

Malta: 2001 Article IV Consultation—Staff Report; and Public Information Notice on the Executive Board Discussion

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 2001 Article IV consultation with Malta, the following documents have been released and are included in this package.

- the staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **April 28, 2001**, 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 16, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a Public Information Notice (PIN), summarizing the **views of the Executive Board of July 30, 2001 in considering** the staff report on issues related to the Article IV consultation.

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MALTA

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the
2001 Consultation with Malta

Approved by Jacques R. Artus and Shigeo Kashiwagi

July 16, 2001

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I. INTRODUCTION

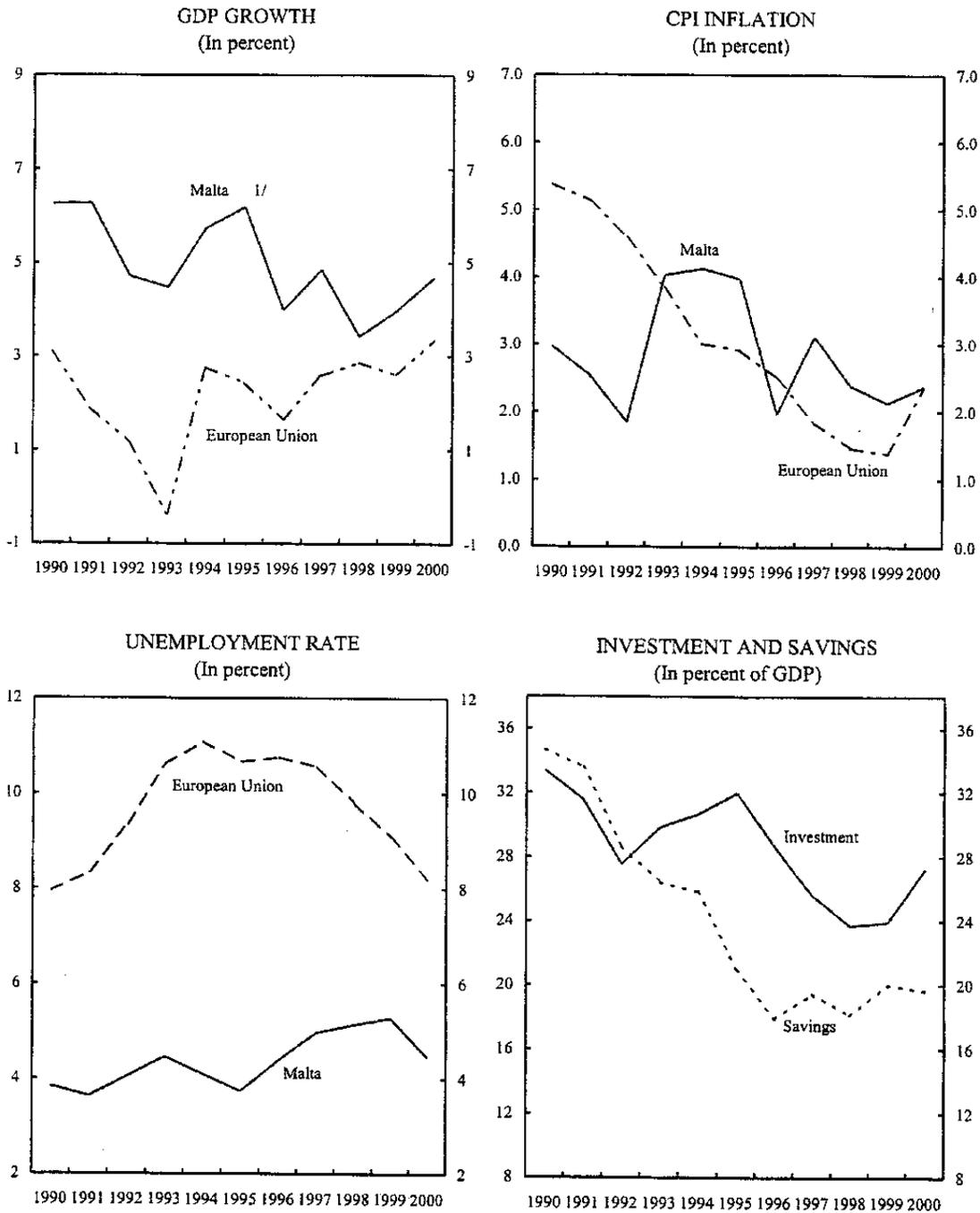
1. The 2001 Article IV consultation discussions with Malta were held in Valetta during April 16–28 2001.¹ Mr. Sdralevich, Assistant to the Executive Director, attended some meetings. The mission met with: Finance Minister Dalli, Central Bank of Malta Governor Bonelli; senior officials in government ministries and the central bank; and representatives of financial institutions, business, and labor.
2. In concluding the last Article IV consultation on June 18, 1999, Directors noted that recent initiatives to strengthen the policy framework—the reintroduction of VAT, the prospect of a fiscal deficit of 4 percent of GDP in 2004, accelerated privatization, and prospective pension reform—would enhance economic performance and support Malta’s accession to the European Union. The projected fiscal consolidation would require reductions in the public wage bill and support for public enterprises, and early technical work was needed to identify reforms in both areas. The fixed-peg exchange rate system remained an effective nominal anchor—though, Directors underscored, it needed the support of appropriately flexible interest rates, fiscal adjustment, and effective financial sector supervision. These were also necessary for effective capital account liberalization.
3. The administration retains its working majority in parliament. The next parliamentary elections must be held before early 2004.

II. ECONOMIC BACKGROUND

4. **Macroeconomic performance has improved in recent years.** The long downward trend in activity growth has been arrested—real GDP growth is estimated at 4.0 and 4.7 percent in 1999 and 2000 respectively; employment rose by some 0.6 percent and 2 percent in the same years with gains across most of the private sector, while registered unemployment has declined towards 4 percent; exports and fixed private investment have grown robustly since 1998 with growth recorded even outside of the key microelectronics sector; and 12-month inflation has declined to 1.1 percent (Table 1 and Figure 1).
5. **The investment and exports of a major microchip plant dominated trends in activity and demand in 2000 (Figures 2 & 3, and Table 2).** Exports and fixed investment soared as the major microchip plant—which accounts for almost 70 percent of merchandise exports—upgraded its product line and output. This accounted for the bulk of the increase in private fixed investment of 3.7 percentage points of GDP. In other sectors, the growth of fixed investment and activity was close to 1999 rates, though activity in tourism was a little below par and the growth of nonmicrochip-related fixed investment was concentrated in mobile phones.

¹ The mission team comprised Messrs. Doyle and Drummond, and Ms. Bal Gunduz (all EU1).

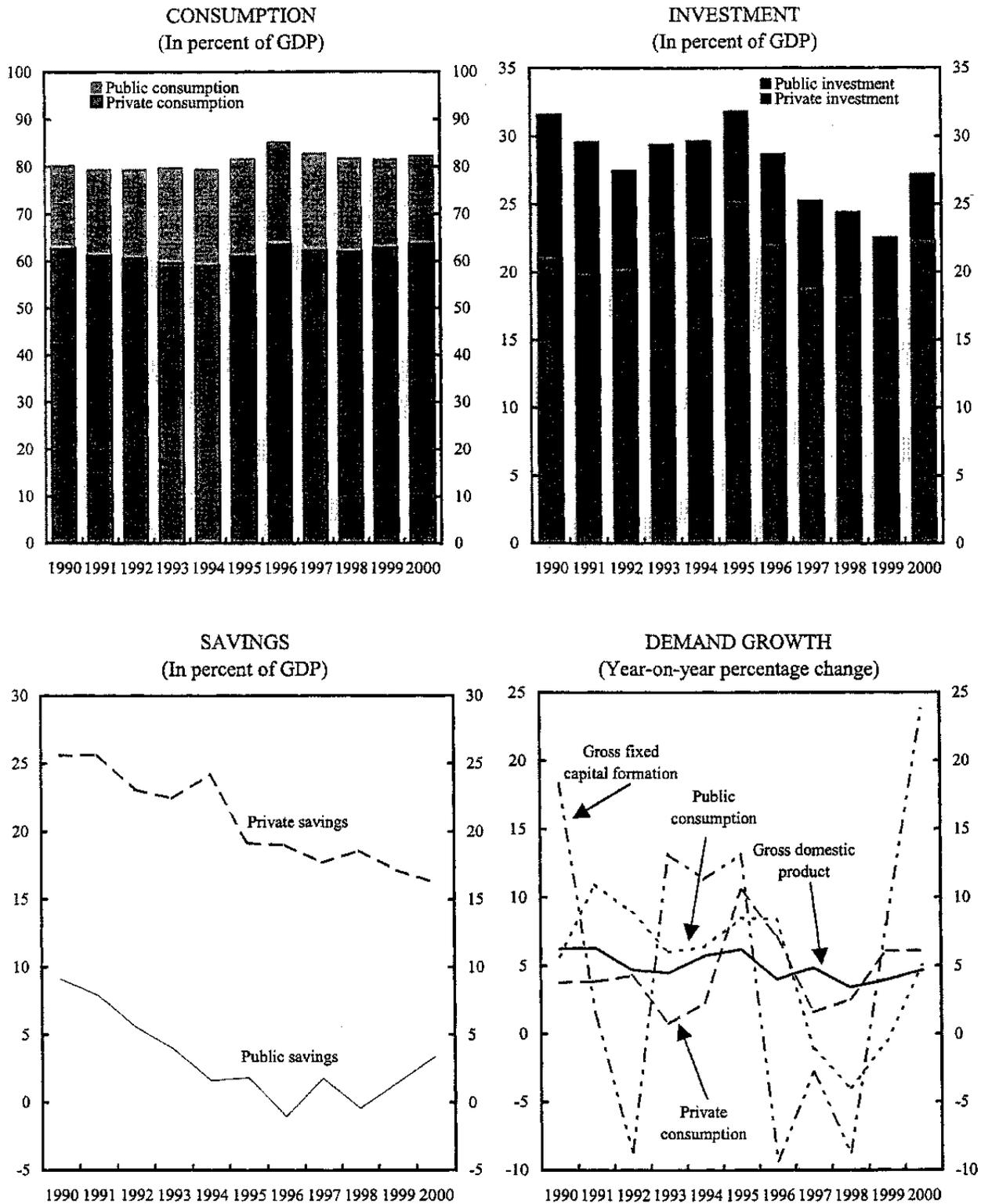
Figure 1. Malta: Main Developments, 1990-2000



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

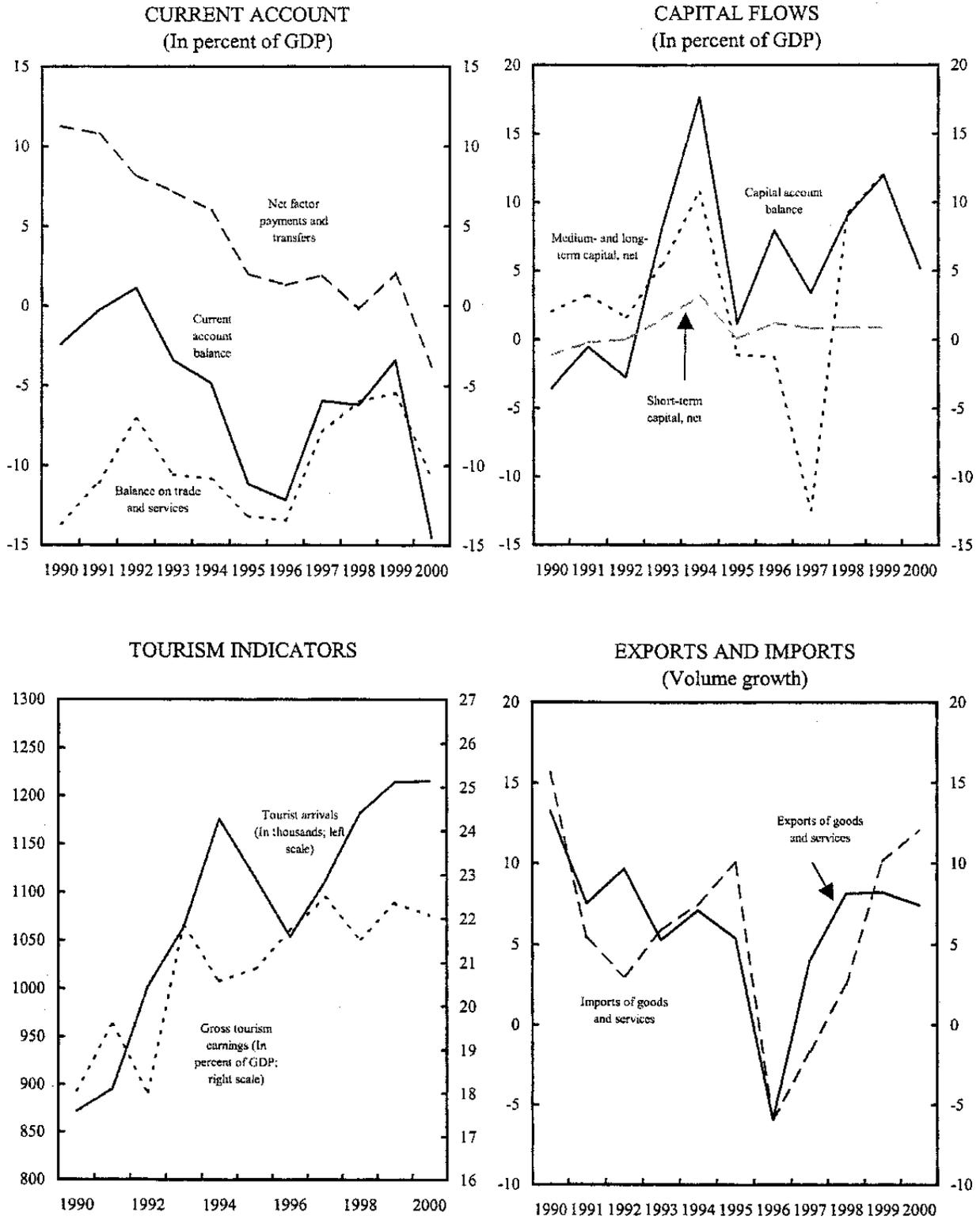
1/ Recorded GDP growth in 1995 was exceptionally high due to improved coverage of economic activities following the introduction of the VAT.

