



MALTA

2013 ARTICLE IV CONSULTATION

July 2013

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 2013 Article IV consultation with Malta, the following documents have been released and are included in this package:

- **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 13, 2013, 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 June 4, 2013. 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.
- **Informational Annex** prepared by the IMF.
- **Press Release** (PR) summarizing the views of the Executive Board as expressed during its June 19 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Malta.

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MALTA

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

June 4, 2013

KEY ISSUES

Context: Malta has maintained macroeconomic stability in the face of a major crisis in Europe. Low reliance on external finance by the government and domestic banks, solid fundamentals, and a sound banking system have contributed to this resilience. However, recent events in Europe have heightened financial stability risks. In the longer term, Malta's attractiveness as a financial and business location could be adversely affected by regulatory and tax reforms at the European level.

Financial sector policies: Risks from the large international bank segment appear contained given limited balance sheet exposure to the Maltese economy, though continued vigilance is warranted. Regulatory changes to increase loan loss provisions and the funding of the deposit compensation scheme would help contain risks in the domestic banking sector.

Fiscal policy: The main challenges for fiscal policy are to reverse the deterioration of public finances and to strengthen the governance framework. Additional measures are needed to ensure that the fiscal deficit falls below 3 percent of GDP in 2013 and public debt remains on a sustainable path. Fiscal risks from the restructuring of public corporations bear close monitoring.

Structural policies: Pension and health care reforms remain a priority to ease long-term fiscal pressures. To expand competitiveness gains, policy efforts are needed to strengthen female labor force participation and education attainment, to ensure a better alignment of wage and productivity developments, and to improve the business climate. These reforms would help mitigate a potential erosion of competitiveness resulting from changes in the tax system.

Approved By
**Reza Moghadam and
 Peter Allum**

Discussions took place in Valletta from May 2-13, 2013. The staff team comprised Ms. Ruiz-Arranz (head), Ms. Niman, Ms. Osorio and Mr. Prokopenko (all EUR), and Mr. Lohmus (MCM). Ms. Ahmed assisted from headquarters. Messrs. Bassanetti and Montanino (OED) participated in the discussions.

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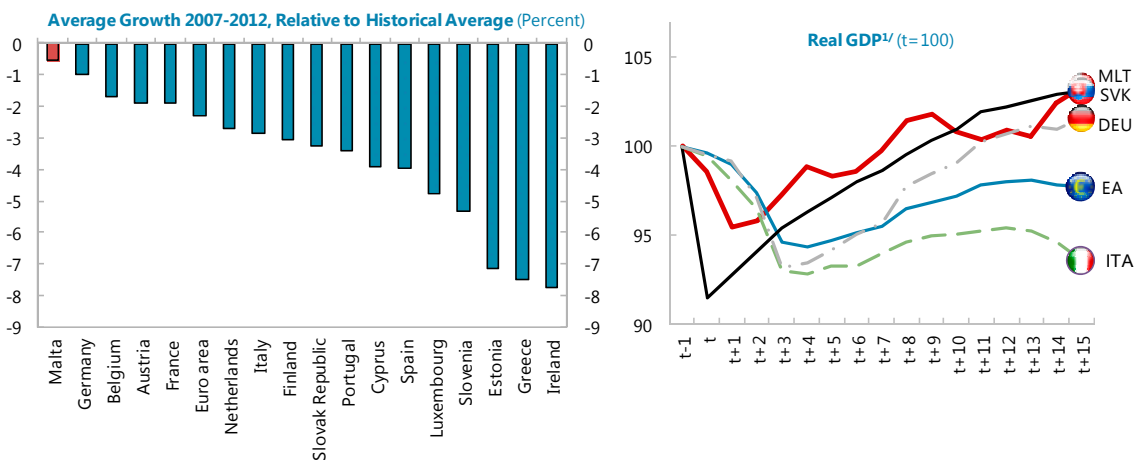
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CONTEXT

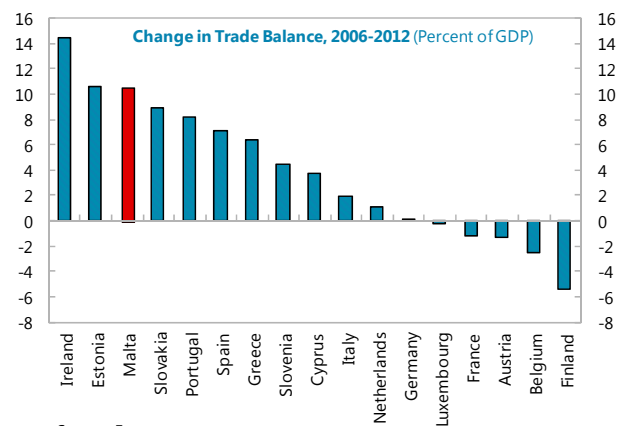
1. Compared with its euro area peers, Malta has shown remarkable macroeconomic resilience. Average growth of the Maltese economy (relative to historical average) has been the best in the euro area since the beginning of the crisis. Malta suffered lower output and employment losses than most advanced economies, and none of its financial institutions required solvency or liquidity assistance. As a result, real GDP is now 2½ percent above pre-crisis level (compared with 2¼ percent below for the euro area) and unemployment is close to historical lows (Appendix I). However, economic growth slowed in 2012 to about ¾ percent, from 1¾ percent in 2011, reflecting a weak external environment and subdued domestic demand. In addition, the fiscal deficit widened by ½ percent to 3.3 percent of GDP and government and guaranteed debt is uncomfortably high (90 percent of GDP), constraining the fiscal space in the event of further shocks.



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.
^{1/2}t denotes first quarter of recession.

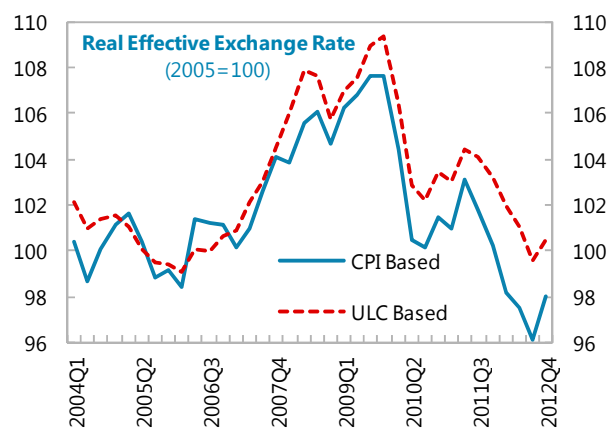
2. Robust exports have been the main source of growth, bringing the current account into surplus in 2012. The sizeable improvement

in the trade balance (10 percent of GDP since 2006) reflected successful export diversification and depreciation of the real effective exchange rate, which is broadly in line with fundamentals (Box 1). As a result, Malta's export market share in services increased rapidly, driven by strong growth in the traditional tourism sector and some new high value-added activities, including financial and business services, online gaming, and ICT. Indeed, Malta's track record of innovation and finding export-oriented opportunities has been remarkable (see Appendix II).



Box 1. Malta's Competitiveness Developments

Malta's price competitiveness measures have improved over the last few years. The CPI-based real effective exchange rate depreciated by 9.5 percent between 2009 and 2012, fully offsetting the appreciation that followed Malta's accession to the EU in 2004. The improvement of the real effective exchange rate based on unit labor cost has been smaller but also substantial. Owing to the relative size of Malta's trade with the United Kingdom, Asia, and the United States, the depreciation of the euro against the UK pound, US dollar, Singaporean dollar and yen between 2009 and 2012 has contributed to this improvement. In contrast, Malta has lost price competitiveness within the euro area given its higher rate of inflation and stronger labor cost growth.



Source: IMF, Information Notice System.

The estimates of exchange rate valuation are broadly in line with fundamentals.

The correction of the equilibrium real exchange rate has been almost 15 percent since the 2009 Article IV consultation. The macro balance and external sustainability approaches also show very small deviations from the equilibrium.

Estimates of Exchange Rate Valuation 1/
(Percent)

	Art IV 2009	Art IV 2012	Current
Macro Balance	2.0	-1.7	-1.2
Equilibrium RER	15.9	5.9	-0.5
External Sustainability	10.7	5.6	5.0

Sources: IMF article IV staff reports; and IMF staff estimates.

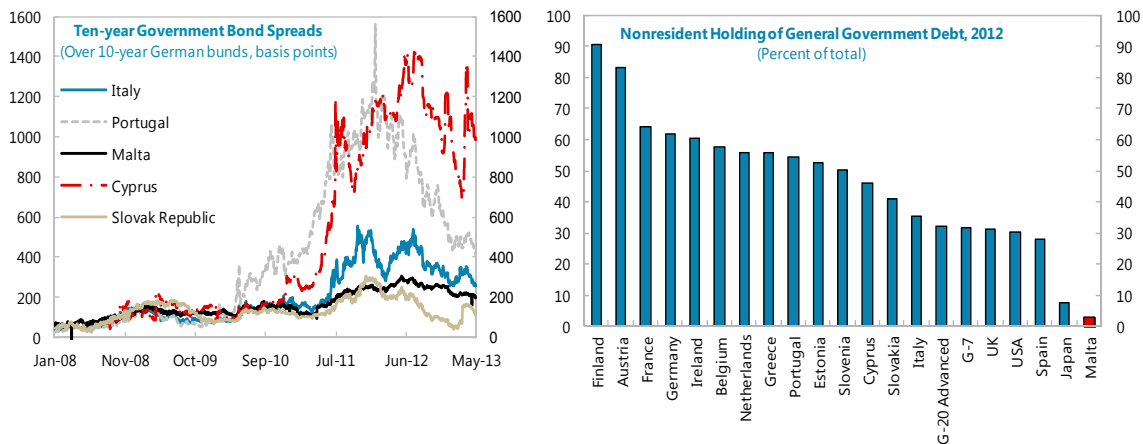
1/ +/- indicates exchange rate over/undervaluation; see IMF Occasional Paper No. 261 for details on the methodology underlying the estimates in this table.

3. Despite the slowdown in growth, inflation remained elevated in 2012. The HICP inflation inched up to 3.2 percent in 2012 from 2.5 percent in 2011. The main reason, however, was higher prices and some methodological changes related to tourist services, which are mainly oriented towards foreigners and therefore have little impact on domestic consumption. That being said, inflation moderated to 0.8 percent in May 2013.

4. Financial spillover from the euro area crisis has so far remained contained reflecting limited reliance on external finance by core domestic banks and the government.

- The core domestic banking sector is largely funded by resident deposits, while the large international banking segment has limited balance sheet exposures to the Maltese economy (Box 2). Unlike many other EU countries, Malta has not experienced any deleveraging pressures, deposits and credit to the private sector continued to grow in 2012, albeit at a slower pace than in 2010-11, and Maltese banks outperformed European peers in terms of profitability (Box 3). Since developments in Cyprus, the fluctuation of bank liabilities has remained within the historical average.

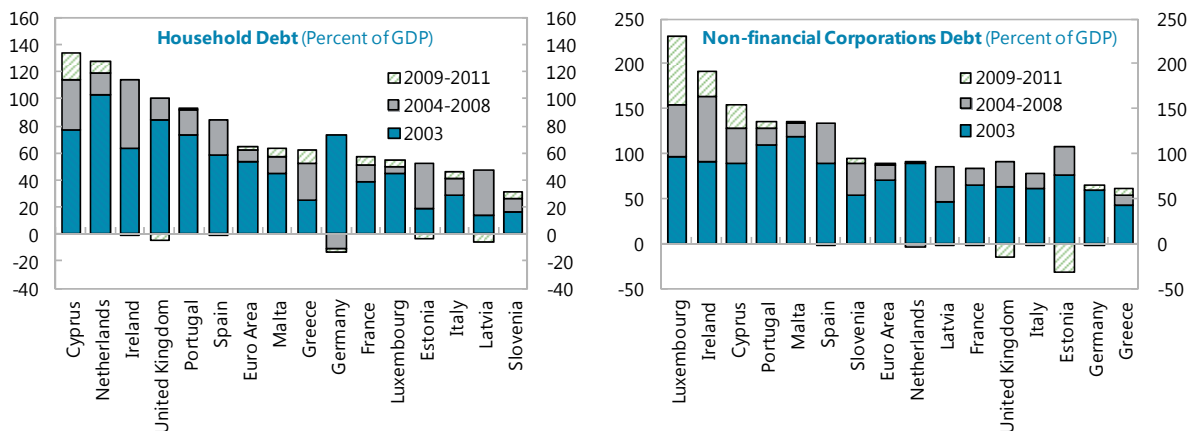
- The Maltese sovereign bond market weathered the storm in other euro area debt markets unscathed, with yields declining on strong domestic demand and manageable government financing needs. In contrast with other advanced economies, 96 percent of Maltese government debt is held by residents, limiting financial spillovers.



Sources: Datastream; Bloomberg; country authorities; and IMF staff calculations.

5. Balance sheet vulnerabilities of the non-financial private sector remain contained.

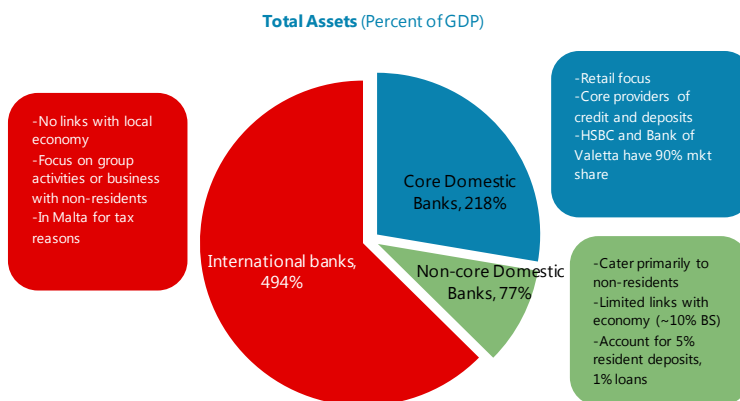
Household debt has increased rapidly since EU accession and reached 63 percent of GDP by end-2011 (latest data available), broadly catching up with the EU average. Despite this increase, households’ net financial assets remain positive, standing at 170 percent of GDP, which is among the highest in the euro area. The corporate debt stands at 140 percent of GDP in 2012, which is relatively high. However, this reflects to some extent the presence of foreign firms, resulting in a large share of intra-group loans matched by intra-group claims on the asset side. Furthermore, around half of this debt is in the form of long-term loans, and the corporate sector also has sizeable assets.



Source: Eurostat; and IMF staff calculations.

Box 2. Structure of the Banking Sector

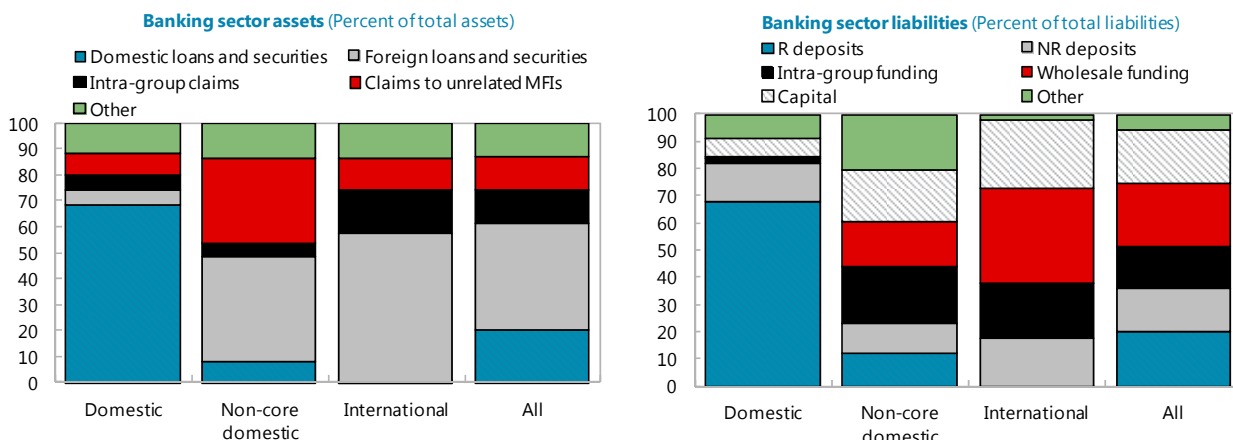
Malta has a large and sharply segmented banking sector. While total banking sector assets exceed 8 times GDP, the largest part of the sector has no balance sheet exposure to the Maltese economy and transactions are exclusively with non-residents. The Central Bank of Malta (CBM) classifies banks in three different categories according to the extent of their involvement in business with residents. Core domestic banks provide around 97 percent of bank lending to residents in Malta, and collect around 94 percent of resident deposits. At the other end of the spectrum, international banks have no balance sheet exposure to the Maltese economy.



Sources: Central Bank of Malta; and European Central Bank.

Banks’ disparate balance sheet structures imply different risk profiles.

- *Core domestic banks* have a traditional business model: they are largely funded by resident deposits and most of their assets represent claims on residents. This segment is dominated by two banks (HSBC and Bank of Valletta). Their main vulnerability is credit risk stemming from high exposure to the property market and collateral in the form of real estate.
- *International banks* rely mostly on equity, wholesale (including intra-group) funding and non-resident corporate deposits of relatively long maturities. These banks lend these funds abroad and operate with a very small physical presence in Malta. Their main risk is liquidity risk. Two branches from Turkey have combined assets exceeding 300 percent of GDP. The largest subsidiaries are Deutsche Bank and Commbank Australia, with combined assets of about 100 percent of GDP.
- *Non-core domestic banks* have a more diverse asset and liability structure, and about 10 percent of their balance sheet is linked to the domestic economy in the form of resident deposits and domestic loans and securities. The main risks stem from potential claims on the deposit compensation scheme and from cross-border deleveraging pressures.



Source: Central Bank of Malta

Box 3. Performance of the Banking Sector

Despite turbulence in the euro area, the performance of Maltese banks has been relatively good.

- Banks are adequately capitalized, profitable, and liquid. The aggregate capital adequacy ratio of all bank peer groups is well above the required minimum. The return on assets and return on equity ratios have actually improved in 2012 underpinned by higher non-interest income. The liquid assets cover substantial part of short-term liabilities, and the reliance on Eurosystem funding is very low.
- The share of nonperforming loans (NPLs) has slightly increased in 2012, mainly due to subdued conditions in the construction and real estate sectors. Just under one third of all loans to the construction companies are classified as nonperforming.
- Banks continued to expand their balance sheets in 2012 albeit at a slower pace than in 2010-11. Resident customer deposits and nonresident customer deposits increased during 2012, while the amount of wholesale funding remained broadly unchanged. Loans to residents have also marginally increased, driven primarily by mortgage lending and (to a lesser extent) loans to the manufacturing sector operating across a range of activities. The exposure of Maltese banks to EU sovereign debt is very low and diversified.

Key Financial Soundness Indicators, Dec 2012

(Percent, unless otherwise indicated)

	Core Domestic Banks	Non-core Domestic Banks	International banks	Total banks
Total Assets 1/	218.2	77.0	493.7	788.8
Capital Adequacy Ratio	14.3	29.1	102.7	53.3
Return on Assets	1.6	1.4	1.3	1.4
Liquid assets to short-term liabilities	49.1	82.4	146.3	55.6
Liquid assets to total assets	28.8	14.4	9.9	19.7
Loan to Deposit Ratio	70.1	145.3	131.4	93.8
Non-performing Loans	8.1	4.1	0.5	3.7

Sources: Central Bank of Malta; and European Central Bank.

1/ Percent of GDP

OUTLOOK AND RISKS

A. Staff's Views

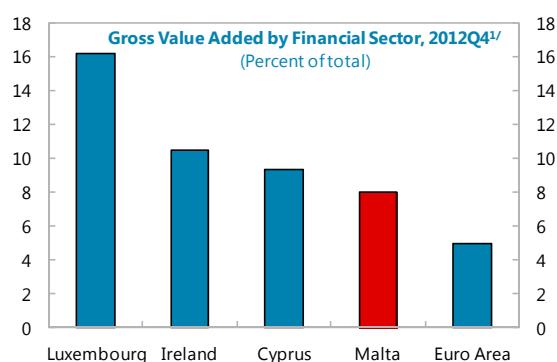
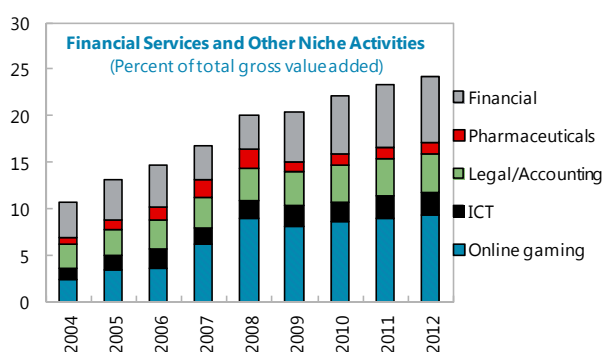
6. Despite good performance overall, GDP growth remains below potential and uncertainties abound. Domestic demand has remained lackluster, reflecting sluggish investment and private consumption and headwinds from a soft real estate market. Going forward, staff projects a moderate acceleration in real GDP growth in 2013-15, which means that Malta would continue to outperform the euro area average. The pick-up in activity to 1¼ percent in 2013 (from ¾ percent in 2012) is predicated on the recovery of private consumption and improved confidence, as policy uncertainty related to the electoral cycle decreases. While this would lead to some increase in imports, the current account balance is projected to remain slightly positive.

7. Short-term risks to this scenario are largely related to the external environment. A protracted period of slower growth in Europe or re-emergence of euro area financial stress if policy momentum is not sustained, would negatively affect the economy through the trade channel. In addition, close financial integration with the euro area entails a spillover risk via banking and financial markets channels (see Risk Assessment Matrix). However, relatively strong fundamentals in Malta, including a comfortable external position, very small reliance on external financing by the government, and relatively healthy balance sheets of households and nonfinancial corporates limit the vulnerability against these risks.

8. Recent events in Europe have heightened perceptions about risks of hosting a large banking sector in a small country. In the case of Malta these risks are contained because the large international banking segment (with assets about 5 times GDP) has limited balance sheet exposures to the Maltese economy and negligible contingent claims on the deposit compensation scheme. The sharp segmentation of the Maltese banking sector implies that the nature of potential threats to financial stability differs substantially across the various institutions.

- The main risk facing the core domestic banks is credit risk, particularly related to the significant concentration of loans to the real estate and construction sectors and loans backed by real estate as collateral. The real estate market risk is contained by the very high share of owner-occupied properties, prudent loan-to-value ratios, and fair market valuations. However, the real estate market is particularly sensitive to shifts in confidence linked to the external environment and it could act as a channel that amplifies the impact of external risks. Furthermore, the over-reliance on immovable collateral may pose risks if the property market were to slow significantly.
- A few non-core domestic and international banks could be exposed to liquidity risk. A change in perceptions of the risks facing creditors may lead to an increase in funding costs of these banks, particularly those which rely significantly on wholesale funding. However, given the insubstantial balance sheet links of these banks with residents, the effects on the economy are likely to be small in the near to medium term (see Appendix III).

9. In the longer term, regulatory and tax reform at the European and global level could adversely affect Malta's attractiveness as a financial and business location. The Maltese economy has greatly benefitted from a business-friendly tax regime (see Appendix III). Although these gains are hard to quantify, the large increase experienced in financial services and other niche activities since 2004 are likely related to Malta's accession to the EU, its macroeconomic stability, and relatively favorable tax regime. Over the last ten years, more than half of the growth in value added is explained by the growth in financial services, ancillary activities (legal, accounting, and consulting), remote gaming, and ICT. These sectors alone account for a quarter of total value added and 12 percent of employment. It is possible that greater fiscal integration of EU member states and a potential harmonization of tax rates could erode some of these benefits, with consequences on employment, output and fiscal revenues.



Source: Eurostat.
1/Ireland data is from 2012Q1, latest available.

The Authorities' Views

10. The authorities broadly agreed with the outlook. Official projections of GDP growth and inflation in 2013–16 are very similar to those of staff. The authorities concurred that the main risk to growth comes from abroad, given continuing weakness in the euro area. The authorities are concerned about possible reputational risks to Malta following events in Cyprus, but expressed confidence that the Maltese banking sector is robust and stable. They also noted that the banking sector in Malta differs substantially from that of banks in some other EU countries affected by the crisis. In particular, the authorities emphasized that the size of Malta's domestic banking system is below the euro area average. The rest of Malta's banking sector is made of non-core and international banks with limited or no links to the domestic market. The authorities were also of the view that an EU-wide tax harmonization would not happen in the short or medium term.

POLICY DISCUSSIONS

A. Maintaining Financial Sector Stability

Staff's Views

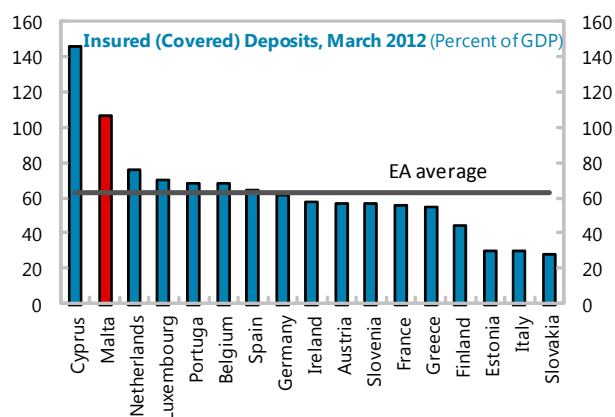
11. Malta has made progress in strengthening the oversight over its financial sector. To enhance monitoring of systemic risks a Joint Financial Stability Board (JFSB) was established by the Central Bank of Malta (CBM) and the Malta Financial Services Authority (MFSA) in January 2013. The JFSB was set up following the recommendations of the European Systemic Risk Board to EU member states and is having monthly meetings. In March 2013, following the intensification of the crisis in Cyprus, the authorities adequately strengthened supervision and introduced extraordinary monitoring of banks through daily reporting of liquidity. The authorities should continue monitoring closely developments in all banks, including links between foreign parent banks and their Maltese entities in the context of the existing colleges of supervisors. The authorities should also stand ready to take action if spillovers from abroad become imminent or the internationally-oriented banks increase their exposure to the domestic economy. In particular, the emerging trend by some small non-core banks of attracting resident deposits—often accompanied by aggressive interest rate policies—to finance assets outside of Malta, requires closer monitoring, though magnitudes are currently small.

12. Further efforts are still needed to shore up the resilience of Maltese banks and ensure financial stability. The ratio of provisions to nonperforming loans for core domestic banks has been hovering around 20 percent in recent years, which is the lowest among the EU countries. Despite ample availability of collateral, the authorities should tighten provisioning rules in order to increase the available buffers to cover loan losses. To this effect, the MFSA could issue guidelines, which would set common parameters for impairment triggers, forbearance measures, and homogeneous collateral valuation practices. In this context, the planned revisions to Banking Rule 09 should ensure that the incurred loan losses are recognized as early as possible, ensuring a more conservative approach to the measurement of provisions within the context of IFRS and providing a level playing field for provisioning in the banking sector. It would also be important to conduct a review of the judiciary procedures related to the foreclosure of the seized properties, which are currently very slow, impacting recovery values.

