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August 2, 1988

To: Members of the Executive Board

From: The Acting Secretary

Subject: Malta - Staff Report for the 1988 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1988 Article IV consultation with Malta, which is tentatively scheduled for discussion on Wednesday, October 12, 1988. A draft decision appears on page 15.

Mr. Thakur (ext. 8793) or Mr. Lopez-Claros (ext. 8843) 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 1988 Article IV Consultation

Prepared by the Staff Representatives
for the 1988 Consultation with Malta

Approved by Massimo Russo and S. Kanesa-Thasan

July 29, 1988

I. Introduction

A staff team consisting of Messrs. S. Thakur, A. Lopez-Claros, P. Guidotti (EP), Ms. S. Sheybani, and Miss P. Nivasabutr as secretary (all EUR) held Article IV consultation discussions in Valletta during June 16-28, 1988. The Maltese representatives included officials from the Central Bank of Malta, the Ministry of Finance, the Departments of Labor, Foreign Affairs, Trade, and Tourism, and the Division of Economic Planning and Management. The mission met with the Minister of Finance, Mr. Bonello Du Puis, and the Governor of the Central Bank of Malta, Mr. Galdes; it also met with representatives of private industry and trade unions. Mr. S. Zecchini, the Executive Director for Malta, attended the concluding meetings as an observer. The last Article IV consultation took place in May 1986 and was concluded by the Executive Board on August 27, 1986 (EBM/86/138). Malta continues to avail itself of the transitional arrangements of Article XIV of the Articles of Agreement.

A Nationalist Party Government came to office in May 1987, following 16 years of rule by the Labor Party.

II. Background

The Maltese economy has been dominated for a long period by the public sector, and beset with some major structural weaknesses, including an inadequate infrastructure and an inflexible labor market. In an attempt to insulate the economy from the effects of the closure of the United Kingdom's military base in 1979 and the second oil price increase, there had been increasing intervention in economic activity, in particular, through the imposition of a freeze on prices and wages in 1983. Moreover, to offset the impact of world inflation, the Maltese lira was allowed to appreciate sharply during 1981-85, while a worsening of the trade balance was prevented by an intensification of import restrictions and resort to bilateral trade agreements. The steady erosion of competitiveness led to a loss of export market shares and a period of decline for the tourism sector--the mainstay of the economy.

In concluding the 1986 Article IV consultation, the Executive Directors addressed these problems and expressed the view that a more market-oriented set of policies would be conducive to an improvement in the medium-term growth prospects of the economy. They expressed concern at the deterioration in public finances and stressed the importance of enhancing competitiveness.

The present Government has declared its intention to address these problems through a shift in policies toward economic liberalization and a greater role for the private sector. At the same time, it has indicated a preference for a gradual approach to this shift in the belief that in a small country, with a history of political polarization, a period of consensus building was necessary. During its first year in office, the Government has thus taken some first steps toward opening up the economy, such as a partial lifting of the wage-price freeze and some relaxation of the extensive quantitative import controls.

III. Recent Economic Developments and Outlook

1. Recent developments

Following a sharp slowdown in economic growth in the first half of the 1980s, economic activity recovered strongly in 1987 with real GNP increasing by 4 1/2 percent (Table 1 and Chart 1). An important stimulus to demand was provided by public consumption, reflecting a surge in public sector employment in the pre-election period of early 1987. As a result, employment rose sharply and the rate of unemployment fell from about 8 percent at the beginning of 1986 to 4 1/2 percent in early 1988 (Chart 2). Fixed investment recovered in 1987 from a cumulative fall of 20 percent in the three preceding years, led by the onset of a program of public sector investment in infrastructure (water, electricity, and telecommunications). Under the impact of the wage-price freeze, partially lifted in November 1987, nominal wages and the consumer price index remained virtually unchanged. This broad stability in wages and prices continued into the early months of 1988.

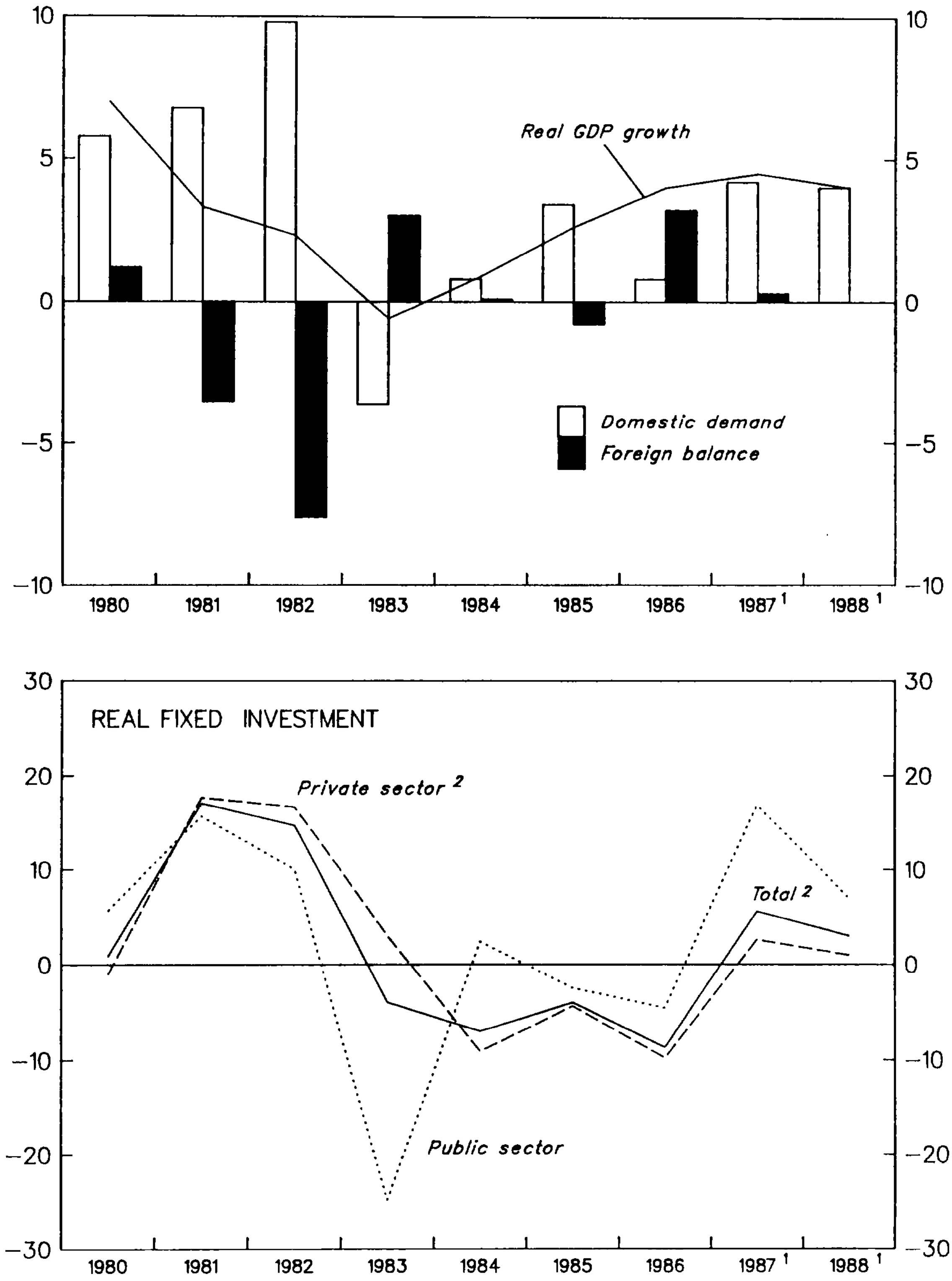
Malta, nevertheless, continued to lose export market shares, and merchandise export volume increased by only 1 percent in 1987. With buoyant import demand, sustained by strong consumer spending, the trade deficit rose to 23 1/2 percent of GNP, from 19 1/2 percent of GNP in 1986 (Table 2 and Chart 3). Nevertheless, aided by strong growth in earnings from tourism, and continued substantial investment income and private transfers, the current account shifted from a position of balance in 1986 to a surplus equivalent to about 1/2 percent of GNP. The rise in tourist arrivals by some 30 percent reflected in part the growth of incomes in overseas markets, especially the United Kingdom, which accounts for the largest proportion (60 percent in 1987) of tourists (Chart 4). More importantly, the recovery in tourism from the

CHART 1

MALTA

CONTRIBUTIONS TO GROWTH OF REAL GDP, 1980–88

(In percent)