Figure 2. Malta: Real Sector, 1990-2000



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

Figure 3. Malta: External Sector, 1990-2000



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

6. **In addition, public savings strengthened by 1.1 percentage points of GDP. (text table; Tables 3, 4, and 5; and Figure 4)** Better enforcement boosted all tax receipts. Indirect tax receipts also reflected strong personal consumption growth, while increased social security contribution rates and fiscal drag boosted personal income tax receipts. Spending, however, including the operations of the off-budget Treasury Clearance Fund (TCF) was higher than the budget estimates.² This was almost entirely due to activity in the TCF.

	1999	Budget 2000	Outturn 2000
Revenue	38.7	39.1	39.7
<i>o/w:</i> VAT	5.8	6.5	6.7
Income taxes	8.8	8.9	9.6
Soc. Sec. Contributions	9.9	10.5	11.0
Spending	47.3	45.5	46.6
Current spending	41.4	40.9	40.7
TCF	0.9	...	1.5
Investment	4.2	3.9	3.9
Balance	-8.6	-6.4	-6.9
Public Savings	-3.6	-1.8	-2.5
Privatization receipts	5.0	4.0	0.8

On budget items were on track overall; investment was cut while current spending growth was contained, despite overruns on health, transfers, and debt service—the latter overrun reflecting a substantial shortfall on projected privatization receipts.

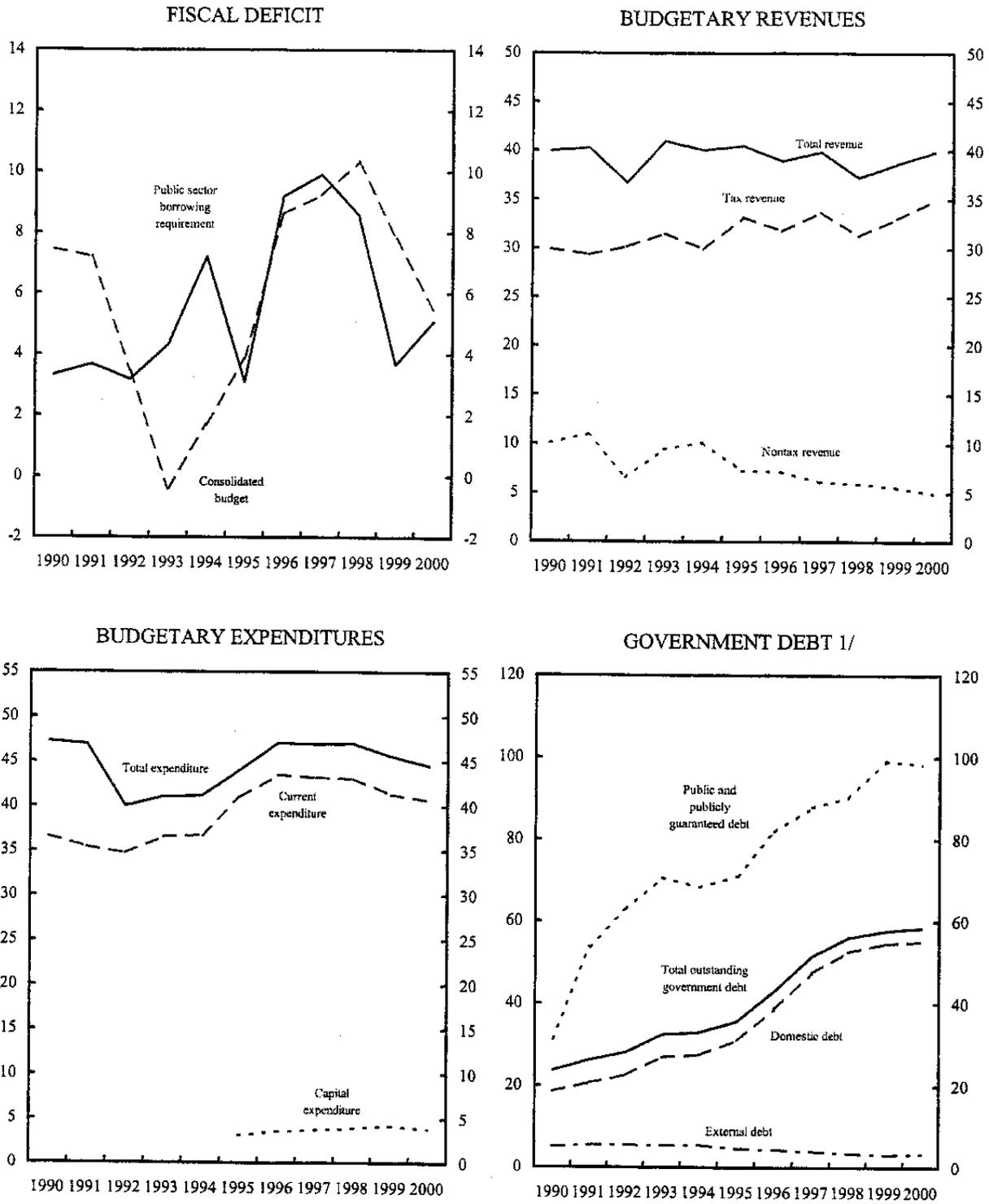
7. **Household consumption growth remained strong after accelerating in 1999, despite decelerating household income** (text table). The strength of consumption may have partly reflected spending by civil servants in anticipation of the large civil service wage rise due in 2001 to which the authorities were committed under an agreement of 1998. Spending in 2000 remained strong, despite a sharp deceleration

	1998	1999	Prov. 2000
Household consumption	2.5	6.1	6.1
Disposable income	4.6	5.6	2.0
<i>o/w:</i> Wage bill	3.7	3.1	3.2
Transfers	4.8	5.9	0.8
Direct taxes	-4.9	7.3	10.6
Household savings ratio	9.7	9.6	7.3

in disposable income, to only 2 percent, as the effect of increased employment and wages on incomes was offset by higher personal taxation and muted growth of transfers. Accordingly, household savings is provisionally estimated to have declined to 7.3 percent of disposable income in 2000 from 9.6 percent in 1999.

² This is a long-standing off-budget fund through which many different transactions pass, including credits and subsidies to public enterprises. Its projected activities are not incorporated in the annual budget presented to parliament, but the outturn balances are made publicly available.

Figure 4. Malta: Fiscal Developments, 1990-2000
(In percent of GDP)



Source: Data provided by the Maltese authorities.

1/ Government debt does not include debt of public corporations.

8. **Declines in inflation and nominal and real wage growth were accompanied by increased employment across most of the private sector (Figure 5).** Inflation declined as the lira basket strengthened vis-à-vis the weak euro during 2000 and because rising international oil prices were not passed onto domestic consumers. Nominal wages rose by only 2.2 percent, led by wage restraint in the public sector in 2000, insulating profits from the strength of the lira. In this context, private sector employment rose 3 percent, rising in most sub-sectors, while it was unchanged in the government sector.

9. **On the external side, a deceleration in tourist receipts, rising oil prices, and a large dividend payment compounded domestic demand pressures on the current account deficit, which rose to 14.5 percent of GDP from 3.4 percent of GDP in 1999 (Table 2, Figure 3).** In a context of good competitiveness (see Box 1), nonmicrochip goods export volumes rose around 3–5 percent in 2000, well below export market growth, as capacity constraints prevented faster growth, despite increased employment. Tourist arrivals were broadly unchanged from 1999, but spending per tourist rose only moderately. Oil imports remained strong in the context of unchanged domestic prices, but increased international prices took fuel imports from 2.5 percent of GDP in 1999 to 3.7 percent in 2000. Nonfuel and nonmicrochip related imports rose some 10 percent in 2000, perhaps boosted by modest tariff reductions implemented in 2000 as part of a three-year program of liberalization. The investment program of the microchip plant accounted for imports of some 2½ percent of GDP, while in Q4 2000, net income recorded an outflow of 4.9 percent of annual GDP, largely a dividend payment by the microchip plant to its parent that was matched by a corresponding inflow of FDI.

Box 1. Competitiveness

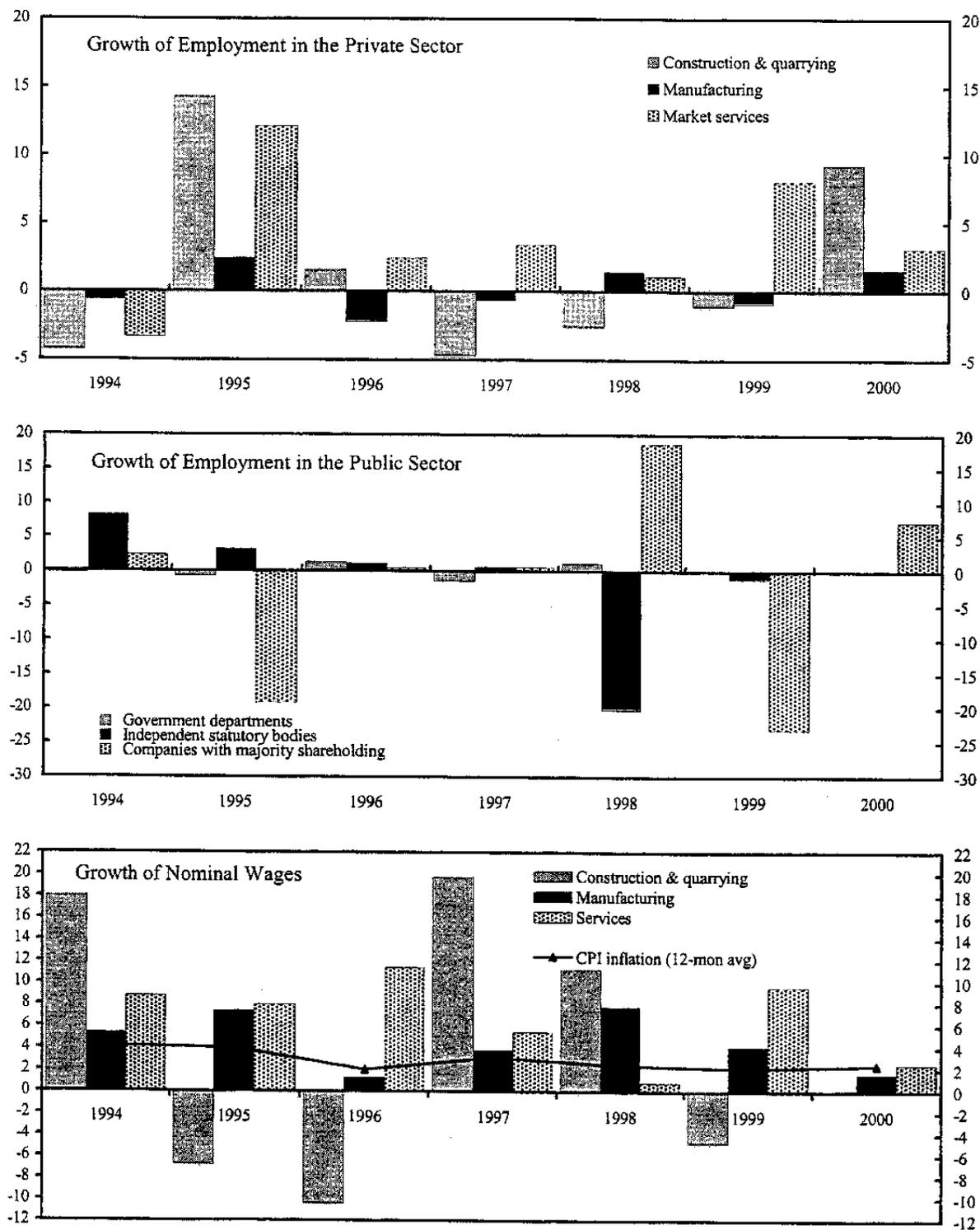
Since mid-1996, the CPI-REER for Malta has steadily appreciated by a cumulative 7 percent (Figure 6). Given the three-currency basket to which the lira is pegged (euro, sterling, and U.S. dollar with weighted 56.8:21.6:21.6, respectively), this largely reflects inflation differentials. Adjusting the trade weights to include tourism increases the measured appreciation over this period to around 10 percent.

The available evidence suggests a considerably less marked impact on the traded sector. The best available indicators of this are relative unit labor costs (Figure 7). Though these show some appreciation since mid 1996, they have technical weaknesses. The indicator for manufacturing is dominated by the microchip plant (viz the sharp change in late 2000) and is constructed using the GDP deflator, not a manufacturing value added deflator, in the absence of the latter. The measure of relative unit labor costs for the whole economy suffers from the drawback that it includes nontraded sectors.

Other evidence suggests that competitiveness remains firm—export volumes appear to be capacity rather than competitiveness constrained, profit growth remains strong, and employment is rising. (See the forthcoming selected issues paper.)