13. Work should also continue to strengthen crisis preparedness and management frameworks. The authorities could start strengthening the bank resolution framework in line with forthcoming reforms at the EU level. It might also be useful to conduct a crisis simulation exercise, given that the bank resolution framework in Malta is untested (there have been no bank failures in Malta in the past decade, and no bank required liquidity or solvency assistance since the beginning of the European financial crisis in 2008). Of particular importance is the need to boost the available resources of the Deposit Compensation Scheme (DCS). Recent amendments to the regulations to increase the size of the DCS to 1 percent of eligible deposits (from 0.77 percent) within the next 3 years are a step in the right direction. However, more needs to be

done in view of sizeable contingent liabilities (relative to the size of the economy) and a potential large increase in eligible deposits covered by the scheme—as foreseen in the EU draft directive on the harmonization of the deposit insurance among EU countries.

Maximum Recourse on the Deposit Compensation Scheme, as of March 2013 (Percent of GDP)	
	Covered Deposits
Core Domestic Banks	97.8
Non-core Domestic Banks	7.1
International Banks	0.5



Source: Central Bank of Malta; and European Central Bank.

14. Looking ahead, like other EU countries, Malta will have to implement EU-level initiatives relating to the bank regulatory and supervisory frameworks. These include:

- *Basel III and Capital Requirement Directive IV (CRD IV)*. Although the Maltese banks have strong capitalization, the higher capital adequacy requirements of CRD IV may pose difficulties for individual banks facing the need to form additional provisions to deal with higher nonperforming loans. Therefore, these banks should be encouraged to further enhance capital buffers through higher profit retention, in line with the timeline proposed under Basel III. Tougher liquidity standards seem unlikely to create any challenges for banks. While an ample transition period for liquidity standards is envisaged, the Maltese authorities should continue to ensure that banks remain well prepared for the implementation of new requirements.
- *Single Supervisory Mechanism (SSM)*. As a result of the EU Council agreement on SSM of December 2012, Malta's two largest domestic banks (Bank of Valetta and HSBC) and possibly CommBank Europe, will be placed under the direct oversight of the ECB from 2014. The MFSA should work closely with the ECB to ensure a smooth transition in the supervision of these banks. While the new framework is expected to result in a more efficient supervision over a longer term, efforts should be made to ensure no reduction in the supervisory capacity of these banks during the transition period.

15. Staff recommends a prompt and an in-depth examination of the financial sector under the IMF Financial Sector Assessment Program (FSAP). The MFSA is commended for its self-imposed quality controls of commissioning regular independent assessments against

international standards. In line with previous staff recommendations, the MFSA is also undertaking a review of the consumer protection and business conduct functions with a view to enhance the integrity of the financial system. An FSAP would report progress since the 2003 assessment and point to areas where further efforts may be needed.

16. In light of the rapid growth in financial sector activities and online gaming, all relevant institutions should maintain an effective anti-money laundering framework. Malta has become an active destination for small international banks and non-bank financial intermediaries, such as re-insurance companies and various investment funds, whose activities are mostly outside Malta. While Malta has a comprehensive legal system to combat money laundering and has increased the resources devoted to the Financial Intelligence Analysis Unit (FIAU), the increasing complexity of the Maltese financial sector warrants closer AML/CFT related monitoring. The FSAP would be an opportunity to conduct a detailed AML/CFT assessment. The ongoing practices of joint inspections carried out by the MFSA and FIAU is a welcome step, but the number of on-site visits remains low and is not commensurate with the size of the financial sector (see Appendix III). To strengthen human resources, consideration should be given to hiring experts from abroad, financed by non-punitive levies on the financial sector.

17. The intention of the authorities to establish a development bank has merits, but requires careful evaluation. Development banks play an important role in many countries in extending the outreach of credit and other financial services to customers, who may not have easy access to commercial banks. However, the international experience with development banks has been mixed, as these banks have sometimes been subject to undue political pressure and weak supervision, which resulted in substantial losses to taxpayers. The authorities should ensure that the conditions required for successful operation of a development bank are in place (Box 4).

Box 4. The Conditions Required for Successful Operation of a Development Bank

Recently, the Central Bank Governor has expressed interest in creating a development bank (DB) to address the national financing gaps not met by the commercial banks. The purpose of the DB would be to provide long-term financing for public projects in infrastructure and social sectors, such as education, communications, and environmental protection and rehabilitation. While the market failure to obtain finance and the positive externalities of such projects provide a rationale for the establishment of a DB, state intervention in the banking sector should be carefully crafted to mitigate the risks of political interference, poor governance, uncontrollable fiscal contingent liabilities, and unfair advantages of the DB over private banks. Some of the steps that can be taken to ensure that the social rate of return from the DB's activities exceeds the private and fiscal costs are listed below:

- **Establish a clear mandate:** The DB mandate should aim at filling the financing gaps arising from market failures. The mandate should specify the DB's objectives, the time period required for implementing and achieving the objectives, and the provisions for transparent accountability.
- **Relationship with the private banks:** The objective should be to act complementarily with respect to private banks, not compete with them.
- **Financial sustainability:** The DB should be financially sustainable over time. However, the objective should not be to maximize profit but generate the resources required for the completion of mandated projects. The DB should be regulated and supervised as a commercial bank.
- **Instruments used:** The mandate should be clear, specific and direct about the instruments used to correct the market failure.
- **Accountable and efficient governance:** Good and accountable governance is critical to prevent government interference in credit decisions. One possible option could be to organize the DB as a corporation comprising shareholders, board of directors and management with each group clearly informed about its rights and responsibilities

The Authorities' Views

18. The authorities agreed with the staff's assessment. The Financial Stability Report of the CBM has encouraged banks to increase loan loss provision, strengthen capital buffers through higher profit retention, and ensure higher funding for the deposit compensation scheme. The MFSA is working on imposing additional capital requirements via Pillar II to account for concentration risk and heightened levels of non-performing loans. The authorities noted that the work on Basel III and SSM is under way, and the Joint Financial Stability Board has already met several times since its inception in January 2013. The Domestic Standing Group, composed of representatives of the CBM, MFSA, and Ministry of Finance, remains another forum for discussion of systemic risks. The daily monitoring of liquidity position of individual banks has not revealed any signs of excess volatility or abnormal capital inflows or outflows. The authorities plan to request an FSAP and think that it could validate the findings of the recent independent assessment of Malta's regulatory and supervisory frameworks. The authorities support the establishment of a development bank in Malta to channel the excess liquidity in the system to infrastructure, social, and environmental projects and to deploy government assets (e.g. underutilized real estate) more efficiently. Their view is that commercial banks cannot fill this gap

because of the medium to long-term nature of the projects. In turn, budget financing is constrained by the high level of public debt.

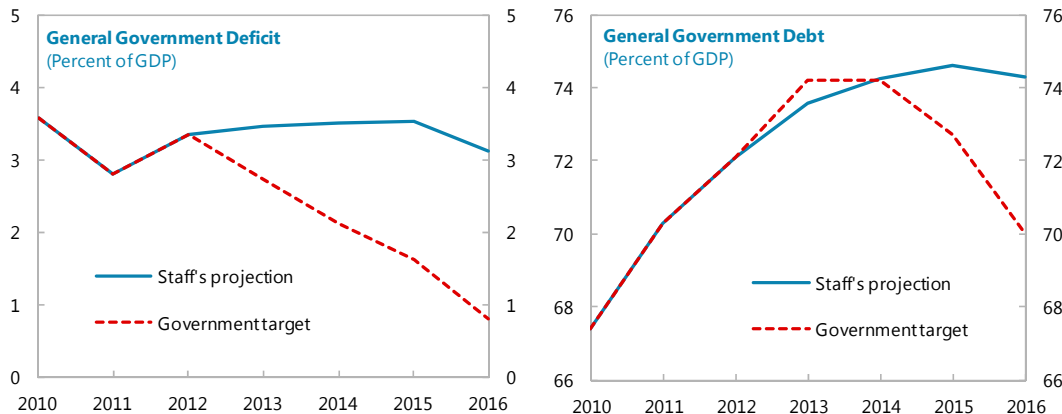
B. Ensuring Fiscal Sustainability

Staff's Views

19. The fiscal consolidation path was reversed in 2012 amid the election cycle. After notable progress in 2011, the fiscal deficit widened by $\frac{1}{2}$ percent to 3.3 percent of GDP in 2012 and government debt rose to 72.1 percent of GDP, or almost 90 percent of GDP including guaranteed debt (Box 5). This has triggered a reassessment of Malta's public finances under the EU Excessive Deficit Procedure (EDP), which Malta had exited in 2012. In late May 2013, the European Commission recommended to initiate the first steps towards re-opening of the EDP, with the deadline to achieve a durable correction of the deficit set for 2014. The fiscal slippage in 2012, which amounted to 1 percentage point of GDP relative to the budget target, was the result of overruns in all components of current spending and lower-than-expected revenues.

- Revenues improved relative to 2011, albeit by less than anticipated by the government. Direct tax revenues increased substantially driven by higher income tax receipts from firms and households. However, the ratio of indirect taxes to GDP fell, reflecting weaker than expected consumption growth because of increased uncertainty surrounding the elections.
- Overruns in current expenditure reflect the fast growth of health care spending and pension outlays. In addition, new collective wage agreements and settlement of arrears from previously acquired wage commitments resulted in a large increase in the wage bill. The increase in current expenditure more than offset the impact of a significant amount of deficit-reducing one-off measures (close to 1 percent of GDP). Since 2009, recourse to such one-off and temporary measures to reduce the deficit has averaged more than $\frac{3}{4}$ percent of GDP per year.

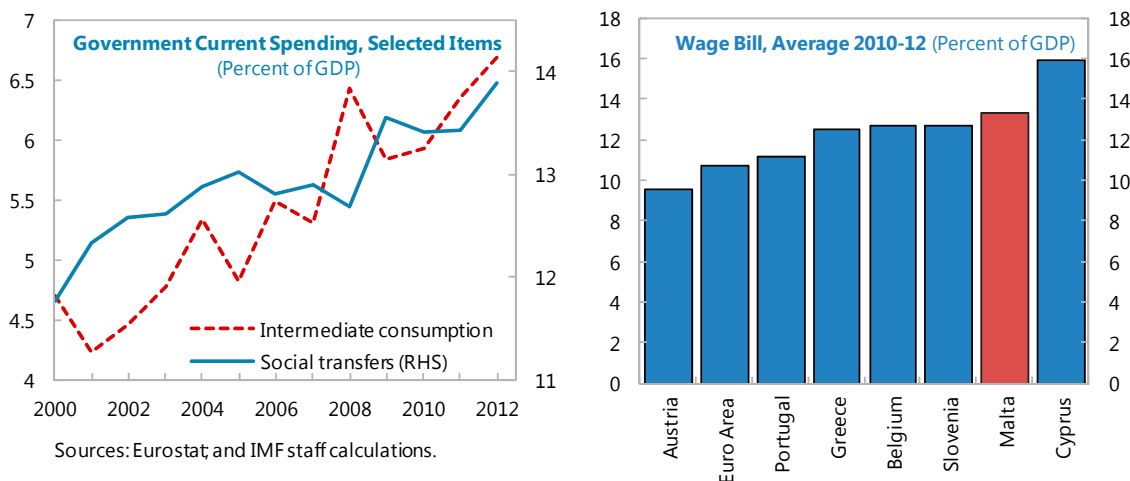
20. The government's objective to balance the budget over the medium term remains essential, but it requires credible and sustainable consolidation efforts. On April 8, the newly elected government and the opposition agreed to approve the 2013 budget rejected by Parliament in December 2012, with only minor modifications. The budget proposed a fiscal deficit of 2.7 percent of GDP in 2013 and a moderate structural adjustment of about $\frac{1}{2}$ percent of GDP per year over the medium-term. However, the discretionary measures announced for 2013 are expansionary and tax revenue projections appear optimistic in light of the moderate growth outlook and developments so far. On a cash basis, the deficit through March 2013 already exceeds the authorities' deficit target for the year. Therefore, in the absence of additional measures, staff projects the deficit to widen further to 3.5 percent points of GDP in 2013, and to remain above 3 percent of GDP in the near to medium term. As a result, the government debt-to-GDP ratio is expected to continue to rise over the next three years.



Sources: Eurostat; Malta Ministry of Finance; and IMF staff calculations.

21. Staff urges the Maltese authorities to adopt additional measures to ensure the deficit falls below 3 percent of GDP in 2013 and public debt remains on a sustainable path.

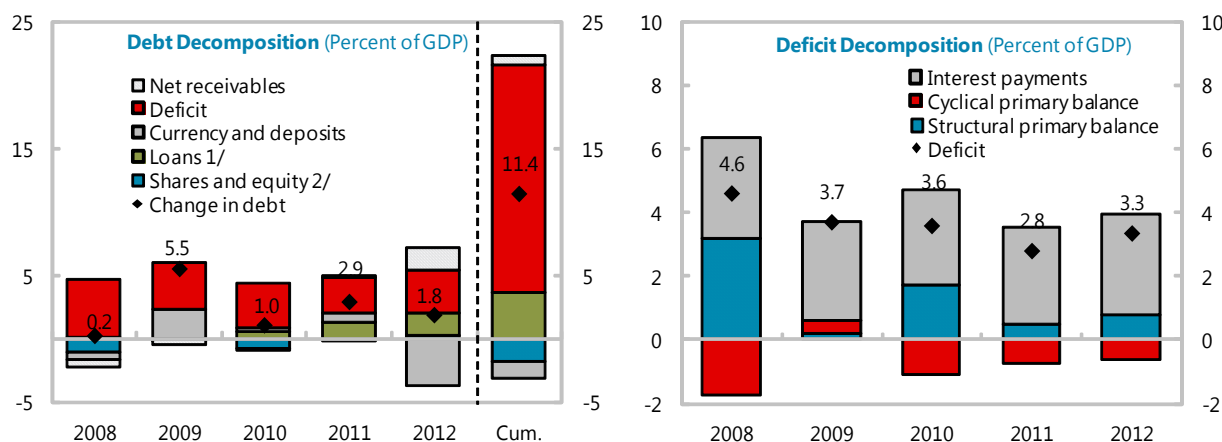
These measures should be designed to contain the fast growth in current expenditures, particularly intermediate consumption and social transfers, which show an unsustainable upward trend, and compensation of employees, which is one of the highest in the EU. The focus should be on tightening controls on the growth of health spending, greater use of means-testing of government benefits, and containing the wage bill through prudent collective wage agreements and compression of public sector employment through attrition. On the other hand, there is a need to preserve capital spending and to increase absorption capacity of EU funds. There is also a need to reduce reliance on one-off and temporary measures to ensure a sufficient and sustainable improvement of the structural balance.



Sources: Eurostat; and IMF staff calculations.

Box 5. Malta: General Government Debt Decomposition

Since 2008 public debt has been rising continuously. The debt-to-GDP ratio increased by 11.4 percentage points between 2008 and 2012, reaching a level of 72.1 percent at the end of 2012. This box identifies the main drivers of public debt accumulation during this period, by means of a debt decomposition exercise that uses data from the financial and non-financial government accounts.



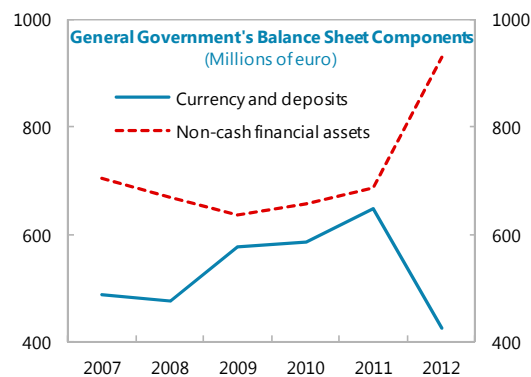
Sources: Central Bank of Malta; National Statistics Office of Malta; and IMF staff calculations.

1/ Mainly EFSF contributions in 2012

2/ ESM contributions and capital injections to Malta

Persistent deficits have contributed to the increase in public debt, but intergovernmental loans to support euro area countries have also been an important contributor in recent years.

- *Interest payments* represent the largest component of the government deficit. The *structural primary deficit* played an important role in 2008, 2010, and to a lesser extent in 2012.
- The government has tended to rely on *one-off measures* to reduce the deficit, as evidenced by the negative contribution of the cyclical primary balance, which includes one-offs, on the deficit in four out of the five years considered.
- In 2012, cash and deposits of the government fell significantly to finance the deficit, contributions to the EFSF, and an accumulation in net receivables.
- This is consistent with the trend observed in the government's balance sheet data. While the *cash position* declined significantly in 2012, non-cash financial assets increased substantially in 2012.



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

22. Restoring the profitability and viability of large public corporations is crucial to alleviate fiscal pressures. The high level of government-guaranteed debt and delicate financial position of Enemalta (the public utilities corporation) and Airmalta heighten concerns about Malta's fiscal sustainability. Progress on the restructuring of Airmalta appears on track and the restructuring plan of Enemalta was recently approved. In this context, budget assistance to Enemalta needs to be phased out. Staff supports the government's objective to reduce energy costs—one of the highest in the EU—and to diversify energy sources. However, any reduction in electricity tariffs should be contingent on the success of the government's strategy to reduce costs and restore Enemalta's financial health (see Appendix IV). It would also be important to make Enemalta's financial reporting more timely and enhance transparency by issuing progress reports on Enemalta's restructuring and the government's energy reform plan.

23. Further progress is needed to strengthen the fiscal governance framework. The authorities need to undertake the necessary reform to ensure that its fiscal governance framework meets the EU requirements under the six-pack and fiscal compact by end 2013 (Box 6)¹. A clear rule-based multi-year fiscal policy framework would reinforce the linkage between annual budget laws and the medium-term target. Fiscal discipline and governance should also be strengthened by establishing an independent fiscal council to guide and assess the government's consolidation efforts. The fiscal council should have a comprehensive mandate, which includes the provision of unbiased macroeconomic estimates and an assessment of consistency between fiscal outcomes and the government's targets derived from the fiscal rules.

The Authorities' Views

24. The authorities were more optimistic than staff regarding the fiscal outlook. The authorities emphasized their commitment to reduce the budget deficit to 2.7 percent of GDP in 2013. With regards the 2013 budget, the authorities highlighted that small changes had been made to the budget proposed by the previous government, largely because of the need to honor previously acquired commitments. They also noted that their revenue projections were less optimistic than those of the previous government and that improvements in tax collection could yield substantial revenues. The authorities agreed with staff about the need to achieve a sustainable fiscal consolidation and to tackle the risks posed by the fast growth of certain current expenditure items. The government is committed to strengthening the governance framework and is considering various options for the mandate and responsibilities of a fiscal council.

¹ The six pack is a set of EU legislative measures to reform the Stability and Growth Pact and to introduce a new macroeconomic surveillance. The fiscal compact is an intergovernmental treaty introduced as a new stricter version of the Stability and Growth Pact.

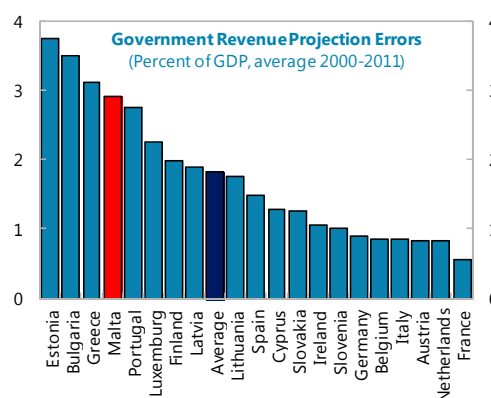
Box 6. Malta: Fiscal Governance Framework

In order to prevent the build-up of fiscal imbalances, the six-pack and fiscal compact require EU member countries to reform their fiscal frameworks by making changes to their legislation. This set of directives, regulations and agreements, establish that the necessary elements to build a strong fiscal framework are: fiscal rules, fiscal councils, medium term budgetary planning, budget coordination, and budget monitoring.

Member States should have clearly defined numerical fiscal rules that promote compliance with the Stability and Growth Program (SGP). Fiscal rules may target the deficit, public debt or government expenditure, and should be reflected in the annual budget. These rules must be effectively monitored, and non-compliance should only be allowed under exceptional circumstances. The effective enforcement of fiscal rules requires a gradual, well-defined and credible sanctions mechanism, which leaves only very limited room for political discretion. To strengthen the enforcement of fiscal rules and counteract governments' inherent deficit bias, compliance with fiscal rules should be monitored by an independent body, such as a fiscal council.

Independent fiscal councils improve the transparency and quality of fiscal policies. These independent bodies contribute to the effectiveness of fiscal rules, by providing unbiased and realistic macroeconomic and budgetary projections, or by scrutinizing the government's projections. Overly optimistic projections yield excessively positive assessments of the underlying fiscal stance, thus masking emerging fiscal imbalances.

- In fact, projections of economic growth and government revenue have been "too optimistic" in a number of EU Member States over the past decade. The Government's excessive optimism is proxied by its revenue projection errors. From 2000 to 2011, Malta has registered one of the highest projection errors among EU countries, while the projection errors have been smaller in countries where forecasts are produced or scrutinized by independent bodies, such as in the Netherlands, Austria and Belgium.



Source: European Central Bank Monthly Bulletin, Feb 2013.

- To contribute to the enforcement of fiscal rules and the eradication of the government's deficit bias, the fiscal council must have the following characteristics: be strictly independent from the government; have a comprehensive mandate; and have the tools to persuade the government by being visible. That is, if the government fails to meet a target or does not follow a given rule, then it must publicly explain the deviations from the fiscal council's advice. Alternatively, the government could be asked to publish the results of ex-post reviews prepared by the fiscal council.

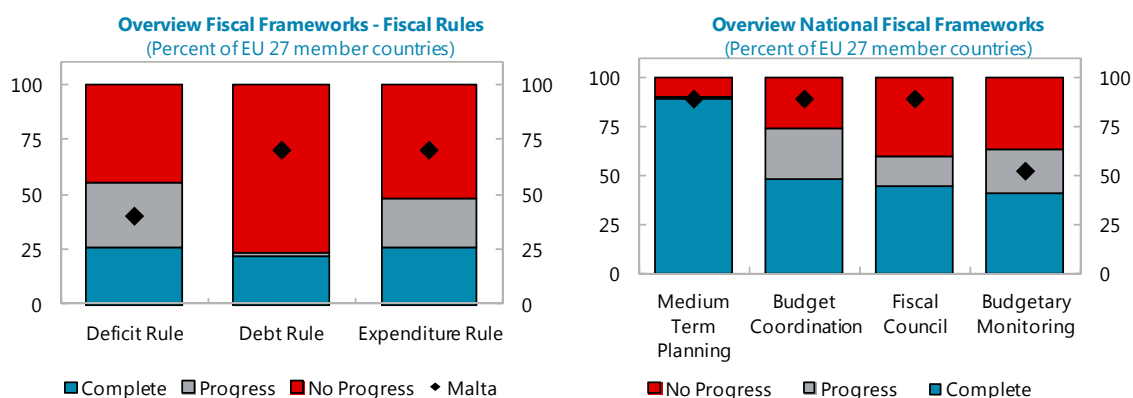
To promote a sound and credible medium-term fiscal planning, a multi-annual fiscal budgeting framework is required. Transparent multi-annual budgetary objectives, for the general government's expenditure, deficit and debt should be published, including the projections of the main revenue and expenditure items for the budget year and beyond. Further, these projections should constitute the basis for future budget preparations. A description of the medium-term policies envisaged should be provided, as well as a forecast of the impact that these policies may have on long-term fiscal sustainability.

Strong budgetary coordination between the different levels of government is important for ensuring full compliance with fiscal rules. EU Member States should have appropriate coordination mechanisms in place across the different sub-sectors of general government. These mechanisms should ensure comprehensive and consistent coverage of all government entities with respect to annual and multi-annual fiscal planning and compliance with the numerical fiscal rules.

Box 6. Malta: Fiscal Governance Framework (concluded)

Finally, an adequate monitoring framework is a crucial element of fiscal surveillance. To ensure that fiscal slippages are detected at an early stage, governments should be required to provide timely and accurate budgetary data, including the publication of data on contingent liabilities, as these could have a large impact on public budgets.

The figure below puts into perspective the progress Malta has made in adapting to the new regulatory framework. Relative to its EU peers, the Maltese government needs to make further efforts in adopting a clear fiscal rule, establish a fiscal council and impose its multi-annual fiscal projections as targets.



Source: European Commission; and European Central Bank.

C. Boosting Long Term Growth and Competitiveness

Staff's Views

25. Steady implementation of structural reforms is critical to boost potential growth and ensure the sustainability of public finances. The mission welcomes the government's recent adoption of the National Reform Program that includes specific measures in different areas, but progress on other reforms has been slow, notably pension reform. If continued income growth depends on flexibility in developing niche service industries, there will be a premium on tackling the country's low female labor force participation and tertiary education and relatively inflexible wage-setting regime. The priority areas should include:

- *Advancing pension and health care reform to ease long-term fiscal pressures.* Without the implementation of mitigating reforms, Malta's deficit would worsen by over 8 percentage points of GDP by 2060, reflecting an expected large increase in ageing-related spending (twice the EU average). The mission recommended: (i) indexing the retirement age to longevity, (ii) accelerating the planned increase in the statutory retirement age to 65, and (iii) introducing a mandatory privately funded second pillar and a voluntary third pillar to supplement the pay-as-you-go system. The latter, which would require an appropriate legal framework, would support the development of the local capital market and allow households to diversify their sources of savings (Appendix V).

- *Strengthening female labor participation.* The authorities have recently introduced tax incentives and child care and maternity support measures to promote female labor participation, which is the lowest in the euro area. This will also help alleviate long-term fiscal pressures from ageing spending through a reduction in the dependency ratio.
- *Enhancing education attainment.* The demand for high skilled labor in Malta is likely to increase with the growth of the financial sector and other high-value added activities. Yet, the rate of early school leavers in Malta is among the highest in the EU, and the rate of tertiary education is among the lowest. Education reforms should focus on promoting greater social inclusion and linking vocational training more closely with labor market needs.
- *Reforming the wage setting mechanism.* Collective wage agreements should ensure better alignment of wage and productivity developments. Wage growth has exceeded productivity growth and increases in unit labor costs continue to outpace the euro area average. While the removal of the cost of living adjustment (COLA) may not be politically feasible and may raise social equitable considerations, a gradual moderation in the indexation mechanism and its greater integration in the collective wage negotiations could help make the labor market more efficient and competitive. Appendix VI discusses possible reform initiatives.
- *Improving the business climate.* Malta ranks particularly poorly in the areas of starting a business, getting construction permits, and contract enforcement. Measures to minimize start-up barriers and improve the legal environment would create a more welcoming business climate.

26. More generally, these reforms would make the economy less vulnerable to sectoral setbacks and more resilient to a potential harmonization of tax rates at the EU level. With Malta's growth model increasingly dependent on financial and niche services, measures to broaden competitiveness would help diversify the economy. This is particularly important at a time when many of Malta's trading partners are undergoing internal devaluation, fiscal consolidation, and structural reforms to restore their competitiveness.

The Authorities' Views

27. The authorities broadly agreed with the assessment but emphasized several obstacles to the swift implementation of some of the proposed reforms. They acknowledged that increasing the retirement age beyond what is already planned would help reduce public expenditure and increase contributions. However, they noted that this would not be politically acceptable in the short term, just as the introduction of the mandatory second pension pillar. The government is exploring measures to reform the public pension system by assessing potential enhancements to the first pension pillar, allowing the development of the third pension pillar, and reviewing incentives aimed at encouraging individuals to save with private pension funds. The authorities noted that measures to increase female labor force participation and education attainment are included in the National Reform Program under the Europe 2020 strategy. The government emphasized that COLA has served the country well in

terms of social cohesion and industrial peace, and noted that wage growth already reflected productivity growth in some sectors of the economy.

