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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/14-1

11:30 a.m., February 22, 2019

1. Malta—2019 Article IV Consultation

Documents: SM/19/36 and Correction 1; and Supplement 1; SM/19/37; SM/19/38; and Correction 1

Staff: Bacalu, MCM; Natal, EUR; Goodman, SPR

Length: 41 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	K. Obiora (AE)
	S. Bah (AF), Temporary
	C. Moreno (AG), Temporary
	J. Shin (AP), Temporary
	A. Maciá (BR), Temporary
	Z. Huang (CC), Temporary
	J. Montero (CE), Temporary
	P. Mooney (CO), Temporary
	C. Just (EC)
	A. Castets (FF)
	K. Merk (GR)
S. Gokarn (IN)	
D. Fanizza (IT)	
	H. Mori (JA), Temporary
	S. Alavi (MD), Temporary
	D. Fadhel (MI), Temporary
	V. Rashkovan (NE)
	I. Skrivere (NO), Temporary
	A. Tolstikov (RU), Temporary
	W. Al Hafedh (SA), Temporary
	K.Tan (ST)
	P. Trabinski (SZ)
S. Riach (UK)	
	M. Svenstrup (US), Temporary

H. Al-Atrash, Acting Secretary
S. Maxwell, Summing Up Officer
D. Alcantara, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
European Central Bank: K. Nikolaou. European Department: C. Mikami Baba, J. Natal, H. Qu. Legal Department: C. El Khoury, M. Markevych. Monetary and Capital Markets Department: A. Alfi, V. Bacalu, M. Gorpe, E. Karlsdottir, J. Morsink, M. Narita, G. Ndedi Ntepe, I. Pardede. Strategy, Policy, and Review Department: M. Goodman.

Alternate Executive Director: R. Alkhareif (SA). Senior Advisors to Executive Directors: Y. Danenov (SZ), M.Gilliot (FF), O. Stradal (EC). Advisors to Executive Directors: S. Buetzer (GR), L. Cerami (IT), T. Hemingway (UK), M. Kikiolo (AP), E. Ondo Bile (AF), R. Pandit (ST), B. Parkanyi (NE).

1. MALTA—2019 ARTICLE IV CONSULTATION

Mr. Fanizza and Ms. Cerami submitted the following statement:

On behalf of the Maltese authorities, we thank staff for very constructive consultations in the context of the Article IV and of the Financial System Stability Assessment missions. Drawing on the two missions, staff have produced a fair and consistent set of reports on the health of the Maltese economy and financial system. The authorities welcome staff's overall favorable assessment. They broadly agree with their policy recommendations, many of which are aligned with measures already being considered or implemented. The authorities appreciate the mutual trust developed through open dialogue during past consultations and value the Fund's expert advice.

Macroeconomic outlook and risks

Malta has been one of the fastest growing economies in Europe since the global financial crisis and the outlook remains favorable, supported by rising export-oriented services, notably remote gaming, business and professional services, information and communication, and tourism. Going forward, growth is expected to gradually converge to its potential rate, which the authorities estimate solidly above 4 percent.

As staff note, risks to the outlook are mainly external, notably rising global protectionism, a disorderly Brexit, and further tightening of global financial conditions. As a small open economy, Malta is highly exposed to external shocks and to mitigate these risks, the country has long been proactively promoting a well-diversified and competitive economy, together with fiscal prudence. With regard to Brexit, the authorities note that the overall impact on Malta may not necessarily be adverse, as the well-developed and internationally oriented financial sector might remain attractive and even benefit from relocating financial services providers.

Regarding domestic risks, the authorities are fully aware of the significance of reputational risks. Following some cases of weak implementation of the AML/CFT framework, they are taking prompt remedial action to preserve the attractiveness of Malta as an international financial center and a place to conduct business. Contrary to staff's assessment, the authorities are less concerned about the risk of a sharp downward correction in housing prices, as their recent rise, although rapid, has been largely driven by economic fundamentals, including sustained inflows of foreign workers and rising disposable income.

Safeguarding Stability, Integrity, and Innovation in the Financial System

Despite its large size, complexity, and linkages with the rest of the world, the Maltese financial system remains sound and well insulated from external shocks, as foreign-linked intermediaries have limited domestic exposures. The authorities welcome the strong resilience underscored by the solvency and liquidity stress tests carried out in the context of the FSAP mission, which were based on quite severe adverse scenarios.

The authorities remain vigilant over banks' asset quality, focusing on remaining pockets of vulnerabilities in the construction and real estate sectors. Since 2016 they have started to collect more granular data on loans and established a central credit registry for monitoring emerging risks closely. Moreover, the Central Bank of Malta will be imminently introducing borrower-based measures to prevent the buildup of vulnerabilities.

The FSAP found some gaps in the supervisory framework, which the authorities are addressing decisively. They agree that the operational capacity for the supervision and the crisis management functions has not kept pace with the rapid development of the financial system. The Malta Financial Services Authority (MFSA) has already upgraded the compensation package for its staff and started hiring new resources. In addition, the authority will be exempt from the regulation on public employment, which required the government's approval of the size of the staff complement, thereby ensuring that the MFSA's recruiting process is more efficient. The MFSA's operational autonomy will further benefit from the ongoing review of the regulatory fees, and by the adoption of a medium-term budget, with government contributions closing any shortfall of projected regulatory revenues. The authorities are also working on bringing the insolvency regime in line with international standards.

Similarly, the authorities have taken corrective action to safeguard financial integrity and maintain trust in the system, after the events which led to the revocation of Pilatus bank's license. This incident did not affect the stability of the financial system, as the bank was solvent and had no exposure to residents, but it raised reputational risks that required immediate action. The authorities have performed a thorough National Risk Assessment, which informed a detailed 50-point action plan, which they are implementing.

The authorities welcome staff's assessment that the plan goes in the right direction by, amongst other measures: adding resources to both the MFSA and the Financial Intelligence Analysis Unit (FIAU); fostering their collaboration though an already agreed Memorandum of Understanding, improving the understanding of risks among all competent authorities; enhancing the application of preventive measures, and of timely corrective measures, including dissuasive penalties.

Staff also recommended establishing a regional approach for the supervision of the AML/CFT framework. While noting that this recommendation should be elevated at the regional level, the authorities think that a regional supervisory framework would not be feasible and effective absent deeper and broader harmonization of national legislations.

The authorities intend to encourage the diffusion of advanced and innovative technologies. The government is developing a multipronged approach to facilitate a variety of applications of blockchain and artificial intelligence and has created a regulatory framework for the digital ledger technology and its application in the financial services industry. This new framework aims at enabling innovation and competition, while mitigating the related financial stability and integrity risks, and ensuring adequate protection of consumers and investors.

A Prudent Fiscal Policy oriented to Sustained and Inclusive Growth

The strong economic performance and the high take-up of the Individual Investor Program (IIP) boosted again revenues in 2018 and, together with lower than anticipated spending, contributed to a fiscal surplus well above the initial government target of 0.5 percent of GDP (exclusive of IIP proceeds). The budget for 2019 aims a smaller surplus to allow for higher capital spending and some targeted tax relief for the most vulnerable, in part offset by savings in current and interest outlays.

Malta is facing the challenging task of managing its own success. Robust and rapid growth have inevitably run into capacity constraints and increased the need for upgrading the physical and human capital. This requires large infrastructure projects to improve road quality and waste management, boost the supply and affordability of housing as well as health and education facilities and services.

The authorities are taking important steps to enhance the availability of financial and technical capacity to address structural bottlenecks and support actual and potential growth.

First, the authorities have completed and followed up on comprehensive spending reviews covering social security, health services, and education, as well as established an institutional framework for the comprehensive spending reviews process, including ad-hoc training of staff.

Second, the authorities are taking steps to improve the reporting of tax expenditures, public investment management and risk analysis, and the framework for managing fiscal risks. In this respect, they appreciate Fund's technical advice received during the recent Fiscal Transparency Evaluation.

Third, the authorities have already initiated major projects targeting road and maritime infrastructure, hospitals, laboratories, and waste management. These projects will be financed by public and private resources and managed by Infrastructure Malta, a public agency responsible for the entire procurement process, thereby avoiding delays resulting from necessary government's approval for each stage of the process.

Fourth, two specialized public agencies, Malta Enterprise and Malta Development Bank have explored several initiatives to enhance access to finance for SMEs, with a special focus on start-ups and more generally innovative sectors.

Finally, the authorities are focusing on measures to reduce absolute and relative poverty and improve social inclusion. They appreciate staff's analysis and valuable technical contribution to the policy debate, that supports current measures to boost women labor participation, lengthen working lives by rewarding late retirement, and upskill the local and foreign-sourced labor force.

Mr. Saito submitted the following statement:

We thank staff for informative set of reports and Mr. Fanizza and Ms. Cerami for their insightful statement. We welcome that the Malta's economic growth has been one of the fastest in the EU since the global financial crisis, supported by export-oriented services such as gaming and tourism. However, the economy faces important capacity constraints including infrastructure gaps, labor skill shortage and housing affordability. Moreover, deficiencies in the implementation of AML/CFT framework are source of concern. Against these backdrop, policies for enhancing economies resilience are needed. In addition, given the Malta's large and complex financial system and rising concern for AML/CFT enforcement, we agree with staff that additional efforts are needed to safeguard financial integrity and stability. As we broadly concur with the thrust of the staff's appraisal, we will limit our comments to the following points:

Fiscal Policy

Containing fiscal risks and shifting expenditure balance toward growth enhancing public investment are key in the medium term. We welcome that the fiscal balance in 2017 registered a record surplus and it is expected to over-achieve its budget target in 2018. It is also commendable that the structural balance excluding Individual Investor Program proceed is achievable in 2022. In these circumstances, reducing fiscal risks including strengthening monitoring and restructuring financially weak SOEs is important to maintain the favorable fiscal conditions. Furthermore, considering infrastructure bottleneck, shifting the composition of expenditures towards growth enhancing public investment is also needed. While we welcome that the government plans to institutionalize comprehensive spending reviews, we encourage the authorities to take into account long-term impacts of age-related spending and strengthen efforts to reduce the cost. Do the authorities plan to implement reforms to reduce age-related fiscal costs?

Financial Sector Policy

Continued efforts are needed to safeguard financial stability and integrity. We welcome staff's comprehensive financial system stability assessment and their finding that the banking sector is healthy, as banks are well capitalized, liquid and profitable. However, the large financial sector connected with the rest of world requires enhancing macroprudential framework, strengthening supervision and crisis management capacity, and developing effective AML/CFT enforcement. Given the increasing demands of supervising the growing number of financial institutions under complex environment, we call for strengthening supervisory capacity in terms of both number of staff with expertise and operational independence of the Malta Financial Services Authority. Containing financial integrity risk should also be a priority as it would create reputational risks and add pressure on corresponding banking relationship (CBR). It is even more important as the authorities are exploring new development areas around blockchain technology. Could staff elaborate on the seriousness of losing CBRs and authorities plan to mitigate the risk in addition to addressing AML/CFT deficiencies? While the government established a new regulatory framework for distributed ledger technology and virtual financial assets, we would like to hear staff's views on whether the regulation strikes a right balance between harnessing the technology and mitigating risks, and whether the framework can be a role model for other jurisdictions.

Structural Policy

Addressing structural weakness is imperative to promote sustained and inclusive growth. We note that capacity constraints hinder higher and inclusive growth. To expand the production capacity, we agree with staff that upgrading public infrastructure, increasing access to finance, and promoting labor force participation are needed. Particularly, given the remaining gender gap in terms of labor market participation, further efforts for enhancing female labor market participation are encouraged. To this end, we support the staff's view that further initiatives such as introducing some compensation for parental leave or increasing leave entitlement for fathers could be considered to catch up with EU average.

Ms. Pollard and Ms. Svenstrup submitted the following statement:

We thank staff for a well written report and for the comprehensive Financial System Stability Assessment.

