September 2003
IMF Country Report No. 03/276

Malta: 2003 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 2003 Article IV consultation with Malta, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **May 19, 2003,** 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 15, 2003.** 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 **August 18, 2003** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its August 18, 2003 discussion** of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Malta.

The document(s) listed below have been or will be separately released.

Financial System Stability Assessment

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

MALTA

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for
the 2003 Consultation with Malta

Approved by Ajai Chopra and Anthony R. Boote

July 15, 2003

- Consultation discussions were held in Valletta during May 8–19, 2003.
- The staff team comprised Messrs. Hoffmaister (head), Céspedes, and Mehrez (all EU1); Mr. Ugolini (MFD) joined the mission for three days to complete and convey the conclusions of the FSAP report; and Ms. Rizzotti (OED) participated in the final meetings.
- The team met with Central Bank of Malta Governor Bonello , Minister of Finance and Economic Affairs Dalli, and other senior officials. It also met with representatives of financial institutions, business, and labor. Malta maintains an exchange system that is free of multiple currency practices and restrictions on payments and transfers for current international transactions.
- Malta maintains a currency peg to a basket of currencies, and has eliminated restrictions under Article XIV and accepted the obligations of Article VIII (sections 2, 3, and 4) of the Articles of Agreement (Appendix I).
- The authorities have indicated their intention to publish this staff report.

Contents

Appendixes

I. Introduction

1. **The 2003 Article IV discussions took place on the heels of a referendum favoring membership in the EU**. Although only 53.6 percent of the votes supported membership, this represented a solid victory for the Nationalist Party (PN) considering that it had defeated the main opposition part, the Malta Labor Party, by smaller margins in the past two general elections. Moreover, Prime Minister Fenech-Adami's mandate was strengthened by winning the sixth general election at the helm of the PN on April 12—four days prior to the formal signature of the EU accession treaty. Malta is now set to join the EU on May 1, 2004.

2. **Having pursued policies in line with Fund advice (Box 1), fiscal consolidation and structural reforms lost momentum over the last year**. The electoral calendar—with EU accession at stake—contributed to difficulties in containing public expenditures. Together with the economic slowdown, this resulted in a widening of the fiscal deficit in 2002. In addition, privatization and restructuring efforts in the parastatal sector slowed in the face of a difficult domestic and international environment. Malta's accession to the EU holds the potential for accelerated income convergence, provided efforts to reform the economy are sustained and a more ambitious fiscal consolidation is achieved.

Box 1. Policy Recommendations and Implementation

Malta has gradually liberalized its economy in line with the Fund staff's advice:

- A five-year plan to open up markets to international competition is scheduled to be completed this year with the removal of import levies on industrial products.

- The capital account has been liberalized cautiously step-by-step; remaining restrictions on short-run capital movements are scheduled to be removed by EU accession on May 1, 2004.

- Restrictions on interest rates were abolished, and the independence of the Central Bank of Malta was increased; interest rates have been managed more flexibly.

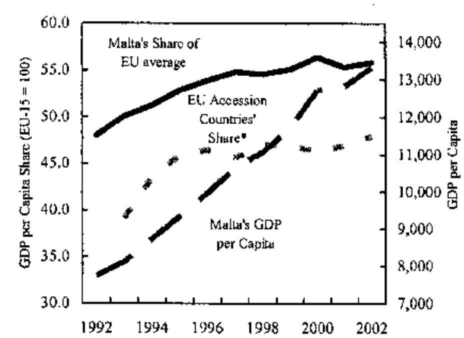
- The weights of the basket of currencies used to peg the Maltese currency have been adjusted to reflect the relative importance of euro area trade. Malta has accepted the obligations of Article VIII (sections 2, 3, and 4) of the Articles of Agreement.

- Despite progress in fiscal consolidation, more will be needed in the medium-term. This should be achieved through expenditure reform rather than increases in the tax burden. The public sector remains large.

- Privatization plans moved forward, and efforts were made to restructure the public sector and enhance the financial viability of public enterprises.

II. ECONOMIC BACKGROUND AND RECENT DEVELOPMENTS

3. **Malta enjoyed rapid economic growth during most of the 1990s**. The economic expansion was fueled by a vibrant tourist sector—accounting for roughly 30 percent of GDP—that draws on Malta's favorable geographical position in the Mediterranean. In addition, the economy was boosted by the semi-conductor industry—roughly 75 percent of manufactured exports—that draws on a skilled labor force. Malta's per capita income almost doubled in the past ten years, and its income as a share of the EU average rose to 56 percent (text figure)—well above most accession candidates, although a bit lower than the least affluent EU members.



(*): Countries set to join on 1st May 2004.

4. **Adverse shocks to tourism and the semi conductor sectors, however, weighed on economic developments in the past two years** (Table 1, and Figure 1). The September 11 attacks further dented the tourism sector that was already beset by a weak European market; tourist arrivals declined by a cumulative 7 percent in 2001 and 2002 (Figure 2). At the same time, the bursting of the high-tech bubble dampened exports and private investment (Figure 3). Despite these adverse developments, relatively flexible labor markets kept unemployment fairly steady at 5–5¼ percent. Following a decline in GDP in 2001, a modest recovery began in 2002—with some improvement in the tourist sector in the second half of the year, particularly tourist arrivals from France and the United Kingdom—but employment growth remained weak (Figure 4).

5. **Concerns about the balance of payments and competitiveness have diminished with a narrowing of the external current account deficit and growing international reserves** (Table 2). Following a dramatic one-off widening of the current account deficit in 2000—associated with substantial capital investment in the semi-conductor sector and large dividend payments—the current account balance has returned to more sustainable levels. The increases in international reserves were associated with the reversal of the interest rate differential in favor of the Maltese lira (Figure 5) and the Foreign Investment Registration Scheme that attracted capital despite flagging direct investment.[1] At about seven months of imports of goods and services at the end of 2002, international reserves are a bit higher than the long-run average, and continue growing; gross external debt is small.

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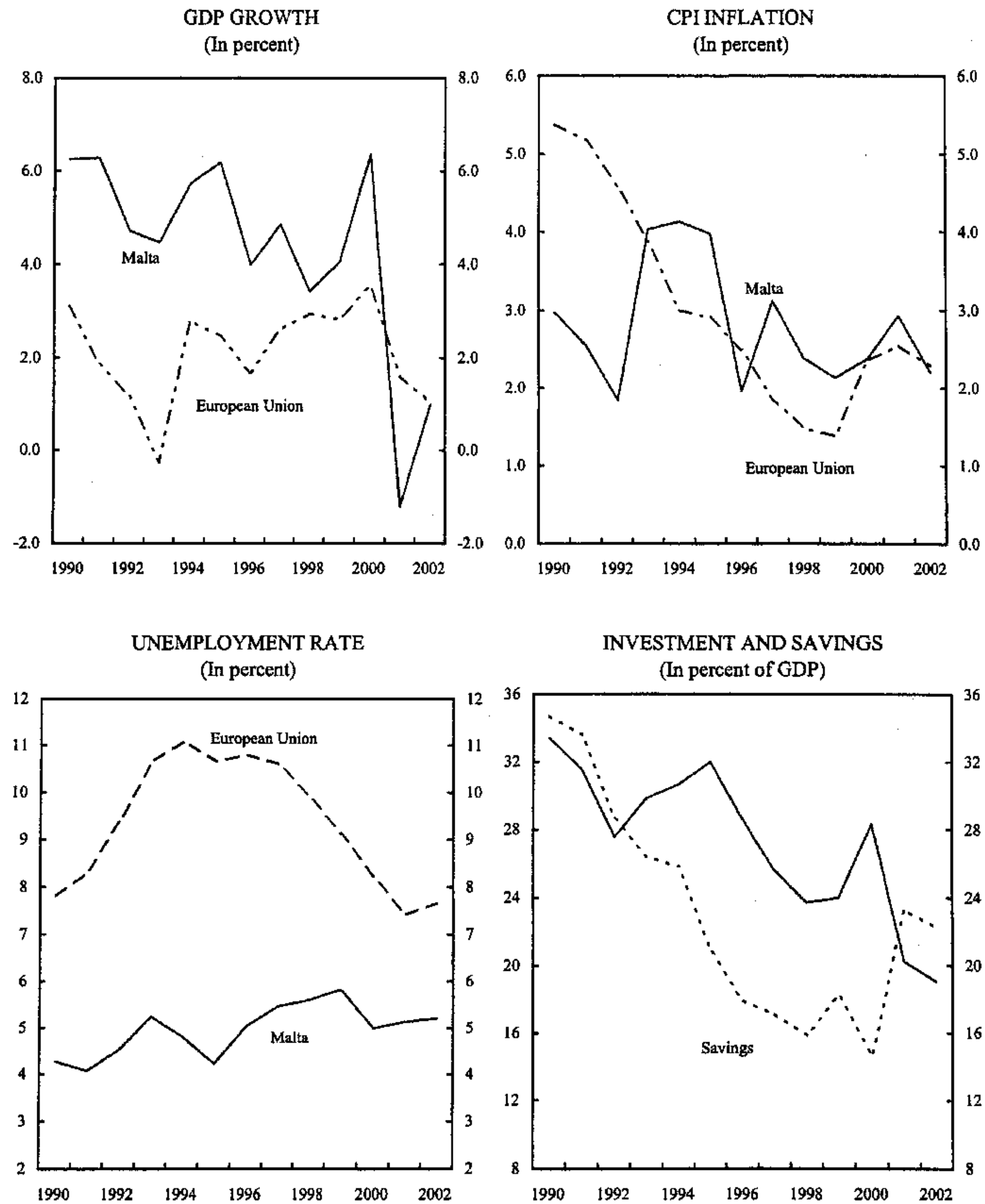
[1] The scheme was launched in 2001, and offered individuals the possibility of regularizing their investments abroad through a small registration fee. These funds could be repatriated if desired. The available information suggests that Lm 291 million were registered, of which Lm 55 million were repatriated.

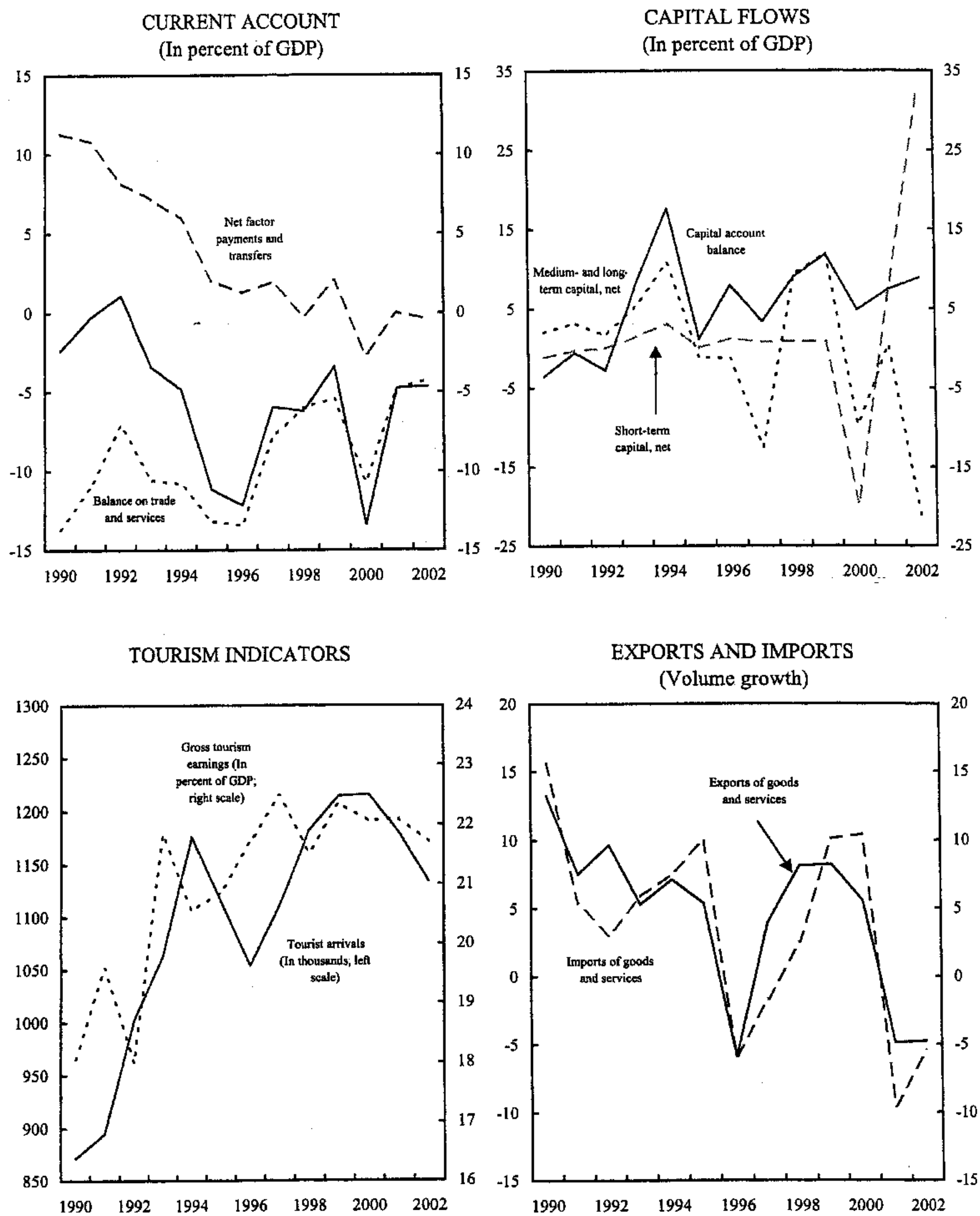
Figure 1. Malta: Main Developments, 1990-2002



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

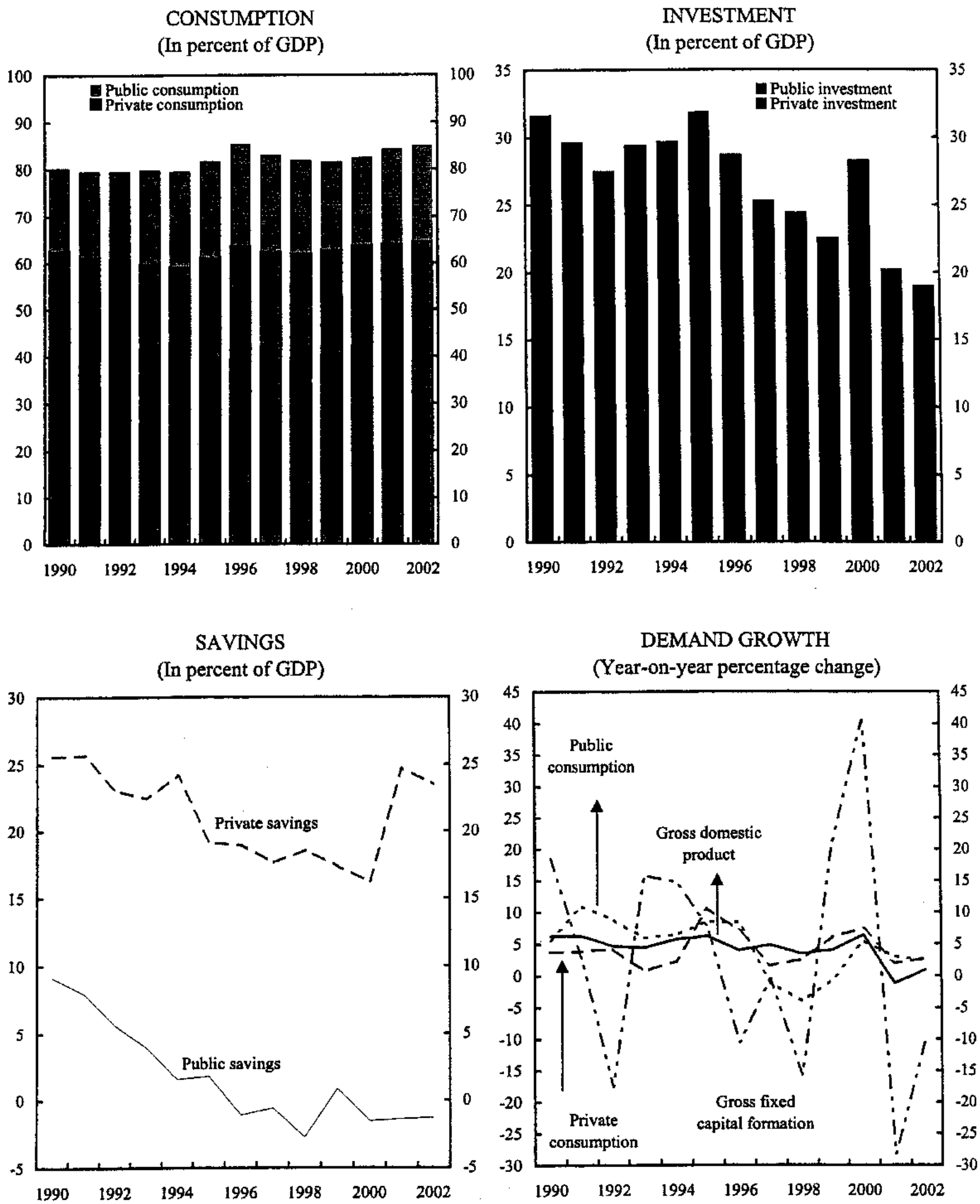
1/ Recorded GDP growth in 1995 was exceptionally high due to improved coverage of economic activities following the introduction of the VAT.