D. Statistical Issues

28. There is room to strengthen data collection and analysis. The recent IMF technical assistance mission on balance of payments (BOP) identified several actions that the CBM and National Statistics Office (NSO) should implement to achieve the latest internationally accepted methodological standards and good practices. The current data collection system is based on a direct reporting system covering the largest companies, which raises concern in terms of coverage and timeliness, particularly in the context of the rapid growth of new activities facilitated by tax incentives.

29. Large revisions to the first released estimates in certain areas, in particular services, point to the need of a re-examination of the data collection strategy. It would be important to build up more robust sampling frames to conduct benchmark and/or regular BOP surveys. The enrichment of the BOP register would constitute a first step. The inclusion of special purpose entities (SPEs) in the external sector accounts would be one of the milestones for which the country has committed as part of *BPM6* adoption in 2014 by Euro area members. The release of new estimates should be preceded by a thorough analysis of their impact on the external sector accounts and other macroeconomic indicators, including GDP. There is a need to reinforce the scarce human resources, in particular at the NSO, to facilitate the implementation of these measures.

30. Although the current provision of statistics is sufficient for surveillance, further efforts in specific areas are needed. For instance, it would be advisable to compile series for household disposable income and household savings.

STAFF APPRAISAL

31. Malta has shown remarkable resilience in the face of a major crisis in Europe. Since the beginning of the crisis, the average real GDP growth in Malta has been one of the best among all EU members and the unemployment rate remains one of the lowest. This resilience was underpinned by robust service export growth and a sound banking system. As a result, the current account balance has improved gradually in recent years, turning into surplus in 2012. Although, economic growth slowed in 2012 reflecting weak external conditions and subdued domestic demand, staff projects a moderate acceleration in 2013-15, which means that Malta would continue to outperform the euro area average. The pick-up in activity is predicated on the recovery of private consumption and improved confidence. While this would lead to some increase in imports, the current account balance is projected to remain slightly positive.

32. Recent events in Europe have heightened perceptions about the risks of hosting a large banking sector in a small country, posing difficult policy challenges for the authorities. These risks are contained in Malta because the large international banking segment has limited balance sheet exposures to the domestic economy. Nonetheless, the authorities should re-double their efforts to monitor closely developments in all banks, including links between foreign parent banks and their Maltese entities, and take concrete measures to strengthen the resilience and bolster the reputation of Malta's financial system. Specifically, loan loss provisions should be increased; the crisis preparedness and management frameworks should be enhanced, notably by boosting the resources of the deposit insurance fund; and, in light of the rapid growth in financial sector and online gaming activities, the implementation of the anti-money laundering framework should be further strengthened. In this regard, staff welcomes the establishment of the Joint Financial Stability Board to monitor system-wide risk and conduct macro-prudential policy, and urges the authorities to undergo a prompt and in-depth examination of the financial sector under the IMF's Financial Sector Assessment Program, including an AML/CFT assessment.

33. The authorities' intention to establish a development bank has merits, but requires careful evaluation. The authorities should ensure that the conditions required for the successful operation of a development bank are in place, including clear mandate and identification of the market failure that the development bank is expected to mitigate, robust governance structure to ensure financial sustainability, and the use of best practices of the private sector. In addition, the operation of the development bank should not cause significant market distortion or compete with the private sector.

34. The immediate challenge for fiscal policy is to reverse the deterioration in the fiscal balance and to strengthen the fiscal governance framework. The fiscal position deteriorated in 2012 amid the election cycle and the level of public debt is uncomfortably high, constraining the fiscal space in the event of further shocks. Furthermore, discretionary measures announced for 2013 are expansionary and tax revenue projections appear optimistic. In the absence of additional credible measures, staff projects the deficit to widen further to 3.5 percent of GDP in 2013. Efforts should focus on containing the fast growth of current spending and reducing the reliance on one-off and temporary measures, while preserving capital spending. Further fiscal consolidation will be required in the medium-term to meet a structural balanced budget and ensure sustainable debt dynamics, thus reducing fiscal risks to manageable levels.

35. Much more needs to be done to reduce contingent liabilities and address Malta's long-term fiscal challenges. Pension and health care reforms are crucial to improve the adequacy and sustainability of the schemes. In particular, the retirement age should be aligned with life expectancy, and second and third pension pillars should be introduced. The latter, which would require an appropriate legal framework, would support the development of the local capital market. Staff supports the government's plans to restructure Enemalta, reduce energy costs, and diversify energy sources. However, there are significant potential fiscal risks from these initiatives that require close monitoring.

36. With Malta’s growth model increasingly dependent on financial and niche services, the medium-term challenge to broaden competitiveness, diversify the economy, and boost long-term growth appear increasingly daunting. Maintaining macroeconomic stability and a sound financial system are necessary but not sufficient for long-term growth. Going forward, policy efforts are needed to strengthen female labor force participation and educational attainment, ensure better alignment of wages and productivity at the enterprise level, promote foreign investment and R&D, and improve the business climate and the judicial system. These reforms would also make the economy less vulnerable to sectoral setbacks and more resilient to a potential harmonization of tax rates at the EU level.

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

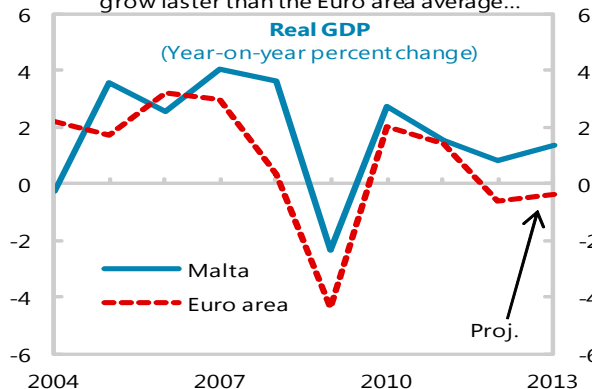
Malta: Risk Assessment Matrix²

Risk	Relative Likelihood	Impact if Realized
Stalled or incomplete delivery of Euro area policy commitments	Medium Re-emergence of euro area financial stress and uncertainty over euro area viability. This could result in significant negative shocks to growth.	High Spillovers through trade and financial channels would reduce growth and weaken banks' balance sheets.
Difficulty in implementing structural reforms	Medium Lack of social consensus leading to reform paralysis.	High Delayed implementation of required structural reforms would have negative impact on long-term fiscal sustainability, competitiveness, and medium-term growth.
Protracted period of slower European growth	Medium The adverse impact of the ongoing public and private sector deleveraging on the real economy could be larger than currently expected, reducing potential output and lowering growth in the euro area over the medium term.	Medium Slower European growth would affect Malta through weaker exports and confidence effects.
Significant declines in real estate prices	Medium Growth in the commercial real estate sector has softened and property-related NPLs are rising. The domestic banks are highly exposed to the property market through lending and collateral in the form of real estate.	Medium Declines in house prices would dampen domestic demand. The deterioration in asset quality would require further loan-loss provisions and bank capital, adversely affecting bank profitability and lending.
Difficulty to sustain the favorable tax regime	Low/Medium Harmonization of the tax framework and regulatory reforms might reduce attractiveness of Malta.	Medium Deleveraging of the international banking and business sector may adversely affect tax revenues and employment.
Global oil shock triggered by geopolitical events	Low Malta's high dependence on oil imports results in a high pass-through of energy prices shocks to inflation and, subsequently, wages due to the wage indexation mechanism.	Medium Price and wage increases could erode recent gains in competitiveness.

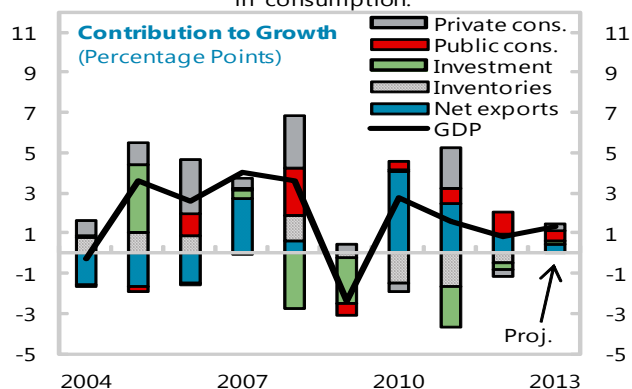
² The RAM shows relatively low probability events that could materially alter the baseline discussed in this report (which is the scenario most likely to materialize in view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of risks surrounding this baseline. The RAM reflects staff's views on the sources of risks as of the time of discussions with the authorities.

Figure 1. Malta: Economic Indicators

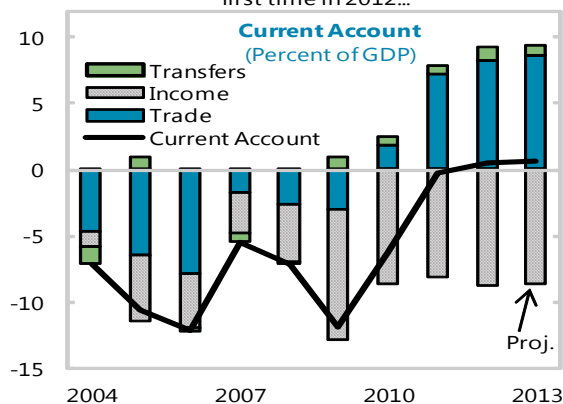
After a slowdown in 2012, the economy is expected to grow faster than the Euro area average...



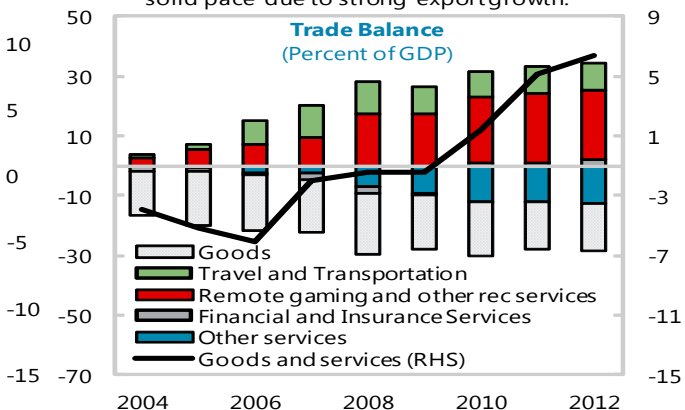
...supported by exports and gradual improvement in consumption.



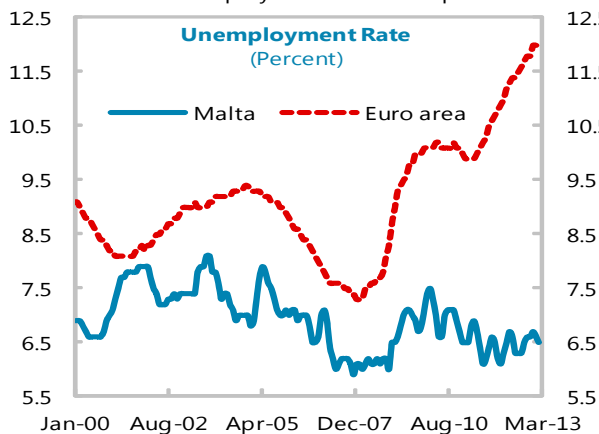
Current account balance turned into surplus for the first time in 2012...



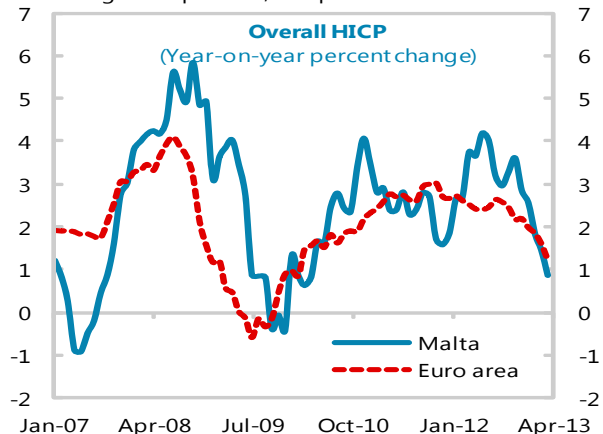
...as the trade balance continued to improve at a solid pace due to strong export growth.



Despite the slowdown in 2012, the labor market remains resilient with unemployment rate below pre-crisis level...

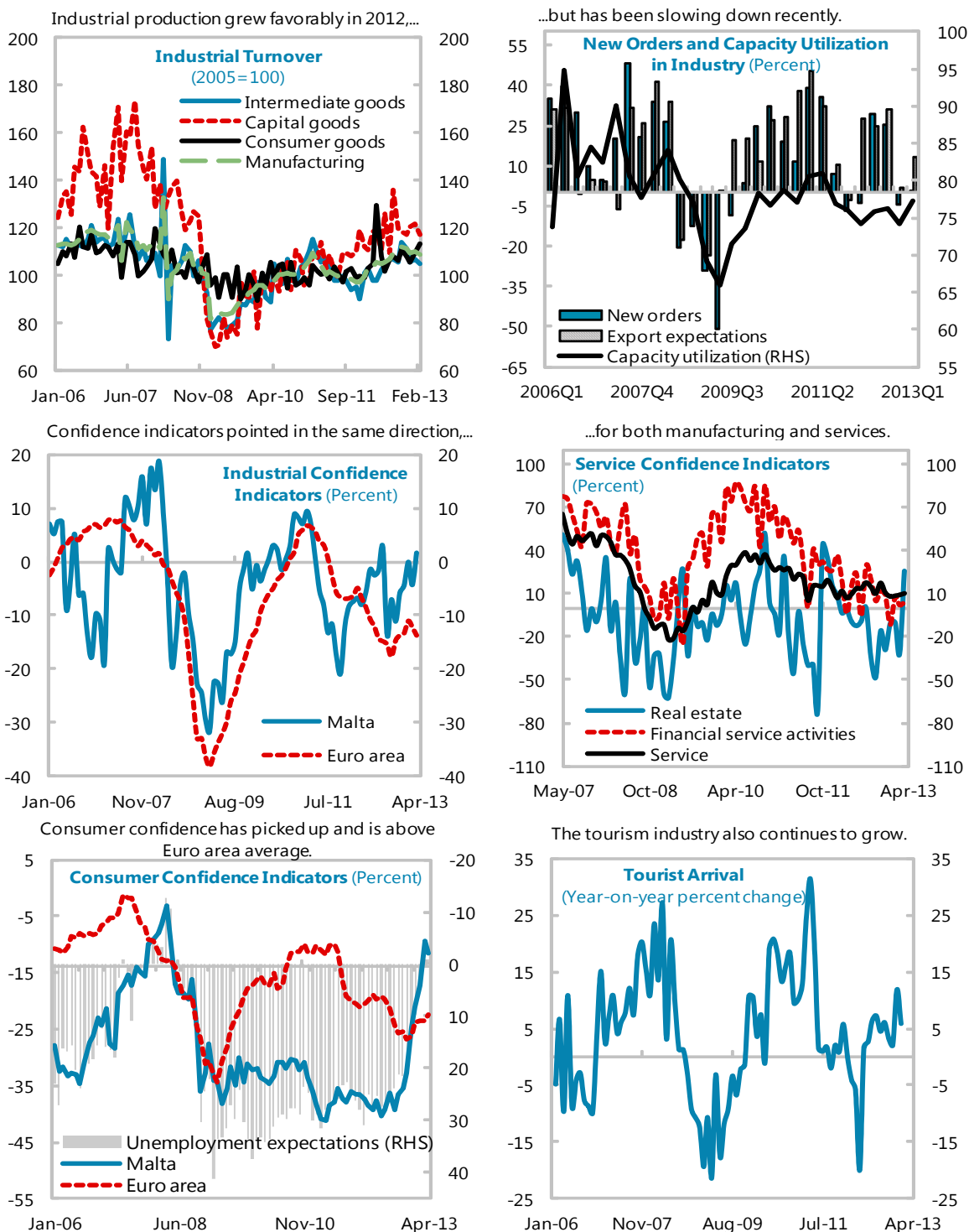


...but inflation continued to increase in 2012, and averaged 3.2 percent, compared to 2.5 for the Euro area.



Sources: Central Bank of Malta; Eurostat; IMF World Economic Outlook; and IMF staff calculations.

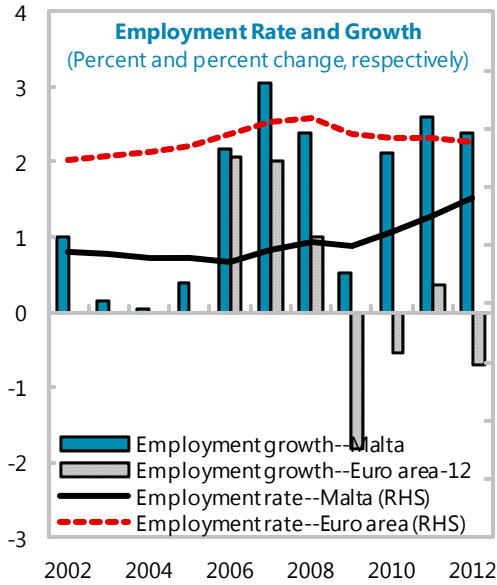
Figure 2. Malta: Short-Term Indicators, 2006-2013



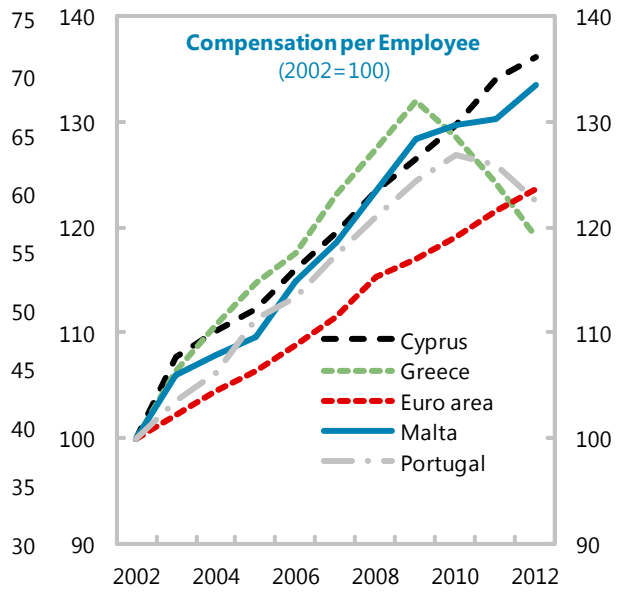
Sources: European Central Bank; Central Bank of Malta; European Commission; and IMF staff calculations.

Figure 3. Malta: Labor Market Indicators, 2000-2013

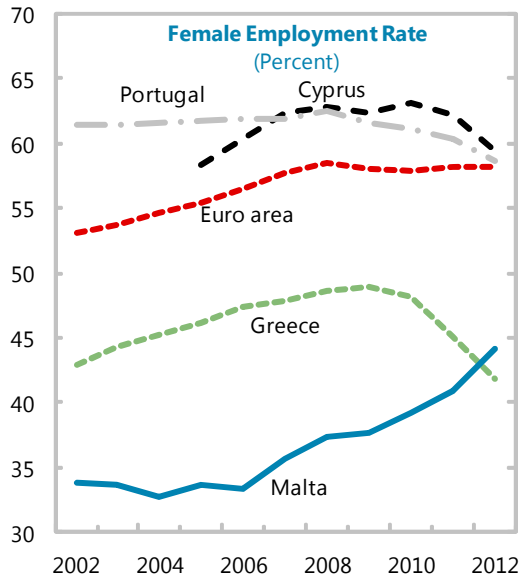
Compared to euro area peers, employment growth has continued to outperform...



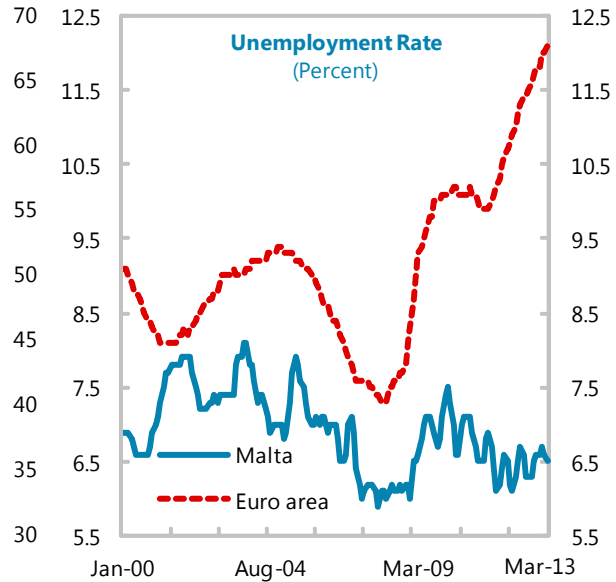
...despite the increase in compensation per employees.



Female labor force participation improved, though remains one of the lowest in the EU.



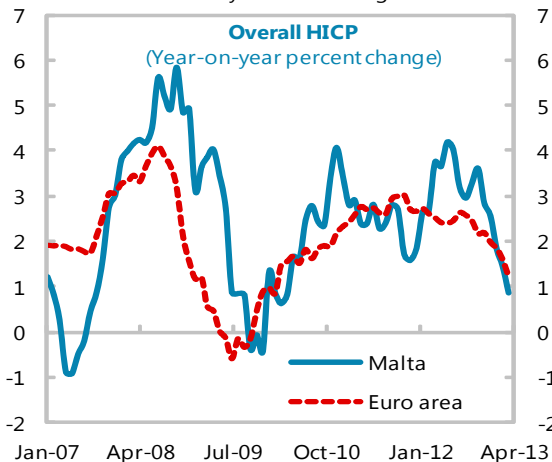
... and the unemployment rate has returned to pre-crisis levels.



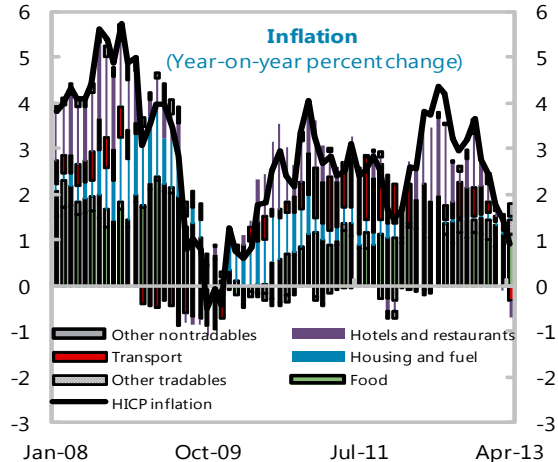
Sources: Eurostat; National Statistics Office; European Central Bank; World Economic Outlook; and IMF staff calculations.
^{1/}Data for Euro Area is based on countries for which data was available.

Figure 4. Malta: Inflation, 2007-2013

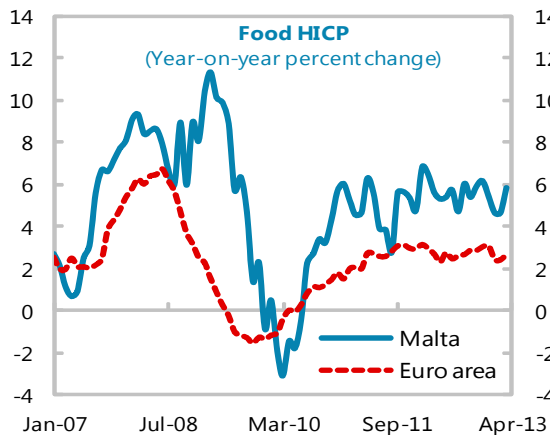
Inflation continued to increase in 2012, but has recently been declining.



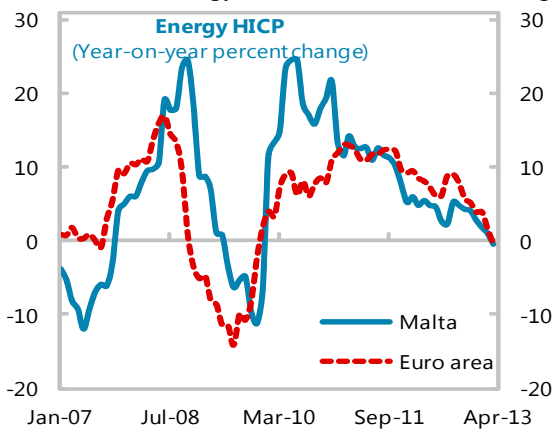
The growth was driven by food and energy prices



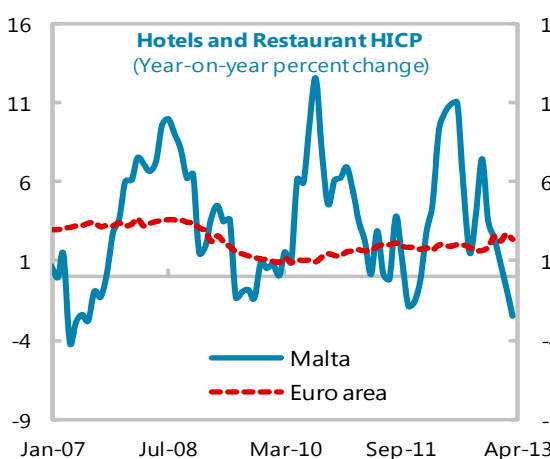
Food inflation remains above the euro area average...



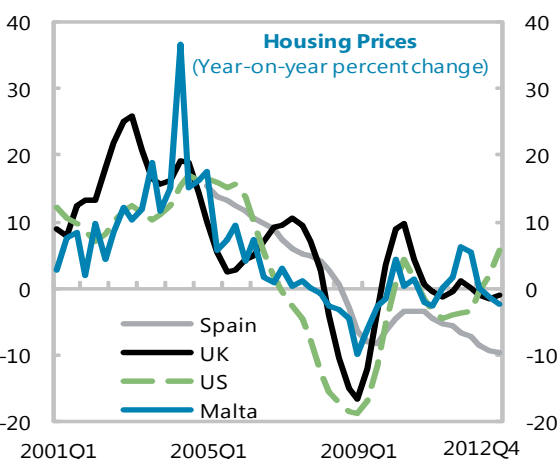
...while the energy inflation differential is narrowing.



Hotel and restaurants inflation remains volatile...



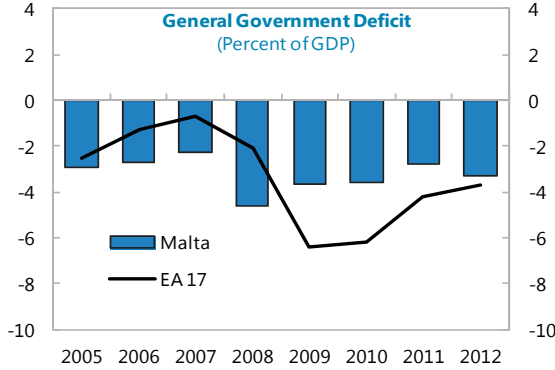
...and housing prices have been decreasing recently.



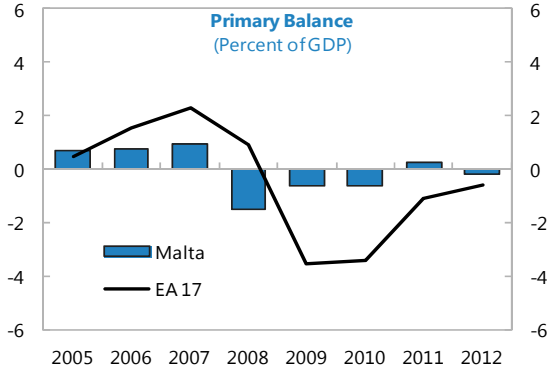
Sources: Eurostat; Central Bank of Malta; Haver; and IMF staff calculations.

