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INFORMATION

July 15, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Malta - Staff Report for the 1986 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with Malta, which is proposed to be brought to the agenda for discussion on Wednesday, August 27, 1986. A draft decision appears on page 13.

Mr. G. Tyler (ext. 8850) or Mr. Nellor (ext. 8835) 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 1986 Article IV Consultation

Prepared by the European Department

(In consultation with the Exchange and Trade Relations,
Legal, Research and Treasurer's Departments)

Approved by L. A. Whittome and W. A. Beveridge

July 11, 1986

I. Introduction

A staff mission consisting of Messrs. Tyler, Nellor, Lopez-Claros, Mrs. Nagy (all EUR), and Mrs. Watson (secretary, ETR) was in Malta from May 20 to May 30, 1986 to conduct the discussions for the 1986 Article IV consultation. The mission had meetings with the Deputy Prime Minister and Minister of Finance and Customs, Mr. Abela, the Acting Governor of the Central Bank, Mr. de Gabrielli, and with officials of the Central Bank of Malta, the Ministry of Finance and Customs and other economic ministries and agencies. Mr. S. Zecchini, the Executive Director for Malta, took part in the final round of the discussions.

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

II. Economic Developments and Prospects

The Maltese economy weathered the difficulties of the 1970s remarkably well. In a period in which most developing countries were experiencing current account deficits in the balance of payments, Malta had surpluses in every year of the decade 1971-80. At the end of the latter year the international reserves of the banking system were equal to 15 months of merchandise imports. Foreign borrowing--mostly public and including little short-term debt--was modest, with outstanding public and publicly guaranteed debt equalling only 8 percent of international reserves. With few exceptions the public sector finances were in surplus through the period and at end-1980, Government deposits totalled Lm 28 million compared with Lm 4 million ten years earlier. During the period, the rate of inflation was less than both the inflation rate of the world as a whole and that of industrial countries. The average annual growth of real GDP was no less than 10.4 percent. While it is true that expenditure connected with the U.K. naval base in Malta and concessional oil purchases from Libya were important elements in the economic performance during the 1970s, clearly economic prudence was a factor.

The second oil shock proved less easy to absorb. Inflation accelerated to an annual rate of 16 percent in 1980 and 11.5 percent in 1981. Externally the current account moved into deficit by 1983, the first since 1970, although it was again in surplus in 1984. In 1982, there was the first public sector deficit since 1975. By 1983-84, the growth of real GDP had virtually halted.

In 1985, after two years of stagnation, the growth rate of real GDP accelerated to 3.1 percent and an increase of more than 4 percent is forecast for 1986. The major factor underlying the acceleration has been the growth rate of domestic demand, which exceeded the growth of GDP in 1985 and which is expected to do so again in 1986. The counterpart of these trends in output and demand was, of course, a deterioration in the external balance. Of the components of domestic demand, private consumption has grown consistently at around 4 percent per annum beginning in 1984. Public consumption and fixed investment, which both declined in real terms in 1984, began to recover in 1985 (up 5 percent and 2 percent, respectively) and in 1986 are forecast to increase by 5.5 percent and 9 percent, respectively. The renewed growth led to an increase of employment of 1.3 percent in 1985 and a marginal decline of about half a percentage point in unemployment, which remained high, however, at 8.5 percent at the end of 1985. Under the influence of the price/wage freeze, prices again fell marginally in 1985. The mission questioned whether the measured index may not underestimate actual price increases, since a priori it might be expected that sellers would tend to lower quality while keeping nominal prices unchanged. The authorities did not believe this was a major problem, pointing out that an important part of the basket comprised in the index consisted of basic commodities, which are imported by the public sector under bulk buying schemes and where quality is known. 1/

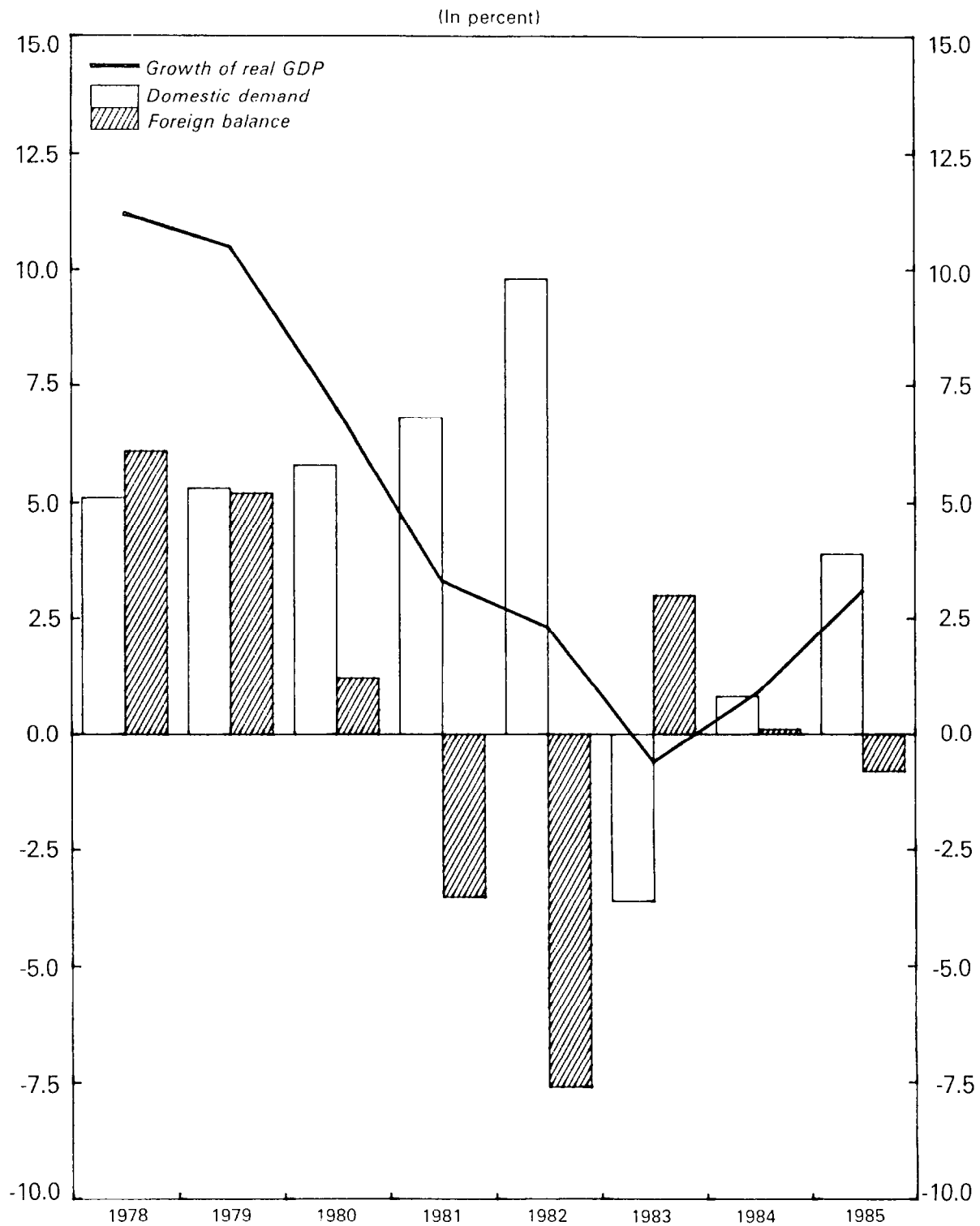
After declining in 1983-84, the real average wage per employee stabilized in 1985, which was perhaps one factor behind the rise in private consumption. However, also important was a continued decline in the private savings ratio, from 13.1 percent in 1983 to 11.9 percent in 1984 and 10.0 percent in 1985. The only explanation that was advanced for this decline was a dishoarding of bank notes, which are currently in the process of being replaced with a new series of notes.

