income to a longer period of working years— are needed to curb the projected increase in public pension outlays.¹ On health care, initial steps in improving medical procurement have been taken, increasing access to drugs and controlling costs. The government is also planning to establish cost centers within hospitals aiming to enhance management practices. However, progress in reforms



¹ The retirement age is set to gradually reach 65 years for both genders only in 2027, whereas 16 EU member states will have already reached or exceeded this level by 2020. No further increases are envisaged. While recently revised population projections will likely result in lower projections for age-related spending, there is still a gap between the projected outlays and available resources.

and its impact on the budget are expected to be modest and gradual. Accelerating the implementation of planned health care measures—such as increasing the administrative efficiency and strengthening primary care— will help contain spending growth.

12. The authorities should continue to push forward with restructuring of state-owned corporations and overall fiscal reforms. Given the extent of ongoing restructuring efforts and implications on the budget, it is important to disclose, analyze, and manage risks to public finances from the state owned enterprises in a consolidated manner. Enemalta's (the utility company) restructuring, once completed as planned, will bolster public finances, reduce guaranteed debt (16 percent of GDP in 2014, about 60 percent of which is due to Enemalta) and help lower energy costs.² As the privatization agreement is at its final stages, a part of the proceeds has been already used to cover the tax arrears, and the rest is going to be used to reduce bank loans. Regarding the infrastructure projects—essential to reduce production costs—the interconnector to Sicily is almost complete, but the completion of one of the power plants, originally scheduled for 2015, is now delayed to 2016. To ensure a sustainable financial position, tariff reductions should be backed by cost containment. The restructuring of Airmalta is continuing (involving a total government injection of €130 million, about 1¾ percent of GDP, to be completed by 2016), but the company is facing challenges in breaking even as planned. Recent nationalization of the public transport company has led to an increase in subsidies (about 1/3 percent of GDP). The authorities are in the process of its re-privatization. Staff encouraged the full implementation of the FRA for the next budget period, which would help manage risks, including from the SOEs, in a multi-year framework. In addition, ongoing initiatives to integrate the revenue administration agencies will help improve the overall budgetary process.

Authorities' views

13. The authorities acknowledged the risks, but were confident that their deficit targets would be met. They noted that the fiscal deficit declined by 1 percentage point in 2013, and additional expenditures in 2014 were concentrated on priority areas, such as health care and education. On SOEs, the authorities anticipate that the expected cost and efficiency gains from Enemalta's restructuring would cover the tariff reductions implemented in 2014 and 2015. In addition, they noted that SOEs are subject to public scrutiny individually. On pension reforms, the authorities noted that they would wait for the results of the updated projections for pension spending based on new population statistics before taking any additional measures. On fiscal reforms, the authorities intend to implement the FRA for the next budget period, starting with the appointment of a fiscal council. They also noted that the National Audit Office reviewed the macro and fiscal projections for the 2015 budget. On spending review, they emphasized that progress has

² During recent years, Enemalta's losses have averaged at around 1 percent GDP, partially met by subsidies, and led to buildup of the guaranteed debt. The authorities signed a memorandum of understanding for a strategic partnership with the Shanghai Electric Power in 2013 and are in the process of completing the deal, selling a 33 percent stake in Enemalta and undertaking energy infrastructure projects.

been made on social security, and they are considering expanding it to other sectors, including through technical assistance by the IMF.

B. Financial Sector Policies

14. The Maltese financial system remains resilient. Solvency and liquidity of banks remain well above regulatory requirements, and profitability is good (Table 5). Solid performance of core domestic banks reflects their conservative business model, particularly limited external assets and liabilities and relatively low loan-to-value ratios. As a result, the largest banks passed the ECB's recent Comprehensive Assessment (CA) without a need to raise additional capital. The large segment of international banks has very limited links with domestic residents, and as a result the recent significant deleveraging of some of these banks had minimal impact on the local economy (Box 2)³. While there may be some spillovers to domestic financial system from stronger cross-border deleveraging and/or regulatory changes elsewhere, the impact on the economy is likely to be limited.

Malta: Results of the ECB's Comprehensive Assessment (percent)

	Year-end 2013 CET1	AQR-adjusted CET1	Adjusted CET1 Ratio after Baseline Scenario	Adjusted CET1 Ratio after Adverse Scenario
Bank of Valletta	11.20	10.71	11.93	8.92
HSBC Bank Malta	9.91	9.02	9.26	8.91
Deutsche Bank (Malta)	281.40	281.40	280.60	138.76
Average	40.20	39.50	40.70	34.00

³ Total assets of international banks declined from about 490 percent of GDP in 2012 to 410 percent of GDP in early 2014.

Box 2. Malta: Overview of the Financial Sector

The Maltese financial sector is very large compared to the size of its economy. As of mid-2014, assets of banks were close to 7 times GDP and assets of non-bank financial institutions (insurance companies and investment funds) were around 2 times GDP. The financial institutions in each of these groups can be classified as either domestic or international, depending on the scope of their involvement in activities with residents. Risks and vulnerabilities related to domestic institutions differ substantially from those related to international institutions. For banks, the Central Bank of Malta (CBM) also separates the category of domestic institutions into core domestic banks and non-core domestic banks.

- Core domestic banks have a traditional business model of attracting household and corporate deposits and providing loans to the economy. These banks have limited external assets and liabilities, provide around 97 percent of bank lending to residents in Malta, and collect around 94 percent of resident deposits. Two banks account for over 90 percent of both loans to and deposits from residents. Core domestic banks that are subsidiaries of big foreign parent banks have not relied on parent funding for their operations in Malta. As of end-June 2014, the core domestic banks had an aggregate capital adequacy ratio of 14.9 percent and liquidity ratio (liquid assets to short-term liabilities) of 42.6 percent, well above the minimum requirements of 8 percent and 30 percent, respectively.
- International banks rely mostly on wholesale (including intra-group) funding and nonresident deposits of relatively long maturities. These banks concentrate on activities for the group (custodian services, trade finance, investment banking). While international banks are particularly large compared to the size of the economy, risks to systemic financial stability arising from these banks are rather low. With negligible direct balance sheet links to the domestic economy both from the assets and the liabilities sides, the systemic financial implications in the event of materialization of solvency or liquidity risk affecting international banks would be contained. Furthermore, with abundant capital and liquidity, these banks should be able to absorb significant pressures before the point of non viability.
- Non-core domestic banks have limited links with the domestic economy and are funded primarily from wholesale markets and non-resident deposits. Unlike the international banks, these banks have some (albeit still small) exposure to residents in the form of loans and deposits. Around 9 percent of assets and 12 percent of liabilities are respectively claims on and due to residents. Therefore, the main risks related to these banks stem from possible cross-border deleveraging pressures and claims on the local deposit compensation scheme in the event of bank failure.

The non-bank financial institutions are relatively small, and the main systemic risk arising from these institutions relates to their interconnectedness with core domestic banks. Around one third of insurance companies (with assets of €2.4 billion as of end-2013) and investment funds (with assets of €0.8 billion) are classified as domestic. The insurance sector is dominated by one company, which has a market share of around 60 percent in terms of assets. Assets of insurance companies and investment funds mainly consist of shares and equity holdings, of which over one half is issued outside Malta. Core domestic banks hold a significant shareholding in several domestic insurance companies, while over 10 percent of insurers' assets consist of deposits held with the Maltese banks. The investment funds have significant investments in local bank equity.

15. The regulatory and supervisory frameworks have recently been strengthened in several areas (Box 3). In late 2013, the Malta Financial Supervisory Authority (MFSA) amended the regulation on loan provisioning, requiring banks to allocate higher provisions for nonperforming loans. As a result, the coverage ratio increased from 39.5 percent in 2013 to 40.3 percent in June 2014, and expected to increase further. The CBM Act was also amended in late 2013, adding the formulation and implementation of macro-prudential policy as an explicit objective of the CBM. In this context, work on developing a macro-prudential toolkit has started. At present, the CBM and the MFSA are conducting research on the macro-prudential toolkit, such as possible use of broad-based and sector-based capital buffers for banks. The Joint Financial Stability Board (JFSB) has

enhanced inter-agency cooperation on financial stability. In November 2014, the supervision of the largest banks was transferred from the MFSA to the Single Supervisory Mechanism (SSM).

Box 3. Malta: Bank Regulatory and Supervisory Frameworks

The Malta Financial Supervisory Authority (MFSA) is a unified supervisor of all financial institutions and markets. The MFSA periodically conducts internal audits or commissions external experts to review compliance of its regulatory and supervisory arrangements with the best international standards. However, there has been no Financial Sector Assessment Program (FSAP) in Malta since 2003.

In response to the past recommendations of staff and the EC, the authorities have taken measures to increase loan loss provisions. Following a consultation with stakeholders, the new regulations (Banking Rule BR/09) became effective as of end-2013. The amended regulations require banks to allocate a higher amount of provisions for NPLs, by allocating reserves of 2.5 percent of a bank's NPLs.

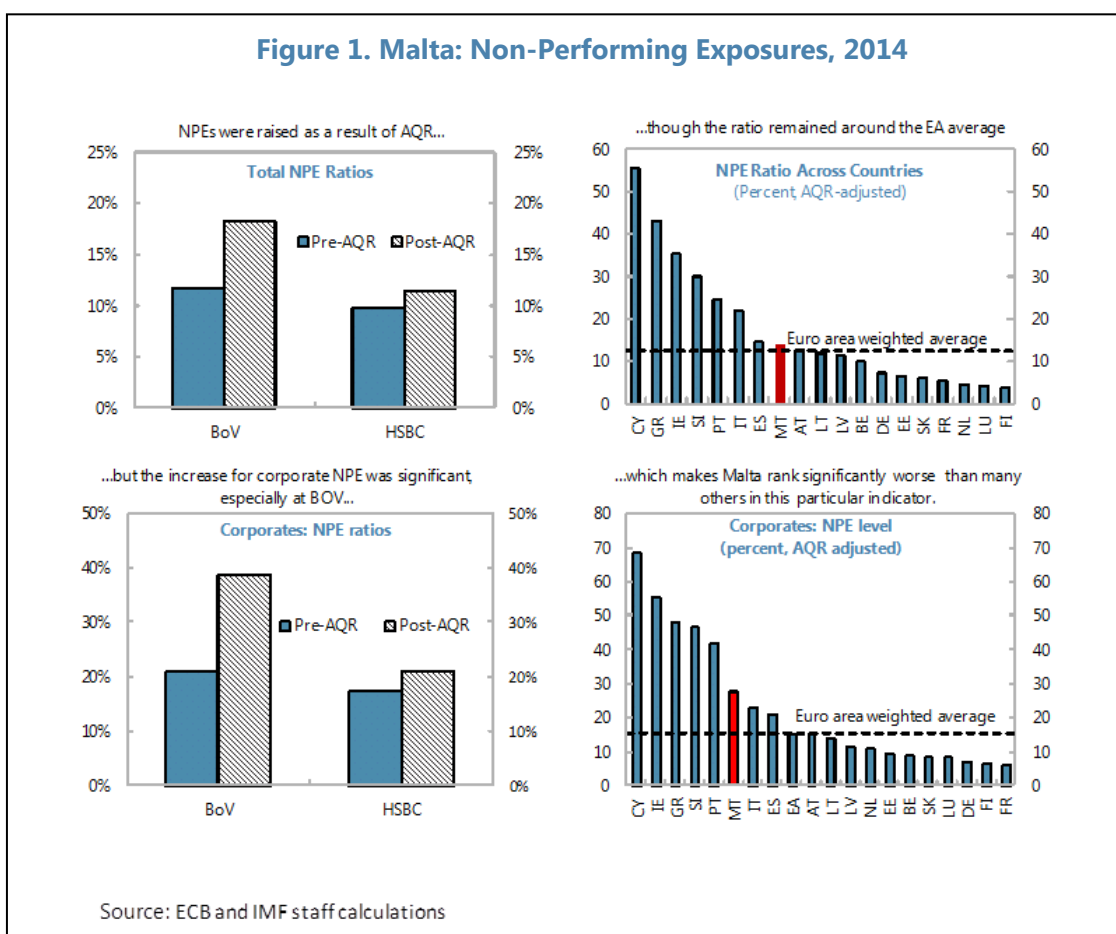
The institutional set up for macro-prudential policymaking has been recently strengthened. The amendments to the CBM Act of November 2013 augmented the responsibilities of the CBM by adding the formulation and implementation of macro-prudential policies to the functions of the CBM. A second deputy governor was appointed with a focus on financial sector issues. The amendments also gave a legal status to the JFSB that was set up in early 2013 and made up of representatives from the CBM, MFSA, and Ministry of Finance, the latter as observer.¹

¹The main objective of the JFSB is to facilitate cooperation between domestic authorities in matters related to systemic financial stability, including the identification and assessment of macro-prudential policy instruments.

Staff's views

16. While noting solid performance of the Maltese banks and welcoming recent legal and regulatory changes, staff pointed to several areas where resilience could be further strengthened. In particular:

- Although the two largest banks were found to be adequately capitalized under the ECB's CA, their NPL ratios were revised substantially upwards, suggesting that the NPL ratio for the rest of the banking sector could also be higher under stricter loan classification rules. Swift implementation of the action plans resulting from the CA would be essential. Of particular importance is the need to align definitions of impairment triggers and forbearance used by individual banks with those used by the European Banking Authority and the SSM, and continued efforts to boost provisioning.
- The MFSA should maintain sufficient resources as needed by the intensity of the regulatory and supervisory work, including in the AML/CFT area. The transfer of supervision of the largest banks from the MFSA to the SSM has been smooth. Continued close cooperation between the MFSA and the SSM is needed to ensure no reduction in supervision of these banks.



- Enhanced focus of the MFSA on smaller banks is now appropriate, given forthcoming changes in ownership. Two mid-sized core domestic banks (Banif and Lombard) are in the process of ownership change.⁴
- One of the main risks facing core domestic banks relates to their exposure to the real estate sector. Around two thirds of loans extended by banks are secured with real estate collateral, and mortgages are one of the few segments of bank loans which have been increasing recently (unlike loans to NFCs). It is important to continue mitigating the risk of exposure concentration to the real estate sector by the application of a cautious collateral valuation and conservative loan-to-value ratios. There is also room to enhance the loan foreclosure process by advancing judicial reform.⁵ This risk can be exacerbated by the weak performance of the EU countries, generating negative spill-over effects on the Maltese economy and its financial sector.

⁴ Banif Bank Malta is majority-owned by Banif Financial Group of Portugal and Lombard Bank is 49 percent owned by Popular Bank of Cyprus. The Portuguese and Cypriot banks received state aid in recent years, which—in accordance with the EU rules on state aid—obliges them to sell their overseas investments.

⁵ As noted by the 2014 World Bank Doing Business report, Malta scores relatively unfavorably compared to the EU average in terms of the time needed for loan foreclosure and recovery rates in insolvency.

- The contingency framework should be strengthened in line with reforms at the EU level. This includes boosting the ex-ante funds of the deposit compensation scheme while lowering the share of banks' special contribution (ex-post payment commitments).⁶ Also, legal amendments are needed to implement the EU Bank Recovery and Resolution Directive, establishing a resolution fund and introducing a bail-in requirement.
- The MFSA and FIAU should continue to aim for high standards in the AML/CFT framework, particularly in light of the large financial and online gaming sectors.
- To get a fuller assessment of the financial sector's condition and oversight, an update of the FSAP—which took place in 2003—would be appropriate.

Authorities' views

17. The authorities agreed with staff on the need to adapt the financial sector policy framework to the changing environment. They intend to maintain local laws and regulations on loan classification, macroprudential oversight, deposit insurance, and bank resolution in line with the EU requirements, and stressed that work is under way in all these areas. In particular, there are plans to amend the MFSA Act with the aim to establish a Resolution Board under the auspices of the MFSA. The authorities were positive about the move toward a banking union in the EU, and both MFSA and the ECB emphasized the importance of close cooperation in supervising the largest banks. The MFSA noted that two mid-sized banks are now in the process of asset quality review similar to the one conducted for the largest banks under the ECB's auspices, and two more banks will be subject to a similar review in 2015. The authorities agreed with the recommendation to ensure high standards in the AML/CFT framework, and indicated that efforts are under way in several areas to address shortcomings noted by the 2012 MONEVAL report. The authorities stated that they would soon request an FSAP update.

18. The authorities broadly shared staff's views on possible sources of risk to the financial sector. They noted that a slow economic recovery in the EU represents a risk to the domestic economy and financial sector. While they agreed that high NPL ratios are an important challenge for core domestic banks, they expected a reduction going forward as growth picks up. The authorities were less concerned than staff about the exposure of banks to the real estate sector. They were of the view that delinquency rates on mortgages have traditionally been one of the lowest, the exposure of banks to speculative property trading is very small, and household income (the main source of vulnerability for mortgages) is growing at a healthy rate.

⁶ Currently, the ex-ante contribution paid by banks to the deposit compensation scheme is equivalent to at least 0.2 percent of eligible deposits, while the special contribution is equal to at least 0.8 percent of eligible deposits. In accordance with the 2014 EU Directive on Deposit Guarantee Schemes (Directive 2014/49/EU), the target level for ex-ante funds should be 0.8 percent of the covered deposits.

C. Structural Policies

19. The authorities are making progress in a number of structural reform areas — energy, judicial reform, and labor market. These priorities are outlined in the National Reform Program (NRP), which aims at increasing competitiveness of the economy and ensuring long-term fiscal sustainability. These steps should help address the low female participation, skill gaps in the labor market, difficulties of early school leavers, Malta’s dependency on oil as the main energy source, and inefficiencies of public procurement.

20. The government is implementing a three year plan for judicial reform based on the recommendations of the Justice Reform Commission. The first year focused on amendments to criminal law, with improvements to civil and commercial law planned in the upcoming year. Planned reforms include: increasing the number of courts assistants, greater use of information technology in court administration, raising the thresholds for streamlined judicial procedures, and introducing alternative dispute resolution mechanisms such as mediation.

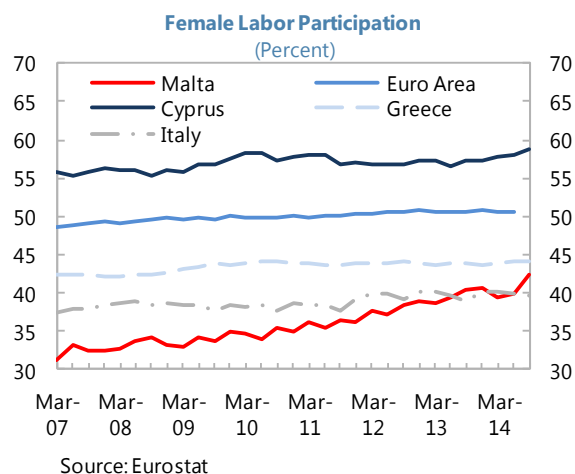
21. A number of labor market and education reforms have been aimed at increasing labor participation and enhancing skills. The authorities have improved incentives to work by introducing free childcare for working mothers, and gradual tapering of social benefits for those entering employment. The government is improving search and matching efficiency by introducing electronic platforms for job vacancies and involving the private sector in finding jobs for youth. Planned measures on education include compiling an employability index for higher education courses to assess how they correspond to labor market requirements, and introducing private tuition support for youth experiencing difficulties in primary education.

Staff’s views

22. Maintaining Malta’s competitiveness will require sustained productivity and value-added growth. In global competitiveness assessments, Malta is lagging behind in some key areas, such as ease of starting a business, access to credit, and legal rights. While Malta’s comparative advantage in the services sector has helped support its exports, some sectors (e.g. remote gaming) remain vulnerable to regulatory and tax changes elsewhere. Competitiveness may also be threatened by increased mismatch between wages and productivity growth, especially when many euro area neighbors continue to reduce their unit labor costs (Appendix 1). At the same time, Malta’s dynamic economy should be supported by affordable lending to viable firms (Appendices 2 and 3). The following areas are priorities for structural reforms.

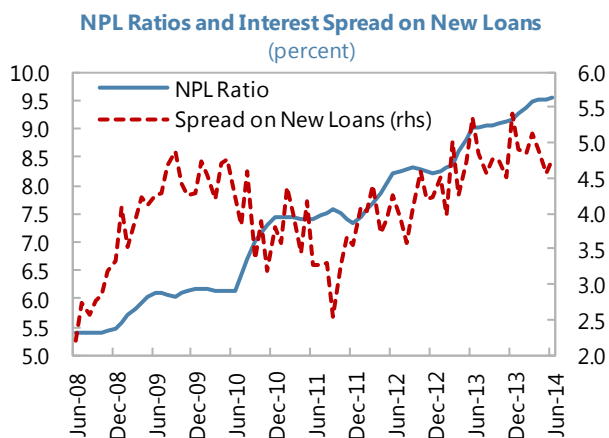
- **Skills upgrading:** Ensuring sufficient growth in labor productivity requires better upgrading and utilization of skills. Malta has one of the lowest tertiary education enrollment rates and one of the highest drop-out rates in the EU. Measures to boost tertiary education enrollment and the quality of vocational training need to continue in order to reduce skills mismatches and improve the quality of labor.