Figure 2. Malta: External Sector, 1990-2002



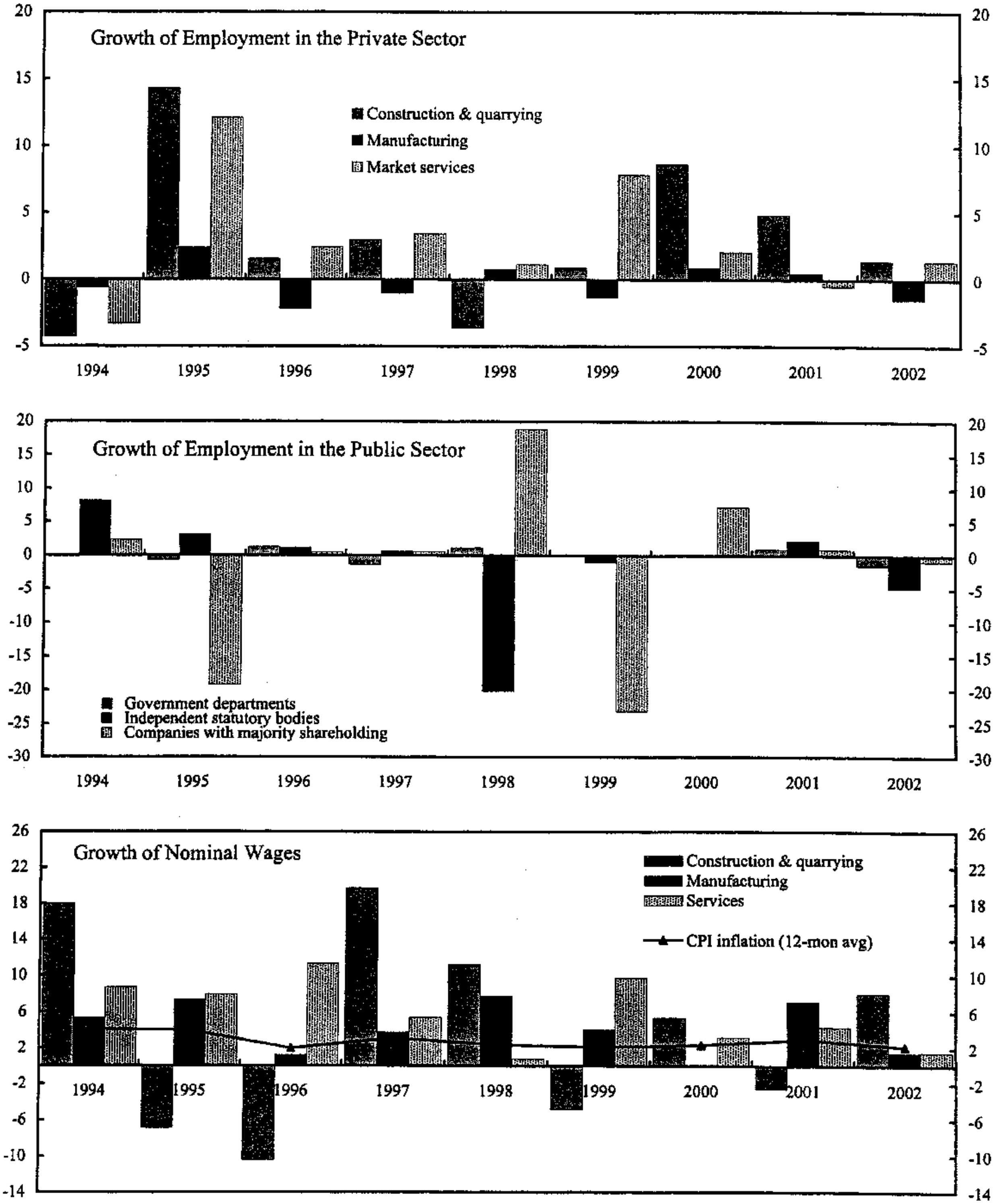
Sources: Data provided by the Maltese authorities; IMF, *International Financial Statistics*; and Fund staff estimates.

Figure 3. Malta: Real Sector, 1990-2002



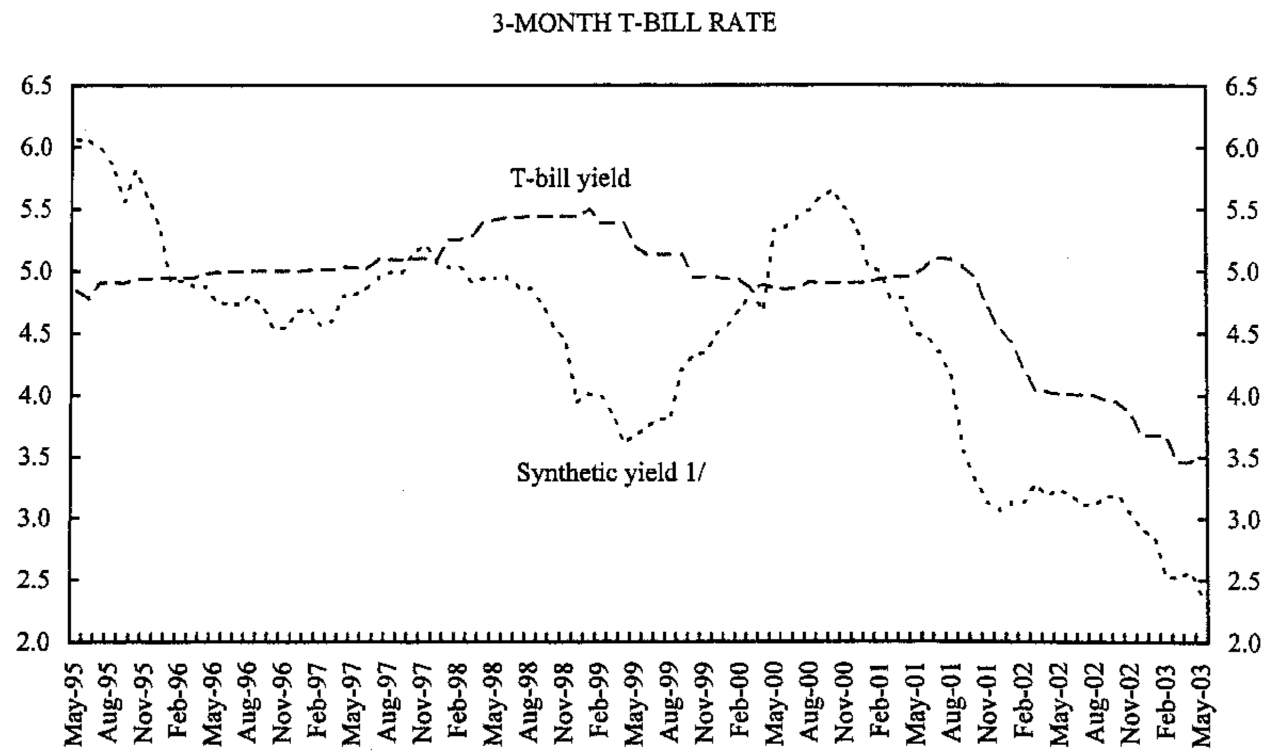
Sources: Data provided by the Maltese authorities; IMF, *International Financial Statistics*; and Fund staff estimates.

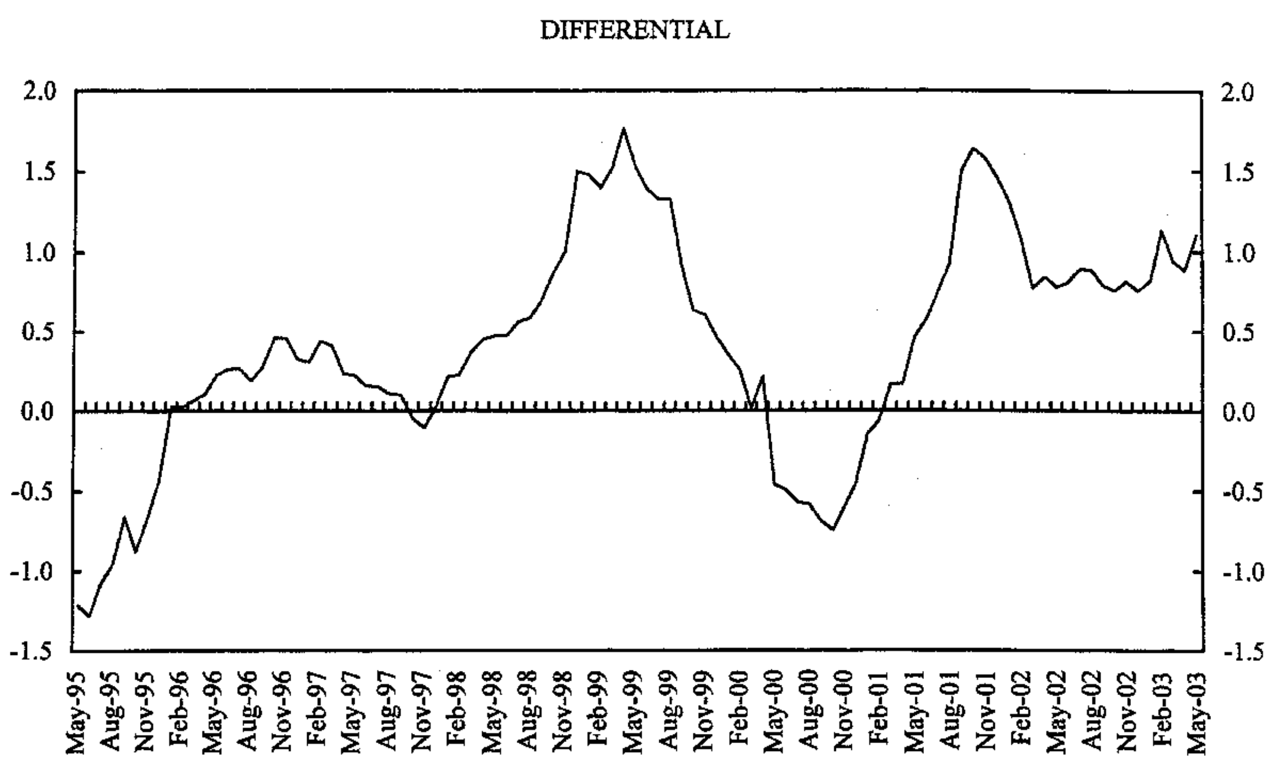
Figure 4. Malta: Employment and Wages, 1994-2002
(In percent)



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

Figure 5. Malta: Interest Rate Developments, 1995-2003

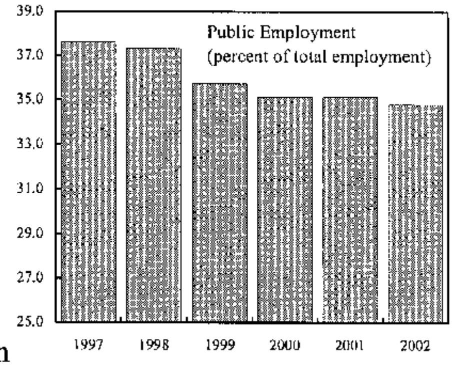




Source: Maltese authorities.

1/ International interest rates weighted according to Malta's currency basket.

6. **The fiscal situation remains difficult, despite some progress in consolidating public finances**. The fiscal deficit has been brought down from well over 10 percent in the mid-1990s to 6½ percent of GDP in 2002, still a high level (Table 3, and Figure 6). The reduction was achieved mainly through increases in taxes (including income taxes and the re-introduction of the VAT, Table 4), and improved collection through the creation of the Tax Compliance Unit. Current expenditures—particularly the public sector wage bill and subsidies to public enterprises—were reduced in the late 1990s, but have crawled back with subsidies reaching 5 percent of GDP in 2002 (Table 5);[2] public sector employment declined but remains high (text figure). Fiscal outturns have exceeded those in the budget by an average ¾ percent of GDP since 2000. These deviations were initially associated with weaker revenues. More recently, expenditure overruns played a role, particularly when pressures associated with the electoral calendar intensified in 2002 (text table). Public debt more than doubled in the 1990s, and stood at 64 percent of GDP in 2002. Privatization proceeds (about 7½ percent of GDP) have, however, limited the increase in public debt to about 6 percentage points of GDP since 1999.



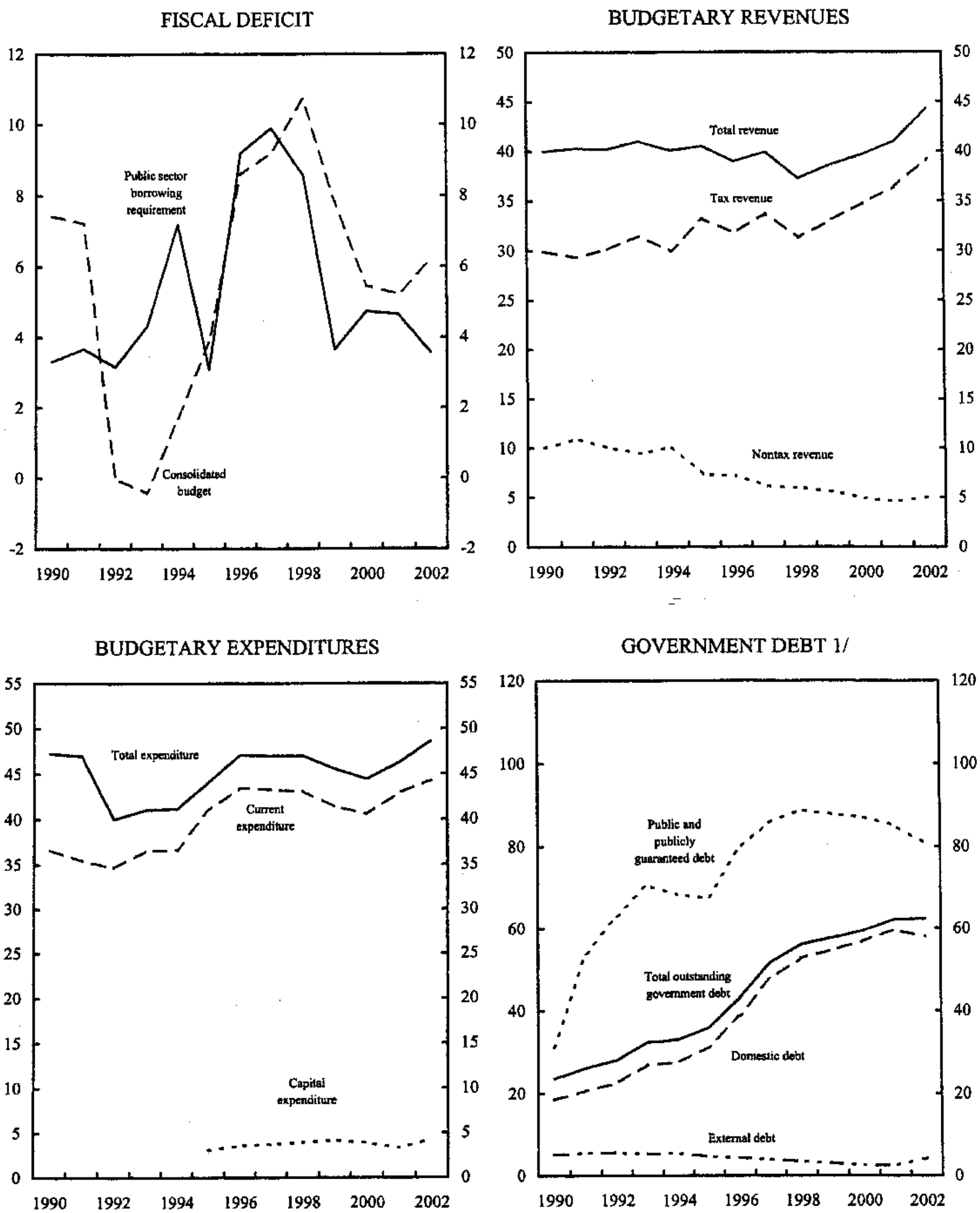
General government budget and outturns

	1999	2000	2001	2002	2003	2004	2005
				(in percent of GDP)			
				A. Deficit			
Actual /1	**8.2**	**7.0**	**6.8**	**6.3**			
1999 Budget Speech	8.5						
2000 Budget Speech		6.4					
2001 Budget Speech			4.8				
2002 Budget Speech				4.6	3.0	2.5	
2003 Budget Speech 1/					4.5	4.2	3.5
				B. Revenues			
Actual	**38.6**	**39.5**	**40.9**	**42.7**			
1999 Budget Speech	37.9						
2000 Budget Speech		38.7					
2001 Budget Speech			41.2				
2002 Budget Speech				43.6	41.8	40.7	
2003 Budget Speech					42.6	41.2	40.1
				C. Expenditures			
Actual 1/	**46.9**	**46.6**	**47.8**	**49.0**			
1999 Budget Speech	46.4						
2000 Budget Speech		45.1					
2001 Budget Speech			46.0				
2002 Budget Speech				48.3	44.8	43.2	
2003 Budget Speech /1					47.1	45.4	43.6

/1 Corresponds to general government ESA95 methodology.

[2] This reflects financial support to Malta Shipyards, Malta Freeport Corporation, and Gozo Ferries.

Figure 6. Malta: Fiscal Developments, 1990-2002
(In percent of GDP)



Source: Data provided by the Maltese authorities.

1/ Government debt does not include government-guaranteed debt.

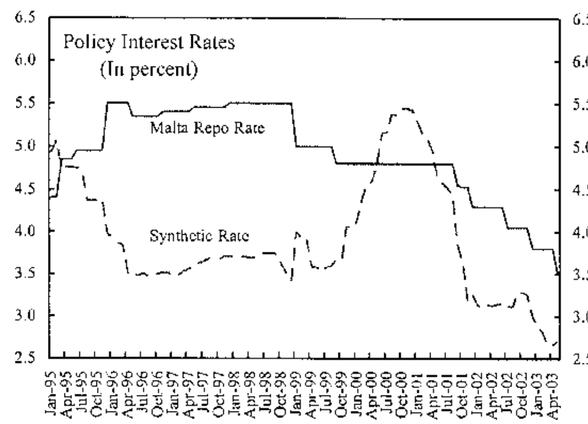
7. **Malta maintains a long-standing exchange rate peg to a basket of currencies—currently composed of the euro, pound sterling, and dollar**. The peg has served Malta well, including during the recent period of liberalization. Inflation has averaged just over 3 percent in the past 20 years, and although it does not seem that the exchange rate regime has hindered Malta's competitiveness (Figure 7), it may have shifted the burden of adjustment to the real sector, where volatility is high, particularly in investment (text table). Initially, capital account restrictions allowed the CBM some room for active monetary policy, but the ongoing gradual liberalization of the capital account has diminished the ability to conduct monetary policy independently of world rates.[3] Thus, the CBM's policy interest rate and the synthetic rate have become increasingly aligned in the past two years—resulting in considerable easing since late 2001 (text figure and Figure 8).[4]

Macroeconomic Volatility 1993-2002

	Malta	Cyprus	EU Accession Countries 1/	Euro Area
GDP				
Average percent change	4.1	3.8	3.5	1.9
Standard deviation	2.1	1.9	2.3	1.2
Coefficient of variation	0.5	0.5	0.7	0.7
Investment 2/				
Average percent change	3.2	0.5	6.8	1.5
Standard deviation	10.3	6.5	9.2	3.7
Coefficient of variation	3.3	13.5	1.4	2.4
Private consumption 2/				
Standard Deviation	3.3	4.5	3.0	1.2
Average percent change	4.3	5.5	4.0	1.7
Coefficient of variation	0.8	0.8	0.8	0.7

Source: WEO.
1/ Countries set to join on May 1, 2004.
2/ Excludes Lithuania.

