INTERNATIONAL MONETARY FUND

IMF Country Report No. 16/20

MALTA

January 2016

2015 ARTICLE IV CONSULTATION—PRESS RELEASE; AND STAFF REPORT

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 2015 Article IV consultation with Malta, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse of time basis, following discussions that ended on November 13, 2015, 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 December 21, 2015.
- An **Informational Annex** prepared by the IMF staff.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

Press Release No. 16/18
FOR IMMEDIATE RELEASE
January 20, 2016

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

IMF Executive Board Concludes 2015 Article IV Consultation with Malta

On January 6, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation[1] with Malta and endorsed the staff appraisal on lapse-of-time basis.[2]

Malta's economy is growing strongly. Real GDP growth has been one of the highest in the euro area since the beginning of the crisis, supported by vibrant domestic demand, large infrastructure projects, and a stable banking sector. Unemployment is at historical lows and labor participation is increasing. The current account remains in surplus and the external position is broadly in line with fundamentals.

The outlook is strong. Growth is expected to remain solid in 2016–17, driven initially by domestic demand and later by a gradual recovery of external demand. Inflation is projected to pick up gradually due to the positive output gap and higher imported inflation on account of the weaker the exchange rate. The current account surplus will likely persist.

The authorities have taken action on multiple fronts. Regarding fiscal policy, an independent fiscal advisory council is now operational. The authorities have been reducing the fiscal deficit and debt, and are making progress on the restructuring of state owned enterprises. As regards the financial sector, regulatory and supervisory frameworks have been strengthened

---

[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.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

in several areas. On structural policies, they took steps to increase labor participation, improve the judicial system and reform the energy sector.

Executive Board Assessment

Malta has remained resilient in the face of global shocks and the economy is growing strongly, helped by policy initiatives. The reliance on domestic funding and the relatively well diversified economy have helped preserve stability. Growth accelerated to 5.1 percent in the first half of 2015 and unemployment is at historic lows.

The outlook is strong and risks are balanced. Growth is expected to remain solid in 2016–17, driven initially by domestic demand and later by a gradual recovery in external demand. Inflation is projected to gradually pick up with the positive output gap and the exchange rate pass-through. The external position remains broadly in line with fundamentals despite high uncertainty driven by volatile components of the current account. While, downside risks include slower global growth, delays in implementation of structural reforms, fiscal slippages, and regulatory and tax changes elsewhere, upside risks stem from increased energy efficiency and further increases in labor participation. The future of migration flows, the majority of which coming from other EU countries, remains uncertain.

Strong migration inflows boost potential output. Large inflows since the early 2000, mostly originating from other EU countries, have offset Malta’s declining working age population and raised potential growth. Refugee inflows have also been significant, but have declined since 2013. The planned agency for refugees should help enhance coordination between institutions to ensure their smooth integration into the labor market and society.

The challenge is to preserve high and stable growth. Given uncertainty regarding the global recovery, volatile migration flows, and ongoing efforts to enhance competitiveness by euro area neighbors, raising potential output in a sustainable manner will depend on i) building fiscal buffers to cope with adverse shocks; ii) maintaining financial sector stability and providing financing for growth; and iii) sustaining structural reforms.

The authorities’ proposed pace of fiscal consolidation for 2016–18 is appropriate. The deficit reduction is continuing, despite rapidly growing current expenditures, supported by revenue measures and stronger-than-expected revenues. The authorities aim to reduce the overall deficit to -0.2 percent of GDP in 2018, but measures beyond 2016 are not well specified at this stage.

Fast growth in current expenditures makes targeted debt reduction challenging, particularly beyond 2016. With the expected growth moderation towards its long-term trend, the fast growth of sticky current expenditures makes the planned consolidation difficult. To ensure meeting the fiscal targets, additional expenditure measures should be considered. In this context, the authorities should ensure that public sector wage negotiations will not result in increases higher than inflation and complete the ongoing and planned spending reviews. With the output gap closed, revenues in excess of targets should primarily be used to build fiscal buffers. Fiscal risks from SoEs should also be disclosed and managed in a consolidated manner.

Pension measures introduced in the 2016 budget are steps in the right direction. These measures aim to address both adequacy and sustainability of the pension system. Given that Malta ranks second worst in the euro area in its age related spending increases, the authorities should ensure that these measures lead to an increase in the effective retirement age and to higher participation in the voluntary third pillar to support disposable income at old age. Efforts to increase the efficiency of health care spending should help support pension reforms.

Ongoing efforts to strengthen fiscal governance and institutions should continue. Continued efforts to strengthen fiscal institutions and the budgetary framework are encouraged to increase efficiency, transparency, and ultimately avoid fiscal slippages. Efforts to link sectoral budget allocations and any new public spending to medium-term plans and outcomes are welcome and will help track the impact of reforms and their medium-term fiscal implications.

The banking system remains resilient. Banks are well capitalized, profitable, and liquid. Solvency and liquidity of core domestic banks and other peer banks remain above the minimum regulatory requirements, and their profitability is above the euro area average. But nonperforming loans (NPLs) and the cost of credit remain high. The increase in the coverage ratio and the national authorities' consideration of using further Pillar II measures to reduce NPLs are welcome, and further increases in coverage ratios as envisaged is appropriate. The completion of the ongoing work on insolvency legislation, aiming to reduce court proceedings time and enhance contract enforcement, should help improve NPL resolution.

Given the large size of the financial sector and ongoing regulatory and supervisory changes, continued policy actions are needed to boost resilience of the banks. Policies should focus on: (i) a swift implementation of bank action plans to ensure a level playing field and sound supervision; (ii) following the transposition of BRRD into national law and the establishment of a separate resolution unit in the MFSA, developing bank recovery plans and collecting of contributions for the resolution fund; (iii) strengthening the contingency framework, including by reducing the share of special contributions to DCS fund, (iv) introducing additional precautionary macroprudential measures, given the rapid increases in mortgages and pick up in real estate prices, and (iv) continuing to coordinate closely and ensure robust implementation of the AML/CFT framework in line with the 2012 FATF standard.
The authorities' request for a Financial Sector Assessment Program Update is very timely, as

the last FSAP was conducted in 2003.

The structural reform priorities, as outlined in the national strategy program, are appropriate, but momentum would need to continue. Raising potential growth requires that measures translate into outcomes. In particular: (i) measures to enhance female participation have been paying off and support the potential growth; (ii) linking measures to achieve the national education strategy goals to budget allocations is welcome; (iii) judicial reforms, including the focus on insolvency regime are welcome but need to be complemented by efforts to track and demonstrate the results, such as conducting an impact assessment, and (iv) ongoing efforts to improve access to credit, such as NPL resolution, judicial reforms, planned credit registry, and multi trading facility by the stock exchange will improve growth financing. The planned development bank (to facilitate SME and infrastructure financing) should be effectively supervised and have strong governance.

Malta: Selected Economic Indicators, 2011–16

(Year-on-year percent change, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016
					Est.	Proj.
Real economy (constant prices)	(Percent change year on year)					
Real GDP	2.1	2.5	2.7	3.6	4.3	3.5
Domestic demand	-2.2	0.1	1.0	5.2	5.3	3.4
CPI (harmonized, average)	2.5	3.2	1.0	0.8	1.5	1.8
Unemployment rate (percent)	6.4	6.3	6.4	5.9	5.5	5.4
Public finance	(General government, percent of GDP)					
Overall balance	-2.6	-3.6	-2.6	-2.1	-1.6	-1.2
Primary balance	0.6	-0.6	0.3	0.8	1.0	1.1
Gross debt	69.8	67.6	69.6	68.3	66.9	66.1
Money and credit	(Percent change year on year)					
Broad money	0.2	9.6	11.0	14.4	...	...
Credit to nonbank private sector 1/	4.2	-1.2	-0.1	4.5	...	...
Interest rates (year average)	(Percent)					
Interest rate for mortgage purposes	3.6	3.6	3.6	3.5	...	...
Ten-year government bond yield	4.5	4.1	3.4	2.6	1.5	1.5
Balance of payments	(Percent of GDP)					
Current account balance	-2.5	1.4	3.2	3.3	1.6	1.7
Trade balance (goods and services)	2.5	4.9	5.7	6.7	5.0	5.1
Exchange rate						
Exchange rate regime	Joined EMU on January 1, 2008.					
Nominal effective rate (2005=100)	100.6	96.8	99.5	100.0	...	...
Real effective rate, CPI-based (2005=100)	99.7	96.5	98.1	97.9	98.0	98.3

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.

MALTA

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

December 21, 2015

KEY ISSUES

Malta has remained resilient in the face of global shocks and the economy is growing strongly. The reliance on domestic funding and the relatively well-diversified economy have helped preserve stability. Boosted by large scale infrastructure investments, low oil prices, a weaker euro, direct income tax cuts, and recent reform efforts, growth accelerated to 5.1 percent in the first half of 2015 and unemployment is at historic lows.

Policies should focus on sustaining high and stable growth in the medium term, which will require pushing ahead with reforms on multiple fronts. Key priorities include:

- **Building fiscal buffers.** The deficit reduction is continuing and the pace of fiscal consolidation for 2016–18 is appropriate, but measures beyond 2016 are not well specified at this stage. With the output gap closed, revenues in excess of targets should be used primarily to build fiscal buffers. It is also important to disclose, and manage risks to public finances from state owned enterprises (SOEs) in a consolidated manner. Pension reform measures in the 2016 budget will make the pension system more sustainable for now, but more measures will likely be necessary to ensure long run sustainability.

- **Maintaining financial sector stability.** Bank regulatory and supervisory frameworks have recently been strengthened. Priorities to preserve financial stability include: i) completing asset quality reviews and the associated action plans; ii) cleaning up bad loans; iii) more progress on contingency planning; and iv) considering additional macroprudential policies. All of this needs to be complemented by better access to credit, especially for SMEs.

- **Raising potential growth.** This requires sustaining structural reforms to increase labor participation, upgrading skill levels and improving the business environment by increasing the efficiency of the judicial system. And energy reforms should ensure reducing energy costs.

Approved By
M. Pradhan and L. Cubeddu

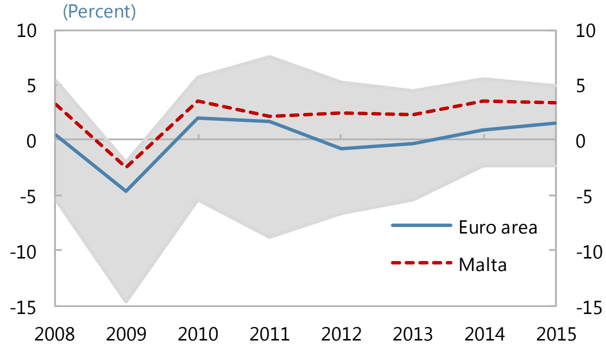
Discussions were held in Valletta during November 2–13, 2015. The staff team comprised P. Berkmen (head), N. Budina, C. Ebeke, F. Grinberg and J. Na (all EUR). D. Smith and D. Santos assisted from headquarters. A. Bassanetti (OED) participated in discussions.

CONTENTS

CONTEXT AND OUTLOOK

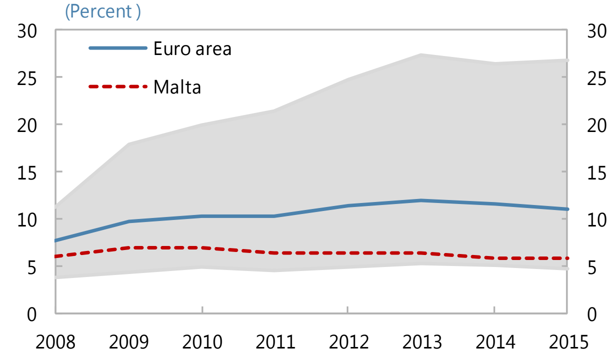
1. **Malta has remained resilient in the face of global shocks.** Despite its high degree of openness to trade (about 300 percent of GDP) and presence of international banks (about 333 percent of GDP), Malta has been insulated from global financial market turmoil because of its reliance on domestic funding and its relatively well diversified economy. The government has used this opportunity to enact timely reforms— on energy, labor markets, the judicial system— and fiscal consolidation. These efforts along with low oil prices and a weaker euro have supported growth and employment.

Annual Growth Rate 1/
(Percent)



Source: IMF, *World Economic Outlook.*
1/ Shaded area represents maximum and minimum.

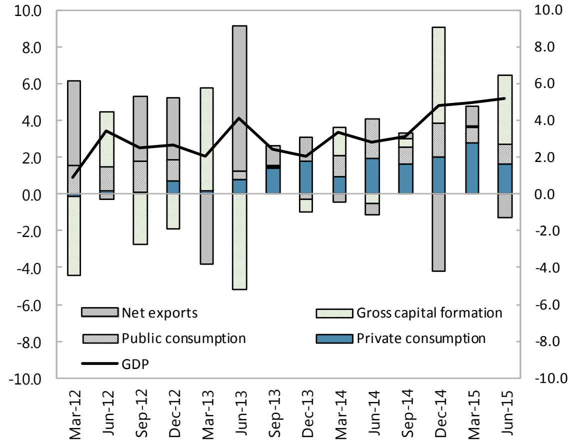
Unemployment Rate 1/
(Percent)



Source: IMF, *World Economic Outlook.*
1/ Shaded area represents maximum and minimum.

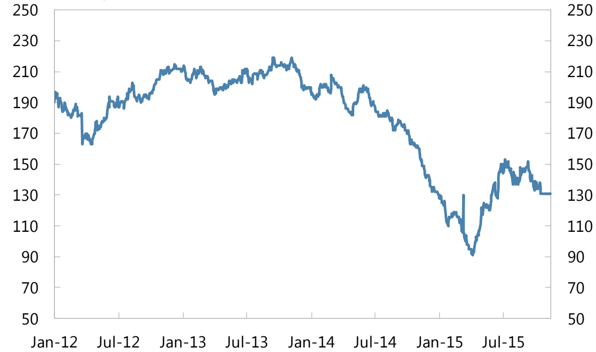
2. **Vibrant domestic demand supports the economy.** Large scale infrastructure investments, strong labor market conditions, as evidenced by low unemployment, low oil prices, a weaker euro, direct income tax cuts, and recent reform efforts support investment and consumption. As a result, growth accelerated to 5.1 percent during the first half of 2015, from 3.6 percent in 2014. A weaker euro has provided support for exchange rate sensitive sectors, but the contribution of exports to growth remained weak, as large financial flows and special purpose entities have been blurring the underlying export dynamics. The current account remained positive at 3 ¼ percent in 2014. While the output gap has closed and is at a positive territory, inflation remains moderate (1¼ percent), partly due to low oil prices and electricity tariff cuts. The ECB's QE has reduced term spreads, helping to support financial conditions.

Malta: Contributions to GDP Growth
(Percent, year-on-year)



Source: National authorities.

Malta: Term-Spread 10 Year 3 Year
(Basis points)



Source: Bloomberg.

3. The outlook is strong.

- **Growth,** driven initially by domestic demand and later by a gradual recovery in external demand, is projected to remain robust at 4¼ and 3½ percent in 2015 and 16, respectively, thanks to energy related infrastructure projects, increasing female labor force participation, low oil prices, and a reduction in income taxes.[1] The ECB's asset purchase program has supported exports through a weaker euro, lowered borrowing costs for the government, and likely contributed to the recent increase in real estate and equity prices. With low yields, corporate bond financing has also picked up. Over the medium-term potential output is estimated at about 3 percent, higher than the euro area and Malta's historical average (Selected Issues (SIP), Chapter I), supported by higher female labor participation, strong migration flows, mostly from the EU, and improved energy efficiency.[2]

- **Strong net migration inflows boost potential output** (SIP, Chapter I). Malta has experienced large inflows since the early 2000s. These inflows, the majority of which originate from other EU countries, have offset Malta's declining working age population and raised potential growth, though their future remains uncertain (Box 1). Refugee inflows have also been significant, but have declined since 2013. The planned agency for

[1] Energy sector projects include construction of a regasification plant and conversion of the Delimara power plant to natural gas. The interconnector to Sicily was completed and is currently in use. Personal income tax of 29 percent applicable to those who earn sixty thousand euro or less was reduced to 25 percent in 2015. The 2016 budget includes an additional measure, entailing raising tax-exemption thresholds for low income earners that did not benefit from the 2015 reduction in the top income tax rate.

[2] Projections for potential output assume an increase of labor force participation of about 6 percentage points by 2020, from its 2014 level and a population growth of 0.1 percent. Recent favorable trends in female participation and migration flows are built in the baseline projections, with high net migration flows, in particular from EU, offsetting the impact of aging population. Furthermore, estimates assume a slightly higher contribution of capital, compared to post-crisis period, to account for the impact of energy projects on investment and slightly higher productivity growth, resulting from improved energy efficiency.

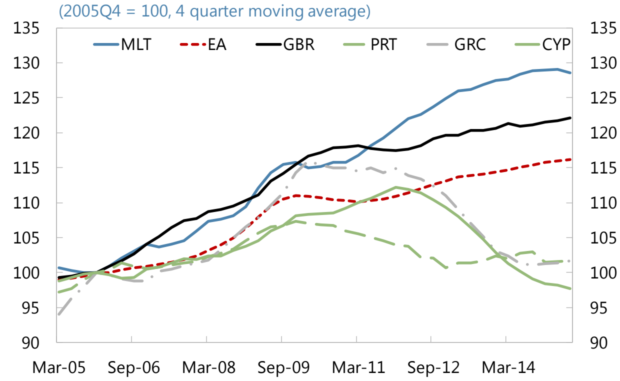
refugees should help enhance coordination between institutions to ensure smooth integration of refugees into the labor market and society.

- **Inflation** is projected to gradually pick up, at a faster rate than the euro area. Upward pressures, including from the positive output gap and strong labor market conditions, and the exchange rate pass-through are expected to be dampened by the pass-through of lower global oil prices and low euro area inflation (Table 1).

- **The current account** is expected to remain in surplus, and the external position is broadly in line with fundamentals. While large energy related projects should reduce the current account surplus in the near-term, it should gradually improve on the back of reduced oil import bill and the recovery in exports of goods and services as global demand picks up. (Table 3). *Unit labor costs* have recently moderated, offsetting partly the faster acceleration compared to the euro area. Overall, the external position remains broadly in line with fundamentals despite high uncertainty driven by volatile components of the current account (Annex III).

