Creditreform Sovereign Rating

Creditreform Rating

Rating Object	Rating Information	
REPUBLIC OF MALTA	Assigned Ratings/Outlook: **A+ /positive**	Type: Monitoring, unsolicited
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	25-11-2016 22-11-2019 “Sovereign Ratings” “Rating Criteria and Definitions”

Rating Action

Neuss, 22 November 2019

Creditreform Rating has revised its outlook on the Republic of Malta to “positive” from “stable” and affirmed the unsolicited long-term sovereign rating of “A+”. Creditreform Rating has also affirmed Malta’s unsolicited ratings for foreign and local currency senior unsecured long-term debt of “A+”.

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Key Rating Drivers

1. Exceptionally strong economic activity remains a key strength, as real GDP growth is set to soften but remain resilient and post well above the euro area average, buttressed by robust domestic demand and a well-performing labor market
2. Relatively wealthy economy which benefits from the structural transformation towards growing export-oriented service industries, but robustness through the economic cycle is awaiting to be tested; significant catching-up potential regarding its business environment and susceptibility to external shocks
3. In spite of generally high quality of institutional conditions, deficiencies in the judicial system and in combatting corruption persist; while we acknowledge ongoing government efforts, we still have some reservations concerning AML/CFT issues and challenges related to supervision, also echoed by IMF FSSA and Moneyval reviews
4. Significant headway in fiscal consolidation; thanks to robust nominal GDP growth, declining interest expenditure and sound fiscal policies, favorable debt trend should remain in place, and debt affordability is likely to improve further; fiscal risks pertaining to sustainability of corporate income tax proceeds
5. External vulnerabilities, volatile and relatively frequently revised current account, but risks balanced by NIIP which is set to remain highly positive due to sustained, though narrowing, current account surpluses

Reasons for the Rating Decision

Creditreform Rating has affirmed its ratings on the Republic of Malta at “A+”, which reflect a low probability that the sovereign will not meet its financial obligations fully and on time.

The ratings are underscored by a strong macroeconomic performance profile, the ongoing improvement in the sovereign's fiscal position and balanced external risks, while there is room to improve institutional conditions.

The outlook on the Republic of Malta was lifted to positive, buttressed by our expectation that (i) Malta will continue to show a strong growth performance, with real GDP remaining solid over the next few years; (ii) the Maltese labor market will continue to evolve favorably; and (iii) the debt-to-GDP ratio will remain on its firm downward path, supported by resilient economic growth and sustained primary surpluses.

Macroeconomic Performance

Our credit assessment reflects Malta's favorable macroeconomic performance profile which is underpinned by relatively high per capita incomes and buoyant economic growth supported by the well-performing labor market. The profile has to be qualified to some extent, as the small open economy's external vulnerability and impediments to its business environment weigh on economic resilience and flexibility, while the structurally changing business model's robustness through the economic cycle and towards external shocks is as of yet untested.

Malta's macroeconomic performance continues to be facilitated by high wealth levels. As signaled by most recent IMF data, Malta continues to post a GDP per capita in PPP terms well above the median of our A-rated sovereigns of USD 35,939, totaling USD 45,164 in 2018, up from 42,675 a year before – -surpassing the weighted EU average by 5%. Being almost on par with major European economies such as the UK and France (USD 45,893 and 45,741), Malta seems more aligned with our AA median of USD 46,244.

Rising per capita incomes have been driven by exceptionally vivid economic growth over recent years. Malta's real GDP expanded by 6.8%, almost the same rate as in 2017 when total output rose by 6.7%. Hence, Malta was the second fastest growing economy in the EU-28, significantly faster than the euro area as a whole (2018: 1.9%) and displaying an impressive 5-year-average of 7.7% since 2014 –outpaced only by Ireland on that account.

Domestic demand took over the growth baton last year, with consumption being the main growth engine. Building on vivid employment and wage growth, private consumption hit the highest growth rate on Eurostat records (7.3%) after having already expanded by 3.0% p.a. in 2013-17. Whilst private household spending contributed a very high 3.3 p.p. to real GDP growth, general government expenditure also evolved dynamically, rising by 12.6% on the year, reflecting higher public investment and public wages and lower intakes from the Individual Investor Program (Eurostat data). Meanwhile, gross fixed capital formation continued to drag on growth, though to a lesser extent than in the year before, as investment activity fell by 1.8% (2017: -7.2%). The decline is largely owing to base effects, as 2015 saw investment growth jolting by 55.6%. Still, gross fixed capital formation was maintained at 19.0% of GDP as compared to an annual average of 19.9% in 2008-17.

Weaker external demand amidst sharply slowing global economic activity, rising trade and geopolitical tensions weighed on Malta's export of goods (-0.4%), while export of services growth held up quite well (2018: 3.3%, 2017: 3.6%). As a result, growth in export of goods

and services halved from 4.8 to 2.6% in 2017-18. Since import growth rose to 2.6% (2017: -0.4%), mainly due to significantly rising imports in the category 'minerals, fuels and lubricants' (+9.7%), net external trade made a moderate growth contribution of 0.5 p.p.

With a view to this and next year, we expect real GDP growth to fall to a still high 4.9% in 2019 before decelerating further to 4.1% in 2020. We thus assume economic prospects will remain favorable and growth will continue to outpace most other EU-28 members, although prospectively moderating as the Maltese economy will not be able to decouple from the international environment, and mirroring that it may have passed its cyclical peak. This is also underscored by quarterly national accounts data, according to which real GDP increased by annual rates of 5.2 and 4.0% in the first and second quarters 2019 (1Q18: 5.0%, 2Q18: 6.9%), with Q2 marking the lowest reading since 4Q13.

In this context, we have to highlight that our expectations are framed by our belief that the UK will not leave the EU without a deal. The economic fallout of a disorderly Brexit could be severe in some sectors given the economy's strong tourism linkages with the UK and, to a lesser extent, the presence of financial linkages. More recent research by Central Bank of Malta staff (forthcoming) indicates that trade links with the UK have diminished over time and financial exposures may have less detrimental effects than previously assumed. While the EU and the UK have reached a new agreement, tail risks remain in place as the UK's parliament has so far refused to endorse the agreement.

Net external trade is likely to act as a drag on growth, as external headwinds such as weaker growth in Malta's main trading partners, persistently high economic and political uncertainty, and the weaker external environment more generally should continue to dampen export growth. According to the IMF, the global trade volume virtually stagnated in 1H19. Soft indicators such as export expectations and new orders in the industry sector hint at modest export growth going forward. Indeed, industry new orders have fallen to the lowest level since 2009. While we see services exports as remaining supportive to growth, key industries such as tourism have also witnessed some moderation more recently. To be sure, tourism should remain strong, but the inflow of tourists has pulled back more recently. Tourist arrivals in the first eight months of 2019 exceeded last year's level by 4.7% as opposed to an annual 15.7% growth between January and August 2018, and the growth rate of the rolling 6-month-sum points in the same direction. Concurrently, import growth will presumably pick up, fostered by more dynamic investment activity.

Gross fixed capital formation should be conducive to growth this year and next, benefiting from large private and public tourism, real estate, and healthcare projects. We deem the national accounts data outturn for the first half of the year constructive in this respect, with total construction investment rising by 22.4 and 18.4% y-o-y in Q1 and Q2. Furthermore, building permits on new dwellings have continued to increase significantly. In 2018, the number of issued permits leapt by another 13.7%, following 16.4% a year before (Planning Authority data). In addition, EU cohesion data suggests that European Structural and Investment Fund financing can be expected to aid public investment activity going forward, as 89% of the financial resources had been allocated to selected projects at the end of 2018 as compared to 50% at the end of 2017 (12-Nov-19: 92%).

Private consumption is set to remain the most important growth pillar, while public consumption expenditure should slow down but also stay healthy. Private household spending growth will be buttressed by the strong labor market development, implying continued employment growth. Wage growth should be sustained, while inflationary pressures are likely to remain moderate in the near term, with positive ramifications for households' purchasing power. Consumer confidence has somewhat deteriorated over the last twelve months but is still upbeat from a historical perspective. By the same token, we do not view the recent slowdown in annual household spending as concerning, but rather as a normalization after the exceptionally strong year 2018.

Labor market conditions have continued to develop favorably since our last review. The annual LFS adjusted unemployment rate decreased from 4.0% in 2017 to 3.7% in 2018, corresponding to one of the lowest readings in the EU-28. Declining redundancies were accompanied by a rising labor supply, as Malta's labor participation rate has continued on its upward trajectory, and was up from 72.2% in 2017 to 74.7% this year (EA-19: 73.5%). According to national accounts data, last year's annual employment growth equated to 5.3%, the fastest growth in the EU-28. We note that Malta displays some weaknesses as regards equal opportunities and access to labor on the EU's Social Scoreboard.

Although we expect employment to grow at a slower pace, the labor market has shown no signs of weakness yet. Employment has been expanding by at least 4.0% y-o-y for 13 consecutive quarters (unadjusted data, 2Q19: 6.2%). Labor input is thus likely to support the economy's trend growth, as should capital accumulation on the back of rebounding private and public investment activity. Judging by EU Commission forecasts, Malta will record the highest potential growth in the EU-28 over 2019-21. Against this background, brisk inward migration has to be mentioned as one of the most salient features of the development of Malta's labor market over the recent years. Malta's crude rate of net migration (plus statistical adjustment, Eurostat) was extraordinarily high over the last five years, surpassing the readings of all other EU-28 members by a substantial margin (2014-18: 25.9% p.a., EA-19: 2.8% p.a.). Since 2014, foreign citizens have increasingly buttressed employment growth, accounting for 65% of total employment growth in 2018 (15-64y, detailed LFS data). The share of foreign workers in total employment increased from 10 to 21% over that period.

At the same time, capacity constraints have to be followed closely. In the event that the foreign labor influx abates and labor demand remains high, labor and skills shortages may curtail the economy's potential growth and competitiveness. According to Eurostat survey data, the Maltese share of enterprises citing labor shortages as a factor limiting production is extremely high and among the highest in Europe – this applies to the industry (3Q19: 35.7%), construction (Oct-19: 50.3%), and service sectors (3Q19: 35.4%).

Foreign labor has helped to prevent the labor market from becoming even tighter, allowing wages to increase without putting too much pressure on Malta's cost competitiveness. As illustrated by one of our preferred measures, real unit labor costs (ULC) have continued to evolve more favorably than in Malta's main trading partners and the euro area as a whole (AMECO data). Stagnating real compensation per employee was met by moderately increasing labor productivity, leading to a real ULC decline of 1.1 and 2.6% as compared to the year before and 2015 respectively (EA-19: +0.5 and +0.1%). Nominal wages are set to

rise given increasingly tight labor markets, as mirrored by further falling quarterly unemployment rates (3Q19: 3.4%, 3Q18: 3.6%); however, we expect wage and productivity developments to remain broadly aligned.

Having said this, cost competitiveness appears to be somewhat challenged by recent real effective exchange rate (REER) movements. The CPI-based REER (Eurostat, 37 partners) has picked up over the last three years (2015-18: +4.2%), faster than in most of its main trading partners. Perhaps more importantly, we see several obstacles on the non-cost competitiveness side which are also well documented by the 2020 edition of the Doing Business Report. The World Bank thus sees ample room for Malta to improve its business environment, ranking the country at 88 out of 190 economies, meaning that Malta is outperformed by most other European countries. Standing out in particular is weak performance regarding registering property (152) and resolving insolvency (121). Malta also ranks behind most euro area countries in terms of the World Economic Forum's Global Competitiveness Index, with a rank of 38 out of 141 economies – also pointing to some catching up-potential, most importantly with a view to infrastructure (rank 47), business dynamism (73), and innovation capability (37). Notwithstanding, Malta's global export market was stable, coming in at 0.08% in 2018 (2017: 0.08%), while the global services export share has increased steadily over the last few years, reaching 0.3% in 2018.

As elaborated during our past reviews, Malta, as a small and very open economy, is susceptible to external shocks. International trade accounts for approx. 269% of GDP, the fifth-highest reading in the world (2018, IMF data). Its economy is going through a significant structural transformation process which has resulted in a very prominent role for services industries, in particular remote gaming, tourism, and business services. In this context, the sector 'art, entertainment, recreation' saw a further increase in the share of total gross value added (GVA) from 15.3 to 15.7% in the year up to 2Q19 (EU-28: 3.3%). In trying to pinpoint the gaming industry, we refer to Malta Gaming Authority, which puts the direct GVA share at 13.1% in 2018 (2017: 12.7%). Tourism revenues, as approximated through travel receipts taken from BOP data, accounted for 14.5% of total GVA or 12.7% of GDP in 2018. We acknowledge that this structural rebalancing has buttressed the very strong macroeconomic performance, translating into vividly rising per capita incomes as well as very high current account surpluses (see below). Nevertheless, the robustness through the economic cycle and towards external shocks is as yet untested.

Institutional Structure

We continue to assess Malta's institutional quality as generally high. The sovereign draws significant benefits from its EU and euro area membership, including advantages related to the common currency, namely broad and deep capital markets and the euro's reserve currency status, financial support via EU funds, and the adoption of common standards and rules. Economic developments in Malta may, however, have only a limited impact on the ECB's monetary policy decisions. More recently, HICP inflation has been better synchronized with euro area developments, while the longer-term track record appears less favorable. MFI interest rates and wages are generally not that closely aligned with euro area developments.

The World Bank's Worldwide Governance Indicators (WGIs), our preferred measure of good governance, reveal that Malta's institutional setup is broadly aligned with the median of our A-rated sovereigns, while standing well below the respective euro area averages – signaling significant room for improvement. Moreover, from a closer look into the latest WGI edition, the overriding impression is that the sovereign's institutional conditions have somewhat deteriorated as compared to last year. As regards the WGI government effectiveness, which captures the capacity to formulate and implement sound policies, Malta dropped from rank 41 to 45 out of 209 economies. At a median rank of 35, other euro area countries compared more favorably last year, while the A-rated sovereigns within our rating universe were almost on par (rank 44). With regard to the indicator gauging the perception of the extent to which public power is exercised for private gain, we observe that Malta's score has slipped to its lowest level since 1998. Ranked 60th in this category, the country noticeably lagged behind fellow euro area members (median rank of 41). When it comes to the WGIs rule of law (38) and voice and accountability (34), the sovereign also underperforms the respective euro area averages (32 and 25 respectively).

Turning to the World Economic Forum's (WEF) Global Competitiveness Report, we note that a somewhat less favorable result within the 'institutions pillar' contributed to the deterioration in the overall ranking (see above), with lower readings in six out of eight sub-categories including checks and balances and transparency. This notwithstanding, Malta maintained its middle-ranking position among EU members (rank 41, median 31). Tying in with this, as described further above, the World Bank's Ease of Doing Business monitor continues to point to impediments in Malta's business environment.

We still have some reservations pertaining to the combating of money laundering (ML) and financing of terrorism, as well as remedying still existing deficiencies regarding banking supervision, including the effective enforcement of the AML/CFT framework, which may have increasing adverse reputational effects on Malta's financial sector going forward. These concerns were also echoed by the IMF during its Financial System Stability Assessment earlier this year. To this end, the IMF pointed to the importance of limiting financial integrity risks, stretched resources on the part of the financial regulator, questions centered around its operational independence, as well as risks relating to activities in the crypto-asset realm and remote gaming.

In the same vein, we took note of the 2019 MONEYVAL report, which highlights remaining shortcomings in Malta's AML/CFT framework, in particular concerning supervision, ML investigation and prosecution, and confiscation. In particular, we take away that the FIAU disseminations are rarely used to develop evidence and trace criminal proceeds related to ML. Designated non-financial businesses and professions could improve their knowledge of how ML could occur. In our view somewhat concerning, the evaluation suggests there is a shortage of both financial and human resources to comprehensively engage in AML measures.

Nevertheless, we acknowledge ongoing government efforts to address the identified shortcomings. Legislative amendments aiming at strengthening the MFSA's efficiency and effectiveness were enacted this year, while FIAU implemented a detailed action plan to enhance its supervisory functions and procedures. Moreover, MFSA's as well as FIAU's staffing are

in the process of being significantly ramped up. Authorities announced a set of measures including the creation of a new agency dedicated to investigating and prosecuting the most serious cases of ML and financial crime, as well as the separation of critical functions of the Attorney General. We understand that full implementation is envisaged for 2020. Also, Malta implemented ATAD I last year, while ATAD II may come into effect next year. Malta has also fully implemented AML4 and is working towards implementing AML5 before January 2020.

We are aware of remaining reservations about investor citizenship schemes on behalf of the EU Commission more generally, as mirrored by the EU Commission report on Investor Citizenship and Residence Schemes in the European Union dating from January 2019. The Commission thus concludes that these pose risks in terms of ML, corruption, circumvention of EU rules, and tax evasion, while drawing attention to deficiencies in governance and the transparency of such schemes. That said, we assess as favorable Malta's firm commitment to a responsible approach towards the Individual Investor Program (IIP), to which a comparatively high share of applicant rejections may pay testimony.

Accelerating judicial procedures remains a work in progress, as Malta remains among those EU countries with the longest time span needed to resolve civil, commercial and administrative cases. Nevertheless, we see that the country managed to further reduce the time needed to resolve civil, commercial and administrative cases in the reference year 2017, from 446 to 331 days – less than half the time needed in the year 2010.

Fiscal Sustainability

We continue to view Malta's public finances as a credit strength given the moderate debt level, favorable debt trend, and prospects of improving debt affordability. Still, sustainability of corporate income tax receipts may be questioned, representing a key fiscal risk, while contingent liability risks stemming from large but declining public guarantees subside.

Following a large fiscal headline surplus of 3.4% of GDP in 2017, the government again outperformed its fiscal target for 2018. Malta thus achieved a headline surplus of 1.9% of GDP as opposed to the target of 1.1% stipulated in the SP 2018, owing to vivid tax revenues, IIP proceeds, declining interest outlays, and lower-than-expected social payments.

Last year saw significantly faster spending growth of 11.7% as compared to total revenues, which rose by 7.3%. While dampened by lower interest expenses, the sharp increase on the spending side (+0.8% of GDP) was mainly due to capital transfers and public investment that rose by 71.0 and 40.7% in 2017-18 respectively, or as measured by GDP, from 0.9 and 2.4% to 1.4 and 3.1% of GDP. The public wage bill also grew significantly (+8.3%), but slower than nominal GDP, resulting in a decline of 0.1% of GDP. The revenue side benefited from IIP proceeds, which contributed approx. 1.5% of GDP. At the same time, dynamic private household spending and inbound tourism led to swiftly increasing taxes on production and imports, mainly coming on the back of a brisk VAT intake which increased by 0.3% of GDP or 13.5% in absolute terms. Also, taxes on income and wealth and net social security increased by 5.1 and 6.2% respectively.

We expect public finances to remain healthy in 2019 and 2020, with the headline surplus narrowing to 1.3 and 1.2% of GDP, mainly reflecting softening but resilient economic activity and government plans to address structural bottlenecks and foster more inclusive growth.

Redistribution measures and initiatives geared towards supporting pensioners, families with children, and vulnerable groups have to be mentioned first. The budgetary impact of measures to address housing affordability, pension adequacy, aiding vulnerable individuals, including e.g. an increase in COLA, higher food and pension allowances, old age benefits, and disability pensions, is estimated at approx. 0.4% of GDP in 2019/20. In addition, policy-makers have envisaged benefits for families and education, such as the child bonus and the extension of the school transport network. The government also continues to implement its strategy of investing in the economy's infrastructure and healthcare system. Accordingly, a host of projects will be financed by the National Development and Social Fund.

Meanwhile, we assume that robust economic growth and the well-performing labor market will provide for solid income growth and product tax receipts, as well as higher social security contributions. Our expectations are corroborated by the data outturn for the consolidated fund balance in 2019. In the first nine months, revenues increased by 14.0% y-o-y, propelled by surging income taxes (+14.9%) and social security contributions (+9.9%). Expenditure rose by 12.8% as compared to the same period in the previous year, translating in a positive balance up to September 2019 which equated to EUR 37.9mn (Jan-Sep 2018: EUR 3.1mn). Revenues should be somewhat curbed by the VAT directive on e-commerce, while the extension of the reduced rate of stamp duties for first- and second-time buyers of residential property, the reduction in tax rates on overtime work, and tax refunds for low income earners and pensioners will have a rather minor impact. While difficult to forecast, IIP proceeds should come in at approx. 1% of GDP this year before increasing again in 2020.

Against this backdrop, we assume that general government debt will continue to follow its firm downward path going forward. Thanks to robust nominal GDP growth, declining interest expenditure, and sound fiscal policies, gross debt is set to fall below 40% of GDP by 2021 at the latest. In 2018, Malta's public debt ratio edged down sharply, declining from 50.3% of GDP in 2017 to 45.8% of GDP. Hence, Malta's debt-to-GDP ratio stood somewhat below our 'A' median of 49.2%, and displays the most rapid decline since 2013 (excluding Ireland).

We view fiscal risks as broadly contained. IIP proceeds represent an upside and downside risk, as these are subject to heightened uncertainty. Public guarantees, mainly related to the State's heavy SOE engagement, continue to decline. According to Central Bank of Malta staff (CBM) data, contingent liabilities dropped from 9.5% to a still high 8.7% of GDP in 2017-18 and fell further to 8.4% of GDP at the end of the first half of 2019.

Risks entailed by the very large banking sector (2Q19: 336% of GDP) appear limited at this stage, although the residential property market and the increasing complexity of the large and interconnected financial sector have to be followed closely. As signaled by EBA data,

the NPL ratio is in line with the European average, amounting to 3.0% in 2Q19 (EU: 3.0%), while the CET 1 ratio rose to 18.1% after 17.4% in 2Q18 – standing well above the EU-28 average of 14.6%. We reiterate that core domestic banks (CDB), accounting for roughly 57% of the Maltese banking sector (191.4% of GDP in 2Q19), appear to be the most relevant segment from a fiscal sustainability perspective, as the segment of international banks (142.5% of GDP) has only weak links to the domestic economy. Thus focusing on CDB-specific metrics (CBM data), we also see that asset quality improved further, with the NPL ratio decreasing from 4.2 to 3.3% in the year up to 2Q19, and that capital buffers increased (tier 1 capital to RWA up from 15.3 to 16.7%). While CDBs play a pivotal role in financing the domestic economy, intragroup corporate lending should be further monitored. As illustrated by CBM 'from-whom-to-whom' data, the non-financial corporates' share in total corporate loans totaled 43.9% in 2Q19.

Risks stemming from real estate appear to be elevated, as house prices have been increasing at 3-year-growth rates of at least 15% for nine consecutive quarters. In this year's second quarter, house prices stood 19.4% above the level seen in 2Q16. Although this development seems to be largely driven by robust economic activity and rising incomes, as well as vivid immigration, it is accompanied by brisk mortgage lending. Lending for house purchase has accelerated since our last review, with outstanding volumes rising by 10.2% on the year in September 2019, up from 8.2% a year ago. Concurrently, banks' exposure to mortgages continued to increase. Household mortgages accounted for 48.9% of total residential loans in September, up from 47.4 and 38.5% in September 2017 and 2014 respectively. Having said this, household debt accounts for a moderate 49.4% of GDP (2018, EA-19: 56.7%). Also, authorities have already seized additional macroprudential measures. CBM published a directive on the regulation of borrower-based measures to strengthen financial sector resilience. As of July 2019, new LTV- and DSTI- limits have entered into force.

Against the background of some challenges regarding the framework for financial sector regulation and supervision (see above), we note that other financial intermediaries (OFIs) command over total assets equaling 1,682.1% of GDP (2018, Eurostat consolidated financial sector accounts). Similarly, supervisory challenges may be implied by advancing into emerging niches such as blockchain. In July, lawmakers adopted three laws to establish a regulatory framework for blockchain, cryptocurrencies, and distributed ledger technology. As a case in point, Bank of Valletta had to temporarily suspend its operations this February after it had been the target of a cyber-attack.

Aside from more general concerns about the sensitivity towards risks associated with potential changes in global taxation standards and financial sector regulation, which may have a serious impact on fiscal metrics, we think that the very high budgetary importance of corporate income tax proceeds continues to pose significant risks to the sustainability of public finances. Corporate income taxes (incl. holding gains) accounted for 21.1% of Malta's total tax receipts in 2018 (EA-19: 10.4%).

We believe that fiscal sustainability risks are moderated by prospectively higher debt affordability. Interest outlays declined to 4.0% of general government revenue, having continuously fallen over the years (2017: 4.6%, 2013: 7.3%). Sound budget execution is a further mitigating factor. Fiscal forecasting has tended to be rather conservative over the last

few years, building on prudent fiscal assumptions. Additionally, authorities continued to pursue their strategy of lengthening the weighted average maturity (WAM) of government debt stocks. At the end of 2018, the WAM stood at 9.1y (MGS), having steadily risen from 6.6y at year-end 2010, also benefiting from the low interest rate environment. Long-term government bond yields have plummeted to new historical lows over the last twelve months. After falling from approx. 1.5% in November 2018 to 0.126% in August 2019, 10y bond yields rose to 0.408% at the beginning of November 2019.

Foreign Exposure

In principle, the Maltese economy remains highly vulnerable to global growth and trade dynamics since Malta is very deeply integrated into global value chains, as is the case with other small, open economies which may be characterized as financial hubs, such as Ireland and Luxembourg. According to OECD TiVA data for 2015, the share of domestic value added embodied in foreign final demand stood at 54.7% – the fourth-highest reading in the TiVA database which considers OECD and non-OECD members alike.

That said, Malta's external position has continued to improve more recently. The country exhibited the largest current account surplus in the EU-28 last year, which remained at the record-high level of 11.4% of GDP recorded in 2017 (Eurostat data). The deficit in the goods balance narrowed further, now standing at 12.6%, up from 20.5% three years ago. Thanks to the ongoing strength of Maltese services exports, the trade in services surplus remained exceptionally large, though having decreased by 1.0 p.p. to 33.5% of GDP, more than compensating for the relatively large deficits in the trade in goods and primary income balances (12.6 and 8.5% of GDP respectively).

We note that the current account is volatile and subject to relatively frequent data revisions. Furthermore, Malta's balance of payment is affected by the strong presence of multinational enterprises and special purpose entities, rendering the interpretation of the underlying trends rather difficult. We believe that the increasing surpluses witnessed over the last five years are also a reflection of the aforementioned shift toward an increasingly export-oriented service economy. While the current account had averaged -4.1% of GDP in the ten years to 2013 (Eurostat data), it posted a surplus of 7.0% in 2014-18. Over the same period, the contribution of the services balance almost doubled from 17.6 to 31.4% p.a.

