

## **Economic Strategy**

### **Macroeconomic Stability**

Central to Government's economic strategy is the achievement of a sustainable rate of economic growth, a commensurate high level of employment, a low and stable inflation rate and improvements in the standard of living. In this context, sustaining Malta's competitiveness in international markets is a key requirement.

Malta must ensure a stable, low-inflation environment, coupled with a healthy balance of payments which can sustain a stable external value of the lira. This should be achieved without the need for prohibitively high interest rates and without the presence of barriers which restrict trade and capital flows. Such macroeconomic stability is vital to economic progress in a small open economy. To achieve this, unwinding the fiscal imbalance which has been building up in the domestic economic structure is a key priority. Already, important results have been achieved in fiscal consolidation in recent years.

The attainment of such a stable macroeconomic framework would foster confidence and certainty - indispensable prerequisites to induce people and business to plan ahead. It should ensure that decisions concerning consumption, investment and savings are taken in an environment which encourages and supports the development of the domestic economy and the achievement of sustainable standards of living.

### **Economic growth**

The Maltese economy expanded by 3.5 per cent in nominal terms during the first three quarters of 2002. As a result, nominal Gross Domestic Product (GDP) reached Lm1,255.0 million. In real terms, GDP advanced by 2.5 per cent during the same period. This economic

growth was led by domestic demand. In particular, a pick-up was registered in private consumption expenditure. It is also pertinent to note that although exports of goods and services registered a decline, this was lower than that recorded in the previous year. It is expected that real GDP growth will be around 5 per cent during 2002 and 2003.

## **Agriculture and Fisheries**

Despite its relatively small share in the local economy, the agriculture and fisheries sector provides a significant contribution to Malta's development. During the first nine months of 2002, the wholesale value of fruit and vegetables increased by 5.7 per cent to reach about Lm6.2 million. On the other hand, fish landings declined by 2.4 per cent, whilst the value of fish exports increased by 17.3 per cent.

In line with last year's Budget Speech, Government started to implement a major reform in this sector. The reform involves the gradual lifting of border tariffs that have until now protected agricultural products, whilst ensuring that the price of certain sensitive products is not adversely affected. Concurrently, the reform plan provides for assistance earmarked to enable the necessary investment and restructuring of the sector.

## **Manufacturing**

The slower-than-expected turnaround in the international economy reflected itself in the performance of the local manufacturing sector. During the first nine months of 2002, manufacturing turnover amounted to Lm726.5 million representing a decrease of Lm20.6 million over the corresponding period a year earlier. Domestic exports decreased by Lm29.5 million while local sales posted an increase of Lm8.9 million during this period. The decline in exports and in total manufacturing sales was due to the negative performance of the communications equipment and apparatus sector as the international market for electronics remained weak during the January-September period. In contrast, other manufacturing sectors registered higher sales,

including the food and beverages sector, the wearing apparel sector, the printing and publishing sector, the fabricated metal sector and the medical and precision equipment sector. It is noteworthy that the average weekly earnings in manufacturing stood at Lm103.28 which represents an increase of Lm4.64 over that recorded in the same period of last year.

Manufacturing remains a key sector in Government's economic strategy. During the year, a number of initiatives have been unfolded with the aim of ensuring that the manufacturing industry is capable of consolidating its contribution to Malta's economic growth. Indeed, during 2002 further momentum was given to the establishment of Malta Enterprise. Apart from combining the activities currently handled by the MDC, METCO and IPSE, Malta Enterprise will enable enterprises to exploit Malta's comparative advantage and compete effectively internationally.

The levy dismantling process has continued as planned. At the beginning of 2002, the levy on a range of imported products was lowered by a further 30 per cent, whilst the remaining 50 per cent will be eliminated as from 1<sup>st</sup> January 2003. However, in the case of the furniture sector, the removal of the final phase of levies has been anticipated to October 2002 following representations by local operators in the sector. During the year, the levies imposed on a number of agro-industry products were also reduced. In today's globalised world environment, the manufacturing industry cannot rely on protection for its survival. It is encouraging that the dismantling of protection is enticing a number of domestic manufacturers to take a pro-active approach and take measures to improve their competitiveness.

## **Tourism**

The tourism industry is Malta's leading service activity contributing significantly to output growth, employment creation and foreign exchange generation. The performance of the industry during the first nine months of this year was to a large extent influenced by the events

that characterised the world around the end of 2001. A general sense of reluctance by air travellers to board planes, coupled with feelings of fear and a weak international economic climate, has prevented a quick turnaround in the global tourism industry to pre-September 11 levels. Indeed, international tourism flows have suffered especially when compared to the positive results posted in 2000. Following these events Government acted by introducing a number of measures intended to cushion the adverse impact on the whole economy.

During the first three quarters of 2002, a total of 897,682 tourists visited Malta representing a decline of 6.8 per cent in arrivals over the previous year. During the past years, the cruise liner market has come to occupy an increasingly important component of the Maltese tourism industry. Indeed, in the period January to September of this year, cruise passengers arrivals increased by 73,586 or 39.2 per cent to 261,475.

## **Shipyards**

During 2002, Government started to implement the recommendations set out in the restructuring plan submitted by the task force on the restructuring of the shipyards. The overall long-term objective of these recommendations is to steer the yards to commercial viability. This will be achieved by exploiting the yards' comparative advantage mainly in its highly skilled workforce to the full.

Central to the attainment of this objective is the reduction in the yards' labour compliment which the plan suggest should be lowered to 1,600. Immediate steps have been taken and a first voluntary early retirement scheme has been launched. The uptake for this scheme reached the expected targets since over 600 workers were accepted as meeting the eligibility criteria. In order to ensure viability of the yards, the restructuring plan also underscores the need for investment in new capital equipment and in processes that are less harmful to the environment.