Unit Labor Costs

(2005Q4 = 100, 4 quarter moving average)



Source: Haver.

4. Risks to the outlook are balanced (Risk Assessment Matrix). In the medium-term, downside risks—of weaker global growth, a gradual loss of competitiveness due to continued increase in unit labor costs, slow progress in structural and judicial reforms and regulatory and tax changes elsewhere—are balanced with the upside risk of increased energy efficiency and higher labor force participation. Fiscal slippages beyond 2016 and a rise in public debt could also lead to higher financing costs, crowding out private investment. Risks from financial market contagion in the euro area appear relatively limited, given that international banks do not have direct linkages to the domestic economy and core domestic banks fund themselves domestically (Box 3). There is also uncertainty around future net migration inflows, the majority of which emanates from other EU countries.

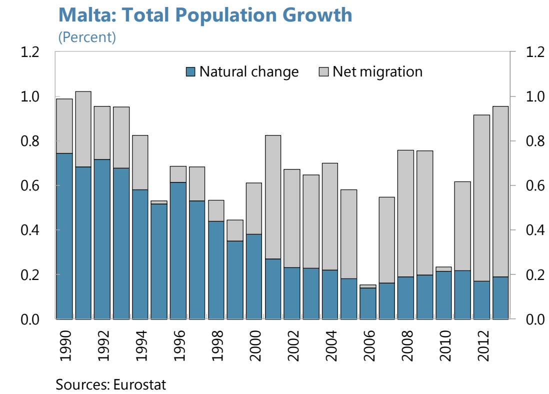
5. Contagion risks from adverse developments in Greece appear low, given limited direct trade and financial links. Like all euro area members, Malta is exposed to Greece through euro area institutions, such as the ECB, the European Financial Stability Facility, and the European Investment Bank (about 2.2 percent of GDP). A Greek subsidiary reduced its balance sheet rapidly in 2015Q1 (from 17 percent of GDP to 9 percent of GDP) with limited impact on the rest of the financial sector—its claims on the deposit guarantee scheme are fully funded (about 0.9 percent of GDP).

Authorities' views

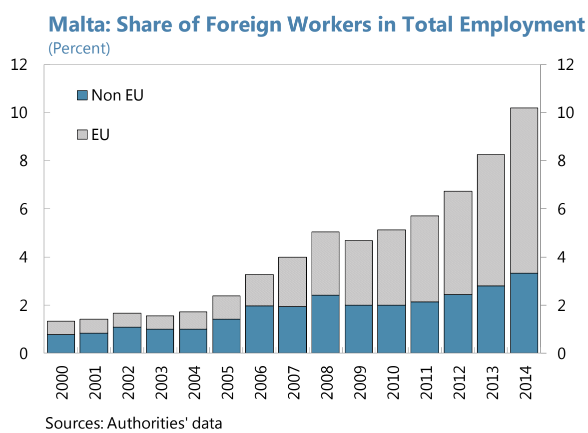
The authorities broadly agreed with staff on the outlook and balance of risks. They noted that upside risks stem from faster than expected acceleration in domestic demand (through higher private consumption and inventories), while downside risks stem largely from weaker global growth, given substantial trade and financial links. The authorities viewed the domestic-dominated investor base as a mitigating factor in case of renewed turmoil in international financial markets.

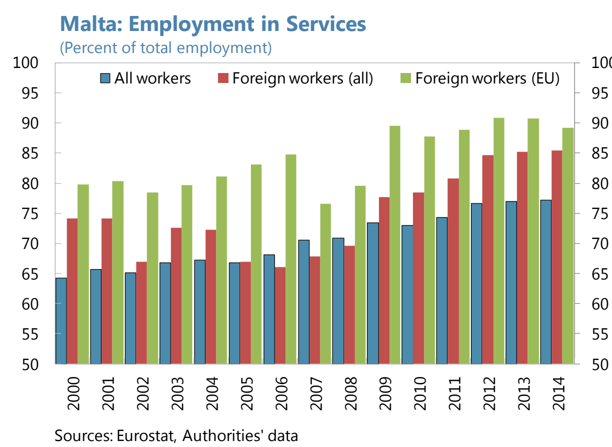
Box 1. Migration in Malta

Malta has received large net migration inflows in the last 15 years. Except for 2008 and 2011, migration has had a larger contribution than demographics to population change, explaining more than 65 percent of population growth since 2000. Absent these inflows, the working age population would have shrunk slightly, instead of rising by 3 percent since 2004. [1] Migrant inflows comprise two groups: skilled workers -mostly from EU- and asylum seekers – mostly from Sub Saharan Africa and the Middle East.



Skilled workers from the EU are the dominant migrant group, employed mostly in service sectors. Since the EU accession in 2004, the share of EU migrants increased from 1 to more than 6 percent of total employment. The main reasons for this increase are high demand for skilled labor, a relatively flexible domestic labor market, and the use of English language. Foreign workers –and EU nationals in particular- tend to concentrate in services, with most of them working in administrative and professional activities, tourism and health sectors. During the last four years, annual average migrant inflows (2800) have nearly doubled compared to the annual average over the last 10 years (1600). The future of these inflows is uncertain, though in part, this surge is a result of structural changes in the Maltese economy.

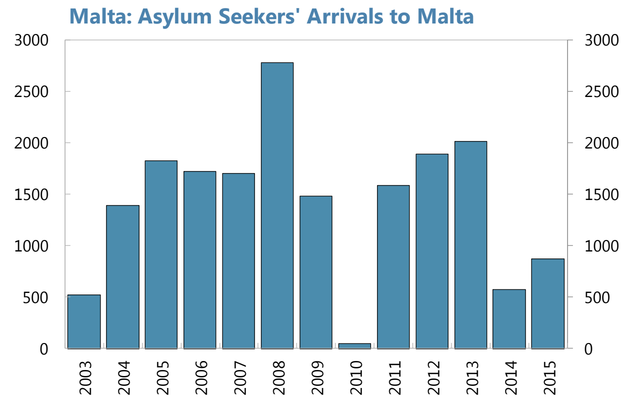




[1] See Grech, Aaron G. (2015), "Understanding the Macroeconomic Impact of Migration in Malta" Central Bank of Malta, Policy Note.

Box 1. Migration in Malta (Concluded)

Malta has also been one of the EU's largest asylum seeker receivers in per capita terms, but these have declined since 2013. Malta has received thousands of asylum seekers in almost every year since the early 2000s. At their height in 2008, Malta received 2,775 arrivals, mainly form Sub-Saharan Africa. Since 2013, these inflows declined as asylum seekers diverted to Eastern routes due to the turmoil in Northern Africa and as Italy became even more active in absorbing the boats crossing the Mediterranean sea. The outflows of refugees to the EU have been significant, as they tend to see Malta as an entry point to the EU.



Source: UNCHR

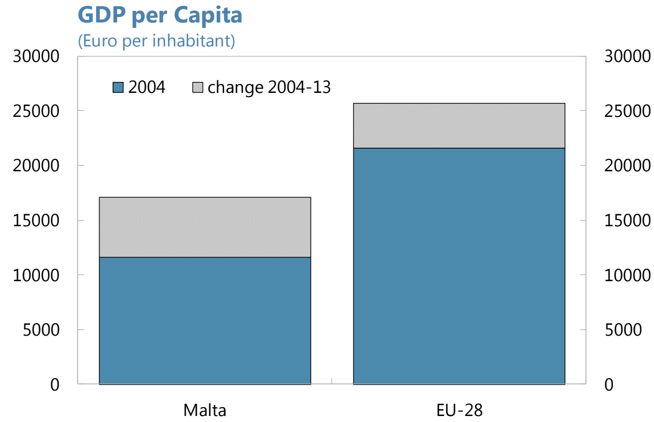
Refugees' labor market integration is ensured de jure but not de facto. When granted refugee status, they are entitled to fully access the labor market. However, they face many obstacles, including language barriers and limited skills, and have seasonal employment opportunities. While a number of policy measures aim to address these issues, enhancing coordination can help as well. The 2016 Budget included the creation of an agency for refugees. This should help enhance coordination between institutions to ensure smooth integration of refugees into the labor market and the society.

The fiscal impact of asylum seekers in Malta is small. Currently about 1000 refugees live in open centers and the authorities estimate the associated costs per refugee of about €10000.[2] This represents a total fiscal cost of less than 0.2 percent of GDP per year, well within the range of estimates provided in the literature (+/-1 percent of GDP, see Hinte and Zimmermann, 2014). Moreover, the reduction in the stock of refugees resulting from resettlement agreements with third countries and/or their migration to other EU countries, took some pressure off the provision of public services.

[2]Note that this estimate does not include the provision of health, education, and social protection.

POLICY AGENDA

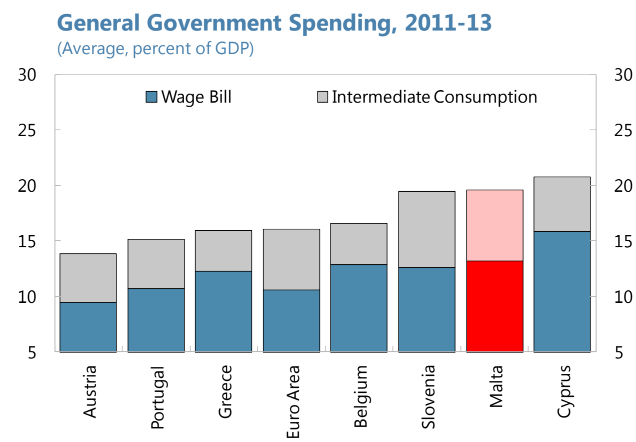
6. The challenge for Malta is to preserve high and stable growth and to close the income gap with the rest of the euro area. Given uncertainty regarding the global recovery, volatile migration flows, and ongoing efforts to enhance competitiveness by euro area neighbors, raising potential output in a sustainable manner will require building fiscal buffers to cope with adverse shocks, maintaining financial sector stability, and sustaining structural reforms.



Source: Eurostat.

A. Fiscal Sustainability

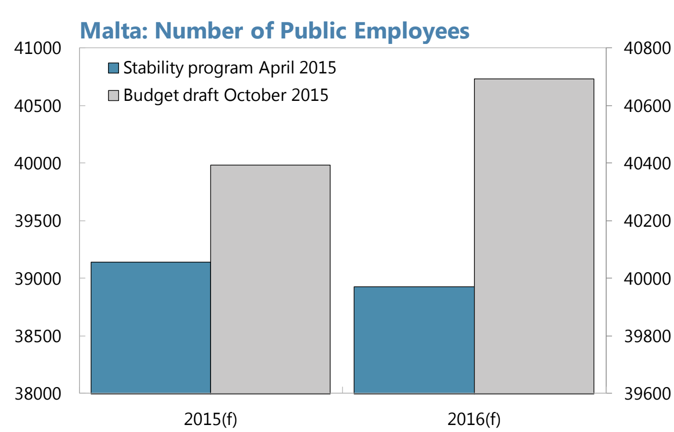
7. Malta has made significant progress with deficit reduction and strengthening fiscal governance. Stronger than expected growth and policy measures helped lower the overall fiscal deficit to 2.1 percent in 2014 from 3.6 percent in 2012 in line with 2014 Article IV advice (Annex I). As a result, public debt declined to 68.3 percent in 2014, after peaking in 2013. At the same time, a medium-term budgeting framework was introduced and an independent fiscal advisory council was established in 2014. The council continues to build its capacity and has produced its first set of reports, increasing fiscal transparency.



Source: Eurostat.

Staff's views

8. The authorities' proposed pace of fiscal consolidation for 2016–18 is appropriate. Deficit reduction is continuing and this year's deficit target is likely to be met, because of revenue measures and stronger than expected revenues, even though current spending is growing rapidly. The authorities plan to continue the process of gradual deficit reduction, aiming to reduce the overall deficit to -0.2 percent in 2018. The proposed targets continue to be appropriate, striking a balance between reducing debt and raising medium-term growth, but measures beyond 2016 are not well specified at this stage.



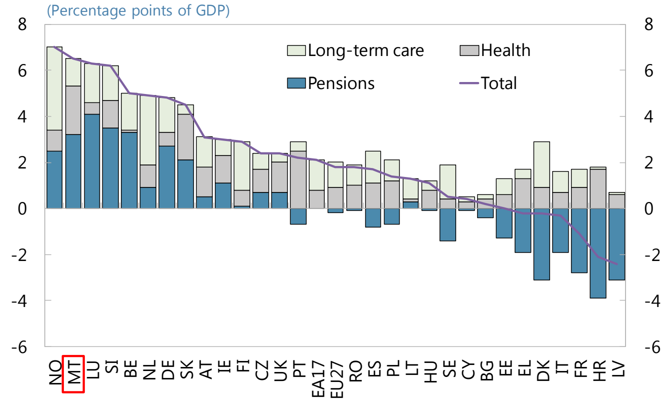
Sources: Malta's MoF

9. Fast growth in current spending makes targeted debt reduction challenging, particularly beyond 2016. Current expenditures rose from 38.3 percent of GDP in 2012 to 39.1 percent of GDP in 2014 (Table 2). With the expected moderation of growth towards its long-term trend, the fast growth of sticky current expenditures makes the planned consolidation difficult. Rapidly increasing compensation of employees and additional unplanned subsidies to various state-owned enterprises present key risks in the near-term. Given possible slippages in the wage bill and lack of specific measures beyond 2016, staff project a slower pace of consolidation than the authorities. In staff's baseline scenario, debt is projected to decline to around 62.1 percent of GDP by 2018, mainly driven by high nominal GDP growth (as opposed to targeted 61 percent by 2018).[3] Stress test scenarios indicate low growth, low inflation, and contingent liabilities—stemming from state owned enterprises (SOEs) and the large banking sector—are the key risks for debt sustainability (Annex II). Refinancing risks are mitigated by the long average maturity of debt (8.6 years) and small share of non-resident holdings (around 8 percent).

10. Additional expenditure measures should be considered to ensure that the proposed fiscal targets are met. In this context, public sector negotiation of collective agreements should be done within the framework of planned fiscal consolidation and should not result in increases higher than inflation. With the output gap closed, revenues in excess of targets (because of either higher than expected growth or windfalls from quantitative easing) should primarily be used to build fiscal buffers. In line with the 2014 article IV recommendations, the spending review on social security helped contain expenditure growth. Similarly, the ongoing spending review of health care and planned spending review of education should help contain expenditures (Annex I).

11. Pension measures, included in the 2016 budget, are steps in the right direction.[4] These include reforms to delay exits from the labor market, incentivize savings and increase the value of minimum pensions for the most vulnerable (Box 2 and SIP, Chapter 2). Pension measures will benefit from periodic reassessments (such as the proposal to review the system every 5 years) to better take into accounts adverse developments, including from unexpected behavioral, demographic and macroeconomic changes. Given that Malta ranks second worst in the euro area in its age related spending increases, further consideration could be

Change in Age Related Spending, 2013-60
(Percentage points of GDP)



Source: European Commission *The 2015 Ageing Report.*

[3] Revenues and expenditures are expected to decline in percent of GDP in 2016, owing to lower EU structural funds and associated capital spending related to the completion of the programming period, and the base effect from the 2015 capital injection in AirMalta.

[4] Earlier policy actions include increasing the retirement age gradually to 65 by 2027 and introducing voluntary third pillar pensions. For a description of earlier reforms please see 2013 AIV Staff Report, Appendix 5.

given to: i) ensuring that contributory years reflect life expectancy in the next assessment; ii) linking pensionable income to life time incomes with a fair valorization to ensure equity across groups; iii) ensuring that incentives lead indeed to an increase in the effective retirement age; and iv) avoiding indexation to wages (Annex I). Ongoing efforts to increase the efficiency of health care spending—such as increasing the administrative efficiency and strengthening the primary care—should help contain age related spending growth and support pension reforms.

Box 2. Pension Reform Measures

The Pension Strategy Group (PSG) has recently proposed a set of recommendations to achieve economic and social sustainability of the system (SIP, Chapter 2).

The authorities have included some key PSG proposals in the 2016 budget to address pension adequacy and sustainability concerns.

- Adequacy measures include the following: (i) An increase in the minimum pension to 140 euros per week for persons with a full contributory period— while a pro rata will be given to persons who do not meet the criteria; (ii) Credits to persons contributing towards the state pension for child bearing and post-graduate studies; and (iii) A planned equity release program and incentives for participation in the voluntary third pillar to support disposable income at old age.
- Sustainability measures: (i) The increase in the contributory period from 40 to 41 years for persons born after 1968; (ii) Incentives for private sector workers to continue working via the topping up of their pension for every year of work post-retirement age. The 2016 budget also enables people who opt to work longer past-retirement age, to do so in agreement with their employer.

12. The authorities should continue to monitor the implementation of restructuring of SOEs. While SOEs provide essential public services, their guaranteed debt amounts to about 14.4 percent of GDP. The partial privatization of Enemalta (the utility company) improved the company's financial position and reduced its arrears to the government. As part of the restructuring of the company, interconnector to Italy has been completed, and two power plants are expected to be operational by end-2016. Cost reductions from these investments should be monitored carefully, as the electricity tariffs were already reduced in 2014 and 2015, before the full efficiency gains could be realized. Airmalta is struggling with competitiveness issues despite the ongoing restructuring plan, involving capacity reduction and selling non-core assets.[5] The public transport service was privatized in January 2015, following an earlier failed privatization, with annual subsidy commitments of $^{1}/_{3}$ of a percent of GDP for 2015 and 2016. It is important to disclose, analyze, and manage fiscal risks from SoEs in a consolidated manner.

Authorities' views

13. The authorities acknowledged the risks to building fiscal buffers, but were confident that deficit targets will be met. They stressed the improved fiscal framework and the reliance on conservative macroeconomic assumptions which all together will reduce risks from

[5] The restructuring plan started in March 2011 with the aim of breaking even by March 2014. The company still makes losses, and is currently projecting to break even by March 2017. With their 2015 budget, a new 3-year plan has been introduced. The government's capital injections amount to 0.7 percent of GDP.

