October 2005
IMF Country Report No. 05/381

Malta: 2005 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Malta

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005Article IV consultation with Malta, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 9, 2005, with the officials of Malta on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 18, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of October 14, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its October 14, 2005 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Malta.

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

MALTA

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the 2005 Consultation with Malta

Approved by Susan Schadler and Anthony R. Boote

July 18, 2005

- Consultation discussions were held in Valletta during April 27–May 9, 2005. Discussions were also held with the European Commission (EC) in Brussels on April 26, 2005.
- The mission comprised Messrs. Hoffmaister (head), Guajardo, and Lissovolik (all EUR); Ms. Rizzotti (OED) joined the mission during the second week.
- The team met with Prime Minister and Minister of Finance Gonzi, Central Bank of Malta Governor Bonello, and other senior officials. It also met with representatives of financial institutions, business, and labor.
- Malta acceded to the European Union (EU) on May 1, 2004, and entered into ERM-2 on May 2, 2005, thereby re-pegging the lira from a basket of currencies to the euro, to which it is fixed unilaterally.
- Malta maintains a peg to the euro and has accepted the obligations of Article VIII (Sections 2, 3, and 4) of the Articles of Agreement, and maintains no restrictions on payments and transfers for current international transactions, except for those imposed for security reasons, which have been notified to the Fund (Appendix I).
- The authorities have indicated their intention to publish this staff report.

Contents Page

Executive Summary 4

I. Introduction 5

II. Economic Background and Recent Developments 6

III. Report on the Discussions....................9
A. Economic Outlook and Short-Run Policy Issues....................9
B. Medium-Term Consolidation and Long-Run Fiscal Challenges 12
C. Fostering Growth 18
D. Exchange Rate Policy, Euro Adoption, and the Financial Sector....................20
E. Other Issues 21

IV. Staff Appraisal....................21

Boxes
1. Policy Recommendations and Implementation 5
2. Exchange Rate Alignment and Exchange Rate Pass-Through to Prices 13
3. The Three-Year Fiscal Plan 14
4. Fiscal and External Sustainability....................17

Tables
1. Selected Economic Indicators, 2000–05....................28
2. General Government Expenditure, 2000–05 29
3. Progress Reforming the Parastatal Sector in 2004....................30
4. Summary Balance of Payments, 1998–2004 31
5. Monetary Developments, 1998–2004....................32
6. Medium-Term Macroeconomic Outlook....................33
7. Public Sector Debt Sustainability Framework, 1999–2050....................34
8. Indicators of External and Banking Sector Vulnerability, 1999–2004....................35
9. Overview of Interim Progress in Implementing Selected FSAP Recommendations 36
10. Summary Balance of Payments, 2003–10 37

Figures
1. Main Developments, 1995–2004....................38
2. Competitiveness Indicators....................39
3. Inflation and Gross Wages....................40

4. Interest Rates, 1997–2005 ... 41
5. Monetary Sector Developments, 1992–2004 ... 42
6. 10-year Interest Rates in New EU Countries ... 43
7. Current Expenditures Indicators ... 44
8. Malta and EU Demographic Indicators ... 45
9. Malta and EU Human Capital Indicators ... 46
10. Selected Currency Indicators ... 47
11. Malta's EU Synergies ... 48

Appendices

I. Fund Relations ... 24
II. Statistical Issues ... 25

EXECUTIVE SUMMARY

Main developments

The Maltese economy continues experiencing sluggish growth. For a fourth consecutive year, growth languished in 2004, reflecting an adverse external environment and domestic factors. The low growth pattern was triggered by shocks to key sectors, and reinforced by the slowing of its main trading partners and restructuring of the manufacturing sector.

Renewed efforts to consolidate the fiscal accounts substantially reduced the deficit in 2004, and produced tangible parastatal reform. In contrast with recent history, the fiscal outturn was on target, implying a decline in the deficit of over 2 percent of GDP in 2004. Also, a fresh wave of reforms led to tangible results, including a better than targeted operating outturn for Malta Shipyards.

Malta entered ERM-2 on May 2, 2005. The Maltese lira was thus re-pegged to the euro, and the authorities unilaterally committed to keep the currency at its central parity.

The Central Bank of Malta raised interest rates by 25 basis points to 3.25 percent in April, and thus restored the interest premium on the lira. The premium was further enhanced by ERM-2, as the higher interest rates on the sterling and the dollar are no longer part of the relevant comparator. Foreign exchange losses since late 2004 were arrested.

Policy requirements

Fiscal consolidation. Reversing increases in public debt is key. In 2005, this will require identifying areas where current expenditure can be under executed, and following through if revenue projections prove optimistic.

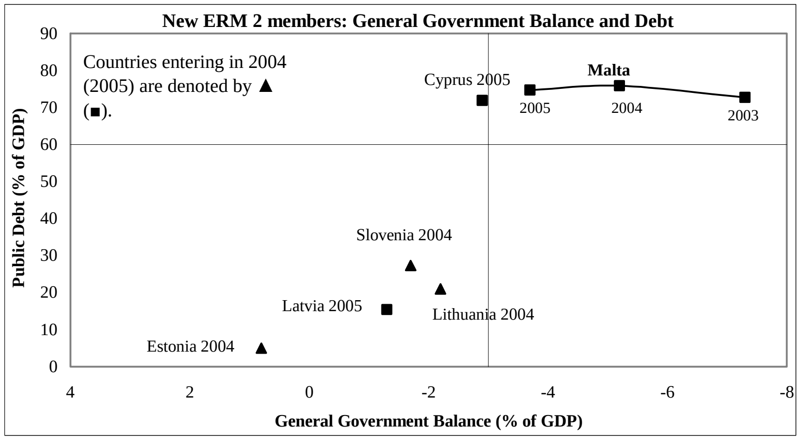
High quality fiscal adjustment and pension reform. A lasting adjustment requires tough decisions to cut spending and articulate policies to: (i) lower public sector employment; (ii) shift part of the financial burden of health care services to the end-user, and (iii) rationalize the welfare system to enhance its effectiveness. This will shield capital spending, and thereby supporting public investment and economic growth. In the long-run, fiscal stability hinges on substantive pension reform.

Fostering growth. Aside from fiscal consolidation, unleashing Malta's growth potential requires reforms addressing long standing problems in the labor market, including releasing redundant public sector employment, enhancing human capital, boosting employment rates—particularly, for women—and streamlining public bureaucracy.

Euro adoption and the financial sector. Malta is well placed to benefit from euro adoption, provided fiscal consolidation is forthcoming. The financial system is strong and well-supervised but a number of regulatory measures, particularly regarding property-related financing, can strengthen its resilience.

I. Introduction

1. **The discussions took place against the backdrop of renewed efforts to deal with macroeconomic imbalances and reinvigorate the economy, which paved the way to EMR-2 entry**. The authorities' macroeconomic management changed sharply on the heels of EU accession in 2004 (text figure): the fiscal deficit was lowered substantially, and parastatal reforms were reinvigorated. Aside from facilitating the EC sanctioning of ERM-2 participation, these developments enhanced Malta's policy alignment with the Fund's recommendations (Box 1). Continued progress is still needed to place public debt on a sustainable path and to foster convergence with the EU.



Source: Eurostat

Box 1. Policy Recommendations and Implementation

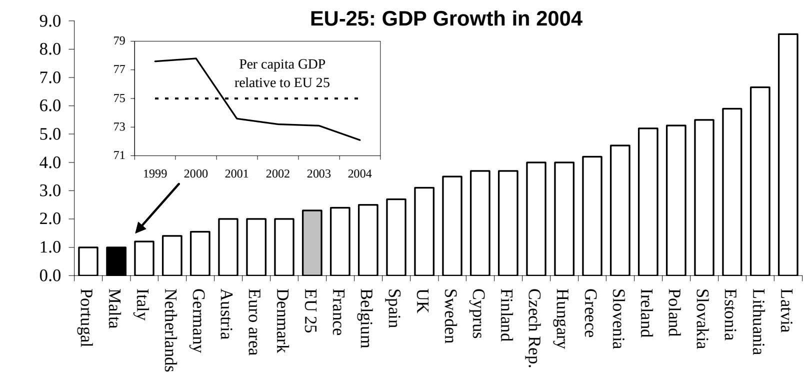
Overall, the authorities have concurred with the thrust of the Fund's policy advice,[1] and its implementation has been spurred by EU membership:

- Opening markets to international competition has been completed upon EU accession.
- Progress has been made in consolidating fiscal accounts in 2004, and the medium-term deficit target is consistent with staff's proposal. There is a need to rebalance expenditure cuts toward current spending, and to reform the welfare and pension systems.
- The pace of privatization and parastatal reform was accelerated in 2004. Further progress in reducing public sector employment is needed.
- Restrictions on interest rates were abolished, and interest rates managed more flexibly as the current account was liberalized gradually, with virtually all restrictions on capital movements dropped upon EU accession. The independence of the Central Bank of Malta has been increased.
- ERM-2 entry has followed progress in lowering fiscal deficits. Successful participation, including euro adoption, hinges on implementing a high-quality fiscal adjustment.
- Malta has accepted the obligations of Article VIII (Sections 2, 3, and 4) of the Articles of Agreement.

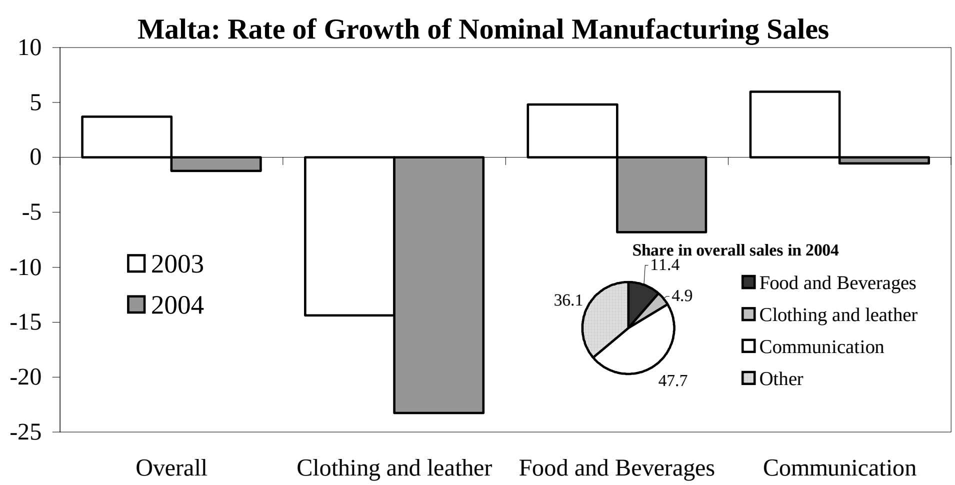
[1] The Staff Report, PIN and Summing Up of the 2003 Article IV are available at www.imf.org/external/pubs/ft/scr/2003/cr03276.pdf

II. Economic Background and Recent Developments

2. **For a fourth consecutive year, growth languished in 2004** (text figure), **reflecting the weakness of, and increasing competition in, Malta's export markets, as well as domestic factors** (Table 1 and Figure 1). The slowdown in Malta—a highly open and narrowly based economy—had begun in 2001 with shocks to the key sectors of tourism and semiconductors, respectively accounting for 12 percent and 10 percent of GDP. The collapse in output growth in 2001 was reinforced by slowing growth in its main trading partners (notably the EU), and more recently by oil price developments. The real effective exchange rate has depreciated since 2002, but Maltese exports lost market share (Figure 2) due to increasing competition from Asia and emerging tourist destinations in Central and Eastern Europe. Still, domestic factors also played a role. The manufacturing sector restructuring—in part following the accession-related dismantling of import levies—resulted in declining sales of processed food products and beverages, and hastened losses in the clothing sector (text figure). Low employment rates and low human capital have also held back output (Section III.C) and hobbled employment growth.



Source: Eurostat



Source: National Statistics Office, Manufacturing performance in Malta.

3. **Despite weak growth, the fiscal balance improved substantially in 2004 and parastatal reform gathered steam** (Tables 2 and 3). In contrast with recent history, the fiscal outturn was on target in 2004 (text table) implying a decline in the deficit of over 2 percent of GDP. Much of the improvement reflected the strength in current revenues, which increased in relation to GDP by 2.8 percentage points to 44 percent of GDP in 2004 (text figure). Nontax revenue—namely the Fifth Italian Protocol[1] and European Structural Funds—accounted for the bulk of the increase (2 percentage points of GDP), but tax revenues were sustained by a hike of 3 percentage points in the VAT rate that rose to 18 percent, and the establishment of an ecotax. On the expenditure side, total expenditure increased in relation to GDP reflecting higher current spending; capital expenditure remained unchanged (but lower than targeted due to difficulties implementing construction projects). A fresh groundswell of parastatal reform resulted in a better than targeted operating outcome for Malta Shipyards; the removal of Enemalta from the Standard & Poor's watch list; and the conclusion of the lengthy negotiation to privatize Malta Freeport. Nonetheless, public debt continued increasing, rising to over 75 percent of GDP in 2004.

Budgets and Fiscal Outcomes, 2000-04

(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004
Fiscal balance 1/					
Actual	-6.3	-6.5	-5.9	-7.3	-5.2
Budget	-6.1	-4.7	-4.7	-5.7	-5.2
Slippage (actual minus budget) 2/	-0.2	-1.8	-1.2	-1.6	0.0
Revenue	0.8	-0.4	-0.8	-1.7	-1.6
Expenditure	1.4	1.5	0.6	0.0	-1.8
Output term	0.4	0.1	0.1	0.1	-0.2
Memo items:					
Output "shortfall" 3/	-7.2	-1.7	-3.2	-0.9	3.0
Budget GDP (million Lm)	1546.0	1660.0	1684.6	1777.2	1902.4
Actual GDP (million Lm)	1665.8	1689.0	1740.1	1793.3	1847.2

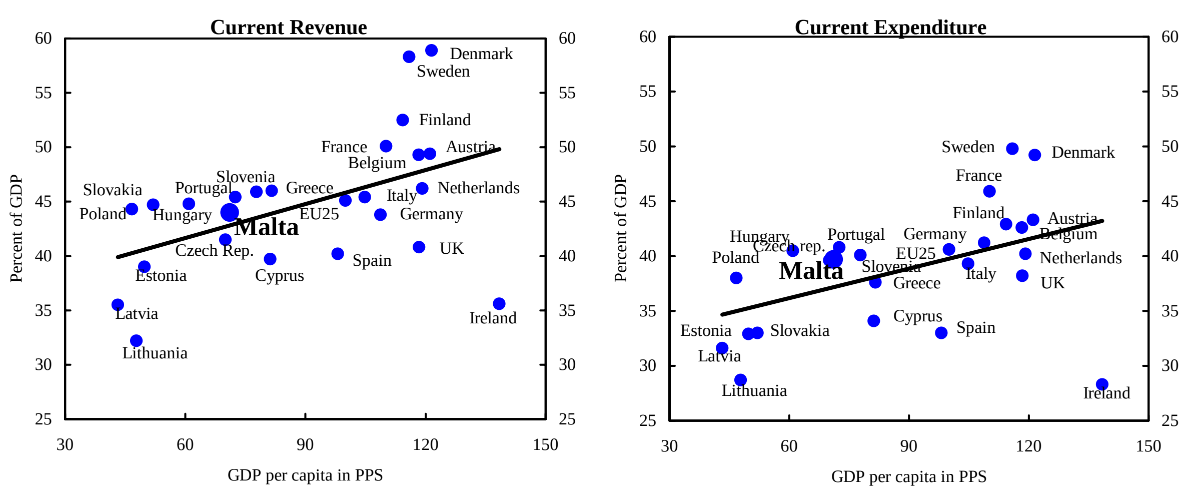
Source: Financial Estimates, Ministry of Finance, and staff calculations.

1/ Refers to general government. Excludes one-off expenditures associated with the shipyards of 3.3 percent of GDP in 2003.

2/ Defined as $(T-G)/Y - (T'-G')/Y'$ where prime refers to the budget. This can be re-expressed as: $(T-T')/Y - (G-G')/Y + (T'-G')/Y' \times (Y'-Y)/Y$, i.e., the revenue overrun minus the expenditure overrun plus an output term. The latter captures the slippage (as a share of GDP) associated with the difference between actual and budget GDP.

3/ Budget output minus actual GDP as a percent of actual.

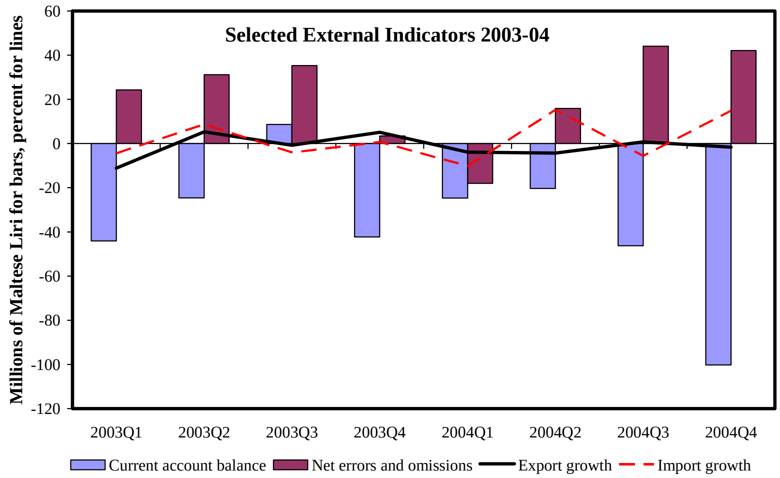
General Government Revenue and Expenditure, and per Capita GDP



Source: National Statistics Office and Eurostat.

[1] These are grants from the Italian government for major infrastructure projects and extend through 2007.

4. **Notwithstanding sluggish growth and an improved fiscal stance, the current account deficit deteriorated to over 10 percent of GDP in 2004** (Table 4). Imports surged, reflecting (i) an influx in foreign consumer goods following the elimination of import levies; (ii) a jump in capital goods imports associated with the EU structural funds; and (iii) a mounting energy bill. Adverse terms of trade developments contributed to a sluggish export performance. External reserves fell to 6.7 months of goods and services, but declines were contained at 3¾ percent of GDP partly due to large positive net errors and omissions (text figure), which could reflect unrecorded economic activity, notably in the financial sector.



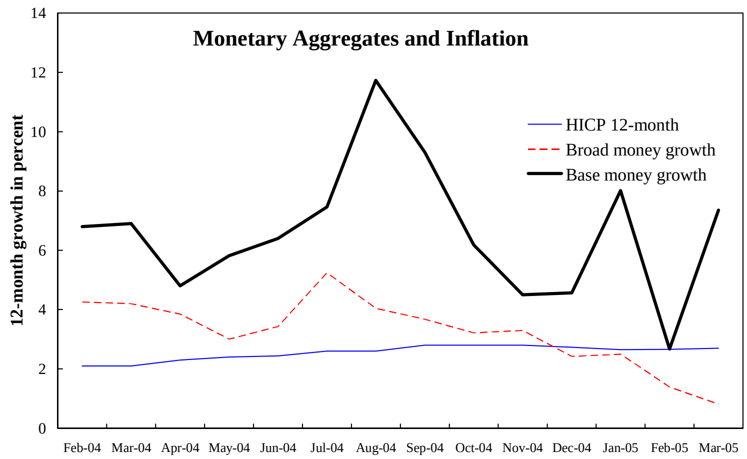
Source: Central Bank of Malta

5. **Inflation spiked as a result of one-off domestic factors in 2004**. Malta's long-standing exchange rate peg to a basket of currencies—comprising the euro (70 percent), sterling (20 percent), and dollar (10 percent)—provided an effective nominal anchor,[2] which was repegged to the euro with no realignment in the value of the Maltese lira (¶19). Nevertheless, prices jumped by 2.7 percent in 2004 following adjustments in tax rates and domestic energy prices. Inflationary pressures remained subdued, nonetheless, as modest increases in public sector wages were partially offset by the declines in (private) service sector—narrowing the margin of price increases of services over headline inflation (Figure 3)—and, so far, housing services (rental rates) have not reflected sharp increases in house prices (¶9).

6. **Given the subdued inflationary pressures and a sizable reserve cushion, the Central Bank of Malta (CBM) had kept the key policy rate unchanged for more than 1½ years, but raised it in April**. Despite the small erosion in the basket-weighted interest rate premium of the lira from the rising interest rates in the U.S. and the U.K. (Figure 4), reserves remained largely unchanged through the third quarter of 2004. But facing persistent reserve losses since late 2004, the CBM decided to increase the intervention rate by 25 basis points in April 2005 to 3.25 percent. This reestablished the premium, which was further enhanced upon ERM-2 entry when the higher interest rates of the sterling and dollar dropped out of the relevant comparator (¶11 and 19).

[2] Inflation has averaged just over 3 percent in the past 20 years. For a discussion of the pros and cons of the Maltese exchange rate regime see Country Report No. 03/276.

