

## **Malta: 2010 Article IV Consultation—Staff Report; 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 2010 Article IV consultation with Malta, the following documents have been released and are included in this package:

- The staff report for the 2010 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on, **November 22, 2010**, with the officials of Malta on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on **January 6, 2011**. 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 Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its **January 24, 2011** 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.

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MALTA

**Staff Report for the 2010 Article IV Consultation**

Prepared by the Staff Representatives for the 2010 Article IV Consultation with Malta

Approved by Ajai Chopra and Thomas Dorsey

January 6, 2011

**Overview:** Malta weathered the global recession relatively well. Output fell less than the euro area average and unemployment rose only modestly, partly reflecting government support. No crisis-related public intervention has been necessary in the financial sector. At the same time, the fiscal deficit has remained relatively contained. Driven by external demand, a cyclical upswing is now underway but expected to moderate soon and some imbalances, built up in the run-up to joining the EU and euro, are expected to weigh on the recovery. To achieve strong and sustainable growth over the medium term, policy makers need to adopt a strategic approach that includes growth friendly and ambitious fiscal consolidation and continued progress in establishing high value export activities. It also requires prudent macroeconomic and financial risk management and prevention policies. Here, efforts need to be stepped up to protect financial stability and safeguard against systemic and fiscal risks.

**The 2010 Article IV discussions were held in Malta during November 11–22, 2010.** The team comprised Mr. Harjes (head), Ms. Flamini, Mr. Munteanu and Ms. Popescu (all EUR).

**The mission met** with the Finance Minister Fenech, Central Bank Governor Bonello, Financial Services Authority Chairman Bannister, and other senior officials, academics, and private sector representatives including from labor unions and employers' associations.

**The mission's concluding statement was published on November 22, 2010 and can be found at:** <http://www.imf.org/external/np/ms/2010/112210.htm>

**Past surveillance:** During the 2009 Article IV Consultation, Directors considered Malta's fiscal stance appropriate, but suggested that consolidation efforts start as soon as feasible. The 2009 deficit remained contained and recently announced government plans include ambitious fiscal targets for the coming years. In light of growing risk in the financial sector, Directors recommended that additional capital buffers be built and pointed out the need to better incorporate systemic considerations into prudential standards.

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## I. THE ECONOMIC AGENDA

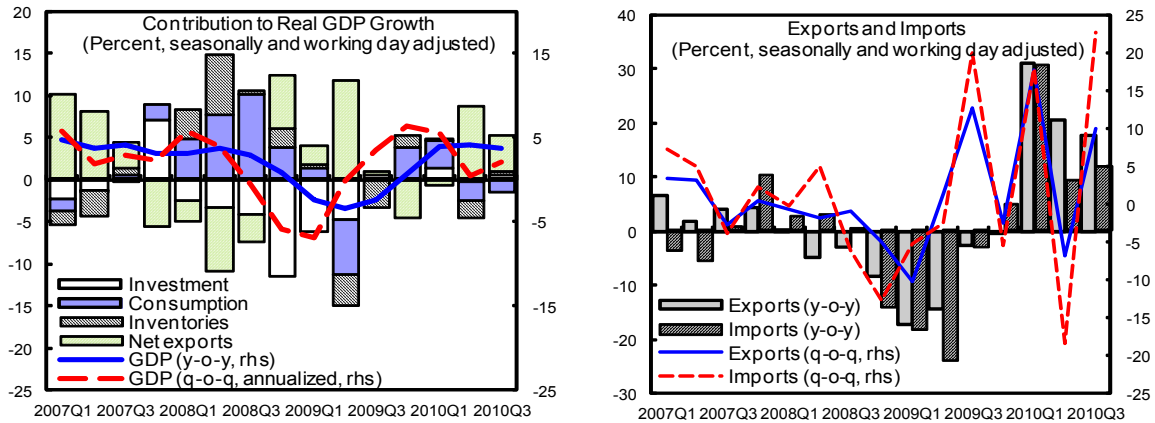
1. **Further policy effort is needed to fully exploit the benefits offered by EU and euro membership.** As a small and very open economy, Malta has benefited from tighter integration into the European economy and participation in the euro area. Pragmatic and flexible policies played a crucial role but more action is needed. Catching up further with incomes of richer European countries requires raising productivity, skills and employment rates simultaneously, which is a formidable challenge many other countries in Europe are facing as well. Continued diversification into high-value exports offers the most promising source of sustained recovery for Malta. Further upgrading the various economic clusters and promoting synergies between them would also reduce the risks stemming from potentially unfavorable changes in the European or international regulatory and taxation framework.
2. **Strong and sustainable growth requires a strategic policy approach and prudent risk management.** The increase to relatively high levels of public debt, guarantees, and implicit liabilities—also related to state-owned enterprises—necessitates ambitious fiscal consolidation. Consolidation should be expenditure based but growth-friendly and not impede further progress in attracting high value added export activities. Recent international experience underlines that prudent financial regulation and supervision, well coordinated with the new European institutions, is indispensable. Rising vulnerabilities associated with high domestic credit risk and the growing linkages of Malta's financial sector with the rest of the world in the context of volatile international financial markets make this all the more urgent. The authorities considered the staff's overall assessment fair and realistic.

## II. THE OUTLOOK FOR MALTA'S ECONOMY

3. **Malta weathered the global recession relatively well.** Output fell less than the euro area average, unemployment rose modestly and the fiscal deficit remained contained at around 4 percent of GDP. Service activities held up especially well during the crisis reflecting ongoing diversification and expansion into higher value added export niches. The government provided some targeted assistance to the manufacturing sector which helped to stabilize output and employment, and some additional social benefits.

### A. Recent Developments and Near-term Outlook

4. **Malta is experiencing a cyclical upswing driven by strong external demand, but momentum is expected to fade.** Manufacturing and tourism activity, hit hard by the global recession, have recovered with the latter near pre-crisis record levels. However, the recovery is not yet broad based and some sectors, including construction and retail, are lagging. On the back of softer real estate prices, elevated unemployment, and higher uncertainty about job prospects, consumption growth slowed but has been supported by very low interest rates. Investment, especially in construction, decelerated sharply and remains sluggish. Inflation has picked up as the ongoing rebound allows firms to rebuild profit margins and pass on higher energy prices, but underlying inflation is expected to remain contained.



Sources: Eurostat; Haver; and IMF staff calculations.

## B. Shape and Strength of the Recovery

5. **Imbalances, primarily accumulated in the run-up to joining the EU and the euro area, are expected to weigh on the recovery.** Over the past two decades, Malta experienced a real-estate boom which intensified around EU accession (Box 1). As in other countries, this boom temporarily boosted tax revenues and consumer and investment demand reflected in elevated current account deficits. Excess supply in segments of the real estate market, combined with high corporate leverage in this sector, is expected to weigh on domestic demand for some time.

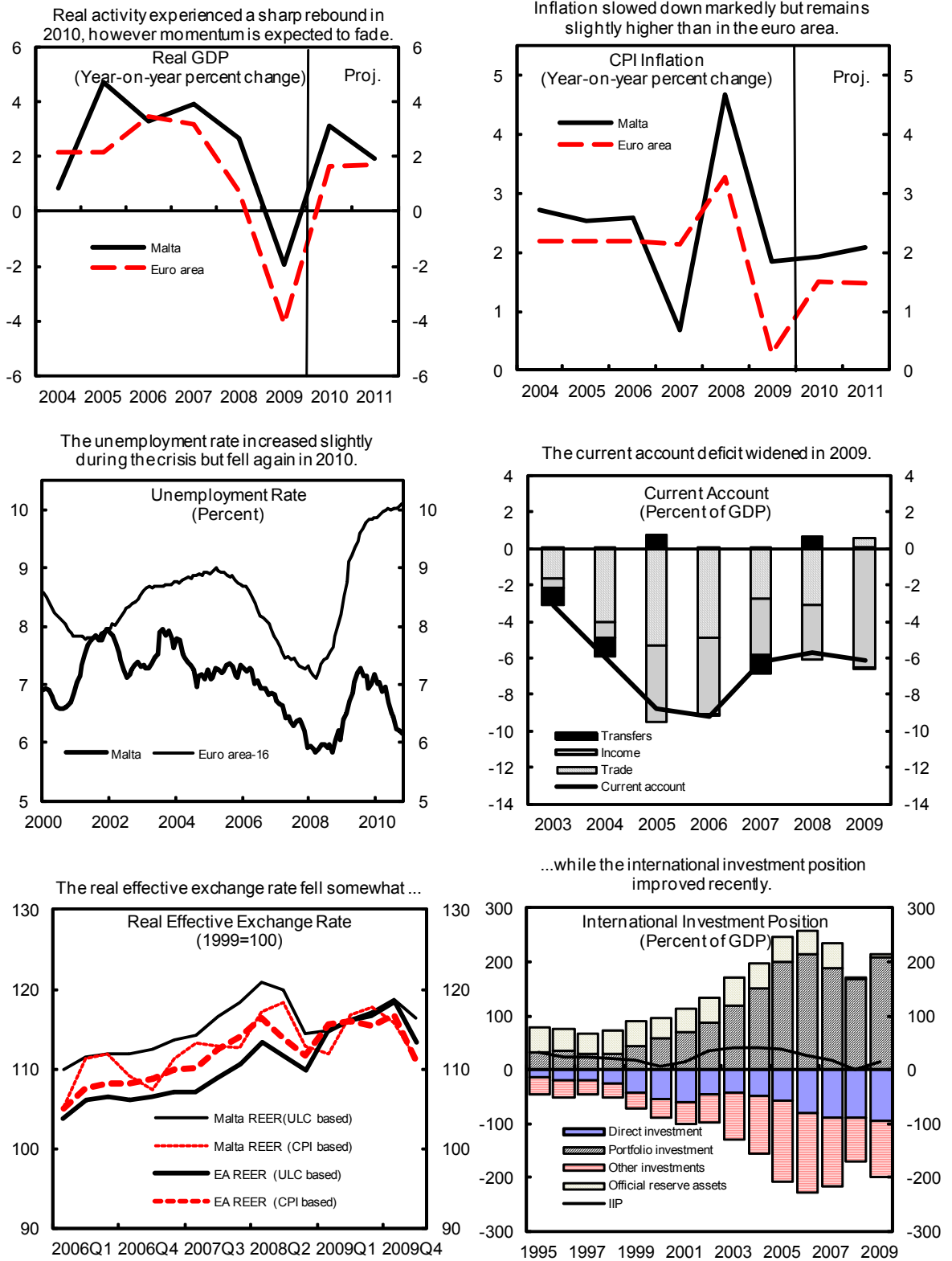
6. **Competitiveness needs to be reinforced to support the export-led recovery.** The persistence of current account deficits suggests some erosion of competitiveness in Malta's traditional exports, especially in the early 2000s, but the gradual loss of market share in merchandise trade has more recently been largely offset by gains in services. Also, large net income deficits increasingly contribute to Malta's relatively weak current account performance reflecting the presence of many foreign-owned corporates, including banks. They also have a sizable effect on Malta's international investment position which, however, remains in positive territory (Figure 1). Traditional price competitive measures, including estimates in line with the CGER methodology, suggest that Malta's real effective exchange rate (CPI, GDP and ULC-based) is broadly in line with fundamentals following some euro depreciation over the past year.

Malta: Real GDP Growth Projections, 2010–12  
(Percent)

Source	Date	2010	2011	2012
IMF	10-Dec	3.1	2.0	2.0
Central Bank	10-Nov	3.2	2.3	2.8
Ministry of Finance	10-Nov	3.4	3.0	...
European Commission	10-Nov	3.1	2.0	2.2
<i>Euro area – WEO projection</i>	10-Oct	1.7	1.5	1.8

Sources: IMF, WEO; and authorities data.

Figure 1. Malta: Economic Indicators, 1995–2011



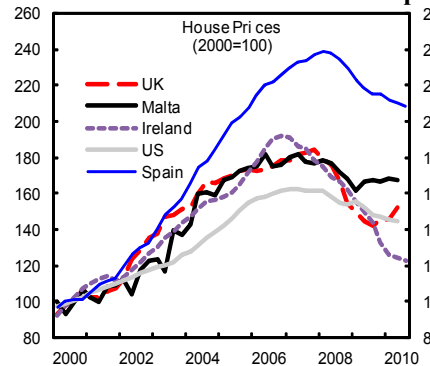
Sources: Central Bank of Malta; Eurostat; WEO; and IMF staff estimates.

7. **Long-term sustainable growth requires policies to focus on raising productivity, skills and employment rates.** Under current policies and in view of the above mentioned imbalances, Malta is expected to grow only slightly faster than the euro area average over the medium term. But further structural reform and a strategic policy approach could lift potential growth further (Box 2).

