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Malta: Staff Report for the 1999 Article IV Consultation

This report was prepared by a staff team of the International Monetary Fund following discussions with the officials of Malta on economic developments and policies. The report was then considered by the IMF's Executive Board in the context of the IMF's periodic consultation with Malta, as required under Article IV of the IMF Articles of Agreement. The views expressed in the staff report itself are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF or of the authorities of Malta; a supplementary statement by IMF staff may also be included. The views of the Executive Board as expressed in the discussion of the Article IV consultation report and as summarized in a Public Information Notice (PIN) are also included. In addition, a statement by the member country authorities may be appended. Further background documentation prepared by IMF staff for the consultation may be published separately at a later date.

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MALTA

Staff Report for the 1999 Article IV Consultation

Prepared by the Staff Representatives for
the 1999 Consultation with Malta

Approved by Malcolm Knight and Carlos G. Muñiz

May 21, 1999

- The consultation discussions were held in Valletta during March 16–26, 1999, and at headquarters on April 26. The staff team comprised Mr. Doyle (Head), Mr. Orsmond, Ms. Tan, and Ms. Dunne (assistant) (all EU1). Mr. Giustiniani, Advisor in the Executive Director's office, attended some meetings. The mission met with Mr. Dalli, Minister of Finance, Mr. Ellul, Governor of the Central Bank, Mr. Bonnici, Minister of Economic Affairs, senior government officials, the trade unions, and business representatives.

- Malta does not subscribe to the SDDS, but its information is generally good and timely. However, improvements are needed in the national accounts, and more comprehensive information on prices and deflators would facilitate surveillance (see Appendix II.)

- In concluding the last Article IV consultation on May 23, 1997, Executive Directors noted Malta's positive growth and inflation performance, but expressed concern at the large fiscal and external imbalances. They called for early and substantial fiscal tightening to halt the rise in the public debt burden and to strengthen the external balance.

- A Nationalist Party administration took office with a comfortable majority after early parliamentary elections in September 1998, and its mandate was reconfirmed in local elections held in March 1999. It has reinstated Malta's application to join the EU, that had been withdrawn by the prior administration, but entry will be subject to a referendum. The EU Commission provided a favorable *avis* in February 1999, but noted, inter alia, that further trade liberalization was needed, budgetary assistance to public enterprises should be curbed, and that various economic laws and practices would need to be adjusted to conform to EU standards.

I. Recent Economic Developments

1. **Malta is a small open economy**. The population of 370,000 enjoys a per capita income of US$9,000 (a little below Greece and Portugal). Exports of goods and services—primarily tourism and manufactures—amount to over 90 percent of GDP.

2. **Economic performance, though creditable, has been weakening in recent years.** Structural reforms in the late 1980s, including trade liberalization and sizable cuts in personal income tax rates, lifted annual per capita growth sharply to 6–7 percent at the turn of the decade and more than halved the unemployment rate to below 4 percent. Subsequently, per capita growth has been falling to some 2 percent per annum and unemployment has increased to 5 percent recently (Table 1 and Figure 1). Anchored by the exchange rate peg, inflation has remained in low single digits throughout, peaking at 4½ percent in 1993 after the 10 percent devaluation of the Maltese lira in 1992, which followed the ERM crisis. Nominal T-bill rates have remained between 4.3 percent and 5.5 percent during the 1990s.

3. **The decline in performance mainly reflects two factors: persistent weaknesses in structural policies and, more recently, instability in the policy framework, including the loss of fiscal discipline.**

4. **Despite advances during the 1990s, key structural inadequacies remain unaddressed.** On the positive side, the main retail banks have been partially privatized, interest rates have been freed, and monetary policy has shifted to the use of indirect instruments. Malta accepted the obligations of Article VIII, Sections 2, 3, and 4 in 1994, and has eased the de facto application of its comprehensive capital account controls. VAT was introduced in 1995, and the remaining quotas were replaced with trade levies in the same year. These advances contrast, however, with stagnation on key structural issues. These include excess employment in the public sector which continues to account for over 35 percent of employment, a reluctance to move beyond hiring freezes to curb overstaffing in the most persistently loss-making public enterprises, and maintenance of the trade levy structures introduced in mid-decade.[1] Furthermore, water and electricity charges have remained unchanged since the early 1980s. As a result of these weaknesses in the public sector, the government wage bill absorbs almost 12 percent of GDP, and public enterprises absorb a further 4–5 percent of GDP annually in subsidies as well as a steady flow of government guaranteed credit, the outstanding balance of which was 37 percent of GDP at end-1998.

5. **Since the mid-1990s, the policy framework was markedly altered.** Following a change of administration, the application for EU membership dating back to 1990 was withdrawn in 1996, the two year old VAT was abolished a year later, and the fiscal deficit (on the staff definition) more than doubled in 1996, rising further to over 10 percent of GDP by

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[1] Chapter II of the accompanying background paper reviews the performance of selected public enterprises, their impact on the budget, and the prospects for improved performance.

1998.[2] The deteriorating trend in the fiscal deficit after 1995 initially reflected added spending ahead of the 1996 elections, which more than doubled the deficit to 8.6 percent of GDP in 1996 (Tables 3, 4, and 5, and Figure 4). The increase in the cash deficit continued in 1997 under the pressure of additional loans to state enterprises, the clearance of expenditure arrears, and revenue losses arising from the replacement of the VAT with an alternative indirect tax structure. In 1998, weakening economic activity dented receipts further, whilst expenditures, including subsidies to state enterprises and a further round of clearance of expenditure arrears, continued to grow. These took the deficit to 10.4 percent of GDP. As a result, in the last five years, public and publicly guaranteed debt has risen by 16 percentage points of GDP to 92 percent of GDP, with almost all the outstanding guarantees being in favor of public enterprises.

6. **Partly as a result of mounting fiscal pressures, the nettle of water and electricity charges was grasped in late 1997.** But the ensuing public outcry resulted in extensive rebates and non-issue of bills pending a review of the price increases. Most bills still had not been issued a year later in November 1998 when, following early national elections, the price increases were substantially—and for a significant number of households, more than fully—reversed.

7. **Against this background, the external current account balance deteriorated sharply in 1995, but it has since strengthened.** Imports boomed reflecting a cluster of private and parastatal investments, including purchase of a commercial aircraft, and consumption that had been brought forward in anticipation of the introduction of VAT. Accordingly, the external current account deficit doubled to 11 percent of GDP in 1995 (Table 2 and Figures 2 and 3). The deficit subsequently declined to 5 percent of GDP in 1998, as real domestic demand slowed sharply, even contracting slightly in 1997 before stabilizing in 1998 as fixed investment and private savings returned to trend levels. The impact of weakening domestic demand on the external current account balance was supported by exceptional increases in electronics exports and falling international energy prices, although the impact of the latter was muted by the effect of past forward purchases. Exceptionally high outward dividend payments of 1½ percent of GDP in 1998 somewhat offset these effects. Long-term capital inflows strengthened in 1997 and 1998, while short-term inflows declined (Table 2). Official reserves rose slightly to give 6 months' import cover in 1998.

8. **Malta's inflation record and competitiveness nevertheless remains strong.** The rise in the consumer price index was limited to 1.3 percent during 1998 as utility prices were cut, international energy prices weakened, and credit growth eased to 11 percent on the back of weakening domestic demand (Table 6). Introduction of the new VAT in January 1999 had a negligible effect on the index, though 12-month inflation rose to 1.9 percent in February

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[2] The staff definition of the cash-based fiscal deficit is used throughout. It includes the extrabudgetary funds, and treats grants and repayments of net lending as revenue—official data treat both as financing items.

1999. The CPI-REER and competitiveness vis-à-vis alternative tourist destinations have slowly returned to their levels prior to the 1992 depreciation (Figure 7). Relative unit labor costs in manufacturing show similarly modest appreciation, and real unit labor costs in the private sector are stable (Figure 8). In response to the introduction of the euro, the composition of the basket to which the lira is pegged was adjusted on January 1, 1999, to 56.8 percent for the euro, and 21.6 percent each for the U.S. dollar and the pound sterling. This did not alter the underlying weights in the basket.

9. **External and fiscal imbalances prompted a modest monetary tightening**. During 1997–98, the Central Bank of Malta (CBM) raised official short-term interest rates by 50 basis points to 5.5 percent, with the modest size of the increase partly reflecting the deceleration of demand already underway. Malta was little affected by recent turbulence in international capital markets and, following the sharp fall in EU short yields in the latter half of 1998, yield differentials with the external synthetic yield—average money market yields for currencies weighted by the shares in Malta's currency basket—increased by 130 basis points through 1998 and net capital inflows strengthened (Figure 6). Partly as a result, the CBM reduced its central intervention interest rate by 10 basis points in January 1999, and by a further 40 basis points in April, though subsequent reductions in EU rates mean that the yield differential remains well above 100 basis points.

10. **The imbalances and policy uncertainties were reflected in a downgrading of Malta's credit ratings**. Moody's downgraded Malta's long-term foreign currency debt rating in March 1998, and Standard & Poor's downgraded the outlook in June. Although market sentiment—as reflected in yield spreads on long-dated government paper—improved after the September 1998 elections, Moody's subsequently downgraded its outlook on foreign-currency bonds and bank deposits from A2 to A3.

II. Report on the Discussions

11. **The challenge is to reinvigorate economic performance**. Growth has fallen below the 4–5 percent range which staff estimate as Malta's potential, and the external current account deficit, though much reduced, remains high.[3] Strengthened fiscal and structural policies will be required to make good the growth shortfall, consistent with a sustainable external current account balance. Were labor saving structural reforms in the public sector—that increase capital intensity and reduce the public labor force—to play a major part in achieving that consolidation, economy-wide productivity and output would be boosted and the labor constraint facing the private sector would be relieved. With the support of further trade liberalization, active promotion of Malta as a FDI destination, and EU accession, this would lay the foundation for Malta to realize its growth potential.

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[3] A growth equation estimated on panel data for 145 countries, yields Maltese growth of 4½ percent, rising to 5 percent with fiscal deficit of 3 percent of GDP. The growth equation is reported in Phillips and Ghosh, IMF *Staff Papers*, December 1998.

12. **Progress has been made to advance this agenda.** The 1999 budget targets a reduction in the fiscal deficit of 1.9 percentage points of GDP to 8.5 percent of GDP. It also incorporates a quantified medium-term fiscal framework, Malta's first, which targets a phased reduction in the fiscal deficit to 4 percent of GDP in 2004. Structural expenditure reform has been initiated, notably concerning pensions and privatization, and the administration has called for savings in the government wage bill, investment partnerships with the private sector, and improved efficiency in public enterprises. There is, however, a dearth of specific current technical work to guide these and related efforts—though the World Bank has recently been invited to contribute to the analytical effort—and post election decisions to reverse the utility price increases and to raise civil service salaries under a three year agreement have compounded fiscal pressures. In this light, the discussions focused on how best to take the fiscal and structural agenda forward.

A. Macroeconomic Outlook for 1999 and the Medium Term

13. **Official projections for 1999 show increases in the rate of growth, trade imbalances, and inflation**. Activity and confidence will be spurred by the fiscal correction anticipated in the 1999 budget, the imminent initiation of several large investment projects that had been delayed in part by the various changes in administration, and increased tourism due to security concerns in some competing tourist destinations in the Mediterranean area. Accordingly, growth is projected to rise from 3.1 percent in 1998 to 3.3 percent in 1999, led by a 6 percent growth in fixed investment and a 3 percent increase in private consumption. The consequent boost to domestic demand, though partly offset by the fiscal consolidation, is projected to increase imports. But given robust exports of goods and tourist receipts, the deficit on goods and services rises modestly to 5.6 percent of GDP in 1999.[4] Inflation is projected to rise from 2.4 percent in 1998 to 3.1 percent in 1999. If the large investment projects continued to experience administrative delays, however, demand, output, the current account deficit and inflation could all be lower than projected in 1999. Staff projections for 1999 were broadly similar, albeit somewhat more optimistic on the outlook for inflation and for the balance of trade in goods and services. The authorities agreed, however, that the possibility of higher-than-assumed international energy prices and domestic investment, and slower EU growth, were the key downside risks for the external current account balance in 1999.

14. **Official medium-term assessments are cautiously optimistic, anchored by falling fiscal deficits**. The full macroeconomic projections of the CBM show average real growth to 2004 of 3½ percent, and a steady decline in the fiscal deficit on the official definition to 6 percent of GDP by 2004. The latter exceeds the target deficit of 4 percent of GDP in the medium-term fiscal framework because the CBM takes account only of announced tax and spending measures and unspecified future "efficiency gains" in the public sector. In this

[4] Official projections refer to the balance on trade in goods and services, rather than to the current account balance, in light of the noise associated with income transfers.

context, unemployment is projected to fall to below 5 percent again, and average inflation is projected at 2½ percent. After a modest deterioration to 2000 as investment picks up, the subsequent steady strengthening in the balance of trade in goods and services to just below 4 percent of GDP by 2004 reflects a recovery of export growth, and the boost to domestic savings emanating from the progressive fiscal correction.

15. **Staff agreed that a decisive fiscal correction would buttress investment and medium-term growth.** The targeted correction and projected privatization receipts would stabilize the ratio of public debt to GDP at around 60 percent of GDP within three years, and the fiscal deficit reduction would supply additional domestic savings and elicit additional nondebt external financing for the anticipated increase in investment. On this basis, staff shared the cautious optimism of the official projections (Table 7). But it was as yet unclear how the fiscal deficit targets would be met. With similar revenue assumptions to those in the medium-term fiscal framework alongside expenditure policies already announced, staff projected that the fiscal deficit would resume its rise in 2001. The implication, which the authorities acknowledged, was that substantial further fiscal measures would be necessary in addition to announced policies to deliver the fiscal deficit targets and the associated projected strengthening in economic performance.

B. Fiscal Policy in 1999

16. **The 1999 budget targets a reduction in the fiscal deficit to 8.5 percent of GDP from 10.4 percent of GDP on the staff definition**. Following downward revisions of 0.4 percentage points of GDP to the estimate of the 1998 fiscal deficit since the budget was presented to parliament, the budget implies increased revenue of 1.5 percentage points of GDP and lower spending of 0.4 percentage points of GDP (Table 3).