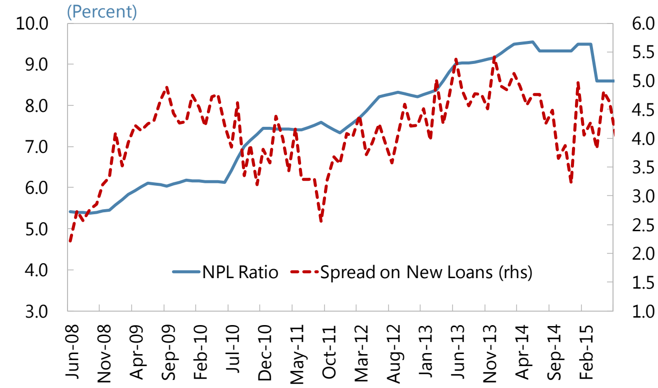
fiscal slippages. In this context, they highlighted the ongoing and planned spending reviews. On pensions, the authorities agreed on the risks stemming from adverse demographic developments and stressed that key recommendations of the PSG have been included in the 2016 budget, and they would wait to see the impact of these measures before taking additional actions. The authorities recognized the risks from SOEs. In the case of Enemalta they agreed that electricity tariff cuts should be matched by efficiency gains. In the case of Airmalta, they noted that in line with the state aid rules, there are no planned subsidies.

B. Financial Sector Stability

14. The financial system (about 700 percent of GDP) remains resilient (Box 3). Banks are well capitalized and liquid. Solvency and liquidity of core domestic banks and other peer bank groups (non-core domestic banks and international banks) remain above the minimum regulatory requirements. Their profitability, despite the decline in 2014, remains healthy (Table 4). The non-bank financial institutions are relatively small, with the main risk to systemic stability arising from their interconnectedness with the core domestic banks.

15. But nonperforming loans (NPLs) and the cost of credit remain high. High NPLs have been contributing to high interest rates, particularly in certain sectors, as implied by the positive correlation between NPL ratios (and relatively high corporate leverage) and lending rates on new loans.[6] The loan-to-deposit ratio is about 60 percent as of December 2014 (core domestic banks), lending to corporations remain weak, and lending rates remain high (SIP, Chapter 1).[7] In June 2015, NPLs—driven to a large extent by construction and manufacturing sectors— declined to 8.6 percent (core domestic banks), compared to their 2014 peak. Coverage ratios have increased but remain low (from 39 percent in 2013 to about 48 percent in June 2015, including BR09 reserves). The supervisory authorities are considering using further Pillar 2 measures to incentivize banks to reduce NPLs.

NPL Ratios and Interest Spread on New Loans 1/
(Percent)



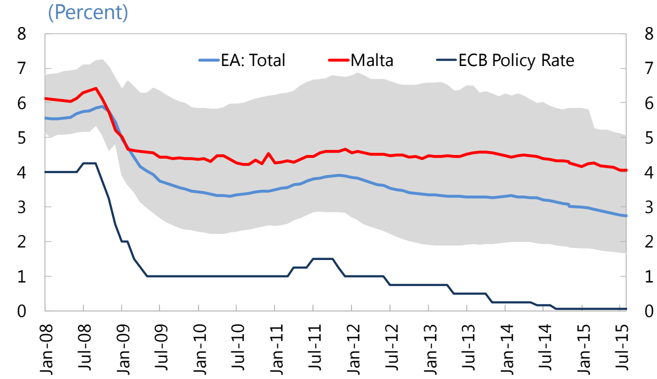
Sources: ECB; CBM; and NPL ratio is non-perfoming loans to gross loans and is interpolated from quarterly data on FSI indicators.
1/ Spread is computed as the difference between interest rate on small loans (loans of less or equal to 1 mln euro) and the ECB policy rate.

[6] See the firm level analysis in Appendix 3, 2014 Article IV Staff Report.

[7] The 2014 AIV and accompanying background notes link the relatively weak pass-through of changes in the ECB policy rates low bank competition, high leverage and high proportion of distressed loans in some sectors, notably in construction, and the dominance of small firms that lack collateral.

16. Regulatory and supervisory changes are ongoing. The SSM took over the supervision of the three largest banks in 2014, and is in the process of reconsidering the composition of the systemic banks. A comprehensive assessment has just been completed for the Mediterranean bank, which revealed an upward revision of NPEs—stemming from impairment trigger definitions—, a relatively low coverage ratio, and a capital shortfall (€5.64 mln) under the adverse scenario. The Bank has already raised capital (€28.7 mln) to meet the minimum capital requirements. [8] Banif bank is in the process of ownership change. The central bank is working on macroprudential policies, and the MFSA, which was designed as the resolution authority, is in the process of operationalizing its resolution mandate.

Lending Rates on Loans to NFCs[1/]
(Percent)



Source: Haver Analytics.
1/ Outstanding amounts; EA16, excluding Estonia, Latvia, and Lithuania.

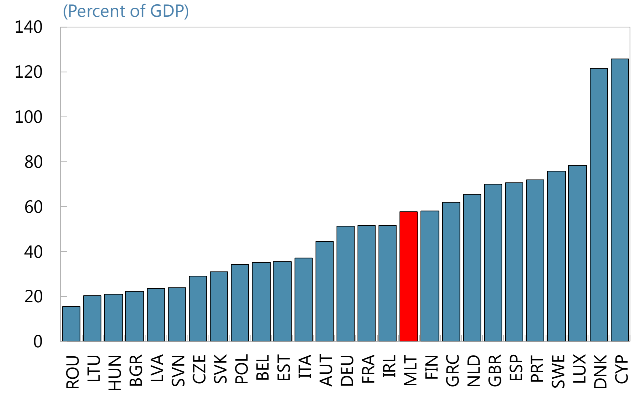
Staff's views

17. Given the large size of the financial sector and ongoing regulatory and supervisory, changes, continued policy actions are needed on multiple fronts (Annex I):

- *Action plans:* The completion of the action plans is essential for a level playing field and sound supervision.

- *Resolution frameworks:* The EU Bank Recovery and Resolution Directive (BRRD) has been transposed into national law and the MFSA established a separate resolution unit. The focus is now, appropriately, on developing bank recovery plans and the collection of contributions for the resolution fund.

Household Debt, 2014
(Percent of GDP)



Source: Haver.

- *Deposit guarantee scheme (DCS):* The minimum for the DCS fund is set at 1.3 percent of covered deposits—above the target level of ex-ante funds of 0.8 percent (EU directives). The share of special contributions (i.e., not cash) will be reduced in line with the EU directives. These measures will help preserve financial

[8] Please see the 2014 Article IV report for the results of the comprehensive assessment for other two systemic banks. The SSM took over the supervision of Bank of Valetta, HSBC Bank Malta, and Deutsche Bank Malta. The Mediterranean Bank (its holding company, Medifin), recently classified as systemic, has replaced Deutsche Bank Malta as one of the systemic banks and the Mediterranean Bank's supervision will be transferred to the SSM. Deutsche Bank Malta will continue to be supervised by the SSM through the Deutsche Bank Group.

stability, given the large size of covered deposits relative to GDP (€8.9 billion or about 112 percent of 2014 GDP).

- *High NPLs:* The increase in the coverage ratio and the national authorities' consideration of using Pillar II measures to reduce NPLs are welcome and further increases in coverage ratios, as envisaged, are appropriate. The completion of the ongoing work on insolvency legislation— reducing court proceedings time and enhancing contract enforcement—should substantially improve NPL resolution.

- *Macroprudential policies:* Given below trend credit-to-GDP ratio, the central bank seems minded to set counter cyclical buffers to zero. Despite the overall weak credit, mortgages are increasing rapidly (10 percent y/y in July 2015). While the default rates on mortgages and household indebtedness have been low, further consideration should be given to precautionary measures, such as loan-to-value (currently at 74 percent for residential and 69 for commercial in 2014) and debt-to-income ratios, given the rapid increase in mortgages, relatively high overall exposure to real estate, and pick up in real estate prices—fueled by a combination of factors, such as tax incentives for first time buyers, increase in rental demand stemming from the international investor program, increased migration, and the ECB's QE.

- *FSAP:* The authorities' request for a Financial Sector Assessment Program Update (FSAP) is very timely, as the last FSAP was conducted in 2003.

- *AML/CFT Framework*: The FIAU's shift to risk based AML/CFT supervision is a positive step and more frequent onsite inspections by the FIAU and the MFSA should contribute to enhancing AML/CFT compliance in the financial sector. In light of the large financial sector, the rapid growth in the online gaming industry, and high demand for the international investor program, the MFSA, the FIAU, the Malta Gaming Authority (MGA), and Identity Malta should continue to coordinate closely and ensure robust implementation of the AML/CFT framework in line with the 2012 FATF standard.[9] This may also assist in ensuring that the level of suspicious transactions reports (STRs) is appropriate.

Authorities' views

18. The authorities agreed with staff on possible sources of risks and noted that actions are being taken. They agreed that the NPLs are high, but noted that they are mostly a legacy issue, limited to some sectors such as construction, and are well collateralized—implying a coverage of more than 100 percent together with provisions. The national authorities expect that ongoing judicial reforms and the possible use of Pillar II measures, currently under consideration, will help tackle NPLs. They also expect the planned credit registry and development bank will improve access to credit. Regarding macroprudential policies, they highlighted that Joint Financial Stability Board started discussions on further measures, given the rapid increase in

[9] Malta's assessment against the 2012 FATF standard is tentatively scheduled for 2017.

mortgages. The authorities are confident that the collection of contributions for the resolution fund and the shift towards DCS ex-ante funds will go smoothly. On the AML/CFT framework, they highlighted that they are at the final stages of the national risk assessment and efforts to improve capacity and training are ongoing.

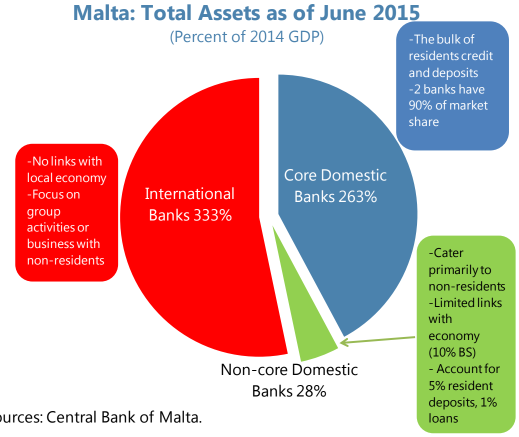
Box 3. Malta: Structure of the Financial Sector

Malta' financial sector is large and highly segmented. As of end-2014, assets of banks were about 6 ¼ times GDP, while assets of non-bank financial institutions are around 2/3 of GDP. A big portion of these banks have limited links to the real economy. The share of the financial sector in value added and employment is about 7 and less than 5 percent, respectively. Banks and non-bank institutions can be divided by domestic or international, depending on the scope of their involvement in activities with residents. For banks, the Central Bank of Malta (CBM) breaks down domestic institutions into core domestic banks and non-core domestic banks.

- *Core domestic banks,* with assets of about 2½ times the *GDP,* provide around 97 percent of bank lending to residents in Malta, and collect around 94 percent of resident deposits. They have limited external assets and liabilities. As of end-June 2015, their capital adequacy and liquidity ratios stood at 13.9 and 52.1 percent, respectively, above the required minimum of 8 and 30 percent. The main vulnerability stems from relatively high non-performing loans (8.6 percent as of end-June 2015) and high exposure to the property market and collateral in the form of real estate.

Malta: Total Assets as of June 2015

(Percent of 2014 GDP)



Sources: Central Bank of Malta.

- *Non-core domestic banks,* with assets slightly more than ¼ of GDP, are funded primarily from wholesale markets and non-resident deposits and have some (albeit still small) exposure to residents, with resident assets and liabilities comprising 10.2 and 19.4 percent, respectively, of the total balance sheet size as of end-2014. The main risks related to these banks stem from possible cross-border deleveraging pressures and claims on the local deposit compensation scheme in the event of bank failure.

- *International banks* rely mostly on wholesale (including intra-group) funding and nonresident deposits of relatively long maturities and focus on activities for the group (custodian services, trade finance, investment banking). Their assets are about 3.3 times the GDP, with the bulk owned by two branches of Turkish banks. The recent deleveraging in this group had limited impact on Malta.

The non-bank financial institutions are relatively small, and the main risk stems from their interconnectedness with core domestic banks. Around a third of insurance companies and investment funds are classified as domestic. The insurance sector is dominated by two companies, accounting for around 90 percent of total assets. Core domestic banks hold a significant shareholding in several domestic insurance companies, while over 10 percent of insurers' assets consist of deposits held with the Maltese banks. The investment funds have significant investments in local bank equity.

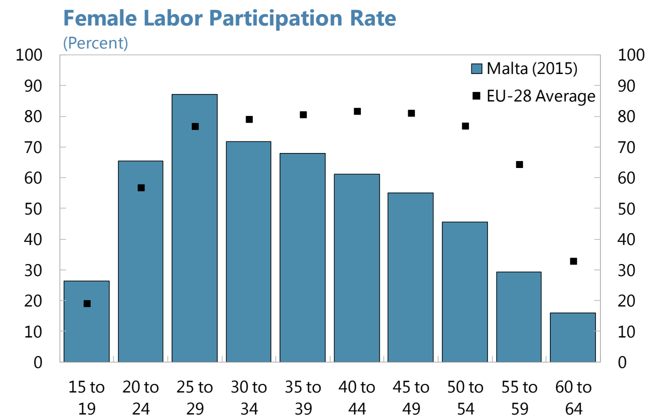
C. Raising Potential Growth

19. The authorities' reform priorities, included in the National Reform Program (NRP), aim to raise potential growth and strengthen fiscal sustainability. Key priorities are: i) increasing labor participation and upgrading skill levels; ii) reforming the energy sector; and iii) improving the business environment, including through judicial reforms and increasing access to finance.

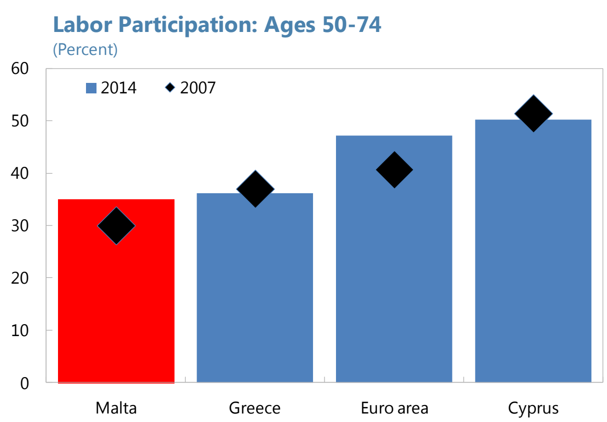
Staff views

20. Simultaneous progress in each of the following key areas will help support potential growth:

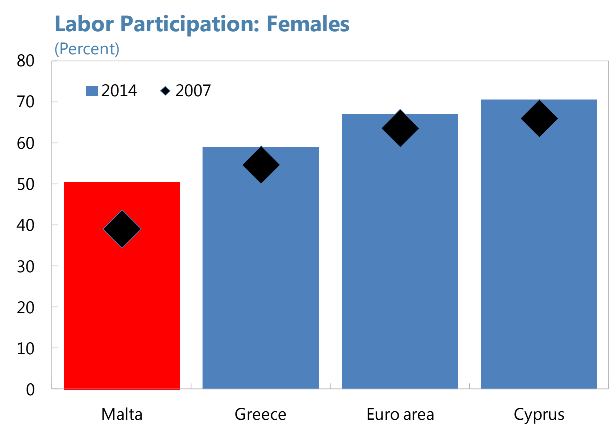
- **Increasing labor participation (SIP, Chapter 1).** The authorities' measures to support female and elderly participation have been paying off, particularly for younger cohorts, which together with strong net migration inflows is offsetting adverse demographic trends and supporting the potential output.[10] Nevertheless, labor participation remains low particularly due to still low activity rates by women and the elderly. Efforts to encourage participation of women and the elderly could raise annual average potential growth over 2015–2020 by $^1/_3$ of a percentage point (SIP Ch.1, p.11, ¶26).



Source: Eurostat.



Source: Eurostat



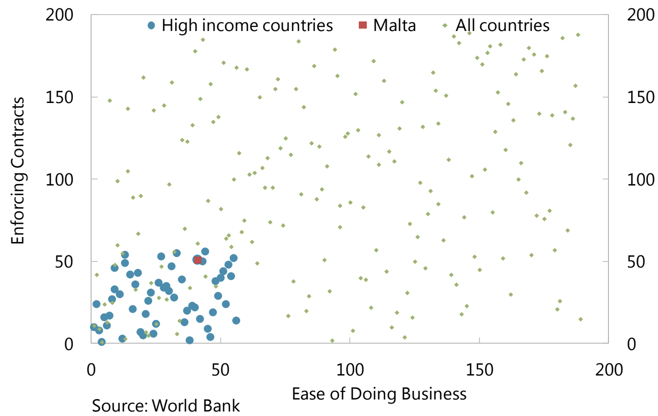
Source: Eurostat

[10] Measures include provision of free childcare, tapering of social assistance benefits, tax incentives and wage subsidies for women above 40 to enter the labor force, tax deductions for older employees, and tax incentives for enterprises to recruit older employees.

- **Upgrading skills.** Achieving goals set by the national education strategy, such as reducing early school leavers and improving lifelong education, will help boost human capital. Efforts to link the budget allocations to explicit outcomes are welcome.

- **Ongoing judicial reforms.** Malta ranks poorly in the EU in terms of length of proceedings in particular for administrative and commercial cases and insolvency procedures (2015 EU Justice Scoreboard). This in turn raises both the cost of doing business and credit, weighing on potential output (SIP, Chapter 1). The current focus is on the insolvency legislation and second chance act with the aim to improve contract enforcement and the business environment, reduce the length of court procedures, and resolve corporate and bank balance sheet problems. Conducting an impact assessment could help better track and demonstrate the costs and results of these reforms.