7. **With limited sterilization, base money growth generally reflected developments in international reserves**. Narrow money, nonetheless, grew in real terms (Table 5 and Figure 5), driven by the low opportunity cost of holding liquid assets in a low-interest-rate environment. Broad money expanded more modestly (text figure), and declined in real terms in early 2005 due to shifts toward government bonds and financial derivatives, which are not part of M3; domestic credit increased by about 5 percent in 2004, fueled by real estate lending.[3]



Source: Central Bank of Malta

III. Report on the Discussions

8. **The discussions centered on leveraging the achievements in 2004 to bring about a high-quality fiscal consolidation and propel growth**. In this connection, fiscal consolidation presents a dilemma: withdrawing fiscal stimulus could prolong sluggish economic activity in the short run, but is essential for public debt sustainability. Mitigating adverse output effects will require putting in place a fully spelled-out fiscal package—articulating measures to cut current expenditure, safeguard capital spending, and address the fiscal consequences of aging—and persevering with the restructuring needed to unleash Malta's potential. A moderate boost to output could also result from lower interest rates—consistent with the experience of countries recently entering ERM-2 (Figure 6)—as markets reassess country risk in line with progress in these areas.

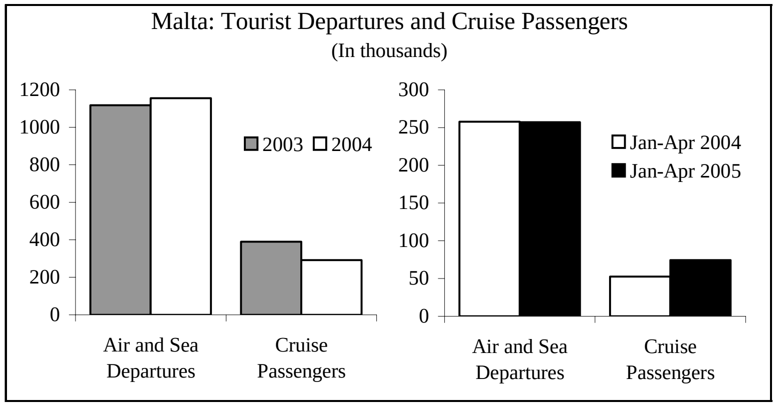
A. Economic Outlook and Short-Run Policy Issues

9. **The near-term outlook remains subdued**. With a shared view that growth would remain below 2 percent in 2005–06 (Table 6), the discussions focused on the main risks to this scenario:

- ***External environment***. The authorities agreed that delays in the recovery of Malta's main trading partners would weigh on exports in 2005. Next year, an envisaged modest export led recovery was predicated on a gradual pickup in Europe that,

[3] Private sector credit growth remained low, nonetheless, as credit to corporates—roughly 70 percent of outstanding credit—was subdued.

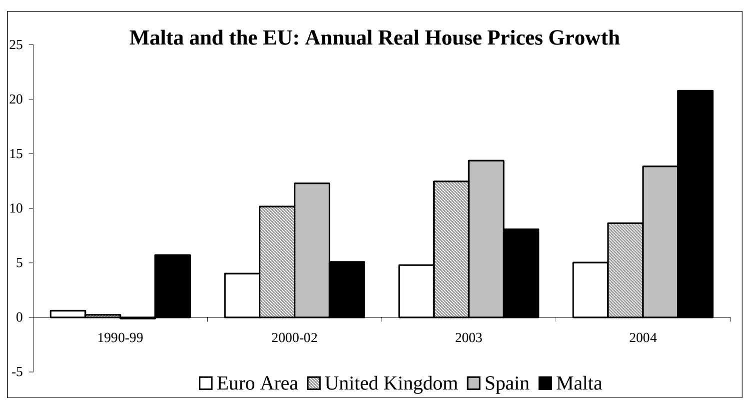
combined with less buoyant imports, would lessen the external drag. However, developments in oil prices—including the uncertainties regarding the persistence of recent increases—and a potential interest rate hike in the euro area were viewed with concern.[4] The authorities voiced cautious optimism regarding the tourism sector (text figure). Low-cost airlines have expressed interest in beginning operations on the island and thus offer the potential to tap into the strong growth in "no-frills" air travel in Europe. Also, some rebound in the number of "day-trippers"—cruise passengers who sleep on board—is envisaged.



Source: National Statistics Office

- ***Semiconductor sector***. The authorities noted that the types of products Malta had increasingly specialized in—automobile and wireless applications—faced strong demand, and prices could inch up later in the year. But the strong euro and competitive pressures manifested in the weak first quarter results, made the mission skeptical regarding the boost that higher prices could provide.

- ***House prices***. The authorities explained that the rate of increase in (real) residential property prices had accelerated sharply to over 20 percent in 2004 (text figure) against the background of low interest rates and demand-augmenting demographic factors. They agreed, moreover, that price increases could be underestimated because the declining size of newer dwellings was not reflected in the Maltese price index. While welcoming ongoing efforts to analyze house prices, the mission noted that these developments had heightened macroeconomic risk by making consumption patterns more uncertain,

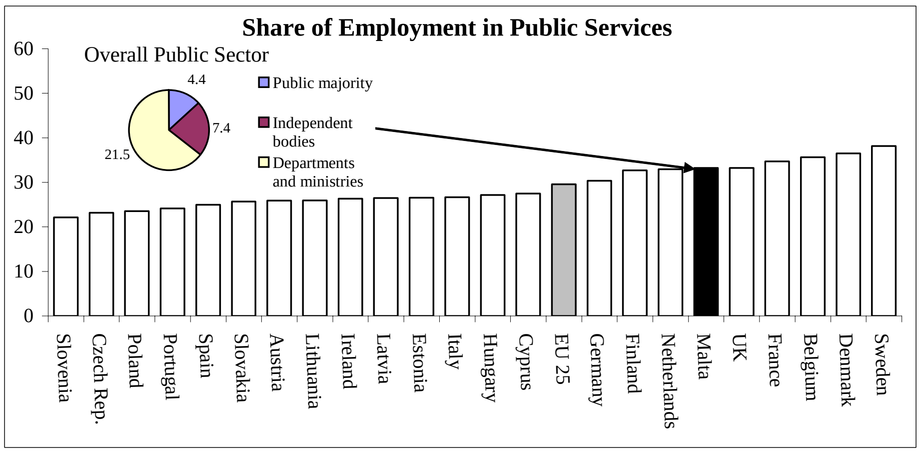


Source: Central Banks of Malta and Spain.

[4] Since the mission concluded, the European Central Bank has been viewed increasingly as aiming to keep interest rates on hold; some analysts see cuts as possible in 2005.

and stressed the need for continued vigilance, particularly concerning trends in the financial sector (¶22).

10. **There was agreement that continued fiscal consolidation was essential in 2005, despite the sluggish economy**. The authorities stressed the need to place public finances on a sustainable path to ensure macroeconomic stability. In this connection, and despite increases in capital spending—including projects financed by the Fifth Italian Protocol and EU funds—the 2005 budget envisages lowering the deficit by 1.5 percent of GDP to 3.7 percent of GDP. An unwavering control of recurrent spending—including reducing the sizable public sector employment (text figure) by filling positions with existing public employees and allowing natural attrition to take place, and wage moderation—would lower current expenditure relative to GDP by 1.6 percentage points. Tax revenues are projected to increase relative to GDP by 0.8 percentage points reflecting increases in non-tax revenues, the impact of a full-year collection of VAT at the new higher rate, and some adjustments in excise taxes. The authorities were confident that the normal margins in the budget, and the evolution of revenue collection thus far would safeguard the deficit target from the statistical effect associated with the downward revision of GDP in 2004. The mission welcomed efforts to address recurrent spending and encouraged the authorities to stand ready to underexecute the budget if revenue projections proved optimistic.



Source: Eurostat and National Statistics Office.

11. **The mission also welcomed the CBM's decision in April to increase interest rates**. The authorities explained that the adjustment reflected their assessment of economic and financial developments, including the evolution of the premium of the lira and the erosion of international reserves. The CBM would continue to use the central intervention rate to influence short-term interest rates in view of the high concentration in Malta's banking system (¶20).

12. **The authorities expected that ERM-2 participation would ease external reserve pressures, which had partly been prompted by market uncertainty over the exchange rate regime and level**. The authorities also commented that the pressures on the exchange

rate had subsided following ERM-2 entry[5] and competitiveness indicators broadly support the view that the lira is not grossly misaligned (Box 2). Nevertheless, the mission pointed to the persistence of sluggish growth, weak export penetration, and increasing unit labor costs relative to other new EU members, as indicating a competitiveness problem. But it agreed that a devaluation would have at best short-lived effects—given the openness of the economy (trade amounts to almost 200 percent of GDP) and speed of the nominal exchange rate pass-through to prices. Enhancing competitiveness thus required an intensification of reform efforts (Section III.C).

B. Medium-Term Consolidation and Long-Run Fiscal Challenges

13. **Stressing the growth-enhancing benefits of fiscal consolidation, the authorities explained their plan to cut the deficit to 1.4 percent of GDP by 2007** (Box 3). To counteract the envisaged decline in grants from the Fifth Italian Protocol and the EU of about 3 percent of GDP, expenditure cuts relative to GDP of more than 5 percentage points are planned. Current expenditure cuts (about 2 percentage points) would be achieved through a broad containment of expenditures (1.3 percentage points), wage moderation and natural attrition (0.4 percentage points), and smaller contributions to government entities as parastatal reform continued (0.2 percentage points). The bulk of the proposed cuts (60 percent) would fall on capital spending, which upon completion of the major infrastructure projects in 2006, would return to levels consistent with the recent past. The authorities pointed out that the projected decline in capital spending was overstated in 2007, because investment projects that could be expected to be financed by European funds from the 2007–13 EU budget had not been budgeted; the effect on the deficit would be limited to the domestic cofinancing requirement.

14. **The mission welcomed the ambitious goal to reduce the fiscal deficit by cutting expenditures but emphasized the need for high-quality adjustment**. The consolidation target is broadly in line with the maximum fiscal deficit that is estimated to be prudent upon euro adoption (text table) and consistent with a primary surplus resulting in a gradual reduction in public debt in the medium-term. While acknowledging that efforts to toughen tax enforcement could reduce the needed expenditure restraint, the mission stressed that a lasting consolidation will require articulating policies to rationalize current expenditure in the 2006–07 budgets (Figure 7) and thus provide room to protect capital expenditures (Section III.C). In particular, the mission stressed the need to take the following actions:

[5] At the time of the writing of this report, pressures have remained subdued.

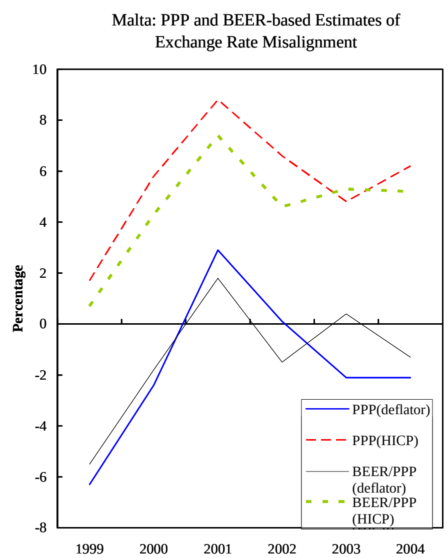
Box 2. Exchange Rate Alignment and Exchange Rate Pass-Through to Prices

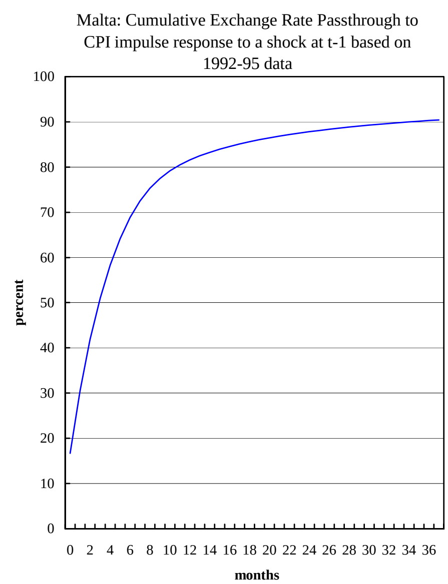
The CBM has completed a comprehensive assessment of the degree of real exchange rate misalignment—using a number of econometric techniques—with the following results:

- PPP-based cross-country estimates suggest that the lira is overvalued (undervalued) against the euro by about 6 (2) percent using the HICP (GDP deflator). Differences in the representativeness of the indexes explain the varying assessments.
- Behavioral equilibrium exchange rate (BEER) time series approach points to a small (2 percent) overvaluation vis-à-vis the "permanent" equilibrium exchange rate, and virtually no deviation from the "current" equilibrium exchange rate.
- Combined PPP-based and BEER panel data measures provide a number of alternative calculations, with roughly an equal number of these pointing to over and undervaluation; none find the overvaluation to be greater than 6 percent.

However, misalignment estimates must be interpreted with caution. In particular, data limitations hinder addressing the issue of whether the estimated equilibrium exchange corresponds to an internal equilibrium. Also, establishing the relevant country benchmark is difficult given Malta's idiosyncrasies; the short time span of the available data impinges on the power of statistical tests to establish the underlying properties.

Still, with Malta's degree of openness, it is unlikely that realigning the nominal exchange rate would result in lasting effects on the real exchange rate. Gauging the degree of pass-through to prices is complicated, however, by the limited informational content of the data from a peg that has not been adjusted. The most recent adjustment was the lira devaluation in 1992, in the wake of the ERM crisis. Staff estimates for that episode (1992–95) suggest that the "long-run" pass-through to prices was in the range of 80 to 90 percent, the bulk of which occurred within a year (text figure).





Source: Central Bank of Malta and IMF staff estimates.

Box 3. The Three-Year Fiscal Plan

The 2005 budget provides a plan for the next two years (text table), whose main elements are:

- Total revenues decline by 3 percent of GDP, but is more than offset by cuts in total expenditures (5.4 percent of GDP).
- Capital expenditures are set to fall by about 3 percent of GDP.
- Public debt declines reflecting primary surpluses beginning in 2005.

Fiscal Consolidation Plan 2004-2007
(percent of GDP at market prices)

	2004	2005	2006	2007
Recurrent Revenue	44.4	45.2	43.7	42.1
Total expenditures	49.5	49.0	46.2	43.7
of which:				
Recurrent expenditure	39.8	38.2	36.9	36.0
Interest payments	3.8	3.9	3.9	3.7
Capital program	5.9	6.9	5.4	4.0
Adj. for financial transactions	-0.1	0.1	0.1	0.2
General Government deficit	5.2	3.7	2.3	1.4
Receipts from sale of shares	0.0	-2.6	0.0	0.0
General Government debt	75.6	74.4	72.9	72.8

Source: 2005 Budget Speech.

- ***Lower public employment***. A proactive policy to identify and eliminate redundancies in the public sector was stressed (¶17). While agreeing on the need to streamline public sector employment, the authorities expressed concern about the pace, even allowing for the training and time-bound assistance needed to address social concerns.

- ***Reform health care***. Shifting part of the burden in the provision of health care to the end user—fees per visit and co-payments—to bring about a more rational use of the system and ease the burden on the public purse. In response the authorities stressed the need to study the factors pressuring health care spending—including, soaring prescription prices—and to address these directly.

Cyclical Sensitivity of Fiscal Deficits and Prudent Fiscal Buffers

	Cyclical Sensitivity 1/	Prudent Fiscal Buffer 2/	Maximum Output Gap Accommodate 3/	Implied Maximum Structural Fiscal Deficit upon Euro Adoption 4/
	(In percent of potential GDP)			
Malta	0.48	1.96	4.3	1.04
Czech Republic	0.42	1.81	4.3	1.19
Hungary	0.47	1.10	2.4	1.90
Poland	0.43	1.85	4.4	1.15
Slovak Republic	0.42	1.43	3.4	1.57
Slovenia	0.44	0.67	1.5	2.33

Source: Fund staff calculations, and IMF Occasional Paper No. 234, Box VII.1
1/ Impact of a 1 percentage point increase in the output gap on the fiscal balance (as a percent of GDP).
2/ The budgetary effect of a two standard-deviation widening of the output gap below the historical mean.
3/ Historical mean output gap (1995-2002) plus two standard deviations.
4/ 3 percent of GDP Maastricht headline deficit ceiling minus the prudent fiscal buffer.

- ***Rationalize social benefits***. Critically review and evaluate the list of benefits with a view to eliminate those that no longer consistent with current needs. Instead, the authorities explained that abuse presented a greater threat to the welfare system.

- ***Extend means testing***. This would ensure that welfare benefits and the social safety net target those in need, and promote social justice by excluding those who are not. The authorities explained that practical considerations—increased incentives to underreport income and the need for a new bureaucracy to oversee the revised system—limited the effectiveness of means testing, despite the mission's proposal to scale reductions in benefits and cross-reference indirect indicators of income, such as electrical power consumption.

The authorities agreed that more resources should be devoted to the budget office, which was overburdened by the additional responsibilities associated with EU membership. This would enhance its ability to assess budget execution, address emerging problems early on, and add an estimation of tax expenditures to the budget documents.

15. **Safeguarding fiscal stability in the long run entails reforming the pension system**. The pay-as-you-go "two-thirds" pension system[6] will come under stress as the population ages in the wake of a sharp drop in fertility rates—half of those prevailing 30 years ago—and life expectancy rises of ten years from the levels of the mid-twentieth century (Figure 8). The mission noted that demographic trends, if left unaddressed would

[6] Financed by tripartite contributions (10 percent each), the old-age pension receives its name from the replacement rate: 67 percent. Annual benefits are capped at Lm. 6,750, which is currently about 33 percent above the average wage.

increase public expenditure in relation to GDP by 3 percent by 2027, and push the public sector debt to over 100 percent in 2050. In this connection, the authorities have recently published a white paper on pension reform, which, provided fiscal consolidation proceeds as planned, would lower debt in the long-run (Box 4). They explained that, while the replacement rate remained unchanged, the reform envisaged phased-in adjustments in other key parameters (text table):

Pension Reform: Adjustments in Key Parameters

Retirement age		Pension reference period		Full pension contribution period	
Individual's age /1	Proposed	Individual's age /1	Proposed	Individual's age /1	Proposed
55 and older /2 /3	61 (60)	55 and older /2	Avg. of best 3 yrs.	46 and older /2	30
52 through 54	62	50 to 54	Avg. of best 5 yrs.	40 to 45	35
49 through 51	63	45 to 49	Avg. of best 10 yrs.	39 and younger	40
48 and younger	65	44 and younger	Last 40 yrs.		

Source: Pensions, Adequate and Sustainable (white paper).
1/ As of January 1, 2007.
2/ Grandfathered.
3/ Male (female).

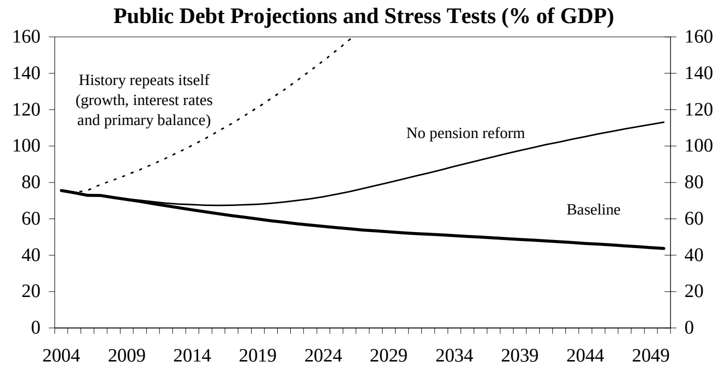
- ***Retirement age*** would increase to 65 years of age, an increment of five years.
- ***Pension benefit base*** would be calculated using the wages from the last 40 years, instead of the best three years in the last decade.
- ***Contribution period*** for a full pension would be extended to 40 years, instead of 30 years.

In addition, the reform calls for the creation of a compulsory, privately funded second pillar and a voluntary third pillar, details of which are to be determined by actuarial studies of the Malta Financial Services Authority (MFSA).

16. **The mission found widespread acknowledgement of the ageing problem and, in welcoming the proposal—including the envisaged periodic reviews—stressed that the desirable phasing-in required that reforms not be watered down or delayed**. Discussions with social partners revealed differing views on pension reform. Labor unions favored strengthening the publicly funded first pillar, establishing a voluntary second pillar, and fostering increases in the retirement age through a more attractive pension package. Employers favored gradually implementing the obligatory second pillar, even if it implied larger social security contributions, to ensure that larger firms—with a higher union presence, and thus less ably to resist calls for its establishment—not be placed at a disadvantage vis-à-vis smaller firms. Consultations with social partners have concluded, and the Pension Working Group's final recommendation are expected to be presented to government in early summer 2005, and to be in place by 2007.

Box 4. Fiscal and External Sustainability

Fiscal Sustainability. The baseline scenario reflects the authorities' ambitious fiscal consolidation and substantive pension reform, which would lower public debt from 75.9 percent of GDP in 2004 to 43.7 percent of GDP in 2050 (text figure and Table 7). Without these policies—using historical averages for real interest rates, output growth and the primary balance—the public debt would exceed 300 percent of GDP in 2050 (stress test 9, Table 7). Moreover, fiscal consolidation without pension reform would not suffice to place debt under control, as debt would exceed 100 percent of GDP by the end of the simulation scenario (stress test 8, Table 7). Other scenarios suggest that the baseline is broadly robust to the assumptions underlying it (Table 7).



