



# MALTA

February 2019

## 2019 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR MALTA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2019 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 February 22, 2019 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 February 22, 2019, following discussions that ended on January 16, 2019, with the officials of Malta on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 7, 2019.
- An **Informational Annex** prepared by the IMF staff.
- A **Debt Sustainability Analysis** prepared by the staff of the IMF.
- A **Statement by the Executive Director** for Malta.

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

Selected Issues  
Financial Stability System Assessment

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### **IMF Executive Board Concludes 2019 Article IV Consultation with Malta**

On February 22, 2019, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation<sup>1</sup> with Malta. The discussion included an assessment of the financial system based on the work of the Financial Sector Assessment Program (FSAP).<sup>2</sup>

Malta has been one of the fastest growing countries in Europe post-crisis, thanks to rapid rebalancing toward export-oriented services, notably remote gaming. And the authorities have recently started to explore new development areas around the blockchain technology. Growth remains rapid and increasingly driven by domestic demand, but a cyclical peak may have been reached. GDP is estimated to have expanded by 6.4 percent in 2018. Despite tight labor market conditions, generalized wage and price pressures are yet to materialize. Strong inflows of foreign workers have helped keep wage pressure contained, but they are also putting rising pressure on infrastructure and housing prices. The fiscal balance is estimated to have registered a surplus in 2018, owing to favorable economic conditions and buoyant proceeds from the Individual Investor Program. The current account balance has remained on a positive trend, driven by a continued surplus in services. Over the medium term, growth is projected to gradually moderate to slightly above 3 percent as wage and inflation stabilize and the current account surplus remains large, driven by strong export of services.

The banking system remains well-capitalized, liquid, profitable and resilient, but faces some challenges. The FSAP stressed shortcomings in banking supervision—which extend to the

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<sup>1</sup> 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.

<sup>2</sup> The Financial Sector Assessment Program (FSAP), established in 1999, is a comprehensive and in-depth assessment of a country's financial sector. FSAPs provide input for Article IV consultations and thus enhance Fund surveillance. FSAPs are mandatory for the 29 jurisdictions with systemically important financial sectors and otherwise conducted upon request from member countries. The key findings of an FSAP are summarized in a Financial System Stability Assessment (FSSA), which is discussed by the IMF Executive Board.

implementation of the anti-money laundering and countering the financing of terrorism (AML/CFT) framework—and weaknesses in the bank liquidation and insolvency framework.

### **Executive Board Assessment<sup>3</sup>**

Executive Directors commended the authorities for sound policies that have supported strong economic performance and job creation while improving public finances. Directors considered risks to the outlook as broadly balanced and encouraged the authorities to continue implementing policies to address challenges and capacity constraints arising from infrastructure gaps, financial sector innovations, rising housing costs, and shortages of labor and skills.

Directors stressed the need for sustained efforts to safeguard financial integrity and stability. They called on the authorities to pursue ongoing reforms to mitigate money laundering and terrorist financing (ML/TF) risks and swiftly close gaps in supervisory and enforcement capacities. Directors welcomed measures taken to implement the recently-enacted 50-point action plan, while also emphasizing the importance of effective enforcement going forward. They concurred that virtual financial asset service providers should be supervised in line with the Financial Action Task Force standards.

Directors noted shortfalls in supervisory capacity and gaps in banks' liquidation and insolvency frameworks. They recommended that the long-term financial and operational independence of the supervisor be guaranteed, and the crisis management framework strengthened, including by adopting an administrative bank insolvency regime. In light of the rapid diversification of corporate financing, Directors also encouraged strengthening oversight of the nonbank financial sector and closing remaining data gaps.

Directors welcomed the planned introduction of borrower-based macroprudential instruments to mitigate the build-up of vulnerabilities in the real estate sector. They also supported further measures to improve housing affordability for low-income households.

Directors encouraged the authorities to maintain a prudent fiscal policy, and called for further efforts to strengthen the structural fiscal position excluding revenues from the Individual Investor Program. They agreed that the key priorities are to contain long-term fiscal risks by addressing age-related spending pressures and further restructuring vulnerable SOEs, shifting the balance of expenditure towards growth-enhancing public investment, and strengthening public investment management and risk analysis. Directors noted ongoing efforts to combat tax evasion and avoidance and recommended exploring further avenues for broadening the tax base.

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<sup>3</sup> At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

Directors emphasized the importance of structural reforms to foster sustained and inclusive growth. They encouraged measures to bridge infrastructure gaps, upskill and reskill the labor force, further encourage female and elderly participation in the labor market, and stimulate innovation through SMEs' enhanced access to finance. They also underscored the need to improve the efficiency of the judicial system.

## Malta: Selected Economic Indicators, 2015–2020

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

Per Capita GDP (2017): €24.2 thousand

Quota: 168.3 million SDR, .04% of total

	Projections					
	2015	2016	2017	2018	2019	2020
Real economy (constant prices)	(Percent change year on year)					
Real GDP	10.6	5.7	6.6	6.4	5.2	4.4
Domestic demand	14.5	1.1	-1.5	6.0	5.3	4.4
CPI (harmonized, average)	1.2	0.9	1.3	1.7	2.0	2.1
Unemployment rate (percent)	5.4	4.7	4.0	4.0	4.1	4.3
Public finance	(General government, percent of GDP)					
Overall balance	-1.1	0.9	3.5	0.9	0.6	0.6
Primary balance	1.3	3.0	5.3	2.5	2.0	1.9
Structural balance <sup>1/</sup>	-2.1	0.6	3.4	0.4	0.3	0.4
Gross debt	57.9	55.4	50.2	45.4	42.4	39.0
Financial sector	(Percent change year on year)					
Credit to nonfinancial private sector <sup>2/</sup>	0.6	1.1	3.5	...	...	...
Credit to the private sector (percent GDP)	87.3	84.4	79.4	...	...	...
Interest rates (year average)	(Percent)					
Interest rate for mortgage purposes	3.1	3.1	3.1	...	...	...
Ten-year government bond yield	1.5	0.9	1.3	...	...	...
Balance of payments	(Percent of GDP)					
Current account balance	2.4	3.4	10.4	10.1	9.3	8.8
Trade balance (goods and services)	9.0	13.2	20.9	21.4	21.4	21.4
Exchange rate						
Exchange rate regime	Joined EMU on January 1, 2008.					
Nominal effective rate (2010=100)	97.7	97.9	99.6	...	...	...
Real effective rate, CPI-based (2010=100)	97.9	98.4	99.5	...	...	...

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

<sup>1/</sup> As a percentage of Nominal Potential GDP.

<sup>2/</sup> Loans to nonfinancial corporate sector and households/individuals.



# MALTA

## STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

February 7, 2019

### KEY ISSUES

**Context:** Malta has been one of the fastest growing countries in the EU after the crisis, thanks to a rapid structural rebalancing towards export-oriented services—mainly remote gaming and tourism. The authorities are now exploring new development areas around the blockchain technology. Prudent fiscal policy and successful structural reforms have helped strengthen public accounts, boost productivity growth and maintain social cohesion. However, because growth has been heavily reliant on foreign labor, the pressure on housing and public infrastructures has increased rapidly with implications for social inclusion. Questions have also recently surfaced regarding the implementation of the country’s anti-money laundering and countering the financing of terrorism (AML/CFT) framework, including new risks related to crypto-asset activities.

**Policy recommendations.** Policies should focus on enhancing the economy’s resilience, ensuring financial stability and integrity and making growth more inclusive.

- **Financial sector.** Safeguard financial integrity by continuing the reforms and swiftly remedying deficiencies in the implementation of the AML/CFT framework. Guarantee the long-term operational independence of the supervisor and increase supervisory capacity. Enhance monitoring of the non-bank financial sector and close remaining data gaps.
- **Housing market.** Consider gradually narrowing the exemptions to the envisaged new borrower-based macroprudential measures and ensure that fiscal incentives do not amplify house price cycles. Address affordability issues for vulnerable households.
- **Fiscal policy.** Continue with prudent medium-term fiscal balance excluding proceeds from the individual investor program (IIP). Shift the balance of expenditure towards infrastructure. Further strengthen revenue collection and broaden the tax base. Improve public investment management and risk analysis.
- **Structural reforms.** Promote strong and inclusive growth by encouraging further labor market participation of women and elderly workers. Increase productivity by fostering innovation through larger public investment in human capital, research and development (R&D) and improved access to finance for SMEs.

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

Discussions were held in Valletta during January 7–16, 2019. The team comprised Mr. Natal (head), Ms. Baba, Mr. Qu, Mr. Salas (All EUR), Ms. Dumo, Ms. Bezerra de Menezes, and Mr. Cai (EUR) assisted from headquarters. Ms. Bacalu (head of the FSAP, MCM) joined the mission from January 14–16. Ms. Cerami (OED) participated in the discussions. The team met with Finance Minister Scicluna, Permanent Secretary Camilleri, Central Bank of Malta Governor Vella, Central Bank Deputy Governors Bonello, and Demarco, Permanent Secretary Fabri, Malta Financial Services Authority CEO Cuschieri, and other senior officials, members of the Parliament, representatives of labor and business organizations, and financial institutions.

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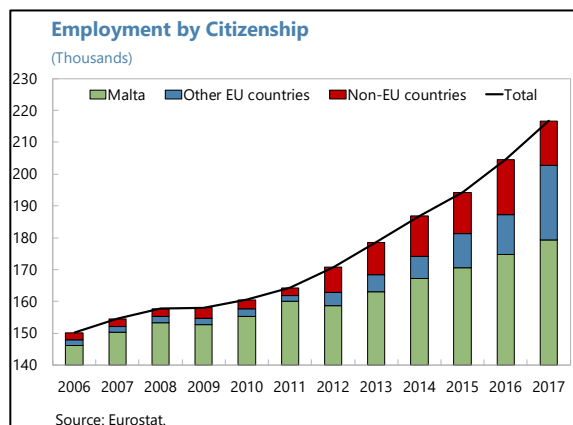
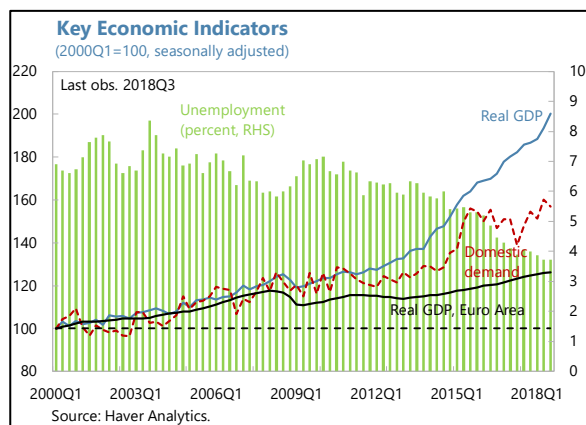
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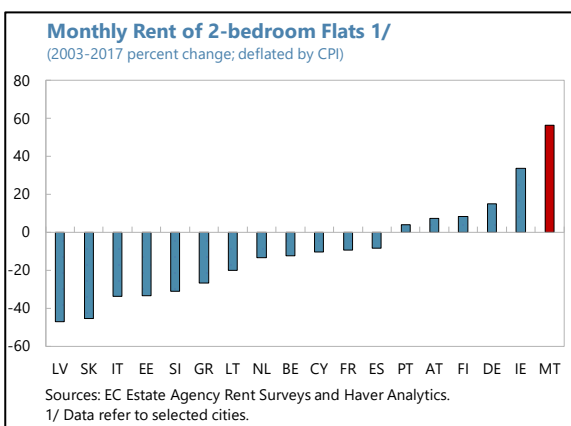
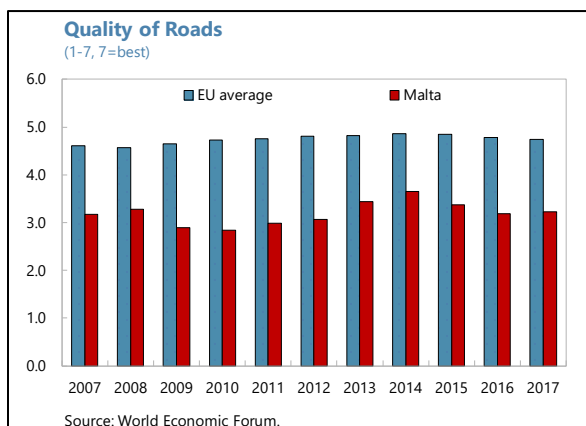
## CONTEXT AND KEY POLICY ISSUES

### 1. The rapid expansion of services exports continues to support Malta's robust growth.

Real GDP growth averaged 7.2 percent over 2013–17, against the backdrop of structural rebalancing towards fast growing export-oriented services industries, notably remote gaming. This structural shift has boosted the current account balance and facilitated rapid income convergence to the EU average. The share of foreign workers in total employment roughly tripled between 2010 to 2017, supporting buoyant job creation.

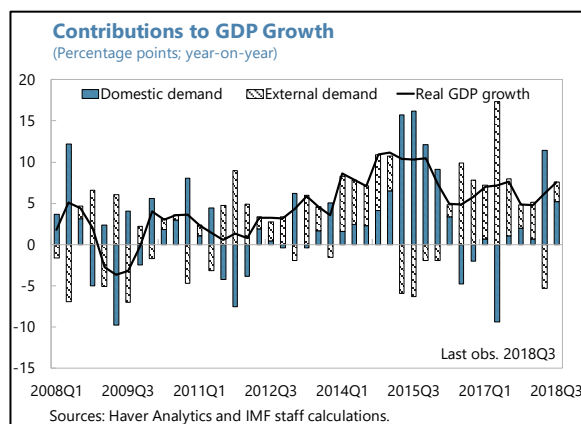


**2. But the economy faces capacity constraints.** The strong economic expansion is exacerbating bottlenecks. Physical infrastructure gaps, including in road quality and waste management, may weigh on future productivity and social welfare. Firms continue to face skills shortages as labor supply has become heavily dependent on migrant inflows. And while supply in the housing market gradually catches up with strong demand, property prices and rents in the non-protected market are rising fast, intensifying affordability concerns. The authorities have devised plans to address these issues (Annex III), but the effects of the measures may take time to fully materialize.

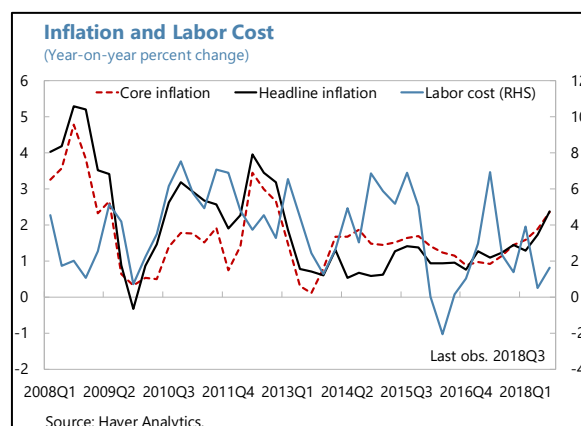


## RECENT DEVELOPMENTS

**3. Rapid growth continued but the economy may be approaching its cyclical peak.** After expanding by 6.6 percent in 2017, real GDP grew by 6.3 percent (y/y) in the first three quarters of 2018, reflecting strong private and public consumption growth. In contrast to 2016–17, the contribution of net exports to growth was small due to the deceleration of real exports and a slight pickup in imports. Several high-frequency indicators, including impressive employment creation, suggest continued growth momentum in the near term. The unemployment rate remained below 4 percent as of 2018:Q3.



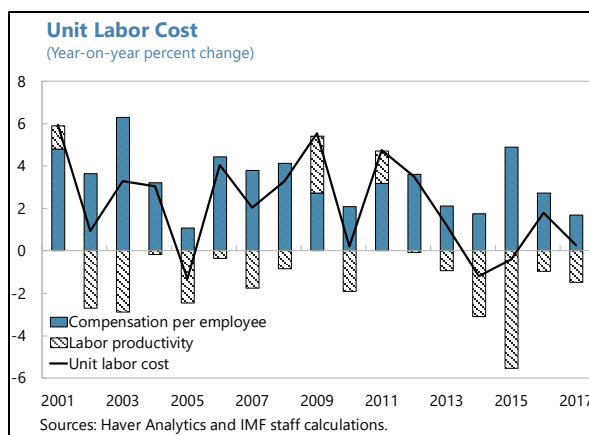
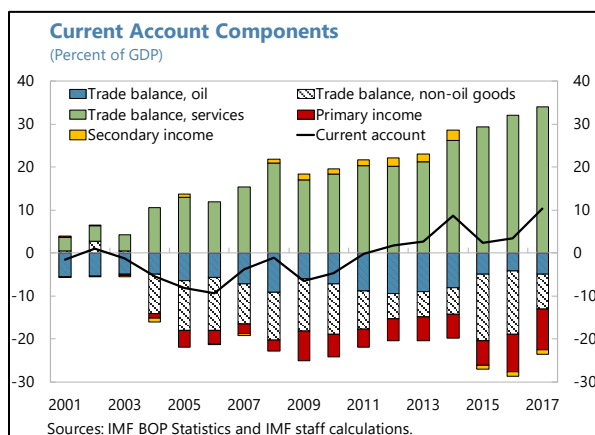
**4. Inflation has picked up somewhat.** In 2018, headline and core inflation (which excludes energy and unprocessed food) gained some pace but remained below 2 percent. Services were the main contributor to inflation, especially tourism-related categories such as accommodation services. Hourly labor costs for the whole economy increased by 1.6 percent in 2018:Q3 compared with a year earlier, below the EU average. Strong inflows of foreign workers and rising labor force participation have helped contain generalized wage pressures, even if signs of acceleration are visible in certain sectors.



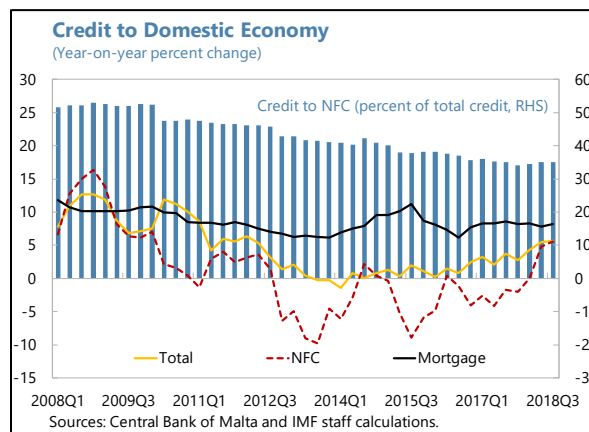
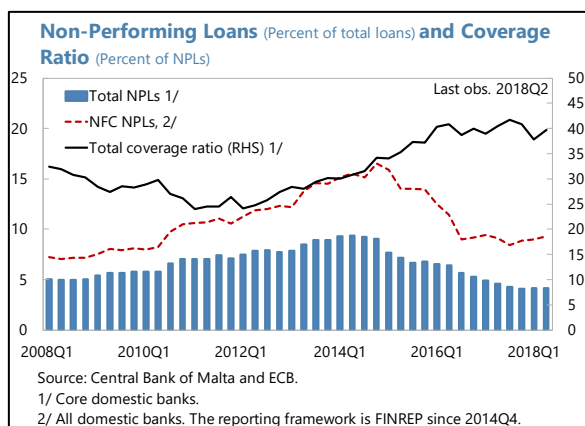
**5. Public finances have continued to improve.** The 2017 fiscal balance printed at a record surplus of 3.5 percent of GDP, outperforming last year's projection of only 0.8 percent of GDP and a budget target of 0.5 percent of GDP. Even excluding the large proceeds from the Individual Investor Program (IIP), the surplus reached 1.3 percent of GDP (1.3 percent of GDP in structural terms), supported by large and partly cyclical tax revenues and contained public-sector compensation. This is well above the medium-term objective (MTO) of a structural balance and helped reduce the public debt to about 50 percent of GDP at the end of 2017.

**6. The current account balance remained on a positive trend, driven by strong services exports.** The external position is assessed to be moderately stronger than fundamentals and desirable policy settings. The current account surplus surged from 3 percent of GDP in 2016 to 10 percent of GDP in 2017 as imports of capital goods moderated following a one-off investment in the aviation sector. The trend continues to be driven by a sizable and increasing trade surplus in services, largely accounted for by remote gaming and tourism. Consecutive current account surpluses in recent years

have also contributed to increase the net international investment position (NIIP), which rose to 66 percent of GDP in 2017, the highest in the EU. Following a decline between 2013 and 2015, the real effective exchange rate (REER) stabilized and only recently appreciated to above pre-crisis levels. Due to its status as a small financial center, Malta hosts a large number of special purpose entities (SPEs) and multinationals—complicating the measurement of the current account—and is undergoing rapid structural changes, all of which introduces high uncertainty to normative conclusions regarding the external position. Relying on IMF methodologies and judgment, staff assess that Malta’s external position was moderately stronger than fundamentals and desirable policy settings in 2018 (see Annex II, Annex IV, Figure 5).



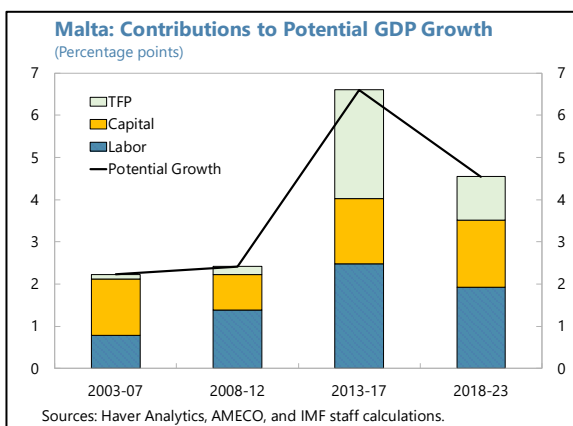
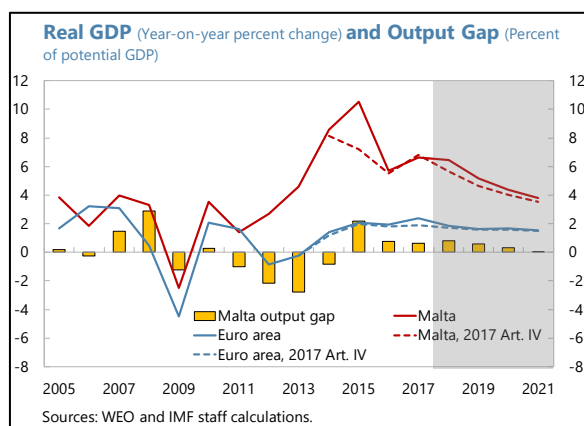
**7. Bank lending has been lagging economic activity reflecting diverging trends in mortgage and nonfinancial corporate (NFC) loans.** Household leverage<sup>1</sup> remained above the euro area average as banks continued to focus on mortgage credit, increasing the sector’s exposure to the housing market. Although credit to NFCs has staged a gradual recovery in 2018 following a five-year contraction, it still grows more slowly than nominal GDP. NPLs in core banks have been reduced rapidly between 2014 and 2017 but progress has stalled since then.



<sup>1</sup> Household leverage includes non-profit institutions serving the household sector.

## OUTLOOK AND RISKS

**8. Growth is projected to gradually moderate as the output gap closes.** Real GDP growth is expected to remain robust, easing to 6.4 percent in 2018 and 5.2 percent in 2019, with highly elastic foreign labor supply supporting potential output. Then, growth would gradually converge to its potential rate of slightly above 3 percent as capacity constraints hamper labor supply and total factor productivity growth – temporarily boosted by efficiency gains in the energy sector and inflows of highly educated foreign workers – slows down to its long-term average pace. The small positive output gap is projected to close over the medium term, consistent with the projected evolution of the unemployment gap, labor compensation and inflation which is set to remain around 2 percent over the near to medium term. Domestic demand is projected to become the main driver of growth as a strong labor market supports private consumption and planned private and public investment projects materialize. While both export and import growth are expected to moderate, the current account surplus should remain large over the forecasting horizon, reflecting enduring trade surpluses in services.



**9. Risks to the outlook are broadly balanced.** On the *downside*, unsustainable macroeconomic policies in systemically important countries, rising global protectionism, a no-deal Brexit, or a sharp tightening of global financial conditions could significantly reduce exports (especially of services) and FDI flows to Malta. Moreover, possible changes in international corporate and personal taxation could adversely affect foreign investment inflows and reduce demand for the IIP, with negative effects on growth, tax revenues and the external position. A sharp correction in housing prices could trigger adverse macrofinancial effects, while slow progress in addressing structural deficiencies may limit potential growth, including by hurting competitiveness and deterring foreign workers. Given Malta's exposure to money laundering risks, a failure to effectively implement the AML/CFT framework could undermine the business and financial environment and potentially imperil financial stability. On the *upside*, employment growth and private consumption could continue to surprise positively, the import intensity of domestic demand could continue to decline, and investment plans (including from businesses related to the blockchain) could be implemented faster than expected possibly implying higher potential growth (see Annex V: RAM).