### Box 1: Real Estate Market Developments in Malta

**Malta experienced a real-estate boom which intensified around EU accession but has tapered off following the global financial crisis.** Increased foreign demand associated with EU entry and a tax amnesty for residents on investments abroad boosted property prices. In 2007–08 the cycle turned, but the price correction of less than 10 percent<sup>1</sup> has been more moderate than in other countries with comparably sharp house price appreciation. The prices of apartments and maisonettes, which constitute the bulk of Maltese properties, have declined the most, while high-end real estate held up considerably better. More recently, house prices appear to have stabilized, supported by stronger labor markets, low interest rates and continued provision of mortgage credit by banks.

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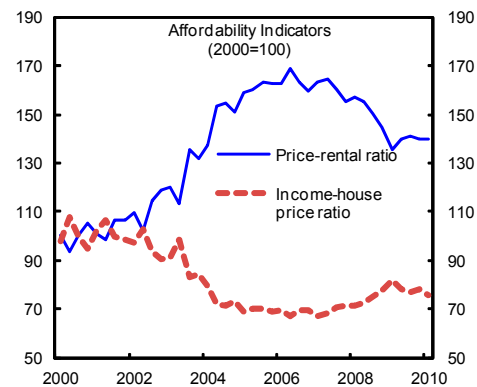
Sources: BIS; and CBM.

**Excess supply remains in segments of the housing market and commercial real-estate.**

Anecdotal evidence suggests that arrears are building in the commercial real estate sector and there is a significant overhang of unsold properties. The very high number of vacant dwellings is partly related to a legal framework that features significant rental restrictions. A recent rental law reform, however, is expected to gradually remove some of these distortions. Moreover, the authorities have argued that the relative scarcity of land, high home ownership and continued strong demand from foreigners will continue to support the Maltese real-estate market.

**With elevated house prices and higher mortgage debt, housing affordability has decreased.**

The income-to-house price ratio has been eroded during the boom years. The price-rental ratio has also increased considerably, although this partly reflects rigidities in rental prices due to strong tenant protection. Low interest rates, increased competition in the mortgage markets and longer maturities continue to stimulate the demand for mortgages. Household mortgage debt has risen to about 44 percent of GDP, close to the euro area average, and 85 percent of mortgage debt is financed with adjustable rates. While some housing loans with higher loan-to-value (LTV) ratios (80 percent to 100 percent) have been granted in recent years, typical LTV ratios for first-time house buyers have been around 63 percent in 2007<sup>2</sup>.



Source: IMF staff calculations based on CBM data.

<sup>1</sup> According to the residential property index compiled by the CBM on the basis of advertised property prices, the fall was on average 7 percent. Based on a separate index computed by the NSO using information from contracts of sale registered with the Inland Revenue Department, the decline amounted to about 5 percent.

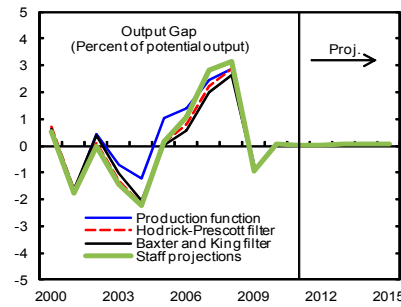
<sup>2</sup> ECB (2009): *Housing Finance in the Euro Area*, Occasional Paper Series, No 101, March.

### Box 2: Drivers for Balanced and Sustainable Growth

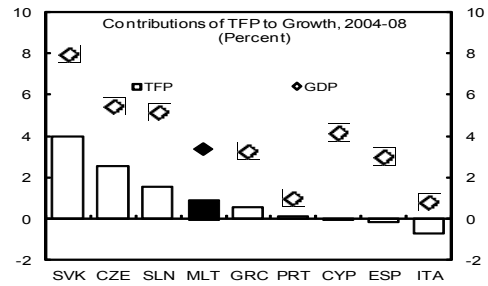
**In the context of joining the EU in 2004 and the euro area in 2008, Malta undertook a wide range of reforms which spurred economic growth.** In terms of GDP per capita and TFP growth – at 3.4 and 0.9 percent respectively between 2004 and 2008—Malta appears to have escaped the stagnation faced by some Southern European countries, but lags behind the fast converging economies in Eastern Europe<sup>1</sup>.

**The global crisis has had a moderate effect on potential output in Malta, although staff estimates suggest potential growth slightly below pre-crisis levels going forward.**

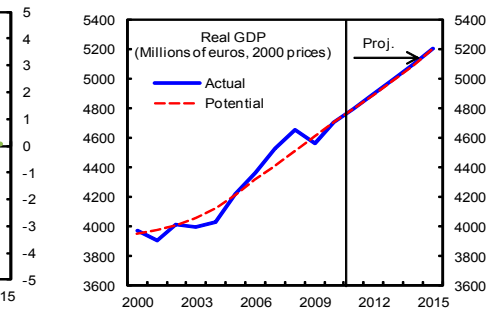
Different estimation methods suggest that output was above potential by almost 3 percent in 2008. The collapse in output since then has taken it below potential, with output gap estimates of about negative 1 percent in 2009. The total impact of the global crisis in terms of potential output contraction was relatively mild in international comparison.



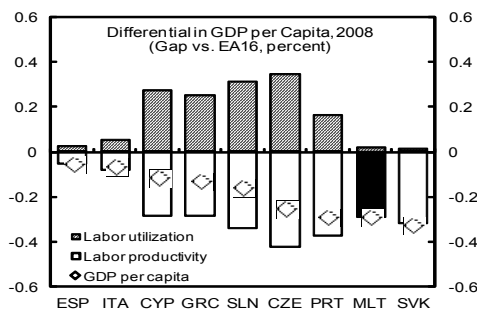
Sources: Eurostat, and IMF staff estimates.



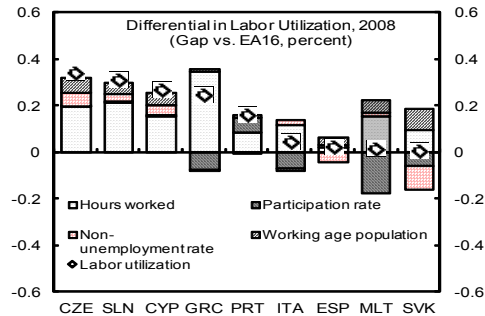
Source: European Commission.



**Increasing potential output requires a comprehensive strategy to enhance both the extensive and intensive sources of growth.** Boosting labor utilization and labor productivity is key to reducing the income gap with richer European countries — which in 2008 stood at 28 percent in terms of per capita GDP. Employment rates, in particular for women, remain low and more flexible arrangements for part-time work and flexible working practices could help. Support for higher education should continue, but efficiency needs to increase and direct support accompanied by rigorous means testing. Increasing human capital through better targeted support, aimed at retaining the highly qualified, as well as improving primary and secondary education, should help satisfy the demand for higher skills. Linking wage increases to productivity gains would foster external competitiveness. Further measures aimed at improving the business environment, including simplifying administrative procedures and addressing infrastructure bottlenecks (as soon financial conditions permit) would increase efficiency and improve further Malta's attractiveness to international investors.



Source: European Commission.

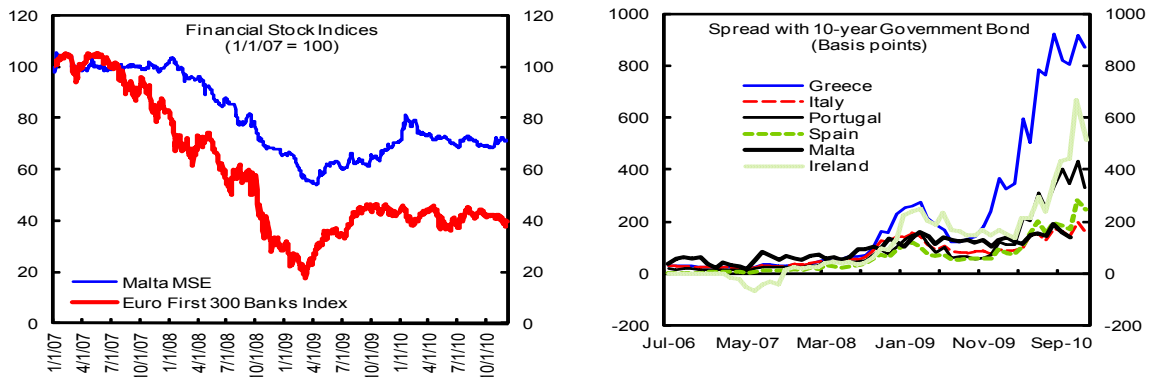


<sup>1</sup> Based on the European Commission's DG ECFIN (2008) "The LIME assessment framework (LAF): A methodological tool to compare, in the context of Europe 2020, the performance of EU Member States in terms of GDP and in terms of twenty policy areas affecting growth". *European Economy*, Occasional Papers No 41. October 2008. Brussels.



### C. Contagion and Other Risks

8. **Uncertainty remains high and the risks tilted to the downside.** Malta is facing high risk of contagion if the fragile economic and financial situation in parts of the euro area worsens. Some banks, involved mainly in international business, are exposed to euro area debt securities that have recently faced significant price pressure. Malta's sovereign spreads have remained relatively contained but international market sentiment has proven volatile over the past year. Real estate market weakness could turn out deeper and more protracted than expected as excess supply in segments of the real estate market and some debt overhang need to be worked off. In this case negative feedback loops between the real economy and the financial sector could materialize. Moreover, Malta's attractiveness as a business location and some of its new high-growth export activities (e.g. some business and financial services, pharmaceuticals, etc.) could be adversely affected should EU or member state regulations or taxation change. On the upside, low interest rates and stronger demand for Malta's exports could sustain growth momentum longer than anticipated.



Sources: Bloomberg; and IMF staff calculations.

#### Authorities' views

The authorities, especially the Ministry of Finance, were more upbeat on the near-term outlook and medium-term prospects. The authorities agreed that there likely is excess supply in segments of the housing market and commercial real estate but referred to sustained demand for upscale housing, including from abroad, and the relative scarcity of land in Malta.

### III. FISCAL POLICY: BACKGROUND, OUTLOOK AND CONSOLIDATION AGENDA

#### A. Background

9. **Fiscal performance weakened in 2008–09, but deficits and debt remained relatively contained** (Figure 2). After several years of fiscal consolidation, the fiscal deficit climbed to 4.7 percent of GDP in 2008 from 2.3 in 2007, reflecting substantial one-offs as well as slippages in current expenditure. The reclassification of Malta Shipyards Ltd within the general government sector, larger energy subsidies in the

context of rising international oil prices, and slippages in healthcare outlays and in the public sector wage bill resulted in a deterioration of about 2 percent of GDP. Despite the recession and helped by the proceeds from a tax amnesty and relatively strong income tax performance by international companies registered in Malta, the overall deficit narrowed to 3.7 percent of GDP in 2009. Additional spending to stimulate the economy accounted for about 0.7 percent of GDP, while energy subsidies dropped sharply as tariffs were raised significantly. Nevertheless, in July 2009 the European Commission concluded that Malta had an excessive deficit and recommended to bring it below 3 percent of GDP by 2011.

### B. Fiscal Outlook and Consolidation Agenda

10. **The 2010 deficit is expected to have remained at about the previous year's level.** Revenue performance was boosted by another tax amnesty and relatively strong corporate profits, which contributed to higher income taxes, also reflecting the economic recovery. Only few and targeted stimulus measures were executed, including some measures to support investment and the tourism sector, some support to households compensating for the sharp rise in utility tariffs, and some increase in childcare benefits. Mostly financed with EU funds, public investment growth is estimated to have accelerated strongly.

Malta: IMF Staff Medium-Term Fiscal Projections, 2010–13  
(Percent of GDP, unless otherwise indicated)

	Est.	Proj.		
	2010	2011	2012	2013
Overall balance	-3.9	-3.0	-3.0	-2.6
Overall balance excl. one-offs	-4.0	-3.1	-3.1	-2.6
Change in the balance excl. one-offs	-0.2	1.0	0.0	0.5
Real primary expenditure growth (percent)	4.0	-0.6	2.2	0.8
Real public investment growth (percent)	8.2	3.2	4.1	6.2
Public debt	67.8	68.0	68.1	67.9
Authorities' target (2011 Budget)	-3.9	-2.8	-2.2	-1.4

Sources: Malta's authorities; and IMF staff estimates.

11. **The government's goal of reducing the fiscal deficit to 1.4 percent by 2013 is appropriate.** Malta's high vulnerability as a small and very open economy calls for prudent debt management which should also anticipate the tightening of EU-wide rules on high levels of public debt. Continued progress in attracting high value added export activities requires Malta's tax regime to remain competitive and consolidation should be expenditure based and conducive to sustainable and strong growth.