Source: Staff calculations.

External Sustainability. External assets and liabilities have been growing significantly— almost quadrupling between 1996 and 2003—with assets continuing to exceed liabilities. Data on external debt is not publicly available (Appendix II) but the CBM estimates that total gross external debt reached 41 percent of GDP in 2004, largely reflecting borrowings by the banking system and in particular by a new foreign-owned bank. Significantly, the proceeds of foreign borrowings are typically used for acquisition of foreign assets in the form of bonds and direct loans. Non-bank external debt—the main source of potential external debt vulnerability—is low (about 16 percent of GDP), and has declined (text table). While in recent years Malta ran substantial current account deficits, these were financed by FDI and other durable inflows, which will likely be boosted by EU membership. Provided fiscal consolidation and structural reforms take hold, current account deficits should decline due to an increase in export shares observed in many new EU members.

Gross External Debt: 2002-04

(In percent of GDP)

	2002	2003	2004
Total	31.2	30.6	41.2
Government	4.0	4.8	4.3
Non-financial public institutions	9.4	8.2	7.7
Banks	13.0	14.1	24.8
Companies and individuals	4.8	3.6	4.4
Memorandum item			
Non-bank external debt	18.2	16.5	16.4

Source: Central Bank of Malta.

17. **The authorities stressed that privatization would enhance economic efficiency and debt reduction**. They noted that the privatization process would be largely concluded by mid-2006 (text table), leaving two final challenges for this legislature: privatizing Enemalta's fuel and gas divisions, and Air Malta. The mission welcomed these efforts and urged the authorities to reduce excess employment in companies slated for privatization, and to release these resources for more productive uses in the private sector.

Malta: Privatization Plan
(2005-06)

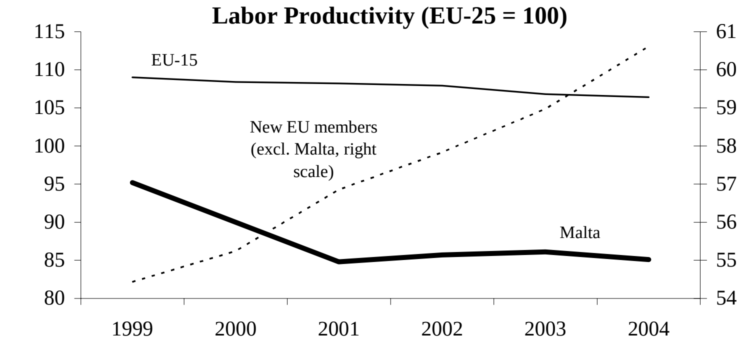
Company	Plan
Bank of Valletta	The privatization is being handled by Rothschilds, and results are expected by summer.
Maltacom	The privatization is being handled by Lehman Brothers, and results are also envisaged by summer.
Interprint	Has been slated for privatization but there have been no takers. The authorities are evaluating options.
Sea Malta	The authorities are finalizing the process and have signed a memorandum of understanding on the transfer of shares to Atlantica S.p.a. di Navigazione, which is part of the Italian Grimaldi Group.
Tug Malta	The privatization process has just began.
MIA	The cabinet has approved selling half of the authorities' 40 percent shareholding in Malta International Airport by the end of the year. There will be a share offer to the employees and existing bondholders. The rest will be offered to the public.
Middle Sea	The authorities have sold off 7 percent of its 15 percent share to a strategic partner and a shareholder, and are attempting to do the same with the rest.
Air Malta's hotels	The process leading up to the sale of Air Malta's three hotels should be concluded by the end of the year. This process will be handled by the Lands Department, since the Air Malta lease is being rescinded and the land handed back to the authorities. Air Malta is also selling Sterling Air Services, its local holiday company, and 60 percent of Air Supplies.

Source: Interview with Minister Gatt, The Malta Independent, May 1, 2005, page 5.

C. Fostering Growth

18. **Unleashing Malta's growth potential will require investing in human capital, boosting employment rates, and streamlining public bureaucracy**. In particular, the discussions noted the following:

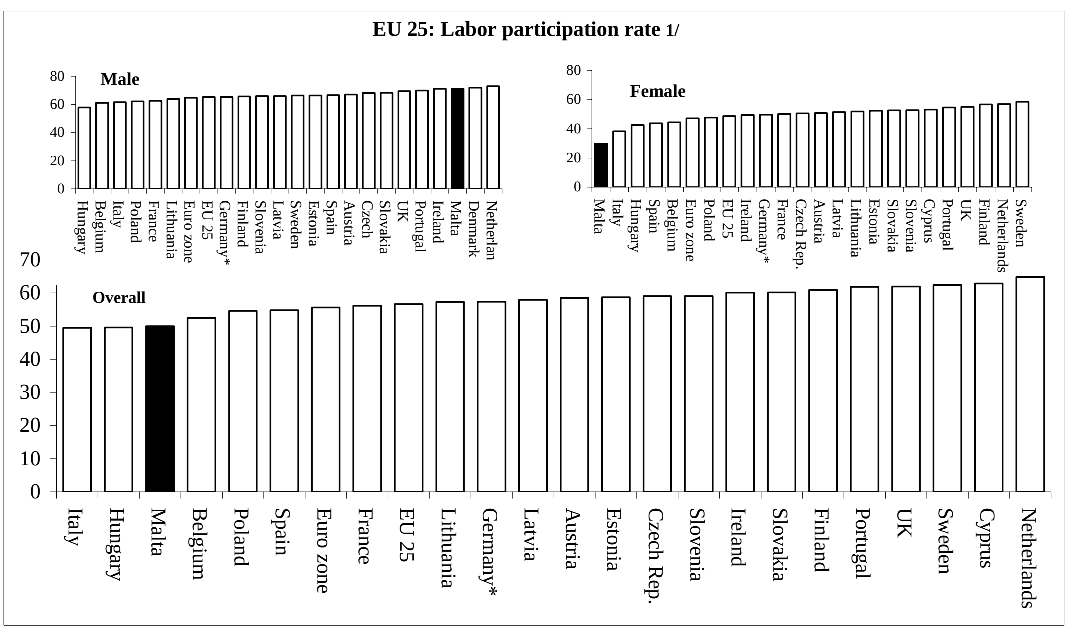
- The available ***human capital development*** indicators portray a worrisome picture (Figure 9). Developments in labor productivity, particularly compared with new EU members, provides no solace in this regard (text figure). The authorities recognized the challenges—including lowering high school drop out rates and boosting the share of students pursuing careers in science and technology—but explained that the low level of youth education attainment reflects the absence of a national certification



Source: Eurostat.
Note: GDP in purchasing power standards (PPS) per person employed relative to EU-25.

scheme, which was currently being developed. They also noted that although student stipends for tertiary students had increased the number of individuals pursuing higher education, further increases were still needed. Thus, they did not see merit in the mission's proposal to target stipends to those careers in key sectors, nor in subjecting these stipends to means testing.

- The authorities noted ongoing efforts to make fuller use of the economy's relatively abundant labor endowment, which was held back by low ***female employment rate*** (text figure). In addition to the child care project in the budget—providing training and incentives for companies to establish child care facilities for their employees—the authorities pointed to the National Action Plan for Employment, which includes lowering the income tax rate for part-time spouses, providing a one-year tax holiday for women returning to work after a five-year absence, and establishing child care regulations and tuition subsidies. In discussing the long run trends, they pointed to the encouraging fact that there were more female than male post-secondary students. The mission welcomed these efforts and the continuing analysis of the barriers that hindered female labor participation.



Source: Eurostat
1/ Corresponds to active population 15 and above, as a share of the population 15 and above.

- The authorities explained that ***streamlining the public sector*** and establishing a business-friendly environment were essential to attract FDI and foster domestic investment needed to create jobs and fuel growth. Even though there have been recent successes in attracting new investment, and several existing foreign companies are expanding, more progress is needed. In this connection, the authorities pointed to the ongoing port reform aimed at lower costs of operating in Malta and the efforts to establish a one-stop registration for businesses. The mission welcomed this approach, but saw the need for a systematic analysis to pinpoint areas hindering business activity.

D. Exchange Rate Policy, Euro Adoption, and the Financial Sector

19. **ERM-2 entry provides continuity to the fixed exchange rate regime**. On May 2, the weight of the euro in the exchange rate basket was increased to 100 percent, and the central parity was set at 0.4293 lira per euro—the closing rate on the previous working day. The authorities commented that Malta would no longer have the small flexibility afforded by the peg to the currency basket. They explained that, in repegging the lira to the euro, a unilateral commitment was made to keep the lira at its central parity, which would be facilitated by a strong international reserve position. The authorities observed that their long-standing experience of operating monetary policy under an exchange rate peg bode well for forgoing the flexibility allowed by the maximum 15 percent band. Moreover, a narrow band—consistent with fluctuations in the past couple of years, that is, plus-minus 2 percent (Figure 10)—would afford only a small margin in operating monetary policy, which would not offset the added uncertainty in its operation. The mission agreed that a small band was not needed but cautioned that Malta's ability to operate a hard peg would depend on fiscal consolidation.

20. **Provided fiscal consolidation is adequately addressed, Malta is well placed to benefit from euro adoption**. The authorities noted some important synergies with the euro area, both in terms of economic structures (Figure 11) and synchronization of economic cycles. In the financial sector, deposit and lending rates have increasingly converged to the euro area levels, but deposit-lending rate spreads still remain wide in Malta, reflecting a high degree of concentration in the banking sector. In these circumstances, adopting the euro—as soon as Maastricht conditions have been met and following the minimum 24-month stay in ERM-2—will serve to lower transaction costs, reduce exchange risk, and expand the range of profitable trading opportunities.

21. **The authorities considered that Malta's sound financial system had continued strengthening and reported improvements in 2003–04**. Bank capitalization, liquidity and profitability indicators improved from very comfortable levels (Table 8). Also, nonperforming loans have declined steadily in recent years (although they edged up in the first quarter of 2005). The authorities explained that periodic stress-testing exercises had revealed limited vulnerability of bank balance sheets to plausible interest rate and exchange rate shocks, and other risks. They noted that EU membership—for which Malta's financial system had been well prepared, including the strengthening and harmonization of its

institutional framework—would generate net benefits for Malta's financial development despite the increased competition. Work was ongoing to prepare the implementation of Basel II, and the authorities provided an update of the progress in implementing the recommendations of the 2003 FSAP (Table 9).

22. **The mission encouraged the authorities to remain vigilant in identifying financial vulnerabilities, particularly regarding mortgage credit**. Weaknesses in the corporate sector and banks' high liquidity have resulted in a sharp expansion in mortgage lending, which has grown by an average of 15 percent annually in the past five years. Moreover, with a marked rise in house prices in 2004, banks have been recently competing by providing higher loan-to-value credit, sometimes up to 90 percent or higher. The mission expressed concern—shared by the authorities—about this trend, and saw the need to tighten regulations governing mortgage credit. For instance, introducing a rising scale for provisioning requirements linked with this ratio, which would serve to internalize the macroeconomic risks of the credit boom. Also, the mission suggested that supervisory bodies could require banks—in their assessment of the repayment ability of the self-employed—to consider only the income declared for tax purposes. Aside from helping to cool the market, this would provide an added incentive to reduce tax evasion.

E. Other Issues

23. The authorities welcomed the **ROSC data module** that will take place during June 22–July 5, as well as efforts to secure **technical assistance on fiscal matters**.

IV. Staff Appraisal

24. **Efforts to address macroeconomic imbalances and reform the economy in 2004 moved Malta a step closer to reaping the full benefits of EU membership**. The fiscal deficit was reduced substantially—despite sluggish growth—and was complemented by a number of tangible results in reforming the parastatal sector. These achievements were recognized in the EC's favorable decision regarding ERM-2 participation. Moreover, the continuity of the exchange rate regime, which has served as an effective nominal anchor, was ensured by re-pegging the Maltese lira to the euro and by the authorities' unilateral commitment to maintain the current parity.

25. **In the near term, the pace of growth is likely to remain moderate**. The external environment continues to pose threats to Malta's two largest sectors: tourism and semiconductors. Also, increases in unit labor costs relative to other new EU members are envisaged to impinge on Malta's ability to compete in export markets; the external current account is expected to narrow slowly, also due to the strength in fuel and capital good imports.

26. **Continuing along the road of fiscal rectitude is essential**. Fiscal consolidation is needed to arrest increases in public debt, which otherwise threaten macroeconomic stability and weaken the credibility of the exchange rate. In 2005, safeguarding the budget target will

require identifying areas where current expenditure can be underexecuted, and following through if revenue projections prove optimistic. These tasks can be facilitated by strengthening the capacity of the Ministry of Finance through assigning additional staff to the budget office to analyze and assess budget execution, and to address deviations early on. This enhanced ability would also serve to introduce a tax expenditure budget as an integral part of the overall budget.

27. **A lasting adjustment requires that high-quality expenditure measures be articulated**. Without prejudicing ongoing efforts to ensure that all pay their fair share of taxes, the experience in Europe suggests that durable adjustment requires reducing expenditures, as opposed to increasing revenues, which are already high. In this connection, and recognizing the political difficulties, Malta will need to make tough decisions to cut spending: (i) lowering public sector employment—beyond a strict control on hiring and natural attrition—and moderate wages; (ii) shifting part of the financial burden of health care services to the end user, in addition to making other cost-containment efforts; and (iii) rationalizing the welfare system to enhance its effectiveness as a social safety net by eliminating outdated benefits and extending means testing to all welfare benefits. As experience is gained with the new system, adjustments may be warranted. Addressing all of these areas will be needed to safeguard capital spending.

28. **In the long run, fiscal stability requires substantive pension reform**. The gains in life expectancy and sharp decline in fertility rates place considerable pressure on the pension system. Implementing the white paper's proposals—including increasing the statutory retirement age and establishing a compulsory second pillar—are needed to secure the system's financial integrity. Putting in place these reforms by 2007 will facilitate the desired phasing-in of the adjustments, and the envisaged periodic reviews will enable timely adjustments to be made in the face of economic and demographic developments.

29. **Revitalizing economic growth will involve complementing fiscal consolidation with reforms addressing long-standing problems in the labor market, including low human capital development**. Free tertiary education and student stipends treat the symptoms of a low human capital development, but making education pay is key to boosting it. There is room, nonetheless, to align student stipends more closely with the needs of the economy by limiting these to careers of high priority. Aside from social considerations, extending means testing to stipends could generate savings, which might serve to increase average stipends. Looking forward, the role of wage compression—resulting from the collective bargaining system and the creep in minimum wages—in dampening incentives for education needs to be assessed and reversed.

30. **Making fuller use of Malta's main resource—its people—calls for continued efforts to eliminate barriers to female labor market participation**. Female participation is set to improve as the increasing number of female university students complete their studies. A more difficult challenge will be to facilitate women's return to the workforce after childbirth. In this connection, closely monitoring the impact of the measures envisaged in the

National Action Plan for Employment should allow the authorities to focus their efforts on those programs that prove to be most effective.

31. **Fostering job creation and economic growth entails establishing a vibrant business environment by streamlining public bureaucracy and lowering the costs of operating in Malta**. A business-friendly environment will play an essential role in boosting investment and creating jobs. Some reassurance can be taken from the recent successes in attracting new investment and from the expansion plans of existing foreign companies. But a quantum leap can result from modernizing the institutional framework and eliminating outdated regulations stifling entrepreneurship. Further efforts are needed to reduce red tape and lower the cost of operating on the island, including by reforming the port system.

32. **Provided fiscal consolidation is forthcoming, Malta is well placed to benefit by adopting the euro**. The economy is very open to international trade, and the importance of the EU—its main trading partner—has risen. These linkages are set to deepen further with the introduction of a common currency, which will serve to lower transaction costs, reduce exchange risk, and expand the range of profitable trading opportunities.

33. **Malta's financial system is strong and well supervised, but its exposure to the narrow economic base and the booming housing market needs to be watched closely**. The banking system is highly capitalized, and should be able to absorb plausible economic shocks and the new prudential requirements associated with the forthcoming adoption of Basel II standards. However, the sharp expansion of mortgage credit needs to be monitored.

34. **A number of regulatory measures may strengthen financial sector resiliency, especially regarding property-related financing**. There is a need to tighten prudential regulations so as to discourage banks from extending credit with high loan-to-value ratios. In this connection, tying the scale for provisioning requirements to this ratio should be considered. Also, supervisory bodies might require banks—in their assessment of the repayment ability of the self-employed—to consider only the income declared for tax purposes. Aside from helping to cool the market, this would provide added incentives to reduce tax evasion. More broadly, the general legal framework governing the rental market is in need of further revisions—including shortening the lengthy tenant eviction process—to contribute to an expansion of the rental market and a more balanced environment for property-related transactions.

35. **Malta's database continues to improve and is adequate for surveillance**. The timeliness of national accounts and fiscal data requires further strengthening.

36. It is recommended that the next consultation be held on a 24-month cycle.

Malta: Fund Relations
(As of May 31, 2005)

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. Malta maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, except for restrictions maintained for security reasons and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).

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

III. **SDR Department**:	**SDR Million**	**% Allocation**
Net cumulative allocation	11.29	100.00
Holdings	31.38	278.00

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

V. **Latest Financial Arrangements**: None

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

VII. **Exchange Rate Arrangement**: The Maltese lira is currently pegged to the euro.

VIII. **Article IV Consultation**: The last Article IV consultation was concluded on August 18, 2003. Malta is on a 24-month consultation cycle.

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

- ROSC Data Module mission visited Malta in June, 2005.
- FSAP missions visited Malta in October 2002, and January 2003.
- MAE missions addressed monetary operations and liquidity forecasting (February 1999), bank supervision and reporting (December 1996), and OMO and forex operations (February 1995). The CBM received assistance from two short-term experts provided by MAE in the areas of forex operations and research and policy.
- STA mission on money and banking statistics visited Malta in March 2001 and September 1994. A technical assistance 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 an UNDP-funded project, from January 1995 to January 1996.

X. **Resident Representative**: None.

MALTA: STATISTICAL ISSUES

In the last few years, Malta has made significant progress improving its macroeconomic statistics. Notably, the National Statistics Office (NSO) was created in March 2001 as an autonomous and independent institution, superseding the Central Office of Statistics (COS). The authorities have made significant efforts to provide it with the needed resources and skilled staff. The NSO is in the process of developing procedures to ensure its coordinating role, as required by the Statistical Act 2000. Moreover, the authorities have been in close contact with the ECB and Eurostat to upgrade their statistical systems to meet euro-area standards, and most of Malta's statistics can be accessed through Eurostat. Malta has participated in the GDDS since September 2000 and its metadata are posted on the Fund's Dissemination Standards Bulletin Board. These metadata were updated in June 2003. Malta is also preparing to subscribe to the SDDS.

Real sector data: Data on retail price movements, labor market indicators, and tourism arrivals are released monthly, usually with a short lag; access to these data is available through the Internet via NSO's web site. The NSO completed the project to improve the coverage of GDP estimates in accordance with *ESA 95*, and are published on the NSO web site, with a 3-month lag, since August 2004. The harmonized index of consumer prices (HICP) was first published in May 2004.

Fiscal data: In accordance with the requirements established for EU membership, Malta has improved significantly the quality of its fiscal data. Several innovations have been introduced to make these consistent with *ESA 95* methodology. Among these, the government has begun presenting fiscal data on an accrual basis and has included the transactions of local governments. Also, more disaggregated information regarding the classification of functions and transactions of the government has been made available and efforts have been made in order to improve information on extra-budgetary units, such as those dealing with the operation of the Treasury Clearance Fund.

Monetary data: Monthly monetary aggregates (which cover deposit money banks, international banking institutions, long-term credit institutions and investment banks), as well as interest rates and data for the analytical accounts of the monetary authorities, deposit money banks, and other banking institutions are available within one month from the end of the reference period. The recording of the monetary data is now on an accrual basis. The Central Bank of Malta (CBM) has begun sending data to STA using the new Standardized Report Forms for monetary statistics.

External sector: 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 three months. More detailed balance of payments data, as well as those on the international investment position, are released annually, the latter with a lag sometimes of more than 1 year. Summary trade statistics are released monthly with a lag of about 40 days. Balance of payments data through the last quarter of 2004 have been published in the June

2005 International Financial Statistics and direction of trade statistics through the last quarter of 2004 in the June 2005 IMF *Direction of Trade Statistics.*

Data on external debt are not publicly available. There is concern that the debt level may be underestimated due to incomplete coverage and to counting part of it as domestic debt.

