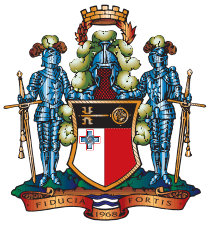

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THE SUSTAINABILITY OF MALTESE GOVERNMENT DEBT

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BOX 6: THE SUSTAINABILITY OF MALTESE GOVERNMENT DEBT[1]

This box assesses the sustainability of Maltese general government debt over different time horizons and evaluates risks stemming from macro-financial linkages. It updates previous debt sustainability analyses published by the Bank.[2,3] The term 'sustainability' as used throughout this analysis is in line with the IMF's definition that 'sovereign debt is sustainable if the country is able to finance its policy objectives and service the resulting debt, without resorting to unduly large adjustments which could otherwise compromise its stability'.

Main messages

The main messages can be summed up as follows:

- The pandemic has brought about increased risks related to the structure and financing of debt, macro-financial linkages and competitiveness, according to a heatmap of relevant indicators.
- This box presents two scenarios which explore the impact on the debt-to-GDP ratio arising from different fiscal policies in the medium term. In most simulations, the debt ratio is not expected to embark on an explosive path. However, the debt ratio can be explosive in periods of prolonged large fiscal deficits, coupled with a shock in GDP growth. In all simulations, the debt ratio is expected to remain above pre-pandemic levels. The extent to which the debt ratio can be brought down depends on the extent and speed of the economic recovery and the pace of fiscal consolidation.
- There exist risks which could not be quantified and incorporated in the scenario analysis. In the immediate term, these mainly reflect the likelihood of additional COVID-related support, state aid to Air Malta and support to cushion the impact of rising commodity prices following the conflict in Ukraine. Medium-to-long term risks include the impact of pre-1995 rent reform on government finances, the reform in the international corporate tax framework and the introduction of new EU-wide revenue raising measures. While these risks may be substantial, the resulting changing structure of the Maltese economy, including as a result of reform implemented in the context of the national Recovery and Resilience Plan, may bring both a positive impact on debt sustainability as well as a negative impact.

Scenario analyses

In the coming years, Government is set to reduce the deficit from the levels it incurred in 2020 and 2021, as COVID-related support measures end and economic activity recovers. At the same time, fiscal policy is set to remain supportive of economic growth in the short term. The following two scenarios explore the impact on the debt-to-GDP ratio arising from different fiscal policies in the medium term.

Up until 2024, assumptions for GDP growth, inflation and Government's borrowing costs in both scenarios are in line with the Bank's latest forecast exercise.[4] Thereafter, a series of common assumptions govern the path of macro items, prices and interest rates (see section at the end of this box). The scenarios differ mainly in the forecast path of fiscal consolidation which is assumed to take place.

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[1] Prepared by John Farrugia, Manager Fiscal Issues and Reports Office within the Economic Analysis Department of the Central Bank of Malta. The views expressed are those of the author and do not necessarily reflect the views of the Central Bank of Malta. Any errors are the author's own.

[2] For further details on government debt dynamics and fiscal sustainability, see Farrugia, J. and Grech, O., "The Sustainability of Maltese Government Debt Revisited", in Grech, A.G., and Zerafa, S. (eds.), Challenges and Opportunities of Sustainable Economic Growth: the Case of Malta, Central Bank of Malta, 2017.

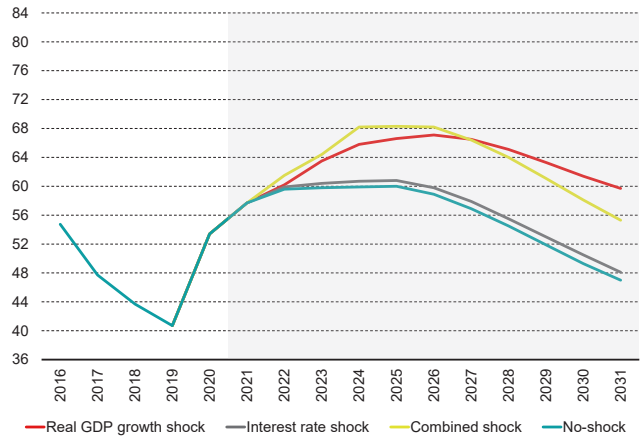
[3] This study uses the national accounts vintage up to the fourth quarter of 2021, published in March 2022 and the general government data vintage up to the third quarter of 2021, published in January 2022. The cut-off date for projections is 11 February 2022.

[4] This exercise includes the impact of fiscal measures announced at the start of February 2022. It is available here: https://www.centralbankmalta.org/economic-projections

Scenario 1 – Baseline Scenario

In this scenario, fiscal deficit targets until 2024 are in line with the Bank's latest projections. Thereafter, it is assumed that Government reverts to its pre-COVID target (a budget surplus in structural terms). Consequently, additional fiscal consolidation measures are assumed to take place between 2025 and 2027. In this scenario, a balanced structural budget is achieved by 2027 and a small surplus is posted in subsequent years.

Chart 1
DEBT-TO-GDP RATIO IN BASELINE SCENARIO
(% of GDP)



Source: Author's calculations.

On the basis of these assumptions and excluding the impact of any shocks, the general government debt is expected to peak in 2024 before declining to around 47.0% of GDP by 2031 (see Chart 1).

Owing to the low level of interest rates at the start of the forecast period, a permanent interest rate shock is expected to exert a small impact on public debt. On the other hand, owing to the denominator effect, a pure permanent shock to GDP growth would have a significant impact on the debt ratio. In the event of a combined shock, where fiscal policy is more supportive in periods of shocks to GDP growth but reverts to a contractionary stance thereafter, the debt-to-GDP ratio stands at just over 55% by 2031.

In this scenario, the debt ratio is not explosive even during periods of shock. In fact, it remains on a downward trajectory even in the combined shock scenario, which reflects a more plausible outcome compared with the pure GDP and interest rate mechanical shocks. However, by the end of the simulation horizon, the debt ratio is expected to remain above pre-pandemic levels. The extent to which the debt ratio is brought down depends on Government's commitment to adhere to consolidation targets.

Scenario 2 – Alternative Scenario

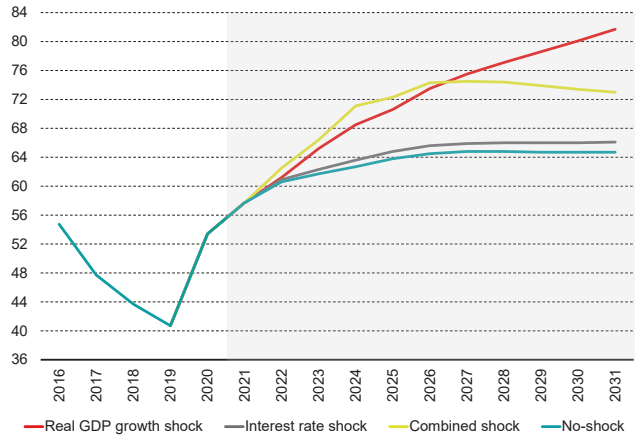
In this scenario, it is assumed that fiscal consolidation is not pursued as aggressively as in the baseline scenario. Between 2022 and 2024, the general government deficit-to-GDP ratio is wider by around one percentage point compared with the baseline scenario. Thereafter, Government is assumed to target a headline deficit-to-GDP target of 3.0%. Consequently, the structural balance remains in deficit throughout the simulation horizon.

Excluding the impact of any shocks, general government debt is set to reach just under 65.0% by 2027 and remain broadly stable thereafter (see Chart 2).

A mechanical and permanent interest rate shock is not expected to significantly affect the debt-to-GDP path. However, owing to the continuous projected large deficits, a mechanical and permanent shock to GDP growth puts the debt ratio on an upward and explosive path. In a more credible scenario as envisaged by the combined shock simulation, the debt-to-GDP ratio is set to gradually decline once

the supportive fiscal stance is scaled down. However, since Government is still assumed to retain a deficit throughout this simulation, the debt ratio is set to decline at a very slow pace and to remain around 73% of GDP by 2031.

Chart 2
DEBT-TO-GDP RATIO IN ALTERNATIVE SCENARIO
(% of GDP)



Source: Author's calculations.

In this scenario, government adopts a looser fiscal stance compared with the baseline scenario. Consequently, in a mechanical shock simulation, debt may embark on an explosive path. In the combined shock simulation, which offers a more plausible path for GDP and fiscal policy in the event of a shock, debt is not explosive. That said, the debt ratio remains significantly above the debt ratio in the baseline scenario. When compared with the baseline scenario, therefore, the alternative scenario highlights the significance of short-to-medium term consolidation measures in bringing down the debt burden.

Heat map of indicators

This section assesses a number of indicators which, according to the literature, are highly relevant for debt sustainability in the short and long term. The thresholds used to grade these indicators are mainly sourced from the European Commission's *Debt Sustainability Monitor* series. The threat that each indicator poses to the debt ratio is colour coded – red indicates a high threat, yellow indicates a medium threat and green signals a low threat to sustainability. The heat map is presented in Table 1.

