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DECEMBER 2004 UPDATE OF THE CONVERGENCE PROGRAMME OF MALTA (2004-2007)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The first update of the convergence programme covering the period 2004-2007 was submitted by the government of Malta on 7 December 2004. The programme broadly complies with the Code of Conduct. Specifically, the breakdown of public expenditures is incomplete and price data are not consistent with the harmonised definitions.

The macroeconomic scenario presented in the updated programme projects a gradual acceleration of economic activity. The estimated GDP growth rate for 2004 (0.6%) is lower than in the Commission services autumn 2004 forecast (1%), while growth projections for 2005 (1.5%) and 2006 (1.8%) appear plausible and fully in line with Commission's projections. Growth is expected to accelerate further at the end of the programme period and attain 2.2% in 2007. Overall, the growth assumptions appear to be plausible.

Year-on-year inflation, which in Malta is currently measured by the annual change in the retail price index, receded somewhat during recent months, and is estimated at 2.9% for the whole year 2004. Projections over the programme period assume that inflation will be kept in a downwards path attaining 2.4% in 2005 and 1.9% in both 2006 and 2007. The effective exchange rate of the Maltese lira recorded a modest appreciation during 2004, in nominal as well as in real terms. The nominal effective exchange rate of the lira is expected to remain broadly unchanged over the programme period. The central bank maintains short term interest rates, its main policy rate, unchanged at 3 percent (100 basis points above the euro area level) since September 2003. Interest rates are projected to increase by a half a percentage point in 2005 and remain at 3.5% until 2007.

Recent information on the implementation of the 2004 budget indicates that the deficit target of 5.2% of GDP, set up for that year, and confirmed in the programme, seems within reach. Deficit targets up to 2007 have also been confirmed in the update. Specifically, the convergence programme still aims at reducing the deficit below the 3% of GDP reference value in 2006. The general government deficit is projected to fall from 5.2% of GDP in 2004 to 3.7% in 2005 and 2.3% in 2006, and to decline further in 2007 to 1.4% of GDP. Fiscal consolidation is based on both revenue-rising measures and expenditure cuts.

The size and the openness of the Maltese economy make it highly volatile and exposed to external shocks. This increases both upside and downside risks associated not only to the macroeconomic scenario but also to the implementation of the fiscal adjustment projected in the programme. However, albeit bearing such risks in mind, the prudent underlying macro-economic scenario, the nature of the announced measures aiming at reducing the deficit, as well as budgetary projections set up in the programme make the consolidation path broadly plausible.

Gross government debt is estimated to reach 73.2% of GDP in 2004, up from 70.4% of GDP in 2003. According to the programme, the debt ratio should fall to 72% in 2005 and to go back to a figure close to 70% by the end of the programme period. The Maltese

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[1]This technical analysis, which is based on information available up to 26 January 2005 accompanies the recommendation by the Commission for a Council opinion on the update of the convergence programme, which the College adopted on 2 February 2005. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to JR Calaf Sole (juan-ramon.calaf-sole@cec.eu.int).

authorities foresee that economic growth, gradual improvements in the primary balance and the sale of assets will drive the reduction of the debt-to-GDP ratio since 2005. However, the projected debt dynamics call for a more detailed information on, and closer monitoring of, below-the-line operations, which partially offset the effects of significant privatization proceeds (more than 2% of GDP in 2005 and 2006).

The programme reviews the government's structural reform programme which focuses on initiatives to restructure public entities and to improve the functioning of certain activity sectors, such as the industry, ports, transport and energy. Privatisations are part of the reform package spelled out in the programme, which also contemplates strengthening the fight against tax and benefit fraud. The government also presented a White Paper on the reform of the Maltese pension system. Other important structural reforms in tax-benefit systems and the healthcare system remain to be undertaken.

There are risks with regard to the long-term sustainability of public finances, reflecting the projected cost of an ageing population. The strategy for ensuring sustainability outlined in the programme is dependent on the achievement of the budgetary targets. It also includes reforms of the pension and healthcare systems that have not yet been defined or implemented. While failure to achieve budgetary targets would definitively put sustainability at risk, the pursuit of the reform process is also important for the containment of the increase in age-related public expenditure in the long term.

Overall, the economic policies outlined in the update are broadly consistent with the country-specific broad economic policy guidelines in the area of public finances. In particular, the programme is in line with the reduction of the general government deficit recommended by the Council.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007
Real GDP (% change)	**CP Dec. 2004**	**0.6**	**1.5**	**1.8**	**2.2**
	COM	1.0	1.5	1.8	n.a.
	CP May 2004	*1.1*	*1.7*	*2.1*	*2.1*
HICP inflation (%)	**CP Dec. 2004**	**2.9**	**2.4**	**1.9**	**1.9**
	COM	3.7	3.1	2.6	n.a.
	CP May 2004	*3.4*	*2.1*	*2.1*	*2.0*
General government balance (% of GDP)	**CP Dec. 2004**	**-5.2**	**-3.7**	**-2.3**	**-1.4**
	COM	-5.1	-4.0	-3.3	n.a.
	CP May 2004	*-5.2*	*-3.7*	*-2.3*	*-1.4*
Primary balance (% of GDP)	**CP Dec. 2004**	**-1.4**	**0.3**	**1.6**	**2.4**
	COM	-1.3	-0.2	0.4	n.a.
	CP May 2004	*-1.4*	*0.1*	*1.4*	*2.2*
Government gross debt (% of GDP)	**CP 2004**	**73.2**	**72.0**	**70.5**	**70.4**
	COM	72.4	73.7	74.2	n.a.
	CP May 2004	*72.1*	*72.4*	*70.5*	*70.4*

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

1. INTRODUCTION

The first update of the Convergence Programme covering the period 2004-2007 was submitted by the government of Malta on 7 December 2004. The programme was compiled by the Ministry of Finance and benefited from contributions from the Central Bank, the National Statistics Office and various Ministries and other entities. The programme is not approved by the Maltese Parliament.

The programme broadly complies with the Code of Conduct. Neither a detailed breakdown of public expenditure nor the current account are provided, and inflation is calculated with the Retail Price Index, instead of using harmonised HICP. Furthermore, unemployment figures refer to registered unemployment rather than to the Eurostat standardised definition.

2. MACROECONOMIC DEVELOPMENTS

The unfavourable international economic environment has significantly affected the performance of the Maltese economy since 2001, which, given its high degree of openness, is strongly exposed to external shocks and hence exhibits high volatility. The updated programme estimates real GDP to have grown at 0.6% in 2004, which compares with 1% in the Commission services autumn 2004 forecast. This difference is mainly explained by lower expectations held by the Maltese authorities on gross fixed capital formation growth.

The macroeconomic outlook until 2007, the last year of the programme, appears plausible and for the years 2005 and 2006, largely in line with Commission services forecasts. GDP is projected to grow by 1.5% and 1.8% in 2005 and 2006, respectively, attainting 2.2% at the end of the programme period. Overall, the economic recovery over the programme period is expected to be mainly driven by external demand. However, in 2005, the programme also envisages the acceleration of domestic demand, especially stockbuilding. The contribution to GDP growth of the external sector is expected to turn temporarily negative in 2005. While total exports are projected to increase by 2%, the programme projects and increase of 3.5% in total imports. The import boost is explained by high public investment. This contrasts with the Commission services autumn 2004 forecast, which foresaw a higher growth of exports and a much lower growth of imports. As a result, according to the Commission, the growth contribution of the external sector would be positive also in 2005.

