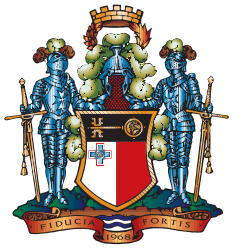

BANK ĊENTRALI TA' MALTA

EUROSISTEMA

CENTRAL BANK OF MALTA

QUARTERLY REVIEW

2017

Vol. 50 No. 3

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The cut-off date for statistical information published in the Economic Survey of this Review is 30 June 2017 unless otherwise indicated. Figures in tables may not add up due to rounding.

ISSN 1811-1254 (online)

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ABBREVIATIONS

APP	Asset Purchase Programme
ECB	European Central Bank
EONIA	Euro OverNight Index Average
ESCB	European System of Central Banks
EU	European Union
EURIBOR	Euro Interbank Offered Rate
GDP	gross domestic product
HCI	harmonised competitiveness indicator
HICP	Harmonised Index of Consumer Prices
IMF	International Monetary Fund
LFS	Labour Force Survey
MFI	monetary financial institution
MGS	Malta Government Stocks
MRO	main refinancing operation
MSE	Malta Stock Exchange
NACE	statistical classification of economic activities in the European Community
NFC	non-financial corporation
NPISH	Non-Profit Institutions Serving Households
NSO	National Statistics Office
PPI	Producer Price Index
RPI	Retail Price Index
ULC	unit labour cost

FOREWORD

While still solid, the pace of economic expansion in Malta slowed in the first quarter of 2017. Real gross domestic product (GDP) rose by 4.2% on an annual basis, following a 4.9% increase in the previous quarter. Domestic demand was the main driver behind the expansion, although net exports also contributed positively to economic growth.

Labour market conditions remained favourable in the first quarter of 2017, partly reflecting government efforts to increase labour market participation and job matching in the context of a buoyant economy. These measures supported employment growth and a further decline in the unemployment rate.

The annual growth rate of the Harmonised Index of Consumer Prices (HICP) rose further to 1.2% in March, from 1.0% in December, propelled mainly by weaker year-on-year declines in energy prices. Notwithstanding the recent increase, inflation in Malta remained below that in the euro area, where it reached 1.5% in March. Downward pressures on domestic costs persisted, as the Producer Price Index (PPI) contracted again on an annual basis. As regards measures of competitiveness, annual growth in Malta's unit labour costs (ULC) remained moderate, while the Harmonised Competitiveness Indicators (HCI) indicate that the deterioration in competitiveness observed in recent quarters levelled off.

Monetary dynamics in Malta remained robust during the first quarter of 2017. Residents' deposits with monetary financial institutions operating in Malta continued to grow steadily in annual terms, driven by growth in overnight deposits in an environment of low interest rates. Credit to residents of Malta grew at a slightly faster pace compared with December 2016, driven by faster growth in credit to government. In contrast, credit to the private sector decelerated, reflecting movements in banks' equity holdings, which offset faster growth in loans.

In the context of continued limited price pressures in the euro area, the Governing Council of the European Central Bank (ECB) maintained an accommodative monetary policy stance. During the first quarter of 2017, the interest rate on main refinancing operations (MRO), the marginal lending facility and the deposit facility were retained at 0.00%, 0.25% and -0.40%, respectively. The Council also maintained the comprehensive package of non-standard measures, which include purchases of eligible securities under the asset purchase programme (APP). The Governing Council confirmed that interest rates are expected to remain low for an extended period of time, and well past the horizon of the asset purchases.

As a result of these accommodative monetary conditions, interest rates on deposits held by Maltese residents continued to decline between January and March. Interest rates on loans also fell for both households and NFCs. In contrast, yields on Treasury bills and longer-term government bonds rose.

As regards public finances, during the first quarter of 2017, the general government recorded a surplus, which contrasts with the deficit recorded a year earlier. When measured as a four-quarter moving sum, the general government surplus reached 2.1% of GDP, up from 1.0% in the final quarter of 2016. Meanwhile, general government debt as a share of GDP, increased from 58.3%

at the end of December 2016, to 59.0% at the end of March 2017. This increase was due to a build-up in bank deposits, which more than offset the surplus recorded during this period.

The latest Eurosystem staff macroeconomic projections, published in June 2017, foresee the euro area recovery to continue, supported by improving labour conditions, progress with deleveraging across sectors and an accommodative monetary policy stance. Euro area GDP growth is expected to edge up from 1.7% in 2016 to 1.9% in 2017 and then moderate slightly to 1.8% and 1.7% in the subsequent two years. HICP inflation is projected to accelerate from 0.2% in 2016 to 1.5% in 2017. It is then expected to moderate to 1.3% in 2018 before accelerating again to 1.6% in 2019.

ECONOMIC SURVEY

1. THE EURO AREA AND THE EXTERNAL ENVIRONMENT

In the first quarter of 2017, growth in real gross domestic product (GDP) decelerated in the United States and the United Kingdom, but edged up slightly in the euro area. The three-month average unemployment rate edged downwards in the euro area and in the United Kingdom, but was unchanged in the United States.

Price pressures generally rose. Annual consumer price inflation in the euro area increased from 1.1% in December to 2.0% in February, before falling to 1.5% in March. In the United States, inflation in March was also above that in December. Price pressures also increased in the United Kingdom, partly reflecting the weakness in sterling. Given this scenario, the Federal Reserve raised the range for the official federal funds rate in March. On the other hand, the European Central Bank (ECB) and the Bank of England maintained their key policy rates on hold, but both central banks continued to implement various monetary measures to stimulate the economy.

Brent oil prices rose between January and early February, as oil production dropped. Later during the quarter, prices decreased, against a backdrop of increasing supply by OPEC members and higher US crude oil inventories. Non-energy commodity prices also rose during the first quarter of 2017.

Key advanced economies

US economic growth moderates further

Economic growth in the United States slowed down further during the first quarter of 2017, with real GDP rising by 0.4%, as against an increase of 0.5% in the final quarter of 2016 (see Table 1.1).

This slowdown was attributable to weaker growth in private consumption and a contraction in inventories and government consumption. In contrast, private fixed investment rose at a faster pace, reflecting stronger dynamics in both residential and non-residential construction. Meanwhile, net exports were less negative compared with the fourth quarter of 2016, as exports recovered while imports increased at a slower pace.

In the labour market, the participation rate increased by 0.3 percentage point, to 63.0%, while the annual rate of employment growth decelerated to 1.1% in March, from 1.4% in December. Meanwhile, the unemployment rate edged down from 4.7% to 4.5%, although the three-month average

Table 1.1
REAL GDP GROWTH IN SELECTED ADVANCED ECONOMIES
Quarter-on-quarter percentage changes; seasonally and working day adjusted

	2015		2016				2017
	Q3	Q4	Q1	Q2	Q3	Q4	Q1
United States	0.5	0.2	0.2	0.4	0.9	0.5	0.4
Euro area	0.3	0.4	0.5	0.3	0.4	0.5	0.6
United Kingdom	0.3	0.7	0.2	0.6	0.5	0.7	0.2

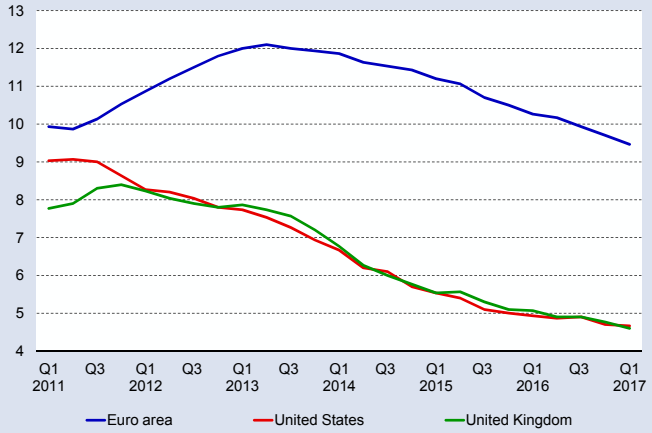
Sources: Bureau of Economic Analysis, US; Eurostat; Office for National Statistics, UK.

rate was unchanged at 4.7% (see Chart 1.1). Payroll data show that in March the number of employees increased on an annual basis in both the private and government sector, with the former rising at a faster rate. Meanwhile, in the private sector, employment rose at a brisk pace in construction and services and moderately in manufacturing.

The annual rate of change of the US consumer price index (CPI) remained above the 2% target of the Federal Reserve, rising from 2.1% in December to 2.7% in February, before falling to 2.4% in March (see Chart 1.2). The rate registered in February was the highest in nearly five years. Higher price pressures were primarily attributable to a significant rise in energy prices. Following five consecutive negative readings, food price inflation turned positive in February and rose further to 0.5% in March. In contrast, inflation excluding food and energy eased. It stood at 2.0% in March, as against 2.2% in December.

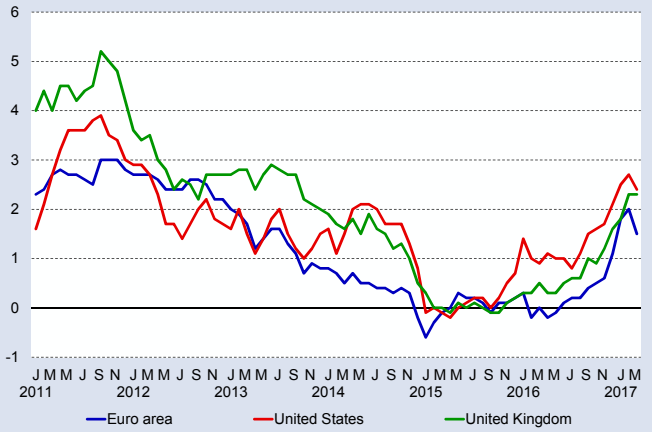
In its meetings held at the end of January and the beginning of February, the Federal Open Market Committee (FOMC) decided to maintain the target range for the federal funds rate unchanged (see Chart 1.3). In March, however, the FOMC increased the range to between 0.75% and 1.00%, from the preceding range of 0.50% to 0.75%. This decision was taken against a backdrop of a further

Chart 1.1
UNEMPLOYMENT RATE
(percentage of the labour force; quarterly average; seasonally adjusted)



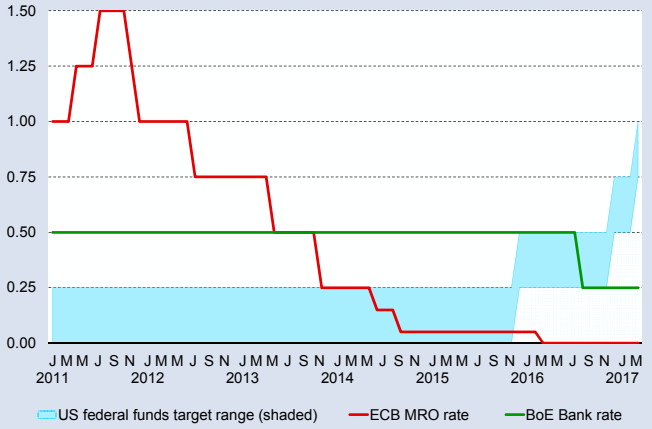
Sources: Eurostat; US Bureau of Labor Statistics; Office for National Statistics, UK.

Chart 1.2
CONSUMER PRICE INFLATION
(annual percentage changes)



Sources: Eurostat; US Bureau of Labor Statistics; UK Office for National Statistics.

Chart 1.3
OFFICIAL INTEREST RATES
(percentages per annum; end of month)



Sources: ECB; Federal Reserve; Bank of England.

strengthening of the labour market and economic activity, and a pick-up in inflation. The Committee also maintained its existing policy of reinvesting principal payments from its agency debt and agency mortgage-backed security holdings in agency mortgage-backed securities, and rolling over maturing Treasury securities at auction. The Committee also said that economic conditions are expected to develop in such a way that they would warrant gradual increases in the federal funds rate. At the same time, the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run.[1]

UK economy expands at a slower pace

In the first quarter of 2017, quarter-on-quarter GDP growth in the United Kingdom decreased to 0.2% from 0.7% in the previous three-month period (see Table 1.1). This reflected a decline in exports, higher imports and a slowdown in consumer spending. On the other hand, investment and government consumption expenditure accelerated. Unemployment in the United Kingdom averaged 4.6% between January and March, 0.2 percentage point lower than the average for the last quarter of 2016 (see Chart 1.1).

Consumer price inflation increased, with the annual rate of change in the CPI reaching 2.3% in March, up from 1.6% in December (see Chart 1.2). Food price inflation turned positive while prices of energy and non-energy industrial goods also increased at a faster pace. In contrast, the rate of increase in the prices of services slowed down towards the end of the quarter under review. Inflation excluding energy, food, alcohol and tobacco rose to 1.8% in March from 1.6% in December.

In its February and March meetings, the Bank of England's Monetary Policy Committee voted to maintain the Bank Rate unchanged at 0.25% (see Chart 1.3). The Committee reiterated that there are limits to the extent that above-target inflation can be tolerated and that the continuing suitability of the current policy stance depends on the trade-off between above-target inflation and slack in the economy. The Committee voted unanimously to continue with the programme of sterling non-financial investment-grade corporate bond purchases totalling up to £10 billion, financed by the issuance of central bank reserves. It also maintained its programme of £60 billion of UK government bond purchases to take the total stock of these purchases to £435 billion.[2]

The euro area

Euro area economy continues to grow moderately

During the first quarter of 2017, the euro area economy continued to grow at a moderate pace, with quarter-on-quarter real GDP growth standing at 0.6% (see Table 1.2). This pace of expansion was marginally faster than that recorded in the last quarter of 2016.

The main driver behind economic activity during the first three months of the year was domestic demand. Government consumption rose at a marginally faster pace when compared with the previous quarter and contributed 0.1 percentage point to economic growth (see Table 1.2). On the other hand, the rate of growth of private consumption and investment slowed down, but together they still pushed up GDP growth by half a percentage point. Changes in inventories and net

[1] In June, given the further strengthening of the labour market and latest developments in inflation, the FOMC increased the target range of the federal funds rate to between 1.00% and 1.25%. It also announced that it would begin implementing a balance sheet normalization program this year, if the economy evolves broadly as anticipated.

[2] The Bank of England's Monetary Policy Committee maintained the Bank Rate and asset purchase programmes unchanged during its May and June monetary policy meetings.

Table 1.2
CONTRIBUTIONS TO QUARTERLY REAL GDP GROWTH IN THE EURO AREA[(1)]
Seasonally and working day adjusted

	2016				2017
	Q1	Q2	Q3	Q4	Q1
	Percentage point contributions				
Private consumption	0.4	0.2	0.2	0.2	0.2
Government consumption	0.2	0.1	0.0	0.1	0.1
Gross fixed capital formation	0.1	0.2	0.0	0.7	0.3
Change in inventories	-0.3	-0.1	0.1	0.4	0.0
Exports	0.2	0.6	0.2	0.8	0.5
Imports	0.0	-0.7	-0.1	-1.6	-0.5
GDP	**0.5**	**0.3**	**0.4**	**0.5**	**0.6**

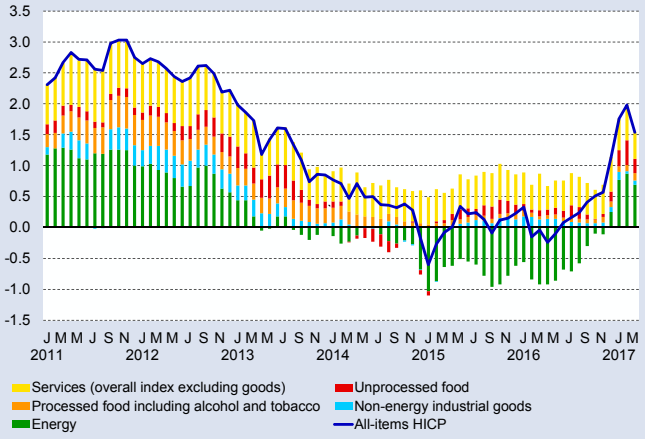
(1) Figures may not add up due to rounding.
Source: Eurostat.

exports had a negligible impact on growth during the quarter under review, with the latter reflecting offsetting increases in imports and exports.

Inflation picks up further

The annual rate of inflation in the euro area, measured on the basis of the Harmonised Index of Consumer Prices (HICP), increased at a faster pace during the first quarter of 2017. In March, it was 1.5%, up from 1.1% in December (see Chart 1.4).

Chart 1.4
CONTRIBUTIONS TO YEAR-ON-YEAR HICP INFLATION IN THE EURO AREA
(percentage points; annual percentage change)



Source: Eurostat.

The acceleration in consumer prices was primarily driven by a strong pick-up in energy inflation, reflecting the recent recovery in international oil prices (see Chart 1.10). The prices of processed and unprocessed food also increased at a faster pace, while prices of non-energy industrial goods rose at the same rate recorded in December. On the other hand, services inflation in March moderated slightly when compared with three months previously.

These developments led to a deceleration in, the annual rate of change of HICP excluding food and energy over the period under review, to stand at 0.7% in March, down from 0.9% in December.

Labour market improves further

Labour market conditions in the euro area continued to improve during the first quarter of 2017. The number of employed continued to increase, with the annual rate of change reaching 1.5% on an annual basis, slightly faster than the 1.4% recorded in the previous quarter.[3] The unemploy-

[3] Employment data for the euro area are based on the national accounts.

ment rate stood at 9.4% in March, down from 9.6% in December and from 10.2% a year earlier (see Chart 1.1).

Euro area recovery expected to continue

The latest Eurosystem staff macroeconomic projections, published in June 2017, foresee the euro area recovery to continue. Economic activity in the euro area is expected to be supported mainly by domestic demand, which should benefit from improving labour conditions and progress with deleveraging across sectors. An accommodative monetary policy stance by the ECB is also expected to continue sustaining the recovery over the forecast horizon, while the expected global economic recovery should support euro area exports. Following a rise of 1.7% in 2016 and robust growth in the first quarter of 2017, real GDP growth is set to edge up to 1.9% in 2017 and then moderate slightly to 1.8% and 1.7% in the subsequent two years (see Table 1.3).

Private consumption growth is expected to continue to recover, supported by favourable labour, as well as the low interest rate environment, improving bank lending conditions and progress with deleveraging. Private consumption is also set to benefit from the recent improvement in consumer confidence across countries to levels well above their long-term averages.

Residential investment is set to benefit from favourable income prospects and financing conditions, although following the relatively fast recovery in 2016, it is projected to lose some momentum over the forecast horizon.

Business investment is expected to develop in line with the cyclical recovery. It is set to benefit from improving business confidence, higher capacity utilisation and the need to modernise the capital stock after years of subdued investment together. An improvement in profit mark-ups is also expected to boost investment. Government consumption growth is expected to moderate in 2017 and remain relatively constant over the rest of the forecast period.

On the external side, exports are set to be backed by the recovery in global demand. After gaining momentum in the second half of 2016 and in early 2017, euro area foreign demand is projected to improve further as import demand is expected to increase in both advanced and emerging market economies. Euro area import growth is set to outpace exports over the forecast horizon, with net exports having almost no impact on GDP growth in the first two years of the forecast period and then making a very small positive contribution in 2019.

Table 1.3
MACROECONOMIC PROJECTIONS FOR THE EURO AREA[(1)]
Average annual percentage changes

	2016	2017	2018	2019
GDP	**1.7**	**1.9**	**1.8**	**1.7**
Private consumption	1.9	1.5	1.6	1.4
Government consumption	1.8	1.2	1.2	1.1
Gross fixed capital formation	3.6	3.7	3.4	3.0
Exports	2.8	4.8	4.3	4.1
Imports	4.0	5.2	4.6	4.3
HICP	**0.2**	**1.5**	**1.3**	**1.6**

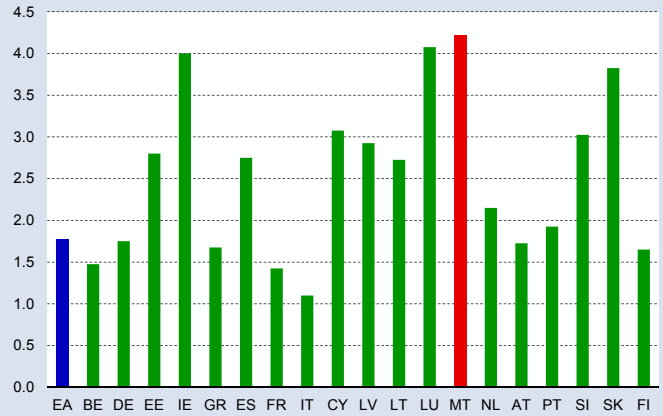
[(1)] Eurosystem staff macroeconomic projections (June 2017).
Source: ECB.

Compared with the ECB staff projections published in March 2017, euro area GDP growth was revised upwards by 0.1 percentage point in all years. In the short term, the upward revisions reflect very favourable business and consumer sentiment and stronger foreign demand. Revisions towards the end of the projections reflect upward impacts from lower oil prices, lower long-term interest rates and higher stock prices, as well as stronger public expenditure. These were only partly offset by an appreciation in the euro exchange rate.

The recovery in the euro area is expected to be broad-based across Member States, with real GDP rising in all countries (see Chart 1.5). Nevertheless, the average growth rates over the projected horizon are expected to be quite diverse, ranging from a low of 1.1% in Italy to a high of 4.2% in Malta.

According to the June 2017 projections, HICP inflation is set to accelerate from 0.2% in 2016 to 1.5% in 2017. It is then expected to moderate to 1.3% in 2018 before accelerating again to 1.6% in 2019. This profile reflects expected movements in energy prices, which are expected to pick up fast in 2017 before moderating thereafter in line with market expectations.

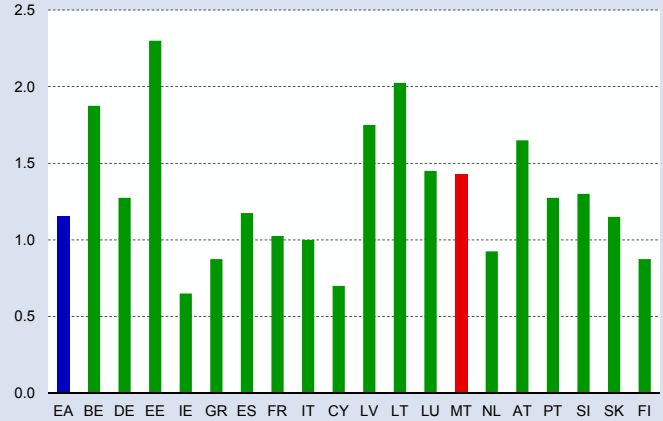
Chart 1.5
AVERAGE REAL GDP GROWTH 2016 - 2019
(annual percentage changes)



Source: Eurosystem.