17. **Indirect and labor taxes have been raised**. VAT was reintroduced effective January 1, and is projected to yield 1 percent of GDP more than the indirect taxes it replaces (Table 5). The standard rate is 15 percent, with a preferential rate of 5 percent for tourist accommodation, several exemptions and zero-ratings, and thresholds for small firms. At the same time, specific rates of excise on cigarettes and petroleum were raised sharply, though rates of other excises were lowered to offset the impact of their inclusion in the base of the VAT. Employee social security contribution rates were raised from 8⅓ percent to 9 percent of basic pay. Many steps are also in hand to strengthen tax administration, though no proceeds from any of these initiatives are included in the 1999 revenue estimates.[5] After the introduction of final payment for personal income tax in 1998, VAT refunds due on current transactions will be netted off against outstanding VAT arrears; penalties on nondeclaration of tax, late submission, and late payment will be increased; and the three tax administrations

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[5] Chapter III of the accompanying paper reviews tax administration and policy issues in recent years, outlining steps that would strengthen the key taxes and compliance.

(Inland Revenue, Customs, and VAT) will be merged. A working group has already prepared a raft of follow-up measures.

18. **Public investment and public companies are the focus of expenditure restraint.** Capital spending—excluding subventions to public entities—is budgeted to drop by 0.1 percentage points of GDP as investment projects are completed (Table 4). Subsidies and lending to public companies decline by 1 percent of GDP. Within this, subsidization of the water utility declines sharply as improved collections are anticipated following the final determination of utility prices in late 1998. These measures are partly offset, however, by added allocations to social services, largely to cover increased pensions, and interest. The budgetary wage bill is unchanged as, apart from back-dated payments to be made in 1999, the wage restructuring anticipated in the recent three-year wage agreement is delayed until 2001, and an "employment freeze" is intended to stem further increases in government employment. Defense spending has been reduced by a further 0.1 percentage point of GDP to 0.7 percent of GDP. Half of the funding of the fiscal deficit, some 4 percent of GDP, would accrue from privatization receipts, the remainder coming from issues of domestic debt.

19. **Staff welcomed the concrete steps taken to commence fiscal adjustment in 1999, and the elaboration of a formal medium-term fiscal framework.** The targeted reduction in the fiscal deficit would slow the upward momentum in public debt, sustain the strengthening in the external current account balance as domestic demand recovered, and deliver the first down payment on the medium-term fiscal plan. The VAT was a major advance, and the hard-won national consensus on this form of indirect taxation was welcome. The assumptions made on the immediate yields from the tax administration were appropriately cautious. Staff agreed that the newly constructed person-by-person database on benefit payments could secure significant savings on budget transfers, and noted that savings might also be achieved on the wage bill if funded vacancies remained unfilled.

20. **There were, however, risks that the fiscal deficit could be larger than targeted for 1999.** Although the VAT has been implemented smoothly—much of the infrastructure of the 1995 VAT was simply reactivated—with only a marginal impact on the consumer price index, caution would remain appropriate until its revenue performance is better known. On the spending side, cash flow projections were not available to demonstrate that public enterprises would be able to adhere to their reduced budgetary allocations, and the "employment freeze" did not rule out increased total government employment.

21. **In addition, the fiscal deficit outturn should be stronger than the budgeted target**. In the staff's assessment, a deficit reduction from the final 1998 outturn of some 3 percentage points of GDP was necessary in 1999. Given an external current account deficit in 1998 of 5 percent of GDP, additional domestic savings were essential in anticipation of strengthened investment, and overperformance against the budget target would also buttress the credibility of the medium-term fiscal framework. Following downward revisions to the 1998 fiscal outturn since the 1999 budget was approved, this implies a deficit target for 1999

of 7½ percent of GDP on the staff definition, some 1 percentage point of GDP stronger than budgeted. To achieve this target, firm budget implementation would be required in order to apply the cushion implicit in the budget projections—estimated by staff to be some ½ of 1 percent of GDP—to the deficit and to address any unanticipated slippages directly. In addition, the restoration of full regular payment of utility bills would have to be achieved immediately, risks that other public enterprises might make additional calls on public resources during 1999 should be identified and headed off promptly, and a formal target to reduce government employment in 1999 should be adopted to secure savings on the budget wage bill.

22. **The authorities noted steps that had been taken to ensure a strong fiscal outturn in 1999.** The VAT had been successfully reintroduced, tax administration was being strengthened in many ways, the regular issue of utility bills had recommenced in April 1999 and arrears arising from the hiatus over prices during 1998 would be collected over time, and natural wastage would offset priority hires in government. Ongoing rigorous budget implementation would aim to secure a prudent margin with respect to the budgeted deficit target.

C. Monetary Policy, Capital Controls, and Financial Sector Issues

23. **Despite its exchange rate pegging arrangement, Malta enjoys a degree of independence of monetary policy action.** This reflects elements of discretion in the operation of the capital account controls and the associated imperfect substitutability of Maltese for foreign financial assets.

24. **During 1998–99, widening yield differentials with the EU elicited capital inflows and the impact on local interest rates was resisted.** The CBM delayed reducing official interest rates following declines in the EU owing to concerns that the growth of bank credit to the private sector (including state-owned firms) was still high, at 10 percent in the year to December 1998, and that strengthening domestic demand could compound pressures on the external balance in 1999. Thus, downward pressure on domestic rates—reflected in a switch to euro-denominated borrowing and declining net foreign assets of commercial banks—was a source of concern, and had been resisted, in part through moral suasion.

25. **Staff suggested that the inflows reflected that the yield differential was excessive.** Given that fiscal consolidation had begun, inflationary pressures had eased, and international reserves were strong, the timing and form of recent capital inflows suggested that the differential in money market yields now exceeded the country risk premium. The means to resist transactions arbitraging this excess had costs—persistent moral suasion upset the free flow of market forces, the application of discretionary powers in the capital control regime would qualify the commitment to liberalization, and straightforward sterilized intervention would exact fiscal costs—and given domestic developments, these costs were excessive. Accordingly, staff saw scope to lower interest rates.

26. **But staff advised that interest rate reductions should be cautious.** They should clearly be seen as reflecting international conditions, rather than any softening of the commitment to prudent policies. Thus, reductions should be moderate, step-wise, and accompanied by a commitment to raise rates again, promptly and decisively, if needed. In April, the CBM lowered its intervention rate by 40 basis points and, a month later, it reduced its discount rate by 25 basis points, indicating on both occasions that further changes would be made as necessary.[6] Banking system deposit and lending rates followed the reductions in official interest rates and capital markets absorbed these adjustments without disturbance.

27. **Capital account controls would be further liberalized**. The 1999 budget doubled the limit on outward direct investments by residents to Lm 300,000, raised the annual limit on resident portfolio outflows to Lm 8,000, and extended the period during which exporters could hold foreign currency earnings to six months. Further liberalization was intended, prioritizing long-term flows, in accord with commitments to the EU. Staff welcomed this intention, noting that liberalization would boost Malta's standing as a destination for FDI inflows. Successful liberalization required the establishment of a fully credible medium-term fiscal policy in order to maintain confidence in the exchange rate peg and progress to strengthen financial sector supervision in anticipation of a more liberalized regime. In particular, flows currently subject to discretionary approval by the Central Bank could be freed of such discretion up to fixed limits, and subject to discretionary approval above those limits. Those limits could be progressively raised. Staff agreed that controls on bank borrowing could also be replaced with a special variable nonrenumerated reserve requirement on such borrowing. But this instrument should be narrowly focused on addressing destabilizing capital flows, and would fail if used as a means of bolstering monetary independence.

28. **The peg arrangement remained appropriate, but would be more effective if the weight of the euro was raised**. Consideration had been given to introducing a modicum of flexibility into the exchange rate regime in light of prospective capital account liberalization. This option had been rejected: a fixed peg was an appropriate nominal anchor for a small open economy with few nontraded goods; and the peg had proved durable, underpinned by the legal requirement that international reserves cover at least 60 percent of base money.[7] Staff endorsed retention of the fixed peg, underscoring that it would require the support of a credible fiscal policy and more flexible nominal interest rates, especially as capital controls were liberalized. Staff suggested, however, that the weight of the euro in the basket should be

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[6] The intervention rate is the CBM's main repo rate. The discount rate is used to define the ceilings on interest rates in legislation against usury and the concessional interest rate for housing loans for first-time buyers.

[7] Chapter IV of the background paper compares Malta's exchange rate and capital control regimes with other island economies, and highlights the implications of prospective EU entry.

raised at the expense of the U.S. dollar.[8] The weight of the latter largely reflects the fact that oil imports are denominated in U.S. dollars. But staff observed that, as oil is a primary commodity, shocks in the real U.S. dollar exchange rate tend to be offset by changes to dollar oil prices, *ceteris paribus*. And shocks that strengthen the dollar and real oil prices simultaneously cause the lira to strengthen in real effective terms in the context of a terms of trade loss for Malta. The authorities concurred and intend to raise the weight of the euro progressively.

29. **Regulation in the financial sector is being strengthened.** The risk-weighted capital ratio of banks was 15.3 percent as of December 1998, and international standards on market risk will be applied from mid-1999. In anticipation, exchange rate exposures in the banking sector are being closely monitored and are being brought into line with the requirements in the few cases where they do not already conform. The prospect of greater interest rate volatility is also reflected in increased monitoring of interest rate risk. Staff agreed that the privatization of a key retail bank would provide a welcome additional spur to efficiency in the banking sector, and welcomed the authorities' intention to thoroughly review their regulatory practices in anticipation of further liberalization of capital account controls.

D. Medium-Term Fiscal and Structural Policy Framework

30. **The medium-term fiscal framework forms the core of the economic program of the administration.** Assuming average nominal GDP growth of 5½ percent, it targets a fiscal deficit of 4 percent of GDP by 2004 (equivalent to 3.4 percent of GDP on the staff definition of the fiscal balance), which stabilizes the public debt ratio at close to current levels and achieves current fiscal balance. The program anticipates improved tax administration and further tax increases in the event that spending trends pose risks to the deficit targets. It also calls for structural expenditure reforms alongside a continued commitment to social assistance for individuals in need. The early abolition of many import levies, strengthened support for small enterprises, and improved efforts to promote inward FDI are also anticipated. The authorities stressed that these actions were required to address Malta's needs, though they would also facilitate entry to the EU.

31. **Staff welcomed the medium-term focus for fiscal policy,** the cautious assumptions on nominal growth underlying the fiscal framework, and the aim to curb further increases in net public sector indebtedness. The framework outlined a strategy to confirm Malta's fiscal solvency, and within this constraint, the appropriate pace of fiscal correction could be determined in relation to overall savings and investment balances, including efficiency issues in the public sector. Staff projections indicated that the targeted fiscal path was consistent with a sustainable external balance (Table 7). Furthermore, the framework was underpinned by accounting improvements—the activities of the extrabudgetary funds have largely been

[8] Half of merchandise exports and almost all tourist receipts are derived from the euro area, as are three-fourths of merchandise imports.

brought on budget, expenditure arrears have been cleared, privatization receipts are reported as financing items, and accrual accounts are also being developed.

32. **The composition of measures to be taken to deliver the fiscal adjustment would have a critical bearing on its impact**. The fiscal imbalance coexists with substantial inefficiencies in the public sector, including notably underemployment and inefficient utility price structures. If measures to correct these weaknesses in the public sector underpinned the fiscal correction, as called for by the authorities, fixed investment and economic growth could be stronger than projected. Accordingly, staff welcomed the creation of a commission on public pensions to address the prospect of increasing deficits in the PAYG system from the mid-2000s, but noted that its work would be facilitated by a mandate to achieve a target saving relative to baseline projections. Similarly focused initiatives were warranted to curb excesses in the public wage bill and inefficiencies supported by subsidies to public enterprises.

33. **In the absence of structural reforms to expenditure, increased taxation was likely to be required to meet the deficit targets.** Though the medium-term fiscal framework does not project an increase in the ratio of revenue to GDP, staff noted that the authorities' commitment to increased taxation to deliver the fiscal deficit targets in the event that spending exceeded projections raised uncertainties about the prospective tax burden, possibly impairing Malta's attractiveness as an investment destination. Though the need to secure the deficit reduction was paramount, the scope for efficiencies in public spending and the fact that revenues already amounted to 35 percent of GDP implied that every effort should be made to avoid raising the overall tax burden further. This aim could be codified in the adoption of a formal cap on the ratio of total government revenue to GDP, set close to current actual levels, once projections were available for the savings to be yielded by public expenditure reforms.

34. **While it remains unclear what steps will be taken to deliver the fiscal targets, staff underscored that the credibility of those targets also remains in doubt.** The "wait and see" attitude delays fixed investment, is reflected in downgrades to Malta's credit ratings, slows restructuring in the public sector, and constrains the options for capital account liberalization. Thus, staff emphasized that early evidence that it is on track is essential, and overperformance in the 1999 budget could be key in this regard. No less important, measures that will deliver the medium-term targets should be announced as soon as possible. In addition, it appeared essential to recoup credibility lost in the recent decisions on utilities prices and the civil service wages by retiring the current utility rebates on schedule, by raising both sets of utility prices (before rebates) at the same time, and by adopting a formal specific target to reduce the number of civil servants. In the context of these policy measures, the commitment to fiscal adjustment could be underscored by describing the path for the fiscal deficit as a ceiling, rather than as a set of targets. This would allow unexpectedly strong revenues or expenditure savings to be applied to accelerated deficit reduction and would address perceptions that the targeted deficit reduction path was overly back-loaded.

35. **If credible fiscal adjustment was underwritten by decisive structural reforms in the public sector, economic performance would strengthen markedly.** This would reflect the improved efficiency of public sector operations, the increased supply of labor to the private sector, the elimination of investor concerns about fiscal sustainability, and the consequent reduction in Malta's country risk premium. In this context, both the strength and the productivity of fixed investment would increase, and household consumption would likely recover from its recent lull, both anticipating improved economic performance in the medium term. Though both these trends would be welcome consequences of strong reform, they would likely add to pressures on the external current account deficit. Given that this is already relatively high, a further boost to domestic savings from the public sector would be necessary to support the external balance in this context. Thus, an accelerated and deeper fiscal adjustment would be required than the consolidation that is now targeted. The structural fiscal reforms themselves would create the scope for this action. Illustrative staff projections on this basis indicate that a fiscal deficit 1–2 percentage points of GDP stronger than targeted early in the next decade would support the increases in fixed investment and GDP growth rising to 4½ percent annually, while containing the current account deficit to 3–4 percent of GDP (Table 7).

36. **The authorities agreed that the medium-term fiscal framework could be strengthened,** that the deficit path would be treated as a ceiling, and that technical work on expenditure reform could be facilitated by the requirement that it achieves specific savings targets. They emphasized, however, that various steps to rationalize current spending were already in hand, including bolstering the management of loss-making public companies, the adoption by one such company of a pay freeze pending improved productivity, the pensions commission, and the resumption of issue of utilities bills. Savings were also being sought in government employment. Furthermore, they argued that the apparent backloading of the deficit reduction path reflected projected government investment spending. And while acknowledging the fiscal impact of the civil service wage agreement, they emphasized that as basic bay would not change until 2001, pension rates that are defined in relation to current basic civil service pay rates would similarly be unaffected until 2001.

