



MALTA

February 2017

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR MALTA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2016 Article IV consultation with Malta, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 17, 2017 consideration of the staff report that concluded the Article IV consultation with Malta.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 17, 2017, following discussions that ended on December 16, 2016, 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 February 2, 2017.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Malta.

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

Selected Issues

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**International Monetary Fund
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INTERNATIONAL MONETARY FUND



Press Release No. 17/55
FOR IMMEDIATE RELEASE
February 21, 2017

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

IMF Executive Board Concludes 2016 Article IV Consultation with Malta

On February 17, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Malta.

Malta is one of fastest-growing economies in Europe. Following an average growth of nearly 8 percent in 2014-15, output is estimated to have expanded by 4.1 percent in 2016, supported by strong domestic demand. Robust job creation drove unemployment to record lows, despite rising labor supply, while subdued wage pressures contributed to low inflation. The external position remains strong, with sizable exports of services keeping the current account in surplus. Owing to buoyant revenues and consolidation measures, the 2016 fiscal deficit narrowed to an estimated level of 0.7 percent of GDP, well below the budget target of 1.1 percent of GDP, while public debt declined further to about 60 percent of GDP.

Domestic banks remain well-capitalized and liquid, with profitability well above the levels seen in European peers. Banks' asset quality continues to improve, while measures have been taken to reduce legacy non-performing loans. Credit growth to the private sector was subdued as credit to the non-financial corporate sector contracted, but mortgage lending remained buoyant, resulting in higher household debt and further increase in banks' exposure to property-related loans. Residential property prices showed a positive momentum in the face of rising demand and sluggish supply response.

The outlook is favorable, though growth is set to moderate to 3.4 percent in 2017 and converge to its potential of about 3 percent over the medium term as the impetus from domestic demand is projected to weaken. As a result, the output gap is expected to close, while the current account surplus is set to increase modestly. Strong job creation is likely to continue, keeping unemployment low, while inflation is expected to pick up as import prices recover. Favorable macroeconomic conditions, the low interest rate environment, and persistent primary fiscal surpluses are expected to bring down public debt as a proportion of GDP in the coming years.

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.

(continued...)

Executive Board Assessment²

The executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for implementing sound macroeconomic policies, which have contributed to strong economic performance, robust job creation, low unemployment, and improved public finances. While noting that Malta's medium-term outlook remains strong, Directors agreed that as a small and open economy, policies ahead should continue to focus on further enhancing the economy's resilience to shocks and strengthening competitiveness. They welcomed the authorities' commitment to building fiscal buffers, preserving financial sector stability, and implementing structural reforms to address the remaining impediments in the labor market, boost productivity, and ensure inclusive growth.

Directors commended the authorities' medium-term fiscal consolidation plan, which strikes an appropriate balance between further lowering public debt and sustaining the growth momentum. To achieve the fiscal targets, they highlighted the need to enhance the efficiency of tax collection and contain the fast growing wage bill and spending on goods and services, including by building on the recommendations of the recent in-depth spending reviews. Directors agreed that further improving the financial health of SOEs and containing the long-term spending pressures would reduce fiscal risks.

Directors noted that the banking system is well capitalized and liquid, with profitability well above levels seen in peers. However, they observed that protracted low interest rates, weak credit growth, legacy corporate non-performing loans (NPLs), and an uncertain external environment pose challenges. In addition, banks' high and increasing exposure to the property market alongside persistent house price appreciation could also lead to imbalances. They encouraged the authorities to deploy targeted macro-prudential tools to enhance the resilience of banks and households to property market swings, close data gaps, and review the fiscal incentives related to the property market. While there has been progress in reducing non-financial corporate sector's legacy NPLs, Directors noted that a faster resolution of remaining distressed loans would help unlock resources for growth. They welcomed the authorities' plans in this area, including their intent to streamline the insolvency and bankruptcy frameworks. Directors underscored that maintaining a robust implementation of the AML/CFT framework in line with international standards would also help continue safeguarding the integrity of the financial system.

Directors concurred that the planned Malta Development Bank could support the economy by alleviating financing constraints faced by small and medium-sized enterprises and by fostering higher development investment. However, they underscored the need to ensure that the Development Bank's operations support the origination of new credit to viable firms, and encouraged the authorities to adopt well-designed origination rules. Directors also noted that a robust governance structure, prudent risk assessment, and adequate supervision will help mitigate contingent liability risks to public finances.

² At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

Directors highlighted that continued structural reform momentum is needed to support high and inclusive long-term growth. They called for sustained efforts to further increase female labor force participation and reduce skill mismatches in the face of changing labor market demand. Directors also underscored the need for further improvements in research and innovation and the efficiency of the judicial system.

Malta: Selected Economic Indicators, 2012-2017
(Year-on-year percent change, unless otherwise indicated)

	2012	2013	2014	2015	2016 Est.	2017 Proj.
Real economy (constant prices)	(Percent change year on year)					
Real GDP	2.7	4.5	8.4	7.4	4.1	3.4
Domestic demand	-0.2	2.7	3.0	12.8	5.5	3.6
CPI (harmonized, average)	3.2	1.0	0.8	1.2	0.9	1.5
Unemployment rate (percent)	6.3	6.4	5.8	5.4	4.8	4.9
Public finance	(General government, percent of GDP)					
Overall balance	-3.7	-2.6	-2.0	-1.3	-0.7	-0.6
Primary balance	-0.6	0.3	0.8	1.2	1.4	1.4
Gross debt	68.0	68.7	64.3	60.8	60.0	59.0
Money and credit	(Percent change year on year)					
Broad money	9.6	11.0	14.4	10.4	10.5	...
Credit to nonbank private sector 1/	-1.2	-0.1	3.8	0.6	1.1	...
Interest rates (year average)	(Percent)					
Interest rate for mortgage purposes	3.6	3.6	3.5	3.1	3.1	...
Ten-year government bond yield	4.1	3.4	2.6	1.6	1.1	...
Balance of payments	(Percent of GDP)					
Current account balance	1.7	3.1	9.6	5.2	4.4	4.4
Trade balance (goods and services)	4.9	7.1	12.6	7.9	7.1	7.0
Exchange rate	Joined EMU on January 1, 2008					
Exchange rate regime						
Nominal effective rate (2005=100)	96.8	99.5	100.1	95.1	97.2	...
Real effective rate, CPI-based (2005=100)	96.5	98.1	97.9	98.0	98.3	...

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

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



MALTA

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

February 2, 2017

KEY ISSUES

Context: Malta has recorded robust growth in recent years. Vibrant domestic demand, favorable external conditions, and further progress with structural reforms supported solid job creation, particularly in services, and reduced unemployment to record-lows. This strong performance, together with fiscal discipline, contributed to continued deficit and public debt reduction while solid profitability and adequate capitalization have kept the banking system stable and resilient.

Outlook and risks: The outlook remains favorable, with medium-term growth estimated at about 3 percent. However, downside risks predominate, reflecting mainly a weaker external environment and rising anti-globalization sentiment. Uncertainties surrounding the Brexit negotiations could weigh on economic activity through direct and indirect exposures, while EU-wide corporate tax reform may impact the economy unfavorably. While current data do not point to a misalignment of housing prices, persistent strength in the property market may lead to imbalances, and—with high exposure of banks to this market—amplify financial stability risks.

Challenges and policy priorities: Malta's key challenges are to close the income gap with the euro area, ensure equitable distribution of growth dividends, and enhance the economy's resilience to adverse shocks. Policies should, therefore, focus on building fiscal buffers, safeguarding financial sector stability, and advancing structural reforms to promote inclusiveness and competitiveness. Key priorities are:

- **Fiscal policy.** Proceed with consolidation to reduce public debt ratio further and build buffers. The adjustment strategy should rely on containing current spending growth, particularly the wage bill and goods and services, and efforts to enhance tax collection. Long-term spending pressures and risks emanating from fragile state-owned enterprises (SOEs) need to be addressed.
- **Macro-financial policies.** Further reduce legacy non-performing loans (NPLs) and increase loan-loss provisions. Close data gaps, adopt targeted macro-prudential measures to enhance the resilience of banks and households to possible property market swings, and ensure that fiscal measures related to the housing market do not amplify the cycle. Increase access to finance to small and medium-sized enterprises (SMEs) and reduce their vulnerabilities to shocks through a faster loan restructuring.
- **Structural reforms.** Increase female labor force participation further and reduce skill mismatches through active labor market policies and expansion of technical and vocational training. Enhance SMEs' innovation activities, including through greater public sector support and provision of nonbank financing options. Improve the efficiency of the judicial system, and streamline the corporate insolvency framework.

Approved By
Mahmood Pradhan
(EUR) and Mary
Goodman (SPR)

Discussions were held in Valletta during December 6–16, 2016. The team comprised Mr. Klein (head), Ms. Budina, Mr. Ebeke, and Mr. Na (All EUR). Mr. Grinberg, Mr. Cai, Ms. Bezerra de Menezes (All EUR), and Mr. Ugazio (STA) assisted from headquarters. Mr. Bassanetti (OED) participated in the discussions. The team met with Finance Minister Scicluna, Central Bank of Malta Governor Vella, Central Bank of Malta Deputy Governors Mifsud and Demarco, Malta Financial Services Authority Chairman Bannister, and other senior officials, representatives of labor and business organizations, and financial institutions.

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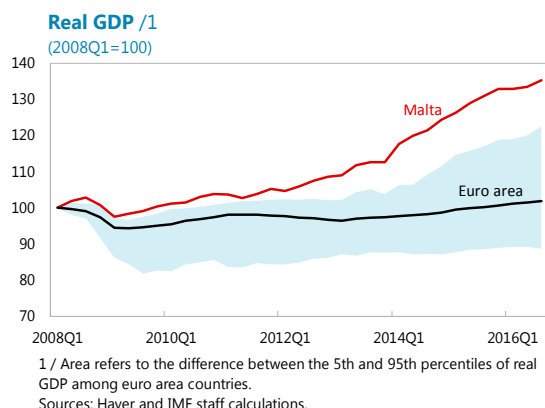
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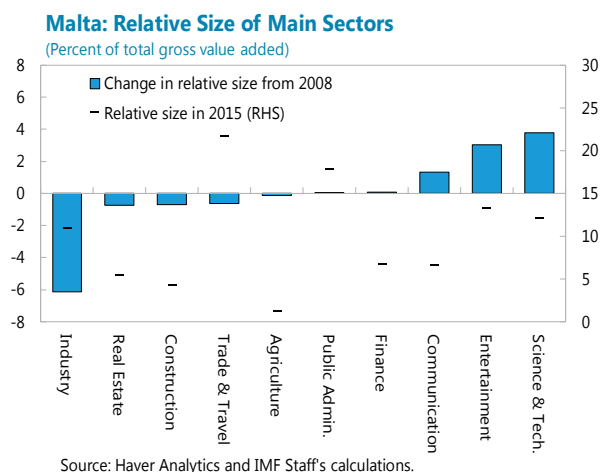
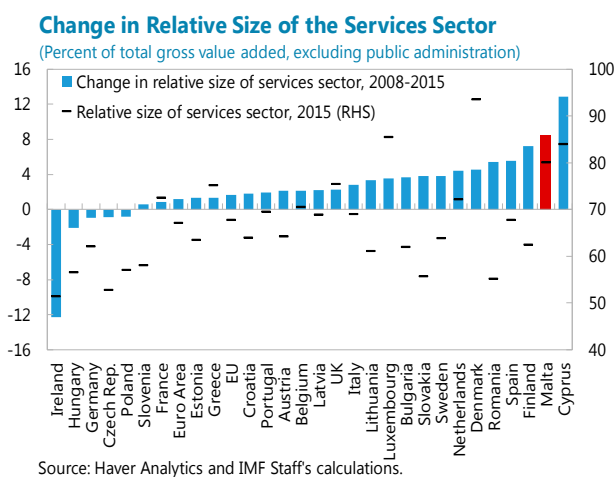
CONTEXT

1. Malta exhibited remarkable macroeconomic resilience to global shocks. Its

diversified economic structure, flexible labor market, and reliance on domestic funding, helped the economy weather the global financial crisis well, and following a short-lived recession in 2009, growth rebounded strongly, averaging 4¾ percent over 2010-15. Robust growth, accompanied by a continuous decline in unemployment, was also supported by a stable banking system, favorable external conditions, and sound policies, which advanced structural reforms and strengthened public finances. Recognizing the improved economic fundamentals, Standard & Poor's upgraded Malta's sovereign rating to A- from BBB+ in October 2016.

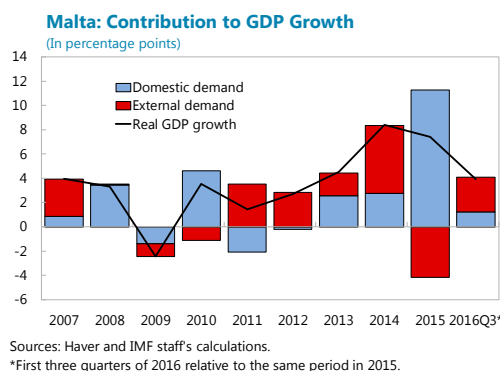


2. The strong economic performance took place in the context of a continued structural rebalancing. The economy has experienced a prominent increase in the relative importance of the services sector in recent years, reflecting the emergence of new niche industries and expansion of more traditional sectors. The structural shift has been job-rich and attracted foreign workers, predominantly from the EU. As the growing sectors were largely export-oriented, this rebalancing also contributed to a surge in services exports, improvement in the current account balance, and a sizable increase in the net international investment position (NIIP).



RECENT DEVELOPMENTS AND POLICY PRIORITIES

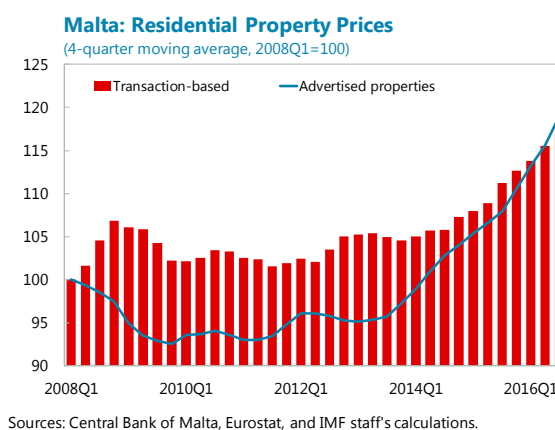
3. Economic performance remained robust. Real GDP expanded by 3.9 percent y/y in the first three quarters of 2016 following exceptional growth in 2014-15.¹ Private consumption continued to benefit from favorable consumer sentiment, easy monetary conditions, and higher employment and incomes (Figure 1). Investment contracted after surging in 2015 due to large-scale infrastructure projects and developments in the aviation industry and, with the related decline in imports, the contribution of net exports to growth turned positive.² High frequency indicators for 2016q4 point to a continued solid performance (Figure 2).



4. Labor market conditions continued to improve while inflation remained low. Solid employment growth brought the unemployment rate to a record-low level of 4.8 percent in 2016q3 from 5.2 percent at end-2015. HICP inflation eased to 0.8 percent y/y in 2016q4 from 1.4 percent in 2015q4, reflecting a moderation in the growth of non-energy goods and services' prices. Expanding labor supply, resulting from higher labor participation and influx of foreign workers, kept wage pressures subdued and thus also contributed to the low inflation.

5. Rising demand has stimulated the property market in the face of limited supply.

Residential property prices have showed a positive momentum, surpassing their pre-crisis peaks. The transaction-based price index increased by a cumulative 20 percent since 2011, while the advertised property price index increased in 2016q3 by about 30 percent in this period. Residential property prices are being boosted by buoyant mortgage lending, low interest rates, rising disposable incomes, and influx of foreign workers. Government's measures such as the Individual Investor Program (IIP), reduced tax rate on rental income, and the first time buyers' stamp duty relief may



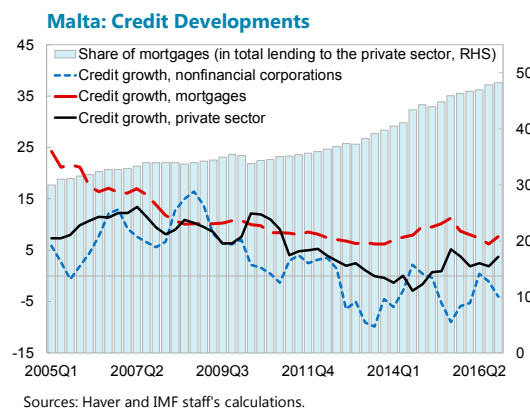
¹ Malta's real GDP level was recently revised by about 5 percent due to incorporation of the 2014 Structural Business Statistics Survey, which indicates that the contribution of online gaming was higher than previously estimated.

² Staff expect an increase in imports and investment in 2016q4 due to a sizable transaction in the aviation industry. Consequently, the 2016 contribution of net exports to growth is projected to remain slightly negative.

have also stimulated demand.³ At the same time, construction activity—although improving—remained subdued, reflecting in part financing constraints and legacy NPLs.

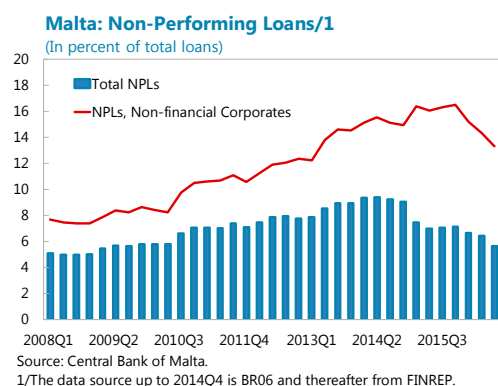
6. Credit growth remained weak and banks' exposure to mortgages increased further.

Mortgage lending continued to grow strongly at about 7½ percent y/y in 2016. However, overall credit growth to the private sector remained subdued as credit to non-financial corporate (NFC) sector continued to contract. The latter reflects tight lending conditions faced by SMEs as well as demand factors, including the deleveraging of highly indebted firms and the ongoing structural shift to less capital intensive services. With buoyant mortgage lending and further contraction of corporate credit, banks' exposure to mortgages continued to increase.

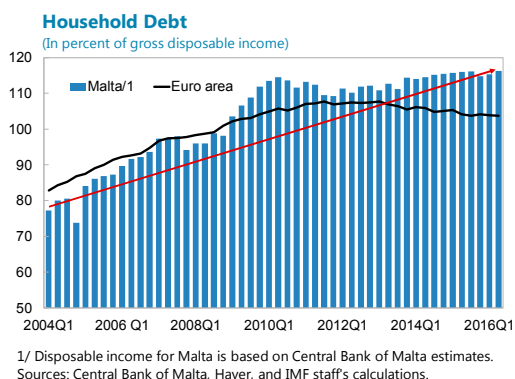


7. Pockets of vulnerabilities, including from legacy NPLs and rising household debt, persist.

- **The NFC sector's** debt remains high at about 140 percent of GDP, though nearly half of it comprises inter-company loans, which are more stable and less prone to sudden reversals. Average profitability remained sound, yet SMEs in some segments are financially weak and vulnerable to shocks (see accompanying Selected Issues Paper (SIP)). The share of NPLs across the corporate sector declined recently, but remains elevated at about 13 percent, largely reflecting distressed legacy loans in construction and real estate activities.



- **Households'** financial wealth is high (200 percent of GDP in 2015) and their default rate remained below 5 percent. However, the solid mortgage lending in recent years pushed household debt up to 116 percent of gross disposable income in 2016Q2 (about 67 percent of GDP) from about 100 percent in the pre-crisis period. Moreover, household debt is concentrated in a relatively small group of home



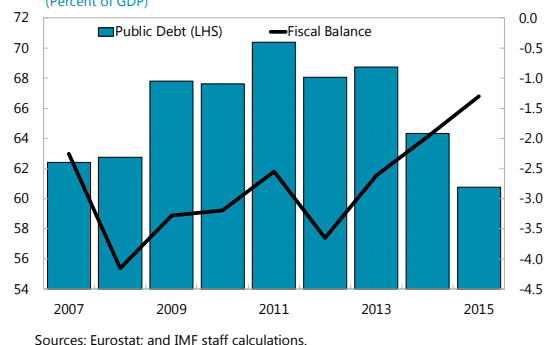
³ The IIP offers individuals a Maltese citizenship. Requirements include residency and a minimum investment in property and financial instruments.

owners, who—given the prevalence of variable rate mortgages—are vulnerable to interest rate movements (see accompanying SIP).

