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December 29, 1992

To: Members of the Executive Board

From: The Acting Secretary

Subject: Malta - Staff Report for the 1992 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1992 Article IV consultation with Malta, which is tentatively scheduled for discussion on Monday, January 25, 1993.

Mr. van Houten (ext. 38850) or Mr. Claassen (ext. 37472) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

MALTA

Staff Report for the 1992 Article IV Consultation

Prepared by the Staff Representatives for the 1992 Consultation with Malta

(In consultation with other Departments)

Approved by Massimo Russo and A. Basu

December 24, 1992

The Article IV consultation discussions were conducted in Valletta from September 28 to October 8, 1992. 1/ The mission met with the Ministers of Finance, Economic Services, Tourism, and Social Security, the Governor of the Central Bank, senior officials of the Administration and the Central Bank, as well as representatives of the financial sector, commerce, industry, trade unions, and employers. Malta is on a 24-month consultation cycle; the last Article IV consultation discussions took place in March 1990, and the consultations were concluded by the Executive Board on June 20, 1990 (SM/90/81, Supplement 1, 6/22/91). Malta continues to avail itself of the transitional arrangements under Article XIV of the Articles of Agreement. The 1992 Article XIV consultation report SM/92/225 was issued on December 23, 1992.

The National Party Government, which came into power in 1987 after 16 years of Labor Party rule, was reelected in February 1992 for a second five-year term. During its first mandate, the present Government began to liberalize the highly centralized economy, and upgrade and expand public infrastructure. At the conclusion of the 1990 Article IV consultation, Executive Directors welcomed the reform measures taken by the Government, i.e., the replacement of quantitative import restrictions by levies, and a tax reform lowering tax rates and reducing the number of rates. They strongly encouraged the authorities to take further steps to tackle structural weaknesses. Directors expressed concern about underlying competitiveness, the overmanned public sector, the highly regulated financial system, and the rising government deficit. They urged the Government to restrain current outlays and introduce a broad-based tax on

1/ The staff team comprised Messrs. van Houten (Head), Claassen, Ms. Doughty (EP), and Mrs. Ball as administrative assistant (all EU1).

consumption. They also called for market-determined interest rates and greater competition in the financial sector.

I. Background to Policy Discussions

The Maltese economy has shown remarkable strength over recent years. Economic growth, which averaged almost 7 percent in real terms in 1987-1989, continued at a brisk pace in 1990-92, notwithstanding the Middle East crisis and the recession in the United Kingdom, Malta's largest tourism market. Both domestic final demand, boosted by large increases in government spending, and exports of goods and services contributed to this performance. 1/

The economy's strong growth has been accompanied by signs of strain in the labor and financial markets. With the unemployment rate below 4 percent of the work force, labor shortages in the export and tourism sectors have increased, notwithstanding illegal immigration, and private sector earnings have accelerated to about 7 percent per year in real terms since 1990. In the public administration, wages have been boosted by a three-year Public Service Reform initiated in 1991. Large public financing requirements, together with strong private credit demand, have put pressure on available financial resources and, in the context of interest rate ceilings, have led to credit rationing and the introduction of non-interest charges by banks. Despite these pressures, measured consumer price inflation has remained low--averaging less than 3 percent in 1990-92--reflecting the impact of a fixed exchange rate and lingering price controls. 2/

The strong expansion in demand, against a background of trade liberalization, has given rise to substantial growth in imports. As a result, the external current account balance shifted into deficit in 1989, reaching 2.4 percent of GDP in 1990. Strong export and tourism earnings, together with a leveling off of capital goods imports by the public sector, have combined to improve the current account balance in 1991-92. Gross official reserves have declined by about SDR 100 million from a high point of SDR 1,039 million reached at end-1989. The rapid growth of imports has caused import coverage to decline to under 8 months of merchandise imports at end-September 1992, down from more than 15 months' coverage in 1989. 3/

Fiscal policy has been a major factor behind the rapid expansion of demand in recent years. Reflecting large outlays on infrastructure and a persistently strong rise in current expenditures, the fiscal deficit in

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1/ A large draw-down of stocks made an almost 6 percent negative contribution to GDP growth in 1992.

2/ A new retail price index was introduced in January 1992. The previous index contained several major deficiencies which are believed to have biased measured inflation downward.

3/ As banks have been allowed to hold higher levels of foreign assets, the decline in reserve coverage measured in terms of banking system reserves has been less pronounced.

1989-91 averaged 6.5 percent of GDP. The deficit is estimated to have declined to 5.4 percent of GDP in 1992, mainly on account of a sharp decline in capital outlays following the completion of several large projects. Current expenditures, however, continued to rise reflecting the public sector pay reform and expanded social benefits.

Monetary policy in recent years has been conducted with the aim of facilitating the financing of the government deficit and supporting the buoyant developments in the real sector of the economy. The cost of funds has been kept low through a combination of interest rate regulations and capital controls. Notwithstanding a broadly accommodating stance by the monetary authorities, the growth of available resources has not kept pace with the strong demand for credit at the prevailing regulated interest rates, resulting in credit rationing to the private sector and the introduction of fees and other non-interest charges by banks. Over 1991-92, around 80 percent of the Government's domestic financing requirement was financed through the Central Bank. Overall, the expansion in the money supply, which remained broadly in line with nominal GDP in 1991-92, has funded growth in domestic credit.

II. Policy Discussions

In view of the signs of resource strain in the economy, the focus of the discussions was on the need for a tightening of fiscal and monetary policies in the short term, and for a faster pace of economic reform to alleviate supply constraints over the medium term. The authorities, while acknowledging the necessity of fiscal retrenchment and reform, emphasized the need to proceed cautiously in view of the importance, in a small island society, of maintaining broad social and political support for adjustment. Hence, they were reluctant to commit themselves to a specific path for fiscal consolidation and a timetable for structural reforms. In their view, the potential benefits of preannounced commitments in terms of establishing the "rules of the game" were outweighed by the risks of having to modify policies on account of unexpected external or domestic developments. The staff, for its part, stressed the importance of a clearly described path of reform for establishing confidence and promoting efficient investment decisions. The Government's recently reaffirmed objective of early membership in the European Community would also require specific medium-term commitments in a number of areas, including external tariff reform and industrial restructuring.

1. Fiscal policy

The authorities recognized that the sizable deficits incurred in recent years could not be sustained. Prior to 1992 these deficits had been justified, in their view, by the need to finance a major expansion of public investment in infrastructure. A cutback in capital spending in 1992 on account of the completion of several major projects, helped to reduce the fiscal deficit to 5.4 percent of GDP. The authorities plan to reduce the fiscal deficit further in 1993 to 4.3 percent of GDP, on the basis of a major revenue effort (equivalent to almost 2 percent of GDP) that is partly of a one-time nature. Current expenditure, however, is budgeted to rise by 0.5 percent of GDP.

General Government Operations, 1991-93

(In percent of GDP)

	1991	1992 Budget	1992 Estimate	1993 Budget
Total revenue	34.2	34.2	34.3	36.1
Tax revenue	25.5	25.6	25.9	27.8
Direct taxes 1/	13.0	12.8	13.4	14.5
Indirect taxes	12.5	12.8	12.5	13.3
Non-tax revenue	8.7	8.6	8.4	8.3
Total expenditure	41.4	40.7	39.8	40.4
Current outlays	32.1	34.3	33.7	34.2
Capital outlays	9.2	6.5	6.1	6.2
Financing	-7.1	-6.5	-5.4	-4.3 2/

1/ Includes social security contributions.
2/ Corresponds to a deficit of 3 percent of GDP in the format of the budget document.

The authorities believe there is little room to curtail current spending in the short term. The rise in the wage bill is mainly predetermined by the last tranche of the 1991 salary reform. Measures to restrain the cost of social benefits and health care would need to await the outcome of studies the Government has commissioned on the viability of the social security system and the costs of the free health care system. Meanwhile, the Government believes it has little choice but to raise taxes and contributions, and rely on efforts to improve tax administration and collect arrears in income tax payments and social security contributions. Specific new revenue measures proposed for 1993 (equivalent to 0.6 percent of GDP) include a new 5 percent tax on tourist accommodations, a broader application of the existing 10 percent tax on food service establishments, a 7 percent capital gains tax, an increase in employers' social security contribution from 8.3 percent to 10 percent, and a rise in stamp duty on the sale of immovable property and shares. The elimination of death and donation duties is offset by the extension of stamp duty to transfers of property. However, most of the budgeted increase in tax revenue for 1993 is expected to come from improved tax administration and collection of arrears

(1.2 percent of GDP). The authorities acknowledge that their estimate for these revenues is optimistic, partly in light of the large volume of arrears in social security premia owed by lossmaking parastatal enterprises.

