



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 2.2.2005
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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 updated 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 policies¹ 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. 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 Member States that joined the EU on 1 May 2004 do not participate in the single currency, but are required to fulfil in due time the convergence criteria, including the one on the sustainability of the government financial position, in order to qualify for the adoption of the euro. In view of a general government deficit of 9.7% of GDP and a debt ratio of 70.4% of GDP recorded in 2003, the Council decided that Malta was in excessive deficit on 5 July 2004 and recommended that the excessive deficit be corrected by year 2006 at the latest. Malta was also recommended to implement measures 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. In its Communication of 22 December 2004, the Commission concluded that the Maltese government had taken effective action regarding the measures envisaged to achieve the 2005 deficit target.

The Member States which joined the EU on 1 May 2004 committed themselves to submitting their convergence programmes by 15 May 2004 and a first update thereof towards the end of 2004.

The first convergence programme of Malta, covering the period 2004-2007, was submitted on 21 May 2004 and assessed by the Council on 5 July 2004. Malta submitted an update of its convergence programme on 7 December 2004. The Commission services have carried out a technical evaluation of this update, taking into account the results of the Commission services autumn 2004 economic forecasts, and having regard to the code of conduct², the commonly agreed methodology for the estimation of potential output, the recommendations in the broad economic policy guidelines for the period 2003-2005 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 coordination of budgetary policies³. This evaluation warrants the following assessment:

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- 1 OJ L 209, 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 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 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 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% (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. Compared with the previous programme, the current update broadly confirms the planned adjustment against unchanged macroeconomic scenario. 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 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.

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

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 updated 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 policies⁴, 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:

- (1) On [17 February 2005] the Council examined the updated convergence programme of Malta, which covers the period 2004 to 2007. The programme broadly complies with the Code of Conduct. However, the breakdown of public expenditures is incomplete and price data are not consistent with the Maastricht harmonised definitions. Accordingly, Malta is invited to achieve compliance with the data requirements
- (2) The macro-economic scenario underlying the programme envisages real GDP growth to pick up from 0.6% in 2004 to 1.8% on average over the rest of the programme period. On the basis of currently available information, this scenario seems to reflect plausible growth assumptions. The programme's projections for inflation also appear realistic.
- (3) On 5 July 2004, the Council decided that an excessive deficit existed in Malta and recommended to correct it by 2006.
- (4) The programme aims at reducing the deficit below the 3% of GDP reference value in 2006. Fiscal consolidation is based on both revenue-rising measures and expenditure cuts. The general government deficit is projected to fall from 5.2% in 2004 to 2.3% of GDP in 2006 and to decline further in 2007 to 1.4% of GDP. Compared with the

4 OJL 209, 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.

previous programme, the current update broadly confirms the planned adjustment against a broadly unchanged macroeconomic scenario.

- (5) The risks to the budgetary projections in the programme appear broadly balanced. In particular, on the one hand, the fiscal target of a general government deficit of 5.2% in 2004 seems within reach, on the other, concerning 2005 and beyond, the prudent underlying macro-economic scenario and 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 within the currently projected external environment.
- (6) In view of this risk assessment the budgetary stance in the programme seems sufficient to reduce the deficit to below 3% of GDP by 2006 and seems to provide a sufficient safety margin against breaching this threshold with normal macroeconomic fluctuations in the programme period. However, it may not be sufficient to ensure that the Stability and Growth Pact's medium-term objective of a budgetary position of close to balance is achieved within the programme period.
- (7) According to the programme the debt ratio is likely to reach 73.2% of GDP in 2004, up from 70.4% of GDP in 2003. Thereafter, it is projected to decline to 70.4% of GDP at the end of the programme period. The Maltese authorities foresee that economic growth, progressive improvements in the primary balance and the sale of assets will drive the reduction of the debt-to-GDP ratio as of 2005. However, a number factors, which partially offset the effects of significant privatization proceeds (more than 2% of GDP in 2005 and 2006), call for a more detailed information on, and closer monitoring of, below-the-line operations.
- (8) 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 clearly 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.
- (9) 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 Oct 2004	1.0	1.5	1.8	n.a.
	<i>CP May 2004</i>	<i>1.1</i>	<i>1.7</i>	<i>2.1</i>	<i>2.1</i>
HICP inflation (%)	CP Dec. 2004	2.9	2.4	1.9	1.9
	COM Oct 2004	3.7	3.1	2.6	n.a.
	<i>CP May 2004</i>	<i>3.4</i>	<i>2.1</i>	<i>2.1</i>	<i>2.0</i>
General government balance (% of GDP)	CP Dec. 2004	-5.2	-3.7	-2.3	-1.4
	COM Oct 2004	-5.1	-4.0	-3.3	n.a.
	<i>CP May 2004</i>	<i>-5.2</i>	<i>-3.7</i>	<i>-2.3</i>	<i>-1.4</i>
Primary balance (% of GDP)	CP Dec. 2004	-1.4	0.3	1.6	2.4
	COM Oct 2004	-1.3	-0.2	0.4	n.a.
	<i>CP May 2004</i>	<i>-1.4</i>	<i>0.1</i>	<i>1.4</i>	<i>2.2</i>
Government gross debt (% of GDP)	CP Dec. 2004	73.2	72.0	70.5	70.4
	COM Oct 2004	72.4	73.7	74.2	n.a.
	<i>CP May 2004</i>	<i>72.1</i>	<i>72.4</i>	<i>70.5</i>	<i>70.4</i>
<i>Sources:</i>					
<i>Convergence programme (CP); Commission services 2004 economic forecasts (COM)</i>					