10. **Monetary policy was unchanged as international rates rose during 2000 boosting capital outflows and compounding downward pressure on international reserves (Figure 8).** The central intervention rate was last changed in September 1999 to

Figure 5. Malta: Employment and Wages, 1994-2000
(In percent)



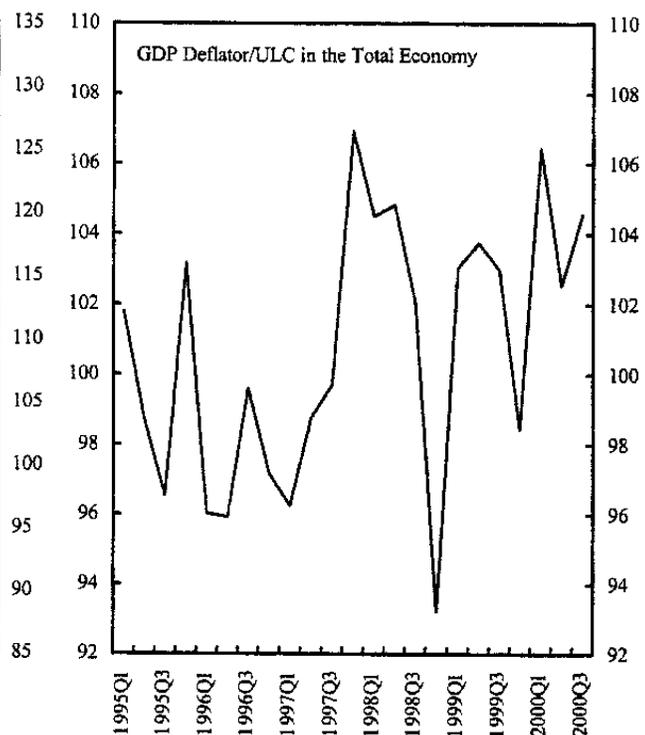
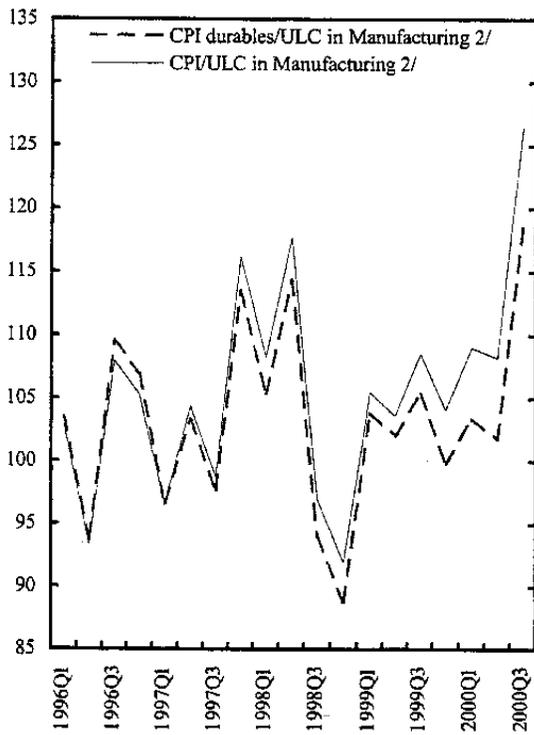
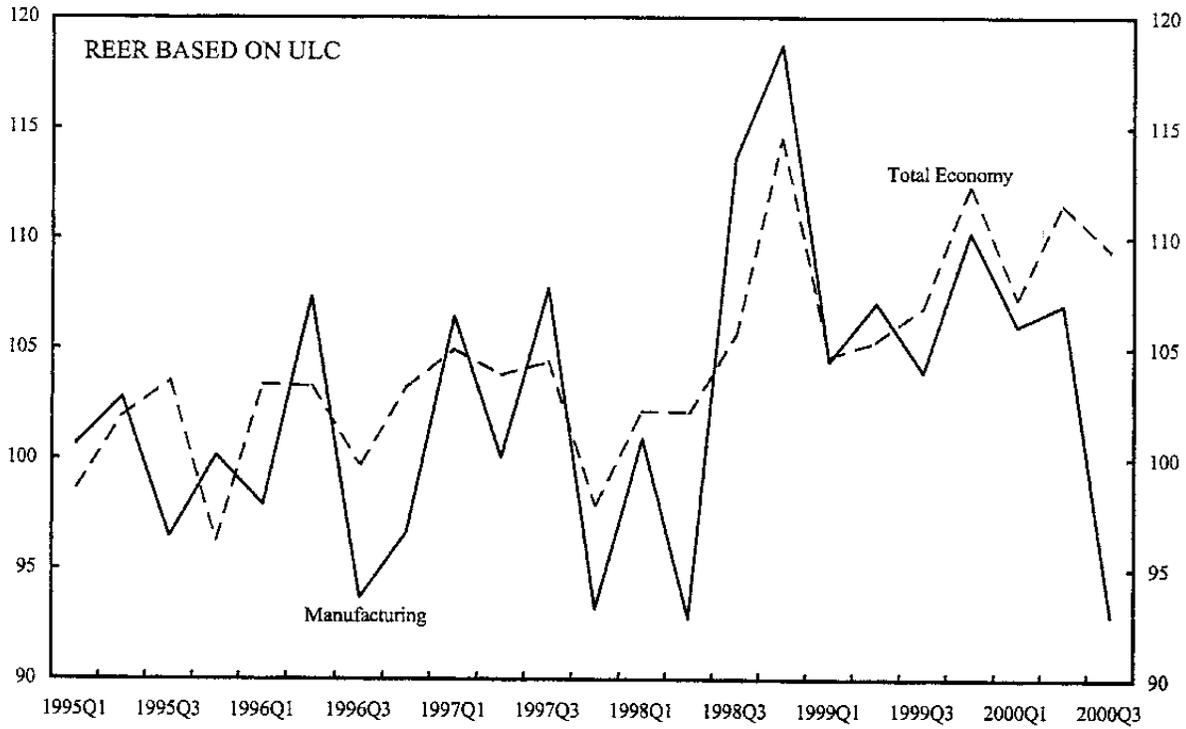
Sources: Data provided by the Maltese authorities; and Fund staff estimates.

Figure 6. Malta: Effective Exchange Rates, 1990-2001



Source: IMF, INS; and Fund staff estimates.
1/ Based on consumer price indices.

Figure 7. Malta: Relative Unit Labor Costs and Unit Labor Costs, 1995-2000 1/
(1990=100)

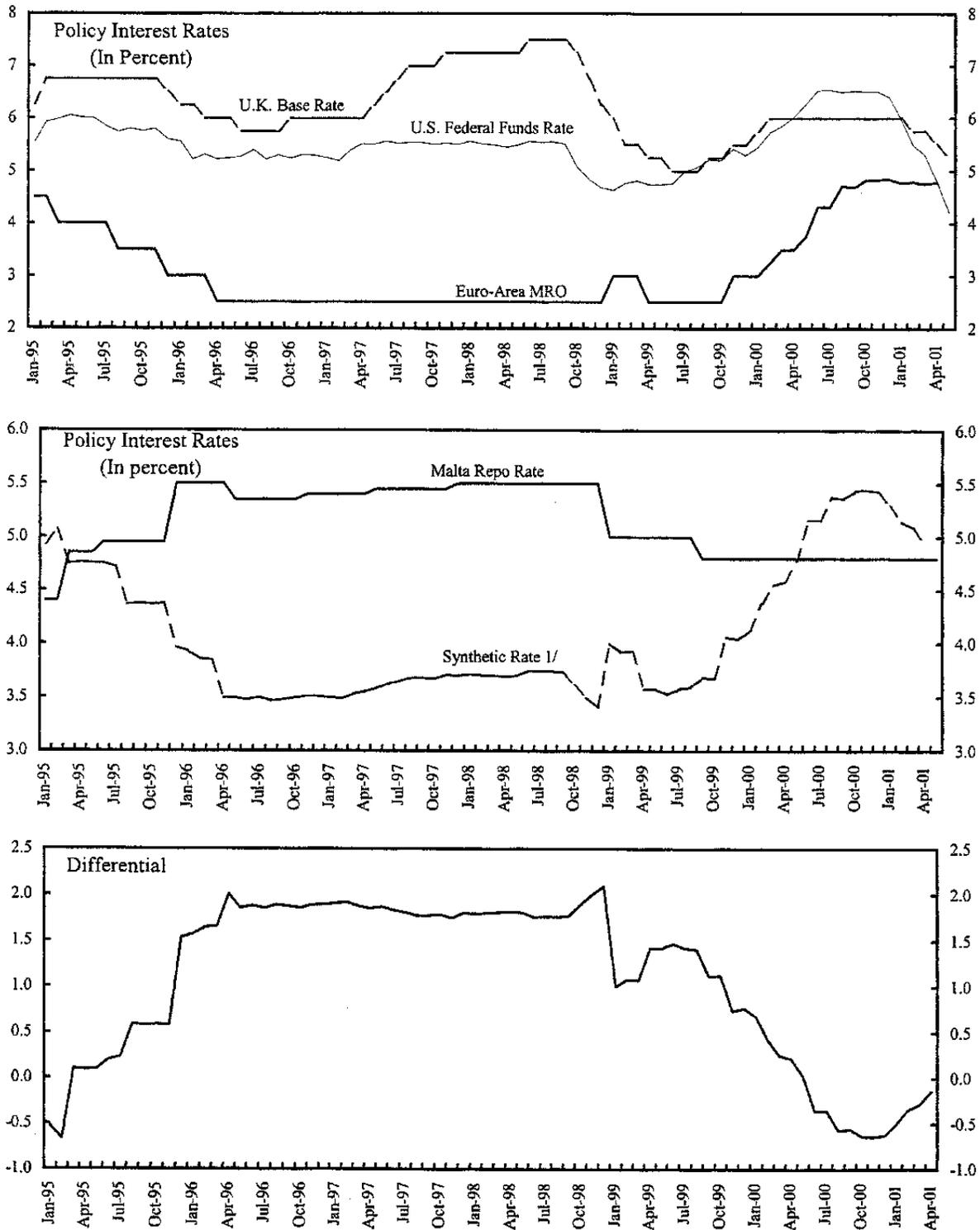


Sources: Data provided by the Maltese authorities; and Fund staff estimates.

1/ Seasonally adjusted.

2/ The consumer price indices are based (1995=100).

Figure 8. Malta: Interest Rates, 1995-2001



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.

4.75 percent. In this context, the decline in household savings was reflected in reduced demand for bank deposits: broad money decelerated from 10 percent at end-1999 to 4 percent in January 2001, while the growth of bank credit to the private sector was also virtually unchanged in 2000 at 11½ percent (Table 6 and Figure 9). As European and U.S. rates subsequently rose, the yield differential against the currencies in Malta's currency basket became negative. This, alongside stock adjustments following further measures to liberalize capital controls implemented in early 2000, prompted capital outflows, notably from domestic commercial banks. In conjunction with the declining current account balance, international reserves fell through 2000, declining particularly sharply in the last quarter. Overall, reserves declined from US\$ 1.8 billion at end-1999 to US\$ 1.5 billion at end-2000, where they were equivalent to 4½ months of merchandise imports. Reserve levels stabilized during the first quarter of 2001.

11. **Looking ahead, WEO projections anticipated a sharp reduction in the rate of growth of export markets from to 8 percent in 2001 from 14 percent in 2000.** However, this was projected to be accompanied by a reduction in international interest rates and some easing of oil prices.

