Rating Action: Moody's affirms Malta's A3 rating, stable outlook

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London, 02 September 2016 -- Moody's Investors Service, ("Moody's") has today affirmed Malta's A3 long-term issuer, senior secured and senior unsecured debt ratings. The outlook remains stable.

The key factors underpinning today's affirmation are:

(1) Malta's resilient economy, supported by high competitiveness and recent structural reforms which increase potential growth from a narrow economic base

(2) Malta's relatively high, although decreasing, debt levels compared to peers coupled with sizeable contingent liabilities

(3) The resilience of the Maltese banking system despite its large size, with domestic banks following a conservative and traditional banking model

The stable outlook reflects Moody's view that fiscal consolidation will continue to support a gentle downward trajectory in the debt burden, although Moody's expects the debt burden will remain above similarly rated peers for some years, and sizeable contingent liabilities from state-owned enterprises will continue to act as a constraint on the rating. Malta's tourism industry is particularly exposed to any fall in British tourists resulting from the UK's decision to leave the EU and the subsequent depreciation in sterling, although there are mitigants in place to limit the impact on economic growth.

In a related rating action, Moody's has today also affirmed the senior unsecured rating of Freeport Terminal (Malta) Limited at A3 with a stable outlook, in line with the sovereign's ratings. The senior debt instruments issued by Freeport Terminal (Malta) Limited are backed by unconditional and irrevocable guarantees from the Maltese government.

Malta's local-currency bond and deposit ceilings and long-term foreign-currency bond and deposit ceilings are unchanged at Aaa. The short-term foreign currency bond and deposit ceilings are also unaffected by this rating action and remain Prime-1.

RATINGS RATIONALE

RATIONALE FOR THE AFFIRMATION

FIRST FACTOR -- MALTA'S RESILIENT ECONOMY REFLECTING HIGH COMPETITIVENESS AND RECENT STRUCTURAL REFORMS

The first key factor supporting the affirmation is Malta's resilient economy, which Moody's classifies as 'Medium+' in terms of its economic strength. While small and with a relatively narrow base, the economy is competitive and exhibits relatively elevated wealth levels.

This resilience is reflected in Malta's 48th position out of 140 countries on the World Economic Forum's 2015-2016 Global Competitiveness rankings. The economy benefits from its central location in the Mediterranean, and its membership in the euro area since 2008 and the European Union since 2004. In addition, Malta scores slightly better (ranked 40th in 2015) on sectoral competitiveness and in particular tourism, the most important sector of the economy. This resilience is also reflected in its elevated wealth level (GDP per-capita of $35,825 (PPP basis) in 2015), which supports the country's ability to absorb future economic shocks.

Malta's recent economic reforms have sought to counter structural challenges, enhancing the economy's resilience to future shocks. For example, reforms aimed at alleviating constraints in the labour market have led to significant improvements in the female participation rate, which rose by around 13 percentage points between 2008 and 2015. Furthermore, progress has been made in reducing Malta's reliance on oil imports as a primary energy source, notably through the recent electricity connection with Italy, which is already playing an important role in energy supply, supported by additional large-scale energy investments.

Progress on structural reforms has led to an upward revision in potential growth, reflecting in part a greater contribution from labour input. However, various factors will continue to constrain Moody's assessment of economic strength, including labour market activity rates which remain below the EU average despite improvements, barriers to investment as evidenced by Malta's relatively low ranking on the World Bank's Doing Business report, and the small size of the domestic market with a population of just over 400,000. In addition, risks to sustaining cost competitiveness are rising, reflecting the challenges to labour productivity from the shift in the economy to more labour-intensive services.

SECOND FACTOR -- DECREASING DEBT BURDEN, THOUGH SIZEABLE CONTINGENT LIABILITY RISKS WEIGH ON CREDIT

The second key factor supporting the affirmation is Malta's 'High-' fiscal strength, which is constrained by the country's relatively high, although decreasing, debt burden. Moody's assessment also takes into account the vulnerability of public finances to contingent liabilities stemming from public sector utilities, in particular from Enemalta plc (not rated), Malta's government-owned energy company.

Malta's general government debt to GDP ratio, after averaging around 68% between 2010 and 2014, declined to 63.8% in 2015 reflecting fiscal consolidation and faster-than-expected nominal GDP growth, although it remains higher than both the A-rated (41.1%) and A3-rated (39.6%) medians. Moody's expects that continued economic growth and the decline in the budget deficit will support a further drop in the debt ratio to close to just below 60% in 2017. These consolidation efforts have been supported by the strengthening of Malta's fiscal framework, including the introduction of the Fiscal Responsibility Act and the operationalization of the independent Fiscal Advisory Council in 2015.

