INTERNATIONAL MONETARY FUND

IMF Country Report No. [18/19]

MALTA

2017 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT

January 2018

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 2018 Article IV consultation with Malta, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its January 26 consideration of the staff report that concluded the Article IV consultation with Malta.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on January 26, following discussions that ended on November 17, 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 January 9, 2018.
- An **Informational Annex** prepared by the IMF staff.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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Press Release No. 18/28
FOR IMMEDIATE RELEASE
January 29, 2018

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700 19th Street, NW
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IMF Executive Board Concludes 2017 Article IV Consultation with Malta

On January 26, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the 2017 Article IV consultation[1] with Malta, and considered and endorsed the staff appraisal without a meeting on a lapse-of-time basis.[2]

Malta's economic growth remains one of the strongest in Europe, owing to favorable economic conditions and sound policies, which advanced structural reforms and supported the strengthening of private and public balance sheets. Output is estimated to have expanded by 6.8 percent in 2017, accompanied by dynamic job creation, which brought unemployment to a record-low. Strong inflows of foreign workers and rising labor force participation kept wage pressures contained in most sectors, thus contributing to low inflation despite a positive output gap. At the same time, the rapid economic expansion and the growing population have put pressure on physical infrastructure and resulted in a continued housing market appreciation. The fiscal balance is estimated to have registered a surplus for the second consecutive year in 2017, thanks to buoyant revenues—including from Individual Investor Program proceeds—and contained capital expenditure growth. The 2017 current account is estimated to have remained in surplus, driven largely by a sizable balance of services.

Domestic banks remain profitable and well-capitalized. High legacy corporate non-performing loans represent a persistent challenge for the banking sector, despite the continued improvement in banks' asset quality. As bank lending remains focused on mortgages, the concentration of property-related loans continued to grow while the non-financial corporate sector has increased its reliance on nonbank financing, particularly on intercompany lending.

The outlook is favorable, with growth decelerating gradually and converging to about 3 percent over the medium term. Growth is expected to be driven largely by domestic demand, backed by rising incomes and historically-low unemployment while buoyant services exports

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] The Executive Board takes decisions under its lapse-of-time procedure when it is agreed by the Board that a proposal can be considered without convening formal discussions.

will continue to sustain current account surpluses. Inflation is set to pick up gradually, reflecting an increase in import prices and tighter labor market conditions. Headline fiscal surpluses are forecast to continue and contribute to a further moderation of public debt.

Executive Board Assessment[3]

In concluding the 2017 Article IV consultation with Malta, Executive Directors endorsed the staff's appraisal, as follows:

The Maltese economy remains on a strong growth trajectory. Rapid expansion of export-oriented services, improved balance sheets, and solid job creation contributed to a robust growth in 2017 and kept unemployment at historically-low levels, despite continued inflows of foreign workers. The favorable economic performance is expected to persist in the coming years, albeit at a more moderate pace, with domestic demand as the main driver. Inflation is expected to pick up gradually, reflecting an increase in import prices and tighter labor market conditions, while buoyant services exports are projected to sustain current account surpluses. Risks to the outlook are broadly balanced, and the external position is assessed to be broadly in line with fundamentals.

Reducing the remaining fiscal risks and building larger fiscal buffers would add strength to Malta's fiscal position. As the economy keeps operating above potential, efforts are needed to ensure that fiscal policy is geared towards addressing the infrastructure challenges while avoiding unwarranted stimulus. The government's strategy to continue complying with the MTO and building larger fiscal buffers is therefore welcome, though identifying further structural measures to attain the MTO, net of IIP proceeds, would put the fiscal position on a stronger footing. With fiscal risks still elevated, it is important to continue to broaden the tax base and strengthen revenue collection, advance the restructuring of financially-weak SOEs, and address age-related spending pressures. A budget-neutral public investment push would help narrow Malta's infrastructure gap, thus supporting the population's well-being and buttressing competitiveness.

Steps to advance balance sheet repair and strengthen the oversight of nonbank lending would enhance financial sector resilience. Continued resolution of legacy corporate NPLs, accompanied with enhanced supervisory oversight, would promote investment and improve the economy's resilience to shocks. The expected increase in the provision coverage ratio and further improvements of the insolvency process would support these efforts. While the diversification of funding sources has served firms well, efforts are needed to address data gaps and enhance the oversight of nonbank lending. Robust governance and well-designed origination rules of the MDB's operations will help contain contingent liability risks to public finances. Ensuring that the MFSA has adequate resources is critical to preserve its operational independence and maintain effective supervision.

Sustained efforts are needed to safeguard the financial system's integrity. Robust implementation and effective enforcement of the Anti-Money Laundering framework is critical given the size of Malta's financial sector, the fast-growing remote gaming activity, and the high demand for the IIP. Continuing strengthening the collaboration between the competent supervisors and regulators, and finalizing the related National Risk Assessment would support these efforts.

The strong momentum in the housing market calls for policy measures. Targeted macroprudential limits for mortgages would strengthen the resilience of bank and household balance sheets to possible housing price corrections and higher interest rates. Closing data gaps on borrower characteristics would help to calibrate these measures effectively. Aligning the tax rate on rental income with tax rates on other sources of income, and introducing periodic reviews of the scope and parameters of the IIP, including the minimum real estate investment or leasing values, could curb housing demand pressure. Accelerating corporate balance sheet repair in the construction sector would help to improve the response of housing supply to price signals.

Safeguarding the reform momentum is critical to sustain high growth and promote inclusiveness. Policies should focus on reducing the severe congestion by improving road quality and increasing the utilization of alternative means of transport, upskilling and reskilling the labor force to better align education with business needs, and increasing female labor force participation further, particularly among older cohorts. Strengthening innovation by developing research infrastructure, increasing the financial support for research and innovation, and improving links between academia and the private sector would enhance productivity and boost growth prospects.

Staff proposes that the next Article IV consultation with Malta follow the standard 12-month cycle.

Malta: Selected Economic Indicators, 2014-2019

(Year-on-year percent change, unless otherwise indicated)

Per Capita GDP (2016): €22.8 thousands

Quota: 168 million SDR, .04% of total

	2014	2015	2016	2017 Est.	Projections 2018	2019
Real economy (constant prices)	(Percent change year on year)					
Real GDP	8.2	7.2	5.5	6.8	5.7	4.6
Domestic demand	2.9	12.4	1.4	1.8	5.4	4.0
CPI (harmonized, average)	0.8	1.2	0.9	1.3	1.7	1.8
Unemployment rate (percent)	5.8	5.4	4.7	4.2	4.4	4.6
Public finance	(General government, percent of GDP)					
Overall balance	-1.8	-1.1	1.1	1.4	0.8	0.7
Primary balance	1.0	1.3	3.3	3.4	2.6	2.4
Structural balance 1/	-2.3	-2.1	0.6	0.8	0.1	0.2
Gross debt	63.9	60.3	57.7	54.2	50.1	47.3
Financial sector	(Percent change year on year)					
Credit to nonfinancial private sector 2/	3.8	0.6	1.1	...	...	...
Credit to the private sector (percent GDP)	95.9	90.8	87.9	...	...	...
Interest rates (year average)	(Percent)					
Interest rate for mortgage purposes	3.5	3.1	3.1	...	...	...
Ten-year government bond yield	2.6	1.5	0.9	...	...	...
Balance of payments	(Percent of GDP)					
Current account balance	8.8	4.6	6.6	10.3	9.6	9.2
Trade balance (goods and services)	12.0	7.4	11.3	16.0	16.2	16.7
Exchange rate						
Exchange rate regime	Joined EMU on January 1, 2008.					
Nominal effective rate (2010=100)	101.6	97.7	97.9	...	...	...
Real effective rate, CPI-based (2010=100)	101.0	97.9	98.4	...	...	...

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

1/ As a percentage of Nominal Potential GDP.

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

INTERNATIONAL MONETARY FUND

MALTA

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

January 9, 2018

KEY ISSUES

Context: Malta remains one of the fastest-growing economies in Europe, aided by a rapid expansion of export-oriented services, favorable labor market dynamics, and prudent policies, which advanced structural reforms and strengthened private and public sectors' balance sheets. At the same time, robust growth, along with the continued influx of foreign workers, has led to increased infrastructure needs and contributed to higher housing prices. The June snap election, which resulted in the Labor Party maintaining a comfortable majority in Parliament, provides a strong mandate for the government to pursue its reform strategy.

Main policy recommendations: Policies should focus on sustaining the strong performance, enhancing the economy's resilience, and making growth more inclusive.

- **Fiscal policy**: Continue building fiscal buffers and reducing the public debt-to-GDP ratio. Contain fiscal risks by strengthening revenue collection, mitigating long-term spending pressures, and reducing contingent liabilities, including by advancing the restructuring of financially-weak state-owned enterprises. Boost public investment in a budget-neutral manner to address infrastructure bottlenecks and support medium-term growth.
- **Financial sector**: Reduce legacy NPLs in the corporate sector further and continue improving the insolvency framework. Ensure a robust governance structure and well-designed origination rules to contain risks related to the operations of Malta Development Bank. Monitor the growing importance of nonbank financing to the non-financial corporate sector and close related data gaps. Ensure that the financial regulator has adequate resources to preserve its independence and continue with effective supervision. Sustain efforts to safeguard the financial system's integrity.
- **Housing market**: Deploy macroprudential measures to enhance the resilience of bank and household balance sheets to sharp house price corrections and higher interest rates. Ensure that fiscal incentives do not amplify the housing cycle, and address supply bottlenecks by accelerating debt restructuring of distressed, but viable, construction firms.
- **Structural reforms**: Increase the structurally-low female labor force participation further and expand technical and vocational training schemes to strengthen human capital. Improve infrastructure quality and enhance SMEs' innovation, including by upgrading research infrastructure and upscaling the public sector support for innovation.

Approved By
Mahmood Pradhan (EUR) and Mary Goodman (SPR)

Discussions were held in Valletta during November 8-17, 2017. The team comprised Mr. Klein (head), Mr. Böwer, Mr. Salas (all EUR) and Mr. Ugazio (STA). Ms. Bezerra de Menezes and Mr. Cai (EUR) assisted from headquarters. Messrs. Leipold and Spadafora (OED) participated in the discussions. The team met with Finance Minister Scicluna, Central Bank of Malta Governor Vella, Central Bank Deputy Governors Bonello and Demarco, Malta Financial Services Authority Chairman Bannister, Parliamentary Secretary for Financial Services, Digital Economy, and Innovation, Schembri, and other senior officials, members of the Parliament, representatives of labor and business organizations, and financial institutions.

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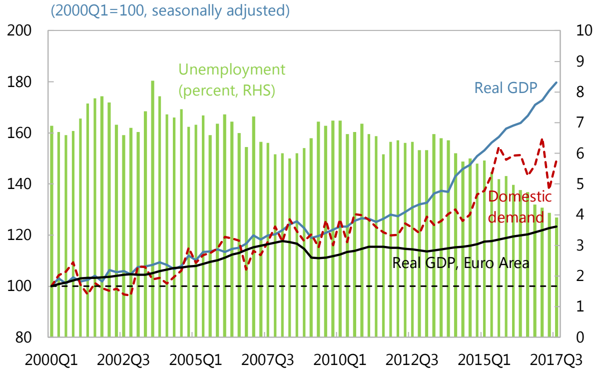
ANNEXES

CONTEXT

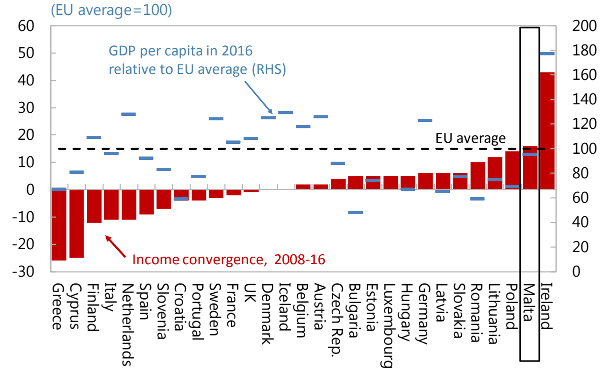
1. **Malta is enjoying robust economic growth, supported by a rapid expansion of services.** Malta remains a top growth performer with an average GDP growth of nearly 6.5 percent in 2013-16. The fast expansion was driven by the services sector, which boosted exports and contributed to a significant improvement in the economy's external position (Figure 1). Prudent fiscal policy helped attain the government's Medium-Term Objective (MTO), three years ahead of schedule, and contributed to a further moderation of the public debt-to-GDP ratio. Private sector balance sheets have strengthened and a steady job creation drove unemployment to record-lows. This strong performance, which also enabled Malta to narrow its income gap with EU members considerably, was recognized by Fitch's upgrade of Malta's credit rating to A+ from A (August 2017).

Key Economic Indicators
(2000Q1=100, seasonally adjusted)



Sources: Haver Analytics.

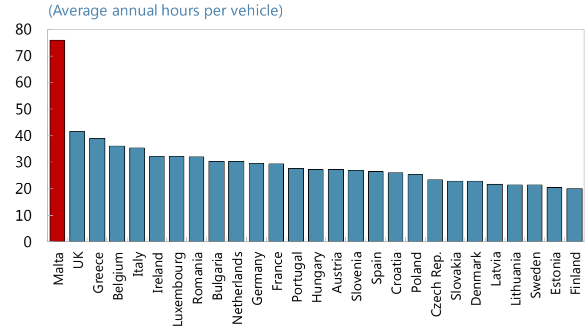
GDP per Capita in PPS, 2008-16
(EU average=100)



Sources: Eurostat and IMF staff.

2. **Pressure on physical infrastructure and public services has increased**. With rapid economic expansion, and inward migration, considerable investment needs have emerged. Transport congestion has become a key concern, given its adverse effects on business productivity and population welfare, while demand for health and education services has mounted. Furthermore, housing prices continued to increase, and the availability of low-cost housing has declined with adverse repercussions to the poor.

Road Congestion, 2015
(Average annual hours per vehicle)



Note: Malta's geography and urbanization affect cross country comparability.
Source: European Commission.

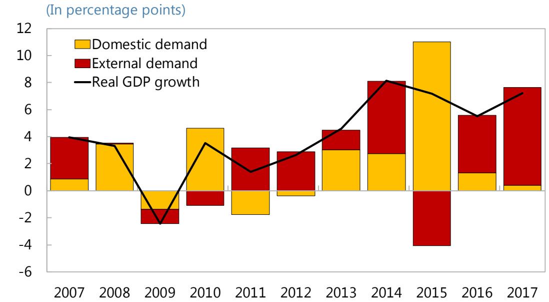
3. **The ruling party's convincing win in the June snap election suggests no major change in the thrust of economic policies**. The Labor Party's comfortable majority in Parliament provides a strong mandate to continue the recent economic policies and reform agenda, which were broadly in line with past IMF policy advice (Annex I). The party's platform focuses on creating jobs, enhancing physical and human capital, further diversifying energy sources, and improving waste management. Recognizing the social challenges, the government committed to increase social inclusion and improve housing affordability, including by expanding social housing.

RECENT DEVELOPMENTS AND POLICY PRIORITIES

4. **The Maltese economy continued to grow at a robust pace**. Activity expanded by 7.2 percent y/y in the first three quarters of 2017, following 5.5 percent in 2016. Net exports, driven by strong services exports and a sharp decline in imports, remain the key driver while the contribution of domestic demand to growth was broadly neutral. The latter mainly reflects strong private consumption growth that was fully offset by a sharp contraction in gross fixed capital formation, following sizable equipment investment in the aviation and energy sectors in previous years. High-frequency indicators suggest that economic activity continued to be robust in 2017Q4 with the Economic Sentiment Indicator exceeding its long-term average (Figure 2).

Malta: Contribution to GDP Growth /1

(In percentage points)



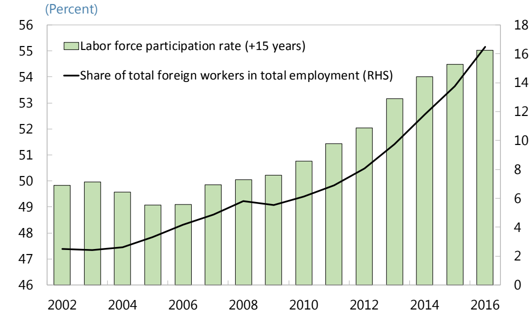
1/ 2017 indicates the growth in the first three quarters relative to the same period in 2016.

Sources: Haver and IMF staff.

5. **Unemployment declined further and inflation increased modestly**. Strong job creation, mainly in services, lowered unemployment to 4 percent in 2017Q3 from 5.2 percent at end-2015. Labor supply increased steadily on the back of continued inflows of foreign workers and rising female labor force participation, thus keeping wage pressures contained on aggregate. The weak wage dynamics, together with subdued price growth of imported goods, contributed to low inflation, although, more recently, HICP and core inflation picked up modestly to about 1.5 percent as prices of services accelerated.

Malta: Labor Participation Rate and Foreign Workers

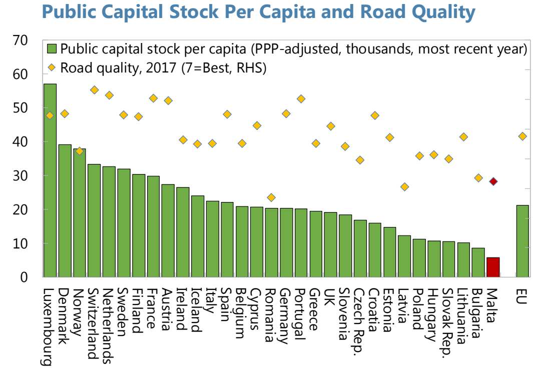
(Percent)



Sources: Eurostat and Jobplus.

6. **Malta is tackling infrastructure gaps amid significant challenges.** The government has taken steps to improve energy efficiency and diversification. However, physical infrastructure has not kept pace with economic development (Selected Issues Paper I). Public capital stock per capita is estimated to be the lowest among EU countries, and high density of car ownership, coupled with weak road quality, has led to severe congestion, with implications for transportation costs, productivity, and public health. To improve the efficiency and quality of transportation, the government adopted the [National Transport Strategy and Transport Master Plan](), and embarked on an ambitious plan to revamp the road network over 7 years at an estimated cost of €700 million (6.5 percent of projected 2017 GDP).

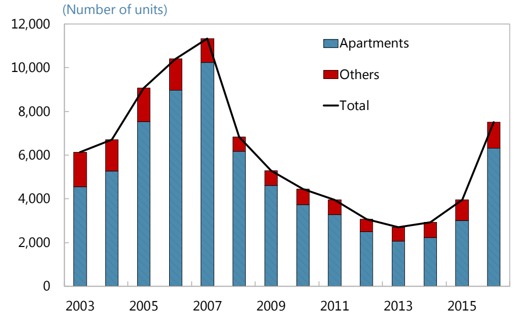
Public Capital Stock Per Capita and Road Quality



Sources: World Economic Forum, and IMF Investment and Capital Stock Dataset.

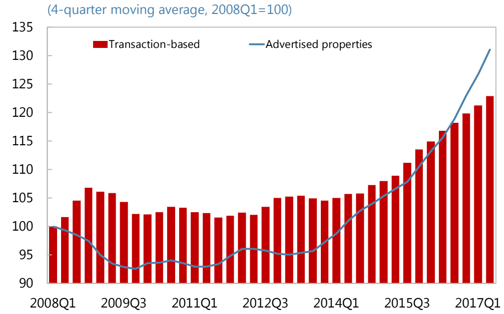
7. Property prices continued to increase owing to strong demand. While new construction is underway, rising disposable incomes, continued influx of foreign workers, higher use of online accommodation services by tourists, and—given low interest rates—portfolio rebalancing towards property investments continued to push property prices and rents upwards. Demand was also fueled by the Individual Investor Program (IIP, Box 1), the extension of the first home buyers stamp duty relief, and the reduced tax rate on rental income. The advertised and the transaction-based house price indices increased by 13 percent and 5 percent y/y in the first half of 2017, respectively, following strong gains in 2014-16.

Malta: Development Permits for Dwellings
(Number of units)



Sources: Central Bank of Malta.

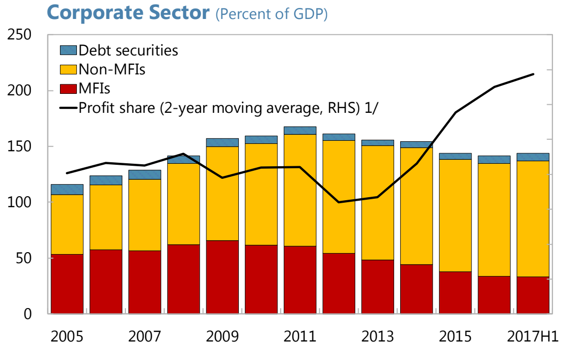
Malta: Residential Property Prices
(4-quarter moving average, 2008Q1=100)



Sources: Central Bank of Malta, Eurostat, and IMF staff.

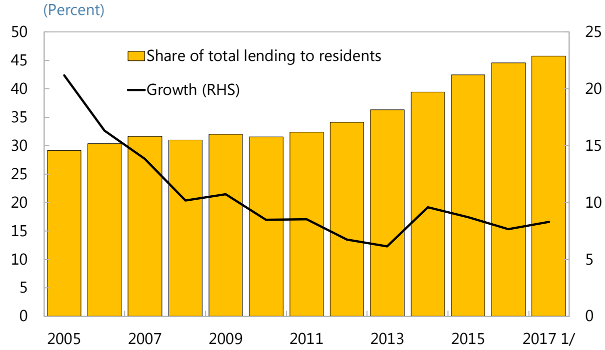
8. Bank lending remained focused on mortgages as the non-financial corporate (NFC) sector has increasingly relied on nonbank financing. Strong mortgage lending has kept household debt elevated compared to historical average at around 110 percent of gross disposable income. Meanwhile, bank credit to the NFC sector contracted further reflecting both demand and supply factors. On the demand side, continued deleveraging of highly-leveraged firms, expansion of less capital-intensive sectors, and a shift to nonbank financing sources weighed on bank lending to NFCs (Selected Issues Paper II). Firms' increased profitability may also have contributed to lower demand for bank loans. Credit supply conditions for NFCs remain tight, with lending rates above the euro area average. Notwithstanding recent improvements, legacy corporate non-performing loans (NPLs) remained elevated at 10 percent while NFC debt, which largely reflects intercompany loans, stood at about 135 percent of GDP in 2017Q2. The opposing trends of mortgage and corporate loans brought the share of mortgages in total lending to a record-high of 45 percent.

