

Rating Object	Rating Information	
REPUBLIC OF MALTA	Assigned Ratings/Outlook: A+ /stable	Type: Follow-up Rating, 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:	28-11-2016 24-11-2017
	Rating Methodologies:	"Sovereign Ratings"

Rating Action

Neuss, 24 November 2017

Creditreform Rating has affirmed the unsolicited long-term sovereign rating of "A+" for the Republic of Malta. Creditreform Rating has also affirmed Malta's unsolicited ratings for foreign and local currency senior unsecured long-term debt of "A+". The outlook is stable.

Key Rating Drivers

1. Very strong growth performance supported further improving labor market conditions; output growth set to remain among the strongest in Europe in 2017-18
2. Despite generally high quality of institutional set-up and reform efforts to strengthen the business environment, persisting inefficiencies in administrative procedures and the judicial system
3. Budget consolidation advanced in 2016 and is set to continue in the medium term; government with track record of overachieving its fiscal targets
4. Underpinned by budgetary surpluses and robust growth prospects, we expect Malta to make further progress on debt reduction, with the government's debt-to-GDP ratio falling close to 50% in 2018
5. Volatility in the current account balance and a high stock of external liabilities are balanced against a strong external asset position and prevalence of domestic funding in the private sector

Reasons for the Rating Decision

The Republic of Malta's credit rating is underpinned by the economy's strong macroeconomic performance. Our macroeconomic assessment balances brisk GDP growth, which supports income convergence towards EU-28 levels and employment growth, against some vulnerabilities arising from Malta's growth model.

We continue to assess Malta's small, open economy (trade-to-GDP ratio, 2016: 268.2%) as wealthy. Standing at USD 39,878 in 2016 (in PPP terms, IMF data), GDP per capita compares favorably to the median per capita income of our A-rated sovereigns. More importantly, since the country's EU accession in 2004, GDP p.c. has increased by 75.6%. Income convergence towards EA-19 levels (2016: 89.6% of EA-19 average) was sup-

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ported by robust real GDP growth over the recent years. After an exceptionally strong outturn in 2015 (+7.1%), growth moderated to a still high 5.5% in 2016. Last year's expansion in total output was mainly driven by net external trade, contributing 4 p.p. to GDP growth. Exports sustained their growth momentum, supported by the economic recovery in the euro area. In particular, service exports (+5.3%) demonstrated a strong performance due to vividly growing inbound tourism. According to data provided by the National Statistical Office, the number of foreign visitors reached 1.96m in 2016, equivalent to an annual change of 10.2%. Moreover, growth in imports sharply decelerated from 7.6 to 0.8% in 2016, reflecting a moderation in investment activity. Last year, gross fixed capital formation stagnated (-0.4%) owing to base effects, as large scale energy projects and the end of the EU 2007-13 programming period had boosted investment in 2015. On the other hand, private consumption grew by 3.0% and made a positive contribution to GDP growth, supported by the favorable labor market development and low inflation.

Looking forward, we expect further gains in disposable household income and ongoing employment growth to support private consumption in maintaining its growth momentum. Our expectation is underpinned by quarterly data, with annual growth in household spending posting at 3.3 and 4.8% in Q1 and Q2-17 respectively. Meanwhile, gross fixed capital formation is set to experience a significant decline this year. Higher investment in machinery and construction are unlikely to compensate for a sharp contraction of investment in transport equipment. The latter was extraordinarily strong in 2016 due to aviation investment linked to aircraft leasing corporations. Although domestic demand should thus not be supportive to growth this year, we expect economic activity to strengthen as illustrated by yearly GDP growth rates of 5.8 and 6.2% in Q1 and Q2 respectively. Mainly buttressed by net exports, GDP should expand by 5.7% in 2017. While imports are likely to decrease against the backdrop of muted investment activity, we anticipate a robust performance of exports. In particular, service exports should record another strong year, as tourism spending was up by 13.9% y-o-y in the first seven months of 2017. With regard to next year, domestic demand should take over from net exports as the main driver of GDP growth. Domestic demand should firm on the back of robust private consumption and a recovery in investment activity. At the same time, we expect higher investment-driven demand for imports and some moderation in exports to dampen the growth impact of net exports. Taken together, the Maltese economy should lose some steam in 2018, prospectively growing at a rate of 5.2%.

In view of these favorable growth prospects, the Maltese labor market is set to fare well in 2017-18, although we believe that employment growth will slow down somewhat. Last year, employment growth (15-64y) leapt to 3.8% – making the Maltese workforce the fastest growing in the EU-28. The unemployment rate also continued to decline. After having averaged at an already low 5.4% in 2015, Malta's annual unemployment rate posted at 4.7% in 2016. The strong labor market performance is also mirrored by the development of the activity rate, which remained on an upward trajectory and increased from 67.6 (2015) to 69.1% in 2016. As a result, convergence towards EU-28 levels, which are still somewhat higher (2016: 72.9%), advanced.