8. The 2015 fiscal deficit came in below the target of 1.6 percent of GDP and public debt declined further.

The 2015 fiscal deficit declined by 0.7 percentage points of GDP to 1.3 percent of GDP, which along with favorable debt dynamics lowered public debt to 60.8 percent of GDP from 64.3 percent of GDP in 2014 (Figure 3). Deficit reduction was largely driven by lower social benefits and higher revenue from IIP and excises. At the same time, the revenue buoyancy that resulted from better-than-expected economic conditions was almost entirely offset by spending overruns on public wages, higher-than-budgeted government co-financing of EU funds, and other temporary spending.

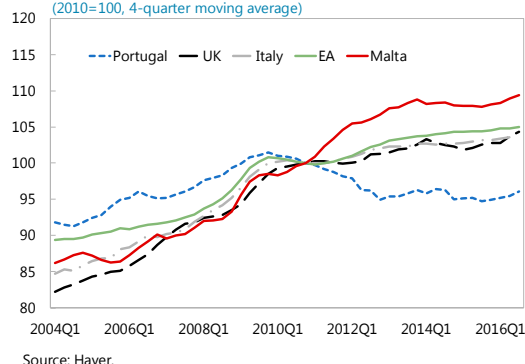
Malta: Public Debt and Fiscal Balance
(Percent of GDP)



9. The external position remained strong and the growth of unit labor costs (ULC) moderated (Figure 5).

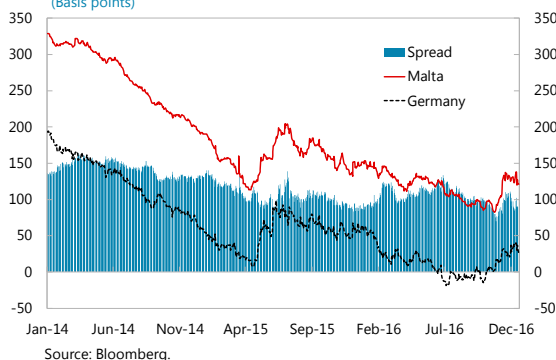
The current account posted a surplus of nearly 7 percent of GDP during January–September 2016 as services receipts more than offset the deficits in the goods and income balances, while the NIIP remained stable at just above 50 percent of GDP. Strong labor productivity growth and weak wage pressures contributed to the moderation of ULC following a rapid increase in recent years. The overall external position is assessed to be in line with fundamentals (Box 1).

Unit Labor Costs
(2010=100, 4-quarter moving average)



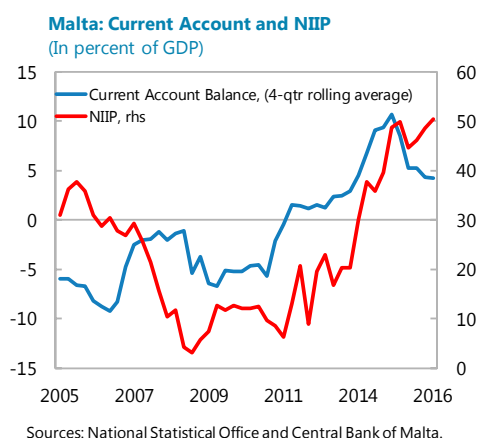
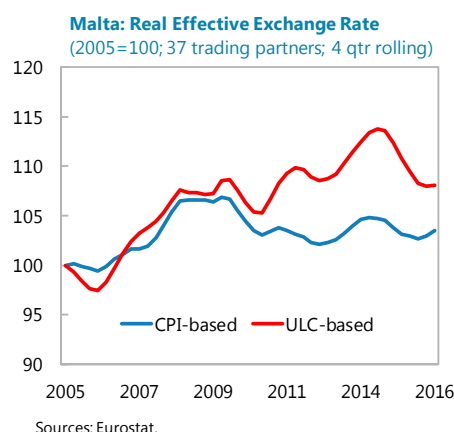
10. Financial conditions remained broadly supportive. Malta's government bond yields increased modestly at end-2016 in line with the steepening of euro-area yield curves, but remained low from historical perspective. After climbing by over 30 percent in 2015, Malta stock exchange index has fluctuated in a relatively narrow range, and registered a modest gain in 2016. A broad-based Index (FCI) developed by staff suggests that financial conditions remained supportive (see accompanying SIP).

Ten-Year Sovereign Bond Yields
(Basis points)



Box 1. Malta's Competitiveness Developments

Malta's external position remains strong. The CPI-based real effective exchange rate (REER) remained broadly stable in recent years, registering a modest depreciation of about 1 percent between 2010 and 2015. However, the ULC-based REER appreciated modestly over this period following a continuous appreciation that took place since EU accession in 2004. The latter largely reflects a rapid increase in ULC due to a composition effect, namely the structural shift from the more labor productive manufacturing sector towards the less productive services sector. Despite the rise in aggregate ULC and the REER appreciation trend, Malta's external balance has improved rapidly in recent years.



The external position is broadly in line with fundamentals. This assessment is based on several

indicators, including the EBA-lite current account norm estimates, misalignment estimates, and idiosyncratic factors. Given the high uncertainty surrounding the estimates, including the volatile balance of payments flows, a number of statistical adjustments were applied in line with the EBA-lite methodology. With these adjustments, the cyclically-adjusted current account norm shifts from 2.7 percent to 0.9 percent of GDP. The resulting gap (the difference between the adjusted current account and the adjusted norm) is 0.9 percentage point of GDP. This translates into a REER undervaluation of 1.1 percent. Contribution from policy gaps increases the current account surplus (mainly explained by Malta's fiscal consolidation efforts). EBA-lite REER estimates suggest a small overvaluation of the REER of 0.5 percent. In a nutshell, staff assesses the external position as broadly consistent with medium-term fundamentals and desirable policy settings.

Exchange rate assessment (EBA-lite methodology)

Current account approach		REER approach	
CA-adjusted*	1.8	ln(REER)-Actual	4.5
CA-Norm	0.9	ln(REER)-Norm	4.5
CA-Gap	0.9		
Policy gap	0.6	Policy gap	0.0
Residual	0.3	Residual (percent)	0.5
REER-Gap (percent)	-1.1	REER-Gap (percent)	0.5

(*) The cyclically-adjusted current account to GDP ratio in 2015 has been adjusted downward (to 1.9 percent of GDP) by a one-off factor which is equivalent to aligning the volatility of the overall current account with its trade or income balance counterparts (around 3.5 percentage points of GDP), broadly in line with Malta's 2015 Article IV report. The adjustment to the estimated cyclically-adjusted current account norm has taken into account the fact that a large share of private sector credit finances non-tradable activities (such as mortgages and residential real estates) and does not necessarily affect the trade balance.

Source: IMF staff estimates.

OUTLOOK AND RISKS

The outlook is strong, but risks are tilted to the downside

11. Strong growth is projected to continue, albeit at a more moderate pace.

- Real GDP growth is projected to remain robust, though decelerate to about 4 percent and 3½ in 2016 and 2017, respectively, on account of a weaker impetus from domestic demand. The completion of large-scale infrastructure projects, notably in the energy sector, and expiration of the previous EU funding cycle will drag investment growth lower while the effect of the recent policy measures to increase disposable income will diminish and lead to a gradual deceleration of private consumption growth. Against a backdrop of loose ECB policy, favorable financial conditions are expected to support household credit growth (see accompanying SIP). The contribution of net external demand to growth is projected to remain low.
- Over the medium term, growth is projected to decelerate towards an estimated potential of about 3 percent, narrowing gradually the positive output gap, while inflation is set to increase moderately as imported prices recover. Domestic demand will remain the main engine of growth. However, ongoing deleveraging in the NFC sector, completion of infrastructure projects, and structural rebalancing towards services, will keep credit to corporates subdued and dampen the expansion of investment, while the moderation of income growth will restrain private consumption growth. Current account surpluses are expected to persist due to sizable services balances, and less buoyant domestic demand.

Malta: Macroeconomic Projections, 2015–21
(Percentage change unless indicated otherwise)

	2015	2016 Est.	Projections				
			2017	2018	2019	2020	2021
Real GDP	7.4	4.1	3.4	3.1	3.1	3.1	3.1
Domestic demand	12.8	5.5	3.6	3.1	3.0	2.9	2.9
Private consumption	5.5	4.0	3.2	2.9	2.8	2.7	2.7
Public consumption	4.7	4.5	5.4	4.4	4.2	4.2	4.2
Fixed investment	49.8	4.0	3.4	2.3	2.3	2.2	2.2
Exports	4.3	1.8	2.4	2.7	2.7	3.0	3.0
Imports	7.7	2.2	2.4	2.6	2.6	2.8	2.8
Current account (percent of GDP)	5.2	4.4	4.4	4.7	4.8	4.9	5.0
Output gap	1.4	1.5	0.8	0.6	0.4	0.3	0.2
Consumer Prices (HICP, period average)	1.2	0.9	1.5	1.6	1.8	1.8	1.8

Source: National Statistics Office; and IMF staff projections.

12. Risks to the outlook are skewed to the downside (see Risk Assessment Matrix, Annex II). In view of Malta's high openness, prolonged weaker growth in key trading partners and rising anti-globalization sentiment would adversely affect exports, erode business confidence, and undermine investment. Rising global interest rates would tighten financial

conditions, yet the limited linkages of international banks to the domestic economy and the reliance of core domestic banks and the government on domestic funding are mitigating factors (Box 2). Uncertainties surrounding the Brexit negotiations may adversely affect the economy through direct and indirect exposures, while EU-wide corporate tax reform may impact Malta unfavorably.⁴ Domestically, recent measures to boost the labor participation rate, completion of infrastructure projects, and efficiency gains in the energy sector could have a prolonged positive effect on growth. However, rising households' debt could amplify risks from a sharp reversal in house prices, while slower implementation of structural reforms could adversely affect competitiveness and long-term growth. Persistent strength in mortgage lending and housing market may lead to imbalances, and increase risks to the financial system and economic activity.

Authorities' views

13. The authorities broadly agreed with staff on the outlook and the sources of risks.

They stressed that Malta's economic activity is expected to remain robust, supported by sound policies, structural reforms and favorable conditions. While agreeing that external environment poses downside risks, the authorities underscored Malta's resilience to shocks owing to increased economic diversification, strong domestic demand growth, and reliance on domestic funding. The authorities viewed risks from the Brexit decision as largely contained, in part due to possible relocation of UK-based firms to Malta. They stressed that, while the EU-wide corporate tax reform may negatively affect the economy, there are other factors that make Malta attractive to foreign firms such as the high labor market flexibility, the government pro-business agenda, low cost compared to euro area peers, and the prevalence of English-speaking population. They also argued that stronger than anticipated private investment growth provides an upside risk, and noted that private consumption growth may prove stronger-than-expected on the back of higher incomes and lower saving rate. Regarding the property market, the authorities acknowledged that strong activity in the market may increase vulnerabilities, but noted that house prices are not misaligned at the current juncture.

⁴ The second phase of the proposed Common Consolidated Corporate Tax Base suggests that firms' profits will be allocated across member states based on a formula intended to reflect the activities in each country.

Box 2. Balance Sheet Analysis (BSA) for Malta¹

The BSA presents a snapshot of outstanding balance sheet positions (stocks) forming the linkages between different sectors of the Maltese economy, including with nonresidents. The BSA can be used to study macroeconomic imbalances at the individual sector level as well as cross-sectoral linkages between different sectors of the economy. The analysis for Malta is based on a rich source dataset, and thus allows for a from-who-to-whom decomposition of financial assets based on 11 subsectors: (1) Government; (2) Central Bank; (3) Core domestic banks; (4) Non-core domestic banks; (5) International Banks (banks with limited interaction with domestic residents); (6) Investment Funds; (7) Insurance; (8) Other Financial Intermediaries (OFIs); (9) Non-financial Corporations (NFCs); (10) Households (HHs); and (11) Rest of the world (ROW).

The analysis confirms Malta's position as a financial hub. The cross-sectoral linkages show that the OFIs hold assets and liabilities vis-à-vis the ROW of approximately 1,950 percent of GDP, mainly reflecting the activity of holding companies, captive financial institutions, and money lenders. Other depository corporations are also very interconnected with the ROW, largely due to international banks' holdings of asset and liabilities. A smaller, but still significant part of financial services with external linkages is the insurance sector (reinsurance in particular).

Potential vulnerabilities from interconnectedness appear low while macroeconomic imbalances are generally small.

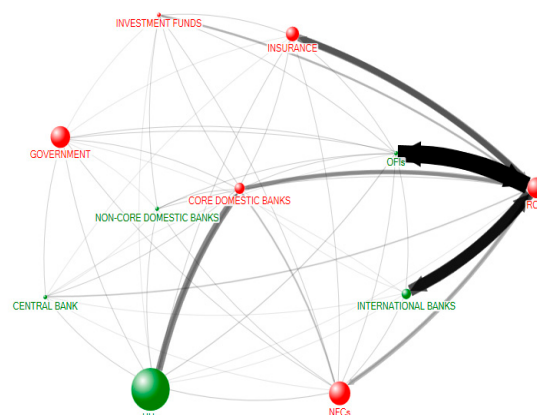
Figure 1 shows that financial institutions with large exposures to nonresidents are not significantly connected to domestic sectors, suggesting that the risk of external spillovers is relatively low.

Additionally, the nodes' size in Figure 1, which represent the sector's net position, show that macroeconomic imbalances are generally modest, though the household sector is a large net lender, with wealth mostly deposited at the core domestic banks. The government and NFCs are net borrowers mainly from banks, households, and the ROW.

Core domestic banks are at the center of inter-sectoral linkages among domestic residents.

They are net borrowers with respect to households, with deposit liabilities almost double compared to loan claims. The excess liquidity not used for lending is mostly distributed between deposits at the central bank and holdings of government and foreign debt securities.

Figure 1: BSA Matrix in Network Map Form
(gross exposures) /1



Source: Central Bank of Malta and IMF staff estimates.
1/ The OFIs in the chart exclude the insurance sector and investment funds. The nodes' size represents the size of the net imbalance between funds borrowed and lent by a sector, while the nodes color represents whether a sector is a net debtor (red) or creditor (green). The thickness of arrows from a sector to another depicts the bilateral exposures.

Table 1. BSA Matrix, 2015q4 (gross exposures, percent of GDP)

	Government		Central Bank		Depository Corporations		OFIs		NFCs		HHs		ROW	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Government			9	7	24	4	13	0	6	11	21	2	8	6
Central Bank	7	9			18	1	1	0	1	0	8	0	11	39
Depository Corporations	4	24	1	18			33	17	36	40	122	53	326	356
OFIs	0	13	0	1	11	27			27	18	68	2	1944	1965
NFCs	11	6	0	1	40	36	18	27			28	10	83	44
HHs	2	21	0	8	53	122	2	68	10	28			0	10
ROW	6	8	39	11	356	326	1965	1944	44	83	10	0		

Source: Central Bank of Malta and IMF staff estimates.

¹ Prepared by Giovanni Ugazio (STA).

POLICY CHALLENGES

Malta's high openness and heavy reliance on export-oriented sectors put a premium on enhancing the economy's resilience to shocks and strengthening competitiveness. Policies should, therefore, focus on building fiscal buffers, safeguarding financial stability, and supporting the operating environment for SMEs. Addressing the remaining structural weaknesses in the labor market and improving the business climate would boost productivity and make growth more inclusive.

A. Further Strengthening Public Finances

14. The 2017 budget aims to reduce the fiscal deficit further, following an over-performance in 2016. Strong economic conditions, lower support to SOEs, and expenditure restraint measures, have led to a marked improvement in the 2016 fiscal position. Based on the outturn through November, staff estimate the 2016 deficit at 0.7 percent of GDP, below the budget target of 1.1 percent of GDP. The deficit reduction implies a structural adjustment of 0.4 percent of potential GDP, supported by higher-than-planned revenue from IIP, which more than offset higher-than-anticipated expenditure on goods and services and compensation of employees. Looking to 2017, the budget targets a deficit of 0.5 percent of GDP to be achieved mainly through higher excises, and lower spending on social benefits, subsidies, and interest payment. These measures are expected to deliver an additional structural adjustment of 0.4 percent of potential GDP and contribute to further reduction of public debt.

15. The authorities' medium-term consolidation plan should be underpinned by specific measures. Malta's high degree of openness, which increases its susceptibility to external shocks, long-term spending pressures, and elevated level of government guaranteed debt (14 percent of GDP) underline the importance of further reducing the public debt-to-GDP ratio. In this regard, the authorities' latest projections, which envisage a cumulative structural adjustment of 1½ percent of GDP in 2017-19 such that their Medium-Term Objective of a structural balance in 2019 will be achieved comfortably, appear appropriate as they strike the right balance between the need to sustain growth momentum and build fiscal buffers. However, with measures not sufficiently specified, staff project a slower adjustment pace than the authorities. Under staff's baseline scenario, the overall deficit is projected to remain at 0.6 percent of GDP from 2017 onwards, thus delivering a cumulative structural adjustment of 0.5 percent of potential GDP in 2017-19. While continued primary surpluses and favorable debt dynamics are projected to gradually reduce

Malta: Fiscal Estimates and Projections
(Percent of GDP)

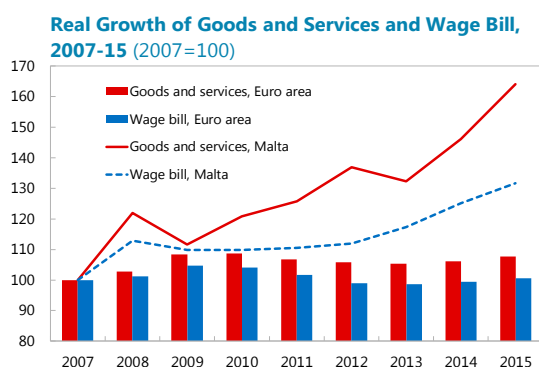
	2016 Est.	Projections		
		2017	2018	2019
Revenue	38.2	37.9	37.9	38.0
Expenditure	38.9	38.6	38.6	38.6
Overall balance	-0.7	-0.6	-0.6	-0.6
Structural balance	-1.3	-0.9	-0.9	-0.8
Public debt	60.0	59.0	56.6	55.2
The authorities' interim forecasts 1/				
Overall balance	-0.7	-0.5	-0.2	0.1
Structural balance	-1.2	-0.3	0.1	0.3
Public debt	60.2	58.9	55.9	53.7

1/ These are the authorities' latest interim forecasts; updated targets will be provided in the Stability Programme following the conclusion of the spring macroeconomic forecasts and revised fiscal projections. Sources: Ministry of Finance and IMF's staff projections.

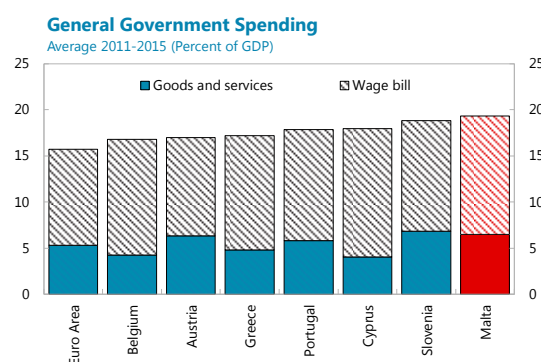
public debt-to-GDP ratio, contingent liabilities—stemming from SOEs and relatively large banking sector—are a key risk (Annex IV).⁵

16. Efforts to contain fast-growing current spending and enhance revenue collection can support the planned fiscal consolidation. In particular,

- The public sector's wage bill and spending on goods and services are relatively high and have increased rapidly in recent years. Measures to restrain these expenditures would help reduce the risk of spending overruns. Furthermore, sustained expenditure rationalization would require incorporation of recommendations of the recent in-depth spending reviews and execution of similar reviews in the broader public sector (Annex III).



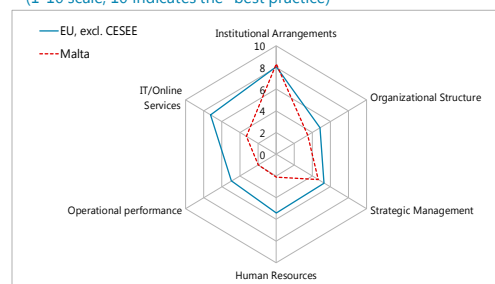
Sources: Eurostat and IMF staff's calculations.



Sources: Eurostat; and IMF staff calculations.

- The authorities have taken steps to simplify the tax system and improve the efficiency of tax collection, and work is underway to merge various revenue departments into a single government revenue function. Nevertheless, while Malta's overall VAT gap is relatively low, recent study suggests that VAT compliance could be strengthened further.⁶ Efforts should, therefore, focus on: (i) making a better use of IT and online services to facilitate compliance and provide high service standards; (ii) ensuring adequate human resources (i.e., staffing and training), and (iii) enhancing the operational performance of the tax administration.