Over the medium term, the authorities indicated that the fiscal deficit would remain around the level planned for 1993 in relation to GDP. While the authorities have recently announced an objective to reduce the share of public sector employment (including public enterprises) from the current level of 42 percent to 25-30 percent, no measures other than natural attrition and improved training have been proposed as yet. Nonetheless, in early 1992, the authorities decided to shift 2,500 temporary workers to permanent status. The Government hopes to reduce the sizable transfers to parastatal enterprises (mainly to shipbuilding and drydock companies) by placing greater emphasis on downsizing or restructuring, but no specific plans have yet been formulated. The problems in social security and public health care will be addressed once the commissioned studies in these areas have been evaluated. On the revenue side, the authorities stated their commitment to improved tax administration and the implementation of a value-added tax by 1994. It was envisaged that the VAT would form part of a broader tax reform package, involving the elimination of protectionist levies, a reduction of duties on imports, and possibly an adjustment of income taxation.

The mission stressed the need for a more ambitious fiscal adjustment in 1993, followed by smaller adjustments in subsequent years, both to reduce domestic demand pressures and for resource allocation reasons. Specifically, the staff recommended halving the 1993 deficit from the level budgeted in 1992. The recent devaluation of the lira, in the context of strains in the economy, has made the need for fiscal adjustment more urgent. A faster pace of adjustment is particularly desirable for structural reasons, in view of the sizable labor and financial resources absorbed by the public sector. The more gradual approach preferred by the authorities risks having to make the structural consolidation during a period of weaker economic growth. In the staff's view, the burden of fiscal adjustment over the medium term should fall mainly on current expenditures, through cuts in public employment and a phaseout of subsidies to parastatal enterprises and tourism. 1/ Improved targeting of social spending and health care benefits will also be essential. Further reliance on cutbacks in capital outlays would be undesirable, as continued economic development may require maintaining a sizable rate of public investment in infrastructure over the medium term.

1/ The exchange rate subsidy to tourism reduces the net profits transferred by the Central Bank to the Government.

2. Monetary policy

Traditionally, monetary policy has accommodated the provision of low cost funds to the public and private sectors. This objective was facilitated by comprehensive interest rate regulations, sectoral credit guidelines, and exchange controls. This policy had worked well, in the view of the authorities, during the period when the banking system had large excess reserves. More recently, the increasing credit demands of both an expanding economy and large public sector deficits have led to a progressive reduction in the excess reserve position of banks. This process, which was reinforced by the imposition of a 5 percent reserve requirement in 1990, has resulted in the emergence of increasing strains in the financial market. In response to excess demand for funds, banks have applied non-interest charges to loans as a means of circumventing interest rate ceilings and have resorted to credit rationing. In 1991-92, the authorities increased central bank financing of the government deficit in an effort to prevent crowding out of private credit demand, and experimented, albeit on a modest scale, with direct liquidity support to the banks through the rediscount mechanism.

Notwithstanding the broadly accommodating monetary policy, the authorities recognize that interest rate liberalization is the only sustainable way to increase financial intermediation and eliminate credit rationing. Market-determined interest rates would provide the Central Bank with an important indicator of monetary conditions and enable the authorities, in turn, to influence market conditions through rediscount policy and open market operations. However, to become fully effective, this approach would be likely to require greater operational autonomy for the Central Bank. Recently, some tentative steps have been taken toward a more flexible interest rate structure. Interest rates on government bonds were raised in September 1992 in an effort to sell government securities to the nonbank public. In November 1992, the authorities announced that banks would henceforth base lending rates on the Central Bank's discount rate--which currently stands at 5.5 percent--plus a margin of 1-3 percentage points. Hence, the maximum lending rate remains 8.5 percent. Lending for the construction or purchase of a residence retains a maximum rate of 1.5 percentage points over the discount rate. Most sectoral credit controls were also removed. Finally, banks were authorized to utilize funds attracted in foreign currency deposits in lending to Maltese residents at market interest rates.

These measures, while in the right direction, fall well short of addressing the need for fully market-determined interest rates to enable monetary policy to support effectively the fixed exchange rate, and bring about an efficient and diversified financial system. In this regard, the mission pointed out that the recent establishment of offshore financial activities within a liberal legal framework is likely to make the existence of a highly regulated domestic financial market increasingly untenable.

3. Exchange rate policy

Prior to the recent turmoil in European currency markets, the authorities had been generally satisfied with exchange rate policy, which aimed to maintain the value of the Maltese lira against a trade-related basket of currencies (Chart 6). Since 1986, the nominal effective exchange rate has been broadly stable, while the real effective exchange rate has shown a marked depreciation. However, the real exchange rate depreciation is believed to overstate the underlying gain in competitiveness as inflation measured by the consumer price index was biased downward due to price controls and technical deficiencies in the index. The staff concurred that the fixed exchange rate policy had served well as an anchor for prices and provided a strong incentive to industry and the tourism sector to control costs and raise productivity. Still, real wages have increased rapidly in the private sector in recent years and it is not clear to what extent this has reflected productivity gains or an erosion of profitability. In this regard, the staff stressed the need for wage moderation and labor market flexibility as key factors in safeguarding the sustainability of the fixed exchange rate. More generally, the staff advised the authorities not to base exchange rate adjustments on short-term considerations, and encouraged the authorities to focus on measures that would promote medium-term competitiveness.

With the realignments in European currency markets in September-November 1992, the authorities became concerned about the competitiveness of Malta's exports and tourism against trade partners and in third markets. Subsequently, on November 24, 1992, the Government depreciated the Maltese lira by 10 percent and updated the weights of the currencies in the basket. 1/ The devaluation resulted in an effective depreciation of the lira of about 6 percent in both nominal and real terms in relation to its value at end-August 1992.

4. Incomes policy

A tri-partite three-year incomes policy agreement was negotiated at the end of 1990. At the heart of the agreement is an annual across-the-board flat wage increase, equivalent to a forward-looking cost-of-living adjustment of the base wage agreed for a three-year period. Productivity-related wage increases are determined by collective bargaining at the firm level. The consensus opinion of the Government, unions, and employers was that the agreement had been instrumental in establishing harmonious industrial relations following a long period marked by labor strife and centralized wage fixing. Discussions had already started on a renewal of the agreement due in December 1993. The staff welcomed the fact that an

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1/ The weights in the basket were changed from 58 percent for the ECU, 26 percent for the U.S. dollar, and 16 percent for the pound sterling to 65 percent for the ECU, 25 percent for the U.S. dollar, and 10 percent for the pound sterling.

element of wages was now determined at the firm level. At the same time, the staff cautioned the authorities that generalized cost-of-living increases tend to hamper wage flexibility and thus could disturb factor income distribution in periods of structural change and external price shocks, including those arising from exchange rate movements. The staff also observed that the civil service reform had led to increased wage demands in the private sector. Moreover, an opportunity had been missed to combine salary reform with public employment reduction and release labor resources for more productive employment.

5. Structural policy issues

The authorities pointed to important structural changes during the past five years that have contributed to raising the economy's potential growth rate. Protection of industry has been reduced, and the income tax system reformed. However, they acknowledged that major structural rigidities remain that impede efficient allocation of resources and hamper the achievement of the economy's full growth potential. The public administration and the government-owned shipbuilding company are greatly overstaffed; domestic production is distorted by excessively high import tariffs and levies, and by large subsidies provided to the parastatal shipbuilding and ship repair sector; the financial market is overregulated; and the price control system--though enforcement has been relaxed--continues to exist as a burdensome administrative apparatus.

The authorities reaffirmed their intention to tackle these issues over the coming years, but stressed that structural change could only occur gradually as the Government was intent on avoiding social unrest. The overstaffing of the public sector, in particular, was a problem with considerable social and political implications. To resolve this issue over time, the authorities intended to rely mainly on natural attrition, retraining, and various incentives to encourage movement of public employees to the private sector. While results so far had been modest, the authorities, nonetheless, remained reluctant to pursue outright cuts in employment as suggested by the staff. In this regard, representatives of tourism and industry indicated that the lack of progress in reducing public employment had become a major constraint on continued private sector growth.

The staff urged the Government to privatize government holdings in commercial enterprises, and to adopt a more deliberate strategy of restructuring, downsizing and/or closing government-owned companies in order to release financial resources and manpower to more productive sectors of the economy. In this regard, the mission emphasized that the huge current and prospective subsidies to shipbuilding and repair should be made conditional on the implementation of restructuring programs within a strict timeframe that aim at eliminating these subsidies and all preferential financial arrangements.

