FOR AGENDA

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June 22, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Malta - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Malta. A draft decision appears on page 14. It is proposed to bring this subject to the agenda for discussion on Friday, July 15, 1983.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Ronald P. Hicks, ext. 74309.

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INTERNATIONAL MONETARY FUND

MALTA

Staff Report for the 1983 Article IV Consultation

Prepared by Staff Representatives for the
1983 Consultation with Malta

Approved by Brian Rose and Subimal Mookerjee

June 21, 1983

I. Introduction

A staff mission consisting of Messrs. H. Ungerer, R. Hicks (EUR), K. Friedman (SEC), Ms. K. Swiderski (EUR, EP) and Ms. S. Adams (EUR) as secretary, was in Valletta from May 3 to 16, 1983 to conduct the 1983 Article IV consultation discussions. The mission met with the Minister of Finance, the Minister of Industry, and senior officials from the Central Bank of Malta, the Prime Minister's Office, and various ministries and agencies. Mr. G. Lovato, the Executive Director for Malta, attended the final meetings as an observer. The previous consultation discussions took place in February 1981, and the Staff Report was considered by the Executive Board on May 11, 1981.

Malta continues to avail itself of the transitional arrangements under Article XIV.

II. The Economic Situation

1. Background

To prepare for the closure of the British military base in April 1979, which was an important source of employment, budget revenue and foreign exchange, the 1973-80 Development Plan focused on achieving a gradual diversification of the economy. Special emphasis was placed on industrial development geared to export markets, while traditional activities such as the building and repair of ships, port services, and tourism were strengthened. Substantial progress was made in restructuring the economy during the 1970s. The economy showed a remarkable resilience to the world-wide recession and inflation, and the sharp growth in exports and domestic demand resulted, over the 1970s, in an average annual growth rate of GDP in real terms of 12 per cent. The rate of unemployment declined to less than 3 per cent by 1979. The share in GDP of the manufacturing sector (including shipbuilding and repair) rose from one fifth in 1971 to one third by 1980, with output of textiles and clothing rising especially fast. The number of tourist arrivals (principally from the United Kingdom) increased fourfold over the decade, to nearly 730,000 in 1980. In addition to the favorable current account, the external position was helped by the high level of foreign investment as well as sizable foreign grants and loans on concessional terms. Furthermore, the special relationship with Libya over the second half of the 1970s yielded major benefits, as a large part of Malta's energy requirements was met through preferentially priced Libyan oil.

2. Recent domestic developments

By 1981, the recessionary developments in Malta's main trading partners, particularly in the EC, were exerting a strong negative influence on Malta's exports of goods and services, which declined in real terms by 11 1/2 per cent in 1981 and by 13 per cent in 1982. Consequently, production in manufacturing fell markedly over this period while tourism was down sharply from its peak in 1980 to about 510,000 visitors in 1982. The Maltese representatives stated that the impact of the world recession was exacerbated by the concentration of activity in sectors subject to international overcapacity and fierce competition (shipbuilding and repair) and to generally weak or volatile demand (textiles, clothing, tourism). At the same time, it was recognized that the successful efforts of the Government over past years to raise living standards, to provide equal pay for men and women, and to improve social benefits had made certain industries, particularly those with low technology, internationally less competitive. The euphoric mood following the rapid increase in tourism might also have induced a lack of care for the quality of service. Construction activity, on the other hand, rose rapidly in 1981-82, as stress was placed on improving the shipbuilding and port facilities and on promoting residential construction.

Real wages increased strongly in the 1970s; further substantial rises were recorded in 1981 and 1982, even though the growth of productivity slackened markedly. The Government plays an important role in wage determination. In close consultation with the main trade union, it sets the tone by raising the minimum wage by a fixed amount on a yearly basis, which in turn determines wages in the public sector. Wage increases in the private sector, however, can substantially exceed the rise in the minimum wage as a result of collective bargaining.

Unemployment started to rise significantly, from an average of some 4 per cent in 1980 to 5 1/2 in 1981 and more than 9 per cent at the end of 1982. While the main reason for this was the general fall in demand, it may also be attributed to a shift to more capital intensive industries in an attempt to compensate for the rise in wage costs. The authorities are deeply worried about these developments and consider the unemployment problem to be their main concern, although until now they have resisted taking large-scale recourse to employment programs or reintroducing a "labor corps" scheme to absorb part of the unemployed.

In an especially open economy like that of Malta, which imports all its raw materials and about three fourths of total food items, trends in price developments follow those abroad. Consequently the retail price index rose by nearly 16 per cent in 1980 and by 11 1/2 per cent in 1981; however, in 1982, the rate of increase dropped to less than 6 per cent. The Government has been applying various measures to keep prices down. A government-sponsored bulk buying scheme for a variety of essential goods provides importers with the possibility of purchasing on the international markets at favorable terms; short-term price fluctuations on the domestic market are minimized by use of future markets for goods and by forward purchases of the required currencies. Prices for a number of essentials are fixed while other prices, mainly for imported goods, are subject to fixed profit margins. These policies have been supported by an exchange rate policy aimed at a relatively strong lira in order to cushion the economy against imported inflation. There are no government subsidies on food or other consumer goods, and a Price Stabilization Fund is used only to smooth out temporary price fluctuations and is not allowed to go into deficit.

