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April 5, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Malta - Staff Report for the 1985 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Malta, which is tentatively scheduled for discussion on Monday, April 29, 1985. A draft decision appears on page 14.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Brehmer (ext. 8805), Ms. Salop (ext. 8793), or Mr. Nellor (ext. 8835).

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INTERNATIONAL MONETARY FUND

MALTA

Staff Report for the 1985 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 J. T. Boorman

April 5, 1985

I. Introduction

A staff team consisting of Mr. E. Brehmer, Ms. J. Salop, Mr. D. Nellor (all EUR), Ms. P. Alonso-Gamo (EP-EUR), and, as secretary, Ms. H. Walters (EUR), visited Valletta February 5-15, 1985 to conduct Article IV consultation discussions. The mission chief met with Mr. Mintoff, the former Prime Minister and the leader of the ruling Labor Party. The mission met with Mr. Abela, Deputy Prime Minister and Minister of Finance, and senior officials from the Central Bank of Malta and various ministries and agencies. Mr. S. Zecchini, the Executive Director for Malta, attended some meetings as an observer.

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

II. The Economic Situation

1. Background

Malta's policies, after its independence from the United Kingdom in 1964, were directed toward the development of new industries (particularly textiles) and at strengthening existing industries (tourism, shipbuilding, and ship repair). This strategy was designed to offset the loss of income and employment resulting from the gradual closure of the U.K. base, completed in 1979, and to increase living standards. Fiscal and monetary policy were coordinated with the development effort. To help finance the restructuring process and to accumulate large foreign reserves, Malta relied on sizeable foreign grants and loans on concessionary terms.

In the 1970s, Malta's economic performance was impressive by most measures. Real GNP rose rapidly and unemployment (which threatened to rise as a result of the closure of the U.K. base) fell to acceptable levels (3 percent in 1979). These developments were related to strong growth in exports and income from tourism, facilitated by a considerable improvement of international competitiveness, and an expansion of foreign direct investment attracted by relatively low and stable interest rates and a skilled labor force. The rate of price increase fluctuated but was not excessive. With rapid improvements in productivity, real wages could rise considerably without endangering competitiveness and employment. The current external account showed significant surpluses and international reserves rose to a level which, in relation to imports, was higher than that of comparable countries. Nevertheless, despite Malta's effort to develop new industries, the export sector remained heavily dependent on tourists from the United Kingdom and exports to the EC area. Associated structural weaknesses made themselves felt during the international recession of the early 1980s, which produced a strongly negative effect on most sectors of the economy, particularly on textiles, clothing and tourism. In addition, in shipbuilding and ship repair, Malta suffered from the problem of world excess capacity.

2. Recent economic developments

In the wake of the international recession, growth of real GDP slowed to 2-3 percent per annum in 1981-82 and was negative in 1983. The unemployment rate, which had averaged 4.1 percent per annum in the 1970s, was 9 percent at end-1983, while the number of workers on short-time work equalled 3.3 percent of the labor force and effectively added a further 0.7 percentage point to the unemployment rate. These developments reflected a sharp drop in the volume of exports of goods and services, which occurred as a result of both cyclical factors and a severe erosion of competitiveness. The latter is evident in the 25 percent loss of export market shares and in a 40 percent decline in gross receipts from tourism in the three-year period 1981-83. The real foreign balance on account of goods and services deteriorated sharply in 1981 and 1982, when sustained growth in domestic demand buoyed imports. In 1983, the real foreign balance improved by the equivalent of 3 percent of GDP; the fall in the volume of exports was largely arrested while the volume of imports fell off sharply. Overall, the current account remained in a comfortable position in the period 1981-83, due to large net transfer receipts which included retirement pensions of former employees of the United Kingdom and remittances from the large number of emigrants.

Developments in 1984 were somewhat more favorable. Real GDP recovered, rising at a rate of 1.5 percent. The number of workers on short-time work fell to 1.6 percent of the labor force by end-1984, although the unemployment rate remained at its high level. The volume growth of merchandise exports of 13 percent was encouraging, as it exceeded substantially the growth in merchandise export markets (7.7 percent). A significant part of the increase was attributable to exports to Libya and the U.S.S.R. under bilateral trade arrangements. On the other hand, there was a further drop in gross earnings from tourism, of 6 percent, largely because of the weakness of the pound sterling vis-à-vis the Maltese lira. The upturn of exports was accompanied by a resurgence of domestic demand, which came from a 2.4 percent increase in private consumption (related to the increase in export trading profits of self-employed, a small rise in real wages, and increases in the value of social benefits) and some rebuilding of stocks. However, real fixed investment in manufacturing and tourism remained sluggish, due in part to unused capacity and relatively high real interest rates. Given the large import content of domestic demand and exports, the volume of imports of goods and services also recovered. These developments produced a deterioration in the real foreign balance equivalent to 0.7 percent of GDP. The account of goods and services remained in large deficit for the third consecutive year, at 5 percent of GDP. However, owing to further large net receipts of transfers, the balance on current external account showed a small surplus. According to provisional data, the capital account showed a net inflow of Lm 10.6 million mainly on account of foreign direct investment and government loans. At the end of 1984 gross official reserves were equivalent to over 18 months of imports.