The significant structural shift in the Maltese economy toward service exports over the past decade has resulted in rapid growth, a reduction in poverty, and increased economic convergence with the EU. However, this shift has also increased risks, particularly in the financial and housing sectors, and highlighted capacity constraints. We broadly agree with staff's analysis and policy recommendations, in particular the need to implement further macroprudential policies to help mitigate housing and financial sector risk, improve public investment management and boost growth-enhancing public infrastructure investment, and focus on improving measures of social inclusion that will also support long-term growth.

The FSSA rightly stresses the urgent need for Maltese authorities to address gaps in supervision, resolution, and crisis management. Given the size and unique features of Malta's financial sector, it is critical for the authorities to take immediate action to strengthen the enforcement of the AML/CFT framework and ensure that banks apply preventative measures in relation to their high-risk activities and clients. We strongly urge the authorities to take the specific measures linked to AML/CFT supervision articulated in paragraph 15 of the staff report.

We also agree with staff that the authorities should take further action to ensure financial and operational independence of supervisory authorities. As staff rightly note, developing a regulatory framework around digital assets and distributed ledger technology is not sufficient. Enforcement and supervision must keep pace with new business models and firms in order to safeguard financial integrity. How do staff assess the risk of regulatory arbitrage around digital asset activity in Malta?

Finally, regarding the Risk Assessment Matrix, could staff provide more context on the “unsustainable policies” at the national level in the EU, specifically what would be the channels for such policies to affect Malta?

Ms. Riach submitted the following statement:

We thank staff for their informative set of papers in the context of Malta’s Article IV consultation and financial sector assessment. We also thank Mr. Fanizza and Ms. Cerami for their informative buff statement.

While we acknowledge Malta’s impressive macroeconomic performance, we recognize that the authorities face significant challenges including managing those factors which have been the main drivers of recent success. The benefits of rapid growth, the inflow of foreign workers, significant revenues from the Individual Investor Program (IIP), and the first-mover advantage of adopting new financial technologies could wane quickly. Therefore, we agree with staff that the authorities should address capacity constraints through more infrastructure investments, upskilling the workforce and improving labor participation, while enhancing Malta’s resilience through better financial oversight and prudent fiscal planning that does not rely on temporary resources. We welcome the numerous steps by the authorities to this end, which should be implemented in full and without delay; nonetheless, we encourage the authorities to continue efforts to improve the effectiveness of the AML/CFT framework.

Macroeconomic developments

Malta’s remarkable growth performance is set to continue. Over the last 5 years or so, the Maltese economy has outperformed the euro area average by a considerable margin. As staff note in their report, this allowed a rapid income convergence to the rest of the euro area. At the same time, staff's analysis suggests that capital formation has not kept pace with growth. Therefore, going forward, the authorities will have to devote more resources to upgrading infrastructure and to ensure that the labor force can expand further. Although external risks clearly dominate – Malta is a very small, open economy – the authorities' success in boosting productivity, ensuring a transparent business environment and demographic challenges will determine longer-term growth.

Fiscal policies

Fiscal policy is on a solid footing and maintaining a prudent stance will be important considering medium- to long-term risks. We welcome the strong fiscal performance in recent years, even disregarding revenues from IIP, that allowed a further rapid reduction in public debt to below 50 percent of GDP. However, public finances still seem highly dependent on the IIP proceeds and on corporate income taxes, which implies that the budget is highly sensitive to economic shocks and to international initiatives on corporate taxation. Against this background, we welcome the authorities' commitment to maintain a balanced structural fiscal position net of IIP proceeds, which will also help ensure space for much needed growth-enhancing investment in infrastructure and inclusion-promoting measures. In addition, contingent liabilities related to SOEs and long-term increases in age-related expenditure remain a source of vulnerability. We welcome the ongoing spending review and its planned institutionalization that could help identify further budget savings. At the same time, further efforts are needed to curb the increase in age-related spending (i.e. deter early retirement and increase the take-up of private pension schemes).

Financial market policies

As highlighted in the FSSA report, Malta's banking system is well capitalized, liquid and profitable. However, there is a risk of erosion of bank's profitability in the long run and pockets of vulnerability remain, especially related to the housing market and in enforcing the AML/CFT framework. As strong demand for housing has been pushing up property prices domestic banks have also shifted their portfolio towards mortgage lending resulting in relatively high household indebtedness and banks' increased exposure to the real-estate market. Against this background, we welcome the authorities' recent efforts to close data gaps as well as the planned introduction of borrower-based macroprudential measures. We also agree that the new borrower-based measures could be adjusted to narrow down exemptions to the LTV limits for loans against secondary and buy-to-let properties, and to extend their scope to also cover non-bank mortgage loans. The revocation of Pilatus bank's license by the ECB has revealed gaps in the supervisory and enforcement capacity of Malta's AML/CFT framework. Given the size and importance of Malta's financial sector, the exposure of certain banks to correspondent banking risk, the fast-growing remote gaming sector, development of virtual financial assets and the high demand for the IIP, the effective enforcement of the AML/CFT framework is critical. We take positive note, in this regard, of the authorities' recently-enacted 50-point action plan (based on the latest National Risk Assessment) that should be fully implemented without delay.

We share the view that capacity constraints and gaps in the regulatory framework undermine the effectiveness of financial supervision and crisis management. The Malta Financial Services Authority (MFSA) is under strain due to the increasing number of financial entities under supervision, the rapid development of new products and the evolving regulatory framework. There are large gaps in operational supervisory capacity. The IMF analysis, in addition, points to gaps in winding-up and crisis management functions. We agree with staff on the need for effective supervision by the MFSA, including its operational independence, transparent processes, sound governance and adequate resources. However, providing MFSA with a financial stability objective could create overlaps between the objectives of the CBM (macroprudential authority) and the MFSA (microprudential authority) and related accountability problems. The recommendation of the Financial System Stability Assessment (FSSA) to ensure that MFSA powers and functions (or tasks) remain distinct from those of the CBM would manage this risk.

Structural policies

To promote high and inclusive growth, infrastructure gaps and skill shortages must be addressed. Staff highlight in their report that the rapid employment growth that was needed to support the fast-paced growth was made possible by attracting a considerable number of foreign workers. Indeed, the female labor participation rate in Malta is still below the EU and euro area averages, although the trend has reversed among younger cohorts, and Malta still ranks amongst the lower performers in the EU regarding its educational attainment rate despite relatively high spending. Therefore, further measures would be needed to strengthen employment and educational attainment to enhance human capital and contribute to productivity and potential output growth. Keeping foreign workers in Malta in the more cyclical sectors of the economy could also prove to be a challenge. We welcome the increased focus on public investments in road infrastructure, hospitals, education, and waste management. At the same time, we would encourage the authorities step up efforts to tackle inefficiencies in the public administration and in the judicial system, notably by fighting corruption and reducing administrative hurdles for companies, as well as policies to increase competition in the non-tradable sector.

Mr. Sigurgeirsson and Ms. Skrivere submitted the following statement:

We thank staff for the comprehensive Article IV and FSSA reports and Mr. Fanizza and Ms. Cerami for their informative BUFF statement. We broadly share staff's appraisal and agree that while growth in Malta remains exceptionally strong, some challenges are on the rise, and it is particularly important to pursue efforts to safeguard financial sector integrity and stability. We associate ourselves with the statement by Ms. Riach, and we offer the following additional remarks on financial sector integrity, supervisory capacity, fiscal policy, and structural reforms.

While financial stability risks appear contained, more forceful actions are needed to address financial integrity risks. Recent events related to Pilatus bank, and, more broadly, the scale of Malta's financial sector, risks of correspondent banking withdrawal, the rapidly growing remote gambling sector and the individual investor program (IIP), and potential inroads into virtual financial assets, all highlight the need to urgently address the remaining deficiencies in effectively implementing the AML/CFT framework. Enhanced cooperation among relevant supervisory and law enforcement agencies is particularly important. We look forward to the results of the assessment against the FATF standard.

We stress the importance of ensuring the operational independence and adequate capacity of the financial sector supervisor. As the number of financial entities under supervision in Malta continues to increase and new products and innovations (including crypto-asset-related companies) are emerging, it is crucial to increase supervisory capacity and ensure that the MFSA has stable funding and full autonomy over its recruitment process, so that it can recruit and retain appropriately qualified staff.

While maintaining a prudent approach, the authorities could consider a more growth-enhancing fiscal policy. We note the authorities' prudent approach to target fiscal balances net of IIP proceeds, which appear to be sizeable but somewhat volatile. This has led to a welcome reduction in public debt levels. Going forward, the authorities should consider the composition of fiscal adjustment, in particular shifting more towards growth-enhancing public investment to address infrastructure gaps, for example improving road quality.

The Maltese authorities should address structural weaknesses in the judicial system, promote innovation, and address labor and skills shortages. We share staff's recommendations on the need to improve the judicial system's efficiency and reduce the time needed to resolve court cases in Malta, which could also contribute to reviving credit growth. As Malta's R&D expenditure lags behind EU averages, we encourage the authorities to consider ways how to support innovation, including in start-ups, that could boost productivity. An important factor contributing to innovation is a highly-educated workforce. We note staff's findings that despite relatively high spending on education, the results remain below those in many other countries, and, therefore, encourage the authorities to assess the efficiency of education spending. While we welcome the authorities' efforts towards increasing female labor force participation, we agree with staff on the need for continued efforts on that front.

Mr. Merk and Mr. Buetzer submitted the following statement:

We thank staff for its insightful report and Mr. Fanizza and Ms. Cerami for their helpful buff. We concur with the thrust of staff's assessment and the given policy recommendations. We associate ourselves with Ms. Riach's statement and would like to add the following comments.

The Maltese economy has experienced robust real GDP growth, mainly driven by export-oriented services. Nonetheless, the economy appears to have reached a cyclical peak. Robust GDP growth, supported by large inflows of foreign workers, has put rising pressures on infrastructure and especially on housing prices. The banking sector is not only intensely exposed to real estate risks but also to external developments due to its strong international orientation, posing downside risks to financial stability. Regarding fiscal policy, public finances have improved as a consequence of prudent fiscal policy and large proceeds from the Individual Investor Program (IIP), exceeding medium-term objectives. Looking ahead, fiscal policy should focus on reducing fiscal risks and shifting expenditures more towards growth-enhancing investments.

The reliance on the services and external sector as well as on foreign labor exposes Malta to heightened external risks. The rapid expansion of services exports has boosted the Maltese current account balance and the economy as a whole. However, we take note that the growth momentum may have passed, indicated by a decrease of real exports and a smaller contribution of net exports to growth. In this context, we would like to emphasize the risks as outlined by staff in the report which could reduce exports as well as FDI flows to Malta in a significant way, thereby weighing on economic activity.

In light of Malta's large and complex financial system, with a high share of foreign ownership, and its recent actions with regard to distributed ledger technology, we agree with staff that the shortcomings in the supervision of financial institutions need to be addressed adequately. While we take positive note of the reduction of NPLs in core banks, the financial sector is still exposed to high risks. These could emanate from money laundering, increased exposure to the housing market, and inefficient insolvency proceedings. Furthermore, contagion, concentration, and liquidity risks stemming from the high share of intercompany loans pose a risk to financial stability. Malta is expected to attract crypto–asset related businesses, which present chances as well as risks for the Maltese economy. Overall, we support the findings of the Financial System Stability Assessment and staff's corresponding policy recommendations, including for a five-year plan to ensure sufficient budgetary resources for the MFSA.

In this context, we would like to particularly emphasize the need to safeguard financial integrity by improving the AML/CFT framework and enhancing the monitoring of the non-bank financial sector. We note that the FSAP highlighted that large gaps in operational capacity for the supervision, winding-up, and crisis management functions have become apparent and need to be addressed urgently. In order for the supervisor to implement the necessary measures, steps should be undertaken to guarantee long-term financial and operational independence of the supervisory authorities.

On the housing market, we would like to stress that rapidly rising house prises coupled with high household indebtedness can pose an important risk to financial stability. We take positive note of the authorities' plan to address this matter through the introduction of borrower-based macroprudential measures. Moreover, we concur with staff that further efforts are needed to promote private investments in the provision of social housing and thus accelerate the process. In this context, we would appreciate further comments on the projects that are underway to increase the stock of social and affordable housing which are alluded to in para. 22.