37. **The authorities emphasized that privatization and labor retraining were also key elements of their program**. A vigorous privatization program had been initiated, led by a task force with public and private representation, aimed to strengthen economic efficiency. The bid for government's majority holding in a key retail bank—at a premium to the bank's prior share price on the stock exchange—had been accepted, subject to completion of a due diligence exercise, and decisions on which enterprises to privatize subsequently would be taken in due course. Staff welcomed the authorities' intentions and urged the early preparation of subsequent steps. But they emphasized the need to maintain fully transparent procedures for decision-making in individual cases, especially when selling assets to strategic investors in order to maintain public confidence in the process and protect the individuals on the task force. The authorities noted that extensive public and private sector labor retraining facilities were available. They agreed, however, that the publicly provided facilities could be better

targeted if the individual beneficiaries contributed more to costs, and if the nature and content of courses offered were adjusted in response to the associated revealed demand.

38. **Trade liberalization will deepen and FDI inflows will be encouraged**. The authorities intend to abolish many of the trade levies in the near future and measures would be strengthened to assist small firms that would be affected by these steps.[9] Staff welcomed these intentions and agreed that international marketing of Malta as a destination for FDI needs to be more focused, backed by a "one-stop shop" process for investors, and effective ongoing support after operations commence. Staff also noted that though an open trade regime was the best instrument to combat suppliers' market power in such a small open economy, anti-trust policy could also be strengthened. The authorities also described ongoing efforts to address the millennium bug, latterly coordinated by a national-level task force, including ongoing work in the public administration and the financial system.

39. **Maltese statistics are adequate for surveillance purposes**. There are, however, long lags before complete data on national income accounts, the public sector, and the balance of payments are released. In addition, statistics on prices and deflators are limited. Programs to strengthen data will be undertaken in collaboration with Eurostat.

III. Staff Appraisal

40. **Malta confronts two related challenges: to correct an unsustainable fiscal imbalance and to address a legacy of structural weaknesses in the public sector.** In the last six months, progress has been made to address these challenges. The targeted fiscal deficit reduction and the reintroduction of the VAT in the 1999 budget mark the beginning of a process to correct the imbalance in the public finances, fiscal policy has been set in a formal medium-term context for the first time, the transparency of the government accounts has been substantially improved, and the flagship privatization under the new program is at an advanced stage. These steps signal a timely renewed purposefulness in policy. If they are sustained and deepened, they herald a reversal of Malta's declining economic growth rate and will support—and be supported by—prospective EU accession.

41. **As the first installment in the phased reduction in the fiscal deficit, the 1999 budget will require firm implementation**. The tax system has been strengthened with the VAT and numerous enhancements to tax administration, and there is scope for savings relative to the budget provisions on a number of expenditure items, notably on transfers and wages. Given that it is essential to curb the increase in public debt, to raise additional domestic funding for investment given the sizable external current account deficit, and to establish the credibility of the whole medium-term fiscal adjustment process, the fiscal deficit should be reduced by 3 percentage points of GDP in 1999. This will require firm action to avoid slippages, the early reestablishment of orderly issue and settlement of utility bills, early

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[9] The characteristics of the trade regime are outlined in Chapter V of the background paper.

identification and correction of any risks that public enterprises might require additional support, and a reduction in government employment.

42. **The apparatus of formal medium-term fiscal targets strengthens fiscal practices.** It highlights the scale of the adjustment that is envisaged. Once credible, it will encourage investors to bring forward investments even before the envisaged fiscal correction is completed, will relax the constraints on further liberalization of capital controls, and will boost international credit ratings. However, the composition of measures taken to achieve fiscal consolidation will have a critical bearing on its impact. Given the extent of inefficiencies reflected in the flow of subsidies and guaranteed credit to public corporations, the size of the public wage bill, and the burden of social spending, these areas should form the focus of measures to achieve the fiscal targets. Early technical work in these areas could facilitate the adoption of a commitment to a formal ceiling on the ratio of revenue to GDP at close to current levels. Supported by early steps to abolish trade levies, alongside labor retraining and privatization, these measures would lay a firm foundation for sustained increases in economic growth and would support, and be supported by, prospective EU accession.

43. **The commitment to the exchange rate peg and to further relaxation of capital account controls is appropriate**. The peg remains an appropriate nominal anchor, supported by strong international reserves, and indicators of competitiveness do not signal cause for concern. In these circumstances, the recent reductions in official interest rates following international trends were appropriate. Plans for further capital account liberalization appropriately prioritize long-term flows. They will require the support of credible fiscal policy and additional interest rate flexibility alongside continued strengthening of regulation of the financial sector.

44. **The statistical data base is adequate but requires further strengthening,** especially to reduce the lags in releasing full national accounts, fiscal, and balance of payments data. Additional series on deflators would substantially assist surveillance.

45. It is recommended that the next Article IV consultation with Malta be held on the current 24-month cycle.

Table 1. Malta: Selected Economic Indicators, 1993-99

	1993	1994	1995	1996	1997	Est. 1/ 1998	Proj. 1/ 1999
Real economy (percentage change; constant prices)							
Real GDP	4.0	5.0	7.3	4.2	2.8	3.1	3.3
Private consumption	0.8	2.3	10.5	7.7	0.9	0.7	2.9
Public consumption	6.0	6.4	8.5	8.4	-1.5	1.6	1.0
Gross capital formation	13.2	11.3	13.1	-4.7	-8.7	0.9	...
Fixed capital formation	11.1	8.5	17.8	-3.8	-8.1	-1.0	6.1
Exports of goods and services	5.3	7.1	5.4	-6.7	3.1	5.1	4.4
Imports of goods and services	5.9	7.5	10.0	-6.3	-3.9	2.3	4.8
Retail prices (period average)	4.0	4.1	4.0	2.4	3.1	2.4	3.1
Retail prices (end period)	4.6	3.5	3.6	1.9	4.3	1.3	...
Unemployment rate (percent of labor force)	4.2	4.2	3.5	3.7	4.6	4.9	4.6
Public finance (percent of GDP)							
Government budget deficit	-3.0	-5.0	-3.9	-8.6	-9.7	-10.4	-8.5
Government debt	32.4	33.0	35.7	42.8	51.6	55.0	56.3
Money and credit (end period; percentage change)							
Narrow money	4.0	9.1	-5.6	3.8	5.7	8.6	...
Broad money	10.3	14.9	7.8	10.4	9.6	8.4	...
Domestic credit	12.9	12.7	26.6	16.7	15.0	10.8	...
Credit to government	12.9	9.7	19.4	32.9	34.5	14.6	...
Credit to the private and parastatal sectors	12.9	13.3	28.0	13.9	11.1	9.8	...
Net foreign assets of the central bank	11.6	25.7	-15.9	-4.6	1.4	11.4	...
(in percent of the monetary base)	127.4	152.9	129.8	119.5	115.4	124.0	...
Interest rates (percent; end period)							
Seven-day reverse repo	n.a.	n.a.	4.9	5.0	5.2	5.4	...
Three-month treasury bill	4.6	4.4	4.9	5.0	5.2	5.5	...
Government bonds (10-year)	7.0	6.7	7.1	7.2	7.3	6.0	...
Balance of payments (percent of GDP)							
Trade balance	-24.3	-23.1	-23.1	-24.0	-21.2	-17.3	...
Goods and services balance	-9.7	-10.2	-13.7	-13.9	-8.5	-4.8	-5.6
Current account balance	-3.4	-4.9	-11.0	-10.7	-6.2	-4.9	...
Official reserves (end period)							
(in millions of U.S. dollars)	1,391	1,876	1,648	1,538	1,433	1,655	...
(in months of imports of goods and services)	6.7	7.5	5.7	5.5	5.6	6.0	...
Exchange rate							
Regime		Pegged to a basket of currencies comprising the euro, pound sterling, and U.S. dollar.					
Nominal effective exchange rate (1990=100)	93.0	93.4	94.5	93.4	94.8	95.9	...
Real effective exchange rate (1990=100)	89.3	90.7	92.7	91.5	94.0	96.5	...
Current rate (May 18, 1999)			US$ 2.51 per Maltese lira				
Memorandum items:							
Nominal GDP (in millions of Maltese liri)	940	1,029	1,146	1,201	1,282	...	...
Central Bank of Malta projection						1,387	...
Ministry of Finance projection						1,391	1,455

Sources: Central Office of Statistics; Central Bank of Malta; Ministry of Finance; IMF, *International Financial Statistics;* and Fund staff estimates.

1/ Central Bank of Malta' projections, except for the public finance variables which are the Finance Ministry's projections.

Table 2. Malta: Summary Balance of Payments, 1993-99

	1993	1994	1995	1996	1997	1998	Proj. 1/ 1999
	(In millions of Maltese liri)						
Current account balance	-32.1	-49.9	-126.3	-128.5	-78.9	-68.6	-49.6
Trade balance	-228.7	-237.6	-264.1	-288.0	-271.3	-240.5	-245.8
Exports, f.o.b.	518.2	593.3	669.9	615.1	612.8	688.0	782.8
Of which: Machinery & transport	227.7	302.8	356.0	304.0	281.8	383.0	459.6
Imports, f.o.b.	746.9	830.9	934.0	903.1	884.1	928.4	1,028.6
Of which: Consumer goods	143.7	149.0	203.4	206.7	216.8	214.1	227.3
Balance on services	137.9	132.7	107.6	120.8	162.5	174.0	189.6
Exports	378.2	400.9	404.8	430.5	483.0	506.0	534.7
Of which: Tourism 2/	317.3	330.5	321.1	327.2	358.8	368.9	389.3
Imports	240.3	268.2	297.2	309.7	320.4	332.0	345.1
Investment income, net	35.5	19.3	12.0	3.2	4.1	-29.5	-21.4
Unrequited transfers, net	23.3	35.6	18.2	35.5	25.8	27.3	28.0
Capital account balance	77.1	181.7	11.6	77.8	45.9	111.7	90.0
Direct investment	26.2	57.7	43.0	23.0	23.2	46.1	50.0
Other long term capital	18.6	95.5	-8.2	7.4	-13.9	23.2	10.0
Of which: Government	13.5	2.1	-14.6	18.3	-10.2	-5.7	0.0
Short term capital, net 3/	14.2	32.5	-23.2	47.4	10.3	24.7	20.0
Change in banks' net foreign position	18.2	-4.0	-23.9	32.9	26.4	17.7	10.0
Errors and omissions	6.5	12.6	3.7	20.2	35.7	20.9	0.0
Overall balance	51.6	144.5	-111.0	-30.6	2.7	64.0	40.4
Memorandum items:							
Official reserves 4/	549.5	690.4	580.7	554.1	561.7	625.8	666.2
(in millions of U.S. dollars)	1,390.7	1,875.6	1,647.9	1,538.2	1,433.0	1,654.7	1,761.6
(in months of imports of GNFS)	6.7	7.5	5.7	5.5	5.6	6.0	5.8
	(In percent of GDP)						
Current account balance	-3.4	-4.9	-11.0	-10.7	-6.2	-4.9	-3.4
(percentage change)	-4.5	-1.4	-6.2	0.3	4.5	1.2	1.5
Goods and services	-9.7	-10.2	-13.7	-13.9	-8.5	-4.8	-3.9
Investment income	3.8	1.9	1.0	0.3	0.3	-2.1	-1.5
Transfers	2.5	3.5	1.6	3.0	2.0	2.0	1.9
Underlying current account 5/	-39.8	-41.1	-44.0	-41.5	-36.8	-35.8	-35.8
(percentage change)	-7.8	-1.3	-2.9	2.5	4.7	1.1	0.0
Of which: Imports of capital and other inputs	46.0	44.2	40.5	39.0	35.6	30.8	31.8
(percentage change)	5.3	-1.8	-3.7	-1.5	-3.4	-4.8	1.0

Sources: Data provided by the Maltese authorities; and Fund staff estimates.

1/ Staff projection.
2/ Includes transportation.
3/ Excludes banking institutions.
4/ Includes customers' deposits and sinking funds held with the central bank, and other official funds held with the treasury.
5/ Overall current account excluding machinery and transport and tourism.