III. Economic Policies in 1983 and 1984

The Government reoriented its economic policies in 1983-84 toward measures designed to stabilize prices, to improve competitiveness, and to foster employment. An important ingredient of the new policies has been a wage-price freeze combined with profit controls applied from the beginning of 1983. The freeze, which represented a significant departure from past policies, is supported by a number of anti-inflationary measures and the goal of domestic price stabilization was aided by a continued nominal effective appreciation of the Maltese lira in 1983 and 1984. There can be little doubt that the latter hampered the desired improvement in international competitiveness and the reduction of unemployment. Nevertheless, because of the lower inflation rate in Malta than in its trading partners, there was a small depreciation in real effective terms over the two years. The authorities have also adopted employment supporting measures since 1982, including the imposition of a restriction on the dismissal of workers by firms, the introduction of short-time work, and the prohibition of overtime work in the public sector. Another important objective of economic policy is to contain the deficit on account of goods and services largely through the measures designed to improve competitiveness, buttressed by reciprocal trade arrangements, controls of nonessential imports and restrictive fiscal policies.

During the July 1983 Board discussion of the staff report for the last Article IV consultation, Directors, while commending the Maltese authorities for their introduction of a wage-price freeze as an immediate response to the loss of competitiveness, noted that the freeze was not a lasting solution because of the distortions it would create in the longer run. They also observed that reliance on the exchange rate as a means of containing inflation had been excessive. Directors suggested that, in order to maintain competitiveness, a further nominal effective appreciation of the Maltese lira should be avoided and that a more flexible exchange rate policy would be desirable along with policies designed to contain excessive wage and price increases but which do not create distortions.

1. Policies designed to improve competitiveness

Under the wage and price controls, wage rates in the private and public sectors have been pegged to the December 1982 levels. To secure "peace" on the wage front the Government introduced a number of anti-inflationary measures that brought about a reduction in domestic retail prices by some 1 percent per annum in 1983 and 1984 and thus sustained a moderate increase in real wages. The Maltese authorities insisted that there were no signs of pent-up price pressure, as the slack in the economy and the price stabilization measures had prevented such pressure from building up. Indeed, movements of uncontrolled prices, namely those for services, tended to support this view. The price stabilization measures included an extension of price and profit margin control in the domestic wholesale and retail trades, a broadening of the scale of the government-sponsored bulk buying scheme (which enables importers to get quantity discounts), a more active role of the Price Stabilization Fund with the view of lowering the prices of a wide range of essential consumer goods, and some smoothing of temporary shortages of agricultural products through imports.

An exchange rate adjustment to improve competitiveness directly was not made as this was considered incompatible with the wage-price freeze. Therefore, the authorities altered neither the currency basket to which the Maltese lira is pegged nor the level of the peg. The Maltese representatives explained that the currency composition of the basket was determined primarily by the relative shares of the various currencies in the invoicing of Malta's merchandise trade, with the weights so derived adjusted on the basis of other considerations, e.g., domestic price stabilization. However, the weights given to relatively strong currencies (the Japanese yen and the U.S. dollar) in the Maltese currency basket are much higher than in Malta's actual trade. This produces a discrepancy between the official basket rate of the lira and its value in nominal effective terms, as calculated by the staff, and explains how the lira was able to appreciate in nominal effective terms, by 14 percent in the period 1983 and 1984, even though it was kept constant in terms of the official basket. Notwithstanding the rise in the nominal effective rate of the Maltese lira, domestic price stability and continued inflation abroad permitted a small real effective depreciation 1/ of the lira in the period 1983 and 1984. This was insufficient, however, to offset the 11 percent real effective appreciation in the period 1981 and 1982.

Commenting on their strategy to improve competitiveness, the Maltese representatives said that any shock to domestic prices created by a devaluation was expected to lead to a wage-price spiral that would be hard to stop and that would tend to leave the real effective exchange rate of the lira unchanged. In view of this, the only avenue open to improving competitiveness was a gradual approach that would keep the growth in real wages below productivity growth--an approach followed in