The Government has announced its intention to phase out all import levies by 1994. Nonetheless, some levies have recently been increased under pressure from local interests. The prospect of widespread closures in furniture manufacturing and the textile sector had so far discouraged the Government from reducing protection for these sectors. The staff encouraged the Government to adopt a realistic import liberalization plan that would include the intended phasing out of the remaining elements of the bulk buying scheme and incorporate a restructuring of the sectors likely to be hardest hit. In particular, the staff noted the importance of coordinating the phasing out of levies and reduction of import duties with the introduction of the value-added tax. Subsequent to the staff mission, the Government announced its intention to eliminate all import levies by 1994 and remove all but two items (wheat and cereals) from the bulk buying system, effective January 1, 1993. 1/ The number of goods subject to import prohibitions will be reduced to a few items of little economic significance. Goods removed from the prohibited list (mainly furniture) have been made subject to import levies.

With regard to price controls, the authorities observed that the policy had not been fully enforced in recent years. The emphasis had shifted from preventing price rises generally to preventing unjustified and excessive price increases by businesses with market power. Controls were still important at the wholesale level, particularly for domestically produced goods, and presented a considerable administrative burden for commerce and industry. The authorities acknowledged the merit of changing the focus of pricing policy from price controls on goods to a policy based on monitoring anti-competitive practices in both goods and services. For the near term, however, such a major shift was unlikely as it was politically difficult to eliminate the system of controls. Rather, it was envisaged that the current system of controls would evolve in the direction of a simple notification system for price changes.

6. The exchange system

The present system of exchange regulations governing payments and transfers for current international transactions is extensive. During 1992, Malta maintained the following exchange measures subject to approval under Article VIII, Sections 2(a) or 3 2/: (i) restrictions on invisible payments to, and transfers by, residents of countries of the former sterling area 3/ including limitations on family living remittances (allowed only in the event of "hardship") and on remittances of profits and dividends that have been lawfully declared. Profit and dividend remittances are permitted by the Exchange Control authorities only if certain formalities are complied

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1/ Sugar, salt, cement, evaporated milk, boneless beef, and soybean oil will no longer be imported under the state trading scheme.

2/ Malta also continues to impose exchange restrictions against Iraq, which it notified to the Fund under Decision No. 144 on September 21, 1990.

3/ These restrictions are also maintained in respect of payments to residents of countries other than those of the former sterling area under Article XIV (SM/92.., 12/../92).

with, requiring in some cases certification that contracts with third parties have not been breached; (ii) exchange restrictions arising under the bilateral payments agreement with Libya, which was renewed in May 1992 for a period of one year. The bilateral payments arrangements with Bulgaria and Poland were terminated in June 1991. The outstanding balance in favor of Bulgaria was settled in 1992, and that in favor of Poland is expected to be settled by the end of December 1992. Pending settlement of this balance, an exchange restriction continues to exist; (iii) a multiple currency practice in the form of a 10 percent tax imposed on the purchase of foreign currency for overseas travel purposes, introduced in July 1990 as a revenue raising measure; and (iv) a multiple currency practice in the form of an exchange rate guarantee scheme for U.K. and Irish tour operators, introduced in late 1983. In addition, a 10 percent tax imposed on the purchase of foreign currency for portfolio investment abroad, introduced in July 1990 as a revenue raising measure, constitutes a multiple currency practice applicable solely to capital transactions.

The mission urged the authorities to remove the remaining restrictive practices and simplify the exchange regulations. Subsequently, in November 1992, the authorities announced that, from January 1, 1993, the multiple currency practices arising from the 10 percent tax on the purchase of foreign currency for overseas travel and portfolio investment purposes would be abolished.

Following the implementation of these measures (and the settlement of the bilateral balance with Poland), Malta's exchange system will still contain (i) exchange restrictions arising under the bilateral payments arrangement with Libya, and arising from the limitation on family living allowances and on remittances of profits and dividends; and (ii) the multiple currency practice arising from the exchange rate guarantee for certain foreign tour operators. The authorities have announced their intention to eliminate the latter practice by 1995. The staff has encouraged the authorities to announce a phase-out schedule, as this would help the tourism industry to undertake the necessary restructuring on a timely basis.

III. Staff Appraisal

Since the last consultation in March 1990, economic growth has averaged almost 6 percent per year, a remarkable occurrence in view of the Middle East crisis and slack in some of Malta's major overseas markets. Output was boosted by large increases in government spending and by brisk growth in tourism and certain export categories. The strong growth in demand has been accompanied by a rapid expansion of imports and has so far not translated into an acceleration of measured consumer price inflation due to the fixed exchange rate and lingering price controls. Nonetheless, resource strains in the domestic economy have intensified, and the strong upward pressure on wages risks undermining medium-term competitiveness.

The present conjuncture calls for a two-pronged strategy to relieve the pressure on resources:

(1) fiscal consolidation and monetary restraint to reduce demand pressures in the near term;

(2) a more ambitious program of structural reform to raise the capacity of the economy to sustain a rapid rate of growth over the longer term.

Tackling the fiscal imbalance has the highest priority, both to reduce domestic demand pressure and for resource allocation reasons. In this regard, both the size and the quality of the authorities' proposed adjustment for 1993 and the medium term are unsatisfactory. The existing strain on resources, together with the expansionary push likely to be provided by the recent devaluation, call for a more ambitious fiscal consolidation in the near term, followed by smaller adjustments over the medium term. Such a program would be consistent with, and supportive of, a faster pace of structural reform as it would release labor and financial resources presently absorbed by the public sector.

With regard to the quality of fiscal adjustment measures, the deficit reduction in 1993 relies exclusively on an enhanced revenue performance--only partially backed by specific revenue measures--while current spending is projected to increase further in relation to GDP. In the staff's view, the burden of adjustment in 1993 and the medium term should fall on current expenditures, through cuts in public employment, a phase-out of subsidies to parastatal enterprises and tourism, and improved targeting of social spending and health care benefits. Current spending restraint should provide room for infrastructure investment in support of structural reform and Malta's eventual accession to the European Community. With regard to revenue policy, the staff supports the authorities' emphasis on administrative improvements and collection of arrears, but notes that the latter would only provide a once-off relief for the public finances. The announced increase in social security contributions will contribute to reducing the deficit of the social security system, but the staff regrets that the increased contribution is levied entirely on employers, thus adding to labor costs in the short term. The staff welcomes the authorities' commitment to introduce a value-added tax in 1994 and to implement simultaneously a general reduction in import tariffs and levies.

With respect to monetary policy, there is a need for a fundamental shift in emphasis from providing low cost funds to the public and private sectors--achieved through capital controls and comprehensive interest rate regulation--to reliance on market interest rates and refinancing operations as the principle means of regulating credit demand and maintaining monetary conditions compatible with the authorities' fixed exchange rate objective. Hence, the staff recommends fully deregulating loan and deposit interest rates and abolishing remaining sectoral credit guidelines. The recent modifications to lending rate ceilings are a welcome step, but need to be followed by the complete removal of ceilings on credit and deposit rates in the near term to achieve the intended effects of interest liberalization. A more rapid pace of financial deregulation is also consistent with the authorities' objective of promoting financial intermediation and the development of offshore financial operations.

The policy of maintaining the value of the lira unchanged against a basket of currencies has served well as an anchor for prices. Nonetheless, the recent devaluation of the currencies of several of Malta's main trading partners has prompted the authorities, in turn, to devalue the lira by 10 percent, resulting in a real effective depreciation of around 6 percent in relation to its level at the end of August 1992. The real depreciation, in the context of increasing labor and financial market strains, is inappropriate, as it is likely to create additional short-term demand pressures and risks a price-wage cycle. Moreover, the external sector has continued to perform satisfactorily. To support the new exchange rate, a sizable fiscal adjustment is required in the near term to dampen demand pressures and ease labor market strains. Over the longer term, maintaining competitiveness will depend on policies that promote labor mobility, raise labor force participation rates, and improve wage flexibility. In this regard, the system of general cost-of-living adjustments--which forms part of the three-year incomes policy agreement of December 1990--detracts from wage flexibility and should be reconsidered when the current agreement expires in 1993.

The staff encourages the authorities to speed up the pace of structural reform as major rigidities remain to be tackled: the public administration is overstaffed; domestic production is distorted by excessively high tariffs and levies, and by large government subsidies; the financial market is overregulated; and the price control apparatus--though enforcement has been relaxed--remains intact. The staff strongly recommends a substantially more ambitious pace of reform in all these areas. It also stresses the need for setting out clearly the intended "rules of the game", as well as the timeframe for reform, as prerequisites for a sustained expansion of investment. A faster pace of reform would also be consistent with the Government's recent reaffirmation of EC membership at an early date.