In contrast, HICP excluding food and energy is expected to pick up over the forecast horizon, rising from 0.9% in 2016 to 1.1% this year, and further to 1.7% by 2019, respectively. The expected pick up in this measure of inflation largely reflects an expected increase in until labour costs and higher production costs, in the context of diminishing labour market slack. Overall inflation projections were revised up by 0.2, 0.3 and 0.1 percentage point in 2017, 2018 and 2019, respectively.

Chart 1.6
AVERAGE HICP INFLATION 2016 - 2019
(annual percentage changes)



Source: Eurosystem.

From a cross-country perspective, inflation is expected to accelerate in almost all euro area countries over the projection horizon (see Chart 1.6). The lowest average inflation

rate over the forecast horizon is expected to be recorded in Cyprus and Ireland, at 0.7%, while the highest average rate is projected in Estonia, at 2.3%. Inflation in Malta is set to average 1.4% over the forecast horizon, slightly above the average of 1.2% for the euro area as a whole.

ECB kept its accommodative monetary policy stance

The ECB's Governing Council maintained an accommodative monetary policy stance during the first quarter of 2017. The interest rates on main refinancing operations (MRO), marginal lending facility and deposit facility were retained at 0.00%, 0.25% and -0.40%, respectively (see Chart 1.3). The Council announced that it continues to expect these rates to remain at present or lower levels for an extended period of time, and well past the horizon of the net asset purchases.[4]

The Council also maintained the comprehensive package of non-standard measures. This includes purchases under the asset purchase programme (APP), which were conducted at a monthly pace of €80 billion until the end of March. Such purchases are intended to continue at a monthly pace of €60 billion until the end of December 2017, or beyond, if necessary, and in any case until the Governing Council see a sustained adjustment in the path of inflation. The Governing Council also noted that net purchases will be made alongside reinvestments of principal payments from maturing securities purchased under the APP.

Money market rates remain at historical lows

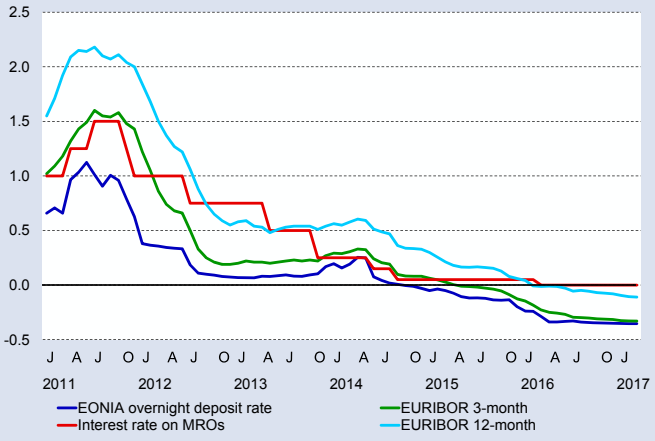
Against a backdrop of an accommodative monetary policy by the ECB, money market rates in the euro area reached new historical lows during the first quarter of 2017. The three-month and twelve-month EURIBOR fell to -0.33% and -0.11%, respectively, in March, down by 1 and 3 basis points, respectively, from their level in December (see Chart 1.7). On the other hand, the EONIA deposit rate remained unchanged at 0.35%.[5]

Spreads widen further as bond yields increase

During the first quarter of 2017, yields on ten-year benchmark government bonds in the euro area increased, partly fuelled by market expectations that the ECB will wind down monetary stimulus as the euro area economy is on the mend, as well as political uncertainty and concerns about the execution of financing programmes in some euro area countries.

The strongest increase was recorded in Italy, where yields

Chart 1.7
KEY INTEREST RATES
(percentages per annum; monthly averages)



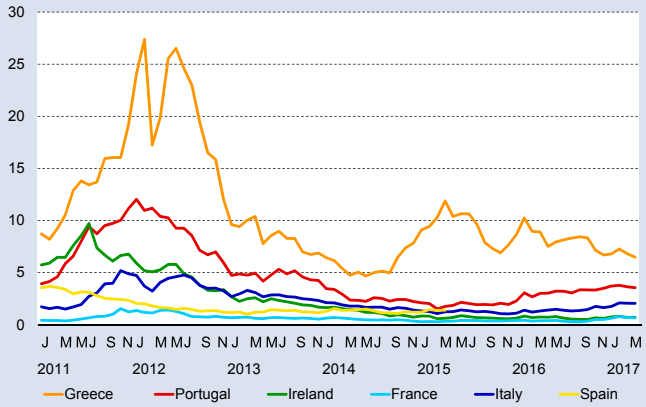
Source: ECB.

[4] The Governing Council kept the key interest rates unchanged during its April and June monetary policy meetings. In June, the Council announced that it continues to expect the key interest rates to remain at present levels for an extended period of time, and well past the horizon of net asset purchases.

[5] EURIBOR is an interest rate benchmark indicating the average rate at which principal European banks lend unsecured funds on the interbank market in euro for a given period. The EONIA (Euro OverNight Index Average) is an effective overnight interest rate, measured as the weighted average of all overnight unsecured lending transactions on the euro area interbank market.

rose by 51 basis points over the three-month period reflecting political uncertainty and market concerns about the banking sector. Yields also rose in Spain (by 28 basis points), France (by 27 basis points), Portugal (by 25 basis points), Greece (by 23 basis points) and Ireland (by 21 basis points). After turning positive in the last quarter of 2016, bond yields in Germany increased further averaging 0.35% in March, 10 basis points higher than the December average.

Chart 1.8
EURO AREA TEN-YEAR GOVERNMENT BOND YIELD SPREADS(1)
(vis-à-vis German ten-year government bond yields)



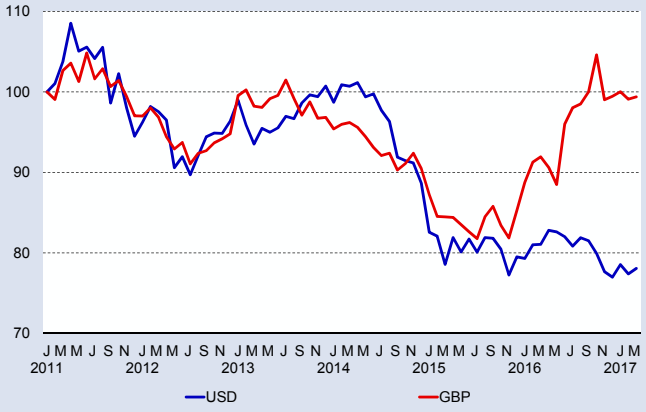
(1) Since there were no data for Greece for July 2015 due to market closure, the spread was left equal to that of the previous month.
Source: ECB.

The spreads between yields on ten-year German bonds and those issued by most other euro area sovereign widened further during the March quarter, especially for the Italian bonds (see Chart 1.8).

The euro depreciates further

The euro exchange rate continued to lose value over the first quarter of 2017. The nominal effective exchange rate against the EER-19 group of countries fell by half a percentage point between end-December and end-March.[6]

Chart 1.9
EXCHANGE RATE MOVEMENTS OF THE EURO AGAINST OTHER MAJOR CURRENCIES
(index of end of month rates; Jan. 2011=100; an increase in the index implies euro appreciation)



Source: Eurostat.

Over the first three months of the year, the euro fell against the majority of currencies within the EER-19 group of countries, such as the Japanese yuan. The euro lost 0.1% against the pound sterling, partly reflecting the assessment that the Bank of England was becoming more receptive to the idea of hiking interest rates in view of higher than expected inflation. On the other hand, the euro gained 1.4% against the US dollar (see Chart 1.9).

Commodities

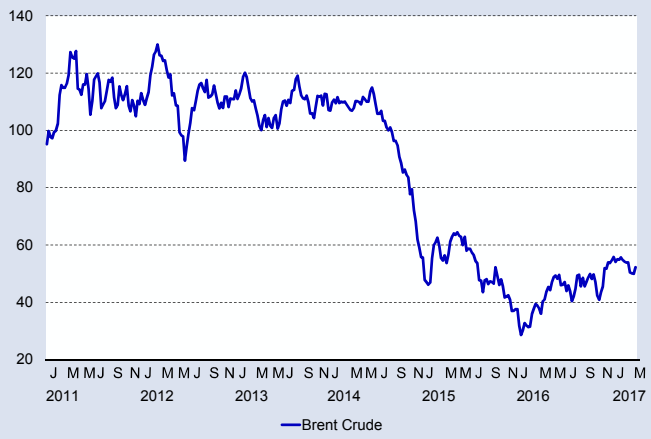
Commodity prices lose some of their gains

After having increased in the beginning of December, in view of the agreement to cut oil production by members of the Organization of the Petroleum Exporting Countries (OPEC), the price of Brent

[6] The effective exchange rate (EER), is based on the weighted averages of the euro exchange rate against the currencies of Australia, Bulgaria, Canada, China, Croatia, Czech Republic, Denmark, Hong Kong, Hungary, Japan, Norway, Poland, Romania, Singapore, South Korea, Sweden, Switzerland, the United Kingdom and the United States.

crude oil generally continued to rise in January and early February as global oil production dropped (see Chart 1.10). Later in February and during most of March prices decreased, falling below USD 50.0 per barrel, against a backdrop of increasing supply and higher US crude oil inventories. At the end of the quarter, the price stood at USD 52.17 per barrel, marking a 4.6% drop since the end of 2016.

Chart 1.10
PRICE OF OIL
(end of week; US dollars per barrel)



Source: Reuters.

As regards non-energy commodity prices, World Bank data show that these generally increased in January and February, before retreating somewhat in March. They ended the quarter 1.4% above their end-December level.

2. OUTPUT AND EMPLOYMENT

The Maltese economy maintained a solid pace of expansion during the first quarter of 2017, although real gross domestic product (GDP) rose at a slower pace than that recorded in the last quarter of 2016. Domestic demand was the main driver behind the expansion, although net exports also contributed positively to economic growth. Nominal sectoral data continue to point towards services as the main driver of growth. However, the manufacturing and construction sectors also registered increases in their gross value added (GVA). In contrast, GVA in primary industries was broadly flat.

Labour market conditions remained favourable in the first quarter of 2017, as employment grew further and the unemployment rate stabilised at an all-time low of 4.2%. This partly reflects government efforts to increase labour market participation and job matching in the context of a buoyant economy.

GDP and industrial production

Economic activity remains robust

During the first quarter of 2017, real GDP rose by 4.2% on a year earlier, after rising by 4.9% in the last quarter of 2016.[1]

Growth in the quarter under review was primarily driven by domestic demand, which contributed 2.9 percentage points to real GDP growth, with all components recovering, or growing at a faster pace compared with the previous quarter (see Table 2.1). Net exports also contributed positively, as they added a further 1.3 percentage points to economic growth.

Real private consumption growth accelarated in the first quarter. It rose by 2.1% on an annual basis, contributing 1.0 percentage point to real GDP growth. In nominal terms, private consumption expenditure grew across most caterogries, except clothing and footwear, as well as communication.

Growth in gross fixed capital formation continued to strengthen. Following a 1.9% year-on-year increase in the last quarter of 2016, investment rose by 3.1% in the quarter under review, contributing 0.7 percentage point to GDP growth. The acceleration in investment reflected a strong increase in dwellings, which continued to expand at double digit rates. Non-residential construction recovered, while investment in intellectual property products picked up. At the same time, capital outlays on cultivated biological resources declined at a slower pace than that recorded in the previous quarter. These developments offset falls in machinery and transport equipment, which in turn were driven by the timing of expenditure on specific large projects in transport. Nominal data show that the increase in gross fixed capital formation stemmed from the private sector, as government investment continued to decline on an annual basis. Changes in inventories also contributed positively to real GDP growth, adding a further 0.8 percentage point.

Government consumption began to recover from the previous two quarters' decline. It increased by 1.7% on a year earlier in the March quarter and pushed up real GDP growth by 0.3 percentage point. Both principal components of government consumption increased in nominal terms. Inter-

[1] The analysis of GDP in this Chapter of the *Quarterly Review* is based on data in NSO *News Release* 093/2017, released on 8 June 2017.

Table 2.1
GROSS DOMESTIC PRODUCT[(1)]

	2016				2017
	Q1	Q2	Q3	Q4	Q1
	Annual percentage changes				
Private final consumption expenditure	6.7	3.0	-1.1	1.8	2.1
Government final consumption expenditure	5.2	2.6	-5.7	-12.7	1.7
Gross fixed capital formation	19.8	0.6	-17.9	1.9	3.1
Domestic demand	**11.4**	**4.8**	**-7.4**	**-1.8**	**3.0**
Exports of goods and services	4.3	-0.7	2.3	8.1	-1.3
Imports of goods and services	7.5	-0.8	-5.9	3.5	-2.2
Gross domestic product	**6.3**	**4.5**	**4.4**	**4.9**	**4.2**
	Percentage point contributions				
Private final consumption expenditure	3.5	1.5	-0.5	0.9	1.0
Government final consumption expenditure	1.0	0.5	-0.9	-2.4	0.3
Gross fixed capital formation	4.0	0.3	-4.6	0.4	0.7
Changes in inventories	2.0	2.3	-0.6	-0.5	0.8
Domestic demand	**10.4**	**4.5**	**-6.6**	**-1.7**	**2.9**
Exports of goods and services	6.5	-1.1	3.2	11.3	-1.9
Imports of goods and services	-10.6	1.1	7.7	-4.7	3.3
Net exports	**-4.2**	**0.0**	**11.0**	**6.6**	**1.3**
Gross domestic product	**6.3**	**4.5**	**4.4**	**4.9**	**4.2**

(1) Chain-linked volumes, reference year 2010.
Sources: NSO; Central Bank of Malta calculations.

mediate consumption rose at a faster pace than compensation of employees, as it was boosted by outlays related to the EU Presidency and health-related expenditure.

Both exports and imports declined when compared with the same quarter a year earlier, with exports falling by 1.3% and imports by 2.2%. As the fall in imports outpaced that in exports, net exports contributed 1.3 percentage points to annual real GDP growth. The positive contribution of net exports mirrored trade in services.

Services remain the main driver of growth

In nominal terms, GDP increased by 6.2% in the first quarter of 2017, following a rise of 6.5% in the last quarter of 2016 (see Table 2.2). This deceleration reflected developments in GVA. The latter increased by 5.6% in the first quarter of 2017, a slower growth than that registered in the previous quarter. It contributed 4.9 percentage points to GDP growth.[2] In contrast to GVA, net taxes on products increased at a faster pace.

Services remained the main driver behind GVA growth, pushing up nominal GDP growth by 4.8 percentage points. The largest additions to growth came from sectors comprising public administration, arts and entertainment, as well as the sector incorporating professional and scientific activities. Together these sectors raised nominal GDP growth by 3.2 percentage points, and accounted for more than three-fifths of the increase in GVA in services.

The manufacturing and construction sectors also supported the expansion, raising nominal GDP growth by 0.2 and 0.1 percentage point, respectively. However, growth in these sectors, as well as in the agricultural sector was moderate. Meanwhile, GVA in the sector incorporating utilities

[2] The difference between nominal GDP and GVA is made up of taxes on production, net of subsidies.

Table 2.2
CONTRIBUTION OF SECTORAL GROSS VALUE ADDED TO NOMINAL GDP GROWTH
Percentage points

	2016				2017
	Q1	Q2	Q3	Q4	Q1
Agriculture, forestry and fishing	0.1	0.1	0.0	0.4	0.0
Mining and quarrying; utilities	0.2	0.2	0.2	-0.3	-0.1
Manufacturing	0.4	0.0	0.5	0.1	0.2
Construction	-0.1	-0.1	0.0	0.1	0.1
Services	6.7	5.0	4.7	5.2	4.8
of which:					
Wholesale and retail trade; repair of motor vehicles; transportation; accommodation and related activities	1.6	0.4	-0.1	0.1	0.4
Information and communication	0.6	0.7	0.7	0.7	0.5
Financial and insurance activities	0.4	0.6	0.4	0.3	0.6
Real estate activities	0.4	0.4	0.4	0.4	0.1
Professional, scientific, administrative and related activities	1.4	0.9	1.2	1.7	0.9
Public administration and defence; education; health and related activities	1.0	1.0	1.1	0.8	1.2
Arts, entertainment; household repair and related services	1.3	0.9	0.9	1.3	1.1
Gross value added	**7.2**	**5.3**	**5.3**	**5.5**	**4.9**
Taxes less subsidies on products	**1.4**	**0.8**	**0.6**	**1.0**	**1.2**
Annual nominal GDP growth (%)	**8.6**	**6.1**	**5.9**	**6.5**	**6.2**

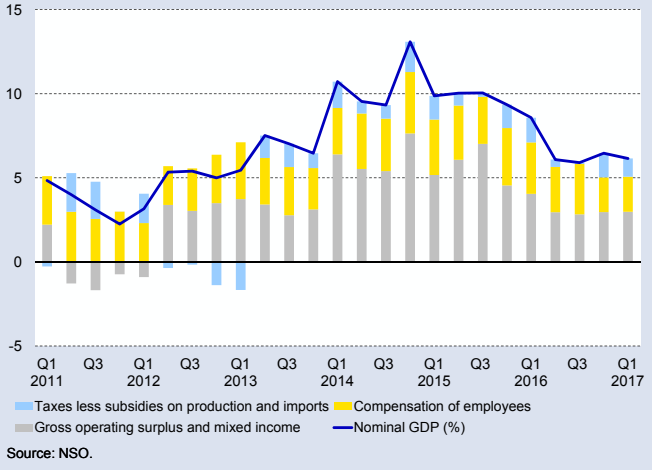
Source: NSO.

continued to decline on an annual basis, although at a slower pace than that registered in the last quarter of 2016. This sector shed 0.1 percentage point from nominal GDP growth.

GDP data by income distribution show that rapid growth in gross operating surplus and mixed income continued in the first three months of 2017, with the annual rate of change stabilising at 6.6%. This component contributed 3.0 percentage points to nominal GDP growth (see Chart 2.1).

In absolute terms, most sectors recorded an increase in their gross operating surplus when compared with the same period a year earlier. The biggest gains were recorded in the sectors incorporating arts and entertainment, financial and insurance activities, as well as professional, scientific and technical activities. On the other hand, the sectors incorporating mining and quarrying, and utilities registered falls in their gross operating surplus, partly reflecting the recent recovery in the international oil price.

Chart 2.1
NOMINAL GDP AND ITS MAIN COMPONENTS
(percentage point contribution)



Source: NSO.

Data on compensation of employees also show further annual increases, although the rate of growth moderated marginally when compared with the previous quarter. The annual rate of growth stood at 4.8% in the first quarter, contributing 2.1 percentage points to nominal GDP growth.

In absolute terms, the strongest increases in compensation were recorded in the sectors of public administration, arts and entertainment, professional, scientific and technical activities, as well as information and communication.

Industrial production increases for the first time in over a year

During the first quarter of 2017, industrial production rose by 4.0% when compared with the same quarter a year earlier.[3] This followed a 1.5% year-on-year decline in the preceding quarter (see Table 2.3).

The manufacturing sector, which accounts for over 80% of the index, expanded following contractions in production that spanned four quarters. Companies producing rubber and plastics, beverages as well as computer, electronic and optical products registered growth in production, while those operating in the pharmaceuticals, printing and reproduction of recorded media and food sectors registered a decline in output when compared with the same quarter of 2016.

Output also rose in the energy sector, but fell in the mining and quarrying sector, although the latter holds a small share in the overall industrial production index.

Table 2.3
INDUSTRIAL PRODUCTION[(1)]
Percentages; annual percentage changes

		2016				2017
	Shares	Q1	Q2	Q3	Q4	Q1
Industrial production	**100.0**	**-4.5**	**-4.0**	**-2.9**	**-1.5**	**4.0**
Manufacturing	**83.3**	**-5.2**	**-4.7**	**-3.8**	**-3.2**	**5.8**
of which:						
Computer, electronic and optical products	18.4	-8.8	-33.0	-5.3	5.8	7.1
Basic pharmaceutical products and pharmaceutical preparations	10.4	-20.6	14.6	-28.3	-23.6	-2.9
Food products	8.1	-6.0	-5.9	-16.2	-2.4	-0.5
Printing and reproduction of recorded media	5.9	-26.4	-7.5	17.8	-29.3	-1.5
Rubber and plastic products	4.4	4.7	2.6	15.6	9.9	22.4
Beverages	3.9	19.6	5.3	-2.9	-3.4	8.8
Energy	**16.3**	**-0.5**	**2.6**	**-3.1**	**3.7**	**5.8**
Mining and quarrying	**0.4**	**43.9**	**11.3**	**10.6**	**-9.7**	**-11.8**

[(1)] The annual growth rates of the industrial production index are averages for the quarter based on working-day adjusted data. The annual growth rates of the components are based on unadjusted data.

Sources: NSO; Eurostat.

[3] Methodological differences may account for divergences between developments in GVA in the manufacturing sector and industrial production. GVA nets input costs from output to arrive at value added and is expressed in nominal terms. Industrial production is a measure of the volume of output that takes no account of input costs. The sectorial coverage between the two measures also differs, since industrial production data also include the output of the energy and, water collection, treatment and supply sectors.

BOX 1: ASSESSING STRUCTURAL CHANGE IN THE MALTESE ECONOMY VIA THE APPLICATION OF A HYPOTHETICAL EXTRACTION ANALYSIS[1]

This Box summarises the results of a broader study conducted for the Central Bank of Malta that aims to assess the extent of change in the production structure of the Maltese economy from the 2000's to date via the application of selected input-output techniques.[2] Over the recent decades, the Maltese economy has passed through a number of significant structural changes such as the shift from manufacturing to service oriented activities leading to greater diversification, as well as to very rapid changes in the labour market. The application of methods which have their foundation in input-output analysis will enable the assessment of the structural change in the Maltese economy making it possible to obtain a deeper understanding of the importance of each sector, in terms of its inter-linkages with the rest of the economy and how this has changed over time.

Data and methodology

The first method employed in this study assumes a full hypothetical sectoral extraction and illustrates the impact that such an extraction would have on the Maltese economy in terms of the percentage loss in total GVA, total labour income and total employment.[3] The latter has been disaggregated in terms of loss in employment of Maltese nationals and loss in employment of foreign nationals, which are caused by the hypothetical extraction of an industry. The magnitude of the resulting extraction effects will therefore depend on both the underlying inter-industry relations but crucially also on the size of the industry itself.