In the external sector, the first significant current account deficit since 1970 2/ appeared, reflecting imbalance between the growth rates of domestic demand and output. The current account deficit in

1/ This question is of some importance since if the consumer price index (which is the only readily available price index--there is no wholesale price index) underestimates actual price increases, the real effective exchange rate data will over estimate the competitiveness of the Maltese lira.

2/ There had been a very small deficit equivalent to 0.1 percent of GDP in 1983 but every other year in the period 1971-84 showed a surplus; the average surplus over the period was in fact 6.8 percent of GDP.

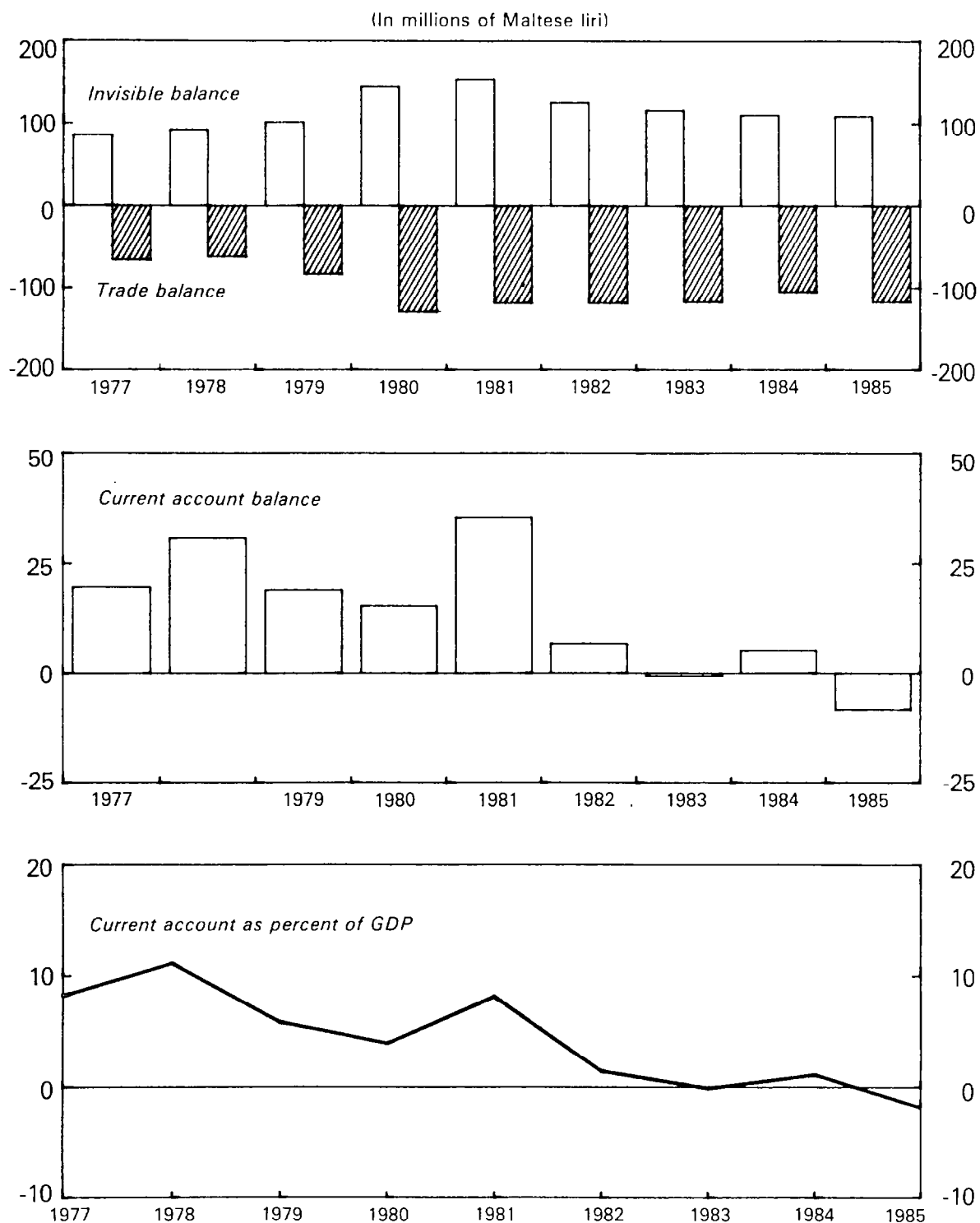
CHART 1
MALTA
CONTRIBUTIONS TO THE GROWTH OF REAL GDP, 1978-85



Source: Data provided by the Maltese authorities.



CHART 2
MALTA
BALANCE OF PAYMENTS, 1977-85



Source: Data provided by the Maltese authorities.

1985, equal to 1.8 percent of GDP, was due mainly to the increase in the trade deficit from Lm 105.2 million in 1984 to Lm 117.5 million in 1985, which in turn arose because imports grew half as fast again as exports. Net services and transfers were almost unchanged as between 1984 and 1985, with service receipts from tourism rising and public transfers declining. In 1985, Malta's share in export markets fell for the fourth time in the years 1981-85 as the growth of its export markets outpaced the growth of export volume, reflecting the decline in the competitiveness of its traditional exports of manufactures. In contrast, after declining the four preceding years both the number of tourist arrivals, particularly from Libya, and tourist receipts increased in 1985, although in both categories performance was still far short of the beginning of the decade.

Net medium and long term capital inflow slightly exceeded the current account balance (other capital movements are not known as yet). Although one would have expected little change in the level of international reserves, they in fact declined during 1985 by SDR 59 million. This was the result of an exchange loss of SDR 112 million in the central bank's reserves, arising because of a very large shift into U.S. dollars from other currencies during a year in which the latter were appreciating against the dollar.

The staff projects a current account deficit in the balance of payments of around Lm 10 million, which is about the same level as that recorded in 1985. ^{1/} In discussing the projections, the authorities considered that, while the staff forecast was reasonable, the outcome would be a smaller deficit or even balance. In their view tourism receipts would grow more rapidly given the depreciation of the lira vis-à-vis the major European currencies and imports might not increase by as much, as the increase in 1985 had satisfied previously pent up demand.

III. Economic Policies

At the 1985 Article IV consultation with Malta, Executive Directors commended the authorities for the short-term results of the policies followed in 1983. However, they commented, inter alia, that there had been a concentration on symptoms rather than on causes of the weaknesses in Malta's economy and that reliance on administrative intervention might have been inimical to business investment. They also believed that the gradual approach to improving competitiveness might have drawbacks and that the maintenance of a price freeze over a long period could damage the allocative function of prices.

^{1/} The forecast assumes an increase of 5 percent in the volume of exports, 7 percent in the volume of imports and a further recovery in tourism. In contrast, investment income declines quite sharply, because of the lower level of international reserves and lower interest rates in 1986 compared with 1985.

1. Monetary policy

Monetary policy in Malta has traditionally been rather passive. The liquid reserve requirement has remained at 25 percent of deposits for many years. 1/ Nominal interest rates have only changed twice since 1970, and then by small amounts. There are no net sales or purchases of securities by the Central Bank of Malta. The latter has basically been willing to accept whatever developments that occur in reserve money and monetary aggregates. The one area where indirect action has been taken is in the field of real interest rates. Although, as mentioned above, nominal interest rates have not changed much, when the price freeze was introduced in 1983 nominal interest rates were not reduced thus establishing positive real interest rates for virtually the first time in more than a decade. In January 1982, the discount rate, the interest rates on central bank deposits and the interest rate on time deposits at the commercial banks were increased in part to encourage a shift to time deposits, while in December 1985 they were reduced by half a percentage point to compensate for a reduction in lending rates made in light of declining interest rates abroad. In the mission's view the relatively high level of real interest rates has been a useful means of increasing the demand for broad money.