Growth in 2006 and 2007 is basically driven by a drastic reduction of net imports, which leads to a positive contribution to GDP growth of external demand higher than 1%. As a result, the external sector explains more than 2/3 of total growth in 2006 and more than ½ in 2007. While private consumption is projected to accelerate until the end of the programme period, domestic demand is expected to remain subdued in 2006 and 2007 due to a sharp slowdown in investment, which, in turn is explained by the end of a number of public works and the concomitant reduction of public investment. Nevertheless, private investment is projected to register positive growth in both years.

The programme foresees sustained employment creation over the period, leading to a gradual decline in the rate of unemployment[2]. This is in line with the Commission services autumn 2004 forecasts. Inflation is expected to peak in 2004 and ease gradually thereafter. Nevertheless, while inflation in the Commission services autumn 2004 forecast is calculated on the basis of the HICP, the update uses the retail price index, which makes comparisons difficult. Still, the outlook for inflation appears plausible. The current account balance is projected to remain negative, in line with Commission's projections.

Table 1: Comparison of macroeconomic developments and forecasts

	2004		**2005**		**2006**		**2007**
	COM	**CP**	**COM**	**CP**	**COM**	**CP**	**CP**
Real GDP (% change)	1.0	0.6	1.5	1.5	1.8	1.8	2.2
Contributions:							
- Final domestic demand	1.4	0.9	1.1	2.1	1.0	0.5	1.0
- Change in inventories	-0.5	-1.2	-0.2	1.1	-0.1	-	0.1
- External balance on g&s	0.2	0.9	0.6	-1.6	0.9	1.3	1.1
Employment (% change)	0.6	0.5	0.3	0.7	0.9	0.7	0.6
Unemployment rate[1] (%)	8.6	5.8	8.5	5.7	8.4	5.4	5.1
HICP inflation[2] (%)	3.7	2.9	3.1	2.4	2.6	1.9	1.9
GDP deflator (% change)	3.4	1.1	2.4	1.2	2.1	1.2	1.2
Current account[3] (% of GDP)	-4.0	-4.6	-3.6	-5.3	-2.8	-3.3	-2.3

[1] CP figures correspond to unemployment rate based on ETC registered unemployment data
[2] CP figures correspond to retail price index
[3] CP figures correspond to balance of goods and services
Sources:
Commission services autumn 2004 economic forecasts (COM); convergence programme update (CP)

Due to the high degree of variability of profits recorded by foreign-owned financial institutions, which dominate the Maltese financial sector, volatility is a main characteristic of the income account in 2004. The capital and financial account (excluding movements in official reserves) were dominated by the effect of the repatriation of assets within the Investment Registration Scheme[3] As a general rule, the current account deficit has been financed in the past by positive capital flows generating a steady accumulation of reserves. This fact suggests that the Maltese external sector, in the absence of sizeable unforeseen shocks, is sustainable in the medium run.

Based on Commission services calculations according to the commonly agreed methodology, potential output growth is projected to be in line with the estimations of the Commission services autumn 2004 forecast. Moreover, contributions to potential growth in both sources are largely similar, with capital accumulation being the main driving force of potential output. This seems to reinforce the plausibility of the macroeconomic outlook set out in the programme.

[2] The Commission and the programme figures are not directly comparable since they have been obtained on the basis of different methodologies. See table 2 for details.

[3] The Investment Registration Scheme was launched in January 2002 and aimed at registering and taxing previously unknown Maltese investments abroad.

Table 2: Sources of potential output growth

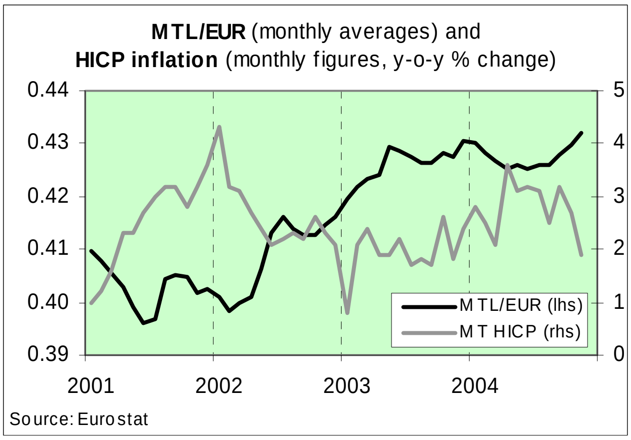
	2004		2005		2006		2007
	COM	CP[3]	COM	CP[3]	COM	CP[3]	CP[3]
Potential GDP growth[1]	1.8	1.7	1.8	1.9	1.7	1.7	1.4
Contributions:							
- Labour	0.1	0.1	0.1	0.2	0.1	0.2	0.1
- Capital accumulation	1.7	1.6	1.7	1.7	1.6	1.5	1.4
- TFP	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Output gap[1,2]	-1.8	-2.1	-2.0	-2.4	-1.9	-2.3	-1.6

Notes:
[1]based on the production function method for calculating potential output growth
[2]in percent of potential GDP
[3]Commission services calculations on the basis of the information in the convergence programme update CP

Sources:
Commission services autumn 2004 economic forecasts (COM); Commission services calculations

3. MEDIUM-TERM MONETARY POLICY OBJECTIVES AND THEIR RELATIONSHIP TO PRICE AND EXCHANGE RATE STABILITY

Following a fall to below 2 percent in 2003, inflation picked up again in 2004, partly due to one-off factors. Indirect taxation, fuel prices and hotel and restaurant sub-index contributed to higher inflation, while food prices exerted a dampening effect on the HICP. Following a peak of 3.6% on the year in April, HICP inflation receded somewhat in the recent months, averaging 2.8% in the first 11 months of 2004. The Retail Price Index, the official Maltese measure of inflation, has followed a similar pattern, albeit at somewhat lower levels. Given subdued demand-side pressures, the update foresees inflation to ease steadily over the projection period. This is broadly in line with the Commission 2004 autumn Forecast, which expects inflation to ease gradually to some 2½ % by 2006.



The Central Bank of Malta pursues its primary goal of price stability through a fixed exchange rate system, whereby the Maltese lira is pegged to a basket of foreign currencies made up of the euro, the US dollar and the pound sterling. Their weights were set at 70, 10, and 20 percent, respectively, at the latest basket revision in August 2002, implying in particular a significant increase in the share of the euro in the pegging basket.

Reflecting the basket composition, bilateral fluctuations of the Maltese lira vis-à-vis the euro were minimal during 2004, which translated into a modest appreciation of both the nominal and real effective exchange rates in 2004.

Malta's exchange rate peg remains supported by an ample level of official reserves. In view of the continued smooth operation of the peg, the central bank has maintained its main policy rate unchanged at 3 percent (100 basis points above the euro area level) since September 2003. Spreads on money markets vis-à-vis the euro area remained contained at around 80-90 basis points during 2004.