## Authorities' Views

### 10. The authorities broadly agreed with staff's assessment of the outlook and risks.

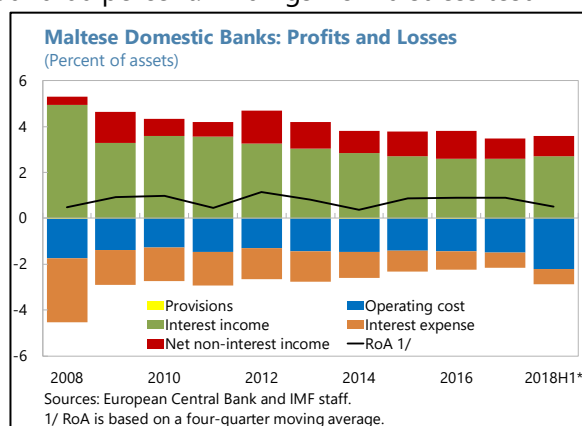
Domestic demand would continue to be the main driver of growth, and persistent labor market tightness might eventually put some pressure on wages and prices. They consider global protectionism as a key external risk and emphasized ongoing actions to address domestic risks related to money laundering. While potential growth is expected to remain healthy, they highlighted their actions and plans to upgrade infrastructure and mitigate labor supply constraints, including by streamlining bureaucratic steps for hiring foreign workers. The government stressed the importance of investing in new technologies, such as blockchain or artificial intelligence, to diversify the economy and support future growth. Finally, the authorities consider that the large current account surplus is sustainable and mainly driven by structural factors, emphasizing that there are no significant macroeconomic imbalances.

## POLICY DISCUSSIONS

### A. Safeguard Financial Stability and Integrity

Malta's financial system is large and complex. The share of foreign ownership and exposure is high, but thanks to a liquid, deposit-based domestic core banking system the domestic economy remains relatively insulated from international financial shocks. Following the global financial crisis, domestic core banks have become increasingly focused on mortgage lending as intercompany loans substituted for bank credit to NFCs. The FSAP has highlighted the resilience of the banking sector to real and housing shocks, but stressed shortcomings in banking supervision—which extend to the implementation of the AML/CFT framework—and in the legal regime for banks winding-up and insolvency proceedings.<sup>2</sup>

**11. The banking system remains well capitalized, liquid and profitable, but faces challenges ahead.** Core domestic banks' capital stayed above 17 percent of risk-weighted assets in 2018H1, with a loan-to-deposit ratio hovering around 60 percent. Findings from a stress test covering 11 banks<sup>3</sup> conducted as part of the FSAP for Malta confirmed that the overall banking system is well capitalized and liquid, with vulnerabilities limited to a few small banks. While banks' profitability remains above peers in the euro area, it is at risk of erosion due to rising exposure to low-yield bonds, a shrunk corporate loan portfolio, increased regulatory compliance costs and the implementation of the minimum required eligible liabilities (MREL).

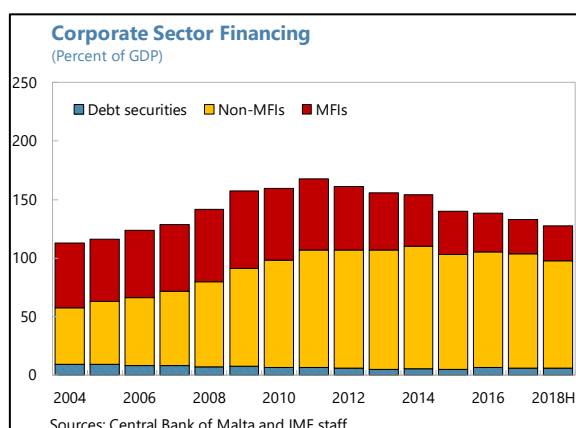
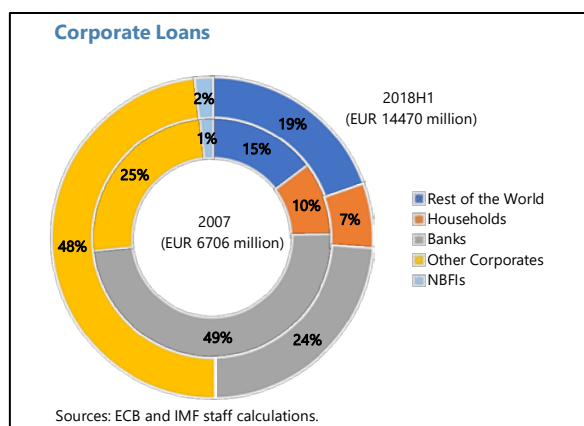


<sup>2</sup> See Annex VIII: FSAP's Main Recommendations.

<sup>3</sup> The sample banks cover 93.4 percent of system assets (excluding non-EU branches).

Competition from rapidly growing corporate bonds market and non-bank financial institutions could pose a challenge in the long run. Partly reflecting recent regulatory reforms (including the phased in threshold on NPL ratio at 6 percent over 5 years) the overall NPL ratio of core domestic banks was reduced from 9 percent to slightly above 4 percent over 4 years. However, this positive development seems to have stalled in 2018 and legacy NPLs in construction and real estate sectors continue to weigh on banks' balance sheets, reflecting enduring inefficiencies in the corporate insolvency process.

**12. The rapidly rising importance of intercompany lending and non-bank financial institutions warrants enhanced data collection and monitoring efforts.** As bank lending conditions tightened post-crisis, corporates have been gradually diversifying their source of funds towards non-bank financial intermediaries. Intercompany loans have become the most important source of funds for Maltese firms, potentially increasing contagion risks as concentration and liquidity risks could be significant in the corporate sector. At the same time, direct issuance of corporate debt and credit from non-bank financial institutions have also increased fast, but from a low level. Strong inter-linkages between some insurance companies and large domestic financial groups may also further elevate contagion risks. Against this backdrop, recent efforts in collecting granular loan-level data and the establishment of a central credit registry will help close some of the data gaps. To improve the monitoring of contagion risks, they need to be complemented by data on sectoral and cross-border intercompany financing. The FSAP also stressed that enhancing the analytical tools to assess systemic risks in the non-bank financial sector would help further mitigate financial stability risk.



**13. Capacity constraints and deficiencies in the regulatory framework undermine the effectiveness of financial supervision and crisis management.** The increasing number of financial entities under supervision, the rapid development of new products and the evolving regulatory framework have put the Malta Financial Services Authority's (MFSA) under considerable strain. The FSAP highlighted that large gaps in operational capacity for the supervision, winding-up and crisis management functions have become apparent and need to be addressed urgently (see Annex VII, FSAP's main recommendations).

- *The authorities need to take rapid actions to ensure the long-term financial and operational independence of supervisory authorities.* They are encouraged to rapidly develop a medium-term quantitative assessment of resource needs, including by mapping required skills, and to conduct regular reviews of the compensation package to guarantee the MFSA's capacity and autonomy to recruit and retain qualified staff. The authorities should also develop a five-year plan to ensure sustained budgetary resources for the MFSA. This is all the more urgent that the effective implementation of the new regulations regarding the licensing and supervision of crypto-asset-related companies will demand significant resources and appropriate expertise.
- *The crisis management framework should be improved.* Protracted and recurrent delays in liquidating banks demonstrate a lack of clarity in the legal insolvency regime, which should be administrative (led by the resolution arm of the MFSA), in line with international standards, rather than court-led. As a prerequisite for efficient insolvency proceedings, the creditor hierarchy in liquidation should be clarified.

**14. The recent revocation of Pilatus bank's license by the ECB has highlighted important deficiencies in the implementation of Malta's AML/CFT framework.** An investigation by the European Banking Authority (EBA) into the country's supervisory and enforcement approach in relation to Pilatus bank pointed to general and systemic shortcomings in the Financial Intelligence Analysis Unit's (FIAU) application of the national rules that transposed European anti-money laundering directives (3<sup>rd</sup> AMLD)<sup>4</sup> and in the MFSA's authorization and supervisory practices. These concerns were echoed by the FSAP which also emphasizes that AML/CFT supervisors need to focus on banks' application of preventive measures regarding their higher risk services and clients, including the significant nonresident sector, politically exposed persons, new technologies (e.g., remote gaming, crypto-currencies) and the IIP.

**15. The Maltese authorities need to take immediate actions to contain financial integrity risks.** Given the size and importance of Malta's financial sector, the exposure of certain banks to correspondent banking risk, the fast-growing remote gaming sector and the high demand for the IIP, the effective enforcement of the AML/CFT framework is critical. The measures taken to implement the recently-enacted 50-point action plan (based on the latest National Risk Assessment) are steps in the right direction, and the authorities should endeavor to implement the plan in full without delay. The FSAP recommends a multi-prong approach, with a focus on developing more effective AML/CFT enforcement and ensuring that banks apply preventive measures in relation to their high-risk activities and clients. First and foremost, supervisory resources at both FIAU and MFSA should be increased and steps should be taken to improve the understanding of risks and enhance their identification through intrusive, risk-based supervision. Second, the authorities need to ensure the effective application of AML/CFT preventive measures (customer due diligence, including with regard to beneficial owners). Third, implementation of fit and proper tests must be enhanced for financial institutions. Fourth, timely, dissuasive and proportionate sanctions must be

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<sup>4</sup> The EBA's assessment was relayed in a formal opinion by the European Commission on November 8, 2018.

imposed whenever breaches of AML/CFT requirements are identified. Finally, the authorities are also encouraged to pursue regional options for strengthening AML/CFT supervision, which would facilitate a consistent and comprehensive approach and minimize regulatory arbitrage.<sup>5</sup>

**16. Malta's new development areas related to the distributed ledger technology (DLT) present both opportunities and risks.** The passage of three bills in June 2018 was an important milestone in establishing a new regulatory framework for DLT and virtual financial assets.<sup>6</sup> This made Malta one of the first countries to provide a specialized regulatory framework to previously unregulated activities and is expected to lead to the migration of some of the largest crypto-asset exchange platforms to the island. Technological innovations surrounding the DLT may provide new growth opportunities for Malta, but these developments exacerbate existing risks and create new ones, particularly financial integrity risks, as the enforcement of the AML/CFT framework is more challenging when virtual financial assets are involved. Given the relatively high ML/TF risk associated with these new activities, the authorities should ensure that virtual financial asset service providers implement AML/CFT requirements in effective manner and are supervised in line with the Financial Action Task Force standards.

### ***Authorities' Views***

**17. The authorities remain committed to safeguard financial stability and integrity.** They acknowledged that the effective implementation of the AML/CFT framework is crucial, especially for banks to retain their correspondent banking relationships. The authorities reiterated their commitment to improve the understanding of ML/TF risks and enhance their identification through risk-based supervision and are closely cooperating with the European Banking Authority towards this goal. In line with FSAP recommendations, the FIAU and the MFSA have recently institutionalized their collaboration in a memorandum of understanding, and plan to conduct joint on-site inspections of high-risk cases. Both outsourcing and foreign hiring are considered given important skill shortages in the domestic labor market. To safeguard the operational independence of the MFSA, Cabinet has approved that future funding of the MFSA will be sourced through an overhaul of the MFSA's fee structure coupled with government's budgetary support. While embracing blockchain technology, the authorities agreed that the risks associated with crypto-asset-related activities warrant a robust regulatory framework and require significant supervisory resources and expertise. In this light, the Government has enacted a robust regulatory legislation. They stressed that no services providers had yet been licensed. since the due diligence process is underway.

<sup>5</sup> See euro area FSAP, 2018.

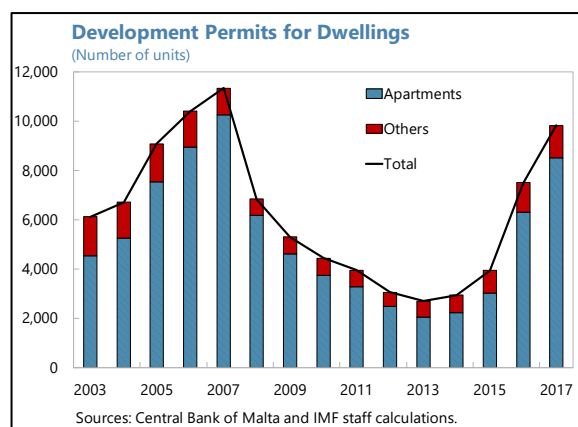
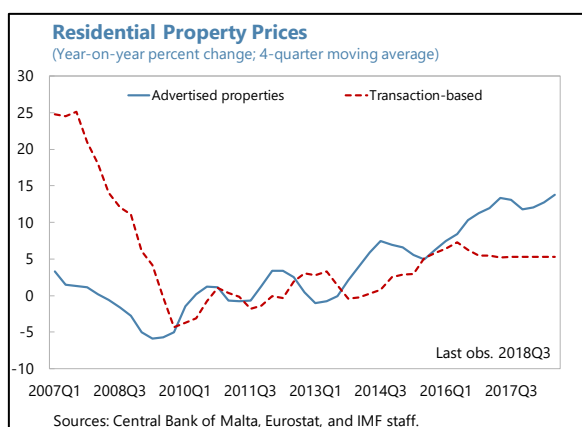
<sup>6</sup> The bills establish the regulatory regime on Initial Coin Offerings (ICOs) and crypto-currency exchanges (Virtual Financial Asset Act or VFSA), the registration and certification regimes for DLT platforms (Innovative Technology Arrangements and Services Act, and the Digital Innovation Authority (Malta Digital Innovation Act) in charge of certification and registration of innovative technology arrangements. The Malta Financial Stability Authority (MFSA) is responsible for the licensing of VFA service providers (e.g., crypto-exchanges) in accordance with the VFSA which came into force on November 1, 2018. It stipulates that VFA agents, issuers and license holders are subject persons in terms of the AML/CFT national regulation. See [MFSA](#) and [FIAU](#) for detailed guidance and FSSA, Annex IV.



## B. Contain Housing Market Pressures

*Rapidly rising house prices and rents may eventually pose financial stability risks while putting some vulnerable households at risk of poverty. Policies that help mitigate the rapid increase of house prices and make rents more affordable while strengthening households and banks' balance sheets should be encouraged.*

**18. Strong demand for housing has continued to push up property prices.** While some signs of overvaluation have started to emerge, recent house price trends can largely be explained by fundamentals such as e.g., strong immigration flows, rising disposable income, portfolio rebalancing towards property investment and a delayed supply response. Other factors such as the extension of the first-time home-buyer stamp duty relief, the reduced tax rate on rental income, surging demand for tourist accommodation and, for the high-end segment, the IIP may also have played a role (but are not directly controlled for in the empirical analysis conducted in Annex I).



**19. Banks' exposure to housing-market-related risks is high and increasing, and the introduction of macroprudential measures should proceed as planned.** All the more so that households' indebtedness is relatively high, low income households are vulnerable to housing price corrections and flexible interest rate on mortgages are prevalent.<sup>7</sup> Against this backdrop, recent efforts to close data gaps (loan-level data collection) and the planned introduction of borrower-based macroprudential measures such as caps to loan-to-value (LTV) ratios at origin, stressed debt-service-to-income (DSTI) limits, and amortization requirements are steps in the right direction (see text table).

<sup>7</sup> See Malta FSAP 2019 Technical Note on Risk Analysis.

**20. To be more effective, the new borrower-based measures could be refined in due course and exemptions to the LTV limit could be narrowed.** To avoid excessive risk concentration, speed limits should be defined in terms of the total value of new loans, not in terms of the number of new loans, and speed limits for loans against secondary and buy-to-let properties, the likely most speculative segment, should be lowered as soon as concerns about any initial disruptions dissipate.<sup>8</sup> Finally, the scope of the new borrower-based measures should be extended to also cover non-bank mortgage loans.<sup>9</sup>

Malta: Borrower Based Macroprudential Measures			
	LTV-O 2/	DSTI-O 2/	Maturity
<b>Category I Borrowers</b> 1/	90 percent LTV-O cap with a "speed limit" of 10 percent on the volume of loans, for loans with a market value in excess of €175,000.	A stressed DSTI-O of 40 percent for loans with a market value in excess of €175,000 with a shock to interest rates of 150 bps.	A maturity term of 40 years or the official retirement age, whichever occurs first.
<b>Category II Borrowers</b> 1/	<b>1<sup>st</sup> year:</b> 85 percent LTV-O cap with a "speed limit" of 20 percent on the volume of loans. <b>2<sup>nd</sup> + year:</b> 75 percent LTV-O cap with a "speed limit" of 20 percent on the volume of loans.	A stressed DSTI-O of 40 percent with a shock to interest rates of 150 bps .	A maturity term of 20 years or the official retirement age, whichever occurs first.
1/ Category I comprises borrowers purchasing their primary residential property and Category II comprises borrowers purchasing their second or additional residential property or buy-to-let properties. 2/ LTV-O refers to the Loan-to-Value-at-Originatio ratios. DSTI-O refers to the Debt-Service-to-Income-at-Originatio ratios. Source: CBM			

**21. Rapidly rising housing costs are affecting vulnerable households.** The government recently relaxed the eligibility requirements for rent subsidies, but the scheme should be periodically reviewed to ensure it remains targeted on low-income households. Further efforts should also be envisaged to accelerate the provision of social housing, including by fiscally incentivizing private investments.

### **Authorities' Views**

**22. Rapidly rising property prices are viewed by the authorities as mainly reflecting economic fundamentals.** Inflows of foreign labor and higher income in general are fueling housing demand. The authorities also see the impact of tax benefits for first and second-time home buyers, the reduced tax rate on rental income and the IIP as marginal. They stressed that the planned borrower-based macroprudential measures were carefully calibrated to have minimal market impact upon their introduction. The authorities have agreed that there is room for refinement, in due course, and emphasized that they can easily recalibrate the measures to mitigate financial stability risks emanating from the housing market in a timely and effective manner. The authorities also recognize the growing importance of making housing more affordable for vulnerable households.

<sup>8</sup> Category I comprises borrowers purchasing their primary residential property and category II comprises borrowers purchasing their second or additional residential property or buy-to-let properties.

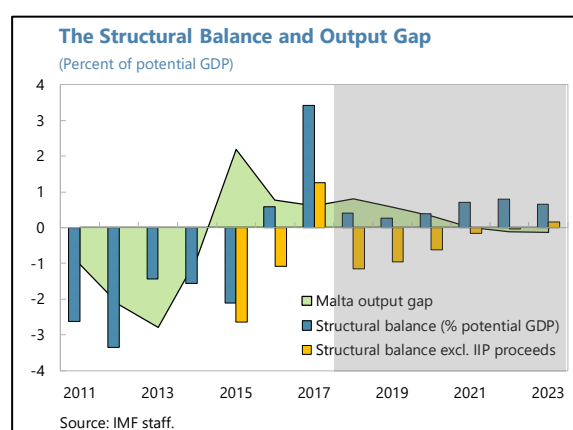
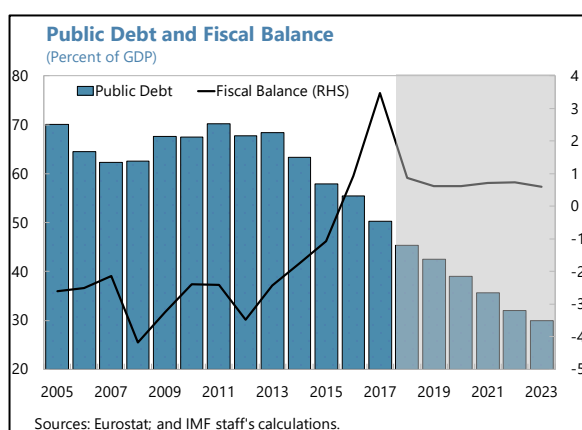
<sup>9</sup> See 2019 Malta FSAP Technical Note on Macroprudential Policy Framework and Tools for more discussions.

They emphasized the progressive nature of the new rent subsidy scheme. Projects are underway to increase the stock of social and affordable housing.

### C. Maintain Prudent but Growth Enhancing Fiscal Policy

*Fiscal policy needs to shift the balance of expenditures towards infrastructure, contain long-term fiscal risks, improve public investment management and risk analysis, and strengthen revenue collection.*

**23. The government is expected to over-achieve its budget target in 2018.** Outturns as of November 2018 suggest another year of fiscal surplus, owing to buoyant tax revenues and IIP proceeds. Allowing for an expected acceleration of public investment (including EU-funded investment) in the second half of the year, staff projects an overall balance of 0.9 percent of GDP in 2018, well above the initial government surplus target of 0.5 percent of GDP. The debt-to-GDP ratio is estimated to moderate further to 45 percent at the end of 2018. Excluding the IIP proceeds, the balance would be a deficit of 0.7 percent of GDP (1.2 percent of potential GDP in structural terms).



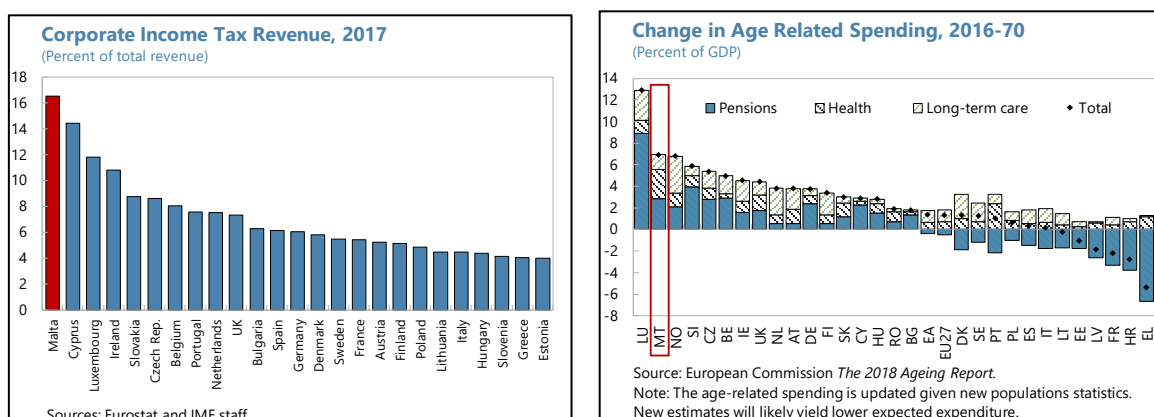
**24. Plans to reach fiscal balance without relying on net IIP appear appropriate and within reach in the medium term.** On the expenditure side, the 2019 budget envisages marginal declines in employee compensations, social payments and interest expenditure as a share of GDP. The tax burden is also reduced for targeted groups (such as low-income earners, single part-time workers, and first-time home buyers). In the short to medium term, the government aims for a positive structural balance, which seems appropriate given the currently favorable cyclical position, still elevated contingent liabilities related to financially weak SOEs and strong demographic pressures.

Malta: Fiscal Estimates and Projections						
(Percent of GDP)						
	Staff Projections					
	2018	2019	2020	2021	2022	2023
Revenue	38.2	37.5	37.3	37.0	37.1	36.0
Expenditure	37.3	36.9	36.7	36.3	36.4	35.4
Overall balance	0.9	0.6	0.6	0.7	0.7	0.6
Structural balance	0.4	0.3	0.4	0.7	0.8	0.7
Structural balance, excl. IIP proceeds	-1.2	-0.9	-0.6	-0.2	0.0	0.2
Public debt	45.4	42.4	39.0	35.6	32.1	30.0

Source: IMF staff.

Public debt appears sustainable and is projected to reach 30 percent of GDP in 2023, but remains vulnerable to contingent liability shocks (see DSA Annex VIII) and long-term prospective increases in age-related spending (see text chart). Overall, staff projects a deficit of 0.9 percent for the structural balance net of IIP in 2019 and a convergence to a structural balance net of IIP proceeds by 2022 (see text table).

**25. Efforts to contain fiscal risks and shift the balance of expenditure towards growth enhancing public investment should remain the priority over the coming years.** To ensure space for much needed, long-term growth-enhancing investment in infrastructure (transportation, energy, water-resource and waste-management) and inclusion-promoting measures (see section D), continued effort is needed to strengthen the structural fiscal position ex-IIP proceeds. The planned institutionalization of the comprehensive spending reviews should help identify further saving opportunities. Moreover, given large projected demographic pressures, further incentives to deter early retirement and increase the take-up of private pension schemes should be explored. On the revenue side, Malta's high reliance on the IIP and corporate tax makes it vulnerable to possible regime changes. Positive steps have been made to help combat tax evasion and avoidance and increase VAT compliance, including the introduction of an electronic tax filing system, a framework to write-off legacy arrears, and the transposition into national law of the EU anti-tax avoidance measures planned over 2019–2022. Further avenues for broadening the tax base should be explored.



**26. Improving fiscal transparency would also help manage fiscal risks.** An IMF Fiscal Transparency Evaluation, conducted in May 2018, assessed Malta's fiscal transparency practices (see Annex VI). Overall, Malta meets many of the fiscal transparency principles at good or advanced level, but there remain gaps to be closed. In substance, the coverage of fiscal reports should be extended to the entire public sector and the reporting on tax expenditures, extrabudgetary units, and performance information should be improved. Presentations across reports could be better harmonized and changes to previous forecasts better explained. Staff also recommended improving public investment management and risk analysis by introducing a cost-benefit analysis and publishing annual fiscal risk statements. The institutional framework for managing fiscal risks should also be strengthened, notably in relation to public corporations. This would help better monitor and advance the restructuring of financially weak SOEs.