In discussing monetary policy, the authorities agreed that, at first sight, it appeared relatively passive. They pointed out, however, that the population had traditionally been willing to hold large amounts of cash and bank deposits rather than to use liquidity to finance higher domestic expenditure. They also noted that moral suasion by the Central Bank was highly effective because of the small size of the banking system combined with the Government's having majority shareholding in all the commercial banks. In addition, in sensitive areas (construction, tourism and textiles), the Central Bank individually approves applications to the commercial banks for loans of significant magnitude.

Broad money increased by 3.7 percent during 1985, compared with an increase in nominal GDP of nearly 3 percent; in 1984 the corresponding increases were 4 percent 2/ and 1 percent, respectively, and in 1983, 8 percent and minus 1 percent, respectively. Staff calculations based on a demand for money function suggest that excess liquidity in the hands of the nonbank public at the end of 1985 was in the rough order of 6 percent of broad money. That this has not affected the price level probably reflects the efficiency of the price freeze. However, the excess liquidity could be one factor underlying the increase in imports. The authorities do not, however, believe that there is excess liquidity, taking the position that the decline in the velocity of circulation reflects an increasing willingness to hold liquid balances,

1/ There is a legal provision, never yet applied, for an additional reserve requirement equal to 20 percent of deposits.

2/ After allowing for the inclusion of a substantial amount of deposits in 1984 that were not included in quasi money in 1983. The increase before making the adjustment was 13 percent.

particularly in the form of time deposits. They therefore do not share the mission's worry that excess liquidity could fuel inflation and import payments if and when the price freeze and the current high level of import restrictions are relaxed.

The increase in M2 in 1985 occurred entirely in quasi money, which rose by 10 percent, while M1 declined by 2 percent. Within M1, currency in circulation fell by 4 percent. An important factor behind this shift from currency in circulation into quasi money was the decision to issue a new series of banknotes following the discovery of high quality forgeries of the previous issue; the new notes incorporate the latest security features. Depositors reacted by dishoarding old notes and moving into savings and time deposits, encouraged perhaps by the relatively high level of real interest rates. The increase in M2 in 1985 was more than accounted for by an increase of 36 percent in net domestic credit, slightly less than half of the increase arising from a decrease in public sector claims on the banking system. In contrast to earlier years, net foreign assets declined by 4 percent.

The mission's concern about the potential future dangers in the monetary area are compounded by the extremely liquid position of the commercial banks. Their liquid assets at the end of 1985 were equal to 52 percent of their own deposits, whereas the liquid reserve requirement is only 25 percent of deposits. In answer to the comment that there would be ample scope for credit expansion should demand increase sharply, the authorities noted that there is the legal provision for an additional special reserve requirement of 20 percent, that the central bank has considerable informal influence on commercial bank lending and that the latter have traditionally been very cautious lenders. In addition, the above mentioned system of individual examination by the central bank of certain loan applications to the commercial banks provided further control over bank credit. Despite these arguments, the mission remained uncomfortable with the high degree of liquidity of the commercial banks and the nonbank public.

2. Fiscal policy

The prudence of fiscal policy has been consistently noted in consultations with Malta. In the past, budget surpluses were the rule and the Government had built up very large balances in various accounts at the central bank totalling Lm 78 million at the end of 1984, equal to almost one third of total spending from the consolidated accounts of the Government (excluding the public enterprises). In 1985, however, there was a major change in the trend of public sector finances. The consolidated government sector (excluding the public enterprises) 1/ had a

1/ In the last consultation, Executive Directors suggested the need to consolidate budget and extrabudgetary operations of the public sector. The authorities and the staff mission were able to do this for 1985 and 1986 but for earlier years, the public enterprises could not be incorporated.

deficit of Lm 20 million, equivalent to 4.2 percent of GDP, compared with 0.6 percent of GDP in 1984. For 1986, the approved fiscal estimates embody a deficit of Lm 23 million (4.5 percent of GDP) although as mentioned below it may not be as large as this. For the whole of the public sector, the deficit in 1985 was Lm 16 million (3.4 percent of GDP), rising to Lm 29 million (5.6 percent of GDP) in 1986. The major reasons for the increase in the deficit have been decisions to stimulate the domestic economy to create more jobs and to undertake several large public sector investments.

The authorities believe that this change in fiscal policies was justified for several reasons. Unemployment was very high and investment in infrastructure and in the external sector was needed to ensure the medium term viability of the balance of payments (for example, in water supply for tourism, in grain and general transshipment facilities, in dry docks and in ship construction). The authorities explained that funds had been built up in earlier years and placed in the Posterity Fund ^{1/} (which was a major source of financing for the public sector) precisely for the purpose of being used at an appropriate time. It was expected that the fruition of expenditure programs would reduce or eliminate public sector deficits in the not distant future and would at the same time improve the balance of payments. For 1986 they believed the deficit provided for in the various parts of the public sector would be reduced because payments for crude oil would be lower, which with unchanged domestic prices would increase profits of the public enterprise importing oil, and because expenditure programs to increase employment would not be implemented as quickly as planned. The staff mission recognized these points and agreed that the deficits in 1985-86 were not in themselves seriously damaging to the economy. Moreover, the level of public sector expenditure has not changed very much in recent years relative to GDP. However, it saw a number of difficulties, immediate and potential, with the current trend in public sector finances. The deficits are absorbing an increasing proportion of domestic savings. The deficits, whether they were financed by running down cash balances or by foreign borrowing, added to reserve money, which was already at a very high level, thus complicating future monetary policy. Also, while public sector productive investment and its resultant job creation might be warranted in the short run, this was not a substitute for increased investment in the private sector, which at present was occurring only slowly.

The mission discussed with the authorities the financing of budget deficits. As explained above, domestic financing has involved the use of existing cash balances at the central bank, which results in an injection of reserve money. This in itself is not desirable from the perspective of monetary policy, and in any case will not be possible when cash balances are exhausted. Given present trends, this would not

^{1/} The Posterity Fund was established in 1981 and its revenue accrues from part of the central bank's profits. It lends to public corporations to finance development projects.

be too far in the future. The mission suggested that it might be appropriate to consider selling bonds to the nonbank public. The authorities were not attracted to this possibility for several reasons, including the cost of borrowing and the fact that they did not believe the level of bank liquidity was a problem. They noted that bonds had been issued many years ago and could be issued again if the need arose.

3. External policies

a. Exchange rate policy

Until late 1985, the authorities placed more weight on the domestic price implications of exchange rate movements than on the effect on competitiveness. Technically, this was achieved by permitting the currency basket to which the lira is pegged to contain a much greater U.S. dollar component than warranted by external payments considerations and by excluding the Italian lira, despite Italy's important external transactions with Malta. The result was that the real effective exchange rate, weighted on the basis of foreign trade, appreciated by more than 12 percent between 1980 and end-1982. It depreciated slightly subsequently but at end-1984 was still more than 8 percent above the 1980 level. Moreover, if allowance is made for the impact of changes in the exchange rates of Malta's most important competitors in tourism, the real effective appreciation of the lira was greater than the amounts described above.

In 1985, the weakening of the U.S. dollar and its high weight in the Maltese currency basket combined with the price freeze led to a sharp decline in the real effective exchange rate, which the authorities permitted. By the final quarter of 1985, the trade weighted real effective rate was only 1-2 percent above the 1980 base, although the competitor country measure was still about 6 percent higher. In December 1985 the authorities decided to stabilize the real effective rate by changing to a new currency basket with weights based in both trade and tourist transactions. The mission supports the adoption of the new basket and the effective depreciation that occurred in 1985. The loss in market shares for exports and even more for tourism clearly reflected an overvalued lira. It is less easy to judge whether the depreciation in 1985 went far enough. The real effective exchange rate is currently close to a level which supported a current account surplus in the late 1970s. At the same time, import restrictions are apparently still necessary and the current account is likely to be in deficit in 1986 (although that may reflect the exchange rate of 1985 rather than of 1986). Even making the most pessimistic assumptions, there is no reason for believing that the lira is seriously overvalued. At the same time, the authorities will need to examine developments in the external sector during 1986 to see what the impact of the depreciation of 1985 will be.

b. Trade and payments restrictions

Although administrative control over imports remains pervasive, with all commodity imports subject in principle to either licensing or state trading, there has been some relaxation since the last Article IV consultation. The prohibition on imports from Italy has been removed although that on imports from Japan remains. During 1985 and in 1986, administration of the licensing system has been more liberal. However, the licensing system remains important in providing substantial protection to domestic production. Restrictions on tourist travel to Italy, introduced in 1984, were lifted in September 1985. In February 1986 travel allowances for both tourist and business travel were increased.