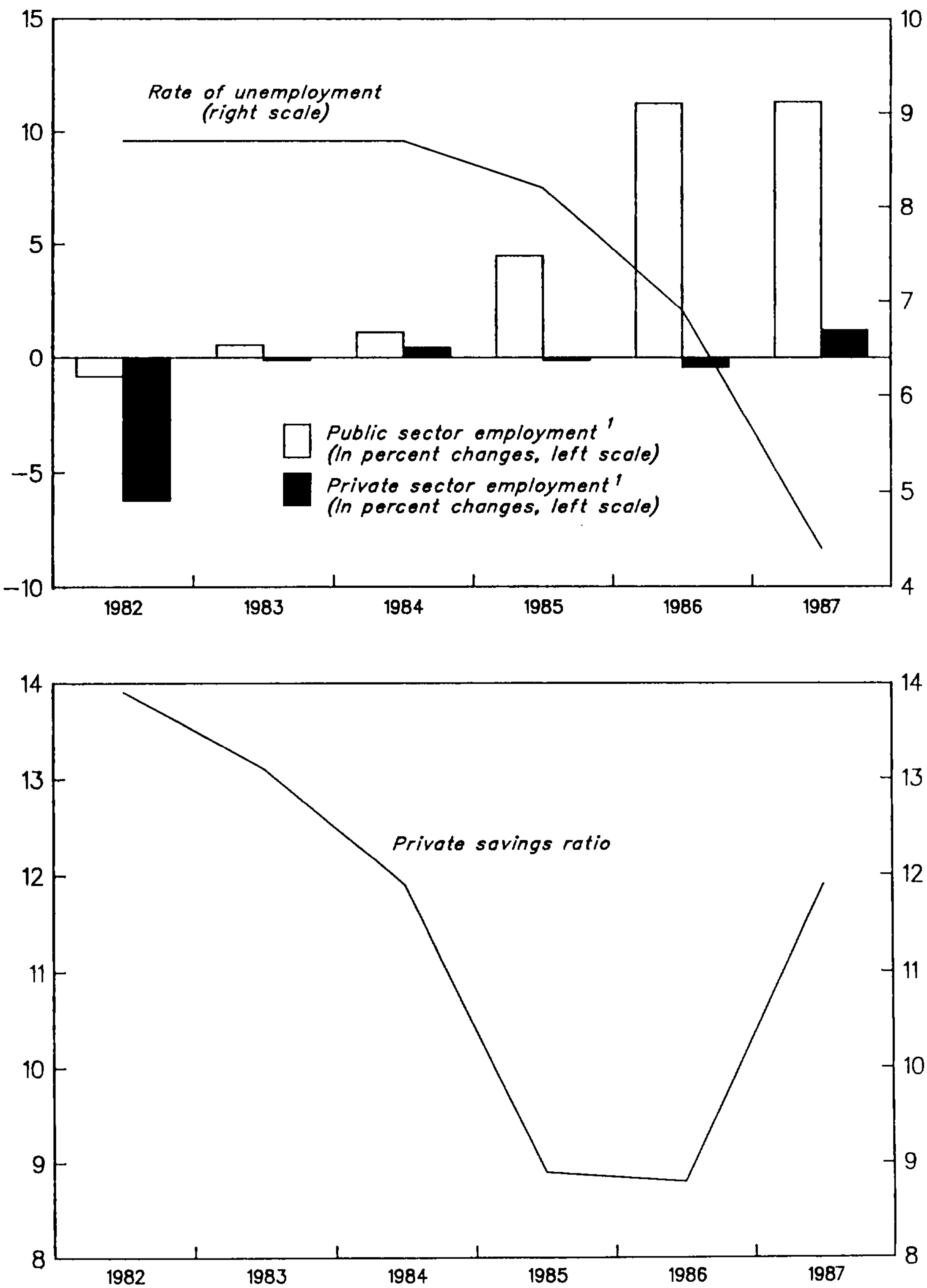


Sources: Data provided by the Maltese authorities; and staff estimates.

[1] Staff estimates and projections.

[2] The data for 1983 and 1987 have been adjusted to exclude large purchases of aircrafts by the national airline.

CHART 2
MALTA
LABOR MARKET DEVELOPMENTS AND PRIVATE
SAVINGS RATIO, 1982–87



Source: Data provided by the Maltese authorities.
[1] Estimated values for the 1981–84 period are based on the new employment classification.

Table 1. Malta: Domestic Economic Indicators, 1983-88

(Annual percentage changes, unless otherwise indicated)

	1983	1984	1985	1986	1987 1/	1988 1/
Real demand and output (at 1973 prices)						
Domestic demand	-3.5	0.8	3.5	0.8	4.4	4.2
Private consumption	1.4	4.0	5.0	2.8	5.0	4.5
Public consumption	-1.1	-2.5	5.6	4.4	9.3	6.0
Gross fixed investment	15.8	-7.0	-4.0	-8.7	22.0	3.0
Increase in inventories 2/	-7.2	0.5	0.4	0.1	-4.0	0.3
Exports of goods and non-factor services	-1.8	4.0	7.4	5.7	11.8	7.5
Imports of goods and non-factor services	-7.2	3.9	9.2	0.1	12.1	8.0
GDP	-0.6	0.9	2.6	4.0	4.5	4.0
GNP	-2.5	1.9	1.4	2.3	4.5	4.0
Labor market						
Employment	0.2	0.6	1.3	4.1	5.9	3.0
Public sector	0.6	1.1	4.5	11.2	11.4	...
Private sector	-0.2	0.5	-0.2	-0.4	1.3	...
Unemployment rate (level)	8.7	8.7	8.3	6.9	4.4	4.1
Real wages per employee 3/	-1.8	-2.5	1.1	-2.0	3.7	...
Prices						
Consumer prices	-0.9	-0.4	-0.3	2.0	0.5	1.8
GDP deflator	-0.3	-0.2	0.6	3.4	2.2	2.5
Income and savings						
Real private disposable income	-0.3	2.5	1.8	2.2	8.4	...
Private savings ratio (level)	13.1	11.9	8.9	8.8	11.9	...

Sources: Data provided by the Maltese authorities and staff estimates.

1/ Staff estimates and projections.
2/ Contributions to GDP growth.
3/ Average wage per employee deflated by the increase in the consumer price index.

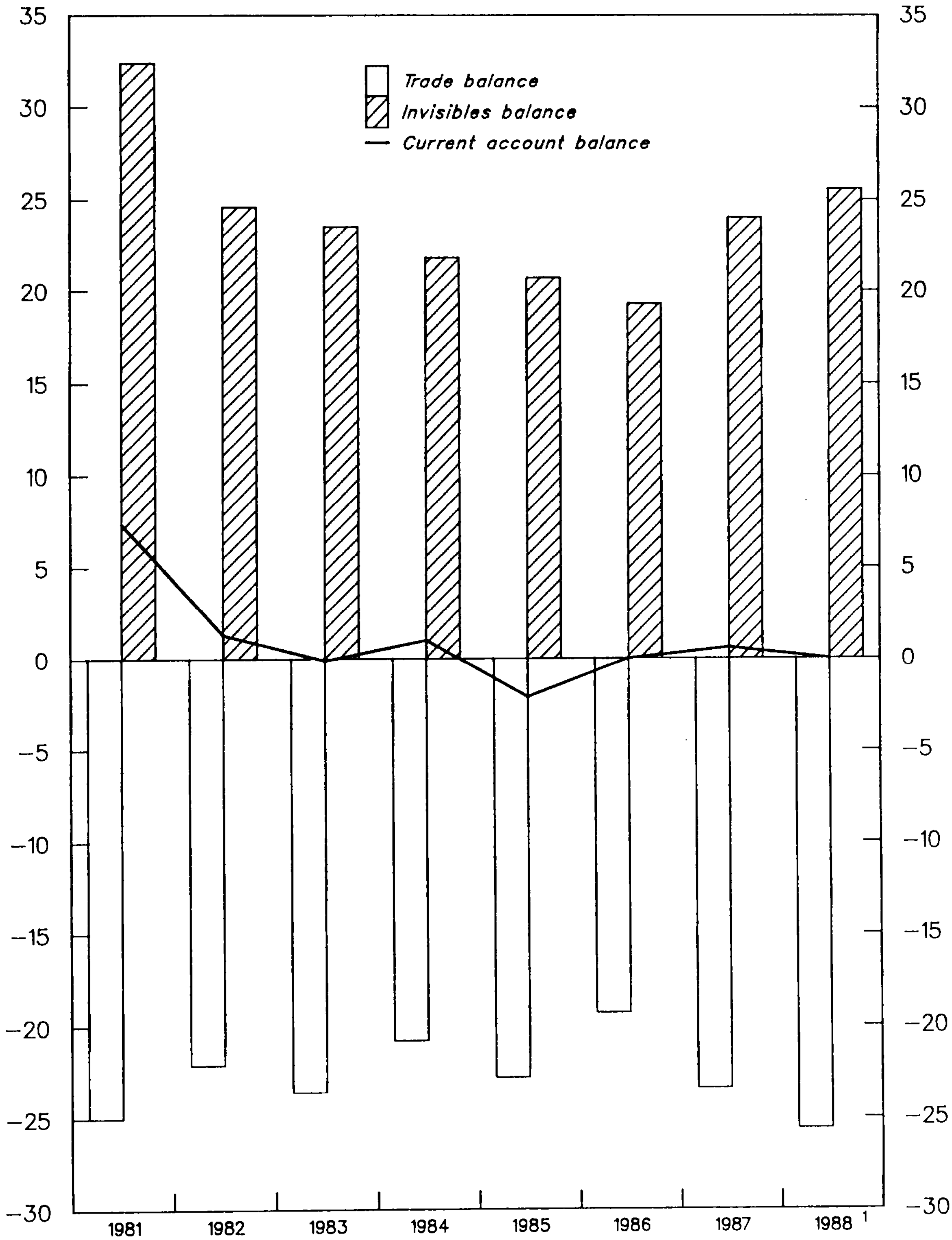
Table 2. Malta: Selected External Indicators, 1984-88