### **Authorities' Views**

**27. The authorities reiterated their commitment to maintain prudent fiscal policy.** They expect continued fiscal surpluses supported by high tax revenues reflecting the strong economy. Prudent spending and lower debt are also expected to gradually create additional space for investment and social transfers. The government's ability to further conduct spending reviews and implement recommendations is being strengthened through staff training partially financed by an EU grant. It is to be noted that in 2017, the Government achieved its fiscal targets net of IIP revenue. While revenues from the IIP are expected to remain sizable, the authorities expect to achieve their medium-term fiscal targets without relying on IIP proceeds, bolstering fiscal sustainability and maneuverability. The government stressed that addressing infrastructure gaps and social challenges arising from rapid growth remain its priority. Finally, work is underway to start publishing fiscal data with a wider coverage of the public sector in 2019, in line with the recommendation of the FTE conducted by the IMF in 2018.

### **D. Promote High and Inclusive Growth**

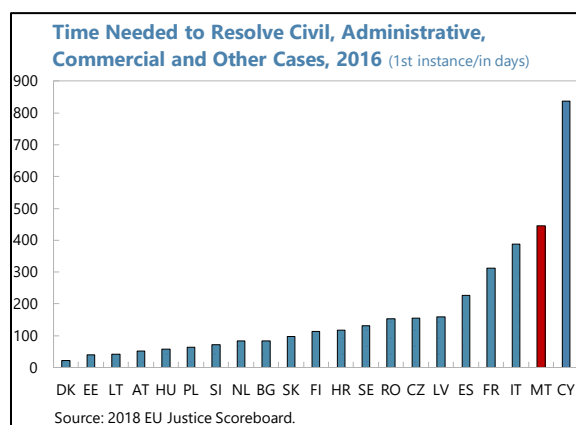
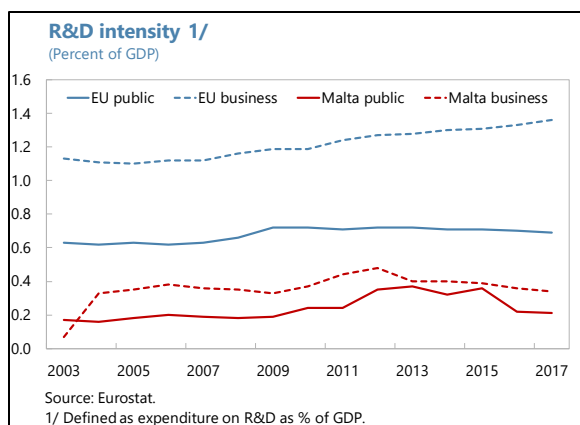
*Addressing remaining structural weaknesses will help sustain Malta's strong growth momentum while promoting inclusiveness. To boost the economy's productive capacity and improve labor productivity, priority areas should include public infrastructure, access to finance, judicial reforms, innovation, labor force participation and skills gaps.*

**28. The authorities' focus on upgrading road infrastructure is appropriate.** Weak road quality has led to severe congestion, with adverse impact on productivity and health. While a €700 million, seven-year plan to upgrade roads is already underway, it is important to ensure that some attention is also given to efficiency aspects for maximizing output gains. Public investment efficiency could be improved by reviewing administrative procedures and avoiding bottlenecks, for instance by removing overlapping responsibilities and moving towards a holistic public investment management approach across government departments. Better planning could also improve the implementation of projects co-financed by EU funds or the private sector through PPP and avoid bottlenecks. To address some of these issues, a new entity was recently created to implement and maintain public infrastructure projects in roads and other sectors.<sup>10</sup>

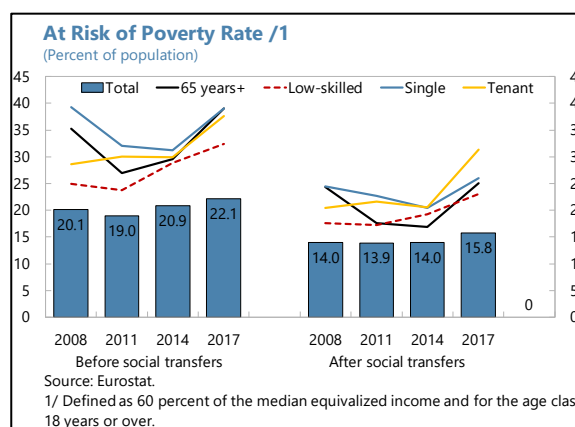
**29. SMEs' enhanced access to finance may help boost innovation and investment.** R&D expenditure indicators remain low in comparison to the EU average. The prevalence of SMEs in Malta—which tend to have a limited capacity to grow due to their constrained access to finance, among other factors—may partly explain why innovation activity tends to lag European peers. Strengthening innovation would help boost productivity growth, and the authorities' focus on start-ups, for example through financial support provided by Malta Enterprise to innovative businesses and programs involving tax credit incentives (Seed Investment Scheme) should be encouraged. The Malta Development Bank is also expected to start providing investment finance to SMEs in coming months, which could contribute to offset the recent decline of private banks' lending to SMEs.

<sup>10</sup> Selected issues paper, Malta staff report, IMF 2018.

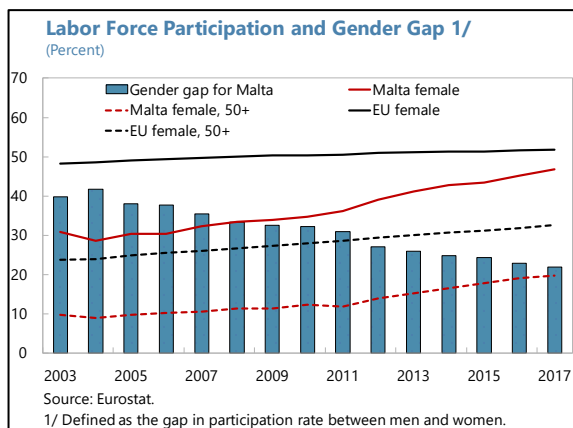
Ensuring prudent risk assessment and robust governance structures will be key. Furthermore, improvements in the judicial system's efficiency, especially for insolvency proceedings, could help increase credit provision to SMEs by accelerating the necessary clean-up of firms' and banks' balance sheets. Despite recent progress, the time needed to resolve civil, commercial, administrative and other cases in Malta is still among the highest in the EU (see 2018 EU Justice Scoreboard).



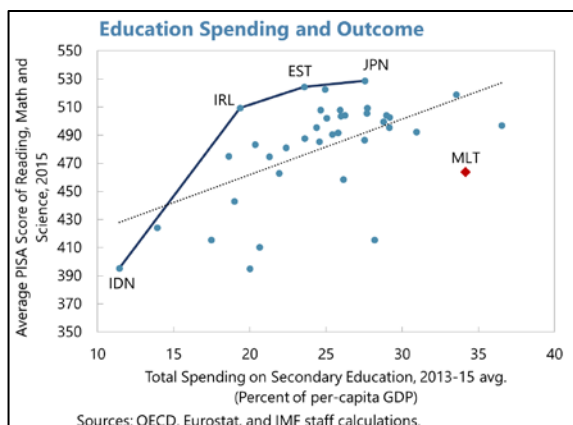
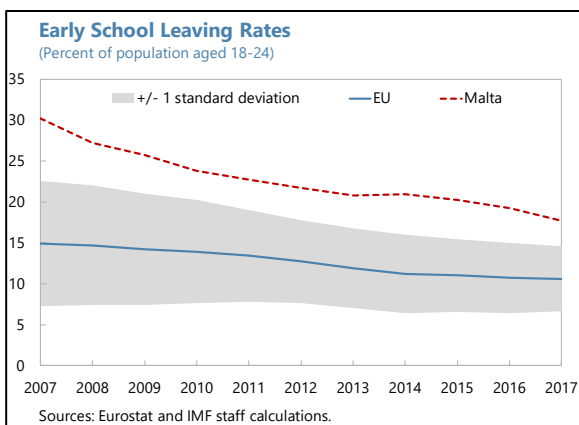
**30. Promoting social inclusion may help boost long-term output.** The share of the population at risk of poverty is relatively stable and below the European average, but *it is high and has been increasing for subgroups of the population: female single earners, low-skilled part-time workers, unemployed and the elderly.* For the most vulnerable, the situation is made worse by the rapid increase of housing costs, in particular rental costs. Tenants are often low-skilled, single earners, unemployed or elderly. The authorities have introduced many programs to address social exclusion, but recent trends suggest that there is scope for more actions. Staff analysis (see SIP) suggests that measures that aim to incentivize female labor market participation, align retirement age with life expectancy and enhance workers' skills would foster inclusion and, at the same time, boost long-term output, thereby mitigating the long-term burden on public finances of these measures.

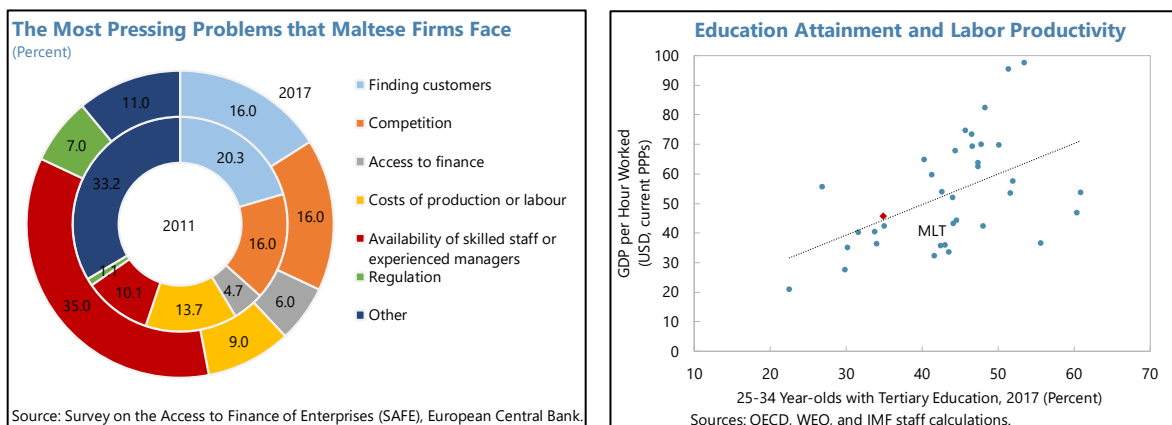


- There is scope to further increase female and elderly participation in the labor market.* Recent government initiatives to “make work pay,” including free childcare, in-work benefits, and the tapering of benefits for those entering employment, have been instrumental in increasing female labor force participation. But continuous efforts are needed to reduce the remaining gender gap, especially for older cohorts, and the increasing pay gap. While part of the remaining gap should decline over time as younger cohorts mature and older cohorts reach retirement age, further initiatives such as introducing some compensation for parental leave or increasing leave entitlement for fathers could help ensure full convergence to EU average. Also, while the statutory retirement age is scheduled to increase gradually to 65 years by 2026, there is scope to better align the effective retirement age to life expectancy by incentivizing later retirement, including through penalties for early retirement and sponsoring of lifelong learning. The government’s plan to extend to public sector employees the private-sector’s delayed pension incentives is a step in the right direction.



- Upskilling and reskilling workers remains a priority.* Policies to improve human capital would help strengthen the effects on growth of enhanced innovation and investment. Although Malta invests heavily in education, basic skills attainment among young people is still weak and strongly influenced by socio-economic status. Also, large gaps vis-à-vis the EU average remain in terms of the early school leaving rate and tertiary educational attainment. These weaknesses underpin widespread skills shortages, which have become a barrier to investment according to survey evidence, as well as the increasing dependence on higher-skilled foreign workers. The new Work-based Learning and Apprenticeship Act came into force in March 2018, creating a legal framework for vocational education and training focused on school-leavers, and aiming to address skills shortages. This act will simplify data collection on training programs, which should help improve outcome-based evaluation.





### Authorities' Views

**31. The authorities stressed that there is no reform fatigue in Malta.** Infrastructure works related to roads, health, education, and waste management are ongoing and a new entity, tasked with increasing public investment efficiency in the implementation of infrastructure projects, has been created. They indicated that the Malta Development Bank is coordinating with commercial banks on new co-financing and loan guarantee schemes for SMEs, while also taking steps to ensure strong governance and increasing its capacity. The authorities stressed ongoing judicial reforms aimed at further reducing the length of proceedings and strengthening the insolvency framework. Policies to increase female labor participation are still in place, and new implemented educational measures are expected to help further reduce the rate of early school leavers. A number of measures have been implemented to tackle pension adequacy whilst safeguarding the long-term pension sustainability. Efforts are also underway to diversify retirement income, in particular through the strengthening of tax incentives associated with contributions to voluntary occupational and third pillar pensions as well as measures to enable home equity release. The government also underscored recent training initiatives for refugees as well as their “equal pay for equal job” policy that should support better integration.

## STAFF APPRAISAL

**32. Growth remains strong in Malta.** Prudent policies and reform efforts have contributed to strengthening balance sheets, while steady job creation has driven unemployment to historically low levels. Growth remained strong during 2018, supported by large inflows of foreign workers, but mounting pressure on infrastructure, rapidly rising housing costs, and labor and skills shortages increasingly pose challenges. Risks to the outlook are broadly balanced, and the external position is assessed to be moderately stronger than fundamentals.

**33. Sustained efforts are needed to safeguard financial integrity and stability.** Given Malta’s large and internationally connected financial sector, the strong demand for the IIP and remote gaming, and the envisaged expansion of blockchain-related activities, it is crucial to mitigate ML/FT risks through sustained reforms. Immediate action is required to close gaps in supervisory



and enforcement capacity, while steps should be taken to improve the understanding of risks and enhance their identification through intrusive, risk-based supervision. It is also crucial to apply timely and adequate sanctions in case of breaches. The authorities should also ensure that virtual financial asset service providers effectively implement AML/CFT requirements, and are supervised in line with the Financial Action Task Force standards.

**34. Remaining supervisory capacity constraints and deficiencies in the regulatory framework should be addressed.** The increasing number of financial entities under supervision, the rapid development of new products, the evolving regulatory environment and the tight labor market have put the MFSA under considerable strain. To improve the effectiveness of the supervisory and crisis management frameworks, the long-term financial and operational independence of the MFSA needs to be guaranteed. Moreover, supervisory actions should not be delayed through judicial appeals, and an administrative bank insolvency regime should be adopted.

**35. Rapid diversification of corporate financing calls for more comprehensive risk monitoring.** Intercompany loans have become the main source of funding for firms. Direct issuance of debt securities and credit from non-bank financial institutions have also grown rapidly, albeit from a low base. While the diversification of funding sources has served Maltese firms well, this development calls for strengthening data quality and management to better monitor contagion risks and enhancing the analytical tools for risk assessment of the non-bank financial sector.

**36. The planned introduction of housing-related macroprudential instruments is appropriate given the rising exposure of banks to real estate risks.** The new measures – comprising LTV and DSTI limits, as well as amortization requirements – are expected to address the build-up of vulnerabilities in the residential real estate market and improve balance sheets' resilience to a reversal in housing market conditions. To improve their effectiveness, these measures could be refined in due course, including by narrowing the exemptions from the LTV and DSTI limits for loans against secondary and buy-to-let properties. The tax treatment of rental income should be aligned with that of other sources of income to avoid amplifying house price cycles.

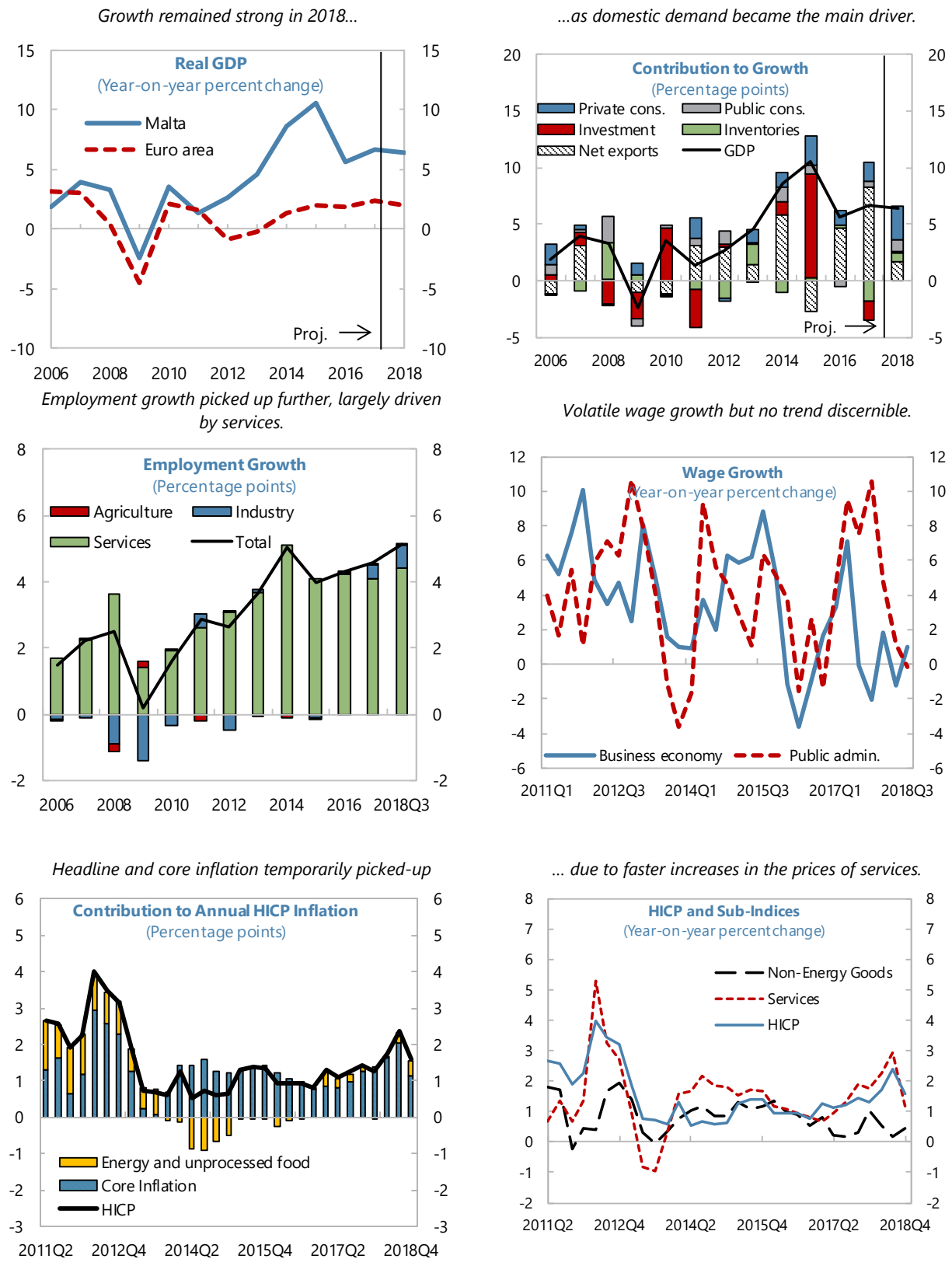
**37. Reducing fiscal risks and shifting the balance of expenditure towards growth-enhancing public investment should remain priorities.** To ensure space for infrastructure investment, it is important to identify measures that would strengthen the structural fiscal position ex-IIP proceeds. Financially vulnerable SOEs should be restructured, and public investment management and risk analysis strengthened, notably by introducing cost-benefit analysis and publishing fiscal risk statements. The planned institutionalization of the comprehensive spending reviews should help identify further saving opportunities. Given large projected demographic pressures, additional incentives to deter early retirement and increase the take-up of private pension schemes should be explored. On the revenue side, Malta's high reliance on the IIP and corporate tax makes it vulnerable to potential regime changes. Recent measures to combat tax evasion and avoidance and increase VAT compliance are adequate, but further avenues for broadening the tax base should be explored.

**38. Sustaining the reform drive is key to foster strong and inclusive long-term growth.**

Attention should be given to addressing infrastructure gaps, upskilling and reskilling the labor force, further encouraging female and elderly participation in the labor market, stimulating innovation (including by easing SME's access to financing), and making housing more affordable for low-income households.

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

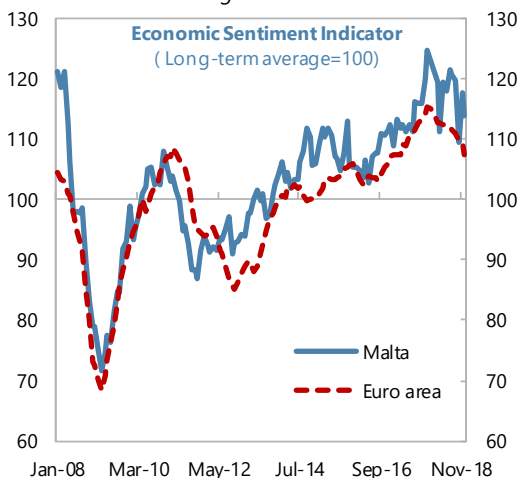
**Figure 1. Malta: Economic Indicators**



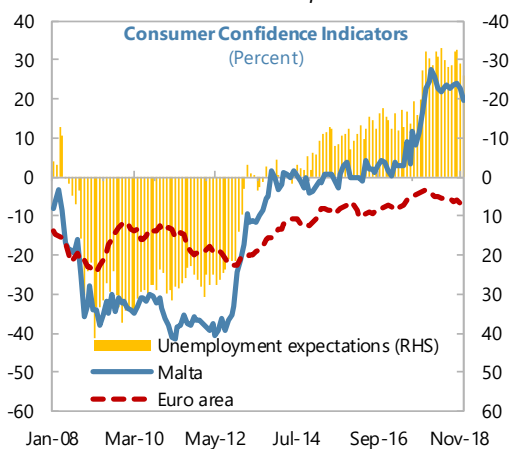
Sources: Central Bank of Malta; Eurostat; IMF *World Economic Outlook*; and IMF staff calculations.

**Figure 2. Malta: Short-Term Indicators**

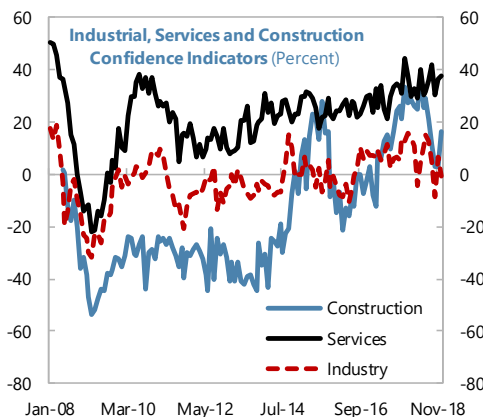
*The overall economic sentiment indicator stabilized at high level ...*



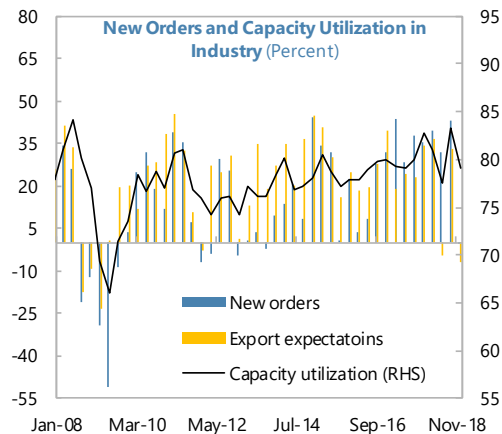
*... supported by a strong labor market and high consumer confidence.*



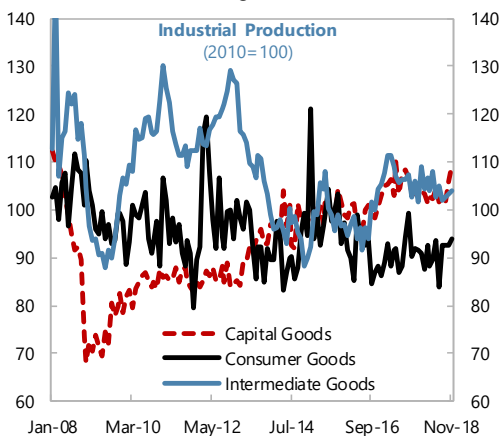
*Confidence remained high in services.*



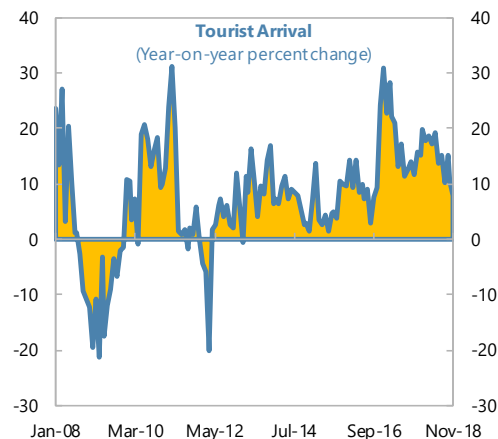
*Capacity utilization remained high reflecting strong demand in the industry.*



*Production of consumer goods continues to lag capital goods*



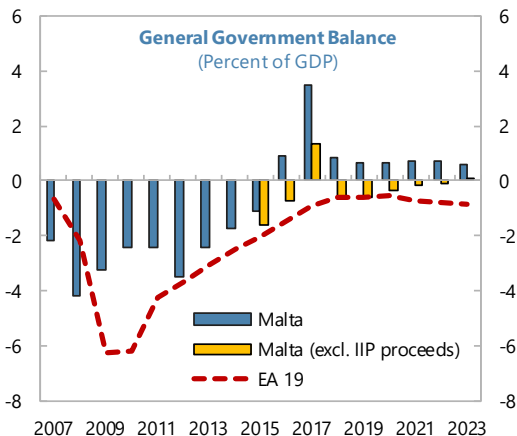
*Tourist inflows remained large.*



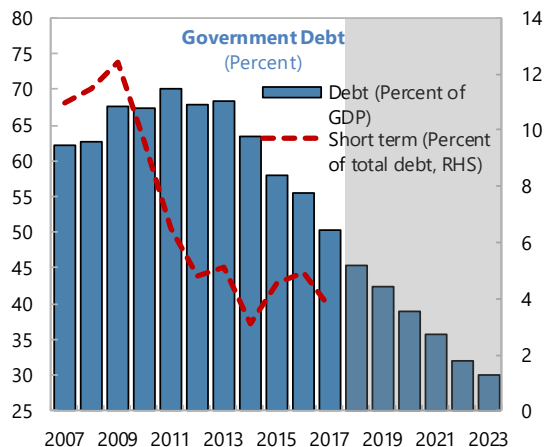
Sources: European Central Bank; Central Bank of Malta; European Commission; and IMF staff calculations.