Table 3. Malta: Government Budget Accounts, 1993-99 1/ 2/

	1993	1994	1995	1996	1997	Budget 1998	Estimated 1998	Budget 1999
				(In millions of Maltese liri)				
Total revenue	352.4	378.0	426.0	425.5	466.6	482.5	462.3	504.1
Tax revenue	263.5	273.9	342.7	339.3	387.5	392.1	381.1	422.1
Direct taxes 3/	151.0	156.8	177.4	177.0	205.4	203.4	201.1	220.6
Indirect taxes	112.5	117.1	165.3	162.3	182.1	188.6	180.0	201.5
Non-tax revenue 4/	89.0	104.1	83.3	86.2	79.0	90.4	81.2	82.0
Total expenditure and net lending	381.1	429.2	470.2	529.0	590.6	606.0	606.3	627.7
Current expenditure	...	...	432.1	480.0	509.6	524.1	535.6	561.4
Capital expenditure	...	...	35.0	42.9	47.8	56.7	53.4	54.2
Net lending	-4.8	5.9	3.1	6.1	33.2	25.1	17.3	12.0
Repayment	10.8	4.4	9.0	0.3	0.3	0.3	5.7	0.0
Loans 5/	6.0	10.3	12.1	6.4	33.4	25.4	22.9	12.0
Balance	-28.7	-51.2	-44.2	-103.5	-124.0	-123.5	-144.0	-123.6
Financing	28.7	51.2	44.2	103.5	124.0	123.5	144.0	123.6
Domestic loans, net	25.5	3.9	18.5	68.9	166.1	50.8	104.5	...
Disbursements	28.8	28.7	32.5	70.0	167.3	50.8	110.0	100.0
Repayments	3.3	24.8	14.0	1.1	1.2	0.0	5.5	...
Foreign loans, net	-0.7	6.8	-4.0	-1.7	-2.3	11.4	-4.0	...
Disbursements	2.9	11.3	0.7	3.2	3.3	11.4	0.0	3.5
Repayments	3.6	4.5	4.7	4.9	5.6	0.0	4.0	...
Asset sales	0.6	12.7	14.6	0.0	0.1	31.3	35.4	60.0
Change in cash balances	3.3	27.8	15.1	36.2	-39.9	30.0	8.2	...
				(In percent of GDP 6/)				
Total revenue	37.5	36.8	37.2	35.4	36.4	34.7	33.2	34.7
Tax revenue	28.0	26.6	29.9	28.2	30.2	28.2	27.4	29.0
Direct taxes 3/	16.1	15.2	15.5	14.7	16.0	14.6	14.5	15.2
Indirect taxes	12.0	11.4	14.4	13.5	14.2	13.6	12.9	13.9
Non-tax revenue 4/	9.5	10.1	7.3	7.2	6.2	6.5	5.8	5.6
	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure and net lending	40.5	41.7	41.0	44.0	46.1	43.6	43.6	43.2
Current expenditure	...	...	37.7	40.0	39.7	37.7	38.5	38.6
Capital expenditure	...	...	3.1	3.6	3.7	4.1	3.8	3.7
Net lending	-0.5	0.6	0.3	0.5	2.6	1.8	1.2	0.8
Repayment	1.1	0.4	0.8	0.0	0.0	0.0	0.4	0.0
Loans 5/	0.6	1.0	1.1	0.5	2.6	1.8	1.6	0.8
Balance	-3.0	-5.0	-3.9	-8.6	-9.7	-8.9	-10.4	-8.5
Financing	3.0	5.0	3.9	8.6	9.7	8.9	10.4	8.5
Domestic loans	2.7	0.4	1.6	5.7	13.0	3.7	7.5	...
Disbursements	3.1	2.8	2.8	5.8	13.0	3.7	7.9	6.9
Repayments	0.4	2.4	1.2	0.1	0.1	0.0	0.4	...
Foreign loans, net	-0.1	0.7	-0.4	-0.1	-0.2	...	...	...
Disbursements	0.3	1.1	0.1	0.3	0.3	0.8	0.0	0.2
Repayments	0.4	0.4	0.4	0.4	0.4	...	...	...
Asset sales	0.1	1.2	1.3	0.0	0.0	2.2	2.5	4.1
Change in cash balances	0.3	2.7	1.3	3.0	-3.1	...	...	...
				(In millions of Maltese liri)				
Memorandum items:								
GDP (authorities' projection)	940.0	1,028.6	1,145.5	1,201.4	1,282.0	...	1,391.0	1,454.5
Balance (authorities' presentation) 2/	-47.8	-68.4	-57.7	-124.6	-128.7	-108.8	-150.4	-134.6
Foreign grants	8.4	12.9	4.5	20.8	9.8	10.4	10.0	11.0
Repayment of government loans	10.8	4.4	9.0	0.3	0.3	0.3	0.3	0.0

Sources: Ministry of Finance, *Budget Estimates*; Treasury, *Malta Financial Report*; and Fund staff estimates.

1/ Consolidated with the Social Security Account.

2/ The authorities classify foreign grants and repayments of government loans as financing items; in the staff presentation, these items areplaced above the line.

3/ The 1997 figure includes Lm 14.3 million in income tax and social security contribution arrears by Malta Drydocks.

4/ The 1998 budget figure includes Lm 4.5 million from a one-time tax on commercial banks' gross profits and Lm 12.9 million in interest arrears by the Water Services Corporation.

5/ Includes extrabudgetary loans to Malta Shipbuilding, Malta Drydocks, the Water Services Corporation, and Gozo Ferries.

6/ Based on the Finance Ministry's estimate for 1998 and projection for 1999 GDP.

Table 4. Malta: Budgetary Expenditure, 1993-99

	1993	1994	1995	1996	1997	Budget 1998	Estimated 1998	Budget 1999
	(In millions of Maltese liri)							
Total expenditure	385.8	423.3	467.1	522.9	557.4	580.8	595.0	615.7
Current expenditure	...	...	432.1	480.0	509.6	524.1	535.6	561.4
Personnel expenditure 1/	124.5	136.9	145.3	157.4	157.9	166.6	163.6	170.8
Social services 2/	140.5	156.4	178.2	201.0	212.6	230.0	218.5	243.3
Subsidies/subventions 3/	...	...	53.1	61.8	62.4	47.1	68.6	55.9
Of which: Shipbuilding and repair	7.5	5.4	7.0	4.9	5.7	4.0	5.0	4.0
WSC	9.0	11.0	11.8	14.6	14.6	6.0	18.5	11.9
Interest payments	13.6	16.5	18.8	22.6	32.2	41.3	40.5	49.7
Other 4/	32.1	33.4	36.7	37.1	44.4	39.2	44.4	41.7
Capital development expenditure	...	...	35.0	42.9	47.8	56.7	53.4	54.2
	(In percent of GDP 5/)							
Total expenditure	41.0	41.2	40.8	43.5	43.5	29.4	42.8	42.3
Current expenditure	...	...	37.7	40.0	39.7	26.6	38.5	38.6
Personnel expenditure 1/	13.2	13.3	12.7	13.1	12.3	8.4	11.8	11.7
Social services 2/	14.9	15.2	15.6	16.7	16.6	11.7	15.7	16.7
Subsidies/subventions 3/	...	...	4.6	5.1	4.9	2.4	4.9	3.8
Of which: Shipbuilding and repair	0.8	0.5	0.6	0.4	0.4	0.2	0.4	0.3
WSC	1.0	1.1	1.0	1.2	1.1	0.3	1.3	0.8
Interest payments	1.4	1.6	1.6	1.9	2.5	2.1	2.9	3.4
Other 4/	3.4	3.2	3.2	3.1	3.5	2.0	3.2	2.9
Capital development expenditure	...	...	3.1	3.6	3.7	2.9	3.8	3.7
Memorandum item:								
Defense spending	1.0	1.0	0.9	1.0	0.9	0.8	0.8	0.7

Sources: Ministry of Finance, *Budget Estimates*; Treasury, *Malta Financial Report*, and Fund staff estimates.

1/ Wages and salaries, allowances, overtime, and bonuses paid to government employees.
2/ Pensions, health services, and social security benefits (including bonuses).
3/ Includes subsidies/subventions which the authorities classify as capital expenditure.
4/ General operational and maintenance expenditures of government organizations.
5/ Based on the Finance Ministry's estimate for 1998 and projection for 1999 GDP.

Table 5. Malta: Current Budgetary Revenue, 1993-99

	1993	1994	1995	1996	1997	Budget 1998	Estimated 1998	Budget 1999
	(In millions of Maltese liri)							
Total revenue	352.4	378.0	426.0	425.5	466.6	482.5	462.3	504.1
Tax receipts	263.5	273.9	342.7	339.3	387.5	392.1	381.1	422.1
Direct taxes	151.0	156.8	177.4	177.0	205.4	203.4	201.1	220.6
Income taxes 1/	85.1	87.9	99.8	93.3	110.5	112.0	110.6	124.0
Individual	45.8	54.6	63.6	61.0	66.3	...	66.5	75.5
Corporations	39.3	33.2	36.2	32.3	44.3	...	44.1	48.5
Social security contributions 1/ 2/	64.4	67.9	77.7	83.7	94.9	91.4	90.5	96.6
Death and donation duties	1.5	1.0	0.0	0.0	0.0	0.0	0.0	0.0
Indirect taxes	112.5	117.1	165.3	162.3	182.1	188.6	180.0	201.5
Customs and excise taxes	83.5	72.0	32.6	32.0	43.2	51.3	52.7	55.7
VAT/CET	n.a.	n.a.	78.1	78.6	84.6	78.0	66.6	85.0
Licenses, taxes, and levies	29.0	45.1	54.6	51.7	54.3	59.3	60.7	60.7
Non-tax receipts	89.0	104.1	83.3	86.2	79.0	90.4	81.2	82.0
Foreign grants	8.4	12.9	4.5	20.8	9.8	10.4	10.0	11.0
Fees & reimbursements	7.7	10.0	10.1	10.0	10.6	13.7	10.6	11.6
Rents, dividends, interest	26.2	26.5	23.1	17.6	17.8	16.9	17.9	17.8
Central Bank profits	24.2	30.0	24.5	23.1	22.2	23.0	24.1	30.0
Lotteries	5.6	6.2	6.5	6.8	6.5	6.8	6.9	7.0
Civil aviation and posts 3/	9.2	11.2	8.2	5.9	6.7	7.7	4.6	1.4
Miscellaneous 4/	7.5	7.4	6.4	2.0	5.5	12.0	7.0	3.2
	(In percent of GDP 5/)							
Total revenue	37.5	36.8	37.2	35.4	36.4	34.7	33.2	34.7
Tax receipts	28.0	26.6	29.9	28.2	30.2	28.2	27.4	29.0
Direct taxes	16.1	15.2	15.5	14.7	16.0	14.6	14.5	15.2
Income taxes 1/	9.1	8.5	8.7	7.8	8.6	8.1	7.9	8.5
Individual	4.9	5.3	5.6	5.1	5.2	...	4.8	5.2
Corporations	4.2	3.2	3.2	2.7	3.5	...	3.2	3.3
Social security contributions 1/ 2/	6.9	6.6	6.8	7.0	7.4	6.6	6.5	6.6
Death and donation duties	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Indirect taxes	12.0	11.4	14.4	13.5	14.2	13.6	12.9	13.9
Customs and excise taxes	8.9	7.0	2.8	2.7	3.4	3.7	3.8	3.8
VAT/CET	n.a.	n.a.	6.8	6.5	6.6	5.6	4.8	5.8
Licenses, taxes, and levies	3.1	4.4	4.8	4.3	4.2	4.3	4.4	4.2
Non-tax receipts 3/	9.5	10.1	7.3	7.2	6.2	6.5	5.8	5.6
Foreign grants	0.9	1.2	0.4	1.7	0.8	0.7	0.7	0.8
Fees & reimbursements	0.8	1.0	0.9	0.8	0.8	1.0	0.8	0.8
Rents, dividends, interest	2.8	2.6	2.0	1.5	1.4	1.2	1.3	1.2
Central Bank profits	2.6	2.9	2.1	1.9	1.7	1.7	1.7	2.1
Lotteries	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.5
Civil aviation and posts 3/	1.0	1.1	0.7	0.5	0.5	0.5	0.3	0.1
Miscellaneous 4/	0.8	0.7	0.6	0.2	0.4	0.9	0.5	0.2

Sources: Ministry of Finance, *Budget Estimates*; Treasury, *Malta Financial Report*; and Fund staff estimates.

1/ The 1997 figure includes Lm 7.9 million in income tax arrears and Lm 6.4 million in social security contribution arrears by Malta Drydocks.

2/ Excludes the state contribution but includes the amount paid by the government as employer.

3/ Excludes posts from 1996 (taken over by Posta Ltd.).

4/ The 1998 budget figure includes Lm 4.5 million from a one-time tax on commercial banks' gross profits and Lm 12.9 million in interest arrears by the Water Services Corporation.

5/ Based on the Finance Ministry's estimate for 1998 and projection for 1999 GDP.

Table 6. Malta: Monetary Developments, 1993-98

	1993	1994	1995	1996	1997	1998
	(In millions of Maltese liri; end of period)					
Central Bank Balance Sheet						
Base money 1/	431.2	451.6	447.5	463.8	486.7	504.7
Net foreign assets	533.4	617.6	508.7	508.6	541.6	610.8
Net credit to general government	15.6	37.5	47.5	51.5	34.5	-11.3
Other items, net 1/	-117.9	-203.5	-108.7	-96.3	-89.3	-94.8
Financial Survey						
M3	1,366.7	1,570.3	1,692.0	1,868.3	2,047.0	2,219.9
Net foreign assets	737.2	877.5	812.9	754.1	735.2	851.6
Domestic credit	858.0	967.2	1,224.8	1,429.6	1,644.7	1,821.9
Net credit to general government	137.3	150.6	179.9	239.1	321.5	368.4
Credit to the parastatal sector	162.9	185.2	234.0	249.5	257.3	243.3
Credit to the private sector	557.8	631.4	810.9	941.0	1,065.9	1,210.2
Other items, net	-228.5	-274.5	-345.8	-315.4	-332.9	-453.6
	(Annual percentage change)					
Base money	0.5	4.7	-0.9	3.6	4.9	3.7
M3	10.3	14.9	7.8	10.4	9.6	8.4
Domestic credit	12.9	12.7	26.6	16.7	15.0	10.8
Net credit to general government	12.9	9.7	19.4	32.9	34.5	14.6
Credit to the parastatal sector	19.7	13.7	26.3	6.6	3.1	-5.4
Credit to the private sector	11.1	13.2	28.4	16.0	13.3	13.5
	(In millions of U.S. dollars)					
Net foreign assets	1,865.7	2,383.9	2,306.9	2,093.4	1,875.7	2,251.8
Central Bank	1,350.0	1,677.9	1,443.5	1,411.9	1,381.7	1,615.1
Other	515.7	706.0	863.3	681.5	494.0	636.7
	(In percent)					
Interest rates						
7-day reverse repo	n.a.	n.a.	4.9	5.0	5.1	5.1
3-month treasury bill	4.6	4.4	4.9	5.0	5.2	5.2
Loans and advances	7.2	7.3	7.5	7.7	8.0	8.0
Memorandum items: (end of period)						
Exchange rate (US$/Lm)	2.53	2.72	2.84	2.78	2.55	2.64
CPI inflation	4.6	3.5	3.6	1.9	4.3	1.3
M3 multiplier	3.2	3.5	3.8	4.0	4.2	4.4
Velocity	0.7	0.7	0.7	0.6	0.6	0.6
NFA/Base money	127.4	152.9	129.8	119.5	115.4	124.0

Sources: Central Bank of Malta; International Monetary Fund, *International Financial Statistics;* and Fund staff estimates.

1/ The stock of term deposits outstanding at end-1994 (Lm106.6 million) has been subtracted from base money and from other items, net.