Efficiency of Tax Administration
(1-10 scale, 10 indicates the "best practice")



Source: OECD, 2015, "Tax Administration. Comparative information on OECD and Other Advanced and Emerging Economies."

⁵ Under contingent liability shocks equivalent to 5 percent of the domestic banks' total assets and 50 percent of the government guaranteed debt, public debt would increase by 18 and 8 percentage points of GDP, respectively.

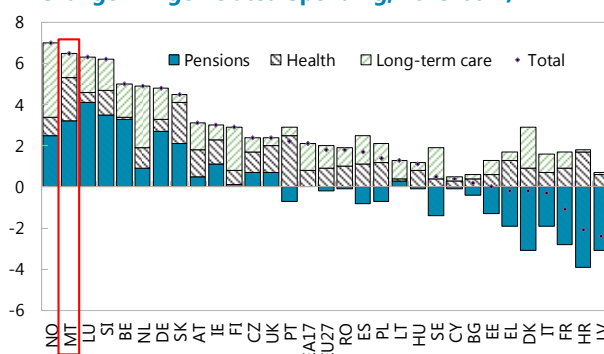
⁶ See European Commission [study](#) on VAT Gap in the EU-28 Member States.

- In view of the uncertainties surrounding the baseline, automatic stabilizers should be allowed to operate fully if growth disappoints while budget windfalls should be used to further reduce the borrowing needs and build fiscal buffers.

17. Reforms of SOEs are progressing, but risks remain. The state electricity provider, Enemalta, has improved its financial standing following internal restructuring and a partial privatization, and posted a profit in 2015 after a prolonged period of losses. Meanwhile, the restructuring of Air Malta, the national carrier, continues to lag behind and, although financial performance has improved recently, the company continues to generate losses.⁷ To this end, a faster restructuring of Air Malta is needed to contain fiscal risks. At the same time, Enemalta's elevated level of government guaranteed debt (about 6 percent of GDP in 2015) calls for continued close monitoring of its operations.

18. Further efforts are needed to reduce long-term spending pressures. Malta is facing rising ageing pressures and is expected to record a significant increase in age-related spending going forward. The recent pension changes adopted by the authorities in the 2016 budget, which included measures to delay retirement, incentivize voluntary savings, and increase minimum pensions for the most vulnerable, are steps in the right direction. Additional measures to align the effective retirement age with life expectancy, better link the pensionable income to life-time incomes, and lengthen the contributory period would further mitigate the associated long-term fiscal risks. Increasing the administrative efficiency in the health sector and strengthening the primary care should also help contain age related spending growth and support the pension reform.

Change in Age Related Spending, 2013-60 1/



Source: European Commission *The 2015 Ageing Report*.

1/ The age-related spending is updated given new populations statistics. New estimates will likely yield lower expected expenditure.

Authorities' views

19. The authorities confirmed their commitment to continue with fiscal consolidation. They expressed confidence in meeting their 2017 deficit target on the back of continued favorable economic conditions, and prudent macro and revenue forecasts. They agreed that measures to support fiscal consolidation should build on containing current spending, including through the implementation of in-depth spending reviews, though noted that the ongoing public sector wage negotiations with the unions pose uncertainty. They also pointed to continued efforts to enhance tax collection efficiency, including by better use of technology and more efficient risk-based tax audits. They recognized risks from contingent liabilities, but stressed

⁷ Air Malta received a cumulative capital injection of about 0.6 percent of GDP by the government in 2015-16.

that the impact of these risks on public debt is contained, also given the ongoing reforms in SOEs. Finally, they agreed with the need to continue addressing long-term spending pressures from ageing and committed to review the effectiveness of the recent measures periodically.

B. Safeguarding Financial Sector Stability

20. The banking sector appears sound and resilient to shocks.⁸ Core domestic banks continued to expand their balance sheets in 2016H1. Profitability remained above levels seen in peers and capital and liquidity positions continued to be strong. Recent stress tests conducted by the Central Bank of Malta indicated that the loss absorption capacity of core domestic banks against adverse macroeconomic conditions remained adequate. The macroprudential framework has been strengthened further with the introduction of the Counter-Cyclical Capital Buffer and buffer for “Other Systematically Important Institutions” in early 2016.

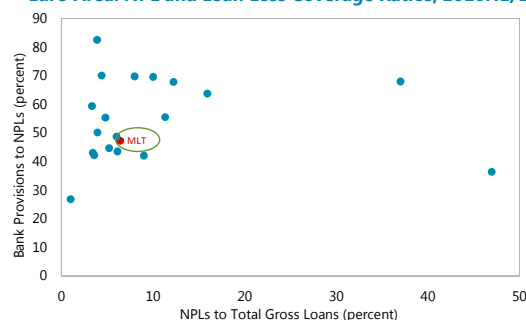
Core Domestic Banks: Key Financial Soundness Indicators
(Percent)

	2012	2013	2014	2015	2016H1
Regulatory Tier 1 capital	12.1	12.9	11.6	12.2	13.0
Loan to deposit	72.1	67.8	64.0	58.2	58.6
Return on assets	1.1	1.1	0.7	0.7	1.0
Interest margin to gross income	61.8	63.6	64.8	64.5	63.9
Non-interest expenses to gross income	45.5	47.1	51.2	54.1	54.5
NPL ratio	7.8	9.0	7.6	7.2	6.4
Coverage ratio	35.5	37.9	40.4	43.5	47.2
Loan-to-Value, residential properties	70.4	71.5	74.2	75.1	75.7
Liquid assets to short term liabilities	51.5	51.7	50.4	50.2	54.1

Source: Central Bank of Malta.

21. However, domestic banks face a number of challenges. Legacy NPLs continued to decline, but remained elevated; the loan-loss coverage ratio remains relatively low at about 47 percent with high heterogeneity across banks; and credit growth continued to be sluggish on account of corporate sector deleveraging. Future regulatory changes and uncertain external environment may affect banks’ profitability and their capacity to support growth. Furthermore, persistent pressures in the property market, combined with increased exposure of banks to property market and elevated households’ indebtedness, could pose risks to financial stability.

Euro Area: NPL and Loan Loss Coverage Ratios, 2016H1/1



1/ Data for Malta are for core domestic banks.

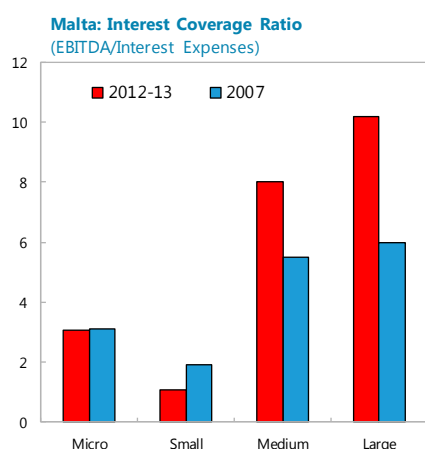
Sources: IMF's Financial Soundness Indicators and Central Bank of Malta.

22. Strengthening the macroprudential framework further would enhance resilience to possible property market swings. Staff’s analysis does not point to a significant misalignment of property prices (see accompanying SIP). However, persistent demand pressures in the housing market could eventually lead to imbalances, particularly given the lagged supply response. With high exposure of core domestic banks to the housing market, a sharp turnaround in housing prices could weaken banks’ financial health—particularly if accompanied by broader economic slowdown and an increase in unemployment—possibly resulting in a negative spiral of low

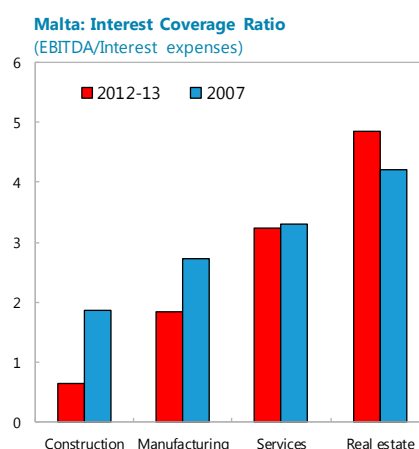
⁸ See description of banking sector’s structure in footnote 1 in Table 4.

lending and investment. While households default rate is currently low and financial wealth is high, their elevated debt, high concentration of assets in real estate, and the prevalence of variable rate mortgages could increase vulnerabilities. Sustained efforts are therefore needed to ensure that imbalances in the housing market will not emerge, including by ensuring that fiscal measures related to the housing market do not amplify the cycle, and by adopting targeted macroprudential measures such as limits on loan-to-value and debt-to-income ratios. Closing data gaps, including on borrower characteristics, is critical for the calibration of the macroprudential measures and for identifying risks in a timely manner.

23. The non-financial corporates, particularly SMEs, remain vulnerable to shocks. Staff's analysis suggests that the financial health of medium and large firms has improved in recent years, but the financial position of smaller enterprises and firms in the construction sector remained generally weak. Furthermore, a decline in profitability and an increase in interest rates would push many firms into a vulnerable state and thus likely result in new defaults and underinvestment (see accompanying SIP).



Sources: Orbis BvD and IMF staff calculations



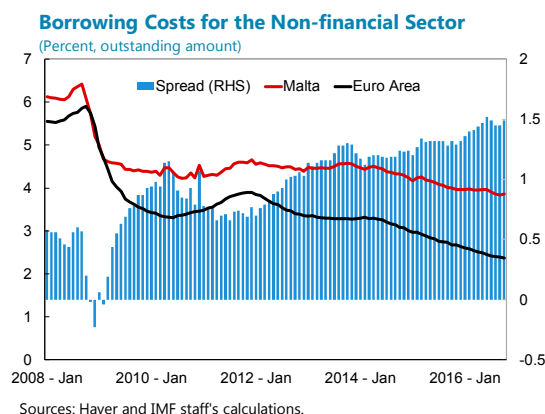
Sources: Orbis BvD and IMF staff calculations.

24. A faster cleanup of banks and firms' balance sheets would improve the credit channel and support investment. High legacy NPLs continue to weigh on banks' balance sheets. Moreover, they have contributed to high borrowing costs, thus weakening the monetary policy transmission mechanism and undermining investment activity, particularly by SMEs that lack sufficient internal funding. In this regard, the recent regulatory changes, which require banks to submit plans to reduce their NPLs ratios to below 6 percent within five years, are steps in the right direction, given the elevated NPLs ratios for some smaller banks, while efforts to streamline the insolvency framework will help support the resolution process.⁹ A further increase in loan-loss provisions would minimize uncertainty regarding future losses and also assist with faster cleanup of banks' balance sheets.

⁹ Banks that will deviate from their NPL resolution plans would have to accumulate a "Reserve for Excessive NPLs".

25. Steps to improve SMEs' access to finance would support sustained economic development.

With high credit risk and lack of competition in the lending market, many SMEs continue to face limited access to bank funding.¹⁰ The recently established central credit register (April 2016) is likely to improve competition by reducing informational monopoly of large banks. In addition, the planned state-owned Development Bank (MDB), expected to commence operations by mid-2017, aims at supporting SME financing by providing long-term loans through commercial banks (Box 3). To this end, the authorities' commitment to adopt well-designed origination rules to ensure that the MDB's operations will result in new credit extension to creditworthy SMEs rather than ever-greening existing bank exposures to distressed borrowers is welcome. Robust governance structure, prudent risk assessment, and adequate supervision, are also needed to mitigate contingent liability risks to public finances.



26. On-going vigilance is needed to contain risks to the integrity of the financial system. Additional resources were made available for AML/CFT supervision, resulting in an increase in intensity and frequency of onsite inspections of obliged entities by the Financial Intelligence Analysis Unit and with the support of the Malta Financial Services Authority as regards to supervision of financial institutions. In light of the growing size of the financial sector, expansion of online gaming activities, and increased demand for IIP, sustained efforts are needed to ensure a robust implementation of the AML/CFT framework in line with international standards, and that the institutions involved have adequate resources for capacity building and operations.

Authorities' views

27. The authorities concurred with staff on the need to enhance the financial sector's resilience and improve access to finance. They underscored that the banking sector is resilient to various shocks, including from house prices. Nevertheless, they noted that granular financial data are being collected to improve the monitoring of risks related to mortgage lending, and that consideration is being given to the introduction of macroprudential limits as precautionary measures. The authorities highlighted that recent regulatory changes and ongoing improvements to the insolvency framework are likely to expedite private sector balance sheet repair. This, together with the establishment of the MDB and introduction of the credit register, would also help ease SMEs access to finance. They reiterated their commitment to maintain a rigorous compliance with AML/CFT regulations.

¹⁰ The two largest core domestic banks provide about 80 percent of the loans to the resident NFC sector.

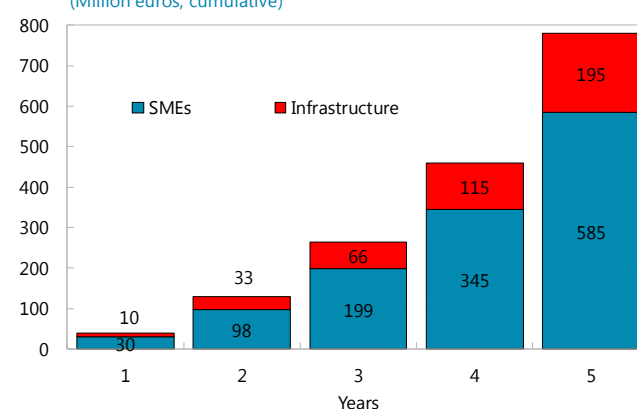
Box 3. The Modalities of the Proposed Malta Development Bank

The Maltese authorities are actively working to establish a Development Bank (MDB), which is expected to be fully operational in mid-2017. It aims to address the [SMEs' financing gap](#) that has emerged in the Maltese economy mainly due to their high risk, insufficient collateral, and required loan duration. The MDB will also co-finance large infrastructure development projects, which otherwise could not be financed entirely by the private sector due to their large size and long maturity. The proposed MDB will be 100 percent government-owned, and, in line with EU State Aid obligations, seeks to complement commercial banks operations where their lending facilities are lacking or insufficient, rather than competing with them. The MDB will be subject to a supervisory board, which is expected to gradually align the MDB with the bank regulatory framework.

Funding: The MDB's funding would be a combination of local issuance of bonds (up to 480 million euros by the fifth year), and direct bilateral loans from international institutions such as the EIB, the CoE Development Bank, and the EBRD. Consideration will be given to private placement of bonds to foreign financial institutions. The government is expected to gradually inject €100 million of equity in the first five years.

Lending: The MDB is expected to provide up to €780 million (equivalent to about 8 percent of the projected 2016 GDP) in its first five years. About 75 percent of the MDB's lending will be allocated, via commercial banks, to viable SMEs that experienced difficulties in accessing credit. These loans will be restricted for new lending and mainly directed for both working capital and investment activities. The remaining share of the lending is expected to be allocated to co-financing social/development infrastructure investments. The MDB loans may be provided on state-aided terms (compliant with the EU *de minimis* Regulation and the General Block Exemption Regulation) and/or on market terms. The infrastructure loans at market rates must be complemented with at least 50 percent of private sector's participation. Overall, the share of loans that will be covered by government guarantees is projected to stand at 30 percent of the MDB's total lending, comprising 45 percent for infrastructure loans and about 25 percent for the SME segment.

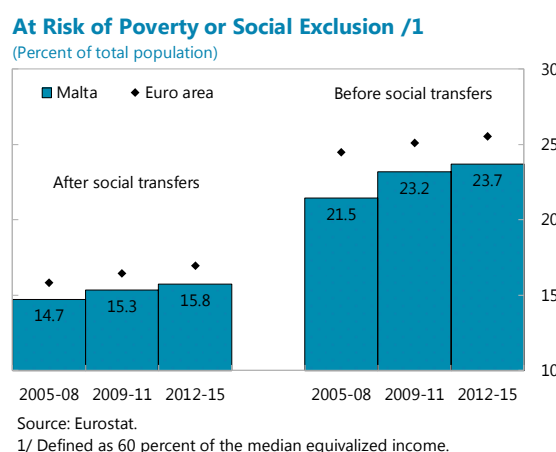
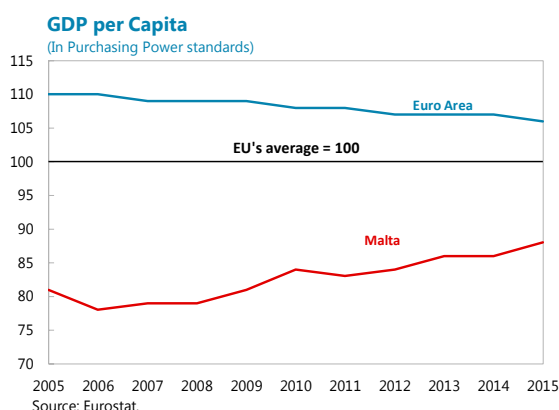
Projected Loans by Malta Development Bank
(Million euros, cumulative)



Source: MDB Working Group.

C. Sustaining High Growth and Increasing Inclusiveness

28. Steady implementation of structural reforms would improve competitiveness, and strengthen the foundations for a high and more inclusive long-term growth. Recent reforms and large-scale infrastructure investment have boosted Malta's medium-term potential growth (see 2015 Article IV's [Selected Issues](#)). Nevertheless, Malta's income gap remains sizable, while social exclusion—although below the euro area average—remains elevated compared to the pre-crisis period (Figure 6). Addressing the remaining structural weaknesses, including the quantity and quality of labor, would help improve competitiveness and support high and more inclusive medium-term growth. In particular, sustained efforts are needed to:

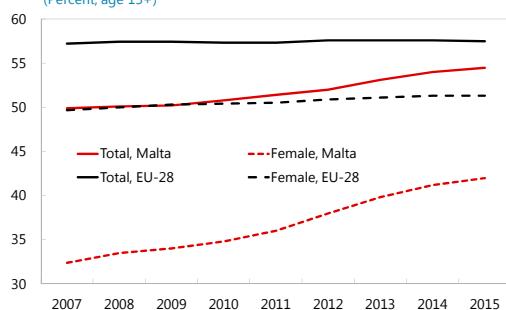


- Increase labor market participation and reduce skill mismatch.** Malta's labor force participation, particularly of women, continues to lag behind the EU average (Figure 6). Beyond cultural factors, this reflects lack of skills needed to meet the changing labor demand.¹¹ Malta's high job vacancy rate, which is one of the highest in the euro area, and the low education attainment also highlight the skill mismatch problem. The recently completed in-depth review of education is timely and its recommendations to better align education and vocational trainings with labor demand are steps in the right direction. Strengthening labor activation policies, reducing early school leavers, and broadening the incentives to delay retirement would also support higher labor force participation.
- Enhance SMEs research and innovation.** Although increasing in recent years, Malta's gross domestic R&D expenditures remained low due to low innovation activities of both business and public sectors. Firm-level data indicates that innovation is significantly lower among SMEs, reflecting in part their weak financial health (see accompanying SIP). Strengthening the balance sheets of weak, but viable, firms, while expanding SMEs' non-bank and equity financing options would help easing financing constraints for R&D activities. Furthermore, enhanced collaboration with the academia, higher internationalization of SMEs, and greater direct public sector's support would encourage innovation, particularly given that existing tax incentives are less effective for small firms that lack sufficient funds to invest in R&D.

¹¹ A recent [study](#) indicates that around three out of four firms consider skill shortage as a relevant obstacle to hiring new workers.

Labor Force Participation

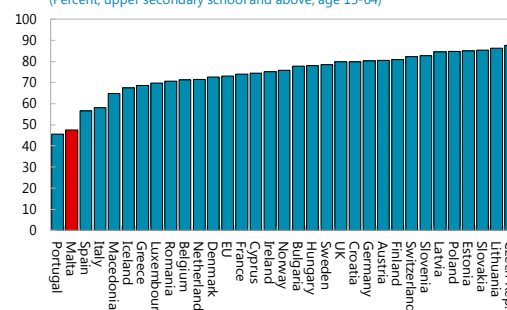
(Percent, age 15+)



Sources: Haver.

Education Attainment, 2015

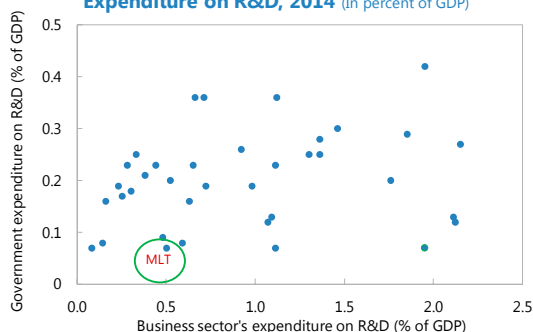
(Percent, upper secondary school and above, age 15-64)



Sources: Eurostat and IMF staff's calculations.