12. **Under current plans, however, the staff expects future deficits to exceed the government targets, especially in outer years.** There are significant risks that

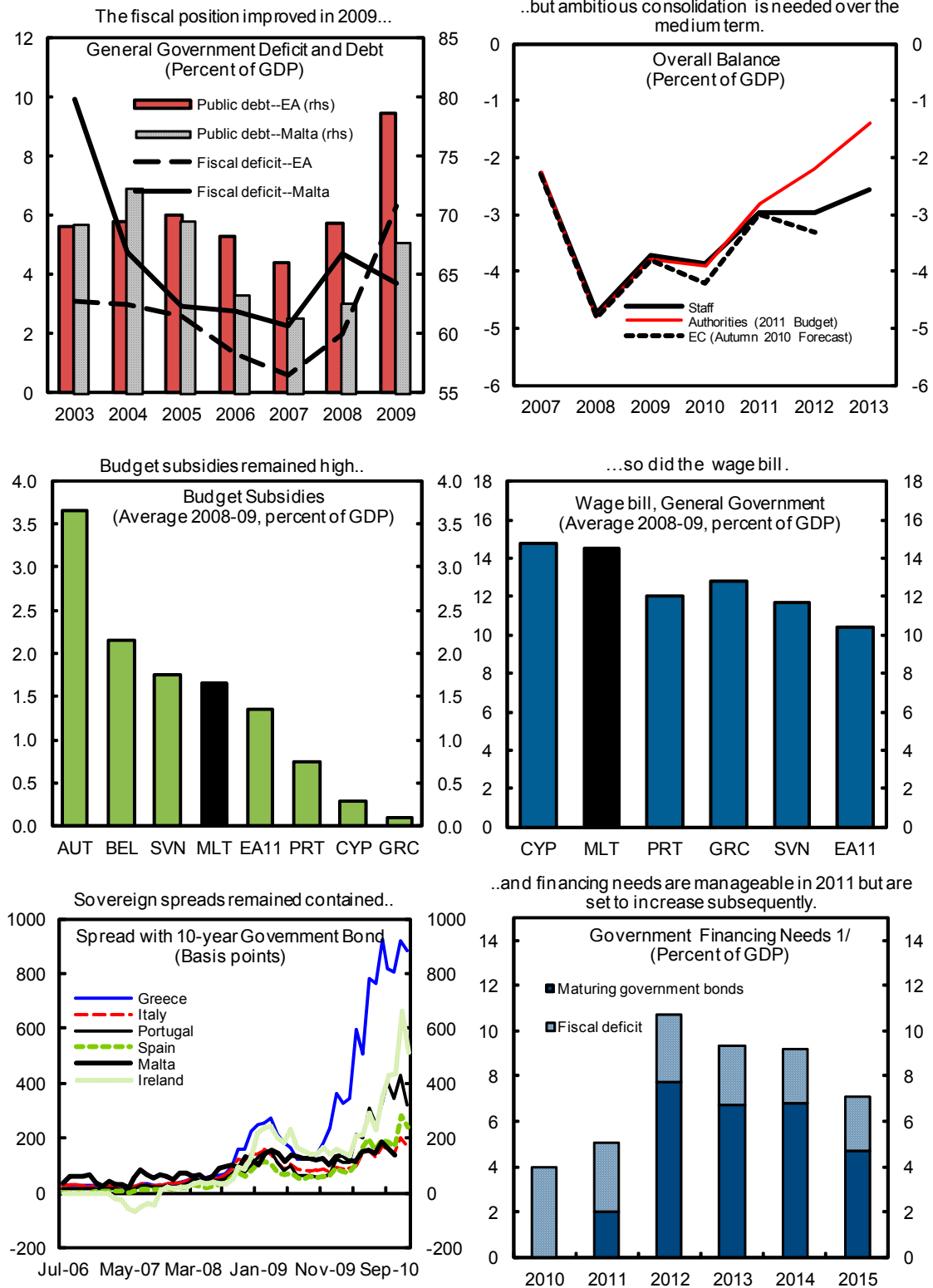
adjustment may fall short of targets, due to possibly lower growth and financial activity than currently expected by the government. In the staff scenario, future tax revenue, including VAT, would turn out lower than the government's latest targets. On the expenditure side, the government's intention to contain wages and spending on goods and services over the next years is welcome but slippages are likely. Plans to raise the efficiency of government departments and entities and to slow recruitment in some areas are well founded but they should be complemented by rigorous means testing of social benefits. The current restructuring of Air Malta is also likely to involve additional fiscal costs and represents an upward risk for the 2011 budget deficit. A more strategic approach for the next budget that protects spending priorities, identifies areas to cut and is fully backed up with concrete measures should raise the credibility of adjustment plans. Moreover, the government should stand ready to introduce additional cost-saving measures to meet its deficit targets, preferably on the expenditure side including through personnel retrenchment, if the staff's more conservative growth outlook or other risks materialize. In the long term, age-related public spending higher than the EU average may pose increasing budgetary pressure (Box 3).

13. **Sovereign financing needs appear manageable in 2011, but are quite substantial in the following years.** The average maturity of Maltese government debt is relatively high—at 7 years—and the rollover need is therefore limited. In 2010, most primary issuance was oversubscribed and spreads remained relatively contained. The annual financing needs in 2011 are projected at about the 2010 level but the rollover needs increase substantially in the following years (Figure 2).

14. **The reformed framework for electricity tariff adjustments should help in limiting fiscal risk.** Significant tariff increases occurred since late 2008 and helped in reducing subsidies to Enemalta. The company's high debt has been singled out by rating agencies as a possible reason for a sovereign debt downgrade. The authorities may want to consider limiting further downside budgetary risk by encouraging the public utility Enemalta to hedge against the possibility of sharp oil price increases at least through the next election year.

15. **A strengthening of fiscal institutions would safeguard the government's consolidation plans.** Ongoing initiatives to enhance accountability and transparency of the financial and budgetary framework are welcome. The government has introduced stricter rules for the approval of expenditure increases for governmental entities and monthly budgetary reviews to ensure fiscal discipline. Additional action should be supported by the recent EU directive on requirements for budgetary frameworks of Member States. The implementation of a legally anchored, strong fiscal rule to better control public expenditure growth should be considered. Further tax amnesties may result in moral hazard and harm tax collection over the medium term.

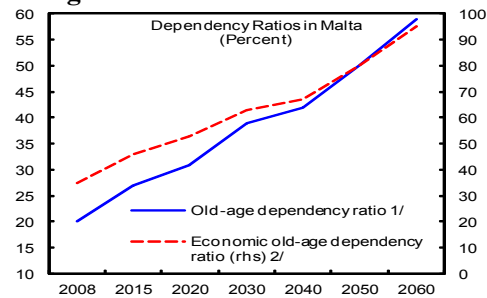
Figure 2. Malta: Fiscal Sector, 2003–15



Sources: Eurostat; European Commission; Maltese Authorities; Bloomberg; and IMF staff estimates.

### Box 3: Age-Related Public Spending in Malta

**The fiscal impact of ageing is projected to be substantial in Malta on account of a sharp rise in the old-age dependency ratio.** Malta's age-related public spending is expected to increase by 9.2 percentage points of GDP between 2010 and 2060, significantly more than the EU average. Despite some pension reform in 2006, most of the increase still reflects higher subsidies for the pay-as-you-go (PAYG) pension system as dependency ratios are set to rise significantly (Table 1).



Source: European Commission, *The 2009 Ageing Report*.  
 1/ Population aged 65+ as a percentage of the population aged 15-64.  
 2/ Inactive population aged 65+ as a percentage of employed population aged 15-64.

**The Government's gradual overhaul of the pension system started in 2006.** The first phase of the reform consisted of a staggered increase in the retirement age from 61 to 65 years and in the regular contribution period to the state pension from 30 to 40 years. The reform also included the introduction of private occupational pension schemes and voluntary personal contributions. Although the overall legislative framework for the establishment of funded schemes has been set up, the specific regulations are yet to be elaborated. Under the current law, the government is legally bound to carry out a periodic strategic review every five years to reflect evolving circumstances in changes to the system. The law stipulates that the first review must be carried out and presented to Parliament by the end of this year.

Malta. Age Related Government Expenditure, Change 2007–60

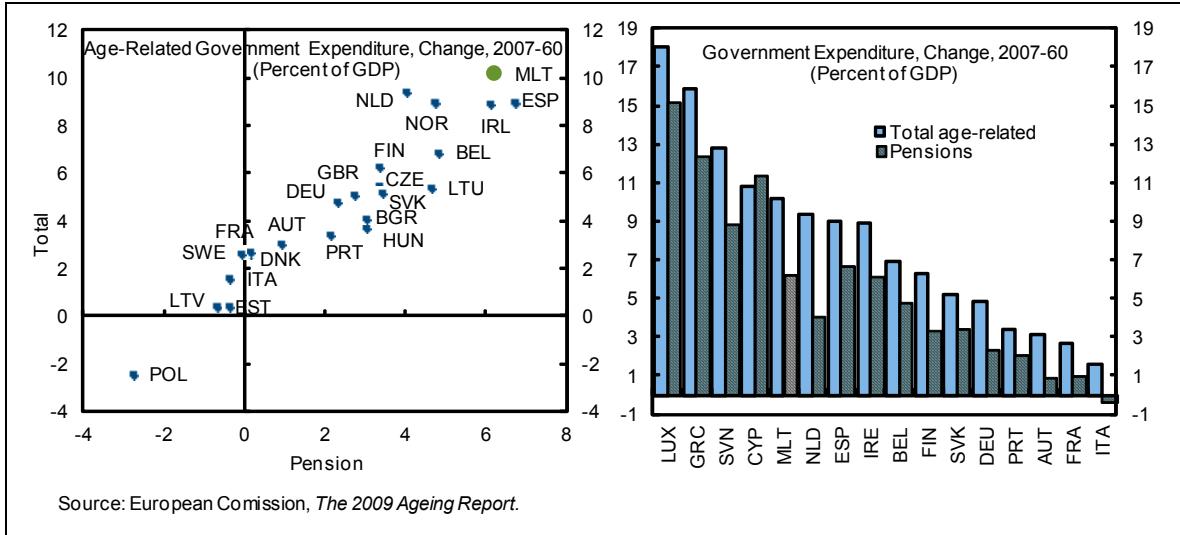
	Pension	Health care	Long-term care	Unemployment benefits	Education	Total
	(Percent of GDP)					
Malta	6.2	3.3	1.6	0.0	-1.0	10.2
EA	2.8	1.4	1.4	-0.2	-0.2	5.2

Source: European Commission, *The 2009 Ageing report*.

**Pension reform in several EU countries has established defined-contribution second pillar systems, substantially improving long-term fiscal sustainability<sup>1</sup>.** A few of these countries also moved from defined benefits to notionally defined contribution systems in the first pillar (Sweden, Italy, Latvia and Poland). For most countries which have successfully reformed their pension systems, the projected increase in age-related public spending is significantly lower than in Malta.

**Further pension reform is critical to contain future fiscal costs of the system.** Additional changes to the current PAYG system could include indexing the retirement age to life expectancy, or further lengthening the contribution period for full entitlement. A timely but gradual introduction of an additional mandatory and privately funded pillar would allow the government to reduce further the benefits of the pay-as-you-go system over time. Another option would be to gradually transition from a pay-as-you go to a notionally defined contribution system under the condition it delivered the needed cost saving. However, this option appears somewhat more difficult to implement and administer and shifts the demographic risk to pensioners requiring a rigorous informational campaign.

<sup>1</sup> Progress and key challenges in the delivery of adequate and sustainable pensions in Europe (*European Economy*, Occasional Papers. 71. November 2010).



### Authorities' views

16. The authorities appeared open to the staff's suggestion for a legally anchored, strong fiscal rule to better control public expenditure growth. They acknowledged the need to contain the costs of the public pension system and pointed to the ongoing review and past reforms. They were confident that the 2010 deficit target would be met.

## IV. FINANCIAL SECTOR: DEVELOPMENTS, VULNERABILITIES AND POLICY CHALLENGES

17. **The Maltese banking sector has weathered the global financial crisis relatively well, but vulnerabilities are rising.** Relatively conservative funding models and little exposure to U.S. toxic assets have kept spillovers from the global financial crisis to banks in Malta at bay. However, a long real estate boom contributed to a significant increase in private sector debt and as a result domestic credit risk. Real estate prices and collateral values experienced some correction and appear to have stabilized more recently, but excess supply remains in segments of the market (Box 1). Household debt has grown rapidly but, at 55 percent of GDP, still remains somewhat below the euro area average. Non-financial corporate sector debt exceeds 130 percent of GDP, with a significant share of debt incurred by the construction and real estate sectors. Banks have tightened lending policies and bank credit growth has decelerated but remains strong compared to the euro area average. At the same time, larger non-financial corporates have substituted bank loans with capital market debt by issuing bonds with construction companies and hotels playing an important role.

