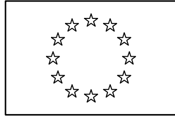

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 08 July 2004
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CONVERGENCE PROGRAMME OF MALTA
(2004-2007)
AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The first Convergence Programme covering the period 2004-2007 was submitted by the government of Malta on 21 May 2004. The programme indicates the intention to move to the final stage of EMU as soon as the country complies with the convergence criteria. The programme aims to achieve a sustainable economic growth and a high and stable level of employment to prompt real convergence. To this end, the policy strategy builds on restoring fiscal balances to sustainable levels in the medium term and to ensure stability in the external sector.

The convergence programme complies only partly with the data requirements of the Code of Conduct. In particular, the statistical information does not entirely adhere to ESA95 standards. GDP and its components are calculated in accordance to the System of National Accounts 1993 (SNA 1993), while fiscal ratios are based on the ESA95 nominal GDP. Therefore, comparability between different parts of the programme is not fully ensured.

The general government deficit increased to 6.5% of GDP in 2003 (excluding a 3.2% of GDP due to one-off operation), above the 3% of GDP Treaty reference value, while the debt ratio increased to 72.0% of GDP, above the 60% of GDP Treaty reference value. The Commission initiated the excessive deficit procedure for Malta on 12 May 2004, with the adoption of a report in accordance with Article 104(3) of the Treaty. The Economic and Financial Committee issued its opinion on the Commission's report on 25 May. On 5 July 2004, the Council is expected, on the basis of two Commission recommendations, to decide that an excessive deficit exists in Malta and to make recommendations to Malta to bring this situation to an end.

The convergence programme presents a significant revision of the SNA93 real GDP growth rate for 2003. In contrast with an estimated real growth rate of 0.4% projected in the Commission 2004 Spring forecast, the programme presents a fall of GDP in real terms of 1.7%. According to the programme, the contraction in 2003 is due to an unexpected fall of exports by 2.2% in real terms coupled with an increase of 6.4% in total imports also in real terms. Private consumption rose only by 0.3%, while, as consequence of a strong fiscal expansion, government consumption increased by 6.0%. Gross fixed capital formation grew by 21.2%. However, such a large increase actually reflects the low level of investment in 2002, when the Maltese government sold an aircraft. In parallel with the strong fall in activity, employment declined by 0.8%. The inflation rate dropped to 1.3% in 2003, due to subdued domestic demand and a low pass-through of the Maltese lira depreciation against the euro. Following the sharp revision of the real GDP growth rate for 2003, the medium-term scenario outlined by the programme for 2004 and 2005 is somewhat more cautious than the Commission 2004 spring forecast.

The government of Malta is committed to achieve a sound public finance position in the medium term. The general government deficit should decrease from 5.2% of GDP in 2004 to 2.3% of GDP in 2006 and 1.4% in 2007, well below the 3% reference value but still inconsistent with a close-to-balance budgetary position. The strategy spelled out in the programme is based on spending control and rationalisation, complemented on the revenue side by improving tax administration in order to avoid tax evasion. A part of the

[1] This assessment has been carried out on the basis of information available as of 16 June 2004.

adjustment is expected to come from higher nominal GDP growth. It is worth noticing that while the adjustment path seems to be consistent with the projected nominal GDP growth rates, calculated on the basis of SNA93, nominal GDP growth rates, on the basis of in ESA95, appear somewhat overestimated, which could lead to an underestimation of the deficit-to-GDP ratio.

The budgetary targets in the convergence programme are somewhat more ambitious than those in the 2003 pre-accession economic programme (PEP), which was based on a slightly more favourable growth scenario. While the PEP projected a general government deficit still above the 3% of GDP reference value in 2006 at 3.4% of GDP, the corresponding figure in the convergence programme is 1.1 percentage points lower at 2.3% of GDP, which would imply the a correction of the excessive deficit by 2006.

Over the programme period, overall revenues are projected to decline from 45.3% of GDP in 2004 to 43.0% of GDP in 2007, while public expenditures would decrease from 50.5% of GDP in 2004 to 44.4% in 2007. The adjustment will fall on both current and capital expenditures. Current expenditure would be reduced by 3 percentage points of GDP, from 39% of GDP in 2004 to 36% of GDP in 2007. Although capital expenditures would be cut by almost 40% between 2004 and 2007, at 4.1% of GDP the target by the end of the period is still expected to remain well above the EU average. This sharp reduction of expenditures is the basis for the significant improvement projected in the primary balance, from a deficit of 1.4% of GDP in 2004 into a surplus of 2.2% in 2007.

The programme considers alternative assumptions on interest rates and on external demand and assesses their impacts on budgetary targets. A percentage point increase in interest rates between 2004 and 2007 is estimated to have a marginal impact on both growth (0.1%) and deficit (0.3% of GDP). However, an additional percentage point in the growth rate of external demand would improve the deficit by 0.4% at the end of the programme period.

Government gross debt increased by more than 10 percentage points of GDP in 2003, which pushed the debt ratio to 72.0% of GDP from 61.7% the year before. This increase is to a large extent attributable to the budgetary costs associated with the restructuring of the shipyards. According to the programme, the debt-to-GDP ratio should remain broadly constant in 2004 and 2005and are expected to decline to just over 70% in 2006 and 2007. These programme projections for 2004 and 2005 contrast with the more cautious scenario presented in the Commission's 2004 Spring forecast[2], where the debt ratio is expected to further deteriorate by almost 4 percentage points of GDP until 2005. This difference is explained by a higher primary deficit in 2004 and larger stock flow adjustment in 2005. The decreasing debt-to-GDP ratio presented in the programme over the years 2006 and 2007 is explained by a rising primary surplus and an increasing contribution of the nominal GDP growth. In addition, the programme foresees a reduction of about 2 percentage points of GDP brought about by privatization receipts between 2004 and 2006.

Albeit not in detail, the programme refers to the government's structural reform plans including the privatization and restructuring of public enterprises. However, there is not yet an agreement on the reform of the healthcare and pension systems. The budgetary impact of this reform agenda is not spelled out in the programme.

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[2] The Commission forecast is done on a no-policy change basis for 2004 and 2005.