We welcome the reduction in public debt, which was supported by favorable economic conditions and growing proceeds from the IIP. However, we agree with staff that Malta's dependence on the IIP and on revenues from corporate taxes make it vulnerable to potential regime changes. We therefore echo staff's call for continued efforts to strengthen the structural fiscal position. We also share staff's view that Malta would benefit from further improving fiscal transparency practices. As regards fiscal pressures from demographic developments, raising incentives to take up private pension schemes and to deter early retirement would be helpful.

We agree with staff that the Maltese government should promote strong and inclusive growth by reducing fiscal risks and shifting its expenditures more towards growth-enhancing public investment. In this context, could staff further elaborate on their assessment of physical infrastructure gaps and the expected evolution of public investment? Given demographic pressures, widespread skills shortages, relatively low female and elderly participation in the labor market, as well as low R&D expenditures in comparison to the EU average, we encourage the authorities to address these structural challenges. While we welcome the recent government initiatives such as the new Work-based Learning and Apprenticeship Act, we support staff in its call for sustained efforts to improve labor productivity, innovation, and inclusion. We take note of staff's analysis that promoting social inclusion may boost long-term output.

Mr. Just and Mr. Stradal submitted the following statement:

We thank staff for their comprehensive and candid set of reports and Mr. Fanizza and Ms. Cerami for their buff statement. Malta's economic growth has significantly outperformed that of its euro area peers since the Global Financial Crisis, resulting in low unemployment and improved public finances. However, the economic expansion has regrettably not been accompanied by commensurate improvements in the regulatory frameworks which leaves Malta widely exposed to integrity risks. The recent revocation of the banking license of Pilatus Bank, as well as the inclusion of Malta's passport selling on the OECD's blacklist of schemes facilitating tax evasion, are cases in point. We associate ourselves with Ms. Riach's statement and would like to add the following comments.

We welcome the results of the stress test showing that the banking sector is generally well capitalized, sufficiently liquid and profitable. We take note of the growing exposures to the real estate sector. We welcome the authorities' efforts to collect loan level data and encourage the timely introduction of macroprudential measures to mitigate the credit cycle.

We are highly concerned by the significant shortcomings in bank supervision as detailed in the Financial System Stability Assessment (FSSA). In combination with cross-border linkages of the large financial sector, the growing importance of non-bank financial institutions, the development of distributed ledger technologies, as well as the practice of selling citizenship, it renders the issue of money laundering as truly macro-critical. In this vein, we take note of the approximately 75 percent of non-resident deposits in non-core banks, as shown in Figure 11 of the FSSA report. We welcome the authorities' acknowledgement that the effective implementation of the AML/CFT framework is key for retention of correspondent banking relationships. We call on the authorities to urgently implement the multi-pronged remedial measures aimed at improving the AML/CFT supervision, including a significant upsize of the supervisory capacities.

We concur with staff that prudent fiscal policy should be maintained in view of the heightened fiscal risks and that the tax base should be broadened to diminish the excessive reliance on corporate income taxes and the citizenship sales proceeds. We also agree that rebalancing of public expenditures towards growth-enhancing public investment measures is warranted given the infrastructure gaps. Improved governance of public investments, as well as of public administration, including the judicial proceedings, will be key complements in this respect. We welcome the recent efforts to facilitate financing of the small and medium-sized enterprises which should contribute to the diversification of the economy.

Mr. Tan and Ms. Pandit submitted the following statement:

We thank staff for the well-presented papers and Mr. Fanizza and Ms. Cerami for their informative buff statement. Rapid structural rebalancing has underpinned Malta's robust economic momentum in recent years, delivering strong employment and income growth while helping to strengthen the fiscal position. Nevertheless, financial system risks remain a near-term headwind, while enhancing social inclusion and tackling structural bottlenecks in physical and human capital are key medium-term priorities. We agree with the thrust of staff's appraisal and would like to raise the following comments for emphasis.

Efforts should continue to enhance the stability and integrity of the financial system. We note positively that the Maltese banking system remains well capitalized and liquid but agree that the authorities should keep an eye on the increase in non-bank lending. The importance of the financial system and sectors such as remote gaming heighten the country's exposure to money laundering risk, and the growth in activity relating to virtual assets and distributed ledgers could also present new vulnerabilities. We welcome the establishment of a new regulatory framework for DLT and virtual financial assets. Like staff, we encourage the authorities to press on with strengthening the AML/CFT framework and its enforcement. Could staff provide a sense of the pace of growth of virtual assets investment in Malta? This calls for strong regulatory and supervisory capacity. In this regard, we note the FSAP's finding of capacity constraints at the MFSA and concur with staff that swift steps should be taken to ensure the adequacy of MFSA resources. We are encouraged by the measures reflected in the buff statement, and in view of growing housing market risks, we see the development of sound supervisory judgment and technical competence as a complementary tool to the planned introduction of housing-related macroprudential instruments to address banks' rising exposure to real estate risks

More transparent and efficient fiscal policy will support fiscal sustainability and continued economic development. We welcome the authorities' prudent fiscal management to date that has contributed to higher fiscal space and lower public debt. Once implemented, the planned institutionalization of the spending reviews and strong revenue collection should further broaden the fiscal room for additional growth-enhancing infrastructure investment and measures to promote inclusion, while we take positive note that Malta has met many of the Fund's fiscal transparency indicators, we agree with staff on the scope for further enhancement including strengthening public investment management through cost-benefit analysis and publication of fiscal risk statements.

Promoting high and inclusive growth is vital to shift to a more resilient and sustainable growth model. Despite the commendable performance of the Maltese economy, several structural issues such as challenging labor market conditions, significant public infrastructure gaps, weak access to SME financing and inefficient judicial process linger. We welcome the authorities' continued commitment to structural reforms to improve economic resilience and social inclusion. As elaborated in the selected issues paper, such reforms may serve to bolster potential growth in the long-term. In this regard, we agree with staff that further efforts to foster inclusive labor market participation and reduce the domestic skills mismatch and income inequality should remain a policy priority for Malta.

With these comments, we wish Malta and its people continued success in their future endeavors.

Mr. Rashkovan and Mr. Cools submitted the following statement:

We thank staff for their informative set of papers on Malta's Article IV consultation and Financial System Stability Assessment and Mr. Fanizza and Ms. Cerami for their insightful buff statement. We associate ourselves with Ms. Riach's statement and would like to add the following points for emphasis, regarding 1) the need to upgrade the MFSA's supervisory capacity; 2) road congestion issues in Malta; and 3) the Selected Issues Paper on Promoting Inclusive Growth.

The FSSA rightfully highlights the need for an imminent strengthening of the supervisory capacity of the MFSA. We fully subscribe to this recommendation, especially given Malta's international banking sector, with many of its banks providing banking services elsewhere in the European Economic Area under free provision of services. In light of this, we welcome Mr. Fanizza's and Ms. Cerami's assurances on the upgrading of the operational capacity for supervision, crisis management, and AML/CFT supervision.

The staff report also mentions that the Cabinet has approved that future funding of the MFSA will be sourced through an overhaul of the MFSA's fee structure coupled with government's budgetary support. Mr. Fanizza and Ms. Cerami confirm in their statement that government contributions should close any shortfall of projected regulatory revenues. While this seems to be a welcome development needed to ensure the necessary resources for the MFSA, we wonder whether this means that the share of government funding for bank supervision will increase? Does staff have a view on the need for bank supervision to be paid for by the supervised banks?

Staff rightly highlights the need for upgrading Malta's road infrastructure. Staff subscribes to an impressive 700 million EUR investment plan in road infrastructure. Were any alternative sustainable options considered, e.g. allocating a part of the funding to public transport as opposed to more road infrastructure? Can we be assured that staff's advice here is compatible with the policy objectives related to the environment and sustainability?

Finally, we very much welcome the Selected Issues Paper on 'Promoting Inclusive Growth in Malta' and the use of the macroeconomic model developed in the Research Department on the economic impact of increasing childcare and aftercare benefits, extending working lives, and upskilling the labor force. Can staff elaborate on other country experiences with this model and clarify when they intend to use this model going forward in other countries' Article IV consultations?

Mr. Raghani, Mr. Bah and Mr. Ndong Ondo Bilee submitted the following statement:

We thank staff for the comprehensive set of papers and Mr Fanizza and Ms. Cerami for their helpful buff statement.

The steadfast implementation of prudent policies and sound structural reforms over recent years has enabled the Maltese authorities to achieve good macroeconomic performance. Supported by demand-enhancing macro policies, growth-friendly reforms and rising exports, the output of this open economy grew by more than 6 percent in 2017 and 2018, while inflation remained below 2 percent. We also note that the fiscal balance has continued to improve with surpluses outperforming the budget targets. Moreover, the current account recorded surpluses, increasing from 3 to 10 percent of GDP from 2016 to 2017. As a result of the buoyant activity, the unemployment rate stood below 4 percent in 2018.

Looking forward, we encourage the authorities to continue the implementation of sound policies and far reaching structural reforms to further strengthen the economy's good macroeconomic performance and unleash its potential growth. We commend the fact that risks to Malta's economic prospects remain broadly balanced in a context of rising global trade tensions and weakening regional and global environment. The key external risk facing Malta being protectionism, we agree on the need to continue ongoing policy measures to sustain domestic demand—notably investment and private consumption—while forcefully addressing domestic risks, including money laundering. In this respect, further efforts will be needed to enhance fiscal policy, promote more inclusive growth, and safeguard financial stability and integrity.

We commend the authorities for their prudent fiscal policy of successive fiscal surpluses supported by both high tax revenues and controlled spending. We are pleased with their commitment to pursue this sound policy to enlarge the fiscal space for further investment and ensure social transfers going forward. In this regard, we welcome the 2019 budget's actions to further increase revenue mobilization through additional efforts to combat tax evasion and avoidance and increase VAT compliance. We also see merit in measures designed to alleviate the tax burden on vulnerable populations and restore the financial soundness of some state-owned enterprises. On the expenditure side, we share the view that introducing cost-benefit analysis and publishing fiscal risks statements will strengthen public investment management. Furthermore, the proposed comprehensive spending reviews should help identify additional saving opportunities.

The soundness and resilience of Malta's financial sector thus far is praiseworthy. However, continued efforts are necessary to address risks to financial stability and integrity. Recent developments in the housing market call for refinements to the macroprudential toolkit, notably by introducing borrower-based instruments to mitigate risk concentration. As the number of financial entities under supervision grows and related products become more complex, actions are required to strengthen the regulatory framework and the operational and financial capacity of Malta Financial Services Authority (MFSA), including the crisis management function, in line with FSAP recommendations. Malta being a financial center, with exposure to crypto-assets, remote gaming, and individual investor program (IIP), we strongly encourage the authorities to implement a risk-based AML/CFT framework. The application of preventive measures regarding financial entities' higher risk services and clients will be essential in this regard and helpful to contain the risks facing the financial integrity of banks and preserve their correspondent banking relationships. Staff's elaboration on progress made to mitigate the ML/FT risks under the cooperation with the European Banking Authority is welcome. In addition, regarding the authorities' intention to promote innovative technologies in the financial service industry, we wonder what application of blockchain is being considered (i.e. smart contracts, securities, record keeping, digital currency, etc.) and which sectors are being targeted. Moreover, what is this project's potential to increase fiscal revenue and save costs? Staff elaboration will be appreciated.

The authorities should pursue their structural reform agenda to foster higher and inclusive long-term growth. In this regard, efforts must further focus on upgrading public infrastructure notably through Infrastructure Malta, facilitating SMEs' access to finance, boosting research and development expenditure, and advancing judicial system reforms. We invite the authorities to build on the progress made thus far in reducing poverty and promoting social inclusion as highlighted in the informative Selected Issues paper to make further strides towards inclusiveness. This can be achieved through policies to narrow inequalities, increase women labor force participation, align the retirement age with life expectancy, and enhance workers' skills.

With these remarks, we wish the Maltese authorities' success in their endeavors.