Enforcement of Contracts Ranking
(Lower: better)



Source: World Bank

- **Improving access to finance, in particularly for SMEs**. While financial sector is large and banks are liquid, credit to NFCs is weak, partly reflecting high interest rate margins. High lending rates could reflect various factors, including higher funding cost of banks (relative to the ECB policy rates), limited competition, high level of NPL ratios, and relatively high corporate sector leverage, particularly for smaller firms and in certain sectors (2014 Article IV Consultation, Staff Report). Ongoing judicial reforms and the work on a credit registry will help improve access and cost of credit, by solving informational asymmetry and reducing the risk premia charged by banks, given the dominance of small and micro loans and time to recover collateral. Setting up a multi trading facility by the stock exchange will help increase access to non-bank finance, particularly for SMEs. The planned development bank (to facilitate SME and infrastructure financing) should be effectively supervised and have strong governance.

Authorities' views

21. The authorities agreed with staff on the importance of structural reforms and stressed that judicial reforms and upgrading the education system are key priorities. They emphasized that reforms would take time given the required institutional and cultural changes. They also acknowledged the importance of access to credit and stressed that ongoing efforts—such as the credit registry, judicial reforms, incentivizing the NPL resolution, measures to incentivize non-bank financing and the planned development bank— are expected to help improve access to credit and lower the cost of credit.

STAFF APRAISAL

22. Malta has remained resilient in the face of global shocks and the economy is growing strongly, helped by policy initiatives. The reliance on domestic funding and the relatively well diversified economy have helped preserve stability. Growth accelerated to 5.1 percent in the first half of 2015 and unemployment is at historic lows.

23. The outlook is strong and risks are balanced. Growth is expected to remain solid in 2016–17, driven initially by domestic demand and later by a gradual recovery in external demand. Inflation is projected to gradually pick up with the positive output gap and the exchange rate pass-through. The external position remains broadly in line with fundamentals despite high uncertainty driven by volatile components of the current account. While, downside risks include slower global growth, delays in implementation of structural reforms, fiscal slippages, and regulatory and tax changes elsewhere, upside risks stem from increased energy efficiency and further increases in labor participation. The future of migration flows, the majority of which coming from other EU countries, remains uncertain.

24. Strong migration inflows boost potential output. Large inflows since the early 2000, mostly originating from other EU countries, have offset Malta's declining working age population and raised potential growth. Refugee inflows have also been significant, but have declined since 2013. The planned agency for refugees should help enhance coordination between institutions to ensure their smooth integration into the labor market and society.

25. The challenge is to preserve high and stable growth. Given uncertainty regarding the global recovery, volatile migration flows, and ongoing efforts to enhance competitiveness by euro area neighbors, raising potential output in a sustainable manner will depend on i) building fiscal buffers to cope with adverse shocks; ii) maintaining financial sector stability and providing financing for growth; and iii) sustaining structural reforms.

26. The authorities' proposed pace of fiscal consolidation for 2016–18 is appropriate. The deficit reduction is continuing, despite rapidly growing current expenditures, supported by revenue measures and stronger-than-expected revenues. The authorities aim to reduce the overall deficit to -0.2 percent of GDP in 2018, but measures beyond 2016 are not well specified at this stage.

27. Fast growth in current expenditures makes targeted debt reduction challenging, particularly beyond 2016. With the expected growth moderation towards its long-term trend, the fast growth of sticky current expenditures makes the planned consolidation difficult. To ensure meeting the fiscal targets, additional expenditure measures should be considered. In this context, the authorities should ensure that public sector wage negotiations will not result in increases higher than inflation and complete the ongoing and planned spending reviews. With the output gap closed, revenues in excess of targets should primarily be used to build fiscal buffers. Fiscal risks from SoEs should also be disclosed and managed in a consolidated manner.

28. Pension measures introduced in the 2016 budget are steps in the right direction. These measures aim to address both adequacy and sustainability of the pension system. Given that Malta ranks second worst in the euro area in its age related spending increases, the authorities should ensure that these measures lead to an increase in the effective retirement age and to higher participation in the voluntary third pillar to support disposable income at old age. Efforts to increase the efficiency of health care spending should help support pension reforms.

29. Ongoing efforts to strengthen fiscal governance and institutions should continue. Continued efforts to strengthen fiscal institutions and the budgetary framework are encouraged to increase efficiency, transparency, and ultimately avoid fiscal slippages. Efforts to link sectoral budget allocations and any new public spending to medium-term plans and outcomes are welcome and will help track the impact of reforms and their medium-term fiscal implications.

30. The banking system remains resilient. Banks are well capitalized, profitable, and liquid. Solvency and liquidity of core domestic banks and other peer banks remain above the minimum regulatory requirements, and their profitability is above the euro area average.

31. But nonperforming loans (NPLs) and the cost of credit remain high. The increase in the coverage ratio and the national authorities' consideration of using further Pillar II measures to reduce NPLs are welcome, and further increases in coverage ratios as envisaged is appropriate. The completion of the ongoing work on insolvency legislation, aiming to reduce court proceedings time and enhance contract enforcement, should help improve NPL resolution.

32. Given the large size of the financial sector and ongoing regulatory and supervisory changes, continued policy actions are needed to boost resilience of the banks. Policies should focus on: (i) a swift implementation of bank action plans to ensure a level playing field and sound supervision; (ii) following the transposition of BRRD into national law and the establishment of a separate resolution unit in the MFSA, developing bank recovery plans and collecting of contributions for the resolution fund; (iii) strengthening the contingency framework, including by reducing the share of special contributions to DCS fund, (iv) introducing additional precautionary macroprudential measures, given the rapid increases in mortgages and pick up in real estate prices, and (iv) continuing to coordinate closely and ensure robust implementation of the AML/CFT framework in line with the 2012 FATF standard.

33. The authorities' request for a Financial Sector Assessment Program Update is very timely, as the last FSAP was conducted in 2003.

34. The structural reform priorities, as outlined in the national strategy program, are appropriate, but momentum would need to continue. Raising potential growth requires that measures translate into outcomes. In particular: (i) measures to enhance female participation have been paying off and support the potential growth; (ii) linking measures to achieve the national education strategy goals to budget allocations is welcome; (iii) judicial reforms, including the focus on insolvency regime are welcome but need to be complemented by efforts to track and demonstrate the results, such as conducting an impact assessment, and (iv) ongoing efforts to improve access to credit, such as NPL resolution, judicial reforms, planned credit registry, and multi trading facility by the stock exchange will improve growth financing. The planned development bank (to facilitate SME and infrastructure financing) should be effectively supervised and have strong governance.

35. Staff proposes that the next Article IV consultation with Malta follow the standard 12-month cycle.

Proposed Decision

The Executive Board endorses the thrust of the staff appraisal in the report for the 2015 Article IV consultation with Malta (SM/15/307, 12/21/15).

It is expected that the next Article IV consultation with Malta will take place on the standard 12-month cycle.

Malta: Risk Assessment Matrix[1]

Source of Risk	Relative Likelihood	Impact if Realized	Policy Response
1. Euro area: weak demand and persistently low inflation from a failure to fully address crisis legacies and undertake structural reforms, leading to low medium-term growth and accumulation of financial imbalances.	**High** Highly open nature of the Maltese economy makes it particularly vulnerable to developments in the euro area.	**Medium** Adverse impact on growth and financial flows.	Reduce the pace of fiscal consolidation, in line with the flexibility under the SGP. Continue to diversify trade and financial activities with non-euro area countries
2. Slowdown in emerging markets and increased global financial market volatility	**Medium/High** A slowdown in emerging markets may stall global recovery and a bumpy UMP exit could lead to real and financial spillovers to Malta.	**Medium/Low** Malta has been relatively insulated from financial market contagion given public and private sectors' reliance on domestic financing, but is still vulnerable to low external demand.	Focus on eliminating vulnerabilities (fiscal and financial) to ensure stability and continue to diversify trade and financial activities.
3. Euro area bond market contagion. Sovereign and financial sector stress reemerges across the Euro area due to protracted policy uncertainty (for example in Greece).	**Medium** A Greece tail event could lead to a re-assessment of investor's risk appetite to euro area exposures. Bank failures and the bail-in of debt holders could have spillovers across European banking system, affecting Malta's international banks.	**Medium/Low** Malta has been relatively insulated from financial market contagion given public and private sectors' reliance on domestic financing, but is still vulnerable to slow external demand.	Focus on eliminating vulnerabilities (fiscal and financial) to ensure stability.
4. Geopolitical fragmentation: i) Russia/Ukraine; ii) fragmentation/state failure in the Middle East	**Medium** Direct links with Russia and Ukraine are low	**Medium/Low** Indirect effects through confidence and external demand might be partially offset by additional tourists given Malta's stability	Focus on eliminating vulnerabilities (fiscal and financial) to ensure stability.
5. Broader than expected changes in the EU regulatory framework	**Low** Malta's attraction as a financial center for cross-border banking activities may diminish	**Medium** Deleveraging of the international banking and business sector may adversely affect tax revenues and employment	Diversify the economy while scrutinizing associated new risks
6. Delays in implementation of energy investment projects	**Low** Delays in energy investment plans can reduce growth and create budgetary pressures.	**Medium** Lower investment could be partly offset by lower imports. Nevertheless with electricity tariffs already reduced this could increase contingent liabilities.	Rapid implementation of the project plans and monitor the efficiency gains regularly
7. Delays in implementing structural reforms, including judicial and pension reforms.	**Medium** Slow progress in judicial reforms and no behavioral changes in response to pension incentives	**High** Delayed implementation of required structural reforms would negatively affect long-term growth and fiscal sustainability	Sustain and monitor the implementation of structural reforms
8. A sharp correction in housing prices	**Low** After a period of downward correction in 2008–09, Malta's housing market seems to have stabilized	**Medium/High** Core domestic banks are significantly exposed to the housing market	Monitor risk and be prepared to use macro-prudential measures

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Table 1. Malta: Selected Economic Indicators, 2011–2018
(Year on year percent change, unless otherwise indicated)

	2011	2012	2013	2014	Proj. 2015	2016	2017	2018
	(Year on year percent change)							
Real GDP	2.1	2.5	2.7	3.6	4.3	3.5	3.0	3.0
Domestic demand	-2.2	0.1	1.0	5.2	5.3	3.4	2.6	3.0
Consumption	2.6	2.1	1.4	4.1	3.1	3.4	3.8	3.2
Private consumption	2.5	0.3	1.9	2.9	3.4	3.4	3.2	2.8
Public consumption 1/	2.8	7.3	0.2	7.5	2.3	3.4	5.6	4.2
Fixed investment	-18.0	4.1	-0.7	9.1	14.7	3.2	-2.4	2.3
Exports of goods and services	2.3	7.0	-0.2	-0.3	0.5	2.2	2.3	2.3
Imports of goods and services	-0.3	5.2	-1.2	0.6	0.9	2.1	2.0	2.3
Contribution to growth	(Percent)							
Domestic demand	-1.8	-0.3	1.0	4.8	4.9	3.2	2.4	2.9
Foreign balance	3.9	2.8	1.6	-1.3	-0.5	0.3	0.5	0.1
Potential GDP growth	2.2	2.4	2.7	3.0	3.3	3.3	3.3	3.1
Output gap (percent of potential GDP)	-0.5	-0.4	-0.5	0.1	1.1	1.3	1.0	0.9
HICP (period average)	2.5	3.2	1.0	0.8	1.5	1.8	1.8	2.1
GDP deflator	2.3	1.9	1.8	1.8	1.7	1.8	2.2	2.5
Unemployment rate EU stand.	6.4	6.3	6.4	5.9	5.5	5.4	5.3	5.3
Employment growth	2.5	2.4	1.8	3.2	2.4	2.2	2.1	2.0
Gross national savings (percent of GDP)	16.9	19.2	20.3	21.7	22.7	22.8	22.3	22.5
Gross capital formation (percent of GDP)	19.3	17.8	17.1	18.4	21.1	21.1	20.0	19.8
Balance of payments	(Percent of GDP)							
Current account balance 2/	-2.5	1.4	3.2	3.3	1.6	1.7	2.3	2.7
Trade balance (Goods and services)	2.5	4.9	5.7	6.7	5.0	5.1	5.7	6.1
Exports of goods and services	158.6	163.6	154.3	145.8	140.0	138.5	137.3	135.7
Imports of goods and services	156.1	158.7	148.6	139.1	135.1	133.4	131.6	129.6
Goods balance	-17.5	-15.4	-14.5	-13.8	-16.1	-15.9	-15.5	-15.2
Services balance	20.0	20.3	20.2	20.5	21.1	21.0	21.3	21.3
Primary income, net	-6.2	-5.0	-4.4	-5.9	-5.9	-5.9	-5.9	-5.9
Secondary income, net	1.3	1.5	1.8	2.5	2.5	2.5	2.5	2.5
Financial account, net	-1.4	9.2	-5.2	-4.7	3.3	3.5	4.1	4.5
Memorandum item:								
Nominal GDP (millions of euros)	6892.8	7205.0	7533.6	7941.3	8425.4	8883.2	9350.1	9870.5
Nominal GDP growth	4.4	4.5	4.6	5.4	6.1	5.4	5.3	5.6

1/ Government's revenue includes income from the International Investor Program (IIP), which is registered as "Other current revenue, Sales". For ESA 2010 purposes, this item reduces Public Final Consumption as it is included in "Market output and output for own final use". Revenue from IIP is expected to be high in 2015 and 2016 (€75 and €80 millions), and to decline since 2017 (€37 millions).

2/ Balance of payment data have been revised, consistent with the IMF BPM6 methodology.

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

Table 2. Malta: Fiscal Developments and Projections, 2011–2020
(Percent of GDP, unless otherwise indicated)

					Projections			
	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	38.3	38.9	40.0	41.9	42.7	40.9	40.9	40.8
Taxes	25.9	26.2	27.0	28.5	28.4	28.6	28.6	28.6
Indirect taxes	13.4	13.0	13.0	13.8	14.0	14.2	14.3	14.3
Direct taxes	12.3	13.0	13.8	14.5	14.3	14.2	14.2	14.2
Other taxes (capital taxes)	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Social contributions	7.1	7.0	7.0	7.1	7.1	7.1	7.1	7.1
Grants and Capital revenue	1.5	1.8	1.9	2.4	2.7	0.9	1.6	1.6
Other revenue	3.9	3.9	4.1	3.9	4.5	4.3	3.6	3.5
Expenditure	40.9	42.5	42.6	44.0	44.3	42.1	42.0	41.7
Expense	38.2	39.2	39.8	40.3	40.2	39.0	38.7	38.6
Compensation of Employees	12.8	12.8	13.0	13.3	13.3	13.3	13.3	13.3
Use of goods and services	6.2	6.7	6.3	6.6	6.8	6.7	6.6	6.6
Interest	3.1	3.0	2.9	2.9	2.6	2.4	2.4	2.4
Subsidies	0.7	1.1	1.1	1.3	1.3	1.3	1.2	1.1
Social benefits	12.8	12.8	12.8	12.6	12.3	12.1	12.0	12.0
Other expense	2.5	2.8	3.7	3.5	3.8	3.4	3.3	3.2
Net acquisition of nonfinancial assets	2.7	3.3	2.8	3.7	4.2	3.1	3.3	3.1
Gross Operating Balance	0.1	-0.3	0.2	1.6	2.6	1.9	2.3	2.2
Net lending/borrowing (overall balance)	-2.6	-3.6	-2.6	-2.1	-1.6	-1.2	-1.0	-0.9
Memorandum items:								
Overall balance excl. one-offs	-3.3	-4.5	-2.9	-2.3	-1.8	-1.3	-1.1	-0.9
Cyclically adjusted overall balance	-2.3	-3.4	-2.4	-2.2	-2.1	-1.8	-1.5	-1.3
Cyclically adjusted overall balance, excl. one-offs	-3.0	-4.3	-2.7	-2.4	-2.3	-1.9	-1.6	-1.3
Primary balance	0.6	-0.6	0.3	0.8	1.0	1.1	1.4	1.5
One-offs	0.7	0.9	0.3	0.2	0.2	0.1	0.1	0.0
Public debt	69.8	67.6	69.6	68.3	66.9	66.1	63.8	62.1
Government guaranteed debt	12.6	16.5	15.9	16.8	14.4	13.6	13.0	12.3
Nominal GDP (millions of euros)	6,893	7,205	7,534	7,941	8,425	8,883	9,350	9,870

Sources: Maltese authorities; and IMF staff projections.

