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Malta: 2012 Article IV Consultation—Staff Report; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2012 Article IV consultation with Malta, the following documents have been released and are included in this package:

- The staff report for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on January 23, 2012, 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 March 6, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A Public Information Notice (PIN).

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MALTA

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

March 6, 2012

KEY ISSUES

Context: After a strong recovery in 2010, the economy has continued to perform well amidst considerable turbulence in the euro area. While spillovers have remained contained to date, Malta's large financial sector (above eight times GDP, see Box 1) and highly open economy heighten contagion and financial stability risks. The government, which has a one-seat majority in Parliament, narrowly survived a vote of no confidence in January. The policy challenge now is to maintain growth and employment, while building buffers against a highly uncertain international environment.

Fiscal policy: Following a significant fiscal effort that reduced the deficit to 3 percent of GDP in 2011, a gradual deficit reduction path of structural annual adjustment of ½ percentage point of GDP would be appropriate. This will help offset the headwinds facing the economy in the near term, while achieving debt sustainability over the medium term. At the same time, better governance and restructuring of public corporations are necessary to reduce contingent liabilities.

Financial sector policy: Safeguarding financial sector stability in this challenging international environment requires sound governance, effective supervision, and robust financial buffers. Improving the framework for financial crisis management and bank resolution and strengthening the deposit compensation scheme could help limit the impact of contagion. Financial stability will benefit from upgrading the macro-prudential policy framework. It is crucial to improve systemic risk monitoring, particularly of spillover risks posed by international banks, and design contingency plans accordingly.

Structural reforms: Longer-term policy challenges remain pressing, including those related to population ageing, labor force participation, and energy policy. These challenges underscore the need to deepen and broaden the reforms so far, raise productivity growth, and further improve competitiveness. Building on progress already made, pensions reform will contribute to resolving anticipated long-term fiscal imbalances and support medium-term growth.

Approved By
Ajai Chopra and Thomas Dorsey

Discussions took place in Valletta during January 12–23, 2012. The staff team comprised Ms. Ruiz-Arranz (head), Mmes. Menkulasi, Sodsriwiboon, Mr. Valckx (all EUR), and Mr. Oosthuizen (MCM).

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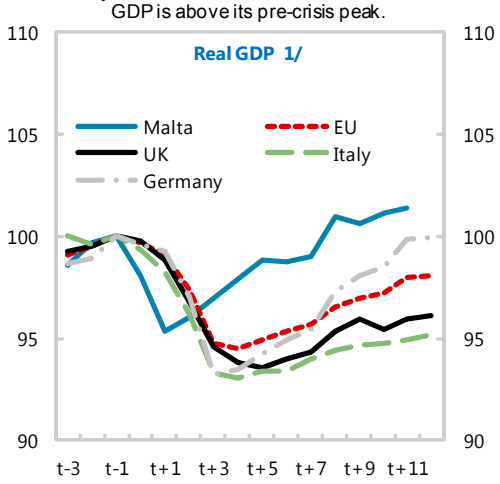
BACKGROUND AND RECENT DEVELOPMENTS

1. Malta is the smallest euro area economy, highly dependent on trade and tourism. Foreign-owned nonfinancial corporations dominate the domestic market and the economy relies on FDI flows and EU funds for investment. These factors make the economy vulnerable to external shocks.

2. In addition, Malta has a large financial sector with substantial international linkages (Box 1). The banking sector, whose assets are eight times GDP, is segmented into: (i) domestically-oriented banks (about 2½ times GDP), half of which are foreign owned, with sound capital and liquidity buffers, low leverage, and a conservative funding model (deposit-to-loan ratio above 100 percent); and (ii) internationally-oriented banks, including subsidiaries of EU banks, with limited involvement in the local economy.

3. Spillovers from the ongoing euro area debt crisis have, nonetheless, remained contained to date. After a strong recovery in 2010, the economy has continued to perform well amidst considerable turbulence across the euro area and North Africa (Figures 1–6). Despite weakening external demand in the second half of the year, real GDP growth is estimated at 2 percent in 2011, supported by private consumption and strong growth in tourism and services exports. In contrast with other euro economies, Malta's real GDP is 1.5 percent above its pre-crisis peak (compared to 2 percent below for the euro area). Labor market indicators improved and the unemployment rate receded to 6.4 percent (from the crisis peak of 6.9 percent), well below the euro area average of 10 percent.

Contrary to other euro area economies, Malta's real GDP is above its pre-crisis peak.

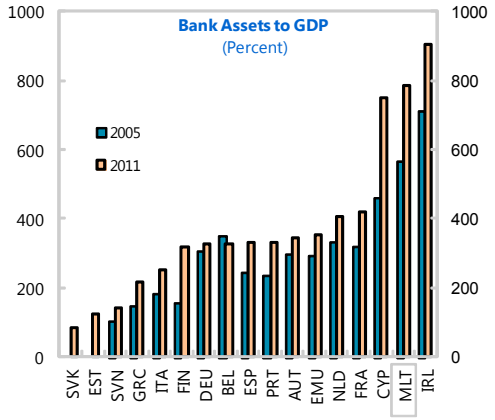


Sources: Haver Analytics; and IMF staff calculations.
1/ t-0 denotes first quarter of recession.

4. Financial contagion has also remained contained. Market reaction to the recent rating downgrades affecting Malta and a number of euro area economies was muted, as Maltese government debt is predominantly held domestically. In fact, bond yields declined slightly during 2011 on robust demand. In turn, the sensitivity of the Maltese banking sector to sovereign risk events in Europe is low. This reflects Maltese banks' very low exposures to EU periphery debt, as well as domestic banks' reliance on a traditional retail deposit-based banking model.

Box 1. Structure of the Maltese Banking Sector

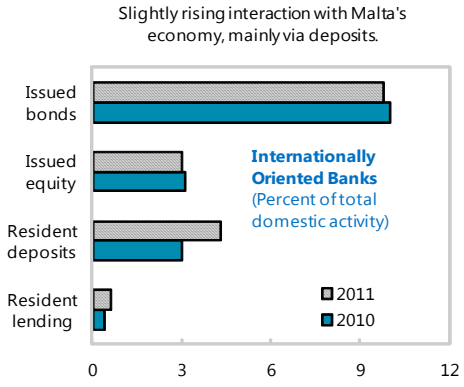
Within the euro area, Malta ranks among the highest in terms of banking sector assets to GDP. Malta's banking sector, with total assets of almost eight times GDP, is composed of seven domestically-oriented and nineteen international banks, of which some are connected with the domestic economy



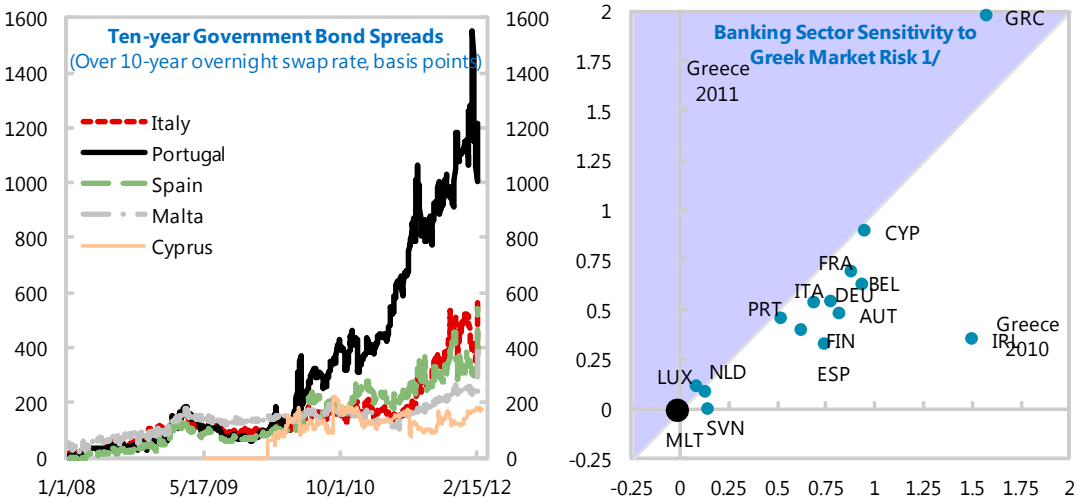
Source: European Central Bank.

Domestically-oriented banks, with total assets of 244 percent of GDP, are a set of seven banks, which are important for domestic financial stability. Three are domestically-owned and four are subsidiaries of other EU banks. These banks operate a traditional business model and have limited exposure to troubled euro area countries and did not invest in ABS or other subprime securities. Deposit-loan ratios were above 125 percent in the first half of 2011, which suggests no direct (wholesale) funding pressures. Regulatory capital stood at 15.8 percent and the tier 1 ratio was 12.3 percent, well above market and EBA benchmarks, while leverage was relatively contained at 9 times total assets in the third quarter of 2011. Return on equity was 9.4 percent. Their main vulnerabilities are credit risk, stemming from high loan exposures to construction, real estate activities and mortgages; and spillover effects from the euro area crisis.

The **international banking sector** refers to a diverse group of banks with assets totaling about 550 percent of GDP. This segment can be further broken down into one which interacts in a limited way with Maltese residents (about 80 percent of GDP) and one with no links (about 470 percent of GDP). Ten of these banks are subsidiaries of foreign banks (of which seven from other EU countries), six domestic, and three organized as branches (of which two non-EU). Some of these institutions are very small, with assets of only €8 million, while the two largest have combined assets of nearly €20 billion. Most of their activity is focused on non-resident business (trade finance, investment banking, intra-group, international money transfer, custodian services). However, the sector's interaction with domestic financing of the economy appears to be on the rise, mainly through deposit-taking, bond issuance and participation in ECB operations, and as such may also affect domestic financial stability. The average Tier 1 capital ratio for international banks amounted to 97.5 percent in June 2011 (40 percent excluding one outlier). Profitability was generally higher than for domestically-oriented banks. The sector's main sources of risk are potential cross-border deleveraging pressures and sensitivity to international financial market trends (due to high reliance on market/wholesale funding, including intra-group), possibly affecting activities in Malta. For Malta as a financial sector hub, there may be reputation risks if one of these banks were to find itself in difficulties, as the country prides itself of a flexible yet robust supervisory regime.



Sources: Central Bank of Malta; and IMF staff computations.
1/ Use of ECB facilities was 65 percent of total by end-2011 (87 percent in 2010).

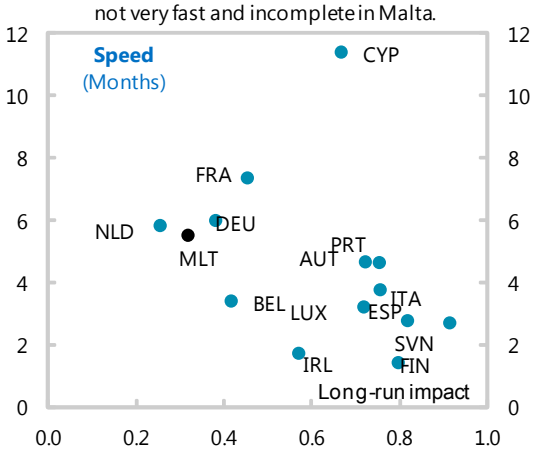


Sources: Datastream; Bloomberg; and IM staff calculations.
1/ The chart shows sensitivity (beta) of bank stock returns to GRC market returns, controlling for the broad market return, over two periods (Greece 2010: November 2009-April 2011 and Greece 2011: June-November 2011).

5. Compared to euro area peers, Maltese banks continue to outperform in terms of profits and capital adequacy (Figures 7–8). Bank profitability declined during 2011, but remains strong (Annex III). Interest income remains broadly stable thanks to a wide interest margin and a moderate pass-through of ECB policy rate changes. Credit growth fell in 2011, but remains well above the euro area's loan growth rate (Box 2). Capital buffers for domestic banks remain sound, with a core Tier 1 ratio of 12.3 percent and low leverage (deposit to loan ratio of 127 percent). One Maltese bank was selected to participate in the 2010–11 EBA stress tests and passed, with a core tier 1 ratio of 10.4 percent. As a follow-up, all Maltese domestic banks were subject to similar stress tests by the authorities, with positive results.

6. Malta's resilience also reflects the authorities' commitment to prudent macro-financial policies and improvements in external competitiveness. As discussed in section III, fiscal tightening is underway to reduce public sector debt to manageable levels, and a number of reforms are aimed at strengthening the resilience of the financial sector. Recent gains in competitiveness are evident in Malta's rising market share in services exports and its successful diversification into high-valued

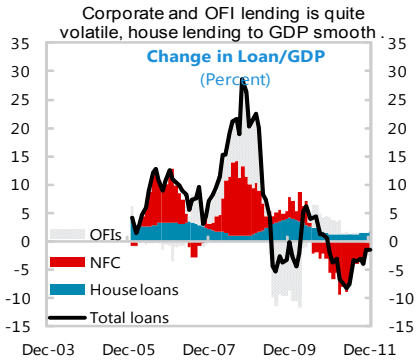
Transmission of ECB policy to housing interest rates is not very fast and incomplete in Malta.



Sources: ECB; and IMF staff computations. Note: speed and long-run pass-through are based on a reduced-form monetary transmission equation $i_{MFI,t} = c_0 + c_1 i_{MFI,t-1} + c_2 i_{ECB,t}$ where i_{MFI} denotes the banking sector's rate, i_{ECB} the ECB policy rate and t for time. The adjustment speed parameter is $1-c_1$ and the long-run pass-through coefficient is $c_2/(1-c_1)$. Estimation with monthly data from January 2008-November 2011.

Box 2. Credit Growth, Bank Lending Conditions and Private Sector Deleveraging

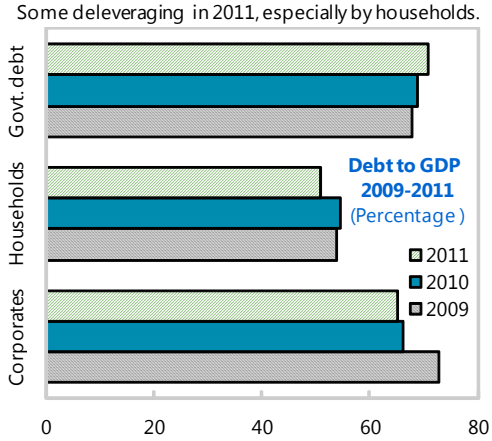
Credit growth in Malta declined in recent years, mainly as a result of lower corporate lending, while household lending remains relatively high. Overall credit growth in 2011 was 3.5 percent, down from 4.2 percent in 2010. Lending to non-financial corporates (NFCs) grew at a negative rate in the first eight months of 2011, but subsequently firmed up to 2.9 percent in December 2011 (year on year). Loans to households fell slightly, from 6.6 percent in 2010 to 6.2 percent in 2011. These different credit growth patterns are also visible when expressed as a percentage of GDP. NFC lending appears volatile and procyclical, accelerating when global growth picks up and slowing down significantly when global growth declines. Household lending –house loans in particular–consistently grew at a faster pace than GDP, although slightly less so since late 2010.



Sources: ECB; IMF staff computations.

For lending to corporates, both falling demand and some tightening of standards played a role. The December 2011 bank lending survey suggested that some Maltese banks tightened standards on loans to NFCs but faced no supply-side constraints related to their own funding or capital position. Falling demand reportedly was a more important factor, on account of higher recourse to restructuring and lower financing needs. No substantial further deleveraging by NFCs took place in 2011, as the NFC debt/GDP ratio was fairly stable in 2011 and expected NFC loan demand remains unchanged.

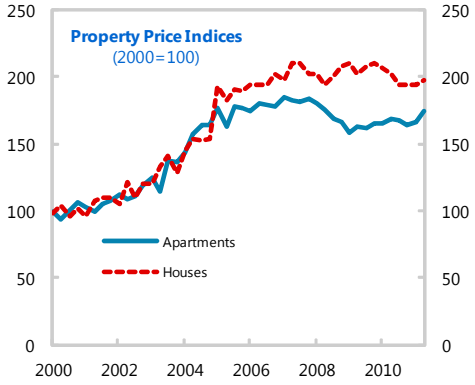
Some deleveraging in 2011, especially by households.



Sources: Central Bank of Malta; Statistical Office of European Communities; and IMF staff calculations.

Lending to households remained mainly demand-driven. In the last quarter of 2011, credit standards and conditions (supply factors) remained unchanged at all banks. However, for the next three months, some banks expect household loan demand to fall, especially consumer credit. In fact, there were some differences in banks' perception of housing market prospects and consumer creditworthiness. So far, housing prices have not declined much during the ongoing global financial crisis and they rebounded strongly in the third quarter of 2011 (see text figure). Similarly, creditworthiness seems underpinned by the low unemployment rate in Malta and some household debt deleveraging in 2011.

House prices slightly below pre-crisis peaks.



Sources: CBM; Eurostat; IMF staff calculations.

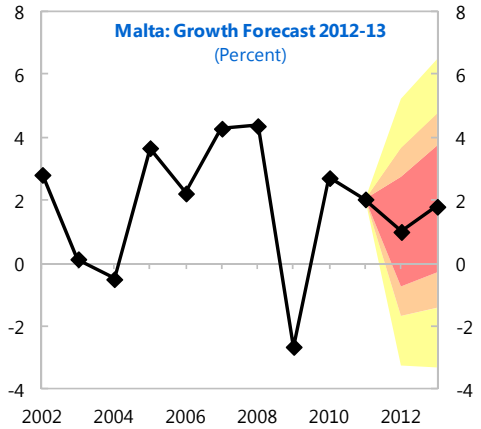
added activities (Annex I). The trade balance, which turned into surplus for the first time in 2010, improved further to about 5 percent of GDP in 2011. The current account thus improved, but remains in deficit reflecting large net income outflows related to the repatriation of profits by foreign companies (Figure 4).

7. Costs adjustment has proved critical to remain competitive. Recent gains have been underpinned by:

- *Narrowing inflation differential vis-à-vis trading partners*. Inflation averaged 2.4 percent in 2011, below the euro area average of 2.7 percent, mainly driven by persistently high food and energy prices, coupled with a rise in excise duties and some revisions in VAT rates (Figure 5).
- *Wage moderation* since 2009 has lead to declines in unit labor costs, despite Malta's wage indexation mechanism.
- The resulting *real exchange rate depreciation* (in the range of 4–10 percent, depending on the estimation method) has resulted in valuations that are broadly in line with fundamentals (Annex I).

OUTLOOK AND RISKS

8. The economy now faces a worsening external environment that is creating new risks to growth and financial stability. The fragile global macroeconomic environment and sustained market volatility are expected to dampen real export growth in 2012. Domestic sources of growth may not be sufficient to offset the drop in external demand, given headwinds from a soft real estate market and the ongoing fiscal consolidation. Combined with increased uncertainty, this will also keep private consumption subdued. In turn, private investment is projected to fall further on deteriorating business confidence. With the euro area expected to go into a mild recession this year, staff projects Malta's real GDP growth in 2012 to be a modest 1 percent. Growth is expected to rebound in 2013 and remain near the potential growth rate of 2 percent over the medium-term.



Sources: Elekdag and Kannan (2009), WEO and IMF staff calculations.

9. Downside risks to the baseline reflect the potential for spillovers from an intensification of the euro area crisis. Malta's high degree of trade openness and very large financial sector heighten contagion risks.

- *Risks to growth*. A deeper than expected downturn in the euro area could have a significant impact on growth through trade and tourism. Staff analysis suggests that Malta's growth is particularly affected by

spillovers from shocks in Italy, France, and the UK. A concurrent decline of trading partners' growth by half a standard deviation could lower Malta's growth by 0.5–0.7 percentage points in 2012 (Box 3). In addition, domestic uncertainty in economic policy could adversely affect growth if investment decisions and structural reforms are put on hold.

- *Risks to financial stability*. Financial contagion could shake the confidence in the entire banking sector. Although the domestically-oriented banks are well-capitalized and funded by retail deposits, a massive retrenchment by parent banks in Europe could disproportionally affect the Maltese economy, whose size is negligible relative to parent banks' balance sheets. And although a liquidity shock on internationally-oriented banks that rely on cross-border (mostly parent) wholesale funding would not materially impact the domestic economy, given their very low market share, it could have negative effects on the Maltese banking sector through confidence and reputational effects. These vulnerabilities are aggravated by an inadequately funded deposit compensation scheme, coupled by concerns about too-big-to-save and fiscal sustainability in case of default or deposit run that required the government to step in.

Authorities' views

10. The authorities shared the views on key risks, but remain "cautiously optimistic" on the growth outlook. The authorities underscored the country's ability so far to weather the euro area crisis well, attributed in their view, to the diversified nature of the Maltese economy. They highlighted that continued FDI inflows, increased tourism activity, resumption of trade with Libya, and sustained growth of financial and business services would support growth in 2012.

POLICY DISCUSSIONS

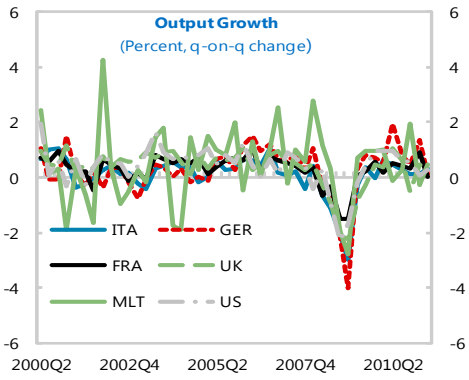
11. Malta's resilience to date cannot be taken for granted. The main policy challenge in 2012 will be to navigate a highly uncertain macroeconomic environment with a deteriorating economic outlook and the ongoing banking and sovereign crisis in Europe**.** Staff emphasized the need for contingency planning for the event that growth is substantially worse than expected or there is financial contagion from a potential intensification of the euro area crisis. At the same time, the authorities need to balance concerns over a slowing economy, which calls for accommodative policies, against increased risks that require more prudent fiscal management.

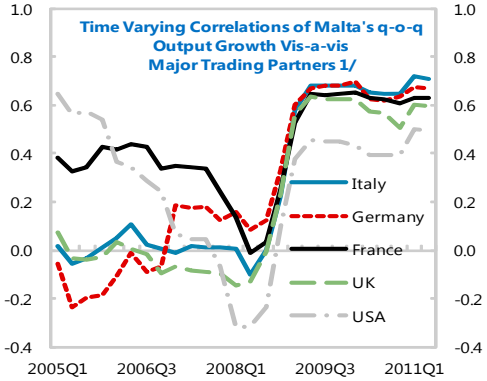
A. Ensuring Fiscal Sustainability While Supporting Growth

12. In an impressive turnaround, the authorities delivered a strong structural adjustment in 2011. The general government deficit narrowed to 3 percent of GDP in 2011, down from 3.7 percent of GDP in 2010, and the primary balance was in surplus for the first time since 2007 (Figure 6). After adjusting for substantial one off revenue measures in 2010,

Box 3. Malta's Growth Spillover Dynamics

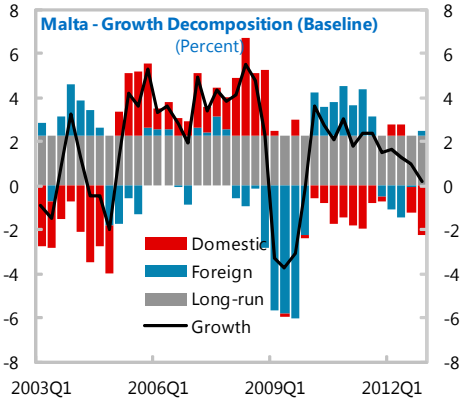
Malta is a small but highly open economy through both trade and financial transactions. Its international trade accounts for two times GDP, with the export-to-GDP ratio amounting to about 100 percent. Malta thus ranks among the most open economies in the world. Malta's major trading counterparts are the euro area (Italy 22%, France 14%, and Germany 12%), UK (13%), USA (8%), and some Asian countries (Singapore 9%, Japan 4%). Malta's financial sector is also very large with total financial sector assets of almost 9 times GDP, of which ¾ of total assets are held by foreign financial institutions.

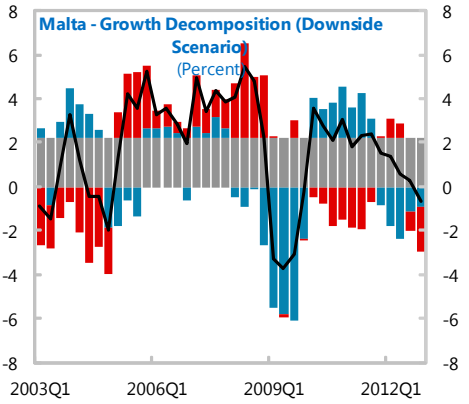




Sources: NSO; WEO; and IMF staff calculations
1/ Correlations of q-o-q output growth between Malta and each major trading partner, rolling over for 20 quarters. Data are from 2000Q1 to 2011Q3.

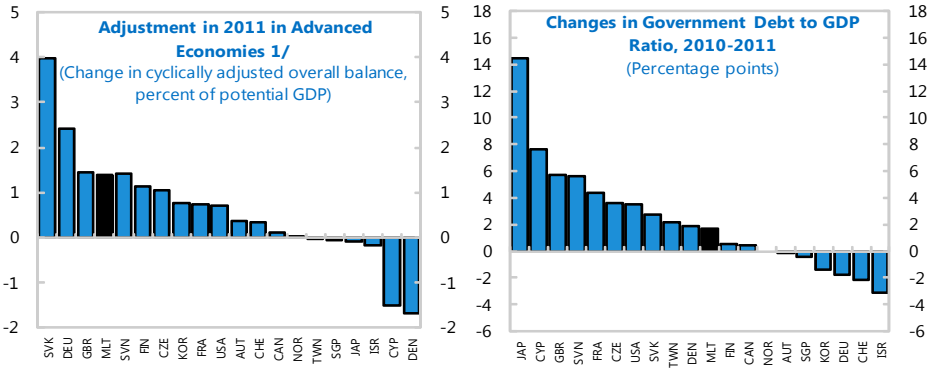
Malta's high degree of openness exposes the country to external shocks. Historically, Malta's growth has been relatively volatile and driven mostly by domestic components. However, growth has increasingly co-moved with that in the euro area since the start of the global financial crisis, reflecting increasing trade and financial integration supported by the Euro adoption in 2008. A VAR-based growth spillover analysis suggests that the large downturn during the 2008–09 crisis was mostly attributable to negative spillovers from other economies. In turn, the recent recovery was supported by improved external conditions. Going forward, Malta's growth dynamics are expected to be aligned with its foreign counterparts, whereas domestic shocks will continue to be a drag. It is estimated that a concurrent decline of trading partners' growth by half a standard deviation (equivalent to 1.2 percentage points of GDP) could lower Malta's growth by 0.5–0.7 percentage point in 2012.