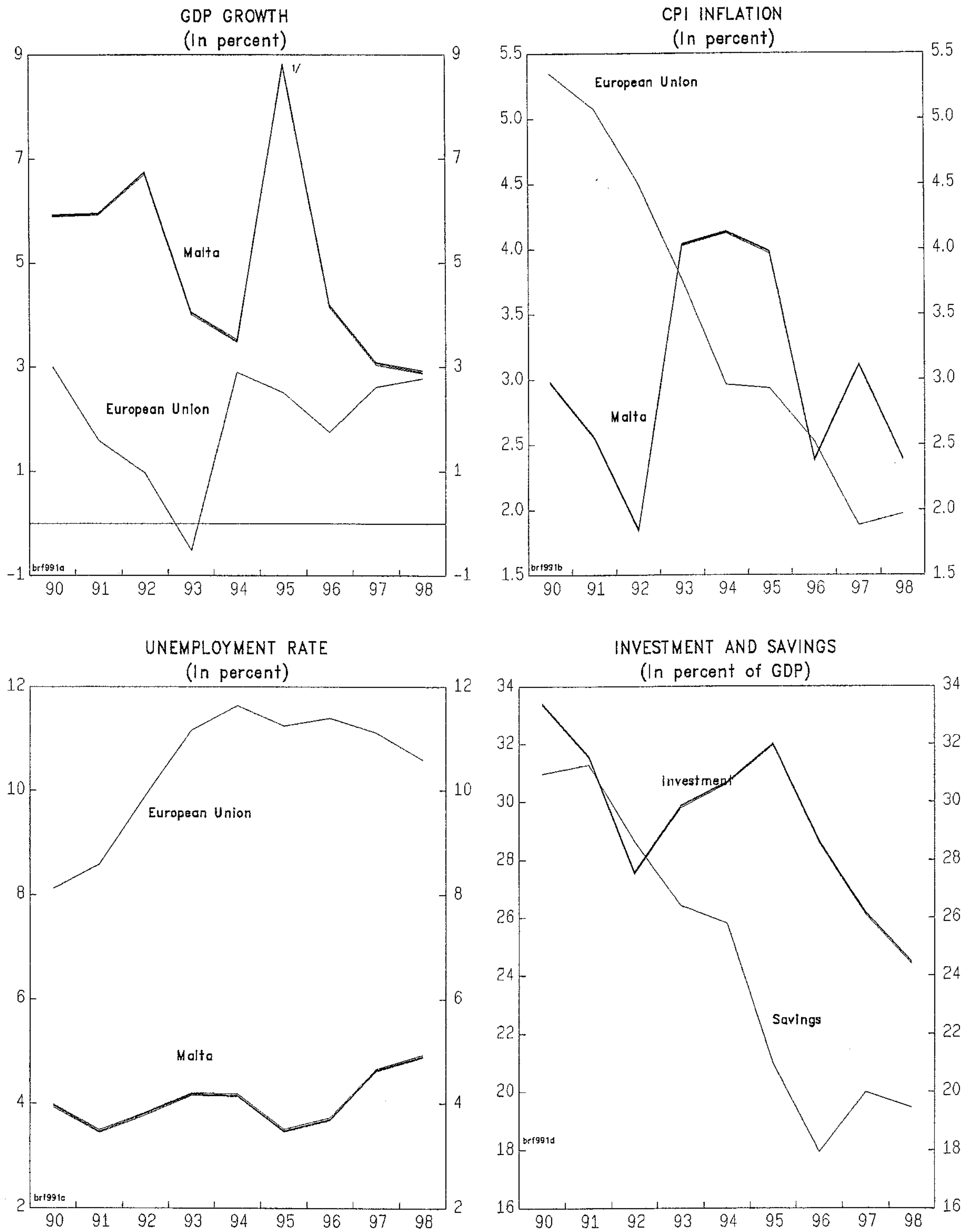
Table 7. Malta: Staff's Medium-Term Macroeconomic Outlook

	1997	1998	Targeted fiscal adjustment 1/ 1999	2000	2001	2002	2003	2004	Stronger fiscal and structural adjustment scenario 2/ 1999	2000	2001	2002	2003	2004
							(Percentage change)							
Output and prices														
Real GDP	2.8	3.0	3.5	3.2	4.3	3.3	3.2	3.1	3.1	3.0	4.2	3.4	4.1	4.6
Domestic demand	-1.7	0.3	2.2	3.3	4.4	3.3	3.4	3.9	1.8	3.1	4.5	3.8	4.8	5.2
Private consumption	0.9	0.8	2.5	3.5	3.5	3.0	3.5	4.0	2.3	3.5	3.5	4.0	4.5	5.0
Public consumption	-1.5	0.5	-0.5	-0.6	5.4	0.9	-2.7	-2.1	-2.4	-1.9	3.5	-2.5	1.4	1.6
Fixed investment	-8.1	-1.0	4.0	6.0	6.0	6.0	8.0	8.0	4.0	6.0	8.0	8.0	8.0	8.0
Exports of goods and services	3.1	7.1	6.6	7.5	7.4	5.9	5.9	3.9	6.6	7.5	7.4	5.9	6.1	5.8
Imports of goods and services	-3.9	3.7	5.1	7.5	7.3	5.8	6.1	4.7	4.9	7.4	7.6	6.3	6.7	6.4
GDP deflator	3.8	2.9	2.0	2.4	2.7	2.9	2.8	2.8	2.0	2.4	2.7	2.9	2.8	2.8
CPI	3.1	2.4	2.5	2.4	2.4	3.0	3.0	3.0	2.5	2.4	2.4	3.0	3.0	3.0
Total employment (per. avg.)	-2.4	-0.2	1.4	0.9	1.2	1.0	1.0	1.0	1.1	1.0	1.2	1.0	1.2	1.4
Unemployment rate (%, per. avg.)	4.6	4.9	4.5	4.5	4.4	4.4	4.4	4.5	4.8	4.8	4.6	4.6	4.4	4.0
							(In percent of GDP 3/)							
Investment and savings														
Investment	25.2	23.7	24.3	24.6	24.6	24.7	25.4	26.1	24.4	24.7	25.2	25.8	26.2	26.5
Fixed investment	25.4	24.0	23.6	23.9	23.9	24.1	24.8	25.5	23.7	24.1	24.5	25.1	25.6	26.0
Private	19.8	18.3	18.2	18.9	18.9	19.0	19.7	20.4	18.2	19.0	19.5	20.1	20.5	20.8
Public	5.4	5.4	6.2	5.7	5.7	5.7	5.7	5.7	6.2	5.7	5.7	5.7	5.7	5.7
Inventory change	-0.2	-0.2	0.7	0.7	0.6	0.6	0.6	0.6	0.7	0.7	0.7	0.6	0.6	0.6
Savings	19.0	18.7	20.6	20.7	20.9	21.6	22.6	23.1	20.9	21.0	21.5	22.2	22.6	22.9
Private	19.8	24.5	24.6	24.3	23.8	24.7	24.1	23.2	24.5	23.8	22.9	22.2	22.2	22.1
Public	-0.8	-5.8	-4.0	-3.6	-3.0	-3.1	-1.5	-0.1	-3.6	-2.8	-1.4	0.0	0.4	0.8
Fiscal accounts														
Budget deficit	9.7	10.5	8.5	7.2	6.6	6.6	5.0	3.6	7.7	6.4	5.0	3.6	3.2	2.7
Revenues 4/	36.4	34.1	34.8	34.9	35.1	34.8	34.6	34.4	34.9	34.9	35.2	34.9	34.7	34.5
Expenditures 5/	46.1	44.6	43.4	42.1	41.6	41.4	39.6	38.0	42.7	41.4	40.2	38.5	37.9	37.2
Primary balance	-7.2	-7.6	-5.1	-3.6	-2.7	-2.5	-0.6	0.9	-4.3	-2.8	-1.2	0.4	0.8	1.2
Privatization receipts 6/	0.0	2.6	4.1	3.3	2.4	1.7	1.1	1.0	4.2	3.3	2.5	1.7	1.1	1.0
Government debt	51.6	56.3	57.3	58.2	58.4	59.9	60.3	59.5	56.7	56.9	55.7	54.2	52.7	50.7
Govt. debt excl. privatization receipts	...	...	61.4	65.4	67.6	70.2	71.2	70.7	60.8	64.1	64.9	64.6	63.5	61.7
External accounts														
Current account balance	-6.2	-5.1	-3.7	-3.9	-3.7	-3.1	-2.8	-3.0	-3.5	-3.7	-3.7	-3.6	-3.6	-3.6
Goods and services (net)	-8.5	-4.9	-4.1	-4.2	-3.7	-3.0	-2.5	-2.6	-4.0	-4.0	-3.8	-3.5	-3.4	-3.3
Official reserves	43.8	46.1	45.8	45.6	45.0	45.2	45.8	46.1	46.1	46.2	45.6	45.4	45.7	46.0
(in months of imports of GNFS)	5.6	6.0	5.8	5.6	5.4	5.4	5.4	5.4	5.8	5.6	5.4	5.4	5.4	5.4
Gross external debt	31.2	30.8	30.8	31.1	30.9	30.6	30.2	30.0	30.8	31.1	30.9	30.8	30.6	30.2
Memorandum item:														
GDP at current prices (in Lm millions)	1,282.0	1,358.8	1,446.9	1,528.9	1,637.9	1,741.6	1,848.1	1,959.8	1,442.4	1,521.7	1,628.3	1,732.3	1,855.6	1,995.7

Sources: Data provided by the Maltese authorities; and Fund staff estimates.

1/ Based on the authorities' medium term fiscal framework and the staff's projection of the underlying macroeconomic framework.
2/ Assuming the targeted fiscal reduction is achieved two years earlier, with further reductions thereafter.
3/ Based on the staff's estimate for 1998 and projections for 1999-2004 GDP.
4/ Excluding privatization receipts.
5/ Includes net lending.
6/ The authorities' projections are used in both scenarios.

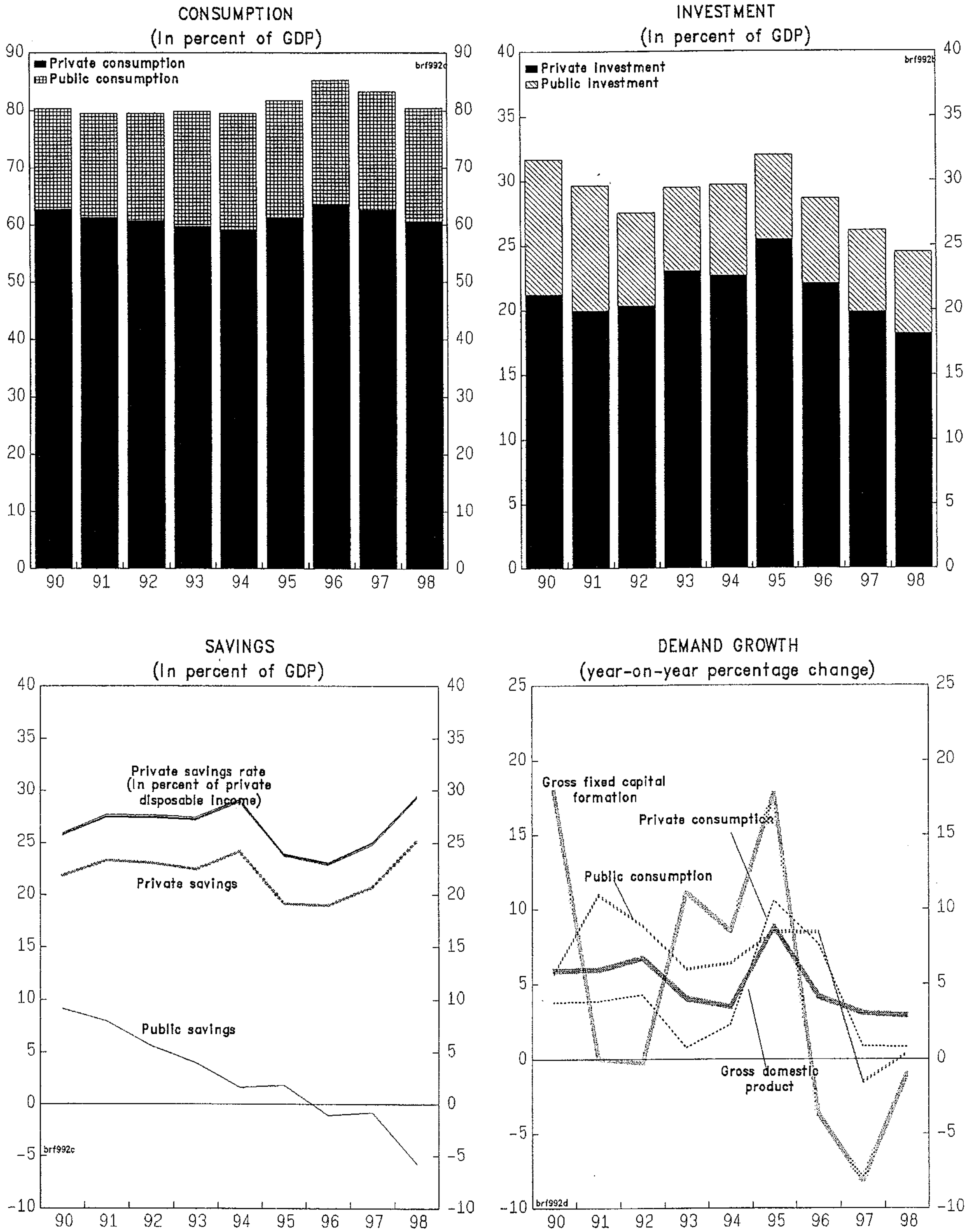
Figure 1. Malta: Main Developments, 1990-98



Sources: Data provided by the Maltese authorities; staff estimates; and IMF, World Economic Outlook