- **Female labor participation:** Female labor force participation has increased, helped by government policies, but it is still one of the lowest in the euro area. With growth increasingly dependent on financial and niche services, the authorities need to ensure ample and well-qualified labor force. Budget measures that incentivize labor participation, especially female participation, should be prioritized over other forms of current spending. Vocational education should be strengthened further by identifying and expanding programs that deliver best employment outcomes.



- **Judicial reforms:** While Malta has made some progress in reducing the time needed for dispute resolution, including insolvency proceedings, it remains high compared to EU peers (see e.g. the 2014 EU Justice Scoreboard). The government should continue planned judicial reforms and monitor their outcomes focusing on the speed of resolving judicial cases and the use of alternative dispute resolution mechanisms such as mediation. Encouraging greater use of the insolvency regime, as well as more out-of-court workouts, accelerating collateral recovery, and reforming bankruptcy procedures are crucial for the resolution of the growing stock of non-performing loans on bank balance sheets and dealing with the debt overhang of some SMEs.
- **Reducing the cost of capital:** A number of measures should be considered to reduce the relatively high cost of capital.
 - Creating a credit registry, as planned by the authorities, should help reduce financing costs and, in the medium-term, help facilitate other forms of market financing, such as securitization. This would complement initiatives to jump start markets for risk capital. Full benefits of the credit registry can be obtained if it is comprehensive (collecting data also from non-financial institutions) and includes not only indebtedness information, but also payment history (including positive history).

- High NPLs are contributing to high interest rates, particularly in certain sectors, as implied by the correlation between NPL ratios (and relatively high corporate leverage) and lending rates on new loans (Appendix 3). There is a need for a strategy for NPL resolution. Such a strategy should include accelerating NPL write-offs, encouraging greater use of the insolvency regime, faster enforcement of creditor rights, and developing options for out-of-court workouts.



Source: ECB; CBM; NPL ratio is non-performing loans to gross loans and is interpolated from quarterly data on FSI indicators.

- While the reliance on domestic funding across sectors (government, banks, and corporates) has helped shield Malta from the global financial crisis, encouraging a moderate increase in cross-border financing should help lower funding costs across the economy.
- A development bank—which is being considered by the authorities—could in principle help stimulate markets for long-term financing of risky projects and stimulate nascent markets. However, it should not be in direct competition with commercial banks, should have a clear and periodically re-evaluated mandate, be effectively supervised, and have strong governance.

Authorities' views

23. The authorities agreed with staff on the importance of structural reforms. Specific areas such as judicial reform and labor market improvements are priorities for the government. The authorities emphasized that reforms would take some time owing to a large amount of institutional changes requiring consensus building, approval by Parliament, and a cultural change in some cases.

24. The authorities agreed that the cost of capital is relatively high. They expected positive results from the planned credit registry and tax measures to stimulate venture capital investments. On credit registry, the authorities expected to finalize the consultation with banks in early 2015 and introduce the registry in two stages. The first stage is expected to be completed by mid 2015, in line with data requirements at the euro area level (the ECB's Anacredit project with a deadline of December 2017). They saw the influence of NPLs as limited only to certain sectors such as construction. The authorities agreed that there may be scope to facilitate increased cross-border financing, but pointed to a number of structural obstacles and trade-offs with financial stability, particularly the small size of issuance and high resulting liquidity premiums.

STAFF APPRAISAL

25. Malta continues to weather the global crisis well. Real GDP growth has been one of the highest in the euro area since the crisis and remains solid going into 2015. The external position has stayed strong, and unemployment is close to historical lows and among the lowest in the euro area. These developments reflect a relatively diversified economy and a stable banking sector.

26. The economic outlook is strong and risks are balanced. Staff project continued robust real GDP growth in 2015–16, driven by domestic demand. Inflation is projected to remain subdued. In the short-term, a prolonged stagnation and deflation in the euro area would reduce external demand and make fiscal adjustment more challenging. While risks related to the delays in restructuring of various state owned enterprises remain, there are potential positive spillovers to private investment and consumption from large infrastructure projects. In the longer term, Malta's competitiveness could be eroded if Malta falls behind in implementing structural reforms while many euro area countries continue to reduce their unit labor costs, including through stepped up regulatory and tax reforms elsewhere.

27. Now is an opportune time to push forward with policies to raise growth in the medium-term in a sustainable manner and reduce vulnerabilities. Despite a robust outlook, Malta faces important challenges: public debt is still high; non-performing loans are elevated; the cost of capital is relatively high despite abundant liquidity; and maintaining competitiveness is increasingly challenging. The policy agenda, therefore, should focus on three areas: (i) strengthening fiscal sustainability; (ii) maintaining financial stability; and (iii) enhancing competitiveness and reducing the cost of capital.

28. The budgetary targets for 2015-2017 are welcome but meeting them will be challenging. The fiscal deficit declined to 2.7 percent of GDP in 2013, and with the output gap closed, there is a window of opportunity to reduce public debt. The consolidation measures proposed by the government for 2015 are mostly on the revenue side, and the underlying growth projections rely on favorable external assumptions. To ensure that the proposed fiscal targets are met, additional expenditure measures should be considered. These measures should be designed to contain the fast growth in current spending while preserving incentives for labor participation and education, and capital spending. If revenues turn out to be higher than projected, they should be used for debt reduction. In this context, full implementation of the comprehensive spending review would help prioritize and contain spending, while increasing efficiency.

29. Broad-based reforms—on pension, healthcare, and public corporations—are critical to contain fiscal pressures going forward. Further measures are needed to curb the projected increase in public pension outlays and health care spending. Authorities should continue to push forward with restructuring of state-owned corporations. More generally, it is important to disclose, analyze, and manage risks to public finances from state owned enterprises in a consolidated manner.

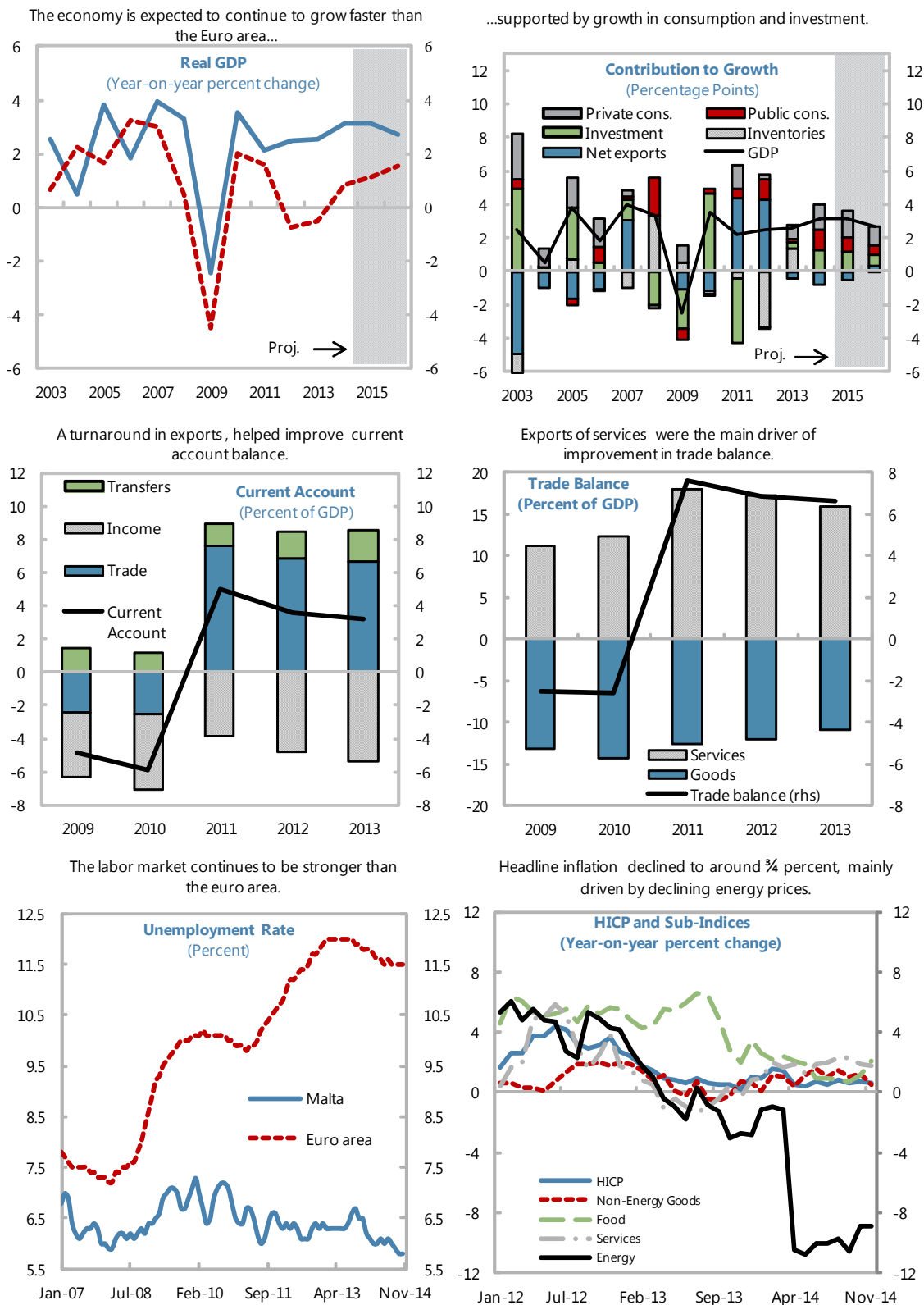
- 30. The government's efforts to strengthen fiscal governance are welcome.** The full implementation of the FRA for the next budget period is encouraged. Ongoing initiatives to integrate the revenue administration agencies will help improve the budgetary process.
- 31. Overall, the financial sector remains stable.** Malta continues to host a relatively large financial sector without exposing itself to excessive risk. The regulatory and supervisory frameworks have recently been strengthened. A fuller assessment of the financial sector's condition under the Financial Sector Assessment Program would be useful.
- 32. Remaining financial sector vulnerabilities stem from the relatively high level of NPLs and exposure to the property market.** The NPL ratios of the largest banks were revised upwards under the AQR. At the same time, exposure of the core domestic banks to the property market remains substantial, leaving the banking sector vulnerable to developments in the real estate sector, particularly in the case of direct exposure to the construction sector.
- 33. Efforts are needed to further boost the resilience of Maltese banks and ensure robust supervisory and contingency arrangements.** Policies should focus on: (i) a swift implementation of the action plans resulting from the ECB's comprehensive assessment, and applying the same standards across the rest of the banking sector; (ii) strengthening the contingency framework in line with reforms at the EU level, including by boosting the resources of the deposit compensation scheme and lowering the share of banks' special contribution; (iii) following through legal amendments needed to implement the EU Bank Recovery and Resolution Directive, establishing a resolution fund and introducing a bail-in requirement; and (iv) continuing to aim for high standards in the AML/CFT framework.
- 34. Maintaining Malta's competitiveness will require sustained productivity growth.** The priorities include improving labor participation and productivity, and reforming the judicial system to improve the business environment. Malta's dynamic economy should be supported by affordable lending to viable small firms. Therefore, policy actions are needed to reduce the cost of capital, including by developing a strategy for NPL resolution, implementing the planned credit registry, and encouraging a moderate increase in cross-border financing.
- 35. Staff proposes that the next Article IV consultation with Malta follows the standard 12-month cycle.**

Malta: Risk Assessment Matrix¹

Source of Risk	Relative Likelihood	Impact if Realized	Policy Response
1. Protracted period of slower growth in the euro area, and emerging economies	High Highly open nature of the Maltese economy makes it particularly vulnerable to developments in the euro area and external demand	Medium Impact on growth and financial flows	Reduce the pace of fiscal consolidation, in line with the flexibility under the SGP. Continue to diversify trade and financial activities with non euro area countries.
2. Geopolitical fragmentation: i) Russia/Ukraine; ii) fragmentation/state failure in the Middle East	Medium Direct links with Russia and Ukraine are low	Low Indirect effects through confidence and external demand might be partially offset by additional tourists given Malta's stability	Focus on eliminating vulnerabilities (fiscal and financial) to ensure stability.
3. Inconsistent and partial implementation of the EU regulatory framework	Medium Malta's attraction as a financial center for cross-border banking activities and advantages in some services sector (such as online gaming) may diminish	Low/Medium Further deleveraging of the international banking and business sector may adversely affect tax revenues and employment Some services sectors (sources of export revenue) may shift out of Malta	Diversify the economy while scrutinizing associated new risks
4. Delays in implementation of SOE restructuring and investment projects	Low Delays in undertaking due diligence procedures could push back planned capital investments and availability of financing. Delays in achieving profitability may increase fiscal pressures	High Large budgetary support may be required, and growth impact would be lower than projected	Rapid implementation of the project plans Improve the governance structure of SOEs, including through managing fiscal risks in a consolidated manner
5. Delays in implementing structural reforms	Medium Lack of social consensus may lead to reform paralysis	High Delayed implementation of required structural reforms would negatively affect long-term fiscal sustainability, competitiveness, and medium-term growth	Pursue structural reforms vigorously, particularly given that cyclical conditions are favorable
6. A sharp correction in housing prices	Low After a period of downward correction in 2008-09, Malta's housing market seems to have stabilized	Medium/High Core domestic banks are significantly exposed to the housing market	Monitor risk and be prepared to use macro-prudential measures

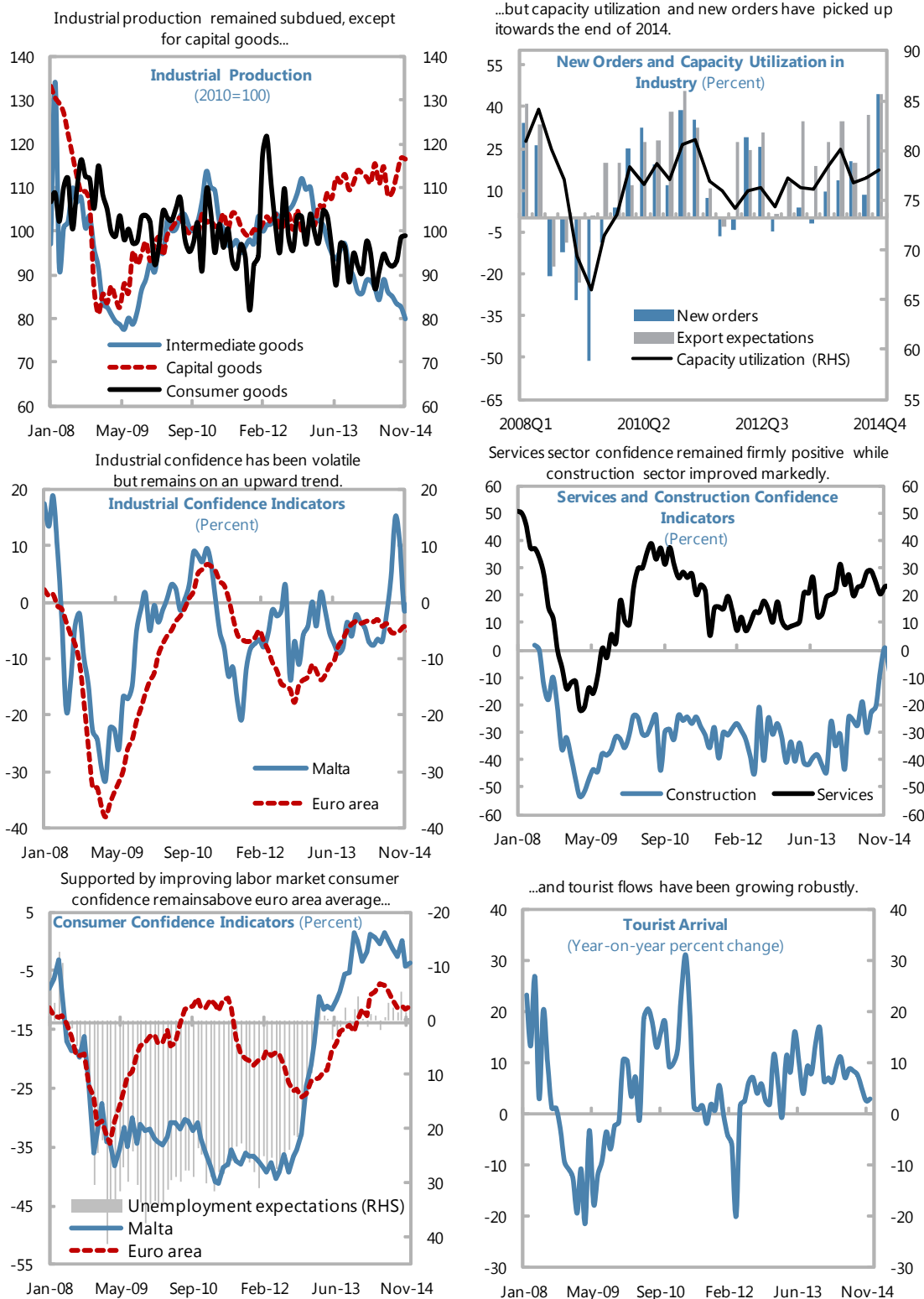
¹The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Figure 2. Malta: Economic Indicators, 2003–2016



Sources: Central Bank of Malta; Eurostat; IMF *World Economic Outlook*; and IMF staff calculations.

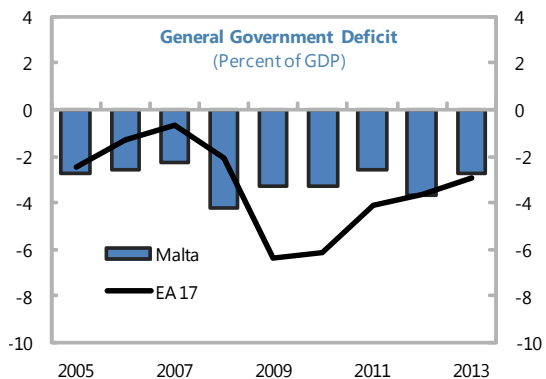
Figure 3. Malta: Short-Term Indicators, 2008–2014



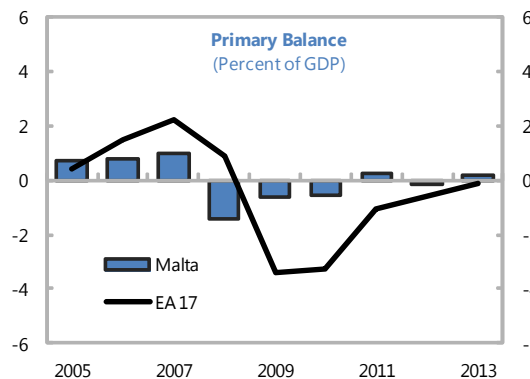
Sources: European Central Bank; Central Bank of Malta; European Commission; and IMF staff calculations.

Figure 4. Malta: Fiscal Developments, 2005–2014

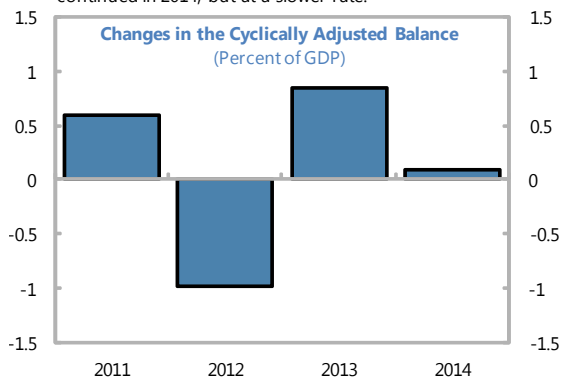
In 2013, the overall deficit declined to 2.7% of GDP ...



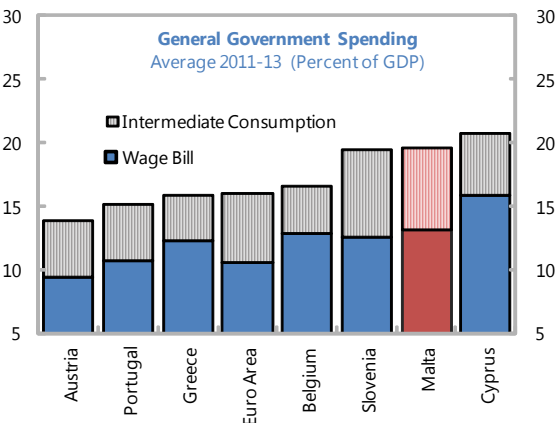
...and primary balance became slightly positive .



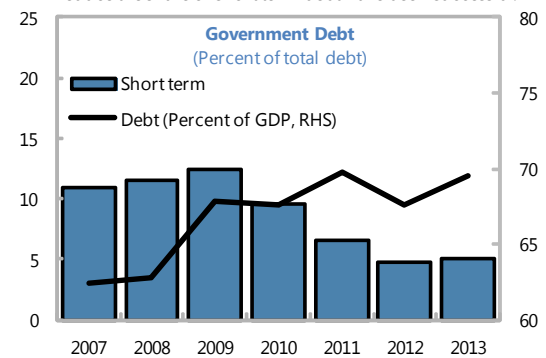
Fiscal consolidation efforts were frontloaded in 2013 and continued in 2014, but at a slower rate.