Sources: Poirson and Weber (2011); and IMF staff estimates.
1/ VAR-based model is estimated to decompose the growth rate into long-run, domestic and foreign dynamics. The sample includes Malta, Italy, Germany, France, UK, USA, and the rest of euro area. Quarterly data are from 2000Q1-2011Q3.

the implied structural adjustment was much larger—1½ percent of GDP, one of the largest among advanced countries (excluding EU peripherals). In recognition of this effort and the government's plan to reduce the deficit further—as detailed in the 2012 budget and subsequent spending review—the European Commission assessed that Malta had taken effective action to correct its excessive deficit and no additional measures under the Excessive Deficit Procedure were needed.



Sources: IMF, *WEO*; and IMF staff estimates.
1/ Excluding Greece , Italy, Ireland, Portugal, and Spain. Excluding one-offs for Malta. Excluding financial sector support recorded above the line for the USA.

13. Nonetheless, the composition of adjustment remains suboptimal. Tax buoyancy and revenue measures, including increases in excise duties and a revision of VAT rates on accommodation, accounted for most of the improvement in the fiscal balance in 2011. In contrast, total expenditure-to-GDP remained largely unchanged, as savings from the expiration of the 2010 stimulus measures and limits on recruitment in the public sector were offset by increases in social transfers and goods and services. As in recent years, the absorption capacity of EU funds related to capital expenditures remains a problem, with less than two-thirds of the allocated amount utilized.

14. The government's commitment to return to fiscal balance over the medium term remains essential. Further fiscal consolidation is required to ensure sustainable debt dynamics, thus reducing fiscal risks to manageable levels. The pace and composition of adjustment should be attuned to the economic cycle. After the strong effort in 2011, a gradual deficit reduction path of structural annual adjustment of ½ percentage points of GDP, while letting automatic stabilizers operate in full, would be appropriate. Given the projected weakening of the economy, this may imply a slightly lower adjustment in nominal terms.

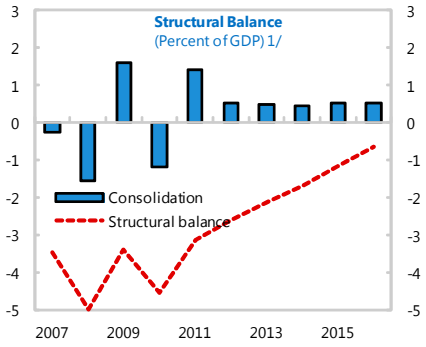
15. This moderate adjustment path would strike the right balance between the growth and debt sustainability objectives. More specifically, it would:

- *Offset somewhat the headwinds facing the economy in the near term*. A larger fiscal contraction in 2012 would be detrimental to growth in light of the cyclical deceleration and Malta's high exposure to countries also planning relatively large fiscal contractions.

- *Still achieve debt sustainability over the medium term*. The suggested consolidation would put debt on a downward trend

starting in 2013, reaching a debt-to-GDP ratio of 60 percent by 2018. This would allow Malta to cope with future adverse shocks and demographic-related spending pressures.

But notwithstanding Malta's favorable debt management policies, it will be important to avoid the recent "stop-go" pattern of fiscal policy to ensure continued confidence in Malta's public finances. Malta's sovereign debt is predominantly (97 percent) held by residents, its average maturity is relatively high (7 years), and rollover risks are manageable with strong demand for government paper and a strategy to smooth the maturity profile.



Sources: Maltese authorities; and IMF staff calculations.
1/ Excluding one-offs.

Malta: IMF Staff Medium Term Fiscal Projections, 2010-14 1/
(Percent of GDP)

	Est.		Proj.		
	2010	2011	2012	2013	2014
Overall balance	-3.6	-3.0	-2.7	-2.4	-1.9
Overall balance excl. one-offs	-4.6	-3.1	-2.9	-2.4	-1.9
Output gap estimates	-0.2	0.0	-0.9	-0.9	-0.7
Structural balance (excl. one-offs)	-4.5	-3.1	-2.6	-2.1	-1.7
Structural adjustment	-1.2	1.4	0.5	0.5	0.5
Public debt	69.1	70.7	71.5	71.0	69.6
Authorities target (2012 Budget)	-3.6	-2.8	-2.3	-1.8	-1.2

Sources: Malta's authorities; and IMF staff estimates.
1/ Projections reflect staff's policy scenario.

16. To be credible, the adjustment should be backed by concrete measures and focused on containing spending. Staff projects the deficit to narrow by 0.3 percentage points of GDP (or ½ percentage points in structural terms) to 2.7 percent of GDP in 2012. The difference with the authorities' target of 2.3 percent of GDP is explained by staff's cautious assessment of the measures in the 2012 budget and spending review, more conservative growth projections (with widening output gap), and higher estimated outturn in 2011. The size of the projected adjustment is appropriate, in light of the weakening economy. However, the consolidation remains largely revenue-based. Further increases in excise duties, incentives to reduce tax arrears, and increases in social security contributions are expected to drive the adjustment effort. Indeed, expenditure-to-GDP is projected to increase, as announced tightening measures (0.6 percent of GDP) will be more than offset by increases in public investment and capital transfers—largely related to the planned Air Malta capital injection. Sound measures underpinning the fiscal effort beyond 2012 need to be specified for the consolidation to be credible.

17. Bold policy actions are necessary to reduce contingent liabilities arising from the public corporations. Government-guaranteed debt amounts to 17 percent of GDP, 60 percent of which is accounted for by Enemalta—the public energy utility corporation. This may increase further as Enemalta's planned investments over the next three years amount to 6 percent of GDP. Staff indicated that sustained high oil prices may require tariff increases if the company is to avoid losses or government assistance. Better governance and restructuring of Air Malta and Enemalta will help staunch losses and limit subsidies, although the latter may entail some upfront fiscal costs.[1] It is essential to agree on a medium to long term strategic plan and

[1] The ongoing restructuring of Air Malta is expected to add about 1½ percent of GDP over the next 5 years.

permit professional independent management to lead these entities, subject to sound governance and performance targets.

18. Building on progress already made, further pensions reform will contribute to resolving anticipated long-term fiscal imbalances and support medium-term growth. The projected increase in ageing-related expenditures is twice the EU average, reflecting an expected sharp rise in dependency ratios that renders the current pay-as-you-go system unsustainable. Staff recommended that the authorities build the necessary consensus to push forward the main recommendations of the Pensions Working Group, notably: (i) indexing the retirement age to longevity; and (ii) introducing a mandatory privately funded second pillar and voluntary third pillar. Consideration could also be given to introducing a notional defined contribution first pension and to accelerating the planned gradual increase in the retirement age to 65.

Authorities' views

19. The authorities reiterated their commitment to fiscal discipline and the new EU fiscal guidelines. They concurred with staff's recommendation to balance growth and debt sustainability considerations, but were confident that the 2012 target would be met. To this end, there had been an early budget review (instead of mid-year), which identified additional spending measures. Regarding composition of the fiscal adjustment, the authorities noted that one-off revenue measures reflected to some extent one-off spending items. The authorities acknowledged the long-run fiscal challenges. Pension reform is currently under review to increase the scheme adequacy and sustainability. The authorities highlighted some concerns associated with implementing a second pillar pension, including the fall in the value of pension funds world-wide as a result of the global financial crisis and the potential impact on employers (higher contribution costs) and employees (less disposable income). The authorities stressed that new EU requirements on budgetary frameworks and governance would add credibility to their consolidation effort (Annex II).

B. Improving Financial System Soundness

20. The financial sector has continued to perform strongly, but—given the large external risks—it is important to strengthen the sector's resilience further. As noted in section I, the banking sector appears healthy, but the sector's sheer size and large foreign ownership represent a number of risks to financial stability and fiscal sustainability. These include concerns about too-big-to-save and the adequacy of backstopping resources in case of default or deposit run, the capacity to deal with the impact of a banking sector shock on the economy, and supervisory challenges. The size of the non-bank financial sector is, on the other hand, relatively small and risks appear limited.

21. Maintaining financial sector stability requires a multi-faceted approach, encompassing macro-prudential policies and surveillance, micro-prudential regulation and supervision, and contingency planning, safety net, and crisis management (Annex IV).

Macro-prudential Policy and Systemic Risk Monitoring

22. The authorities are clarifying the institutional architecture for macro-prudential policy. In line with recent ESRB recommendations and IMF staff analysis[2], this should include:

- Determining the institution or forum with ultimate decision-making powers to recommend and enforce macro-prudential polices. The Maltese authorities are considering a joint financial stability committee between the Central Bank of Malta (CBM) and the Maltese Financial Services Authority (MFSA).
- Defining the tasks, powers, and instruments of the macro-prudential authority.
- Establishing clear lines of accountability.
- Ensuring operational independence from political bodies and from the financial industry.

23. Macro-prudential policy requires a capacity to identify systemic risks early enough so timely action can be taken to support financial stability. Staff recommended further strengthening the analysis of risks posed by the financial sector, particularly the internationally-oriented banks that have or intend to grow their Maltese footprints, especially by taking deposits locally and investing them internationally. In this context, staff commended the Central Bank of Malta (CBM) and the Malta Financial Services Authority (MFSA) for extending the EU-wide stress testing exercise to all domestic banks, and for extensively participating in EU-wide insurance sector stress tests.

Micro-prudential Regulation and Supervision

24. Malta's financial regulatory and supervisory framework should keep pace with the demands and risks of a sophisticated and fast-growing financial market. As part of its self-imposed quality controls, in 2010 the MFSA commissioned an independent assessment of regulation and supervision of banking, insurance, and securities markets against the respective international standards (Box 1, Annex IV). The assessment concluded that progress had been made since the 2003 IMF Financial Stability Assessment Program (FSAP), but weaknesses remained in supervisory capacity (notably staffing), definition and monitoring of connected party transactions, and internal audit functions. The increase in recruitment of qualified staff, the creation of an enforcement unit, and work in the area of concentration risk represent commendable progress. Continuing efforts along the report's recommendations are needed to more fully comply with international sound practice. A review of the MFSA's consumer protection and business conduct functions could be considered to secure consumer protection, promote efficiency, and enhance the integrity of the financial system.

25. Substantial credit concentration in the banking sector and rising credit risks

[2] See "Towards Effective Macro-prudential Policy Frameworks: An Assessment of Stylized Institutional Models" (IMF, Monetary and Capital Markets Department, 2011), and Recommendations of the European Systemic Risk Board of 22 December 2011 on the macro-prudential mandate of national authorities (ESRB/2011/3).

warrant close supervisory scrutiny and strong financial buffers. Lending is highly concentrated in housing and construction, loan quality has deteriorated[3], and the number of restructured loans increased. Worryingly, provisioning is a mere 19 percent of non-performing loans, substantially below the euro area average. Bank profitability may suffer if loan losses were to increase further, due to declines in real estate prices or a fall in growth (Annex III). Furthermore, Maltese banks may be adversely affected by the forthcoming EU Capital Requirements Directive (CRD IV). Preliminary estimates by the MFSA and CBM indicate that Maltese banks could face liquidity shortfalls under current proposals. Against this background:

- Banks with riskier profiles should be encouraged to increase provisioning and restrain dividend payout policies to strengthen capital buffers.
- Further improvement in the MFSA's assessment of the robustness of banks' processes for loan classification, impairment determination, and provisioning are needed, and plans to enhance these aspects of supervision are welcome.
- An action plan to enable the implementation of new liquidity regulations, including individual liquidity guidelines and liquidity stress testing, is needed. In this context, banks should be encouraged to lengthen the maturity profile of their deposit base as they still rely largely on demand deposits. Anecdotal evidence indicates that this is already underway as various banks are offering multi-year deposits and new products at attractive rates.

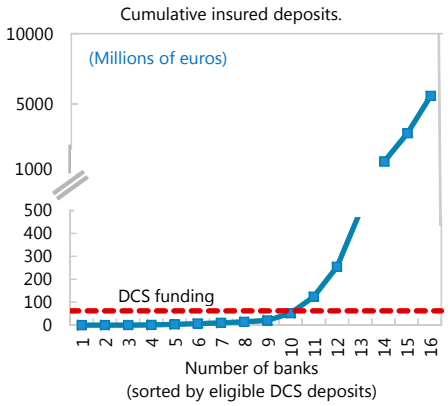
[3] NPL ratios have risen to historically high levels in recent years, on loans to corporates it amounted to 12 percent in June 2011 (especially high among construction and real estate firms), while NPL on household loans it remained at 3 percent.

Financial Sector Safety Net

26. In light of the ongoing euro area crisis, it is imperative to ensure a sound financial safety net.

- **Contingency planning for crisis preparedness** should move to the forefront of the policy agenda and involve: (i) stress testing to assess the adequacy of financial buffers; (ii) the development of scenarios for key material risks; (iii) performing crisis simulation exercises regularly, covering all systemically relevant institutions, as well as cross-border dimensions; and (iv) reviewing existing coordination arrangements between the key institutions. It would be advisable for the MFSA to incorporate these techniques as standard components of its supervisory approach.
- The range of **resolution tools** will be broadened once new European regulations come in place. These encompass prompt corrective action, partial purchase and assumption, the use of bridge banks, and the establishment of a resolution fund.
- The target size of the **Deposit Compensation Scheme (DCS)**—0.77 percent of eligible deposits—is unsatisfactory. Given current resources, the DCS would be able to compensate 10 very small banks or one medium-sized bank, which is below IMF and EU

recommendations.[4] A shortfall could have knock-on effects on the entire banking system through confidence and reputation effects and on the government's budget in case the DCS needs emergency funding. As a small economy with a large financial sector and idiosyncratic features, the authorities should give due recognition to the potentially high risks to financial stability, by erring on the conservative side and targeting buffers above the suggested minima.



Source: IMF staff calculations.

Authorities' views

27. The authorities shared the mission's emphasis on prudent management of the financial sector. As a precaution, the central bank has called on banks to maintain conservative dividend policies and increase provisioning. The authorities noted that the large size of the banking sector draws attention, but cause of alarm is mitigated by specific features of the structure of the sector. They stressed that the domestic-oriented banking segment is safe and sound, and the internationally-oriented segment poses no material risks for Malta. The authorities agreed with staff on the need to strengthen the Deposit Compensation Scheme, and plan to align their framework with the anticipated EU rules. In relation to the mission's concerns about concentration risk on fixed property, the MFSA noted that Malta's small size limits the ability of the banking sector to diversify. Regulators take the issue of concentration risk into account under Pillar 2 of Basel II. The MFSA noted that staff's recommendation to increase provisioning and to address shortcomings in the regulation relating to asset classification and provisioning will give new impetus to the authorities' initiatives to improve supervision in this area.

C. A Strong Structural Reform Agenda to Secure Long-Term Growth

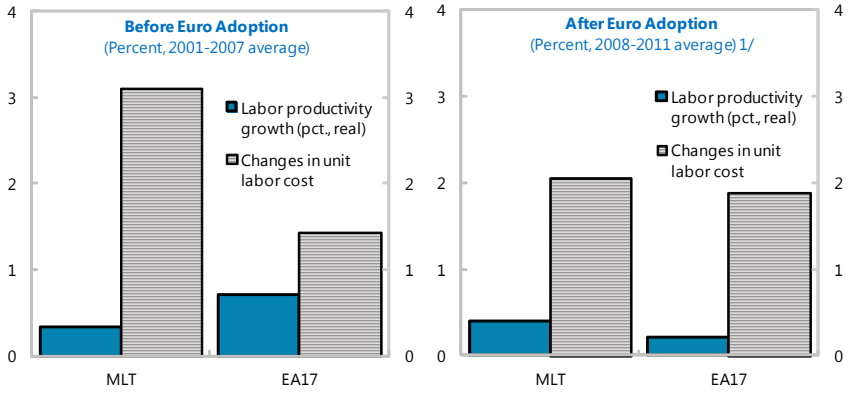
28. Longer-term policy challenges remain pressing, including those related to population ageing, labor force participation, education, and energy policy. As discussed earlier, the budgetary impact of ageing, including pensions, is significantly higher in Malta than the EU average. Fostering participation of women in the labor market is another major challenge, given Malta's lowest female employment rate in the EU. And so is raising the labor force skills: Malta has the highest rate of early school-leavers and records a low share of people with a tertiary level of education. Malta is also dependent on imported oil for energy, making the economy vulnerable to oil price shocks. Furthermore, current electricity production is both cost- and

[4] EU proposals on deposit-guarantee scheme (DGS), dated 07-19-2010, envisage that a DGS much have 1.5 percent of eligible deposits on hand after a transition period of 10 years. In addition, banks must pay extraordinary (ex post) contributions of up to 0.5 percent of eligible deposits if necessary.

energy-inefficient, resulting in high energy costs and potential fiscal liabilities.

29. These challenges underscore the need to deepen and broaden the reforms so far, raise productivity growth, and further improve competitiveness. Policies should focus on further diversifying the economy into high value-added activities, reducing the economy's dependence on energy imports, and strengthening female labor force participation and education attainment. A comprehensive ageing strategy is needed to resolve anticipated long-term fiscal imbalances. These steps should be supported by a cautious settlement of wage negotiations at the firm-level to ensure better alignment of wage and productivity developments. The ongoing review of the wage indexation formula is welcome. Overall nominal wage increases below those of Malta's main trading partners will underpin confidence and secure recent gains in competitiveness.

Labor Productivity and Wage Growth



Sources: IMF staff calculations; and European commission (2011), "Reaching the Employment Target: Progress and Thematic Surveillance".
1/ The 2011 labor productivity data for Malta are based on an average of two quarters and the data for EA17 is based on the first quarter. The unit labor cost for 2011 for both Malta and EA17 are based on a average of three quarters.

Authorities' views

30. Malta's National Reform Programme sets out ambitious targets and a policy action plan to address longer-term challenges. The authorities pointed to four strengths supporting future growth. These include: the increase in education levels, female labor force expansion facilitated by child and tax-friendly policies, oil search and energy policy reform, and continued wage moderation. As to the latter, the authorities agreed with staff's recommendation of aligning wage increases with productivity growth, but underscored that the current wage indexation mechanism did not generally result in full inflation-indexation and was granted in absolute terms and only on a base salary. They also indicated that sectoral analysis of wage dynamics showed significant amount of flexibility.

STAFF APPRAISAL

31. After a strong recovery in 2010, the economy has continued to perform well amidst considerable turbulence across the euro area. Spillovers from the euro area crisis have remained contained to date. The growth momentum continued through 2011 and labor indicators improved. Despite the recent rating downgrades, sovereign bond spreads remain contained as government debt is predominantly held domestically. In turn, the sensitivity of the Maltese banking sector to sovereign risk events in Europe is low given very low direct exposures to EU periphery debt, though indirect exposures may be larger.

32. The fragile external environment has created new risks to growth and financial stability. Malta's high degree of trade openness and very large financial sector heighten contagion risks. The fragile global macroeconomic environment and sustained market volatility are expected to dampen real export growth in 2012. Domestic sources of growth may not be sufficient to offset the drop in external demand, given headwinds from a soft real estate market, deteriorating confidence, and ongoing fiscal consolidation. At the same time, uncertainty in economic policy could adversely affect growth if investment decisions and structural reforms are put on hold. With the euro area expected to go into a mild recession in 2012, Malta's real GDP growth in 2012 will be relatively modest. Risks and uncertainty around this scenario are significant, reflecting the potential for large negative spillovers from the euro area crisis.

33. Contingency planning needs to move to the forefront of the policy agenda. Malta's resilience to date cannot be taken for granted. The main policy challenge now is to maintain growth and employment, while building buffers against a highly uncertain international environment. At the same time, the authorities need to balance concerns over a slowing economy, which calls for accommodative policies, against increased risks that require more prudent fiscal management.

34. Malta has taken effective action to correct its excessive deficit, shoring up confidence in Malta's public finances. The structural fiscal adjustment in 2011 was one of the largest among advanced countries. The deficit is estimated to have narrowed to 3 percent of GDP and the primary balance turned into surplus for the first time since 2007. Following the announcement of the 2012 budget and additional expenditure measures in January, the fiscal deficit is expected to fall further this year. Nonetheless, the composition of adjustment remains suboptimal, relying excessively on one-off and revenue measures.

35. Returning to fiscal balance over the medium run remains essential. Further fiscal consolidation is required to ensure sustainable debt dynamics, thus reducing fiscal risks to manageable levels. After the strong effort in 2011, a gradual deficit reduction path of structural annual adjustment of ½ percentage points of GDP, while letting automatic stabilizers operate in full, would be appropriate. This adjustment path would help offset the headwinds facing the economy in the near term, while achieving debt sustainability over the medium term**.** The measures underpinning the fiscal effort

beyond 2012 need to be specified for the consolidation to be credible.

36. Bold policy actions are necessary to reduce contingent liabilities and address Malta's long-run fiscal challenges. Better governance and restructuring of the public corporations will help staunch losses and limit subsidies. With a large projected increase in ageing-related expenditures, it is crucial to build broad public consensus for further pension and health care reform aimed at increasing the adequacy and sustainability of the current schemes.

37. Given the large external risks, it is important to strengthen the financial sector's resilience further. The financial sector has continued to perform strongly, but its sheer size and large foreign ownership represent a number of risks to financial stability and fiscal sustainability. These include concerns about too-big-to-save and the adequacy of backstopping resources in case of default or deposit run, the capacity to deal with the impact of a banking shock on the economy, as well as supervisory challenges. Improving the framework for financial crisis management and bank resolution and strengthening the deposit compensation scheme could help limit contagion risks. Ongoing efforts to strengthen financial buffers and tighten supervision relating to asset quality are welcome. Commendable progress has also been made to better align the regulatory and supervisory frameworks with international standards.

38. Financial stability will further benefit from establishing a formal framework for macro-prudential policy. Such a framework should define the tasks, powers, and instruments of the macro-prudential authority; establish clear lines of accountability; and ensure operational independence from political bodies and from the financial industry. It is crucial to improve systemic risk monitoring, particularly of spillover risks posed by international banks, and design contingency plans accordingly.

39. Longer-term policy challenges remain pressing. Challenges related to population ageing, labor force participation, education, and energy policy underscore the need to broaden the reforms so far, raise productivity growth, and further improve competitiveness. Reforms to secure these objectives include further diversifying the economy into high value-added activities, reducing the economy's dependence on energy imports, and strengthening female labor force participation and education attainment. These steps should be supported by a cautious settlement of wage negotiations to ensure better alignment of wage and productivity developments.