Malta faces risks of budgetary imbalances in meeting the projected costs of an ageing population. Securing an adequate primary surplus in the medium term together with the implementation of further measures to stem the rise of age-related expenditures, particularly concerning healthcare, is essential to place public finances on a sustainable footing.

Table 1: **Comparison of key macroeconomic and budgetary projections**

		2003	**2004**	**2005**	**2006**	**2007**
Real GDP (% change)	**CP**	**-1.7**	**1.1**	**1.7**	**2.1**	**2.1**
	COM	0.4	1.4	2.0	*n.a.*	*n.a.*
	PEP	1.3	2.5	3.2	3.6	*n.a.*
RPI inflation (%)	**CP**	**1.3**	**3.4**	**2.1**	**2.1**	**2.0**
	COM	1.3	2.7	2.1	*n.a.*	*n.a.*
	PEP	1.6	1.8	1.9	2.0	*n.a.*
General government balance (% of GDP)	**CP**	**-9.7**	**-5.2**	**-3.7**	**-2.3**	**-1.4**
	COM	-9.7	-5.9	-4.5	*n.a.*	*n.a.*
	PEP	-7.4	-5.8	-4.1	-3.4	*n.a.*
Primary balance (% of GDP)	**CP**	**-6.0**	**-1.4**	**0.1**	**1.4**	**2.2**
	COM	-5.9	-2.0	0.5	*n.a.*	*n.a.*
	PEP	-2.8	-1.0	0.6	1.5	*n.a.*
Government gross debt (% of GDP)	**CP**	**72.0**	**72.1**	**72.4**	**70.5**	**70.4**
	COM	72.0	73.9	75.9	*n.a.*	*n.a.*
	PEP	71.7	72.2	70.6	68.4	*n.a.*

Sources:
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecasts (COM)

1. INTRODUCTION

The first Convergence Programme covering the period 2004-2007 was submitted by the government of Malta on 21 May 2004. The programme was compiled by the Ministry of Finance and benefited from inputs from the Central Bank, the National Statistics Office, the National Commission for Welfare Reform and various Ministries and other entities.

The programme complies only partly with the Code of Conduct. Data do not entirely adhere to ESA95 standards. GDP and its components are calculated in accordance to the System of National Accounts 1993 (SNA 1993). This seriously hampers the comparison between different parts of the programme, such as, for instance, fiscal targets expressed in percentage points of GDP, which are based on ESA95 data.

In addition, the programme does not include the chapter V specifically devoted to assess the quality of public finances. However, it presents two annexes on the methodology used to estimate the cyclically adjusted budget balance and a note on the calculation of healthcare and other expenditures affected by long-term trends. It also contains two boxes related to the assumptions underlying age-related projections and an explanatory note on the current pension system in Malta.

The programme considers alternative assumptions on interest rates and on external demand and assesses their impacts on budgetary targets, but it does not carry out a proper sensitivity analysis with respect to alternative growth assumptions.

According to the programme, the general government deficit should decrease from 5.2% of GDP in 2004 to 2.3% in 2006 and then to 1.4% in 2007, well below the 3% reference value but still inconsistent with a close-to-balance budgetary position. In parallel, the programme envisages reversing the upward trend of the debt-to-GDP ratio from 72.1% of GDP in 2004 to 70.4% at the end of the programme period. This strategy is underpinned by a package of measures aiming at controlling and rationalising spending and, on the revenue side, at avoiding tax evasion.

2. MACROECONOMIC DEVELOPMENTS

2.1. Macroeconomic scenario

The external outlook presented in the document is broadly in line with the external economic assumptions released by the Commission in the 2004 Spring forecast. Some differences are displayed regarding interest rates and USD/EUR exchange rate. As far as world trade assumptions are concerned, the programme presents growth prospects per each of the most important export markets for Malta.

The programme includes revised growth figures for 2003 calculated by the National Statistics Office of Malta. According to the programme, the real GDP growth rate has turned negative (-1.7%). This figure sharply contrasts with the estimated positive real growth rate of 0.4% presented in the 2004 spring forecast. High volatile GDP growth is an inherent characteristic of small and open economies, such as the Maltese, which adds to the difficulties of any forecasting exercise.

Real GDP growth revision in 2003

In the Convergence Programme, the Maltese authorities report a drop in real GDP of 1.7% in 2003 due to a revision of the external trade figures for 2003 (see table 2.1 of the programme). The Ministry of Finance has also revised upwards the GDP deflator (SNA 1993) to 1.21, from 1.18 in the Spring Forecast (a difference of 2.5%). As a result, nominal GDP would have increased by only 1.6% in 2003.

Data on GDP and its components in the section 2 of the programme are calculated in accordance with the System of National Accounts 1993 (SNA 1993) and hence not comparable to other data compiled according to ESA95 methodology presented in other sections of the programme.

This is particularly the case of the general government deficit and the debt-to-GDP ratio figures, in which the denominator is the GDP in nominal terms and has been calculated on the basis of the ESA95 methodology. Fiscal targets for the programme period are obtained by applying to the ESA95 GDP of 2003, which was validated by EUROSTAT, the same growth rates as the ones assumed for the SNA 1993 DGP over the Programme period.

At the same time, the Maltese authorities assume in the programme that the revision of the SNA 1993 GDP growth rates does not affect the figures of the general government deficit and debt for 2003, which were communicated in the March 2004 Notification of Debt and Deficit levels. Consequently, the corresponding GDP ratios have been assumed to remain unaffected by the revision of the SNA 1993 data. Since the ESA 95 data notified in March 2004 have not been officially revised, the Commission assessment is based on the validated figures of EUROSTAT and on the Commission 2004 spring forecast.

The contraction of real GDP in 2003 was due to a fall of 2.2% in total exports and to an increase of total imports of 6.4%, both in real terms. Such developments had not been observed or anticipated at the moment of the Commission's 2004 Spring forecast. As a result, the current account deficit amounted to 5.9% of GDP, compared to the estimated 3.4% of GDP in the 2004 Spring forecast. The large impact on GDP growth is explained by the weight of the external sector in the Maltese economy, where the ratio of exports and imports to GDP account for 90% and 95.3% of GDP, respectively.