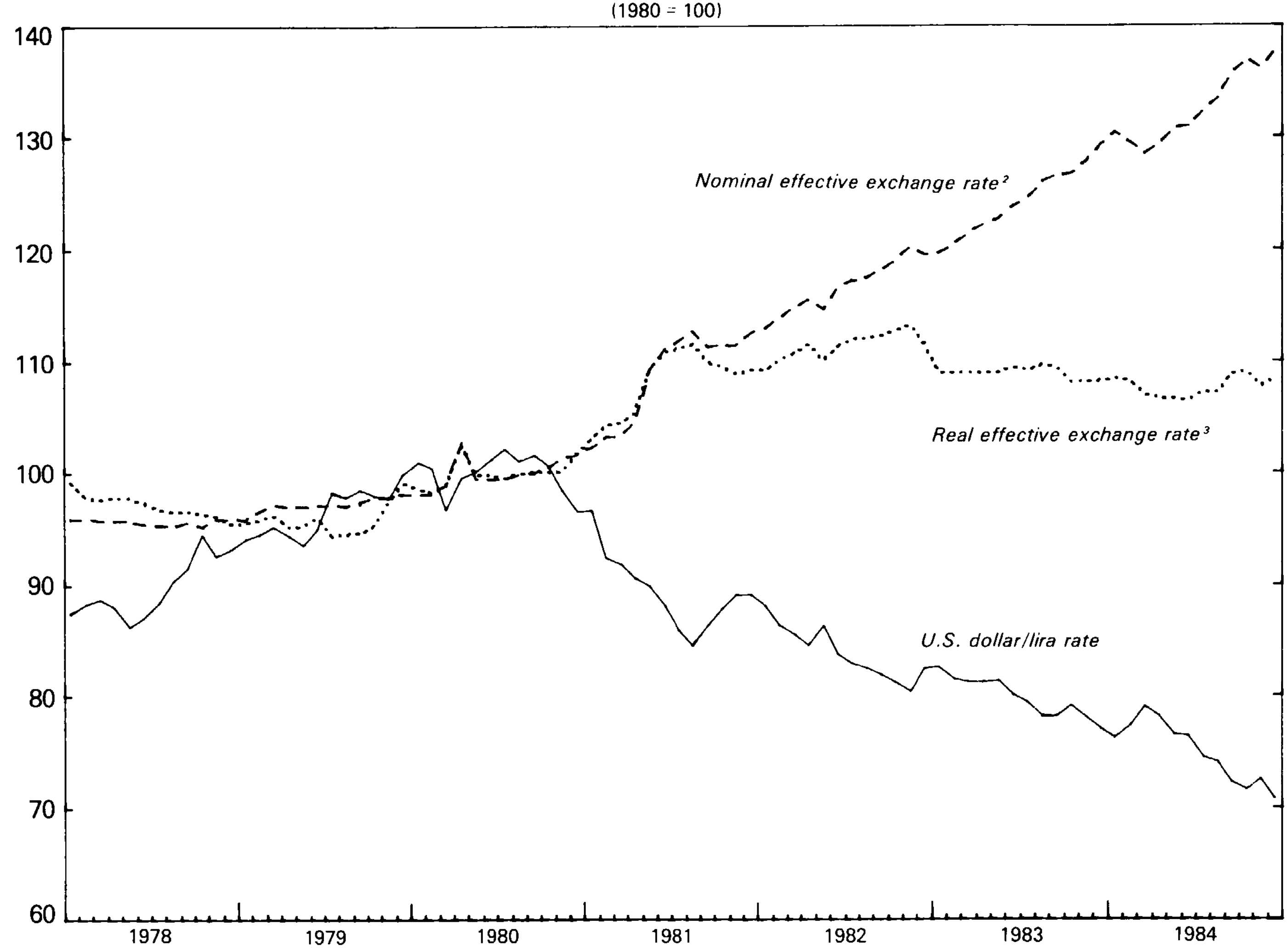
1/ The real effective depreciation, calculated by the staff, was 3.5 percent. The precision of this measure is reduced under a regime of price controls.

CHART 1

MALTA

EXCHANGE RATE INDICES, 1978-84[1]

(1980 = 100)



Sources: IMF, *International Financial Statistics;* and staff estimates.

[1] The weights were based on the average trade with 35 countries in 1980.

[2] An increase in the index indicates an appreciation of the Maltese lira.

[3] Relative price levels were measured by consumer price indices.

the 1970s, when there was a considerable real effective depreciation of the Maltese currency. The Maltese representatives expect this strategy, which relies on wage-price control to lead to an improvement in the relative price of Maltese exports though only gradually as a result of productivity increases and a superior inflation performance relative to its trading partners rather than immediately through cuts in real wages. In their attempt to restore competitiveness the authorities are also relying on improvements of product quality and on marketing which had, in the past, received less emphasis.

2. Commercial policy

The authorities embarked on their policy of "trade reciprocity" late in 1982 as a step toward offsetting the impact of the international recession on domestic activity and to compensate for the economy's vulnerability due to its small size and limited range of exportable goods. Under this policy, the Government concludes bilateral agreements with other governments for the export of Maltese goods and for the import of particular goods from the partner country. These agreements are not intended to provide for a full one-to-one exchange nor are they necessarily limited to the trading of goods; rather, the Government sees them as an important means of opening up new markets. At present, Malta has a reciprocal agreement with only one Fund member, Libya, and three with nonmembers, Bulgaria, Poland and the U.S.S.R. The agreement with the U.S.S.R. is a trade protocol covering trade between the two countries for the years 1984-86. An agreement with North Korea has been signed, but its startup is subject to the resolution of a technical problem. All the agreements, except the one with the U.S.S.R., which is on a cash basis, entail bilateral payments arrangements involving regular periodic settlement in convertible currencies, with the interest on the outstanding balances varying among agreements. The period of settlement is six months in several cases, and balances are not transferable to third countries in the meantime.

For the most part, imports under the reciprocal agreements are raw materials and semiprocessed industrial inputs. While Malta is trying to export finished products in return, such exports are in no way guaranteed under the agreements; instead the Maltese exporters have to be competitive to win contracts. Exports under the agreements were less than a third of imports under the agreements in 1983, and more than half in 1984. In the latter year, trade under the agreements accounted for less than 10 percent of total Maltese trade. Poor export prospects and unacceptable financing conditions required by the trading partner have been partly to blame for the nonrenewal of some of the agreements expiring at end-1984 (Iraq, Romania, and Turkey). Nevertheless, the reciprocal trading policy is considered by the authorities to have improved the trade balance, since the imports under the agreements would have been made anyhow, while some of the exports were in new markets.

In 1983 and 1984 import licensing (directed mainly against nonessential consumer goods) has been made more restrictive. In some cases there was a tightening of import restrictions for reasons of safety and quality.