The staff welcomes the announced liberalization of the multiple currency practices which takes effect January 1, 1993. The staff notes the authorities' announced intention to eliminate the preferential exchange rate for certain foreign tour operators by 1995, but regrets that no schedule has as yet been set for phasing out the subsidy. The staff urges the termination of the bilateral payments arrangement with Libya as well as the elimination of the remaining restrictions on invisible payments and transfers. The staff does not recommend approval of the exchange restrictions arising under the bilateral payments agreements with Libya and Poland or the multiple currency practice arising from the exchange rate guarantee scheme because of their discriminatory character. Nor does the staff recommend approval of the multiple currency practice arising from the tax on purchase of foreign exchange for overseas travel services, because it was not introduced for balance of payments purposes. Also, in the absence of a clear timetable for their elimination, no approval is recommended for the remaining restrictions on invisible payments to, and transfers by, residents of countries of the former sterling area.

The staff recommends that the next Article IV consultation with Malta take place on the 24-month cycle.

Table 1. Malta: Domestic Economic Indicators, 1985-92

(Annual Percentage Change, unless otherwise indicated)

	1985	1986	1987	1988	1989	1990	1991	1992 1/
Real demand and output (at 1973 prices)								
Domestic final demand	3.1	-0.1	7.5	7.8	8.0	7.0	4.3	3.7
Private consumption	5.0	1.4	0.5	9.0	9.2	3.8	4.0	3.1
Public consumption	5.6	4.4	9.1	6.0	12.7	5.7	10.9	9.5
Gross fixed investment	-4.0	-8.7	30.7	6.1	1.0	17.9	0.0	0.6
Changes in inventories 2/	0.4	0.1	-3.6	3.4	0.5	0.8	0.4	-5.8
Exports of goods and services	7.4	7.0	12.6	6.1	10.7	13.3	7.8	16.4
Imports of goods and services	9.2	0.1	12.3	11.1	11.1	15.7	5.6	5.4
Gross domestic product (GDP)	2.6	3.9	4.1	8.4	8.2	6.3	6.1	4.9
Labor market (end of period)								
Employment 3/	1.3	4.1	5.9	2.5	0.9	0.9	2.9	1.0
Public sector 3/	4.1	8.6	12.0	3.1	-1.2	-1.1	0.5	-0.4
Private sector	-0.8	1.2	1.2	2.1	2.6	2.4	4.7	2.1
Unemployment rate (in percent of labor force, end of period)	8.2	6.9	4.4	4.0	3.7	3.9	3.6	3.9
Average weekly earnings	0.6	-1.0	3.6	2.7	6.7	9.7	8.7	8.3
Real average weekly earnings	1.8	-3.0	3.1	1.7	5.8	6.5	6.0	7.4
Prices								
Consumer prices	-0.2	2.0	0.4	1.0	0.9	3.0	2.5	1.7 4/
GNP deflator	0.2	2.6	3.4	1.7	2.2	3.4	3.1	2.9
Income and savings								
Private disposable income	1.5	4.3	8.5	7.2	9.4	10.1	8.9	6.5
Private savings rate (in percent of disposable income)	8.9	9.9	15.1	12.6	12.3	13.7	15.1	16.7

Sources: Central Office of Statistics; Central Bank of Malta; data provided by the Maltese authorities.

1/ January-September 1992 over the same period in 1991.
2/ Contribution to GDP growth.
3/ Includes temporary workers.
4/ A new retail price index was introduced in January 1992. In previous years, inflation was understated by the existence of price controls and an inadequate coverage of the retail price index.

Table 2. Malta: Selected External Indicators, 1985-92

	1985	1986	1987	1988	1989	1990	1991	1991 1/	1992 1/
	(In millions of Maltese liri)								
Exports, f.o.b.	197.8	205.0	218.1	250.9	301.9	366.8	412.2	273.7	346.9
Imports, f.o.b.	315.3	311.5	356.8	404.4	462.7	557.1	615.3	431.9	479.1
Merchandise trade balance	-117.5	-106.5	-138.7	-153.5	-160.8	-190.3	-203.1	-158.2	-132.2
Services, net	81.1	83.0	118.0	120.9	123.2	144.8	160.3	118.6	121.5
of which:									
Tourism, net	49.2	56.8	84.8	98.4	106.5	113.9	132.5	96.2	102.2
Investment income, net	38.8	28.1	30.7	28.3	35.8	55.0	46.4	36.3	33.4
Transfers, net	25.7	28.1	29.8	55.1	36.4	27.8	37.3	21.9	21.2
Private	16.9	26.9	30.0	41.2	28.3	20.5	21.4	16.0	11.2
Public	8.8	1.2	-0.2	13.9	8.1	7.3	15.9	5.3	10.0
Current account balance	-10.7	4.6	9.1	22.6	-1.2	-17.7	-5.5	-17.7	10.5
As percent of GDP	(2.1)	(0.9)	(1.7)	(3.7)	(-0.2)	(-2.4)	(-0.7)	(-3.0)	(1.6)
Medium- and long-term capital	11.7	6.0	8.2	10.2	19.5	27.1	34.8	...	...
Short-term capital 2/ 3/	-13.6	-4.0	-13.2	-3.7	-6.1	13.3	-7.7	...	...
Changes in net foreign position of banks	-18.7	-7.8	-6.7	-17.7	-40.9	-53.3	-47.1	...	...
Overall balance	-31.3	-1.8	-2.6	11.4	-28.7	-30.6	-25.5	...	...
	(Changes in percent)								
Memorandum items:									
Exports value 5/	4.4	3.6	6.4	15.0	20.3	21.5	12.4		26.7
Imports value 5/	6.3	-1.2	14.5	13.3	14.4	20.4	10.4		10.9
Nominal effective exchange rate 4/ 5/	2.0	-4.9	-1.1	0.8	1.2	-1.8	-0.1		-1.1
U.S. dollar/Maltese lira rate 4/ 5/	-1.5	19.2	13.7	4.4	-5.1	9.8	-1.7		3.8
Real effective exchange rate 4/	-3.0	-5.3	-3.2	-1.4	-2.6	-4.1	-2.3		...
Net international reserves 6/ (in millions of SDRs)	915.0	953.0	1,013.0	1,030.0	1,039.0	1,012.0	936.0		940.0
External debt (in millions of Maltese liri) 7/	42.5	35.4	31.3	30.5	26.9	37.5	44.7		
(as percent of GNP)	(8.3)	(6.6)	(5.4)	(4.8)	(3.8)	(4.7)	(5.3)		

Source: Data provided by the Maltese authorities.

1/ January-September period.
2/ Includes errors and omissions.
3/ Includes increases in foreign currency accounts of non-residents with the domestic banking system.
4/ A positive change implies an appreciation of the Maltese lira.
5/ January-September 1992 over January-September 1991.
6/ End-of-period; with gold valued at SDR 35 per ounce.
7/ Medium- and long-term public debt.

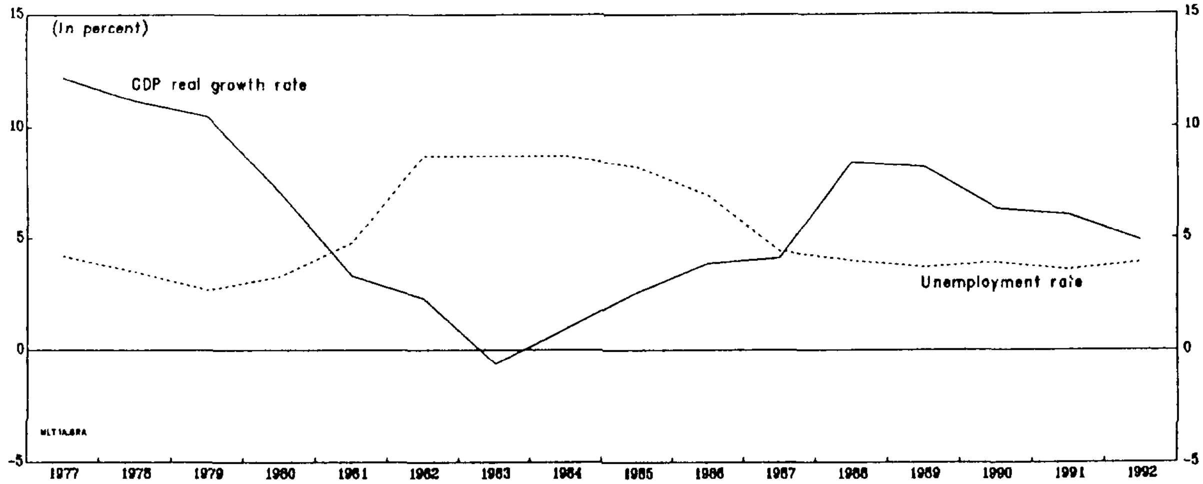
Table 3. Malta: Selected Monetary and Fiscal Indicators, 1985-93