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

Table 1. Malta: Selected Economic Indicators, 2007–15

					Est.	Proj.			
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Real Economy					(Percent)				
Real GDP	4.3	4.3	-2.6	2.9	2.0	1.0	1.8	2.0	2.2
Domestic demand	1.0	3.1	-4.3	-2.0	-0.1	-0.3	1.2	1.2	1.6
Consumption	0.6	6.5	-1.5	-0.5	2.1	0.6	0.9	0.8	1.2
Private consumption	0.6	5.0	-1.4	-0.9	1.9	0.4	1.0	1.1	1.1
Public consumption	0.5	12.2	-1.7	0.9	2.5	1.6	0.9	0.0	1.7
Fixed investment	1.1	-20.4	-17.6	9.9	-12.4	-6.1	2.5	3.3	3.8
Exports of goods and services	9.9	1.7	-10.1	17.3	-3.8	-4.1	2.1	4.6	5.0
Imports of goods and services	6.3	0.6	-11.5	12.2	-5.9	-5.6	1.5	4.1	4.7
Contribution to growth					(Percent)				
Domestic demand	1.1	3.2	-4.4	-2.0	-0.1	-0.2	1.1	1.1	1.5
Consumption	0.5	5.3	-1.2	-0.4	1.7	0.5	0.8	0.7	1.0
Private consumption	0.4	3.1	-0.9	-0.6	1.2	0.2	0.6	0.7	0.6
Public consmption	0.1	2.3	-0.3	0.2	0.5	0.3	0.2	0.0	0.3
Fixed investment	0.2	-4.4	-3.2	1.6	-2.2	-1.0	0.4	0.5	0.6
Inventory accumulation	0.3	2.1	-0.2	-3.0	0.0	0.0	0.0	0.0	0.0
Foreign balance	3.2	1.2	1.7	4.9	2.1	1.2	0.8	0.9	0.7
Exports of goods and services	10.1	1.8	-10.5	16.7	-4.2	-4.2	2.1	4.6	5.1
Imports of goods and services	-6.8	-0.7	12.2	-11.8	6.3	5.4	-1.3	-3.7	-4.3
Potential GDP growth	2.3	2.2	1.8	1.8	1.8	1.8	1.9	1.9	2.0
Output gap (percent of potential GDP)	1.2	3.3	-1.2	-0.2	0.0	-0.9	-0.9	-0.7	-0.5
HICP (period average)	0.7	4.7	1.8	2.0	2.4	2.0	1.9	2.0	2.1
GDP deflator	3.1	2.6	2.7	2.9	2.2	2.3	2.4	2.8	2.8
Unemployment rate EU stand. (percent)	6.5	6.1	6.9	6.9	6.4	6.6	6.5	6.4	6.3
Employment growth (percent)	3.1	2.4	0.8	2.6	1.2	1.0	1.1	1.1	1.2
Gross national savings (percent of GDP)	14.1	12.4	7.5	10.2	9.2	8.2	8.4	8.8	9.6
Gross capital formation (percent of GDP)	19.4	17.7	15.3	14.4	12.2	11.1	11.2	11.6	12.3
Public finance					(Percent of GDP)				
General government balance	-2.4	-4.6	-3.7	-3.6	-3.0	-2.7	-2.4	-1.9	-1.3
Structural balance, excl. one-offs	-3.4	-5.0	-3.4	-4.5	-3.1	-2.6	-2.1	-1.7	-1.2
Revenue	40.5	39.5	39.7	39.3	40.1	40.8	40.3	39.8	39.8
Expenditure	42.9	44.2	43.5	43.0	43.0	43.5	42.8	41.7	41.1
General government debt	62.3	62.5	68.0	69.1	70.7	71.5	71.0	69.6	67.6
Balance of payments					(Percent of GDP)				
Current account balance	-5.3	-5.3	-7.8	-4.2	-3.0	-2.9	-2.8	-2.8	-2.7
Trade balance (Goods and services)	-1.1	-1.7	-0.5	3.3	4.7	4.7	4.8	4.8	4.8
Exports of goods and services	95.3	94.1	84.2	95.0	96.0	95.0	95.0	96.7	98.4
Imports of goods and services	96.4	95.9	84.7	91.7	91.3	90.3	90.2	91.9	93.6
Income, net	-3.7	-3.4	-8.1	-7.9	-8.0	-7.9	-7.9	-7.9	-7.8
Transfers, net	-0.5	-0.1	0.7	0.5	0.3	0.3	0.3	0.3	0.3
Capital account, net	1.3	0.4	1.7	1.7	1.1	1.1	1.1	1.1	1.1
Financial account, net	5.2	4.1	2.4	-2.3	2.0	1.8	1.7	1.7	1.6
Direct investment	13.3	6.2	9.0	11.4	4.4	4.5	4.6	4.8	4.8
Portfolio investment	6.8	6.3	-32.9	-52.5	-20.3	-20.8	-21.0	-21.1	-21.4
Other investment	-8.9	-10.3	26.4	39.1	17.9	18.1	18.1	18.0	18.1
Reserves (- inflow; + outflow)	-6.0	1.9	0.0	-0.4	0.0	0.0	0.0	0.0	0.0
Errors and omissions	-1.2	0.7	3.7	4.8	0.0	0.0	0.0	0.0	0.0
Memorandum item:									
Nominal GDP (millions of euros)	5434.4	5814.7	5812.7	6154.2	6411.8	6618.8	6902.9	7237.7	7606.1

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

Table 2. Malta: Fiscal Developments and Projections, 2007–14

(Percent of GDP)

					Est.	Proj.		
	2007	2008	2009	2010	2011	2012	2013	2014
Revenue	40.5	39.5	39.7	39.3	40.1	40.8	40.3	39.8
Current revenue	39.5	39.0	38.9	37.8	38.6	39.0	38.6	37.9
Tax revenue	28.4	27.3	27.9	26.9	27.7	27.9	27.2	26.8
Indirect taxes	14.8	14.3	14.0	13.6	14.1	14.4	13.7	13.4
Direct taxes	13.4	12.8	13.7	13.1	13.4	13.2	13.2	13.2
Other taxes (capital taxes)	0.3	0.3	0.2	0.2	0.2	0.4	0.2	0.2
Social security contributions	7.3	7.4	7.5	7.4	7.5	7.6	7.6	7.4
Other current revenue	3.8	4.3	3.5	3.4	3.4	3.4	3.8	3.6
Capital revenue	1.0	0.5	0.9	1.6	1.5	1.8	1.8	1.9
Expenditure	42.9	44.2	43.5	43.0	43.0	43.5	42.8	41.7
Current expenditure	38.8	40.8	40.4	39.5	39.5	39.2	38.6	37.9
Wages and salaries	13.0	14.3	14.3	13.7	13.4	13.2	13.1	12.9
Goods and services	5.4	6.5	6.1	6.1	6.2	6.3	6.3	6.0
Social transfers	13.2	13.0	13.9	13.8	13.9	13.7	13.5	13.3
Subsidies	2.1	2.2	1.1	1.0	1.0	0.8	0.8	0.7
Interest payments	3.3	3.2	3.2	3.0	3.2	3.3	3.4	3.5
Other current expenditure	1.7	1.6	1.9	1.9	1.8	1.8	1.6	1.5
Capital expenditure	4.1	3.4	3.1	3.5	3.5	4.2	4.1	3.8
Overall balance	-2.4	-4.6	-3.7	-3.6	-3.0	-2.7	-2.4	-1.9
Overall balance excl. one-offs	-3.0	-3.8	-3.8	-4.6	-3.1	-2.9	-2.4	-1.9
Memorandum items:								
Cyclically adjusted overall balance	-2.8	-5.8	-3.3	-3.5	-3.0	-2.4	-2.1	-1.6
Cyclically adjusted overall balance, excl. one-offs	-3.4	-5.0	-3.4	-4.5	-3.1	-2.6	-2.1	-1.7
Cyclically adjusted primary balance, excl. one-offs	-0.1	-1.8	-0.2	-1.5	0.1	0.7	1.3	1.8
Primary balance	1.0	-1.4	-0.6	-0.6	0.2	0.6	1.0	1.6
One-offs	-0.6	0.8	-0.1	-1.0	-0.1	-0.2	0.0	0.0
Of which: Malta Shipyards reclassification/liquidation		-1.1	-0.6	...	...	...	...	...
Public debt	62.3	62.5	68.0	69.1	70.7	71.5	71.0	69.6
Government guaranteed debt 1\	11.1	11.8	14.9	16.2	16.9	...	...	...

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

1\ 2011 data as of September 2011.

Table 3. Malta: Balance of Payments, 2007–15

	2007	2008	2009	2010	Est. 2011	Proj. 2012	2013	2014	2015
				(Millions of euros)					
Current account balance	-290	-307	-455	-257	-195	-189	-193	-203	-205
Trade balance (Goods and services)	-61	-101	-28	201	299	314	332	348	366
Goods balance	-929	-1,217	-1,053	-1,001	-1,030	-1,070	-1,123	-1,184	-1,252
Exports	2,700	2,526	2,060	2,697	2,822	2,907	3,025	3,164	3,318
Imports	-3,629	-3,743	-3,114	-3,698	-3,852	-3,977	-4,147	-4,349	-4,570
Services balance	868	1,115	1,026	1,202	1,329	1,384	1,455	1,532	1,618
Exports	2,480	2,947	2,836	3,148	3,333	3,382	3,531	3,834	4,166
Imports	-1,612	-1,831	-1,810	-1,946	-2,004	-1,998	-2,076	-2,302	-2,548
Current income, net	-200	-200	-470	-487	-513	-523	-546	-572	-594
Current transfers, net	-29	-6	43	29	19	20	21	22	23
Private	-57	11	45	1	14	37	-4	-4	10
Public	28	-17	-3	28	5	-17	24	26	13
Capital account, net	69	24	101	106	68	72	78	83	87
Financial account, net	284	241	138	-142	127	117	114	120	118
Direct investment	725	362	523	703	282	298	318	347	365
Portfolio investment	368	368	-1,915	-3,230	-1,302	-1,377	-1,450	-1,527	-1,628
Other investment	-482	-598	1,532	2,408	1,147	1,196	1,246	1,300	1,380
Reserves (- inflow; + outflow)	-326	109	-2	-24	0	0	0	0	0
Errors and omissions	-63	42	217	293	0	0	0	0	0
				(Percent of GDP)					
Current account balance	-5.3	-5.3	-7.8	-4.2	-3.0	-2.9	-2.8	-2.8	-2.7
Trade balance (Goods and services)	-1.1	-1.7	-0.5	3.3	4.7	4.7	4.8	4.8	4.8
Goods balance	-17.1	-20.9	-18.1	-16.3	-16.1	-16.2	-16.3	-16.4	-16.5
Exports	49.7	43.4	35.4	43.8	44.0	43.9	43.8	43.7	43.6
Imports	-66.8	-64.4	-53.6	-60.1	-60.1	-60.1	-60.1	-60.1	-60.1
Services balance	16.0	19.2	17.6	19.5	20.7	20.9	21.1	21.2	21.3
Exports	45.6	50.7	48.8	51.2	52.0	51.1	51.1	53.0	54.8
Imports	-29.7	-31.5	-31.1	-31.6	-31.3	-30.2	-30.1	-31.8	-33.5
Current income, net	-3.7	-3.4	-8.1	-7.9	-8.0	-7.9	-7.9	-7.9	-7.8
Current transfers, net	-0.5	-0.1	0.7	0.5	0.3	0.3	0.3	0.3	0.3
Private	-1.0	0.2	0.8	0.0	0.2	0.6	-0.1	-0.1	0.1
Public	0.5	-0.3	0.0	0.4	0.1	-0.3	0.4	0.4	0.2
Capital account, net	1.3	0.4	1.7	1.7	1.1	1.1	1.1	1.1	1.1
Financial account, net	5.2	4.1	2.4	-2.3	2.0	1.8	1.7	1.7	1.6
Direct investment	13.3	6.2	9.0	11.4	4.4	4.5	4.6	4.8	4.8
Portfolio investment	6.8	6.3	-32.9	-52.5	-20.3	-20.8	-21.0	-21.1	-21.4
Other investment	-8.9	-10.3	26.4	39.1	17.9	18.1	18.1	18.0	18.1
Reserves (- inflow; + outflow)	-6.0	1.9	0.0	-0.4	0.0	0.0	0.0	0.0	0.0
Errors and omissions	-1.2	0.7	3.7	4.8	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Official reserves, end of period									
(Millions of euros)	2,561.4	268.3	373.7	404.9	...	...	...	...	...
(In months of imports of goods and services)	5.9	0.6	0.9	0.9	...	...	...	...	...
Gross external debt (Percent of GDP)	511.1	551.4	512.3	534.5	526.5	515.9	506.9	495.4	483.4
Net external debt (Percent of GDP)	-87.2	-73.0	-89.9	-176.2	-162.3	-164.3	-164.9	-165.1	-165.2

Sources: National Statistics Office; and IMF staff estimates.

Table 4. Malta: International Investment Position, 2005–10

	2005	2006	2007	2008	2009	2010
			(Millions of euros)			
International investment position	1,779	1,427	988	158	663	421
Direct investment	-2,805	-4,088	-4,824	-5,059	-5,577	-11,387
Assets	841	873	814	697	1,072	1,137
Liabilities	-3,645	-4,962	-5,638	-5,757	-6,649	-12,524
Portfolio investment	9,641	10,963	10,287	9,637	11,946	15,119
Assets	10,054	11,371	10,694	10,188	12,444	15,598
Liabilities	-413	-408	-407	-551	-499	-478
Financial derivatives	-2	-15	28	-5	-40	-90
Other investment	-7,244	-7,673	-7,064	-4,684	-6,040	-3,626
Assets	9,596	12,319	19,394	25,890	22,104	27,438
Liabilities	-16,839	-19,992	-26,457	-30,574	-28,145	-31,064
Reserves	2,189	2,241	2,561	268	374	405
			(Percent of GDP)			
International investment position	36.9	28.2	18.2	2.7	11.4	6.8
Direct investment	-58.2	-80.8	-88.8	-87.0	-95.9	-185.0
Assets	17.4	17.3	15.0	12.0	18.4	18.5
Liabilities	-75.7	-98.1	-103.7	-99.0	-114.4	-203.5
Portfolio investment	200.1	216.8	189.3	165.7	205.5	245.7
Assets	208.7	224.8	196.8	175.2	214.1	253.4
Liabilities	-8.6	-8.1	-7.5	-9.5	-8.6	-7.8
Financial derivatives	0.0	-0.3	0.5	-0.1	-0.7	-1.5
Other investment	-150.4	-151.7	-130.0	-80.5	-103.9	-58.9
Assets	199.2	243.6	356.9	445.3	380.3	445.8
Liabilities	-349.6	-395.3	-486.8	-525.8	-484.2	-504.8
Reserves	45.4	44.3	47.1	4.6	6.4	6.6
Memorandum items:						
Gross external debt (millions of euros)	17,585	21,123	27,773	32,062	29,779	32,894
Gross external debt (percent of GDP)	365.0	417.7	511.1	551.4	512.3	534.5
Net external debt (percent of GDP)	-87.5	-91.0	-87.2	-73.0	-89.9	-176.2

Sources: Central Bank of Malta

Table 5. Malta: Financial Soundness Indicators, 2008–11 1/

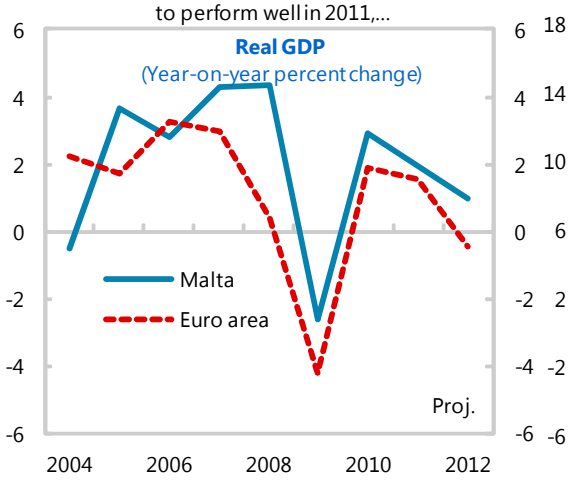
(Percent)

	2008	2009	2010	2011 Q3
Regulatory Capital to Risk-Weighted Assets	14.6	15.9	15.3	15.8
Regulatory Tier 1 Capital to Risk-Weighted Assets	12.5	13.0	12.1	12.3
Non-performing Loans to Total Gross Loans	4.8	5.6	7.3	7.7
Return on Assets 2/	-0.3	2.0	1.3	0.9
Return on Equity 2/	-3.5	19.2	12.6	8.2
Interest Margin to Gross Income 2/	154.0	51.3	68.5	125.8
Non-interest Expenses to Gross Income 2/	106.1	37.7	47.5	57.7
Liquid Assets to Total Assets (Liquid Asset Ratio)	20.3	20.9	23.1	23.6
Liquid Assets to Short Term Liabilities	45.1	43.7	44.6	46.7
Capital to Assets	9.5	10.6	10.8	10.8
Spread Between Reference Lending and Deposit Rates	276.9	295.8	336.1	345.8
Customer Deposits to Total (Non-interbank) Loans	120.3	118.1	125.5	122.1
Foreign-Currency-Denominated Loans to Total Loans	5.5	4.2	4.5	3.2
Foreign-Currency-Denominated Liabilities to Total	16.4	15.0	17.9	14.5

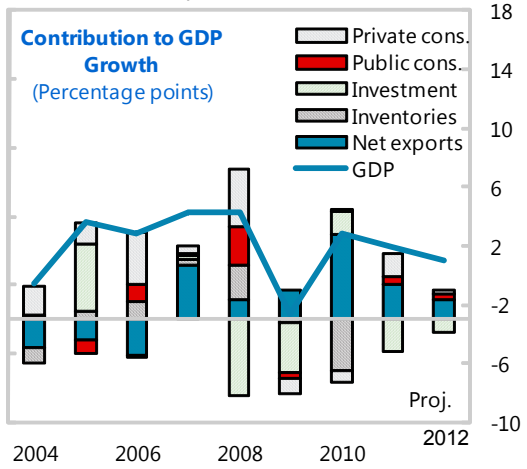
Source: IMF, Financial Soundness Indicators (FSI) database.
1/ Domestically-oriented banks.
2/ First three quarters of 2011 (annualized).

Figure 1. Malta: Economic Indicators, 2004–12

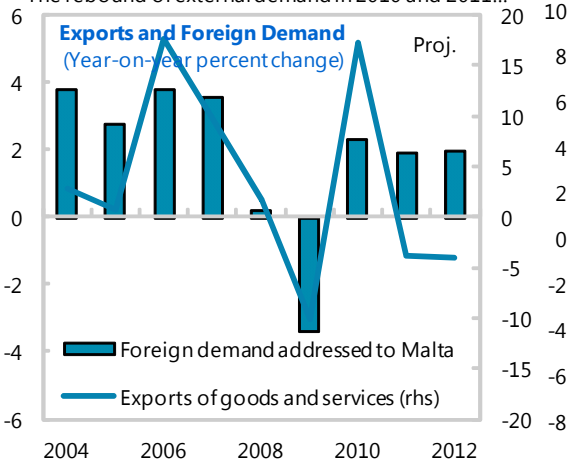
After a strong recovery in 2010, the economy continued to perform well in 2011,...



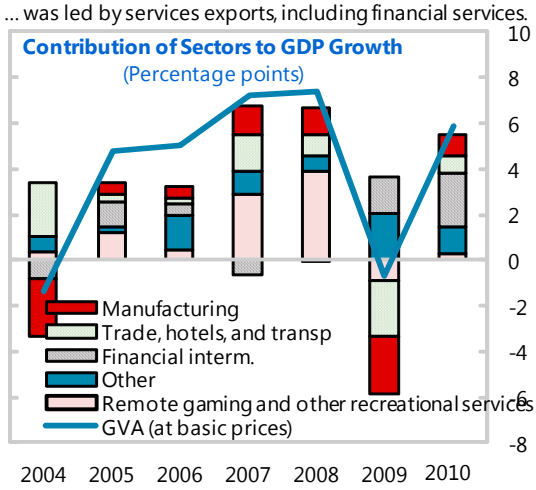
...supported by consumption and exports.



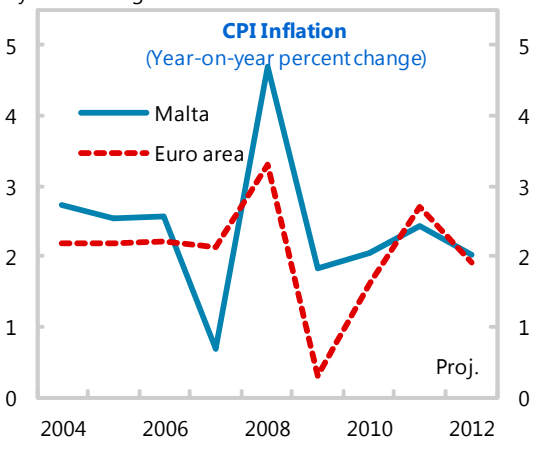
The rebound of external demand in 2010 and 2011...



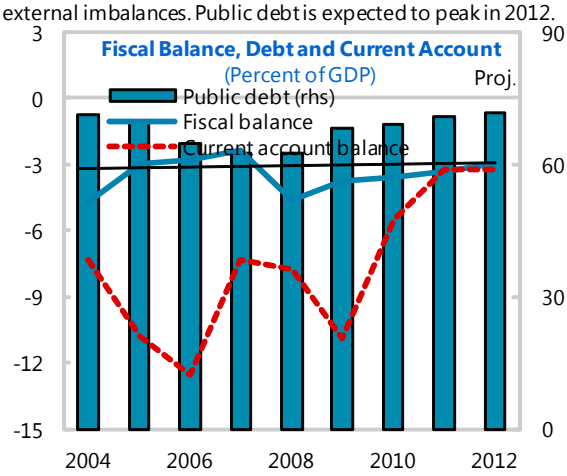
... was led by services exports, including financial services.



Gains in external competitiveness were also underpinned by a narrowing inflation differential vis-à-vis the Euro area.



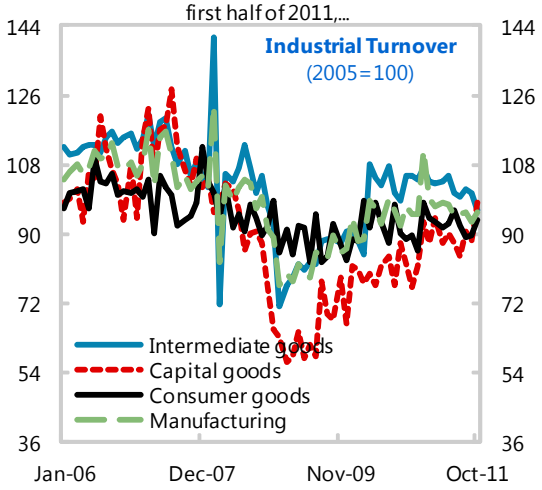
Malta has taken effective action to correct its fiscal and external imbalances. Public debt is expected to peak in 2012.



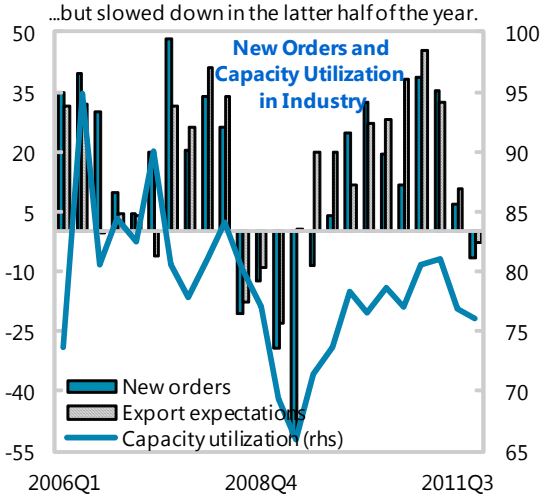
Sources: Central Bank of Malta; Eurostat; WEO; and IMF staff estimates.

Figure 2. Malta: Short-Term Indicators, 2006–12

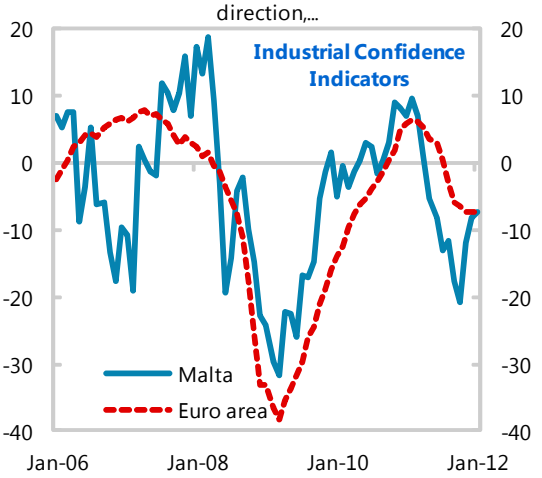
Industrial production grew favorably in the first half of 2011,...



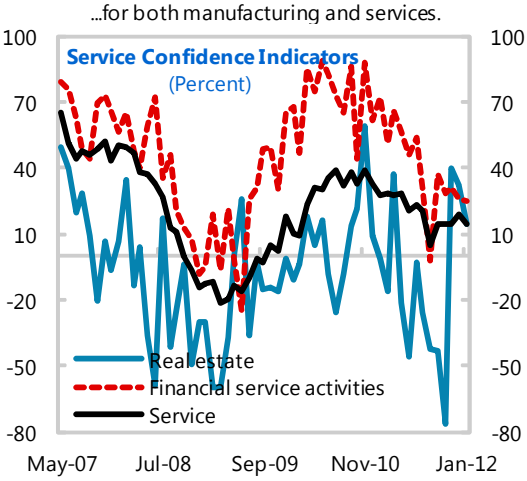
...but slowed down in the latter half of the year.



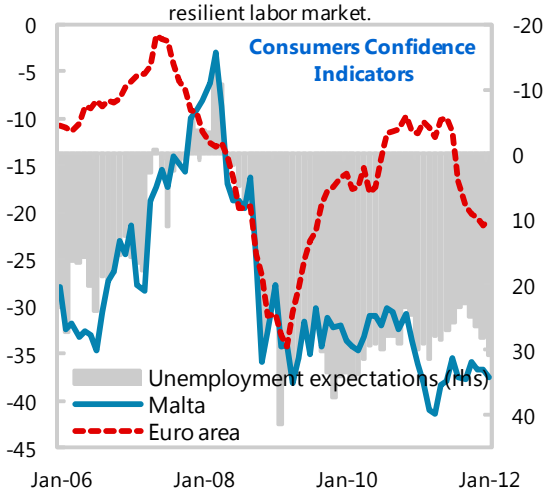
Confidence indicators pointed toward the same direction,...



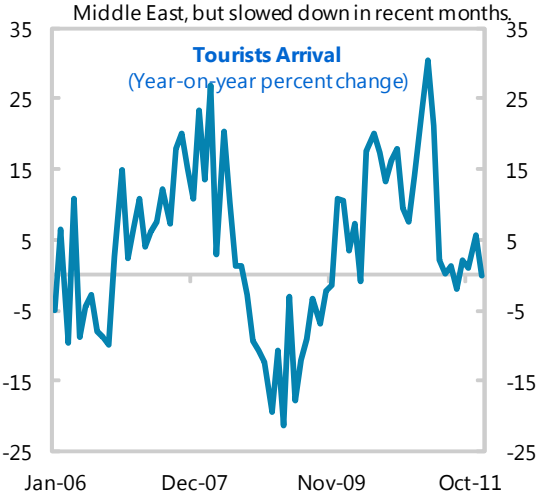
...for both manufacturing and services.



Consumer confidence remained subdued, despite resilient labor market.



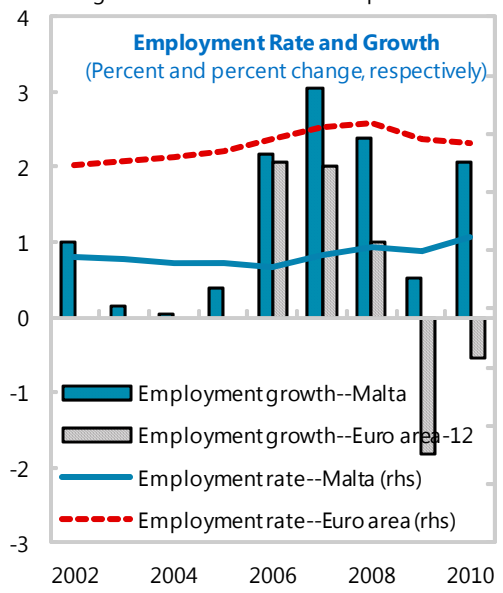
Tourism industry benefited from turmoil in the Middle East, but slowed down in recent months.