In addition, import licenses have been denied to the extent that the ongoing import substitution program provided adequate supplies of domestic alternatives of comparable quality and price. Furthermore, in 1984 the authorities introduced a restriction on imports from Italy, in addition to the existing restriction on imports from Japan (introduced in 1982). Under these restrictions, which were designed to reduce the large import surplus vis-à-vis these countries, import licenses are generally granted only for essential products that cannot be obtained elsewhere. The Maltese representatives stated that negotiations with Japan and Italy were underway to resolve the question of import restrictions vis-à-vis these countries.

Restrictions on tourist travel allowances were tightened in July 1983, while those on the allowance for business travel were eased. The per trip foreign exchange allocation for tourist travel had previously covered only the costs incurred abroad but it now applies to all trip expenses, including those paid in advance in Maltese lira. A limit on the number of trips was also introduced. In addition, from October 1984 foreign exchange allowances for tourist travel to Italy have been denied. This measure represents both an intensification of restrictions and an introduction of a discriminatory practice.

One consequence of the authorities' exchange rate policy and the composition of the currency basket has been a sharp appreciation of the Maltese lira vis-à-vis pound sterling. This has greatly discouraged the inflow of tourists from the United Kingdom, Malta's most important tourist market. To reduce uncertainty about the pound sterling cost of travel in Malta, the Maltese authorities offered, in the period November 1983 to December 1984, a guaranteed rate of Lm 1 = £1.52 (equal to the spot rate in November 1983) to British tour operators under a forward cover facility for advance commitments on package tours. Little use was made of the facility even though the terms of the offer made clear that the forward contracts would not have to be executed if pound sterling appreciated below Lm 1 = £1.52. The measure was not renewed for 1985.

3. Financial policies

a. Fiscal policy

Fiscal policy is designed to provide adequate resources to carry out planned capital works under the development plan. The major capital projects in 1983 and 1984 have been intended to enhance employment opportunities and growth of the export sector. The stance of budgetary policy in these years was also consistent with the short-term policy objective of external adjustment of the goods and services account and the associated desire to contain demand, including that for imports.

In 1983 and 1984 capital expenditures including net lending were sustained slightly below their 1982 level. With the introduction of the wage-price freeze, the growth of current expenditures slowed markedly in both years. The rate of growth of revenues also slowed significantly in 1983, and in 1984 revenue actually declined. While the fiscal deficit remained approximately stable at a level equal to 2.4 percent of GNP in 1983, it rose to the equivalent of 3.2 percent of GNP in 1984.

Tax revenues declined throughout the 1983-84 period due to the wage-price freeze and the sluggishness of business activity. At the same time, greater reliance was placed on nontax revenues (e.g. dividends from public corporations and interest receipts) as these are viewed by the authorities as a more socially acceptable financing source than taxation. As a consequence, nontax revenues now comprise some 35 percent of revenues against 20 percent in 1980.

In 1983, foreign grants and loans received for budget financing were almost double their budgeted level, while in 1984 foreign financing of the budget was significantly less than anticipated as, among other factors, a new financial protocol with the EC was not concluded. The authorities continue to view foreign financing as the major source of deficit financing partly for balance of payments reasons. The Government's capital program has a high import content involving an outflow of foreign exchange. Hence, foreign financing is used to avoid a decline in foreign exchange reserves. Foreign borrowing is restricted to loans with rates of interest not exceeding 3 percent in order that debt servicing requirements should not become onerous. In this respect, a shift to domestic borrowing would greatly increase the debt service burden of the Government.

While the fiscal deficits in 1983 and 1984 were relatively high in terms of Maltese experience, the cyclically adjusted fiscal impulse of the budget became sharply contractionary in 1983. This was due to a deceleration in the growth rate of expenditure, which reinforced an already contractionary revenue impulse. The contractionary fiscal impulse, on a cyclically adjusted basis, continued in 1984, although it was much smaller in magnitude as the expansionary revenue impulse partially offset the contractionary expenditure impulse. Analysis of the impact of the Government's fiscal activities is made difficult by the decision to use extra-budgetary funds for the financing of the Government's capital expenditure and lending program. This applies, in particular, to the recent decision to shift the financing of government lending from the budget to the Posterity Fund which so far has invested its resources (generated by part of the Central Bank's profits) in foreign assets and in deposits at the Central Bank. The staff team suggested to the Maltese authorities that these accounts should be presented on a consolidated basis.

b. Monetary policy

Monetary policy has traditionally been designed to support the development effort by ensuring an adequate supply of loanable funds and the maintenance of low and stable nominal interest rates. While the authorities stand ready to use monetary instruments for purposes of economic stabilization, the circumstances have not, in their view, required this, as other policy tools have been effective. Furthermore, the authorities' ability to pursue an independent monetary policy is constrained by the openness of the economy, although staff analysis suggests that there is scope for short-run influence.

Selective controls are used to allocate credit in accordance with the Government's development strategy; banks have been encouraged to provide credit for projects with a high value-added content and to technologically advanced industries and, conversely, to limit their lending to the tourist and textile sectors to modernization rather than further expansion. Bank lending for the purchase or construction of owner-occupied housing continues to enjoy priority.