Malta: Financing and Profitability of the Non-Financial Corporate Sector (Percent of GDP)



1/ Gross operating surplus as a share of gross value added.
Sources: Central Bank of Malta and IMF staff.

Malta: Mortgage Lending
(Percent)



Sources: Haver and IMF staff.
1/ Average growth of the first ten months.

Box 1. Malta's Individual Investor Program (IIP)

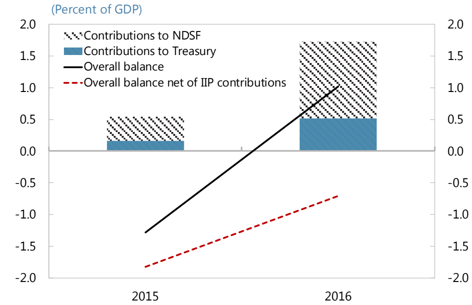
Malta's IIP was introduced in 2014. It is a citizenship-by-investment program that allows individuals to acquire citizenship in exchange for major investments in the Maltese economy. Similar programs in other countries have proliferated in recent years and, while they differ in their design and conditions, they all confer citizenship with limited residency requirements and financial contributions to the state (Gold and El-Ashram, 2015).

The IIP is capped at 1800 successful applications, although the government is considering to extend the program. Since its inception, the IIP received about 1000 applications, with most applicants coming from non-EU European and Middle-Eastern countries. The application process is subject to stringent due-diligence by Identity Malta, resulting in a rejection rate of around 20 percent. By October 2017, more than 800 applications were approved.

The cost of the IIP is relatively high compared to other citizenship programs. It requires an investment in financial instruments for a minimum value of €150,000, and in real estate (by purchasing property for a minimum value of €350,000, or leasing for at least €16,000 per annum), with a minimum holding period of five years. Individual applicants must also contribute €650,000, of which 10 percent is retained by Identity Malta and Henley & Partners as fees. The remainder goes to the Treasury's Consolidated Fund (30 percent), and the National Development and Social Fund (NDSF) (70 percent) to be used for investment projects in areas such as health, education, social housing, and research and innovation (R&I).

The IIP has generated significant fiscal revenues. Contributions to the Treasury and the NDSF rose from €50 million in 2015 to €172million in 2016 (0.5 and 1.7 percent of GDP, respectively). In 2017, staff project these inflows to reach €230 million, roughly equivalent to 2.1 percent of GDP and 5.4 percent of fiscal revenue. As of November 2017, no resources from the NDSF had been committed to specific projects.

IIP Inflows and Fiscal Balance
(Percent of GDP)

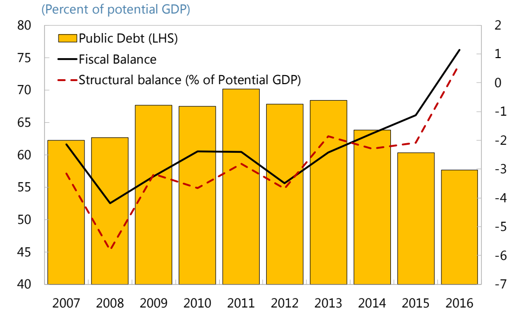


Source: Maltese authorities and IMF staff calculations.

Citizenship-by-investment schemes involve potential challenges and risks. Fiscal challenges include achieving a prudent management of the inflows, which might be volatile and unsustainable. Macro-financial risks could be triggered by a rapid influx of housing investment, leading to property market bubbles. Reputational and money laundering risks may arise if the due-diligence procedure is not sufficiently rigorous.

9. **The 2016 fiscal balance outperformed the budget target, registering a surplus for the first time in three decades.** The 2016 fiscal balance recorded a surplus of 1.1 percent of GDP compared with a budget deficit target of 1.1 percent of GDP. The improvement reflects stronger-than-anticipated economic expansion and tax revenues, buoyant IIP proceeds, and lower-than-expected capital expenditure. Contained growth of current expenditure backed by the recent spending reviews also contributed to the overperformance. The structural balance registered a small surplus, complying with the government's MTO of a structural balance (Figure 3). The public debt-to-GDP ratio declined further to about 58 percent.

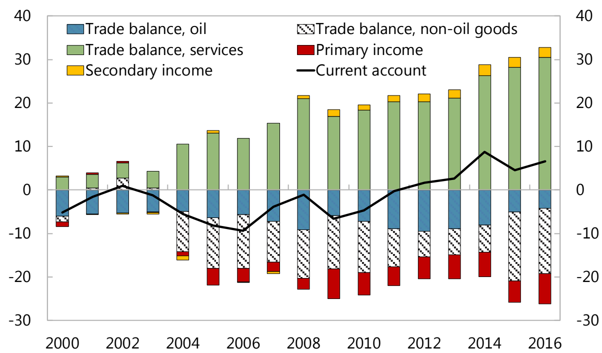
Malta: Public Debt and Fiscal Balance
(Percent of potential GDP)



Sources: Eurostat; and IMF staff calculations.

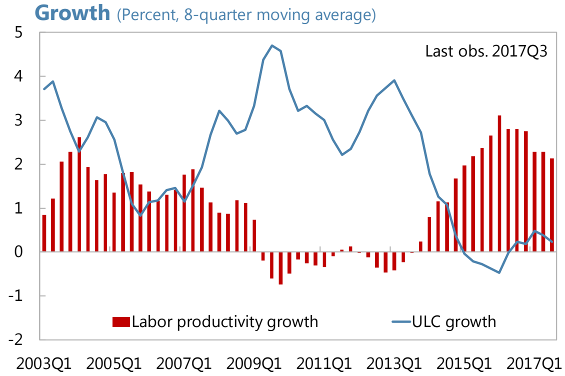
10. Fast-growing services exports continue to enhance Malta's external position. In the first three quarters of 2017, the current account posted a surplus of about 13 percent of GDP, following a surplus of 6.6 percent of GDP in 2016. The sizable surplus—largely reflecting robust services proceeds of tourism, remote gaming, and aviation as well as lower imports of goods—contributed to an increase in the net international investment position (NIIP) to about 63 percent of GDP in 2017Q3 from 47 percent in 2016Q4. Strong productivity gains kept the growth of unit labor costs (ULC) subdued in 2016, supporting competitiveness. The external sector assessment suggests that the external position is broadly in line with fundamentals (Annex II).

Malta: Current Account Components
(percent of GDP)



Sources: Haver Analytics and IMF staff.

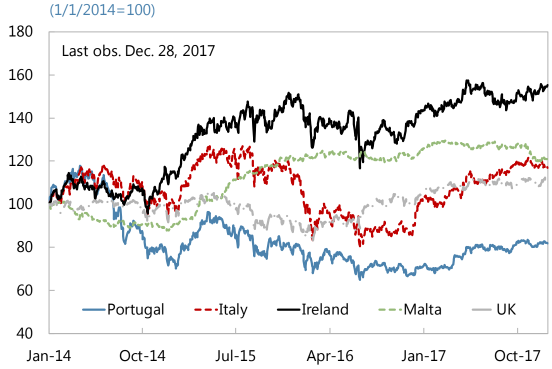
Malta: Labor Productivity and Unit Labor Cost (ULC) Growth (Percent, 8-quarter moving average)



Sources: Haver and IMF staff.

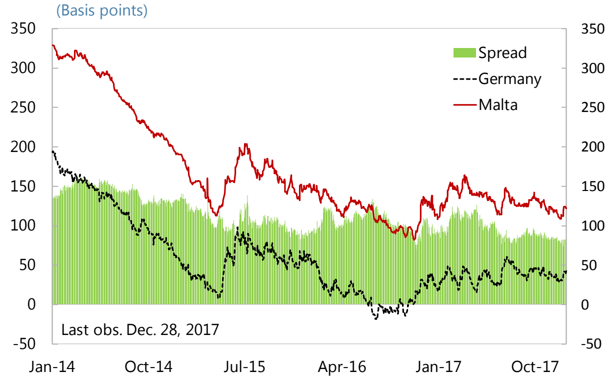
11. Financial conditions remained supportive, despite a modest pickup in long-term yields. Strong demand has kept the 10-year government bond yields low with the spread over German bunds fluctuating in a relatively narrow range of 80-120bps. Bank lending rates for both NFCs and households remained on a downward trend. Malta's stock index, which has been relatively isolated from external factors, declined moderately in 2017Q4.

Stock Market Indices
(1/1/2014=100)



Source: Bloomberg Financial Market L.P.

Ten-Year Sovereign Bond Yields
(Basis points)



Source: Bloomberg Financial Market L.P.

OUTLOOK AND RISKS

12. Growth is projected to remain robust throughout the forecast horizon. Real GDP is projected to grow by 6.8 percent in 2017 and 5.7 percent in 2018, supported by solid growth of exports and private consumption. Notwithstanding buoyant construction activity and improved firms' balance sheets, large base effects are expected to result in contracting investment and imports in 2017, before bouncing back in 2018. Highly elastic foreign labor supply and a rising share of less-capital intensive services sectors in the economy result in procyclical potential growth estimates and have limited overheating pressures. Over the medium term, growth is expected to converge to its potential of just above 3 percent, supporting a gradual narrowing of the output gap, while inflation, which is largely driven by import prices, is expected to pick up modestly. Domestic demand is projected to become the main contributor to growth as continued favorable labor market dynamics will support private consumption, while infrastructure upgrades will contribute to investment. Steady expansion of exports-oriented services, including gaming, will keep the contribution of net exports to growth positive and help sustain current account surpluses.

Malta: Macroeconomic Projections, 2016–22
(Percentage change unless indicated otherwise)

			Projections				
	2016	2017 Est.	2018	2019	2020	2021	2022
Real GDP	5.5	6.8	5.7	4.6	4.0	3.5	3.2
Domestic demand	1.4	1.8	5.4	4.0	3.3	2.7	2.4
Private consumption	3.1	4.3	4.2	3.6	3.1	2.6	2.4
Public consumption	-2.5	4.8	5.2	4.0	3.6	3.2	3.0
Fixed investment	-0.9	-8.0	8.4	5.0	3.5	2.5	1.8
Exports	4.5	2.5	3.2	3.3	3.3	3.3	3.3
Imports	1.6	-1.5	2.8	2.6	2.6	2.6	2.6
Current account (percent of GDP)	6.6	10.3	9.6	9.2	8.9	8.8	8.7
Potential GDP growth	6.1	6.4	5.9	5.1	4.5	4.0	3.3
Output gap	1.4	1.8	1.6	1.2	0.7	0.3	0.1
Consumer Prices (HICP)	0.9	1.3	1.7	1.8	1.9	1.9	2.0

Source: National Statistics Office; and IMF staff projections.

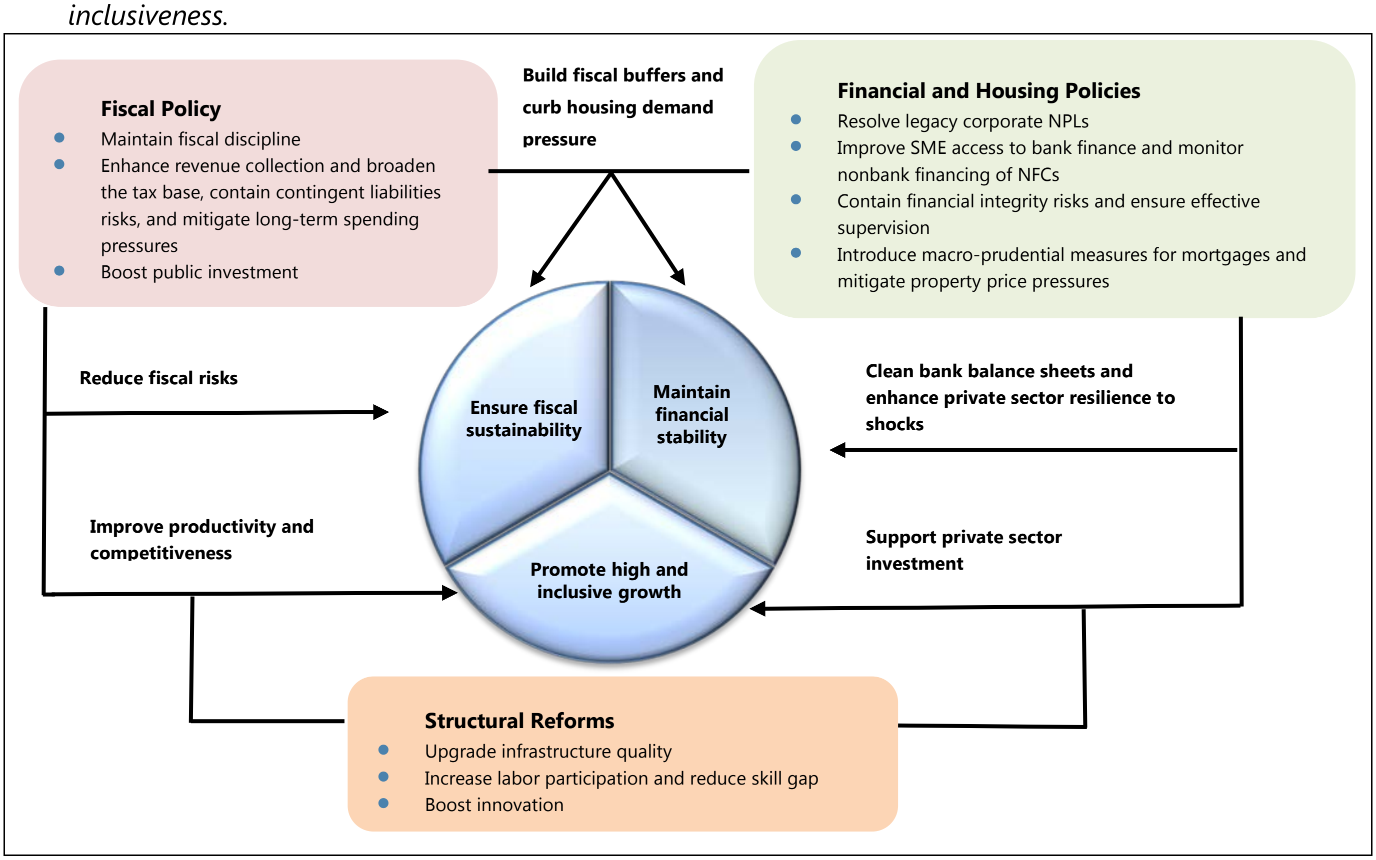
13. Risks to the outlook are broadly balanced (Annex III, Risk Assessment Matrix). Structurally weak growth in advanced economies, policy and geopolitical uncertainties, and increasingly inward looking policies, including in the context of post-Brexit arrangements, could undermine cross-border trade, confidence, and growth, while possible changes in international corporate taxation could adversely affect FDI inflows, tax revenues, and the external position. Domestically, private consumption could prove stronger-than-expected if labor market developments translate into strong wage increases, and robust implementation of infrastructure plans and strong SME investment—including due to MDB operations—could lift investment growth above baseline. Slow progress in addressing the remaining structural weaknesses could undermine competitiveness and growth prospects. Strong increases in housing prices and mortgage lending may increase financial stability risks and limit potential growth by deterring foreign workers.

Authorities' Views

14. **The authorities shared staff's assessment on the outlook and risks**. They expressed confidence that the economy will continue to perform strongly, supported by solid employment growth, buoyant services activity, and strengthening domestic production with declining import content. The authorities agreed that the risks are broadly balanced, though acknowledged that slower growth in trading partners and a hard Brexit are key external downside risks. They also noted that rapid and uncoordinated changes in international corporate taxation might pose a risk and stressed that EU and OECD initiatives should be closely synchronized. The authorities did not see any material overvaluation in the property market, pointing to housing price increases broadly in line with income growth and household indebtedness declining as a share of GDP. They agreed, however, that potential delays in supply of new residential units may result in sustained growth of housing prices and upward pressure on wages, thus jeopardizing competitiveness. The authorities viewed the external position as in line with fundamentals.

POLICY DISCUSSIONS

Malta's key challenges are to enhance the economy's resilience to shocks, sustain the high growth while avoiding overheating pressures, and make it more inclusive. This requires continued work to reduce fiscal risks, including by building larger fiscal buffers, and ensure that fiscal policy supports a balanced growth; safeguard financial stability and strengthen private sector balance sheets; and address the remaining structural impediments to boost productivity and bolster potential output and inclusiveness.



MAINTAIN A PRUDENT FISCAL POLICY

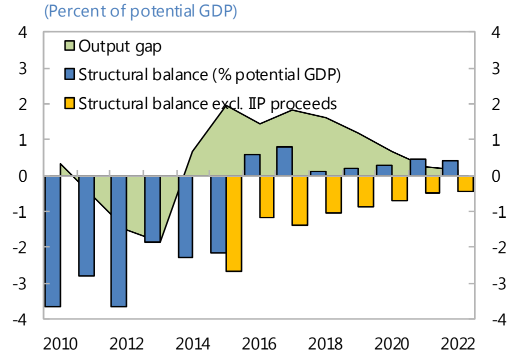
Build Fiscal Buffers and Tackle Fiscal Risks

15. The government is set to over-achieve the 2017 budget target. Outturns for the first six months point to strong revenue growth mainly thanks to higher-than-expected IIP and tax proceeds. Additionally, lower-than-expected capital expenditure was partly compensated by elevated spending related to Malta's EU presidency and healthcare. Based on these trends, staff estimate a surplus of 1.4 percent of GDP in 2017, well above the initial budget deficit target of 0.5 percent, and further moderation of the public debt-to-GDP ratio to about 54 percent. The 2017 structural balance is estimated to have further improved to 0.8 percent of potential GDP.

16. Plans to build further fiscal buffers and continue complying with the MTO are appropriate. The 2018 budget and the medium-term fiscal strategy aim to continue reducing the public debt ratio by maintaining a headline surplus at 0.5 percent of GDP in 2018-20. Based on the authorities' projections, this trajectory would result in a continued compliance with the MTO, although some structural relaxation is envisaged in 2018, largely related to the projected decline in IIP proceeds. Staff view the government's plans as appropriate, given the economy's cyclical position and possible vulnerabilities, which emanate from Malta's high openness and susceptibility to external shocks, as well as the outstanding fiscal risks, including elevated contingent liabilities, demographic pressures, and possible changes in international corporate taxation (see below).

17. Structural measures beyond the IIP would put the fiscal position on a stronger footing. Staff's baseline scenario suggests that the fiscal targets are achievable, as the fiscal surplus is projected to stand at 0.8 percent of GDP in 2018 and then moderate slightly to 0.5 percent of GDP at the end of the forecast horizon. Nevertheless, the attainment of these targets partly depends on IIP proceeds, which are volatile and difficult to predict. Even with the authorities' intention to extend the IIP, it is expected to remain limited in scope, presenting a challenge for long-term fiscal adjustment. Excluding IIP revenues, staff project the structural fiscal balance to improve by a cumulative 0.9 percent of potential GDP in 2018-22, but remain negative. Hence, identifying additional measures would help strengthen the fiscal position, particularly if IIP revenue underperforms. Public debt is projected to reach 41.2 percent of GDP in 2022, yet it remains vulnerable to contingent liability shocks. This underlines the need to further increase fiscal buffers, including by saving future revenue windfalls (Annex V).

Malta: The Structural Balance and Output Gap
(Percent of potential GDP)



Source: IMF staff.

Malta: Fiscal Estimates and Projections
(Percent of GDP)

		Staff's Projections				
	2017 Est.	2018	2019	2020	2021	2022
Revenue	39.6	38.9	38.7	38.4	38.4	38.4
Expenditure	38.1	38.1	38.0	37.8	37.8	37.9
Overall balance	1.4	0.8	0.7	0.6	0.6	0.5
Structural balance	0.8	0.1	0.2	0.3	0.5	0.4
Structural balance, excl. IIP proceeds 1/	-1.4	-1.0	-0.9	-0.7	-0.5	-0.5
Public debt	54.2	50.1	47.3	44.4	42.4	41.2

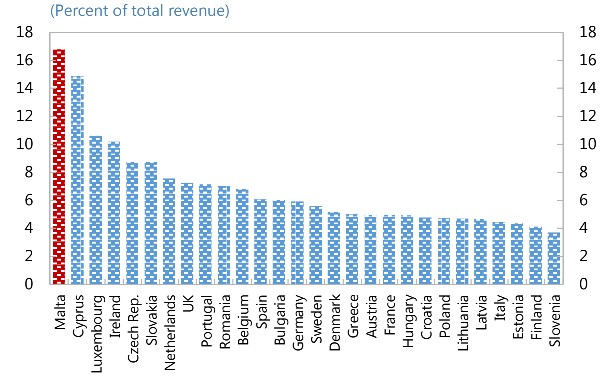
Source: IMF staff.
1/ Not accounting for IIP-related spending envisaged via the NDSF.

18. Fiscal risks need to be managed carefully to ensure public finances' sustainability. Efforts are needed to:

- **Broaden the tax base and strengthen revenue collection.** Malta's share of corporate tax revenue in total revenue is much higher than in other EU members. With a large presence of foreign-owned firms and pro-business tax regime, possible changes in international corporate taxation may affect Malta unfavorably, thus calling for further broadening the tax base and increasing revenue collection, including by strengthening VAT compliance.[1] The recent measures to combat tax evasion and avoidance, such as establishing the Joint Enforcement Unit, strengthening the IT system to monitor tax compliance, and consolidating, streamlining and automatizing services of revenue departments, are steps in the right direction. Further increasing female labor participation would also help broadening the tax base.