**Figure 3. Malta: Fiscal Developments**

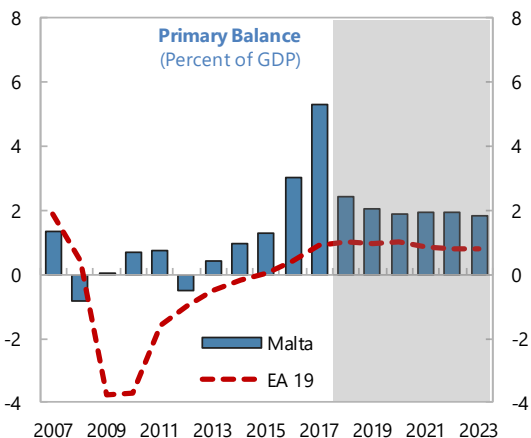
*Large fiscal surplus, largely due to IIP proceeds, ...*



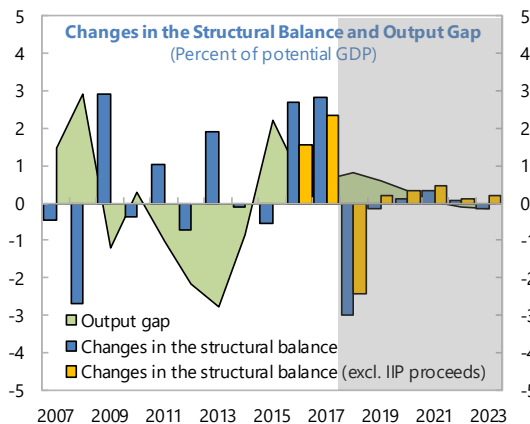
*... and strong growth should result in declining debt ratios.*



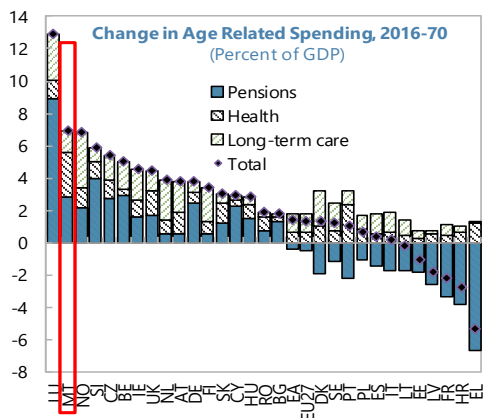
*The primary surplus is expected to moderate but remains large in the medium term.*



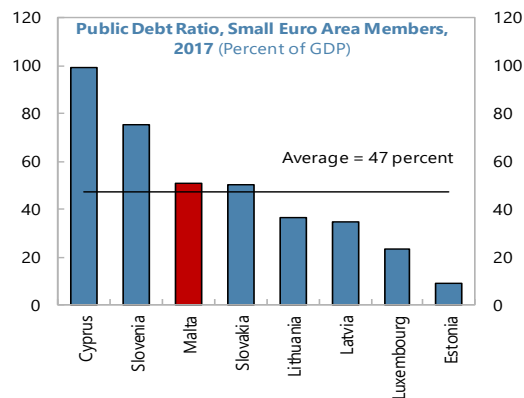
*The structural balance is expected to remain broadly stable in the medium term*



*Malta is facing large spending pressures in the long term.*



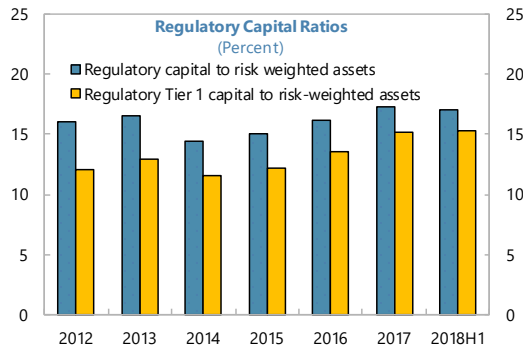
*The public debt ratio is on par with peers.*



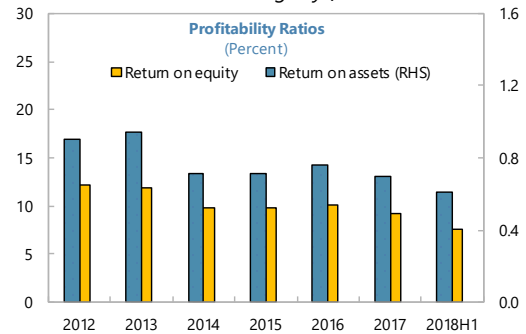
Sources: Eurostat, Haver Analytics, and IMF staff.

**Figure 4. Malta: Financial Soundness Indicators <sup>1/</sup>**

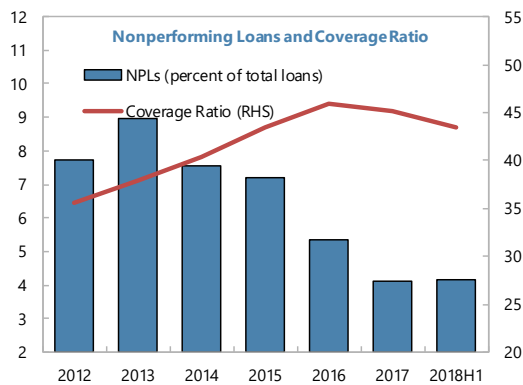
*Banks are adequately capitalized ...*



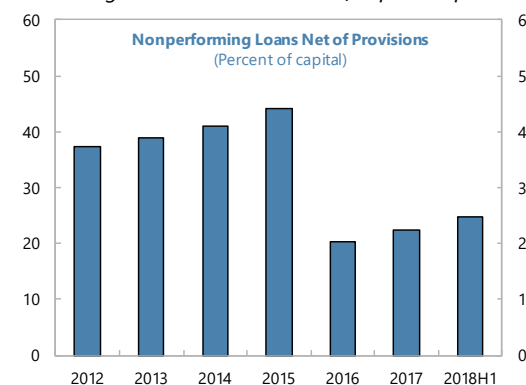
*... and profitability remained healthy – even though it moderated slightly from 2016.*



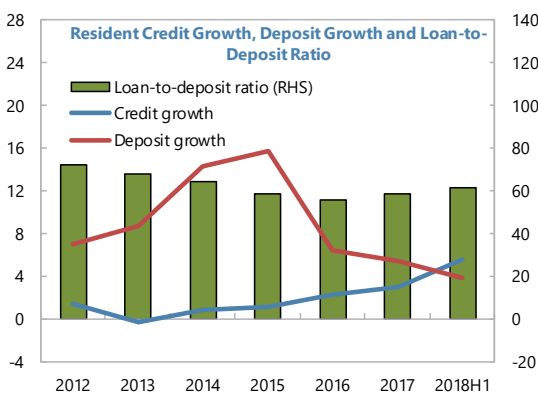
*NPLs stabilized as a percent of total loans ...*



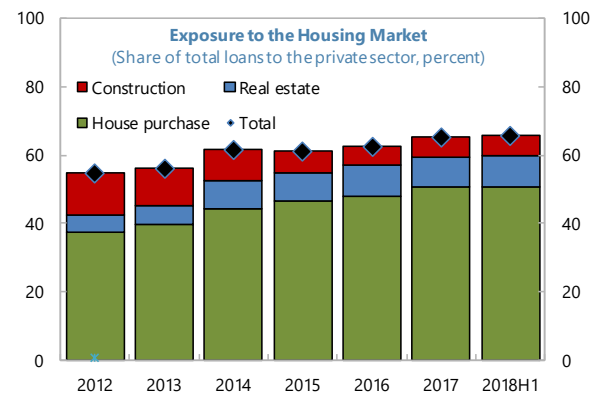
*... and the coverage ratio deteriorated a bit, resulting in a slight increase in the risk of capital impairment.*



*Loan-to-deposit-ratio increased slightly from a low level*



*Banks' exposure to the real estate market is high and increased further.*

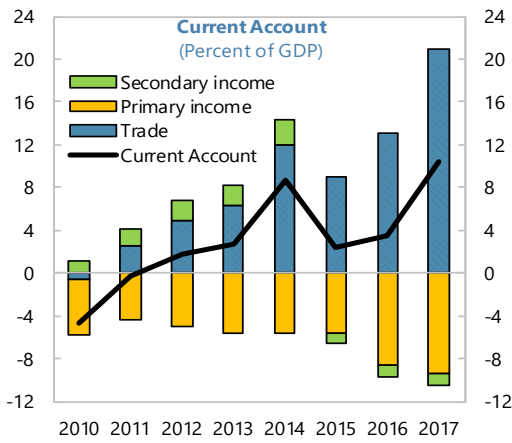


<sup>1/</sup> The financial soundness indicators cover only core domestic banks in Malta, except for credit growth, deposit growth, and housing market exposure where the total banking sector is included.

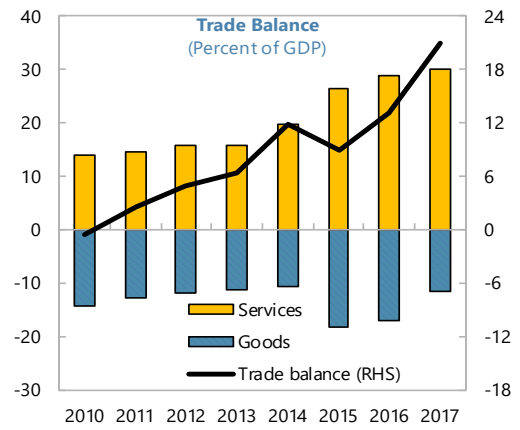
Sources: IMF, *Financial Soundness Indicators*, Central Bank of Malta, Malta Financial Services Authority, and IMF staff.

**Figure 5. Malta: External Sector**

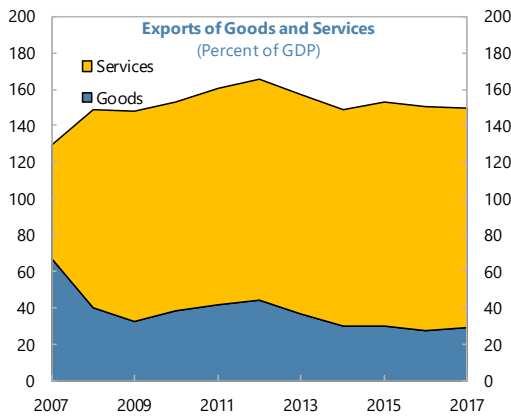
*The current account surplus increased in 2017 ...*



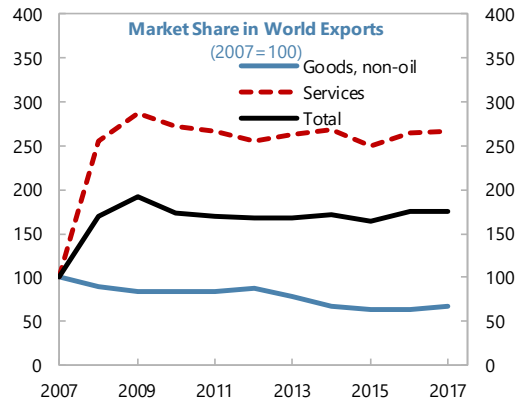
*... supported by a rising surplus in the services balance*



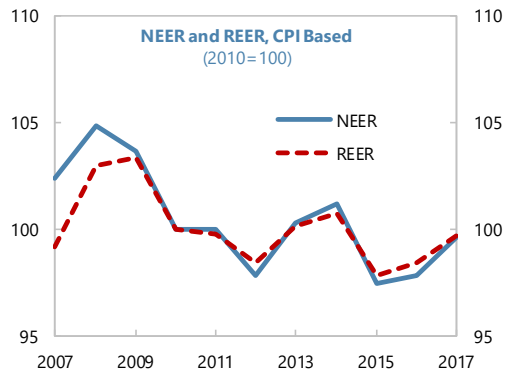
*The share of services exports increased considerably in recent years ...*



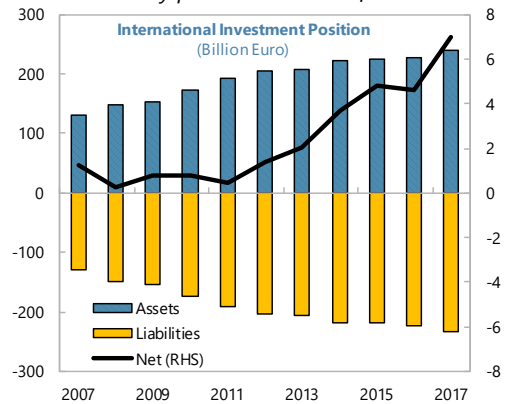
*... resulting in a higher export market share.*



*The REER CPI based declined since its peak in 2009.*



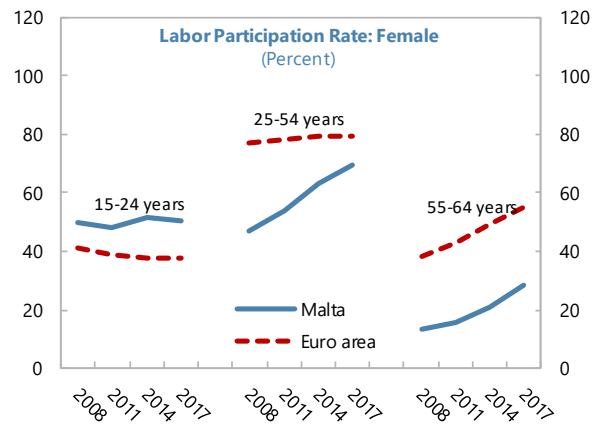
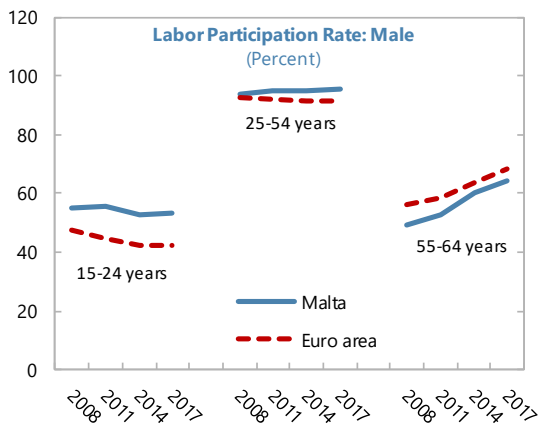
*The net IIP continued increasing steadily as both asset and liability position increased from 2016*



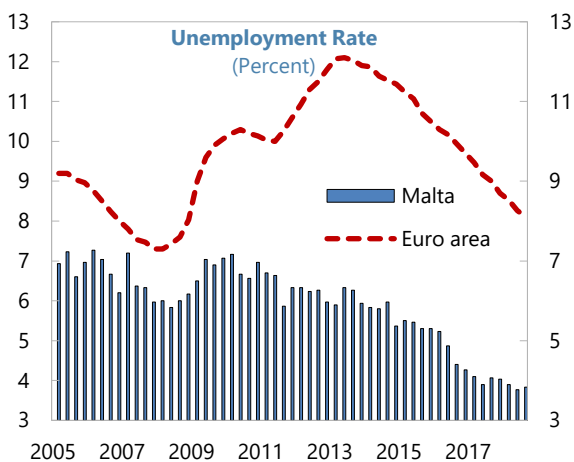
Sources: Haver Analytics; Eurostat; UNCTAD; IMF World Economic Outlook; and IMF staff.

**Figure 6. Malta: Labor Market and Income Inequality Developments**

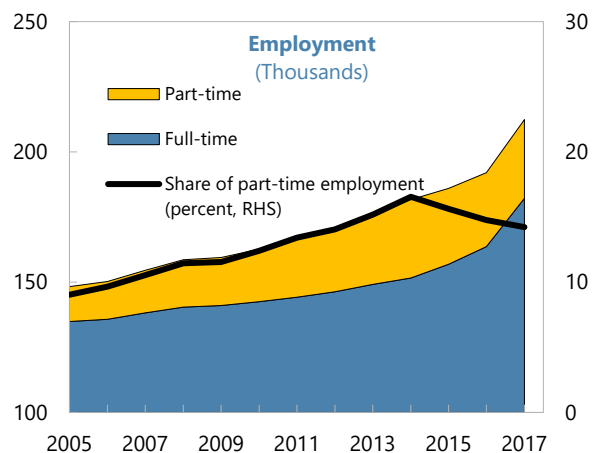
Female labor participation continued to increase in 2017, but falls short of European peers, especially among middle-aged and older cohorts.



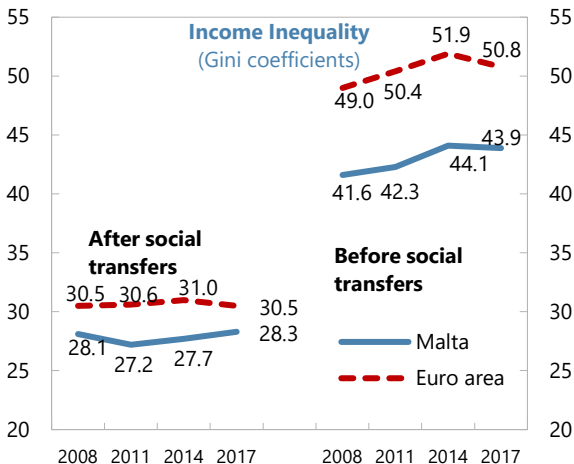
Unemployment stabilized to a record-low level ...



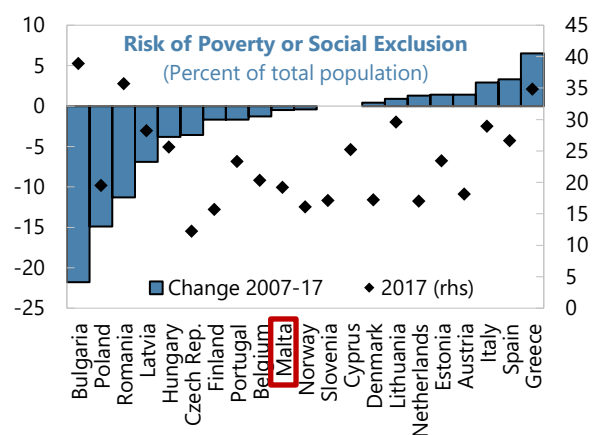
... as employment accelerated sharply, supported by new inflows of foreign labor



Market inequality is lower than in the euro area on average, but increased significantly since the crisis ...



... while poverty risk stabilized on average.



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



**Table 1. Malta: Selected Economic Indicators, 2016–24**  
(Year on year percent change, unless otherwise indicated)

Population (millions):	0.5			Per capita income (2017, euros):	24,538				
Quota (as of Oct. 31, 2018; millions of SDRs):	168.3			At-risk-of-poverty rate 1/	16.8				
				Projections					
	2016	2017	2018 Est.	2019	2020	2021	2022	2023	2024
	(Year on year percent change)								
Real GDP	5.7	6.6	6.4	5.2	4.4	3.8	3.5	3.3	3.2
Domestic demand	1.1	-1.5	6.0	5.3	4.4	3.3	3.0	2.8	2.7
Consumption	1.2	3.4	6.3	4.6	3.9	3.4	3.2	3.0	2.8
Private consumption	2.7	3.6	6.4	4.5	4.0	3.5	3.3	3.0	2.8
Public consumption	-2.8	2.8	6.0	5.0	3.7	3.2	3.0	3.0	3.0
Fixed investment	-0.1	-7.7	0.5	7.6	6.4	3.1	2.5	2.1	2.0
Exports of goods and services	4.4	5.3	1.6	2.2	2.2	2.2	2.2	2.1	2.1
Imports of goods and services	1.4	-0.1	0.5	1.9	1.9	1.7	1.7	1.6	1.6
Contribution to growth	(Percent)								
Domestic demand	1.0	-1.6	4.6	4.3	3.6	2.7	2.4	2.2	2.1
Foreign balance	4.7	8.3	1.8	0.9	0.9	1.1	1.0	1.0	1.0
Potential GDP growth	7.2	6.8	6.2	5.4	4.7	4.1	3.6	3.3	3.2
Output gap (% potential GDP)	0.8	0.6	0.8	0.6	0.3	0.0	-0.1	-0.1	-0.1
HICP (period average)	0.9	1.3	1.7	2.0	2.1	2.1	2.0	2.0	2.0
GDP deflator	1.5	2.4	2.2	2.2	2.3	2.2	2.2	2.2	2.1
Unemployment rate EU stand.	4.7	4.0	4.0	4.1	4.3	4.5	4.7	4.7	4.7
Employment growth	3.2	7.8	5.4	3.5	2.5	2.1	2.0	2.0	2.0
Gross national savings (percent of GDP)	27.9	29.7	29.1	28.9	28.8	28.5	28.2	27.8	27.6
Gross capital formation (percent of GDP)	24.4	19.3	19.1	19.6	20.0	19.9	19.9	19.7	19.6
Public finance	(Percent of GDP)								
Net lending/borrowing (overall balance)	0.9	3.5	0.9	0.6	0.6	0.7	0.7	0.6	0.6
Structural overall balance (% potential GDP)	0.6	3.4	0.4	0.3	0.4	0.7	0.8	0.7	0.7
General government debt	55.4	50.2	45.4	42.4	39.0	35.6	32.1	30.0	28.1
Balance of payments	(Percent of GDP)								
Current account balance	3.4	10.4	10.1	9.3	8.8	8.5	8.3	8.1	8.0
Trade balance (Goods and services)	13.2	20.9	21.4	21.4	21.4	21.8	22.1	22.5	22.9
Exports of goods and services	150.8	150.0	142.8	138.3	134.8	132.3	130.2	128.3	126.6
Imports of goods and services	137.6	129.0	121.4	117.0	113.4	110.5	108.0	105.8	103.7
Goods balance	-18.9	-13.1	-13.8	-14.6	-14.5	-14.0	-13.6	-13.1	-12.7
Services balance	32.1	34.0	35.2	35.9	35.9	35.8	35.7	35.6	35.6
Primary income, net	-8.6	-9.4	-10.2	-10.9	-11.5	-12.1	-12.7	-13.3	-13.8
Secondary income, net	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
Financial account, net	8.1	11.4	10.6	9.9	9.3	9.1	8.8	8.6	8.5
Financial sector									
Credit to the private sector (% GDP)	84.4	79.4	...	...	...	...	...	...	...
Credit growth, private sector	3.7	2.7	...	...	...	...	...	...	...
Memorandum item:									
Nominal GDP (millions of euros)	10343.0	11294.9	12276.9	13203.1	14105.8	14964.9	15830.2	16710.4	17607.6
Nominal GDP growth	7.3	9.2	8.7	7.5	6.8	6.1	5.8	5.6	5.4

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 2017.