18. **Profitability in the banking sector is coming increasingly under pressure.** The sharp price recovery of equity and debt securities boosted profitability in 2009. Low funding rates and higher capital markets activity in Malta also supported banks' profitability. Moreover, some improvement in interest income, possibly also reflecting

increased risk appetite by some banks, has occurred more recently. However, provisions and non-performing loans are on an upward trend, with mortgages, construction and other real estate loans being key drivers weighing on profitability. Through the third quarter of 2010, banks' return on equity (ROE) declined to 5.5 percent from 12.2 percent at the end of 2009, and the dispersion across banks remains significant.

19. **The upward trend in NPLs calls for close monitoring and adequate provisioning.** Total NPLs of domestically-oriented banks<sup>1</sup> reached 6.3 percent of their total loans in September 2010 mainly reflecting problem loans in the real estate, wholesale and retail sectors. The NPL ratio for all banks registered in Malta, however, improved slightly to 2.3 percent of total loans. Households NPLs have increased to 3.1 percent in 2010 from 2.5 percent in 2008. Coverage ratios are relatively low in Malta, at about 22 percent, compared to over 50 percent for the euro area average. Together with some degree of uncertainty associated with real estate collateral valuation, this requires a conservative supervisory approach to ensure appropriate provisioning.

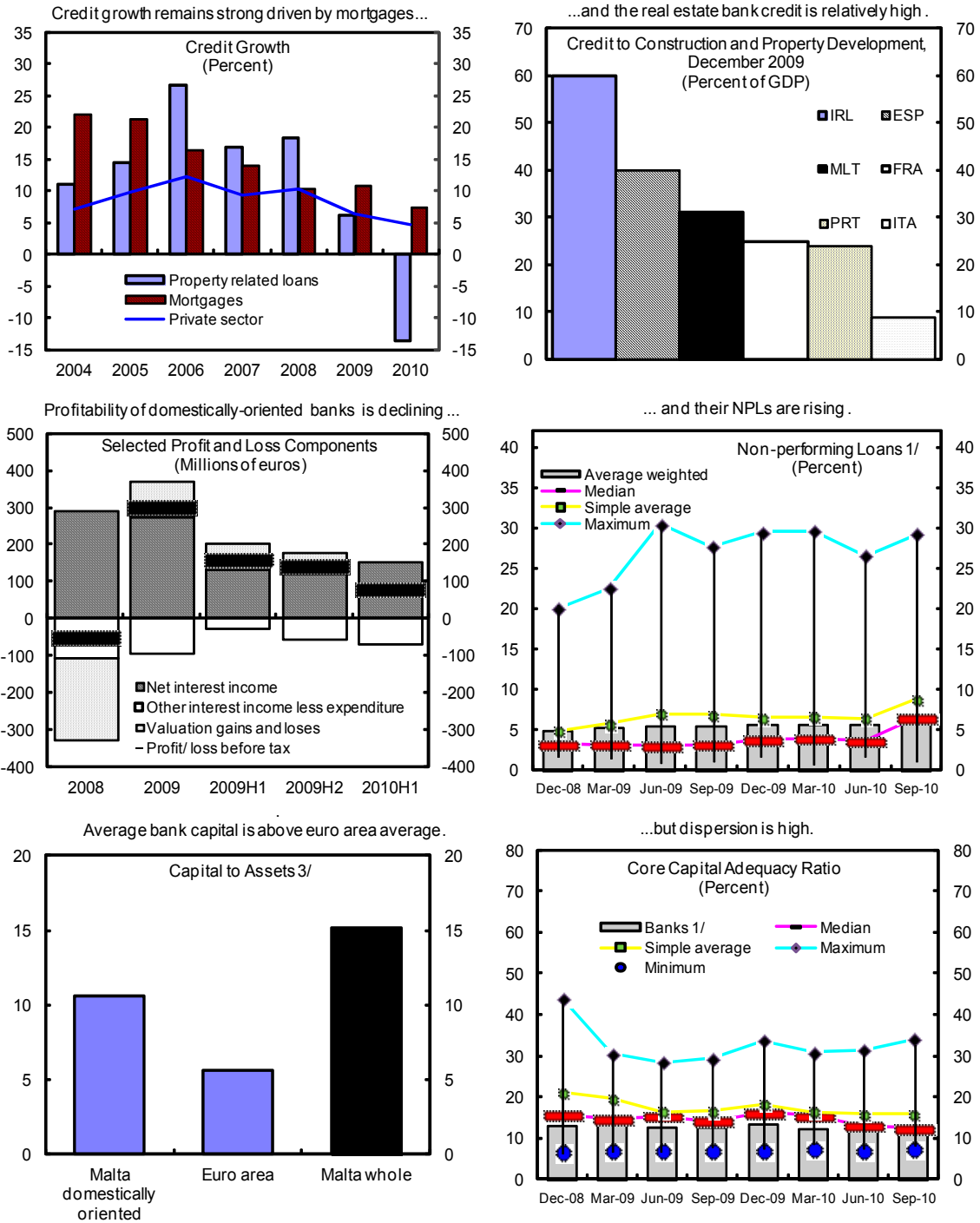
20. **More protracted weakness in the real-estate market could lead to some financial sector pressures.** The banking sector remains exposed to real-estate collateral where valuation uncertainty raises vulnerabilities. Household mortgages and loans to construction and real-estate companies account for close to 60 percent of total loans and NPLs in these sectors are rising. While household mortgage NPLs are still relatively low, the figures are much higher in the construction and real-estate sectors, at 15.7 and 8.7 percent respectively. As banks are curtailing credit for commercial real-estate, some developers have issued unrated bonds to the domestic base of retail investors seeking higher yields, which calls for heightened transparency and auditing standards.

21. **Also, the risks associated with the growing exposure to debt securities in parts of the banking sector require heightened vigilance and determined supervisory action.** A few banks are highly invested in foreign debt securities, including to euro-area peripherals currently under stress, making full use of ECB enhanced credit support and low refinancing rates. Stringent bank stress testing is essential including for banks that are applying the simple standardized approach under Basle II, often heavily relying on ratings that at times may lag actual developments, especially for debt securities classified as held-to-maturity. The authorities should discourage bank business models that are overly reliant on ECB facilities for financing large investment portfolios and employ all available tools to aggressively reduce leverage in these cases.

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<sup>1</sup> In its Financial Stability Reports, the central bank classifies banks based on their business into internationally- and domestically-oriented banks which are defined by a combined minimum-threshold resident exposure of one percent for several asset categories (assets, deposit, securities). However, reclassification often takes place with significant lags if licensed banks decide to alter their business model.

Figure 3. Malta: Financial Sector Developments, 2004–10  
(Percent)



Sources: IMF, *Global Financial Stability Report*; Central Bank of Malta; and IMF staff calculations.

1/ Refers to domestically oriented banks.

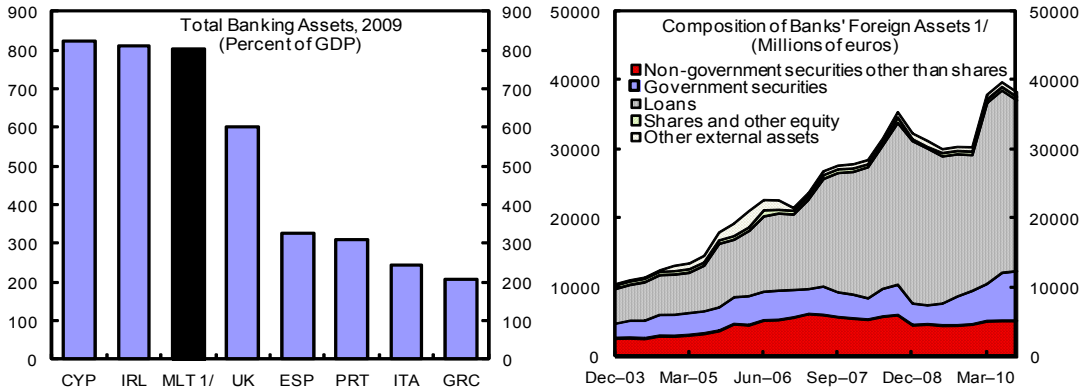
2/ As of end-September, 2010 (for Malta).

3/ January-September 2010 (for Malta).



### Box 4: Malta's Rapidly Expanding Banking Sector

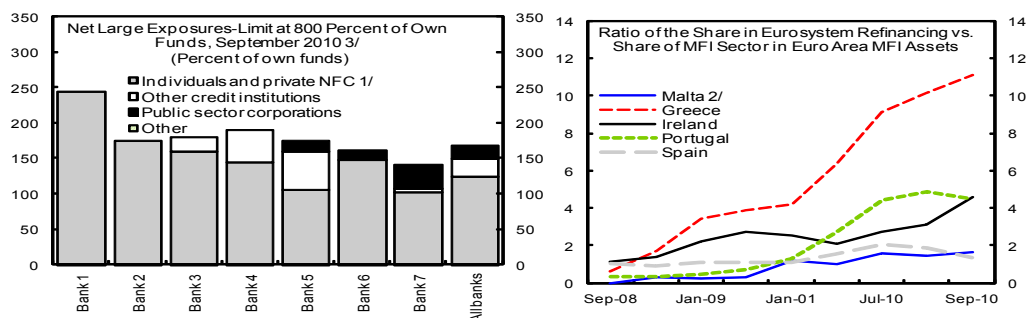
Malta's banking sector expanded significantly during 2004-10. Bank assets surged from about €20 billion in 2004 to currently about €50 billion, over eight times of GDP. At the same time, the number of licensed banks increased from 16 to 25 of which many are subsidiaries of foreign banks.



Sources: Central Bank of Malta; and European Central Bank, *EU Banking Structures*, September 2010.  
1/ Data as of September 2010.

Foreign financial institutions benefit from low costs for certain activities, including back-office functions, and easy access to the regulatory and supervisory authorities, as well as a competitive tax regime, featuring low tax rates for dividend payments, backed by extensive double-taxation treaties. EU membership in 2004 and subsequent euro adoption have further raised Malta's attractiveness as a financial hub. The entry of foreign banks crucially helped in improving competition for many banking services in Malta and boosted the GDP contribution of financial services and tax revenues. However, the rapid expansion of the banking sector also entails risks, including:

- Exposure to a broad variety of international loans, trade financing and securities, which require a sophisticated internal risk assessment and close supervision.
- Higher funding risk due to increased bond and other wholesale funding and increased reliance on ECB liquidity of some banks.
- High concentration risk and large exposure to parent banks, which increased in the wake of the financial crisis.



Source: Central Bank of Malta.  
1/ Including connected parties.  
2/ The value of 'zero' for Malta for January 2008 is due to the fact that there was no local participation in refinancing operations as at end of January 2008.  
3/ Refers to domestically oriented banks.

In view of the systemic and fiscal risk these developments may pose, effective supervision and regulation of all banks registered in Malta is essential.

22. **In view of high credit risk and stricter regulatory requirements under Basle III, a number of banks need to raise capital.** Average capital adequacy ratios have declined somewhat relative to 2009, but capital predominantly consists of equity and retained earnings and Tier 1 capital to risk-weighted assets still stood at about 12 percent in September 2010. However, there is wide dispersion across banks, and concentration risk remains high.

23. **The authorities need to step up efforts to protect financial stability and safeguard against systemic and fiscal risks.** Growing linkages in financial markets require that the central bank's Financial Stability Reports include all banks operating in Malta, and continue discussing them in an appropriately differentiated manner by, for example, grouping them by business model. The reports should also include thorough assessments of the real estate and capital markets. For the latter, transparency and auditing standards should be raised as credit rating for domestic corporate bond issuance is mostly absent, often involving retail investors or insurance companies while relying on the same auditing firm that has worked in the bond issuance process. As a result of a recent self assessment of Basle core principles, the MFSA decided to better separate licensing and supervisory functions. However, a strengthening of supervisory and regulatory arrangements especially to better link macro and micro prudential regulation is warranted, for both the banking sector and capital markets in line with developments at the European level. This should be supported by enhanced coordination between the relevant institutions and more frequent high-level meetings which would also facilitate crisis management.

#### **Authorities' views**

24. The authorities agreed that a conservative supervisory approach is needed to ensure appropriate provisioning given the soft property market and the fact that a substantial proportion of loans is backed by real estate. The authorities also thought that a number of banks would require additional high-quality capital, preferably equity and retained earnings, to ensure sufficient buffers. Moreover, the authorities agreed with the mission's call for a prompt strengthening of the supervisory and regulatory arrangements to better link macro and micro prudential regulation, and of the crisis management framework. They considered the staff's overall assessment of the financial sector realistic.

### **V. STAFF APPRAISAL**

25. **Malta's economy is expected to grow at a moderate pace over the medium term.** Malta is experiencing a robust cyclical upswing driven by strong external demand but more modest growth is expected over the next years while some imbalances and debt overhang need to be worked off. In the long term, growth may exceed the euro area average if reform momentum and diversification into high value export activities is sustained.