Turnover at Malta Drydocks registered a decline of around 50 per cent, as the figure for 2001 was boosted by work on two major projects. Turnover at Malta Shipbuilding was also below the figure registered during the first nine months of 2001.

## **Malta Freeport**

During the first nine months of 2002, the transshipment throughput handled by the Malta Freeport Terminal Ltd. reached 862,797 Twenty Equivalent Units (TEUs), from 796,825 TEUs in the corresponding period in 2001. An increase of 7.1 per cent was registered in the amount of oil handled by the Freeport's oil tanking services, whilst the level of activity at the industrial warehousing services also remained high.

Malta Freeport is facing significant competition from other ports in the Mediterranean, and hence it is imperative that it continues to strive to improve its efficiency. Its privatisation, which is expected to be concluded in the near future, should assist in achieving improved competitiveness.

## **Inflation**

The 12-month moving average for the Retail Price Index (RPI) provide the official measure of inflation in Malta. The 12-month inflation rate stood at 2.89 per cent in September 2002, from 2.42 a year earlier. This corresponds to an increase of Lm1.75 per week as cost of living adjustment. It is noteworthy that the inflation rate has followed an increasing trend in the first four months of 2002, but subsequently has registered consistent declines. It is expected that the inflation rate will be around 2.5 per cent for 2002 and also for 2003.

Achieving a low and a stable inflation is a key priority in Government's economic agenda. The liberalisation of the economy and in particular the dismantling of the levy regime on imports should contribute to attain this aim.

## **Employment**

During the twelve months to September 2002, the labour supply declined by 948 and stood at 144,484. The gainfully occupied population fell to 136,964 in September of this year from 138,448 in the corresponding month of 2001. The Maltese labour market was affected by the slowdown in the international economy and its effect on the domestic economy. The restructuring process which the domestic economy is undergoing also had a bearing on the labour market. In particular a number of voluntary early retirement schemes were implemented during the year. At the end of September 2002, the rate of unemployment (including Part I of the registered unemployed) stood at 4.7 per cent.

A key aspect of Government's economic strategy is the creation of an appropriate climate that supports the generation of better employment opportunities - both in quantitative and qualitative terms.

Government has continuously promoted various initiatives with the aim of encouraging the creation of productive jobs within the private sector. More investment is being undertaken in the educational infrastructure in particular to equip the young generation with the skills demanded by industry. In addition, resources are being channelled to training and reskilling of persons entering the labour market as well as unemployed persons. Measures are also being taken to improve the level of occupational health and safety, which is another important aspect of the quality of work.

## **Disposable Income**

Total income from employment has increased 1.8 per cent to reach Lm557.6 million. The per capita average income per employee amounted to Lm109.43 per week during the first nine months of 2002, an increase of Lm3.15 or 3.0 per cent. Gross trading profits also registered an advance, amounting to 2.0 per cent during the January-September period.

## **Foreign Trade and Payments**

Developments in Malta's foreign trade activities and the corresponding effects on the Balance of Payments during the first nine months of this year have to a large extent been influenced by the international economic situation. Despite the recovery registered by our main trading partners, this has turned out to be slower than previously anticipated. Moreover, seen in the aggregate, the upturn in these economies may mask a weaker performance in certain markets which are important sectors of our industry. For instance, the electronics sector, which constitutes a main manufacturing activity, was still facing weak international prospects during the first nine months of 2002.

Indeed, the performance of this sector has affected the outcome of Malta's trade activity. The fall in exports in the electronics sub-sector has adversely affected total exports, even if the latter at Lm672.0 million registered a marginal increase in the first nine months of 2002. After netting the decline in exports of machinery and transport equipment, the remaining sub-sectors showed a rise in exports of Lm25.0 million. Total merchandise imports, which fell by Lm17 million during the first nine months of this year, were mainly pulled down by a decline in imports of machinery and transport equipment. In fact, consumer goods during the first nine months of 2002 were around Lm13 million higher than the corresponding period of the previous year.

It is noteworthy that despite these results, the extent of the decline in the exports and imports of the electronics sector has been lower than that recorded in the previous year. This bodes well for the future of the electronics and to a return to the positive results registered by this sub-sector in the past years.

As a result of the developments in imports and exports, the trade gap stood at Lm229.8 million, from Lm250.5 million in the first nine months of 2001. The deficit on the current account of the Balance of Payments amounted to Lm35.9 million, from Lm22.2 million in the January-September 2001 period. This was underpinned by the changes registered with respect to merchandise goods as well as by lower foreign exchange earnings from tourism, reflecting the downturn which this industry is facing internationally.

## **Monetary Policy**

Government under took steps to ensure that monetary policy is firmly established in the hands of the Central Bank. Following changes to the Central Bank of Malta Act, the Bank is now fully recognised as an independent and autonomous institution. These amendments to the Act, which came into force in October, strengthen the Maltese macro-economic policy framework which is oriented towards stability in line with best international practice. In particular, they establish price stability as the primary objective of the Central Bank, they reinforce the Bank's independence, and increase its accountability and operational flexibility. The Bank is also explicitly prohibited from financing Government deficits which formalises the practice followed for a number of years.

The Central Bank has traditionally sought to achieve price stability by pegging the exchange rate of the Maltese lira to a basket of major currencies – the euro, the US dollar and sterling. In this way, the Bank limits imported inflation, which is a key concern in an extremely open economy like ours, and imposes discipline on domestic price and wage setters. In August this year, the Monetary Authorities revised the weights of the component currencies of the Maltese lira, to reflect current and prospective developments in external trade patterns. Hence, the weight allocated to the euro rose, at the expense of the dollar, while the weight given to the pound sterling was reduced slightly. The euro's increased weight in the basket should attenuate fluctuations in the exchange rate of the lira against that currency and thus have a beneficial impact on trade between Malta and its European partners and on domestic price levels. It will also be a further step in the direction of full participation in EMU and the adoption of the euro following EU membership.

The Bank continued to pursue a more active monetary policy and towards the end of 2001, and in the beginning of this year, it reduced official interest rates by a total of 50 basis points. The Bank noted the significant premium in favour of Maltese lira interest rates and the consequent strong increase in the official external reserves. It's decision to cut rates was also compatible with local developments, since both demand and underlying inflation remained subdued. Meanwhile the Bank's external reserves continued to rise throughout the year.

## **Monetary Developments**

Developments in the monetary and financial sectors during the twelve months to September this year broadly reflect economic developments in Malta and abroad.

Broad money expanded by 12.2%, during the twelve months to September this year, compared with an increase of 7.5% in the previous year. Time deposits accounted for more than two-thirds of the rise as the personal sector continued to place funds with the banking system, although corporate time deposits also grew strongly. The remainder of the increase in broad money is explained mostly by an increase in savings deposits.

Whereas last year domestic credit drove monetary growth, this year the net foreign assets of the banking system were the major counterpart to monetary expansion. Net foreign assets increased rapidly, adding Lm308 million, or more than 30%, over the year, with both the Central Bank and the rest of the banking system recording equal increments.

A variety of factors combined to produce the strong advance in net foreign assets. Towards the end of 2001, the interest rate premium on the Maltese lira was relatively high when compared to recent years, as foreign interest rates declined in response to deteriorating economic prospects abroad and subdued inflation expectations. Although the Central Bank followed central banks overseas counterparts by reducing

local rates, the interest rate spread continued to favour Maltese lira assets. This, together with uncertainty in global financial markets, made domestic financial investments more attractive. Moreover, the success of the Investment Registration Scheme, which was announced during last year's Budget Speech also had a positive impact on inward capital flows.

In contrast, domestic credit expanded at a slower pace with the growth rate declining steadily to 2.3% at the end of September. While last year credit grew more strongly a substantial part of this rise was due to an increase in the banking sector's net claims on Government, which was not repeated this year.

We have noted that although the banking system has generally been flush with liquidity, and lending rates have fallen, banks have adopted stricter lending policies in response to concerns about the quality of their loan portfolio. While this has had the effect of restricting credit growth in the short-term, in the longer-term a more careful allocation of funds would help place the whole economy on a sounder financial footing. At the same time, slower economic growth – as well as the recourse to non-bank sources of finance – may also have restrained the demand for credit.

## **Financial Sector Developments**

The development of a stable and effective financial system is a necessary element of any successful growth strategy. Funds must be efficiently transferred from lenders to borrowers in order to allocate savings to their most productive use. The liberalisation of capital controls is making it easier for cross border flows to take place, allowing domestic players to tap the breadth and depth of global financial markets. However, as with any increase in freedom, capital account liberalisation involves a greater degree of risk. In recognition of this, efforts to strengthen the financial sector continued in earnest this year.

The package of financial laws passed by Parliament in September introduced brand new legislation governing retirement funds and updated various laws regulating banks, insurance companies and investment services firms in line with the best international practice. The new legislation also places greater emphasis on the protection of the consumer of financial services.

Moreover, this year Government transferred responsibility for the supervision and regulation of credit and financial institutions from the Central Bank to the Malta Financial Services Authority (MFSA). At the same time, responsibility for the oversight of certain aspects of the capital market was transferred from the Malta Stock Exchange to the MFSA. These transfers proceeded smoothly. The need for a dedicated regulator and supervisor of financial corporations had become increasingly apparent as these firms have transcended boundaries that once separated credit institutions from non-banks. This notwithstanding, the Central Bank is expected to continue to play an important role in monitoring the overall stability of the financial system and this has been clearly stated in the amended Central Bank of Malta Act.

Malta's reputation as a financial services centre was enhanced as further steps were taken to combat money laundering. Following the enactment of the Prevention of Money Laundering (Amendment) Act, 2001, the Financial Intelligence Analysis Unit (FIAU) was formally established in March this year. The Unit will receive and analyse reports of transactions suspected to involve money laundering, hence helping to ensure that the Maltese financial system attracts reputable participants only.

The Government continued to be a major player in domestic financial markets this year. In the twelve months to September, Government once again issued securities both to pay maturing stocks and to meet cash flow requirements, although on a smaller scale than last year. Both Treasury bills and Government stock outstanding increased, although no new stocks were issued after October 2001. In contrast with the previous year, long-term debt held by the non-bank sector increased by more than that held by the banks, which showed a

preference for Treasury bills instead. Looking ahead, given our commitment to fiscal consolidation and the on-going privatisation programme, the reliance on debt financing should decrease.

The sound regulatory framework that we have put in place should underpin investor confidence in the local financial markets. In this context, the publication of a code of principles on corporate governance by the Malta Stock Exchange was most welcome. It is argued that listed companies and firms in general to abide by these principles.

During the past twelve months, the Maltese capital market continued to develop. Private firms issued bonds and equities on the primary market. Bonds were the preferred instrument, reflecting the current environment of low interest rates and falling share prices. Bond issues were well received by the public, being oversubscribed in all cases, which is not surprising given the persistent liquidity that characterised the economy throughout the year. In the secondary market, trading in both equities and corporate bonds was lower than last year, while turnover in Government bonds also declined substantially.

In the banking sector, during the past twelve months, three international banks surrendered their licence, whilst another had its licence revoked by the Central Bank of Malta following developments abroad. One international bank also upgraded its licence in October 2002 in order to be able to participate fully in the local banking market, which should increase the degree of competition in the financial system as a whole.

Banks are also facing growing competition from non-bank financial intermediaries. In fact, after having decreased last year, funds placed with locally based collective investments schemes recovered, with total assets rising from Lm221 million in December 2001 to Lm246 million at the end of July this year.