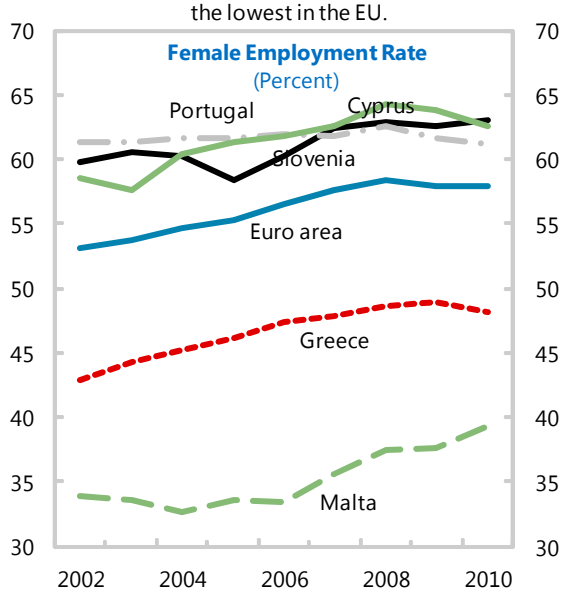
Sources: European Central Bank; Central Bank of Malta; European Commission; and IMF staff calculations.

Figure 3. Malta: Labor Market Indicators, 2000–11

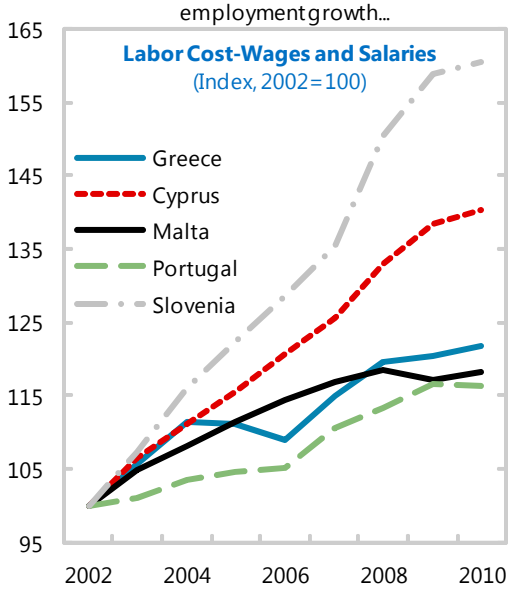
Compared to euro area peers, employment growth has continued to outperform.



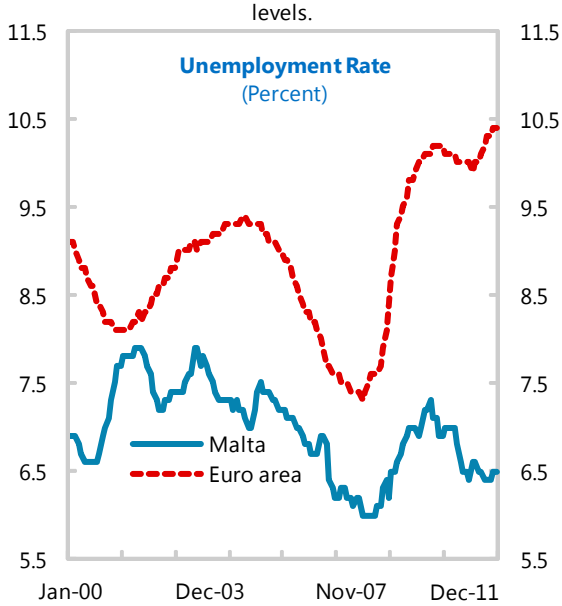
Female labor force participation improved, though remains the lowest in the EU.



The containment of labor costs supported employment growth...

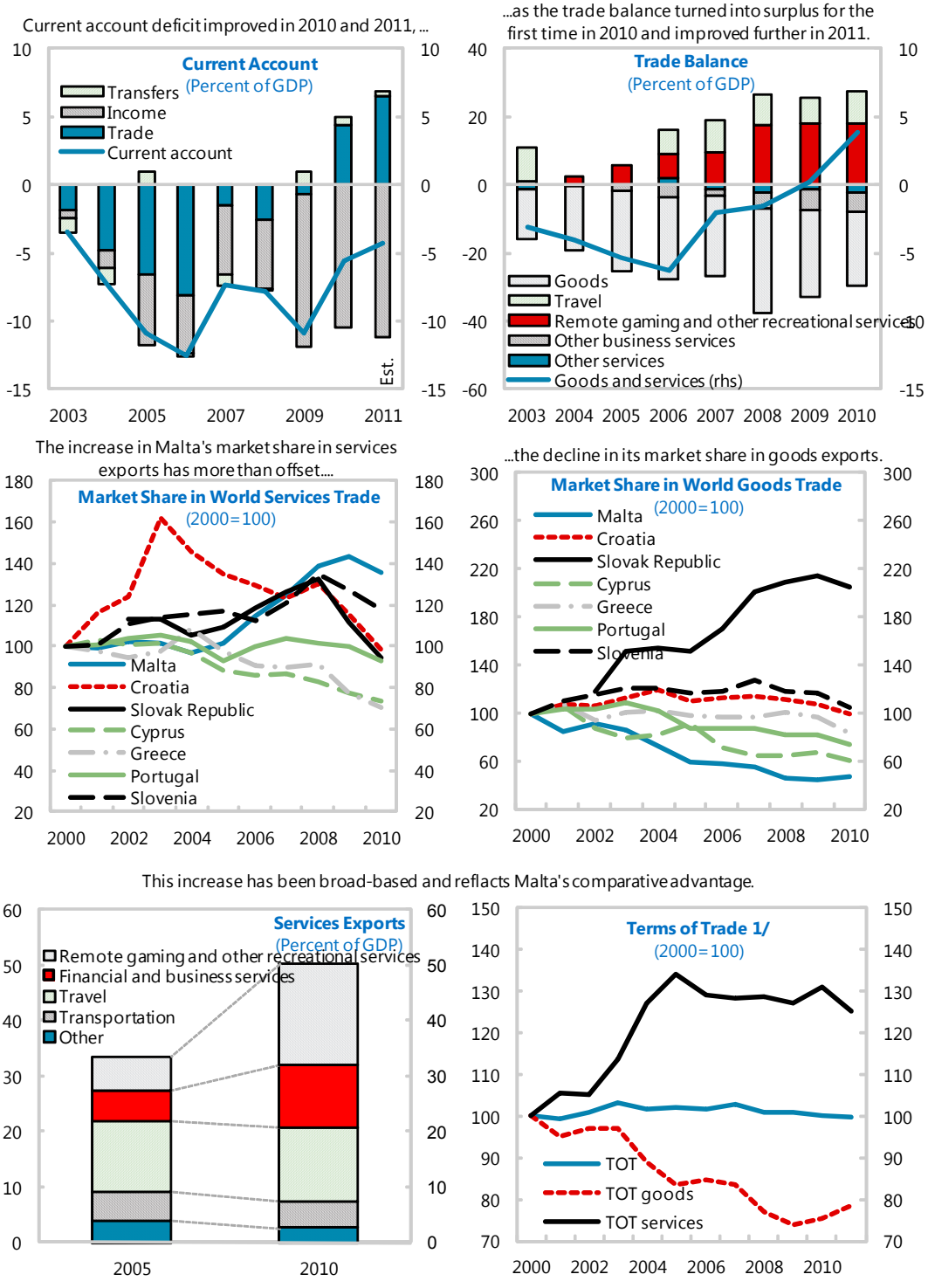


... and the unemployment rate is returning to pre-crisis levels.



Sources: Eurostat; National Statistics Office; European Central Bank; World Economic Outlook; and IMF staff calculations.

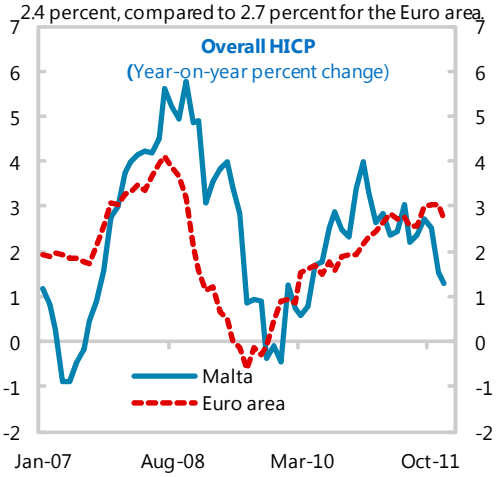
Figure 4. Malta: External Sector, 2000–11



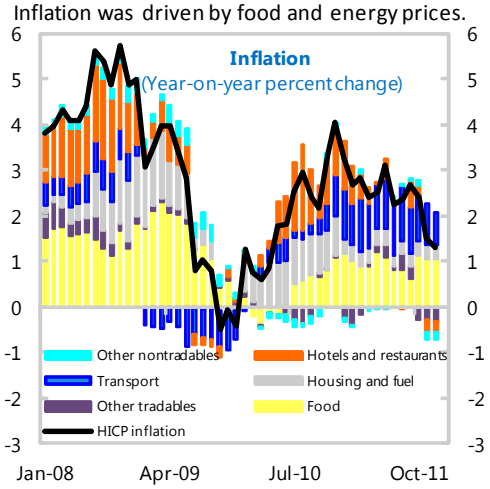
Sources: Central Bank of Malta; Eurostat; IMF, Direction of Trade Statistics; and IMF staff calculations.
1/ 2011 data is an average of three quarters.

Figure 5. Malta: Inflation, 2007–11

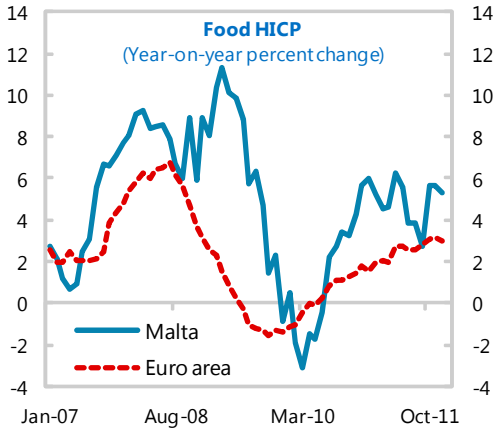
Inflation continued to increase in 2011, but averaged 2.4 percent, compared to 2.7 percent for the Euro area.



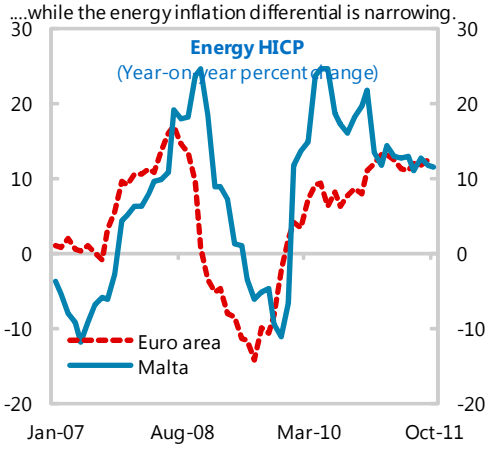
Inflation was driven by food and energy prices.



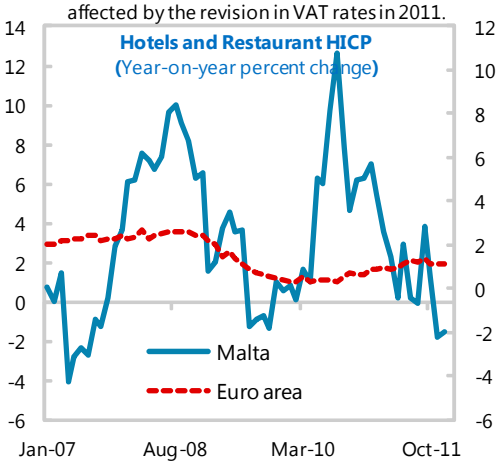
Food inflation remains above the euro area average…



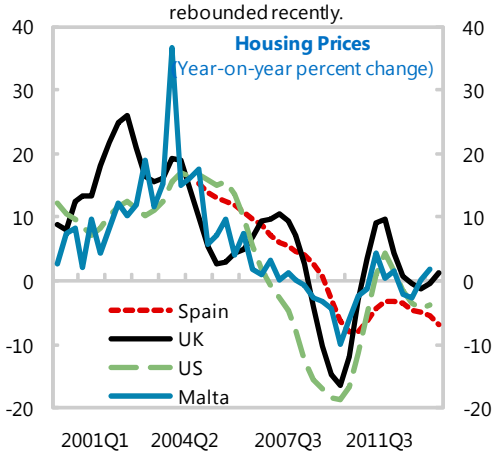
…while the energy inflation differential is narrowing.



Hotel and restaurants inflation remains volatile and was affected by the revision in VAT rates in 2011.

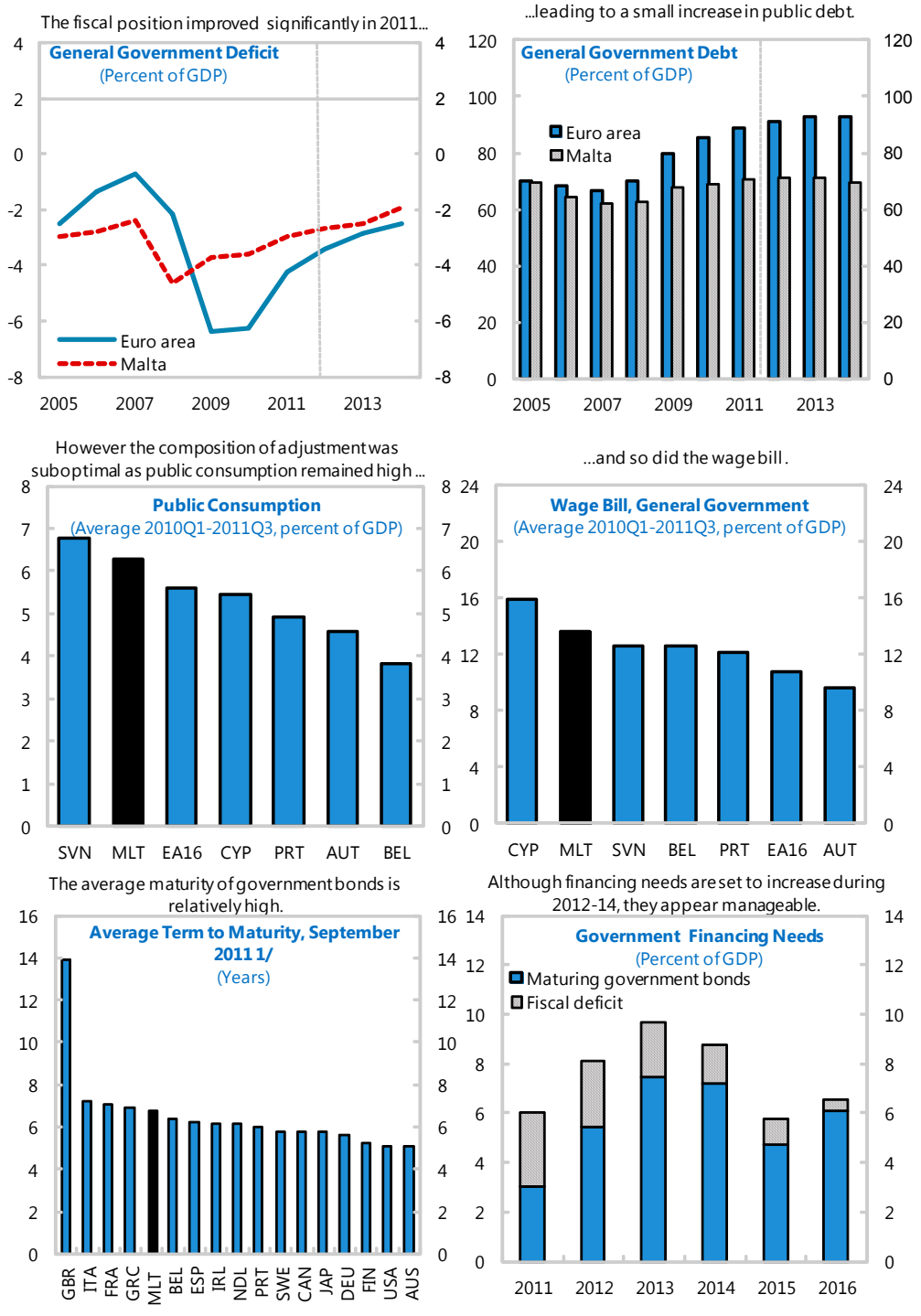


Housing prices continued to stabilize and have rebounded recently.



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

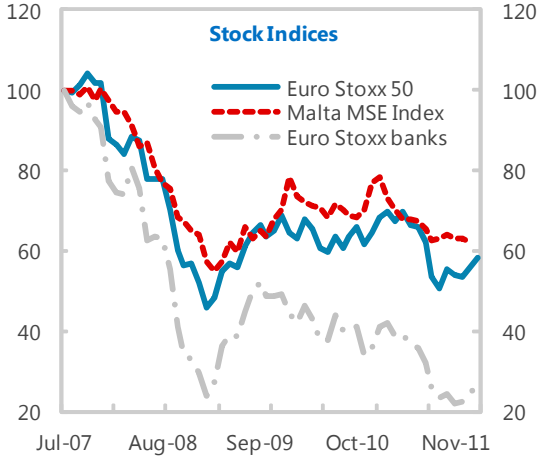
Figure 6. Malta: Fiscal Sector, 2005–16



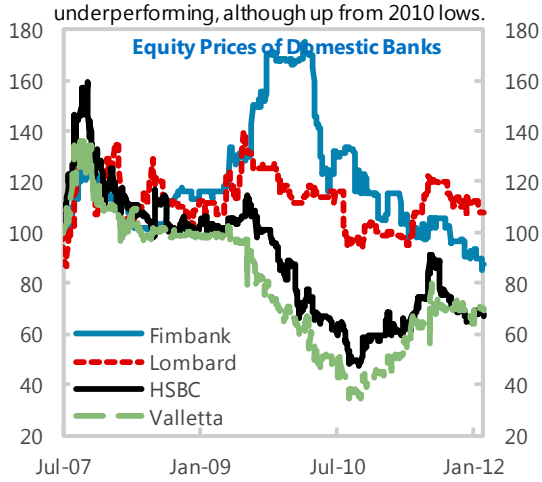
Sources: Eurostat; European Commission; Maltese Authorities; Bloomberg; Datastream; and IMF staff estimates.
1/ Average term to maturity is based on government securities. Data for Malta as of the end of 2011.

Figure 7. Malta: Financial Indicators, 2005–12

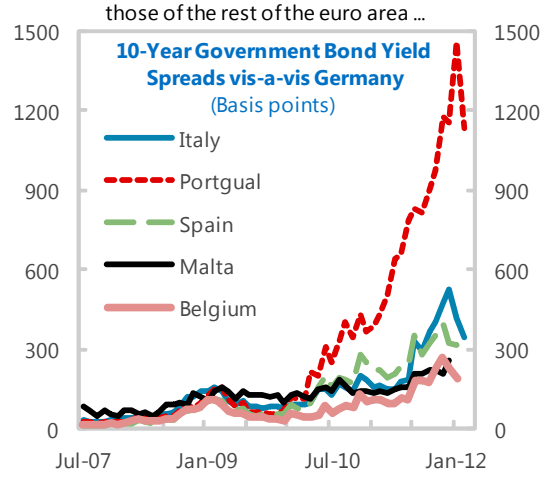
The Maltese stock market broadly moves in line with the euro area index ...



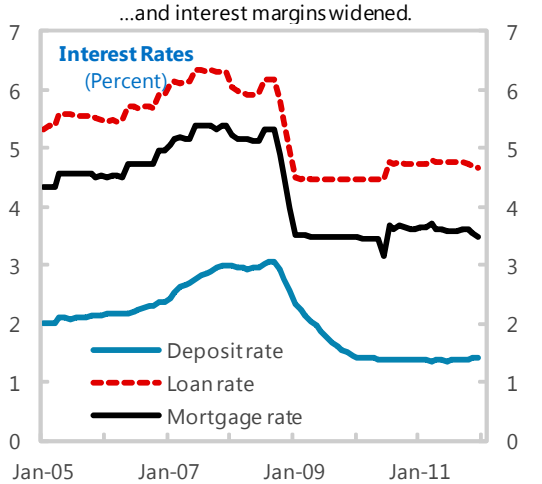
...although Malta's major domestic bank's equity price is underperforming, although up from 2010 lows.



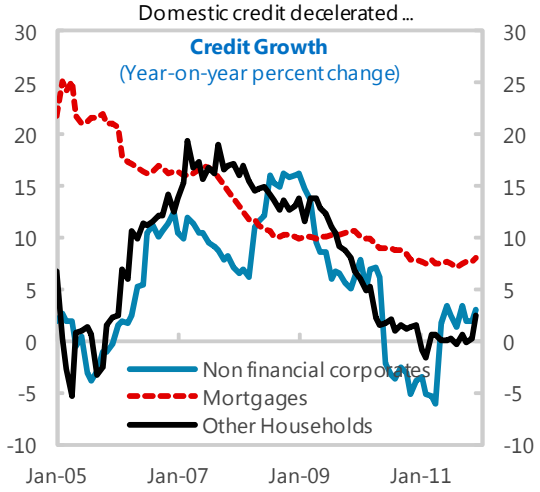
Sovereign yields are on the raise in line with those of the rest of the euro area ...



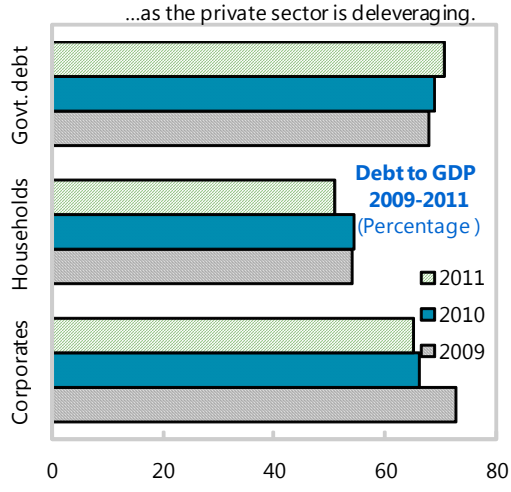
...and interest margins widened.



Domestic credit decelerated ...



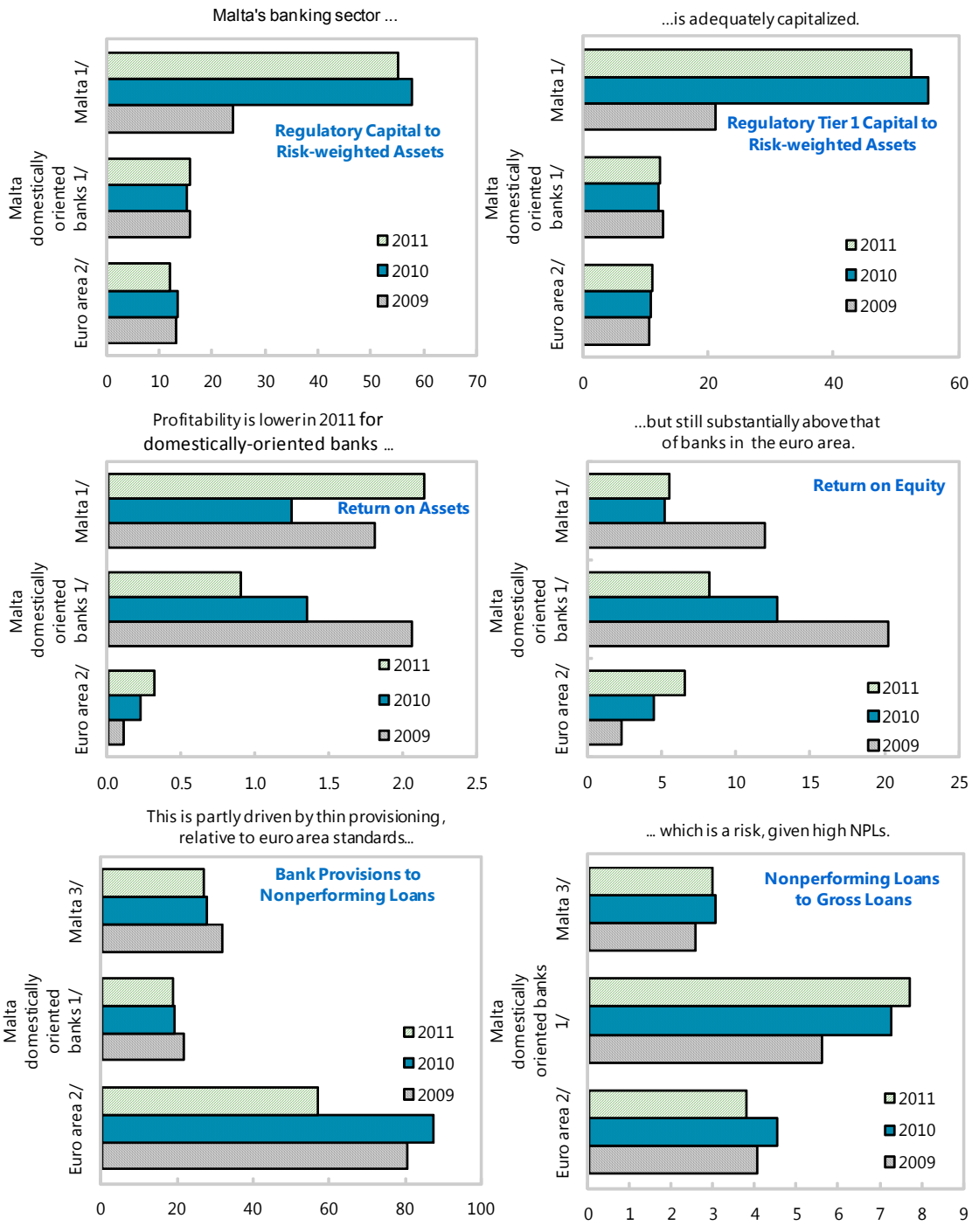
...as the private sector is deleveraging.