The second method applies the non-complete hypothetical extraction method, proposed by Dietzenbacher and van der Linden, to derive separate backward and forward linkages indicators (which remove sectoral size effects) for each sector in the economy.[4] Sectoral linkages captures the interrelations between production sectors, reflecting the notion that a sector simultaneously purchases inputs from other industries for its production process (the sector's backward linkage) and that the same sector also supplies inputs to other industries (its forward linkage). The analysis of these backward and forward linkages enables researchers to identify the industries that are regarded as key to the economic development strategy of a country. These linkages indicators were utilized for the identification of the key sectors in the Maltese economy across the specified time period. In order to assess the extent of change in the production structure of the Maltese economy the study employed three symmetric input-output tables (SIOTs) for the reference years 2000, 2008 and 2010.[5] The three SIOTs were compiled at the following seventeen industry level of sectoral disaggregation (see Table 1).

[1] Prepared by Dr Ian P. Cassar, who was engaged by the Central Bank of Malta to conduct the research under the editorial supervision of Mr Brian Micallef, Manager of the Research Office. Dr Cassar is a lecturer in the Economics Department of the University of Malta. Helpful comments and suggestions by Dr A. G. Grech are gratefully acknowledged. The views expressed in this Box are those of the author and do not necessarily reflect those of the Central Bank of Malta. Any errors are the author's own.

[2] This study is found at https://www.centralbankmalta.org/en/working-papers-2017

[3] The seminal studies in the literature are: Strassert, G. (1968). Zur Bestimmung strategischer Sektoren mit Hilfe von Input-Output-Modellen. *Jahrbücher für Nationalökonomie und Statistik*, 182, 211-215; Dietzenbacher, E., & Lahr, M. (2013). Expanding Extractions, *Economic Systems Research*, 25(3).

[4] Dietzenbacher, E., & van der Linden, J.A. (1997). Sectoral and spatial linkages in the EC production structure. *Journal of Regional Science*, 37(2), 235-257.

[5] Further details on the data sources used in this study are available in Cassar, I.P. (2017). Assessing structural change in the Maltese economy via the application of a hypothetical extraction analysis. Working Paper WP/01/2017, Central Bank of Malta.

Table 1
CLASSIFICATION OF INDUSTRIES UTILISED FOR THE SECTORAL AGGREGATION

Sector No.	NACE Rev. 2 Code	Sector
1	A	Agriculture, forestry and fishing
2	C	Manufacturing
3	D, E	Electricity, gas, water supply and waste management
4	F, B	Mining, quarrying and construction
5	G	Wholesale and retail trade; repair of motor vehicles and motorcycles
6	H	Transportation and storage
7	I	Accommodation and food service activities
8	J	Information and communication
9	K	Financial and insurance activities
10	L	Real estate activities
11	M, N	Professional, scientific and technical activities and administrative and support service activities
12	O	Public administration and defence
13	P	Education
14	Q	Human health and social work activities
15	R[(1)]	Arts, entertainment and recreation
16	S	Other service activities
17	T,U	Households as employers and activities of extraterritorial organisations

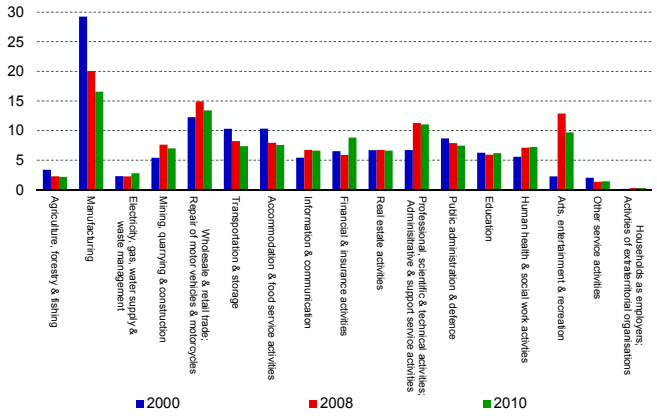
(1) This sector includes gambling and betting activities.

Summary of results

The main results are summarized in Charts 1, 2 and 3, which illustrate the impact that the extraction of each sector would have on the Maltese economy in terms of the percentage loss in total GVA, total labour income and total employment (disaggregated in terms of loss in employment of Maltese, as well as foreign nationals), respectively.

Between 2000 and 2010, the manufacturing sector generates the largest extraction effects in terms of total GVA, total labour income and total employment. However, these extraction effects have been declining over time reflecting the increased level of sectoral diversification which has occurred in the production structure of the Maltese economy since 2000. Indeed, over the

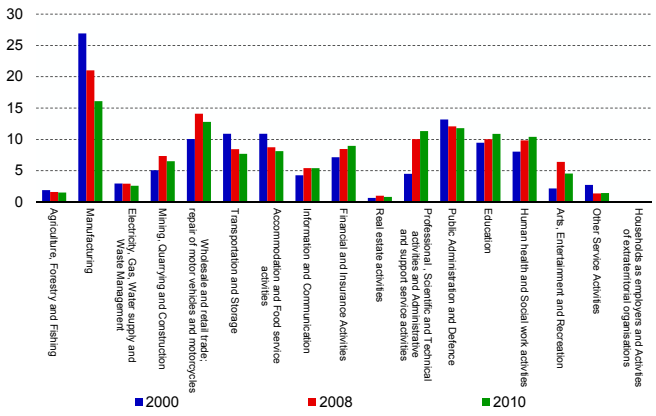
Chart 1
PERCENTAGE LOSS IN TOTAL GROSS VALUE ADDED RESULTING FROM THE HYPOTHETICAL EXTRACTION OF EACH SECTOR
(per cent)



Source: Author's calculations.

same period, a number of sectors experienced significant increases in all three extraction effects. The two sectors with the most significant growth in all three extraction effects are the [11] Professional, scientific and technical activities and administrative and support service activities sector and the [15] Arts, entertainment and recreation activities sector. Other sectors that also experienced a sizable increase in all three extraction effects are the [9] Financial and insurance activities sector, the [14] Human health and social work activities sector and the [8] Information and communication activities sector.

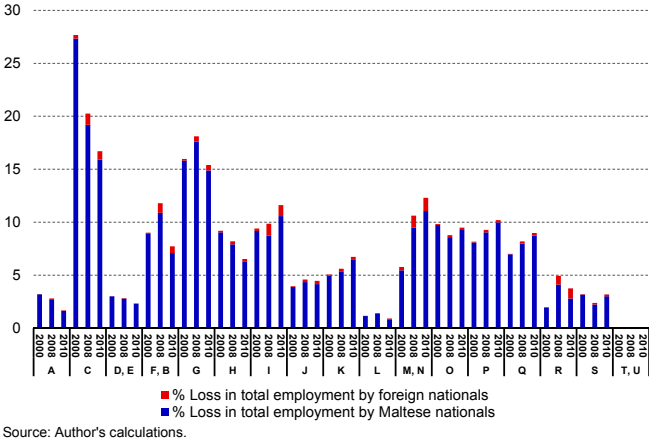
Chart 2
PERCENTAGE LOSS IN TOTAL LABOUR INCOME RESULTING FROM THE HYPOTHETICAL EXTRACTION OF EACH SECTOR
(per cent)



Source: Author's calculations.

According to Chart 3, the largest extraction effects on the employment of foreign nationals were generated by the [11] Professional, scientific and technical activities, and administrative and support service activities followed by the [7] Accommodation and food service activities sector and the [15] Arts, Entertainment and Recreation activities sectors. The growth in these extraction effects and the impact on foreign nationals observed in nearly all sectors, across all three SIOTs, reflects the increased importance of foreign nationals to the production activities of the Maltese economy.

Chart 3
PERCENTAGE LOSS IN TOTAL EMPLOYMENT RESULTING FROM THE HYPOTHETICAL EXTRACTION OF EACH SECTOR
(per cent)



Source: Author's calculations.

An assessment of the forward and backward linkages, for each sector and across the three SIOTs, provides significant insights into the changes which have occurred in the production structure of the Maltese economy between 2000 and 2010.[6] Table 2 presents a summary of the resulting sectoral linkage classifications obtained for each of

[6] For the full set of backward and forward linkages results refer to the full study which can be found at https://www.centralbank-malta.org/en/working-papers-2017.

Table 2
A SUMMARY OF THE VARIATION IN SECTORAL LINKAGES OVER THE THREE SIOTs[(1)]

	Strong backward and forward linkages (Key Sector)	Only strong backward linkages	Only strong forward linkages	Weak linkages
SIOT 2000	1, 2, 8, 9, 11	6, 7, 12, 15	3, 5	4, 10, 13, 14, 16, 17
SIOT 2008	3, 4, 5, 6 ,8, 9, 11	1, 7, 12, 16		2, 10, 13, 14, 15, 17
SIOT 2010	1, 3, 4, 5, 6, 8, 11	7, 12, 16	10	2, 9, 13, 14, 15, 17

[(1)] The sector numbers shown in this table correspond with those listed in Table 1.
Source: Author's calculations.

the three SIOTs and derived from the application of the non-complete hypothetical extraction method. It should be noted that a sector is classified as a key sector if it is found to have both strong forward and backward linkages. An initial assessment of the results obtained illustrate that between 2000 and 2010 there was an increase in the number of sectors classified as key sectors, from five to seven, indicating a higher degree of sectoral interdependence that reflects greater sectoral diversification.

Across all three SIOTs, only two sectors were found to be consistently classified as key sectors, the [11] Professional, scientific and technical activities and administrative and support service activities sector and the [8] Information and communication services sector, highlighting the importance of these two sectors within the context of the economic development strategy of the Maltese economy. Two other sectors which, based on the linkages analysis, should also be regarded as strategically important are the [7] Accommodation and food service activities sector[7] and the [3] Electricity, gas, water supply and waste management sector, which exhibited the strongest backward and forward linkages, respectively, across all three SIOTs.

Conclusion

The results obtained indicate that the production structure of the Maltese economy has passed through a number of significant structural changes over the last fifteen years. As expected, these changes were more pronounced between the 2000 and 2008 SIOTs than between the 2008 and 2010 SIOTs. It should be noted that although hypothetical exaction analysis is subject to the limitations of standard input-output methodology, the results are to an extent also affected by changes in statistical compilation methodologies and the degree of aggregation used.[8]

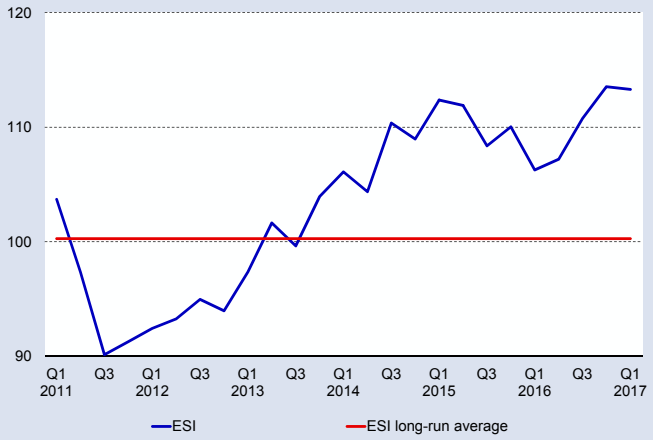
The measures obtained from the hypothetical extraction analysis undertaken in the study should be viewed by policy makers as a robust indication of how the production structure of the Maltese economy has evolved since 2000. Thus, these indicators, which account for the sectors' degree of interdependence, may be utilized to assess the role of each sector in promoting growth and strengthening Malta's overall competitiveness.

[7] This sector is often used as an approximation for the tourism industry.
[8] For instance, the manufacture of food and beverages, the manufacture of electronics and the manufacture of pharmaceuticals, along with other industries, have all been aggregated within the manufacturing sector. This implies that it was not possible to derive estimates that capture the strength of the sectoral linkages exhibited by these aggregated sectors.

Business and consumer surveys

During the first quarter of 2017, the economic sentiment indicator (ESI) fell marginally to 113, from 114 in the last quarter of 2016,[4] but remained above its long-term average of 100 (see Chart 2.2).[5] A decline in sentiment in construction, services, and industrial sectors as well as among consumers, more than offset a significant improvement in the retail sector.

Chart 2.2
ECONOMIC SENTIMENT INDICATOR
(seasonally adjusted; percentage points)



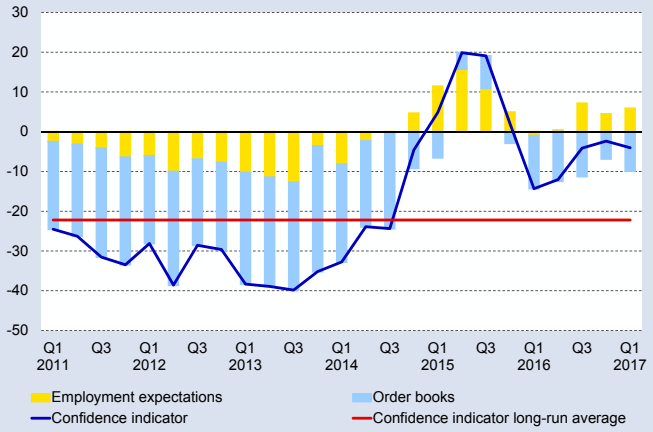
Source: European Commission.

Confidence in the construction sector remains negative[6]

Sentiment in the construction sector deteriorated during the first quarter of 2017, with the confidence indicator falling to -4, from -2 in the preceding quarter (see Chart 2.3).

Although the overall construction confidence indicator remains well above its long-term average of -22, it has been negative for five consecutive quarters. This was largely driven by firms' assessment of order books.

Chart 2.3
CONSTRUCTION CONFIDENCE INDICATOR
(seasonally adjusted; percentage points)



Source: European Commission.

This component also explains the fall in construction confidence during the first quarter of 2017. In contrast, employment expectations for the subsequent three months were more optimistic.

Additional survey data indicate that in the first quarter of this year, more respondents have on balance, reported positive building activity developments during the preceding three months. Also, more firms expected selling prices to rise in the subsequent three months.

[4] The ESI summarises developments in confidence in five surveyed sectors (industry, services, construction, retail and consumers). Quarterly data in this Box represent three-month averages.

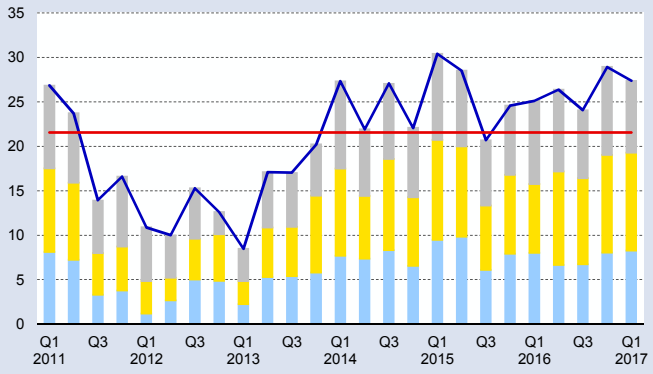
[5] Long-term averages are calculated over the entire period for which data are available. For the consumer and industrial confidence indicators, data became available in November 2002, while the services and construction confidence indicator data became available in May 2007 and May 2008, respectively. Since the retail confidence indicator began to be published as from May 2011, its long-term average is calculated since then. The long-term average of the ESI is computed from November 2002.

[6] The construction confidence indicator is the arithmetic average of the seasonally adjusted balances (in percentage points) of replies to two survey questions, namely those relating to order books and employment expectations over the subsequent three months.

Confidence in the services sector weakens slightly[7]

In the first quarter of 2017, the services confidence indicator fell to 27, following an increase to 29 in the fourth quarter of 2016. Notwithstanding this decline, it still compared favourably with a long-term average of 22 (see Chart 2.4).

Chart 2.4
SERVICES CONFIDENCE INDICATOR
(seasonally adjusted; percentage points)



Source: European Commission.

The fall in confidence in the services sector in the quarter under review was solely driven by respondents' expectations of demand for the following three months. On the other hand firms' assessment of their business situation over the preceding three months improved marginally. Their assessment of past demand however, was unchanged.

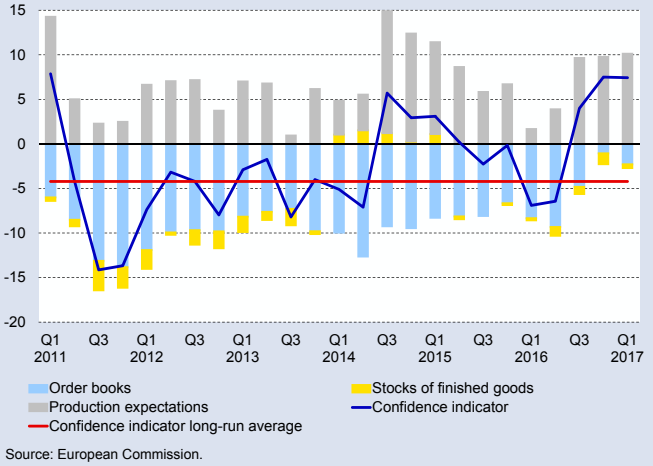
Additional survey data indicate that a larger net share of respondents reported higher employment in the preceding three months, while a smaller share of firms expected employment to increase in the following three months. On balance, firms expected prices to rise in the following three months.

Industrial confidence stabilizes at a high level[8]

Confidence in the industrial sector also remained above its long-term average, despite falling marginally to 7 in the first quarter of 2017, from 8 in the preceding quarter (see Chart 2.5).

Positive sentiment in the first quarter of 2017 was entirely due to favourable production expectations. This outweighed persistently weak order books and above-normal stocks of finished goods.[9]

Chart 2.5
INDUSTRIAL CONFIDENCE INDICATOR
(seasonally adjusted; percentage points)



Source: European Commission.

[7] The services confidence indicator is the arithmetic average of the seasonally adjusted balances (in percentage points) of replies to survey questions relating to the business climate, the evolution of demand in the previous three months and demand expectations in the subsequent three months.

[8] The industrial confidence indicator is the arithmetic average of the seasonally adjusted balances (in percentage points) of replies to a subset of survey questions relating to expectations about production over the subsequent three months, to current levels of order books and to stocks of finished goods.

[9] Above-normal stock levels indicate lower turnover and affect the overall indicator in a negative way. Such levels are thus represented by negative bars in Chart 2.5.

The marginal reduction in industry sentiment during the quarter under review was driven by firms' assessment of order books, which fell significantly when compared with the preceding three months. In contrast, stocks of finished goods were less pronounced and production expectations within the industry improved between the two quarters.

Meanwhile, additional survey data suggest that more respondents expected to increase their labour complement in the subsequent three months. At the same time, on balance, fewer respondents expected to decrease their selling prices.

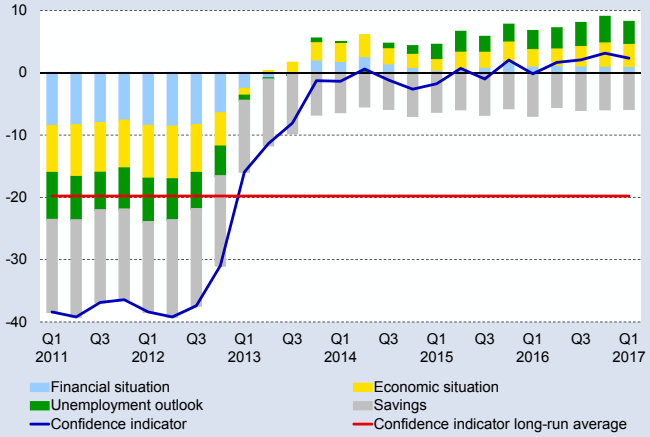
Consumer confidence remains mildly positive[10]

The consumer confidence indicator edged down to 2 in the first quarter of 2017, from 3 in the preceding three-month period. However, it still remained well above its long-term average of -20 (see Chart 2.6).

During the quarter under review unemployment was foreseen to fall more slowly compared with the last quarter of 2016.[11] Also, a smaller share of respondents expected an improved general economic situation in the subsequent 12 months. These offset slightly more favourable savings expectations. Meanwhile, respondents' expectations of their financial situation remained unchanged.

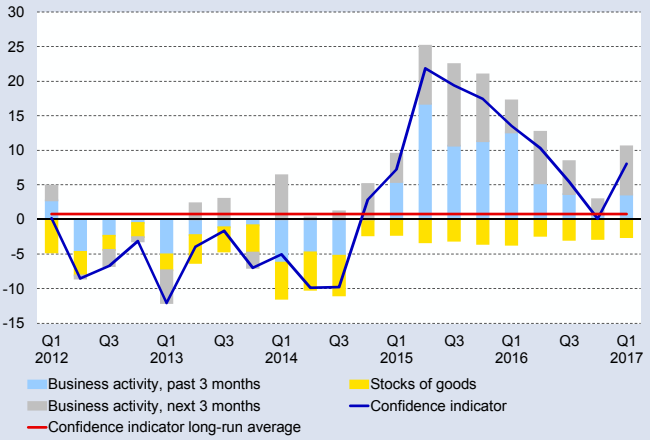
Additional survey data suggest that the share of consumers intending to reduce major purchases over the subsequent 12 months decreased. The survey also indicates that, on balance, consumers' inflation expectations increased substantially in the quarter under review.

Chart 2.6
CONSUMER CONFIDENCE INDICATOR
(seasonally adjusted; percentage points)



Source: European Commission.

Chart 2.7
RETAIL CONFIDENCE INDICATOR
(seasonally adjusted; percentage points)



Source: European Commission.

[10] The consumer confidence indicator is the arithmetic average of the seasonally adjusted balances (in percentage points) of replies to a subset of survey questions relating to households' financial situation, their ability to save, the general economic situation and unemployment expectations over the subsequent 12 months.

[11] Negative unemployment expectations affect the overall indicator in a positive way. Such falls are thus represented by positive bars in Chart 2.6.

Confidence in the retail sector increases[12]

Sentiment in the retail sector increased for the first time in almost two years. The retail confidence indicator rose from 0 in the fourth quarter of 2016, to 8 in the first three months of 2017 (see Chart 2.7).

Firms in this sector continued to express a favourable assessment of past and expected business activity, with both indicators increasing between the two quarters under review. However, on balance respondents continued to assess stock levels to be above normal, with the share of respondents expressing this view broadly unchanged from that in the preceding quarter.

Additional survey data indicate that selling prices are expected to fall during the three months ahead, while on balance, a marginally smaller share of respondents expected employment to increase.

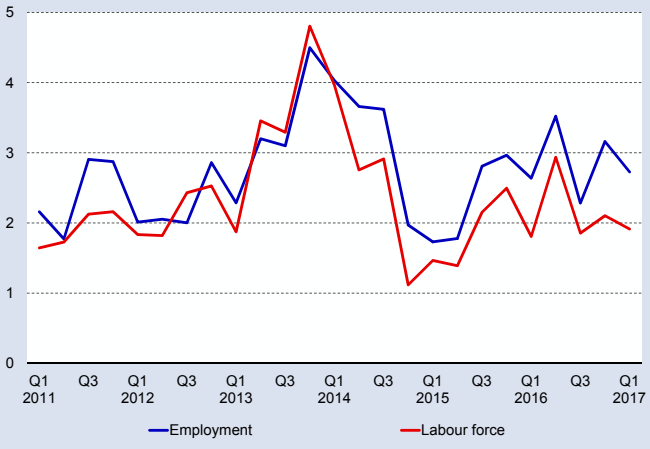
The labour market[13]

Labour force continues to grow strongly

Labour Force Survey (LFS) data show that in the first quarter of 2017 the labour force grew by 1.9% over the same quarter of 2016, marginally down from 2.1% in the last quarter of 2016 (see Chart 2.8).[14] Employment grew at a slower pace, while the number of unemployed decreased further.

The activity rate stood at 68.7% in the first quarter of 2017, up from 67.7% in the same quarter a year earlier.[15] This reflected increased activity among both males and females. The female participation rate edged up 1.6 percentage points, to reach 55.6%, while that of males increased by 0.3 percentage point to 81.2% (see Table 2.4).

Chart 2.8
LABOUR FORCE AND EMPLOYMENT BASED ON THE LFS
(annual percentage changes)



Source: NSO.

Employment grows further

The annual rate of change in employment fell to 2.7%, from 3.2% in the fourth quarter of 2016, but still stood marginally higher than the 2.6% recorded in the first quarter of 2016. The increase in employment during the first quarter of 2017 reflected further growth in the number of full-time jobs as well as

[12] The retail confidence indicator is the arithmetic average of the seasonally adjusted balances (in percentage points) of replies to survey questions relating to the present and future business situation and stock levels.

[13] This section draws mainly on labour market statistics from two sources: the LFS, which is a household survey conducted by the NSO on the basis of definitions set by the International Labour Organization and Eurostat, and administrative records compiled by Jobsplus according to definitions established by domestic legislation on employment and social security benefits.

[14] The LFS defines the labour force as all persons aged 15 and over active in the labour market. This includes those in employment, whether full-time or part-time, and the unemployed, defined as those persons without work but who are actively seeking a job and are available for work.

[15] The activity rate measures the number of persons in the labour force aged between 15 and 64, as a proportion of the working age population, which is defined as all those aged 15 to 64 years.

Table 2.4
LABOUR MARKET INDICATORS BASED ON THE LFS
Persons; annual percentage changes

	2016				2017	Annual change
	Q1	Q2	Q3	Q4	Q1	%
Labour force	**196,869**	**201,206**	**203,763**	**201,329**	**200,636**	**1.9**
Employed	187,171	191,384	193,893	192,807	192,277	2.7
By type of employment:						
Full-time	160,160	162,641	164,904	164,741	164,727	2.9
Part-time	27,011	28,743	28,989	28,066	27,550	2.0
Unemployed	9,698	9,822	9,870	8,522	8,359	-13.8
Activity rate (%)	**67.7**	**69.1**	**70.0**	**69.1**	**68.7**	
Male	80.9	81.9	82.9	81.9	81.2	
Female	54.0	55.6	56.6	55.7	55.6	
Employment rate (%)	**64.3**	**65.7**	**66.5**	**66.1**	**65.8**	
Male	76.9	78.3	79.0	78.8	77.9	
Female	51.2	52.5	53.6	52.9	53.0	
Unemployment rate (%)	**4.9**	**4.9**	**4.8**	**4.2**	**4.2**	
Male	4.8	4.4	4.7	3.7	3.9	
Female	5.1	5.6	5.2	5.1	4.5	

Source: NSO.

increased employment on a part-time basis (see Table 2.4). Full-time employment increased by 4,567, or 2.9% on the same quarter of 2016, while the number of part-timers, which includes those employed on a full-time with reduced hours basis, increased by 539, or 2.0%, following a 2.3% decline in the preceding quarter.

During the first quarter of 2017 the overall employment rate rose to 65.8% and registered a year-on-year increase of 1.5 percentage points on a year earlier.[16] This reflects developments in both the male and female employment rates, which increased by 1.0 and 1.8 percentage points respectively. Indeed, the male employment rate reached 77.9%, from 76.9% a year earlier, while that of females rose to 53.0% from 51.2% in the first quarter of 2016. These gains were especially pronounced among male workers aged between 15 and 24 and among females aged between 25 and 54.

The recent development in both activity and employment rates is in line with the Government's target of increasing the employment rate to 70.0% by 2020.[17]

The unemployment rate was unchanged

In the first quarter of 2017, the unemployment rate based on the LFS stood at 4.2%. This was unchanged from the preceding quarter, and 0.7 percentage point less than a year earlier.[18] The jobless rate for males declined by 0.9 percentage point to 3.9%, while that of females fell by 0.6 percentage point to 4.5% compared with the first quarter of 2016 (see Table 2.4).

[16] The employment rate measures the number of persons aged between 15 and 64 employed on a full-time or part-time basis as a proportion of the working-age population.

[17] See *The National Employment Policy*, Ministry for Education and Employment, May 2014, p.13 and *Malta: National Reform Programme 2017*, Ministry for Finance, April 2017, p.33.

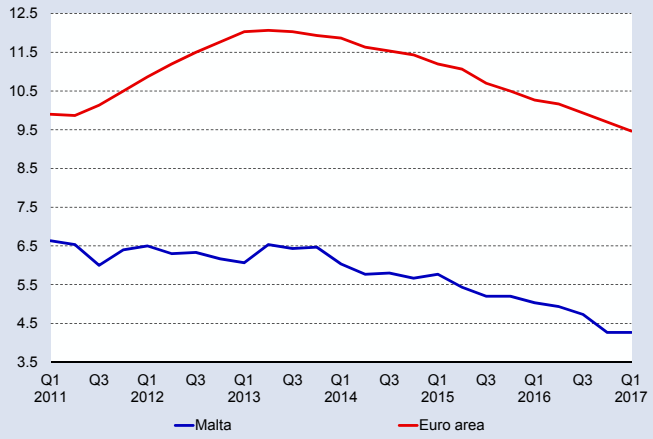
[18] According to the LFS the unemployed comprise persons aged between 15 and 74 years who are without work, available for work and who have actively sought work during the four weeks preceding the survey. In contrast, the number of unemployed on the basis of the Jobsplus definition includes only those persons registering for work under Part 1 and Part 2 of the unemployment register.

Eurostat's seasonally-adjusted unemployment rate stood at 4.3% in the first quarter of 2017, down from 5.0% in the corresponding quarter of 2016. The unemployment rate in Malta remains well below the average rate for the euro area, though the latter also continued to decline (see Chart 2.9).

Jobsplus data also show favourable labour market developments. Indeed, the average number of registered unemployed stood at 2,768 in the first quarter of 2017, 1,650 persons less than those registered in the same quarter of 2016 (see Chart 2.10).

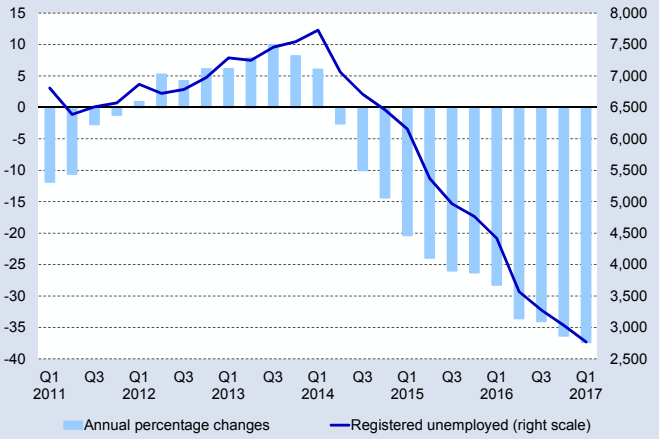
Apart from a growing demand for labour, the drop in the number of registered unemployed since the beginning of 2014 was also influenced by a range of measures aimed at reducing reliance on social benefits, as well as the extension of schemes which encourage employment, training and re-skilling.

Chart 2.9
UNEMPLOYMENT RATE
(seasonally adjusted; per cent)



Source: Eurostat.

Chart 2.10
REGISTERED UNEMPLOYED
(annual percentage changes; persons)



Source: NSO.

BOX 2: THE PROCESS OF ECONOMIC CONVERGENCE IN MALTA[1]

Convergence, both economically and institutionally, was always a key milestone of the European Union (EU) project. It is also a prerequisite for increasing cohesion within the EU, especially with the New Member States (NMS) that joined the EU since 2004 that have a lower per capita income level compared to the EU15 Member States. Convergence is facilitated through access to the Single Market, with its four freedoms and a common set of rules, combined with limited transfers from the EU regional policy, targeted primarily on infrastructural projects and economic development.

[1] Prepared by Brian Micallef, Manager Research Office. The views expressed in this Box are those of the author and do not necessarily reflect those of the Central Bank of Malta. Any errors are the author's own. This Box summarizes the main findings published in Micallef (2017), The process of economic convergence in Malta and in the European Union, Policy Note, March 2017, Central Bank of Malta.

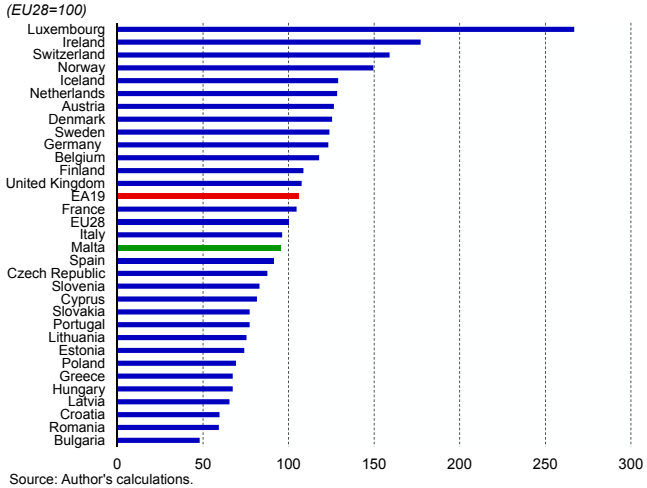
GDP per capita in EU countries

International comparisons of per capita GDP have to be expressed in a common currency and adjusted for differences in price levels. Failing to do so would result in an overestimation of GDP levels for countries with high price levels relative to countries with low price levels. GDP per capita is therefore defined in purchasing power standards (PPS), a common currency that eliminates the differences in price levels between countries, therefore allowing for a meaningful volume comparison of GDP between countries.

Chart 1 shows the GDP per capita in PPS in 2016 for the EU28 countries together with three countries in the European Free Trade Agreement (EFTA) – Iceland, Switzerland and Norway. As expected, there are substantial differences in income levels in this group of countries.[2] Luxembourg has by far the highest GDP per capita among the countries considered, standing at around 267% of the EU average. One particular feature of Luxembourg's economy which to some extent explains the country's very high GDP per capita is the fact that a large number of foreign workers are employed in the country and thus contribute to its GDP, while at the same time they are not included in the resident population. The three EFTA countries in the sample all have high per capita incomes, ranging from 129% of the EU average in Iceland to 159% in Switzerland. Among the EU countries, the richest countries are Ireland, the Netherlands, Austria, Germany, Denmark and Sweden, all with per capita income exceeding 120% of the EU average. With the exception of Greece and Portugal, members of the EU15 group of countries rank at the upper end of the table. At the other end, the three latest members of the EU – Bulgaria, Romania and Croatia – have the lowest per capita income. Bulgaria's income per capita, at 48% of the EU average in 2016, is the lowest in the EU.

Malta stands as the best performer among the NMS, with a GDP per capita of 95% of the EU average in 2016, up from 80% at the time of EU membership in 2004. Malta's GDP per capita in PPS in 2016 stood at around 27,600 PPS. Between 2010 and 2016, Malta's increase in GDP per capita in PPS averaged 4.8% per annum, slightly higher than the average increase of 3.9%

Chart 1
GDP PER CAPITA IN PPS in 2016
(EU28=100)



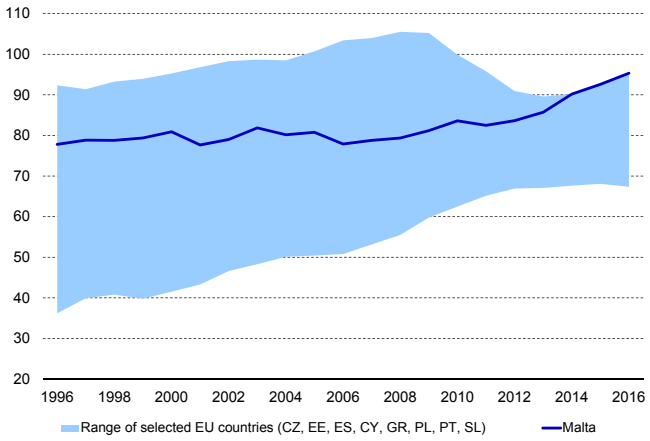
Source: Author's calculations.

[2] This Box follows the literature and uses GDP per capita in PPS as the measure of convergence. The country ranking in Chart 1 remains broadly unchanged if one uses Gross National Income (GNI) per capita in PPS. GNI per capita in Luxembourg and Ireland are however substantially lower compared to per capita GDP. The former is due to the large banking sector while the latter is due to the presence of multinational companies that have an incentive to report their profits in Ireland for tax purposes. While GDP is mainly an indicator of the level of economic activity, Actual Individual Consumption (AIC) is an alternative indicator better adapted to describe the material welfare of households. Levels of AIC per capita are more homogeneous than GDP although there are still substantial differences across the EU Member States.

registered between 1996 and 2009.

Chart 2 plots Malta's GDP per capita in PPS vis-à-vis the EU average between 1996 and 2016 together with selected EU economies. The countries in the range had a GDP per capita of 75% to 95% of the EU average in the mid-1990s: Czech Republic, Greece, Spain, Cyprus, Portugal and Slovenia. The group also includes Estonia, one of the fastest growing NMS, as well as Poland, which is the only country that was not affected by the 2009 recession.

Chart 2
CONVERGENCE PROCESS IN MALTA AND SELECTED EU ECONOMIES
(EU28=100)



Source: Author's calculations.

Malta's per capita GDP increased gradually in the late 1990s as the economy benefitted from a broad programme of structural adjustment that included price deregulation, privatisation, and financial and trade liberalisation, all of which encouraged greater private sector involvement in the economy.[3] However, this catching-up process came to a halt in the early 2000s as the economy was hit by a combination of adverse demand and supply shocks. For most of the 2000s, the Maltese economy made no progress in closing its income gap vis-à-vis the EU, remaining at slightly above 81% by 2009. Since then, however, the country accelerated its pace of convergence with higher economic growth compared with the rest of the EU countries.

The range of selected EU economies in Chart 2 starts relatively wide in the mid-1990s but gradually converges by 2016 for two reasons. The first relates to the catching-up process of the NMS. For instance, Estonia increased its per capita GDP from 35% of the EU average in 1996 to 74% by 2016. Similarly, Poland improved its per capita GDP from less than 43% to 69% in two decades. On the other hand, countries that were severely affected by the financial crisis of 2009 and the European sovereign debt crisis of 2012 experienced a decline in their per capita GDP. By 2016, Malta's GDP per capita, at 95% of the EU average, is the highest from the range of countries in Chart 2 as well as among the NMS that joined the EU in 2004.

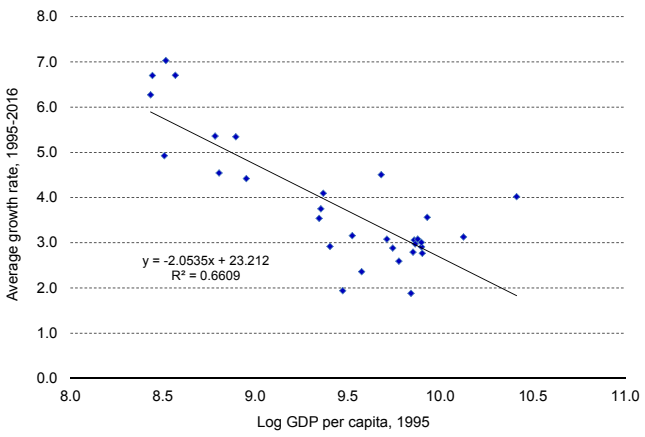
Different measures of convergence

Economic theory postulates that developing economies have the potential to grow at a faster rate than developed ones since diminishing returns, in particular to capital, are not as strong as in capital-rich economies. In addition, developing economies can adopt and

[3] Ebejer, I. (2006). Malta's growth predicament: from frontrunner to laggard…and back? *ECFIN Country Focus*, Vol. III, Issue 14, November 2006.

replicate the production methods, technologies, and institutions of developed countries, leading to faster economic growth.

Chart 3
BETA CONVERGENCE: 1995-2016



Source: Author's calculations.

The growth literature distinguishes between two types of convergence processes, *"beta-convergence"* and *"sigma-convergence"*.[4] Beta-convergence refers to the concept that poor countries should grow faster than rich ones and therefore, will gradually 'catch-up'. Sigma-convergence refers to the reduction in the dispersion of per capita GDP levels among different countries. Beta convergence is necessary but not sufficient for sigma convergence.

Beta-convergence is estimated on the basis of univariate cross-country regression of per capita income growth. A negative sign of the estimated coefficient indicates absolute beta convergence, suggesting that countries at lower initial income levels grow faster.

Chart 3 presents empirical results on beta convergence in the EU28 and EFTA countries over the period 1995-2016. The scatter diagram and the fitted trend line point to a strong inverse relationship between the starting level of per capita GDP and subsequent growth over the following two decades. These results provide evidence that supports the beta convergence process in the EU. According to the parameters of the fitted regression, the average rate of convergence among this group of countries in this period has been around 2% per annum. This result is in line with the "2% rule" of convergence documented in the first studies of the convergence hypothesis.[5]

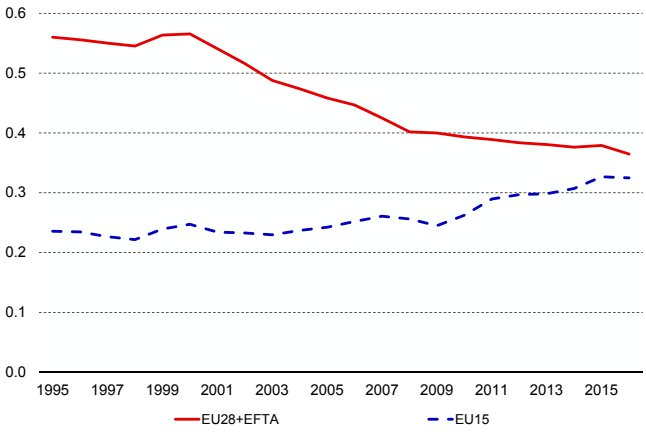
As a measure of dispersion, sigma-convergence is calculated by the standard deviation of per capita incomes in PPS of the countries in the sample. Chart 4 illustrates the evolution of sigma-convergence for all the countries as well as the EU15 covering the period 1995-2016.

A number of results stand out. First, the main trend during this period among the EU countries has been towards a declining standard deviation of per capita income, especially in the period after 2000. This process has been driven by the NMS that joined the EU after 2004, which have recorded higher growth rates than the older Member States. Second, the pace of the reduction of income dispersion has slowed down after the crisis. This can be

[4] Barro, R. & Sala-i-Martin, X. (2004). *Economic Growth*. MIT Press, Second Edition.
[5] Mankiw, G., Romer, D., & Weil, D. (1992). A contribution to the empirics of economic growth. *Quarterly Journal of Economics*, 107 (May), 407-437.

observed by the flattening of sigma convergence for all the countries in the sample starting from around after 2009. On the contrary, in the EU15 countries, there has been a reversal of sigma-convergence since the start of the crisis. This process was driven by the considerable heterogeneity observed within this group of countries, with a number of countries being severely affected by the financial crisis and the European sovereign debt crisis, leading to a widening of dispersion in per capita incomes.

Chart 4
SIGMA CONVERGENCE: 1995-2016
(standard deviation of logarithm of per capita GDP in PPS)



Source: Author's calculations.

Decomposition of GDP per capita in PPS into labour productivity and utilization

Beyond the beta and sigma measures of convergence, GDP per capita in PPS can be decomposed into its two main determinants: labour productivity and labour utilization. More formally, GDP per capita can be expressed as:

$$\frac{GDP}{Population} = \frac{GDP}{Employment} x \frac{Employment}{Population}$$

where $\frac{GDP}{Employment}$ refers to labour productivity, that is, the output produced in an economy divided by total employment. Productivity depends on the amount of physical and human capital per worker as well as the state of technology. The term $\frac{Employment}{Population}$ refers to labour utilization, which can be further decomposed into three factors:

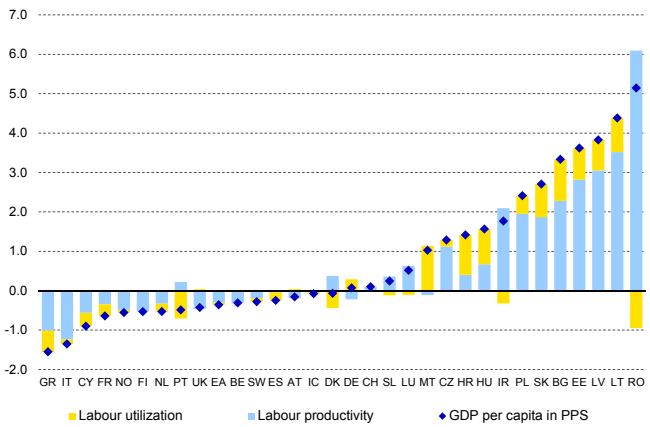
$$\frac{Employment}{Population} = \frac{Employment}{Labour\ Supply} x \frac{Labour\ Supply}{Working\ Age\ Population} x \frac{Working\ Age\ Population}{Population}$$

The term $\frac{Employment}{Labour\ Supply}$ refers to the share of employment in the labour force, or alternatively, to $(1 - \frac{unemployment\ rate}{100})$, since an increase in unemployment rate will lower this ratio. The term $\frac{Labour\ Supply}{Working\ Age\ Population}$ refers to the participation rate, while $\frac{Working\ Age\ Population}{Population}$ captures demographic factors.