In the early 1980s, Malta entered into a number of bilateral trade arrangements with associated payments arrangements. Trade with the partner countries has not shown the hoped for rapid increase and remains a minor segment of total trade (3 percent of total exports and imports in 1985). From the Maltese side there has been an insistence that the bilateral trade be governed by normal commercial principles. Since the last consultation, the associated payments arrangements with Libya and Romania have been terminated.

c. Distribution of international reserves

One unfortunate aspect of external policy in 1985 relates to the investment of the large international reserves. As mentioned on page 4, through most of the year there was a shift from other currencies to the U.S. dollar, which at end-1985 comprised 80 percent of the reserves compared with 43 percent a year earlier. This was the main reason for the decline of 5 percent in the SDR value of the reserves during 1985. There was a very sharp reversal in the currency composition of reserves in 1986 and by end-March 1986 the proportion held in dollars had declined to 20 percent.

d. Foreign debt

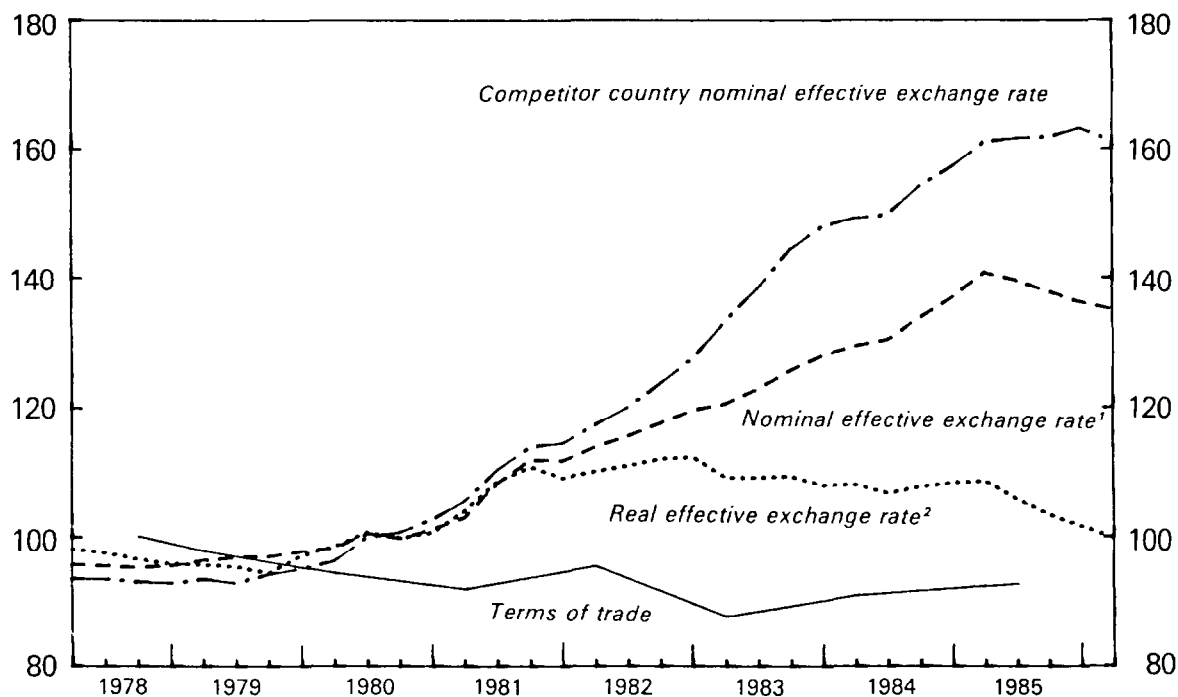
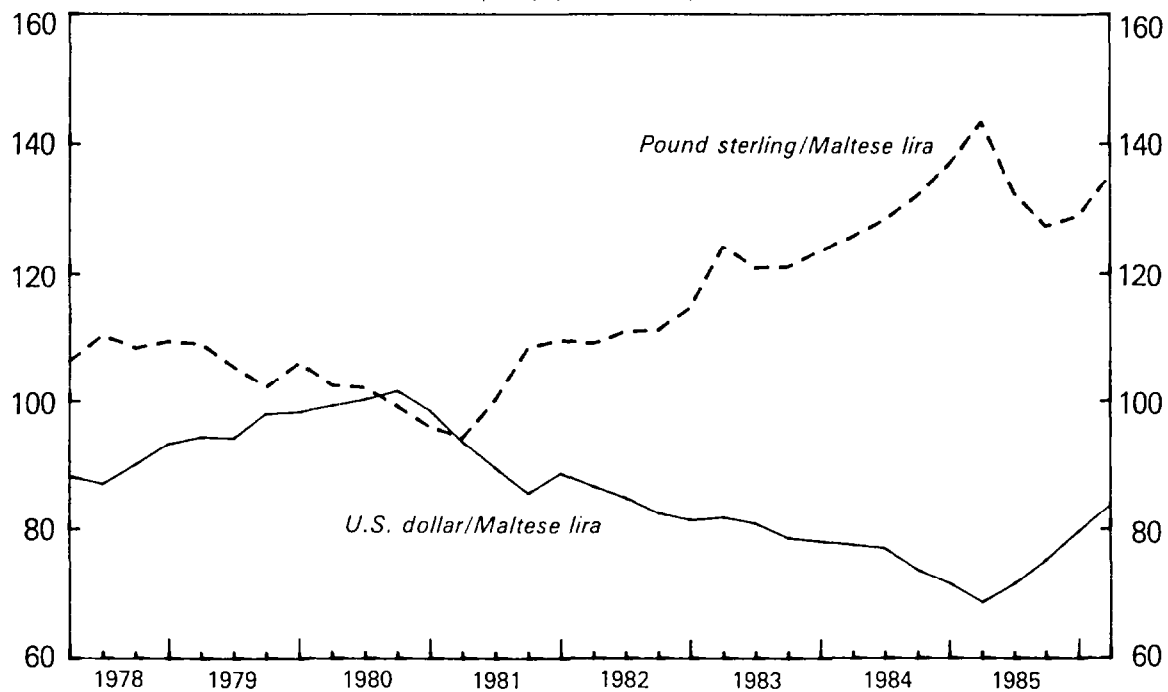
By any standard, Malta's outstanding foreign debt is very low and its servicing presents no problem. By law, the Government cannot borrow abroad at an interest rate that exceeds 3 percent. Data are available only on public sector debt (all of which is medium- to long-term) but it is not thought that private sector debt extends much beyond normal short-term trade financing. Outstanding public and publicly guaranteed disbursed debt of the public sector at the end of 1985 was only 9.1 percent of GDP and the debt service ratio was only 1.3 percent of exports of goods and nonfactor services.

e. Relations with EC

In December 1985, Malta signed a second Financial Protocol with the EC, which contemplates financial assistance for the period ending

CHART 3 MALTA EXCHANGE RATE DEVELOPMENTS, 1978(1)-1986(1)

(Indices 1980 = 100)



Source: IFS and data provided by the Maltese authorities.