Despite the sharp fall in exports of goods and services, real GDP continued to grow in 1981 and 1982, by 3.3 and 2.7 per cent, respectively, substantially below the high rates of growth achieved in the 1970s and in 1980. The rise in domestic demand accounted for the growth of GDP in 1981 and 1982, chiefly owing to the expansion of private consumption, reflecting the rise in disposable incomes, and also of public investment. Private investment, on the other hand, was weak, largely because of the excess capacity in many industries due to the recession. There was a decline in imports of goods and services which was however far less pronounced than for exports.

3. The balance of payments

Traditionally, the balance of payments has registered a large trade deficit which has been more than covered by net receipts from services, in particular tourism and investment income, and by private and government transfers. The capital account has also been in surplus over the past decade, with direct foreign investment being the most important item.

In 1981, the value of exports of goods (in Maltese lira) increased only modestly over 1980, and in 1982 exports actually fell below the 1980 level (Table 1). In all three years--1980-82--the trade deficit remained within the range of Lm 114-117 million, as imports moved in line with exports. In 1982, a major change occurred with regard to services. Net tourist receipts, already down somewhat in 1981 from 1980, decreased in 1982 by nearly 40 per cent, and net receipts from "other transportation" declined sharply, mainly owing to a fall in earnings of Air Malta related to the decline in tourism. These losses were offset only in part by a rise in net investment income, which derives mainly from the investment of the foreign exchange reserves of the Central Bank. With transfers holding up well, the current account surplus for 1982, was down to Lm 12.3 million (2.6 per cent of GDP) from Lm 39.6 million in 1981

(9.1 per cent of GDP) and Lm 29.1 million in 1980 (7.4 per cent of GDP). Net capital inflows were more than halved in 1982, with falls in both private nonmonetary and official capital inflows and an outflow of monetary capital. Public external debt at the end of 1982 amounted to 7 per cent of GDP while the debt service ratio was 0.4 per cent.

In reflection of these developments, official reserves rose by Lm 45.7 million in 1981 and by Lm 29.7 million in 1982. In the first four months of 1983, they increased by Lm 4.0 million, to Lm 454.1 million (equivalent to SDR 987.8 million, or 17 months of imports).

II. Economic Policies

Malta is a mixed economy, with the Government exerting a substantial influence on economic developments through its wage and price policies, and its development, industrial and trade policies. Fiscal and monetary policies are basically conservative. Fiscal policy is geared toward providing support for the development effort and implementing the social objectives of the Government, and the main aims of monetary policy are to direct a steady supply of credit at low cost toward productive investment while avoiding any undue expansionary stimulus from the monetary side. Substantial financial reserves have been built up by the Government during good years, and government debt is quite modest.

The Maltese representatives stressed that the Government, while playing an important role in the Maltese economy, wanted the private sector to play its full part. However, because of a lack of entrepreneurial initiative and managerial skill, the authorities had found it necessary to step in and take the lead in various fields in order to foster the development of the economy. The authorities have maintained a liberal attitude toward foreign investment. There are no limitations on foreign investment (such as a requirement for minimum local participation) and it is encouraged as long as it is consistent with the development strategy of the Government.

1. Fiscal policy

Consistent with the role accorded to fiscal policy of promoting Malta's economic and social development, the budgets for 1981 and 1982 were constructed within the context of the 1981-85 Development Plan, placing emphasis on productive and infrastructural development while giving due attention to the social objective of improving the standard of living. However, the onset of the domestic recession in 1981, particularly with its adverse effect on employment, led the authorities to shift fiscal policy in the direction of supporting domestic activity. This has been reflected in an increase in the overall fiscal deficit, which nonetheless remained below 3 per cent of GNP in 1982.

The budgets for 1981 and 1982 again provided that by far the larger part of capital expenditures would be financed by current revenues; in the event, the current surplus in 1981 was equivalent to 6 per cent of GNP and in 1982 to 5 per cent. About two thirds of capital spending was to focus on productive investment; the other part was related principally to infrastructural outlays. Capital spending was budgeted to decline slightly in 1981 but to increase significantly in 1982, particularly with the expansion of water and harbor projects. In keeping with the Government's social objectives, the budgets for 1981 and 1982 provided for significant increases in current spending as a result of higher wages and salaries and enlarged social benefits. Current revenues were to be boosted by higher personal income tax rates introduced in 1981, and steps were taken to cut back on tax evasion; however, both the 1981 and the 1982 budgets provided for some income tax relief by increasing personal tax allowances. Various fees, duties and rates were raised in both budgets, and national insurance contributions were increased in order to keep the social security system largely selffinancing.