Table 3. Malta: Balance of Payments, 2011–2018 1/

					Projections			
	2011	2012	2013	2014	2015	2016	2017	2018
	(Millions of euros)							
Current account balance	-170	100	239	262	133	152	218	268
Trade balance (Goods and services)	171	351	431	532	419	454	536	604
Goods balance	-1,208	-1,108	-1,091	-1,095	-1,360	-1,412	-1,452	-1,499
Exports	2,845	3,195	2,862	2,608	2,658	2,771	2,892	3,017
Imports	4,053	4,303	3,953	3,703	4,018	4,183	4,343	4,516
Services balance	1,379	1,459	1,522	1,627	1,780	1,866	1,988	2,103
Exports	8,084	8,589	8,764	8,970	9,142	9,529	9,945	10,377
Imports	6,705	7,130	7,242	7,344	7,362	7,663	7,957	8,274
Current income, net	-428	-361	-331	-470	-498	-526	-553	-584
Current transfers, net	87	110	139	200	212	223	235	248
Private	-649	-680	-638	-619	-658	-693	-730	-770
Public	736	790	777	819	869	917	965	1,018
Capital account, net	82	135	130	138	146	154	162	172
Financial account, net	-93	664	-389	-370	279	307	380	440
Direct investment	-10,533	-7,440	-5,322	-5,054	-5,362	-5,653	-5,950	-6,280
Portfolio investment	11,623	9,318	8,903	11,990	12,720	13,412	14,116	14,901
Other investment	-884	-897	-3,827	-6,743	-6,469	-6,808	-7,109	-7,465
Reserves (- inflow; + outflow)	-53	121	-39	12	0	0	0	0
Errors and omissions	-5	429	-758	-770	0	0	0	0
	(Percent of GDP)							
Current account balance	-2.5	1.4	3.2	3.3	1.6	1.7	2.3	2.7
Trade balance (Goods and services)	2.5	4.9	5.7	6.7	5.0	5.1	5.7	6.1
Goods balance	-17.5	-15.4	-14.5	-13.8	-16.1	-15.9	-15.5	-15.2
Exports	41.3	44.3	38.0	32.8	31.5	31.2	30.9	30.6
Imports	58.8	59.7	52.5	46.6	47.7	47.1	46.5	45.8
Services balance	20.0	20.3	20.2	20.5	21.1	21.0	21.3	21.3
Exports	117.3	119.2	116.3	113.0	108.5	107.3	106.4	105.1
Imports	97.3	99.0	96.1	92.5	87.4	86.3	85.1	83.8
Primary income, net	-6.2	-5.0	-4.4	-5.9	-5.9	-5.9	-5.9	-5.9
Secondary income, net	1.3	1.5	1.8	2.5	2.5	2.5	2.5	2.5
Private	-9.4	-9.4	-8.5	-7.8	-7.8	-7.8	-7.8	-7.8
Public	10.7	11.0	10.3	10.3	10.3	10.3	10.3	10.3
Capital account, net	1.2	1.9	1.7	1.7	1.7	1.7	1.7	1.7
Financial account, net	-1.4	9.2	-5.2	-4.7	3.3	3.5	4.1	4.5
Direct investment	-152.8	-103.3	-70.6	-63.6	-63.6	-63.6	-63.6	-63.6
Portfolio investment	168.6	129.3	118.2	151.0	151.0	151.0	151.0	151.0
Assets	170.5	123.8	109.3	160.0	160.0	160.0	160.0	160.0
Liabilities	1.8	-5.5	-8.9	9.0	9.0	9.0	9.0	9.0
Other investment	-12.8	-12.4	-50.8	-84.9	-76.8	-76.6	-76.0	-75.6
Assets	47.4	6.6	-1.9	-42.2	-15.5	-15.5	-15.5	-15.5
Liabilities	60.2	19.0	48.9	42.7	61.3	61.2	60.5	60.1
Reserves (- inflow; + outflow)	-0.8	1.7	-0.5	0.2	0.0	0.0	0.0	0.0
Errors and omissions	-0.1	6.0	-10.1	-9.7	0.0	0.0	0.0	0.0
Memorandum items:								
Official reserves, end of period								
(Millions of euros)	395.9	533.8	435.4	…	…	…	…	…
(In months of imports of goods and services)	0.4	0.6	0.5	…	…	…	…	…
Gross external debt (Percent of GDP)	1,136.4	1,137.4	1,130.9	1,172.6	1,106.8	1,051.4	1,001.3	951.3
Net external debt (Percent of GDP)	-802.3	-786.0	-753.2	-717.1	-680.0	-648.8	-618.9	-588.0

1/ Balance of payment data have been revised, consistent with the IMF BPM6 methodology.

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

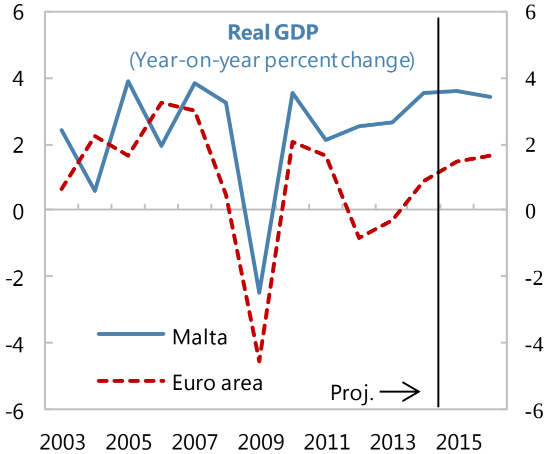
Table 4. Malta: Financial Soundness Indicators, 2012–June 2015
(Percent, unless otherwise indicated)

					Non-core domestic banks				International banks				Total banks			
	2012	2013	2014	Jun-15	2012	2013	2014	Jun-15	2012	2013	2014	Jun-15	2012	2013	2014	Jun-15
Core FSIs																
Regulatory capital to risk weighted assets	16.1	16.5	14.5	13.9	28.9	22.6	17.4	18.6	115.7	119.6	69.2	42.1	55.8	46.2	25.8	18.6
Regulatory Tier 1 Capital to risk weighted assets	12.1	12.9	11.6	11.5	25.7	22.1	17.0	18.2	115.2	119.6	69.1	41.4	53.3	43.9	23.7	16.7
Nonperforming loans net of provisions to capital	37.4	39.0	41.7	40.3	7.6	2.1	7.6	0.4	0.2	0.8	2.0	5.2	6.2	9.4	17.9	24.2
Nonperforming loans to total gross loans	7.8	8.9	9.0	8.6	4.1	3.7	7.4	6.3	0.5	1.4	1.4	2.0	3.8	5.6	6.3	6.3
Return on assets	1.1	1.1	0.7	0.8	1.4	0.3	-1.3	-1.8	1.1	0.3	0.9	0.9	1.1	0.6	0.7	0.8
Return on equity	15.5	15.3	9.8	10.9	6.5	1.6	-6.4	13.7	4.5	2.3	2.4	2.7	5.9	3.7	3.6	4.6
Interest margin to gross income	61.8	63.6	64.8	62.0	28.9	42.0	46.3	46.1	123.5	173.6	201.9	184.2	83.1	101.2	115.1	107.4
Non-interest expense to gross income	45.5	47.1	51.2	48.6	28.4	64.8	56.1	59.7	7.1	10.0	11.9	13.2	27.4	34.9	36.8	35.9
Non-interest income to gross income (iv)	33.2	36.4	35.2	38.0	71.1	58.0	53.7	53.9	-24.4	-73.6	-101.9	-84.2	16.9	-1.2	-15.1	-7.4
Liquid assets to total assets	26.6	27.2	28.3	31.5	14.4	20.2	31.7	35.1	9.9	28.1	19.3	17.9	19.6	26.9	27.2	30.5
Liquid assets to short-term liabilities	51.5	51.6	50.4	52.1	82.4	72.1	77.9	75.0	146.0	204.2	84.7	79.7	55.6	59.6	53.9	54.5
Other FSIs																
Coverage ratio	37.6	39.1	43.4	45.9	59.7	94.6	78.6	108.3	95.1	43.0	45.4	48.5	43.6	41.1	45.9	49.5
Domestic Investment Securities to Total Assets	10.7	10.9	9.6	9.5	2.9	5.5	4.6	7.1	0.0	0.0	0.0	0.1	3.6	4.1	3.9	4.4
Foreign Investment Securities to Total Assets	18.0	19.3	23.3	22.1	38.3	21.0	19.5	14.5	35.9	37.6	52.3	49.4	29.5	30.4	39.9	36.3
Unsecured Loans to Total Lending	16.8	20.6	22.2	21.3	50.7	74.8	65.2	69.4	55.6	57.3	48.4	44.9	40.6	39.0	34.3	32.3
Assets to Total Capital and Reserves (Ratio)	13.2	12.6	14.0	14.3	4.9	3.4	8.4	8.2	1.5	1.3	1.6	1.9	3.1	3.7	6.3	8.3
Large exposure to capital	102.0	139.4	98.1	80.8	111.7	199.9	342.7	274.7	10.8	17.1	44.8	13.2	31.4	48.0	86.6	59.7
Gross asset position in financial derivatives to capital	2.7	2.1	2.5	3.5	0.6	0.4	2.3	0.8	0.5	0.0	0.9	0.1	0.9	0.5	1.6	2.1
Gross liability position in financial derivatives to capital	9.5	4.5	8.1	6.6	2.7	0.4	2.8	1.6	0.1	0.1	0.5	0.5	1.5	1.1	3.7	4.0
Personnel expenses to non-interest expenses	53.9	50.6	50.8	49.2	39.6	42.0	45.0	45.8	25.2	33.3	27.5	28.9	48.4	48.1	47.4	46.0
Customer deposits to customer loans	138.6	147.5	156.3	165.6	68.8	103.9	132.1	150.5	71.3	125.8	107.5	120.8	106.6	138.3	139.3	151.2
Net open position in equities to capital	13.6	13.5	14.3	15.2	75.9	169.4	45.0	55.3	0.3	0.0	0.3	0.7	7.6	10.6	8.9	14.6

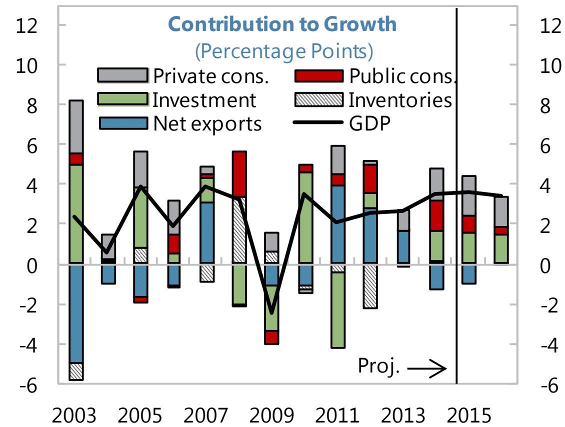
Source: National Statistics Office of Malta

Figure 1. Malta: Economic Indicators 2003–2016

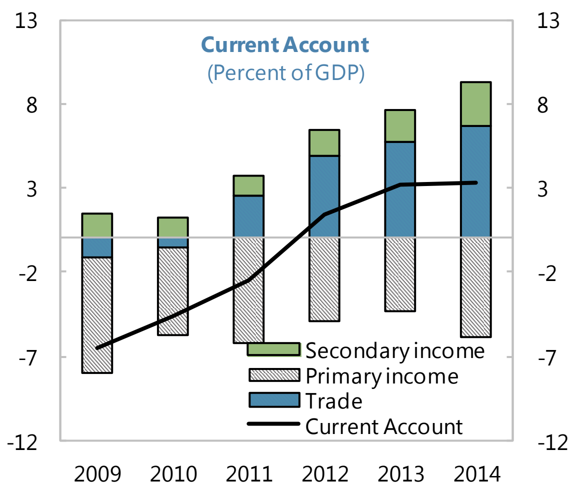
The economy is expected to continue to grow faster than the euro area…



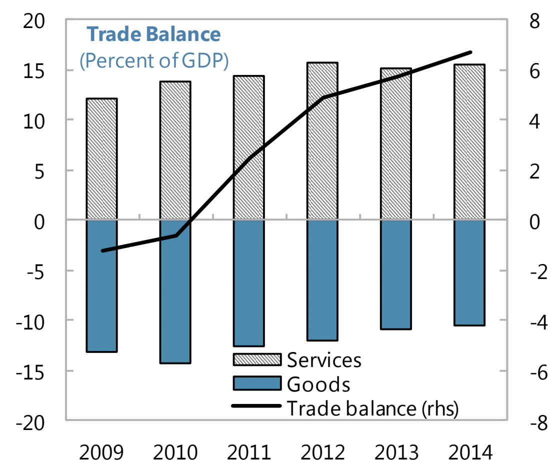
…supported by growth in consumption and investment.



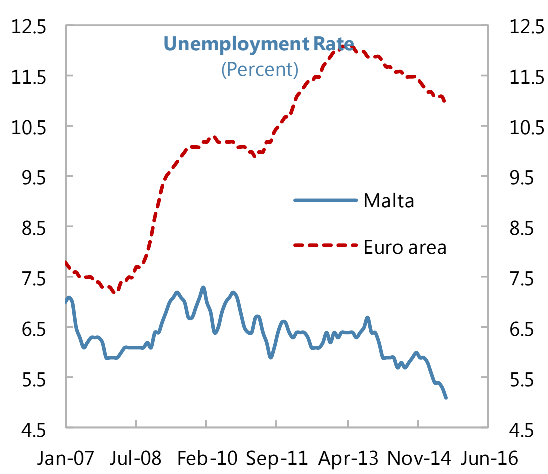
A turnaround in exports helped improve current account balance.



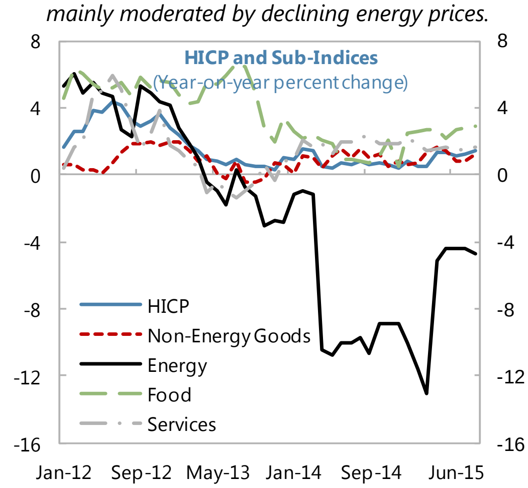
Exports of services were the main driver of Improvement in trade balance.



The labor market continues to be stronger than the euro area.



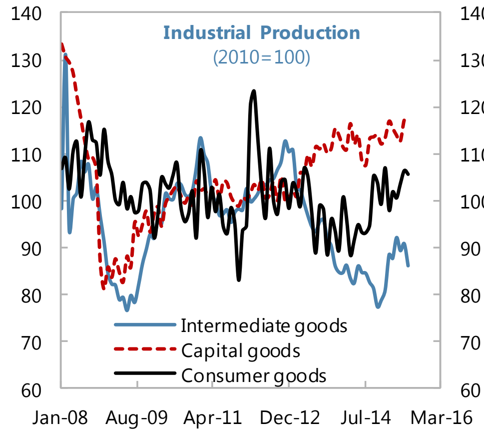
Headline inflation fluctuates at around 1½ percent, mainly moderated by declining energy prices.



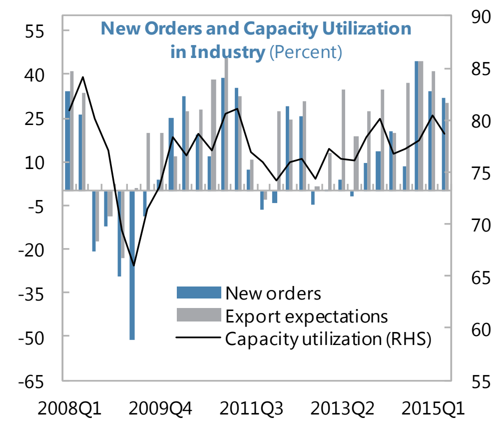
Sources: Central Bank of Malta; Eurostat; IMF World Economic Outlook; and IMF staff calculations.

Figure 2. Malta: Short-Term Indicators, 2008–2014

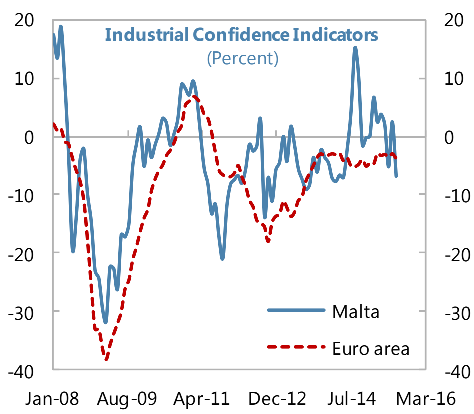
Industrial production remained subdued, except for capital goods...



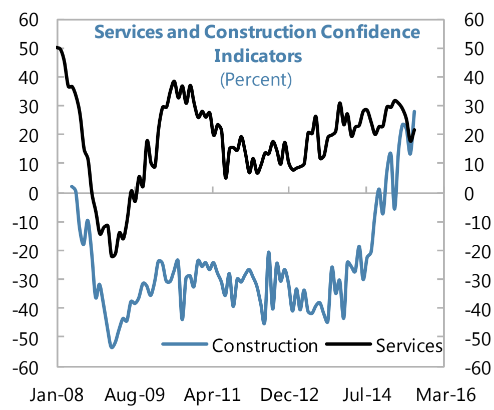
...but capacity utilization and new orders have picked up towards the end of 2014.



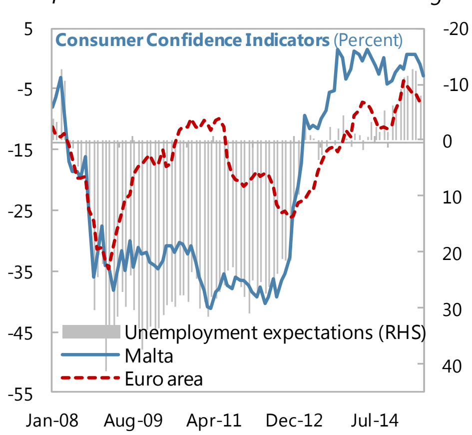
Industrial confidence has been volatile.



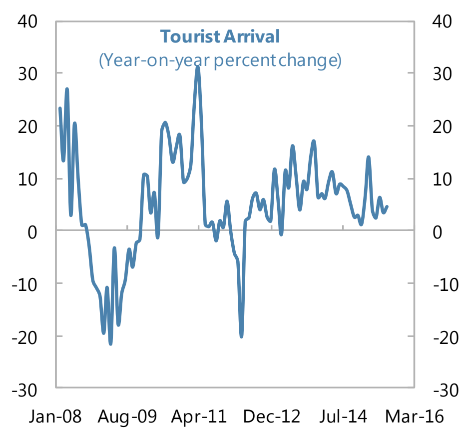
Services sector confidence remained firmly positive while construction sector improved markedly.



Supported by strong labor market conditions, consumer confidence remains above euro area average...