8. **Domestic credit growth remains on a downward trend, with banking credit to the private sector particularly weak** (Table 6 and Figure 9). Aside from the soft economic activity that has contributed to a feeble demand for credit, corporates appear to be switching to corporate bond issues—doubling to Lm 25.5 million in 2002—and away from bank loans. This has occurred against the background of stricter lending requirements associated with the implementation of new banking regulations, "Bank Directive 09." Combined with the strong growth in deposits in the past couple of years, this has led to a rapid buildup of liquidity in the banking system and pressures to reduce interest rates that are now fully liberalized.



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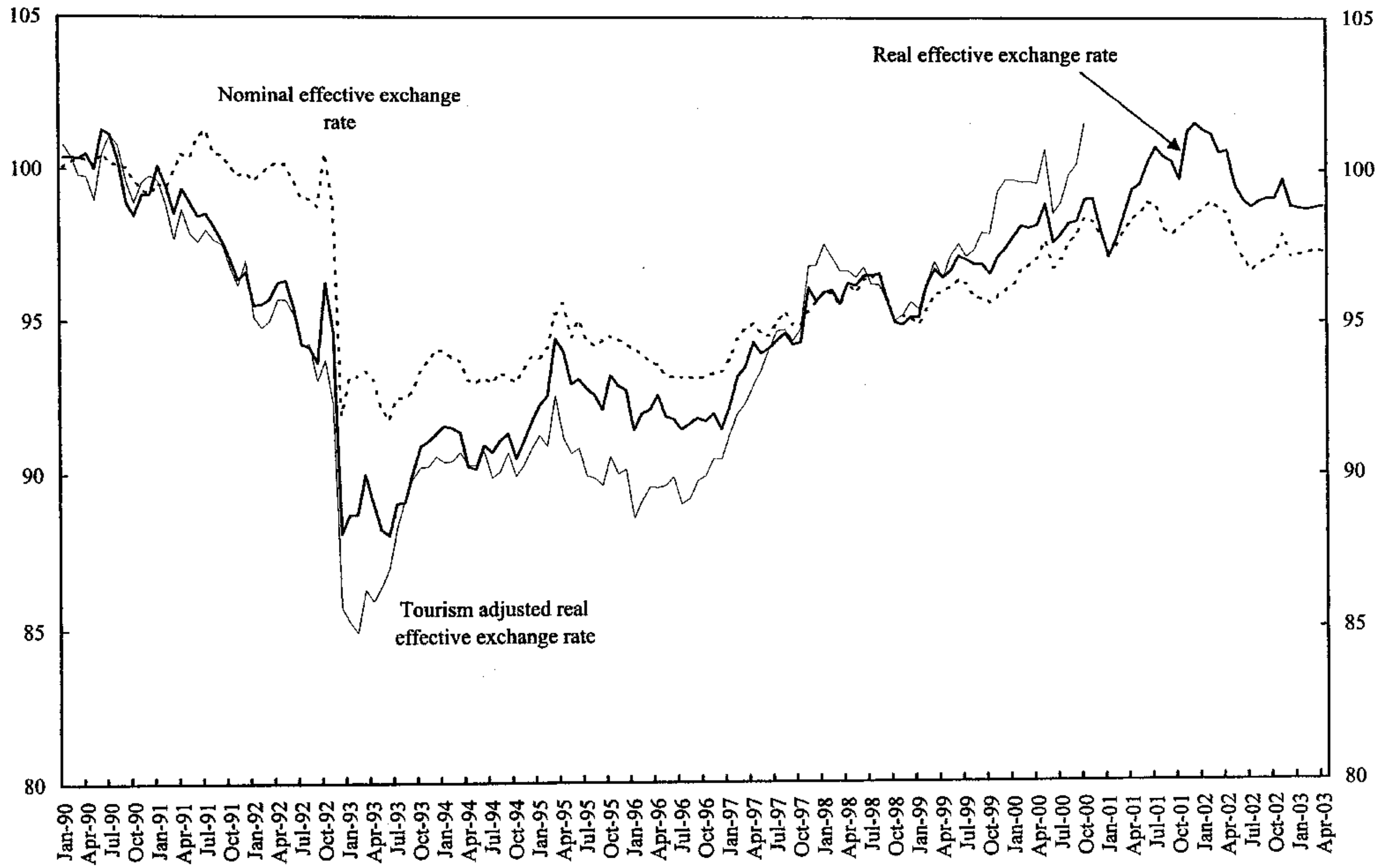
[3] Since January 2003, the main restrictions that remain are those on capital flows of less than six months.

[4] This has occurred against the background of greater institutional independence of the CBM. Amendments of the CBM Act approved by parliament in September 2002 aimed at: defining price stability as the primary objective; strengthening its independence to formulate and implement monetary policy; and increasing powers to collect, verify and publish information required to monitor and oversee the financial and payment system.

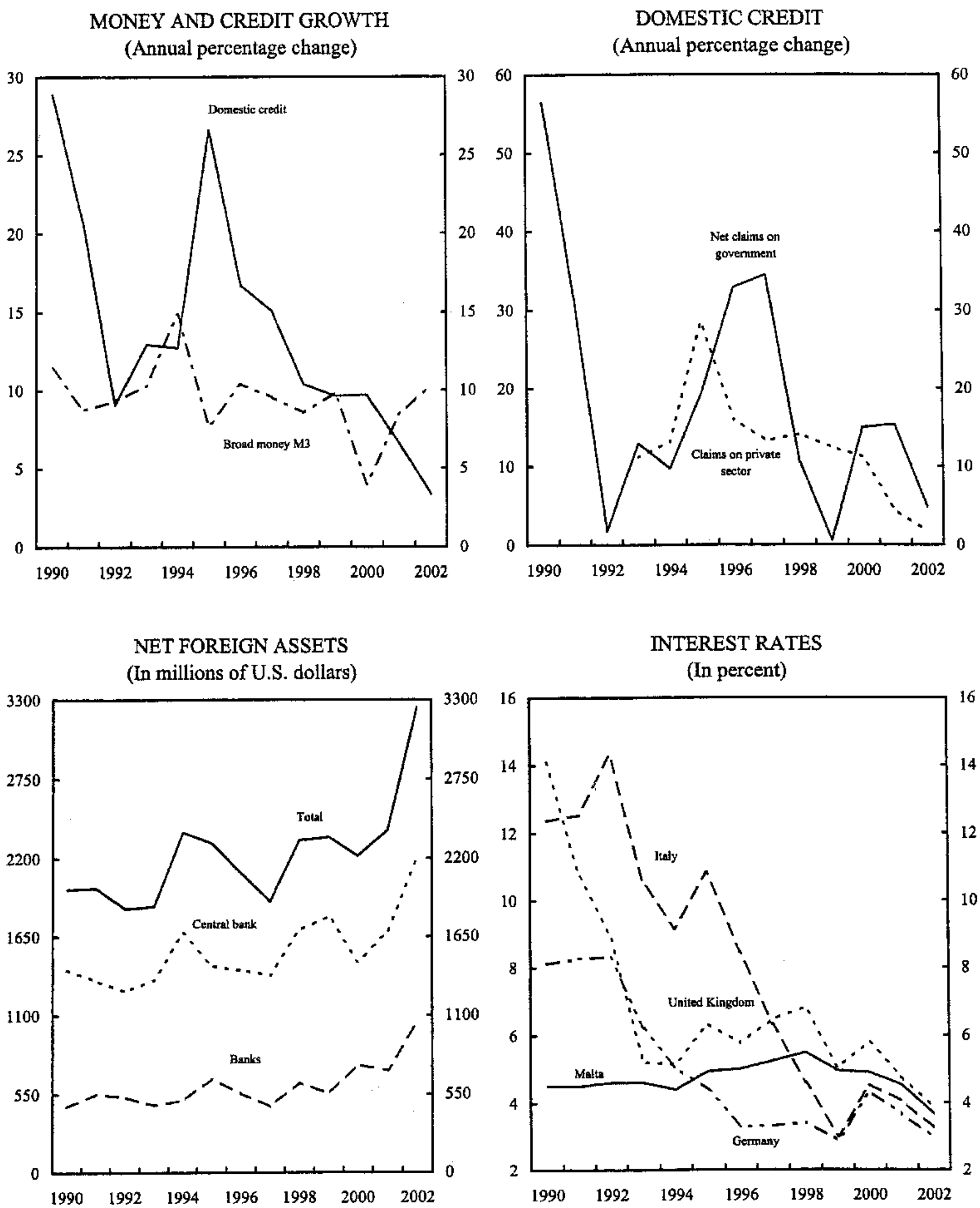
Figure 7. Effective Exchange Rates, 1990-2002



Source: IMF, INS; and Fund staff estimates.

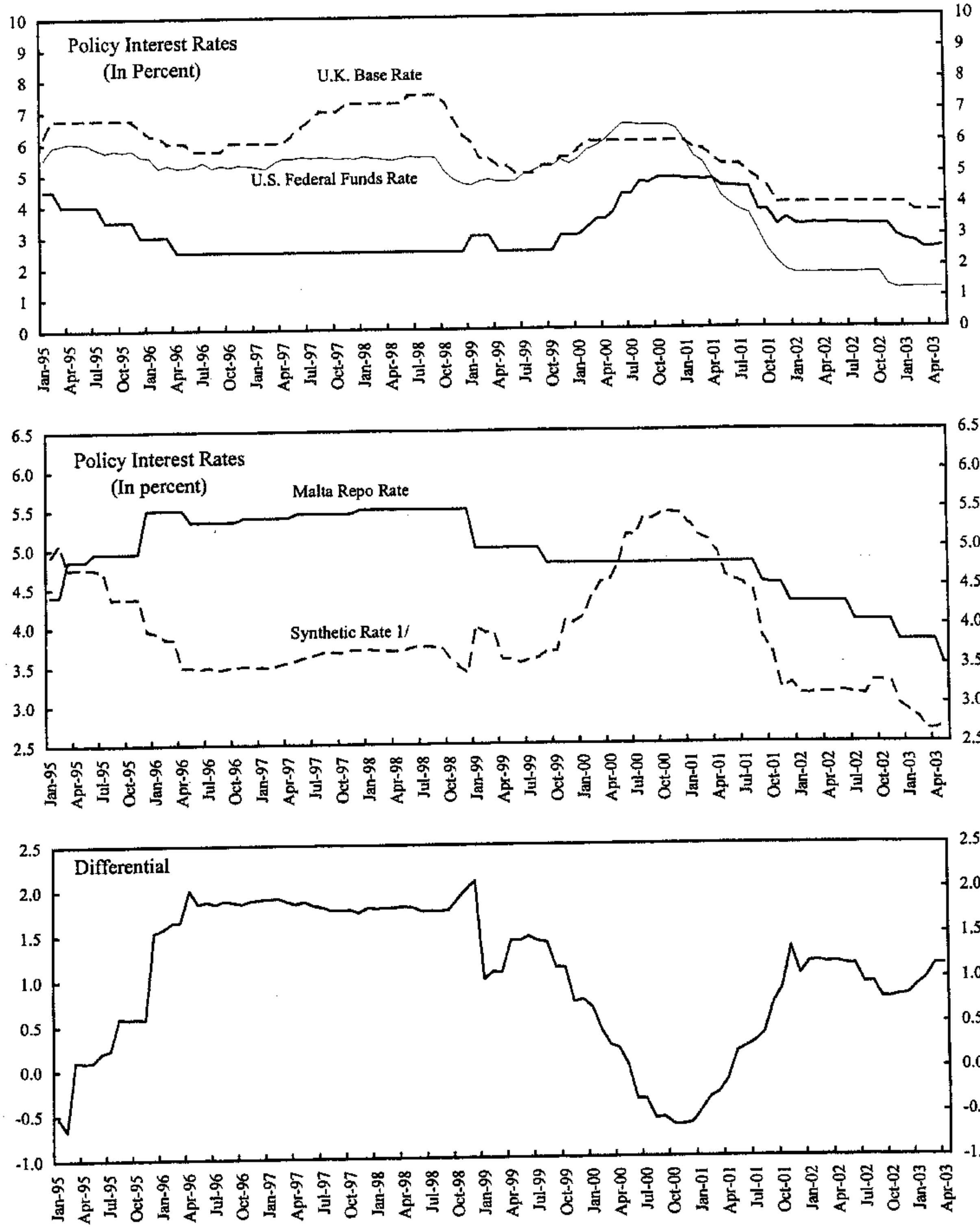
1/ Based on consumer price indices.

Figure 8. Malta: Monetary Sector Developments, 1990-2002



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

Figure 9. Malta: Interest Rates, 1995-2003



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.

9. **With the liberalization of the financial sector, steps have been taken to strengthen supervision.** Financial intermediation is well developed: total deposits of commercial banks (excluding international banking institutions) accounted for about 140 percent of GDP in 2002; and domestic credit to the nonfinancial private sector has risen to almost 100 percent of GDP. However, the banking sector remains highly concentrated, with two (Bank of Valletta, and HSBC Malta) of four domestic banks accounting for about 90 percent of loans and deposits; loan portfolios are also concentrated reflecting the limited diversification of the economy. To strengthen the regulatory and supervisory environment, supervisory responsibilities were consolidated in the Malta Financial Service Authority (MFSA) in January 2002. The previous responsibility of the CBM for oversight of the banking sector has thus been transferred to the MFSA, which also supervises the less developed securities and insurance sectors. (For further discussion of the financial sector see the FSSA report.)

III. Report on Discussions

10. **With Malta joining the EU on May 1, 2004, the discussions centered on how macroeconomic and structural policies should be framed to foster economic growth and income convergence.** In the short run, the weak recovery presents a dilemma for fiscal policy: much needed fiscal adjustment could hinder the incipient recovery, but failing to address fiscal problems promptly may led to harsh adjustment latter. Delaying adjustment also poses challenges to enter ERM2 and the eventual adoption of the euro. Looking beyond the near term, macroeconomic policies will need to be consistent with the demands associated with EU membership, and it will also be important to press ahead with structural reforms to improve economic efficiency.

A. Economic Outlook and Short-Run Policy Issues

11. **Prospects are for only a gradual recovery in 2003 and 2004.** Official projections place real GDP growth at 3 percent in 2003 and accelerating to 3.3 percent (close to potential growth) in 2004. The acceleration is driven by a doubling of export growth to about 5¾ percent, and a boost to investment from resolving the uncertainty regarding EU accession. Consumption, which has remained fairly robust during the downturn, is envisaged to continue to grow at a health pace. The authorities underscored that these projections depend on a pick-up of growth in Europe in the second half of 2003, and a gradual fading of the geo-political tensions that have weighed on the tourist industry. Staff's growth projections are similar (Tables 7 and 8), although they are premised on somewhat stronger domestic demand and, in light of developments in the euro area, a weaker recovery of exports.

12. **The fiscal deficit is projected to again exceed the 2003 budget target.** The authorities noted that the 2003 budget envisaged reducing the general government deficit to 4.5 percent of GDP, or almost 2 percentage points lower than the outturn in 2002 (Box 2). Recent estimates, however, suggest that the deficit would be closer to 5 percent of GDP. The authorities noted that expenditures are running higher than budgeted in a number of

Box 2. The 2003 Budget and the Three-Year Plan

The 2003 budget provides some income tax relief with the reintroduction of five income tax brackets, and more generous deductions. Direct taxes, however, were increased by extending the VAT to electricity and gas products (with Enemalta paying the tax bill). Expenditures increases are concentrated in various programs and initiatives, such as: supplementary income allowances; payment for maintenance of children in cases of marriage separations; increases in income allowance for those with three or more children; and increases in social security benefits. Also, old age pensions are adjusted using a new price index resulting in more generous (some 10 percentage points higher) COLA adjustments.

The 2003 Budget also provides a plan for the next two years (text table). The main elements are:

- Both current revenues and expenditures are expected to decline roughly 2.5 percent of GDP; interest payments remain roughly unchanged.
- Capital expenditures are set to fall by 1.3 percent of GDP, mirroring the reduction in the fiscal deficit in the three year period.
- Reflecting privatization receipts, public debt is expected to decline in 2003, but is set to exceed 60 percent from 2004 onward.

Fiscal Consolidation Plan 2003-2005
(percent of GDP at market prices)

	2002	2003	2004	2005
Receipts	43.6	42.6	41.2	40.1
Recurrent costs	38.4	37.5	36.1	34.9
Interest on public debt	3.7	3.3	3.5	3.3
Capital expenditure	6.0	6.0	5.3	4.7
Fiscal Balance (Consolidated Fund)	-4.6	-4.1	-3.6	-2.8
Adjustments to Consolidated Fund	-1.7	-0.4	-0.6	-0.6
Local Councils	0.1	0.1	0.1	0.1
Fiscal Balance General Government	-6.2	-4.5	-4.1	-3.4
Asset sales	2.2	2.8	0.0	0.0
Government debt	61.2	59.8	60.4	60.5

Source: Budget Speech 2003.

items (including subsidies associated with the renewal of the public transportation fleet and free medicines), and current expenses associated with the EU accession were not budgeted. And, on the revenue side, although collections were weak in the first quarter of 2003, this is partly due to temporary factors that the authorities expect will be reversed later in the year. Nevertheless, they now view the revenue projections as somewhat optimistic in light of the shortfalls experienced late last year.

13. **The mission stressed the importance of achieving lasting fiscal consolidation, and limiting expenditure to the level in the 2003 budget**. The authorities noted that some additional expenditure in 2003 was unavoidable, but efforts are underway to partially offset them by issuing a guideline that calls on ministries and departments (the main budgetary units) to execute only 90 percent of the total expenditure allocated in the budget.[5] Further they noted that overruns in the public sector wage bill are less likely this year because the collective wage agreement includes the COLA, in contrast with previous agreements where the COLA was not included. To the extent possible, the authorities intend to fill public sector vacancies by redeploying public employees. The mission noted that these steps could help limit expenditure overruns, but this is a blunt instrument and questions remain as to the ability of spending units to adhere to this guideline. In light of previous difficulties in containing expenditures and the level of public sector employment, a lasting solution would involve strengthening the institutional setting to enhance fiscal discipline and reduce public sector employment (as discussed further below).