The emergence of relatively high positive real interest rates in 1983-84 (amounting to some 9 percent on the lending side), as a result of domestic price stabilization, has implicitly reversed the low real interest rate policy (which had prevailed for some time) and has in the view of the staff team tended to discourage private investment in fixed assets. The authorities, however, do not view the real lending rate as an important determinant of bank lending. A general reduction in lending rates is thus not anticipated, although capital controls would permit some scope for a lowering. However, the possibility of offering reduced bank lending rates to some sectors is under study.

The onset of higher real deposit rates--with an increase in 1982 of the nominal interest rate from 5 percent to 6 percent on one-year time deposits and then the price freeze--saw a dramatic increase in time deposits and a significant fall in the velocity of broad money in 1983. In 1984, the growth in broad money accelerated, to a rate of 14 percent, due largely to the closing of the Government Savings Bank (whose deposits were not included in broad money) and the absorption of its deposits by the commercial banks. Commercial bank liquidity in excess of the required level rose to almost 30 percent of deposits at the end of the year. Nevertheless, a reduction in deposit rates is not considered as this would in the view of the authorities induce a shift of household balances from interest-bearing accounts with the banks to currency outside banks where it might more easily find its way into consumption.

The growth in net foreign assets has traditionally been the principal source of broad money growth, although in 1984 their paths diverged. After expanding at a fairly rapid rate in the early 1980s, the growth of net foreign assets of the banking system slowed to about 8 percent in 1983 and decelerated to 0.6 percent by the end of 1984, reflecting an increase in net outflows on the merchandise account and reduced official transfers and concessionary loans. Net domestic credit slowed in 1983 due, in part, to the recession and to an increase in the cash balances of government, while it accelerated during 1984 as the Government made recourse to its cash balances and credit demand of the business sector picked up, largely to finance a rebuilding of stocks of oil products.

CHART 2

MALTA

VELOCITY OF BROAD MONEY AND REAL INTEREST RATES, 1978-84

Sources: Data provided by the Maltese authorities, and IMF Data Fund

[1] Defined as the ratio of nominal GDP to the average stock of broad money multiplied by 100

[2] The closure of the Government Savings Bank commenced in November 1983 resulting in an increase in broad money as savings deposits were transferred to time deposits in the commercial banks. This resulted in a larger decline in velocity than would otherwise have occurred. In the absence of this change, the velocity of broad money line would have flattened out in late 1983 and 1984.

[3] Defined as the nominal rate of interest on one year time deposits deflated by the inflation rate one period ahead.

IV. Prospects and Future Policies

While unemployment had been a problem for some time, its persistence at very high levels has now made it an overriding policy concern. The authorities have responded to this concern in the 1985 budget by introducing incentives for additional private sector employment. The format of these incentives is still under discussion. Consideration is also being given to a relaxation of the ban on public sector hiring introduced in 1982. Nevertheless, for the near term, the authorities remain committed to their gradual approach to improving competitiveness coupled with emphasis on trade reciprocity, despite the postponement of the return to full employment implicit in such a strategy.

The continued reliance on the gradual approach reflects the authorities' political and economic assessment of the likely consequences of a more frontal attack. On that assessment, the unions are likely to resist any cut in real wages induced by a depreciation of the exchange rate that was seen to have been engineered by the authorities and that, in view of the high dependence of the Maltese economy on imports, would sacrifice price stability. Therefore, the preferred strategy for improving competitiveness in the view of the Maltese authorities, is to contain real wage growth below the underlying growth in productivity, while leaving the peg of the lira to and the composition of the official basket unchanged.

Under this strategy, Malta's prospects for improved competitiveness over the near term will depend crucially on the course of the U.S. dollar. If that currency continues to appreciate vis-à-vis European currencies, the lira will also appreciate in nominal effective terms. However, as long as the magnitude of the latter appreciation in 1985 is less than the forecast 5 percent rate of inflation in Malta's competitor countries, Malta's competitiveness will still improve somewhat this year.

The Maltese representatives acknowledged that there could be some scope for an accelerated improvement in competitiveness if the lira would depreciate in nominal effective terms as a result of external forces, such as a drop in the value of the U.S. dollar vis-à-vis the European currencies. Indeed if such a drop prompted only a moderate rise in import prices, the unions might accept the associated decline in real wages without pressing for nominal wage compensation. The Maltese representatives indicated that, for this reason, the authorities would welcome an easing of the U.S. dollar and that in such an event they would not change the composition of the currency basket in an effort to maintain the value of the lira in terms of European currencies.

On the other hand, if there were a large drop in the U.S. dollar, implying a large depreciation of the lira vis-à-vis other European currencies with substantial domestic price implications, strong upward pressure on wages would likely ensue, although lower prices for imports priced in U.S. dollars would partly counterbalance higher prices for imported European products. In these discussions, the staff team took the view that a sharp drop in the U.S. dollar would warrant a thorough review of the authorities' whole policy approach, and would necessitate wage restraint, supported by restrictive financial policies if an inflationary spiral is to be avoided.

Fiscal policy will remain restrictive in 1985. The budget deficit is expected to fall to about one third of its 1984 level or to the equivalent of 1.1 percent of GNP due to a revival of revenue growth and continued slow growth in total expenditure including net lending. On a cyclically adjusted basis, the budget will show about the same large contractionary impact as in 1983. However, if account would be taken of the extra-budgetary expenditure financed by the Posterity Fund (for which 1985 estimates are not available), the contractionary fiscal impulse would be much lower.