Corporate Income Tax Revenue, 2016

(Percent of total revenue)

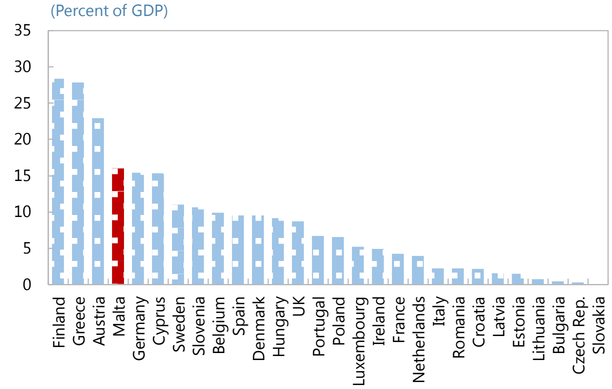


Sources: Eurostat and IMF staff.

- **Contain contingent liability risks.** Government guaranteed debt stood at 14 percent of GDP in 2016 and it is projected to remain elevated in the coming years, even after the termination of the temporary guarantees to ElectroGas (about 4 percent of GDP). Advancing the restructuring and maintaining close monitoring of financially weak SOEs would help mitigate fiscal risks.

Government Guarantees, 2015

(Percent of GDP)



Sources: Eurostat.

- **Address long-term demographic challenges.** Age-related spending, particularly pension and healthcare, is projected to increase significantly and faster than in most peers over the long term (Figure 3).[2] The government has implemented measures to address the adequacy and sustainability of the pension system and introduced incentives to deter early retirement and increase voluntary saving. However, further adjustments—as part of the planned periodic reviews—are needed to align the contributory period with life expectancy and better link the life-time incomes to pensionable incomes. Improving the efficiency of healthcare spending by building on the recommendations of the recent spending review would also help contain age-related spending growth.

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[1] According to the recent EC report, Malta's VAT compliance gap, albeit declining rapidly, stood at 23 percent in 2015, above the EU average of 13 percent.

[2] The EC's 2015 Aging Report estimates that Malta's age-related spending are set to increase by 6.6 percentage points of GDP by 2060.

Strengthen Infrastructure to Support Growth

19. Increasing capital expenditure would buttress Malta's competitiveness and welfare. In view of Malta's estimated low public capital stock per capita and weak infrastructure quality, staff support the authorities' plans to upscale public investment to revamp the road network, encourage higher utilization of public transportation, and improve public services. The envisaged road overhaul and the government's Transport Master Plan would help mitigate congestion and increase business productivity. While Malta's public investment efficiency is broadly at par with the average of advanced economies, higher efficiency would improve Malta's infrastructure, both in quality and quantity, thus fostering a greater impact on growth.[3]

20. Raising public investment in a budget-neutral manner would help build further fiscal buffers and support a more balanced outlook. To ensure that public finances remain on a sound footing and avoid unwarranted fiscal stimulus when output is estimated at above potential, public investment should increase in a budget-neutral manner and be well-prioritized, based on a prudent cost-benefit assessment. Raising EU funds' absorption and spreading it evenly within the programming period as well as strengthening revenue collection would help finance additional investment needs.[4] Finally, potential savings from the implementation of the recent spending reviews and execution of additional reviews could be redirected towards investment.[5]

Authorities' Views

21. The authorities expressed commitment to a continued prudence of fiscal policy. They expected the 2017 overall budget balance to remain in surplus of nearly one percent of GDP, noting that strong IIP proceeds and some potential delays in capital spending pose an upside risk. The authorities re-affirmed their medium-term fiscal targets and continued efforts to exercise fiscal prudence through a conservative revenue projection. While expecting buoyant IIP proceeds, they noted their intention to ensure compliance with the MTO, net of IIP. The authorities plan to further reduce fiscal risks, including by considering to expand other possible revenue sources, addressing tax evasion, improving the balance sheets of financially-weak SOEs, and reviewing the effectiveness of measures to mitigate age-related spending pressures periodically. They confirmed their intention to upgrade the road infrastructure, partly by using IIP proceeds accumulated in the NDSF.

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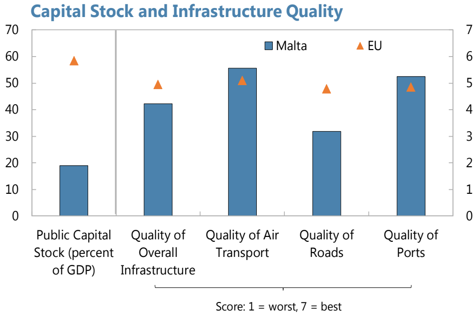
[3] Staff's analysis indicates a public investment efficiency gap of about 20 percent. Closing this gap would reduce the financing need of the road upgrade plan by €140 million.

[4] Closing half of Malta's estimated VAT gap would free around €100 million per year.

[5] Previous spending reviews point to savings of €25 million over a 3-years in social security benefits, and €11 million over a 2-year period in healthcare. An additional spending review is envisaged to cover Management Efficiency Unit and the Malta College for Arts, Science and Technology.

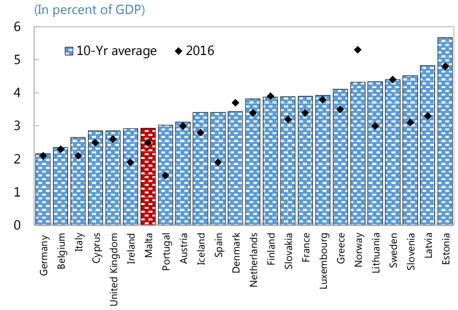
Capital Stock and Infrastructure Quality



Sources: World Economic Outlook, World Development Indicators, IMF Investment and Capital Stock Dataset, and World Economic Forum.

Public Investment

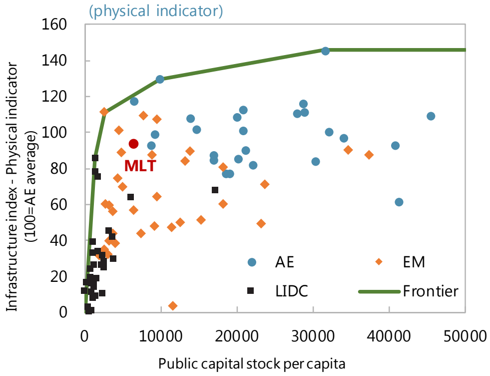
(In percent of GDP)



Sources: Eurostat and IMF staff.

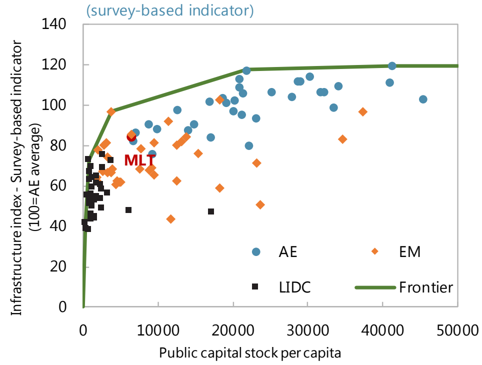
Public Investment Efficiency Frontier /1

(physical indicator)



Public Investment Efficiency Frontier /1

(survey-based indicator)



1/ The physical indicator combines data on the volume of economic infrastructure and social infrastructure while the survey-based indicator is based on the World Economic Forum's survey of the quality of key infrastructure services.
Sources: IMF staff.

SAFEGUARD FINANCIAL STABILITY

Repair Corporate Balance Sheets and Ensure Prudent Lending

22. The domestic banking system remains well-capitalized and profitable, but faces several challenges. Core domestic banks continued to expand their balance sheets and remained highly liquid with a loan-to-deposit ratio at below 60 percent. Stable net interest margin and contained operating costs kept banks' profitability at healthy levels, thus supporting their loss-absorption capacity (Figure 4). Going forward, banks' profitability remains subject to headwinds from subdued lending to the NFCs, a prolongation of the ECB's accommodative monetary policy stance, and upcoming regulatory changes, which may require higher loan-loss provisions (IFRS9) and may lead to higher funding costs (MREL). Further challenges stem from the elevated legacy NPLs, especially among small banks, and the high and increasing concentration of property-related loans.[6]

Core Domestic Banks: Key Financial Soundness Indicators

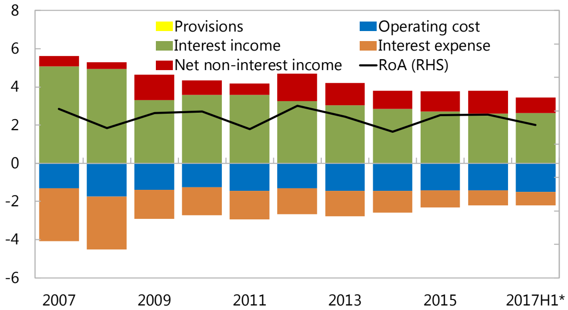
(Percent)

	2013	2014	2015	2016	2017H1
Regulatory Tier 1 capital	12.9	11.5	12.2	13.6	13.4
Loan to deposit	67.8	64.0	58.2	56.0	58.8
Return on assets	0.9	0.7	0.7	0.8	0.6
Interest margin to gross income	63.6	64.8	64.5	62.2	68.0
Non-interest expenses to gross income	47.1	51.2	54.2	52.7	56.5
NPL ratio	9.0	7.6	7.1	5.3	4.6
Coverage ratio	37.9	40.4	43.5	45.9	46.3
Loan-to-Value, residential properties	71.5	74.2	75.3	75.1	72.7
Liquid assets to short term liabilities	51.7	50.4	50.2	55.8	55.2

Source: Central Bank of Malta.

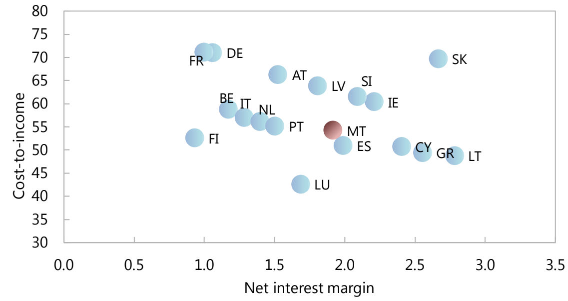
[6] Malta's FSAP is scheduled for 2018.

Maltese Domestic Banks: Profits and Losses
(Percent of assets)



* RoA is based on a four-quarter moving average.
Sources: European Central Bank and IMF staff.

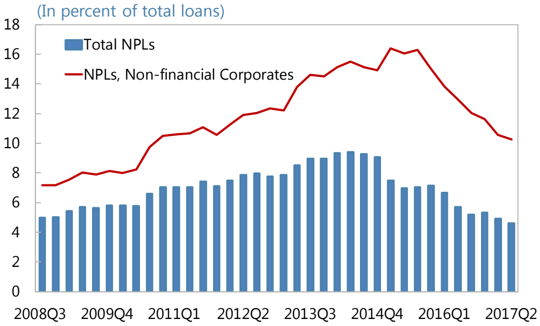
Net interest Margin and Cost-to-Income Ratio, 2017H1 1/



1/ Domestic banking group and stand-alone banks. Net interest margins figures are annualized.
Sources: European Central Bank and IMF staff.

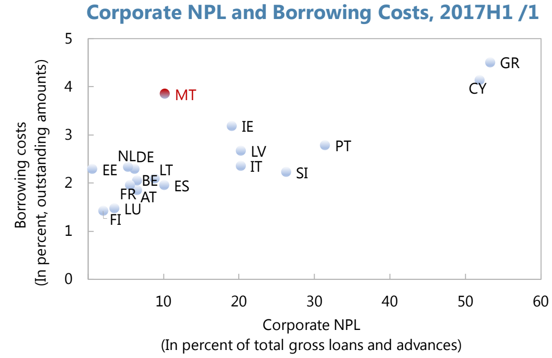
23. Higher loan-loss provisions and enhanced insolvency framework would support further NPL reduction. While bank asset quality has improved steadily, owing to buoyant economic conditions and sizable write-offs, elevated legacy corporate NPLs, which partly reflect distressed loans in construction and real estate activities, continue to weaken the credit channel by contributing to firms' high borrowing costs. The recent regulatory response, requiring credit institutions to reduce their overall NPL ratio to below 6 percent over five years, would give banks further impetus to continue reducing the share of distressed assets. The introduction of IFRS9, which will result in higher provision coverage ratios, would also support these efforts. As the lengthy insolvency proceedings remain a key impediment for NPL resolution, further improvements in the insolvency process, in addition to the recent amendments to the Companies Act (March 2017), remain critical.[7] With persistent real estate appreciation, it is important to maintain prudent collateral valuation.

Malta: Non-Performing Loans /1
(In percent of total loans)



1/The data souce up to 2014Q4 is BR06 and thereafter from FINREP.
Source: Central Bank of Malta.

Corporate NPL and Borrowing Costs, 2017H1 /1



1/ NPLs of domestic banks.
Sources: European Central Bank, Central Bank of Malta, and IMF staff.

24. Improving SMEs' access to finance and diversifying their funding sources would foster resilience and growth, but adequate safeguards are needed to contain risks.

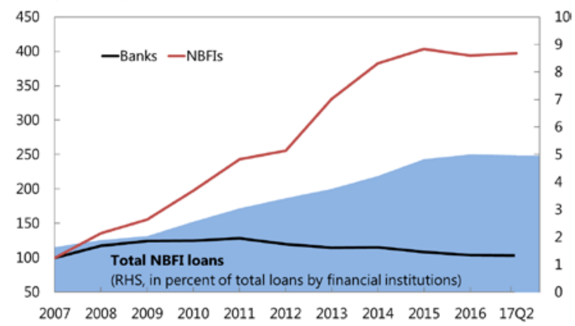
- *Malta Development Bank (MDB).* The MDB, which is planned to commence operations in the second half of 2018, could alleviate SMEs financing constraints by providing loans and

[7] Recent amendments introduce a streamlined process to wind up firms, including through out-of-court mediation, and a time limit of approximately one year for the restructuring process.

guarantees, via commercial banks, to viable firms with limited access to finance due to insufficient collateral and required loan duration.[8] As the MDB's operational framework is being set up, it is important to ensure robust governance structure, prudent risk assessments, adequate supervision, and well-designed origination rules to contain contingent liability risks to public finances.

- *Lending by Non-Bank Financial Institutions (NBFIs).* Although still contained (about 2 percent of GDP, 2017Q2), corporate loans issued by NBFIs have quadrupled since 2007 and could emerge as an important funding source for NFCs (Selected Issues Paper II). Closing data gaps and better monitoring these trends would help ensure that credit provision by these institutions does not lead to excessive buildup of corporate leverage or large indirect exposure of banks to corporates, particularly if concentrated in specific sectors.

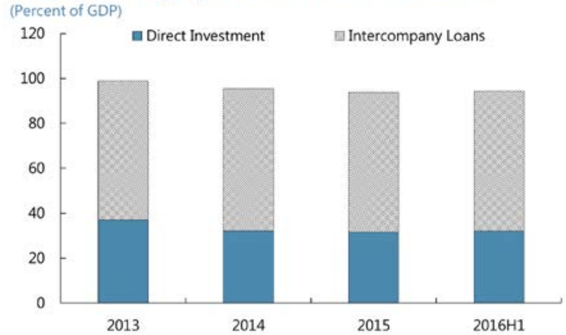
Malta: Loans to Nonfinancial Corporations
(2007=100)



Sources: Central Bank of Malta, European Central Bank, and IMF Staff.

- *Intercompany lending.* Intercompany loans within Malta have replaced bank loans as the largest financing source for NFCs. While this development seems to have served firms' financing needs well, the strong linkages between corporates may increase contagion risks. Lending between unrelated corporates is subject to licensing by Malta Financial Services Authority (MFSA), but evidence suggests that large exposures between resident corporates are not monitored as closely as bank lending. Stepping up efforts to better monitor intercompany liabilities would help mitigate financial stability risks.

Malta: Intercompany Loans and Direct Investment[1]
(Percent of GDP)



Sources: National Statistics Office, Central Bank of Malta and IMF Staff.
1/ Inward direct investment in nonfinancial sectors.

Support Effective Supervision and Contain Financial Integrity Risks

25. The growing size and complexity of the financial sector represent a challenge for supervision. The increasing number of financial firms, the rapid developments of new products, and the evolving regulatory environment have put the MFSA under strain, despite its recent expansion. Further pressure emanates from tight labor market conditions, which contributed to high MFSA staff turnover. Ensuring that the MFSA has adequate resources is critical to preserve its operational independence, improve its capacity to retain experienced staff and support the continuation of effective supervision. The recently launched public consultation, aiming to strengthen the MFSA, could be a useful platform to attain this objective.

[8] The MDB Act was enacted in May 2017. See description of the MDB's modalities in Box 3 in the 2016 Article IV Staff Report.

26. Sustained efforts are needed to contain financial integrity risks. Effective implementation of the Anti-Money Laundering (AML) framework is critical given the size of Malta's financial sector, the fast-growing remote gaming activity, and high demand for the IIP, all of which are exposed to significant money laundering risks. Continuing strengthening the collaboration between the competent supervisors and regulators, and stepping-up enforcement to ensure robust and consistent compliance with AML requirements would support this goal. The recent transposition of the EU's 4th AML Directive into national law (December) is a step in the right direction. Finalizing the National Risk Assessment to inform risk-based approach to AML should complement these efforts.[9]

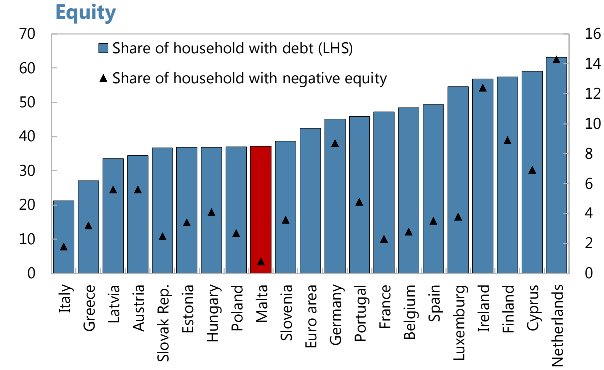
Authorities' View

27. The authorities remain committed to safeguard financial stability. The resolution of legacy corporate NPLs and improvement of the insolvency framework remains a priority. In this context, the recent regulatory changes and introduction of IFRS9 would improve provisioning levels, while new legislation, which would streamline the liquidation procedures for firms, is underway. The authorities agreed on the need to close data gaps with regards to intercompany lending and NBFI credit, and step up oversight of nonbank corporate financing to mitigate potential financial stability risks. They expected an improvement in SMEs access to finance with the MDB, but concurred that MDB's lending program should be carefully supervised. Finally, the authorities confirmed their commitment to strengthen the AML/CFT framework, and plan to finalize the National Risk Assessment report shortly. They recognized the need to ensure adequate resources to the MFSA to maintain effective supervision.

ADDRESS HOUSING MARKET PRESSURES

28. Strong momentum in the housing market may increase financial stability risks. Household balance sheets are generally sound with a low default rate and financial wealth exceeding peer levels. However, given the high exposure of core domestic banks to property-related loans, a sharp drop in house prices or increases in interest rates may lead to a negative spiral of low lending and investment and adverse macro-financial repercussions. Future unwinding of real estate investments by successful IIP applicants may also put downward pressure on housing prices. While staff does not see immediate financial stability risks, persistent strength in mortgage lending and sustained demand for properties without a corresponding increase in household income could lead to significant imbalances. Staff's analysis—although subject to uncertainty—indicates that housing prices have entered a modest overvaluation territory by several metrics (Annex IV). Moreover, about 80 percent of the respondents to a recent central bank's survey viewed residential properties as overpriced in 2016.

Percentage of Households with Debt and Negative Equity



Source: Household Finance and Consumption Survey (2016), European Central Bank.

[9] Malta's assessment against the FATF standards is tentatively scheduled for 2018.

29. Steps to pre-empt a potential buildup of risks in the housing market are therefore warranted, including by:

- Deploying targeted macro-prudential limits for mortgages (e.g. limits on loan-to-value and debt service-to-income ratios) to enhance the resilience of bank and household balance sheets to a possible sharp reversal in market conditions. Closing the remaining data gaps on borrower characteristics would help calibrating these measures effectively.
- Ensuring that fiscal incentives do not amplify the housing cycle by aligning the tax rate on rental income with the tax rates on other sources of income. Introducing periodic reviews of the scope and parameters of the IIP, including the minimum real estate investment or leasing values, could help curb housing demand and may improve fiscal revenues' predictability.
- Repairing corporate balance sheets in the construction sector to increase housing supply.[10]

30. Accelerated delivery of social housing would mitigate the impact of rising housing prices on the poor. The government has taken measures to increase the availability of social housing units to low-income groups, including by incentivizing private investment through tax exemptions, and provision of financial incentives for the restoration of old properties to be loaned for social housing. Ensuring that eligibility criteria for rent subsidies and social home loans are prudently assessed and means-tested is important.

Authorities' View

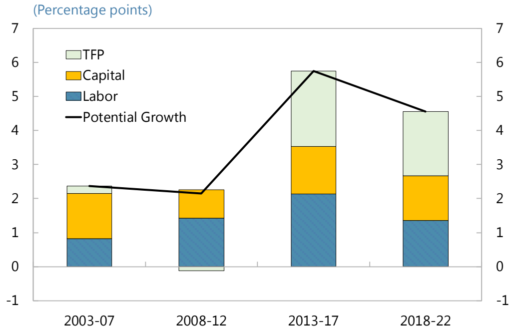
31. The authorities regarded property prices as broadly in line with fundamentals, but acknowledged strong demand pressures. They indicated that inflows of foreign workers and tourists are the key demand drivers in the housing market, with acute impact on rents. The reduced tax rate on rental income and the IIP were not viewed as major demand-side factors. The authorities emphasized that risks related to bank exposure to the property market are mitigated by the small fraction of buy-to-rent loans, the diversification of credit risk among many small borrowers, and conservative lending practices, including prudent haircuts on collateral values. However, they agreed that closing further data gaps is necessary, as they are evaluating possible macroprudential policies to mitigate financial stability risks. They intend to publish a White Paper with a view to strengthen the legal framework in the rental market, including through registration of rental contracts. They highlighted that several measures in the 2018 Budget will increase the availability of social housing.