In the event, the fiscal stimulus in 1982 was considerably more pronounced than in 1981, a development considered appropriate by the authorities as the recession grew in severity. The overall budgetary deficit increased from Lm 2.2 million in 1980 to Lm 5.9 million (1.2 per cent of GNP) in 1981, and to Lm 14.8 million (2.8 per cent of GNP) in 1982 (Table 2). The deficit in 1981 was more than covered by foreign borrowings and grants (principally from Italy under a bilateral agreement) so that the Government continued to increase its cash balances over the year. However, in 1982, the larger fiscal deficit and the much smaller amount of foreign grants and loans required the Government to take recourse to bank credit and also to run down part of its cash balances. The enlarged fiscal deficit in 1982 was due primarily to the resumption of strong growth in capital spending and slower expansion in current revenues, chiefly because receipts from customs and excise duties were adversely affected by the slow pace of importing, and tax relief measures significantly cut back growth of direct tax revenues. Nontax revenues increased sharply in both 1981 and 1982, owing largely to the transfer of a part of the substantial Central Bank profits to the Government.

2. Monetary policy

A principal objective of monetary policy has been to ensure a plentiful and steady supply of funds at relatively low and stable interest rates in order to promote productive investment and to attract foreign investment to Malta. The implementation of that policy has been facilitated by persistent positive rates of growth in the net foreign assets of the banking system, and by the favorable budgetary position of the Government.

Selective controls are used to allocate credit in accordance with the Government's development strategy. In order to shift resources away from sectors characterized by low technology, banks have been encouraged to limit their lending for the expansion of the textile and tourist industries. With private home ownership enjoying a high priority in the Government's social program, the extension of credit for the purchase or construction of houses for owner occupation has been encouraged.

In 1981, the growth in net foreign assets caused an acceleration in the rate of growth of broad money to 9.3 per cent, despite a more than halving of domestic credit expansion (Table 3). In 1982, domestic credit expansion gathered momentum because of renewed acceleration of credits to public enterprises, a decline in the Government's net creditor position with the banking system and the rise in credit for private housing. In contrast, the weakening of the surplus on invisibles and on the capital account produced a smaller rise in net foreign assets. As a result, the growth of broad money in 1982 declined to 7.5 per cent. In both years, the accumulation of government reserves in the Posterity Fund 1/ exerted a restraining influence on the growth of money supply.

At the beginning of 1982, the monetary authorities increased the interest rate for time deposits of one year maturity, which had remained unaltered since 1970, from 5 to 6 per cent. At the same time, a new time deposit category with a maturity of six months was introduced carrying an interest rate of 5 per cent. Along with the sharp decline in the rate of inflation in 1982, this resulted in a downturn in the velocity of circulation, a large shift of funds from demand and savings deposits (with a rate of 3 per cent) into time deposits as well as slower growth of currency in circulation as hoarded cash began to be absorbed by the banking system.

On the lending side, the maximum domestic lending rate remained unchanged at 8 per cent, in line with the policy of providing low-cost credit. The lending rate structure was made more flexible, however, when for the first time, the banking system, in conjunction with a number of nonbank institutions, extended, with the approval of the Minister of Finance, a substantial consortium loan to the national airline at a rate exceeding 8 per cent. Moreover, since April 1983, Maltese savers may, with the approval of the Minister of Finance, participate directly in public enterprises and other commercial ventures at an interest rate which compares favorably with the rates prevailing abroad.

3. Development and industrial policies

In the 1970s, Malta concentrated on developing labor-intensive industries to take advantage of its low wage level. As real wages increased substantially in Malta--in line with government intentions--Maltese industries faced increasing competition, especially from Far Eastern and East European countries. The development policy of the Government therefore put stronger emphasis on further diversifying the economy and upgrading existing industries. While the international recession made

1/ The Posterity Fund was established in 1981. The Fund receives at least half of the Central Bank's profits, and is to be used for purposes related to the future welfare of the Maltese community.

it more difficult for Malta to smoothly absorb labor becoming redundant in the process of restructuring industry, the authorities feel that their policy will pay dividends in the medium term.

With regard to the textile and garment industries, the objective is to use more advanced technology in the production process and to move to higher quality goods. More emphasis is being placed on light and semiheavy engineering, which would fit the skills of the Maltese labor force. To stimulate such development, the Government established a foundry, which is presently coming on stream; the authorities expect the new foundry to spin off a number of light-engineering enterprises that would use its castings.

In the shipping sector, additional facilities are being created with the construction of a new shipbuilding yard and transshipment facilities which could service a large part of the Mediterranean. The Maltese authorities also see great possibilities for servicing large pieces of machinery and equipment of neighboring countries either in Malta (e.g., helicopters) or in the field by sending specialized Maltese crews abroad.

The Maltese representatives do not expect any major difficulties in financing these and future projects. Malta still has substantial unused credit lines with Arab development funds and is expecting to receive funds under the Association Agreement with the EC. The authorities also expect financial participation from potential transshipment customers.

In the field of tourism, the authorities are encouraging higher quality standards in service and improved facilities. They hope to attract more higher-income tourists from other European countries and even from the United States and Japan, in addition to the traditional U.K. visitors, who come mainly on pre-arranged package tours.