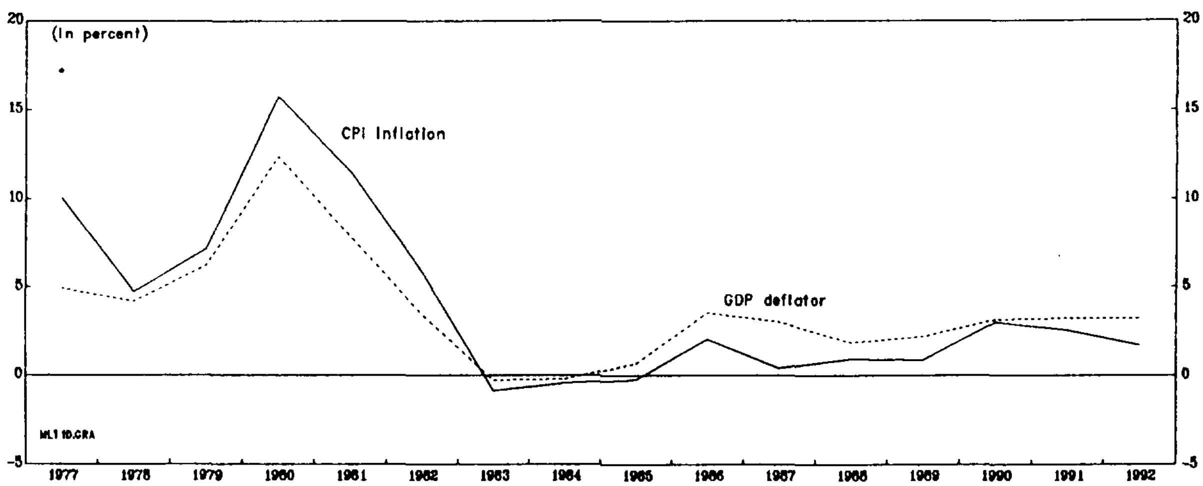
	1985	1986	1987	1988	1989	1990	1991	1991 1/	1992 2/	1993 3/
				(In Percent of GDP)						
Fiscal Indicators										
Total revenue	39.3	38.3	35.6	37.7	35.9	39.9	39.5	34.2	34.3	36.1
Tax revenue	26.0	25.0	24.0	24.5	24.3	25.8	25.5	25.5	25.9	27.8
Direct taxes	16.0	14.6	13.7	13.5	12.9	13.7	13.0	13.0	13.4	14.5
Indirect taxes	10.0	10.4	10.3	11.0	11.4	12.1	12.5	12.5	12.5	13.3
Nontax revenue	13.3	13.3	11.6	13.2	11.6	14.2	14.1	8.7	8.4	8.3
Total expenditure and net lending	40.8	40.7	42.8	40.4	41.9	46.5	46.7	41.4	39.8	40.4
Current expenditure	33.9	33.1	33.2	32.2	32.2	32.5	33.1	32.1	33.7	34.2
Capital expenditure	8.1	8.2	9.0	7.2	10.5	13.8	13.1	8.7	6.0	6.3
Net lending	-1.2	-0.6	0.6	1.0	-0.8	0.1	0.5	0.5	0.1	-0.2
Deficit	-1.5	-2.4	-7.2	-2.7	-6.0	-6.5	-7.1	-7.1	-5.4	-4.3
Public debt	14.7	12.3	16.2	18.6	17.8	23.7	26.2	26.2	28.5	32.2
				(Percent changes at end of period)			June'92/June'91			
Monetary indicators										
Narrow money (M1)	-1.4	0.6	10.0	3.4	1.6	4.5	5.8	7.8		
Quasi money	14.7	9.2	9.3	13.4	16.6	16.0	10.5	13.3		
Broad money (M2)	6.5	5.2	9.6	8.9	10.2	11.4	8.8	11.1		
Domestic credit	6.9	23.1	25.0	14.8	26.8	28.9	20.5	17.8		
of which:										
To private sector 4/	7.2	14.4	13.9	14.9	19.9	24.8	18.5	15.6		
Net foreign assets	-4.8	4.2	3.6	3.2	0.7	-0.9	1.7	1.0		
Income velocity of M2 5/	0.726	0.738	0.737	0.745	0.752	0.744	0.745	...		
Nominal interest rates										
Deposit 6/	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5		
Lending 7/	7.5	7.3	7.3	7.2	7.1	7.0	7.1	7.1		
Real interest rates 8/										
Deposit 6/	4.8	2.5	4.1	3.6	3.6	1.5	2.0	1.8		
Lending 7/	7.8	5.2	6.8	6.2	6.2	3.9	4.5	4.3		

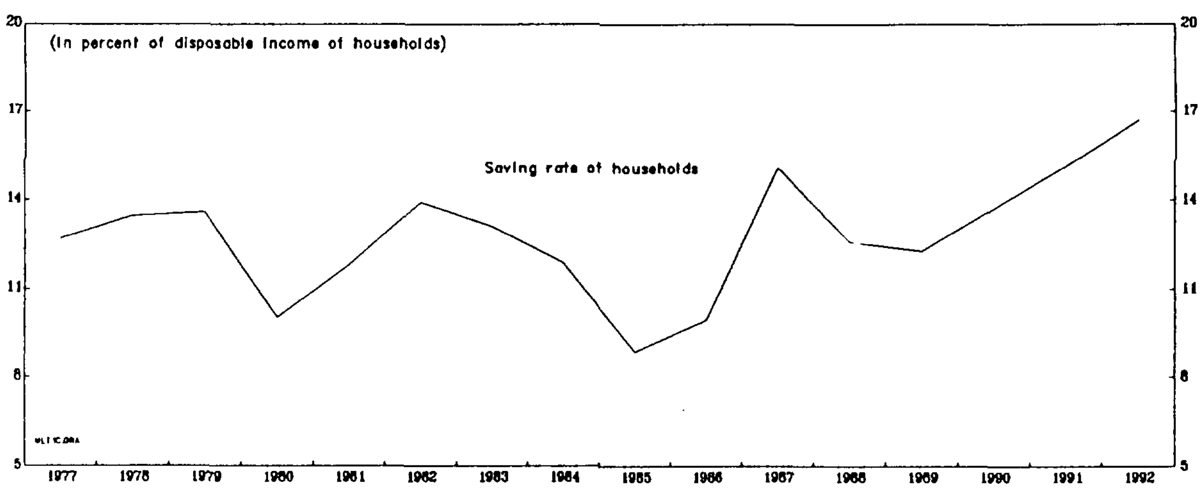
Sources: Ministry of Finance; Central Bank of Malta.

1/ Starting 1992, the budget has been framed differently from earlier budgets in two respects. First, capital expenditure of Enemalta, Telemalta and the Housing Authority is no longer imputed to the Consolidated Fund; neither is the own contribution--which contained both borrowed resources and retained earnings--of these companies to their capital expenditure program. Secondly, as the Government has created five new five new semi-autonomous entities (the Water Services Corporation the Maritime Authority, the Planning Authority, the Public Transport Authority, and the Employment and Training Corporation) gross income and expenditure--both current and capital--of these entities are no longer accounted for in the Consolidated Fund. To overcome problems of comparability, the 1991 figures have been worked back.
2/ Official estimates.
3/ Budget estimates.
4/ Includes public enterprises.
5/ Ratio of nominal GDP to average broad money stock.
6/ Time deposits (six months).
7/ Advances and loans (effective rate).
8/ Nominal rates deflated by CPI inflation rates.