SUSTAIN HIGH AND INCLUSIVE GROWTH

32. Addressing remaining structural weaknesses would support sustained and inclusive growth. Safeguarding the reform momentum by further upgrading human capital, addressing the structurally-low female labor force participation, and increasing investment in infrastructure and innovation would boost productivity, increase social inclusion—including of low-skilled population—and alleviate the constraints for future development.

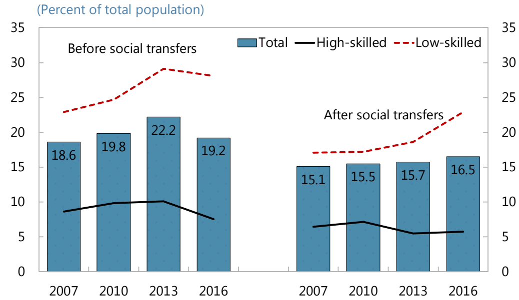
[10] NPLs in construction and real estate activities—although declining—stood at 25 percent in 2017Q2.

Malta: Contributions to Potential GDP Growth
(Percentage points)



Sources: Haver Analytics and IMF staff.

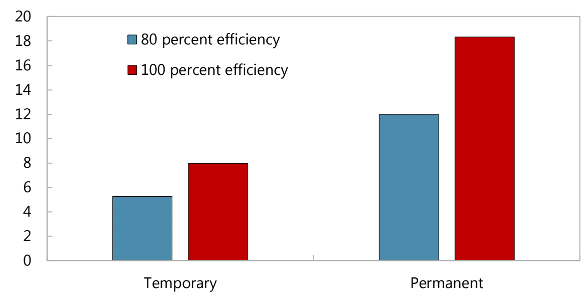
Malta: At Risk of Poverty or Social Exclusion /1
(Percent of total population)



Sources: Eurostat.
1/ Defined as 60 percent of the median equivalized income.

33. Closing the infrastructure gap would boost potential growth. Malta's potential growth—though relatively high compared to peers—remains constrained by insufficient and low-quality infrastructure. Upgrading infrastructure would enhance the productive capacity, crowd-in private investment, and support a sustainable convergence toward a higher income level. Staff's analysis suggests that a budget-neutral increase of public investment by one percentage point of GDP over a period of 7 years, broadly corresponding to the authorities' plan to upgrade road infrastructure, would result in a GDP gain of about 5 percent in net present value terms over 30 years. If the investment boost is permanent and accompanied with an increase in public investment efficiency, the output gain would increase significantly.

Malta: GDP Impact of Public Investment Boost
(net present value effect on GDP, in percent)

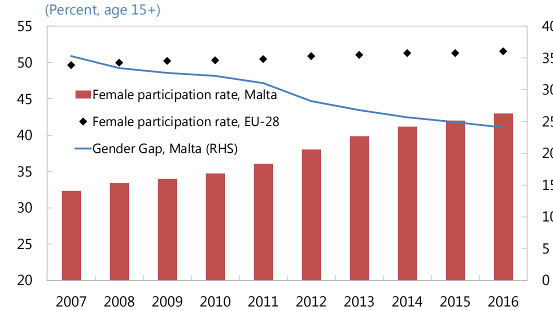


Source: IMF staff.
Note: The temporary shock denotes a public investment increase by 1 percent of GDP over 7 years. It remains at the elevated level in the permanent shock scenario. The NPV is discounted over 30 years at a 3 percent interest rate. Efficiency refers to public investment efficiency.

34. Continued efforts to strengthen labor supply will help enhancing the inclusiveness of growth. Priorities include:

- **Increasing female labor-force participation further**. Owing to recent make-work-pay policies, including the free childcare scheme, in-work benefits, and tapering of benefits for those entering employment, the female labor force participation rate has increased significantly in recent years. Nevertheless, the gender gap in labor force participation remains large, especially among older cohorts (Figure 6). While cultural factors play an important role, continued steps to incentivize women to work and delay retirement should be pursued.

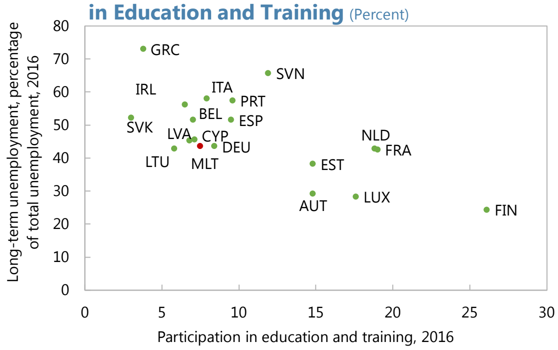
Labor Force Participation and Gender Gap 1/
(Percent, age 15+)



1/ Defined as the gap in participation rate between men and women.
Sources: Haver.

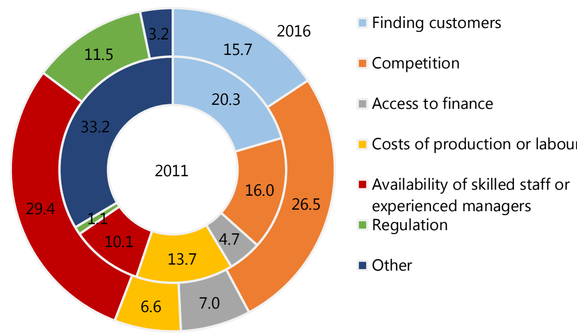
- **Upskilling and reskilling the labor force to improve employability prospects**. Notwithstanding significant progress, Malta's share of early school leavers remains elevated, with about half of the adults having a lower-secondary education attainment or less. Moreover, participation in lifelong learning and second chance education programs remains low. Due to rapid growth in high-skilled sectors, labor and skill shortages have emerged. The availability of skilled staff or experienced managers has become the most pressing problem of Maltese firms, resulting in increasing reliance on foreign labor. Recent initiatives to strengthen the vocational and training system would help contain the skill gap, decrease inactivity in the labor market, and reduce income disparities. These initiatives include the proposed Work-Based Learning Act, which provides a framework for developing effective work-placements, apprenticeships and internships, as well as the establishment of the National Skills Council (December 2016), which aims to better align education with business needs.

Long-Term Unemployment and Participation in Education and Training (Percent)



Sources: Eurostat and IMF staff.

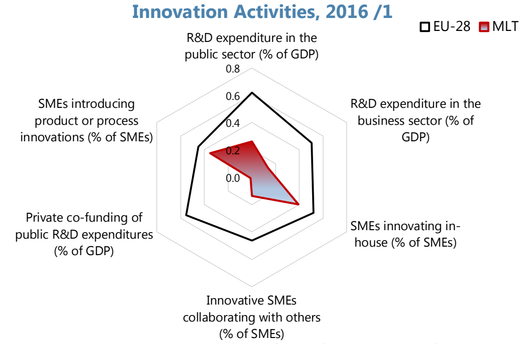
The Most Pressing Problem that Maltese Firms Face
(percent)



Source: Survey on the Access to Finance of Enterprises (SAFE), European Central Bank.

35. Strengthening innovation would sustain productivity growth. Malta continues to lag its peers on many fronts, reflecting low, albeit increasing, level of investment in R&I in both public and private sectors. Continued implementation of the National R&I Action Plan, which contains measures to enhance research infrastructure, upscale financial support for enterprises, and improve knowledge transfer through stronger links between academia and the private sector, would enhance SMEs' productivity, thus help boosting their growth prospects.

Innovation Activities, 2016 /1



1/ Based on normalized scores. A score of one reflects the best performer.
Source: European Innovation Scoreboard 2017 Database.

Authorities' view

36. The authorities agreed on the importance of addressing structural challenges. Their new plans on infrastructure investment prioritize reshaping and redefining road networks, enhancing multi-modal transportation, increasing the availability of social housing, and improving waste management. The National Skills Council (NSC) is developing strategies to improve work-based learning and digital skills to tackle labor and skills shortages. Additionally, Jobsplus, the Public Employment Services, has strengthened the efficiency and monitoring of its training programs aimed at low-skilled workers, while investing in targeted intervention and vocational programs to reduce early school leaving. The authorities reiterated their efforts to increase R&D intensity, including through schemes for small firms offered by Malta Enterprise and the National R&I Fund, as well as new NSC's initiatives to strengthen the links between the private sector and academia.

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37. The Maltese economy remains on a strong growth trajectory. Rapid expansion of export-oriented services, improved balance sheets, and solid job creation contributed to a robust growth in 2017 and kept unemployment at historically-low levels, despite continued inflows of foreign workers. The favorable economic performance is expected to persist in the coming years, albeit at a more moderate pace, with domestic demand as the main driver. Inflation is expected to pick up gradually, reflecting an increase in import prices and tighter labor market conditions, while buoyant services exports are projected to sustain current account surpluses. Risks to the outlook are broadly balanced, and the external position is assessed to be broadly in line with fundamentals.

38. Reducing the remaining fiscal risks and building larger fiscal buffers would add strength to Malta's fiscal position. As the economy keeps operating above potential, efforts are needed to ensure that fiscal policy is geared towards addressing the infrastructure challenges while avoiding unwarranted stimulus. The government's strategy to continue complying with the MTO and building larger fiscal buffers is therefore welcome, though identifying further structural measures to attain the MTO, net of IIP proceeds, would put the fiscal position on a stronger footing. With fiscal risks still elevated, it is important to continue to broaden the tax base and strengthen revenue collection, advance the restructuring of financially-weak SOEs, and address age-related spending pressures. A budget-neutral public investment push would help narrow Malta's infrastructure gap, thus supporting the population's well-being and buttressing competitiveness.

39. Steps to advance balance sheet repair and strengthen the oversight of nonbank lending would enhance financial sector resilience. Continued resolution of legacy corporate NPLs, accompanied with enhanced supervisory oversight, would promote investment and improve the economy's resilience to shocks. The expected increase in the provision coverage ratio and further improvements of the insolvency process would support these efforts. While the diversification of funding sources has served firms well, efforts are needed to address data gaps and enhance the oversight of nonbank lending. Robust governance and well-designed origination rules of the MDB's operations will help contain contingent liability risks to public finances. Ensuring that the MFSA has adequate resources is critical to preserve its operational independence and maintain effective supervision.

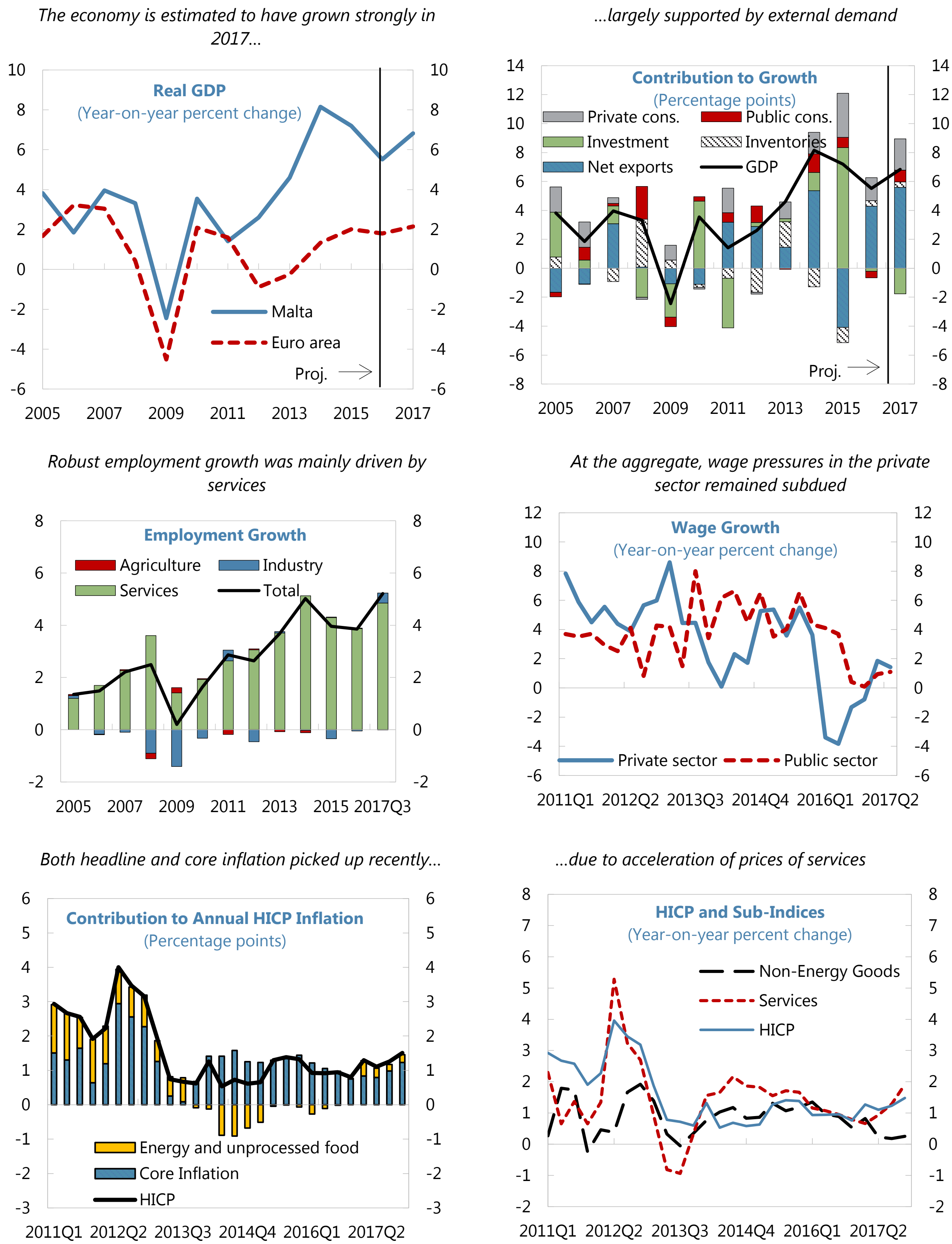
40. Sustained efforts are needed to safeguard the financial system's integrity. Robust implementation and effective enforcement of the Anti-Money Laundering framework is critical given the size of Malta's financial sector, the fast-growing remote gaming activity, and the high demand for the IIP. Continuing strengthening the collaboration between the competent supervisors and regulators, and finalizing the related National Risk Assessment would support these efforts.

41. The strong momentum in the housing market calls for policy measures. Targeted macroprudential limits for mortgages would strengthen the resilience of bank and household balance sheets to possible housing price corrections and higher interest rates. Closing data gaps on borrower characteristics would help to calibrate these measures effectively. Aligning the tax rate on rental income with tax rates on other sources of income, and introducing periodic reviews of the scope and parameters of the IIP, including the minimum real estate investment or leasing values, could curb housing demand pressure. Accelerating corporate balance sheet repair in the construction sector would help to improve the response of housing supply to price signals.

42. Safeguarding the reform momentum is critical to sustain high growth and promote inclusiveness. Policies should focus on reducing the severe congestion by improving road quality and increasing the utilization of alternative means of transport, upskilling and reskilling the labor force to better align education with business needs, and increasing female labor force participation further, particularly among older cohorts. Strengthening innovation by developing research infrastructure, increasing the financial support for research and innovation, and improving links between academia and the private sector would enhance productivity and boost growth prospects.

43. Staff proposes that the next Article IV consultation with Malta follow the standard 12-month cycle.

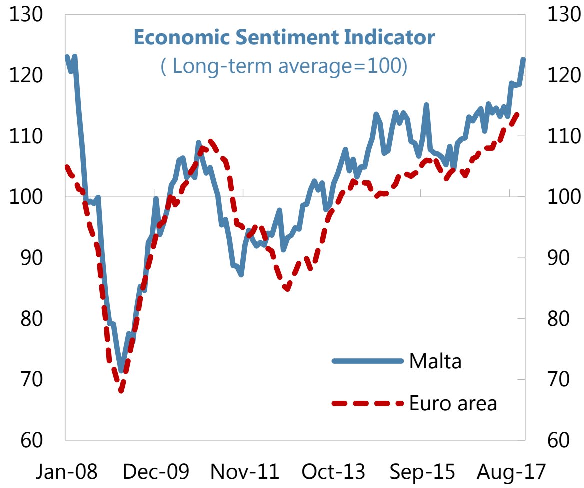
Figure 1. Malta: Economic Indicators



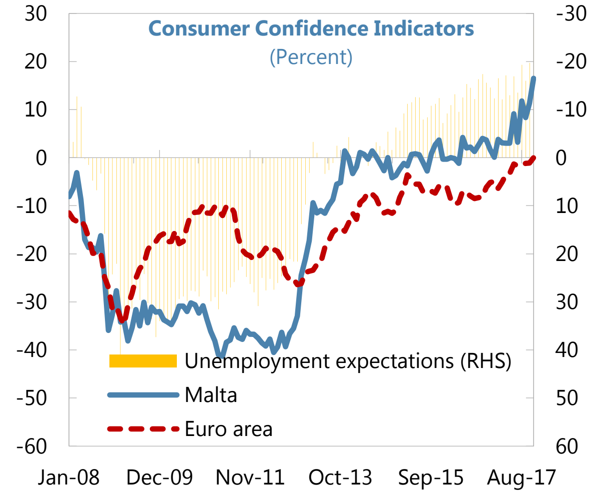
Sources: National Statistics Office, Central Bank of Malta; Eurostat; IMF *World Economic Outlook*; and IMF staff.

Figure 2. Malta: Short-Term Indicators, 2008–2017

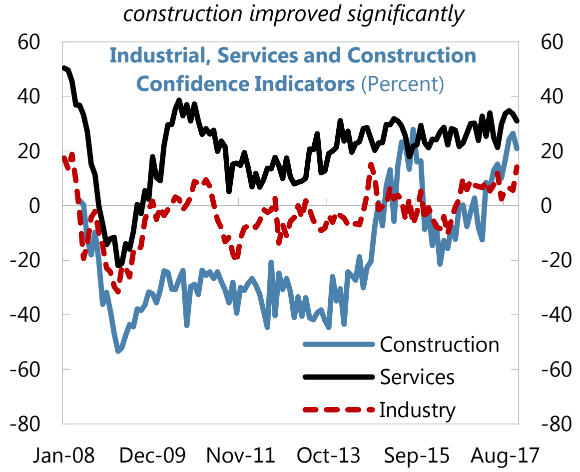
Overall economic sentiment remained strong, and above that in the Euro Area...



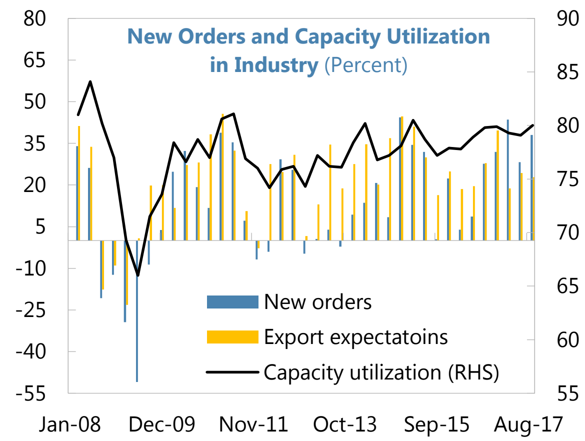
...supported by strong labor market conditions, and robust consumer confidence



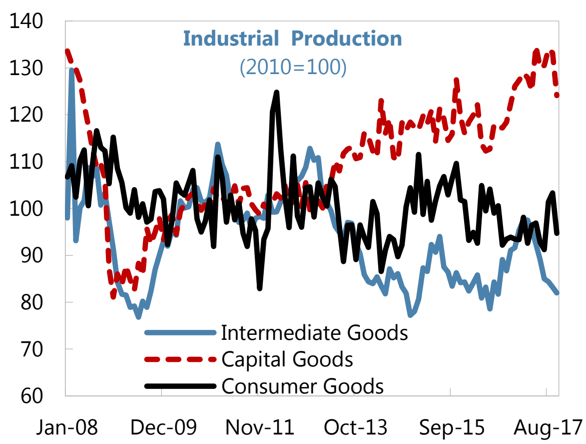
Services sector confidence remained positive while that in construction improved significantly



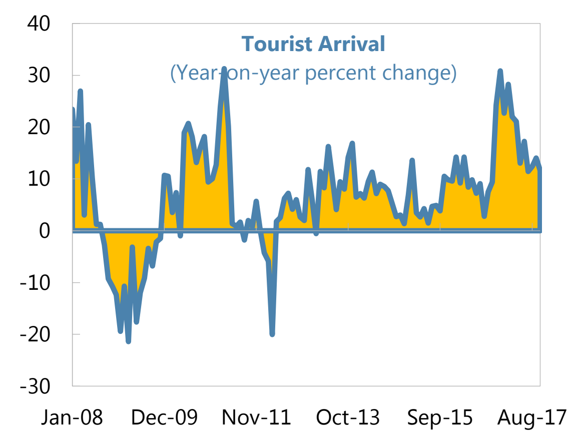
Capacity utilization has increased recently as new orders remain high



Production of consumer and intermediate goods lagged that of capital goods



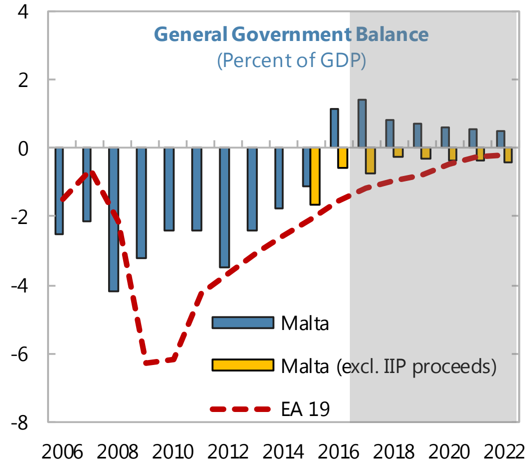
Tourism flows remained buoyant



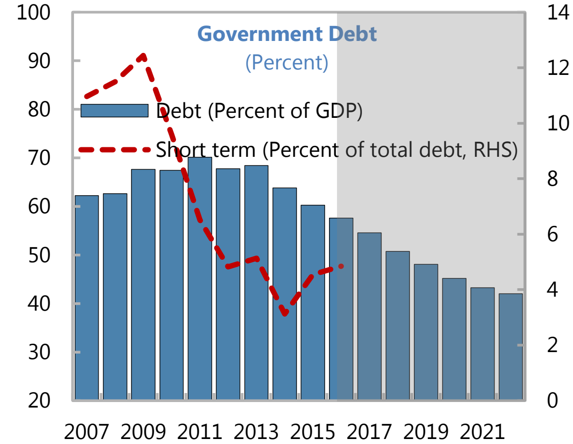
Sources: Eurostat, Haver Analytics, and IMF staff.