¹ Trade weighted average of exchange rates expressed in units of foreign currency for Maltese lira. The weights are based on the distribution of exports and imports with 35 partner countries in 1980. A decline in the index indicates a depreciation.

² Relative consumer prices deflated by the nominal effective exchange rate.



October 31, 1988, totalling ECU 24.5 million (of which ECU 16 million in EIB loans, ECU 3 million in soft loans and ECU 10.5 million of grants). The first disbursements may take place in late 1986. A new understanding has been signed regarding textile exports to the EC but it was noted that in the past Malta had in fact not been able to utilize all its available quotas. Other developments include the extension of the Association Agreement to include Greece and the postponement of proposals to reduce duties on EC imports of certain agricultural products from Malta because of transitional arrangements following the entry of Portugal and Spain into the EC.

4. Longer term policy considerations

Staff simulations have been prepared in an endeavor to gain some insight into the implications of possible broad courses of action by the authorities. These are described in Appendix IV. The exercise is strictly mechanical and the results should be treated not as forecasts but as the implications of the assumptions built into the various scenarios. However, the results suggest several conclusions. If, at one extreme, the growth of foreign exchange earnings were not to accelerate from existing growth rates and GDP growth were to continue to be fuelled by domestic demand, the current account deficit would soon reach high levels. However, even at the end of the five year period the debt service ratio would not yet be excessive, although it would be increasing at an unsustainable rate. At the other extreme, if foreign exchange earnings can be made to grow more rapidly, GDP can grow at satisfactory rates without large current account deficits and with little increase in the debt service ratio. The scenarios also imply that two or three years of quite large deficits would be manageable provided they were followed by a stronger growth of foreign exchange earnings.

A judgment on actual medium-term prospects for the economy hinges very much on what will happen in two key areas. The first is the success of recent major public sector investments in the grain reshipment facility, in the general transshipment facility, in dry docks, and in shipbuilding. The second is the ability to attract more direct foreign investment in the external sector as a supplement to domestic private savings. It is not easy to be certain about what will happen in either of these areas. As regards the first, there is little experience in similar projects elsewhere to judge the likely prospects and profitability of transshipment in the Mediterranean. One might have some questions about the long-term viability of dry docks and ship-building, given existing world capacity and low costs in some developing countries. However, if the authorities' expectations are realized, the scope of domestic growth would be much enhanced. As for foreign investment as a supplement to private savings, much would presumably depend on costs in Malta relative to those in other countries attempting to attract foreign capital on the basis of low labor costs and an adequately skilled work force. Obviously, relative costs will depend

crucially on the effectiveness of Malta's economic policies, including exchange rate policy; it will also be important to reverse the recent downward trend in the private savings ratio.

IV. Staff Appraisal

Malta's economic performance in recent years has been mixed and this continues to be so in 1985-86. On the positive side, growth of real output is now increasing after two years of stagnation in 1983-84 and the high level of unemployment declined slightly in 1985. However, these trends were led by a sharp rise in domestic demand and in imports, with the emergence of a deficit in the current account of the balance of payments. Moreover, the renewal of growth has owed much to deficit spending by the public sector. These weaknesses in the public sector and in the balance of payments are not in themselves serious. The public sector deficits, while large as a proportion of GDP, follow a long period when the sector was almost always in surplus. The deficits on the current account of the balance of payments are not excessive, Malta's international reserves, built up during many years of surpluses, are high, and the outstanding level of foreign debt is very low. However, if the authorities are to achieve their aim of reducing unemployment through a strong growth of exports of goods and services, with which the staff agrees, future policies must be tailored to ensure an expansion of the external sector.

Malta's economic strategy is centered around a wage/price freeze, which aims at reducing costs so that the external sector may regain its earlier competitiveness. Concurrently the authorities are undertaking a number of public sector investments, which they believe will both add to employment and strengthen the external sector. Financial policies have largely been passive with an acceptance of public sector deficits, which the authorities believe will be reversed later, and the existence of a considerable expansion of liquidity of both commercial banks and nonbank sector. The external sector is characterized by direct controls on imports and, until recently, by an exchange rate policy that placed considerable weight on containing domestic inflationary pressures, but which allowed the lira to appreciate in real effective terms. An underlying thread through all policy making has been a considerable degree of official intervention. The crucial question is whether this policy mix will reverse the deterioration in the external sector over the medium-term. For policies to be successful they must encourage adequate private investment in the external sector from both domestic and foreign sources.

The depreciation of the real effective exchange rate during 1985 improved the competitiveness of the lira after a period of some years when the lira had appreciated significantly. The adoption of a more appropriate currency basket should reduce the possibility of perverse movements of the real effective exchange rate in the future. The loss in market shares both in goods and tourism that Malta experienced in the

1980s, the emergence of deficits on the current account of the balance of payments and the need to maintain relatively severe import restrictions, all suggest that the lira has become noncompetitive. Since competitiveness is a prerequisite for achieving the authorities' economic goals, they will have to pay careful attention to trends in the external sector and if there is not a fairly quick improvement in the current account, consideration will have to be given to additional measures.

Exchange restrictions that are maintained by Malta in accordance with Article XIV, Section 2 comprehend restrictions on payments and transfers for invisibles and remittances of profits, royalties and dividends, which are subject to exchange control approval. The measures relating to the tourism allowances and the bilateral payments arrangement with a Fund member constitute exchange restrictions subject to the Fund's Article VIII. ^{1/} Following an intensification of restrictions on trade and payments in recent years, the staff welcomes the fact that there has been some liberalization since the 1985 Article IV consultation. In particular, the emphasis on bilateral trade and payments arrangements has been reduced and two bilateral payments arrangements terminated, tourist allowances have been liberalized, some import restrictions have been reduced, and the prohibition of imports from Italy has been eliminated, although imports from Japan are still prohibited. As regards restrictions subject to approval under Article VIII, the staff does not recommend approval.

It is somewhat disappointing that the price freeze and the related wage freeze are not to be relaxed in 1986. The absence of proper price signals, especially now that the freeze is continuing for a relatively long period, is not likely to encourage the best allocation of resources and may well discourage the inflow of foreign investments. The much lower level of inflation in the world economy as well as lower oil and other commodity prices would have seemed to have made 1986 an ideal year in which to begin to phase out these controls.

Although the liquidity of the banks and the nonbank public has increased substantially, there has not been any obvious impact on prices, because of the price freeze, and the impact on the balance of payments has been reduced by the controls on imports. While the supply of broad money has increased, demand for it has been encouraged by positive real interest rates and the authorities do not believe that excess liquidity exists. However, the staff remains uncomfortable with such a high degree of liquidity. Moreover, the commercial banks have a very large legal possibility for expanding credit, although it is clear that the authorities have considerable informal control over bank lending. In the circumstances, at the very least it would seem

^{1/} Of the bilateral payments arrangements concluded by Malta only one with the Fund member, Poland, is operative. Other arrangements are with nonmembers.

appropriate to try to contain the increase in reserve money, which has implications for public sector finances, and to maintain real interest rates at existing levels.

The consolidated public sector accounts data show that in 1985, for the first time the public sector was in substantial overall deficit, equivalent to more than 3 percent of GDP and a deficit of more than 5 percent of GDP is in prospect for 1986. In both instances, the use of government cash balances is the main source of financing, with the remainder coming from net borrowing and grants from abroad. In contrast to the past, when the Government budget was the principal source of the public sector surpluses or deficits, net transactions of other public sector entities, especially the Posterity Fund, have become increasingly important. As a temporary measure, to finance productive investment in the external sector, the higher expenditures underlying the public sector deficit are understandable, especially since the cash balances used as financing were accumulated for such a purpose. However, the result is a substantial addition to bank liquidity and the absorption of an increasing proportion of domestic savings by the public sector at a time when the private savings ratio appears to be declining.

