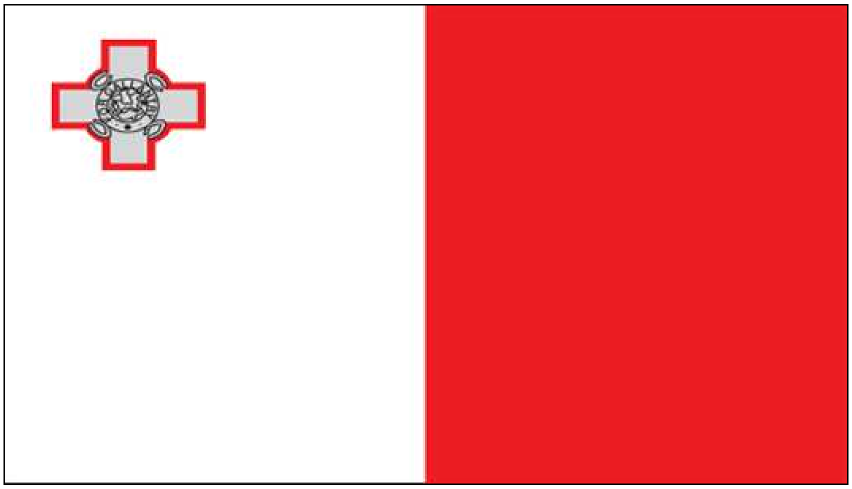
# Country report **Malta**



**Summary**
Malta is a very small but developed democratic island state in the Mediterranean Sea, member of the EU since 2004 and of the euro zone since 2008. Since the mid-1990's, while preparing to join the EU, it improved its attractiveness to foreign investors. Tourism, shipping, business services and a very large financial sector are the basis of the economy. Malta has an attractive tax regime, an efficient and capable legal system, but corruption persists.
Inflation is slightly above the EU average and with labor productivity increasing very slowly, relative unit labor costs have been rising. This caused a loss of external competitiveness. The fiscal 'Maastricht' criteria are modestly breached and should not pose a short-term risk for holders of governments paper. As a euro zone country Malta is not subject to transfer risk.
Geo-politically, Malta is a neutral country without external threats, but the influx of North African refugees in 2011 caused tension with the EU and neighboring Italy.

**Things to watch:**

- Impact of current euro zone crisis on financial sector
- Domestic reaction to refugees immigration

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## Malta

| National facts | | |
|---|---|---|
| Type of government | Parliamentary republic | |
| Capital | Valletta | |
| Surface area (thousand sq km) | 0.3 | |
| Population (millions) | 0.4 | |
| Main languages | Maltese (90%) | |
| | English (6%) | |
| Main religions | Roman Catholic (98%) | |
| Head of State (president) | George Abela | |
| Prime Minister | Lawrence Gonzi | |
| Monetary unit | Euro (EUR) | |

| Economy | | 2010 |
|---|---|---|
| *Economic size* | *bn USD* | *% world total* |
| Nominal GDP | 8 | 0.01 |
| Nominal GDP at PPP | 10 | 0.01 |
| Export value of goods and services | 7 | 0.04 |
| IMF quotum (in mln SDR) | 102 | 0.05 |
| *Economic structure* | *2010* | *5-year av.* |
| Real GDP growth | 3.6 | 2.6 |
| Agriculture (% of GDP) | n.a. | n.a. |
| Industry (% of GDP) | n.a. | n.a. |
| Services (% of GDP) | n.a. | n.a. |
| *Standards of living* | *USD* | *% world av.* |
| Nominal GDP per head | 19974 | 202 |
| Nominal GDP per head at PPP | 24697 | 210 |
| Real GDP per head | 16292 | 203 |

| Social and governance indicators | rank / total |
|---|---|
| Human Development Index (rank) | 33 / 169 |
| Ease of doing business (rank) | n.a. / 183 |
| Economic freedom index (rank) | 57 / 179 |
| Corruption perceptions index (rank) | 37 / 178 |
| Press freedom index (rank) | 14 / 178 |
| Gini index (income distribution) | n.a. |
| Population below $1.25 per day (PPP) | n.a. |

| Foreign trade | | | 2010 |
|---|---|---|---|
| *Main export partners (%)* | | *Main import partners (%)* | |
| Singapore | 11 | Italy | 22 |
| Germany | 10 | UK | 8 |
| France | 6 | Germany | 8 |
| US | 4 | France | 7 |
| *Main export products (%)* | | | *2009* |
| Transport Equipment | | | 57 |
| Manufactured goods | | | 18 |
| Chemicals | | | 12 |
| Semi-manufactures | | | 5 |
| *Main import products (%)* | | | |
| Machinery & Transport equipment | | | 40 |
| Food | | | 13 |
| Manufactured goods | | | 12 |
| Fuels | | | 11 |
| *Openness of the economy* | | | *2010* |
| Export value of G&S (% of GDP) | | | 85 |
| Import value of G&S (% of GDP) | | | 83 |
| Inward FDI (% of GDP) | | | 12.0 |

