COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 22.2.2006
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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, 2005-2008

(presented by the Commission)

EXPLANATORY MEMORANDUM

Background

The Stability and Growth Pact, which entered into force on 1 July 1998, is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. In 2005, the Pact was amended for the first time. The reform acknowledged the Pact's usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes). The first convergence programme of Malta was submitted in May 2004. In accordance with the Regulation, the Council delivered an opinion on it on 5 July 2004 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. In accordance with the same procedure, updated stability and convergence programmes are assessed by the Commission and examined by the Committee mentioned above, while the Council may examine them.

In these programmes, Member States need to specify their medium-term objective for the budgetary position and set out the policy measures to achieve and maintain it, including the accompanying economic assumptions. Following the reform of the Pact, the medium-term objective should be differentiated for individual Member States in the light of the economic and budgetary heterogeneity in the Union, including as regards the fiscal risk to sustainability. Other elements of the reform are that a more symmetrical approach to fiscal policy over the cycle through enhanced budgetary discipline in economic good times should be achieved, while "major structural reforms" with a verifiable impact on long-term sustainability should be taken into account for a temporary deviation from the medium-term objective or the adjustment path towards it.

Taking into account the Commission services' autumn 2005 forecast, the code of conduct[2], the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008, the Commission has examined the recently submitted update of the convergence programme of Malta and, based on its assessment below, has adopted a recommendation for a Council opinion on it.

[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). 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] "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

Assessment

(1) Malta submitted the second update of the convergence programme covering the period 2005-2008 on 6 January 2006, more than a month after the 1 December deadline specified by the Code of Conduct. The programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct[3].

(2) On 5 July 2004 the Council decided that Malta was in excessive deficit. According to the Council recommendation under Article 104(7) of 5 July 2004, the excessive deficit has to be corrected by 2006. In its opinion of 17 February 2005 on the previous update of the convergence programme, covering the period 2004-2007, the Council invited Malta to do all the necessary to ensure the correction of excessive deficit by 2006, ensure that the debt ratio declines at a satisfactory pace towards the 60% of GDP reference value and make further progress in the design and implementation of the pension and health care reforms.

(3) Malta's real GDP growth averaged 2¾% per year between 1995 and 2005. However, since 2001 economic growth stalled in the wake of unfavourable external conditions and domestic structural weaknesses. The combination of these two factors resulted in a loss in competitiveness, while export performance worsened adding further pressure on the external deficit. In recent years, the general government deficit has averaged around 6% of GDP, peaking at 10.3% of GDP in 2003, and declined to 5.1% of GDP in 2004.

(4) The update foresees a gradual pick-up in economic activity until the end of the programme period. From 0.9% in 2005, GDP growth is forecast to strengthen to 1.1% and 1.2% in 2006 and 2007, respectively. The update foresees a further acceleration of growth to 2.0% in 2008. Overall, the programme growth assumptions appear to be plausible, except for the relatively quick recovery projected in 2006. The update foresees an improvement in the external deficit of goods and services, falling from 8% of GDP in 2005 to 4¼% in 2008. Inflation as measured by the Retail Price Index is projected to decelerate from 3.1% in 2006 to 2.5% in 2007 and just below 2% in 2008, which appears achievable, though not without risks.

(5) Following a pick-up in HICP inflation in 2004, mainly due to temporary factors, inflation developments in Malta were mixed during 2005. After accelerating in the first three months, inflation showed some volatility in the subsequent two quarters, while further increases were recorded in the last quarter, bringing the yearly average to

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3 The programme has gaps in the compulsory and optional data prescribed by the new code of conduct. Specifically, price data are not consistent with the harmonised definition and employment and unemployment figures are not based on labour force survey data but refer to registered persons, while forecasts for all the items included in the sectoral balances and FISIM data are not provided. Missing optional data are: table 1c (Labour market developments): employment and labour productivity in hours worked are not provided; table 1d (Sectoral balances): no forecasts are provided for almost all items; table 2 (General government budgetary developments): breakdown of total social transfers not provided; table 3 (General government expenditure by function): forecasts for 2008 of single items not provided; table 4 (General government debt developments): breakdown of stock-flow adjustment and other relevant variables not provided; table 5 (Cyclical developments): contributions to potential GDP growth not provided.