The Maltese authorities sketched the following likely profile of economic developments in 1985. The volume of merchandise exports was expected to remain at the greatly increased level of 1984; consolidation at this level would be viewed as an achievement by itself. New export productive capacity was not expected to bring about significant increases in exports in the foreseeable future. Whether the current account would be in surplus would depend crucially on whether the expected recovery of tourist receipts would materialize, but this is uncertain. Real private consumption was expected to rise by about 2 percent, while public consumption could increase if the Government lifted the ban on public sector hiring. There is likely to be a decline in public construction as many projects are due to be completed in the course of the year. On the other hand, fixed investment in manufacturing is likely to recover while investment in the tourist sector will be stable because of the large underutilization of capacity. All told, real GNP is projected to grow by 1-2 percent, which is below its potential, and unemployment will remain high.

For the medium term, the Maltese representatives said that development policy was directed at establishing an industrial structure that would ensure full employment. To this end, it was important to restore competitiveness and to attract foreign direct investment that promised access to foreign markets, thereby diversifying Malta's export markets and structure. The Maltese representatives did not view their bilateral trading arrangements as a long-run substitute for improving competitiveness, rather they thought of them as a stop-gap measure to gain time for their gradual approach to take effect. From the perspective of medium-term policy, competitiveness was also assessed in terms of the package of fiscal and other incentives that were on offer to attract direct foreign investment. Malta had lost out in the last few years as competitor countries had responded to the worldwide recession by offering enlarged incentives for foreign investment. The authorities were currently reassessing the adequacy of Malta's investment incentive package--which presently offers accelerated depreciation schedules, subsidized factory space, and exemption from import duties--in light of the incentives provided in other countries.

V. Staff Appraisal

The international recession of the early 1980s had a substantial negative effect on the Maltese economy. This was aggravated by a severe loss of competitiveness reflected in a sharp drop of export market shares and sluggish enterprise investment. With the ensuing decline in exports and receipts from tourism, the growth in real GDP fell off sharply resulting in a significant increase in unemployment. Although there was a substantial deterioration in the account of goods and services, the overall current account position was not a source of concern thanks to large net receipts of transfers.

Against this background and the threat of inflationary pressures from abroad, the Government shifted its policy priorities in 1983-84 to the improvement of competitiveness, domestic price stabilization, and employment support. A discretionary devaluation of the Maltese lira was ruled out because of the likelihood of an ensuing wage-price spiral which would soon negate any competitive advantage gained by such a measure. Instead, to achieve its objectives, the Government has relied, since early 1983, on a wage-price freeze supported by a number of anti-inflationary measures which minimized the build-up of inflationary pressures. These policies produced a small decline in prices and a modest growth in real wages. While a continued nominal effective appreciation of the Maltese lira aided the Government's policy to stabilize domestic prices, it limited considerably the improvement in competitiveness. Nevertheless, over this period the exchange rate of the lira, in real effective terms, appears to have depreciated somewhat, although the precise magnitude is difficult to establish under a wage-price freeze.

The employment supporting measures included the conclusion of reciprocal trade agreements designed to develop new export markets. The staff notes that these do not constitute barter arrangements and that trade under the agreements has to be competitive. Most agreements entail a bilateral payments arrangement, including one with a Fund member. The agreements seem to have had a positive net effect on the Maltese balance of payments as the imports under these agreements, concentrated on primary products, would have been undertaken anyhow. But in the international context they constitute a diversion of trade.

Although the government budget in 1983 and 1984 was in deficit, it was consistent with the emphasis on external adjustment of the goods and services account, as it became contractionary on a cyclically adjusted basis under the wage-price freeze. Analysis of the budgetary impact is made difficult by the decision to shift a large part of the responsibility for government lending to corporations from the budget to extra-budgetary funds. Therefore, in the view of the staff, these extra-budgetary operations should be integrated into the budget figures. Monetary policy has also tended to restrain domestic demand, with the emergence of relatively high positive real interest rates as a result of the domestic price stabilization.

The policies of the Government have had a measure of success. Real GDP recovered in 1984 but was insufficient to make a dent in the high unemployment rate. The growth in the volume of merchandise exports considerably exceeded export market growth, owing mainly to exports to two countries under reciprocal trade agreements. However, taking account of a further drop of earnings from tourism, Malta probably did not make a net gain in overall export market shares. There was also a resurgence of domestic demand in 1984, although industrial investment remained sluggish because of the high real interest rate and excess capacity. Imports recovered with GDP so that the deficit on account of goods and services remained large, at 5 percent of GDP, for the third consecutive year. Large net transfers received ensured, however, a small current account surplus and at end-1984 gross official reserves were equivalent to over 18 months of imports.

Large net receipts of transfers and the very high level of reserves have rendered the task of external adjustment on account of goods and services less urgent than would otherwise be the case. However, the balance of payments may face difficulties in the medium term, if the flow of transfers to Malta were to drop or if some reciprocal trade agreements would not be renewed. Therefore, and because of the urgency of solving the unemployment problem, restoration of competitiveness is essential. Having ruled out the possibility of a "home-made" devaluation, the Maltese authorities plan to continue in 1985 with their gradual approach to improving competitiveness on the basis of the wage-price freeze, under which the growth in real wages would be kept below productivity growth. With this strategy, the projected increase of 5 percent in prices in Malta's partner countries could lead to a further real effective depreciation of the lira depending on Malta's relative inflation performance and the evolution of the nominal effective exchange rate. The projected contractionary impulse of the 1985 government budget will help ensure that export demand is not crowded out of the domestic market. Monetary policy will continue to support growth of the export sector through credit guidelines.