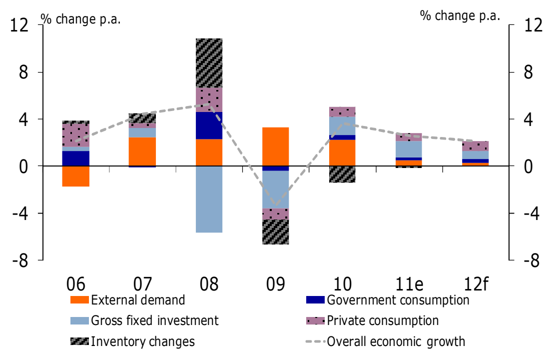
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

**Economic structure and growth**

The three islands of Malta together is one of the smallest of the 17 euro zone countries. With just 400,000 inhabitants living on barely 300 km$^2$ it has the highest population density of the euro zone. The lack of space explains the limited existence of manufacturing (semiconductors being an exception) and agriculture. Services, including finance, tourism and shipping dominate the economy, although macroeconomic data for these sectors is missing. The infrastructure and skills and education level of the local labor force is in line with other southern EU member countries.
Malta has a past of flirting with centrally planned development, but moved away from socialism in the early 1990's. As a signatory to numerous double-taxation agreements, Malta attracted tax-driven financial institutions. The considerable tax exemptions and benign tax regime for hedge funds even caused the country to be accused of being a tax-haven in international official fora: now policy has changed and is directed to attract respectable fund management services that now tend to land in high-cost Luxembourg. Thus, since the accession to the EU in 2004 taxation advantages have become more aligned with EU regulations. Although the banking remains an major sector, it is surpassed as a money earner by international tourism, although also their revenues suffered from the 2008-2009 crisis.
Nominal GDP per capita is at the level of that of Portugal and the Czech and Slovak Republics, but at only 60% of that of Italy. With real growth exceeding the average GDP growth in the EU, some income convergence must have taken place over the past decade. This living standard convergence is an aim that is pursued by means of often EU sponsored government programs to attract foreign

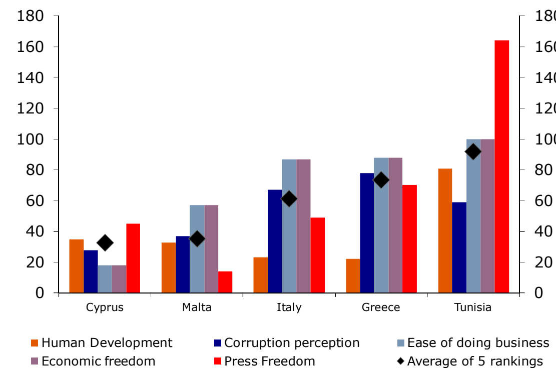
investors, to increase the female labor market participation and diversify into higher value-added sectors.
As chart 1 shows, growth has suffered a major dip in 2009 in the wake of the 2008-2009 global financial crisis. Real investments were reduced by 20% and 25% and consumers' spending appetite was also reduced ( -2%). In 2009 and 2010, sales from inventory stocks were not replenished. In 2010 exports more than recovered from the 10% decline in 2009. Malta's share on its export markets is however declining, as wages keep on rising faster than labor productivity, thus is increasing the unit labor costs. Since joining the euro zone in 2008, the exchange rate and the policy interest rates are no longer policy instruments, with wage and price adjustments the only way to go.

**Chart 1: Growth drivers**




Source: EIU

**Chart 2: Governance and social indicators**




Source: EIU

The financial sector has performed well, but 70% of assets and deposits are in foreign-owned banks. Domestic banks are reputed to be conservative (no complex products, no foreign adventures and abundantly funded by local deposits). Also tight supervision is strictly adhered to. Local banks' assets are valued at 260% of GDP, high but stable and mostly in private mortgages. Foreign banks have established since 2004 and their growth has been remarkably. Their total financial assets now total 600% of GDP, numerically comparable to pre-crisis Iceland. These 'offshore banks' benefit from the benign taxman, but hardy touch base in Malta itself. In case of financial distress, these international banks are expected to refer to their parent companies and home governments.