2½%. Core inflation (HIPC excluding energy and unprocessed food) remained relatively contained at an annual average of 2%, though with an increase towards the end of the year. Following entry in ERM II on 2 May 2005, the Maltese lira has remained fully stable against the euro. Long-term benchmark bond yields remained stable at some 4.7% through mid-2005 and subsequently recorded a moderate decrease to around 4.4%. The update reiterates Malta's goal to enter the euro area on 1 January 2008.

(6) The update estimates the 2005 deficit close to 4% of GDP, against 4¼% of GDP in the Commission services' autumn 2005 forecast and a target of 3¾% of GDP set in the previous update of the convergence programme. The difference between the update and the Commission services' autumn 2005 forecast is explained by the inclusion of recent data showing lower general government expenditure than previously projected.

(7) The budgetary strategy outlined in the update aims at reducing the deficit to below the 3% of GDP reference value in 2006 and at pursuing fiscal consolidation to reach a deficit of 1¼% in 2008. The deficit targets in the update include one-off revenues of 0.75% to 1% of GDP per year until 2007. Consolidation is mainly expenditure-based, with expenditures falling by 7½% of GDP until the end of the programme period, half of which is accounted for by investment. Compared with the previous programme, the fiscal adjustment in the update is somewhat less ambitious against a less favourable macroeconomic scenario.

(8) According to the Commission services' calculations on the basis of the programme and the commonly agreed methodology, the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) is projected to improve from around -3¾% of GDP in 2005, to about 0.5% of GDP in 2008. The programme clearly identifies the medium-term objective (MTO) for the budgetary position of a balanced budget in cyclically-adjusted terms and net of one-off and temporary measures as meant in the Stability and Growth Pact of a balanced budget, which it aims to achieve by 2008. As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1¾% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO is at an appropriate level because it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

(9) The budgetary outcome could be worse than projected in the programme, especially on account of the favourable macroeconomic scenario projected for 2006. Although, the update foresees higher indirect taxes in 2006 than in the Commission services' autumn 2005 forecast, projections for total revenues in that year are comparable. While the information given in the programme on the policy measures for 2006 do not seem to fully justify these developments, the measures underpinning the consolidation process are not disclosed for 2007 and 2008, making an overall assessment difficult to carry out.

(10) Assuming that the 2006 budget is fully implemented and the macroeconomic risks are duly addressed, the budgetary stance in the programme seems consistent with a correction of the excessive deficit by the deadline indicated by the Council. Following the planned correction of the excessive deficit and taking into account the balance of

risks the projected improvement in the structural budget balance appears ambitious, especially against the backdrop of unfavourable cyclical conditions. The budgetary strategy outlined in the programme seems sufficient to ensure that the programme's MTO of a balanced budget will be broadly achieved by 2008. According to the Commission services' calculations on the basis of the programme and the commonly agreed methodology, the safety margin against breaching the 3% of GDP deficit limit would be provided from 2007, as long as the risks to the budgetary targets are duly addressed.

(11) Gross debt is estimated at 76¾% of GDP for 2005, above the 60% of GDP reference value. Starting in 2006, the debt ratio is expected to gradually fall, reaching 67¼% of GDP by the end of the programme period. This improvement is expected to be achieved through privatisation proceeds, especially in 2006, while for the remaining years an increasing surplus in the primary balance will act as the main driver of a lower debt-to-GDP ratio. There are implementation risks associated to the large privatisation plans for 2006, while there are some unexplained below-the-line operations offsetting potential privatisation receipts. In view of such risks, outcomes may be worse than anticipated, although the debt ratio appears to be sufficiently diminishing.