Mr. Moreno and Mr. Montero submitted the following statement:

We thank staff for its comprehensive set of reports and Mr. Fanizza and Ms. Cerami for their useful buff statement. We broadly share staff's appraisal and associate ourselves with Ms. Riach's statement. We would like to add the following comments for emphasis.

Prudent fiscal policy and successful structural reforms have underpinned a period of impressive growth and job creation in the Maltese economy, allowing also for a rapid structural rebalancing towards export-oriented services. This has also helped strengthen both external and public accounts and maintain a high degree of social cohesion. However, this positive performance seems to be hitting its limits due to increasingly biting capacity constraints, in terms of both physical infrastructure capital and human capital—as labor supply relies heavily on migrant inflows—which may have negative implications for long-term growth and social inclusion.

As shown in the FSAP, the banking system remains well capitalized, liquid and profitable, with vulnerabilities limited to a few small banks. We share staff's view that the increasing importance of intercompany lending and non-bank financial institutions pose a threat to bank profitability and financial stability going forward, thus warranting enhanced data collection and monitoring efforts. Moreover, we urge the authorities to address gaps in operational capacity for the supervision—including the strengthening of its independence—winding-up and crisis management functions. This is all the more pressing in view of the increasing role expected to be played by crypto-asset related companies.

Strong demand for housing has continued to push up property prices, with incipient signs of some overvaluation. Apart from fundamentals, this house price trend is reinforced by the existence of a variety of tax incentives. These benefits may not be accruing to the intended persons, but appropriated by housing developers through higher prices. Besides, they may be expensive in fiscal terms. Could staff provide an estimate of the fiscal cost of these benefits and an assessment of its efficiency? Banks' exposure to housing-market-related risks is high and increasing, so we commend the authorities for the planned introduction of a comprehensive set of borrower-based macroprudential measures, such as caps to LTV ratios and DSTI limits. We nonetheless see merit in the proposal to fine tune these measures along the lines suggested by staff, in particular to extend their scope to also cover non-bank mortgage loans.

We note with concern recent developments in the area of AML/CFT, which has resulted in the revocation of a bank's license. We take positive note, in this regard, of the authorities' recently-enacted 50-point action plan that should be fully implemented without delay. We echo FSAP's recommendations to focus on banks' application of preventive measures regarding high-risk services and clients, including the significant non-resident sector, politically exposed persons, new technologies and the individual investor program. We also see merit in staff's proposals in the areas of intrusive risk-based supervision, customer due diligence, fit and proper tests, sanctions and EU-level arrangements.

We concur with staff that plans to reach fiscal balance without relying on IIP revenues in the short to medium term seem appropriate. However, efforts to shift expenditure towards growth-enhancing public investment and to reduce the high reliance on the IIP and corporate taxation should remain the priority of fiscal policy going forward. Those efforts would ensure fiscal space to address infrastructure bottlenecks—by improving road quality and waste management, boosting the supply and affordability of housing as well as health and education facilities and services—while at the same time contributing to mitigate fiscal risks. On a more structural note, we support staff's priority measures that aim to incentivize female labor supply, enhance workers´ skills and align retirement age with life expectancy, as they would foster both long-term growth and social inclusion.

Mr. Sun and Mr. Huang submitted the following statement:

We thank staff for the set of papers and Mr. Fanizza and Ms. Cerami for their informative buff statement. The Maltese economy continues its robust growth on the back of strong service exports. As a financial center and a small and open economy, it is essential for Malta to safeguard its financial stability and integrity, and enhance its economic resilience. We agree with the thrust of staff's appraisal and would limit our comments to the following.

Blockchain technologies and virtual assets bring not only opportunities but also challenges. The establishment of a legal framework for the adoption of digital ledger technology and crypto-assets is an important step for making Malta a virtual financial asset exchange center, therefore boosting export of services. At the same time, the adoption of such technologies could also bring about challenges such as money laundering/terrorist financing risks. In this regard, it is important to implement the AML/CFT requirements in line with the Financial Action Task Force standards, as suggested by staff. It is also important to enhance financial consumer protection, given the high volatility of virtual asset prices and its vulnerabilities to cyber-attacks.

The banking system is broadly healthy, but some vulnerabilities warrant attention. The recent withdrawal of Pilatus bank's license indicates deficiencies in implementing the AML/CFT framework. The authorities' recent actions to safeguard financial integrity, including a thorough National Risk Assessment, are commendable. We share staff's concerns on the recent rising house prices and banks' increasing exposures to the housing market. Could staff elaborate more on the composition of the housing market demand? Are there significant international capital inflows into Malta's housing market? If so, do staff have any policy suggestions on capital flow management?

Enhancing economic resilience is important for a small and open economy like Malta. The pillar industries of Malta, online gaming and tourism, are not only pro-cyclical, but also dependent on external demands. Against this backdrop, we welcome the efforts the authorities have taken to keep fiscal policy prudent and to bring the debt-to-GDP ratio down. The authorities also make good use of recent favorable conditions to upgrade road infrastructure and push forward structural reforms. Going forward, we encourage the authorities to diversify the economy to make it more resilient to cyclical downturns, and to improve domestic human capital to make the economy less dependent on higher-skilled foreign workers.

With these remarks, we wish the authorities every success in their policy endeavors.

Ms. Levonian, Ms. McKiernan and Mr. Mooney submitted the following statement:

We thank staff for their comprehensive report and Mr. Fanizza and Ms. Cerami for their informative buff statement. The Maltese economy continues to perform well as reflected in strong growth accompanied by moderate inflation, record low unemployment, and declining public debt. Notwithstanding these positive outcomes, Malta still faces a number of challenges which require ongoing attention. We broadly concur with staff's assessment and recommendations and offer the following remarks for emphasis.

We note that economic growth is set to remain healthy, with the current account surplus remaining large over the forecasting horizon. We agree with staff's assessment that the priority over the coming years should be the containment of fiscal risks and the shifting of expenditure towards growth-enhancing public investment. We welcome the authorities' commitment to maintaining a prudent fiscal policy which prioritizes addressing infrastructure gaps and social challenges arising from rapid growth.

We welcome the findings of the FSAP that the banking system in Malta is in good health, while noting that its profitability is at risk, due to factors such as the tightening of financial markets and the ongoing requirements to meet EU bail-in rules. We note the FSAP recommendation pertaining to the development of more effective AML/CFT enforcement and welcome the ongoing commitment by the authorities to safeguard financial stability and integrity. We welcome the reduction in the overall NPL ratio in the core banks in recent years while noting the legacy NPLs in the construction and real estate sectors.

We support the authorities' inclusive labor market policies, in particular the promotion of female labor participation, and note the conclusion in the SIP that such policies are expected to boost potential growth, employment, and consumption. We note the increase in property prices and the consequent risks to vulnerable households and financial stability noted in the report. While the Maltese authorities view these price rises as reflecting economic fundamentals of higher general income and inflows of foreign labor, we encourage continued vigilance by the authorities in this regard.

Mr. Di Tata submitted the following statement:

We thank staff for the informative set of reports on the Maltese economy and Mr. Fanizza and Ms. Cerami for their insightful buff statement.

Malta continues to experience a prolonged period of fast economic growth based on rising export-oriented services, notably remote gambling and tourism, but the economy may be approaching its cyclical peak. The strong economic performance has been supported by a prudent fiscal policy and successful structural reforms, but heavy reliance on foreign labor is increasing pressures on housing and public infrastructure. Real GDP growth is estimated at 6.4 percent in 2018 and is expected to converge gradually to its potential growth rate. Could staff comment on reasons for the difference between its own projection of potential growth (slightly above 3 percent) and that of the authorities (4 percent)? In addition to rising protectionism and the possibility of a sharp tightening of global financial conditions, external risks also include possible changes in international corporate and personal taxation. At the same time, the main domestic risks identified in the report comprise a sharp correction in housing prices, slow progress in addressing structural deficiencies, and failure to implement effectively the AML/CFT framework.

The authorities should be commended for their prudent fiscal management. Strong revenues and the IIP program contributed to a fiscal surplus well above the initial government target of 0.5 percent of GDP in 2018, with the debt to GDP ratio falling to 45 percent. Looking forward, we welcome the authorities' plans to reach fiscal balance without relying on IPP proceeds and to reduce the public debt further to 30 percent of GDP by 2023, particularly in view of the still high level of contingent liabilities and strong demographic pressures. We also welcome the authorities' intention to reorient expenditures towards public investment and improve transparency, including through the planned institutionalization of comprehensive spending reviews and improvements in the reporting of tax expenditures, public investment management, and the framework for managing fiscal risks. We encourage the authorities to complement these measures by restructuring financially vulnerable SOEs, exploring further incentives to deter early retirement and increase the take up of private pension schemes, and address the pending recommendations made by the May 2018 Fiscal Transparency Evaluation. Could staff elaborate on possible additional measures to broaden the tax base?

The FSAP conducted recently concluded that the banking system remains well capitalized, liquid and profitable, but faces several challenges. We welcome the authorities' efforts to remain vigilant over banks' asset quality, focusing on the construction and real estate sectors, as well as the planned introduction of housing-related macroprudential instruments that could be refined in the future. We notice that banks' profitability remains above peers in the euro market but could be affected by several factors, including increased regulatory compliance costs for banking institutions and competition from the rapidly growing corporate bonds market and from non-bank financial institutions. In this regard, we agree with staff on the need to enhance data collection and monitoring of non-bank financial institutions and intercompany lending, which have become the most important sources of funds for firms. We welcome the establishment of a central credit registry.

We take positive note of the steps being taken by the authorities to address the gaps identified by the FSAP in the supervisory framework, including those to strengthen the financial and operational independence of the Malta Financial Services Authority (MFSA). These steps comprise the decision to upgrade the compensation system for MFSA staff and hire new resources, as well as the ongoing review of regulatory fees and the adoption of a medium-term budget. We also welcome the efforts under way to bring the insolvency regime in line with international standards.

Regarding the AML/CFT framework, we encourage the authorities to address promptly the shortcomings identified by staff in the Financial Intelligence Unit (FIAU) and in the MFSA's authorization and supervisory practices. Prompt actions are needed to contain financial integrity risks, particularly in view of the exposure of certain banks to correspondent banking risks, fast growing remote gaming, and high demand for IIP. In this regard, we welcome the measures taken to implement the recently enacted 50-point action plan based on the National Risk Assessment, as well as the development of a regulatory framework for the digital ledger technology and virtual financial assets. Going forward, we encourage the authorities to ensure that virtual financial asset service providers implement AML/CFT requirements in an effective manner. Could staff elaborate on the differences of opinion with the authorities regarding the possibility of establishing a regional approach for AML/CFT supervision?

Regarding structural reforms, we welcome the authorities' focus on infrastructure, including roads, maritime infrastructure, hospitals, laboratories, and waste management. As noted by staff, these projects should give proper attention to efficiency by reviewing administrative procedures and avoiding bottlenecks. In this regard, the creation of Infrastructure Malta, a public agency responsible for the entire procurement process, appears to be a step in the right direction. We also encourage the authorities to continue with the efforts under way to provide financial support to innovative businesses and investment finance to SMEs; improve the efficiency of the judicial system, especially for insolvency procedures; address social inclusion, including by incentivizing female and elderly labor market participation; and enhance human capital by strengthening vocational education and training.

With these comments, we wish the Maltese authorities every success in their future endeavors.

Mr. Trabinski and Mr. Danenov submitted the following statement:

We thank staff for a valuable set of papers and Mr. Fanizza and Ms. Cerami for their insightful buff statement. We welcome the strong and increasingly balanced economic growth of Malta on the back of prudent macroeconomic policies and reforms. We note that some growing sectors can be considered cyclical and sensitive to a changing regulatory environment, which in combination with high openness of the economy can weight on its shock-absorbing capacities. We broadly share the thrust of staff's appraisal and agree with the assessment of risks included in the RAM.

