COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.2.2007
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Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of Malta, 2006-2009

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL 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. The 2005 reform of the Pact acknowledged its 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 Stability and Growth 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.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of Malta, submitted on 7 December 2006, and has adopted a recommendation for a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the updated convergence programme is assessed, the following paragraphs summarise:

(1) the economic and budgetary performance over the last ten years

(2) the country's position under the corrective arm of the Stability and Growth Pact (excessive deficit procedure)

(3) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the convergence programme)

(4) the Commission's assessment of the October 2006 national reform programme.

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[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

2.1. Recent economic and budgetary performance

Following a period of strong economic growth in the second half of the nineties, the performance of the Maltese economy slowed down appreciably between 2001 and 2005[2]. Although unfavourable cyclical developments contributed to this outcome, domestic structural weaknesses - magnified by sectoral concentration in manufacturing - have progressively led to a loss in Malta's external competitiveness. This resulted in a fall in exports and a worsening external deficit which in 2005 stood at around 11% of GDP. While estimates for TFP growth may capture 'quality' aspect of factor inputs, the low total factor productivity in recent years appears to be another reason behind Malta's weak economic growth. In the past years, Malta recorded a general government deficit. Although various attempts have led to a decline in the deficit-to-GDP ratio since 1998, the adjustment was not always durable. For most years the adjustment was achieved through higher revenue, however recently adjustment is being attained through expenditure control which should contribute to a more lasting consolidation. However, despite the success in restraining overall spending in recent years, certain expenditure items - such as those related to healthcare and social protection - have followed an upward trend between 1998 and 2004.

2.2. The excessive deficit procedure for Malta

On 5 July 2004 the Council adopted a decision stating that Malta had an excessive deficit in accordance with Article 104(6). At the same time, the Council addressed a recommendation under Article 104(7) specifying that the excessive deficit had to be corrected by 2006. In particular, Malta was recommended to implement with vigour measures, particularly those of a structural nature, aimed at rationalising and reducing expenditure. The Council also recommended Malta to end the rise in the debt ratio in 2005 and reduce it thereafter.

2.3. The assessment in the Council opinion on the previous programme

On 14 March 2006, the Council adopted its opinion on the previous update of the convergence programme, covering the period 2005-2008. The Council was of the opinion that "overall the programme is consistent with the correction of the excessive deficit by 2006". The Council invited Malta to "implement with rigour the 2006 budget measures and ensure the correction of the excessive deficit this year and in line with the updated convergence programme, and ensure that budgetary consolidation towards the programme's medium-term objective is sustained after the excessive deficit has been corrected", to "ensure that the debt ratio is declining towards the 60% of GDP Treaty reference value at a satisfactory pace from 2006 onwards" and to "improve the long-term sustainability of the public finances by making further progress in the design and implementation of the pension reform".

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[2] On 7 December 2006, the Maltese authorities transmitted to Eurostat new GDP data since 1995, showing - with respect to figures published in September 2006 - downward revisions in nominal GDP levels up to around 1% between 1996 and 2003. For 2004 and 2005, nominal GDP has been revised upwards by 0.4% and 0.9%, respectively, and for the first half of 2006 the revision corresponds to 1.1%. These revisions were carried out within the regular assessment process of compliance with Eurostat's statistical practices. The latest figures have been used by the Commission in its assessment of the updated programme.

2.4. The Commission assessment of the October 2006 national reform programme

The implementation report of the national reform programme of Malta, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 15 October 2006. Malta's national reform programme identifies as key challenges/priorities: sustainability of public finances, competitiveness, the environment, employment and education and training. The Commission's assessment of this programme (adopted as part of its December 2006 Annual Progress Report[3]) showed that Malta is making good progress in the implementation of its National Reform Programme. Implementation is advancing strongly in the area of fiscal sustainability, considered by the authorities to be a crucial element for achieving more growth and jobs and adopting the euro. The implementation efforts in the micro-economic and employment area are more moderate.

Against the background of strengths and weaknesses identified, Malta was recommended to take action in the areas of: strengthening competition and reduce and redirect state aid; attracting more people into the labour market, tackle undeclared work and implement changes to the tax and benefit system.

[3] Communication from the Commission to the Spring European Council, "Implementing the renewed Lisbon strategy for growth and jobs - A year of delivery" - COM(2006) 816, 12.12.2006.

Box: Main points covered by the assessment

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2006 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[4];
- the degree of integration with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[5], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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4 Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

5 "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.

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

On the updated convergence programme of Malta, 2006-2009

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

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

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [27 February 2007] the Council examined the updated convergence programme of Malta, which covers the period 2006 to 2009.