CHART 1
MALTA
MAIN ECONOMIC INDICATORS, 1977-92 1/



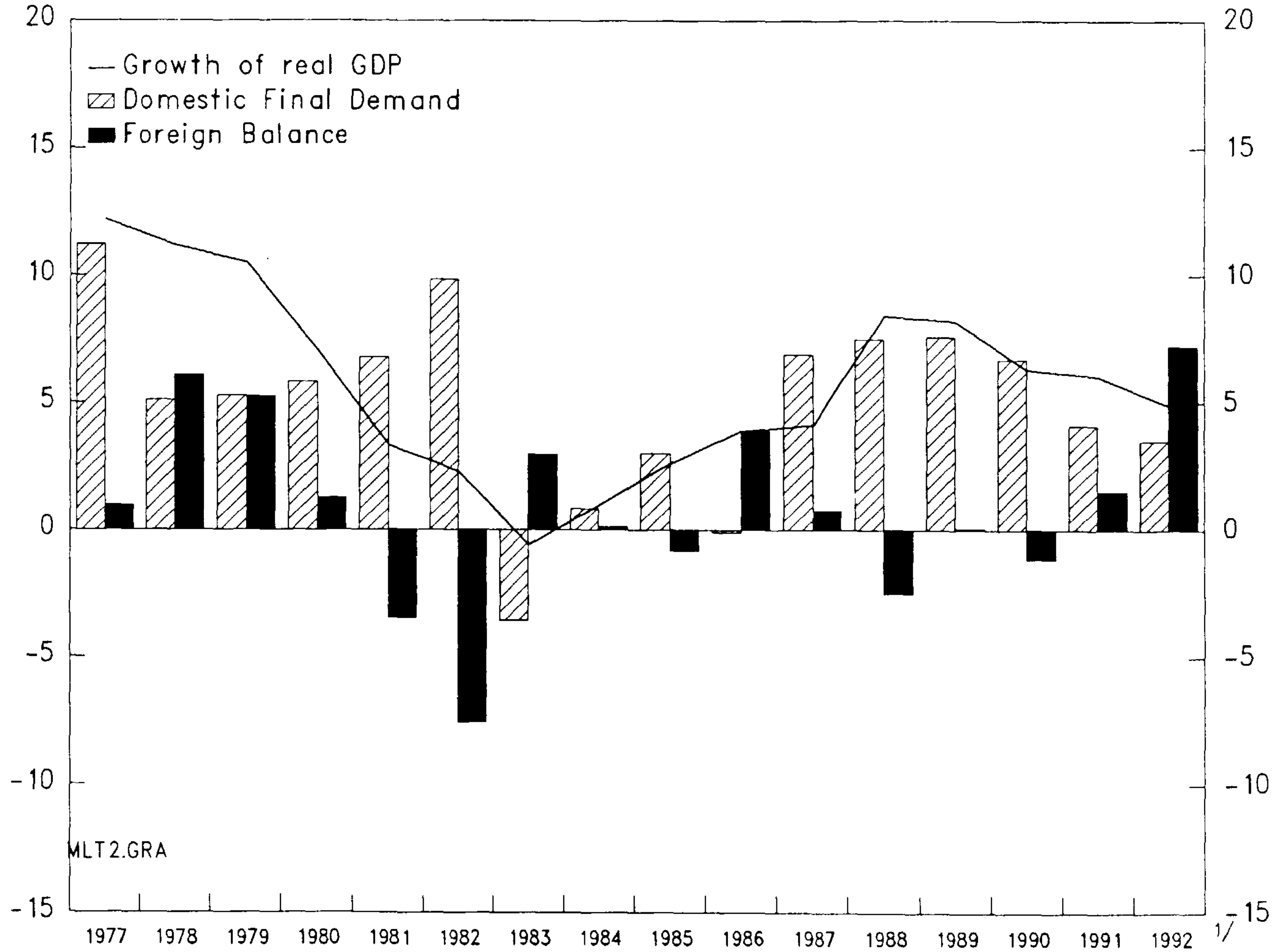




Sources: Central Office of Statistics, National Accounts of the Maltese Islands; Ministry of Finance, Economic Survey.

1/ January-September 1992 over January-September 1991.

Chart 2
MALTA
CONTRIBUTIONS TO GROWTH OF REAL GDP, 1977-92
(In percent)



Sources: Central Office of Statistics, National Accounts of the Maltese Islands; Ministry of Finance, Economic Survey.

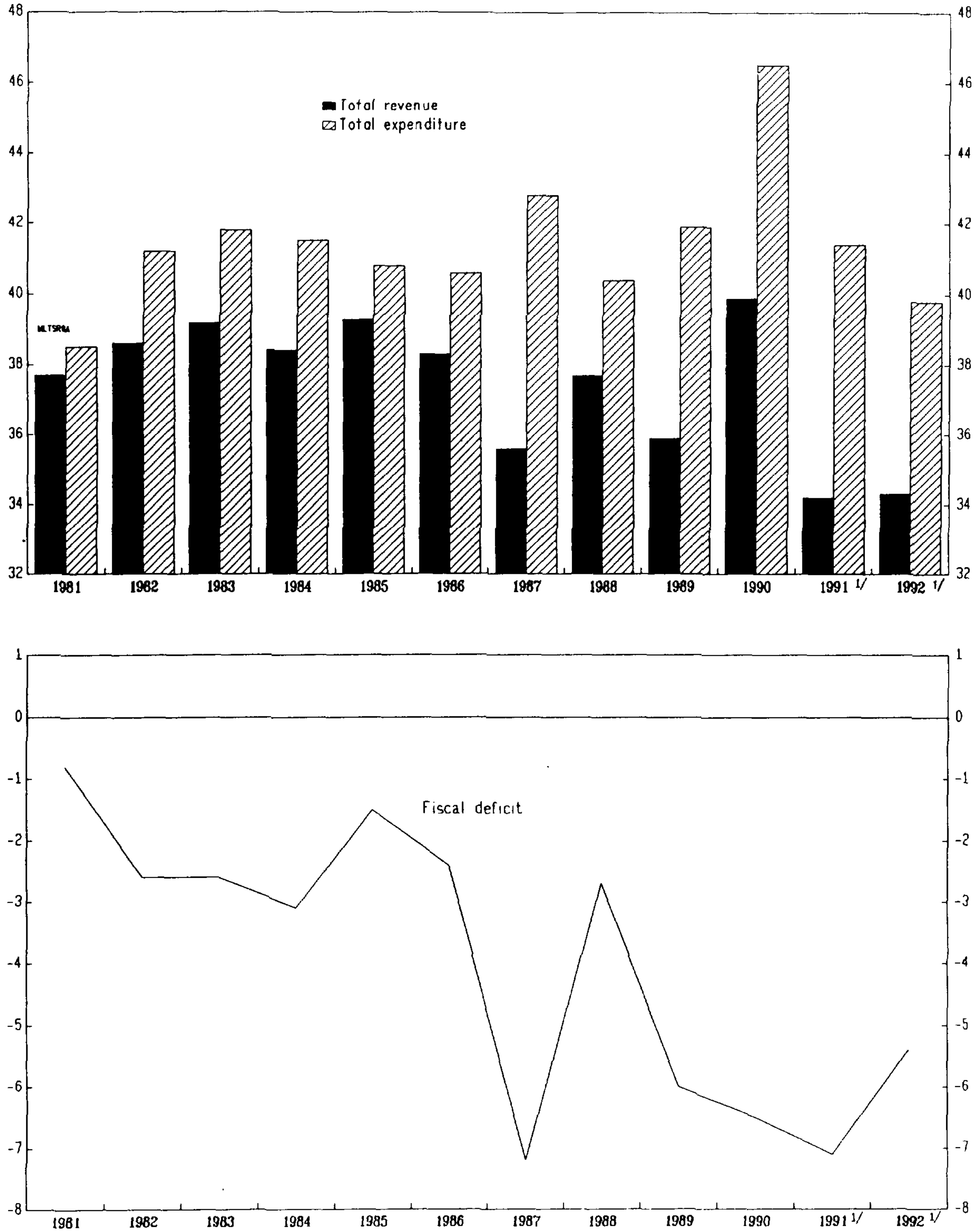
1/ January-September 1992 over January-September 1991.