**Table 2. Malta: Fiscal Developments and Projections, 2016–24**  
(Percent of GDP, unless otherwise indicated)

	2016	2017	2018 Est.	Projections					
				2019	2020	2021	2022	2023	2024
Revenue	37.4	39.2	38.2	37.5	37.3	37.0	37.1	36.0	36.0
Taxes	25.7	26.5	26.5	26.4	26.3	26.3	26.3	26.3	26.3
Indirect taxes	12.2	12.4	12.4	12.3	12.3	12.3	12.3	12.3	12.3
Direct taxes	13.4	13.9	13.9	13.9	13.8	13.8	13.8	13.8	13.8
Other taxes (capital taxes)	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social contributions	6.2	6.2	6.2	6.1	6.0	5.9	5.9	5.9	5.9
Grants and Capital revenue	0.5	0.6	1.0	1.2	1.5	1.5	1.5	0.4	0.4
Other revenue	5.1	5.8	4.5	3.8	3.6	3.3	3.4	3.4	3.4
Expenditure	36.5	35.7	37.3	36.9	36.7	36.3	36.4	35.4	35.4
Expense	34.0	33.5	34.4	33.9	33.3	32.9	32.9	32.9	32.8
Compensation of Employees	11.4	11.3	11.4	11.4	11.4	11.4	11.4	11.4	11.4
Use of goods and services	6.1	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4
Interest	2.1	1.8	1.6	1.4	1.3	1.2	1.2	1.2	1.2
Subsidies	1.3	1.2	1.4	1.4	1.4	1.2	1.2	1.2	1.2
Social benefits	10.5	10.1	9.9	9.9	9.7	9.6	9.6	9.6	9.6
Other expense	2.7	2.7	3.8	3.4	3.2	3.1	3.1	3.1	3.1
Net acquisition of nonfinancial assets	2.4	2.2	2.9	3.0	3.4	3.4	3.5	2.5	2.5
Gross Operating Balance	3.4	5.7	3.7	3.7	4.1	4.1	4.2	3.1	3.1
Net lending/borrowing (overall balance)	0.9	3.5	0.9	0.6	0.6	0.7	0.7	0.6	0.6
Memorandum items:									
Overall balance excl. one-offs	0.9	3.7	0.8	0.5	0.5	0.7	0.7	0.6	0.6
Overall balance excl. IIP proceeds	-0.7	1.3	-0.7	-0.6	-0.4	-0.2	-0.1	0.1	0.3
Cyclically adjusted overall balance	0.6	3.2	0.5	0.4	0.5	0.7	0.8	0.7	0.7
Structural balance 1/	0.6	3.4	0.4	0.3	0.4	0.7	0.8	0.7	0.7
Structural balance excl. IIP proceeds 1/	-1.1	1.3	-1.2	-0.9	-0.6	-0.2	0.0	0.2	0.3
Cyclically adjusted primary balance	2.7	5.0	2.1	1.8	1.8	1.9	2.0	1.9	1.9
Structural primary balance 1/	2.7	5.2	2.0	1.7	1.7	1.9	2.0	1.9	1.9
Structural primary balance excl. IIP proceeds 1/	1.0	3.1	0.4	0.5	0.7	1.1	1.2	1.4	1.6
Primary balance	3.0	5.3	2.5	2.0	1.9	1.9	2.0	1.8	1.8
One-offs	0.0	-0.2	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Public debt	55.4	50.2	45.4	42.4	39.0	35.6	32.1	30.0	28.1
Government guaranteed debt	13.5	9.5	8.9	8.3	7.7	7.3	6.9	6.5	6.2
Nominal GDP (millions of euros)	10,343	11,295	12,277	13,203	14,106	14,965	15,830	16,710	17,608

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

Table 3. Malta: Balance of Payments, 2016–24

	2016	2017	2018 Est.	Projections					
				2019	2020	2021	2022	2023	2024
	(Millions of euros)								
Current account balance	357	1,174	1,235	1,231	1,235	1,279	1,316	1,356	1,404
Trade balance (Goods and services)	1,362	2,364	2,627	2,820	3,017	3,259	3,506	3,768	4,033
Goods balance	-1,960	-1,478	-1,691	-1,926	-2,043	-2,093	-2,151	-2,189	-2,235
Exports	2,577	3,002	2,953	2,913	3,000	3,089	3,215	3,382	3,517
Imports	4,537	4,480	4,644	4,840	5,042	5,182	5,366	5,571	5,752
Services balance	3,321	3,842	4,317	4,746	5,060	5,352	5,657	5,957	6,268
Exports	13,017	13,935	14,582	15,349	16,016	16,713	17,393	18,058	18,776
Imports	9,696	10,093	10,265	10,603	10,956	11,361	11,736	12,101	12,508
Current income, net	-894	-1,062	-1,252	-1,439	-1,622	-1,811	-2,011	-2,223	-2,430
Current transfers, net	-111	-128	-139	-150	-160	-170	-179	-189	-200
Private	-115	-129	-140	-151	-161	-171	-181	-191	-201
Public	4	1	1	1	1	1	1	1	1
Capital account, net	32	60	65	70	75	80	84	89	94
Financial account, net	835	1,289	1,300	1,301	1,310	1,358	1,401	1,445	1,497
Direct investment	-8,587	-9,427	-10,688	-11,495	-12,281	-13,029	-13,782	-14,548	-15,329
Portfolio investment	4,757	6,720	7,304	7,855	8,392	8,904	9,418	9,942	10,476
Other investment	4,584	3,956	4,801	5,066	5,332	5,625	5,914	6,210	6,518
Reserves ( - inflow; + outflow)	88	146	0	0	0	0	0	0	0
Errors and omissions	446	55	0	0	0	0	0	0	0
	(Percent of GDP)								
Current account balance	3.4	10.4	10.1	9.3	8.8	8.5	8.3	8.1	8.0
Trade balance (Goods and services)	13.2	20.9	21.4	21.4	21.4	21.8	22.1	22.5	22.9
Goods balance	-18.9	-13.1	-13.8	-14.6	-14.5	-14.0	-13.6	-13.1	-12.7
Exports	24.9	26.6	24.1	22.1	21.3	20.6	20.3	20.2	20.0
Imports	43.9	39.7	37.8	36.7	35.7	34.6	33.9	33.3	32.7
Services balance	32.1	34.0	35.2	35.9	35.9	35.8	35.7	35.6	35.6
Exports	125.9	123.4	118.8	116.3	113.5	111.7	109.9	108.1	106.6
Imports	93.7	89.4	83.6	80.3	77.7	75.9	74.1	72.4	71.0
Primary income, net	-8.6	-9.4	-10.2	-10.9	-11.5	-12.1	-12.7	-13.3	-13.8
Secondary income, net	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
Private	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1	-1.1
Public	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capital account, net	0.3	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Financial account, net	8.1	11.4	10.6	9.9	9.3	9.1	8.8	8.6	8.5
Direct investment	-83.0	-83.5	-87.1	-87.1	-87.1	-87.1	-87.1	-87.1	-87.1
Portfolio investment	46.0	59.5	59.5	59.5	59.5	59.5	59.5	59.5	59.5
Assets	46.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5	60.5
Liabilities	0.5	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Other investment	44.3	35.0	39.1	38.4	37.8	37.6	37.4	37.2	37.0
Assets	-0.9	70.2	70.2	70.2	70.2	70.2	70.2	70.2	70.2
Liabilities	-45.2	35.2	31.1	31.8	32.4	32.6	32.8	33.0	33.2
Reserves ( - inflow; + outflow)	0.9	1.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	4.3	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Gross external debt (Percent of GDP)	866.0	822.3	766.6	722.1	684.7	653.9	626.5	601.6	578.9
Net external debt (Percent of GDP)	-204.8	-207.5	-210.3	-213.1	-215.8	-218.7	-221.6	-224.6	-227.8

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

**Table 4. Malta: Financial Soundness Indicators, 2014–18H1 <sup>1/</sup>**  
(Percent, unless otherwise indicated)

	Core Domestic Banks					Non-Core Domestic Banks					International Banks					Total Banks					
	2014	2015	2016	2017	2018H1	2014	2015	2016	2017	2018H1	2014	2015	2016	2017	2018H1	2014	2015	2016	2017	2018H1	
<b>Core FSIs</b>																					
Regulatory capital to risk weighted assets	14.4	15.0	16.2	17.3	17.0	17.4	22.1	15.5	16.7	17.3	69.2	56.3	49.2	47.2	50.8	25.7	21.8	21.2	21.6	21.8	
Regulatory Tier 1 capital to risk-weighted assets	11.5	12.2	13.6	15.2	15.3	17.1	18.6	12.3	13.3	16.9	69.1	56.2	46.4	44.5	48.2	23.6	19.2	17.5	19.3	20.1	
Non-performing loans net of provisions to capital	41.0	44.2	20.4	22.4	24.7	7.7	7.9	12.0	6.9	4.6	3.0	5.7	9.3	12.6	10.5	18.2	25.0	19.1	18.2	18.3	
Non-performing loans to total gross loans	7.6	7.2	5.4	4.1	4.2	4.4	4.0	3.5	2.3	2.1	0.7	1.2	2.2	1.7	1.8	4.0	4.7	4.1	3.1	3.1	
Return on assets	0.7	0.7	0.8	0.7	0.6	-1.3	0.2	0.3	0.3	0.2	0.9	1.0	1.0	1.5	0.9	0.7	0.9	0.8	1.0	0.7	
Return on equity	9.8	9.8	10.1	9.2	7.6	-6.4	1.4	3.4	2.9	1.9	2.4	3.4	3.7	4.9	3.9	3.6	5.9	6.7	7.3	6.0	
Interest margin to gross income	64.8	64.5	62.3	70.8	68.9	46.3	43.5	31.2	31.1	29.9	201.9	137.8	92.6	78.8	87.6	115.1	93.0	73.0	73.3	75.5	
Non-interest expenses to gross income	51.2	54.2	52.2	58.8	71.2	56.1	73.4	66.5	78.3	72.0	11.9	24.8	31.9	28.1	37.4	36.8	43.3	44.7	44.0	55.9	
Non-interest income to gross income	35.2	35.5	37.8	29.2	31.2	53.7	56.5	68.8	68.9	70.1	-101.9	-37.8	7.4	21.2	12.4	-15.1	7.0	27.0	26.7	24.5	
Liquid assets to total assets	28.3	31.8	36.5	38.6	28.2	31.7	36.3	31.6	38.8	23.5	19.7	22.7	30.1	33.1	28.8	27.3	31.2	35.4	38.0	27.9	
Liquid assets to short-term liabilities	50.4	50.2	55.8	43.5	41.8	77.9	63.3	62.7	37.4	27.9	84.7	83.6	96.3	43.7	65.5	53.9	52.6	58.3	43.0	42.0	
<b>Other FSIs</b>																					
Total Coverage ratio (total provisions to NPLs as per BR/09)	40.4	43.5	45.9	45.2	43.5	77.1	65.2	53.9	65.9	83.1	40.5	50.4	54.8	42.3	61.3	37.5	40.0	48.0	45.3	49.0	
Domestic debt securities to total assets	9.6	9.3	7.9	7.0	7.0	4.6	7.7	4.9	3.2	2.3	0.0	0.2	0.1	0.2	0.1	3.9	4.5	4.0	3.6	3.7	
Foreign debt securities to total assets	23.3	21.8	20.6	16.8	17.0	19.5	12.5	15.0	11.9	12.1	52.4	50.4	46.9	42.7	34.4	39.9	36.0	32.8	28.9	24.4	
Unsecured loans to total lending	29.0	27.4	25.4	27.7	29.4	65.2	70.9	65.4	67.2	72.2	48.4	30.7	26.7	16.2	15.9	37.7	30.8	28.2	25.0	26.8	
Assets to total capital and reserves	14.1	13.7	13.3	12.0	12.2	8.4	8.4	12.1	11.5	9.0	1.7	2.0	2.9	3.4	3.0	6.4	8.0	9.6	9.3	8.9	
Large exposure to total own funds	103.4	96.5	110.8	87.8	103.6	339.9	157.6	268.6	275.8	274.3	45.3	129.9	129.9	133.0	93.0	88.9	115.8	130.5	115.6	114.7	
Gross asset position in financial derivatives to total own funds	1.1	1.3	1.7	0.9	0.9	0.8	0.3	0.6	0.3	0.7	15.7	67.2	104.4	131.2	174.3	8.9	25.9	41.0	42.7	57.8	
Gross liability position in financial derivatives to total own funds	4.5	2.0	2.0	1.0	1.1	2.2	0.3	3.6	0.3	0.1	10.4	15.9	69.2	80.2	111.7	10.4	15.3	22.6	26.4	37.3	
Personnel expenses to non-interest expenses	50.8	51.2	48.8	48.1	38.8	45.0	42.5	49.7	45.6	48.9	27.4	23.2	19.9	16.2	14.9	47.4	44.0	40.5	37.6	32.2	
Customer loans to customer deposits	64.0	58.2	56.0	58.9	61.1	75.7	60.7	46.5	47.1	51.9	93.1	104.1	108.1	111.6	105.8	71.8	67.9	65.7	70.4	71.0	
Net open position in equities to total own funds	14.4	15.4	14.0	13.1	12.7	45.0	81.8	146.8	139.0	109.7	0.3	2.7	1.5	3.4	0.9	9.0	18.1	21.9	18.6	17.1	

<sup>1/</sup> Banks' total assets amounted to 395 percent of GDP (about €46 billion) at 2018H1. About 44 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 50 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. Housing Price Valuation

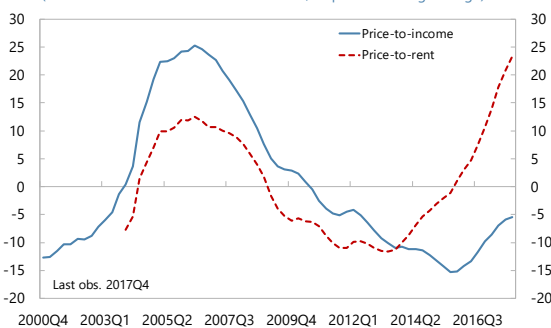
A battery of indicators and empirical models suggests some signs of overvaluation in the housing market, but the uncertainty surrounding both price measures and model estimates is large. However, given the prevalence of floating interest rate mortgages in Malta, the strong acceleration of house prices over the last three years calls for close monitoring of housing developments and supports the introduction of borrower-based macroprudential measures.

### Price-to-income and price-to-rent ratios are picking up, but point to different conclusions.

The house price-to-income ratio increased slightly but remained about 5 percent below its historical average, indicating a small undervaluation. In contrast – and despite growing pressure in the rental market – the price-to-rent ratio continued to increase fast, and stood at over 20 percent above its long-term average (10 percentage point above its previous peak) in 2017:Q4, suggesting significant overvaluation. This may partly reflect the fact that a high share of tenants continues to benefit from fixed rent contracts.

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

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

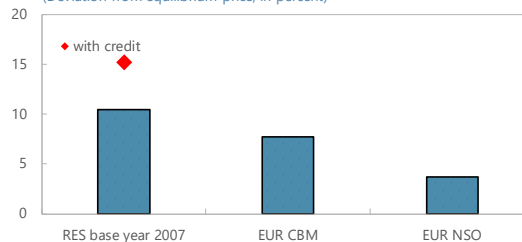


Source: Global Property Guide, IFS, and IMF staff.

**Model-based analysis points to some signs of overvaluation of housing prices, but there is considerable uncertainty surrounding these estimates.** Accelerating property prices have been accompanied by strong immigration flows, rising disposable income and large portfolio rebalancing towards property investment, suggesting that a significant part of recent price increases may be due to fundamental factors. To assess valuation gaps with respect to fundamental factors, we consider two different approaches. The first model, developed by the IMF's research department (RES), introduces house prices in growth rate as a function of traditional demand factors (population, income, interest rate and credit) and a simple long-term relationship between house prices and income per capita. The model is estimated using price data from the Global Property Guide Price Index, and suggests modest overvaluation. An alternative approach, developed by the European department (EUR) introduces house prices in levels and exploits the long-term cointegration relationships between the price and demand fundamentals, allowing for supply side factors in the analysis. Since credit is not statistically significant in the EUR model, it has been left out. The degree of overvaluation in this model is much smaller and does not suggest significant price misalignment. Since 2017:Q4, advertised prices increased by more than 9 percent, while transaction prices dropped by close to 1.3 percent.

### House Price Valuation, 2017Q4

(Deviation from equilibrium price, in percent)



Source: IMF staff calculations.

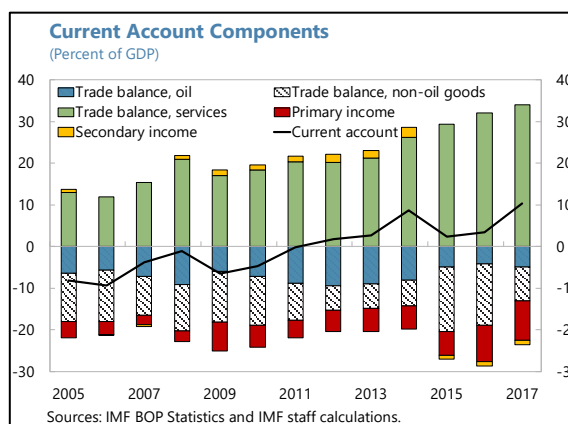
Note: Two different house price indices are used in the EUR model. The price index published by the CBM is based on advertised prices of the residential property, while the price index published by the NSO is based on actual market transactions.

## Annex II. Current Account Surplus: Drivers and Sustainability<sup>1</sup>

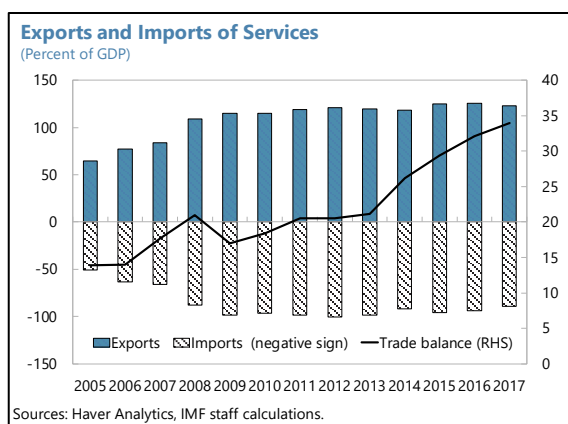
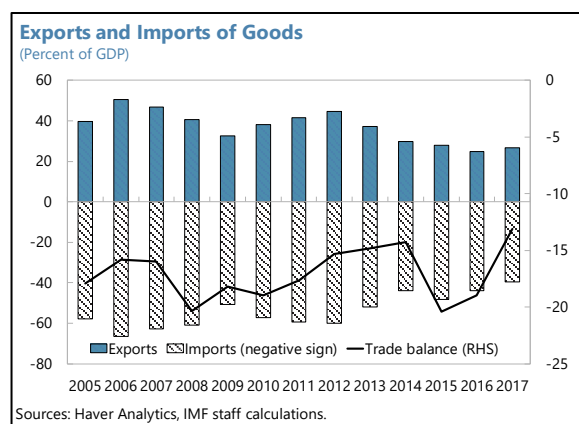
This note summarizes key stylized facts and analyzes drivers of recent current account surpluses in Malta. These drivers include the economy's rapid structural rebalancing toward export-oriented services and a related decline in import intensity, the rising saving rate, and price competitiveness gains experienced until recently. As several drivers are seemingly structural, large and persistent surpluses may be expected in coming years. Importantly, the current account balance is strongly affected by the cross-border activity of internationally-oriented firms operating in Malta, which also likely gives rise to measurement biases.

### A. Current Account Components

**1. Malta has recorded current account (CA) surpluses in recent years.** The surpluses have recently become large, increasing to above 10 percent of GDP in 2017 from an average of nearly 5 percent of GDP in 2014-16. Looking at the CA components, the main driver of this rising trend was the surplus in services, which over the last decade increased from roughly 20 percent of GDP to 34 percent of GDP. In addition, the oil trade deficit declined substantially over the same period.



**2. The trade balance has greatly improved due to the performance of services.** The trade deficit in goods hovered around 17 percent of GDP since 2005, falling below 13 percent of GDP in 2017 on the back of a contraction in imports. Both exports and imports of goods, as shares of GDP, declined since around 2013 compared to previous years. Meanwhile, the trade surplus in services rose fast since 2006, initially because of booming exports and more recently also because of a moderate import contraction.

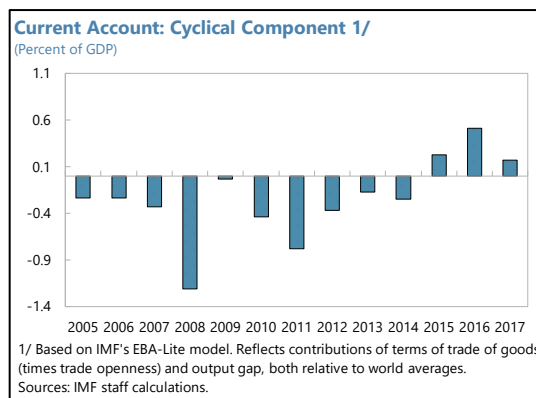


<sup>1</sup> Prepared by Jorge Salas. Yuanchen Cai provided excellent research assistance.

## B. Assessing the Underlying Drivers of the Current Account Surplus

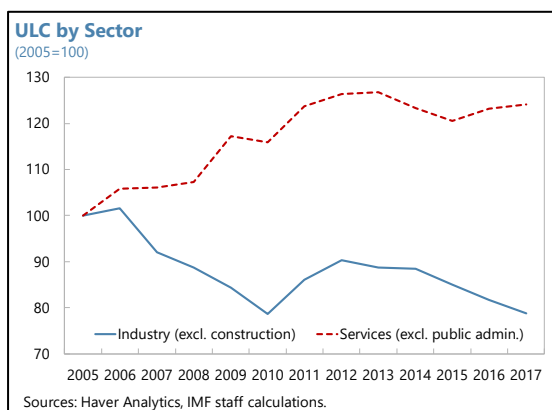
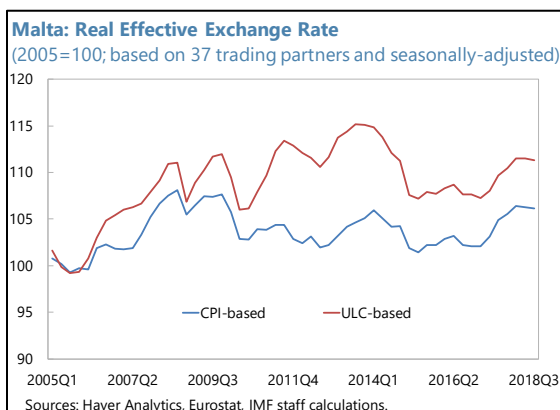
### Cyclical Factors

**3. The cyclical component of the CA has been relatively small.** This component is estimated as the sum of the contributions from two variables included in the IMF's EBA-Lite CA model: the detrended terms of trade of goods interacted with trade openness, and the output gap. Both are measured relative to their world averages. For Malta, the cyclical component has been generally small relative to the size of the CA balances. In 2015 that component turned positive and since then it positively contributed to the CA surplus, but on average by less than 0.5 percent of GDP.



### Traditional Drivers of the Current Account

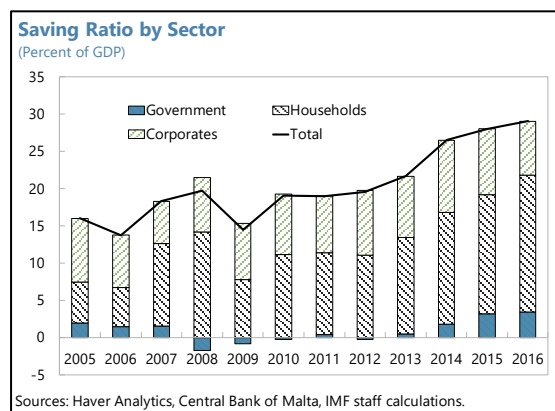
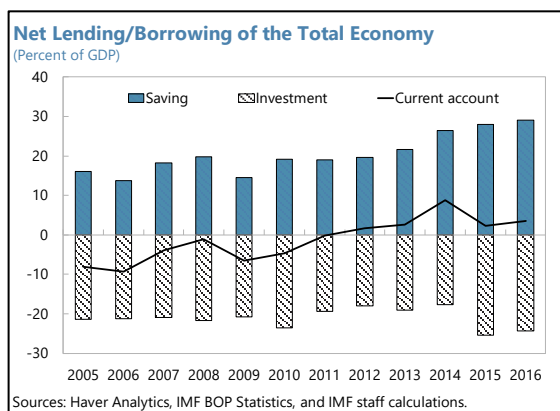
**4. Recent competitiveness gains have been partly overturned but may have contributed somewhat to the CA surplus.** Following a depreciation between 2013 and 2015, the real effective exchange rate (REER) stabilized and more recently appreciated. Despite the ongoing economic boom, the growth of Maltese unit labor costs (ULC) has remained subdued compared both to previous years and to that of trading partners. To assess the role of price competitiveness shocks and two other traditional drivers of the CA, a simple model-based analysis relying on pairwise correlations between the CA, the output gap, and the (change in the) ULC-based REER, suggests that the evolution of competitiveness since 2012, on average, has played some role in the increase of the CA balance.<sup>2</sup> This correlation analysis also suggests that neither foreign demand shocks nor domestic demand shocks were key contributors to Malta's rising CA balance.



<sup>2</sup> Over 2012-17, there was a positive correlation between the current account and the output gap, and negative correlations between the REER and both the CA and the output gap. The analysis is based on a graphical representation of income determination and the trade balance, originally proposed by Rudi Dornbusch. See Wyplosz, C., 2013, "Europe's Quest for Fiscal Discipline", European Economy Economic Papers 498, European Commission.

## Saving-Investment Gap

**5. The CA surplus mainly reflects rising saving.** The saving rate increased from below 20 percent of GDP in 2012 to almost 30 percent of GDP in 2016. The rise in saving is mostly explained by the private sector, particularly households, which could reflect the rising share of second earners (as female labor force participation grew) and a stronger propensity to save for retirement. Government saving has also gradually increased, especially since 2014. Although total investment expanded in 2015–2016, its growth was smaller than that of saving.