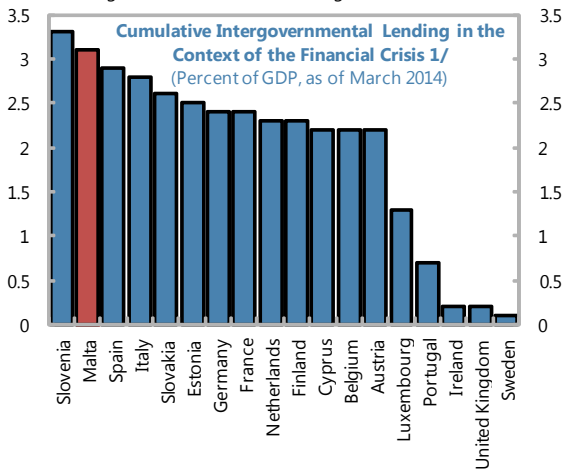
...but there is room for adjustments to spending.



Government debt is at about 70 percent, but efforts to reduce the share of short term debt have been successful.



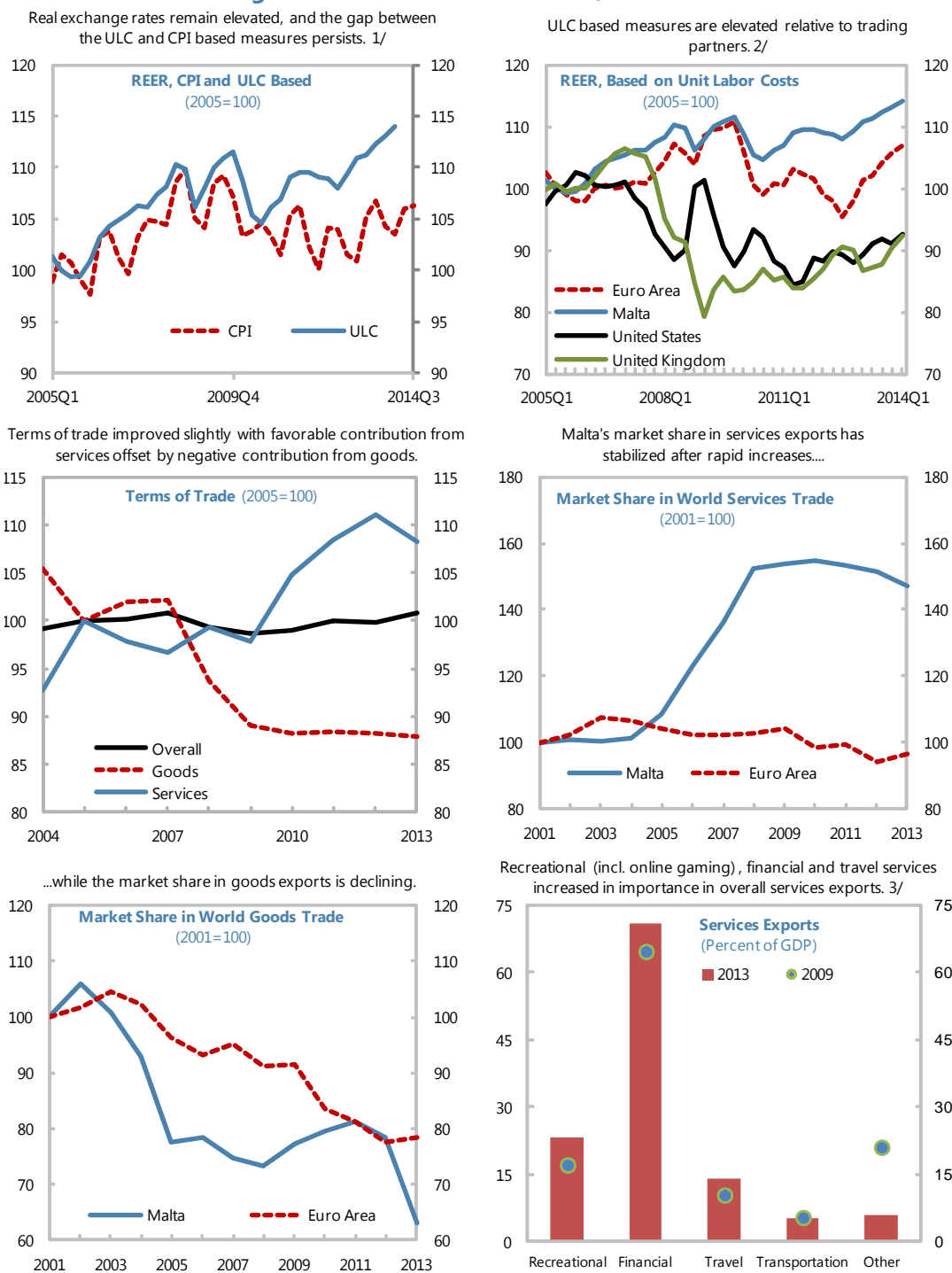
The contribution of loans to the EFSF and Greece was small, although relative to GDP it ranks high in the Euro area.



Sources: Eurostat, IMF *World Economic Outlook*; and IMF staff calculations.

1/ Data are ESA1995, since ESA2010 data are not yet available for Belgium, Cyprus, Spain and Slovakia.

Figure 5. Malta: External Sector, 2001–2014



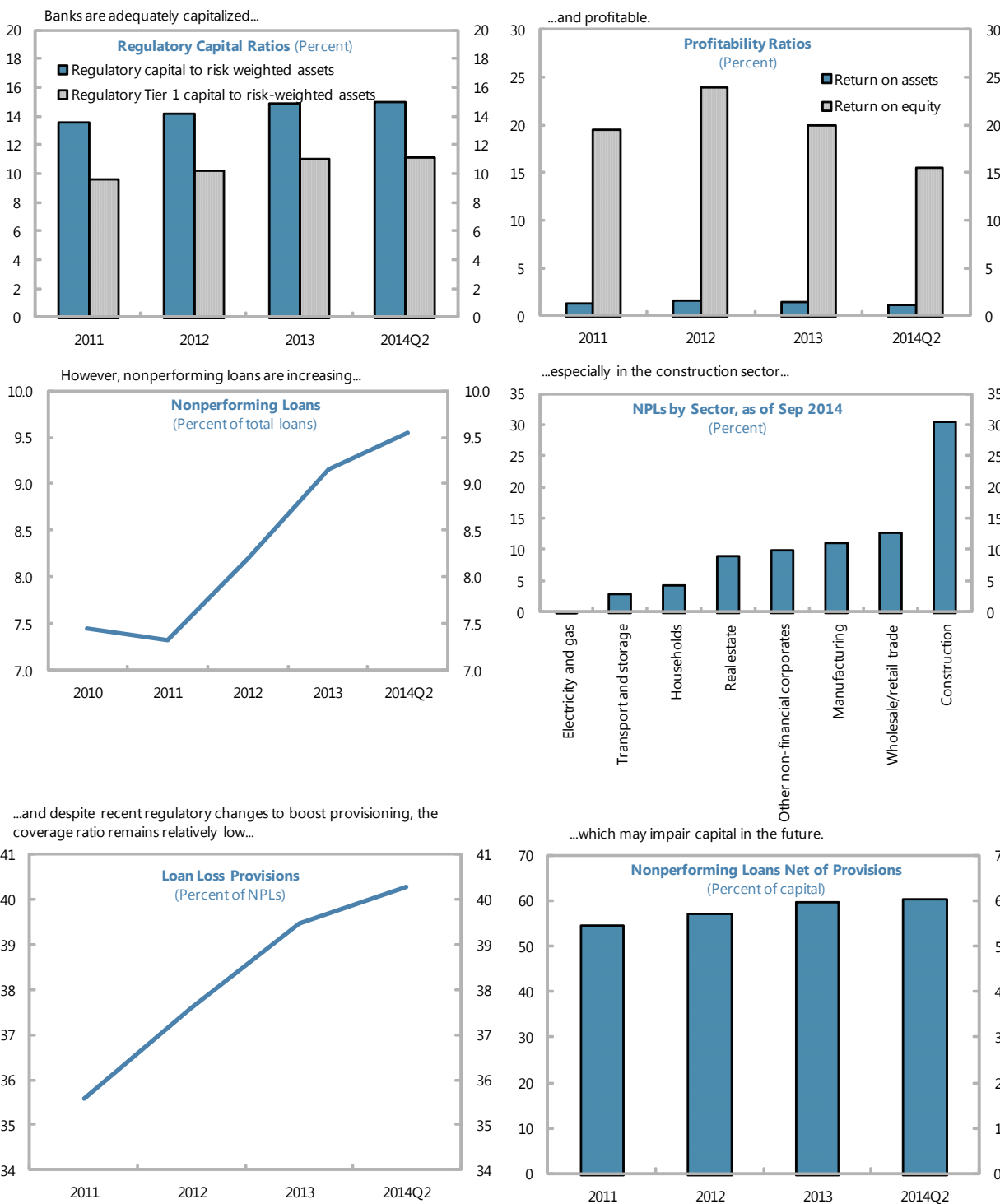
Sources: Central Bank of Malta; Eurostat; Malta NSO, UNCTAD, and IMF staff calculations.

1/ Real exchange rate measures disseminated by the Eurostat differ from those used in CGER calculations (based on INS data). Eurostat exchange rates assign greater weight to euro area trading partners making the impact of recent euro nominal depreciation appear more muted.

2/ All available real exchange measures use weights that are based on trade in goods only. For Malta, whose primary exports are in services they should be interpreted with caution.

3/ The decline in other services is driven by insurance and pension services and the use of intellectual property.

Figure 6. Malta: Financial Soundness Indicators



Sources: Central Bank of Malta; and Malta Financial Services Authority.

Table 1. Malta: Selected Economic Indicators, 2010–16
(Year on year percent change, unless otherwise indicated)

	2010	2011	2012	2013	2014 est.	Projections	
						2015	2016
	(Year on year percent change)						
Real GDP	3.5	2.2	2.5	2.5	3.1	3.1	2.7
Domestic demand	4.6	-2.2	-2.0	3.0	4.3	3.9	2.5
Consumption	0.2	2.6	1.9	1.3	3.6	3.2	2.2
Private consumption	-0.2	2.5	0.4	1.6	2.7	2.8	2.1
Public consumption	1.6	2.8	6.3	0.5	6.1	4.3	2.4
Fixed investment	26.4	-18.0	-0.5	2.3	7.6	6.8	4.0
Exports of goods and services	6.9	2.5	7.9	-1.2	0.0	3.1	3.2
Imports of goods and services	7.6	-0.4	5.2	-1.0	0.5	3.6	3.1
Contribution to growth	(Percent)						
Real GDP	3.5	2.2	2.5	2.5	3.1	3.1	2.7
Domestic demand	4.6	-2.3	-1.9	2.8	4.0	3.7	2.4
Consumption	0.2	2.0	1.5	1.0	2.7	2.5	1.7
Private consumption	-0.1	1.4	0.3	0.9	1.5	1.6	1.2
Public consumption	0.3	0.6	1.2	0.1	1.2	0.9	0.5
Fixed investment	4.6	-3.8	-0.1	0.4	1.3	1.2	0.7
Inventory accumulation 1/	-0.2	-0.4	-3.3	1.5	-0.1	0.0	0.0
Foreign balance	-1.1	4.4	4.3	-0.4	-0.7	-0.5	0.3
Exports of goods and services	10.2	3.8	12.1	-2.0	0.0	4.7	4.8
Imports of goods and services	-11.3	0.6	-7.8	1.6	-0.7	-5.2	-4.5
Potential GDP growth	2.0	2.1	2.3	2.3	2.8	3.2	2.8
Output gap (percent of potential GDP)	-0.6	-0.5	-0.3	0.0	0.3	0.2	0.1
HICP (period average)	2.0	2.5	3.2	1.0	0.8	1.1	1.4
GDP deflator	3.8	2.2	2.1	2.0	1.1	2.1	1.4
Unemployment rate EU stand.	6.9	6.4	6.3	6.4	5.8	6.1	6.3
Employment growth	2.0	2.5	2.4	2.1	4.8	3.2	1.6
Gross national savings (percent of GDP)	17.7	24.3	19.3	20.3	22.7	23.3	23.6
Gross capital formation (percent of GDP)	23.6	19.3	15.7	17.0	17.8	18.3	18.6
Balance of payments	(Percent of GDP)						
Current account balance	-5.9	5.0	3.6	3.2	4.9	4.9	5.0
Trade balance (Goods and services)	-2.5	7.6	6.8	6.6	5.9	5.9	6.0
Exports of goods and services	159.6	174.2	165.9	157.0	149.8	146.7	145.4
Imports of goods and services	-162.1	-166.6	-159.0	-150.3	-143.9	-140.8	-139.3
Goods balance	-19.0	-17.5	-15.4	-14.6	-14.0	-13.7	-13.5
Services balance	16.4	25.1	22.2	21.2	19.9	19.6	19.5
Primary income, net	-4.5	-3.9	-4.9	-5.4	-3.5	-3.5	-3.5
Secondary income, net	1.2	1.3	1.6	2.0	2.5	2.5	2.5
Financial account, net	10.4	5.8	12.6	-6.9	7.1	7.2	7.2
Memorandum item:							
Nominal GDP (millions of euros)	6599.5	6893.2	7212.8	7543.9	7865.6	8279.5	8624.1

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

1/ Includes statistical discrepancy.

Table 2. Malta: Fiscal Developments and Projections, 2010–16

(Percent of GDP, unless otherwise indicated)

	2010	2011	2012	2013	2014 est.	Projections	
						2015	2016
Revenue	37.7	38.3	38.8	39.7	40.5	42.1	41.4
Taxes	25.4	25.8	26.0	27.0	27.7	28.0	28.1
Indirect taxes	12.9	13.3	12.9	13.0	13.7	14.0	13.9
Direct taxes	12.2	12.3	13.0	13.8	13.9	13.9	14.0
Other taxes (capital taxes)	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social contributions	6.9	7.1	7.0	7.0	7.1	7.2	7.2
Grants and Capital revenue	1.4	1.4	1.8	1.8	1.9	2.7	1.8
Other revenue	4.0	4.0	4.0	4.0	3.8	4.3	4.3
Expenditure	41.0	40.9	42.5	42.4	42.7	44.0	43.1
Expense	38.8	38.2	39.2	39.6	39.6	40.6	40.1
Compensation of Employees	13.0	12.8	12.8	13.0	13.1	13.1	13.1
Use of goods and services	6.1	6.2	6.6	6.1	6.3	6.5	6.5
Interest	3.1	3.2	3.0	2.9	3.0	3.0	2.9
Subsidies	0.8	0.7	1.1	1.1	1.4	1.7	1.8
Social benefits	12.8	12.8	12.9	12.8	12.8	12.7	12.7
Other expense	3.1	2.5	2.8	3.6	2.9	3.6	3.1
Net acquisition of nonfinancial assets	2.2	2.7	3.3	2.8	3.1	3.5	3.0
Gross Operating Balance	-1.1	0.1	-0.3	0.1	0.9	1.6	1.3
Net lending/borrowing (overall balance)	-3.3	-2.6	-3.6	-2.7	-2.2	-1.9	-1.7
Net financial transactions	-3.3	-2.6	-3.6	-2.7	...	...	...
Net acquisition of financial assets	2.0	3.6	1.6	1.7	...	...	...
Currency and deposits	0.7	0.9	-3.2	-0.3	...	...	...
Shares other than shares	0.0	0.0	0.0	0.0	...	...	...
Loans	0.5	1.2	1.7	0.5	...	...	...
Shares and other equity	0.0	0.2	0.6	0.3	...	...	...
Other financial assets	0.8	1.2	2.5	1.2	...	...	...
Net incurrence of liabilities	5.1	6.2	5.1	4.4	...	...	...
Currency and deposits	0.1	0.1	0.1	0.1	...	...	...
Securities other than shares	4.4	4.6	2.4	4.4	...	...	...
Loans	-0.2	0.2	1.2	0.4	...	...	...
Other liabilities	0.8	1.4	1.5	-0.4	...	...	...
<i>Statistical discrepancy</i>	-0.2	0.0	-0.2	0.1	...	...	...
Memorandum items:							
Overall balance excl. one-offs	-4.4	-3.3	-4.5	-3.0	-2.4	-2.1	-1.8
Cyclically adjusted overall balance	-3.0	-2.4	-3.5	-2.7	-2.4	-2.0	-1.8
Cyclically adjusted overall balance, excl. one-offs	-4.1	-3.1	-4.4	-3.0	-2.6	-2.2	-1.9
Primary balance	-0.2	0.5	-0.7	0.2	0.7	1.0	1.2
One-offs	1.1	0.7	0.9	0.3	0.2	0.2	0.1
Public debt	67.6	69.8	67.5	69.5	70.3	69.8	68.4
Government guaranteed debt	11.8	12.5	16.4	15.8	15.5	13.3	12.7
Nominal GDP (millions of euros)	6,600	6,893	7,213	7,544	7,866	8,280	8,624

Sources: Maltese authorities and IMF staff projections.

Table 3. Malta: Balance of Payments, 2010–16

	2010	2011	2012	2013	2014 est.	Projections	
						2015	2016
(Millions of euros)							
Current account balance	-391	345	261	241	385	409	433
Trade balance (Goods and services)	-168	525	494	500	464	492	520
Goods balance	-1,251	-1,208	-1,108	-1,098	-1,104	-1,134	-1,166
Exports	2,527	2,845	3,195	2,854	2,839	2,928	3,021
Imports	-3,778	-4,053	-4,303	-3,952	-3,944	-4,061	-4,187
Services balance	1,084	1,733	1,602	1,598	1,568	1,626	1,686
Exports	8,005	9,165	8,770	8,987	8,942	9,219	9,514
Imports	-6,921	-7,432	-7,168	-7,388	-7,373	-7,593	-7,828
Current income, net	-300	-267	-351	-406	-275	-290	-302
Current transfers, net	77	87	118	147	197	207	216
Private	-13	-23	-23	-30	11	12	13
Public	90	110	141	178	185	195	203
Capital account, net	129	82	135	130	175	184	192
Financial account, net	687	398	910	-521	560	594	625
Direct investment	-3,104	-11,554	-8,815	-7,130	-5,443	-5,729	-5,968
Portfolio investment	4,828	11,484	9,319	8,903	12,648	13,314	13,868
Other investment	-798	767	723	-2,155	-7,250	-6,924	-7,205
Reserves (- inflow; + outflow)	24	-53	121	-39	181	0	0
Errors and omissions	949	-28	513	-893	0	0	0
(Percent of GDP)							
Current account balance	-5.9	5.0	3.6	3.2	4.9	4.9	5.0
Trade balance (Goods and services)	-2.5	7.6	6.8	6.6	5.9	5.9	6.0
Goods balance	-19.0	-17.5	-15.4	-14.6	-14.0	-13.7	-13.5
Exports	38.3	41.3	44.3	37.8	36.1	35.4	35.0
Imports	-57.2	-58.8	-59.7	-52.4	-50.1	-49.1	-48.6
Services balance	16.4	25.1	22.2	21.2	19.9	19.6	19.5
Exports	121.3	133.0	121.6	119.1	113.7	111.3	110.3
Imports	-104.9	-107.8	-99.4	-97.9	-93.7	-91.7	-90.8
Primary income, net	-4.5	-3.9	-4.9	-5.4	-3.5	-3.5	-3.5
Secondary income, net	1.2	1.3	1.6	2.0	2.5	2.5	2.5
Private	-0.2	-0.3	-0.3	-0.4	0.1	0.1	0.1
Public	1.4	1.6	2.0	2.4	2.4	2.4	2.4
Capital account, net	2.0	1.2	1.9	1.7	2.2	2.2	2.2
Financial account, net	10.4	5.8	12.6	-6.9	7.1	7.2	7.2
Direct investment	-47.0	-167.6	-122.2	-94.5	-69.2	-69.2	-69.2
Portfolio investment	73.2	166.6	129.2	118.0	160.8	160.8	160.8
Assets	70.9	168.4	123.7	109.1	160.8	160.8	160.8
Liabilities	-2.2	1.8	-5.5	-8.9	0.0	0.0	0.0
Other investment	-12.1	11.1	10.0	-28.6	-92.2	-83.6	-83.6
Assets	-15.7	70.4	29.0	19.8	11.1	11.1	11.1
Liabilities	-3.6	59.2	19.0	48.3	103.3	94.7	94.6
Reserves (- inflow; + outflow)	0.4	-0.8	1.7	-0.5	2.3	0.0	0.0
Errors and omissions	14.4	-0.4	7.1	-11.8	0.0	0.0	0.0
Memorandum items:							
Official reserves, end of period							
(Millions of euros)	404.9	395.9	533.8	435.4	...	...	...
(In months of imports of goods and services)	0.5	0.4	0.6	0.5	...	...	...
Gross external debt (Percent of GDP)	500.1	487.9	487.9	463.4	469.3	470.8	477.0
Net external debt (Percent of GDP)	-157.6	-148.6	-164.4	-159.4	-153.2	-145.8	-140.1

Sources: National Statistics Office of Malta; and IMF staff projections.