Figure 5. Malta: Fiscal Developments

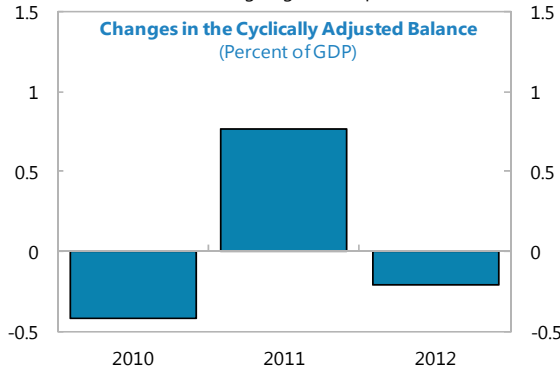
The deficit fell to 3.3% of GDP in 2012 and Malta is now at risk of entering the EDP...



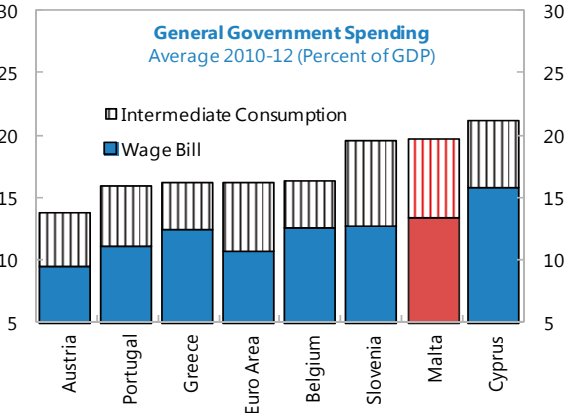
...primary balance was also slightly negative in 2012.



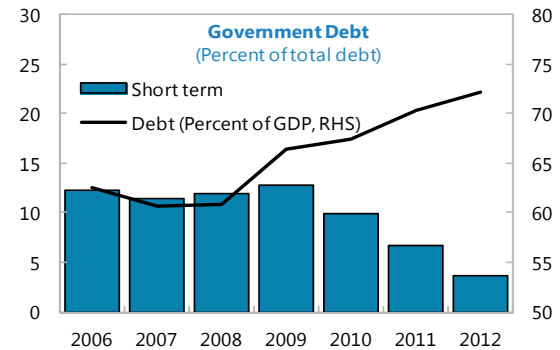
Fiscal consolidating efforts receded in 2012, and the lack of concrete measures going forward poses a risk.



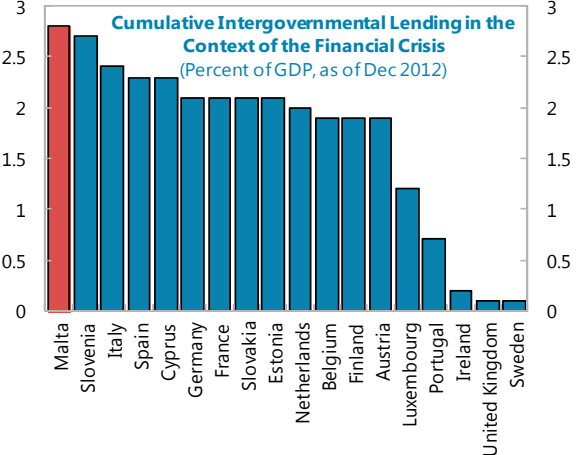
But there is room for adjustments to spending.



Government debt continues to increase, but efforts to reduce the share of short term debt have been successful.



The contribution of loans to the EFSF and Greece was small, despite it being the highest within the Euro Area



Sources: Eurostat, IMF *World Economic Outlook*; and IMF staff calculations.

Figure 6. Malta: Financial Soundness Indicators



Table 1. Malta: Selected Economic Indicators, 2009-2015

(Year on year percent change, unless otherwise indicated)

	2009	2010	2011	2012	Proj.		
					2013	2014	2015
	(Year on year percent change)						
Real GDP	-2.6	2.9	1.7	0.8	1.3	1.8	2.0
Domestic demand	-2.6	-1.4	-0.9	0.0	1.1	1.5	1.7
Consumption	-0.1	-0.1	3.4	0.9	1.0	1.2	1.5
Private consumption	0.7	-0.7	3.3	-0.6	0.5	0.8	1.3
Public consumption	-2.7	1.7	3.8	5.5	2.3	2.4	1.9
Fixed investment	-13.4	0.9	-14.1	-2.5	1.8	3.1	3.3
Exports of goods and services	-8.4	18.1	0.8	5.2	2.6	4.0	4.0
Imports of goods and services	-8.2	12.7	-2.0	4.4	2.3	3.8	3.9
Contribution to growth	(Percent)						
Foreign balance	0.0	4.0	2.4	0.9	0.4	0.4	0.4
Exports of goods and services	-6.9	14.0	0.7	4.6	2.4	3.7	3.8
Imports of goods and services	6.9	-10.0	1.7	-3.6	-2.0	-3.3	-3.4
Potential GDP growth	1.7	1.7	1.6	1.6	1.6	1.7	1.7
Output gap (percent of potential GDP)	-1.1	0.0	0.1	-0.7	-0.9	-0.7	-0.5
HICP (period average)	1.8	2.0	2.5	3.2	2.4	2.0	2.1
GDP deflator	2.8	2.9	2.1	2.2	2.2	2.4	2.2
Unemployment rate EU stand.	6.9	6.9	6.5	6.3	6.4	6.3	6.2
Employment growth	0.4	2.1	2.6	1.7	1.6	1.9	2.0
Gross national savings (percent of GDP)	9.6	12.2	12.8	12.8	13.1	13.7	14.0
Gross capital formation (percent of GDP)	18.2	16.9	12.9	12.4	12.6	12.9	13.2
Balance of payments	(Percent of GDP)						
Current account balance	-8.6	-4.7	-0.2	0.4	0.5	0.8	0.8
Trade balance (Goods and services)	-2.2	1.4	5.1	6.3	6.5	6.8	6.8
Goods balance	-18.8	-18.3	-16.1	-16.0	-16.1	-16.2	-16.3
Services balance	16.7	19.8	21.2	22.3	22.6	23.0	23.1
Income, net	-7.1	-6.6	-5.8	-6.8	-6.5	-6.5	-6.5
Transfers, net	0.7	0.4	0.5	0.8	0.5	0.5	0.5
Financial account, net	-0.5	-2.8	-1.4	-5.0	-1.6	-1.9	-2.0
Memorandum item:							
Nominal GDP (millions of euros)	5969.3	6316.7	6556.4	6755.8	6998.0	7295.1	7605.4

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

Table 2. Malta: Fiscal Developments and Projections, 2007-2015

(Percent of GDP, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	Projections		
							2013	2014	2015
Revenue	39.5	38.6	38.7	38.4	39.3	40.5	41.0	40.8	40.8
Taxes	27.7	26.7	27.1	26.4	27.0	27.7	27.8	27.8	27.8
Indirect taxes	14.4	14.0	13.6	13.4	13.8	13.6	13.8	13.8	13.8
Direct taxes	13.0	12.5	13.3	12.8	13.0	13.8	13.8	13.8	13.8
Other taxes (capital taxes)	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social contributions	7.1	7.2	7.3	7.2	7.4	7.5	7.6	7.6	7.6
Grants and Capital revenue	1.0	0.5	0.8	1.5	1.5	1.9	2.1	1.9	2.0
Other revenue	3.7	4.2	3.4	3.3	3.4	3.4	3.4	3.4	3.3
Expenditure	41.8	43.2	42.4	42.0	42.1	43.9	44.5	44.3	44.3
Expense	38.6	40.7	40.3	39.8	39.6	41.2	41.5	41.3	41.6
Compensation of Employees	12.7	13.9	13.9	13.3	13.3	13.5	13.5	13.5	13.5
Use of goods and services	5.3	6.4	5.8	5.9	6.4	6.7	6.9	6.9	6.9
Interest	3.3	3.1	3.1	2.9	3.1	3.2	3.2	3.2	3.2
Subsidies	2.0	2.1	1.1	1.1	1.0	1.1	1.2	1.3	1.2
Social benefits	12.9	12.7	13.6	13.4	13.4	13.9	13.7	13.6	13.6
Other expense	2.4	2.5	2.9	3.2	2.5	2.8	2.9	2.7	3.1
Net acquisition of nonfinancial assets	3.2	2.5	2.1	2.2	2.4	2.7	3.0	3.0	2.7
Gross Operating Balance	0.9	-2.1	-1.6	-1.4	-0.3	-0.7	-0.5	-0.5	-0.8
Net lending/borrowing (overall balance)	-2.3	-4.6	-3.7	-3.6	-2.8	-3.3	-3.5	-3.5	-3.5
Net financial transactions	-2.3	-4.6	-3.7	-3.6	-2.8	-3.3	...	...	...
Net acquisition of financial assets	1.7	0.6	2.4	1.9	4.3	1.1	...	...	...
Currency and deposits	1.1	-0.1	2.3	0.8	1.8	-3.5	...	...	...
Shares other than shares	0.0	0.0	0.0	0.0	0.0	0.0	...	...	...
Loans	0.0	0.1	-0.1	0.5	1.3	1.8	...	...	...
Shares and other equity	-0.6	-0.1	0.0	0.0	0.2	0.6	...	...	...
Other financial assets	1.2	0.7	0.2	0.6	1.0	2.2	...	...	...
Net incurrence of liabilities	3.7	5.1	6.0	5.5	7.3	4.9	...	...	...
Currency and deposits	0.1	0.4	0.1	0.1	0.1	0.1	...	...	...
Securities other than shares	2.2	3.6	6.2	4.6	4.8	2.6	...	...	...
Loans	0.1	-0.2	-0.9	0.0	0.4	1.3	...	...	...
Other liabilities	1.2	1.4	0.6	0.8	2.1	1.0	...	...	...
<i>Statistical discrepancy</i>	-0.3	-0.1	-0.1	0.0	0.2	0.5	...	...	...
Memorandum items:									
Overall balance excl. one-offs	-2.9	-4.6	-4.3	-4.7	-3.5	-4.2	-3.8	-3.6	-3.6
Cyclically adjusted overall balance	-2.8	-6.1	-3.2	-3.6	-2.8	-3.0	-3.1	-3.2	-3.3
Cyclically adjusted overall balance, excl. one-offs	-3.4	-6.1	-3.8	-4.7	-3.5	-3.9	-3.4	-3.3	-3.4
Primary balance	0.9	-1.5	-0.6	-0.6	0.3	-0.2	-0.3	-0.3	-0.3
One-offs	0.6	0.0	0.6	1.1	0.7	0.9	0.3	0.1	0.1
Public debt	60.7	60.9	66.4	67.4	70.3	72.1	73.7	74.2	74.5
Government guaranteed debt	10.8	11.5	14.4	15.7	16.3	17.6	...	...	...
Nominal GDP (millions of euros)	5,575	5,963	5,969	6,317	6,556	6,756	6,998	7,295	7,605

Sources: Maltese authorities; and IMF staff projections.

Table 3. Malta: Balance of Payments, 2007-2015

	2007	2008	2009	2010	2011	2012	Proj.		
							2013	2014	2015
	(Percent of GDP)								
Current account balance	-4.0	-4.9	-8.6	-4.7	-0.2	0.4	0.5	0.8	0.8
Trade balance (Goods and services)	-1.2	-1.8	-2.2	1.4	5.1	6.3	6.5	6.8	6.8
Goods balance	-16.6	-20.7	-18.8	-18.3	-16.1	-16.0	-16.1	-16.2	-16.3
Exports	48.4	42.4	34.1	41.8	45.4	46.1	46.0	45.9	45.8
Imports	-65.0	-63.0	-52.9	-60.1	-61.4	-62.1	-62.1	-62.1	-62.1
Services balance	15.3	18.9	16.7	19.8	21.2	22.3	22.6	23.0	23.1
Exports	43.7	49.5	47.7	53.9	54.8	56.3	57.9	60.0	61.7
Imports	-28.4	-30.6	-31.0	-34.1	-33.6	-34.0	-35.3	-37.0	-38.6
Current income, net	-2.2	-2.9	-7.1	-6.6	-5.8	-6.8	-6.5	-6.5	-6.5
Current transfers, net	-0.5	-0.1	0.7	0.4	0.5	0.8	0.5	0.5	0.5
Private	-0.4	-0.3	-0.1	0.0	-0.1	-0.2	0.0	0.0	0.0
Public	-0.1	0.2	0.8	0.4	0.7	1.0	0.5	0.5	0.5
Capital account, net	1.2	0.4	1.7	1.7	1.0	1.5	1.1	1.1	1.1
Financial account, net	3.6	3.5	-0.5	-2.8	-1.4	-5.0	-1.6	-1.9	-2.0
Direct investment	9.9	5.7	3.7	10.7	4.3	2.8	4.1	4.1	4.1
Portfolio investment	6.6	6.2	-32.4	-50.8	-47.3	-23.7	-23.9	-23.9	-23.9
Other investment	-7.0	-10.1	28.3	37.7	40.8	17.7	18.2	17.9	17.9
Reserves (- inflow; + outflow)	-5.9	1.8	0.0	-0.4	0.8	-1.8	0.0	0.0	0.0
Errors and omissions	-0.8	0.9	7.4	5.8	0.6	3.1	0.0	0.0	0.0
Memorandum items:									
Official reserves, end of period									
(Millions of euros)	2,561.4	268.3	373.7	404.9	395.9	...	...	...	...
(In months of imports of goods and services)	5.9	0.6	0.9	0.8	0.8	...	...	...	...
Gross external debt (Percent of GDP)	498.3	538.4	500.0	525.0	513.1	521.9	523.7	523.1	523.0
Net external debt (Percent of GDP)	-85.0	-71.9	-85.8	-166.6	-159.4	-176.4	-175.5	-173.2	-170.9

Sources: National Statistics Office of Malta; and IMF staff projections.

Table 4. Malta: General Government Financial Balance Sheet

(Millions of euros)

	2008				2009				2010				2011				2012			
	Opening balance	Trans-actions	OEJ	Closing balance	Trans-actions	OEJ	Closing balance	Trans-actions	OEJ	Closing balance	Trans-actions	OEJ	Closing balance	Trans-actions	OEJ	Closing balance				
Net worth and its changes	....	....	....	....	....	....	....	....	....	....	....	....	....	....	....	....
Nonfinancial assets	....	....	....	....	....	....	....	....	....	....	....	....	....	....	....	....
Net Financial Worth:	-2,353.0	-270.0	-272.0	-2,895.0	-216.0	101.0	-3,010.0	-224.0	53.0	-3,181.0	-198.0	-12.0	-3,391.0	-258.0	134.0	-3,515.0				
Financial Assets	1,662.0	37.0	-88.0	1,611.0	143.0	27.0	1,781.0	121.0	32.0	1,934.0	282.0	-84.0	2,132.0	71.0	236.0	2,439.0				
Currency and deposits	488.0	-7.0	-5.0	476.0	138.0	-36.0	578.0	50.0	-42.0	586.0	117.0	-55.0	648.0	-236.0	13.0	425.0				
Debt securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0				
Loans	27.0	6.0	0.0	33.0	-3.0	0.0	30.0	33.0	0.0	63.0	87.0	1.0	151.0	121.0	0.0	272.0				
Equity and inv. fund shares	836.0	-4.0	-92.0	740.0	-1.0	58.0	797.0	-1.0	59.0	855.0	14.0	-27.0	842.0	39.0	199.0	1,080.0				
Other financial assets	311.0	42.0	9.0	362.0	9.0	5.0	376.0	39.0	15.0	430.0	64.0	-3.0	491.0	147.0	24.0	662.0				
Liabilities	4,015.0	307.0	184.0	4,506.0	359.0	-74.0	4,791.0	345.0	-21.0	5,115.0	480.0	-72.0	5,523.0	329.0	102.0	5,954.0				
Currency and deposits	8.0	23.0	0.0	31.0	6.0	0.0	37.0	4.0	0.0	41.0	5.0	0.0	46.0	4.0	0.0	50.0				
Debt securities	3,309.0	214.0	140.0	3,663.0	371.0	-40.0	3,994.0	291.0	22.0	4,307.0	317.0	1.0	4,625.0	174.0	91.0	4,890.0				
Loans	273.0	-11.0	22.0	284.0	-55.0	0.0	229.0	1.0	0.0	230.0	23.0	0.0	253.0	86.0	7.0	346.0				
Other liabilities	425.0	81.0	22.0	528.0	37.0	-34.0	531.0	49.0	-43.0	537.0	135.0	-73.0	599.0	65.0	4.0	668.0				
Memorandum items:																				
Net financial worth (in % of GDP)	-42.2			-48.5			-50.4			-50.4			-51.7			-52.0				
Financial assets (in % of GDP)	29.8			27.0			29.8			30.6			32.5			36.1				
Liabilities (in % of GDP)	72.0			75.6			80.3			81.0			84.2			88.1				
GDP nominal prices	5,575.4			5,963.4			5,969.3			6,316.7			6,556.4			6,755.8				

Sources: Eurostat; National Statistics Office of Malta; and IMF staff calculations.

Table 5. Malta: International Investment Position, 2005-2011

	2005	2006	2007	2008	2009	2010	2011
	(Millions of euros)						
International investment position	1,779	1,426	1,112	374	862	584	494
Direct investment	-2,805	-4,088	-4,699	-4,779	-5,064	-10,880	-10,850
Assets	841	874	838	798	1,067	1,266	1,248
Liabilities	3,646	4,962	5,538	5,577	6,131	12,146	12,098
Portfolio investment	10,467	11,779	11,102	10,739	12,944	16,064	17,621
Assets	10,054	11,371	10,695	10,188	12,442	15,577	17,169
Liabilities	-413	-408	-407	-551	-502	-487	-453
Of which: Debt instruments	-231	-222	-229	-393	-358	-331	-329
Financial derivatives	-2	-15	28	-5	-40	-90	-76
Other investment	-7,244	-7,674	-7,066	-4,748	-6,348	-3,942	-5,692
Assets	9,596	12,318	19,498	25,904	21,682	26,974	25,583
Liabilities	-16,840	-19,992	-26,564	-30,652	-28,030	-30,915	-31,276
Reserves	2,189	2,241	2,561	268	374	405	396
	(Percent of GDP)						
International investment position	36.0	27.4	19.9	6.3	14.4	9.2	7.5
Direct investment	-56.8	-78.5	-84.3	-80.1	-84.8	-172.2	-165.5
Assets	17.0	16.8	15.0	13.4	17.9	20.0	19.0
Liabilities	73.8	95.3	99.3	93.5	102.7	192.3	184.5
Portfolio investment	212.0	226.2	199.1	180.1	216.8	254.3	268.8
Assets	203.6	218.4	191.8	170.8	208.4	246.6	261.9
Liabilities	-8.4	-7.8	-7.3	-9.2	-8.4	-7.7	-6.9
Financial derivatives	-4.7	-4.3	-4.1	-6.6	-6.0	-5.2	-5.0
Other investment	0.0	-0.3	0.5	-0.1	-0.7	-1.4	-1.2
Assets	-146.7	-147.4	-126.7	-79.6	-106.3	-62.4	-86.8
Liabilities	194.3	236.6	349.7	434.4	363.2	427.0	390.2
Reserves	-341.0	-384.0	-476.4	-514.0	-469.6	-489.4	-477.0
Memorandum items:							
Gross external debt (millions of euros)	17,585	21,119	27,784	32,108	29,845	33,164	33,640
Gross external debt (percent of GDP)	356.1	405.6	498.3	538.4	500.0	525.0	513.1
Net external debt (percent of GDP)	-85.4	-88.4	-85.0	-71.9	-85.8	-166.6	-159.4

Source: Central Bank of Malta

Table 6. Malta: Financial Soundness Indicators, 2009-2012

(Percent, unless otherwise indicated)

	Core domestic banks				Non-core domestic banks				International banks				Total banks			
	2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012	2009	2010	2011	2012
Core FSIs																
Regulatory capital to risk weighted assets	13.5	12.9	13.5	14.3	32.6	29.8	29.4	29.1	34.2	111.8	119.5	102.7	24.2	57.7	57.5	53.3
Regulatory Tier 1 capital to risk-weighted assets	10.1	9.2	9.5	10.3	30.5	27.9	27.7	25.9	31.8	110.2	118.3	102.2	21.3	55.1	54.9	50.9
Non-performing loans net of provisions to capital	42.4	55.9	54.9	56.2	2.5	9.8	9.7	7.4	1.7	0.4	0.1	0.2	12.7	6.6	6.8	7.4
Non-performing loans to total gross loans	6.2	7.4	7.3	8.1	2.4	3.6	4.5	4.1	0.5	0.6	0.5	0.5	2.6	3.0	3.3	3.7
Return on assets	1.6	1.4	1.3	1.6	3.1	1.3	0.6	1.4	1.7	1.1	1.2	1.3	1.8	1.2	1.1	1.3
Return on equity	26.6	22.4	19.6	23.9	14.8	4.3	1.9	6.5	22.6	3.1	3.9	3.6	11.8	5.0	5.1	5.9
Interest margin to gross income	62.4	70.7	72.4	66.8	36.0	63.4	70.4	28.9	45.6	62.0	89.0	124.6	49.8	66.0	79.1	83.2
Non-interest expenses to gross income	48.4	49.7	54.1	45.5	16.5	35.5	45.4	28.4	14.9	8.3	9.2	7.1	26.7	30.1	34.3	27.4
Non-interest income to gross income	37.6	29.3	27.6	33.2	64.0	36.6	29.6	71.1	54.4	38.0	11.0	-24.6	50.2	34.0	20.9	16.8
Liquid assets to total assets	22.3	24.9	24.1	28.8	14.1	10.9	14.7	14.4	8.3	5.8	7.4	9.9	16.5	15.1	16.1	19.7
Liquid assets to short-term liabilities	41.2	42.9	44.1	49.1	129.0	82.9	90.7	82.4	92.4	86.1	112.4	146.3	47.5	47.8	49.6	55.6
Other FSIs																
Coverage ratio (total provisions to NPLs as per BR/09)	21.9	19.8	19.7	22.1	84.3	31.7	36.9	45.8	63.8	76.0	107.7	96.4	31.8	27.7	28.4	29.5
Coverage ratio (total provisions to impaired loans as per IFRS)	32.7	30.6	26.5	32.9	...	...	...	...	...	...	...	...	...	...	...	...
Domestic Investment Securities to Total Assets	11.9	12.3	12.8	12.0	2.8	2.2	2.2	2.9	0.0	0.0	0.0	0.0	4.0	3.5	3.8	3.6
Foreign Investment Securities to Total Assets	13.2	11.9	11.5	10.7	27.0	35.1	36.1	38.3	27.8	28.8	31.5	36.5	23.2	24.8	26.4	29.6
Unsecured Loans to Total Lending	19.6	20.0	19.8	22.4	65.4	54.7	39.5	50.7	39.4	56.0	54.2	57.8	35.2	44.5	40.6	43.5
Assets to Total Capital and Reserves (Ratio)	16.1	15.8	15.5	14.6	3.4	4.1	4.2	4.9	4.2	1.6	1.6	1.5	3.9	1.9	1.9	3.1
Large exposure to capital	143.9	144.9	138.6	122.4	86.3	72.9	130.4	111.0	45.8	6.0	5.4	10.9	76.9	24.1	28.2	31.5
Gross asset position in financial derivatives to capital	1.4	2.2	4.9	3.2	0.2	0.7	1.5	0.5	0.2	0.5	0.4	0.5	0.4	0.6	1.0	0.9
Gross liability position in financial derivatives to capital	5.0	7.9	11.6	10.8	0.3	1.1	2.4	2.7	0.3	0.1	0.1	0.1	1.3	0.9	1.6	1.5
Personnel expenses to non-interest expenses	57.5	55.6	52.4	54.0	32.7	34.5	35.9	39.6	6.3	19.1	20.1	26.7	40.9	48.0	46.2	48.7
Customer deposits to customer loans	135.5	141.7	137.5	142.7	27.3	38.2	55.6	68.8	52.6	81.9	71.9	76.1	79.9	102.6	99.8	106.6
Net open position in equities to capital	14.3	16.1	17.9	17.3	77.0	80.4	78.7	75.4	3.7	0.8	0.9	0.1	17.6	7.1	7.7	7.5

Source: Central Bank of Malta

Appendix I. An Overview of Malta's Resilience During the Crisis¹

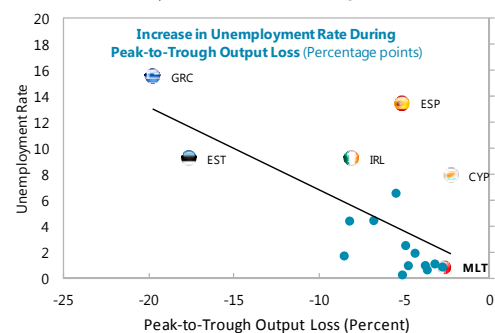
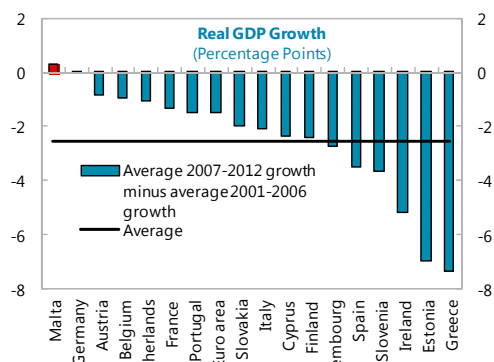
1. **Compared to its euro area peer, Malta has shown remarkable resilience during the financial and the euro area sovereign debt crises.** Average real GDP growth relative to the country's own pre-crisis growth has been the best in Malta, even surpassing Germany, amongst euro area countries.

2. **The increase in the unemployment rate was less drastic in Malta.** The global financial crisis and the subsequent euro area sovereign debt crisis resulted in a sharp spike in the unemployment rate across advanced economies. Compared to the pre-crisis trend, the unemployment rate actually decreased in Malta during the crisis. The fall in real GDP growth was not only lower than in other euro area counterparts, but also resulted in less job loss than in the other countries.

3. **Malta's resilience was underpinned by robust export growth.** The export sector of the European countries was severely hit by the crisis. Malta also had to wither the storm. However, the fall in export growth was less than in most countries due to the strong performance of the tourism sector and niche services like remote gaming and financial services.

4. **Robust real consumption growth also contributed towards the country's resilience.** Real consumption growth, compared to the country's historical performance, has been well above the average performance of its euro area peers, except Germany, Belgium, Luxembourg, and Austria.

5. **Government bond spreads remained contained.** The bond yield in Malta has remained low during the euro area sovereign debt crisis, when the 10 year government bond spreads raised by more than 1000 bps in Portugal and Cyprus, causing severe funding constraints.

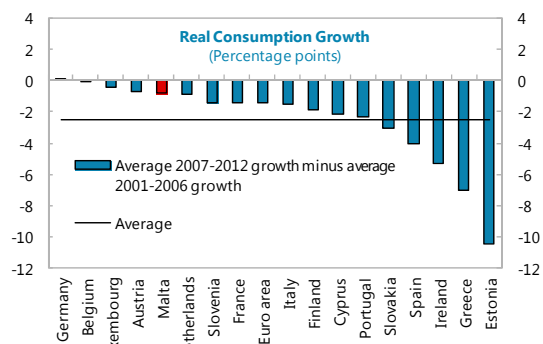


Sources: Eurostat and IMF staff calculations.