EU Members: Government and Business Sector Expenditure on R&D, 2014

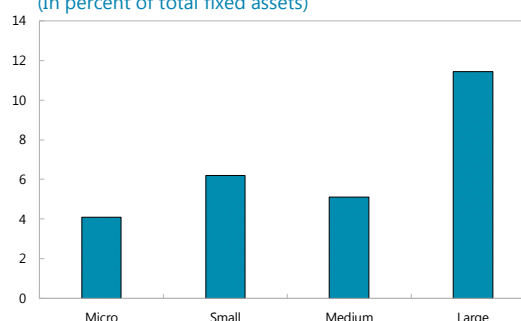
(In percent of GDP)



Sources: Eurostat and IMF staff's calculations.

Malta: Intangible fixed assets, 2011-13

(In percent of total fixed assets)

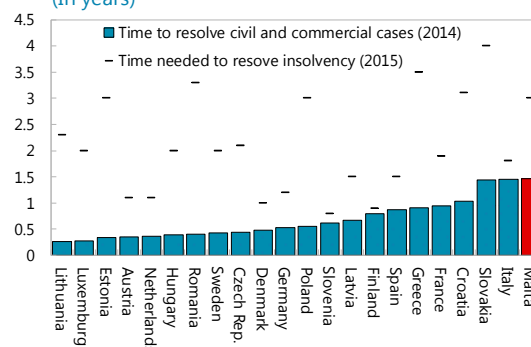


Sources: Orbis BvD and IMF staff calculations.

- Improve the judicial system efficiency.** Insolvency proceedings are lengthy, and—although improving—the time needed to resolve commercial, civil, or administrative case has been among the highest in the EU ([2016 EU Justice scoreboard](#)).¹² Recent measures to streamline the legal proceedings, including by allocating greater resources to courts, increasing the number of court sittings, and expanding the use of IT systems, are welcome. The adoption of the proposed amendments to the Companies Act, which set a time limit for the insolvency process, introduce a “Second Chance” principle for entrepreneurs, and provide mediation in voluntary winding up of companies, would shorten the insolvency proceedings and further improve the business climate.

Length of Legal Proceedings

(In years)



Source: Justice Scoreboard 2016

¹² The Justice Score is largely based on quantitative data that are provided by member states.

Authorities' views

29. The authorities concurred with the need to advance structural reforms. They agreed that further strengthening productivity is of utmost importance given the demographic challenges. In this regard, they highlighted that recent and ongoing measures to expand the labor supply and reduce skill mismatches together with adjustments in the pension system have already led to significant labor force participation gains. The authorities also reiterated their commitment to increase the R&D intensity in the economy and highlighted several initiatives to support innovation by smaller firms. Efforts are also underway to improve the overall business environment, notably by expediting the processes to establish or close a business, shortening the length of legal proceedings and increasing out-of-court resolutions. In addition, they stressed that the amendments to the Companies Act, expected to be adopted in early 2017, should enhance the insolvency framework.

STAFF APPRAISAL

30. Robust economic activity is set to continue, albeit a more moderate pace. Sound policies and favorable macroeconomic conditions have supported Malta's exceptionally strong growth and contributed to a reduction in unemployment to record-lows and an improvement in public finances. Domestic demand-led growth is projected to remain solid and stabilize at potential rate of about 3 percent over the medium term. Strong job creation is expected to continue, keeping unemployment low, while inflation is likely to increase modestly as import prices recover. The external position, which is expected to remain strong, remains broadly in line with fundamentals.

31. However, downside risks predominate. Malta's high openness makes it vulnerable to a weaker external environment and rising anti-globalization sentiment. Uncertainties surrounding the Brexit negotiations could weigh on economic activity through both direct and indirect exposures while EU-wide corporate tax reform may impact Malta unfavorably. Domestically, recent structural reforms could have a stronger-than-expected positive effect on growth. While data do not point to a misalignment of house prices, persistent strength in mortgage lending and the housing market may lead to imbalances, amplifying risks to the financial system and the broader economy.

32. The authorities' medium-term consolidation plan is appropriate, but measures need to be better specified. Achieving the medium-term objective of a structural fiscal balance will put public debt on a firmly downward path while sustaining the growth momentum. Measures beyond 2017 need to be better specified. Priority should be given to containing the fast-growing wage bill and intermediate consumption, including by building on the recommendations of the recent in-depth spending reviews and conducting similar reviews for the broader public sector. Ongoing efforts to enhance tax collection efficiency would support the adjustment while creating space for growth-enhancing policies. Improving the financial health of SOEs, and containing long-term spending pressures would help reducing fiscal risks.

33. The banking system appears sound and resilient, but faces a number of challenges.

Domestic banks report adequate capitalization and liquidity, and profitability above levels seen in peers. However, headwinds from protracted low interest rates, weak credit growth, and legacy corporate NPLs pose challenges. Future regulatory changes and uncertain external environment may affect banks' profitability prospects and capacity to support growth. High and increasing banks' exposure to the property market may increase financial stability risks.

34. The resilience of the private sector needs to be bolstered further. Deployment of targeted macro-prudential tools linked to mortgage lending would enhance banks' and households' resilience to possible property market swings. Closing data gaps is critical to calibrate such measures. A careful review of the fiscal incentives related to property market together with measures to address housing supply bottlenecks would help prevent housing market imbalances. A faster resolution of legacy NPLs would strengthen private sector balance sheets and unlock resources for growth. In this regard, the recent regulatory changes, requiring banks to submit time-bound plans to reduce their NPL ratios and efforts to streamline legal proceedings, are steps in the right direction.

35. The planned development bank could support the economy but fiscal risks should be contained. The establishment of the MDB could help alleviate financing constraints faced by SMEs and foster higher development investment. The authorities' intentions to ensure that MDB's operations will lead to new credit origination by banks to viable firms would reduce the risk of evergreening existing exposures to distressed borrowers. Robust governance structure, prudent risk assessment, adequate supervision, and well-designed origination rules are also needed to mitigate contingent liability risk to public finances.

36. Ongoing vigilance is needed to contain financial system's integrity risks. Continued efforts should be pursued to effectively implement the AML/CFT framework, including by ensuring that the competent authorities are adequately resourced and coordinate closely in supervising compliance.

37. Steady reform implementation will support high and inclusive long-term growth. Continued reform momentum—consistent with the government's national strategy—would help address the remaining structural impediments, close the income gap, and ensure a more equitable distribution of growth dividends. In particular, sustained efforts are needed to (i) increase the labor force participation, particularly of women, and reduce skill mismatch in the face of the changing labor demand; (ii) enhance SMEs' innovation, including by strengthening their balance sheets and broadening financing options, increasing public R&D spending, and fostering close partnerships with education institutions; and (iii) further streamline the legal process and address the shortcomings of insolvency and bankruptcy frameworks.

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

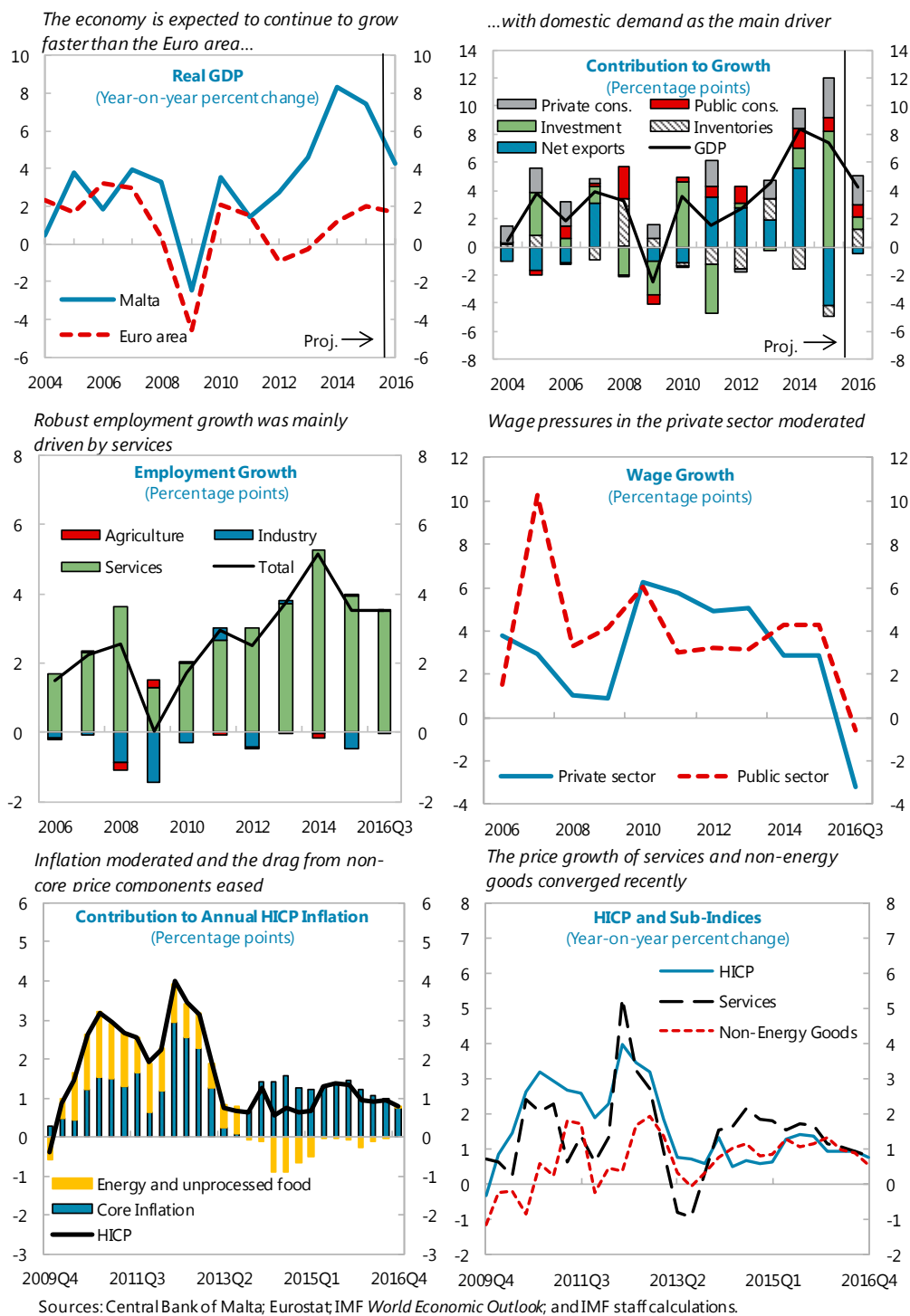
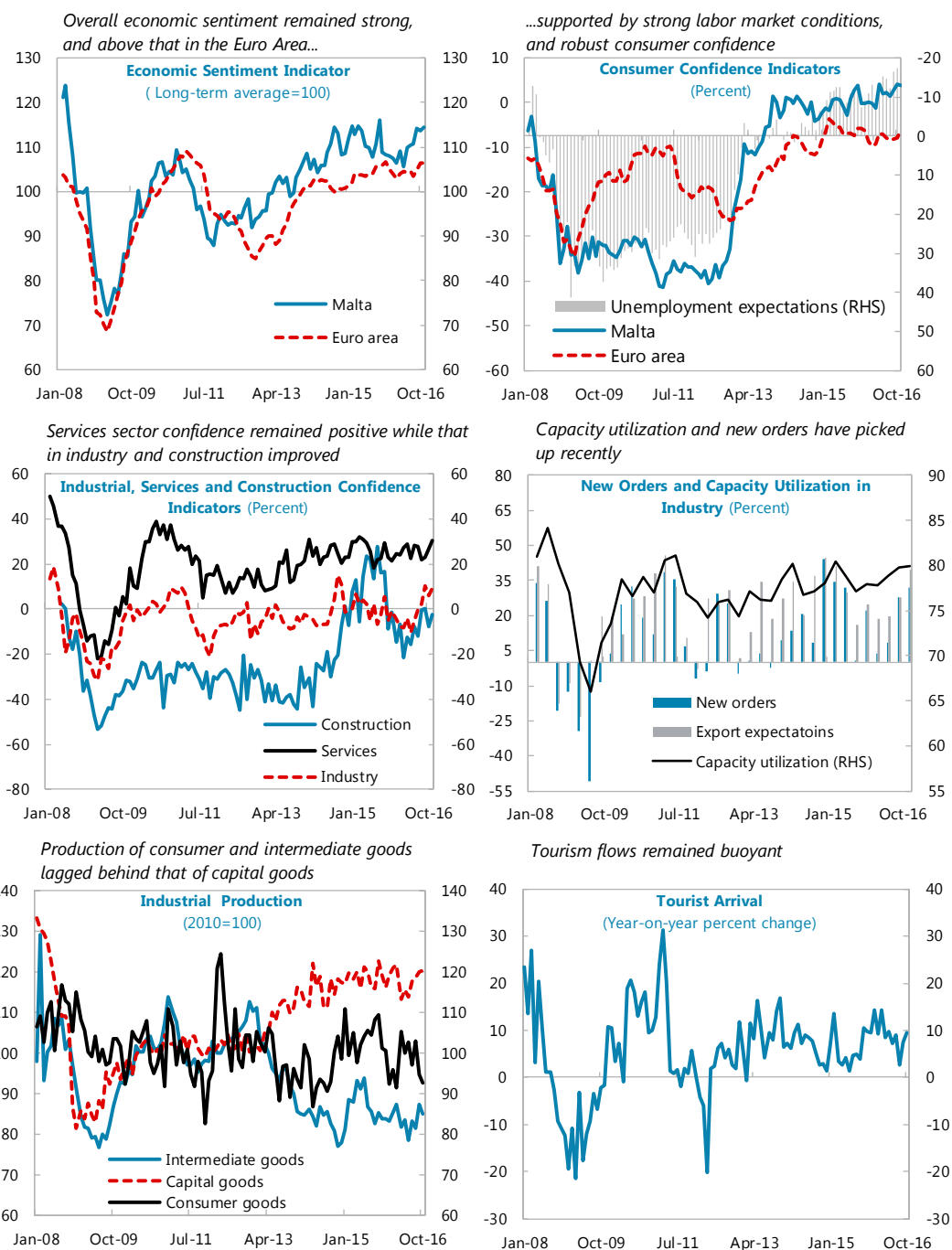
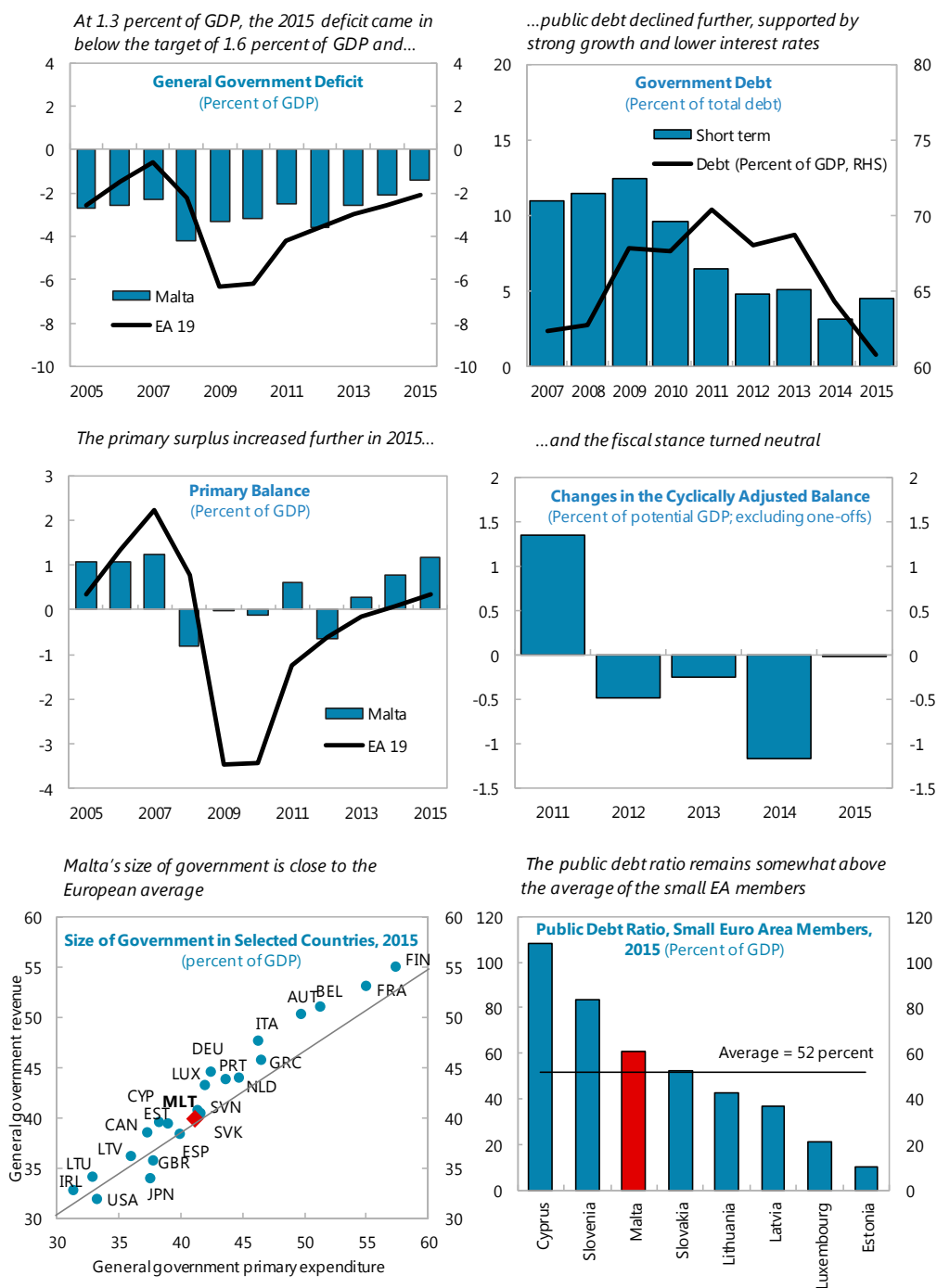
Figure 1. Malta: Economic Indicators 2004-2016

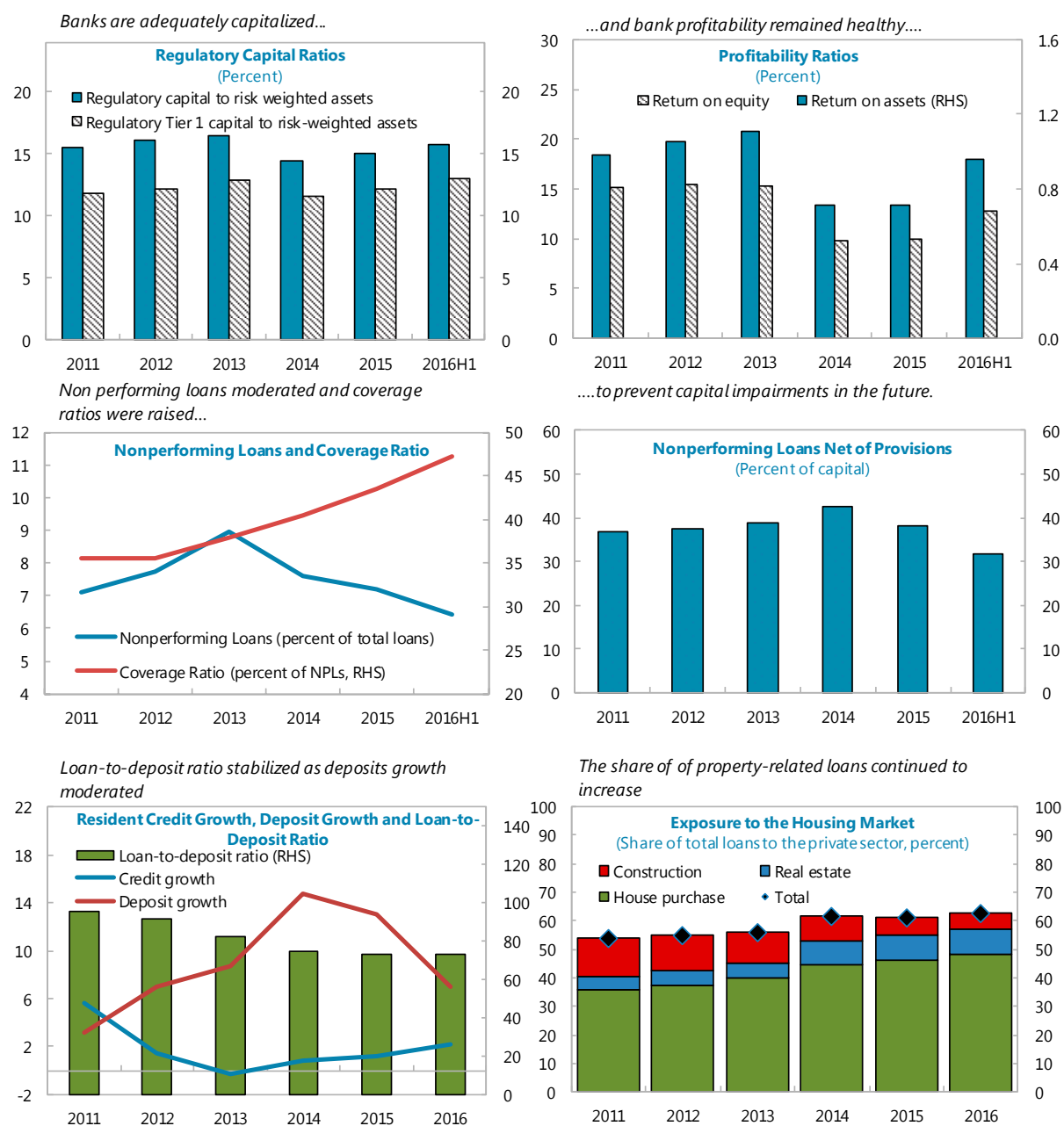
Figure 2. Malta: Short-Term Indicators, 2008–2016