Table 4. Malta: General Government Financial Balance Sheet

(Millions of euros)

	2008			2009			2010			2011			2012			2013			
	Opening balance	Trans- actions	Closing Opening balance	Trans- actions	OE	Closing Opening balance	Trans- actions	OE	Closing Opening balance	Trans- actions	OE	Closing Opening balance	Trans- actions	OE	Closing Opening balance	Trans- actions	OE	Closing Opening balance	
Net worth and its changes	....	....	....	....	....	....	....	....	....	....	....	....	....	....	....	....	....	....
Nonfinancial assets	....	....	....	....	....	....	....	....	....	....	....	....	....	....	....	....	....	....
Net Financial Worth:	-2,352.7	-276.4	-273.4	-2,902.4	-221.3	105.2	-3,018.5	-224.6	55.3	-3,187.9	-178.2	-34.0	-3,400.1	-215.3	121.9	-3,493.5	-205.9	-32.3	-3,731.6
Financial Assets	1,661.2	39.2	-89.5	1,610.9	140.9	30.1	1,781.9	132.2	33.8	1,947.9	259.0	-37.2	2,169.7	112.1	215.2	2,497.0	116.7	34.1	2,647.8
Currency and deposits	487.9	-5.9	-5.5	476.6	135.8	-34.8	577.6	52.1	-40.5	589.2	70.3	-3.5	656.0	-231.5	3.0	427.5	-9.1	-3.3	415.1
Debt securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	27.5	5.3	0.0	32.8	-3.3	0.0	29.5	33.5	0.0	63.1	84.8	0.0	147.9	120.2	0.0	268.1	45.8	0.0	313.9
Equity and inv. fund shares	836.1	-5.1	-91.2	739.8	-0.9	58.9	797.8	-0.8	58.5	855.5	16.1	-27.8	843.8	44.0	212.2	1,100.1	23.2	37.3	1,160.6
Other financial assets	309.7	44.9	7.2	361.7	9.3	6.0	377.1	47.2	15.8	440.1	87.9	-5.9	522.0	179.4	0.0	701.4	56.7	0.0	758.2
Liabilities	4,013.9	315.6	183.9	4,513.4	362.2	-75.1	4,800.4	356.8	-21.5	5,135.8	437.2	-3.2	5,569.8	327.4	93.3	5,990.5	322.6	66.3	6,379.5
Currency and deposits	8.3	22.9	0.0	31.2	6.0	0.0	37.2	3.8	0.0	41.0	4.9	0.0	45.8	4.6	0.0	50.5	4.8	0.0	55.3
Debt securities	3,308.6	214.3	139.9	3,662.9	371.7	-40.3	3,994.3	291.4	21.8	4,307.5	316.9	0.6	4,625.0	174.3	90.4	4,889.6	334.4	70.1	5,294.1
Loans	272.8	-9.9	21.2	284.1	-46.7	0.0	237.4	-0.3	0.3	237.4	22.7	0.0	260.2	85.8	-0.1	345.9	30.1	0.0	375.9
Other liabilities	424.1	88.4	22.8	535.3	31.2	-34.8	531.6	61.8	-43.6	549.9	92.7	-3.9	638.8	62.8	3.0	704.5	-46.7	-3.7	654.1
Memorandum items:																			
Net financial worth (in % of GDP)	-40.9			-47.4			-49.2			-48.3			-49.3			-48.4			-45.1
Financial assets (in % of GDP)	28.9			26.3			29.0			29.5			31.5			34.6			32.0
Liabilities (in % of GDP)	69.7			73.6			78.2			77.8			80.8			83.1			77.1
GDP nominal prices	5,757.5			6,128.7			6,138.6			6,599.5			6,893.2			7,212.8			8,279.5

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

Table 5. Malta: Financial Soundness Indicators, 2010–13
(Percent, unless otherwise indicated)

	Core domestic banks				Non-core domestic banks				International banks				Total banks			
	2010	2011	2012	2013	2010	2011	2012	2013	2010	2011	2012	2013	2010	2011	2012	2013
Core FSIs																
Regulatory capital to risk weighted assets	12.9	13.5	14.1	14.9	29.8	29.1	28.9	24.2	104.7	115.5	115.6	118.4	54.6	56.8	55.8	46.1
Regulatory Tier 1 Capital to risk weighted assets	9.2	9.6	10.2	11.1	27.9	27.3	25.7	22.9	103.1	114.4	115.1	118.4	52.1	54.2	53.3	43.8
Nonperforming loans net of provisions to capital	55.9	54.4	57.0	59.4	9.8	8.9	7.6	7.7	0.4	0.1	0.3	0.8	6.9	6.8	10.3	11.6
Nonperforming loans to total gross loans	7.4	7.3	8.2	9.2	3.6	4.5	4.1	4.7	0.6	0.5	0.5	0.5	3.0	3.3	3.8	5.6
Return on assets	1.4	1.3	1.6	1.4	1.3	0.5	1.4	1.0	1.1	1.2	1.3	0.8	1.2	1.2	1.4	1.0
Return on equity	22.4	19.5	23.9	19.9	4.3	1.4	6.5	5.8	3.1	3.9	3.6	2.7	5.0	5.1	5.9	5.0
Interest margin to gross income	70.7	72.5	66.8	65.3	63.4	70.0	28.9	52.9	62.0	89.0	124.3	176.8	66.0	79.1	83.1	100.4
Non-interest expense to gross income	49.7	54.1	45.5	48.0	35.5	45.5	28.4	41.1	8.2	8.9	7.1	10.3	30.0	34.1	27.4	34.4
Non-interest income to gross income (iv)	29.3	27.5	33.2	34.7	36.6	30.0	71.1	47.1	38.0	11.0	-24.3	-76.8	34.0	20.9	16.9	-0.4
Liquid assets to total assets	24.9	24.1	28.8	29.4	10.9	14.7	14.4	16.5	5.8	7.4	9.9	28.2	15.1	16.1	19.6	26.8
Liquid assets to short-term liabilities	42.9	44.1	49.1	48.9	82.9	90.4	82.4	94.9	86.2	111.0	146.3	401.4	47.8	49.6	55.6	59.5
Other FSIs																
Coverage ratio	34.3	35.6	37.6	39.5	43.8	54.3	59.7	42.4	76.0	107.7	95.1	52.2	40.2	43.3	43.6	40.8
Domestic Investment Securities to Total Assets	12.3	12.8	12.0	12.1	2.2	2.2	2.9	4.3	0.0	0.0	0.0	0.0	3.5	3.8	3.6	4.1
Foreign Investment Securities to Total Assets	11.9	11.5	10.7	11.9	35.1	36.1	38.3	39.2	28.8	31.5	36.5	38.3	24.8	26.4	29.5	30.4
Unsecured Loans to Total Lending	20.0	19.8	19.5	21.8	54.7	39.5	50.7	61.5	30.8	54.2	57.8	61.9	29.4	40.6	42.4	41.9
Assets to Total Capital and Reserves (Ratio)	15.8	15.5	14.5	13.8	4.1	4.2	4.9	5.0	1.6	1.6	1.5	1.3	3.1	3.1	3.1	3.7
Large exposure to capital	144.9	138.5	123.1	136.1	72.9	131.2	111.7	108.8	6.4	10.2	10.9	17.3	25.4	32.0	31.4	46.5
Gross asset position in financial derivatives to capital	2.2	4.9	3.2	2.1	0.7	1.5	0.6	1.3	0.5	0.4	0.5	0.0	0.7	1.0	0.9	0.5
Gross liability position in financial derivatives to capital	7.9	11.6	10.8	5.5	1.1	2.5	2.7	0.8	0.1	0.1	0.1	0.1	1.0	1.5	1.5	1.1
Personnel expenses to non-interest expenses	55.6	52.4	53.9	51.2	34.5	36.2	39.6	43.9	19.4	21.2	26.3	33.8	48.1	46.5	48.6	48.1
Customer deposits to customer loans	141.7	137.5	142.7	150.5	38.2	55.7	68.8	88.4	81.9	71.9	76.1	139.6	102.6	99.8	106.6	139.8
Net open position in equities to capital	16.1	17.7	17.4	17.4	80.4	79.7	75.9	80.7	0.9	0.9	0.3	0.0	7.5	7.7	7.6	10.6

Source: CBM/MFSA

Annex I. Implementation of IMF Recommendations

The Maltese authorities have taken on board the majority of policy recommendations made by the Fund in previous Article IV consultations (Annex Table 1).

Table 1. Implementation of IMF Recommendations

	2013 Art. IV Advice	Actions since 2013 Art. IV
Fiscal issues	Adopt additional consolidation measures to contain the widening of the budget deficit, particularly containing the fast growth in current expenditures	Fiscal consolidation was pursued in 2013 and 2014, assisted by the strong economic growth. Current expenditures continue to grow at a rapid rate
	Restore the profitability and viability of large public corporations in order to alleviate fiscal pressures	Restructuring of the large public corporations is under way
	Advance efforts to strengthen fiscal governance	Fiscal Responsibility Act was enacted and the Fiscal Council was appointed
Financial sector issues	Closely monitor liquidity developments in banks and take action if spillovers from abroad (eg, from Cyprus) become imminent	Done; there have been very limited spillovers from the developments in Cyprus
	Tighten loan loss provisioning rules	New provisioning requirements were adopted
	Strengthen the bank resolution framework in line with forthcoming reforms at the EU level	Work is under way in line with developments at the EU level
	Continue the move to Basel III capital framework	Ongoing in line with the EU-wide timetable
	Work closely with the ECB to ensure a smooth transition of supervision of the largest banks to the SSM	The transition of supervision has been smooth
	Conduct an FSAP update	An FSAP update may be requested shortly
	Maintain an effective anti-money laundering framework	Efforts are ongoing
	Reevaluate the merits of the intended establishment of a developmental bank	A working group was formed to assess the benefits of a developmental bank
Structural reforms	Advance pension and healthcare reforms	A private third pillar pension scheme was introduced and steps to improve medical procurement have been taken
	Strengthen female labor participation	Incentives to work were improved, eg by introducing free childcare for working mothers
	Enhance education attainment	Several measures were initiated
	Improve the business climate	A credit registry is to be established at the CBM; broad judicial reform has been launched

Annex II. Debt Sustainability Analysis (DSA)

1. The public debt to GDP ratio has been rising since 2008, but is projected to decline after 2014. The general government debt-to-GDP ratio is projected to increase from 62.7 in 2008 to 70.3 in 2014. Under the baseline scenario the debt-to-GDP ratio is expected to peak in 2014, before declining to 62.7 percent in 2020.

2. The stock of contingent liabilities is expected to stabilize in 2015. Government guaranteed debt is projected to increase from 7.5 percent of GDP in 2008 to 16 percent of GDP in 2014. This increase is largely attributable to Enemalta (the national utility company), whose financial performance has been poor. With Enemalta's ongoing restructuring plan and its partial privatization, its guaranteed debt and the fiscal pressures are expected to decline in 2015.

3. To assess the sustainability of government debt, a number of adverse scenarios are considered. Although under the baseline scenario the debt-to-GDP ratio converges to a level below 70 percent of GDP, the ratio is sensitive to shocks, if they were to materialize.

- Under a growth shock that lowers output by 1.9 percent (equivalent to 1 standard deviation of growth over the past 10 years) in 2016–2017 and inflation declining by 0.9 percent in 2016, debt would peak at 73.4 percent of GDP in 2017, 6.1 percentage points higher than in the baseline.
- A sustained interest rate shock of 200 bps would slow down the rate of debt decline so that by 2020 the debt-to-GDP ratio is 1 percentage points higher with respect to the baseline.
- A primary fiscal balance shock of 0.4 percentage points over 2016–17 (1/2 standard deviation of the historical 10-year average) yields a debt-to-GDP ratio 1 percentage point higher in 2020 relative to the baseline.
- A combined macro-fiscal shock including the three shocks above would lead to debt peaking at almost 73.5 percent of GDP in 2017, 3.2 percentage points higher relative to the baseline, and declining slowly to about 70.6 percent of GDP in 2020.
- Under a financial contingent liability shock there is a one-time increase in non-interest expenditures equivalent to 10 percent of the banking sector assets—which could also be contributed partially by contingent liabilities stemming from SOEs—that leads to a real GDP growth shock as the one above (with growth declining for 1 standard deviation over 2016–17), revenue-to-GDP ratio remains the same as in the baseline while the deterioration of the

primary balance leads to higher interest rates and the decline in growth lowers the inflation rate. This leads to debt jumping to 82.3 percent of GDP in 2017 and declining only to 78.5 percent of GDP in 2020.

- A low inflation shock lowers inflation by 0.7 percentage point in each year from 2016 to 2020 with respect to the baseline (equivalent to a decline in 1 standard deviation of inflation over the past 10 years), output growth is lower by 0.5 percentage points with respect to the baseline in 2016 to 2020, revenue decreases by 2 percent each year, expenditures remain the same, and there is a 100 basis points increase in risk premium with feedback to growth each year. As a result, the debt-to-GDP ratio follows an upward trend and reaches about 78.4 percent of GDP in 2020.

4. Risks stemming from Malta's high external financing requirements are mitigated by large holdings of foreign assets. In fact, 85 percent of outstanding short-term debt is for other monetary and financial institutions (OMFI) and is fully backed by foreign assets. Excluding OMFI's and intra company lending, outstanding short-term debt at the end of 2013 was 31.8 percent of GDP and total net debt is about minus 120 percent of GDP.

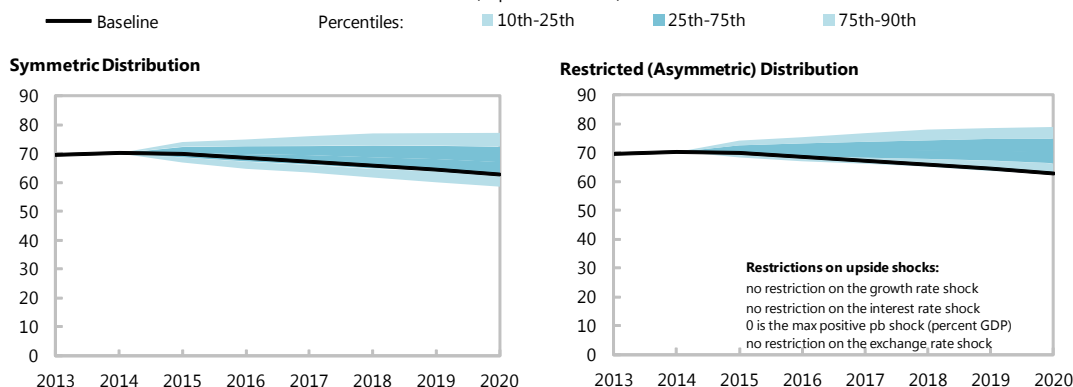
Figure 1. Malta Public DSA Risk Assessment

Heat Map

Debt level ^{1/}	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs ^{2/}	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile ^{3/}	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

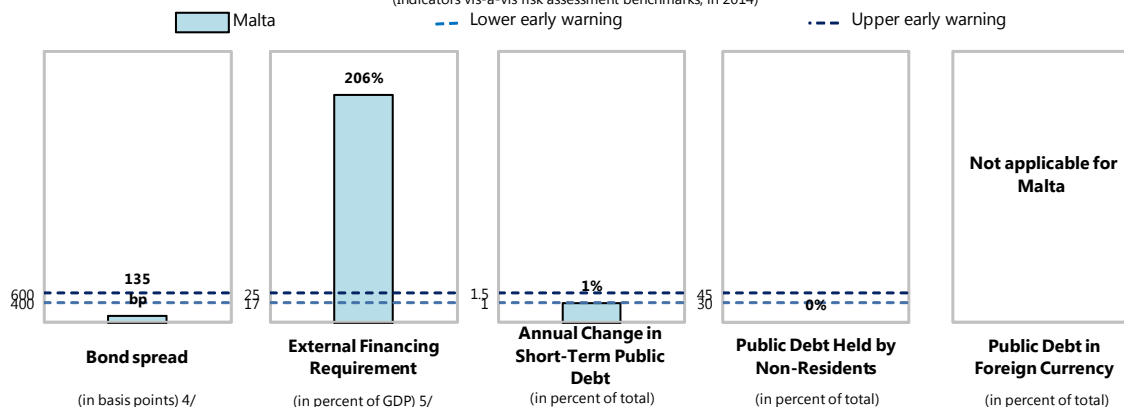
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2014)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85 percent is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20 percent is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

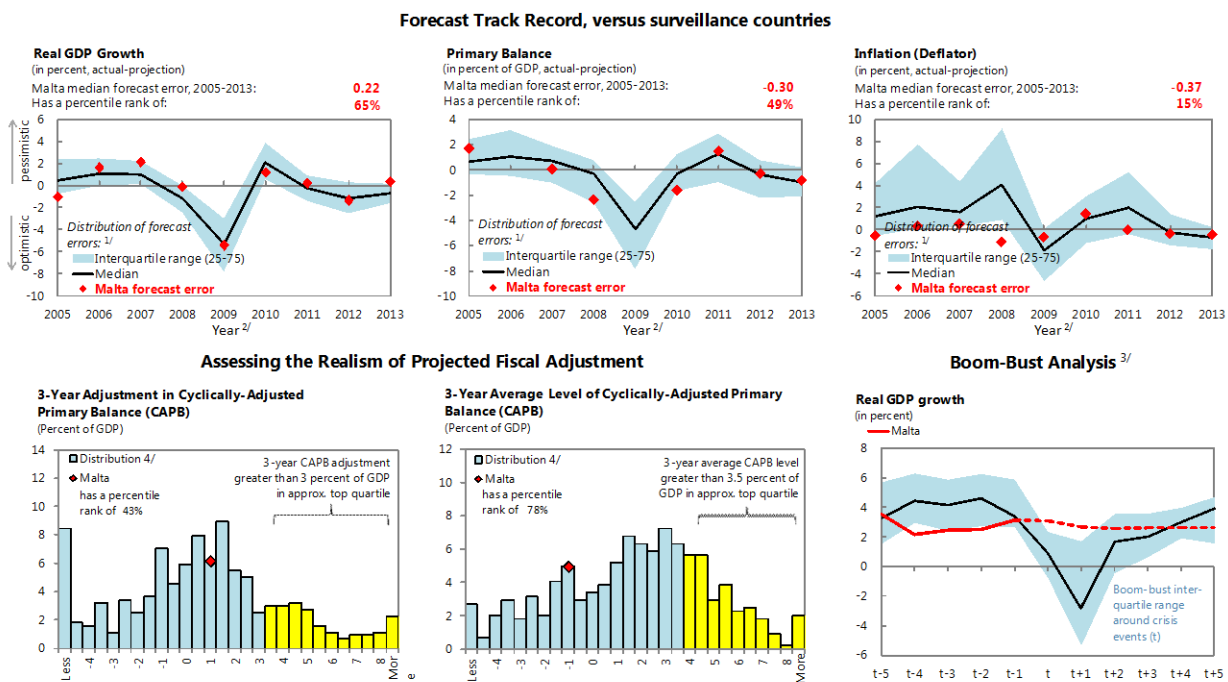
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white. Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over German bonds, an average over the last 3 months, October 11, 2014 through January 9, 2015.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure 2. Malta Public DSA – Realism of Baseline Assumptions



Source: IMF staff.

1/ Plotted distribution includes surveillance countries; percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Malta has had a positive output gap for 3 consecutive years, 2012–14 and a cumulative increase in private sector credit of 478 percent of GDP, 2011–14. For Malta, t corresponds to 2015; for the distribution, t corresponds to the first year of the crisis.