(12) With regard to the sustainability of public finances, Malta appears to be at medium risk on grounds of the projected budgetary costs of ageing populations. The level of gross debt is currently above the 60% reference value and the currently high structural deficit, if unchanged, will prevent the necessary reduction of the gross debt ratio from falling below the Treaty reference value over the long term. Implementing rigorously the planned budgetary consolidation over the programme period would therefore contribute to reduce debt below the reference value, with positive consequences for risks to public finance sustainability. Changes to the pension system are envisaged by the Maltese authorities, aiming at ensuring adequacy and sustainability of the pension system. The implementation of the reform would be key in ensuring the financial sustainability of the public pension system.

(13) The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. Although the update foresees the correction of the excessive deficit and the reduction of the debt ratio at a satisfactory pace in line with the Council's recommendations and anticipates the achievement of the medium-term budgetary objective within the programme period, it does not announce implementation measures to address the problem of the long-term sustainability.

(14) The National Reform Programme of Malta, submitted on 21 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies the following challenges with significant implications for public finances: sustainability of public finances; competitiveness; the environment; employment; and education and training. Although not explicitly stated, the update takes into account the budgetary implications of the NRP. The measures in the area of public finances envisaged in the convergence programme are broadly in line with the actions foreseen in the National Reform Programme. In particular, the updated convergence programme confirms the intention to pursue reforms to enhance the efficiency of the public sector, improve tax compliance, pursue privatisation and provide support for the training of the labour force.

In view of the above assessment, the programme is overall consistent with the correction of the excessive deficit by 2006. In the light of the recommendations made by the Council under Article 104(7) of 5 July 2004, it would be appropriate for Malta to:

– implement with rigour the 2006 budget measures and ensure the correction of the excessive deficit this year;

– ensure that the debt ratio is declining towards the 60% of GDP Treaty reference value at a satisfactory pace from 2006 onwards;

– improve the long-term sustainability of the public finances by making further progress in the design and implementation of the pension reform.

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, 2005-2008

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[4], 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 [14 March 2006], the Council examined the updated convergence programme of Malta, which covers the period 2005 to 2008.

(2) Malta's real GDP growth averaged 2¾% per year between 1995 and 2005. However, since 2001 economic growth stalled in the wake of unfavourable external conditions and domestic structural weaknesses. The combination of these two factors resulted in a loss in competitiveness, while export performance worsened adding further pressure on the external deficit. In recent years, the general government deficit has averaged around 6% of GDP, peaking at 10.3% of GDP in 2003, and declined to 5.1% of GDP in 2004.

(3) On 5 July 2004, the Council decided that Malta was in excessive deficit. According to the Council recommendation under Article 104(7) of the same date, the excessive deficit had to be corrected by 2006. The Council opinion of 17 February 2005 on the previous update of convergence programme, covering the period 2004-2007, invited Malta to do the necessary to ensure the correction of the excessive deficit in 2006, ensure that the debt ratio is declining towards the 60% of GDP Treaty reference value

4 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, 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

at a satisfactory pace and make further progress in the design and implementation of the pension and health care reforms.

(4) The update estimates the 2005 deficit close to 4% of GDP, against 4¼% of GDP in the Commission services' autumn 2005 forecast and a target of 3¾% of GDP set in the previous update of the convergence programme. The difference between the update and the Commission services' autumn 2005 forecast is explained by the inclusion of recent data showing lower general government expenditure than previously projected.

(5) The update was submitted five weeks beyond the 1 December deadline set in the code of conduct. The programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct[5].

(6) The macroeconomic scenario underlying the programme envisages that real GDP growth will pick up from 0.9% in 2005 to an average of 1.4% over the rest of the programme period reflecting an improved external demand. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions, except in 2006. In particular, the update projects a relatively quick economic recovery driven by a strong contribution of external demand to growth, mainly attributed to a recovery in the electronics industry. The possibility that the long-anticipated pickup in this industry will not materialise in 2006 poses a downside risk to GDP growth.