Malta: Table of Common Indicators Required for Surveillance
As of July 5, 2005

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of publication[7]
Exchange Rates	7/11/05	7/11/05	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	6/30/05	7/11/05	M	M	M
Reserve/Base Money	5/05	7/11/05	M	M	M
Broad Money	5/05	7/11/05	M	M	M
Central Bank Balance Sheet	6/30/05	7/11/05	M	M	M
Consolidated Balance Sheet of the Banking System	6/30/04	7/11/05	M	M	Q
Interest Rates[2]	7/08/05	7/11/05	W	W	W
Consumer Price Index	5/05	6/17/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	5/05	6/24/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	5/05	6/24/05	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	5/05	6/24/05	M	M	M
External Current Account Balance	2005 Q1	6/06/05	Q	Q	Q
Exports and Imports of Goods and Services	2005 Q1	6/06/05	Q	Q	Q
GDP/GNP	2005 Q1	6/09/05	Q	Q	Q
Gross External Debt[6]	n.a.	n.a.	n.a.	n.a.	n.a.

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Although overall gross external debt is not available, public sector gross external debt is available on a monthly basis, with the last release for 2/05 on 3/24/05.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Irregular (I); Not Available (NA)

Table 1. Malta: Selected Economic Indicators, 2000-05

	2000	2001	2002	2003	2004	2005 1/
Real economy (percentage change; constant prices)						
Real GDP	6.4	-0.4	1.0	-1.9	1.0	1.5
Private consumption	7.4	0.2	-0.9	2.0	0.7	1.0
Public consumption	5.4	0.1	3.9	2.9	0.6	-1.0
Gross capital formation	26.5	-31.4	-22.7	47.4	9.1	7.8
Fixed capital formation	17.4	-15.9	-23.0	36.5	6.2	7.8
Exports of goods and services	5.6	-1.4	2.9	-4.0	3.2	2.0
Imports of goods and services	10.4	-8.6	-2.3	7.0	4.5	3.5
HICP Inflation (period average)	3.1	2.5	2.7	1.9	2.7	2.4
HICP Inflation (end period)	1.0	3.6	2.1	2.4	1.9	2.4
Unemployment rate (percent of labor force)	6.8	7.7	7.7	8.0	7.3	7.0
Employment growth	...	2.8	1.0	0.2	0.0	1.0
Public finance (percent of GDP)						
Government budget deficit (Consolidated Fund)	-6.3	-6.6	-5.9	-10.6	-5.2	-3.7
Revenues 2/	37.0	39.5	41.3	41.2	44.4	45.2
Expenditures 3/	43.3	46.0	47.2	51.7	49.6	48.9
General government debt (authorities' presentation)	57.0	63.5	63.2	72.7	75.9	74.4
Money and credit (end period; percentage change)						
Base money	3.9	0.6	8.8	0.9	4.6	...
M3	4.0	8.4	10.4	2.4	2.4	...
Domestic credit	9.7	6.6	3.3	10.1	5.1	...
Credit to government	15.0	15.4	4.8	14.1	-4.0	...
Credit to the private and parastatal sectors	8.5	4.6	3.0	9.0	6.3	...
Net foreign assets of the central bank	-13.0	18.1	15.8	4.4	-5.4	...
(in percent of the monetary base)	114.1	134.0	142.6	147.6	133.5	...
Interest rates (percent; end period)						
Seven-day reverse repo	4.7	4.2	3.7	3.1	3.1	...
Three-month treasury bill	4.9	4.5	3.7	2.9	3.0	...
Government bonds (10-year)	7.2	6.5	6.1	5.3	5.3	...
Balance of payments (percent of GDP)						
Trade balance	-19.9	-15.1	-8.9	-14.7	-16.5	-17.6
Goods and services balance	-10.0	-5.2	1.1	-5.5	-8.0	-9.4
Current account balance	-12.6	-4.4	0.3	-5.8	-10.4	-10.5
Official reserves (end period)						
(in millions of U.S. dollars)	1,471	1,682	2,209	2,723	2,685	...
(in months of imports of goods and services)	4.4	6.1	7.2	7.4	6.7	...
Exchange rate						
Nominal effective exchange rate (2000=100)	100.0	100.9	100.4	100.1	100.6	...
Real effective exchange rate (2000=100)	100.0	102.4	102.6	100.8	101.9	...
Regime	Pegged to the euro since May 2 of 2005, when it entered ERM-2.					
Current rate (July 5, 2005)	0.4293 Maltese liri per euro					
Memorandum items:						
Nominal GDP (in millions of Maltese liri)	1,666	1,689	1,740	1,793	1,847	1,906

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

1/ Fund staff estimates.

2/ Excluding privatization receipts.

3/ Includes net lending and advances from the Treasury Clearence Fund.

Table 2. Malta: General Government Expenditure, 2000-05

	2000	2001	2002	2003	Budget 2004	Outturn 2004	Budget 2005
				(In Millions of Maltese liri)			
Recurrent revenue	617.7	668.6	719.9	739.2	843.0	813.1	900.1
Tax revenue	541.2	593.7	634.8	668.3	726.5	702.1	756.3
Direct taxes	311.8	345.5	371.4	393.8	408.5	400.9	421.3
Social Security Contributions	162.0	179.1	181.1	188.4	194.6	189.7	199.1
Indirect taxes	229.4	248.2	263.4	274.5	318.0	301.2	335.0
Non-tax revenue	76.5	74.9	85.1	70.9	116.5	111.0	143.8
Total Expenditure	702.8	753.9	807.5	844.7	937.8	907.0	972.4
Recurrent Expenditure	549.8	614.6	646.0	677.7	739.2	732.8	759.5
Education	40.0	46.7	47.5	49.0	49.7	50.0	51.0
Social security	175.9	184.4	190.7	200.9	206.5	206.5	209.7
Others	333.9	383.5	407.7	427.7	483.0	476.3	498.8
Interest Payments	54.4	58.7	63.8	63.0	71.9	69.6	75.8
Capital Program	98.6	80.6	97.7	104.0	126.7	104.6	137.1
Productive Investment	35.8	26.4	31.5	25.8	22.2	23.9	32.8
Infraestructure	33.8	26.9	27.4	34.1	45.1	40.5	52.4
Social	28.9	27.4	38.8	44.1	59.4	40.2	52.0
Adjustment for financial transactions	-20.8	-26.4	-15.6	-83.8	-4.1	-2.2	1.8
Central Government Balance	-106.0	-111.7	-103.2	-189.2	-98.9	-96.1	-70.5
Local Government Balance	1.0	0.9	0.5	-0.6	-0.5	-0.6	0.0
General Government Balance	-105.0	-110.8	-102.8	-189.8	-99.3	-96.7	-70.5
				(In percent of GDP)			
Recurrent revenue	37.1	39.6	41.4	41.2	44.3	44.0	47.2
Tax revenue	32.5	35.2	36.5	37.3	38.2	38.0	39.7
Direct taxes	18.7	20.5	21.3	22.0	21.5	21.7	22.1
Social Security Contributions	9.7	10.6	10.4	10.5	10.2	10.3	10.4
Indirect taxes	13.8	14.7	15.1	15.3	16.7	16.3	17.6
Non-tax revenue	4.6	4.4	4.9	4.0	6.1	6.0	7.5
Total Expenditure	42.2	44.6	46.4	47.1	49.3	49.1	51.0
Recurrent Expenditure	33.0	36.4	37.1	37.8	38.9	39.7	39.8
Education	2.4	2.8	2.7	2.7	2.6	2.7	2.7
Social security	10.6	10.9	11.0	11.2	10.9	11.2	11.0
Others	20.0	22.7	23.4	23.9	25.4	25.8	26.2
Interest Payments	3.3	3.5	3.7	3.5	3.8	3.8	4.0
Capital Program	5.9	4.8	5.6	5.8	6.7	5.7	7.2
Productive Investment	2.1	1.6	1.8	1.4	1.2	1.3	1.7
Infraestructure	2.0	1.6	1.6	1.9	2.4	2.2	2.7
Social	1.7	1.6	2.2	2.5	3.1	2.2	2.7
Adjustment for financial transactions	-1.2	-1.6	-0.9	-4.7	-0.2	-0.1	0.1
Central Government Balance	-6.4	-6.6	-5.9	-10.6	-5.2	-5.2	-3.7
Local Government Balance	0.1	0.1	0.0	0.0	0.0	0.0	0.0
General Government Balance	-6.3	-6.6	-5.9	-10.6	-5.2	-5.2	-3.7
Memorandum items:							
Gross Government Debt (Lm Millions)	950	1073	1101	1304	1405	1401	1423
Gross Government Debt (% of GDP)	57.0	63.5	63.2	72.7	73.9	75.9	74.7
Government Guaranteed Debt (Lm Millions)	445	395	356	273	--	304	--
Government Guaranteed Debt (% of GDP)	26.7	23.4	20.5	15.2	--	16.4	--
Loans (% of GDP)	0.0	6.3	0.6	7.4	0.7	5.4	6.0
Receipts from sale of shares (% of GDP)	0.7	0.0	1.6	0.0	1.8	0.0	2.6
Other Extraordinary Receipts (% of GDP)	0.8	1.3	0.8	0.1	0.5	0.5	0.2
Contrib. Sinking Fund/Loan repay. (% of GDP)	0.8	0.8	0.7	0.7	0.7	2.9	0.8
Nominal GDP (Lm Millions)	1666	1689	1740	1793	1902	1847	1906

Source: National Statistics Office and Minitry of Finance, Malta.

Table 3. Malta: Progress Reforming the Parastatal Sector in 2004

Public Entity	Action	Result
Restructuring:		
Malta Shipyards	Continued implementing business plan objectives by improving work practices, despite labor opposition.	Lower deficit than expected in the 2004 Budget.
Enemalta	Continued implementing the business plan by revamping top management, and proceeding with middle management. An internal audit system is being set up, and reforms in the financial systems proceed.	Standard& Poors removed it from watch list in January (cautioning, nonetheless, that its pricing mechanism exposes its bottom line to developments in world oil prices.)
Gozo Channel Company	Toll increases.	Deficit sharply lower.
Air Malta	Business plan unveiled.	Restoring profitability in three years.
Public Broadcast Service	Redundant employment cut, and flexible work practices agreed with labor unions.	Lower the deficit in 2005.
Malta Tourism Authority	Restructuring report drawn up by external consultants.	
Privatization:		
Malta Freeport	Completed three-year negotiation.	30-year lease to the French CMA-CGM operator, for $421million over the period, and investment to expand transshipment operations to an annual 2.3 million containers from 1.3 million.
Maltacomm	Privatization Unit currently working on selling public shares to a strategic partner	Transaction expected to be completed in 2005.
Bank of Valletta	Agreement reach with other major share holder (Banco di Sicilia) to sell the combined shareholdings (40 percent).	Transaction expected to be completed in 2005.
Sea Malta Company	Placed on the privatization block	The Privatization Unit was working with two prospective buyers, The deal would include a public service obligation ensuring operations between Malta and Southern Italy.
Kordin Grain Terminal, Maltapost, and Libyan Arab Maltese Holding Company	The authorities reviewing its shareholding position.	

Source: 2005 Budget Speech.

Table 4. Malta: Summary Balance of Payments, 1998-2004

	1998	1999	2000	2001	2002	2003	2004
	(In millions of Maltese liri)						
Trade balance	-260.6	-265.2	-331.0	-254.7	-154.2	-263.2	-304.0
Exports, f.o.b.	708.4	805.0	1,087.7	900.6	999.2	942.1	918.9
Imports, f.o.b.	969.0	1,070.3	1,418.7	1,155.3	1,153.4	1,205.3	1,222.9
Balance on services	179.3	186.1	163.7	166.2	173.2	164.9	155.7
Exports	458.4	487.7	485.1	498.5	493.4	477.5	481.7
Of which: Tourism 1/	377.0	404.2	400.0	406.0	391.4	383.8	401.1
Imports	279.1	301.6	321.4	332.4	320.2	312.6	326.0
Investment income, net	-25.4	12.9	-53.1	11.1	2.6	13.9	-18.3
Unrequited transfers, net	22.3	17.0	11.2	3.8	-16.1	-20.4	-25.9
Private	21.3	20.5	10.8	0.2	-19.3	-29.3	-34.3
Public	1.0	-3.5	0.3	3.6	3.2	8.9	8.4
Current account balance	-84.5	-49.3	-209.2	-73.6	5.4	-103.3	-191.3
Capital account, net	11.1	10.4	8.3	0.7	2.9	2.4	25.3
Financial account, net	111.9	171.3	90.5	64.8	85.0	61.4	12.5
Direct investment	99.1	321.3	261.3	106.7	-180.8	103.7	137.6
Portfolio investment 2/	-10.1	-201.5	-324.7	-218.9	-159.4	-576.8	-577.7
Other	22.9	51.4	154.0	177.0	425.2	534.4	452.5
of which official long term capital	-4.4	90.4	-10.2	0.8	5.3	28.4	-3.8
Errors and omissions	35.1	-36.1	12.9	123.5	28.5	94.3	84.1
Overall balance 3/	73.6	96.3	-97.6	115.3	121.8	54.7	-69.5
	(In percent of GDP)						
Current account balance	-6.2	-3.4	-12.6	-4.4	0.3	-5.8	-10.4
Merchandise	-19.1	-18.2	-19.9	-15.1	-8.9	-14.7	-16.5
Services	13.2	12.8	9.8	9.8	10.0	9.2	8.4
Investment income	-1.9	0.9	-3.2	0.7	0.1	0.8	-1.0
Transfers	1.6	1.2	0.7	0.2	-0.9	-1.1	-1.4
Memorandum items:							
Official reserves (in percent of GDP) 4/	47.0	50.8	38.7	45.0	50.6	52.2	46.6
(in millions of Maltese liri)	640.0	740.3	644.1	760.4	880.8	935.5	860.6
(in millions of U.S. dollars)	1,695.7	1,793.8	1,471.4	1,682.1	2,208.6	2,723.3	2,684.8
(in months of imports of goods and services)	6.2	6.5	4.4	6.1	7.2	7.4	6.7

Source: Data provided by the Maltese authorities.

1/ Includes transportation.

2/ Net portfolio investment flows reflect investments by resident banks in long-term assets, such as bonds and notes. The drop in "other" financial inflows in 2004 was driven by an increase in loans from resident banks to non-residents and by a fall in the repatriation of residents' holdings of foreign currency deposits.

3/ The overall balance figures are not strictly comparable with changes in net official foreign reserves because of exchange rate effects and differences in the timing of valuation.

4/ Includes customers' deposits and sinking funds held with the Central Bank, and other official funds held with the treasury.

Table 5. Malta: Monetary Developments, 1998-2004

	1998	1999	2000	2001	2002	2003	2004
	(In millions of Maltese liri; end of period)						
Central Bank Balance Sheet							
Base money	506.1	543.3	564.5	567.6	617.7	623.3	651.7
Net foreign assets	640.0	740.3	644.1	760.4	880.8	919.8	870.3
Net credit to general government	-23.9	-90.0	-47.0	-63.3	-39	-75	-94
Other items, net	-110.0	-107.0	-32.7	-129.5	-224.5	-221.2	-124.3
Financial Survey							
M3	2,222.6	2,441.8	2,538.9	2,752.9	3,038.1	2,849.0	2,918.3
Net foreign assets	878.4	969.2	970.8	1,083.5	1,293.6	1,416.9	1,445.9
Domestic credit	1,815.8	1,991.0	2,184.2	2,328.3	2,406.1	2,649.0	2,785.0
Net credit to general government	356.0	358.1	411.8	475.1	498.0	568.0	545.0
Credit to the parastatal and private sectors	1,459.8	1,632.9	1,772.4	1,853.2	1,908.2	2,080.0	2,210.0
Other items, net	-471.6	-518.3	-616.1	-658.9	-661.7	-1,216.9	-1,312.6
	(Annual percentage change)						
Base money	4.3	7.3	3.9	0.6	8.8	0.9	4.6
M3 /1	8.6	9.9	4.0	8.4	10.4	2.4	2.4
Domestic credit	10.4	9.6	9.7	6.6	3.3	10.1	5.1
Net credit to general government	10.7	0.6	15.0	15.4	4.8	14.1	-4.0
Credit to the parastatal and private sectors			8.5	4.6	3.0	9.0	6.3
	(In millions of U.S. dollars)						
Net foreign assets	2,567.9	2,352.2	2,475.1	2,877.0	3,552.9	4,124.6	4,510.8
Central Bank	1,961.6	1,552.0	1,737.0	1,948.5	0.0	2,677.6	2,715.1
Other	606.3	800.2	738.1	928.5	3,552.9	1,447.0	1,795.7
	(In percent)						
Interest rates							
7-day reverse repo	5.4	4.7	4.7	4.2	3.7	3.1	3.1
3-month treasury bill	5.5	5.0	4.9	4.5	3.7	2.9	3.0
Average lending rate (weighted)	8.1	7.3	7.2	6.5	6.1	5.3	5.3
Memorandum items: (end of period)							
Exchange rate (US$/Lm)	2.65	2.42	2.28	2.21	2.51	2.91	3.12
CPI inflation	1.3	3.3	1.1	4.6	0.3	2.4	2.8
M3 multiplier	4.4	4.5	4.5	4.8	4.9	4.6	4.5
Velocity	0.6	0.6	0.7	0.6	0.6	0.6	0.6
NFA/Base money	126.4	136.3	114.1	134.0	142.6	147.6	133.5

Sources: Central Bank of Malta; International Monetary Fund, *International Financial Statistics;* and Fund staff estimates.
1/ For comparability, 2003 broad money growth was adjusted for the methodological change in the series in September 2003.

Table 6. Malta: Medium-Term Macroeconomic Outlook

	Est.	Proj. 1/					
	2004	2005	2006	2007	2008	2009	2010
Output and prices							
Real GDP	1.0	1.5	1.8	2.2	2.2	2.2	2.2
Domestic demand	2.3	2.9	0.5	1.2	1.1	1.1	1.0
Private consumption	0.7	1.0	1.4	1.6	1.6	1.6	1.6
Public consumption	0.6	-1.0	-0.1	-0.5	-0.5	-0.5	-0.5
Fixed investment	6.2	7.8	-1.6	0.4	0.4	0.4	0.4
Exports of goods and services	3.2	2.0	3.6	4.1	4.1	4.1	4.1
Imports of goods and services	4.5	3.5	2.0	2.8	2.8	2.8	2.8
GDP deflator	2.0	1.7	2.0	1.7	1.8	1.8	1.8
CPI	2.7	2.4	1.9	2.0	2.0	2.0	2.0
Total employment (per. avg.)	0.7	0.7	1.0	1.0	1.0	1.0	1.0
Unemployment rate (%, per. avg.)	7.3	7.0	6.8	6.5	6.5	6.5	6.5
Fiscal accounts							
Budget deficit	5.2	3.7	2.3	1.4	1.4	1.4	1.4
Revenues 2/	44.0	47.2	44.5	42.9	42.9	42.9	42.9
Expenditures 3/	49.2	50.9	46.8	44.3	44.3	44.3	44.3
Primary balance	-1.3	-0.1	1.3	2.1	2.0	1.9	1.8
Privatization receipts 4/	0.0	2.6	0.0	0.0	0.0	0.0	0.0
Govt. debt excl. privatization receipts	75.6	74.4	72.9	72.8	71.8	70.9	70.2
Government debt	75.6	71.8	70.3	70.2	69.2	68.3	67.5
External accounts							
Current account balance	-10.4	-10.5	-8.6	-7.8	-7.1	-6.2	-5.3
Goods and services (net)	-8.0	-9.4	-8.2	-7.2	-6.2	-5.2	-4.2
Official reserves	46.6	39.3	33.9	31.9	32.3	32.3	32.1
(in months of imports of GNFS)	6.7	5.6	4.9	4.6	4.7	4.7	4.7
Gross external debt	41.2	44.1	46.0	47.5	48.6	49.3	49.7
Memorandum item:							
GDP at current prices (in Lm millions)	1,847.2	1,906.3	1,978.7	2,052.0	2,127.9	2,206.6	2,288.3

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

1/ Staff's projection.
2/ Excluding privatization receipts.
3/ Includes net lending and advances from the Treasury Clearence Fund.
4/ The authorities' projection for 2001 and staff projections for 2002-2004.