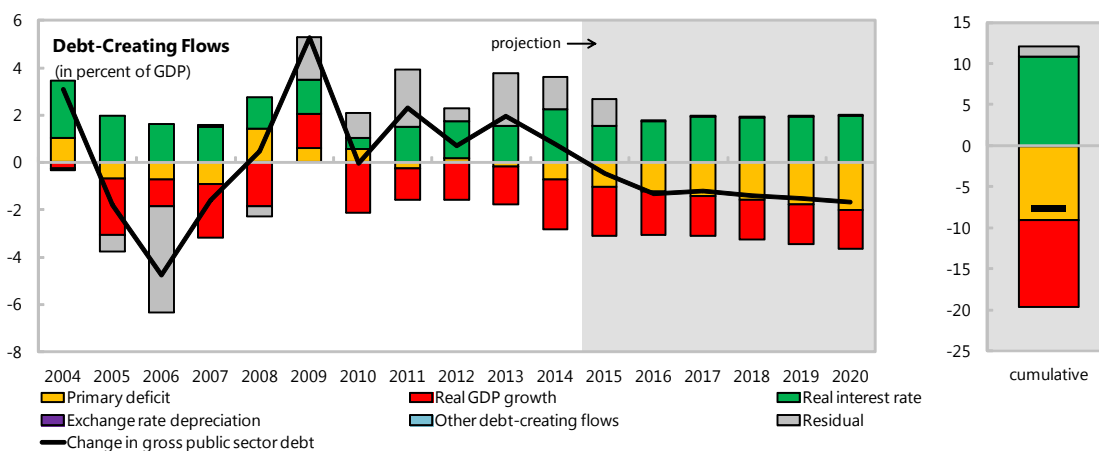
4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 3. Malta Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario
(in percent of GDP unless otherwise indicated)

	Actual			Projections						As of January 09, 2015	
	2004-2012 ^{2/}	2013	2014	2015	2016	2017	2018	2019	2020		
Nominal gross public debt	63.8	69.5	70.3	69.8	68.5	67.3	65.9	64.4	62.7	Sovereign Spreads Spread 3/	73
Public gross financing needs	5.9	6.1	6.3	8.9	8.1	8.5	7.9	5.9	6.0	Ratings	Foreign A3 A3
Real GDP growth (in percent)	2.1	2.5	3.1	3.1	2.7	2.6	2.6	2.6	2.6	Moody's	A3 A3
Inflation (GDP deflator, in percent)	2.6	2.0	1.1	2.1	1.4	1.5	1.6	1.6	1.6	S&P's	BBB+ BBB+
Nominal GDP growth (in percent)	4.8	4.6	4.3	5.3	4.2	4.2	4.3	4.2	4.2	Fitch	A A
Effective interest rate (in percent) ^{4/}	5.2	4.5	4.5	4.4	4.1	4.5	4.6	4.7	4.8		

Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance ^{9/}
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020		
Change in gross public sector debt	0.4	2.0	0.8	-0.5	-1.3	-1.2	-1.4	-1.5	-1.7	-7.6	
Identified debt-creating flows	0.4	-0.3	-0.6	-1.6	-1.3	-1.2	-1.4	-1.5	-1.7	-8.7	
Primary deficit	0.1	-0.2	-0.7	-1.0	-1.2	-1.4	-1.6	-1.8	-2.0	-9.1	
Primary (noninterest) revenue and grants	37.9	39.1	40.5	42.1	41.4	41.5	41.5	41.6	41.7	249.8	
Primary (noninterest) expenditure	38.1	38.9	39.8	41.1	40.2	40.0	39.9	39.8	39.7	240.7	
Automatic debt dynamics ^{5/}	0.3	-0.1	0.1	-0.6	-0.1	0.2	0.2	0.3	0.3	0.3	
Interest rate/growth differential ^{6/}	0.3	-0.1	0.1	-0.6	-0.1	0.2	0.2	0.3	0.3	0.3	
Of which: real interest rate	1.5	1.5	2.2	1.5	1.7	1.9	1.9	1.9	1.9	10.9	
Of which: real GDP growth	-1.3	-1.6	-2.1	-2.1	-1.8	-1.7	-1.7	-1.7	-1.6	-10.6	
Exchange rate depreciation ^{7/}	0.0	0.0	0.0	...	...	...	...	...	...	...
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
0 (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euroan)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes ^{8/}	0.0	2.2	1.4	1.2	0.0	0.0	0.0	0.0	0.0	1.2	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)] / (1+g+\pi+g\pi)$ times previous period debt ratio, with r = interest rate; π = 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).

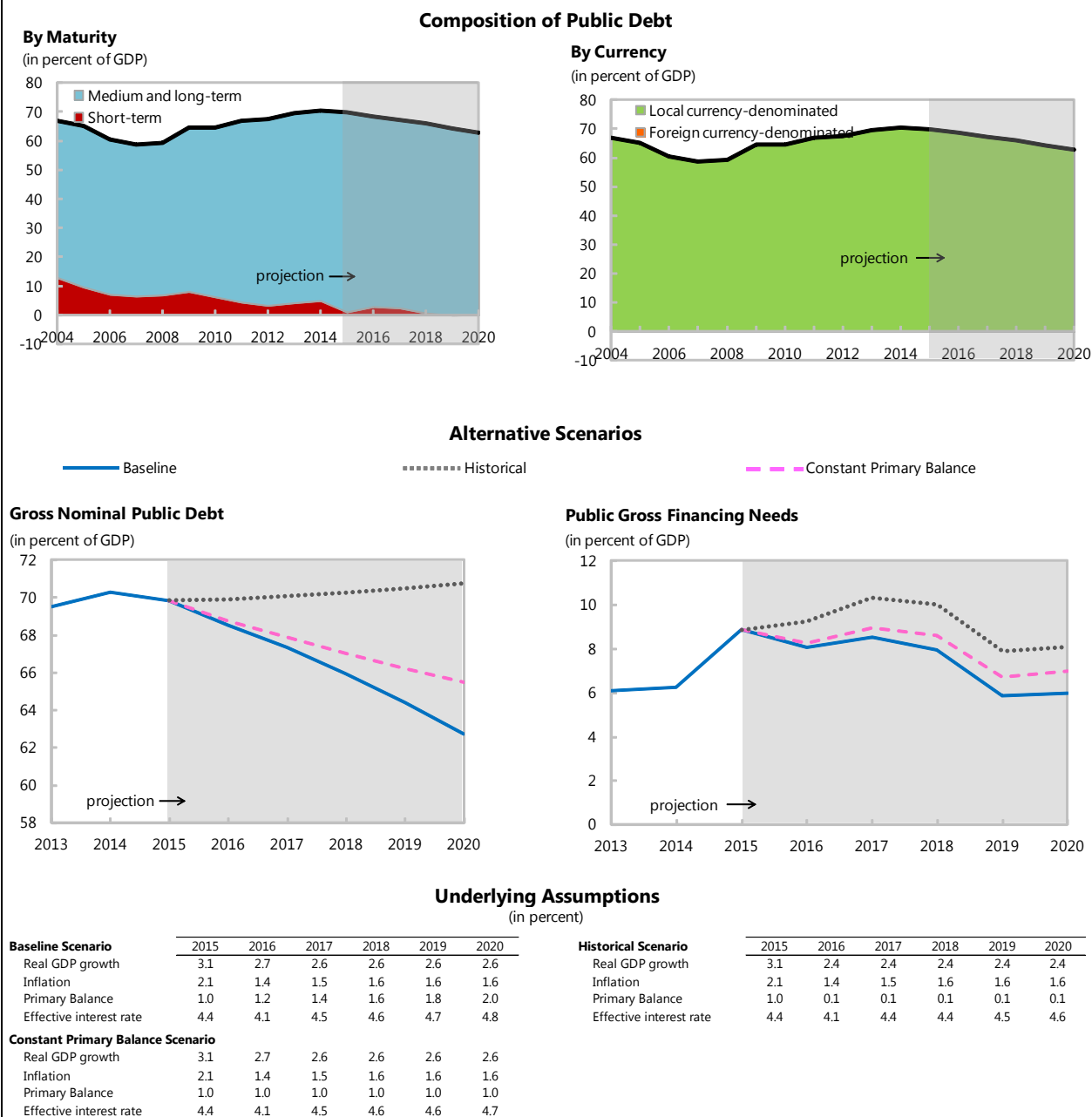
6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$; the real growth contribution as $-g$.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

8/ Includes asset changes, interest revenues (if any) and debt reduction related to Enemalta's restructuring. For projections, includes exchange rate changes during the projection period.

9/ 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.

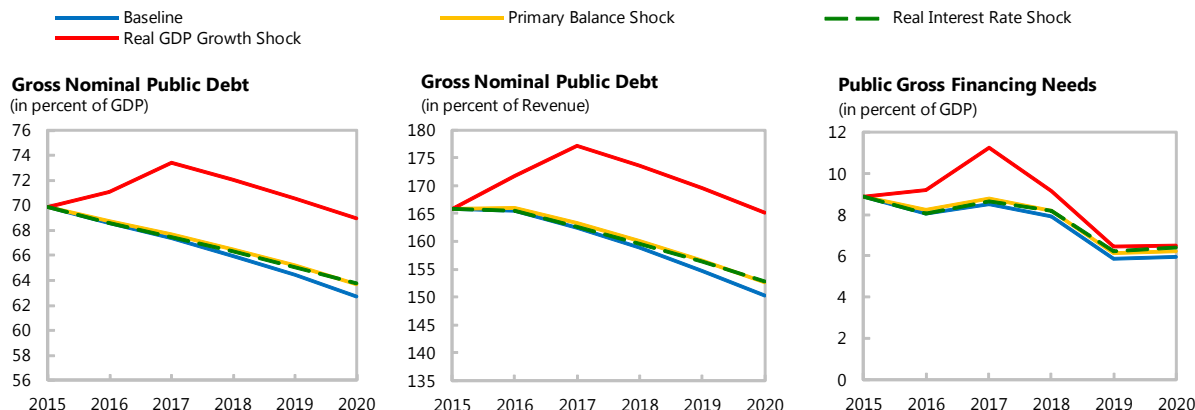
Figure 4. Malta Public DSA – Composition of Public Debt and Alternative Scenarios



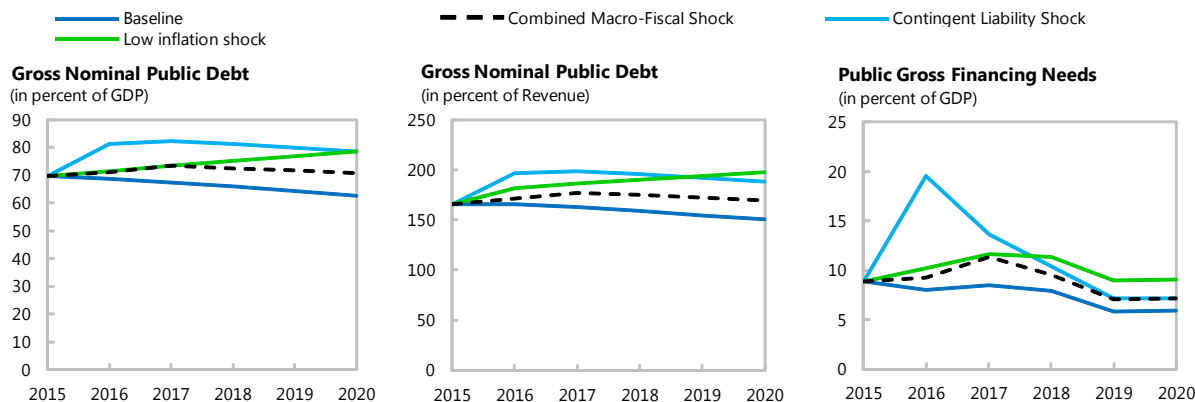
Source: IMF staff.

Figure 5. Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

	2015	2016	2017	2018	2019	2020		2015	2016	2017	2018	2019	2020
Primary Balance Shock							Real GDP Growth Shock						
Real GDP growth	3.1	2.7	2.6	2.6	2.6	2.6	Real GDP growth	3.1	0.9	0.7	2.6	2.6	2.6
Inflation	2.1	1.4	1.5	1.6	1.6	1.6	Inflation	2.1	0.9	1.1	1.6	1.6	1.6
Primary balance	1.0	1.0	1.2	1.4	1.6	1.8	Primary balance	1.0	0.3	-0.5	1.6	1.8	2.0
Effective interest rate	4.4	4.1	4.5	4.6	4.7	4.8	Effective interest rate	4.4	4.1	4.5	4.6	4.7	4.8
Real Interest Rate Shock							Low inflation shock						
Real GDP growth	3.1	2.7	2.6	2.6	2.6	2.6	Real GDP growth	3.1	2.0	1.9	1.9	1.9	1.9
Inflation	2.1	1.4	1.5	1.6	1.6	1.6	Inflation	2.1	0.7	0.8	0.9	0.9	0.9
Primary balance	1.0	1.2	1.4	1.6	1.8	2.0	Primary balance	1.0	-0.8	-0.6	-0.4	-0.2	0.0
Effective interest rate	4.4	4.1	4.7	4.9	5.1	5.4	Effective interest rate	4.4	4.1	4.5	4.7	4.9	5.0
Combined Shock							Contingent Liability Shock						
Real GDP growth	3.1	0.9	0.7	2.6	2.6	2.6	Real GDP growth	3.1	0.9	0.7	2.6	2.6	2.6
Inflation	2.1	0.9	1.1	1.6	1.6	1.6	Inflation	2.1	0.9	1.1	1.6	1.6	1.6
Primary balance	1.0	0.3	-0.5	1.4	1.6	1.8	Primary balance	1.0	-9.8	1.4	1.6	1.8	2.0
Effective interest rate	4.4	4.1	4.7	4.9	5.2	5.4	Effective interest rate	4.4	4.3	4.7	4.8	5.0	5.1

Source: IMF staff.

Appendix I. Developments in Malta's Competitiveness in Goods Sector¹

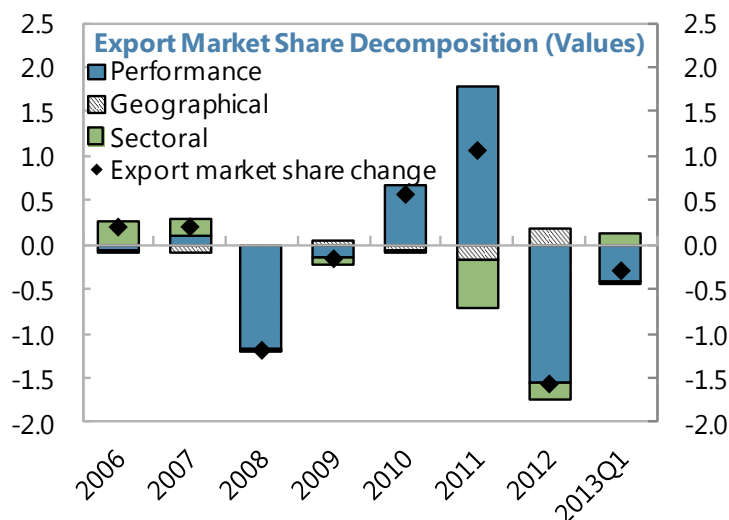
1. Malta has made impressive strides in improving its trade balance since its accession to the European Union in 2004. The trade balance reverted from a deficit of 6 percent of GDP in 2006 to a surplus of 6.6 percent of GDP in 2013. Given the high degree of openness of Malta's economy, maintaining its competitiveness is key in sustaining the current growth rates. This appendix analyzes the recent progress in Malta's external competitiveness focusing on the goods sector (given data availability).

2. To better assess Malta's competitiveness in the goods sector, Malta's export market shares are decomposed into structural and performance effects. This appendix looks beyond the growth in exports and real exchange rate developments, which could reflect other factors such as an increase in trade partner's demand and hidden developments in various subcomponents, providing only a partial picture of competitiveness gains. To better measure improvements in Malta's performance, this section uses econometric shift-share decomposition, with data covering 2005 to 2013: Q1 at the 6-digit Harmonized System (HS) classification (Cheptea and others, 2014; and Gaulier and others, 2013). This decomposition isolates the effects of a change in demand and a change in export composition from other determinants of export performance that account for competitiveness.

3. This decomposition identifies the determinants of changes in market shares. In particular, changes in market shares are decomposed into three components: a geographical composition effect (a change in market share due to growth in imports of specific markets), a sectoral composition effect (a change in market share due to growth in exports of individual products), and a pure performance effect (indicating the degree to which the exporting country has been able to gain or lose market share after controlling for composition effects). The first two effects are structural and the latter is usually taken as a proxy for competitiveness. The pure performance effect may also include other determinants not explained by the structural effects, since it implies that a country is more competitive than another one if its exports and market shares increase above those of countries that have the same composition of exports.

4. The gains and losses in Malta's market shares were mainly driven by performance effects. Overall there is a large variation in terms of the evolution of market shares and their determinants. In particular:

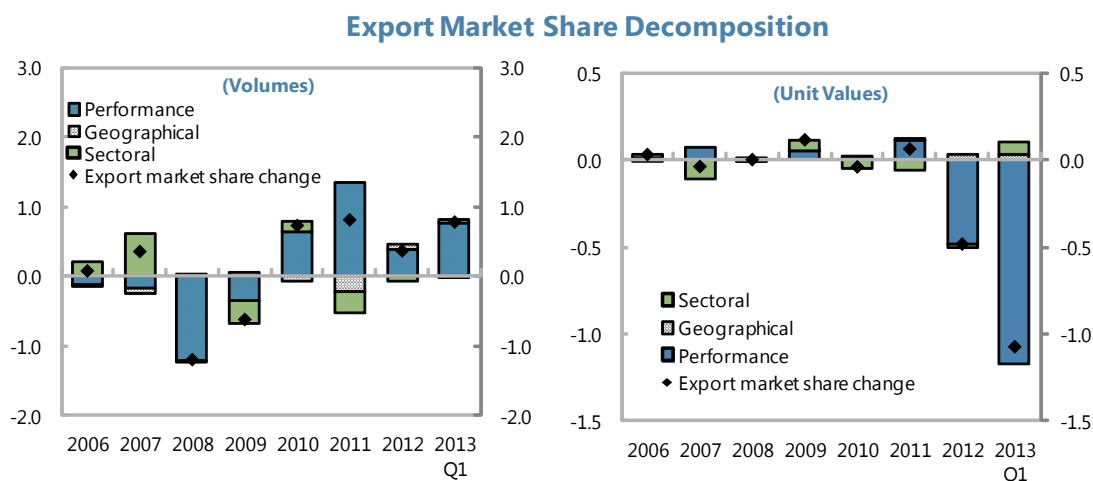
¹ Prepared by Luciana Juvenal.



Source: Bank of France, Export Competitiveness Database, and IMF staff calculations

- Prior to the crisis, Malta's market share expanded slightly (2006–2007).** This increase is mainly explained by a sectoral composition effect, suggesting that Malta specialized in products and sectors that on average have had a relatively higher growth. During this period, the geographical composition and export performance effects played broadly a neutral role.
- The global financial crisis affected export growth negatively.** The dramatic drop in market shares in 2008 is linked to the collapse in global trade during the global financial crisis and not driven by developments in Malta itself. In fact, world trade suffered an unprecedented collapse in the last quarter of 2008 (see Levchenko and others 2011). The performance effect has been the main driver.
- Market shares in Malta recovered in 2010 and 2011, driven by gains in performance.** In 2011, this was partly offset by the losses stemming from geographical and sectoral effects—implying that despite the specialization in sectors that had lower growth and countries that had lower import demand, Malta managed to increase its market share.
- During 2012 and 2013: Q1, Malta lost market share with respect to their trading partners.** This decline in market shares is mainly explained by a negative contribution of performance. While in 2012 sectoral effects were negative, they contributed positively in 2013: Q1. While a part of the declines in market shares in recent years could be driven by the semiconductor sector—which has suffered significantly during recent years—it is not possible to isolate this effect given data availability.

5. While non-price competitiveness has improved since 2010, price competitiveness has worsened. It is illustrative to differentiate the effects stemming from volumes and prices.² We follow the common practice and use changes in unit values as a proxy for changes in prices. Unit values are calculated as the ratio between value and quantity exported. While the decomposition based on volumes shows gains in market share since 2010, the decomposition based on prices shows a decline—driven by performance effects.



Source: Bank of France, Export Competitiveness Database, and IMF staff calculations

6. Maintaining Malta's dynamic export performance and boosting its competitiveness will require actions in various fronts. The determinants of Malta's market shares have varied across time. First, it is important to diversify the export base both geographically and across sectors. Second, policies aiming at improving productivity and competitiveness will help support market share gains. Indeed, historically, performance effects have been an important driver of Malta's export shares. Finally, price competitiveness is as important as non-price competitiveness in maintaining market shares.

References

Cheptea A., Fontagné L. and S. Zignago, 2014. "European export performance," *Review of World Economics*, Springer, 150(1), 25-58.

² One limitation about this methodology is that when disentangling between price and quantity effects, only the intensive margin of trade is taken into account. Incorporating the extensive margin is non-trivial from a computational point of view.

Gaulier, G., Santoni, G., Taglioni, D. and S. Zignago, 2013. "Market Shares in the Wake of the Global Crisis: the Quarterly Export Competitiveness Database," Working papers 472, Banque de France.

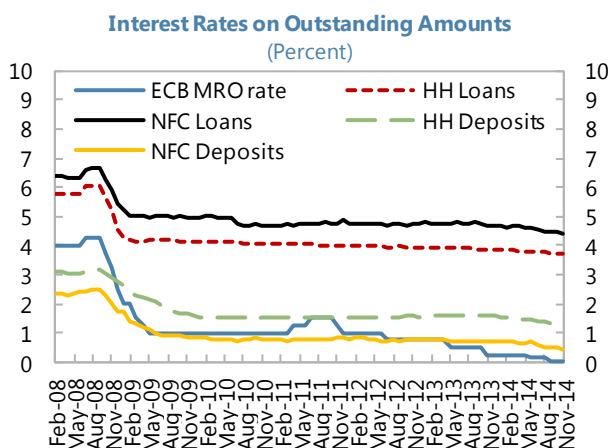
Levchenko A.A., Lewis, L.T., and L.L. Tesar, 2010. "The Collapse of International Trade during the 2008–09 Crisis: In Search of the Smoking Gun," *IMF Economic Review*, 58(2), 214-253.

Appendix II. Interest Rate Pass-Through in Malta¹

This appendix estimates the short-term and long-term interest rate pass-through coefficients in Malta. Interest rate pass-through is low in Malta both in an absolute sense and relative to the rest of the euro area. This is driven by significant reliance on deposit funding, limited competition in the banking sector, and, possibly, by rising share of non-performing loans.