Long-term interest rates, which had fallen in tandem with short rates during the period of monetary easing between 2001 and 2003, remained virtually stable at a level of 4.7 percent throughout 2004. This has implied some fluctuation in spreads vis-à-vis the euro area around an average of some 50 basis points. While spreads had receded below 30 basis points in mid-year, they have since gone up again to around 90 basis points, which had also been the average level for 2003.

The update does not address issues of timing relating to euro adoption or ERM II entry. It reiterates the Maltese authorities' intention *"to move to the final stage of EMU as soon as economic convergence permits"*, with particular emphasis on progress in fiscal consolidation along the lines foreseen in the update.

4. BUDGETARY IMPLEMENTATION IN 2004

In spite of the downward revision of GDP growth (from 1.1% in May 2004 to 0.6% in the update), the general government deficit target of 5.2% of GDP for 2004 set out in the convergence programme of May 2004 remains unchanged. The deficit target is in line with the Commission services projections and should be within reach. The primary deficit in 2004 is expected to attain 1.4% of GDP, which represents a significant improvement compared with the figure of 5.8% of GDP recorded in 2003. Since interest payments remained unchanged at 3.8% of GDP between 2003 and 2004, the improvement in the nominal deficit (from 9.6% in 2003 to 5.2% of GDP in 2004) reflects an equivalent improvement of primary deficit. Fiscal retrenchment has mainly been revenue-based, while expenditure cuts have only accounted for 0.4 percentage point of GDP.

On the revenue side, total receipts are projected to have increased from 40.7% of GDP in 2003 to 44.7% of GDP in 2004. Tax revenues are estimated to have risen by 1.5% of GDP, other revenues should be higher by 2.5% of GDP. The latter increase reflects higher inflows from EU funds, as well as from those related to the Fifth Italian Financial Protocol[4]. Although the level of estimated revenues in the update are lower than in the May 2004 convergence programme (45.3%) and in the Commission services autumn 2004 forecast (45.6%), the increase with respect to 2003 is still larger than anticipated in May or October 2004, since the update presents a downward revision of the revenue figure for 2003.

The update sets somewhat less ambitious expenditure targets for 2004 (49.9% of GDP) than in the May 2004 Convergence Programme or the Commission forecast (around 50% of GDP). Compared with 2003, spending reduction in 2004 (0.4% of GDP) is lower than projected by the convergence programme in May and by the Commission in October (around 2%). However, such difference does not reflect a less tight expenditure control in the programme, but is rather the result of a downward revision of expenditure figures for 2003 in the update. The source of this expenditure retrenchment is current spending, which is projected to increase at a slower rate than nominal GDP. Moreover, although

[4] Co-operation agreement signed between Italy and Malta to finance on a grant basis public works in Malta.

public investment is expected to grow at a faster pace in terms of GDP, reflecting increased expenditure on major infrastructural projects, the increase is of only 0.2 percentage points (from 4.6% in 2003 to 4.8% in 2004), not large enough as to offset the reduction of the share of current expenditures in the GDP.

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

5.1. Evolution of budgetary targets in successive programmes

Both the convergence programme presented in May 2004 and the update set out the same adjustment path for the general government deficit, from 5.2% of GDP in 2004 to 1.4% in 2007. This adjustment favourably compares with the somewhat less ambitious path of the August 2003 Pre-accession Economic Programme (PEP).

Table 3: Evolution of budgetary targets in successive programmes

		2003	2004	2005	2006	2007
General government balance (% of GDP)	**CP 2004**	**-9.6**	**-5.2**	**-3.7**	**-2.3**	**-1.4**
	CP May 2004	-9.7	-5.2	-3.7	-2.3	-1.4
	PEP August 2003	-7.4	-5.8	-4.1	-3.4	-
General government expenditure (% of GDP)	**CP 2004**	**50.3**	**49.9**	**49.7**	**46.8**	**44.3**
	CP May 2004	52.4	50.5	48.9	46.3	44.4
	PEP August 2003	51.7	50.9	49.1	46.6	-
General government revenues (% of GDP)	**CP 2004**	**40.7**	**44.7**	**45.9**	**44.5**	**42.9**
	CP May 2004	42.8	45.3	45.2	43.9	43.0
	PEP August 2003	44.3	45.0	45.0	43.2	-
Real GDP (% change)	**CP 2004**	**-0.3**	**0.6**	**1.5**	**1.8**	**2.4**
	CP May 2004	-1.7	1.1	1.7	2.1	2.1
	PEP August 2003	1.3	2.5	3.2	3.6	-

Sources:
Convergence programme (CP); pre-accession economic programme (PEP)

The three documents present comparable budgetary strategies, in which fiscal consolidation is expenditure-based over the whole programme period. The consolidation process leads to a smaller size of the public sector through a gradual and simultaneous decline in both expenditures and revenues in terms of GDP. However, the expenditure ratio is projected to fall by much more than the revenue ratio. Specifically, according to the update, expenditures should decline by 5.6% of GDP between 2004 and 2007 (6.1% of GDP in the Convergence Programme of May 2004), while revenues should fall by 1.8% of GDP (2.3% of GDP in the 2004 Convergence Programme).

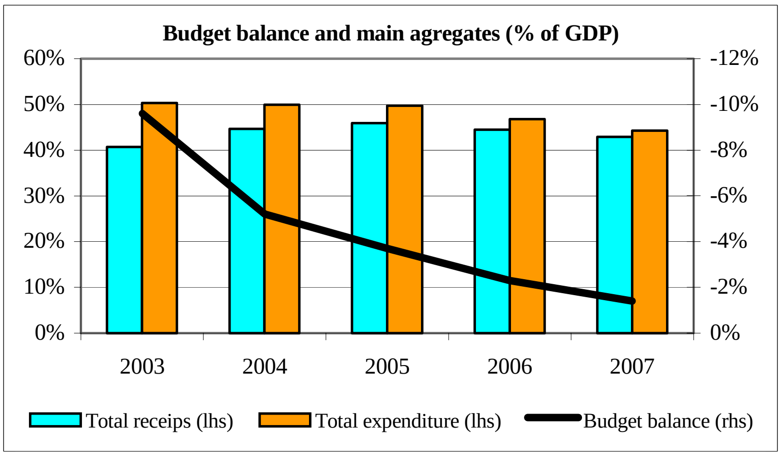
Box 1: The excessive deficit procedure for Malta

On the basis of a general government deficit of 9.7% of GDP in 2003, above the 3% of GDP reference value, and of a debt ratio of 72% of GDP, the Council decided on 5 July 2004 that Malta had an excessive deficit and recommended that this be corrected by 2006 at the latest. In particular, Malta was recommended to put an end to the excessive deficit situation as rapidly as possible and by 2006 at the latest by taking action in a medium-term framework in order to achieve their objective in a credible and sustainable manner, in accordance with the path for deficit reduction specified in the Council Opinion of 5 July 2004 on the convergence programme submitted in May 2004. The Maltese authorities were invited to implement with vigour the measures envisaged in the May 2004 convergence programme, in particular those of a structural nature aimed at rationalising and reducing expenditures and to take effective action by 5 November 2004 regarding the measures envisaged to achieve the 2005 deficit target. The Maltese authorities were also invited to ensure that the rise in the debt ratio is brought to a halt in 2005 and reversed thereafter.

