

# Macroeconomic Policy Frameworks of Small States

A Case Study of Malta

*Gérard Adonis*



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Commonwealth Secretariat

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# Abbreviations and acronyms

AML	anti-money laundering
CBM	Central Bank of Malta
CFI	companies with foreign income
CFT	countering the financing of terrorism
CPI	consumer price index
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EC	European Commission
EU	European Union
FDI	foreign direct investment
FIAU	Financial Intelligence Analysis Unit
GDP	gross domestic product
HDI	Human Development Index
IT	information technology
ICT	information and communication technology
IHC	international holding company
IPSE	Institute for the Promotion of Small Enterprise
IR	interest rate
IMF	International Monetary Fund
IPSE	institute for the promotion of small enterprise
IHC	international holding companies
ITC	international trading companies
Lm	Malta's lira
LPG	liquid petroleum gas
MCAST	Malta College of Arts, Science, and Technology
MDC	Malta Development Corporation
METCO	Malta External Trade Corporation

MFSA	Malta Financial Services Authority
MGS	Malta Government Stock
MaRIS	Malta Real-time Interbank Settlement System
MSE	Malta Stock Exchange
MOU	memorandum of understanding
MDG	Millennium Development Goals
MSW	municipal solid waste
NCB	National Central Bank
PDAC	Public Debt Advisory Committee
PES	public enterprise sector
PPP	purchasing power parity
OECD	Organization for Economic Co-operation and Development
OSCE	Organization for Security and Co-operation in Europe
SIDS	small island developing states
SICAV	Société d'Investissement à Capital Variable
TB	treasury bills
UK	United Kingdom
US	United States
WTO	World Trade Organization

# About the author

An econometrician by profession and researcher on small island economy, Dr Gérard Adonis is presently the Head of the Faculty of Humanities at the University of Seychelles and a consultant mainly in the area of economics, econometrics and small island issues. Dr Adonis was founding member/trustee of the Seychelles University Foundation. He holds a PhD in Econometrics, a masters degree in Econometrics and is a Bachelor of Economics. Being an Econometrician, Dr Adonis has been involved in dynamic modelling using non-parametric techniques. Recently Dr Adonis was invited by the Commonwealth to give two presentations on the impact of the global financial crisis on small states. Among his current research works are: *Density Forecast with Regression Quantiles*; *Volatility Forecasts*; *Quantile Autoregressive Model* and *Fiscal Policy and Monetary Policy to Cope with the Inherent Vulnerability of Small States*.



# Preface

The implementation of macroeconomic policies in small states is affected by the inherent vulnerability of these countries. The inherent vulnerability of small states stems from their high dependence on a narrow range of exports and on strategic imports such as food and fuel. These features render small states disproportionately exposed to external economic shocks. Other characteristics which pose disadvantages for small states include their limited ability to exploit economies of scale, and their limited opportunities for diversification. These features have constrained policy implementation and success in small states and increased the importance and influence of external reserves, external financing, foreign investment and the international economic climate on domestic policy.

This study on the macroeconomic policies of Malta examines how the country has been successful in implementing policies that have been largely successful in promoting growth and generating employment. The best practices showed in Malta can be implemented in other small states.

Malta's strategic geographical location in the Mediterranean, close to major markets (EU) and its strong knowledge-based economy (despite its limited natural resources), have contributed to the island's advantages and spared the country from some of the adversities and vulnerabilities faced by other small states. Nonetheless, Malta relies heavily on external financial flows (mainly from the EU) for economic and social sustainability. In spite of being largely dependent on the rest of the world, Malta was partially immune to the global financial crisis. EU accession, a healthy financial system and the adoption of the euro as the national currency were the main factors that cushioned the economy from the full impact of the external shocks.

The existence of a sound and efficient financial system has brought major benefits to the banking sector and to the economy in Malta. The well-capitalised position of the banks, coupled with their low reliance on interbank funding and high dependence on retail deposits are the main factors insulating the banking sector in Malta. Despite the economic achievement, Malta is faced with the daunting task of preserving the environment, which is greatly affected by pollution. The country is struggling to strike a balance between environmental conservation and economic development. Despite the government's relentless efforts to address the impact of environmental degradation, the cost of sustaining the conservation programme is proving to be a burden on Malta's economy.



# The country profile

The Republic of Malta comprises 6 small islands covering an area of approximately 320 square km. It is situated in the Mediterranean Sea, 93 km south of Sicily and 290 km north of the African Continent. Only 3 of the 6 islands are permanently inhabited. The largest city is Valletta, which is also the nation's capital. Malta is a bilingual state and both languages, Maltese and English, are official. Maltese is the most widely spoken language of the country with 90.2 per cent, followed by English with 6 per cent, multilingual 3 per cent and other 0.8 per cent.

Malta has been inhabited since prehistoric times. The country was first colonised by the Phoenicians, then the Romans, Arabs, Normans, the Knights Hospitallers of St. John of Jerusalem, and lately the British. Despite having been colonised for a long time, the age-old Maltese traditions managed to survive through the generations. The reliance on maritime trade has helped to shape and conserve what we now know as Maltese culture. Maltese are generally regarded as religious people and religion plays a fundamental role in their day-to-day living. The official Maltese religion is Roman Catholic, representing almost 97 per cent of the population.

Malta got its independence in 1964 after almost 150 years of British rule. After independence, the country became a member of the British Commonwealth, with a parliamentary democracy and Queen Elizabeth II as the head of state. On December 13, 1974, Malta became a fully independent republic and replaced the queen with an elected president. The president is appointed by parliament. In turn, the president appoints the prime minister, the leader of the party that wins a majority of seats in a general election for the unicameral (one chamber) House of Representatives.

Malta is a member of the European Union and continues to be an active participant in the United Nations, the Commonwealth, the Council of Europe, the Organization for Security and Co-operation in Europe (OSCE), World Trade Organization (WTO) and various other international organisations.

The constitution is the supreme law of the land and, besides setting up and regulating major institutions – such as parliament the executive and the judiciary – it has a chapter dealing with 'Declaration of Principles', which is fundamental to the governance of the country, and another chapter dealing with 'Fundamental Rights and Freedoms of the Individual'.

The population of Malta was estimated at 405,165 in July 2009. The population is characterised by a slow growth rate, low births and mortality, and an aging population.

According to 2009 estimates, the age structure is distributed as follows: 0–14 years: 16.1 per cent, 15–64 years: 69.4 per cent and 65 years and over: 14.5 per cent. The infant mortality rate is estimated around 5.94 deaths per 1,000 births. Life expectancy is 75.49 years for males and 80.62 for females.

# 1

## Introduction

The geographical location of Malta at the heart of the Mediterranean has given the island a natural strategic advantage as a major trading centre. This has contributed significantly towards Malta's strong economic position. Today, Malta plays a key role in the region, as a strategic hub for trade, services and manufacturing. This has been possible thanks to the well-established public-private partnership. While the private sector provides the necessary entrepreneurial element and skills to drive the enterprise, the government ensures the enabling climate for business to prosper. Besides, the country's liberal trade policies have given the private sector a pre-eminent role in the economy.<sup>1</sup>

As mentioned previously, Malta's geographical position plays a key role in fostering further economic activities, hence strengthening the country's economic position. Malta has been very successful in exploiting its strategic advantage, creating an economy well-suited for business opportunities. Entry into the European Union (EU) has further amplified business opportunities in Malta, as the EU is now giving the Mediterranean region a bit more attention through co-operation and partnership agreements. The strategic location of Malta gives the country the opportunity to be the bridge between the EU and those emerging markets. Malta's well-developed infrastructure, information technology (IT) facilities and financial services sector are big advantages for the country.

It is important to note that EU accession has instigated fundamental reforms in Malta. Those reforms could have taken much longer to materialise or not materialised at all had Malta not joined the EU. Two important changes that occurred as part of Malta's preparation for EU accession were the restructuring of the vast and inefficient public enterprise sector (PES) and the liberalisation of trade policies. In addition, the obligation of Malta under the Maastricht Treaty anchored policy and led to substantial fiscal consolidation as stated by the IMF Country Report 2007. As a result therefore this has provided the impetus to the restructuring of the PES.

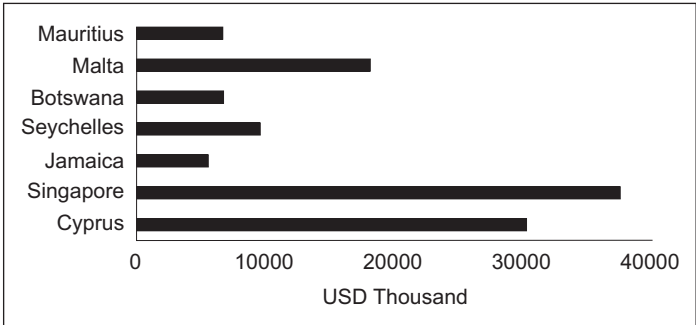
Apart from its strategic location, Malta is rapidly developing into the leading knowledge-based economy and society in the Mediterranean. Malta has distinguished itself as elite in the field of information and communication technology (ICT) both in terms of IT expertise and range and quality of ICT services offered. Malta's great stride and success in ICT has been demonstrated through the implementation of projects such as SmartCity Malta. The well-developed ICT infrastructure of the country has over-spill benefits to other sectors, namely financial services, specialist software development and iGaming. These sectors have recorded significant growth as a result of ICT development.

Malta is well-known for its sound and stable financial system, supported by prudent monetary policy. The sound financial system, together with the adoption of the euro, has saved Malta from the brunt of the global economic downturn. The financial sector appears to be resilient in the face of the global turmoil and has thus far been able to weather the external shocks.

Unlike other small island developing states (SIDS), such as Seychelles and Mauritius, Malta has been spared from some of the adversities and vulnerabilities faced by other island states.

Like many other SIDS, Malta's economy is largely dependent on a few sectors, namely foreign trade, manufacturing (especially electronics and pharmaceuticals), tourism and financial services. Besides, Malta produces only about 20 per cent of its food needs, has limited fresh water supplies and has few domestic energy sources.

Overall, Malta's economy has been quite a successful story with gross domestic product (GDP) per capita of approximate US\$24,200 (2008 estimate). Figure 1.1 gives an international comparison of GDP per capita. With EU accession, it is expected that more prosperity awaits. Although the EU is the principal market for Malta's exports, there are other export markets which have developed such as North Africa, the Near East and North America. According to a report published by the Euro Info Centre, Malta is amongst the world's ten most trade-dependent nations. In consequence, this exposes Malta to the vicissitudes of the global and European economic downturns



**Figure 1.1** GDP per capita (2009 estimates)

Source: IMF and World Bank estimates

## Notes

1. [http://www.focusmm.com/malta/ma\\_manif.htm](http://www.focusmm.com/malta/ma_manif.htm) [last accessed May 2011]

# **FISCAL POLICY FRAMEWORK**



# Part I – Key Issues and Lessons Learnt

## 2

### Economy of Malta

Malta has been a fully integrated member of the European Union since 2004 and in January 2008, adopted the euro as its currency. In the build-up to entry into the EU, Malta had to implement a string of reforms in line with EU standards and practices. As a result, most of its major economic policies are guided by EU principles and regulations. Malta has had much to gain from its entry into the EU, particularly from its entry into the eurozone in January 2008, when it adopted the euro.

The benefits to a small open economy like Malta's with a vulnerability to external and sector-specific shock could be significant. From a monetary policy standpoint, eurozone membership implies eliminating the various risks associated in managing a small, vulnerable currency like the Maltese lira, with the greater security afforded by a major reserve unit such as the euro.

Malta's entry into the eurozone coincided with the global recession – a time of great uncertainty for the global economic outlook, characterised by business bankruptcies, bank closure, widespread loss of confidence and financial meltdown. This timely entry has surely saved the Maltese economy from the external and sector-specific shocks. Malta was partially spared from the global financial crisis thanks to the euro.

Besides the euro, another important factor that has contributed significantly to mitigating the impact of the global recession is the existence of a sound financial system. Malta's EU membership has brought renewed benefits to the small island economy. In the midst of the global recession, many central banks across the world adopted a slack monetary policy stance, especially with regard to interest rates (IR). The euro area was no exception as the European Central Bank (ECB) decided to act likewise by reducing the IR on its main financing operations gradually from its peak of 4.0 per cent in October 2007 to 1.5 per cent by March 2008. As a member of the Eurosystem<sup>1</sup> (European Monetary Union), Malta benefited from the rate reduction that was passed on to bank borrowers. Such a reduction in borrowing costs would have been improbable had Malta not been part of the Eurosystem.

An interesting – though surprising – outcome of the global economic downturn has been the return of government intervention in the economy through the use of fiscal policy to stimulate aggregate demand. Several governments, including those in the eurozone, announced huge fiscal stimulus packages to bail out their ailing financial institutions at the time when the world was experiencing one of the worst financial crises in history. Despite Malta's favourable economic condition, it would have been difficult to undertake such measures should the need

arise due to its relatively high budget deficit and debt level. Fortunately, due to Malta's strong financial position, the government did not have to intervene.

Nevertheless, Malta was not completely insulated from the global economic downturn, although its impact was less severe than in other countries, including those in the eurozone. Malta depends a lot on foreign trade, so it would be very surprising if the country were utterly immune. The economy started quite well in 2008 but as time progressed, especially towards the second part of the year, things suddenly took a U-turn. It began with a significant drop in exports of goods and tourist arrivals followed suit. As the year closed during the fourth quarter, the global economic downturn was even more bleak. This time it was the manufacturing sector (in particular the electronics and automotive components industries) that was the victim. Both tourism and manufacturing were affected as a result of sharp decline in foreign demand, as both sectors depend on external markets. In consequence, it was not surprising to see growth in the last quarter being negative as investment spending was also on the decline. Although real growth recorded a positive value, it was less than for the previous year.

## **2.1 The productive sector**

Like the Seychelles, the productive sector of Malta is largely dominated by two main industries: tourism and manufacturing. Financial services (including offshore) are also becoming an important sector contributing significantly towards the economy.

### **2.1.1 Tourism**

Tourism is the mainstay of the Maltese economy and its share of GDP has continuously increased over the years, making a direct contribution of around 35 per cent towards the GDP. The tourism industry has experienced rapid growth since 1987 as a result of an increase in foreign exchange tourism-earnings and tourism arrivals (see Figure 2.1 below). Nonetheless the industry suffered some temporary setbacks after the 9/11 terrorist attack in the USA.

Figure 2.1 depicts the number of tourists visiting Malta over the period 1998–2007. The overall trend is increasing, except for 1996, which recorded a significant decline

Like Seychelles, Malta's heavy dependence on tourism makes the island highly susceptible to the vicissitudes of global economic conditions and changing tastes of tourists. The principal market for tourism in Malta is from four main European sources: the UK, Germany, France and Italy. The UK is by far the leading market accounting for almost one third of all international travellers.

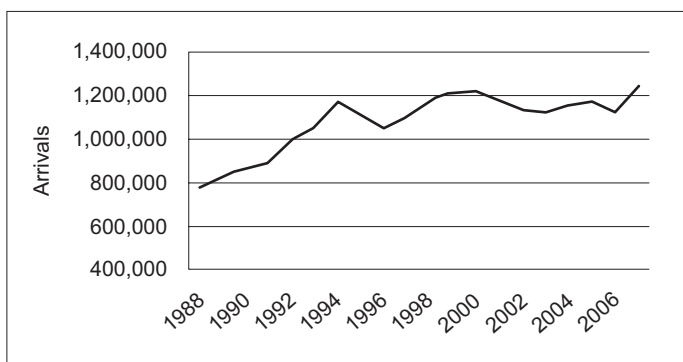


Figure 2.1 Malta tourist arrivals, 1998–2007

## 2.1.2 Manufacturing

The manufacturing industry accounts for some 25 per cent of GDP. This industry is dominated by the manufacturing of value-added products, namely electronics and pharmaceuticals. Most goods are produced for export and the manufacturing sector is supported by a strong presence of foreign-owned, export-oriented enterprises (over 250).

Today, many well-known ICT centres of excellence and training such as CISCO, Microsoft and Oracle are located in Malta. This is partly due to the country's outstanding communications infrastructure and highly-skilled human capital. Malta is classed highly among EU countries in most major indicators of ICT infrastructure and service provision. It is important to note that Malta's achievement in ICT development has become possible due to the well-established co-operation strategy between the government and the private sector. The Maltese government has been very instrumental and supportive with regard to major investment, providing the private sector with an enabling environment.

Malta, like many other small island states, does not have vast natural resources, but has nonetheless been very successful. This success stems from the ability to exploit their technological base, geographical position and knowledge society. Malta's industrial strategy is centred on attracting foreign direct investment (FDI).

Due to its outstanding communication infrastructure and highly-skilled manpower, Malta has become an ideal place for a number of economic activities. This includes among others:<sup>2</sup>

- the manufacture of medium- and high-technology products requiring special skills;
- the manufacture of MSEi-customised small batch products requiring 'just-in-time' delivery;
- manufacturing activities that require a significant degree of quality control;
- operations requiring access to EU markets; and
- service companies seeking a location to meet international demand for their products.

To facilitate the establishment of businesses, strategic industrial estates have been created throughout the island. All the estates are equipped with purpose-built standard factories, readily available on demand to start business. In its endeavour to attract further investment, the government has built the Mosta Technopark, a purpose-built facility to house advanced technology companies.

To foster further investment in the manufacturing industry, the government has come up with a generous incentive package which includes:<sup>3</sup>

- ten-year tax holidays for new export-oriented companies;
- training grants for approved programmes offered to employees and soft loans offered to management;
- ready-built factories at subsidised rents;
- duty-free importation of plant, machinery and all materials;
- full repatriation of capital and profits;
- duty-free importation to the EU;
- liberal work permit policy.

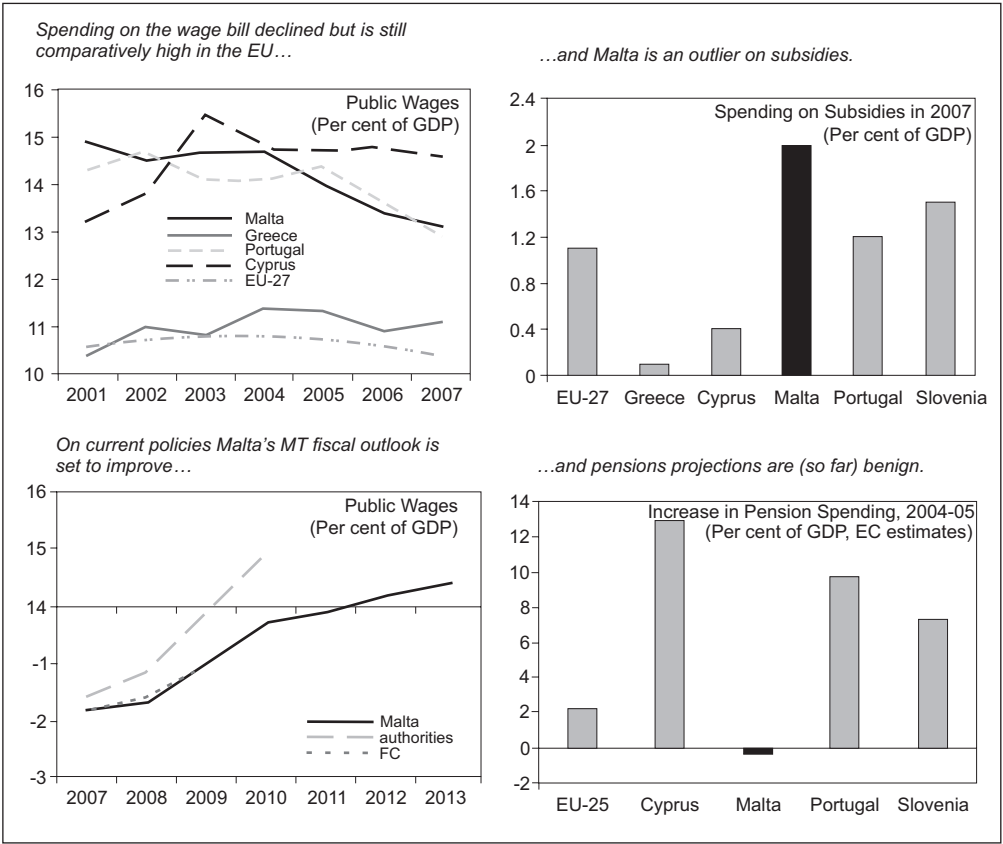
Despite Malta's current success in creating a high-tech manufacturing base, its traditional manufacturing is struggling. Traditional manufacturing encompasses semiconductors, clothing and textiles. The textile industry has been hit particularly hard, with output and employment down by 60 per cent from 2004–2006 and factory closures. The misfortune of Malta's traditional manufacturing industries is a direct result of stiff competition from low-cost countries. To counter the downfall in those industries, some manufacturers, e.g. those of semiconductors, are trying to reposition themselves by moving to more technological products.

## **2.2 Government revenue and expenditure**

Fiscal policy in Malta has for some years been geared towards reducing the budget deficits. Malta has persistently recorded budget deficits throughout the entire period as illustrated by Figure 2.2 below. From a low of almost -11 per cent of GDP in 1998 the deficit-to-GDP ratio has since progressively been reduced to -2 per cent in 2007. Since 2006 the deficit-to-GDP ratio has been kept below -3 per cent, in conformity with EU requirement for accession into the Eurosystem. However, the year 2008 recorded a worsening in the deficit-to-GDP ratio of -4.7 per cent.

Despite Malta's continuous effort to consolidate expenditure, public finances remain a challenge. As also indicated in the IMF Country Report 2008, public finances are under considerable pressure. This is in consequence to the large subsidies (about twice the EU average) and state aid (four times the EU average); health care costs; the public wage bill (13 per cent of GDP); pensions and other social spending (over 13 per cent of GDP). Apart from the aforementioned, public enterprise guarantees and other contingent liabilities are also contributing factors.

Figure 2.2 below (taken from IMF Country Report 2008), shows the fiscal development in Malta.



**Figure 2.2** Malta's fiscal development  
 Sources: Eurostat; European Commission; EPC; and IMF staff calculations

**2.2.1 Trend in revenue and expenditure**

A further glance at Figure 2.3a below reveals that expenditure is the main culprit in exacerbating the fiscal deterioration over the years as manifested through the persistent budget deficit. While both revenue and expenditure appear to be trending upward, the former has always out-paced the latter. In consequence the budget has persistently remained in deficit, despite showing signs of improvement towards the latter part of the period. Coincidentally the upturn in the deficit-to-GDP ratio gathered momentum after 2003.

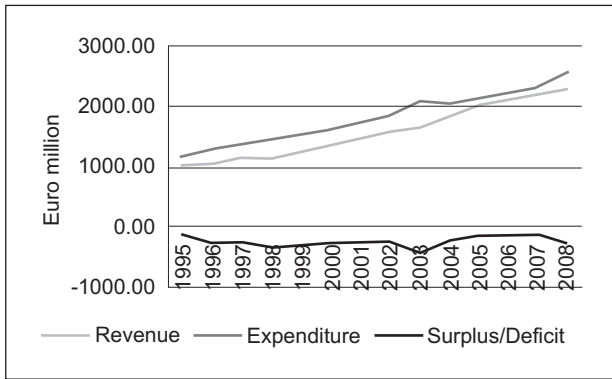


Figure 2.3a Government revenue v expenditure

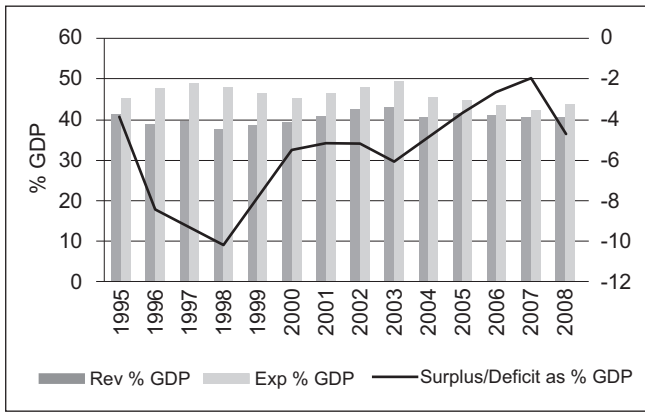


Figure 2.3b Revenue, expenditure and surplus/deficit as percentage share of GDP

Figure 2.3b depicts revenue, expenditure and surplus/deficit as percentage shares of GDP. Evidence (as demonstrated by Figure 2.3b) appears to suggest that the share of expenditure to GDP has remained high (above 40 per cent) despite a decline after 2003. Whilst the trend in expenditure as percentage of GDP appears to be sliding, the trend in revenue has remained more or less stagnant at around 40 per cent since 2004. A further glance at Figure 2.3 reveals a structural break at 2003 in the expenditure data series and surplus/deficit data series. A structural break indicates a change in regime; 2003 was a transition year for Malta in preparation for entry into the EU in 2004.

### 2.2.2 Net revenue composition

The main components of net revenue, i.e. revenue net of loans, sale of shares and other extraordinary receipts are: grants, customs and excise, value added tax, income tax and social security. Income tax and social security constitute the lion share of net revenue as depicted by Figure 2.4 below. On average they account for about 50 per cent of net revenue.

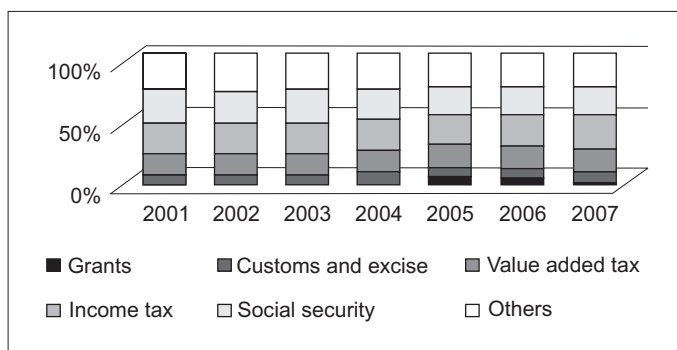


Figure 2.4 Net revenue composition

### 2.2.3 Tax revenue as a percentage of GDP

Whilst the share of revenue to GDP tends to fluctuate within the range of 35–40 per cent, tax revenue appeared to be trended upward. Tax revenue, which consists of direct and indirect taxes, has increased significantly over the entire period. Interestingly, Figure 2.5 below reveals a similar structural break in the tax revenue series at 2003.

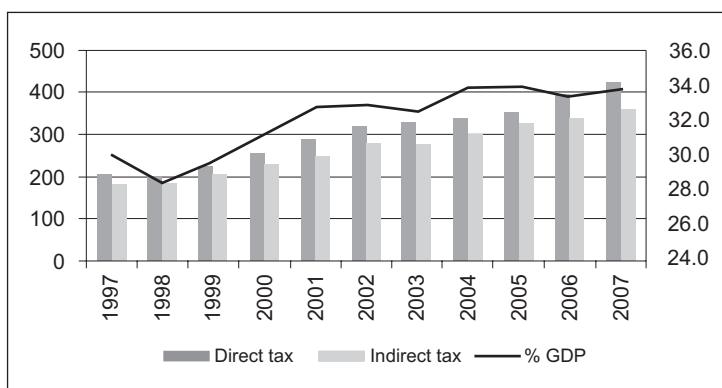


Figure 2.5 Composition of tax revenue v tax revenue as percentage of GDP

## 2.3 Budget surplus and deficit

As per EU requirement for joining the eurozone, Malta had to ensure a budget deficit-to-GDP ratio not exceeding 3 per cent by the end of 2007. The date set for Malta to enter the Eurosystem was 1 January 2008. This has necessitated a complete change in policy orientation with the main focus on curbing the fiscal deficit. Over the years, fiscal policy in Malta has been geared towards curbing the budget deficit.

Following sustained fiscal consolidation since 2003, there has been consistent reduction in the budget deficit until 2007, where it hit a record low of 1.8 per cent of GDP. Figure 2.6 below can be referred to for further details. The Maltese authorities are determined to pursue further with the deficit reduction. In this regard, they have set a target for structural budget balance by 2010 and committed themselves for a budget surplus after 2010 as their main policy objective.

One area that Malta needs to address if it is to curb the budget deficit further is the large public enterprise sector. In its Country Report 2008, the IMF warned that the PES is a source of distortions and budgetary pressure for the Maltese authorities. The substantial subsidies to the PES are putting severe stress on the budget. Furthermore, one other area that requires reform is the administered prices, as it has been found to lag import price increases. Besides, the high social expenditure (predominantly due to health care, pension outlays and benefits fraud) is also taking its toll on the budget.

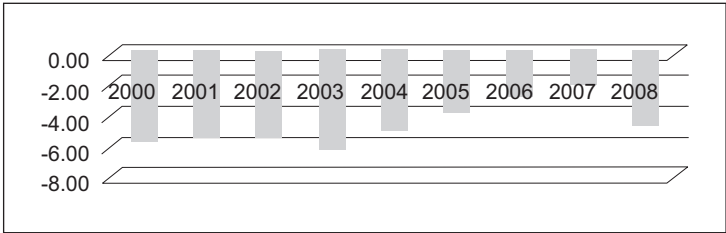


Figure 2.6 Government surplus/deficit as percentage of GDP

### 2.3.1 Current account balance

As demonstrated by Figure 2.7 below, the current account had persistently remained in deficit with the exception of 2002. While the services account balance had shown signs of improvement, the trade balance and current account have all deteriorated.

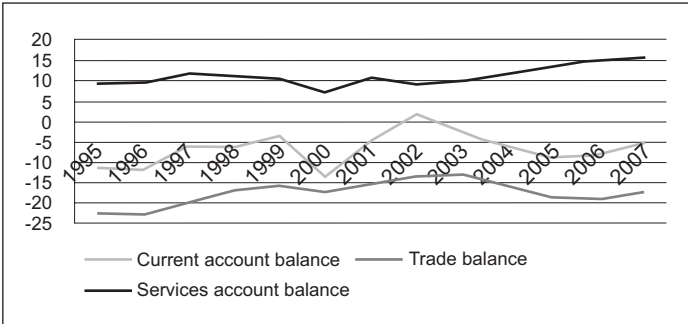


Figure 2.7 Current account (percentage of GDP)

## 2.4 Public debt

Public debt in Malta consists of treasury bills (TB), government stock, foreign borrowing, other debt assumptions and the Malta Government Stock (MGS) investments in government debt. Overall, the debt burden as a share of GDP has declined over the past couple of years after a peak in 2004 of 70.2 per cent, as illustrated by Figure 2.8 below. At the end of 2008, public debt stood at 63 per cent of GDP, an increase of 2.1 per cent from the previous year.

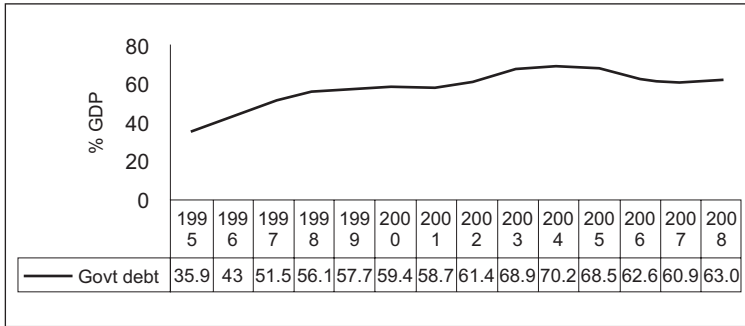


Figure 2.8 Government debt (percentage of GDP)

Figure 2.8 above shows government debt (domestic and foreign) as a share of GDP over the period 1995–2008. It is evident from Figure 2.8 that the trend is increasing, especially over the period 1995–2005.

Figure 2.9 below depicts the composition of government debt for the period 2001–2007. As indicated, the bulk of government debt (over 60 per cent) consists of government stock. This is followed by treasury bills, which account for less than 20 per cent.

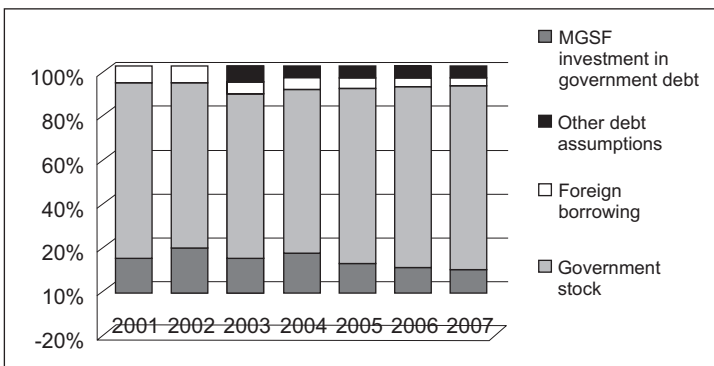
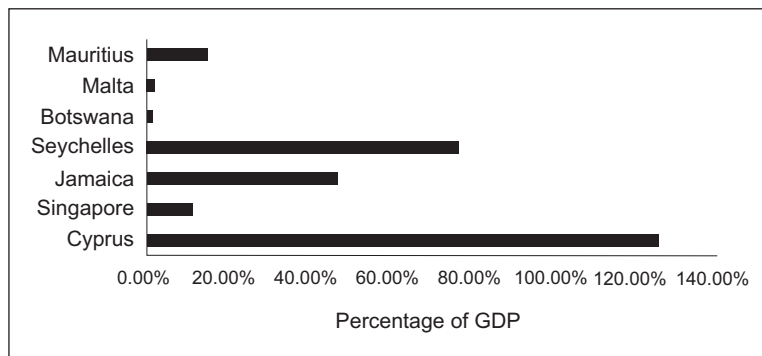


Figure 2.9 Composition of government debt, 2001–2007

By international comparison, Malta's external debt is quite low at less than 20 per cent of GDP. Figure 2.10 below gives an international comparison of external debt for the year 2007.



**Figure 2.10** External debt (2007 estimates)

Source: [http://www.nationmaster.com/graph/edu\\_edu\\_spe](http://www.nationmaster.com/graph/edu_edu_spe)

### **2.4.1 Management of public debt**

With the budget still running at a deficit, despite this showing significant reduction in recent years, Malta's fiscal situation still needs major revision. High on the agenda is the easing of public expenditure and improvement of the structural trade deficit. It is hoped that this will be achieved through the adoption of prudent fiscal policies. To ease pressure on public expenditure, the authorities have pledged to undertake reform aimed at curtailing spending and expect to achieve this by restraining three key elements, namely subsidies and state aid, the public wage bill, and the entitlement programmes.

The management of the public debt in Malta is undertaken by three principal government agencies. The agencies responsible are the Ministry of Finance, the Central Bank of Malta (CBM), and the Accountant General's Office. Though the activities surrounding the management of the debt stock are carried out by the three agencies, they are co-ordinated by the Public Debt Advisory Committee (PDAC). PDAC consists of senior representatives from each of these agencies and an additional one from the Malta Stock Exchange (MSE).

## **2.5 Economic growth**

One aspect of vulnerability that Malta did not share with other small states such as Seychelles and Mauritius is remoteness from major markets. Its proximity to Europe and being a member of EU has brought a lot of benefit to Malta. Almost 50 per cent of Malta's total exports went to the EU, which is the principal market for Malta's exports as depicted in Figure 2.11 below.

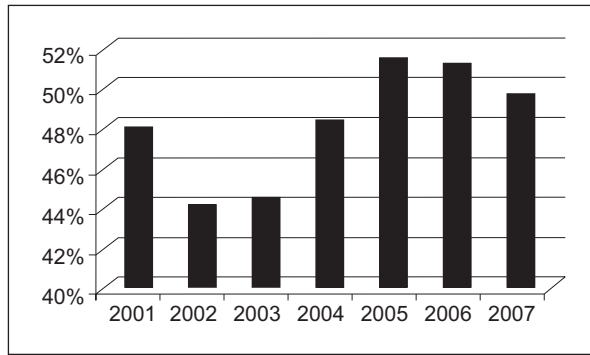


Figure 2.11 Percentage total export to EU

The export structure of Malta is undergoing brisk transformation owing in large part to robust expansion of niche exports and tourism. This has resulted in remarkable improvement in the trade deficit in goods and services from 5.3 per cent of GDP in 2005 to only 1.9 per cent in 2007.

The rejuvenation in export activities has been led by an upsurge in FDI that in turn has seen a redeployment of resources towards the export sector. While the export of goods has witnessed continuous decline over the years as depicted by Figure 2.12<sup>4</sup> below, this has been compensated by increase in manufacturing, aeroplane maintenance, and a tripling of generic pharmaceuticals output. Alongside the increase in the above export-oriented industry, there is a host of new export services that have emerged. This includes: online gaming; IT, call centres, and other business services; and financial services. They account for 9 per cent, 10 per cent and 3 per cent of GDP<sup>5</sup> respectively. Figure 2.12<sup>6</sup> below, taken from the IMF Country Report 2008, helps to clarify the above statement.

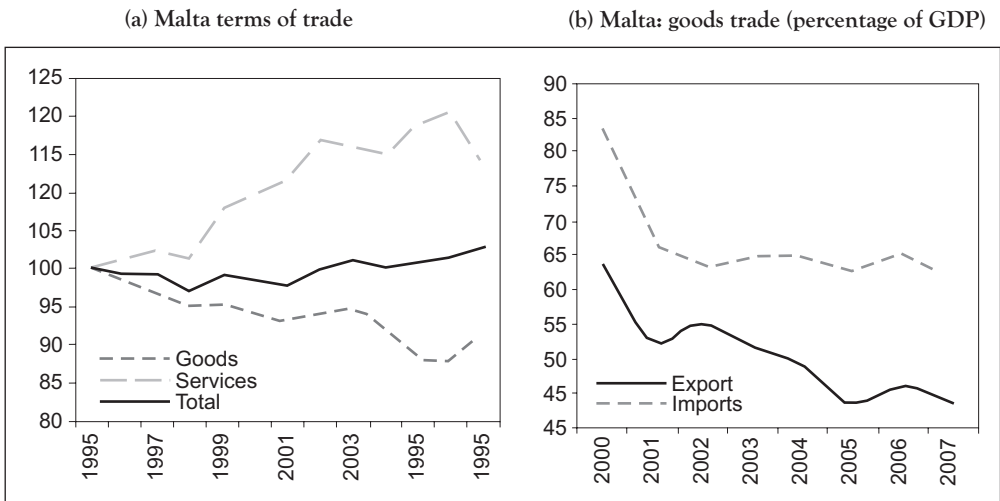
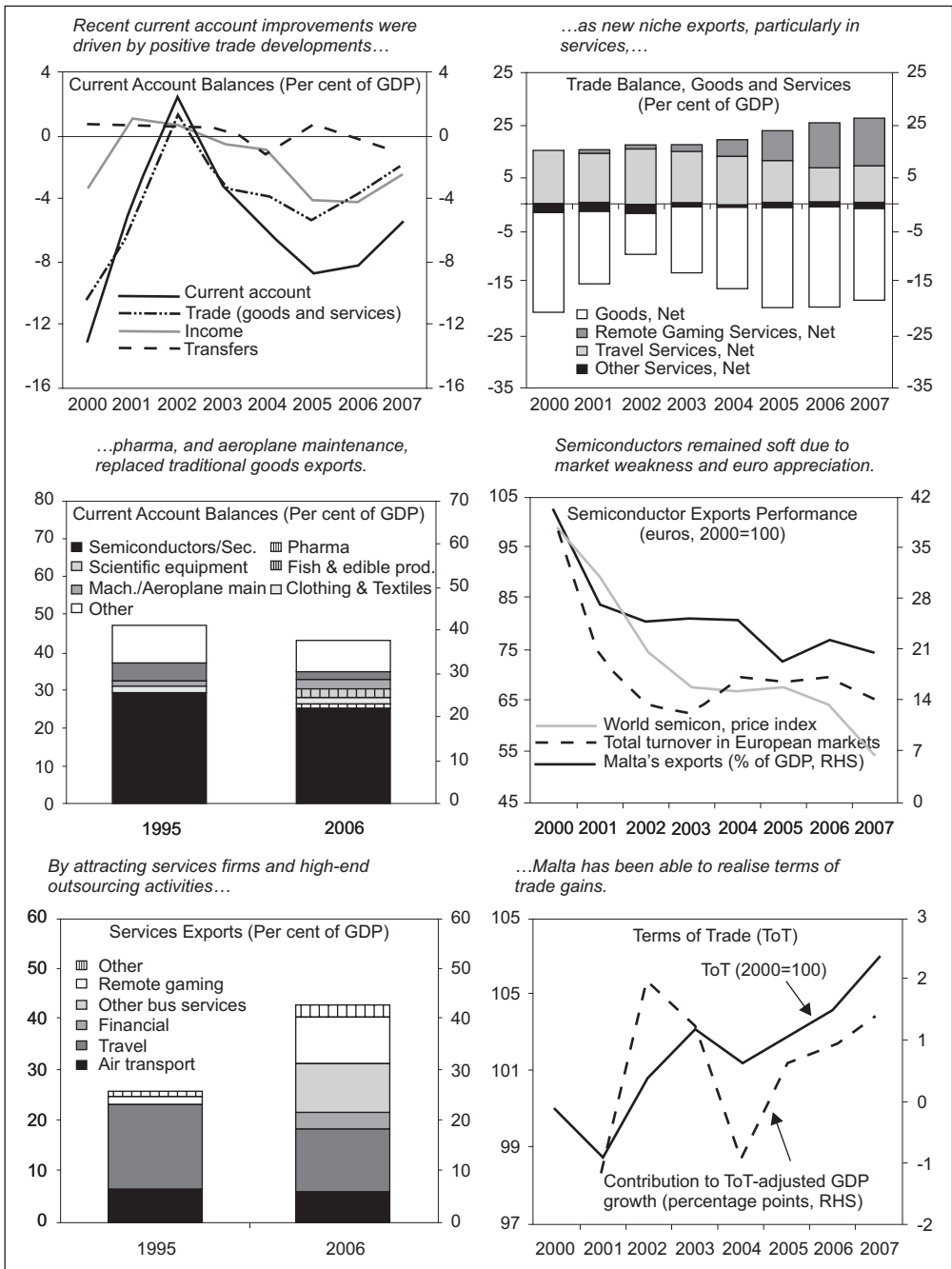


Figure 2.12 (a) Malta terms of trade; (b) Malta: goods trade (percentage of GDP)



**Figure 2.13** External current account development

Sources: National Statistics Office; European Commission; Eurostat; MSEiconductor Industry Association; IMF Direction of Trade Statistics; IMF Balance of Payments Statistics; and IMF staff calculations

Figure 2.12a depicts Malta's terms of trade. It is evident that the trend in trade in goods and trade in services appear to move in opposite directions over the period of study. Given Malta's fast growing service industry, it is no surprise therefore to see trade in services out-pace trade in goods. In addition, Figure 2.13<sup>7</sup> above, also taken from the IMF Country Report 2008, provides an overview of the trade performance of Malta over the period 2000–2007.

### 2.5.1 Real GDP growth

Malta's economic situation has been strengthened by the favourable international economic climate, mainly in the EU, and the government industrial policies, which are geared towards foreign export-oriented investment. As a result Malta's economy has experienced a period of sustainable growth, especially during the periods 1995–2000 and 2005–2007 as illustrated by Figure 2.14a and Figure 2.14b respectively. In 2008 the economy suffered some setbacks with a growth rate of 1.6 per cent, reflecting the dwindling global economic conditions. Economic growth over the entire period has been modest and somewhat volatile, with the exception of the year 2000 which recorded a growth rate of 6.3 per cent. The period 2001–2004 was turbulent from Malta's economic point of view. From a peak of 6.3 per cent in 2000, economic growth plummeted to rock bottom in 2001 with a recorded negative growth of -1.6 per cent. It was not until 2005 that the economy recovered fully.

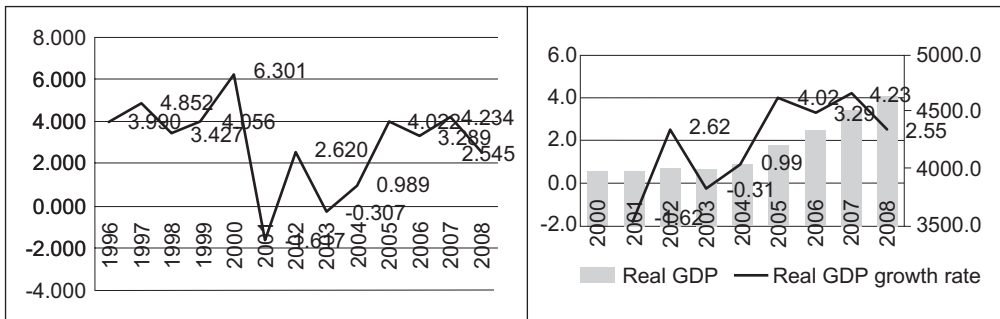


Figure 2.14a Real GDP growth rate

Figure 2.14b Real GDP and GDP growth rate, 2000–2008

Figure 2.14 above depicts real GDP and GDP growth rate for the period 2000–2008. Real GDP growth rate appears to be more rapid during the second half of the period, i.e. after 2003.

The economy regained momentum after 2003 as manifested by real GDP growth (see Figure 2.14b). The year 2004 is important and perhaps noteworthy as it marked Malta's entry into the EU. Presumably it is no coincidence that Malta's economy gathered some strength after 2003. Entry into the EU has surely given Malta the upper hand and the impetus to salvage its economy from further downfall. This came in the wake of criticism that the Maltese economy was performing below its full potential. It is important to note that Malta's economy has been under constant competitive pressure, especially during the late 1990s due to high wage growth and low labour productivity.

## 2.5.2 Aggregate demand

Malta's economic recovery was supported in part by strong domestic demand (mainly consumption), which started picking up in 2005 and resulted from major increases in government spending (see Figure 2.15 below), and exports of goods and services. The hefty public investment financed largely by grants from the EU and Italy was vital in supporting Malta at a time of weak economic growth. All these have further boosted Malta's favourable economic performance, especially after 2003. In addition, domestic demand supported by an increase in private consumption remained robust in 2008, despite the deteriorating global economic conditions.

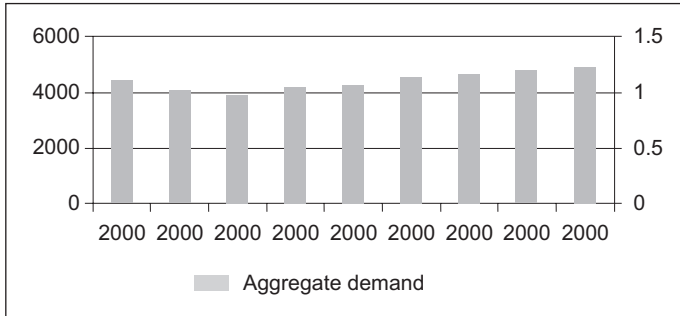


Figure 2.15 Aggregate demand, 2000–2008

## 2.6 Public involvement in the productive sector

Until recently, the Maltese government was very much active in the economy, owning a number of businesses spanning the whole spectrum of the economy and employing a large labour force. The type of business owned by the government included telecommunications, postal services, port services, shipyards and banks. It is worth noting that with the reform programme in place, the government has scaled down its involvement in those key business areas.

Despite the significant reduction in government participation in the economy, they still have a pervasive presence. At the end of 2008 there were some 40 public enterprises in the field of banking, waste management, aviation, energy and public utilities amongst others that are fully-owned or partially-owned by the government.

Furthermore by the end of 2008 the public enterprise sector was employing about 30 per cent of the labour force. The large public sector enterprise is a drain on government resources, accounting for a substantial amount of subsidies and state aid, the highest in the EU. There are widespread criticisms that the large public sector employment is putting pressure on the government budget, thus making them underperform. On the basis of an international comparison, the size of the public sector in Malta is identical to that of the Seychelles at 30 per cent.

## 2.6.1 Employment by sector

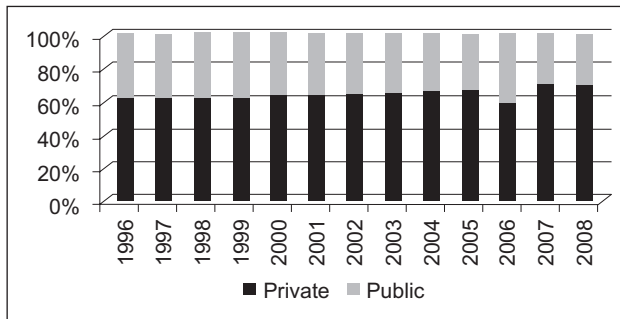


Figure 2.16 below shows the public/private sector employment for the period 1996–2008

The Maltese government was a major employer with some 40 per cent of the labour force during the 1990s, but has since reduced to about 30 per cent in 2008. The reduction in public sector employment is an indication of the ongoing privatisation programme.

## 2.6.2 Unemployment

Historically, unemployment has been relatively high in Malta despite the sustainable rapid growth of the economy. Nevertheless, unemployment is mostly confined to the unskilled work force. In contrast, rapid growth coupled with the knowledge-based economy has put additional pressure on the market for skilled labour. In consequence Malta is now suffering from an acute skilled labour shortage despite illegal immigration, and a significant increase in real earnings. This emerging gap between the skilled and unskilled labour markets was so pronounced that in 1999, it was reported that there were on average three times as many unemployed people for each vacancy in the unskilled job category as there were for job vacancies generally.

The rising trend of unemployment in Malta dates back to 1996 and has since remained high. This rising trend is to a large extent caused by weaker domestic demand, which as a consequence impacted negatively on the demand for labour, particularly in the construction and service industries. Moreover there were attempts by the government to reduce public sector workers further.

Figure 2.17 below depicts the quarterly (Q) unemployment rate for the period 2000 (Q2) to 2009 (Q1). For most of the entire period, unemployment has remained above 6 per cent, with the exception of the third quarter (Q3) of 2007 and 2008 respectively. The unemployment rate for 2007 (Q3) and 2008 (Q3) was 5.98 per cent and 5.84 per cent respectively, but had risen again to above 6 per cent in 2009.

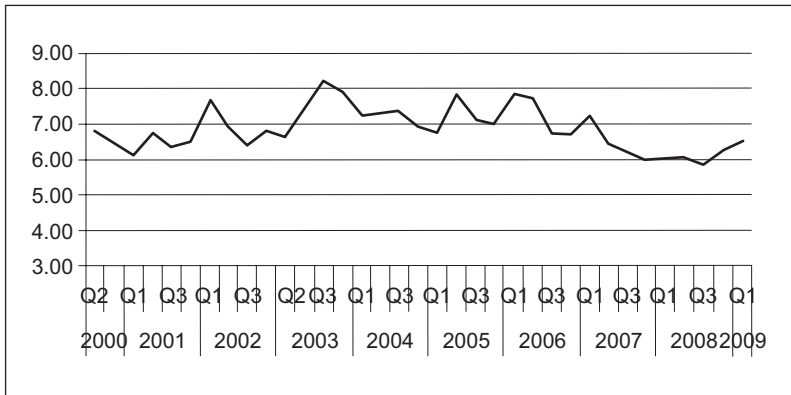


Figure 2.17 Unemployment rate, 2000–2009

Figure 2.17 above shows that the unemployment rate has consistently remained above 5 per cent over the entire period. The highest rate was recorded in 2003 (Q3) standing at 8.24 per cent.

## 2.7 Economic vulnerability

### 2.7.1 Pollution

The greatest challenge faced by Malta is the controlling of pollution, which appears to be on the rise. Among the polluting activities are waste generation, energy generation and development. The existing legislations are ineffective in making the polluters account for the full cost of their activities on the environment. Nonetheless there are efforts on the part of the government to mitigate the impact of pollution. Two main areas have already been earmarked by the government for immediate action; biodiversity and climate change. In the case of biodiversity there are a number of pressures arising from ongoing development. Biodiversity, both on land and in the marine environment, is under constant pressure and risk of degradation. The other taxing area is climate change. Despite the commitment from the government to address the issue of climate change, this could be a daunting task. Malta is partly responsible for contributing towards climate change (though not on a large scale) through greenhouse gas emissions arising from electricity generation and transport.

### 2.7.2 Climatic change

Over the past few years, global climate change has emerged as one of the major threats of this century. Flooding in Asia, hurricanes of various magnitudes, droughts in Africa, a rise in sea level, ice melting in the North Pole and heightened global temperatures are all realities of today's world. All these occurrences are directly related to global climate change. Malta, the Seychelles and other SIDS are very much the victims, but unfortunately have to share in the consequences.

A paper entitled 'The First Communication of Malta to the United Nations Framework Convention on Climate Changes 2004', published by Malta's Ministry of Rural Affairs and Environment, highlighted some of Malta's main challenges to global climate changes:

'The main characteristics that make the Maltese islands particularly vulnerable to climate change are the following:

1. Malta has one of the smallest populations in the world. Smallness tends to increase vulnerability to climate change (Briguglio, 1995).
2. Malta is one of the most densely populated countries, with over 1,200 inhabitants per square kilometre. This increases vulnerability and hampers adaptation to climate change (Attard et al., 1996).
3. Tourists raise the effective population, especially during the summer months when an increase of about 10 per cent is typical. The tourism sector is highly susceptible to climate change (Bijlsma et al., 1996).
4. The demography of Malta is similar to that of other developed countries, with very low birth and death rates and an ageing population. This exacerbates socio-demographic vulnerability to climate change and costs of adaptation.'

Malta's direct exposure to climatic changes does pose serious threats to economic sustainability. A potential source of economic vulnerability according to the authors is the disruption of productive and expenditure activities. Sectors most prone to climate changes are agriculture, manufacturing and tourism. The latter two sectors are worrying as they account for a significant share of GDP in Malta.

In analysing the above threats posed by climate change to the Maltese economy, a similar pattern can be witnessed in Seychelles and Mauritius. All three of these island states share a common economic characteristic that directly relates to climate changes: tourism.

## Notes

1. The Eurosystem consists of the European Central Bank and the National Central Bank (NCB)
2. [http://www.focusmm.com/malta/ma\\_manif.htm](http://www.focusmm.com/malta/ma_manif.htm) [last accessed May 2011]
3. [http://www.focusmm.com/malta/ma\\_manif.htm](http://www.focusmm.com/malta/ma_manif.htm) [last accessed May 2011]
4. IMF Country Report 2008.
5. GDP as at 2007.
6. IMF Country Report 2008.
7. IMF Country Report 2008.



# Part II – Fiscal Policy Strategies in Small States

## 3

# Economic liberalisation and privatisation programme

The Maltese government over the years has pursued a policy of gradual economic liberalisation and privatisation. The economic liberalisation/privatisation programme was carried out with the aim of changing the focus of orientation of trade and financial policies towards a market mechanism principle. As a result, this has shifted policy orientation from reliance on direct government intervention and control towards a pro-market mechanism.

Part of the liberalisation/privatisation programme saw many formerly state-owned companies being privatised and the market liberalised. So far, the reform programme has been successful, judging by the results. The process of economic liberalisation has brought about significant change to Malta's economy. As a consequence of the liberalisation reform, Malta has experienced a three-year-long expansion driven mainly by FDI and export diversification.<sup>1</sup> For three years in succession over the period 2005–2007, Malta recorded an average real growth rate of 3.85 per cent. Meanwhile in 2007, current account deficit dropped to 5.5 per cent of GDP and unemployment was also down to 6.48 per cent, one of its lowest rates for years. The remarkable growth rate has been spearheaded by booming new manufacturing and export services activities, and a revitalised tourism industry.

The public enterprises being privatised recently were mainly in the sector of telecommunication, harbour towage and cargo handling, and postal services. The government is keen to continue with the streamlining of the public sector as part of its reform programme. The privatisation is in full swing and intended to continue with other sectors, namely shipyards, liquid petroleum gas (LPG) and gasoline distribution. Despite the reforms being hailed as successful by international standards, the Maltese economy remains fairly regulated and continues to be hampered by some longstanding structural weaknesses.

### **3.1 Measures to address budget deficit**

In its endeavour to curtail the budget deficit, the Maltese authorities have introduced a system of budgetary targets. As for the year 2008, a targeted budget deficit of -1.2 per cent of GDP was established. Nonetheless, provisional estimates as depicted by Figure 2.6 above indicates that they are well below their target (-4.6 per cent). In the light of the

unforeseeable circumstances, especially higher than projected oil prices and other costs, the authorities have taken precautionary measures to contain the deficit. Measures taken include prioritising and sequencing of capital projects and additional hiring controls. The authorities have also raised the electricity prices, thus limiting electricity subsidies to 0.7 per cent of GDP.

The authorities are determined to pursue the fiscal reform aimed at curbing the budget deficit. The reform programme was premeditated to give the government the upper hand with its revenue and expenditure through stronger fiscal consolidation. The authorities intend to press on with subsidies reduction and also streamline the large public sector employment. With regard to subsidies reduction, the authorities have already indicated the abolition of shipyard and bread subsidies in 2009. Other areas have already been earmarked as potential for reducing subsidies and cost-cutting. Health is one such area. The Maltese authorities are determined to press ahead with their medium-term objective of a balanced structural budget by 2010, claiming that this will provide domestic stability, thus cushioning the economy from external shocks.

## **3.2 The business environment in Malta**

The key to the success of businesses in Malta is its excellent infrastructure and good telecommunications facilities. Supported by an efficient public administration, Malta provides a conducive environment and is an effective place to conduct business. Furthermore, foreign investors are welcomed with open arms and are entitled to 100 per cent ownership of businesses in nearly all sectors. There are extensive investment incentive schemes (see below). To date there are over 250 foreign companies with manufacturing operations located in Malta.

Businesses have been boosted further by the existence of a sound and robust financial system. A number of local and foreign banks offering a variety of services ranging from e-banking to advanced (cross-border) payment systems further amplify the excellent business environment. Nonetheless, as part of the Exchange Control Act, 1972, foreign banks in Malta were subject to a large degree of control. Upon Malta's accession to the EU, free capital movements were permitted and the act was gradually repealed. As a result, banks can now operate freely.

In its endeavour to boost existing investments and attract new ones, the Maltese government introduced a new incentive package in 2001 predominantly targeting the manufacturing sector, with over 30,000 employees. The new investment package provides fiscal incentives including reduced rates of corporate tax, investment tax credits, value added incentive schemes, special provisions for small businesses and other incentives related to training and job creation.

### **3.2.1 Malta's freeport**

Like Singapore and most recently Mauritius, Malta has been actively engaged in freeport<sup>2</sup> services since the introduction of the Freeport Act in 1989. The Freeport Act made

provision for a number of fiscal and other incentives to companies operating in the freeport zone. Among the incentives are exemption from customs duties, income tax, stamp duty, withholding tax (except for distributions to Maltese residents), exchange control and death duties. Furthermore, employees of freeport companies may benefit from a slight reduction in income tax and importation of personal items duty- and tax-free for the first six months of their stay.

Among the facilities offered by the freeport are: extensive storage space including a container terminal; ship repair; and a range of other support services.

For a company to be qualified to operate in the freeport, it must be incorporated in Malta and must operate under one of the following headings:<sup>3</sup>

- the labelling, packaging, sorting, warehousing, storage, exhibition or assembly of any goods, materials, commodities, equipment, plant or machinery; or
- any activity concerned solely with the conduct of a freeport including, but not limited to stevedoring, wharfage, operation of terminals and container handling; or
- the rendering of services analogous or complementary to the activities mentioned in (i) above.

The main benefits of the freeport include employment generation and foreign currency earnings. In terms of employment generation, new employment opportunities have been created, as well as the introduction of new skills and technologies. The types of employment created range from ship repair to insurance. The freeport has given a further boost to Malta's economy in terms of foreign currency earnings, as most of the revenue is generated in US\$.

### **3.2.2 Foreign investment**

In its endeavour to encourage more foreign investment to Malta, the government set up the Malta Enterprise in 2004. This newly-incorporated body assumed the responsibility previously discharged by three separate entities, i.e. the Malta Development Corporation (MDC), the Malta External Trade Corporation (METCO), and the Institute for the Promotion of Small Enterprise (IPSE). Technically the three entities are still operational but function under the umbrella of the Malta Enterprise.

The main function of the MDC is to look at business development. This basically involves attracting FDI, trade promotion, marketing strategies, knowledge management, and foreign offices. METCO's role is principally to handle client relationship management while IPSE was mandated to deal with corporate services.

Since the incorporation of Malta Enterprise in 2004, direct investment seems to have received a new breath of life. As depicted by Figure 3.1 below, from a peak of about €800 million in 1999, direct investment has since dropped and remained below €400 million. As of 2004 the trend in direct investment somehow took a different turn and started rising until it hit a record height of about €1.5 billion in 2006.

Figure 3.1 below depicts trends in direct investment in Malta over the period 1998–2008.

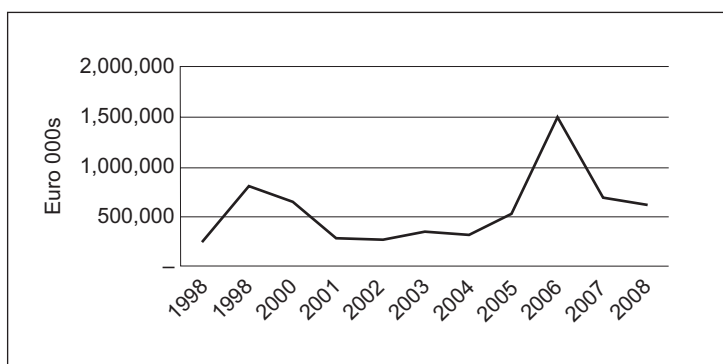


Figure 3.1 Direct investment in Malta, 1998–2008

Malta is well-known for having a long tradition of stable institutions and a favourable business environment. This has been the cornerstone in attracting large FDI inflows, which in turn has been a major source in financing the current account deficit.

### 3.2.3 Malta Offshore Tax System

In Malta, offshore companies can be incorporated under the following headings:

- International trading company (ITC, now closed to new entrants)
- International holding company (IHC)
- SICAV (Société d'Investissement à Capital Variable)
- Offshore company (now defunct)
- Trust

Malta is considered to be a low-tax country, having tax treaties with many countries including most of the OECD countries. The offshore tax is regarded as very generous. Nonetheless upon accession to the EU, there were concerns about which aspects of Malta offshore regime would remain. In August 2003, as part of a European Commission (EC) exercise carried out in ten potential acceding countries, the EC identified seven harmful tax practices that Malta had to eliminate. In March 2006, under EC Treaty state aid rules, Malta's was made to abolish the tax regime for Maltese companies with foreign income (CFI) and the international trading companies' (ITC) regime by the end of 2010 at the latest.

In May 2006, Malta formally accepted the EC recommendation to phase out the preferential tax regime. Accepting the EC recommendation implies that:<sup>4</sup>

- the existing ITC and CFI schemes were effectively abolished by 1 January 2007;
- a new refundable tax credit system was to be enacted by Malta provided that it does not effectively favour foreign-owned companies over domestic-owned companies;
- the tax status of ITC is prohibited to any new company registered in Malta after 31 December 2006;

- the existing ITCs will benefit from the current system only until 31 December 2010; and
- the number of newly-created ITCs between the date of acceptance of the appropriate measures and 31 December 2006 was limited to the yearly average number of ITC companies created in the last five years.

In spite of the above measures, the Malta offshore sector continues to perform well. Malta is ranked 6th out of 37 countries globally that are described as ‘frontrunners’ in terms of high FDI potential.<sup>5</sup> Furthermore Malta is placed in the 4th position among 66 jurisdictions as a centre ‘that is most likely to increase in importance over the next few years’.<sup>6</sup>

### **3.3 Effect of regional and international agreements on fiscal policy**

Following Malta’s accession into the EU in 2004, there has been a rise in the number of worldwide blue chip companies, banks and international entrepreneurs coming to settle in the country. On average, 250 new companies are registered per month, and this trend is expected to grow further.

#### **3.3.1 Double taxation treaties**

To date, Malta has double taxation agreements with a number of countries (46 in all and 15 pending) spread over five continents. These agreements have brought a lot of benefits to Malta, where those benefits are available to all Maltese companies. The agreement between Malta and Singapore for example is expected to facilitate the cross-flow of trade, investment, financial activities and technical know-how between the two countries. The Maltese double tax treaties are based on the OECD Model Convention.<sup>7</sup>

Malta has a growing network of double tax treaties with countries like Australia, Kuwait, Holland, France, India, South Africa, Singapore, USA, Barbados, Canada and Scandinavia to name but a few. Besides the main treaties mentioned above, Malta has offered three additional types of avoidance from double taxation treaties, namely Commonwealth income tax relief, unilateral relief and a flat rate foreign tax credit.

Commonwealth income tax relief is applicable where double tax treaty relief is not available. As the name suggests this makes provision for tax relief on income under the law of a Commonwealth country (other than Malta and the UK). However, this also implies that the law in the respective country provides for a similar relief in respect of tax charged on income both in that country and in Malta.

Unilateral relief is granted in circumstances where overseas tax is imposed on income received from a country with which Malta does not have a double tax treaty and Commonwealth income tax relief is not available.

Flat rate foreign tax credit is applicable in situations where the other forms of tax relief are unavailable. This form of tax relief is available to a Maltese company that receives income from overseas. This is evaluated at a rate of 25 per cent of the amount of the overseas income or gain received by the company, before allowable expenses.

### **3.3.2 Other international agreements**

In January 2004, a memorandum of understanding (MOU) was signed between the Malta Financial Services Authority (MFSA) and the Guernsey Financial Services Commission. This MOU had set a platform for greater co-operation, which includes the exchange of information and investigative assistance between the two regulatory bodies.

In May 2004, financial regulators from Malta and the UK entered into a MOU, with the aim of facilitating the exchange of information and investigative assistance.

In July 2004, the MFSA and the Gibraltar Financial Services Commission signed a MOU on exchange of information. The MOU had set a framework for more formal co-operation, especially in the fields of banking, insurance, investment services, provision of professional trusteeship and company management services, and the exchange of information on supervisory practices and techniques.

In November 2005, the Jersey Financial Services Commission and the MFSA entered into a MOU, specifically aiming at the exchange of information between the two financial services regulators. In May 2008, a declaration of signing of a MOU was made between the Central Bank of Cyprus and the MFSA.

The MOU had set the platform for mutual co-operation and exchange of information between the two authorities. This would facilitate the consolidated supervision of cross-border establishments and ensure the safe functioning of credit institutions in the respective countries, in accordance with their national laws and regulations.

In February 2009, The Cayman Islands Monetary Authority and the MFSA formally established bilateral ties.

## **3.4 The factors that reduce the fiscal size in the country**

### **3.4.1 Labour participation**

Malta has a low labour participation rate, with only 54 per cent of the working-age population actually engaged in full-time employment. This is far below the 70 per cent required in the Lisbon Strategy. The low participation rate is particularly concentrated among women.

### **3.4.2 Diversification of industry and exports**

A typical challenge faced by most small island economies, including Malta, is economic diversification. Despite their relentless effort to diversify, governments of small states have to face a daunting task trying to overcome this challenge. Furthermore, the development capacity of the country is seriously constrained by the small size of its domestic market, high production costs, limited natural resources and shortage of labour, in particular skilled labour.

As a small state, Malta has not been spared from these challenges. The difficulties in diversifying have consequentially led to Malta becoming disproportionately dependent on exports in a narrow sphere of industry sectors, most notably electronics and technology. The dependence on exports and tourism makes Malta hugely vulnerable to global economic

downturn. Nonetheless there is a strong call for Malta to diversify at least into less traditional sectors. This, according to analysts, will allow the economy to switch to competing in an alternative range of areas when conventional industries begin to fail.

### **3.4.3 Reform in the education system**

Contrary to general wisdom, Malta has a very high rate of early school leavers. Statistics have shown that only 45 per cent of people in their twenties had attained an education up to upper secondary level. This represents one of the lowest rates among the EU member states as of 2004. This lack of qualified manpower is a real setback for Malta given its reliance on the electronics industry, much of which requires highly technical skill and broad knowledge for continued innovation. Critics are challenging the efficiency of the education system and are calling for reform to reverse the current trend, rather than focusing on policy aiming at increasing funding and expansion.

### **3.4.4 High unemployment**

Historically, unemployment in Malta has been relatively high despite the sustainable rapid growth of the economy. Ironically, despite the relatively high unemployment rate, Malta is suffering from acute skilled labour shortage. Unemployment in Malta is concentrated largely among the unskilled.

### **3.4.5 Large public sector enterprises**

Despite the recent restructuring of the vast and inefficient PES, it is still relatively large by international standards. The PES is not only weighing on the budget but is also a drag on economy-wide productivity. Malta needs to undertake further reform if it is to curtail the budget deficit and attain a surplus. In addition, the PES is a source of distortions and the substantial subsidies awarded to it are another source of budgetary pressure.

### **3.4.6 High social cost**

The high social expenditure (predominantly due to health care, pension outlays and benefits fraud) is a drain on the budget. In 2009 alone it was estimated that Malta taxpayers paid an approximate €354 million towards social security benefits. On average, the share of social security benefit to GDP is about 15 per cent; 40 per cent of total government expenditure. For a small country with a population of 410,290, this is extremely high when compared to countries like Switzerland and Australia, 11 per cent and 8 per cent of GDP respectively.

### **3.4.7 Persistent competitive pressure**

Malta is currently faced with considerable competitive pressure from outside. This can pose a substantial challenge for potential growth and standard of living in Malta over the

medium term. A number of factors have been identified as contributing towards the erosion of international competitiveness and they are:<sup>8</sup> large wage increases in the public sector, low labour productivity, and the need for substantial and sustainable adjustment among major trading partners.

### **3.4.8 Persistent current account deficit**

Malta's current account balance has persistently remained in deficit and has deteriorated over the years. Moreover, as identified by the IMF Country Report 2007, the export sectors and tourism have both lost market share during this decade.

## **Notes**

1. IMF Country Report 2008.
2. A freeport is an area or section of a port whereby transactions are exempted from customs regulations such as tariffs and other duties. Duty is levied only if the goods are moved from the freeport section into other area not designated as a freeport.
3. <http://www.lowtax.net/lowtax/html/jmaoltr.html>
4. <http://www.lowtax.net/lowtax/html/jmaoltr.html>
5. The World Investment Report, released by the UN Conference on Trade and Development.
6. The Global Financial Centres Index 3 – City of London Report.
7. The OECD model ensures that the same income is not taxed twice in different jurisdictions.
8. IMF Country Report 2007.

## 4

# The socio-economic context

Like Seychelles and Mauritius, the Maltese government has long recognised the fact that despite economic development being regarded as the driving force, this is insufficient for sustainable development. Sustainable and durable development and progress (including human resources development) need a solid base in the form of good infrastructure and facilities. Without considerable investment in capital and human resources, economic and social progress will take longer to achieve. This has been manifested by the huge public investment over the past decade to provide the foundation (ICT infrastructure) the private sector so needed.

Over the years, Malta has emerged as a technology-based economy with the state-of-the-art ICT infrastructure that global capital and business require. Malta's technological knowledge has lifted the country's international image and placed it among the elite in the ICT sphere. Today, Malta is ranked second among the EU states for e-Government services. Other achievements include; excellent access to broadband (66 per cent); two satellite stations; two submarine fibre optic cables and more planned; a fully-liberalised communications market; three competitive mobile operators; ICT regional centre of excellence – Microsoft, Oracle and CISCO training centres.

Despite Malta's lack of natural fresh water sources, the island still has robust water and electricity supplies. Over half of Malta's potable water comes from the desalination process.

With a small population of 405,165 and surface area of only 316 square kilometres Malta is considered to be one of the most densely-populated countries. The population density per square km is 1,298. Despite the high number of licensed road vehicles (699.8 per 1,000 inhabitants) Malta has one of the lowest road casualty rates at only 2.9 per 1,000 inhabitants.

### *Socio-economic development*

The Human Development Index (HDI) 2007/2008 has awarded Malta a value of 0.878, which gives the country a ranking of 34th out of 177 countries. The HDI presents a measure of three magnitudes of human development, namely living a long and healthy life, being educated, and having a decent standard of living. These are measured by life expectancy, adult literacy and enrolment at the primary, secondary and tertiary level, and purchasing power parity (PPP) income, respectively.

The HDI ranking for 2007/2008 is based on 2005 information. As for the case of Malta the following factors were accounted for; life expectancy at birth was 79.1 years, adult literacy rate (ages 15 and older) was 87.9 per cent, combined primary, secondary and tertiary gross enrolment ratio was 80.1 per cent and GDP per capita (PPP US\$) was US\$19,189.

### *EU membership*

The entry of Malta into the EU had stimulated interest in the island's strategic location as an ideal place for service providers. The types of services provided include call centres, aircraft repair and back-office operations. According to the IMF Country Report 2007, companies offering these services were attracted by Malta's skilled work force, which benefited from significant public investment in technical and vocational training, particularly through the Malta College of Arts, Science, and Technology (MCAST). It is important to note that these activities are operating on a small scale.

### *Measures to address climate change*

In their quest to address the issue of climate change, the government has devised a plan of action that includes the following:

- Capture of methane from waste disposal and treatment.
- Replace existing uncontrolled landfill with alternative engineered landfills and further improve upon the treatment of municipal solid waste (MSW).
- Promote the increased use of biofuels through the exemption of excise duties on their importation as well as by encouraging increased throughput volumes as a result of a pilot collection scheme currently underway for the collection of used cooking oil.
- Encourage the greater utilisation of non-conventional sources of water, namely treated sewage effluent and surface water run-off, instead of more costly drinking water for uses that are of a non-potable origin.

The success of the above measures remains to be seen, but their implementation will be costly.

## **4.2 Key development indicators**

The following tables illustrate the national demographic and socio-economic indicators for Malta.

**Table 4.1** Demographic indicators

<i>Indicators</i>	<i>Year</i>	<i>Value</i>
Adult literacy rate (%)	2000–2007*	92%
Age distribution (%)		
0–14	2006 est.	17.1%
15–64		69.1%
65 and over		13.7%
Child mortality rate (per 1,000 children aged 1–4 years)	2007	4
Crude death rate (per 1,000 population)	2007	8
Dependency ratio	2005	19.8%
GDP per capita (US\$)	2005	19,189
Human Development Index (rank)	2005	34th
Infant mortality rate (per 1,000 live births)	2007	4
Life expectancy at birth (yrs)	2007	79
Maternal mortality rate (per 100,000 live births)	2005	8
Net enrolment rate in primary education (%)	2000–2007*	91%
Percentage of population below national poverty line		N/A
Percentage of underweight under-five children		N/A
Population growth rate (%)	1990–2007	0.6%
Population size (mid-year)	2007	400,000
Population with access to treated water supply	2006	100%
Population with access to flush toilets	2006	100%
Ratio of girls to boys in primary education (%)	2007	101.1
Sex ratio (per 100 females)	2008	106 males
Total fertility rate	2007	2

\*Source: Unicef <http://www.unicef.org/infobycountry/malta.html>

**Table 4.2** Education indicators, 2002–2006

<i>Description</i>	<i>Year</i>	<i>Value</i>
Primary school enrolment ratio, gross, male	2007	101
Primary school enrolment ratio, gross, female	2000–2007	99
Enrolment and attendance ratio: females as a % of males, net secondary school, enrolled	2000–2007*	107
Female adult literacy rate (as to % of male rate)	2006	103
Net secondary school enrolment ratio of male to female	2006	1.06

\*Sources: Unicef [www.unicef.org/infobycountry/malta.html](http://www.unicef.org/infobycountry/malta.html)

By the end of 2007, the number of fixed line and mobile phone subscribers stood at 55.6 per cent and 91 per cent respectively. The number of personal computers in use and internet users has surpassed the 50 per cent mark at over 300,000 and 250,000 respectively. It has been testified by the Malta Communications Authority that by the end of September 2005 there were 324,763 wireless subscribers in the country, representing a penetration rate of 81 per cent.

**Table 4.3** Selective indicators (per 100 population)

<i>Indicator</i>		2004	2005	2006	2007
Fixed subscriptions	telephone	52.4	51.8	51.5	55.6
Mobile subscription	telephone	76.8	80.2	84.9	91.0
Pagers subscription		1.1	1.2	1.2	1.2
Cable TV subscriptions		25.1	25.3	27.7	29.3
Internet subscriptions		21.9	21.9	23.4	24.4

*Source:* National Statistics Office, Malta

# **MONETARY POLICY FRAMEWORK**



# Part I – Key Issues and Lessons Learnt

## 5

### Introductory remarks

Adopting the euro as its national currency would imply that the Central Bank of Malta had relinquished control of its monetary policy. This was not so; the bank was mandated to contribute towards the formulation of monetary policy for the euro area. Monetary policy in Malta is dictated by the Governing Council of the European Central Bank and implemented by the CBM.

#### **5.1 Transparency of monetary and financial policies**

The CBM has made tremendous strides ahead in its effort to conduct monetary policy in a transparent manner. It has been commended for observing most of the transparency practices outlined in the Code of Good Practices for Transparency in Monetary and Financial Policies. In this perspective, the amended CBM Act of October 2002 is in accordance with the EU requirements.

As a consequence of the amended act of 2002, focus of orientation of monetary policy was placed on the pursuit of price stability. Despite the CBM's commitment in transparency practices, there were shortcomings in the transparency of monetary policy. The major shortcomings identified related to the lack of clarity in the description of the objectives and procedures of the CBM's operations in government securities markets and the lack of monthly information about the CBM's off-balance sheet commitments, especially its forward contracts in the foreign exchange market.<sup>1</sup>

It has been suggested by the IMF that for Malta to improve in the transparency of its financial policies, it should define and publicly disclose both (i) the roles of the MFSA and CBM in regulating and supervising the securities depository and settlement system, and (ii) the arrangements for the exchange of information between domestic as well as international supervisory and regulatory authorities.<sup>2</sup>

#### **5.2 The financial system of Malta**

The financial services sector in Malta is relatively large and well-developed, but largely dominated by banks. On average it accounts for about 12 per cent of GDP, employing over 7,000 people. The financial services sector has witnessed an extraordinary 30 per cent annual growth over the last three years. By the end of 2007, banks accounted for 72.8 per cent of the total assets of the financial system. As in Mauritius, no distinction is made

between inshore and offshore banks in Malta. The offshore regime for banks was revoked in 2003.

Financially, international banks seem to be performing better than domestic banks. This is demonstrated by the fact that in 2007, the share of domestic banks dropped to 37.6 per cent from its previous position of 45.6 per cent in 2006. With regard to banking assets, domestic banks accounted for only 19.7 per cent by the end of 2007. The financial system also encompasses the insurance sector, which despite its growth in recent years constitutes only a minor share of total financial assets of 2.8 per cent in 2007.

The existence of a sound and efficient financial system has brought major benefits to the banking sector and to the economy in Malta. This is highlighted by the fact that the banking sector was pretty much unaffected by the recent credit crunch. The well-capitalised position of the banks, coupled with a low reliance on interbank funding and a high dependence on retail deposits, are the main factors insulating the banking sector in Malta. Most of the basic financial sector infrastructure (including payment, securities trading and settlement systems) are in place, are running efficiently and are quite modern. In addition, access to financial services is widely available.

The efficient financial sector has helped in reducing asymmetry in information flow and concurrently promoting innovations. A key attribute instigating efficiency in the financial sector is transparency. Increase in market efficiency has been a direct result of transparency because asymmetric information tends to skew the distribution of information between financial institutions and investors. Low transparency can lead to loss of confidence. It is very important therefore to uphold a good level of transparency and disclosure in line with international best practice, if confidence is to be maintained.

### **5.2.1 Structure of the banking sector**

There are a number of local and foreign banks in Malta. By the end of 2007 there were 22 credit institutions in the banking sector, which is classed under two broad categories. The first category is known as the international banks, which are engaged mostly in foreign currency transactions targeting mainly non-residents. The other category is referred to as the domestic banks and they conduct business with both residents and non-residents. Prior to accession into the EU, foreign banking activity in Malta was heavily controlled as part of the Exchange Control Act, 1972.

The banks have continued to remain competitive and this has been possible through the launching of innovative products. In 2003, there were further developments in mobile and internet banking. A major development that occurred in 2003 was the launching of the Depositor Compensation Scheme (see case study for further details). The main objective of this fund was to provide safety for private depositors by maintaining a fund to be used for payment of compensation in the event of a bank failure.

Overall, banks in Malta are well-capitalised and sufficiently covered for credit risk. It is widely believed that banks on the island are well-positioned to weather the effects of the global crisis. Their strong liquidity position,<sup>3</sup> negligible exposure to subprime-related assets and good funding profile are key factors insulating the banks from the financial crisis.

Nonetheless, according to the CBM Annual Report 2007 there is a high concentration in the domestic banks' lending portfolio. With real estate-related loans accounting for some 57 per cent of total resident loans, this poses a potential source of risk and is a cause for concern. In any case, given that domestic banks are adequately hedged, the risk may not be credible. This was confirmed by the bank's stress testing, which found the risk posed to the domestic banks to be limited.

Malta's banking sector was spared by the financial crisis because of their traditional reliance on retail deposits as their primary source of funding. As a result, banks rely less on the interbank market to finance their daily operations. This is in contrast to most countries, whereby banks rely heavily on wholesale funding and market liquidity. As a matter of fact this was one of the main reasons the banking sector in many countries collapsed during the financial crisis. An important lesson to be learnt from the credit crunch is the high degree of exposure to interbank funding. Like Malta, banks in Seychelles were partially insulated from the credit crunch due to limited exposure to interbank activities.

The domestic demand for credit has been a major factor driving growth in the banking sector in Malta. Bank credit to households by the end of 2007 reached 58 per cent of GDP. Bank lending has been the major source of external funding for the corporate sector in 2008. This is illustrated by a substantial increase in the ratio of domestic corporate bank borrowing to GDP from 68 per cent at end 2007 to 75 per cent at end of 2008. Furthermore, in spite of strict lending requirements, lending to households expanded by 12.9 per cent (€813.4 million) in 2008. This ratio surpassed the eurozone average of 52.3 per cent as at end 2008. In spite of the increase in domestic corporate bank borrowing to GDP, the bank remained sufficiently liquid and well-capitalised to sustain its credit to the corporate sector. As a result, the financial situation for the corporate sector made progress.

The continued expansion in credit to the domestic economy at a time when the global economy is facing a severe credit crunch should be a cause for concern. The increased indebtedness of households to banks implies a high debt-servicing ratio. Although the increase in household wealth has been able to withstand the macroeconomic shocks, should the economic downturn persist, debt repayment could become a problem for the banks. In addition, private sector indebtedness in Malta is already high at 124.1 per cent of GDP as at end 2008.

### **5.2.2 Malta Stock Exchange**

The Malta Stock Exchange (MSE) was founded in 1992 following the introduction of the Stock Exchange Act 1990. The act also formed the Stock Exchange Council, headed by a chairman whose responsibility is to manage and oversee stock exchange operations. This involves approval of applications for listing and supervising performance of ongoing obligations of listed companies. The rules and regulations guiding the listing procedure have to be in compliance with EU standards. Since 2001, the MSE has become an Associate Member of the Federation of European Securities Exchanges.

In addition to this, the MSE has been recognised by the UK HM Revenue and Customs under Section 841(10(b)) – Income and Corporation Taxes Act of 1998. It has also been approved as a recognised stock exchange for inheritance tax purposes.

Since launching towards the end of 1992, the MSE has grown rapidly in size and importance. By the end of 2004, there were some 14 equity listings and 27 corporate bonds listed on the exchange, along with some Maltese government stocks.<sup>4</sup> There are also some 40 mutual funds listed, with well-known names such as Fidelity and HSBC. As of end July 2005, total market capitalisation represented Lm2.5 billion, a 19 per cent increase from the previous year. Total market capitalisation as of end 2005 stood at Lm2.9 billion.

The MSE is under the watchful eyes and strict scrutiny of the appointed external bodies to ensure good practice, especially against money laundering, and market abuse. The latter is governed by the Prevention of Financial Markets Abuse Act 2005, which sets the rules regarding inside information and disclosure.

The supervision of money laundering is under the responsibility of the Financial Action Task Force, while market abuse is under the supervision of the Financial Services Authority. Amendments were made to the MSE Act in 2002 to transfer the responsibility of the MSE regulatory functions, in particular those concerning admissions to listing and licensing of stockbrokers, to the Financial Services Authority. Besides covering for market abuse, the Prevention of Financial Markets Abuse Act 2005 also makes provision for issuers and their managers, ordinary investors, national statistics bodies, competent authorities in Malta and abroad, operators of recognised investment exchanges and other insiders.

The MSE has also recently extended its services to transacting in treasury bills issued by the government and to having these cleared and settled on the same day. From the government's point of view, treasury bills are crucial elements in the effective functioning of the institution. Liquid and well-run primary and secondary markets add value to these securities.

### **5.2.3 MSE performance in 2008**

The year 2008 was a pretty bad one for the MSE in terms of performance. The MSE index recorded one of its lowest values (3,208) since 2005, making a loss of 35 per cent. The sharp decline in the index is a direct consequence of the slump in value of bank equity. Despite the banks' strong position with regard to weathering the effects of the global crisis, some banks still endured losses from valuation adjustments.

The decline in share prices had created some uncertainty in the market as manifested by an increase in volatility during 2008. The volatility was more pronounced in the case of bank equity, as a result of adverse perception and scepticism in the market. Figure 5.1 below, taken from the Central Bank of Malta's Financial Stability Report 2008, depicts the indices of selected stock exchange.

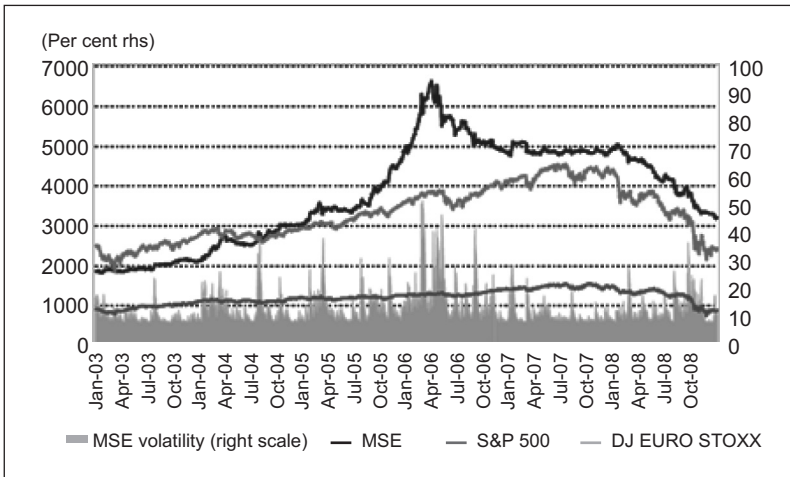


Figure 5.1<sup>5</sup> Indices of selected stock exchanges (percentage rhs)

### 5.2.4 Market capitalisation

In spite of a sound and efficient financial system and the strong liquidity position of the banks, market capitalisation reduced to €6.7 billion in 2008. The main factor contributing towards the contraction in market capitalisation was the loss in value of equities. The equity share of market capitalisation dropped from 50.6 per cent in 2007 to 38.3 per cent in 2008. The loss in value of equities was largely attributable to the slump in value of bank equity. The share prices of banks declined by approximately 48 per cent in 2008, following the declaration of a fall in profits.

### 5.3 The external reserves

Under the Central Bank of Malta Act, the bank is compelled to maintain external reserves in proportion<sup>6</sup> to its currency and deposit liabilities. The bank also has the responsibility to manage a portfolio of external reserves, one of the purposes of which is to intervene in the foreign exchange market to defend the exchange rate as and when necessary. This is the function of the liquid asset component of the bank's portfolio. The other uses of the external reserves include ensuring adequate funds in various currencies to sustain market needs and to generate income.

The bank has an Investment Management Committee, responsible for the formulation of the reserve management policy. This committee is chaired by the governor and consists of the deputy governor and senior bank officials.

Apart from the liquid assets, part of the bank's portfolio is invested to earn income. The strategy is to diversify its portfolio to minimise risk. The bank's portfolio, according to the CBM Annual Report, mainly comprises placements with foreign banks and debt securities issued by non-residents. It is also made up of gold, Special Drawing Rights and claims on

the International Monetary Fund. To minimise credit risk, the bank only holds claims on top-rated banks and issuers of securities. As part of its risk management strategy the bank has also developed a comprehensive market risk model in line with international best practice in order to safeguard the value of its reserves. Regarding liquidity risk management, the domestic banking sector has developed a comprehensive framework to strengthen its management capabilities in that respect. The framework strategy involves vigorous internal governance, stress testing, monitoring and adequate contingency funding plans.

Figure 5.2 below shows the external reserves in months of imports over the period 1995–2007. Since 2001, the international reserves<sup>7</sup> have remained around six months of imports.

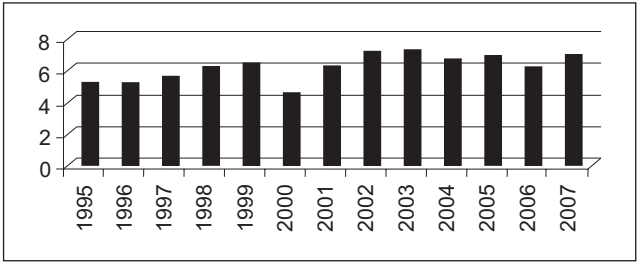
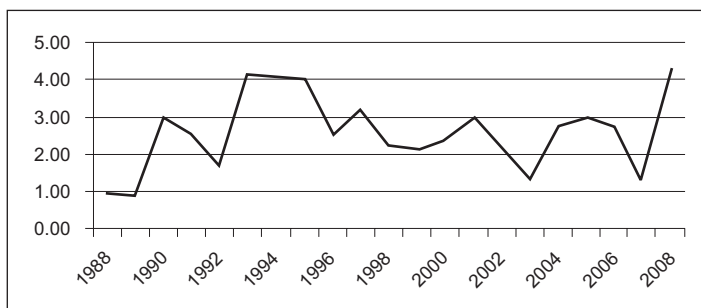


Figure 5.2 External reserves (months of imports), 1995–2007

### 5.4 Inflation

On average, inflation in Malta has been relatively low over the entire period, with sporadic peaks in 1993, 1994 and more recently in 2008. Overall, the inflation rate has remained at around 3 per cent or below. Nonetheless, as depicted in Figure 5.3 below, the year 2008 has been somewhat of an exception, with an inflation rate of 4.24 per cent. Rising fuel and commodity prices on the international market were noted as the principal causes for the sudden increase in inflation in 2008.

The year 2007, spilling over into 2008, was characterised by surging fuel prices, soaring world commodity prices and the collapse of the subprime market in the USA. These were consequences of a multitude of factors, namely tension in the Middle East, political instability in the Niger Delta (Nigeria) and strong demand from the emerging economy, especially China. As a result, the price of fuel reached a record high in July 2008, before sliding rapidly to a record low due to global recession.



**Figure 5.3** Inflation rate measured by CPI, 1988–2008

Figure 5.3 above depicts the inflation rate measured by the consumer price index (CPI) over the period 1988–2008. It is evident from Figure 5.3 that the inflation rate over the entire period has been relatively low.

A similar trend was also depicted in the global commodity prices until around July 2008, when the global recession started kicking in and prices suddenly dropped due to weaker global demand. It is important to note that no country was immune to these global shocks and Malta was no exception, as demonstrated above.

## Notes

1. IMF Country Report August 2003.
2. IMF Country Report August 2003.
3. Banks in Malta rely heavily on resident deposits and this has cushioned them from external financial shocks.
4. <http://www.lowtax.net/lowtax/html/jmaoltr.html>
5. MSE is referred to as Malta Stock Exchange.
6. This proportion was set at a minimum of 60 per cent in 1968.
7. International reserves usually comprise foreign currencies, other assets expressed in foreign currencies, gold, SDRs and IM reserve positions. Every country must have international reserves as backup in times of need, for example during an economic crisis, to stabilise the exchange rate. Sometimes the international reserves are denominated in terms of the number of weeks/months of import.



# Part II – Monetary Policy Strategies, Targets, Instruments, Transmission Mechanisms for Addressing the Most Common Shocks Facing Small States

## 6

### Independence and transparency of the institution

#### **6.0.1 Central Bank**

The Central Bank of Malta is an independent institution and a fully-functioning member of the Eurosystem. It has as its major functions the regulation and supervision of banks and financial institutions, and the conduct of monetary policy. These powers are vested in the bank under the Banking Act 1994 and the Financial Institutions Act 1994. It also has, as mandated by the Malta Stock Exchange Act 1990, the responsibility of supervision of the exchange to protect investors and promote a sound securities market.

The regulatory and supervisory role which entails policy formulation is the responsibility of the Joint Banking Committee as per the Banking Act 1994. Apart from policy formulation, the committee also monitors and ensures soundness of the banking system, which is its main role. The committee has as its chairman the governor, assisted by four other bank officials.

The primary objective of the bank is however to foster good economic practice and maintain price stability. Maintenance of price stability is the core requirement prescribed by the Central Bank of Malta Act 1994. Under the act, the bank is also mandated to ‘promote the orderly and balanced economic development of Malta and a rising level of employment and income consistent with the maintenance of monetary stability in Malta and the external value of the currency.’ Besides its main function and objective as mentioned above, the CBM also assists in the formulation of exchange rate policy, a joint responsibility with the government.

In 2002, there was an amendment to the CBM Act 1994. Following the amendment, the primary objective of the bank was defined formally as the maintenance of price stability. This is in accordance with the ECB recommendation.<sup>1</sup> As per the CBM Annual Report

2002, under the amended act of 2002, the bank's independence was reinforced. It was given the operational flexibility required to implement its functions in a liberalised financial environment, whilst at the same time providing for more accountability and transparency. To further consolidate the bank's authority under the amended act, full power to undertake decision on monetary policy was vested to the governor. The Monetary Policy Advisory Council was given a statutory basis, responsible for advising the governor on matters related to monetary policy.

Despite this amendment, the CBM retained its responsibility to foster good economic practice. During the past years, the bank continued with its prime objective, by pursuing policies aimed at containing inflation. Pursuing policies aimed at maintaining price stability helped create a platform for attaining balanced economic development and sustainable growth in employment and income. This was achieved through transparent monetary policy based on a system of exchange rate peg. Having a system of exchange rate peg (i.e. prior to entering the Eurosystem) helped to control cross-border inflation by linking domestic inflation to that of Malta's key trading partners.

In 2002, as part of the amendment to the CBM Act, a framework governing payment systems was established, the first formal system for Malta in accordance with international standards. The establishment of the Malta Real-time Interbank Settlement System (MaRIS) came into effect in October 2002. MaRIS represents an initial step in the integration of Malta's payment systems with other cross-border payment systems, including the TARGET system that operates in the eurozone.

It is important to note that since 1 January 2008, the CBM no longer holds responsibility for monetary policy in Malta. This is because Malta is now a fully-integrated member of the Eurosystem whereby monetary policy formulation is done at EU level, through the governor's participation in the Governing Council of the ECB. The CBM's new role is to implement the common policy decision as devised by the ECB Governing Council. Despite the changing role of the CBM, its prime objective remains and that is the maintenance of price stability.

## **6.1 Supervision of credit and financial institutions**

As the authority that was responsible for the supervision of credit and financial institutions until 2002, the CBM still has to ensure compliance with the provisions of the relevant acts and directives. Supervision is carried out on a regular basis by a team of inspectors. This involves both on-site inspection and off-site supervision, applying a risk-management approach. As part of their supervisory activities, the bank also meets with the institutions' external auditors.

Since January 2002, the responsibility for licensing, regulating and supervising credit and financial institutions as per the Banking Act 1994 and the Financial Institutions Act 1994 was transferred to the MFSA. The same applies to the MSE, which has since October 2002 transferred to the MFSA, as per the new Financial Markets Act 2002.

A number of issues are covered by on-site inspection, amongst which are; credit risk and asset quality, internal audit functions, adherence to licensing requirements and

internal controls at financial institutions, and accuracy of reporting. As for the off-site inspection this basically involves the examination by off-site supervisors of the statutory returns that credit and financial institutions regularly submit to the CBM. Besides the regular inspection of the structure of the institutions' balance sheets, other aspects of the inspections focus on market risk and profitability and assessing the management and organisation of each institution.

### **6.1.1 Financial Intelligence Analysis Unit**

In Malta, the functions of financial intelligence which include anti-money laundering (AML) and countering the financing of terrorism (CFT) are carried out by the Financial Intelligence Analysis Unit (FIAU). Unlike Seychelles and Mauritius, the FIAU is not directly under the authority of the CBM. It is governed by a board whose members are appointed by the Minister of Finance as per the Anti-Money Laundering Act 1994.

Under Article 2 of Anti-Money Laundering Act 1994 it states that:

'The Minister shall appoint the four members referred to in sub-article (1)(a) by selecting one member from each of four panels, each of at least three persons, nominated respectively by the Attorney General, the Governor of the Central Bank, the Chairman of the Malta Financial Services Authority and the Commissioner of Police.'

The FIAU is the focal point for requesting, receiving, analysing and disseminating reports of transactions or attempted transactions relating to the offence of money laundering or financing of terrorism, to the appropriate law enforcement agencies and supervisory agencies. It is also the unit responsible for ensuring compliance with any legislation on AML and CFT.

To enforce its jurisdiction so as to ensure full compliance with the new legislation on AML and CFT, Malta participates actively in meetings at EU level, for example the Council of Europe Select Committee of Experts on the Evaluation of Money Laundering. Malta's law on AML and CFT is a directive of EU legislations.

## **6.2 Transparency in monetary policy operations**

The transparency with which the operation of monetary policy is conducted has so far been very open. The bank has made it its obligation to be transparent and publicly accountable. This is achieved through the publication of its financial statements, effective communications and announcements through its website, other publications and regular reporting to parliament on its policies and operations.<sup>2</sup> In addition, the CBM operates and maintains a very informative and comprehensive website with very detailed statistics and other information, including quarterly reviews, annual reports and monthly statistical release on monetary aggregates and their determinants.

Furthermore, under the Central Bank of Malta Act 2004, the bank was granted total legal independence. As a member of the Eurosystem, the CBM subscribes to the Eurosystem's mission, strategic intents and organisational principles. The CBM is also

reported to be making good progress in implementing the Basel II Core Principles and other EU prudential standards.

### **6.2.1 Monetary Policy Council**

In Malta all decisions regarding monetary policy stance is taken by the CBM Monetary Policy Council, whose members are top bank officials. The council is chaired by the governor, assisted by the board of directors and senior officials of the bank. Usually the council meets on a regular basis on the last Thursday of each month.

### **6.2.2 Contribution of CBM towards the stability of the financial system**

As of January 2008, Malta became a full member of the eurozone after adopting the euro as its legal tender. Being a fully-integrated member of the Eurosystem implies that the CBM objective has to be in line with the EU directives.

Financial stability is one of the core principles, especially given that Malta's entry into the eurozone has coincided with a time when the world has been going through financial turbulence. With regard to financial stability, the objective of the bank states that:

'The bank contributes to the stability of the financial system through ongoing macro-surveillance of the infrastructure, financial institutions and markets and by monitoring and assessing the implications for financial stability of economic and financial developments, both domestically and in the euro area.'

In its quest to ensure a sound financial sector and safeguard it against eventual adversities, the bank has set up an early warning system. This system makes use of available information, based on data analysis to detect sources of peril, and tests the resilience of the financial sector to withstand eventual shocks. In recognising the importance of such a system, the bank has also developed a sound framework for the management of crisis situations and emergency procedures. To further assume its commitment as caretaker of the financial sector and hence safeguard its stability, the bank acts as lender of last resort.

### **6.2.3 Reserve requirements**

This is a requirement imposed on the banking system by the CBM for all domestic banks to maintain reserve deposits equivalent to a percentage<sup>3</sup> of their deposit liabilities. The CBM allows certain flexibility with regard to holding these reserves provided that, on average, over the month, the ratio is maintained. This implies that the banks can go below the ratio at times as long as they satisfy the ratio on average.

