COMMISSION OF THE EUROPEAN COMMUNITIES

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COM(2007) 258 final

REPORT FROM THE COMMISSION

CONVERGENCE REPORT 2007 ON MALTA

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

{SEC(2007) 622}

1. PURPOSE OF THE REPORT

Article 122(2) of the Treaty requires the Commission and the ECB to report to the Council, at least once every two years, or at the request of a Member State with a derogation, on the progress made by the Member States in fulfilling their obligations regarding the achievement of economic and monetary union.

This report has been prepared in response to the request submitted by Malta on 27 February 2007. A more detailed assessment of the state of convergence in Malta is provided in a technical annex to this report (SEC(2007) 622).

The content of the reports prepared by the Commission and the ECB is governed by Article 121(1) of the Treaty. This Article requires the reports to include an examination of the compatibility of national legislation, including the statutes of its national central bank, and Articles 108 and 109 of the Treaty and the Statute of the ESCB and of the ECB (ESCB Statute). The reports must also examine whether a high degree of sustainable convergence has been achieved in the Member State concerned by reference to the fulfilment of the convergence criteria (price stability, government budgetary position, exchange rate stability, long-term interest rates), and by taking account of several other factors mentioned in the final sub-paragraph of Article 121(1). The four convergence criteria are developed further in a Protocol annexed to the Treaty (Protocol No 21 on the convergence criteria).

The examination of the compatibility of national legislation, including the statutes of the national central banks, with Articles 108 and 109 of the Treaty and the ESCB Statute requires an assessment of compliance with the prohibition of monetary financing (Article 101 EC) and the prohibition of privileged access (Article 102 EC); consistency with the ESCB's objectives (Article 105(1) EC); central bank independence (Article 108 EC); and integration of national central banks into the ESCB (several EC Treaty and ESCB Statute articles).

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

Article 1 of the Protocol on the convergence criteria further stipulates that “the criterion on price stability […] shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions”. The requirement of sustainability implies that the satisfactory inflation performance must essentially be attributable to the behaviour of input costs and other factors influencing price developments in a structural manner, rather than the influence of temporary factors. Therefore, the convergence examination includes an assessment of the factors underlying inflation and of medium-term prospects. It also assesses whether the country is likely to meet the reference value in the months ahead[1].

The inflation reference value was calculated to be 3.0% in March 2007[2], with Finland, Poland and Sweden as the three best-performing Member States.

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

Article 3 of the Protocol on the convergence criteria stipulates: "The criterion on participation in the exchange rate mechanism of the European Monetary System (…) shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period".

The relevant two-year period for assessing exchange rate stability in this report is 27 April 2005 to 26 April 2007.

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

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

The interest rate reference value was calculated to be 6.4% in March 2007.

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1 The forecast of the reference value is subject to significant uncertainties given that it is calculated on the basis of the inflation forecasts for the three Member States projected to have the lowest inflation in the forecast period, thereby increasing the possible margin of error.

2 The cut-off date for the data used in this report is 26 April 2007.

Article 121 of the Treaty also requires an examination of other factors relevant to economic integration and convergence. These additional factors include financial and product market integration, the development of the balance of payments on current account and the development of unit labour costs and other price indices. The latter are covered within the assessment of price stability.

In the December 2006 Convergence Report, the Commission assessment was that Malta fulfilled one of the convergence criteria (on long-term interest rates). Pending the adoption of the draft law amending the Central Bank of Malta Act, legislation in Malta was considered not fully compatible with Article 109 of the Treaty and the ESCB Statute as regards central bank integration into the ESCB at the time of the adoption of the euro.

2. LEGAL COMPATIBILITY

All outstanding incompatibilities have been addressed in an Act amending the Central Bank of Malta Act that was adopted by Parliament on 28 February 2007 and should enter into force on the date of the introduction of the euro in Malta. In particular, the Act has repealed or amended a series of articles so as to take account of the respective roles and competences assigned by the EC Treaty to the ECB, ESCB and EC Council. This concerns notably provisions on the monetary functions, operations and instruments of the ESCB, on the holding and managing of foreign reserves and on the right to authorise the issue of banknotes and the volume of coins.

Legislation in Malta, in particular the Central Bank of Malta Act, is compatible with the requirements of the EC Treaty and the ESCB Statute.

3. PRICE STABILITY

Respect of the reference value

12-month average inflation in Malta has been at or below the reference value since July 2005 except for the period May – October 2006. The average inflation rate in Malta during the 12 months to March 2007 was 2.2%, below the reference value of 3.0%, and is likely to remain below the reference value in the months ahead[3].