A. Context

1. Interest rates in Malta have remained relatively high and constant for an extended period of time. Even as the ECB policy rate has declined to historically low levels, interest rates on deposits and loans fell only marginally in the aftermath of the global financial crisis. In this appendix we estimate the pass-through from the ECB policy rate to a set of deposit and lending rates for Malta and compare it with the rest of the euro area. The second part of the appendix focuses on the lending rates to nonfinancial corporations (NFCs).



Sources: Central Bank of Malta

Notes: HH denotes households and NFC: non-financial corporations.

B. Methodology

2. An autoregressive distributed lag model (ARDL) is used to calculate short- and long-term pass-through in Malta. The model for a range of lending and deposit rates is:

$$\Delta r_t = \alpha + \sum_{i=0}^{i^*} \beta_i \Delta p_{t-i} + \sum_{j=1}^{j^*} \gamma_j \Delta r_{t-j} + \varepsilon_t, \quad (1)$$

Where r stands for lending or deposit rates, p stands for the policy rate, and i^* and j^* refer to optimal lag lengths (Micallef and Gauci, 2014). Policy rate is the main refinancing rate set by the ECB, and lending and deposit rates are interest rates available to the Maltese residents. Deposit rates cover households, businesses and the weighted average of these two. Lending rates cover mortgages, consumer loans, loans to businesses and also a weighted average for loans overall. The

¹ Prepared by Bartek Augustyniak and Sergejs Saksonovs.

interest rates are for the “outstanding amounts” to maintain compatibility with earlier published analyses of interest rate pass-through in Malta.² This, however, creates a downward bias in the pass-through rates, because the pass-through from policy rates to interest rates on new loans is higher than the pass-through to the rates on outstanding amounts (which represent an average rate that includes loans granted before the change in the policy rate). The estimation period is for January 2008 to November 2014 (post-EA accession). Since all interest rates series are non-stationary and integrated of order 1, they are used in the model in a form of first differences.

3. The appendix considers both long-and short-run pass-through. The short-run pass-through is obtained by estimating coefficient β_0 in equation (1), whereas the long-run pass-through is calculated using the following equation that assumes an inter-temporal equality across interest rates in the long-run:

$$LR_t = \frac{\sum_{i=0}^{i^*} \beta_i}{(1 - \sum_{j=1}^{j^*} \gamma_j)} \quad (2)$$

C. Pass-through for Lending and Deposit Rates

4. The estimated long-term pass-through is less than 50 percent for both deposits and lending rates. The pass-through range is between 5.8 and 37.4 percent in the short-term and 21.5 and 42.2 percent in the long-term. These results broadly match earlier findings by Micallef and Gauci (2014). The number of lags for both policy rate (i^*) and the applicable interest rate is chosen to ensure that residuals do not display autocorrelation.³

Table 1. Malta: Estimations of Interest Rate Pass-through from ECB Policy Rate
(Percent, period: January 2008–November 2014)

	Short-term	Long-term	i^*	j^*
MFI interest rates on deposits				
NFCs	17.2	38.4	3	4
Households	5.8	24.0	0	2
Weighted average	6.5	21.5	0	2
MFI interest rates on loans				
NFCs	23.5	41.3	2	4
Households	37.4	42.2	1	3
Mortgages	25.0	42.0	2	4
Weighted average	28.8	38.8	1	3

Sources: CBM; and Staff estimates.

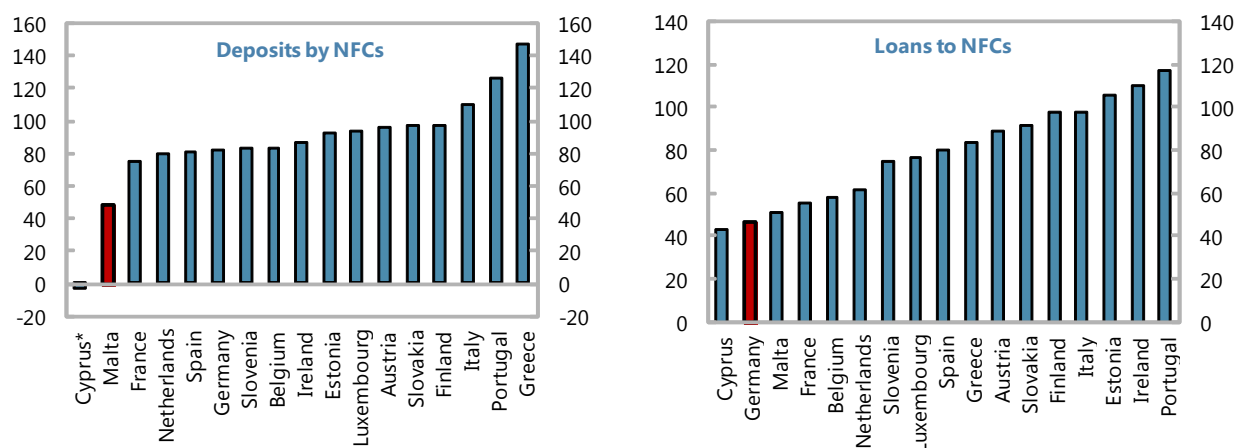
² Micallef and Gauci (2014) point out that the series on new rates exhibit considerable volatility in Malta that complicates estimation of pass-through coefficients.

³ More precisely the model selection strategy is as follows: (i) begin with the model with $i^* = 0$ and $j^* = 1$. We then augment first j^* and then i^* by 1 each time using Breusch–Godfrey LM test for autocorrelation in the residuals of up to 12th order. The most parsimonious model where autocorrelation is rejected for all 12 lags is then chosen.

5. The long-term pass-through for Maltese NFCs is one of the lowest in the euro area.

Using comparable data for all countries from the ECB⁴, and the model in (1)⁵ suggests that the pass-through rates for loans and deposits to non-financial corporations in Malta is one of the lowest in the euro area. For household loan and deposit rates the pass-through from policy rates is slightly larger, but still ranks in the bottom half of the distribution. Low pass-through to NFC rates may reflect limited competition in the banking sector, as well as considerations specific to Maltese NFCs, including their high leverage and relatively large level of non-performing loans on the balance sheets of core domestic banks.

Figure 1: Long-term Interest Rate Pass-Through Estimates in the Euro Area
(percent)



Source: ECB, Staff estimates.

Notes: Symbol * next to a country name indicates not a statistically significant coefficient. These results show a rough comparison of Malta and other euro area member states, but do not represent a comprehensive analysis and should be interpreted with caution. Not only does the use of rates on outstanding amounts introduce a bias, but there are country specific considerations such as loan rejection frequencies that change the extent to which loan rates on outstanding amounts are informative about financial conditions.

D. Closer Look at the NFC Lending Rates

6. Additional determinants of lending rates to NFCs. Limited pass-through is especially important in the case of lending rates to NFCs, which remain high in Malta. This can discourage

⁴ There are slight differences between the CBM and the ECB data, which result in small differences in long-term pass-through estimates.

⁵ For all countries $i^* = 3$ and $j^* = 4$, based on the largest number of lags that produced uncorrelated residuals as shown in Table 1.

viable firms (especially SMEs) to invest and grow, which in turn can inhibit economic growth. In order to analyze the drivers of low pass-through and high interest rates the previous ARDL model is augmented by additional variables, capturing bank funding costs as well as growth outlook (uncertainty index and confidence indicators). Consequently, the estimated equation takes a following form:

$$\Delta l_t = \alpha + \sum_{i=0}^{i^*} \beta_i \Delta b_{t-i} + \sum_{j=1}^{j^*} \gamma_j \Delta l_{t-j} + \sum_{k=0}^{k^*} \delta_k \Delta d_{t-k} + \theta X_t + \varepsilon_t \quad (3)$$

Where l refers to interest rate on outstanding business loans to NFCs, b refers to ECB policy rate, d refers to average interest rate on outstanding business deposits (a weighted average of both household and NFC deposits), i^* , j^* and k^* refer to optimal lag lengths, and X is a vector of additional variables such as economic uncertainty index⁶ or confidence indicators.⁷ Bank funding costs are proxied by deposit rates since Malta's two core domestic banks are predominantly funded by residential deposits. The method for lag choices for the baseline model remains as in Section C. The number of lags for deposit rates is chosen based on the Akaike selection criterion.

7. The short-term pass-through to NFC lending rates remains low but robust. The first column in Table 2 corresponds to the basic model of the equation (1), which includes only ECB policy rate and lagged lending rates as explanatory variables. The coefficient of the short-term pass-through is 23.5 percent and is statistically significant. Both its value and significance remain robust when deposit rates are included (in the second column (2), as well as when crisis dummy is added (for periods before June 2009)).⁸

⁶ The uncertainty index measures European policy-related economic uncertainty and it is based on newspaper articles regarding policy uncertainty. The source of the data can be found here: http://www.policyuncertainty.com/europe_monthly.html

⁷ These include economic sentiment indicator, industrial confidence indicator and services confidence indicator, all of which come from Eurostat.

⁸ The crisis dummy is insignificant and not reported in Table 2

Table 2. Estimated Models for Pass-through to Interest Rates

	Rates on Loans to NFCs (outstanding)	
	(1)	(2)
ECB	0.235*** (0.057)	0.217*** (0.056)
ECB (-1)	0.130** (0.064)	0.080 (0.060)
ECB (-2)	0.127* (0.066)	0.043 (0.063)
Loans to NFCs (-1)	0.183 (0.123)	0.134 (0.119)
Loans to NFCs (-2)	0.112 (0.116)	0.079 (0.107)
Loans to NFCs (-3)	-0.357*** (0.112)	-0.149 (0.211)
Loans to NFCs (-4)	-0.130 (0.102)	-0.240** (0.097)
Ave. Deposits		0.876*** (0.213)
Ave. Deposits (-1)		-1.294*** (0.388)
Ave. Deposits (-2)		0.413* (0.238)
Constant	-0.004 (0.008)	0.009 (0.024)
Adjusted R-squared	0.58	0.66
Observations	78	78
Short-term pass-through from policy rate	23.5	20.3
Long-term pass-through from policy rate	41.3	31.6

Notes: Standard errors in parentheses. Stars denote significance levels as follows: * $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$.

8. The short-term pass-through from deposit rates is significant and close to a 100 percent. This reflects the aforementioned core banks' dependence on deposit funding. The short-term pass-through from ECB policy rate drops to slightly to around 19 percent, when deposits rates are added to the model, however the adjusted R-squared increases by almost 10 percentage points and the coefficients on deposit rates are statistically significant.

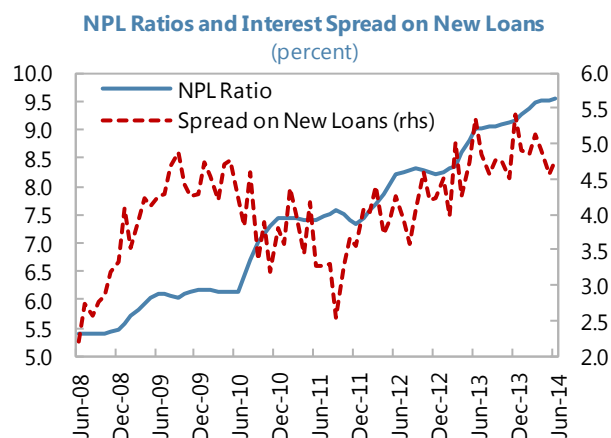
9. Confidence and uncertainty indicators are not statistically significant. After accounting for the policy rate and deposit rate, including these additional variables (either in levels or in differences) does not improve the fit of the model.

10. High NPL levels may increase the spread between lending rates and policy rates and limit pass-through.

The spread between the loan rate on short-term small loans (less than one year and less than one million euro) and the policy rate has been increasing in tandem with the NPL ratio since mid 2011, after reaching previous peaks in the aftermath of the global financial crisis.

Consistent series on longer maturities and larger amounts are not available. Anecdotal evidence suggests that NPL levels may affect

interest rates in certain sectors more than others, especially construction.



Source: ECB; CBM; NPL ratio is non-performing loans to gross loans and is interpolated from quarterly data on FSI indicators.

References

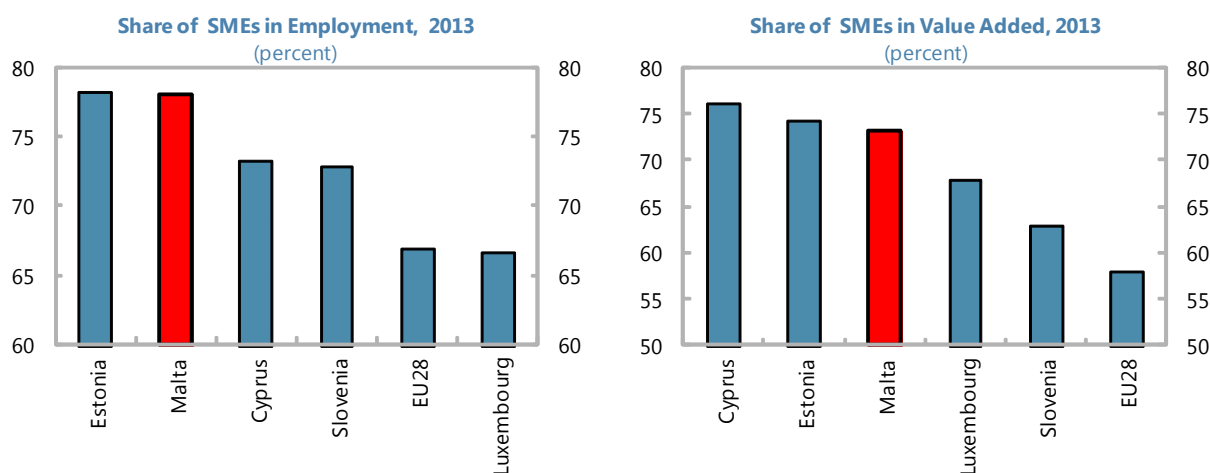
Micallef, B., Gauci, T., 2014, "Interest Rate Pass-through in Malta", Central Bank of Malta, Quarterly Review 2014:1.

Appendix III. Small and Medium Enterprises in Malta¹

This appendix reviews the financial position of Maltese SMEs. Maltese SMEs have comparable profitability to that of their European peers; however, there is a larger share of firms experiencing losses and there is a heterogeneity across industries and sizes. The smallest firms have the highest levels of leverage. Maltese SMEs rely primarily on bank finance, which is generally available, although at high interest rates. SME sector could be strengthened further by improving credit information sharing and reducing non-performing loans.

A. Context

1. SMEs² generate three quarters of employment and value added in Malta. The European Commission (EC) estimates suggest that this share in Malta is close to other smaller countries in the European Union and higher than for the European Union as a whole. However, the EC estimates explicitly exclude financial and insurance sectors of the economy³ (European Commission, 2014a).



Source: European Commission (2014a). Notes: Shares are a proportion of the total for non-financial business economy.

¹ Prepared by Sergejs Saksonovs.

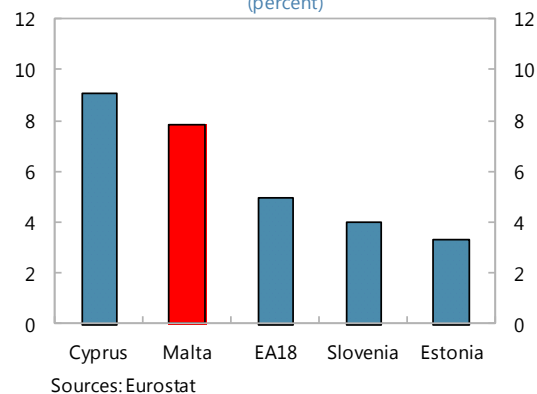
² SMEs are defined in the EU as firms with less than 250 employees and a turnover of less than 50 million euro or total assets of less than 43 million euro.

³ Estimates cover sections B to J and L to N of NACE (classification of economic activities) Revision 2.

2. Financial sector is unusually important for

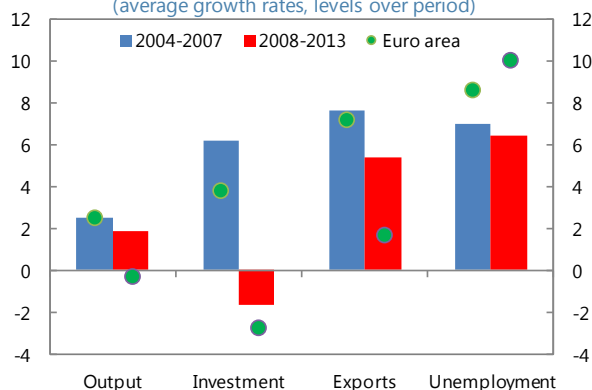
Malta. In 2013, the share of financial and insurance services (including all enterprises not just SMEs) in gross value added was 7.8 percent, behind Cyprus, but significantly above the euro area average of 4.9 percent. Business registry data suggests that 13 percent of firms are in the financial services sector and that the vast majority of these firms employ less than 10 people.

Share of Financial Services in Gross Value Added, 2013
(percent)

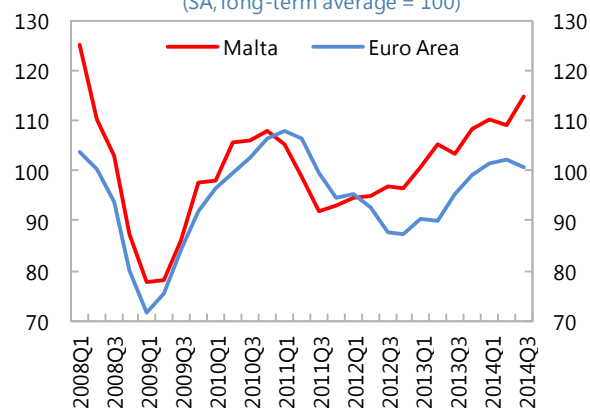


3. Malta's SMEs have weathered the crisis better than European peers. The number of registered business units employing less than 250 people was 8 percent higher in 2013 than in 2008. Similarly, the number of people employed and value added from 2008 to 2013 have also increased by 8 and 15 percent respectively. In terms of value added Maltese SMEs outperformed large firms, which may have suffered more due to their greater exposure to exports markets (European Commission, 2014b). Significantly stronger growth, investment and exports than in the euro area overall helped support SMEs. As a result, unemployment in Malta has actually been lower after the crisis, and overall economic sentiment, having diverged from the euro area average around 2012, is now close to historically high levels.

Malta and EA: Select Macroeconomic Indicators
(average growth rates, levels over period)



Economic Sentiment Indicator,
(SA, long-term average = 100)



Notes: Economic sentiment indicator is the weighted average of the industrial, service, consumer, construction and retail trade confidence indicators.

Source: Eurostat, European Commission

4. Concerns about the SME sector center on the availability of financing and particular

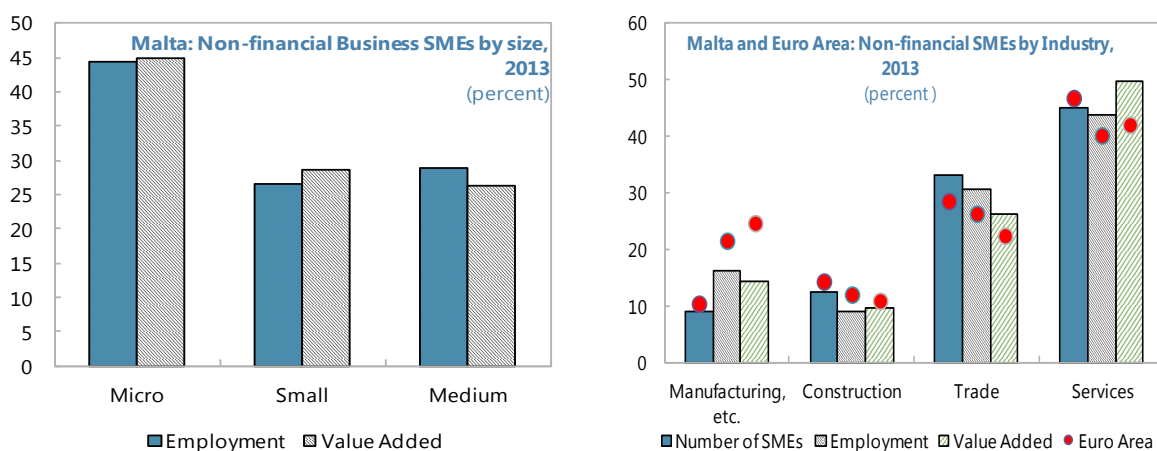
industries. Lending volumes in Malta have declined and interest rates remain higher than in the euro area overall. At the same time, Maltese firms are relatively highly leveraged, especially in certain industries such as construction. In addition, a number of structural gaps limit the

effectiveness of SME financing, earning Malta one of the lowest ranks on the “Getting Credit” component of the World Bank Doing Business Indicators (World Bank, 2014).

B. Financial Position of Maltese SMEs

Non-financial business economy

5. Malta’s SME sector is dominated by small firms, primarily in services and trade. Most of Maltese SMEs are family owned (Malta Business Bureau, 2013). Firms with less than 10 employees have close to 45 percent of total employment and value added compared to the average of 37 percent for the European Union. Almost half of the value added in the non-financial sector is generated by services, and an additional third is generated by trade. Services are the most productive sector in Malta (in terms of value added per employee), followed by construction.