14. **With tighter fiscal policy, there was agreement that there is scope to reduce interest rates in line with world interest rates**. The continued accumulation of international reserves suggests that confidence in the exchange rate regime has remained high as capital movements have become increasing liberalized. Moreover, inflation pressures remain under control, and the recent evolution of oil prices was reassuring. The authorities observed that although the scope to set interest rates independently of world rates was disappearing, interest rate decisions still need to be consistent with the risk premium associated with financial assets denominated in domestic currency. As this premium tended to reflect investors' perceptions of fiscal policy, the ability to narrow the interest rate differential is linked to progress in fiscal consolidation. Following the consultation discussions, the authorities cut interest rates by 25 basis points on May 28 and June 24, the latter followed the ECB's 50 basis point cut on June 5.

15. **The resulting policy mix should provide support for the economy in the short-run as fiscal consolidation moves forward**. At the time of the consultation discussions, the authorities viewed the policy mix to be skewed, with slippage in fiscal policy tipping the balance in 2002. They noted, however, that the ability of monetary policy to offset the

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[5] "Variable budgeting" was introduced in January, and allows units to exceed the limit only with prior authorization of the Ministry of Finance. Strict adherence to the 90 percent execution of the budget would cut spending by about 3.2 percent of GDP.

demand effect of fiscal policy was limited by the exchange rate regime and the high degree of capital mobility. Moreover, as fiscal consolidation moves ahead—further enhancing the credibility of the exchange rate regime—the stage will be set for additional interest rate cuts.

B. Medium- and Long-Term Challenges

16. **EU accession marks a turning point in Malta's economic history, and will require a strengthening of the policy environment**. In this regard, the discussions focused on: (a) aligning fiscal and monetary policies with the rigors associated with EU membership, thereby providing a solid foundation to adopt the euro and deal with an ageing population; and (b) continuing with structural reforms focused on reducing the public sector involvement in the economy.

Fiscal policy

17. **Looking forward to ERM2 and the eventual adoption of the euro, the authorities' three-year fiscal plan would benefit from more ambitious objectives for consolidation**. The authorities' goal, as established in the 2003 Budget Speech, is to reduce the fiscal deficit to 3.4 percent by 2005. This would be achieved primarily by increased revenues (boosted by continued efforts to improve tax collection and the economic recovery) and some expenditure containment; this differs somewhat from the consolidation envisaged in the 2003 budget and a revised plan will be unveiled in the 2004 Budget speech due out in November. The mission noted that given the substantial progress in improving tax collections there was little room to continue increasing revenues without raising tax rates that are already high. Thus, consolidation will require cutting expenditure. Staff stressed the importance of not exceeding the 2003 deficit target of 4½ percent of GDP and that the next three-year fiscal plan should aim to reduce the deficit to close to 2 percent by 2006. This could be achieved by limiting increases in the public sector wage bill (wage moderation and more ambitious public sector employment retrenchment), continuing efforts to curtail abuse in the welfare system (prioritizing benefits and extending means testing to all benefits), and enhancing efficiency in public sector enterprises. This would head off the need for abrupt fiscal adjustment, provide some room to safeguard against cyclical downturns, and enable early ERM2 entry (as discussed further in ¶ 20). Moreover, although current estimates place the public debt at about 60 percent of GDP in 2006—the Maastricht ceiling—there is a danger that the ratio could end up much higher, particularly if the historical volatility of the real interest rate and the primary balance are not tempered (for details see Appendix II). The authorities acknowledged the difficult fiscal position, but favored a more gradual adjustment in line with the leeway that other countries benefited from when adopting the euro.

18. **Enhancing the medium-term fiscal framework is critical**. The authorities noted the rolling three-year financial plan has become an integral part of the budget speech, reflecting continued commitment to fiscal consolidation. The mission agreed that these plans are an important first step in constructing a full-fledged medium-term framework, but stressed the need to supplement them by establishing binding expenditure ceilings to enhance commitment. In addition, there would be benefits in replacing the use of extra-

budgetary funds (Treasury Clearance Fund or TCF, and Supplementary Estimates) with a strict and transparent process ensuring their exceptional use. For instance, this could be accomplished by completing the transfer of all TCF transactions to the budget and subjecting the Supplementary Estimates to the same (ex-ante) parliamentary approval process as the budget. The authorities explained that parliamentary approval would add at least three weeks to the process, and that flexibility was needed to offset Malta's rigid budgetary laws that prohibit using the savings in one expenditure item to be used to offset overruns in another. The mission agreed that some flexibility was needed, but given the difficulties in limiting expenditures stressed that institutional changes were needed to establish hard expenditure ceilings.

19. **Addressing the fiscal consequences of an ageing population will need to be a key aspect of the medium-term framework**. Notwithstanding the inherent uncertainty associated with long-term population projections, estimates suggest that expenditure on old-age pensions (as a share of GDP) are set to increase steadily and more than double (to about 11 percent of GDP) in the next 20 years. The authorities explained that reforming pensions, and more generally the welfare system, and placing them on a sound financial footing is an integral part their medium-term strategy. In this connection, the National Welfare Commission (NWC) was established in 1999, but progress has been slowed by difficulties in producing a comprehensive proposal upon which to base reforms. Nonetheless, they noted that with the recent appointment of the new chairman, the NWC is expected to complete a technical report on pension reform later this year. The authorities noted that, without pre-judging the outcome of the report, changes to the welfare system are likely to be gradual and have little immediate impact on public finances; the main objective will be to ensure the long-term viability of the pension system. The mission found that the social partners were increasingly aware of the challenges posed by an ageing population, and the financial stress facing the pension and welfare systems—as evidenced by the public debate on the "Welfare Gap."[6] Further, common ground exists regarding reforms that would, on the one hand, establish a balance between the generations and, on the other hand, not overburden the cost of employment.[7] The mission agreed that a gradual implementation of pension reform might be feasible, but noted it could be so only if the process started early enough, was continuous, and sufficiently ambitious.

[6] The imbalance resulting from the contributions to and benefits paid out by the welfare system.

[7] These range from gradually increasing the pension age (that was set at 60 years in 1948, and revised once to 61 years for men in the 1970s) to rationalizing and establishing means testing for specific welfare benefits.

Monetary policy, ERM2, and the financial sector

20. **The authorities expressed their desire to enter ERM2 as soon as possible, although work continues to determine the precise timing of entry and euro adoption.** They explained that the structure of the economy made it well-suited to join the euro area (Appendix III) and that the benefits of early adoption for Malta—a small open economy that trades primarily with the euro area—were clear. The authorities' key concern, however, relates to the social costs of the rapid fiscal consolidation that would need to be achieved to underpin these objectives. Given the importance assigned to fiscal policy, they noted that the natural place to articulate the euro adoption strategy is the Budget Speech. The authorities stressed, however, that entering ERM2 would not involve a major deviation from the current arrangement and would be consistent with the evolution of the currency basket (Box 3). The mission agreed that, provided lasting fiscal consolidation was forthcoming, the present exchange rate regime is a suitable framework to join ERM2 and adopt the euro. It also stressed the importance of conveying clearly to the public plans for ERM2 and euro adoption.

21. **Malta's financial system is sound and well supervised but, reflecting the country's narrow economic base, is fairly concentrated.** Financial soundness indicators (Table 9) and the FSAP stress tests show that the domestic banks are profitable, liquid, and well capitalized. The authorities noted that a comprehensive legal framework is in place, and that banking supervision adheres to most international standards and codes. The FSAP exercise found that the supervisory framework has been further strengthened to bring it in line with EU standards, and the capacity to manage the vulnerabilities in the financial system is improving rapidly. Nonetheless, the limited diversification of banks' loan portfolios, the strong reliance on real estate property as collateral, and the high concentration of domestic banking activities in the two major banks weaken the resiliency of the system. The authorities were in general agreement with the broadly positive assessment and conclusions of the FSAP exercise. They also pointed out that the unification of the supervision of all financial sectors in the MFSA had gone smoothly and that a Memorandum of Understanding between the MFSA and CBM has been signed providing for the creation of appropriate consultative mechanisms. (These issues are covered in greater detail in the FSSA report.)

22. **Capital account liberalization—which will be completed upon EU accession—opens new investment opportunities for domestic banks, but also exposes them to foreign competition.** The authorities noted that Malta's historic ties with Northern Africa and its geographical location affords a competitive advantage in niche markets, and these are likely to flourish with accession. Financial market participants observed that the international cost of funding for domestic banks was likely to experience a sharp drop in 2004: provisioning requirements for foreign loans to Maltese banks are likely to fall closer to 20 percent (the average required for EU banks) following accession, from 100 percent currently. The authorities noted, and financial market participants confirmed, that banks were actively engaged in seeking out markets that could help offset business lost to increased competition and the shrinking income from foreign exchange rate operations. Still, domestic banks are likely to see increased competition for Maltese blue chip business,

Box 3. Malta's Exchange Rate Regime, EU Accession, and ERM2

The Maltase lira is fixed to a basket of currencies: the euro, the pound sterling, and the dollar. Reflecting the movements in the valuation between these currencies, the CBM sets daily the three bilateral rates—with a small bid-ask spread to cover the costs of operating the FOREX window—that keep the value of the basket fixed.

Over time, the weights of the currencies in the basket have been adjusted to reflect the relative importance of Malta's bilateral trade; accordingly the weight of the euro has increased steadily. The most recent adjustment was on August 23, 2002 and entailed increasing the euro weight to 70 (from 56.8) percent and lowering the weights of the pound and the dollar respectively to 20 (21.6) and 10 (21.6) percent. As in previous adjustments, the CBM's cautious approach ensured that the exchange rate did not come under pressure.

All accession countries are expected to eventually adopt the euro, having spent at least two years in ERM2 without major economic upheavals. It is up to individual countries to determine when to enter ERM2. This requires an agreement on a central parity vis-à-vis the euro, and keeping the currency within a band of 15 percent in each direction. Although adjustments to the central parity are not ruled out, these are expected to be infrequent and in the direction of an appreciation. Hence, a wide-range of exchange rate regimes are compatible with ERM2, but if the exchange rate is fixed it must be fixed to the euro.

In this context, Malta faces two options to enter ERM2:

- ***Fixing the lira to the euro***, i.e., increasing the euro weight to 100 percent.
- ***Floating the lira within a narrow band.***

Fixing the lira to the euro would continue the steady process of increasing the weight of the euro. This implies that Malta could no longer benefit from the daily adjustment in bilateral rates. However, given the predominance of the euro in the current basket, this loss appears to be fairly small, provided the evolution of the euro/sterling rate remains within the small range observed in the past few years. Although the euro/dollar rate has varied significantly, its effect is dampened by its small weight. Moreover, the tried and proven nominal anchor would remain in place.

Floating the lira within a band would be a radical departure from the current exchange rate regime and is not being considered by the authorities. Volatility would likely increase compared with the current fixed exchange rate in light of the concentrated nature of the economy and the relatively thin foreign exchange market. And increases in competitiveness are likely to be small, if any, since Malta is reasonably competitive. Moreover, floating the currency requires setting up a new nominal anchor and overcoming the associated technical difficulties.

and there were already incipient signs of interest in mortgage lending. The mission pointed to the need to remain vigilant during this period of expected rapid transformation in the financial sector, stressing the need for supervisors to react without delay if needed.

Structural reforms

23. **Transforming the parastatal sector remains a high priority to raise public enterprise efficiency, improve service to the public, and deploy national resources more efficiently**. The authorities' blueprint for reforms is set out in the Privatization White Paper. Progress continued with the privatization of Malta Post and Malta International Airport in 2002, and negotiations are advanced for the privatization of Malta Lotto and Mediterranean Offshore Bunkering Company. The authorities noted, nonetheless, that technical difficulties and adverse market conditions hampered their recent efforts, notably regarding Malta Freeport Terminals. Plans to revitalize public enterprises were continuing. In particular, Malta shipyards have made progress in implementing the strategic business plan by focusing on its core business and trimming excess employment.[8] The authorities were confident that financial viability would be achieved within the six-year framework, with further downsizing in the next two years preparing the ground. Regarding Enemalta, the authorities noted that its petrol operations remain profitable and the adjustments in domestic prices every quarter had been carried out except in the first quarter this year. They explained that its electrical power operations would require fewer subsidies due to the efforts to increase the efficiency of electrical generation and reduced generation losses. The authorities also noted that the regulatory framework for public enterprise was being adjusted to conform with EU regulations. Staff welcome progress in restructuring the parastatal sector, and encouraged the authorities to press ahead with the agenda laid out in the White Paper.

24. **Redeploying resources to the private sector and increasing female participation can speed up real convergence**. The authorities noted that efficiency gains from revitalizing the parastatal sector and a more extensive use of the available labor resources would maximize opportunities for development and fuel growth. To the extent possible, the authorities intend to achieve restructuring of the parastatal sector by redeploying workers to other areas in the public sector where they were needed. However, workers choosing to seek employment in the private sector would be assisted by a clearing house matching worker's skills with those demanded; re-training would complement these efforts. Staff noted that downsizing total public sector employment was essential to enhance economic efficiency. And in the course of the discussions, business sector representatives expressed confidence in the economy's ability to assimilate excessive public sector employment. Regarding female

[8] The strategic business plan identified ship repair and conversion and the maintenance of super yachts as areas where it has a competitive edge. The plan envisages downsizing the labor force, and labor has been trimmed to 2,500 since 2001, with some 700 workers opting for voluntary retirement.

labor market participation, the authorities expressed their goal of increasing the integration of women in the work force, which would provide a boost to the economy. They noted that cultural attitudes are changing gradually with increasing labor participation among women in the 20–30 year age bracket, particularly in some career streams (banking, medical, and legal). This trend was expected to continue as over half of the university population are women. The mission supported the goal of increasing female participation closer to European levels and concurred that higher female participation in the work force would help widen the population pyramid, but noted that this would only delay the fiscal impact of an ageing population.

C. Other Issues

25. **The process of opening the economy to international trade continues**. The authorities noted that accession will mark the total dismantling of protective import levies on industrial products, increasing the outward orientation of the economy. Tariffs on most industrial products were eliminated on January 1, 2003; the authorities pointed to reassuring experience with the furniture sector, where tariffs were eliminated two months earlier.[9] At this point, only tariffs and levies on agricultural and agro-industry remain, and these will be lifted by the time of accession. The future of the agricultural sector is expected to lie in exploiting niche markets in Europe. This transformation would be achieved with the help of direct income support for farmers and restructuring assistance for agro-industry that will be gradually phased out over ten years.

26. **Economic data has improved, and Malta is expected to subscribe to the SDDS this year**. With the creation of the independent National Statistic Office in 2001 (Appendix IV), the authorities explained that progress was made in a number of areas: the rebasing of retail price index in line with the EU's harmonized index is almost ready; and national accounts data are being compiled on the ESA-95 basis, with coverage requirements to be achieved shortly. They noted that work continues to establish a rolling calendar of data publications, and deal with some reporting delays in government financing. Nonetheless, accession would pose a challenge to international trade data: customs with EU countries will be dismantled. They explained that efforts are currently underway to maintain the quality and coverage of these data. The SDDS data infrastructure, including the metadata, has been completed.

IV. Staff Appraisal

27. **Malta is well placed to reap the benefits from EU accession and embark on a path of rapid growth**. The economy has gradually been opened to international trade, allowing a greater role for market forces in allocating resources. At the same time, large

[9] Operators formed an association and have carved out a niche market for custom made furniture, and windows and doors (the latter facilitated by the lack of standardization of sizes). In addition, they are bidding on a contract to refurbish hotels in Northern Africa.

fiscal deficits have been reduced, and confidence in the exchange rate regime is high. Malta's human capital and geographic location places it in a favorable position to benefit from EU accession. However, achieving robust growth hinges on further improvements in public finances and sustained efforts to reform the economy.

28. **The near term outlook is for a gradual rebound in growth**. The pace of the recovery will be tempered by Malta's main economic activities—tourism and semi-conductors—that depend largely on developments in Europe, where growth is set to disappoint for a third year. Still, reductions in taxes are likely to boost consumption, and investment is poised to pick-up as the pre-referendum wait-and-see environment fades.

29. **The key immediate policy need is to put the public finances on a sound footing**. Although headway was made in consolidating the fiscal position, the pace has been slow with the deficit last year still twice that required for euro entry. Moreover, public sector employment remains high, the parastatal sector continues to rely on public subsidies, and the welfare system is under strain. In addition, the excessive deficits in the late 1990s have left Malta with a high public sector debt, despite significant privatization proceeds in the past five years. Strengthening the fiscal position can provide insurance against economic shocks to safeguard Malta's achievements, and by reducing public sector involvement in the economy foster a more efficient use of resources and economic growth. Moreover, current fiscal plans—elaborated amidst the uncertainty about EU accession—do not address the potentially adverse debt dynamics, and strengthening them (including fleshing out the needed policy measures) will be important to ensure smooth sailing in the run-up to ERM2 and the eventual adoption of the euro. The consolidation plans should be anchored in cutting current expenditure, which will require establishing spending priorities. This will involve persistent efforts to reduce public sector employment, rationalize the welfare system to enhance its effectiveness and curtail abuse, and enhance the efficiency of the parastatal sector.

30. **A tighter fiscal policy facilitates cutting interest rates in line with world interest rates**. The resulting policy mix will support the gradual rebound in growth in the near term.

31. **Going forward, there is a need to strengthen the medium-term fiscal framework**. The three-year planning horizon in the budget is a welcome step forward in establishing a medium-term fiscal framework. Instilling fiscal discipline, however, requires introducing strict expenditure ceilings. The right formulation to achieve this discipline would cap spending without unduly restricting flexibility across categories; capital spending should be protected. Parliamentary approval, while slowing the process, would nonetheless foster transparency allowing society to discuss openly the case of modifying fiscal targets. Looking forward, as experience is gained with the three-year rolling horizon, introducing longer term projections would help capturing the impact of an ageing population early on; extending the rolling horizon to five years could be considered.

32. **Clinching the medium-term framework requires addressing the largely unaddressed challenges posed by an ageing population**. Although there is an increasing

awareness that this shock will present fiscal policy with a mounting challenge in the next 20 years, pension reform has lagged. Substantive reforms will require adjusting key parameters, including increasing the minimum pension age—that has remained largely unchanged for over 50 years—and bringing benefits closer in line with contributions. In addition, private pension schemes and other so-called second and third pillars are options that could be considered. The National Welfare Commission's forthcoming report should provide the technical analysis required to guide the details of these reforms. A public debate on the reforms will be important to foster a spirit of co-responsibility for Malta's future. As long as meaningful reforms are introduced soon, there is room to phase in key provisions.