Hence, Malta's large current account surplus should remain in place, but we expect to see some moderation, as softening external demand is likely to weigh on export growth, and imports should increase given our expectation of robust domestic demand. Assuming recurrent, though somewhat narrowing, current account surpluses and robust economic growth, Malta's net international investment position (NIIP) is likely to increase in the near to medium term. The extraordinarily high and positive NIIP remains among the highest in the EU-28, being broadly stable at 62.7% of GDP in 2018, after 63.0% in 2017 (Eurostat data), somewhat shielding Malta from too severe adverse effects from external shocks.

Rating Outlook and Sensitivity

Our Rating outlook on Malta's sovereign ratings is positive, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – is likely to improve over the next 12-24 months.

We could raise the sovereign's credit ratings if the public debt ratio remains on its downward path, if medium-term real GDP growth evolves in line with our expectations, and/or if benign labor market conditions remain in place without putting pressure on cost competitiveness or dampening the economy's potential growth.

While the positive outlook indicates that a downgrade is rather unlikely at present, downward pressure on the outlook or the rating could result from medium-term growth falling short of our expectations, which may occur in the event of a disorderly Brexit. This is indicated by our Brexit Risk Indicator, according to which Malta is among those countries most heavily exposed to UK-related trade and capital flows in the EU-27 (BRI: 3.4, EU-27 median 2.0; see "What if… – Consequences of a hard Brexit for the EU-27 states"). We could also consider a downgrade if fiscal metrics deteriorate materially, in particular if the debt trend reverses as a result of significant fiscal slippages related to changes in global taxation standards or the materialization of contingent liabilities stemming from the financial sector.

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Ratings*

Long-term sovereign rating	A+ /positive
Foreign currency senior unsecured long-term debt	A+ /positive
Local currency senior unsecured long-term debt	A+ /positive

*) Unsolicited

Economic Data

	2014	2015	2016	2017	2018	2019e	2020e
Real GDP growth	8.7	10.8	5.7	6.7	6.8	4.9	4.1
GDP per capita (PPP, USD)	35,188	38,481	40,108	42,675	45,164	47,405	49,589
HICP inflation rate, y-o-y change	0.8	1.2	0.9	1.3	1.7	1.6	1.6
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	82.1	82.0	82.6	82.4	n.a.	n.a.	n.a.
Fiscal balance/GDP	-1.7	-1.0	0.9	3.4	1.9	1.3	1.2
Current account balance/GDP	5.8	2.8	3.8	11.4	11.4	n.a.	n.a.
External debt/GDP	1098.7	943.9	863.7	818.6	744.1	n.a.	n.a.

Source: International Monetary Fund, Eurostat, own estimates

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	25.11.2016	A+ /stable
Monitoring	24.11.2017	A+ /stable
Monitoring	23.11.2018	A+ /stable
Monitoring	22.11.2019	A+ /positive

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. Central Bank of Malta (CBM) and the Maltese Ministry of Finance (MOF) participated in the credit rating process as the authorities provided additional data and commented on a draft version of this report. Thus, the report represents an updated version which was augmented in response to the factual remarks of CBM and MOF. The rating outcome as well as the related outlook remained unchanged.

The rating was conducted on the basis of CRAG´s "Sovereign Ratings" methodology in conjunction with its basic document "Rating Criteria and Definitions". CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG´s rating methodologies and basic document "Rating Criteria and Definitions" is published on the following internet page: www.creditreform-rating.de/en/regulatory-requirements/.

To prepare this credit rating, CRAG used the following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, World

Economic Forum, Central Bank of Malta, National Statistics Office Malta, Ministry of Finance, Malta Gaming Authority, Moneyval, Planning Authority.

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG´s "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

As regards the rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the rating report; the first release is indicated as "initial rating"; other updates are indicated as an "update", "upgrade or downgrade", "not rated", "affirmed", "selective default" or "default".

In accordance with Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

An explanatory statement of the meaning of each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

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