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CONVERGENCE REPORT 2007 ON MALTA

(prepared in accordance with Article 122(2) of the Treaty at the request of MALTA)

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European Economy

Convergence Report 2007 on Malta – Technical Annex

A Commission services working paper

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Aknowledgements

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Abbreviations and symbols used

Member States

BE	Belgium
BG	Bulgaria
CZ	Czech Republic
DK	Denmark
DE	Germany
EE	Estonia
EL	Greece
ES	Spain
FR	France
IE	Ireland
IT	Italy
CY	Cyprus
LV	Latvia
LT	Lithuania
LU	Luxembourg
HU	Hungary
MT	Malta
NL	The Netherlands
AT	Austria
PL	Poland

PT	Portugal
RO	Romania
SI	Slovenia
SK	Slovakia
FI	Finland
SE	Sweden
UK	United Kingdom

EU10	European Union Member States that joined the EU on 1 May 2004 (CZ, EE, CY, LT, LV, HU, MT, PL, SI, SK)
EUR13	European Union Member States having adopted the single currency (BE, DE, EL, ES, FR, IE, IT, LU, NL, AT, PT, SI, FI)
EU15	European Union, 15 Member States before 1 May 2004 (EUR-12 plus DK, SE and UK)
EU25	European Union, 25 Member States before 1 January 2007
EU27	European Union, 27 Member States

Currencies

EUR	euro
ECU	European currency unit
USD	US dollar
MTL	Maltese lira

Other abbreviations

CBM	Central Bank of Malta
CPI	Consumer price index
CR5	Concentration ratio (defined as the aggregated market share of five banks with the largest market share)
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EMI	European Monetary Institute
EMU	economic and monetary union
ERM II	exchange rate mechanism II
ESCB	European System of Central Banks
Eurostat	Statistical Office of the European Communities
FDI	foreign direct investment
GDP	gross domestic product
GFCF	gross fixed capital formation
HICP	harmonised index of consumer prices
ICT	information and communications technology
MTO	medium-term objective
MFSA	Malta Financial Services Authority
PPS	Purchasing Power Standard
SGP	Stability and Growth Pact
ULC	unit labour costs
VAT	value added tax

1. INTRODUCTION

1.1. Role of the report

The euro was introduced on 1 January 1999 by eleven Member States, following several years of successful adjustment efforts to achieve a high degree of sustainable convergence. The decision¹ by the Council (meeting in the composition of the Heads of State or Government) on 3 May 1998 in Brussels on the eleven Member States deemed ready to participate in the single currency (from the beginning) had, in accordance with the Treaty (Article 121(4)), been prepared by the Ecofin Council on a recommendation from the Commission. The decision was based on the two Convergence Reports made by the Commission² and the European Monetary Institute (EMI), respectively.³ These reports, prepared in accordance with Article 121(1) of the Treaty, examined in considerable detail whether the Member States satisfied the convergence criteria and met the legal requirements.

Those Member States which are assessed as not fulfilling the necessary conditions for the adoption of the single currency are referred to as "Member States with a derogation". Article 122(2) of the Treaty lays down provisions and procedures for examining the situation of Member States with a derogation (Box 1). At least once every two years, or at the request of a Member State with a derogation, the Commission and the European Central Bank (ECB) are required to prepare Convergence Reports on such Member States.

Box 1: Article 122(2) of the Treaty

"At least once every two years, or at the request of a Member State with a derogation, the Commission and the ECB shall report to the Council in accordance with the procedure laid down in Article 121(1). After consulting the European Parliament and after discussion in the Council, meeting in the composition of the Heads of State or Government, the Council shall, acting by a qualified majority on a proposal from the Commission, decide which Member States with a derogation fulfil the necessary conditions on the basis of the criteria set out in Article 121(1), and abrogate the derogations of the Member States concerned."

Denmark and the United Kingdom negotiated opt-out arrangements before the adoption of the Maastricht Treaty⁴ and do not participate in the third stage of EMU. Until these Member States indicate that they wish to participate in the third stage and join the single currency, they are not the subject of an assessment by the Council as to whether they fulfil the necessary conditions.

Greece submitted a request on 9 March 2000 for its convergence situation to be re-examined. The Ecofin Council adopted the decision⁵ that Greece fulfilled the necessary conditions for adoption of the single currency on 19 June 2000. The decision was taken on the basis of a proposal from the Commission and having regard to the discussion of the Council, meeting in the composition of the Heads of State or Government. The decision was based on two Convergence Reports made by the Commission⁶ and the ECB⁷, which covered both Greece and Sweden. Greece adopted the single currency with effect from

¹ OJ L 139, 11.5.1998, pp. 30-35.

² Report on progress towards convergence and recommendation with a view to the transition to the third stage of economic and monetary union, COM(1998)1999 final, 25 March 1998.

³ European Monetary Institute, Convergence Report, March 1998.

⁴ Protocol (No 26) on certain provisions relating to Denmark, Protocol (No 25) on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland.

⁵ OJ L 167, 7.7.2000, pp. 19-21.

⁶ European Commission, Convergence Report 2000, COM(2000) 277 final, 3 May 2000.

⁷ European Central Bank, Convergence Report 2000, May 2000.

1 January 2001. Sweden was assessed in 2000 as not fulfilling the necessary conditions for the adoption of the single currency.

In 2002, the convergence assessment covered only Sweden and concluded that Sweden was not fulfilling the necessary conditions for the adoption of the single currency and continued to be referred to as a "Member State with a derogation".⁸

In 2004, Sweden was examined together with the ten countries that joined the EU on 1 May 2004. In accordance with Article 4 of the Act of Accession, the ten countries became upon entry "Member States with a derogation". Although the maximum period referred to in Article 122(2) of the Treaty had not elapsed for these countries in 2004, the re-assessment of Sweden was seized as an opportunity to analyse also the state of convergence in the new Member States. None of the eleven assessed countries was considered to have fulfilled the necessary conditions for the adoption of the single currency.⁹

In 2006, two convergence assessments have been carried out. In May, the Commission and the ECB presented reports on Lithuania and Slovenia, prepared at the request of the national authorities.¹⁰ While Slovenia was deemed to fulfil all the convergence criteria and to be ready to adopt the euro in January 2007, the report on Lithuania suggested that there should be no change in the status of Lithuania as a Member State with the derogation. The remaining nine Member States with a derogation were assessed in regular Convergence Reports issued in December 2006.¹¹ None of the countries assessed was deemed to

meet the necessary conditions for adopting the single currency.

On 27 February 2007, Malta submitted a request for a convergence assessment. As a response to this request, the Commission and the ECB prepared Convergence Reports for Malta.

This Commission services working paper is a technical annex to the Convergence Report on Malta and includes a detailed assessment of the progress with convergence. The remainder of the first chapter presents the methodology used for application of the assessment criteria. Chapters 2 to 7 examine fulfilment of each of the convergence criteria and other requirements in the order as they appear in Article 121(1). The cut-off date for the statistical data included in the convergence report and in this technical annex is 26 April 2007.

1.2. Application of the criteria

In accordance with Article 121(1), the convergence reports shall examine the compatibility of national legislation with the Treaty and the Statute of the European System of Central Banks (ESCB) and of the European Central Bank. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment of the four convergence criteria dealing with price stability, the government budgetary position, exchange rate stability and long-term interest rates as well as some additional factors (Box 2). The four convergence criteria have been developed further in a Protocol annexed to the Treaty (Protocol No 21 on the convergence criteria).

⁸ European Commission, Convergence Report 2002, COM(2002) 243 final, 22 May 2002; and European Central Bank, Convergence report 2002, May 2002.

⁹ European Commission, Convergence Report 2004, COM(2004) 690 final, 20 October 2004; and European Central Bank, Convergence Report 2004, October 2004.

¹⁰ European Commission, Convergence Report 2006 on Lithuania, COM(2006) 223 final, 16 May 2006; European Commission, Convergence Report 2006 on Slovenia, COM(2006) 224 final, 16 May 2006; and European Central Bank, Convergence Report May 2006, May 2006. On the basis of the reports, the Ecofin Council adopted on 11 July 2006 the Decision that Slovenia fulfilled the necessary conditions for adoption of the single currency (OJ L 195, 15.7.2006, pp 25-27).

¹¹ European Commission, Convergence Report December 2006, COM(2006) 762 final, 6 December 2006; and European Central Bank, Convergence Report December 2006, December 2006.

Box 2: Article 121(1) of the Treaty

"1. The Commission and the EMI shall report to the Council on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of economic and monetary union. These reports shall include an examination of the compatibility between each Member State's national legislation, including the statutes of its national central bank, and Articles 108 and 109 of this Treaty and the Statute of the ESCB. The reports shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfilment by each Member State of the following criteria:

- the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability;*
- the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104(6);*
- the observance of the normal fluctuation margins provided for by the exchange rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State;*
- the durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the European Monetary System being reflected in the long term interest rate levels.*

The four criteria mentioned in this paragraph and the relevant periods over which they are to be respected are developed further in a Protocol annexed to this Treaty. The reports of the Commission and the EMI shall also take account of the development of the ECU, the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices."

Compatibility of legislation

In accordance with Article 121(1) of the Treaty, the legal examination includes an assessment of compatibility between a Member State's legislation, including the statute of its national central bank, and Articles 108 and 109 of the Treaty and the Statute of the ESCB/ECB. This assessment mainly covers three areas. First, the objectives of the national central bank must be examined, in order to verify their compatibility with the objectives of the ESCB as formulated in Article 105(1) and Article 2 of the Statute of the ESCB/ECB. The ESCB's primary objective is to maintain price stability. Without prejudice to this objective, it shall support the general economic policies in the Community. Second, the independence of the national central bank and of the members of its decision-making bodies (Article 108) must be assessed. This assessment covers all issues linked to a national central bank's institutional and financial independence and to the personal independence of the members of its decision-making bodies. Third, the integration of the national central

bank into the ESCB has to be examined, in order to ensure that the national central bank acts in accordance with the ECB's guidelines and instructions once the country concerned has adopted the single currency.

Price stability

The price stability criterion is defined in the first indent of Article 121(1) of the Treaty: *"the achievement of a high degree of price stability [...] will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability"*.

Article 1 of the Protocol on the convergence criteria further stipulates that *"the criterion on price stability [...] shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms of price stability."*

Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions”.