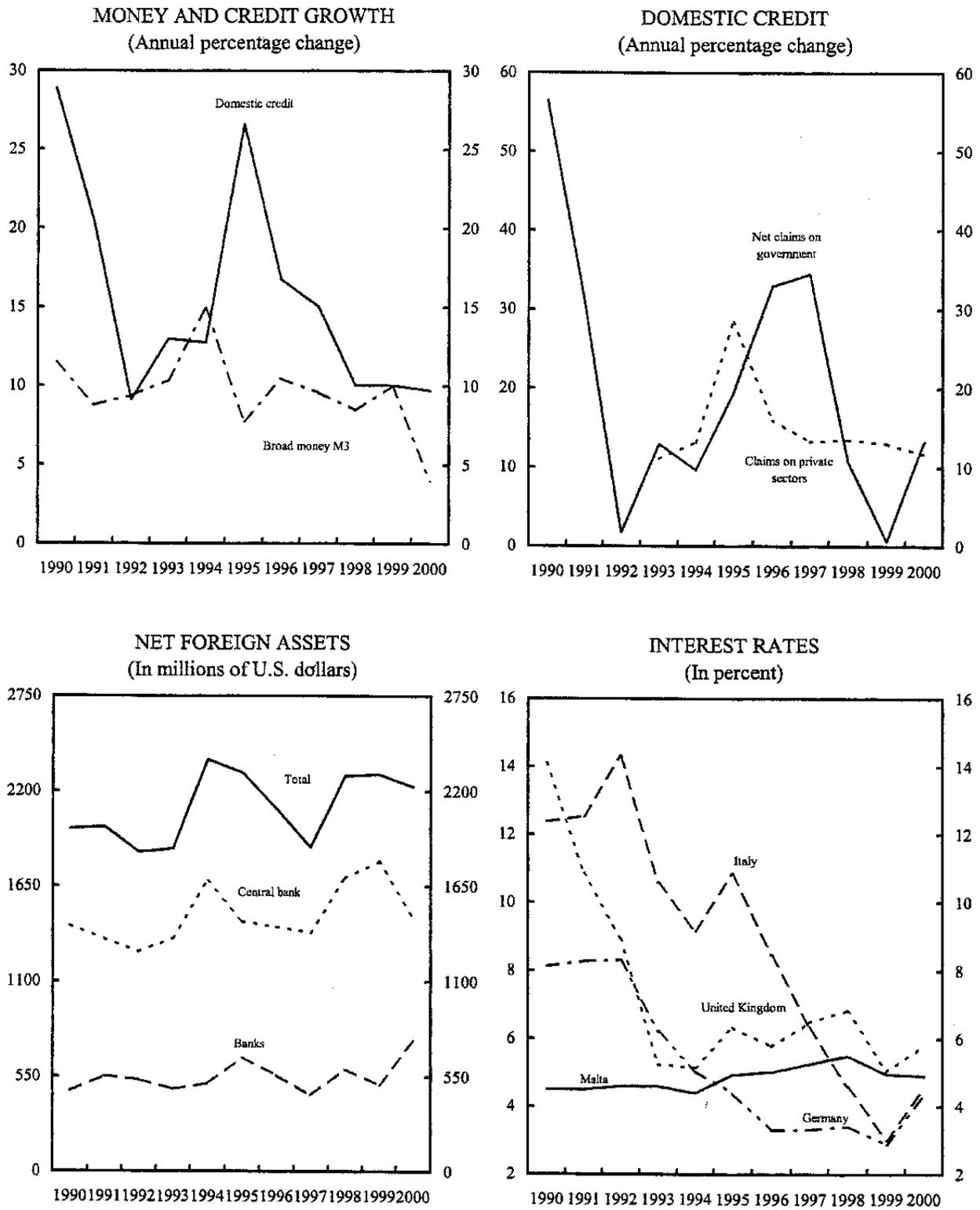
III. REPORT ON THE DISCUSSIONS

12. **Discussions focused initially on whether immediate policy action was required to address the external current account imbalance.** The authorities and staff agreed that the deterioration during 2000 was largely due to temporary factors and was set to largely reverse during 2001. Nevertheless, the current account deficit could remain high and thus fiscal policy should remain focused on ensuring a sustainable path for the external balance over the medium term. This would build on the reduction in the fiscal deficit of 4 percentage points of GDP achieved since 1998. This ongoing consolidation, in conjunction with trade liberalization, privatization, and public sector restructuring underway since 1998 would support the exchange rate peg. And the combination of fiscal and structural reform was expected to continue to yield dividends in terms of efficiency of public services, employment in the private sector, and activity. These policies would constitute an appropriate response to any deterioration in external demand in 2001 and provide impetus to the administration's ambitions to secure early accession the European Union.³

13. **Malta would also, however, remain exposed to "investment shocks" and to short-term capital flows—with consequent potential volatility of the current account balance and international reserves.** These characteristics of economic behavior put a high premium on strong policies. This motivated discussion of the nature of prospective fiscal reforms and the appropriate role of monetary policy and two sets of trade-offs were highlighted. First,

³ The authorities reported that 13 of 29 chapters of the *Acquis Communautaire* had been closed and progress with the remaining chapters was expected to be swift. Key points for future negotiation included, however, government support for public enterprises.

Figure 9. Malta: Monetary Sector Developments, 1990-2000



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

though further fiscal consolidation is necessary, anticipated, and rightly expected to focus on spending, the authorities are reluctant to commit to tighter policies even though they anticipate them. This reflects the desire to avoid appearing to move the “goalposts,” and to strike a balance between maintaining appropriate room for fiscal maneuver and avoiding undue uncertainty about fiscal prospects. Second, the authorities place a high premium on maintaining the stability of interest rates. But the opening of the capital account regime alongside the conventional pegged exchange rate regime sharpens the trade-off between the stability of interest rates and that of international reserves.

A. Macroeconomic Outlook for 2001 and the Medium Term

14. **For 2001, the authorities and staff anticipated a sharp reduction in the current account deficit.** The current fixed investment program of the microchip manufacturer had been largely completed during 2000, and further expansion would likely await an upturn in international microchip markets. This decline would only partly be offset by the initiation of several tourist-related projects in 2001. There was also no prospect of the sizeable dividend payment that had occurred in late 2000. There was also some prospect of a stabilization or partial easing of international oil prices and at least a partial recovery in household savings rates after the decline in 2000 as household incomes rose—the result of increased civil service salaries in the context of an unchanged personal income tax regime. Nevertheless, the authorities anticipated that household responses to continued fiscal consolidation in 2001 as well as longer term factors affecting savings propensities, including financial deepening and increasing “consumerism,” would likely prevent a return to household savings rates recorded in 1999. The authorities also target a fiscal consolidation of 0.7 percentage points of GDP in 2001, which would boost public savings.

15. **However, the staff was more concerned than the authorities about the risks for activity posed by weakening external market growth.** WEO projections indicated that export market growth would drop to 8 percent. The authorities were nevertheless confident, on the basis of soundings of their major exporters, that robust export market growth would continue in 2001 as in 2000. Staff agreed that the binding constraint on Malta’s export growth was likely not export market growth but the growth in competitive export capacity. But it seemed unlikely that even hitherto capacity constrained exporters would be completely insulated from a deceleration of external demand. The staff therefore was more concerned about possible downside risks to real activity and employment growth than were the authorities.

16. **Over the medium term, the private sector savings investment balance was likely to deteriorate, requiring offsetting fiscal policy actions to secure external sustainability (Table 7).** Given that the likely sizeable external current account deficit even after the temporary factors in 2000 had unwound, the authorities agreed with staff that medium-term external sustainability was a key issue. They also agreed that declines in household savings from 1999 levels were likely in the context of a strong policy framework, the steady deepening of financial markets, the aging of the population, and increased confidence in medium-term income growth. Fixed investment ratios would likely remain around levels

attained in 1999 as major tourist investment projects came on stream alongside investment implemented in the restructuring process. These assessments, broadly shared by the authorities and staff, suggested that in the absence of further fiscal consolidation, projected FDI inflows would be insufficient to secure a sustainable path for external debt—associated with a current account balance in the order of 4–5 percent of GDP in the medium term.

17. **This prospective underlying trend deterioration in the private savings-investment balance underlies the need for medium-term fiscal consolidation.** The authorities target a consolidation of 0.7 percentage points of GDP in 2001. Given the prospective self-correction of much of the current account deficit seen in 2000, the staff welcomed the authorities 2001 fiscal deficit target as an appropriate step towards medium-term consolidation. The latter goal remains defined by the 1998 fiscal framework for 1999–2004. This projected a decline in the officially defined fiscal deficit to 4 percent of GDP in 2004 from 11 percent of GDP in 1998, though the authorities expect to secure a deficit of around 3 percent of GDP in 2004. The latter expectation would imply a consolidation of 2½ percentage points of GDP from the 2000 outturn. Staff suggested that a consolidation of some 3–4 percentage points of GDP from the 2000 outturn would be needed by 2004 in order to maintain a sustainable underlying current account balance (See Table 7). This would be consistent with output growth at or around Malta’s estimated potential of 4-4½ percent in the medium term. With the exchange rate peg supported by fiscal and structural policies, inflation would remain close to EU rates.

B. Fiscal and Structural Policy for 2001 and the Medium Term

18. **The government budget for 2001 anticipates a consolidation of 0.7 percentage points of GDP.** The adjustment is anticipated to occur on the revenue side. The taxation of fringe benefits under the personal income tax is tightened, and the brackets in that tax are again unchanged, implying further fiscal drag. The VAT base is extended in various ways, excises are raised, and a further round of reductions of import tariffs is implemented in accord with the three-year liberalization program. On the spending side, current spending is projected to rise by 0.3 percentage points of GDP, partly offset by a similar decline in net lending. However, the composition of spending changes markedly: personnel expenditure rises by 0.8 percentage points due to implementation of the 1998 civil service wage agreement, offset by declines in operations, and interest spending—the latter presuming strong privatization receipts.

19. **The official data exclude off-budget fiscal operations conducted through the TCF.** These activities—consisting largely of transfers and loans to public enterprises, notably the shipyards—summed to 1½ percent of GDP in 2000, up from 0.9 percent of GDP in 1999. The increase in 2000 largely reflects unanticipated funding for the shipyards and for the Freeport. The authorities expected that activity in the TCF in 2001 could be at or below levels seen in 2000 relative to GDP. Thus, on the staff definition of the fiscal balance, assuming unchanged operations in the TCF relative to GDP, the fiscal deficit is expected to decline from 6.9 percent of GDP in 2000 to 6.2 percent in 2001.

20. **The authorities emphasized that fiscal adjustment in 2001 at least as great as indicated in the headline fiscal deficit measure would be secured, even allowing for off-budget transactions.** They were confident that the budget estimates contained adequate cushions and that an adjustment of 0.7 percent of GDP would be secured even on the staff measure of the deficit. Such an adjustment was necessary to support the external current account balance and to continue progress towards the medium-term fiscal goal. Staff noted several concerns, however: the estimates for VAT could be high if the rate at which arrears are cleared declines relative to 2000; spending on free medicines might again overrun the estimates in 2001; and cash flow projections for public enterprises consistent with the budget and TCF estimates were, as in earlier years, not available to underpin those estimates. The authorities argued that arrears accumulation in VAT since its reintroduction in 1999 had been minimal but acknowledged difficulties in projecting spending on medicines. Nevertheless, this risk was offset by some cushions in the revenue estimates, notably in the estimates for the yield on further tax administration measures.

21. **While underscoring the continued need to increase tax compliance, the authorities acknowledged that further increases in the tax burden were undesirable.** They noted that the priority of fiscal deficit reduction, the difficulty of effecting spending rationalization, and the scope to combat tax evasion, meant that increases in the tax burden had, until now, inevitably been the focus of deficit reduction. This pattern would remain during 2001 when taxes on benefits paid in kind would be fully applied and through the introduction of benchmarking exercises for small firms. But increases in tax rates had further stimulated evasion and increases in the overall tax burden had weakened incentives for private investment. Staff welcomed the strengthened tax administration and enhancements to the tax system more generally—notably through the effective reintroduction of VAT in 1999 and the steady widening of its base—and endorsed the view that the tax burden had likely approached if not exceeded efficient levels.

22. **The authorities noted that the emphasis in deficit reduction would therefore increasingly shift to expenditure rationalization, though further tax increases could not be ruled out.** They noted three initiatives of spending reform already underway:

- **The Commission on Welfare Reform**, set up in 2000, was examining options to reform the current PAYG pension system and was due to report soon. Issues to be addressed include: the automatic links between individual pension levels and current wages; nominal caps on individual contributions and pension payouts; and demographic challenges as the population ages. All the social partners are represented and all options for reform are on the table. Prior to the report, there is no outline timetable for implementation.
- **A privatization program** is underway, the proceeds of which will be used to lower public debt and hence, debt service. The program focuses on sales of high quality assets and builds on the flagship sale of Mid-Med Bank in 1999. Legal and technical obstacles, which impeded the sale of the Freeport in 2000, have been addressed. This sale, alongside others including the government holdings in a major bank, is on track

for completion before end-2001. The aim is to sell mainly to strategic investors—on the basis of price, the quality of the business plan, and employment guarantees. Efforts are also being made to increase the implementation capacity of the unit responsible for preparing the sales, and the authorities remain committed to transparency in the sales processes, guided by the 2000 White Paper on privatization.

- **Flows of public funds to public enterprises** will be curbed through two actions. First, fuel prices will be tied to international oil prices from end-2001, though the details of the new pricing arrangement have yet to be worked out. Consideration is being given to similar treatment for other energy prices. Second, central control over public enterprise multi-year wage agreements is being strengthened, with every agreement now being individually centrally vetted in advance.

23. **The staff welcomed the intention to prioritize spending rationalization.** They strongly encouraged early completion of the work of the pension's commission and agreed that the privatization of Mid-Med bank in 1999 had yielded significant benefits in terms of productivity and the robustness of the financial sector. Further gains would likely accrue in the context of the sale of the government's remaining stake in the second major commercial bank. Staff also noted that privatization could help by bringing the largely consensual character of industrial relations in the private sector into hitherto public operations. Steps to overcome technical obstacles that had impeded the privatization process during 2001 were welcome, as were those to provide the privatization task force with personnel resources commensurate with its task.

24. **However, staff urged a more ambitious reform agenda.** They expressed concern at the absence of plans to curb the public sector wage bill, despite considerable evidence of scope for savings there. In addition, uniform lump sum wage increases should be replaced by percentage increases to maintain the wage structure over time, thereby avoiding the need for periodic major adjustments to restore an appropriate wage structure as occurred in 2001. Staff also suggested that consideration be given to defining multi-year wage agreements on the wage bill, rather than on wage rates, to encourage rationalization of the public sector workforce at a socially acceptable pace. These steps could contribute to reducing the flow of subsidies to public enterprises, which would not only yield fiscal benefits, but would also relieve labor shortages in the private sector.

25. **In implementing their medium-term fiscal objectives, the authorities remain committed to the content and the form of the projections made in their 1998–2004 fiscal framework.** While recognizing that Malta's officially defined fiscal deficit in 2000 was already lower than had been projected in late 1998, the authorities were reluctant to alter their official fiscal balance projections to 2004 in this light, lest this should confuse the public. They were confident that the fiscal outturns in the future would be stronger than projected, as in the past, and argued that reflecting this expectation in official projections or in recasting the fiscal balance projections into targets or ceilings would add little of substance while curtailing flexibility. On similar grounds, they were skeptical of the case to strengthen the accounting standards used in the official fiscal framework. Even though flows through the

TCF should be included in the headline fiscal deficit outturn and historical data showing this would soon be regularly published by the EU-commission on an ESA-95 basis, the authorities argued that the public would be confused by changes to the accounting standards used in the medium-term fiscal framework.