A Commission communication of 22 December 2004 concluded that, on current information and on the basis of the measures detailed in the 2005 budget, it appears that the Maltese government has taken effective action to achieve the 2005 deficit target in response to the Council recommendation. While the budget for 2005 was presented after the 5 November deadline, this does not change the assessment of effective action.

5.2. Budgetary targets in the updated programme

Although over the whole programme period fiscal consolidation is expenditure-based, the planned improvement in the balance up to 2005 is obtained through a rise in the revenue ratio, which is followed by a more rapid fall in the expenditure ratio in the other years of the programme.



The new targets of the general government deficit are practically identical to those in the May 2004 convergence programme. Specifically, the update foresees the general government deficit to decline from 5.2% of GDP in 2004 to 3.7% of GDP in 2005. The deficit is targeted to fall to 2.3% of GDP in 2006, well below the 3% reference value, and to keep declining in 2007 to 1.4% of GDP. The primary balance is projected to follow a similar trend, improving from a deficit of 1.4% of GDP in 2004 to a surplus of 2.4% of GDP in 2007.

Total revenues are expected to peak at some 46% of GDP in 2005 and to decline to 43% of GDP at the end of the programme period. A large part of these developments is explained by changes in other revenues and, in particular, in receipts associated to the Italian Financial Protocol (see footnote 3), which will be phased out in 2007, although EU funds are expected to increase over the programme period.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2003	2004	2005	2006	2007	Change: 2007-2004
Revenues	40.7	44.7	45.9	44.5	42.9	**-1.8**
of which:						
- Taxes & social security contributions	32.8	34.1	34.7	34.3	34.1	**0.0**
- Other (residual)	7.8	10.3	11.0	10.0	8.5	**-1.8**
Expenditure	50.3	49.9	49.7	46.8	44.3	**-5.6**
of which:						
- Primary expenditure	46.5	46.1	45.7	42.9	41.5	**-4.6**
of which:						
Gross fixed capital formation	4.6	4.8	-	-	-	**-**
Consumption	10.6	11.2	-	-	-	**-**
Transfers & subsidies	14.9	14.5	14.0	13.5	13.2	**-1.3**
Other (residual)	16.3	15.5	-	-	-	**-**
- Interest payments	3.8	3.8	4.0	3.9	3.8	**0.0**
Budget balance	**-9.6**	**-5.2**	**-3.7**	**-2.3**	**-1.4**	**3.8**
Primary balance	**-5.8**	**-1.4**	**0.3**	**1.6**	**2.4**	**3.8**
Sources: *Convergence programme update; Commission services calculations*						

At 49.7% of GDP total expenditures are projected to remain unchanged between 2004 and 2005 to sharply decline in 2006 (46.8%) and 2007 (44.3%). Lack of a detailed breakdown of expenditures in the update does not allow to identify the sources of the retrenchment. On the basis of the information provided by the programme, it appears that around 1/4 of the expenditure reduction between 2004 and 2007 (4.6% of GDP) comes from lower transfers and subsidies (1.3% of GDP), which seems to be, partly at least, associated with the discontinuation of subsidies to industry. The rest of the spending reduction is, according to the programme, attributable to a sharp reduction by almost 3% of GDP in public investment. This reduction, which would take place at the end of the period, stems from the finalisation of major infrastructure projects (viz. Mater Dei hospital), some of them associated to the Italian Financial Protocol (roads). Interest payments on general government debt are estimated to remain at around 4 per cent of GDP between 2004 and 2007.

In the light of the prudent underlying macro-economic scenario set out for the period 2005-2007, as well as the announced fiscal measures and the budgetary strategy outlined in the update justify a positive assessment of the consolidation path, which appears broadly plausible. The figures in the update are in line with the Commission services autumn 2004 forecast, especially for 2005, while the Commission projections for 2006 were made under the no-policy-change assumption. However, any assessment of the risks associated to the budgetary strategy needs to take account of the small size and openness of the Maltese economy, which results in a strong exposure to external shocks and a very high degree of volatility. All in all, Malta is on track to correct its excessive deficit by the deadline set by the Council and conforms to the deficit reduction path specified by the Council to attain a general government deficit below the 3% reference value by 2006.

Box 2: The budget for 2005

The 2005 Budget plans for further budget consolidation through both revenue-raising measures and expenditure cuts.

The main revenue-raising measures are:

-Owners of real state derived from inheritance within a specified period will be given the opportunity to adjust, by mid-2005, the declared value in order to take into account the change in the value of the real state up to 25 November 2003.

-Broadening of the items that will be subject to eco-contribution.

-Excise duty and VAT will be charged on kerosene.

-The passenger departure tax payable on outgoing air fares will be doubled.

-Excise duty levied on mobile telephony.

-Sale of Government property in 2005.

The planned expenditure cuts are:

-Restructuring of public entities.

-Limiting public sector hiring and reducing administrative costs.

-Strengthening the fight against the benefit and tax fraud.

5.3. Sensitivity analysis

Although the update does not carry out a complete sensitivity analysis, the budgetary impact of alternative assumptions on interest rates, external demand and growth developments is assessed. The results are presented in terms of deviations from the baseline general government deficit, gross general government debt, and GDP.

An increase of 1 percentage point in the level of GDP in 2005 results in a 0.3 percentage point deficit reduction in comparison with the baseline scenario. The deficit impact gradually fades away over the programme period. The debt ratio falls by 0.5 percentage point in the first year, and is estimated to be around 0.2 percentage point of GDP lower than the baseline scenario in 2007. A permanent 1 percentage point increase in the interest rate between 2004 and 2007 is expected to have an impact on both growth (0.1%) and deficit (0.3% of GDP). Consequently, this would lead to a general government deficit of 1.7% of GDP and to a reduction of the debt ratio of around 0.8 p.p. by 2007. Finally, a transitory 1 percentage point increase of external demand in the first year of the programme period results in a rise of 0.2 percentage point in real GDP, when compared to the baseline. The budget deficit and the debt-to-GDP ratio would improve by 0.4 and 1.6 percentage points of GDP, respectively in 2007.

Although it appears that budgetary targets are relatively robust to nominal and external shocks, the sensitivity analyses in the programme give only a partial picture as they do not consider the effects of a protracted shock to GDP or external demand.

6. EVOLUTION OF THE DEBT RATIO

According to the update of the convergence programme the debt should reach 73.2% of GDP in 2004, up from 70.4% of GDP in 2003. Thereafter, it is projected to fall back to around 70% of GDP at the end of the programme period. The Maltese authorities foresee that economic growth, together with progressive improvements in the primary balance and the sale of assets will permit a steady reduction of the debt-to-GDP ratio already in 2005. However, the comparison between the convergence programme and the Commission services autumn 2004 forecast, such targets appear to be dependent on the realization of privatization operations without which the debt would continue to increase over the programme period. With interest payments constant at around 4% of GDP, the so-called snow-ball effect is projected to have a debt increasing effect throughout the programme period, although on a declining scale in line with the recovery in nominal GDP..