Real private consumption increased only by 0.3% in 2003, while public current expenditure expanded by 6.0%, reflecting the strongly expansionary fiscal policy implemented by the government. Gross fixed capital formation grew by 21.2% in 2003 also in real terms. Such a high growth rate is to some extent the result of a structural effect reflecting the disinvestment recorded in 2002 due to the sale of an aircraft by the national airline[3]. Employment declined by 0.8%, less than expected in the Commission forecast. The inflation rate remained at a low 1.3% in 2003, although it is expected to increase in 2004 reflecting the increase in the standard VAT rate from January 2004.

Following the sharp revision of the real GDP growth rate in 2003, the medium-term scenario outlined by the programme is somewhat more cautious than the one projected in the latest Commissions forecast. After the fall of 2003, growth is expected to resume and reach 1.1% in 2004 and 1.7% in 2005. This compares with the Commission forecast of 1.4% and 2.0% for, 2004 and 2005, respectively. Growth projections are 2.1% in both 2006 and 2007. According to the programme, headline GDP is expected to grow below

[3] The sale was registered as a disinvestment in 2002.

potential until 2006. The average growth rate of potential output in the period 2000-2003 is estimated around 2.4% compared to an average of 3.7% in the period 1995-1999. During the 2004-2005 period, potential output growth is foreseen to further decline to an average of 1.8%. It is worth noting that while GDP growth rates in nominal terms, based on the SNA93 methodology, seem consistent with the overall macroeconomic scenario presented in section 2, GDP growth rates in nominal terms in ESA95 used to calculate the fiscal ratios appear somewhat overestimated.

Although proper sensitivity analyses with respect to alternative growth assumptions are not carried out, the programme considers alternative assumptions on interest rates and on external demand and assesses their impacts on budgetary targets. A percentage point increase in the interest rate between 2004 and 2007 is expected to have a marginal impact on both growth (0.1%) and deficit (0.3% of GDP). An additional percentage point in the growth rate of external demand would improve the deficit by 0.4% at the end of the programme period.

Table 2: Comparison of macroeconomic developments and forecasts

	2003		2004		2005		2006		2007	
	COM	**CP**	**COM**	**CP**	**COM**	**CP**	**COM**	**CP**	**COM**	**CP**
Real GDP (% change)	0.4	-1.7	1.4	1.1	2.0	1.7	n.a.	2.1	n.a.	2.1
Contributions:										
- Final domestic demand	3.7	5.5	1.1	2.0	1.5	0.9	n.a.	0.2	n.a.	1.4
- Change in inventories	-3.8	0.3	-2.6	0.1	-1.8	-0.2	n.a.	-0.1	n.a.	-0.1
- External balance on g&s	-4.5	-7.6	-1.2	-1.0	-0.1	1.0	n.a.	1.9	n.a.	0.8
Employment (% change)	-1.4	-0.8	-0.2	0.8	1.1	0.7	n.a.	0.7	n.a.	0.7
RPI inflation (%)	1.3	1.3	2.7	3.4	2.1	2.1	n.a.	2.1	n.a.	2.0
GDP deflator (% change)	4.6	1.2	1.1	1.2	1.5	1.3	n.a.	1.3	n.a.	1.3
Current account (% of GDP)	-3.4	-5.9	-4.3	n.a.	-3.9	n.a.	n.a.	n.a.	n.a.	n.a.

Sources:
Convergence programme (CP); Commission services spring 2004 forecasts (COM)

2.2. Sectoral balances

The current account deficit decreased substantially in 2002 due to an exceptional low trade deficit, reflecting the above-mentioned sale abroad of an aircraft by the national airline. The price of this transaction amounted to 2.4% of GDP. Thus, the current account deficit netted from the sale of the aircraft would have attained 3.5% of GDP in 2002. The data provided in the document point to a deterioration in the current account deficit to 5.9% of GDP in 2003, due to a lower surplus in the services balance and to a higher trade deficit.

The direct comparison of figures on exports of goods for 2003 and 2002 leads to a fall of 3.2% in 2003. However, once the exceptional transaction of the sale of aircraft is netted out, the annual rate of change of exports becomes positive at 2.5%, while imports of goods rose by 4.3%. In parallel the surplus in services shrunk by 6.6% in 2003, the transport component absorbing the whole of this amount.

The foreign investment activities of financial institutions in Malta make the income balance very much influenced by income on equity and on debt (interest), while flows between residents and non-residents are relatively marginal. Due to the high degree of variability of the profits recorded by foreign-owned financial institutions, volatility is a main characteristic of the income account. While this account recorded a surplus of 0.6%

of GDP in 2001, the balance turned to the red (by 0.1% of GDP) in 2002 and again to a surplus of 0.8% in 2003. The balance for transfers deteriorated from a surplus of 0.2% of GDP in 2001 to a deficit of 1.1% in 2003.

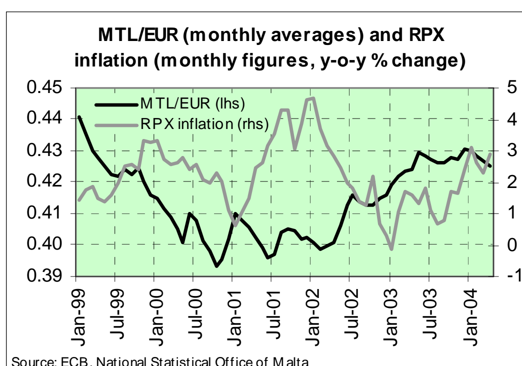
The capital and financial account (excluding movements in official reserves) registered a diminishing surplus from 7.3% of GDP in 2001, to 5.9% of GDP in 2002 and 4.4% of GDP in 2003. The figures in 2002 and, to a lesser extent, in 2003 were dominated by the effect of the repatriation of assets due to the Investment Registration Scheme. Finally, net errors and omissions showed a firm upward trend over the last four years.

All in all, the current account deficit has been financed in the past by the capital and financial account balance generating a gradual increase in reserves. This fact suggests that the Maltese external sector, in the absence of extraordinary shocks, appears to be sustainable in the medium run.