We commend the authorities for maintaining prudent fiscal stance. Improved tax revenues and high profits stemming from the Individual Investor Program contributed to another year of fiscal surplus in 2018. We encourage the authorities to shift from the focus on fiscal expenditures towards infrastructure investments and social transfers to the most vulnerable, using created fiscal space. We agree with staff that further improvements in revenue collection and public management are needed. Moreover, given the favorable cyclical position, existing contingent liabilities of financially vulnerable SOEs, and expected age-related spending, continued prudent fiscal policies and well-thought through reforms are warranted.

We take positive note of the FSSA's findings which emphasize that the Maltese banking sector remains liquid, well-capitalized, profitable and resilient. However, the financial sector also faces challenges associated with the bank's supervision, in the context of a rapid diversification of financing and sources of corporate funding, as well as the strained housing market. We agree with the staff that existing shortcomings call for policy measures designed to ensure budgetary and operational independence of supervisory authorities. In this regard, we commend the authorities' efforts aimed at strengthening the MFSA regulatory framework and improving its overall independence and competency. Given the high level of international connectedness of the Maltese financial sector and a rapid increase of virtual financial assets flows, the effective implementation of AML/CFT requirements is essential for safeguarding financial stability.

We take note of a possible housing price misalignment. Even though it is not easy to accurately assess the risks of overheating - rapid increase of property prices, driven by both demand and supply factors, requires mitigating policy measures. Staff's report rightly suggests a set of macro-prudential limits and recommends accelerating the provision of social housing. The latter step is particularly important as market overheating may further widen the gap between low and high wage earners.

Structural reforms remain critical in achieving sustainable and inclusive growth. We agree with the set of reforms proposed by the staff in the report, for instance, strengthening the labor market, addressing the infrastructure gaps and fostering innovation. We underscore the need to thoroughly investigate relationships between efficiency, equity and inclusiveness of structural reforms. Lastly, we recognize that the recommendations included in the Selected Issues are a good step forward in that regard.

Mr. Castets, Ms. Gilliot and Ms. Susbielle submitted the following statement:

We thank staff for the insightful set of documents and Mr. Fanizza and Ms. Cerami for their informative buff statement. Malta's economic performances are commendable, and we salute the prudent policy-mix implemented by the authorities while achieving a recomposition of the sources of growth towards export-led services. Malta's economic and financial openness also involves a high dependency to foreign capitals, external economic and financial conditions and external labor supply. It is therefore highly exposed to a market downturn that could affect foreign investment inflows, trade flows and domestic demand. Accordingly, we are pleased to read that the authorities are willing to keep the reform momentum in order to upgrade the social and transport infrastructure, increase SMEs' access to finance, increase the inclusiveness of growth while tackling the adequacy and sustainability of the pension system. The Financial System Stability Assessment provides an insightful analysis of the financial system, highlighting the robustness of the banking sector where risky sectorial exposures could nonetheless affect small entities. Main concerns are focused on the regulatory and supervision framework and that is highly linked to the cross-border nature of banks' business model. Specific policy measures are warranted to mitigate risks related to the increasing concentration of mortgage loans, the reliance on nonresident deposits, the rise in the use of complex digital products (crypto assets) and, as a result, in Money Laundering and Terrorism Financing (ML/TF) risks. We associate ourselves with Ms Riach's statement and wish to add the following comments.

Outlook and risks

Malta's robust growth performance is set to continue in 2019 and is projected to then gradually moderate as capacity constraints hamper labor supply and total factor productivity growth. Given the openness of the economy, we concur with staff that downside risks to the external environment could put pressure on domestic economy and revenues and thus should encourage the authorities to address structural deficiencies (labor supply constraints, skills mismatches) and develop reliable sources of potential growth such as investment in social and transport infrastructure and new technologies, as well as more flexible labor supply. Malta's exposure to money laundering risks requires closely monitored and effective implementation of the AML/CFT framework. The Brexit might also cause a slowing down of the tourism sector as the UK remains the largest contributor to Maltese international tourism (plus 24 percent revenue in 2018). Can staff elaborate on the total impact the Brexit might have on the Maltese economy under the difference possible scenarios?

Fiscal policies

The positive structural balance projected for the next coming years is encouraging and we salute the ongoing efforts of the authorities to achieve their medium-term fiscal targets without relying on IIP proceeds. We note that fiscal targets excluding IIP proceeds was reached in 2017 and we are confident in the authorities' capacity to achieve a new surplus in the medium-term. On the revenue side, the alleviation of the tax burden for targeted and vulnerable groups is welcomed. We understand that any step regarding corporate tax is highly sensitive. However, broader tax compliance on VAT, anti-tax avoidance legislation and broadening the tax base could create additional fiscal space. The current strong growth momentum also provides a great opportunity for further expenditure savings as well as for specific spending measures. While deterring workers from early retirement and private pension schemes are proposed as solutions to address demographic pressures, the provision of looming age-related spending and the increase in pension contributions aren't contemplated in the report. Could staff elaborate on this aspect?

External position

The external position is assessed to be moderately stronger than fundamentals and policy settings. The large current account surplus will persist in the coming years. Driven by the performance of services, rising saving from the private sector and, to a lesser extent, to competitiveness gains, the surplus has significantly widened in 2017 to 10,4 percent of GDP from an average of nearly 5 percent of GDP in 2014-16. We thank staff for the very interesting analysis provided in annex IV which reflects the underlying drivers of this improvement. While idiosyncratic factors explained a part of the large unexplained residual of 10,1 percent of GDP obtained through the EBA-lite CA model, we note that measurement issues linked to income flows of special purpose entities and multinationals with limited links to the domestic economy suffer the same bias – observed in other surplus countries – of accounting investment income and particularly retained earnings. Since there are not specific policy recommendation on this bias which could account for about 7 percent of GDP in the underlying CA surplus, we would appreciate staff 's comments on the ongoing work with the authorities, if any, to solve this measurement discrepancy. Investing in infrastructures (transportation, energy, water-resource and waste management) and inclusion-promoting measures would allow to re-balance current account and to address structural bottlenecks to support actual and potential growth.

Housing market

As banks' exposure to housing-market related risks is high and increasing, we welcome recent efforts to close data gaps (loan-level data collection) and the planned introduction of borrower-based macroprudential measures such as caps to loan-to-value (LTV) ratios at origin, stressed debt service-to-income (DSTI) limits, and amortization requirements. We also agree with staff that the new borrower-based measures could be adjusted to narrow down exemptions to the LTV limits for loans against secondary and buy-to-let properties, and to extend their scope to also cover non-bank mortgage loans. In contrast, overall risks to financial stability from real estate remain contained at present, though an extension of recent trends may result in potential macro-financial imbalances.

Structural reforms

Upgrading public infrastructures, enhancing SME's access to finance and improving human capital would be key to foster a sustainable and more inclusive growth as well as boost productivity. Although Malta has developed a performing financial system, the credit is insufficiently channeled to the productive factors. Bank credit to the private sector has declined to a historic low of about 80 percent of GDP by end-2017 while intercompany borrowing among nonfinancial corporates has been increasing. Providing additional support to SMEs would certainly contribute to enhance innovation and productivity. The creation of a new entity in charge of the implementation and maintaining public infrastructures projects is a step in the right direction. We concur with staff's recommendations on the need to enhance R&D investment, improve the efficiency of the judicial system and address the gender gap, especially in the labor market.

Financial System Stability Assessment

Malta's financial system is robust and resilient but discrepancy on the regulatory and supervisory framework could entail serious challenges. The reliance on retail deposits to fund banks' lending operations (excepted for international banks) has provided ample liquidity that could however prove to be insufficient in case of shocks as reliance on nonresident deposits has kept on growing.

Increasing risks linked to worldwide uncertainty pose challenges for Malta's financial stability as concentration risk stemming from direct and indirect exposure to construction property development and mortgages sectors has been increasing. In this respect, although it has been reduced to an acceptable level on core domestic banks, the reduction of the NPL ratio has stalled since 2017, with persistent stocks in some sectors like construction and real estate. Local banks show low levels of NPL provisioning. These remaining pockets of vulnerability should be addressed through an enhancement of the legal macroprudential framework, the adoption of an administrative bank insolvency framework and granting the supervisor MFSA's resolution powers and the capacity to intervene at an early stage. We agree with staff on the need to complement recent efforts in collecting granular loan-level data and the establishment of a central registry credit by data on sectoral and cross-border intercompany financing.

The recent revocation of Pilatus Bank by the ECB highlighted deficiencies in the implementation of Malta's AML/CFT framework. The inclusion of Malta's passport selling on the OECD's blacklist of schemes facilitating tax evasion, is also a matter of concern. Accordingly, the priority for the authorities should be to urgently ensure the long-term financial and operational independence of supervisory authorities and improve the crisis management framework. It is crucial regarding the upcoming migration of some of the largest crypto-asset exchange platforms to the island. The recently-enacted 50-point action plan should be fully implemented without delay. We encourage the authority to ensure that banks apply preventive measures in relation to their high-risk activities and clients and to impose dissuasive and proportionate sanctions whenever breaches of AML/CFT requirements are identified.

Mr. Ray, Mr. Shin and Mr. Kikiolo submitted the following statement:

We are encouraged by Malta's robust economic growth, a better than expected fiscal outcome, its sound banking system, and an impressive performance from the external sector which benefited largely from strong services exports. Some of the factors that have driven these outcomes present challenges for the authorities. We encourage them to bolster financial supervision and address capacity constraints. We thank staff for the set of reports and Mr. Fanizza and Ms. Cerami for their useful buff statement. We agree with the thrust of the staff assessments and offer the following comments for emphasis.

We take note of the authorities' plan to invest in new technologies such as blockchain and artificial intelligence to support future growth. As with remote gaming, Malta is strategically positioning itself to take advantage of being the first country that advances these new technologies in the region. While we note the risks associated with such undertakings, Malta's successes with online gaming and advancements on the distributed ledger technology (DLT) front could spur "learn from thy neighbor" initiatives from other Fund members. We would appreciate hearing from staff what policy advice they would give to any other similar sized economies that intend to follow Malta's lead on remote gaming and DLT.

We welcome the findings of the Financial System Stability Assessment (FSSA) that Malta's banking system remains well capitalized, profitable and has ample liquidity. While noting the risks the FSSA highlighted, we are also encouraged by Mr. Fanizza's and Ms. Cerami's buff statement that the authorities have and will continue to take corrective measures to safeguard the stability and integrity of the financial system. Given Malta's deliberate fostering of online gaming and development of virtual financial assets, a robust legal framework and effective enforcement, including of AML/CFT, will be especially important. We would appreciate if staff could elaborate on the differences between staff's and the authorities' views.

We commend the authorities for maintaining fiscal prudence. Like staff, we believe there is scope for the authorities to re-orient more resources towards capital expenditure going forward. In this regard, we are encouraged by the 2019 budget which aimed for a lower surplus and shifted some resources towards capital spending. We appreciate the IMF Fiscal Transparency Evaluation staff undertook in May 2018 as it gives a useful snapshot on fiscal transparency in Malta.

Sustaining reform momentum is important to address structural bottlenecks and support inclusive growth. While welcoming the authorities' commitment to build necessary infrastructure, we concur with staff that it is also important to emphasize the need to ensure efficiency gains. The selected issues paper is useful in this regard. In the medium term, upskilling both local and foreign workers and lifting the labor participation rate would also support potential growth.