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

Figure 8. Malta: Financial Soundness Indicators, 2009–11

(Percent)



Sources: National Authorities; Financial Soundness Indicators, SNL; and IMF staff calculations.
1/ First three quarters of 2011.
2/ Euro area FSIs are calculated from SNL using individual bank data and refer to first half of 2011.
3/ First half of 2011.

ANNEX I. PRESERVING MALTA'S COMPETITIVENESS[1]

Malta has successfully upgraded its export structure in recent years. It continues to gain competitiveness among new high-value-added export activities, particularly financial and business services and remote gaming. Market liberalization, a favorable tax regime, and a highly-skilled work force have facilitated these shifts. Going forward, Malta will need to continue enhancing its productivity by focusing on education, research and development as well as aligning wages with labor productivity in order to preserve its recent gain in competitiveness and sustain growth.

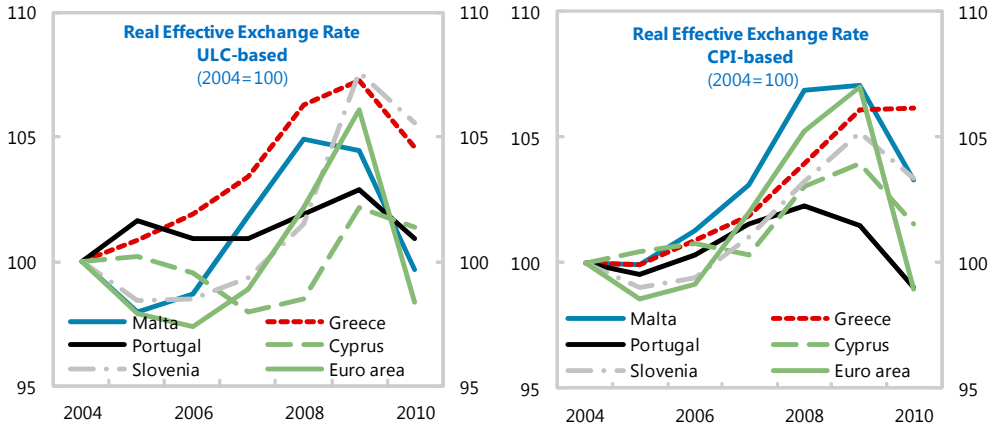
1. Malta has seen a significant gain in competitiveness in recent years through a sectoral shift toward export-oriented services. Services exports grew at double-digit rates during 2004–07. While negatively affected by the global financial crisis in 2009, the sector has steadily recovered. Overall, exports of services have tripled in size over the last decade and the share of services exports to total exports reached 60 percent in 2010, up from 30 percent in 2004. As a consequence, the current account deficit has shrunk by half over the past five years. The price and cost competitiveness indicators have also showed a correction after the 2008–09 financial crisis.

2. This note discusses recent developments in Malta's competitiveness based on both price and non-price measures and policy recommendations. In particular, to further improve its competitiveness, it is essential for Malta to continue to diversify the economy into high value-added activities, raise productivity growth through the improvement of labor force skills, as well as strengthen female labor force participation. These steps should be supported by a cautious settlement of wage negotiations to ensure better alignment of wage and productivity developments.

Measuring Malta's Competitiveness

3. Traditional cost and price competitiveness measures have improved recently. A decrease in unit labor costs and narrowing inflation differentials vis-à-vis trading partners translated into a real depreciation of about 4–5 percent on price-based competitive measures in 2011. Malta's wage setting mechanism comprises the cost-of-living-adjustment (COLA) and other wage agreements. COLA consists of a base wage, indexed with the annual average retail price index (RPI) inflation. Although COLA has been applied at the national level, firm-level wage agreements could overwrite the COLA increase. It is evident that during the past crisis the Maltese social partners agreed on wage moderation—a 0.6 percent decline in wages and salaries in 2010 among the main sectors including industry, construction, and services, thus contributing to a correction in Malta's competitiveness and maintaining employment through labor hoarding.

[1] Prepared by Piyaporn Sodsriwiboon (EUR).



Sources: European Commission and IMF staff calculations.

4. The current account deficit narrowed significantly over the last two years, on account of strong export growth. The current account deficit narrowed to 4¼ percent of GDP in 2010 and to 3 percent of GDP in 2011 (from 7¾ percent of GDP in 2009). Exports of merchandised goods surged to around 35 percent in 2010 and continued to grow by the same pace in the first half of 2011. Exports of services, including business travel, communication and financial services, increased by 8.5 percent in 2010, though growth slowed down in the first half of 2011. Imports rose at a much slower pace, (19 percent for goods and 5 percent for services). As a result, the trade balance registered a surplus of 3.4 percent of GDP, the largest over the past decade. On the other hand, the net income account continued to record a large outflow of 7 percent of GDP, reflecting the repatriation of benefits by foreign companies, particularly banks which showed very positive results.

5. Estimates of the competitiveness gap also present significant improvement. The CGER-type estimates of exchange rate valuation are broadly in line with fundamentals.[2] All three approaches point toward the same trend. The correction in the real exchange rate overvaluation was about 4 percent for the macrobalance and external sustainability approaches, and about 10 percent for the equilibrium real exchange rate approach. The decline in the real exchange rate gap is in line with recent development in wages and price, as well as the large swing in the current account deficit from 7.8 percent in 2009 to 3 percent in 2011 which sharply narrows the medium-term current account projections.

Estimates of Exchange Rate Valuation 1/
(Percent)

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

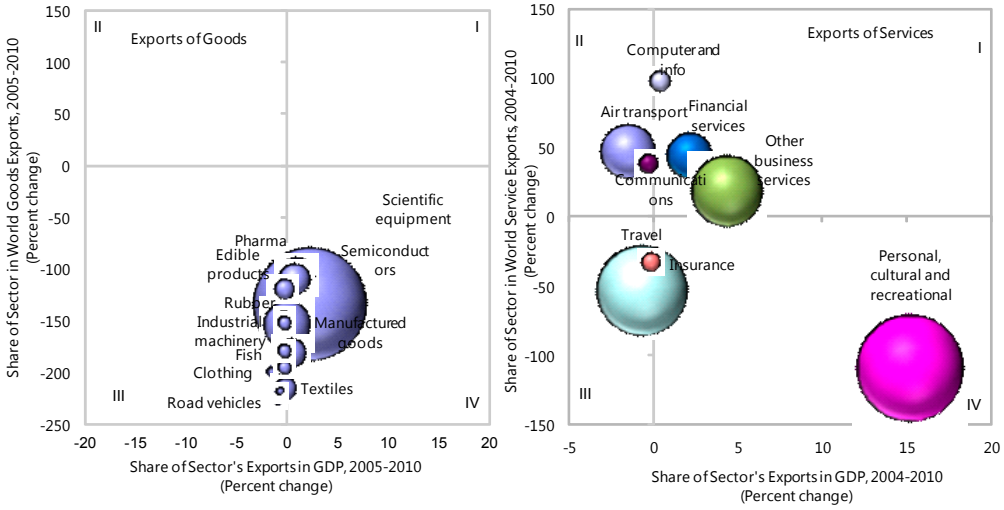
Source: IMF Staff Estimate.
1/ +/- indicates exchange rate over/undervaluation; see IMF Occassional Paper No. 261 for details on the methodology underlying the estimates in this table.

6. Market shares in services have been growing. Malta's service exports have

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

emerged as a new growth engine (Box 1). As of 2010, the sector reached 50 percent of GDP and hired about a fifth of the total work force. Remote gaming, financial services, call centers, and airplane services were buoyant. In particular, Malta's banking sector is one of the largest in the EU in relation to GDP and has been resilient throughout the crisis. Malta is also home to a number of hedge funds and numerous administrations of funds and insurances. Furthermore, Malta's tourism share continues to increase, benefiting last year from the geopolitical tensions in North Africa.

Malta: External Competitiveness 1/



Sources: IMF, *IFS*; UN Comtrade; and IMF staff calculations.
1/ Size of the speres depicts the size of exports as a percentage of GDP in last available year.
Area I presents sunrise industry; *area III* presents sunset industry.

Box 1. What Makes Malta an Attractive Financial Center?

Malta is an attractive location for financial services. Economic and legal, regulatory and tax framework are some of its key advantages.

As part of the euro area, Malta benefits from the EU passport regime as well as the effective and sophisticated legislation based on EU directives, thus facilitating the financial flows across member countries. Malta has been an EU member since 2004 and adopted the Euro in January 2008. The Euro adoption eliminated the currency risk among euro area members, while the adjustment process toward the Maastricht criteria had contributed to economic stability. Malta's financial services legislation is also business-friendly and industry-oriented. The Banking Act is modeled on EU directives and complies with the EU's stringent quality standards.

Financial sector is regulated efficiently and responsively. The Malta Financial Services Authority (MFSA) is the single financial regulator. Its mandate includes (i) supervising financial services, (ii) monitoring business practices in the supply of financial products, and (iii) promoting fair competition and consumer choice in the sector. Its area of responsibility spans from banking, insurances, investment services, and financial markets.

Malta's EU-approved tax regime is competitive and efficient. Corporate income tax rate is 35 percent, but to promote investment activities, Malta has a number of tax incentives, including a reduced tax on approved projects (a reduced rate of 15.75 percent), a reduced tax rate in terms of double tax treaties with all major economies (a reduced rate of 15 percent), and tax credits allowing for further tax reduction. In particular, income and capital gains from participating holdings are tax exempted.

Other advantages include Malta's strategic location and time zone, modern infrastructure, skilled labor supply, English language, and political stability.

Identifying Structural Bottlenecks

7. Further improving Malta's productivity growth is key to sustaining recent gains in competitiveness. Strong growth in financial and business services will demand more high-skilled labor force. In particular, empirical evidence shows that productivity growth within these sectors significantly contribute to export growth (table below and see also Monteagudo and Montaruli (2011)[3]). Higher labor productivity growth in the services sector could potentially have a positive long-term effect on exports, estimated at 0.6 percent in the case of financial intermediation and 1.3 percent in the case of business services for each percentage point increase in the sector's labor productivity. Therefore, the efforts to improve the quality of human capital would be crucial going forward. These results need to be interpreted with caution as the estimated based on limited data may be subject to small sample bias.

Exports and Services in the Euro Area 1/

Dependent variable: Real exports	(i)		(ii)	
	Coefficient	S.E.	Coefficient	S.E.
Lagged real exports	0.996	(0.01)**	0.998	(0.01)**
Demand	0.093	(0.03)**	0.099	(0.04)**
REER	-0.214	(0.08)**	-0.320	(0.09)**
Lagged labor productivity growth, business activities	…	…	0.003	(0.07)**
Lagged labor productivity growth, financial intermediation	…	…	0.001	(0.06)**
Constant	0.587	(0.35)*	1.034	(0.46)**

Source: IMF staff estimates.

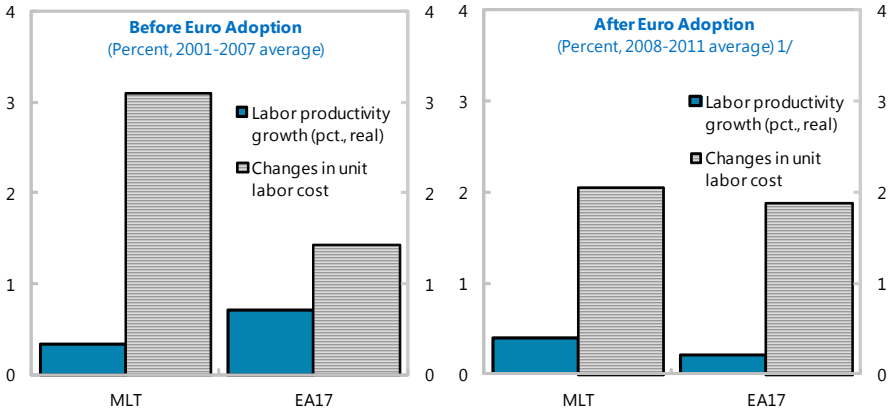
1/ Export demand equation is estimated using Arellano-Bond dynamic panel regression with robust variance. Sample includes 17 euro area countries for the period 1995-2007. Data are from AMECO, European Commission and EU KLEMS. All variables are in logs, except for labor productivity growth. Dependent variable is real exports of goods and services. The external demand measures the size of country's export markets, proxied by real total imports of main partners weighted by country's exports to such countries. REER is the real effective exchange rate index based on consumer price index (ULC-based REER is also tested, but does not alter the result). **, * shows significance at 5 and 10 percent respectively.

8. Malta's productivity growth has lagged behind peers. Labor productivity growth over the last decade averaged only 0.2 percent, compared to 0.5 percent for the euro area and 0.8 percent for the European Union. Overtime, Malta's productivity growth has tended to be volatile, it averaged around 0.5 percent in 2001–08 and declined by 1 percent during the global financial crisis. Nonetheless, the lack of sectoral productivity data limits the scope for competitiveness analysis. For Malta, where the economy is increasingly diversified, it would be worthwhile to develop labor productivity indicators across economic sectors or industries to differentiate developments. In turn, such analysis will be necessary to determine wage settlement policies by underlying wage adjustments based on sectoral productivity developments. This will also help cross-country comparisons, where the country comparators across sectors may be different.

[3] Monteagudo and Montaruli (2011), "Analysing non-price competitiveness in Euro Area countries," in *Measuring Italy's External Competitiveness*, Codogno and Paganetto (eds), Rome.

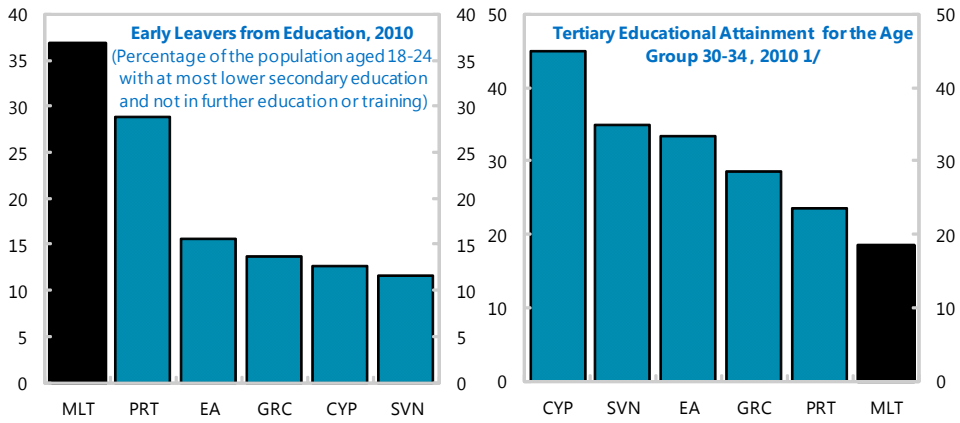
9. Wage growth has exceeded productivity growth over the last decade, although recent wage moderation was encouraging. For Malta, wage growth (2.8 percent) was about 14 times productivity growth (0.2 percent) over the past decade. The wage indexation mechanism by which wages are indexed to the country's inflation could contribute to persistently high wage growth, despite productivity developments. Nonetheless, Malta's wage moderation in light of the crisis helped narrow the gap between wage and productivity.

Labor Productivity and Wage Growth



Sources: IMF staff calculations; and European commission (2011), "Reaching the Employment Target: Progress and Thematic Surveillance".
1/ The 2011 labor productivity data for Malta are based on an average of two quarters and the data for EA17 is based on the first quarter. The unit labor cost for 2011 for both Malta and EA17 are based on a average of three quarters.

10. Structural changes in Malta's production may lead to a bottleneck in the supply of highly skilled labor. Strong growth of new high value-added exports was fundamentally supported by Malta's highly-skilled English-speaking workforce. However, Malta has the highest rate of early school-leavers among euro area peers, while the share of college graduates hits the lowest. Malta has also a long-standing issue of low female participation in the labor force. The lack of high-level education could create a shortage in the highly skilled-labor segment in the labor market, thus hindering the country's potential and competitiveness. In addition, its research and development spending is the smallest among the euro area peers.



Source: Eurostat.
1/ The share of the population aged 30-34 years who have successfully completed university or university-like (tertiary-level) education with an education level ISCED 1997 (International Standard Classification of Education) of 5-6. This indicator measures the Europe 2020 strategy's headline target to increase the share of the 30-34 years old having completed tertiary or equivalent education to at least 40% in 2020.

Preserving Malta's Competitiveness

11. Malta, therefore, will need to continue making progress on structural reforms along with the EU's Lisbon agenda to address its structural weaknesses, boost productivity growth, and sustain growth. These include (i) improving the quality of human capital through education targeted on labor market needs, and encouraging female labor participation; (ii) adopting productivity-enhancing measures through training and R&D; and (iii) improving business environment and efficiency by removing rigidities and reducing an oversized and inefficient public sector as well as promoting energy efficiency. Furthermore, strengthening the AML/CFT preventive measures in the international banking sector and in the online gaming sector will contribute to preserve the sustainability of Malta's competitiveness in these sectors.

12. Finally, Malta should maintain the reform momentum to reform the wage-setting and indexation to better align wage and productivity developments. The working group represented by social partners, the ministry of finance, and central bank of Malta has been set up and made progress on introducing some elements of productivity into COLA formula. The revised formula, however, still needs to be agreed among social partners. Furthermore, the wage-productivity relation could be enhanced by the more-refined sectoral analysis. The Maltese authorities should (i) continue to improve the national accounts output measures following best practices, particularly on data classification, treatment of deflators, as well as services output and price measures, in which these changes would improve both the quality of the national accounts and their international comparability, (ii) speed up the timeliness of labor productivity data, and (iii) in the longer term, account for labor quality, including educational level, age group and gender by industry.

ANNEX II. A RULES-BASED FISCAL FRAMEWORK FOR MALTA[1]

Malta has committed to reform its budgetary framework in line with the recently agreed EU fiscal compact treaty. Adhering to the new guidelines will strengthen fiscal policy making, by adding credibility to the government consolidation strategy and enforcing greater discipline and transparency. Malta-specific simulations suggest that a rules-based framework has the potential to improve fiscal outcomes and promote debt sustainability.

1. Malta's current budgetary framework needs strengthening. A key weakness of Malta's framework is the non-binding nature of the multi-annual targets, which implies a relatively short fiscal planning horizon. The multi-annual projections presented in the annual budget are not underpinned by an articulated medium-term strategy, nor by the detailed measures to achieve them. Other weaknesses relate to the lack of expenditure ceilings and corrective measures in the event of deviations from the target. Malta's framework is also characterized by the absence of an independent budgetary institution to provide independent macroeconomic and fiscal forecasts and to assess fiscal sustainability and compliance with the fiscal mandate. Improving the monitoring of budget execution remains a key challenge, as public expenditure is still subject to discretionary decisions in the implementation phase.

2. The government's commitment to implementing the EC directives on budgetary frameworks and the additional requirements envisaged in the Fiscal Compact agreed on January is a big step towards fiscal discipline. Twenty five EU members, including Malta, committed to achieving and maintaining structural deficits below ½ percent of GDP. Balanced-budget rules will be embedded into national constitutions or primary law. If the target is missed, an automatic correction mechanism will be triggered to bring the deficit back in track. Governments also committed to reducing their gross debt-to-GDP ratios at a pace equal to 1/20th of the distance between the current level and the 60 percent target. In addition to numerical targets, the implementation of the rule will also involve the monitoring of compliance by independent institutions.

3. The establishment of a permanent rules-based framework and strengthened fiscal governance could yield a number of benefits. The requirements outlined in the new treaty would provide a durable constraint on fiscal discretion ensuring sustainable debt dynamics The rising use of some form of fiscal rule over the last two decades reflects the view that well-designed and properly implemented fiscal rules could support credibility and discipline and help limit distorted incentives in policymaking (Box 1). After an appropriate transition period, once the public finances are closer to balance, the EU-mandated structural balanced budget rule could secure the gains of the consolidation process, support fiscal discipline, and anchor long-term expectations about fiscal sustainability.

[1] Prepared by Jeta Menkulasi (EUR).

4. In order to illustrate how a rules-based fiscal framework can improve budgetary outcomes, this annex simulates the hypothetical path of key fiscal variables predicted by various fiscal rules had they been in place in Malta since 2000. The rules-based simulated outcomes are then compared to the actual fiscal outturns over the same period. For simulation purposes, the deficit target is set to -3 percent of GDP, in order to assess what the fiscal outcome would be had Malta targeted the Stability and Growth Pact threshold since 2000.Three fiscal rules are analyzed. A formal representation of these rules and the choice of parameter values are discussed in Box 2.

- **Structural Balance Rule**: This rule allows for temporary deviations in the overall fiscal balance from its medium-term structural deficit target according to cyclical developments. It allows for the full operation of automatic stabilizers leading to higher deficits when the output gap is negative and lower deficits when the output gap is positive. While this can be considered as being very similar to the structural deficit target in the EU treaty, it does not explicitly take into account how the deficit would adjust in case of a deviation from the target.

- **Augmented growth based (AGB)** rule also allows for temporary deviation for the medium term target when the current period economic growth deviates from its long term trend. Hence, it has the countercyclical nature of the structural balance rule but without requiring explicit estimates of the output gap. In addition, this rule also allows for a gradual adjustment back to the medium term target when past shocks cause the balance to deviate from its target. Hence, differently from the structural balance rule, the AGB rule avoids unrealistically high adjustments in a single year by allowing more time for the balance to converge back to the target. In this respect, the AGB rule not only takes into consideration cyclical concerns like the structural balance rule does but also incorporates an automatic correction mechanism making it more likely to encompass the proposed fiscal rule in the EU treaty.

- **Expenditure Rule.** This rule sets a ceiling for the annual growth rate of real expenditure. Revenues are not constrained by the rule. Real government expenditures can be set to equal the long term growth of real GDP. Cross country experience shows that this rule is usually associated with additional requirements such as debt brakes or deficit ceilings.

5. The three fiscal rules under consideration would have delivered better fiscal outcomes than the actual policy stance during the period 2000–07. In particular, the rules would have been more effective in:

- **Containing the fiscal deficit.** The actual deficit during this period was 5.2 percent of GDP on average, while the deficit predicted by the structural balance and AGB rules would have been around 3 percent of GDP. Fiscal policy was quite expansionary and procyclical during this period, especially before Malta joined the EU (2000-04). An expenditure rule would have performed worse than the balance rules, though still achieving a better

Box 1. Country Examples of Fiscal Rules

Multi-year Expenditure Rules in Finland, Netherlands and Sweden (Ljungman 2008)

All three countries have had positive experiences with expenditure ceilings, contributing to maintaining robust public finances. They all include a medium term framework, which in the case of Finland and Netherlands is 4 years (the amount of time that a government is in power), whereas for Sweden it includes a 3 year rolling ceiling. Ceilings are defined in real terms in the case of Netherlands and Finland, which are then adjusted for inflation and converted into nominal ceilings. In Sweden on the other hand, the ceiling is directly defined in nominal terms. The coverage of expenditure items differs across countries. While in all cases countries have opted to exclude interest payments on the grounds that it is a very volatile and procyclical item, their stance differs regarding the coverage of cyclically sensitive items such as unemployment benefits. Netherlands and Sweden expenditure ceilings are comprehensive, by covering almost all of central government spending. Finland, on the other hand, excludes cyclically sensitive items from expenditure ceilings in order to allow for the full operation of automatic expenditure stabilizers. During an economic downturn,, the cyclical component of expenditures would be allowed to increase without requiring a compensating cut in other expenditure items. While in all three cases expenditure rules are not regulated in legislation and there are no predetermined sanctions in case of deviations, political commitment and compliance has been high. It is also important to note that in all three cases such fiscal rule has been implemented in the aftermath of a serious fiscal crisis. However such rules were introduced after the consolidation had been achieved.

Structural balance rule in Germany

In June 2009, the German parliament amended the constitution to include a new rule for both federal and state governments. The rule requires the federal government's structural deficit not to exceed 0.35 percent of GDP. The rule becomes binding in 2016, with a transition period starting in 2011. The states will be bound by a balanced structural budget from 2020. Execution errors are cumulated in a notional account that has to be corrected once errors accumulate above 1 percent of GDP. However, the adjustment only needs to start after an economic recovery is in place to avoid a procyclical tightening. The provisions allow for an escape clause that can be invoked by parliamentary majority in the event of natural catastrophes and other emergencies outside government control.

Augmented growth-based balance rule in Turkey

Turkey has recently considered adopting a fiscal rule that promotes countercyclical policy while circumventing the need to estimate the output gap. The draft law submitted to Parliament specifies a general government deficit target of 1 percent of GDP. In any given year, the actual deficit may deviate from the target to account for cyclical developments. In this case, the deficit may react to changes in the growth rate (relative to the long-run trend of 5 percent), rather than changes in the output gap. In addition, the rule allows gradual adjustment when the deficit is away from its medium-term target. As a result, the amount of required adjustment in any given year would almost always be feasible, making the rule more politically durable. For details see Fletcher and Benelli (2010).

Box 2. Formal Representation of Fiscal Rules

Structural Balance Rule

Under a structural balance rule, the overall budget balance in any given year is equal to the medium-term overall balance target adjusted for changes in the output gap. Formally,

$$b_t = b^* + \alpha y_t^G, \quad \alpha > 0$$

where b_t is the overall balance (as a percent of GDP) in the current year , b^* is the medium-term overall balance target, α is the semi-elasticity of the budget balance with respect to the output gap and y_t^G is the output gap in the current period. The parameter α can also be seen as the cyclical coefficient which determines the extent to which automatic stabilizers and discretionary countercyclical policy works. In the baseline simulation we follow Girouard and Andre, 2005 and set α equal to 0.45. With this value, the rule allows automatic stabilizers to work fully, but no discretionary policy countercyclical policy is allowed.. b^*, the overall medium term balance target is set to be -3 percent of GDP.