**Political and social situation**

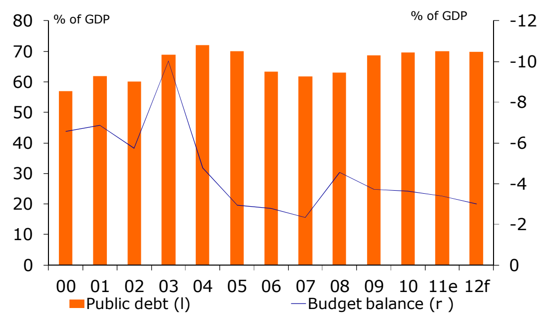
After over 150 years of British colonial rule, and independence in 1964, Malta became a parliamentary democracy within the Commonwealth in 1974. Malta joined the EU in 2004. The political system is similar to the British, with two major political parties vying for power. The conservative pro-EU National Party most of the years holds just a minimal majority in parliament. It has been almost continuously in power since 1987 and can count on the strong informal power of the Catholic church. The Malta Labor Party (MLP), split between the nostalgic étatist and Eurosceptic left versus the more enlightened social democrats, has been the all-time opposition since 1987. Among the population, there remain strong anti-market and anti-privatization sentiments fed by trade-unions.
After the era of political violence of the 1980's and 1990's, elections have been very orderly. Latest parliamentary, European and presidential elections show narrow margins between the leading parties. Spring 2011, a referendum on civil divorce was narrowly won (53%) by the pro-divorce

forces, among which the opposition Labor Party dominates. The political situation in Malta is now generally stable, although infighting and sharp policy divisions could re-emerge.
When looking at comparative indicators of social development, business climate and governance (chart 2), Malta is roughly on par with Cyprus, but in many respects better ranked than Italy, Greece or Turkey.
Not unlike ports in southern Italy and in northern African countries there is drug-related crime and the large financial sector may hide money laundering transactions. But in general there are no security concerns. Also internationally, relations between Malta and other EU member states are generally very cordial. A border dispute with Libya over a maritime area supposedly with oil reserves is still unsettled, but not pressing. Libya , which also has financial stakes in Maltese enterprises, was until very recently virtually the only energy supplier for the island, which is now seeking to reduce energy type (oil) and supplier dependency. As Malta's neutrality is enshrined in its constitution, Malta's support for the anti-Khadafy forces remains largely verbal.
There are no security threats, but the influx of migrants from North Africa seeking entry to the EU is a cause of concern for the domestic and maritime authorities. It also caused diplomatic strains with other EU states and Italy in particular.

**Economic policy**

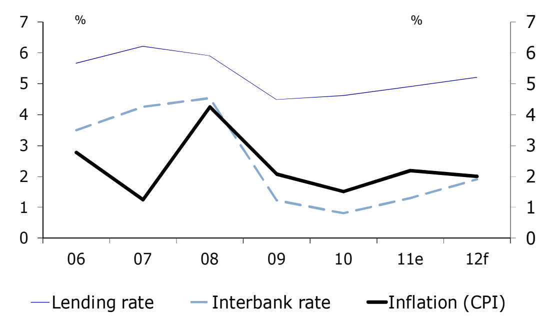
Overall economic policy of the present conservative government is aimed at further integration in the EU as a member with a respectable economic activity (high-tech industries) rather than as a tax-haven. The proper introduction of the VAT, compliance to the Maastricht criteria (public deficit and public debt reduction) and economic structural reforms aim at developing the real economy, rather than favoring the financial sector.