Since national consumer price indices (CPIs) diverge substantially in terms of concepts, methods and practices, they do not constitute the appropriate means to meet the Treaty requirement that inflation must be measured on a comparable basis. To this end, the Council adopted on 23 October 1995 a framework regulation¹² setting the legal basis for the establishment of a harmonised methodology for compiling consumer price indices in the Member States. This process resulted in the production of the *Harmonised Indices of Consumer Prices (HICPs)*, which have been used for assessing the fulfilment of the price stability criterion. Until December 2005, HICP series had been based on 1996 as the reference period. A Commission Regulation (EC) No 1708/2005¹³ provided the basis for a change of the HICP index base reference period from 1996=100 to 2005=100.

As has been the case in past convergence reports, a Member State's *average rate of inflation* is measured by the percentage change in the arithmetic average of the last 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period. The *reference value* is calculated as the arithmetic average of the average rate of inflation of the three best-performing Member States in terms of price stability plus 1.5 percentage points (Box 3).

Over the 12 month period covering April 2006-March 2007, the three best-performing Member States in terms of price stability were Finland, (1.3%), Poland (1.5%) and Sweden (1.6%) yielding a reference value of 3.0%.

The Protocol on the convergence criteria not only requires Member States to have achieved a high degree of price stability but also calls for a price performance that is sustainable. The requirement of *sustainability* aims at ensuring that the degree of price stability and inflation convergence achieved in previous years will be maintained after adoption of the euro. This implies that the satisfactory inflation performance must essentially be due to the adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflecting the influence of temporary factors. Therefore, this technical annex examines also developments in unit labour costs as a result of trends in labour productivity and nominal compensation per head, and developments in import prices to assess whether and how external price developments have impacted on domestic inflation. From a forward-looking perspective, the report includes an assessment of medium-term prospects for inflation. The analysis of factors that have an impact on the inflation outlook, such as credit developments and cyclical conditions, is complemented by a reference to the most recent Commission forecast of inflation. That forecast can subsequently be used to assess whether the country is likely to meet the reference value also in the months ahead.¹⁴

¹² Council Regulation (EC) No 2494/95 of 23 October 1995 concerning harmonised indices of consumer prices (OJ L 257, 27.10.1995, pp. 1-4).

¹³ Commission Regulation (EC) No 1708/2005 of 19 October 2005 laying down detailed rules for the implementation of Council Regulation (EC) No 2494/95 as regards the common index reference period for the harmonised index of consumer prices, and amending Regulation (EC) No 2214/96.

¹⁴ According to the Commission Spring 2007 Forecast, the reference value is forecast to stand at 2.8% in December 2007. The forecast of the reference value is subject to significant uncertainties given that it is calculated on the basis of the inflation forecasts for the three Member States projected to have the lowest inflation in the forecast period, thereby increasing the possible margin of error.

Box 3: Assessment of price stability and the reference value

The numerical part of the price stability criterion implies a comparison between a Member State's average price performance and a reference value.

A Member State's **average rate of inflation** is measured by the percentage change in the unweighted average of the last 12 monthly indices relative to the unweighted average of the 12 monthly indices of the previous period, rounded to one decimal.

This measure captures inflation trends over a period of one year as requested by the provisions of the Treaty. Using the commonly used inflation rate – calculated as the percentage change in the consumer price index of the latest month over the index for the equivalent month of the previous year – would not meet the one year requirement. The latter measure may also vary importantly from month to month because of exceptional factors.

The **reference value** is calculated as the unweighted average of the average rates of inflation of, at most, the three best-performing Member States in terms of price stability plus 1.5 percentage points. The outcome is rounded to one decimal. While in principle the reference value could also be calculated on the basis of the price performance of only one or two best performing Member States in terms of price stability, it has been existing practice to select the three best performers.

The reference value has been defined in the Maastricht Treaty in a relative way. An absolute reference value could, depending on the overall economic circumstances at the time of the assessment, be considered to be unduly harsh or too loose. Alternatively, using the average of the inflation rates of all Member States as a basis for the reference value would imply that high inflation rates of a few countries could increase the average to undesired levels. These problems are avoided in the Treaty by requiring convergence towards the best performing Member States within a margin of 1.5 percentage points. As the reference value is a relative concept based on the Member States with the lowest rate of inflation, a margin of 1.5 percentage points is added.

Article 121(1) of the Treaty refers to 'Member States' and does not make a distinction between euro area and other Member States. The Convergence Reports therefore select the three best performers from all Member States – EU15 for the Convergence Reports before 2004 and EU25 for the reports as of 2004.

As a principle, and in line with what was intended by the authors of the Maastricht Treaty, the Commission and ECB reports select as best performers in terms of price stability those Member States which have the lowest average rate of inflation. In the 2004 report, the Commission decided to exclude countries in deflation from the calculation of the reference value because these countries could not be considered to be 'best performers' in terms of price stability – as suggested by the Treaty Protocol, which refers only to an average rate of inflation.

Table 1 lists the reference value as used in the Convergence Reports issued since 1998.

Table 1.

Inflation reference value in previous and current Convergence Reports ¹⁾

Convergence Report adoption date	Cut-off month	Three best performers ²⁾	Reference value	Euro area average inflation rate ²⁾
1998	January 1998	Austria, France, Ireland	2.7	1.5
2000	March 2000	Sweden, France, Austria	2.4	1.4
2002	April 2002	United Kingdom, Germany, France	3.3	2.4
2004	August 2004	Finland, Denmark, Sweden	2.4	2.1
2006 May	March 2006	Sweden, Finland, Poland	2.6	2.3
2006 December	October 2006	Poland, Finland, Sweden	2.8	2.2
2007	March 2007	Finland, Poland, Sweden	3.0	2.1

1) EU15 until April 2004; EU25 between May 2004 and December 2006; EU27 from January 2007 onwards.

2) Measured by the percentage change in the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices of the previous period.

Source: Commission services.

Government budgetary position

The convergence criterion dealing with the government budgetary position is defined in the second indent of Article 121(1) of the Treaty as “*the sustainability of the government financial position: this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104(6)*”. Furthermore, Article 2 of the Protocol on the convergence criteria states that this criterion means that “*at the time of the examination the Member State is not the subject of a Council decision under Article 104(6) of this Treaty that an excessive deficit exists*”.

The convergence assessment in the budgetary area is thus directly linked to the excessive deficit procedure which is specified in Article 104 of the Treaty and further clarified in the Stability and Growth Pact. The existence of an excessive deficit is determined in

relation to the two criteria for budgetary discipline set in Article 104(2), namely on the government deficit and the government debt. Failure by a Member State to fulfil the requirements under either of these criteria can lead to a decision by the Council on the existence of an excessive deficit, in which case the Member State concerned does not comply with the budgetary convergence criterion (for further information on this procedure, see Box 4).¹⁵

¹⁵ The definition of the general government deficit used in this report is in accordance with the excessive deficit procedure, as was the case in previous convergence reports. In particular, interest expenditure, total expenditure and the overall balance include net streams of interest expenditure resulting from swaps arrangements and forward rate agreements. Government debt is general government consolidated gross debt at nominal value.

Box 4: The excessive deficit procedure¹⁶

The excessive deficit procedure (EDP) is specified in Article 104 of the Treaty, the associated Protocol on the EDP and Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the EDP¹⁷, which is the “dissuasive arm” of the Stability and Growth Pact (SGP). Together, they determine the steps to be followed to reach a Council decision on the existence of an excessive deficit, which forms the basis for the assessment of compliance with the convergence criterion on the government budgetary position, and the steps to be followed to correct a situation of excessive deficit. According to Article 104(2), compliance with budgetary discipline is to be examined by the Commission on the basis of the following two criteria:

- “(a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value [specified in the Protocol as 3%], unless:
- either the ratio has declined substantially and continuously and reached a level that comes close to the reference value;
 - or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;
- (b) whether the ratio of government debt to gross domestic product exceeds a reference value [specified in the Protocol as 60%], unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace”.

According to the Protocol, the Commission provides the statistical data for the implementation of the procedure. As part of the application of this Protocol, Member States have to notify data on government deficits, government debt and nominal GDP and other associated variables twice a year, namely before 1 April and before 1 October¹⁸. After each reporting date, Eurostat examines whether the data are in conformity with ESA95¹⁹ rules and related Eurostat decisions and, if they are, validates them.

The Commission is required to prepare a report if a Member State does not fulfil the requirements under one or both of the criteria given above (Article 104(3)). The report also has to take into account whether the government deficit exceeds government investment expenditure and all other relevant factors (considerations related to the medium-term economic and budgetary position of the Member State). These factors should be considered in the steps of the EDP leading to the decision on the existence of an excessive deficit only under the double condition that the deficit is close to the reference value and its excess over it is temporary. Special provisions are foreseen for pension reforms introducing a multi-pillar system including a mandatory, fully-funded pillar (for further details, see Box 1.5 of the December 2006 Convergence Report).

The next step in the procedure is the formulation by the Economic and Financial Committee of an opinion on this report within two weeks of its adoption by the Commission (Article 104(4)). If it considers that an excessive deficit exists or may occur, the Commission then addresses an opinion to the Council (Article 104(5)). On the basis of a Commission recommendation, the Council decides, after an overall assessment, whether an excessive deficit exists (Article 104(6)). Any such decision has to be adopted as a rule within four months of the reporting dates (1 April, 1 October).

When it decides that an excessive deficit exists, the Council has to issue a recommendation to the Member State concerned with a view to bringing that situation to an end within a given period, also on the basis of a Commission recommendation (Article 104(7)). The Council recommendation has to specify when the correction of the excessive deficit should be completed, namely in the year following its identification unless there are

¹⁶ Information regarding the excessive deficit procedure and its application to different Member States since 2002 can be found at: http://ec.europa.eu/economy_finance/about/activities/sgp/edp_en.htm.

¹⁷ OJ L 209, 2.8.1997, p. 6. Regulation as amended by Regulation (EC) No 1056/2005 (OJ L 174, 7.7.2005, p. 5).

¹⁸ Council Regulation (EC) No 3605/93 on the application of the Protocol on the excessive deficit procedure (OJ L 332, 31.12.1993, p. 7). Regulation as last amended by Regulation (EC) No 2103/2005, (OJ L 337, 22.12.2005, p. 1).