	1984	1985	1986	1987	1988 1/
	(In millions of Maltese liri)				
Exports, f.o.b.	189.4	197.8	205.0	218.2	227.9
Imports, f.o.b.	294.7	315.3	309.1	354.0	386.3
Merchandise trade balance	-105.3	-117.5	-104.1	-135.8	-158.4
Services, net	80.7	81.1	76.0	109.7	114.4
Of which:					
Tourism, net	42.8	49.2	54.9	80.8	87.4
Investment income, net	45.5	38.8	28.1	32.9	32.0
Transfers	29.9	25.7	28.0	29.8	44.0
Private	14.4	16.9	19.9	21.8	22.0
Public	15.5	8.8	8.1	8.0	22.0
Current account balance	5.3	-10.7	-0.1	3.7	--
As percent of GNP	(1.0)	(-2.1)	(--)	(0.6)	(--)
Medium- and long-term capital	15.8	11.7	6.0	...	...
Short-term capital 2/	-11.6	-13.6	--	...	...
Changes in net foreign position of banks	4.2	-18.7	-7.8	...	...
Overall balance	13.7	-31.3	-1.9	...	...
	(Changes in percent)				
Memorandum items:					
Market shares	6.7	-1.0	2.3	-3.4	-3.4
Exports, unit value	1.8	0.3	2.5	4.8	2.4
Exports, volume	14.3	2.4	4.4	0.9	2.0
Imports, c.i.f., unit value	-1.9	-1.4	-3.8	0.7	1.0
Imports, c.i.f., volume	6.3	8.7	2.1	12.3	8.0
Nominal effective exchange rate 3/	4.5	2.0	-4.9	-1.2	-0.2 4/
U.S. dollar/Maltese lira rate 3/	-6.1	-1.6	19.2	13.8	8.9 4/
Net international reserves 5/ (in millions of U.S. dollars)	1,055	1,122	1,309	1,579	1,513 6/
External debt (in millions of Maltese liri) 7/	45.3	42.5	35.4	31.3	...
(as percent of GNP)	(8.9)	(8.3)	(6.6)	(5.4)	(...)

Sources: Data provided by the Maltese authorities; and staff estimates.

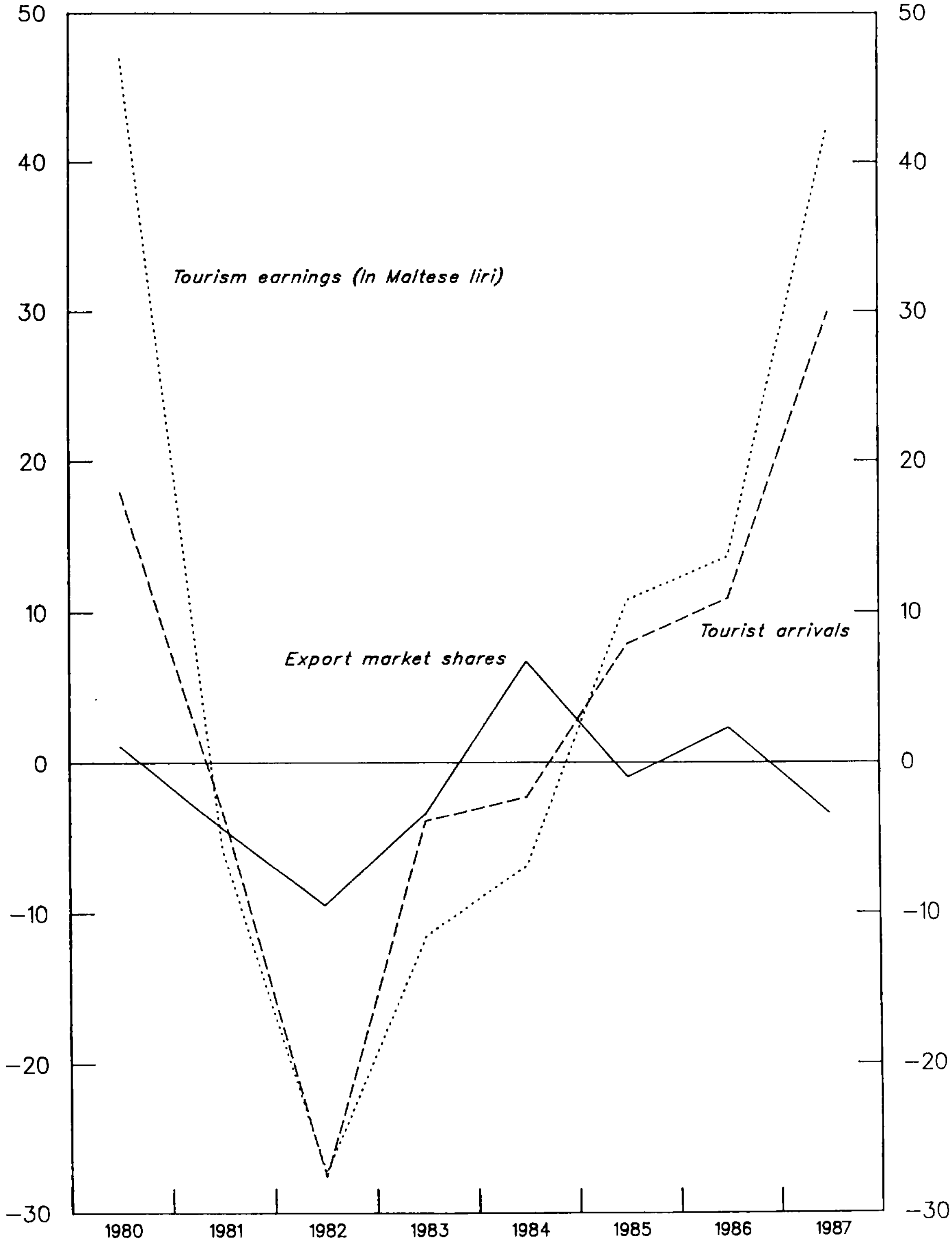
1/ Staff projections.
2/ Includes errors and omissions.
3/ A positive change implies an appreciation of the Maltese lira.
4/ Average change over January-May with respect to corresponding period in the preceding year.
5/ End-of-period stock.
6/ End-April.
7/ Medium- and long-term public debt.

CHART 3
MALTA
BALANCE OF PAYMENTS, 1981–88
(In percent of GNP)



Source: Data provided by the Maltese authorities.
[1] Staff estimates.

CHART 4
MALTA
INDICATORS OF EXTERNAL PERFORMANCE, 1980-87
(In percent changes over the preceding year)



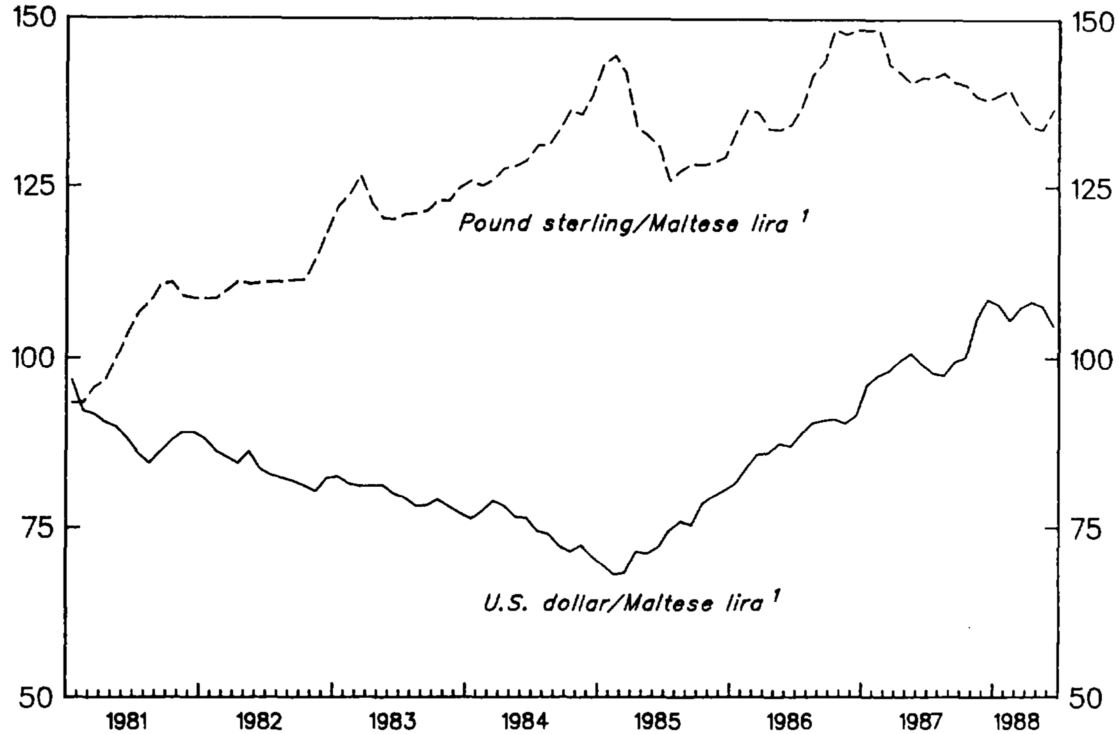
Sources: Data provided by the Maltese authorities; and staff estimates.