26. **Staff welcomed the authorities' expectation that the fiscal balance would be stronger than projected between 2000 and 2004**, given the need to rein in the external current account deficit and support the exchange rate peg. But staff noted that greater transparency in the fiscal framework—by revising the official projections and accounting standards in line with the authorities' actual expectations and intentions—could help to anchor investor's expectations and help to coordinate efforts within the government to ensure that the authorities expectations were realized. Both of these benefits could be significant in the context of a de facto open capital account, a fixed exchange rate peg, and of a likely deterioration in external market conditions in 2001. Staff recommended that the authorities should undertake a self-assessment against the Code of Fiscal Transparency to highlight key areas where improvements could be made.

27. **Malta is midway through a phased program of tariff reductions for nonagricultural products.** Beginning in 1999, so-called "levies" on nonagricultural imports have been lowered in conformity with a three-year program: various levies were abolished in October 1999 and January 2000, and the remaining levies were lowered by 20 percent in January 2001, will be further lowered in January 2002, and abolished in January 2003. The schedule of adjustments was announced in advance so as to encourage adjustment in advance of the reductions and, on that basis, it was decided to leave the greatest reductions until 2003. The authorities confirmed that the program remained on track and that the reductions scheduled for 2002 and 2003 would be fully implemented at that time.

C. Monetary, Financial Sector, and Exchange Regime Policies

28. **The key monetary policy decisions in 2000 had been to leave domestic interest rates unchanged even as external interest rates rose above those in Malta and elicited capital outflows.** The authorities noted that their decision to leave interest rates unchanged in this context reflected two key assessments. First, from early 2000, the increases in international interest rates and sharp deterioration in the current account balance were seen as temporary. Furthermore, much of the deterioration in the current account was matched by increased FDI inflows. Thus, the negative influences on international reserves were likely to be self-correcting. Second, at the same time, domestic activity seemed set to be held back under the influence of the planned fiscal consolidation, ongoing trade liberalization, clearance of arrears of household utility bills, and the tightening of credit criteria by commercial banks in the wake of the 1999 Mid-Med Bank privatization. Indeed, many commentators suggested that these gave rise to a "liquidity squeeze" on the island that a monetary tightening would have compounded, perhaps unduly. While staff agreed that the current account deterioration had, in all likelihood, been correctly interpreted as temporary, the recent declines in international interest rates had been more of a surprise. In addition, through 2000, evidence had mounted that domestic activity remained strong, notably given

buoyant exports and employment. And furthermore, the speed with which capital flows and international reserves had responded to trends in the yield differential underscored the openness of the capital account and the need for more decisive action on interest rates to maintain the credibility—in the short and longer term—of the peg. The authorities underscored that they had kept a close eye on the international reserve levels while the yield differential declined and became negative. But in their view, the balance of concerns at each stage justified an unchanged monetary stance and the stabilization of reserves in 2001 had vindicated those assessments.

29. **Looking ahead, the monetary authorities underscored that monetary policy should not become overburdened.** They emphasized that while an appropriate degree of flexibility of interest rates was important, fiscal and structural policies would need to be fully supportive, lest monetary policy become overburdened. Staff concurred, noting that given the fixed peg and capital account liberalization, interest rates needed to be clearly focused on supporting reserves and the peg.

30. **The step-by-step liberalization of capital account controls has continued, increasing Malta's potential exposure to short-term capital flows.** In the 2001 budget, limits on outward portfolio and real estate investments were doubled and trebled respectively, limits on foreign currency holdings with local banks were sharply raised, and foreign lending and borrowing by residents were liberalized completely for maturity periods in excess of a year. Furthermore, exporters were allowed to retain proceeds in foreign currency up to one year. Staff welcomed these most recent steps in the progressive liberalization of controls, and discussion focused on the extent to which they increased Malta's exposure to short-term speculative flows. The authorities noted that the prevalence of tourists on the island meant that the control regime had never been watertight. But they agreed that the liberalization of controls on exporters and importers had significantly increased the exposure to short-term flows through legal channels—since importers could increase their purchase of forward cover and exporters could delay conversion of proceeds for up to a year. Alongside potential flows by banks—which are subject only to prudential controls—and by households, and nonresidents, this implied that short-term capital movements over relatively short periods through legal channels could be large relative to the stock of international reserves. The authorities noted that with the exception of banks, agents' behavior suggested that sensitivity to interest rate differentials was still somewhat muted—other capital outflows during 2000 had largely reflected structural change in financial markets, notably the growth of mutual funds. But they agreed with staff that this sensitivity would likely increase.

31. **In this context, maintaining strong competitiveness was agreed to be critical.** The authorities noted that the appreciation of the CPI-based real effective exchange rate had not been accompanied by similar increases in the relative unit labor cost measures, though the latter can only be measured imprecisely. Indicators of profit share, employment, and of export growth (outside the electronics sector) also suggested that competitiveness remained firm. Nominal and real wage moderation, reflecting the credibility of the exchange rate peg, had played a key role in securing this outcome. Staff noted, however, that on available

evidence, the U.S. dollar remained overweighted in the currency basket relative to Maltese trade patterns in nonprimary goods and services. In this sense, the basket weights were not fully efficient and this had resulted in a nominal effective appreciation of the lira in the context of euro weakness. The staff recommended that if a further review of trade data confirmed the overweighing of the U.S. dollar, this should be corrected by reweighting the basket in line with nonprimary trade patterns. The authorities agreed that the U.S. dollar appeared to be overweighted in the basket. But as in recent years, they were inclined to retain that overweighing in the expectation of a euro recovery.

32. **The increasing openness of the capital account in the context of the exchange rate peg also raises the premium on the soundness of the financial sector.** The authorities noted that the privatization of Mid-Med Bank had ushered in a significant tightening of banking practices throughout the banking sector. The main banks had thoroughly reassessed their loan books, significantly increasing their bad debt provisions in the process. However, even after these added provisions, bank capital stands at 13.6 percent of risk weighted assets. The authorities agreed, however, that there was little hard information concerning foreign exchange exposures being run in the corporate sector, and that in adverse circumstances, these could impact the credit risk of banks. They indicated that efforts would be made, where possible, to improve surveillance of such exposures. Preparations for the sale of the remaining government stake in the second major commercial bank had also included a significant improvement in its procedures and practices. And the process of phasing out the offshore banking licenses was continuing; the remaining such institutions would be incorporated under onshore legislation by 2004.

33. **Preparations were also underway to unify all financial sector regulation in a single regulator outside the central bank.** This long-mooted reform is intended to secure economies of scale in regulation and to separate monetary policy from regulatory functions. The authorities indicated that considerable care was being given to ensuring a smooth transfer of functions and personnel, and that a draft memorandum of understanding concerning the information flow between the new regulator and monetary policymakers was under review. While welcoming these assurances, staff noted that regulators were heavily engaged with preparations for the privatization of the second major bank in Malta. On these grounds, staff suggested that the reform only occur once the sale of the remaining government stake in that bank has been concluded so as to ensure effective completion of that process. The authorities concurred.⁴ They also expressed interest in completing a FSAP

⁴ The authorities also outlined the actions taken to strengthen their ability to combat money laundering. The Prevention of Money Laundering Act was amended to bring it in line with European legislation—widening the range of offenses, limiting the transferability of bank accounts, and eliminating confidentiality within financial groups. In addition, draft legislation to address nominees' bank accounts is expected to be enacted by end-2001, and a financial intelligence unit to linking law enforcement agencies and financial institutions will be set up.

to provide further guidance for regulatory initiatives. Staff welcomed all these developments and indicated support for an FSAP, subject to resource availability.

34. **The authorities remain committed to maintaining the fixed exchange rate peg regime, supported by a strengthening of the Central Bank of Malta Act.** They see no case for an immediate change of regime in light of possible EU accession and remain committed to a pegged arrangement on many grounds: Malta's openness; the long-standing success of the peg; the flexibility of nominal and real wage behavior; strong competitiveness; and the supportive stance of medium term fiscal policy. Entry into ERMII would require removal of noneuro currencies from the basket but the implications of that will be assessed at the time. Preparations are also underway to strengthen the Central Bank of Malta Act, including steps to make price stability the primary objective of the bank, to extend the appointments of the governor and deputy governors to a minimum of five years, and to prohibit central bank lending to the government. The staff agreed that the pegged regime remained appropriate and that early passage of the reforms to the Central Bank Act would support that arrangement.

IV. STAFF APPRAISAL

35. **Macroeconomic performance has improved in recent years.** Real GDP growth rose to 4.7 percent in 2000 and employment increased some 2 percent with gains across most of the private sector in the same year. Registered unemployment has fallen towards 4 percent, and exports and fixed private investment have grown robustly since 1998, with growth recorded even outside of the microelectronics sector. Inflation has declined.

36. **These trends are the first fruits of a strengthening of the policy framework since 1998 in a setting of rapid growth of Malta's export markets.** The fiscal deficit, including off-budget items, has been lowered by 4 percentage points of GDP; the tax system has been strengthened, including through the successful reintroduction of VAT; trade protection has been lowered; a bold privatization program has begun; interest rates have been fully liberalized; financial regulation has been strengthened; and capital account controls have been steadily eased. Alongside sharp increases in export market growth in 1999–2000, these developments leave Malta well placed to pursue its application to join the European Union.

37. **However, Malta remains vulnerable to "investment shocks" and to short-term capital flows.** If the exchange rate peg is to be sustained in these circumstances, the policy framework needs to be firm, perhaps particularly in 2001 if external market conditions weaken as projected. The first step in this process is a strong fiscal outturn for 2001. In this light, the target fiscal consolidation of 0.7 percentage points of GDP represents an appropriate step and every effort should be made to meet or over perform against this goal.

38. **Further fiscal consolidation will need to follow.** Demographic factors, financial deepening, and rising incomes are likely on balance to continue to lower household savings rates, as they have done in recent years, while tourist-related projects in coming years will boost private fixed investment rates relative to those in 1998–99. This establishes the need

for further sizeable reductions in the fiscal deficit to secure sustainable current account balances over the medium term. Accordingly, the authorities' expectation of a fiscal deficit of the order of 3 percent of GDP in 2004 is welcome, though an even more ambitious target may be necessary. But it would more effectively garner investor confidence if it was presented as a formal target rather than as a set of projections, if it was embedded in a framework including a clear statement of the overall revenue and expenditure actions to be taken to secure that target, and if it was defined to include all spending through the TCF.

39. **The particular steps taken to secure fiscal deficit reduction in the short- and medium-term can be as important as the deficit reduction itself in strengthening overall economic performance.** To date, deficit reduction has been achieved on the revenue side. Though many positive steps to strengthen the tax system have been taken, they have been employed not to reduce the burden of taxation on compliant payers through cuts in tax rates but to secure deficit reduction in the face of largely unreformed public spending programs. Since the tax burden is high, it encourages tax evasion and is a disincentive to business, inward foreign and domestic investment, and employment. Thus, a medium-term fiscal program should seek to lower the overall tax burden relative to GDP, while maintaining the high priority now accorded to increasing the efficiency of tax policies and administration.

40. **Accordingly, further fiscal deficit reduction should focus on exploiting the ample scope for rationalization of public spending.** There is a broad consensus on the islands that inefficiencies in current spending programs are rife. Four areas for reform appear to be key: subsidies to public enterprises need to be curbed—these lock labor into the public sector while labor shortages persist in the private sector and they maintain inefficient pricing structures; pensions need to be reformed to support and focus the pensions system more effectively on the needy; the government wage bill needs to be curbed, even more so following recent wage increases; and privatization needs to move ahead decisively in order to unlock considerable productive potential and lower the burden of public debt. In each area, steps are being taken, but there is particular need to deepen the thrust of efforts to address the wage bill in the public sector.

41. **The fixed peg exchange rate regime has served Malta well; but further action to buttress this regime would be prudent.** On the available evidence, Malta remains competitive at current rates but continued vigilance will be required, including efforts to ensure continued appropriate flexibility of nominal and real wages. The durability of the peg, Malta's size and openness, the strength of the financial system, and the flexibility of private sector labor markets all indicate that the peg remains a workable nominal anchor. There may, however, be a case for further adjustments in the weights in the currency basket if a further review of the available data on trade patterns confirms that the weights are misaligned.

42. **However, it is essential to ensure appropriate reserve cover—this is the primary operational indicator for monetary policy, given the exchange rate peg.** Given appropriate fiscal and structural policies, interest rates should respond swiftly to movements in foreign rates so as to support international reserves. Given a need to rebuild reserves after the losses in 2000, however, reserves should be allowed to accumulate again before

consideration is given to reductions in the central intervention rate in line with international rates. In this context, the proposed amendments to the Central Bank Act—the adoption of a clear mandate to maintain price stability, the prohibition of lending operations to the budget, and steps to strengthen the Bank’s independence formally—will boost market confidence that monetary policy will be appropriately conducted.

43. **The maintenance of a robust financial system will also be key to ensuring the durability of the peg, given an open capital account.** If plans to unify financial regulation in one institution go ahead, it is essential that the flow of information to the central bank about conditions in banking and financial markets be secured. But a strong case can be made that unification should not proceed prior to completion of the sale of the remaining government stake in a major commercial bank. In recent years, many steps have been taken to strengthen banking practices and to provision properly against delinquent debt, and banks remain well in excess of the minimum recommended capital adequacy ratios. Nevertheless, banks and supervisors should increase surveillance of foreign exchange exposures being run by debtors either through their trade status or through the currency denomination of their lending or borrowing. These issues could usefully be further explored in the context of an FSAP. Self-assessments against international standards—in addition to that already completed for the banking sector against the Basel Core Principles—would provide a first pass at identifying where steps might usefully be taken to strengthen institutions and policy transparency. In this light, steps taken to implement ESA-95 standards in fiscal data are welcome.