¹⁹ European System of National and Regional Accounts, adopted by Council Regulation (EC) No 2223/96 (OJ L 310, 30.11.1996, p. 1). Regulation as last amended by Regulation (EC) No 1267/2003 of the European Parliament and of the Council (OJ L 180, 18.7.2003, p. 1).

special circumstances, and has to include a deadline of six months at most for effective action to be taken by the Member State concerned. The recommendation should also specify that the Member State concerned has to achieve a minimum annual improvement of at least 0.5% of GDP as a benchmark in its cyclically-adjusted balance net of one-off and temporary measures.

If effective action has been taken in compliance with a recommendation under Article 104(7) and, compared with the economic forecasts in this recommendation, unexpected adverse economic events with major unfavourable consequences for government finances occur subsequent to its adoption, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under the same article, which may notably extend the deadline for the correction of the excessive deficit by one year. Where it establishes that there has been no effective action in response to its recommendations, the Council adopts a decision under Article 104(8) on the basis of a Commission recommendation immediately after the expiry of the deadline for taking action (or at any time thereafter when monitoring of the action taken by the Member State indicates that action is not being implemented or is proving to be inadequate). The provisions of Article 104(9 and 11), on enhanced Council surveillance and ultimately sanctions in case of non-compliance, are not applicable to Member States with a derogation (that is, those that have not yet adopted the euro), which is the case of the Member States considered in this report.

When, in the view of the Council, the excessive deficit in the Member State concerned has been corrected, the Council abrogates its decision on the existence of an excessive deficit, on the basis of a Commission recommendation (Article 104(12)).

Exchange rate stability

The Treaty refers to the exchange rate criterion in the third indent of Article 121 as *“the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State”*.

Article 3 of the Protocol on the convergence criteria stipulates: *“The criterion on participation in the exchange rate mechanism of the European Monetary System (...) shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency’s bilateral central rate against any other Member State’s currency on its own initiative for the same period”*. Based on the Council Resolution on the establishment of the ERM II²⁰, the European Monetary System has been replaced by the Exchange Rate Mechanism II upon the introduction of the euro, and the euro has become the centre of the mechanism.

As in previous reports, the assessment of this criterion verifies the participation in ERM II and examines exchange rate behaviour within the mechanism. The relevant period for assessing exchange rate stability in

this technical annex is 27 April 2005 to 26 April 2007.

Long-term interest rates

The fourth indent of Article 121(1) of the Treaty requires *“the durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the European Monetary System being reflected in the long-term interest rate levels”*. Article 4 of the Protocol on the convergence criteria further stipulates that *“the criterion on the convergence of interest rates (...) shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions”*.

For the assessment of the criterion on the convergence of interest rates, yields on benchmark 10-year bonds have been taken, using an average rate over the latest 12 months. The reference value is calculated as the simple average of the average long-term interest rates of the three best-performing Member States in terms of price stability plus 2 percentage points. In March 2007, the reference value, derived from the average

²⁰ 97/C 236/03 of 16 June 1997, OJ C 236, 2.8.1997, p.5.

interest rate in Finland (3.9%), Poland (5.3%) and Sweden (3.8%), was 6.4%.

Additional factors

The Treaty in Article 121 also requires an examination of other factors relevant to economic integration and convergence. These additional factors include financial and product market integration and the development of the balance of payments. The examination of the development of unit labour costs and other price indices, which is also prescribed by Article 121 of the Treaty, is covered in the chapter on price stability.

The additional factors are an important indicator that the integration of a Member State into the euro area would proceed without major difficulties. As regards the *integration of financial markets*, the focus is on compliance with the *acquis communautaire* in respect of the financial sector, on main characteristics, structures and trends of the financial sector and on progress in financial integration. *Integration of product markets* is assessed through trade, foreign direct investment and a smooth functioning of the internal market. Finally, the situation and development of *the current account of the balance of payments* is examined to ensure that the Member States joining the euro area are not subject to unsustainable external imbalances.

2. LEGAL COMPATIBILITY

2.1. Legal situation

Following Malta's independence in 1964, the Central Bank of Malta (CBM) was established in April 1968 on the basis of the Central Bank of Malta Act (1967). It is a corporate body with a distinct legal personality. The CBM became an independent central bank pursuing price stability as its primary objective following amendments to the Act adopted in October 2002. The CBM Act was amended twice in 2005. A further Act (Act n° I of 2007) amending the CBM Act was adopted by Parliament on 28 February 2007, entering into force on the date to be established by the Minister of Finance. This date should be the date of the introduction of the euro in Malta.

The decision-making bodies of the CBM are the Governor and the Board of Directors. The sole authority (and responsibility) to take decisions and to perform any function or duty or to exercise any power relating to monetary policy is vested in the Governor, who, when performing this function, shall act in accordance with the powers and duties conferred by the Treaty and the ESCB Statute. The Governor may establish a Monetary Policy Advisory Council to advise him on matters relating to monetary policy.

Objectives

The primary objective of the CBM is to maintain price stability. The secondary objective of the CBM (Article 4(1)) has been amended and fully reflects the ESCB's secondary objective.

Independence

According to Article 108 of the Treaty neither a national central bank nor any member of its decision-making bodies shall, when exercising the powers and carrying out the tasks and duties conferred upon them by the EC Treaty and the ESCB Statute, seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body. Inversely, the Community institutions and bodies and the governments of the Member States

have to respect this principle and may not seek to influence the members of the decision-making bodies of the national central banks in the performance of their tasks. The different features which make up independence may be grouped into three categories: institutional, personal and financial independence.²¹ In particular concerning personal independence, the ESCB Statute contains specific provisions, for example, on the term of office of the governor of a national central bank and the grounds for his dismissal (Article 14.2 ESCB Statute).

The CBM Act was already considered compatible with the Treaty as regards independence in the 2006 Convergence Report.

Integration in the ESCB

The incompatibilities raised in the 2006 Convergence Report have been removed. The Act on the amendments to the Central Bank of Malta Act notably repeals Articles 4(2)a, 17A, 17D, 19, 37(2) and (3), 39, 40, 41 as well as Article 43(3) and (4) of the initial Act. Moreover, a series of articles have been amended so as to take account of the respective roles and competences assigned by the EC Treaty to the ECB, ESCB and the EC Council. This concerns in particular Articles 15(2) on the holding and managing of foreign reserves, Articles 42 and 43(1) and (2) on the right to authorise the issue of banknotes and the volume of coins, Articles 15(1) and 37(1) on the monetary functions, operations and instruments of the ESCB, Article 52a on the imposition of sanctions and Article 22 on the financial provisions related to the ESCB.

Prohibition of monetary financing

In line with the prohibition of monetary financing (Article 101(1) of the Treaty), the CBM shall not grant overdrafts or any other type of credit facility to Community institutions or bodies, to the government or any public authority, to bodies governed by public

²¹ See European Commission, Convergence Report 2004, p. 10-11.

law, public undertakings or government-owned corporations of any Member State. Moreover, the CBM shall not directly purchase debt instruments of such entities (Article 27(1)).

However, an imperfection subsists in this respect: Article 17(1)g of the revised Act (Article 15(1)g of the initial Act) offers the possibility for the CBM of providing lending to any Maltese credit institution in order to safeguard financial stability and in other exceptional circumstances. It should be ensured, e.g. through a specific safeguard clause, that the CBM does not possibly end up bearing financial costs to be borne by the state. Otherwise monetary financing would be involved, which would be contrary to Article 101 of the Treaty. Moreover, the CBM's financial independence could be put at risk.

2.2. Assessment of compatibility

Legislation in Malta is compatible with the requirements of the EC Treaty and the ESCB Statute.

One residual imperfection subsists in the Central Bank of Malta Act with respect to the prohibition of monetary financing.

3. PRICE STABILITY

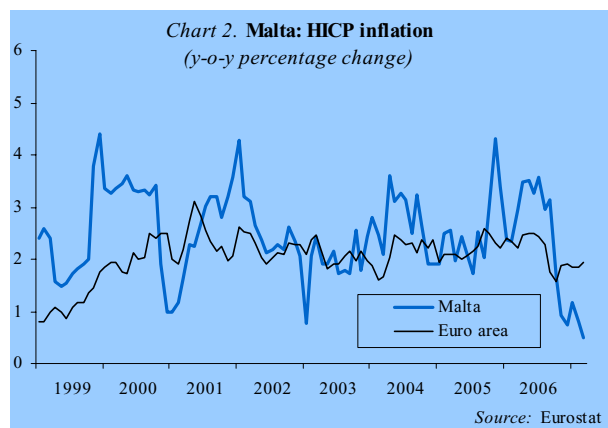
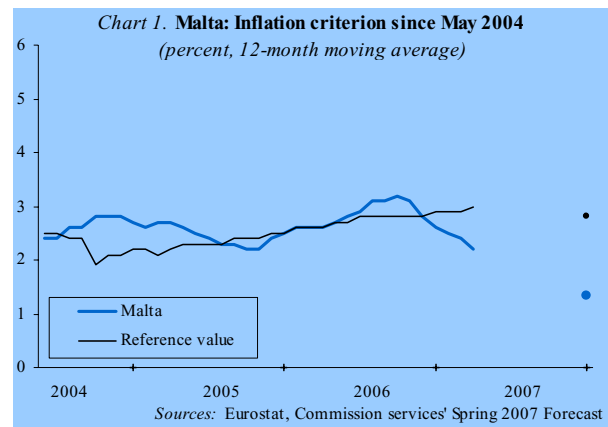
3.1. Respect of the reference value

The 12-month average inflation rate for Malta, which is used for the convergence assessment, has fluctuated around the reference value for the past years. 12-month average inflation has been at or slightly below the reference value since July 2005 except for the period May – October 2006. In March 2007, the reference value was 3.0%, calculated as the average of the 12-month average inflation rates in the three best-performing Member States (Finland, Poland and Sweden) plus 1.5 percentage points. The corresponding inflation rate in Malta was 2.2%, i.e. 0.8 percentage point below the reference value.

3.2. Recent inflation developments

Since 1999, HICP inflation in Malta²² has been moderate with annual averages between 2 and 3%. At the same time, Malta's inflation has been characterised by marked intra-year volatility reflecting the high sensitivity of the small and open economy to external price shocks and exchange rate fluctuations. Having stayed close to 2% since 2002, inflation picked up in 2004, mainly due to indirect tax increases, but it returned to around 2% at the beginning of 2005. In autumn 2005, inflation increased again and more considerably, reflecting a strong rise in energy prices related to higher oil prices. Between October 2005 and September 2006, headline

inflation hovered around 3.5%. When the impact of higher oil prices ebbed away, inflation dropped markedly to below 1% at the end of 2006 and it has stayed close to that level since then. Since November 2006, Malta has been the EU Member State with the lowest HICP inflation rate. Apart from the significant base effects in energy inflation, the decline reflects a drop in prices of clothing and footwear and air transport (following the arrival of low-cost airlines in November 2006).