However, there is always the risk of a further nominal effective appreciation of the lira, e.g. as a result of a continued rise of the U.S. dollar against European currencies, which would offset any gain of competitiveness due to Malta's performance on the anti-inflation front. In that event, Malta could adapt the composition of its currency basket to the actual pattern of its trade, so that any further rise of the U.S. dollar would avoid excessive appreciation of the lira vis-à-vis the currencies of Malta's trading partners. Under all circumstances, such an adjustment of the basket would provide for greater stability of the lira in nominal effective terms.

The avenue chosen by Malta to improve competitiveness can only be a gradual one as long as low inflation rates abroad combine with a rising U.S. dollar and low domestic productivity growth. The gradual approach has several drawbacks: (1) a possible permanent loss of market shares, as other countries supplant Malta in its traditional exports markets; (2) the damage done to the allocative function of prices by a price freeze applied over a longer period; and (3) the postponement of the return to full employment. Furthermore, in the view of the staff the shift of policies away from reliance on market mechanisms to a system subject to greater bureaucratic intervention in the economy, undertaken for the most part to compensate for the lack of competitiveness, cannot on the whole have been conducive to business investment although the Maltese authorities tend to discount any adverse effects.

Therefore, the question remains whether there is scope for an accelerated improvement in competitiveness in response to "outside" influences, such as a drop in the U.S. dollar vis-à-vis European currencies which would depreciate the lira in nominal effective terms. This depends, of course, on public acceptance of the associated cut in real wages, which in any event might be lessened by switching to a greater extent to dollar denominated imports. In the event of a sharp drop in the U.S. dollar over a short period there will be pressure on prices and a reassessment of Malta's broad approach toward improving competitiveness, in particular the wage-price freeze, would be required. Any new strategy would have to include wage restraint flanked by supportive financial policies.

Recently Malta has intensified the restrictiveness of the exchange and trade system. Allowances for tourist travel were reduced, discriminatory restrictions on most imports from Italy, in addition to those already in force on imports from Japan deemed to be nonessential, were introduced, and bilateral payments arrangements, including one with a Fund member, were concluded. 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. In the absence of exchange rate and other market-related policies that would provide the basis for elimination of restrictive practices, the staff does not recommend that the Executive Board grant approval for them.

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

VI. Proposed Decision

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

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 Decision 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 adopt a liberal system of payments and transfers for current international transactions.

Fund Relations with Malta

(As of February 28, 1985; 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 million

(b) Total Fund holdings of Maltese liri: SDR 15.32 million (33.98 percent of quota).

(c) Reserve tranche position: SDR 29.81 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 36.65 million or 324.67 percent of net cumulative allocation.

B. Nonfinancial Relations

V. Exchange rate arrangements

Since July 1972, the value of the Maltese lira has been pegged to an adjustable trade-weighted basket of the currencies of Malta's major trading partners. The nominal effective trade-weighted exchange rate is estimated to have appreciated by 13.7 percent from 1982 to 1984. On February 28, 1985 the exchange rate of the Maltese lira was Lm 1 = SDR 2.05.

VI. The last Article IV consultation was concluded on May 16, 1983 and the staff report (SM/83/140, 6/21/83) was considered by the Executive Board on July 18, 1983, when the following decision was adopted:

> 1. The Fund takes this decision in concluding the 1983 Article XIV consultation with Malta, in the light of the 1983 Article IV consultation conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).
>
> 2. The Fund hopes that Malta will continue to maintain its present relatively liberal system of payments and transfers for current international transactions.

The mission will propose that the next Article IV consultation be held on an 18-month cycle as its predecessor.

VII. Technical assistance

A Fund mission from the Bureau of Statistics visited Malta in March 1984 to advise on money and banking statistics.

A consultant, appointed by the Central Banking Department for a period of three months, is presently in Malta to advise on investment strategies for official reserves.

Malta--Statistical Issues

1. Outstanding Statistical Issues

a. Monetary statistics

The Bureau of Statistics is reviewing the comments sent by the Central Bank on the proposed revisions in reclassifying the financial institutions which was the main issue in the Report on Mission to Malta (sent October 1984).

b. Government finance

The 1984 issue of the GFS Yearbook contains data for 1982 for statistical tables and data for 1980 for the derivation table. The mission encouraged the authorities to provide data for the derivation table for 1981-82, and to compile monthly data in the government finance statistics format.

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

During the past year, the reporting of data for inclusion in IFS has been good.