Source: European Commission SME Performance Review

Notes: Micro enterprises defined as employing 0 to 9 people. Small enterprises employ 10 to 49 people, while medium enterprises employ 50 to 249 people.¹ Manufacturing, etc. is defined as the sum of mining and quarrying (B), manufacturing (C), electricity, gas, steam and air conditioning supply (D), and water supply (E). Services are defined as the sum of transportation and storage (H), accommodation and food service activities (I), information and communication (J), real estate (L), professional, scientific and technical, as well as administrative and support service activities (M and N).

¹ There are also limits on the amount of assets or turnover—less than 2 million euro for micro enterprises and less than 10 million euro for small enterprises.

6. Within the dominant services sector, considerable changes have occurred over time.

Turnover in accommodation and food services as well as administration and support services is now at historically high levels. On the other hand, turnover in information and communication sector and professional, scientific and technical activities has declined in 2012–13. Employment, hours worked and wages followed similar trends, except they have been steadily increasing in the professional, scientific and technical activities.

7. Malta's SMEs are more leveraged than larger firms. Grima and Vella (2014) show that leverage (defined as the ratio of assets to equity) of Maltese NFCs by size over the period from 2004 until 2011 was relatively stable, even in the years of the global financial crisis. The smallest companies had the highest levels of leverage.

8. Firm-level data and sample selection. In order to get a more granular picture of the financial characteristics of Maltese SMEs, we rely on firm-level data from ORBIS dataset by Bureau van Dijk. The ORBIS database in principle aims to cover all private and publicly listed firms. Nevertheless the data available covers only a small subset (1615 of an estimated 35,000 Maltese SMEs), even with the generous sampling criteria.⁴

9. Data on employment. The ORBIS dataset lacks data on employment for most Maltese firms making the application of this part of the SME definition problematic. We therefore define two samples: a *broad* sample, which includes the firms for which no data on employment is available and a *narrow* sample where the employment criterion is applied as well. The *narrow* sample includes 313 firms.

10. How representative is the sample? Suitable benchmarks to judge the representativeness of the sample could be its composition by firm size and industry because the European Commission estimates population sizes by these criteria. The EC, estimates, however do not include financial firms, which makes it necessary to consider them separately.

Table: ORBIS SME sample for Malta (Broad Sample), 2011-2013, percent of total					
	Manufacturing, etc.	Construction	Trade	Services	Total
Micro	9.2	1.9	6.1	3.3	4.5
Small	14.7	9.0	13.1	11.6	12.4
Medium	61.3	53.3	64.7	39.0	50.5

Source: ORBIS, European Commission, Staff estimates

Table: ORBIS SME sample for Malta (Narrow Sample), 2011-2013, percent of total					
	Manufacturing, etc.	Construction	Trade	Services	Total
Micro	0.3	0.2	0.3	0.2	0.2
Small	9.8	5.6	10.6	6.9	8.6
Medium	58.1	53.3	55.9	35.6	46.0

Source: ORBIS, European Commission, Staff estimates

⁴ We focus on firms that met the limits for turnover and assets in at least one of the years from 2011 until 2013. For calculations, the year in which the enterprise matched this limited definition of SME is used. We exclude firms with more than 250 employees (when employee data is available). To avoid double counting, we focus our search on firms with unconsolidated accounts and exclude firms that have only consolidated accounts available. We also exclude firms with zero or negative equity and/or negative liabilities.

11. Available firm level data are skewed towards larger firms in particular industries. Even though the vast majority of Maltese firms are small, they are relatively poorly represented in the sample with less than 10 percent of firms included in the broad sample and less than 1 percent in the narrow sample. This suggests that firms for which no employment data is available are primarily small in terms of assets and turnover. On the other hand, for medium-sized firms, more than half of the population for manufacturing, trade and construction sectors is included. To correct for the particular characteristics of the sample, we use probability weights in estimating population parameters. Probability weights are the inverse of the sampling fractions. For example, in weighted sample observations from micro firms in manufacturing count more than six times as much as observations from medium firms.

12. A significant proportion of firms report zero profits. Out of 1615 firms in the broad sample, 997 (62 percent) of mostly smaller firms report exactly zero profits. In the narrow sample only 12 (4 percent) of firms report zero profits. This may reflect either a gap in the data gathering procedure or tax specific considerations. Thus, while median leverage can be computed for the entire sample, firms with zero profits are excluded from the sample for calculation of median profitability indicators and the share of loss-making firms.⁵

Table: SME Profitability Indicators, 2011 - 2013

	Weighted			Unweighted		
	ROA	ROE	Share of Loss-making Firms	ROA	ROE	Share of Loss-making Firms
Malta (Broad)	5.3 (1.1)	22.4 (4.7)	28.3 (2.7)	6.7 (0.6)	22.0 (2.1)	22.8 (1.7)
Malta (Narrow)	5.3 (1.9)	14.0 (5.9)	26.6 (5.4)	6.9 (0.7)	19.3 (2.5)	17.9 (2.2)
Austria	2.3 (1.0)	8.1 (2.8)	36.2 (4.2)	4.8 (0.3)	14.2 (0.8)	18.8 (1.1)
Belgium	4.1 (0.0)	12.7 (0.1)	24.8 (0.2)	3.7 (0.0)	11.5 (0.1)	24.2 (0.1)
France	5.6 (0.0)	16.0 (0.1)	22.9 (0.1)	5.4 (0.0)	15.7 (0.1)	22.1 (0.1)
Germany	6.6 (0.2)	21.0 (0.6)	14.1 (0.4)	6.6 (0.1)	22.6 (0.3)	11.8 (0.2)
Netherlands	3.5 (0.7)	7.2 (1.5)	31.8 (2.1)	5.5 (0.2)	15.2 (0.3)	19.2 (0.6)
United Kingdom	5.2 (0.2)	11.7 (0.5)	26.0 (0.5)	5.9 (0.1)	15.5 (0.2)	19.2 (0.2)

Source: ORBIS, Staff estimates

Notes: Median return on assets (ROA) and returns on equity (ROE) are reported. Standard errors are reported in brackets. Share of loss-making firms is in percent to the total.

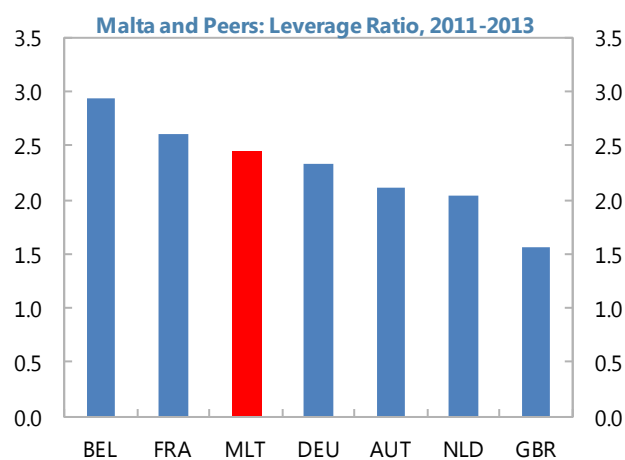
⁵ This requires computing a new set of weights.

13. Median profitability of Maltese firms is relatively high compared to peers⁶, however so is the share of loss-making firms. This is true for both narrow and broad samples. The unweighted estimates of profitability are similar in both narrow and broad samples, while weighted estimates for narrow sample have lower ROE, but not ROA, in other words, lower leverage. Note that estimates for Malta have relatively larger standard errors illustrating greater uncertainty arising from a small sample (especially in the narrow sample).

14. Median leverage ratios for Maltese firms are higher than for peers. Median

leverage ratio is 2.4 for the weighted broad sample and 2.3 for the unweighted sample, suggesting, similar to Grima and Vella (2014), that smaller companies have higher leverage ratios. For the narrow sample, where smaller companies receive larger weighting, the difference between weighted and unweighted numbers estimates is larger still (2.7 and 2.3 respectively). In absolute magnitudes firm-

level estimates are higher than suggested in Grima and Vella (2014), who argue that smaller companies are more likely to be leveraged and since the share of smaller firms is higher in Malta, higher leverage is a "*structural feature*" of the economy.

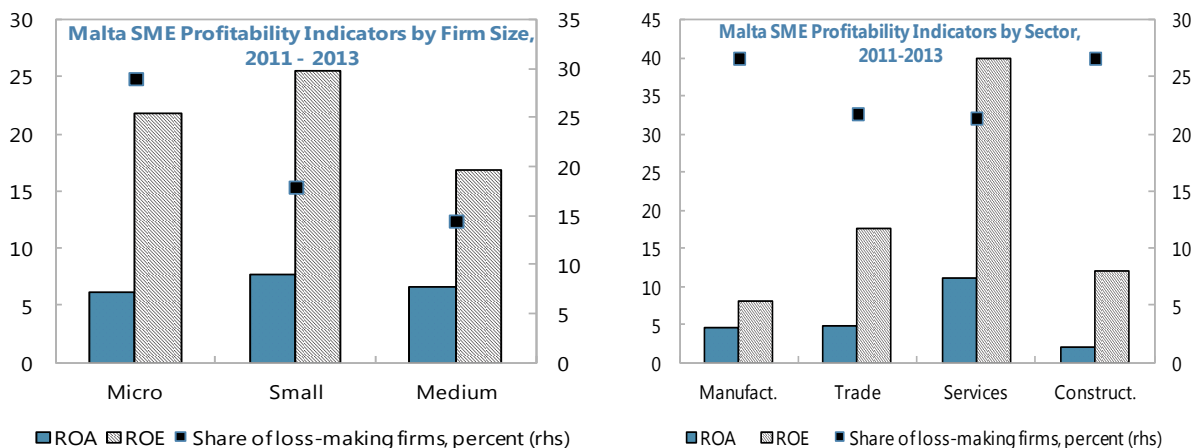


Source: ORBIS, European Commission, and IMF staff estimates

15. Differences by sector and size. Returns on assets are comparable across all three size classes, however returns on equity are higher for smaller and micro-sized firms⁷, confirming that smaller companies may have higher leverage in Malta. On the other hand, micro-sized companies also have the largest proportion of firms experiencing losses. Among sectors, construction has notably lower returns on assets as well relatively higher share of firms experiencing losses, suggesting continued difficulties within this sector. On the other hand, the services sector has the highest returns on assets and equity, suggesting also greater leverage. Construction has by far the highest leverage ratio of 3, followed by services at 2.5.

⁶ For peer countries because of greater data availability, the SME sample is composed by applying a full definition (including the number of employees), based on 2013 data. Those estimates were originally obtained in IMF (2014).

⁷ Only results based on the broad sample are reported to maximize representation by firm sizes and industry.



Sources: ORBIS, European Commission, Staff estimates

Financial Services

16. Financial services sector has low profitability, comparable leverage and high share of loss-making firms. The broad (without employment data) sample of financial and insurance firms yields 676 firms, a substantial addition to the overall sample size of 1615. Of these, 117 firms have exactly zero profits. Another 271 have assets less than equity, which is likely another tax issue or imperfection in data collection. After removing such firms from the sample, the median leverage ratio of financial services firms is 2.4, comparable to the non-financial business economy firms. However, median profitability is lower with an estimated 2.3 percent return on assets, 8.7 percent return on equity and 35 percent of firms experiencing losses.⁸

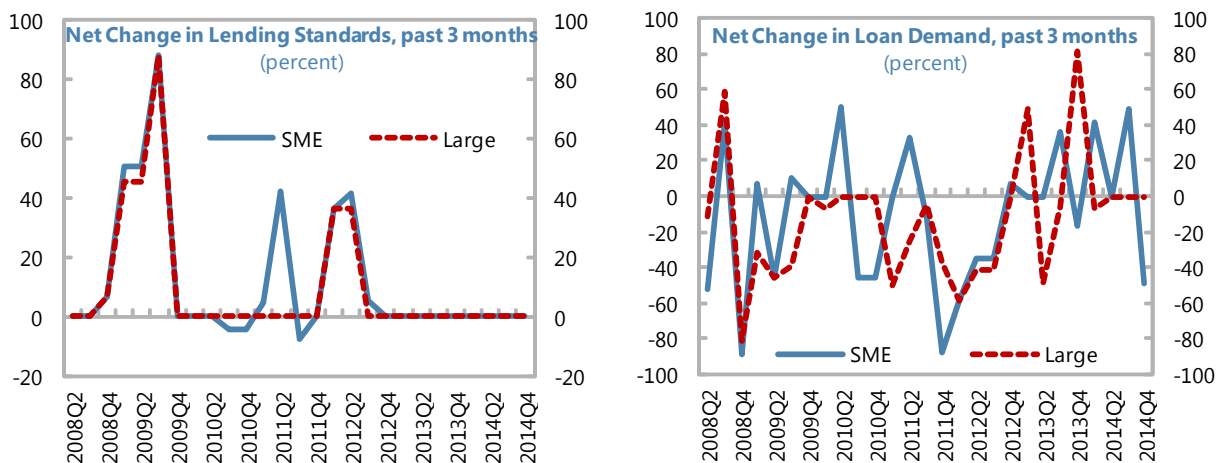
C. SME Financing in Malta

17. Besides own finance, bank based financing is the main source of SME finance. The dominant forms of bank finance have been overdraft facilities and credit cards, followed by trade credit and bank loans. Surveys suggest that loans are generally used by larger SMEs, while in the case of smaller companies only about half have used them before (Malta Business Bureau, 2013).

18. Bank lending standards and loan demand for SMEs are similar to large firms. After a significant tightening in 2008 and 2012 (as well as additional tightening for SMEs in 2011), lending standards remained unchanged for both large firms and SMEs. Survey evidence suggests that the

⁸ Note that these estimates are subject to somewhat higher uncertainty given even smaller sample sizes. Employment data is available only for 45 firms of the above sample.

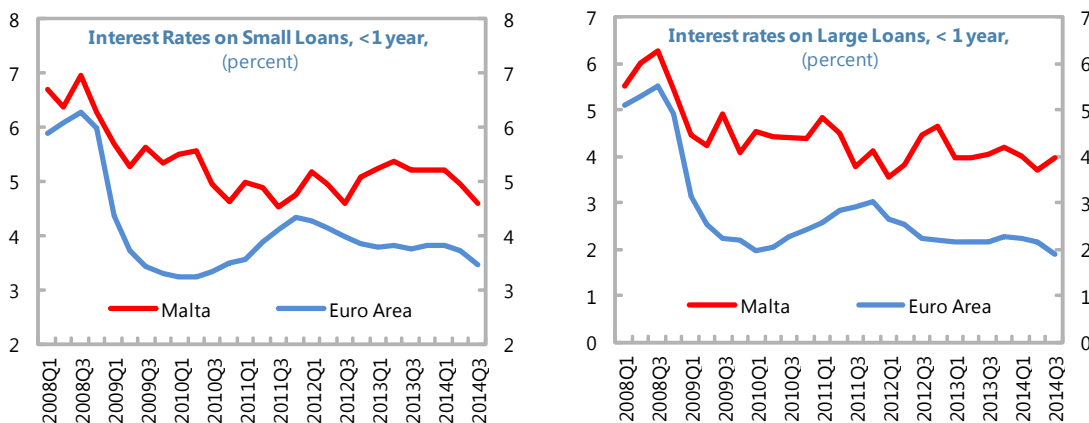
last tightening was related to changes in the perception of firm outlook and risk on the collateral demanded. Demand for loans has been volatile, especially for SMEs.



Source: ECB Bank Lending Survey

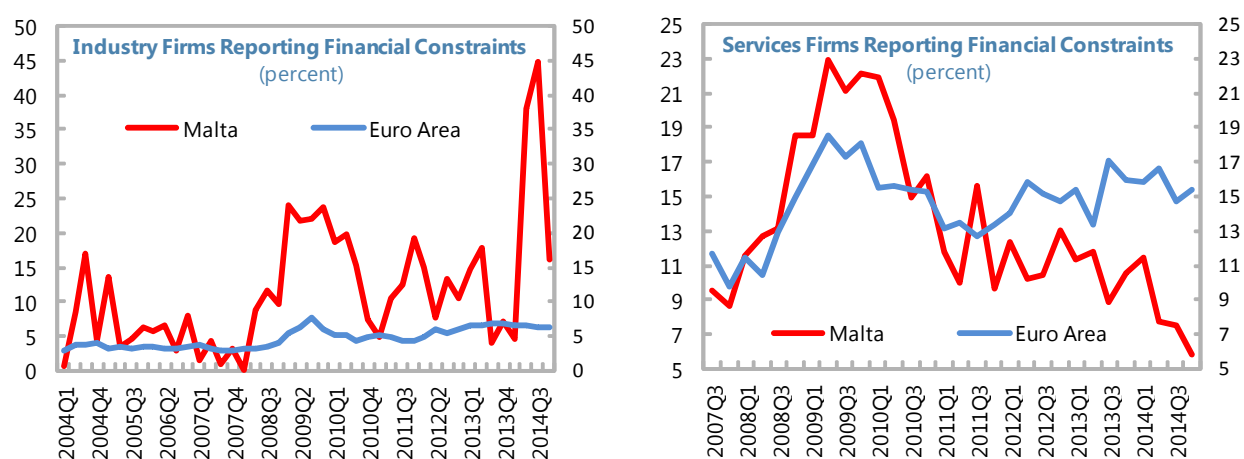
19. The frequency of application rejections for loans is lower in Malta than in the euro area. According to the European Commission (2014) it was almost zero in 2013, compared to the average of 14.4 percent for the euro area. No rejections have been documented by the SME survey performed in Malta Business Bureau (2013).

20. However, interest rates on new loans are significantly higher in Malta than in the euro area. The difference is larger for large loans (for amounts greater than 1 million euro). The existence of a large spread between Maltese and euro area rates may in part be driven by the limited competition in the financial sector. However, this spread has not been constant suggesting that other factors may also be important.



Note: Rates on maturities of less than 1 year are used since that is the series with the largest continuous availability for Malta.
Source: European Central Bank

21. Surveys suggest substantial financial constraints for manufacturing but not services firms. The share of firms in the manufacturing industry reporting financial constraints has been persistently higher in Malta than in the euro area overall. The spike in the third quarter of 2014 is especially worrying, although evidence derived from surveys with small samples as may be the case in Malta can be volatile, and in the last quarter of 2014 the share of firms reporting financial constraints return to it. On the other hand, service firms appear relatively less constrained in Malta than in the euro area overall and, unusually so, less constrained than Maltese manufacturing firms. Firms also indicate availability of labor as a constraint. Different from many other euro area countries, demand is relatively less important.



Source: European Commission

22. Non-bank finance for the most part is not used in Malta. A number of venture capital initiatives have existed in the past but met with limited success. Stakeholders indicated various reasons for this such as low quality of the projects by start-ups, unwillingness to dilute ownership, administrative difficulties, and past experiences of failed local mergers (Malta Business Bureau, 2013).

D. Policies to Strengthen the SME Sector

Existing Policies

23. The government has supported SMEs extensively through a mix of various subsidies, grants as well as measures to improve access to finance. Most of the support is provided through Malta Enterprise, a national development agency responsible for the growth and development of Maltese firms (Malta Business Bureau, 2013). Support measures include both

subsidies and grants. The authorities have also successfully utilized and leveraged EU structural funds. For example, the JEREMIE (Joint European Resources for Micro to Medium Enterprises) Malta fund is the first loss portfolio guarantee vehicle set up in Malta to grant SMEs and self-employed loans of up to 500,000 euro at advantageous interest rates and considerably lower collateral requirements. A similar scheme is being planned in the future.

Policy Proposals

24. There is scope for improvement in the legal framework of access to credit. The World Bank Doing Business indicators highlight access to credit as the area where Malta has the largest distance to the frontier of the best performing economies. The reasons are the lack of credit information sharing as well as relatively weaker legal rights of creditors. To the extent that structural gaps or slow enforcement of collateral weaken creditor's rights, they will likely be reflected in higher overall risk premiums on loans and therefore higher interest rates.

25. Ongoing work on credit information sharing could improve the efficiency of bank lending and strengthen competition. There is empirical evidence that after the introduction of a credit bureau, the likelihood that a firm has access to finance increases, interest rates drop, maturity lengthens, and the share of working capital financed by banks increases (Peria and Singh, 2014). Introducing credit information sharing can also overcome one of the most significant barriers to SME loan securitization – heterogeneity of SME loans.

26. High leverage in certain sectors and sizes suggests that there may be scope to reduce debt overhang. From the SME side possible steps could include reforming bankruptcy procedures, including by introducing time limits to expedite reorganization or pre-packaged insolvency. Greater reliance on online court filings could speed up foreclosures, while best practice guidelines for restructuring would encourage more out-of-court workouts. From bank side, NPL write-offs could be accelerated by, for example, higher capital charges or time limits for writing off NPLs. Regulatory changes could also be used to encourage banks to establish NPL asset management companies.

