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REPORT FROM THE COMMISSION

Malta

Report prepared in accordance with Article 104(3) of the Treaty

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1. INTRODUCTION AND JUSTIFICATION OF THE REPORT

On 7 April 2004, the Commission published its Spring 2004 forecasts. According to these forecasts, which took into consideration data reported by Malta and validated by Eurostat in March 2004, the general government deficit in Malta reached 9.7% of GDP in 2003, thus exceeding the 3% of GDP Treaty reference value.

Table 1: General government balance and debt (% of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005
General government balance	-10.8	-7.6	-6.5	-6.4	-5.7	-9.7	-5.9	-4.5
General government gross debt	64.9	56.2	57.1	61.8	61.7	72.0	73.9	75.9

Source: Eurostat and Commission Spring 2004 forecasts.

At this stage, the estimated figure for the 2003 deficit provides evidence on the existence of an excessive deficit in Malta, in the sense of the Treaty and the Stability and Growth Pact. The Commission therefore has decided to initiate the excessive deficit procedure (EDP) for Malta.

The application of the EDP is governed by Article 104 of the Treaty and Council Regulation (EC) No 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure", which is part of the Stability and Growth Pact (SGP).

Article 104(3) of the Treaty stipulates that "if a Member State does not fulfil the requirements under one or both of these criteria[1], the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State. …"

The present report prepared by the Commission according to Article 104(3) assesses recent and current budgetary developments in Malta and reviews the short-term prospects in the light of overall economic conditions and policy action taken by the government.

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[1] The criteria are (a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds the reference value of 3°%, unless: either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value; (b) whether the ratio of government debt to gross domestic product exceeds the reference value of 60 %, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

2. RECENT MACROECONOMIC DEVELOPMENTS AND PROSPECTS

After 2000, when the Maltese economy attained a 6.4% GDP growth rate, Malta entered a period of lower growth. The economy largely recovered from the effects of the international slowdown in 2002, but failed to keep pace in 2003. The main drivers for economic growth in 2003 were high public expenditure and a jump in gross fixed capital formation, which led to an increase in imports. Uncertainty in international markets, especially faltering demand for semiconductors, a key product, negatively influenced export growth in 2003, but is likely to improve gradually as the expected strengthening of the technological sector in the United States and Asia occurs. A negative outcome in the trade balance and poor results in the tourist sector led to a widening of the external deficit by 1.3 percentage points, to 3.4% of GDP in 2003. The immediate outlook for the economy is for a gradual upswing in the growth rate to 1.4% in 2004, accelerating to 2.0% in 2005, supported by an improvement in external demand and with a strong contribution from capital formation.

Lower activity in the tourist sector and industrial restructuring in manufacturing has caused considerable job losses and negatively influenced employment developments. The survey-based unemployment rate worsened to 8.2% in December 2003, from 6.8% in 2002.

Inflation performance has been relatively good, helped by monetary and exchange rate stability. The main consumer prices measure, the Retail Prices Index, decelerated from 2.9% in 2001 to 1.3% in 2003. The annual rate of inflation would have been even lower in 2003 but for significant price increases in the fourth quarter, probably anticipating the announcement in the November Budget of higher prices of cigarettes and the rise in the standard VAT rate to 18% from the beginning of 2004.

Table 2: Macroeconomic developments and outlook

	1998	1999	2000	2001	2002	2003	2004	2005
Real GDP (% change)	3.4	4.1	6.4	-1.2	1.7	0.4	1.4	2.0
Contribution: Domestic demand including change in inventories	-1.1	6.0	11.3	-5.9	-2.7	4.9	2.7	2.1
External trade	4.6	-1.9	-4.9	4.7	4.4	-4.5	-1.2	-0.1
Unemployment rate (% of labour force)	n.a.	n.a.	7.0	6.7	7.5	8.2	8.6	8.1
Unit labour costs (% change)	n.a.	n.a.	n.a.	n.a.	11.5	-0.5	-0.4	0.6
Retail Prices Index (% change)	2.4	2.1	2.4	2.9	2.1	1.3	2.7	2.1
External account[a] (% of GDP)	-6.3	-3.4	-13.4	-4.5	-2.1	-3.4	-4.3	-3.9
GDP/capita, PPS (% of EU-15 avg.)	n.a.	71.3	70.9	69.5	69.1	68.9		

[a] Net lending/ borrowing vis-à-vis the rest of the world = current account + capital account

Source: Eurostat and Commission Spring 2004 forecasts.

The downward trend in inflation is foreseen to be reversed in the first half of 2004 due to the standard VAT rate increase from 15% to 18%. However, the complete removal of excises and import duties from May 2004 is expected partly to offset the previous rises, thus helping the rate of inflation to remain around 2% in 2004 and 2005. As regards recent wage developments, the weighted average weekly wage in September 2003[2] was 3% higher than a year earlier. The prospect is of continuing contained growth of compensation per head, aided by a growing consensus emerging among all social partners on the need for moderate increases in order to enhance productivity and widen employment. In the period, Malta's GDP/capita in PPS as % of the EU average diminished slightly (see table 2).