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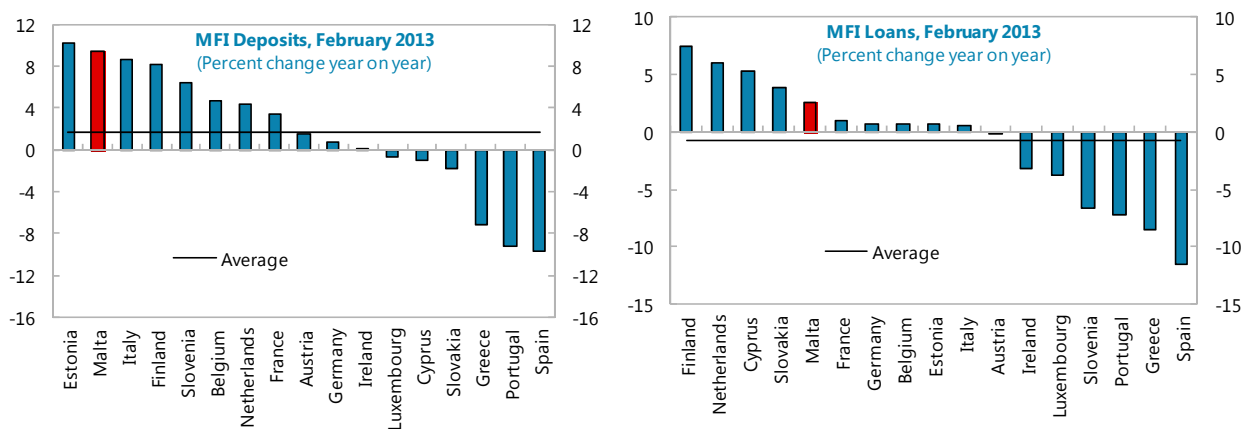
^{1/}2007-2011 used for Greece.



Sources: Eurostat and IMF staff calculations.

¹ Prepared by Swarnali Ahmed (EUR).

6. **Deposit and credit growth was robust.** The performance of the banking sector in Malta remained solid during the crisis and better than the average performance of its euro area peers. Funding and liquidity levels remained robust, with both deposit and loan growth safely above the euro area average.

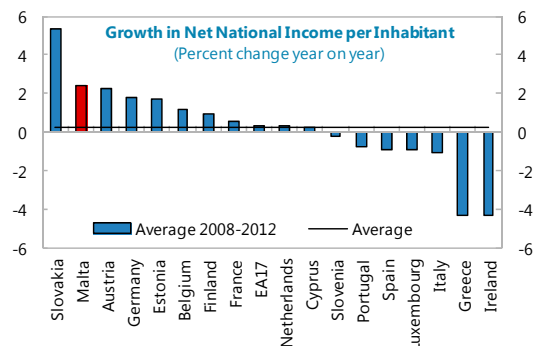


Sources: European Central Bank; and IMF staff estimates.

Factors Contributing to Malta's Resilience

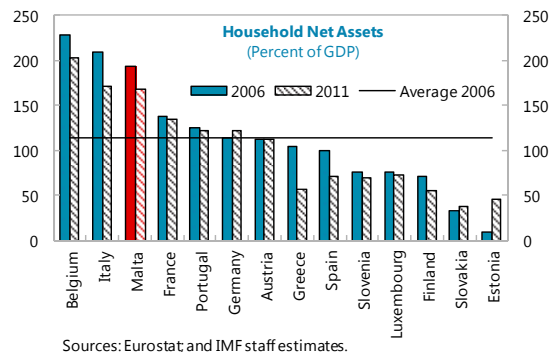
7. **Robust household income, low consumer leverage and robust credit growth contributed towards consumption resilience.** The resilience of the household sector during the crisis can be attributed to five factors:

- Stable household income. Since Malta does not publish data on disposable income, the net national income per capita can be viewed as a proxy. The growth of household income per capita was negative in 2009. However, it rebounded strongly on the back of, amongst other factors, positive developments in the labor market and relatively contained inflation. The expansion in household income in real terms also contributed.
- Stable household loans as a share of GDP. At the onset of the crisis, Malta's household loan as a share of GDP was 52 percent in 2006, lower than Portugal, Ireland and Spain. Hence, unlike a lot of advanced economies, there was no real pressure of deleveraging. Though the total household loan as a share of GDP has increased since then, the interest rate burden on the household remained stable since the household income was rising in line with the growth in debt.



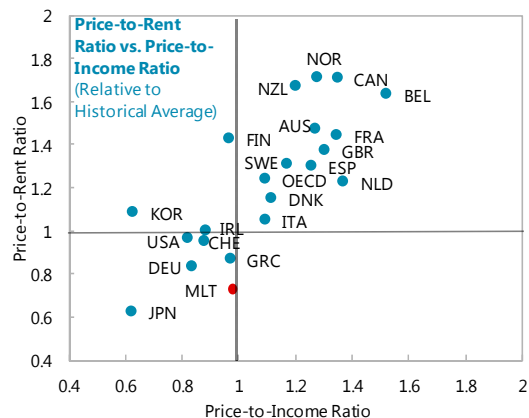
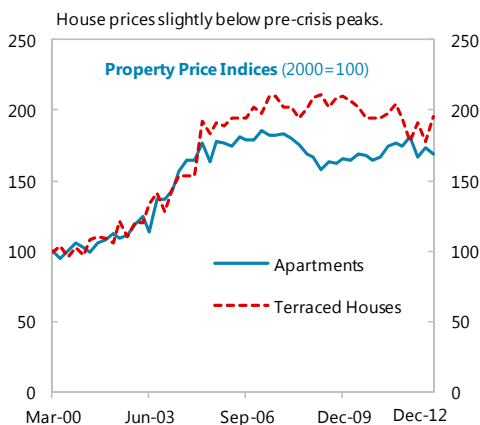
Sources: Eurostat and IMF staff estimates.

- Strong balance sheet. Malta has one of the strongest household balances sheets, with net assets close to 200 percent of GDP in 2006, much higher than the euro area average, and continues to remain strong at close to 170 percent in 2011.
- Robust consumer credit and mortgage growth. The consumer credit growth has been robust with Slovakia being the only country amongst the comparator countries that outperformed Malta during the crisis.

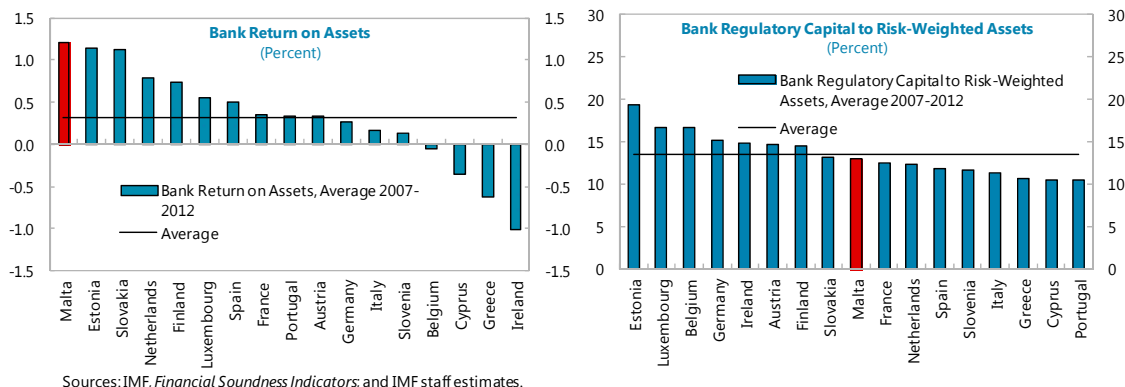


Although consumer loan growth dropped in the negative territory in 2010, it rebounded in 2011 and 2012. A similar resilience is also exhibited by household mortgage loans where Malta’s performance during the crisis is well above the euro area average. The mortgage loan growth in 2009 was also strong when other countries faced headwinds in the mortgage market due to the plunge in their GDP growth.

- The fall in property prices was not drastic. The decline in property prices during the crisis was 8 percent. The loss in household wealth from property was thus moderate. Malta’s house prices are one of the most undervalued amongst the advanced economy countries, indicating there is no potential risk of correction in the property market. Both the price-to-income and price-to-rent ratio remain one of the lowest among the advanced economies.



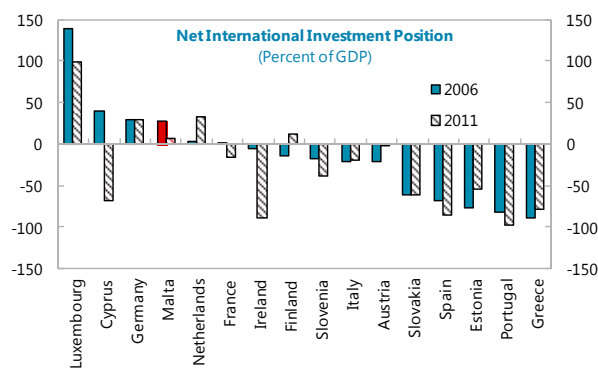
8. Export diversification, in terms of products, has helped Malta maintain robust export growth. In the past years, Malta has very successfully reduced its trade balance and gradually shifted from -6.1 percent of GDP in 2006 to 5.3 percent of GDP in 2011. The positive trade balance has been achieved on the back of export diversification from goods to services, as discussed in Appendix II. The market share in world services trade continues to increase at a rapid pace in Malta, successfully offsetting the decrease in Malta’s share of world goods.



9. **Malta's conservative domestic banking system with less reliance on wholesale funding acted as a cushion during the crisis.** The domestic banking sector in Malta has sound capital and liquidity buffers, low leverage, and follows a conservative funding model (high deposit-to-loan ratio). This has helped Malta's banking sector to outperform its euro area peers, with both banking sector's return on equity and return on assets posting the best profit numbers amongst the euro area countries. This performance was also supported by solid bank capital to assets and bank regulatory capital to risk-weighted assets that were at par with other euro area peers. According to the *Financial Stability Report 2011*, released by the Central Bank of Malta, the core domestic banks had a very limited exposure of 8 percent of total assets to euro area assets. Moreover, those holdings were diverse and exposed to higher rated sovereign states, with 39 percent of the foreign sovereign holdings from France, 18 percent from Germany. The exposure to EU/IMF program countries was 14 percent of the total (Ireland 7 percent, Greece 4.5 percent, and Portugal 2.8 percent).

10. **One of the main reasons for Malta's strong fiscal stand during the crisis, relative to its peers, is the limited foreign exposure of the country's government debt.** This left the government bond prices insulated from the developments of the euro area sovereign crisis. Malta's foreign holding of government debt, at 4 percent in 2012, is by far the smallest amongst advanced economies; and even smaller than that of Japan. Consequently, as discussed in the first section, the government bond spreads remained low.

11. **Malta's strong internal investment position (IIP) acted as a great cushion during the crisis.** Malta had entered the crisis with a strongly positive net international investment position. However, the net foreign asset position of Malta has decreased from 28.1 percent of GDP in 2006 to 7.5 percent of GDP in 2011.



Appendix II. Malta's External Competitiveness¹

1. **Malta's trade balance, driven by increases in services, has improved remarkably since 2004.** This note sheds light into possible avenues for further improvement by comparing Malta's export performance to that of Germany. The comparative exercise shows that, despite less favorable supply factors, Malta has benefited from a strong demand for its exports. The country could improve its export performance by reorienting its exports, both in terms of products and destinations, and by reducing the cost of production.

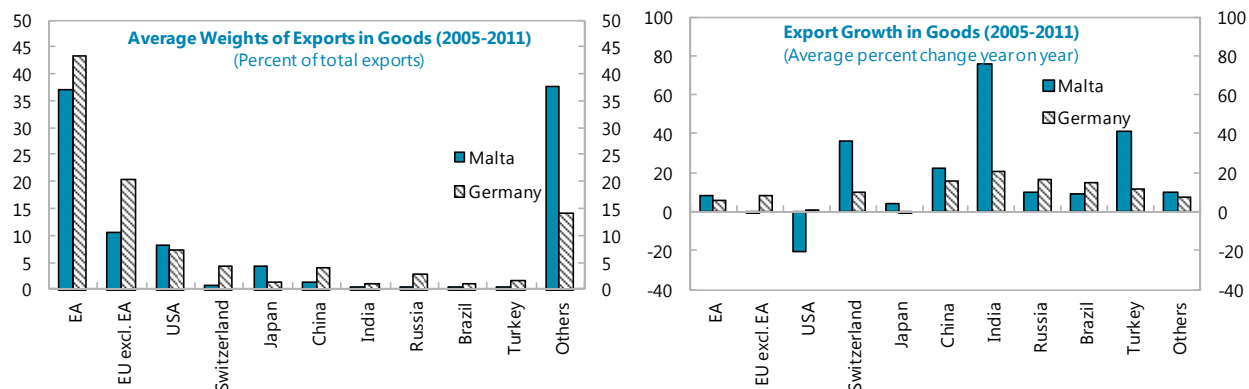
2. **Continued export diversification could preserve and extend Malta's recent competitiveness gains.** Although Malta has done tremendous progress, there is scope for further diversification of exports towards fast growing economies in emerging markets and newer varieties. To shed light into possible avenues for improvement, Malta's export performance is compared to that of Germany's. Germany has been a forerunner in the euro area as a country who has successfully shifted its export base, both in terms of composition of trade and export destinations. Also, Germany is one of the top five contributors of world export services growth, making it a suitable benchmark for services trade as well.

3. **Malta has made tremendous progress in non-price competitiveness, by successfully diversifying its trade (Appendix I).** Malta's external trade performance has improved significantly since 2004. The improvement in the trade balance has been one of the best in the region, only outperformed by Estonia and Latvia, and even better than Germany, Austria, and the Netherlands. The improvement in the trade balance has been driven by increases in services.

Exports of goods

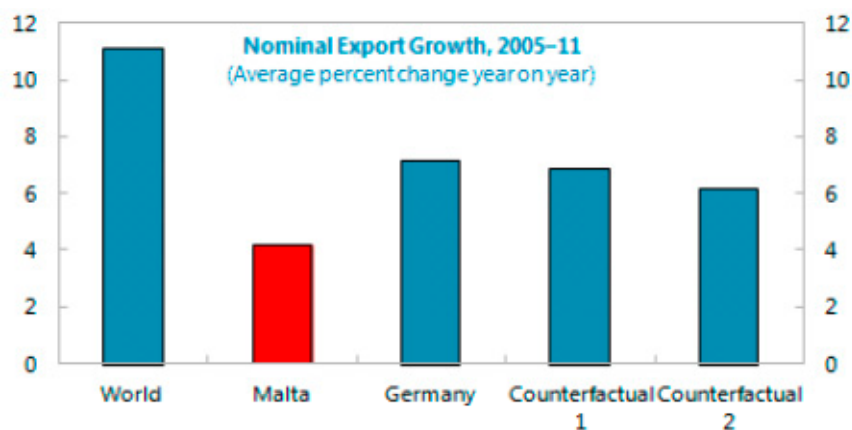
4. **Malta's lower exposure to fast growing economies and its higher cost of producing goods explain Malta's worse trade performance relative to Germany.** Malta's exports of goods grew by an average of 4 percent over 2005–11, compared to 7 percent in Germany. This partly reflects Germany's larger share of exports going to fast growing emerging markets, such as China, India, Russia, Brazil, and Turkey. Furthermore, Germany's goods have also done better in Malta's main destination markets, suggesting that supply factors (e.g. cost of producing goods, productivity) are at play. In other words, Malta's higher wage growth and lower productivity growth, relative to Germany places Malta at a disadvantage in world's export markets. There are two aspects worth highlighting, nevertheless. First, although Malta's trade share to the fast growing emerging markets is smaller than Germany's, Malta's export growth in most of these markets is higher than Germany's, suggesting a large upside potential for Malta in these destinations. Second, Malta's exposure to the euro area seems to be lower than Germany's, which does indicate that Malta has, to some extent, diversified its export partners.

¹ Prepared by Swarnali Ahmed (EUR).



Sources: IMF, *Direction of Trade Statistics*; and IMF staff calculations.

- Counterfactual 1: Malta's export growth of goods, but Germany's destination markets.**
 What would be the export growth in Malta with the same destination markets as Germany? The exercise suggests that Malta's average export growth over the period 2005–2011 would have been 6.9 percent, in par with Germany's 7.1 percent over the same period, and higher than the actual performance of 4.1 percent.
- Counterfactual 2: Malta's destination markets, but Germany's export growth of goods.**
 What would be the export growth in Malta with German goods? The country's growth would then have been 6.2 percent, higher than its realized growth and closer to Germany's overall export growth.

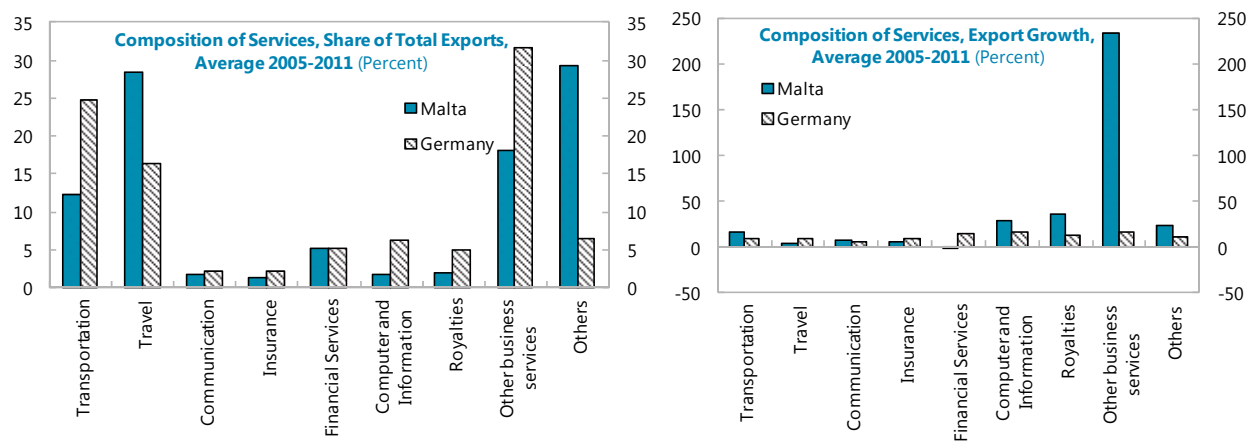


Sources: IMF, *Direction of Trade Statistics*; World Trade Organization; and IMF staff calculations.

Exports of Services

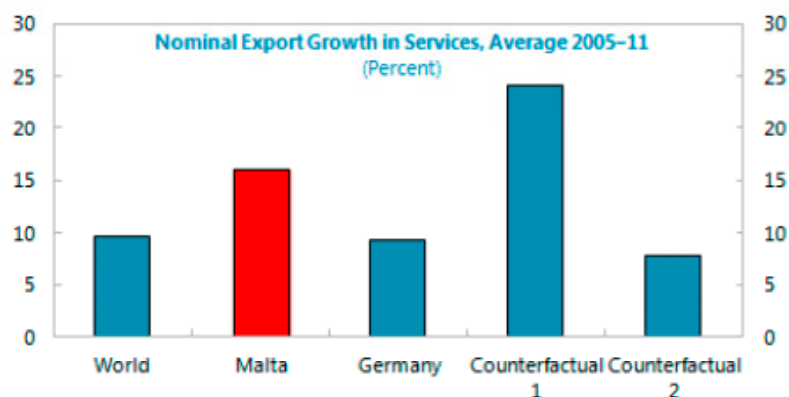
5. **Malta has outperformed Germany in terms of services exports, but could do better by improving its composition.** Malta's growth in the service sector in the period 2005–2011 was 16 percent, compared to 9.3 percent in Germany over the same period. Malta's export base of services is less diversified than Germany's. The highest share of export services in Malta is occupied by the category 'others' which mostly reflects exports of personal, cultural and recreational services, including online gaming. However, compared to Germany, the export growth to almost all the

service components has been higher. The best performers have been computer, information, personal, cultural, recreational and business services.



Sources: World Trade Organization; and IMF staff calculations.

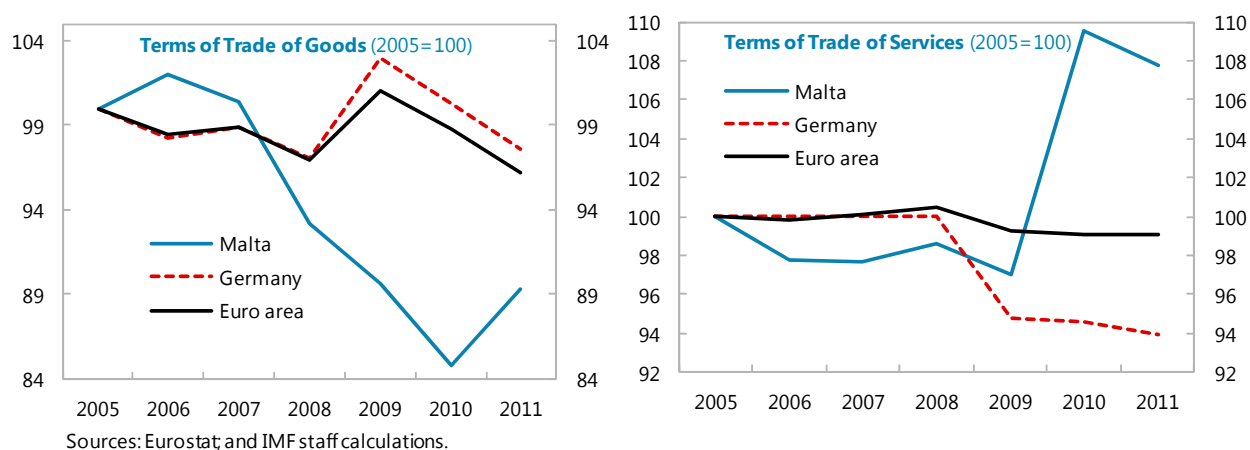
- Counterfactual 1: Malta's growth of services exports, but Germany's composition of services.** What would be the export growth of services in Malta with the same composition of services exports as Germany? Malta's average export growth for the period 2005–11 would have been 24.1 percent, much higher than its 16 percent realized growth.
- Counterfactual 2: Malta's composition of services exports, but Germany's growth of services exports.** What would be the export growth in Malta with German growth rates? Malta's export growth would have been 7.8 percent, lower than Malta's actual number. This suggests that supply factors have weighed in the trade performance of Malta's goods but not of its exports. In other words, Malta's new niches of services exports are relatively competitive. This is consistent with the findings in Appendix VI, which suggests that wage growth in the newer industries has not outpaced productivity growth, as in more traditional sectors.



Sources: IMF, *Direction of Trade Statistics*; World Trade Organization; and IMF staff calculations.

6. **The comparative exercise with Germany suggests that Malta could improve its export growth performance by further reorienting its export, both in terms of products and destinations, and by reducing the cost of the goods it produces.** With the euro area in recession and future domestic demand growth likely to be coming from emerging markets like BRICs and Indonesia, successful geographical diversification is warranted to preserve the continued positive performance in the trade sector. Similarly, diversification toward new types of services could also improve trade performance. However, one has to also acknowledge that, given the size of the economy compared to Germany's and its economic structure, it might be difficult to expand the composition of tradable goods and services. Finally, increased effort to align wage and productivity developments at the sectoral level could reduce the cost of producing Maltese goods and services, increasing their competitiveness in international markets.

7. **Despite less favorable supply factors compared to Germany, Malta has benefited from a strong demand for its exports, particularly services.** Malta's large improvement in the trade balance reflects strong external demand for Maltese services. This is evident from the evolution of the terms of trade in the past years. The overall terms of trade of goods and services has fallen in the past years, but the terms of trade of services has increased remarkably, outperforming Germany and euro area, indicating increase in foreign demand for Malta's service sector. In addition, the real GDP of trading partners has grown in line with that of Germany, and in some years, has outperformed Germany. This has also boosted the country's trade performance. The service sector has not been affected from the relative lag in competitiveness of the supply side due to the strong external demand factor.



Appendix III. International-Oriented Banks¹

- 1. Malta has been an important international banking centre in the past 25 years.** A special offshore regime for banks (and other non-bank institutions) was promoted since the late 1980s. Like in several other European jurisdictions (Cyprus, Ireland, Luxembourg, or Switzerland), the main incentives offered to foreign investors at that time included exemptions from various regulations imposed on onshore banks and a favorable fiscal treatment.
- 2. The separate offshore supervisory framework was eliminated in 2002.** As part of the planned accession into the EU, Malta was required to amend its financial policies to treat local businesses the same as international companies. In the mid-1990s, Malta started abolishing its offshore banking. In 2002, the legal amendments to the Banking Law removed an offshore banking option. Since then, all banks operate under the same regulatory and fiscal frameworks.
- 3. However, Malta maintained a substantial tax incentive for attracting foreign investors in its banking and other businesses.** This was achieved through tax refunds based on the dividends that a local bank distributes to its shareholders. While the headline corporate income tax rate in Malta is 35 percent, the application of a tax refund system positions Malta as the country with one of the lowest effective tax in the EU, which ranges between 0 and 12 percent. The quantum of the tax refund depends on the nature of income and is generally equal to 6/7th of the underlying tax (35 percent), resulting in a 30 percent tax refund of the taxable profits.
- 4. In addition, the EU accession in 2004 and the euro adoption in 2008 boosted international banking and non-bank financial sector activities in Malta.** Several large banking groups from various countries around the world (Australia, Germany, Saudi Arabia, etc) established their presence in Malta since the mid-2000s. The EU and euro area memberships inspired confidence; the former also allowed non-EU investors an easy access to European markets, while the latter facilitated transactions for EU-based investors. The availability of skilled people and the use of English as the official language also contributed to making Malta an attractive place for doing business by the multinational banks.
- 5. As a result, the internationally-active banks have become large compared to the size of the Maltese economy.** As of October 2012, there were 13 non-core domestic banks and 8 international banks, with assets of respectively €5.3 billion (80 percent of GDP) and €33.1 billion (500 percent of GDP). The majority of these banks are subsidiaries of EU banks offering a range of services to non-residents that include trade finance, investment banking, and group funding operations.
- 6. Unlike some other EU countries with a big international financial centre (for example, Cyprus or Ireland), Malta has not experienced any deleveraging pressures in recent years.** As a result, measured by the total bank assets to GDP ratio, Malta now ranks higher than Cyprus or Ireland, and is second only to Luxembourg among all EU countries.

¹ Prepared by Vassili Prokopenko (EUR).

Table 1. Structural Banking Indicators of Selected EU Countries
(June 2012)

	Malta	Cyprus	Ireland	Luxembourg
Number of banks	26	39	31	138
Bank assets (€ bn)	53.6	120.3	1,091.6	787.8
External assets (€ bn)	40.7	61.7	389.6	582.0
External liabilities (€ bn)	30.5	53.1	335.2	428.4
GDP (€ bn)	6.5	18.0	159.0	42.6
Population ('000)	416	862	4,583	525
Number of employees in banks	4,026	12,825	35,612	26,696
Number of bank branches	105	902	1,099	227
GDP per capita (€ '000)	15.7	20.9	34.7	81.2
Bank assets/GDP	819	669	687	1,848
External assets/GDP	622	343	245	1,365
External liabilities/GDP	466	295	211	1,005
Bank employees/Population (in %)	0.97	1.49	0.78	5.08

Sources: Central Bank of Malta, BIS, ECB, Eurostat.