²² In the context of compliance monitoring and quality assurance, Eurostat has been reviewing the statistical practices used to compile the HICP for Malta against HICP methodology and other guidelines and good practices in the field of consumer price indices. Eurostat considers that in general the methods used for producing the Maltese HICP are satisfactory. The Maltese data passes all standard HICP validation tests, and should be considered broadly comparable to the HICPs of other EU countries. While the accuracy and reliability of the HICP are judged as generally adequate, some points for improvement are suggested. The compliance report is available under http://epp.eurostat.ec.europa.eu/pls/portal/docs/page/pgp_ds_hicp/TAB61582098/information%20note%20on%20cm%20-%20malta%202006-10.pdf

Table 2.

Malta: Components of inflation¹⁾
(percentage change)

	2001	2002	2003	2004	2005	2006	Mar-07	weights in total 2007
HICP	2.5	2.6	1.9	2.7	2.5	2.6	2.2	1000
Non-energy industrial goods	0.2	0.4	-1.3	1.5	1.7	1.7	1.4	321
Energy	0.3	3.7	2.2	5.9	15.9	17.1	9.6	56
Unprocessed food	6.6	0.6	2.3	-1.0	2.2	2.2	2.8	79
Processed food	3.0	5.1	1.5	4.5	1.5	1.6	1.8	143
Services	3.7	3.6	4.6	3.2	2.3	1.4	1.4	401
HICP excl. energy and unproc. food	2.3	2.7	1.9	2.8	2.0	1.6	1.5	865

1) Measured by the arithmetic average of the latest 12 monthly indices relative to the arithmetic average of the 12 monthly indices in the previous period.

Sources: Eurostat, Commission services.

Core inflation (measured as HICP inflation excluding energy and unprocessed food) has remained contained at an average of 2% in 2005 and 1.6% in 2006, though this masks considerable intra-year volatility amid fluctuations in sub-items such as food, clothing, accommodation and administered prices (water). At the end of 2006, this measure of core inflation fell to historically low levels below 1% before rebounding to 1.2% in the first quarter of 2007. Moderate core inflation dynamics suggest that underlying inflationary pressures have remained limited, against the background of a negative output gap and low wage pressures. In particular, there have been no signs of second-round effects from energy prices so far, suggesting that inflationary expectations remain well-anchored.

3.3. Underlying factors and sustainability of inflation

Macroeconomic policy-mix and cyclical stance

The Maltese economy is estimated to be operating below potential, following two years of negative or flat real GDP growth in 2003 and 2004, and despite a relatively robust recovery to a growth rate of around 3% in 2005 and 2006. Real GDP growth is expected to stay around 3% in 2007 and 2008, which would narrow but not close the negative output gap. While in 2005 the recovery was based on relatively robust growth in both private and public investment and a revival of private consumption, a rebound of exports was an additional impetus in 2006. The main drivers in 2007 should be foreign investment and strong private consumption stemming from a lower income tax and cash de-hoarding in anticipation of the euro changeover. Unemployment has been stable at around 7.4% since 2004, but is expected to decrease in the period ahead.

The fiscal stance, as measured by changes in the cyclically-adjusted primary balance, has been tightened in 2004 and 2005 and was roughly neutral in 2006. Fiscal impulses have thus not been a driver of inflation. A moderate decline of the cyclically-adjusted primary surplus is expected for 2007, though against the background of a still negative output gap. Exchange rate stability and a credible monetary policy have also contributed to keep inflation at relatively low levels.

Wages and labour costs

Inflationary pressures from the labour cost side appear contained at present, amid slow growth of both wages and labour productivity. Following a few years of deceleration (from 5.8% in 2001 to slightly above 1% in 2005 and 2006), annual growth of nominal compensation per employee is expected to recover moderately to some 1.6% this year. Labour productivity has recorded strong cyclical fluctuations (as GDP volatility was not directly translated into employment) around a low trend rate. Productivity fell alongside real GDP in 2003 and grew at around 1.2% annually in the following two years. A slight pick-up to around 2% is estimated for 2006 and 2007. Together, wage and

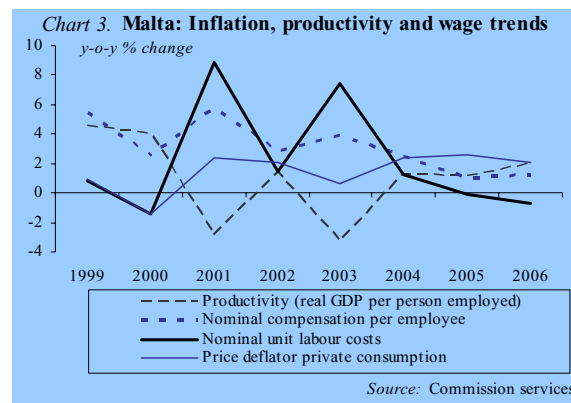


Table 3.

**Malta: Other inflation and cost indicators
(annual percentage change)**

	2001	2002	2003	2004	2005	2006	2007 ¹⁾
Private consumption deflator							
Malta	2.4	2.1	0.6	2.4	2.6	2.0	1.4
Euro area	2.3	1.8	2.1	2.0	2.0	2.0	1.8
Nominal compensation per employee							
Malta	5.8	2.8	3.9	2.5	1.1	1.2	1.6
Euro area	2.7	2.7	2.8	2.5	1.9	2.2	2.6
Labour productivity							
Malta	-2.8	1.4	-3.3	1.2	1.2	2.0	2.1
Euro area	0.5	0.4	0.8	1.6	0.9	1.4	1.4
Nominal unit labour costs							
Malta	8.9	1.4	7.4	1.2	-0.1	-0.7	-0.5
Euro area	2.2	2.4	2.0	0.9	1.0	0.9	1.2
Imports of goods deflator							
Malta	-4.2	2.5	-5.7	-3.3	3.1	12.2	1.0
Euro area	0.2	-2.9	-2.2	1.5	4.0	4.7	0.7

1) Commission services' Spring 2007 Forecast.

Source: Commission services.

productivity developments in 2000-2004 have yielded somewhat volatile results in terms of nominal unit labour costs (ULC). Since 2005, ULC have been decreasing, and slightly negative growth is expected also in 2007.

Negative ULC growth confirms that wage agreements in the private sector have in the recent past tended to broadly take account of productivity concerns. It also suggests that no second-round effects from recent energy price increases through the wage-setting process have materialised so far. Public sector wage discipline has been fostered through a multi-year collective agreement concluded in late 2005. Wage agreements in private sector reflect a need to regain competitiveness. Flexibility of the wage setting process in Malta is somewhat diminished by partial wage indexation (cost-of-living adjustment based on the "social wage", which is lower than the average wage), although indexation can be waived at firm level. Preserving wage discipline in both the public and private sector will be important to contain spillover risks from temporary factors affecting headline inflation.

Import prices

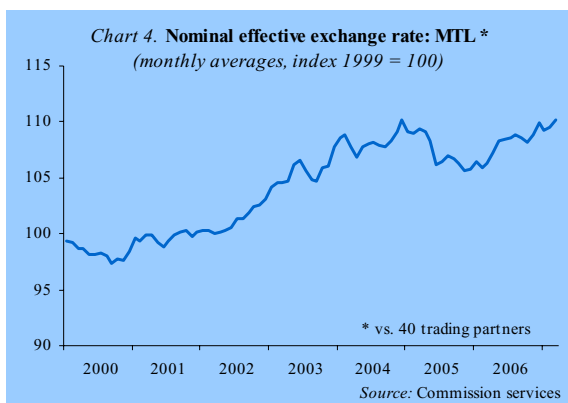
Given Malta's small size and high degree of openness, imported goods account for a large share of the consumer basket. Import price developments, as

measured by the import of goods deflator in the national accounts, have been favourable to disinflation in 2003 and 2004, with decreases of 5.7 and 3.3%, respectively. Import price inflation strengthened to around 3% in 2005 and is estimated to have increased further in 2006, thus generating upward pressure on headline inflation.²³

Import price fluctuations have been heavily influenced by global oil price developments, with year-on-year fuel price inflation accelerating from 12% on average in 2005 to some 21% on average during the first 9 months of 2006, though followed by a 10% year-on-year drop since November. High commodity prices have been partly counterbalanced by favourable effects from trade liberalisation, including in the context of EU accession, and increased global market integration, which may have held down import price inflation in some sectors (e.g. food, clothing, furniture). Exchange rate developments have also had a bearing on import price dynamics over the past years. The nominal effective exchange rate of the lira, measured against a group of

²³ However, it should be noted that the current statistics suggesting a surge in the import deflator by 12 percent in 2006 is surrounded by some uncertainty due to the specifics of such a small economy (non-availability of comparable products for one-off imports, new products, etc.).

40 trade partners, appreciated steadily by around 10% between 2000 and 2004, dampening import price dynamics. The effective exchange rate broadly stabilised in 2005 and 2006, thus remaining roughly neutral with regard to import prices.



Administered prices and taxes

The share of administered prices in the Maltese HICP basket is relatively low, reflecting *inter alia* a comparatively small share of energy products in the basket. Still, Malta's inflation profile in the last years has been strongly shaped by developments in regulated prices for energy and related products, as pent-up price pressures have been released. In particular, electricity and water supply prices were increased significantly in January 2005 through the imposition of a "surcharge"²⁴, with a particularly sharp hike in November 2005.

Due to the introduction of the surcharge, the impact of higher oil prices on inflation was more pronounced in Malta than in other EU Member States, despite a lower share of energy in the HICP basket (at some 6%, compared to around 9% in the euro area). During the first 10 months of 2006, electricity prices were 37% higher than one year before and energy accounted for around 1.5 percentage points of Malta's HICP inflation. A 30-percent increase in the administered price of water supply in November 2005, which added another 0.2 percentage point to headline inflation, was also related to higher oil

prices, given the energy-intensive desalination process used to generate drinking water. The combined impact of a drop in energy and water inflation – resulting from both strong base effects and falling prices of fuel in autumn 2006 – contributed by almost 2 percentage points to the sharp decline in headline inflation in October and November 2006. In the first quarter of 2007, energy and water contributed to inflation negatively, by about -0.3 percentage point.