## Capital Control Liberalisation

As Government had promised some years ago, we intend completing the programme of capital liberalisation over the next year. So far we have implemented a series of measures which were primarily aimed at removing controls on long term and medium term transactions. The first package of measures introduced in 2000 focused mainly on the relaxation of restrictions on inward and outward investments of a long-term nature, in particular direct investment. At the same time, however, a limited number of liberalisation measures involving transactions of a medium to short-term nature were also introduced.

The second set of measures in the following year included, in particular, the removal of controls on investment in real estate overseas, and the liberalisation of lending/borrowing transactions between residents and non-residents where the maturity period exceeded one year. The 2002 package of measures then extended the liberalised regime by mainly increasing the allowances for various types of transactions particularly portfolio investment.

While it is the intention to remove the remaining restrictions by the end of the coming year the Government intends to maintain controls over some short-term categories of capital transactions until Malta's accession to the EU. This will ensure that the economy and the financial sector in particular will not be exposed to volatile, destabilising capital movements.

The remaining controls will be removed in a number of stages over the next 12 months with measures being announced a month before they come into effect. We intend introducing the first package of measures from the beginning of January 2003, and a second set of measures will be introduced on the 1 June 2003. The final liberalisation measures will come into on accession to the EU on 1 January 2004.

As was stated earlier we would like to emphasise that short term transactions involving portfolio investment and borrowing/lending will only be liberalised at the end of the coming year. Short term transactions are defined as those transactions which do not exceed a maturity period of six months. However transactions involving the financial institutions, which are related to normal money market

transactions, will not be effected by this measure. The first tranche of measures that will be introduced from January 2003 are being announced in this Speech while details and related reporting procedures will be published by the Central Bank on the 1 December 2002.

As capital control liberalisation has now reached an advanced stage we feel that it is appropriate to repeal the Exchange Control Act. In fact, from early next year this Act will be abrogated and replaced by a new piece of legislation entitled the Exchange Transactions Act. This Act will provide the infrastructure for the total liberalisation of capital controls but will also give the Minister of Finance the authority to impose controls in the event of a balance of payments crisis.

## **Details of Exchange Control Liberalisation Measures with effect from 1 January 2003**

### *Objectives of the measures*

The overall objective of the measures is to continue the liberalisation process which is expected to be completed by EU accession in 2004. Thus remaining quantitative limits on current and capital payments are either lifted completely or relaxed further.

#### **1. Travel allowance**

The purchase of foreign currency for travel purposes is completely liberalised.

#### **2. Cash gift allowance**

The limit for payments in connection with cash gifts or family subsistence allowances is raised to Lm20,000 per adult person each year from the present level of Lm10,000.

#### **3. Imports effected through a spot transaction overseas**

The purchase of foreign currency for export by residents who intend travelling overseas to make payments for merchandise imports is completely liberalised.

**4. Importation into Malta of local currency**

The importation into Malta by a resident/non-resident of any notes and coins which are or have been legal tender in Malta is completely liberalised.

**5. Exportation from Malta of local currency**

The exportation from Malta by a resident/non-resident of any notes and coins which are or have been legal tender in Malta is completely liberalised.

**6. The portfolio investment allowance**

The annual foreign portfolio investment allowance for an adult resident person is raised from Lm50,000 to Lm100,000.

**7. Foreign currency holdings/demand deposit account – natural persons**

- (i) The amount of foreign currency that a resident is exempted from surrendering to an authorised dealer is increased to Lm20,000 annually from the present limit of Lm15,000.
- (ii) This amount may be deposited in a foreign currency demand deposit account with a local bank.

**8. Foreign currency holdings/bank deposit accounts - bodies corporate/retail outlets**

- (i) Bodies corporate/local retail outlets which receive foreign currency, in cash, in the course of their business activities may retain up to Lm20,000 in cash for use in their business activities.
- (ii) This amount may be deposited in foreign currency accounts with local banks. The balance that may be held in such accounts is increased from the current level of Lm15,000 to Lm20,000.
- (iii) These accounts may be debited with payments in foreign currency related to current account transactions.

- (iv) Furthermore, bodies corporate who act as commission agents on behalf of foreign companies may receive and deposit into these accounts any payments in foreign currency made to them by their local customers as long as such funds are remitted to the foreign company within a month of receipt.

**9. Credit facilities in Maltese Liri to non-residents operating locally**

Local banks are permitted to grant credit facilities in Maltese currency to non-residents carrying out economic activities in Malta for periods of six months and over. Currently the minimum period for the extension of such facilities is one year.

**10. Loans by residents to non-residents**

Residents are permitted to extend credit to non-residents for periods of six months and over. Currently the minimum period for such loans is one year.

**11. Borrowing by residents in foreign currencies**

Residents are permitted to borrow in foreign currencies from resident or non-resident sources for periods of six months and over. Currently the minimum period for such borrowing is one year.

**12. Investment by fund investment schemes**

Fund investment schemes which collect funds in Maltese liri from residents with the specific aim of investing such funds in Maltese liri-denominated securities on the local market are now permitted to invest up to a maximum of 15% of their shareholders' funds in foreign assets, instead of 10% as at present.

**13. Clients' accounts of financial services companies**

Financial services companies which provide investment services to local clients are permitted to maintain clients' accounts with foreign banks overseas.

**14. Obligation to declare import/export of cash**

The reporting obligation that was announced in last year's budget, which was aimed at strengthening existing measures to combat money laundering or other criminal activities such as the channelling of funds for terrorist activities, will come into effect from early 2003 following the issue of a legal notice. The reporting form will have to be filled in by incoming and outgoing travellers (resident and non-resident) who carry on them cash in excess of Lm5,000. Cash is defined as any currency (bank notes and coins) and may include gold or silver bullion and monetary instruments.

## **The Fiscal Policy**

Given that fiscal consolidation can be conducive to improved economic performance over the medium to long-term, fiscal policy is being given particular importance by the Government as a main macro-economic policy instrument. As well as contributing to a more efficient allocation of resources and fairer income redistribution, fiscal policy pursues the objective of stabilising economic activity.

The economic policy of the State has the restoration of the country's public finances as one of its main objectives, more so as the impact on the fiscal deficit can assume broader dimensions on an open economy such as ours. It is for this reason, therefore, that in order to achieve fiscal sustainability, the objectives of the budget policy should remain those of underpinning the thrusts towards more economic growth.

### **The medium-term fiscal framework**

The fiscal imbalance this year is expected to increase to Lm78.5 million or 4.58% of the Gross Domestic Product. The budget balance over the medium-term 2003-2005, however, is expected to go back in line with the structured reduction that Government has planned to stabilise the fiscal deficit. In fact, it is expected that the balance between receipts and costs within the Consolidated Fund will go down gradually to Lm74.8 million, or 4.14% of the Gross Domestic Product in 2003, and to Lm56.6 million or 2.8% of the Gross Domestic Product in 2005. Public Debt, therefore, is expected to go down from 61.24% of the Gross Domestic Product this year to 60.1% of the Gross Domestic Product forecasts for 2005.

The fiscal tightening necessary to contain the deficit in the National Budget is expected to be achieved through an increase in Government's total receipts which more than offset expansion in public expenditure. In fact, total receipts, net of public debt interests, between 2003 and 2005 are expected to increase by Lm60.4 million or 8.1% while total costs are expected to go up

by Lm34.8 million or 4.6% notwithstanding an average annual inflation increase of 2.5%.

## Government Revenue in 2002 and medium-term projections

### **2002**

Ordinary revenue in 2002 is expected to increase from Lm735.2 million, as originally projected, to Lm746.3 million. This increase will result from less receipts in tax revenue which will be offset by more than Lm5 million in additional revenue from licences, taxes and fines that will include more duty on documents and oil rental licences, and by receipts amounting to Lm21 million that resulted from transactions between Malta International Airport plc. and the Government regarding property that had been held in full ownership by the company.

### Medium-term revenue projections

Within the medium-term framework, Government's total receipts as a percentage of the Gross Domestic Product are expected to fluctuate around 40%. In absolute terms, total receipts, were expected to maintain the upward trend registered in recent years.

Government tax revenue is projected to follow an upward trend over the coming years following an increase of 11% that is expected to be registered this year over 2001. In fact, tax receipts are expected to increase by Lm87.3 million by 2005 mainly as a result of Government's ongoing programme to improve tax efficiency and enforcement in order to curb evasion rather than of increasing taxes. In this regard, apart from the efficiency gains made in tax administration by the Inland Revenue Department, one may note further the progress registered by the Tax Compliance Unit. The main section of the Unit is the investigations section: this currently employs 22 professional accountants and auditors. This section is responsible for carrying out high level investigations on tax evasion and tax avoidance. These investigations cover evasion from VAT, Income Tax, Capital Gains Tax, Import Duties, and Social Security. These investigations draw upon warehoused-data that include information on declarations by VAT-registered taxpayers, on corporate business details, registration of property, trading licences, insurance

cover payments, and registration of assets such as pleasure crafts and motor vehicles. Benchmarking has also been established and is being applied in the case of payment for services, in sectors such as professionals, construction, automobile, and other services including domestic appliances technicians and hairdressers.

Another increase in tax receipts is also expected from royalties and gaming taxes that Government is projecting to receive following the privatisation of Public Lotto.

One should well note here that, in these projections, account has been taken of the fact that from 2003 certain one-off sources of revenue that happened this year will not recur. Among them are the fiscal dues and the one-off dividends paid by the Malta International Airport plc. already mentioned above, and registration fees paid under the Investment Registration Scheme which is being implemented this year. This Scheme is providing an opportunity for Maltese citizens to regularise their investment position under the Exchange Control Act, the Income Tax Act and other fiscal laws. It is also pertinent to note that non-tax receipts for 2003 reflect the receipts from EU Pre-Accession Aid which are expected to amount to €21 million or Lm8.7 million. However, for period 2004-2005, the financial aspects of the post-accession aid were not taken into account as negotiations on net balances are still in progress with the EU Commission. However, a general comment on the Commission's proposals has been included to cover the transition period 2004-2006.

## **Government expenditure in 2002 and medium-term projections**

### **2002**

Recurrent costs in 2002, net of public debt interest payments, are expected to be contained at Lm657.4 million, that is, almost at the same level originally projected. One should note that this year there was a relatively significant increase reflecting the reclassification of certain subsidies which were previously considered as capital expenditure.

Government's declared policy continues to be that of containing public spending: recurrent expenditure as a proportion of the Gross Domestic Product is expected to decline over the coming years. Recurrent expenditure over the medium-term includes the costs of the Agricultural Support Scheme which was announced in the Budget for this year and which provides farmers and all operators in the agro-industry as levies on agricultural and agro-industrial goods started being dismantled in June of this year.

Among others, excesses are expected in 2002 in the payment of Treasury pensions and gratuities as the original projections seemed to have been understated. However, the resulting increase will be offset by a lower outlay in subsidies paid to Malta Drydocks as a result of the early retirement scheme under which no less than 700 yard employees opted for terminal benefits. Of course, the provision for the payment of these terminal benefits has impacted upon the relevant Capital Expenditure Vote.

### **Public Debt Interests Costs in 2002**

Interest costs on public debt in 2002 will be increasing to Lm63.7 million from the original projections of Lm59.8 million. This is explained by a higher interest outlay becoming due in the wake of loans amounting to Lm100 million that had been raised in Government Stocks in 2001 to balance part of that year's and previous years' deficits, as well as by the fact that in 2002 the privatisation process did not keep pace with the desired plans and, therefore, the anticipated yield did not materialise as projected. Government's borrowing needs, therefore, were met through increased issues of Treasury Bills and, as a result, the impact on higher interest costs could not

but be felt. This impact was somewhat softened by lower interest rates at which maturing stocks were rolled-over.

While I shall be referring back to the issue of interests costs later on as I shall address the current and projected situation for public debt, I would mention that, in the medium-term framework, interests on public debt are expected to increase from Lm59.8 million next year to Lm67.4 million in 2005 or 3.3% of the Gross Domestic Product forecast for that year.

#### Recurrent costs in the medium-term

Recurrent expenditure over the medium-term 2003-2005, net of public debt interest payments, is expected to move up from Lm657.4 million this year to Lm701.5 million in 2005: a net increase of Lm44.1 million or 6.7% of the increase in the Gross Domestic Product over the same period. Almost Lm13.7 million, or 31% of this increase, will represent incremental and cost-of-living increases in the Government pay-roll. The remainder, or Lm30.4 million, will be absorbed by the additional costs in social security benefits and in the state contribution to Social Security.

As may be seen, Government's policy remains focused on rationalising public spending in particular through the more efficient allocation of funds. In fact, after 2001, recurrent costs reached 37.7% of the Gross Domestic Product, they are expected to decline to around 34.9% in 2005. It is pertinent to note that, notwithstanding the subdued expansion in total expenditure over the forthcoming years, sustainable levels of economic growth are still expected to be attained.

#### Capital Expenditure

##### **2002**

Capital expenditure in 2002 increased by Lm8.2 million to Lm103.6 million from the original projections of Lm95.4 million. This expenditure includes the Early Retirement Scheme introduced for the Shipyards and which, for this year, cost Lm6.6 million or 0.4% of the Gross Domestic Product. However, other increases are attributable to the out-of-court

settlement of dues on the Tal-Qroqq Junction where an additional Lm1,161,000 were paid in excess of the provision in this year's estimates, an additional Lm200,000 in subsidies to meet more purchases of new route buses as part of the plan to restructure existing public transport. An additional Lm400,000 to meet more compensation costs for the expropriation of property from the private sector, and an additional Lm300,000 to enable the Occupational Health and Safety Authority to purchase its own premises.

#### Medium-term forecasts

It is not expected that these additional costs will recur over the medium-term. The provision for capital expenditure, therefore, over the medium-term, will be brought down to the average 2002 levels of around Lm100 million.

Table No 24 provides the position of the Consolidated Fund including medium-term projections.

Table No 24		<b>Position of the Consolidated Fund</b>							
		<i>Lm 000's</i>							
	2002 <sup>(R)</sup>		2003 <sup>(P)</sup>		2004 <sup>(P)</sup>		2005 <sup>(P)</sup>		
<b>Receipts</b>									
Tax Yield	661,200		686,574		720,652		748,499		
Non-Tax Yield	85,078	<b>746,278</b>	83,956	<b>770,530</b>	65,642	<b>786,294</b>	58,149	<b>806,648</b>	
<b>Recurrent Costs</b>									
Personal Emoluments	197,070		197,776		205,473		210,814		
Operational & Maintenance	46,517		44,215		44,132		44,135		
Special Expenditure	773		635		565		565		
Programmes & Initiatives	343,199		358,529		358,901		368,673		
Cont. to Govt. Entities	69,867	<b>657,426</b>	76,227	<b>677,382</b>	78,752	<b>687,823</b>	77,306	<b>701,493</b>	
Interest on Public Debt		<b>63,728</b>		<b>59,800</b>		<b>66,800</b>		<b>67,400</b>	
<b>Recurrent surplus</b>		<b>25,124</b>		<b>33,348</b>		<b>31,671</b>		<b>37,755</b>	
<b>Capital Expenditure</b>		<b>103,603</b>		<b>108,178</b>		<b>100,398</b>		<b>94,351</b>	
<b>Budget deficit</b>		<b>(78,479)</b>		<b>(74,830)</b>		<b>(68,727)</b>		<b>(56,596)</b>	
<b>Financing:</b>									
Direct loan repayments	(1,000)		(1,000)		0		0		
Cont. to Sink. Fund:									
(Foreign)	(3,984)		(3,984)		(5,961)		(5,862)		
Local	(7,246)		(6,571)		(6,371)		(5,480)		
Unutilised Cont. to Conv.									
Local loans	13,250		5,000		9,000		4,000		
Asset sales	37,500	<b>38,520</b>	50,000	<b>41,914</b>	0	<b>(3,332)</b>	0	<b>(7,342)</b>	
Net Borrowing requirements		<b>(39,959)</b>		<b>(32,916)</b>		<b>(72,059)</b>		<b>(63,938)</b>	
GDP at current prices		<b>1,713.50</b>		<b>1,807.74</b>		<b>1,907.16</b>		<b>2,012.06</b>	
Deficit/GDP ratio		<b>4.58%</b>		<b>4.14%</b>		<b>3.60%</b>		<b>2.81%</b>	

(R) - Revised; (P) - Projected

## The Consolidated Fund and the ESA'95 methodology

As distinct from the other Funds and Accounts held and/or administered by the Government, the Consolidated Fund incorporates all moneys belonging to the Government. This Fund provides for a system of accounting and control for the collection of revenue and the administration of expenditure appropriated by Parliament. Parallel to the receipts and payments of Central Government registered in the Consolidated Fund, importance was also given to their classification under the European System of Accounts (ESA' 95). Moreover, the projections I spoke about earlier are being computed to reflect further refinements in the application of this international methodology which is widely being adopted by many governments.

These adjustments would lend themselves to reflect not only those of the Government, which we may call Central Government but also an extended

Government or one that is known as General Government. Accounting for extended or General Government transactions includes also the financial balances of revenue and expenditure and the resulting deficits and debt levels of a number of public entities that would fall as an integrated part of Government. I am referring to those public entities with no less than 50% of their revenues coming from Central Government.