However, Malta's sizeable contingent liabilities, which are among the highest in the EU and above the median of similarly rated peers, weigh on Moody's assessment of fiscal strength. Moody's notes that Malta's track record of support to public corporations has fiscal implications and that the debt guaranteed by Malta's government remains significant at €1.4 billion or around 16% of 2015 GDP. While recent private investment in the energy sector has led to a decline in guarantees provided to Enemalta plc, total government guarantees related to the entity are sizeable, and the uncertainties that surround the firm's longer-term financial sustainability will remain a source of risk for the government's financial position. Furthermore, Moody's notes that the restructuring of Air Malta p.l.c. (not rated), which has resulted in

Related Issuers

Freeport Terminal (Malta) Limited

Malta, Government of

Related Research

Credit Opinion: Government of Malta – A3 Stable: Update Following Affirmation of Rating and Outlook

Credit Opinion: Government of Malta – A3 Stable: Semi-Annual Update

Announcement: Moody's update on Sovereign calendar issuers

Sector Comment: Sovereigns – Brexit and European Union: Direct impact is minor, but may have credit implications for those with less policy space

Country Statistics: Malta, Government of

previous capital injections by the government, has yet to place the airline on a secure financial footing.

THIRD FACTOR -- STRONG RESILIENCE OF THE BANKING SYSTEM DESPITE ITS LARGE SIZE

The third key affirmation factor is the resilience of Malta's very large banking system, with domestic banks following a traditional banking model.

Despite its large size (around 540% of GDP in 2015), several features of Malta's banking system substantially limit the risk it poses to the sovereign from a financial stability and contingent liability risk perspective. There is a clear delineation between international and domestic banking activities which limits the spill-overs from the international system into Malta's domestic economy. Indeed, Moody's notes that the recent reduction in the size of banking system assets by more than 100 percentage points of GDP, due in part to the exit of a large international bank in 2015, had little obvious effect on the domestic economy. Furthermore, the domestic system, which is dominated by two systemic banks, is well capitalized (tier 1 capital ratio for core domestic banks was 12.2% at year-end 2015) and has a very low reliance on wholesale funding (loan to deposit ratio of 58.2%).

However, the domestic economy remains vulnerable to the high concentration risk in the domestic banking system, given the economic impact (for example through the availability of credit) should one of these systemic banks exit the system. Furthermore, the government's reliance on domestic funding makes it vulnerable to the health of the banking system, such that issues which impact the banking system not only affect the real sector and government finances through recapitalisation costs, but also government liquidity risk should the sovereign's access to one of its traditional funding sources be impeded.

RATIONALE FOR STABLE OUTLOOK

The stable outlook on the rating reflects Moody's view that fiscal consolidation will continue to support a gentle downward trajectory in the debt burden, although Moody's expects the moderation in economic growth together with the recent strong growth in current expenditure will make further reductions in the debt burden more challenging, such that the debt ratio will remain above similarly rated peers for some years. In particular, the budget position will continue to benefit from robust growth in tax receipts and inflows from Malta's Individual Investor Programme, however the revenue generated from the latter remains uncertain. Furthermore, sizeable contingent liabilities from state-owned enterprises will weigh on fiscal strength and continue to act as a constraint on the rating.

After registering growth of 6.4% in 2015, Moody's expects robust, albeit slower, economic growth, supported by household spending, reflecting improvements in the labour market, and public consumption. In particular, growth will moderate to around 3.7% on average over the next two years as investment stabilizes from a high base following the end of the peak construction phase of major energy projects, before GDP reaches a more sustainable and balanced growth rate of around 3% in the medium term.

Malta's tourism industry, an important contributor to economic activity, is particularly exposed to a loss of custom from the UK, most likely as a result of the depreciation of UK sterling following the UK's decision to leave the EU, although there are mitigants in place to help limit the impact on economic growth. A sustained depreciation of the UK sterling would reduce UK tourist flows to Malta (which account for around 30% of arrivals), although Moody's expects the impact would be partly offset by the growth in tourist arrivals from other destinations and as Malta benefits from ongoing political instability in competing locations. However, important ties with the UK's health and education sectors, in terms of service provision and knowledge transfer, could be at risk following the UK's vote to leave the EU.

WHAT COULD CHANGE THE RATING UP/DOWN

Upward pressure could come from a very marked improvement in the government's balance sheet including the reduction in contingent liabilities, leading to greater convergence of the debt burden with A rated peers. Furthermore, substantial structural reforms focused on removing bottlenecks in the labour and energy markets, enhancing competitiveness and improving the business environment would also be credit positive.

Material fiscal slippage that jeopardizes debt sustainability would generate downward pressure on the rating, such as from the materialization of significant contingent liabilities. Such negative rating pressure could also develop if Malta's economic growth prospects were to deteriorate significantly, thereby obstructing fiscal consolidation and leading to a significant further deterioration in the sovereign's key credit metrics. The rating could also be downgraded if the financial system were to undergo a large negative shock that hinders its ability to provide funding to the sovereign.

GDP per capita (PPP basis, US$): 35,825 (2015 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 6.4% (2015 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 1.3% (2015 Actual)

Gen. Gov. Financial Balance/GDP: -1.5% (2015 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 2.6% (2015 Actual) (also known as External Balance)

External debt/GDP: [not available]

Level of economic development: High level of economic resilience

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 31 August 2016, a rating committee was called to discuss the rating of the Government of Malta. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. The issuer's susceptibility to event risks has not materially changed.

The principal methodology used in these ratings was Sovereign Bond Ratings published in December 2015. Please see the Ratings Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

REGULATORY DISCLOSURES

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