The representative from the European Central Bank submitted the following statement:

> We would like to thank Mr. Fanizza and Ms. Cerami for their buff statement and Staff for their report. We associate ourselves with the statement by Ms Riach and would like to further highlight a few issues.
>
> While the outlook for growth remains positive, we expect the pace of growth to be milder in the short-term compared to Staff's assessment, with risks tilted to the downside. Compared to the euro area average Malta has been growing fast after the crisis. While we expect growth to remain robust we foresee stronger import growth in 2019-21, therefore a smaller contribution from net exports to growth, and assume weaker labor productivity growth on average. We consider that risks to the outlook are tilted to the downside. Downside risks are mostly linked to the external environment, in view of the very open Maltese economy. Upside risks, are contingent on swift progress in the implementation of key structural economic reforms aimed at improving Malta's business environment.
>
> We concur with Staff that Malta should identify growth-enhancing measures that would strengthen its structural fiscal position and reduce fiscal risks. In particular, we agree with Staff's recommendation to strengthen the structural fiscal position, excluding receipts from the International Investor Programme (IIP). This is all the more important as the current environment of strong growth may mask underlying vulnerabilities. For example, it would be more difficult to assess whether the estimated structural balance accurately captures its underlying budgetary position, as it may also reflect extraordinary revenue growth above its long-term trend. At the same time, it is important to ensure that expenditure is shifted towards growth-enhancing items, such as filling existing infrastructure gaps. Turning to fiscal risks, expenditure developments should be monitored carefully in light of possible fragility of revenues in a downturn. Notably, long-term spending pressures and risks emanating from fragile state-owned enterprises (SOEs) need to be addressed.
>
> We agree with Staff that Malta's financial stability risks are contained at present, however pockets of vulnerability remain. Strong demand for housing, mainly driven by strong immigration flows and rising disposable income, is pushing up property prices. Moreover, banks' exposure to housing-market-related risks is high and increasing, households' indebtedness is relatively high and flexible interest rate on mortgages are prevalent. Against this background, we welcome recent efforts to close data gaps (loan-level data collection) as well as the planned introduction of borrower-based

macroprudential measures as steps in the right direction. We also agree that the new borrower-based measures could be adjusted to narrow down exemptions to the LTV limits for loans against secondary and buy-to-let properties, and to extend their scope to also cover non-bank mortgage loans.

We stress the need to keep Malta's Financial Services Authority (MFSA) powers and functions (or tasks) distinct from those of the Central Bank of Malta (CBM). We agree with Staff on the need for effective supervision by the MFSA, which shall include operational independence, transparent processes, sound governance and adequate resources including sufficiently skilled staff. However, providing MFSA with a financial stability objective could create overlaps between the objectives of the CBM (macroprudential authority) and the MFSA (microprudential authority) and related accountability problems. Therefore, we welcome the recommendation of the Financial System Stability Assessment (FSSA) to ensure that MFSA powers and functions (or tasks) remain distinct from those of the CBM.

We concur with Staff that the Maltese authorities need to take immediate actions to address financial integrity risks**.** Given the size and importance of Malta's financial sector, the exposure of certain banks to correspondent banking risk, the fast-growing remote gaming sector and the high demand for the IIP, the effective enforcement of the AML/CFT framework is critical.

The Acting Chair (Mr. Furusawa) remarked that Malta had been one of the fastest growing economies in the EU in recent years, supported by prudent fiscal policy and successful structural reforms and new developments in the financial sector. There had been recent pressures on housing and public infrastructure and Directors had emphasized the need to ensure financial stability and integrity, enhance the economy's resilience including by investing in infrastructure, and make growth more inclusive.

Mr. Fanizza made the following statement:

I wish to start by thanking Directors for their enriching and supportive statements. I also thank both the staff of the Article IV team and the Financial Sector Assessment Program (FSAP) team for their openness and valuable advice through the whole process.

I am pleased to highlight something that is important, the high degree of implementation of the Fund's policy recommendations in recent years. This constitutes a good example of constructive dialogue leading to good traction and sound policies. While the sound policies have contributed to sustained, robust growth, which has led per capita income to approach the euro area average, a major result for a small country like Malta, diversification is essential to increasing economic resilience. In fact, the economy has already gradually shifted toward export-oriented services, including tourism, but also increasingly financial services and advanced services such as remote gaming, business and professional services, communication, and information.

Structural changes are taking place. The country has already started to become a well-diversified and competitive economy, attracting foreign capital and high-skilled workers to complement the limited domestic resources. Many colleagues have pointed out that greater openness to trade and innovation creates not only opportunities but also important challenges. That is absolutely true. For example, the increasing focus on financial resilience requires that financial development be complemented by greater attention to safeguarding financial stability and integrity, attention to maintaining consumer and investor trust, and preserving correspondent banking relationships (CBRs). The latest one is very important.

Addressing reputational risks is a key priority for the Maltese authorities. They are taking quite seriously the recommendation received from the Fund and from the competent regional bodies. They have taken a comprehensive approach that includes not only financial services but also the fintech industry.

On the newly established regulatory framework for the distributed ledger technology (DLT) and its application in the financial sector, in financial services, we share the staff's prudent approach. Because the fintech industry is still in its infancy, regulators around the world are still working on understanding its implications. Therefore, the authorities have positioned the country to benefit from new technologies by reducing regulatory uncertainty and mitigating related financial and reputational risks. For example, they have established a new authority, the digital innovation authorities, with regulatory certification and enforcement power, distinct from the standard financial service authorities. Importantly, all subjects involved in the issuance of virtual financial assets will be identified as subject person for the purpose of Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) checks and obligations.

These are just a few building blocks of the new framework, but the real book is far from complete, and work is needed in response to the needs of a rapidly evolving industry. It is also too early to assess the framework itself, but the Maltese authorities remain attentive to ensuring that it remains consistent with the evolving international standards.

Finally, let me conclude with the note on an observation that many gray statements contained, the need to address the remaining bottlenecks to growth. Malta has already taken important steps in this direction. The recent development of the current accounts not only reflects buoyant exports of services but also reduced oil imports partly as a result of reforms already taken to the energy sector that have boosted productivity and diversified the energy mix. The expansion of the labor-intensive service sector has been supported by policies to raise both domestic and foreign-sourced labor participation.

Needless to say, the country still faces many challenges the authorities are focusing upon. The list of these envisaged measures is long, but there is no reform fatigue exactly because the country has benefited greatly from the reforms that have already been implemented. The authorities remain strongly committed to growth-oriented policies and fiscal progress.

Mr. Al Hafedh made the following statement:

We commend the authorities for the impressive economic performance over the past years, showcasing excellent strategic development and fiscal management. At the same time, Malta faces many challenges, as rightly highlighted in the staff report and the FSAP, and we are glad to hear Mr. Fanizza’s emphasis on the authorities’ commitment to ensure effective implementation and enforcement of the AML/CFT framework. Enhancing macroprudential measures to manage the housing market risks is also important.

Finally, we welcome the authorities’ continuous efforts to implement reforms to enhance resilience and inclusiveness. We are also encouraged by the authorities’ efforts to improve social inclusion, boost the affordability of housing for low-income households. With these remarks, we wish the authorities further success.

Ms. Riach made the following statement:

As Mr. Fanizza said in his buff statement, the main challenge for Malta is managing its own success. We share this view, but the challenges are nonetheless significant. The benefits of rapid growth, the inflow of foreign workers, significant revenues from the individual investor program, and the first mover advantage of adopting new financial technologies could wane quickly. Therefore, we agree with the staff that the authorities should further enhance Malta's resilience through infrastructure investments, labor market measures, and prudent fiscal planning.

Over the last years, the Maltese economy has outperformed the euro area average by a considerable margin. As the staff notes, this is a larger rapid income convergence to the rest of the euro area. At the same time, the staff's analysis suggests that capital formation has not kept pace with growth. Going forward, the authorities will have to devote more resources to updating infrastructure and to ensuring that the labor force can expand further.

Malta is a small open economy with strong ties to the rest of the euro area and is therefore vulnerable to external risks. Nevertheless, long-term growth will be determined by domestic action, including measures to boost productivity, ensure a transparent business environment, and address demographic challenges.

Malta's fiscal policy is on solid footing, and we welcome the strong fiscal performance in recent years. This has allowed a further rapid reduction in public debt to below 50 percent of GDP. However, public finances still seem highly dependent on Individual Investor Program (IIP) proceeds and on corporate income taxes, which implies that the budget is highly sensitive to economic shocks and to international initiatives and corporate taxation. Against this background, we welcome the authorities' commitment to maintain a balanced structural fiscal position net of IIP proceeds, and we welcome the ongoing spending review and its planned institutionalization. Further efforts are needed to curb the increase in age-related spending.

To promote high and inclusive growth, infrastructure gaps and skills shortages must be addressed. The staff report highlights that the rapid employment growth is made possible by attracting a considerable number of foreign workers. Indeed, the labor market participation rate in Malta is still below the EU and euro area averages, especially for women, and Malta still ranks amongst the lower performers in the EU regarding educational attainment rate. Therefore, further measures are needed to strengthen employment and educational attainment.

We welcome the staff's assessment that Malta's banking system is well capitalized and profitable. However, there is a risk of erosion of banks' profitability in the long run, and pockets of vulnerability remain, especially related to the housing market and enforcing the AML/CFT framework. Given the size and importance of Malta's financial sector, the exposure of certain banks to correspondent banking risks, the fast-growing remote gaming sector, and the high demand for the IIP, the effective enforcement of the AML/CFT framework is critical. We therefore take positive note of the authorities' recently enacted 50-point action plan and Mr. Fanizza's comments this morning about the authorities' commitment to implement Fund recommendations.

We share the staff's view that capacity constraints and gaps in the regulatory framework undermine the effectiveness of financial supervision and crisis management and agree on the need for effective supervision by the Malta Financial Services Authority, including its operational independence, transparent processes, sound governance, and adequate resources.

Mr. Just made the following statement:

We thank the staff for a good quality Article IV report and a timely FSAP with many valuable policy recommendations. We look forward to the discussion on the follow-up of this implementation and the progress by the authorities in future reviews. We associate ourselves with Ms. Riach's intervention.

Malta's economic growth has been astounding. In his comprehensive buff statement, Mr. Fanizza notes that Malta faces the challenge of managing its own success. This success can be attributed in part to a level of risk acceptance and risk tolerance that may be higher than other countries. The risk management by the authorities, particularly in the financial sector, has for some time not been commensurate with this actual risk.

We appreciate Mr. Fanizza's opening statement that the authorities will have addressed concerns about the effectiveness of financial sector supervision and urge the authorities to make swift progress in implementing the FSAP recommendations. In this context, we would like to raise two points.

First, authorities may act faster once the risk is quantified in terms of possible costs of inaction. While it is difficult to attach a numerical value to the loss of CBRs or expected fines for violating AML/CFT regulations, some rough estimates of the possible costs may help authorities to advance reforms. We would appreciate if the staff could include such rough estimates of potential costs as part of the financial sector surveillance.

Second, on the prospective regulatory framework for virtual assets in Malta, we ask the staff to pay particular attention to the regulatory arbitrage concerns in view of the EU single markets. We also support the staff's call on Malta's competent authority to support the possible euro area level institution tasked with some AML/CFT aspects to address cross-border AML/CFT risks in the banking union. EU rules need to be enforced with the same high standards across the union to avoid creating any weak links.

Mr. Tan made the following statement:

I want to pick up on two points that were not touched on in our gray statement. The first is the issue around the rising property prices in Malta, and this comes on the back of the staff's presentation a week ago on housing market policy challenges, where the Board had a good discussion on the policy tensions at play and the range of policy levers available. Against that background and also more specifically in the context of Malta's housing market pressures—where there was an observation that the rising property prices are mainly reflecting economic fundamentals and that the macroprudential measures can be easily calibrated to mitigate any financial stability risks in a timely and effective manner—I would appreciate the staff's thoughts on how one should go about gauging whether signs of housing market pressures can be explained by fundamentals and when they may point to something more systemic in nature. This is of particular interest given experiences elsewhere with housing markets running ahead of fundamentals quickly, especially when these pressures stem from significant foreign inflows or cross-border spillovers rather than being solely driven by domestic circumstances. In that light, the question is whether there is also a need for the timing and calibration of the appropriate policy response to take this into account, especially given the potential policy lag in the measures to be taken.

The second point is on closing the AML/CFT gaps. Having been involved in financial supervision in my past life, I can fully appreciate the staff's perspective on this issue, and those of many other Directors, including Ms. Riach, whose comments I fully agree with. I would like to add my voice again to the staff's emphasis that an effective AML/CFT framework should not be just backed up by rigorous supervision, but it should also involve a preparedness to take tough enforcement actions, because the hard reality that we have come to know globally and that I personally learned from experience, is that no amount of regulation and supervision can detect and prevent all illicit activities on an ex ante basis, especially as such activities are becoming more complex and sophisticated, with or without the help of innovative technologies. Hence, when there are violations committed, when breaches are found, enforcement actions should measure up decisively so as to have a clear, strong deterrence effect. With that I wish the authorities continued success.