VAT and excise increases, partly related to EU accession, had a relatively strong impact on inflation in Malta in 2004, but Malta's inflation profile since 2005 has not been appreciably influenced by changes in indirect taxes.

Medium-term prospects

Inflation performance in 2007 will mainly reflect the path of prices for energy and related products. As base effects related to strong price increases in these categories in late-2005 subside towards the end of 2007, headline inflation is expected to move back towards rates more consistent with medium-term trends. The Commission 2007 Spring Forecast projects a deceleration of annual average HICP inflation from 2.6% in 2006 to 1.4% in 2007 and an increase in 2008 to 2.1%.

Risks to this inflation outlook appear broadly balanced. The main risks are related to energy prices and are two-sided. Apart from the development of oil prices, uncertainties arise as regards the planned expiry of the energy surcharge scheme in late 2007, although no significant impact is expected. The ongoing liberalisation of the energy sector in Malta could result in downward pressure on energy prices

Consumer prices in Malta are some 70-75% of the EU average. This suggests some potential for some gradual further price level convergence in the long-term, as income levels (currently about 70% of the EU25 average in PPS) rise towards the EU average.

Medium-term inflation prospects will also depend strongly on wage and productivity developments as well as the competitive environment. Measures should be taken (including in the field of education and labour market regulation) in order to prevent labour shortages and skill mismatches, in particular in the light of some upcoming large investment projects (e.g. "Smart City – Malta"). Advancing structural reforms to improve the functioning of product markets (in particular utilities) is warranted with a

²⁴ A surcharge on electricity and water prices was introduced in January 2005 to reflect the development of oil price. In the previous regime, the prices of electricity and water had been kept constant and all losses resulting from higher international oil prices were absorbed by state-owned electricity and water providers. The surcharge is currently adjusted bi-monthly in light of developments in oil prices.

view to price developments. Fiscal discipline will also be important to stem inflationary risks as cyclical conditions improve.

4. GOVERNMENT BUDGETARY POSITION

4.1. The excessive deficit procedure for Malta²⁵

In July 2004, the Council decided that Malta was in excessive deficit, based on a deficit of 9.7% of GDP in 2003 and a rising debt ratio, which stood at 72% of GDP in 2003. At the same time, the Council issued a recommendation to correct the excessive deficit. In particular, Malta was recommended to take action in a medium-term framework in order to bring the deficit below 3% of GDP by 2006 in a credible and sustainable manner, in line with the Council Opinion on the May 2004 Convergence Programme. The Council endorsed the following intermediate targets for the general government deficit: 5.2% of GDP in 2004, 3.7% in 2005 and 2.3% in 2006. Malta was also recommended to bring the rise in the debt ratio to a halt in 2005.

In its Opinion on the December 2006 update of the Convergence Programme, the Council noted that the debt ratio seemed to be diminishing at a satisfactory pace towards the 60% of GDP reference value and that the programme was consistent with a correction of the excessive deficit by 2006. In view of these developments and the Commission services' Spring 2007 Forecast, the Commission considers that the excessive deficit has been corrected with a credible and sustainable reduction of the deficit below 3% of GDP and the rise in the debt to GDP ratio has been decreasing since 2004. The Commission is therefore recommending to the Council to abrogate the decision on the existence of an excessive deficit for Malta.

4.2. Developments until 2006

Over the 2000-2006 period, the general government deficit averaged around 5.5% of GDP reaching a high of 10% of GDP in 2003, when a one-off expenditure-increasing transaction amounting to some 3% of GDP in relation to the restructuring of the shipyards took

place. Since then, the deficit-to-GDP ratio has progressively declined, reaching 2.6% of GDP in 2006. The 2006 outcome is 0.1 percentage points better than the official target of 2.7% of GDP set in the January 2006 update of the convergence programme. The primary balance, after reaching a through of -6.5% of GDP in 2003, turned into a surplus in 2005 and stood at 1.1% in 2006. Interest expenditure was relatively stable in a range between 3.4% and 3.8% of GDP during this period.

The revenue-to-GDP ratio followed an upward trend between 2000 and 2005, increasing by 8 percentage points, on account of both new and higher taxes and in response to the government's drive to achieve a more efficient tax collection. In 2006, total revenue declined marginally in relation to GDP and stood at 42.7% mainly reflecting a fall in both social contributions and capital transfers. Nevertheless, capital transfers rose substantially in 2004 and 2005, supported by financial inflows from the Italian financial protocol²⁶ and EU funds. Total expenditure as a% of GDP increased until 2003, but declined thereafter. Rising current spending - mainly as a result of higher final consumption expenditure and social transfers - underpinned the upward trend in total expenditure up to 2003. Capital spending also contributed to the rise in expenditure primarily reflecting spending related to the building of the *Mater Dei* hospital. The decline in total expenditure in 2004 occurred on the back of a fall in capital outlays as current expenditure continued to rise. In 2005, the fall in the general government expenditure ratio to GDP was due to a decline in current spending which more than offset higher total capital expenditure. In 2006, the further decline in total expenditure ratio reflected both lower current spending and public investment, the latter mainly reflecting constraints in the capacity to absorb EU funds.

Recourse to one-off and other temporary measures was substantial since 2003. Apart from 2003, one-off measures in the other years under consideration were

²⁵ All documents related to the excessive deficit procedure for Malta can be found at:
http://ec.europa.eu/economy_finance/about/activities/sfp/procedures_en.htm.

²⁶ Co-operation agreement signed between Italy and Malta providing grants to finance public projects in Malta.

deficit-reducing operations consisting mainly of sale of land averaging around 1% of GDP each year. The structural deficit (i.e. cyclically-adjusted deficit net of one-off and other temporary measures) improved from a high of 6.4% of GDP in 2003 to 3.8% in 2005. In 2006, the structural deficit declined further to 2.7% of GDP.

As a result of the deficit recorded in successive years, the general government debt moved from a position below 60% of GDP in 2000 to one substantially above the reference value. Specifically, the debt ratio increased from around 56% of GDP in 2000 to slightly below 74% of GDP in 2004. The acceleration in debt accumulation which occurred in 2003 reflects a one-off transaction as government took over debt incurred in the past by the shipyards as part of restructuring this sector. However, starting from 2005 the debt ratio followed a downward path reaching around 66.5% of GDP in 2006. During these years, stock-flow adjustments – specifically, proceeds from privatisation – dampened the rise in debt. In particular, the decline in the general government debt in 2006 was to a large extent due to substantial privatisation proceeds amounting to around 3.5% of GDP.

4.3. Medium-term prospects

The Budget for 2007 was approved by Parliament on 17 November 2006. The main measures presented in the Budget include a reform of the personal income tax regime, a new licensing system for gaming machines, lower social contributions for certain categories of part-time employment, tax deductions for parents utilising the services of childcare facilities, a reduction in the airport tax, an energy benefit aimed at alleviating the cost of energy to low-income households and improvements in certain social benefits. The Budget also announced the securitisation of certain government property (estimated at around 1 percentage point of GDP) to finance payment for expropriated land. The 2007 Budget targets a further decline in the general government deficit to 2.3% of GDP in 2007, which was subsequently improved to 1.9% of GDP in the April 2007 fiscal notification. Compared to the April 2007 fiscal notification, the Commission services' Spring 2007 forecast projects a slightly more cautious adjustment to 2.1% of GDP in 2007, primarily due to lower revenue from social contributions as compared to the projections of the Maltese authorities.

The structural deficit is projected to improve marginally from 2.7% of GDP in 2006 to 2.6% of

GDP in 2007. This suggests that the relatively high economic growth and the progressive closing of the output gap anticipated for 2007 are not being utilised fully to speed up the pace of adjustment.

The December 2006 update of the convergence programme covers the period from 2006 to 2009. The budgetary strategy outlined in the update aims at reducing the deficit below the 3% of GDP reference value in 2006 and at pursuing fiscal consolidation thereafter, to a broadly balanced budget by 2009.²⁷ The medium-term objective (MTO) for the budgetary position is a balanced position in structural terms. According to the December 2006 programme, the MTO will be achieved beyond the programme period.

The Commission services' Spring 2007 forecast projects general government debt of 65.9% of GDP for 2007, down from 66.5% of GDP recorded in the previous year. According to the December 2006 convergence programme, the debt ratio is foreseen to follow a downward path between 2007 and 2009, when it is expected to reach 59.4% of GDP.

In its Opinion of 27 February 2007 on the December 2006 update of the Convergence Programme, the Council noted that, in a context of strong growth prospects, the programme envisaged adequate progress towards the MTO but that there were risks to the achievement of the budgetary targets after 2007. In particular, while in the years following the correction of the excessive deficit, the pace of adjustment towards the MTO implied by the programme was broadly in line with the Stability and Growth Pact, there were some risks to the budgetary projections in the programme, especially with regard to the assumed favourable macroeconomic assumptions in 2008 and 2009. The Council invited Malta to pursue the planned progress towards the MTO, ensure that the debt-to-GDP ratio was reduced accordingly and to make further progress in the design and implementation of the healthcare reform in order to improve the long-term sustainability of public finances.

²⁷ The successive updates of the convergence programme and the assessments by the Commission and Council can be found at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

Table 4.