44. **Malta’s database is adequate for surveillance but requires further strengthening.**⁵ There remains a need to reduce the lags in producing the full set of national accounts, as well as those for fiscal data. Additional indicators for deflators would substantially assist analysis.

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

⁵ During 2000–01, Malta has made preparations to introduce fiscal accounts consistent with the European System of Accounts (ESA-95). Malta is a participant in the Fund's GDDS and its metadata are posted on the Fund's Dissemination Standards Bulletin Board. Malta's aims eventually to comply with the requirements of the SDDS.

Table 1. Malta: Selected Economic Indicators, 1995-2000

	1995	1996	1997	1998	1999	Prov. 1/ 2000
Real economy (percentage change; constant prices)						
Real GDP	6.2	4.0	4.9	3.4	4.0	4.7
Private consumption	10.5	7.1	1.6	2.5	6.1	6.1
Public consumption	8.5	8.4	-1.1	-4.0	-0.6	5.0
Gross capital formation	13.1	-9.3	-2.8	-8.7	8.0	23.7
Fixed capital formation	17.8	-8.4	-4.5	-3.4	4.0	17.0
Exports of goods and services	5.4	-5.9	4.0	8.1	8.2	6.1
Imports of goods and services	10.0	-5.9	-1.7	2.5	10.1	10.6
Retail prices (period average)	4.0	2.0	3.1	2.4	2.1	2.4
Retail prices (end period)	3.6	1.9	4.3	1.3	3.3	1.1
Unemployment rate (percent of labor force)	3.5	3.7	4.6	4.9	5.3	4.8
Public finance (percent of GDP)						
Government budget deficit	-5.4	-8.3	-11.0	-10.9	-8.6	-6.9
Government debt	35.7	43.0	51.5	56.1	57.7	60.1
Money and credit (end period; percentage change)						
Narrow money	-5.8	4.0	5.7	9.1	11.0	2.3
Broad money	7.8	10.4	9.6	8.4	10.0	4.0
Domestic credit	26.6	16.7	15.0	10.0	10.0	9.7
Credit to government	19.4	32.9	34.5	10.7	0.6	13.3
Credit to the private and parastatal sectors	28.0	13.9	11.1	9.8	12.3	8.9
Net foreign assets of the central bank (in percent of the monetary base)	-15.9	-4.6	1.4	13.9	15.7	-13.0
	129.8	119.5	115.4	121.2	136.3	114.1
Interest rates (percent; end period)						
Seven-day reverse repo	5.5	5.4	5.5	5.5	4.8	4.8
Three-month T-bill	4.9	5.0	5.2	5.5	5.0	4.9
Government bonds (10-year)	7.1	7.2	7.3	6.0	5.6	6.0
Balance of payments (percent of GDP)						
Trade balance	-22.3	-22.9	-19.7	-16.8	-15.7	-17.4
Goods and services balance	-13.2	-13.4	-7.9	-6.0	-5.4	-10.8
Current account balance	-11.2	-12.2	-5.9	-6.2	-3.4	-14.5
Official reserves (end period) (in millions of U.S. dollars)	1,444	1,414	1,381	1,696	1,794	1,471
(in months of imports of goods and services)	5.1	5.1	5.5	6.2	6.5	4.4
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	95.9	95.9
Real effective exchange rate (1990=100)	93.0	91.8	94.2	95.9	96.7	97.1
Current rate (June 8, 2001)	US\$ 2.144 per Maltese lira					
Memorandum items						
Nominal GDP (in millions of Maltese liri)	1,146	1,201	1,288	1,362	1,455	1,556

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

1/ Estimates provided by the Maltese authorities.

Table 2. Malta: Summary Balance of Payments, 1995-2000

	1995	1996	1997	1998	1999	<u>Prel.</u> 2000
(In millions of Maltese liri)						
Trade balance	-255.3	-275.2	-253.5	-229.5	-228.7	-270.6
Exports, f.o.b.	687.9	639.1	642.0	708.4	805.0	1,088.3
Imports, f.o.b.	943.1	914.3	895.5	937.8	1,033.7	1,358.9
Balance on services	104.2	113.6	152.2	148.1	149.5	102.9
Exports	369.2	385.7	430.2	458.4	487.7	485.3
Of which: Tourism 1/	324.6	321.8	356.9	377.0	404.2	404.0
Imports	264.9	272.1	278.0	310.3	338.2	382.4
Investment income, net	14.0	4.3	3.4	-25.4	12.9	-65.2
Unrequited transfers, net	9.1	11.1	21.4	22.3	17.0	6.7
Private	9.9	11.5	19.7	21.3	20.5	6.4
Public	-0.8	-0.4	1.7	1.0	-3.5	0.3
Current account balance	-127.9	-146.2	-76.6	-84.5	-49.3	-226.2
Capital account, net	4.5	21.1	3.2	11.1	13.2	8.3
Financial account, net	8.6	74.3	40.3	111.9	161.3	72.5
Direct investment	44.8	97.4	24.8	97.9	310.1	266.7
Portfolio investment	-162.1	-42.1	42.4	-32.2	-201.3	-250.8
Other	125.9	19.0	-26.9	46.2	52.5	56.6
Errors and omissions	3.8	20.2	35.7	35.0	-28.9	47.8
Overall balance 2/	-111.0	-30.6	2.7	73.6	96.3	-97.6
(In percent of GDP)						
Current account balance	-11.2	-12.2	-5.9	-6.2	-3.4	-14.5
Merchandise	-22.3	-22.9	-19.7	-16.8	-15.7	-17.4
Services	9.1	9.5	11.8	10.9	10.3	6.6
Investment income	1.2	0.4	0.3	-1.9	0.9	-4.2
Transfers	0.8	0.9	1.7	1.6	1.2	0.4
Memorandum items						
Official reserves (in percent of GDP) 3/	50.7	46.1	43.6	47.0	50.9	41.4
(in millions of Maltese liri)	580.7	554.1	561.7	640.0	740.3	644.2
(in millions of U.S. dollars)	1,647.9	1,540.8	1,432.2	1,695.7	1,793.8	1,471.5
(in months of imports of goods and services)	5.9	5.7	5.8	6.2	6.6	4.5

Source: Data provided by the Maltese authorities.

1/ Includes transportation.

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.

3/ 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, 1995-2001 1/ 2/

	1995	1996	1997	1998	1999	Budget 2000	Outturn 2000	Budget 2001
(In millions of Maltese liri)								
Total revenue	463.8	468.0	513.6	507.4	562.4	604.6	617.7	675.6
Tax revenue	380.5	381.8	434.5	426.2	481.0	528.4	541.2	599.7
Direct taxes 3/	215.2	219.5	252.4	246.5	272.9	300.0	311.5	345.5
Indirect taxes	165.3	162.3	182.1	179.7	208.1	228.3	229.7	254.2
Nontax revenue 4/	83.3	86.2	79.0	81.2	81.4	76.2	76.5	75.8
Total expenditure and net lending (incl. TCF)	525.2	567.7	654.6	655.7	688.2	703.8	725.1	...
Total expenditure and net lending	508.0	571.5	632.5	648.1	675.1	703.8	701.7	753.6
Current expenditure	469.9	522.5	556.9	586.8	601.7	633.0	632.8	684.8
Capital expenditure	35.0	42.9	47.8	53.4	60.7	60.6	59.4	60.7
Net lending (Consolidated Fund)	3.1	6.1	27.8	7.8	12.7	10.2	9.4	8.1
Repayment	9.0	0.3	0.3	5.7	0.0	0.0	0.0	0.0
Loans	12.1	6.4	28.1	13.5	12.7	10.2	9.4	8.1
Advances (Treasury Clearance Fund) 5/	17.2	-3.8	22.1	7.6	13.0	...	23.4	...
Balance (Consolidated Fund and TCF)	-61.4	-99.7	-141.1	-148.3	-125.8	-99.2	-107.5	...
Balance (Consolidated Fund)	-44.2	-103.5	-119.0	-140.7	-112.7	-99.2	-84.0	-78.0
Financing	61.4	99.7	141.1	148.3	125.8	99.2	107.5	78.0
Domestic loans, net	18.5	68.9	166.1	104.5	84.0	...	0.0	...
Disbursements	32.5	70.0	167.3	110.0	84.0	0.0	0.0	100.0
Repayments	14.0	1.1	1.2	5.5	0.0	...	0.0	...
Foreign loans, net	-4.0	-1.7	-2.3	-4.0	0.0	...	0.0	...
Disbursements	0.7	3.2	3.3	0.0	0.0	3.0	0.0	2.7
Repayments	4.7	4.9	5.6	4.0	0.0	...	0.0	...
Asset sales	14.6	0.0	0.1	35.4	73.3	62.0	12.0	40.0
Change in cash balances	32.3	32.4	-22.9	12.5	-31.5	...	95.5	-64.7
(In percent of GDP)								
Total revenue	40.5	39.0	39.9	37.2	38.7	39.1	39.7	40.7
Tax revenue	33.2	31.8	33.7	31.3	33.1	34.2	34.8	36.1
Direct taxes 3/	18.8	18.3	19.6	18.1	18.8	19.4	20.0	20.8
Indirect taxes	14.4	13.5	14.1	13.2	14.3	14.8	14.8	15.3
Nontax revenue 4/	7.3	7.2	6.1	6.0	5.6	4.9	4.9	4.6
Total expenditure and net lending (incl. TCF)	45.8	47.3	50.8	48.1	47.3	45.5	46.6	...
Total expenditure and net lending	44.3	47.6	49.1	47.6	46.4	45.5	45.1	45.4
Current expenditure	41.0	43.5	43.2	43.1	41.4	40.9	40.7	41.3
Capital expenditure	3.1	3.6	3.7	3.9	4.2	3.9	3.8	3.7
Net lending	0.3	0.5	2.2	0.6	0.9	0.7	0.6	0.5
Repayment	0.8	0.0	0.0	0.4	0.0	0.0	0.0	0.0
Loans	1.1	0.5	2.2	1.0	0.9	0.7	0.6	0.5
Advances (Treasury Clearance Fund) 5/	1.5	-0.3	1.7	0.6	0.9	...	1.5	...
Balance	-5.4	-8.3	-11.0	-10.9	-8.6	-6.4	-6.9	...
Balance (Consolidated Fund)	-3.9	-8.6	-9.2	-10.3	-7.7	-6.4	-5.4	-4.7
Financing	5.4	8.3	11.0	10.9	8.6	6.4	6.9	4.7
Domestic loans	1.6	5.7	12.9	7.7	5.8	...	0.0	...
Disbursements	2.8	5.8	13.0	8.1	5.8	0.0	0.0	6.0
Repayments	1.2	0.1	0.1	0.4	0.0	...	0.0	...
Foreign loans, net	-0.4	-0.1	-0.2	...	...	...	...	...
Disbursements	0.1	0.3	0.3	0.0	0.0	0.2	0.0	0.2
Repayments	0.4	0.4	0.4	...	...	...	...	...
Asset sales	1.3	0.0	0.0	2.6	5.0	4.0	0.8	2.4
Change in cash balances	2.8	2.7	-1.8	...	-2.2	...	6.1	-3.9
Memorandum items								
GDP (authorities' projection)	1,145.5	1,201.3	1,288.2	1,362.3	1,455.0	1,546.0	1,556.1	1,660.0
Balance (authorities' presentation) 2/	-5.0	-10.4	-10.0	-11.0	-8.5	-7.1	-6.1	-5.3
Balance (medium-term projections) 6/	...	...	...	...	-9.3	-7.7	-7.7	-7.0
Balance (authorities' presentation incl. TCF) 7/	-6.5	-10.1	-11.7	-11.6	-9.4	...	-7.6	...
Foreign grants	4.5	20.8	9.8	10.0	9.7	10.0	9.5	9.1
Repayment of government loans	9.0	0.3	0.3	0.3	0.0	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/ The authorities classify foreign grants and repayments of government loans as financing items; in the staff presentation, these items are placed above the line.

In 2001 budget net EU financing amounting to Lm 4.2 million is deducted from the total expenditure in authorities' presentation. Staff transferred this item to foreign grants.

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

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

5/ The Treasury Clearance Fund is an extrabudgetary fund and no budget is approved for it. The budget 2001 column presents the authorities' estimate for advances from the TCF.

6/ Projections by the authorities published in Consolidated Account Structure - Trends & Projections 1985-2004.

7/ Including the advances from the Treasury Clearance Fund.