**Chart 3: Public finances**




Source: EIU, Fitch

**Chart 4: Inflation and interest rates**




Source: EIU

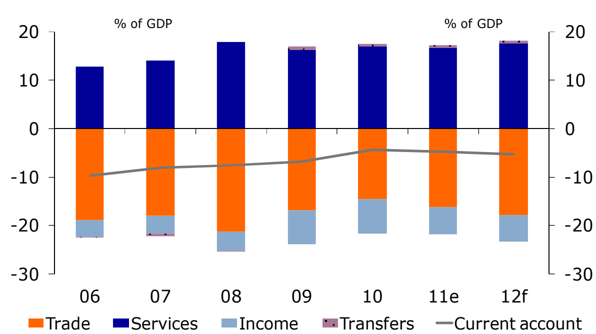
Fiscal policy seeks to reduce the public deficit to below the 3% of GDP and public debt to below 60% of GDP, both following the Maastricht treaty. Malta did make considerable progress in cutting budget deficits prior to euro zone entry, but as chart 3 shows, public debt kept on increasing and neither Maastricht target has been reached so far or is expected to be reached in the next years. Long-run contingent liabilities are related to the future costs of healthcare and general services for the ageing population, not only to the "pay-as-you-go" pension system itself. In the shorter run, funds may be needed to aid state-owned companies (Air Malta, shipping, ports) and banks, in case of a domestic home-owned property crisis. Foreign owned banks, which may be exposed to risky sovereigns, are not considered a contingent liability for the Maltese budget, but for those of their home governments.
Malta being part of the euro zone, the authorities are deprived of monetary policy instruments to influence the inflation rate or the exchange rate. Inflation has over the past decade been

comparatively stable at around 2.5% just above the 2% maximum ECB-acceptable euro zone level. External competitiveness is under pressure, due to a real wage drift that raises unit labor costs for exportable goods and services. As a result, the real effective exchange rate has risen by more than 20% between 2000 and 2010, but this is not so much out of sync with other Southern Euro zone economies like Cyprus, Italy and Portugal. But as in these other euro-countries, the loss of competitiveness must be dealt with by means of more long-term structural labor market policies aiming at increasing supply of skilled labor, higher female labor market participation and training and education; on all of these fiscal incentives have very limited short-term impact.

**Balance of Payments**

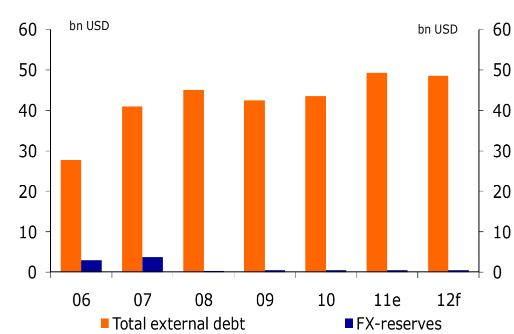
Being a small services-based island economy, with little agriculture and manufacturing industries apart from some promising electronics and pharmaceutical production, the trade balance shows very large structural deficits of around 17% of GDP. Both merchandise imports and exports are for almost two-thirds related to the EU. Despite the geographical position, Malta did not gain an entrepot status for European exports to the North African markets. Only Libya has been an important export destination (7% of total exports in 2010, with negligible imports from that country). The Libyan civil war will impact the export volumes in 2011 and likely also later. However, the overall merchandise deficit is mostly offset by equally structural surpluses on the services account of similar magnitude, as chart 5 shows. Tourism, general business, shipping and international financial sector services drive these net non-merchandise exports, which virtually all are also directed towards Europe. The structural deficit on the incomes account (net interests and dividends paid and repatriated profits) equals around 6% of GDP. This income deficit is confirmed by the IMF, but not easily reconcilable with IMF data concerning Malta's consistent modest net international creditor position to the amount of 13% of GDP (2009), which would suggest small net inflows through the years.
The resulting deficits on the current account range between 5% and 10% of GDP. This deficit has - over the past decade - largely been met by net inflows of foreign direct investments of between 9% and 29% of GDP. Since the adaptation of the euro as legal currency, the then euro-denominated official foreign exchange reserves became domestic currency reserves, which is reflected by the 90% decrease of the level of official FX reserves in 2008.

**Chart 5: Current account**




Source: EIU

**Chart 6: Foreign debt and official reserves**



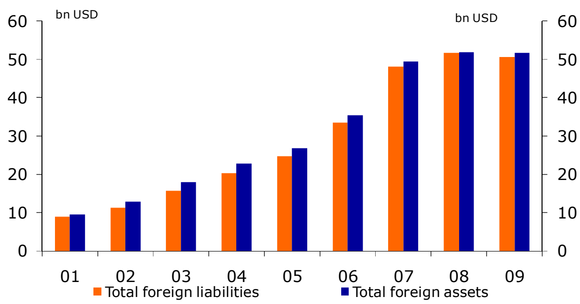

Source: EIU

**External position**

Total external debt shows a rising trend when expressed in USD (see chart 8) and reached end of 2010 almost USD 44bn. But debt ratios are rather stable since 2007 at over five times GDP and 400% of export revenues. The bulk of these debts are held by Malta based banks that mostly attract foreign deposits (USD37bn; all maturities) to on-lend in non-Maltese assets (latest data for 2009). The short-term debt amounting to USD 31.7bn (2010; 73% of total gross debts), consists largely of these basically offshore short-term interbank deposits. Even when abstracting from these short term offshore business, the external debt ratios would still be high at 150% of GDP and 110% of annual current foreign earnings.