Malta: Budgetary developments and projections
(as percentage of GDP unless otherwise indicated)

Outturn and forecast ⁽¹⁾	2000	2001	2002	2003	2004	2005	2006	2007		
General government balance	-6.2	-6.4	-5.5	-10.0	-4.9	-3.1	-2.6	-2.1		
- Total revenues	34.9	36.7	38.2	38.6	41.9	42.9	42.7	42.2		
- Total expenditure	41.0	43.1	43.8	48.6	46.8	46.0	45.2	44.3		
Of which: - Interest expenditure	3.6	3.4	3.6	3.5	3.7	3.8	3.7	3.3		
- Current primary expenditure	33.6	36.4	36.5	37.8	39.0	37.9	37.6	36.6		
- Gross fixed capital formation	4.2	3.7	4.5	5.1	2.1	5.3	4.6	5.2		
Primary balance	-2.5	-3.1	-1.9	-6.5	-1.2	0.7	1.1	1.2		
p.m. Tax burden	28.2	30.4	31.9	31.8	33.8	34.5	34.9	35.2		
Cyclically-adjusted balance	-7.8	-6.9	-6.2	-9.2	-3.6	-2.2	-2.0	-1.9		
One-off and temporary measures	-	-	-	-2.9	0.7	1.7	0.7	0.6		
Structural balance ⁽²⁾	-	-	-	-6.4	-4.3	-3.8	-2.7	-2.6		
Structural primary balance	-	-	-	-2.9	-0.6	0.0	1.0	0.8		
Government gross debt	56.0	62.1	60.8	70.4	73.9	72.4	66.5	65.9		
p.m. Real GDP (% change)	6.4	-1.1	1.9	-2.3	0.4	3.0	2.9	3.0		
p.m. Output gap	5.5	1.4	2.0	-2.1	-3.4	-2.5	-1.5	-0.6		
p.m. GDP deflator (% change)	1.7	2.9	2.7	4.6	1.4	2.4	2.6	2.3		
Convergence programme						2005	2006	2007	2008	2009
General government balance						-3.2	-2.6	-2.3	-0.9	0.1
Primary balance						0.8	1.1	1.1	2.5	3.2
Structural balance ⁽²⁾⁽³⁾						-3.8	-2.9	-2.0	-1.0	-0.4
Government gross debt						74.2	68.3	66.7	63.2	59.4
p.m. Real GDP (% change)						2.2	2.9	3.0	3.1	3.1

⁽¹⁾ Commission services' Spring 2007 Forecast.

⁽²⁾ Cyclically-adjusted balance excluding one-off and other temporary measures.

⁽³⁾ Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures according to the programme are 1.6% of GDP in 2005, 1.1% of GDP in 2006, 0.2% of GDP in 2007, 0.2% of GDP in 2008 and 0.2% of GDP in 2009, all deficit-reducing.

Sources: Eurostat, Commission services and December 2006 update of the convergence programme.

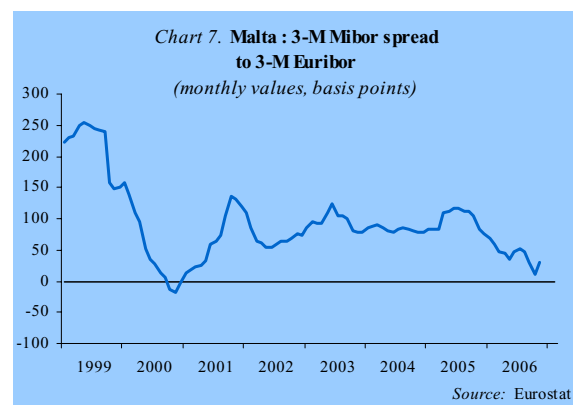
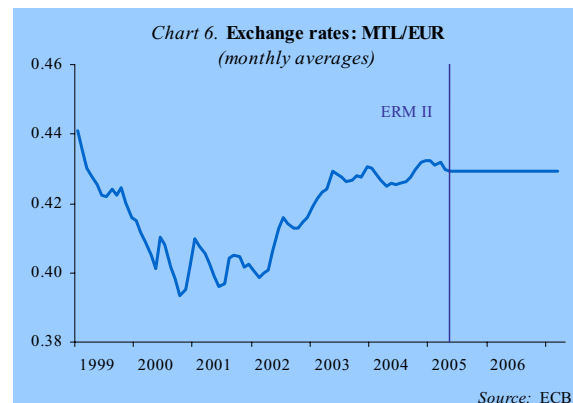
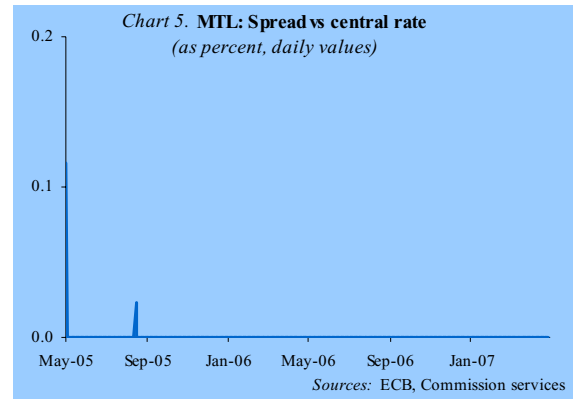
5. EXCHANGE RATE STABILITY

On 2 May 2005, the Maltese lira entered ERM II at the previous trading day's ECB reference rate of 0.4293 MTL/EUR, with a standard fluctuation band of $\pm 15\%$. Upon joining ERM II, the Maltese authorities unilaterally committed to maintain the lira exchange rate at the central rate. At the time of the adoption of this report, the lira has been participating in ERM II for 24 months.

Before ERM II entry, Malta had followed a basket peg since the 1970s. Within this regime, the only exchange rate realignment occurred in 1992, when the lira was devalued by 10% against the basket, in response to devaluations by major trade partners and competitors in the context of the ERM crisis. The last basket adjustment occurred in August 2002, raising the share of the euro in the basket to 70%, with the US dollar and British pound accounting for the remaining share at 10 and 20%, respectively. At the time of ERM II entry, the lira was re-pegged to the euro. This step did not affect the external value of the lira.

Since mid-2003, the lira stayed very close to its future central rate, with monthly average deviations smaller than 0.8%. During its participation in ERM II, the lira has exhibited no fluctuations against the central rate, save for two minor technical deviations on the stronger side of the band, with a maximum deviation of 0.12% recorded on the first day of ERM II participation.

Additional indicators do not point to pressures on the exchange rate. The Central Bank of Malta (CBM) is under a legal obligation to hold at least 60% of its currency and deposit liabilities as foreign currency reserves, thus ensuring a significant reserve buffer. In practice, despite some fluctuations, the reserve cover has consistently exceeded 100% of liabilities. At the end of February 2007, reserves stood at 103% of currency and deposit liabilities, equivalent to around 132% of the monetary base.



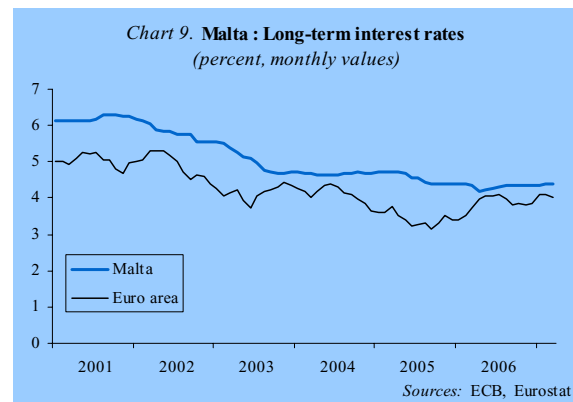
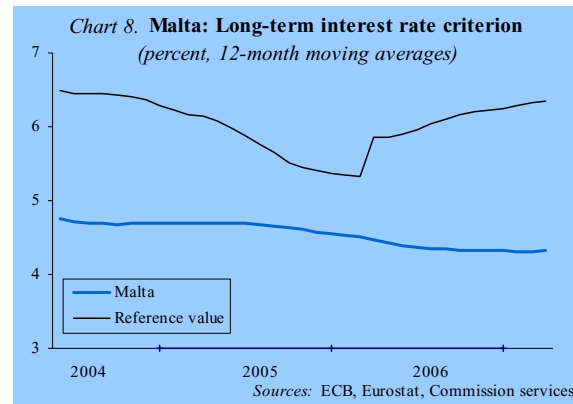
The CBM closely monitors reserve developments in setting policy interest rates. Following significant monetary easing between 2001 and 2003, mirroring developments in the countries represented in the pegging basket, the CBM left its main policy rate on hold between September 2003 and April 2005 at a level of 3%, i.e. 100 basis points above euro area rates. In view of adverse reserve developments since late-2004, reflecting pressures on the current account as well as portfolio shifts by investors, the CBM raised rates by 25 basis points in April 2005. Together with ERM II entry in May, this served to underpin investor sentiment and restore reserve stability. Since the start of monetary tightening by the ECB in late-2005, the policy interest rate differential between Malta and the euro area has narrowed significantly, from 125 to currently 25 basis points. The CBM slowed the pace of policy rate convergence through three 25 basis point rate hikes in May and October 2006 and in January 2007 with a view to ensuring stable foreign reserves and providing sufficient support to the exchange rate peg. Spreads on Maltese money market rates vis-à-vis the euro area, which had hovered around 80-90 basis points until spring 2005, widened in line with the interest rate hike in April 2005, but have narrowed to about 30 basis points currently in tandem with policy rate convergence.

6. LONG-TERM INTEREST RATES

Long-term interest rates in Malta used for the convergence examination reflect secondary market yields on a basket of benchmark government bonds.

The Maltese 12-month moving average long-term interest rate relevant for the assessment of the Treaty criterion has progressively declined over the whole assessment period, reflecting a global decline in bond yields as well as a decreasing country risk premium. In March 2007, the reference value, given by the average of long-term interest rates in Finland, Poland and Sweden plus 2 percentage points stood at 6.4%. The 12-month moving average of the yield on ten-year Maltese benchmark bond stood at 4.3%, 2.1 percentage points below the reference value.

At the beginning of 2001, Malta had the lowest long-term interest rate among the new Member States. Since then, Maltese long-term interest rates have declined further towards euro area levels, albeit not on a continuous path. Maltese long-term interest rates decreased by around 150 basis points during the period of monetary easing between 2001 and autumn 2003, and subsequently remained stable at a level of 4.7% through mid-2005. This has implied some fluctuation in spreads vis-à-vis the euro area, with spreads dropping to a low of around 25 basis points in mid-2004 and widening to around 135 basis points by mid-2005. Spreads recorded a broad narrowing trend since then, reflecting both a moderate decrease in Maltese long-term rates and rising yields in the euro area. Having dropped to around 4.4% in August 2005, Maltese long-term rates recorded a further slight decrease in spring 2006, but increased at the beginning of 2007. Yield spreads vis-à-vis the euro area narrowed to a low of around 20 basis points in spring 2006, widened moderately to around 50 basis points in late 2006 and narrowed back to around 30 basis points in the first quarter of 2007.