Table 5: Debt dynamics

	average 2000-2003	2004		2005		2006		2007
	COM	COM	CP	COM	CP	COM	CP	CP
Government gross debt ratio		72.4	73.2	73.7	72.0	74.2	70.5	70.4
Change in debt ratio (1 = 2+3+4)		2.1	2.8	1.3	-1.2	1.5	-1.5	-0.1
Contributions:								
- **Primary deficit** (2)		1.3	1.4	0.2	-0.3	-0.4	-1.7	-2.5
- **"Snow-ball" effect** (3)		0.8	1.7	1.0	0.7	0.9	0.9	1.1
- Interest expenditure		3.8	3.8	3.8	4.0	3.7	3.9	3.8
- Real GDP growth		-0.7	-0.4	-1.1	-1.1	-1.3	-1.3	-1.5
- Inflation (GDP deflator)		-2.3	-1.7	-1.7	-2.3	-1.5	-1.8	-1.2
- **Stock-flow adjustment** (4)		0.0	-0.3	0.0	-1.6	0.0	-0.8	1.2
- Cash/accruals								
- Accumulation of financial assets			0.0		-2.6		-2.5	0.0
of which: Privatisation proceeds								
- Valuation effects & residual adj.								

Note:
The change in the gross debt ratio can be decomposed as follows:

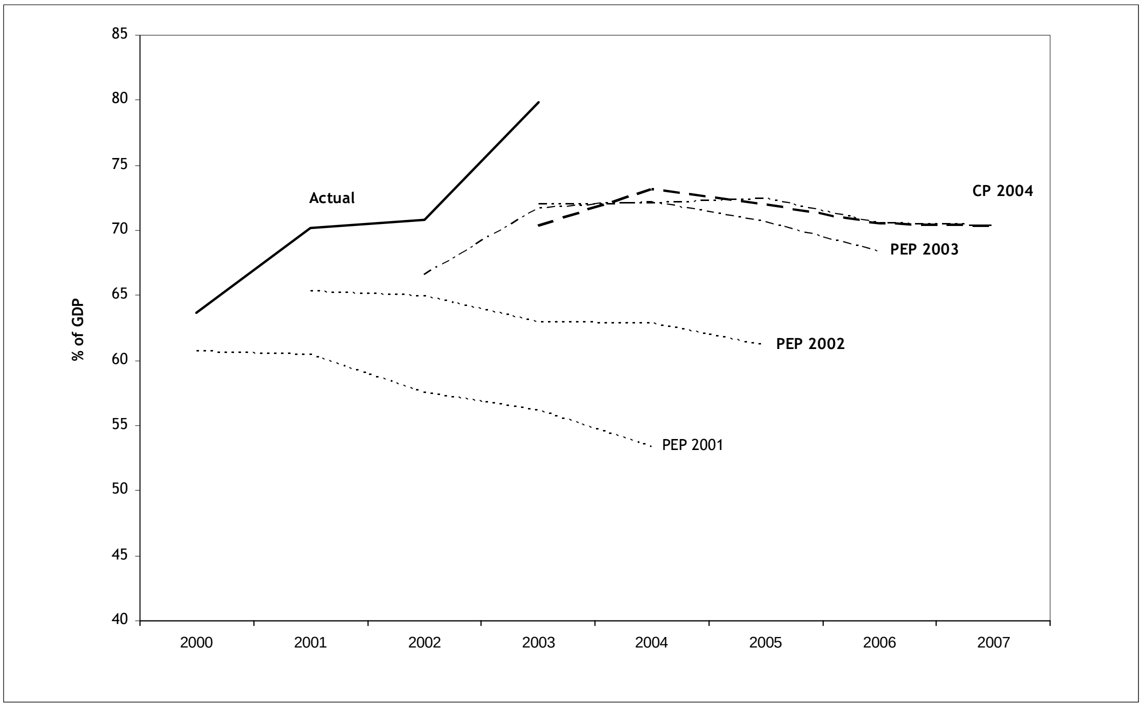
$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

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 term in parentheses represents the "snow-ball" effect.

Sources:
Convergence programme update (CP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations

A tentative assessment of the pace of debt reduction over a medium-term horizon is presented in the graph 1. It compares the projections for the debt ratio in each year of the programme (starting from the projection for 2004) with the values obtained for the same year by applying an illustrative "rolling debt reduction rule". This rule describes a minimum reduction in the debt ratio over the previous five-year period; for example, the projection for 2004 is compared with the values obtained for the same year by applying the formula over the periods 2000-2004 and 2001-2004. If the debt levels projected in the programme exceed those obtained by applying the rule, this is taken as an indicator of a slow reduction in then insufficiently diminishing debt ratio. This is consistent with the idea that the minimum debt reduction should be ensured not year after year but over a medium-term horizon.

Graph 1: Pace of debt reduction over a medium-term horizon



The graph shows that, based on the debt projections in the programme, the debt ratio is planned in the update to diminish over the entire programme period by less than implied by the rolling debt reduction rule.

7. Structural reform and the quality of public finances

In line with its stated aim of achieving higher growth through structural reform, the government has taken in the past, or has announced within the framework of the 2005 budget, a number of initiatives to foster the restructuring of industry, energy, transport and ports, as well as to reform pension and health care systems. Where the public sector is concerned, the package reform particularly focuses on privatizations and the restructuring of public enterprises.

The objective of industrial restructuring is to support enterprises in their efforts to adapt to the new situation created by Maltese accession to the EU. This includes industrial infrastructure and business promotion, as well as the setting up of venture capital to SMEs. Furthermore, fiscal and other incentives have been created to promote R&D, vocational training and investment. In the same line, the government plans to implement reforms in the port system to liberalize and improve the provision of handling cargo and other services. The package also includes measures for the improvement of public transport and the liberalization of the energy market.

Full or partial privatization of a number of public enterprises, coupled with restructuring programmes of the remaining public industrial sector, are measures planned by the Maltese government with the double aim of increasing efficiency and underpinning the sustainability of public finances. Privatizations are planned in shipping, banking, transport and other economic activities. The restructuring of public enterprises in turn affects transport activities by sea and air, as well as broadcasting and tourism.

Where other areas of reform are concerned, the government presented a White Paper on the reform of the Maltese pension system with the aim to launch a consultation involving social partners leading a sustainable system (see box 3). Other important structural reforms in tax-benefit systems and the healthcare system remain to be undertaken.

Some of these measures will favorably affect the quality of public finances by reducing current spending in the medium term. The 2005 budget puts some emphasis on limiting public sector hiring and reducing administrative costs. On the revenue side, the 2005 budget aims at strengthening the fight against tax and benefit fraud. However, the largest part of the fiscal retrenchment over the programme period comes from a drastic reduction of public infrastructure investment, due to the termination of specific projects. This would not appear in line with and improvement in quality on the expenditure side. Nevertheless, in terms of GDP public investment should represent around of 4% of GDP, which is still clearly above the EU average.

8. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of Maltese public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The quantitative indicators project debt development according to two different scenarios to take into account different budgetary developments over the medium term. The "programme" scenario (baseline) assumes that the medium-term objective set up in the programme is actually achieved, while the "2004" scenario assumes that the underlying primary balance remains at the 2004 level throughout the programme period.