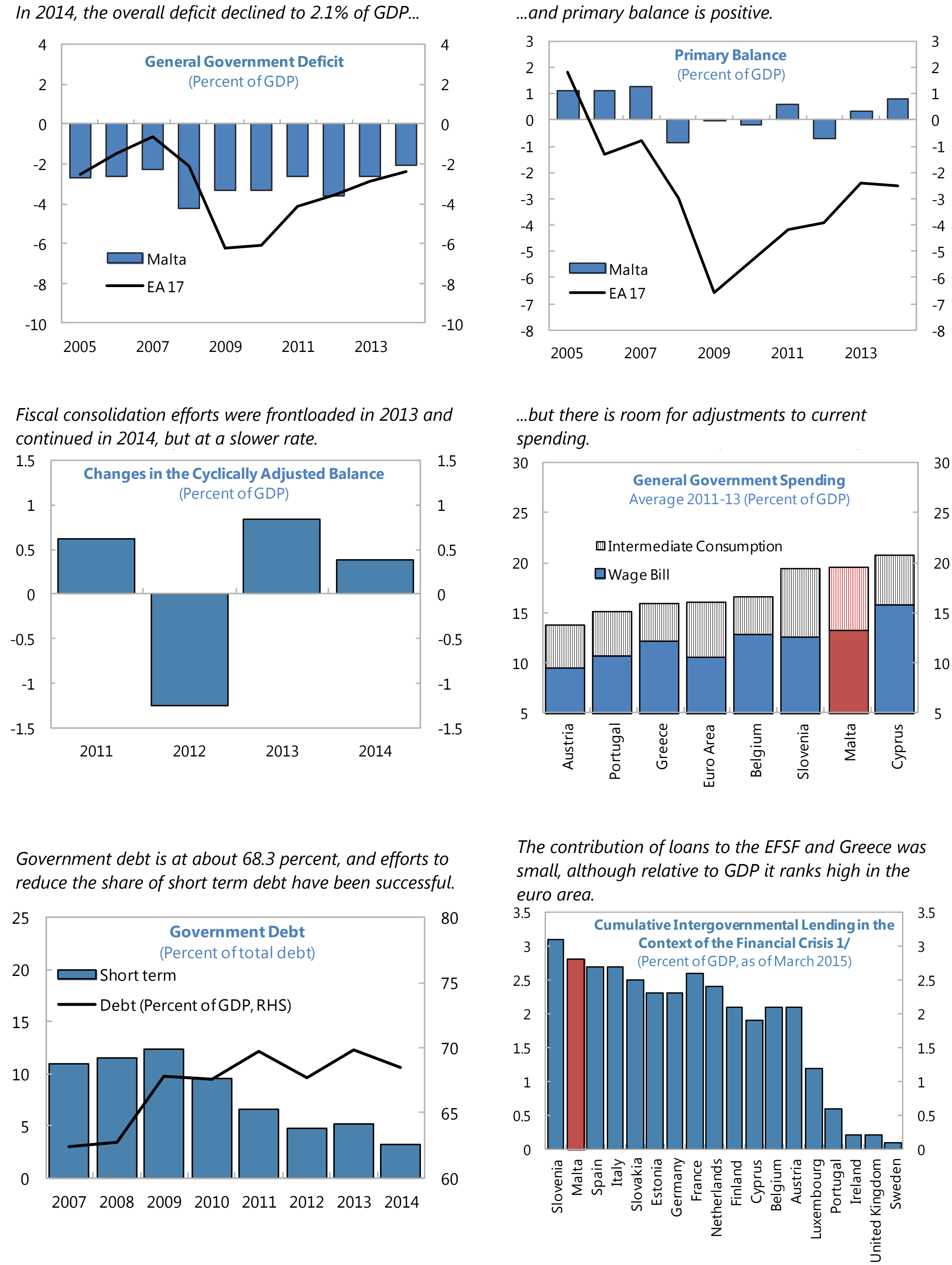


...and tourist flows have been growing robustly.



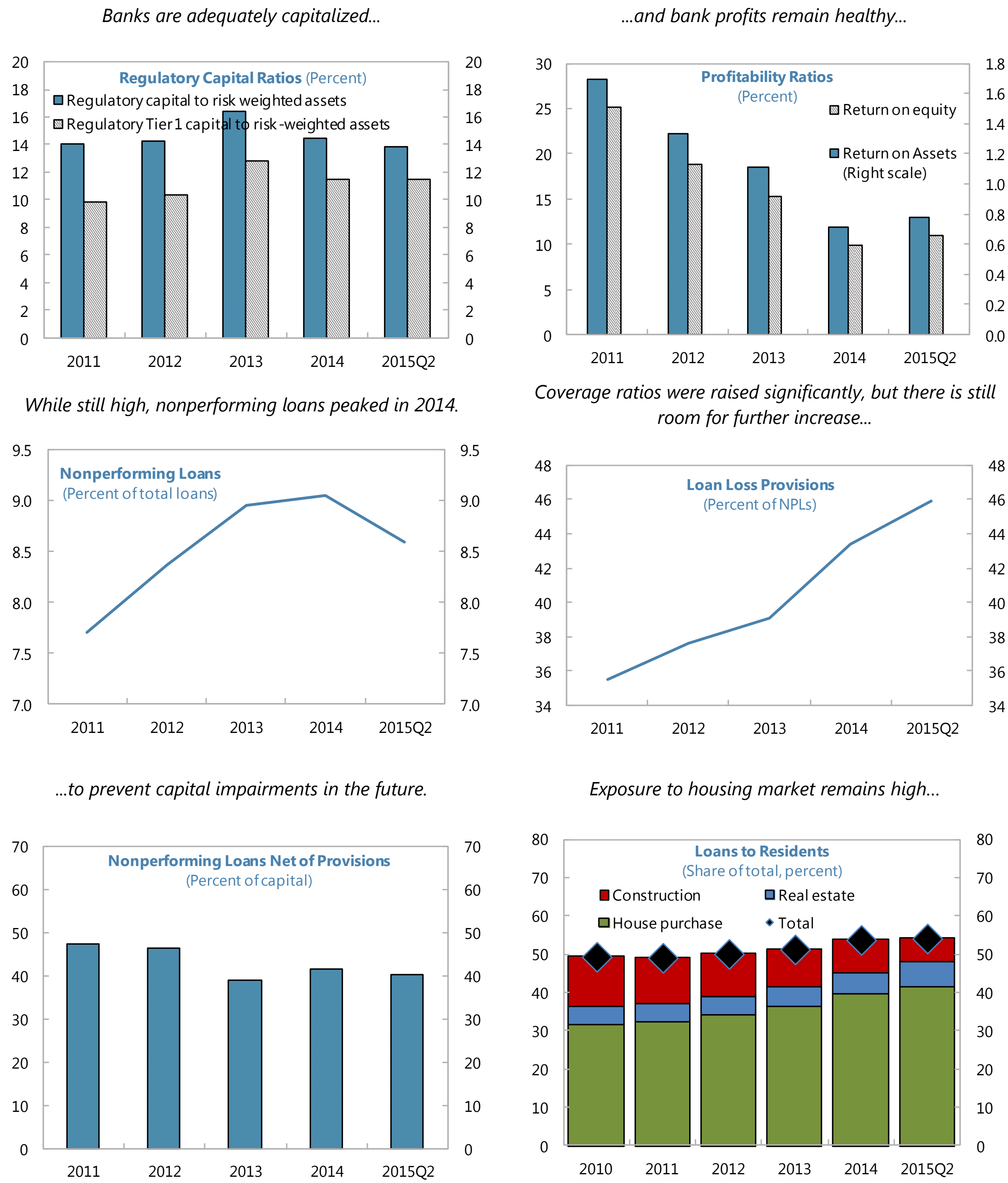
Sources: European Central Bank; Central Bank of Malta; European Commission; and IMF staff calculations.

Figure 3. Malta: Fiscal Developments



Sources: Eurostat, IMF World Economic Outlook; and IMF staff calculations.
1/ This data is ESA1995, since ESA2010 data is not yet available for Belgium, Cyprus, Spain and Slovakia.

Figure 4. Malta: Financial Soundness Indicators



Sources: Central Bank of Malta; and Malta Financial Services Authority.

Annex I. Implementation of IMF Recommendations

The Maltese authorities have taken on board the majority of policy recommendations made by the Fund in previous Article IV consultations (Annex Table 1).

Table 1. Implementation of IMF Recommendations

	2014 Art. IV Advice	Actions since 2014 Art. IV
Fiscal issues	Adopt additional consolidation measures to contain the fast growth in current expenditures and use unexpected revenues primarily for building fiscal buffers.	Fiscal consolidation was pursued in 2014 and 2015, helped by the strong economic growth. Current expenditures continue to grow at a rapid rate.
	Pursue broad-based expenditure reforms – on social security, healthcare and education – to contain fiscal pressures going forward.	Spending review on social security was completed and spending review on health care is going on. A proposal for pension reform has been prepared, and a part of the proposed measures were adopted in 2016 draft budget.
	Push forward with restructuring of state owned corporations to restore the profitability and viability of state-owned enterprises to reduce fiscal risks.	The partial privatization of Enemalta has been completed and infrastructure projects are onoging. The implementation of restructuring plan for Airmalta continues, which includes disposal of non-core businesses.
	Pension reforms: (i) accelerate planned increase in retirement age; (ii) link pension income to a longer period of working years; and (iii) accelerate the progress of the private third pillar pension scheme.	On (i), the 2016 budget raised the contributory period from 40 to 41 years for persons born after 1968 and introduced topping up of pension benefit for every year worked post retirement age. On (ii), the PSG recommended linking pension income to the last 15 years prior to retirement - an improvement over the previous regime, where only the best 3 years were used. On (iii), new financial products to encourage individual to save for their retirement in the voluntary private third pillar were launched by two financial institutions in November 2015.
	Advance efforts to strengthen fiscal governance.	The Fiscal Advisory Council continues to build its capacity and has produced its first set of reports, increasing fiscal transparency.
Financial sector issues	A swift implementation of action plans resulting from the ECB's comprehensive assessment, and applying the same standards across the rest of the banking sector.	Implementation of bank action plans continues; AQR for Mediterranean Bank completed.

Table 1. Implementation of IMF Recommendations (Concluded)

	2014 Art. IV Advice	Actions since 2014 Art. IV
	Strengthen the contingency framework in line with reforms at the EU level, including by boosting the resources of the deposit compensation scheme and lowering the share of banks' special contribution.	The minimum for the DCS fund is set at 1.3 percent of covered deposits—above the target level of ex-ante funds of 0.8 percent (EU directives). The share of special contributions (i.e., not cash) will be reduced in line with the EU directives.
	Follow through legal amendments needed to implement the EU Bank Recovery and Resolution Directive (BRRD), establish a resolution fund and introduce a bail-in requirement.	The EU BRRD has been transposed into national law and the MFSA established a separate resolution unit. The focus is now on bank recovery plans and the collection of contributions for the resolution fund.
	Conduct an FSAP update.	An FSAP update has been requested.
	Continue to aim for high standards in the AML/CFT framework.	FIAU shifted to a risk based AML/CFT supervision. Efforts to build capacity and training are underway.
Structural reforms	Strengthen female labor participation.	Incentives to work were improved, eg by introducing free childcare for working mothers.
	Enhance education attainment.	Ongoing, within the framework of national education strategy.
	Improve the business climate through judicial reforms.	Judicial reforms are ongoing with a a focus on the insolvency regime.
	Improve the business climate through increasing access to credit.	Ongoing on multiple fronts including judicial reforms, planned credit registry, efforts to incentivize banks to reduce NPLs, the planned development bank and multi trading facility by the stock exchange.

Annex II. Debt Sustainability Analysis

1. **The public debt-to-GDP ratio fell to 68.3 percent in 2014 from 69.6 in 2013**. The primary balance turned positive in 2013 and is expected to rise above 1 percent of GDP in 2016. This puts the debt-to-GDP ratio on a downward trajectory.

2. **The stock of contingent liabilities is expected to stabilize in 2015.** Government guaranteed debt increased from 7.5 percent of GDP in 2008 to about 16.8 percent of GDP in 2014, mainly stemming from Enemalta (the national utility company). With the partial privatization of Enemalta, guaranteed debt declined to 14.4 percent in 2015Q2.

3. **In order to assess the sustainability of government debt, a number of adverse scenarios are considered.** Although under the baseline scenario the debt-to-GDP ratio is expected to remain on the downward trajectory, this is very sensitive to shocks.

- Under a *growth shock* that lowers output by 2.7 percentage points (equivalent to 1 standard deviation of growth over the past 10 years) in 2015–2016 and inflation declining by 0.3 percentage points in 2016, debt would peak at 69.8 percent of GDP in 2017, 6.0 percentage points higher than in the baseline.

- A sustained *interest rate shock* of 200 bps would slow down the rate of debt decline such that by 2019 the debt-to-GDP ratio is 0.7 percentage points higher with respect to the baseline.

- A *primary fiscal balance shock* of 0.3 percentage points over 2015–2016 yields a debt-to-GDP ratio 0.7 percentage points higher in 2019 relative to the baseline.

- A *combined macro-fiscal shock* including the three shocks above would lead to debt peaking at 69.9 percent of GDP in 2017, 6.1 percentage points higher relative to the baseline, and declining to about 66.8 percent of GDP in 2019.

- Under a *contingent liability shock* there is a one-time increase in non-interest expenditures equivalent to 10% of the banking sector credit (or about 2/3 of the current guaranteed debt). This leads to a real GDP growth shock as the one above (with growth declining for 1 standard deviation over 2015–2016)— revenue-to-GDP ratio remains the same as in the baseline while the deterioration of the primary balance leads to higher interest rates and the decline in growth lowers the inflation rate. This leads to debt reaching 75.3 percent in2019.

4. **Overall, key risks to public debt are assessed to be originating from low growth and inflation, and contingent liabilities**.

5. **Risks stemming from Malta's high external financing requirements are partly mitigated by large holdings of foreign assets.** While total net external debt as of at the end of 2014 is about negative (325 percent of GDP), the short term net debt is positive (264 percent of GDP). Most of outstanding short term debt is dominated by financial institutions (79 percent of net short term debt and 64.1 percent of gross short term debt). Excluding financial institutions and the central bank, short term debt is about 157 percent of GDP.

Figure 1. Malta Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

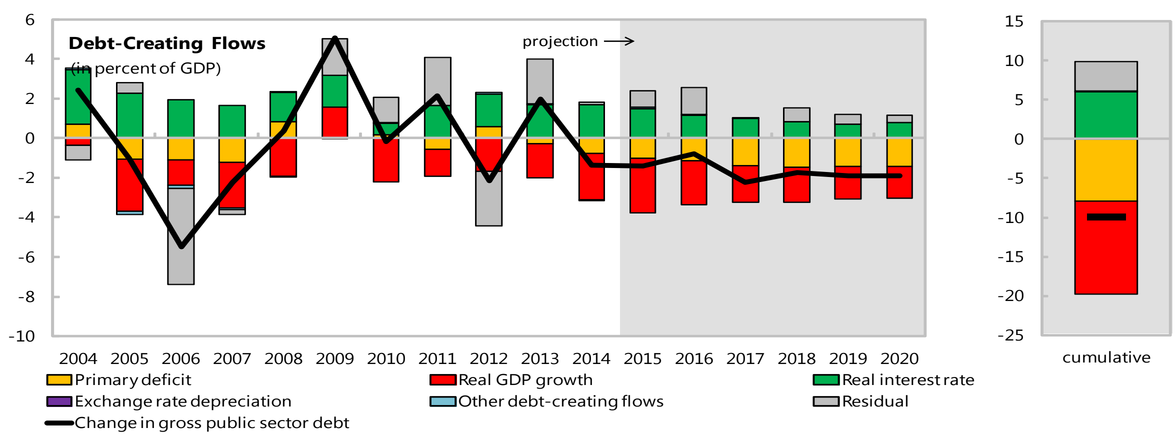
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2004-2012 [2]	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	67.1	69.6	68.3	66.9	66.1	63.8	62.1	60.2	58.3
Public gross financing needs	5.6	6.0	6.1	7.6	8.3	6.6	6.4	6.1	6.7
Real GDP growth (in percent)	2.1	2.7	3.6	4.3	3.5	3.0	3.0	2.8	2.8
Inflation (GDP deflator, in percent)	2.5	1.8	1.8	1.7	1.8	2.2	2.5	2.8	2.8
Nominal GDP growth (in percent)	4.7	4.6	5.4	6.1	5.4	5.3	5.6	5.6	5.6
Effective interest rate (in percent) [4]	5.3	4.5	4.4	4.1	3.7	3.8	4.0	4.1	4.2

As of September 24, 2015		
Sovereign Spreads		
EMBIG (bp) 3/		109
5Y CDS (bp)		208
Ratings	Foreign	Local
Moody's	A3	A3
S&Ps	BB+	BB+
Fitch	BBB+	BBB+

Contribution to Changes in Public Debt

	Actual			Projections							
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing
Change in gross public sector debt	-0.1	2.0	-1.4	-1.4	-0.8	-2.2	-1.7	-1.9	-1.9	-9.9	primary
Identified debt-creating flows	0.2	-0.3	-1.5	-2.2	-2.2	-2.3	-2.4	-2.4	-2.2	-13.7	balance [9]
Primary deficit	-0.2	-0.3	-0.8	-1.0	-1.1	-1.4	-1.5	-1.5	-1.5	-7.9	-0.8
Primary (noninterest) revenue and gra	38.7	40.0	41.9	42.7	40.9	40.9	40.8	40.8	40.8	246.9	
Primary (noninterest) expenditure	38.5	39.7	41.1	41.7	39.7	39.6	39.3	39.3	39.3	238.9	
Automatic debt dynamics [5]	0.4	0.0	-0.7	-1.3	-1.1	-0.9	-1.0	-0.9	-0.8	-5.9	
Interest rate/growth differential [6]	0.4	0.0	-0.7	-1.3	-1.1	-0.9	-1.0	-0.9	-0.8	-5.9	
Of which: real interest rate	1.7	1.7	1.7	1.5	1.2	1.0	0.8	0.7	0.8	6.0	
Of which: real GDP growth	-1.4	-1.7	-2.3	-2.8	-2.2	-1.9	-1.8	-1.6	-1.6	-11.9	
Exchange rate depreciation [7]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.1	
Please specify (1) (e.g., drawdown of	-0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euro	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.1	
Residual, including asset changes [8]	-0.3	2.2	0.1	0.8	1.4	0.1	0.7	0.5	0.4	3.8	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

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

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi (1+g)$ and the real growth contribution as $-g$.