Status of IFS Data

		Latest Data in March 1985 IFS
Real Sector	- National Accounts	1983
	- Prices	November 1984
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government Finance	- Deficit Surplus	1980
	- Financing	1980
	- Debt	1980
Monetary Accounts	- Monetary Authorities	November 1984
	- Deposit Money Banks	November 1984
	- Other Financial Institutions	November 1984
External Sector	- Merchandise Trade: Values	November 1984
	- Merchandise Trade: Prices	November 1984
	- Balance of Payments	1983
	- International Reserves	January 1985
	- Exchange Rates	January 1985

Basic Data 1/

Area and population		
Area	316 sq. kilometers (122 sq. miles)	
Population (October 1984) 2/	331,221	
Population increase (average annual rate)	1.1 percent	
GDP per capita (1984)	Lm 1,406 or US$3,046.8	

Output by sector (1984)	In millions of Maltese liri	As percent of total
Agriculture and fisheries	19.0	4.5
Manufacturing, shipbuilding and repair	128.2	30.1
Construction and public utilities	47.2	11.1
Public administration	56.1	13.2
Other services	231.6	54.4
GDP at factor cost	426.0	100.0

Demand and supply	1981	1982	1983	1984
	Percentage change in constant prices			
Private consumption	3.3	2.9	1.4	2.4
Public consumption	7.5	5.6	-1.1	-3.0
Gross fixed investment	17.2	14.7	15.8	-4.2
Changes in stocks 3/	1.2	4.7	-7.2	2.2
Total domestic demand	7.5	10.4	-3.5	2.2
Exports of goods and services	-11.4	-13.8	-1.8	3.0
Imports of goods and services	-7.7	-1.9	-7.2	4.5
GDP at market prices	3.3	2.3	-0.6	1.5
(GDP at factor cost)	(3.9)	(3.5)	(0.2)	(2.6)

Labor market	1981	1982	1983	1984
	In thousands; end-period			
Labor force	122.9	122.3	120.9	122.3
Gainfully employed	116.2	111.1	110.6	111.3
Unemployment rate (in percent)	5.5	9.2	9.0	8.9

Prices and incomes	1981	1982	1983	1984
	Annual percentage change			
Retail prices	11.5	5.8	-0.9	-0.5
GDP deflator	7.8	3.4	-0.3	-0.1
National minimum wage	17.5	11.2	--	--
Unit labor costs in manufacturing	14.8	7.1	-0.1	2.2
Real personal disposable income	5.3	5.5	0.4	2.1

Government finance	1981	1982	1983	1984 Revised	1985 Budget
	In millions of Maltese liri				
Total domestic revenue	164.6	178.4	179.2	176.8	190.5
Of which: Tax revenue	123.2	125.7	121.7	115.8	124.8
Total expenditure and net lending	168.0	189.9	191.2	192.9	196.1
Of which:					
Current expenditure	137.7	153.1	156.0	159.5	160.0
Capital expenditure and net lending	30.3	36.8	35.2	33.4	36.1
Fiscal deficit (in percent of GNP)	-0.7	-2.2	-2.4	-3.2	-1.1
Use of cash balances (in percent of GNP)	-2.9	0.7	-1.0	1.4	0.4

	1981	1982	1983	1984 4/
	Change in millions of Maltese liri; end-of-year data			
Monetary survey				
Net foreign assets	48.4	29.0	38.9	3.0
Domestic credit	9.9	26.9	10.9	37.5
Government	-7.0	3.6	-5.2	14.5
Private sector 5/	16.8	23.4	19.7	23.0
Other items, net	8.7	23.4	11.5	-36.1
Broad money	49.6	32.5	41.9	76.6
Percentage change in broad money	11.8	6.9	8.3	14.0

	1981	1982	1983	1984
Balance of payments	In millions of Maltese liri			
Exports, f.o.b.	181.8	173.5	165.2	189.9
Imports, f.o.b.	298.2	293.2	286.5	296.9
Trade balance	-116.4	-119.7	-121.3	-107.0
Travel, net	87.4	52.9	50.0	43.0
Other services	32.0	41.8	38.7	40.9
Transfers, net	35.0	30.8	28.7	23.7
Current account balance	39.6	8.0	-1.7	0.6
Capital balance	25.3	14.8	45.3	10.6
Overall balance	59.9	22.8	43.6	11.2
Current account balance:				
In millions of SDRs	87.8	17.4	-3.6	1.2
In percent of GDP	9.1	1.8	-0.4	0.1

	1981	1982	1983	1984
Export performance	Annual percentage change			
Growth of export volume	-11.3	-6.4	0.6	13.0
Market growth 6/	0.6	2.9	4.3	7.7
Terms of trade (merchandise goods)	13.8	3.9	-8.2	...

	1981	1982	1983	1984
Foreign reserves and debt	End-period data			
Official reserves 7/ (in millions of SDRs)	898.1	952.8	1,029.5	1,030.3
Import coverage (in months)	14.9	16.5	17.7	18.3
External public debt (in millions of SDRs)	72.5	71.1	90.5	88.2
In percent of GDP	(7.5)	(7.1)	(9.2)	(9.1)
External debt service (in percent of exports of goods and services)	0.4	0.4	1.2	1.2
Exchange rate				
SDR per Malta lira (end-period)	2.2185	2.1821	2.1440	2.0744
Real effective exchange rate:				
Average (1980 = 100)	108.2	111.4	108.9	107.6
End-period (1980 = 100)	109.2	112.5	108.0	108.4

1/ 1984 figures are provisional.
2/ Excluding foreign residents and tourists.
3/ Change in the rate as a percentage of previous year's GDP.
4/ The closure of the Government Savings Bank during 1984 increased the share of total financial assets held by commercial banking system.
5/ Includes public enterprises.
6/ Calculated on the basis of movements in the import volume of Malta's major trading partners weighted by their share in Malta's exports.
7/ Gold valued at US$42 per ounce.