3. Medium-term monetary policy objectives and their relationship to price and exchange rate stability

The Retail Price Index (RPI) was officially introduced in January 2003 with base December 2002 and is the measure of inflation of reference in Malta. On May 18th, for the first time ever, the National Statistics Office published the Harmonised Index of Consumer Prices (HICP), covering the period January 1996 to December 2002. The HICP will henceforth be published on a monthly basis, but data of RPI are more timeless calculated so far.

Retail price inflation continuously decelerated from 2.9% in 2001 to 1.3% in 2003. The drop in 2003 was mainly attributable to subdued domestic demand, and reflected a low pass-through of the Maltese lira depreciation against the euro. The year-on-year percentage change was mostly due to large increases in the prices of clothing and footwear, beverages and tobacco that occurred in the fourth quarter, likely in anticipation of increases in VAT and in tobacco prices at the beginning of 2004. The downward trend in inflation registered from 2001 is expected to be reversed in the first half of 2004, mostly due to the VAT increase. However, the complete removal of excises and import duties from May 2004 is forecast to partly offset the previous rise in prices, thus helping the rate of inflation to remain at 3.4% in 2004 and subsequently to fall back to its pre-2004 levels of around 2.% per annum.



Source: ECB, National Statistical Office of Malta

In view of weaknesses in the domestic and international economic environment and given muted inflation risks, the central bank eased its monetary policy stance substantially since mid-2001, cutting the central intervention rate seven times by a cumulative 175 basis points to 3% by September 2003. Since then, the policy rate has been left unchanged. Government bond yields have substantially converged towards euro area levels, particular in the second half of 2003.

The primary goal of the Central Bank of Malta (CBM) is to achieve price stability. This objective is being realised through a fixed exchange rate system, whereby the Maltese lira is pegged to a basket of foreign currencies consisting of the euro, the US dollar and the pound sterling. The last basket revision was undertaken in August 2002, bringing the weights of these currencies to 70%, 10%, and 20%.

Given the large share of the euro in the reference currency basket, fluctuations in the Maltese lira/euro exchange rate have been limited during the past years. In 2003, the lira depreciated modestly against the euro, while gaining against the other major reserve currencies. Since 1999, the effective exchange rate of the lira has recorded a moderate appreciation, both in nominal and real terms. The real effective exchange rate also recorded a moderate appreciation over that period.

The Converge programme does not address issues of timing relating to euro adoption or ERM II entry, stating merely that *"the Maltese authorities intend to move to the final stage of EMU as soon as economic convergence permits."*

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

4.1. Budgetary developments until 2003

The general government deficit gradually improved from 10.8% to 5.7% of GDP in the period 1998-2002. Cyclical factors can partly explain the reduction in the deficit achieved in 1999 and 2000. However, discretionary adjustment efforts were also made in 2001 and 2002, when GDP growth was not supportive of fiscal consolidation.

Table 3: **General government balance and debt, 1998-2003 (% of GDP)**

	1998	1999	2000	2001	2002	2003
General government balance	-10.8	-7.6	-6.5	-6.4	-5.7	-9.7
General government gross debt	64.9	56.2	57.1	61.8	61.7	72.0

Source:
Commission services

The general government deficit recorded a substantial increase in 2003, when it jumped to 9.7% of GDP compared to 5.7% in the previous year. This outturn implies a substantial slippage compared with the target of 4.6% of GDP set in the Pre-accession Economic Programme (PEP) of 2002, which assumed a real GDP growth of 3.1%. Although the Budget for 2003, presented in November 2002, lowered the growth projection to 2.8%, the former deficit target of 4.6% for 2003 was kept unchanged. These predictions proved unrealistic. Deficit figures were revised upward on the occasion of the presentation of the 2004 Budget, which projected a growth rate of 0.8% and a deficit of 6.4% for 2003.

Despite the difference in growth projections, much of the slippage is not of cyclical nature. It is mainly due to higher than planned public expenditure, and the restructuring of the shipyard industry in 2003. Restructuring of shipyards and associated debt assumed by the general government accounted for a one-off increase of 3.2 percentage points in the deficit. Hence, in 2003, without including the cost of such major one-off operation, the general government deficit would anyhow have spiked to 6.5% of GDP. As a result of such poor budget performance, the debt-to-GDP ratio jumped from 61.7% in 2002 to 72.0% of GDP in 2003.

4.2. Programme overview

The document outlines the government commitment to adopt the necessary policy measures, albeit not thoroughly spelled out, with the aim of achieving a sound public finance position in the medium term. The budgetary strategy is underpinned by enhancing the fight against tax evasion and by rationalizing and reducing public expenditures in terms of GDP. Although to some extent the improvement in the deficit stems from a modest and gradual recovery of the economy, the consolidation path of the fiscal position presented in the programme primarily relies on spending control.

The general government deficit should decrease from 5.2% of GDP in 2004 to 3.7% in 2005, 2.3% in 2006 and 1.4% in 2007. Although the deficit figure at the end of the programme period is well below of the 3% reference value, it still remains inconsistent with a close-to-balance budgetary position.

Over the programme period, budgetary revenues are expected to decline from 45.3% of GDP in 2004 to 43.0% of GDP in 2007. While taxes and social security contributions are projected to remain stable, other revenues are deemed to fall from 10.4% in 2004 to 8.3% in 2007. Public expenditure is projected to decrease from 50.5% of GDP in 2004 to 44.4% in 2007. The programme provides only comprehensive quantitative information on the evolution of some of the components of expenditure.

Current expenditure is expected to fall from 39% of GDP in 2004 to 36% of GDP in 2007, as the government plans to keep the growth rate of this item below nominal GDP growth. Government expenditure is expected to rise by less than 1% with the exception of 2006 when it is expected to decrease by 1.6%. Although the reforms of the national healthcare system and the retirement pension scheme are mentioned in the programme, their budgetary impact is not taken into account in the projection of current expenditures.

Capital expenditures will also fall from 6.7% of GDP in 2004 to 4.1% of GDP in 2007. This represents a fall in nominal terms of 30%, due to the completion of the new hospital in Tal-Qroqq. Interest payments are expected to remain constant below 4% of GDP over the period.