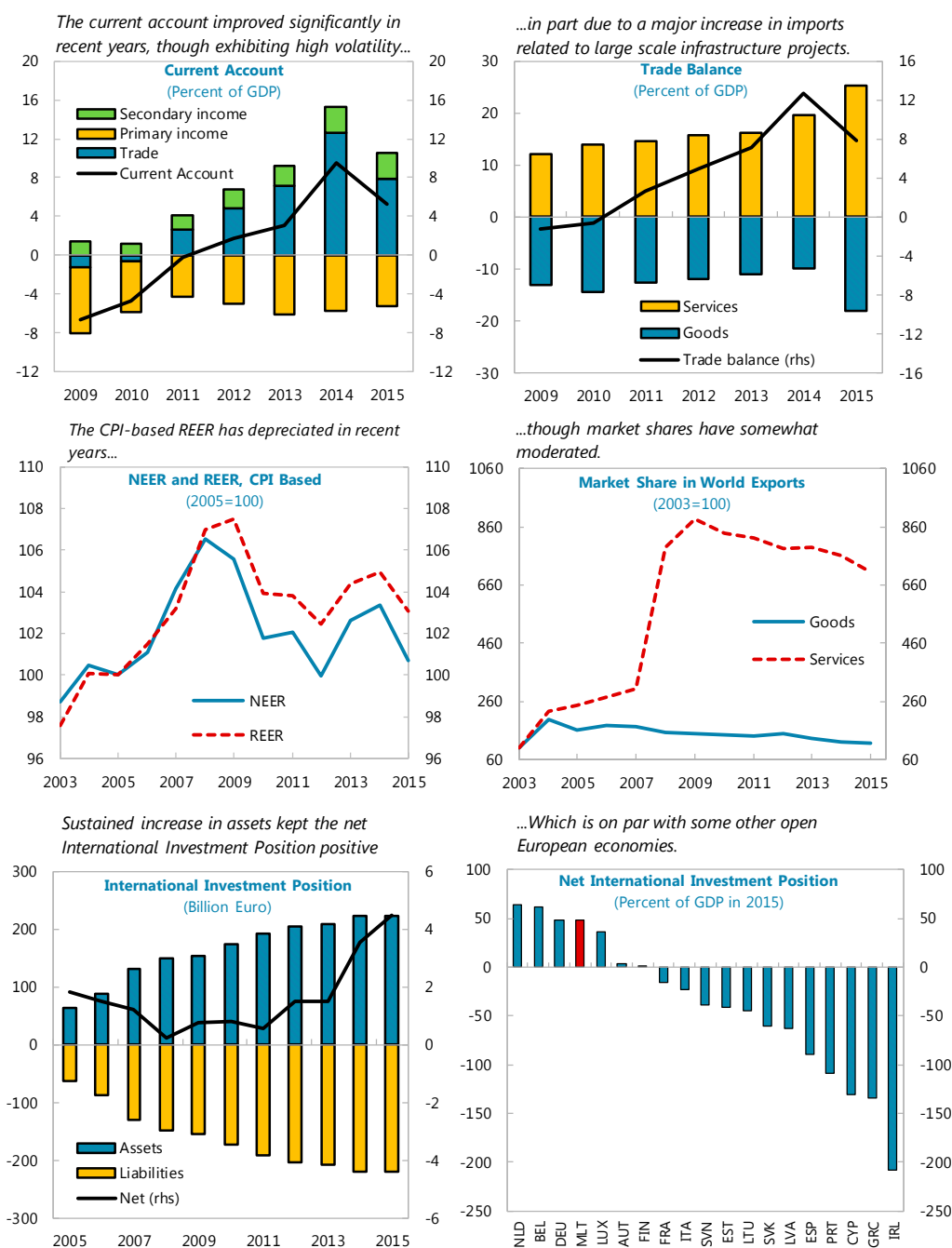
Sources: European Central Bank; Central Bank of Malta; European Commission; and IMF staff calculations.

Figure 3. Malta: Fiscal Developments

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

Figure 4. Malta: Financial Soundness Indicators

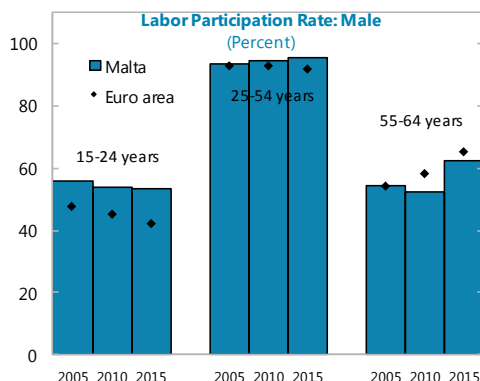
Sources: IMF, *Financial Soundness Indicators*; Central Bank of Malta; and Malta Financial Services Authority.

Figure 5. Malta: External Sector

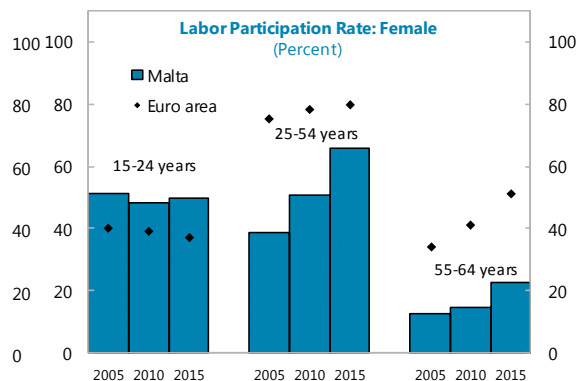
Sources: Haver Analytics; Eurostat; UNCTAD; IMF World Economic Outlook; and IMF staff calculations.

Figure 6. Malta: Labor Market and Income Inequality Developments

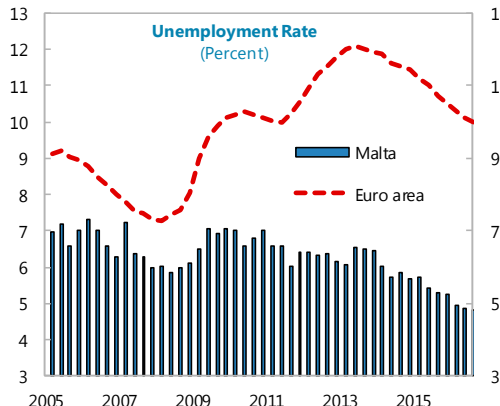
The labor market participation rate among males is in line with the European average..



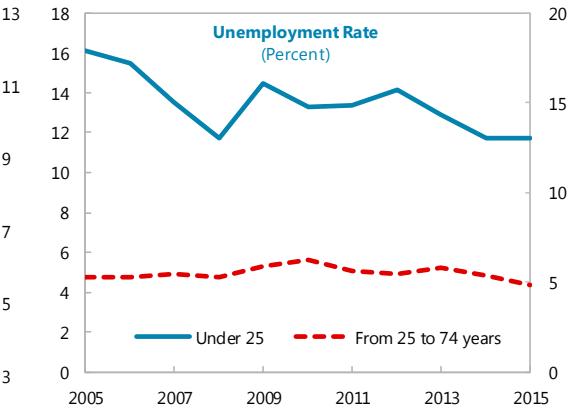
...but falls short among female, particularly above the age of 25



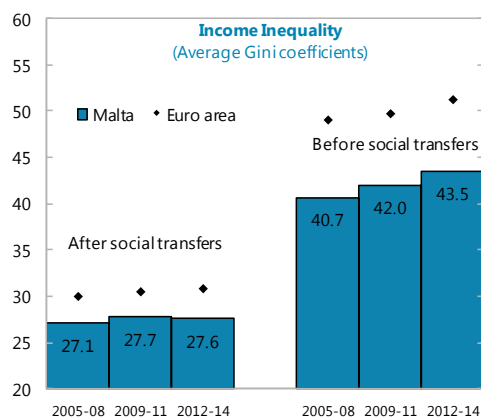
The unemployment rate continued to decline to a record-low level..



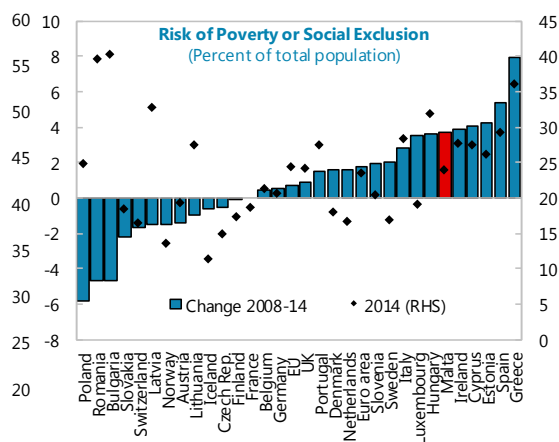
...reflecting in part a decline of youth unemployment



Despite the strong growth, income inequality remains elevated compared to the pre-crisis period...



...and the share of population under a risk of poverty increased



Sources: Eurostat, and IMF staff calculations.

Table 1. Malta: Selected Economic Indicators, 2014-2021
(Year on year percent change, unless otherwise indicated)

	Projections							
	2014	2015	2016 Est.	2017	2018	2019	2020	2021
(Year on year percent change)								
Real GDP	8.4	7.4	4.1	3.4	3.1	3.1	3.1	3.1
Domestic demand	3.0	12.8	5.5	3.6	3.1	3.0	2.9	2.9
Consumption	3.8	5.3	4.1	3.7	3.3	3.2	3.1	3.1
Private consumption	2.6	5.5	4.0	3.2	2.9	2.8	2.7	2.7
Public consumption	7.0	4.7	4.5	5.4	4.4	4.2	4.2	4.2
Fixed investment	8.8	49.8	4.0	3.4	2.3	2.3	2.2	2.2
Exports of goods and services	5.1	4.3	1.8	2.4	2.7	2.7	3.0	3.0
Imports of goods and services	1.5	7.7	2.2	2.4	2.6	2.6	2.8	2.8
Contribution to growth	(Percent)							
Domestic demand	2.8	11.6	4.6	3.4	2.9	2.8	2.7	2.7
Foreign balance	5.6	-4.2	-0.4	0.0	0.2	0.3	0.4	0.3
Potential GDP growth	4.3	5.8	4.1	4.1	3.3	3.3	3.3	3.1
Output gap (percent of potential GDP)	-0.1	1.4	1.5	0.8	0.6	0.4	0.3	0.2
HICP (period average)	0.8	1.2	0.9	1.5	1.6	1.8	1.8	1.8
GDP deflator	1.9	2.2	1.9	2.0	2.0	2.0	2.0	2.0
Unemployment rate EU stand.	5.8	5.4	4.8	4.9	4.9	5.0	5.1	5.2
Employment growth	3.4	2.3	2.3	2.2	2.0	2.0	2.0	2.0
Gross national savings (percent of GDP)	26.1	28.6	29.1	29.1	29.3	29.4	29.4	29.5
Gross capital formation (percent of GDP)	16.5	23.4	24.6	24.7	24.6	24.6	24.5	24.5
Balance of payments	(Percent of GDP)							
Current account balance	9.6	5.2	4.4	4.4	4.7	4.8	4.9	5.0
Trade balance (Goods and services)	12.6	7.9	7.1	7.0	7.3	7.4	7.6	7.7
Exports of goods and services	148.8	143.4	137.8	136.3	135.5	134.5	133.9	133.3
Imports of goods and services	136.2	135.5	130.7	129.3	128.2	127.0	126.3	125.6
Goods balance	-13.3	-20.0	-17.6	-18.0	-18.3	-18.7	-19.1	-19.1
Services balance	25.9	27.9	24.7	25.0	25.7	26.1	26.7	26.8
Primary income, net	-5.7	-5.3	-5.3	-5.3	-5.3	-5.3	-5.3	-5.3
Secondary income, net	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Financial account, net	2.4	-7.1	6.2	6.2	6.5	6.6	6.7	6.8
Financial sector								
Credit to the private sector (% GDP)	96.1	91.0	88.9	...	...	...	...	...
Credit growth, private sector	-1.7	3.9	3.7	...	...	...	...	...
Memorandum item:								
Nominal GDP (millions of euros)	8426.3	9250.3	9819.0	10355.9	10893.0	11454.8	12045.9	12663.3
Nominal GDP growth	10.4	9.8	6.1	5.5	5.2	5.2	5.2	5.1

Sources: Maltese authorities; and IMF staff projections.

Table 2. Malta: Fiscal Developments and Projections, 2014-2019

(Percent of GDP, unless otherwise indicated)

	2014	2015	2016 Est.	Projections		
				2017	2018	2019
Revenue	39.5	39.9	38.2	37.9	37.9	38.0
Taxes	26.9	26.4	26.4	26.4	26.4	26.4
Indirect taxes	13.0	12.8	12.9	13.0	12.9	12.9
Direct taxes	13.7	13.4	13.3	13.3	13.3	13.3
Other taxes (capital taxes)	0.1	0.2	0.2	0.2	0.2	0.2
Social contributions	6.6	6.4	6.4	6.4	6.3	6.3
Grants and Capital revenue	2.3	3.1	1.0	1.7	2.0	2.2
Other revenue	3.7	4.0	4.4	3.4	3.2	3.1
Expenditure	41.5	41.2	38.9	38.6	38.6	38.6
Expense	38.0	37.1	35.7	35.2	35.2	35.1
Compensation of Employees	12.5	12.1	12.2	12.2	12.3	12.3
Use of goods and services	6.2	6.5	6.7	6.7	6.8	6.8
Interest	2.7	2.5	2.1	2.0	2.0	2.0
Subsidies	1.2	1.2	1.1	1.0	1.0	1.0
Social benefits	11.9	11.1	10.9	10.6	10.6	10.5
Other expense	3.4	3.7	2.7	2.6	2.6	2.6
Net acquisition of nonfinancial assets	3.5	4.2	3.3	3.3	3.4	3.5
Gross Operating Balance	1.5	2.9	2.6	2.7	2.8	2.9
Net lending/borrowing (overall balance)	-2.0	-1.3	-0.7	-0.6	-0.6	-0.6
Memorandum items:						
Overall balance excl. one-offs	-1.8	-1.1	-0.6	-0.6	-0.6	-0.6
Cyclically adjusted overall balance	-1.9	-1.9	-1.4	-1.0	-0.9	-0.8
Cyclically adjusted overall balance, excl. one-offs	-1.7	-1.7	-1.3	-0.9	-0.9	-0.8
Cyclically adjusted primary balance	1.2	0.9	0.9	1.2	1.0	1.1
Cyclically adjusted primary balance, excl. one-offs	1.0	0.7	0.8	1.1	1.0	1.1
Cyclically adjusted overall balance /1	-1.9	-1.9	-1.4	-1.0	-0.9	-0.8
Cyclically adjusted overall balance, excl. one-offs /1	-1.7	-1.7	-1.3	-0.9	-0.9	-0.8
Cyclically adjusted primary balance /1	1.2	0.9	0.9	1.2	1.0	1.1
Cyclically adjusted primary balance, excl. one-offs /1	1.0	0.7	0.8	1.1	1.0	1.1
Primary balance	0.8	1.2	1.4	1.4	1.3	1.3
One-offs	0.2	0.2	0.1	0.1	0.0	0.0
Public debt	64.3	60.8	60.0	59.0	56.6	55.2
Government guaranteed debt	15.8	15.2	14.3	13.6	12.9	12.3
Nominal GDP (millions of euros)	8,426	9,250	9,819	10,356	10,893	11,455

Sources: Maltese authorities; and IMF staff projections.

1/ As a percentage of Nominal Potential GDP.

Table 3. Malta: Balance of Payments, 2014–2019

	Projections					
	2014	2015	2016 Est.	2017	2018	2019
	(Millions of euros)					
Current account balance	805	485	434	451	510	545
Trade balance (Goods and services)	1,066	731	695	726	800	850
Goods balance	-1,117	-1,854	-1,732	-1,864	-1,996	-2,140
Exports	2,618	2,708	2,762	2,823	2,893	2,956
Imports	3,736	4,562	4,494	4,687	4,889	5,096
Services balance	2,183	2,584	2,427	2,590	2,796	2,990
Exports	9,923	10,557	10,768	11,288	11,868	12,447
Imports	7,739	7,972	8,341	8,698	9,072	9,457
Current income, net	-482	-489	-519	-547	-576	-605
Current transfers, net	221	243	258	272	286	301
Private	-598	-591	-742	-783	-823	-866
Public	819	834	1,000	1,055	1,110	1,167
Capital account, net	141	166	177	186	196	206
Financial account, net	199	-657	611	637	706	751
Direct investment	-6,616	-8,780	-9,396	-8,874	-9,335	-9,816
Portfolio investment	13,201	4,703	4,992	5,265	5,538	5,824
Other investment	-5,821	4,460	6,042	5,329	5,642	5,941
Reserves (- inflow; + outflow)	12	-73	0	0	0	0
Errors and omissions	-746	-1,309	0	0	0	0
	(Percent of GDP)					
Current account balance	9.6	5.2	4.4	4.4	4.7	4.8
Trade balance (Goods and services)	12.6	7.9	7.1	7.0	7.3	7.4
Goods balance	-13.3	-20.0	-17.6	-18.0	-18.3	-18.7
Exports	31.1	29.3	28.1	27.3	26.6	25.8
Imports	44.3	49.3	45.8	45.3	44.9	44.5
Services balance	25.9	27.9	24.7	25.0	25.7	26.1
Exports	117.8	114.1	109.7	109.0	108.9	108.7
Imports	91.8	86.2	84.9	84.0	83.3	82.6
Primary income, net	-5.7	-5.3	-5.3	-5.3	-5.3	-5.3
Secondary income, net	2.6	2.6	2.6	2.6	2.6	2.6
Private	-7.1	-6.4	-7.6	-7.6	-7.6	-7.6
Public	9.7	9.0	10.2	10.2	10.2	10.2
Capital account, net	1.7	1.8	1.8	1.8	1.8	1.8
Financial account, net	2.4	-7.1	6.2	6.2	6.5	6.6
Direct investment	-78.5	-94.9	-95.7	-85.7	-85.7	-85.7
Portfolio investment	156.7	50.8	50.8	50.8	50.8	50.8
Assets	157.3	40.5	40.5	40.5	40.5	40.5
Liabilities	0.6	-10.3	-10.3	-10.3	-10.3	-10.3
Other investment	-69.1	48.2	61.5	51.5	51.8	51.9
Assets	-23.7	-21.8	-21.8	-21.8	-21.8	-21.8
Liabilities	45.3	-70.0	-83.3	-73.2	-73.6	-73.7
Reserves (- inflow; + outflow)	0.1	-0.8	0.0	0.0	0.0	0.0
Errors and omissions	-8.9	-14.1	0.0	0.0	0.0	0.0
Memorandum items:						
Gross external debt (Percent of GDP)	1,109.9	962.8	911.4	868.5	830.4	794.4
Net external debt (Percent of GDP)	-298.7	-249.5	-250.7	-252.0	-253.4	-255.0