Table 7. Malta: Public Sector Debt Sustainability Framework, 1999-2050

(In percent of GDP, unless otherwise indicated)

	Actual						Projections									
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2020	2030	2040	2050
I. Baseline Medium-Term Projections																
1 Public sector debt 1/	57.7	55.5	63.5	63.2	72.7	75.9	74.7	73.2	73.1	71.9	70.9	69.8	59.2	52.5	48.3	43.7
o/w foreign-currency denominated	3.4	2.9	2.7	2.4	3.0	4.2	3.7	3.7	3.8	0.4	0.4	0.4	0.4	0.4	0.4	0.4
2 Change in public sector debt	-0.6	-2.2	8.0	-0.3	9.5	3.1	-1.2	-1.5	-0.1	-1.1	-1.1	-1.1	-0.9	-0.5	-0.4	-0.5
3 Identified debt-creating flows (4+7+12)	-0.6	-2.7	4.4	1.3	3.6	0.8	-0.6	-0.2	-1.0	-1.1	-1.1	-1.1	-0.9	-0.5	-0.4	-0.5
4 Primary deficit	4.4	1.8	1.6	1.4	2.4	1.3	-0.2	-1.5	-2.3	-2.2	-2.2	-2.1	-1.6	-1.1	-1.0	-1.0
5 Revenue and grants	38.6	37.1	39.6	41.4	41.2	44.0	47.2	45.9	44.4	44.4	44.4	44.4	44.4	44.4	44.4	44.4
6 Primary (noninterest) expenditure	43.0	38.9	41.2	42.7	43.6	45.3	47.0	44.5	42.1	42.2	42.2	42.3	42.8	43.3	43.4	43.4
7 Automatic debt dynamics 2/	0.0	-3.8	2.8	1.5	1.2	1.3	2.2	1.3	1.3	1.1	1.1	1.1	0.7	0.7	0.6	0.5
8 Contribution from interest rate/growth differential 3/	-0.3	-4.0	2.7	1.8	1.6	1.6	1.6	1.3	1.3	1.1	1.1	1.1	0.7	0.7	0.6	0.5
9 Of which contribution from real interest rate	1.9	1.0	1.8	3.2	0.5	2.7	2.7	2.6	2.9	2.7	2.6	2.6	2.2	1.9	1.8	1.6
10 Of which contribution from real GDP growth	-2.2	-5.0	0.9	-1.4	1.1	-1.1	-1.1	-1.3	-1.6	-1.5	-1.5	-1.5	-1.4	-1.3	-1.2	-1.1
11 Contribution from exchange rate depreciation 4/	0.3	0.2	0.1	-0.3	-0.4	-0.3	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
12 Other identified debt-creating flows	-5.0	-0.7	0.0	-1.6	0.0	-1.9	-2.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
13 Privatization receipts (negative)	-5.0	-0.7	0.0	-1.6	0.0	-1.9	-2.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	0.1	0.5	3.6	-1.6	5.9	2.4	-0.6	-1.3	0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Dependency ratio						0.29						0.35	0.44	0.47		0.57
Public sector debt-to-revenue ratio 1/	149.4	149.8	160.5	152.9	176.4	172.3	158.1	159.3	164.6	162.1	159.6	157.2	133.3	118.2	108.9	98.4
Gross financing need 5/	16.8	14.9	18.5	18.1	20.8	20.8	22.4	20.8	19.6	19.6	19.3	19.0	16.4	14.8	13.7	12.4
in billions of U.S. dollars	0.6	0.6	0.7	0.7	1.0	1.1	1.2	1.1	1.1	1.2	1.2	1.2	1.6	2.2	3.1	4.3
Key Macroeconomic and Fiscal Assumptions																
Real GDP growth (in percent)	4.1	9.9	-1.7	2.2	-1.8	1.5	1.5	1.8	2.2	2.2	2.2	2.2	2.5	2.5	2.5	2.5
Average nominal interest rate on public debt (in percent) 6/	6.3	6.5	6.3	5.9	5.7	5.3	5.4	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.6	5.6
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.6	2.4	3.2	5.1	0.8	3.8	3.7	3.6	4.1	3.8	3.8	3.8	3.8	3.8	3.8	3.8
Nominal appreciation (increase in US dollar value of local currency, in percent)	-8.4	-5.9	-3.2	13.3	16.4	7.5	-12.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	2.7	4.1	3.2	0.8	4.9	1.5	1.7	2.0	1.5	1.8	1.8	1.8	1.8	1.8	1.8	1.8
Growth of real primary spending (deflated by GDP deflator, in percent)	-0.6	-0.5	3.9	6.1	0.2	5.6	5.3	-3.8	-3.2	2.3	2.3	2.3	2.6	2.6	2.5	2.5
II. Stress Tests for Public Debt Ratio																
1. No fiscal consolidation: Real GDP growth, real interest rate, and primary balance at historical averages.						**74.9**	**74.7**	**75.8**	**79.1**	**81.6**	**84.1**	**86.6**	**113.2**	**142.5**	**174.8**	**210.4**
2. Real interest rate is at historical average plus two standard deviations in 2005 and 2006						**75.9**	**76.6**	**77.1**	**77.1**	**76.0**	**75.0**	**74.0**	**63.9**	**57.8**	**54.4**	**50.5**
3. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006						**75.9**	**82.0**	**88.8**	**88.5**	**87.1**	**85.8**	**84.5**	**71.7**	**63.6**	**58.7**	**53.1**
4. Primary balance is at historical average minus two standard deviations in 2005 and 2006						**75.9**	**77.4**	**80.0**	**80.0**	**79.0**	**78.0**	**77.1**	**67.4**	**61.7**	**58.8**	**55.5**
5. Combination of 2-4 using one standard deviation shocks						**76.4**	**81.6**	**88.5**	**88.5**	**87.4**	**86.4**	**85.3**	**74.9**	**68.9**	**65.9**	**62.6**
6. One time 30 percent real depreciation in 2005 7/						**75.9**	**76.0**	**74.5**	**74.4**	**73.3**	**72.3**	**71.2**	**60.8**	**54.3**	**50.4**	**46.0**
7. 10 percent of GDP increase in other debt-creating flows in 2005						**75.9**	**84.7**	**83.3**	**83.4**	**82.5**	**81.5**	**80.6**	**71.4**	**66.3**	**64.0**	**61.4**
8. Fiscal consolidation without pension reform						**75.9**	**74.7**	**73.2**	**73.1**	**72.0**	**71.2**	**70.4**	**68.8**	**81.8**	**99.2**	**113.1**
9. No fiscal consolidation and no pension reform						**74.9**	**74.7**	**75.8**	**79.1**	**81.7**	**84.5**	**87.5**	**127.4**	**186.1**	**253.3**	**321.8**
Historical Statistics for Key Variables (past 10 years)	Historical Average		Standard Deviation			**Average 2005-10**										
Primary deficit	1.7		0.4			**-1.7**										
Real GDP growth (in percent)	2.0		4.8			**2.0**										
Nominal interest rate (in percent) 6/	6.0		0.5			**5.6**										
Real interest rate (in percent)	3.1		1.6			**3.8**										
Inflation rate (GDP deflator, in percent)	2.9		1.7			**1.7**										
Revenue to GDP ratio	40.7		2.6			**45.1**										

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 8. Malta: Indicators of External and Banking Sector Vulnerability, 1999-2004
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002	2003	2004	Latest Data	*Date*
Financial indicators								
Government debt	60.8	57.0	63.5	63.2	72.7	75.9	75.9	*Dec. 04*
Broad money (percent change, 12-month basis)	9.9	4.0	8.4	10.4	2.4	2.4	-0.2	*Apr. 05*
Private sector credit (percent change, 12 month basis) 1/	11.9	8.5	4.6	3.0	9.0	6.3	7.1	*Apr. 05*
Three month T-bill yield	5.0	4.9	4.5	3.7	2.9	3.0	3.2	*Apr. 05*
Three month T-bill yield (deflated by 12-mth CPI, e.o.p.)	1.6	3.7	-0.1	3.3	0.5	0.2	0.4	*Apr. 05*
Change in Stock Market Index (in percent, 12-month)	170.7	3.0	-34.8	-15.0	13.6	44.4	31.6	*Apr. 05*
Financial soundness indicators								
Nonperforming loans to gross loans (domestic banks)	13.0	13.5	17.0	15.5	12.7	10.5	10.8	*Mar. 05*
Nonperforming loans to gross loans (all banks, excl. branches)	...	...	...	13.4	11.1	9.1	9.3	*Mar. 05*
Return on equity (domestic banks)	...	9.7	9.4	8.7	8.9	14.7	18.0	*Mar. 05*
Return on assets (domestic banks)	...	0.7	0.8	0.7	0.9	1.5	1.6	*Mar. 05*
Capital to risk-weighted assets (domestic banks)	14.3	16.0	16.1	16.3	17.8	19.1	17.5	*Mar. 05*
Capital to risk-weighted assets (all banks)	16.5	17.1	17.4	18.7	19.7	21.4	19.1	*Mar. 05*
Interest margin to gross income (domestic banks)	68.2	69.4	70.4	69.8	72.6	66.8	68.9	*Mar. 05*
Interest margin to gross income (all banks)	70.0	83.0	67.0	71.2	70.9	45.7	56.5	*Mar. 05*
Non-interest expenses to gross income (domestic banks)	60.0	59.9	59.8	69.8	56.6	46.9	42.6	*Mar. 05*
Non-interest expenses to gross income (all banks) 2/	57.1	58.7	21.2	68.9	57.8	46.9	36.2	*Mar. 05*
Personnel expenses to non-interest expenses (domestic banks)	59.8	60.6	57.5	47.6	56.8	58.3	58.6	*Mar. 05*
Personnel expenses to non-interest expenses (all banks) 2/	3.8	3.4	19.5	30.8	34.9	38.8	49.4	*Mar. 05*
Liquid assets to total assets (domestic banks)	22.9	20.6	25.0	22.7	20.4	21.0	20.6	*Mar. 05*
Liquid assets to total assets (all banks)	23.3	20.8	27.6	24.5	24.4	24.3	23.9	*Mar. 05*
Liquid assets to short-term liabilities (domestic banks)	41.1	36.6	46.6	48.9	47.8	46.6	45.8	*Mar. 05*
Liquid assets to short-term liabilities (all banks)	48.0	46.0	59.5	54.7	55.8	45.5	52.9	*Mar. 05*
Sectoral loan concentration of selected sectors (percent of total)								
Manufacturing 3/	12.5	11.6	10.8	10	7.9	5.9	5.5	*Mar. 05*
Building and construction 3/	5.9	5.7	4.5	4.7	8.6	8.3	8.2	*Mar. 05*
Tourism 3/	13.2	13.6	13	13.3	8.9	7.9	8.2	*Mar. 05*
Trade 3/	17.4	16.7	15.9	15.5	12.3	11.2	11.3	*Mar. 05*
Personal loans 3/	21.7	22.1	24.5	27.2	26.1	27.6	28.5	*Mar. 05*
Coverage ratio (domestic banks)	...	...	...	19.1	23.2	25.4	24.3	*Mar. 05*
Loans in foreign currency to total loans (domestic banks)	...	...	...	16.1	18.3	22.8	21.8	*Mar. 05*
External Indicators								
Exports of G&NFS (percent change, average in US$)	7.8	11.0	-13.5	10.9	9.3	6.8	6.8	*Dec. 04*
Imports of G&NFS(percent change, average in US$)	6.9	15.8	-16.8	3.0	18.4	10.4	10.4	*Dec. 04*
Current account balance	-3.4	-12.6	-4.4	0.3	-5.8	-10.4	-10.4	*Dec. 04*
Capital and financial account balance	12.5	5.9	3.9	5.1	3.6	2.0	2.0	*Dec. 04*
o/w: Inward portfolio investment (debt securities etc.)	-13.8	-19.5	-13.0	-9.2	-32.2	-31.3	-31.3	*Dec. 04*
Other investment (loans, trade credits etc.)	3.5	9.2	10.5	24.4	29.8	24.5	24.5	*Dec. 04*
Inward foreign direct investment	22.1	15.7	6.3	-10.4	5.8	7.5	7.5	*Dec. 04*
External government loans	3.0	2.4	2.4	2.6	4.0	3.7	3.7	*Dec. 04*
Gross official reserves (in US$ millions; e.o.p.)	1,794	1,471	1,682	2,209	2,723	2,685	2,324	*May 05*
Official reserves in months of imports GNFS	6.3	4.4	6.1	7.2	7.4	6.7	6.7	*Dec. 04*
Ratio of foreign reserves to Base Money (%)	136.3	114.1	134.0	142.6	150.1	132.1	117.3	*May 05*
Ratio of foreign reserves to Broad Money(%)	30.3	25.2	27.6	28.8	32.8	29.8	27.5	*Apr. 05*
Exchange rate (per US$, period average)	2.50	2.29	2.22	2.31	2.65	2.87	2.87	*Dec. 04*
Exchange rate (per US$, end of period)	2.42	2.28	2.21	2.51	2.91	3.12	2.87	*May 05*
REER appreciation (+) (e.o.p. basis)	0.9	1.7	1.6	-0.1	-1.8	1.1	1.1	*Dec. 04*

Sources: Central Bank of Malta; Central Office of Statistics; International Monetary Fund; staff estimates and projections.

1/ Claims on private sector have been replaced with claims on private and parastatal sector due to a change in methodology.

2/ Data through 2001 refer to international banks only.

3/ Domestic banks.

Table 9. Malta: Overview of Interim Progress in Implementing Selected FSAP Recommendations

Area	Recommendation	Result
Transparency	Clarification of roles between the Central Bank of Malta and the Malta Financial Services Authority.	In addition to the MoU on the exchange of information in the field of financial services signed in February 2003, another MoU on co-operation with respect to payment and securities settlement systems was signed in May 2003. Both MoUs have been placed on the CBM's and MFSA's respective websites.
	Publication of Code of Ethics.	A revised Code of Ethics has been drawn up and placed on CBM's website in August 2004. In considering the implementation of other observations made for the inclusion of internal control and corporate governance issues, there is a review to include these and the Code of Ethics in one document.
Financial Sustainability	Improved stress-testing of the banking system.	The authorities continued to develop their stress-testing exercises particularly to include macro-stress testing. The Office has also continued with discussions with the banks in conjunction with their development of internal stress testing exercises in view of Basle II.
Payment System	Establishment of an oversight function of payment systems.	The oversight function has been established within Payment Systems Office. A high level Oversight Policy Document has been posted on the CBM website.
	Criteria to establish whether a payment system is an important one.	Established under the Oversight Policy Document.
	Adoption of a Delivery versus Payment (DvP) system.	Legal Notice 287 of 2004 issued in terms of the Financial Markets Act, Cap345, introduces the DvP concept.
Financial Markets	Phasing-out of Bank's security pricing policy.	Partly implemented.
Economics and Research	Publish a real estate price index.	In its Quarterly Reviews 2004:4 and 2005:1, the Central Bank published its studies on the revised house price index. Further refinements are ongoing in cooperation with the National Statistics Office (NSO).
Economic Intelligence Analysis Unit	Full customer identification procedures for all types of customers.	Implemented in August 2003 -- Legal Notice 199 -- transposing the EU Second AML Directive.
Banking	Recalculation of loan loss reserves, earnings and capital in respect of misclassified assets.	Credit Portfolio on-site examination reports have been enhanced to include a specific section accordingly.
	Clarification regarding the definition of connected persons.	Issued Banking Directive BD/11 on arms' length principle.

Source: Discussions with the authorities.

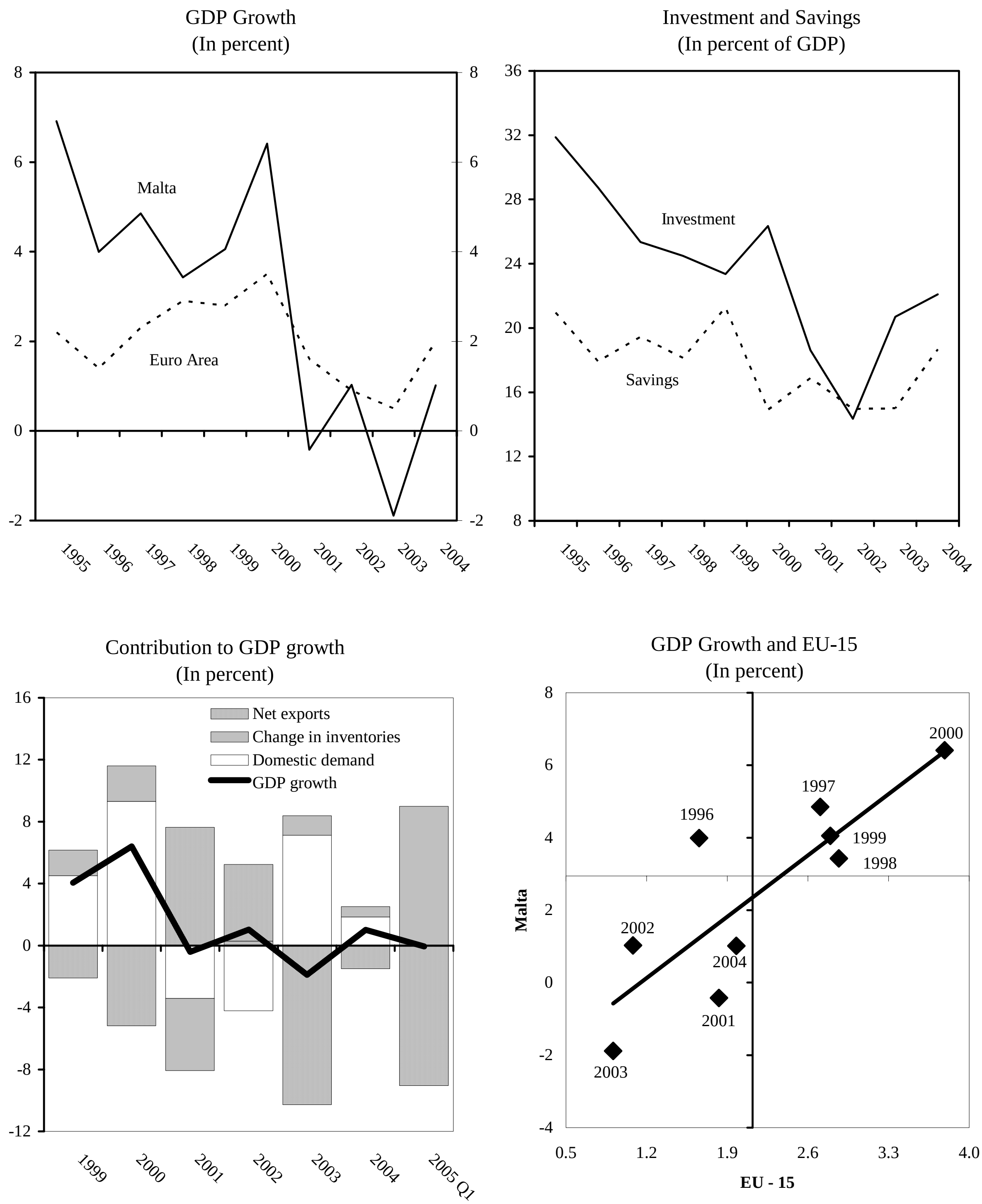
Table 10. Malta: Summary Balance of Payments, 2003-10

	2003	2004	2005	2006	2007	2008	2009	2010
				(In millions of Maltese liri)				
Trade balance	-263.2	-304.0	-336.3	-331.4	-329.5	-327.0	-323.8	-319.9
Exports, f.o.b.	942.1	918.9	919.0	960.3	1,003.5	1,048.7	1,095.9	1,145.2
Imports, f.o.b.	-1,205.3	-1,222.9	-1,255.3	-1,291.7	-1,333.0	-1,375.7	-1,419.7	-1,465.1
Balance on services	164.9	155.7	157.0	169.6	181.8	194.8	208.4	222.9
Exports	477.5	481.7	501.0	523.5	547.1	571.7	597.4	624.3
Imports	-312.6	-326.0	-343.9	-353.9	-365.2	-376.9	-389.0	-401.4
Investment income, net	15.4	-17.1	1.3	-0.3	-2.1	-3.9	-5.7	-7.6
Unrequited transfers, net	-20.4	-25.9	-22.0	-7.5	-11.0	-14.2	-16.7	-16.8
Private	-14.8	-19.8	-30.9	107.8	123.6	136.0	122.0	118.1
Public	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current account balance	-103.3	-191.3	-200.0	-169.6	-160.7	-150.2	-137.8	-121.5
Capital account, net	2.4	25.3	58.0	60.0	31.8	38.8	47.7	53.1
Financial account, net	61.4	12.5	31.1	31.0	112.5	144.0	116.1	89.7
Direct investment	103.7	137.6	120.0	120.0	130.0	140.0	150.0	150.0
Portfolio investment	-576.8	-577.7	-295.6	-336.4	-355.6	-360.1	-380.2	-411.8
Other	534.4	452.5	206.7	247.3	338.1	364.1	346.3	351.5
Errors and omissions	94.3	84.1	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance 1/	54.7	-69.5	-110.9	-78.7	-16.5	32.6	26.0	21.3
				(In percent of GDP)				
Current account balance	-5.8	-10.4	-10.5	-8.6	-7.8	-7.1	-6.2	-5.3
Merchandise	-14.7	-16.5	-17.6	-16.7	-16.1	-15.4	-14.7	-14.0
Services	9.2	8.4	8.2	8.6	8.9	9.2	9.4	9.7
Investment income	0.9	-0.9	0.1	0.0	-0.1	-0.2	-0.3	-0.3
Transfers	-1.5	-1.8	-1.3	-0.4	-0.6	-0.8	-0.9	-0.9

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

1/ The overall balance figures are not strictly comparable with changes in net official foreign reserves because of exchange rate effects and differences in the timing of valuation.