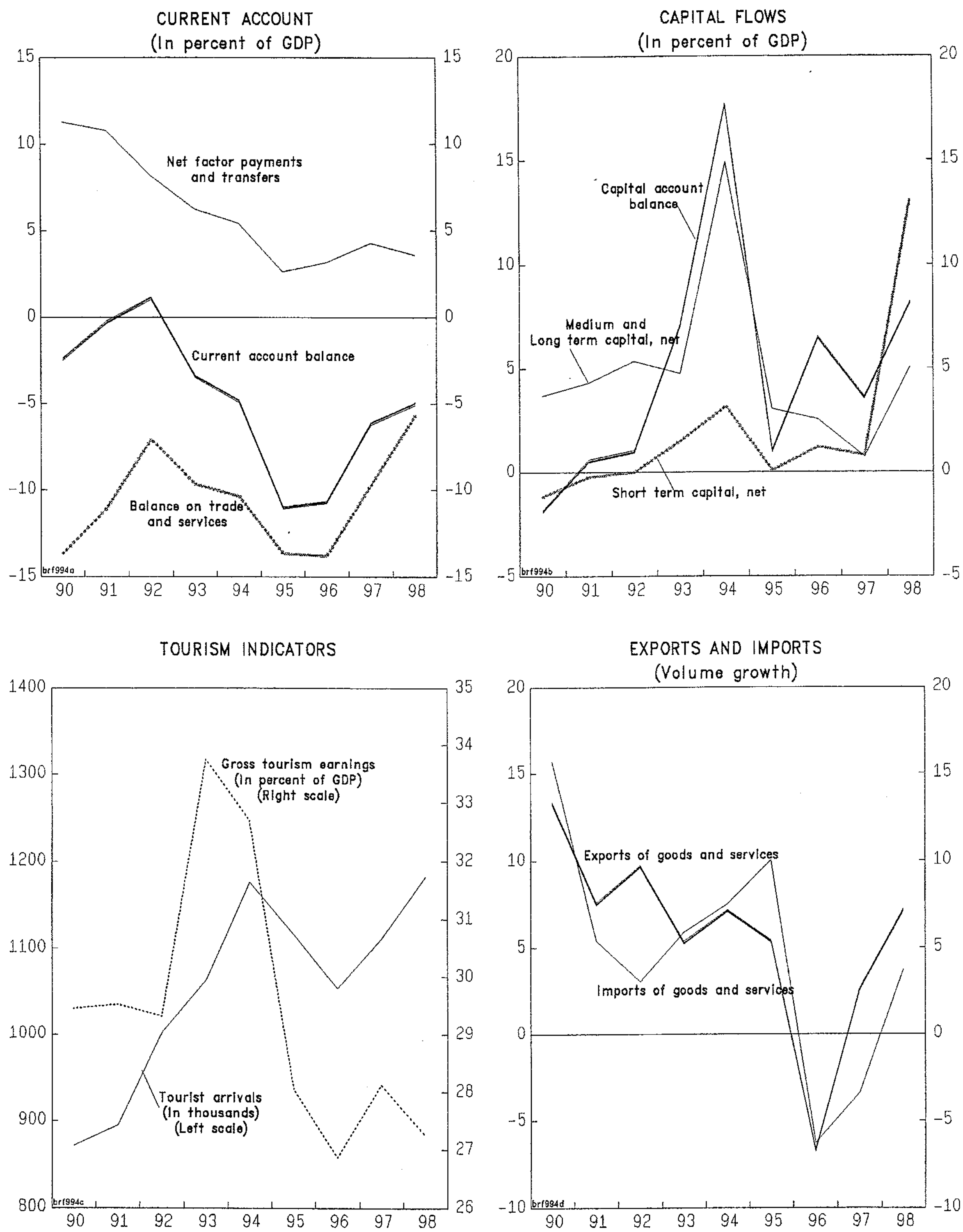
1/ Recorded GDP growth in 1995 was exceptionally high due to improved coverage of economic activities following the introduction of the VAT.

Figure 2. Malta: Real Sector, 1990-98



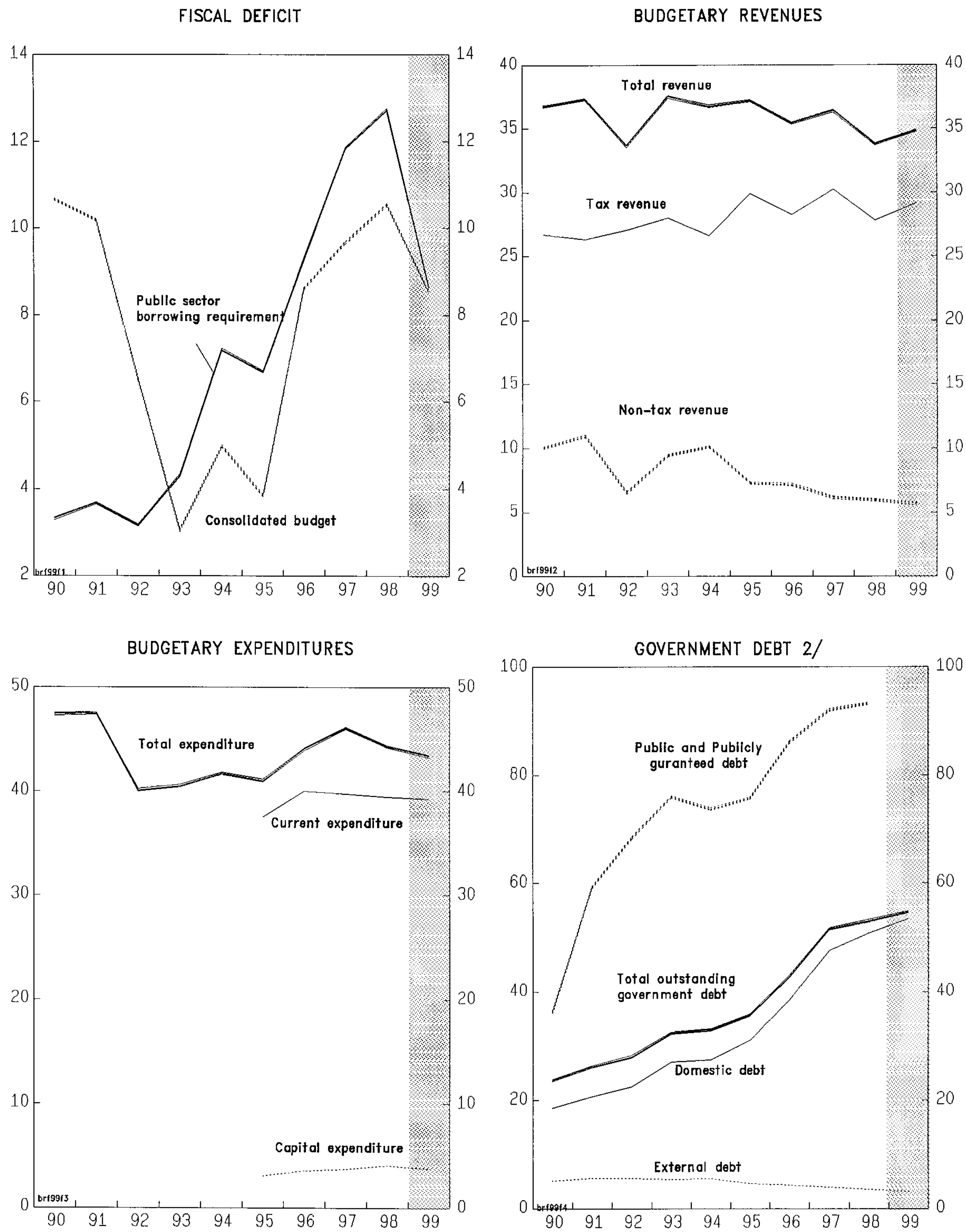
Sources: Data provided by the Maltese authorities; International Monetary Fund, International Financial Statistics (IFS); and staff estimates.

Figure 3. Malta: External Sector, 1990-98



Sources: Data provided by the Maltese authorities; International Monetary Fund, International Financial Statistics (IFS); and staff estimates.

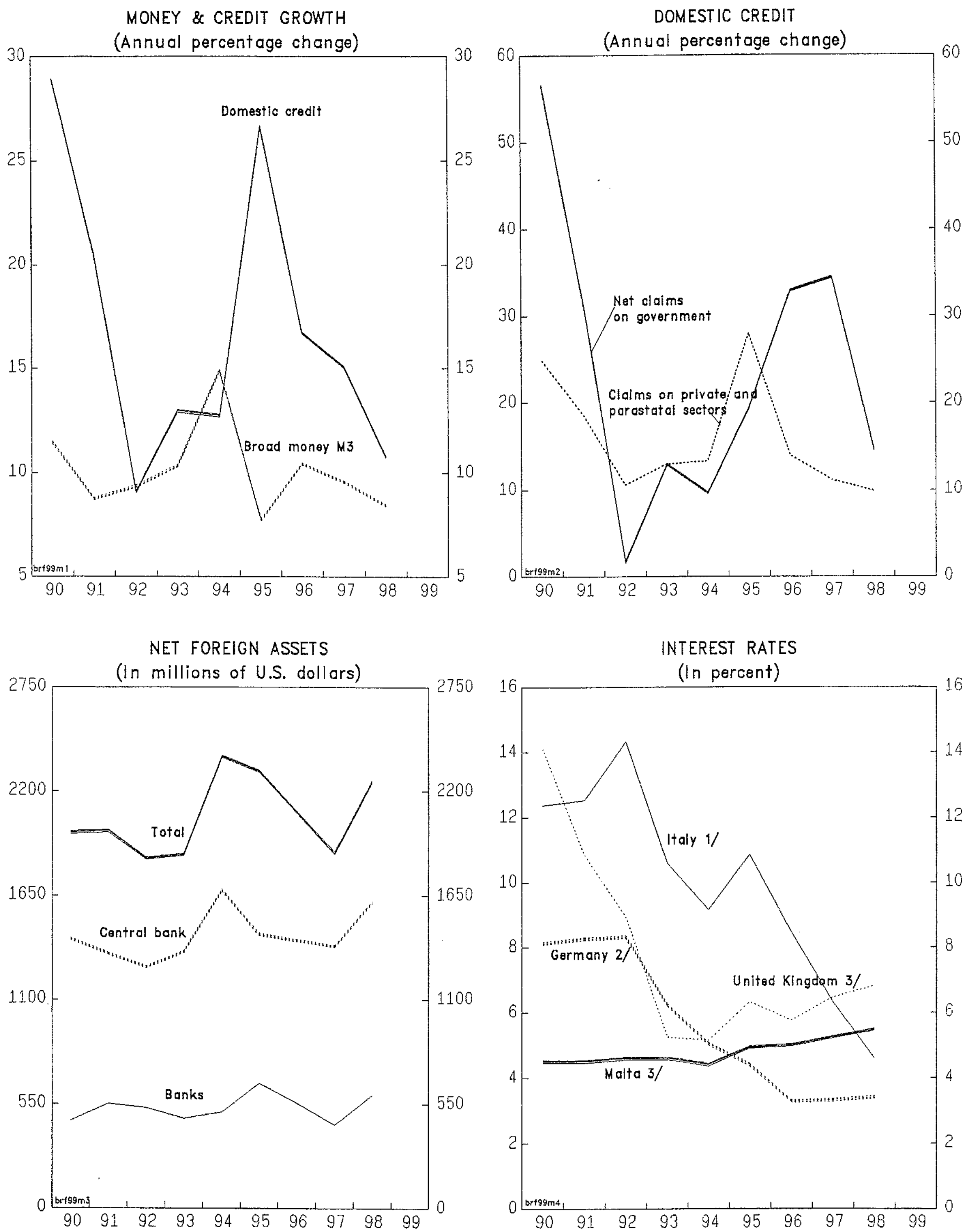
Figure 4. Malta: Fiscal Developments, 1990-99 1/
(In percent of GDP)



Sources: Data provided by the Maltese authorities; and staff estimates.

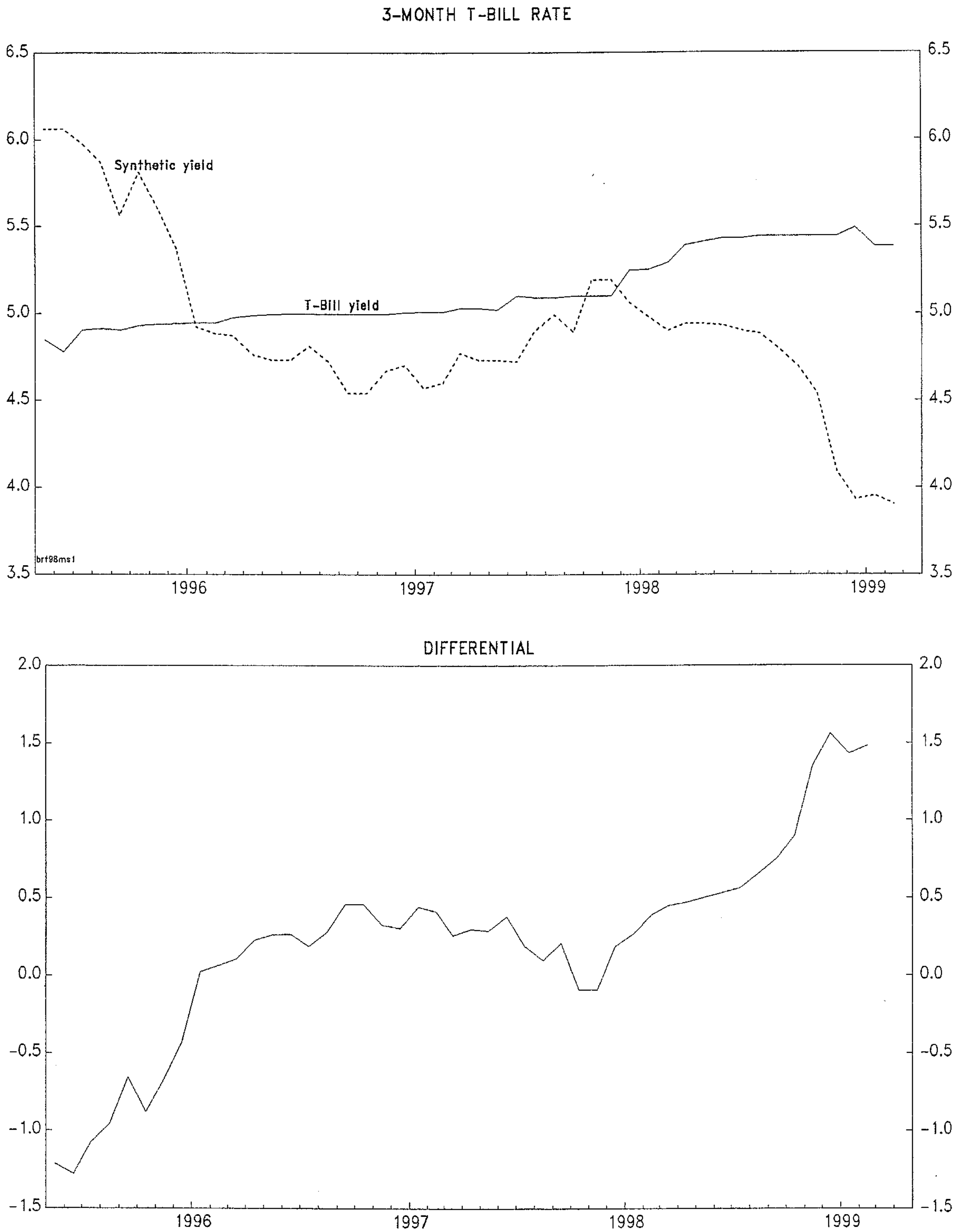
1/ Data for 1999 show the authorities budget estimate.
2/ Government debt does not include debt of public corporations.