The update does not present a new comprehensive outlook on the long-term sustainability of the Maltese public finances, but maintains the same framework portrayed in the May 2004 Convergence Programme based on simulations carried out by the World Bank in its report on pension reform to the Malta Commission of Economic and Social Development.

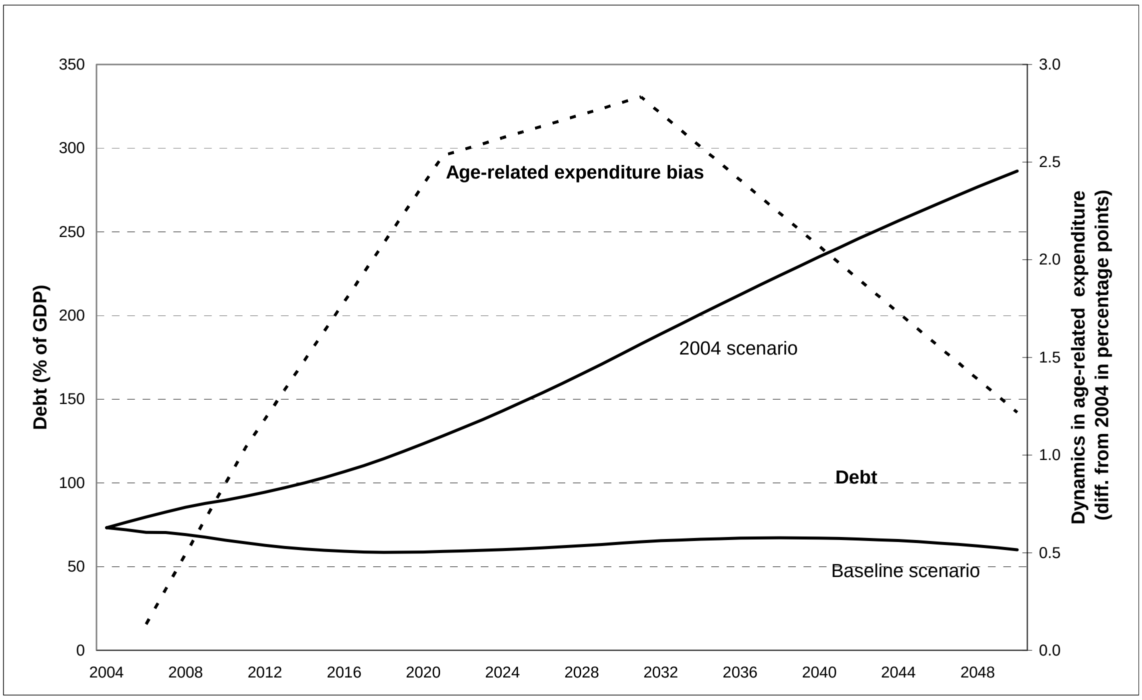
The graph below presents the gross debt development according to the two different scenarios. On the basis of the programme, age-related expenditure is foreseen to increase by 0.5% of GDP between 2008 and 2050 (see annex for a breakdown of different age-related expenditures). Gross debt is projected to remain broadly stable over the entire projection period, reflecting the expected decline in future public pension expenditures.[5] The debt dynamic would significantly worsen if the expected consolidation path in the programme period does not materialise.

On the basis of the debt projections, it is possible to calculate a set of sustainability indicators to measure the gap between the current policies and a sustainable one. The S1 indicator shows the permanent change in the primary balance in order to have a debt to GDP ratio in line with the Maastricht Treaty reference value in the very long run (year

[5] It should be recalled that, being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of likely outcomes and should not be taken at face value.

2050).[6] S2 shows the permanent increase in the primary balance needed to satisfy the inter-temporal budget constraint, namely, to equal the current stock of debt and the discounted value of future primary surpluses. According to the latter, Malta's planned primary balance in the last year of the programme period seems sufficient to tackle the cost of ageing entirely through a budgetary strategy. This would lead to a debt ratio at the level of less than 70% of GDP by the middle of this century. The budgetary effort over the first 5 years of the projections to respect the inter-temporal budget constraint requires a primary surplus of about 1.7% of GDP, compared with a primary surplus of 2.4% of GDP forecasted for the last year of the programme period.

Graph 2: Long-term sustainability: summary results



Sustainability gap

	S1*	S2**	RPB***
Baseline scenario	0.0	-0.1	1.7
2004 scenario	4.1	3.9	1.9

Notes:
* It indicates the required change in tax revenues as a share of GDP over the projection period that guarantees to reach debt to GDP ratio of 60% of GDP in 2050.
** It indicates the required change in tax revenues as a share of GDP that guarantees the respect of the intertemporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon to the debt as existing at the outset of the projection period.
*** Based on S2, the Required Primary Balance (RPB) indicates the average minimum required cyclically adjusted primary balance as a share of GDP *over the first five years* of the projection period that guarantees the respect of the intertemporal budget constraint of the government for this period.

These results are broadly in line with the analysis presented in the programme, according to which a further substantial improvement of the budget balance up to 2007 is required to ensure a sustainable evolution of debt. Assumptions in the convergence programme

[6] The respect of the underlying debt path does not ensure sustainability over an infinite horizon, but only that debt remains below 60% up to 2050. In most cases, this would imply an increasing trend and possible unbalances after the end of the projection period.

underlying the projected long-term sustainability are however somewhat on an optimistic side, especially with regards to labour productivity growth and fertility rate, while the assumptions on the participation rate seem achievable.

Coping with ageing population would require the budgetary strategy to be accompanied with reforms in the pension and health care system. Pension expenditure as a share of GDP is projected to fall significantly after 2020; by almost 3 percentage points of GDP. This projection relies on the fact that pensions are indexed to wage growth but also subject to a ceiling, indexed to the rise in cost of living. Therefore, over time, an increasing number on pensioners should reach the ceiling, which would result in an increase of pension expenditure below nominal GDP growth. However, given the long period necessary to make the ceiling effective, the projections are not exempt from political risks.

The reform of the pension system presented in a recent White Paper constitutes the first step of a process, providing a framework for the social partners to negotiate the future shape of a (multi-pillar) sustainable pension system.

On the other hand, however, despite the ongoing consultation process, no clear initiatives have been carried out to reform the health-care system, an issue of significant importance, given the projected increase in the health-care expenditure over the long-term.

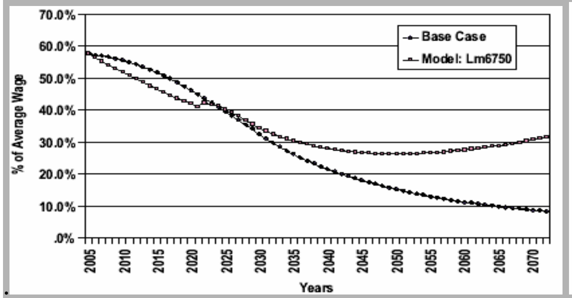
Box 3: The White Paper for the reform of the pension system

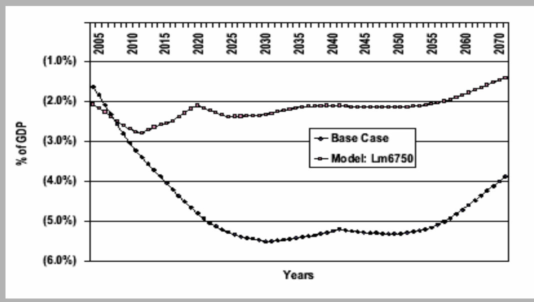
In November 2004, the Maltese government presented as a white paper the report prepared by the Pensions Working Group. The government’s aim is to launch a process of discussion and consultations among the social partners leading to the reform of the Maltese pension system.

