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Research Update:

Malta Ratings Affirmed At 'BBB+/A-2'; Outlook Remains Positive

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Research Update:

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Overview

- We project that the Maltese economy will expand by 2.8% annually in real terms during 2016-2018.
- We expect budgetary consolidation to continue, bringing net general government debt down to 54% of GDP in 2018, from 57% in 2014.
- Malta's current account has turned from historically persistent small deficits to consistent surpluses, which we expect will reduce external vulnerabilities.
- We are affirming our 'BBB+/A-2' ratings on Malta.
- The outlook is positive, reflecting a one-in-three likelihood of an upgrade within the next 18 months.

Rating Action

On Jan. 8, 2016, Standard & Poor's Ratings Services affirmed its 'BBB+/A-2' long- and short-term foreign and local currency sovereign credit ratings on Malta. The outlook remains positive.

Rationale

The ratings on Malta are supported by our assessment of the country's economic growth prospects and gradual budgetary consolidation, which we expect will place the government's debt-to-GDP trajectory on a steady downward course. At the same time, the ratings are constrained by what we view as moderate contingent liabilities and a relatively low degree of economic diversification compared with eurozone peers.

Malta's real GDP grew by 4.5% in 2015, by our estimate, and we project that it will expand by 2.8% annually on average in 2016-2018. We believe Malta's economic growth will continue to outpace that of the eurozone as a whole, driven by strong investment in the energy sector and growth in consumption, underpinned by wage growth, employment growth, steady net migration, the decline in oil prices, and moderate inflation. Lastly, consumption trends are also supported by an increased participation in the labor market by women and older people, which until recent years lagged well behind the large majority of eurozone peers. The total employment rate in Malta among 20-to-64-year-olds has increased to 66.3% in 2014 from about 57% in 2005.

Energy investments, most of them frontloaded to 2015, include the laying of an electricity interconnector cable to Sicily, as well as the building of a liquefied natural gas terminal, a natural gas plant, and the conversion of an oil-fired power plant to gas. Coupled with lower global energy prices, we believe that these investments will not only reduce Malta's import bill, but will also improve the business environment in Malta as access to electricity eases. In expectation of

lower energy prices, the government has mandated 25% cuts to utility tariffs, which have provided further support to private consumption. Beyond 2016, further diversification of the economy--particularly into information and communication technology, education, and medical tourism--could support further investment activity.

Malta's tax regime has attracted significant foreign investment into the country's banking, insurance, and IT industries, implying that the economy would be sensitive to a eurozone-wide standardization of corporate tax regimes. In addition, the business environment in Malta is still constrained by Malta's judicial framework, leading to slow contract enforcement. Despite this problem, we see the overall political and institutional framework of Malta as broadly supportive of the ratings.

On the external side, we view Malta as an open, services-oriented economy. Since 2007, the services surplus has doubled, with the size of services receipts and payments in 2014 having increased to 3.7x and 4.7x their 2007 levels, respectively, reflecting both actual flows and balance of payments methodology changes. Maltese service exports consist principally of financial services, transportation, tourism, and remote gaming; we project that tourism will continue to perform well on the back of a favorable euro/pound sterling exchange rate and a more challenging security situation in competing tourist destinations to the south and the east. Over our 2016-2018 forecast horizon, we expect that Malta will run a current account surplus on the back of improving trade and service balances. We see this as a structural shift from the pre-2012 situation of small but consistent deficits, and we see the strength of the service sector as a key driver of this change.

The methodology for calculating Malta's International Investment Position (IIP) has switched to the new statistical standard of BPM6 for 2013 and 2014 historical data, which creates a break in our series between 2012 and 2013. Under the new methodology, the external debt of the nonbank private sector is calculated at a much higher level than previously, which puts our preferred external indebtedness measure of narrow net external debt at a net liability position of 59% of current account receipts (CARs) in 2015. We continue to see the high level of short-term debt in the banking sector as a potential source of volatility of financial flows, which could undermine Malta's external liquidity. We expect Malta's gross external financing needs to average 326% of CARs plus usable reserves in 2016-2018 and to be stable over the period.

We believe that Malta's favorable economic growth prospects support further budgetary consolidation. We forecast that the general government deficit will decline gradually through 2018, primarily owing to increased tax receipts from strengthening domestic demand and the expected decline in current expenditure growth from 2016 onward. We nevertheless believe that, in the light of likely higher-than-budgeted revenues, the pressure on spending slippages may be difficult to contain.

As a result, we expect net general government debt to decrease to 54% of GDP by the end of 2018, from 57% in 2014. We forecast general government gross debt will be 65% of GDP in 2016, excluding the guarantees related to the European Financial Stability Facility (EFSF; see "S&P Clarifies Its Approach To Accounting For EFSF Liabilities

When Rating The Sovereign Guarantors," published Nov. 2, 2011, on RatingsDirect). We forecast general government interest payments will average 6% of general government revenues per year over 2016-2018.

Malta's contingent fiscal liabilities stemming from nonfinancial public enterprises (NFPEs) derive mostly from government-guaranteed debt of power utility Enemalta (estimated at about 9.5% of GDP in 2015). Enemalta will likely not generate profits until 2017, but we note that the current drop in international oil prices is helping its expected return on investments. Other state-owned enterprises also represent fiscal risks, as exemplified by this year's government financial support to Air Malta, estimated at 0.5% of GDP. Government guarantees of NFPEs' debt totaled 14.3% of GDP according to the latest 2015 data. Moreover, we note that without further reforms in the pension and health care systems, the progress in budgetary consolidation will become strained in the medium and long term. That said, the improvement in labor force participation, as well as ongoing economic growth, have led to improvements in the sustainability of the social security system.

Under our criteria, we see contingent fiscal risks to public finances coming from the banking sector. Malta's domestic banking sector operates alongside a large offshore sector that we believe the government would not support in case of financial distress. However, dislocations in the funding of this sector could affect the island's reputation as a financial center and potentially weaken its growth prospects. Nevertheless, these operations do not significantly affect the rest of the financial sector, as exemplified by the October 2015 decision by Deutsche Bank to close its operations on Malta (and in several other jurisdictions) and related repatriation of €4.2 billion (equivalent to about 50% of Malta's GDP). Assets of the total banking sector are over 6x GDP, while assets of core domestic banks amounted to about 2.5x GDP in June 2015. The largest domestic systemically important banks are 25% state-owned Bank of Valleta (total assets of €9.9 billion in September 2015) and HSBC Malta Bank (total assets of €5.9 billion in June 2015), as well as fast-growing Mediterranean Bank (total assets of €2.4 billion in September 2015), which in 2015 joined the former two under the European Central Bank's supervision. Malta's Depositor Compensation Scheme (DCS) is financed by cash contributions and assets pledged by all banks licensed by the regulator (the DCS fund accounts for 1.3% of covered deposits as of June 2015, compared with the EU minimum requirement of 0.8%). Because the DCS is a timely (20-day) deposit guarantee covering household and corporate deposits up to €100,000 across 27 licensed financial institutions, Malta's central government would likely have to provide substantial bridge financing to the DCS to cover any shortfall financing for depositors' claims in the unlikely event that a regulated institution suffered difficulties.

Among core domestic banks, nonperforming loans (NPLs) represented 8.6% of total loans in the first half of 2015, which remains a challenge for the economy, despite a recent decline due to acceleration in credit activity. Almost half of NPLs are in the construction and commercial real estate sectors. Core domestic banks' aggregate loan loss provisioning rose to 45.9% as of end-June 2015, which we still consider low. Indeed, banks take a while to realize collateral in Malta, a characteristic that we regard as common to small jurisdictions.

Membership in the eurozone anchors Malta's monetary policy and provides its banks access to funding at low nominal interest rates. Nevertheless, we believe that membership in a monetary union increases the onus on member governments to support competitiveness through fluid labor, product, and services markets, and to build up fiscal buffers against future shocks. This is more the case now than a year ago, given that the ECB is undershooting its medium-term price stability target of close to, but lower than, 2% for the eurozone as a whole. Despite increases in unit labor costs, we have not observed a deterioration in the current account, which often accompanies such losses of competitiveness.

Outlook

The positive outlook reflects our opinion of at least a one-in-three likelihood of an upgrade within the next 18 months if medium-term growth continues without a return to current account deficits or emergence of other macroeconomic imbalances. We could also raise the ratings if fiscal consolidation advances faster than we currently expect, including further improvements in budgetary sustainability--for example, progress on pension and healthcare funding reform measures--while the risk of materalization of contingent liabilities diminishes.

We could revise the outlook to stable if, all else being equal, we observe that economic growth prospects are weakening, the government's budgetary position fails to improve as expected (because, for example contingent liabilities materialize), or risks to the economy's external position increase. We could also revise the outlook to stable if we saw a deterioration in the performance of the financial sector, such as significantly worsened asset quality or profitability, which could have a material negative impact on the transmission mechanism and economic growth.

Key Statistics

Table 1

Republic of Malta Selected Indicators

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. €)	6.1	6.6	6.9	7.2	7.5	7.9	8.5	8.9	9.4	9.8
Nominal GDP (bil. $)	8.6	8.7	9.6	9.3	10.0	10.6	9.4	9.5	10.0	10.4
GDP per capita (000s $)	20.8	21.1	23.1	22.2	23.7	24.8	22.0	22.1	23.0	23.9
Real GDP growth	(2.5)	3.5	2.1	2.5	2.6	3.5	4.5	3.2	2.7	2.6
Real GDP per capita growth	(3.2)	2.8	1.9	1.9	1.7	2.6	3.8	2.5	2.2	2.1
Real investment growth	(11.8)	26.4	(18.3)	4.5	(0.7)	9.1	21.0	(5.0)	1.0	1.0
Investment/GDP	20.8	23.6	19.3	17.8	17.1	18.4	21.8	20.1	19.7	19.4
Savings/GDP	14.2	19.0	16.9	19.1	20.8	21.1	23.5	23.2	22.4	21.9
Exports/GDP	147.7	153.3	159.4	164.6	157.3	149.4	145.8	145.0	144.7	144.5
Real exports growth	(0.4)	6.9	2.3	7.0	(0.2)	(0.3)	2.0	3.1	3.5	3.5
Unemployment rate	6.9	6.9	6.4	6.3	6.4	5.9	5.8	5.6	5.5	5.5

Table 1

Republic of Malta Selected Indicators (cont.)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(6.6)	(4.7)	(2.5)	1.3	3.7	2.7	1.7	3.1	2.6	2.5
Current account balance/CARs	(2.2)	(1.7)	(0.8)	0.4	1.2	1.0	0.6	1.1	0.9	0.9
Trade balance/GDP	(18.2)	(19.0)	(17.5)	(15.4)	(14.7)	(14.0)	(14.2)	(13.7)	(13.6)	(13.6)
Net FDI/GDP	88.1	68.3	129.5	127.0	93.4	85.8	80.0	80.0	75.0	75.0
Net portfolio equity inflow/GDP	(103.2)	(73.8)	(168.6)	(129.3)	(116.8)	(156.0)	(40.0)	(100.0)	(100.0)	(100.0)
Gross external financing needs/CARs plus usable reserves	251.8	249.2	232.5	234.2	235.6	307.9	329.4	331.5	326.2	320.2
Narrow net external debt/CARs	(16.5)	(47.9)	(35.6)	(43.7)	53.2	58.2	59.2	62.8	65.2	67.3
Net external liabilities/CARs	(4.5)	(3.6)	(1.9)	(7.2)	(8.4)	(13.7)	(16.3)	(18.0)	(18.9)	(19.7)
Short-term external debt by remaining maturity/CARs	153.3	153.1	135.9	138.8	142.4	215.1	237.6	240.2	234.5	228.0
Reserves/CAPs (months)	0.2	0.3	0.2	0.2	0.3	0.2	0.3	0.3	0.3	0.3
FISCAL INDICATORS (%, General government)										
Balance/GDP	(3.3)	(3.2)	(2.6)	(3.6)	(2.6)	(2.1)	(1.7)	(1.3)	(1.1)	(1.0)
Change in debt/GDP	5.2	4.6	4.8	1.6	4.5	2.4	1.2	2.9	1.5	1.5
Primary balance/GDP	(0.0)	(0.1)	0.6	(0.6)	0.3	0.8	0.9	1.1	1.3	1.4
Revenue/GDP	38.6	37.9	38.3	38.9	40.0	41.9	42.2	40.1	40.0	39.8
Expenditures/GDP	41.9	41.1	40.9	42.5	42.6	44.0	43.9	41.4	41.1	40.8
Interest /revenues	8.5	8.1	8.2	7.7	7.3	6.9	6.2	5.9	6.0	6.1
Debt/GDP	67.8	67.6	69.5	68.1	69.7	68.5	65.3	64.9	63.5	62.1
Net debt/GDP	58.7	56.7	57.0	56.1	57.6	57.0	56.2	56.2	55.2	54.2
Liquid assets/GDP	9.1	11.0	12.5	12.0	12.1	11.5	9.1	8.7	8.3	7.9
MONETARY INDICATORS (%)										
CPI growth	1.8	2.0	2.5	3.2	1.0	0.8	1.0	1.5	1.8	2.0
GDP deflator growth	2.7	3.8	2.3	2.0	1.9	1.8	2.3	2.0	2.0	2.0
Banks' claims on resident non-gov't sector growth	5.1	6.0	5.4	1.7	0.0	7.2	2.0	3.0	3.0	3.0
Banks' claims on resident non-gov't sector/GDP	129.2	127.4	128.5	125.0	119.6	121.6	116.0	113.5	111.6	109.9
Foreign currency share of claims by banks on residents	0.8	4.2	4.1	3.7	3.4	2.3	3.0	3.0	3.0	3.0

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. The data and ratios above result from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Republic of Malta Ratings Score Snapshot

Key rating factors	
Institutional assessment	Neutral
Economic assessment	Neutral
External assessment	Neutral
Fiscal assessment: flexibility and performance	Strength
Fiscal assessment: debt burden	Weakness
Monetary assessment	Neutral

Standard & Poor's analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of Standard & Poor's "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with Standard & Poor's sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 23, 2014
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009

Related Research

- Credit Conditions: Growth In Europe Is On Track, But Geopolitical Risks Have Risen- December 02, 2015
- Economic Research: Eurozone Recovery: Hangin' In There Despite Weak Foreign Demand - November 25, 2015
- Economic Research: The Eurozone's Housing Markets Are On The Mend, Thanks To QE - November 13, 2015
- Outlook On Malta Revised To Positive On Economic Growth And Fiscal Consolidation Prospects; 'BBB+/A-2' Ratings Affirmed - July 10, 2015.
- Maltese Power Utility Enemalta 'B+' Rating Affirmed On Ongoing Restructuring; Outlook Stable - March 13, 2015
- Default, Transition, and Recovery: 2014 Annual Sovereign Default Study AndRating Transitions - May 18, 2015
- Why Record-Low Interest Rates On Eurozone Government Bonds Are Unlikely ToLead To Sovereign Upgrades - May 7, 2015

- Four Reasons Why QE Won't Restore Eurozone Growth - March 19, 2015

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that external risk assessment had improved. All other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ratings List

	Rating	
	To	From
Malta (Republic of)		
Sovereign credit rating		
Foreign and Local Currency	BBB+/Positive/A-2	BBB+/Positive/A-2
Transfer & Convertibility Assessment	AAA	AAA
Senior Unsecured		
Local Currency	BBB+	BBB+
Short-Term Debt		
Local Currency	A-2	A-2
Malta Freeport Corp. Ltd.		
Senior Unsecured		

Ratings List Continued...

Foreign Currency[1]	BBB+	BBB+

[1] Dependent Participant(s): Malta (Republic of)

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