Figure 5. Malta: Monetary Sector Developments, 1995-99



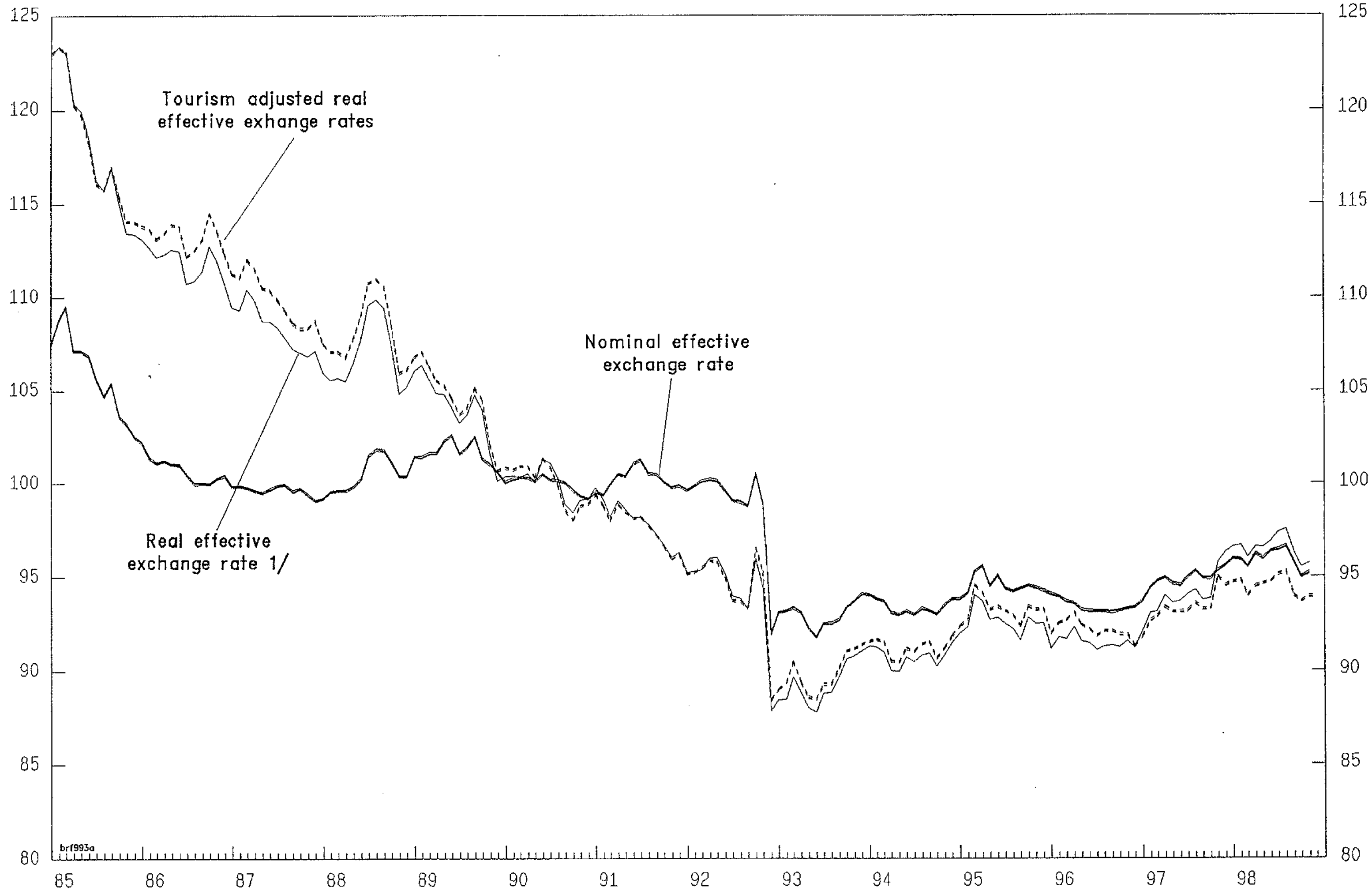
1/ The synthetic yield is based on three-month money market deposit rates in the ECU, pound sterling, and U.S. dollars, weighted by the respective portions of these currencies in the Maltese lira basket.

Figure 6. Malta: Interest Rate Developments, 1995-98



Source: Maltese authorities.

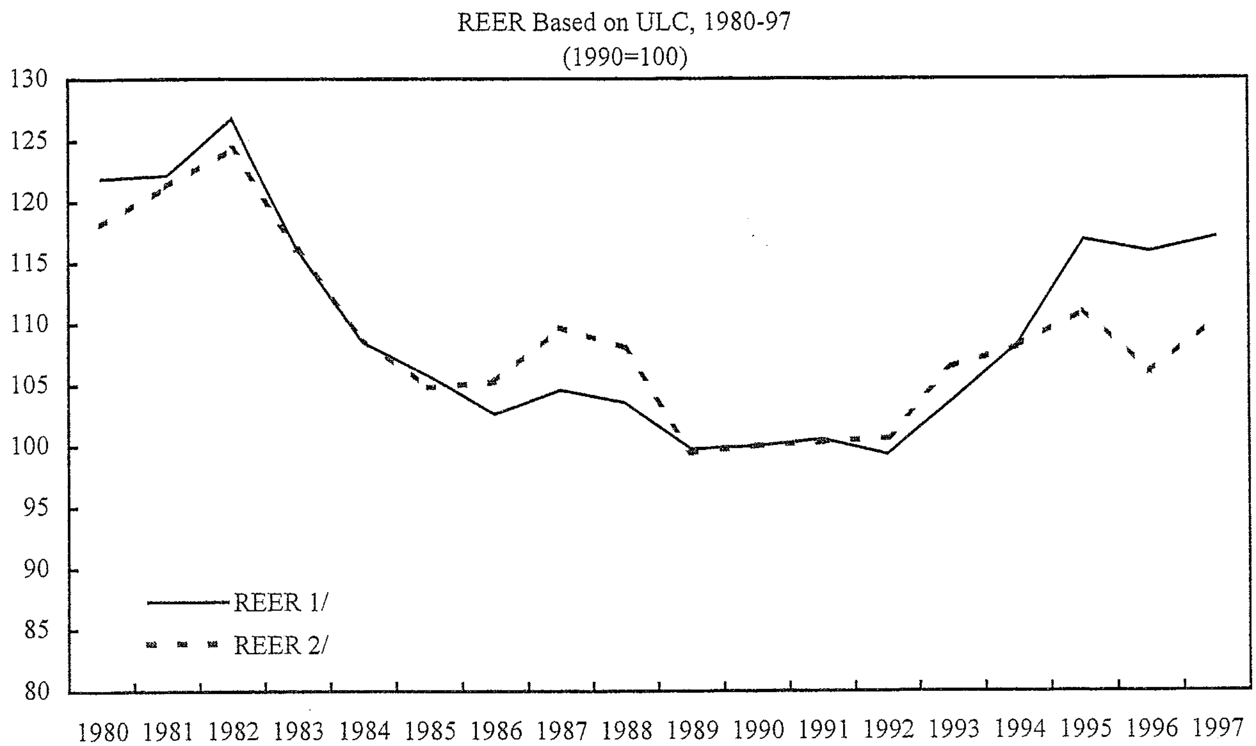
Figure 7. Effective exchange rates, 1985-98

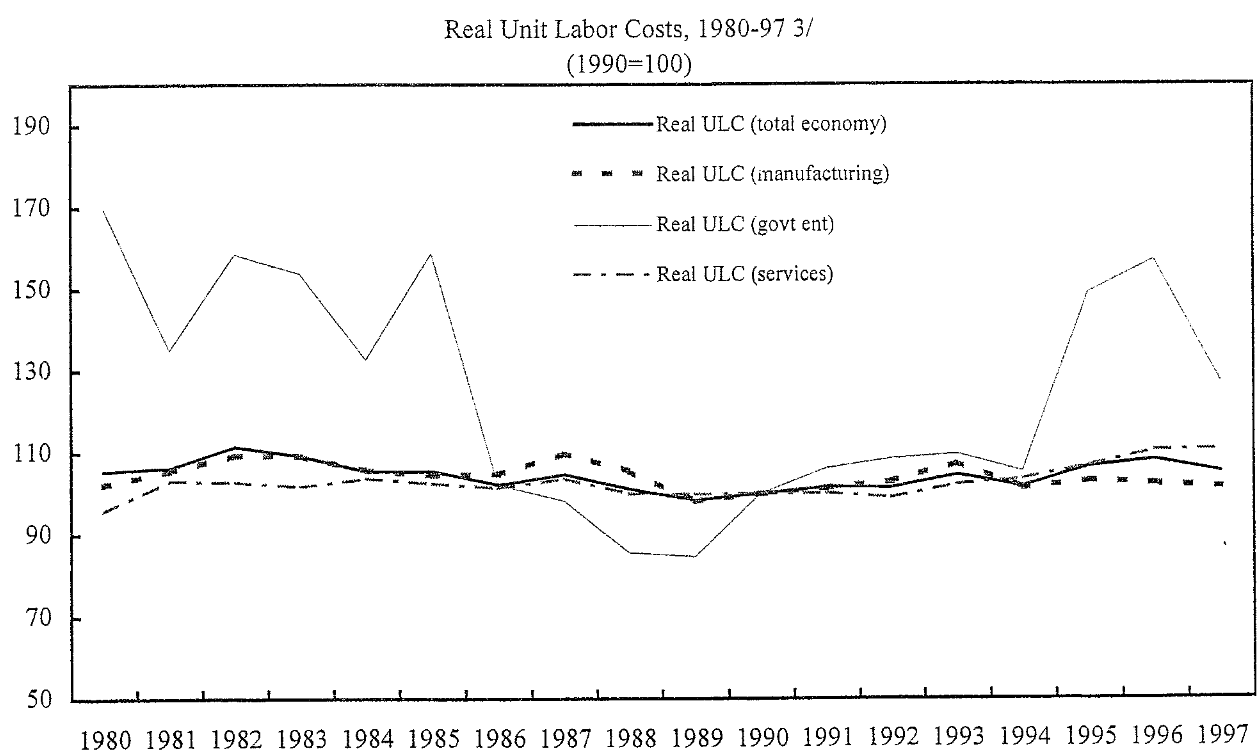


1/ Based on consumer price indicies.

Sources: International Monetary Fund, INS and staff estimates

Figure 8. Malta: Relative Unit Labor Costs and Real Unit Labor Costs, 1980-97





Source: Data provided by the Maltese authorities; and staff estimates.

1/ ULC of the total economy divided by the weighted average of manufacturing sector ULCs in 16 partner countries.

2/ ULC of the manufacturing sector divided by the weighted average of manufacturing sector ULCs in 16 partner countries.

3/ Deflated by the GDP deflator.

Malta: Fund Relations
(As of April 30, 1999)

I. **Membership Status**: Malta became a member of the Fund on September 11, 1968. It eliminated all remaining restrictions under Article XIV of the Articles of Agreement, and accepted the obligations of Article VIII (Sections 2, 3 and 4) of the Articles of Agreement on November 30, 1994.

II. **General Resources Account**:	**SDR Million**	**% Quota**
Quota	102.00	100.0
Fund holdings of currency	61.75	60.5
Reserve position in Fund	40.26	39.5

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	11.29	100.0
Holdings	21.29	188.6

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

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangement**:

The Maltese lira is currently pegged to a trade-weighted basket of three currencies: the euro, the U.S. dollar, and the pound sterling, in the ratio 56.8:21.6:21.6.

VIII. **Article IV Consultations**:

The last Article IV consultation was concluded by the Executive Board on May 23, 1997 (SUR/97/56)

IX. **Technical Assistance**: (1994-present)

MAE missions have addressed monetary operations and liquidity forecasting (February 1999), bank supervision and reporting (December 1996), and open market and forex operations (February 1995). The Central Bank of Malta is also receiving assistance from two short-term experts provided by MAE, in the areas of foreign exchange operations and research and policy.

An STA mission on money and banking statistics visited Malta in September 1994. An STA mission on government finance statistics visited Malta in June 1998. A long-term expert was assigned as Chief Statistical Advisor to the Government of Malta by STA, under a UNDP-funded project, from January 1995 to January 1996.

X. **Resident Representative**: None

Malta—Statistical Issues

1. Malta's macroeconomic statistics are of uneven quality. The government has decided to modify the legal status of the Central Office of Statistics (COS) to provide it with greater operational independence, and hopes to expand the range and quality of statistics produced by the COS and other government agencies; the relevant legislation has been drafted but not yet approved by parliament. Moreover, in anticipation of possible membership in the European Economic and Monetary Union, the Maltese authorities are in contact with the European Central Bank and Eurostat to upgrade their statistical systems to meet Euro Area standards.

Real sector data

2. Data on retail price movements, labor market indicators, and tourism arrivals are released monthly, usually with a very short lag; a user-friendly COS web site provides easy access to this data through the Internet. National accounts data are subject to much longer lags: the most recent data on the COS web page is the fourth quarter of 1998 for income-side data, and the third quarter of 1998 for the expenditure-side data. The most recent full set of national accounts published (*National Accounts of the Maltese Islands*) is for 1996. Deflators used to develop constant price estimates of the national accounts are subject to significant methodological weaknesses. Also, there is a paucity of data on short-term output trends.

3. A new retail price index (RPI) was introduced in January 1996, using weights that differ substantially from that of the old index: interpretation of recent trends in inflation is complicated by the non-standard methodology employed by the COS to link the old and new price indices. The RPI is the sole indicator available to monitor short-term price trends. The methodology employed in constructing the RPI is subject to the approval of an independent committee that includes representatives of business groupings and trade unions.

Fiscal data

4. Summary data on budgetary developments are published irregularly. The disaggregation employed on the expenditure side is based on an institutional, rather than analytical, classification; annual data on expenditure according to an economic classification is produced on an *ad hoc* basis for the Article IV consultation, while data for the GFS *Yearbook* are produced with a lag of two years.

5. Extrabudgetary operations executed through the Sinking Fund and the Treasury Clearance Fund impair the transparency of the fiscal accounts. Also, considerable limitations to fiscal analysis result from the long delay in the provision of data on the broader fiscal sector (e.g., the PSBR), which become available only when comprehensive national accounts data are released.

Monetary data

6. Data on the Central Bank balance sheet, short-term interest rates, and the broader monetary aggregates (which cover deposit money banks, international banking institutions, long-term credit institutions and investment banks) are available on a monthly basis, with a lag of about two months. Accounts of the monetary authorities, deposit money banks, and other banking institutions, and interest rate data published in IFS become available with a lag of about four months.

External sector

7. Summary balance of payments data (merchandise trade, current account balance, and selected capital account data) are released on a quarterly basis, with a lag of about 3 months. More detailed balance of payments data are released—irregularly—on the COS web page; the most recent release covers the fourth quarter of 1998. The latest full set of balance of payments accounts is in the *National Accounts of the Maltese Islands* for 1996.