26. **The government's goal of reducing the fiscal deficit to 1.4 percent by 2013 is appropriate.** Malta's high vulnerability as a small and very open economy calls for particularly prudent debt management which should also anticipate the tightening of EU-wide rules on high debt. The increase in public debt, guarantees, and implicit liabilities also related to state-owned enterprises, necessitates ambitious fiscal consolidation. Consolidation should be expenditure based and not impede further progress in attracting high value added export activities. Setting expenditure priorities and containing entitlements are crucial for lasting fiscal consolidation.

27. **However, there are significant risks that adjustment may fall short of targets, especially in outer years.** A more strategic approach for the next budget that protects spending priorities, identifies areas to cut and is fully backed up with concrete measures would raise the credibility of adjustment plans. This would limit the chance of last minute cuts, often at the expense of investment, or missing deficit targets. If the staff's more conservative growth outlook or other risks to the government's deficit targets materialize, the government should be prepared to introduce additional cost-saving measures, preferably on the expenditure side including through personnel retrenchment. A strengthening of fiscal institutions would safeguard the government's consolidation plans and the implementation of a legally anchored, strong fiscal rule to better control public expenditure growth should be considered.

28. **A comprehensive pension reform is critical to contain its future fiscal costs.** Under the current system, Malta's age-related public spending is projected to increase significantly over the long term and by more than the EU average. A timely but gradual introduction of an additional mandatory and privately funded pillar would allow the government to reduce further the benefits of the pay-as-you-go system over time. Another option would be to gradually transition from a pay-as-you go to a notionally defined contribution system under the condition it delivered the needed cost saving.

29. **The authorities need to step up efforts to protect financial stability and safeguard against systemic and fiscal risks.** Growing linkages in financial markets require that the central bank's financial stability assessment include all banks operating in Malta in addition to thorough assessments of the real estate and capital markets. For the latter, transparency should be raised as credit rating for domestic corporate bond issuance is absent and often involves retail investors. A strengthening of supervisory and regulatory arrangements to better link macro and micro prudential regulation is warranted, for both the banking sector and capital markets as is also being implemented at the European level. The crisis management framework should also be enhanced.

30. **High credit risk and growing exposure to securities in parts of the Maltese banking sector call for heightened vigilance and determined supervisory action.** Vulnerabilities are rising in Malta's financial sector. The past real estate boom led to a large increase in private debt. More protracted weakness in the real-estate market could lead to financial sector pressures. Some banks need to strengthen their capital buffers,

preferably through equity injections and retained earnings. The authorities should discourage bank business models that are overly reliant on ECB facilities for financing large investment portfolios.

**31. Raising productivity, skills and employment rates simultaneously is a challenge but necessary for catching up with incomes of richer European countries.**

State divestment has boosted economic efficiency and should be continued. Wages should follow productivity developments. Employment rates, in particular for women, remain low and more flexible arrangements for part-time work and flexible working practices could help. Support for higher education should increase, but a high quality public primary and secondary education system is also critical to reduce skill mismatch and ensure good employment and income opportunities for all.

32. It is recommended that the next Article IV consultation with Malta be held on the standard 12-month cycle.

Table 1. Malta: Selected Economic Indicators, 2007–16

	2007	2008	2009	Est.		Proj.				
				2010	2011	2012	2013	2014	2015	2016
Real economy				(Percent change)						
Real GDP	3.9	2.7	-1.9	3.1	2.0	2.0	2.0	2.0	2.0	2.0
Domestic demand	0.5	2.7	-4.1	1.2	1.7	1.8	1.9	2.0	1.9	1.9
Consumption	0.8	6.2	-0.5	0.8	1.3	1.4	1.7	1.8	1.9	1.9
Private consumption	1.0	4.4	-0.4	0.8	1.3	1.5	1.8	2.0	2.0	2.0
Public consumption	0.0	12.8	-1.0	1.0	1.1	1.3	1.4	1.4	1.5	1.5
Fixed investment	5.0	-26.3	-16.2	1.5	4.9	4.7	3.5	3.2	2.5	2.5
Inventory accumulation 1/	-1.3	3.6	-1.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Foreign balance 1/	3.4	-0.2	2.4	1.9	0.3	0.2	0.2	0.0	0.1	0.1
Exports of goods and services	4.9	-5.1	-8.2	18.4	2.9	3.4	3.4	3.2	3.2	3.2
Imports of goods and services	1.2	-4.8	-10.4	15.8	2.6	3.2	3.2	3.2	3.1	3.1
Potential GDP growth	2.3	2.3	2.1	2.1	2.0	2.0	2.0	2.0	2.0	2.0
Output gap (percent of potential GDP)	2.8	3.2	-0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
HICP (period average)	0.7	4.7	1.8	1.9	2.1	2.2	2.3	2.4	2.4	2.4
GDP deflator	2.9	2.5	2.6	2.7	2.2	2.2	2.2	2.2	2.2	2.2
Unemployment rate EU stand. (percent)	6.4	6.0	7.0	6.5	6.5	6.4	6.4	6.4	6.4	6.4
Employment growth (percent)	3.1	2.5	1.1	0.5	1.3	1.5	1.6	1.6	1.5	1.5
Gross domestic savings (percent of GDP)	15.2	13.3	9.0	11.5	12.0	12.6	13.0	13.4	13.7	13.9
Gross capital formation (percent of GDP)	20.7	18.9	15.8	16.0	16.6	17.1	17.4	17.6	17.8	17.9
Public finance				(Percent of GDP)						
General government balance	-2.3	-4.7	-3.7	-3.9	-3.0	-3.0	-2.6	-2.4	-2.4	-2.4
Revenue	39.9	39.7	39.6	39.3	39.3	39.3	39.3	39.0	39.0	39.0
Expenditure	42.2	44.4	43.3	43.2	42.3	42.3	41.8	41.4	41.4	41.4
General government debt	61.3	62.6	67.7	67.8	68.0	68.1	67.9	67.5	67.2	67.2
Balance of payments				(Percent of GDP)						
Current account balance	-5.5	-5.7	-6.8	-4.4	-4.6	-4.5	-4.3	-4.2	-4.1	-4.0
Trade balance (goods and services)	-1.0	-3.0	0.2	1.5	0.9	0.8	0.8	0.7	0.6	0.6
Exports of goods and services	90.0	83.1	72.9	76.3	77.8	78.9	80.1	81.5	82.7	84.0
Imports of goods and services	91.0	86.0	72.7	74.9	77.0	78.1	79.4	80.8	82.1	83.4
Goods balance	-17.8	-21.2	-16.6	-18.8	-18.9	-19.1	-19.4	-19.7	-19.9	-20.1
Services balance	16.8	18.3	16.8	20.3	19.8	19.9	20.1	20.4	20.5	20.7
Income, net	-3.5	-3.5	-6.4	-5.9	-5.5	-5.3	-5.1	-4.9	-4.7	-4.5
Transfers, net	-1.0	0.8	-0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capital account, net	0.9	0.5	1.2	1.5	1.7	1.9	2.1	2.1	2.1	2.1
Financial account, net	5.5	6.0	2.2	2.9	2.9	2.6	2.2	2.1	2.0	1.9
Direct investment	13.2	7.4	9.6	7.0	7.5	8.0	8.0	7.8	8.1	8.1
Portfolio investment	6.7	6.3	-32.7	-18.5	-18.3	-18.1	-17.2	-17.0	-17.0	-17.0
Other investment	-8.4	-9.6	25.4	14.4	13.7	12.7	11.4	11.3	10.9	10.8
Reserves ( - inflow; + outflow)	-5.9	1.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	-1.0	-0.8	3.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum item:										
Nominal GDP (millions of euros)	5,509	5,797	5,830	6,174	6,433	6,712	6,999	7,298	7,611	7,938

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

1/ Contribution to growth.

Table 2. Malta: Fiscal Developments and Projections, 2007–13  
(Percent of GDP)

	2007	2008	2009	Est.	Proj.		
				2010	2011	2012	2013
Revenue	39.9	39.7	39.6	39.3	39.3	39.3	39.3
Current revenue	38.9	39.1	38.7	38.1	38.1	38.0	37.9
Tax revenue	28.0	27.4	27.8	27.3	27.2	27.0	26.8
Indirect taxes	14.6	14.3	13.9	13.8	13.7	13.7	13.8
Direct taxes	13.2	12.8	13.6	13.2	13.2	13.0	12.8
Other taxes (capital taxes)	0.3	0.3	0.2	0.2	0.3	0.2	0.2
Social security contributions	7.2	7.5	7.5	7.3	7.3	7.4	7.3
Other current revenue	3.7	4.3	3.5	3.5	3.5	3.7	3.7
Capital revenue	1.0	0.5	0.9	1.2	1.2	1.3	1.4
Expenditure	42.2	44.4	43.3	43.2	42.3	42.3	41.8
Current expenditure	38.2	41.1	40.3	40.0	39.1	39.0	38.4
Wages and salaries	12.8	14.3	14.3	13.8	13.5	13.6	13.5
Goods and services	5.3	6.7	6.1	6.3	6.2	6.1	6.0
Social transfers	13.0	13.1	13.9	13.7	13.7	13.8	13.8
Subsidies	2.0	2.2	1.1	1.0	0.8	0.8	0.7
Interest payments	3.3	3.2	3.1	3.1	3.1	3.1	3.0
Other current expenditure	1.7	1.6	1.8	2.1	1.7	1.6	1.5
Capital expenditure	4.0	3.3	3.0	3.2	3.2	3.3	3.4
Overall balance	-2.3	-4.7	-3.7	-3.9	-3.0	-3.0	-2.6
Overall balance excl. one-offs	-2.9	-3.9	-3.8	-4.0	-3.1	-3.1	-2.6
Memorandum items:							
Cyclically adjusted overall balance	-2.8	-5.3	-3.5	-3.9	-3.0	-3.0	-2.6
Cyclically adjusted overall balance, excl. one-offs	-3.4	-4.5	-3.6	-4.1	-3.1	-3.1	-2.6
Cyclically adjusted primary balance, excl. one-offs	-0.1	-1.2	-0.5	-1.0	0.1	0.0	0.4
Primary balance	1.0	-1.5	-0.6	-0.8	0.2	0.2	0.4
One-offs	0.6	-0.8	0.1	0.2	0.1	0.1	0.0
Of which: Malta Shipyards reclassification/liquidation		-1.1	-0.6				
Public debt	61.3	62.6	67.7	67.8	68.0	68.1	67.9
Government guaranteed debt	11.4	12.1					

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

Table 3. Malta: Balance of Payments, 2007–16  
(Percent of GDP)

	2007	2008	2009	Est.	Proj.					
				2010	2011	2012	2013	2014	2015	2016
Current account balance	-5.5	-5.7	-6.8	-4.4	-4.6	-4.5	-4.3	-4.2	-4.1	-4.0
Trade balance (goods and services)	-1.0	-3.0	0.2	1.5	0.9	0.8	0.8	0.7	0.6	0.6
Goods balance	-17.8	-21.2	-16.6	-18.8	-18.9	-19.1	-19.4	-19.7	-19.9	-20.1
Exports	43.7	37.4	29.6	35.4	35.9	36.3	36.6	37.0	37.2	37.4
Imports	-61.5	-58.7	-46.3	-54.2	-54.8	-55.4	-56.0	-56.7	-57.1	-57.5
Services balance	16.8	18.3	16.8	20.3	19.8	19.9	20.2	20.4	20.5	20.7
Exports	46.3	45.6	43.2	40.9	41.9	42.6	43.5	44.5	45.5	46.6
Imports	-29.5	-27.4	-26.4	-20.7	-22.2	-22.7	-23.4	-24.1	-25.0	-25.9
Current income, net	-3.5	-3.5	-6.4	-5.9	-5.5	-5.3	-5.1	-4.9	-4.7	-4.5
Current transfers, net	-1.0	0.8	-0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Private	0.3	-0.3	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Public	-1.4	1.2	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Capital account, net	0.9	0.5	1.2	1.5	1.7	1.9	2.1	2.1	2.1	2.1
Financial account, net	5.5	6.0	2.2	2.9	2.9	2.6	2.2	2.1	2.0	1.9
Direct investment	13.2	7.4	9.6	7.0	7.5	8.0	8.0	7.8	8.1	8.1
Portfolio investment	6.7	6.3	-32.7	-18.5	-18.3	-18.1	-17.2	-17.0	-17.0	-17.0
Other investment	-8.4	-9.6	25.4	14.4	13.7	12.7	11.4	11.3	10.9	10.8
Reserves ( - inflow; + outflow)	-5.9	1.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	-1.0	-0.8	3.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Official reserves, end of period 1/										
Gross external debt	503.1	551.7	506.6	577.8	653.3	723.8	790.6	854.5	914.2	970.3
Net external debt	-88.7	-75.9	-81.4	-80.8	-82.1	-84.0	-86.2	-88.3	-90.7	-93.1

Sources: National Statistics Office; and IMF staff estimates.

1/ Projection for 2008.