Table 4: Composition of the budgetary adjustment (% of GDP)

	2003	2004	2005	2006	2007	Change: 2007-2003
Revenues	42.8	45.3	45.2	43.9	43.0	**0.2**
of which:						
- Taxes & social security contributions	33.2	34.6	35.3	35.0	34.4	**1.2**
- Other (residual)	9.3	10.4	9.7	8.8	8.3	**-1.0**
Expenditure	52.4	50.5	48.9	46.3	44.4	**-8.0**
of which:						
- Primary expenditure						
of which:						
Gross fixed capital formation	4.7	4.8	n.a.	n.a.	n.a.	
Consumption	10.8	11.2	n.a.	n.a.	n.a.	
Transfers & subsidies	16.1	15.4	14.9	14.4	13.9	
Other (residual)	20.3	17.7	n.a.	n.a.	n.a.	
- Interest payments	3.6	3.8	3.8	3.7	3.6	
Budget balance	**-9.7**	**-5.2**	**-3.7**	**-2.3**	**-1.4**	**8.3**
Primary balance	**-6.0**	**-1.4**	**0.1**	**1.4**	**2.2**	**8.2**

Sources:
Convergence programme; ECFIN calculations

Comment: Page: 1
Please update table 2 pp20 in the assessment annex summary table with these figures.

Table 5: Comparison with 2003 pre-accession economic programme and Commission forecasts (% of GDP)

	2003	2004	2005	2006	2007
			General government balance		
CP	**-9.7**	**-5.2**	**-3.7**	**-2.3**	**-1.4**
COM	-9.7	-5.9	-4.5	n.a.	n.a.
PEP	*-7.4*	*-5.8*	*-4.1*	*-3.4*	*n.a.*
			General government expenditure		
CP	**52.4**	**50.5**	**48.9**	**46.3**	**44.4**
COM	n.a.	46.1	43.7	n.a.	n.a.
PEP	*51.7*	*50.9*	*49.1*	*46.6*	*n.a.*
			General government revenues		
CP	**42.8**	**45.3**	**45.2**	**43.9**	**43.0**
COM	n.a.	40.2	39.2	n.a.	n.a.
PEP	*44.3*	*45.0*	*45.0*	*43.2*	*n.a.*

Sources:
Convergence programme (CP); August 2003 pre-accession economic programme (PEP); Commission services spring 2004 forecasts (COM)

The steady and sharp fall of nominal deficit, coupled with an interest burden almost constant should lead to a substantial improvement in the primary balance, from -1.4% of GDP in 2004 to +2.2% in 2007.

The budgetary developments projected in the Convergence Programme are somewhat more optimistic than the estimations released in the 2003 PEP, which projected a more favourable economic scenario. In the programme, public expenditures expressed as a percentage of GDP are lower than in the PEP, while public revenues are kept higher. Consequently, while the 2003 PEP projected a general government deficit above the Maastricht reference value in 2006 of 3.4% of GDP, the programme projects to reach a general government deficit of 2.3% of GDP by 2006.

4.3. Targets and adjustment in 2004

The deficit target for 2004 in the programme, 5.2% of GDP, is lower than that of the 2004 budget (5.7%), which was presented in November 2003. The target for 2004 is also lower than both the 2003 PEP and the latest fiscal notification, in which the general government deficit was 5.8% of GDP. The Commission's 2004 Spring Forecast foresaw a very close figure of 5.9% of GDP. This was based on expected economic growth developments for 2004 (1.4%) worse than projected in the PEP (2.5%).

Total revenues are set at 45.3% of GDP. Receipts are expected to increase by 5.3% points of GDP. Half of this amount is due to inflows under the Italian Financial Protocol[4] and from EU funds. Other additional receipts should come from enhanced enforcement in tax collection, mainly in the real estate sector, where specific measures were announced, and to a higher VAT tax rate and excise duties.

Total expenditures should reach 50.5% of GDP, which implies an increase of 3.6% of GDP compared to 2003. Such additional expenditures are mainly attributable to rising social benefits and interest payments on public debt. Capital expenditures would increase to 6.6% of GDP, due to the Mater Dei hospital construction project. With a view to promoting awareness of the fact that taxes and other revenues are collected in order to finance specific projects, increasing transparency and control in public finances, the budget will be broken-down into sub-accounts reflecting programmes on the tourist sector, culture, roads, construction and maintenance, health and environment and embellishment.

Recent developments in the Maltese economy, in particular downward revision of real GDP growth rate to -1.7% in 2003, raise some doubts on the feasibility of the public finances scenario presented in the programme for 2004.

4.4. Targets and adjustment in 2005 and beyond

The programme foresees a decrease in the general government deficit to 3.7% of GDP in 2005. Under the no-policy change assumption, the Commission 2004 spring forecast projected a general government deficit of 4.5% of GDP for 2005, whilst in the 2003 PEP the deficit was targeted at 4.1% of GDP, close to the figure anticipated in the 2004 budget (4.3%). The programme foresees the acceleration of the deficit reduction to 2.3% in 2006 and 1.4% in 2007, which contrasts with the scenario outlined in the 2003 PEP where the projected general government deficit remained above the 3% of GDP in 2006.

While revenues are expected to fall slightly after 2005, expenditure reduction is the driving force behind the downward path followed by the deficit until the end of the programme period.

On the revenue side, tax receipts including social security contributions are expected to decrease from 35.3% of GDP in 2005 to 34.4% of GDP 2007. This is notably the result of higher nominal GDP growth. Non-tax revenue is foreseen to decline in the period

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[4] Co-operation agreement between Malta and Italy.

2005-2007 as a result of the Italian Financial Protocol. Consequently, total revenues are projected to decrease from 45.2% of GDP in 2005 to 43.0% in 2007.

According to the programme, total expenditures should fall to 48.9% of GDP in 2005 (from 50.5% in 2004) and to 46.3% and 44.4% in respectively 2006 and 2007. Since the government decided to maintain public employment at 2003 levels, public wages are expected to increase around 2% in annual terms over the period. Other current expenditures, including healthcare, would increase by 6% in 2005 due to some payments in arreas, but they should decrease by 1% and 3% in 2006 and 2007. Furthermore, although the contributions to government entities will increase by 6% in 2005, they should decelerate to 1% and 3% in 2006 and 2007 respectively. This includes state aid to the recently restructured shipyards which is expected to fall by around 50% between 2004 and 2007.