Figure 3. Malta: Fiscal Developments

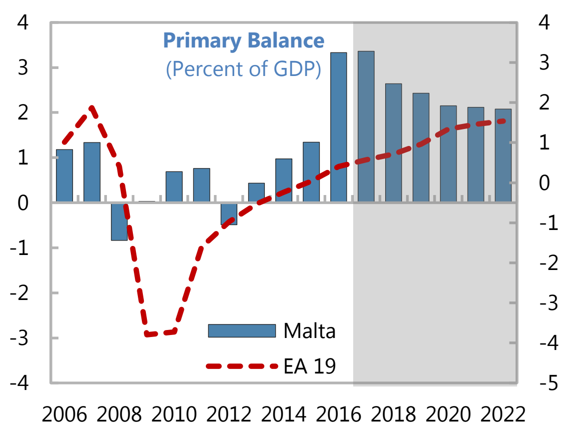
Fiscal surpluses are projected to persist owing in part to buoyant IIP proceeds…



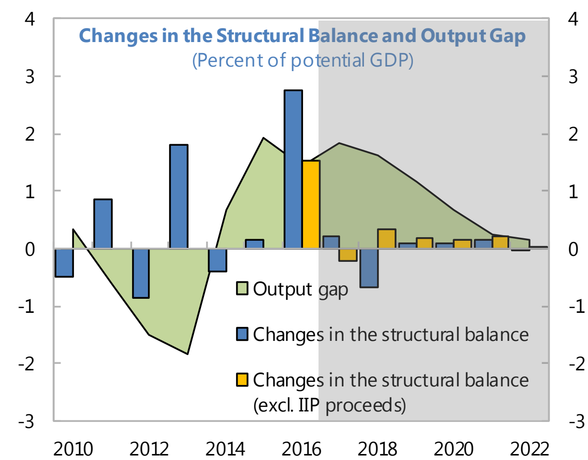
…and, together with strong growth, further lower the public debt-to-GDP ratio



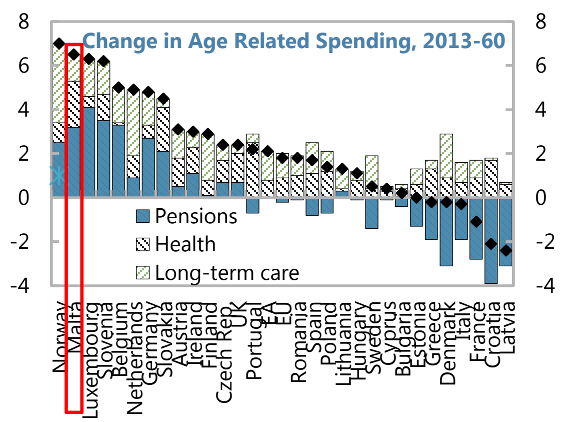
The primary surplus is expected to moderate but remain large over the medium term



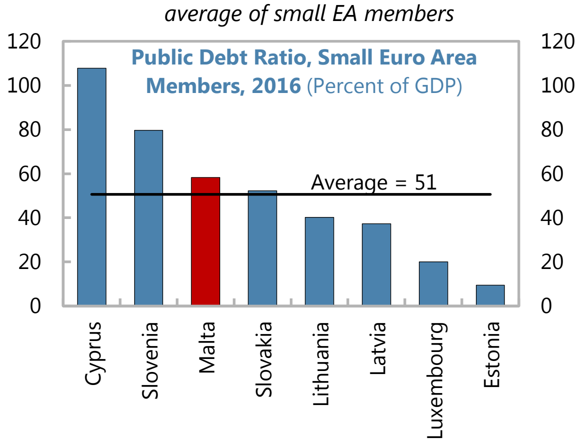
The structural balance is projected to improve modestly over the medium term



Malta is facing significant long-term spending pressures

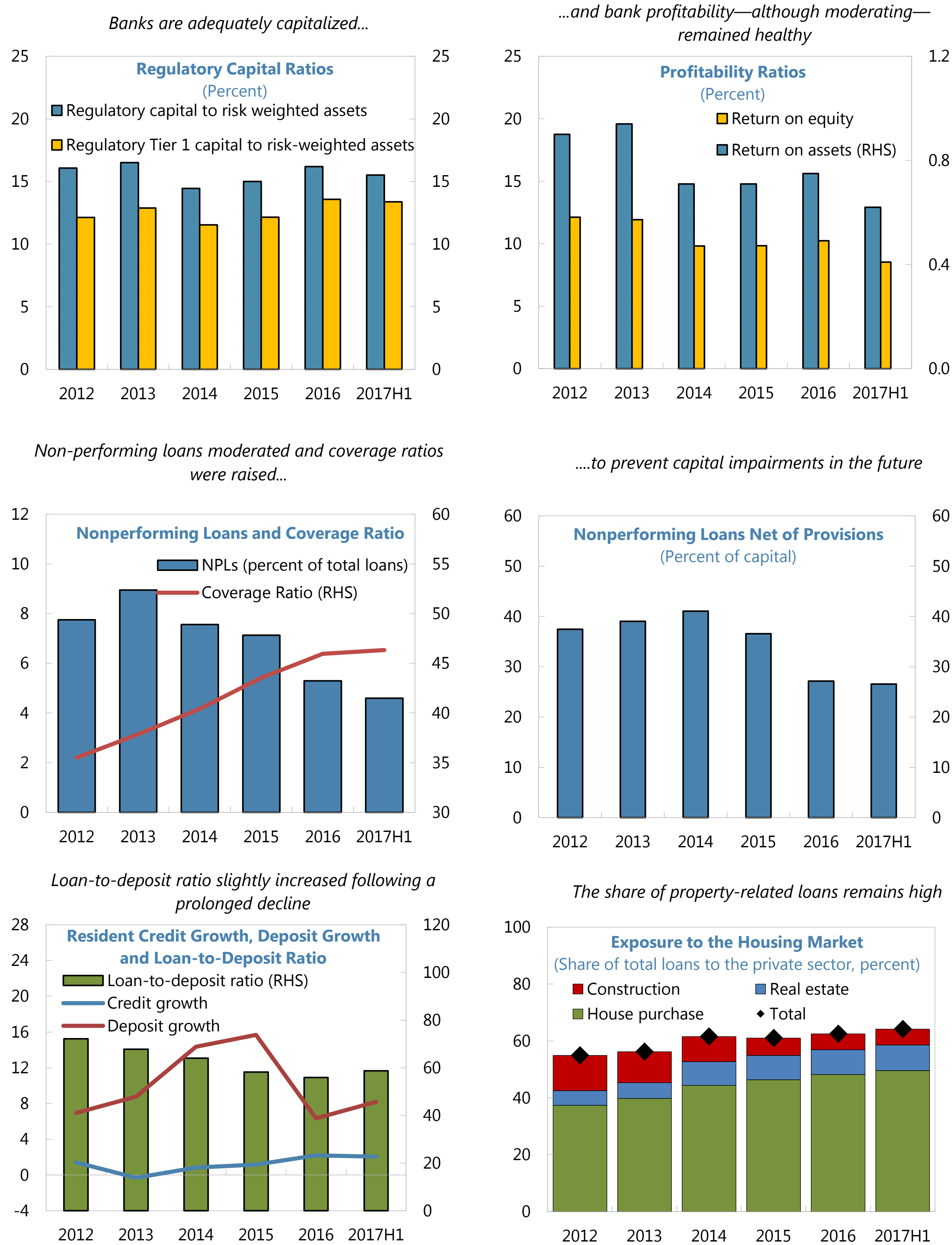


The public debt ratio remains somewhat above the average of small EA members



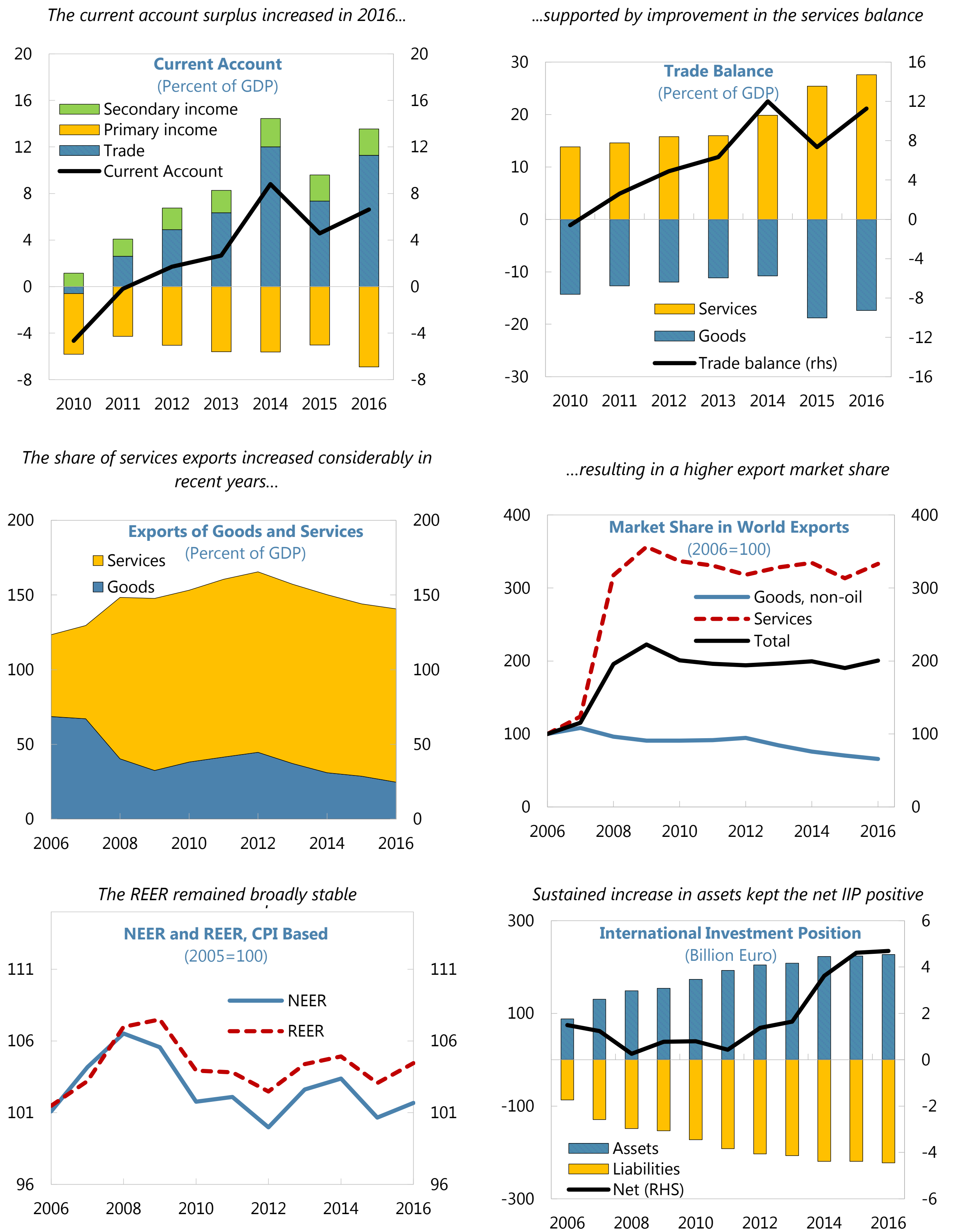
Sources: Eurostat, Haver Analytics, and IMF staff.

Figure 4. Malta: Financial Soundness Indicators



Sources: IMF, *Financial Soundness Indicators,* Central Bank of Malta, Malta Financial Services Authority, and IMF staff.

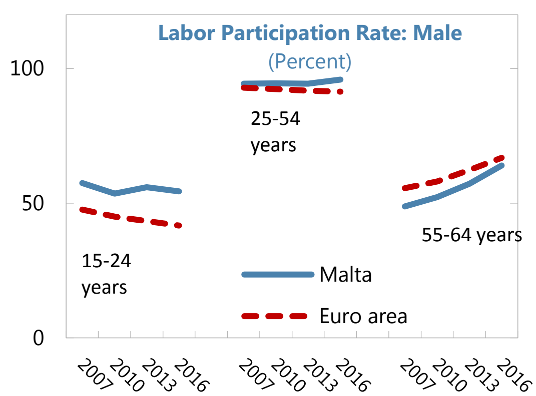
Figure 5. Malta: External Sector

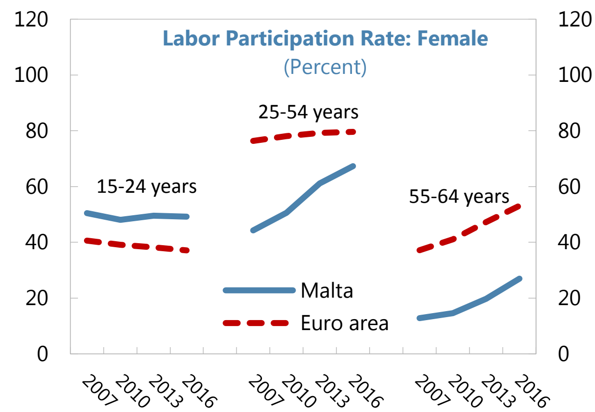


Sources: Haver Analytics; Eurostat; UNCTAD; IMF *World Economic Outlook*; and IMF staff.

Figure 6. Malta: Labor Market and Income Inequality Developments

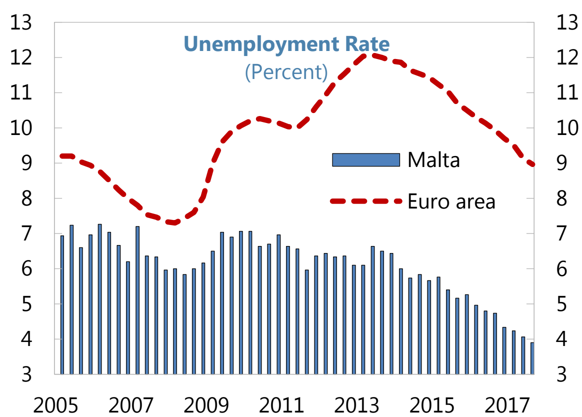
While increasing, the female labor market participation rate falls short compared to EA peers, especially among middle-aged and older cohorts

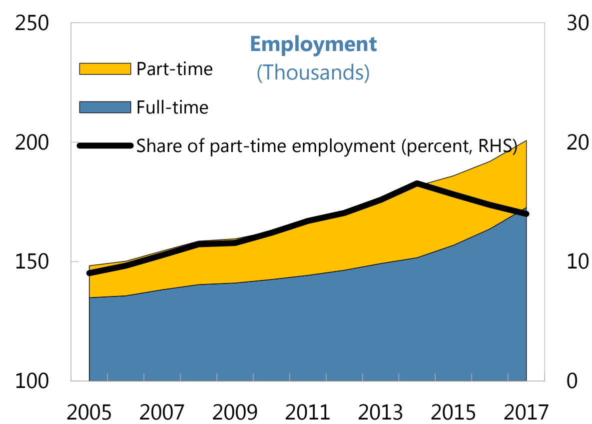




Unemployment continued to decline to a record-low...

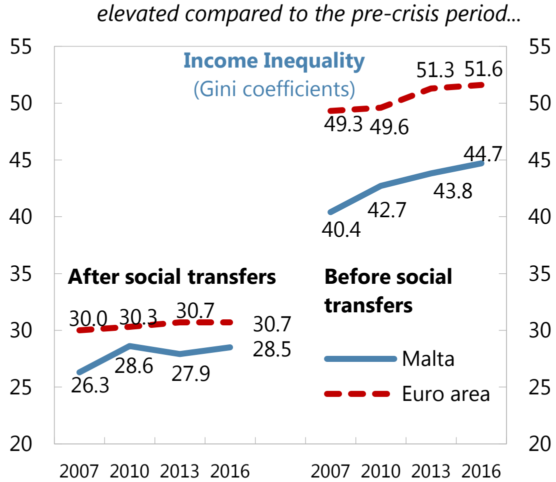
...reflecting strong employment growth

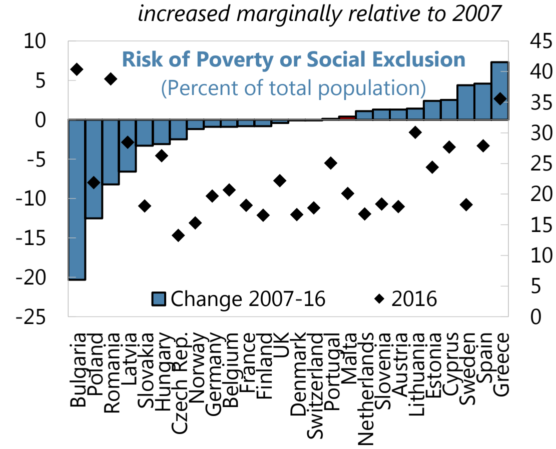




Despite strong growth, income inequality remains elevated compared to the pre-crisis period...

...while the share of population at risk of poverty increased marginally relative to 2007





Sources: National Statistics Office, Eurostat, Haver Analytics, and IMF staff.

Table 1. Malta: Selected Economic Indicators, 2015–2022

(Year on year percent change, unless otherwise indicated)

Table 1. Malta: Selected Economic Indicators, 201	0.4	Per capita income (2016, euros):	22,851
Quota (as of Nov. 30, 2017; millions of SDRs):	168.3	At-risk-of-poverty rate 1/	16.5

				Projections				
	2015	2016	2017 Est.	2018	2019	2020	2021	2022
				(Year on year percent change)				
Real GDP	7.2	5.5	6.8	5.7	4.6	4.0	3.5	3.2
Domestic demand	12.4	1.4	1.8	5.4	4.0	3.3	2.7	2.4
Consumption	5.2	1.6	4.4	4.5	3.7	3.3	2.8	2.6
Private consumption	5.8	3.1	4.3	4.2	3.6	3.1	2.6	2.4
Public consumption	3.7	-2.5	4.8	5.2	4.0	3.6	3.2	3.0
Fixed investment	49.5	-0.9	-8.0	8.4	5.0	3.5	2.5	1.8
Exports of goods and services	4.1	4.5	2.5	3.2	3.3	3.3	3.3	3.3
Imports of goods and services	7.4	1.6	-1.5	2.8	2.6	2.6	2.6	2.6
Contribution to growth				(Percent)				
Domestic demand	11.3	1.2	1.2	4.6	3.4	2.8	2.3	2.0
Foreign balance	-4.1	4.3	5.6	1.1	1.2	1.2	1.2	1.2
Potential GDP growth	5.8	6.1	6.4	5.9	5.1	4.5	4.0	3.3
Output gap (% potential GDP)	1.9	1.4	1.8	1.6	1.2	0.7	0.3	0.1
HICP (period average)	1.2	0.9	1.3	1.7	1.8	1.9	1.9	2.0
GDP deflator	2.3	1.5	1.8	2.1	2.0	2.0	2.0	2.0
Unemployment rate EU stand.	5.4	4.7	4.2	4.4	4.6	4.7	4.7	4.7
Employment growth	2.3	3.0	3.4	2.9	2.5	2.1	2.0	2.0
Gross national savings (percent of GDP)	29.1	30.1	30.8	30.7	30.5	30.3	30.1	29.8
Gross capital formation (percent of GDP)	24.5	23.5	20.5	21.1	21.4	21.4	21.3	21.1
Public finance				(Percent of GDP)				
Net lending/borrowing (overall balance)	-1.1	1.1	1.4	0.8	0.7	0.6	0.6	0.5
Structural overall balance (% potential GDP)	-2.1	0.6	0.8	0.1	0.2	0.3	0.5	0.4
General government debt	60.3	57.7	54.2	50.1	47.3	44.4	42.4	41.2
Balance of payments				(Percent of GDP)				
Current account balance	4.6	6.6	10.3	9.6	9.2	8.9	8.8	8.7
Trade balance (Goods and services)	7.4	11.3	16.0	16.2	16.7	17.1	17.7	18.2
Exports of goods and services	143.5	140.9	135.5	132.2	130.0	128.6	127.8	127.4
Imports of goods and services	136.2	129.6	119.5	116.0	113.4	111.5	110.2	109.2
Goods balance	-20.8	-19.2	-18.8	-18.7	-18.4	-18.5	-18.3	-18.3
Services balance	28.2	30.5	34.8	35.0	35.1	35.6	36.0	36.6
Primary income, net	-5.0	-6.9	-7.9	-8.9	-9.7	-10.4	-11.1	-11.8
Secondary income, net	2.2	2.3	2.2	2.2	2.2	2.2	2.2	2.2
Financial account, net	4.5	13.6	11.1	10.4	10.0	9.7	9.6	9.5
Financial sector								
Credit to the private sector (% GDP)	90.8	87.9	…	…	…	…	…	…
Credit growth, private sector	3.9	3.7	…	…	…	…	…	…
Memorandum item:								
Nominal GDP (millions of euros)	9266.1	9926.6	10794.4	11639.9	12419.8	13177.2	13915.3	14655.5
Nominal GDP growth	9.7	7.1	8.7	7.8	6.7	6.1	5.6	5.3

Sources: Maltese authorities; and IMF staff projections.