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

Table 4. Malta: Financial Soundness Indicators, 2012-2016 H1 /1

(Percent, unless otherwise indicated)

	Core Domestic Banks					Non-Core Domestic Banks					International Banks					Total Banks				
	2012	2013	2014	2015	2016H1	2012	2013	2014	2015	2016H1	2012	2013	2014	2015	2016H1	2012	2013	2014	2015	2016H1
Core FSIs																				
Regulatory capital to risk weighted assets	16.1	16.5	14.5	15.0	15.8	26.9	22.6	17.4	22.5	15.9	115.7	119.6	69.2	56.9	66.8	55.8	46.2	25.8	21.9	24.1
Regulatory Tier 1 capital to risk-weighted assets	12.1	12.9	11.6	12.2	13.0	24.3	22.1	17.1	18.9	12.8	115.2	119.6	69.1	51.1	62.2	53.3	43.9	23.7	18.5	21.0
Non-performing loans net of provisions to capital	37.4	39.0	42.6	38.0	31.7	7.7	2.1	7.7	8.5	11.3	0.2	0.8	3.0	4.6	4.2	6.2	9.4	21.6	23.6	18.9
Non-performing loans to total gross loans	7.8	9.0	7.6	7.2	6.4	9.8	3.7	4.6	4.1	4.3	0.5	1.4	5.5	0.9	1.3	3.8	5.6	7.7	4.3	4.1
Return on assets	1.1	1.1	0.7	0.7	1.0	1.2	0.3	-1.3	0.2	0.7	1.1	0.3	0.9	1.0	1.6	1.1	0.6	0.7	0.9	1.3
Return on equity	15.5	15.3	9.8	9.9	12.8	6.9	1.6	-6.4	1.4	7.8	4.6	2.3	2.4	3.4	24.9	5.9	3.7	3.6	5.9	18.1
Interest margin to gross income	61.8	63.6	64.8	64.5	63.9	14.7	42.0	46.3	43.5	32.4	123.3	173.6	201.9	137.8	86.9	83.1	101.2	115.1	93.0	73.2
Non-interest expenses to gross income	45.5	47.1	51.2	54.1	54.5	28.7	64.8	56.1	73.4	70.2	7.1	10.0	11.9	24.8	26.2	27.4	34.9	36.8	43.3	42.0
Non-interest income to gross income	33.2	36.4	35.2	35.5	36.1	71.0	58.0	53.7	56.5	67.6	-24.4	-73.6	-101.9	-37.8	13.1	16.9	-1.2	-15.1	7.1	26.8
Liquid assets to total assets	26.6	27.2	28.3	31.8	34.1	15.5	20.2	31.7	36.3	33.1	9.9	28.1	19.7	22.7	40.5	19.6	26.9	27.3	31.2	34.8
Liquid assets to short-term liabilities	51.5	51.7	50.4	50.2	54.1	57.9	72.1	77.9	63.3	61.3	146.0	204.2	84.7	83.6	115.6	55.6	59.6	53.9	52.6	57.0
Other FSIs																				
Total Coverage ratio (total provisions to NPLs as per BR/09)	35.5	37.9	40.4	43.5	47.2	63.8	94.6	77.1	63.2	60.6	95.2	43.0	40.5	54.2	51.3	43.6	42.3	42.7	40.2	48.5
Domestic Investment Securities to Total Assets	10.8	11.0	9.7	9.3	9.3	2.9	5.5	4.6	7.7	7.2	0.0	0.0	0.0	0.2	0.2	3.6	4.1	3.9	4.5	4.6
Foreign Investment Securities to Total Assets	18.0	19.3	23.3	21.8	21.5	22.8	21.0	19.5	12.5	14.2	36.2	37.9	52.8	50.4	48.6	29.8	30.6	40.1	36.0	34.9
Unsecured Loans to Total Lending	22.8	26.2	29.0	27.4	27.1	72.0	74.8	65.2	70.9	74.5	55.6	57.3	48.4	30.7	28.9	42.4	41.3	37.7	30.8	30.3
Assets to Total Capital and Reserves (Ratio)	13.2	12.6	14.1	13.7	13.4	3.2	3.4	8.4	8.4	11.1	1.5	1.3	1.7	2.0	2.1	3.1	3.7	6.4	8.0	8.1
Large exposure to total capital	102.0	108.0	103.4	96.5	64.9	186.6	199.9	339.9	158.5	249.2	10.8	17.1	45.3	124.8	97.9	31.4	48.0	88.9	114.0	92.3
Gross asset position in financial derivatives to total capital	2.7	2.1	2.5	2.0	2.5	0.3	0.4	2.3	0.3	0.4	0.5	0.0	0.9	0.6	0.1	0.9	0.5	1.6	1.3	1.2
Gross liability position in financial derivatives to total capital	9.5	4.5	8.2	3.8	5.0	0.8	0.5	2.8	0.7	2.9	0.1	0.1	0.6	0.3	0.4	1.5	1.1	3.7	2.1	2.8
Personnel expenses to non-interest expenses	53.9	50.6	50.8	51.2	51.3	39.6	42.1	45.0	42.5	43.6	25.2	33.3	27.4	23.1	20.8	48.5	48.1	47.4	43.9	41.9
Customer loans to customer deposits	72.1	67.8	64.0	58.2	58.6	86.9	96.2	75.7	60.7	52.8	140.6	79.5	93.1	104.2	79.9	94.0	72.3	71.8	67.9	63.7
Net open position in equities to total own funds	13.8	13.5	13.9	15.4	14.3	139.7	169.4	45.3	82.3	135.7	0.3	0.0	0.3	2.7	1.2	7.8	10.9	9.0	18.1	16.6

1/ Banks' total assets amounted to about 500 percent of GDP (about €48 billion) at 2016H1. Half of these assets are owned by international banks, which have limited or no linkages to the domestic economy. Core domestic banks, which account for 44 percent of the banking sector's total assets, are tightly linked to domestic activity as they rely mainly on domestic deposits and provide the bulk of lending to residents. Non-core domestic banks, which account for about 5 percent of the banking system's assets, maintain small exposure to residents.

Source: Central Bank of Malta

Annex I. Implementation of IMF Recommendations

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

Table 1. Implementation of IMF Recommendations

	2015 Art. IV Advice	Actions since 2015 Art. IV
Fiscal issues	Adopt additional expenditure measures to meet the fiscal targets and use revenues in excess of target to build fiscal buffers.	Fiscal consolidation was pursued in 2016 and the deficit is estimated to have over-performed the budget target. The 2017 budget aims to further reduce the deficit. In-depth reviews of health and education were carried out in 2015 and 2016, respectively, with a view to improve the efficiency and quality of public services.
	Ensure that pension reform measures lead to an increase of effective retirement age and to higher participation in voluntary third pillar.	Some measures were adopted in the 2016 budget . The government is considering the next steps with respect to the other recommendations of Pension Strategy Group.
	Disclose and manage fiscal risks from SOEs.	Enemalta is expected to remain profitable in 2016 following a partial privatization in 2015. Discussions on a possible sale of 49 percent of Air Malta's shareholdings to Alitalia were recently terminated (January 2017).
Financial sector issues	Develop bank recovery plans, collect contributions for resolution fund, and strengthen contingency framework.	Ongoing.
	Introduce additional precautionary macroprudential measures.	Counter-cyclical capital buffer came into effect in 2016. "Other Systemically Important Institutions" (O-SII) buffer will be phased in gradually in 2016-19.
	Coordinate and ensure robust implementation of AML/CFT framework.	Ongoing.
Structural reforms	Encourage participation of women and the elderly.	Ongoing. Recent measures, including free childcare, tapering of benefits, and Employment Aid Program, are expected to continue support higher labor participation rate.
	Ensure effective supervision and strong governance of the planned Development Bank.	Ongoing. The European Commission approved the modalities of the proposed Malta Development Bank (MDB). The MDB is expected to become operational in mid-2017.
	Further improve the efficiency of the judicial system.	Ongoing. More resources were allocated to civil courts (first quarter of 2016). To expedite civil and commercial cases, the parliament adopted an array of amendments to the code of organization and civil procedure (January 2016).

Source of Risks	Relative Likelihood ¹	Impact if Realized
Structurally weak growth in key advanced and emerging economies.	High/ Medium	Medium The Maltese economy is highly open with exports standing at about 143 percent of GDP in 2015, though there is a considerable import content. A secular weak external demand, accompanied by lower FDI, would have an adverse effect on domestic confidence and growth prospects. Higher-than-envisaged gains from recent large scale infrastructure projects and labor market reforms may mitigate adverse spillovers.
Policy response: Allow automatic stabilizers to operate in the short run if growth disappoints. Improve access to finance and maintain structural reform momentum to remove impediments to growth. Continue diversify trade and financial activities. Fiscal policy could be used to mitigate the impact on vulnerable groups.		
Protracted uncertainty associated with negotiating post-Brexit arrangements.	Medium	Medium Malta's trade and financial links with the UK makes it susceptible to a slowdown in the UK economy and to a further depreciation of the Sterling. Heightened uncertainty regarding future relationships between the UK and EU, may weigh on confidence and adversely affect growth prospects. These effects could be larger than projected in the baseline, especially if the process is volatile and/or has significant political repercussions. Some of these effects, however, are likely to be mitigated given the diversification, and capacity constraints in the tourism sector, and possible relocation of firms that service the EU from the UK to Malta, resulting also in a potential increase of FDI inflows over the medium term.
Policy response: Allow automatic stabilizers to operate if growth disappoints. ECB should stand ready to provide liquidity support to euro-system banks if needed. Continue monitoring developments and develop contingency plan to mitigate adverse effects. Continue close supervision to ensure that banks would be able to withstand negative shocks. Fiscal policy could be used to mitigate the impact on vulnerable groups.		
Rising anti-globalization sentiment	High	Medium As a small open economy, Malta is vulnerable to external shocks through trade linkages. Financial spillovers are limited given the relatively high reliance of government and core domestic banks on domestic funding.
Policy response: Participate in a coordinated policy response at the European level. Allow automatic stabilizers to operate. Maintain structural reform momentum to remove impediments to growth. Continue diversify trade and financial activities. Fiscal policy could be used to mitigate the impact on vulnerable groups.		
Tighter and more volatile global financial conditions.	Medium	Medium/Low Malta has been relatively insulated from financial market contagion given public and private sector's reliance on domestic financing, but still vulnerable to weak external demand and lower FDI inflows.
Policy response: ECB should stand ready to provide liquidity support to euro-system banks if needed. Continue to reduce vulnerabilities (fiscal and financial) to ensure stability, improve access to finance and remove remaining structural impediments.		

Source of Risks	Relative Likelihood	Impact if Realized
Slow implementation of structural reforms	Medium	Medium/Low While the positive impact of recent structural reforms is likely to persist over the medium term, delayed implementation of the planned initiatives would negatively affect competitiveness and long-term growth, while increasing long-term fiscal risks. It may also increase social exclusion.
Policy response: Sustain and monitor the implementation of structural reforms, and implement additional measures to safeguard long-term fiscal sustainability.		
A sharp correction in housing prices.	Medium/Low	Medium Core domestic banks are significantly exposed to property market shocks. A significantly lower house prices could weaken bank and household balance sheets, with adverse effects on financial stability and growth. High financial wealth of households, low default rates and the low share of population with mortgages are mitigating factors.
Policy response: Monitor risks, close data gaps, and implement targeted macro-prudential measures. Limit exposure of banks to asset price bubble if they begin to emerge. Ensure that fiscal measures related to the property market, including incentives to first time buyers, do not exacerbate imbalances.		
Changes in the EU corporate tax framework	Medium/Low	Medium Malta's attractiveness as a financial and business location may weaken, with adverse effect on tax revenues, foreign investment, and the external position.
Policy response: Continue diversify the economy and accelerate structural reform implementation to remove impediments to growth, boost productivity and enhance competitiveness. Scrutinize associated new risks.		
¹ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term" and "medium term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.		

Annex III. In-Depth Spending Reviews

To enhance efficiencies and support fiscal consolidation, the government is adopting the recommendations of several in-depth spending reviews that were conducted in recent years.

- **Social benefits.** The first in-depth spending review on social security benefits, completed in September 2014, provided a number of recommendations that were included in the subsequent budgets. The main recommendations included tapering of benefits to enhance the incentives for unemployed to search for employment, in-work benefits to incentivize low-income workers with children to stay in employment, and the youth guarantee scheme to improve the employability and further educational prospects of youths who are not in employment, education, and training.
- **Health.** The in-depth health spending review, completed in September 2015, focused on the State Hospital, given its importance for the health financial resources. The review recommended better scrutiny of the payroll system, overtime, sick leave and allowances, reducing spending on medicines and medical supplies, and improving procurement process. The ongoing budget decentralization at the department level and the notional billing introduced between departments is enhancing transparency of decision making process and enables departments to become more aware of their staffing costs.
- **Education.** The in-depth review in education, initiated in January 2016, includes series of initiatives, such as: (i) free child care for all to ensure school readiness; (ii) a breakfast club state schools, allowing children to attend school before the start of official school hours; (iii) The 3 to 16 club, allowing children to do homework and other extra-curricular activities after school. In addition, the ongoing review aims to use the existing resources more efficiently by consolidating schools, improving teaching and learning, and reducing early school leavers from 20 to 10 percent.

Annex IV. Debt Sustainability Analysis

Malta's public debt has moderated in recent years on the back of deficit reduction, strong growth, and favorable financing conditions. The debt dynamics are robust to most shocks, though under a contingent liability shock that is combined with a low growth scenario, the public debt ratio would increase considerably and remain elevated throughout the projection horizon. The moderate gross financing needs and the low share of debt held by non-residents limit potential vulnerabilities. With large external assets that comfortably cover external liabilities, Malta's external position appears resilient to various types of shocks.

Public debt sustainability

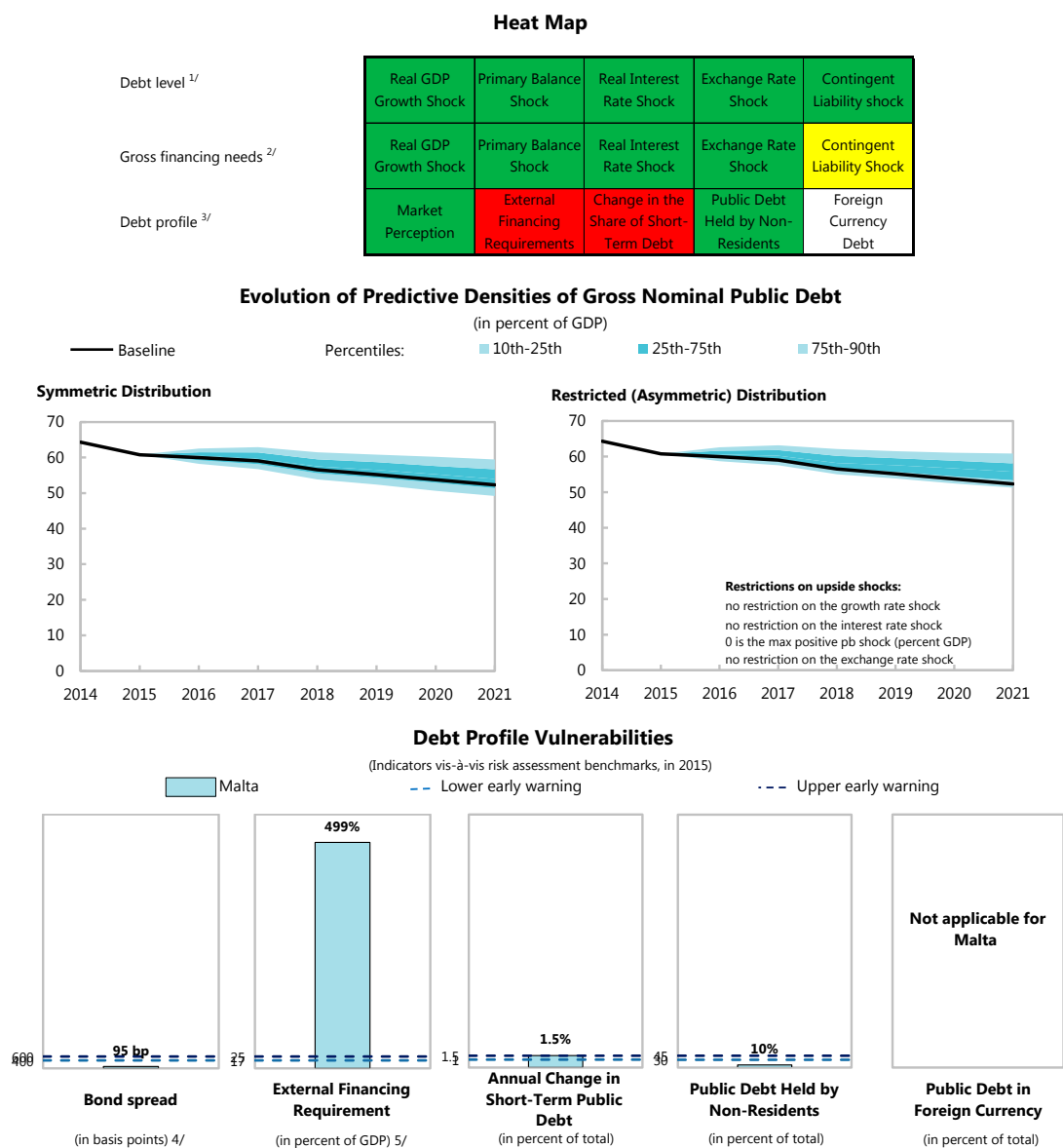
- 1. The public debt is set to remain on a downward trajectory.** Strong nominal GDP growth (9.8 percent) and a higher primary fiscal balance lowered the public debt to 60.8 percent of GDP in 2015 from 64.3 percent of GDP in 2014. Going forward, favorable growth prospects, further fiscal consolidation, and improved financing conditions are expected to support a continued moderation of public debt to about 52 percent of GDP by 2021.
- 2. The stock of government guaranteed debt to non-financial SOEs modestly decreased, but remains high.** Government guaranteed debt declined to 15.2 percent of GDP in 2015 from 15.8 percent of GDP in 2014. The partial privatization of Enemalta and improvement of its financial health, alongside continued restructuring of Air Malta, are likely to reduce risks emanating from SOEs.
- 3. In order to assess the sustainability of government debt, a number of adverse scenarios are considered.** These scenarios include low growth, high borrowing costs, a deterioration in the primary balance, and materialization of contingent liabilities. The results indicate that public debt-to-GDP ratio remains vulnerable to a number of shocks. In particular:
 - Under a growth shock, which envisages a reduction of output by 3.0 percentage points in 2017 and 2018 relative to the baseline (equivalent to one standard deviation of growth over the past 10 years) and a decline in inflation by 0.8 percentage points in 2017 and 0.7 percentage points in 2018 relative to the baseline, debt would peak at 65.4 percent of GDP in 2018, 8.8 percentage points higher than in the baseline and decline to 61.1 percent of GDP in 2021.
 - A sustained interest rate shock of 200bps would slow down the moderation of the public debt ratio such that by 2021 it would reach 53.5 percent of GDP, which is 1.2 percentage points higher with respect to the baseline.
 - A primary fiscal balance shock of 0.4 percentage points in 2017 and 0.3 percentage points in 2018 relative to the baseline would bring public debt to 53.0 percent of GDP in 2021, which is 0.7 percentage points higher relative to the baseline.

- A combined macro-fiscal shock including growth, interest rate and primary balance shock above would result in debt peaking at 65.6 percent of GDP in 2018, 9.0 percentage points higher relative to the baseline, and decline to 62.4 percent of GDP in 2021.
- A contingent liability shock envisages a one-time increase in non-interest expenditures equivalent to 5 percent of the domestic banks' total assets. This shock is accompanied by a real GDP growth shock as the one above (with growth declining by one standard deviation over 2017–2018) while revenue-to-GDP ratio remaining the same as in the baseline. The deterioration of the primary balance leads to higher interest rates while the slowdown in GDP growth lowers the inflation rate. Overall, this shock would increase public debt to 75.0 percent of GDP in 2018, 18.4 percentage points higher relative to the baseline. At the end of the projection horizon, public debt would moderate to 71.0 percent of GDP.
- The government guaranteed shock reflects a contingent liability risk from SOEs. It includes a one-time increase in non-interest expenditures equivalent to 50 percent of government guaranteed debt, accompanied by a transitory negative confidence impact on Malta's spread. Under this shock the debt ratio would peak at 66.6 percent of GDP in 2017, 7.6 percentage points higher than in the baseline, and decline to 60.0 percent in 2021.

