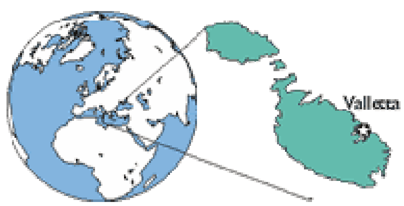
COUNTRY REVIEW

Malta



19 May 2008

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EULER HERMES COUNTRY RISK GRADE: A

Country Risk Grades are on a scale of AA, A, BB, B, C, D

where AA is the lowest and D the highest risk.

Strengths

- Good regional and international relations; EU and EMU membership
- Stable political system and relatively effective policymaking
- Strong business environment overall
- Sound banking sector
- Euro zone membership almost eliminates transfer, exchange rate and balance of payments risks

Weaknesses

- Weak fiscal position (public debt-to-GDP ratio of around 62.6% in 2007)
- High current account deficits in recent years
- Large dependence on two export sectors with high vulnerability to external shocks

Country Risk Assessment

Ratings	Malta		Median	Peers		
	Latest	Previous	Grade A	Slovenia	Hong Kong	Chile
Systemic Political Risk:	**P1**	**P1**	**P2+**	**P1**	**P2+**	**P1**
Systemic Economic Risk:	**E2**	**E2**	**E2**	**E2**	**E2**	**E2**
ME rating:	ME2	ME2	ME2	ME2	ME2	ME2
Structure	*2.3*	*3.3*	*3.2*	*1.6*	*3.3*	*4.0*
Policy	*2.3*	*1.7*	*2.5*	*3.8*	*1.0*	*1.3*
Solvency	*1.9*	*2.3*	*1.1*	*1.7*	*1.0*	*1.0*
External Liquidity	*2.3*	*2.8*	*2.0*	*2.2*	*3.8*	*3.3*
SBE rating:	SBE1	SBE2	SBE2	SBE2	SBE1	SBE1
COUNTRY GRADE:	**A**	**A**	**A**	**A**	**A**	**A**

Nomenclature:
Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).
Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).
ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).
The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).
SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).
Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Valetta
Population:	0.404748 mn (2006)
GDP:	USD 6372 mn (2006)
Currency:	Euro (EUR)
Form of state:	Parliamentary republic
Head of government:	Prime Minister Lawrence GONZI (since March 2004)
Next elections:	Presidential: 2009 / Legislative: 2013

Major Industries (% of GDP at market prices, 2005)	
Services	74.1%
Industry	23.4%
Construction	4.8%
Agriculture, hunting & fishing	2.4%

Global Assumptions	2007	2008
Real GDP grth (% yr/yr) *	2.3	2.0
Inflation (%, av) *	2.1	1.6
US 3-month LIBOR (%)	5.2	4.7
Dated brent (USD/b)	72	83

* Major economies

Main Exports (% of total, 2006)	
Machinery and transport equipment	63.3%
Miscellaneous manufactured articles	16.7%
Chemicals and related products	6.3%
Food and live animals	5.5%
Manufactured goods classif. by mat.	5.2%

Main Imports (% of total, 2006)	
Machinery and transport equipment	46.8%
Miscellaneous manufactured articles	12.4%
Manufactured goods classif. by mat.	10.1%
Food and live animals	9.7%
Mineral fuels, lubricants & related mat.	9.0%

Lead Export Markets (% of total exports, 2006)	
France	15.0%
Germany	12.8%
Singapore	12.7%
USA	12.5%

Lead Import Markets (% of total imports, 2006)	
Italy	28.3%
United Kingdom	10.1%
France	9.5%
Germany	7.7%

Basic indicators

Selected economic indicators	2004	2005	2006	2007	2008f
Nominal GDP (USD mn)	5,571	5,929	6,373	7,410	8,565
Population (mn)	0.400	0.403	0.405	0.407	0.410
GDP per capita (USD)	13,923	14,727	15,745	18,187	20,883
Real GDP growth (% yr/yr)	0.2	3.4	3.4	3.8	2.5
Inflation (HCPI%, eop)	1.9	3.4	0.8	3.1	3.2
Fiscal balance (ESA 95, % of GDP)	-4.6	-3.0	-2.5	-1.8	-1.7
Current account balance (% of GDP)	-6.0	-8.7	-6.7	-5.5	-6.1
External debt/GDP (%)	28.7	37.7	42.6	41.6	39.7
External debt/Exports of goods & services (%)	36.1	48.7	48.3	47.7	49.6
Debt-service ratio (%)	n.a.	n.a.	n.a.	n.a.	n.a.
Foreign exchange reserves (USD mn) *	2,622	2,473	2,865	3,662	487
Import cover (months) *	6.8	6.1	5.9	6.6	0.8
Exchange rate assumption, EUR:USD (av)	0.80	0.80	0.80	0.73	0.67

f: CRU central forecast; * Malta adopted the EUR in 2008 and has since access to pooled foreign exchange reserves of the ECB.