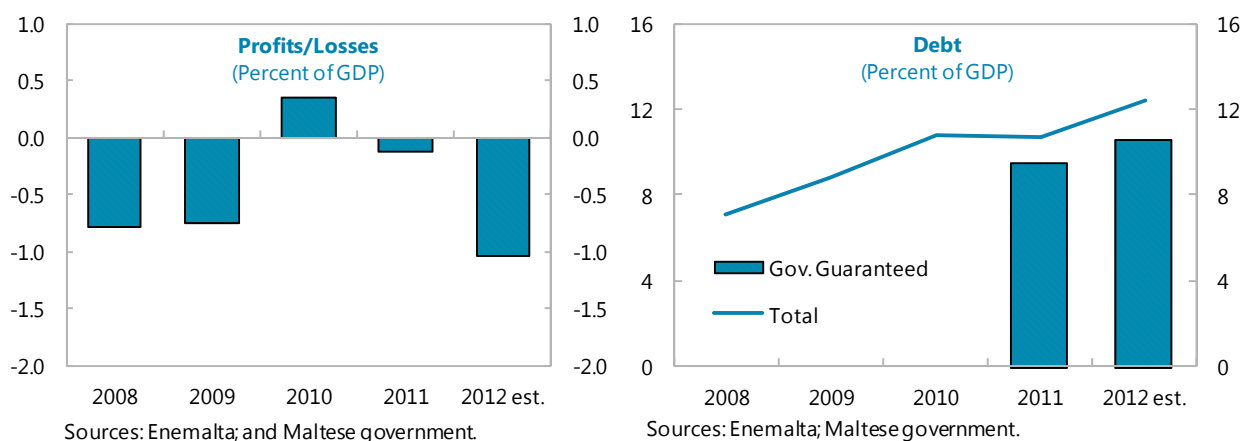
7. **Finally, the AML/CFT regime in Malta remains largely untested, and the rapid growth in financial sector activities calls for further strengthening it.** Most of the right laws and regulations are in place in Malta, and progress in strengthening the AML/CFT regime has been achieved in recent years. The 2012 report of MONEYVAL (the Council of Europe Committee of Experts on the Evaluation of Anti-Money Laundering Measures) notes that the money laundering offences in Malta are broad and fully cover the elements of the Vienna and Palermo Conventions.¹ The legal base for financing of terrorism is also broadly in line with the international standards, and even goes beyond the minimum required by the Terrorist Financing Convention in some areas. However, the framework remains largely untested, and the AML/CFT laws and regulations have not been sufficiently used. As a result, the MONEYVAL concluded that the effectiveness of the system is difficult to assess. Some of the conclusions of the 2012 MONEYVAL Report are:

² The AML/CFT framework in Malta is periodically assessed by MONEYVAL. A comprehensive MONEYVAL assessment of the compliance with the FATF 40 Recommendations and 9 Special Recommendations was conducted in 2007. Since then two progress reports were made to MONEYVAL and a follow up targeted assessment was performed in June 2011 (4th assessment visit) which focused on key and core FATF Recommendations as well as those for which Malta had received non-compliant and partially compliant ratings in the 2007 assessment. The report on the 4th assessment visit was adopted by MONEYVAL in March 2012. The 2007 MONEYVAL Report, the progress reports and the 2012 4th Assessment Report can be found at http://www.coe.int/t/dghl/monitoring/moneyval/Countries/Malta_en.asp

- While the comprehensive reporting obligations are now in place in Malta, the level of reporting of suspicious transactions for both money laundering and terrorism financing remains relatively low.
- The current Maltese legislation provides for broad measures in terms of powers of sanctioning of subject persons for non compliance, but these sanctions have not been sufficiently used, and the financial penalties that have been imposed were not necessarily dissuasive. No sanctions have been imposed on the financial institutions.
- The practice of joint inspections carried out by MFSA and FIAU (the financial intelligence unit of Malta) is a welcome step that has certainly contributed towards strengthening the supervisory regime. However, the number of the on-site visits remains low and not commensurate with the size of the financial market.
- The absence of a national risk assessment to identify the most risky areas for money laundering/terrorist financing gives rise to concerns with regard to the effective implementation of risk based supervisory activity.

Appendix IV. Restructuring Enemalta in the Context of a New Energy Reform Plan¹

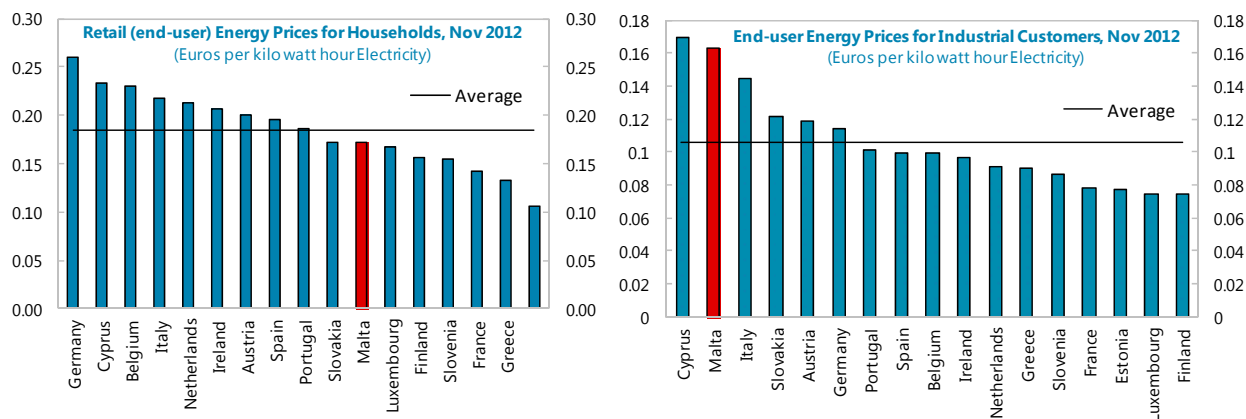
1. **The delicate financial position of the national utility company, Enemalta², has added to Malta's fiscal pressures.** The budget has been providing subsidies to cover the company's losses, and government-guaranteed debt has been rising in line with Enemalta's increasing debt. The company's losses amounted to 70 million euro (1 percent of GDP) in 2012, 36 percent of which were covered by the budget. In turn, Enemalta's total debt in 2012 grew to 836 million euro (12.4 percent of GDP), of which 85 percent is guaranteed by the government.



2. **Enemalta's poor financial performance reflects the company's exposure to oil prices, the lack of timely and cost-reflective adjustments in electricity tariffs, and inefficiency costs.** Enemalta's operations have been consistently loss-making for two reasons. First, the company has had to assume losses ensuing from the increase in international oil prices. About 75 percent of Enemalta's costs are fuel-related and the company is not allowed to pass oil price increases to final consumer tariffs, as electricity prices for industrial customers in Malta are among the highest in Europe. Indeed, to avoid further tariff hikes, the government has been supporting Enemalta through subsidies. This situation reflects the fact that Malta is highly dependent on energy imports. Its energy dependence ratio is 100 percent, which is above the Euro Area average of 68.9 percent. On the other hand, Enemalta also has important inefficiency costs. The technical losses in distribution are estimated at 4.6 percent, and an additional 5.2 percent arises from unbilled electricity in relation to meter deficiencies and theft.

¹ Prepared by Carolina Osorio (EUR).

² Enemalta is the main provider of energy generation and distribution in Malta, and is 100 percent owned by the state.



3. **In December 2012, Parliament approved a plan to restructure the company's debt to ensure payment of outstanding obligations, while avoiding increases in tariffs.**

The restructuring plan involves setting a special purpose vehicle (SPV) - Vault Finance. The SPV is a financing intermediary that would allow Enemalta to reschedule debt repayments by aligning available cash flows from tariff income, and smooth the effects of bullet repayments by transforming loan repayments into a rental expense of about 20 million euro per year. Enemalta has contributed to the asset side of the SPV by selling and leasing-back from the SPV two power stations and other properties. On the the liability side, the utility company initially transferred 243.5 million Euros worth of debt by settling the loan and taking out a new loan, for the same amount, in the name of Vault Finance. A further 75 million worth of debt will be transferred to the SPV in 2015, to settle a loan due, on that date, to its German creditor, Depfa. To sum up, Enemalta's interest payments on the debt transferred to Vault Finance and the depreciation expenditure of the assets sold and leased-back from it are substituted with a rental charge. This rent is meant to cover both principal and interest payments of the SPV's new loan.

4. **Enemalta's debt restructuring is an essential part of a larger energy reform plan, which aims at reducing electricity generation costs, lowering tariffs, and diversifying energy sources.**

The energy agenda of the new government seeks to lower the cost of electricity generation by reducing the dependence on oil and the costs emanating from operational inefficiencies. The government pledged to pass the savings brought about by these measures to the final consumer in the form of lower electricity tariffs. In this context, households' electricity tariffs are expected to be reduced by 25 percent, starting in March 2014. Tariffs charged to industrial customers are expected to be reduced in March 2015. To lower the cost of electricity generation, Enemalta has embarked on several major investment projects that need financing. Some projects will be financed through private public partnerships (PPP), and other investments require funding from European Investment Bank (EIB).

- Enemalta will widen its energy mix through the interconnector to Sicily, which is scheduled to be completed by 2014. Connecting the Maltese electricity grid to the European grid will

allow Malta to secure energy supplies by reducing its dependency on a single fuel and its exposure to fuel price shocks. Further, Malta will benefit from economies of scale of larger plants with more competitive prices, and the increased capacity will allow the old Marsa power station to be phased out. This will reduce the costs associated with the operational inefficiencies.

- The new government is also pursuing various projects to reduce electricity generation costs by shifting towards natural gas power generation and renewable energy sources.
- A new gas-fired power plant will be built and is expected to become fully operational by 2015. This new plant will be configured so as to operate exclusively on natural gas. In turn, the supply of natural gas requires the construction of infrastructure for receiving, storing, and re-gasifying liquefied natural gas.
- The new gas-fired plant and gas supply infrastructure will be financed through public private partnerships (PPP). In April 2013, the government issued an Expressions of Interest and Capability (EoIC) to enter into a power purchase agreement and a gas supply agreement with the private sector. The successful tenderer(s) will build, own, and operate the gas and power plants at Enemalta. Enemalta will lease properties to the private partner(s), and the latter will make an upfront payment to the utility company. Enemalta will use this sum to pay the SPV rent until profitability is restored.
- The liquefied natural gas infrastructure will supply power to Enemalta's old heavy fuel oil power plant, but the latter will eventually be converted to run on natural gas. This project will be undertaken by Enemalta.
- Malta's current renewable energy production is 0.4 percent of its gross final consumption, which is the lowest in the EU and below the targets foreseen for 2012. To meet the EU 2020 target of producing 10 percent of energy through alternative sources, the government has engaged in large wind farm energy projects, but progress has been slow. The uptake of projects such as the installation of photovoltaic power and solar water heaters has exceeded the government targets, but the contribution of these initiatives is small. In response to these challenges, the government will launch a comprehensive renewable energy policy framework by the end of summer 2013.
- The policy framework will include measures to promote the purchase of solar panels and bio-fuel transport, improved management of street lighting, and government support for private investment in renewables.
- Finally, the government has implemented several measures to contain the operational and efficiency losses of the company. To enhance revenue collection and avoid theft, Enemalta has invested in activating a large number of smart meters. Moreover, operational inefficiencies are being addressed through a cost rationalization program. Together, these

measures could improve the company's cash-flow position by around 40 million in 2013, and about 20 million in the following year.

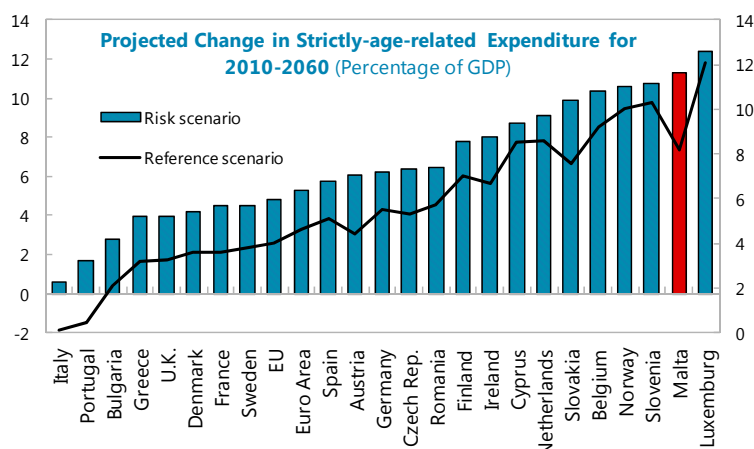
5. **The government's plans to restructure Enemalta's debt, reduce electricity generation costs and diversify energy sources are appropriate.** However, the risks ensuing from these initiatives warrant close monitoring. The government expects Enemalta to breakeven by 2015. To meet its financial obligations, including the SPV rent, during the bridge years, the utility company is expected to rely on government subsidies, operational efficiency savings, energy reduction costs brought about by the Sicily interconnector, and the upfront payment from the PPP private tender. It is crucial that electricity tariffs are only reduced once electricity generation and transmission costs are successfully lowered and the company's financial health is restored. In this regard, the timely completion of the interconnector to Sicily is essential. Furthermore, it is important to make Enemalta's financial reporting more timely and enhance transparency by issuing progress reports on Enemalta's restructuring and the government's energy reform plan. This would contribute to the identification of inefficiencies and vulnerabilities that could put additional strain on the company's financial position and the budget, thus allowing authorities to act promptly.

Appendix V. Pension and Health Care Reform¹

Medium-Term Risks of Ageing-Related Spending

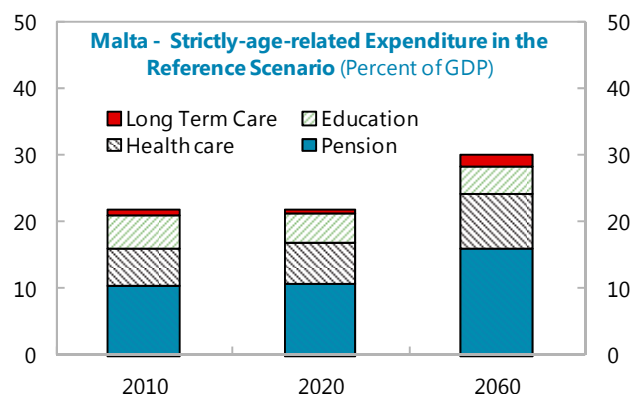
1. The fiscal impact of an ageing population is expected to be significant in Malta.

According to the 2012 Ageing Working Group (AWG)² report, the expected increases in age-related government spending in Malta could pose significant risks to the sustainability of public finances. Under the reference scenario, which focuses on the budgetary impact of demographic developments, strictly-age-related public spending³ will increase by 8.2 percentage points of GDP between 2010 and 2060. In turn, under the risk scenario⁴, Malta will experience the second highest increase in age-related spending within the EU, which will amount to 11.3 percentage points of GDP between 2010 and 2060.



Sources: European Commission; and the Economic Policy Committee.

2. **The main challenge for Malta is to curb the expected increase in public pension and health care spending.** Between 2010 and 2060, public pension expenditure will increase by 5.5 percentage points of GDP, reaching a level 15.9 percent of GDP in 2060. In turn, the share of health care age-related expenditure is expected to reach 8.3 percent of GDP in 2060, up from a level of 5.4 percent of GDP in 2010.



Sources: European Commission; and Economic Policy Committee.

¹ Prepared by Carolina Osorio (EUR)

² The Ageing Working Group (AWG) is commissioned by the European Commission and mandated by the Economic Policy committee, and does not incorporate reforms legislated after December 2011. For countries that have implemented reforms since December 2011, the report estimates are not the latest projections

³ In contrast to total age-related spending, strictly age-related spending excludes unemployment benefits. This is due to the fact that the latter are driven by cyclical factors

⁴ The AWG risk scenario takes into account the impact of non-demographic drivers of health care and long-term care expenditure (such as technological changes and institutional mechanisms). The risk scenario assumes a more dynamic spending growth in the beginning of the projection period in line with past trends for the EU as a whole. This scenario puts more pressure on public budgets.

Pension and Health Care Reform by Authorities

3. **The path for future reforms to the public pension and health care systems is not yet well-defined.** The 2006 reform initiatives to the public pension system started being implemented in 2007. However, some of the legislated changes, most notably the increase in the retirement age, have been slow. What is more, the consultation process following the launch of the 2010 report of the Pensions Working Group, presented a number of recommendations for further reform. But the government has yet to agree on the reform agenda going forward. With respect to the health care system, as far as population coverage is concerned, no changes have been made through legislation. Nevertheless, the benefit packages have been modified in ways that have not contributed to restrain public spending.

4. **The Maltese public pension system consists of a mandatory earnings-related framework, which is financed on pay-as-you-go (PAYG) basis.** The system covers all strata of the Maltese society⁵, and contributions are payable on a weekly basis by all gainfully occupied persons between the age of 16 and the retirement age (employees, self-occupied or self-employed persons).

- **In the early 2000's, basic demographic trends suggested that the system had become unsustainable.** Between 2003 and 2050 the share of the population aged 61 and above is expected to grow, while the share of those aged between 16 and 61 is set to decline. By 2050, each person in the working age population is expected to support 0.8 non-active persons, compared to 0.6 non-active persons in 2003. Further, while in 2003 there were around 4 persons in employment for every retired person; by 2050 this estimate is expected to drop to 2 employed people per retired person⁶.
- **To address these concerns, a pension reform was enacted in 2006.** The main measures are listed in Table 1. In addition to these measures, every 5 years the Ministry of Social Security is committed to prepare a report reviewing the Public Pensions System, upon which further recommendations could be made.
- **From the first of these reports, 45 additional recommendations were issued, thus suggesting that a second reform is warranted.** The recommendations made by the Pensions Working Group in December 2010 are summarized in Table 1. To date, these recommendations have not yet been legislated, and the consultation process following the 2010 strategic review report of the Pensions Working Group continued through 2012.

⁵ The system includes the provision of retirement pensions as well as survivor's benefits and invalidity pensions.

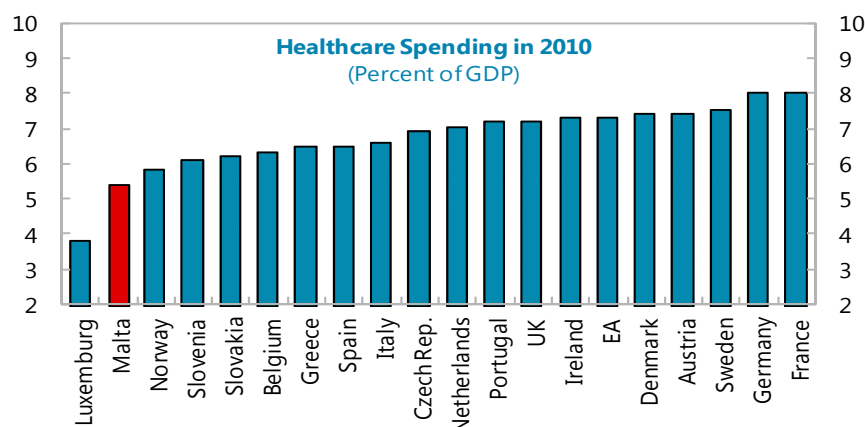
⁶ These estimates correspond to the results reported in the 2007 EC Occasional Papers Series No. 35, pp. 246, http://ec.europa.eu/economy_finance/publications/publication_summary10175_en.htm. The results were based on the World Bank's pension reform options simulation toolkit-PROST, which was run by the Economic Policy Division of the Ministry of Finance.

Table 1. Pension Reform in Malta (Selected Measures)

	2006 Pension Reform		PWG 2010 Recommendations
	Before	After	
Pension Age	61 for males; 60 for females	Gradual increase to 65 for males and females (from 2010 to 2026).	Link pension age to life expectancy
Contribution Years for Full-Pension	30 years	Gradual increase to 40 years	
Pensionable Income	Best 3 out of 10 years for employed; last 10 years for self-employed.	Gradual adjustment to the best 10 years within the last 40 years.	
Minimum Pension	80% of minimum wage for couples; 66% for any other	Minimum pension payable (minimum 60% of national median income)	
Pension Indexation	Pension update on the basis of the COLA and wage increases on previous occupation	70% pension update given by increase national average wage; 30% pension update given by inflation rate	
Others			Mandatory 2nd pillar; Voluntary 3rd pillar; Tax credits for child education

5. **Public health care expenditure in Malta is relatively low compared to other EU countries.** This is partly explained by the fact that Malta has fewer hospital beds and fewer physicians per 100,000 inhabitants than other countries in the European Union¹. Further, the system is highly centralized and operates within a small jurisdiction that is densely populated.

¹ As of 2009, Malta had a similar number of beds per 100,000 inhabitants as Greece, Netherlands and Slovenia. Germany and Austria had a higher number of hospital beds. There have been various efforts, across EU member states to decrease the number of hospital beds, since a lower number of beds is meant to lead to financial and operational efficiency.



Sources: European Commission; and Economic Policy Committee.

- The public health care system is mainly funded through taxation and operates through public hospitals and health care centers.** 65 percent of total health expenditure is financed through general taxation. This is complemented by private financing expenditure (33 percent) and private health insurance (2 percent). The latter is a voluntary system that provides supplementary financing and does not replace mandatory statutory contributions. Public hospitals and health care centers are available to all residents and offer primary, secondary and tertiary health care services free of charge². Primary health care is offered by the public and private systems, although they function independently. Secondary and tertiary care is mainly provided by specialized public hospitals of varying size and function.
- The Government is facing an increasing burden from health care expenditure.** The Maltese are ageing and living longer, and the private health insurance sector is small. Private insurance coverage is becoming more unaffordable due to spiraling health care costs, while public hospital care has been upgraded. Hence, fewer people are seeking private full insurance coverage, and more individuals are shifting to public health care in spite of the insurance cover available.³
- Health care reform in Malta has focused on quality issues, but it has ignored the need to curb public spending.** Under the previous government, there was political controversy regarding the effects that the planned reduction in public current spending could have on the health care sector. The measures that have been implemented include an increase in the number of medicines provided, and the introduction of new services which, previously, were only offered

² Provisions include free medical services at Health Centers and free hospitalization. No user charges or co-payments apply. There are a few services that are provided subject to means testing. These include dental treatment, optical services and certain formulary medicines. Patients are sent overseas for highly specialized care required for rare diseases. The private sector acts as a complementary mechanism for health care coverage, funded by out of pocket payments and private health insurance.

³ This private health insurance rate is estimated at 21 percent of the population, the same as in 2002. Further, only 10 percent of the population benefits from an extensive refund plan. The rest subscribe to policies for very limited refunds. Those covered by basic plans find their policy useful when paying for low-valued medical consultations, but private hospitalization exceeds their benefit limits. In addition, patients with a full refund scheme choose to use public hospitals, as treatment offered there is more intensive and sophisticated.

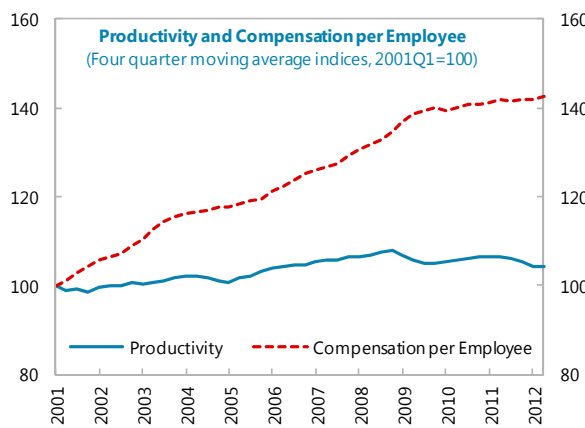
in the UK. Efforts to reform primary health care by giving doctors more access to patient information have been implemented. These measures are expected to improve efficiency and possibly alleviate health care costs, but the benefits are likely to materialize only in the long run.

Staff Assessment and Further Recommendations

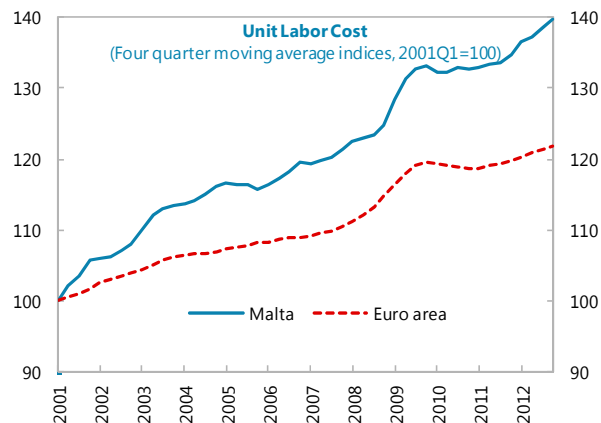
6. **The Malta-2012 IMF Article IV Concluding Statement supported the main recommendations of the Pensions Working Group.** The staff judged that further pension reform would contribute to address the anticipated long term fiscal imbalances ensuing from an ageing population, while supporting medium-term growth. In particular, the staff favored the proposals of indexing retirement age to longevity, accelerating the planned increase in retirement age, and introducing a mandatory privately funded second pillar and voluntary third pillar.
7. **Further recommendations include measures to increase the involvement of the private sector and to encourage labor participation.** In the absence of second or third pillar pension schemes, and given the existence of a number of voluntary long-term savings products, private/funded pensions could complement the PAYG system if accompanied with fiscal incentives for savers. Addressing existing bottlenecks in labor market participation is also important. Some progress has been achieved in retaining older workers in employment, and measures to encourage female labor participation have been implemented. Yet, further efforts are warranted as the female employment rate in Malta remains the lowest in the EU.
8. **The sustainability of the health care system requires measures that increase the role of private health care providers and improve the efficiency of the system.** Since public financing is prevalent, sources of funding other than general taxation should be explored. Public Private Partnerships (PPPs) could be considered for undertaking business operations and care delivery. Further, since the private health insurance market is small, the government could intervene to stimulate and regulate the buying of insurance. The health care market is highly concentrated. Over 95 percent of hospital beds are publicly owned, which implies that there is considerable scope for increasing private sector involvement. This requires the setup of control mechanisms and the provision of proper incentives. Regulatory reform is also necessary to control costs by changing the behavior of practitioners and patients.

Appendix VI. Factors Influencing Wage Determination in Malta¹

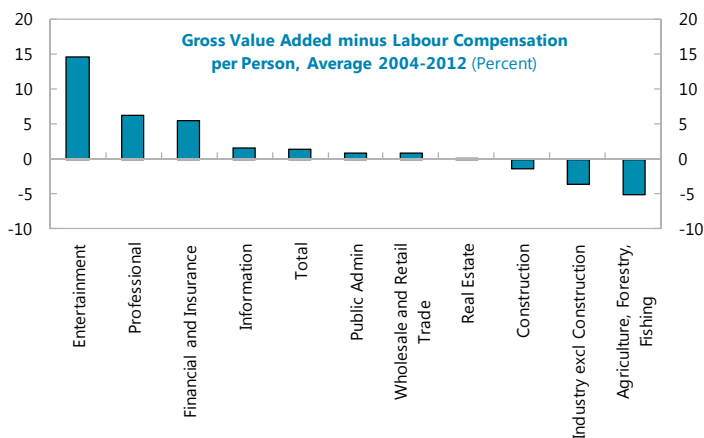
1. The recent crisis has brought to the fore the negative consequences of the misalignment of wage and productivity growth. Wage growth in Malta has surpassed productivity growth resulting in increases in unit labor costs. The current discussion on structural reforms to increase competitiveness and decrease labor cost in the euro area periphery has underscored the need for a better understanding of the determinants of wage growth, and reforms needed in the labor market in Malta. As discussed in Appendix II, Malta has lagged other euro area peers in terms of price competitiveness measures and, despite progress in narrowing differentials, increases in unit labor costs continue to outpace the euro area average. This note discusses possible ways of reforming the wage determination process in Malta so that wage growth is more in tune with productivity growth.