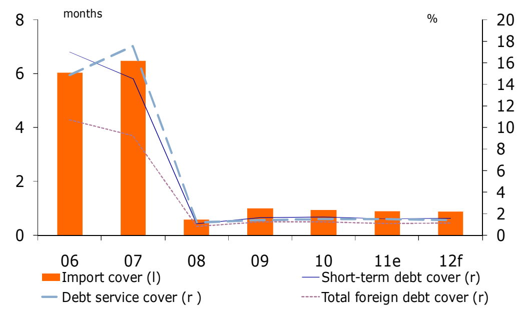
Chart 7 shows how assets and liabilities increased in parallel to around USD50bn in 2009 in line with the expansion of the international banking sector. For all years, small positive net assets positions ranging between USD 100m (2008) and USD 2.5bn (2004) were registered. The persistent current account deficits over the past decade till 2009 total USD 3.5bn, but net foreign asset situation has remained stable as exchange rate and value changes apparently moved to benefit Malta's net value.

**Chart 7: Foreign assets and liabilities**




Source: EIU

**Chart 8: External liquidity**




Source: EIU

The reclassification as per January 2008 of all euro-denominated foreign exchange reserves in domestic reserves of the central bank explains the sudden reduction of all four liquidity ratios per January 2008 that is so notable in chart 8. However, the low level of official FX reserves at the central bank relative to total foreign trade and debt repayment flows is at a similar level of that of other euro zone economies. Since 2008, FX reserves are no longer needed to defend Malta's own local currency, but now form part of a European Central Bank (ECB) managed pool to absorb euro-wide shocks and the external value of the fully convertible euro. Moreover, with central bank authority largely transferred to the ECB, the ability of the Maltese monetary authorities to administratively block non-euro debt repayments (pure transfer risk) has been eliminated.

FX reserves have lost their importance for the individual euro zone economies, including that of Malta. Only if Malta were to reintroduce its own currency, FX reserves would regain their relevance. FX reserves would in that theoretical case most likely bounce back to former levels as euro-denominated assets would instantaneously be reclassified back as foreign currency assets.