4. Energy policy

As regards energy, the Government has actively sponsored the development of domestic alternatives to foreign energy sources. In particular, it has constructed coal-fired plants for the production of electricity, undertaken off-shore oil drilling and established a research center for solar energy. The price of imported petroleum products, which meet the bulk of Malta's energy needs, increased substantially in 1980 following the expiration of the agreement with Libya providing oil at concessionary prices. Subsequently, domestic prices of most oil products have been adjusted, in line with international developments.

5. Trade policies

An important new element in the efforts of the Maltese authorities to offset the strong impact of the international recession on domestic activity and to compensate for the economy's particular vulnerability arising from its small size and the limited range of goods, is a policy of "trade reciprocity." Another objective for the medium term is to develop new export markets as the industrial base of the Maltese economy broadens.

Under this policy, the Government concludes bilateral agreements with other governments for the export of Maltese goods and for the import of particular goods from the partner country. These agreements are not intended to provide for a full one-to-one exchange, nor are they necessarily limited to the trading of goods; the Government sees them as an important means of opening up new markets and establishing wider economic relations. In particular, Malta would like to include provisions for direct investment, joint ventures or financial assistance. To date, agreements under the policy of reciprocity have been concluded with Bulgaria and Poland. After the return of the mission, agreements have also been concluded with two Fund members (Turkey and Libya). These agreements, involving small amounts, have not yet become operative; it is possible that they will later, upon further examination, prove to involve payments features that are restrictive. A general agreement for economic cooperation was recently concluded with Italy.

In general, apart from the bulk buying scheme described above, all imports are subject to licensing, with one aim being to assist the industrialization policy of the Government by gradually redirecting imports away from finished products and toward semifinished goods or raw materials. In addition, licensing is used as a tool to limit the size of the trade deficit by discouraging the importation of certain nonessential items in years of poor export growth. In accordance with this policy, some 60 categories of consumer goods were banned in November 1982. Furthermore, all imports from Japan were suspended. Malta's trade with Japan has for years been particularly one-sided. The Maltese representatives expected the discussions currently under way to lead to a solution giving Maltese products greater access to the Japanese market.

The mission suggested that the policy of trade reciprocity involved the risk of restricting access to the most favorable supplier as well as shifting the marketing initiative from Maltese private enterprises to the Government. The Maltese representatives replied that, apart from the short-term employment aspects of the policy, the lack of entrepreneurial initiative in Malta and the tremendous difficulties of Maltese enterprises (which by international standards are very small) in penetrating international markets required the Government to take on the task of spearheading marketing efforts. The Maltese representatives viewed this as complementary to, and not a substitute for, the enterprises' own efforts.

6. Exchange rate policy

Exchange rate policy is principally directed at cushioning the economy against imported inflation. This basic orientation has to be seen against the fact that the Maltese economy is highly dependent on imports--especially of raw materials and foodstuffs--and that exports of goods have an average import content of about 50 per cent. The Maltese authorities, in setting the exchange rate, use a basket of currencies which takes into account trade with its main partners but places special emphasis on the U.S. dollar and other strong currencies. The dollar is considered to be of particular importance because of the high share (14 1/2 per cent) of oil in total imports and because it is widely used as the currency of invoice. The basket has been revised several times since its introduction in 1972. Most important, in March 1981 and May 1981 the Italian lira, and the Belgian franc, respectively, were excluded from the basket, and their weights were allocated to the U.S. dollar and the Japanese yen. As a result, strong currencies, in particular the U.S. dollar, have a greater weight in the Maltese basket than is justified by trade flows according to country of origin or destination (even allowing for the practice of fixing oil prices in dollars).

As a consequence, in the period from the third quarter of 1979 to the fourth quarter of 1982, the Maltese lira appreciated in effective, trade-weighted terms by nearly 20 per cent. By the end of April 1983 there was a further slight appreciation. After taking into account developments in consumer price indices, the real effective appreciation over the three years up to the fourth quarter of 1982 amounted to nearly 21 per cent.

Before passing any judgment on the basis of these figures, it should be noted that prior to mid-1979, the Maltese lira had depreciated in real effective terms for a number of years, and there is no indication that the third quarter of 1979 marked a point of equilibrium. Nevertheless, there can be little doubt that over the past three and a half years, the appreciation of the Maltese lira not only effectively shielded the Maltese economy against the full impact of international inflation but also weakened its international competitiveness. It seems, therefore, that the external difficulties for Maltese exports, caused by the international recession and by the particular weakness in Malta's traditional markets, have been exacerbated by exchange rate developments.

IV. Policies and Prospects for 1983

The main concerns of the authorities are, at this stage, the weak level of demand and the high unemployment, the narrowness of their export markets, and, in the medium-term, the direction and scope of development policies.

A central element in the efforts to improve the competitiveness of the Maltese economy (which in the view of the authorities is not only a problem of costs and prices but also of the range of goods and services available for export) are the wage and price policies. A total freeze was imposed in January 1983 on all wages in the public and the private sectors; while this is a fairly radical step for an economy which, over the past decade or so, became accustomed to large wage increases, the Maltese representatives emphasized the general consensus of all the partners in the economy in favor of this policy. The wage policy is accompanied by various measures to cushion the impact of the recession on unemployment. In particular, employers are urged to avoid overtime in favor of hiring additional people, while legislation concerning the termination of employment is designed to ensure that employers consult the authorities before shedding labor, thereby helping to avoid labor disputes; in this way, it was explained, employers were encouraged to delay dismissals as long as possible, though they were not prevented from shedding redundant labor. The main support for the successful implementation of the wage policy is the price policy of the authorities, which is intended to avoid a lowering of living standards of the population. The Maltese representatives indicated that an extension of the wage and price freeze beyond 1983 had not been ruled out.