(2) The macroeconomic scenario underlying the programme envisages that real GDP growth will hover around 3% over the programme period. Assessed against currently available information, this scenario appears to be based on favourable growth assumptions for 2007 and markedly favourable ones thereafter, especially due to the optimistic medium-term evolution of the external sector. Less favourable net exports in the medium term than foreseen in the programme could heighten the external imbalance recorded in recent years.

(3) For 2006, the general government deficit is estimated at 2.9% of GDP in the Commission services' autumn 2006 forecast, against a target of 2.7% of GDP set in the previous update of the convergence programme. The estimated outturn for 2006 in the new update (2.6% of GDP) is below that projected in the Commission services' autumn 2006 forecast and seems plausible in the light of recent information on GDP growth and government finance cash data.

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6 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

(4) The budgetary strategy outlined in the update aims at reducing the deficit below the 3% of GDP reference value in 2006 and at pursuing fiscal consolidation thereafter. The update foresees a gradual reduction in the general government deficit leading to a broadly balanced budget by 2009. With a projected decline in the interest burden, the primary surplus is expected to reach 3¼ % of GDP by 2009. The adjustment is to be achieved through a cut in the primary expenditure ratio by almost 5¾ percentage points of GDP, which more than offsets a decline in the revenue ratio by almost 3¾ percentage points of GDP. Despite the success in restraining overall spending, healthcare expenditure followed an upward trend in the past years. Lower recourse will be made to deficit-reducing one-off measures than in the recent past. The programme broadly confirms the planned nominal budgetary adjustment in the previous update against a much more favourable macroeconomic scenario.

(5) The structural deficit (i.e. the cyclically-adjusted deficit net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to improve from around 3% of GDP in 2006 to ½% of GDP at the end of the programme period. As in the previous update of the convergence programme, the medium-term objective (MTO) for the budgetary position presented in the programme is a balanced position in structural terms but the new programme does not aim to achieve the MTO within the programme period. As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1¾% of GDP), achieving it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The MTO 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.

(6) The risks to the budgetary projections in the programme appear broadly balanced for 2007 but the budgetary outcomes could be worse than projected in the programme thereafter. This is due to a favourable GDP growth projected for 2007 and a markedly favourable macroeconomic scenario in 2008-2009 underlying the update's projections (although tax projections for these years seem cautious). In addition, after 2007 no details are given on the adjustment strategy increasing the risks attached to the planned fiscal consolidation.

(7) In view of this risk assessment, the budgetary stance in the programme seems consistent with a correction of the excessive deficit by 2006 as recommended by the Council. In addition, it seems to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations from 2008 onwards. In the years following the correction of the excessive deficit, the pace of the adjustment towards the MTO implied by the programme is broadly in line with the Stability and Growth Pact, which specifies that, for euro-area and ERM II Member States, the annual improvement in the structural balance should be 0.5% of GDP as a benchmark and that the adjustment should be higher in good economic times and could be lower in bad economic times.

(8) Government gross debt is estimated to have reached 68¼% of GDP in 2006, above the 60% of GDP Treaty reference value. The programme projects the debt ratio to decline by 8¾ percentage points of GDP over the programme period. The evolution of the debt ratio is likely to be less favourable than projected in the programme given the risks to the budgetary targets mentioned above. In view of this risk assessment, the

debt ratio seems to be sufficiently diminishing towards the reference value over the programme period.

(9) Malta has recently enacted a pension reform aimed at both increasing the effective retirement age and raising the level of pensions. As a result estimates in the programme suggest that pension expenditures will be higher, leading to a higher increase in age-related expenditure, close to the EU average. Although at a somewhat slower pace than historical trends, projections for healthcare spending show an increase of around 1¾ percentage points of GDP in the long term, if current trends persist. The current budgetary position would not ensure a steady reduction of debt to below the Treaty reference value. Therefore, improving the budgetary position, as projected in the programme, would contribute to reducing the risks to the sustainability of public finances. Overall, Malta appears to be at medium risk with regard to the sustainability of public finances.

(10) The convergence programme does not contain a qualitative assessment of the overall impact of the October 2006 implementation report of the national reform programme within the medium-term fiscal strategy. However, it provides systematic information on the direct budgetary costs or savings of the main reforms envisaged in the national reform programme and its budgetary projections explicitly take into account the public finance implications of the actions outlined in the national reform programme. The measures in the area of public finances envisaged in the convergence programme seem consistent with those foreseen in the national reform programme. In particular, both programmes envisage the implementation of the pension reform while the convergence programme provides details of the tax reform announced in the national reform programme.

(11) The budgetary strategy in the programme is broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

(12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and optional data[7].