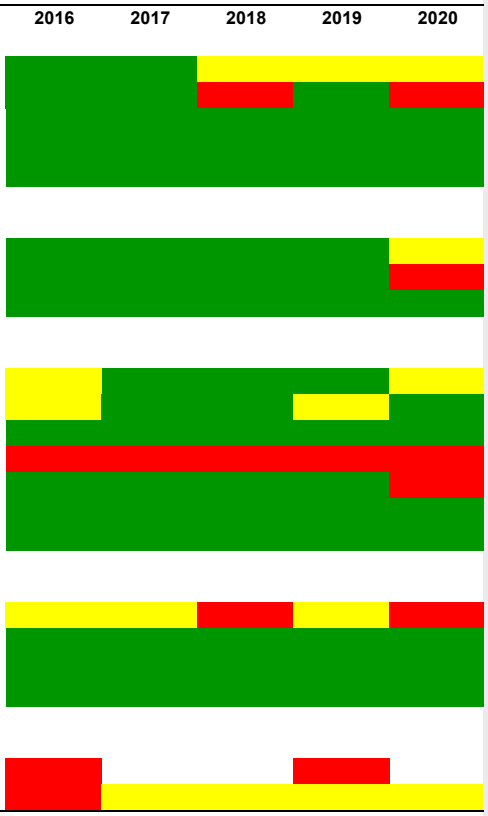
This is a backward looking analysis using information up to 2020. At the time this exercise was completed, data at end-2021 was not available for most indicators.

The pandemic has brought about increased risks surrounding the structure of debt and liquidity risks. In 2020, the share of short-term debt in the total debt maintained its upward trend and consequently remained as a medium threat. This is mainly due to a higher level of Treasury bills outstanding and the increased financing needs brought about by the pandemic. Despite a drawdown of existing government deposits (from 8.6% of GDP in 2019 to 7.4% of GDP in 2020), the net financing needs of general government remained substantial and stood just above the high-risk threshold used in this heat map.

From a macro-financial perspective, the main risks to debt sustainability stem from the elevated share of NPLs in the total loans extended by the core domestic banks compared with the applicable threshold. This metric increased for the first time since 2013, reflecting adverse pandemic-related conditions. Nevertheless, it remained close to historic lows.

Regarding implicit liabilities, ageing costs (pensions, healthcare and long-term care) as a share in GDP form another significant risk to sustainability. According to the Commission's 2021 *Ageing Report* projections, at 8.0 points, Malta is set to have the fourth highest increase in age-related spending in the euro area between 2019 and 2070. Compared with the previous *Ageing Report* publication, costs

Table 1
HEAT MAP



Source: Author's calculations.

are expected to increase at a faster rate. However, whereas in the previous Report costs were set to reach the euro area average by 2070, they are now set to remain below it.

Government-guaranteed debt increased in 2020 due to the introduction of pandemic-related support schemes (see below). Its share in GDP stood at 9.0%, with the bulk of guarantees debt mainly concentrated in the energy sector.[5] However, this ratio is in line with the euro area average and remains lower than the recent peaks observed in 2012 and 2014. For this reason, this metric remains classified as a medium risk.

Non-quantifiable risks

This section outlines other debt sustainability risks which are likely to materialise but cannot be quantified at present.

In the immediate term, the main risks to debt sustainability concern the likelihood of additional support measures. These include schemes to support industries hard-hit by the pandemic as well as measures aimed at mitigating high commodity prices. At the time this exercise was finalised, no definite date for the withdrawal of existing COVID-19 support measures was announced and Government remained committed towards cushioning the impact of rising commodity prices following the conflict in Ukraine. Another immediate risk concerns the likelihood of state support to Air Malta. In January, the Finance Minister announced a restructuring exercise in which the company's existing personnel

[5] See National Audit Office Malta (2021). "Annual Audit Report: Public Accounts 2020" for further details.

is set to be reduced by around half. Employees will be offered the option to transfer to another public sector institution, under similar working conditions. At the same time, Government remains in talks with the European Commission over the possibility of additional State aid.

In the short-to-medium term, sustainability risks relate to the inability of some firms to repay loan obligations, particularly once government guarantees and moratoria are phased out. Government finances stand to be affected through its exposure to the MDB CGS, if a portion of the guarantees are called. However, according to the Bank's *Interim Financial Stability Report* 2021, this risk is seen as small given banks' overall resilience, the substantial decline in active moratoria and the relative stability in the volume of loans granted under the CGS in 2021 (see chapter on monetary and financial developments).

Other short-to-medium term risks reflect the impact of a reform in rental costs for properties bound under pre-1995 leases. Under the reform, which came into effect in June 2021, landlords can increase the annual rent up to two per cent of the property's market value. However, tenants in gainful employment will not spend more than 25% of their income on rent, while pensioners and social welfare beneficiaries will not experience an increase in rent. Instead, the difference in rent will be borne by the State. This reform will affect up to 10,000 families. Since any increases in rent need to be determined on a case-by-case basis by the Rent Regulation Board, the fiscal impact in the medium term cannot be ascertained at present.

Medium-to-long term sustainability risks reflect the impact of a reform in the international corporate tax framework, as agreed by members of the Organization for Economic Co-operation and Development (OECD)/G20 Inclusive Framework. The reforms affect large multinational companies and seek the partial re-allocation of taxing rights from their home countries to markets where they also earn turnover. The reforms are also set to introduce a 15% global minimum effective corporate tax rate. The European Commission already proposed a directive on the implementation of the minimum effective tax, which is set to take effect from 2023. The impact of these proposals on Government finances is hard to quantify at this stage but could prove to be material.

Other medium-to-long terms risks reflect the likelihood of new EU-wide revenue raising measures, which Member States in principle agreed to introduce in order to repay financing of the NGEU rescue package. These include a revision of the EU Emissions Trading System, the introduction of a carbon border adjustment mechanism and an own resource requirement from the above mentioned international corporate taxation framework.[6] If implemented, such measures have the potential to significantly affect the Maltese economy and public debt sustainability. On the one hand, the introduction of new taxation systems may disrupt existing industries and negatively affect inflows from corporate taxes. On the other hand, the shift towards new industries may boost competitiveness and productivity, leading to increased investment. The long-run impact of structural reforms implemented as part of the national Recovery and Resilience Plan – which ought to reduce sustainability risks – is also difficult to gauge.

Assumptions and technical information

Scenario analyses: common assumptions (from 2025 onwards)

Potential output growth is determined exogenously in this framework. Real GDP growth is set to grow in line with the forecast structural primary balance and potential output growth. The growth is therefore determined by the fiscal multiplier – i.e. the degree to which fiscal policy affects economic growth – and the output gap, which eventually closes. For further details, refer to the *Annual Report* 2018 Box.

[6] See https://ec.europa.eu/commission/presscorner/detail/en/ip_21_7025

Table 2
SCENARIO ASSUMPTIONS: MAIN DETERMINANTS OF DEBT

Per cent

	Baseline scenario		Alternative scenario	
	2021-2024 average	2025-2031 average	2021-2024 average	2025-2031 average
Real GDP growth rate	6.1	3.3	6.1	3.3
Inflation (GDP deflator growth rate)	2.2	2.0	2.2	2.0
Interest rate applied to				
Short-term debt	-0.2	0.4	-0.2	0.4
Long-term debt maturing within a year	0.4	0.9	0.4	0.9
Non-maturing long-term debt	2.5	2.7	2.5	2.7
DDAs (% of GDP)	0.4	0.5	0.4	0.5
Primary balance (% of GDP)	-4.7	0.8	-5.4	-1.5

Source: Authors' calculations.

Inflation, which in this box is measured by growth in the GDP deflator, is assumed to remain at around 2.0%, in line with the ECB's target for inflation over the medium term.

Meanwhile, the level of the DDA is assumed to revert to its long-run average. No temporary fiscal measures, other than those related to COVID-19, are assumed to take place.

Government debt is forecast on the basis of different types of maturity. The share of each category of debt is assumed to revert to its long-run average. Interest payment projections are based on separate interest rate estimates applied to each maturity category.

The forecast path of interest rates is based on ECB assumptions for the EURIBOR (used to determine interest payments on short-term debt) and the 10-year yield on Malta Government Bonds (used to determine interest payments on rolled-over, long-term debt).[7] Interest rates on non-maturing debt are based on the maturity profile of outstanding Malta Government Bonds.

The forecast path for the main determinants of debt is shown in Table 2.

Scenario analyses: shocks (applied from 2022 onwards)

Permanent mechanical shocks to GDP growth and interest rates are based on the standard deviation of historic data, similar to the approach used by the IMF in its Article IV Mission. On average, compared with the no-shock scenarios, there is a 2.3 percentage point decrease in the yearly, real GDP growth and a 0.9 percentage point increase in the interest rate.

Combined shock simulations assume a 1.0 percentage point decline in real GDP growth for three years, and a permanent 1.0 percentage point increase in interest rates. At the same time, the pace of fiscal consolidation is relaxed in the years when GDP growth is negatively affected, but is then pursued more vigorously compared with the no-shock simulation.

[7] The euro area interest rate projections were sourced from the ECB's technical assumptions.