The staff was told that, while the Government remained in principle flexible in their view of exchange rate policy, an overall devaluation of the Maltese lira was not at present considered a feasible solution to the problems in the export field and in tourism. The Maltese representatives emphasized the importance of structural factors and the lack of demand for certain goods even at lower prices. In the latter respect, only an international economic recovery, which was seen as being on the horizon, could provide relief. Furthermore, because of the strong and immediate impact of a devaluation on domestic prices for consumption as well as its effect on the costs of exports, the authorities believe that it would erode the consensus in favor of the wage freeze, and its possible beneficial effect on exports would quickly dissipate. For these reasons, the authorities feel that the appropriate remedy to make up for lost competitiveness was a combination of wage stability and improved productivity, and a wider range and higher quality of goods for export.

The policy of trade reciprocity is intended to give short-run relief for hard-pressed industries and thus help sustain employment. It will therefore continue to play an important part in government policies. In the medium term, the policy is seen as being closely linked with the industrialization and development policies of the country.

Fiscal policy for 1983 is directed toward the employment situation. The budget is projected to show a larger overall deficit (Table 2), and no tax measures (apart from reinforcement of tax collection) have been taken. Current expenditures remain under tight control and the current account will continue to show a surplus, albeit a somewhat smaller one than in earlier years. Strong emphasis is being put on investment expenditures, which are projected to increase by another 6 per cent, following a sharp rise of 22 per cent in 1982, thus bringing their share in total budgetary expenditures to 21 per cent. In 1983--as was the case in 1982--selected development projects (in particular the transshipment harbor) are being accelerated to support employment. The expected budget deficit for 1983 will be financed by foreign grants and loans and by recourse to domestic cash reserves.

The Maltese representatives explained that the budgetary developments in the first months of 1983--particularly concerning revenue from customs duties--had been somewhat disappointing, and that the actual deficit for 1983 as a whole would probably be larger than had been projected. The Government would not like to see the fiscal position weaken unduly, but there was little scope for tightening current expenditures while the Government would be reluctant to increase the tax burden significantly and remained committed to its capital investment program. However, at present the Government was not overly worried about budget deficits in view of the ample level of reserves.

The Maltese authorities did not provide the mission with any quantitative forecasts for 1983, but gave instead an overall picture of possible future developments. They felt that the recession in Malta was bottoming out. Agreements with various partner countries regarding imports of Maltese goods would result in a small rise in exports and hence in industrial production. The performance of tourism would probably be less favorable in 1983 than in 1982, but activity in the construction sector would be much better owing both to the acceleration of public investment projects and the surge in residential construction associated with the government-sponsored home ownership program. Moreover, the shipbuilding and ship repair sector should benefit from various foreign contracts, and agriculture should improve somewhat because of a new irrigation scheme allowing an additional planting in the fall. Thus, under the most favorable assumptions, economic growth in 1983 could be the same as in 1982 (i.e., in terms of GDP, around 2 1/2 per cent). The unemployment situation would not improve significantly in 1983. Consumer prices had fallen somewhat in the first quarter of 1983 and could stabilize in 1983 since contracts setting prices for the whole year had been agreed for many essential commodities.

In 1983, domestic credit activity is likely to be buoyant because of a stepping up of the public investment program, the expected high level of bulk buying, the increasing number of firms facing cash flow difficulties, and the large consortium loan extended to the national airline for the purchase of three new aircraft. The expansionary impact of these expenditures, however, should be considerably dampened by their high import content, and in view of the weakening balance of payments position, the rate of monetary expansion is expected to slow further in 1983.

As regards the balance of payments, a deterioration in the trade balance is likely since exports should be at or slightly above the level of 1982 while imports are expected to rise somewhat--despite efforts to substitute domestically produced goods for imported goods. Net tourist receipts will probably fall again in 1983 as a further drop in the number of visitors was already in evidence in the first quarter. In recent years, investment income has been of great importance for the outcome of the current account; the major determinant for 1983 will be the level of interest rates prevailing abroad, which is expected to decline. No rise either in earnings of Maltese workers abroad--registered under "other items"--or in transfers is foreseen. All in all, it is expected that the current account may show a moderate deficit in 1983. The Maltese representatives, however, stressed that such a deficit--should it not be compensated by net capital inflows--could be easily financed from existing international reserves.

V. Staff Appraisal and Proposed Decision

After many years of strong growth, the Maltese economy was strongly affected by the international recession in 1981 and 1982, and the intensely competitive international climate this created. The effects were particularly serious for shipbuilding and ship repairing, textiles and garments, and tourism. As a result, industrial production fell over this period and the number of tourists was down substantially and the growth of real GDP slowed to around 3 per cent in both 1981 and 1982. Unemployment rose sharply, particularly in 1982.