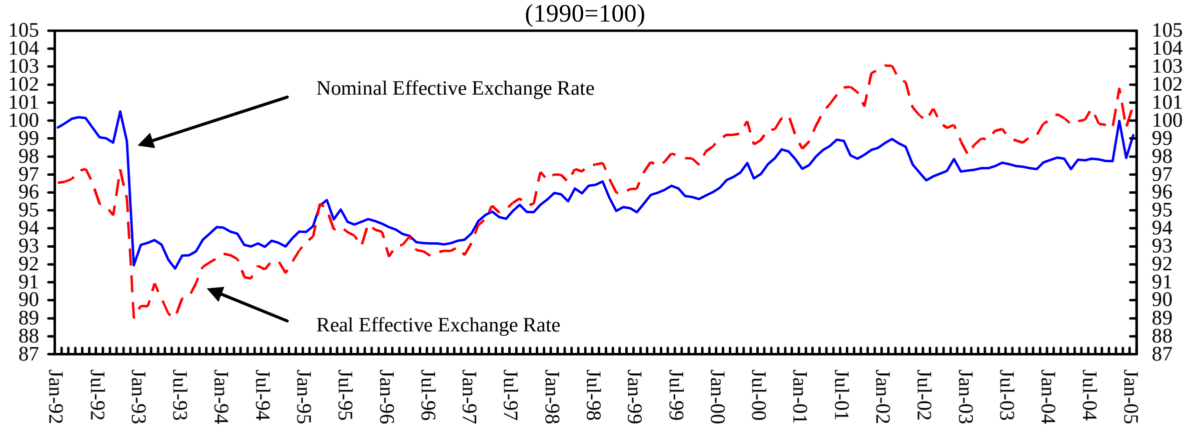
Figure 1. Malta: Main Developments, 1995-2004



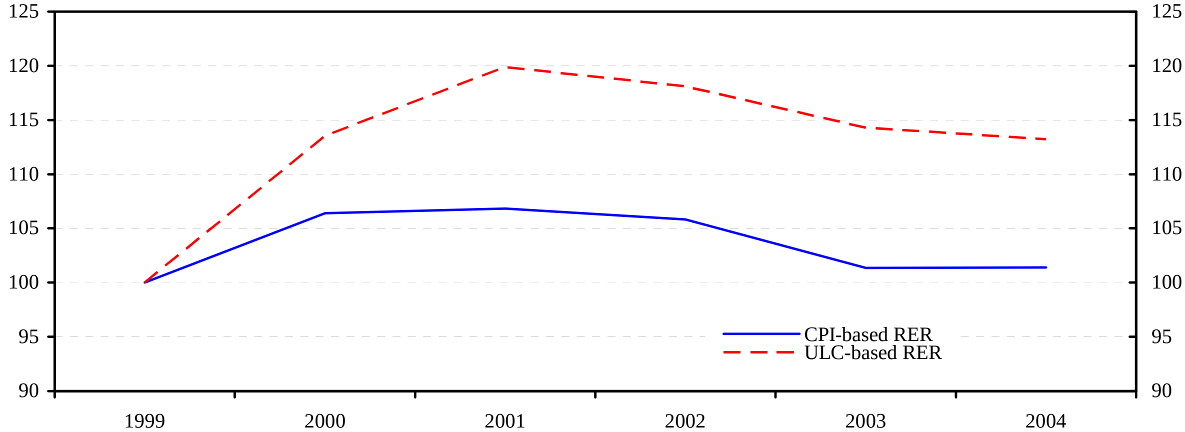
Source: National Statistics Office, Eurostat and IMF staff estimates.

Figure 2. Malta: Competitiveness Indicators

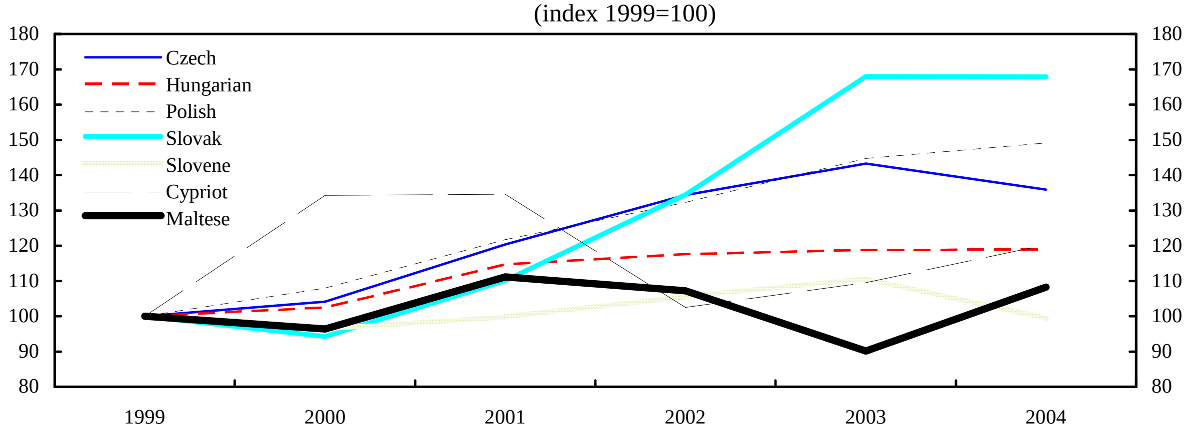
Nominal and Real Effective Exchange Rates, 1992-2005
(1990=100)



Real Exchange Rate Measures (Malta versus the Euro area 1999=100)

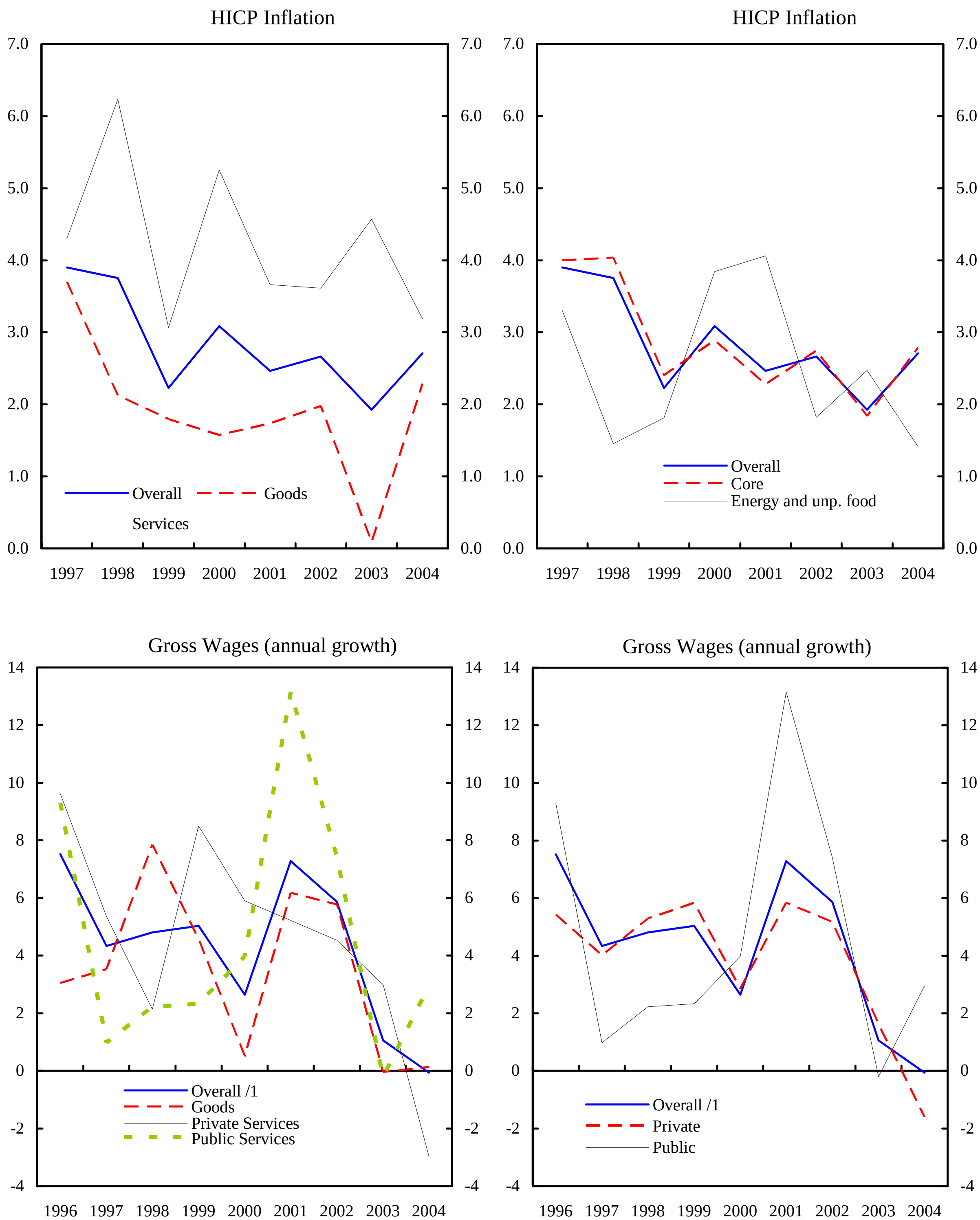


Exports to EU-15 as share of total EU-15 imports
(index 1999=100)



Source: Eurostat and IMF staff calculations.

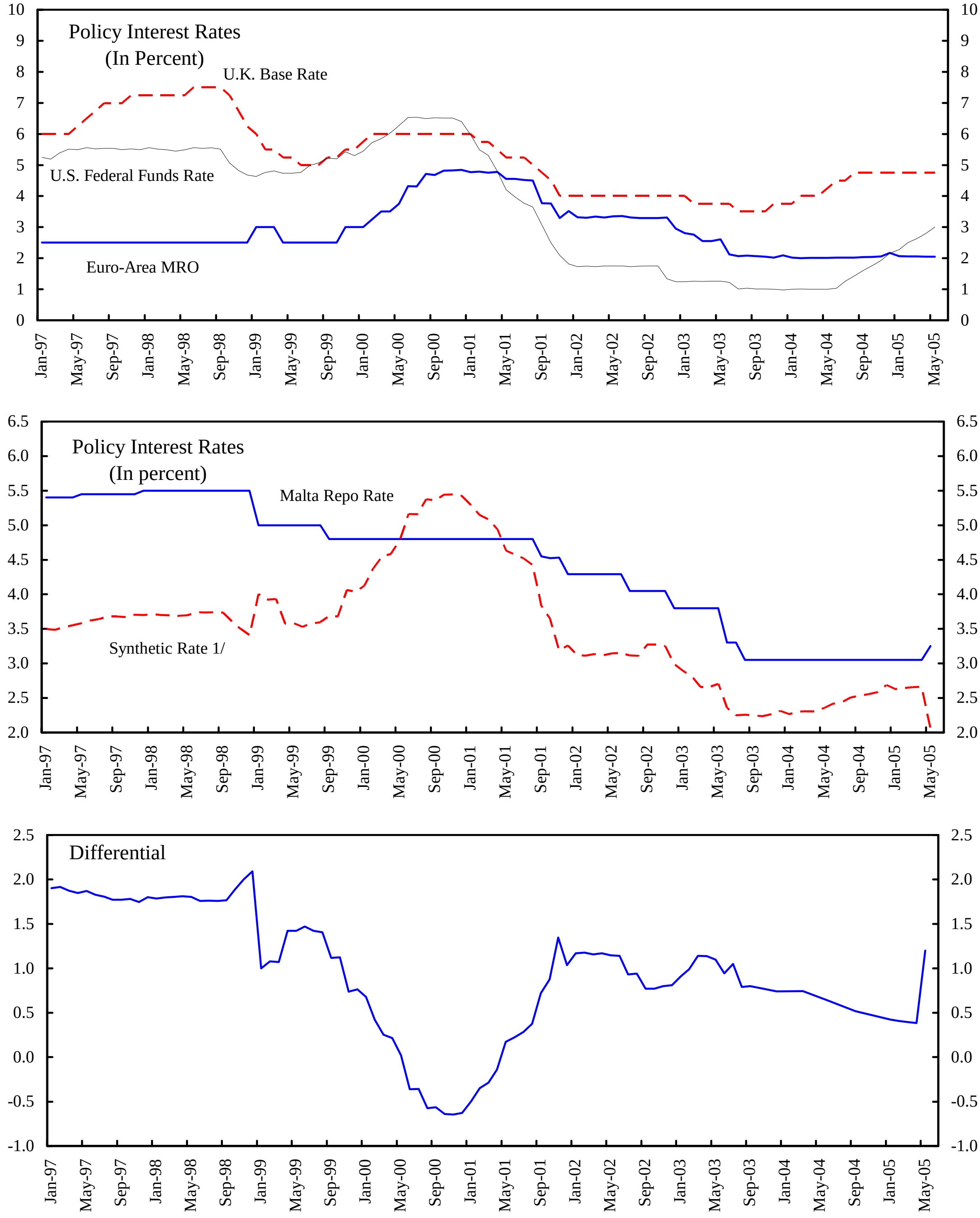
Figure 3. Malta: Inflation and Gross Wages



Source: Eurostat and National Statistics Office - Malta

1/ It excludes Agricultural and Fishing sectors

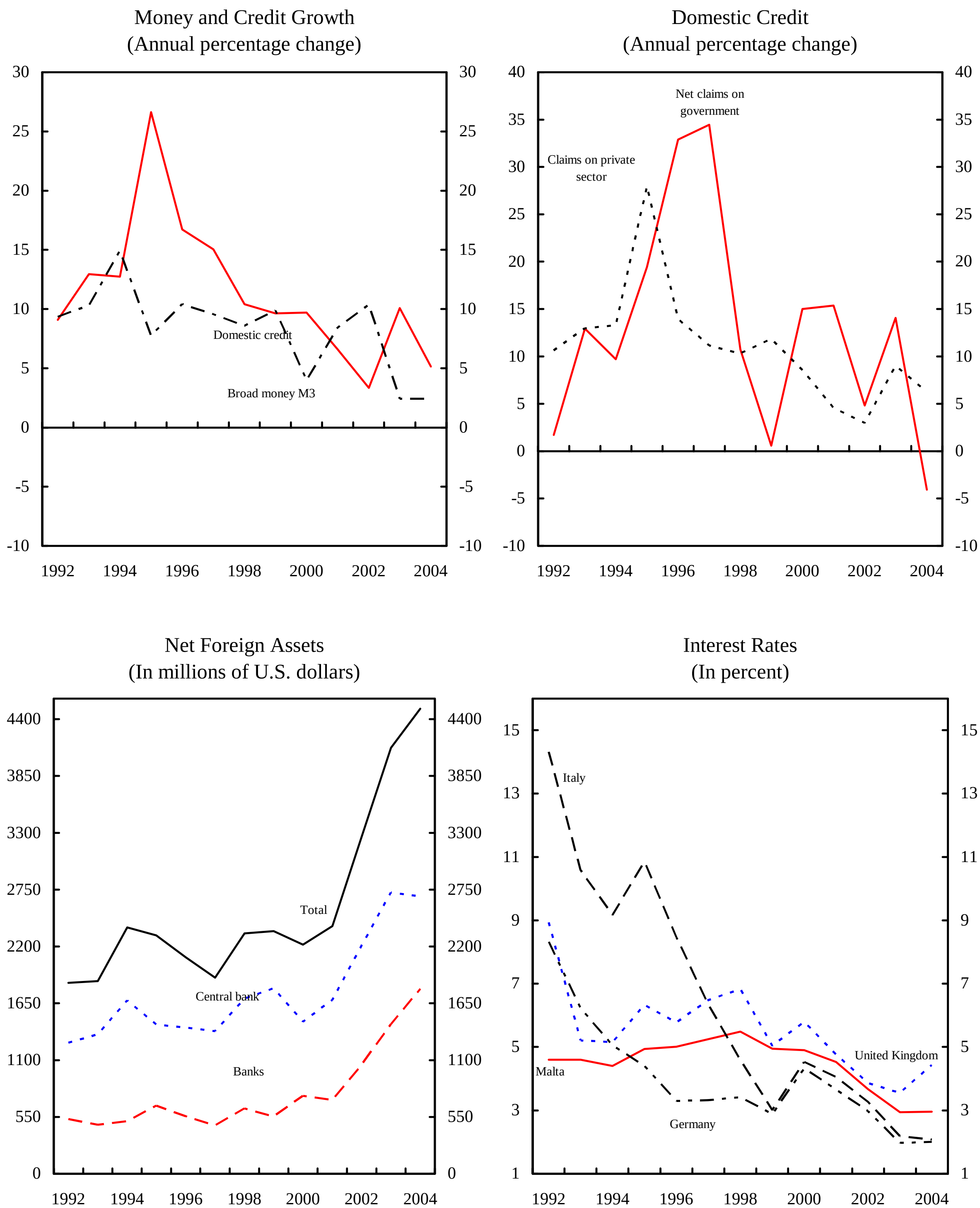
Figure 4. Malta: Interest Rates, 1997-2005



Sources: Data provided by the Maltese authorities; IMF, *International Financial Statistics*; and Fund staff estimates.

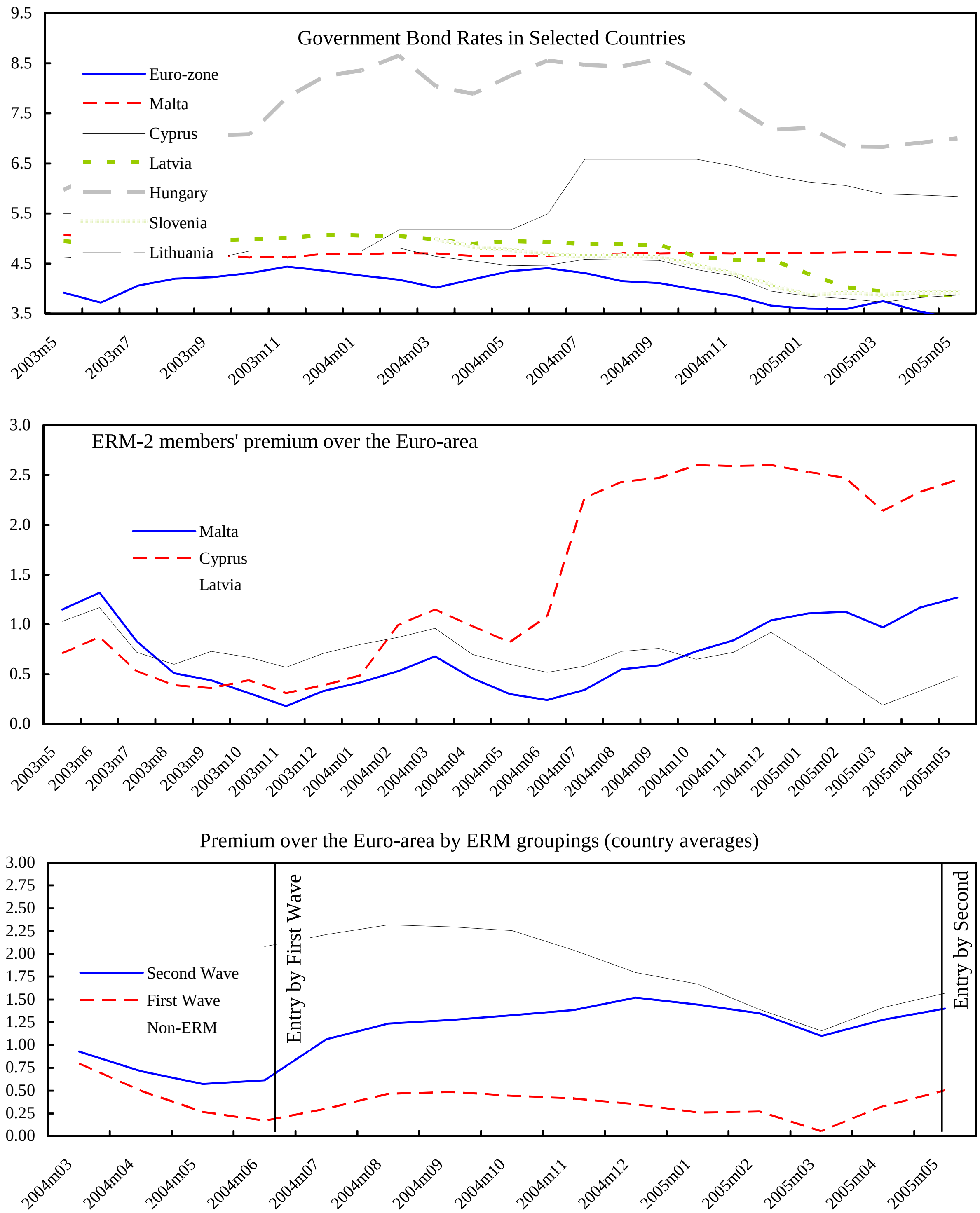
1/ The weighted average of the U.K. base rate, U.S. federal funds rate and the euro-area MRO rate according to Malta's currency basket.