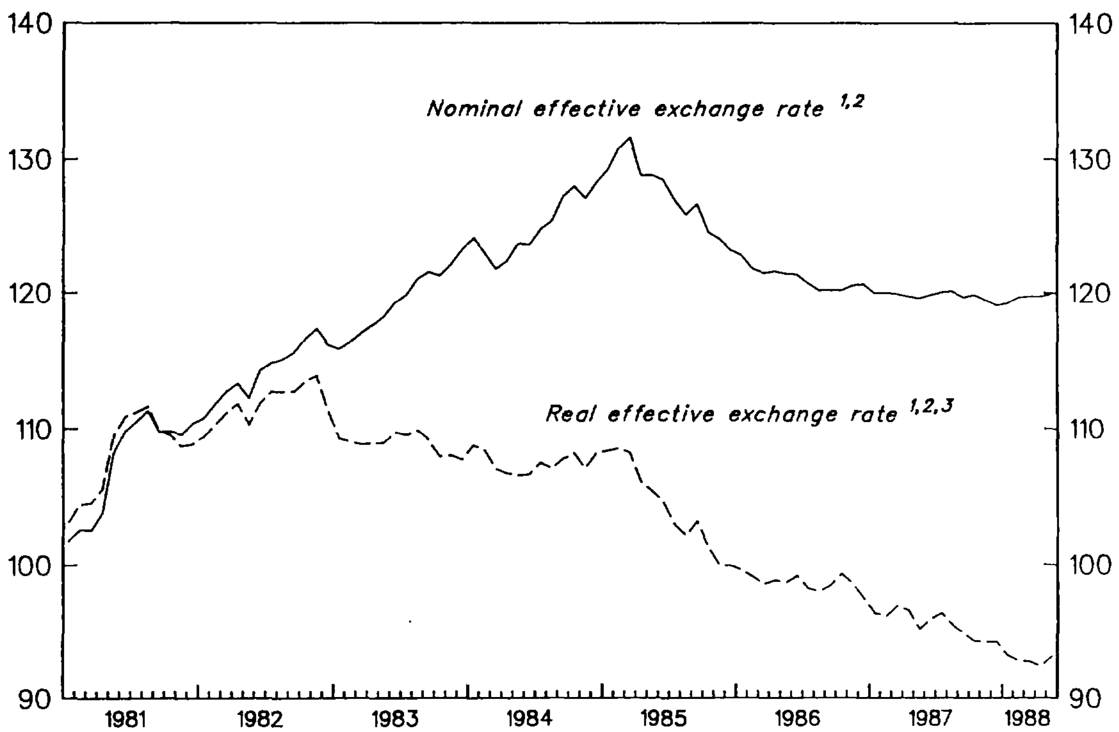
CHART 5

MALTA

EXCHANGE RATE DEVELOPMENTS, 1981–88

(Indices 1980=100)





Source: IMF, *Information Notice System.*

[1] An increase in the index shows an appreciation of the lira.

[2] Vis-a-vis 13 major partner countries.

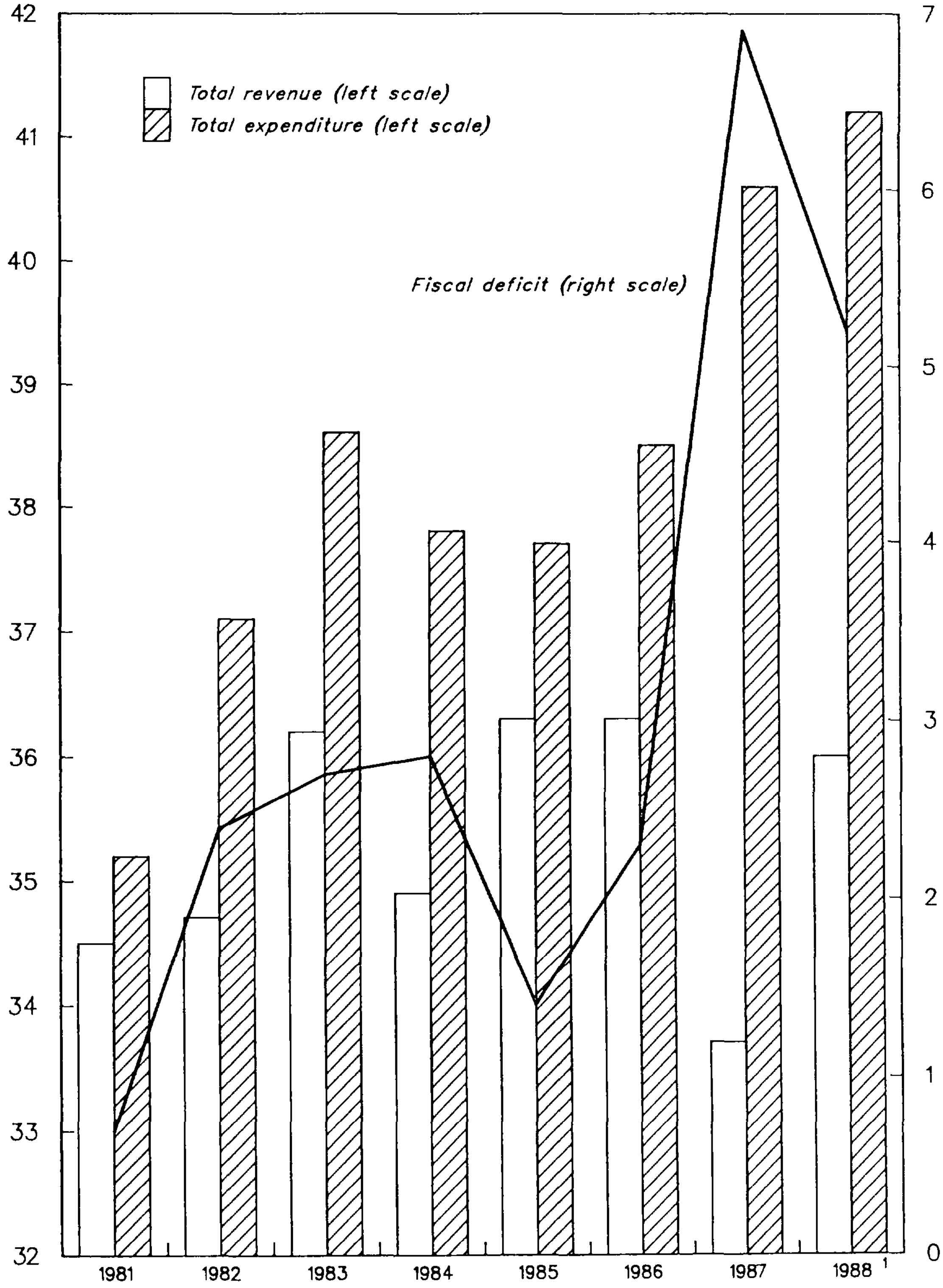
[3] Relative consumer prices adjusted for exchange rate changes.

CHART 6

MALTA

FISCAL INDICATORS, 1981–88

(In percent of GNP)



Source: Data provided by the Maltese authorities.

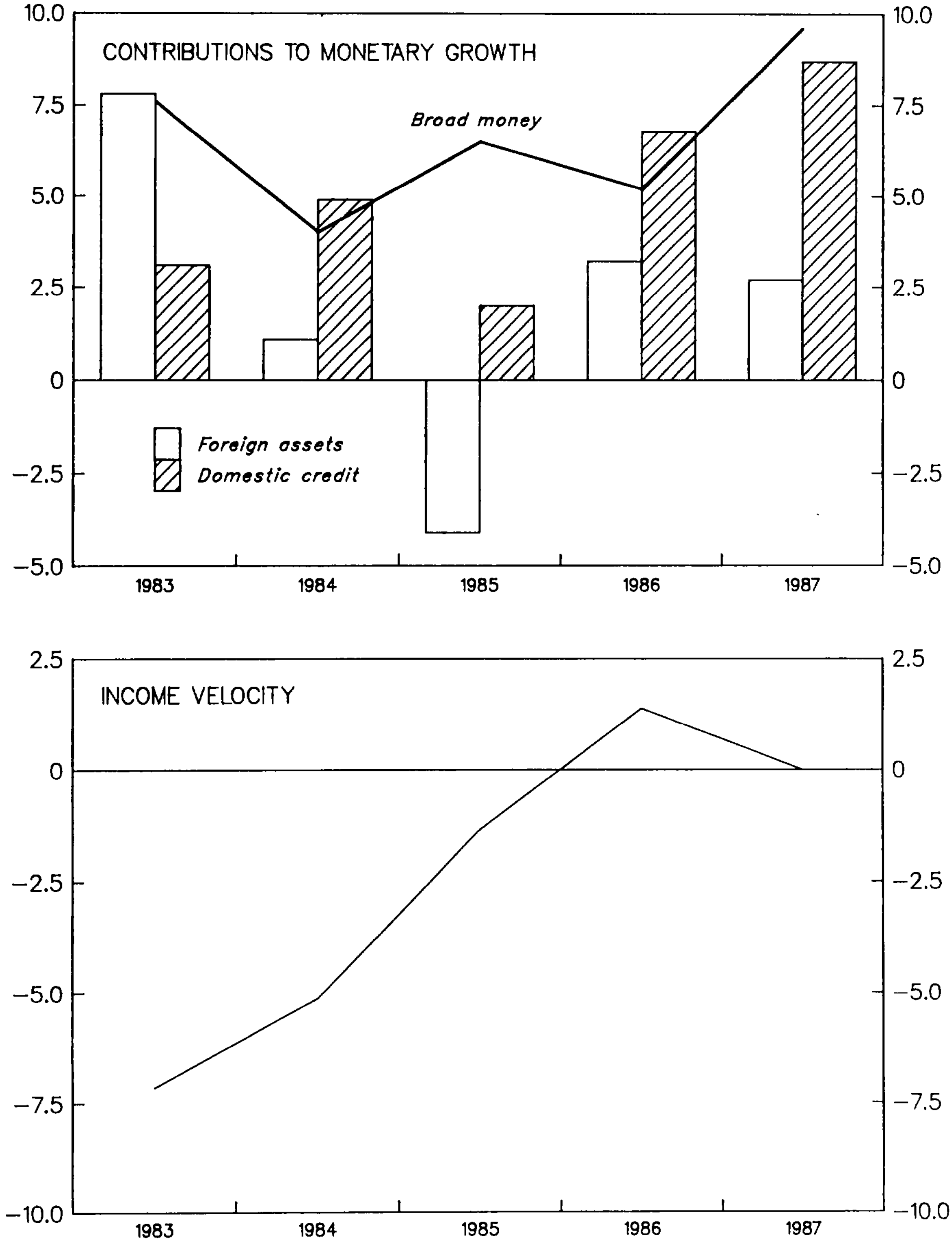
[1] Budget estimates.