33. **Malta's exchange rate peg provides a suitable framework to join ERM2 and eventually adopt the euro**. The favorable experience with a peg to a basket of currencies suggests that the economy is able to cope with the rigors of a fixed exchange rate. Labor markets, in particular, appear to be sufficiently flexible to deal with the economy's volatility without generating long spells of high unemployment. Further, the economy is increasingly tied to the euro area market, and continuing to align domestic interest rates with world rates instills confidence in the exchange rate regime. Moreover, the conclusions of the FSAP exercise regarding the soundness of the financial and banking system are reassuring. To facilitate a smooth transition to ERM2, a concerted communication strategy that ensures agents view it as the natural culmination of the Maltese currency basket should be an integral part of this transition. Still, the timing to enter ERM2 will depend on Malta's ability to strengthen its fiscal position and achieve the durable consolidation needed to buffer against the associated economic rigors.

34. **Strengthened supervision will play a critical role in maintaining the health and ensuring the viability of the financial system, particularly as competition intensifies with accession**. The consolidation of the supervisory responsibilities at the MFSA is an important step in this regard. And with the signing of a Memorandum of Understanding, a close working relationship between officials of the MFSA and CBM is essential to ensure that each institution has access to all of the relevant information required to fulfill their statutory responsibilities. If needed, prompt corrective action steps should be taken to address any emerging problems.

35. **Reforms in the parastatal sector are ongoing but difficult choices lie ahead**. Privatization continues, albeit with some delays. Completing the task will lead to a significant reduction of the public sector's involvement in the economy, attracting foreign direct investment, and contributing to a more efficient deployment of resources. In this connection, decisive actions to cut public sector employment are needed. Releasing excessive public sector employment to the private sector will be key to boost economic efficiency, and contribute to lasting economic growth.

36. **Malta's database has improved significantly and is adequate for surveillance**. The timeliness of national accounts and fiscal data require further strengthening nonetheless.

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

Table 1. Malta: Selected Economic Indicators, 1995-2002

	1995	1996	1997	1998	1999	2000	2001	2002
Real economy (percentage change; constant prices)								
Real GDP	6.9	4.0	4.9	3.4	4.1	6.4	-1.2	1.0
Private consumption	10.5	7.1	1.6	2.5	6.1	7.4	2.0	2.7
Public consumption	8.5	8.4	-1.1	-4.0	-0.6	5.4	3.0	2.5
Gross capital formation	14.5	-9.1	-3.2	-7.3	10.3	23.4	-28.2	-9.9
Fixed capital formation	17.8	-8.4	-4.5	-3.4	4.0	17.4	-11.2	-4.2
Exports of goods and services	5.4	-5.9	4.0	8.1	8.2	5.6	-4.9	-4.7
Imports of goods and services	10.0	-5.9	-1.7	2.5	10.1	10.4	-9.6	-5.5
Retail prices (period average)	4.0	2.0	3.1	2.4	2.1	2.4	2.9	2.2
Retail prices (end period)	3.6	1.9	4.3	1.3	3.3	1.1	4.6	0.3
Unemployment rate (percent of labor force)	4.2	5.0	5.5	5.6	5.8	5.0	5.1	5.2
Public finance (percent of GDP)								
Government budget deficit (Consolidated Fund)	-3.9	-8.6	-9.2	-10.7	-7.8	-5.5	-5.2	-6.1
Government debt	35.9	43.0	51.3	55.9	57.5	59.0	61.9	63.8
Money and credit (end period; percentage change)								
Narrow money	-5.6	3.8	5.7	8.6	11.5	2.3	6.9	7.0
Broad money	7.8	10.4	9.6	8.6	9.9	4.0	8.4	10.4
Domestic credit	26.6	16.7	15.1	10.4	9.6	9.7	6.6	3.3
Credit to government	19.4	32.9	34.5	10.7	0.6	15.0	15.4	4.8
Credit to the private and parastatal sectors	28.0	13.9	11.2	10.3	11.9	8.5	4.6	3.0
Net foreign assets of the central bank	-15.9	-4.6	1.4	13.9	15.7	-13.5	18.7	14.9
(in percent of the monetary base)	129.8	122.6	115.8	126.5	136.3	113.5	134.0	142.6
Interest rates (percent; end period)								
Seven-day reverse repo	5.5	5.4	5.5	5.5	4.8	4.8	4.3	3.8
Three-month treasury bill	4.9	5.0	5.2	5.5	5.0	4.9	4.5	3.7
Government bonds (10-year)	7.1	7.2	7.3	6.0	5.6	6.0	6.1	5.4
Balance of payments (percent of GDP)								
Trade balance	-25.0	-25.1	-21.6	-19.1	-18.2	-21.2	-15.6	-13.1
Goods and services balance	-13.2	-13.4	-7.9	-6.0	-5.4	-10.7	-4.8	-4.2
Current account balance	-11.2	-12.2	-5.9	-6.2	-3.4	-13.4	-4.7	-4.6
Official reserves (end period)								
(in millions of U.S. dollars)	1,444	1,414	1,432	1,696	1,794	1,463	1,682	2,191
(in months of imports of goods and services)	5.1	5.1	5.7	6.2	6.5	4.4	6.2	7.1
Exchange rate								
Regime	Pegged to a basket of currencies comprising the euro, pound sterling, and U.S. dollar.							
Nominal effective exchange rate (1990=100)	94.5	93.4	94.8	95.8	95.8	97.4	98.2	97.7
Real effective exchange rate (1990=100)	93.0	91.8	94.2	95.9	96.7	98.3	99.7	99.7
Current rate (April 7, 2003)	US$ 2.5099 per Maltese lira							
Memorandum item:								
Nominal GDP (in millions of Maltese liri)	1,146	1,201	1,288	1,362	1,456	1,562	1,630	1,685

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

Table 2. Malta: Summary Balance of Payments, 1996-2002

	1996	1997	1998	1999	2000	2001	2002
	(In millions of Maltese liri)						
Trade balance	-302.1	-277.9	-260.6	-265.2	-331.0	-254.9	-221.4
Exports, f.o.b.	639.1	642.0	708.4	805.0	1,087.7	900.6	929.8
Imports, f.o.b.	941.2	919.9	969.0	1,070.3	1,418.7	1,155.5	1,151.2
Balance on services	140.6	176.6	179.3	186.1	163.7	177.1	150.3
Exports	385.7	430.2	458.4	487.7	485.1	497.4	472.0
Of which: Tourism 1/	321.8	356.9	377.0	404.2	400.0	405.7	383.2
Imports	245.1	253.6	279.1	301.6	321.4	320.4	321.7
Investment income, net	4.3	3.4	-25.4	12.9	-53.1	-2.9	-1.2
Unrequited transfers, net	11.1	21.4	22.3	17.0	11.2	3.4	-5.8
Private	11.5	19.7	21.3	20.5	10.8	-0.2	-9.0
Public	-0.4	1.7	1.0	-3.5	0.3	3.6	3.2
Current account balance	-146.2	-76.6	-84.5	-49.3	-209.2	-77.3	-78.1
Capital account, net	21.1	3.2	11.1	10.4	8.3	0.7	1.7
Financial account, net	74.3	40.3	111.9	161.3	67.8	120.2	148.0
Direct investment	97.4	24.8	97.9	310.1	261.1	134.2	-167.7
Portfolio investment	-42.1	42.4	-32.2	-201.3	-343.0	-199.8	-178.5
Other 2/	19.0	-26.9	46.2	52.5	149.7	185.8	494.2
Of which: official long term capital	18.5	-10.2	-4.4	90.4	-10.2	5.9	3.1
Errors and omissions	20.2	35.7	35.1	-26.1	35.6	-14.4	51.9
Overall balance 3/	-30.6	2.7	73.6	96.3	-97.6	29.1	123.4
	(In percent of GDP)						
Current account balance	-12.2	-5.9	-6.2	-3.4	-13.4	-4.7	-4.6
Merchandise	-25.2	-21.6	-19.1	-18.2	-21.2	-15.6	-13.1
Services	11.7	13.7	13.2	12.8	10.5	10.9	8.9
Investment income	0.4	0.3	-1.9	0.9	-3.4	-0.2	-0.1
Transfers	0.9	1.7	1.6	1.2	0.7	0.2	-0.3
Memorandum items:							
Official reserves (in percent of GDP) 4/	46.1	43.6	47.0	50.8	41.2	46.7	52.3
(in millions of Maltese liri)	554.1	561.7	640.0	740.3	644.1	760.4	880.8
(in millions of U.S. dollars)	1,537.4	1,456.3	1,648.5	1,853.1	1,472.2	1,690.1	2,034.8
(in months of imports of goods and services)	5.6	5.7	6.2	6.5	4.4	6.2	7.2

Source: Data provided by the Maltese authorities.

1/ Includes transportation.
2/ The almost tripling in 2002, reflects the reconstitution of balance sheets of the international banking sector. This sector is funded from abroad and deals exclusively with non-residents.
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 3. Malta: Government Budget Accounts, 1997-2003 1/

	1997	1998	1999	2000	2001	Budget 2002	Outturn 2002	Budget 2003
				(In millions of Maltese liri)				
Total revenue	513.9	507.4	562.3	617.7	667.1	735.2	703.1	770.5
Tax revenue 2/	434.8	426.2	481.0	541.2	593.7	659.9	629.3	686.6
Direct taxes	252.7	246.5	272.9	311.8	345.5	379.6	365.9	397.9
Indirect taxes	182.1	179.7	208.2	229.4	248.2	280.3	263.4	288.7
Non-tax revenue	79.0	81.2	81.3	76.5	73.4	75.2	73.8	84.0
Total expenditure & net lending (inc. TCF)	654.6	661.1	696.5	726.3	765.9	...	811.4	...
Total Expenditure&net lending	632.5	653.5	676.3	702.8	752.4	812.8	806.8	845.4
Current expenditure	556.8	586.8	602.8	632.8	689.8	733.2	724.9	753.3
Capital expenditure	47.8	53.4	60.7	60.6	54.3	70.9	72.1	84.0
Net lending (Consolidated Fund)	27.8	13.2	12.7	9.4	8.3	8.7	9.7	8.0
Repayment	0.3	0.3	0.0	0.0	1.5	0.0	0.0	0.0
Loans	28.1	13.5	12.7	9.4	9.8	8.7	9.7	8.0
Advances (Treasury Clearence Fund) 3/	22.1	7.6	20.2	23.4	13.5	...	4.7	...
Balance (Consolidated Fund&TCF)	-140.8	-153.7	-134.2	-108.6	-98.8	...	-108.3	...
Balance (Consolidated Fund)	-118.6	-146.1	-113.9	-85.2	-85.3	-77.7	-103.7	-74.8
Financing (Consolidated Fund)	118.6	146.1	113.9	85.2	85.3	77.7	103.7	74.8
Domestic loans, net	166.1	104.5	84.0	0.0	100.0	0.0	0.0	100.0
Disbursements	167.3	110.0	84.0	0.0	100.0	0.0	0.0	100.0
Repayments	1.2	5.5	0.0	0.0	0.0	0.0	0.0	0.0
Foreign loans, net	-2.3	-4.0	0.0	0.0	6.8	1.0	10.6	12.5
Disbursements	3.3	0.0	0.0	0.0	6.8	1.0	10.6	12.5
Repayments	5.6	4.0	0.0	0.0	0.0	0.0	0.0	0.0
Asset sales	0.1	35.4	73.3	12.0	0.0	85.0	27.3	50.0
Change in cash balances	-45.3	10.2	-43.4	73.2	-21.5	-8.3	65.8	-87.7
				(In percent of GDP)				
Total revenue	39.9	37.2	38.6	39.5	40.9	43.6	41.7	43.4
Tax revenue	33.8	31.3	33.0	34.6	36.4	39.2	37.4	38.6
Direct taxes	19.6	18.1	18.7	20.0	21.2	22.5	21.7	22.4
Indirect taxes	14.1	13.2	14.3	14.7	15.2	16.6	15.6	16.2
Non-tax revenue	6.1	6.0	5.6	4.9	4.5	4.5	4.4	4.7
Total expenditure & net lending (inc. TCF)	50.8	48.5	47.8	46.5	47.0	...	48.2	...
Total Expenditure&net lending	49.1	48.0	46.4	45.0	46.2	48.3	47.9	47.6
Current expenditure	43.2	43.1	41.4	40.5	42.3	43.5	43.0	42.4
Capital expenditure	3.7	3.9	4.2	3.9	3.3	4.2	4.3	4.7
Net lending	2.2	1.0	0.9	0.6	0.5	0.5	0.6	0.5
Repayment	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Loans	2.2	1.0	0.9	0.6	0.6	0.5	0.6	0.5
Advances (Treasury Clearence Fund)	1.7	0.6	1.4	1.5	0.8	...	0.3	...
Balance	-10.9	-11.3	-9.2	-7.0	-6.1	...	-6.4	...
Balance (Consolidated Fund)	-9.2	-10.7	-7.8	-5.5	-5.2	-4.6	-6.2	-4.2
Financing (Consolidated Fund)	9.2	10.7	7.8	5.5	5.2	4.6	6.2	4.2
Domestic loans	12.9	7.7	5.8	0.0	6.1	0.0	0.0	5.6
Disbursements	13.0	8.1	5.8	0.0	6.1	0.0	0.0	5.6
Repayments	0.1	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Foreign loans, net	-0.2	-0.3	0.0	0.0	0.4	0.1	0.6	0.7
Disbursements	0.3	0.0	0.0	0.0	0.4	0.1	0.6	0.7
Repayments	0.4	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Asset sales	0.0	2.6	5.0	0.8	0.0	5.0	1.6	2.8
Change in cash balances	-3.5	0.7	-3.0	4.7	-1.3	-0.5	3.9	-4.9
Memorandum items:								
GDP (authorities' forecast)	1,288.2	1,362.3	1,456.1	1,562.1	1,629.9	1,684.6	1,684.6	1,777.2
Balance (authorities' presentation)	-9.2	-10.3	-7.8	-5.5	-5.2	-4.6	-5.2	-4.2
Balance (Medium Term Projections Budget 2002)	...	...	...	...	...	-4.5	...	-2.9
Balance (authorities' presentation inc. TCF) 4/	-10.9	-10.8	-9.2	-7.0	-6.1	...	-5.5	...
Foreign grants	9.8	10.0	9.7	9.5	1.4	8.5	2.7	22.7
Repayment of government loans	0.3	0.3	0.0	0.0	1.5	0.0	0.0	0.0

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

1/ Consolidated with the Social Security Account.

2/ Includes Lm 14.3 million in income tax and social security contribution arrears by Malta Drydocks in 1997. Excludes Lm 5.4 million income tax receipts (0.3% of GDP) and Lm 11.3 million special dividend (0.7% of GDP) associated with the MIA privatization process in 2002.

3/ The Treasury Clearence Fund is an extrabudgetary fund and no budget is approved for it.

4/ Including the advances from the Treasury Clearence Fund.

Table 4. Malta: Current Budgetary Revenue, 1997-2003

	1997	1998	1999	2000	2001	Budget 2002	Outturn 2002	Budget 2003
	(In millions of Maltese liri)							
Total revenue	513.9	507.4	562.3	617.7	667.1	735.2	703.1	770.5
Tax receipts	434.8	426.2	481.0	541.2	593.7	659.9	629.3	686.6
Direct taxes	252.7	246.5	272.9	311.8	345.5	379.6	365.9	397.9
Income taxes 1/	110.5	110.6	128.4	149.5	166.3	186.1	184.8	198.8
Individual	66.5	66.8	74.0	84.2	103.7	...	109.1	115.3
Corporations	44.0	43.7	54.3	65.3	62.6	...	81.1	83.5
Social security contributions 2/	142.2	135.7	144.3	162.0	179.1	193.4	181.1	199.0
Death and donation duties	0.0	0.3	0.2	0.3	0.2	0.1	0.0	0.1
Indirect taxes	182.1	179.7	208.2	229.4	248.2	280.3	263.4	288.7
Customs and excise taxes	43.2	52.7	55.4	55.1	60.9	67.8	59.8	66.5
VAT/CET	84.6	66.6	85.0	104.1	114.7	126.5	117.5	131.0
Licenses, taxes, and levies	54.3	60.4	67.7	70.2	72.6	86.0	86.0	91.2
Non-tax receipts	79.0	81.2	81.3	76.5	73.4	75.2	73.8	84.0
Foreign grants	9.8	10.0	9.7	9.5	1.4	8.5	2.7	22.7
Fees & reimbursements	10.6	10.6	11.1	11.9	13.1	21.0	23.5	14.4
Rents, dividends, interest	17.8	17.9	15.9	16.2	18.5	14.5	15.0	15.7
Central Bank profits	22.2	24.1	30.2	27.1	25.9	26.3	25.7	20.0
Lotteries	6.5	6.9	7.3	6.4	7.1	0.0	0.0	0.0
Civil aviation and posts 2/	6.7	4.6	2.1	0.0	0.0	0.0	0.0	0.0
Miscellaneous	5.5	7.0	5.0	5.2	7.4	4.9	6.9	11.1
	(In percent of GDP)							
Total revenue	39.9	37.2	38.6	39.5	40.9	43.6	41.7	43.4
Tax receipts	33.8	31.3	33.0	34.6	36.4	39.2	37.4	38.6
Direct taxes	19.6	18.1	18.7	20.0	21.2	22.5	21.7	22.4
Income taxes	8.6	8.1	8.8	9.6	10.2	11.0	11.0	11.2
Individual	5.2	4.9	5.1	5.4	6.4	...	6.5	6.5
Corporations	3.4	3.2	3.7	4.2	3.8	...	4.8	4.7
Social security contributions	11.0	10.0	9.9	10.4	11.0	11.5	10.8	11.2
Death and donation duties	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Indirect taxes	14.1	13.2	14.3	14.7	15.2	16.6	15.6	16.2
Customs and excise taxes	3.4	3.9	3.8	3.5	3.7	4.0	3.6	3.7
VAT/CET	6.6	4.9	5.8	6.7	7.0	7.5	7.0	7.4
Licenses, taxes, and levies	4.2	4.4	4.7	4.5	4.5	5.1	5.1	5.1
Non-tax receipts	6.1	6.0	5.6	4.9	4.5	4.5	4.4	4.7
Foreign grants	0.8	0.7	0.7	0.6	0.1	0.5	0.2	1.3
Fees & reimbursements	0.8	0.8	0.8	0.8	0.8	1.2	1.4	0.8
Rents, dividends, interest	1.4	1.3	1.1	1.0	1.1	0.9	0.9	0.9
Central Bank profits	1.7	1.8	2.1	1.7	1.6	1.6	1.5	1.1
Lotteries	0.5	0.5	0.5	0.4	0.4	0.0	0.0	0.0
Civil aviation and posts	0.5	0.3	0.1	0.0	0.0	0.0	0.0	0.0
Miscellaneous	0.4	0.5	0.3	0.3	0.5	0.3	0.4	0.6
GDP at current market prices (Lm mil)	1,288.2	1,362.3	1,456.1	1,562.1	1,629.9	1,684.6	1,684.6	1,777.2

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

1/ Includes Lm 7.9 million in income tax arrears and Lm 6.4 million in social security contribution arrears by Malta Drydocks in 1997. Excludes Lm5.4 million income tax receipts (0.3% of GDP) and Lm11.3 million special dividend (0.7% pf GDP) associated with the MIA privatization process in 2002.