Figure 5. Malta: Monetary Sector Developments, 1992-2004



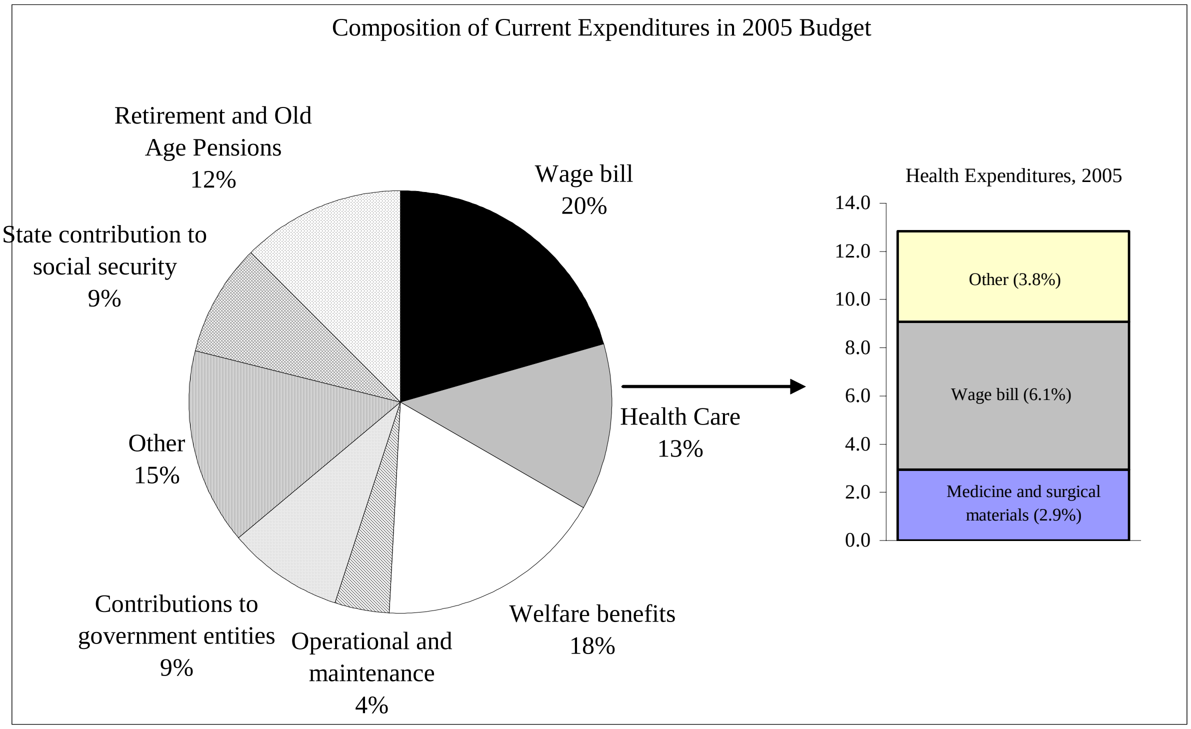
Sources: Data provided by the Maltese authorities; IMF, *International Financial Statistics*.

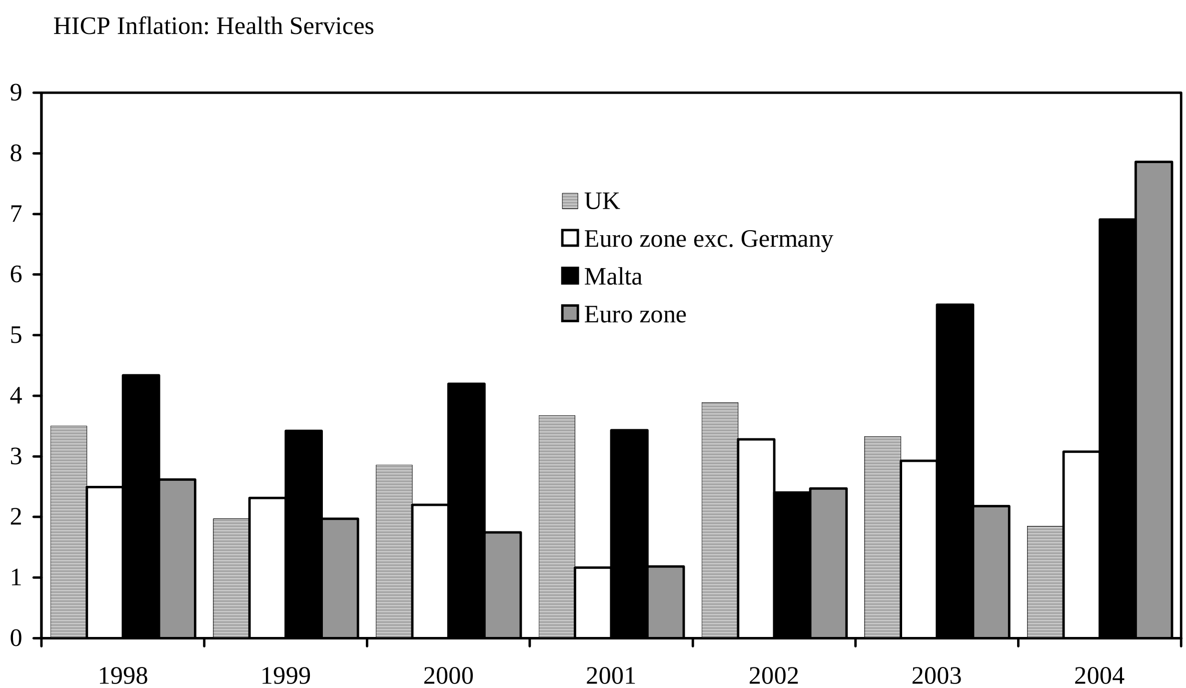
Figure 6. Malta: 10-year Interest Rates in New EU Countries



Source: Eurostat and Fund staff calculations.

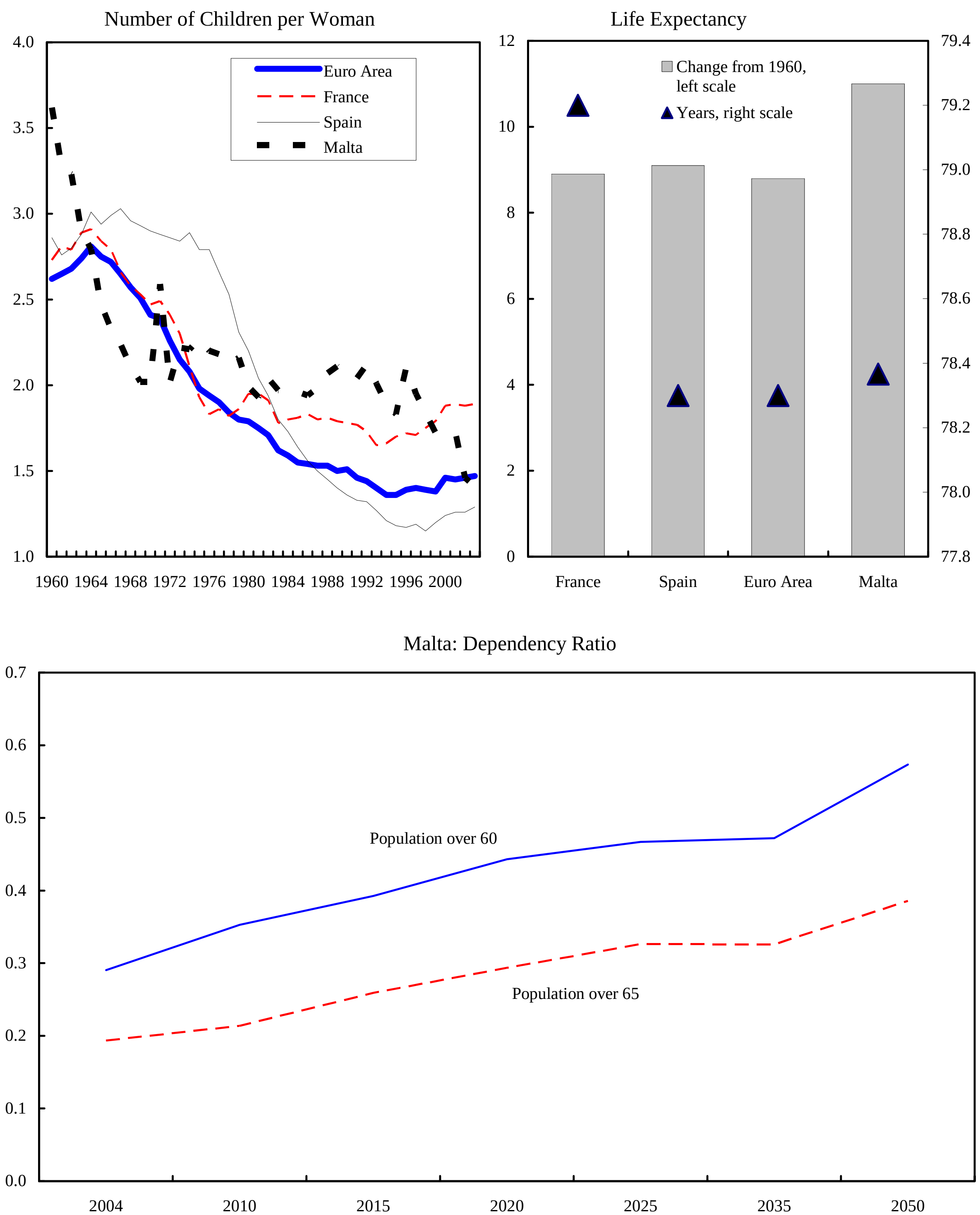
Figure 7. Malta: Current Expenditures Indicators





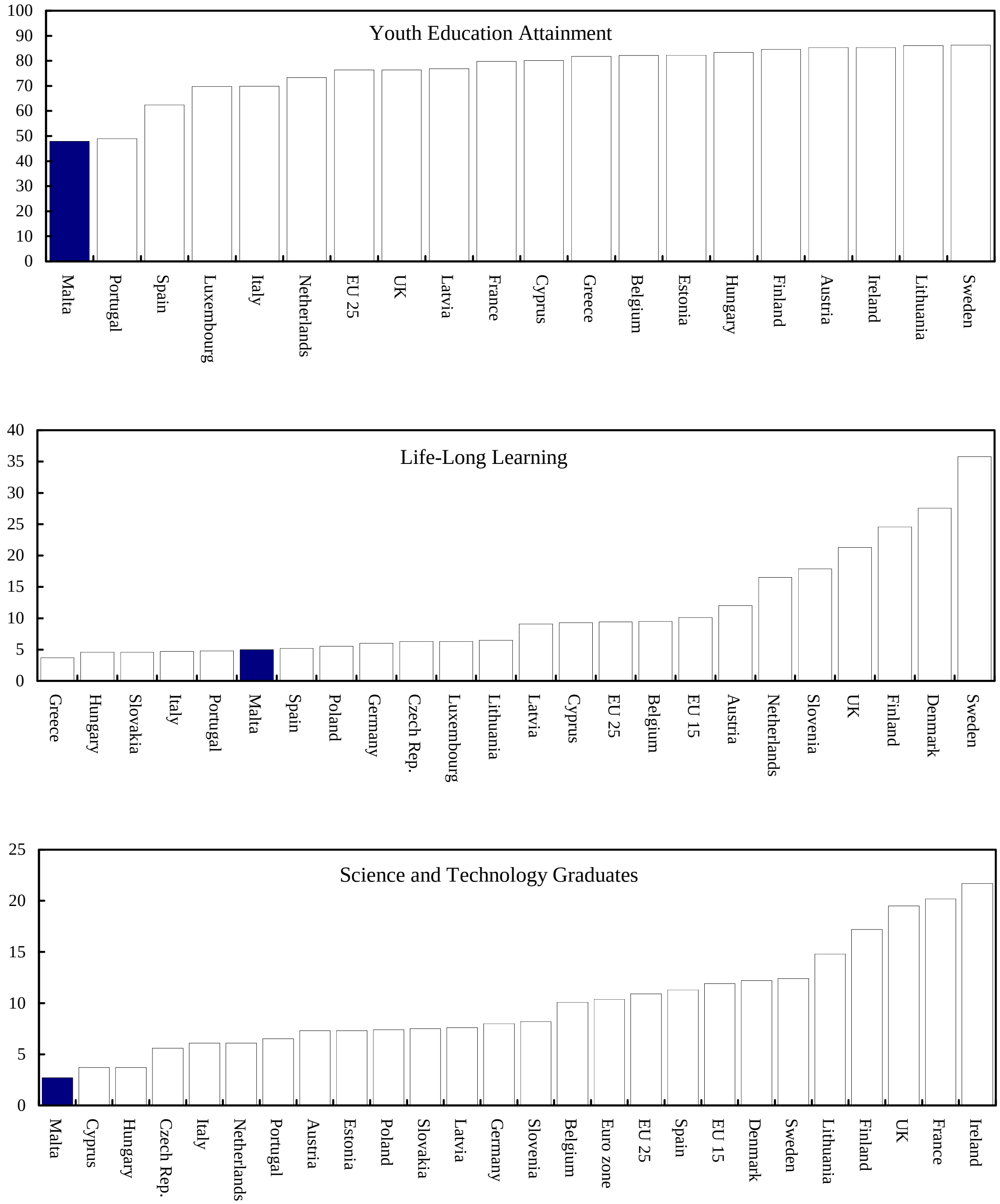
Source: Eurostat, 2005 Budget Speech and National Statistic Office

Figure 8. Malta and EU Demographic Indicators



Source: Eurostat and National Statistical Office - Malta

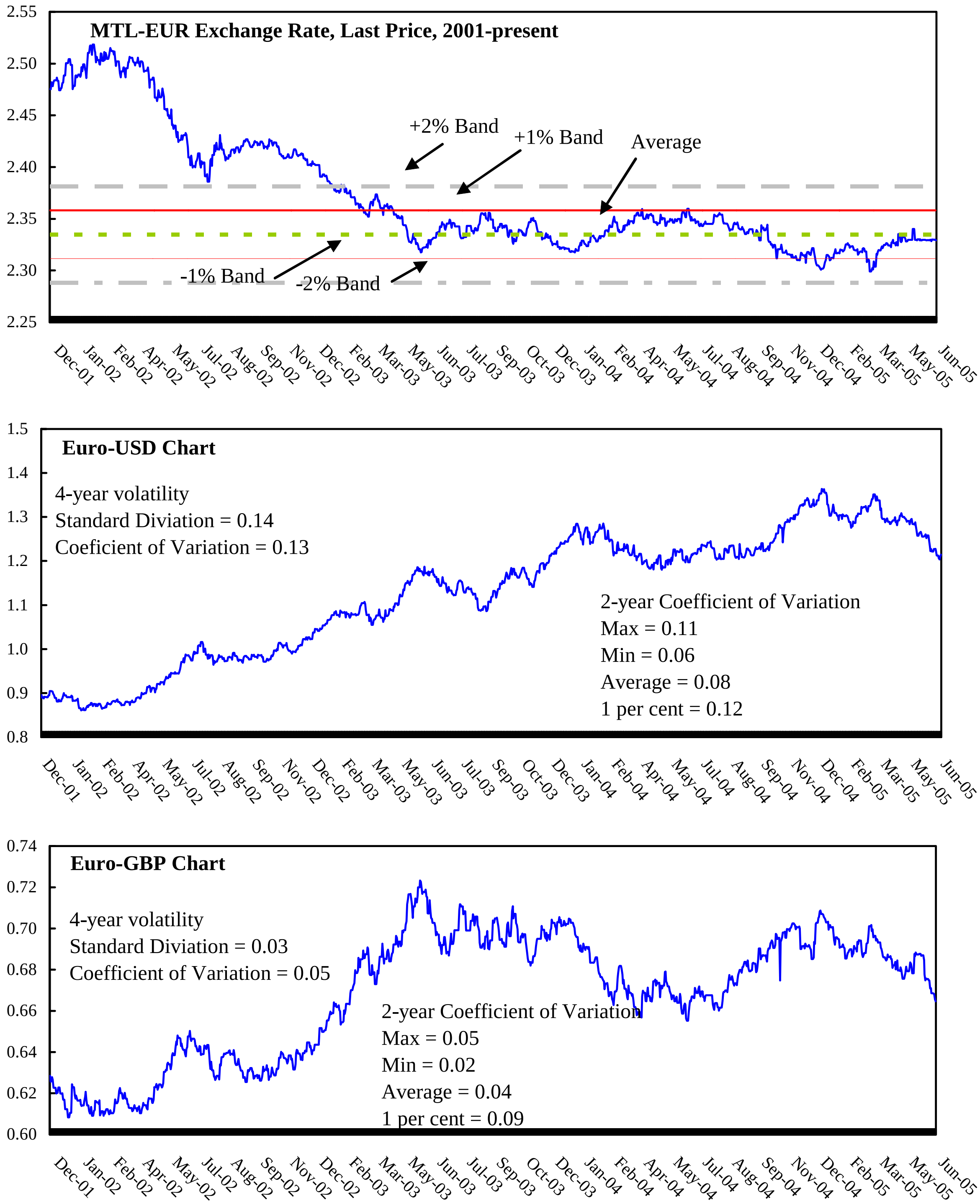
Figure 9. Malta and EU Human Capital Indicators



Source: Eurostat

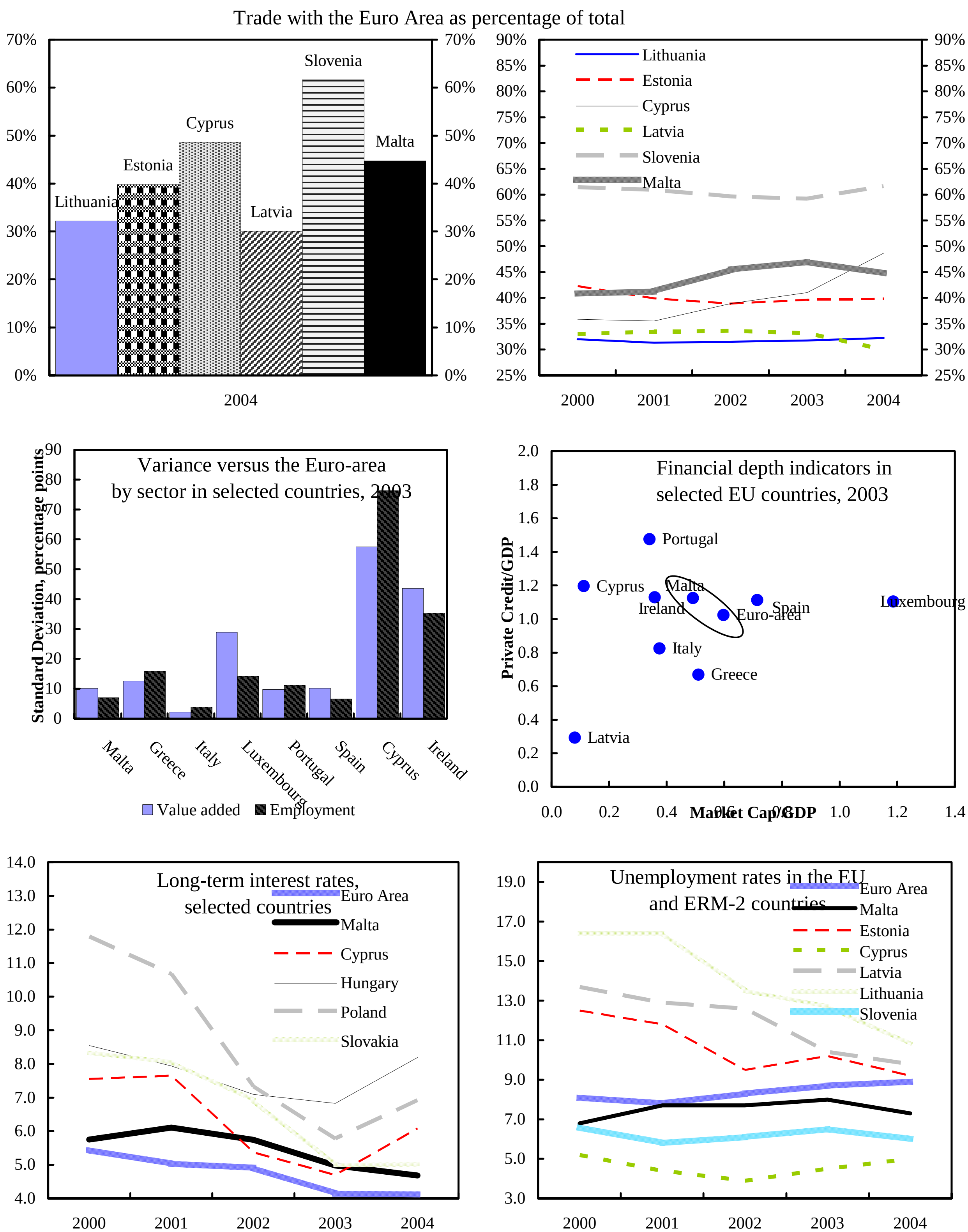
Note: Youth education attainment is defined as the percentage of young people aged 20-24 years having attained at least upper secondary education attainment level; life-long learning refers to persons aged 25 to 64 who stated that they received education or training in the four weeks preceding the survey (numerator); and science and technology graduates includes new tertiary graduates in a calendar year from both public and private institutions completing graduate and post graduate studies compared to an age group that corresponds to the typical graduation age.

Figure 10. Malta: Selected Currency Indicators



Source: Bloomberg, IMF Staff Calculations

Figure 11. Malta's EU Synergies



Source: Eurostat; IMF Direction of Trade Database; staff calculations.