Overall, the key risk to public debt is assessed to be originating from contingent liabilities, and low growth.

External debt sustainability

4. Malta's gross external debt is very large but ample external assets appear to comfortably cover its external liabilities. The net short term debt is relatively high (176 percent of GDP), and largely held by international deposit taking corporations, which have limited links to the domestic economy. Limited currency risks and substantial inter-company lending help to reduce potential vulnerabilities. External asset accumulation is likely to continue over the medium-term, on the back of steady service-led current account surpluses. Overall, Malta's external position is likely to remain robust and resilient to various types of shocks.

Figure 1. Malta: Public DSA Risk Assessment

Source: IMF staff.

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

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

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

Lower and upper risk-assessment benchmarks are:

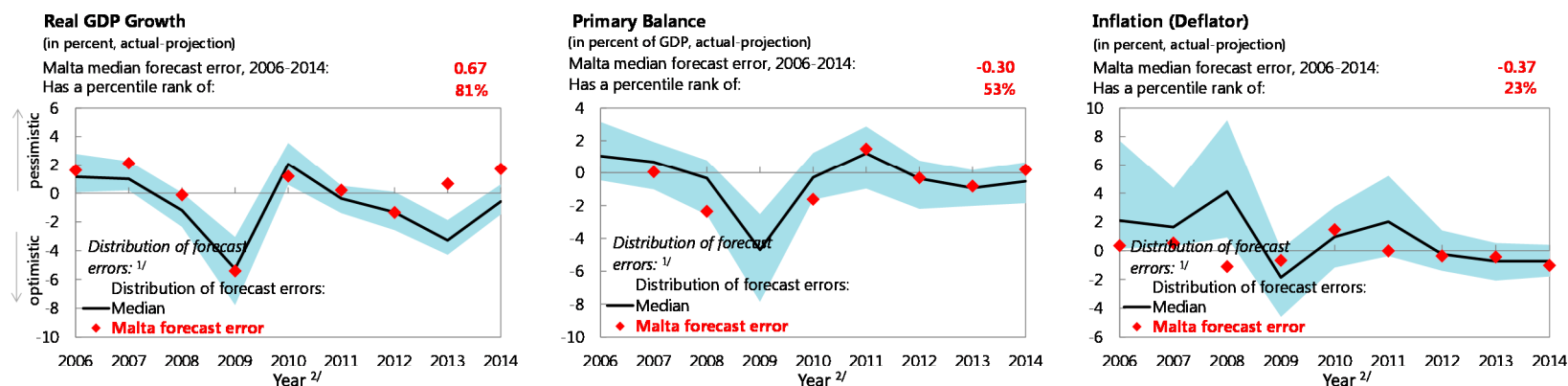
400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 06-Aug-16 through 04-Nov-16.

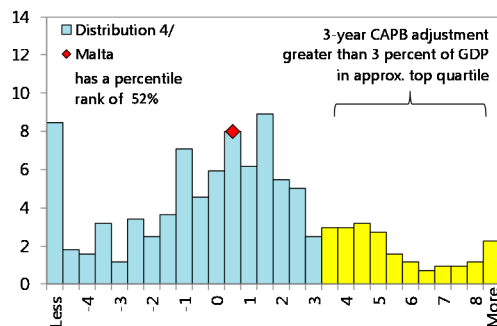
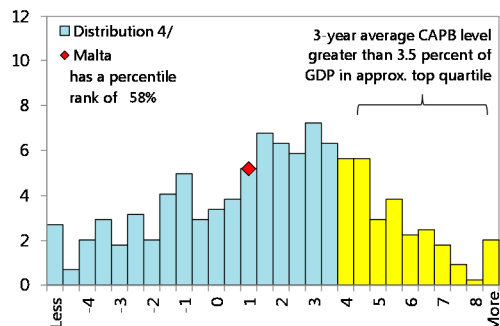
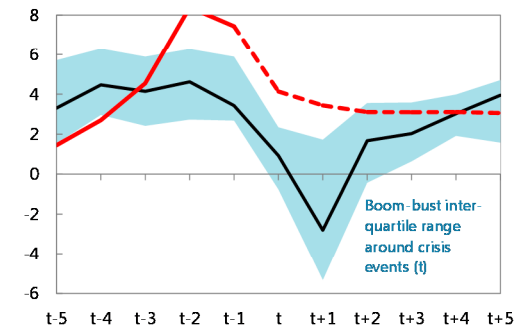
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure 2. Malta: Public DSA – Realism of Baseline Assumptions

Forecast Track Record, versus surveillance countries



Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)Boom-Bust Analysis ^{3/}Real GDP growth
(in percent)

Source : IMF Staff.

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

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

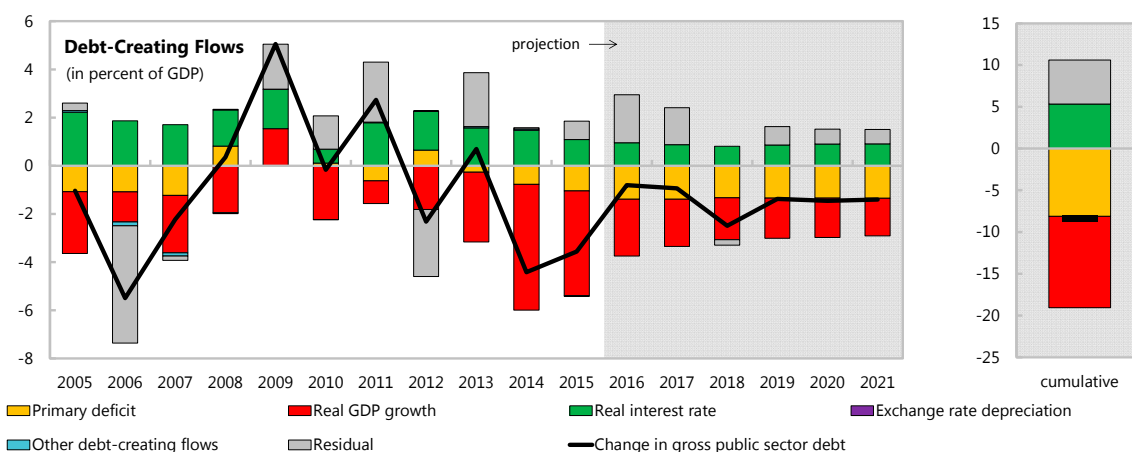
3/ Malta has had a positive output gap for 3 consecutive years, 2013-2015. For Malta, t corresponds to 2016; for the distribution, t corresponds to the first year of the crisis.

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

Figure 3. Malta: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario
(in percent of GDP unless otherwise indicated)

	Debt, Economic and Market Indicators ^{1/}										As of November 04, 2016		
	Actual			Projections									
	2005-2013 ^{2/}	2014	2015	2016	2017	2018	2019	2020	2021	Sovereign Spreads			
Nominal gross public debt	66.9	64.3	60.8	60.0	59.0	56.6	55.2	53.7	52.3	EMBIG (bp) ^{3/} 86			
Public gross financing needs	5.2	4.8	4.9	7.9	7.9	7.8	6.6	6.5	6.7	5Y CDS (bp) 209			
Real GDP growth (in percent)	2.5	8.4	7.4	4.1	3.4	3.1	3.1	3.1	3.1	Ratings	Foreign	Local	
Inflation (GDP deflator, in percent)	2.6	1.9	2.2	1.9	2.0	2.0	2.0	2.0	2.0	Moody's	A3	A3	
Nominal GDP growth (in percent)	5.2	10.4	9.8	6.1	5.5	5.2	5.2	5.2	5.1	S&P's	A-	A-	
Effective interest rate (in percent) ^{4/}	5.2	4.4	4.2	3.7	3.6	3.5	3.7	3.8	3.9	Fitch	A	A	

	Contribution to Changes in Public Debt										
	Actual			Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	debt-stabilizing primary balance ^{9/}
Change in gross public sector debt	-0.3	-4.4	-3.6	-0.8	-0.9	-2.5	-1.4	-1.5	-1.4	-8.5	
Identified debt-creating flows	-0.3	-4.5	-4.3	-2.8	-2.5	-2.3	-2.1	-2.1	-2.0	-13.7	
Primary deficit	-0.3	-0.8	-1.0	-1.4	-1.4	-1.3	-1.3	-1.3	-1.3	-8.1	-0.6
Primary (noninterest) revenue and grants	38.9	39.5	39.8	38.2	37.9	37.9	38.0	38.0	38.0	228.0	
Primary (noninterest) expenditure	38.6	38.7	38.8	36.8	36.5	36.6	36.6	36.6	36.6	219.9	
Automatic debt dynamics ^{5/}	0.0	-3.7	-3.3	-1.4	-1.1	-0.9	-0.8	-0.7	-0.6	-5.6	
Interest rate/growth differential ^{6/}	0.0	-3.7	-3.3	-1.4	-1.1	-0.9	-0.8	-0.7	-0.6	-5.6	
Of which: real interest rate	1.6	1.5	1.1	1.0	0.9	0.8	0.9	0.9	0.9	5.3	
Of which: real GDP growth	-1.6	-5.2	-4.4	-2.4	-2.0	-1.7	-1.7	-1.6	-1.6	-10.9	
Exchange rate depreciation ^{7/}	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipt (negative)	-0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
ESM and euroarea loans	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes ^{8/}	0.1	0.0	0.8	2.0	1.5	-0.2	0.8	0.6	0.6	5.3	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

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

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r))/(1+g+\pi+g\pi)]$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate;

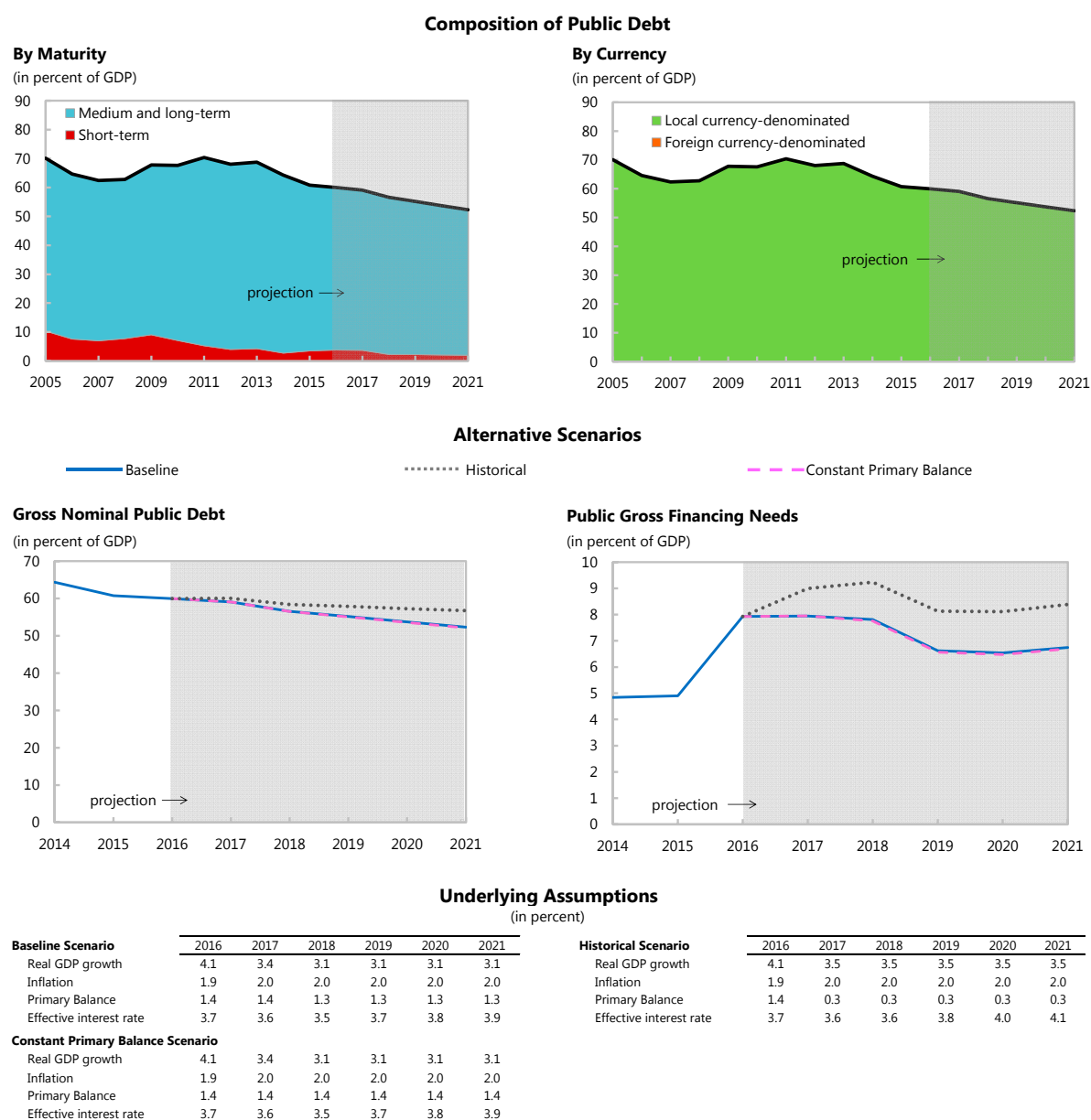
a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

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

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

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

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

Figure 4. Malta: Public DSA – Composition of Public Debt and Alternative Scenarios

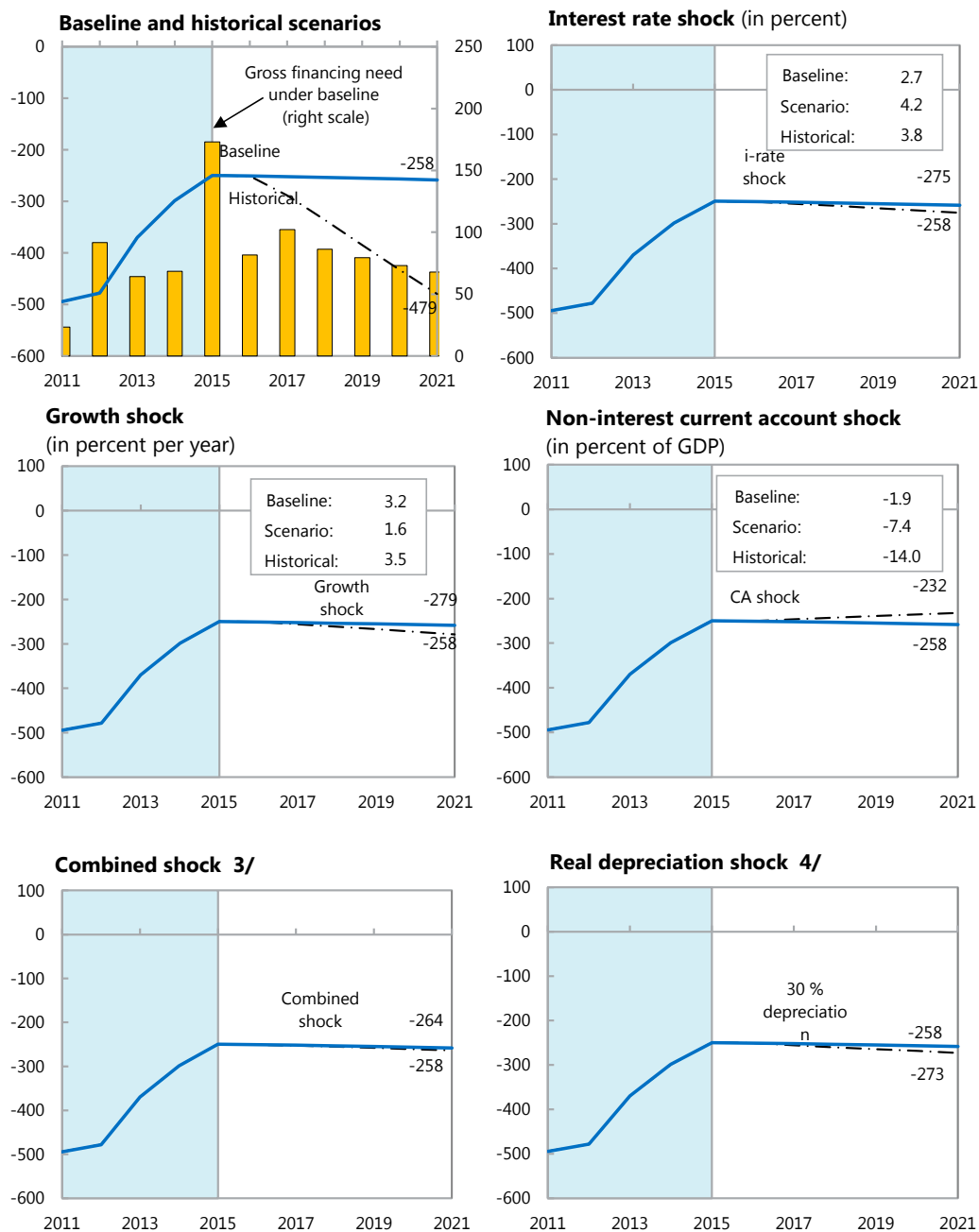
Source: IMF staff.

Figure 5. Malta: Public DSA – Stress Tests



Source: IMF staff.

Figure 6. Malta: External Debt Sustainability: Bound Tests 1/ 2/
(Net External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks.

Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2017.

Table 1. Malta: External Debt Sustainability Framework, 2011-2021
(Net external debt, in percent of GDP unless otherwise indicated)

	Actual					Projections						Debt-stabilizing non-interest current account 6/ -4.4	
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021		
1 Baseline: External debt	-494.3	-478.0	-369.9	-298.7	-249.5	-250.7	-252.0	-253.4	-255.0	-256.6	-258.4		
2 Change in external debt	-5.4	16.3	108.2	71.1	49.2	-1.2	-1.3	-1.4	-1.5	-1.7	-1.8		
3 Identified external debt-creating flows (4+8+9)	-85.4	-35.7	-14.9	37.0	20.4	-8.1	-6.4	-7.5	-7.3	-7.1	-7.0		
4 Current account deficit, excluding interest payments	14.8	12.5	9.4	-0.2	1.6	1.0	1.1	1.5	2.0	2.4	2.6		
5 Deficit in balance of goods and services	-2.6	-4.9	-7.1	-12.6	-7.9	-7.1	-7.0	-7.3	-7.4	-7.6	-7.7		
6 Exports	160.6	165.6	157.2	148.8	143.4	137.8	136.3	135.5	134.5	133.9	133.3		
7 Imports	158.0	160.7	150.2	136.2	135.5	130.7	129.3	128.2	127.0	126.3	125.6		
8 Net non-debt creating capital inflows (negative)	-101.7	-57.6	-40.8	11.6	-2.1	-13.4	-10.6	-10.3	-10.0	-9.7	-9.4		
9 Automatic debt dynamics 1/	1.5	9.4	16.5	25.5	20.9	4.3	3.1	1.2	0.7	0.3	-0.1		
10 Contribution from nominal interest rate	-14.6	-14.2	-12.6	-9.4	-6.8	-5.4	-5.5	-6.2	-6.7	-7.3	-7.6		
11 Contribution from real GDP growth	6.5	13.8	19.7	28.1	24.2	9.7	8.6	7.5	7.5	7.5	7.5		
12 Contribution from price and exchange rate changes 2/	9.6	9.8	9.3	6.8	3.5	...	...	...	...	...	...		
13 Residual, incl. change in gross foreign assets (2-3) 3/	80.0	52.1	123.1	34.2	28.8	6.9	5.1	6.1	5.7	5.4	5.2		
External debt-to-exports ratio (in percent)	-307.9	-288.7	-235.2	-200.7	-174.0	-182.0	-184.9	-187.0	-189.6	-191.7	-193.9		
Gross external financing need (in billions of US dollars) 4/	2.2	8.4	6.5	7.7	17.8	8.9	11.1	9.9	9.6	9.3	9.0		
in percent of GDP	23.5	91.5	64.1	68.5	173.1	10-Year	10-Year	81.8	102.1	86.4	79.4	73.1	67.9
Scenario with key variables at their historical averages 5/						-250.7	-288.5	-336.2	-384.6	-433.0	-479.4	-59.8	
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation						
Real GDP growth (in percent)	1.4	2.7	4.5	8.4	7.4	3.5	3.0	4.1	3.4	3.1	3.1	3.1	
GDP deflator in US dollars (change in percent)	7.1	-5.8	5.3	1.9	-14.7	1.7	8.1	1.7	-2.9	1.8	2.1	1.8	
Nominal external interest rate (in percent)	3.3	2.8	2.9	2.8	2.1	3.8	2.9	2.3	2.2	2.6	2.8	3.0	3.1
Growth of exports (US dollar terms, in percent)	13.8	-0.2	4.5	4.6	-11.7	14.9	28.9	1.7	-0.7	4.3	4.4	4.9	4.4
Growth of imports (US dollar terms, in percent)	11.5	-1.5	2.9	0.2	-8.8	13.4	27.8	2.1	-0.7	4.0	4.3	4.7	4.3
Current account balance, excluding interest payments	-14.8	-12.5	-9.4	0.2	-1.6	-14.0	10.9	-1.0	-1.1	-1.5	-2.0	-2.4	-2.6
Net non-debt creating capital inflows	101.7	57.6	40.8	-11.6	2.1	67.1	46.7	13.4	10.6	10.3	10.0	9.7	9.4

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.