(7) The budgetary strategy outlined in the update aims at reducing the deficit to below the 3% of GDP reference value in 2006 and at pursuing fiscal consolidation to reach a deficit of 1¼% in 2008. The deficit targets in the update include one-off revenues of 0.75% to 1% of GDP per year until 2007. The time profile of the primary surplus is similar, with an improvement from 0.25% in 2005 to 2½% at the end of the period. Consolidation is mainly expenditure-based, with expenditures falling by 7½% of GDP until the end of the programme period, of which investment accounts for almost half. Compared with the previous programme, the adjustment in the update is less ambitious against a broadly less favourable macroeconomic scenario.

(8) Over the programme period, the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated by the Commission services according to the commonly agreed methodology is planned to improve on average by 1% of GDP per year. The programme clearly identifies its medium-term objective (MTO) as a balanced budgetary position, which it aims to achieve by the end of the programme period. As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1¾% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO is at an appropriate level because it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth

5 The programme has gaps in the compulsory and optional data prescribed by the new code of conduct. Specifically, price data are not consistent with the harmonised definition and employment and unemployment figures are not based on labour force survey data but refer to registered persons, while forecasts for all the items included in the sectoral balances and FISIM data are not provided. Missing optional data mainly concern: employment and productivity in hours, forecasts of sectoral balances and breakdown of social transfers.

Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

(9) The budgetary outcome could be worse than projected in the programme, especially on account of the favourable macroeconomic scenario projected for 2006. Although, the update foresees higher indirect taxes in 2006 than in the Commission services' autumn 2005 forecast, projections for total revenues in that year are comparable. While the information given in the programme on the policy measures for 2006 do not seem to fully justify these developments, the measures underpinning the consolidation process are not disclosed for 2007 and 2008, making an overall assessment difficult to carry out.

(10) Assuming that the 2006 budget is fully implemented and the macroeconomic risks are duly addressed, the budgetary stance in the programme seems consistent with a correction of the excessive deficit by the deadline indicated by the Council. The programme seems to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations after the planned correction of the excessive deficit. The budgetary strategy outlined in the programme seems sufficient to ensure that the programme's MTO is broadly achieved in 2008. In the years following the correction of the excessive deficit, the annual structural adjustment towards the programme's MTO implied by the programme, is well above 0.5% of GDP, and hence consistent with the Stability and Growth Pact.

(11) The gross government debt is estimated to have reached 76¾% of GDP in 2005, above the 60% of GDP Treaty reference value. Starting in 2006, the debt ratio is expected to gradually fall, reaching 67¼% of GDP by the end of the programme period. The evolution of the debt ratio might be less favourable than projected in the programme in view of the risks associated to some implementation risk surrounding privatisation given its critical role in reducing the debt ratio in 2006. Unexplained below-the-line operations which partially offset privatisation receipts in 2006 call for more detailed information and closer monitoring. Taking into account the balance of risks, the debt ratio seems to be sufficiently diminishing towards the reference value.

(12) With regard to the sustainability of public finances, Malta appears to be at medium risk on grounds of the projected budgetary costs of ageing populations. The level of gross debt is currently above the 60% reference value and the currently high structural deficit, if unchanged, will prevent the necessary reduction of the gross debt ratio from falling below the Treaty reference value over the long term. Implementing rigorously the planned budgetary consolidation over the programme period would therefore contribute to reduce debt below the reference value, with positive consequences for risks to public finance sustainability. Changes to the pension system are envisaged by the Maltese authorities, aiming at ensuring adequacy and sustainability of the pension system. The implementation of the reform would be key in ensuring the financial sustainability of the public pension system[6].

(13) The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period

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6 Details on long-term sustainability are provided in the technical assessment of the programme by the Commission services (http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm).

2005-2008. Although the update foresees the correction of the excessive deficit and the reduction of the debt ratio at a satisfactory pace in line with the Council's recommendations and anticipates the achievement of the medium-term budgetary objective within the programme period, it does not announce implementation measures to address the problem of the long-term sustainability.