1/ Share of population with an equivalised disposable income (including social transfers) below the threshold of 60 percent of the national median equivalised disposable income after social transfers. Data is as of 2016.

Table 2. Malta: Fiscal Developments and Projections, 2015-2022

(Percent of GDP, unless otherwise indicated)

	2015	2016	2017 Est.	Projections 2018	2019	2020	2021	2022
Revenue	40.1	39.2	39.6	38.9	38.7	38.4	38.4	38.4
Taxes	26.4	27.0	26.9	26.9	26.9	26.8	26.8	26.8
Indirect taxes	12.8	12.9	12.7	12.7	12.6	12.6	12.6	12.6
Direct taxes	13.4	13.9	14.1	14.1	14.1	14.0	14.0	14.0
Other taxes (capital taxes)	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social contributions	6.4	6.4	6.4	6.3	6.3	6.3	6.3	6.3
Grants and Capital revenue	3.1	0.6	1.2	1.5	1.8	2.1	2.1	2.2
Other revenue	4.2	5.3	5.0	4.2	3.8	3.2	3.2	3.1
Expenditure	41.2	38.1	38.1	38.1	38.0	37.8	37.8	37.9
Expense	37.0	35.6	35.4	35.0	34.9	34.5	34.4	34.4
Compensation of Employees	12.0	11.9	12.1	12.0	12.0	12.0	12.0	12.0
Use of goods and services	6.4	6.4	6.7	6.5	6.5	6.4	6.4	6.4
Interest	2.5	2.2	1.9	1.8	1.7	1.6	1.6	1.6
Subsidies	1.2	1.3	1.1	1.1	1.0	1.0	1.0	0.9
Social benefits	11.2	10.9	10.6	10.5	10.4	10.2	10.2	10.2
Other expense	3.7	2.8	3.0	3.1	3.3	3.3	3.3	3.3
Net acquisition of nonfinancial assets	4.2	2.5	2.8	3.1	3.1	3.3	3.4	3.5
Gross Operating Balance	3.1	3.6	4.2	3.9	3.8	3.9	4.0	4.0
Net lending/borrowing (overall balance)	-1.1	1.1	1.4	0.8	0.7	0.6	0.6	0.5
Memorandum items:								
Overall balance excl. one-offs	-1.2	1.2	1.6	0.8	0.7	0.6	0.6	0.5
Overall balance excl. IIP proceeds	-1.7	-0.6	-0.7	-0.3	-0.3	-0.4	-0.4	-0.4
Cyclically adjusted overall balance	-2.0	0.5	0.6	0.1	0.2	0.3	0.5	0.4
Structural balance 1/	-2.1	0.6	0.8	0.1	0.2	0.3	0.5	0.4
Structural balance excl. IIP proceeds 1/	-2.7	-1.2	-1.4	-1.0	-0.9	-0.7	-0.5	-0.5
Cyclically adjusted primary balance	0.5	2.7	2.6	1.9	1.9	1.9	2.0	2.0
Structural primary balance 1/	0.4	2.8	2.8	1.9	1.9	1.9	2.0	2.0
Primary balance	1.3	3.3	3.4	2.6	2.4	2.2	2.1	2.1
One-offs	0.1	-0.1	-0.2	0.0	0.0	0.0	0.0	0.0
Public debt	60.3	57.7	54.2	50.1	47.3	44.4	42.4	41.2
Government guaranteed debt	15.2	14.1	9.4	8.7	8.0	7.4	7.0	6.6
Nominal GDP (millions of euros)	9,266	9,927	10,794	11,640	12,420	13,177	13,915	14,656

Sources: Maltese authorities; and IMF staff projections.
1/ As a percentage of Nominal Potential GDP.

Table 3. Malta: Balance of Payments, 2015–2022

	2015	2016	2017 Est.	2018	2019	2020	2021	2022
				Projections				
	(Millions of euros)							
Current account balance	424	658	1,110	1,113	1,139	1,179	1,222	1,269
Trade balance (Goods and services)	681	1,119	1,723	1,890	2,068	2,257	2,458	2,673
Goods balance	-1,932	-1,909	-2,029	-2,182	-2,289	-2,432	-2,551	-2,686
Exports	2,612	2,499	2,430	2,502	2,597	2,696	2,797	2,902
Imports	4,544	4,409	4,459	4,684	4,886	5,128	5,348	5,589
Services balance	2,613	3,028	3,751	4,072	4,358	4,689	5,009	5,360
Exports	10,689	11,487	12,195	12,885	13,553	14,254	14,992	15,768
Imports	8,076	8,459	8,444	8,812	9,195	9,565	9,983	10,409
Current income, net	-465	-686	-853	-1,037	-1,206	-1,371	-1,546	-1,730
Current transfers, net	208	225	240	259	277	293	310	326
Private	-605	-609	-666	-718	-766	-813	-859	-904
Public	813	834	907	978	1,043	1,107	1,169	1,231
Capital account, net	167	79	86	93	99	105	111	117
Financial account, net	414	1,351	1,196	1,206	1,239	1,284	1,334	1,386
Direct investment	-8,909	-8,311	-9,361	-10,094	-10,771	-11,428	-12,068	-12,710
Portfolio investment	4,900	4,769	5,186	5,592	5,967	6,331	6,686	7,041
Other investment	5,394	4,811	5,378	5,715	6,050	6,389	6,725	7,064
Reserves (- inflow; + outflow)	-73	88	0	0	0	0	0	0
Errors and omissions	-178	614	0	0	0	0	0	0
	(Percent of GDP)							
Current account balance	4.6	6.6	10.3	9.6	9.2	8.9	8.8	8.7
Trade balance (Goods and services)	7.4	11.3	16.0	16.2	16.7	17.1	17.7	18.2
Goods balance	-20.8	-19.2	-18.8	-18.7	-18.4	-18.5	-18.3	-18.3
Exports	28.2	25.2	22.5	21.5	20.9	20.5	20.1	19.8
Imports	49.0	44.4	41.3	40.2	39.3	38.9	38.4	38.1
Services balance	28.2	30.5	34.8	35.0	35.1	35.6	36.0	36.6
Exports	115.4	115.7	113.0	110.7	109.1	108.2	107.7	107.6
Imports	87.2	85.2	78.2	75.7	74.0	72.6	71.7	71.0
Primary income, net	-5.0	-6.9	-7.9	-8.9	-9.7	-10.4	-11.1	-11.8
Secondary income, net	2.2	2.3	2.2	2.2	2.2	2.2	2.2	2.2
Private	-6.5	-6.1	-6.2	-6.2	-6.2	-6.2	-6.2	-6.2
Public	8.8	8.4	8.4	8.4	8.4	8.4	8.4	8.4
Capital account, net	1.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Financial account, net	4.5	13.6	11.1	10.4	10.0	9.7	9.6	9.5
Direct investment	-96.1	-83.7	-86.7	-86.7	-86.7	-86.7	-86.7	-86.7
Portfolio investment	52.9	48.0	48.0	48.0	48.0	48.0	48.0	48.0
Assets	42.6	48.6	48.6	48.6	48.6	48.6	48.6	48.6
Liabilities	-10.2	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Other investment	58.2	48.5	49.8	49.1	48.7	48.5	48.3	48.2
Assets	-14.0	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Liabilities	-72.2	-47.4	-48.7	-48.0	-47.6	-47.4	-47.2	-47.1
Reserves (- inflow; + outflow)	-0.8	0.9	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	-1.9	6.2	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:								
Gross external debt (Percent of GDP)	961.2	872.5	812.6	763.2	724.4	691.7	663.8	639.0
Net external debt (Percent of GDP)	-257.8	-222.0	-224.9	-227.7	-230.6	-233.6	-236.8	-240.0

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

Table 4. Malta: Financial Soundness Indicators, 2013-2017H1 /1

(Percent, unless otherwise indicated)

	Core Domestic Banks					Non-Core Domestic Banks					International Banks					Total Banks				
	2013	2014	2015	2016	2017H1	2013	2014	2015	2016	2017H1	2013	2014	2015	2016	2017H1	2013	2014	2015	2016	2017H1
Core FSIs																				
Regulatory capital to risk weighted assets	16.5	14.4	15.0	16.2	15.5	22.6	17.4	22.1	15.5	16.2	119.6	69.2	56.3	49.2	47.9	46.2	25.7	21.8	21.2	20.3
Regulatory Tier 1 capital to risk-weighted assets	12.9	11.5	12.2	13.6	13.4	22.1	17.1	18.6	12.3	13.2	119.6	69.1	50.6	41.9	40.5	43.9	23.6	18.4	17.8	17.3
Non-performing loans net of provisions to capital	39.0	41.0	36.6	27.2	26.5	2.1	7.7	7.9	12.0	7.0	0.8	3.0	5.7	9.3	14.6	9.4	18.2	21.8	22.2	20.0
Non-performing loans to total gross loans	9.0	7.6	7.1	5.3	4.6	3.7	4.4	3.9	3.1	2.3	1.4	0.7	0.9	1.7	2.5	5.6	4.0	4.3	3.8	3.7
Return on assets	0.9	0.7	0.7	0.8	0.6	0.7	-1.3	0.2	0.3	0.2	0.6	0.9	1.0	1.0	1.1	0.7	0.7	0.9	0.8	0.8
Return on equity	11.9	9.8	9.8	10.2	8.5	2.3	-6.4	1.4	3.4	2.6	2.0	2.4	3.4	5.6	4.4	3.5	3.6	5.9	8.0	6.6
Interest margin to gross income	63.6	64.8	64.5	62.2	68.0	42.0	46.3	43.5	31.2	35.3	173.6	201.9	137.8	92.6	88.0	101.2	115.1	93.0	73.0	75.1
Non-interest expenses to gross income	47.1	51.2	54.2	52.7	56.5	64.8	56.1	73.4	66.5	74.9	10.0	11.9	24.8	31.9	33.7	34.9	36.8	43.3	45.0	47.7
Non-interest income to gross income	36.4	35.2	35.5	37.8	32.0	58.0	53.7	56.5	68.8	64.7	-73.6	-101.9	-37.8	7.4	12.0	-1.2	-15.1	7.0	27.0	25.0
Liquid assets to total assets	27.2	28.3	31.8	36.5	36.7	20.2	31.7	36.3	31.6	39.6	28.1	19.7	22.7	30.2	29.5	26.9	27.3	31.2	35.4	36.2
Liquid assets to short-term liabilities	51.7	50.4	50.2	55.8	55.2	72.1	77.9	63.3	62.7	80.3	204.2	84.7	83.6	96.3	100.3	59.6	53.9	52.6	58.3	59.0
Other FSIs																				
Total Coverage ratio (total provisions to NPLs as per BR/09)	37.9	40.4	43.5	45.9	46.3	94.6	77.1	65.2	53.9	64.9	43.0	40.5	50.4	54.8	42.5	42.3	37.5	40.0	48.0	46.1
Domestic Investment Securities to Total Assets	10.9	9.7	9.3	7.9	7.9	5.5	4.6	7.7	4.9	5.0	0.0	0.0	0.2	0.1	0.2	4.1	3.9	4.5	4.0	4.2
Foreign Investment Securities to Total Assets	19.3	23.3	21.8	20.6	19.0	21.0	19.5	12.5	15.0	11.5	37.6	52.8	50.4	46.9	49.4	30.4	40.1	36.0	32.8	32.5
Unsecured Loans to Total Lending	26.2	29.0	27.4	25.4	28.5	74.8	65.2	70.9	65.4	67.3	57.3	48.4	30.7	26.7	27.4	41.3	37.7	30.8	28.2	29.8
Assets to Total Capital and Reserves (Ratio)	12.6	14.1	13.7	13.3	13.9	3.4	8.4	8.4	12.1	11.6	1.3	1.7	2.0	2.9	3.1	3.7	6.4	8.0	9.5	10.0
Large exposure to total own funds	108.0	103.4	96.5	110.8	85.6	199.9	339.9	157.6	268.6	244.3	17.1	45.3	129.9	129.9	119.0	48.0	88.9	115.8	130.5	109.3
Gross asset position in financial derivatives to total own funds	2.1	1.1	1.3	1.7	1.3	0.4	0.8	0.3	0.6	0.5	0.0	15.7	67.2	104.4	110.2	0.5	8.9	25.9	38.0	38.9
Gross liability position in financial derivatives to total own funds	4.5	4.5	2.0	2.0	1.7	0.5	2.2	0.3	3.6	0.1	0.1	15.9	38.1	54.9	58.2	1.1	10.4	15.3	20.9	21.1
Personnel expenses to non-interest expenses	50.6	50.8	51.2	48.3	47.7	42.1	45.0	42.5	49.7	47.6	33.3	27.4	23.2	19.9	18.5	48.1	47.4	44.0	40.3	38.8
Customer loans to customer deposits	67.8	64.0	58.2	56.0	58.8	96.2	75.7	60.7	46.5	45.3	79.5	93.1	104.1	108.1	102.2	72.3	71.8	67.9	65.7	66.3
Net open position in equities to total own funds	13.5	14.4	15.4	14.0	12.7	169.4	45.0	81.8	146.8	158.8	0.0	0.3	2.7	1.2	1.0	10.6	9.0	18.1	20.3	19.8

1/ Banks' total assets amounted to 467 percent of GDP (about €46 billion) at 2016. About 48 percent of these assets are owned by international banks, which have limited or no linkages to the domestic economy. Core domestic banks, which account for 47 percent of the banking sector's total assets, are tightly linked to domestic activity as they rely mainly on domestic deposits and provide the bulk of lending to residents. The remainder of the assets are held by non-core domestic banks, which maintain small exposure to residents.

Source: Central Bank of Malta.

Annex I. Implementation of IMF Recommendations

The Maltese authorities have taken on board many policy recommendations made by the Fund in previous Article IV consultations.

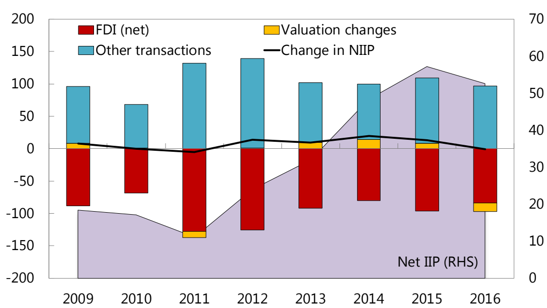
	2016 Art. IV Advice	Actions since 2016 Art. IV
Fiscal issues	Continue with fiscal consolidation, enhance efficiency of tax collection, and contain growth of wage bill and expenditure on goods and services.	The government attained its Medium-Term Objective of a structural balance in 2016, three years ahead of schedule. The Updated Stability Program 2017-20 aims to maintain a small surplus over the medium term and further reduce the public debt ratio. The government took measures to enhance tax collection, including by strengthening the IT system and establishing the Joint Enforcement Unit to strengthen tax compliance. Merger of various revenue departments is underway.
	Reduce fiscal risks by improving the financial health of SOEs and containing long-term, age-related spending pressures.	Ongoing. The 2017 budget included fiscal incentives for contributions to private pension plans. National Strategy for Retirement and Financial Capability was launched in January 2017. Policy recommendations from in-depth spending review of health carried out in 2015 are being implemented. Following an internal restructuring, the state-owned carrier, Air Malta, is expected to break even in 2017/18.
Financial sector issues	Close data gaps, strengthen macroprudential measures, and review fiscal incentives related to the property market.	Ongoing. The Central Credit Register is looking to broaden the coverage of individual debt, beyond bank loans, while the Joint Financial Stability Board is evaluating possible macro-prudential measures to mitigate risks.
	Promote a faster resolution of legacy NPLs, including by further increases in loan-loss provisions.	Ongoing. The recent regulatory changes, which require banks to reduce NPLs to below 6 percent within 5 years, is being implemented. The insolvency framework has been strengthened (see below).
	Ensure strong governance, prudent risk assessment, and adequate supervision of the Malta Development Bank.	Ongoing. Malta Development Bank (MDB) Act, approved in May 2017, envisages creation of Risk, Audit, Ethics and Governance Committees, and defines role of the MDB's Supervisory Board.
	Maintain a robust implementation of the AML/CFT framework.	Ongoing. The Fourth EU Anti-Money Laundering was fully transposed into national law. The ML/FT National Risk Assessment is being finalized.
Structural reforms	Further increase female labor force participation and reduce skill mismatches.	Ongoing. Recent make-work-pay measures with focus on supporting female employment continue to be implemented. Training and work placement schemes are being provided to reduce the skill gap and support employment of low-skilled individuals.
	Enhance SMEs' research and innovation.	Revised National R&I Action Plan, approved at end-2016, is being implemented. New tax credit on expenses incurred on research projects.
	Further improve the judicial system efficiency.	Ongoing. Amendments to the Companies Act adopted in March 2017 include changes to legal framework on "company reconstructions", including voluntary mediation between companies and creditors, allowing creditors to file "company recovery "application, and shortening the restructuring period.

Annex II. External Sector Assessment

Malta's external competitiveness remained strong. Fast expansion of knowledge-intensive services sectors and related productivity gains have supported Malta's competitiveness in recent years and brought the ULC-based real effective exchange rate (REER) to levels last seen in 2009. The CPI-based REER has moved in a relatively narrow range, reflecting stability in both nominal exchange rate and inflation differentials with Malta's key trading partners. Robust growth in services exports has widened the services balance and, together with the reduction of import intensity and higher private and public savings, contributed to sizable current account surpluses and kept Malta's market share in world's exports broadly stable in recent years, despite the moderation in the share of goods exports (Figure 5).

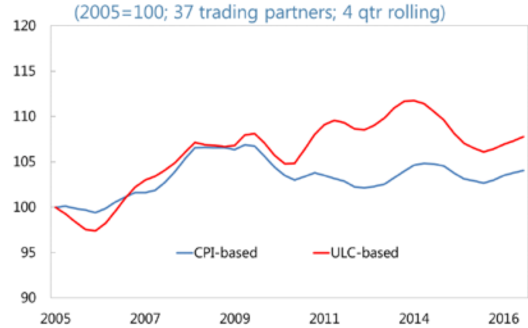
Recent current account surpluses supported the increases of Malta's NIIP. Malta's NIIP developments result from very large and volatile gross flows. The portfolio investment position is the main positive driver of the NIIP, while large foreign direct investment (FDI) flows partly offset the accumulation of foreign assets. The overall net FDI stock, which amounted to 10 times of GDP in 2016, is subject to volatile valuation changes, and resulted in significant changes to the NIIP in some periods.

Malta: Changes in Net International Investment Position
(In percent of GDP)



Sources: CBM; and IMF staff estimates.

Malta: Real Effective Exchange Rate
(2005=100; 37 trading partners; 4 qtr rolling)



Sources: Eurostat.

Staff assess that the external position is broadly in line with fundamentals and desirable policy settings. Both the REER Index Model and the Current Account (CA) approach suggest an undervaluation, though they show partially diverging results. The EBA-lite REER estimates, which may be more informative in small financial centers (see EBA-lite methodology), suggest a modest REER undervaluation of 2.2 percent, implying an external position in line with fundamentals. The CA model suggests a larger undervaluation, with the CA-gap at 4.7 percent and the external position substantially stronger than fundamentals. However, in Malta's case, staff judgement suggests the CA model can only partly capture Malta's idiosyncratic factors and misses some key fundamentals affecting the CA. First, exports of services—particularly the gaming sector (Selected Issues Paper III)—is the main contributor to recent CA surpluses. The nature of this sector requires very little capital investment while producing significant export flows that are broadly unrelated to exchange rate movements or changes in competitiveness. In addition, the contribution of the credit/GDP gap variable in the CA regression may create a downward bias in the fitted results as recent growth of credit is almost entirely related to non-tradables (real estate), which have limited connection to the CA. In both models, the rapid fiscal consolidation largely explains the undervaluation.

Exchange rate assessment (EBA-lite methodology)

Current account approach		*REER approach*	
CA-Cyclically Adj.	6.8	ln(REER)-Actual	4.6
CA-Cyclically Adj. Norm*	2.0	ln(REER)-Norm	4.6
CA-Gap	4.7		
Policy gap	1.7	Policy gap	-1.0
Residual	3.0	Residual (percent)	-1.2
REER-Gap (percent)	-4.8	REER-Gap (percent)	-2.2

(*) The current account norm is adjusted to reflect Malta as a financial center (the financial center dummy is set to one).

Source: IMF staff estimates.