Since some expenditure projects will end during the programme period, capital expenditures are also foreseen to decrease between 2005 and 2007. This includes: the completion of the new hospital and cuts of spending allocated to road construction and repair associated to the phasing out of the Italian Protocol. Additionally, under the assumption of constant interest rates, interest payments are expected to remain below 4% of GDP in 2005 and subsequent years.

The lack of information provided by the programme makes difficult to assess the plausibility of the fiscal targets presented in the document. Specifically, there is no estimation of the impact on expenditure of the healthcare system and pension system reforms. In addition to this, the programme does not include estimates of the fiscal impact of Structural and Cohesion funds co-financing, the amount of which will depend on the capacity of the Maltese economy to undertake new investment projects.

4.5. Debt ratio

After a considerable increase of 10.3 percentage points of GDP in 2003 attributable to the restructuring of the shipyards, which led to a debt-to-GDP ratio of 72.0%, the programme projects a quasi stabilisation of debt in 2004 (72.1%) and 2005 (72.4%). After the peak of 2005, debt is expected to decline to 70.5% in 2006 and 70.4% in 2007. Such relatively positive developments contrast with a more cautious path projected in the Commission Spring forecast[5], where the ratio was expected to deteriorate significantly in 2004 (by 1.9 percentage points of GDP) and in 2005 (by 2 percentage points) to reach 75.9%.

The source of the discrepancy between the Commission forecast and the programme for 2004 lies on a higher primary deficit, although the contribution from the nominal GDP growth is higher in the Commission forecast. For 2005, the main difference stems from a lower stock flow adjustment in the programme.

Privatisation proceeds partially explain the stabilisation of debt levels until 2005 and the decline projected for 2006. The programme refers to the privatisation of enterprises in the services sector, namely Malta Freeport Terminals Limited, telecommunications and banking. However, there is no a detailed quantification of such proceeds, although the programme refers to an effect on the debt ratio of about 2 percentage points 2004 and

[5] The Commission forecast is done on a no-policy change basis for 2004 and 2005.

2006. The declining of debt-to-GDP ratio projected in the last two years of the programme period is driven by a rising primary surplus and rising nominal and real GDP growth rates approaching potential growth.

The debt dynamics should be reassessed in the light of the recent revision of nominal GDP growth for 2003 done by the Maltese authorities.

As far as the structure of the general government debt is concerned, 90% of the total is accounted for by the central government. The share of foreign debt is expected to stay at around 6% till 2007, which implies a high dependence from the domestic market and thus a very limited risk to exchange rate fluctuations. Long term debt maturity is around 81% of total financing in 2003 and it is projected to increase to 87% in 2006-2007.

Table 6: Debt dynamics

	2003		2004		2005		2006	2007
	COM	CP	COM	CP	COM	CP	CP	CP
Government gross debt ratio	72.0	72.0	73.9	72.1	75.9	72.4	70.5	70.4
Change in debt ratio (1 = -2+3+6)	10.3	10.3	1.9	0.1	2.0	0.3	-1.9	-0.1
Contributions:								
- primary balance (2)	5.9	6.1	2.0	1.4	-0.5	-0.1	-1.5	-2.3
- snow-ball effect (3 = 4+5)	0.8	2.9	2.1	0.9	1.5	1.6	1.0	0.7
- interest expenditure (4)	3.8	3.7	3.9	4.0	4.0	4.0	3.9	3.8
- nominal GDP growth (5)	-3.0	-0.8	-1.8	-3.1	-2.5	-2.4	-2.9	-3.1
- stock-flow adjustment (6)	3.6	1.3	-2.2	-2.2	1.0	-1.2	-1.4	1.5

Sources:
Convergence programme (CP); Commission services spring 2004 forecast (COM); ECFIN calculations
Note:
The decomposition of the change in the gross debt ratio is based on the following equation for the budget constraint:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth

The programme provides a sensitivity analysis to interest rate fluctuations. One percentage point increase in the interest rate would deteriorate the public budget balance by around 0.3 percentage points of GDP after four years and the debt-to-GDP ratio would increase by 0.1 percentage points in 2004 and by about 0.8 p.p. in 2007.

The programme reports government guarantees at 15% of GDP in 2003 and projects a fall to around 12% in 2007 due to the effect of nominal GDP growth. It is pertinent to note that, according to the programme, there have been no calls on guarantees and there is no indication that such guarantees are likely to be called. The programme warns about comparability problems with data on public guarantees presented in the 2003 PEP (22% of GDP in 2002) which included guarantees to entities which form part of the general government .

5. THE QUALITY OF THE PUBLIC FINANCES

The programme does not include an independent chapter on the quality of public finances, although it makes reference to projects that aim at enhancing structural reforms.

These include the privatisation package, already mentioned in the section on debt, as well as the restructuring of Malta Shipyards, which foresees the phasing out of subsidies to the shipyard industry by 2008, as well as a package for restructuring public enterprises. This latter package is intended to ensure that public entities operate in a more efficient way, which should positively contribute to the country's competitiveness. This includes companies in the transport (Airmalta, Gozo Channel, Malta Traffic, etc.) and telecommunication (Maltapost, Public Broadcasting Services) sectors, as well as some utilities (Water Services Corporation) and the Bank of Valletta.

According to the programme, structural reforms would also concern public governance, aiming at improving the quality of public services, enhancing the use of information technologies by public administrations (e-Government) and promoting Private Public Partnerships.

More detailed measures to improve the quality of public finances were announced in the 2004 Budget. The Budget identified weaknesses in the transparency, efficiency and control of both revenues and expenditures. Measures have been implemented to fight against tax evasion in the real state sector. However, important structural reforms in tax-benefit systems, including healthcare and pensions, remain to be undertaken.

6. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The section on the long-term sustainability of public finances includes demographic and macroeconomic assumptions as well as projections for public expenditures on old-age pensions and health care.