CHART 3

MALTA

FISCAL INDICATORS, 1981-92

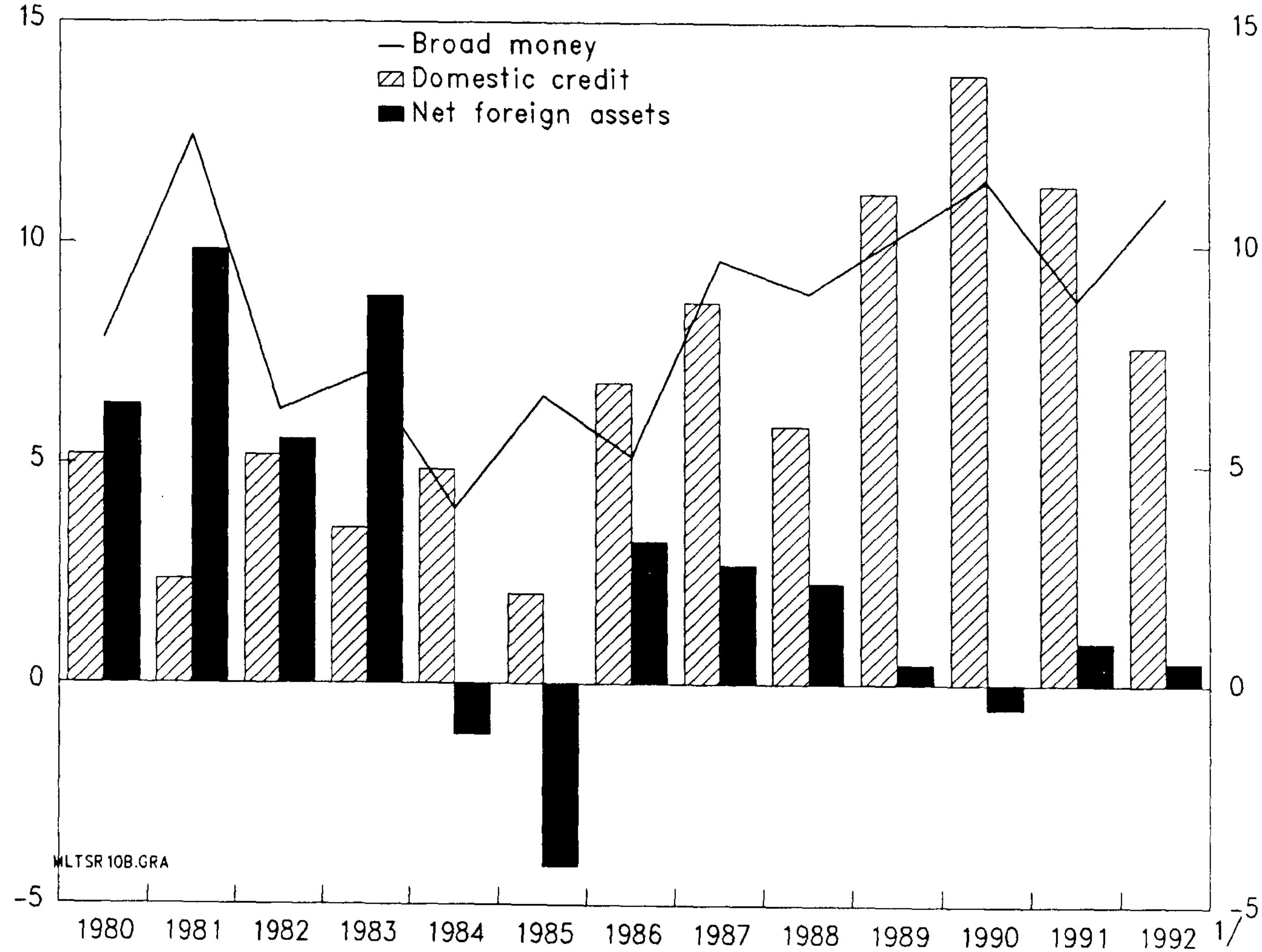
(In percent of GDP)



Sources: Data provided by the Maltese authorities.

1/ See footnote 1 to Table 3: Selected Monetary and Fiscal Indicators

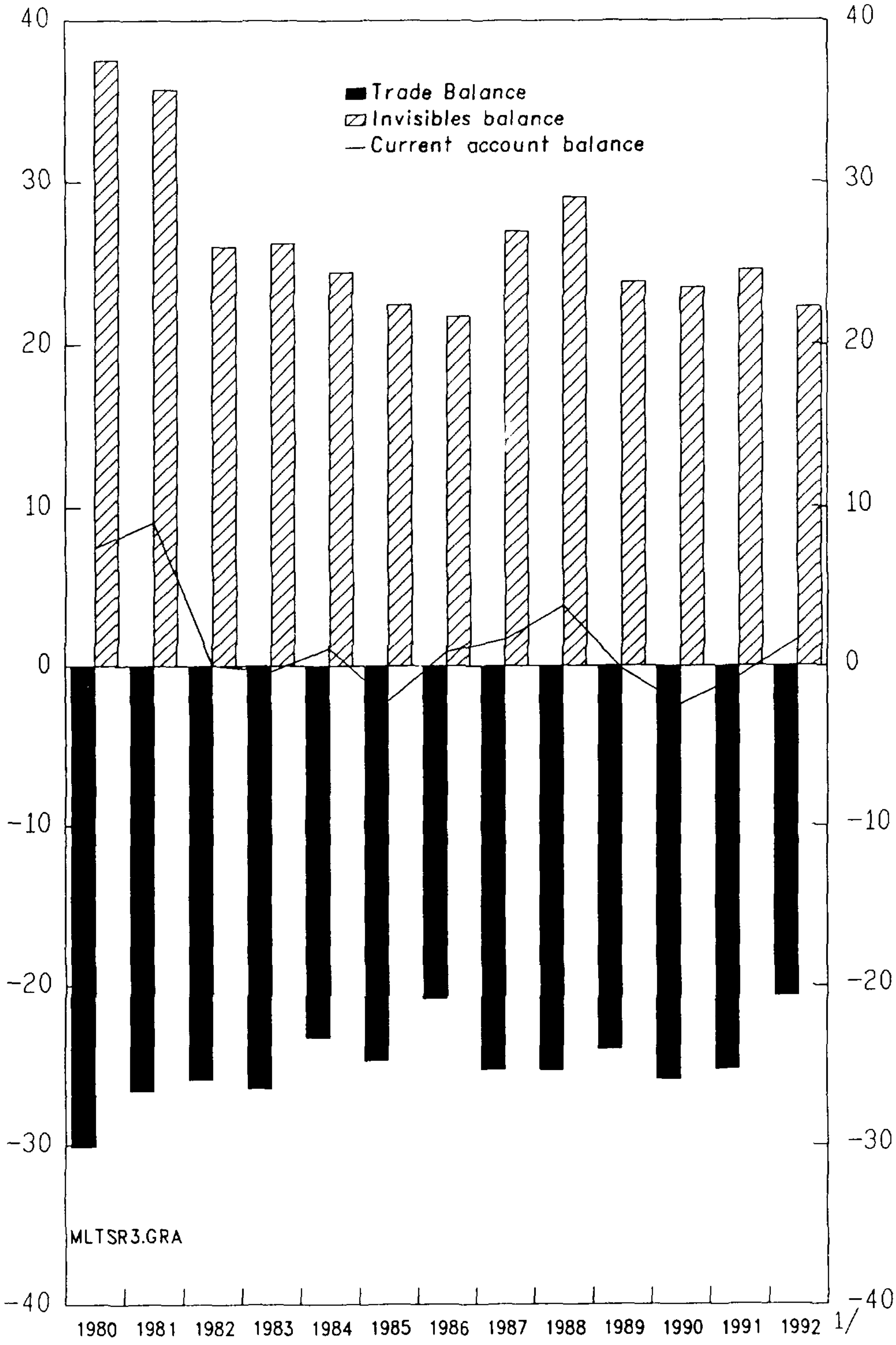
Chart 4
MALTA
CONTRIBUTIONS TO MONEY GROWTH, 1980-92
(In percent, end of period)



Source: Central Bank of Malta, Quarterly Review.

1/ June 1991-June 1992.

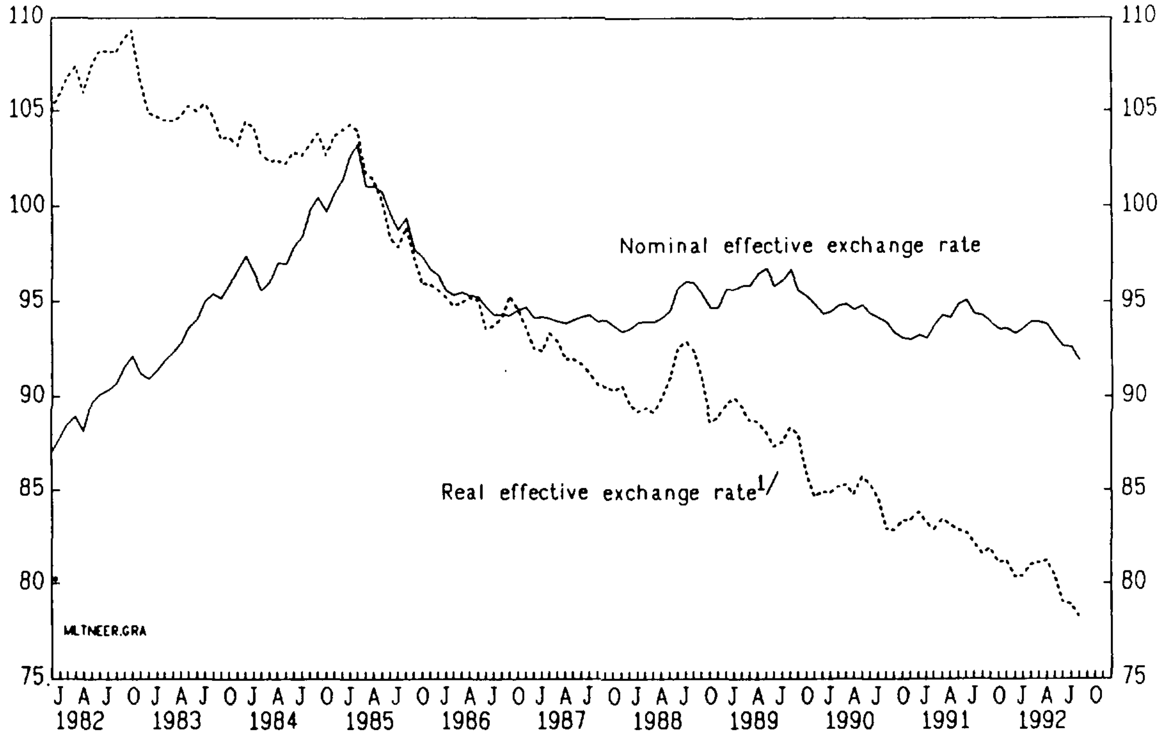
Chart 5
MALTA
BALANCE OF PAYMENTS, 1980-92
(In percent of GDP)