Chart 5 plots the contributions of labour productivity and utilization, to GDP per capita in PPS over the period between 2000 and 2016. As expected, the largest gains in per capita GDP were registered in the NMS, especially Romania, Bulgaria and the Baltic countries.

With few exceptions, the convergence process in the NMS was mostly driven by labour productivity, which accounted on average for around 75% of the increase in per capita GDP, with labour utilization accounting for the remaining 25%. In Malta's case, however, the convergence process was primarily driven by labour utilization. At the other end of the table, Italy and Greece stands as the biggest losers, with an average decline in GDP per capita of more than 1% per annum. The decline in Italy was mainly driven by labour productivity, while both productivity and utilization contributed almost equally to the Greek's situation.

Chart 5
LABOUR PRODUCTIVITY AND UTILIZATION
(average % change between 2000 and 2016)



Source: Author's calculations.

A caveat is in order in the interpretation of relative labour productivity. Malta's productivity level was already relatively high compared with the EU average in the early 2000s, much more than the other NMS. For instance, Malta's labour productivity was around 95% of the EU average in 2000, while in Estonia, it was only 44%. Hence, it is only natural that in these countries, productivity would play a much more important role in closing the gap with the EU. In other words, the Balassa-Samuelson effect was more pronounced in the NMS compared with Malta. However, this 'gap' has not narrowed since 2000, which explains the slightly negative contribution of labour productivity in Chart 5. However, in the above framework, labour productivity is defined as GDP per person employed, while a better measure would be GDP per hour worked, given for instance, the increase in part-time employment. A recent study shows that a broader and more comprehensive measure of productivity – total factor productivity – derived from a production function has recovered strongly in recent years to levels last seen in the 1990s. This bodes well for the country's convergence prospects.[6]

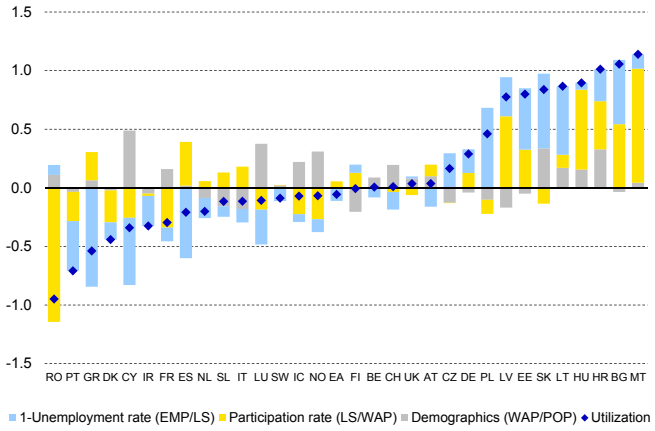
Chart 6 decomposes labour utilization into the effects of demographics, the participation rate and the unemployment rate. As expected, one observes a lot of cross-country heterogeneity in the evolution of labour utilization over this period.

The largest gains in labour utilization were registered by Bulgaria, Malta, Croatia and the Baltic countries. In Malta, more than 80% of the gains were due to higher participation rates, driven by a number of initiatives taken by the authorities to encourage more

[6] Micallef, B., & Ellul, R. (2017). Medium-term estimates of potential output growth in Malta. In *Challenges and opportunities of sustainable economic growth: the case of Malta*. Edited by Grech A. G., Central Bank of Malta.

people to join and remain longer in the labour market.[7] The reduction in the unemployment rate also played a minor role. On the contrary, an ageing population acted as a drag on the labour utilization, though this impact was to an extent mitigated by the inflow of foreign workers.

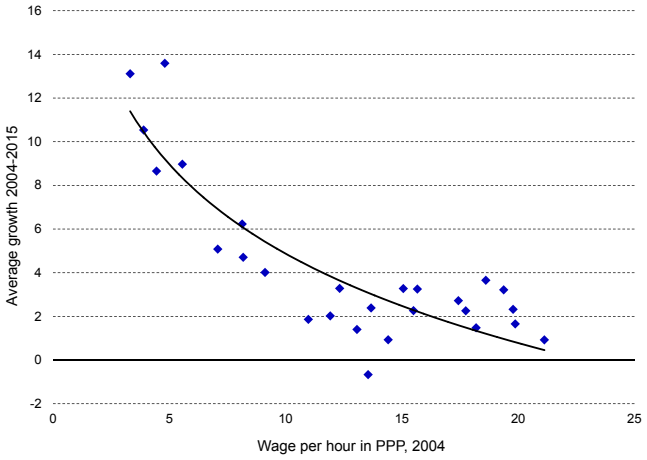
Chart 6
DECOMPOSITION OF LABOUR UTILIZATION
(average % change between 2000 and 2016)



Source: Author's calculations.

In the Baltic countries, the reduction in the unemployment rate from the relatively high levels seen in the early 2000s played a more important role. At the other end of the table stand Romania and the countries that were most severely affected by the crisis, such as Portugal, Greece and Cyprus. The deterioration in the latter group of countries is mainly driven by the increase in the unemployment rate after the crisis.

Chart 7
BETA CONVERGENCE IN HOURLY WAGES



Source: Author's calculations.

The convergence process by the NMS observed above is also reflected in increases in hourly wages, although the latter still remain substantially lower compared with the levels prevailing in the older Member States. Chart 7 plots the beta estimates of convergence based on hourly wages in all EU countries, adjusted for differences in price levels, by comparing their level in 2004 with the average growth rate registered over the period 2004-2015.[8] As expected, there are large differences in hourly wages among EU countries, with the highest wages being paid in Belgium, Denmark and Germany. However, hourly wages increased more rapidly in most of the NMS over the last

[7] See Micallef, B. (2015), Estimating the impact on potential output of structural reforms to increase the female participation rate. Policy Note November 2015, Central Bank of Malta, and Grech, A.G. (2016), The possible impact of pension age changes on Malta's potential output. Policy Note April 2016, Central Bank of Malta.

[8] The indicator refers to wages and salaries per hour for industry, construction and services (excluding public administration, defence and compulsory social security). This measure differs from labour costs which, in addition to wages and salaries, also include non-wage costs, such as employers' social security contributions. The PPPs used in Chart 7 refer to Actual Individual Consumption (AIC) instead of GDP. In this case, AIC is more appropriate given that the focus is on wages.

decade, in line with the beta hypothesis of convergence, while they averaged around 2% per annum in the older Member States.

The way forward for Malta

Compared with the other NMS, Malta started from a higher initial level and, despite some ups and downs during the process, registered a gradual catching-up with the EU income level. The Maltese economy recovered quickly after the financial crisis of 2009 and was not affected by the European sovereign debt crisis of 2012. Malta's growth was underpinned by sound macroeconomic policies, diversification towards higher value added sectors as well as reforms to attract and retain more people in the labour market. Growth was not fuelled by credit but by an increase in competitiveness that led to the current account turning to surplus position after years of persistent deficits and a gradual reduction in the fiscal deficit.

After a recession in 2009, the economy recovered strongly such that, by 2011, it had already exceeded the pre-crisis level. By end-2016, real GDP stood 39% higher when compared with the pre-crisis peak. Estimates by the Central Bank of Malta suggest that potential GDP has accelerated substantially in recent years, returning to growth rates that characterised the economy in the 1990s.

The labour market has kept the pace with the rapid evolution of the economy since EU membership and proved resilient to the crisis. In the services sector, job creation continued unabated even during the crisis. The unemployment rate and NAIRU were hardly affected by the crisis and maintained their downward trend, reaching historical lows in 2016. The labour supply increased sharply, driven by reforms targeted to increase the participation rate of females as well as an influx of foreign workers. The share of the latter increased from less than 2% of the workforce at the time of EU membership in 2004 to more than 15% in 2016. In addition, the pension reforms of 2006 and 2015 should eventually encourage older workers to remain active for a longer period of time over the coming years.

Going forward, the speed of convergence towards the EU depends on whether the movements in the two components of per capita GDP – labour productivity and utilization – cumulate or offset each other. In Malta's case, convergence over the last decade was driven primarily by a higher utilization of labour. While the participation rate is still relatively low by European standards, therefore still providing some catching-up potential, with the unemployment rate at a historical low and unfavourable demographics, future convergence cannot rely solely on labour utilization but increasingly on labour productivity. This will require considerable investment to up-skill the Maltese workforce and to make sure that existing skill mismatches are addressed quickly.

3. PRICES, COSTS AND COMPETITIVENESS

Consumer price pressures edged up but remained contained during the first quarter of 2017. The annual growth rate of the Harmonised Index of Consumer Prices (HICP) rose to 1.2% in March, while annual inflation based on the Retail Price Index (RPI) increased to 1.5%. On the other hand, downward pressures on domestic costs persisted, as the Producer Price Index (PPI) contracted again on an annual basis. As regards competitiveness, annual growth in Malta's unit labour costs (ULC) remained moderate, while Harmonised Competitiveness Indicators (HCI) indicated that the deterioration in competitiveness observed in recent quarters levelled off.

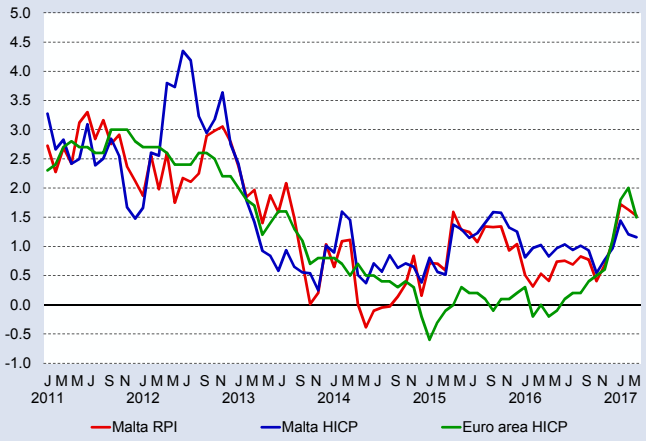
Inflation

HICP inflation edges up

Annual HICP inflation in Malta edged up to 1.2% in March, from 1.0% in December (see Chart 3.1).[1] Notwithstanding this increase, HICP inflation was below that in the euro area, where inflation reached 1.5% on account of higher energy prices.

Price pressures in Malta picked up during the first quarter of 2017 when compared with the average for 2016, though they remain contained. The recent pick-up in inflation mainly reflected developments in energy inflation, which contracted at a slower pace of -1.0% in March, from -4.6% in December (see Table 3.1 and Chart 3.2). Prices for transport fuel were raised in January 2017, though they remain below the

Chart 3.1
INFLATION RATES IN MALTA AND IN THE EURO AREA
(annual percentage changes)



Sources: NSO; Eurostat.

Table 3.1
HICP INFLATION
Annual percentage change

	2016						2017		
	July	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
Unprocessed food	2.9	4.1	4.0	3.3	4.0	6.3	8.4	6.8	5.4
Processed food including alcohol and tobacco	2.3	2.2	1.9	2.0	1.8	1.9	2.4	2.3	2.4
Energy	-4.3	-3.9	-3.9	-4.6	-4.6	-4.6	-1.0	-1.0	-1.0
Non-energy industrial goods	1.0	0.8	0.9	0.2	0.6	0.8	1.6	0.5	0.4
Services (overall index excluding goods)	0.9	1.0	0.9	0.7	0.9	0.8	0.4	0.7	0.9
All Items HICP	**0.9**	**1.0**	**0.9**	**0.5**	**0.8**	**1.0**	**1.4**	**1.2**	**1.2**

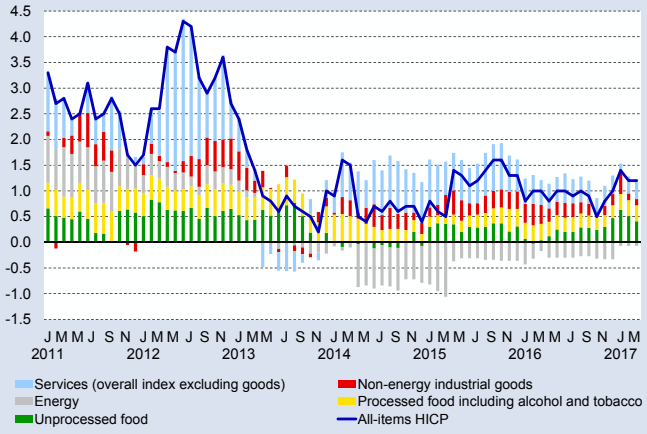
Source: Eurostat.

[1] The HICP weights are revised on an annual basis to reflect changes in household consumption patterns. In 2017 the weight allocated to energy stood at 6.6%, while that of non-energy industrial goods was 28.9%. Services accounted for 44.2% of the index, while the share allocated to food stood at 20.3%.

levels observed a year earlier. As a result, the negative contribution of energy inflation to the headline index went to -0.1 percentage point in March, from -0.3 three months earlier.

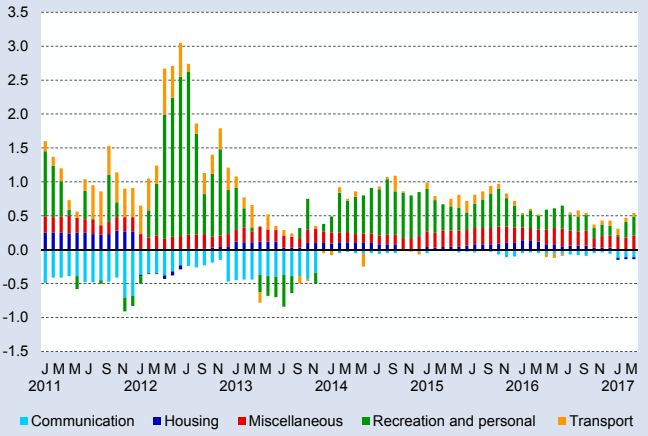
Services prices – the largest component in the overall HICP index – also contributed slightly to the acceleration in HICP inflation, as these rose at an annual rate of 0.9% in March, following 0.8% growth three months earlier. The contribution of this component thus stood at 0.4 percentage point, mainly driven by services related to recreation and personal care, such as accommodation and cultural services (see Chart 3.3).

Chart 3.2
CONTRIBUTIONS TO YEAR-ON-YEAR HICP INFLATION
(percentage points; annual percentage change)



Source: Eurostat.

Chart 3.3
CONTRIBUTIONS FROM SERVICES TO HICP INFLATION
(percentage points)



Source: Eurostat.

In contrast, non-energy industrial goods (NEIG) inflation continued to weaken (see Table 3.1 and Chart 3.2). Inflation on this component eased from 0.8% in December, to 0.4% in March. This deceleration was driven by a number of items, such as prices for motor vehicles, household items and appliances, and items related to the maintenance and repair of dwellings. In part, these developments could reflect the weakening of the pound sterling over the past twelve months. As a result, the overall contribution of the NEIG component to headline inflation dropped to 0.1 percentage point at the end of the first quarter.

Food inflation remained stable at 3.5% during the period under review, with the overall contribution to the headline index unchanged at 0.7 percentage point (see Table 3.1 and Chart 3.2). This reflected contrasting developments in the processed and unprocessed food components. Processed food inflation accelerated from 1.9% in December to 2.4% in March, reflecting faster growth in most food sub-categories. At the same time, inflation in unprocessed food peaked in January following a reading of 6.3% in December, before easing to 5.4% in March. This mainly reflected developments in vegetable prices, though the other subcategories of unprocessed food also contributed to the easing of price pressures in this component.

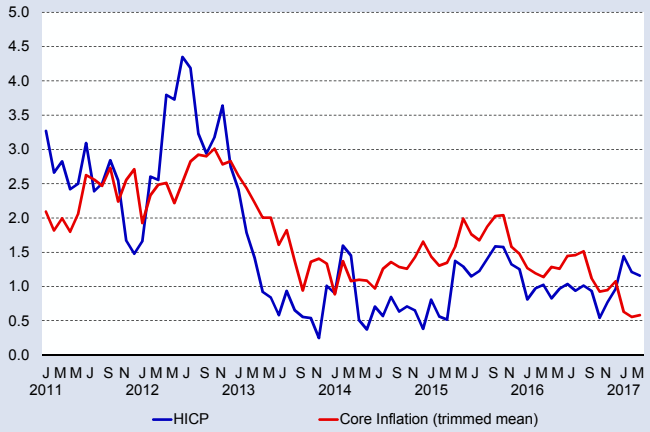
Core HICP inflation falls

Despite the increase in overall inflation, core HICP inflation dipped during the first quarter, going from 1.1% in December to 0.6% in March (see Chart 3.4).[2] As a result, core inflation fell below the headline index, indicating that the latter was supported by the more volatile components of the index during the period.

RPI inflation accelerates

Annual inflation based on the RPI index picked up during the first quarter of 2017, rising to 1.5% in March, from 1.1% three months earlier (see Table 3.2).[3] This acceleration was primarily driven by developments in the transport and communications category. In line with developments in HICP inflation, this partly reflected the increase in transport fuel prices in January. The contribution of the food and the recreation and culture sub-indices also rose during the quarter under review.

Chart 3.4
HICP IN MALTA: OVERALL AND CORE MEASURE
(annual percentage change)



Sources: Eurostat; Central Bank of Malta estimates.

Table 3.2
CONTRIBUTIONS TO YEAR-ON-YEAR RPI INFLATION
Percentage points

	2016						2017		
	July	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
Food	0.6	0.7	0.7	0.6	0.7	1.0	1.2	1.2	1.1
Beverages and tobacco	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Clothing and footwear	-0.1	-0.1	-0.2	-0.3	-0.2	-0.2	0.0	-0.1	-0.1
Housing	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Water, electricity, gas and fuels	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Household equipment and house maintenance costs	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2
Transport and communications	-0.6	-0.5	-0.5	-0.5	-0.5	-0.4	-0.2	-0.1	-0.1
Personal care and health	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Recreation and culture	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.1
Other goods and services	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0
RPI (annual percentage change)	**0.7**	**0.8**	**0.8**	**0.4**	**0.7**	**1.1**	**1.7**	**1.6**	**1.5**

Source: NSO.

[2] The Central Bank of Malta uses a "trimmed mean" approach to measure core inflation, whereby the more volatile components of the index are removed from the basket of consumer goods so as to exclude extreme movements from the headline inflation rate. See Gatt, W. (2014). An Evaluation of Core Inflation Measures for Malta. *Quarterly Review 2014*(3), 39 – 45, Central Bank of Malta.

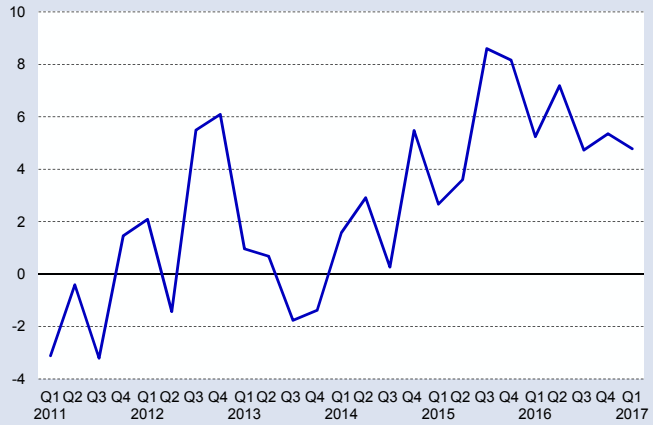
[3] The RPI index differs from the HICP index in that RPI weights are based on expenditure by Maltese households, while HICP weights also reflect expenditure patterns by tourists in Malta. The allocation of weights in both indices was changed at the start of 2017.

Residential Property Prices

Residential property prices rise at a slower pace

The Property Price Index, published by the National Statistics Office (NSO), increased further during the first quarter of 2017 (see Chart 3.5). The index, which is based on actual transactions involving apartments, maisonettes and terraced houses, rose by 4.8% when compared with the same period in the previous year.[4] This increase was more moderate than the 5.4% registered in the last quarter of 2016.

Chart 3.5
MOVEMENTS IN RESIDENTIAL PROPERTY PRICES
(annual percentage changes)

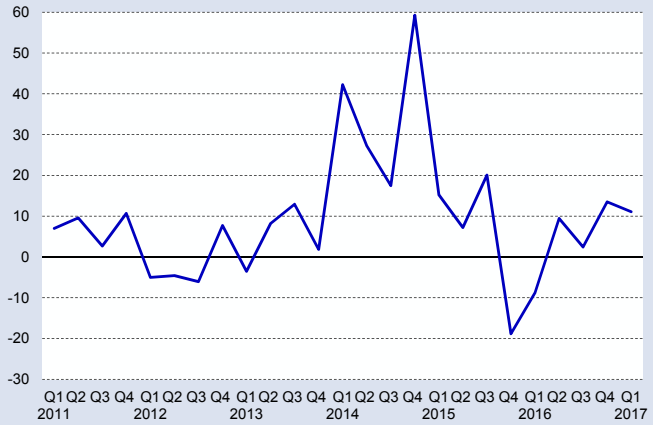


Source: NSO.

Growth in residential property prices in Malta is being supported by a number of factors, ranging from the government scheme for first-time buyers and a low interest rate environment which makes property more attractive to purchase.[5] Buoyant labour market conditions and growth in disposable income, together with the rise in foreign workers and the Individual Investor Programme, also continue to lift property prices.

The property volume index (PVI), which measures the number of transactions for apartments, maisonettes and terraced houses, has increased further, although at a slightly slower rate than that recorded in the previous quarter. In the first quarter of 2017, the number of property transactions increased by 11.1% on an annual basis, compared with a rise of 13.5% recorded in the last quarter of 2016 (see Chart 3.6).

Chart 3.6
RESIDENTIAL PROPERTY VOLUME INDEX
(annual percentage changes)



Source: NSO.

[4] 'Apartments' are defined as dwellings with self-contained rooms or a suite of rooms that have a separate entrance accessible from a common passage way, landing or stairway. 'Maisonettes' have a separate entrance that is accessible from the street and are either at ground-floor level with overlying habitation, or at first-floor level with underlying habitation. 'Terraced houses' are dwellings with at least two floors, own access at street level and airspace and with no underlying structures that are not part of the house itself. They are attached to other structures on both sides. Further information is available in NSO *Release* 091/2017.

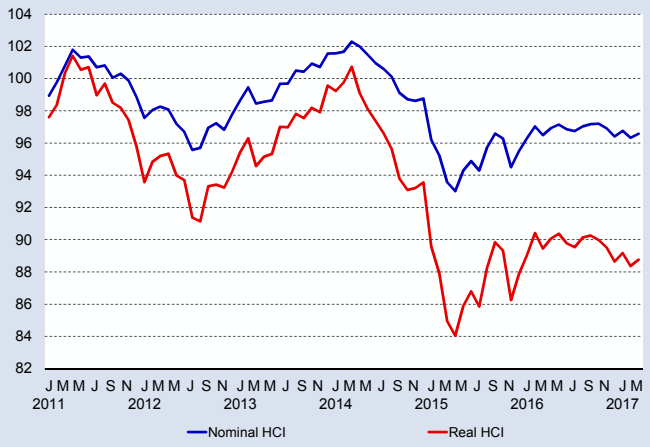
[5] This scheme, which was introduced in 2013 and subsequently extended, provides relief from the duty on documents due on the first €150,000 of the total value paid for the purchase of eligible property.

Costs and competitiveness

Producer prices continue to contract

The PPI index continued to contract on an annual basis, during the first quarter, going to -0.9% in March from -1.9% three months earlier. The latest reading extends a pattern of weak price pressures that has lasted almost five years.[6] The intermediate goods sub-sector, which is the largest component of the index and includes items such as electronics and semiconductors, remained the main driver behind this contraction. Producer prices for such goods, as well as those for consumer goods, both decreased at a slower pace in March. Contributions from the other components of the PPI index, namely capital goods and energy, remained largely unchanged during the period under review.

Chart 3.7
HARMONISED COMPETITIVENESS INDICATORS
(May 2004 = 100)



Source: ECB.

HCIs point to an improvement in international competitiveness

Annual growth in Malta's nominal HCI, a measure of international competitiveness based on trade-weighted exchange rates decelerated to 0.1% in March, from 1.0% in December (see Chart 3.7).[7] At the same time, the real HCI, which also takes into account differences in relative consumer prices, dropped by 0.8% in annual terms, in contrast to a 0.9% year-on-year increase in December. These movements indicate that the deceleration in the nominal HCI due to exchange rate movements was amplified by favourable developments in relative prices, leading to an overall improvement in competitiveness in real terms.

Malta's HCIs generally followed an upward trend in 2015 and the first half of 2016, but have since began to show signs of flattening or decline. This reflects the appreciation of the euro against the pound sterling over the past quarters, as well as lower relative prices in Malta when compared with its international trading partners.

Growth in unit labour costs remains moderate

The ULC index, which is measured as the ratio of compensation per employee to labour productivity, continued to grow moderately during the first quarter of 2017. Measured on a four-quarter moving average basis, the annual growth rate of Malta's ULC stood at 1.2%, unchanged from the previous quarter, as slower productivity growth matched a deceleration in compensation

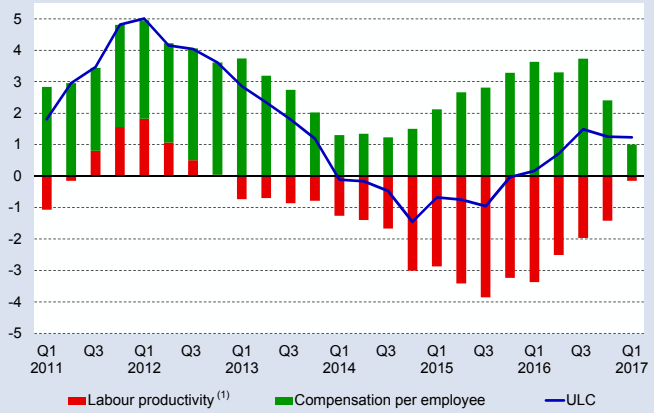
[6] The Industrial PPI measures the prices of goods at the factory gate and is commonly used to monitor inflationary pressures at the production stage.

[7] The nominal HCI tracks movements in the country's exchange rate against the currencies of its main trading partners, weighted according to the direction of trade in manufactured goods. The real HCI incorporates both exchange rate changes and the relative inflation of a country vis-à-vis its main trading partners. A higher (or lower) score in the HCI indicates a deterioration (or improvement) in a country's international price competitiveness.

per employee (see Chart 3.8).[8] Annual ULC growth in Malta turned positive at the start of 2016, although it remains relatively contained from a historical perspective.

During the first quarter of 2017, annual growth in compensation per employee eased to 1.0% from 2.4% in the previous quarter, when measured on a four-quarter moving average basis, while labour productivity grew by 0.1%, down from 1.4% in the previous quarter.

Chart 3.8
DECOMPOSITION OF UNIT LABOUR COSTS IN MALTA
(annual percentage change; four-quarter moving average)



(1) A rise (drop) in productivity contributes negatively (positively) to ULC growth.
Sources: NSO; Central Bank of Malta estimates.

[8] A degree of caution is required in the interpretation of ULC in view of contemporaneous structural shifts in the composition and factor-intensity of production, notably the shift to labour-intensive services. See Micallef, B. (2015). Unit labour costs, wages and productivity in Malta: a sectoral and cross-country analysis. Policy Note August 2015, Central Bank of Malta, available at https://www.centralbankmalta.org/en/working-papers-2015, and Rapa, N. (2016). Measuring international competitiveness. *Quarterly Review 2016*(1), 53 – 63, Central Bank of Malta.

4. THE BALANCE OF PAYMENTS

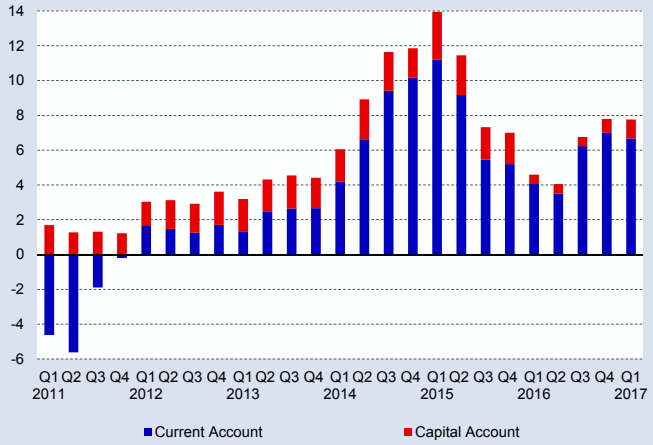
During the first quarter of 2017 the surplus on the current account of the balance of payments declined when compared with the corresponding quarter of 2016. This drop was predominantly attributable to higher net outflows related to primary income. Nonetheless, a marginal widening in the merchandise trade gap also contributed. These movements offset a significant rise in net services receipts and a small increase in net inflows from secondary income. At the same time, net inflows on the capital account rose on a year earlier, while higher net lending was posted on the financial account.

The current account

The current account surplus narrows

In the first three months of 2017, the current account registered a surplus of €56.9 million, down from €79.1 million a year earlier. The lower surplus was largely driven by higher outflows on the primary income component. When measured on a four-quarter sum basis, the surplus on the current account in the first quarter of 2017 stood at €669.8 million, up from €383.6 million in the twelve months to March 2016. This improvement was driven by a rise in net services receipts and, to a lesser extent, a narrowing in the merchandise trade deficit (see Table 4.1). As a result, when expressed as a four-quarter moving sum, the current account surplus increased to 6.7% of gross domestic product (GDP), up from 4.1% in year ending March 2016 (see Chart 4.1).

Chart 4.1
CURRENT AND CAPITAL ACCOUNT BALANCES
(four-quarter moving sums as a percentage of GDP)



Source: NSO.

The merchandise trade deficit widens marginally

In the quarter under review, the merchandise trade deficit

Table 4.1
BALANCE OF PAYMENTS
EUR millions

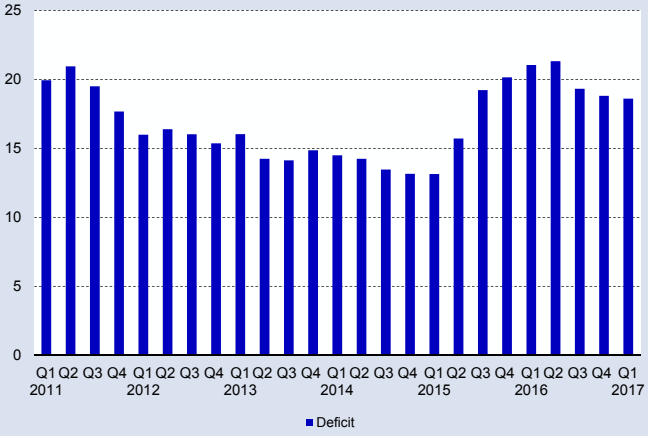
	Four-quarter moving sums						
	2016 Q1	2016 Q2	2016 Q3	2016 Q4	2017 Q1	2016 Q1	2017 Q1
Current account	**383.6**	**336.0**	**607.4**	**692.0**	**669.8**	**79.1**	**56.9**
Goods	-1,990.7	-2,047.4	-1,882.9	-1,862.1	-1,868.6	-410.0	-416.6
Services	2,663.2	2,729.9	2,863.7	3,009.2	3,078.6	590.9	660.3
Primary income	-514.5	-573.6	-599.9	-677.8	-766.7	-155.5	-244.4
Secondary income	225.6	227.1	226.5	222.6	226.5	53.7	57.7
Capital account	**50.7**	**52.6**	**51.0**	**79.3**	**109.1**	**7.7**	**37.5**
Financial account [(1)]	**444.4**	**405.7**	**1,279.5**	**1,374.8**	**1,729.5**	**82.6**	**437.3**
Errors and omissions	**10.2**	**17.1**	**621.2**	**603.5**	**950.6**	**-4.2**	**342.9**

[(1)] Net lending (+) / net borrowing (-)

Source: NSO.

widened by €6.6 million on the corresponding period of a year earlier, reaching €416.6 million. This reflected a contraction of €29.3 million in exports, which outweighed a drop of €22.8 million in imports.

Chart 4.2
GOODS DEFICIT
(four-quarter moving sums as a percentage of GDP)



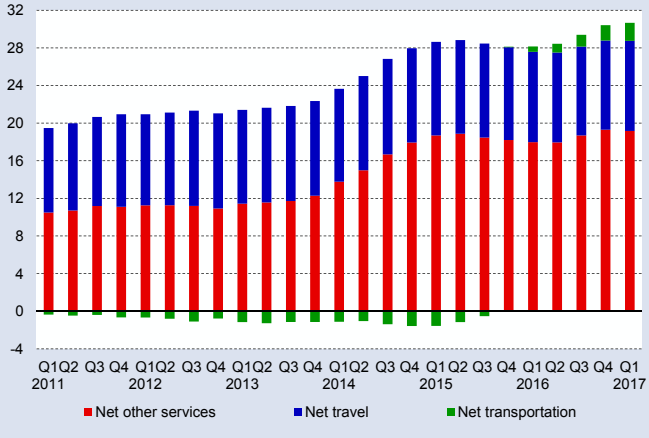
Source: NSO.

On the contrary, when measured on a four-quarter cumulative basis, the visible trade gap narrowed by €122.1 million, to €1,868.6 million in the March quarter of 2017. This improvement arose as imports contracted at a faster pace than exports; the former declined by €317.6 million whilst the latter dropped by €195.6 million. Thus, the merchandise deficit decreased to 18.6% of GDP, from 21.0% of GDP a year earlier, partly reflecting the decrease in capital imports from their recent peak (see Chart 4.2).

The surplus on services increases significantly

In the first three months of 2017, the services industry generated a net surplus of €660.3 million, a rise of €69.4 million on the corresponding quarter of 2016. The higher surplus was stimulated by a significant rise in exports, which offset a smaller increase in imports. Sector data show that the improvement was driven by transactions related to transport and travel. Net receipts related to transport increased by €31.3 million, partly reflecting the continued expansion of the aviation services industry. At the same time, net travel exports rose by €23.3 million, as a significant increase in inbound tourists' spending offset higher expenditure by Maltese residents abroad. Net receipts from "other services", also rose, albeit at a slower pace. This increase was mainly spurred by significantly higher net receipts from personal and recreational services, including remote gaming. Nonetheless, these positive developments were partly dampened by a year-on-year rise in net payments related to business services.

Chart 4.3
SERVICES BALANCE
(four-quarter moving sums as a percentage of GDP)



Source: NSO.

Partially reflecting developments in the quarter under review, the overall surplus on the services balance in the four quarters to March 2017 rose to €3078.6 million, or 30.7% of GDP, up from 28.2% twelve months earlier (see Chart 4.3).

Primary income account records higher net outflows[1]

In the first quarter of 2017, net outflows on the primary income account stood at €244.4 million, compared with net outflows of €155.5 million in the same period of 2016. Larger net outflows were predominantly driven by lower net portfolio income as well as a rise in dividends distributed to foreign owned firms operating in Malta. When measured on a four-quarter sum basis, net outflows on this account reached €766.7 million in the year to March 2017; €252.2 million more than a year earlier. Movements on this component of the current account continued to be strongly influenced by internationally-oriented firms which transact predominantly with non-residents.

Inflows on the secondary income account increase[2]

Between January and March 2017, net inflows on the secondary income account rose by €3.9 million on a year earlier, to stand at €57.7 million. In the four quarters to March 2017, net inflows on the secondary income reached €226.5 million, broadly unchanged from a year earlier.

Buoyancy in tourism activity persists

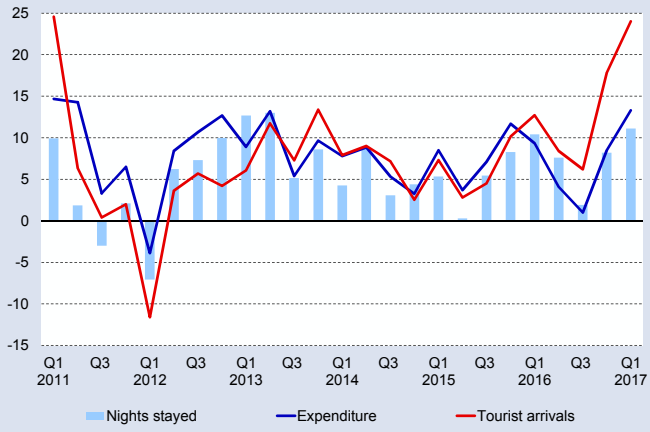
The tourism sector continued to expand at a solid pace during the first quarter of 2017, with inbound tourists, nights stayed in Malta and expenditure each growing at double-digit rates in annual terms.

The number of inbound tourists reached 348,890 in the first quarter of the year, 24.0% higher than the same period a year earlier (see Chart 4.4). This increase was mainly driven by tourists that visited Malta for leisure purposes, although the number of tourists visiting for business purposes and educational, religious and health motives also rose.

In the three months to March, tourists spent 2.3 million nights in Malta, a rise of 11.1% on the same period a year earlier. This rise was driven by an increase in nights stayed in private accommodation, which rose by 20.0% on the preceding year. Meanwhile nights spent in collective accommodation increased by 6.9%.[3]

In the first quarter of 2017, tourist expenditure in Malta was up by 13.3% on a year earlier, reaching €237.2 million.[4] This was mainly attributable to higher spending on non-package holidays, in particular, increases in the "other" component of tourism spending and accommodation. Expenditure on air/sea fares also rose. During the

Chart 4.4
TOURISM INDICATORS
(quarterly averages; annual percentage changes)



Source: NSO.

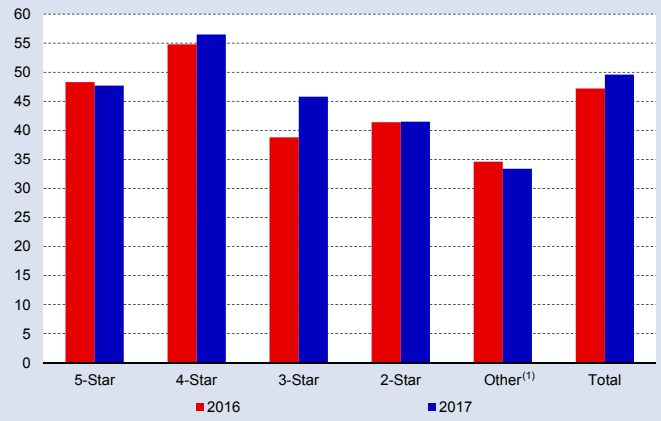
[1] The primary income account shows income flows related mainly to cross-border investment and compensation of employees.
[2] The secondary income account shows current transfers between residents and non-residents.
[3] Private accommodation includes self-catering apartments, farmhouses, and private residences. As per Eurostat recommendation, time-share accommodation is classified as "private accommodation". Collective accommodation comprises hotels, aparthotels, guesthouses, hostels and tourist villages.
[4] Total expenditure is split into package, non-package and "other".

same quarter however, expenditure on package holidays fell further, decreasing at an annual rate of 4.5%.[5]

As tourist expenditure increased at a slower pace compared with arrivals, expenditure per capita decreased to €680, from €744 in the first quarter of 2016. This decline also reflected a shorter average length of stay, which decreased to 6.5 nights in the quarter under review from 7.3 nights in the same period a year earlier.

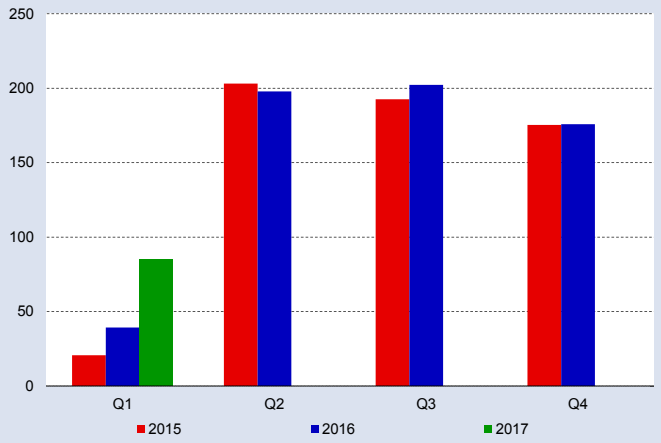
Meanwhile, total nights spent in collective accommodation establishments rose by 96,639 on a year earlier. This led to a 2.4 percentage point increase in the total occupancy rate, to 49.6% (see Chart 4.5). Higher occupancy rates were registered in the three-star and to a lesser degree in the four-star categories. Occupancy rates in two-star establishments remained practically unchanged, while lower rates were registered in the five-star and in the "other" establishments categories.

Chart 4.5
AVERAGE OCCUPANCY RATES IN THE FIRST QUARTER
(per cent)



(1) Includes guest houses, hostels and holiday complexes.
Source: NSO.

Chart 4.6
CRUISE LINER PASSENGERS
(thousands)



Source: NSO.

In the first quarter of 2017, the number of cruise liners visiting Malta rose to 34, an additional 17 cruise liners compared with a year earlier. The number of foreign cruise liner passengers more than doubled, from 39,303 in the first quarter of 2016 to 85,133 in the quarter under review (see Chart 4.6).

[5] Non-package holiday expenditure is subdivided into spending on accommodation and travel fares, while the "other" component captures any additional expenditure by tourists during their stay in Malta.

BOX 3: THE EXIT OF THE UNITED KINGDOM FROM THE EUROPEAN UNION – ITS SHORT TO MEDIUM-TERM IMPACT ON THE MALTESE ECONOMY[1]

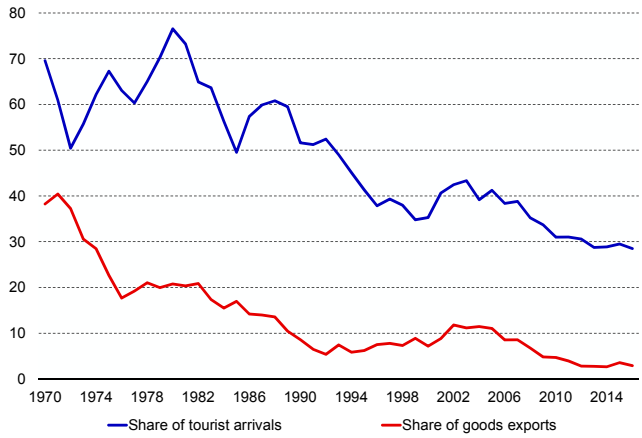
On 23 June 2016, the United Kingdom voted to leave the European Union. At this stage there is still a high degree of uncertainty surrounding the terms at which the United Kingdom is likely to exit the European Union. However, one can safely predict that any post-Brexit agreement is bound to trade-off some degree of market accessibility with more independence for the UK policy makers. In light of their mutual trade dependence, the United Kingdom's exit from the European Union is bound to have important effects on the two economies. Moreover, given Malta's strong economic ties with both the European Union and the United Kingdom, the latter's decision to leave the European Union is likely to impact the Maltese economy. This Box focuses on the short to medium-run economic implications of Brexit on the Maltese economy.

Malta's economic relationship with the United Kingdom

Since Malta was part of the British Empire until 1964, it has traditionally held strong economic ties with the United Kingdom.[2] However, post-independence the Maltese economy evolved relatively quickly and diversified greatly. As a result the relative dependence on the UK market declined substantially over time. Chart 1 shows that the share of Malta's export of goods to the United Kingdom has fallen from 40% in the early 1970s to about 3% in recent years,[3] whereas the share of UK tourists has fallen from nearly 80% in the early 1980s to less than 30% in 2016. Moreover, Maltese exports of goods to the United Kingdom fell from nearly 10% of GDP in the mid-1970s to just 1.4% of GDP by 2016. Expenditure by UK tourists was estimated at €485.1 million in 2016, up from close to €400 million in 2001, but in terms of share of GDP, this expenditure now amounts to 4.9% of GDP, down from 9.4% in 2001.

By 2015, Maltese exports of services to the United Kingdom amounted to €1.2 billion, equivalent to

Chart 1
TRENDS IN MALTA'S DEPENDENCE ON THE UK MARKET
(% of total)



Source: Author's calculations using CBM macroeconomic time series database.

[1] Prepared by Noel Rapa. The author is a Senior Research Economist in the Economic and Research Department. The views expressed in this Box are the author's own and do not necessarily represent the views of the Bank. This Box summarizes the main conclusions presented in Rapa, N. (2017), The exit of the United Kingdom from the European Union – Its short to medium-term impact on the Maltese economy, *Policy Note*, Central Bank of Malta, March 2017.

[2] For more details See Grech, A.G. (2015), *The evolution of the Maltese economy since independence*, Central Bank of Malta.

[3] Malta imports more goods from the United Kingdom than it exports. In 2016, imports of goods from the United Kingdom amounted to €343.3 million, or 5.3% of goods imports.

some 13% of GDP. However a considerable amount of these exports are financial services flows, which tend to have nearly equivalent entries as imports of services. In fact, Malta's net exports of services to the United Kingdom amounted to €559 million, or 6% of GDP – the bulk of which represent the expenditure of UK tourists in Malta.

By 2016, Malta's core domestic banks had an exposure to the United Kingdom equivalent to 7.4% of their total assets. About two-thirds of this exposure was constituted by loans to UK residents, while the rest was UK securities, prevalently relating to the UK sovereign. On the liabilities side, the exposure is much smaller, at 1.3%, mostly made up of short-term deposits of UK residents. This suggests that financial ties with the United Kingdom are broadly in line with the trade relationship between the two countries.

On the other hand, there is evidence that Malta's reliance on UK workers has risen over time. There were 3,985 UK citizens working in Malta in 2016, about 17.6% of all foreign workers.[4] This constituted 1.8% of all persons currently in employment, a proportion higher than the share of all foreign workers at the time of Malta's accession to the European Union. Moreover, the Office for National Statistics suggests that there could be 9,000 Maltese citizens in the United Kingdom, and that many are not there for working purposes.

The effect of Brexit on the United Kingdom and the European Union

The European Union is the United Kingdom's main export partner. Thus, the exit of the United Kingdom from the European Union and the potential loss of access to the single market are likely to have substantial effects on the UK economy. At this stage however, there is a high degree of uncertainty surrounding the terms at which the United Kingdom is likely to exit the European Union. Consequently, given the large number of alternative arrangements that the United Kingdom can negotiate with the European Union, the channels by which the UK and EU economies could be affected vary substantially. Despite this uncertainty, formal assessments conducted by researchers and international institutions point at significant downward economic risks to the UK economy stemming both from reduced access to international trade as well as from the potential loss of the United Kingdom's banking system EU passporting rights. On the other hand, the likelihood of an increase in long-run productivity due to a possible deregulation in the United Kingdom is especially low considering the low degree of regulation already in place in the United Kingdom. Moreover, potential long-run productivity gains driven by deregulation are likely to be outweighed by productivity losses caused by restrictions on migration. These factors, coupled with the uncertainty caused by the still untested withdrawal process, are likely to weigh negatively both on the short-run and long-run GDP growth in the United Kingdom. All this seems to be weighing on the pound sterling which has depreciated substantially against both the euro and the US dollar since the Brexit vote.

EU economies, mostly Germany, France and the Netherlands, also export a significant amount of goods and services to the United Kingdom.[5] Thus even EU member states stand

[4] See reply to Parliamentary Question 27178 http://pq.gov.mt/PQWeb.nsf/7561f7daddf0609ac1257d1800311f18/c1257d2e0046dfa1c125803e00508f5f!OpenDocument

[5] See IMF (2016). *IMF Country Report No. 16/169*, United Kingdom, Selected Issues.

to lose economically from Brexit, although the effects are expected to be smaller than those affecting the United Kingdom. Moreover, given their combined size and importance, developments in the EU and the UK economies are likely to have global economic effects. Most studies point at a possible deterioration in the United Kingdom's and the European Union's main trading partners, mainly the United States. However, these are projected to be more contained when compared with the economic contractions likely to occur in the United Kingdom and the European Union, thereby helping to push up the value of the US dollar against both the pound sterling and the euro.

Still, in light of the uncertainty surrounding the aftermath of the United Kingdom's exit from the European Union, there is no consensus on the magnitude of these negative effects. Indeed, the quantification of the effects of the United Kingdom's exit from the European Union depends on the agreements that the two parties will be able to reach. The negotiation process has a number of possible outcomes. First, the best case scenario is that the United Kingdom adopts the so-called Norwegian model thereby becoming a member of the European Economic Area (EEA). This option would allow the United Kingdom to retain access to the single market. In return, however, it would need to accept free movement of people as well as contribute to the EU budget. Moreover, under such a scenario the United Kingdom would not be allowed to benefit from the customs union and other third party trade agreements struck by the European Union. The second option is to adopt the Swiss-model which is similar to the Norwegian model, but allows free-trade to occur within specific goods categories. Crucially however, this option does not predict (at least for the time being) trade concessions in financial services. The third scenario would come into place should negotiations between the two parties fail. Under this option all UK trade including that with the European Union will be governed by the WTO Most Favoured Nation rules. The United Kingdom would lose access to the single market, but will be free to set its own rules concerning migration and would not contribute to the EU budget.

The effects of Brexit on Malta

Given its openness, the Maltese economy is likely to be affected in two ways. First, foreign demand for Maltese exports is likely to slow down due to both direct effects caused by subdued economic growth in the United Kingdom, as well as from the indirect effects caused by the likely slowdown in the United Kingdom's main trading partners, such as the euro area and the United States. Secondly, the real effective exchange rate (REER) for Malta is likely to be negatively affected by the depreciation of the pound sterling vis-à-vis the euro and positively affected by the appreciation of the US dollar vis-à-vis the euro.[6]

To quantify the effects of these shocks, a scenario analysis is conducted using STREAM, the Central Bank of Malta's macro-econometric model.[7] In the light of the uncertainty surrounding the negotiation process between the United Kingdom and the European Union, this Box explores two scenarios which stand at opposite ends of the spectrum of trade agreements that are likely to be struck by the United Kingdom. S*cenario 1* is the best case scenario and assumes that the United Kingdom will become an EEA member, in line with

[6] The REER is also expected to appreciate due to an increase in import prices should the European Union start imposing import duties on UK exports. This scenario has not been explored in this note.

[7] Grech, O., & Rapa, N. (2016). STREAM: A Structural Macro-Econometric Model of the Maltese Economy. Working Paper WP/01/2016, Central Bank of Malta.

outcome 1 described above. *Scenario 2* assumes unsuccessful negotiations between the United Kingdom and the European Union, so that the trade agreement between the two parties defaults to the WTO rules, in line with outcome 3 explored above.

Table 1 summarizes the main assumptions used for the two scenarios. The direct and indirect effects on foreign demand are assumed to follow predictions made by the Bank of England for the United Kingdom, IMF for the euro area and Goldman Sachs for the United States and rest of the world. Both scenarios assume an appreciation of the US dollar vis-à-vis the pound sterling and to a lesser extent vis-à-vis the euro. This in turn implies an appreciation of the euro vis-à-vis the pound sterling. The magnitude of the appreciation is in line with the one assumed by Goldman Sachs in a study published in 2016.[8]

The results summarised in Table 2 show that the peak effects on baseline GDP are projected to lie between -0.24 to -0.54%. As expected given the nature of the shocks under consideration, the main contributor behind these falls, at least in the first two years, emanate from the external sector. Falls in aggregate demand then lead to a reduction in private consumption and investment, leading to a peak contribution of domestic demand which equates or slightly exceeds that of foreign sector by 2018.

Needless to say, the results should be considered preliminary and treated with caution given the high degree of uncertainty surrounding the terms of the United Kingdom's exit from the European Union. As a result, the simulations presented here focus solely on the impact of exchange rate movements and foreign demand on economic activity, using assumptions provided by international institutions.

Table 1
IMPACT ON KEY FOREIGN VARIABLES FOLLOWING THE UNITED KINGDOM'S DECISION TO EXIT THE EUROPEAN UNION

Per cent deviation from baseline

	2017	2018	2019
UK GDP *(percentage deviation from baseline)*			
Scenario 1	-0.30	-1.00	-1.60
Scenario 2	-0.80	-3.70	-5.20
EA GDP *(percentage deviation from baseline)*			
Scenario 1	-0.05	-0.11	-0.18
Scenario 2	-0.14	-0.29	-0.43
ROW GDP *(percentage deviation from baseline)*			
Scenario 1	-0.03	-0.06	-0.09
Scenario 2	-0.03	-0.06	-0.09
Exchange rate *(percentage deviation from baseline)*			
GBP/EUR	6.19	6.19	6.19
USD/EUR	-2.35	-2.35	-2.35

Source: Author's calculations.

[8] Hatzius, J., & Stehn, S. J. (2016). How Has The 'Brexit-Shock' Affected Our Economic Forecasts? Goldman Sachs, Note to customers. The magnitude of the exchange rate shocks is equal to the change in bilateral exchange rates that happened between Thursday 23rd and Friday 24th June 2016. Assuming that the markets were not expecting the exit vote to win, the change in the exchange rate that followed the referendum result should in theory price in the United Kingdom's decision to exit the European Union.

Table 2
IMPACT OF MALTESE VARIABLES FOLLOWING THE UNITED KINGDOM'S EXIT

Per cent deviation from baseline

	Scenario 1			Scenario 2		
	2017	2018	2019	2017	2018	2019
Economic activity *(percentage deviation from baseline)*						
Real GDP	-0.12	-0.20	-0.24	-0.16	-0.40	-0.54
Private consumption	-0.02	-0.08	-0.09	-0.02	-0.14	-0.28
Exports of goods & services	-0.22	-0.27	-0.31	-0.30	-0.59	-0.71
Imports of goods & services	-0.13	-0.19	-0.22	-0.18	-0.42	-0.54
Contributions to growth *(percentage points)*						
Domestic	-0.03	-0.08	-0.11	-0.04	-0.16	-0.29
Foreign	-0.09	-0.10	-0.12	-0.12	-0.22	-0.24

Source: Author's calculations.

The scenarios described above can be further improved as more information on the United Kingdom's terms of exit from the European Union becomes available. For instance, the results presented in this note do not take into consideration the impact of higher import prices on Malta's competitiveness due to potential rises in tariff barriers. Similarly, the scenarios abstract from the potential adverse effects of a rise in the volatility of financial markets or a deterioration in the banks' asset quality. On the upside, fuelled by robust domestic performance as well as by an increasing momentum in the global economy, economic growth recently registered in the United Kingdom has been stronger than what has been initially envisaged in the immediate aftermath of the Brexit vote. Moreover, in the medium to long run, Malta could also benefit from the United Kingdom's exit from the European Union, especially if it manages to attract companies that seek to relocate outside the United Kingdom, for instance, in the financial sector, especially given the high proficiency of Malta's workforce in the English language and in the light of the similarities that exist between Maltese and British legislations.

The capital account

Net inflows on the capital account amounted to €37.5 million during the quarter under review; €29.8 million more than in the same quarter of 2016 (see Table 4.1). This was mostly attributable to higher transfers to government, which in turn were propelled by the timing of funds received under EU financing programmes. When measured on a four quarter cumulative basis, capital inflows in the year to March 2017 totalled €109.1 million, more than double the amount recorded a year earlier.

5. GOVERNMENT FINANCE

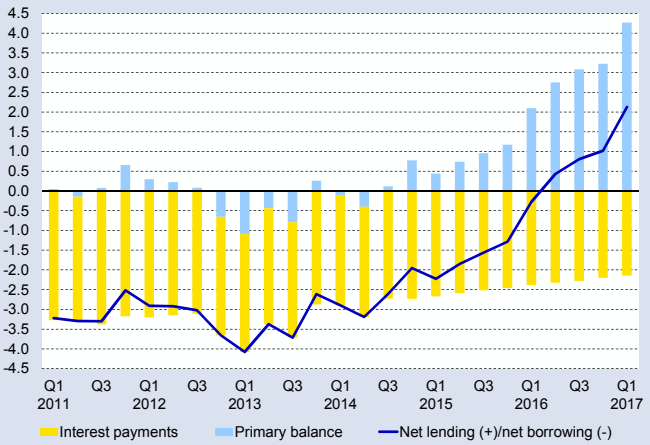
During the first quarter of 2017, the general government registered a surplus when compared with a deficit over the same period of 2016. This was due to an increase in government revenue offsetting that in total expenditure. When measured on the basis of a four-quarter moving sum, the general government recorded a surplus of 2.1% of gross domestic product (GDP), up from 1.0% in the fourth quarter of 2016. Meanwhile, general government debt, as a share of GDP, increased from 58.3% at the end of 2016, to 59.0% at the end of March 2017.

General Government

General government balance-to-GDP ratio improves

During the first quarter of 2017, the general government balance remained in surplus. When measured as a four-quarter moving sum, this surplus reached 2.1% of GDP (see Chart 5.1). This is an improvement of 1.1 percentage points over the last quarter of 2016, largely as the result of positive developments in the primary balance, which excludes interest payments from government expenditure. This improved by 1.0 percentage point over the previous quarter, reaching 4.3% of GDP. A further 0.1 percentage point improvement resulted from lower interest payments, which were equivalent to 2.1% of GDP.

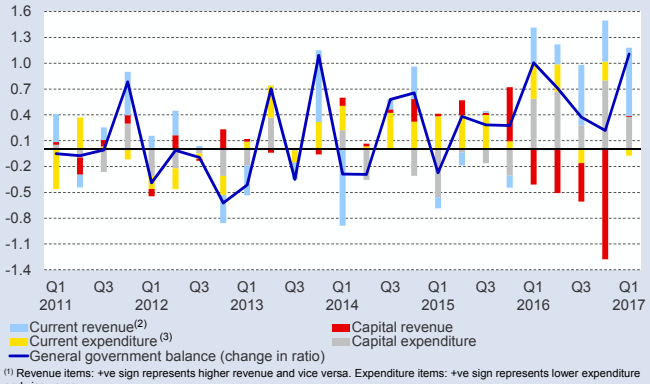
Chart 5.1
GENERAL GOVERNMENT BALANCE
(four-quarter moving sums; % of GDP)



Source: NSO.

The positive developments in the general government balance were mostly driven by improvements in current revenue (see Chart 5.2). In fact, its ratio to GDP, measured as a four-quarter moving sum, rose by 0.8 percentage point compared with the fourth quarter of 2016. A lower capital expenditure-to-GDP ratio also contributed towards the improvement in the general government balance. This drop amounted to 0.4 percentage point of GDP. The capital revenue-to-GDP ratio remained broadly stable.

Chart 5.2
IMPACT ON GENERAL GOVERNMENT BALANCE[1]
(percentage point)



[1] Revenue items: +ve sign represents higher revenue and vice versa. Expenditure items: +ve sign represents lower expenditure and vice versa.
[2] The term 'current revenue' represents most tax revenue as well as income from investments and sales. 'Capital revenue' mainly represents capital taxes and grants received.
[3] The term 'current expenditure' mainly represents spending on wages, social benefits and operational and maintenance expenses. 'Capital expenditure' mainly represents spending on investment and capital transfers.
Sources: NSO; Central Bank of Malta.

Meanwhile, the current expenditure-to-GDP ratio increased by 0.1 percentage point, lowering slightly the surplus.

In level terms, the general government registered a €44.2 million surplus. This is a marked improvement over the first quarter of 2016, when the government registered a fiscal deficit of €68.3 million. This development reflects growth in government revenue that was stronger than that in primary expenditure. In fact, the primary balance improved by €109.7 million, reaching a surplus of €94.2 million in the quarter under review.

Revenue rises driven by both tax and non-tax inflows

Government revenue rose by €137.2 million, or 16.3%, when compared with the first quarter of 2016, reaching €979.2 million (see Table 5.1). This increase was spread across all revenue items, particularly through higher tax inflows and "other" revenue. In level terms, taxes on production and imports grew by €32.0 million, equivalent to 10.8%, mainly due to higher value added tax receipts, in line with the buoyant consumption levels recorded for the period. Higher revenue from motor vehicle registration and gaming taxes also contributed towards this increase, as did growth in duty on documents, which reflects the positive developments in the property market. Meanwhile, current taxes on income and wealth increased by €41.1 million, or 15.4%. This growth was

Table 5.1
GENERAL GOVERNMENT BALANCE
EUR millions

	2016				2017	Change 2017Q1-2016Q1	
	Q1	Q2	Q3	Q4	Q1	Amount	%
Revenue	**842.0**	**910.9**	**967.4**	**1,150.9**	**979.2**	**137.2**	**16.3**
Taxes on production and imports	296.8	278.4	315.2	374.3	328.8	32.0	10.8
Current taxes on income and wealth	267.1	382.2	324.7	401.9	308.2	41.1	15.4
Social contributions	152.9	155.1	152.5	178.8	165.3	12.5	8.1
Capital and current transfers receivable	22.5	23.8	18.8	32.0	29.9	7.4	32.9
Other[(1)]	102.8	71.5	156.2	163.9	147.0	44.1	42.9
Expenditure	**910.3**	**884.5**	**947.6**	**1,027.8**	**935.0**	**24.7**	**2.7**
Compensation of employees	292.2	298.4	301.8	293.3	310.5	18.3	6.2
Intermediate consumption	139.5	148.3	151.6	196.6	167.3	27.8	20.0
Social benefits	269.7	270.4	256.1	282.7	274.6	4.9	1.8
Subsidies	30.9	25.6	39.9	32.9	32.5	1.6	5.2
Interest	52.8	54.8	56.0	54.2	50.0	-2.8	-5.3
Other current transfers payable	29.1	40.0	55.6	68.8	37.0	7.9	27.2
Gross fixed capital formation	63.3	38.9	61.6	88.1	55.9	-7.4	-11.8
Capital transfers payable	30.3	8.2	26.3	12.5	6.9	-23.4	-77.3
Other[(2)]	2.5	0.0	-1.2	-1.2	0.3	-2.2	-
Primary balance	**-15.5**	**81.2**	**75.8**	**177.2**	**94.2**	**109.7**	**-**
General government balance	**-68.3**	**26.4**	**19.8**	**123.1**	**44.2**	**112.5**	**-**

(1) "Other" revenue includes market output as well as income derived from property and investments.
(2) "Other" expenditure principally reflects changes in the value of inventories and in the net acquisition of valuables and other assets.
Source: NSO.

Table 5.2
COMPOSITION OF GOVERNMENT FINANCE ITEMS
Percentage points

	2016 Q1	2017 Q1	Change
Share in total revenue			
Taxes on production and imports	35.2	33.6	-1.7
Current taxes on income and wealth	31.7	31.5	-0.2
Social contributions	18.2	16.9	-1.3
Capital and current transfers receivable	2.7	3.1	0.4
Other[(1)]	12.2	15.0	2.8
Share in total expenditure			
Compensation of employees	32.1	33.2	1.1
Intermediate consumption	15.3	17.9	2.6
Social benefits	29.6	29.4	-0.3
Subsidies	3.4	3.5	0.1
Interest	5.8	5.3	-0.5
Other current transfers payable	3.2	4.0	0.8
Gross fixed capital formation	7.0	6.0	-1.0
Capital transfers payable	3.3	0.7	-2.6
Other[(2)]	0.3	0.0	-0.2

(1) "Other" revenue includes market output as well as income derived from property and investments.
(2) "Other" expenditure principally reflects changes in the value of inventories and in the net acquisition of valuables and other assets.
Source: NSO.

a result of increases in taxes collected from both households and companies. A buoyant labour market also led to a higher inflow of social contributions, equivalent to €12.5 million.

Capital and current transfers receivable grew by €7.4 million, due to higher current transfers. Meanwhile, the "other" revenue component grew by €44.1 million, or 42.9%, driven partly by receipts from the Individual Investor Programme (IIP).

In relative terms, "other" income grew significantly faster than the other components, leading to a shift in the composition of revenue. Overall, compared with the first quarter of 2016, the share of tax inflows in total revenue fell by over three percentage points (see Table 5.2). The share of income from taxes on production and imports and social contributions declined the most, falling by 1.7 percentage points and 1.3 percentage points to reach 33.6% and 16.9% respectively. The share of revenue from current taxes on income and wealth also declined slightly, by 0.2 percentage point.

At the same time, the share of "other" revenue increased by 2.8 percentage points, reaching 15.0%. The share of capital and current transfers received also increased, by 0.4 percentage point.

Recurrent expenditure increases, offsetting lower capital spending

Total government expenditure rose by €24.7 million, or 2.7%, during the period under review. The largest increase in expenditure was recorded in intermediate consumption. This grew by €27.8

million, or 20.0%, partly due to spending on the EU Presidency, and on health. Compensation of employees also contributed towards the increase in expenditure, as it grew by €18.3 million, or 6.2%, mostly due to increases within the public administration, education and health sectors. The increase in social benefits was more limited, amounting to €4.9 million.

Other items of recurrent expenditure, namely subsidies and other current transfers payable also grew. The increases amounted to €1.6 million and €7.9 million, respectively. On the other hand, given the prevailing low interest rate environment, interest payments maintained their downwards trend, recording a decline of €2.8 million.

Capital expenditure fell during the period under review. Gross fixed capital formation declined by €7.4 million, partly due to one-off expenditure made in the first quarter of the previous year. Capital transfers also declined compared with the first quarter of 2016, when the last tranche of payments to Air Malta was made in the corresponding period in 2016. The "other" component of expenditure fell by €2.2 million.

With current expenditure mainly increasing and capital expenditure falling, the shift towards recurrent expenditure observed in the last few quarters persisted during the quarter under review. This is mainly due to increases in the shares of intermediate consumption and compensation of employees within total expenditure. The share of these components in total expenditure rose by 2.6 percentage points and 1.1 percentage points, respectively (see Table 5.2). Other current transfers payable and subsidies also contributed towards the increase of the share of recurrent expenditure. On the other hand, social benefits and interest payments recorded drops in their respective shares. The share of gross fixed capital formation fell by 1.0 percentage point, to reach 6.0%, while capital transfers payable dropped by 2.6 percentage points, reaching 0.7% of total expenditure. The share of the "other" component of expenditure fell marginally.

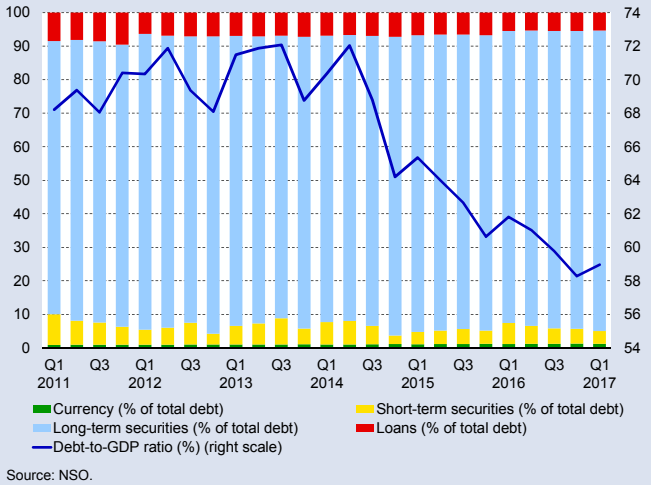
General government debt ratio rises due to a positive deficit-debt adjustment

During the first three months of 2017, the stock of general government debt rose by €152.5 million, reaching €5,919.1 million. As a result, the debt-to-GDP ratio increased from 58.3% at the end of 2016 to 59.0% in March (see Chart 5.3).

A higher debt-to-GDP ratio was registered despite the positive general government balance (see Chart 5.4). This was due to a positive deficit-debt adjustment, which in turn was mainly the result of a large increase in financial assets, namely deposits held with Maltese banks.

During the first three months of 2017, the share of long-term securities (mainly composed of Malta Government Stocks)

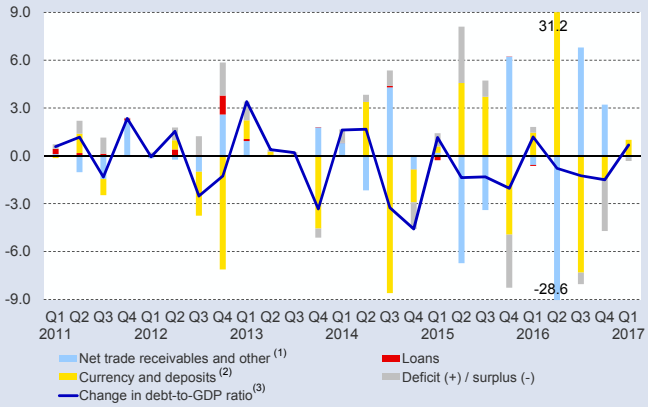
Chart 5.3
GENERAL GOVERNMENT DEBT



Source: NSO.

in total debt increased by 0.7 percentage point, to reach 89.6%. This confirms a trend seen in the previous quarters, as the prevailing low interest rate environment allows long-term financing at a relatively cheap rate. On the other hand, the share of short-term securities fell by 0.6 percentage point, to reach 3.8%, while the share of loans also decreased by 0.1 percentage point, to 5.3%. The share of government liabilities in the form of currency remained broadly stable.

Chart 5.4
CONTRIBUTION TO CHANGE IN DEBT
(percentage points)



(1) Also includes transactions related to shares and other equity and adjustments for valuation and volume effects .
(2) Composed mainly of transactions in deposits held with the Central Bank of Malta.
(3) GDP data are four-quarter moving sums.
Source: Central Bank of Malta.

6. MONETARY AND FINANCIAL DEVELOPMENTS

Monetary dynamics in Malta remained robust during the first quarter of 2017.[1] Residents' deposits with monetary financial institutions (MFIs) operating in Malta continued to grow steadily in annual terms, adding 9.9% in annual terms. The shift to overnight deposits persisted, in an environment of low interest rates. Credit to residents of Malta also grew further, driven by credit to general government and loans to households. In contrast, credit to non-financial corporations (NFC) decreased.

Against a backdrop of an accommodative monetary policy stance, the composite interest rate on deposits and loans to residents fell during the period. In contrast, long-term government bond yields rose. In the equity market, domestic share prices also registered an increase over the three months to March 2017.

Monetary aggregates and their counterparts

Total assets pertaining to the Maltese banking system rose by €294.4 million between December 2016 and March 2017, to €46.3 billion. This increase was mainly driven by the core domestic banks, which offset a drop in the assets of international banks.[2]

Maltese residents' deposits continue to expand

Total deposits held by Maltese residents with MFIs in Malta continued to grow during the first quarter of 2017, with the annual rate of change picking up from 6.7% in December to 9.9% in March (see Table 6.1).

Table 6.1
DEPOSITS OF MALTESE RESIDENTS

	EUR millions	Annual percentage changes				
	2017	2016				2017
	Mar.	Mar.	June	Sep.	Dec.	Mar.
Overnight deposits	**12,505,045**	**17.8**	**12.6**	**13.3**	**13.4**	**19.3**
of which						
Households	6,916,094	17.9	15.7	15.4	17.0	21.6
Non-financial corporations	2,947,279	19.4	6.2	11.1	3.7	8.8
Deposits redeemable at notice of up to three months	**92,317**	**-7.3**	**-12.2**	**-16.9**	**-15.2**	**-18.0**
of which						
Households	80,327	-4.8	-7.4	-17.3	-16.4	-15.9
Non-financial corporations	8,770	-20.7	-45.2	-40.9	-49.2	-35.6
Deposits with an agreed maturity of up to two years	**3,173,335**	**-6.2**	**-10.5**	**-11.2**	**-9.3**	**-9.7**
of which						
Households	2,521,184	-9.3	-11.9	-12.9	-8.7	-6.2
Non-financial corporations	249,689	29.9	-9.8	-17.8	-20.6	-37.0
Deposits with an agreed maturity above two years	**1,516,738**	**5.3**	**5.6**	**8.0**	**-0.4**	**-7.0**
of which						
Households	1,398,791	7.3	7.2	7.3	-2.4	-9.1
Non-financial corporations	60,345	-23.2	-24.4	4.8	18.2	-0.7
Total residents' deposits[(1)]	**17,287,435**	**10.0**	**6.0**	**6.7**	**6.7**	**9.9**

[(1)] Total residents' deposits exclude deposits belonging to central government.

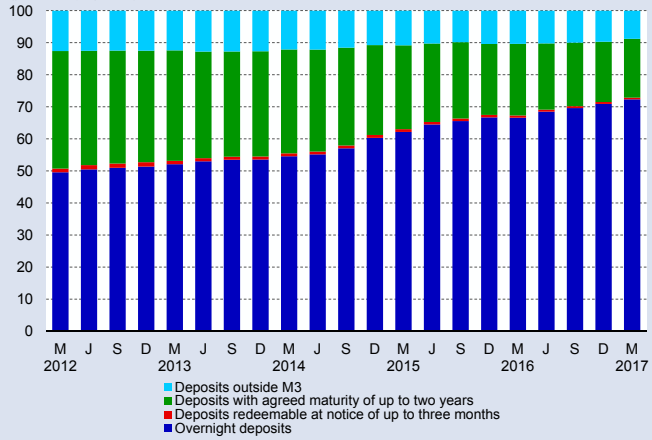
Source: Central Bank of Malta.

[1] Monetary data analysed in this Chapter are compiled on the basis of statistical standards found in the Statistics section on the Central Bank of Malta website.

[2] As at March 2017, the domestically relevant banks or "core" domestic banks were APS Bank Ltd, Banif Bank (Malta) plc, Bank of Valletta plc, HSBC Bank Malta plc, Lombard Bank Malta plc, Mediterranean Bank plc and Mediterranean Corporate Bank.

Growth in total deposits remained driven by overnight deposits. Annual growth for this category of deposits accelerated from 13.4% in December to 19.3% in March. Demand for overnight deposits was particularly strong among households, with the low interest rate environment continuing to sustain a preference for liquidity.

Chart 6.1
DISTRIBUTION OF TOTAL RESIDENT DEPOSITS(1)
(percentage points)



(1) Deposits exclude those belonging to central government.
Source: Central Bank of Malta.

On the other hand, time deposits continued to contract. In particular, deposits with an agreed maturity of up to two years declined further, going down by an annual 9.7% in March. This followed a 9.3% decrease in December. Deposits with an agreed maturity of over two years also continued to contract, falling at an annual rate of 7.0%. The smallest component of residents' deposits, namely deposits redeemable at notice of up to three months, also continued to shrink.

As a result, the shift away from term deposits towards overnight deposits persisted, with the share of overnight deposits in total residents' deposits rising to 72.3% in March, from 66.6% a year earlier (see Chart 6.1). The share of overnight deposits in total residents' deposits has been growing almost continuously since 2012. In contrast, the share of deposits with an agreed maturity of up to two years declined to 18.4%, from 22.3% a year earlier, while the share of deposits with an agreed maturity of over two years edged down to 8.8%, from 9.7%. The share of deposits redeemable at notice of up to three months remained limited.

Interest rates on deposits continue to decline

Interest rates on residents' deposits declined further during the first quarter of 2017, with the composite rate offered to households and NFCs going down by 3 basis points since December, to 0.45% (see Table 6.2).[3] This was driven by a drop in time deposit rates, with overnight rates already very close to zero. When compared with a year earlier, the composite deposit rate lost 19 basis points, reflecting the ongoing accommodative monetary policy of the euro area.

Credit to residents expands at a faster pace

Credit to Maltese residents accelerated slightly during the first quarter of 2017, with the annual rate of change going to 2.7% in March, from 2.5% in December (see Chart 6.2).

Credit to general government drove this acceleration, with annual growth accelerating to 3.6% in March from 1.4% three months earlier. Developments in credit to general government were mainly influenced by changes in banks' holdings of Malta Government Stocks (MGS), in part relating to the timing of MGS issuances and redemptions.

[3] MFI interest rate data on outstanding amounts shown in Table 6.2 cover euro-denominated deposits belonging to households and NFCs residents in Malta. The household sector includes non-profit institutions serving households.

Table 6.2
INTEREST RATES ON DEPOSITS AND LOANS

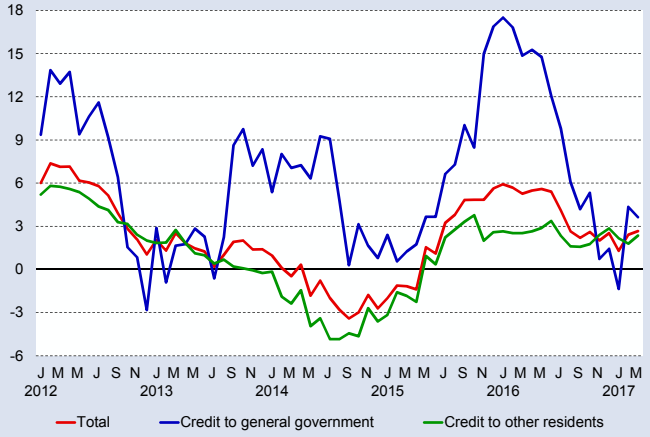
Percentages per annum to residents of Malta; weighted average rates as at end of period

	2014	2015	2016				2017
	Mar.	Mar.	Mar.	June	Sep.	Dec.	Mar.
Total deposits[1]	**1.34**	**0.93**	**0.64**	**0.58**	**0.52**	**0.48**	**0.45**
of which							
Overnight deposits							
Households	0.27	0.15	0.11	0.11	0.07	0.06	0.06
Non-financial corporations	0.26	0.17	0.09	0.08	0.08	0.03	0.03
Time deposits (less than 2 years)							
Households	2.03	1.53	0.98	0.88	0.79	0.79	0.79
Non-financial corporations	1.93	1.33	0.80	0.75	0.71	0.65	0.61
Time deposits (more than 2 years)							
Households	3.54	3.35	2.90	2.85	2.76	2.64	2.54
Non-financial corporations	3.09	2.70	2.13	1.97	2.06	2.03	1.89
Total Loans[1]	**4.20**	**3.98**	**3.78**	**3.75**	**3.69**	**3.68**	**3.64**
of which							
Households and NPISH	3.83	3.68	3.58	3.57	3.53	3.52	3.49
Non-financial corporations	4.65	4.36	4.06	4.02	3.92	3.93	3.87
Spread[2]	**2.86**	**3.05**	**3.14**	**3.17**	**3.17**	**3.20**	**3.19**
ECB main refinancing operations rate	0.25	0.05	0.00	0.00	0.00	0.00	0.00

[1] Annualised agreed rates on outstanding euro-denominated amounts belonging to households and non-financial corporations.
[2] Difference between composite lending rate and composite deposit rate.
Source: Central Bank of Malta.

On the other hand, credit to residents other than general government grew at a slower pace compared with December, with their annual rate of change down to 2.4% in March, from 2.9% three months earlier. This deceleration was driven by decreased MFI holdings of equity in non-bank financial institutions. In contrast, loans, the largest component of credit to other residents, rose at a faster pace of 3.0% in March, from 2.7% three months earlier.

Chart 6.2
CREDIT TO RESIDENTS OF MALTA
(annual percentage changes)



Source: Central Bank of Malta.

The pick-up in loans reflected continued robust growth in loans to households, which accelerated to 6.4% in March, from 5.8% in December (see Chart 6.3). Lending for house purchases remained the main driver of growth in this component, growing by 8.3% in annual terms. In contrast, consumer credit and other lending contracted by 5.6%.

Meanwhile, loans to NFCs contracted at a slower pace, with annual growth going to -2.6% in March from -4.5% in December. A sectoral breakdown of loans extended to NFCs shows that this slower

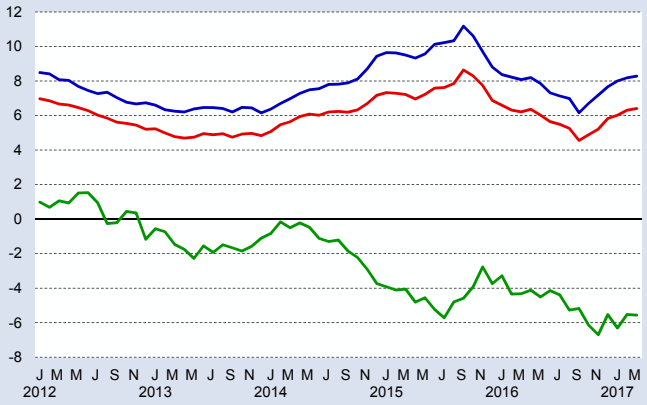
Table 6.3
SECTORAL CONTRIBUTIONS TO YEAR-ON-YEAR GROWTH IN LOANS TO NFCs
Percentage points; annual percentage changes

	Total NFCs				
	2016				2017
	Mar.	June	Sep.	Dec.	Mar.
Accommodation and food service activities	0.6	1.4	-0.7	-1.6	-0.5
Construction	-3.2	-2.0	-2.5	-0.8	-1.9
Manufacturing	-0.5	-0.4	-0.3	-0.4	0.5
Real estate activities	0.0	1.0	1.4	1.3	2.3
Transportation and storage	0.4	-0.1	-0.6	-1.3	-1.0
Wholesale and retail trade	0.1	-0.1	-0.4	-0.9	-0.2
Other	-3.0	0.2	1.3	-0.9	-1.8
Total	**-5.5**	**0.0**	**-1.8**	**-4.5**	**-2.6**

Source: Central Bank of Malta.

decline was driven by smaller contractions in loans to the accommodation and food services sector and to the wholesale and retail trade (see Table 6.3). At the same time, loans to the real estate sector rose at a faster pace and loans to the manufacturing sector recovered.

Chart 6.3
LOANS TO HOUSEHOLDS
(annual percentage changes)



Source: Central Bank of Malta.

Interest rates on loans fall

Interest rates on loans to Maltese residents declined during the quarter under review, with the composite rate paid by households and NFCs edging down by 4 basis points over the three months to March, to 3.64% (see Table 6.2). When compared with a year earlier, this signifies a drop of 14 basis points, reflecting developments in loan rates to both NFCs and households. The rate on NFC loans remains above that charged to households, possibly reflecting different assessments of credit risk.

The spread between the composite lending rate and the deposit rate stood at 319 basis points at the end of the first quarter. When compared with a year earlier, this signifies a widening of the spread by 5 basis points, suggesting that the transmission of the European Central Bank's (ECB) monetary policy easing measures to retail lending rates was weaker than that to deposit rates (see Table 6.2).

Bank Lending Survey indicates unchanged credit standards

According to the Bank Lending Survey (BLS), which was conducted in March 2017, respondent banks reported unchanged credit standards and credit terms and conditions during the first quarter of the year for NFCs. Likewise, no changes for the second quarter were expected. The assessment of demand was mixed, with half of the respondents reporting an unchanged demand for credit, while the remaining banks reported a slight increase during the first quarter of the year.

Credit demand in the second quarter of 2017 is expected to remain stable on balance, with only one bank anticipating an increase.

Respondent banks participating in the BLS survey reported unchanged standards and terms and conditions on loans for house purchases and consumer credit during the first quarter of 2017, with no changes expected to take place during the second quarter of 2017. Likewise, the demand for these forms of credit was mostly assessed to have remained unchanged, with only one bank reporting a small decrease in the demand for house purchases and consumer credit. Going forward, participating banks expected the demand for these types of credit to remain stable in the second quarter of 2017.

The majority of banks participating in the March BLS reported no changes in market access of wholesale and retail funding and their risk transfer capability as a result of the prevailing situation in financial markets. One bank however, reported a slight deterioration in long-term deposits and other retail funding instruments, as well as its access to the short-term money market, though access to short-term deposits eased slightly. Banks were also asked to describe their current level of credit standards relative to those which prevailed in 2003 and 2010. Compared with the start of the intensification of the sovereign debt crisis in 2010, the majority of banks reported a moderate tightening in credit standards for loans to enterprises. Half of the banks however claimed that the level of credit standards for loans to households has remained the same, with only one bank reporting moderately looser standards for house purchases.

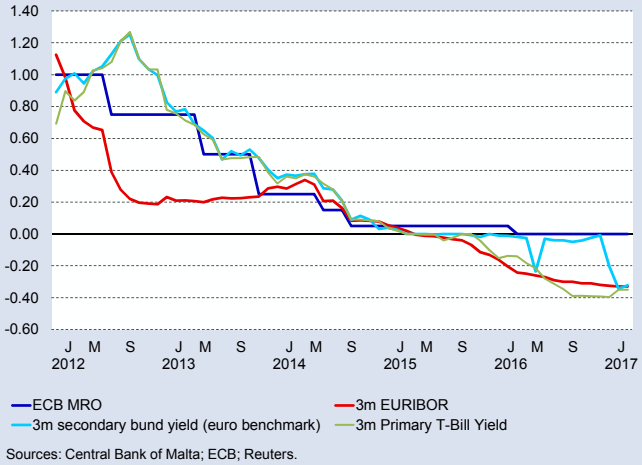
The majority of banks reported no effect of the ECB's expanded asset purchase programme (APP) on their assets and liquidity. Likewise, their lending behaviour was unchanged and expected to remain stable in the following six months. Half of the reporting banks felt that the ECB's negative deposit facility rate is not having an impact on their lending to enterprises and households, while the rest reported a slight upward impact. The negative deposit facility rate contributed to a slight lowering in lending rates to households and enterprises.

The money market

Domestic money market interest rates rose marginally

The ECB maintained its key interest rates unchanged during the first quarter of 2017. In particular, the rate on its main refinancing operations was held at 0.00%. Meanwhile, in euro area money markets, the three-month EURIBOR fell marginally by 1 basis point, to -0.33%. The domestic primary market yield, as measured by the yield on three-month Treasury bills rose to -0.35% at the end of March 2017, from -0.39% at the end of December.

Chart 6.4
MONEY MARKET INTEREST RATES
(percentages per annum; end of month rates)



Sources: Central Bank of Malta; ECB; Reuters.

During the quarter, the secondary market yield on three-month German government securities, which acts as a benchmark for euro area yields, rose by 3 basis points, to -0.96 (see Chart 6.4). Consequently, the spread between the domestic rate and the euro area benchmark remained broadly stable at 61 basis points at the end of the first quarter of the year.

During the first quarter of 2017, the Government issued €142.2 million in Treasury bills, down from €290.5 million issued between September and December.

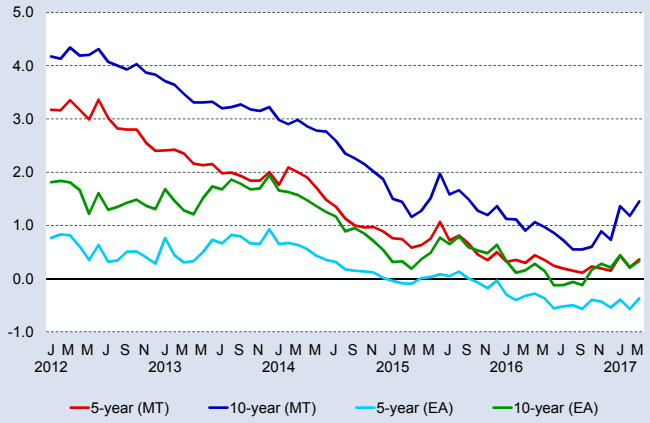
The capital market

The Government issued six MGSs with a total value of €182.9 million during the first quarter of 2017. Meanwhile, over the same period, Von der Heyden Group Finance plc issued €25 million unsecured bonds.

In the secondary market, turnover in government bonds during the first quarter of 2017 fell to €87.1 million, from €168.7 in the previous quarter, while corporate bond turnover rose from €17.8 million to €21.6 million over the same period.

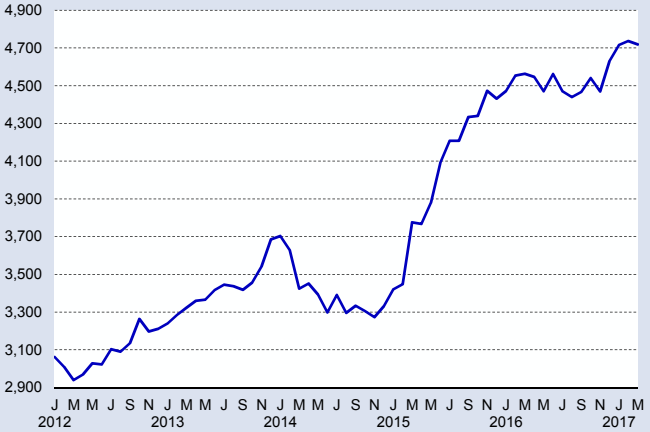
Secondary market yields on Maltese government bonds rose during the first quarter of 2017 (see Chart 6.5). The yield on five-year government bonds increased by 21 basis points since the end of December, to close March at 0.36%. Meanwhile, the yield on ten-year bonds rose by 72 basis points to 1.45%.[4] In the euro area, the comparable five-year yield rose by 17 basis points to -0.38% at end-March, while the ten-year yield rose by 12 basis points to 0.33%. Thus, the ten-year euro-area benchmark yield remained in positive territory.

Chart 6.5
GOVERNMENT BOND YIELDS
(percentages per annum; end of month)



Sources: Central Bank of Malta; ECB.

Chart 6.6
MALTA STOCK EXCHANGE SHARE INDEX
(end of month)



Source: MSE.

MSE share index rose further during the first quarter of 2017

Share prices in Malta as measured by the Malta Stock

[4] Between December 2016 and March 2017, the change in the 10-year yield for Malta was amplified by changes in the composition of the reference basket.

Exchange (MSE) index, increased in January and February, but fell in March. Nonetheless, the index ended March 1.9% higher that its end-December level and 3.4% higher than the level registered a year earlier (see Chart 6.6). Turnover in equity rose from €15.2 million in the last quarter of 2016 to €19.5 million in the first quarter of 2017.