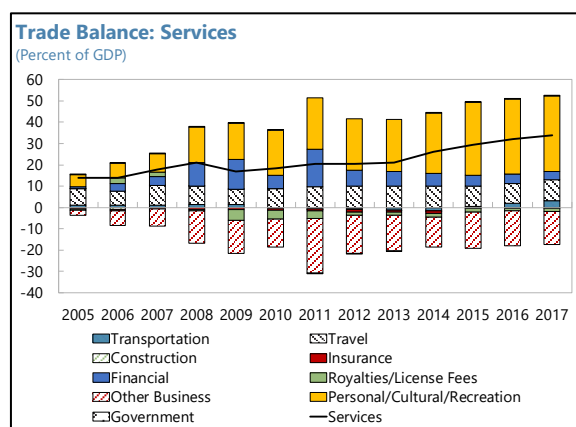


## Structural Changes

**6. In recent years, the economy underwent a rapid structural rebalancing toward services.**

The remote gaming industry has been a key engine of this transformation, becoming one of the largest and most dynamic sectors in Malta, boosted by foreign-owned companies. The gaming industry (included in the

Personal/Cultural/Recreation sector) is highly export-oriented: it accounts for more than one-fifth of the economy's total exports and its trade surplus is close to 30 percent of GDP. While its domestic inter-industry linkages are relatively limited, the gaming sector accounts for about 12 percent of Malta's nominal gross value added, and for a roughly similar share of total employment as other important sectors such as finance and construction.<sup>3</sup>

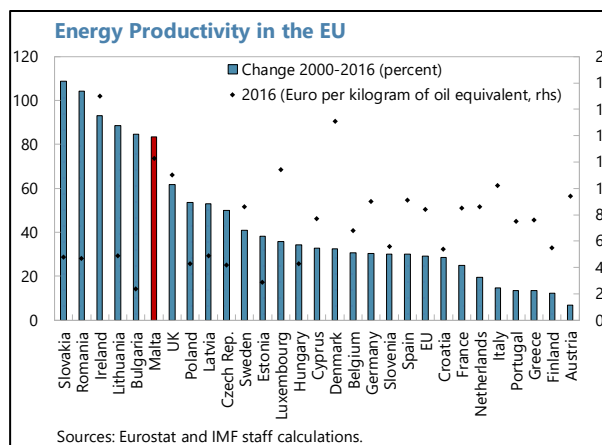
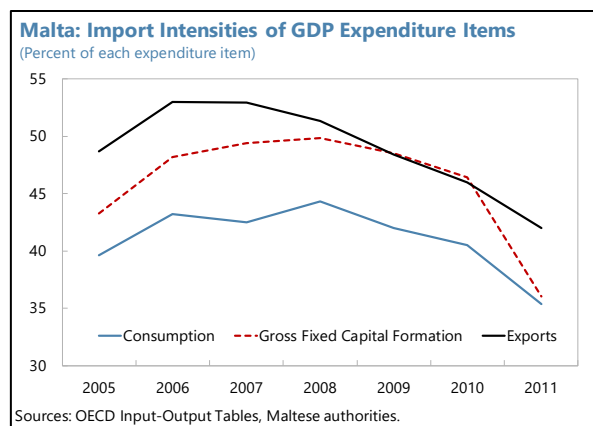


**7. Import intensity has declined rapidly reflecting the structural shift toward services and energy sector reforms.** As the share of services in economic activity rose, including gaming and

<sup>3</sup> See IMF, 2018, "The Gaming Industry in Malta". Malta: Selected Issues, IMF Country Reports 18/20.



other sectors which are relatively low-capital intensive, the import content of GDP expenditure items (gross fixed capital formation, exports, and consumption) declined, according to OECD data available until 2011. Moreover, Malta has implemented energy reforms to upgrade the sector's productivity and to diversify the energy mix. It completed an electricity connector with Italy, upgraded the energy infrastructure, and switched electricity production from oil to gas. As a result, the dependence on imported oil has moderated.



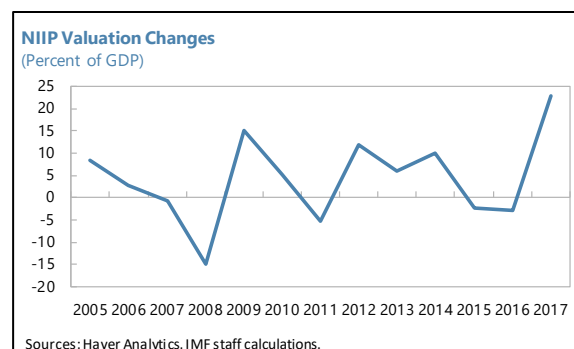
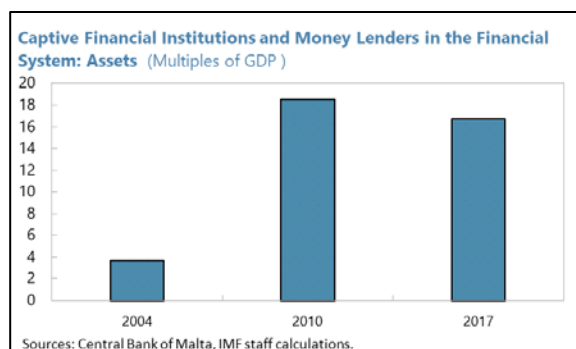
### Measurement Issues and the Influence of Internationally-Oriented Firms

**8. Malta is a small financial center and hosts many multinationals.** In small financial centers and, more generally, in countries that host many multinational companies, the CA is strongly influenced by the cross-border activity of internationally-oriented firms. Trade, income and financial flows associated with those firms may be mainly driven by factors outside the country. Moreover, relevant income flows could be over or under-recorded in case of shortcomings at identifying ultimate ownership. Biases can also arise because of accounting issues in measuring investment income, particularly in connection to retained earnings on portfolio equity (which are not recorded in the income balance) and to income from debt instruments (which is recorded in nominal terms, thus inducing an inflation bias).<sup>4</sup> While Malta does not produce data on its “underlying CA”, i.e. excluding the influence of internationally-oriented firms, and estimates on Malta-specific biases are not available, some evidence suggests that measurement issues could be significant. For example, there are many captive financial institutions and money lenders, including several thousand special purpose entities (SPEs) in the financial sector alone, with total assets equivalent to more than 16 times Malta’s GDP and almost entirely invested outside of the country, underlining Malta’s role as a financial center.<sup>5</sup> Also, valuation changes embedded in the Net

<sup>4</sup> See Technical Supplement Box 1 in IMF, 2018, “2018 External Sector Report—Technical Supplement”.

<sup>5</sup> A link between SPEs and biases in foreign direct investment data has also been documented. See, e.g., Damgaard, J. and T. Elkjaer, 2017, “The Global FDI Network: Searching for Ultimate Investors”, IMF Working Paper No. 17/258.

International Investment Position (NIIP)—a rough indicator of measurement distortions in CA balances—tend to be sizable, amounting on average to 8 percent of GDP over 2012–2017.<sup>6</sup>



## C. Common Drivers of Current Account Surplus Reversals

**9. Looking at some common drivers of CA surplus reversals sheds light on why Malta has not experienced such a reversal.** A recent IMF staff's case-study analysis found that, on average, significant and sustained reversals from large and persistent CA surpluses have been historically associated with REER appreciation, fiscal expansion, terms of trade deterioration, increase in private credit, and a reduction in saving rather than a rise in investment.<sup>7</sup> In line with the continued CA surpluses in Malta so far, none of the aforementioned common drivers of reversals are yet visible in the Maltese data except for a recent moderate REER appreciation. The same study also found that reversals have been rare, especially among advanced economies, and that they tend to happen when CA surpluses become very large, averaging around 9 percent of GDP in the three years prior to the reversal.

<sup>6</sup> Valuation changes reflect the difference between the change in the NIIP and the current account. While valuation changes generally reflect shifts in exchange rates and asset prices, among other factors they can also convey information on the degree to which CA balances are distorted due to measurement biases.

<sup>7</sup> IMF, 2017. "2017 External Sector Report" – Special Feature: A Focus on Current Account Surpluses.

## Annex III. Implementation of IMF Recommendations

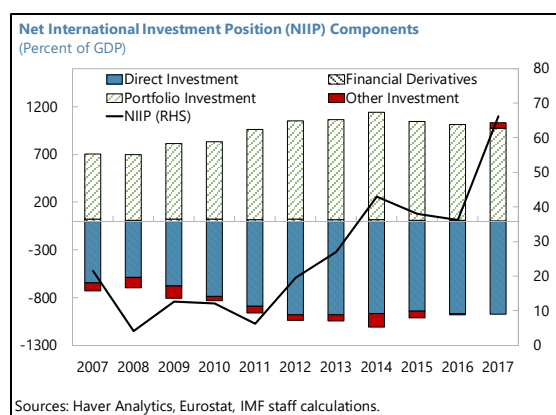
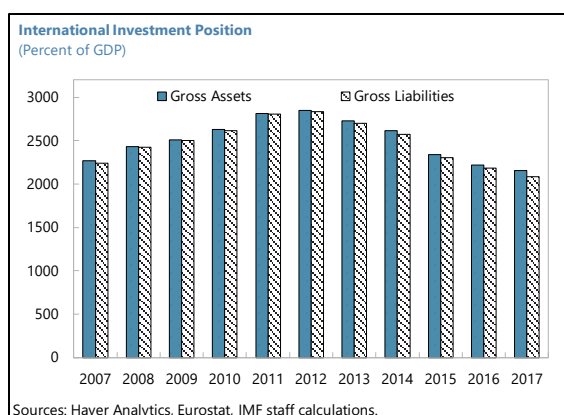
	2017 Art. IV Advice	Actions since 2017 Art. IV
<b>Fiscal issues</b>	Continue building fiscal buffers, strengthening revenue collection and identifying further structural measures.	The medium-term fiscal strategy aims to maintain a structural balance net of Individual Investor Program (IIP) revenues and related expenditures, and to further reduce the public debt ratio. A Joint Enforcement Task Force is addressing VAT evasion.
	Reduce fiscal risks by improving the financial health of SOEs and containing long-term, age-related spending pressures.	Policy recommendations from the in-depth spending review of health, social security and education carried out in 2015 -2016 are being implemented.
	Raise public investment in a budget-neutral manner.	The government's capital expenditure is envisaged to increase between 2018 and 2021, financed by both EU and own funds. Targeted sectors include roads, the environment, health, and education.
<b>Housing market and financial sector issues</b>	Close data gaps, deploy macroprudential measures, and review fiscal incentives related to the property market.	The Central Bank of Malta drafted a Directive to introduce borrower-based measures, including limits on the loan-to-value (LTV) ratio, the debt-service-to-income (DSTI) ratio, and to restrict the maturities for residential real estate loans provided by banks. A new White Paper on rents was launched in October 2018 with proposals on reforms to the rental market.
	Facilitate continued resolution of legacy NPLs and improve the insolvency process.	Recent regulation mandating banks to reduce NPL ratios below 6 percent within 5 years, is being implemented. NPL resolution plans of small banks with relatively weak asset quality continue to be monitored.
	Ensure strong governance and well-designed origination rules of the Malta Development Bank's operations.	The MDB's Audit Committee was created. The formation of a Risk Committee and the drafting of a Code of Professional Conduct and Ethics are under way.
	Ensure adequate resources for the financial supervisor and strengthen oversight of nonbank lending.	Per the new funding structure of the Malta Financial Service Authority (MFSA), any funding shortfalls of the agency should be provided by the government. A new intercompany loan dataset was recently compiled.
	Ensure robust implementation and effective enforcement of the AML/CFT framework.	The recently revised ML/FT National Risk Assessment led to an action plan to strengthen Malta's AML/CFT framework, which is currently being implemented. The MFSA and the Financial Intelligence Analysis Unit have institutionalized their collaboration in a memorandum of understanding and adopted joint supervisory procedures.
<b>Structural reforms</b>	Further increase female labor force participation and address skills gap problem.	Recent make-work-pay policies, including free childcare scheme, in-work benefits, and tapering of benefits for those entering employment are in place. The new Work-based Learning and Apprenticeship Act came into force, providing a standardized legal framework for vocational education and training.
	Strengthen innovation, including by upgrading research infrastructure and upscaling the public support for innovation	Malta Enterprise has launched several incentives to support businesses in upgrading investment in research and development. Legislation was enacted to help boost Fintech-related industries.

## Annex IV. External Sector Assessment

The external position of Malta in 2018 was assessed to be moderately stronger than fundamentals and desirable policy settings. While the recorded current account surplus was sizable, staff's judgment takes into account that Malta is a small financial center, hosts many special purpose entities and other multinationals—compounding measurement issues related to the current account—and is undergoing rapid structural changes. Based on external developments until 2018:Q3, staff's assessment remains unchanged.

### Foreign Asset and Liability Position

**1. Malta is a small financial center and hosts a large number of multinationals.** Its net international investment position (NIIP) is therefore strongly influenced by cross-border transactions of internationally-oriented firms, including many special purpose entities in the financial sector. The NIIP rose to 66 percent of GDP at end-2017, improving by almost 40 percentage points since 2013, mostly reflecting sustained current account surpluses over the period. Gross assets and liabilities are very large, with particularly sizable positions in portfolio investment assets (1000 percent of GDP) and direct investment liabilities (1639 percent of GDP). Most of the gross liabilities are in the form of equity. While valuation effects tend to be large and volatile, the considerable share of intra-company lending stands as a mitigation factor to possible risks. The NIIP is expected to remain highly positive over the medium term, in line with projected current account surpluses.



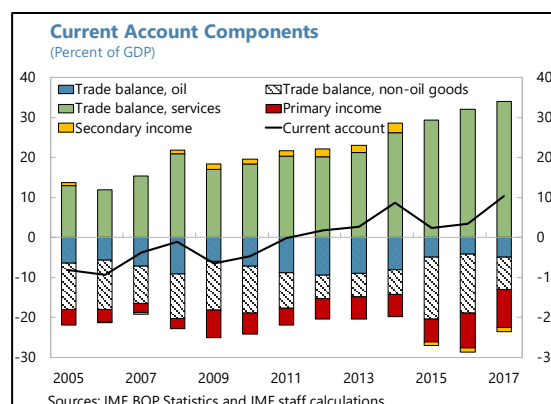
### Current Account

**2. The current account (CA) surplus significantly widened to 10.4 percent of GDP in 2017, mainly due to lower imports of capital goods and a higher surplus in services compared to 2016.** Strong and rising net exports of services, which continue to largely reflect proceeds of remote gaming and tourism, account for the bulk of the CA improvement in recent years. The oil trade deficit remained subdued, thanks in part to recent energy sector reforms. More generally, the economy's structural shift toward services has been associated with a reduction in import intensity.

The CA has recorded sustained surpluses since 2012, averaging around 6 percent of GDP over 2013–17. Continued surpluses, though gradually declining, are expected over the medium term. As of 2018:Q3, the CA surplus remained close to 11 percent of GDP.

### 3. The EBA-lite CA model points to a large CA gap of 10 percent in 2018, a norm of nearly 0 percent and a policy gap of 0.3 percent (Table 1).

However, staff consider that the large unexplained residual of 10.1 percent of GDP could be at least partially explained by a number of idiosyncratic factors:



- First, as a small financial center, Malta’s CA balance is strongly influenced by cross-border trade and income flows reflecting operations from special purpose entities and multinationals with limited links to the domestic economy. These factors compound CA measurement issues, including biases due to retained earnings on portfolio equity (which are not recorded in the income balance) and to interest payments on debt assets (which are recorded in nominal terms, departing from the relevant economic notion of real income and hence inducing an inflation bias). Previous IMF staff analysis estimated that the joint biases due to retained earnings and inflation distortions overstated the CA balance of a financial center by as much as 3 percent of GDP.<sup>1</sup> Extrapolating that upper-bound estimate to Malta, a highly tentative measure of its “underlying” CA surplus would be about 7 percent of GDP.
- Second, the CA balance reflects the revenues from the government’s Individual Investor Program (IIP), which is recorded in national accounts as exports of services. The authorities estimate that annual IIP export receipts amounted to roughly 1 percent of GDP over 2015–2017, on average. Since this program is not envisaged to last permanently, discounting this temporary factor (subtracting IIP export receipts) from the CA balance further reduces the surplus to around 6 percent of GDP.
- Third, the EBA-Lite CA model has undergone several changes compared to last year, which significantly brought down Malta’s CA norm. Those changes included the removal of a financial center dummy variable which contributed with more than 4 percent of GDP to Malta’s CA norm. Moreover, a new explanatory variable proxying for remittances inflows introduces a large negative contribution to the norm of about minus 3 percent of GDP. However, it can be argued that in the case of a high-income country like Malta, the contribution of remittances to the CA could be positive if they were associated with higher saving and hence higher CA balances. This would potentially raise (rather than lower) the CA norm by about 3 percentage points, bringing it to nearly 3 percent of GDP.

<sup>1</sup> See Technical Supplement Box 1 in IMF, 2018, “2018 External Sector Report—Technical Supplement”.

- Fourth, the economy has undergone a rapid structural rebalancing towards exports of services, especially the remote gaming industry, whose export flows are largely unrelated to competitiveness changes.<sup>2</sup> In addition, the CA surplus largely reflects the high corporate saving of foreign-owned firms based in Malta, including gaming and financial companies as well as other multinationals. Taking these factors into account would bring the CA norm to a potentially higher level than 3 percent of GDP.

**4. In sum, staff assess the CA gap as close to 3 percent of GDP,** but the size of this gap is subject to considerable uncertainty in light of CA measurement problems and other idiosyncratic factors characteristic of Malta's pro-business tax regime and its situation as a small financial center. Thus, the external assessment also relies on the results from the REER model, described below.

### Real Exchange Rate

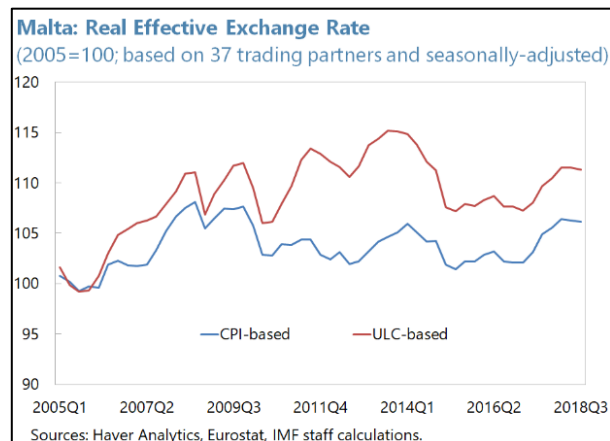
**5. Both the ULC-based REER and the CPI-based REER appreciated by around 1 percent in 2017.** Compared to their 2017 averages, as of 2018:Q3 they further appreciated by about 2 percent. While the two measures have been broadly stable over the last decade, the competitiveness gains in 2013–15 (particularly those implied by the ULC-based REER) may have played some role in the increase of the trade surplus. The EBA-lite REER model reaches a different conclusion than the CA model (Table 1) and points to a modest REER overvaluation of about 4 percent.

**6. To summarize the external assessment, the CA gap is estimated at nearly 3 percent of GDP, with an implied undervaluation of 3.5 percent but it is particularly uncertain, whereas the REER model suggests a modest overvaluation of 4 percent.** Together, staff assess that the external position in 2018 was moderately stronger than fundamentals. Staff will continue work to deepen its understanding of Malta's underlying external position.

**Table 1. Results Based on IMF's EBA Lite Methodology**

Malta: Results Based on IMF's EBA-Lite Methodology, 2018			
Current account approach 1/		REER approach	
Actual CA (percent of GDP)	6.1	Ln(REER), actual	4.6
Cyclically-adjusted CA	6.4	Ln(REER), norm	4.5
Cyclically-adjusted CA norm	2.7	REER gap (percent)	3.7
Multilaterally consistent cyc.-adj. norm	3.2	Policy gap (percent)	-0.8
CA gap	3.2	Residual (percent)	4.3
Policy gap	0.3		
Residual	3.1		
Implied REER gap (percent)	-3.5		

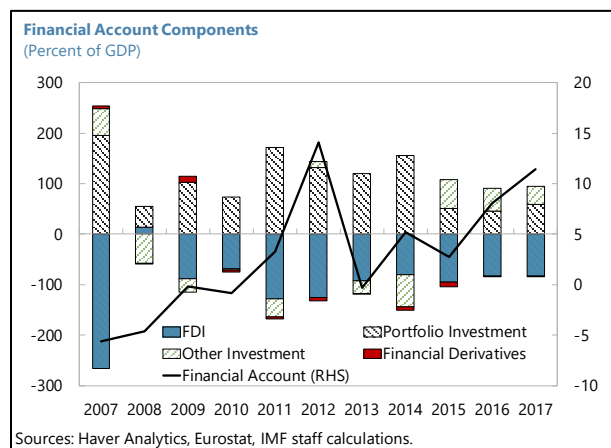
1/ The "actual CA" includes an adjustment of around -4 percent of GDP for measurement issues and temporary factors. The "CA norm" includes an adjustment of about +3 percent of GDP for the likely different impact of remittances in a high-income country. See text for details. The contributions from a "natural disasters and conflicts" dummy are not shown. Source: IMF staff calculations.



<sup>2</sup> The trade surplus of the sector which includes the gaming industry has increased by about 11 percent of GDP over 2013-17, reaching 35 percent of GDP.

## Capital and Financial Flows

**7. Gross and net financial flows tend to be large relative to GDP.** These flows are strongly influenced by cross-border transactions of the several internationally-oriented firms that Malta hosts, including special purpose entities. Net FDI inflows and net portfolio investment outflows are particularly sizable. In recent years, the sum of net outflows accounted for by portfolio investment and other investment have exceeded the amount of net FDI inflows.



Source of Risks	Relative Likelihood <sup>1</sup>	Impact if Realized
<b>Weaker-than-expected global growth.</b>	<b>Medium</b>	<b>Medium</b> Since Malta is a highly open economy, weaker external demand, accompanied by lower FDI inflows, would have adverse effects on domestic growth prospects. Higher-than-envisaged gains from recent large-scale infrastructure projects and labor market reforms may mitigate adverse spillovers.
<b>Policy response:</b> 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 activities. Fiscal policy could be used to mitigate the impact on vulnerable groups.		
<b>Unsustainable macroeconomic policies.</b>	<b>Medium</b>	<b>Medium</b> In Europe, unsustainable policies at the national level could undermine regional cohesion, while inappropriate policies in other systemically important economies could exacerbate vulnerabilities and even backfire by hurting confidence and global growth. Potential adverse effects on growth in Malta through lower investment and trade, are likely to be contained given Malta's trade diversification and excess demand in the tourism sector. If economic deceleration is significant enough, banks' profitability could be negatively affected by increasing asset impairment.
<b>Policy response:</b> 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.		
<b>Sharp tightening of global financial conditions.</b>	<b>High</b>	<b>Medium/Low</b> Malta should be relatively insulated from direct international financial market contagion given public and private sector's high reliance on domestic financing. However, it is still vulnerable to weaker external demand, lower FDI inflows and potential financial contagion through cross-border and cross-sectoral interlinkages. Additionally, continued monetary policy normalization and abrupt change in global risk appetite could lead to sudden, sharp increases in interest rates as term premia decompress, and associated tightening of financial conditions. Loss of market confidence and increases in risk premia would lead to declines in assets prices, and cause valuation losses and higher funding cost for banks.
<b>Policy response:</b> Continue to reduce fiscal and financial vulnerabilities to ensure stability, and further diversify trade activities. Continue close financial supervision and further improve banks' asset quality to increase the banking system's loss absorption capacity, and further enhance crisis management framework. The authorities should stand ready to cooperate with the ECB in providing liquidity support if needed. Remove remaining structural impediments to growth.		
<b>Rising protectionism and retreat from multilateralism.</b>	<b>High</b>	<b>Medium</b> As a small open economy, Malta is vulnerable to external shocks through trade linkages. In the short term, escalating trade tensions, including a no-deal Brexit, could increase uncertainty about growth leading to higher financial market volatility with potential negative consequences for investment and growth. Direct financial spillovers should be limited given the relatively high reliance of government and core domestic banks on domestic funding. Possible relocation of firms that service the EU from the UK to Malta may also support FDI inflows over the medium term.
<b>Policy response:</b> 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 activities. Fiscal policy could be used to mitigate the impact on vulnerable groups.		