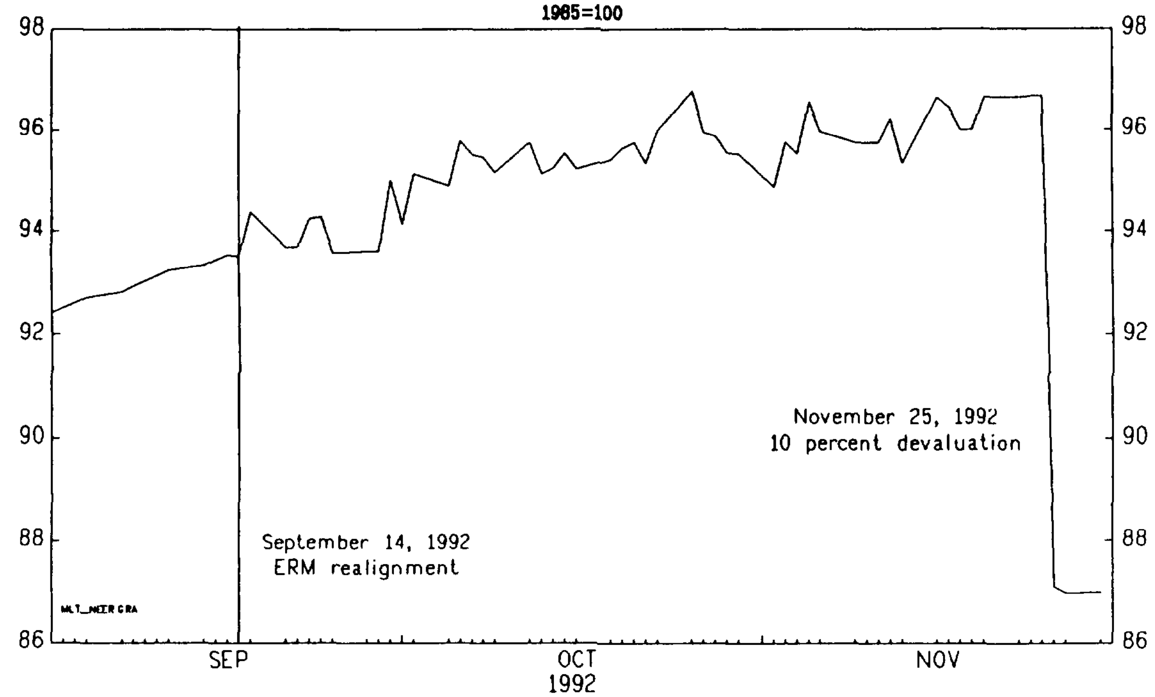
Sources: Data provided by the Maltese authorities, and Staff estimates.

1/ January-September 1992.

CHART 6
MALTA
NOMINAL AND REAL EXCHANGE RATES, 1982-92
(Indices 1985=100)



NOMINAL EFFECTIVE EXCHANGE RATE, SEPTEMBER 1992-NOVEMBER 1992
1985=100



Source: Staff calculations.

1/ Relative CPI basis. The real effective depreciation is overstated by both the existence of price controls in Malta, and the inadequate coverage of the Retail Price Index over most of the period shown.

Basic Data

Area	316 sq. kilometers (122 sq. miles)
Population (in thousands, 1991)	359.5
Domestic labor force (in thousands, end-1991)	135.3
GNP (1991, at current prices)	Lm 851.2 million
GNP per capita, 1991	Lm 2,368 or US$7,341 (SDR 5,366)

Social indicators (1991)

Infant mortality	9.6 per 1,000 live births	
Life expectancy (years)	Male: 73.6	Female: 78.3
Number of students (in thousands)	Total: 91.8	University: 2.8

Demand and output, 1991	In millions of Maltese liri	In percent of GDP
Private consumption	493.5	61.3
Public consumption	147.1	18.3
Fixed investment	239.1	29.7
Stockbuilding	14.3	1.8
Total domestic demand	894.0	111.1
Exports of goods and services	703.7	87.4
Imports of goods and services	793.1	98.6
Gross domestic product	804.7	100.0

	1990	1991	1992 1/
	Selected economic indicators, percentage change from the preceding year		
Demand, output, and prices			
GDP at current prices	9.7	9.5	8.1
GDP at constant 1973 prices	6.3	6.1	4.9
Total consumption	4.2	5.6	4.6
Private consumption	3.8	4.0	3.1
Public consumption	5.7	10.9	9.5
Gross fixed investment	17.9	--	0.6
Exports of goods and services	13.3	7.8	16.4
Imports of goods and services	15.7	5.6	5.4
Consumer prices	3.0	2.5	1.7
GDP deflator	3.2	3.2	3.1
Total employment (end period)	0.9	2.9	1.0
Unemployment rate (end period)	3.9	3.6	3.9

Fiscal indicators (in percent of GDP)	1991	1992 (Est.)	1993 (Budget)
General government			
Total revenue	34.2	34.3	36.1
Tax revenue	25.5	25.9	27.8
Current expenditure	32.1	33.7	34.2
Capital expenditure and net lending	9.2	6.1	6.2
Financial deficit	-7.1	-5.4	-4.3
Public debt (end of period)	26.2	28.5	32.2

Monetary survey (percentage changes)	1990	1991	1992 June92/June91
Monetary base	-5.6	6.8	10.2
Broad money (M2)	11.4	8.8	11.1
Narrow money (M1)	4.5	5.8	7.8
Domestic credit	28.9	20.5	17.8
Net foreign assets	-0.9	1.7	1.0
Interest rate (six month time deposit in percent)	4.5	4.5	4.5

External sector (in millions of liri)	1989	1990	1991
Exports, f.o.b.	301.9	366.8	412.2
Imports, f.o.b.	462.7	557.1	615.3
Trade balance	-160.8	-190.3	-203.1
Invisible balance	159.7	172.6	197.6
Of which: tourism earnings (net)	106.5	113.9	132.5
Current account	-1.2	-17.7	-5.5
(In percent of GDP)	(-0.2)	(-2.4)	(-0.7)
External debt as percent of GDP	4.0	5.1	5.6
Foreign exchange reserves 2/ (In millions of U.S. dollars)	1,253.8	1,319.8	1,211.7
Nominal effective exchange rate 2/ (Average percentage change)	1.2	-1.8	-0.2
Real effective exchange rate 2/ (Average percentage change)	-2.7	-4.1	-2.2

1/ January-September 1992 over same period of 1991.
2/ IMF, International Financial Statistics.

Malta: Fund Relations
(As of November 30, 1992)

I. Membership Status: Malta became a member of the Fund on September 11, 1968. It continues to avail itself of the transitional arrangements under Article XIV of the Articles of Agreement. It also maintains restrictions on current payments and transfers of current international transactions and multiple currency practices subject to approval under Article VIII.

II. General Resources Account:	SDR Million	% Quota
Quota	67.50	100.0
Fund holdings of currency	40.67	60.2
Reserve position in Fund	26.86	39.8
Operational budget transfers (net)	2.50	

III. SDR Department:	SDR Million	% Allocation
Net cumulative allocation	11.29	100.0
Holdings	33.10	293.2
Designation plan amount		

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

VI. Projected Obligations to Fund: None

VII. Exchange Rate Arrangement:

Since 1972, the value of the Maltese lira has been pegged to a trade weighted basket of currencies. Effective November 25, 1992, the Maltese lira devalued by 10 percent against the currencies in the basket, i.e., the U.S. dollar, the European Currency Unit (ECU), and the pound sterling. At the same time, the weights of these currencies in the basket were adjusted in order to reflect the current account flows in the period 1989-91. On November 30, 1992, the exchange rate of the Maltese lira was Lm 1 = US$2.6924.

VIII. Article IV Consultations:

(a) The last Article IV consultation discussions were conducted in March 1990.

(b) The staff report (SM/90/81, 5/2/90) was considered by the Executive Board on June 20, 1990 (EBM/90/97).

IX. Technical Assistance:

Missions: September 3-21, 1990, Fiscal Affairs Department mission on indirect taxation; December 9-20, 1991, Statistics Department mission on National Accounts. The Central Bank of Malta, through longer term assignments of experts, also received assistance for its Research and Supervision Departments.

X. Resident Representative: None