Table 4. Malta: International Investment Position, 2003–09

	2003	2004	2005	2006	2007	2008	2009
	(Millions of Euros)						
International investment position	1,784	1,815	1,779	1,419	921	51	769
Direct investment	-1,881	-2,159	-2,805	-4,121	-4,875	-5,142	-5,495
Assets	737	823	841	874	820	769	1,041
Liabilities	-2,618	-2,982	-3,645	-4,994	-5,695	-5,911	-6,536
Portfolio investment	5,271	6,790	9,641	10,963	10,289	9,635	11,935
Assets	5,601	7,144	10,054	11,371	10,696	10,191	12,437
Liabilities	-329	-355	-413	-408	-407	-556	-502
Of which: debt instruments	-292	-237	-231	-222	-228	-393	-358
Financial derivatives	-21	-27	-2	-15	28	-5	-43
Other investment	-3,786	-4,818	-7,244	-7,649	-7,082	-4,705	-6,001
Assets	5,803	6,745	9,596	12,351	19,404	25,705	21,857
Liabilities	-9,590	-11,563	-16,839	-19,999	-26,486	-30,410	-27,859
Reserves	2,200	2,029	2,189	2,241	2,561	268	374
	(Percent of GDP)						
International investment position	40.6	40.4	36.9	27.6	16.7	0.9	13.2
Direct investment	-42.9	-48	-58.1	-80	-88.5	-88.7	-94.2
Assets	16.8	18.3	17.4	17	14.9	13.3	17.9
Liabilities	-59.6	-66.4	-75.6	-97	-103.4	-102	-112.1
Portfolio investment	120.1	151.1	199.8	212.9	186.8	166.2	204.7
Assets	127.6	159	208.4	220.8	194.2	175.8	213.3
Liabilities	-7.5	-7.9	-8.6	-7.9	-7.4	-9.6	-8.6
Of which: debt instruments							
Financial derivatives	-0.5	-0.6	0	-0.3	0.5	-0.1	-0.7
Other investment	-86.3	-107.2	-150.1	-148.5	-128.6	-81.2	-102.9
Assets	132.2	150.1	198.9	239.8	352.2	443.4	374.9
Liabilities	-218.5	-257.4	-349	-388.3	-480.8	-524.6	-477.8
Reserves	50.1	45.2	45.4	43.5	46.5	4.6	6.4
Memorandum items:							
Gross external debt (millions of euros)	10,157	12,120	17,585	21,124	27,716	31,982	29,534
Gross external debt (percent of GDP)	231.5	269.8	364.5	410.2	503.1	551.7	506.6
Net external debt (percent of GDP)	-81.9	-87	-86.4	-89.1	-88.7	-75.9	-81.4

Sources: Central Bank of Malta; and IMF staff estimates.



Table 5. Malta: Financial Soundness Indicators, 2005–10  
(Percent)

	2005	2006	2007	2008	2009	2010
Banking sector (unless noted, includes internationally-oriented banks) 1/						
Regulatory capital to risk-weighted assets	20.4	22.0	20.3	17.7	24.2	55.2
Regulatory Tier 1 capital to risk-weighted assets	19.0	20.8	19.0	15.7	21.4	52.7
Nonperforming loans net of provisions to capital	20.1	12.5	10.6	10.8	12.6	5.6
Nonperforming loans to total gross loans	3.9	2.8	1.8	1.7	2.6	2.3
Return on assets	1.4	1.3	1.0	0.6	1.8	1.3 (*)
Return on equity	13.0	12.7	11.9	4.6	12.2	5.5 (*)
Interest margin to gross income	48.6	56.4	56.3	59.5	49.8	64.0 (**)
Noninterest expenses to gross income	41.4	44.4	53.8	60.4	26.3	30.2 (**)
Liquid assets to total assets	21.7	19.7	21.9	17.4	16.5	14.8
Liquid assets to short-term liabilities	55.7	52.5	52.7	49.3	47.5	49.8
Net open position in foreign exchange to capital 2/	1.0	2.2	8.8	-0.4	0.2	-0.2
Capital to assets	12.9	14.2	13.7	12.6	15.2	30.9
Gross asset position in financial derivatives to capital	1.4	1.2	1.8	5.9	0.5	0.5
Gross liability position in financial derivatives to capital	1.9	1.4	1.1	5.1	1.6	1.2
Trading income to total income 3/	22.7	18.0	20.0	1.3	33.3	17.5 (**)
Personnel expenses to noninterest expenses	40.9	36.8	25.7	26.4	40.1	46.8 (**)
Customer deposits to total (noninterbank) loans	100.1	75.4	66.0	58.7	74.4	80.5
Net open position in equities to capital	34.5	24.9	20.7	11.7	17.5	7.1
Residential real estate loans to total loans	13.2	12.8	10.4	9.5	12.2	11.5
Commercial real estate loans to total loans	18.2	18.1	20.1	19.4	22.5	17.1
Spread between reference lending and deposit rates (basis points)	347.8	345.3	348.1	266.4	259.2	223.2
Domestically oriented banks						
Regulatory capital to risk-weighted assets	17.1	15.0	14.7	14.6	15.9	14.9
Regulatory Tier 1 capital to risk-weighted assets	15.6	13.5	12.7	12.5	13.0	11.8
Nonperforming loans net of provisions to capital	33.6	29.9	26.3	26.5	31.3	38.1
Nonperforming loans to total gross loans	7.4	5.9	5.1	4.8	5.6	6.3
Return on assets	1.6	1.8	1.5	-0.3	2.1	1.3 (*)
Return on equity	12.8	15.4	14.1	-3.4	20.3	12.6 (*)
Interest margin to gross income	66.0	64.6	67.5	154.0	51.3	69.2 (**)
Noninterest expenses to gross income	46.0	44.1	43.6	106.1	37.7	47.1 (**)
Liquid assets to total assets	23.1	21.8	24.3	20.3	20.9	23.2
Liquid assets to short-term liabilities	53.0	50.3	49.0	45.1	43.7	46.9
Net open position in foreign exchange to capital 1/	-2.9	1.4	0.4	-0.8	0.0	0.3
Capital to assets	12.0	10.9	10.5	9.5	10.6	10.7
Gross asset position in financial derivatives to capital	2.4	3.0	3.5	15.0	1.1	1.7
Gross liability position in financial derivatives to capital	3.0	3.3	2.4	8.3	3.9	7.6
Trading income to total income 2/	11.1	8.2	5.9	-108.5	27.2	10.2 (**)
Personnel expenses to noninterest expenses	54.0	53.8	55.9	56.8	56.0	54.8 (**)
Customer deposits to total (noninterbank) loans	132.5	127.3	136.2	120.3	118.1	124.0
Net open position in equities to capital	47.1	48.4	41.3	20.9	39.4	42.0
Residential real estate loans to total loans	25.3	26.9	30.5	30.0	31.4	33.2
Commercial real estate loans to total loans	32.3	32.7	32.8	31.8	31.5	30.1
Spread between reference lending and deposit rates (basis points)	347.8	345.5	348.3	301.1	265.4	312.3

Source: Central Bank of Malta.

1/ The spike in CAR is due to the inclusion of an international bank in March 2010, which had substantial amount of capital.

2/ Break in time series in 2007 due to change in the reporting schedule.

3/ Prior to 2008 a different methodology was used. The results under the old methodology for 2007 were 10.5 and -5, and for 2008 the results were -5.7 and -122.4 for the total and domestically oriented banks, respectively.

(\*) End-September 2010, net profit before tax is the flow for a year (Oct-09, Sep-10)

(\*\*) End-September 2010, covers the period Jan-Sep 2010.

INTERNATIONAL MONETARY FUND

MALTA

**Staff Report for the 2010 Article IV Consultation—Informational Annex**

Prepared by the Staff Representatives for the 2010 Consultation with Malta  
(In Consultation with Other Departments)

January 6, 2011

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**APPENDIX I. Malta: Fund Relations**

(As of November 30, 2010)

**I. Membership Status:** Joined: September 11, 1968; Article VIII

<b>II. General Resources Account:</b>	SDR Million	Percent Quota
Quota	102.00	100.00
Fund holdings of currency	81.18	79.59
Reserve Tranche Position	20.82	20.41

<b>III. SDR Department:</b>	SDR Million	Percent Allocation
Net cumulative allocation	95.40	100.00
Holdings	95.85	100.47

**IV. Outstanding Purchases and Loans:** None**V. Financial Arrangements:** None**VI. Projected Obligations to Fund** (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2010	2011	2012	2013	2014
Principal					
Charges/Interest		0.00	0.00	0.00	0.00
<b>Total</b>		<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>

**VII. Exchange Rate Arrangement:** Member of the euro area since January 1, 2008.**VIII. Article IV Consultation:** Malta is on the standard 12-month consultation cycle. The previous consultation discussions took place during June 11–22, 2009, and the staff report (Country Report No.09/287, 09/04/09) was discussed on September 4, 2009.**IX. Technical Assistance:**

Date	Department	Subject
April 2009	STA	SDDS subscription finalization
November 2006, April and December 2007	STA	Producer price index/SDDS preparations (expert visits)
June 2005	STA	ROSC Data Module
October 2002–January 2003	MFD	FSAP missions (joint with World Bank)
March 2001	STA	Money and banking statistics
February 1999	MAE	Monetary operations and liquidity forecasting

**X. Resident Representative:** None.

## APPENDIX II. Malta: Statistical Information

(As of December 22, 2010)

**Data provision** is adequate for surveillance purposes. Significant progress in improving macroeconomic statistics has been made in close cooperation with the European Central Bank (ECB) and Eurostat while upgrading statistical systems to meet the euro area standards.<sup>1</sup> However, national accounts and balance of payments data have remained subject to substantial revisions, often affecting several years. Most macroeconomic statistics can now be accessed through Eurostat. The country has been a participant in the GDDS since September 11, 2000, with the metadata posted on the IMF's Dissemination Standards Bulletin Board.

**Real sector statistics:** Data on retail and consumer prices, labor market indicators, and tourism arrivals are released monthly, usually with a short lag. These data are available through Eurostat and via the Internet at the Central Bank of Malta (CBM) and the National Statistical Office (NSO) websites. Presently the NSO releases national accounts data in euros with one quarter lag. Statistical discrepancies (captured under stock building) are often large, particularly on the first release, and typically lead to sizable revisions. Supply-side GDP estimates by type of economic activity are not available, but the recently published producer price index will facilitate their compilation. National accounts imports and exports data are not disaggregated into goods and services. The harmonized index of consumer prices was first published in May 2004.

**Government finance statistics:** Fiscal statistics meet basic requirements, with quarterly accrual-based data on general government operations compiled in accordance with the *ESA95* methodology and disseminated with a one-quarter lag. The general government comprises data from the consolidated fund of government adjusted to include other accounts of government, the accruals elements, and the financial performance of the Extra Budgetary Units and of the Local Councils. The NSO also publishes monthly statistics on the cash operations of the central government, for which the authorities plan to utilize the targeted timeliness flexibility option in light of additional time required for the final month of the fiscal year.

**Monetary and financial statistics:** Monetary statistics are timely and of good quality. Since the entry into the euro area in January 2008, monetary data for IMF statistical publications are now obtained through a gateway arrangement with the ECB, thus reducing the reporting burden of the country. The country participated in the pilot project—Coordinated Compilation Exercise—for Financial Soundness Indicators and submitted indicators as of

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

end-2005 along with metadata, which are now available to the public through the IMF's website (<http://www.imf.org/external/np/sta/fsi/part.asp?iso=MLT>).

**External sector statistics:** Summary data (merchandise trade, current account balance, and selected financial account data) are released on a quarterly basis with a lag of about three months. More detailed BOP and IIP data are released annually, the latter with a lag sometimes exceeding one year. Summary trade statistics are released monthly with a lag of about 40 days.

Malta: Table of Common Indicators Required for Surveillance  
(As of Dec 15, 2010)

	Date of latest observation	Date received	Frequency of Data <sup>6</sup>	Frequency of Reporting <sup>6</sup>	Frequency of Publication <sup>6</sup>	Memo Items:	
						Data Quality – Methodological soundness <sup>7</sup>	Data Quality – Accuracy and reliability <sup>8</sup>
Exchange Rates	Current	Current	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities <sup>1</sup>	10/10	12/10	M	M	M		
Central Bank Balance Sheet	10/10	12/10	M	M	M	...	...
Consolidated Balance Sheet of the Banking System	10/10	12/10	M	M	Q	...	...
Interest Rates <sup>2</sup>	10/10	12/10	M	M	M		
Consumer Price Index	10/10	11/10	M	M	M	O, LO, O, O	O, O, LO, LO, O
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – General Government <sup>4</sup>	2010:Q2	11/10	Q	Q	Q	O, LO, O, LO	O, O, O, LO, O
Revenue, Expenditure, Balance and Composition of Financing <sup>3</sup> – Central Government	4/10	6/10	M	M	M		
Stocks of General Government and General Government-Guaranteed Debt <sup>5</sup>	2009:Q1	7/09	Q	Q	Q		
External Current Account Balance	2010:Q1	7/10	Q	Q	Q	O, LO, O, O	LO, O, O, O, LNO
Exports and Imports of Goods and Services	2010:Q1	7/10	Q	Q	Q		
GDP/GNP	2010:Q3	12/10	Q	Q	Q	O, LNO, O, LO	LO, O, LO, LO, LO
Gross External Debt	2009:Q1	7/09	Q	Q	Q		
International Investment Position <sup>6</sup>	2009	8/10	A	A	A		

<sup>1</sup> Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

<sup>2</sup> Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

<sup>3</sup> Foreign, domestic bank, and domestic nonbank financing.