<b>Slow progress in addressing structural weaknesses.</b>	<b>Medium</b>	<b>Medium/Low</b> 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, and increase long-term fiscal risks.
<b>Policy response:</b> 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.		
<b>Slow progress in effectively implementing the AML/CFT framework.</b>	<b>Medium</b>	<b>Medium</b> Failure to effectively implement the AML/CFT framework would weaken Malta's attractiveness as a financial and business location, with adverse effects on tax revenues, foreign investment, jobs, and the external position.
<b>Policy response:</b> Effectively and swiftly implement and enforce the AML/CFT framework, address supervisory capacity constraints, and improve collaboration between the National Competent Authorities (NCAs).		
<b>Source of Risks</b>	<b>Relative Likelihood</b>	<b>Impact if Realized</b>
<b>Sharp correction in housing prices.</b>	<b>Medium</b>	<b>Medium</b> Property-related loans account for a significant fraction of the loan portfolio of core domestic banks, thus increasing their vulnerability to possible property market shocks. 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 widespread distress through an adverse feedback loop of decreased lending and investment affecting financial stability and growth. However, mitigating factors include 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.
<b>Policy response:</b> 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.		
<b>Possible changes in international corporate and personal taxation.</b>	<b>Medium/Low</b>	<b>High/Medium</b> Malta's attractiveness as a financial and business location may weaken, and demand for its Individual Investor Program (IIP) could decrease, with adverse effect on tax revenues, auxiliary financial services, foreign investment, and the external position.
<b>Policy response:</b> 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 and IIP revenues.		
<sup>1</sup> 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 VI. Fiscal Transparency Evaluation

**The IMF conducted a Fiscal Transparency Evaluation in Malta.** The IMF's Fiscal Transparency Code is the international standard for disclosure of information about public finances. The Code comprises a set of principles built around the four pillars (i) fiscal reporting, (ii) fiscal forecasting & budgeting, (iii) fiscal risk analysis & management, and (iv) resource revenue management. For each transparency principle, the Code differentiates between basic, good, and advanced practices to provide countries with clear milestones toward full compliance. The first three pillars are currently operational, while the fourth pillar is being developed and expected to be finalized by January 2019. Upon request of the authorities, an IMF technical assistance team visited Malta on April 30-May 14, 2018 to conduct a Fiscal Transparency Evaluation (FTE).

**Overall, Malta meets many of the fiscal transparency principles at good or advanced level.** Malta meets the good or advanced practice in 21 out of 35 principles of the Fiscal Transparency Code. It meets the basic practice on 12 principles. The principle related to natural resources was not assessed. Practices are stronger in the areas of fiscal reporting and fiscal forecasting & budgeting, which are largely covered by the EU's comprehensive reporting framework. In the fiscal risk analysis & management area, Malta's practices are generally found weaker.

**Fiscal reporting of public corporations could be improved.** Fiscal reporting is mostly deemed good or advanced, and reports are published in a timely manner and are comparable to each other. Statistics are prepared by the professionally independent National Statistics Office and government financial statements are audited by an independent audit office. However, a consolidated reporting on public corporations, as well as reporting of nonfinancial assets and employment-related pension entitlements are lacking. Moreover, tax expenditures could be more comprehensively reported.

**Fiscal forecasting & budgeting exhibits gaps for extrabudgetary units and public investment.** Fiscal forecasting & budgeting is found largely good or advanced. Budget documentation includes medium-term macroeconomic forecasts, and fiscal policy objectives are embedded in a medium-term budget framework. An independent fiscal council evaluates macro and fiscal forecasts. However, extrabudgetary units are not sufficiently documented. Information and cost-benefit analysis related to public investment projects is limited. Performance information and consistency of presentations could be improved.

**Fiscal risk analysis & management fall short of or meets only the basic practice of the Code.** While advanced in the areas of macroeconomic scenarios and public debt, risk analysis of government assets is limited. Reporting on the overall performance of public corporations and a common framework for exercising ownership functions and monitoring performance are absent. Another important gap pertains to the lack of a summary report on specific risks to the fiscal forecast, which would include enhanced reporting on long-term fiscal sustainability, government guarantees, and public-private partnerships.

**The evaluation provides seven recommendations.**

1. Gradually expand the coverage of fiscal reports to the public sector;
2. Better report on and control tax expenditures;
3. Improve budget documentation in relation to extrabudgetary units and performance information;
4. Harmonize presentations across reports and explain changes to previous forecasts;
5. Strengthen the framework for public investment management;
6. Publish an annual fiscal risk statement;
7. Strengthen the institutional framework for managing fiscal risks, notably on public corporations.

## Annex VII. Main FSAP Recommendations <sup>1/</sup>

<b>Risk Analysis</b>	
1.	Strengthen the risk analysis by incorporating new dimensions in liquidity stress testing, conducting regular sensitivity analysis on selected vulnerabilities, and enhancing data management (CBM, MFSA)
<b>Macroprudential Policy</b>	
2.	Close remaining data gaps, and enhance analytical tools (CBM, NSO, MFSA)
3.	Refine and introduce the planned borrower-based instruments to address possible buildup of vulnerability in the housing and household sectors. (CBM)
<b>Financial Sector Supervisory Resources and Independence</b>	
4.	Ensure stable funding for the MFSA, grant it full autonomy over its recruitment and maintain a dedicated statutory committee on supervisory issues. (MFSA, Government)
5.	Address the significant gap in supervisory and enforcement capacity by increasing staff and broadening the skill set. (MFSA)
<b>Banking Regulation and Supervision</b>	
6.	Increase the number and risk orientation of onsite inspections of LSIs. Enhance supervision of third country branches. (MFSA)
7.	Take timely supervisory actions (including for ML/TF) and increase the use of monetary fines. Ensure supervisory action is not delayed through judicial appeal, including by amending the law, if needed. (MFSA, FAIU, Government)
<b>Insurance and Securities Regulation and Supervision</b>	
8.	Strengthen conduct supervision and enhance the sectoral risk-based supervision framework. (MFSA)
<b>AML/CFT</b>	
9.	Improve the authorities' assessment and understanding of ML/TF risks and strengthen the national coordination. (National Coordination Committee)
10.	Adopt a multi-prong strategy that includes: (i) ensuring that banks appropriately apply preventive measures; (ii) fully implementing a risk-based AML/CFT supervision; and (iii) applying timely, dissuasive, and proportionate sanctions and effective fit-and-proper tests. (MFSA, FIAU, ROC, Government)
11.	Support establishing an EU-level arrangement responsible for AML/CFT supervision. (Government)
<b>Safety Nets and Crisis Management</b>	
12.	Adopt an administrative bank insolvency regime with explicit powers to transfer assets/liabilities. Clarify the creditor hierarchy. (Government)
13.	Shift responsibility for decisions on bank insolvency and liquidation, post-license revocation, from the MFSA's supervisory function to its resolution function (MFSA)
14.	Review the adequacy of the Resolution Unit's staffing and increase its resources accordingly (MFSA)

<sup>1/</sup> Please refer to Malta Financial System Stability Assessment 2019 for the full set of FSAP recommendations.

## Annex VIII. Debt Sustainability Analysis

*Malta's debt sustainability has been improving in recent years, thanks to prudent fiscal policy, strong growth, and favorable financing conditions. The debt is expected to remain sustainable and its dynamics are robust to most of standard adverse macroeconomic shocks, but vulnerabilities may arise from large contingent liabilities and a loss of fiscal revenues from IIP. Malta's external debt sustainability appears robust to various shocks.*

### **Public Debt Sustainability**

1. **Malta's public debt ratio has remained on a rapid downward path.** The gross public debt declined to 50.2 percent of GDP in 2017, from 55.4 percent of GDP in 2016, reflecting strong nominal GDP growth and a higher primary fiscal balance. In a baseline scenario, this path continues against the background of strong fiscal surplus supported by strong economic activity, continued IIP proceeds, and reduced interest payment burdens. The public debt is projected to decline to 45 percent of GDP in 2018 and continue a downward trajectory to 30 percent in 2023.
2. **Contingent liabilities declined moderately but are still significant.** The stock of government guarantees stood at 10 percent of GDP in 2017, down from 14 percent in 2016. Much of them are provided to non-financial state-owned enterprises (SOEs) whose liabilities represent 21 percent of GDP in 2016. Contingent liabilities related to public-private partnerships accounts for 1 percent of GDP. Overall, these contingent liabilities can represent more than 20 percent of GDP.
3. **The debt sustainability is resilient to most of standard adverse macroeconomic shocks, while it is more vulnerable to low growth.**
  - **Growth shock:** The scenario envisages a reduction of GDP growth by 3.7 percentage points (equivalent to one standard deviation of growth over the past ten years) and a 0.9 percentage points drop in inflation rate relative to the baseline in 2019 and 2020. Nominal interest rates increase by 41 and 83 basis points, respectively, in 2019 and 2020 reflecting higher risk premiums. The debt would increase to 48 percent of GDP by 2020, 9 percentage points higher than the baseline, then follows a declined path thereafter to reach 38 percent of GDP in 2023.
  - **Primary balance shock:** A cumulative reduction of 1.8 percentage points (equivalent to one standard deviation shock) in primary balance, coupled with a 25 basis point increase in interest rate, in 2019 and 2020 would increase the debt ratio by about 2 percentage points relative to the baseline.
  - **Interest rate shock:** A sustained increase of 200 basis points in spread throughout the projection period would slow down the debt reduction modestly, by about 0.5 percentage point of GDP by 2023.

- **Real exchange rate shock:** A 13 percent real exchange rate depreciation with pass-through to the inflation rate is applied to 2019. Given that the almost all public debt is denominated in the local currency, this scenario would decelerate the debt reduction only negligibly.
- **Combined macro-fiscal shock:** The scenario combines above-mentioned shocks to the growth, the primary balance, the interest rate, and the exchange rate. The debt ratio would rise to 48 percent by 2020, 9 percentage points higher than the baseline, then fall thereafter to 39 percent of GDP in 2023.

#### 4. **The debt sustainability could be seriously affected by government's contingent liabilities and realization of IIP proceeds.**

- **Financial contingent liability shock:** The scenario analyzes the impact of a one-time increase in non-interest expenditures equivalent to 10 percent of the size of the banking sector, coupled with slower real GDP growth (a one standard deviation reduction in the growth rate over 2019-20), inflation decreasing by 0.25 percentage points for every one percent point reduction growth, and interest rate spread rising by 0.25 basis points for every one percent of GDP deterioration in the primary balance. While the revenue-to-GDP ratio is assumed to remain the same as the baseline, the shock would deteriorate the primary balance to -33 percent of GDP, largely reflecting banks' large gross foreign assets. The debt ratio is project to rise sharply to 80 percent of GDP in 2019 and peak at 81 percent of GDP in 2020, 42 percentage points higher than the baseline. It would decline to 74 percent of GDP at the end of the projection horizon.
- **Government guarantee shock:** This scenario analyzes a contingency liability risk from SOEs and other government guaranteed debt, by assuming a one-time increase in expenditures equivalent to 50 percent of SOE liabilities. The other shocks follow the same assumptions as for financial contingent liability shock above, and include slower growth, higher inflation and higher interest rate spreads. With these shocks combined, the debt-to-GDP ratio would increase to 55 percent of GDP in 2019, 12 percentage points higher than the baseline. The debt ratio would resume the declining trend thereafter to reach 43 percent of GDP at the end of the projection period.
- **IIP proceed shock:** The sustainability of the debt without the IIP revenues is analyzed by excluding the IIP revenues from non-interest revenues and assuming modest increase in interest rate spreads. The rate of decline in the debt ratio decelerate relative to the baseline, while the debt ratio still declines to 33 percent of GDP at the end of the projection period, 3 percentage points higher compared to the baseline.

#### **External Debt Sustainability**

5. **Malta's external position remains strong with large holdings of external assets.** Gross external debt is large at 822 percent of GDP at the end of 2017, but this is more than covered by large amount of external assets. The external debt largely represents stable intercompany lending and liabilities of offshore financial institutions that have limited links to the domestic economy. The total net external debt is about minus 208 percent of GDP at end-2017, and is projected to fall gradually over the medium term on the back of expected current account surplus. Standard tests suggest that Malta's external position would be robust to most adverse shocks.

**Figure 1. Malta: Public DSA Risk Assessment**

**Heat Map**

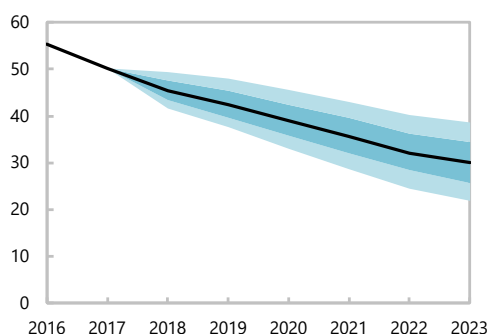
Debt level <sup>1/</sup>	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs <sup>2/</sup>	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile <sup>3/</sup>	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**

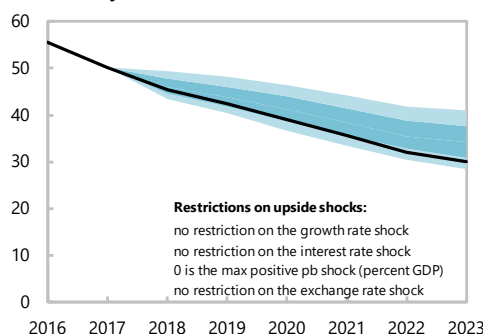
(in percent of GDP)

— Baseline      Percentiles:    ■ 10th-25th    ■ 25th-75th    ■ 75th-90th

**Symmetric Distribution**

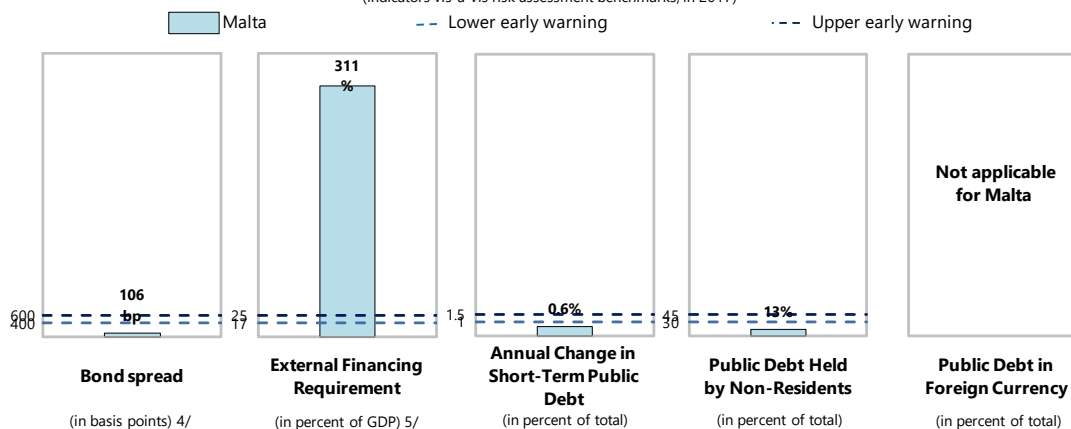


**Restricted (Asymmetric) Distribution**



**Debt Profile Vulnerabilities**

(Indicators vis-à-vis risk assessment benchmarks, in 2017)



Source: IMF staff.

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

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

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

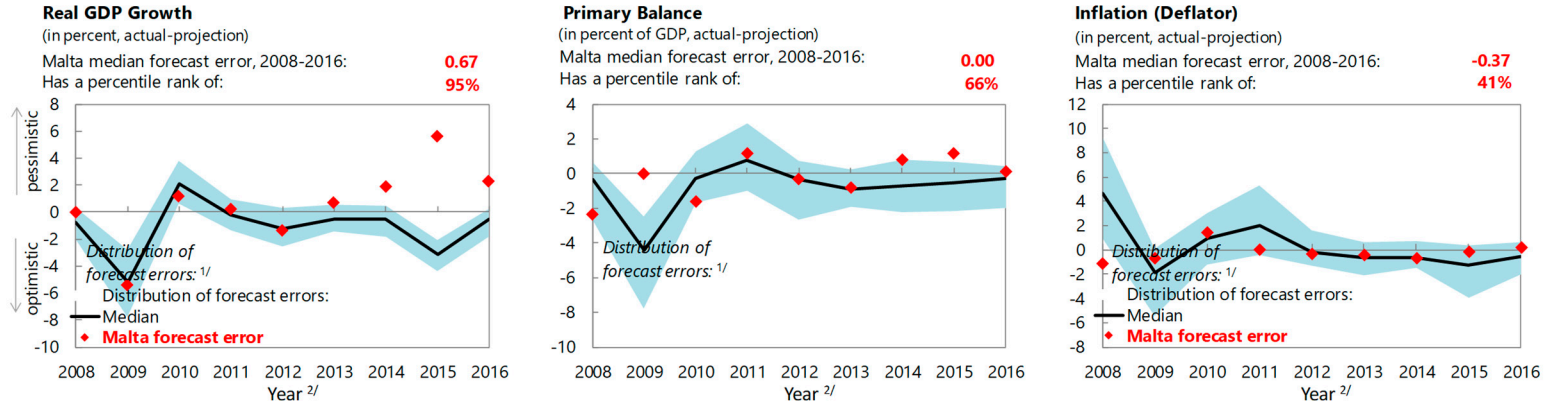
400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over German bonds, an average over the last 3 months, July 25, 2018 through October 23, 2018.

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.

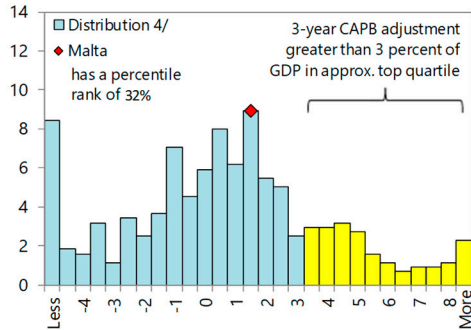
**Figure 2. Malta: Public DSA – Realism of Baseline Assumptions**

**Forecast Track Record, versus surveillance countries**

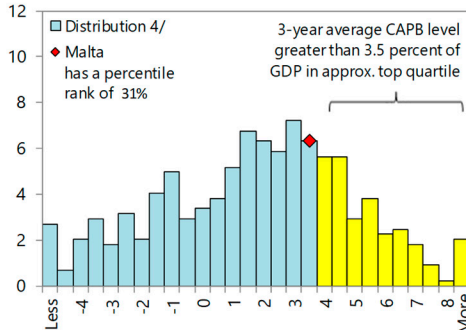


**Assessing the Realism of Projected Fiscal Adjustment**

**3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)**  
(Percent of GDP)

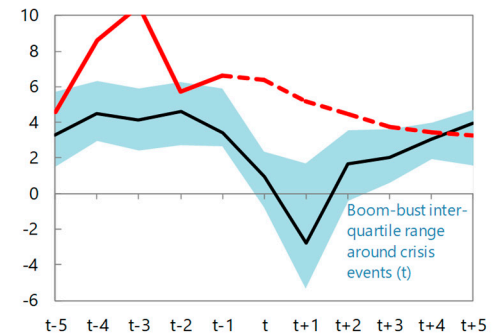


**3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)**  
(Percent of GDP)



**Boom-Bust Analysis<sup>3/</sup>**

**Real GDP growth**  
(in percent)



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, 2015–2017. For Malta, t corresponds to 2018; for the distribution, t corresponds to the first year of the crisis.

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

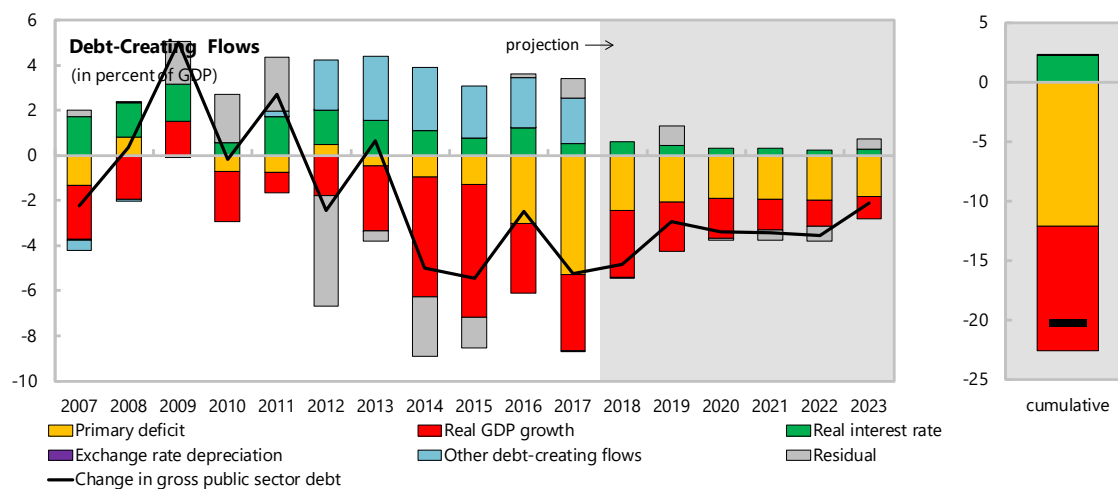
**Figure 3. Malta: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario**

(in percent of GDP unless otherwise indicated)

	Debt, Economic and Market Indicators <sup>1/</sup>									As of October 23, 2018	
	Actual			Projections							
	2007-2015 <sup>2/</sup>	2016	2017	2018	2019	2020	2021	2022	2023	Sovereign Spreads	
Nominal gross public debt	65.3	55.4	50.2	45.4	42.4	39.0	35.6	32.1	30.0	EMBIG (bp) <sup>3/</sup>	114
Public gross financing needs	5.7	3.8	-0.2	4.8	4.9	4.8	4.5	4.0	1.8	5Y CDS (bp)	209
Net public debt	65.3	55.4	50.2	45.4	42.4	39.0	35.6	32.1	30.0		
Real GDP growth (in percent)	4.0	5.7	6.6	6.4	5.2	4.4	3.8	3.5	3.3	Ratings	Foreign Local
Inflation (GDP deflator, in percent)	2.6	1.5	2.4	2.2	2.2	2.3	2.2	2.2	2.2	Moody's	A3 A3
Nominal GDP growth (in percent)	6.7	7.3	9.2	8.7	7.5	6.8	6.1	5.8	5.6	S&Ps	A- A-
Effective interest rate (in percent) <sup>4/</sup>	4.9	3.9	3.6	3.6	3.4	3.2	3.3	3.0	3.2	Fitch	A+ A+

**Contribution to Changes in Public Debt**

	Actual			Projections						cumulative	debt-stabilizing primary balance <sup>9/</sup>
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023		
Change in gross public sector debt	-0.7	-2.5	-5.2	-4.8	-2.9	-3.4	-3.4	-3.6	-2.1	-20.2	
Identified debt-creating flows	-0.4	-2.6	-6.1	-4.8	-3.8	-3.3	-3.0	-2.9	-2.5	-20.3	
Primary deficit	-0.5	-3.0	-5.3	-2.5	-2.0	-1.9	-1.9	-2.0	-1.8	-12.1	
Primary (noninterest) revenue and grants	38.9	37.4	39.2	38.2	37.5	37.3	37.0	37.1	36.0	223.1	
Primary (noninterest) expenditure	38.4	34.4	33.9	35.7	35.5	35.4	35.0	35.1	34.2	210.9	
Automatic debt dynamics <sup>5/</sup>	-1.1	-1.8	-2.9	-2.4	-1.7	-1.4	-1.0	-0.9	-0.7	-8.2	
Interest rate/growth differential <sup>6/</sup>	-1.1	-1.8	-2.9	-2.4	-1.7	-1.4	-1.0	-0.9	-0.7	-8.2	
Of which: real interest rate	1.4	1.2	0.5	0.6	0.4	0.3	0.3	0.2	0.3	2.2	
Of which: real GDP growth	-2.4	-3.1	-3.4	-3.0	-2.2	-1.8	-1.4	-1.2	-1.0	-10.4	
Exchange rate depreciation <sup>7/</sup>	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	1.1	2.2	2.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
ESM and euro area loans	1.2	2.2	2.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes <sup>8/</sup>	-0.3	0.2	0.9	0.0	0.9	-0.1	-0.4	-0.6	0.4	0.1	



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;  $\pi$  = 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.