Sources: Eurostat; European Central Bank; and IMF staff calculations.



2. The productivity and compensation gap differs amongst sectors. The lack of sectoral productivity data makes it difficult to identify the sectors where the labor market inefficiency is the highest, in terms of the gap between productivity and wages. We use gross value added as a proxy for productivity and find that the gap is the highest for the agriculture, forestry, and fishing sectors, industry, and construction. On the other hand, the gap is the lowest for arts, entertainment, professional, and financial services.

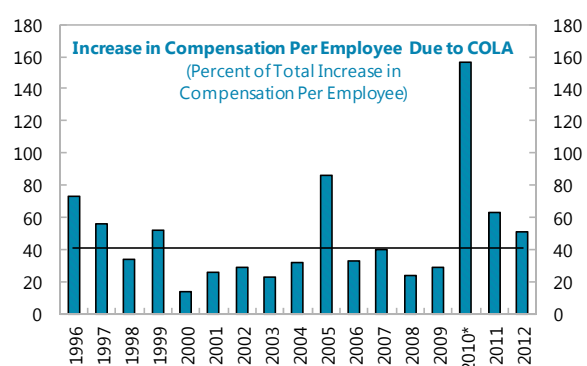


Sources: European Central Bank; and IMF staff calculations.

¹ Prepared by Swarnali Ahmed (EUR)

3. Wage indexation and collective agreements are two key features of Malta's wage determination. In Malta, wages are predominantly regulated by collective agreements at the company level, and a cost of living adjustment (COLA) is imposed by legislation. COLA is added to the pay of all workers based on the average inflation rate of the previous 12 months, as calculated by the Retail Price Index (RPI). Wage indexation is a feature of Malta's labor market, which is present in only three other euro area countries, namely Cyprus, Belgium, and Luxembourg. The idea of wage indexation is to link wages to the living costs with the aim of preserving the real wages, and thereby, the living standard of people. In Belgium, Cyprus and Luxembourg, the cost of adjustment is calculated using the Consumer Price Index (CPI). The wage adjustment is done every year in Malta and Belgium and every six months in Luxembourg and Cyprus. In Luxembourg, the wage indexation is applied only if the CPI rises above 2.5 percent.

4. The misalignment of wage and productivity growth in Malta cannot be entirely attributed to the wage indexation mechanism. One hypothesis for the mismatch between wage growth and productivity is the implementation of wage indexation in Malta. However, it is estimated that COLA has, on average, accounted for about 40 percent of the wage increase during 1996-2012. The remaining increase is attributed to the collective agreements. However, in many cases, COLA is superimposed to the outcome of collective agreement, further compounding the wage rise, instead of being part of the collective agreement. As emphasized by the Governor of Malta in a recent speech¹, rather than imposing it on the collective agreements, the COLA increase due to wage indexation should form part of the negotiation process. This would ensure that the COLA increase is to some extent included in the wage rise due to productivity growth, and make the wage negotiation system more efficient.



Source: Government of Malta; ECB; and IMF staff calculations.

*The total wage increase in 2010 was smaller than the COLA increase. One possible explanation is that the COLA was fully incorporated, but that the result of the negotiations was to lower wages a bit in exchange of labor hoarding.

5. The current wage setting process may be partly responsible for the downward rigidity of wages and inflation during economic slowdowns. Excessive wage increases can trigger risk of inflation spirals—a process when the rise in inflation causes wages to increase, and as a second round response, the rise in wages in turn increase inflation further. Although there is no sign of self-perpetuating inflation spiral in Malta, the inflation differential vis-à-vis the euro area has been high. The growth in compensation of employees, headline and core inflation, relative to their historical averages, in the year after economic slowdown, for the period 2001-2012, was higher in Malta, Belgium, Cyprus and Luxembourg than in other euro area economies (excluding the four countries with wage indexation mechanism). However, the fall in output, relative to historical average, was also lower in these countries than the euro area countries during economic slowdown episodes making it

¹ "Economic growth in turbulent times," Address by Professor Josef Bonnici, Governor, Central Bank of Malta; in Annual Dinner, Institute of Financial Services – Malta, 14 December 2012.

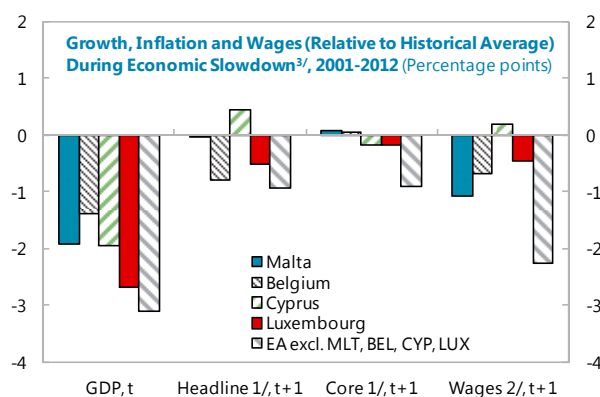
difficult to assess whether the stickiness of wages and inflation can be completely attributable to the wage indexation mechanism.

6. A recent survey commissioned by the Central Bank of Malta also shows evidence of downward wage rigidity. A recent survey² of 161 firms in 2008 revealed that firms usually opt to reduce the cost of production by decreasing non-labor costs during negative economic shocks, rather than decreasing wages. The labor market inflexibility is also exhibited by the fact that firms opt for a freeze in wages as opposed to a cut in wages. Even during periods with high labor supply, firms usually do not lower wages due to the implicit impact on work effort.

7. The combination of wage indexation and collective agreements could result in less job creation. By providing less flexibility in the pay offered by the employers, wage indexation superimposed on the collective agreements can negatively impact employment growth and the efficiency of the labor market. During episodes of economic boom, employment growth of both the current year and the next year, relative to their historical averages, is lower in Malta, Cyprus and Luxembourg than in euro area countries without wage indexation mechanism. While in Malta, this might also be due to varying degree of output changes compared to the euro area (excluding the four countries), employment growth, relative to historic average, is much lower in Luxembourg compared to the euro area (excluding the four countries) despite having similar output changes, relative to the historical averages.

8. Malta's wage setting process could also lead to higher mismatch in the labor market.

The job vacancy rate in Malta is one of the highest in the euro area. Moreover, for a given job vacancy rate, the unemployment rate is one of the highest in the euro area, indicating less efficiency and more mismatch in the labor market. The fact that the unemployment is relatively high during periods of high vacancy rate or high demand for labor suggests that the employers may hesitate in recruiting due to the wage setting mechanism, which results in higher wages and less downward



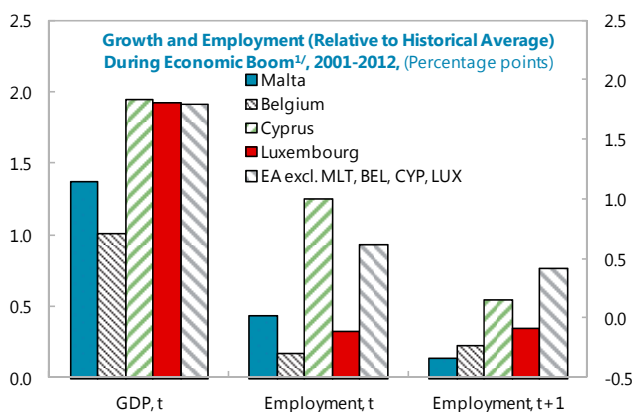
Source: Eurostat; IMF WEO; ECB; and IMF staff calculations.

¹Inflation

²Compensation per Employee

³Economic slowdown are episodes where real GDP growth is below the country's growth average of 2001-12.

Similarly, all the indicators represent their annual growth at period t (or t+1) relative to their average of the period 2001-12; where t represents the year of economic slowdown, and t+1 the next year.



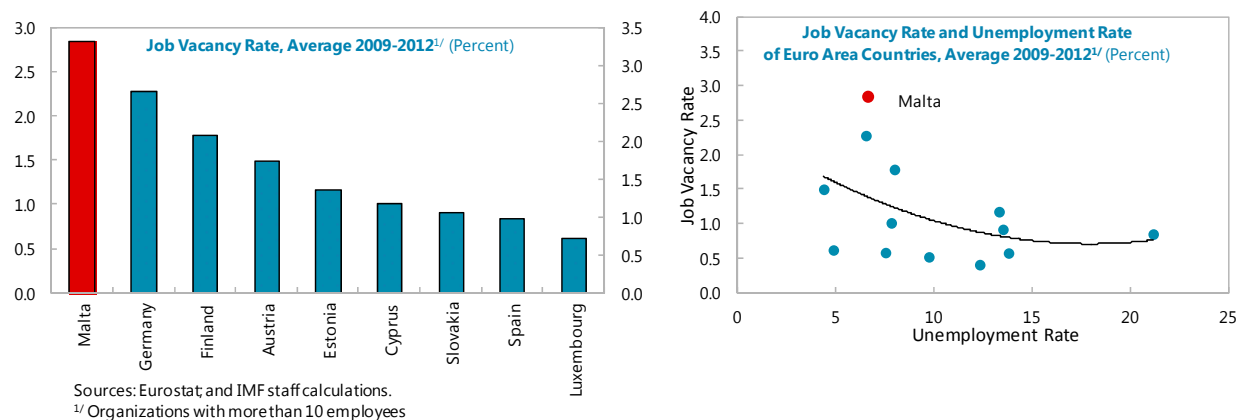
Source: Eurostat; IMF WEO; ECB and IMF staff calculations.

⁴Economic boom are episodes where real GDP growth is above the country's growth average of 2001-12.

Similarly, all the indicators represent their annual growth at period t (or t+1) relative to their average of the period 2001-12; where t represents the year of economic boom, and t+1 the next year.

² "Wage Dynamics Report Malta," commissioned by the Central Bank of Malta and prepared by E-cubed Consultants on behalf of the Malta Chamber of Commerce, Enterprise and Industry.

rigidity in wages during downturn. The moderation of wage indexation and collective agreements could possibly result in the creation of more jobs in the economy, as employers would be encouraged to hire due to the increased flexibility in setting the wages of their employees.



9. The COLA should be part of the negotiation process. The staff condones the Governor's recommendation that the COLA should be part of the negotiation process, rather than imposed on collective agreements by legislation. In that light, it is a positive development that a number of collective agreements already incorporate the COLA increase. This would prevent from compounding the problem of misalignment of productivity and wage growth due to the addition of COLA on the company level collective agreement.

10. Wage negotiations should take productivity at the firm or enterprise level into consideration. The analysis on the gap between sector gross value added and compensation suggests that this gap is not same all across sectors, and wage negotiation needs to take this into account. The authorities should take initiative to produce productivity data on sectoral levels so that the issue of productivity can be discussed during wage negotiation. The wage indexation mechanism could only be implemented to sectors where the compensation is lower than the gross value added by that sector. The other alternative would be to complement the wage determination process in certain sectors with better measures to improve productivity in such sectors. The negotiated wage could be conditional on the improvement of productivity to provide incentives to make the production process more efficient.

11. The wage setting process should not hinder job creation. The fact that Malta has one of the highest vacancy rates in the euro area and the highest unemployment rate for the level of vacancy rate strongly hints that wage setting mechanism possibly has a detrimental impact on the hiring of employees. Measures and initiatives should be taken to make the labor market more flexible, and to give more leeway to the employers in setting the pay of their workers. The supply side factors also need to be improved so that there is a better match between the jobs offered by the employers and the skills offered by the employees.

12. Reforms in wage indexation could help in aligning productivity with wages in Malta.

While the abolishment of wage indexation may not be politically feasible and may also raise social equitable considerations, a gradual moderation in the indexation mechanism could help in making the labor market more efficient and competitive. Some of the possible reforms that the authorities could take are listed below:

- *Scope of coverage:* The wage indexation mechanism could only be applied for wages less than a certain threshold. Such a mechanism would assure the social equitable issues while not making the entire labor market inefficient.
- *Index wages only if inflation is above a threshold level.* Instead of applying wage indexation for all inflation levels, the mechanism could be operated only when the inflation rises above a threshold level. This is practiced in Luxembourg where the wage indexation is implemented when the inflation is above 2.5 percent.
- *Adjust RPI weights more frequently to reflect current standards of living.* The wage indexation in Malta is done using the retail price index as the benchmark of the cost of living adjustment. The RPI measures price changes but does not take into account the manner in which households change their pattern of expenditure. Consequently, newly significant goods are not included in the RPI. According to documents released by Malta's *National Statistics Office*, the weights are updated almost once every decade. The last update was done in 2000–01. To make the wage indexation more relevant, the RPI weights should be adjusted on a more regular basis. This would ensure that the COLA accurately reflects the impact of prices on the living standards of people.

Appendix VII. Debt Sustainability Analysis

1. **The public debt to GDP ratio has been on a rising path since 2007.** The general government debt-to-GDP ratio increased from 60.9 in 2008 to 72.1 in 2012. Besides financing the deficit, since 2010 the Government has also issued debt to fund the loans made to the countries affected by the crisis through the European Financial Stability Facility and the European Stability Mechanism. Under the baseline scenario, the debt-to-GDP ratio is expected to peak in 2015 at a level of 74.5 percent. Under current policies, the primary balance is only expected to turn into surplus in 2016. This will help stabilize debt below 74 percent of GDP by 2018.
2. **The stock of contingent liabilities, largely in the form of government debt guarantees, continued to increase.** Government guaranteed debt amounted to 17.6 percent of GDP in 2012, 6.1 percentage points higher than in 2008. About 60 percent of the guaranteed debt corresponds to Enemalta (the national utility company), which has been facing financial problems for a number of years.
3. **In order to assess the sustainability of debt a number of adverse shocks are considered.**
 - A ½ standard deviation permanent shock to economic growth is expected to place debt on an increasing path, whereby it would reach a level of 84 percent of GDP by 2018.
 - A ½ standard deviation shock to the general government primary balance would stabilize debt at 75 percent of GDP, slightly above the baseline forecast.
 - A one-time shock to contingent liabilities is also assessed, because the latter are sizeable and essential to the dynamics of public debt. The shock is assumed to amount to 10 percentage points of GDP and to be originated in 2014. This shock captures the case where some contingent liabilities are called upon and recorded on the government's balance sheet. Under this scenario, the debt-to-GDP ratio increases sharply to 84 percent, and then remains roughly at that level.
4. The structure of public debt (Figure 2) is predominantly in the form of long-term securities excluding financial derivatives and held by resident credit institutions and households.

Table 1. Malta: Public Sector Debt Sustainability Framework, 2008-2018
(Percent of GDP, unless otherwise indicated)

	Actual					Projections							Debt-stabilizing primary balance 9/
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018		
Baseline: Public sector debt 1/	60.9	66.4	67.4	70.3	72.1	73.7	74.2	74.5	74.2	74.0	73.8	-0.1	
<i>Of which:</i> Foreign-currency denominated	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Change in public sector debt	0.2	5.5	1.0	2.9	1.8	1.5	0.5	0.3	-0.3	-0.2	-0.2		
Identified debt-creating flows (4+7+12)	0.2	3.6	-0.1	0.3	1.3	1.0	0.5	0.5	-0.2	-0.2	-0.2		
Primary deficit	1.5	0.6	0.6	-0.3	0.2	0.3	0.3	0.3	-0.1	-0.1	-0.1		
Revenue and grants	38.6	38.7	38.4	39.3	40.5	41.0	40.8	40.8	40.6	40.6	40.6		
Primary (noninterest) expenditure	40.1	39.3	39.1	39.0	40.7	41.3	41.1	41.1	40.5	40.5	40.5		
Automatic debt dynamics 2/	-0.8	3.0	-0.7	0.6	1.1	0.7	0.2	0.2	-0.1	-0.1	-0.1		
Contribution from interest rate/growth differential 3/	-0.8	3.0	-0.7	0.6	1.1	0.7	0.2	0.2	-0.1	-0.1	-0.1		
<i>Of which:</i> Contribution from real interest rate	1.4	1.4	1.1	1.7	1.6	1.6	1.5	1.6	1.4	1.3	1.2		
<i>Of which:</i> Contribution from real GDP growth	-2.2	1.6	-1.8	-1.1	-0.6	-0.9	-1.3	-1.4	-1.5	-1.4	-1.3		
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...
Other identified debt-creating flows	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Privatization receipts (negative)	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		
Residual, including asset changes (2-3) 5/	0.0	1.8	1.1	2.5	0.6	0.5	0.0	-0.1	-0.1	0.0	0.0		
Public sector debt-to-revenue ratio 1/	157.7	171.7	175.4	178.8	177.9	179.6	182.0	182.8	182.9	182.4	181.8		
Gross financing need 6/	6.2	7.2	6.6	7.2	8.7	13.0	10.7	8.2	9.2	7.7	6.9		
Billions of U.S. dollars	0.2	0.3	0.3	0.3	0.5	0.7	0.6	0.5	0.6	0.5	0.5		
Scenario with key variables at their historical averages 7/	...	...	...	...	...	73.7	75.0	76.2	77.4	78.8	80.2	0.7
Scenario with no policy change (constant primary balance) in 2013-2018	...	...	...	...	...	73.7	74.2	74.5	74.6	74.8	75.0	-0.1
Key Macroeconomic and Fiscal Assumptions Underlying Baseline													
Real GDP growth (percent)	3.9	-2.6	2.9	1.7	0.8	1.3	1.8	2.0	2.1	1.9	1.9		
Average nominal interest rate on public debt (percent) 8/	5.5	5.0	4.7	4.7	4.6	4.6	4.5	4.5	4.5	4.5	4.5		
Average real interest rate (nominal rate minus change in GDP deflator, percent)	2.6	2.2	1.8	2.6	2.4	2.4	2.2	2.3	2.0	1.9	1.8		
Nominal appreciation (increase in US dollar value of local currency, percent)	8.1	-6.7	10.4	0.3	-0.1	...	...	...	...	...	...
Inflation rate (GDP deflator, percent)	3.0	2.8	2.9	2.1	2.2	2.2	2.4	2.2	2.4	2.6	2.7		
Growth of real primary spending (deflated by GDP deflator, percent)	8.1	-4.6	2.3	1.6	5.2	2.8	1.3	1.9	0.7	1.9	1.9		
Primary deficit	1.5	0.6	0.6	-0.3	0.2	0.3	0.3	0.3	-0.1	-0.1	-0.1		

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

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

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

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

5/ For projections, this line includes exchange rate changes.

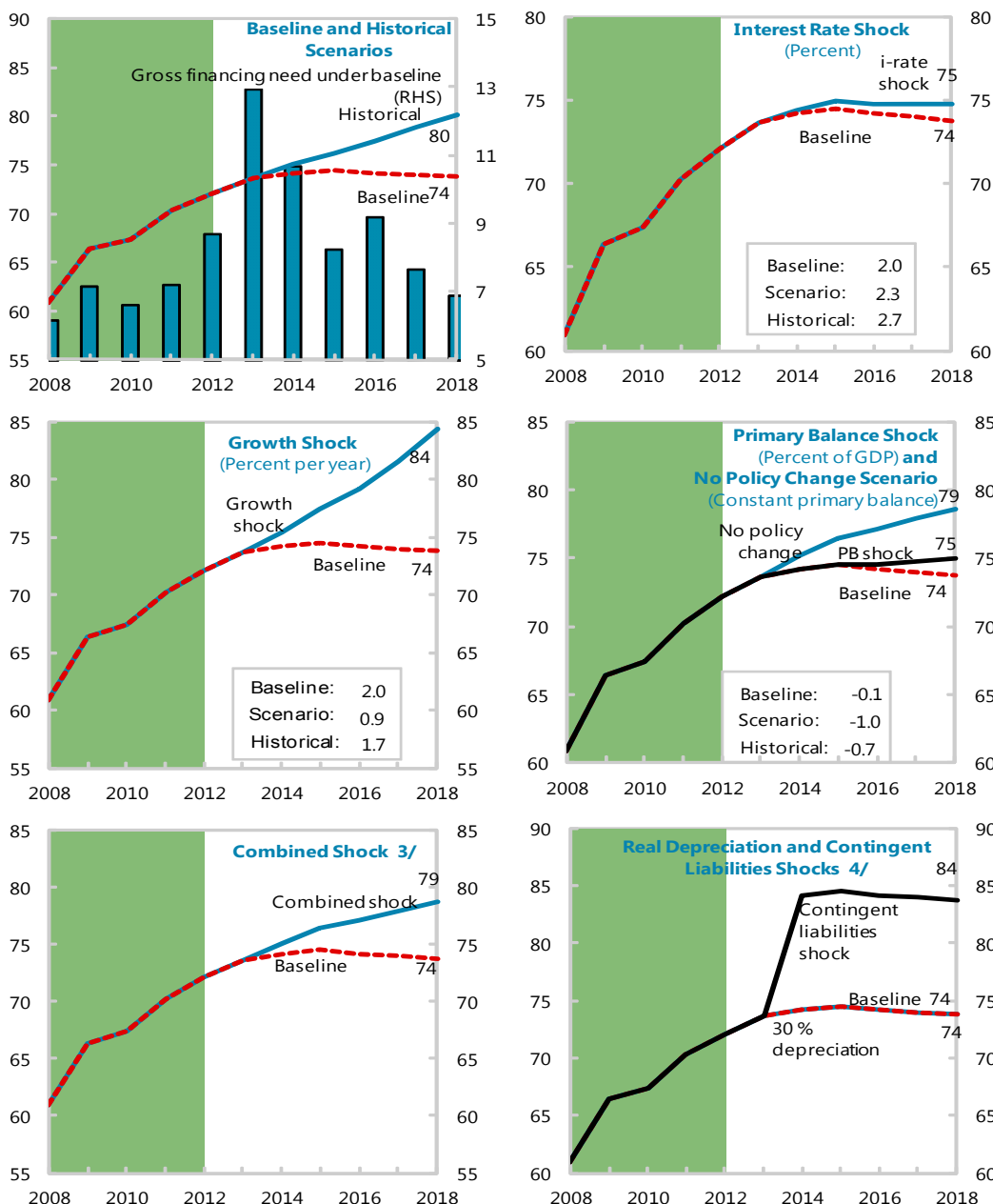
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

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

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

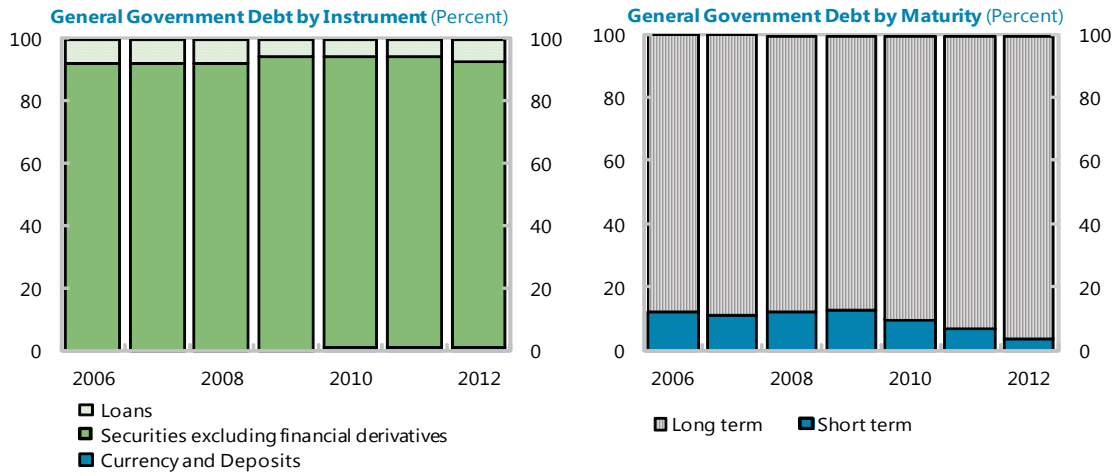
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 1. Malta: Public Debt Sustainability: Bound Tests 1/ 2/
(Percent of GDP)

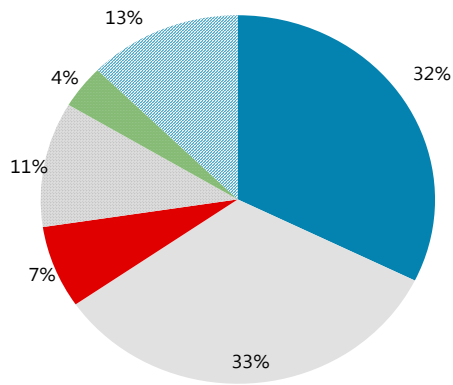


Sources: International Monetary Fund, country desk data, and IMF staff estimates.
 1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
 2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
 3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
 4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2013, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

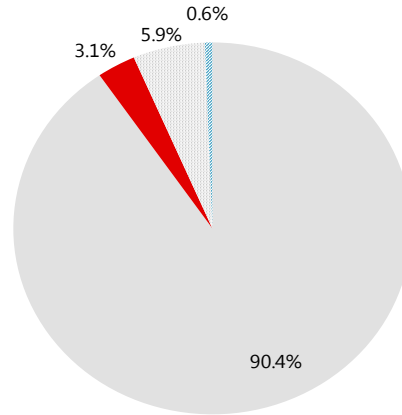
Figure 2. Malta: The Structure of Public Debt



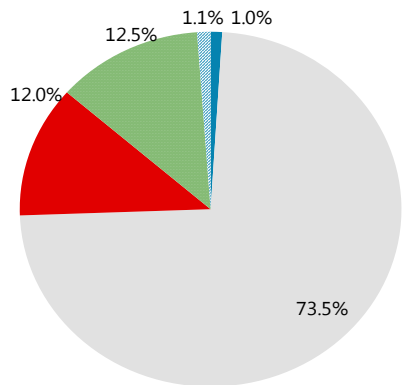
Fixed-Rate MGS by Investor Type, as of 2013Q1 (Percent)



Floating-Rate MGS by Investor Type, as of 2013Q1 (Percent)



Distribution of T-Bills by Investor Type, as of 2013Q1 (Percent)



- Nom. Individuals
- Resident Credit Institutions
- Resident Collective Investment Scheme
- Resident Insurance Company
- Non-Residents
- Others

Sources: Ministry of Finance; and Eurostat.