Mr. Trabinski made the following statement:

We thank the staff for an informative report, and we are of the view that Malta's economic growth is impressive and supported by both prudent policies and a strong reform effort. We are encouraged by Mr. Fanizza's words about the high degree of implementation of the Fund's policies by Maltese authorities, and we also note that the economy is shifting toward export of services.

I have one additional question to the staff. Could the staff elaborate on the current state of development and implementation of the legal framework for DLT-based financial tools? I would also like to follow-up on Ms. Riach's points on the importance of having in place appropriate provisions supporting the AML/CFT framework.

The staff representative from the European Department (Mr. Natal) made the following statement:[1]

I thank Mr. Fanizza and other Directors for helpful comments and reactions to our report.

I would like to address a few points that I saw in the gray statements. I would like to look at the implication for policy of development in the housing market and for social inclusion, which are two related issues in Malta.

Starting with the housing market, the staff's estimate suggests that the bulk of the increase in house prices can be related to domestic fundamentals—we highlight population growth, disposable income, portfolio shifts due to low interest rates, and other factors. We are in good company given that other institutions have also made the same assessment that, by and large, the bulk of the increase is driven by fundamentals so far. But there are some tentative signs of overvaluation that we would not characterize at this point as being in bubble territory.

When is it the time to pull the trigger or at least to raise a signal? The approach we have had so far, at least concerning the macroprudential tools that are related to the housing market, is to implement them before there are

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

obvious signs of overvaluation and bubbles. The Fund has been advising Malta for many years to introduce these measures, like in many other countries, and we are happy and glad to see that this year the Maltese authorities have planned to start introducing borrower-based measures—a loan-to-value (LTV) ratio, debt-service-to-income (DSTI) amortization requirements, which are all measures that are meant to preempt the building up of vulnerabilities. We welcome these developments.

In terms of other instruments, we have also in the past mentioned that the tax rate on rental income could be harmonized with other tax rates on other income in the economy. That would help dampen demand for buy-to-let properties and also would represent a non-negligible fiscal input for Malta. This measure has not been done. We have had discussions with the authorities on this topic.

One related issue is that rising housing costs are increasingly posing problems for vulnerable households in Malta. A simple number is that 40 percent of tenants are at risk of poverty according to the index, and this number has been rising over the last few years. The authorities are well aware of these issues and have put in place a series of measures. Rent subsidies is one. They have been investing in social housing with the help of European investment banks. We are talking about 1,100 units forthcoming, and there are also incentives for the private sector to start investing in social housing, so many measures have been put in place. They are very recent, so it is difficult for us to take a stand on how effective they are, but this is something that we will follow up in future Article IV consultations.

The staff representative from the Monetary and Capital Markets Department (Ms. Bacalu), in response to questions and comments from Executive Directors, made the following statement:

I would like to express my gratitude to the Maltese authorities for constructive engagement, open communication throughout the whole, long FSAP process, and also to welcome the authorities' consent to publish the FSAP-related documents. I thank Directors for their insightful comments and questions.

Let me underline from the outset that it is satisfying to see clear traction from the authorities and to see their commitment to implement the FSAP recommendations as well as the recommendations coming from the EU regulators. The ongoing full assessment of the AML/CFT framework by the MONEYVAL is also expected to guide the authorities in their further reform efforts aimed at strengthening financial stability, especially in the area of the AML/CFT framework.

Directors had several questions on the financial supervisor's funding in light of the recent change of its revenue model. We have stressed in the report that adequate sustainable, predictable funding of the Malta Financial Services Authority is a critical component of its operational independence. Ensuring sustained funding is particularly important given the growing complexity of the financial sector and the ongoing overhaul of its supervision.

We welcome the authorities' intention to introduce automation in management of supervisory data and to increase staffing and step up building of necessary skills to face the challenges of the growing complexity of the financial sector, including in innovative fintech-related activities.

Some Directors raised questions regarding different aspects of the regulatory framework for DLT and virtual financial assets. As a more general comment and echoing Mr. Fanizza's comment, it is important to stress that the international standards and best practices in this area are still a work in progress. The Financial Action Task Force (FATF) today has been holding a plenary session to discuss the detailed implementation requirements for effective regulation and supervision monitoring of virtual asset service providers. The recommendations of this session will be formally adopted in June 2019.

It is worth mentioning that even during the time of this FSAP, definitions and notions in this area have been developing. The evolving nature of thinking and approaches to the oversight of fintech-related activities is one of the reasons why it is premature to identify the exact detailed best practices at this point.

Against this background, we cautioned in our report about the challenges emanating from the existing AML/CFT deficiencies, such as those in the oversight of beneficial owners of the subject person, especially when the latter is a virtual asset service provider, and respective risks of regulatory arbitrage.

To address the question at the Board, the authorities have adopted three major legislative pieces in the area of DLT and virtual assets, but the challenge now—and they are working hard on adopting the underlying corresponding regulations—comes from the fact that both the laws that were adopted before the FATF has issued its initial guidance, and the underlying supervisory regulation needs to be designed and built as thinking evolves and during the development of international standards as well.

Finally, we are concerned about the risks for CBRs, and despite the authorities' efforts to mitigate the risks by engaging with relevant international counterparties and adopting alternative ways to service the transfers, and by domestic banks implementing their de-risking strategies, our assessment is that the risk to CBRs still exists. In this regard, the results of the ongoing MONEYVAL assessment will be important, but equally important will be the pace at which the authorities address the deficiencies identified in the AML/CFT framework. It is difficult to attach a numerical value to the possible materialization of risk of loss of CBRs, and worldwide experience is not very wide on the good side, and there are no standard tools to assess or to design such stress tests. Our stress tests were more or less standard. We wanted to design them in a way that we stressed the system against any sudden withdrawal or drying up of liquidity. That is the only thing we could think of in terms of what can be initiated by reputational risks materialization, but loss of correspondent banking per se is difficult to assess, so as of today we do not have a good answer for this.

There was another request for the staff to shed some light on the European rules related to AML/CFT regulations and the regional cooperation on it. Ass we stated in our questions and answers, the euro area FSAP has recommended at the regional level to adopt such rules with a purpose to strengthen the framework. Then as a follow-up, when we conduct the national FSAP, such as in the case of Malta, we advise the authorities to support adopting such rules, and further work will need comprehensive research and decisions.

The Acting Chair (Mr. Furusawa) noted that Malta is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for sound policies that have supported strong economic performance and job creation while improving public finances. Directors considered risks to the outlook as broadly balanced and encouraged the authorities to continue implementing policies to address challenges and capacity constraints arising from infrastructure gaps, financial sector innovations, rising housing costs, and shortages of labor and skills.

Directors stressed the need for sustained efforts to safeguard financial integrity and stability. They called on the authorities to pursue ongoing reforms to mitigate money laundering and terrorist financing (ML/TF) risks and swiftly close gaps in supervisory and enforcement capacities. Directors welcomed measures taken to implement the recently enacted 50-point action plan, while also emphasizing the importance of effective enforcement going forward. They concurred that virtual financial asset service providers should be supervised in line with the Financial Action Task Force standards.

Directors noted shortfalls in supervisory capacity and gaps in banks' liquidation and insolvency frameworks. They recommended that the long-term financial and operational independence of the supervisor be guaranteed, and the crisis management framework strengthened, including by adopting an administrative bank insolvency regime. In light of the rapid diversification of corporate financing, Directors also encouraged strengthening oversight of the nonbank financial sector and closing remaining data gaps.

Directors welcomed the planned introduction of borrower-based macroprudential instruments to mitigate the build-up of vulnerabilities in the real estate sector. They also supported further measures to improve housing affordability for low-income households.

Directors encouraged the authorities to maintain a prudent fiscal policy, and called for further efforts to strengthen the structural fiscal position excluding revenues from the Individual Investor Program. They agreed that the key priorities are to contain long-term fiscal risks by addressing age-related spending pressures and further restructuring vulnerable SOEs, shifting the balance of expenditure towards growth-enhancing public investment, and strengthening public investment management and risk analysis. Directors noted ongoing efforts to combat tax evasion and avoidance and recommended exploring further avenues for broadening the tax base.

Directors emphasized the importance of structural reforms to foster sustained and inclusive growth. They encouraged measures to bridge infrastructure gaps, upskill and reskill the labor force, further encourage female and elderly participation in the labor market, and stimulate innovation through SMEs' enhanced access to finance. They also underscored the need to improve the efficiency of the judicial system.

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

APPROVAL: April 13, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and Risks

1. ***Could staff comment on reasons for the difference between its own projection of potential growth (slightly above 3 percent) and that of the authorities (4 percent)?***

- The difference between staff's assessment of potential growth and the authorities' likely reflects different horizons. Staff's projection refers to the end of the projection horizon (2023). The authorities' projection of 4 percent seems to correspond to a more proximate horizon. The Central Bank of Malta currently projects potential growth at 4 percent for 2021, very similar to staff's projection at 4.1 percent.

2. ***We note that measurement issues linked to income flows of special purpose entities and multinationals with limited links to the domestic economy suffer the same bias – observed in other surplus countries – of accounting investment income and particularly retained earnings. Since there are not specific policy recommendation on this bias which could account for about 7 percent of GDP in the underlying CA surplus, we would appreciate staff 's comments on the ongoing work with the authorities, if any, to solve this measurement discrepancy.***

- Discussions have started with the authorities for possible common work on identifying measurement biases related to the income balance, particularly from over or under-recording income flows due to shortcomings at identifying ultimate ownership, notably for companies in the remote gaming sector. Addressing other possible sources of measurement issues, such as those linked to retained earnings, could also be considered as part of a common research agenda in the near future.

3. ***Regarding the Risk Assessment Matrix, could staff provide more context on the "unsustainable policies" at the national level in the EU, specifically what would be the channels for such policies to affect Malta?***

- The risks in the RAM are taken from the GRAM, July 2018. "Unsustainable macroeconomic policies in systemically important countries to boost near-term activity beyond sustainable levels (due to domestic political pressures or in response to external policy spillovers) exacerbate underlying vulnerabilities and, in some cases, backfire by hurting confidence and global growth". These policies could lead to strains in market access for affected sovereigns, financial fragmentation and market volatility. Against this backdrop, external demand and foreign investment flows could ebb, affecting FDI inflows to, and exports from Malta. In the event of significant growth slowdown in Malta, increased asset impairment could also affect bank profitability.

4. ***Can staff elaborate on the total impact the Brexit might have on the Maltese economy under the difference possible scenarios?***

- In general, staff considers that escalating trade tensions, including a no-deal Brexit, could increase uncertainty about growth and lead to financial market volatility, with likely negative consequences for investment and growth. A pessimistic Brexit scenario and further pound depreciation of Sterling could hurt the tourism sector somewhat since the UK is the main source of tourists for Malta. However, under any Brexit scenario, Malta could also benefit from possible relocation of firms that service the EU from UK territories, for example in the financial and remote gaming sectors.

Fiscal Policy

5. ***Do the authorities plan to implement reforms to reduce age-related fiscal costs? While deterring workers from early retirement and private pension schemes are proposed as solutions to address demographic pressures, the provision of looming age-related spending and the increase in pension contributions aren't contemplated in the report. Could staff elaborate on this aspect? Do the authorities plan to implement reforms to reduce age-related fiscal costs?***

- A large part of age-related fiscal costs arises from pension obligations. The authorities plan to review the *sustainability* and *adequacy* of the pension system by the end of 2020 (strategic pension reviews). Ongoing adjustments to the regime of pensions in Malta revolve around increasing the statutory retirement age to 65 years old (from 61) by 2026 and incentivizing later retirement by linking pension payouts to the number of years of contribution after the statutory retirement age. This latter incentive was introduced in 2015 for the private sector and will be extended to the public sector from 2019 on. Additional information on fiscal implications of pension liabilities can be found in the 2016 Selected issues paper "Pension Reform in Malta". Further efforts to improve long-term pension adequacy, in the face of rapid increase of poverty risk among pensioners, include tax incentives linked to contributions to voluntary occupational and private pension schemes. Plans to enable home equity release are also considered given the high proportion of home-owners among the elderly population.