Sources: National Statistics Office, Central Bank, IMF, World Bank, UN, Eurostat, Euler Hermes Country Risk Unit

Political Stability

Malta is a parliamentary republic that has preserved military neutrality in its constitution. On the domestic front, politics as well as the Maltese people have traditionally been polarised between the two main parties—the Nationalist Party (PN) and the Malta Labour Party (MLP)—which continue to enjoy roughly equal levels of support. This was confirmed once more by the general election in March 2008, which the PN won narrowly by just 0.5 percentage points of the votes from MLP, and 35 to 34 seats in parliament. Nonetheless, the PN has been uninterruptedly in power since 1998, and its re-election should ensure policy continuity, particularly of EU-required reforms, even if PM Lawrence Gonzi, in office since 2004, is re-elected as leader in the autumn of 2008.

Malta's international relations are very good. The country has been a member of the EU since May 2004 and joined the euro-zone at the start of 2008 (together with Cyprus). The latter was achieved thanks to the government's fiscal austerity measures—a marked reduction in expenditures and some one-off measures—which the Maastricht criteria for euro adoption to be met. Although a further tightening of fiscal policy is envisaged, high social expenditure and large public sector wage costs will continue to weigh heavily in the budget.

Overall, the political system continues to be risk-free for business activities. Malta's accession to the EU and to the euro-zone also opens new opportunities for social and economic development and provides an important underpinning of political stability.

Economic Stability

Malta is a high income country with estimated GDP per capita of more than USD18,000 in 2007. Services account for about 74% of GDP, industry for 23% and agriculture for 2%. Since the mid-1980s, the island state has become a freight transhipment point, financial centre, and tourist destination. The economy is highly export-intensive, with an export ratio of about 87% in 2007. Manufactured exports, although diversified in terms of market destinations, are mainly produced by one single, large foreign electronics company and services earnings, which account for roughly one third of total exports, are highly dependent on tourism, making the economy somewhat vulnerable to external shocks. EU membership, however, has provided a wider access to export markets and euro-zone accession has reduced export risks such as transaction costs and exchange rate risks.

After 15 years of continued high growth, adverse shocks to tourism and high-tech export sectors drove the Maltese economy into recession in 2001. Economic growth remained relatively anaemic until 2004 before recovering modestly to annual rates above 3% in 2005 thanks to some structural changes, a cyclical upturn and a public investment boom. Real GDP grew by 3.8% in 2007, but we expect growth to slow to about 2.5% in 2008 owing to weaker external demand. Nonetheless, the overall growth outlook remains positive because domestic demand continues to be boosted by public-sector investment and, increasingly, by private consumption, which is driven by employment growth and rising wages, credit growth and de-hoarding of money (the conversion of undeclared cash balances into euro).

Economic policies have been successful in facilitating euro-zone entry at the start of 2008. Long-term ongoing price stability had provided the appropriate framework that enabled Malta to enter the EU's Exchange Rate Mechanism II (ERM II, a 2-year waiting room prior to entry to the European Monetary Union—the euro zone) in May 2005. Substantial fiscal consolidation resulted in sufficient improvements of the two fiscal indicators, previously major concerns regarding euro adoption, in order to meet the Maastricht criteria in time for entry in 2008. The fiscal deficit has rapidly improved since 2003 (10% of GDP), was squeezed under the 3% of GDP Maastricht threshold in 2006 and amounted to 1.8% of GDP in 2007. The public debt-to-GDP ratio fell from a peak of 72.6% in 2004 to 62.6% in 2007. Although this was still above the 60% Maastricht threshold, the clear downtrend was assessed positively by the European Commission. The fiscal indicators are forecast to remain in a comfortable range in 2008-2009 (see Political Stability section). However, euro-zone entry expectations combined with rising food and energy prices have boosted inflation since the final quarter of 2007, to 3.1% at end-2007 and 4.3% yr/yr in March 2008. Given the current economic environment, we expect inflation to average about 4% in the course of 2008. This is not worrisome in the short term since the overall economic outlook is positive. Moreover, membership of the European Monetary Union has substantially decreased external vulnerabilities as it has virtually removed any future uncertainties over exchange rate volatility, convertibility and transfer risk (Malta is now backed by the foreign exchange reserves of the ECB).