Prices more or less followed international trends. But in 1982, the rate of inflation decelerated from two-digit figures in 1980 and 1981 to less than 6 per cent, aided by the effective appreciation of the Maltese lira.

For many years, development policy was successfully directed at taking advantage of the initially low level of wages. Subsequently it was aimed at moving the economy gradually into a technologically more advanced state with a broader industrial base, while not endangering employment or internal and external stability. These efforts were greatly supported by development-oriented monetary and fiscal policies.

The onslaught of the recession disrupted the smooth implementation of the authorities' development strategy. The rise in unemployment may be related in part to a lack of synchronization between the increase in redundant labor in declining sectors of the economy and its absorption in other sectors, and in part to the increasing emphasis on capital-intensive technology. At the same time real wages, which had risen strongly in the 1970s in line with the Government's intention to improve living standards, continued to rise significantly in 1981 and 1982, outpacing gains in productivity. Hence, while the standard of living for those with work continued to improve, the number of those suffering from unemployment rose.

The Government is endeavoring to deal with the problems facing the economy through a variety of measures. Emphasis is appropriately being given to accelerating the implementation of selected development projects, particularly servicing activities (e.g., transshipment) and light and semi-heavy engineering, and to upgrading existing industries. This strategy is supported by a policy of "trade reciprocity" which is designed, through bilateral agreements, to foster trade and to establish wider economic relations. In addition to its short-term aim of bolstering employment, this policy has the objective of developing new markets for Malta's present and future lines of production. While recognizing that export marketing efforts by a small economy with small enterprises may require a lead from the Government, the staff feels that the authorities should be keenly aware of the potential harmful effects of "reciprocity" on the Maltese economy, particularly in the longer run. Such a policy is also undesirable from an international point of view.

Fiscal policy continues to be cautious. However, as a result of the fiscal discipline of the past, the Government has room to use fiscal policy to support economic activity and employment without running the risk that the Government will become heavily indebted. Given the conjunctural situation, there is no reason to be overly concerned about the budget deficits realized in 1982 and projected for 1983, also in view of the ample cash reserves of the Treasury. Interest rate policy has recently become more flexible, which is welcome.

Although the external account has remained in overall surplus, there was a substantial decline in the current account surplus in 1982. While the trade deficit remained unchanged in 1982 as imports weakened in line with exports, the traditional surplus on services and transfers was substantially reduced, mainly because of a dramatic fall in net receipts from tourism and a decline in net transfers. The overall balance of payments in 1983 may show a modest deficit, but there seems to be no reason for great concern, in view of Malta's very comfortable international reserves.

To improve the structure of the balance of payments, the Government is combining its policy of broadening the industrial base with efforts to improve international competitiveness to enable the economy to take full advantage of the hoped for recovery in Malta's export markets. Such an improvement can be facilitated by action in various areas. The staff agrees with the authorities that, in the special circumstances of Malta, the present wage freeze in the public and private sectors, effective January 1983, and supported by strict price and profit controls, should make an important contribution; the staff feels, though, that an extended use of such arrangements carries the risk of creating distortions in the economy. Cautious monetary and fiscal policies will also continue to play an important flanking role, and further effective appreciation of the lira should be avoided. In implementing its economic policies, the Government should pay due attention to all the instruments having a bearing on Malta's competitive position.

It is recommended that the next Article IV consultation with Malta be held on the standard 12-month cycle.

VI. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision in concluding the 1983 Article XIV Consultation with Malta, in the light of the 1983 Article IV Consultation conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund hopes that Malta will continue to maintain its present relatively liberal system of payments and transfers for current international transactions.

Table 1. Malta: External Developments, 1979-82

	1979	1980	1981	1982 1/
	(In millions of Maltese lira)			
Balance of payments summary				
Exports, f.o.b.	158.6	176.2	181.8	175.0
Imports, f.o.b.	241.7	292.8	296.6	289.0
Trade balance	-83.1	-116.6	-114.8	-114.0
Services, net	79.2	125.8	119.4	95.7
Of which:				
Tourism, net	65.8	95.0	87.4	54.4
Investment income, net	13.0	30.6	41.2	54.8
Transfers, net	22.7	19.9	35.0	30.6
Of which:				
Government	10.2	8.5	22.4	15.3
Current balance	18.8	29.1	39.6	12.3
(As per cent of GDP)	(5.8)	(7.4)	(9.1)	(2.6)
Medium- and long-term capital	3.4	5.2	23.0)	10.0
Short-term capital 2/	-1.7	-0.4	-2.7)	
Overall balance	20.5	33.9	59.9	22.3
Of which: changes in net international reserves, net (increase -)	-20.5	-29.8	-45.7	-29.7
	(Percentage change)			
Trade developments				
Imports, c.i.f. 3/				
Unit value	12.8	8.1	2.6	...
Volume	8.8	10.2	0.0	...
Exports, f.o.b. 3/				
Unit value	8.0	4.4	16.7	...
Volume	8.1	4.3	-11.3	...
Memorandum items:				
Net official reserves 4/	344.9	374.7	420.4	450.1
In months of imports 5/	14.1	15.1	17.5	17.0
U.S. dollars per Maltese lira (period average)	2.79	2.90	2.59	2.43
Nominal effective exchange rate (percentage change) 6/	0.4	1.6	8.4	6.4
Real effective exchange rate (percentage change) 7/	-1.8	4.0	9.2	3.2
Public external debt (end of period)/GDP	7.7	8.0	7.5	7.0
Debt service ratio	0.4	0.3	0.4	0.4