3. THE SITUATION OF GOVERNMENT FINANCES

After a progressive decrease in the period 1999-2002, the general government deficit jumped from 5.7% of GDP in 2002 to 9.7% of GDP in 2003. This is mostly explained by high public expenditure, cyclical factors and the restructuring of the shipyard industry in 2003. The deficit is expected to remain well above the 3% reference value in 2004 but to decline substantially on the previous year.

The analysis of budgetary developments is still hampered by slow data processing. In particular, a consistent series of fully consolidated ESA95 data for government revenues and expenditures in 2003 is not yet available.

3.1. Recent budgetary developments until 2002

The general government deficit gradually improved from 10.8% of GDP to 5.7% of GDP in the period 1998-2002. Cyclical factors can partly explain the consolidation progress achieved in 1999 and 2000, but adjustment efforts were made in 2001 and 2002, when GDP growth was not supportive of fiscal consolidation.

Table 3: GDP growth and general government balance and debt

(% of GDP, unless otherwise indicated)	1998	1999	2000	2001	2002	2003	2004	2005
Real GDP (% change)	3.4	4.1	6.4	-1.2	1.7	0.4	1.4	2.0
General government balance	-10.8	-7.6	-6.5	-6.4	-5.7	-9.7	-5.9	-4.5
Primary balance	3.4	6.6	-0.4	6.2	1.6	5.9	2.5	1.1
Total expenditures	48.0	46.4	45.0	46.1	48.0	n.a	n.a	n.a
of which: gross public investment	7.2	7.2	6.5	4.9	5.8	5.7	6.6	6.1
Total revenues	48.4	49.6	41.0	48.8	45.9	n.a	n.a	n.a
General government gross debt	64.9	56.2	57.1	61.8	61.7	72.0	73.9	75.9

Source: Eurostat and Commission Spring 2004 forecasts.

[2] Economic Survey, Jan.-Sept. 2003, Ministry of Finance and Economic Affairs.

While the trend of total revenues relative to GDP has been erratic in the period (growing in 1999 and 2001, and contracting in 2000 and 2002), the ratio of total expenditure grew steadily to 2000 before accelerating in 2001 and 2002. The primary balance was positive over the whole period except in 2000, reflecting the drop in public revenue in that year.

At sectoral level, the basis of the general government deficit lies with central government, given that local institutions and the social security sector operate on a balanced basis.

3.2. Budgetary developments in 2003

The general government deficit recorded a substantial increase to 9.7% of GDP in 2003 from 5.7% in 2002. This figure compares negatively to the target of 4.6% of GDP set in the August 2002 Pre-accession Economic Programme (PEP), which assumed GDP growth of 3.1%. The November 2002 Budget forecast GDP growth of 5.0% in 2003 but kept unchanged the general government deficit target at 4.6% of GDP. These predictions proved unrealistic and were revised downward in August and in November 2003 (2003 PEP and 2004 Budget respectively). However, the final outcome for 2003 was still worse.

Table 4: Successive targets for the 2003 general government balance and estimated outcome

	Real GDP growth assumption (%)	Government balance (% of GDP)
August 2002: 2002 PEP	3.1	-4.6
November 2002: budget for 2003	5.0	-4.6
August 2003: 2003 PEP	1.3	-7.4
November 2003: budget for 2004	0.8	-6.4
April 2004: Commission Spring 2004 forecasts	0.4	-9.7

Source: Commission services

The principal reasons for the deviation from the budgetary target lie in lower tax collection due to weak GDP growth and in the restructuring of Maltese shipyards in November 2003. As regards the latter, the appropriate accounting treatment of associated debt assumed by the general government sector brought about an increase in public liabilities of 3.2% of GDP.

3.3. Prospects for 2004

The 2004 budget was presented in November 2003. On the revenue side, receipts are expected to increase by 5.3% points of GDP, half of this amount due to inflows under the Italian Financial Protocol (a co-operation treaty between Malta and Italy) and from EU funds. Other increases will stem from stronger enforcement in tax collection, mainly in the real estate sector, and VAT rate and excise increases. On the expenditure side, recurrent payments are forecast to increase by 3.6% points of GDP, linked to increases in social benefits and debt interest. Capital expenditures will rise from 5.7% of GDP in 2003 to 6.6% of GDP, with this increase largely attributable to a major hospital construction project.

The 2003 PEP projected a general government deficit of 5.8% of GDP in 2004. Given more recent outturn data, the Commission's 2004 spring forecast raised this figure only slightly to 5.9% of GDP, despite being based on economic growth developments somewhat lower than projected in the PEP (1.4% real GDP growth compared with 2.5% respectively).