Thus, labor market policies implemented since 2014 which aimed to strengthen work incentives, seem to be bearing fruit. Among others, the government's making-work-pay measures included the introduction of in-work benefits for families with low income and the provision of free childcare to women. However, some labor market challenges persist. The participation rate of women is still at a low level by European standards and the differential between activity rates of men and women remains significant. Standing at 25.8 p.p. in Q2-17, Malta exhibits the largest gender gap in activity rates in the EU-28. Apart from low female labor market participation, skill mismatches may have curbed a further build-up of employment. According to the European business surveys, both the industry and services sector reported labor shortages above the EU-28 levels.

Although we do not believe that Malta can sustain its current growth momentum beyond 2018, medium-term growth prospects remain favorable. According to the latest estimates by the EU commission, Malta exhibits potential growth rates well above the euro area average, largely driven by employment growth and labor productivity gains. However, some downside risks to the economy's medium-term outlook have to be pointed out. Although this is not our baseline scenario, a disorderly exit of the UK from the EU could have a detrimental effect on growth, given its strong trade linkages with Malta. Despite a decrease in the share of tourists from the UK in 2017, due to an increasing number of visitors from other countries, the UK remains an important market for Maltese tourism. In 2016, tourists from the UK represented the largest group of visitors, accounting for 28.5% of inbound tourism. In the same vein, tighter regulation of gaming and financial services (2016: 18.6% of gross value added), as well as changes in the international tax environment, could dampen growth going forward. As currently being discussed at the EU level, the implementation of a Common Consolidated Corporate Tax Base (CCCTB) could weaken Malta's attractiveness for foreign direct investment.

Turning to Malta's budgetary performance, we note significant improvements in 2016, with the budget balance turning positive for the first time in 35 years. Fiscal targets outlined in the 2016 stability program (-0.7% of GDP) were outperformed by a wide margin, with the general government balance posting a surplus of 1.1% of GDP. The stronger-than-expected GDP expansion in 2016 translated into brisk revenue growth, which accounted for about three quarters of the budgetary improvement. Proceeds from the government's Individual Investor Program (IIP) came in 0.7 p.p. GDP above expectations, while tax and social security contributions benefited from favorable labor market trends and higher corporate profits. Direct taxes increased by 11.8% and social security contributions were up by 7.2%, reflecting ongoing job creation and higher wages. Meanwhile, the expenditure side of the budget remained broadly stable as higher spending on employee compensation (5.9%) and intermediate consumption (7.5%) were more than offset by savings on capital expenditure. Government investment dropped by 37.7% as compared with 2015, mirroring the transition to the new EU 2014-20 programming period.

In our opinion, Malta will sustain a budgetary surplus in 2017-18, although we expect the government to relax its fiscal stance somewhat. This year, costs associated with Malta's 2017 EU council presidency and policies related to the government's Anti Poverty Strategy should result in higher expenditures. The measures, which include an extension of the

in-work benefit scheme, an increase of the carers allowance, and higher minimum pensions, aim to support vulnerable groups such as low-income earners and pensioners. Additionally, proceeds from the National Development and Social Fund as well as higher excise duties on tobacco, toiletries and construction material should be used to finance both intermediate consumption and public investment. It has to be emphasized that overall revenue growth remained strong in the first half of 2017, supporting our view that the government's budgetary target of 0.8% of GDP is within reach this year. Looking into 2018, the implementation of discretionary measures outlined in the draft budget should lower the surplus on the general government level. According to the budget proposal, individuals with earnings of less than EUR 60,000 as well as SMEs should be provided with some tax relief. Also, the government envisages increasing investment on healthcare, transport, and energy projects and reckons with a decline in IIP proceeds. As a result, we expect Malta's budget surplus to narrow to 0.6% of GDP in 2018.

Hence, the re-elected Maltese government should remain committed to sound public finances. After calling snap elections in June 2017 to counter political instability associated with alleged governance issues, PM Muscat won a second term in office. His labor party retained a comfortable majority, winning 55% of the votes. In general, medium-term fiscal sustainability risks appear limited against the backdrop of recently implemented pension reform measures and receding contingent liability risks. Contingent liabilities, which amounted to a relatively high 14.1% of GDP in 2016, are expected to drop to 9.7% of GDP this year, mainly due to the expiration of a guarantee to ElectroGas. Maintaining budgetary surpluses over the coming years should support a further decline in government debt, which fell below the 60%-mark last year (57.6% of GDP). Assuming no additional discretionary measures and growth in line with our expectations, government debt should approach 50% of GDP by the end of 2018.

In general, we regard fiscal risks arising from Malta's large banking sector, which has a size of 4.7x GDP (2016, Central Bank of Malta data), as limited. However, this figure includes operations of international banks with assets totaling 222.7% of GDP which focus on interbank and non-resident lending. These banks have only minor linkages to the domestic economy, as illustrated by their low share in lending to Maltese residents. In 2016, Maltese customer loans made up for only 1.7% of international banks' loan portfolios. By contrast, core domestic banks (CDBs) with assets amounting to 219.9% of GDP stand for the bulk of lending to Malta's private sector.

Given the high reliance of NFCs and households on CDBs, we believe the resilience of this sector is of paramount importance for the domestic economy. As illustrated by financial soundness indicators, CDB loans were sufficiently covered by deposits (loan-to-deposit ratio 56%). The capitalization of the sector improved in 2016, with the regulatory tier 1 capital rising from 12.2 to 13.4% of risk-weighted assets, while return on assets stood at 0.8%, up from 0.7% one year earlier. Last year's improvement in profitability can be attributed to lower net impairment losses and an increase in non-interest income coupled with a drop in operating expenses. Asset quality improved on the back of favorable macroeconomic conditions but also due to write-offs. As a result, the overall NPL ratio of CDBs fell from 7.1 to 5.3%. Notwithstanding these favorable trends, asset quality remains

a key challenge, given that 13.9% of loans outstanding to Maltese NFCs were still impaired in 2016. In particular, loans outstanding to the construction and real estate sector were characterized by relatively weak asset quality, accounting for more than a third of total NPLs. In order to promote a faster workout of NPLs, MFSA (Malta Financial Services Authority) amended the Banking Rule (BR/09/2016) authorized under the Banking Act 1994. The new provisions published in Dec-16 provide credit institutions with incentives to resolve their legacy NPLs. Banks with a two-year average NPL ratio above 6% are thus required to submit detailed reduction plans to lower their NPLs below this threshold within five years. Automatic sanctions (higher capital requirements) will apply to those banks which fail to meet the targets.

The comparatively high level of NPLs has negative repercussions on credit intermediation. Credit outstanding to NFCs continued to contract in 2017. Sluggish lending activity could partly be a result of relatively high borrowing costs. As illustrated by ECB data, interest rates on new NFC loans were only higher in Greece and Cyprus in Sep-17. Admittedly, Maltese corporates also diversified their funding mix, making greater use of capital market financing. The attractiveness of market funding has benefited from high liquidity in the Maltese household sector. To ease financing conditions, Malta is establishing the Malta Development Bank, which is expected to have an authorized capital of EUR 200m and to commence its operations by the end of 2017. What is more, Maltese corporates continue to repair their balance sheets, thus improving the shock-absorbing capacity of the Maltese corporate sector. Despite elevated levels (Q1-17: 195.1% of GDP), corporate debt has been on a downward trajectory since mid-2012, when it peaked at 228.7% of GDP. At the same time, we consider balance sheets of households to be sound. With net assets worth 183.2% of GDP, wealth of Maltese households exceeds EA-19 levels (148.2% of GDP) by far. Against this backdrop, we believe that the current rise in house prices, which is accompanied by increasing demand for mortgage lending, does not pose immediate risks to the stability of the domestic banking system, though it should be closely monitored. Driven by strong demand for property and supply side pressures, house prices posted growth rates in the 5%-range throughout 2017. Concurrently, the growth in mortgage lending was even more pronounced, with yearly growth of about 8% per month.

We consider Malta's institutional framework as a supportive factor to its credit rating, as the country's World Governance Indicator (WGI) profile is broadly in line with euro area peers. Regarding the quality of its regulatory framework and the degree of democratic participation, the country is ranked 32 and 25 respectively, as compared to euro area median ranks of 33 and 29. However, Malta has room to improve when it comes to the level of perceived corruption and the effectiveness of policy formulation and implementation. Improving the efficiency of the public administration could also have positive effects on the business environment, which is ranked 84 out of 190 economies in the World Bank's 2018 Doing Business report. Progress on reforms geared towards facilitating company registration procedures, and thereby supporting entrepreneurship, resulted in a notably improvement in Malta's start-up conditions. At the same time, the effectiveness of Malta's insolvency framework remains a major weakness. Recovery rates are significantly lower than in comparable countries (38.8 vs 71.2%), while proceedings take on average

longer than in OECD high income economies. Inefficiencies pertaining to the insolvency framework are partly explained by bottlenecks in the judicial system. To be sure, Malta has achieved remarkable progress in accelerating court procedures. According to the 2017 EU Justice Scoreboard, the length of proceedings almost halved from in 2010-15. However, standing at 445 days (2015), the time needed to resolve litigious civil and commercial cases was only higher in Italy (527 days). That said, Maltese authorities continue with their efforts to improve the efficiency of the insolvency framework. Going forward, the implementation of Act XI, which entered into force in Apr-17, and the envisaged establishment of a commercial court should further speed-up recovery procedures and strengthening creditor rights.

Risks related to Malta's external position are broadly balanced. Potential vulnerabilities associated with the large stock of external liabilities are tempered by the pivotal role of core domestic banks for private sector funding, significant external assets, and sustained current account surpluses. In general, Malta's external balance continues to be characterized by a high degree of volatility, as indicated by current account developments in recent years. After posting at 8.8% of GDP (2014), Malta's current account surplus dropped to 4.6% in 2015 before rising to 6.6% of GDP last year. Last year's increase in the current account surplus was mostly explained by an improving trade balance. While import demand was somewhat dampened by the slowdown in domestic investment activities, net receipts from services reported double-digit growth. As a result, the increase in the trade balance surplus more than offset a rising primary income deficit resulting from Malta's significant stock of FDI liabilities, which accounted for the largest share of Malta's external liabilities, amounting to almost 1,740% of GDP at the end of 2016. However, due to sizeable net portfolio assets, the economy's overall net international investment position remains highly positive (Q4-16: 47.2% of GDP).

Rating Outlook and Sensitivity

Our rating outlook on the long-term sovereign rating is stable, 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 – will remain fundamentally unchanged over the next 12 months.

We could consider a downgrade of our ratings if medium-term growth turns out to be substantially lower than in our baseline scenario. Given the country's high degree of openness, we believe that Malta would be disproportionately affected by a period of subdued growth in the world economy. More importantly, changes in international corporate taxation standards could affect Malta's attractiveness as a financial hub. Our ratings could also be lowered if we observe a significant deterioration of fiscal metrics coupled with a reversal in the government's debt trajectory.

We could raise our credit ratings if the Maltese economy expands at a higher-than-expected growth rate over the medium term. Against this backdrop, the implementation of structural reforms which aim to improve the efficiency of the public administration and the judicial system could be beneficial to Malta's growth potential. In the same vein, faster-

than-projected progress on fiscal consolidation or NPL resolution could lead to upward pressure on our ratings.

Primary Analyst
Johannes Kühner
Sovereign Credit Analyst
j.kuehner@creditreform-rating.de
+49 2131 109 1462

Chair Person
Benjamin Mohr
Head of Sovereign Ratings
b.mohr@creditreform-rating.de
+49 2131 109 5172

Ratings*

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

*) Unsolicited

Economic Data

[in %, otherwise indicated]	2012	2013	2014	2015	2016	2017e	2018e
Real GDP growth	2.6	4.6	8.2	7.1	5.5	5.7	5.2
GDP per capita (PPP, USD)	30,656	32,285	35,213	37,757	39,878	42,532	45,127
Inflation rate, y-o-y change	3.2	1.0	0.8	1.2	0.9	1.3	1.5
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	80.7	81.7	81.9	81.9	n.a.	n.a.	n.a.
Fiscal balance/GDP	-3.5	-2.4	-1.8	-1.1	1.1	0.9	0.6
Current account balance/GDP	1.7	2.7	8.8	4.6	6.6	n.a.	n.a.
External debt/GDP	1181.7	1154.1	1010.2	942.3	829.7	n.a.	n.a.

Source: International Monetary Fund, World Bank, Eurostat, own estimates

Appendix

Regulatory Requirements

This sovereign rating is an unsolicited credit rating. Central Bank of Malta (CBoM) and the Maltese Ministry of Finance (MoF) participated in the credit rating process as the authorities 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 CBoM 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. 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 is published on the following internet page: www.creditreform-rating.de.

To prepare this credit rating, CRAG has used 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, Central Bank of Malta, National Statistics Office Malta, Ministry of Finance

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 and that the rating action was and is free of any existing or potential conflicts of interest. 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".

In the case of a 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 regard to the rated entity CRAG regarded available historical data as sufficient.

In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

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Creditreform Rating AG

Creditreform Rating AG

Hellersbergstrasse 11
D - 41460 Neuss

Phone +49 (0) 2131 / 109-626
Fax +49 (0) 2131 / 109-627
E-Mail info@creditreform-rating.de
Internet www.creditreform-rating.de

CEO: Dr. Michael Munsch
Chairman of the Board: Prof. Dr. Helmut Rödl

HRB 10522, Amtsgericht Neuss