CHART 7

MALTA

MONETARY INDICATORS, 1983–87

(Percent changes over preceding year)



Source: Central Bank of Malta, *Quarterly Bulletin*, various issues.

Table 3. Malta: Selected Monetary and Fiscal Indicators, 1983-1988

	1983	1984	1985	1986	1987	1988 1/ Year
			(In percent of GNP)			
Fiscal indicators						
Total revenue	36.2	34.9	36.3	36.3	33.7	36.0
Tax revenue	24.6	22.9	24.1	23.7	22.7	22.9
Direct taxes	16.0	14.6	14.8	13.9	13.0	13.4
Indirect taxes	8.6	8.3	9.3	9.8	9.7	9.5
Nontax revenue	11.6	12.1	12.2	12.6	11.0	13.1
Total expenditure and net lending	38.6	37.8	37.7	38.5	40.6	41.2
Current expenditure	31.5	31.2	31.4	31.3	31.5	31.5
Capital expenditure	6.3	7.4	7.5	7.8	8.5	9.0
Net lending	0.8	-0.8	-1.2	-0.6	0.6	0.7
Deficit	-2.4	-2.8	-1.4	-2.2	-6.9	-5.2
Public debt	14.1	14.4	13.6	11.7	15.3	10.1
	1983	1984	1985	1986	1987	1988 2/ April
			(Percent changes at end of period)			
Monetary indicators						
M1	6.8	2.1	-1.4	0.6	10.0	3.6
Quasi-money	8.5	6.0	14.7	9.2	9.3	11.0
Broad money (M2)	7.6	4.0	6.5	5.2	9.6	7.7
Other items (Net)	24.6	-1.7	-58.3	84.4	17.0	23.4
Domestic credit	12.6	18.8	6.9	23.1	25.0	23.7
Claims on private sector	14.8	15.5	7.2	14.3	13.9	13.3
Net foreign assets	8.8	-1.3	-4.9	4.3	3.6	1.8
Income velocity 3/	-7.1	-5.1	-1.4	1.4	--	...
Nominal interest rates						
Deposit 4/	5.0	5.0	4.5	4.5	4.5	4.5
Lending 5/	7.6	7.6	7.5	7.3	7.3	7.2
Real interest rates 6/						
Deposit 4/	6.0	5.4	4.8	2.5	4.0	2.7
Lending 5/	8.6	8.0	7.8	5.2	6.8	5.3

Source: Central Bank of Malta.

1/ Budget estimates.
2/ Percent changes correspond to the year-on-year rate.
3/ Ratio of nominal GDP to average broad money stock.
4/ Time deposits (six months).
5/ Advances and loans (effective rate).
6/ Nominal rates deflated by CPI inflation rates.

slump of the early 1980s and the subsequent stagnation reflected the introduction of an exchange rate subsidy for package tour operators from the United Kingdom 1/--a subsidy which amounted to 25 percent during 1987.

Although the nominal effective exchange rate of the Maltese lira, which is pegged to a basket of currencies reflecting both trade and invisible transactions, remained virtually unchanged in the year to June 1988, it was still 20 percent higher than its level in 1980--a year of broad macroeconomic balance--since the sharp appreciation over the first half of the 1980s (by some 27 percent) was reversed only partially in 1986-87 (Chart 5). In November 1987, the authorities modified the currency basket, resulting in an increased weight for the U.S. dollar and reduced weights for the deutsche mark and the Italian lira. The real effective exchange rate, based on relative consumer prices, depreciated by 2 percent in the year to May 1988 and stood at 6 percent below its level in 1980. 2/

Official international reserves rose by SDR 42 million in 1987 and stood at SDR 1.1 billion at end-April 1988, equivalent to 18 months of merchandise imports. Gross medium- and long-term external public debt was estimated at only 5 1/2 percent of GNP and the debt service ratio at less than 2 percent of exports of goods and nonfactor services.

On the domestic financial front, the Government's fiscal position underwent a marked deterioration in 1987. A shortfall in revenue, combined with large overruns in current spending, led to a widening of the overall deficit from 2 1/4 percent of GNP in 1986 to about 7 percent of GNP (Table 3 and Chart 6). The budget for 1988 aims at a reduction in the deficit to 5 1/4 percent of GNP, principally through efforts at raising tax revenues. The increase in the fiscal deficit in 1987 was largely financed by the banking system. Driven largely by an expansion of domestic credit, the growth of broad money accelerated to 9 1/2 percent (Table 3 and Chart 7).

In an effort to revive private investment, the authorities announced in late 1987 a package of incentives, including a ten-year tax holiday for investment in export-oriented industries. A gradual liberalization of the extensive quantitative import restrictions, a phased elimination of the official monopoly of imports of a large number of commodities, and a partial lifting of the wage-price freeze were also announced as first steps in a program of liberalization.

1/ The scheme was formally introduced in 1983, but the subsidy became significant only in 1986-87.

2/ However, distortions introduced in the domestic consumer price index by the prolonged wage-price freeze considerably reduce the usefulness of this measure of competitiveness.

2. Outlook for 1988-89

Available indicators suggest that domestic demand and activity remained buoyant in the first half of 1988. Nevertheless, the outlook for 1988 as a whole is for some deceleration in economic growth, reflecting a decline in the large fiscal stimulus and a slowdown in the growth of tourism. With only a gradual lifting of wage and price controls, partly offset by some downward pressure on prices stemming from the import liberalization, consumer prices are expected to rise by less than 2 percent. With continued buoyant domestic demand and growing imports of capital goods for some major infrastructure projects, the trade deficit is projected to rise further and the current account surplus to disappear. Under the usual assumptions of unchanged exchange rates and present policies, economic growth is likely to slow down further in 1989 and a small deficit on the external current account is likely to emerge.

IV. Economic Policy Issues

There was agreement between the mission and the Maltese officials that, notwithstanding the apparently satisfactory macroeconomic indicators such as growth, inflation, and the external current account, the Maltese economy suffered from serious structural imbalances. If not corrected, these imbalances would undermine the medium-term prospects for economic growth and a sustainable external balance. A backdrop for the discussions was provided by the medium-term scenarios prepared by the staff with a view to exploring the consequences of alternative policy strategies for the medium-term evolution of the economy. (See Appendix I for details.) While the quantitative aspects of the scenarios were illustrative and subject to qualification, their main message was that, in the absence of structural adjustment and enhanced competitiveness, the economy faced the danger of being trapped in a low-growth equilibrium. Such a prospect could be envisaged in a situation in which scope for further fiscal stimulus was very limited, and the private sector was hampered by controls and a lack of confidence. In order to achieve sustainable high economic growth, a strategy centered on structural reforms and fiscal adjustment, combined with a lower real exchange rate and trade liberalization, was required. The Maltese officials fully concurred with this basic policy diagnosis. The discussions, therefore, focused on an assessment of the progress so far and the feasibility of accelerating the pace of change in several areas of economic policy.

1. Competitiveness

The Maltese officials agreed that, notwithstanding the current account surplus registered in 1987 and the relatively low level of external debt, the underlying level of competitiveness in recent years was unsatisfactory. The continuous appreciation of the Maltese lira over 1981-85 had adversely affected the profitability of the tradables sector, with merchandise exports losing market shares, especially in the main market of the European Communities. Despite the intensification of import restrictions which contributed to a sharp contraction of the volume of imports, the trade deficit had worsened and the large current account surpluses of the 1970s had almost disappeared. The import compression contributed to a severe slowdown in economic growth to an average of 1 1/2 percent during 1981-85.

A series of artificial support measures adopted by the authorities to offset the loss of competitiveness played a vital role in the relative recovery of the external position in 1986-87. The most important of these measures were the exchange rate subsidy provided to the tour operators from the United Kingdom through the guaranteed exchange rate scheme and the export subsidy to merchandise exports in the form of the Export Stabilization Scheme. The former subsidy amounted to 17 percent in the 1986 tourist season and 25 percent in 1987, and played a major role in the sharp upturn in tourism--especially from the United Kingdom--experienced in 1987. 1/ The cost of the subsidy was equivalent to 1 1/4 percent of GNP in 1987.