The overall conclusion is that the programme is consistent with a correction of the excessive deficit by 2006 and, in a context of strong growth prospects, envisages adequate progress towards the MTO thereafter. The debt ratio as envisaged by the programme seems to be diminishing at a satisfactory pace towards the 60% of GDP reference value. However, there are risks to the achievement of the budgetary targets after 2007. Maintaining a budgetary position that is robust to possible reversals of the projected strong growth pattern is important especially in light of the recent build-up of external imbalances. In view of the above assessment, Malta is invited to:

(i) pursue adequate progress towards the MTO and ensure that the debt-to-GDP ratio is reduced accordingly, while spelling out the budgetary strategy, especially on the expenditure side, with a longer time perspective;

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7 In particular, the data on sectoral balances in particular forecasts for net lending/borrowing vis-à-vis the rest of the world for 2006-2009 and employment and labour productivity in hours worked are not provided.

(ii) in view of the level of debt and the projected increase in age-related expenditure, improve the long-term sustainability of public finances by achieving the MTO and making further progress in the design and implementation of the healthcare reform.

Comparison of key macroeconomic and budgetary projections

		2005	**2006**	**2007**	**2008**	**2009**
Real GDP (% change)	**CP Dec 2006**	**2.2**	**2.9**	**3.0**	**3.1**	**3.1**
	COM Nov 2006	2.2	2.3	2.1	2.2	n.a.
	CP Jan 2006	*0.9*	*1.1*	*1.2*	*2.0*	*n.a.*
HICP inflation (%)	**CP Dec 2006**	**2.5**	**3.1**	**2.2**	**2.1**	**2.0**
	COM Nov 2006	2.5	3.0	2.6	2.4	n.a.
	CP Jan 2006[6]	*2.8*	*3.1*	*2.5*	*1.9*	*n.a.*
Output gap (% of potential GDP)	**CP Dec 2006**[1]	**-2.8**	**-2.1**	**-1.3**	**-0.3**	**0.9**
	COM Nov 2006[5]	-2.1	-1.4	-1.1	-0.5	n.a.
	CP Jan 2006[1]	*-2.9*	*-3.7*	*-4.2*	*-4.4*	*n.a.*
General government balance (% of GDP)	**CP Dec 2006**	**-3.2**	**-2.6**	**-2.3**	**-0.9**	**0.1**
	COM Nov 2006	-3.2	-2.9	-2.7	-2.9	n.a.
	CP Jan 2006	*-3.9*	*-2.7*	*-2.3*	*-1.2*	*n.a.*
Primary balance (% of GDP)	**CP Dec 2006**	**0.8**	**1.1**	**1.1**	**2.5**	**3.2**
	COM Nov 2006	0.8	0.9	0.7	0.6	n.a.
	CP Jan 2006	*0.3*	*1.4*	*1.5*	*2.4*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP Dec 2006**[1]	**-2.2**	**-1.8**	**-1.8**	**-0.8**	**-0.2**
	COM Nov 2006	-2.4	-2.3	-2.3	-2.7	n.a.
	CP Jan 2006[1]	*-2.8*	*-1.3*	*-0.7*	*0.4*	*n.a.*
Structural balance[2] (% of GDP)	**CP Dec 2006**[3]	**-3.8**	**-2.9**	**-2.0**	**-1.0**	**-0.4**
	COM Nov 2006[4]	-4.0	-3.5	-2.5	-2.7	n.a.
	CP Jan 2006	*-3.8*	*-2.3*	*-1.4*	*0.3*	*n.a.*
Government gross debt (% of GDP)	**CP Dec 2006**	**74.2**	**68.3**	**66.7**	**63.2**	**59.4**
	COM Nov 2006	74.2	69.6	69.0	68.6	n.a.
	CP Jan 2006	*76.7*	*70.8*	*68.9*	*67.3*	*n.a.*

Notes:
[1] Commission services calculations on the basis of the information in the programme.
[2] Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.
[3] One-off and other temporary measures taken from the programme (1.6% of GDP in 2005, 1.1% of GDP in 2006, 0.2% of GDP in 2007, 0.2% of GDP in 2008 and 0.2% of GDP in 2009; all deficit-reducing).
[4] One-off and other temporary measures taken from the Commission services' autumn 2006 forecast (1.6% of GDP in 2005, 1.1% of GDP in 2006, 0.2%of GDP in 2007, 0% of GDP in 2008; all deficit-reducing).
[5] Based on estimated potential growth of 2.2%, 1.7%, 1.7% and 1.6% respectively in the period 2005-2008.
[6] The January 2006 CP figures correspond to the Retail Price Index.
Source:
Convergence programme (CP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations