

**COUNCIL OPINION**  
**of 14 March 2006**  
**on the updated convergence programme of Malta, 2005-2008**

(2006/C 82/11)

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies <sup>(1)</sup>, and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

- (1) On 14 March 2006, the Council examined the updated convergence programme of Malta, which covers the period 2005 to 2008.
- (2) Malta's real GDP growth averaged 2,75 % per year between 1995 and 2005. However, since 2001 economic growth stalled in the wake of unfavourable external conditions and domestic structural weaknesses. The combination of these two factors resulted in a loss in competitiveness, while export performance worsened adding further pressure on the external deficit. In recent years, the general government deficit has averaged around 6 % of GDP, peaking at 10,3 % of GDP in 2003, and declined to 5,1 % of GDP in 2004.
- (3) On 5 July 2004, the Council decided that Malta was in excessive deficit. According to the Council recommendation under Article 104(7) of the same date, the excessive deficit had to be corrected by 2006. The Council opinion of 17 February 2005 on the previous update of the convergence programme, covering the period 2004-2007, invited Malta to do the necessary to ensure the correction of the excessive deficit in 2006, ensure that the debt ratio is declining towards the 60 % of GDP Treaty reference value at a satisfactory pace and make further progress in the design and implementation of the pension and health care reforms.
- (4) The update estimates the 2005 deficit close to 4 % of GDP, against 4,25 % of GDP in the Commission services' autumn 2005 forecast and a target of 3,75 % of GDP set in the previous update of the convergence programme. The difference between the update and the Commission services' autumn 2005 forecast is explained by the inclusion of recent data showing lower general government expenditure than previously projected.
- (5) The update was submitted 5 weeks beyond the 1 December deadline set in the code of conduct. The programme broadly follows the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct <sup>(2)</sup>.

<sup>(1)</sup> OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website:  
[http://europa.eu.int/comm/economy\\_finance/about/activities/sgp/main\\_en.htm](http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm)

<sup>(2)</sup> The programme has gaps in the compulsory and optional data prescribed by the new code of conduct. Specifically, price data are not consistent with the harmonised definition, and employment and unemployment figures are not based on labour force survey data but refer to registered persons, while forecasts for all the items included in the sectoral balances and FISIM data are not provided. Missing optional data mainly concern: employment and productivity in hours, forecasts of sectoral balances and breakdown of social transfers.

- (6) The macroeconomic scenario underlying the programme envisages that real GDP growth will pick up from 0,9 % in 2005 to an average of 1,4 % over the rest of the programme period reflecting an improved external demand. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions, except in 2006. In particular, the update projects a relatively quick economic recovery driven by a strong contribution of external demand to growth, mainly attributed to a recovery in the electronics industry, as well as sustained investment activity. The possibility that the long-anticipated pickup in this industry will not materialise in 2006 poses a downside risk to GDP growth.
- (7) The budgetary strategy outlined in the update aims at reducing the deficit to below the 3 % of GDP reference value in 2006 and at pursuing fiscal consolidation to reach a deficit of 1,25 % in 2008. The deficit targets in the update include one-off revenues of 0,75 % to 1 % of GDP per year until 2007. The time profile of the primary surplus is similar, with an improvement from 0,25 % in 2005 to 2½ % at the end of the period. Consolidation is mainly expenditure-based, with expenditures falling by 7,5 % of GDP until the end of the programme period, of which investment accounts for almost half. Compared with the previous programme, the adjustment in the update is less ambitious against a broadly less favourable macroeconomic scenario.
- (8) Over the programme period, the structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated by the Commission services according to the commonly agreed methodology is planned to improve on average by 1 % of GDP per year. The programme clearly identifies its medium-term objective (MTO) as a balanced budgetary position, which it aims to achieve by the end of the programme period. As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1,75 % of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The programme's MTO is at an appropriate level because it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.
- (9) The budgetary outcome could be worse than projected in the programme, especially on account of the favourable macroeconomic scenario projected for 2006. Although the update foresees higher indirect taxes in 2006 than in the Commission services' autumn 2005 forecast, projections for total revenues in that year are comparable. While the information given in the programme on the policy measures for 2006 do not seem to fully justify these developments, the measures underpinning the consolidation process are not disclosed for 2007 and 2008, making an overall assessment difficult to carry out.
- (10) Assuming that the 2006 budget is fully implemented and the macroeconomic risks are duly addressed, the budgetary stance in the programme seems consistent with a correction of the excessive deficit by the deadline indicated by the Council. The programme seems to provide a sufficient safety margin against breaching the 3 % of GDP deficit threshold with normal macroeconomic fluctuations after the planned correction of the excessive deficit. The budgetary strategy outlined in the programme seems sufficient to ensure that the programme's MTO is broadly achieved in 2008. In the years following the correction of the excessive deficit, the annual structural adjustment towards the programme's MTO implied by the programme is well above 0,5 % of GDP, and hence consistent with the Stability and Growth Pact.
- (11) The gross government debt is estimated to have reached 76,75 % of GDP in 2005, above the 60 % of GDP Treaty reference value. Starting in 2006, the debt ratio is expected to gradually fall, reaching 67,25 % of GDP by the end of the programme period. The evolution of the debt ratio might be less favourable than projected in the programme in view of the risks associated to some implementation risk surrounding privatisation given its critical role in reducing the debt ratio in 2006. Unexplained below-the-line operations partially offset privatisation receipts in 2006. Taking into account the balance of risks, the debt ratio seems to be sufficiently diminishing towards the reference value.