References

European Commission, 2014a, "Annual Report on European SMEs 2013/2014 – A Partial and Fragile Recovery", Available at http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/supporting-documents/2014/annual-report-smes-2014_en.pdf

- European Commission, 2014b, "2014 SBA Fact Sheet: Malta", Available at http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/countries-sheets/2014/malta_en.pdf
- Grima, M., Vella, K., 2014, "Corporate Financing in Malta", Economic Policy Department, Ministry of Finance
- International Monetary Fund, 2014, "Kingdom of the Netherlands – Selected Issues", *IMF Country Reports 14/328*
- Malta Business Bureau, 2013, "Market gaps in access to finance and the feasibility of new financing instruments in the EU addressing the credit needs of Maltese Business", Available at <http://www.mbb.org.mt/Articles/Article.aspx?Section=policies&ArticleId=3298>
- Peria, M. S. M., Singh. S., 2014, "The Impact of Credit Information Sharing Reforms on Firm Financing", *World Bank Policy Research Working Paper 7013*
- World Bank, 2014, "Doing Business 2015: Going Beyond Efficiency". Washington, DC: World Bank. DOI: 10.1596/978-1-4648-0351-2.



MALTA

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

February 5, 2015

Prepared By

European Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS	2
STATISTICAL INFORMATION	4

FUND RELATIONS

(As of November 30, 2014)

Membership Status

Joined: September 11, 1968; Article VIII

General Resources Account	SDR Million	Percent Quota
Quota	102.00	100.00
Fund holdings of currency	63.75	62.50
Reserve Tranche Position	38.30	37.54
Lending to the Fund		
Borrowing Agreement	11.71	

SDR Department	SDR Million	Percent Allocation
Net cumulative allocation	95.40	100.00
Holdings	84.51	88.58

Outstanding Purchases and Loans

None

Financial Arrangements

None

Projected Obligations to Fund 1/

(SDR million; based on existing use of resources and present holdings of SDRs)

	2014	2015	Forthcoming		2018
			2016	2017	
Principal					
Charges/Interest	0.00	0.01	0.01	0.01	0.01
Total	0.00	0.01	0.01	0.01	0.01

1/ When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section..

Exchange Rate Arrangement

Member of the euro area since January 1, 2008. Malta maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions.

Article IV Consultation

Malta is on the standard 12-month consultation cycle. The previous consultation discussions took place during May 02–13, 2013, and the staff report (Country Report No.13/203, 07/12/2013) was discussed and the consultation was completed on June 19, 2013.

Technical Assistance

Date	Department	Subject
November 2014	FAD	Revenue Administration Mission
March 2014	FAD	Strengthening Public Financial Management
May 2013	STA	Balance of Payments
April 2009	STA	SDDS subscription finalization
November 2006	STA	Producer price index/SDDS preparations (expert visits)
April and December 2007		
June 2005	STA	ROSC Data Module
October 2002– January 2003	MFD	FSAP missions (joint with World Bank)
March 2001	STA	Money and banking statistics
February 1999	MAE	Monetary operations and liquidity Forecasting

Resident Representative

None

STATISTICAL INFORMATION

(As of January 6, 2015)

Data provision is adequate for surveillance purposes. Significant progress in improving macroeconomic statistics has been made in close cooperation with the European Central Bank (ECB) and Eurostat while upgrading statistical systems to meet the euro area standards¹. Most macroeconomic statistics can now be accessed through Eurostat. The country has been a participant in the SDDS since December 1, 2009, with the metadata posted on the IMF's Dissemination Standards Bulletin Board.

Real sector statistics: Malta has compiled its national accounts in accordance with the guidelines of *ESA 2010* since October 2014. The effect of the conceptual differences from *ESA 1995* on the estimated level of GDP in 2010 was a relative small upward revision of 0.5 percent. Data on retail and consumer prices, labor market indicators, and tourism arrivals are released monthly, usually with a short lag. A harmonized index of consumer prices has been published since May 2004. These data are available through Eurostat and via the Internet at the Central Bank of Malta (CBM) and the National Statistical Office (NSO) websites. The NSO releases quarterly national accounts data in current and constant prices with a lag of about two months, annual nonfinancial sectoral accounts in current prices with a lag of about 11 months, and a monthly index of industrial production with a lag of just over a month. However, national accounts data have been subject to substantial revisions, often affecting several years. The reasons for revisions include large statistical discrepancies (captured under changes in inventory stocks), particularly on the first release and revisions of deflators. Furthermore, supply-side GDP estimates by type of economic activity are only available at current prices. The producer price index for manufacturing has been published, but that for services sector is still under discussion. National accounts imports and exports data are not disaggregated into goods and services. Financial balance sheets and transactions by sectors, and data on household debt saving are not available.

Government finance statistics: Fiscal statistics meet basic requirements, with quarterly accrual-based data on general government operations compiled in accordance with the *ESA2010* methodology and disseminated with a one-quarter lag. 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. The NSO also publishes monthly statistics on the cash operations of the central government, for which the authorities plan to utilize the targeted timeliness flexibility option in light of additional time required for the final month of the fiscal year.

¹ The 2007/08 Eurostat peer review on the implementation of the European Statistics Code of Practice found that the NSO had reached a remarkable compliance with large parts of the Code despite its small size, but underscored the need to improve adequacy of resources and data quality management.

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. Malta has reported Financial Soundness Indicators beginning from 2005 along with metadata, which are available on the IMF's website (<http://fsi.imf.org>).

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 and IIP data are released annually, the latter with a lag sometimes exceeding one year. The balance of payments data are usually subject to large revisions. Summary trade statistics are released monthly with a lag of about 40 days. The CBM also publishes the external debt templates in line with requirements of the SDDS, including both gross and net external debt. In line with the European regulation, Malta has prepared the first BOP estimates in the *BPM6* format covering the period 2009-onwards; however these data have not yet been approved for publication in the IFS. The country is planning to release historical data, possibly starting from 2004 in 2015. The new BOP data include estimates for SPEs and other coverage improvements.

Table 1. Malta: Table of Common Indicators Required for Surveillance
(As of January, 2015)

	Date of latest observation	Date received	Frequency of Data 8/	Frequency of Reporting 8/	Frequency of Publication 8/	Memo Items:	
						Data Quality – Methodological soundness 9/	Data Quality – Accuracy and reliability 9/
Exchange Rates ^{1/}	Current	Current	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ^{2/}	2014:Q3	Dec 2014	Q	Q	Q		
Central Bank Balance Sheet	2014:Q3	Dec 2014	Q	Q	Q	...	...
Consolidated Balance Sheet of the Banking System	2014:Q3	Dec 2014	Q	Q	Q	...	...
Interest Rates ^{3/}	Jan 2015	Jan 2015	M	M	M		
Consumer Price Index	Dec 2014	Jan 2015	M	M	M	O, LO, O, O	O, O, LO, LO, O
Revenue, Expenditure, Balance and Composition of Financing ^{4/} – General Government ^{5/}	2014:Q3	Jan 2015	Q	Q	Q	O, LO, O, LO	O, O, O, LO, O
Revenue, Expenditure, Balance and Composition of Financing ^{4/} – General Government	2014:Q3	Jan 2015	Q	Q	Q		
Stocks of General Government and General Government-Guaranteed Debt ^{6/}	2014:Q3	Jan 2015	Q	Q	Q		
External Current Account Balance	2014:Q3	Dec 2014	Q	Q	Q	O, LO, O, O	LO, O, O, O, LNO
Exports and Imports of Goods and Services	2014:Q3	Dec 2014	Q	Q	Q		
GDP/GNP	2014:Q3	Dec 2014	Q	Q	Q	O, LNO, O, LO	LO, O, LO, LO, LO
Gross External Debt	2014:Q3	Dec 2014	Q	Q	Q		
International Investment Position ^{7/}	2014:Q2	Jan 2015	Q	A	A		

1/ Exchange rate arrangement is free floating.

2/ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

3/ Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

4/ Foreign, domestic bank, and domestic nonbank financing.

5/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

6/ Including currency and maturity composition.

7/ Includes external gross financial asset and liability positions vis a vis nonresidents.

8/ Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

9/ 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).



INTERNATIONAL MONETARY FUND



Press Release No. 15/75
FOR IMMEDIATE RELEASE
February 26, 2015

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

IMF Executive Board Concludes Article IV Consultation with Malta

On February 23, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Malta.

Malta's economy continues to weather the global crisis well. Spillovers from turmoil in international financial markets have been contained due to low reliance on external financing by the government and banks. Real GDP growth has been one of the highest in the euro area since the beginning of the crisis, supported by relatively diversified exports, a recent recovery in domestic demand, and a stable banking sector. Unemployment is close to historical lows and among the lowest in the euro area. The external position is strong, and progress has been achieved in reducing the budget deficit.

The macroeconomic outlook is favorable. Growth is expected to remain robust in 2015–16, supported by domestic demand. Inflation is projected to remain subdued. The current account surplus will likely persist.

The authorities have taken action on multiple fronts. Regarding fiscal policies, the Fiscal Responsibility Act was enacted, and restructuring of various state-owned enterprises are ongoing. As regards financial sector policies, the regulatory and supervisory frameworks have been strengthened in several areas. On structural policies, steps have been taken to increase labor participation and improve the judicial system.

Despite the robust outlook and policy action, Malta faces important challenges: public debt is still high, nonperforming loans in banks are elevated, capital is relatively costly, and maintaining external competitiveness is increasingly difficult.

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.

Executive Board Assessment²

Executive Directors welcomed Malta's continued good economic performance and commended the authorities for their consistent prudent policies. The external position is strong, the economy is relatively diversified, and the banking sector is stable. Although the economic outlook is robust, challenges remain, and policies should aim to further strengthen fiscal sustainability, maintain financial stability, and enhance competitiveness.

Directors welcomed the authorities' fiscal targets for 2015–17. They recommended more focus on expenditure measures by containing the growth in current spending while preserving incentives for labor participation and education, and capital spending. Full implementation of the comprehensive spending review would help prioritize and contain spending, while increasing efficiency. Directors commended the authorities' efforts to strengthen fiscal governance, and stressed the importance of broad-based reforms on pensions, healthcare, and public corporations to contain fiscal pressures going forward.

Directors observed that the large financial sector remains stable, and welcomed the progress in strengthening the regulatory and supervisory frameworks. They considered that reducing the relatively high level of nonperforming loans would further boost the resilience of Maltese banks. It will also be important to remain vigilant to the exposure of banks to the real estate sector. Directors encouraged the authorities to implement the action plans resulting from the ECB's Comprehensive Assessment of the largest banks, and to apply the same standards across the rest of the banking sector. They saw a need to strengthen the contingency framework in line with reforms at the EU level, by boosting the resources of the deposit compensation scheme, establishing a resolution fund, and introducing a bail-in requirement. Continuing to aim for high standards in the AML/CFT framework will be important as well. Directors supported the authorities' intention to request an update of the Financial Sector Assessment Program.

Directors encouraged the authorities to maintain the momentum of structural reforms to enhance external competitiveness and boost medium-term growth. They called for continued action to improve labor participation, upgrade skills, and reform the judicial system. To support affordable lending to viable firms, Directors recommended measures to reduce the cost of capital, by developing a strategy for the resolution of nonperforming loans, implementing the planned credit registry, and encouraging a prudent increase in cross-border financing.

² 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. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

Malta: Selected Economic Indicators, 2010–2016

Per Capita GDP (thousands): €18.6

Population (thousands): 422

Quota: 102 million SDR, 0.05% of total

Tertiary education rate: 38%

Economy based on services: Agriculture (2%); industry and construction (17%); trade and communication (29%); financial and real estate (14%); other services (39%).

Main trade partners: Germany, France, Italy United Kingdom, Singapore, United States, and Libya.

	2010	2011	2012	2013	2014	2015	2016
					est.	Proj.	Proj.
Real economy (constant prices)	(Percent change year on year)						
Real GDP	3.5	2.2	2.5	2.5	3.1	3.1	2.7
Domestic demand	4.6	-2.2	-2.0	3.0	4.3	3.9	2.5
CPI (harmonized, average)	2.0	2.5	3.2	1.0	0.8	1.1	1.4
Unemployment rate (percent)	6.9	6.4	6.3	6.4	5.8	6.1	6.3
Public finance	(General government, percent of GDP)						
Overall balance	-3.3	-2.6	-3.6	-2.7	-2.2	-1.9	-1.7
Primary balance	-0.2	0.5	-0.7	0.2	0.7	1.0	1.2
Gross debt	67.6	69.8	67.5	69.5	70.3	69.8	68.4
Money and credit	(Percent change year on year)						
Broad money	16.3	0.2	9.6	11.0	...	...	...
Credit to nonbank private sector 1/	3.2	4.2	-1.2	-0.1	...	...	...
Interest rates (year average)	(Percent)						
Interest rate for mortgage purposes	3.6	3.6	3.6	3.6	...	...	...
Ten-year government bond yield	4.2	4.5	4.1	3.4	3.2	3.4	3.7
Balance of payments	(Percent of GDP)						
Current account balance	-5.9	5.0	3.6	3.2	4.9	4.9	5.0
Trade balance (goods and services)	-2.5	7.6	6.8	6.6	5.9	5.9	6.0
Exchange rate	Joined EMU on January 1, 2008.						
Exchange rate regime	Joined EMU on January 1, 2008.						
Nominal effective rate (2005=100)	100.0	100.6	96.8	99.5	...	...	...
Real effective rate, CPI-based (2005=100)	100.0	99.7	96.5	98.1	99.5	99.7	99.9

Sources: National Statistical Office of Malta; Central Bank of Malta; European Central Bank; Eurostat; European Commission; and IMF staff estimates.

1/ Loans to nonfinancial corporate sector and households/individuals.

**Statement by Carlo Cottarelli, Executive Director for Malta
and Antonio Bassanetti, Senior Advisor to Executive Director**

February 23, 2015

I. Overview

The Maltese authorities thank staff for a very constructive and valuable dialogue. The Report for the 2014 Article IV Consultation is well-balanced and comprehensive. It conveys the message that consistent structural, fiscal, and financial policies allowed Malta to weather the global economic crisis well and resume a path of strong economic growth. On all these fronts they are delivering steady and progressive results. The authorities are in broad agreement with staff's assessment and policy recommendations.

II. Economic Outlook and Structural Policies

Since the onset of the crisis, Malta's GDP growth outpaced that of the euro area and output is currently around 14 percent higher than in 2008. This performance reflects strong fundamentals, sound and prudent macroeconomic policies, and a resilient and well-supervised financial sector. The remarkable diversification achieved by the Maltese productive system has also strengthened the capacity of the economy to weather negative external shocks. In particular, recent years have witnessed the sustained growth – in terms of both value added and employment – of financial services, internet-related services, and aviation services, compounded by the reorientation of more traditional sectors such as manufacturing and tourism (for example, the latter is benefiting from the tapping of new source markets).

While the flexibility and adaptability of the productive structure makes investing in Malta attractive (operating surpluses as a percentage of gross value added is well above the average in the euro area), the authorities agree with staff that continued efforts are needed to prevent the Maltese competitive edge from being eroded. In this respect, it is reassuring that the priorities established by the National Reform Plan – and on which work has already been in progress for a few years – largely overlap with staff's recommendations. The steady increase of the participation rate – particularly of the female component – is the result of a number of recent initiatives (Free Childcare, among others). Together with the renewed efforts on youth education and vocational training (Youth Guarantee scheme), it will help reducing skill gaps. Ongoing progress in reforming the energy sector – including through the well-advanced restructuring of

Enemalta and the diversification of energy sources (gas, renewables, interconnector to Sicily) – will contribute enhancing the country’s infrastructures and its business environment. The latter will also benefit from the ongoing judicial reform, with positive spillovers to the credit market, and the reduction of bureaucracy which is underway. On these and other fronts the authorities are committed to deliver steady progress to sustain productivity and attract further investment.

III. Fiscal Policy

Building on the important results achieved in recent years, the authorities remain committed to prudent fiscal policies. Despite some skepticism on the side of staff (Report for the 2013 Art. IV Consultation), the 2013 target of a deficit below 3 percent was achieved with a sizeable margin (2.7 percent). The authorities expect the 2014 deficit to have decreased to 2.1 percent, and target its further decline to 1.6 percent of GDP in 2015. They note that staff projects a somewhat larger deficit in 2015. While believing the measures undertaken so far are sufficient to achieve the target, the authorities stand ready to revise the fiscal strategy as developments unfold to comply with the fiscal targets committed in the Stability Programme and later confirmed in the Budget estimates for 2015. To this purpose, revenue and expenditure outcomes will continue being monitored closely, on a monthly basis, also in line with the new monitoring requirements established by virtue of the Fiscal Responsibility Act and under the scrutiny of the newly established Fiscal Council. In particular, as for the expenditure side, the authorities take careful note of staff’s suggestions and observe that the budgetary targets are based on a three-year medium term framework for expenditure commitments, complemented by the Comprehensive Spending Review which is conducted at each Ministry level and should ensure a continuous scrutiny of spending activities.

According to the latest estimates – based upon an updated information set made available after the cut-off date of the staff Report and which includes payment of arrears as well as other factors – after peaking at around 69.5 percent in 2013, public debt-to-GDP is estimated to have declined to 68.2 percent in 2014 and the reduction is expected to continue steadily in the following years, reaching 64.4 percent in 2017. Though with some more caution, a sustained fall in both the deficit and the debt ratios is projected also by the recently published Winter Forecasts of the European Commission. The latter bode well for the upcoming Excessive Deficit Procedure Decision.

The authorities remain vigilant also to ensure the long-term sustainability of aging-related expenditures. As staff described, initial important steps have been already taken on health care to enhance the efficiency of spending. A review of the medicines and medical devices procurement and distribution processes got underway with a view to reducing wastage. Looking forward, the increased focus of the administration on primary care should also provide an important contribution to sustainability.

Careful attention is also being paid to the pension system with the recent introduction of the third pillar – the so-called Personal Retirement Scheme – supplemented by the Individual Savings Account scheme. Both schemes are supported by fiscal incentives to encourage savings for retirement. As correctly reported by staff, before considering if additional measures are needed, the authorities prefer to wait for the availability of the updated pension projections to be published in the 2015 Ageing Report of the European Commission (envisaged in May 2015). The authorities are committed to ensure the long-term sustainability of the system and stand ready to introduce, where necessary, further reforms to the first pillar. A Pension Strategy Group (PSG) was set up in 2013 to assess and recommend how reforms can be introduced in the pension system. The PSG has delivered its report to Government and a presentation with the proposals is expected to be delivered shortly to the Cabinet.

There are plans to realign the national parliamentary programme closer to the European Semester. This might imply that the Government would initiate the budget process at an earlier stage, allowing the finalisation of the national budget closer to the submission of the draft budget plan. This should ensure a better evaluation by the European Commission.

IV. Financial Sector

The resilience of the financial sector is a key ingredient of Malta's competitiveness. The core domestic banks continue to rely on a cautious business model, based on stable retail deposit funding and locally-oriented lending, with a low loan-to-deposit ratio. The international banking sector – though sizeable – has virtually no links with the domestic economy, and continues to be profitable. Solvency and liquidity indicators compare broadly well with the average of the European Union both for the domestic and the international banking sectors. The recent ECB's Comprehensive Assessment did not identify any capital shortfalls for the three participating banks that operate in Malta. Continuous efforts are needed to preserve the resilience and

reputation of the system, to diversify funding sources, and to reduce exposure to non-performing loans.

In this context, as staff pointed out, the amendments to Banking Rules 09 and 12 adopted by the Joint Financial Stability Board are aimed at improving the banks' overall coverage ratios and provisioning practices, further strengthening the capital base, and enhancing governance structures and risk oversight. These same amendments should also contribute to mitigating potential risks from the exposure to the real estate sector, although we would recall – as we did last year – that this kind of exposure, particularly in terms of collateral, is to some extent unavoidable given the small dimension of the country. It is also pertinent to mention that although advertised residential property prices have picked up recently, this follows a period of modest growth. There are currently no signs of stress in the housing market.

The authorities will monitor closely the effectiveness of the adopted measures and the developments of the broad financial system, standing ready to intervene as appropriate to continue safeguarding financial stability.

As to staff's recommendations, the authorities confirmed that the supervising institutions will continue to be endowed with adequate resources and that the alignment of local definitions of impairment triggers and forbearance with those used by the European Banking Authority and the SSM has been already implemented through the amended Banking Rule 09 which became effective in December 2013. Furthermore the Maltese authorities will be requesting an FSAP to be undertaken by the second half of 2016.

The relative soundness of the banking sector should allow a gradual recovery of bank credit growth, which, as staff pointed out, remains low. The authorities are tackling this issue through different initiatives. A credit register administered by the Central Bank of Malta is being introduced and will contribute easing informational asymmetries and lowering risk premia. At the same time an assessment of potential market failures influencing access to finance is under way, while the authorities are also considering the establishment of a Development Bank which would complement lending activities undertaken by existing domestic banks. According to the authorities, weak credit growth is partly attributable to a relatively high cost of capital, particularly to SMEs, that could be addressed by a more diversified funding base by banks to lower the cost of funding, and to some extent also by a stronger degree of competition in the banking market. The judicial reform being undertaken to expedite liquidation of collateral, and

hence the resolution of non-performing loans, would also contribute to lower interest rates. The authorities are also seeking to widen the possibilities of access to more diversified capital markets for SMEs; actions in this direction include the setting up of a venture capital initiative.