(14) The National Reform Programme of Malta, submitted on 21 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies the following challenges with significant implications for public finances: sustainability of public finances; competitiveness; the environment; employment; and education and training. Although not explicitly stated, the update takes into account the budgetary implications of the NRP. The measures in the area of public finances envisaged in the convergence programme are broadly in line with the actions foreseen in the National Reform Programme. In particular, the updated convergence programme confirms the intention to pursue reforms to enhance the efficiency of the public sector, improve tax compliance, pursue privatisation and provide support for the training of the labour force.

In view of the above assessment, the Council notes that, overall, the programme is consistent with the correction of the excessive deficit by 2006. In the light of the recommendations under Article 104(7), the Council invites Malta to:

– implement with rigour the 2006 budget measures and ensure the correction of the excessive deficit this year;

– ensure that the debt ratio is declining towards the 60% of GDP Treaty reference value at a satisfactory pace from 2006 onwards;

– improve the long-term sustainability of the public finances by making further progress in the design and implementation of the pension reform.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP (% change)	**CP Jan 2006**	**0.2**	**0.9**	**1.1**	**1.2**	**2.0**
	COM Nov 2005	0.4	0.8	0.7	1.1	n.a.
	CP Dec 2004	*0.6*	*1.5*	*1.8*	*2.2*	*n.a.*
HICP inflation (%)	**CP Jan 2006**[1]	**2.8**	**2.8**	**3.1**	**2.5**	**1.9**
	COM Nov 2005	2.7	3.1	2.6	2.2	n.a.
	CP Dec 2004[1]	*2.9*	*2.4*	*1.9*	*1.9*	*n.a.*
Output gap (% of potential GDP)	**CP Jan 2006**[2]	**-1.8**	**-2.9**	**-3.7**	**-4.2**	**-4.4**
	COM Nov 2005[6]	-2.0	-3.1	-4.3	-5.1	n.a.
	CP Dec 2004[2]	*-2.1*	*-2.4*	*-2.3*	*-1.6*	*n.a.*
General government balance (% of GDP)	**CP Jan 2006**	**-5.1**	**-3.9**	**-2.7**	**-2.3**	**-1.2**
	COM Nov 2005	-5.1	-4.2	-3.0	-2.5	n.a.
	CP Dec 2004	*-5.2*	*-3.7*	*-2.3*	*-1.4*	*n.a.*
Primary balance (% of GDP)	**CP Jan 2006**	**-1.0**	**0.3**	**1.4**	**1.5**	**2.4**
	COM Nov 2005	-1.0	0.2	1.3	1.9	n.a.
	CP Dec 2004	*-1.4*	*0.3*	*1.6*	*2.4*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP Jan 2006**[2]	**-4.4**	**-2.8**	**-1.3**	**-0.7**	**0.4**
	COM Nov 2005	-4.3	-2.9	-1.2	-0.3	n.a.
	CP Dec 2004[2]	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Structural balance[3] (% of GDP)	**CP Jan 2006**[4]	**-5.1**	**-3.8**	**-2.3**	**-1.4**	**0.3**
	COM Nov 2005[5]	-5.0	-3.9	-2.2	-1.0	n.a.
	CP Dec 2004	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**CP Jan 2006**	**76.7**	**76.7**	**70.8**	**68.9**	**67.3**
	COM Nov 2005	75.9	77.2	77.4	77.1	n.a.
	CP Dec 2004	*73.2*	*72.0*	*70.5*	*70.4*	*n.a.*

Notes:
[1] CP figures correspond to the Retail Price Index.
[2] Commission services' calculations on the basis of the information in the programme.
[3] Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.
[4] One-off and other temporary measures taken from the programme: 0.7% in 2004, 1.0% of GDP in 2005, 1.0% in 2006, 0.7% in 2007 and 0.1 in 2008; all deficit-reducing.
[5] The Commission services' forecast include the same one-offs as the programme.
[6] Based on estimated potential growth of 1.3%, 2.0%, 2.0% and 2.0% respectively in the period 2004-2007.
Source:
Convergence programme (CP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations.