Republic of Malta
Rating Report

SCOPE A+ STABLE OUTLOOK

Credit strengths

- Euro area membership
- High economic growth
- Prudent fiscal management
- Strong external position

Credit weaknesses

- Elevated contingent liabilities
- Unfavourable demographics
- External vulnerabilities
- Regulatory shortcomings

Rating rationale and Outlook: Malta's A+ rating is underpinned by the country's euro area membership, rapid economic growth, prudent fiscal management, and strong external position. The rating is constrained by elevated contingent liabilities, unfavourable demographics, which need to be addressed via health and pension reforms, external vulnerabilities, the lack of skilled labour, and regulatory shortcomings in the financial sector. The Stable Outlook reflects our assessment that risks to Malta's economic growth remain broadly balanced over the medium term.

Figure 1: Sovereign scorecard results

Scope's sovereign risk categories	Malta	Peer comparison	
		Average	Ireland
Domestic economic risk			
Public finance risk			
External economic risk			
Financial risk			
Political and institutional risk			
Qualitative adjustment (notches)	-2		-2
Final rating	A+		A+

AAA	AA	A	BBB	BB	B	CCC	CC	C

Source: Scope Ratings GmbH

NB. The comparison is based on Scope's Core Variable Scorecard (CVS), which is determined by the relative rankings of key sovereign credit fundamentals. The CVS peer group average is shown together with two selected countries chosen from the entire CVS peer group. The CVS rating can be adjusted by up to three notches depending on the size of relative credit strengths or weaknesses.

Positive rating-change drivers

- Structural reforms raising growth potential
- Continued fiscal consolidation
- Effective completion of reforms to strengthen financial supervision

Negative rating-change drivers

- Significant slowing of growth
- Failure to increase investment spending

Ratings and Outlook

Foreign currency

Long-term issuer rating	A+/Stable
Senior unsecured debt	A+/Stable
Short-term issuer rating	S-1+/Stable

Local currency

Long-term issuer rating	A+/Stable
Senior unsecured debt	A+/Stable
Short-term issuer rating	S-1+/Stable

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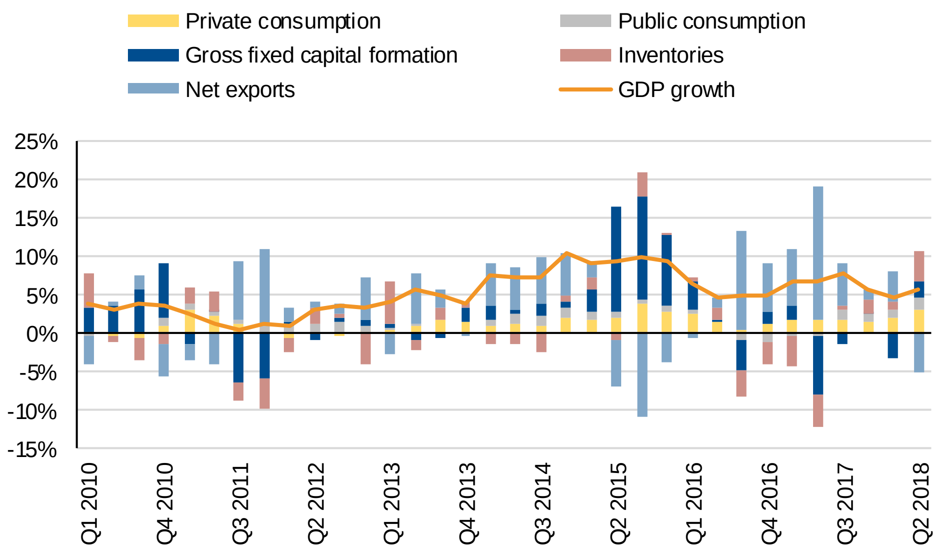
Domestic economic risk

Strong growth potential limited by infrastructure and skilled labour

Malta has shown buoyant growth rates during the recent decade with an average real expansion of 4.3% since 2007, behind only Ireland in the EU. The main drivers of Malta's growing economy are the high service exports (tourism, transport and gaming), and robust private consumption. For 2018, we anticipate annual growth to reach close to 5%, on the back of record-low unemployment of below 4.6%[1], strong employment growth due to migration, and recovering investment, especially in the housing market. Growth in 2018 is driven by private consumption and private and public investment, whereas the external sector provides less support than in previous years.

Going forward, we expect robust growth momentum over the medium term, but limited to around 4% owing to adverse demographics, congested infrastructure, and a lack of macro-prudential oversight.

Figure 2: Real GDP growth (YoY, %)



Source: ECB, Eurostat

Over the medium term, the country faces supply-side constraints, induced by a tighter labour market and congested infrastructure. Despite state-led labour reforms to improve skill attainment and tertiary education among young people, the economy still faces a large gender employment gap, and educational outcomes remain closely linked to one's socio-economic background. Infrastructure investment is projected to increase strongly, with higher absorption of EU funds and expected investment in health-related projects.

Low inflation and strong institutional framework

Malta benefits from a strong institutional framework with low inflation rates despite a positive output gap, which is supported by prudent fiscal policies. We expect prices to accelerate gradually during the coming months, based on higher wages and buoyant consumption.

Malta's economic policy framework also benefits from recent government reforms to reduce poverty and social exclusion via 'make work pay' policies. The government has also enacted measures to better integrate immigrants. However, income inequality remains below the EU average. Major weaknesses reflect the need to strengthen

[1] Source: IMF World Economic Outlook, October 2018

financial supervision and increasing tensions with the EU on tax policies and financial regulation.

Establishment of the Malta Development Bank

The Malta Development Bank started operations in December 2017. The state-owned bank was established to facilitate lending to small and medium-sized enterprises and will be involved in large-scale infrastructure projects. The government will not finance the bank but will guarantee its assets and liabilities.

Macroeconomy instability through risk of money laundering

Malta's economic strength is partly related to a booming gaming sector and large revenues from the IIP, which attracts foreigners who seek European citizenship. Financial inflows are more than tenfold the country's GDP, thereby remaining a source of uncertainty despite being mostly decoupled from domestic economic activity. Despite the implementation of several Anti-Money Laundering Directives has improved due diligence and transparency, the European Commission asked the government to take a stand on anti-money laundering measures following allegations against the Pilatus Bank whose banking license was revoked in November 2018 by the European Central Bank. In July, the European Banking Authority (EBA) pointed out that the measures taken by the Maltese Financial Intelligence Analysis Unit were not sufficient to satisfy the identified shortcomings, requesting further action to comply with the Anti-Money Laundering (AML) and Countering Terrorism Financing Directive (CFT). The Maltese authorities have responded by launching the AML/CFT Strategy, which includes an improvement of the supervisory framework and an increase of resources to strengthen legal enforcement.[2]

Public finance risk

Individual Investment Programme contributes to consolidation

In 2017, Malta's fiscal surplus reached a widely unexpected 3.9% of GDP (four-quarter moving sum), according to the latest central bank's economic update[3]. More than 2% of the surplus is attributed to contributions under the IIP, whose inflows are difficult to anticipate but have already resulted in more than EUR 400m of extra fiscal inflows since its inception in 2015. The government has capped citizenship application approvals at 1,800; 50% have already received a passport in exchange for an individual investment of EUR 1.1m, of which EUR 500m has flowed to the public budget. Besides its positive impact on public finances, the IIP has also raised the attention of EU officials who currently investigate if Malta (among other members countries) adheres to the requirements that citizenship can only be offered to people with a link to the country.[4]

Expenditures remain low but show high growth rates

Apart from windfall gains of the IIP programme, Malta's past primary balances have been positive thanks to high growth rates, low interest payments, and a broadening tax base, which reflect better monitoring compliance and increasing female labour participation. Expenditure is below the euro area average but has recently picked up. Capital transfers in 2018 are primarily driven by the acquisition of landing rights from the national airline, Air Malta (EUR 63.5m equal to 0.5% of GDP).[5]

Going forward, the government targets a general fiscal surplus of 1.3% of GDP for 2019, including net IIP revenues and gross fixed capital formation of 3.5% of GDP. Fiscal expenditures are expected to decline slightly from 38.4% to 37.8% of GDP, based on a one-time capital transfer to Air Malta and projected savings due to higher labour market participation and low inflationary developments.

[2] Source: Malta's Draft Budgetary Plan 2019, submitted to the EU Commission in October 2018
[3] Source: Central Bank of Malta, Economic Update, October 2018
[4] See the official press statement of Commissioner Jourová on the occasion of her visit to Malta on 14 June 2018
[5] Source: Finance Ministry of Malta's Draft Budgetary Plan 2019

Debt sustainability analysis

Malta's debt-to-GDP ratio has steadily declined since 2012, falling below the 60 percent Maastricht threshold in 2015. The last two years have brought a further decline by almost 8 percentage points, thanks to exceptionally strong growth and a slightly positive fiscal balance.

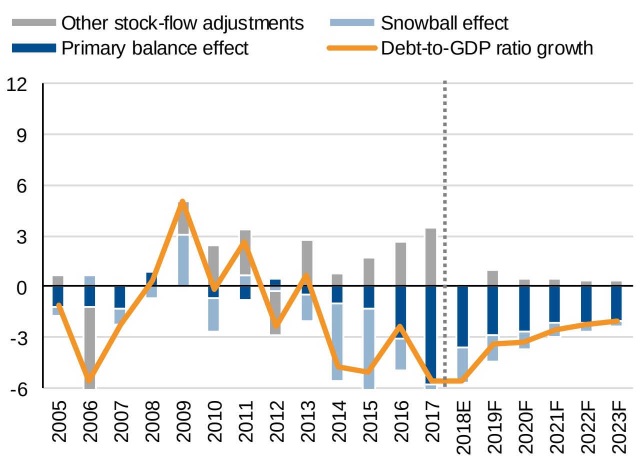
Debt ratio remains elevated but with favourable trajectory

The government projects a decline of the debt-to-GDP ratio to 46.9% for 2018, another drop by four points, and an additional 3.1% decline in 2019, assuming the primary surplus of 2.7% exceeds interest rate expenditure (1.6%) and the stock-flow adjustment (1.6% of GDP). Our baseline scenario, in line with the IMF forecast, foresees a continued, albeit less pronounced, decline in debt over the projection horizon to around 30% of GDP, supported by positive primary balances and high growth.

High contingent liabilities from weak SOEs

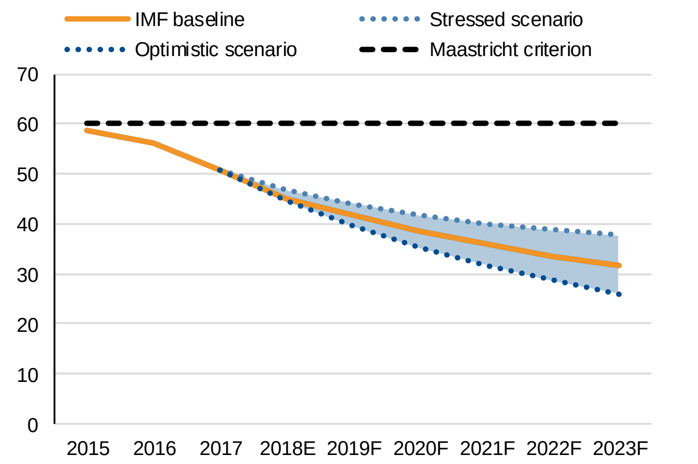
Malta's strongly declining public debt ratio is still facing an additional burden from the relatively high contingent liabilities of 14% of GDP (in 2016), a result of the financially weak state-owned enterprises (SOEs). These risks remain elevated over the forecast horizon despite a constant downward trend, which brought guaranteed debt down to more moderate levels of 9.3% of GDP by June 2018.[6]

Figure 3: Contribution to gov't debt changes, % of GDP



Source: IMF, Scope Ratings GmbH

Figure 4: General government debt, % of GDP



Source: IMF, Scope Ratings GmbH

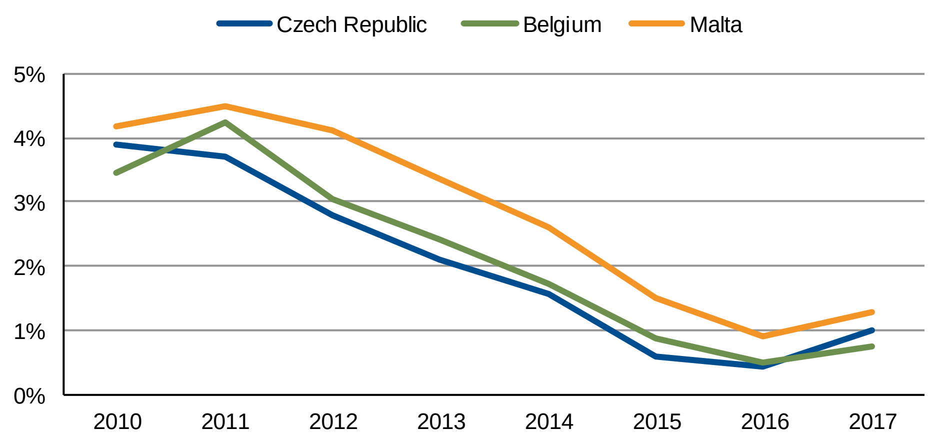
Scenario	Period	Real GDP growth (%)	Primary bal. (% of GDP)	Real eff. int. rate (%)	Debt, end period (% of GDP)
History	2013-17	6.8	2.3	1.6	50.7
IMF baseline	2018-23	4.0	2.6	1.6	31.5
Optimistic scenario		4.5	2.8	1.6	26.0
Stressed scenario		3.5	1.6	2.3	37.7

The downward trajectory of Malta's debt to GDP is also supported by a decline in refinancing costs, reflecting the low interest rate environment. The government recently issued a domestic fixed-rate savings bond (3% p.a.) with a total nominal value of EUR 93.5m for individuals born in 1965 or before.

[6] Source: Central Bank of Malta, ESA2010 accounting

Compared to euro area peers, Malta's yield spread remains above those of large and more mature issuers such as Belgium or the Czech Republic. The average maturity of debt was 9.8 years in 2017 (beginning of the year) with a weighted average coupon of 4.1%.

Figure 5: Government bond yields, in %



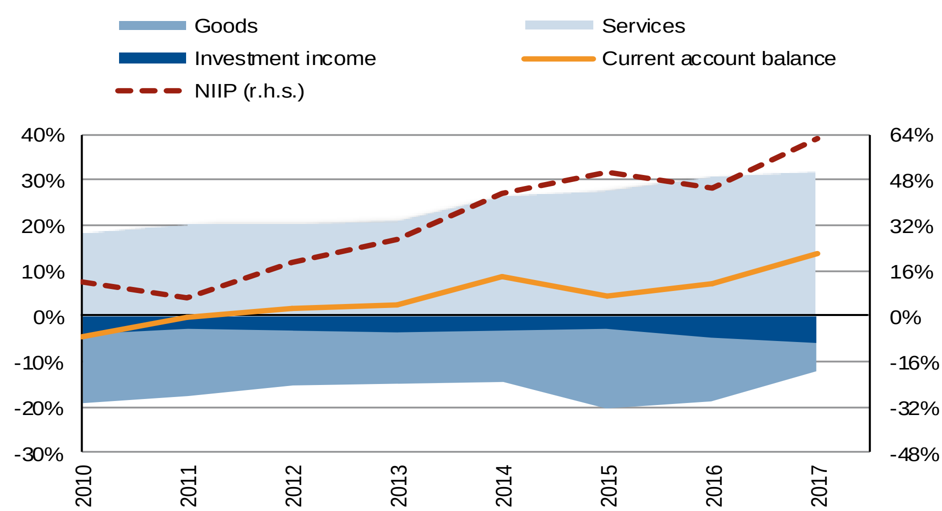
Sources: Central Banks of Malta, Czech Republic and Belgium

External economic risk

Strong external performance based on gaming and tourism

The external position of Malta's economy has been robust in previous years, leading to a net international investment position (NIIP) of 62.6% in 2017. This development is dominated by rising services exports in transport, tourism and gaming. The gaming sphere in Malta contributed almost 12% to the country's gross value-added in 2016. Although the country has a negative balance on goods exports, the quality of exported manufacturing goods is markedly above the EU average, with 40% of the export value related to top-quality goods. In contrast to the positive NIIP, Malta's gross external debt stands at more than 800% of GDP, including inter-company lending and liabilities of offshore institutions, which, however, are unrelated to domestic residents and more than covered by external assets.

Figure 6: Current account and NIIP, as % of GDP



Sources: National Statistical Office, Central Bank of Malta

Going forward, we expect Malta to retain its current account surplus, albeit at lower levels towards 2019, based on rising import shares and the country's nascent financial centre. However, pending discussions on the dubious sources of financial inflows, along with the European Commission's efforts to strengthen its authority to withdraw banking licences, may adversely affect Malta's current business model of exporting gaming and financial services.

Financial stability risk

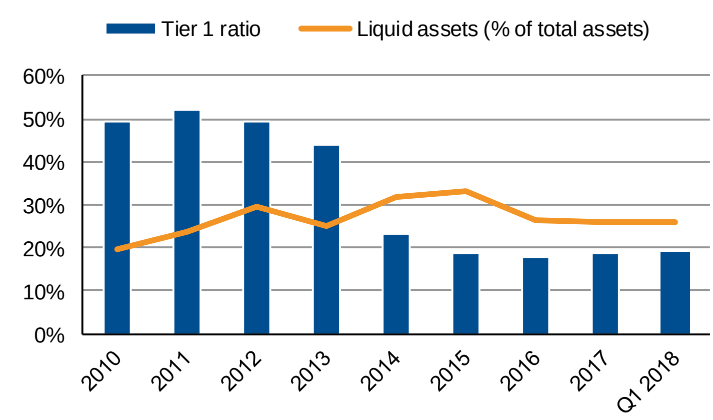
Well-capitalised banking sector, but high exposure to real estate

The financial sector is a major pillar of the Maltese economy. Although bank assets have decreased steadily from 756% of GDP in 2010 to 431.8% in 2017, activities have become more concentrated in the domestic sector with increased lending to households, primarily mortgage contracts (54% of total resident loans). At the same time, lending to non-financial corporates remains weak, reflecting the shift towards a more labour-intensive service-based economy with its low capital needs. The high concentration of mortgage loans is partly compensated by ample liquidity; although deposits as the main funding source are mostly short term, increasing maturity mismatch risks due to the high share of long-term mortgage contracts on bank balance sheets. The loan-to-deposit ratio of core domestic banks stands at a healthy 60%, and rising house prices could partly be driven by foreign demand induced by the IPP requirement to acquire real estate and the recent immigration of foreign workers. Uncertainties surrounding the impact of IIP-related real estate investment requires a close monitoring of the mortgage market. Also, despite their declining trend, the legacy of non-performing loans in the corporate sector needs the attention of supervisory authorities.

Money laundering leads to banking license withdrawal

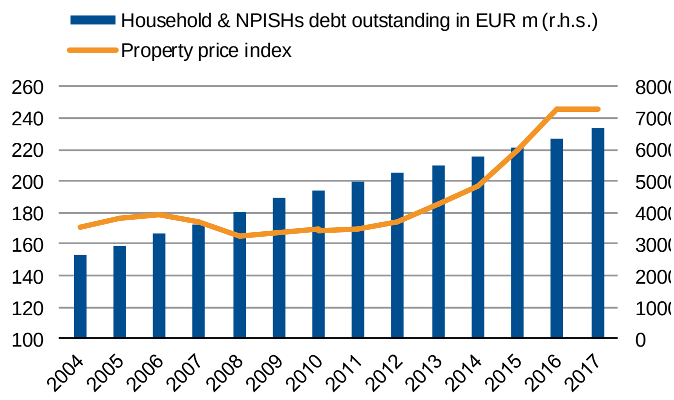
We recognise that the recent allegations regarding money laundering, as mentioned above in the 'Domestic Economic Risk' section, have no likely impact on public finances, and further acknowledges that the Maltese government's efforts are likely to address any potential reputational risk as regards the country's position as an emerging financial centre. As a small, open economy, Malta remains especially vulnerable to external shocks, particularly with the economy remaining highly reliant on the export of business-cycle relevant services.

Figure 7: Bank capitalisation, in %



Source: European Central Bank

Figure 8: Property price index



Source: Central Bank of Malta

Institutional and political risk

Labour government responds to criticism on regulatory framework

After 25 years in opposition, the Labour party won the 2013 and 2017 elections against the Nationalist party. The current prime minister, Joseph Muscat, is running the country with a government dedicated to prudent fiscal policies and to laying the grounds as an attractive location for international investors. The government has focused on establishing a comparative advantage for Malta in the provision of a regulatory framework for upcoming industries with special regulatory needs such as the gaming sector. The Maltese authorities have responded by launching the AML/CFT Strategy, which aims at improving the supervisory framework and increase resources to strengthen legal enforcement.

Environmental, social and governance (ESG) factors

We consider ESG sustainability issues during the rating process as reflected in our sovereign methodology. Governance-related factors are explicitly captured in our assessment of ‘institutional and political risk’, for which Malta scores high according to the World Bank’s Worldwide Governance Indicators. Qualitative governance-related assessments in the ‘geo-political risk’ category of our Qualitative Scorecard are assessed as ‘neutral’ compared with Malta’s sovereign peers. Socially related factors are captured in our Core Variable Scorecard in Malta’s rapidly growing GDP per capita (USD 27,326 in 2017) and record-low unemployment but increasing old-age dependency ratio. Qualitative assessments of social factors are reflected in our ‘macroeconomic stability and sustainability’ category, for which we assess Malta as ‘weak’. Finally, environmental factors were considered during the rating process but did not have an impact on this rating action.

Outlook and rating-change drivers

The Stable Outlook reflects our assessment that the risks Malta faces remain manageable given its significant strengths.

The rating could be upgraded if: i) the government implements structural reforms, which raise the growth potential; ii) if there is continued fiscal consolidation; and/or iii) reforms to strengthen financial supervision are effectively completed.

The rating could be downgraded in the event of: i) a significant slowing of growth; and/or ii) failure to increase investment spending.

Foreign- versus local-currency ratings

Maltese debt is almost entirely issued in local currency. Because of the country’s history of openness to trade and capital flows, we see no evidence that Malta would differentiate between any contractual debt obligations based on currency denomination.

Recent rating actions

	Rating action	Outlook
9 November 2018	First-time rating: A+	Stable

Source: Scope Ratings GmbH

I. Appendix: CVS and QS results

Sovereign rating scorecards

Our Core Variable Scorecard (CVS), which is based on the relative rankings of key sovereign credit fundamentals, signals an indicative ‘AA’ (‘aa’) rating range for the Republic of Malta. This indicative rating range can be adjusted by up to three notches on the Qualitative Scorecard (QS) depending on the size of relative credit strengths or weaknesses versus peers based on analysts’ qualitative findings. For the Republic of Malta, the QS signalled credit weaknesses for the following analytical categories: i) economic policy framework; ii) macro-economic stability and sustainability; iii) market access and funding sources; iv) external debt sustainability; v) vulnerability to short-term external shocks; vi) recent events and policy decisions; vii) banking sector oversight and governance; and viii) financial imbalances and financial fragility. The combined relative credit strengths and weaknesses generate a two-notch negative adjustment and signal a sovereign rating of A+ for Malta.

CVS

Rating indicator	Category weight
Domestic economic risk	**35%**
Real GDP growth	
Real GDP volatility	
GDP per capita	
Nominal GDP	
Inflation rate	
Unemployment rate	
Old-age dependency ratio	
Public finance risk	**30%**
Primary balance	
Interest payments	
Gross debt	
Gross financing needs	
External economic risk	**15%**
External debt	
Currency turnover/reserves	
Net international investment position (NIIP)	
Current account balance	
Institutional and political risk	**10%**
World Bank Worldwide Governance Indicators	
Financial risk	**10%**
Non-performing loans (NPLs)	
Tier 1 ratio	
Credit to GDP gap (bubble)	
Credit to GDP gap (imbalance)	
Indicative rating range	**aa**
QS adjustment	**-2**
Final rating	**A+**

QS

Maximum adjustment = 3 notches

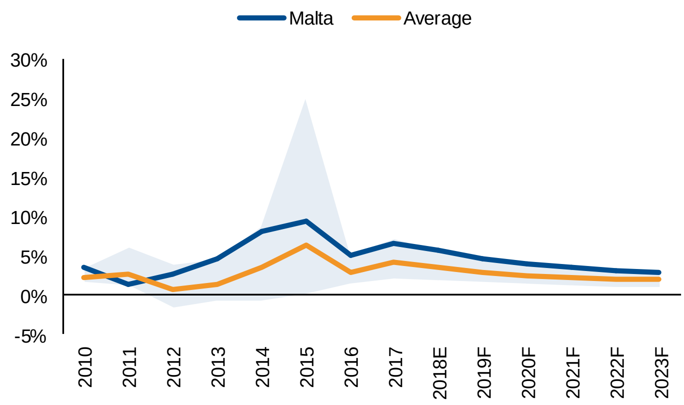
	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Growth potential of the economy	○ Excellent outlook, strong growth potential	○ Strong outlook, good growth potential	● Neutral	○ Weak outlook, growth potential under trend	○ Very weak outlook, growth potential well under trend or negativ
Economic policy framework	○ Excellent	○ Good	○ Neutral	● Poor	○ Inadequate
Macro-economic stability and sustainability	○ Excellent	○ Good	○ Neutral	● Poor	○ Inadequate
Fiscal policy framework	○ Exceptionally strong performance	○ Strong performance	● Neutral	○ Weak performance	○ Problematic performa
Debt sustainability	○ Exceptionally strong sustainability	○ Strong sustainability	● Neutral	○ Weak sustainability	○ Not sustainable
Market access and funding sources	○ Excellent access	○ Very good access	○ Neutral	● Poor access	○ Very weak access
Current account vulnerability	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
External debt sustainability	○ Excellent	○ Good	○ Neutral	● Poor	○ Inadequate
Vulnerability to short-term external shocks	○ Excellent resilience	○ Good resilience	○ Neutral	● Vulnerable to shock	○ Strongly vulnerable to shocks
Perceived willingness to pay	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Recent events and policy decisions	○ Excellent	○ Good	○ Neutral	● Poor	○ Inadequate
Geopolitical risk	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Banking sector performance	○ Excellent	○ Good	● Neutral	○ Poor	○ Inadequate
Banking sector oversight and governance	○ Excellent	○ Good	○ Neutral	● Poor	○ Inadequate
Financial imbalances and financial fragility	○ Excellent	○ Good	○ Neutral	● Poor	○ Inadequate

* Implied QS notch adjustment = (QS notch adjustment for domestic economic risk)*0.35 + (QS notch adjustment for public finance risk)*0.30 + (QS notch adjustment for external economic risk)*0.15 + (QS notch adjustment for institutional and political risk)*0.10 + (QS notch adjustment for financial stability risk)*0.10

Source: Scope Ratings GmbH

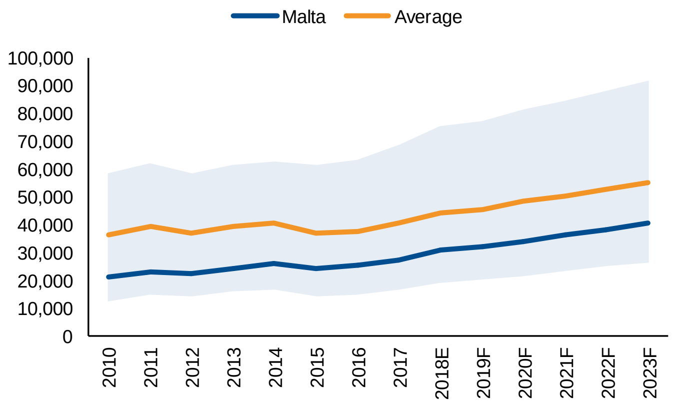
II. Appendix: Peer comparison

Figure 9: Real GDP growth



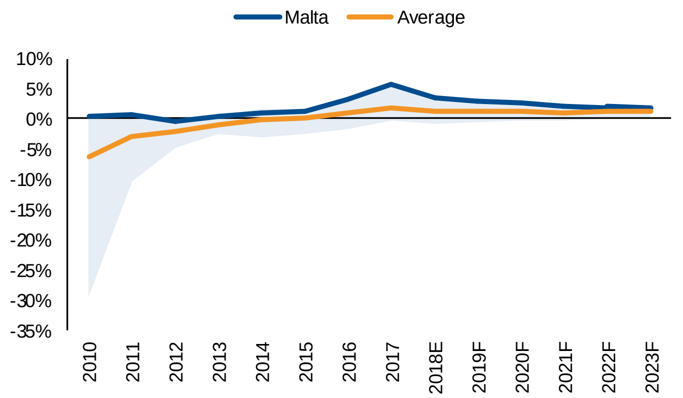
Source: IMF, calculations Scope Ratings GmbH

Figure 10: GDP per capita, USD



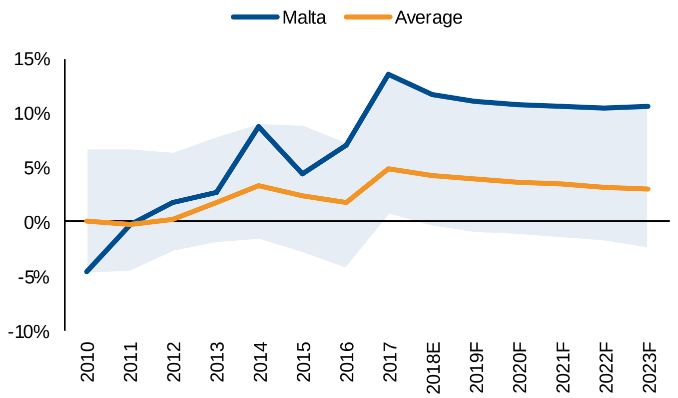
Source: IMF, calculations Scope Ratings GmbH

Figure 11: Primary balance, % of GDP



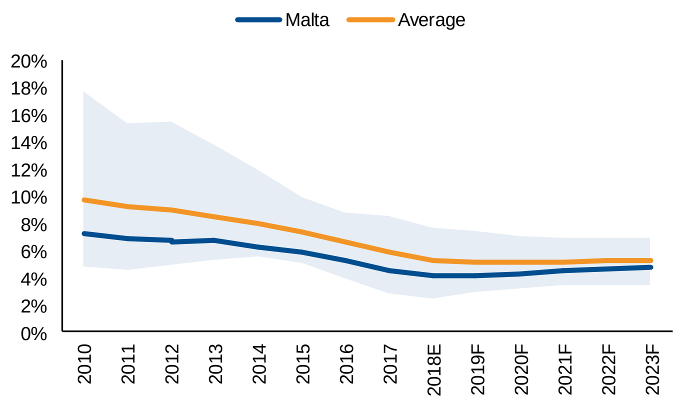
Source: IMF, Calculation Scope Ratings GmbH

Figure 12: Current account balance, % of GDP



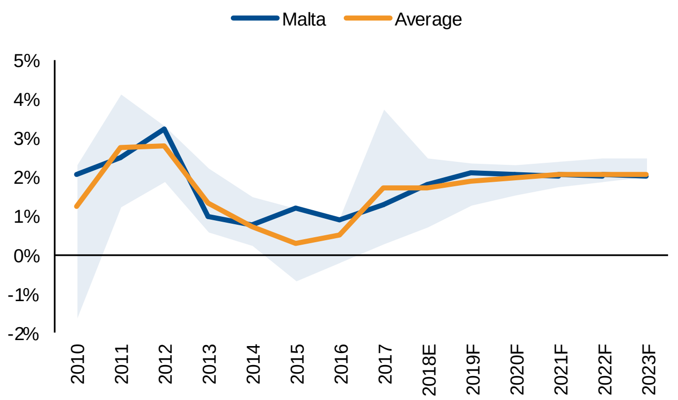
Source: IMF, Calculation Scope Ratings GmbH

Figure 13: Unemployment rate



Source: IMF, Calculations Scope Ratings GmbH

Figure 14: Inflation rate



Source: IMF, Calculations Scope Ratings GmbH

III. Appendix: Statistical tables

	2013	2014	2015	2016	2017	2018E	2019F
Economic performance							
Nominal GDP (EUR bn)	7.6	8.5	9.5	10.2	11.1	12.0	12.9
Population ('000s)	423.0	429.0	440.0	450.0	460.0	467.0	473.0
GDP per capita PPP (USD)	31,063.9	33,229.5	35,787.9	37,363.3	39,534.9	-	-
GDP per capita (EUR)	18,086.5	19,718.4	21,662.0	22,601.5	24,201.1	25,762.6	27,231.0
Real GDP, % change	4.6	8.2	9.5	5.2	6.7	5.7	4.6
GDP growth volatility (10-year rolling SD)	2.1	2.7	3.4	3.3	3.5	3.5	2.5
CPI, % change	1.0	0.8	1.2	0.9	1.3	1.8	2.1
Unemployment rate (%)	6.1	5.7	5.4	4.7	4.0	-	-
Investment (% of GDP)	19.1	17.9	26.7	24.8	19.9	19.9	20.1
Gross national savings (% of GDP)	21.8	26.7	31.2	31.8	33.5	31.6	31.2
Public finances							
Net lending/borrowing (% of GDP)	-2.4	-1.8	-1.1	1.0	3.9	1.7	1.4
Primary net lending/borrowing (% of GDP)	0.4	1.0	1.3	3.1	5.8	3.6	2.9
Revenue (% of GDP)	39.5	39.5	39.0	38.1	40.3	39.8	39.3
Expenditure (% of GDP)	42.0	41.3	40.1	37.1	36.4	38.0	37.9
Net interest payments (% of GDP)	2.9	2.7	2.4	2.1	1.9	1.8	1.6
Net interest payments (% of revenue)	7.3	6.9	6.1	5.6	4.6	4.6	4.0
Gross debt (% of GDP)	68.4	63.7	58.6	56.3	50.7	45.1	41.7
Net debt (% of GDP)	59.0	54.1	50.1	43.7	38.5	-	-
Gross debt (% of revenue)	173.0	161.1	150.4	147.6	125.6	113.4	106.0
External vulnerability							
Gross external debt (% of GDP)	1,111.6	1,104.0	935.2	850.7	808.9	-	-
Net external debt (% of GDP)	-376.7	-301.6	-250.5	-216.0	-205.3	-	-
Current account balance (% of GDP)	2.7	8.8	4.5	7.0	13.6	11.6	11.1
Trade balance (% of GDP)	-	-13.4	-19.6	-18.3	-14.3	-14.4	-14.5
Net direct investment (% of GDP)	-92.1	-80.1	-93.5	-81.5	-82.0	-	-
Official forex reserves (EOP, EUR m)	262.3	365.9	378.6	498.4	553.5	-	-
REER, % change	1.3	0.7	-3.8	1.4	1.2	-	-
Nominal exchange rate (AVG, USD/EUR)	1.3	1.3	1.1	1.1	1.1	-	-
Financial stability							
Non-performing loans (% of total loans)	8.9	7.6	7.1	5.3	4.1	-	-
Tier 1 ratio (%)	43.9	23.6	19.2	18.5	18.9	-	-
Consolidated private debt (% of GDP)	143.9	135.7	122.5	123.5	120.2	-	-
Credit-to-GDP gap (%)	-18.5	-24.2	-29.0	-28.2	-26.2	-	-

Source: IMF, European Commission, European Central Bank, Central Bank of Malta, National Statistics Office, World Bank, Haver Analytics, Scope Ratings GmbH

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