<sup>4</sup> The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

<sup>5</sup> Including currency and maturity composition.

<sup>6</sup> Includes external gross financial asset and liability positions vis a vis nonresidents.

<sup>7</sup> Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

<sup>8</sup> Reflects the assessment provided in the data ROSC (published on August 18, 2006, and based on the findings of the mission that took place during June 2005) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).

<sup>9</sup> Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment, and revision studies.

### **APPENDIX III. Malta: Public Sector Debt Sustainability**

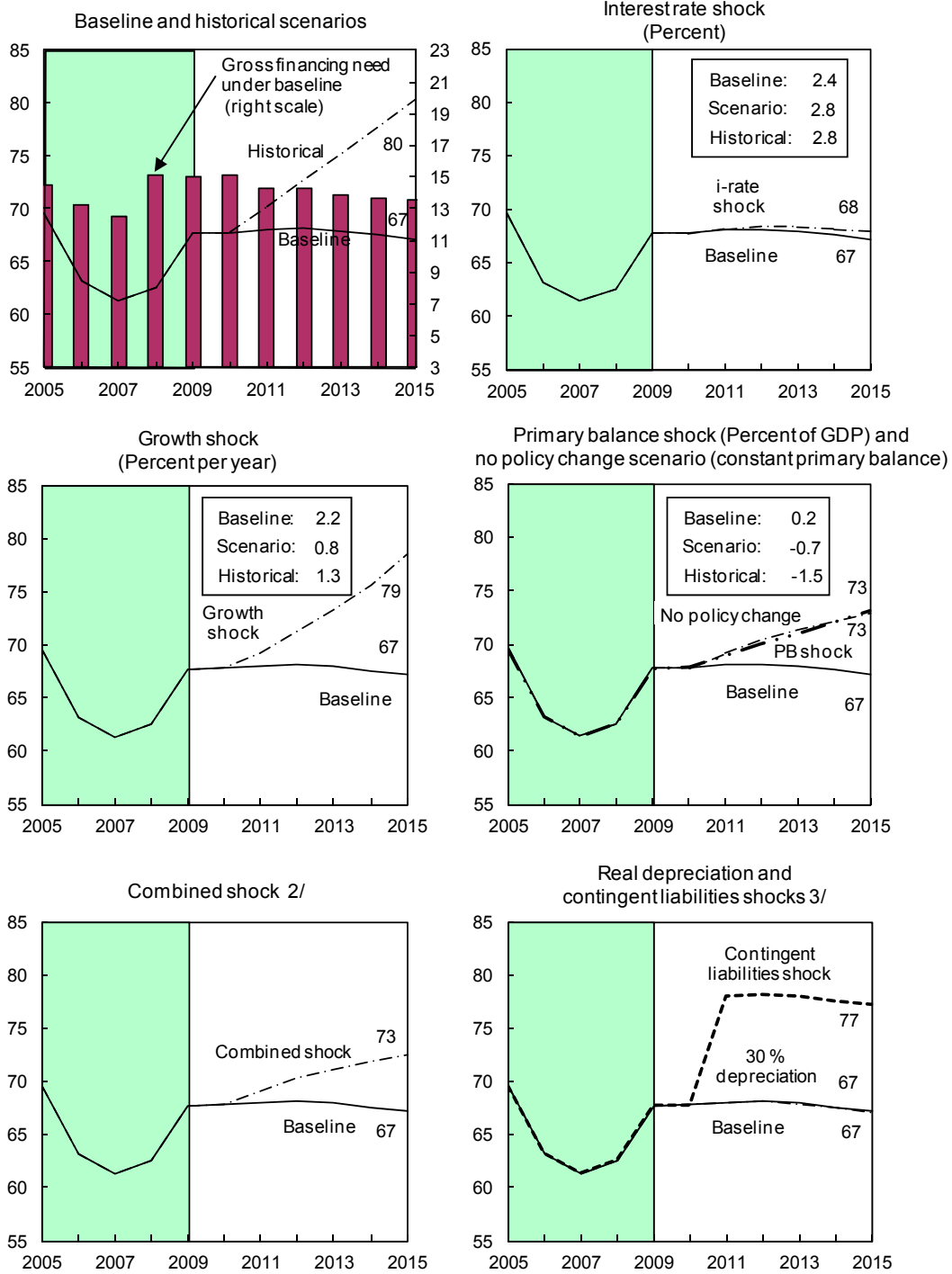
#### **Fiscal Sustainability**

General government debt has increased from 61.3 percent of GDP in 2007 to 67.7 percent in 2009 as a result of the deterioration in the fiscal position. Under the baseline scenario, the debt ratio is expected to remain at 67.8 percent of GDP in 2010, reflecting the contained primary deficit (0.8 percent of GDP). In the medium term, the primary deficit is expected to turn into surplus through continued fiscal consolidation efforts and economic growth, stabilizing the debt ratio at about 67.2 percent of GDP in 2015.

The debt sustainability analysis illustrates the importance of continued fiscal consolidation. Under a scenario where the primary balance is kept constant at the 2009 level, general government debt would reach 80.4 percent of GDP in 2015. The sustainability of the fiscal position is only marginally sensitive to exogenous macroeconomic shocks, as indicated by the bound tests (Figure 1).

The analysis presented in this appendix is based on public debt figures excluding government guarantees. Government guaranteed debt amounted to 15 percent of GDP as of June 2010, of which 6 percent relates to Enemalta debt. According to ESA 95, as long as the guarantee is not called, it is a contingent liability, recorded off-balance sheet.

Figure 1. Malta: Public Debt Sustainability: Bound Tests 1/  
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).



Table 1. Malta: Public Sector Debt Sustainability Framework, 2005–2015  
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing primary balance 10/ 0.3
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	
	<b>I. Baseline Projections</b>											
<b>Public sector debt 1/</b>	69.5	63.2	61.3	62.6	67.7	<b>67.8</b>	<b>68.0</b>	<b>68.1</b>	<b>67.9</b>	<b>67.5</b>	<b>67.2</b>	
o/w foreign-currency denominated	0.3	0.2	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Public debt plus guarantees	82.2	74.0	72.3	74.4	82.6	82.7	83.0	83.1	82.9	82.6	82.3	
Change in public sector debt	-2.8	-6.4	-1.8	1.2	5.1	0.1	0.2	0.1	-0.2	-0.4	-0.4	
Identified debt-creating flows (4+7+12)	-2.0	-2.8	-5.0	1.2	3.4	0.0	0.3	0.1	-0.2	-0.4	-0.4	
Primary deficit	-0.7	-0.8	-1.0	1.5	0.6	0.8	-0.2	-0.2	-0.4	-0.7	-0.7	
Revenue and grants	41.6	40.9	39.9	39.7	39.6	39.3	39.3	39.3	39.3	39.0	39.0	
Primary (noninterest) expenditure	40.9	40.1	38.9	41.1	40.2	40.1	39.1	39.2	38.9	38.3	38.3	
Automatic debt dynamics 2/	-1.2	-0.9	-0.8	0.2	2.8	-0.7	0.4	0.3	0.2	0.3	0.3	
Contribution from interest rate/growth differential 3/	-1.3	-0.9	-0.8	0.2	2.8	-0.7	0.4	0.3	0.2	0.3	0.3	
Of which contribution from real interest rate	1.9	1.2	1.5	1.8	1.6	1.2	1.7	1.6	1.5	1.6	1.6	
Of which contribution from real GDP growth	-3.2	-2.1	-2.3	-1.6	1.2	-2.0	-1.3	-1.3	-1.3	-1.3	-1.3	
Contribution from exchange rate depreciation 4/	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other identified debt-creating flows	0.0	-1.1	-3.1	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	-1.1	-3.1	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
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	
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	
Residual, including asset changes (2-3)	-0.8	-3.6	3.2	0.0	1.8	0.0	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	167.1	154.6	153.6	157.7	171.0	172.4	173.0	173.3	172.9	173.0	172.2	
<b>Gross financing need 5/</b>	14.5	13.3	12.5	15.1	15.0	15.1	14.3	14.3	13.9	13.7	13.6	
in billions of U.S. dollars	0.9	0.9	0.9	1.3	1.2	1.2	1.2	1.3	1.3	1.3	1.4	
												Projected Average
<b>Key Macroeconomic and Fiscal Assumptions</b>												
Real GDP growth (in percent)	4.7	3.3	3.9	2.7	-1.9	3.1	2.0	2.0	2.0	2.0	2.0	2.2
Average nominal interest rate on public debt (in percent) 6/	5.5	5.4	5.6	5.6	5.1	4.8	4.8	4.8	4.6	4.7	4.7	4.7
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.9	2.0	2.6	3.1	2.5	2.0	2.6	2.5	2.4	2.5	2.5	2.4
Nominal appreciation (increase in US dollar value of local currency, in percent)	-10.9	11.0	11.8	-7.5	7.2	-4.6	0.6	-0.5	-0.5	-0.5	-0.5	-1.0
Inflation rate (GDP deflator, in percent)	2.5	3.4	2.9	2.5	2.6	2.8	2.2	2.2	2.2	2.2	2.2	2.3
Growth of real primary spending (deflated by GDP deflator, in percent)	2.1	1.3	0.8	8.6	-4.2	2.9	-0.4	2.2	1.2	0.7	2.0	1.4
Primary deficit	-0.7	-0.8	-1.0	1.5	0.6	0.8	-0.2	-0.2	-0.4	-0.7	-0.7	-0.2
	<b>II. Stress Tests for Public Debt Ratio</b>											
<b>A. Alternative Scenarios</b>												Debt-stabilizing primary balance 10/ 0.3
A1. Key variables are at their historical averages in 2010-2015 7/						<b>67.8</b>	<b>70.2</b>	<b>72.7</b>	<b>75.2</b>	<b>77.8</b>	<b>80.4</b>	<b>1.2</b>
A2. No policy change (constant primary balance) in 2010-2015						<b>67.8</b>	<b>69.0</b>	<b>70.0</b>	<b>71.0</b>	<b>72.1</b>	<b>73.1</b>	<b>0.3</b>
<b>B. Bound Tests</b>												
B1. Real interest rate is at baseline plus one standard deviations						<b>67.8</b>	<b>68.1</b>	<b>68.4</b>	<b>68.3</b>	<b>68.1</b>	<b>67.9</b>	<b>0.5</b>
B2. Real GDP growth is at baseline minus one-half standard deviation						<b>67.8</b>	<b>69.3</b>	<b>71.2</b>	<b>73.2</b>	<b>75.6</b>	<b>78.5</b>	<b>1.3</b>
B3. Primary balance is at baseline minus one-half standard deviation						<b>67.8</b>	<b>69.1</b>	<b>70.4</b>	<b>71.3</b>	<b>72.1</b>	<b>72.9</b>	<b>0.3</b>
B4. Combination of B1-B3 using one-quarter standard deviation shocks						<b>67.8</b>	<b>69.0</b>	<b>70.2</b>	<b>71.1</b>	<b>71.8</b>	<b>72.5</b>	<b>0.8</b>
B5. One time 30 percent real depreciation in 2011 9/						<b>67.8</b>	<b>68.0</b>	<b>68.1</b>	<b>67.8</b>	<b>67.4</b>	<b>67.1</b>	<b>0.3</b>
B6. 10 percent of GDP increase in other debt-creating flows in 2011						<b>67.8</b>	<b>78.0</b>	<b>78.2</b>	<b>78.0</b>	<b>77.6</b>	<b>77.3</b>	<b>0.3</b>

1/ General government gross debt.

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

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  $ae(1+r)$ .

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/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ The implied change in other key variables under this scenario is discussed in the text.

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

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



INTERNATIONAL MONETARY FUND

*Public Information Notice*

EXTERNAL  
RELATIONS  
DEPARTMENT

Public Information Notice (PIN) No. 11/11  
FOR IMMEDIATE RELEASE  
January 28, 2011

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

## **IMF Executive Board Concludes 2010 Article IV Consultation with Malta**

On January 24, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the 2010 Article IV consultation with Malta.<sup>1</sup>

### **Background**

Malta weathered the global recession relatively well. Output fell less than the euro area average and unemployment rose only modestly, partly reflecting government support. Driven by external demand, a cyclical upswing is now underway and manufacturing and tourism activity, hit hard by the global recession, have recovered with the latter near pre-crisis record levels. However, the recovery is not yet broad based and some sectors, including construction and retail, are lagging. On the back of softer real estate prices, elevated unemployment, and higher uncertainty about job prospects, consumption growth slowed but has been supported by very low interest rates. Investment, especially in construction, decelerated sharply and remains sluggish. Inflation has picked up as the ongoing rebound allows firms to rebuild profit margins and pass on higher energy prices, but underlying inflation is expected to remain contained.