In this light, the relatively high current account deficit is of lesser concern. In any event, the deficit improved from 6.7% of GDP in 2006 to 5.5% in 2007, reflecting a pick-up in the tourism industry as

Malta became a destination for low cost air-carriers, an increase in merchandise exports (supported by strong global demand for electronics in 2006 and 2007) and an apparently successful shift to the production of higher value-added goods. In 2008, however, the deficit is likely to widen again slightly to 6% of GDP or so as weaker global demand reduces the pace of export growth and high energy prices contribute to an increase in imports. Nevertheless, very favourable net foreign direct investment (FDI) inflows will further reduce any residual external liquidity risks. Net FDI inflows covered annual current account deficits more than four times in 2006 and 2007 and are expected to stay within that range in 2008 owing to the government's plan of building a technological and communications hub. Furthermore, the skilled, English speaking workforce should attract investors.

Generally, data on Malta's external debt position are not very transparent. According to the Central Bank of Malta, gross external debt has remained in a manageable range in relation to GDP (41.6% in 2007) and export earnings (47.7%). Other sources report Malta to be in a net creditor position, without providing detailed data.

Overall, given the favourable political and business environment, EU and Euro zone membership, the risk of an external liquidity or debt crisis is low. Furthermore, transaction costs have declined substantially, which is particularly favourable for tourism. Declining competitiveness in the longer term, resulting from euro zone entrance and Malta's process of catching up with the other EU member states, might pose some downside risks to growth, but economic fundamentals are robust and stable in the medium term.

Structural Business Environment

The Structural Business Environment is very strong. Malta belongs to the highest category in our assessment overall, ranked 33rd out of the 210 economies we monitor. The regulatory framework is transparent, largely free of unnecessary bureaucratic procedures, making all aspects of business formation relatively efficient and providing for a flexible commercial environment. The straightforward and business-friendly legal framework is protecting investors well. Corruption is seldom in evidence. Further strengths include the high level of trade freedom, sound infrastructure, the reduced level of transactions costs thanks to euro adoption and the sound banking sector. Remaining weaknesses include government size, burdensome taxes and labour market restrictions. Furthermore, even though Malta welcomes foreign investment as witnessed by large scale FDI inflows, restrictions remain in the real estate, wholesale retail trade, public utilities and information technology sectors. Moreover, all investments are carefully screened for interference with local businesses by the government. Overall, however, membership of the EU and the euro zone combined with high trade and business freedoms seem to more than compensate these inconveniences for investors.

Malta's banking sector is assessed as sound, well-supervised and increasingly competitive, though quite small. The foreign-controlled HSBC (Malta) Ltd. and the Bank of Valletta, which was floated on the Malta Stock Exchange in 2003 (though the government still holds a 25% stake), dominate the sector, but foreign banks have a significant presence in the market. The share of non-performing loans in gross loans has further improved from 9.3% in 2005 to 2.8% in 2006 and private sector credit growth has remained robust and manageable, standing at roughly 12% yr/yr in January-September 2007.

Several surveys of international institutions confirm this generally positive view. The Heritage Foundation's *Index of Economic Freedom 2008* survey ranks Malta 47th out of 157 countries, while the Fraser Institute's *Economic Freedom of the World 2007* survey assigns it rank 32 our of 141 economies. The United Nation's *Human Development Index 2007/2008* ranks Malta 34th out of 177 countries and Transparency International's *Corruption Perceptions Index 2007* assigns it rank 33 out of 182 countries.