Annex III. Risk Assessment Matrix

Source of Risks	Relative Likelihood[1]	Impact if Realized
Structurally weak growth in key advanced and emerging economies.	**High**	**Medium** The Maltese economy is highly open with exports standing at about 142 percent of GDP in 2016, though there is a considerable import content. A secular weak external demand, accompanied by lower FDI, would have an adverse effect on domestic confidence and growth prospects. Higher-than-envisaged gains from recent large scale infrastructure projects and labor market reforms may mitigate adverse spillovers.
Policy response: Allow automatic stabilizers to operate in the short run if growth disappoints. Improve infrastructure quality and maintain structural reform momentum to remove supply-side bottlenecks, spur investment, and promote higher productivity growth. Continue diversifying trade and financial activities. Fiscal policy could be used to mitigate the impact on vulnerable groups.		
Policy and geo-political uncertainties.	**High**	**Medium** Heightened uncertainty regarding the post-Brexit arrangement and policymaking in the US may weigh on confidence and adversely affect growth prospects through lower investment and trade. Some of these effects, however, are likely to be mitigated given Malta's high trade diversification, excess demand in the tourism sector, and possible relocation of firms that service the EU from the UK to Malta, resulting also in a potential increase of FDI inflows over the medium term.
Policy response: Allow automatic stabilizers to operate if growth disappoints. Monitor developments and develop contingency plan to mitigate adverse effects. Continue close supervision and further improve banks' asset quality to increase the banking system's loss absorption capacity. Fiscal policy could be used to mitigate the impact on vulnerable groups.		
Tighter and more volatile global financial conditions.	**High**	**Medium/Low** Malta has been relatively insulated from financial market contagion given public and private sector's reliance on domestic financing, but is still vulnerable to weak external demand and lower FDI inflows.
Policy response: ECB should stand ready to provide liquidity support to euro-system banks if needed. Continue to reduce vulnerabilities (fiscal and financial) to ensure stability, and further diversifying trade and financial activities. Remove remaining structural impediments.		
Retreat from cross-border integration.	**Medium**	**Medium** As a small open economy, Malta is vulnerable to external shocks through trade linkages. Financial spillovers are limited given the relatively high reliance of government and core domestic banks on domestic funding.
Policy response: Participate in a coordinated policy response at the European level. Allow automatic stabilizers to operate. Maintain structural reform momentum and improve infrastructure to remove impediments to growth. Continue diversifying trade and financial activities. Fiscal policy could be used to mitigate the impact on vulnerable groups.		
Slow progress in addressing the remaining structural weaknesses	**Medium**	**Medium/Low** While the positive impact of recent structural reforms is likely to persist over the medium term, delayed implementation of the planned initiatives, including on infrastructure and labor market, would negatively affect competitiveness and long-term growth, while increasing long-term fiscal risks.
Policy response: Sustain and monitor the implementation of structural reforms, particularly in education, labor market and infrastructure, while safeguarding long-term fiscal sustainability and improving the quality of public finances.		

Source of Risks	Relative Likelihood	Impact if Realized
A sharp correction in housing prices.	Medium	Medium Property-related loans account for more than 60 percent of the loan portfolio of core domestic banks, thus increasing their vulnerability to possible property market shocks. A significantly lower house prices could weaken bank and household balance sheets—particularly if accompanied by broader economic slowdown and an increase in unemployment—and lead to a wide-spread distress with negative spiral of low lending and investment and adverse effects on financial stability and growth. Banks' strong capital and liquidity positions as well as households' high financial wealth, low default rates, and the low share of population with mortgages and negative equity are mitigating factors.
Policy response: Monitor risks and implement targeted macro-prudential measures. Limit exposure of banks to property-related loans if a bubble begins to emerge. Ensure that fiscal measures related to the property market, including the Individual Investor Program and the reduce tax rate on income rental, do not exacerbate imbalances, and address potential constraints to housing supply.		
Possible changes in international corporate taxation	Medium/Low	Medium Malta's attractiveness as a financial and business location may weaken, with adverse effect on tax revenues, foreign investment, and the external position.
Policy response: Continue diversifying the economy and accelerate structural reform implementation to remove impediments to growth, boost productivity and enhance competitiveness. Strengthen the quality of public finances, improve spending efficiency, and enhance revenue collection to reduce the heavy reliance on CIT revenue. Scrutinize associated new risks.		
[1]The 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 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 between 30 and 50 percent). 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. "Short term" and "medium term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.		

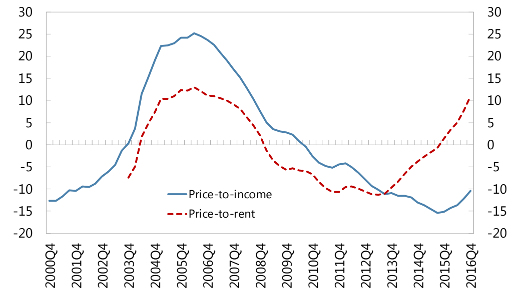
Annex IV. Property Price Valuation

Alternative methods are used to assess valuation gaps in Maltese property prices. While some metrics suggest modest overvaluation, the results are subject to uncertainty, partly due to the rapid increase in household financial wealth, which improved housing affordability.

Price-to-income and price-to-rent ratios. Rising property prices since 2014 have been accompanied by strong disposable income growth. In recent years, the house price-to-income ratio, albeit increasing, has remained relatively stable, at about 10 percent below its historical average, suggesting a small undervaluation. At the same time, despite strong pressure in the rental market, the price-to-rent ratio increased continuously reflecting in part the still high share of tenants that continue to benefit from social rents. This ratio stood at about 11 percent above its long-term average (2016Q4), broadly similar to 2005-07 levels.

Price-to-Income and Price-to-Rent Ratios

(Percent deviations from historical means, 4-quarter moving average)



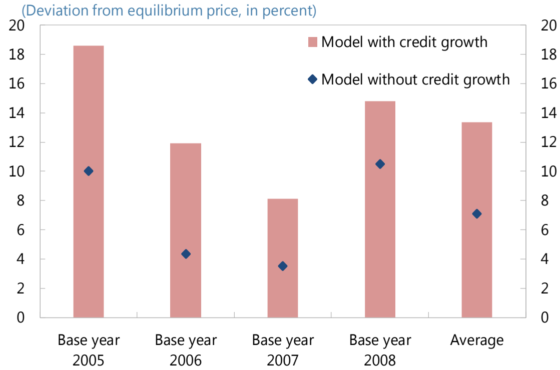
Source: Global Property Guide, IFS, and IMF staff.

HP filter. A simple HP filter, which captures the deviations from a time-varying trend, indicates that house prices at end-2016 have shifted to above-trend territory for the first time since 2008, although the deviation has been rather modest so far.

Econometric approach. An error correction model is used to assess misalignments in house prices relative to economic fundamentals. The model includes demand-side factors such as the growth rates of income per capita, population, and credit, while considering a long-term equilibrium relationship with the price-to-income ratio, which measures housing affordability. On average, the results indicate that prices in 2016Q4 were modestly overvalued: the model with credit growth predicts a 13 percent overvaluation, while excluding credit growth yields an overvaluation of about 7 percent. These findings should be treated with caution given the model limitations in capturing supply-side dynamics.

House Price Valuation using Econometric Model, 2016Q4

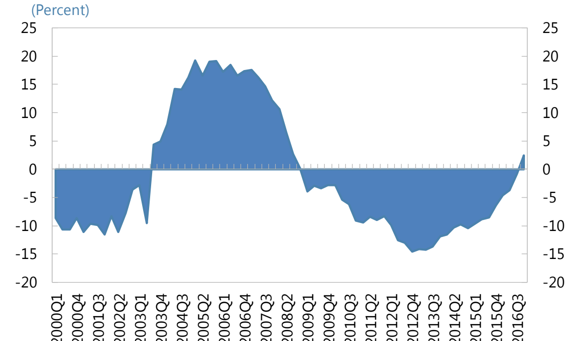
(Deviation from equilibrium price, in percent)



Source: IMF staff calculations.

House Price Deviation from HP Trend

(Percent)



Source: Global Property Guide, IFS, and IMF staff calculations.

Note: HP filter applied on seasonally-adjusted series; lambda parameter = 100,000.

Annex V. Debt Sustainability Analysis

Malta's public debt has further moderated in recent years on the back of fiscal consolidation, strong growth, and favorable financing conditions. The debt dynamics are robust to most shocks, though under a contingent liability shock that is combined with a low growth scenario, the public debt ratio would increase considerably and remain elevated throughout the projection horizon. The moderate gross financing needs and the low share of debt held by non-residents limit potential vulnerabilities. With large external assets that comfortably cover external liabilities, Malta's external position appears resilient to various types of shocks.

Public debt sustainability

1. Public debt is set to remain on a downward trajectory. Strong nominal GDP growth (7.1 percent) and a higher primary fiscal balance lowered the public debt to 57.7 percent of GDP in 2016, from 60.3 percent of GDP in 2015. Going forward, favorable growth prospects, strong fiscal revenues, including from the International Investor Program (IIP), and improved financing conditions are expected to support a continued moderation of public debt to about 41 percent of GDP by 2022.

2. The stock of government guaranteed debt to non-financial SOEs decreased modestly, but remains high. Government guaranteed debt declined to 14.1 percent of GDP in 2016 from 15.2 percent of GDP in 2015, and is projected to remain elevated in the coming years, even after the termination of temporary guarantees to ElectroGas Malta (about 4 percent of GDP).

3. In order to assess the sustainability of government debt, a number of adverse scenarios are considered. These scenarios include low growth, high borrowing costs, a deterioration in the primary balance, and materialization of contingent liabilities. The results indicate that public debt-to-GDP ratio remains vulnerable to a number of shocks. In particular:

- Under a growth shock, which envisages a reduction of output by 3.0 percentage points in 2018 and 2019 relative to the baseline (equivalent to one standard deviation of growth over the past 10 years) and a decline in inflation by 0.8 percentage points in 2018-19 relative to the baseline, debt would peak at 55.2 percent of GDP in 2019, 7.9 percentage points higher than in the baseline and decline to 48.9 percent of GDP in 2022.

- A sustained interest rate shock of 200bps would slow down the moderation of the public debt ratio such that by 2022 it would reach 42.0 percent of GDP, which is 0.8 percentage points higher with respect to the baseline.

- A primary fiscal balance shock of 0.5 percentage points in both 2018-19 relative to the baseline would bring public debt to 42.3 percent of GDP in 2022, which is 1.1 percentage points higher relative to the baseline.

- A combined macro-fiscal shock including growth, interest rate and primary balance shock above would result in debt peaking at 55.3 percent of GDP in 2019, 8.0 percentage points higher relative to the baseline, and decline to 49.8 percent of GDP in 2022.

- A contingent liability shock envisages a one-time increase in non-interest expenditures equivalent to 5 percent of the domestic banks' total assets. This shock is accompanied by a real GDP growth shock as the one above (with growth declining by one standard deviation over 2018–2019) while revenue-to-GDP ratio remaining the same as in the baseline. The deterioration of the primary balance leads to higher interest rates while the slowdown in GDP growth lowers the inflation rate. Overall, this shock would increase public debt to 72.1 percent of GDP in 2019, 24.8 percentage points higher relative to the baseline. At the end of the projection horizon, public debt would decline to 65.6 percent of GDP.

- The government guarantee shock reflects a contingent liability risk from SOEs. It includes a one-time increase in non-interest expenditures equivalent to 50 percent of government guaranteed debt, accompanied by a transitory negative confidence impact on Malta's spread. Under this shock the debt ratio would peak at 57.1 percent of GDP in 2018, 7.0 percentage points higher than in the baseline, and decline to 47.7 percent in 2022.

Overall, the key risk to public debt is assessed to be originating from contingent liabilities, and low growth.

External debt sustainability

4. Malta's external position remains strong, notwithstanding a very large gross external debt. Malta's gross external debt stood at 873 percent of GDP in 2016, but this is more than covered by large amounts of external assets. Malta has been building a very large NIIP surplus, on the back of current account surpluses, which are projected to continue boosting external assets in the medium term. Moreover, Malta's external liabilities include large amounts of stable inter-company lending, as well as liabilities of offshore institutions (banks and nonbanks) that have little connection to domestic residents and, as such, are unlikely to spill potential vulnerability over into the economy.

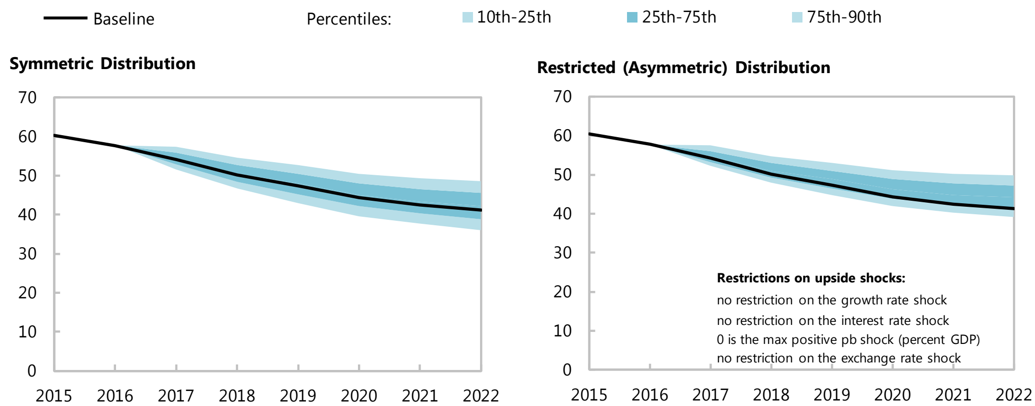
Figure 1. Malta: Public DSA Risk Assessment

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

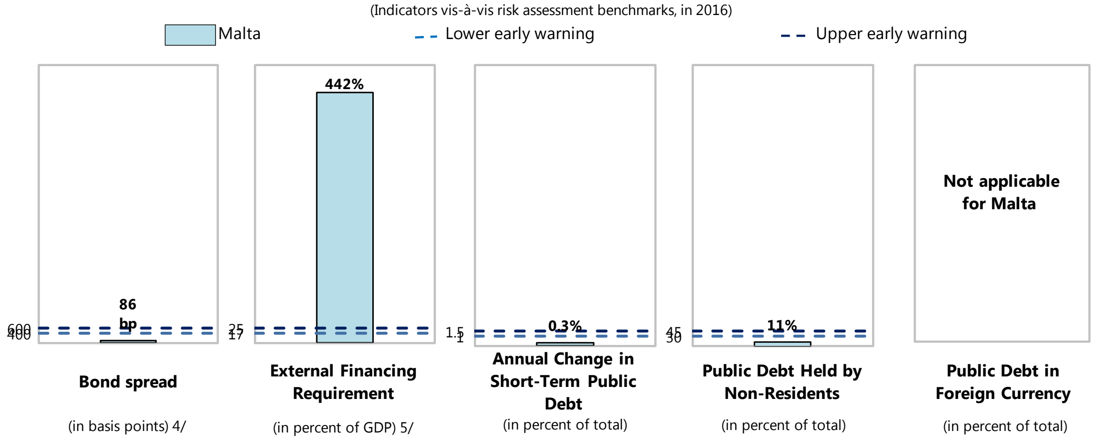
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2016)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% 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% 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.

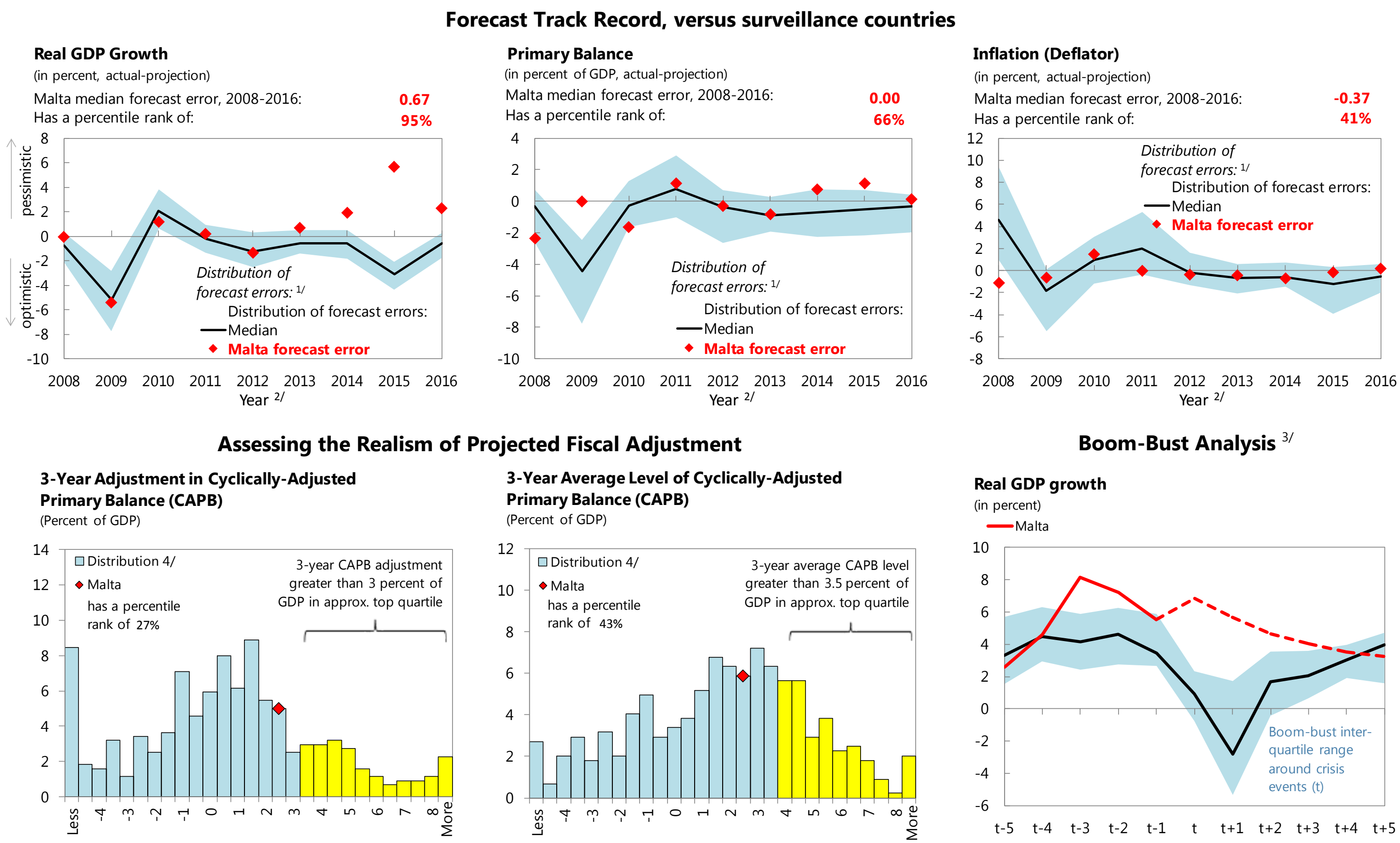
Lower and upper risk-assessment benchmarks are:

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, 07-Sep-17 through 06-Dec-17.

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, 2014-2016 and a cumulative increase in private sector credit of 94 percent of GDP, 2013-2016. For Malta, t corresponds to 2017; for the distribution, t corresponds to the first year of the crisis.

4/ Data cover annual obervations 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)

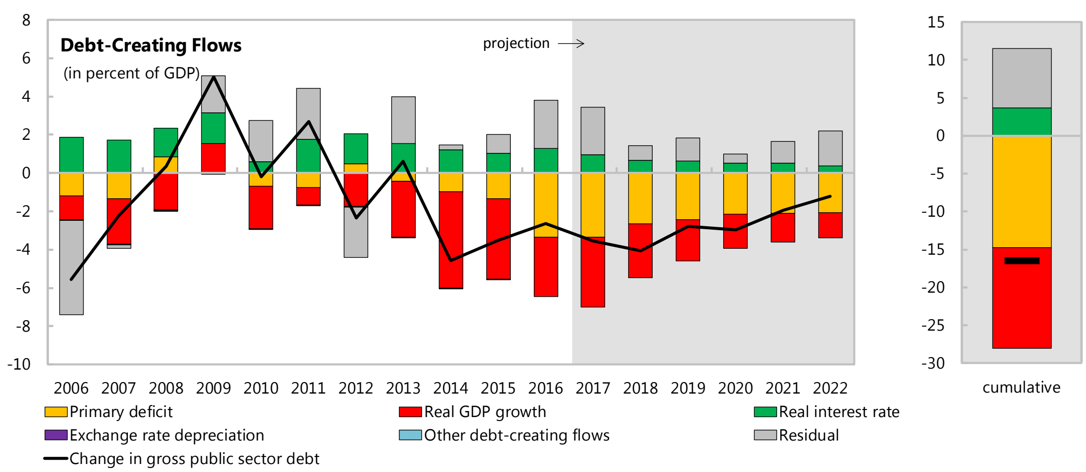
Debt, Economic and Market Indicators 1/

	Actual			Projections					
	2006-2014 2/	2015	2016	2017	2018	2019	2020	2021	2022
Nominal gross public debt	66.1	60.3	57.7	54.2	50.1	47.3	44.4	42.4	41.2
Public gross financing needs	4.6	4.6	5.9	8.8	4.9	5.1	5.0	4.5	3.6
Real GDP growth (in percent)	3.0	7.2	5.5	6.8	5.7	4.6	4.0	3.5	3.2
Inflation (GDP deflator, in percent)	2.6	2.3	1.5	1.8	2.1	2.0	2.0	2.0	2.0
Nominal GDP growth (in percent)	5.7	9.7	7.1	8.7	7.8	6.7	6.1	5.6	5.3
Effective interest rate (in percent) 4/	5.0	4.2	3.9	3.8	3.5	3.4	3.2	3.3	3.0

As of December 06, 2017		
Sovereign Spreads		
EMBIG (bp) 3/		82
5Y CDS (bp)		209
Ratings	Foreign	Local
Moody's	A3	A3
S&Ps	A-	A-
Fitch	A+	A+