Fiscal performance weakened in 2008–09, but deficits and debt remained relatively contained. After several years of fiscal consolidation, the fiscal deficit rose to over 4 percent of GDP in 2008 from about 2 percent in 2007, reflecting substantial one-offs as well as slippages in current expenditure. Despite the 2009 recession, however, and helped by the proceeds from a

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<sup>1</sup> Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

tax amnesty and relatively strong income tax performance by international companies registered in Malta, the overall deficit narrowed somewhat in 2009. Nevertheless, in July 2009 the European Commission concluded that Malta had an excessive deficit and recommended to bring it below 3 percent of GDP by 2011. In 2010, revenue performance was boosted by another tax amnesty and relatively strong corporate profits, which contributed to higher income taxes, also reflecting the economic recovery. Only few and targeted stimulus measures were executed, including some measures to support investment and the tourism sector, some support to households compensating for the sharp rise in utility tariffs, and some increase in childcare benefits.

The Maltese banking sector has weathered the global financial crisis relatively well, but vulnerabilities are rising. Relatively conservative funding models and little exposure to U.S. toxic assets have kept spillovers from the global financial crisis to banks in Malta at bay. However, a long real estate boom contributed to a significant increase in private sector debt and as a result domestic credit risk. Real estate prices and collateral values experienced some correction and appear to have stabilized more recently, but excess supply likely remains in segments of the market. Household debt has grown rapidly but still remains somewhat below the euro area average. Non-financial corporate sector debt has risen to elevated levels, with a significant share of debt incurred by the construction and real estate sectors. Banks have tightened lending policies and bank credit growth has decelerated but remains strong compared to the euro area average. In parts of the banking sector the growing exposure to debt securities, including to euro-area peripherals currently under stress, poses additional risk.

### **Executive Board Assessment**

Executive Directors commended the authorities for their effective policy actions, which helped Malta weather the global crisis relatively well. The economy is now showing signs of a robust cyclical upswing. The challenge ahead will be to achieve strong and sustainable growth. This will require strategic fiscal consolidation and prudent risk management. Continued progress with structural reforms will also be important to establish high value exports and to raise productivity and employment rates.

Directors endorsed the government's ambitious fiscal consolidation plans in response to the increase of public debt and guarantees and implicit liabilities to relatively high levels. They noted that although fiscal deficits have remained contained, a more rigorous approach that spells out specific measures underpinning priorities for the next budget will raise the credibility of adjustment plans. Directors commended the authorities for the recent efforts to improve expenditure control. Strengthening fiscal institutions, particularly by introducing a strong fiscal rule will improve the long term sustainability of public finances. Further pension reform will help avoid a surge of age-related public spending.

Directors noted that Malta's financial sector showed resilience during the global crisis. However, high credit risk following a long real estate boom and the large exposure of a few banks to foreign securities, including to euro-area peripherals currently under stress, warrant heightened vigilance and determined supervisory action. This includes encouraging banks to

strengthen their capital buffers, preferably through equity injections and retained earnings. Directors also called for enhancing supervisory and regulatory arrangements to better link macro and micro prudential regulation, in line with developments at the European level.

Directors agreed that further structural reforms will be critical for increasing Malta's competitiveness, productivity and attractiveness to foreign direct investments. Measures to enhance the education system and encourage women and older workers to participate in the labor market will be important to raise employment. Further liberalization of the regulated sectors will boost economic efficiency.

**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. The [staff report](#) (use the free [Adobe Acrobat Reader](#) to view this pdf file) for the 2010 Article IV Consultation with Malta is also available.

### Malta: Selected Economic Indicators, 2006–11

	2006	2007	2008	2009	2010 Est.	2011 Proj.
Real economy (constant prices)						
			(change in percent)			
Real GDP	3.3	3.9	2.7	-1.9	3.1	2.0
Domestic demand	3.1	0.5	2.7	-4.1	1.2	1.7
CPI (harmonized, average)	2.6	0.7	4.7	1.8	1.9	2.1
Unemployment rate (in percent) 1/	7.1	6.4	6.0	7.0	6.5	6.5
Public finance			(general government; in percent of GDP)			
Overall balance	-2.7	-2.3	-4.7	-3.7	-3.9	-3.0
Primary balance	0.8	1.0	-1.5	-0.6	-0.8	0.2
Gross debt	63.2	61.3	62.6	67.7	67.8	68.0
Money and Credit 2/			(change in percent)			
Broad money	5.2	11.1	7.1	0.2	2.7	...
Credit to nonbank private sector 3/	14.9	9.4	13.6	7.6	5.8	...
Interest rates (year average)			(in percent)			
Interest rate for mortgage purposes	4.7	5.3	5.0	3.4	3.4	...
Ten-year government bond yield 4/	4.3	4.7	4.8	4.5	4.2	...
Balance of payments (in percent of GDP)			(in percent of GDP)			
Current account balance	-9.2	-5.5	-5.7	-6.8	-4.4	-4.6
Trade balance (goods and services)	-4.9	-1.0	-3.0	0.2	1.5	0.9
Goods balance	-18.8	-17.8	-21.2	-16.6	-18.8	-18.9
Services balance	13.8	16.8	18.3	16.8	20.3	19.8
Fund position (as of November 30, 2010)						
Holdings of currency (in percent of quota)					79.6	
Holdings of SDRs (in percent of allocation)					100.5	
Quota (in millions of SDRs)					102.0	
Exchange rate			Joined EMU on January 1, 2008			
Exchange rate regime						
Nominal effective rate (2000 = 100) 4/	109.5	112.8	116.4	117.0	112.9	...
Real effective rate, CPI-based (2000 = 100) 4/	111.6	113.2	116.6	118.9	114.6	...
Real effective rate, ULC-based (2000 = 100) 5/	116.0	119.2	123.6	121.9	120.5	...

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

1/ EU Labor Force Survey.

2/ Data are from the CBM. For 2010, growth rate over the January-November period.

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

4/ For 2010, January-November average.

5/ For 2010, January-June average.

**Statement by Mr. Arrigo Sadun, Executive Director for Malta  
and Mr. Francesco Spadafora, Senior Advisor to Executive Director  
January 24, 2011**

On behalf of the Maltese authorities, we thank staff for the well-written and informative report, which once again witnesses the fruitful and close cooperation with the authorities.

**Overview**

The Maltese economy has weathered the global recession relatively well, with output falling less than the euro area average. The resilience of service activities stands out, reflecting the ongoing diversification and expansion into higher value-added productions. The surplus of the services balance in 2010 and beyond is expected to be higher than its pre-crisis levels. FDI inflows, attracted by Malta's stable institutional and business environment, continue to provide ample resources to finance a current account deficit that has ceased to deteriorate.

Unemployment rose modestly during the crisis, from 6 to 7 percent between 2008 and 2009, and fell to 6.5 percent in 2010; the fiscal deficit remained contained at around 4 percent of GDP, despite some countercyclical targeted assistance by the government to the manufacturing sector and some additional social benefits. Underlying inflation remains contained.

Malta is now experiencing a cyclical upswing driven by strong external demand, and by a recovery of manufacturing and tourism activities. Although the legacy of the past real estate boom, in terms of excess supply in segments of the housing market and commercial property, is expected to dampen domestic demand (where investment in construction is involved), the authorities, especially the Ministry of Finance, are more confident than staff that growth momentum will be sustained in the near future, supported by very low interest rates. Moreover, in the authorities' view, a recent reform of rental laws, continued strong demand from foreigners, and the relative scarcity of land will continue to support the Maltese housing market.

The authorities are aware that Malta faces risks of contagion from external developments, but point to the fact that the country's sovereign spreads have remained relatively contained even in a volatile international environment.

**Fiscal Policy**

After reaching 4.7 percent of GDP in 2008 (from 2.3 in 2007), the overall fiscal deficit narrowed to 3.7 percent of GDP in 2009 despite the recession and countercyclical spending of about 0.7 percent of GDP. This improvement is accounted for by the proceeds from a tax amnesty, relatively strong income tax performance by international companies registered in Malta, and a sharp reduction in energy subsidies, as tariffs were raised significantly.

While the fiscal deficit rose very modestly in 2010 (to 3.9 percent), the authorities are committed to bringing it below 3 percent of GDP by 2011, in line with the request from the European Commission, and further down to 1.4 percent by 2013.

The authorities are mindful that fiscal consolidation and prudent debt management are instrumental in preserving a competitive tax regime that continues to attract high value-added export activities to Malta. The authorities take note of the staff's concerns, but are confident that the 2010 deficit target will be met. The Maltese government is committed to achieving the fiscal targets set for the coming years. The government estimates that the projected tax revenue will follow the macroeconomic projections closely. Moreover, efforts against tax evasion are being strengthened. Furthermore, close monitoring of important sources of government revenue is being reinforced through the enhanced coordination of the relevant tax structures.

In order to control current expenditure, the government intends, over the next few years, to contain wages and spending on goods and services, to raise the efficiency of government departments and entities, and to slow recruitment in some areas.

More specifically, plans for a more rigorous means testing of social benefits will be implemented shortly, and this should help attain a social assistance network that targets those who are most in need. Recruitment in non-essential categories in the public sector is being restricted by only partly replacing vacancies. Furthermore, caution is being exercised in awarding compensation increases to employees.

Throughout 2011, the government will sustain its emphasis on the need for line Ministries to devise and implement plans that achieve quantifiable efficiency gains, while respecting government priorities of public sector deliverables. Stricter rules for the approval of expenditure increases for government entities and monthly budgetary reviews to ensure fiscal discipline have been introduced recently. In particular, the introduction, beginning in January of this year, of a specially-designed reporting system for the financial positions of departments should assist the Finance Ministry in the execution stage of the budget.

The authorities also acknowledged the need to contain the costs of the public pension system. To this end, a gradual overhaul of the pension system started in 2006, and its law-mandated review is to be completed by the end of this year.

## **Financial Sector**

The recent growth of the Maltese financial sector has been driven by internationally-oriented banks, which account for the bulk of total assets and underpin the growing linkages of this sector with the rest of the world. As evidenced by the developments of the past two years, the ability of the Maltese banking sector to weather the global financial crisis relatively well is based on a conservative funding model and little exposure to U.S. toxic assets.

As a result, no financial crisis has taken place, and the banks' capital adequacy and liquidity have not been affected by the global crisis and remain at pre-crisis levels. This outcome is in line with the result of the stress test exercise that was conducted for all EU countries, indicating that Malta's banks are strong and capable of absorbing large

external shocks. Bank credit growth has remained strong compared to the euro area average, despite its recent deceleration (partly due to tighter lending policies applied by the banks).

The authorities considered the staff's overall assessment of the financial sector to be realistic. They are aware that heightened vigilance is needed in order to monitor the credit risk associated with the significant increase in household debt (which still remains somewhat below the euro area average), spurred by a long real estate boom. Given the banks' predominant exposure to the housing sector at large and the potential risks posed by some of its segments, the authorities are determined to pursue a conservative supervisory approach to address the slightly upward trend in NPLs triggered by the global crisis (this marginal increase is well below the rate experienced by several EU countries). The authorities will continue to ensure appropriate provisioning.

Declining bank profitability and the growing exposure to foreign debt securities in parts of the banking sector are further areas closely monitored by supervisors. Maltese banks' capital predominantly consists of equity and retained earnings, and Tier 1 capital to risk-weighted assets still stood at about 12 percent in September 2010. Even though banks are capitalized at a level well above the statutory requirement, the authorities concur with staff on the need for a number of banks to raise additional high-quality capital, preferably equity and retained earnings, to ensure sufficient buffers.

In January 2010, the Malta Financial Services Authority (MFSA) decided to separate licensing and supervisory functions, and concluded an independent assessment of compliance with the Basel Core Principles for Effective Banking Supervision (BCPs). The results of such an assessment show a strong compliance with the overall BCP framework.

Finally, the authorities support the staff's call for a strengthening of the supervisory and regulatory arrangements to better link macro- and micro-prudential regulation, as well as a strengthening of the crisis management framework.

### **Structural Reforms**

The authorities are committed to increasing the economy's competitiveness, productivity, and attractiveness to FDI. This requires continued implementation of the structural reform program. In view of an increasingly competitive international environment, cost competitiveness remains key to ensure sustainable economic growth. The strengthening of the regulatory institutions which oversee market competition and consumer protection as well as the liberalization of hitherto regulated sectors are of paramount importance.