6. ***Could staff further elaborate on their assessment of physical infrastructure gaps and the expected evolution of public investment?***

- This question was treated in detail in last year's selected issue paper ("Closing Malta's Infrastructure Gap," in IMF Country Report No. 18/20. It shows that infrastructure gaps vis-à-vis other EU countries are most striking in road and energy networks, both in terms of quality and quantity. Capital expenditure is expected to increase from 3.1 percent of GDP in 2017 to 4.6 percent of GDP on average between 2018-2022.

7. ***Could staff elaborate on possible additional measures to broaden the tax base?***

- Recent efforts in fighting tax avoidance and improving VAT compliance should be pursued. Moreover, policies that further encourage female and elderly participation in the labor market will also help broaden the tax base.

Housing market

8. ***We would appreciate further comments on the projects that are underway to increase the stock of social and affordable housing which are alluded to in para. 22.***

- Multiple social housing projects are being implemented or planned, including a 500-apartment project in collaboration with the European Investment Bank and the European Council Development Bank, and 700 additional units with part of the funding coming from the National Development and Social Fund. The authorities also plan to refurbish dilapidated government properties to be used as social housing. The 2019 budget speech contains further details.

9. ***Could staff elaborate more on the composition of the housing market demand? Are there significant international capital inflows into Malta's housing market? If so, do staff have any policy suggestions on capital flow management?***

- The housing market is mainly supported by fundamental and domestic factors including strong immigration flows, rising disposable income, and portfolio rebalancing towards property investment. Robust demand for tourist accommodation may also have played a role. Nevertheless, considering fast growing prices and rising banks' exposure to real estate, staff has consistently advised a rapid implementation of housing-related macroprudential measures and welcomes their planned introduction in 2019.

10. ***Could staff provide an estimate of the fiscal cost of these [house price] benefits and an assessment of its efficiency?***

- The precise cost estimate of tax incentives related to housing such as stamp duty exemptions and reductions and the reduced tax rate for rental income is not available. However, very rough back of the envelope calculations would suggest that aligning the tax rate on rental income to other incomes could provide substantial tax revenues. Further analysis is needed.

Financial sector policy

11. ***Government contributions should close any shortfall of projected regulatory revenues. While this seems to be a welcome development needed to ensure the necessary resources for the MFSA, we wonder whether this means that the share of government funding for bank supervision will increase?***

- Before the separation of the Registry of Companies (ROC) from the MFSA in April 2018, MFSA ran surpluses and there was no need for government funding. ROC revenues are now collected directly by the government, so if everything else equal, there would not be additional government funding involved. However, since there is a need for considerable investment (including in IT) and increase in staffing over the next few years, ROC revenues are likely to be insufficient and additional budgetary support would be needed. On the other hand, MFSA is planning an overhaul of its fee structure aimed at increasing the proportion of supervisory costs to be paid by supervised financial entities.

12. ***Does staff have a view on the need for bank supervision to be paid for by the supervised banks?***

- Staff is of the view that several funding models are acceptable as long as appropriate checks and balances are in place. Each model has its advantages and disadvantages. The Basel Core Principles do not prescribe the funding sources for the supervisory authorities. However, international standards require budgetary processes that do not undermine autonomy and adequacy of supervisor's resources. In the case of Malta, the need to negotiate for governmental and parliamentary approval on an annual basis introduces a degree of uncertainty, especially in the context of significant expenditure increases envisaged to address capacity gaps. Ensuring the stability of funding is therefore paramount. In that respect, staff considers that a five-year plan to increase the resources should be introduced and supported by a strong, publicly announced commitment from the government. This would address the lack of budgetary certainty in the current annual process.

13. ***Staff's elaboration on progress made to mitigate the ML/FT risks under the cooperation with the European Banking Authority is welcome.***

- In July 2018, the European Banking Authority (EBA) issued a Recommendation addressed to the Maltese Financial Intelligence Analysis Unit (FIAU) after establishing it had breached Union law in relation to its supervision of Pilatus Bank. The EBA Recommendation aims at remedying the particular failings identified by the EBA by encouraging the FIAU to take all the necessary actions to comply with the Anti-Money Laundering and Countering Terrorism Financing Directive (AML/CTF). The Maltese authorities have been presenting regular progress reports to the EBA on the status of implementation of the recommendations. The recently taken measures aim at strengthening risk-based supervision and include enhancing data collection, drafting a comprehensive record-keeping template for data management, developing questionnaires for targeted sectors, strengthening methodology and tools to develop a risk score, stepping up training for relevant stakeholders, etc.

14. ***Could staff elaborate on the seriousness of losing CBRs and authorities plan to mitigate the risk in addition to addressing AML/CFT deficiencies?***

- Some banks' CBRs are currently subject to pressures and various restrictions, particularly when they themselves provide correspondent banking services and channel flows from high-risk jurisdictions or deal with high-risk clients (e.g., nonresidents, e-gaming, virtual-asset operators, IIP, and politically exposed persons). Going forward, recurrent AML/CFT violations, poor results by the ongoing MONEYVAL mutual evaluation (that could lead to FATF listing), or potential enforcement actions imposed by domestic or foreign supervisors could put additional pressure on CBRs and lead to withdrawals by foreign banks. In addition to addressing AML/CFT deficiencies, the MFSA and Maltese banks are conducting regular outreach to correspondent banks to reassure them about progress in mitigating risks. Also, domestic banks have adopted their de-risking agenda in the last two years.

15. ***Could staff elaborate on the differences of opinion with the authorities regarding the possibility of establishing a regional approach for AML/CFT supervision?***

- Maltese authorities and staff do not have differences of views on the need to establish a regional approach for AML/CFT supervision. According to the authorities, Malta was one of a few Member States which supported and have spoken in favor of such initiative during the ECOFIN meeting. It is worth noting that one of the recommendations of the Euro Area FSAP (2018) is: "The authorities should consider ultimately establishing a European-level institution responsible for AML/CFT supervision, which would facilitate a consistent and comprehensive approach to what are often cross-border risks." In line with this recommendation, we are calling on the National Competent Authorities (of Malta in this case) to support the approach. It is particularly relevant and important for Malta.

16. ***Given Malta's deliberate fostering of online gaming and development of virtual financial assets, a robust legal framework and effective enforcement, including of AML/CFT, will be especially important. We would appreciate if staff could elaborate on the differences between staff's and the authorities' views.***

- The Maltese authorities and Staff did not have differences of views in this regard. The staff and the authorities had constructive discussions on AML/CFT issues. The authorities were engaged and agreed with the trust of staff's assessment and recommendations.

17. ***Regarding the authorities' intention to promote innovative technologies in the financial service industry, we wonder what application of blockchain is being considered (i.e. smart contracts, securities, record keeping, digital currency, etc.) and which sectors are being targeted. Moreover, what is this project's potential to increase fiscal revenue and save costs? Staff elaboration will be appreciated.***

- Staff is not aware of the authorities targeting any particular technologies. The Virtual Financial Asset (VFA) act would cover a wide range of blockchain-based technologies such as smart contracts and digital currencies. The framework is still in the process of implementation and it is too early to judge whether the authorities will be successful in attracting particular projects or services providers. So far, only a small number of DLT businesses have submitted applications to the Digital Innovation Authority, and it is therefore too early to assess the fiscal implications of these activities. Staff will follow up in upcoming consultations.

18. ***While the government established a new regulatory framework for distributed ledger technology and virtual financial assets, we would like to hear staff's views on whether the regulation strikes a right balance between harnessing the technology and mitigating risks, and whether the framework can be a role model for other jurisdictions.***

- The steps taken by Malta are welcome, but some adjustments are still needed and discussions within the Financial Action Task Force (FATF) regarding the necessary AML/CFT regulatory framework for virtual asset service providers are still ongoing. Staff recommended the authorities to continue addressing ML/TF risks related to expanding blockchain technologies and virtual assets. It is important to close any related gaps in the AML/CFT framework and ensure that the definition and AML/CFT oversight of a "subject person" are in line with the requirements of the FATF regarding virtual asset service providers. Immediate action is also needed to strengthen resources for AML/CFT oversight of virtual asset service providers. Considering that discussions within the FATF on the practicalities of the AML/CFT regulatory framework for virtual asset service providers are still ongoing, it is premature to identify best practices in that context.

- Staff also notes the significant resources and expertise needed for effective implementation of the framework. Therefore, staff recommended gradual implementation, which would allow addressing new challenges, including the build-up of supervisory resources. Gradual implementation, such as through a regulatory sandbox, would enable the authorities to strike the right balance between harnessing the technology and mitigating risks, and would also help to make the framework consistent with rapidly evolving international best practices and standards.

19. ***We would appreciate hearing from staff what policy advice they would give to any other similar sized economies that intend to follow Malta's lead on remote gaming and DLT.***

- In general, we welcome regulatory reforms to adopt new Fintech developments as is described in Bali Fintech Agenda. However, it should be noted that DLT/crypto assets area is a very small subset of FinTech activities. In addition, as is stated in the FSSA, DLT and crypto-related services could bring significantly higher risk than traditional investment. Therefore, our general advice was to have: 1) careful studies of costs and benefits; 2) well prepared implementation plans; 3) appropriate resource allocation to the supervisory authority; 4) gradual implementation of initiatives such as through sandbox; and 5) robust safeguards to mitigate the associated risks.

20. ***How do staff assess the risk of regulatory arbitrage around digital asset activity in Malta?***

- As is described in the Bali Fintech Agenda, there is a potential for regulatory arbitrages in digital asset activities such as crypto exchanges and Initial Coin Offerings (ICOs). In addition to differences in regulatory and enforcement powers, there could be differences in implementation capacity. Thus, internationally consistent regulation would be indispensable in the future to address the risk of regulatory arbitrage for VFA service providers and their activities. As implementation of the legal framework is ongoing in Malta, it is too soon to assess potential regulatory arbitrage.

21. ***Could staff provide a sense of the pace of growth of virtual assets investment in Malta?***

- While data is unavailable on investment in virtual assets in Malta, anecdotal evidence suggest that such investment is still small. Staff was informed that several firms have applied for licenses, but how much they would invest is not clear.

Structural reforms

22. ***We very much welcome the Selected Issues Paper on 'Promoting Inclusive Growth in Malta' and the use of the macroeconomic model developed in the Research Department on the economic impact of increasing childcare and aftercare benefits, extending working lives, and upskilling the labor force. Can staff elaborate on other country experiences with this model and clarify when they intend to use this model going forward in other countries' Article IV consultations?***

- The model is a general equilibrium, multi-country model developed by the IMF's research department, which is routinely used for structural analysis in Art. IV reports and the WEO. The same model was used in the last year's Article IV consultation for Malta to analyze the macroeconomic impact of boosting public infrastructure investments. The simulation presented in this year's selected issues paper are inspired by a similar exercise conducted in a selected issues paper attached to the 2016 Article IV consultation for Germany.

23. ***Staff subscribes to an impressive 700 million EUR investment plan in road infrastructure. Were any alternative sustainable options considered, e.g. allocating a part of the funding to public transport as opposed to more road infrastructure? Can we be assured that staff's advice here is compatible with the policy objectives related to the environment and sustainability?***

- Last year's Selected Issues Paper on public infrastructure identified important needs to develop and upgrade Malta's road network. Malta ranked first in road congestion time per citizen-year, which is also a very important source of pollution in Malta. The authorities have been envisaging alternative modes of transportation as reflected in their long-term infrastructure planning, including improved facilities for public transport, pedestrian and cyclists. The 2019 budget projects new ferry landing ports, the extension of free public transportation to all students (previously 16-20 year old only), free transport to and from school for all children in Malta and Gozo and various incentives for switching to less polluting vehicles. Staff will continue to monitor progress.