Contribution to Changes in Public Debt

	Actual			Projections							
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance 9/
Change in gross public sector debt	-0.7	-3.5	-2.6	-3.5	-4.1	-2.8	-3.0	-1.9	-1.2	-16.5	
Identified debt-creating flows	-0.9	-4.5	-5.2	-6.0	-4.8	-4.0	-3.4	-3.1	-3.0	-24.3	
Primary deficit	-0.5	-1.3	-3.3	-3.4	-2.6	-2.4	-2.2	-2.1	-2.1	-14.8	-0.9
Primary (noninterest) revenue and grant	39.1	40.1	39.2	39.6	38.9	38.7	38.4	38.4	38.4	232.3	
Primary (noninterest) expenditure	38.6	38.8	35.9	36.2	36.3	36.3	36.2	36.2	36.3	217.6	
Automatic debt dynamics 5/	-0.4	-3.2	-1.8	-2.6	-2.2	-1.5	-1.3	-1.0	-0.9	-9.5	
Interest rate/growth differential 6/	-0.4	-3.2	-1.8	-2.6	-2.2	-1.5	-1.3	-1.0	-0.9	-9.5	
Of which: real interest rate	1.5	1.0	1.3	1.0	0.7	0.6	0.5	0.5	0.4	3.7	
Of which: real GDP growth	-1.9	-4.2	-3.1	-3.6	-2.8	-2.2	-1.8	-1.5	-1.3	-13.2	
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	
Privatization receipts (negative)	-0.1	-0.1	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	
ESM and euro area loans	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes 8/	0.2	1.0	2.5	2.5	0.8	1.2	0.5	1.1	1.8	7.8	



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 $r - \pi(1+g)$ and 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 and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

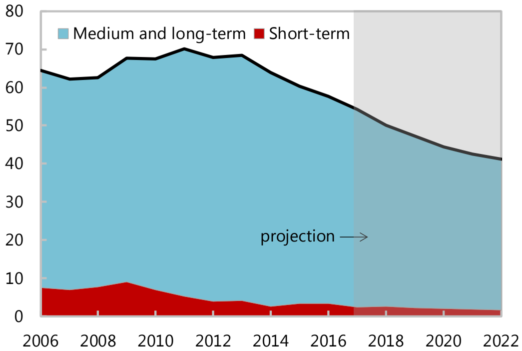
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

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

Composition of Public Debt

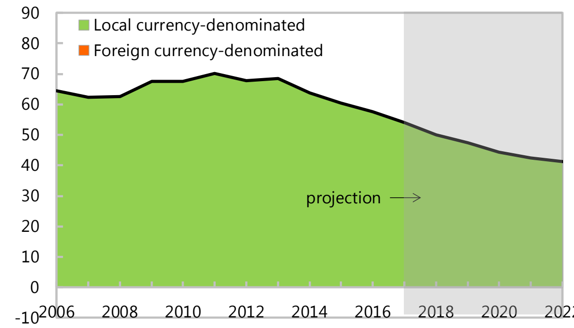
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

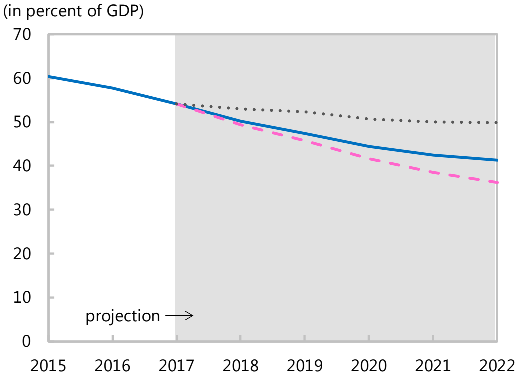


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

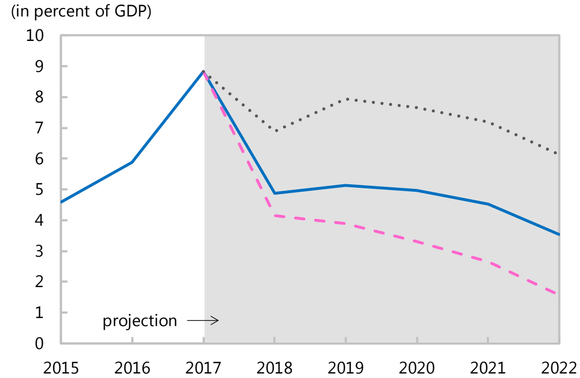
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

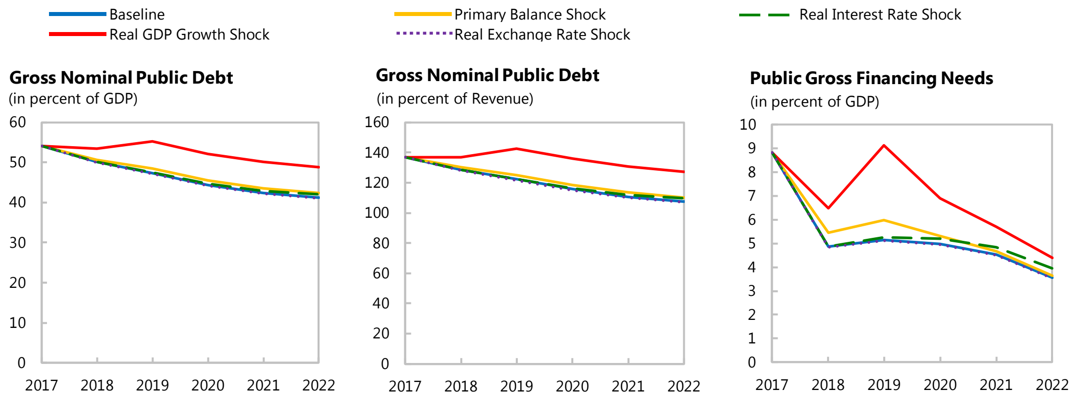
Baseline Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	6.8	5.7	4.6	4.0	3.5	3.2
Inflation	1.8	2.1	2.0	2.0	2.0	2.0
Primary Balance	3.4	2.6	2.4	2.2	2.1	2.1
Effective interest rate	3.8	3.5	3.4	3.2	3.3	3.0
Constant Primary Balance Scenario						
Real GDP growth	6.8	5.7	4.6	4.0	3.5	3.2
Inflation	1.8	2.1	2.0	2.0	2.0	2.0
Primary Balance	3.4	3.4	3.4	3.4	3.4	3.4
Effective interest rate	3.8	3.5	3.5	3.3	3.4	3.1

Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	6.8	3.8	3.8	3.8	3.8	3.8
Inflation	1.8	2.1	2.0	2.0	2.0	2.0
Primary Balance	3.4	0.8	0.8	0.8	0.8	0.8
Effective interest rate	3.8	3.5	3.5	3.3	3.5	3.3

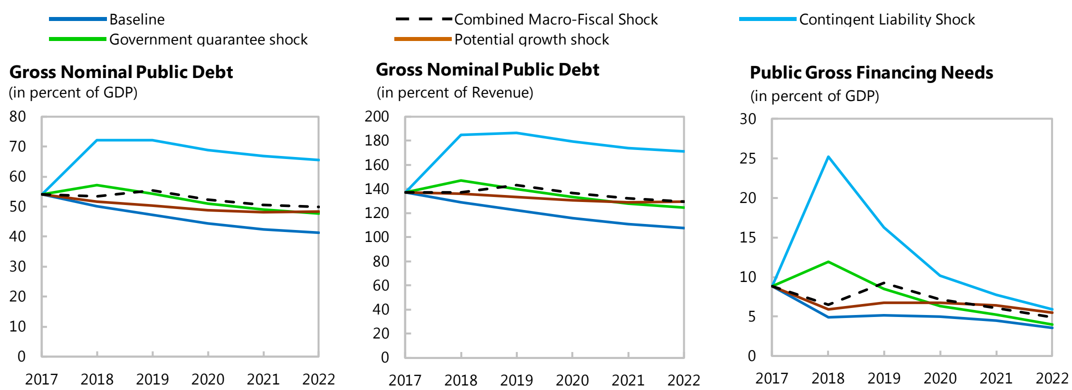
Source: IMF staff.

Figure 5. Malta: Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

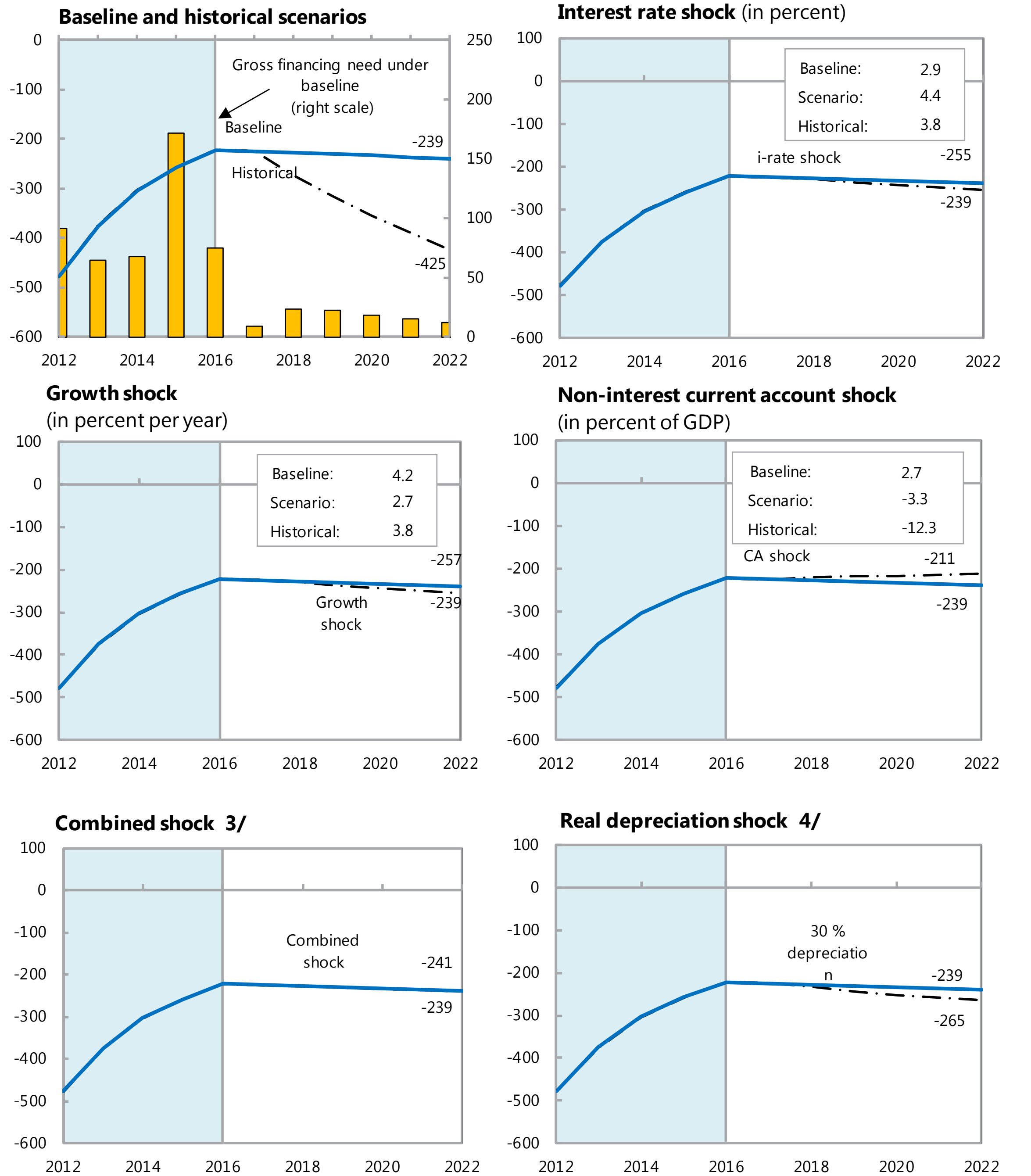
Primary Balance Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	6.8	5.7	4.6	4.0	3.5	3.2
Inflation	1.8	2.1	2.0	2.0	2.0	2.0
Primary balance	3.4	2.1	1.9	2.2	2.1	2.1
Effective interest rate	3.8	3.5	3.4	3.2	3.3	3.0
Real Interest Rate Shock						
Real GDP growth	6.8	5.7	4.6	4.0	3.5	3.2
Inflation	1.8	2.1	2.0	2.0	2.0	2.0
Primary balance	3.4	2.6	2.4	2.2	2.1	2.1
Effective interest rate	3.8	3.5	3.6	3.6	3.8	3.8
Combined Shock						
Real GDP growth	6.8	2.7	1.6	4.0	3.5	3.2
Inflation	1.8	1.3	1.2	2.0	2.0	2.0
Primary balance	3.4	1.3	-0.3	2.2	2.1	2.1
Effective interest rate	3.8	3.5	3.6	3.6	3.8	3.8

Real GDP Growth Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	6.8	2.7	1.6	4.0	3.5	3.2
Inflation	1.8	1.3	1.2	2.0	2.0	2.0
Primary balance	3.4	1.3	-0.3	2.2	2.1	2.1
Effective interest rate	3.8	3.5	3.4	3.3	3.3	3.1
Real Exchange Rate Shock						
Real GDP growth	6.8	5.7	4.6	4.0	3.5	3.2
Inflation	1.8	2.5	2.0	2.0	2.0	2.0
Primary balance	3.4	2.6	2.4	2.2	2.1	2.1
Effective interest rate	3.8	3.5	3.4	3.2	3.3	3.0
Contingent Liability Shock						
Real GDP growth	6.8	2.7	1.6	4.0	3.5	3.2
Inflation	1.8	1.3	1.2	2.0	2.0	2.0
Primary balance	3.4	-17.3	2.4	2.2	2.1	2.1
Effective interest rate	3.8	3.7	4.6	3.7	3.8	3.6

Source: IMF staff.

Figure 6. Malta: External Debt Sustainability: Bound Tests 1/ 2/

(Net external debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2017.

Table 1. Malta: External Debt Sustainability Framework, 2012-2022

(Net external debt, in percent of GDP unless otherwise indicated)

	Actual							Projections						
	2012	2013	2014	2015	2016			2017	2018	2019	2020	2021	2022	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	-477.7	-375.4	-303.5	-257.8	-222.0			**-224.9**	**-227.0**	**-230.3**	**-233.4**	**-236.4**	**-239.3**	**-10.0**
Change in external debt	16.5	102.4	71.9	45.7	35.7			-2.9	-2.0	-3.3	-3.1	-3.0	-2.9	
Identified external debt-creating flows (4+8+9)	-75.8	-21.0	-16.9	45.8	-0.9			-17.6	-14.7	-15.2	-15.6	-16.2	-16.4	
Current account deficit, excluding interest payments	12.5	9.9	0.7	2.3	-1.1			-5.6	-4.1	-3.2	-2.4	-1.9	-1.7	
Deficit in balance of goods and services	-4.9	-6.3	-12.0	-7.4	-11.3			-16.0	-16.2	-16.6	-17.1	-17.6	-18.2	
Exports	165.6	157.1	148.9	143.5	140.9			135.5	131.8	129.8	128.5	127.6	127.0	
Imports	160.7	150.8	136.9	136.2	129.6			119.6	115.6	113.2	111.4	110.0	108.8	
Net non-debt creating capital inflows (negative)	-97.6	-47.8	-44.1	22.5	-11.5			-21.0	-16.5	-15.8	-15.4	-15.2	-15.1	
Automatic debt dynamics 1/	9.3	16.9	26.5	21.0	11.6			9.0	5.9	3.8	2.2	0.9	0.3	
Contribution from nominal interest rate	-14.2	-12.5	-9.5	-6.9	-5.5			-4.7	-5.4	-6.0	-6.5	-6.8	-6.9	
Contribution from real GDP growth	13.3	19.9	27.6	23.8	13.3			13.7	11.3	9.8	8.7	7.8	7.3	
Contribution from price and exchange rate changes 2/	10.1	9.5	8.4	4.1	3.8			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	92.3	123.4	88.8	-0.1	36.7			14.7	12.6	11.9	12.5	13.3	13.5	
External debt-to-exports ratio (in percent)	-288.5	-238.9	-203.8	-179.6	-157.6			-165.9	-172.3	-177.4	-181.6	-185.2	-188.4	
Gross external financing need (in billions of US dollars) 4/	8.4	6.6	7.7	17.7	8.4			1.2	3.2	3.2	2.9	2.5	2.1	
in percent of GDP	91.5	65.2	68.5	172.3	76.1	10-Year	10-Year	9.5	23.4	22.0	18.5	15.5	12.4	
Scenario with key variables at their historical averages 5/								**-224.9**	**-274.2**	**-314.8**	**-353.4**	**-389.0**	**-423.6**	**-56.2**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	2.6	4.6	8.2	7.2	5.5	3.8	3.0	6.8	5.7	4.6	4.0	3.5	3.2	
GDP deflator in US dollars (change in percent)	-5.7	5.4	2.3	-14.6	1.2	1.4	8.0	3.7	6.5	2.4	2.2	1.7	1.6	
Nominal external interest rate (in percent)	2.8	2.9	2.8	2.1	2.3	3.8	2.9	2.3	2.7	2.8	3.0	3.1	3.1	
Growth of exports (US dollar terms, in percent)	-0.2	4.6	4.9	-11.7	4.9	12.8	28.7	6.6	9.3	5.6	5.2	4.5	4.4	
Growth of imports (US dollar terms, in percent)	-1.5	3.4	0.5	-8.9	1.7	11.0	27.6	2.2	8.7	5.0	4.6	3.9	3.7	
Current account balance, excluding interest payments	-12.5	-9.9	-0.7	-2.3	1.1	-12.6	11.7	5.6	4.1	3.2	2.4	1.9	1.7	
Net non-debt creating capital inflows	97.6	47.8	44.1	-22.5	11.5	63.8	53.6	21.0	16.5	15.8	15.4	15.2	15.1	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate,
e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels
of the last projection year.

INTERNATIONAL MONETARY FUND

MALTA

January 9, 2018

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By	European Department (In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of November 30, 2017)

Membership Status
Joined: September 11, 1968; Article VIII

General Resources Account	SDR Million	Percent Quota
Quota	168.30	100.00
Fund holdings of currency	141.48	84.06
Reserve Tranche Position	26.85	15.96

SDR Department	SDR Million	Percent Allocation
Net cumulative allocation	95.40	100.00
Holdings	87.22	91.43

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)

	Forthcoming			
	2018	2019	2020	2021
Principal				
Charges/Interest	0.06	0.06	0.06	0.06
Total	0.06	0.06	0.06	0.06

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 with the exception of restrictions notified to the Fund in accordance with decision No. 144-(52/51).

Article IV Consultation

Malta is on the standard 12-month consultation cycle. The previous consultation discussions took place during December 6–16, 2016, and the staff report (Country Report No.17/56) was brought for the Executive Board's consideration on a lapse-of-time basis. The Article IV Consultation with Malta was concluded on February 17, 2017.

Technical Assistance

Date	Department	Subject
April 2015	FAD	Revenue Administration
November 2014	FAD	Revenue Administration
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
April and December 2007		Expert visits
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 ISSUES APPENDIX

(As of December 31, 2017)

I. Assessment of Data Adequacy for Surveillance
General: 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 standards. Most macroeconomic statistics can now be accessed through Eurostat and Haver Analytics. The country has subscribed to the SDDS since December 1, 2009, with the metadata posted on the IMF's Dissemination Standards Bulletin Board.
National Accounts: Malta compiles 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 Haver Analytics as well as 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 10 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 and compilation of volume measures is currently progressing. Volume estimates of expenditure GDP are obtained using annual-chain linking with 2010 as the reference year. The monthly producer price index for total industry 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. Annual financial balance sheets and transactions by sectors are published on the Eurostat website. However, data on household savings are not available.
Price Statistics: Data on retail and consumer prices 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 Haver Analytics and via the Internet at the Central Bank of Malta (CBM) and the National Statistical Office (NSO) websites. The monthly producer price index for total industry has been published, but that for services sector is still under discussion.

Government finance statistics: Fiscal statistics meet 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 with a lag of one month, 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.
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 have been obtained through a gateway arrangement with the ECB, thus reducing the reporting burden of the country.
Financial Sector Surveillance: 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 (current account balance, and selected financial account data) are released by the NSO on a quarterly basis with a lag of about three months. More detailed BOP and IIP data are released quarterly, the latter with a lag sometimes of about one year. Summary trade statistics are released monthly with a lag of about 40 days. The CBM 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 transitioned to *BPM6* and has revised the estimates back to 2004. In line with the BPM6 requirements, the new data include estimates for the SPEs and other coverage improvements, affecting in particular the primary incomes and the financial account (direct and portfolio investments), as well as position data (IIP). The BPM6 implementation and data back casting entailed a series of data revisions recently.

II. Data Standards and Quality	
The country has subscribed to the SDDS since December 1, 2009, with the metadata posted on the IMF's Dissemination Standards Bulletin Board.	A data ROSC was published in 2006.

Malta: Table of Common Indicators Required for Surveillance (As of December 31, 2017)					
	Date of latest observation (For all dates in table, please use format dd/mm/yy)	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	Current	Current	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities 1/	Nov 2017	Dec 2017	M	M	M
Central Bank Balance Sheet	Nov 2017	Dec 2017	M	M	M
Consolidated Balance Sheet of the Banking System	Nov 2017	Dec 2017	M	M	M
Interest Rates 2/	Oct 2017	Dec 2017	M	M	M
Consumer Price Index	Nov 2017	Dec 2017	M	M	M
Revenue, Expenditure, Balance and Composition of Financing 3/ – General Government 4/	Jun 2017	Oct 2017	Q	Q	Q
Revenue, Expenditure, Balance and Composition of Financing 3/– Central Government	Nov 2017	Dec 2017	M	M	M
Stocks of General Government and General Government-Guaranteed Debt 5/	Jun 2017	Oct 2017	Q	Q	Q
External Current Account Balance	Sep 2017	Dec 2017	Q	Q	Q
Exports and Imports of Goods and Services	Sep 2017	Dec 2017	Q	Q	Q
GDP/GNP	Sep 2017	Dec 2017	Q	Q	Q
Gross External Debt	Sep 2017	Dec 2017	Q	Q	Q
International Investment Position 6/	Sep 2017	Dec 2017	Q	Q	A

1/ Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
2/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
3/ Foreign, domestic bank, and domestic nonbank financing.
4/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
5/ Including currency and maturity composition.
6/ Includes external gross financial asset and liability positions vis-à-vis nonresidents.
7/ Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).