These public entities include Local Councils as well as a large number of other entities which range from those of an administrative or regulatory function, such as boards, commissions, and tribunals, to those of a commercial or quasi-commercial nature. These public entities are being shown in Table No. 25 hereunder.

Table No 25	
<b>Entijiet Pubbliċi li jidhlu taht il-Metodoloġġja tal-ESA'95</b>	
Academy of Criminal Justice	Malta Council for Economic Development
Centre for Creativity (Arts Centre)	Malta Counter Trade Co. Ltd
Arts Council	Malta Shipbuilding Co. Ltd
Aviation Security Committee	Malta Stock Exchange Tribunal
Clean Air Board	Malta Tourism Authority
Cleaner Technology Centre	Malta / EU Information Centre
Commission for the Administration of Justice	Maltese Heritage Foundation
Commission for Advancement of Women	Mediterranean Academy of Diplomatic Studies
Committee of 'Ta' Braxia' Cemetry	MIMCOL
Consumer Claims Tribunal	National Commission for Disabled Persons
Bord tal-Koperattivi	National Commission for Information Technology
Cultural Council for Gozo	National Commission for Mental Health Reform
Program Fejda	National Commission for UNESCO
Financial Services Tribunal	National Commission on Welfare Reform
Foundation for Human Resources Development	National Consumer Affairs Council
Foundation for Social Welfare Services	National Employment Authority
Gozo Ferries Co. Ltd	National Festivities Committee
Institute of Public Administration & Management	National Pool Complex
Inter-Departmental Planning Committee	National Youth Council
International Maritime Law Institute	Occupational Health & Safety Authority
Malta Arbitration Centre	Office of the Ombudsman
Malta Centre for Restoration	Office of the University Ombudsman
Telecommunications Regulator	Permanent Commission Against Corruption
Traffic Control Board	Sports Council

Malta Communications Authority	St John's Co - Cathedral Foundation
Suret il-Bniedem	Malta Statistics Authority
Art Centre (included in EB02)	Malta Transport Authority
REMPEC	Medicinal Products Regulatory Authority
Building Industry Consultative Council	National Family Commission
Broadcasting Authority	Roads Directorate
Commission for Fair Trading	Malta Resources Authority
Electoral Commission	National Audit Office
Employment and Training Centre	National Orchestra
Employment Commission	Planning Authority
Foundation for International Studies	Public Transport Authority
Foundation for Medical Sciences and Services	Sedqa - Agency against Drug & Alcohol Abuse
IPSE Ltd.	Social Welfare Development Programme
Institute of Tourism Studies	Society of Arts, Manufacture and Commerce
International Institute on Ageing	University of Malta
MCAST	Tax Compliance Unit
Malta Council for Science and Technology	Voice of the Mediterranean
Malta Development Corporation	Zammit Clapp Hospital
Malta External Trade Corporation	Manoel Theatre Management Committee
Malta Government Investments Ltd. (included with MIMCOL)	Mediterranean Conference Centre
Malta Standards Authority	Foundation for Tomorrow's Schools
e-Malta Commission	Malta Export House Co. Ltd.
Foundation for Educational Services	

The revenue and expenditure of all these public entities was projected on an annual basis for 2003 to 2005 and the resulting balances were added on to those of the Consolidated Fund. In this way, the balance for the extended or General Government resulted providing a more wholesome scenario of its deficit and debt levels.

In absolute terms, the deficit of extended or General Government, is expected to be Lm89.0 million this year, and is expected to decline to around Lm68.5 million in 2005. This deficit as a percentage of the Gross Domestic Product is expected to decline gradually from 5.2% in 2002 to around 3.4% in 2005. This will happen as a result of reflecting both the expected growth of the local economy as well as the control on public expenditure and higher receipts. As already stated, the upward trend in interest payments that is expected to take place will be maintained during the medium-term period. This will impact on a higher level of gross Government debt.

Table No 26 provides the transition between the deficit in the Consolidated Fund and the extended or General Government deficit:

<b>Year</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
<b>Structural Deficit of Consolidated Fund transactions</b>	<b>(78,479)</b>	<b>(74,830)</b>	<b>(68,727)</b>	<b>(56,596)</b>
<i>Adjustments to the Consolidated Fund:</i>				
Loans granted <sup>(A)</sup>	21,195	21,800	18,300	15,800
Loans repaid <sup>(B)</sup>	0	0	0	0
Acquisition of shares <sup>(C)</sup>	20	0	0	0
Other financial transactions <sup>(D)</sup>	(769)	(769)	(769)	(769)
Other accounts receivable	727	0	0	0
Diff. Between interests accrued and interests paid <sup>(E)</sup>	1,447	1,447	1,447	1,447
Net borrowing of extra-budgetary units <sup>(F)</sup>	(28,137)	(23,937)	(24,478)	(25,018)
Other adjustments <sup>(G)</sup>				
(i)	(4,000)	(3,500)	(3,000)	(2,500)
(ii)	(2,000)	(2,000)	(2,000)	(2,000)
(iii)	0	0	0	0
<b>Gross Imbalance of General Government</b>	<b>(89,996)</b>	<b>(86,789)</b>	<b>(79,227)</b>	<b>(69,636)</b>
Local Councils	1,004	1,050	1,100	1,150
<b>Net deficit of General Government</b>	<b>(88,992)</b>	<b>(80,739)</b>	<b>(78,127)</b>	<b>(68,486)</b>
<b>GDP at current market value prices</b>	<b>1,713.50</b>	<b>1,807.74</b>	<b>1,907.16</b>	<b>2,012.06</b>
<b>GDP/deficit ratio</b>	<b>5.19%</b>	<b>4.47%</b>	<b>4.10%</b>	<b>3.40%</b>

*Explanatory Notes:*

<sup>(A)</sup> Consolidated Fund loans to Malta Drydocks, Malta Shipbuilding and Gozo Ferries Co. Ltd. (all 100% Government-owned)

<sup>(B)</sup> Repayments made by Malta Government Investments/Malta Development Corporation (Lm1.4 million), Malpro Ltd. for security provided to it for credit facilities (Lm1 million) and Water Services Corporation (Lm0.5 million).