The white paper identifies demographic developments, inefficiencies in the Maltese labor market and the financial constraints caused by the inadequacy and lack of sustainability of the existing scheme as crucial issues that concurrently threaten the future viability of the current system. The paper recommends the change of the current PAYG scheme to a three pillar system. The main principle is that health funding should be separated from social security funding. The retirement age is gradually increased to 65 years of age for both men and women.

The First Pillar should be mandatory and guarantee a minimum pension as a safety-net against poverty for those individuals with short careers or very low earnings during their working lives. Recipients of the First Pillar pension would have their retirement pension indexed to the Retail Price index. The contribution period should be increased from 30 to 40 years, while the base-line for the calculation of the pension should be changed from the best consecutive three years from the last ten years to the average of the 40 year contributions accumulation history. The Second Pillar should also be mandatory but introduced in a transitional manner, first on a voluntary basis as from January 2006, to become fully mandatory by 2010, subject to an assessment to determine whether the prevailing conditions at that time require the mandatory introduction in 2010. The Second Pillar should be devoted to supplement pension benefits received. The Third Pillar should also provide for voluntary individual retirement provisions and should be introduced as from January 2006. The annual contribution to this Pillar up to a capped value should not be taxed, while income tax on the basis of the individual’s rate of PAYE (pay as you earn) will be paid upon maturity of the investment.

The projections modelled by the World Bank compare a baseline scenario of no change and a model scenario with the introduction of the proposed changes. The base case shows a deficit deterioration within a relatively short period of time, while in the model scenario the deficit increases steeply in the first 10 years, but less than in the base case, due to the transfer of First Pillar contributions to the health fund. However, under the proposed reform the deficit will decrease from 3% of GDP to 2% of GDP by 2025.





Sustainability **Adequacy**

The implementation of the reform should also notably smooth the deterioration of the benefits as a percentage of the average wage, stabilizing at 30% of average wage by 2023 to gradually improve to 40% of average wage.

The white paper draws a gradual and long term scenario for the implementation of a comprehensive reform of the pension system in order to make the transition to the new system easier and to smooth the impact on individuals, employers and the economy as a whole. It is noted that the reform must be managed in an ongoing manner with structured periodic reviews to allow for the adoption of parametrical changes as and when appropriate. It is also pertinent to mention that the well developed financial sector in Malta paves the way for the risk diversification of pension assets generated for a funded pillar and, at the same time, contributes to the expansion of the domestic financial market.

* * *

Annex 1: Summary tables from the convergence programme update

Growth and Associated Factors

Table 1

	ESA Code	2003	2004[1]	2005	2006	2007
Percentages unless otherwise indicated						
GDP growth at constant market prices (7+8+9)	B1g	-0.3	0.6	1.5	1.8	2.2
GDP level at current market prices (Lm million)	B1g	1,846.1	1,902.4	1,992.0	2,079.2	2,161.9
GDP deflator (% changes)		4.8	2.4	3.2	2.5	1.8
RPI change (annual average)		1.3	2.9	2.4	1.9	1.9
Employment growth		-0.8	0.5	0.7	0.7	0.6
Labour productivity growth [2]		0.5	0.2	0.8	1.2	1.6
Sources of growth: percentage changes at constant prices						
1. Private final consumption expenditure[3]	P3	1.6	0.4	1.0	1.4	1.6
2. General government final consumption expenditure	P3	1.6	1.2	-1.0	-0.1	-0.5
3. Gross fixed capital formation	P51	41.4	2.0	7.8	-1.6	0.4
4. Changes in inventories and net acquisition of valuables as a % of GDP	P52+P53	3.2	2.0	3.0	3.0	3.0
5. Exports of goods and services	P6	-3.8	2.8	2.0	3.6	4.1
6. Imports of goods and services	P7	7.1	1.6	3.5	2.0	2.8
Contribution to GDP growth						
7. Final domestic demand (1+2+3)		7.3	0.9	2.1	0.5	1.0
8. Change in inventories and net acquisition (=4) of valuables	P52+P53	2.4	-1.2	1.1	–	0.1
9. External balance of goods and services	B11	-10.1	0.9	-1.6	1.3	1.1

[1] Forecasts from 2004 onwards
[2] Growth of GDP at market prices per person employed at constant prices
[3] Includes NPISH final consumption expenditure

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	-9.6	-5.2	-3.7	-2.3	-1.4
2. Central government	S1311	-9.6	-5.2	-3.7	-2.3	-1.4
3. State government	S1312	-	-	-	-	-
4. Local government	S1313	—	—	0.0	0.0	0.0
5. Social security funds	S1314	-	-	-	-	-
General government (S13)						
6. Total receipts	ESA	40.7	44.7	45.9	44.5	42.9
7. Total expenditures	ESA	50.3	49.9	49.7	46.8	44.3
8. Budget balance	B9	-9.6	-5.2	-3.7	-2.3	-1.4
9. Net interest payments		3.8	3.8	4.0	3.9	3.8
10. Primary balance		-5.8	-1.4	0.3	1.6	2.4
Components of revenues						
11. Taxes	D2+D5	26.0	27.3	28.0	27.8	27.7
12. Social contributions	D61	6.8	6.8	6.7	6.5	6.4
13. Interest income	D41	0.2	0.4	0.3	0.2	0.3
14. Other		7.8	10.3	11.0	10.0	8.5
15. Total receipts	ESA	40.7	44.7	45.9	44.5	42.9
Components of expenditure						
16. Collective consumption	P32	10.6	11.2	...	...	...
17. Social transfers in kind	D63	—	—	--	--	--
18. Social transfers other than in kind	D62	12.8	12.8	12.5	12.2	12.0
19. Interest payments	D41	3.8	3.8	4.0	3.9	3.8
20. Subsidies	D3	2.1	1.7	1.5	1.3	1.2
21. Gross fixed capital formation	P51	4.6	4.8	...	...	...
22. Other		16.3	15.5	...	...	...
23. Total expenditures	ESA	50.3	49.9	49.7	46.8	44.3

General Government Debt Developments

Table 3

Percentages of GDP	ESA code	2003	2004	2005	2006	2007
Gross debt level		70.4	73.2	72.0	70.5	70.4
Change in gross debt		8.1	2.8	-1.2	-1.5	-0.1
Contributions to change in gross debt						
Primary balance		6.0	1.4	-0.3	-1.7	-2.5
Interest payments	D41	4.0	3.9	4.2	4.1	4.0
Nominal GDP growth	B1g	-2.7	-2.1	-3.3	-3.0	-2.7
Other factors influencing the debt ratio		0.8	-0.4	-1.8	-0.9	1.1
Of which: Privatisation receipts		0.0	0.0	-2.6	-2.5	0.0
p.m. implicit interest rate on debt		5.4	5.2	5.6	5.6	5.4