Table 4. Malta: Budgetary Expenditure, 1995-2001

	1995	1996	1997	1998	1999	Budget 2000	Outturn 2000	Budget 2001
(In millions of Maltese liri)								
Total expenditure and net lending (incl. TCF)	487.4	525.2	654.6	655.7	689.3	703.8	726.3	...
Total expenditure	467.1	522.9	604.7	640.2	663.6	693.6	693.4	745.5
Current expenditure	469.9	522.5	556.9	586.8	601.7	633.0	632.8	684.8
Personnel expenditure 1/	145.3	157.4	157.9	163.6	163.8	172.9	170.8	195.8
Social services 2/	215.9	243.5	259.9	269.7	283.5	305.5	298.4	330.3
Subsidies/subventions 3/	53.1	61.8	62.4	68.6	61.6	57.2	58.5	60.5
Of which: Shipbuilding and repair	7.0	4.9	5.7	5.0	14.4	5.0	5.6	5.0
MIMCOL(Kalaxlokk) 6/	...	...	...	...	6.0	...	...	...
WSC	11.8	14.6	14.6	18.5	11.9	9.9	9.9	9.9
Interest payments	18.8	22.6	32.2	40.5	50.1	52.7	54.4	53.9
Other 4/	36.7	37.1	44.4	44.4	42.7	44.7	50.7	44.3
Capital development expenditure	35.0	42.9	47.8	53.4	60.7	60.6	60.6	60.7
Net lending (Consolidated Fund)	3.1	6.1	27.8	7.8	12.7	10.2	9.4	8.1
Shipbuilding and repair	12.1	6.4	3.5	8.0	6.4	4.4	5.1	3.5
Malta drydocks	0.0	0.0	24.6	0.0	0.0	0.0	0.0	0.0
Gozo ferries	0.0	0.0	0.0	5.5	6.3	5.8	4.3	4.6
Advances (Treasury Clearance Fund)	17.2	-3.8	22.1	7.6	13.0	...	23.4	...
Malta Shipbuilding	...	...	1.8	0.0	0.0	...	0.0	...
MDD	...	...	7.0	9.4	8.0	...	11.0	...
WSC	...	...	3.5	0.0	0.0	...	0.0	...
Malta Freeport	...	...	0.0	0.0	7.3	...	12.0	...
Other	...	...	0.0	0.0	-2.2	...	0.4	...
(In percent of GDP)								
Total expenditure and net lending	42.5	43.7	50.8	48.1	47.4	45.5	46.7	...
Total expenditure	40.8	43.5	46.9	47.0	45.6	44.9	44.6	44.9
Current expenditure	41.0	43.5	43.2	43.1	41.4	40.9	40.7	41.3
Personnel expenditure 1/	12.7	13.1	12.3	12.0	11.3	11.2	11.0	11.8
Social services 2/	18.9	20.3	20.2	19.8	19.5	19.8	19.2	19.9
Subsidies/subventions 3/	4.6	5.1	4.8	5.0	4.2	3.7	3.8	3.6
Of which: Shipbuilding and repair	0.6	0.4	0.4	0.4	1.0	0.3	0.4	0.3
MIMCOL(Kalaxlokk) 5/	...	...	...	...	0.4	...	...	...
WSC	1.0	1.2	1.1	1.4	0.8	0.6	0.6	0.6
Interest payments	1.6	1.9	2.5	3.0	3.4	3.4	3.5	3.2
Other 4/	3.2	3.1	3.4	3.3	2.9	2.9	3.3	2.7
Capital development expenditure	3.1	3.6	3.7	3.9	4.2	3.9	3.9	3.7
Net lending	0.3	0.5	2.2	0.6	0.9	0.7	0.6	0.5
Shipbuilding and repair	1.1	0.5	0.3	0.6	0.4	0.3	0.3	0.2
Malta drydocks	0.0	0.0	1.9	0.0	0.0	0.0	0.0	0.0
Gozo ferries	0.0	0.0	0.0	0.4	0.4	0.4	0.3	0.3
Advances (Treasury Clearance Fund)	...	...	1.7	0.6	0.9	...	1.5	...
Malta shipbuilding	...	...	0.1	0.0	0.0	...	0.0	...
MDD	...	...	0.5	0.7	0.5	...	0.7	...
WSC	...	...	0.3	0.0	0.0	...	0.0	...
Malta Freeport	...	...	0.0	0.0	0.5	...	0.8	...
Other	...	...	0.0	0.0	-0.2	...	0.0	...
Memorandum item	...	...	...	...	...	...	...	...
Defense spending	0.9	1.0	0.9	0.8	0.8	0.8	0.7	0.7
GDP at current market prices (in millions of Lm) 6/	1,145.52	1,201.29	1,288.22	1,362.32	1,455.00	1,546.00	1,556.06	1,660.00

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

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

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

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

4/ General operational and maintenance expenditures of government organizations.

5/ Severance for workers in Kalaxlokk who took early retirement.

6/ Based on the Finance Ministry's estimate for 2000 and projection for 2001 GDP.

Table 5. Malta: Current Budgetary Revenue, 1995-2001

	1995	1996	1997	1998	1999	Budget 2000	Outturn 2000	Budget 2001
(In millions of Maltese liri)								
Total revenue	463.8	468.0	513.6	507.4	562.4	604.6	617.7	675.6
Tax receipts	380.5	381.8	434.5	426.2	481.0	528.4	541.2	599.7
Direct taxes	215.2	219.5	252.4	246.5	272.9	300.0	311.5	345.5
Income taxes 1/	99.8	93.3	110.3	110.6	128.3	137.0	149.5	163.2
Individual	63.6	61.4	66.7	67.4	74.8	...	85.8	94.5
Corporations	36.2	31.9	43.5	43.2	53.5	...	63.7	68.7
Social security contributions 1/ 2/	115.5	126.2	142.2	135.7	144.3	162.8	162.0	182.1
Death and donation duties	0.0	0.0	0.0	0.3	0.3	0.2	0.0	0.2
Indirect taxes	165.3	162.3	182.1	179.7	208.1	228.3	229.7	254.2
Customs and excise taxes	32.6	32.0	43.2	52.7	55.4	60.2	55.1	62.1
VAT/CET	78.1	78.6	84.6	66.6	85.0	100.0	104.1	116.0
Licenses, taxes, and levies	54.6	51.7	54.3	60.4	67.7	68.1	70.4	76.1
Nontax receipts	83.3	86.2	79.0	81.2	81.4	76.2	76.5	75.8
Foreign grants	4.5	20.8	9.8	10.0	9.7	10.0	9.5	9.1
Fees & reimbursements	10.1	10.0	10.6	10.6	11.1	12.2	11.9	11.8
Rents, dividends, interest	23.1	17.6	17.8	17.9	15.9	15.2	16.2	15.7
Central bank profits	24.5	23.1	22.2	24.1	30.2	27.0	27.1	27.0
Lotteries	6.5	6.8	6.5	6.9	7.3	7.7	6.4	7.7
Civil aviation and posts 2/	8.2	5.9	6.7	4.6	2.1	0.0	0.0	0.0
Miscellaneous 3/	6.4	2.0	5.5	7.0	5.0	4.1	5.2	4.6
(In percent of GDP)								
Total revenue	40.5	39.0	39.9	37.2	38.7	39.1	39.7	40.7
Tax receipts	33.2	31.8	33.7	31.3	33.1	34.2	34.8	36.1
Direct taxes	18.8	18.3	19.6	18.1	18.8	19.4	20.0	20.8
Income taxes 1/	8.7	7.8	8.6	8.1	8.8	8.9	9.6	9.8
Individual	5.6	5.1	5.2	4.9	5.1	...	5.5	...
Corporations	3.2	2.7	3.4	3.2	3.7	...	4.1	...
Social security contributions 1/	10.1	10.5	11.0	10.0	9.9	10.5	10.4	11.0
Death and donation duties	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Indirect taxes	14.4	13.5	14.1	13.2	14.3	14.8	14.8	15.3
Customs and excise taxes	2.8	2.7	3.4	3.9	3.8	3.9	3.5	3.7
VAT/CET	6.8	6.5	6.6	4.9	5.8	6.5	6.7	7.0
Licenses, taxes, and levies	4.8	4.3	4.2	4.4	4.7	4.4	4.5	4.6
Nontax receipts 2/	7.3	7.2	6.1	6.0	5.6	4.9	4.9	4.6
Foreign grants	0.4	1.7	0.8	0.7	0.7	0.6	0.6	0.5
Fees & reimbursements	0.9	0.8	0.8	0.8	0.8	0.8	0.8	0.7
Rents, dividends, interest	2.0	1.5	1.4	1.3	1.1	1.0	1.0	0.9
Central Bank profits	2.1	1.9	1.7	1.8	2.1	1.7	1.7	1.6
Lotteries	0.6	0.6	0.5	0.5	0.5	0.5	0.4	0.5
Civil aviation and posts 2/	0.7	0.5	0.5	0.3	0.1	0.0	0.0	0.0
Miscellaneous 3/	0.6	0.2	0.4	0.5	0.3	0.3	0.3	0.3
GDP 4/	1,145.5	1,201.3	1,288.2	1,362.3	1,455.0	1,546.0	1,556.1	1,660.0

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

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

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

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

4/ Based on the Finance Ministry's estimate for 2000 and projection for 2001.

Table 6. Malta: Monetary Developments, 1995-2000

	1995	1996	1997	1998	1999	2000
(In millions of Maltese liri; end of period)						
Central Bank balance sheet						
Base money	447.5	463.8	486.7	528.2	543.3	564.5
Net foreign assets	508.7	508.6	541.6	640.0	740.3	644.1
Net credit to general government	47.5	51.5	34.7	-23.9	-90.0	-47.0
Other items, net	-108.7	-96.3	-89.5	-87.9	-107.0	-32.7
Financial survey						
M3	1,692.0	1,868.3	2,047.0	2,219.9	2,441.8	2,538.9
Net foreign assets	812.9	754.1	735.2	864.1	948.3	974.8
Domestic credit	1,224.8	1,429.6	1,644.7	1,809.5	1,991.0	2,184.2
Net credit to general government	179.9	239.1	321.5	356.0	358.1	405.7
Credit to the parastatal sector	234.0	249.5	257.3	243.3	265.1	251.6
Credit to the private sector	810.9	941.0	1,065.9	1,210.2	1,367.8	1,526.9
Other items, net	-345.8	-315.4	-332.9	-453.7	-497.4	-620.2
(Annual percentage change)						
Base money	-0.9	3.6	4.9	8.5	2.8	3.9
M3	7.8	10.4	9.6	8.4	10.0	4.0
Domestic credit	26.6	16.7	15.0	10.0	10.0	9.7
Net credit to general government	19.4	32.9	34.5	10.7	0.6	13.3
Credit to the parastatal sector	26.3	6.6	3.1	-5.4	9.0	-5.1
Credit to the private sector	28.4	16.0	13.3	13.5	13.0	11.6
(In millions of U.S. dollars)						
Net foreign assets	2,306.9	2,096.9	1,874.6	2,289.6	2,297.6	2,226.8
Central Bank	1,443.5	1,414.3	1,380.9	1,695.7	1,793.8	1,471.5
Other	863.3	682.7	493.7	593.9	503.8	755.3
(in percent)						
Interest rates						
Seven-day reverse repo	5.5	5.4	5.5	5.5	4.8	4.8
Three-month T-bill	4.9	5.0	5.2	5.5	5.0	4.9
Average lending rate (weighted)	7.5	7.9	8.0	8.1	7.3	7.2
Memorandum items (end of period)						
Exchange rate (US\$/Lm)	2.84	2.78	2.55	2.65	2.42	2.28
CPI inflation	3.6	1.9	4.3	1.3	3.3	1.1
M3 multiplier	3.8	4.0	4.2	4.2	4.5	4.5
Velocity	0.7	0.6	0.6	0.6	0.6	0.6
NFA/Base money	129.8	119.5	115.4	118.5	136.3	114.1

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

Table 7. Malta: Staff's Medium-Term Macroeconomic Outlook, 1999-2004

	Est.	Proj. 1/				
	1999	2000	2001	2002	2003	2004
(Percentage change)						
Output and prices						
Real GDP	4.0	4.7	4.3	4.5	4.5	4.5
Domestic demand	5.3	9.9	1.3	5.1	4.7	4.2
Private consumption	6.1	6.1	5.5	5.5	5.3	5.3
Public consumption	-0.6	5.0	1.0	1.0	1.0	1.0
Fixed investment	4.0	17.0	-11.0	7.0	7.0	5.0
Exports of goods and services	8.2	6.1	5.4	5.3	5.5	5.6
Imports of goods and services	10.1	10.6	1.6	6.3	5.9	5.4
GDP deflator	2.7	2.2	3.6	2.1	2.1	2.0
CPI	2.1	2.4	1.8	2.0	2.0	2.0
Total employment (per. avg.)	0.7	1.8	0.6	1.1	1.1	1.0
Unemployment rate (percent, per. avg.)	5.3	4.8	5.2	5.1	5.0	5.0
(In percent of GDP)						
Investment and savings						
Investment	23.9	27.3	22.4	22.3	22.6	22.5
Fixed investment	23.4	26.3	21.8	22.3	22.8	22.9
Private	18.7	22.4	17.8	17.7	18.0	17.8
Public	5.2	4.9	4.7	4.7	4.7	4.7
Inventory change	0.6	1.0	0.7	0.1	-0.1	-0.4
Savings	23.1	20.8	24.4	25.1	25.6	25.6
Private	26.7	23.3	26.6	26.1	25.6	24.7
Public	-3.6	-2.5	-2.2	-0.9	0.0	0.9
Fiscal accounts						
Budget deficit	8.6	6.9	6.3	5.0	4.0	3.0
Revenues 2/	38.7	39.7	40.6	40.5	40.5	40.4
Expenditures 3/	47.3	46.6	46.9	45.5	44.5	43.4
Primary balance	-5.2	-3.4	-3.1	-1.7	-0.7	0.3
Privatization receipts 4/	5.0	0.8	2.4	2.2	2.1	1.5
Government debt	57.7	60.1	59.6	58.6	56.9	54.9
Govt. debt excl. privatization receipts	62.8	60.9	62.0	60.8	58.9	56.3
External accounts						
Current account balance	-3.4	-14.5	-5.6	-5.0	-4.9	-4.6
Goods and services (net)	-5.4	-10.8	-5.1	-4.9	-5.0	-4.7
Official reserves	50.9	41.4	42.9	43.2	44.8	46.5
(in months of imports of GNFS)	6.5	4.4	5.0	5.0	5.2	5.4
Gross external debt	30.5	34.3	34.0	33.9	33.7	33.5
Memorandum item						
GDP at current prices (in millions of Lm)	1,455.0	1,556.1	1,680.8	1,793.0	1,912.7	2,038.3

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

1/ Staff's projection.