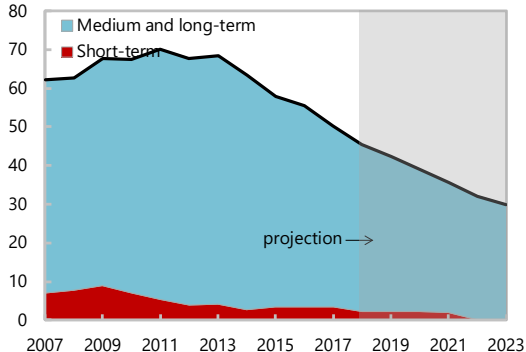


**Figure 4. Malta: Public DSA - Composition of Public Debt and Alternative Scenarios**

**Composition of Public Debt**

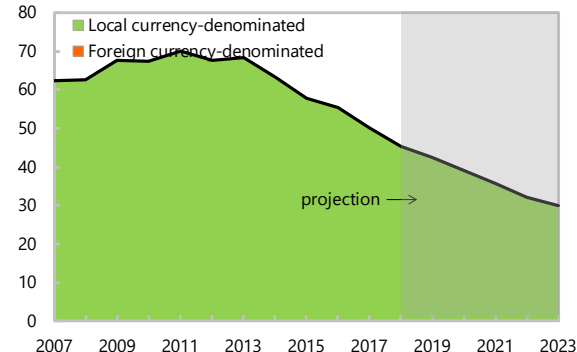
**By Maturity**

(in percent of GDP)



**By Currency**

(in percent of GDP)



**Alternative Scenarios**

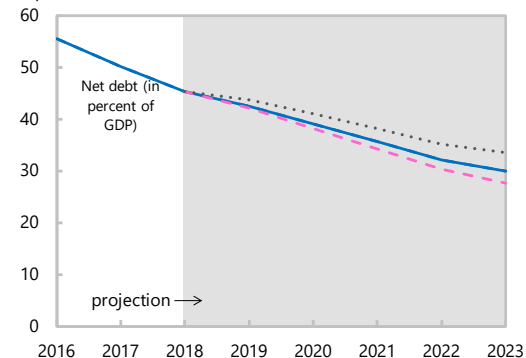
— Baseline

..... Historical

- - - Constant Primary Balance

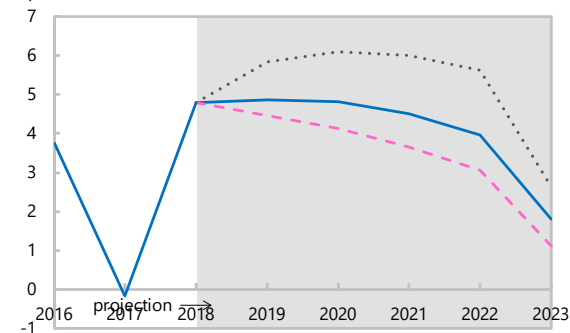
**Gross Nominal Public Debt**

(in percent of GDP)



**Public Gross Financing Needs**

(in percent of GDP)



**Underlying Assumptions**

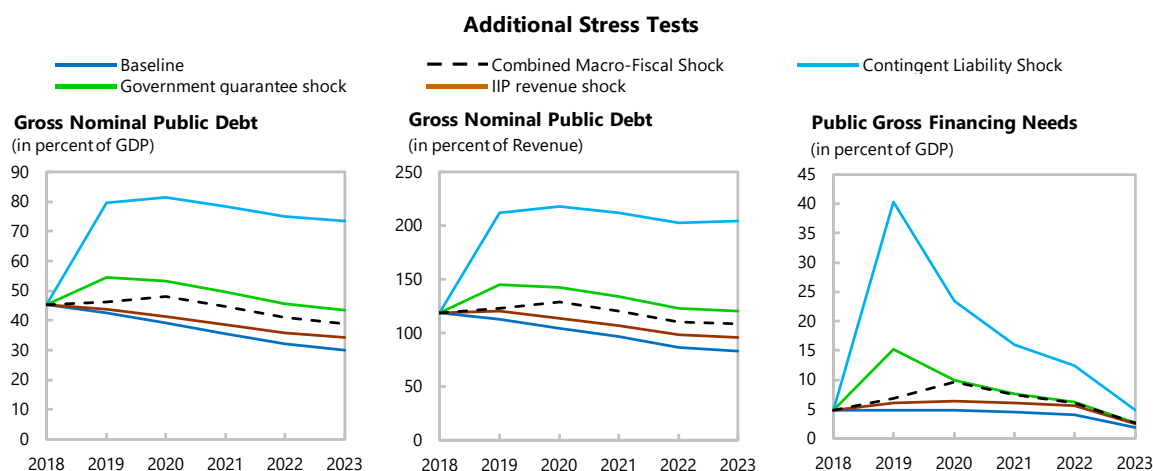
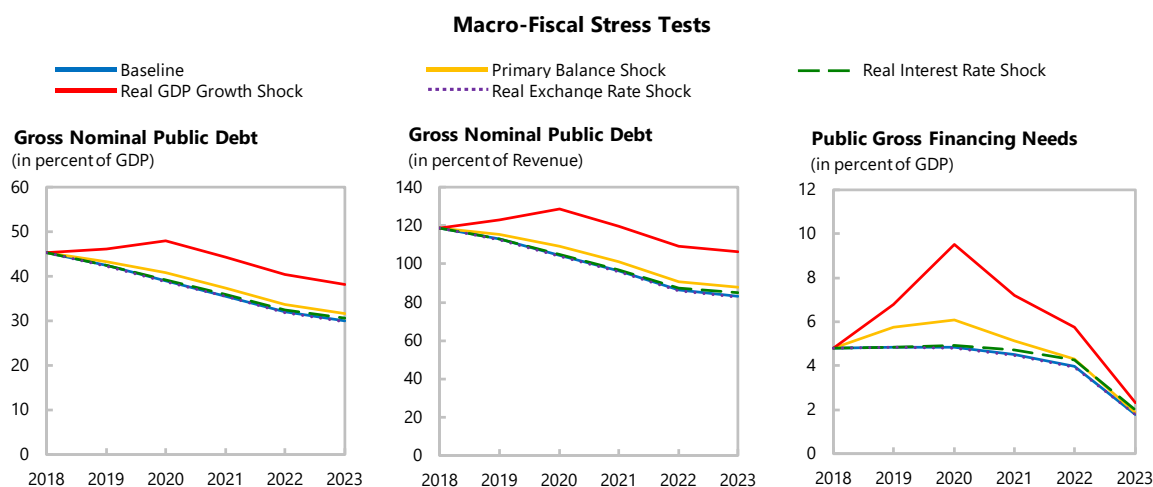
(in percent)

Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	6.4	5.2	4.4	3.8	3.5	3.3
Inflation	2.2	2.2	2.3	2.2	2.2	2.2
Primary Balance	2.5	2.0	1.9	1.9	2.0	1.8
Effective interest rate	3.6	3.4	3.2	3.3	3.0	3.2
<b>Constant Primary Balance Scenario</b>						
Real GDP growth	6.4	5.2	4.4	3.8	3.5	3.3
Inflation	2.2	2.2	2.3	2.2	2.2	2.2
Primary Balance	2.5	2.5	2.5	2.5	2.5	2.5
Effective interest rate	3.6	3.4	3.3	3.3	3.0	3.2

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	6.4	4.5	4.5	4.5	4.5	4.5
Inflation	2.2	2.2	2.3	2.2	2.2	2.2
Primary Balance	2.5	1.1	1.1	1.1	1.1	1.1
Effective interest rate	3.6	3.4	3.4	3.4	3.3	3.6

Source: IMF staff.

Figure 5. Malta: Public DSA - Stress Tests

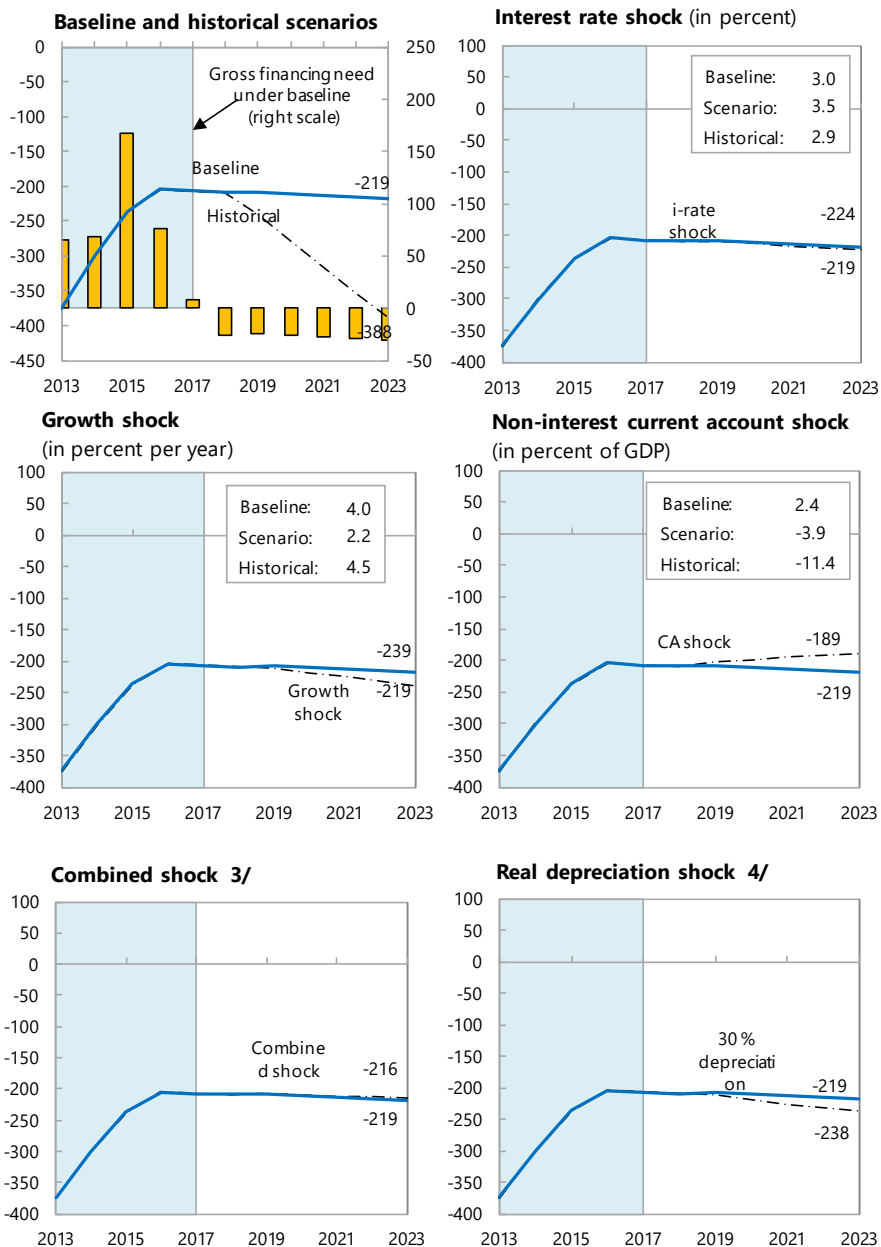


**Underlying Assumptions**  
(in percent)

	2018	2019	2020	2021	2022	2023
<b>Primary Balance Shock</b>						
Real GDP growth	6.4	5.2	4.4	3.8	3.5	3.3
Inflation	2.2	2.2	2.3	2.2	2.2	2.2
Primary balance	2.5	1.1	1.0	1.9	2.0	1.8
Effective interest rate	3.6	3.4	3.2	3.3	3.0	3.2
<b>Real Interest Rate Shock</b>						
Real GDP growth	6.4	5.2	4.4	3.8	3.5	3.3
Inflation	2.2	2.2	2.3	2.2	2.2	2.2
Primary balance	2.5	2.0	1.9	1.9	2.0	1.8
Effective interest rate	3.6	3.4	3.5	3.7	3.5	3.9
<b>Combined Shock</b>						
Real GDP growth	6.4	1.5	0.7	3.8	3.5	3.3
Inflation	2.2	1.3	1.4	2.2	2.2	2.2
Primary balance	2.5	0.4	-1.4	1.9	2.0	1.8
Effective interest rate	3.6	3.4	3.5	3.7	3.6	4.0
<b>Real GDP Growth Shock</b>						
Real GDP growth	6.4	1.5	0.7	3.8	3.5	3.3
Inflation	2.2	1.3	1.4	2.2	2.2	2.2
Primary balance	2.5	0.4	-1.4	1.9	2.0	1.8
Effective interest rate	3.6	3.4	3.2	3.3	3.0	3.3
<b>Real Exchange Rate Shock</b>						
Real GDP growth	6.4	5.2	4.4	3.8	3.5	3.3
Inflation	2.2	2.7	2.3	2.2	2.2	2.2
Primary balance	2.5	2.0	1.9	1.9	2.0	1.8
Effective interest rate	3.6	3.4	3.2	3.3	3.0	3.2
<b>Contingent Liability Shock</b>						
Real GDP growth	6.4	1.5	0.7	3.8	3.5	3.3
Inflation	2.2	1.3	1.4	2.2	2.2	2.2
Primary balance	2.5	-32.9	1.9	1.9	2.0	1.8
Effective interest rate	3.6	3.8	6.9	5.2	5.1	5.3

Source: IMF staff.

**Figure 6. Malta: External Debt Sustainability: Bound Tests <sup>1/2/</sup>**  
 (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, 2013–2023**  
(Net external debt, in percent of GDP unless otherwise indicated)

	Actual					Projections						Debt-stabilizing non-interest current account 6/	
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023		
<b>Baseline: External debt</b>	-375.0	-300.3	-237.2	-204.8	-207.5	<b>-209.5</b>	<b>-208.8</b>	<b>-211.0</b>	<b>-213.8</b>	<b>-216.2</b>	<b>-219.1</b>	<b>-9.2</b>	
Change in external debt	102.2	74.8	63.1	32.3	-2.7	-1.9	0.7	-2.2	-2.8	-2.4	-2.9		
Identified external debt-creating flows (4+8+9)	-57.3	-20.9	-2.8	23.4	-4.6	-17.5	-15.0	-15.4	-15.9	-15.8	-15.6		
Current account deficit, excluding interest payments	9.9	0.7	4.3	1.6	-6.1	-5.1	-3.8	-2.7	-2.2	-1.9	-1.6		
Deficit in balance of goods and services	-6.3	-11.9	-9.0	-13.2	-20.9	-21.3	-20.9	-20.9	-21.3	-21.6	-22.0		
Exports	157.0	147.9	153.0	150.8	150.0	142.3	135.6	131.8	129.4	127.0	125.2		
Imports	150.7	136.0	144.0	137.6	129.0	121.0	114.6	110.9	108.1	105.4	103.2		
Net non-debt creating capital inflows (negative)	-84.0	-50.1	-37.0	10.8	-11.4	-19.1	-16.1	-15.4	-15.0	-14.6	-14.3		
Automatic debt dynamics 1/	16.8	28.5	29.9	11.0	12.9	6.7	4.9	2.7	1.3	0.7	0.3		
Contribution from nominal interest rate	-12.5	-9.4	-6.6	-5.1	-4.3	-4.9	-5.4	-5.8	-6.2	-6.3	-6.3		
Contribution from real GDP growth	19.8	29.0	33.5	12.6	12.2	11.6	10.2	8.6	7.4	6.9	6.6		
Contribution from price and exchange rate changes 2/	9.5	8.9	3.1	3.4	5.0	...	...	...	...	...	...		
Residual, incl. change in gross foreign assets (2-3) 3/	159.5	95.7	65.9	8.9	1.9	15.5	15.7	13.2	13.1	13.4	12.7		
External debt-to-exports ratio (in percent)	-238.9	-203.0	-155.0	-135.9	-138.4	-147.2	-154.0	-160.1	-165.3	-170.2	-175.1		
<b>Gross external financing need (in billions of US dollars) 4/</b>	6.6	7.7	18.0	8.8	1.0	-3.7	-3.8	-4.5	-5.0	-5.6	-6.2		
in percent of GDP	65.2	68.1	168.0	76.8	7.8	10-Year	10-Year	-25.4	-24.4	-26.8	-28.2	-29.4	-30.5
<b>Scenario with key variables at their historical averages 5/</b>						<b>-209.5</b>	<b>-240.8</b>	<b>-279.8</b>	<b>-316.3</b>	<b>-352.7</b>	<b>-387.8</b>	<b>-54.6</b>	
<b>Key Macroeconomic Assumptions Underlying Baseline</b>						Historical Average	Standard Deviation						
Real GDP growth (in percent)	4.6	8.6	10.6	5.7	6.6	4.5	3.7	6.4	5.2	4.4	3.8	3.5	3.3
GDP deflator in US dollars (change in percent)	5.4	2.5	-14.4	1.2	4.5	0.7	7.1	7.3	0.9	3.7	2.8	3.1	2.7
Nominal external interest rate (in percent)	2.9	2.8	2.1	2.3	2.3	2.9	1.0	2.7	2.7	3.0	3.1	3.1	3.1
Growth of exports (US dollar terms, in percent)	4.6	4.9	-2.1	5.4	10.8	4.1	6.2	8.3	1.1	5.3	4.7	4.7	4.5
Growth of imports (US dollar terms, in percent)	3.4	0.5	0.3	2.2	4.5	12.3	26.7	7.0	0.6	4.7	4.0	4.0	3.8
Current account balance, excluding interest payments	-9.9	-0.7	-4.3	-1.6	6.1	-11.4	12.7	5.1	3.8	2.7	2.2	1.9	1.6
Net non-debt creating capital inflows	84.0	50.1	37.0	-10.8	11.4	61.3	44.5	19.1	16.1	15.4	15.0	14.6	14.3
<p>1/ Derived as <math>[r - g - r(1+g) + ea(1+r)] / (1+g+r+gr)</math> times previous period debt stock, with <math>r</math> = nominal effective interest rate on external debt; <math>r</math> = change in domestic GDP deflator in US dollar terms, <math>g</math> = real GDP growth rate, <math>e</math> = nominal appreciation (increase in dollar value of domestic currency), and <math>a</math> = share of domestic-currency denominated debt in total external debt.</p> <p>2/ The contribution from price and exchange rate changes is defined as <math>[-r(1+g) + ea(1+r)] / (1+g+r+gr)</math> times previous period debt stock. <math>r</math> increases with an appreciating domestic currency (<math>e &gt; 0</math>) and rising inflation (based on GDP deflator).</p> <p>3/ For projection, line includes the impact of price and exchange rate changes.</p> <p>4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.</p> <p>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.</p> <p>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.</p>													



# MALTA

## STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

February 7, 2019

Prepared By

European Department  
(In Consultation with Other Departments)

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## FUND RELATIONS

(As of December 31, 2018)

### Membership Status

Joined: September 11, 1968; Article VIII

General Resources Account	SDR Million	Percent Quota
Quota	168.30	100.00
Fund holdings of currency	139.68	82.99
Reserve Tranche Position	28.65	17.03

SDR Department	SDR Million	Percent Allocation
Net cumulative allocation	95.40	100.00
Holdings	87.32	91.53

### Outstanding Purchases and Loans

None

### Financial Arrangements

None

### Projected Obligations to Fund <sup>1/</sup>

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

	Forthcoming				
	2019	2020	2021	2022	2023
Principal					
Charges/Interest	0.09	0.09	0.09	0.09	0.09
Total	0.09	0.09	0.09	0.09	0.09

<sup>1/</sup> 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 November 8–17, 2017, and the staff report (Country Report No.18/19) was brought for the Executive Board’s consideration on a lapse-of-time basis. The Article IV Consultation with Malta was concluded on January 26, 2018.

**Technical Assistance**

<b>Date</b>	<b>Department</b>	<b>Subject</b>
September 2018- January 2019	MCM	FSAP missions
September 2018	FAD	Fiscal Transparency
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

(As of December 31, 2018)

<b>I. Assessment of Data Adequacy for Surveillance</b>
<p><b>General:</b> 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.</p>
<p><b>National Accounts:</b> In September 2014, Malta together with all other EU Member States introduced the European System of Accounts 2010 and performed a benchmark revision for reference years 1995 to 2014Q2. It is recommended that benchmark revisions are performed every five years. Consequently, NSO is planning to perform a benchmark revision in September 2019. Data on retail and consumer prices, labor market indicators, and tourism arrivals are released monthly, usually with a short lag. These data are available through 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.</p>
<p><b>Price Statistics:</b> 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. Malta also publishes a quarterly residential Property Price Index and a monthly industrial Producer Price Index with base year 2015.</p>



**Statement by Domenico Fanizza, Executive Director for Malta and Laura Cerami,  
Advisor to the Executive Director  
February 22, 2019**

On behalf of the Maltese authorities, we thank staff for very constructive consultations in the context of the Article IV and of the Financial System Stability Assessment missions. Drawing on the two missions, staff have produced a fair and consistent set of reports on the health of the Maltese economy and financial system. The authorities welcome staff's overall favorable assessment. They broadly agree with their policy recommendations, many of which are aligned with measures already being considered or implemented. The authorities appreciate the mutual trust developed through open dialogue during past consultations and value the Fund's expert advice.

*Macroeconomic outlook and risks*

Malta has been one of the fastest growing economies in Europe since the global financial crisis and the outlook remains favorable, supported by rising export-oriented services, notably remote gaming, business and professional services, information and communication, and tourism. Going forward, growth is expected to gradually converge to its potential rate, which the authorities estimate solidly above 4 per cent.

As staff note, risks to the outlook are mainly external, notably rising global protectionism, a disorderly Brexit, and further tightening of global financial conditions. As a small open economy, Malta is highly exposed to external shocks and to mitigate these risks, the country has long been proactively promoting a well-diversified and competitive economy, together with fiscal prudence. With regard to Brexit, the authorities note that the overall impact on Malta may not necessarily be adverse, as the well-developed and internationally oriented financial sector might remain attractive and even benefit from relocating financial services providers.

Regarding domestic risks, the authorities are fully aware of the significance of reputational risks. Following some cases of weak implementation of the AML/CFT framework, they are taking prompt remedial action to preserve the attractiveness of Malta as an international financial center and a place to conduct business. Contrary to staff's assessment, the authorities are less concerned about the risk of a sharp downward correction in housing prices, as their recent rise, although rapid, has been largely driven by economic fundamentals, including sustained inflows of foreign workers and rising disposable income.

*Safeguarding Stability, Integrity, and Innovation in the Financial System*

Despite its large size, complexity, and linkages with the rest of the world, the Maltese financial system remains sound and well insulated from external shocks, as foreign-linked

intermediaries have limited domestic exposures. The authorities welcome the strong resilience underscored by the solvency and liquidity stress tests carried out in the context of the FSAP mission, which were based on quite severe adverse scenarios.

The authorities remain vigilant over banks' asset quality, focusing on remaining pockets of vulnerabilities in the construction and real estate sectors. Since 2016 they have started to collect more granular data on loans and established a central credit registry for monitoring emerging risks closely. Moreover, the Central Bank of Malta will be imminently introducing borrower-based measures to prevent the buildup of vulnerabilities.

The FSAP found some gaps in the supervisory framework, which the authorities are addressing decisively. They agree that the operational capacity for the supervision and the crisis management functions has not kept pace with the rapid development of the financial system. The Malta Financial Services Authority (MFSA) has already upgraded the compensation package for its staff and started hiring new resources. In addition, the authority will be exempt from the regulation on public employment, which required the government's approval of the size of the staff complement, thereby ensuring that the MFSA's recruiting process is more efficient. The MFSA's operational autonomy will further benefit from the ongoing review of the regulatory fees, and by the adoption of a medium-term budget, with government contributions closing any shortfall of projected regulatory revenues. The authorities are also working on bringing the insolvency regime in line with international standards.

Similarly, the authorities have taken corrective action to safeguard financial integrity and maintain trust in the system, after the events which led to the revocation of Pilatus bank's license. This incident did not affect the stability of the financial system, as the bank was solvent and had no exposure to residents, but it raised reputational risks that required immediate action. The authorities have performed a thorough National Risk Assessment, which informed a detailed 50-point action plan, which they are implementing.

The authorities welcome staff's assessment that the plan goes in the right direction by, amongst other measures:

- adding resources to both the MFSA and the Financial Intelligence Analysis Unit (FIAU);
- fostering their collaboration through an already agreed Memorandum of Understanding;
- improving the understanding of risks among all competent authorities;
- enhancing the application of preventive measures, and of timely corrective measures, including dissuasive penalties.

Staff also recommended establishing a regional approach for the supervision of the

AML/CFT framework. While noting that this recommendation should be elevated at the regional level, the authorities think that a regional supervisory framework would not be feasible and effective absent deeper and broader harmonization of national legislations.

The authorities intend to encourage the diffusion of advanced and innovative technologies. The government is developing a multipronged approach to facilitate a variety of applications of blockchain and artificial intelligence and has created a regulatory framework for the digital ledger technology and its application in the financial services industry. This new framework aims at enabling innovation and competition, while mitigating the related financial stability and integrity risks, and ensuring adequate protection of consumers and investors.

#### *A Prudent Fiscal Policy oriented to Sustained and Inclusive Growth*

The strong economic performance and the high take-up of the Individual Investor Program (IIP) boosted again revenues in 2018 and, together with lower than anticipated spending, contributed to a fiscal surplus well above the initial government target of 0.5 per cent of GDP (exclusive of IIP proceeds). The budget for 2019 aims a smaller surplus to allow for higher capital spending and some targeted tax relief for the most vulnerable, in part offset by savings in current and interest outlays.

Malta is facing the challenging task of managing its own success. Robust and rapid growth have inevitably run into capacity constraints and increased the need for upgrading the physical and human capital. This requires large infrastructure projects to improve road quality and waste management, boost the supply and affordability of housing as well as health and education facilities and services.

The authorities are taking important steps to enhance the availability of financial and technical capacity to address structural bottlenecks and support actual and potential growth.

- First, the authorities have completed and followed up on comprehensive spending reviews covering social security, health services, and education, as well as established an institutional framework for the comprehensive spending reviews process, including ad-hoc training of staff.
- Second, the authorities are taking steps to improve the reporting of tax expenditures, public investment management and risk analysis, and the framework for managing fiscal risks. In this respect, they appreciate Fund's technical advice received during the recent Fiscal Transparency Evaluation.
- Third, the authorities have already initiated major projects targeting road and maritime infrastructure, hospitals, laboratories, and waste management. These projects will be financed by public and private resources and managed by Infrastructure Malta, a public agency responsible for the entire procurement process,

thereby avoiding delays resulting from necessary government's approval for each stage of the process.

- Fourth, two specialized public agencies, Malta Enterprise and Malta Development Bank have explored several initiatives to enhance access to finance for SMEs, with a special focus on start-ups and more generally innovative sectors.

Finally, the authorities are focusing on measures to reduce absolute and relative poverty and improve social inclusion. They appreciate staff's analysis and valuable technical contribution to the policy debate, that supports current measures to boost women labor participation, lengthen working lives by rewarding late retirement, and upskill the local and foreign-sourced labor force.