The programme projections on demographic dynamics in Malta evidence a significant budgetary pressure resulting from population ageing in the coming decades. Gradual increase in life expectancy together with the decreasing population within working age is indicated by a significant worsening of the old-age dependency ratio (from 32.7% in 2005 to 81.1% in 2050). If realised, even a relatively optimistic assumption on fertility rates over the period (increasing from 1.37 in 2012 to 2.1 in 2050) does not appear sufficient for counterbalancing the general trend of ageing. On the whole, the total dependency ratio is expected to increase from 75.2% in 2005 to 125.6% in 2050.

In order to improve the prospects for long-term sustainability of public finances, the Maltese authorities have set up a National Commission for Welfare Reform aimed at presenting proposals for the reform of the 1st pillar later this year. Concerning health care, the authorities want to conclude discussions on the health care reform, which envisages a rationalisation of health care expenditures by the end of the year. Additional improvements in the health care system are required in order to contain the expected increase in health expenditures over the projection period, in particular between 2010 and 2030.

On the basis of the available quantitative information in the programme, age-related expenditures are foreseen to increase by 1% of GDP between 2005 and 2050. While pension expenditures are foreseen to decrease by 1.6 percentage points, health care expenditures are projected to increase by 2.6 percentage points over the projection period. However, considering also the expected fall in pension contributions stemming from the demographic evolution, the financing gap in the Maltese pension and health care system will be much higher. The programme projections confirm the need for reforming the pension system as the current pension system's deficit is expected to

increase significantly from its present level (0.2% of GDP in 2003) until 2030 (4.7% of GDP) before stabilising at the level just above 4% of GDP in 2050. Moreover, given that health expenditures are currently financed by revenue generated from contributions, health care system will be also under high budgetary pressure. Particularly significant is the projected dynamics in the age-related expenditures in the period between 2010 and 2030, when the full impact of ageing should take place. As far as the medium-term is concerned, budgetary strategy of the programme based on a gradual budgetary consolidation over the programme period would allow the government debt/GDP ratio to decline from currently relatively high levels.

The risk to long-term sustainability of public finances further increases if the objectives set in the convergence programme fail to materialise. Firstly, given the expected imbalances in pension and health care systems, substantial reforms are required to mitigate the effects of an ageing population. Moreover, negative dynamics in government debt/GDP ratio during the recent years, has resulted from the negative impact of primary balance and relatively high interest payments. For the government debt/GDP ratio to start falling according to the programme, it is therefore of the utmost importance that the planned budgetary consolidation is achieved. In addition, given the relatively high government debt/GDP ratio the expected decline in state guarantees should be closely monitored (from 15% of GDP in 2004 to 12% of GDP over the medium-term). On the whole, planned budgetary consolidation, strict application of the Financial Administration and Audit Act and successful privatisation of remaining state assets should have a favourable impact on the debt dynamics in the programme period.

Summing up, the future unfavourable demographic situation requires a comprehensive strategy for containing the costs of population ageing. The recent high deficits and government debt/GDP ratio are a source of great concern for long-term sustainability of public finances and it is critical for Malta to consolidate its general government imbalances according to the programme. If fully applied, the budgetary strategy outlined in the programme is compatible with improving the sustainability of public finances. In addition, monitoring of the risks associated with the outstanding state guarantees is necessary to avoid future budgetary imbalances. On the whole, there are risks of budgetary imbalances emerging in Malta if the budgetary strategy outlined in the programme is not adhered to.

ANNEX: SUMMARY TABLES FROM THE CONVERGENCE PROGRAMME

Growth and Associated Factors

Table 1

	2003	2004[1]	2005	2006	2007
Percentages unless otherwise indicated					
GDP growth at constant market prices	-1.7	1.1	1.7	2.1	2.1
GDP level at current market prices	1,712.2	1,789.2	1,850.0	1,925.9	2,014.5
GDP deflator	1.2	1.2	1.3	1.3	1.3
RPI change (annual average)	1.3	3.4	2.1	2.1	2.0
Employment growth	-0.8	0.8	0.7	0.7	0.7
Labour productivity growth [2]	-0.9	0.2	1.0	1.3	1.4
Sources of growth: percentage changes at constant prices					
1. Private consumption expenditure	0.3	0.2	0.8	1.5	1.8
2. Government consumption expenditure	6.0	1.1	-1.1	-0.3	-0.9
3. Gross fixed capital formation	21.2	6.7	2.1	-2.6	1.7
4. Changes in inventories and net acquisition of valuables as a % of GDP	-4.2	-4.0	-4.1	-4.1	-4.1
5. Exports of goods and services	-2.2	1.3	2.9	3.0	2.7
6. Imports of goods and services	6.4	2.3	1.6	0.8	1.8
Contribution to GDP growth					
7. Final domestic demand	5.5	2.0	0.9	0.2	1.4
8. Change in inventories and net acquisition of valuables	0.3	0.1	-0.2	-0.1	-0.1
9. External balance of goods and services	-7.6	-1.0	1.0	1.9	0.8

Note: National Accounts figures are based on the System of National Accounts 1993 (SNA 1993).
[1] Forecasts from 2004 onwards.
[2] Growth of GDP at market prices per person employed at constant prices.

General Government Budgetary Developments

Table 2

Percentages of GDP	ESA code	2003	2004	2005	2006	2007
Net lending (B9) by sub-sectors						
1. General government	S13	-9.7	-5.2	-3.7	-2.3	-1.4
2. Central government	S1311	-9.7	-5.2	-3.8	-2.4	-1.4
3. State government	S1312	n/a	n/a	n/a	n/a	n/a
4. Local government	S1313	--	--	--	--	--
5. Social security funds	S1314	n/a	n/a	n/a	n/a	n/a
General government (S13)						
6. Total receipts	ESA	42.8	45.3	45.2	43.9	43.0
7. Total expenditures	ESA	52.4	50.5	48.9	46.3	44.4
8. Budget balance	B9	-9.7	-5.2	-3.7	-2.3	-1.4
9. Net interest payments		3.6	3.8	3.8	3.7	3.6
10. Primary balance		-6.0	-1.4	0.1	1.4	2.2
Components of revenues						
11. Taxes	D2+D5	26.3	27.8	28.5	28.3	27.9
12. Social contributions	D61	6.9	6.8	6.8	6.7	6.5
13. Interest income	D41	0.3	0.2	0.2	0.2	0.2
14. Other		9.3	10.4	9.7	8.8	8.3
15. Total receipts	ESA	42.8	45.3	45.2	43.9	43.0
Components of expenditure						
16. Collective consumption	P32	10.8	11.2	…	…	…
17. Social transfers in kind	D63	--	--	--	--	--
18. Social transfers other than in kind	D62	13.0	12.9	12.7	12.4	12.1
19. Interest payments	D41	3.6	3.8	3.8	3.7	3.6
20. Subsidies	D3	3.1	2.5	2.2	2.0	1.8
21. Gross fixed capital formation	P51	4.7	4.8	…	…	…
22. Other		20.3	17.7	…	…	…
23. Total expenditures	ESA	52.4	50.5	48.9	46.3	44.4