In summary, the Maltese economy is passing through a phase which, if temporary, should not be of major concern since sound past performance has provided a cushion that would permit a gradual approach to solving present problems. However, a continuance of public sector deficits, very high levels of liquidity and a weakening of the balance of payments would be worrisome. Such a situation would also make it more difficult to reduce the present reliance on direct controls, which the staff believes is damaging in the longer run to balanced growth based on an expanding external sector.

It is recommended that the next Article IV consultation with Malta be held on an 18-month cycle.

V. 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, 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 restrictions 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 arrangement with Fund members and urges Malta to terminate the remaining bilateral payments arrangement with a Fund member.

Table 1. Malta: Selected Economic Indicators, 1983-86

(Annual percentage change)

	1983	1984	1985 <u>1/</u>	1986 <u>2/</u>
Real demand and output (At 1973 prices)				
Domestic demand	-3.5	0.8	4.0	4.4
Private consumption	1.4	4.0	4.2	4.0
Public consumption	-1.1	-2.5	5.4	5.5
Gross fixed investment	15.8	-7.0	2.1	9.0
Increase in inventories <u>3/</u>	-7.2	0.5	0.2	-0.7
Exports of goods and nonfactor services	-1.8	4.0	6.5	6.3
Imports of goods and nonfactor services	-7.2	3.9	8.3	6.5
GDP at market prices <u>4/</u>	-0.6	0.9	3.1	4.3
Labor market				
Employment	-0.5	0.6	1.3	...
Unemployment rate (level in percent)	9.0	8.9	8.5	...
Real average wage per employee	-1.2	-2.5	0.9	...
Prices				
Consumer prices	-0.9	-0.4	-0.3	--
GDP deflator	-0.3	-0.2	-0.2	3.3
Income				
Private disposable income	-0.6	2.1	1.6	...
Private savings rate (level in percent)	13.1	11.9	10.0	...

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

1/ Provisional estimates.

2/ Staff projections.

3/ Contribution to GDP growth.

4/ The rates of GDP growth are affected significantly by the use of 1973 weights rather than those of a more recent year. For example, using 1984 weights, GDP growth in 1985 would have been 2.0 percent and the projected 1986 growth rate would be 3.7 percent.

Table 2. Malta: Monetary Survey, 1982-85.

	1982	1983	1984 <u>2/</u>	1985
(In millions of Maltese liri end of period)				
Net foreign assets	499.4	543.2	583.9	562.7
Net domestic credit	94.9	99.3	128.7	175.4
Government sector	-49.8	-65.1	-58.7	-37.4
Private sector	144.7	164.4	187.4	212.8
Broad money	523.1	566.6	638.8	662.6
Narrow money	308.7	328.3	329.0	321.3
Currency in circulation	259.8	279.6	283.7	273.4
Demand deposits	48.9	48.7	45.3	47.9
Quasi money	214.4	238.3	309.8	341.3
Other items, net	71.4	75.9	73.8	75.5
(Changes in percent)				
Net foreign assets	6.6	8.8	7.5	-3.6
Net domestic credit	14.2	4.6	29.6	36.3
Government sector <u>1/</u>	30.0	30.7	-9.8	-36.3
Private sector	19.2	13.6	14.0	13.6
Broad money	5.8	8.3	12.7	3.7
Narrow money	4.5	6.3	0.2	-2.3
Quasi money	7.7	11.1	30.0	10.2
Income velocity of broad money	0.91	0.84	0.77	0.73

Sources: Data provided by the Maltese authorities; and IMF, International Financial Statistics.

1/ A negative sign indicates a use of government cash balances.

2/ The Government Savings Bank (GSB), which had not been included in the monetary survey, was closed in 1984. Its deposits were distributed among commercial banks, leading to a marked increase in quasi money in 1984; of the increase of 12.7 percent in broad money it is estimated that about 8 percentage points are attributable to this change. GSB credit to the government was also transferred to the commercial banks increasing their claims on government.

Table 3. Malta: Accounts of the Consolidated Government,
1983-86 1/

	1983	1984	1985	1986 <u>2/</u>
(In millions of Maltese liri)				
Total revenue	250.0	249.4	249.0	251.6
Tax revenue	121.7	115.8	123.9	126.9
Direct taxes	79.2	74.2	76.2	76.7
Indirect taxes	42.5	41.6	47.7	50.2
Nontax revenue	128.3	133.6	125.1	124.7
Total expenditure and net lending	247.2	252.2	269.0	274.7
Total expenditure	236.1	246.6	249.3	269.1
Current expenditure	205.1	209.2	210.6	221.5
Capital expenditure	31.0	37.4	38.7	47.6
Net lending	11.1	5.6	19.7	5.6
Loans	14.9	14.1	40.5	12.1
Repayments	3.8	8.5	20.8	6.5
Overall balance	2.8	-2.8	-20.0	-23.1
(As percent of GDP)	0.6	-0.6	-4.2	-4.5
Foreign financing	16.8	9.3	0.2	6.0
Grants	6.8	7.0	0.2	1.5
Loans, net	10.0	2.3	0.0	4.5
Loans	13.9	5.7	3.5	8.5
Repayments	3.9	3.4	3.5	4.0
Domestic financing	-19.6	-6.5	19.8	17.1
Bank financing <u>3/</u>	-19.6	-6.5	19.8	17.1
(Changes in percent)				
Memorandum items:				
Total revenue	-6.9	-0.2	-0.2	1.0
Tax revenue	-3.2	-4.8	7.0	2.4
Nontax revenue	-10.2	4.1	-6.4	-0.3
Total expenditure and net lending	-6.5	2.0	6.7	2.1
Total expenditure	-8.8	4.4	1.1	7.9
Current expenditure	-7.9	2.0	0.7	5.2
Capital expenditure	-13.9	20.6	3.5	23.0

Source: Data provided by the Maltese authorities.

1/ Includes the Consolidated Revenue Fund, Treasury Clearance Fund, Sinking Fund, Posterity Fund, and the Fund for the Acquisition of Property for Public Purposes.

2/ Budget estimates.

3/ A negative sign indicates an increase in government cash balances and a positive sign indicates a use of government cash balances.

Table 4. Malta: Accounts of The Consolidated Public Sector, 1985-86

(In millions of Maltese liri)

	Consolidated Government <u>1/</u>	Enemalta	Telemalta	Housing Corporation	Consolidated public sector
(Accounts for 1985)					
Gross receipts	249.6	87.1	20.7	0.6	358.0
Less transfers from other public sector	34.2	21.2	7.7	--	63.1
Net receipts	215.4	65.9	13.0	0.6	294.9
Gross expenditure and net lending	269.6	83.1	20.9	0.5	374.1
Current expenditure	(211.2)	(82.0)	(19.4)	(0.2)	(312.8)
Capital expenditure	(38.7)	(11.7)	(1.7)	(0.3)	(52.4)
Net lending	(19.7)	(-10.6)	(-0.2)	(--)	(8.9)
Less transfers to other public sector	28.9	23.4	10.5	0.3	63.1
Net expenditure	240.7	59.7	10.4	0.2	311.0
Overall balance	-20.0	4.0	-0.2	0.1	-16.1
Financing					
External financing	0.2	--	--	--	0.2
Grants	0.2	--	--	--	0.2
Net borrowing	--	--	--	--	--
Domestic financing <u>2/</u>	19.8	-4.0	0.2	-0.1	15.9
(Accounts for 1986)					
Gross expenditure	251.6	58.6	17.7	0.6	328.5
Less transfers from other public sector	15.9	--	4.7	--	20.6
Net receipts	235.7	58.6	13.0	0.6	307.9
Total net expenditure and net lending	274.7	64.1	17.7	0.8	357.3
Current expenditure	221.5	55.5	11.8	0.3	289.1
Capital expenditure	47.6	8.3	4.8	0.5	61.2
Net lending	5.6	0.3	1.1	--	7.0
Less transfers to other public sector	4.7	8.8	6.6	0.5	20.6
Net expenditure	270.0	55.3	11.1	0.3	336.7
Overall balance	-23.1	-5.5	--	-0.2	-28.8
Financing					
External financing	6.0	5.2	--	--	11.2
Grants	1.5	--	--	--	1.5
Net borrowing	4.5	5.2	--	--	9.7
Domestic financing <u>2/</u>	17.1	0.3	--	0.2	17.6

Source: Data provided by the Maltese authorities.