<sup>(C)</sup> Acquisition of shares in Multilateral Investment Guarantee Agency (subscription shares), European Bank for Reconstruction and Development (subscription shares), and Malta Government Privatisation plc. (increase in shareholding).

<sup>(D)</sup> Non-trading profits among CBM transfers to Government.

<sup>(E)</sup> Difference between interest accrued and interest paid on Government short/long term borrowing.

<sup>(F)</sup> Based on linear-trend approach

<sup>(G)</sup> (i) Deposits in Treasury Clearance Fund  
(ii) Advances from Treasury Clearance Fund  
(iii) Loan cancellation in favour of Kalaxlokk Co. Ltd.

## Financing of the Consolidated Fund Deficit

The way in which Government deficits are financed is of relevance for the assessment of fiscal policy stance since each method of financing has particular macro-economic effects and costs.

In Malta, Government finances the deficit by the issuing of domestic public bonds: foreign borrowing constitutes a relatively low share. Indeed, while the share of domestic borrowing makes up around 96% of Public Debt, the reliance on foreign loans amounts to around 4%. This heavy reliance on domestic rather than on foreign sources is expected to shift somewhat in the medium-term as the Government is currently undertaking talks with the Council of Europe Development Bank for the extension of the existing loan facility for financing part of the costs of the new Mater Dei Hospital. It is expected that this facility will be extended up to 50% of the total project costs. In fact, in the forthcoming years, the share of foreign debt is expected to move up to an average of 8.9%.

As indicated earlier, domestic borrowing allows the Government to sustain a deficit without increasing the monetary base or depleting national reserves. Moreover, it is an effective way to avoid both inflation and pressures on the external reserves.

The deficits in the Consolidated Fund in the medium-term period are primarily expected to be financed out of asset-sale proceeds which, in 2003, are expected to amount to around Lm50 million. No further plans, however, are being announced by the Government in the subsequent year period. Another financing source is the transfer of unutilised balances in sinking funds of converted loans: these are expected to provide Lm14.2 million this year but will go down to an average annual of Lm4 million over the 3-year medium-term period.

These total incomes will bring down Government's borrowing needs. I have already commented on the debt balances arising out of the year-on imbalances in the Consolidated Fund. Public Debt is expected to go down marginally from 61.24% of the Gross Domestic Product this year to 60.48% of what is expected to be the Gross Domestic Product in 2005.

These results are being shown in Table No 27 hereunder:

<i>Table No 27</i>						
<b>Government Debt Balance</b>						
						<i>Lm 000's</i>
	2000	2001	2002	2003	2004	2005

Treasury Bills	169,008	156,125	164,584	83,466	143,028	194,466
LDRS/MGS	712,728	812,854	812,854	912,854	912,854	912,854
Foreign Loans	39,353	40,494	71,994	84,497	96,994	109,494
<b>Government Debt</b>	<b>921,089</b>	<b>1,009,472</b>	<b>1,049,432</b>	<b>1,080,817</b>	<b>1,152,876</b>	<b>1,216,814</b>
% of GDP	59.11%	61.85%	61.24%	59.79%	60.44%	60.48%
<b>Change in Gross Debt</b>		<b>(85,799)</b>	<b>(39,958)</b>	<b>(31,385)</b>	<b>(72,059)</b>	<b>(63,938)</b>
<b>GDP at current market price</b>	<b>1,558,377</b>	<b>1,638,000</b>	<b>1,713,50</b>	<b>1,807.74</b>	<b>1,907.16</b>	<b>2,012.06</b>

## Government-guaranteed Debt

Government-guaranteed debt has gone down substantially from Lm416.8 million as at 31 December last year and is projected to level down at Lm375 million by the end of this year. From this amount, Lm212 million represent exposure to domestic loans/credit facilities raised with foreign finance institutions.

Table No 28 provides a statement of the Government Guaranteed Debt.

<i>Table No 28</i>					
<b>Government Guaranteed Debt</b>					
	<i>(Lm 000's)</i>				
	<b>2001</b>	<b>2002<sup>(A)</sup></b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Guarantees	360,642	353,598	350,530	350,530	350,530
Letters of Comfort	29,662	29,724	29,459	29,459	29,459
Letter of Undertaking	26,518	-	16,943	16,943	16,943
<b>TOTAL</b>	<b>416,822</b>	<b>383,322</b>	<b>396,932</b>	<b>396,932</b>	<b>396,932</b>

<sup>(A)</sup> as on 30 Sept 2002

The Ministry of Finance is currently strengthening its institutional capacity for professional and effective debt management in order to integrate it into an overall macro-economic strategy. The Treasury, therefore, has just launched a project for the setting up of a Public Debt Management Office. This is being done with the technical assistance of the UK Treasury.

## Fiscal Risks

The risk exposure of the Government due to the size of the public debt does not provide unmanageable problems. Indeed, the risk parameters of Malta's public debt are more favourable when compared to various other countries. As I have already stated foreign borrowing on average accounts for a low 4% of Government debt and does not, therefore, impose exchange rate risk.

Moreover, given that 80% of public debt has an average maturity exceeding twelve months, the necessity of short-term refinancing maturing debt is relatively low eliminating any interest rate risk. Moreover, interest rates follow a relatively stable path thus reducing any fiscal risk that can arise from interest rate volatility.

The main source of fiscal risk arises from the issuance of Government guarantees. This reflects Government's declared policy not to provide any further security or comfort or other form of undertaking to credit or loans raised by public entities.