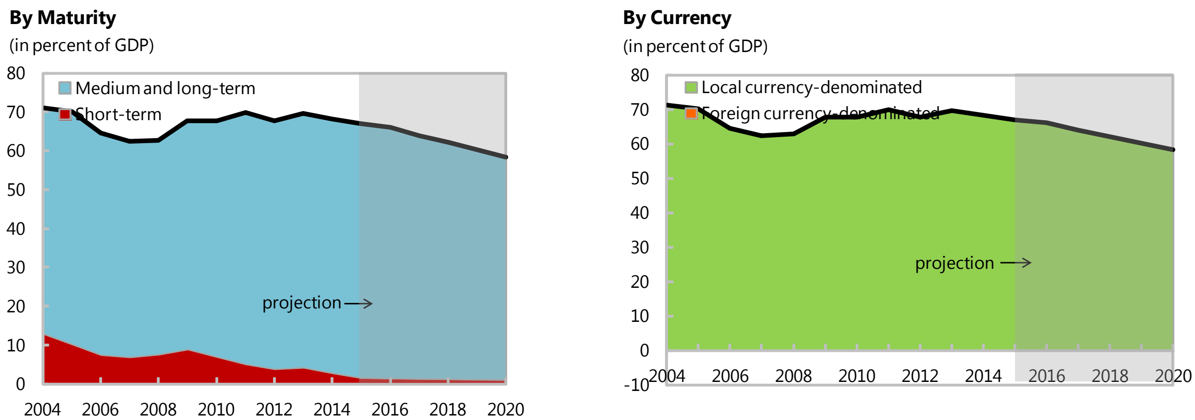
7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

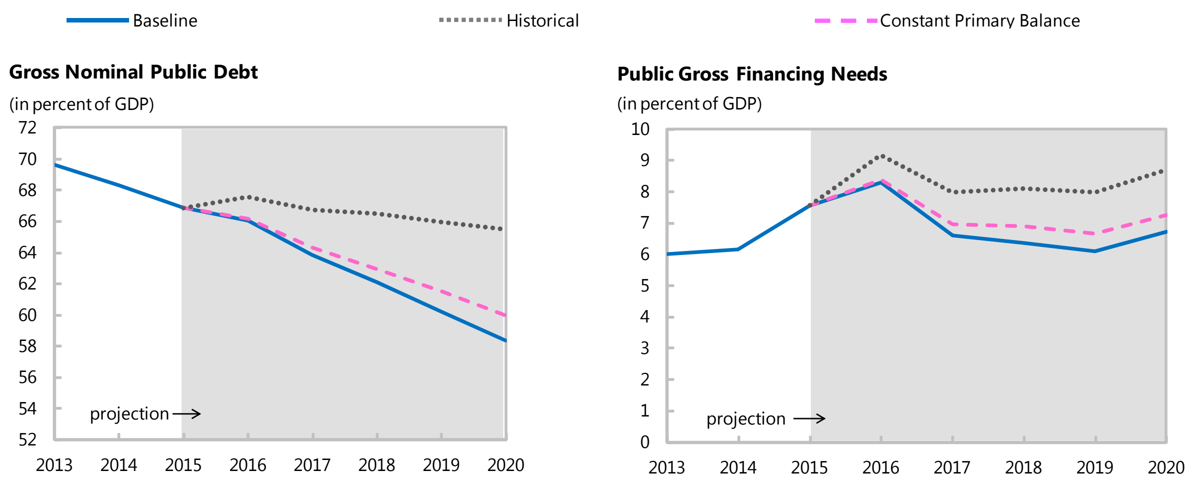
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 2. Malta Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt



Alternative Scenarios



Underlying Assumptions

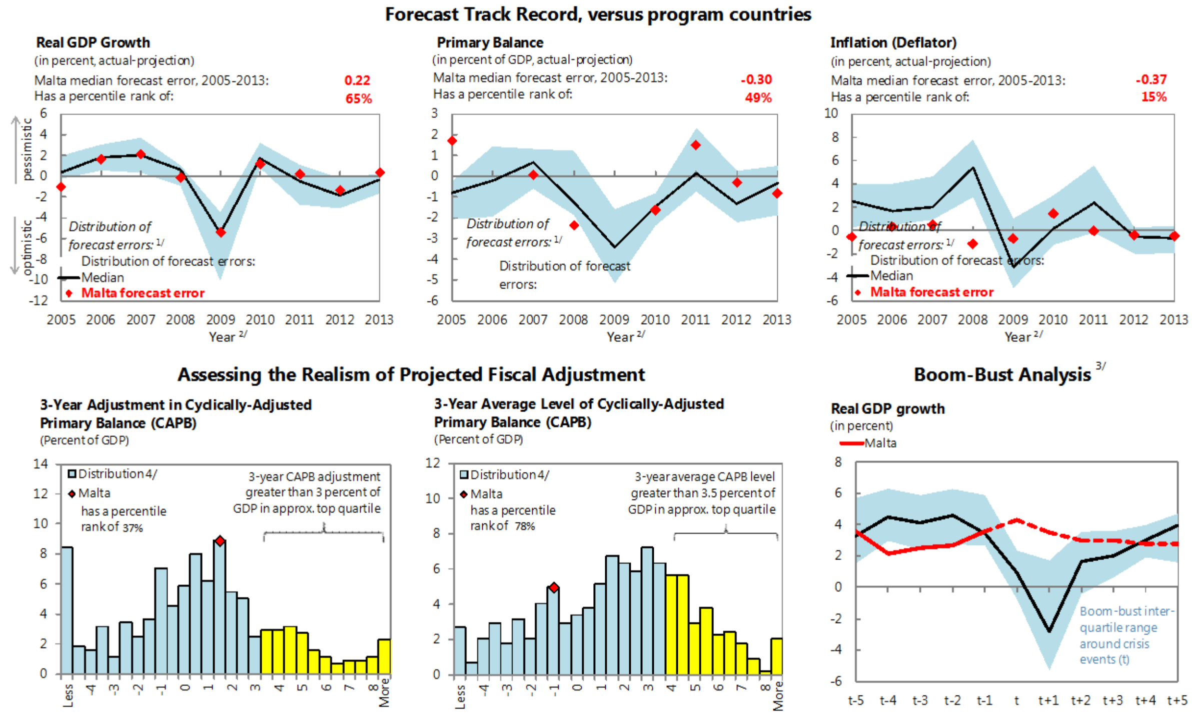
(in percent)

Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	4.3	3.5	3.0	3.0	2.8	2.8
Inflation	1.7	1.8	2.2	2.5	2.8	2.8
Primary Balance	1.0	1.1	1.4	1.5	1.5	1.5
Effective interest rate	4.1	3.7	3.8	4.0	4.1	4.2
Constant Primary Balance Scenario						
Real GDP growth	4.3	3.5	3.0	3.0	2.8	2.8
Inflation	1.7	1.8	2.2	2.5	2.8	2.8
Primary Balance	1.0	1.0	1.0	1.0	1.0	1.0
Effective interest rate	4.1	3.7	3.8	4.0	4.1	4.2

Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	4.3	2.5	2.5	2.5	2.5	2.5
Inflation	1.7	1.8	2.2	2.5	2.8	2.8
Primary Balance	1.0	0.3	0.3	0.3	0.3	0.3
Effective interest rate	4.1	3.7	3.9	4.1	4.3	4.5

Source: IMF staff.

Figure 3. Malta Public DSA - Realism of Baseline Assumptions



Source: IMF staff.

1/ Plotted distribution includes program countries; percentile rank refers to all countries.

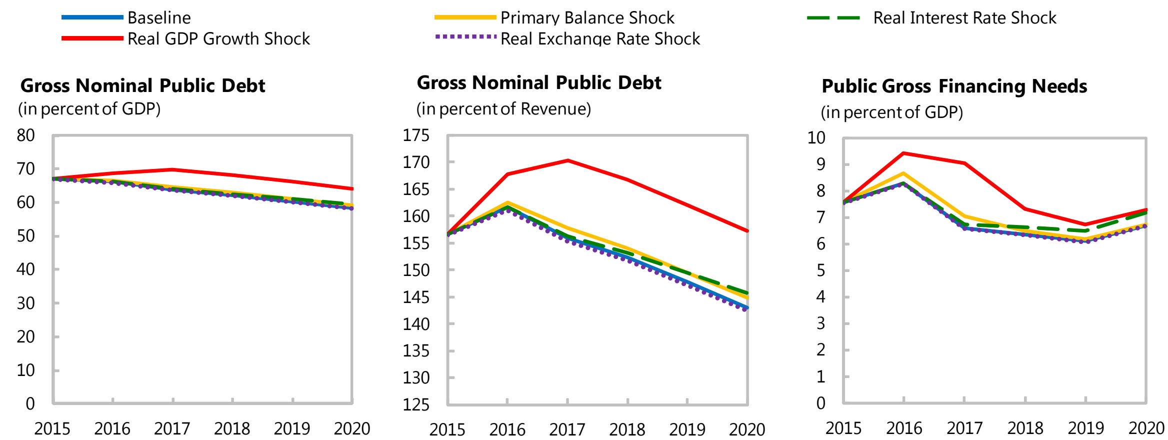
2/ Projections made in the spring WEO vintage of the preceding year.

3/ Malta has had a positive output gap for 3 consecutive years, 2012–2014. For Malta, t corresponds to 2015; for the distribution, t corresponds to the first year of the crisis.

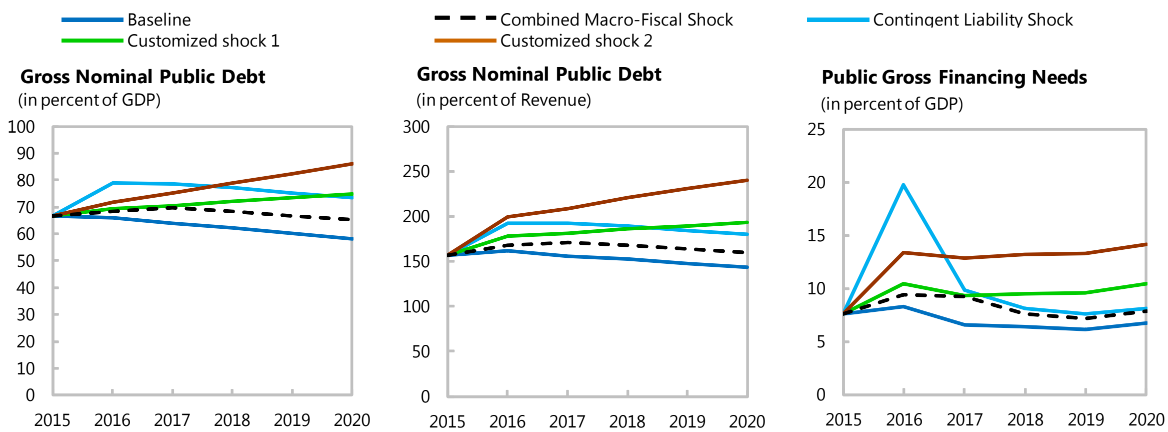
4/ Data cover observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. percent of sample on vertical axis.

Figure 4. Malta Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	4.3	3.5	3.0	3.0	2.8	2.8
Inflation	1.7	1.8	2.2	2.5	2.8	2.8
Primary balance	1.0	0.8	1.0	1.5	1.5	1.5
Effective interest rate	4.1	3.7	3.8	4.0	4.1	4.2
Real Interest Rate Shock						
Real GDP growth	4.3	3.5	3.0	3.0	2.8	2.8
Inflation	1.7	1.8	2.2	2.5	2.8	2.8
Primary balance	1.0	1.1	1.4	1.5	1.5	1.5
Effective interest rate	4.1	3.7	4.1	4.4	4.6	4.9
Combined Shock						
Real GDP growth	4.3	1.6	1.1	3.0	2.8	2.8
Inflation	1.7	1.4	1.7	2.5	2.8	2.8
Primary balance	1.0	0.2	-0.5	1.5	1.5	1.5
Effective interest rate	4.1	3.7	4.1	4.4	4.6	4.9

Real GDP Growth Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	4.3	1.6	1.1	3.0	2.8	2.8
Inflation	1.7	1.4	1.7	2.5	2.8	2.8
Primary balance	1.0	0.2	-0.5	1.5	1.5	1.5
Effective interest rate	4.1	3.7	3.8	4.0	4.1	4.2
Real Exchange Rate Shock						
Real GDP growth	4.3	3.5	3.0	3.0	2.8	2.8
Inflation	1.7	2.2	2.2	2.5	2.8	2.8
Primary balance	1.0	1.1	1.4	1.5	1.5	1.5
Effective interest rate	4.1	3.7	3.8	4.0	4.1	4.2
Contingent Liability Shock						
Real GDP growth	4.3	1.6	1.1	3.0	2.8	2.8
Inflation	1.7	1.4	1.7	2.5	2.8	2.8
Primary balance	1.0	-9.9	1.4	1.5	1.5	1.5
Effective interest rate	4.1	4.0	4.4	4.5	4.5	4.6

Source: IMF staff.

Figure 5. Malta Public DSA Risk Assessment

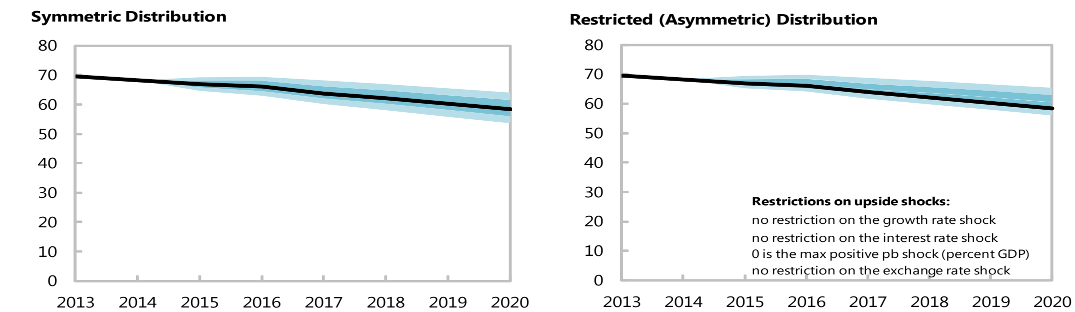
Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)

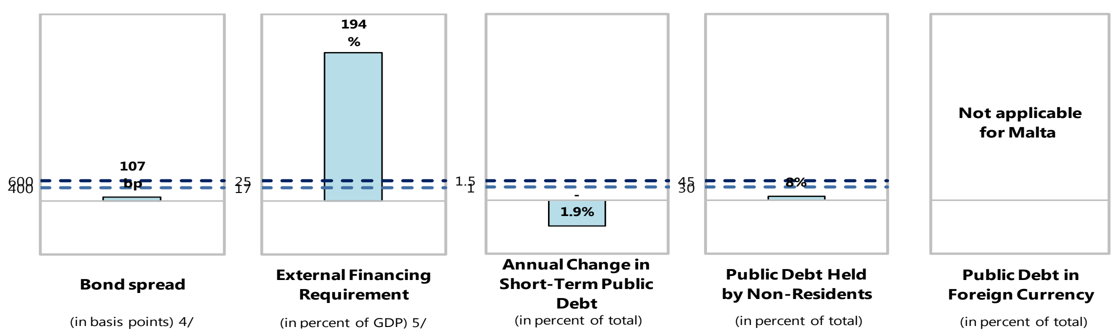
Baseline   Percentiles: 10th-25th   25th-75th   75th-90th



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2014)

Malta   Lower early warning   Upper early warning



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white. Lower and upper risk-assessment benchmarks are: 400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

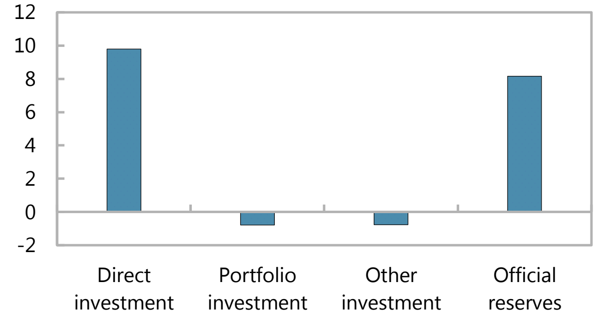
4/ Long-term bond spread over German bonds, an average over the last 3 months, 26-Jun-15 through 24-Sept-15.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Annex III. Malta: External Sector Assessment[1]

1. **Malta's external balance has improved rapidly over recent years**. Malta recorded a current account surplus of 3.3 percent of GDP in 2014 (an all-time high) from an average 4 percent deficit over the period 1995 to 2014. On the financial side, while the NIIP appears not concerning, major vulnerabilities might still arise given large gross stock positions. Staff calculations indicate that valuation effects on the liabilities side are substantial and mostly originate from foreign direct investment. However, the large share of intra-company lending stands as a mitigation factor to possible risks.

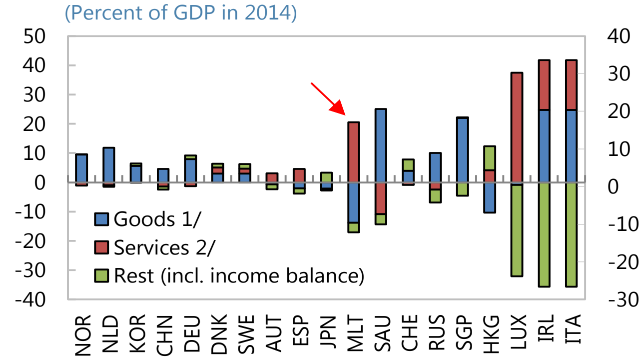
Valuation Effects in Foreign Liabilities and Official Reserves
(as a ratio of corresponding flows; average 2009-14)



Sources: CSO; IMF staff calculations.
Implied valuation effects are deived as the difference between annual change in stocks and corresponding annual BoP flows).

2. **The structure of Malta's current account is complex, with "nontraditional" items accounting for a large fraction of the surplus.** Most of the gains recorded in the current account come from the rapid acceleration in service exports in recent years. The net balance of trade of services moved from 9 percent of GDP in early 2000s to more than 20 percent of GDP recently, compared to about 1 percent of GDP for the euro area as a whole. Rising service balance mainly reflects increase in exports of remote gaming companies, telecommunications, insurance services, and travel.

Structure of Largest Current Account Surpluses
(Percent of GDP in 2014)



Sources: Haver Analytics; WEO; IMF staff calculations.
1/ Excluding nonmonetary gold and merchanting.
2/ Excluding finance, insurance and license fees.