1/ Provisional data.
2/ Includes errors and omissions.
3/ Customs basis, in Maltese lira.
4/ End of period, in millions of Maltese lira. Gold acquired prior to March 1980 is valued at US$35 per ounce while gold bought since March 1980 is valued at the purchase prices.
5/ Imports of goods during the following 12-month period.
6/ The weights were based on the average distribution of export and import trade with 13 major trading countries in 1978-79. A positive figure indicates an appreciation of the Maltese lira.
7/ Adjusted by relative consumer prices.

Table 2. Malta: Summary of Government Accounts, 1980-83 1/

(In millions of Maltese lira)

	1980	1981	1982	1983 Budget estimate
Current revenue 2/	142.7	166.2	179.7	180.7
(percentage change)	(...)	(16.5)	(8.1)	(0.6)
Direct tax	62.9	73.9	80.0	81.9
Indirect tax	46.7	49.3	45.7	48.5
Nontax 3/	33.1	43.0	54.0	50.3
Current expenditure 2/	-110.1	-137.7	-153.1	-156.3
(Percentage change)	(...)	(25.1)	(11.2)	(2.1)
Current balance	32.6	28.5	26.6	24.4
Capital expenditure	-32.6	-31.8	-38.7	-41.1
(percentage change)	(...)	(-2.5)	(21.7)	(6.2)
Debt repayments and sinking fund provision	-2.2	-2.6	-2.7	-2.9
Overall balance	-2.2	-5.9	-14.8	-19.6
Financed by:				
Foreign grants	2.4	15.5	7.0	7.3
Foreign borrowing	8.3	2.7	--	7.1
Domestic borrowing	--	--	2.0	--
Change in cash balance	8.5	12.3	-5.8	-5.2
Memorandum items:				
Total expenditure as a percentage of GNP	33.8	35.5	36.9	...
Overall balance as a percentage of GNP	-0.5	-1.2	-2.8	...
Long-term public debt as a percentage of GNP	13.9	12.6	11.6	...
Tax revenue as a percentage of total current revenue	76.8	74.1	69.9	72.2
Capital expenditure as a percentage of total expenditure	22.8	18.8	20.2	20.8

Sources: Ministry of Finance, Estimates, various issues; Treasury, Malta Financial Report, various issues; and data provided by the Maltese authorities.

1/ Consolidated with National Insurance Account. Data are not available on a calendar year basis earlier than 1980 as the fiscal year previously ended in March.

2/ Including receipts/payments of the National Insurance Account on a net basis.

3/ Includes revenue from Central Bank profits, fees and reimbursements, rents, dividends and interest, lotteries and sales (chiefly of government lands and oil).

Table 3. Malta: Monetary Indicators, 1979-83

	In Millions of Maltese lira end-March 1983	Percentage change over previous 12 months; end of period				
		1979	1980	1981	1982	1983 March
Broad money	547.3	12.6	8.0	9.3	7.5	6.3
Currency and demand deposits	308.5	19.0	11.7	10.9	6.7	5.5
Quasi-money	238.8	5.7	3.5	7.3	8.5	7.4
Foreign assets, net	481.3	7.5	7.1	10.2	6.2	3.5
Domestic credit	130.1	19.0	35.5	12.0	29.2	42.4
Central Government	-29.2	-35.7	-66.2	-31.2	12.1	18.8
Private sector 1/	159.3	21.7	40.9	16.1	19.2	25.1
Other items, net	64.1	-31.2	66.1	25.1	36.8	54.0
Of which: Posterity Fund 2/	27.2	...	...	...	173.1	35.0
Reserve money	380.0	10.2	1.7	8.9	5.3	5.1
Memorandum items:						
Contribution to broad money growth from:						
Foreign assets, net		7.2	6.5	9.2	5.7	3.2
Domestic credit		2.6	5.0	2.1	5.3	7.5
Other items, net		2.8	-3.5	-2.0	-3.5	-4.4
Of which: Posterity Fund		(--)	(--)	(-1.4)	(-2.3)	(-1.4)
Currency in circulation/broad money		41.0	44.4	47.2	47.6	47.6
Income velocity (percentage change)		4.2	8.8	2.2	-2.2	...

Sources: Central Bank of Malta, Quarterly Review; and IMF, Data Fund.

1/ Includes public and parastatal enterprises.
2/ The Posterity Fund was created in 1981.