Cyclical Developments

Table 4

Percentages of GDP	ESA code	2003	2004	2005	2006	2007
1. GDP growth at constant prices	B1g	-0.3	0.6	1.5	1.8	2.2
2. Actual balance	B9	-9.6	-5.2	-3.7	-2.3	-1.4
3. Interest payments	D41	3.8	3.8	4.0	3.9	3.8
4. Potential GDP growth		1.9	1.8	1.8	1.8	1.9
5. Output gap		-1.1	-2.2	-2.5	-2.4	-2.2
6. Cyclical budgetary component		-0.6	-1.3	-1.5	-1.5	-1.3
7. Cyclically-adjusted balance (2-6)		-9.0	-3.8	-2.2	-0.9	-0.1
8. Cyclically-adjusted primary balance (7-3)		-5.2	-0.1	1.8	3.1	3.7

Divergence from Convergence Programme May 2004

Table 5

Percentages of GDP	ESA code	2003	2004	2005	2006	2007
GDP growth						
previous update	B1g	-1.7	1.1	1.7	2.1	2.1
latest update	B1g	-0.3	0.6	1.5	1.8	2.2
Difference		1.4	-0.5	-0.2	-0.3	0.1
Actual budget balance						
previous update[1]	B9	-9.7	-5.2	-3.7	-2.3	-1.4
latest update	B9	-9.6	-5.2	-3.7	-2.3	-1.4
Difference		0.1	0.0	0.0	0.0	0.0
Gross debt levels						
previous update		72.0	72.1	72.4	70.5	70.4
latest update		70.4	73.2	72.0	70.5	70.4
Difference		-1.6	1.1	-0.4	0.0	0.0

[1] The 2003 figure includes the effect of a one-off operation related to the restructuring of the shipyards
This effect is of about 3.2 percentage points of GDP

Basic Assumptions

Table 6

	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	1.6	2.1	2.1	2.1
United States: long-term (10-year government bonds)	4.0	4.3	4.8	4.8	4.8
Exchange Rates					
USD/EUR exchange rate (level)	1.1	1.2	1.2	1.2	1.2
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	4.2	5.7	4.8	4.6	4.6
United States,GDP growth	3.1	4.4	3.0	2.9	2.9
Japan, GDP growth	2.4	4.2	2.1	2.3	2.3
EU-25 GDP growth	1.0	2.5	2.3	2.4	2.4
World Trade (% change)					
Growth of relevant foreign markets	0.7	2.1	2.2	2.1	2.1
World import volumes, excluding EU	10.3	11.6	8.8	8.3	8.3
International Prices					
World prices based on the producer price Indices of the Euro Area (% change)	2.1	1.9	1.9	1.8	1.8
Oil prices, (Brent, USD/barrel)	28.9	36.4	41.8	37.2	37.2
Non-oil commodity prices (in USD)	6.3	12.9	-2.9	-0.5	-0.5

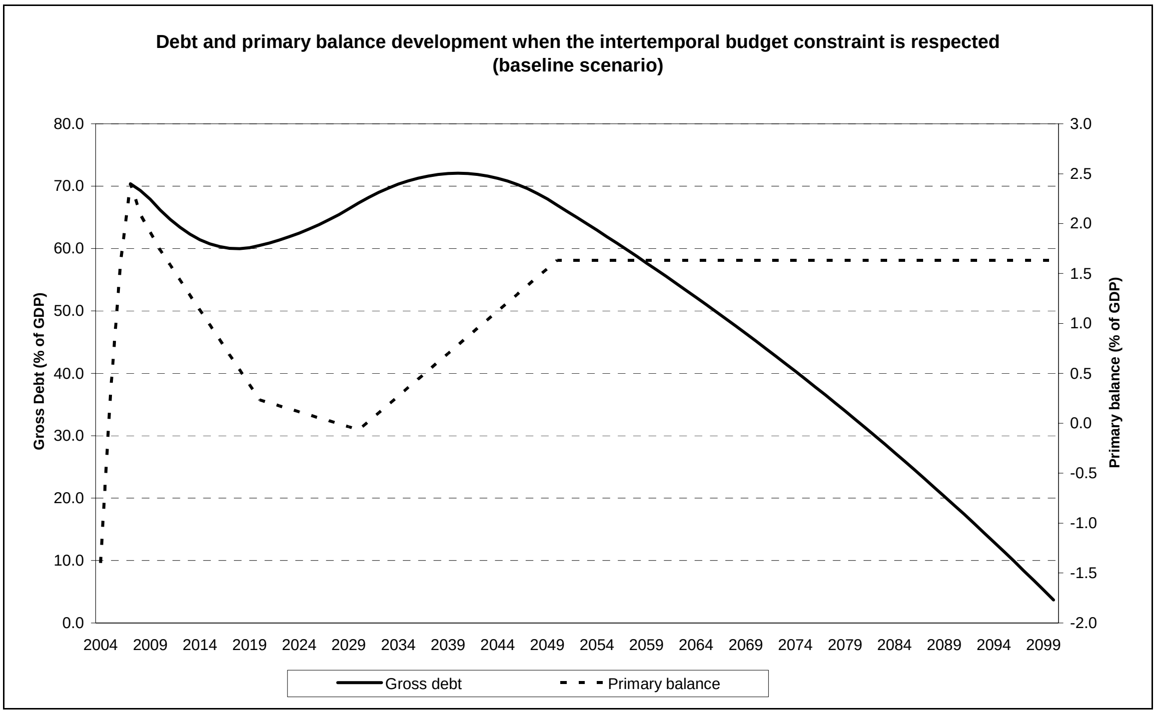
Annex 2: Indicators of long-term sustainability

Main assumptions - baseline scenario (as % GDP)	**2008**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Total age-related spending	12.4	12.8	14.3	14.6	13.8	12.9	0.5
Pensions	7.8	8.0	8.7	8.1	7.0	5.8	-2.0
Health care	4.7	4.8	5.6	6.5	6.8	7.1	2.4
*Total primary non age-related spending**	28.2						
*Total revenues**	42.9						

* constant

Results (as % GDP)	**2008**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Baseline scenario							
Gross debt	69.2	65.8	58.8	64.1	67.1	60.1	-9.1
i + 0.5*	69.5	66.8	62.9	72.1	80.1	78.5	9.0
2004 scenario							
Gross debt	85.4	89.8	118.7	177.0	235.1	286.3	200.9
i + 0.5*	85.8	91.0	129.9	192.2	263.7	332.8	247.0

* i + 0.5 represents the evolution of debt under the assumption of the nominal interest rate being 50 basis points higher throughout the projection period.


Debt and primary balance development when the intertemporal budget constraint is respected
(baseline scenario)
Gross Debt (% of GDP)
Primary balance (% of GDP)
80.0
70.0
60.0
50.0
40.0
30.0
20.0
10.0
0.0
3.0
2.5
2.0
1.5
1.0
0.5
0.0
-0.5
-1.0
-1.5
-2.0
2004
2009
2014
2019
2024
2029
2034
2039
2044
2049
2054
2059
2064
2069
2074
2079
2084
2089
2094
2099
Gross debt
Primary balance