2/ Excluding privatization receipts.

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

4/ The authorities' projection for 2001 and staff projections for 2002-04.

Table 8. Malta: Indicators of External and Banking Sector Vulnerability, 1995-2001
(In percent of GDP, unless otherwise indicated)

	1995	1996	1997	1998	1999	Latest Data		Date
						2000	2001	
Financial indicators								
Government debt	28.2	31.8	37.9	45.6	49.1	58.7	...	November 00
Broad money (percent change, 12-month basis)	7.8	10.4	9.6	8.4	10.0	4.0	7.5	April 01
Private sector credit (percent change, 12-month basis)	28.4	16.0	13.3	13.5	13.0	11.6	9.8	April 01
Three-month T-bill yield	4.9	5.0	5.2	5.5	5.0	4.9	5.0	May 01
Three-month T-bill yield (deflated by 12-month CPI, e.o.p.)	0.9	3.0	2.1	3.0	2.8	2.5	2.5	March 01
External Indicators								
Exports of goods and nonfactor services (percent change, average in US\$)	14.7	-5.7	-2.6	9.2	6.9	9.7	...	December 00
Imports of goods and nonfactor services (percent change, average in US\$)	17.8	-4.2	-7.5	6.2	6.6	15.8	...	December 00
Current account surplus	-11.2	-12.2	-5.9	-6.2	-3.4	-14.5	...	December 00
Capital and financial account balance	1.9	14.1	6.5	17.2	23.1	9.9	...	December 00
Of which: Inward portfolio investment (debt securities, etc.)	-14.1	-3.5	3.3	-2.4	-13.8	-16.1	...	December 00
Other investment (loans, trade credits, etc.)	11.0	1.6	-2.1	3.4	3.6	3.6	...	December 00
Inward foreign direct investment	4.1	8.3	2.4	7.6	22.5	18.0	...	December 00
Gross official reserves (in millions of US\$; e.o.p.)	1,647.9	1,540.8	1,432.2	1,695.7	1,793.8	1,471.5	1,376.7	April 01
Official reserves in months of imports GNFS	5.9	5.7	5.8	6.4	6.4	4.5	...	December 00
Ratio of foreign reserves to base money (in percent)	129.8	119.5	115.4	121.2	136.3	114.1	111.4	April 01
Ratio of foreign reserves to broad money (in percent)	97.4	82.5	70.0	76.4	73.5	58.0	51.9	April 01
Total gross external debt/GDP (in percent)	...	0.0	31.0	30.8	30.5	34.3	...	December 00
Total gross external debt to exports GNFS (in percent)	...	0.0	38.3	36.5	35.2	35.2	...	December 00
Exchange rate (per US\$, period average)	2.83	2.77	2.59	2.58	2.50	2.29	2.19	May 01
REER appreciation (+) (e.o.p. basis)	2.1	-1.2	2.6	1.8	0.9	1.6	-0.4	March 01

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

Malta: Fund Relations

(As of June 27, 2001)

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

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

III.	SDR Department:	SDR Million	% Allocation
	Net cumulative allocation	11.29	100.0
	Holdings	25.57	226.5

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

V. **Financial Arrangements:** None

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

VII. **Exchange Rate Arrangement:**

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

VIII. **Article IV Consultation:**

The last Article IV consultation was concluded by the Executive Board on June 18, 1999 (SUR/99/67).

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

MAE missions have addressed monetary operations and liquidity forecasting (February 1999), bank supervision and reporting (December 1996), and open market and forex operations (February 1995). The Central Bank of Malta 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: Statistical Issues

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

Real sector data

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

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

Fiscal data

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

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

Monetary data

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

External sector

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—on the COS web page; the most recent release covers the fourth quarter of 1998. The latest full set of balance of payments accounts is in the *National Accounts of the Maltese Islands* for 1996.

Malta: Core Statistical Indicators
(as on July 1, 2001)

	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	07/01/01	Mar. 2001	Apr. 2001	Dec. 2000	Apr. 2001	06/30/01	Apr. 2001	Mar. 2001	2001 Q1	Feb. 2001 2/	2000 Q4	2000
Date received	07/01/01	06/13/01	06/13/01	04/19/01	03/07/01	06/30/01	06/13/01	04/31/01	06/27/01	04/02/01	11/23/00	Jan.2001
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	COS, CBM	COS, CBM	COS	COS, CBM	COS, CBM	Ministry of Finance
Mode of reporting	Internet (CBM)	Electronic copy (CBM)	Electronic copy (CBM)	Internet (CBM)	Internet (CBM)	Internet (CBM)	Internet (COS)	Internet (COS)	Electronic copy (COS)	Internet (COS), Press, Fax (CBM)	Internet (COS)	Publication
Confidentiality	No	No	No	No	No	No	No	No	No	No	No	No
Frequency of publication	Daily	Monthly	Monthly	Monthly	Monthly	Weekly	Monthly	Monthly	Quarterly	Irregular	Quarterly/ Irregular	Annual

1/ Public external debt.

2/ Estimated budget outturn for 2000 was released on 11/20/00.



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IMF Concludes 2001 Article IV Consultation with Malta

On July 30, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Malta.¹

Background

Strong external demand boosted economic activity in 1999 and 2000 in combination with fiscal consolidation and structural reforms underpinned a strengthening of overall economic performance. Real GDP growth in 1999 and 2000 was robust, estimated at 4.0 and 4.7 percent respectively, driven by strong fixed investment and exports, and reflecting, inter alia, the expansion of activities of a large microchip plant. Private consumption also remained strong, on the back of declining savings.

Economic growth has been accompanied by rising employment. Private sector employment rose 3 percent in 2000, rising in most sub-sectors, while nominal and real wage growth declined led by wage restraint in the public sector.

Inflation has remained subdued, as the lira basket strengthened vis-à-vis the weak euro during 2000 and because rising international oil prices were not passed on to domestic consumers. The 12-month retail price inflation declined to 1.1 percent by the end of 2000.

On the external side, despite strong export growth, a number of developments compounded domestic demand pressures on the current account deficit. Real exports of goods and services rose by 8 and 6 percent in 1999 and 2000, respectively, with machinery exports performing particularly strongly. But imports rose even more strongly, buoyed by strong domestic demand and a large investment program in the microelectronics sector. In conjunction with a deceleration in tourist receipts, rising international oil prices, and a large dividend payment, the current account deficit widened to 14.5 percent of GDP.

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 review by the Executive Board. At the conclusion of the review, a summary of the views of Executive Directors is transmitted to the country's authorities. The 2001 Article IV consultation with Malta was concluded on July 30, 2001. This PIN summarizes the assessment of the Executive Board.

Monetary policy was unchanged during 2000 as international rates rose, compounding downward pressures on international reserves. Capital outflows, notably from domestic commercial banks, reflected a negative yield differential for most of 2000, alongside stock adjustments following further measures to liberalize capital controls implemented in early 2000. As a result, international reserves declined to US\$1.47 billion at end-2000.

The fiscal position improved significantly in 1999 and 2000, reflecting the impact of economic recovery and better tax enforcement. The government deficit, including off-budget items, was 8.6 and 6.9 percent of GDP in 1999 and 2000, respectively, a cumulative improvement of 4 percentage points since 1988. The fiscal consolidation in 1999 and 2000 marked significant progress towards the authorities' medium-term plan to reduce the fiscal deficit to 3–4 percent of GDP by 2004.

Executive Board Assessment

Malta has consolidated its economic performance in the past two years, reflecting strengthened policy and a benign external environment. The long deceleration in economic growth has stopped, employment has risen strongly in 2000 taking unemployment down towards 4 percent, and inflation remains low, anchored by the fixed peg exchange rate regime. These achievements leave Malta well placed to pursue its application to join the European Union.

Strengthened fiscal and structural policies since 1998 have underpinned these achievements. The reduction in the fiscal deficit of 4 percentage points of GDP, even faster than anticipated in the authorities medium-term projections, has boosted domestic savings, thereby supporting fixed investment, the external current account balance and the fixed exchange rate peg. In addition, tax policy has been strengthened, most notably by the successful reintroduction of VAT in 1999 and its subsequent extensions. Alongside other structural initiatives—including a reduction in trade protection and capital account controls, strengthened policies towards public enterprises, privatization, and enhanced financial sector regulation—the authorities have signaled a clear commitment to strengthened medium-term economic performance that has already begun to yield dividends.

Challenges remain, however. Though the sharp deterioration in the external current account balance in 2000 largely reflected temporary factors, the underlying external deficit remains high and will be boosted by the weaker external environment in 2001 and by prospective additional fixed investment in manufacturing and tourism. Thus, the authorities rightly remain intent on further fiscal consolidation in 2001 and over the medium-term to make room for additional fixed investment while containing the external imbalance. But fiscal deficit reduction in the medium-term will likely need to be more ambitious than anticipated if the macroeconomic framework is to remain sustainable.

Such fiscal deficit reduction would best be achieved through expenditure reform rather than through further increases in the tax burden. Thus, the broad thrust of proposed expenditure initiatives—notably on welfare, privatization, subsidies to public enterprises, and the public wage bill—is welcome. But implementation is urgent if the fiscal deficit targets are to be secured alongside securing progress towards reducing the share of tax in GDP. And, with labor shortages emerging in the private sector, efforts to rationalize public sector employment and the associated flow of subsidies to public enterprises should be given added priority. The

beneficial impact of such steps could be maximized with increased fiscal transparency, in line with international codes, notably through the incorporation of off-budget flows into the main budget and into a formal restatement of the medium-term fiscal framework.

In the context of largely open capital accounts, monetary policy needs to acquire added flexibility so as to maintain strong international reserve levels even as foreign interest rates rise and fall. Given that competitiveness remains firm but with little room for maneuver, a flexible monetary policy stance will be key to maintaining confidence in the pegged exchange rate regime, achieving this effect in part by encouraging continued appropriate flexibility of nominal and real wage settlements. Proposals under consideration to strengthen the Central Bank of Malta Act would increase confidence that monetary policy will be conducted in this manner. And the effectiveness of such a policy stance will be enhanced by ongoing efforts to strengthen the performance and robustness of the financial sector, notably through privatization and continued strengthening of financial regulation.

The fixed exchange rate regime continues to serve Malta well. The durability of the peg, Malta's openness, the strength of the financial system, and the flexibility of private sector labor markets all indicate that the pegged regime remains appropriate. There may be a case, however, to review the weights of the currency basket.

Malta subscribes to the General Data Dissemination Standard and its statistics are generally of good quality. Surveillance would be enhanced, however, by shortening the lags with which some of the key data are produced.

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 2001 Article IV Consultation with Malta is also available.

Malta: Selected Economic Indicators, 1995-2000

	1995	1996	1997	1998	1999	Prov. 1/ 2000
Real economy (percentage change; constant prices)						
Real GDP	6.2	4.0	4.9	3.4	4.0	4.7
Private consumption	10.5	7.1	1.6	2.5	6.1	6.1
Public consumption	8.5	8.4	-1.1	-4.0	-0.6	5.0
Gross capital formation	13.1	-9.3	-2.8	-8.7	8.0	23.7
Exports of goods and services	5.4	-5.9	4.0	8.1	8.2	6.1
Imports of goods and services	10.0	-5.9	-1.7	2.5	10.1	10.6
Retail prices (period average)	4.0	2.0	3.1	2.4	2.1	2.4
Unemployment rate (percent of labor force)	3.5	3.7	4.6	4.9	5.3	4.8
Public finance (percent of GDP)						
Government budget deficit	-5.4	-8.3	-11.0	-10.9	-8.6	-6.9
Government debt	35.7	43.0	51.5	56.1	57.7	60.1
Money and credit (end period; percentage change)						
Broad money	7.8	10.4	9.6	8.4	10.0	4.0
Domestic credit	26.6	16.7	15.0	10.0	10.0	9.7
Net foreign assets of the central bank (in percent of the monetary base)	-15.9	-4.6	1.4	13.9	15.7	-13.0
	129.8	119.5	115.4	121.2	136.3	114.1
Interest rates (percent, end period)						
Three-month treasury bill	4.9	5.0	5.2	5.5	5.0	4.9
Government bonds (10-year)	7.1	7.2	7.3	6.0	5.6	6.0
Balance of payments (percent of GDP)						
Trade balance	-22.3	-22.9	-19.7	-16.8	-15.7	-17.4
Goods and services balance	-13.2	-13.4	-7.9	-6.0	-5.4	-10.8
Current account balance	-11.2	-12.2	-5.9	-6.2	-3.4	-14.5
Official reserves (end period) (in millions of U.S. dollars)	1,444	1,414	1,381	1,696	1,794	1,471
(in months of imports of goods and services)	5.1	5.1	5.5	6.2	6.5	4.4
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	95.9	95.9
Real effective exchange rate (1990=100)	93.0	91.8	94.2	95.9	96.7	97.1
Current rate (June 28, 2001)	US\$2.169 per Maltese lira					
Memorandum item						
Nominal GDP (in millions of Maltese liri)	1,146	1,201	1,288	1,362	1,455	1,556

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

1/ Estimates provided by the Maltese authorities.