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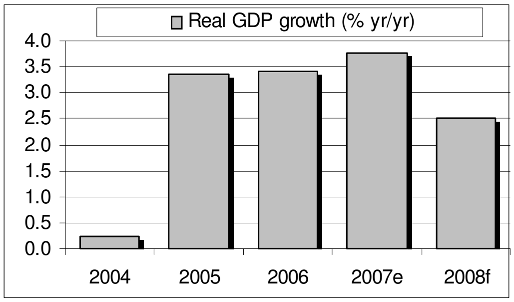
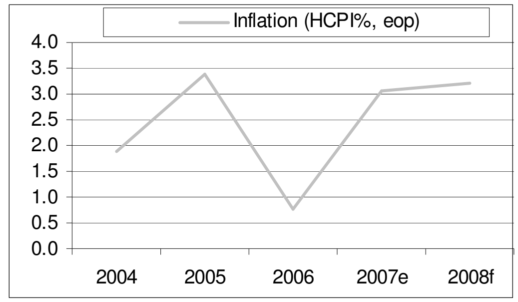
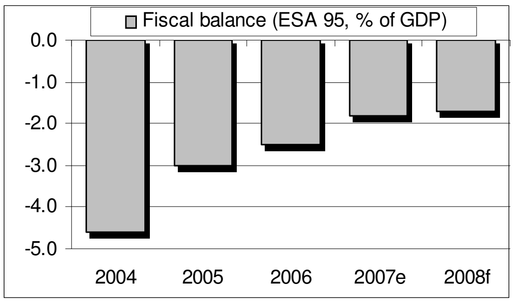
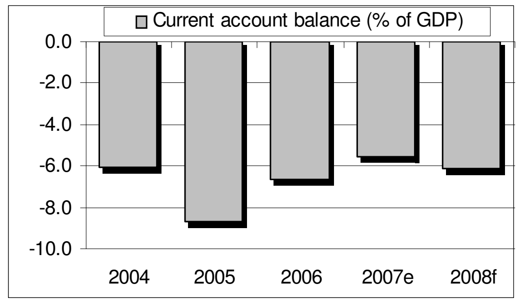
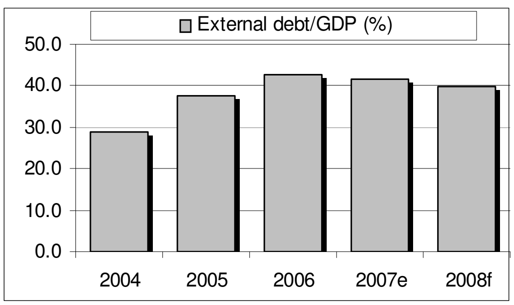
Charts


Real GDP growth (% yr/yr)
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
2004
2005
2006
2007e
2008f

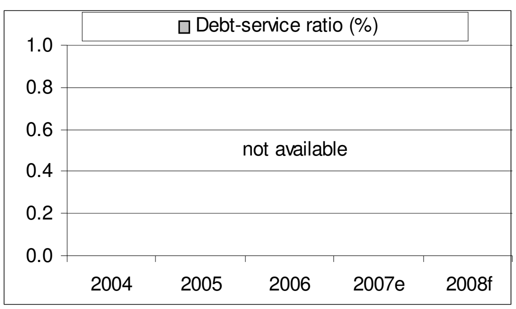

Inflation (HCPI%, eop)
4.0
3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
2004
2005
2006
2007e
2008f

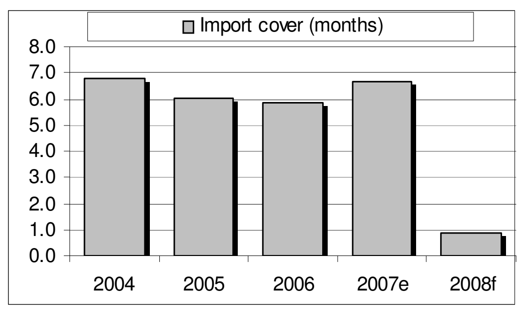

Fiscal balance (ESA 95, % of GDP)
0.0
-1.0
-2.0
-3.0
-4.0
-5.0
2004
2005
2006
2007e
2008f


Current account balance (% of GDP)
0.0
-2.0
-4.0
-6.0
-8.0
-10.0
2004
2005
2006
2007e
2008f


External debt/GDP (%)
50.0
40.0
30.0
20.0
10.0
0.0
2004
2005
2006
2007e
2008f


External debt/Exports of goods & services (%)
60.0
50.0
40.0
30.0
20.0
10.0
0.0
2004
2005
2006
2007e
2008f


Debt-service ratio (%)
1.0
0.8
0.6
0.4
0.2
0.0
not available
2004
2005
2006
2007e
2008f


Import cover (months)
8.0
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
2004
2005
2006
2007e
2008f