MALTA

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

February 2, 2017

Prepared By

European Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS	2
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FUND RELATIONS

(As of December 31, 2016)

Membership Status

Joined: September 11, 1968; Article VIII

General Resources Account	SDR Million	Percent Quota
Quota	168.30	100.00
Fund holdings of currency	137.15	81.49
Reserve Tranche Position	31.19	18.53

SDR Department	SDR Million	Percent Allocation
Net cumulative allocation	95.40	100.00
Holdings	87.53	91.74

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			
	2017	2018	2019	2020
Principal				
Charges/Interest	0.02	0.02	0.02	0.02
Total	0.02	0.02	0.02	0.02

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

Exchange Rate Arrangement

Member of the euro area since January 1, 2008. Malta maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions with the exception of restrictions notified to the Fund in accordance with decision No. 144-(52/51).

Article IV Consultation

Malta is on the standard 12-month consultation cycle. The previous consultation discussions took place during November 2–13, 2015, and the staff report (Country Report No.16/20) was brought for the Executive Board's consideration on a lapse-of-time basis. The Article IV Consultation with Malta was concluded on January 6, 2016.

Technical Assistance

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

Resident Representative

None

STATISTICAL ISSUES APPENDIX

(As of January 31, 2017)

I. Assessment of Data Adequacy for Surveillance
General: Data provision is adequate for surveillance purposes. Significant progress in improving macroeconomic statistics has been made in close cooperation with the European Central Bank (ECB) and Eurostat while upgrading statistical systems to meet the euro area standards. Most macroeconomic statistics can now be accessed through Eurostat and Haver Analytics. The country has subscribed to the SDDS since December 1, 2009, with the metadata posted on the IMF's Dissemination Standards Bulletin Board.
National Accounts: Malta compiles its national accounts in accordance with the guidelines of <i>ESA 2010</i> since October 2014. The effect of the conceptual differences from <i>ESA 1995</i> on the estimated level of GDP in 2010 was a relative small upward revision of 0.5 percent. Data on retail and consumer prices, labor market indicators, and tourism arrivals are released monthly, usually with a short lag. A harmonized index of consumer prices has been published since May 2004. These data are available through Eurostat and Haver Analytics as well as via the Internet at the Central Bank of Malta (CBM) and the National Statistical Office (NSO) websites. The NSO releases quarterly national accounts data in current and constant prices with a lag of about two months, annual nonfinancial sectoral accounts in current prices with a lag of about 10 months, and a monthly index of industrial production with a lag of just over a month. However, national accounts data have been subject to substantial revisions, often affecting several years. The reasons for revisions include large statistical discrepancies (captured under changes in inventory stocks), particularly on the first release and revisions of deflators. Furthermore, supply-side GDP estimates by type of economic activity are only available at current prices and compilation of volume measures is currently progressing. Volume estimates of expenditure GDP are obtained using annual-chain linking with 2010 as the reference year. The monthly producer price index for total industry 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. Annual Financial balance sheets and transactions by sectors are published on the Eurostat website. However, data on household savings are not available.
Price Statistics: Data on retail and consumer prices are released monthly, usually with a short lag. A harmonized index of consumer prices has been published since May 2004. These data are available through Eurostat and Haver Analytics and via the Internet at the Central Bank of Malta (CBM) and the National Statistical Office (NSO) websites. The monthly producer price index for total industry has been published, but that for services sector is still under discussion.
Government finance statistics: Fiscal statistics meet requirements, with quarterly accrual-based data on general government operations compiled in accordance with the <i>ESA2010</i> 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 with a lag of one month, for which the authorities plan to utilize the targeted timeliness flexibility option in light of additional time required for the final month of the fiscal year.

Monetary and Financial Statistics: Monetary statistics are timely and of good quality. Since the entry into the euro area in January 2008, monetary data for IMF statistical publications have been obtained through a gateway arrangement with the ECB, thus reducing the reporting burden of the country.

Financial Sector Surveillance: Malta has reported Financial Soundness Indicators beginning from 2005 along with metadata, which are available on the IMF's website (<http://fsi.imf.org>).

External sector statistics: Summary data (merchandise trade, current account balance, and selected financial account data) are released by the NSO on a quarterly basis with a lag of about three months. More detailed BOP and IIP data are released quarterly, the latter with a lag sometimes of about one year. Summary trade statistics are released monthly with a lag of about 40 days. The CBM publishes the external debt templates in line with requirements of the SDDS, including both gross and net external debt. In line with the European regulation, Malta has transitioned to *BPM6* and has revised the estimates back to 2008. In line with the BPM6 requirements, the new data include estimates for the SPEs and other coverage improvements, affecting in particular the primary incomes and the financial account (direct and portfolio investments), as well as position data (IIP). The BPM6 implementation and data back casting entailed a series of data revisions recently.

II. Data Standards and Quality

The country has subscribed to the SDDS since December 1, 2009, with the metadata posted on the IMF's Dissemination Standards Bulletin Board.

A data ROSC was published in 2006.

Malta: Table of Common Indicators Required for Surveillance

(As of January 31, 2017)

	Date of latest observation (For all dates in table, please use format dd/mm/yy)	Date received	Frequency of Data ⁷	Frequency of Reporting ⁷	Frequency of Publication ⁷	Memo Items: ⁸	
						Data Quality – Methodological soundness ⁹	Data Quality – Accuracy and reliability ¹⁰
Exchange Rates	Current	Current	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities 1/	Dec 2016	Jan 2017	M	M	Q		
Central Bank Balance Sheet	Dec 2016	Jan 2017	M	M	Q	...	...
Consolidated Balance Sheet of the Banking System	Dec 2016	Jan 2017	M	M	Q	...	...
Interest Rates 2/	Dec 2016	Jan 2017	M	M	M		
Consumer Price Index	Dec 2016	Jan 2017	M	M	M	O, LO, O, O	O, O, LO, LO, O
Revenue, Expenditure, Balance and Composition of Financing 3/ – General Government 4/	Sep 2016	Jan 2017	Q	Q	Q	O, LO, O, LO	O, O, O, LO, O
Revenue, Expenditure, Balance and Composition of Financing 3/ – Central Government	Nov 2016	Dec 2016	M	M	M		
Stocks of General Government and General Government-Guaranteed Debt 5/	Sep 2016	Jan 2017	Q	Q	Q		
External Current Account Balance	Sep 2016	Dec 2016	Q	Q	Q	O, LO, O, O	LO, O, O, O, LNO
Exports and Imports of Goods and Services	Sep 2016	Dec 2016	Q	Q	Q		
GDP/GNP	Sep 2016	Dec 2016	Q	Q	Q	O, LNO, O, LO	LO, O, LO, LO, LO
Gross External Debt	Sep 2016	Dec 2016	Q	Q	Q		
International Investment Position 6/	Sep 2016	Dec 2016	Q	Q	A		

Malta: Table of Common Indicators Required for Surveillance
(As of January 31, 2017) (Concluded)

- 1/ Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
- 2/ Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
- 3/ Foreign, domestic bank, and domestic nonbank financing.
- 4/ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
- 5/ Including currency and maturity composition.
- 6/ Includes external gross financial asset and liability positions vis-à-vis nonresidents.
- 7/ Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
- 8/ These columns should only be included for countries for which Data ROSC (or a Substantive Update) has been published.
- 9/ This reflects the assessment provided in the data ROSC or the Substantive Update (published on August 2006, and based on the findings of the mission that took place during June 22 – July 5, 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).
- 10/ Same as footnote 9, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

**Statement by Carlo Cottarelli, Executive Director for Malta and Antonio Bassanetti,
Senior Advisor to the Executive Director
February 17, 2017**

The authorities of Malta express their appreciation to the Fund staff for very constructive consultations, based on open dialogue, mutual trust and careful consideration of each other's point of view. Pursuing such an approach over the years allowed the Fund to be considered as a trusted advisor in Malta, as testified by the very high degree of implementation of the policy recommendations made in previous Article IV consultations.

The authorities of Malta are in broad agreement with the thrust of the 2016 Article IV Report, and would like to provide the following comments.

Macroeconomic outlook

As clearly described in the Report, over the last few years Malta has experienced strong growth, low unemployment, contained inflation, and a buoyant external position. Such a performance is neither the result of a post-crisis rebound – Malta weathered well both the global financial crisis and the euro area sovereign crisis – nor of an unbalanced growth model. Rather it reflects the continued strengthening of fundamentals through a proactive approach to macroeconomic, structural, and financial policies. Beyond being beneficial *per se*, the authorities' policy strategy allowed the country to take full advantage also of the improving external environment.

Since joining the euro in 2008, Malta has halved its per capita GDP gap with respect to both the EU and the euro area average, with the latter gap closing from around 74 to 87 percent (in purchasing power standards). Malta is thus a leading example of European integration. Going forward, the authorities' assessment of the outlook is broadly in line with that of the IMF staff, though they see risks as being more balanced, rather than tilted to the downside.

Regarding external risks, Malta has already demonstrated its resilience in recent years, despite the severe negative shocks that hit its regional context. Malta is well placed to respond to future shocks by relying on an even stronger set of fundamentals, including and increasingly attractive business environment, a well-diversified economy, and sounder public finances. On the domestic side, there is broad consensus that the capacity to deliver on sound policies and relevant structural reforms is a critical competitive advantage of the country, and that – as proven by the recent performance – there is a premium in 'staying ahead of the curve' when tackling potential vulnerabilities.

The Maltese authorities agree that the main challenge now facing Malta is consolidating the recent achievements, which would then form the basis for further leveraging its development prospects. This requires addressing the main bottlenecks in the country's production capacity: labor supply should rise faster, skill mismatches should be overcome, innovative

capability should be improved, and infrastructure should be strengthened – particularly in the transport sector. The authorities are determined to pursue these objectives, while persevering with a sound, balanced and cautious approach to macroeconomic policies.

Economic structure

All available estimates point to a sharp increase of Malta's potential output growth since the global financial crisis. It is now time to push for a further breakthrough in each single component – labor, capital, productivity – in order to ensure continued progress.

Labor supply. Since 2010, the labor market participation in Malta has increased by around 7 percentage points, to 67.6 percent, mainly on the back of the steep positive trend in female participation. The measures introduced in recent years – like free childcare for working parents, tax deductions for the use of private child care centers, free early and after school opening, and fiscal incentives for females returning to the labor market – have thus proven to be very effective. Yet, both the remaining gap with the European average – though more than halved in the last five years – and the labor shortages that are being experienced, point to the need for further improvements in labor supply.

The authorities rank this among the highest priorities and are confident that many recent measures undertaken on several fronts will deliver results in the coming years. Such measures include, among others, the 2016 pension reform which provides incentives for remaining active in the labor market beyond the statutory retirement age; the tapering of some social benefits to stimulate the search for employment; the in-work benefit scheme to help low-income working parents staying employed; the progressive reduction of personal income tax spread over 2013-2015 and the raising of the tax-free income tax thresholds.

The Maltese authorities also recognize the need to enhance the quality of labor supply. The goal is for educational attainments and vocational training to be better attuned to the rapidly changing structure of the Maltese economy. Reflections are ongoing on ways to enhance both teaching and learning, including through the recently concluded in-depth review of the education system. Vocational training is also being pursued through the Youth Guarantee Scheme – in place since a few years – and the educational grants for unemployed single parents.

Capital stock. In recent years the capital stock has been boosted by the implementation of some large projects, particularly in the energy sector (building of new gas plants, realization of an interconnector with Sicily, among others). A substantial contribution came also from strong government investment, which in turn benefitted from the authorities' capacity to ensure full absorption of the country's entitlements to EU structural funds.

However, like in the case of the labor supply, the infrastructure development is not matching the pace of a fast growing economy, particularly when it comes to the transport sector. Tackling these bottlenecks inevitably takes some time. The very small dimension of the island and its morphology add complexity to the issue. However, apart from substantial infrastructural investments in major road arteries to ease traffic flows, the authorities have increased substantially the subsidy contribution to the Public Transport operator, a measure that has contributed to enhance the service leading to greater use. This year those turning 18 years old have been granted free entitlement to unlimited public transport use to get them used to it before buying a private car, 18 being the legal driving age. There are also plans for expansion of the Airport terminal by the private operator and the construction of a breakwater to Valletta's second harbor is being considered for financing under the EFSI Junker Plan.

Productivity. The authorities are aware that there is significant room for improving productivity. Besides the focus on the education and vocational systems, measures are being taken to facilitate access to finance, particularly for SMEs, as a precondition to foster investment and innovations; particular care is also taken to assist firms to internationalize and to ensure continued improvements in the business environment. More specifically:

- As for SMEs: (i) the so-called Microinvest scheme – which proved very effective in recent years by envisaging a tax rebate for investment activity – has been extended to 2020; (ii) in 2016 the B-Start scheme has been launched to support innovative start-ups; (iii) since a couple of years, Malta Enterprise – the national development corporation – is offering a microguarantee scheme for loans to SMEs; (iv) the recent launch of the Credit Register will reduce asymmetries of information; (v) the Development Bank should become operational this year with the objective of facilitating access to credit for SMEs and financing infrastructure investments; (vi) finally Trade Malta will provide support to SMEs in their internationalization efforts.
- As for the business environment, Malta Enterprise has recently overhauled the procedures for setting up a business, thereby reducing the required days from 32 to just 2 or 3 by filling out a short electronic form on an online portal following a two-steps procedure. A similarly sharp decrease in the costs of setting up a business has also been achieved (down to around €100 from more than €1,000). Self-employed could start operations by following a simple and free one step procedure which can be completed in one day. The time needed to open up the utilities accounts (electricity, water, etc.) decreased by around 60 percent. For the coming years, Malta Enterprise is working on further simplification of the procedures for both running and closing a business.
- In order to favor a healthier corporate sector, the amendment to the Companies' Act – envisaging substantial modifications to the insolvency regime – is being discussed by Parliament. Among the proposed changes, the new regime foresees a short period of

time – just four months – to complete the insolvency procedures (extendable to twelve months only under exceptional circumstances). An out-of-court mediation mechanism is also envisaged under specific circumstances. Finally, a “second chance” principle would be introduced. These measures should contribute to a quick repair of businesses’ balance sheets, thereby saving jobs and enhancing recovery ratios.

- As reported by staff, many measures have been adopted in recent years to improve the judicial systems. Efficiency indicators are providing some encouraging evidence. The average disposition time has decreased from 834 days in 2013 to 668 in 2015; at the same time, the clearance rate has substantially increased and, by standing above 100 percent since a couple of years, allows the gradual reduction of the backlog. Measures are also being considered to hasten contract enforcement by licensed credit and financial institutions as this will help reducing their NPL levels.

Fiscal policy

The strengthening of fiscal accounts achieved in recent years has been notable. The primary surplus improved and is estimated to have reached 1.5 percent of GDP in 2016. The overall deficit is estimated to have declined to 0.7 percent of GDP, well below the original target, and the public debt-to-GDP ratio fell from the peak of 69 percent in 2013 to an estimated 60 percent in 2016. Going forward, the authorities are determined to continue building fiscal buffers. They plan reaching a surplus of 0.1 percent of GDP by 2019, corresponding to an improvement of 1.5 percentage points in structural terms, thereby reaching the MTO of a balanced budget as planned. This would imply a further sharp decrease of the debt ratio, to close to 55 percent of GDP.

The authorities take note that – in the absence of a full specification of measures – staff projects a slower adjustment pace. At the same time, they would like to reiterate the credibility of their commitment – won by delivering on the sizeable adjustment of recent years – and would recall the strong and broad political support for further enhancing fiscal fundamentals. Their intention is to continue intervening on both sides of the budget, in the context of prudent revenue projections.

On the revenue side, and as reported by staff, the authorities have been adopting measures to improve the efficiency of revenue administration. On the expenditure side, they will further pursue expenditure control and rationalization, relying – among other things – on the evidence provided by the in-depth spending reviews conducted in the last three years in the critical areas of social benefits, health, and education.

The authorities agree with staff’s suggestion to restrain current spending growth. This said, Malta’s current expenditure as a ratio to GDP decreased from 38.4 to 37.1 percent in the last

three years and is significantly lower than the average for the euro area (44.4 percent). As for the risk of spending overruns, in recent years expenditure in priority areas such as health and education was adjusted only in so far as revenues exceeded expectations. In any case, the authorities agree on the need to exercise restraint.

Aging-related pressures are also on their radar screen. The pension reform adopted in 2016 – inspired by the principle of enhancing both adequacy and sustainability – aimed at balancing contributions and benefits through a number of initiatives, mainly through an increase in the contributory period from 40 to 41 years for persons born after 1968, and including an increase in minimum pensions, as well as measures and incentives to delay retirement and increase voluntary savings. The envisaged 5-year monitoring of the results will allow a calibration of the system, if needed, with a view to maintain a stable proportion between the contribution periods and the periods of time during which it is expected that the pension will be paid.

Financial system

As reported by staff, the Maltese financial system is strongly capitalized, highly liquid, profitable, well supervised, and represents one of the points of strength of Malta's economy. These features apply to all the segments of the system, including the core domestic banks, which have the strongest linkages to the domestic economy. The authorities are traditionally taking a proactive approach to further strengthen resilience.

While on a decreasing trend – which is expected to continue on the back of improved credit-worthiness of both NFCs and households – NPLs of core domestic banks (5.6 percent as at September 2016, down from the peak of 9.0 percent in 2013) continue to be closely monitored. The authorities believe that – besides the continued increase of provisions and the significant collateral coverage – building up further buffers is warranted. Thus, they (i) suggest restraint in dividend distribution; (ii) introduced the Other Systemically Important Institutions capital buffers to preserve a strong capital position in the most systemically important banks for the domestic economy; (iii) launched the Countercyclical Capital Buffer to be activated in case of excessive credit growth; and (iv) proposed a change in Banking Rule 9 aimed at establishing concrete plans for banks with NPLs higher than 6 percent to reduce such stock over a 5 year period (in case of failure to deliver on the plans, banks will be required to accumulate additional reserves).

The staff Report points to the high exposure of the banking sector to the real estate industry, which is somehow a structural feature of the Maltese system given the small dimension of the country and the prevailing social and cultural preferences. Bank lending to other sectors is constrained by the extent of foreign direct investment, particularly in manufacturing, where reliance on domestic bank financing is more limited. Furthermore, the shift of the economy towards services, which is less capital intensive, tends to magnify the share of real estate

lending. Given the very high home ownership culture, banks' exposure to the real estate sector is mostly through retail mortgages, where the NPL performance is quite positive. Lending to developers is much more guarded and restrained.

Relatedly, the authorities agree with staff that currently there are no misalignments in property prices. Concerning household debt, the authorities would take a more nuanced view compared to staff, as most of the rise of the debt as a ratio of disposable income occurred prior to 2009-10, with the ratio being broadly stable ever since (as shown also by the chart in the main Report and in the SIP). In other words, in the last six years, mortgage growth has been broadly in line with growth in household disposable income. Furthermore, some mitigating factors further reduce risks, as acknowledged also by staff, such as the sizeable households' financial wealth and their very low default rate. Also, while mortgage loans are concentrated in a small fraction of highly exposed households, the latter mostly belong to younger cohorts, with a relatively high level of education and – thus – favorable perspectives in terms of disposable income. In any case, the authorities are monitoring the situation closely – for example by enhancing data collection on banks' exposure to the real estate sector and on credit standards (which remain prudent with low loan-to-value and debt-servicing-to-income ratios), or by running stress tests assuming sharp drops in housing prices (in the order of 20 to 30 percent). They stand ready to intervene through macro-prudential measures, if needed. In this respect, the European Systemic Risk Board has recently concluded that no further measures are currently needed in Malta.