In the mission's view, the existence of the two subsidies as well as the extensive quantitative import restrictions provided strong evidence that a lower real exchange rate was required for external balance at a satisfactory level of economic activity. The Maltese officials, did not dispute this view, but were noncommittal on the timing of action. They felt that only a gradual adjustment in the nominal exchange rate was feasible since, in their view, a large discrete adjustment was likely to lead to pressures for wage increases which would prevent a real depreciation. It was noted that the revision in the currency basket in November 1987 was motivated by a desire to strike a better balance between considerations of price stability and those of competitiveness. However, the nominal effective exchange rate had remained broadly stable in the first half of 1988. The Maltese officials stated that they were searching for ways to operate the basket peg in a more flexible manner so as to bring about a gradual depreciation. The authorities had stated their desire to eliminate the exchange rate guarantee scheme, and a committee of senior officials had been appointed to study means of phasing it out. However, no timetable had been specified. The mission noted that the scheme, besides being discriminatory, was a multiple currency practice, and stressed that it was important to address the problem of competitiveness at its source and not resort to temporary palliatives.

1/ Based on the spot exchange rate prevailing in June, the subsidy for the 1988 season is estimated at 13 percent. The export subsidy is related to the value added by an exporting firm and amounted to about 0.4 percent of GNP in 1987. For details on the two subsidies, see the recent economic developments paper. An assessment of the recent performance of the tourism sector is contained in Appendix II of the RED.

2. Fiscal policy

After a long period of cautious fiscal management, the financial position of the Government has deteriorated in the 1980s. The emphasis on supporting economic activity through public spending has progressively curtailed the ability of fiscal policy to play a countercyclical role and led to the emergence of a large fiscal deficit in 1987. The Maltese officials noted that the large increase in public sector employment in early 1987 was a major factor behind the overrun in current spending. The shortfall in income tax revenue illustrated the growing problem of tax evasion and avoidance. Revenues were also adversely affected by the stagnation in social security contributions in recent years.

The outturn for the first five months of 1988 suggested that the budgeted reduction in the deficit would be achieved. The Maltese officials, nevertheless, conceded that this improvement would be difficult to sustain without further discretionary measures, especially since the weakness of the underlying revenue position was masked by some large revenue increases of a one-off nature. The anticiptated large public investment in infrastructure over the coming years was regarded as essential. The main task on the expenditure side was therefore to arrest the sharp upward trend of current spending. The authorities needed to make difficult decisions regarding overmanning in the public sector and arresting the rapid increase in social welfare benefits. Officials were hopeful that gradual progress in these areas could be achieved. In the medium term, the tax base had to expand, both through improved tax administration and by means of a tax reform (see Section 4 below).

3. Monetary policy

Monetary policy has traditionally been passive, viewed by the authorities primarily as an instrument to promote development objectives rather than as a tool of demand management. During the 1980s, there was growing reliance on exchange rate appreciation and direct wage-price controls to contain inflation. In this context, monetary policy has been guided principally by the desire to ensure a steady supply of credit to the private sector at controlled interest rates, and selective credit controls have been used to direct resources to "priority" sectors and subsidize activities such as home ownership.

The authorities have indicated a desire to move toward a more active and market-oriented monetary policy. However, progress so far has been slow. The monetary authorities remain hampered by the maintenance of a rather inflexible interest rate structure--interest rates are subject to legal ceilings and have been changed only infrequently, a rigid reserve ratio, and the lack of a market for government securities. The Maltese representatives acknowledged that progress in financial deregulation had been slow. They cited the shortage of skilled managers and the difficulty of altering entrenched attitudes as important obstacles to faster progress. The mission stressed that further substantial liberalization was essential in order to afford a more market-oriented operation of monetary policy and to accomplish the authorities' objective of modernizing the financial system (see next section).

4. Structural issues

a. Financial reform

The authorities have expressed a desire to develop a more diversified financial system with a view to mobilizing private savings and channeling these toward productive investment. 1/ They have recently taken some steps toward broadening the available menu of financial assets by issuing treasury bills and allowing time deposits of longer maturity. The Maltese officials did not disagree with the view that a more market-oriented interest rate structure and greater competition and private participation in the financial sector, which at present is fully under government control, is essential for the development of a diversified financial system. However, they regarded the lack of an appropriate regulatory framework for depositor protection as an obstacle to moving at present in this direction.

With the aim of developing Malta as an offshore financial center in the medium term, the authorities are also planning legislation to provide an appropriately liberal fiscal and regulatory framework for offshore business activities. However, they do not envisage a rapid liberalization of the domestic financial system. The Maltese officials believed that in the short run a liberal regulatory setup for offshore entities could coexist with a highly regulated onshore financial structure. The mission expressed the view that, while such a dualistic financial structure could be feasible for a period, given the authorities' desire that the offshore activities should have strong spill-over effects on the economy in terms of employment and technology, liberalization of the domestic financial system would become increasingly difficult to avoid, and would indeed be desirable in its own right. 2/

b. Tax reform

The tax regime, with a top marginal rate of income tax of 65 percent, is widely believed to entail serious disincentive effects on work effort and to contribute to the growth of tax avoidance and evasion. The underground economy is estimated to have grown rapidly in recent

1/ A financial sector mission from the Central Banking Department is planning to visit Malta at the end of August.

2/ Some issues relating to financial sector reform including considerations relevant to the development of an offshore financial center are discussed in Appendix I to the recent economic developments paper.

years. The heavy reliance on income taxation and the absence of a broad-based consumption tax point to the need for a reassessment and reform of the tax system. 1/ The mission suggested that a reform along the lines of those implemented recently in several countries, centered around reducing the high marginal rates of income tax and broadening the tax base, inter alia, by introducing a broad-based consumption tax, should be considered. The Maltese authorities are requesting technical assistance from the Fund for an assessment of the tax system and tax administration machinery.

c. The trade regime

The trade system is characterized by extensive quantitative import restrictions with almost all imports subject to licensing or state trading monopoly. The authorities have initiated a gradual program of import liberalization by removing some commodities from the state-controlled system of bulk buying and by relaxing quotas on imports of some consumer goods. They have also announced their goal of abolishing the State's trading monopoly, moving to a system of a negative list (in which all unlisted goods would be free of licensing) and eventually replacing quotas by tariffs. They regarded these steps as facilitating their goal of eventual entry of Malta into the EC. The Maltese officials underlined the importance of moving gradually in this area so as to minimize disruption to domestic industry. The mission stressed that announcement of a clear timetable for import liberalization would assist private sector planning and minimize misallocation of resources during the transition period. It also suggested that, pending the move from quotas to tariffs, a system of auctioning of import licenses could be implemented. Such a system would help inject an element of market mechanism and transparency in the allocation of licenses and the observed premia would provide some guidance about the equivalent tariff rates.

d. The labor market

The prolonged period of wage-price controls and the dominance of the public sector as an employer--45 percent of the employed are in the public sector--have led to a lack of flexibility in the labor market. The authorities acknowledged the severity of the problem of overmanning in the public sector and the urgency of creating employment in the private sector. Shortages of skilled labor in many sectors highlighted the problem of mismatch in the labor market. The authorities have taken initiatives such as the introduction of the Auxiliary Workers Scheme to train the unemployed and underemployed and they intend to take steps to upgrade the quality of education and labor training. The public service

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1/ The share of taxes on domestic goods and services in total central government revenue in 1985 was 5 percent, compared with 29 percent for the developing country group and 34 percent for the European developing countries.

was also suffering from the disincentive effects stemming from an excessive compression of wage relativities. The recently appointed Public Sector Organization Commission was expected to address the issue of an appropriate wage structure and ways to improve the link between responsibilities and rewards in the public service.

V. Staff Appraisal

The economic policy setting has undergone important changes since the last consultation. The Government that took office in May 1987 declared its intention to bring about a shift toward economic liberalization and a more market-oriented approach to economic management. Such a shift in the direction of policy has been favored by the Executive Board and the staff for some time in the belief that it would foster long-needed structural changes and would enhance the economy's growth potential over the medium term.

The new Government has taken some welcome first steps toward liberalization. The wage-price freeze has been partially lifted; a start--albeit cautious--has been made toward reducing import restrictions. However, the authorities have emphasized their preference for a gradual change. In the staff's view, the case for gradualism may have merit in the Maltese case. However, if the pace of change is unduly slow, there is a danger of losing momentum, and the pressure from interest groups overwhelming the authorities' agenda for reform. In order to establish credibility, it is important that the authorities are seen as not too susceptible to such pressures and that the policies are implemented in a mutually reinforcing and sequentially consistent manner.

Economic activity in 1987 and so far this year has been buoyant, sustained by the strength of domestic demand and an upturn in the tourism sector, following several years of decline. The surge in public sector employment in early 1987 led to a sharp drop in the rate of unemployment. Under the impact of the wage-price freeze, the consumer price index has remained virtually stable. The outlook for 1988 is for some deceleration in economic growth as the growth in tourism slows down, and a rough balance in the external current account. Notwithstanding this apparent broadly satisfactory performance, a number of weaknesses and distortions in the economic structure as well as financial imbalances raise questions about the medium-term prospects for sustainable economic growth.

On the structural front, the dominance of the public sector as an employer and extensive regulation of economic activity--illustrated by the long-standing regime of quantitative import controls and the protracted wage-price freeze--have undermined private initiative. In recent years, these difficulties have been compounded by a steady erosion of competitiveness, and the adverse effects have been contained only by a subsidy to exporters and by the introduction of an exchange rate subsidy for tour operators from the United Kingdom.

The Government's fiscal position deteriorated markedly in 1987, with the overall deficit widening to about 7 percent of GNP. Although the budget for 1988 aims for a reduction in the deficit, principally through a rise in revenues, the underlying fiscal position remains weak. Given the large investment in infrastructure envisaged over the coming years, efforts at spending restraint should focus on current expenditures, which account for almost 80 percent of government spending.