Augmented Growth-Based Balance (AGB) Rule

The rule broadly mimics a structural rule, but makes some adjustments to avoid relying on output gap estimates, which in some cases are uncertain or subject to revision. The rule replaces the output gap with the difference between actual and long-term growth. To promote countercyclicality and avoid requiring an unrealistically large adjustment in any single year, the rule also includes a term that smoothes the adjustment from any deviation from the medium-term overall balance target in the previous year. Formally,

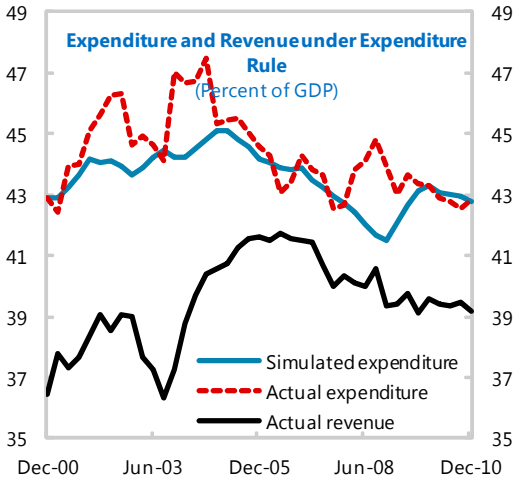
$$b_t = b^* + \alpha(g_t - g^*) + c(b_{t-1} - b^*), \quad \alpha > 0, \quad 0 < c < 1$$

where b_t , b^*, α are defined as for the structural balance rule and *c* is the pace of adjustment when the overall balance in the previous year is away from the medium-term target. A smaller coefficient c implies a faster correction. g_t and g^* are the current period and historical trend growth rate of real GDP respectively. In the simulations, $b^* \; and \; \alpha$ are set to -3 percent of GDP and 0.45. The correction parameter c is set to 0.65. Trend growth rate is set to 1.5 percent, which is the average growth during 2000–10.

Expenditure Rule

This rule sets a limit on the growth rate of real government expenditures. In the baseline simulations we assume that real expenditures cannot grow higher than 1.5 percent on an annual basis, which is also the long term growth of real GDP.

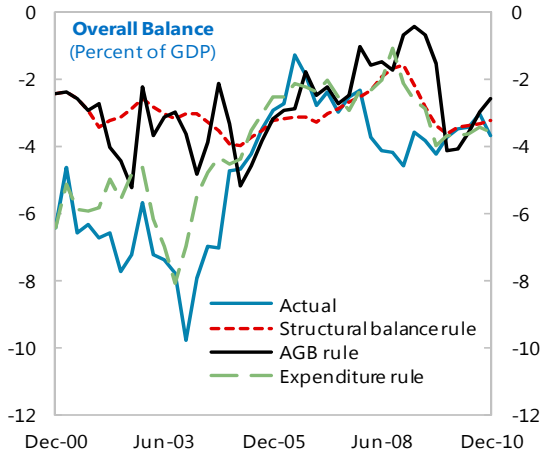
deficit outcome than the actual one. Simulated expenditure-to-GDP ratios under the rule are not very different to those that actually occurred, suggesting that actual real expenditure grew in line with real GDP during this period. This implies that the deficit underperformance was, largely, attributable to shortfalls in revenues, which are unconstrained by an expenditure rule, rather than spending overruns. This result underscored the need to place constraints in the overall fiscal balance, and not solely on expenditures.

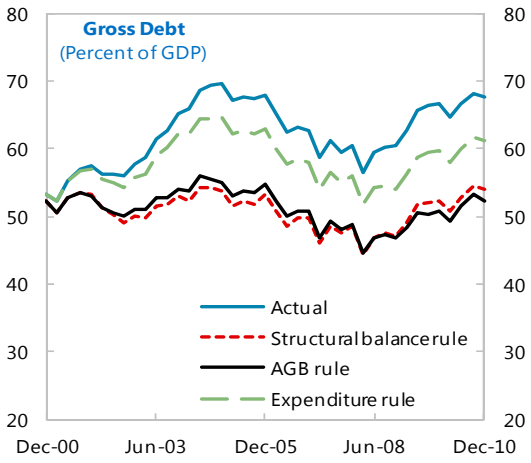


Sources: Maltese authorities; and IMF staff calculations.

- **Reducing debt**. Debt under the three rules would have been lower. Actual debt during 2000–07 stood at an average of 62 percent of GDP, whereas the fiscal rules would have predicted a lower debt of around 50 percent of GDP for the structural and AGB rules and 58 percent for the expenditure rule.

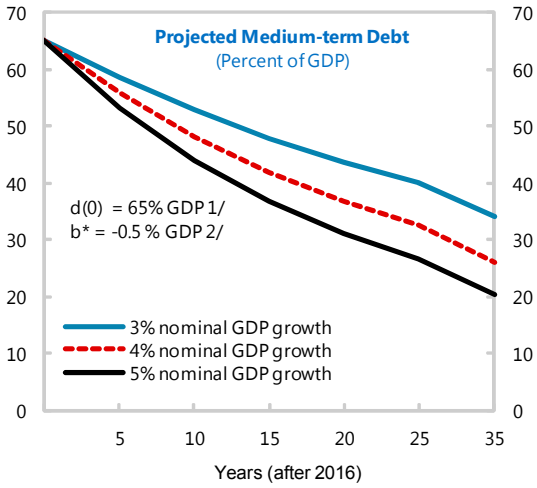
6. As the economy was overheating in the run-up to the crisis, the deterioration of the fiscal balance would have been contained under each of the fiscal rules. In 2008 the overall balance deteriorated by 2 percentage points to 4.6 percent of GPD from an average of 2.5 percent of GDP in the two previous years. Fiscal policy at this time was looser than warranted by cyclical considerations, as the structural balance and AGB rules would have both predicted a deficit of around 1 percent of GDP. This year was also associated with very high expenditure growth, which surpassed GDP growth by a large margin.





Sources: Maltese authorities; and IMF staff calculations.

7. The increase in debt as a result of the recession and public sector restructuring as well as the expected increase in ageing-related costs call more a more stringent balance target in the period ahead. In line with the new EU treaty, after an appropriate transition period, Malta is expected to implement a fiscal rule that would target a structural deficit below 0.5 percent of GDP. During the transition period, Malta should move towards a multi-year budgetary framework and deliver an annual structural adjustment of at least ½ percentage points of GDP. Under staff's policy scenario, Malta's deficit would have narrowed to 0.7 percent of GDP and its debt ratio to 65 percent of GDP by 2016. Targeting a structural deficit of -0.5 percent of GDP from then onwards would be consistent with reaching the 60 percent of GDP debt target after 2 years (by 2018). Accordingly, debt would fall below 50 percent of GDP after 10 years (assuming a long-run growth rate of nominal GDP of 4 percent). This suggests that meeting the debt requirement in the fiscal compact would not impose an excessive adjustment in Malta.



Source: IMF staff calculations.
1/ d(0) denotes estimated level of debt in 2016.
2/ b* is the medium-term structural balance target.

ANNEX III. MALTESE BANKS' PROFITABILITY OUTLOOK[1]

A. Introduction

1. Bank profitability analysis is important for a proper assessment of financial stability. The ongoing financial crisis has reinforced the importance of scenario analysis and stress testing of bank balance sheets and income in order to assess their resilience to shocks. In Europe, the European Banking Authority (EBA) has undertaken bank-level stress tests since 2009 for a sample of large EU banks, including one domestic Maltese bank which passed the tests successfully. However, EBA stress tests do not project bank profitability in full, leaving certain items unchanged from a base year (notably, fee and commission income, trading income, operating expenses). Separately, the Central Bank of Malta undertakes univariate stress tests in its Financial Stability Report, related to asset quality deterioration, an economic slowdown, house price correction and deposit withdrawals.

2. This annex presents two alternative methods to gauge Maltese banks' profitability. The first uses a dynamic panel regression approach while the second is a downside risk simulation based on assumptions about loss rates and adverse income shocks. These two approaches provide complementary information on the profitability outlook and risks facing Maltese banks.

B. Panel Regression Approach

3. The quantitative approach relies on bank-panel regressions for major income components. A general-to-specific panel regression specification search was conducted for the main income items, except trading income. Data extend from 1997 (or earliest available) until 2010 or 2011 and are taken from Bankscope (bank level data) and IMF (macroeconomic and financial data series). All data are annual and expressed as a percentage of banks' total assets to address scaling issues (heteroskedasticity). A panel approach was adopted in order to exploit common trends across banks and save on degrees of freedom in the estimation. Extraordinary income was omitted from the analysis because this is difficult, if not impossible, to predict as it reflects one-off events affecting individual banks.

4. Two slightly different versions are presented. One version has separate equations for net interest income, fees and commissions and trading income, while the second version combines the latter two as non-interest income. In addition, there are equations for loan loss provisions and operating and administrative expenses. In the first version, trading income was modeled in a non-parametric way by aligning it with GDP growth using historical data for the past 15 years. This reflects the fact that unfavorable trading results coincide mostly with macroeconomic shocks.[2]

5. Maltese banks' income subcomponents are a function of a few

[1] Prepared by Nico Valckx (EUR).

[2] To reduce discontinuity of matched series, a high-dimensional parametric fit function was used for each bank to align real GDP growth with trading income. This approach is described in IMF Country Report No. 11/371, Germany: Technical Note on Stress Testing, December 2011.

macro-financial factors, and in line with expectations. Besides a lagged dependent variable, the specification search shows that net interest income varies positively with GDP growth and a steepening of the interest margin, viz. the difference between lending and deposit rates (see Table 1). Fee and commission income tends to fall when short-term rates increase and also correlates inversely with the size of banks. In the second version, fees and commission income and trading income are combined as (net) non-interest income, which appears to be well explained by the interest rate-growth differential (relevant in growth accounting and public debt sustainability) and marginally, also stock prices have a positive impact. Loss provisions decrease as GDP growth rises and increases as stock market volatility and lending rates are higher. Operating expenses are a function of inflation and changes in the output gap.

Table 1. Panel Regression Specifications for Bank Income Subcomponents

	NII	FEE	NONINT	LLP	OPEX
Lagged dependent	0.136[a]	0.457[a]	0.281[a]	0.365[a]	0.584[a]
GDP growth	0.028[c]	...	...	-0.021[b]	0.053[c 2/]
Interest margin	0.244[c]	...	...	...	...
EONIA rate	...	-0.02	...	...	...
T-bill rate 1/	...	-0.063[b]	...	...	...
Lending rate, lagged	...	...		0.060[b]	...
Stock return	...	...	0.002	...	...
Stock volatility, change	...	...	...	0.018[c]	...
Real interest–growth	...	...	0.057[a]	...	...
CPI Inflation rate	...	...	...	...	0.094
Size (log assets)	...	-0.138[b]	...	...	...
R2 adj	0.56	0.936	0.86	0.543	0.847
N obs	104	104	104	72	104
N cross sections	15	15	15	11	15

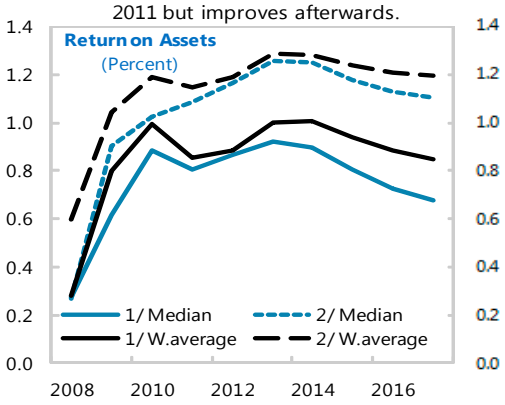
Table reports panel regression results, using OLS and cross-section fixed effects (not reported). NII: net interest income, FEE: fee and commission income, NONINT: non-interest income, LLP: loan impairments, OPEX: Other operating expenses and administrative costs, all as a percent of total assets.
1/T-bill rate is orthogonalized to EONIA rate, as both appear in the same equation. 2/ Change in the output gap. Coefficients are statistically significant at [a] 1, [b] 5 and [c] 10 percent level.

6. Maltese bank profitability appears robust on average, although profitability in 2011 was likely lower. Based on the above panel regression results, individual bank profits can be projected using an expected path for the macro-financial factors. For the latter, developments are assumed to be in line with the Fund staff baseline macro forecast for Malta, while some auxiliary regressions provide the likely paths for series which are not part of staff's projections. In the absence of end-2011 profitability estimates, the regression results suggest that average bank profitability likely fell from 0.99 percent in 2010 to 0.85 percent in 2011 in one model, or from 1.19 to 1.15 in the other model (see left figure in panel below). This decline is confirmed by anecdotal evidence from one bank which reported full-year figures for 2011 already.[3] In the next three years, profitability is projected to improve before reversing a bit in the long term. A breakdown by major income categories shows

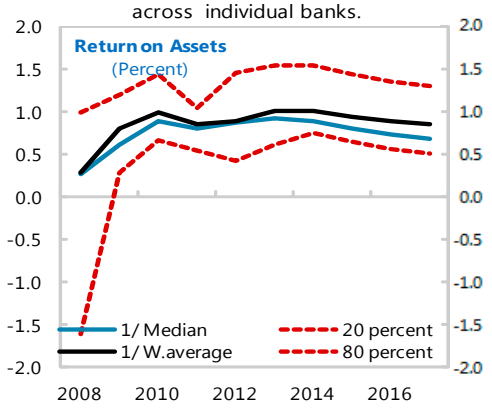
[3] Note that these figures are different from the ones reported in the main report, as the analysis here relies on a less complete set of banks for which information is available in public data sources only, and excludes extraordinary revenues from bank profits.

that this is broadly attributable to roughly stable net interest income, declining operating costs and loss provisions, although the latter rise again from 2015 onwards as lending rates increase. Moreover, in the first model, fee income exhibits a trend decline while trading income rebounds from 2012 onward. However, these very long-term projections reservations as conjunctural developments may well overtake these forecasts. Furthermore, large banks appear to be more profitable than small and medium-sized banks, since the median bank profitability is smaller than the weighted average. In terms of the level, profitability is quite different under the various, although the trend is in the same direction. Finally, looking at the distribution across banks, there seem to be quite large differences in profit levels, which persist over time. Moreover, in the first model, fee income exhibits a trend decline while trading income rebounds from 2012 onward—owing to the profile of interest rates and GDP growth. In the second model, aggregate non-interest income is more stable, as the real interest differential as projected to increase from close to zero in 2011 to over 1 percent in 2012–13 before falling to around 0.50, while stock returns approach 5 percent in the long run (see bottom two figures below).

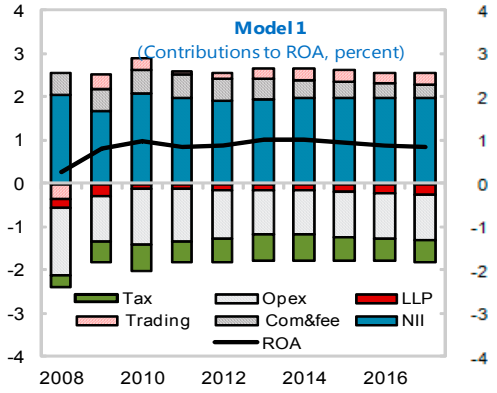
Maltese banks' baseline profitability falls in 2011 but improves afterwards.



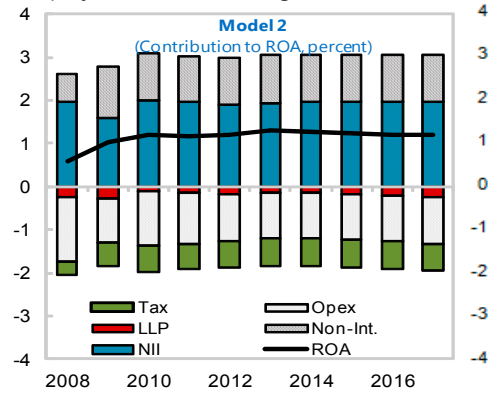
...although there is quite some variation across individual banks.



Moderate costs and LLP s, stable NII and positive trading income support ROA in 2012



...while in model 2, higher average ROA projections stem from higher non-interest



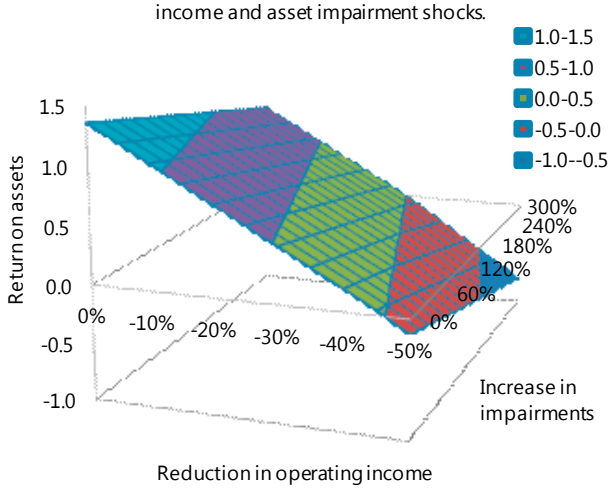
Sources: Bankscope; IMF staff computations.
Note: Sample consists of between 9 and 15 Maltese banks with sufficient data to perform in and out-of-sample forecasts of return on assets (ROA), based on the sum of income component projections as in Table 1. Top left panel shows asset-weighted and median return on assets projections for model 1 and model 2 (see text). Top right panel shows the 20th and 80th percentile distribution of projected return on assets of individual banks around the mean/median for model 1. Bottom panels show the contributions of the income and cost components to each of the two models weighted average ROA.

C. Accounting-Based Simulation Approach

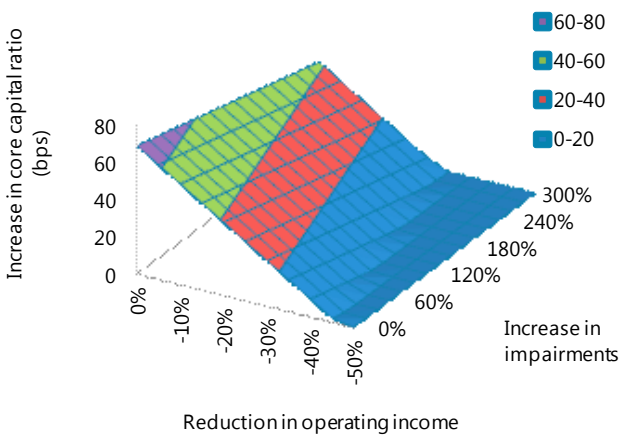
7. An alternative accounting-based simulation shows that bank profits and capital buffers are very resilient to bank revenue and asset impairment shocks. A simple sensitivity analysis, reducing operating income and increasing their loss impairments to various degrees, illustrates the effect of adverse shocks on domestic Maltese banks' profits and capital buffers. Put another way, it shows the amount of stress Maltese banks can cope with before they start experiencing losses or capital adequacy is adversely affected, given a specific starting position. Such exercise reflects a stressed environment in which interest margins, trading and commission and fee income come under pressure, coupled with a further deterioration in the credit cycle as the result of a potentially worsening growth outlook. The simulation is performed at an aggregate level for domestic banks using end-2010 balance sheet and income data, but can easily be implemented at the individual bank level too.

8. The results suggest that domestic banks can cope with quite a substantial degree of stress, thanks to a robust starting position end-2010 (see first text figure below). Only in extreme scenarios—with income falling by more than 40 percent and/or impairment losses more than doubling—would the banking sector experience substantial losses. However, even in these extreme cases, most of the adverse shocks would be buffered by strong levels of capital: in the most extreme simulation, the aggregate core capital ratio would still be around 14 percent, down from 15.3 at end-2010 (not shown). Nevertheless, it may be prudent for domestic banks to maintain a conservative dividend policy. To illustrate, if Maltese banks were to double their profit retention rate from 35 to 70 percent, core capital could be boosted by up to 70 basis points, and more strongly so as their performance improves (see second text figure below).

Maltese (domestic) bank profits are quite resilient to operating income and asset impairment shocks.



Core capital ratio strenghtens substantially if dividend payouts were to be restricted, and more strongly when banks perform well.



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

D. Conclusions

9. The analysis indicated that the Maltese banking sector's profitability is sound in the short to medium term. The analysis indicated that the Maltese banking sector's profitability is sound in the short to medium term. However, there appear to be some weaker spots, which underline the need for adequate (intensified) supervision of the weaker banks along various policy dimensions. For the weakest, higher dividend retention policies may be appropriate, as the Central Bank of Malta already recommended. For others, a targeted risk reduction may be opportune to rebalance loan portfolios, so as to reduce somewhat large and concentrated exposures, in order to improve their asset quality and enhance profitability. Also, while the current analysis focused on Maltese banks in isolation, the broader euro area debt crisis context could impact Maltese banks in a short time span, e.g., through rising funding costs, increased uncertainty, higher chances of a recession, among others.

ANNEX IV. MALTA: FINANCIAL STABILITY POLICY FRAMEWORK[1]

To date, the Maltese financial system has maintained financial stability, notwithstanding the stresses and strains in the global financial system, lately stoked by the European sovereign debt and banking crisis. Against this backdrop, as well as significant risks going forward, this note examines the key elements of Malta's financial stability policy framework, with the focus on the banking sector, given its dominance of the financial system. The note concludes that the regulatory framework relating to macro-prudential surveillance, micro-prudential supervision, bank resolution, and the deposit compensation scheme should be strengthened, financial buffers be bolstered, and surveillance and supervision tightened.

A. Context

1. Malta has a bank-dominated financial sector, with the capital markets playing a limited role. Accordingly, banks are the key sources of finance for the real sector. As at the end of 2010, banking sector assets constituted 84 percent of the total assets of the financial system, whereas insurance and investment fund sector assets, respectively, constituted 11 percent and 5 percent.

2. The Maltese financial stability policy framework was not subjected to materially stressful conditions over the recent past. During the period 2007 to date, Malta managed to avoid and prevent any material financial stability dislocations, notwithstanding the turbulence globally and regionally. It is important to realize from the outset that the current arrangements have not been tested by a systemic crisis or the failure of systemically important financial institutions in recent years.

3. As the financial sector is a common good, it is incumbent upon the authorities to ensure its effective functioning. A financial sector is indispensible to an efficient modern economy, and financial deepening increases its potential to benefit an economy. However, the financial sector is fragile, in view of its dependence on client confidence, and exposure to systemic risk. Safeguarding its stability is thus a major policy objective.

4. Maintaining financial sector stability requires a multi-faceted approach. One facet encompasses the arrangements for monitoring and managing systemic risk through macro-prudential policies; a second is the quality of micro-prudential regulation and supervision; and a third is the safety net that enables the authorities to manage crises when they occur, including emergency liquidity assistance, bank resolution, and deposit insurance. The latter also includes contingency planning for crises. This note addresses each of these aspects of the financial stability framework of Malta.

B. Systemic Risk Monitoring Arrangements and Macro-Prudential Policy

5. The Ministry of Finance, the Central Bank of Malta (CBM) and the Malta Financial Services Authority (MFSA) jointly set up structures to discuss issues of a technical nature relating to financial stability and crisis management. The main structures in place are as follows: The Domestic Standing Group (DSG), the Working Group on Crisis Management (WGCM) and the

[1] Prepared by Carel Oosthuizen (MCM).

Joint Task Force on Bank Resolution (JTFBR) - the latter two being substructures to the former. The WGCM developed a policy document titled "A Framework on the Management of Domestic Financial Crises." The JTFBR developed a policy document titled "A Report on the Review of the Domestic Bank Resolution and Insolvency Regime."

6. The authorities are considering vesting the DSG with decision-making powers, to recommend and enforce macro-prudential policies. It will be important to determine the committee's related mandate, scope, power, instruments and governance. This forum would also be responsible for the overall contingency planning and crisis management, including coordination of and information exchange among the financial sector safety net participants, as well as for public communication.

7. The central mandate for the overall financial sector stability is vested in the Central Bank of Malta (CBM). The CBM's highest internal forum dealing with financial stability is the Financial Stability Committee. The Financial Stability Committee (FSC) was created as a co-ordination forum, with the task of formulating the CBM's assessment of the stability of the financial system, and, as a consultative forum, with the task of discussing various issues related to the stability of the financial system. The CBM's Financial Stability Department (FSD) provides secretarial support to the FSC. The FSC convenes a minimum of four times a year, and as circumstances may necessitate. On a half yearly basis, the CBM convenes a Forum for Financial Stability, for local banks' risk officers, wherein systemic risk issues are discussed.

8. The CBM has been proactive in developing its capacities and capabilities in the area of financial stability. The CBM established a Financial Stability Department (FSD), consisting of two legs, namely firstly a division titled Financial Stability, Surveillance, Assessment and Data, and secondly a division titled Policy, Crisis Management and Stress Testing. Since 2008, the Financial Stability Department has produced three annual and three interim Financial Stability Reports. A summarized version of the Financial Stability Report is published, whereas a detailed version of the Financial Stability Report is shared with the MFSA.

9. The CBM relies on a structured framework in order to detect potential triggers of financial instability and early signs of systemic distress, which consists, inter alia, of the following components: Analysis of various quantitative indicators such as compliance with regulatory quantitative requirements for capital and liquidity, financial soundness indicators, balance sheet and profit and loss developments, and credit risk exposures; meetings with the MFSA and with various banks and other stakeholders; monitoring of news media; and financial markets statistics.

10. The FSD furthermore performs various tasks in order to obtain relevant information. The FSD identifies and obtains information which will enable it to identify and address systemic imbalances and systemic risks, threats and vulnerabilities. FSD analysts regularly carry out surveillance work, in order to detect signs of stress. Also, the FSD performs stress testing in order to test for credit risk/asset quality, interest rate risk, a bank run, a house price shock and an economic downturn, whereupon the results

are published in the Financial Stability Review. In addition, the CBM performs ad hoc scenario testing in response to current events, such as a price shock to sovereign exposures. Recently, the Maltese authorities extended the EU-wide European Banking Authority's stress testing exercise of a limited number of banks, being the systemically important banks, to all domestic-oriented banks.