Statement by the IMF Staff Representative
October 14, 2005

1. **This statement provides an update on recent developments since the staff report for the 2005 Article IV consultation with Malta was issued**. The new information does not change the thrust of the staff appraisal.

2. **Economic indicators for the second quarter of 2005 point to subdued economic growth**. The evolution of output is consistent with growth lingering below 2 percent in 2005. Domestic demand advanced moderately as the weakness in private consumption was offset by a sharp increase in investment (inventory accumulation), which expanded by 8.2 percent (y-o-y) in the second quarter. The summer tourism season finished strong in August—hotel occupancy rates were high although prices were weak. An uptick in manufacturing appears underway, but semi-conductors prices continued to be soft. Inflation was subdued through August, and will likely remain so if the landmark six-year collective agreement is reached. So far, the impact of oil prices has been moderate due to the averaging effect of the quarterly adjustment mechanism for domestic petrol prices.

3. **The outturn of general government accounts through August remains broadly consistent with the nominal budget target**. Revenue collection has been boosted by the strength in nontax revenue—foreign grants associated with the Italian Protocol and EU funds—that has more than offset the weakness in tax revenue. Expenditures have reflected one-off outlays on medical equipment, which have been countered by lower debt service payments and capital expenditures. In preparation for the 2006 budget, the authorities have issued an innovative White Paper on fiscal policy covering a five-year timeframe (2006–10). The paper envisages the fiscal deficit to decline to less than 1½ percent of GDP by 2007, and proposes a host of measures, including redeploying redundant public sector employees to the private sector, and establishing means testing to determine eligibility for social benefits. On pension reform, the authorities are considering the recommendations of the working group.

4. **The current account deficit fell to 9 percent of GDP in the second quarter, a narrowing of 2 percent of GDP from the previous quarter**. A weak recovery in exports of goods—primarily semiconductors—was accompanied by robust import growth. Increases in service exports marked the beginning of the high tourism season, but was constrained by near-full capacity operation in the tourist sector. Caution is needed in interpreting developments in service exports, however, as the positive errors and omissions reflect the difficulties in fully capturing this expanding sector.

5. **The Central Bank of Malta has kept interest rates unchanged since April noting increases in international reserves since ERM-2 entry and subdued inflationary pressures**. The evolution of reserves validates the authorities' ERM-2 strategy and provides reasonable assurance that markets have judged the interest rate premium on the Maltese lira as being appropriate. Developments in monetary aggregates continue to reflect the reallocation of portfolios toward government securities and longer-term deposits, which are

not part of M3. Overall domestic credit growth has been weak, but credit to the private sector continued to growth appreciably—almost 7 percent in the 12 months to August—reflecting a buoyant mortgage market.

Statement by Arrigo Sadun, Exeucitve Director for Malta and Lucio Landi, Advisor to Executive Director October 14, 2005

Introduction

The Maltese authorities would like to express their deep appreciation to Mr. Hoffmaister and his team for the constructive discussions held in the capital and for the well-balanced Staff Report. The authorities are in broad agreement with the staff's main conclusions. Over the past few years the policy dialogue with staff has been very fruitful and staff's recommendations have been broadly implemented, as Box 1 in the paper clearly recognizes.

Recent macroeconomic developments and outlook

Malta has adopted a totally liberalized trade and capital regime and implemented a bold program of reforms to strengthen the market infrastructure, following membership in the European Union in May 2004. The aim of these policies is to enable the economy to take full advantage of the European Union membership. However, as a result of these more open policies, the Maltese economy is more exposed to external developments.

The Maltese economy is projected to grow by 1 percent in 2005, roughly the same rate as that recorded in 2004. This growth rate remains below potential and mainly reflects the persistent weakness in external demand for manufactured goods, particularly electronic components, and tourism. The main factor driving economic growth this year is thus expected to be investment, in both the public and private sectors.

Higher imports of capital equipment and consumer goods, the latter reflecting an ongoing shift in household consumption patterns following total trade liberalization in 2004, are expected to result in a worsening of the external account, especially as exports of goods and services continue to experience only minimal growth at best. Consequently the current account deficit as a percentage of GDP is now expected to exceed 8 percent this year. The capital and financial account, on the other hand, should register a significant surplus underpinned by inflows of foreign direct investment and capital transfers, particularly from the EU.

With regard to inflation, the generally slow pace of the economy is expected to dampen inflationary pressure. However, inflation is expected to remain above the 2 percent level as a result of higher energy prices. Concerning the situation of the labor market, wage increases should remain moderate, while a slight reduction in the unemployment rate is expected as investment continues to pick up in light of the industrial restructuring program and ongoing infrastructure projects.[1]

[1] In the first quarter of 2005 the unemployment rate stood at 6.7 percent, compared with 7.2 in the first quarter of 2004. Source: *A Better Quality of Life, 2006-2010, Pre-budget Document*, The Maltese Government.

Fiscal policy and debt sustainability

The authorities are fully aware that the adherence to a fixed exchange rate policy, the efforts to align the economy closely with that of the European partners, and the need for reducing the public debt require a high quality program adjustment. In 2004 important improvements were achieved (an on-target fiscal outturn and some implemented parastatal reforms) which have paved the way for further consolidation. In line with the medium-term fiscal program, the authorities are committed to reducing the fiscal deficit substantially, despite the weak GDP growth projected for this year and the next. The deficit-to-GDP ratio is expected to drop from 5.2 percent in 2004 to 3.7 this year, and continue to decline to 2.3 in 2006, and 1.4 in 2007. The public debt-to-GDP ratio is also projected to decline from 75.6 percent in 2004 to 74.4 in 2005, to 72.9 in 2006 and to 72.8 in 2007, reverting the upward trend shown in the last years.

The ambitious fiscal consolidation plan hinges on a comprehensive, articulated, and calibrated set of measures aiming at fiscal stability, while allowing some stimulus for growth. The key features of the plan are as follows. First, in 2005 cuts in recurrent spending (reduction in the public sector employment, re-deployment of employees, and wage moderation) and increases in tax revenues are projected. Second, to reduce the deficit to 1.4 percent in 2007, expenditure cuts over two years totaling 5.4 percentage points of GDP (40 percent in current expenditure and 60 percent in capital spending) are projected. The reduction in public spending is accompanied by a decline in total revenues of 3 percent of GDP. Third, to ensure long-term sustainability of public debt and address the aging problem, a far-reaching pension reform is envisaged to be put in place in 2007, centered on the following elements: a) a 5-year increase in the retirement age, b) revision of the pension benefit base, extended to consider the wages from the last 40 years instead of the best 3 years in the last decade; c) extension of the contribution period to 40 years; 4) a compulsory privately-founded second pillar and voluntary third pillar; 5) periodic review of the new pension system over time.

The European Commission in its February 2005 assessment stated that "the prudent underlying macro-economic scenario and the nature of the announced measures aimed at reducing the deficit, as well as budgetary projections set up in the program, make the consolidation path broadly plausible."

The authorities fully agree with staff on the need for rationalizing public spending in the 2006-2007 period in the areas of public employment, health care, and social benefits; however, they prefer different implementation actions, or a more cautious pace, than those suggested by staff. For example, with regard to the reform of the health care system, the authorities have introduced pilot reference pricing for the procurement of pharmaceuticals, instead of shifting the cost of health care to the end user through co-payments, as suggested by staff.

As the DSA exercise shows that debt is projected to decrease to 43.7 percent of GDP in 2050, provided that the envisaged fiscal adjustment and the pension reform are both implemented. Such a scenario appears to be robust with respect to a series of stress tests. As far as external debt is concerned, while official data are not available, the main source of vulnerability, namely the non-banking component, is estimated to be low and declining over time. The public component of the external debt is very low and estimated at 4.3 percent of GDP for 2004.

Monetary policy

A major development this year was the participation of the Maltese lira in the ERM II. Upon entry into the mechanism on May 2, the Maltese lira was re-pegged from the previous currency basket to the Euro, with the central parity rate being set equal to the previous day's closing level. In order to retain the stability and benefits of a fixed exchange rate regime enjoyed in the past, the Maltese Authorities have unilaterally decided to maintain the exchange rate of the Maltese lira at the central parity rate, eschewing the use of the standard fluctuation bands. The transition to the ERM II occurred smoothly and did not require fundamental policy changes. Monetary policy and the level of short-term interest rates will in fact continue to be oriented to supporting the exchange rate peg.

Indeed, in April, prior to ERM II entry, the Central Bank of Malta raised its central intervention rate by 25 basis points to 3.25 percent, following a period in which the Bank’s external reserves had declined. The rise in interest rates was intended to curb excessive credit growth, dampen inflationary pressures and help address imbalances between saving and spending. The increase in official interest rates, and Malta’s subsequent participation in ERM II in May, helped to stabilize the Bank’s external reserves and these continued to increase over the summer.

Structural reforms

Malta faces a competitiveness problem that requires the implementation of structural reforms.

The authorities are committed to a wide range of measures to increase the growth potential and competitiveness of the economy: a) completion of the privatization process by mid-2006, with the exception of the energy sector and Air Malta; b) increased investment in education and human capital to raise labor productivity; c) increased participation rate, especially for women, by more flexible labor practices, and childcare schemes; d) streamlined public bureaucracy and the establishment of a business-friendly environment (in this regard the reform of the port system, which is scheduled to be implemented from June next year, is crucial).

Concerning education, in line with the staff’s recommendations, the authorities launched in September 2005 the reform of student grants and stipends, focusing on increased benefits for poor students and for those enrolled in degree programs in science and technology, considered relevant for the country’s economic development. On the contrary, grants and stipends for students enrolled in other types of degree programs have been decreased. As a strategic goal, the government intends to increase the participation rate in tertiary education from 23 to 30 percent by 2010.

In July a pre-budget document[2] set forth the strategies for the government's action over the coming years. *Inter alia*, there will be a shift from direct taxation to environmental-related taxes, the introduction of tax incentives to stimulate the rental market, and the revision of the child allowance system in consideration of the aging population and falling birth rates.

Financial sector

The financial sector has been strengthened over the last few years, in view of EU accession, and is well supervised. The authorities implemented almost all the 2003 FSAP recommendations. The process for the introduction of Basel II recommendations is under way. The authorities are vigilant on the developments of the mortgage market, and stand ready to adopt additional measures if required. As a preliminary step, in August the government asked the Financial Services Authority of Malta to probe banks' lending terms with the view of tighten regulations on the provision of mortgage credit if necessary.

Statistics

As staff recognize, the macroeconomic statistics system has greatly improved in recent years, in order to meet the Euro-area standards. The authorities are committed to improving the timeliness of national accounts and fiscal data.

Concluding remarks

The authorities are committed to strengthening the policy dialogue with staff in the coming years and to pursuing fiscal consolidation in view of the adoption of the Euro. In this regard, they would like to underscore the importance of receiving technical assistance from the IMF on fiscal matters.

[2] *A Better Quality of Life, 2006-2010, Pre-budget Document.*

INTERNATIONAL MONETARY FUND
Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 05/148
FOR IMMEDIATE RELEASE
October 24, 2005

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

IMF Executive Board Concludes 2005 Article IV Consultation with Malta

On October 14, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Malta.[1]

Background

Notwithstanding Malta joining the European Union on May 1, 2004, growth languished in 2004 for a fourth consecutive year. Slow growth reflected the weakness of, and increasing competition in, Malta's export markets, as well as domestic factors. The slowdown had begun with shocks to the key sectors, and was reinforced by slow growth in Malta's trading partners and by recent oil price rises. Despite real effective exchange rate depreciation since 2002, exports suffered from increasing competition from Asia and emerging tourist destinations. Still, domestic factors have also played a role. Manufacturing sector restructuring resulted in declining sales in those sectors coming under increasing competition. Low employment rates and low human capital have also held back output and hobbled employment growth.

Although growth was weak, the fiscal balance was improved substantially in 2004, and parastatal reform gathered steam. In contrast with recent history, the fiscal outturn was on target in 2004, implying a decline of over 2 percent of GDP in the deficit. Much of the improvement reflected the strength in current revenues. Nontax revenues—namely the Fifth Italian Protocol, and European funds—accounted for the bulk of the increase, but also tax

---

[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.

revenues were sustained by a hike of 3 percentage points in the VAT rate that rose to 18 percent and the establishment of an ecotax. On the expenditure side, total expenditure increased in relation to GDP, reflecting higher current spending; capital expenditure remained unchanged but lower than targeted. A fresh groundswell of parastatal reform resulted in tangible results, including a better-than-targeted operating outcome for Malta Shipyards. Nonetheless, public debt continued increasing, rising to over 75 percent of GDP in 2004.

The current account deficit deteriorated sharply to over 10 percent of GDP in 2004, as imports surged—reflecting an influx of consumer goods, strong imports of capital goods, and a mounting energy bill—and exports remained weak. External reserves loses were contained at 3¾ percent of GDP, however, partly due to large positive net errors and omissions, which could reflect unrecorded economic activity, notably in the financial sector.

Inflation spiked as a result of one-off factors in 2004. The long-standing exchange rate peg provided an effective nominal anchor, which was repegged to the euro (with no realignment) when Malta entered ERM2 on May 2, 2005. But prices jumped as tax rates were adjusted. Also, domestic energy prices reflected rises in world oil prices. Wage pressures remained subdued, however, as modest increases in public sector wages were partially offset by the declines in (private) service sector. And so far housing services—rental rates—have not followed the intensification of house price increases.

Given the subdued inflationary pressures and a sizable reserve cushion, the Central Bank of Malta had kept the key policy rate unchanged for more than 1½ years, but in April raised it 25 basis points to 3.25 percent in the face of persistent reserve losses since late 2004; the interest rate premium on the Maltese lira was further enhanced by entry into the ERM2 when the higher interest rates of the pound sterling and dollar dropped out of the relevant comparator. Broad money expanded modestly, while domestic credit increased by about 5 percent in 2004, fueled by real estate lending.

Executive Board Assessment

Executive Directors congratulated the authorities on Malta's successful accession to the European Union and the smooth initial transition to a lira/euro peg in the context of ERM2. Commendable progress has also been achieved in strengthening macroeconomic management, including the substantial reduction of the fiscal deficit in 2004 despite weak economic growth, and in reforming the parastatal sector. Directors observed that Malta is well-positioned to derive the full benefits of euro adoption, provided continued progress is made in consolidating fiscal accounts and reforming the economy to promote private sector-led growth.

Although short-term growth prospects are moderate, Directors stressed that continued consolidation of Malta's public finances remains a key priority in light of the sharp increase in public debt, which—if not addressed—would threaten macroeconomic stability and weaken the credibility of the exchange rate. Achieving the 2005 budget target will be essential, and Directors encouraged the authorities to identify proactively areas where current spending could be contained—a process that would be facilitated by assigning additional staff to the budget office. It will also be important to follow through should revenue projections prove to be overoptimistic.

Directors underscored the importance of high-quality fiscal adjustment to reduce the fiscal deficit further, while protecting capital spending in priority areas. While welcoming the authorities' commitment under the medium-term fiscal program and ongoing efforts to improve tax administration, they stressed that durable adjustment will entail lowering expenditure. This will involve politically difficult but necessary decisions aimed at reducing public sector employment, shifting part of the financial burden of health care to the end user, and reforming the welfare system to enhance its effectiveness as a social safety net. Directors also recommended extending means testing to those welfare benefits that are not currently covered. Progress in these areas will require continued consensus-building efforts, and some Directors also advised the authorities to proceed at a cautious pace in some of the most sensitive areas.

Directors saw the reforms envisaged in the White Paper on the pension system as important steps that would bolster long-run fiscal stability by addressing the fiscal consequences of population aging. In particular, they highlighted the importance of raising the statutory retirement age to secure the pension system's financial integrity. The establishment of a compulsory, privately funded second pillar should complement the pay-as-you-go old-age pension. Directors urged the authorities to begin implementing reforms promptly to ensure that measures can be phased in gradually, and to avoid the need to take more drastic actions when the demographic shock is imminent.

To revitalize economic growth and enhance competitiveness, Directors stressed the need to complement fiscal consolidation with structural reforms aimed at developing human capital and raising labor productivity. While acknowledging recent efforts to align student grants and stipends more closely with the needs of the economy, they saw room for further strengthening incentives for education, including through reforms to increase wage dispersion. Directors also underscored the importance of improving labor utilization and welcomed efforts to eliminate barriers to female participation in the labor market. In this regard, they urged the authorities to continue assessing the impact of the measures included in the National Action Plan for Employment, with a view to focusing efforts on those measures that prove to be effective.

Directors stressed that a business-friendly environment will be key to boosting investment and fostering job creation. They welcomed the authorities' commitment to the ambitious privatization plan, and looked forward to its expeditious implementation. Directors also encouraged further efforts to streamline bureaucracy, eliminate outdated regulations, and, more generally, lower the cost of operating on the island, including by reforming the port system and establishing a one-stop registration for businesses.

Directors welcomed the authorities' decision to increase domestic interest rates in the run-up to ERM2, and noted that markets have so far judged the interest rate premium on the Maltese lira as being appropriate. Going forward, they considered that Malta is well poised to benefit from euro adoption, since its openness to international markets and close trade links with the European Union are likely to increase even further as the introduction of the common currency will lower transaction costs, reduce exchange risk, and expand the range of profitable trading opportunities. Directors nevertheless emphasized that Malta's significant current account deficit underscores the need for the authorities to persevere with fiscal consolidation and step up structural reforms to boost the economy's competitiveness, including through greater attention to labor market flexibility and wage moderation.

Directors noted that Malta's financial system appears to be sound and well supervised. The highly capitalized banking system should be able to absorb economic shocks, as well as the new prudential requirements associated with Basel II standards. Directors cautioned, however, that the increasing bank exposure to the booming housing market calls for close monitoring. They urged the authorities to tighten prudential regulations to discourage banks from extending credit with high loan-to-value ratios. This could involve tying provisioning requirements to that ratio, and requiring that banks consider only the income declared for tax purposes when assessing the repayment ability of the self-employed. Directors also underscored the need to address the problems affecting the housing market, in particular by reforming the legal framework governing the rental market.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Malta: Selected Economic Indicators, 1999–05

	1999	2000	2001	2002	2003	2004	2005 1/
Real economy (percentage change; constant prices)							
Real GDP	4.1	6.4	-0.4	1.0	-1.9	1.0	1.5
Private consumption	6.1	7.4	0.2	-0.9	2.0	0.7	1.0
Public consumption	-0.6	5.4	0.1	3.9	2.9	0.6	-1.0
Gross capital formation	12.0	26.5	-31.4	-22.7	47.4	9.1	7.8
Exports of goods and services	8.2	5.6	-1.4	2.9	-4.0	3.2	2.0
Imports of goods and services	10.1	10.4	-8.6	-2.3	7.0	4.5	3.5
HICP Inflation (period average)	2.2	3.1	2.5	2.7	1.9	2.7	2.4
Unemployment rate (percent of labor force)	6.6	6.8	7.7	7.7	8.0	7.3	7.0
Public finance (percent of GDP)							
Government budget deficit (Consolidated Fund)	-8.2	-6.3	-6.6	-5.9	-10.6	-5.2	-3.7
General government debt	60.8	57.0	63.5	63.2	72.7	75.9	74.4
Money and credit (end period; percentage change)							
Broad money	9.9	4.0	8.4	10.4	2.4	2.4	3.4
Domestic credit	9.6	9.7	6.6	3.3	10.1	5.1	4.5
Net foreign assets of the central bank	15.7	-13.0	18.1	15.8	4.4	-5.4	-2.0
(in percent of the monetary base)	136.3	114.1	134.0	142.6	147.6	133.5	128.6
Interest rates (percent; end period)							
Seven-day reverse repo	4.7	4.7	4.2	3.7	31	3.1	3.0
Three-month treasury bill	5.0	4.9	4.5	3.7	2.9	3.0	2.9
Government bonds (10-year)	7.279	7.2	6.5	6.1	5.3	5.0	5.1
Balance of payments (percent of GDP)							
Trade balance	-18.2	-19.9	-15.1	-8.9	-14.7	-16.5	-17.6
Goods and services balance	-5.4	-10.0	-5.2	1.1	-5.5	-8.0	-9.4
Current account balance	-3.4	-12.6	-4.4	0.3	-5.8	-10.4	-10.5
Official reserves (end period)							
(in millions of U.S. dollars)	1,794	1,471	1,682	2,209	2,723	2,685	2,556
(in months of imports of goods and services)	6.5	4.4	6.1	7.2	7.4	6.7	6.4
Exchange rate							
Nominal effective exchange rate (2000=100)	98.4	100.0	100.9	100.4	100.1	100.6	...
Real effective exchange rate (2000=100)	98.4	100.0	102.4	102.6	100.8	101.9	...
Regime	Pegged to the euro since May 2, 2005, when it entered ERM-2						
Current rate (July 5, 2005)	0.4293 Maltese liri per euro						
Memorandum items:							
Nominal GDP (in millions of Maltese liri)	1,456	1,666	1,689	1,740	1,793	1,847	1,906

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

1/ Fund staff estimates.