## Malta

| Nominal GDP (in bn US$) | 6.4 | 7.5 | 8.7 | 8.1 | 8.3 | 8.9 | 8.5 |
|---|---|---|---|---|---|---|---|
| Selection of economic indicators | 2006 | 2007 | 2008 | 2009 | 2010 | 2011e | 2012f |
| *Key country risk indicators* | | | | | | | |
| GDP (% real change pa) | 2.1 | 4.4 | 5.3 | -3.4 | 3.6 | 2.6 | 2.1 |
| Consumer prices (average % change pa) | 2.8 | 1.3 | 4.3 | 2.1 | 1.5 | 2.2 | 2.0 |
| Current account balance (% of GDP) | -9.7 | -8.1 | -7.6 | -6.9 | -4.3 | -4.8 | -5.2 |
| Total foreign exchange reserves (mln USD) | 2977 | 3785 | 368 | 532 | 536 | 515 | 531 |
| *Economic growth* | | | | | | | |
| GDP (% real change pa) | 2.1 | 4.4 | 5.3 | -3.4 | 3.6 | 2.6 | 2.1 |
| Gross fixed investment (real change pa) | 1.6 | 3.4 | -24.8 | -19.5 | 11.6 | 9.4 | 4.3 |
| Private consumption (real change pa) | 2.7 | 0.5 | 3.1 | -1.5 | 1.2 | 1.1 | 1.3 |
| Government consumption (real change pa) | 6.8 | -0.5 | 12.4 | -2.0 | 2.1 | 1.2 | 1.3 |
| Exports of G&S (real change pa) | 10.3 | 3.1 | 1.9 | -9.5 | 17.7 | 6.6 | 4.3 |
| Imports of G&S (real change pa) | 11.1 | 0.5 | -0.5 | -12.3 | 14.7 | 6.1 | 4.0 |
| *Economic policy* | | | | | | | |
| Budget balance (% of GDP) | -2.8 | -2.4 | -4.5 | -3.7 | -3.6 | -3.4 | -3.0 |
| Public debt (% of GDP) | 63 | 62 | 63 | 69 | 70 | 70 | 70 |
| Malta, Money market interest rate (%) | 3.5 | 4.3 | 4.5 | 1.2 | 0.8 | 1.3 | 1.9 |
| M2 growth (% change pa) | 6 | 18 | 14 | 7 | 14 | 6 | 2 |
| Consumer prices (average % change pa) | 2.8 | 1.3 | 4.3 | 2.1 | 1.5 | 2.2 | 2.0 |
| Exchange rate LCU to USD (average) | 0.8 | 0.7 | 0.7 | 0.7 | 0.8 | 0.7 | 0.8 |
| Recorded unemployment (%) | 7.1 | 6.4 | 6.0 | 7.0 | 6.8 | n.a. | n.a. |
| *Balance of payments (mln USD)* | | | | | | | |
| Current account balance | -618 | -607 | -656 | -558 | -359 | -430 | -440 |
| Trade balance | -1209 | -1350 | -1849 | -1370 | -1213 | -1440 | -1520 |
| Export value of goods | 2937 | 3305 | 3190 | 2427 | 3056 | 3280 | 3520 |
| Import value of goods | 4146 | 4656 | 5038 | 3798 | 4267 | 4730 | 5040 |
| Services balance | 816 | 1053 | 1541 | 1318 | 1402 | 1490 | 1490 |
| Income balance | -212 | -273 | -337 | -569 | -586 | -510 | -460 |
| Transfer balance | -10 | -38 | -12 | 65 | 38 | 40 | 50 |
| Net direct investment flows | 1811 | 980 | 530 | 627 | 904 | 770 | 760 |
| Net portfolio investment flows | 2000 | -400 | -400 | 1900 | 3200 | 0 | 0 |
| Net debt flows | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Other capital flows (negative is flight) | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Change in international reserves | 402 | 818 | -3425 | 165 | 2 | 10 | 20 |
| *External position (mln USD)* | | | | | | | |
| Total foreign debt | 27800 | 40900 | 45000 | 42500 | 43500 | 49300 | 48500 |
| Short-term debt (including bank deposits ) | 17500 | 26100 | 35000 | 32100 | 31700 | 35900 | 35400 |
| Total debt service due, incl. short-term debt | 20000 | 21543 | 31267 | 38725 | 36100 | 35700 | 39900 |
| Total foreign exchange reserves | 2977 | 3785 | 368 | 532 | 536 | 540 | 560 |
| International investment position | 1869 | 1355 | 71 | 959 | n.a. | n.a. | n.a. |
| Total assets | 35388 | 49443 | 51784 | 51642 | n.a. | n.a. | n.a. |
| Total liabilities | 33519 | 48088 | 51713 | 50683 | n.a. | n.a. | n.a. |
| *Key ratios for balance of payments, external solvency and external liquidity* | | | | | | | |
| Trade balance (% of GDP) | -19.0 | -18.0 | -21.3 | -16.8 | -14.7 | -16.2 | -17.9 |
| Current account balance (% of GDP) | -9.7 | -8.1 | -7.6 | -6.9 | -4.3 | -4.8 | -5.2 |
| Inward FDI (% of GDP) | 29 | 13 | 10 | 9 | 12 | 9 | 10 |
| Foreign debt (% of GDP) | 436 | 547 | 519 | 523 | 526 | 553 | 573 |
| Foreign debt (% of XGSIT) | 353 | 397 | 375 | 400 | 398 | 422 | 407 |
| International investment position (% of GDP) | 29.3 | 18.1 | 0.8 | 11.8 | n.a. | n.a. | n.a. |
| Debt service ratio (% of XGSIT) | 254 | 209 | 261 | 364 | 330 | 306 | 335 |
| *DSR excluding short term debt (% of XGSIT)* | *26* | *39* | *43* | *35* | *37* | *34* | *34* |
| Interest service ratio incl. arrears (% of XGSIT) | 18 | 21 | 22 | 21 | 22 | 22 | 23 |
| FX-reserves import cover (months) | 6 | 6 | 1 | 1 | 1 | 1 | 1 |
| FX-reserves debt service cover (%) | 15 | 18 | 1 | 1 | 1 | 2 | 1 |
| *Cover excluding short term debt* | *74* | *94* | *7* | *14* | *13* | *14* | *14* |
| Liquidity ratio | 112 | 136 | 135 | 97 | 100 | 111 | 95 |
| *Liquidity ratio excl ST debts (bank deposits)* | *300* | *321* | *366* | *359* | *345* | *366* | *343* |

Source: EIU, Fitch and Rabobank estimates, August 2011