3. **Malta's current account exhibits large volatility that is largely unrelated to movements in the real exchange rate and global demand**. The standard deviation of the Malta's current account surplus, computed over the last decade, is 4.5 percentage points of GDP, one of the highest among advanced economies. The bulk of this volatility comes from fluctuations in net exports of services—such as financial services[2] and online gaming[3], and primary account—which reflect international bank transfers.[4] Goods account is also volatile,

---

[1] Prepared by Christian Ebeke (EUR).

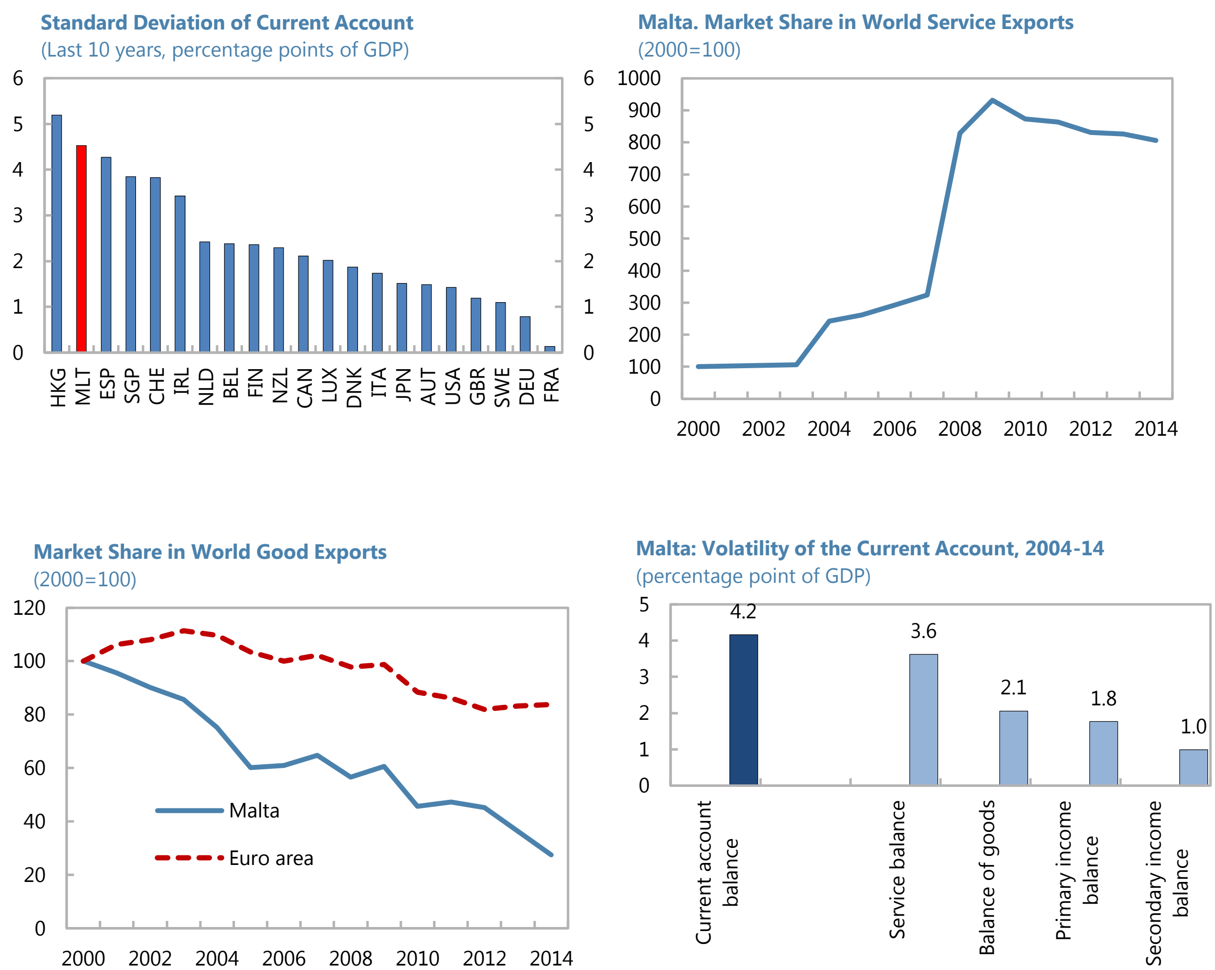
[2] These transactions are mostly driven by international banks that have little connection to the real domestic economy.

[3] Regulatory and fiscal changes in other EU countries (including in the U.K.) have led Malta to take advantage of its competitive advantage in online gaming activities.

[4] An example of the current account's high volatility is the decline in its deficit from 5.9 percent of GDP in 2009 to a surplus of 5 percent of GDP one year later without a sizeable change in the trade balance. Service exports rose by almost 6 percentage points of GDP in a year.

partly reflecting oil re-exports.[5] This implies that the Malta's current account is affected by sizeable non-traditional factors in addition to the standard fluctuations in REER or foreign demand. There has been a rebalancing of Malta's current account away from goods to services exports, with the decline in market share of good exports being compensated by the gains in exports of services.

Figure 1. Malta: Global Integration and Current Account Volatility



Sources: Haver Analytics; WEO; IMF Direction of Trade Statistics; IMF Balance of Payment Statistics; and IMF staff calculations.

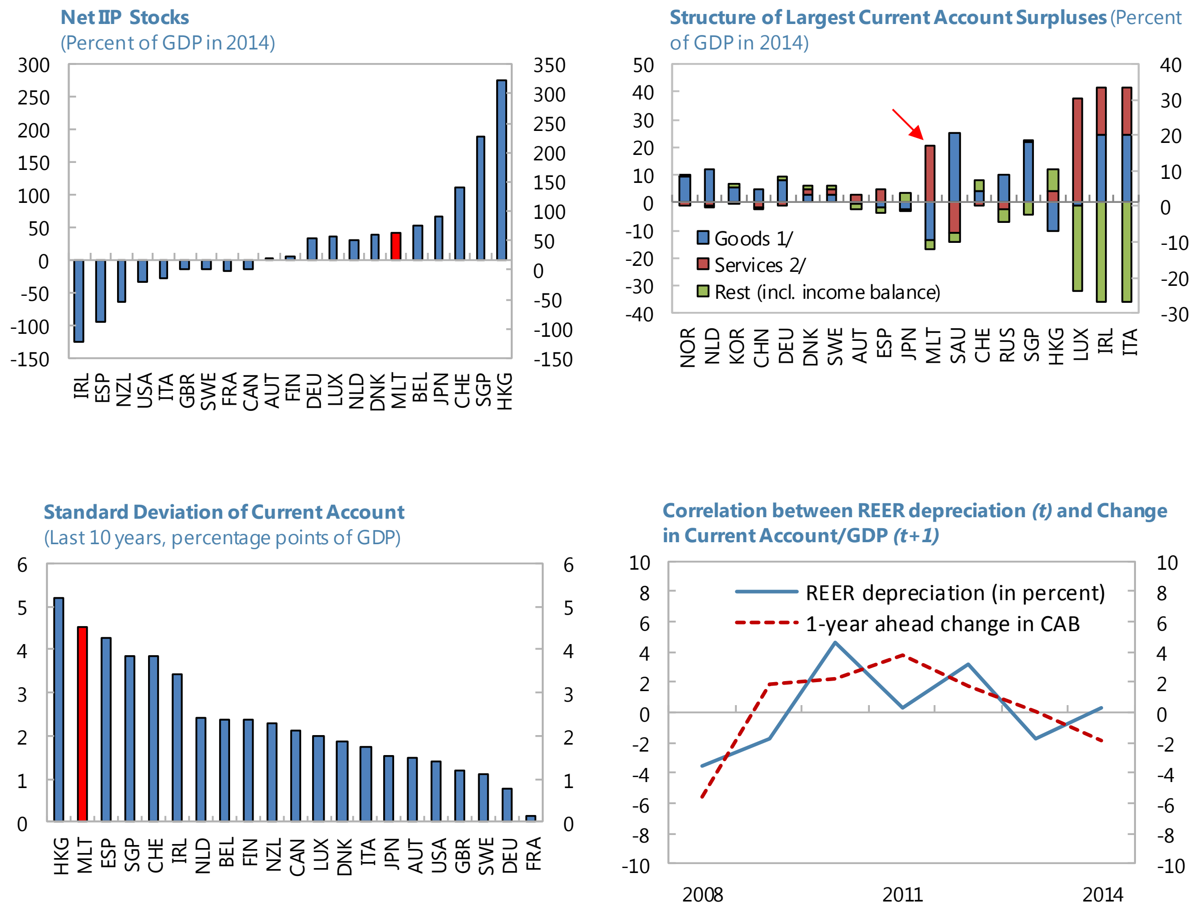
[5] Trade data includes oil bunkering activities that bring enormous volumes of oil to Malta which are then re-exported.

4. **Staff views Malta's external position as having been broadly in line with fundamentals in 2015, though this assessment is subject to high uncertainty.** This judgment reflects a balance of a number of factors, including the EBA–lite current account norm estimates, misalignment estimates, and Malta-specific factors. Given the high uncertainty surrounding estimates, staff has proceeded to a number of statistical adjustments using the EBA-lite methodology. First, the cyclically-adjusted current account to GDP ratio in 2015 has been adjusted downward (to -0.4 percent of GDP) by a one-off factor which is equivalent to aligning the volatility of the overall current account with its trade or income balance counterparts (around 2 percentage points of GDP; see text-figure above). Second, the adjustment to the estimated cyclically-adjusted current account norm has taken into account the fact that a large share private sector credit finances non-tradable activities (such as mortgages and residential real estates) and does not necessarily affect the trade balance. The adjustment to the norm has also taken into account the slightly reduced energy dependency in line with ongoing large energy investment projects. Taking into account these adjustments, the current account norm improves from around -3 percent to -0.3 percent of GDP. The resulting current account gap (the difference between the "revised" cyclically-adjusted current account and cyclically-adjusted norm) is -0.1 percentage point of GDP.[6] This translates into a REER *overvaluation* of 0.1 percent.[7] Contribution from policy gaps increases the current account surplus (mainly explained by Malta's recent fiscal consolidation efforts compared with trading partners and private credit in line with fundamentals) but rather limited (0.3 percent). EBA REER estimates suggest an *overvaluation* of the REER of 0.5 percent. In a nutshell, staff assesses the external position as broadly consistent with medium-term fundamentals and desirable policy settings.

[6] A negative current account gap and/or a positive REER imply an *overvaluation* of the REER.

[7] Without adjustment made, the current account gap amounts to 4.4 percentage points of GDP of which 4.1 percentage points are pure residuals. Taking into account current account elasticity with respect to REER, the implied exchange rate misalignment without any adjustment stands at -4.8 percent.

Figure 2. Malta: External Sector Position and Real Effective Exchange Rate Dynamics



Sources: Haver Analytics; WEO; and IMF staff calculations.
1/ Excluding nonmonetary gold and merchanting.
2/ Excluding finance, insurance and license fees.

INTERNATIONAL MONETARY FUND

MALTA

December 21, 2015

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | European Department (In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of October 31, 2015)

Membership Status
Joined: September 11, 1968; Article VIII

General Resources Account	**SDR Million**	**Percent Quota**
Quota	102.00	100.00
Fund holdings of currency	72.67	71.25
Reserve Tranche Position	29.36	28.79
Lending to the Fund		
Borrowing Agreement	1.37	

SDR Department	**SDR Million**	**Percent Allocation**
Net cumulative allocation	95.40	100.00
Holdings	84.51	88.59

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)

			Forthcoming		
	2015	**2016**	**2017**	**2018**	**2019**
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.

Article IV Consultation

Malta is on the standard 12-month consultation cycle. The previous consultation discussions took place during December 3–15, 2014, and the staff report (Country Report No.15/32, 02/06/2015) was discussed and the consultation was completed on February 23, 2015.

Technical Assistance

Date	Department	Subject
April 2015	FAD	Revenue Administration
November 2014	FAD	Revenue Administration
March 2014	FAD	Strengthening Public Financial Management
May 2013	STA	Balance of Payments
April 2009	STA	SDDS subscription finalization
November 2006	STA	Producer price index/SDDS preparations
April and December 2007		(expert visits)
June 2005	STA	ROSC Data Module
October 2002–January 2003	MFD	FSAP missions (joint with World Bank)
March 2001	STA	Money and banking statistics
February 1999	MAE	Monetary operations and liquidity Forecasting

Resident Representative

None

STATISTICAL ISSUES APPENDIX

(As of November 11, 2015)

I. Assessment of Data Adequacy for Surveillance
General: Data provision is adequate for surveillance purposes. Significant progress in improving macroeconomic statistics has been made in close cooperation with the European Central Bank (ECB) and Eurostat while upgrading statistical systems to meet the euro area standards. Most macroeconomic statistics can now be accessed through Eurostat and Haver Analytics. The country has subscribed to the SDDS since December 1, 2009, with the metadata posted on the IMF's Dissemination Standards Bulletin Board.
National Accounts: Malta compiles its national accounts in accordance with the guidelines of *ESA 2010* since October 2014. The effect of the conceptual differences from *ESA 1995* on the estimated level of GDP in 2010 was a relative small upward revision of 0.5 percent. Data on retail and consumer prices, labor market indicators, and tourism arrivals are released monthly, usually with a short lag. A harmonized index of consumer prices has been published since May 2004. These data are available through Eurostat and Haver Analytics as well as via the Internet at the Central Bank of Malta (CBM) and the National Statistical Office (NSO) websites. The NSO releases quarterly national accounts data in current and constant prices with a lag of about two months, annual nonfinancial sectoral accounts in current prices with a lag of about 11 months, and a monthly index of industrial production with a lag of just over a month. However, national accounts data have been subject to substantial revisions, often affecting several years. The reasons for revisions include large statistical discrepancies (captured under changes in inventory stocks), particularly on the first release and revisions of deflators. Furthermore, supply-side GDP estimates by type of economic activity are only available at current prices and compilation of volume measures is currently progressing. Volume estimates of expenditure GDP are obtained using annual-chain linking with 2010 as the reference year. The producer price index for total industry and agricultural products have been published, but that for services sector is still under discussion. National accounts imports and exports data are not disaggregated into goods and services. Annual Financial balance sheets and transactions by sectors are published on the Eurostat website. However, data on household savings are not available.
Price Statistics: Data on retail and consumer prices are released monthly, usually with a short lag. A harmonized index of consumer prices has been published since May 2004. These data are available through Eurostat and Haver Analytics and via the Internet at the Central Bank of Malta (CBM) and the National Statistical Office (NSO) websites. The producer price index for total industry and the agricultural price index have been published, but that for services sector is still under discussion.
Government finance statistics: Fiscal statistics meet requirements, with quarterly accrual-based data on general government operations compiled in accordance with the *ESA2010* 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 have been obtained through a gateway arrangement with the ECB, thus reducing the reporting burden of the country.
Financial Sector Surveillance: Malta has reported Financial Soundness Indicators beginning from 2005 along with metadata, which are available on 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 by the NSO on a quarterly basis with a lag of about three months. More detailed BOP and IIP data are released quarterly, the latter with a lag sometimes of about one year. Summary trade statistics are released monthly with a lag of about 40 days. The CBM publishes the external debt templates in line with requirements of the SDDS, including both gross and net external debt. In line with the European regulation, Malta has transitioned to *BPM6* and has revised the estimates back to 2008. In line with the BPM6 requirements, the new data include estimates for the SPEs and other coverage improvements, affecting in particular the primary incomes and the financial account (direct and portfolio investments), as well as position data (IIP). The BPM6 implementation and data back casting entailed a series of data revisions recently.

II. Data Standards and Quality	
The country has subscribed to the SDDS since December 1, 2009, with the metadata posted on the IMF's Dissemination Standards Bulletin Board.	A data ROSC was published in 2006.

APPENDIX I: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

Malta: Table of Common Indicators Required for Surveillance

(As of November 11, 2015)

	Date of latest observation (For all dates in table, please use format dd/mm/yy)	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:[8] Data Quality – Methodological soundness[9]	Memo Items:[8] Data Quality – Accuracy and reliability[10]
Exchange Rates1/	Current	Current	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities 2/	Sep 2015	Oct 2015	M	M	Q		
Central Bank Balance Sheet	Sep 2015	Oct 2015	M	M	Q	…	…
Consolidated Balance Sheet of the Banking System	Sep 2015	Oct 2015	M	M	Q	…	…
Interest Rates 3/	Sep 2015	Nov 2015	M	M	M		
Consumer Price Index	Sep 2015	Oct 2015	M	M	M	O, LO, O, O	O, O, LO, LO, O
Revenue, Expenditure, Balance and Composition of Financing 4/ – General Government 5/	Sep 2015	Oct 2015	M	M	Q	O, LO, O, LO	O, O, O, LO, O
Revenue, Expenditure, Balance and Composition of Financing 4/– General Government	Sep 2015	Oct 2015	M	M	Q		
Stocks of General Government and General Government-Guaranteed Debt 6/	2015:Q2	Oct 2015	Q	Q	Q		
External Current Account Balance	2015:Q2	Sep 2015	Q	Q	Q	O, LO, O, O	LO, O, O, O, LNO
Exports and Imports of Goods and Services	2015:Q2	Sep 2015	Q	Q	Q		
GDP/GNP	2015:Q2	Sep 2015	Q	Q	Q	O, LNO, O, LO	LO, O, LO, LO, LO

Gross External Debt	2015:Q2	Oct 2015	Q	Q	Q		
International Investment Position 7/	2015:Q1	Jul 2015	Q	A	A		
Exchange Rates1/	Current	Current	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities 2/	Sep 2015	Oct 2015	M	M	Q		

1/ Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
2/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
3/ Foreign, domestic bank, and domestic nonbank financing.
4/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
5/ Including currency and maturity composition.
6/ Includes external gross financial asset and liability positions vis-à-vis nonresidents.
7/ Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
8/ These columns should only be included for countries for which Data ROSC (or a Substantive Update) has been published.
9/ This reflects the assessment provided in the data ROSC or the Substantive Update (published on …, and based on the findings of the mission that took place during…) 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).
10/ Same as footnote 7, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.