Malta - Fund Relations

(As of May 31, 1983)

Date of membership	September 1968.
Status	Article XIV.
Quota	SDR 30 million.
Fund holdings of Maltese lira	SDR 4.4 million, or 14.7 per cent of quota. Malta has never made use of Fund resources.
Malta's holdings of SDRs	SDR 28.0 million, or 247.8 per cent of net cumulative allocation.
Direct distribution of profits from gold sales	Malta received US$2.55 million in the first and second distributions.
Gold distribution	Malta acquired 13,693 fine ounces of gold.
Exchange system	Since July 1972, the value of the Maltese lira has been pegged to an adjustable trade weighted basket of the currencies of Malta's major trading partners. The effective trade-weighted exchange rate is estimated to have appreciated by 21 1/2 per cent from August 1979 to April 1983. On May 31, 1983, the exchange rate was Lm 1 = SDR 2.18.
Last consultation	The staff report for the 1981 Article IV consultation (SM/81/81, 4/13/81) was considered by the Board on 5/11/81 (EBM/81/78), when the following decision was adopted: 1. The Fund takes this decision in concluding the 1981 Article XIV consultation with Malta, in the light of the 1981 Article IV consultation with Malta conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies). 2. The Fund notes with satisfaction that Malta maintains a liberal system of payments and transfers for current international transactions.

Basic Data

Area and population	
Area	316 sq. kilometers (122 sq. miles)
Population (mid-1982)	322,821
Domestic labor force (end-1982)	122,296
Gross domestic product (1982, at current prices)	Lm 465.1 million
GDP per capita, 1982	Lm 1,441 or US$3,499

Use and supply of resources (1982)	In millions of Maltese lira	In per cent of total
Private consumption	313.0	67.3
Public consumption	84.3	18.1
Fixed investment	117.2	25.2
Stockbuilding	23.8	5.1
Gross domestic expenditure	538.3	115.7
Exports of goods and services	321.1	69.0
Imports of goods and services	-394.3	-84.7
Gross domestic product	465.1	100.0

Selected economic indicators (annual percentage change)	1980	1981	1982
GDP at current prices	20.3	11.4	6.6
GDP at constant prices	7.0	3.3	2.7
Private consumption	6.2	3.3	4.0
Public consumption	1.8	7.5	4.5
Gross fixed investment	0.8	17.2	9.9
Exports of goods and services	12.0	-11.4	-13.2
Imports of goods and services	11.8	-7.7	-3.9
Unemployment rate (average level)	4.2	5.5	9.2
GDP deflator	12.4	7.8	3.8
Consumer price index; annual average	15.8	11.5	5.8
Reserve money; end-of-year	1.7	8.9	5.3
Money supply (M1), end-of-year	11.7	10.9	6.7
Money supply (M3), end-of-year	8.0	9.3	7.5
Total domestic credit expansion, end of year	35.5	12.0	29.2
Net foreign assets, end of year	7.1	10.2	6.2
Exports of goods (f.o.b., Maltese lira value, customs data)	9.6	4.2	-2.0
Imports of goods (c.i.f., Maltese lira value, customs data)	19.0	2.6	-2.8

	1980	1981	1982
Government budgetary finances (in millions of Maltese lira)			
Current revenue	142.7	166.2	179.7
Current expenditure	110.1	137.7	153.1
Capital expenditure (including amortization)	34.8	34.4	41.4
Budget deficit	2.2	5.9	14.8
Balance of payments (in millions of SDRs)			
Exports, f.o.b.	392.0	399.0	384.8
Imports, f.o.b.	651.5	651.0	635.5
Trade balance	-259.5	-252.0	-250.7
Net services and transfers	324.2	338.9	277.7
Current account balance	64.7	86.9	27.0
Gross official reserves, end of period	829.6	932.7	982.2
External debt, end of period	69.5	72.5	71.1
Selected ratios (in per cent of GDP)			
Domestic savings	19.2	18.7	14.6
Gross investment	24.6	27.1	30.3
Commodity exports, f.o.b.(customs data)	42.5	39.8	36.6
Commodity imports, c.i.f.(customs data)	82.6	76.1	69.4
Current account surplus	7.4	9.1	2.6
Reserve money, end of year	83.6	81.8	80.9
Money supply (M1), end-of-year	66.0	65.8	65.9
Money supply (M3), end-of-year	118.3	116.2	117.2
Budgetary revenue	36.4	38.1	38.6
Budgetary expenditure	37.0	39.4	41.8
Budget deficit	0.6	1.4	3.2
External debt, end-of-year	8.0	7.5	7.0
External debt service	0.3	0.4	0.4
Selected ratios (in per cent of indicated variables)			
Oil imports: to total imports	9.9	13.3	14.6
to total exports	19.9	25.6	27.6
External debt service:			
To exports of goods	0.7	0.9	0.9
To current account receipts	0.3	0.4	0.4

IMF (as of May 31, 1983)

Quota	SDR 30 million
Fund holdings of Maltese lira	SDR 4.4 million (14.7 per cent of of quota)
Cumulative allocation of SDRs	SDR 11.3 million
Holdings of SDRs	SDR 28.0 million (247.8 per cent of net cumulative allocation)

1 Maltese lira = SDR 2.18