The staff also believes that a high priority needs to be given to tax reform, with a view to reducing the current high marginal rate of income tax and broadening the tax base, possibly by introducing a consumption tax. Such a tax reform, if properly designed, would not have adverse effects on revenues--indeed it might raise them--and would help contain tax avoidance and evasion.

The authorities' aim to implement a more flexible interest rate policy and to introduce a variety of financial instruments to provide a channel for private savings is welcome. However, progress in this direction has been slow. Monetary policy should rely less on selective credit controls and work more through a market-oriented interest rate structure. Such a market orientation and greater competition in the financial sector, which at present is almost fully under government control, are essential to foster the development of a diversified financial system.

The prolonged wage controls and dominance of the public sector as an employer have led to a lack of flexibility in the labor market. Government policy can play an important role in fostering an appropriate structure of incentives, especially in the public sector. It is to be hoped that the recently appointed Public Sector Organization Commission would focus on the disincentive effects of an excessive compression of wage relativities. More generally, the problems of skill shortages and mismatching in the labor market underline the need for labor training and upgrading the quality of education.

Notwithstanding the comfortable current account and reserves positions, Malta's underlying competitive position is rather weak. The sharp appreciation of the nominal effective exchange rate over the first half of the 1980s was reversed only partially in 1986-87. Although the real effective exchange rate as measured by relative consumer prices has depreciated in the last few years, the distortions introduced in the price index by the wage-price freeze considerably reduce the usefulness of this measure of competitiveness. Merchandise exports have suffered large losses of market shares in recent years. The continuation of extensive quantitative import restrictions and the introduction of an export subsidy and an exchange rate subsidy also strongly suggest that a lower real exchange rate is required for the external balance to be compatible with a satisfactory level of domestic activity and productive employment opportunities. The exchange rate subsidy given to tour operators from the United Kingdom has played a dominant role in the revival of the tourism sector. This subsidy amounts to a multiple currency practice and is discriminatory. The staff welcomes the authorities' desire to phase it out and urges them to do so as early as possible. In view of its discriminatory nature and the absence of a clear timetable for its elimination, the staff does not recommend its approval. An adjustment in the exchange rate would not only allow a speedy elimination of the subsidy but would be desirable in the context of the liberalization of import controls. A more flexible management of the basket peg could help bring about such an adjustment.

Trade liberalization should be a key element of a program to increase the level of competition in the Maltese economy. The steps taken so far to liberalize import restrictions on some commodities are in the right direction. However, given the high level of reserves and the extensive system of import quotas, there is clearly scope for accelerating the pace of trade liberalization. This would also put downward pressure on domestic prices, thereby offsetting some of the impact of the removal of price controls.

It is recommended that the next Article IV consultation with Malta be held on the 24-month cycle.

VI. Proposed Decision

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

1. The Fund takes this decision relating to Malta's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1988 Article XIV consultation with Malta, in the light of the 1988 Article IV consultation conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The restrictions on the making of payments and transfers for current international transactions as described in SM/88/164 and SM/88/ , are maintained by Malta in accordance with Article XIV, Section 2, except that the restriction on exchange allowances for foreign travel and the restriction evidenced by a bilateral payments arrangement with a Fund member are subject to approval under Article VIII, Section 2(a), and the guarantee of exchange rates for tour operators from a member country is subject to approval under Article VIII, Section 3. The Fund welcomes the authorities' desire to eliminate the guaranteed exchange rate, and urges Malta to terminate the guarantee and its other exchange restrictions as soon as possible.

Medium-Term Scenarios

With a view to illustrating the consequences of alternative policy strategies for the medium-term evolution of the Maltese economy, and, especially, the path of the external accounts compatible with a sustainable rate of economic growth, the staff has made some illustrative calculations (Table 4, Chart 8). These scenarios are preliminary and their intent is mainly illustrative. In particular, the quantitative results need to be interpreted with caution, given the preliminary nature of the data and, more importantly, the large degree of uncertainty characterizing the key parameters and the true nature of the behavioral relationships on which the calculations are based.

The assumptions regarding domestic demand growth, the growth of foreign demand and competitiveness are spelled out in Table 4. The external environmental assumptions (viz., foreign demand, oil prices, and import prices) are taken from the recent World Economic Outlook exercise.

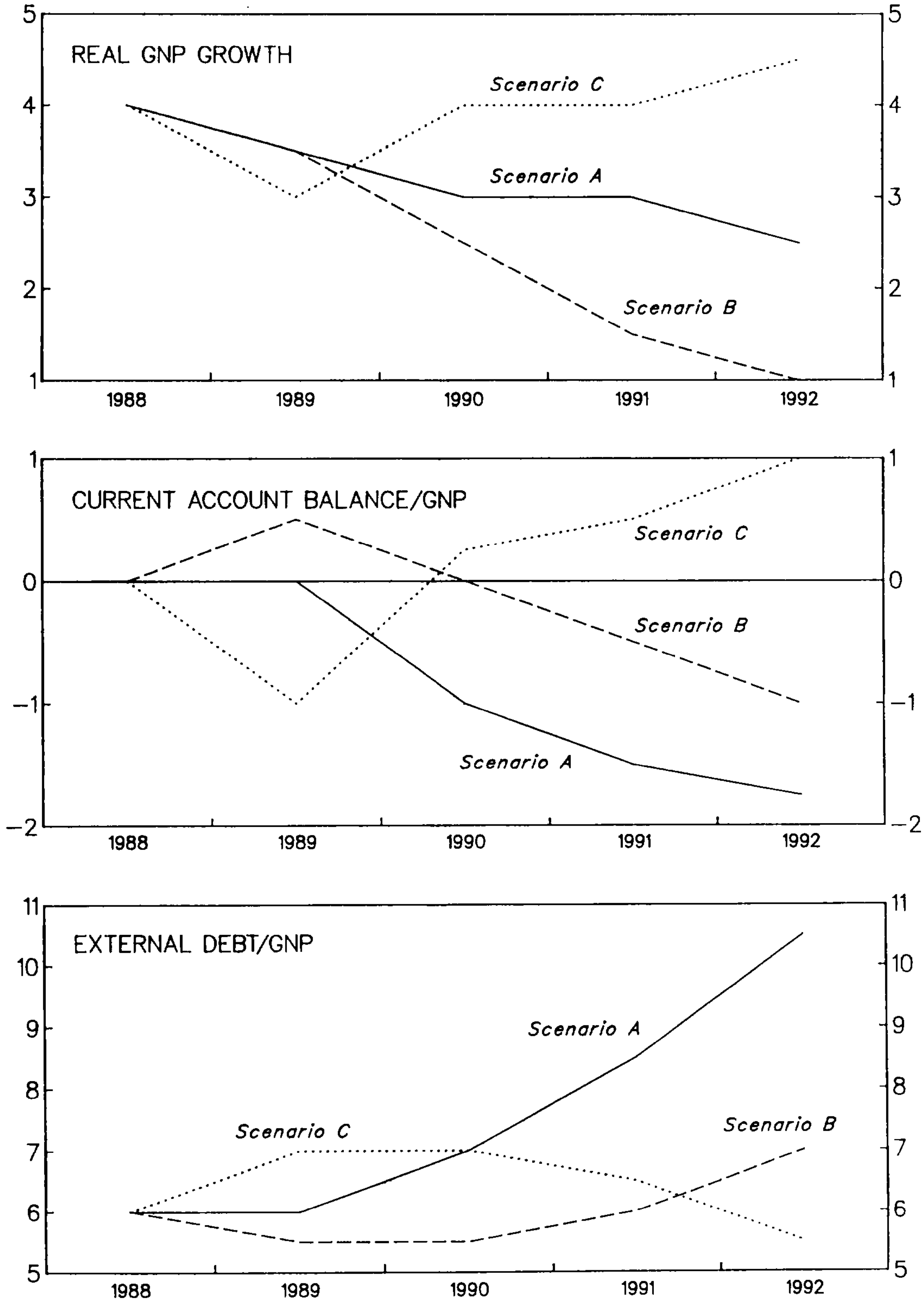
The first scenario illustrates the consequences of "no adjustment" measures. In this case, the growth of domestic demand would outstrip that abroad, the current account would begin to show substantial deficits by 1992, and economic growth would start slowing down, as the scope for fiscal stimulus progressively disappears and private sector activity decelerates. Although the external debt and debt service would remain manageable, given their low initial levels, the direction of the evolution of external accounts would point to an eventual serious external constraint.

In the second scenario, characterized as one of a "low growth path," a compression of demand at home, without any accompanying liberalization or supply-side measures leads to a situation of initial external current account surpluses, followed by a period of small deficits, but with low economic growth and a stagnating export sector. This scenario assumes a continuation of a regime of stringent import controls and a worsening competitive position. This scenario illustrates a case where the economy, while not heading into an imminent external constraint, is nevertheless trapped in a low-growth equilibrium over the medium term.

The third scenario traces out the consequences of an adjustment-cum-liberalization policy mix pursued over a period of years. Along with a reduction in the fiscal deficit and deregulation of the domestic capital market, a steady liberalization of the import control system, accompanied by an improved competitive position is assumed. Since domestic demand restraint is offset by a pickup in export growth, economic growth remains high. Although the external current account initially deteriorates due to a surge in imports and lags involved in the impact of an improved competitive position on the current account, the scenario is characterized by a satisfactory external position by 1992, with debt and debt service remaining modest.

APPENDIX I

CHART 8
MALTA
ILLUSTRATIVE MEDIUM TERM SCENARIOS, 1988–92



Source: See Table 4.