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

Table 5. Malta: Budgetary Expenditure, 1997-2003

	1997	1998	1999	2000	2001	Budget 2002	Outturn 2002	Budget 2003
	(In millions of Maltese liri)							
Total expenditure & net lending (inc. TCF)	654.6	661.1	696.5	726.3	765.9	...	811.6	...
Total expenditure & net lending (Consolidated Fund))	632.5	653.5	676.3	702.8	752.4	812.8	807.0	845.4
Total expenditure	604.7	640.3	663.6	693.4	744.1	804.1	797.3	837.4
Current expenditure	556.8	586.8	602.8	632.8	689.8	733.2	724.9	753.3
Personnel expenditure 1/	158.1	163.6	163.8	170.8	195.0	197.6	196.5	197.8
Social services 2/	259.9	269.7	283.5	298.4	321.6	341.7	336.6	358.5
Subsidies/subventions 3/	62.1	68.6	62.8	58.5	68.5	88.2	84.8	92.4
Of which: Shipbuilding and repair	5.7	5.0	7.5	5.6	0.0	0.0	0.0	0.0
MIMCOL(Kalaxlokk) 4/	...	...	6.0	...	...	...	...	...
WSC	14.6	18.5	11.9	9.9	9.9	9.4	9.4	9.4
Interest payments	32.2	40.5	50.1	54.4	58.7	59.8	63.3	59.8
Other 5/	44.5	44.3	42.7	50.7	46.1	45.9	43.8	44.9
Capital development expenditure	47.8	53.4	60.7	60.6	54.3	70.9	72.3	84.0
Net lending (Consolidated Fund)	27.8	13.2	12.7	9.4	8.3	8.7	9.7	8.0
Shipbuilding and repair	3.5	8.0	6.4	5.1	5.0	4.5	5.5	4.0
Malta Drydocks	24.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gozo Ferries	0.0	5.5	6.3	4.3	4.8	4.2	4.2	4.0
Advances (Treasury Clearence Fund)	22.1	7.6	20.2	23.4	13.5	...	4.7	...
Malta Shipbuilding	1.8	-1.8	0.0	0.0	0.0	...	0.0	...
MDD	7.1	9.4	8.0	11.0	12.9	...	0.0	...
WSC	3.5	-3.5	0.0	0.0	0.0	...	0.0	...
Malta Freeport	0.0	0.0	7.3	12.0	1.6	...	0.0	...
Other	13.2	0.0	12.2	12.4	0.7	...	4.7	...
	(In percent of GDP)							
Total expenditure & net lending (inc. TCF)	50.8	48.5	47.8	46.5	47.0	...	48.2	...
Total expenditure & net lending (Consolidated Fund))	49.1	48.0	46.4	45.0	46.2	48.3	47.9	47.6
Total expenditure	46.9	47.0	45.6	44.4	45.7	47.7	47.3	47.1
Current expenditure	43.2	43.1	41.4	40.5	42.3	43.5	43.0	42.4
Personnel expenditure	12.3	12.0	11.2	10.9	12.0	11.7	11.7	11.1
Social services	20.2	19.8	19.5	19.1	19.7	20.3	20.0	20.2
Subsidies/subventions	4.8	5.0	4.3	3.7	4.2	5.2	5.0	5.2
Of which: Shipbuilding and repair	0.4	0.4	0.5	0.4	0.0	0.0	0.0	0.0
MIMCOL(Kalaxlokk)			0.4			...		...
WSC	1.1	1.4	0.8	0.6	0.6	0.6	0.6	0.5
Interest payments	2.5	3.0	3.4	3.5	3.6	3.5	3.8	3.4
Other	3.5	3.3	2.9	3.2	2.8	2.7	2.6	2.5
Capital development expenditure	3.7	3.9	4.2	3.9	3.3	4.2	4.3	4.7
Net lending	2.2	1.0	0.9	0.6	0.5	0.5	0.6	0.5
Shipbuilding and repair	0.3	0.6	0.4	0.3	0.3	0.3	0.3	0.2
Malta Drydocks	1.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gozo Ferries	0.0	0.4	0.4	0.3	0.3	0.2	0.2	0.2
Advances (Treasury Clearence Fund)	1.7	0.6	1.4	1.5	0.8	...	0.3	...
Malta Shipbuilding	0.1	-0.1	0.0	0.0	0.0	...	...	...
MDD	0.6	0.7	0.5	0.7	0.8	...	...	...
WSC	0.3	-0.3	0.0	0.0	0.0	...	...	...
Malta Freeport	0.0	0.0	0.5	0.8	0.1	...	...	...
Other	1.0	0.0	0.8	0.8	0.0	...	...	...
Memorandum item:								
Defense spending	0.9	0.8	0.7	0.7	0.7	0.0	0.7	0.0
GDP at current market prices (Lm mil)	1288.2	1362.3	1456.1	1562.1	1629.9	1684.6	1684.6	1777.2

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

1/ Wages and salaries, allowances, overtime, and bonuses paid to government employees.

2/ Pensions, health services, and social security benefits (including bonuses).

3/ Includes subsidies/subventions which the authorities classify as capital expenditure.

4/ Serverance for workers in Kalaxlokk who took early retirement.

5/ General operational and maintenance expenditures of government organizations.

Table 6. Malta: Monetary Developments, 1997-2002

	1997	1998	1999	2000	2001	2002
	(In millions of Maltese liri; end of period)					
Central Bank Balance Sheet						
Base money	485.2	506.1	543.3	564.5	567.6	612.8
Net foreign assets	541.6	640.0	740.3	644.1	760.4	880.8
Net credit to general government	34.7	-23.9	-90.0	-47.0	-63.3	-39
Other items, net	-91.1	-110.0	-107.0	-32.7	-129.5	-229.4
Financial Survey						
M3	2,047.0	2,222.6	2,441.8	2,538.9	2,752.9	3,038.1
Net foreign assets	744.4	878.4	969.2	970.8	1,083.5	1,294.9
Domestic credit	1,644.8	1,815.8	1,991.0	2,184.2	2,328.3	2,406.1
Net credit to general government	321.5	356.0	358.1	411.8	475.1	498.0
Credit to the parastatal sector	257.3	243.2	265.1	251.6	266.1	293.7
Credit to the private sector	1,066.0	1,216.6	1,367.8	1,520.8	1,587.1	1,614.5
Other items, net	-342.2	-471.7	-518.3	-616.1	-658.9	-663.0
	(Annual percentage change)					
Base money	7.4	4.3	7.3	3.9	0.6	8.0
M3	9.6	8.6	9.9	4.0	8.4	10.4
Domestic credit	15.1	10.4	9.6	9.7	6.6	3.3
Net credit to general government	34.5	10.7	0.6	15.0	15.4	4.8
Credit to the parastatal sector	3.1	-5.5	9.0	-5.1	5.7	10.4
Credit to the private sector	13.3	14.1	12.4	11.2	4.4	1.7
	(In millions of U.S. dollars)					
Net foreign assets	1,898.1	2,327.5	2,348.3	2,217.6	2,396.9	3,246.8
Central Bank	1,432.1	1,695.7	1,793.8	1,463.1	1,682.1	2,191.1
Other	466.0	631.8	554.5	754.4	714.8	1,055.7
	(In percent)					
Interest rates						
7-day reverse repo	5.2	5.4	4.7	4.7	4.2	3.7
3-month treasury bill	5.2	5.5	5.0	4.9	4.5	3.7
Average lending rate (weighted)	8.0	8.1	7.3	7.2	6.5	6.1
Memorandum items: (end of period)						
Exchange rate (US$/Lm)	2.55	2.65	2.42	2.28	2.21	2.51
CPI inflation	4.3	1.3	3.3	1.1	4.6	0.3
M3 multiplier	4.2	4.4	4.5	4.5	4.8	5.0
Velocity	0.6	0.6	0.6	0.6	0.6	0.6
NFA/Base money	115.8	123.6	139.1	113.5	134.0	154.0

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

Table 7. Malta: Staff's Medium-Term Macroeconomic Outlook, 2002-08

	Est.	Projected 1/					
	2002	2003	2004	2005	2006	2007	2008
				(Real growth rates)			
Output and prices							
Real GDP	1.0	2.8	3.3	4.3	4.5	4.2	4.0
Domestic demand	0.2	3.6	4.1	3.7	3.6	3.5	3.4
Private consumption	2.7	2.5	2.8	3.6	3.4	3.2	3.0
Public consumption	2.5	2.1	1.5	2.0	2.0	1.6	1.6
Fixed investment	-4.2	2.0	3.0	5.4	5.2	5.0	5.0
Exports of goods and services	-4.7	2.0	3.2	4.8	5.0	5.4	5.5
Imports of goods and services	-5.5	3.0	4.0	4.0	3.8	4.4	4.6
GDP deflator	2.3	2.4	2.7	2.3	3.0	2.3	2.5
CPI	2.2	2.0	2.0	2.0	2.1	2.3	2.2
Total employment (per. avg.)	0.1	0.8	1.1	1.2	1.2	1.0	1.0
Unemployment rate (%, per. avg.)	5.2	5.6	5.5	5.3	5.1	5.1	5.1
				(In percent of GDP)			
Investment and savings							
Investment	19.0	21.6	23.5	24.1	24.6	24.7	25.2
Fixed investment	23.1	23.3	23.5	24.1	24.6	24.7	25.2
Private	13.8	15.8	18.7	20.3	20.8	20.9	21.3
Public	5.3	5.8	4.8	3.9	3.9	3.9	3.9
Inventory change	-4.0	-1.7	0.0	0.0	0.0	0.0	0.0
Savings	22.2	25.2	26.9	27.9	28.4	29.3	30.5
Private	23.5	24.8	26.8	28.0	28.4	29.0	30.0
Public	-1.3	0.4	0.1	-0.2	0.0	0.2	0.4
Fiscal accounts							
Budget deficit	6.1	4.8	3.7	3.0	2.8	2.6	2.4
Revenues 2/	41.7	43.1	41.8	40.0	38.6	38.6	38.8
Expenditures 3/	47.8	47.9	45.4	43.0	41.4	41.2	41.2
Primary balance	-2.4	-1.4	-0.3	0.4	0.6	0.8	1.0
Privatization receipts	1.6	2.8	0.0	0.0	0.0	0.0	0.0
Government debt	63.8	62.5	62.6	61.6	60.1	58.9	57.7
Govt. debt excl. privatization receipts	66.0	65.4	62.6	61.6	60.1	58.9	57.7
External accounts							
Current account balance	-4.6	-4.1	-4.1	-3.7	-3.7	-3.0	-2.3
Goods and services (net)	-4.2	-6.0	-6.7	-6.2	-4.8	-3.8	-3.0
Official reserves	51.9	55.0	57.6	59.4	60.1	61.3	62.8
(in months of imports of GNFS)	7.1	7.5	7.9	8.3	8.6	8.9	9.2
Gross external debt	35.0	34.9	34.5	33.9	32.9	32.1	31.0
Memorandum item:							
GDP at current prices (in Lm millions)	1,684.6	1,773.5	1,881.6	2,007.8	2,161.0	2,304.7	2,457.5

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

1/ Staff's projection.
2/ Based on the staff's estimate for 2003 and projections for 2004-08 GDP.
3/ Includes net lending.

Table 8. Malta: Summary Balance of Payments, 2002-08

	2002	2003	2004	2005	2006	2007	2008
	(In millions of Maltese liri)						
Trade balance	-221.4	-254.5	-277.4	-285.8	-283.1	-283.7	-287.5
Exports, f.o.b.	929.8	921.8	965.2	1,021.1	1,088.5	1,161.5	1,239.3
Imports, f.o.b.	-1,151.2	-1,237.3	-1,306.6	-1,374.5	-1,443.3	-1,521.2	-1,606.4
Balance on services	150.3	120.6	123.0	132.4	147.6	163.1	178.3
Exports	472.0	510.0	534.0	564.9	602.2	642.6	685.6
Imports	-321.7	-342.7	-361.9	-380.7	-399.8	-421.3	-444.9
Investment income, net	-1.2	-1.2	-1.2	-1.3	-1.3	-1.3	-1.3
Unrequited transfers, net	-5.8	45.6	64.6	64.3	33.1	27.4	27.7
Current account balance	-78.1	-73.4	-77.4	-74.9	-80.5	-69.0	-55.7
Capital account, net	1.7	7.4	7.9	8.3	8.9	9.5	10.2
Financial account, net	148.0	108.3	114.1	113.5	121.1	111.8	99.1
Direct investment	-167.7	173.3	196.4	196.4	196.4	196.4	196.4
Portfolio investment 1/	-178.5	-138.5	-150.9	-179.1	-196.0	-194.8	-176.6
Other	494.2	73.4	68.4	95.9	120.3	109.7	78.6
Errors and omissions	51.9	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance 2/	123.4	42.4	44.6	47.0	49.5	52.3	53.5
	(In percent of GDP)						
Current account balance	-4.6	-4.1	-4.1	-3.7	-3.7	-3.0	-2.3
Merchandise	-13.1	-14.4	-14.7	-14.2	-13.1	-12.3	-11.7
Services	8.9	6.8	6.5	6.6	6.8	7.1	7.3
Investment income	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Transfers	-0.3	2.6	3.4	3.2	1.5	1.2	1.1

Source: Data provided by the Maltese authorities.

1/ The almost tripling of other capital in the Financial account to over LM 490 million in 2002, reflects the reconstitution of balance sheets of the international banking sector. This sector is funded from abroad and deals exclusively with non-residents.

2/ 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.

Table 9. Malta: Indicators of External and Banking Sector Vulnerability, 1997-2003
(in percent of GDP, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	Latest Data 2003	*Date*
Financial indicators								
Government debt	51.3	55.9	57.5	59.2	62.0	64.3	68.9	*June 03*
Broad money (percent change, 12-month basis)	9.6	8.4	10.0	4.0	8.4	10.4	7.5	*Apr. 03*
Private sector credit (percent change, 12 month basis)	13.3	13.5	13.0	11.2	4.4	1.7	3.9	*Apr. 03*
Three month T-bill yield	5.2	5.5	5.0	4.9	4.5	3.7	3.5	*Apr. 03*
Three month T-bill yield (deflated by 12-mth CPI, e.o.p.)	0.9	4.2	1.6	3.7	-0.1	3.3	...	
Nonperforming loans to gross loan 1/	...	...	13.0	13.5	17.0	15.5	...	...
External Indicators								
Exports of G&NFS (percent change, average in US$)	-2.2	8.1	7.7	11.1	-13.6	10.2	...	*Dec. 02*
Imports of G&NFS(percent change, average in US$)	-7.6	5.7	6.8	15.8	-17.5	2.9	...	*Dec. 02*
Current account surplus	-5.9	-6.2	-3.4	-13.4	-4.7	-12.6	...	*Dec. 02*
Capital and financial account balance	3.4	9.0	11.8	4.9	7.4	16.7	...	*Dec. 02*
Of which:								
Inward portfolio investment (debt securities etc.)	3.3	-2.4	-13.8	-22.0	-12.3	-7.7	...	*Dec. 02*
Other investment (loans, trade credits etc.)	-2.1	3.4	3.6	9.6	11.4	43.6	...	*Dec. 02*
Inward foreign direct investment	2.4	7.6	22.5	17.4	8.4	-19.9	...	*Dec. 02*
Gross official reserves (in US$ millions; e.o.p.)	1,456.3	1,648.5	1,853.1	1,472.2	1,690.1	2,034.8	2,446.0	*Mar. 03*
Official reserves in months of imports GNFS	5.6	6.2	6.6	4.4	6.3	7.1	7.5	*Dec. 02*
Ratio of foreign reserves to Base Money (%)	115.4	121.2	136.3	114.1	134.0	142.6	149.0	*Apr. 03*
Ratio of foreign reserves to Broad Money(%)	27.4	28.8	30.3	25.4	27.6	28.8	28.9	*Apr. 03*
Total gross external debt/GDP (in percent)	31.0	30.8	30.5	33.8	34.2	35.0	34.9	
Total gross external debt to exports GNFS (in percent)	37.3	35.9	34.3	33.5	39.9	42.1	...	*Dec. 02*
Exchange rate (per US$, period average)	2.59	2.58	2.50	2.29	2.22	2.31	2.6	*Apr. 03*
REER appreciation (+) (e.o.p. basis)	2.6	1.7	0.9	1.6	1.5	0.0	...	*Dec. 02*

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

1/ Data relating to gross loans excludes Interbank lending.

Malta: Fund Relations
(As of April 30, 2003)

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 multiple currency practices and restrictions on the making of payments and transfers for current international transactions.

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	29.19	258.60

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

V. **Latest Financial Arrangements**: None

VI. **Projected Payments to Fund**: N/A

VII. **Exchange Rate Arrangement**:
The Maltese lira is currently pegged to a trade-weighted basket of three currencies: the euro, the U.S. dollar, and the pound sterling, in the ratio 70:10: 20.

VIII. **Article IV Consultation**:
The last Article IV consultation was completed on a lapse of time basis. On July 23, 2001, the Executive Board endorsed the staff appraisal in the report for the 2001 Article IV consultation with Malta (SM/01/226, 7/16/01).

IX. **Technical Assistance**: (1994-present)
FSAP mission visited Malta in October 2002, and January 2003.

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

Fiscal debt sustainability assessments were conducted over the medium-term. Malta's foreign assets exceed its liabilities.