Underlying factors and sustainability

HICP inflation in Malta has fluctuated around 2.5% over recent years. There has been some volatility, primarily due to the fact that Malta is a small and open economy vulnerable to external shocks (particularly in food and energy prices), and to changes in indirect taxes. Inflation picked up considerably in autumn 2005, mainly reflecting a sharp rise in regulated prices for energy and related products in response to higher oil prices. When the impact of the energy price shock ebbed away, inflation dropped markedly at the end of 2006 to below 1%. In addition to the significant base

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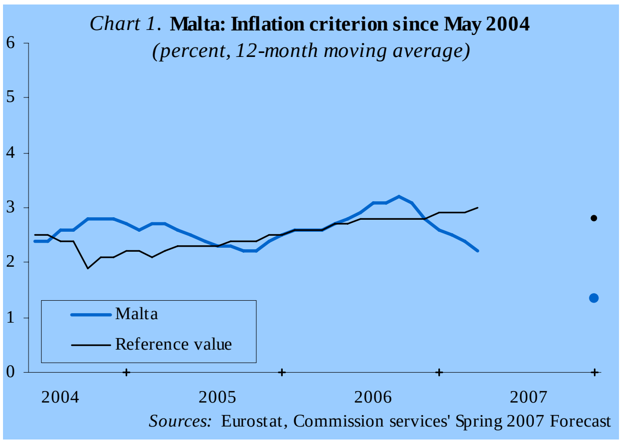
[3] According to the Commission Spring 2007 Forecast, 12-month average inflation in Malta will decrease to 1.4% in December 2007, while the reference value is forecast to stand at 2.8%.

effects in energy inflation, the decline reflected a drop in prices of clothing and footwear and air transport.

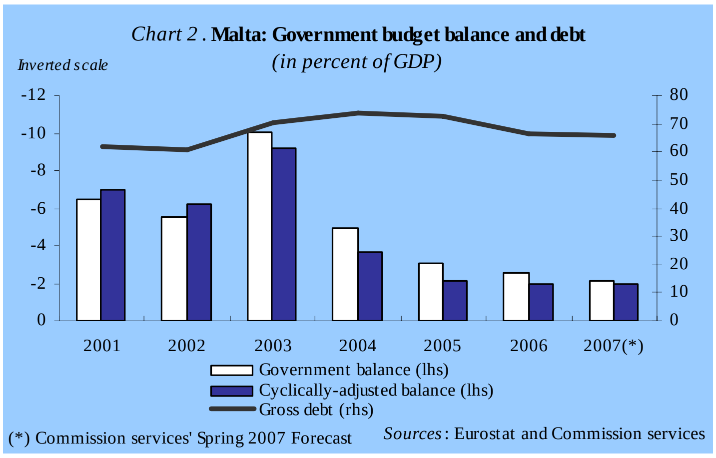


HICP inflation excluding energy and unprocessed food declined to 1.6% in 2006, from 2% in 2005. Moderate core inflation suggests that underlying inflationary pressures have remained limited, against the background of a negative output gap and low wage pressures. Unit labour costs have been decreasing since 2005, reflecting strong wage discipline both in the private and public sector. There have been no signs of second-round effects from energy prices so far, suggesting that inflationary expectations remain well-anchored. The effective exchange rate broadly stabilised in 2005 and 2006, thus remaining roughly neutral with regard to import prices

Looking ahead, headline inflation is expected to remain on a moderate path in the medium term, although it is projected to increase somewhat from the current low levels as favourable base effects in energy prices subside. Risks to the outlook appear broadly balanced. The main risks are related to oil prices and are two-sided. Otherdownward risks include the on-going liberalisation of the energy sector in Malta and the other structural reforms improving functioning of product markets. Upward risks could stem from the tightening of the labour market as cyclical conditions improve.

Malta fulfils the criterion on price stability.

4. GOVERNMENT BUDGETARY POSITION



Malta is at present the subject of a Council Decision on the existence of an excessive deficit (Council Decision of 5 July 2004)[4].

Malta's general government deficit was relatively high at the beginning of the 2000s, reaching a high of around 10% of GDP in 2003 (mainly due to a significant one-off operation). Since then, the budget deficit has

4 Decision 2005/186/EC (OJ L 62, 9.3.2005, p. 21).

considerably decreased in the context of the government's fiscal consolidation programme. The deficit-to-GDP ratio reached 2.6% in 2006 and according to the Commission services' Spring 2007 Forecast will amount to 2.1% of GDP in 2007. The revenue ratio has followed an upward trend, whilst expenditure as a share of GDP increased until 2003 but decreased thereafter.

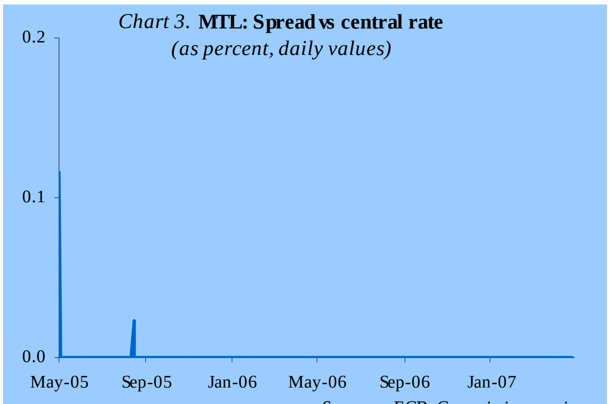
General government debt increased significantly in the first half of the decade, peaking at around 74% in 2004. However, starting from 2005 the debt ratio followed a downward path reaching around 66.5% of GDP in 2006. The Commission services' spring 2007 forecast projects a general government debt of 65.9% of GDP for 2007.

In its Opinion of 27 February 2007 on the December 2006 update of the Convergence Programme, the Council noted that the debt ratio appeared to be diminishing at a satisfactory pace towards the 60% of GDP reference value and that the programme was consistent with a correction of the excessive deficit by 2006. At the same time, the Council noted that there were risks to the budgetary projections in the programme, especially with regard to the assumed favourable macroeconomic assumptions in 2008 and 2009. The Council invited Malta to pursue the planned progress towards the MTO, ensure that the debt-to-GDP ratio was reduced accordingly and to make further progress in the design and implementation of the healthcare reform in order to improve the long-term sustainability of public finances.

In view of these developments and the Commission services' Spring 2007 Forecast, the Commission considers that the excessive deficit has been corrected with a credible and sustainable reduction of the budget deficit below 3% of GDP and the debt-to-GDP ratio diminishing towards the reference value of 60%. The Commission is therefore recommending that the Council abrogate the decision on the existence of an excessive deficit for Malta (SEC(2007) 621). If the Council decides to abrogate the excessive deficit procedure for Malta, Malta will fulfil the criterion on the government budgetary position.

5. EXCHANGE RATE STABILITY

Chart 3. **MTL: Spread vs central rate**
(as percent, daily values)

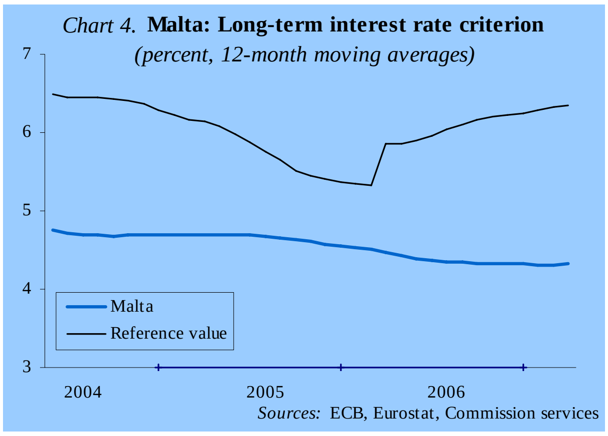


Sources: ECB, Commission services

The Maltese lira has participated in ERM II since 2 May 2005, i.e. for 24 months at the time of adoption of this report. Before entering ERM II, the lira was pegged to a euro-dollar-sterling basket. During the period of the assessment not covered by ERM II participation (27 April – 1 May 2005), the lira stayed close to the future central rate. Upon ERM II entry, the Maltese authorities unilaterally committed to maintain the lira at the central rate. During ERM II participation, the lira has remained stable vis-à-vis the central rate and has not experienced severe tensions. Additional indicators, such as developments in short-term interest rates and foreign exchange reserves, do not point to pressures on the exchange rate.

Malta fulfils the exchange rate criterion.

6. LONG-TERM INTEREST RATES



The average long-term interest rate in Malta in the year to March 2007 was 4.3%, below the reference value of 6.4%. Average long-term interest rates in Malta have been below the reference value since EU accession. Long-term yield spreads *vis-à-vis* the euro area have fluctuated at relatively moderate levels over the past years, hovering around 30 basis points in the first quarter of 2007. Contained yield spreads indicate that the residual country risk priced in by markets is limited.

Malta fulfils the criterion on the convergence of long-term interest rates.

7. ADDITIONAL FACTORS

Additional factors have also been examined, including product and financial market integration and balance of payments developments. The Maltese economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and Malta’s financial system is substantially inter-linked with the financial systems of other countries, both in and outside the EU, via the establishment of financial intermediaries and the provision of cross-border services. Malta's current account balance has been rather volatile over the past years, reflecting the small size and narrow sectoral base of the economy. The external position shows large disparities in net trade in goods and services, with a high deficit in goods trade being partly compensated for by a substantial services surplus. The current account deficit has increased significantly in recent years, reaching a level of 8.2% of GDP in 2005. This increase reflected difficult market conditions in the dominant electronics and tourism sectors and, in 2005, a strong increase in the oil bill. In 2006, the current account deficit fell to 6.3% of GDP on account of a significant increase in current transfers due to increased receipts from the booming online services industry. The deficit in the combined current and capital account decreased from around 4.9% of GDP in 2004-2005 to 3.2% of GDP in 2006. On the financing side, net FDI inflows have largely covered the current account deficits.

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In the light of its assessment on the fulfilment of the convergence criteria and assuming that the Council will follow the Commission's recommendation for the abrogation of the excessive deficit, the Commission considers that Malta has achieved a high degree of sustainable convergence.