11. The CBM takes the lead in conducting crisis simulation exercises designed to assess, evaluate and enhance crisis management preparedness. Such exercises are carried out every two to three years. Typically, scenarios are identified and then developed by the Working Group on Crisis Management, which is comprised of representative from the CBM, the MFSA and the Ministry of Finance. These exercises have focused on testing most of the arrangements established in the Framework on the Management of Domestic Financial Crises, including the testing of (i) crisis management practices, (ii) the use and exchange of information, (iii) communication and decision-making, and (iv) the Systemic Impact Assessment Framework (as proposed in the 2008 MoU on cross-border financial stability.) Following a simulation exercise, a debriefing report is compiled, highlighting the achievements and short-comings, and containing recommendations for further enhancement of crisis management arrangements and practices. The CBM also provides assistance to domestic banks in the development of their own simulation exercises. The CBM also participated in two crisis communication simulation desktop exercises.

12. Further strengthening the analysis of risks posed by the financial sector, including by the so-called international banks and insurers, is key to identifying and addressing systemic imbalances before they materialize.

C. Micro-Prudential Regulation and Supervision

13. In pursuit of discharging its micro-prudential mandate, the MFSA applies a multi-faceted approach. The MFSA performs analyses of information submitted by the banks and generates CAMEL ratings and a "traffic light" classification of banks. Though the MFSA itself does not explicitly undertake stress testing, scenario analyses or crisis simulation exercises, it has been involved, from time-to-time, in a number of initiatives which involve some of these techniques, inter alia, in conjunction with the CBM.

14. The MFSA holds the view that all relevant information can and will be exchanged with the CBM and any relevant overseas supervisory authority should a bank become a problem bank. The MFSA Act contains extensive and comprehensive prescriptions pertaining to information exchange.[2] Also, MoUs with local and international counterparts enable information exchange. The governor is a member of the MFSA board.

15. The authorities are responsive to international developments. In response to the EU's Larosiere report, the MFSA restructured itself by setting up separate supervision units for banking, insurance and financial markets; by also creating a cross-

[2] MFSA Act: article 18; Banking Act: articles 4, 19, 25, 35B, 28, 29 and 34; and CBM Act: articles 36–39. See also the framework of cooperation with other domestic policy makers, as well as non-domestic parties, set out in a preceding paragraph.

sectoral authorization unit and regulatory development unit. On a two to three year cycle, the MFSA undertakes an assessment of itself against international standards and developments. Recently, the MFSA commissioned an independent assessment by the governance of its supervision.

16. The asset classification, impairment and provisioning framework needs to be tightened. The framework for asset classification and provisioning is not fully in line with sound practice. In addition, to date, the authorities have not undertaken back-testing on the asset classification and provisioning framework. It is recommended to update this framework and gather relevant information to build the necessary time series, which will enable back-testing.

17. The MFSA is commended for its self-imposed quality controls of commissioning regular independent assessments against international standards. In 2010, the MFSA commissioned an independent assessment of regulation and supervision of banking, insurance and securities markets against the respective international standards. The assessment concluded that progress had been made since the 2003 IMF Financial Stability Assessment Program (FSAP), but weaknesses remained in supervisory capacity (notably staffing), definition and monitoring of connected party transactions, and internal audit functions (Box 1).

18. The MFSA has been quick to respond to recommendations of the abovementioned recent independent assessment of the quality of supervision in banking, insurance and securities. The substantial increase in staff, the creation of an enforcement unit, and work in the area of concentration risk represent commendable progress. Continuing efforts along the lines of the report's recommendations are needed more fully to comply with international sound practice.

19. The MFSA exercises its powers of enforcement and sanction, and monitors corrective action plans. The MFSA's Supervisory Council takes formal decisions on sanctions, which decisions are published on the MFSA's website. The enforcement unit is responsible for giving effect to such sanctions. For example, in the recent past, a bank's license was revoked and a substantial fine was imposed on the largest domestic-oriented bank. It might be advisable for the MFSA to have a "catch all" power, enabling such MFSA actions to prevent a bank from doing or neglecting anything which may result in the bank becoming or continuing to be unsafe or unsound. The authorities are commended for the decisive steps taken to develop a formal and effective approach to enforcement, thus counteracting the potential for regulatory capture. Through sound judgment and experience, it should be possible to build an enviable track record.

20. Contingency planning for crisis preparedness should place particular focus on systemically important banks and develop plans to attend to the issue of too-big-to-fail/save banks. The adequacy of financial buffers should be assessed through regular stress testing. The development of scenarios for material risks would enable the undertaking of meaningful crisis simulation exercises on a regular basis, involving relevant stakeholders and covering systemically relevant institutions, as well as cross-border dimensions. Arrangements for coordination and information exchange between the key

Box 1. Independent Assessment of Financial Sector Standards (BCPs; IOSCO; IAIS)

Background

The Malta Financial Services Authority (MFSA), a single regulator for financial services, was established in 2002. Soon thereafter, Malta requested the IMF/World Bank to conduct a FSAP, which was finalized early in 2003. Malta acceded to the European Union in 2004.

Thereupon, the Board of Governors of the MFSA(the Board), in pursuit of high standards in regulation and supervision, requested that an internal audit of the MFSA regulatory activities be carried out every two to three years following a IMF/World Bank assessment. Internal audits were carried out in 2005 and 2007. In the light of the global financial crisis, the Board, noting that increased transparency was being demanded by the markets, decided that the 2010 internal audit should take the form of an independent assessment and should be carried out using the same format as the FSAP and this assessment and future assessments should be made public.

During 2010, a team of independent experts performed the following updates of the 2003 FSAP ROSC assessments: a BCP assessment, an IOSCO assessment and an IAIS assessment, all based on MFSA self-assessments. A report on the authorities' progress in relation to the recommendations which arose from the 2010 assessment was produced in December 2011 (2011 IA PR).

BCP assessment

The 2010 independent assessment (2010 IA) concluded that the MFSA was "Compliant" with twenty BCPs and "Largely compliant" with 5 BCPs. Accordingly, in no instances was the MFSA found to be "Materially non-compliant" or "Non-compliant" with any of the principles. (The 2003 FSAP had concluded that the MFSA was "Compliant" with ten BCPs, "Largely compliant" with thirteen BCPs and "Materially non-compliant" with one BCP and one BCP was considered to be not applicable.)

The 2010 IA noted that it had "found a significant improvement in the overall compliance to the BCPs. The main recommendations relate to addressing staffing constraints, improving the regime relating to fines, requiring that connected party prescriptions be tightened, improving the nature and extent of contact with bank boards and managements and formalizing corrective and enforcement policy.

IOSCO assessment

The 2010 IA concluded that the MFSA had "Implemented" twenty four principles, had "Broadly implemented" four principles, that no principles were "Partially implemented" and none "Non-implemented", and that two principles were "Not applicable". (The 2003 FSAP had concluded that the MFSA had "Implemented" 22 principles, had "Partially implemented" 6 principles, that no principles were "Broadly implemented" or "Non-implemented" and that two principles were "Not applicable".)

The main recommendations relate to addressing staffing constraints, ensuring the effective on-going review of capital adequacy and formalizing an early warning system.

The key recommendations were that prescriptions for the internal audit function needs to be strengthened and that the planning, staff resources, time set aside for and follow up regarding on-site inspections should be strengthened.

IAIS assessment

The 2010 IA concluded that the MFSA had "Observed" twenty two principles, had "Largely observed" four principles, had "Partly observed" 2 principles and had "Non-observed" no principles, nor was any principle found to be "Not applicable". The 2003 FSAP had concluded that MFSA had "Observed" twelve principles, had "Broadly observed" three principles, had "Materially non-observed" two principles, and had "Non-observed" no principles, nor was any principle found to be "Not applicable".

The key recommendations were that prescriptions for the internal audit function needs to be strengthened and that the planning, staff resources, time set aside for and follow up regarding on-site inspections should be strengthened.

institutions, as well as public communication should be tested and updated from time to time. It would be advisable for the MFSA to incorporate these techniques as standing components of its supervisory approach, and to create, develop and maintain the capacity and capabilities to apply these techniques as appropriate.

21. Though the MFSA has the mandate for consumer protection and business conduct, it has not as yet developed or implemented the relevant regulations. Consumer protection and business conduct needs to be integrated into the overall financial sector regulatory and supervisory framework, whilst ensuring achieving a careful balance with safety and soundness concerns. A review of the MFSA's consumer protection and business conduct functions could be considered to secure consumer protection, promote efficiency, and enhance the integrity of the financial system. The mission recommends prompt execution on the relevant mandate.

D. Financial Sector Safety Net

Emergency Liquidity Arrangements (ELA)

22. The provision of ELA is not a Euro-System/ECB activity and, accordingly, is subject to the prohibition against monetary financing. The CBM stands ready to provide modest (in relation to the requesting bank's balance sheet) amounts of short-term liquidity to any illiquid, yet solvent, institution, against adequate collateral discounted sufficiently for the risk exposure undertaken by the CBM. If considered necessary by the CBM, it may require a state guarantee prior to engaging in ELA, to avoid putting its capital at risk. Though the CBM has the capacity to accommodate all requests for ELA, subject to such ELA not interfering with the implementation of the single EU monetary policy, the CBM is required in advance to inform the ECB if the ELA will exceed €500 million.

Resolution Regime for Banks

23. Although the MFSA has most of the necessary resolution powers there appears to be gaps or grey areas in the resolution regime. These include:

- ***Ideally, a non-judicial special resolution regime (SRR) should apply to banks***. In the light, of the unique and complex nature of banking, the imperative to avoid systemic risk, the indispensible role which confidence plays in banking, and the consequent need for prompt, speedy, definitive and final resolution, it has become generally accepted that a jurisdiction is typically best served by a non-judicial SRR for banks. However, it should be recognized that the best SRR remains merely a tool which requires a positive enabling environment, sound governance and well-versed and experienced actors to optimize the outcome. The courts should not have the power to stay a decision of the authorities to intervene a bank and no appeal should be available to an aggrieved party where a bank is intervened by the authorities, other than in respect of the question whether due process was followed or on points of law—consequently, aggrieved parties should not have the right to claim restitution of rights violated or removed, but only monetary compensation.

- ***It may be necessary to consider expanding the MFSA's resolution powers***. It would be useful for the MFSA also to have the power to apply prompt

corrective action (PCA), facilitate purchase-and-assumption transactions and the creation of bridge banks, which are generally created for systemic banks in order to buy time for a more effective resolution. The legislative framework should include explicit support for early intervention by the supervisor, in the event of prudential problems. The MFSA is in the process of finalizing a policy document on a PCA framework which explicitly acknowledges that bank failure is a possibility and incorporates an exit strategy for an insolvent bank or a failing bank which is not longer viable and cannot be rehabilitated. These principles constitute important elements for the development of a decision-tree on how to deal with a problem bank problem situation.

- ***Seemingly, deposits currently rank equally with general creditors in the event of liquidation***. Consideration should be given to providing insured deposits with a preference over general creditors' interests. In addition to improving the protection afforded insured depositors' interests, insured deposit preference ensures that the "no creditor worse off" principle does not undermine insured depositors' interests, as creditors would not have grounds to object to "good" assets becoming the subject of a purchase and assumption transaction on the basis that it would result in them being worse off than in a liquidation.

- ***Living wills and resolution and recovery plans***. The Maltese authorities should engage with the systemically important banks with a view to the banks developing living wills along with resolution and recovery plans, to ensure the maintenance of financial stability irrespective of the ultimate fate of a particular bank.

24. The EC intends to publish imminently a directive on establishing a framework for the recovery and resolution of credit institutions and investment firms. Accordingly, it would be advisable for the Maltese authorities to await this publication prior to undertaking any of the suggested amendments.

25. The MFSA should ensure that its personnel are properly prepared and ready to deal with a problem situation. To this end, training should be developed and presented on applying the resolution framework.

Deposit Protection Arrangements

26. The target and actual size of the Deposit Compensation Scheme (DCS) fund is unsatisfactory. The target size of the DCS is 0.77 percent of eligible deposits, constituted of an initial contribution of 0.1 percent, to be paid over to the DCS, and a reserve of 0.67 percent, to be held and maintained by the credit institution (and pledged to the DCS) until called for by the DCS. Accordingly, the DCS is a hybrid scheme, being composed partly of ex ante elements and partly an ex post elements. We strongly caution against a scheme composed wholly or partly of ex post elements, in view of the pro-cyclical implications thereof—the remaining banks are forced to contribute to pay depositors of a failed bank during what is probably a time of financial distress for them as well. In terms of the official published policy, the primary backstop for the DCS is the private sector. The CBM noted in its latest Financial Stability Report that the failure of a large financial

institution or a few modest-sized institutions would tax the DCS's ability to meet its financial obligations. Legislation should enable the DCS funds to be used for the purpose of a purchase and assumption transaction, but nor for open bank assistance. It is recommended that the authorities give due recognition to the small economy with a large financial sector and idiosyncratic features, and the consequent potentially high risks to financial stability, and err on the conservative side by imposing buffers above the EU proposed minima. As a precautionary measure for emergency purposes, the authorities should put in place backstopping financing arrangements and facilities in relation to the DCS' fund.

ANNEX V. MALTA: RISK ASSESSMENT MATRIX[1]

Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next 1-3 Years and Channel of Vulnerability (high, medium, or low)	**Expected Impact if Threat is Realized** (high, medium, or low)
1. Spillovers from the intensifying euro area crisis	**Medium** • Malta's high degree of openness exposes the country to external shocks.	**High** • A euro area downturn would affect Malta via lower exports and tourism, and potentially affect fiscal consolidation efforts. • The concurrent decline in growth of Malta's major trading partners by half standard deviation could lower Malta's growth by 0.5-0.7 percent in 2012.
2. Financial contagion from the intensification of the euro area debt crisis	**Medium** • Malta's large financial sector (above 8 times GPD) and foreign ownership heighten contagion risks.	**High** • Financial contagion could shake the confidence in the entire banking sector. • A massive retrenchment of European banks could disproportionally affect Malta
3. Inflationary pressure	**Medium** • Malta's high dependency on oil-imports and cost-inefficient electrical production result in high pass-through of energy price shocks into inflation. • Despite wage moderation in light of the crisis, wages are set to increase.	**Medium** • Wages and prices increase could erode recent gains in competitiveness. • A rise in interest rates (by the ECB) would increase the costs of borrowings and debt repayments, and potentially dampen new investments.
4. Significant declines in real estate prices	**Low** • Real estate prices declined during the crisis, but have stabilized as of late. • However, the real estate hangover in the banking sector remains significant and property-related NPLS are rising.	**Medium** • The deterioration in asset quality would require further increase in loan-loss provisioning and bank capitalization. This could restrain bank profitability and lending going forward.
5. Delayed structural reforms	**Low** • Longer-term policy challenges remain pressing, including those related to population ageing, labor force participation and energy policy. • However, intensified political uncertainty could put structural reforms on hold.	**Medium** • The delayed implementation of required structural reforms would have negative impacts on longer-term fiscal sustainability, competitiveness and medium-term growth.

[1] Prepared by Piyaporn Sodsriwiboon (EUR).

INTERNATIONAL MONETARY FUND

MALTA

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

March 6, 2012

Prepared By European Department

CONTENTS

ANNEX I. MALTA—FUND RELATIONS

(As of December 31, 2011)

Membership Status
Joined: September 11, 1968; Article VIII

General Resources Account

	SDR Million	Percent Quota
Quota	102.00	100.00
Fund holdings of currency	81.18	79.59
Reserve Tranche Position	20.82	20.41

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocation	95.40	100.00
Holdings	95.85	100.47

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				
	2012	2013	2014	2015	2016
Principal	...	...	...	...	...
Charges/Interest	0.01	0.01	0.01	0.01	0.01
Total	0.01	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.

Article IV Consultation
Malta is on the standard 12-month consultation cycle. The previous consultation discussions took place during November 11–22, 2010, and the staff report (Country Report No.11/29, 01/28/11) was discussed on January 28, 2011.

Technical Assistance

Date	Department	Subject
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

ANNEX II. MALTA—STATISTICAL INFORMATION

(As of February 1, 2012)

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[1]. Most macroeconomic statistics can now be accessed through Eurostat. The country has been a participant in the GDDS since September 11, 2000, with the metadata posted on the IMF's Dissemination Standards Bulletin Board.

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

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

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

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

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

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

Malta: Table of Common Indicators Required for Surveillance

(As of Feb 6, 2012)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo Items:	
						Data Quality – Methodological soundness[7]	Data Quality – Accuracy and reliability[8]
Exchange Rates	Current	Current	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Dec 2011	Jan 2012	M	M	M		
Central Bank Balance Sheet	Dec 2011	Jan 2012	M	M	M	…	…
Consolidated Balance Sheet of the Banking System	Dec 2011	Jan 2012	M	M	Q	…	…
Interest Rates[2]	Dec 2011	Jan 2012	M	M	M		
Consumer Price Index	Dec 2011	Jan 2012	M	M	M	O, LO, O, O	O, O, LO, LO, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2011:Q3	Jan 2012	Q	Q	Q	O, LO, O, LO	O, O, O, LO, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Nov 2011	Dec 2011	M	M	M		
Stocks of General Government and General Government-Guaranteed Debt[5]	2011:Q3	Jan 2012	Q	Q	Q		
External Current Account Balance	2011:Q3	Dec 2011	Q	Q	Q	O, LO, O, O	LO, O, O, O, LNO
Exports and Imports of Goods and Services	Nov 2011	Jan 2012	Q	Q	Q		
GDP/GNP	2011:Q3	Dec 2011	Q	Q	Q	O, LNO, O, LO	LO, O, LO, LO, LO
Gross External Debt	2011:Q3	Dec 2011	Q	Q	Q		
International Investment Position[6]	2010:Q4	Jul 2011	Q	A	A		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[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 a vis nonresidents.

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

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

[9] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment, and revision studies

ANNEX III. MALTA—PUBLIC SECTOR DEBT SUSTAINABILITY ANALYSIS

General government debt has been on an increasing path, rising from 62 percent of GDP in 2007 to 69 percent of GDP in 2010 as the fiscal position has deteriorated. Under the baseline scenario, the debt-to-GDP ratio is expected to peak at 71.5 percent in 2012. In the medium term, expected primary surpluses are expected to put the debt ratio on a downward path reaching 62 percent by 2017.

A significant amount of contingent liabilities for the Maltese government, such a government debt guarantees emanating from the operation of public corporations, constitute additional risks. Government guaranteed debt amounted to 16.9 percent of GDP in 2011 Q3, a 2 percentage point increase from 2009, 60 percent of which relates to Enemalta debt. [1]

In order to assess the sustainability of debt a number of adverse shocks are considered.

- A permanent growth shock of ½ standard deviation, which brings growth permanently down for the whole forecast period, is expected to put debt on an increasing path reaching 72 percent by 2017.
- A primary balance shock of ½ standard deviation would still set debt on a sustainable path, reaching 67 percent of GDP by 2017.
- Given the magnitude of contingent liabilities and their importance in debt dynamics, a one-time shock of 10 percent of GDP has been considered. This would capture the case that some contingent liabilities would be called and would be recorded on-balance sheet. Given that this is a large but temporary shock, the debt–to-GDP ratio increases to 81 percent in 2013 (when the shock takes place) and then declines to 72 percent by 2017.

The structure of public debt (Figure 2) is predominantly in the form of long-term securities excluding financial derivatives and held by resident credit institutions and households.

[1] According to ESA95, as long as the guarantee is not called (in the event of a default by a public corporation), it is a contingent liability, recorded off-balance sheet.

Table 1. Malta: Public Sector Debt Sustainability Framework, 2007-2017

(Percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Debt-stabilizing primary balance 9/
Baseline: Public sector debt 1/	62.3	62.5	68.0	69.1	70.7	**71.5**	**71.0**	**69.6**	**67.6**	**65.0**	**61.9**	**0.0**
Of which: Foreign-currency denominated	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...
Change in public sector debt	-2.0	0.2	5.6	1.0	1.7	0.8	-0.5	-1.4	-2.0	-2.6	-3.0	...
Identified debt-creating flows (4+7+12)	-2.6	0.5	3.7	-0.2	0.2	0.5	-0.5	-1.4	-2.0	-2.6	-3.0	...
Primary deficit	-1.0	1.4	0.6	0.6	-0.2	-0.6	-1.0	-1.6	-2.0	-2.5	-3.1	...
Revenue and grants	40.5	39.5	39.7	39.3	40.1	40.8	40.3	39.8	39.8	39.8	39.8	...
Primary (noninterest) expenditure	39.5	40.9	40.3	39.9	39.8	40.2	39.4	38.2	37.8	37.3	36.7	...
Automatic debt dynamics 2/	-1.1	-0.9	3.2	-0.7	0.5	1.1	0.5	0.2	0.0	-0.1	0.1	...
Contribution from interest rate/growth differential 3/	-1.1	-0.9	3.2	-0.7	0.5	1.1	0.5	0.2	0.0	-0.1	0.1	...
Of which: Contribution from real interest rate	1.4	1.7	1.5	1.1	1.8	1.8	1.7	1.5	1.4	1.3	1.4	...
Of which: Contribution from real GDP growth	-2.6	-2.5	1.6	-1.9	-1.3	-0.7	-1.3	-1.4	-1.5	-1.4	-1.4	...
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	...
Other identified debt-creating flows	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...
Privatization receipts (negative)	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...
Residual, including asset changes (2-3) 5/	0.6	-0.4	1.8	1.2	1.5	0.3	0.0	0.0	0.0	0.0	0.0	...
Public sector debt-to-revenue ratio 1/	153.8	158.0	171.2	175.5	176.5	175.4	176.0	174.9	169.8	163.3	155.6	...
Gross financing need 6/	5.4	6.2	7.3	6.7	7.5	8.2	10.1	9.1	6.1	6.8	5.9	...
Billions of U.S. dollars	0.4	0.5	0.6	0.5	0.7	0.7	0.9	0.8	0.6	0.7	0.6	...
Scenario with key variables at their historical averages 7/	...	...	...	...	...	**71.5**	**73.0**	**74.5**	**76.0**	**77.5**	**79.0**	**0.6**
Scenario with no policy change (constant primary balance) in 2012-2017	...	...	...	...	...	**71.5**	**71.4**	**70.9**	**70.3**	**69.6**	**69.0**	**0.1**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (percent)	4.3	4.3	-2.6	2.9	2.0	1.0	1.8	2.0	2.2	2.2	2.2	...
Average nominal interest rate on public debt (percent) 8/	5.6	5.5	5.0	4.7	4.9	4.8	5.0	5.1	5.1	5.1	5.3	...
Average real interest rate (nominal rate minus change in GDP deflator, percent)	2.5	3.0	2.4	1.8	2.7	2.6	2.6	2.3	2.2	2.2	2.4	...
Nominal appreciation (increase in US dollar value of local currency, percent)	11.8	-7.5	7.2	-4.7	4.9	...	...	...	...	...	...	...
Inflation rate (GDP deflator, percent)	3.1	2.6	2.7	2.9	2.2	2.3	2.4	2.8	2.8	2.9	2.9	...
Growth of real primary spending (deflated by GDP deflator, percent)	0.8	8.1	-4.1	1.9	1.7	1.8	-0.2	-0.9	1.0	0.9	0.7	...
Primary deficit	-1.0	1.4	0.6	0.6	-0.2	-0.6	-1.0	-1.6	-2.0	-2.5	-3.1	...

