

## Fitch Affirms Malta at 'A'; Outlook Stable

Fitch Ratings, **London**, 10 September 2014: Fitch Ratings has affirmed Malta's Long-term foreign and local currency Issuer Default Rating (IDRs) at 'A'. The Outlooks are Stable. The issue ratings on Malta's unsecured foreign and local currency bonds have also been affirmed at 'A'. The agency has also affirmed Malta's Short-term foreign-currency IDR at 'F1' and the Country Ceiling at 'AAA'.

### KEY RATING DRIVERS

The affirmation and the Stable Outlook reflect the following key rating drivers:

GDP growth is outperforming the eurozone average. In 2013 the economy grew by 2.9%, better than 2012 (1.1%) and higher than the eurozone average (negative 0.4%), but still below the 'A' median of 3.4% over five years. In 1H14 real GDP grew by 3.5%, mainly driven by domestic demand, underpinned by the reduction in electricity tariffs and favourable labour market conditions. Fitch expects above potential growth averaging 2.5% in 2015-16, continuing above the eurozone average.

At 5.7% in July the unemployment rate is below both the 'A' median and the eurozone average, while the employment rate has risen, underpinned by the increasing female labour market participation rate. The decline in unemployment therefore took place against the backdrop of a strong increase in the labour force.

Public finances remain a sovereign rating weakness but they are on an improving trend. While public debt/GDP continues to exceed the 'A' median, Fitch's public debt sensitivity analysis has marginally improved. Fitch forecasts that general government gross debt (GGGD) peaked at 72% of GDP in 2013 (73% in 2014-15 previously) and will decline marginally in the medium term, reaching 70% of GDP by 2020.

Malta has brought its general government deficit (GGD) under control over the course of 2013. Following significant fiscal slippage in 2012, GGD declined to 2.8% of GDP, below Fitch's projection at the time of the latest rating review (3% of GDP). Deficit reduction in 2013 reflected strong increases in income tax and indirect tax receipts. Fitch expects a deficit of 2.5% of GDP in 2014 and 2015, closer to the rating median (2.1%).

Stronger revenues contrast with rising expenditure, reflecting significant underlying pressures which Fitch has highlighted in previous rating reviews. Fiscal figures on a cash-basis for January-July indicate expenditure slippages, particularly in the areas of healthcare, social security and transport. Fitch does not expect these developments to compromise deficit reduction in 2014 as in 2H14 revenues should receive a boost from payments of excise and duty taxes by Enemalta, the public energy utility, to the government (around 0.6% of GDP).

Continued slippages in public expenditure, however, could pose a risk to public debt reduction should revenues underperform in the future. In this respect, the adoption of the Fiscal Responsibility Act could help anchor fiscal policy and particularly growth in public expenditure.

Enemalta poses the main risk to 2015 fiscal outturns. Fitch notes the authorities' decision to reduce energy tariffs for commercial users from March 2015, while simultaneously cutting production costs at Enemalta. However, the latter is subject to execution risk. Importantly, it assumes that the interconnector with Sicily will be completed by end-2014. Moreover the plan could negatively impact Enemalta's profitability, should cost savings fail to materialise. This in turn would have an impact on the budget and be rating negative.

Contingent liabilities pose additional risks to creditworthiness. Government-guaranteed liabilities stood at 15% of GDP in 1Q14, the majority of them related to Enemalta. Furthermore, consolidated government payment arrears are around 9% of GDP (in 2013), the second highest level within the eurozone, albeit down from a peak of 10.2% in 2012.

Malta's sovereign credit profile benefits from a deep pool of domestic savings. Public debt is predominantly held by domestic investors and financing capacity is underpinned by a liquid banking sector.

Despite its size, at seven times GDP in 2013, the banking sector is strong and has proved resilient to the eurozone crisis. The core domestic banks have a loan/deposit ratio of only around 66% and have not been drawing on any significant amount of ECB liquidity facilities. Banks are well-capitalised and the government has not needed to provide capital or liquidity. Loan portfolios are concentrated in mortgages, construction and real estate, where NPLs have risen: a sharp housing market correction combined with problems for real estate developers are the main domestic risks to financial stability but Fitch considers such a scenario unlikely.

Malta also has a robust net external creditor position relative to rating peers and positive international investment position. The banking sector is the main contributor, but the sovereign also enjoys modest net external creditor status. External finances data is affected by the presence of a large international banking sector.

#### RATING SENSITIVITIES

The Outlook is Stable. Consequently, Fitch's sensitivity analysis does not currently anticipate developments with a high likelihood of leading to a rating change. However, future developments that could individually or collectively, result in a downgrade include:

- Significant slippage from fiscal targets leading to a deteriorating public debt dynamics.
- Crystallisation of material contingent liabilities from public sector companies (particularly Enemalta), a shock to the banking sector or eurozone bail-out packages.

The main factors that individually or collectively could trigger positive rating action are:

- An improved track record in consolidating the public finances that leads to a significantly lower public debt level.
- A significant decline in contingent liabilities.

#### KEY ASSUMPTIONS

Fitch assumes that the deal between Enemalta and Shanghai Electric Power Company will be finalised before the end of this year. Shanghai Electric Power Company has agreed to acquire a 33% stake in Enemalta. This deal reportedly has the potential to enhance the utility's

profitability over the medium term and reduce its debt. A successful restructuring of the company would allay concerns around crystallisation of contingent liabilities. The agreement should be presented to the Maltese parliament before the end of September 2014.

Fitch assumes that implementation of ESA 2010 accounting changes will result in limited upward revisions in GGGD. Fitch will base its forecast on the new methodology once it is introduced across all countries in the EU.

Fitch assumes that in case of need, the government of Malta would only be predisposed towards supporting core domestic banks (210% of GDP in 2013), which are systemically important, in particular Bank of Valletta (100% of GDP). For HSBC Bank Malta (90% of GDP), Fitch believes that any necessary support would come from its parent company. In Fitch's view, the Maltese government would be very unlikely to support the international banks (413% of GDP) and would probably not support non-core banks (74% of GDP) either.

Fitch assumes the Eurozone will avoid long-lasting deflation, such as that experienced by Japan from the 1990s. Fitch also assumes the gradual progress in deepening fiscal and financial integration at the eurozone level will continue; key macroeconomic imbalances within the currency union will be slowly unwound; and eurozone governments will tighten fiscal policy over the medium term. It also assumes that the risk of fragmentation of the eurozone remains low.

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Additional information is available on [www.fitchratings.com](http://www.fitchratings.com)

Applicable criteria, 'Sovereign Rating Criteria' dated 12 August 2014 and 'Country Ceilings' dated 28 August 2014, are available at [www.fitchratings.com](http://www.fitchratings.com).