7. ADDITIONAL FACTORS

7.1. Financial market integration

Reflecting its history as a regional financial centre, Malta's financial system is substantially inter-linked with the financial systems of other countries, both in and outside of the EU, via the establishment of financial intermediaries and the provision of cross-border services. Over the past decade, Malta has moved from being an offshore to an onshore jurisdiction by reforming its finance sector legislation in line with international best practice. All offshore licences terminated in 2004. Compliance with the *acquis communautaire* in the field of financial services was already broadly achieved on accession and the transposition process of legislation adopted under the Financial Services Action Plan is close to completion.²⁸

Malta's financial sector is well-developed in relation to its stage of economic development.²⁹ Bank intermediation is predominant, but activities of other financial intermediaries are developing also. In terms of GDP, the value of outstanding credit in terms of GDP exceeds the euro area average, while the importance of the Maltese capital market for private sector funding remains limited despite the relatively high value of outstanding domestic fixed-income securities and stock market capitalisation compared to the EU 10 average.

The banking sector expanded considerably in 2005, as new licences were issued to a number of credit and financial institutions and 29 banks from other Member States were authorised to provide cross-border services in Malta. While the market share of foreign owned credit institutions is still a bit lower than for the EU10 average, and the degree of

concentration in terms of CR5 ratio³⁰ of 75% would not be unusual in such a small market, domestic lending is de facto dominated by only two institutions. There was also an increase in the number of licensed insurance companies, insurance managers and affiliated insurance companies as well as a rapid growth of investment funds in 2005. However, insurance and investment funds are still of minor importance when compared to the banking system and private pension funds are just developing.

The growth rate in domestic credit picked up to 9% over 2006, as negative net lending to the central government compensated only partly a significant 15% rise in claims on other residents, which reflected mainly an increase in household borrowing for house purchases and associated borrowing by the construction sector. According to the Central Bank of Malta, the share of foreign currency loans in domestic lending has increased over the past years, but was still limited at 8% at the end of 2006. Moreover, exchange-rate risk for the economy should be mitigated by the domestic currency denomination of central government debt and the fact that net foreign assets of deposit money banks and international banking institutions have either stabilised or increased over the past years. Malta's capital markets remain relatively small and illiquid. The decline of the Maltese stock market since March 2006 had a negative impact on trading activity, which was mostly concentrated in bank equities. The number of actively traded corporate bonds was also very limited. Secondary market turnover fell also for government bonds, which dominate the fixed income market, and for which the central bank acts as market maker.

The importance of adequate supervisory structures is heightened by Malta's role as a regional financial centre and the activity of foreign banks within the system. Regulatory and supervisory responsibilities have been consolidated in the Malta Financial Services Authority (MFSA) since 2002. The MFSA

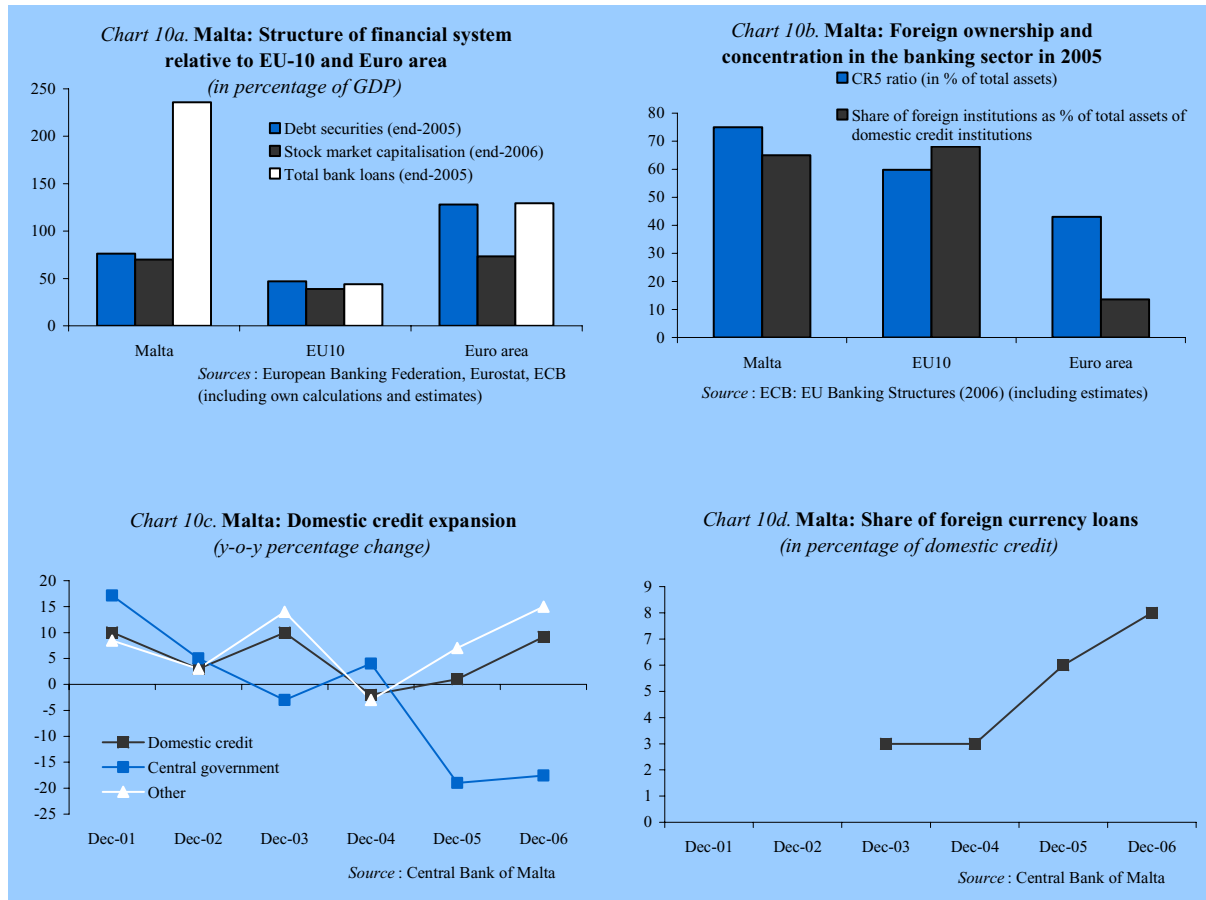
²⁸ See: Transposition of FSAP Directives - State of play as of 15/01/2007.
http://ec.europa.eu/internal_market/finances/docs/actionplan/index/070124_annex_b_en.pdf

²⁹ Malta's GDP per capital level (PPS) stood at 69% of the EU25 average in 2005, which is the fourth highest level after Cyprus (83%), Slovenia (80) and the Czech Republic (73%).

³⁰ The CR5 concentration ratio is defined as the aggregated market share of five banks with the largest market share.

supervises the banking, securities and insurance sectors, but the central bank retains responsibility for monitoring the financial system's overall stability. These institutional changes have been accompanied by measures to facilitate cross-border co-operation between Malta and foreign supervisory bodies, and

the MFSA has continued to increase the number of bilateral and multilateral Memoranda of Understanding with other regulators over 2006.



7.2. Product market integration

The high degree of openness and the intensity of integration with the EU are outstanding features of the Maltese economy. This promotes competition pressure across the economy and therefore ensures that firms are given the right incentives to improve their level of efficiency. However, the small size of the Maltese economy hampers the scope for the diversification of production activities and leads to a high degree of trade specialisation in a small number of sectors, notably electronics (in particular semiconductors) and tourism. Such dependence on a few sectors increases the exposure of the economy to asymmetric shocks determined by the evolution of

international markets. Nonetheless, there is evidence of progress in terms of the diversification of economic activities, namely with the expansion of other services sectors like financial services and ICT and the build-up of clusters in manufacturing sectors like pharmaceuticals.

Malta is among the most open economies in the EU25 and in the euro-area. The trade openness ratio has decreased during the first half of the decade but this evolution is largely driven by cyclical developments, namely the downturn at the beginning of the decade in the tourism industry and in the semiconductors sectors, which dominate Malta's trade. Over time the EU25 has been reinforcing its position as Malta's

main trading partner. In 2005, the weight of extra-EU trade in Malta's total trade (around 32%) was lower than the weight of extra-EU trade in the total trade of the EU25 (36%). Moreover, trade integration with the euro-area is particularly well advanced. In 2005, 77% of Malta's intra-EU trade flows were with euro-area Member States.

With respect to the composition of trade, the relatively low share of intra-industry trade in total manufacturing trade with the EU25 is striking, reflecting the high level of specialisation. Manufacturing trade is dominated by the electronics industry. However, this is largely driven by the presence of one large manufacturer affiliated to a multinational company of semi-conductors.³¹ The pattern of trade specialisation reveals considerable duality with respect to the level of technology intensity.³² While there is a dominance of high technology sectors (largely due to the semiconductors sector), the other sectors where the country has comparative advantage are mostly of low and medium-low technology, like for example clothing. The relatively high transport costs contribute to explaining the importance of the services sectors in trade flows, namely tourism and financial services. In 2005, the share of services in total trade was around 30% compared to 22% in the EU25.

FDI has also been an important channel for economic integration with the EU. The evolution of FDI inflows in recent years has been volatile but on average the ratio of FDI inflows to GDP remained above the EU25 average over the period 2001-2006. FDI outflows remain very limited. In 2004, the ratio of inward FDI stock to GDP reached 67.5% in 2004 which is among the highest in the EU25. The EU25 is by far the main investor in Malta and investment flows overwhelmingly target services sectors, in particular financial services.³³

Despite the increasing market integration with the EU25, the price level of goods and services remained around 25% below the EU25 average in 2005. The remaining price gap is mainly driven by services as the price level of goods was already around 91% of

the EU25 level. In contrast, price levels remain particularly low in services sectors such as recreational and cultural services and energy where prices are still administered (41% of the EU25 average price level in 2005).³⁴

The relative underdevelopment of the medium-high technology manufacturing sectors when compared to the EU25 and the dependence on the electronics and tourism sectors are important features of the integration of Malta in the EU economy. A process of restructuring towards other innovation-driven sectors and activities to reduce the economy's exposure to the fluctuations of these sectors and to prevent competitiveness strains from the increasing competition pressure in low technology sectors from lower-cost economies is underway. However, the conditions for such a successful and sustained transition are not yet fully in place.

Malta's innovation performance remains well below the EU average.³⁵ Recent survey data show that while 42% of EU27 enterprises are actively engaged in innovation, only 21% of Maltese enterprises do so.³⁶ R&D spending is still well below the EU average level, despite the ongoing efforts led by the authorities to promote research and innovation performance across the business sector. Efforts to foster the adoption and diffusion of ICT are also underway which could have an important impact on the prevalent services sectors. There is already evidence of good progress for example regarding ICT diffusion as the rate of broadband penetration approaches the EU25 average.