A. Fiscal Sustainability

The baseline scenario envisages a reduction in the public debt to GDP ratio from 61.9 in 2001 to 57.7 in 2008 (Table 1). This reduction is based on Malta's fiscal consolidation efforts in recent years, current estimates of the 2003 fiscal deficit, and achieving the deficit targets for 2004–05 as stated in the 2003 budget speech. The scenario is consistent with the fulfillment of the Maastricht criteria (and the Stability and Growth Pact (SGP)) from 2007 onward. However, the stress tests indicate that fulfilling these requirement requires a strong commitment from the authorities, and closing of the output gap by 2007. When the historical average values of the real interest rate, output growth, and the primary balance are used in to project the path for public debt in the period 2003–08 (stress test 1), the public debt ratio reaches 73.9 percent in 2008. This is about 15 percentage points above the baseline level, and clearly not consistent with the SGP. Other stress tests confirm that achieving Maastricht criteria for the fiscal deficit and public debt, is not robust to the macroeconomic assumptions underlying the baseline scenario.

B. External Sustainability

External assets and liabilities have been growing significantly during the past decade—almost quadrupling between 1995 and 2000—with external assets continuing to exceed liabilities.

Table 1. Malta: Public Sector Debt Sustainability Framework, 1997-2008
(In percent of GDP, unless otherwise indicated)

	Actual						Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
I. Baseline Medium-Term Projections												
Public sector debt 1/	51.3	55.9	57.5	59.0	61.9	63.8	**62.5**	**62.6**	**61.6**	**60.1**	**58.9**	**57.7**
o/w foreign-currency denominated	5.1	4.3	3.5	3.1	2.6	2.6	2.6	4.8	5.1	5.3	5.0	4.6
Change in public sector debt	8.3	4.6	1.6	1.5	3.0	1.9	-1.2	0.1	-1.0	-1.5	-1.2	-1.3
Identified debt-creating flows (4+7+12)	6.7	5.2	-0.5	1.0	2.9	2.2	-1.2	0.1	-1.0	-1.5	-1.2	-1.3
Primary deficit	6.7	7.7	4.4	2.0	1.6	2.4	1.4	0.3	-0.4	-0.6	-0.8	-1.0
Revenue and grants	39.9	37.2	38.6	39.5	40.9	41.7	43.1	41.8	40.0	38.6	38.6	38.8
Primary (noninterest) expenditure	46.6	45.0	43.0	41.5	42.6	44.1	44.5	42.1	39.6	38.0	37.8	37.8
Automatic debt dynamics 2/	0.0	0.0	0.2	-0.2	1.2	1.4	0.2	-0.2	-0.6	-1.0	-0.4	-0.3
Contribution from interest rate/growth differential 3/	-0.4	0.2	-0.2	-0.4	1.1	1.8	0.2	-0.2	-0.6	-1.0	-0.4	-0.3
Of which contribution from real interest rate	1.5	1.8	2.0	3.0	0.5	2.3	1.9	1.7	2.0	1.6	2.0	1.9
Of which contribution from real GDP growth	-1.9	-1.7	-2.1	-3.4	0.7	-0.6	-1.7	-2.0	-2.5	-2.6	-2.4	-2.2
Contribution from exchange rate depreciation 4/	0.4	-0.2	0.3	0.2	0.1	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Other identified debt-creating flows	0.0	-2.6	-5.0	-0.8	0.0	-1.6	-2.8	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	0.0	-2.6	-5.0	-0.8	0.0	-1.6	-2.8	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	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	0.0
Residual, including asset changes (2-3)	1.6	-0.6	2.1	0.5	0.1	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Public sector debt-to-revenue ratio 1/	128.7	150.1	148.8	149.1	151.3	152.8	145.1	149.8	154.0	155.7	152.6	148.6
Gross financing need 5/	19.0	20.9	16.8	15.9	19.2	19.6	20.5	18.5	16.8	15.7	14.7	13.7
in billions of U.S. dollars	0.6	0.7	0.6	0.6	0.7	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Key Macroeconomic and Fiscal Assumptions												
Real GDP growth (in percent)	4.9	3.4	4.1	6.4	-1.2	1.0	2.8	3.3	4.3	4.5	4.2	4.0
Average nominal interest rate on public debt (in percent) 6/	6.2	6.1	6.6	6.5	6.4	6.3	5.6	5.7	5.7	5.9	6.0	6.1
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	4.0	3.9	3.9	5.7	0.7	3.9	3.2	3.1	3.5	2.9	3.7	3.6
Nominal appreciation (increase in US dollar value of local currency, in percent)	-8.3	3.9	-8.6	-5.7	-3.2	13.3	0.0	0.0	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	2.3	2.2	2.7	0.9	5.6	2.3	2.4	2.7	2.3	3.0	2.3	2.5
Growth of real primary spending (deflated by GDP deflator, in percent)	7.0	-0.1	-0.5	2.7	1.3	4.6	3.8	-2.3	-1.7	0.3	3.7	4.0
II. Stress Tests for Public Debt Ratio												
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007							**63.2**	**65.4**	**67.5**	**69.7**	**71.8**	**73.9**
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004							**64.8**	**67.1**	**66.1**	**64.5**	**63.3**	**62.0**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004							**65.0**	**68.0**	**66.9**	**65.3**	**64.0**	**62.6**
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004							**70.4**	**79.5**	**78.4**	**76.6**	**75.3**	**74.0**
5. Combination of 2-4 using one standard deviation shocks							**69.1**	**77.5**	**75.1**	**72.2**	**69.8**	**67.3**
6. One time 30 percent real depreciation in 2003 7/							**63.9**	**64.0**	**63.0**	**61.4**	**60.3**	**59.0**
7. 10 percent of GDP increase in other debt-creating flows in 2003							**72.5**	**72.6**	**71.5**	**69.8**	**68.6**	**67.3**

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation	Average 2003-08
Primary deficit	2.8	3.3	-0.2
Real GDP growth (in percent)	4.2	2.6	3.9
Nominal interest rate (in percent) 6/	6.0	0.5	5.8
Real interest rate (in percent)	3.3	1.8	3.3
Inflation rate (GDP deflator, in percent)	2.7	1.7	2.5
Revenue to GDP ratio	39.9	1.3	40.2

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).

MALTA: REFLECTIONS ON JOINING THE EURO AREA MONETARY UNION

The characteristics of Malta's economy suggest that it is well placed to join the euro area. Indeed, more than half of its trade is associated with the euro area, its business cycle appears to be increasingly correlated with the euro area cycle, and it already operates successfully a peg to a basket of currencies (Box 2). Moreover, the main cost of joining the euro area—the loss of monetary policy independence—has for the most part been incurred as the euro already plays a dominant role in the currency basket, and the lifting of capital account restrictions have reduced the CBM's ability to set domestic interest rates independently of world markets.

In principle, Malta will benefit from joining the euro area:

- ***Exchange rate volatility and trade***: Adopting the euro will reduce the volatility of the exchange rate vis-à-vis the euro (it will fall to zero) although it will increase vis-à-vis the pound and the dollar (text table). Trade and foreign investment flows are thought to be inversely related to exchange rate volatility. But available empirical is mixed: some authors (Frankel and Wei, 1997) find the expected result that exchange rate volatility reduces trade in a large sample of countries, while others find no effect on trade (Tenreyro, 2003). In Malta, assuming a well behaved relation, trade and investment flows are likely to increase: the reduction in the volatility vis-à-vis the euro will likely to dominate increases vis-à-vis the pound and dollar because trade flows are primarily with the euro area.

Malta: Exchange Rate Volatility (1999-2003)

	Lm per €	Lm per £	€ per £	Lm per $	€ per $
Average exchange rate	0.41	0.65	1.58	0.43	1.04
Standard deviation	1.1%	1.1%	5.9%	2.4%	8.5%
Coefficient of variation	2.7%	1.7%	3.7%	5.6%	8.2%

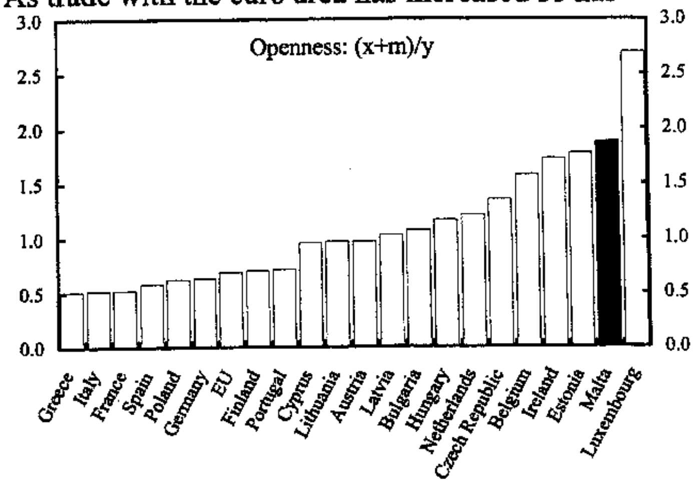
Source: Bloomberg.

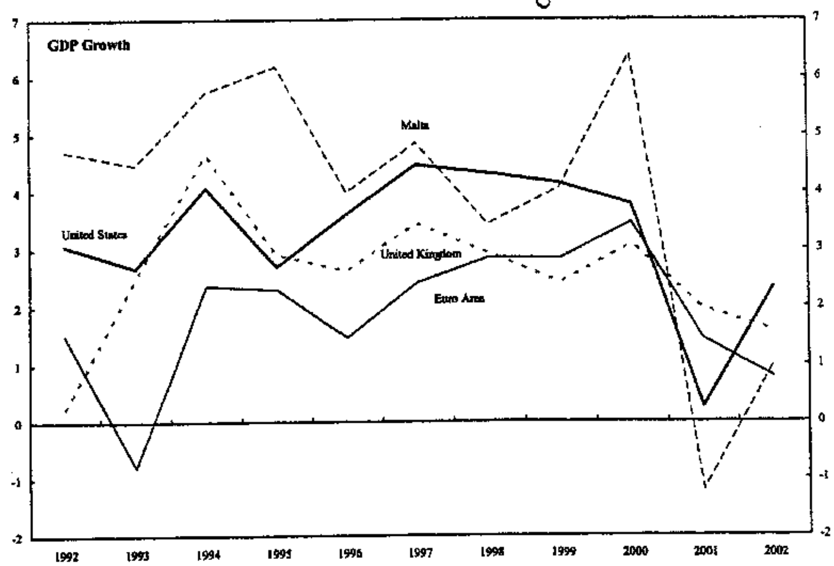
- ***One currency and trade***: Adopting the euro will enable transactions with residents in the euro area to be carried out in one currency, without the need of an intervening currency exchange. Thus, trade can be expected to increase as transaction costs are reduced. Regarding the benefits associated with the use of a common currency in trade, the evidence indicates that trade is positively affected with trade of countries sharing a common currency being as much as three times higher than the one of countries with different currencies (Rose, 2000).

- ***Credibility, investment, and output***: Malta's exchange rate peg provides a credible anchor for the prices and has delivered low inflation. Nonetheless, adopting the euro can further enhance credibility by subjecting Malta's fiscal policy to the restrictions imposed by the SGP. Already, in the run up to accession the PEP reports have enhanced transparency, particularly regarding fiscal policy. With increased credibility comes lower real interest rates, higher levels of investment and income.

And the adverse effects are likely to be mitigated:

- ***Synchronization of economic cycles***: The literature on optimal monetary area has stressed the importance of trade linkages, and about half of Malta's high level of trade (text figure) is with the euro area. As trade with the euro area has increased so has Malta's correlation with the euro area business cycle (text figure). Indeed, correlation coefficients of Malta's output growth with the three largest economies of the euro area (Germany, France and Italy) suggest that its cycle has become increasingly synchronized with the EU in the 1990s (text table). Although the correlation is still on the low side compared with other euro area members, it is likely to increase as exchange rate volatility declines and transactions costs fall. Indeed, some economists (see Frankel and Rose, 1997) have argued that the correlation between business cycles is endogenous, due to the fact that trade increases when joining a monetary union. Moreover, recent evidence (Frankel and Rose, 2002) suggests that this does not result from trade diversion but higher openness.



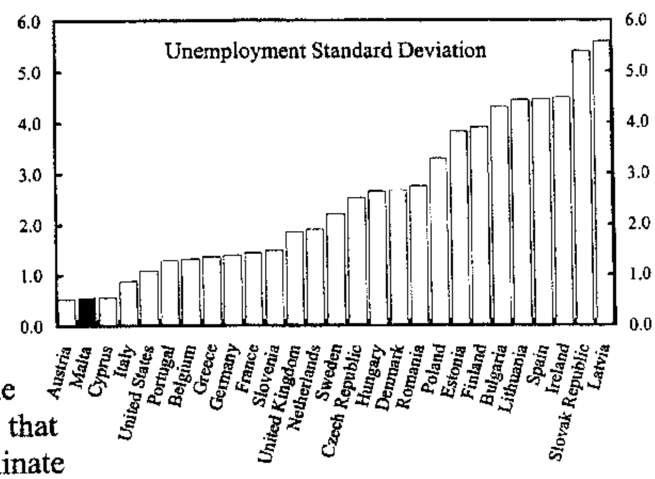


Synchronization of business cycles (correlation of growth rates) with the EU-3 1/

	Malta	Belgium	Spain	Ireland	Netherlands	Austria	Portugal	Finland	Greece
1971-1990	0.10	0.83	0.57	0.08	0.77	0.68	0.81	0.33	0.46
1990-2002	0.42	0.90	0.84	0.57	0.73	0.79	0.75	0.33	0.47

1/ EU-3 refers to France, Germany and Italy.

- ***Flexible labor markets***: A pegged exchange rate transfers the brunt of the economic adjustment to nominal wages (and prices). The lack of extended periods of high unemployment in face of significant adverse developments, is prima facie evidence that labor markets in Malta have been able to adjust; unemployment is far less volatile than in euro area (text figure). Indeed, the "Joint Assessment of the Employment Policy Priorities of Malta" prepared by the EC and the Ministry of Social Policies in 2001, concludes that although full-time indefinite contracts predominate this has not hindered flexibility. Moreover, labor movements from manufacturing to services, and from the public to the private sector have occurred without leading to a mayor impact on unemployment in the 1990s. Also, recent trends suggest that flexibility will be enhanced by the increasing as the prevalence of fixed-term and part-time contracts continue to increase.



- ***Similar rates of inflation and preferences on monetary policy targets.*** Malta's inflation rate has been low for a number of years, and recently renewed its commitment to low inflation by increasing the CBM's independence. These conditions are in tune with the average rate of inflation in the euro area and the goals of the ECB. This is not surprising, nonetheless, given its exchange rate peg and the high import good component of consumer goods in Malta. Moreover, the similar inflation rates will aid in avoiding severe misalignments in the real exchange rate.

Inflation Rates

	Euro Area	Malta	Differential
1999	1.1	2.1	1.0
2000	2.1	2.4	0.3
2001	2.4	2.9	0.5
2002	2.3	2.2	-0.1

MALTA: STATISTICAL ISSUES

In the last few years, Malta has made significant progress improving its macroeconomic statistics. Notably the NSO was created in March, 2001 as an autonomous and independent institution; it supercedes 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, in anticipation of EU accession, the Maltese authorities have been in close contact with the ECB and Eurostat to upgrade their statistical systems to meet euro-area standards. Malta has participated in the GDDS since September 2000 and its metadata are posted on the Fund's Dissemination Standards Bulletin Board.

Real sector data: Data on retail price movements, labor market indicators, and tourism arrivals are released monthly, usually with a short lag; access of these data is available through the Internet via NSO's user-friendly web site. National accounts data are subject to longer lags: the most recent income-side and expenditure-side data on the NSO web page are for the fourth quarter of 2002. The NSO is undertaking a project to improve the coverage of GDP estimates, including research dealing with the estimation of illegal activities; compilation and validation of GDP results in accordance with ESA 95 is underway. Work towards compiling a harmonized index of consumer prices (HICP) was completed in the first quarter of 2002.

Fiscal data: In accordance with the requirements established for EU accession, Malta has improved significantly the quality of its fiscal data. Several innovations have being introduced to make these consistent with ESA95 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 data on the central bank's balance sheet, broad 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 Central Bank of Malta (CBM) is largely implementing the action plan agreed with the monetary and financial statistics mission in 2001. In particular, the recording of the monetary data is now on an accrual basis. The CBM is also making progress in meeting the data reporting requirements of the ECB as part of Malta's accession to EU membership.

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 are released irregularly. The latest full set of balance of payments accounts is in the *Balance of Payments* 2000 and *Trade Statistics* 2000 published by the NSO. Balance of payments data through 2001 have been published in the *2002 Balance of Payments Statistics Yearbook.*

Malta: Core Statistical Indicators
(As of July 8, 2003)

	Exchange rates	International reserves	Reserve/ base money	Central bank balance sheet	Broad money	Interest rates	Consumer price index	Exports/ Imports	Current account balance	Overall government balance	GDP/GNP	External debt 1/
Date of latest Observation	6/25/03	Apr. 2003	May 2003	5/31/03	May 2003	5/25/03	Mar. 2003	Mar. 2003	2002 Q4	Mar. 2003	2002 Q4	2002
Date received	6/25/03	7/1/03	7/1/03	7/1/03	7/1/03	7/1/03	4/28/03	5/14/03	3/27/03	5/9/03	4/10/03	Mar. 2003
Frequency of data	Daily	Monthly	Monthly	Monthly	Monthly	Weekly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Annual
Frequency of reporting	Daily	Monthly	Monthly	Monthly	Monthly	Weekly	Monthly	Monthly	Quarterly	Irregular	Quarterly/ Irregular	Annual
Source of data	CBM	CBM	CBM	CBM	CBM	CBM	NSO, CBM	NSO, CBM	NSO	NSO, CBM	NSO, CBM	Ministry of Finance, CBM
Mode of reporting	Internet (CBM)	Electronic copy (CBM)	Electronic copy (CBM)	Internet (CBM)	Internet (CBM)	Internet (CBM)	Internet (NSO)	Internet (NSO)	Electronic copy (NSO)	Internet (COS), Press, Fax (CBM)	Internet (NSO)	Publication
Confidentiality	No	No	No	No	No	No	No	No	No	No	No	No
Frequency of publication	Daily	Monthly	Monthly	Monthly	Monthly	Weekly	Monthly	Monthly	Quarterly	Irregular	Quarterly/ Irregular	Quarterly

1/ Public external debt.

Statement by the IMF Staff Representative
August 18, 2003

1. This statement provides an update on economic and policy developments since the staff report was issued. The new information does not change the thrust of the staff appraisal, but—given the continued fiscal slippages—strengthens the call for improved expenditure control.

2. Economic indicators for the first quarter (Q1) provide a mixed picture with regard to the modest economic recovery that began last year. Employment increased by a healthy 3.4 percent (year-on-year), and the improvement in the tourist sector persisted as arrivals from the United Kingdom continued growing. However, preliminary GDP estimates for Q1 show that despite sharp increases in investment and public consumption, output fell by 1.9 percent (year-on-year) largely due to a strong increase in imports.