General Government Debt Developments

Table 3

Percentages of GDP	ESA code	2003	2004	2005	2006	2007
Gross debt level		72.0	72.1	72.4	70.5	70.4
Change in gross debt		10.3	0.1	0.3	-1.9	-0.1
Contributions to change in gross debt						
Primary balance		6.1	1.4	-0.1	-1.5	-2.3
Interest payments	D41	3.7	4.0	4.0	3.9	3.8
Nominal GDP growth	B1g	-0.8	-3.1	-2.4	-2.9	-3.1
Other factors influencing the debt ratio		1.3	-2.2	-1.2	-1.5	1.5
Of which: Privatisation receipts		-	-1.9	-2.6	-2.5	-
p.m. implicit interest rate on debt		5.0	5.3	5.3	5.3	5.1

Cyclical Developments

Table 4

Percentages of GDP	ESA code	2003	2004	2005	2006	2007
1. GDP growth at constant prices		-1.7	1.1	1.7	2.1	2.1
2. Actual balance	B9	-9.7	-5.2	-3.7	-2.3	-1.4
3. Interest payments	D41	3.6	3.8	3.8	3.7	3.6
4. Potential GDP growth		2.0	1.8	1.8	1.8	1.9
5. Output gap		-1.8	-2.5	-2.6	-2.3	-2.1
6. Cyclical budgetary component		-1.1	-1.6	-1.6	-1.4	-1.3
7. Cyclically-adjusted balance (2-6)		-8.6	-3.6	-2.1	-0.9	-0.2
8. Cyclically-adjusted primary balance (7-3)		-5.0	0.2	1.7	2.8	3.4

Note: National Accounts figures are based on the System of National Accounts 1993 (SNA 1993).

Divergence from PEP for 2003

Table 5

Percentages of GDP	ESA code	2003	2004	2005	2006	2007
GDP growth[1]						
previous update		1.3	2.5	3.2	3.6	n/a
latest update		-1.7	1.1	1.7	2.1	2.1
Difference		-3.0	-1.4	-1.5	-1.5	n/a
Actual budget balance						
previous update	B9	-7.4	-5.8	-4.1	-3.4	n/a
latest update	B9	-9.7	-5.2	-3.7	-2.3	-1.4
Difference		-2.3	0.6	0.4	1.1	n/a
Gross debt levels						
previous update		71.7	72.2	70.6	68.4	n/a
latest update		72.0	72.1	72.4	70.5	70.4
Difference		0.3	-0.1	1.8	2.1	n/a

[1] National Accounts figures are based on the System of National Accounts 1993 (SNA 1993).

Long-Term Sustainability of Public Finances

Table 6

Percentages of GDP	2002	2005	2010	2020	2030	2050
Total expenditure	49.9	53.0	53.9	55.0	56.1	56.4
Old-age pensions	7.2	7.4	8.0	8.7	8.1	5.8
Healthcare (including care for the elderly)	4.3	4.5	4.8	5.6	6.5	7.1
Interest payments	4.0	4.4	4.2	3.7	4.5	6.6
Total revenues	43.8	49.0	50.0	49.2	47.2	44.2
of which: from pensions contributions*	10.7	8.7	7.8	7.6	5.6	2.6
National pension fund assets (if any)	-	-	-	-	-	-
Assumptions						
Labour productivity growth	-1.8	0.3	3.7	3.0	3.1	3.8
Real GDP growth	-1.0	1.7	4.3	3.1	2.5	2.5
Participation rate males (aged 16-61)	84.6	79.7	77.9	77.5	77.4	81.6
Participation rate females (aged 16-61)	43.4	42.7	43.7	47.2	51.5	63.4
Total participation rates (ages 16-61)	64.1	61.5	61.3	63.1	65.3	73.3
Unemployment rate	7.7	7.5	7.3	7.0	6.6	6.0

*Includes Government contribution

Note: Data in this table may not be strictly comparable with that found in other tables in this document.

Basic Assumptions

Table 7

	2003	2004	2005	2006	2007
Interest Rates (in % p.a., annual averages)					
Short-term interest rate	3.0	3.0	3.5	3.5	3.5
Long-term interest rate	4.7	4.7	5.2	5.2	5.2
United States: short-term (three-month money market)	1.2	1.2	1.7	1.7	1.7
United States: long-term (10-year government bonds)	4.0	4.2	4.6	4.6	4.6
Exchange Rates					
USD/EUR exchange rate (level)	1.1	1.1	1.1	1.1	1.1
Nominal effective exchange rate (annual averages)	1.1	1.1	1.1	1.1	1.1
Exchange rate vis-a-vis the EUR	2.3	2.3	2.3	2.3	2.3
GDP (in real terms %)					
World GDP growth, excluding EU	4.4	5.1	4.7	4.7	4.7
United States,GDP growth	3.1	4.2	3.2	3.2	3.2
Japan, GDP growth	2.7	3.4	2.3	2.3	2.3
EU-15 GDP growth	0.8	2.0	2.4	2.4	2.4
World Trade (% change)					
Growth of relevant foreign markets	0.6	1.9	2.3	2.3	2.3
World import volumes, excluding EU	7.3	9.7	8.5	8.5	8.5
International Prices					
World prices based on the producer price Indices of the Euro Area (% change)	2.0	1.6	1.7	1.7	1.7
Oil prices, (Brent, USD/barrel)	28.5	31.1	28.9	28.9	28.9
Non-oil commodity prices (in USD)	6.6	15.6	-2.6	-2.6	-2.6