External Debt Sustainability Analysis

Table 1. Malta: External Debt Sustainability Framework, 2008-2018
(Percent of GDP)

	Actual					Projections						Debt-stabilizing non-interest current account 6/ -3.3	
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018		
Baseline: External debt	-71.9	-85.8	-166.6	-159.4	-176.4	-175.5	-173.2	-170.9	-168.2	-165.5	-163.0		
Change in external debt	-71.9	-13.8	-80.8	7.3	-17.0	0.9	2.3	2.3	2.8	2.6	2.6		
Identified external debt-creating flows (4+8+9)	10.2	5.1	-2.7	11.7	-8.1	0.6	1.1	1.1	1.3	0.8	0.7		
Current account deficit, excluding interest payments	12.6	10.3	9.4	4.8	3.9	3.8	3.5	3.4	3.6	3.6	3.7		
Deficit in balance of goods and services	1.8	2.2	-1.4	-5.1	-6.3	-6.5	-6.8	-6.8	-6.7	-6.7	-6.6		
Exports	91.8	81.8	95.6	100.2	102.4	103.9	105.9	107.5	108.4	109.7	110.8		
Imports	93.6	84.0	94.2	95.0	96.1	97.4	99.1	100.7	101.6	103.0	104.2		
Net non-debt creating capital inflows (negative)	-2.4	0.6	-8.1	-2.0	0.2	-1.1	-1.2	-1.4	-1.5	-1.6	-1.7		
Automatic debt dynamics 1/	0.0	-5.8	-4.0	8.9	-12.2	-2.1	-1.2	-1.0	-0.8	-1.2	-1.3		
Contribution from nominal interest rate	0.0	-1.8	-4.6	-4.7	-4.3	-4.3	-4.3	-4.3	-4.3	-4.3	-4.3		
Contribution from real GDP growth	0.0	-2.0	2.4	2.6	1.4	2.2	3.1	3.3	3.5	3.1	3.0		
Contribution from price and exchange rate changes 2/	0.0	-2.0	-1.8	11.0	-9.3	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 3/	-82.1	-19.0	-78.1	-4.5	-8.9	0.3	1.2	1.2	1.4	1.8	1.9		
External debt-to-exports ratio (in percent)	-78.4	-104.9	-174.2	-159.1	-172.2	-168.9	-163.6	-159.0	-155.2	-150.9	-147.1		
Gross external financing need (in billions of US dollars) 4/ in percent of GDP	12.2 139.0	19.7 236.7	12.9 153.8	8.8 96.8	10.8 124.1	10.6 113.9	12.0 124.9	12.3 123.1	12.6 121.4	12.8 119.1	13.1 117.2		
Scenario with key variables at their historical averages 5/						-175.5	-173.5	-171.2	-169.0	-166.8	-164.7	-7.8	
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation						
Nominal GDP (US dollars)	8.8	8.3	8.4	9.1	8.7			9.3	9.6	10.0	10.3	10.7	11.2
Real GDP growth (in percent)	3.9	-2.6	2.9	1.7	0.8	1.7	2.1	1.3	1.8	2.0	2.1	1.9	1.9
GDP deflator in US dollars (change in percent)	9.8	-2.7	-2.0	7.0	-5.5	5.5	7.7	5.6	1.6	1.5	1.7	1.9	2.0
Nominal external interest rate (in percent)	10.4	2.3	5.5	3.1	2.6	6.0	4.2	2.6	2.5	2.6	2.6	2.6	2.7
Growth of exports (US dollar terms, in percent)	13.7	-15.6	17.9	14.0	-2.6	10.2	12.3	8.5	5.4	5.1	4.7	5.2	5.0
Growth of imports (US dollar terms, in percent)	14.4	-15.0	13.1	9.8	-3.7	9.8	11.8	8.4	5.2	5.2	4.9	5.3	5.1
Current account balance, excluding interest payments	-12.6	-10.3	-9.4	-4.8	-3.9	-10.0	5.0	-3.8	-3.5	-3.4	-3.6	-3.6	-3.7
Net non-debt creating capital inflows	2.4	-0.6	8.1	2.0	-0.2	6.2	5.9	1.1	1.2	1.4	1.5	1.6	1.7

1/ Derived as $[r - g - r(1+g) + ea(1+r)]/(1+g+r+gr)$ times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-r(1+g) + ea(1+r)]/(1+g+r+gr)$ times previous period debt stock. r increases with an appreciating domestic currency ($e > 0$) and rising inflation (based on GDP deflator).

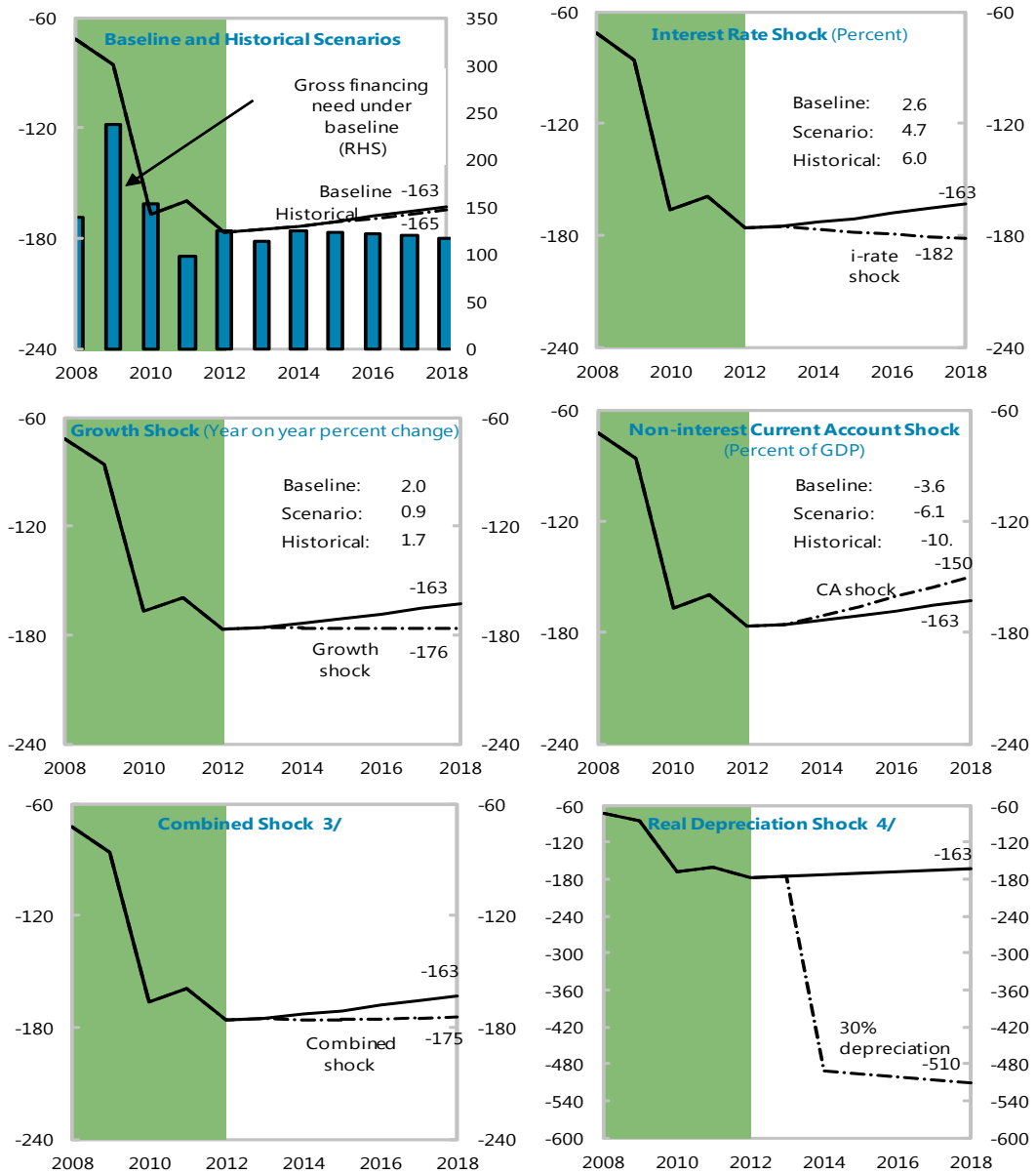
3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 1. Malta: External Debt Sustainability: Bound Tests 1/ 2/
(Percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.
 1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
 2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
 3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
 4/ One-time real depreciation of 30 percent occurs in 2013.



MALTA

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 4, 2013

Prepared By

European Department
(In Consultation with Other Departments)

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FUND RELATIONS

(As of March 31, 2013)

Membership Status

Joined: September 11, 1968; Article VIII

General Resources Account	SDR Million	Percent Quota
Quota	102.00	100.00
Fund holdings of currency	68.81	67.46
Reserve Tranche Position	33.21	32.56
Lending to the Fund		
Borrowing Agreement	15.00	

SDR Department	SDR Million	Percent Allocation
Net cumulative allocation	95.40	100.00
Holdings	89.45	93.76

Outstanding Purchases and Loans

None

Financial Arrangements

None

Projected Obligations to Fund 1/

(SDR million; based on existing use of resources and present holdings of SDRs)

	2013	2014	Forthcoming		
			2015	2016	2017
Principal					
Charges/Interest	0.00	0.01	0.01	0.01	0.01
Total	0.00	0.01	0.01	0.01	0.01

1/ When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section..

Exchange Rate Arrangement

Member of the euro area since January 1, 2008. Malta maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, except for restrictions maintained for security reasons which have been notified to the IMF pursuant to Executive Board Decision No. 144-(52/51).

Article IV Consultation

Malta is on the standard 12-month consultation cycle. The previous consultation discussions took place during January 12-23, 2012. On March 21, 2012, the Executive Board of the IMF concluded the Article IV consultation with Malta on a lapse-of-time basis. The staff report (Country Report No.12/105) was published.

Technical Assistance

Date	Department	Subject
May 2013	STA	Balance of Payments
April 2009	STA	SDDS subscription finalization
November 2006	STA	Producer price index/SDDS preparations (expert visits)
April and December 2007		
June 2005	STA	ROSC Data Module
October 2002–January 2003	MFD	FSAP missions (joint with World Bank)
March 2001	STA	Money and banking statistics
February 1999	MAE	Monetary operations and liquidity Forecasting

Resident Representative

None

STATISTICAL INFORMATION

(As of May 28, 2013)

Data provision is adequate for surveillance purposes. Significant progress in improving macroeconomic statistics has been made in close cooperation with the European Central Bank (ECB) and Eurostat while upgrading statistical systems to meet the euro area standards¹. Most macroeconomic statistics can now be accessed through Eurostat. The country has been a participant in the GDDS since September 11, 2000, with the metadata posted on the IMF's Dissemination Standards Bulletin Board.

Real sector statistics: Data on retail and consumer prices, labor market indicators, and tourism arrivals are released monthly, usually with a short lag. These data are available through Eurostat and via the Internet at the Central Bank of Malta (CBM) and the National Statistical Office (NSO) websites. Presently the NSO releases national accounts data in euros with one quarter lag. However, national accounts data have remained subject to substantial revisions, often affecting several years. The reasons for revisions generally include (i) large statistical discrepancies (captured under stock building), particularly on the first release, (ii) changes in data classification for large shipments of oil exports and imports, and (iii) revisions of deflators. Furthermore, supply-side GDP estimates by type of economic activity are only available at current prices. The producer price index for manufacturing has been published, but that for services sector is still under discussion. National accounts imports and exports data are not disaggregated into goods and services. The harmonized index of consumer prices was first published in May 2004. It is recommended that the Maltese authorities start to compile the financial balance sheets and transactions by sectors, household debt, and saving rate.

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

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

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

Financial Soundness Indicators and submitted indicators as of end-2005 along with metadata, which are now available to the public through the IMF's website (<http://fsi.imf.org>).

External sector statistics: Summary data (merchandise trade, current account balance, and selected financial account data) are released on a quarterly basis with a lag of about three months. More detailed BOP and IIP data are released annually, the latter with a lag sometimes exceeding one year. The balance of payments data are usually subject to large revisions. Summary trade statistics are released monthly with a lag of about 40 days. The CBM also publishes the external debt templates in line with requirements of the SDDS, including both gross and net external debt.

Table 1. Malta: Table of Common Indicators Required for Surveillance
(As of May 28, 2013)

	Date of latest observation	Date received	Frequency of Data 8/	Frequency of Reporting 8/	Frequency of Publication 8/	Memo Items:	
						Data Quality – Methodological soundness 9/	Data Quality – Accuracy and reliability 9/
Exchange Rates 1/	Current	Current	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities 2/	Dec 2012	Apr 2013	Q	Q	Q		
Central Bank Balance Sheet	Dec 2012	Apr 2013	Q	Q	Q	...	...
Consolidated Balance Sheet of the Banking System	Dec 2012	Apr 2013	Q	Q	Q	...	...
Interest Rates 3/	Apr 2013	Apr 2013	M	M	M		
Consumer Price Index	Apr 2013	Apr 2013	M	M	M	O, LO, O, O	O, O, LO, LO, O
Revenue, Expenditure, Balance and Composition of Financing 4/ – General Government 5/	2013:Q1	Apr 2013	Q	Q	Q	O, LO, O, LO	O, O, O, LO, O
Revenue, Expenditure, Balance and Composition of Financing 4/– Central Government	2013:Q1	Apr 2013	Q	Q	Q		
Stocks of General Government and General Government Guaranteed Debt 6/	2013:Q1	Apr 2013	Q	Q	Q		
External Current Account Balance	2012:Q4	Apr 2013	Q	Q	Q	O, LO, O, O	LO, O, O, O, LNO
Exports and Imports of Goods and Services	2012:Q4	Apr 2013	Q	Q	Q		
GDP/GNP	2012:Q4	Apr 2013	Q	Q	Q	O, LNO, O, LO	LO, O, LO, LO, LO
Gross External Debt	2012:Q1	Apr 2013	Q	Q	Q		
International Investment Position 7/	2012:Q4	Apr 2013	A	A	A		

1/ Exchange rate arrangement is free floating.

2/ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

3/ Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

4/ Foreign, domestic bank, and domestic nonbank financing.

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

6/ Including currency and maturity composition.

7/ Includes external gross financial asset and liability positions vis a vis nonresidents.

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

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



Press Release No. 13/254
FOR IMMEDIATE RELEASE
July 12, 2013

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2013 Article IV Consultation with Malta

On June 19, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Malta.¹

Malta has shown remarkable resilience in the face of a major crisis in Europe. Since the beginning of the crisis, the average growth of the Maltese economy has been one of the best in the euro area and the unemployment rate remains one of the lowest. This resilience was underpinned by robust service sector export growth and a sound banking sector. As a result, the current account balance has improved gradually in recent years, turning into surplus in 2012. However, economic growth slowed in 2012 and remains below potential, reflecting a weak external environment and subdued domestic demand. Although activity is expected to pick up moderately going forward, uncertainties abound. A protracted period of slower growth in Europe or re-emergence of euro area financial stress would negatively affect the Maltese economy.

The performance of Maltese banks has been satisfactory, despite turbulence in the euro area. All banks report adequate capitalization, liquidity, and profitability and are well positioned to transition to the Basel III regime. In contrast to many European countries, domestic banks' deposits and credit to the private sector continued to increase in 2012, albeit at a slower pace than in 2010-11. However, these banks are heavily exposed to the local property market and loan loss provisions are low. The large international banking segment and smaller group of non-core domestic banks have limited balance sheet exposures to the Maltese economy, but recent events in Europe have heightened perceptions about risks of hosting a large banking segment in a small country. In response, the authorities have strengthened supervision and monitoring of banks' liquidity positions.

After notable progress in 2011, the fiscal position deteriorated in 2012 amid the election cycle, and the high level of public debt and guaranteed debt constrains the fiscal space in the

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. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

event of further shocks. Against this backdrop, the European Commission has recently decided to initiate the excessive deficit procedure for Malta. The government's deficit target of 2.7 percent of GDP in 2013 appears unattainable in light of expansionary discretionary measures, optimistic revenue targets, and developments so far. The new government is committed to restructure Enemalta, the loss making and highly indebted public utilities corporation, and has embarked on a major energy reform program to reduce energy costs and diversify energy sources.

Executive Board Assessment

Executive Directors commended Malta's resilience through the global and European crises, which has been underpinned by solid macroeconomic and financial fundamentals. Nevertheless, with the growth outlook vulnerable to external and fiscal risks, Directors encouraged the authorities to continue to pursue prudent policies and deepen structural reforms.

Directors noted that the banking system is sound and that risks from its large international bank segment appear contained because of limited balance sheet exposures to the domestic economy. However, they called for stronger efforts to monitor developments in all banks, given the size of the banking sector relative to GDP, some weakening in asset quality, and concentration of loans to the real estate and construction sectors. Directors welcomed the progress in strengthening the regulatory framework for banks and the recent establishment of the Joint Financial Stability Board. They encouraged additional steps to shore up the resilience, including by tightening rules on loan loss provisioning and boosting the funding of deposit insurance. The increasing complexity of Malta's financial sector also warrants further strengthening of the anti-money laundering regime. Looking ahead, Directors encouraged the authorities to participate in Fund's Financial Sector Assessment Program.

Directors underscored the importance of reducing the fiscal deficit this year and achieving a balanced budget over the medium term. In this context, they generally emphasized the need for stronger measures to rein in current expenditure, particularly the wage bill, and to advance pension and health care reforms. Restoring the profitability and viability of public corporations would also help reinforce Malta's fiscal position.

More broadly, Directors agreed that fiscal governance would benefit from a clear rules-based multi-year policy framework that would reinforce the linkage between annual budget laws and the medium-term target. An independent fiscal council would also support the credibility of the government's consolidation plans.

Directors underscored that steady implementation of structural reforms is essential to achieve a higher growth trajectory and enhance competitiveness. Priority should be given to diversifying the economy, improving the business environment, encouraging female participation to the labor force, enhancing education attainment, and strengthening wage-setting mechanisms by better aligning wages with productivity growth. Timely implementation of the energy reform will also be helpful.

Malta: Selected Economic Indicators, 2009-2014

Per Capita GDP (thousands): €16.2
 Quota: 102 million SDR, 67.5% of total
 Economy based on services: Agriculture (2%); industry and construction (18%); trade and communication (22%); financial and real estate (14%); other services (44%).
 Main trade partners: Germany, France, Italy and United Kingdom.

Population (thousands): 416.7
 Tertiary education rate: 21%

	2009	2010	2011	2012	2013 Proj.	2014 Proj.
Real economy (constant prices)	(Percent change year on year)					
Real GDP	-2.6	2.9	1.7	0.8	1.3	1.8
Domestic demand	-2.6	-1.4	-0.9	0.0	1.1	1.5
CPI (harmonized, average)	1.8	2.0	2.5	3.2	2.4	2.0
Unemployment rate (percent)	6.9	6.9	6.5	6.3	6.4	6.3
Public finance	(General government, percent of GDP)					
Overall balance	-3.7	-3.6	-2.8	-3.3	-3.5	-3.5
Primary balance	-0.6	-0.6	0.3	-0.2	-0.3	-0.3
Gross debt	66.4	67.4	70.3	72.1	73.7	74.2
Money and credit	(Percent change year on year)					
Broad money	0.2	5.5	3.3	8.7	...	...
Credit to nonbank private sector 1/	7.6	3.2	4.2	1.8	...	...
Interest rates (year average)	(Percent)					
Interest rate for mortgage purposes	3.5	3.6	3.6	3.6	...	...
Ten-year government bond yield	4.5	4.2	4.5	4.0	3.9	3.8
Balance of payments	(Percent of GDP)					
Current account balance	-8.6	-4.7	-0.2	0.4	0.5	0.8
Trade balance (goods and services)	-2.2	1.4	5.1	6.3	6.5	6.8
Exchange rate						
Exchange rate regime	Joined EMU on January 1, 2008.					
Nominal effective rate (2005=100)	107.1	102.6	103.2	99.4	...	...
Real effective rate, CPI-based (2005=100)	107.1	101.6	101.5	97.4	...	...

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

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

**Statement by Andrea Montanino, Executive Director for Malta and
Antonio Bassanetti, Senior Advisor
June 19, 2013**

The Authorities of Malta thank staff for the useful discussions during the IMF mission and for a broadly fair and objective Report. The assessment points to the strong fundamentals of the Maltese economy. Some challenges emerge, in particular on the fiscal side, but Authorities reiterate their strong commitment to reduce the deficit-to-GDP ratio within the EU limits already in 2013.

Outlook

The Maltese economy proved to be notably resilient since the onset of the global crisis. Authorities broadly agree with staff's outlook projections anticipating an acceleration of GDP in the current and coming years, mostly driven by the strengthening of domestic demand. Exports are foreseen to expand and the current account balance should maintain a positive sign. Inflation is expected to moderate. While taking into account the significant degree of uncertainty surrounding macro projections, we consider risks to GDP forecasts to be broadly balanced.

Fiscal Policy

The fiscal slippage recorded in 2012 was partly attributable to a rather prolonged period of political uncertainty culminating in the rejection of the November 2012 budget and the subsequent call for elections. Such uncertainty was a factor behind the weaker domestic demand, with signs that private consumption was postponed. This deterioration was in contrast with fundamentals – particularly wages and employment growth – further suggesting that such developments were likely to be transitory. This also created cash flow constraints on a number of private operators. As a result revenue, especially from indirect taxes, was significantly weaker than expected. Authorities are convinced that now that the democratic process has taken its due course and a new administration is in place, economic activity will recover in line with fundamentals. Together with a number of structural measures this should influence positively the public finance situation in 2013.

In particular, Authorities remain firmly committed to close the current year with a deficit below the 3 percent threshold. To pursue the goal, several initiatives are being implemented, both on the expenditure and, mostly, on the revenue side.

On the expenditure side, a Spending Review Unit has already been set up within the Ministry of Finance to identify cost savings through the elimination of waste and inefficiencies. Further, the 2006 reform of the pension system is estimated to reduce expenditure and increase revenues from social contributions. The stepping up of the

efforts to curb fiscal abuse and to increase efficiency in revenue collection will also provide a support. This shall be achieved through the acceleration of the process of consolidating the various functions of Government revenue into one authority. The largest part of the fiscal improvement, however, is estimated to reflect a tax revenue buoyancy supported by the favorable composition of growth projections, the stronger economic recovery and the easing of the above mentioned temporary cash flow constraints.

Still, Authorities take note of the more pessimistic deficit projections of both staff and the European Commission, mainly rooted in less favorable revenue developments. However, on June 1, 2013 the Government launched a new Malta residence programme for non-EU nationals, called Global Residence Programme. This scheme could have a positive impact on the revenue side.

Further, in order to ensure the achievement of the target, Authorities will be monitoring the fiscal situation on a month-by-month basis and be ready to intervene when and as required. They are also in the process of implementing the necessary reforms to the fiscal framework, including the introduction of numerical rules, independent fiscal institutions and a binding medium term budgetary framework. Malta has also just ratified the Fiscal Compact.

Finally, as noted by staff, the ongoing restructuring of Air Malta, the structural reforms in the energy sector and the financial restructuring of Enemalta should minimize the risk of a call on the contingent liabilities emanating from these major state-owned enterprises.

Financial Sector

Authorities concur with staff that the risks stemming from the relatively large Maltese banking sector are contained. Core domestic banks, which are systemically important, operate along traditional lines and have limited exposure to the countries which are under pressure. Non-core domestic banks play a more restricted role. International banks, which account for the largest share of the sector, have virtually no links with the domestic economy and are therefore of low systemic significance. As a whole, the structure of the Maltese banking sector is thus much different than those of stressed member States.

Further, as highlighted by the staff's report, the sector is sound and robust. Capital adequacy ratio, profitability, and liquidity measures are higher than the EU average. Malta's household wealth - the third largest in the euro area - contributes to the stability of the retail deposit base. The absence of funding distress is confirmed also by the modest recourse to Eurosystem financing.

Still, Authorities concur with staff that further improvements have to be achieved. In particular, they will continue to call for more prudent dividend policies in order to: i) further increase the banks' capital base; ii) strengthen the Depositor Compensation Scheme; iii) enhance loan loss provisioning. On the latter issue we note that, while loans are mostly backed by real estate as collateral, the level of collateralization in Malta is

very high and a fairly conservative haircut is usually applied. Concentration risk is, to some extent, unavoidable given the small dimension of the country. This notwithstanding, the real estate market proved notably resilient in recent years and currently there are no signs of overvaluation; in addition, as already emphasized, the banks' liquidity position is very good and should shield them from shortages of liquidity.

Authorities remain highly vigilant to preserve financial stability, as proved by the daily monitoring of the liquidity position of banks that have been put in place since the onset of the crisis in Cyprus. They are determined to maintain high supervisory standards. Further, they aim at strengthening and updating the institutional framework: the establishment of the Joint Financial Stability Board (JSB) early this year is a step forward to a closer coordination among financial and monetary Authorities and responds to the European Systemic Risk Board recommendation regarding the macro-prudential mandate at the national level. So far, during its monthly meetings, the JFSB has devoted particular attention to the NPLs issue to verify the possibility to improve on directives. In this context, a revised Banking Rule (BR/09) will be implemented aiming at a more conservative approach to accounting impairment provisioning. The BR/09 encompasses also the implementation of conservative triggers to identify losses as early as possible; moreover it will require institutions to allocate additional capital buffers to address heightened levels of non-performing loans.

An FSAP will be required in due course. It is relevant to note that currently an asset quality review is being planned in association with the Single Supervisory Mechanism which is being set up by the ECB.

As regards the Anti Money Laundering regime, Authorities argue that most of the right laws and regulations are in place in Malta, as noted by staff. Furthermore, the legal framework for preventing terrorism activities is adequate and in line with international standards; Authorities stress that, however, it has never been used because no suspicious activities of terrorism financing have occurred in the country.

Competitiveness and structural reforms

The search for diversification of economic activities and market niches, especially in the service sector, has been a key factor for the resilience of the Maltese economy. The economic attractiveness of the country cannot be attributed just to a favourable tax regime, though this element clearly plays a role given the very small scale of the economy and its scanty endowment of natural resources. Other factors are crucial: the stability of the country, its strategic geographical location, well developed telecommunication infrastructures, relatively low costs of production, and the use of English as an official language also in legislation.

Still, competitiveness needs to be continually strengthened. To this purpose, a national reform agenda has been adopted. In particular, the new Government has set as top priorities: the increase of the participation rate, especially of the female component; higher educational attainments and improved labour force skills; a more efficient energy

production system. The latter, as acknowledged by the staff's report, implies a broad energy reform that will bring first results already in 2014 in terms of diversified sources, with a much reduced dependency on oil, lower costs and tariffs, enhancement of the energy company's financial soundness.

Authorities take note of the staff's suggestion to reform the wage setting mechanisms, in particular its cost-of-living adjustment component. At the same time, they emphasize that, according to a recent in-depth analysis, the current setting does not appear to have resulted in major erosion of competitiveness in Malta and had only a marginal impact on developments in the labour market. Indeed an important factor underpinning these results pertains to the partial indexation feature of the wage setting mechanism as applied in Malta.

As regards pensions, Authorities consider that the gradual increase in retirement age adopted in the 2006 reform remains valid and do not think there is an urgency in further accelerating the process. However they remain vigilant to ensure the long term sustainability of the system. Legislation for a voluntary third pillar of private pensions has already been approved and it will come into force in due time. Further, a Pensions Strategy Group is being set up with the task of reviewing the recommendations outlined by the Pensions Working Group, drawing a holistic strategy aimed at addressing the adequacy and sustainability of pensions.

As concerns health care, Authorities take note of recommendations made by staff and remain firmly committed to continue working on tightening controls on spending. In this context, various internal control mechanisms and the monitoring of operational costs will be introduced. Work is also underway on the setting up of a Health System Performance Assessment Framework that links inputs with outputs and outcomes, to check for the efficient use of resources.

Finally, Authorities are considering the establishment of a Development Bank to meet medium and long-term financing needs, particularly for infrastructural, social and environmental purposes. On this regard, they appreciate the useful suggestions put forward by staff and will take them in due consideration.