3. Fiscal developments in the first half of 2003 suggest that the deficit is likely to be about 7 percent of GDP, appreciably higher than in the staff report. So far, the authorities' efforts have had limited impact in containing expenditure overruns. In addition, revenues continued to disappoint in the second quarter. Preliminary data suggest that public debt increased by about 4½ percentage points in the first half of 2003 to just under 69 percent of GDP at end-June 2003. Part of this increase, however, could reflect routine cash management operations.

4. The Central Bank of Malta left interest rates unchanged in July noting the stable level of international reserves in the last two months, and the continued presence of imbalances in the fiscal position. Inflation remains low.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 03/108
FOR IMMEDIATE RELEASE
September 3, 2003

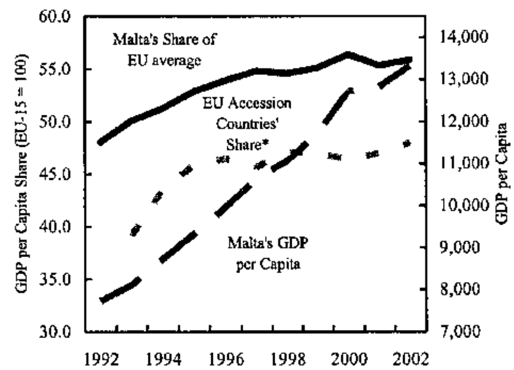
International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2003 Article IV Consultation with Malta

On August, 18, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Malta.[1]

Background

Malta enjoyed rapid economic growth during most of the 1990s fueled by a vibrant tourist sector (which accounts for roughly 30 percent of GDP) and the semi-conductor industry (which accounts for about 75 percent of manufactured exports). Malta's per capita income almost doubled in the past ten years, and its income as a share of the European Union (EU) average rose to 56 percent—well above most accession candidates, although lower than the least affluent EU members.



(*): Countries set to join on 1st May 2004.

Adverse shocks to tourism and the semi conductor sectors, however, weighed on economic developments in the past two years. The September 11 attacks further dented the tourism sector that was already affected by a weak European market. At the same time, the bursting of the high-tech bubble dampened exports and private

[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.

investment, the latter being further weakened by the uncertainty about the EU referendum. Despite these adverse developments, relatively flexible labor markets kept unemployment fairly steady at 5–5¼ percent. A modest recovery began in 2002—with some improvement in tourist arrivals in the second half of the year—but employment growth remained weak.

The fiscal situation remains difficult despite some progress in consolidating public finances. The deficit was brought down to 6½ percent of GDP in 2002, still a high level, mainly through increases in tax rates, and improved collection through the creation of the Tax Compliance Unit. Current expenditures—particularly the public sector wage bill and subsidies to public enterprises—were reduced in the late 1990s, but have crawled back up with subsidies reaching 5 percent of GDP in 2002; public sector employment remains high. Fiscal deficit outturns have exceeded the budget by an average ¾ percent of GDP since 2000. Substantial privatization proceeds since 1999 (about 7½ percent of GDP) limited increases in public debt, which stood at 64 percent of GDP in 2002.

Malta maintains a long-standing exchange rate peg to a basket of currencies—currently composed of the euro, pound sterling, and dollar. The peg has delivered low inflation and served Malta well, including during the recent period of liberalization. Initially, capital account restrictions allowed the Central Bank of Malta (CBM) some room for active monetary policy, but the gradual liberalization of the capital account has diminished the ability to conduct monetary policy independently of world rates. Thus, the CBM's central intervention rate and world rates have become increasingly aligned in the past two years—resulting in considerable easing since late 2001. Nonetheless, a favorable interest rate differential remains that combined with the investment repatriation scheme have led to growing international reserves. A narrowing of the external current account deficit further contributed to diminish worries about the balance of payments and competitiveness.

Domestic credit growth remains on a downward trend, with banking credit to the private sector particularly weak. Combined with the strong growth in deposits in the past couple of years, this has led to a rapid buildup of liquidity in the banking system and pressures to reduce interest rates that are now fully liberalized. With the liberalization of the financial sector, steps have been taken to strengthen supervision: supervisory responsibilities were consolidated in the Malta Financial Service Authority (MFSA) during 2002. The previous responsibility of the CBM for oversight of the banking sector has thus been transferred to the MFSA, which also supervises the less developed securities and insurance sectors.

Executive Board Assessment

Executive Directors noted that Malta has advanced towards accession to the EU and that its progress in opening markets to international competition and reducing the fiscal deficit has contributed to rapid economic growth and enhanced the economy's resilience to economic shocks. They stressed, however, that achieving sustained, robust growth hinges on fiscal consolidation and continued efforts to reform the economy.

Directors observed that Malta's economic growth in the near term will be restrained by the difficult international environment, but that as the European economy improves, growth is expected to pick up gradually over the course of 2004. They saw this improved economic outlook supported by stronger domestic investment following the positive outcome of the EU referendum in early 2003 and continued robust consumption buoyed by a decline in income taxes.

Directors attached great importance to strengthening the public finances, which deteriorated in 2002 owing to election-related expenditure overruns and weak tax revenue reflecting the economic slowdown. They expressed concern at the large projected 2003 budget deficit, which would miss the budget target by a substantial margin.

Directors strongly urged the authorities to strengthen the medium-term fiscal consolidation objectives beyond those envisaged in the 2003 budget, which would also be consistent with meeting the Maastricht criteria. This would help guard against economic shocks, decisively reverse the increase in public debt, prepare for ERM II and the economic requirements associated with euro adoption, and allow room for interest rate cuts.

Directors stressed that the fiscal adjustment should avoid social dislocations and should be anchored by cuts in current expenditure, especially the public sector wage bill, subsidies to public enterprises, and welfare payments to those abusing the system. They observed that a heavy existing tax burden makes it difficult to increase taxes.

Directors welcomed the rolling three-year financial plan as an important step in establishing a medium-term fiscal framework. They saw merit in introducing strict expenditure ceilings—allowing flexibility for routine budgetary management across expenditure categories—to instill fiscal discipline and foster lasting consolidation.

Directors saw reforms to the pension and welfare systems as supporting fiscal consolidation. They supported the authorities' commitment to deal with the challenges posed by an ageing population by increasing social awareness of the need for reforms and encouraged the authorities to move forward without further delays with a sufficiently ambitious pension reform that would ensure the financial viability of the system.

Directors considered that the current exchange rate regime was an appropriate framework to prepare for ERM II, and that the exchange rate peg has served Malta well—including during the recent period of capital account liberalization—and has contributed to low inflation rates. They concurred with the authorities' decision to increase the weight of the euro in the currency basket. They stressed, however, that the timing of ERM II entry should be linked to Malta's ability to deliver lasting fiscal consolidation.

Directors commended recent amendments to the central bank law, which strengthen the bank's independence and define price stability as the primary goal of monetary policy. They indicated a need to improve transparency in central bank operations in government securities.

Directors noted that the financial system appears to be sound and well supervised, though they expressed concern about the concentration of bank lending, a high level of nonperforming loans, and recent inflows into the banking system. In this connection, they welcomed the steps taken to improve prudential oversight, including the consolidation of regulatory and supervisory responsibilities of the financial system in the MFSA. They encouraged the authorities to remain vigilant in preserving the soundness of the financial system as competition and transformation in the financial sector intensifies with EU accession. They welcomed the authorities' efforts in the area of anti money laundering and the combating of the financing of terrorism, and urged the authorities to specifically criminalize the financing of terrorism.

Directors highlighted the importance of further structural reforms in order to improve the economy's competitiveness and diversification. They welcomed efforts to reduce public sector involvement in the economy and encouraged the authorities to press ahead with privatization and related reforms. In view of the labor market constraints on growth and a need to reduce income inequality with EU countries, they supported the authorities' policies to reduce excessive employment in the parastatal sector and their encouragement of increased female participation in the work force.

Directors welcomed Malta's progress in improving the quality of data and the intention to subscribe to the Special Data Dissemination System this year.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with Malta is also available.

Malta: Selected Economic Indicators, 1997-2003

	1997	1998	1999	2000	2001	2002	2003
Real economy (percentage change, constant prices)							
Real GDP	4.9	3.4	4.1	6.4	-1.2	1.2	2.8
Private consumption	1.6	2.5	6.1	7.4	1.7	2.5	2.5
Public consumption	-1.1	-4.0	-0.6	5.4	3.0	2.5	2.1
Gross capital formation	-3.2	-7.3	10.3	23.5	-26.4	-14.6	9.1
Exports of goods and services	4.0	8.1	8.2	5.6	-4.9	0.2	2.0
Imports of goods and services	-1.7	2.5	10.1	10.4	-9.2	-2.2	3.0
Retail prices (period average)	3.1	2.4	2.1	2.4	2.9	2.2	2.0
Unemployment rate (percent of labor force)	5.5	5.6	5.8	5.0	5.1	5.2	5.6
Public finance (percent of GDP)							
Government budget balance (Consolidated Fund)	-9.2	-10.7	-7.8	-5.5	-5.2	-6.2	-7.0
Government debt	51.3	55.9	57.5	59.0	62.0	64.3	68.0
Money and credit (end period; percentage change)							
Broad money	9.6	8.6	9.9	4.0	8.4	10.4	...
Domestic credit	15.1	10.4	9.6	9.7	6.6	3.3	...
Net foreign assets of the central bank	1.4	13.9	15.7	-13.5	18.7	14.9	...
(in percent of the monetary base)	115.8	126.5	136.3	113.5	134.0	142.6	...
Interest rates (percent; end period)							
Seven-day reverse repo	5.2	5.4	4.7	4.7	4.2	3.7	...
Three-month treasury bill	5.2	5.5	5.0	4.9	4.5	3.7	...
Government bonds (10-year)	7.3	6.0	5.6	6.0	6.1	5.4	...
Balance of payments (percent of GDP)							
Trade balance	-21.6	-19.1	-18.2	-21.2	-15.6	-13.0	-14.4
Goods and services balance	-7.9	-6.0	-5.4	-10.7	-5.4	-4.0	-6.0
Current account balance	-5.9	-6.2	-3.4	-13.4	-4.5	-3.9	-4.1
Official reserves (end period)							
(in millions of U.S. dollars)	1,456.3	1,648.5	1,853.1	1,472.2	1,690.1	2,034.8	2,446.0
(in months of imports of goods and services)	5.7	6.2	6.5	4.4	6.2	7.1	7.5

Exchange rate							
Regime	Pegged to a basket of currencies comprising the euro, pound sterling, and U.S. dollar						
Nominal effective exchange rate (1990=100)	94.8	95.8	95.8	97.4	98.2	97.7	97.7
Real effective exchange rate (1990=100)	94.2	95.9	96.7	98.3	99.7	99.7	99.8
Current rate (July 14, 2003)	US$2.6449 per Maltese lira						
Memorandum items:							
Nominal GDP (in millions of Maltese liri)	1,288	1,362	1,456	1,562	1,634.4	1,675.3	1,755.7

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

1/ IMF staff projections.

Statement by Pier Carlo Padoan, Executive Director for Malta and Ludovica Rizzotti, Assistant to Executive Director August 18, 2003

Introduction

Our Maltese Authorities wish to express their appreciation to Mr. Hoffmaister and his team for the quality of their work and for their constructive policy advice. The Maltese Authorities think the staff's report gives a fair account of the Maltese economy over the last two years, highlighting the positive trends but also drawing attention to imbalances and weaknesses in the macroeconomic framework. The discussions have been fruitful and the staff's analytical work and its recommendations, which aim to support the medium-term priorities in achieving strong sustainable economic growth, could be helpful also in helping to build support for required, but yet to be implemented, policy adjustments.

Malta faced a challenging period since the last Art. IV discussions. While the authorities were engaged in demanding negotiations for achieving the historical goal of EU accession, adverse external shocks hit the Maltese economy. Moreover, the situation was complicated by the uncertainty surrounding the results of the EU referendum and the general elections, held in early 2003. With the referendum results in favor of EU membership and the signing of the Accession Treaty in April 2003, Malta is now set to join the EU on May 1, 2004.

Recent Macroeconomic Developments

The strong economic growth enjoyed during the nineties, which implied a substantial increase in living standards, was interrupted in 2001 by negative external shocks. Due to its small size and openness, the Maltese economy was substantially affected by the global economic downturn. The weak European market, the September 11 attacks, and the adverse developments in the high-tech sector had a negative impact on the tourism and semiconductor industry, which represent the most important sectors for the Maltese economy.

A recovery began in 2002, with growth partly driven by domestic demand during the first half of the year and by a pick-up in exports during the second half, mainly reflecting the strong performance of the manufacturing sector. The tourism sector was generally weak in the first half of the year but a persistent decline in tourist arrivals was finally reversed in the last quarter of 2002. Gross fixed capital formation continued to contract in real terms. However, the relatively flexible labour market kept the unemployment rate relatively low, especially when compared to the EU average (unemployment rose slightly to 5.3% in 2003 from 5.1% a year earlier). The weaker conditions in the labour market and a deceleration in food prices, which had risen significantly the previous year, were the main factors contributing to a fall in the rate of inflation from 2.9% in 2001 to 2.2% in 2002.
These developments led to a further reduction in the current account deficit of the balance of payments, which narrowed to 4.6% of GDP. At the same time, the capital account continued to record significant inflows, partly reflecting the success of a scheme aimed at encouraging residents with undeclared investments overseas to regularise their position and repatriate

their funds. Consequently, the external reserves of the Central Bank of Malta increased to about seven months of imports of goods and services at the end of 2002.

Outlook

Economic growth in 2003 should remain below potential, due to uncertainties about external demand and the international geopolitical situation. On the assumption that external demand conditions do not deteriorate further, growth in Malta is expected to be around 3% driven by a further recovery in net manufacturing exports and by a recovery in the tourism industry in the second half of the year. Investment should also contribute positively to growth in 2003 mainly as a result of a number of private sector construction projects which are expected to gather momentum during 2003. Thus the unemployment rate is expected to decline marginally during 2003 while inflation is also expected to fall as a result of lower imported inflation and moderate wage increases. A stronger recovery is expected for 2004.

The expected rise in investment during 2003 could however lead to a higher current account deficit, which could rise to around 5% of GDP. However the capital account is still expected to show a substantial surplus, though not as high as in the previous year when inflows were boosted by one-off factors. The Government is continuing with its efforts to control public expenditure. However, as explained in the latter section on fiscal policy, the original target for the deficit to GDP ratio is not expected to be achieved.

Monetary Policy

The Central Bank's powers have been strengthened by recent amendments to the Central Bank of Malta Act which have given the Bank full independence and have clearly defined price stability as the primary goal of monetary policy.

In achieving this objective, the Central Bank continues to pursue a fixed exchange rate policy (managed successfully for about 30 years) with the Maltese lira pegged to a basket of three currencies, the euro with a 70% weight within the basket, the pound sterling with 20% and the US dollar with 10% weights respectively. In August 2002 the Central Bank revised the currency basket so as to better reflect Malta's trade patterns, increasing the weight of the euro in the basket up from 56%. The present regime and the evolution in the weights of the basket should provide a suitable framework to join ERM-II, which would not constitute a major deviation from the current arrangement.

Since the beginning of 2002, the Bank has continued to cautiously ease monetary policy so that its central intervention rate now stands at the 3.25% level. At the same time the Government has continued to eliminate capital controls with a number of measures being introduced from the start of 2003.

Fiscal policy

The Government's endeavours to reduce the budget deficit to more sustainable levels has continued. The fiscal deficit has been reduced from 10.7% in 1998 to 6.3% of GDP in 2002. While the Government remains committed to further fiscal consolidation in 2003 and over the medium term. the budget deficit for 2003 is expected to be significantly higher than that projected in the 2003 Budget Estimates last November, possibly at around 7% of GDP. This is mainly due to the following factors:

1. Revenue growth slower than projected as a result of the economic slowdown recorded in 2002 and the first half of 2003 which, in turn, is a direct effect of the downturn in the global economy.

2. The uncertainty about Malta's membership of the European Union and about the results of the general elections in April which also left their mark on domestic demand and contributed further to the sluggish economic conditions 3. Higher outlays on the social welfare programme although expenditure on public administration remained on target 4. Additional expenditure on the new hospital, as the pace of work on the project has accelerated, and on aid to farmers in view of the further liberalisation of the agricultural sector.

Regarding the impact of EU accession, despite some increase in the administrative expenses, Malta should be a net beneficiary of the EU budgetary resources. EU funds will address mainly rural development and infrastructure investments.

The high fiscal deficits in the nineties increased public debt substantially, which reached 64% of GDP in 2002. However, since 1999 the growth of the debt/GDP ratio was limited thanks to privatization proceeds.

Regarding the debt sustainability analysis presented in Appendix II, we would like to make a few comments on the fulfillment of the Maastricht criteria. In particular, we note that in the baseline scenario the debt/GDP ratio will not go below 60% before 2007. However, the ratio will be set on a declining trend already in 2005, and therefore it would be in line with the application of the Maastricht criteria regarding the debt/GDP ratio. The same holds for most of the stress test cases, (with the exception of the stress test 1, when the historical average values are used), which show that after the initial increase, the debt/GDP ratio sets out on a declining trend , that would be consistent with the application of the Treaty.

However, we agree with staff that there are risks that could undermine the macroeconomic assumptions underlying the baseline scenario. The Maltese authorities are aware that the reduction in the debt/GDP ratio and the fulfillment of Maastricht criteria in the medium term require a substantial fiscal consolidation effort.

Structural Reforms

The Government's privatisation programme continued over the last year with the involvement of new foreign shareholders in the local postal services corporation and the Malta International Airport. Meanwhile, negotiations for the privatisation of the lotteries system and the Mediterranean Offshore Bunkering Company are advanced and should be concluded by the end of the year. The Maltese Authorities are also making progress with the restructuring of public enterprises (in particular Malta shipyards).

Reforming pensions and, more generally, the welfare system is part of the Authorities' medium-term strategy. In this respect, the National Welfare Commission is expected to complete a technical report by the end of the year.

Financial sector and its supervision

The FSSA found that Malta's financial system is sound and well supervised, though fairly concentrated due to the county's narrow economic base. The supervisory framework has been further strengthened to bring it in line with EU standards. The recent (January 2002) unification of the supervision of all financial sectors in the Malta Financial Services Authority has been smooth. The signing of a Memorandum of Understanding between the MFSA and the Central Bank of Malta (February, 2003) provides for the establishment of appropriate consultative mechanisms.