Table 4. Malta: Illustrative Medium-Term Scenarios 1988-92

(Percent changes and ratios to GDP)

	1987	1988	1989	1990	1991	1992
	Scenario A: 1/ No adjustment case					
Domestic demand	4 1/2	4	4 1/2	4 1/2	4 1/2	4
Real GNP	5	4	3 1/2	3	3	2 1/2
Current account balance (ratio to GNP)	1/2	--	--	-1	-1 1/2	-1 3/4
External debt/GNP	6	6	6	7	8 1/2	10 1/2
Debt service ratio	1	1	1	1 1/4	1 1/2	2 1/2
	Scenario B: 1/ Low growth (Adjustment without improved competitiveness and structural change)					
Domestic demand	4 1/2	4	3 1/2	3	2	1 1/2
Real GNP	5	4	3	2 1/2	1 1/2	1
Current account balance	1/2	--	1/2	--	-1/2	-1
External debt/GNP	6	6	5 1/2	5 1/2	6	7
Debt service ratio	1	1	1	1	1 1/2	1 1/2
	Scenario C: 1/ High growth (Adjustment with improved competitiveness and structural change)					
Domestic demand	4 1/2	4	4	3 1/2	3 1/2	3 1/2
Real GNP	5	4	3	4	4	4 1/2
Current account balance	1/2	--	-1	1/4	1/2	1
External debt/GNP	6	6	7	7	6 1/2	5 1/2
Debt service ratio	1	1	1 1/4	1 1/4	1 1/4	1

Source: Staff calculations.

1/ The main environmental assumptions underlying the three scenarios are based on the Fund's most recent World Economic Outlook. The real domestic demand in Malta's principal trade partners increases by about 3 percent in 1988 and about 2 1/4 percent per annum thereafter. Oil prices are assumed to decline in U.S. dollar terms by 5 1/2 percent in 1988, increase by 4 percent in 1989, and by 3 1/2 percent per annum thereafter. The export prices of partner countries for non-oil products are assumed to rise by 10 percent in U.S. dollar terms in 1988, 5 percent in 1989, and 3 1/2 percent per annum thereafter. Scenarios A and B assume a worsening of competitiveness by 2 percent per annum, while Scenario C assumes improvement in competitiveness by 5 percent per annum in 1989-90 and 2 percent per annum in 1991-92.

Fund Relations with Malta

(As of June 30, 1988)

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.

A. Financial Relations

II. General department (General Resources Account)

(a) Quota: SDR 45.1 million.
(b) Total Fund holdings of Maltese lira: SDR 16.4 million (36.3 percent of quota).
(c) Reserve tranche position: SDR 28.8 million.
(d) Current operational budget: The Maltese lira is included in the operational budget for June-August 1988 for maximum sales of SDR 3.5 million and maximum receipts of SDR 1.3 million.

III. Stand-by or Extended Arrangements and Special Facilities

Malta has never made use of Fund resources.

IV. SDR Department

(a) Net cumulative allocation: SDR 11.3 million.
(b) Holdings: SDR 48.3 million or 427.4 percent of net cumulative allocation.

B. Nonfinancial Relations

V. Exchange rate arrangements

Since 1972, the value of the Maltese lira has been pegged to a trade-weighted basket of currencies. On November 25, 1987, the Central Bank announced a revised weighting scheme. The new weights incorporate all current account transactions excluding the investment income of the banking sector. These weights are based on the 1984-86 flows except in the case of travel receipts for which the 1987 estimate has been taken into account. The currency basket has also been expanded to include the SDR with a weight of about 18 percent. The above adjustments were based on the U.S. dollar/Lm rate of US$3.0913 prevailing on November 18, 1987. On June 30, 1988 the exchange rate of the Maltese lira was Lm 1 = SDR 2.2522 (US$2.9517).

VI. The last Article IV consultation was concluded on August 27, 1986 when the staff report (SM/86/171, 6/15/86) was considered by the Executive Board; the following decision was adopted:

> 1. The Fund takes this decision relating to Malta's exchange measures subject to Article VIII, Section 2(a), in concluding the 1986 Article XIV consultation with Malta, in the light of the 1986 Article IV consultation conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).
>
> 2. As described in SM/86/171, the restrictions on the making of payments and transfers for current international transactions are maintained by Malta in accordance with Article XIV, Section 2, except that the restriction on exchange allowances for foreign travel and the restriction evidenced by a bilateral payments arrangements with a Fund member are subject to approval under Article VIII, Section 2(a). The Fund welcomes the actions by Malta to reduce exchange restrictions through increases in exchange allowances for foreign travel and the termination of two bilateral payments arrangements with Fund members and urges Malta to terminate the remaining bilateral payments arrangement with a Fund member.

Malta--Statistical Issues

1. Outstanding statistical issues

a. Balance of payments

Malta has recently sent provisional current account data for 1987 to the Bureau of Statistics and has promised to send additional data during the final quarter of 1988.

b. Government finance

The government finance data in IFS are the same as those published in the GFS Yearbook. The GFS Yearbook publishes annual central government 1/ data from 1975-85, excluding 1979 due to a change in the fiscal year.

c. Real sector

The authorities have agreed to the Fund's proposal to publish data for nominal and real effective exchange rates in IFS. However, they inquired about the possibility of expanding the coverage of the trade weights to include trade in tourism services and about the scope for compiling sectoral cost and price series. The scope for technical assistance in these areas and national accounts statistics is being considered by the Bureau.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for Malta in the August 1988 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Central Office of Statistics and the Central Bank of Malta which, during the past year, have generally been provided on a timely basis.

1/ There is no local government in Malta.

Status of IFS Data

		Latest Data in August 1988 IFS
Real sector	- National accounts	1987
	- Prices: consumer	May 1988
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government finance	- Deficit/surplus	1985
	- Financing	1985
	- Debt	1985
Monetary accounts	- Monetary authorities	March 1988
	- Deposit money banks	March 1988
	- Other banking institutions	March 1988
Interest rates	- Discount rate	March 1988
	- Bank lending/deposit rates	March 1988
	- Bond yields	n.a.
External sector	- Merchandise trade: Values	December 1987
	Prices	Q1 1986
	- Balance of payments	1987
	- International reserves	April 1988
	- Exchange rates	May 1988

Basic Data

Area	316 sq. kilometers (122 sq.miles)
Population (1987)	345,636
Domestic labor force	127,551
GDP (1987, at current prices)	Lm 546.5 million
GDP per capita, 1987:	Lm 1,580 or US$4,608 (SDR 3,563)

Social indicators

Infant mortality (1986):	10.1 per 1,000 live births
Life expectancy (1986):	Male: 72, female: 77
Primary and secondary school enrollment (1985):	92 percent of all persons between 6 and 17 years of age

Demand and output, 1987 1/	In millions of Maltese lira	In percent of total
Private consumption	365.7	63.1
Public consumption	98.2	16.9
Fixed investment	146.9	25.3
Stock building	-5.2	-0.9
Total domestic demand	605.6	104.5
Exports of goods and services	420.7	72.6
Imports of goods and services	479.8	82.8
Gross domestic product	546.5	100.0

	1985	1986	1987 1/
	Selected economic indicators, percentage change from the preceding year		
Demand, output, and prices			
GDP at current prices 1/	3.2	7.5	6.8
GDP at constant 1973 prices	2.6	4.0	4.5 2/
Private consumption	5.0	2.8	5.0 2/
Public consumption	5.6	4.4	9.3 2/
Gross fixed investment	-4.0	-8.7	22.0 2/
Exports of goods and services	7.4	5.7	11.8
Imports of goods and services	9.2	0.1	12.1
Consumer prices	-0.3	2.0	0.5
GDP deflator	0.6	3.4	2.2 2/
Total employment	1.3	4.1	5.9
Unemployment rate (end-period)	8.3	6.9	4.4

	1985	1986	1987
Fiscal indicators (as percentage of GNP)			
General government			
Total revenue	36.3	36.3	33.7
Tax revenue	24.1	23.7	22.7
Current expenditure	31.4	31.3	31.5
Capital expenditure	7.5	7.8	8.5
Financial deficit	-1.4	-2.2	-6.9
Public debt, outstanding at end-year	13.6	11.7	15.3
Monetary sector (percentage changes)			
Monetary base	0.6	0.9	2.3
Broad money (M2)	6.5	5.2	9.6
Narrow money (M1)	-1.4	0.6	10.0
Net domestic credit	6.9	23.1	25.0
Net foreign assets	-4.9	4.3	3.6
Interest rates (one year time deposit)	5.5	5.5	5.0
External sector (in millions of lira)			
Exports, f.o.b.	197.8	205.0	218.2
Imports, f.o.b.	315.3	309.1	354.0
Tourism earnings	49.2	54.9	60.8
Trade balance	-117.5	-104.1	-135.8
Invisible balance	106.8	104.0	139.5
Current account	-10.7	-0.1	3.7
(In percent of GNP)	(-2.1)	(--)	(0.6)
Overall balance	-31.3	-1.9	...
External debt as percent of GNP	8.3	6.6	5.4
Net official international reserves (in millions of U.S. dollars)	1,122	1,309	1,578
Nominal effective exchange rate (Average percentage change)	2.0	-4.9	-1.2
Real effective exchange rate 3/ (Average percentage change)	-3.1	-5.3	-3.2

1/ Preliminary.
2/ Staff estimates and projections.
3/ Relative consumer prices. Based on the Fund's Information Notice System.