3.4. Recent debt developments and prospects

From 1999 onwards, a gradual trend increase in the debt ratio was relatively contained as the effect of high nominal GDP growth largely offset primary deficits. By 2002 the ratio had risen to 61.7%, from 56.2% in 1999. In 2003, however, as a result of the restructuring of the shipyard sector in Malta and a substantial reversal of the previous year's stock-flow adjustment, the debt-to-GDP ratio jumped to 72.0% of GDP, thus rising further above the 60% of GDP reference value. In 2004, the reduced primary deficit should slow the increase of the public debt ratio, to 73.9% of GDP. Although the Maltese authorities are expected to re-launch the privatization process as the international environment and market conditions improve, in 2004 no significant reductions in the debt level are expected from new privatizations.

Table 5: Debt dynamics

	1998	1999	2000	2001	2002	2003	2004	2005
Government gross debt	64.9	56.2	57.1	61.8	61.7	72.0	73.9	75.9
Change in debt ratio (1=2+3+6)	13.6	-8.7	1.0	4.7	-0.1	10.3	1.9	2.0
Primary balance (2)	-7.8	-4.2	-3.0	-2.8	-1.9	-5.9	-2.0	-0.5
Snowball effect (3=4+5)	0.2	-0.8	-0.3	1.1	2.1	0.8	2.1	1.5
Interest expenditure (4)	3.0	3.4	3.5	3.6	3.8	3.8	3.9	4.0
Contribution of nominal GDP growth (5)	-2.8	-4.2	-3.8	-2.5	-1.7	-3.0	-1.8	-2.5
Stock-flow adjustment (6)	5.6	-12.1	-1.8	0.8	-4.1	3.6	-2.2	0.0

Source: Eurostat and Commission Spring 2004 forecasts.

4. OTHER RELEVANT FACTORS

4.1. Medium-term prospects

In the medium term, the government expressed its commitment in the August 2003 PEP to reduce the general government deficit to 5.8% of GDP and 4.1% of GDP in 2004 and 2005, respectively. However, in the November 2003 budget, the government programmed a decline in the deficit of around 1 p.p. of GDP for the same period. The thrust of this strategy is, on the one side, a strong commitment to continue to combat tax evasion and, on the other, the structured review of expenditure; the reform of the pension system and the healthcare service are expected to start within this horizon.

4.2. Investment

Article 104(3) of the Treaty foresees that the present Commission report "shall also take into account whether the government deficit exceeds government investment expenditure". General government gross investment fell from 7.2% of GDP in 1998 to 4.9% of GDP in 2001 (see table 3). In 2002, while the deficit continued its downward trend to 5.7% of GDP, general government gross investment increased to 5.8% of GDP. In 2003, the deficit, excluding the shipyard operation referred to above, grew by 1 percentage point to 6.7% of GDP; the government investment ratio remained approximately stable at 5.7% of GDP. Developments in investment rates are consistent with the public investment needs linked to the catching-up process of the Maltese economy.

4.3. External account

In the period 1998-2003 Malta registered external account[3] deficits averaging 5½% of GDP, though declining to 2.1% and 3.4% of GDP in 2002 and 2003, respectively. The surpluses of the service balance in the two latter years of around 12% of GDP provided by tourism and other services were more than offset by trade balance deficits of around 14-17% of GDP. The extremely open nature of the Maltese economy, given its small size, makes it essential to remain competitive. The general government deficit does not seem to be strongly linked to the external account balance, except in 2003 where outlays due to the equipment purchases abroad related to major construction impacted negatively on the current account balance. The Commission Spring forecast projects a slightly widening external account deficit to around 4% of GDP in 2004 and 2005, reflecting a parallel movement of the trade deficit.

5. CONCLUSIONS

The general government deficit increased to 9.7% of GDP in 2003 in Malta (including the cost of a major one-off operation estimated at 3.2% of GDP). Although budgetary developments have been adversely affected by weakness in economic activity, the excess of the general government deficit over the 3% of GDP reference value does not result, in the sense of the Stability and Growth Pact, from an unusual event outside the control of the Maltese authorities, nor is it the result of a severe economic downturn.

According to the Commission Spring 2004 forecasts and as well as the Maltese authorities own forecasts, the general government deficit will, at 5.9% of GDP, be well above 3% of GDP in 2004. The debt-to-GDP ratio reached increased to 72% of GDP in 2003 in Malta. According to the Commission Spring 2004 forecast this ratio will be 73.9% of GDP in 2004, remaining also well above the 60% of GDP Treaty reference value.

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[3] Net lending/ borrowing vis-à-vis the rest of the world = current account + capital account. In the current system of national accounts, this is what corresponds to the concept of the "balances of payments on current account" mentioned in Article 121(1) of the Treaty.