Malta: Core Statistical Indicators
(as on April 27, 1999)

	Exchange rates	Interna-tional reserves	Reserve/ base money	Central Bank balance sheet	Broad money	Interest rates	Consumer price index	Exports/ Imports	Current account balance	Overall government balance	GDP/GNP	External debt 1/
Date of latest observation	04/27/99	Feb. 99	Feb. 99	Dec. 98	Feb. 99	04/09/99	Feb. 99	Feb. 99	1998 Q4	Nov. 1998 2/	1998 Q3	1998
Date received	04/27/99	04/05/99	04/05/99	04/26/99	04/05/99	04/13/99	04/05/99	04/07/99	04/07/99	01/11/99	11/04/98	Jan.99
Frequency of data	Daily	Monthly	Monthly	Monthly	Monthly	Weekly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Annual
Frequency of reporting	Daily 3/	Monthly	Monthly	Monthly	Monthly	Weekly	Monthly	Monthly	Quarterly	Irregular	Quarterly/ Irregular	Annual
Source of data	CBM	CBM	CBM	CBM	CBM	CBM	COS, CBM	COS, CBM	COS	COS, CBM	COS, CBM	Ministry of Finance
Mode of reporting	Fax	Fax	Fax	Fax	Fax	Fax, Press	Internet (COS), Fax (CBM)	Internet (COS), Fax (CBM)	Internet	Internet (COS), Press, Fax (CBM)	Internet (COS), Fax (CBM)	Publication
Confidentiality	No	No	No	No	No	No	No	No	No	No	No	No
Frequency of publication	Daily	Monthly	Monthly	Monthly	Monthly	Weekly	Monthly	Monthly	Quarterly	Irregular	Quarterly/ Irregular	Annual

1/ Public external debt.
2/ Estimated budget outturn for 1998 was released on 11/04/98.
3/ Daily for CBM's US$ middle rate. Monthly for ECU, DM, sterling, and yen rates.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 99/59
FOR IMMEDIATE RELEASE
July 13, 1999

International Monetary Fund
Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with Malta

On June 18, 1999, the Executive Board concluded the Article IV consultation with Malta[1].

Background

Economic activity slowed in 1997 and 1998 to around 3 percent, the external current account deficit declined to 5 percent of GDP in 1998, and inflation remains in the low single digit range.

Real GDP growth in 1997 and 1998 continued the declining trend of recent years. The contribution to demand from net exports offset weaker growth of real consumption and investment. Export volumes rose by 3 and 5 percent in 1997 and 1998, respectively, with machinery exports performing particularly strongly, while import volumes contracted in 1997 by 4 percent before rising by 2½ percent in 1998. Import behavior mirrored that of domestic demand, which slowed as the growth of household consumption fell to below 1 percent in 1997 and 1998 and as fixed investment contracted by 8 percent in 1997 and by a further 1 percent in 1998 as major investment projects were completed. In the context of moderating economic growth, unemployment edged up to a little over 5 percent in recent months.

Slow import growth—reflecting subdued domestic demand and the decline in international oil prices—alongside an increase in export receipts yielded a marked reduction in the **external current account deficit.** This fell from 10.7 percent of GDP in 1996 to 6.2 percent in 1997 and to 4.9 percent in 1998. These trends, alongside strengthening of capital inflows in 1998, were

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

reflected in an increase in international reserves to $1.65 billion at end-1998.

Annual average Inflation declined from 4 percent in 1993–1995 to between 2 to 3 percent in 1996–1998. It rose slightly in 1997 due to increased indirect taxes on goods and services, and declined in 1998 to 2.4 percent reflecting muted growth of domestic demand and declining imported energy prices.

The decline in economic growth and the external current account deficit occurred alongside a further deterioration in the **fiscal accounts** in 1997 and 1998. The fiscal deficit on a cash basis rose to 9.7 percent of GDP in 1997 and rose further to 10.4 percent of GDP in 1998. In part, this trend reflected the impact of declining economic growth on the performance of direct taxes, but the loss of revenue from indirect taxation following the 1997 reforms and increased government subsidies and loans to the state enterprises accounted for the bulk of the deterioration. As a result of these fiscal trends, the ratio of public debt to GDP ratio has risen from 35.7 percent of GDP in 1995 to 55 percent in 1998, taking public and public guaranteed debt to 92 percent of GDP in 1998.

The **1999 budget** reintroduced the VAT and targets a reduction in the fiscal deficit of 1.9 percentage points of GDP to 8.5 percent of GDP. This reduction is the first step in the authorities' newly adopted medium-term plan to reduce the fiscal deficit to 4 percent of GDP by 2004, which is equivalent to 3½ percent of GDP on the staff definition of the fiscal balance. The 1999 budget also anticipates a substantial increase in privatization receipts, which has already been achieved following the sale of a major domestic retail bank to a foreign strategic investor.

In 1997–98, external and fiscal imbalances prompted a modest **monetary tightening**. During 1997–98, the Central Bank of Malta (CBM) raised official short-term interest rates by 50 basis points to 5.5 percent. As international yields declined during 1998, the yield differential with the EU well above 100 basis points and was reflected in increased pressures for capital inflows. The CBM reduced its central intervention rate by 10 basis points in January 1999. Following further reductions in international interest rates in 1999 and continued signs of muted domestic inflationary pressures, the CBM reduced its central intervention rate by a further 40 basis points in April, and reduced its discount rate by 25 basis points in May 1999.

Executive Board Assessment

Executive Directors commended the authorities' recent initiatives to strengthen the policy framework, notably the reintroduction of the value-added tax, the adoption of formal medium-term targets for the fiscal deficit, and action to strengthen the privatization process. Since policies have been supportive, Directors noted that the decline in economic growth during the 1990s reflected supply side constraints and policy uncertainties. They emphasized that the key challenges ahead were to raise economic growth, while maintaining a sustainable external current account balance. This would require early actions to secure adherence to the medium-term fiscal targets, and continued efforts to sustain the momentum of structural reforms. These steps would also support Malta's accession to the European Union.

Directors welcomed the authorities' commitment to correct the deterioration in the fiscal accounts. They were encouraged by the initial steps taken by the authorities in the framework of the 1999 budget to reduce the fiscal deficit through increased revenue from indirect and labor taxes, the reintroduction of the value-added tax, and expenditure restraint.

Directors recommended that the fiscal adjustment efforts focus on the expenditure side, and they noted the considerable scope for improved efficiency in public spending, notably with regard to transfers and subsidies to public enterprises, and in the public wage bill. They also urged early action to ensure that the public enterprises do not overshoot their allocation in the budget.

Directors welcomed the adoption of a formal medium-term fiscal framework. They noted that meeting the medium-term fiscal targets would be a considerable challenge, and stressed that early initiation of technical work to identify appropriate reforms would help to underpin the credibility of the medium-term fiscal consolidation objective. Directors also attached importance to reform of the civil service.

Directors welcomed the steps that had already been taken to strengthen structural policy. They noted in particular that the reinvigoration of the privatization program would help to improve efficiency and reduce government debt, and that the commission on pension reform had also begun its work to improve pension provision. They welcomed the commitment to early rationalization of the trade levies and to further restructuring and privatization.

Directors agreed that Malta's fixed exchange rate system had proved to be an effective inflation anchor and that it remained appropriate for that purpose. They endorsed the authorities' intention to adjust the currency basket to increase the weight of the euro. They observed that the continued effectiveness of the peg will require firm implementation of the anticipated fiscal adjustment. Noting that the scope for capital account liberalization had been constrained by the difficult fiscal situation, Directors considered that the cautious liberalization contained in the 1999 budget was appropriate. In addition, they welcomed the authorities' intention to review closely the implications of the liberalization of capital flows for the supervision of domestic financial institutions.

Directors also welcomed the reductions in official interest rates since the beginning of the year. The decline in international interest rates provided the context for these actions, and the authorities had rightly underscored that official interest rates would be adjusted flexibly as needed.

While noting that the statistical base was adequate for surveillance, Directors reiterated their call for continued efforts to strengthen the database further. Some Directors encouraged the authorities to subscribe to the SDDS.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. As part of a pilot project, the staff report for the 1999 Article IV consultation with Malta will also be available.

Malta : Selected Economic Indicators

	1993	1994	1995	1996	1997	Est. 1998
Real economy (percentage change; constant prices)						
Real GDP	4.0	5.0	7.3	4.2	2.8	3.1
Private consumption	0.8	2.3	10.5	7.7	0.9	0.7
Public consumption	6.0	6.4	8.5	8.4	-1.5	1.6
Gross capital formation	13.2	11.3	13.1	-4.7	-8.7	0.9
Exports of goods and services	5.3	7.1	5.4	-6.7	3.1	5.1
Imports of goods and services	5.9	7.5	10.0	-6.3	-3.9	2.3
Retail prices (period average)	4.0	4.1	4.0	2.4	3.1	2.4
Unemployment rate (percent of labor force)	4.2	4.2	3.5	3.7	4.6	4.9
Public finance (percent of GDP)						
Government budget deficit	-3.0	-5.0	-3.9	-8.6	-9.7	-10.4
Government debt	32.4	33.0	35.7	42.8	51.6	55.0
Money and credit (end period; percentage change)						
Broad money	10.3	14.9	7.8	10.4	9.6	8.4
Domestic credit	12.9	12.7	26.6	16.7	15.0	10.8
Net foreign assets of the central bank	11.6	25.7	-15.9	-4.6	1.4	11.4
(in percent of the monetary base)	127.4	152.9	129.8	119.5	115.4	124.0
Interest rates (percent; end period)						
Three-month treasury bill	4.6	4.4	4.9	5.0	5.2	5.5
Government bonds (10-year)	7.0	6.7	7.1	7.2	7.3	6.0
Balance of payments (percent of GDP)						
Trade balance	-24.3	-23.1	-23.1	-24.0	-21.2	-17.3
Goods and services balance	-9.7	-10.2	-13.7	-13.9	-8.5	-4.8
Current account balance	-3.4	-4.9	-11.0	-10.7	-6.2	-4.9
Official reserves (end period) (in millions of U.S. dollars)	1,391	1,876	1,648	1,538	1,433	1,655
(in months of imports of goods and services)	6.7	7.5	5.7	5.5	5.6	6.0
Exchange rate						
Regime	Pegged to a basket of currencies comprising the euro, pound sterling, and U.S. dollar.					
Nominal effective exchange rate (1990=100)	93.0	93.4	94.5	93.4	94.8	95.9
Real effective exchange rate (1990=100)	89.3	90.7	92.7	91.5	94.0	96.5
	US$2.51 per Maltese lira					
Memorandum items:						
Nominal GDP (in millions of Maltese lira) 1/	940	1,029	1,146	1,201	1,282	1,387

Sources: Central Office of Statistics; Central Bank of Malta; Ministry of Finance; IMF, *International Financial Statistics;* and IMF staff estimates.

1/ For 1998, GDP is estimated by the Central Bank of Malta. The public finance variables for 1998, however, are expressed in relation to the Ministry of Finance's estimate of GDP of Lm 1,391 million.

Statement by Mr. Schlitzer on Malta
June 18, 1999

The Maltese authorities wish to express their appreciation to the staff for the excellent work done on the occasion of this consultation. They attach great value to the views and recommendations of IMF staff and broadly share those contained in the present report.

As the Maltese authorities are supportive of the Fund's approach towards greater transparency, they intend to participate in the pilot project on publication of Art. IV staff reports. Since Malta is on a 24-month cycle, it would be eligible to participate under the subcategory agreed upon by the Board for countries on a longer consultation cycle that would be unable to participate otherwise.

Since the last Art. IV consultation in 1997, Malta's policy performance has been mixed. However, following elections in September 1998 and the establishment of a new administration, Malta has initiated a new stage of stabilization measures and market-oriented reforms. The aim is to put the economy back on the high growth-high investment path experienced in the first half of the 1990s. The goal of EU membership, for which the new administration has reinstated Malta's application, is seen as instrumental to this. The working assumption is that Malta will be able to join the six "fast track" candidate countries and that accession could take place in January 2003.

Since 1996 a gradual deterioration of the public accounts has taken place due to the combination of increases in spending (mostly current expenditure) and shortfalls in revenues following the replacement of the VAT. The lack of fiscal discipline, coupled with a weakening of economic growth, pushed the deficit up to 10.4 percent of GDP in 1998. The new administration intends to put the public finances back on track and aims at reducing the fiscal deficit to 8.5 percent of GDP in 1999. For this purpose important measures are being implemented: (i) on the revenue side, a new VAT was introduced in January 1999 and a general reinforcement of the tax administration system is underway; (ii) on the expenditure side, the transfers to public companies through subsidies and lending is scheduled to be reduced by 1 percent of GDP and substantial further public savings will be made thanks to an employment freeze and a comprehensive civil servant wage restructuring.

It is important to note that for the first time a medium-term fiscal framework has been introduced, and this will reinforce Malta's fiscal credibility and buttress the prospects for EU

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membership. In particular, the authorities intend to scale down the fiscal deficit to 4 percent of GDP by the year 2004 (3.4 percent in the staff definition of fiscal balance). This deficit reduction path should be treated as a ceiling, and the authorities do not dismiss a priori that a stronger consolidation effort could be realized, as recommended by the staff.

The Maltese authorities are fully aware that the most appropriate way to achieve fiscal consolidation is through a structural reduction of spending. To this end, they intend to reduce permanently the heavy burden that public enterprises impose on public finances. A strong privatization program has been initiated. The main retail bank was fully privatized in May, and the government has announced that further privatization will take place in the coming year. A privatization unit, composed of senior representatives from the private and public sectors, was formed in March with the mandate of identifying public enterprises eligible for privatization and formulating appropriate methods and timing.

Concerning the tax system, as stated by the staff the reforms put in place during the 1990s have been quite successful and comprehensive. While further major changes are not necessary, some fine-tuning measures could be required in the future to put the system fully in line with EU standards and to enhance tax compliance.

The authorities intend to maintain the current peg arrangement, which they consider fully appropriate for a small, open economy like Malta's. In providing a useful nominal anchor, the peg has allowed Malta to afford relatively low inflation rates. The commitment to the peg will be firmly maintained amid continuing gradual liberalization of Malta's capital account, which will tend to prioritize long-term flows.

Malta's banking system and regulatory procedures are relatively sound. The regulatory regime, in particular, compares well to international standards, as concluded in 1997 by a mission of the Monetary and Exchange Affairs Department, after which further important improvements took place. This facilitates the task of the authorities, who intend to continue with orderly capital account liberalization, reducing the remaining controls as circumstances permit.