1/ Includes the Consolidated Revenue Fund, Treasury Clearance Fund, Sinking Fund, Posterity Fund, and the Fund for the Acquisition of Property for Public Purposes.

2/ A negative sign indicates an increase in government cash balances and a positive sign indicates a use of government cash balances.

Table 5. Malta: Summary of the Balance of Payments, 1983-86

	1983	1984	1985 <u>1/</u>	1986 <u>2/</u>
(In millions of Maltese liri)				
Exports, f.o.b.	167.9	189.1	197.8	204.9
Imports, f.o.b.	285.1	294.3	315.3	312.1
Merchandise trade balance	-117.2	-105.2	-117.5	-107.2
Services, net	87.8	80.6	83.6	67.6
Of which:				
Tourism, net	47.6	43.0	48.7	54.0
Investment income, net	38.1	45.7	43.4	25.0
Transfers	28.7	29.8	25.6	29.7
Private	14.2	14.4	16.9	18.0
Public	14.5	15.4	8.7	11.7
Current account balance	-0.7	5.2	-8.3	-9.9
As percent of GDP	-0.1	1.1	-1.8	-1.9
Medium and long term capital	11.9	17.1	10.7	...
Short term capital <u>3/</u>	33.8	-7.6
Overall balance	45.0	14.7
(Changes in percent)				
Memorandum items:				
Market growth	3.4	6.4	3.8	3.4
Domestic exports, unit value	-6.6	1.8	0.3	-1.4
Domestic exports, volume	0.7	14.3	2.4	5.0
Imports, c.i.f., unit value	1.8	-1.9	-1.4	-7.7
Imports, c.i.f., volume	-4.3	6.3	8.7	7.0
Nominal effective exchange rate <u>4/</u>	6.5	6.8	4.4	...
US dollar/Maltese lira rate <u>4/</u>	-4.7	-6.1	-1.6	18.2
Net international reserves <u>5/</u>	-39.7	-4.0	45.9	...

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

- 1/ Provisional.
- 2/ Staff projections.
- 3/ Includes errors and omissions.
- 4/ A positive change implies an appreciation of the Maltese lira.
- 5/ Changes in millions of Maltese liri. An increase is denoted by a negative sign.

Table 6. Malta: Net International Reserves, 1982-85

	1982	1983	1984	1985
(In millions of SDRs; end of period)				
Central Bank	969.2	1,050.5	1,018.5	948.7
Assets	969.2	1,050.5	1,018.5	948.7
Gold ^{1/}	51.5	54.2	50.2	123.3
SDRs	21.2	31.0	35.7	39.6
Reserve position in the Fund	25.8	28.8	30.9	29.7
Foreign exchange	870.7	936.5	901.7	756.1
Liabilities	--	--	--	--
Commercial banks	107.8	93.0	96.1	106.8
Assets	130.8	122.0	123.3	192.6
Liabilities	23.0	29.0	27.2	85.8
Total net international reserves	<u>1,077.0</u>	<u>1,143.5</u>	<u>1,114.6</u>	<u>1,055.5</u>
Memorandum items:	(In months of imports) ^{2/}			
Net official reserves	16.4	18.6	17.8	15.0
Net total reserves	18.2	20.2	19.5	16.7

Source: IMF, International Financial Statistics.

^{1/} Gold holdings at national valuation.

^{2/} Merchandise imports (c.i.f.) during the previous 12 month-period.

Table 7. Malta: Medium- and Long-Term Public External Debt
and Service Payments, 1980-85 1/

(In millions of Maltese lira; end of period)

	1982	1983	1984	1985
Total	32.6	42.4	45.3	42.5
Debt service payments	<u>1.5</u>	<u>4.4</u>	<u>4.0</u>	<u>4.2</u>
Amortization	<u>1.1</u>	<u>3.9</u>	<u>3.5</u>	<u>3.5</u>
Interest	0.4	0.5	0.5	0.7
(Ratios in percent)				
Memorandum items:				
Outstanding debt/GDP	7.0	9.3	9.8	9.1
Debt service/exports of goods and nonfactor services	0.4	1.4	1.2	1.3
Interest payments/outstanding public debt	1.2	1.2	1.1	1.6
Average terms <u>2/</u>				
Interest (in percent)	3.0	2.3	-- <u>3/</u>	2.5
Maturity (years)	19.8	15.2	--	18.0
Grace (years)	5.3	2.7	--	5.5

Sources: Data provided by the Maltese authorities and IBRD, Debt
Reporting System.

1/ Disbursed only.

2/ Based on new public debt commitments.

3/ Insufficient data was available for estimates.

Fund Relations with Malta

(As of June 26, 1986; in millions of SDRs)

I. Membership status

Malta became a member of the Fund on September 11, 1968. Malta 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 13.9 million
(30.8 percent of quota).
- (c) Reserve tranche position: SDR 31.3 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 41.5 million or 367.4 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. From December 2, 1985 weights are based on the average flows during the three years to mid-1985 in both Malta's merchandise trade and foreign exchange earnings from tourism. The nominal effective trade-weighted exchange rate has appreciated by 18.8 percent from 1982 to 1985. On May 31, 1986 the exchange rate of the Maltese lira was Lm 1 = SDR 2.1545.

VI. The last Article IV consultation was concluded on April 29, 1985 when the staff report (SM/85/99, 4/5/85) was considered by the Executive Board; the following decision was adopted:

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Malta, in the light of the 1985 Article IV consultation conducted under Decition No. 5392- (77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that Malta has in the recent past added several restrictions on payments and transfers for current international transactions including restrictions arising from a bilateral payments arrangement with a Fund member. The Fund encourages Malta to eliminate these restrictions as soon as possible and to adhere thereafter more strictly to a liberal system of payments and transfers for current international transactions.

Malta - Statistical Issues

1. Outstanding statistical issues

a. Government finance

Data in IFS are on an annual basis and are those included in the GFS Yearbook. The 1985 Yearbook includes statistics through 1983.

b. Real sector

Data on total employment and industrial production are to be published in a coming issue of IFS. These data are obtained from bulletins of the Central Office of Statistics.

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 June 1986 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Central Bank of Malta and the Central Office of Statistics. In the case of monetary statistics reported by the Central Bank, reports have been received on an irregular basis in the past year.