## **6.3 Exchange rate policy**

The Maltese lira was pegged to a basket of low inflation currencies like Seychelles and Mauritius prior to their exchange liberalisation.<sup>4</sup> The basket of currencies consisted of the euro, the US\$ and GBP. Evidence appeared to suggest that the fixed exchange rate regime

that was in place until the adoption of the euro in 2008 proved to be effective in containing inflation. As illustrated by Figure 5.3, domestic inflation has remained pretty much under control over the years (i.e. below 5 per cent). Furthermore, as also commented in the CBM Annual Report 2002, domestic inflation managed to stay within an acceptable range of the average inflation rate in the respective countries in the currency basket.

Figure 6.1 below shows the exchange rate of Malta’s lira against the euro. Further scrutiny of the diagram reveals that there is a dichotomy at 2003. Prior to 2003 the exchange rate appears to be volatile and trended, while for the period starting 2003, which coincides with Malta’s entry into the EU, the exchange rate appears to be stable and the fluctuation within a narrow band.

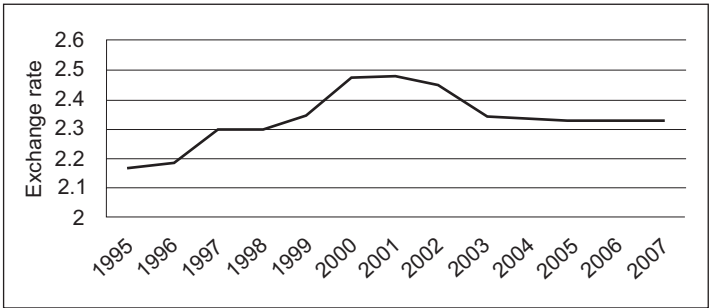


Figure 6.1 Exchange rate – Malta’s lira v euro

From Figure 6.1 above, the period 1995–2001 was characterised by a sharp appreciation of the exchange rate. The period 2001–2003 saw a significant decline in the exchange rate, which then stabilised.

Exchange rate stability is vital for Malta, in view of the economy’s dependence on external trade and on inflows of foreign investment.<sup>5</sup> Upon the launching of the euro in January 1999, the CBM reacted by revising the weight allocation of the currencies in the basket, favouring the euro. The new weights for the three currencies, i.e. euro, US\$ and GBP, were initially set at 56.8 per cent, 21.6 per cent and 21.6 per cent respectively. In 2002 the Monetary Authority made a substantial revision to the currencies basket, to reflect current trends and likely future patterns in Malta’s external trade more closely. The new revision saw the euro share increase to 70 per cent while the US\$ and GBP were each allocated 20 per cent and 10 per cent respectively. It is interesting to note that since 2004, Malta’s exports to the EU have increased significantly.

In order to maintain the fixed exchange rate, the bank uses a variety of instruments. One such instrument is the buying and purchasing of foreign exchange at the official rate. The bank has also utilised IR to manage movements in its external reserves by adjusting the official rates. Altering the official IR has been an important tool in dampening upward pressure on the Maltese lira. Other mechanisms used by the bank as monetary policy instruments, but less frequently, are reserve requirements, standing facilities and controls on capital movements.

## **6.4 Interest rates**

Altering the official IR has been widely used as a means to regulate pressure on the exchange rate. It is important to note that the movements in the official IR impacted on returns in domestic money and capital markets as well as retail bank deposit and lending rates. Malta's fixed exchange rate regime,<sup>6</sup> coupled with the gradual liberalisation of capital movements, implies that domestic IR are greatly subjected to rates abroad.

To ensure compatibility with its monetary policy stance and the short-term IR, the bank made use of the open market operations<sup>7</sup> tool to regulate liquidity in the banking system. As a means to facilitate this process, the bank introduced an overnight deposit facility in 1999. This facility was put in place to mop up excess liquidity from the banking system. The IR offered on this facility was set at 295 basis points below the bank's central intervention rate. This rate acts as a floor for the inter-bank rates.

### **6.4.1 Open market operation**

Open market operations are common, particularly in countries with advanced financial systems. It is an effective method used as a primary instrument by central banks to regulate the degree of liquidity within the economy. In the case of Malta, when the CBM wants to absorb liquidity temporarily from the banking system, it uses weekly auctions of term deposits with a maturity of 14 days. On the other hand, when the CBM wants to inject liquidity into the banking system, it uses auctions repos.

In the repo, the CBM agrees to purchase government securities from the banking system in exchange for liquidity. However the agreement is only temporary, as the bank will re-sell the same securities after a predetermined period of time (usually 14 days). Despite the CBM's active support to the market for government securities through the buying of TB and government stocks, it only operates in the secondary market. The bank does not participate in the primary market.

### **6.4.2 Discount window and other standing facilities**

When the CBM finds it necessary, it discounts TB and other eligible securities to provide liquidity for the banking system. Apart from the discount window, the CBM also offers a collateralised loan facility to the banking system to help them in a situation of temporary shortage of liquidity. To help banks meet their liquidity requirement, an overnight credit facility is on offer. The basic IR on this facility has been set at 55 basis points above the CBM's central intervention rate.

## **6.5 Exchange control**

Like Seychelles prior to the exchange liberalisation, Malta also used to have a system of exchange control. As per the Exchange Control Act 1972, the CBM was appointed as the government agent for this purpose. In 1999 the CBM implemented a series of liberalisation measures to ease the control further. Among the measures implemented are<sup>8</sup> an

increase in the limit on direct investment abroad by residents of Malta to Lm300,000 from Lm150,000. In addition, there was a rise of Lm3,000 in the annual ceiling on personal portfolio investment abroad from Lm5,000 to Lm8,000. The period during which local companies could retain export proceeds in foreign currency was extended from four to six months. Furthermore, the bank issued guidelines to authorised dealers on lending in foreign currency to residents. Ultimately, all restrictions on the amount that authorised dealers could lend to non-residents in connection with the acquisition of property in Malta were removed.

A second round of liberalisation took place in November 1999. The measures taken included<sup>9</sup> a complete removal of restrictions on direct investment abroad by companies resident or domiciled in Malta, the limit on personal portfolio investment abroad by residents was raised further to Lm15,000 and restrictions on the surrender of foreign currency receipts by export-oriented companies in the services sector were eased.

In January 2002 a number of liberalisation measures came into effect. This was part of the government's plan to completely remove all controls by beginning 2003, with the exception of those that apply to capital transactions with a maturity period of less than six months. This was in line with Malta's entry into the EU in 2004. The Exchange Control Act 1972 was replaced by the External Transactions Act in 2003. This new piece of legislation, according to the Central Bank Annual Report 2002, would provide the infrastructure for the total liberalisation of capital controls. It would also allow the government power to impose controls in the event of a financial or balance of payments crisis.

## **6.6 Relationships with other international institutions**

In addition to the IMF, Malta is also a member of the World Bank Group, the European Bank for Reconstruction and Development (EBRD) and the European Central Banks (ECB).

### **6.6.1 Malta and the WTO**

Malta became a WTO member on 1 January 1995. Under EU regulation, all its member States are WTO members, for legal reasons known as the European Communities in WTO matters.

Malta has much to gain as a WTO member, as also echoed by its Minister for Commerce in a WTO conference in 1996. Being a small island economy with limited resources, Malta depends heavily on international trade for its livelihood and wellbeing.

Malta is a net food importing country, producing only about 20 per cent of its food needs. Apart from food, Malta also imports nearly all the raw materials and capital goods required for manufacturing industries. Furthermore, the island imports virtually all of its energy needs. Its main exports are electronic products.

## Notes

1. Promoting price stability in the euro area is one objective of the CBM and this is done through the participation of the governor in the Governing Council of the ECB.
2. CBM Annual Report 2007.
3. The percentage is not fixed so has a tendency to change subject to the Central Bank of Malta decision.
4. Both Seychelles and Mauritius now have a floating exchange regime.
5. CBM Annual Report 1999.
6. That is prior to Malta joining the Eurosystem in 2008.
7. These are transactions in the domestic financial markets to regulate the level of liquidity in the banking system.
8. CBM Annual Report 1999 p.72.
9. CBM Annual Report 1999 p.72.

# Part III – Country Case Studies

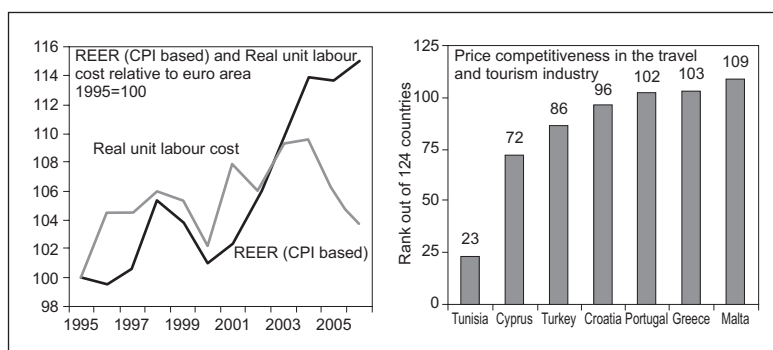
## 7

# Malta's deteriorating external competitiveness

The case study below has been taken directly from the IMF Country Report 2007.

### Box 7.1 Malta's deteriorating external competitiveness

Malta is a prototypical small open economy with a narrow economic base. It is a price-taker in international markets and, at 83 per cent, the share of exports in GDP (2006) is high. Two major sectors – tourism and electronics – generate more than one third of GDP and half of exports. Underscoring the fragility of the economic base, a single semiconductor plant – belonging to a large multinational corporation – generates the bulk of electronics exports.



Source: Eurostat; IMF; Travel and Tourism Competitiveness Report 2007; and World Economic Forum.

Several indicators suggest rising competitive pressures. Deteriorating trade and services balances and an appreciating REER, are evidence of eroding competitiveness. Although increasing trade integration has contributed to a declining share of value added in output – including for the tourism and electronics sector – profit margins appear to be falling. Moreover, market share declines, including for the major exports, point to a possible loss of competitiveness.

## 7.1 Depositor Compensation Scheme

The case study below has been taken directly from the CBM Annual Report 2003.

### Box 7.2 Depositor compensation scheme

The Depositor Compensation Scheme (formerly referred to as the Deposit Guarantee Scheme) came into force in January 2003 and was extensively revised in November. Modelled on the EU Directive on deposit guarantee schemes (94/19/EC), the Scheme is designed to provide for the compensation of eligible depositors in the event of a bank failure.

The Scheme currently applies to deposits denominated in Maltese lira, and all banks licensed to operate in Malta that accept Maltese lira deposits are obliged to participate in it.

The main objective of the Depositor Compensation Scheme is to maintain a fund to be used for the payment of compensation so as to provide a means of protection for private depositors. The Scheme has a distinct legal personality and is governed by a Management Committee made up of representatives from the Malta Financial Services Authority (MFSA), the Central Bank of Malta, associations representing banks and a consumer.

The Committee is responsible for managing and administering the Scheme and the contribution paid into it by the participating banks. It is also responsible for verifying any claims made and deciding on the compensation to be paid to claimants.

The Committee is obliged to publish a set of audited financial statements on an annual basis in order to ensure complete transparency with respect to the transaction of funds within the Scheme. While it should ensure that the general public is adequately informed about the Scheme, and participating banks are required to make available adequate and clear information about its applicability, participants in the Scheme are subject to the Professional Secrecy Act, and are thus obliged to keep confidential any information obtained in the course of their operations.

Compensation to claimant depositors is only payable when a bank is unable to repay funds to the depositor and in case where there is no prospect of the bank being able to do so in the foreseeable future. The total compensation to be paid out is the *lesser* of an amount representing 90% of a depositor's eligible deposits, or the Maltese lira equivalent of 20,000 euros calculated on the basis of the official exchange rate prevailing on the date of settlement of the claim.

Any depositor who entrusts funds on deposit to a credit institution – except for the purposes of a business, trade of profession – is eligible to make a claim.<sup>1</sup> The regulations exclude the following from the definition of a depositor:<sup>2</sup>

- Sole traders, companies and other commercial partnerships;
- Professional and institutional depositors;
- National and international institutions, governments and administrative authorities;
- Local and municipal councils or authorities.

Depositors have the right to claim all their eligible deposits, including the total aggregate deposits held with a bank (or bank) and any interest accrued thereon. However, the compensation paid out must be netted against any outstanding loans or other liabilities which a claimant may have from/ to the failed credit institution.

1. For the purpose of the regulation, debt securities issued by the same institution and liabilities arising out of own acceptance and promissory notes do not constitute a deposit.
2. Refer to the First Schedule to the Regulations.

*Source:* Central Bank of Malta, Annual Report 2003

# Conclusion

Despite being largely dependent on the rest of the world, Malta was partially immune to the global financial crisis. EU accession, a healthy financial system and the adoption of euro as the national currency were the main factors that have cushioned the economy from the full impact of the external shocks. Malta has benefited a lot as a result of EU accession, despite having to relinquish control over domestic policies. Unlike other small island states, proximity to major markets and its favourable geographical location have brought further benefits to the Maltese economy. Malta's socio-economic success has been remarkable. This small Mediterranean island economy is classed among the top 40 for HDI and like Seychelles, has achieved all the Millennium Development Goals (MDGs). Furthermore, Malta is ranked 52nd out of 133 in the 2009 Global Competitiveness Index. However, despite Malta's great economic success, the island still has some major fiscal issues to be addressed, notably the huge deficit. Malta also has high unemployment rate especially among the unskilled. The greatest challenge to Malta, as is the case for other SIDS, is the impact of climate change. Malta is also faced with the daunting task of preserving the environment, which is greatly affected by pollution. It appears that Malta is finding it difficult to strike a balance between environmental conservation and economic development. More effective policies need to be implemented in order to ensure that polluters bear the full cost. Despite the government's relentless efforts to address the impact of environmental degradation, the cost of sustaining the conservation programme as per the action plan could be a burden on Malta's economy. Malta perhaps can learn from Seychelles' experience in this respect, as the latter has been very successful in implementing effective environmental conservation programmes.



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Malta's socio-economic successes have been remarkable. Key policy decisions have enabled this small island state to cope with its inherent vulnerabilities. This book reviews the implementation of macroeconomic policies in Malta, identifying the key issues, lessons learnt and best practices which could be adapted by other small states. It also sets out the country's challenges for the future, which include managing a huge fiscal deficit, a high unemployment rate and attending to the conflicting demands of environmental conservation and economic development.

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