The promotion of a market-based adjustment is facilitated by improvements in the business environment, namely regarding the speeding up of the process for starting up a company and the increase of the quality of the regulatory framework. However, barriers to further restructuring remain as many activities, namely in professional services, are still heavily regulated. Competition pressure is also not yet fully ensured in some sectors such as importation and distribution of fuel products, retail, transport and construction. Sectoral state aids also remain relatively high and their redirection towards horizontal objectives in particular R&D is also lagging.

³¹ This operator accounts for more than half of the industry's total output and exports, see "Malta's growth predicament: from runner to laggard and back?", *ECFIN Country Focus*, vol. III, issue 14.

³² See: *EU Industry Structure*, DG ENTR, (forthcoming).

³³ See: *Balance of Payments - Direct Investment in Malta and Abroad*, National Statistics Office, News release, 2 February 2007.

³⁴ See: "Comparative Price Levels for Selected Consumer Services in Europe for 2005", *Statistics in Focus*, no.12/2006, Eurostat.

³⁵ See: *2006 European Innovation Scoreboard*.

³⁶ See: *Fourth Community Innovation Survey*.

Table 5.

Malta: Product market integration

	Malta						EU25					
	2001	2002	2003	2004	2005	2006	2001	2002	2003	2004	2005	2006
Trade openness ¹⁾ (%)	-	-	-	79.5	73.1	-	-	-	35.4	36.7	38.3	-
Extra-EU trade in goods GDP ratio ²⁾ (%)	22.9	22.8	22.2	20.4	17.4	21.3	9.9	9.4	9.1	9.6	10.4	11.1
Intra-EU trade in goods GDP ratio ³⁾ (%)	33.6	32.9	33.5	35.7	33.6	32.8	19.0	18.5	18.4	19.0	19.6	21.0
Intra-EU trade in services GDP ratio ⁴⁾ (%)	-	-	-	16.2	15.6	-	-	-	4.6	4.7	4.9	-
Intra-EU trade balance in goods ⁵⁾	-0.8	-0.9	-1.0	-1.1	-1.2	-1.1	89.4	96.2	90.7	77.9	72.6	81.4
Intra-EU trade balance in services ⁶⁾	-	-	-	0.4	0.4	-	-	-	1.9	17.0	15.9	-
Intra-EU trade balance GDP ratio ⁷⁾ (%)	-	-	-	-15.8	-17.0	-	-	-	0.9	0.9	0.8	-
Total FDI inflows GDP ratio ⁸⁾ (%)	7.3	-10.2	19.5	7.3	11.0	-	5.8	5.0	3.6	2.2	4.6	-
Intra-EU FDI inflows GDP ratio ⁹⁾ (%)	-	-	-	5.3	1.1	-	4.3	3.7	2.3	1.6	3.7	-
FDI intensity ¹⁰⁾	-	-	-	2.3	0.2	-	3.9	3.7	2.5	1.9	3.8	-
Internal Market Directives ¹¹⁾	-	-	-	6.0	1.2	1.0	-	-	-	3.6	1.6	1.2
Price levels ¹²⁾	75.5	73.7	71.2	71.8	72.5	-	100	100	100	100	100	100

1) (Imports + Exports of goods and services/2xGDP at current prices)*100. (Foreign trade statistics/ Balance of payments).

2) (Extra-EU Imports+Exports/2xGDP at current prices)*100. (Foreign trade statistics).

3) (Intra-EU Imports+Exports/2xGDP at current prices)*100. (Foreign trade statistics).

4) Intra-EU25 trade in services (average credit and debit in % of GDP at current prices). (Balance of payments).

5) Difference between export and imports of goods (credit minus debit) in bn euros. (Foreign trade statistics).

6) Difference between export and imports of services (credit minus debit) in bn euros. (Balance of payments).

7) Difference between export and imports of goods and services as a % of GDP. (Foreign trade statistics/ Balance of payments).

8) Total FDI inflows as a % of GDP (at current prices).

9) Intra-EU total FDI inflows as a % of GDP (at current prices).

10) Average value of Intra-EU25 inward and outward FDI flows, divided by GDP and multiplied by 100.

11) Percentage of Internal Market directives not yet communicated as having been transposed in relation to the total number.

12) Comparative price levels of final consumption by private households including direct taxes (EU25=100).

Sources: Eurostat, Commission services.

Further economic integration with the EU, improvements in the business environment and upgrading of the innovation performance of the economy will also promote the attraction of more FDI. FDI has been contributing to the diversification of the economy's production structure, namely towards financial services and can also play an important role as a means for technology, organisational- and managerial-skill transfer. Trade and investment relations with the EU will also benefit

from the envisaged improvements in Malta's infrastructure, namely regarding port and interconnections to connection to Europe's energy networks. The ongoing process of integration is also facilitated by the swift transposition of the EU directives. According to the December 2006 Internal Market Scoreboard n° 15bis³⁷, Malta further reduced the deficit in the transposition of Internal Market directives in 2006, which is now at 1% compared to the EU25 average of 1.2%.

³⁷ http://ec.europa.eu/internal_market/score/index_en.htm

7.3. Development of the balance of payments

Malta's current account balance has been in deficit since 1998 (except for 2002), averaging -5% of GDP, with large merchandise trade deficits not fully compensated by sizeable surpluses in the services balance. Year-on-year swings were large, partly reflecting one-off factors that disproportionately affect the aggregate in an economy of Malta's size. After having recorded a surplus in 2002, the current account balance worsened sharply to -8.2% of GDP in 2005. This was primarily due to a marked worsening of the trade balance, whose deficit increased from 8 to 20% of GDP between 2002 and 2005, while the services balance remained stable in that period. The adverse trend was compounded by a steady deterioration of the income balance. As a mitigating influence, net current transfers picked up strongly in 2005, following several years of marginal increases.

Over the last years, the Maltese current account balance has been strongly affected by swings in the tourism and electronics sectors, as well as stronger exposure to import competition in previously well-protected manufacturing sectors, partly related to EU accession. The electronics sector alone accounts for well over half of total goods exports, with one large

semi-conductor firm dominating the market. The sector's performance has reflected difficult global market conditions after 2001, thus underscoring the vulnerability associated with a narrow sectoral base in a small economy. At the same time, Malta's tourism industry has performed sluggishly during the past years, reflecting both a fallout from geopolitical concerns and intensified competitive pressure. Imports were underpinned by strong investment activity, including by the public sector, while the oil bill increased strongly in line with global market developments.

In 2006, the current account balance improved to 6.3% of GDP on account of a significant increase in current transfers due to increased receipts from the booming online gaming industry. A slight deterioration in trade balance was triggered by higher imports of capital goods (such as cranes, ships) which masked a strong recovery in exports (especially pharmaceuticals, scientific instruments and electronics). The deterioration in surplus of services trade reflected mainly a weak performance of the tourism industry. There is however a revival in this sector following the arrival of low-cost airlines in November 2006.

Table 6.

Malta: Balance of payments (percentage of GDP)

	2001	2002	2003	2004	2005	2006
Current account	-3.8	2.4	-3.2	-6.4	-8.2	-6.3
Of which: Balance of trade in goods	-14.3	-8.1	-13.1	-16.0	-19.6	-19.8
Balance of trade in services	8.9	9.4	9.8	9.8	8.0	6.2
Income balance	1.0	0.7	-0.5	-1.2	-2.8	-1.5
Balance of current transfers	0.6	0.5	0.6	1.0	6.2	8.8
Financial and capital accounts	-2.9	-1.0	2.6	5.1	8.2	9.2
Of which: Net FDI	6.4	-10.0	8.5	7.4	10.5	27.4
Net portfolio inflows	-12.6	-8.6	-32.3	-38.2	-46.1	-39.6
Net other inflows ⁽¹⁾	9.9	24.2	28.9	30.8	44.5	20.0
Net capital account	0.0	0.2	0.4	1.5	3.4	3.1
Change in reserves (+ is a decrease)	-6.7	-6.7	-2.9	3.6	-4.1	-1.7
Errors and omissions	6.7	-1.5	0.6	1.3	0.0	-2.9
Gross capital formation	18.7	14.3	17.5	17.0	21.6	19.8
Gross saving	14.9	17.0	14.7	10.6	13.3	13.5

⁽¹⁾ Including financial derivatives

Sources: Eurostat and Commission services.

So far, the financing of the current account deficits has been largely unproblematic, but the external position reflects substantial financing needs. While in 2004 net capital inflows did not fully match the current account deficit, leading to a drop in external reserves, this was reversed again in 2005 in line with longer-term trends. Net FDI inflows constituted the dominant category of external financing over the past years, generally exceeding the current account shortfall, though with some large year-to-year volatility. Reflecting sizeable capital transfers from the EU and Italy, the capital account improved to a surplus of 3.4% of GDP in 2005 and 3.1% in 2006. As a result, the deficit in the combined current and capital account decreased from slightly below 5% of GDP in 2004-2005 to 3.2% of GDP in 2006.

Some caution is warranted in interpreting Malta's balance of payments data, as in recent years the residual "net errors and omissions" were consistently strongly positive, implying an overestimation of the current account deficit and/or an underestimation of net inflows on the capital and financial account in the order of 2-3% of GDP.

The outlook for Malta's balance of payments is influenced by external factors (such as developments on global energy and electronics markets), but also crucially depends on prospects to improve the competitive position of the Maltese economy.

Extensive restructuring has taken place in the last few years, with activity in shrinking sectors (such as clothing) being progressively replaced by sectors with competitive edge (pharmaceuticals, remote gaming, aircraft maintenance, financial services, auditing), and with product upgrading in the main exporting industry (electronics). Increased openness to the world trade after EU accession has contributed significantly to this process.

A narrowing of the current account deficit to some 3-4% of GDP is expected in the coming years. The main factors behind this improvement should be exports of manufacturing goods (pharmaceuticals), higher revenues from travel industry and tourism and higher current transfers (as a result of the buoyant remote gaming industry).

A sustained improvement in Malta's external balance will need to be supported by strengthened efforts to maintain external competitiveness, including through policies fostering productivity growth, appropriate wage developments, and further progress in diversifying the sectoral export structure. A prudent fiscal stance is important to underpin domestic savings. On the financial account side, ensuring a positive investment climate is vital to underpin FDI inflows.