COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 24.6.2004
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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the convergence programme of Malta, 2004-2007

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1] stipulates that non-participating Member States, that is, those which have not adopted the single currency, have to submit convergence programmes to the Council and the Commission for the purpose of multilateral surveillance at regular intervals under Article 99 of the Treaty.

In accordance with Article 9 of this Regulation, the Council has to examine each convergence programme based on assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). On the basis of a recommendation from the Commission and after consulting the Economic and Financial Committee, the Council is required to deliver an opinion, following its examination of the programme. According to the Regulation, Member States need to submit annual updates of their convergence programmes, which may also be examined by the Council in accordance with these same procedures.

The ten countries that joined the EU on 1 May 2004 have a derogation and thus do not yet participate in the single currency. They committed themselves to submitting their convergence programmes by 15 May 2004 and a first update thereof towards the end of 2004.

The first Maltese convergence programme covering the period 2004-2007 was submitted on 21 May 2004. The Commission services have carried out a technical evaluation of this programme, taking into account the results of the Spring 2004 forecasts and having regard to the “code of conduct on the content and format of stability and convergence programmes”[2] and the principles laid down in the Communication from the Commission to the Council and the European Parliament of 27 November 2002 on strengthening the co-ordination of budgetary policies[3]. This evaluation warrants the following assessment:

> The first Maltese convergence programme covering the period 2004-2007 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.
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> 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.

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1 OJ L209, 2.8.1997. All the documents referred to in this text can be found at the following website http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

2 Revised Opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the ECOFIN Council on 10.7.2001.

3 COM (2002) 668 final, 27.11.2002.

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 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[4], 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 2004 and 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.

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.

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

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[5] 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)

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the convergence programme of Malta and is forwarding it to the Council.

[5] Malta does not provide HICP but retail price index (RPI).

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Art. 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the convergence programme of Malta, 2004-2007

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[6], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [5 July] 2004 the Council examined the convergence programme of Malta, which covers the period 2004 to 2007. The programme complies only partly with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes". In particular, data for GDP and its components are not yet fully in line with ESA95 standards. This hampers comparability across different parts of the programme.

The budgetary strategy underlying the programme aims at reducing the general government deficit to below 3% of GDP already by 2006, with the following intermediate targets: 5.2% of GDP in 2004, 3.7% of GDP in 2005 and 2.3% of GDP in 2006 to reach 1.4% at the end of the period programme. The programme projects a significant improvement in the primary balance, which is expected to turn from a deficit of 1.4% of GDP in 2004 to a surplus of 2.2% in 2007. In parallel, the programme envisages reversing the upward trend of the debt-to-GDP ratio in 2005 to reach 70.4% at the end of the programme period.

The budgetary strategy is underpinned by a package of measures aiming at controlling and rationalising spending and, on the revenue side, at avoiding tax evasion. In particular, on the expenditures side, current spending is projected to be cut by 3 percentage points of GDP, through the contention of the growth of public wages and the progressive phasing out of subsidies to the shipyard industry. Capital expenditures are also expected to fall by more than

6 OJ L209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

2.5 percentage points of GDP over the programme period. However, public investment will still remain above 4% of GDP.

On the basis of currently available information, the macro-economic scenario underlying the programme seems to reflect plausible growth assumptions. However, it is subject to a certain degree of uncertainty given a possible overestimation of the nominal ESA95 GDP and the exposure to external shocks of the Maltese economy.

Although the programme foresees the reduction of the deficit below the 3% reference value in 2006, to further fall thereafter, these targets are not consistent with a position of close-to-balance during the programme period.

The consolidation path is somewhat ambitious, although it seems to be within reach, given the room for manoeuvre provided by the termination of some investment projects. The potential implications of the recent revision of the real GDP growth figure for 2003 also add some downward risks. Therefore, the budgetary stance in the programme may not be sufficient to reduce the deficit to below the 3% of GDP deficit threshold by 2006. In addition, the evolution of the debt ratio is likely to be less favourable than projected given such downward risks.

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.

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On [5 July] 2004, on the basis of recommendations from the Commission, the Council decided that an excessive deficit existed in Malta in accordance with Article 104(6) of the Treaty and made recommendations under Article 104(7) to Malta with a view to bringing that situation to an end, in which the Council expresses its policy advice.

Key projections from the convergence programme of Malta

	2003	**2004**	**2005**	**2006**	**2007**
Real GDP growth (%)	-1.7	1.1	1.7	2.1	2.1
Employment growth (%)	-0.8	0.8	0.7	0.7	0.7
RPI inflation (%)	1.3	3.4	2.1	2.1	2.1
General government balance (% of GDP)	-9.7	-5.2	-3.7	-2.3	-1.4
Government gross debt (% of GDP)	72.0	72.1	72.4	70.5	70.4