		<u>Latest Data in June 1986 IFS</u>
Real Sector	- National Accounts	1984
	- Prices	February 1986
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	1983
	- Financing	1983
	- Debt	1983
Monetary Accounts	- Monetary Authorities	March 1986
	- Deposit Money Banks	March 1986
	- Other Financial Institutions	March 1986
Interest Rates	- Discount Rate	February 1986
	- Bank Lending/Deposit Rate	December 1985
	- Bond Yield	n.a.
External Sector	- Merchandise Trade: Values	February 1986
	Prices	Q3 1985
	- Balance of Payments	1984
	- International Reserves	April 1986
	- Exchange Rates	April 1986

Basic Data

Area	316 sq. kilometers (122 sq.miles)
Population (1985)	331,650
Domestic labor force	122,805
GDP (1985, at current prices) <u>1/</u>	Lm 474.5 million
GDP per capita, 1985:	Lm 1,431 or US\$3,060

<u>Demand and Output, 1985</u>	<u>In millions of Maltese lira</u>	<u>In percent of total</u>
Private consumption	329.4	69.4
Public consumption	84.3	17.8
Fixed investment	131.1	27.6
Stockbuilding	7.1	1.5
Total domestic demand	551.9	116.3
Exports of goods and services	341.8	72.0
Imports of goods and services	419.2	88.3
Gross domestic product	474.5	100.0

Selected Economic Indicators, 1983-85
(Annual percentage change)

	<u>1983</u>	<u>1984</u>	<u>1985 1/</u>
Demand, output, and prices			
GDP at current prices	-0.9	0.8	2.9
GDP at constant prices	-0.6	0.9	3.1
Private consumption	1.4	4.0	4.2
Public consumption	-1.1	-2.5	5.4
Gross fixed investment	15.8	-7.0	2.1
Exports of goods and services	-1.8	4.0	6.5
Imports of goods and services	-7.2	3.9	8.3
Consumer prices	-0.9	-0.4	-0.3
GDP deflator	-0.3	-0.2	-0.2
Unemployment rate (average level)	9.0	8.9	8.5

Fiscal Indicators (As percentage of GDP)

Consolidated General Government			
Current revenue	54.6	54.1	52.5
Current expenditure	44.8	45.4	44.4
Capital expenditure (and net lending)	9.2	9.3	12.3
Overall balance	0.6	-0.6	-4.2
Public debt	15.3	15.8	14.8

Monetary sector (Annual percentage change)

Reserve money	6.8	2.0	0.9
Broad money (M1)	6.3	0.2	-2.3
Narrow money (M2)	8.3	12.7 <u>2/</u>	3.7
Net domestic credit	4.6	29.6	36.3
Net foreign assets	8.8	7.5	-3.6

<u>External sector (In millions of lira)</u>	<u>1983</u>	<u>1984</u>	<u>1985</u> <u>1/</u>
Trade balance	-117.2	-105.2	-117.5
Invisible balance	116.5	110.4	109.2
Current account	-0.7	5.2	-8.3
(In percent of GDP)	-0.1	1.1	-1.8
Overall balance	45.0	14.7	...
External debt as percent of GDP	9.3	9.8	9.1
Net international reserves	533.3	537.3	491.4
Nominal effective exchange rate			
(Annual percentage change)	6.5	6.8	4.4
Real effective exchange rate <u>3/</u>			
(Annual percentage change)	-2.2	-1.1	-2.6

1/ Preliminary estimates.

2/ The Government Savings Bank (GSB), which had not been included in the monetary survey, was closed in 1984. Its deposits were distributed among commercial banks, leading to a marked increase in quasi money in 1984; of the increase of 12.7 percent in broad money it is estimated that about 8 percentage points are attributable to this change. GSB credit to the government was also transferred to the commercial banks increasing their claims on government.

3/ Staff estimates; index of the trade weighted average ratio of Malta's consumer price index to the consumer price indices of partner countries multiplied by the nominal effective exchange rate. In light of the price freeze this index may not be a reliable indicator of external competitiveness.

Malta: Illustrative Scenarios of Medium-Term Developments

Simulations of the external sector of the Maltese economy have been prepared to illustrate the impact on the balance of payments, including the foreign debt position, of different broad policy approaches. Even in the worst circumstances Malta does not face a debt problem in the medium-term because of its large international reserves. However, the simulation may be helpful in suggesting implications for future policy. This appendix explains the methodology and major assumptions of the simulations in the Maltese external accounts during the next five years. The results of these scenarios depend crucially on the assumed parameters of domestic economic performance and the external environment.

The first scenario can be characterized as programmatic. A time path for the current account is chosen and developments in external debt are then derived based on assumptions about nondebt capital inflows, the accumulation of reserves, and the terms of external debt. The permissible level of imports is derived by projecting exports of goods and services and by using the current account assumption. The feasible rates of growth of GDP, total demand and aggregate demand are derived on the basis of an assumption about the import elasticity. Predictably, higher foreign exchange earnings permit a faster growth of GDP. In both examples of this scenario, the debt service ratio remains at a very low level.

The second scenario highlights the combined consequences of deteriorating competitiveness and an attempt to maintain the growth rate of GDP by faster growth of domestic demand. In this scenario a time path for GDP is chosen. The current account is projected based on assumptions about export performance and the elasticity of imports with respect to demand. The level of external borrowing is derived on the basis of the same set of parameters used in the first scenario and permits interest payments to be determined. The rate of domestic growth required to achieve the target growth of GDP is derived residually by reference to export and import performance. The simulation shows a growth in debt service much faster than in the two earlier examples. The situation at the end of the simulation period is not serious in the absolute sense, but the growth rate of debt service is accelerating rapidly and would soon reach unacceptable levels. This case illustrates the importance of establishing the conditions for a sustained growth of exports and the unsustainability of securing employment and output gains in the longer-run through the continued expansion of domestic demand.

Malta: Illustrative Medium Term Scenarios, 1987-91

(Percentage changes in domestic currency
unless otherwise specified)

	1987	1988	1989	1990	1991
Scenario A: Programming the current account <u>1/</u> Case (i)					
Major assumptions:					
Foreign exchange earnings	5.2	5.2	5.2	5.2	5.2
Current account deficit as percent of GDP	1.9	1.8	1.8	1.7	1.6
Import prices	3.0	3.0	3.0	3.0	3.0
Elasticity of imports to aggregate demand	1.2	1.2	1.2	1.2	1.2
GDP deflator	2.0	2.0	2.0	2.0	2.0
Interest rate on external debt	2.0	2.0	2.0	2.0	2.0
Major results:					
Import volume	2.0	2.0	2.0	2.0	2.0
Reserves (in months of imports of goods and services)	12.0	11.6	11.4	11.2	11.0
Domestic demand	0.8	0.7	0.7	0.7	0.7
GDP	1.5	1.5	1.5	1.5	1.5
External debt/GDP (level)	9.5	8.8	8.5	8.1	7.6
Debt service ratio (in percent)	1.4	1.0	1.4	1.8	2.1
Case (ii)					
Major assumptions:					
As in case (i) except foreign exchange earnings	6.3	6.8	6.8	6.8	6.8
Current account deficit as percent of GDP	1.9	1.8	1.7	1.6	1.6
Major results:					
Import volume	3.0	3.5	3.6	3.6	3.6
Reserves (in months of imports of goods and services)	11.8	11.4	11.0	10.6	10.3
Domestic demand	1.4	1.7	1.7	1.7	1.6
GDP	2.3	2.6	2.6	2.6	2.7
External debt/GDP (level)	9.4	8.6	8.2	7.7	7.2
Debt service ratio (in percent)	1.4	1.0	1.3	1.7	1.9
Scenario B: Growth through domestic demand					
Major assumptions:					
GDP	4.0	4.0	4.0	4.0	4.0
GDP deflator	2.0	2.0	2.0	2.0	2.0
Elasticity of imports to aggregate demand	1.2	1.3	1.4	1.4	1.4
Foreign exchange earnings	4.8	5.2	5.2	5.2	5.2
Import prices	3.0	3.0	3.0	3.0	3.0
Interest rate on external debt	2.0	3.0	4.0	5.0	6.0
Major results:					
Import volume	5.4	6.3	7.3	7.4	7.4
Reserves (in months of imports of goods and services)	11.6	10.8	10.1	9.4	8.8
Domestic demand	5.1	5.5	6.1	6.2	6.2
Current account deficit as percent of GDP	5.0	8.7	13.6	19.2	25.7
External debt/GDP (level)	14.9	23.4	36.7	55.2	79.3
Debt service ratio (in percent)	1.6	1.7	3.1	5.5	9.2

Source: Staff estimates.

1/ The difference between cases (i) and (ii) is in the assumed export performance. In case (i) merchandise export volume growth is 2.5 percent and growth of nonfactor services is 4.5 percent. In case (ii) the external sector is assumed to be more competitive and the volume of merchandise exports grows by 4.5 percent and nonfactor services by 6 percent.