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

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

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

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

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

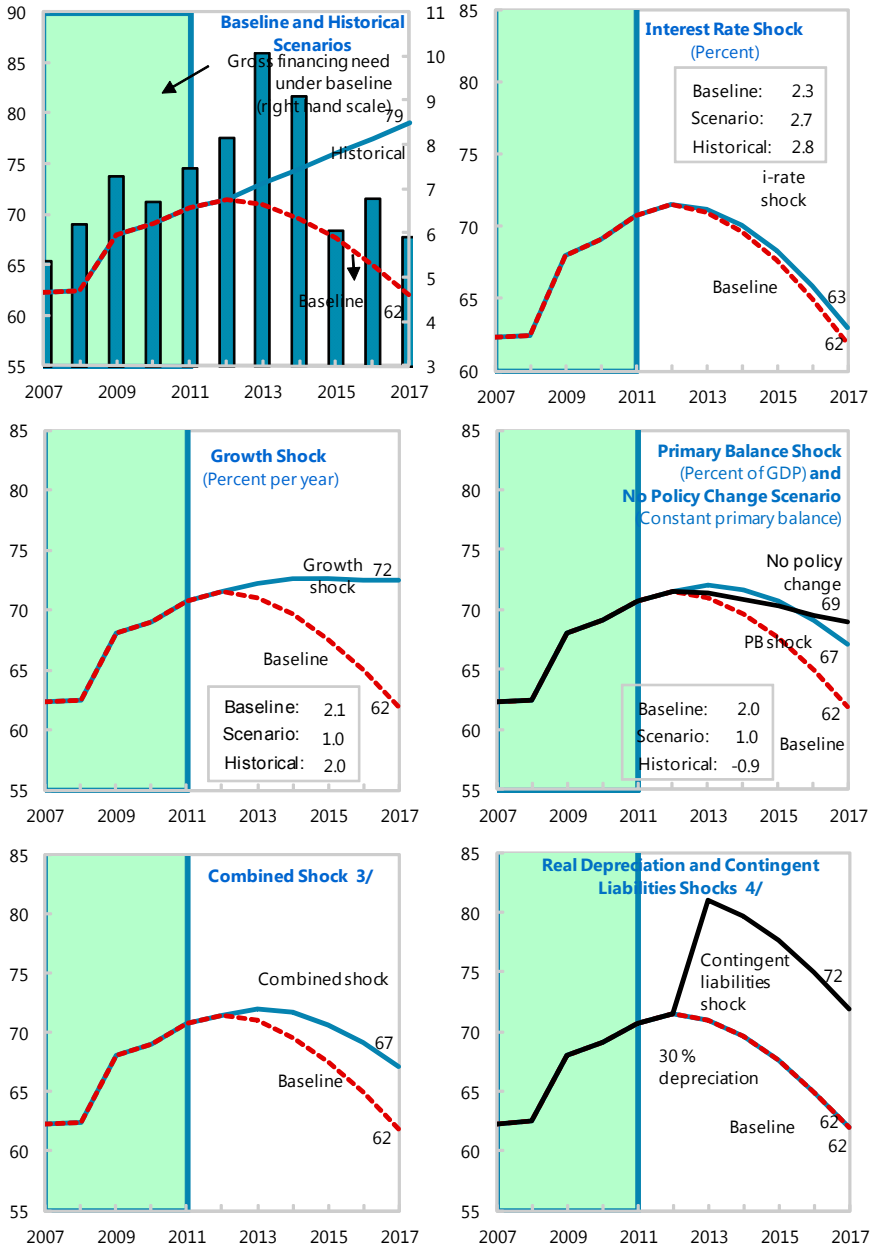
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

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

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

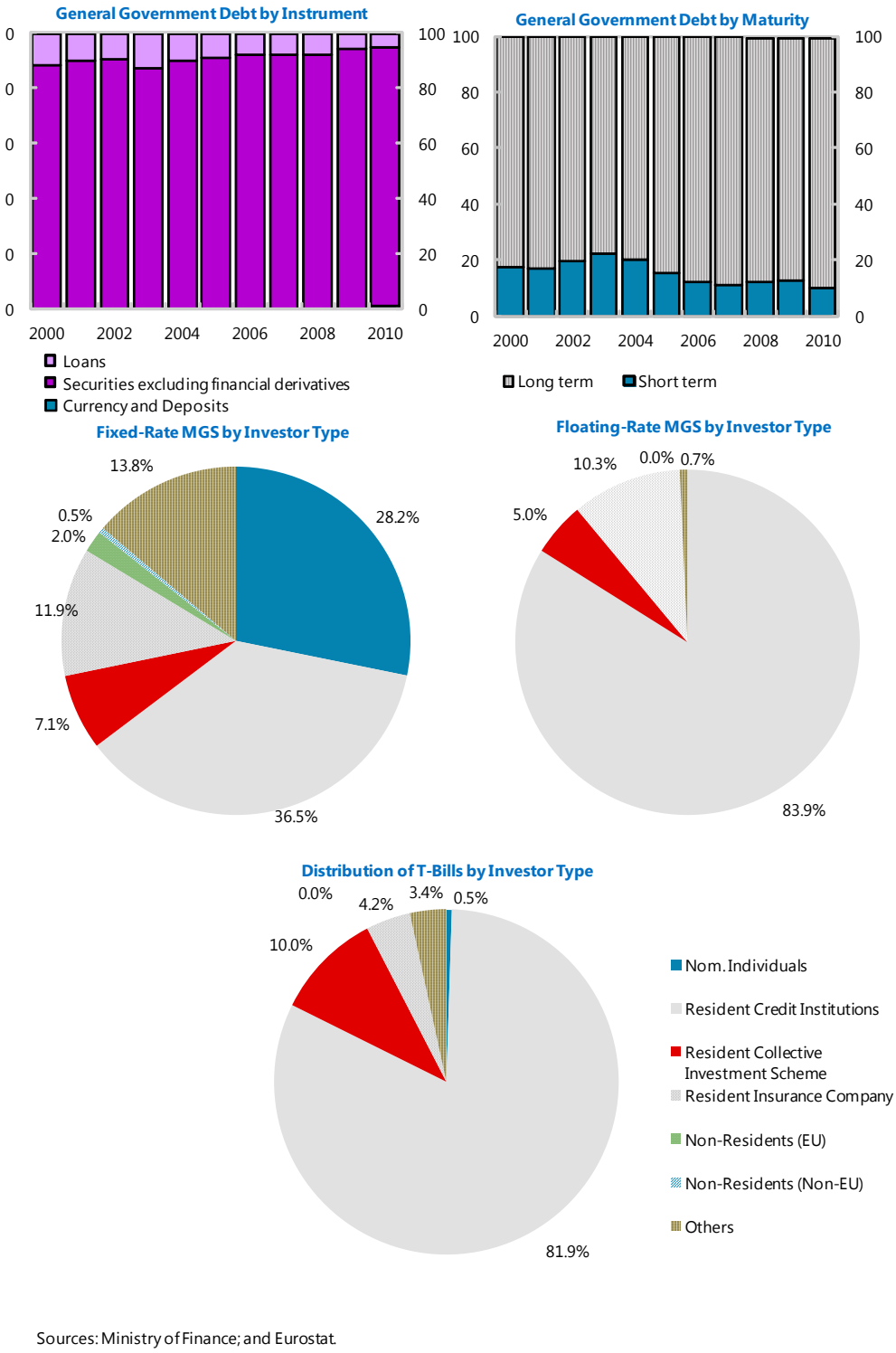
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

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



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

Figure 2. Malta: The Structure of Public Debt



Sources: Ministry of Finance; and Eurostat.

ANNEX IV. MALTA—EXTERNAL DEBT SUSTAINABILITY ANALYSIS

Malta's gross external debt is very large and rising. However, Malta's ample external assets appear to comfortably cover its external liabilities. The external asset accumulation is likely to continue over the medium-term, resulting in further increases in net external assets. Overall, Malta's external position is likely to remain robust and resistant to various types of shocks.

Malta's gross external debt is very large and rising, while the accumulation of external assets increased significantly. As of September 2011, the gross external debt position recorded €33.7 billion or 525.4 percent of GDP, up from €29.8 billion at end-2009. The gross external debt is mostly originated from other monetary and financial institutions (OMFIs) 86.5 percent of total, mostly short-term non-resident deposits, and to lesser extent short-term and long-term loans. On the other hand, the net asset position doubled from €5 billion at end-2009 to about €10.5 billion or about 164 percent of GDP at end-September 2011. The financial transactions of OMFIs accounted for most of the changes. The Maltese OMFIs held net liabilities through short-term deposits and loans; at the same time, possessed substantial foreign assets through long-term loans and securities. It is important to note that this investment profile may, however, expose Malta to the risk of maturity mismatch, especially in the event of large short-term redemptions that would require large-scale asset liquidation.

A baseline scenario projects that the net external asset position would continue to increase throughout the medium-term. The external debt projections reflect planned external financing needs[1] and the balance of payment developments, particularly the underlying financial transactions—foreign direct investment, portfolio and other investment. The continued narrowing in current account deficit is expected to contribute to stabilizing Malta's external debt, while increasing the net asset position. By 2017, net external assets reprojected to reach 165.4 percent of GDP.

The Maltese external position remains robust to various shocks. Alternative scenarios assume a permanent ¼ standard deviation shock applied to real interest rates, growth rate, and current account balance, as well as a one-time real depreciation of 30 percent in 2013.

- Interest rate and growth shocks are likely to have a positive impact on Malta's external position. Given the large net external assets, the impact of a permanent ¼ standard deviation increase of about 150 basis points increase in real interest rate would increase the net asset position

[1] For public sector external financing, the amortization schedule and interest payments are from the Article IV 2012 questionnaire response. For private sector external financing, total amortization due assumes 20 percent of medium- and long-term external obligations and interest payments are derived from the projected net current income, of which net interest income on debt and other investment.

by about 13 percent of GDP from the baseline. Likewise, a permanent ¼ standard deviation decline in growth rate from 2.1 percent to 1 percent would increase the net asset position by approximately 11 percent of GDP.

- An increase in the current account deficit would deteriorate the Maltese net asset position. An increase of non-interest current account deficit to 11.8 percent of GDP, from 9 percent of GDP in the baseline scenario, would lower the net asset position by 13 percent of GDP.
- The real depreciation shock would significantly increase the net asset position by nearly 80 percent of GDP.

Table 1. Gross and Net External Debt
(Billions of euros)

	2007	2008	2009	2010	2011-Sep
Gross External Debt 1/2/	27.8	32.1	29.8	32.9	33.7
General government	0.1	0.3	0.3	0.2	0.2
Short-term	0.0	0.1	0.1	0.0	0.0
Long-term	0.1	0.2	0.2	0.2	0.2
Monetary authorities	0.0	0.7	0.8	1.2	0.6
Short-term	0.0	0.7	0.8	1.2	0.6
Long-term	0.0	0.0	0.0	0.0	0.0
OMFIs 4/	25.2	28.5	25.8	28.1	29.2
Short-term	17.1	23.3	20.6	21.6	22.8
Loans	5.6	9.3	7.3	4.8	7.5
Currency and deposits	11.1	13.1	13.2	16.6	15.2
Long-term	8.1	5.2	5.2	6.5	6.3
Loans	7.9	5.0	5.1	6.5	6.3
Other sectors 5/	1.3	1.5	1.6	1.9	2.1
Short-term	0.6	0.8	0.8	1.0	1.0
Long-term	0.7	0.7	0.8	0.9	1.0
Direct investment: intercompany lending	1.1	1.1	1.3	1.5	1.7
Net external debt 2/3/	-4.7	-4.2	-5.2	-10.8	-10.5
General government	0.1	0.3	0.3	0.2	0.2
Short-term	0.0	0.1	0.1	0.0	0.0
Long-term	0.1	0.2	0.2	0.2	0.1
Monetary authorities	-2.5	-0.9	-0.7	-0.8	-1.8
Short-term	-1.5	0.2	0.6	1.0	0.2
Long-term	-1.0	-1.1	-1.2	-1.7	-2.0
OMFIs 4/	-2.1	-3.3	-4.0	-9.7	-8.5
Short-term	13.5	17.1	14.1	12.0	11.4
Loans	4.7	7.8	6.0	3.7	7.1
Currency and deposits	8.3	8.5	8.2	8.4	4.3
Long-term	-15.5	-20.3	-18.1	-21.7	-19.8
Bonds and notes	-9.2	-7.7	-9.5	-12.1	-11.9
Loans	-6.6	-12.7	-8.6	-9.6	-7.9
Other sectors 5/	-0.6	-0.7	-1.0	-0.8	-0.7
Short-term	-0.5	-0.6	-0.8	-0.7	-0.7
Long-term	-0.1	-0.1	-0.2	-0.1	0.0
Direct investment: intercompany lending	0.3	0.3	0.2	0.2	0.2

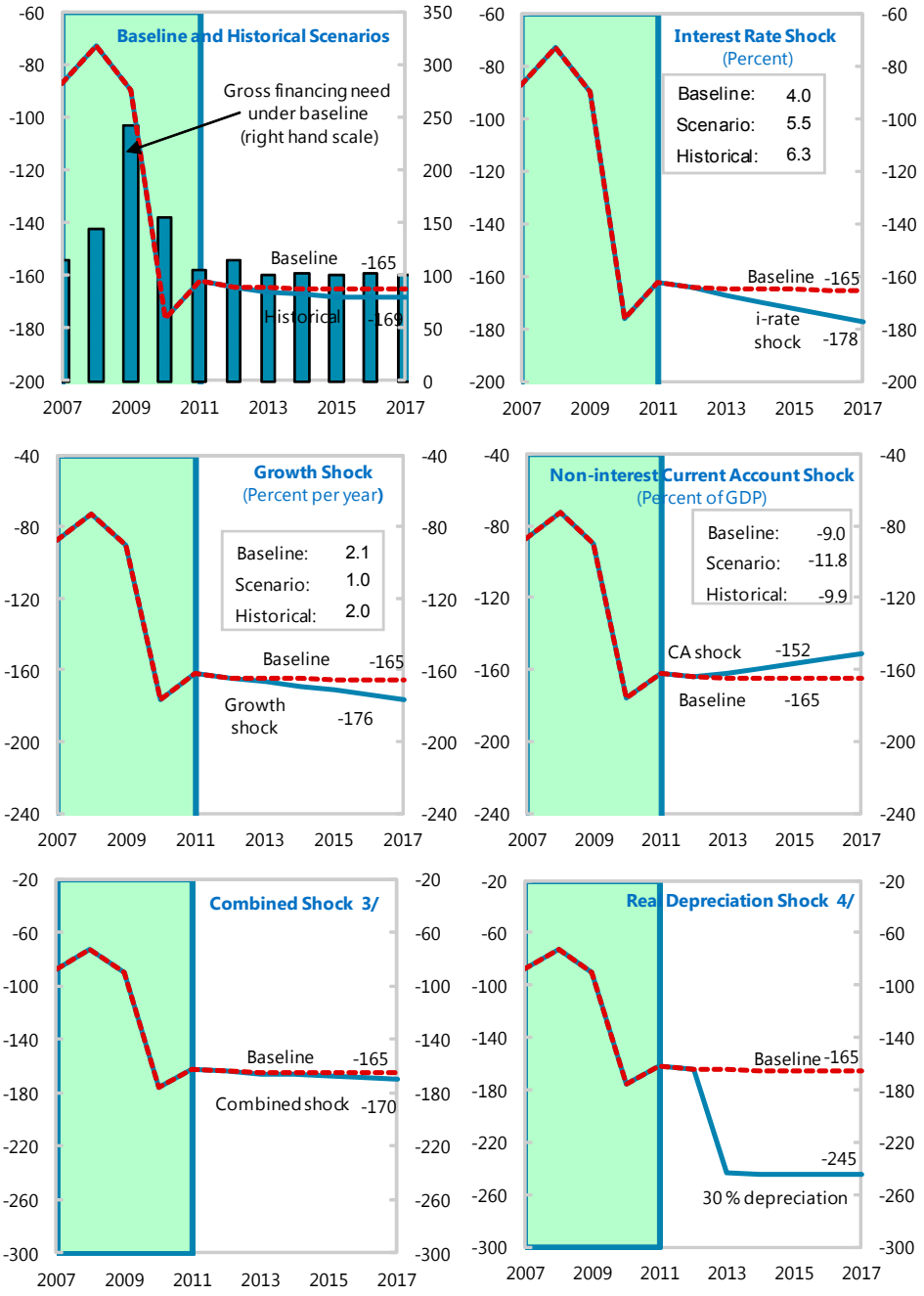
Source: Central Bank of Malta.
1/ The gross external debt illustrates only a fraction of the overall International Investment Position of Malta with countries abroad. Gross external debt data do not comprise Malta's claims vis-à-vis foreign countries which act as a counter balance to Malta's gross debts. Detailed data according to the International Investment Position can be found in the website and the Quarterly Review of the Central Bank of Malta.
2/ Data are provisional.
3/ A negative figure denotes a net asset position.
4/ The debt of the OMFIs is fully backed by foreign assets.
5/ Comprising the non-monetary financial institutions, insurance companies, non-financial corporations and NPISH.

Table 2. Malta: External Debt Sustainability Framework, 2007-2017
(Percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Debt-stabilizing non-interest current account 6/
Baseline: External debt	-87.2	-73.0	-89.9	-176.2	-162.3	**-164.3**	**-164.9**	**-165.1**	**-165.2**	**-165.3**	**-165.4**	**-1.1**
Change in external debt	3.8	14.2	-16.9	-86.3	13.8	-2.0	-0.6	-0.1	-0.1	-0.1	-0.2	...
Identified external debt-creating flows (4+8+9)	8.7	13.3	-2.0	-3.1	16.8	3.1	4.1	4.0	4.1	3.9	3.6	...
Current account deficit, excluding interest payments	12.0	11.9	15.6	10.9	9.7	9.4	9.2	9.1	8.9	8.8	8.7	...
Deficit in balance of goods and services	1.1	1.7	0.5	-3.3	-4.7	-4.7	-4.8	-4.8	-4.8	-4.8	-4.9	...
Exports	95.3	94.1	84.2	95.0	96.0	95.0	95.0	96.7	98.4	99.9	101.8	...
Imports	96.4	95.9	84.7	91.7	91.3	90.3	90.2	91.9	93.6	95.1	97.0	...
Net non-debt creating capital inflows (negative)	-10.2	-2.8	-5.6	-8.1	-1.2	-1.4	-1.6	-1.9	-2.1	-2.3	-2.5	...
Automatic debt dynamics 1/	6.9	4.2	-11.9	-6.0	8.3	-4.9	-3.5	-3.2	-2.8	-2.6	-2.5	...
Contribution from nominal interest rate	-6.7	-6.6	-7.8	-6.7	-6.6	-6.5	-6.4	-6.3	-6.2	-6.1	-6.0	...
Contribution from real GDP growth	3.3	3.3	-2.0	2.6	3.2	1.6	2.9	3.1	3.5	3.5	3.5	...
Contribution from price and exchange rate changes 2/	10.3	7.5	-2.1	-1.8	11.7	...	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 3/	-4.9	1.0	-15.0	-83.1	-3.0	-5.1	-4.7	-4.1	-4.2	-4.0	-3.8	...
External debt-to-exports ratio (percent)	-91.5	-77.5	-106.8	-185.5	-169.1	-172.9	-173.7	-170.7	-167.9	-165.4	-162.4	...
Gross external financing need (in billions of US dollars) 4/	8.5	12.2	19.6	12.7	9.4	9.7	8.9	9.3	9.7	10.2	10.6	...
Percent of GDP	113.3	143.0	242.1	155.0	105.1	113.9	100.6	100.7	100.5	100.8	100.4	...
Scenario with key variables at their historical averages 5/	...	...	...	...	...	**-164.3**	**-166.2**	**-167.4**	**-168.2**	**-168.6**	**-168.6**	**-3.6**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (percent)	4.3	4.3	-2.6	2.9	2.0	1.0	1.8	2.0	2.2	2.2	2.2	...
GDP deflator in US dollars (change, percent)	12.8	9.4	-2.9	-2.0	7.1	-5.7	2.3	2.4	2.3	2.4	2.4	...
Nominal external interest rate (percent)	8.6	8.7	10.1	7.6	4.1	3.8	4.1	4.0	4.0	3.9	3.8	...
Growth of exports (U.S. dollar terms, percent)	22.7	12.7	-15.3	13.7	10.4	-5.8	4.1	6.4	6.4	6.3	6.7	...
Growth of imports (U.S. dollar terms, percent)	15.9	13.4	-16.4	9.2	8.8	-5.9	4.1	6.5	6.5	6.4	6.8	...
Current account balance, excluding interest payments	-12.0	-11.9	-15.6	-10.9	-9.7	-9.4	-9.2	-9.1	-8.9	-8.8	-8.7	...
Net non-debt creating capital inflows	10.2	2.8	5.6	8.1	1.2	1.4	1.6	1.9	2.1	2.3	2.5	...

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

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



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

INTERNATIONAL MONETARY FUND
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EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 12/43
FOR IMMEDIATE RELEASE
May 7, 2012

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

IMF Executive Board Concludes 2012 Article IV Consultation with Malta

On March 21, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Malta on a lapse-of-time basis[2].

Background

After a strong recovery in 2010, the economy has continued to perform well amidst considerable turbulence in the euro area, supported by robust consumption and services exports. Output has surpassed its pre-recession level and labor market indicators have improved. The trade balance, which turned into surplus in 2010, improved further in 2011. Recent gains in competitiveness have been underpinned by wage moderation, a narrowing inflation differential vis-à-vis trading partners, and continued diversification into high-value added activities.

Malta has taken effective action to correct its excessive fiscal deficit, shoring up confidence in the country's public finances. The structural fiscal adjustment was one of the largest among advanced countries. The general government deficit is estimated to have narrowed to 3 percent of GDP and the primary balance turned into surplus for the first time since 2007. Following the announcement of the 2012 budget and additional expenditure measures in January, the deficit is expected to fall further this year. Nonetheless, the composition of adjustment remains suboptimal, relying excessively on one-off and revenue measures.

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[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.

Despite the recent rating downgrades, sovereign bond spreads have remained contained as government debt is predominantly held domestically. In turn, the sensitivity of the Maltese banking sector to sovereign risk events in Europe is low given very low direct exposures to vulnerable countries, as well as domestic banks' reliance on a traditional retail deposit-based banking model. Compared to euro area peers, Maltese banks continue to outperform in terms of profits and capital adequacy.

While spillovers from the euro area crisis have remained contained to date, Malta's large financial sector (above eight times GDP) and highly open economy heighten contagion and financial stability risks. The fragile macroeconomic environment and sustained market volatility are expected to dampen export growth in 2012. Domestic sources of growth may not be sufficient to offset the drop in external demand, given headwinds from a soft real estate market, deteriorating confidence, and ongoing fiscal consolidation. At the same time, uncertainty in economic policy could adversely affect growth if investment decisions and structural reforms are put on hold. With the euro area expected to go into a mild recession in 2012, Malta's real GDP growth in 2012 will be relatively modest. Risks and uncertainty around this scenario are significant, reflecting the potential from large spillovers from the euro area crisis.

Executive Board Assessment

In concluding the 2012 Article IV consultation with Malta, Executive Directors endorsed the staff's appraisal, as follows:

The government's commitment to prudent macroeconomic policies has helped Malta weather the euro area crisis relatively well. But the fragile external environment has created new risks to growth and financial stability. The main policy challenge now is to maintain growth and employment, while building buffers against a highly uncertain international environment. Malta's resilience to date cannot be taken for granted. Contingency planning needs to move to the forefront of the policy agenda for the event that growth is substantially worse than expected or there is financial contagion from a potential intensification of the euro area crisis. At the same time, the authorities need to balance concerns over a slowing economy, which calls for accommodative policies, against increased risks that require more prudent economic management.

The government's commitment to return to fiscal balance over the medium-term remains essential. Further fiscal consolidation is required to ensure sustainable debt dynamics, thus reducing fiscal risks to manageable levels. The pace and composition of adjustment should be attuned to the economic cycle. Following a significant fiscal effort in 2011, a gradual deficit reduction path of structural annual adjustment of ½ percentage points of GDP, while letting automatic stabilizers operate in full, would be appropriate. This will help offset the headwinds facing the economy in the short-term, while achieving debt sustainability over the medium-term. The measures underpinning the fiscal effort beyond 2012 need to be specified for the consolidation to be credible.

Bold policy actions are necessary to reduce contingent liabilities and address Malta's long-run fiscal challenges. Better governance and restructuring of public corporations will help

staunch losses and limit subsidies. With a large projected increase in ageing-related expenditures, it is crucial to build broad public consensus for further pension and health care reform aimed at increasing the adequacy and sustainability of the current schemes.

Given the large external risks, it is important to strengthen the financial sector's resilience further. The financial sector has continued to perform strongly, but its sheer size and large foreign ownership represent a number of risks to financial stability and fiscal sustainability. These include concerns about too-big-to-save and the adequacy of backstopping resources in case of default or deposit run, the capacity to deal with the impact of a banking shock on the economy, as well as supervisory challenges. Improving the framework for financial crisis management and bank resolution and strengthening the deposit compensation scheme could help limit the impact of contagion. Ongoing efforts to strengthen financial buffers and tighten supervision relating to asset quality are welcome. Commendable progress has also been made to better align the regulatory and supervisory frameworks with international standards.

Financial stability will further benefit from establishing a formal framework for macro-prudential policy. Such a framework should define the tasks, powers, and instruments of the macro-prudential authority; establish clear lines of accountability; and ensure operational independence from political bodies and from the financial industry. It is crucial to improve systemic risk monitoring, particularly of spillover risks posed by international banks, and design contingency plans accordingly.

Longer-term policy challenges remain pressing**.** Challenges related to population ageing, labor force participation, education, and energy policy underscore the need to broaden the reforms so far, raise productivity growth, and further improve competitiveness. Reforms to secure these objectives include further diversifying the economy into high value-added activities, reducing the economy's dependence on energy imports, and strengthening female labor force participation and education attainment. These steps should be supported by a cautious settlement of wage negotiations to ensure better alignment of wage and productivity developments.

Malta: Selected Economic Indicators, 2007—12

	2007	2008	2009	2010	2011 Est.	2012 Proj.
Real economy (constant prices)			(Change, percent)			
Real GDP	4.3	4.3	-2.6	2.9	2.0	1.0
Domestic demand	1.0	3.1	-4.3	-2.0	-0.1	-0.3
CPI (harmonized, average)	0.7	4.7	1.8	2.0	2.4	2.0
Unemployment rate (percent)	6.5	6.1	6.9	6.9	6.4	6.6
Public finance			(General Government; percent of GDP)			
Overall balance	-2.4	-4.6	-3.7	-3.6	-3.0	-2.7
Primary balance	1.0	-1.4	-0.6	-0.6	0.2	0.6
Gross debt	62.3	62.5	68.0	69.1	70.7	71.5
Money and credit			(Change, percent)			
Broad money	11.5	-4.6	0.2	5.5	9.0	…
Credit to nonbank private sector 1/	9.4	13.6	7.6	3.2	4.2	…
Interest rates (year average)			(Percent)			
Interest rate for mortgage purposes	5.3	5.0	3.5	3.5	3.6	…
Ten-year government bond yield	4.7	4.8	4.5	4.2	4.5	…
Balance of payments			(Percent of GDP)			
Current account balance	-5.3	-5.3	-7.8	-4.2	-3.0	-2.9
Trade balance (goods and services)	-1.1	-1.7	-0.5	3.3	4.7	4.7
Fund position (as of January 31, 2012)						
Holdings of currency (percent of quota)	…	…	…	…	…	68.9
Holdings of SDRs (percent of allocation)	…	…	…	…	…	95.1
Quota (millions of SDRs)	…	…	…	…	…	102.0
Exchange rate						
Exchange rate regime			Joined EMU on January 1, 2008.			
Nominal effective rate (2000=100) 2/	111.4	113.9	112.5	108.0	107.14	…
Real effective rate, CPI-based (2000=100) 2/	112.2	116.3	116.5	112.4	111.77	…

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

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

2/ 2011 is an average of three quarters.