- (12) With regard to the sustainability of public finances, Malta appears to be at medium risk on grounds of the projected budgetary costs of ageing populations. The level of gross debt is currently above the 60 % reference value and the currently high structural deficit, if unchanged, will prevent the necessary reduction of the gross debt ratio from falling below the Treaty reference value over the long term. Implementing rigorously the planned budgetary consolidation over the programme period would therefore contribute to reducing debt below the reference value, with positive consequences for risks to public finance sustainability. Changes to the pension system are envisaged by the Maltese authorities, aiming at ensuring adequacy and sustainability of the pension system. The implementation of the reform would be key in ensuring the financial sustainability of the public pension system <sup>(1)</sup>.
- (13) The envisaged measures in the area of public finances are broadly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. Although the update foresees the correction of the excessive deficit and the reduction of the debt ratio at a satisfactory pace in line with the Council's recommendations and anticipates the achievement of the medium-term budgetary objective within the programme period, it does not announce implementation measures to address the problem of the long-term sustainability.
- (14) The National Reform Programme of Malta, submitted on 21 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies the following challenges with significant implications for public finances: sustainability of public finances; competitiveness; the environment; employment; and education and training. Although not explicitly stated, the update takes into account the budgetary implications of the NRP. The measures in the area of public finances envisaged in the convergence programme are broadly in line with the actions foreseen in the National Reform Programme. In particular, the updated convergence programme confirms the intention to pursue reforms to enhance the efficiency of the public sector, improve tax compliance, pursue privatisation and provide support for the training of the labour force.

In view of the above assessment, the Council notes that, overall, the programme is consistent with the correction of the excessive deficit by 2006. In the light of the recommendations under Article 104(7), the Council invites Malta to:

- (i) implement with rigour the 2006 budget measures and ensure the correction of the excessive deficit this year and in line with the updated convergence programme, and ensure that budgetary consolidation towards the programme's medium-term objective is sustained after the excessive deficit has been corrected;
- (ii) ensure that the debt ratio is declining towards the 60 % of GDP Treaty reference value at a satisfactory pace from 2006 onwards;
- (iii) improve the long-term sustainability of the public finances by making further progress in the design and implementation of the pension reform.

#### Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP (% change)	<b>CP Jan 2006</b>	<b>0,2</b>	<b>0,9</b>	<b>1,1</b>	<b>1,2</b>	<b>2,0</b>
	COM Nov 2005	0,4	0,8	0,7	1,1	n.a.
	CP Dec 2004	0,6	1,5	1,8	2,2	n.a.
HICP inflation (%)	<b>CP Jan 2006 <sup>(1)</sup></b>	<b>2,8</b>	<b>2,8</b>	<b>3,1</b>	<b>2,5</b>	<b>1,9</b>
	COM Nov 2005	2,7	3,1	2,6	2,2	n.a.
	CP Dec 2004 <sup>(1)</sup>	2,9	2,4	1,9	1,9	n.a.

<sup>(1)</sup> Details on long-term sustainability are provided in the technical assessment of the programme by the Commission services ([http://europa.eu.int/comm/economy\\_finance/about/activities/sgp/main\\_en.htm](http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm)).

		2004	2005	2006	2007	2008
Output gap (% of potential GDP)	<b>CP Jan 2006</b> <sup>(2)</sup>	<b>- 1,8</b>	<b>- 2,9</b>	<b>- 3,7</b>	<b>- 4,2</b>	<b>- 4,4</b>
	COM Nov 2005 <sup>(6)</sup>	- 2,0	- 3,1	- 4,3	- 5,1	n.a.
	CP Dec 2004 <sup>(2)</sup>	- 2,1	- 2,4	- 2,3	- 1,6	n.a.
General government balance (% of GDP)	<b>CP Jan 2006</b>	<b>- 5,1</b>	<b>- 3,9</b>	<b>- 2,7</b>	<b>- 2,3</b>	<b>- 1,2</b>
	COM Nov 2005	- 5,1	- 4,2	- 3,0	- 2,5	n.a.
	CP Dec 2004	- 5,2	- 3,7	- 2,3	- 1,4	n.a.
Primary balance (% of GDP)	<b>CP Jan 2006</b>	<b>- 1,0</b>	<b>0,3</b>	<b>1,4</b>	<b>1,5</b>	<b>2,4</b>
	COM Nov 2005	- 1,0	0,2	1,3	1,9	n.a.
	CP Dec 2004	- 1,4	0,3	1,6	2,4	n.a.
Cyclically-adjusted balance <sup>(3)</sup> (% of GDP)	<b>CP Jan 2006</b> <sup>(2)</sup>	<b>- 4,4</b>	<b>- 2,8</b>	<b>- 1,3</b>	<b>- 0,7</b>	<b>0,4</b>
	COM Nov 2005	- 4,3	- 3,0	- 1,4	- 0,5	n.a.
	CP Dec 2004 <sup>(2)</sup>	n.a.	n.a.	n.a.	n.a.	n.a.
Structural balance <sup>(2)</sup> (% of GDP)	<b>CP Jan 2006</b> <sup>(4)</sup>	<b>- 5,1</b>	<b>- 3,8</b>	<b>- 2,3</b>	<b>- 1,4</b>	<b>0,3</b>
	COM Nov 2005 <sup>(5)</sup>	- 5,0	- 4,0	- 2,4	- 1,2	n.a.
	CP Dec 2004	n.a.	n.a.	n.a.	n.a.	n.a.
Government gross debt (% of GDP)	<b>CP Jan 2006</b>	<b>76,7</b>	<b>76,7</b>	<b>70,8</b>	<b>68,9</b>	<b>67,3</b>
	COM Nov 2005	75,9	77,2	77,4	77,1	n.a.
	CP Dec 2004	73,2	72,0	70,5	70,4	n.a.

Notes:

<sup>(1)</sup> CP figures correspond to the Retail Price Index.

<sup>(2)</sup> Commission services' calculations on the basis of the information in the programme.

<sup>(3)</sup> Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.

<sup>(4)</sup> One-off and other temporary measures taken from the programme: 0.7% in 2004, 1.0% of GDP in 2005, 1.0% in 2006, 0.7% in 2007 and 0.1 in 2008; all deficit-reducing.

<sup>(5)</sup> The Commission services' forecast include the same one-offs as the programme.

<sup>(6)</sup> Based on estimated potential growth of 1.3%, 2.0%, 2.0% and 2.0% respectively in the period 2004-2007.

Source:

Convergence programme (CP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations.