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Address

Pjazza Kastilja
Valletta VLT 1060
Malta

Telephone

(+356) 2550 0000

Fax

(+356) 2550 2500

Website

www.centralbankmalta.org

E-mail

info@centralbankmalta.org

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ABBREVIATIONS

APP	asset purchase programme
BLS	Bank Lending Survey
DCC	dynamic conditional correlations
ECB	European Central Bank
EER	effective exchange rate
EONIA	Euro OverNight Index Average
ESI	economic sentiment indicator
EU	European Union
EURIBOR	Euro Interbank Offered Rate
FOMC	Federal Open Market Committee
GDP	gross domestic product
GVA	gross value added
HCI	harmonised competitiveness indicator
HICP	Harmonised Index of Consumer Prices
LFS	Labour Force Survey
MFI	monetary financial institution
MGS	Malta Government Stocks
MRO	main refinancing operation
MSE	Malta Stock Exchange
NEIG	non-energy industrial goods
NFC	non-financial corporation
NPISH	non-profit institutions serving households
NPL	non-performing loans
NSO	National Statistics Office
PPI	Producer Price Index
RPI	Retail Price Index
SAFE	Survey on Access to Finance of Enterprises
SME	small and medium-sized enterprises
TLTRO	targeted longer-term refinancing operation
ULC	unit labour cost

FOREWORD

Economic activity in Malta remained robust in the second quarter of 2017, with real gross domestic product (GDP) rising by 6.4% on an annual basis, following a 6.2% increase in the preceding quarter. Net exports were the sole driver behind the expansion, as domestic demand contributed negatively to economic growth, mainly on account of a drop in investment which was exceptionally high a year earlier.

Labour market conditions remained favourable in the second quarter of 2017, as employment grew further and the unemployment rate reached an all-time low of 4.1%. This partly reflects increased labour market participation and improved job matching in the context of a buoyant economy.

Price pressures remained contained, as annual inflation, based on the Harmonised Index of Consumer Prices (HICP) eased to 1.0% in June, from 1.2% in March. This deceleration was driven by slower growth in the prices of food and non-energy industrial goods, which offset a higher contribution from energy inflation. Inflation in Malta remained below that in the euro area, where HICP inflation stood at 1.3% in June.

Domestic cost pressures were also moderate, although annual producer price inflation turned positive after a sequence of negative readings. As regards measures of competitiveness, annual growth in Malta's unit labour costs, measured on a four-quarter moving average basis, was subdued. In contrast, Harmonised Competitiveness Indicators indicated a deterioration in competitiveness, owing mainly to unfavourable exchange rate movements.

Monetary dynamics in Malta remained steady during the second quarter of 2017. Residents' deposits with monetary financial institutions operating in Malta continued to grow at a solid pace in annual terms, driven by growth in overnight deposits in an environment of low interest rates. At the same time, growth in credit to residents eased, mainly driven by developments in credit to general government and loans to non-financial corporations (NFC).

In the context of subdued price pressures in the euro area, the Governing Council of the European Central Bank maintained an accommodative monetary policy stance during the second quarter of 2017. The interest rates on main refinancing operations, the marginal lending facility and the deposit facility were kept at 0.00%, 0.25% and -0.40%, respectively. The Council also retained the comprehensive package of non-standard monetary measures, which include purchases of eligible securities under the asset purchase programme (APP). The Council continues to expect interest rates to remain at present or lower levels for an extended period of time, and well past the horizon of the net asset purchases. The Governing Council also confirmed that net purchases will be made alongside reinvestments of principal payments from maturing securities purchased under the APP.

Reflecting these accommodative monetary conditions, interest rates on deposits held by Maltese residents declined further between March and June. Interest rates on household loans increased marginally, while those on loans to NFCs remained unchanged over this period. Meanwhile, Treasury bill yields rose marginally, while secondary market yields on longer-term government bonds fell.

As regards public finances, in the second quarter of 2017, the general government surplus declined on the comparable period of 2016, as expenditure grew at a faster pace than revenue. When measured as a four-quarter moving sum, the general government surplus narrowed to 2.0% of GDP, from 2.3% in the first quarter of 2017. Meanwhile, general government debt, as a share of GDP, decreased from 58.1% at the end of March 2017, to 56.8% at the end of June 2017.

ECONOMIC SURVEY

1. THE EURO AREA AND THE EXTERNAL ENVIRONMENT

Economic growth as measured by real gross domestic product (GDP) accelerated in the United States and edged up slightly in the euro area. In contrast, it remained unchanged in the United Kingdom. The three-month average unemployment rate continued to decline in all the three economies.

Between March and June, inflation eased in the euro area and in the United States. However, it rose in the United Kingdom. Annual consumer price inflation in the euro area fell to 1.3% in June, from 1.5% in March. In the United States, the fall in inflationary pressures was even more pronounced as inflation in June stood at 1.6%, down from 2.4% three months earlier. Meanwhile, in the United Kingdom price pressures increased, as inflation rose to 2.6% from 2.3% previously.

Central banks continued to maintain an accommodative monetary policy stance. However, while the European Central Bank (ECB) and the Bank of England kept their key policy rates unchanged, the Federal Reserve raised the target rate for the federal funds rate in June.

Brent oil prices generally rose in April amid lower inventory levels and expectations of further cuts in production. Throughout May and June, prices mainly fell as agreed production cuts fell short of expectations. As a result, the price of Brent oil ended the quarter lower than in March. Non-energy commodity prices also decreased over the three months to June.

Key advanced economies

US economic growth accelerates

The US economy grew at a faster pace in the second quarter of 2017, with real GDP rising by 0.8% quarter-on-quarter, up from 0.3% in the previous quarter (see Table 1.1). This acceleration followed two consecutive quarters of decelerating growth.

This acceleration reflected faster growth in private consumption, as well as a recovery in private investment and in federal government spending. These were partly offset by lower state and local government spending.

In the labour market, the participation rate edged down slightly to 62.8% in June from 63.0% in March, as the labour force rose more slowly than the working age population. Over this period, the annual rate of employment growth accelerated to 1.4% from 1.3%. Payroll data show that

Table 1.1
REAL GDP GROWTH IN SELECTED ADVANCED ECONOMIES

Quarter-on-quarter percentage changes; seasonally and working day adjusted

	2015		2016			2017	
	Q4	Q1	Q2	Q3	Q4	Q1	Q2
United States	0.1	0.1	0.6	0.7	0.4	0.3	0.8
Euro area	0.4	0.5	0.3	0.5	0.6	0.5	0.6
United Kingdom	0.7	0.2	0.5	0.4	0.6	0.3	0.3

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

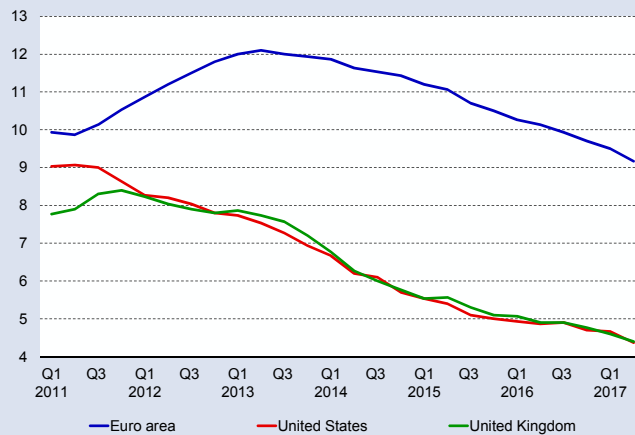
on an annual basis the number of employees working in the manufacturing and construction sectors grew at a stronger pace compared with March, while those working in the public sector increased at a slightly slower pace. Meanwhile, the annual rate of change in private services remained unchanged.

The unemployment rate fell marginally to 4.4% in June from 4.5% in March. On a three-month average basis, the unemployment rate decreased by 0.3 percentage point to 4.4% (see Chart 1.1).

The annual rate of inflation based on the Consumer Price Index (CPI) edged down during the quarter under review and fell below the 2% target of the Federal Reserve. In June, consumer price inflation stood at 1.6%, compared with 2.4% three months earlier (see Chart 1.2). The deceleration in the inflation rate was primarily attributable to weaker growth in energy prices and, to a lesser extent, services prices. On the other hand, food price inflation rose further. Inflation excluding energy and food eased from 2.0% in March to 1.7% in June.

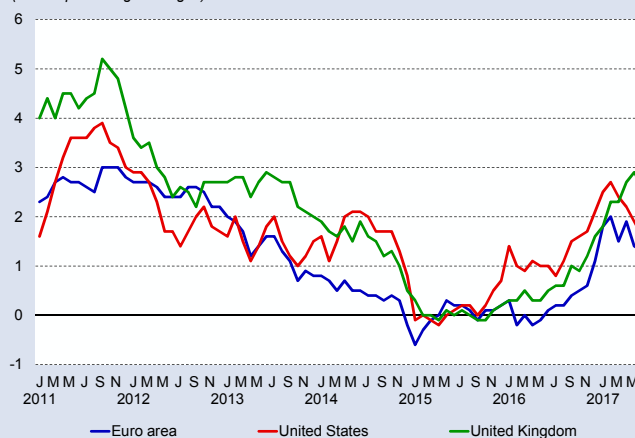
In its meeting held at the beginning of May, the Federal Open Market Committee (FOMC) decided to maintain the target rate for the federal funds rate unchanged (see Chart 1.3). In mid-June, however, the FOMC raised the range to between 1.00% and 1.25%, from the preceding range of 0.75% to

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



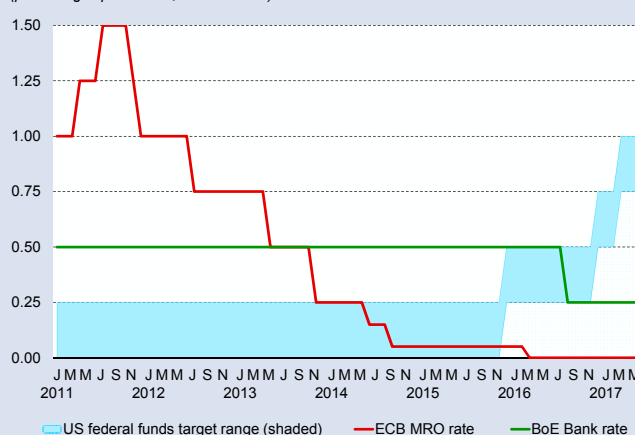
Sources: Eurostat; US Bureau of Labor Statistics; Office for National Statistics, UK.

**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.

1.00%. The Committee decided to raise the range as economic activity and labour market conditions were expected to strengthen further. Inflation was also expected to somewhat pick-up and stabilise around the 2% objective over the medium term. The Committee 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.¹

UK economy grows at the same pace

Quarter-on-quarter GDP growth in the United Kingdom remained unchanged compared with that recorded in the preceding three-month period, at 0.3% (see Table 1.1). Investment increased at a faster pace as did net exports. On the other hand, both government consumption expenditure and consumer spending slowed down. Changes in inventories also lowered GDP growth. In the labour market, employment increased at an annual rate of 1.2% in the second quarter, after having risen by 1.1% in the previous three-month period. Unemployment in the United Kingdom averaged 4.4% in the three months to June, 0.2 percentage point lower than the average for the preceding quarter (see Chart 1.1).

Consumer price inflation increased in April and May before slowing down again in June (see Chart 1.2). In June, the inflation rate stood at 2.6%, up from 2.3% in March. Faster growth in the prices of food, services and non-energy industrial goods offset weaker growth in energy prices. Indeed, inflation excluding energy, food, alcohol and tobacco rose to 2.4% in June, from 1.8% in March.

In the meetings held in May and June, the Bank of England's Monetary Policy Committee maintained the Bank Rate unchanged at 0.25% (see Chart 1.3). All Committee members agreed that any increases in the Bank Rate would be expected to be at a gradual pace and to a limited extent. The Committee said that it will continue to monitor closely the incoming economic information and that it stands ready to respond to changes in the economic outlook as they unfold to ensure a sustainable return of inflation to the 2% target. The Committee voted unanimously to maintain the stock of sterling non-financial investment-grade corporate bond purchases totalling up to GBP 10 billion, financed by the issuance of central bank reserves. It also maintained the stock of UK government bond purchases, financed by the issuance of central bank reserves, at GBP 435 billion.²

The euro area

Euro area economy maintained moderate growth

The euro area economy continued to grow at a moderate pace during the second quarter of 2017, with real GDP growth rising marginally to 0.6% on a quarterly basis, from 0.5% in the second quarter (see Table 1.2).

Domestic demand was the primary driver behind economic activity during the quarter under review. Private consumption and government expenditure accelerated and together contributed 0.4 percentage point to real GDP growth. Investment rose after falling in the previous quarter, pushing up economic activity by a further 0.2 percentage point. These increases offset the negative contribution stemming from changes in inventories.

¹ This assessment was broadly confirmed at the FOMC's meetings held in July and September, with the target range for the federal funds rate left unchanged from that announced in June.

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

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

	2016			2017	
	Q2	Q3	Q4	Q1	Q2
	<i>Percentage point contributions</i>				
Private consumption	0.2	0.2	0.3	0.2	0.3
Government consumption	0.0	0.0	0.1	0.0	0.1
Gross fixed capital formation	0.5	0.0	0.3	-0.1	0.2
Change in inventories	-0.3	0.2	0.1	-0.1	-0.1
Exports	0.6	0.2	0.7	0.6	0.5
Imports	-0.7	-0.2	-0.9	-0.2	-0.4
GDP	0.3	0.5	0.6	0.5	0.6

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

Source: Eurostat.

As exports decelerated while imports grew at a faster pace, net exports contributed marginally to real GDP growth.

Inflation moderates

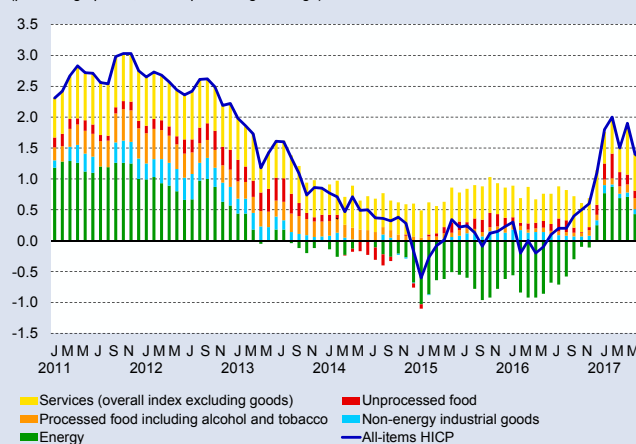
In June, the annual rate of inflation in the euro area, measured on the basis of the Harmonised Index of Consumer Prices (HICP), eased slightly compared with March. In June, the inflation rate stood at 1.3%, down from 1.5% in March (see Chart 1.4).

This moderation was primarily driven by a fall in energy and unprocessed food inflation. On the other hand, prices of non-energy industrial goods, processed food and services rose faster.

These developments led to an increase in the annual rate of change of HICP excluding energy and food during the second quarter. This measure of inflation rose to 1.1% in June from 0.7% in March.

Labour market conditions ameliorate

Over the second quarter of 2017, labour market conditions in the euro area improved further. The number of employed continued to increase, with the annual rate of change standing at 1.6% on an annual basis, marginally above the 1.5% recorded in the previous quarter.³ The seasonally adjusted rate of unemployment fell further. It stood at 9.1% in June, down from 9.4% in March and from 10.1% a year earlier. The three-month average eased from 9.5% in the first quarter to 9.2% in the second (see Chart 1.1).

³ Employment data for the euro area are based on the national accounts.**Chart 1.4**
CONTRIBUTIONS TO YEAR-ON-YEAR HICP INFLATION IN THE EURO AREA
(percentage points; annual percentage change)

Source: Eurostat.

Euro area to maintain its recovery

The latest ECB staff macroeconomic projections, published in September 2017, foresee the euro area recovery to continue, with growth rates well above potential. Economic activity in the euro area is projected to be supported mainly by domestic demand, which is expected to be sustained by continued improving labour conditions, past progress with deleveraging as well as the accommodative monetary policy stance of the ECB. On the other hand, exports are expected to have a limited impact on GDP growth. Following an increase of 1.8% in 2016 and robust growth in the first half of 2017, real GDP growth is expected to edge up to 2.2% in 2017 before moderating to 1.8% and 1.7% in 2018 and 2019, respectively (see Table 1.3).

Private consumption is set to continue to increase robustly over the forecast horizon, supported by further enhancements in the labour market, the low interest rate environment, improving bank lending conditions and progress with deleveraging. Consumer confidence is assessed to be high from a historical perspective and therefore supportive for consumer spending in the near term. Subsequently private consumption is set to move in line with real disposable income growth.

Residential investment is expected to continue recovering, as recent data point towards a strong pick up in many euro area countries. It has been sustained by favourable income prospects and financing conditions as well as portfolio reallocation towards housing. Nevertheless, some loss of momentum is anticipated over the forecast horizon.

The recovery in business investment is set to progress, on the back of improving business confidence, higher capacity utilisation and the need to modernise the capital stock after years of subdued investment. Government consumption is set to decelerate in 2017, and then rise at a relatively constant growth rate over the rest of the forecast period.

With regards to the external side, the global recovery is expected to support exports, offsetting the recent appreciation of the euro. However, imports are set to outpace exports over the forecast horizon, with net exports making a very small negative contribution.

Compared with the Eurosystem staff projections published in June 2017, euro area GDP growth was revised upwards by 0.3 percentage point in 2017 and is broadly unchanged thereafter. The revision was driven by the recent revisions in GDP data.

Table 1.3
MACROECONOMIC PROJECTIONS FOR THE EURO AREA⁽¹⁾

Average annual percentage changes

	2016	2017	2018	2019
GDP	1.8	2.2	1.8	1.7
Private consumption	2.0	1.7	1.8	1.5
Government consumption	1.8	1.2	1.2	1.1
Gross fixed capital formation	4.1	4.0	3.9	3.1
Exports	3.2	4.7	3.7	3.8
Imports	4.5	5.2	4.6	4.2
HICP	0.2	1.5	1.2	1.5

⁽¹⁾ ECB staff macroeconomic projections (September 2017).

Source: ECB.

In their latest projections, ECB staff project HICP inflation to accelerate from 0.2% in 2016 to 1.5% this year. Euro area inflation is then expected to moderate to 1.2% in 2018, before rising again to 1.5% in 2019. The initial slow-down in the inflation profile reflects a fall in energy inflation. The subsequent pick up is in line with the continuing economic recovery and a rebound in energy inflation.

In contrast to overall inflation, HICP excluding energy and food is expected to pick up over the forecast horizon, rising from 0.9% in 2016 to 1.1% this year. It is then forecasted to reach 1.3% in 2018 and 1.5% in 2019, respectively. The acceleration in this measure of inflation mainly reflects the expected increase in labour costs as labour market slack subsides. Overall inflation projections were revised down by 0.1 percentage point in 2018 and 2019, respectively. HICP excluding energy and food was also revised down in these years.

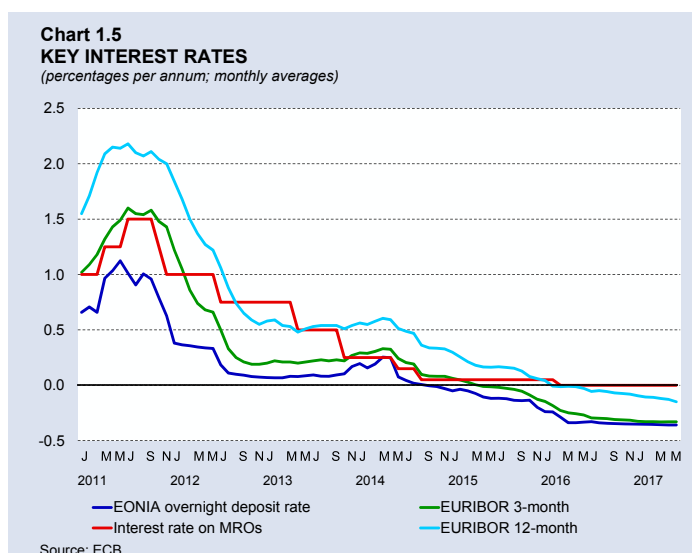
ECB maintained its accommodative monetary policy stance

The ECB's Governing Council maintained an accommodative monetary policy stance during the second quarter of 2017. The interest rates on main refinancing operations (MRO), marginal lending facility and deposit facility were kept at 0.00%, 0.25% and -0.40%, respectively (see Chart 1.3). The Council 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 retained the comprehensive package of non-standard measures. This includes purchases under the asset purchase programme (APP). In April, the Council announced that these will be conducted at a monthly pace of €60 billion until the end of December, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation. The Governing Council also confirmed 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, some money market rates in the euro area reached new historical lows during the June quarter. The twelve-month EURIBOR fell by 4 basis points to -0.15% over the three-month period, while the three-month rate remained constant at -0.33% (see Chart 1.5). The EONIA deposit rate fell by 1 basis point to -0.36% in June.⁵



⁴ The Governing Council kept the key interest rates unchanged during its July monetary policy meeting.

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.

Spreads narrow as bond yields decline

Ten-year benchmark government bond yields in the euro area fell during the second quarter of 2017, with the monthly average in Germany standing at 0.25% in June, from 0.35% in March. The decrease in yields partly reflected lower political risks and positive economic releases for the euro area.

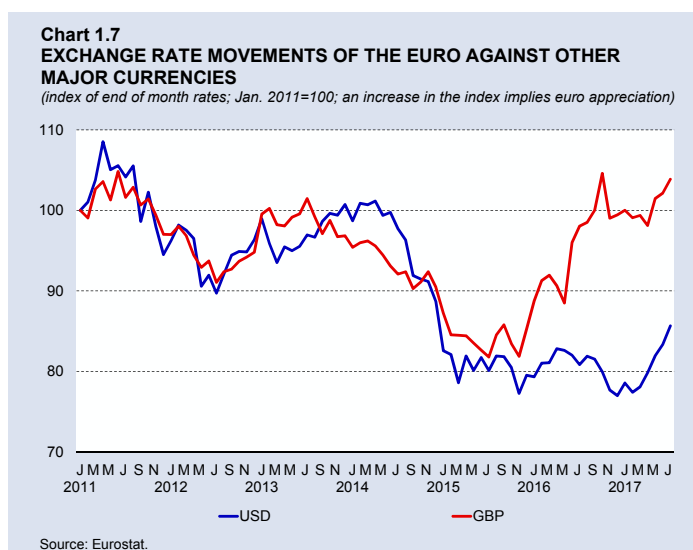
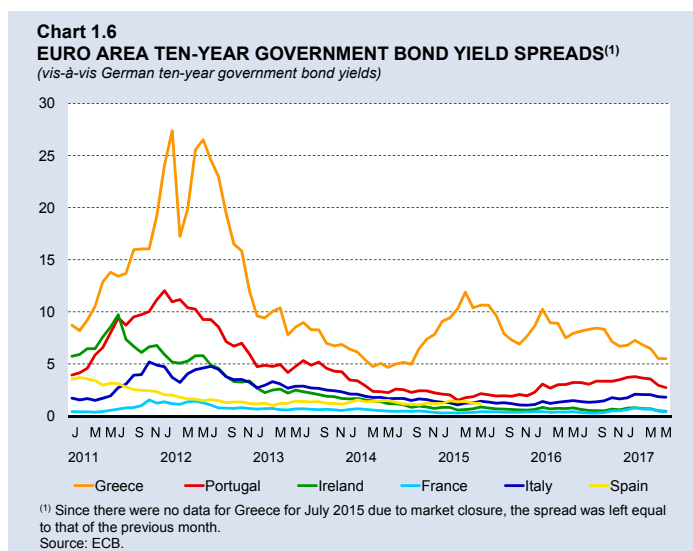
The declines were more pronounced in lower-rated euro area countries, with Greece and Portugal recording the strongest falls, of 141 and 102 basis points, respectively. Greece's borrowing costs fell to their lowest since September 2014, as in June the country's creditors agreed to release new loans after months of uncertainty. On the other hand, the decline in Portugal's yields reflected an improving economy as well as a shrinking budget deficit. Yields also fell in France (by 36 basis points), Italy (by 35 basis points), Ireland (by 35 basis points) and Spain (by 27 basis points).

Spreads between yields in these countries and the ten-year German bond yield declined during the June quarter, especially for Greece and Portugal (see Chart 1.6).

The euro appreciates

During the second quarter of 2017, the euro exchange rate appreciated against major currencies. The nominal effective exchange rate (EER) against the EER-19 group of countries rose by 3.3% between March and June.⁶ The euro benefited from market expectations that the ECB will start to reduce stimulus amid signs of improving economic conditions.

Over the June quarter, the euro gained 6.7% against the US dollar and rose by 2.8% against the pound sterling (see Chart 1.7). The euro also increased against



⁶ The 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.

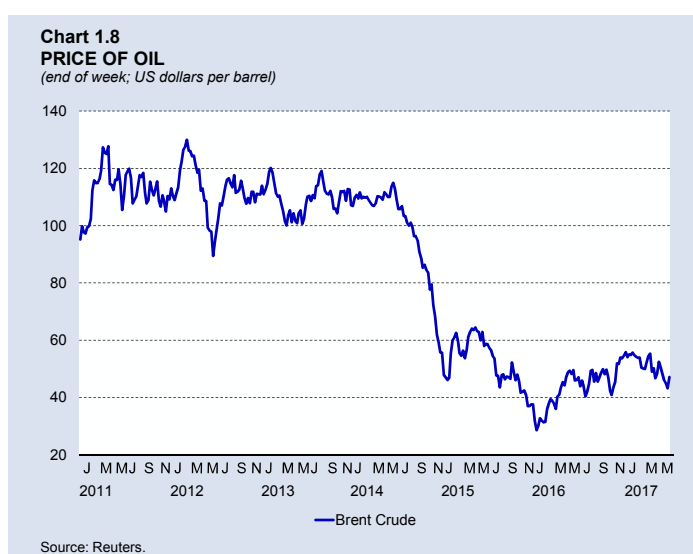
a range of other currencies within the EER-19 groups of countries, such as the Japanese yuan and the Chinese yuan renminbi.

Commodities

Commodity prices fluctuate

The price of Brent crude oil generally rose at the beginning of April propelled by declining US inventories and outages in Libya's largest oilfield. Expectations that the OPEC cut would be extended for the second half of 2017 added further upward pressures on prices (see Chart 1.8). Energy prices generally fell during May and June. The agreement reached by OPEC and 11 non-OPEC countries on 25 May 2017 was widely anticipated and was therefore priced in before the meeting. Although some countries raised expectations of another arrangement that would entail more intense or prolonged cuts, such agreement did not materialise, amid persistent concerns of oversupply. At the end of the second quarter, the price of Brent stood at USD 47.13 per barrel, representing a decline of 9.7% compared with end-March.

As regards, non-energy commodity prices, World Bank data indicate that these generally decreased during the second quarter. Between March and June, non-energy commodity prices fell by 3.8%.



2. OUTPUT AND EMPLOYMENT

Economic activity continued to grow at a solid pace during the second quarter of 2017, with annual growth in real gross domestic product (GDP) accelerating from the previous quarter. Net exports was the sole driver behind the expansion, as domestic demand contributed negatively to economic activity, mainly on account of a drop in investment which was exceptionally high a year earlier. Nominal sectoral data continue to point towards services as the main driver of growth, although the manufacturing and construction sectors also registered increases in their gross value added (GVA). On the other hand, GVA in the agricultural sector was broadly flat while that in the sector comprising utilities declined.

Labour market conditions remained favourable in the second quarter of 2017, as employment grew further and the unemployment rate reached an all-time low of 4.1%. This partly reflects increased labour market participation and improved job matching in the context of a buoyant economy.

GDP and industrial production

Economic growth remains strong

The Maltese economy continued to record robust growth during the second quarter of 2017. Real GDP rose by 6.4% on a year earlier, after increasing by 6.2% in the March quarter.¹

Growth was driven by net exports. These contributed 15.6 percentage points to real GDP growth, as exports expanded and imports contracted (see Table 2.1). On the other hand, domestic demand

	2016			2017	
	Q2	Q3	Q4	Q1	Q2
	<i>Annual percentage changes</i>				
Private final consumption expenditure	3.3	-0.2	2.3	3.7	5.0
Government final consumption expenditure	3.4	-4.8	-11.2	-3.7	-9.9
Gross fixed capital formation	0.7	-17.5	2.1	3.8	-27.4
Domestic demand	5.2	-6.6	-1.0	3.8	-9.6
Exports of goods and services	-0.5	2.0	8.1	0.2	5.0
Imports of goods and services	-0.5	-5.8	3.3	-1.6	-6.5
Gross domestic product	4.9	4.6	5.9	6.2	6.4
	<i>Percentage point contributions</i>				
Private final consumption expenditure	1.7	-0.1	1.1	1.9	2.4
Government final consumption expenditure	0.7	-0.7	-2.1	-0.7	-1.9
Gross fixed capital formation	0.4	-4.5	0.4	0.9	-7.6
Changes in inventories	2.3	-0.6	-0.4	1.6	-2.1
Domestic demand	5.0	-6.0	-0.9	3.7	-9.2
Exports of goods and services	-0.8	2.9	11.2	0.2	6.9
Imports of goods and services	0.7	7.7	-4.4	2.3	8.6
Net exports	0.0	10.6	6.8	2.6	15.6
Gross domestic product	4.9	4.6	5.9	6.2	6.4

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

¹ The analysis of GDP in this Chapter of the *Quarterly Review* is based on data in NSO News Release 141/2017, released on 6 September 2017.

contributed negatively to growth as higher private consumption was offset by falls in government expenditure and investment, while the contribution of changes in inventories turned negative. Domestic demand shed 9.2 percentage points from economic growth.

In the second quarter, exports increased by 5.0% on an annual basis, following marginal growth in the previous quarter. Meanwhile, imports contracted at a stronger pace when compared to the preceding three months, falling by 6.5%. Therefore, net exports pushed up real GDP growth by 15.6 percentage points, with the positive contribution partly mirroring trade in services, where exports outpaced imports by a comfortable margin. In addition, goods imports decreased strongly in annual terms.

Real private consumption growth accelerated further during the second quarter, rising by 5.0% on a year earlier and contributing 2.4 percentage points to real GDP growth. Nominal data point to higher private consumption expenditure across all categories when compared with the same period of 2016.

Gross fixed capital formation fell by 27.4% in annual terms, shedding 7.6 percentage points from economic growth. The contraction in investment reflected lower outlays on machinery and equipment, which were extraordinarily high in the corresponding quarter of last year. Movements in this investment component continued to be heavily influenced by developments in aviation services, which more than offset increases in other categories. Indeed, both investment in non-residential construction and in dwellings increased at double digit rates. Investment in cultivated biological resources and intellectual property products also rose on the corresponding quarter of 2016. Nominal data show that the contraction in investment stemmed from the private sector, as government investment increased on an annual basis.

Government consumption continued to contract in the June quarter, falling by almost 10% on an annual basis and shedding 1.9 percentage points from real GDP growth. Both principal components of government consumption increased in nominal terms, though intermediate consumption rose at a faster pace than compensation of employees. The increase in intermediate consumption partly reflected outlays related to the EU Presidency and health. The contraction in government expenditure rather reflected an increase in sales, which are netted against expenditure in the national accounts. This increase in sales was in turn driven by inflows under the Individual Investor Programme (IIP).

Changes in inventories also contributed negatively to real GDP growth, shedding 2.1 percentage points.

Nominal GDP accelerates, services remain the main driver of growth

Nominal GDP increased by 8.5% in annual terms in the second quarter of 2017, following a rise of 8.0% in the previous quarter (see Table 2.2). This acceleration reflected developments in GVA, which increased by 8.9% on an annual basis and contributed 7.9 percentage points to nominal GDP growth.² On the other hand, net taxes on products increased at a slower pace.

Services remained the main driver of GVA growth, contributing 7.2 percentage points to nominal GDP growth. The largest additions within the services-related sectors came from the

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

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

Percentage points

	2016			2017	
	Q2	Q3	Q4	Q1	Q2
Agriculture, forestry and fishing	0.1	0.0	0.4	0.1	0.0
Mining and quarrying; utilities	0.3	0.2	-0.2	-0.2	-0.3
Manufacturing	0.0	0.5	0.1	0.3	0.5
Construction	-0.1	0.0	0.1	0.2	0.4
Services	5.3	4.9	6.1	6.3	7.2
<i>of which:</i>					
Wholesale and retail trade; repair of motor vehicles; transportation; accommodation and related activities	0.4	0.1	0.6	0.4	1.8
Information and communication	0.7	0.6	0.6	0.6	0.4
Financial and insurance activities	0.9	0.4	0.6	0.4	0.5
Real estate activities	0.4	0.4	0.4	0.1	-0.1
Professional, scientific, administrative and related activities	1.0	1.2	1.7	2.5	2.6
Public administration and defence; education; health and related activities	1.1	1.2	0.8	1.0	0.8
Arts, entertainment; household repair and related services	0.9	0.9	1.3	1.2	1.2
Gross value added	5.6	5.6	6.5	6.8	7.9
Taxes less subsidies on products	0.8	0.6	1.0	1.3	0.6
Annual nominal GDP growth (%)	6.4	6.2	7.5	8.0	8.5

Source: NSO.

sectors comprising of professional and scientific activities, wholesale and retail as well as arts and entertainment. Together these sectors pushed up nominal GDP growth by 5.7 percentage points, and accounted for more than three-fourths of the increase in GVA of services.

The manufacturing and construction sector also supported the expansion in economic activity, as they registered a much faster rate of growth than in the previous quarter and contributed 0.5 and 0.4 percentage point, respectively to nominal GDP growth. GVA in the agricultural sector increased at a slower pace and had a negligible impact on growth, while the sector incorporating utilities contracted at a faster pace and shed 0.3 percentage point from economic growth.

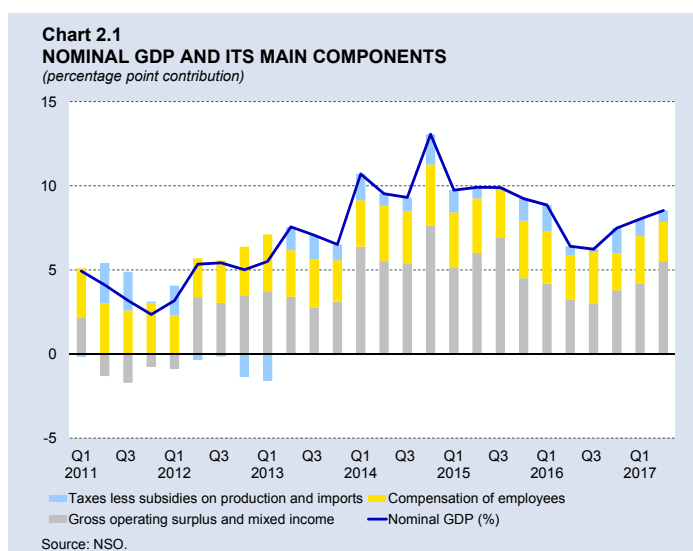
GDP data by income distribution show that the acceleration in nominal GDP was driven by developments in gross operating surplus and mixed income as compensation of employees increased at a slower pace.

Gross operating surplus and mixed income continued to grow strongly in the second quarter of 2017, with the annual rate of change accelerating to 11.7%, from 9.3% in the previous quarter. It contributed 5.5 percentage points to nominal GDP growth (see Chart 2.1).

In absolute terms, the majority of 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 administration and support services, arts and entertainment as well

as accommodation and food services. On the other hand, the sectors comprising of agriculture, forestry and fishing as well as utilities and real estate registered falls in their gross operating surplus.

Compensation of employees rose by 5.5% and added 2.3 percentage points to nominal GDP growth. In absolute terms, the largest increases in compensation were registered in the sectors comprising arts and entertainment, education as well as administration and support services.



Industrial production records the second consecutive increase

During the second quarter of 2017, industrial production rose by 4.3% when compared with the same quarter a year earlier.³ This followed a 5.9% year-on-year increase in the preceding quarter (see Table 2.3).

Growth was led by the manufacturing sector, which accounts for over 80% of the index. Companies producing computer, electronic and optical products, rubber and plastics, as well as beverages

Table 2.3
INDUSTRIAL PRODUCTION⁽¹⁾

Percentages; annual percentage changes

	Shares	2016			2017	
		Q2	Q3	Q4	Q1	Q2
Industrial production	100.0	-4.0	-2.9	-1.6	5.9	4.3
Manufacturing	83.3	-4.7	-3.8	-3.4	8.3	3.6
<i>of which:</i>						
Computer, electronic and optical products	18.4	-33.0	-5.3	5.8	15.9	30.8
Basic pharmaceutical products and pharmaceutical preparations	10.4	14.6	-28.3	-23.6	-2.9	-29.6
Food products	8.1	-5.9	-16.2	-2.4	0.4	-9.3
Printing and reproduction of recorded media	5.9	-7.5	17.8	-29.3	0.1	0.3
Rubber and plastic products	4.4	2.6	15.7	9.8	22.4	14.2
Beverages	3.9	5.3	-2.9	-3.4	8.8	2.7
Energy	16.3	2.6	-3.1	3.7	5.8	0.6
Mining and quarrying	0.4	11.3	10.6	-9.7	-11.9	-11.5

⁽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.

registered growth in production. Meanwhile those operating in the pharmaceuticals and food sectors registered a decline in output when compared with the same quarter of 2016. Production within the printing and reproduction of recorded media sector was broadly unchanged in annual terms.

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

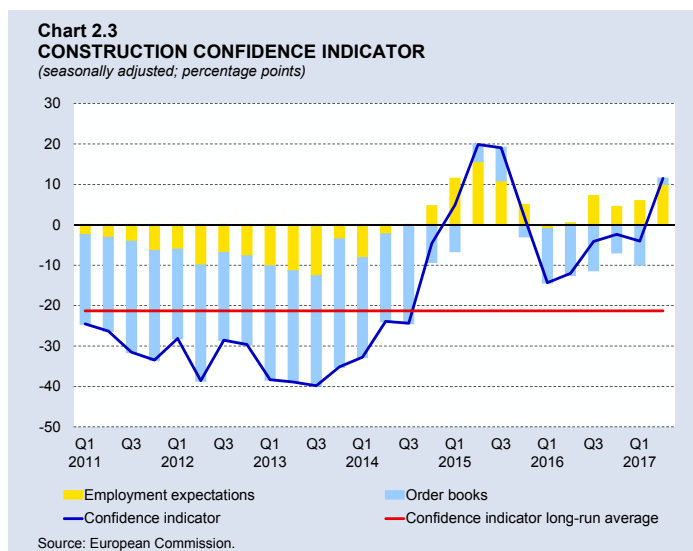
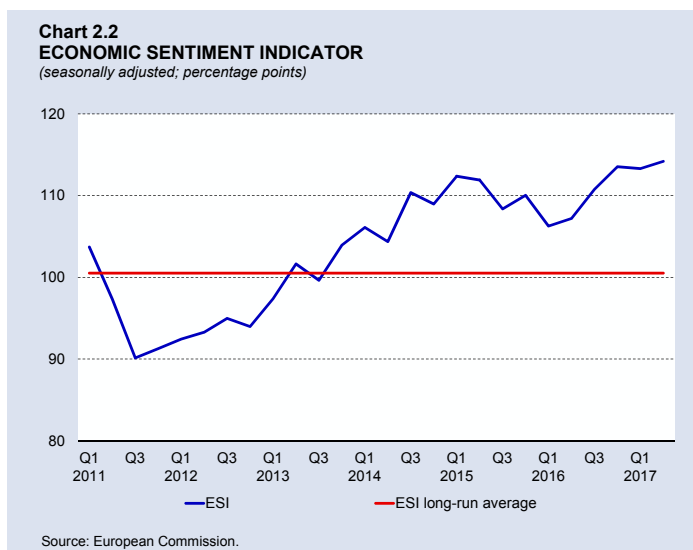
Business and consumer surveys

During the second quarter of 2017, the economic sentiment indicator (ESI) rose marginally to 114, from 113 in the preceding quarter,⁴ thus remaining above its long-term average of 101 (see Chart 2.2).⁵ Increased sentiment in construction, among consumers and in the industrial sector, more than offset a significant deterioration in the retail sector. Confidence within the services sector remained broadly unchanged.

Confidence in the construction sector turns positive⁶

Sentiment in the construction sector increased significantly during the second quarter of 2017. Indeed, the indicator turned positive after five consecutive quarters of negative readings, reaching 11 (see Chart 2.3).

The rise in confidence during the second quarter of 2017 was mainly driven by firms' assessment of order books. Indeed, firms assessed their order book levels to be above normal for the first time in seven quarters. Employment expectations for the subsequent three months were also more optimistic.



⁴ The ESI summarises developments in confidence in five surveyed sectors (industry, services, construction, retail and consumers). Quarterly data in this section 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. The long-term average of the retail confidence indicator is calculated as from May 2011, when it was first published. However, 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.

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

Consumer confidence increases⁷

The consumer confidence indicator rose to 5 in the second quarter of 2017, from 2 in the preceding three-month period. Therefore, it remained well above its long-term average of -19 (see Chart 2.4).

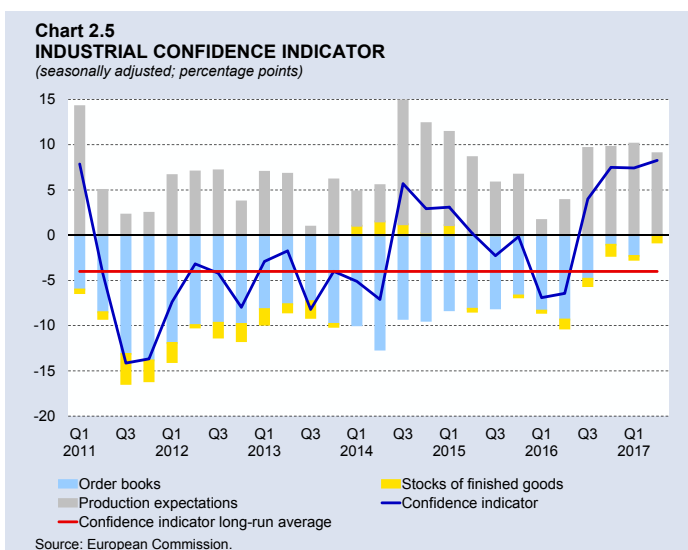
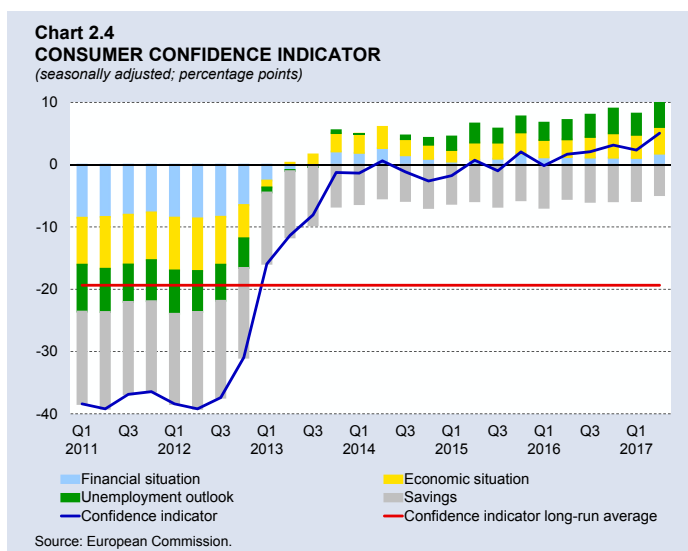
All components contributed to the increase in Q3 sentiment, with savings expectations for the year ahead being the main driver. Compared with the first quarter of 2017, a larger share of respondents expected their financial situation and the general economic situation over the following 12 months to improve. Also, more respondents expected unemployment to fall further compared with the first quarter of 2017.⁸

Additional survey data suggest that the share of consumers intending to reduce major purchases over the subsequent 12 months decreased further. At the same time, on balance, a higher share of consumers expected inflation to rise.

Industrial confidence edges up⁹

Confidence in the industrial sector edged up to 8 in the second quarter of 2017, from 7 in the preceding quarter, thus remaining above its long-term average of -4 (see Chart 2.5).

The marginal increase in industrial sentiment during the quarter under review was driven by firms' assessment of order books, which were no longer seen as



⁷ 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.

⁸ Negative unemployment expectations affect the overall indicator in a positive way. Such falls are thus represented by positive bars in Chart 2.4.

⁹ 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.

being below what is normal for the season. In contrast, stocks of finished goods were more pronounced, and production expectations for the subsequent three months were less optimistic, compared with the previous quarter.¹⁰

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.

Confidence in the retail sector turns negative¹¹

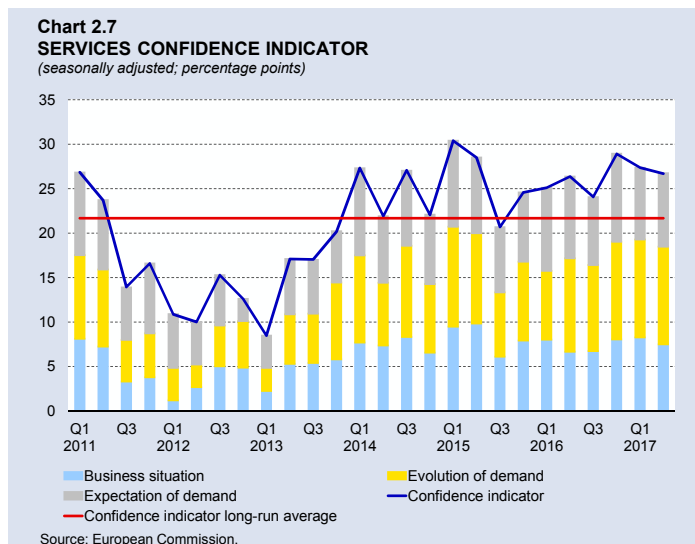
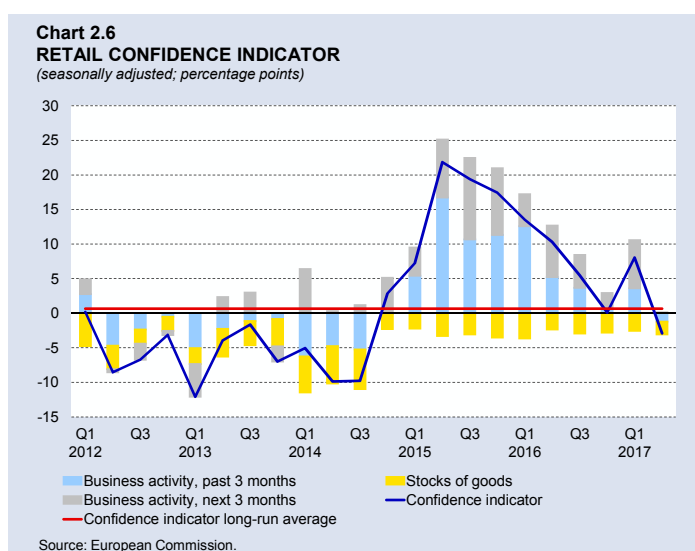
Sentiment in the retail sector fell significantly to -3 from 8 in the first quarter of 2017 and turned negative for the first time since the third quarter of 2014. Following this drop, it stood below its long-term average of 1 (see Chart 2.6).

The decline in confidence was driven by both firms' assessment of past and expected business activity, with both indicators declining sharply between the two quarters under review. At the same time, on balance respondents continued to assess stock levels to be above normal, with the share of respondents expressing this view declining only marginally from that in the preceding quarter.¹²

Additional survey data indicate that selling prices are expected to rise during the three months ahead, while on balance, respondents expected employment to decline.

Confidence in the services sector broadly unchanged¹³

In the second quarter of 2017, the services confidence indicator was broadly unchanged at 27. Therefore, it still compared favourably with its long-term average of 22 (see Chart 2.7).



¹⁰ 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.

¹¹ 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.

¹² A decline in the balance of above-normal stock levels affect the overall indicator in a positive way.

¹³ 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.

A slight weakening in firms' assessment of their business situation over the preceding three months was offset by an increase in expectations of demand for the following three months. Their assessment of past demand however, was unchanged for the third consecutive quarter.

Additional survey data indicate that a smaller net share of respondents reported higher employment in the preceding three months. In contrast, employment expectations for the following three months were unchanged compared with the preceding quarter. Only a small net share of respondents indicated that they expected prices to increase in the following three months.

The labour market¹⁴

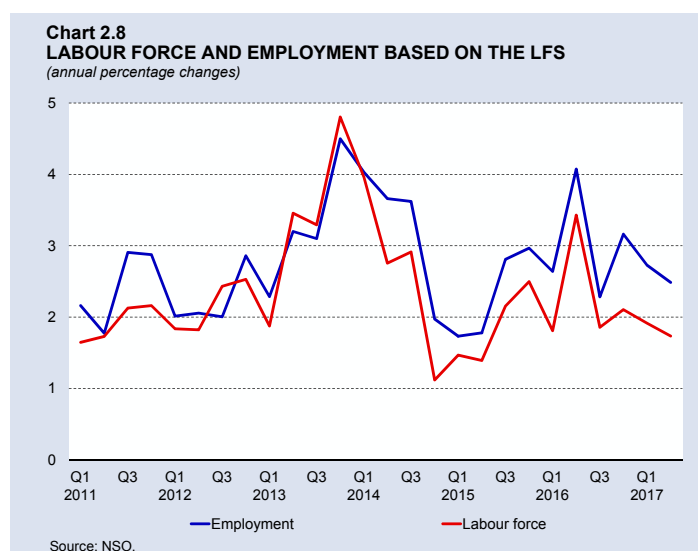
Labour force continues to grow strongly

LFS data show that in the second quarter of 2017 the labour force grew by 1.7% over the same quarter of 2016, marginally lower than 1.9% in the first quarter of 2017 (see Chart 2.8).¹⁵ Employment grew at a slower pace, while the number of unemployed decreased further in annual terms.

The activity rate stood at 69.9% in the second quarter of 2017, up from 69.3% in the same quarter a year earlier.¹⁶ This reflected increased activity among females. Indeed, the female participation rate edged up by 0.9 percentage point, to reach 56.9%, while that of males was unchanged from a year earlier, at 82.2% (see Table 2.4).

Employment growth eased marginally

The annual rate of change of employment eased to 2.5%, from 2.7% in the first quarter of 2017, and from 4.1% in the second quarter of 2016. The increase in employment during the second quarter of 2017 reflected further growth in the number of full-time jobs, as employment on a part-time basis declined (see Table 2.4). Full-time employment increased by 5,396, or 3.3% on the same quarter of 2016,



¹⁴ This section draws mainly on labour market statistics from two sources: the Labour Force Survey (LFS), which is a household survey conducted by the National Statistics Office (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.

¹⁵ 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.

¹⁶ 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 %
	Q2	Q3	Q4	Q1	Q2	
Labour force	202,169	203,763	201,329	200,636	205,673	1.7
Employed	192,405	193,893	192,807	192,277	197,188	2.5
<i>By type of employment:</i>						
Full-time	163,376	164,904	164,741	164,727	168,772	3.3
Part-time	29,029	28,989	28,066	27,550	28,416	-2.1
Unemployed	9,764	9,870	8,522	8,359	8,485	-13.1
Activity rate (%)	69.3	70.0	69.1	68.7	69.9	
Male	82.2	82.9	81.9	81.2	82.2	
Female	56.0	56.6	55.7	55.6	56.9	
Employment rate (%)	66.0	66.5	66.1	65.8	67.0	
Male	78.5	79.0	78.8	77.9	78.9	
Female	52.9	53.6	52.9	53.0	54.4	
Unemployment rate (%)	4.8	4.8	4.2	4.2	4.1	
Male	4.4	4.7	3.7	3.9	4.0	
Female	5.5	5.2	5.1	4.5	4.4	

Source: NSO.

while the number of part-timers, which includes those employed on a full-time with reduced hours basis, fell by 613, or 2.1%, following a 2.0% increase in the preceding quarter.

During the second quarter of 2017 the overall employment rate rose to 67.0% and registered a year-on-year increase of 1.0 percentage point.¹⁷ This reflects developments in both the male and female employment rates, which increased by 0.4 and 1.5 percentage points respectively. Indeed, the male employment rate reached 78.9%, from 78.5% a year earlier, while that of females rose to 54.4% from 52.9%. Gains were registered among male workers aged between 25 and 54 and among females aged between 15 and 54.

These outcomes suggest that the Government is on track to attain its target of increasing the employment rate to 70.0% by 2020.¹⁸

The unemployment rate edged down

In the second quarter of 2017, the unemployment rate based on the LFS stood at 4.1%. This was marginally lower than the 4.2% registered in the preceding quarter, and 0.7 percentage point less than a year earlier.¹⁹ The jobless rate for males declined by 0.4 percentage point to 4.0%, while that of females fell by 1.1 percentage points to 4.4% compared with the second quarter of 2016 (see Table 2.4).

¹⁷ 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.

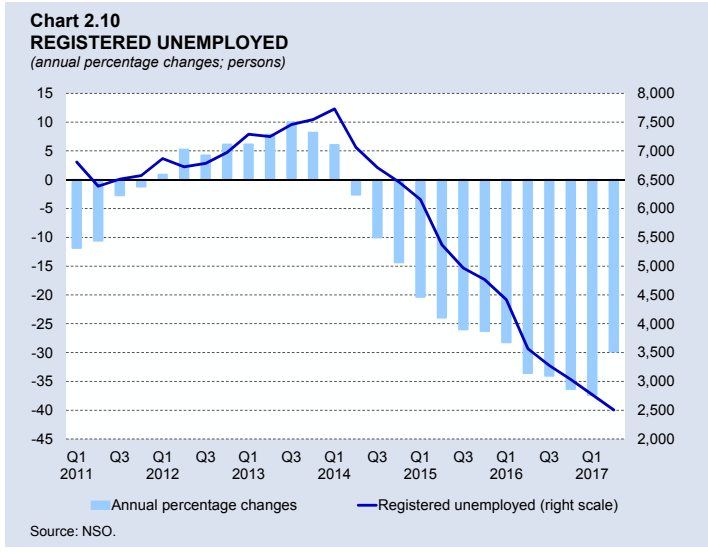
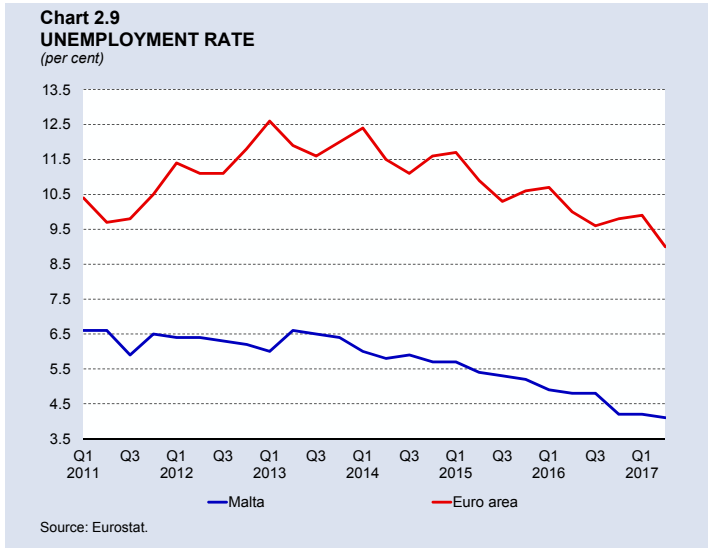
¹⁸ See *The National Employment Policy*, Ministry for Education and Employment, May 2014, p.13 and *Malta: National Reform Programme 2017*, Ministry for Finance, April 2017, p.33.

¹⁹ 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 Jobplus definition includes only those persons registering for work under Part 1 and Part 2 of the unemployment register.

The LFS 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. The average number of registered unemployed stood at 2,504 in the second quarter of 2017, 1,064 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.



3. PRICES, COSTS AND COMPETITIVENESS

Consumer price pressures remained contained during the second quarter of 2017. The annual growth rate of the Harmonised Index of Consumer Prices (HICP) eased to 1.0% in June, while annual inflation based on the Retail Price Index (RPI) dropped to 1.2%. Domestic production costs were also moderate, although annual producer price inflation turned positive after a sequence of negative readings. As regards competitiveness, annual growth in Malta's unit labour costs (ULC) remained moderate, while Harmonised Competitiveness Indicators (HCI) indicate a deterioration in competitiveness, owing mainly to unfavourable exchange rate movements.

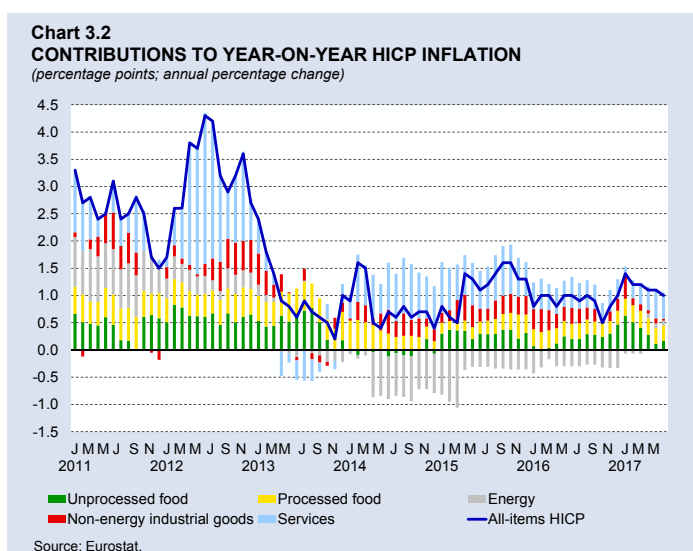
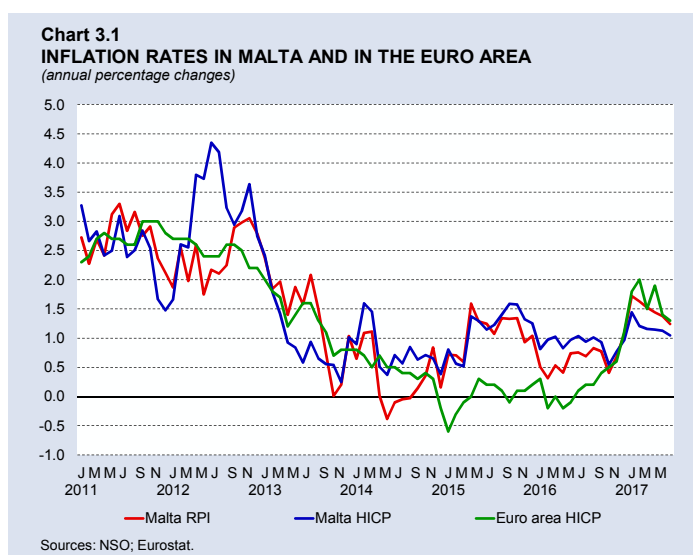
Inflation

HICP inflation eases

Price pressures eased slightly during the second quarter of 2017, with the annual rate of HICP inflation falling to 1.0% in June, from 1.2% in March (see Chart 3.1).¹ Despite the strength of economic activity, price pressures remain contained and below the level observed in the euro area, where HICP inflation stood at 1.3% in June.

The easing of HICP inflation during the second quarter was driven by slower growth in the prices of food and non-energy industrial goods (NEIG) components, which offset a higher contribution from energy inflation (see Table 3.1 and Chart 3.2).

Food inflation decelerated to 2.2% in June, from 3.5% three months earlier. Following strong annual growth rates at the start of the year, price inflation for unprocessed food items such as vegetables and fruit moderated during the second quarter. Indeed, unprocessed food inflation more than halved over the quarter, going from 5.4% in



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%.

Table 3.1
HICP INFLATION

Annual percentage change

	2016			2017					
	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May	June
Unprocessed food	3.3	4.0	6.3	8.4	6.8	5.4	3.7	1.3	2.1
Processed food including alcohol and tobacco	2.0	1.8	1.9	2.4	2.3	2.4	2.3	2.3	2.2
Energy	-4.6	-4.6	-4.6	-1.0	-1.0	-1.0	1.3	1.5	1.5
Non-energy industrial goods	0.2	0.6	0.8	1.6	0.5	0.4	0.2	0.3	0.1
Services (overall index excluding goods)	0.7	0.9	0.8	0.4	0.7	0.9	0.9	1.1	0.9
All Items HICP	0.5	0.8	1.0	1.4	1.2	1.2	1.1	1.1	1.0

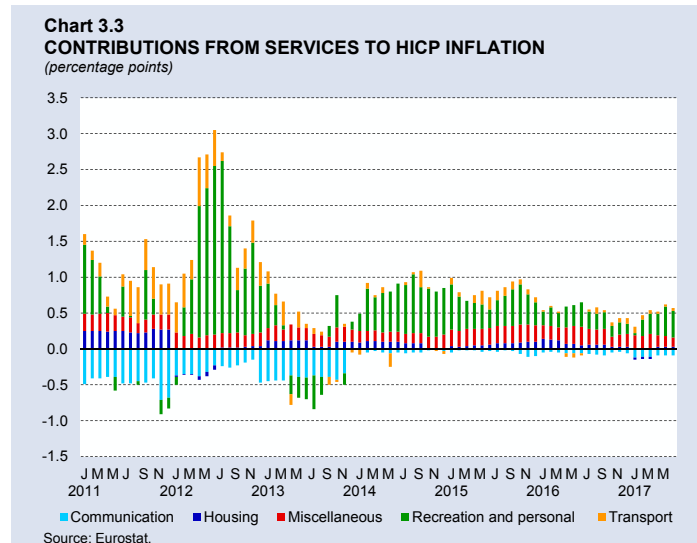
Source: Eurostat.

March to 2.1% in June. At the same time, processed food inflation eased to 2.2%, driven by weaker growth in the prices of bread and cereals. As a result, the contribution of the overall food component to headline HICP inflation dropped by 0.3 point during the quarter, to 0.5 percentage point.

Similarly, NEIG inflation weakened during the period under review, going from 0.4% in March to 0.1% in June, as prices for clothing and footwear fell faster. As a result, the overall contribution of the NEIG component to headline inflation dropped to zero, from 0.1 point in March. Inflation within this component has been weak for some time, mirroring developments in the euro area. This ongoing weakness could also reflect the impact of the stronger euro/sterling exchange rate on goods imported from the UK, as well as competitive pressures in a number of industries.

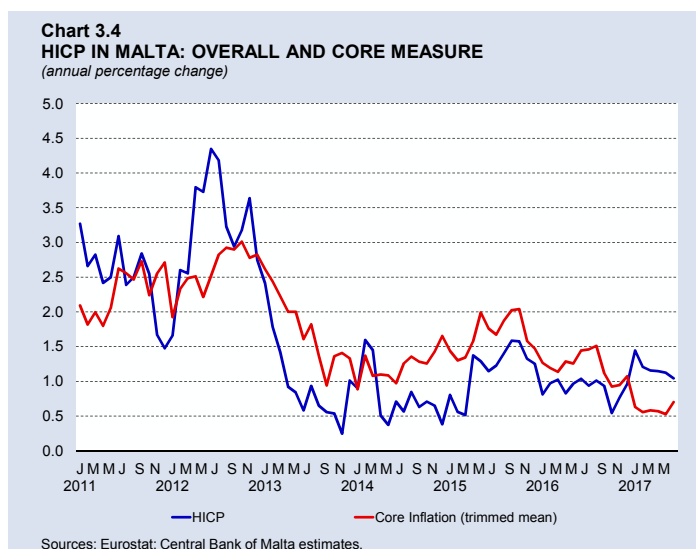
In contrast, energy inflation turned positive during the second quarter, going from -1.0% in March to 1.5% in June. Movements in this component reflect developments in fuel and gas prices, as electricity tariffs have been unchanged since April 2014. The recent swing in energy inflation was driven by the fuel component. Although no price change was announced during the quarter under review, the price of transport fuel was lowered during the corresponding quarter of 2016, leading to higher inflation this year. As a result, the contribution of energy inflation to the headline HICP inflation rose by 0.2 point, to 0.1 percentage point.

Overall services inflation, which has the largest weight in the overall HICP index, remained unchanged at 0.9% at the end of the second quarter when compared with three months earlier. The contribution of this component thus stood at 0.5 percentage point in June. Price competition within sectors such as tourism, food services, communications, and air transport could in part explain the relatively contained inflation rates within this component (see Chart 3.3).



Core HICP inflation rises

Notwithstanding the moderation in overall inflation, the Bank's measure of core HICP inflation picked up marginally during the second quarter, going from 0.6% in March to 0.7% in June (see Chart 3.4).² Nonetheless, core inflation remained below the headline index, indicating that overall HICP is partly being supported by the more volatile components of the index.



RPI inflation decelerates

Annual inflation based on the RPI index eased during the second quarter of 2017, going to 1.2% in June, from 1.5% three months earlier (see Table 3.2).³ In line with developments in HICP inflation, this mainly reflected easing price pressures within the food component and faster declines in the prices of clothing and footwear.

Table 3.2
CONTRIBUTIONS TO YEAR-ON-YEAR RPI INFLATION

Percentage points

	2016			2017					
	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May	June
Food	0.6	0.7	1.0	1.2	1.2	1.1	1.0	0.7	0.7
Beverages and tobacco	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Clothing and footwear	-0.3	-0.2	-0.2	0.0	-0.1	-0.1	-0.1	-0.2	-0.3
Housing	0.1	0.1	0.1	0.0	0.0	0.0	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	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Transport and communications	-0.5	-0.5	-0.4	-0.2	-0.1	-0.1	-0.1	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	-0.1	0.0	0.0	0.0	0.0	0.1	0.1	0.2	0.2
Other goods and services	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	-0.1
RPI (annual percentage change)	0.4	0.7	1.1	1.7	1.6	1.5	1.4	1.4	1.2

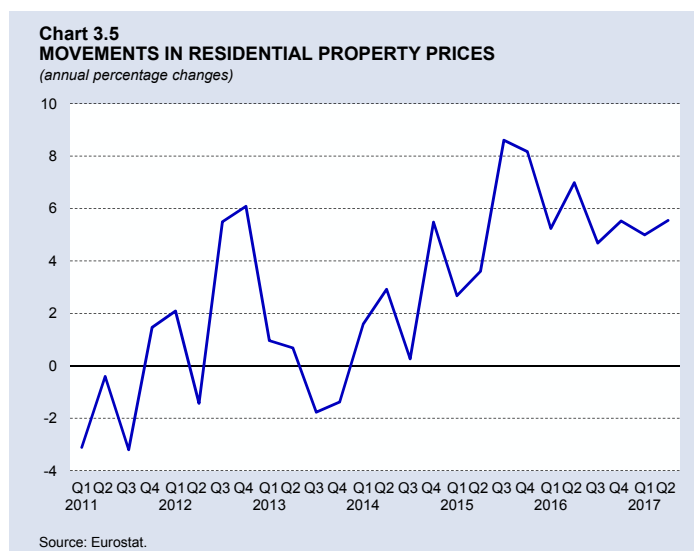
Source: NSO.

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

The National Statistics Office's (NSO) Property Price Index increased at a faster pace during the second quarter of 2017 (see Chart 3.5). The index, which is based on actual transactions involving apartments, maisonettes and terraced houses, rose by 5.5% on an annual basis, after increasing by 5.0% in the March quarter.⁴ This rate of increase remained higher than the annual growth rate registered in the euro area, which stood at 3.8%.



Residential property prices are 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 a more attractive asset.⁵ Buoyant labour market conditions and strong growth in disposable income, together with the rise in foreign workers and the Individual Investor Programme, also continue to lift property prices.

Costs and competitiveness

Producer prices pick up

Cost inflation accelerated during the quarter under review, with annual inflation based on the Producer Price Index (PPI) going up to 1.2% in June, from -0.9% three months earlier. PPI inflation had previously followed a pattern of weak/negative readings lasting a number of years.⁶ The intermediate goods sub-sector, which is the largest component of the index and includes items such as electronics and semiconductors, was the main driver behind the recent acceleration. Producer prices for consumer durables also accelerated. Contributions from the other main components of the index, namely capital goods and energy, remained small and largely unchanged during the period under review. Despite the recent acceleration, overall PPI inflation remains contained, suggesting moderate underlying price pressures at the initial stage of production.

HCIs point to deterioration in international competitiveness

Annual growth in Malta's nominal HCI, a measure of international competitiveness based on trade-weighted exchange rates, accelerated to 1.6% at the end of the second quarter, from

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.

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.

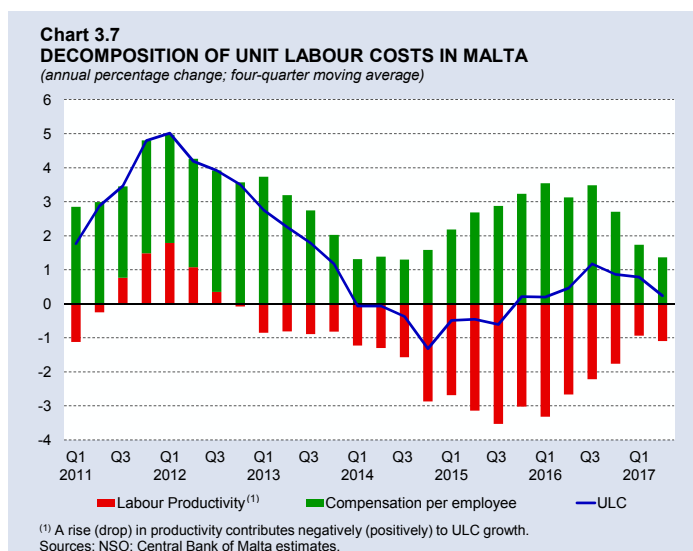
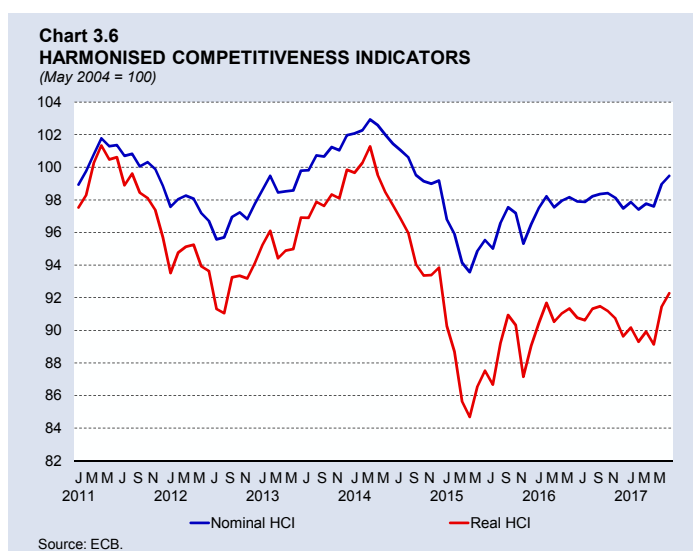
⁶ The Industrial PPI measures the prices of goods at the factory gate and is commonly used to monitor inflationary pressures at the production stage.

0.2% three months earlier (see Chart 3.6).⁷ Similarly, annual growth in the real HCI, which also takes into account differences in relative consumer prices, rose from -0.7% to 1.6%. These figures indicate an overall deterioration in Malta's international competitiveness, caused by unfavourable movements in exchange rates and, to a lesser extent, in relative prices.

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 second quarter of 2017. Measured on a four-quarter moving average basis, the annual growth rate of Malta's ULC stood at 0.2%, down from 0.8% in the previous quarter. This recent deceleration partly reflected slower annual growth in compensation per employee, which moderated from 1.7% during the first quarter to 1.4% in the second quarter. At the same time, a pick-up in productivity growth also had a downward impact on ULC growth. Labour productivity grew by 1.1% in the second quarter, following a 0.9% increase in the previous period (see Chart 3.7).⁸

Annual ULC growth in Malta turned positive at the start of 2016, although it remains relatively contained from a historical perspective.



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.

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 second quarter of 2017 the surplus on the current account of the balance of payments increased when compared with the corresponding quarter of 2016. This rise was predominantly attributable to a narrowing in the merchandise trade gap and higher net services receipts. A small increase in net inflows from secondary income also contributed. These movements offset higher net outflows on the primary income. Meanwhile, net inflows on the capital account rose on a year earlier, while higher net lending was recorded on the financial account.

The current account

The current account surplus widens

In the April to June period of 2017, the current account registered a surplus of €440.6 million, up from €44.5 million a year earlier. This increase was mainly driven by a narrowing in the merchandise trade deficit and a larger surplus from services. When measured on a four-quarter moving sum basis, the surplus on the current account stood at €1,123.4 million, significantly higher than the €303.5 million in the 12 months to June 2016. This improvement was driven by both a rise in net services receipts and a lower merchandise trade deficit (see Table 4.1). As a result, the current account surplus increased to 10.9% of gross domestic product (GDP), up from 3.2% over the four quarters ending in June 2016 (see Chart 4.1).

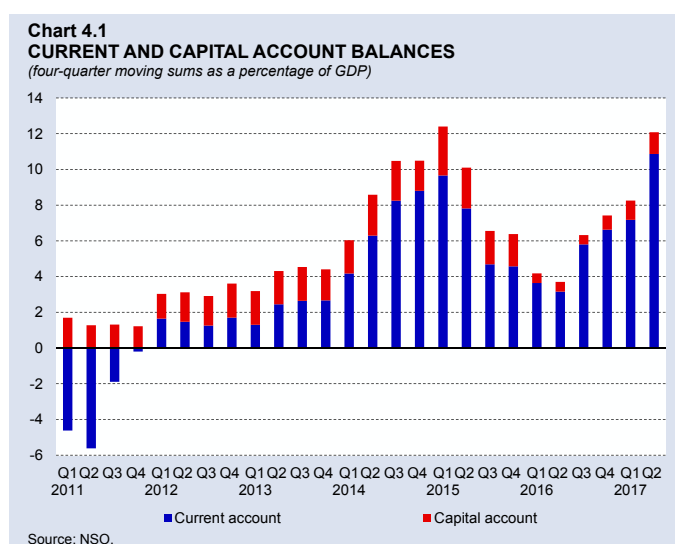


Table 4.1
BALANCE OF PAYMENTS

EUR millions

	Four-quarter moving sums					2016 Q2	2017 Q2
	2016 Q2	2016 Q3	2016 Q4	2017 Q1	2017 Q2		
Current account	303.5	566.8	658.4	727.4	1,123.4	44.5	440.6
Goods	-2,089.4	-1,937.0	-1,910.0	-1,915.8	-1,655.2	-586.5	-325.9
Services	2,735.3	2,874.7	3,022.6	3,058.6	3,229.4	745.5	916.3
Primary income	-569.6	-595.8	-674.9	-640.0	-677.3	-169.8	-207.1
Secondary income	227.1	224.8	220.8	224.6	226.5	55.4	57.3
Capital account	52.6	51.0	79.3	109.1	126.0	34.0	50.9
Financial account⁽¹⁾	511.9	1,395.3	1,518.9	1,793.1	1,896.2	435.9	538.9
Errors and omissions	155.8	777.5	781.2	956.6	646.8	357.3	47.4

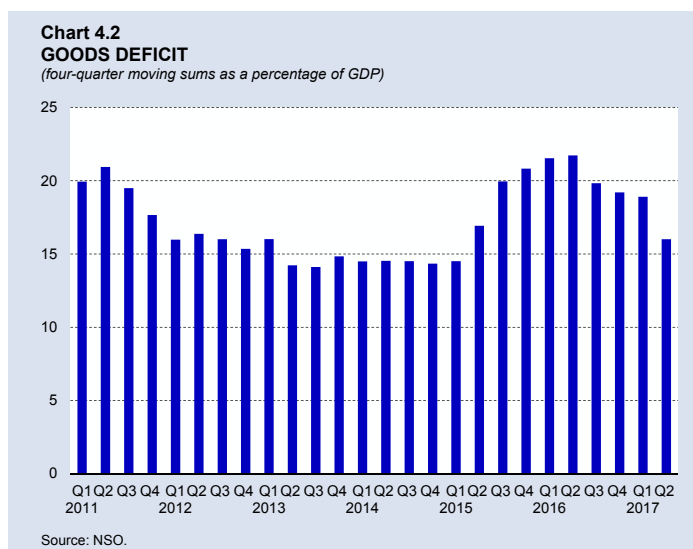
⁽¹⁾ Net lending (+) / net borrowing (-).

Source: NSO.

The merchandise trade deficit narrows significantly

In the quarter under review, the merchandise trade deficit narrowed by €260.6 million on the corresponding period of a year earlier, to stand at €325.9 million. This improvement was almost entirely driven by a contraction in imports, as exports edged up only marginally.

Partly reflecting developments in the period under review, when measured on a four-quarter cumulative basis, the visible trade gap narrowed by €434.2 million; to €1,655.2 million in the June quarter of 2017. This improvement stemmed from a contraction in imports of €496.2 million, partly reflecting the decrease in capital imports from their previous peak, whilst exports dropped by €62.0 million on a year earlier. As a result, the merchandise deficit decreased to 16.0% of GDP, from 21.7% of GDP a year earlier (see Chart 4.2).

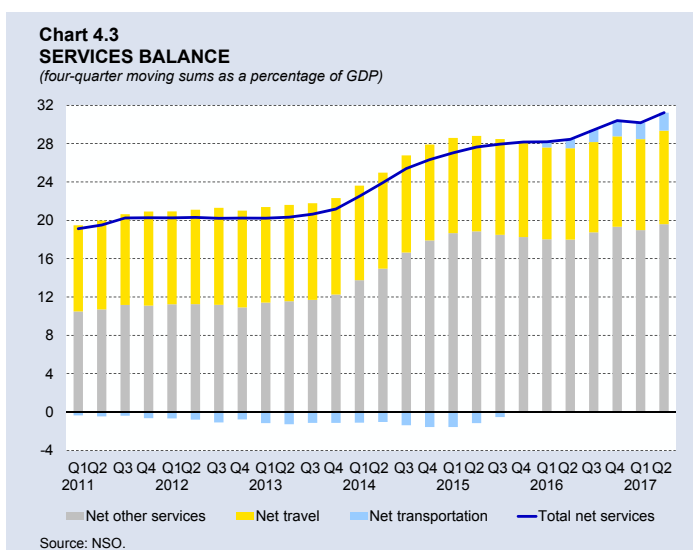


The surplus on services rises further

In the second quarter of 2017, the services industry generated a net surplus of €916.3 million, a rise of €170.8 million on the June quarter of 2016. The higher surplus was stimulated by exports, which rose faster than imports. Sectoral data show that the improvement was broad based across economic sectors. Higher net receipts from the “other services” category increased by €104.3 million, mainly spurred by a rise in exports related to remote gaming, business services and financial services.

At the same time, net travel exports rose by €47.1 million, as a significant increase in inbound tourists’ spending offset a higher expenditure by Maltese residents abroad. Moreover, net transport receipts edged up by €19.4 million on the corresponding quarter of 2016, partly reflecting the continued expansion of the aviation services industry.

When measured on a four-quarter cumulative basis, the overall surplus on the services balance rose to €3,229.4 million in the four quarters to June 2017. It stood at 31.2% of GDP, up from 28.5% 12 months earlier (Chart 4.3).



Primary income account records higher net outflows¹

Between April and June 2017, net outflows on the primary income account reached €207.1 million, compared with net outflows of €169.8 million in the same period of 2016. Larger net outflows were predominantly driven by lower net portfolio income. When measured on a four-quarter moving sum basis, net outflows on this account reached €677.3 million in the year to June 2017; €107.7 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 increase²

During the second quarter of 2017, net inflows on the secondary income account rose by €1.9 million on a year earlier, to stand at €57.3 million. In the year to June 2017, net inflows on the secondary income reached €226.5 million, marginally lower than the flows recorded a year earlier.

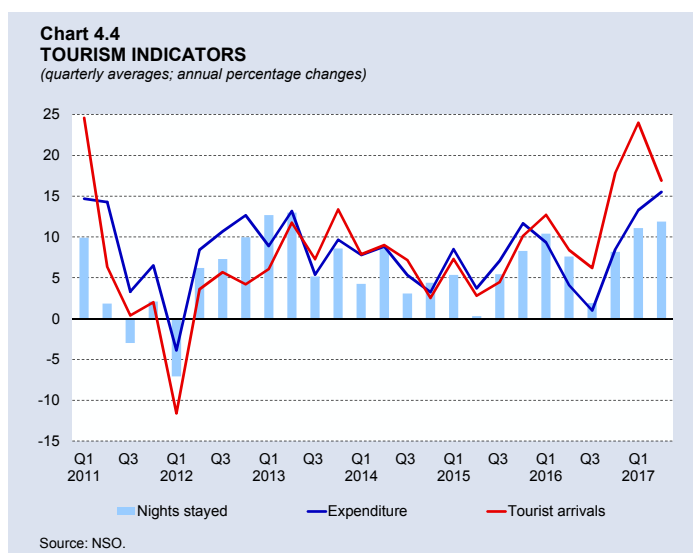
Tourism activity

Activity in the tourism sector remained buoyant in the second quarter of 2017, in line with developments observed in previous quarters. Inbound tourists, nights stayed in Malta and expenditure all increased at double-digit rates in annual terms.

In the second quarter of 2017, the number of inbound visitors reached 641,292, a rise of 16.9% compared with the same period a year earlier (see Chart 4.4). This increase continued to be mainly driven by a higher number of tourists that visited Malta for leisure purposes, although the number of tourists coming over for business and other purposes also rose.

Over the period reviewed, the number of nights that tourists spent in Malta reached 4.3 million, an 11.9% rise on a year earlier. Growth was mainly propelled by an increase in nights stayed in private accommodation, which were up by 20.9% on the preceding year. At the same time, nights spent in collective accommodation went up by 6.7%.³

Meanwhile, tourist expenditure in Malta rose at an annual rate of 15.5% on the previous year, reaching €516.5 million.⁴ All sub-components within this category reported gains, with the highest increase in absolute terms being registered in the non-package category of tourism expenditure, which rose by 27.4%. The “other” component



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”.

of tourism spending also rose significantly. However, expenditure on package holidays grew by a marginal 2.2%, following four consecutive declines.⁵

As tourist expenditure increased at a slower pace compared with arrivals, expenditure per capita decreased to €806, from €815 in the second quarter of 2016. This decline also reflected a shorter average length of stay, which fell to 6.6 nights in the quarter under review from 6.9 nights in the same period a year earlier.

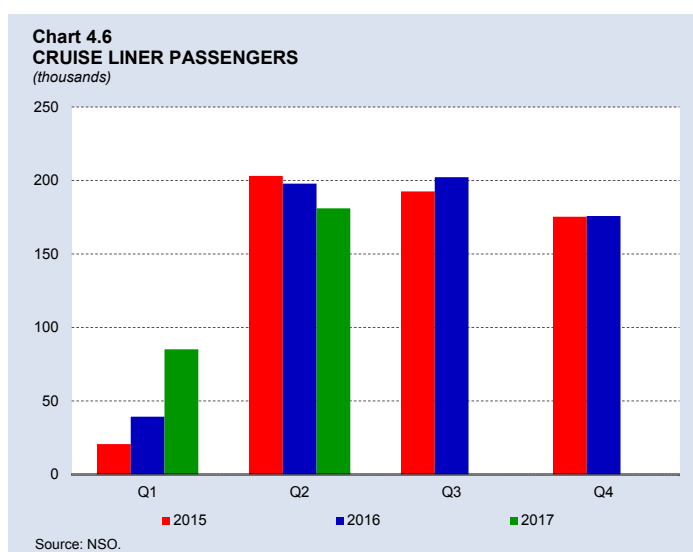
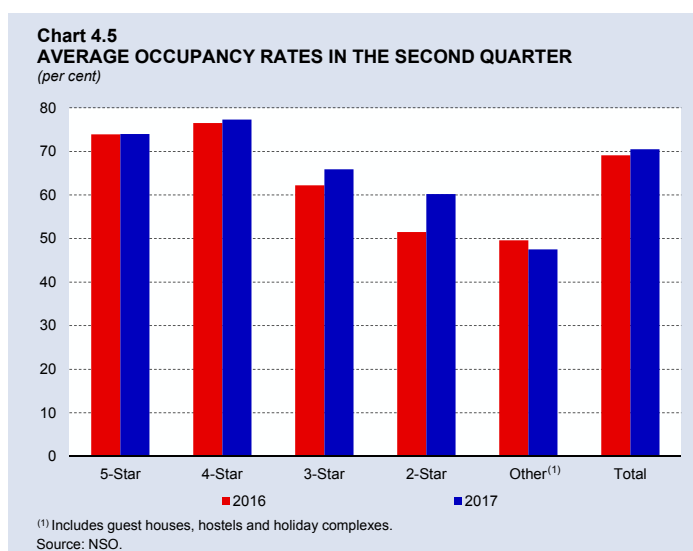
In the second quarter of 2017, the total occupancy rate in collective accommodation establishments rose to 70.5% from 69.1% in the second quarter of 2016 (see Chart 4.5). Higher occupancy rates were registered across all hotel categories, with the highest increases being recorded in the two-star and three-star categories. On the other hand, occupancy in the “other” establishments category declined.

In the second quarter of 2017, the number of cruise liners visiting Malta totalled 115, seven more than a year earlier. Nonetheless, the number of foreign cruise liner passengers was down to 181,050, from 197,842 a year earlier (see Chart 4.6). Thus in the quarter reviewed, cruise liner passengers decreased by 8.5% in annual terms, following a 2.6% decline in the corresponding quarter of 2016.

The capital account

Net inflows on the capital account amounted to €50.9 million during the quarter under review, €16.9 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 moving sum basis, capital inflows in the year to June 2017 totalled €126.0 million, up by €73.4 million on a year earlier.

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.



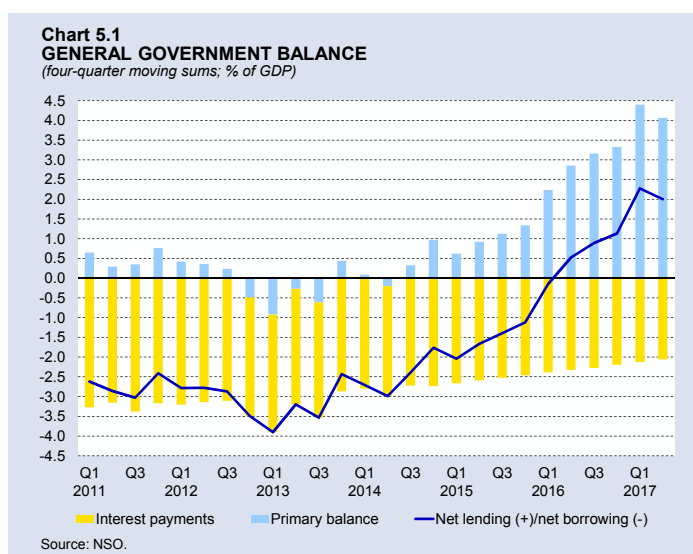
5. GOVERNMENT FINANCE

During the second quarter of 2017, the general government surplus declined when compared with the corresponding period a year earlier. This occurred as government expenditure grew at a faster pace than government revenue. When measured on the basis of a four-quarter moving sum, the general government surplus narrowed to 2.0% of gross domestic product (GDP), from 2.3% in the first quarter of 2017. Meanwhile, general government debt, as a share of GDP, decreased from 58.1% at the end of March 2017, to 56.8% at the end of June 2017.

General government

General government balance remains in surplus

During the second quarter of 2017, the general government maintained a positive balance. When measured as a four-quarter moving sum, the surplus was equivalent to 2.0% of GDP, a reduction of 0.3 percentage point over the surplus recorded in the first quarter of the year (see Chart 5.1). This occurred mainly as a result of a decline in the primary surplus, which excludes interest payments from government expenditure. As a share of GDP, the primary surplus declined by 0.3 percentage point over the previous quarter, to 4.1%. In contrast, interest payments maintained a constant share of 2.1%.



Higher capital expenditure was the main contributor towards the drop in the overall general government balance (see Chart 5.2). In fact, its ratio to GDP, measured as a four quarter moving sum, increased by 0.7 percentage point to 3.5%. An increase in the share of current expenditure in GDP also contributed to the narrowing of the surplus. This upsurge in expenditure cancelled out a 0.6 percentage point rise in the share of current revenue, with the latter reaching 39.6% of GDP.

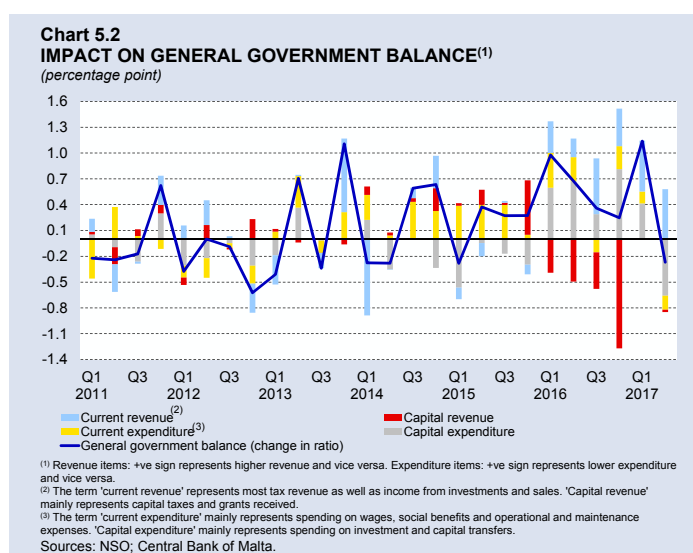


Table 5.1
GENERAL GOVERNMENT BALANCE

EUR millions

	2016			2017		Change 2017Q2-2016Q2	
	Q2	Q3	Q4	Q1	Q2	Amount	%
Revenue	916.3	970.2	1,163.0	977.4	1,056.4	140.2	15.3
Taxes on production and imports	281.4	318.2	376.7	332.3	295.2	13.8	4.9
Current taxes on income and wealth	382.2	324.7	409.9	300.3	404.2	22.0	5.8
Social contributions	155.1	152.5	178.8	165.3	168.8	13.8	8.9
Capital and current transfers receivable	23.5	19.2	33.1	26.2	16.2	-7.3	-30.9
Other ⁽¹⁾	74.1	155.6	164.4	153.4	171.9	97.8	132.1
Expenditure	888.7	947.2	1,034.2	926.3	1,051.9	163.2	18.4
Compensation of employees	298.1	299.5	292.7	309.8	318.1	20.1	6.7
Intermediate consumption	149.1	148.6	200.4	157.7	202.7	53.6	35.9
Social benefits	272.3	258.1	285.3	277.5	284.6	12.4	4.5
Subsidies	25.6	39.9	32.9	33.6	24.8	-0.8	-3.0
Interest	54.8	56.0	54.1	50.3	52.3	-2.6	-4.7
Other current transfers payable	41.0	58.4	68.2	36.7	47.6	6.6	16.0
Gross fixed capital formation	39.2	60.6	88.0	53.3	66.3	27.1	69.0
Capital transfers payable	8.3	27.1	13.4	7.0	57.2	48.9	591.1
Other ⁽²⁾	0.3	-0.8	-0.8	0.3	-1.7	-2.0	-
Primary balance	82.4	79.0	182.9	101.5	56.8	-25.6	-
General government balance	27.5	23.0	128.7	51.2	4.5	-23.0	-

⁽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.

In level terms, the general government balance registered a surplus of €4.5 million, a reduction of €23.0 million when compared with the surplus registered in the second quarter of 2016. This occurred as the government primary expenditure outpaced government revenue. Consequently, the primary surplus narrowed from €82.4 million to €56.8 million (see Table 5.1).

Revenues' rise driven mainly by non-tax revenues

Government revenue rose by €140.2 million, or 15.3%, when compared with the second quarter of 2016, reaching €1,056.4 million. This increase was chiefly driven by the "other" component of revenue, which more than doubled in annual terms. In fact, the share of this revenue component increased by 8.2 percentage points, to 16.3% (see Chart 5.2). The resulting increase in this component overshadowed growth in income from taxation, which continued to benefit from favourable economic conditions. Consequently, the shares of current taxes on income and wealth, taxes on production and imports and social contributions in total revenue declined in the period under review. Meanwhile, capital and current transfers receivable also declined in annual terms. Consequently, their share of total revenue lost a full percentage point (see Table 5.2).

Table 5.2
COMPOSITION OF GOVERNMENT FINANCE ITEMS

Percentage points

	2016 Q2	2017 Q2	Change
Share in total revenue			
Taxes on production and imports	30.7	27.9	-2.8
Current taxes on income and wealth	41.7	38.3	-3.4
Social contributions	16.9	16.0	-0.9
Capital and current transfers receivable	2.6	1.5	-1.0
Other ⁽¹⁾	8.1	16.3	8.2
Share in total expenditure			
Compensation of employees	33.5	30.2	-3.3
Intermediate consumption	16.8	19.3	2.5
Social benefits	30.6	27.1	-3.6
Subsidies	2.9	2.4	-0.5
Interest	6.2	5.0	-1.2
Other current transfers payable	4.6	4.5	-0.1
Gross fixed capital formation	4.4	6.3	1.9
Capital transfers payable	0.9	5.4	4.5
Other ⁽²⁾	0.0	-0.2	-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.

In level terms, taxes on production and imports maintained their upward trend as they grew by €13.8 million on a year earlier, equivalent to 4.9%. This occurred mainly due to higher value added tax receipts, in line with the buoyant consumption levels recorded for the period. Higher taxes from motor vehicle registration and customs and excise duties also contributed positively. Current taxes on income and wealth increased by €22.0 million, or 5.8%. Favourable labour market conditions also contributed to higher intakes from social contributions, which rose by €12.5 million. Capital and current transfers receivable was the only revenue component which experienced a decline in absolute terms, falling by €7.3 million. This was partly due to lower grants received from EU institutions.

The "other" component grew by €97.8 million, or 132.1%, driven mainly by higher receipts from the Individual Investor Programme (IIP).

Recurrent and capital expenditure increases

During the quarter under review, total government expenditure rose by €163.2 million, or 18.4%, on the corresponding period of 2016. Both current and capital spending increased over the same period a year earlier. Overall, however, the share of recurrent expenditure in total expenditure declined, led by lower shares for social benefits and compensation of employees. Respectively, these fell by 3.6 and by 3.3 points. This occurred as the increase in capital expenditure items, namely capital transfers payable and gross fixed capital formation, was much more pronounced

than that of recurrent expenditure. In particular, the share of capital transfers payable increased from 0.9% to 5.4%, while that of gross fixed capital formation increased by 1.9 percentage points.

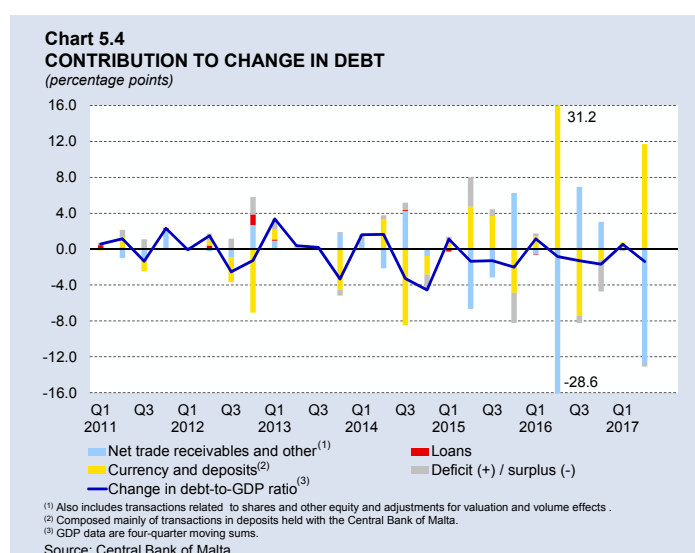
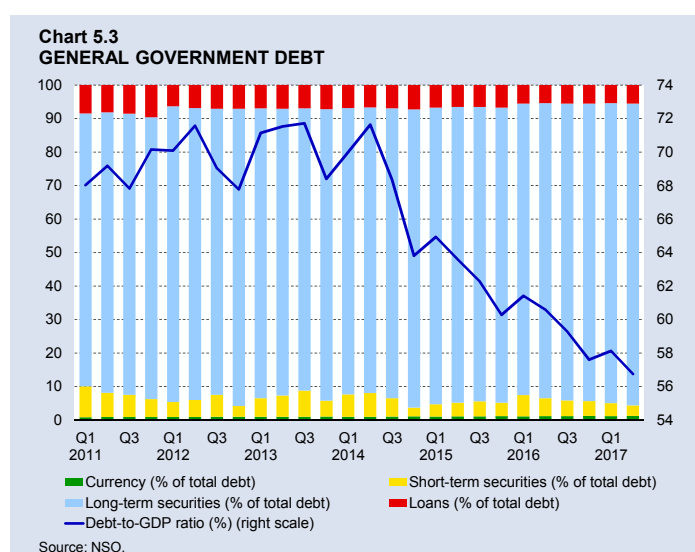
During the period under review, the largest absolute increase in expenditure was recorded by intermediate consumption, which grew by €53.6 million, or 35.9% in annual terms. This was a result of higher outlays in public administration, education and expenditure related to EU Presidency. Compensation of employees added €20.1 million, or 6.7%. This was driven by higher expenditure within the education as well as health sectors. Social expenditure also increased on the back of higher spending on pensions. Current transfers payable increased by €6.6 million. On the other hand, interest payments and subsidies declined.

Capital expenditure increased considerably during the second quarter of 2017 when compared with the second quarter of 2016. In fact in level terms, capital transfers payable experienced the second largest increase in government expenditure, of €48.9 million or 591.1%. This was partly due to expenditure related to the Depositor Compensation Scheme as well as an increase in investment incentives. Gross fixed capital formation rose by €27.1 million as spending on construction and transport equipment increased. The former increased due to higher investment in road infrastructure, including the upgrade of the Kappara road junction, while the rise in transport equipment was mainly related to the purchase of an AFM aircraft.

General government debt ratio falls mainly due to a negative deficit-debt adjustment

In June, the stock of general government debt amounted to €5,868.8 million, a decrease of €21.7 million when compared with March 2017. This led to a drop of 1.4 percentage points in the debt-to-GDP ratio, to 56.8% (see Chart 5.3).

The decrease in the debt ratio was more pronounced than the general government surplus (see Chart 5.4). This resulted



on the back of a negative deficit-debt adjustment, as an increase in currency and deposits held by the government were offset by lower net receivables.

During the second quarter of 2017, the share of long-term securities (mainly composed of Malta Government Stocks (MGS)) in total debt maintained its upward trend, highlighting the Government's strategy to extend the maturity profile of existing debt given the prevailing low interest environment. As a result, the share of long-term securities within total debt increased by 0.4 percentage point, to reach 90%. On the other hand, the share of short-term securities (composed of Treasury Bills) fell by 0.6 percentage point, to reach 3.2%. Meanwhile, the share of government liabilities in the form of currency, as well as loans edged up slightly, to 1.3% and 5.6% of total debt, respectively.

BOX 1: CORRELATION BETWEEN MALTESE AND EURO AREA SOVEREIGN BOND YIELDS¹

This Box summarises a study on government bond yields in Malta and their correlation with other euro area sovereign bond yields.² Yields on long-term sovereign bonds are a fundamental metric in financial markets, as they act as benchmarks in the pricing of long-term financial assets as well as in financial decision making. The relationship between long-term bond yields in Malta and in its euro area partners is important for monetary policy analysis, macro-prudential policymaking, financial stability considerations and public debt management.

The relationships between different European economies have been analysed frequently over the past decades. These studies have expanded to the inter-linkages among various European financial markets to investigate the nature of European economic integration. However, many of these studies tend to focus on economic convergence or stock exchange market movements, rather than bond market relationships. More recently, studies on sovereign bond yields have emerged but these tend to focus on larger economies, such as the United States, Japan and Germany.

The literature suggests that sovereign bond yields are determined by various factors, such as risk aversion (time-factor) and liquidity (country specific factor). Other important economic factors linked with underlying economic fundamentals include GDP growth rates, unemployment rates, inflation rates, debt-to-GDP ratios, public deficits and short-term interest rates.

¹ Prepared by Reuben Ellul. The author is a Senior Economist within the Economics and Research Department at the Central Bank of Malta. The author would like to thank Dr Aaron G. Grech and Mr Andre Psaila for their comments and suggestions to an earlier draft of this study, as well as Mr Alexander Demarco, Mr Alfred Mifsud, Mr Brian Micallef and Mr Ian Borg for their helpful comments. The views expressed 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 A more detailed discussion on the topic is available in Ellul, R. (2017), "Correlation between Maltese and euro area sovereign bond yields", Working Paper 03/2017, Central Bank of Malta. The author of this study had no access to the official methodology used by the Central Bank of Malta in its market making role and relied solely on observations available in the public domain. Moreover, the econometric modelling detailed in the paper is carried out for investigative purposes and does not purport to be the official method with which the Bank carries out its market making activity.

General government debt in Malta stood at just over €5.7 billion euro as at end-2016. While the total outstanding debt of the Maltese government is comparable with the volume of a single debt issuance by a larger country, its efficient management is somewhat challenging. This is because there are no private market agents willing to act as a market maker for MGSs and consequently, the Central Bank of Malta has taken up this role and acts as a market maker for these securities since its foundation in 1968.

The market for MGSs reflects the characteristics of the Maltese economy. Factors such as the composition of the investor base, the relative small size of the market – particularly when compared with foreign public debt markets – may affect important bond market metrics, such as liquidity premia.

Simple, rolling correlations between Maltese and euro area sovereign bond yields suggest that MGS yields appear to move in line with euro area yields, returning strong correlations (see Table 1).

More complex dynamic conditional correlations (DCC) allow for a better understanding of the correlation between MGS yields and those of other euro area sovereign bond yields. These techniques are important for the analysis of interdependencies and contagion effects. As expected, this approach also points to correlation between MGS yields and those of other euro countries, with average pairwise-DCCs ranging from 0.2 with Greece to 0.4 with Italy.³ These correlation coefficients also suggest that MGS yields have been relatively insulated from negative shocks affecting southern Mediterranean countries in

Table 1
SIMPLE ROLLING CORRELATIONS COMPUTED FOR SPREADS OVER THE GERMAN TEN-YEAR BOND BENCHMARK

	AT	BE	ES	FI	FR	GR	IR	IT	MT	NL	PT
AT	1.00										
BE	0.89	1.00									
ES	0.69	0.83	1.00								
FI	0.88	0.73	0.52	1.00							
FR	0.85	0.91	0.89	0.70	1.00						
GR	0.70	0.84	0.87	0.48	0.87	1.00					
IR	0.70	0.85	0.86	0.54	0.76	0.78	1.00				
IT	0.76	0.88	0.97	0.58	0.95	0.91	0.82	1.00			
MT	0.68	0.78	0.85	0.49	0.78	0.75	0.82	0.84	1.00		
NL	0.89	0.76	0.65	0.91	0.78	0.54	0.59	0.69	0.62	1.00	
PT	0.73	0.90	0.91	0.54	0.90	0.94	0.87	0.94	0.80	0.61	1.00

Source: Author's calculations.

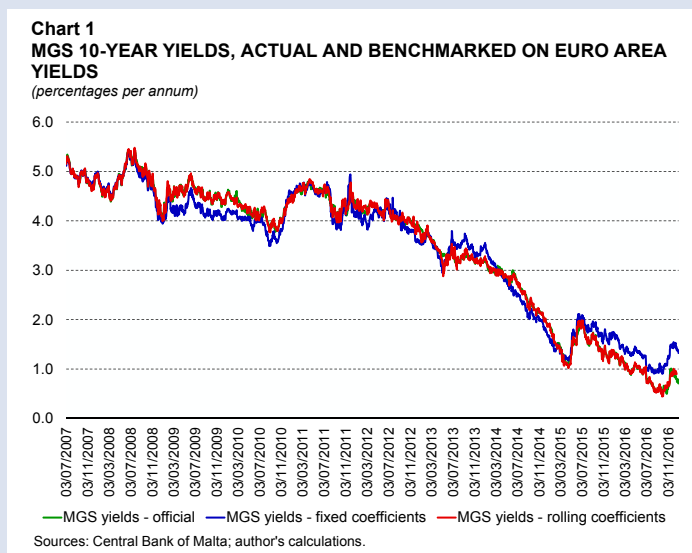
³ Average pairwise-DCCs betray significant correlations in certain periods. Peaks in raw DCCs stood as high as almost 0.7 in some cases. Furthermore, such correlations on sovereign bonds were found to be much higher when compared with a separate study that focused on average DCCs of Malta's stock market with five other major stock exchanges. Further details on the latter study are available in: Ellul, R. (2015), "Analysis correlation between the MSE index and global stock markets", Xjenza Online, *Journal of the Malta Chamber of Scientists* (3), 174-182.

recent years, with swings to negative correlations around episodes of financial turmoil in these countries.

Ten-year MGSs in Malta can be modelled following two assumptions. On the one hand, yields can be seen to result from underlying economic fundamentals in the Maltese economy.⁴ Yields may also be thought of as a function of international sovereign bond yields.⁵ The aim of the study is not to uncover the actual methodology used to arrive at indicative MGS prices but to put forward “fitted” MGS yields based on the two methods discussed above and compare the resulting “benchmark” yields with the actual yields.

The benchmark MGS yield based on euro area bond yields tracks closely the official MGS yield series (see Chart 1). The two are almost indistinguishable at first glance, with short-term deviations being rare. This is particularly evident when the benchmark is estimated using rolling-time windows. The fixed coefficients benchmark, which estimates the coefficients over the whole sample, does track the official series – although there are instances where the discrepancy is more pronounced. These can be explained either by volatilities affecting yields in the basket during specific periods, such as 2009 and 2010, or MGS composition effects – as may be the case from mid-2015 onwards.

The benchmark yield based on economic fundamentals also exhibits a similar pattern to the official MGS yield over an extended period. However, it shows more short-term volatility than the official measure, due to fluctuations present in Maltese macroeconomic datasets (see Chart 2). Moreover, actual MGS yields were higher, and MGS prices lower, than what true underlying economic conditions would have indicated during the global financial crisis of 2008 and again during the period of economic recovery in



⁴ Modelled as: $MT_{10YR} = C + \Delta HICP + \Delta GDP + \text{Unemployment Rate} + \text{German Bund} + D2011 + D2012$, where MT_{10YR} is the ten-year MGS yield, $\Delta HICP$ is the annual inflation rate, ΔGDP is the GDP growth rate, and $D2011$ and $D2012$ are annual dummy variables.

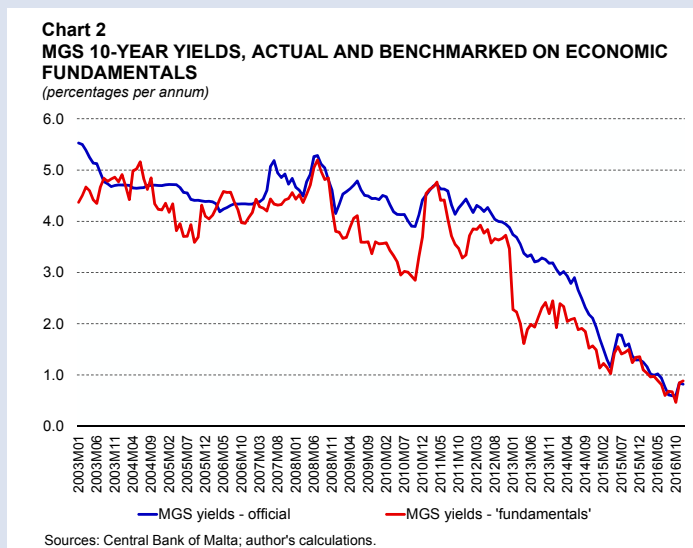
⁵ In this study the author considers yields on bonds issued in the four largest euro area countries. The MGS yield is thus modelled as: $MT_{10YR} = C(1) + C(2) * DE_{10YR}(-1) + C(3) * FR_{10YR}(-1) + C(4) * ES_{10YR}(-1) + (1 - C(2) - C(3) - C(4)) * IT_{10YR}(-1)$, with the ten-year bond yields of Germany, France, Spain and Italy. The same equation was estimated over the full-time period (‘fixed coefficients’) and over a rolling time window. A subsidiary equation specified in daily changes returned significant coefficients for changes in MGS yields on Spanish, Italian and French bond yields. The aim of the equation presented above is not to assess the stationarity conditions of the series, but to check the hypothesis that MGS yields can be summarised as some linear combination of the previous trading day’s euro area yields.

the following years.⁶ The analysis based on economic variables indicates that from mid-2015 onwards, official MGS yields follow closely a benchmark derived from underlying economic fundamentals.

This latter benchmark confirms the indications from the dynamic conditional correlations, which show that MGS yields are broadly insulated from shocks reflecting both

euro area and events specific to other countries, such as bailout requests, political instability or speculation. While some volatility linked with specific international events does exist, swings are markedly less sharp. Additionally, factors linked with the limited size of the MGS market – such as yield basket, liquidity premia and composition effects – may be playing a role in the determination of MGS yields.

While the pricing appears to be consistent with euro area yields over the long-run, if the Maltese economy keeps growing substantially faster than its euro area partners, economic fundamentals might imply that a differential should begin to feature between these yields and those in Malta’s euro area partners.⁷ However, considerations relating to market liquidity and other size constraints mentioned above may prove to be inhibiting factors for these fundamentals to be fully reflected in Malta’s yields and, indirectly, in its sovereign ratings.



⁶ A sensitivity analysis of the results based on different assumptions and modelling strategies may be found in Appendix 2 of Central Bank of Malta Working Paper 03/2017.

⁷ According to a recent study, Malta’s medium-term estimate of potential GDP growth stood at 3.25%, which is significantly higher than growth estimates for the euro area. Further details are available in Micallef, B., & Ellul, R., “Medium term estimates of potential output growth in Malta”, in Grech, A.G., & Zerafa, S. (eds.), *Challenges and Opportunities of Sustainable Economic Growth: the case of Malta*, Central Bank of Malta, 2017.

6. MONETARY AND FINANCIAL DEVELOPMENTS

Monetary dynamics in Malta remained steady during the second quarter of 2017.¹ Residents' deposits with monetary financial institutions (MFI) operating in Malta continued to grow at a solid pace, adding 9.5% in annual terms. The shift to overnight deposits persisted, in an environment of low interest rates and high liquidity. At the same time, growth in credit to residents eased, mainly driven by developments in credit to general government and loans to non-financial corporations (NFC). The spread between MFI interest rates on loans and deposits widened further during the period under review.

Domestically, the primary market yield on Treasury bills rose marginally during the quarter, while secondary market yields on longer-term government bonds fell. In the equity market, domestic share prices fell marginally from their end-March level, though they were higher than a year earlier.

Monetary aggregates and their counterparts

The total assets pertaining to the Maltese banking system dropped by €776.2 million between March and June 2017, to €45.7 billion. This was mainly the result of a drop in the assets of international banks, which offset a further increase in the assets of core domestic banks.²

Maltese residents' overnight deposits continue to expand at a fast pace

Total deposits held by Maltese residents with MFIs in Malta continued to increase during the second quarter of 2017, with the annual rate of change standing at 9.5% in June. This was slightly lower than the growth rate of 9.9% registered three months earlier (see Table 6.1).

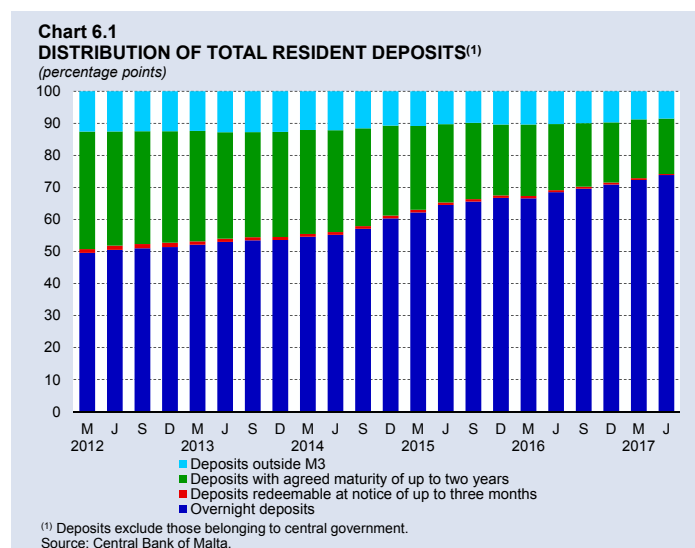
	EUR millions 2017 June	Annual percentage changes				
		2016		2017		
		June	Sep.	Dec.	Mar.	June
Overnight deposits	13,021,282	12.6	13.3	13.4	19.3	18.1
<i>of which</i>						
Households	7,236,000	15.7	15.4	17.0	21.6	20.6
Non-financial corporations	3,114,618	12.0	8.3	8.9	13.4	5.9
Deposits redeemable at notice of up to three months	51,837	-12.2	-16.9	-15.2	-18.0	-49.5
<i>of which</i>						
Households	47,085	-7.4	-17.3	-16.4	-15.9	-46.4
Non-financial corporations	1,725	-45.2	-40.9	-49.2	-35.6	-83.7
Deposits with an agreed maturity of up to two years	3,051,679	-10.5	-11.2	-9.3	-9.7	-8.1
<i>of which</i>						
Households	2,437,030	-11.9	-12.9	-8.7	-6.2	-6.1
Non-financial corporations	244,576	-9.8	-17.8	-20.6	-37.0	-4.9
Deposits with an agreed maturity above two years	1,502,396	5.6	8.0	-0.4	-7.0	-8.7
<i>of which</i>						
Households	1,384,605	7.2	7.3	-2.4	-9.1	-10.8
Non-financial corporations	67,141	-24.4	4.8	18.2	-0.7	15.2
Total residents' deposits⁽¹⁾	17,627,194	6.0	6.7	6.7	9.9	9.5

(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 Since 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, and Mediterranean Bank plc.

Growth in total deposits remained driven by overnight deposits. Annual growth for this category of deposits stood at 18.1% in June, with demand for overnight deposits particularly strong among households. This growth rate is relatively strong from a historical perspective, and indicates an abundance of liquidity in the context of robust economic growth as well as a continued preference for holding liquid assets in an environment of low interest rates.



On the other hand, time deposits continued to contract.

In particular, deposits with an agreed maturity of up to two years contracted by 8.1% in the year to June, while deposits with an agreed maturity of over two years dropped by 8.7% over the same period. Deposits redeemable at notice of up to three months also continued to contract.

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 73.9% in June, from 68.5% 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 17.3%, from 20.6% a year earlier, while the share of deposits with an agreed maturity of over two years edged down to 8.5%, from 10.2% a year earlier. 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 with MFIs in Malta declined further during the second quarter of 2017, with the composite rate offered to households and NFCs going down by 2 basis points to 0.42% when compared with three months earlier (see Table 6.2). This was mainly driven by a drop in rates on deposits with maturity exceeding two years held by households. When compared with a year earlier, the composite deposit rate lost 16 basis points, reflecting the lagged pass-through of the ongoing accommodative monetary policy of the euro area.

Credit to residents expands at a slower pace

Credit to Maltese residents moderated during the second quarter of 2017, with the annual rate of change going to 1.0% in June, from 2.7% three months earlier (see Chart 6.2). Both credit to government and credit to other residents decelerated.

Annual growth in credit to general government dropped to 0.3% in June, from 3.6% in March. 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.

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	
	June	June	June	Sep.	Dec.	Mar.	June
Total deposits⁽¹⁾	1.30	0.85	0.58	0.52	0.48	0.45	0.42
<i>of which</i>							
Overnight deposits							
Households	0.27	0.15	0.11	0.07	0.06	0.06	0.07
Non-financial corporations	0.24	0.12	0.08	0.08	0.03	0.03	0.02
Time deposits (less than 2 years)							
Households	1.96	1.40	0.88	0.79	0.79	0.79	0.79
Non-financial corporations	1.82	1.22	0.75	0.71	0.65	0.61	0.60
Time deposits (more than 2 years)							
Households	3.54	3.30	2.85	2.76	2.64	2.54	2.45
Non-financial corporations	2.88	2.60	1.97	2.06	2.03	1.89	1.89
Total Loans⁽¹⁾	4.15	3.90	3.75	3.69	3.68	3.64	3.66
<i>of which</i>							
Households and NPISH	3.80	3.64	3.57	3.53	3.52	3.49	3.52
Non-financial corporations	4.60	4.25	4.02	3.92	3.93	3.87	3.87
Spread⁽²⁾	2.86	3.05	3.17	3.17	3.20	3.19	3.24
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 (including NPISH) and non-financial corporations.

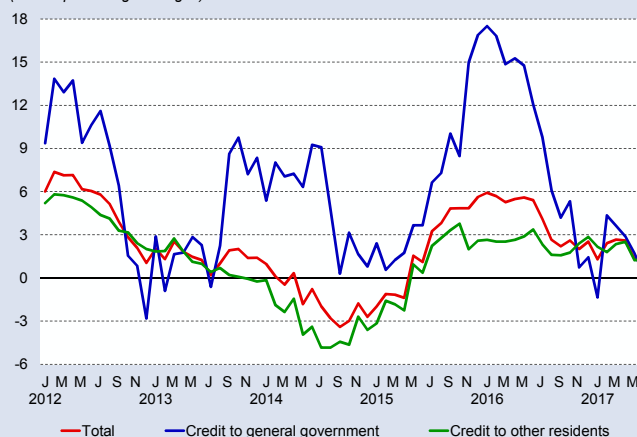
⁽²⁾ Difference between composite lending rate and composite deposit rate.

Source: Central Bank of Malta.

Similarly, credit to residents other than general government grew at a slower pace compared with March, with the annual rate of change going from 2.4% to 1.3%. This deceleration was driven by loans, the largest component, whose annual growth rate decreased from 3.0% in March to 1.7% in June.

The slowdown in loans was mainly caused by a faster contraction in loans to NFCs, which dropped by an annual 4.4% in June. A sectoral breakdown suggests that this steeper decline was driven by a faster contraction in loans to the accommodation and food services sector (see Table 6.3). The recent weakness in loans to NFCs contrasts with the current pace of economic activity, and could reflect increased use of internal funding and capital markets by companies, a shift away from capital-intensive industries, and an overall shift in banks' loan portfolios towards households and away from NFCs (see Box 3).

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



Source: Central Bank of Malta.

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

	Total NFCs				
	June	2016 Sep.	Dec.	2017 Mar.	June
Accommodation and food services activities	1.4	-0.7	-1.6	-0.5	-2.2
Construction	-2.0	-2.5	-0.8	-1.9	-2.2
Manufacturing	-0.4	-0.3	-0.4	0.5	0.6
Real estate activities	1.0	1.4	1.3	2.3	1.8
Transportation and storage	-0.1	-0.6	-1.3	-1.0	-0.7
Wholesale and retail trade	-0.1	-0.4	-0.9	-0.2	-0.1
Other	0.2	1.3	-0.9	-1.8	-1.6
Total	0.0	-1.8	-4.5	-2.6	-4.4

Source: Central Bank of Malta.

Indeed, annual growth in loans to households remained robust in June, although it decelerated to 6.0% from 6.4% three months earlier (see Chart 6.3). Lending to households continued to be supported by robust growth in mortgage loans, which grew by 8.3% in the year to June. In contrast, consumer credit and other lending contracted by 8.8%.

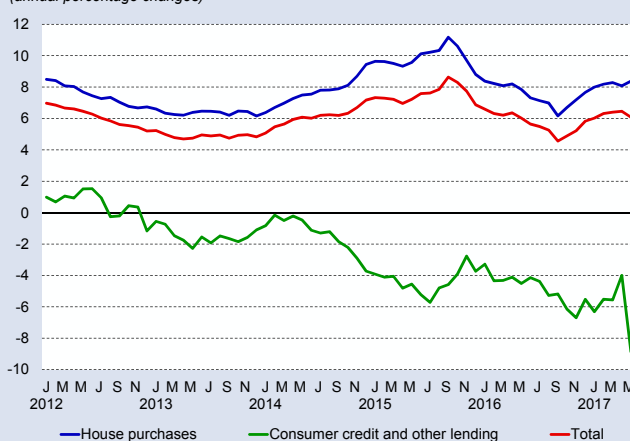
Interest rates on loans edge up

Interest rates on loans to Maltese residents increased marginally during the quarter under review, with the composite rate paid by households and NFCs edging up by 2 basis points, to 3.66% (see Table 6.2). When compared with a year earlier, loan rates were still down by 9 basis points. Loan rates charged on NFC loans remain above those charged to households, possibly reflecting different assessments of credit risk.

The spread between the composite lending rate and the deposit rate stood at 324 basis points at the end of the second quarter. When compared with a year earlier, this signifies a widening of the spread by 7 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 conditions in the second quarter

The majority of banks participating in the Bank Lending Survey (BLS) that was conducted in June 2017 reported unchanged credit standards, terms and conditions for NFCs, house purchases and

Chart 6.3
LOANS TO HOUSEHOLDS
(annual percentage changes)

Source: Central Bank of Malta.

consumer credit during the second quarter of 2017. Only one bank has reported some easing in credit standards for enterprises.

As regards the third quarter, the majority of banks generally did not expect changes in these standards, terms and conditions, with the exception of one bank which foresaw an easing of standards for NFCs and house purchases.

The banks' assessment of demand for credit to NFCs was mixed. Whereas half of the participating banks reported an increase in demand for credit by NFCs in the second quarter, the remaining half reported unchanged demand. Expectations for the third quarter were also mixed.

Respondents' assessment of demand for credit for house purchases was also varied in the second quarter. As regards the third quarter, only one bank expected increased demand for house loans, while the majority of banks foresaw no change in demand. Meanwhile, participating banks reported a stable demand for consumer credit and are expecting no changes to take place during the third quarter.

In reply to a series of ad hoc questions, the majority of banks participating in the June BLS report-ed no changes in market access to 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. The majority of banks expected their market access to wholesale and retail funding to remain unchanged in the third quarter, although one bank foresaw some easing of the long-term instruments on retail funding.

Banks were also asked to report on the extent to which the new regulatory requirements set out in the Capital Requirements Regulation/Capital Requirements Directive IV have impacted their lending policies. The majority of banks reported an unchanged position in their total assets, capital and funding conditions in connection with the new regulatory or supervisory actions. Only one bank reported a moderate increase in assets and capital. Looking forward to the six months ahead, another bank expected some increase in capital. Otherwise, assets, capital and funding conditions, were generally expected to remain unchanged by the remaining banks.

Participating banks were also asked about the impact of the targeted longer-term refinancing operations (TLTRO) conducted by the Eurosystem between September 2014 and June 2016 as well as the TLTRO-II operations conducted between June 2016 and March 2017. Only one bank participated in the most recent TLTRO-II due to its attractive conditions. The participating bank claimed that the operation contributed considerably in the granting of loans and helped it improve its liquidity, profitability and capital position. Furthermore, participation eased credit standards, terms and conditions for loans to enterprises. Meanwhile, the remaining banks on balance felt that they enjoyed a comfortable liquidity position and felt no need to participate, although one bank believed that future participation could support loans to NFCs.

BOX 2: THE RELATIONSHIP BETWEEN CREDIT AND ECONOMIC ACTIVITY¹

Economic development is usually significantly influenced by credit activity and the ability of firms to access finance. During the past decade, the financial crisis has highlighted the need to understand and monitor macro-financial linkages. Following the role that the banking sector had in propagating the initial shock to macroeconomic activity, in several countries, the provision of funding to the non-financial private sector was impaired by the need of banks to strengthen their capital and liquidity. The aim of this Box is to assess the relationship between credit to NFCs and the growth of the Maltese economy, in the light of the weakness in credit that has prevailed in recent years, which coincided with fast rates of gross domestic product (GDP) growth.

Developments in the level of credit to NFCs

The reliance of the non-financial business economy on small- and medium-sized enterprises (SME) in Malta is higher than in any other European Union Member State, with estimates for 2016 showing that around 99.8% of firms fall under this classification.² Although the information opacity and credit riskiness of SMEs increases their dependence on bank financing, the Survey on Access to Finance of Enterprises (SAFE) indicates that in the aftermath of the financial and economic crises, competition and skilled labour shortages were of a greater concern to SMEs in Malta than access to finance. Domestically, only around 8% of SMEs considered access to finance as their most pressing problem in 2009, as opposed to 17% of SMEs across EU Member States.

In fact, the Maltese banking sector emerged relatively unscathed from both the economic and financial crisis of 2009 and the European sovereign debt crisis of 2012. The sector remained sufficiently liquid and well-capitalised, and therefore it did not need to resort to credit rationing. This has been corroborated by banks' responses to the BLS, which shows that despite increased risk aversion to lending to certain sectors, such as construction, restrictions were generally in the form of tighter collateral requirements, loan covenants and non-interest charges, rather than quantity restrictions.

The level of credit to NFCs however, remained muted, especially when compared with that observed in the pre-crisis period. Likewise, the euro area experienced periods of declining credit. However, whereas in the euro area this reflected periods of subdued economic growth, domestically the decline in credit to NFCs occurred in a period of robust economic growth and historically low levels of unemployment. Chart 1 shows how growth in loans typically lagged economic growth, but significant discrepancies are visible in the annual growth of these variables in recent years. Since 2012, credit growth has been considerably weaker, even though the Maltese economy was relatively unaffected by the economic downturn

¹ Prepared by Sandra Zerafa. The author is the Coordinator of economic publications at the Economic Analysis Office. 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 Zerafa, S. (2017), "Access to finance for firms in Malta: Estimating the impact of reduced credit", Policy Note March 2017, Central Bank of Malta.

² Source: European Commission (2016), 2016 SBA Fact Sheet – Malta. Estimates indicate that these generated around 80% of value added of the non-financial business economy and 81% of employed persons.

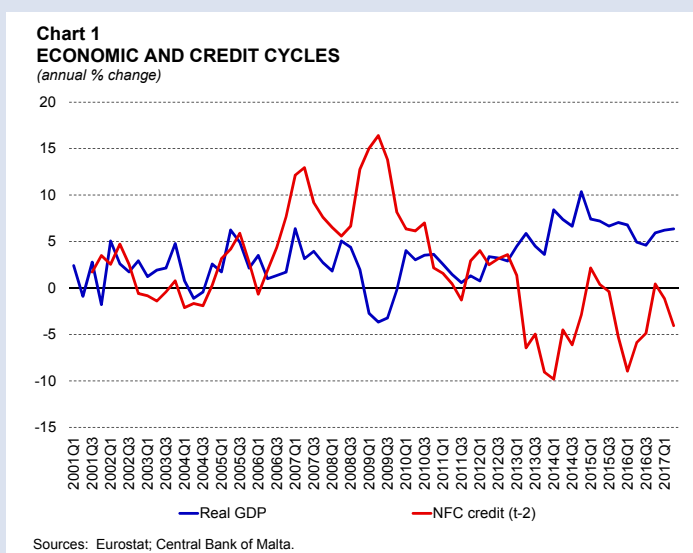
that hit the rest of the euro area. Until 2006 the cycle of credit to NFCs was largely in line with the economic cycle, but since then, contractions and expansions in the flow of credit were significantly more pronounced.

At around €3.4 billion in the third quarter of 2016, the stock of credit by banks to NFCs was still at the level prevailing in the first quarter of 2008.

However, when measured as a ratio to GDP, it declined to historical lows unseen since the mid-1990s. In annual terms, the growth rate of loans to NFCs fell from around 16% at the end of 2008 to -6.4% at the end of 2012. Thereafter, lending remained weak and contracted further on a year-on-year basis, ending August 2017 1.7% lower than a year earlier.

In order to quantify the level of credit that would have prevailed if the trend observed between 1995 and 2011 persisted, two approaches were used. In the first approach, a simple statistical approach was applied by fitting a linear time trend to NFC credit over the period 1995 and 2011.³ The extrapolation of this trend over the period 2012 and 2016 showed that the line of best fit no longer approximates the lower level of credit that has prevailed since 2012. In fact, as at 2016Q3, nominal credit to NFCs was 27% less than the hypothetical estimation based on past trends, which would have amounted to €1.3 billion more credit to NFCs.

Given that this approach excludes other macroeconomic variables that affect NFC credit, the results were cross-checked with those derived from an econometric estimation that includes nominal GDP and non-performing loans (NPL) as explanatory variables. The regression was estimated for the period 1995 and 2011.^{4,5} Results indicate that in the short-run, a 1% increase in nominal GDP leads to an increase in NFC credit of 0.18%, whereas in the long-run, NFC credit increases by 0.34%. With regards to NPLs, a 1% increase in NPLs reduces credit by 0.05% in the short-run and by 0.1% in the long-run, everything else remaining constant. An estimation of credit to NFCs for the period 2012Q1 and 2016Q3



³ This is an update of the measures used in: Micallef, B. (2015), "Estimating a credit gap for non-financial corporations in Malta", Working Paper WP/04/2015, Central Bank of Malta.

⁴ A priori, economic activity is expected to have a positive impact on bank credit while an increase in NPLs is expected to have the opposite effect.

⁵ Micallef (2015) tested the impact that the interest rate on NFC loans, and house prices, which reflect the impact of asset prices on a firm's net worth, can have on NFC credit. These were not statistically significant and an autoregressive term was included to capture the impact of other variables not included in the model.

based on the regression shows that the credit difference is in line with that obtained using the statistical approach, and has widened by almost 33% by the third quarter of 2016, amounting to around €1.7 billion less in credit to NFCs.

The weaker relationship between NFC credit and GDP in the more recent period was corroborated by estimating the same regression over an extended time frame until 2016. As expected, the coefficient of GDP was statistically significant only when data up to 2011 was included. Regressed over an extended period, GDP is no longer statistically significant and fails to explain variations in credit to NFCs.

The impact of reduced credit on the Maltese economy

Given the large number of SMEs in Malta and their high generation of value added and employment, a reduction in bank lending can have potentially significant negative consequences on real economic activity. In order to measure the impact of reduced credit on the Maltese economy, a simulation of the macroeconomic effects of a credit shock was conducted using the Bank's model STREAM.⁶ The simulation quantified the impact of a positive credit shock equivalent to the difference between actual NFC credit and the level estimated on the basis of the econometric approach.

Table 1 shows that if the level of credit to NFCs between 2012 and 2016 had remained in line with trends observed pre-2011, the largest impact would have been on gross fixed capital formation (GFCF). Simulation results show a slightly negative impact on GFCF in 2012, due to observed credit being above the estimated trend in the previous years. From then onwards, if the level of NFC credit had reflected past trends, investment levels would have been significantly higher.

Table 1
THE MACROECONOMIC IMPACT OF A POSITIVE SHOCK IN CREDIT TO NFCs

Percentage deviation from baseline

	2012	2013	2014	2015	2016
Economic activity					
Real GDP	-0.01	0.05	0.36	0.61	0.94
Private Consumption	0.00	0.03	0.19	0.49	0.70
Government Consumption	0.00	0.01	0.23	0.52	0.90
Gross Fixed Capital Formation	-0.40	5.63	11.28	13.64	18.62
Exports	0.00	0.00	0.00	0.01	0.07
Imports	-0.06	0.75	1.44	1.95	2.79
Labour market					
Unemployment rate	0.00	0.00	-0.01	-0.04	-0.05

Source: Calculations based on STREAM.

⁶ The Bank's macro-econometric model is a traditional structural model with full-fledged fiscal and financial blocks. The latter block models the demand and supply aspects of credit institutions in Malta and allows the model to generate a financial accelerator mechanism through the co-movement of credit and asset prices as well as credit constraints that emanate from the financial health of Maltese institutions. The model distinguishes between consumer and other credit, housing credit and credit to NFCs. Real credit to NFCs is influenced by real GDP in the short run and real non-dwelling private investment in the long run. For more information see Grech, O., & Rapa, N. (2016), "STREAM: A structural macro-econometric model of the Maltese economy", Working Paper WP/01/2016, Central Bank of Malta.

A higher credit level would have also raised government consumption. Private consumption would also have been higher, although the impact on this variable is smaller. Exports would have remained broadly unchanged. Although the rise in domestic demand would have been offset to some degree by a rise in imports, the net impact on GDP would have been positive.

When it comes to the labour market, the overall effect on employment is insignificant, as the shock would have had the effect of raising labour hours in response to higher investment. The increase in hours worked would in turn have led to higher disposable income and private consumption.

Overall, simulation results indicate that in 2013 a higher level of credit to NFCs would have increased real GDP by 0.1% more than its baseline. By 2016, a level of credit to NFCs that would have been in line with that observed prior to 2011 would have boosted real output by 0.9%.

Although this simulation suggests that higher NFC credit would have had a positive impact on the Maltese economy, its short-term effect on real output would have been limited in the context of the very rapid growth that characterised this period. In fact, the economy grew by 8.2% and 7.1% in 2014 and 2015 in real terms respectively.

Structural changes in the Maltese economy may help explain these developments in credit to NFCs. Improvements in Malta's potential output since 2004 were driven by rapid increases in labour participation, but relatively low increases in capital stock. This reflected the economy's higher orientation towards services, in particular higher value added activities generated by the financial services sector, specialised forms of tourism, professional services, back-office administration, information technology and gaming.

These sectors appear to be less capital intensive than other sectors in the Maltese economy, and in a period of rapid growth have also tended to rely more on internal sources of finance. For instance, whereas the share of the gross value added of the arts, entertainment & recreation sector, which includes remote gaming, rose from 7.6% of total gross value added in 2007 to 13.5% in 2016, its share in the economy's overall fixed capital formation remained broadly stable over the same period. Furthermore, in recent years there has been evidence of a process of financial disintermediation in Malta, with an increase in corporate bond issuance and greater reliance on intra-company loans.⁷

Conclusion

The relationship between bank credit to NFCs and GDP growth in Malta has weakened considerably in recent years, such that an increase in the level of credit can now be expected to have a smaller impact on activity than it did in the pre-crisis period. Indeed, in recent years, low or negative credit growth to NFCs has coincided with very fast GDP growth.

This may reflect the changing structure of the Maltese economy, particularly the shift towards industries with low capital intensity as well as increased recourse to alternative

⁷ See Darmanin, J. (2017), "The financing of companies in Malta", Policy Note July 2017, Central Bank of Malta.

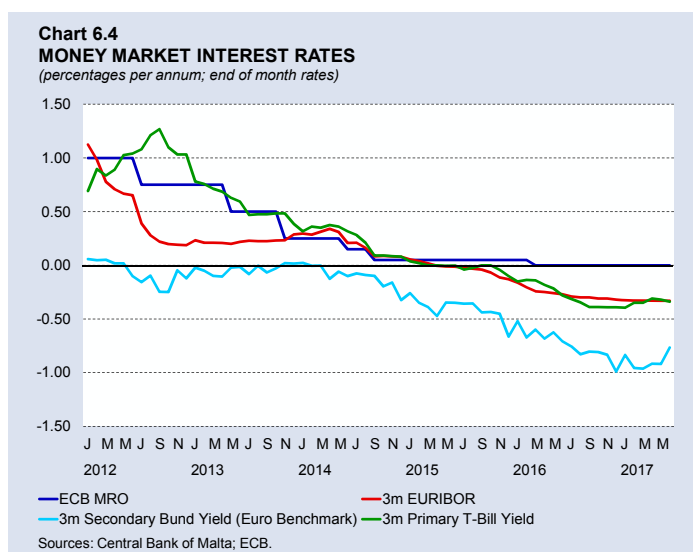
sources of finance. However, tightening conditions on the part of banks may also have played a role in leading to these changes.

Although the results of model simulations presented here suggest that the impact of lower credit availability on economic activity was somewhat limited, access to finance for firms remains a pre-requisite for investment and growth. In coming years, credit availability could remain constrained in view of new capital, liquidity and leverage rules. In this light compensating measures such as the increased use of the central credit registry, easier access to finance via the domestic capital markets and use of EU funds, together with the setting up of the Malta Development Bank are in order to facilitate the financing of SMEs.

The money market

Domestic money market interest rates remained unchanged

The ECB maintained its key interest rates unchanged during the second quarter of 2017, with the rate on its main refinancing operations held at 0.00%. In euro area money markets, the three-month EURIBOR stood at -0.33%, unchanged from the rate that prevailed at the end of March. The domestic primary market yield, as measured by the yield on three-month Treasury bills rose marginally to -0.34% at the end of June 2017, from -0.35% at the end of March.



During the second quarter of 2017, the secondary market yield on three-month German government securities, which acts as a benchmark for euro area yields, rose by 20 basis points to -0.77% from -0.96% at the end of March (see Chart 6.4). Consequently, the spread between the domestic rate and the euro area benchmark narrowed to 43 basis points, from 61 basis points in March.

The Government issued €112.4 million in Treasury bills during the second quarter of 2017. This is a reduction of €29.8 million from €142.2 million of Treasury bills issued between January and March.

The capital market

During the second quarter of 2017 the Government did not issue new MGSs. Over the same period however, SD Finance plc and Eden Finance plc issued €65 million and €40 million in unsecured bonds, respectively.

In the secondary market, turnover in government bonds rose to €93.0 million during the second quarter of 2017, from €87.1 in the previous quarter. Corporate bond turnover fell from €21.6 million to €19.5 million over the same period.

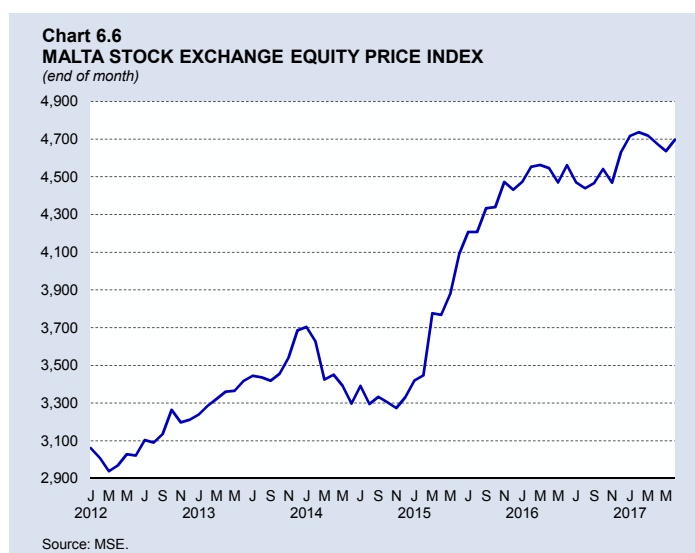
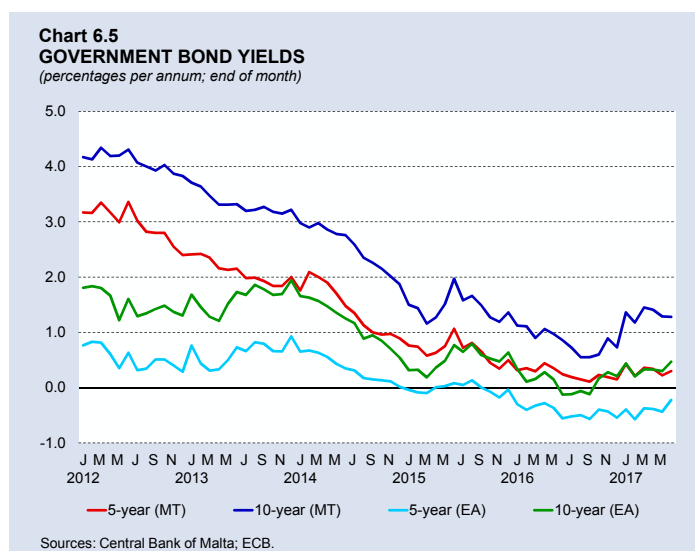
Secondary market yields on Maltese government bonds fell during the second quarter of 2017 (see Chart 6.5). The yield on five-year bonds declined by 6 basis points since the end of March, to close June at 0.30%. Meanwhile, the yield on ten-year bonds fell by 17 basis

points to 1.28%.³ In contrast, in the euro area, the comparable five-year yield rose by 15 basis points to -0.22% at end-June, while the ten-year yield rose by 14 basis points to 0.47%. Thus, the spread against the ten-year euro-area benchmark yield narrowed from 112 basis points in the first quarter of this year, to 81 basis points in the quarter under review.

MSE share index fell slightly during the second quarter of 2017

The Malta Stock Exchange (MSE) Equity Price index, which is a measure of share prices in Malta, shows that these fell in April and May, before rising in June. Nonetheless, the index ended June at 0.4%, marginally lower than its end-March level, though 3.0% higher than the level recorded a year earlier (see Chart 6.6). At the same time, the MSE Equity Total Return Index, which accounts for changes in both equity prices and dividends, was largely unchanged from its end-March level.

During the second quarter of 2017, equity turnover fell to €13.5 million from €19.5 million in the first quarter of 2017.



³ 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.

BOX 3: THE FINANCING OF COMPANIES IN MALTA¹

This Box summarises a study on the financing of NFCs in Malta and the causes behind the observed decline in bank lending to companies.²

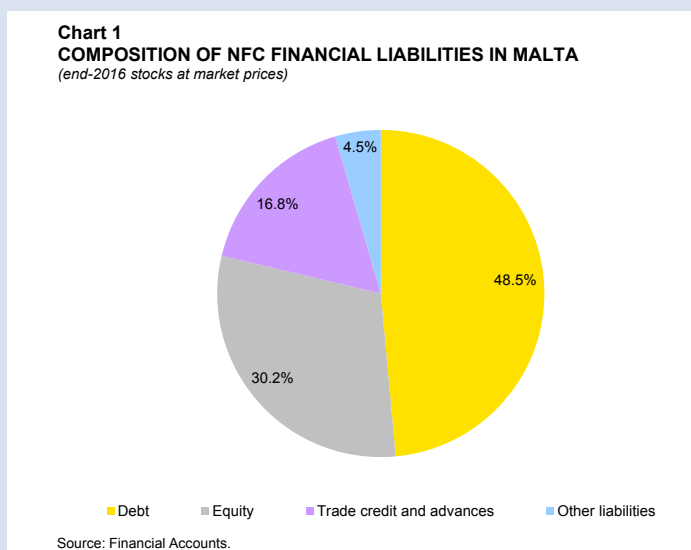
The financial crisis of 2009 had a detrimental impact on financing conditions in the euro area. From a peak of 14.9% in the first quarter of 2008, annual growth in bank lending to NFCs averaged just 0.2% between 2009 and 2010. Following a brief recovery, lending contracted by an average of 1.7% between 2012 and 2015 as a result of a more pessimistic economic outlook due to the European sovereign debt crises. This trend has only started being reversed recently, in 2016. On the other hand, although following a similar pattern between 2008 and 2015, bank lending to NFCs in Malta has as yet failed to recover, contracting by around 2.7% in 2016.

Overview of NFC financing

Chart 1 gives a snapshot of the financial liabilities of NFCs resident in Malta at the end of 2016. With a share of 48.5%, debt is the main source of financing for resident NFCs. Indeed, non-consolidated NFC debt stood at 136.0% of GDP in 2016, though this was lower than the peak of 161.3% registered in 2009. The rest of NFC financial liabilities are mainly composed of equity (mainly private equity) and trade credit and advances. When compared to their peers in the euro area, Maltese NFCs are more reliant on debt (mainly loans) and trade credit, while firms in the bloc are more reliant on equity as their main source of finance.

Domestically, loans make up around 94.9% of NFC debt. Given this high share, it is important from a policy perspective to understand the factors behind the sustained weakness in bank lending to NFCs in Malta.

Chart 2 gives an overview of the stock of loans granted to NFCs, based on Financial Accounts data.³ During the years following EU membership

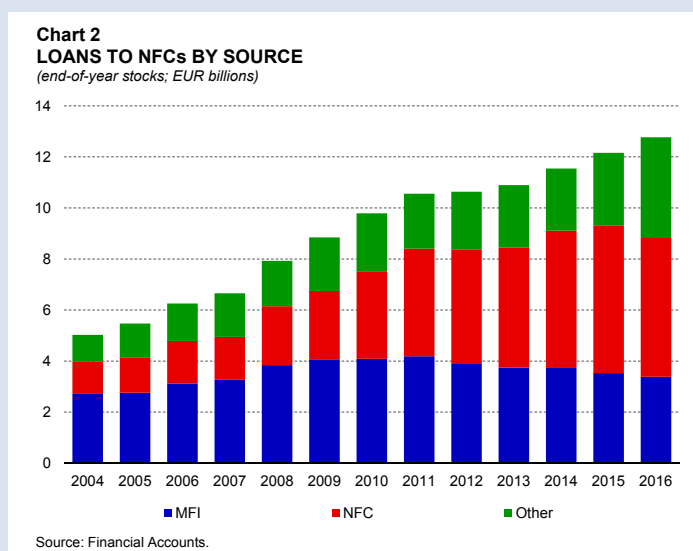


¹ Prepared by Jude Darmanin. The author would like to thank Mr Alexander Demarco, Dr Aaron G. Grech, Ms Rita Schembri, Mr Brian Micallef, and Ms Janica Muscat for their valuable help and comments. The views expressed in this note are those of the author and do not necessarily reflect those of the Central Bank of Malta. Any errors are the author's own.

² Darmanin, J. (2017), "The Financing of Companies in Malta", Policy Note July 2017, Central Bank of Malta.

³ Annual Report 2016, "Sectoral Financial Linkages Using Malta's Financial Accounts", pp. 30-35, Central Bank of Malta.

in 2004, MFIs constituted the main share of NFC loan financing, averaging 49.8% of total NFC loans between 2005 and 2007. However, consistent with the decline in bank lending growth, this share began to drop following the financial crisis in Europe in 2008, reaching 26.5% in 2016. This is consistent with Micallef (2015), who concluded that a credit gap in bank funding to Maltese NFCs emerged in 2012 and widened substantially in 2013 and 2014 to around 15%-18%.⁴

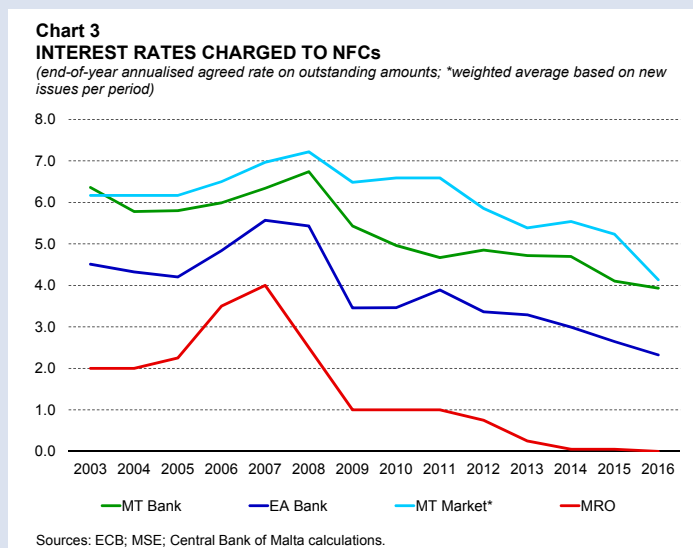


At the same time, the chart points to a sustained increase in the share of intra-sectoral lending between NFCs after the crisis, with the share of NFC-to-NFC loans increasing from 25.0% in 2005 to 42.6% in 2016.⁵ Other loan sources are mainly comprised of loans from the rest of the world, namely foreign bank loans or trans-border NFC-to-NFC lending.

Factors behind financial disintermediation

These developments in the debt financing of NFCs can be attributed to a combination of loan supply restrictions on the part of banks and shifts in the demand needs of companies.

On the supply side, despite their recent downward trend, interest rates on bank lending to NFCs remain high when compared with those prevailing in most euro area countries (see Chart 3).



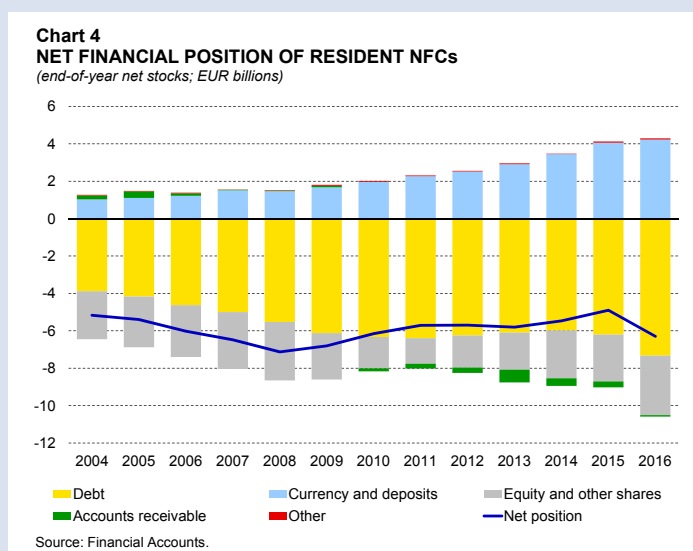
⁴ Micallef, B. (2015), "Estimating a Credit Gap for Non-Financial Corporations in Malta", Working Paper 04/2015, Central Bank of Malta.

⁵ The Financial Accounts statistics do not disaggregate intra-sectoral lending, thus preventing a more detailed sectoral analysis of NFC-to-NFC lending. Additionally, this prevents the deduction of whether lending between NFCs is related mainly to intra-group NFCs or between unrelated companies.

Since the end of 2007, prior to the ECB's first wave of key interest rate cuts, interest rates on NFC loans in Malta have fallen by 241 basis points, when compared with 325 basis points in the euro area, leading to a further widening of the spread between domestic and euro area rates to 161 basis points at end-2016. This corresponds with the conclusion of a Central Bank of Malta study that concluded that the interest rate pass-through from the ECB policy rates to the bank lending rates for firms in Malta is one of the lowest in the euro area.⁶ This may be attributed to the funding structure of banks (since most banks in Malta rely on deposits as their main source of finance rather than the wholesale market) and also the higher debt/equity ratio of resident NFCs when compared with those in the euro area, as alluded to in Chart 1 above.

Survey data and other anecdotal evidence suggest that banks have upped their efforts to boost capital ratios in part through a tightening of lending to NFCs. In 2014 the European Commission reported that "lending standards were tightened significantly in response to the crisis, particularly for the construction sector, and have remained largely unchanged since then".⁷ This is backed by results from past BLSs, which indicated a tightening of credit supply and terms and conditions around 2011 and 2012 that were not fully reversed in the following years. The higher perceived risks associated with the NFC sector, such as the lack of collateral and asymmetric information regarding newer economic sectors, as well as the need to diversify away from the construction sector, could be driving banks to shift their loan portfolios away from NFCs and toward households.

At the same time, evidence points to an increase in alternative sources available to companies in place of bank funding. Increased turnover on account of a robust economy has allowed companies to self-finance themselves internally or through their parent companies, while construction companies are able to sell properties on plan to finance building costs. Chart 4 shows how the net financial wealth of NFCs has generally improved over the past few years, with strong growth registered in companies' currency and deposits. Furthermore, company surveys such as the SAFE indicate a growing number of firms not applying for bank loans due to sufficient



⁶ Micallef, B., Rapa, N., & Gauci, T. (2016), "The Role of Asymmetries and Banking Sector Indicators in the Interest Rate Pass-Through in Malta", *Journal of Advanced Studies in Finance*, Vol. 7, 1(13), p. 5. However, studies also suggest that the interest rate pass-through can also be influenced by the banks' funding structure.

⁷ European Commission (2014), "Macroeconomic Imbalances Report - Malta", available at http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/pdf/ocp184_en.pdf.

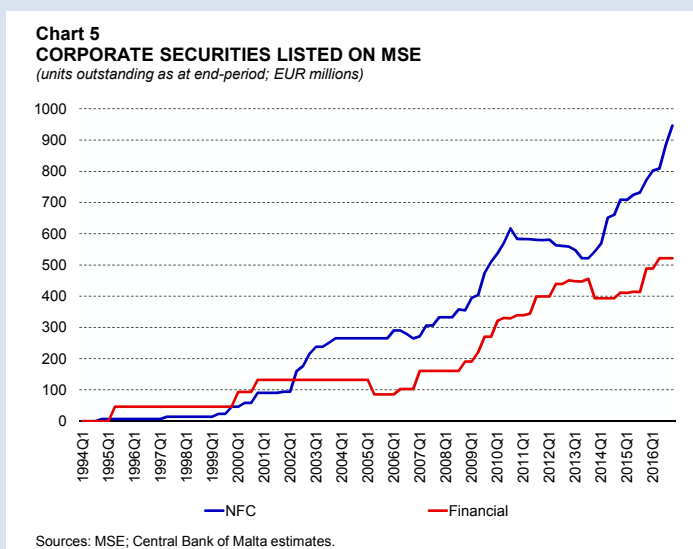
internal funds.⁸ This could explain the observed shift in the share of NFC loans from bank to intra-sectoral lending, as given a sufficient amount of internal funds, a company would find it cheaper and less bureaucratic to borrow from within the company group rather than from an intermediary with tightened lending standards.⁹

Financial accounts data suggests that the increase in intra-sectoral lending is especially evident within the short maturity loans category, which could indicate increased replacement of short-term bank loans such as overdraft facilities and credit lines with internal funding.¹⁰

Structural changes in the economy represent another factor that could be driving the drop in bank lending. In 2014 a European Commission report stated that “(the) structural shift in the (Maltese) economy to some extent lowers the capital intensity of the economy, resulting in lower need for investment, thus also lowering the demand for credit”.¹¹ This refers to the gradual shift in Malta’s economic structure towards more labour-intensive services industries. Indeed, Malta’s private investment-to-GDP ratio has gradually declined over the years, from 15.9% in 2004 to 13.3% in 2014.¹²

Issuance on capital markets

Apart from increased use of internal funding, NFCs facing constraints in the loan market are expected to meet their demand for funds through increased issuance on capital markets. Chart 5 backs this argument, showing strong increases in the number of debt securities outstanding on the MSE, particularly since 2009. By the end of 2016, there was €946.4 million of NFC debt outstanding on the MSE in nominal terms, of which over three quarters was issued since 2009. The average maturity of debt has also risen in recent years, from 7.4 years between 2005 and 2008 to 9.2 years during the period 2013 to 2016. This all suggests that the decline in bank credit



⁸ Zerafa, S. (2016), “Survey on Access to Finance”, *Quarterly Review* 2016:1, pp. 80-88, Central Bank of Malta.

⁹ Furthermore, one cannot exclude the inclusion of items such as movements in company funds for internal accounting purposes, estimation errors, and differences in the level of disaggregation of NFCs across countries, in the intra-sectoral lending figures. Further information on the statistical treatment of intra-sectoral lending is available in Hertkorn, A. (2015), “Consolidated and non-consolidated debt measures of non-financial corporations”, IFC Bulletin No. 39.

¹⁰ Short-term loans consist of loans with a maturity of less than one year.

¹¹ European Commission (2014), “Macroeconomic Imbalances Report - Malta”, available at http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/pdf/ocp184_en.pdf.

¹² Although the ratio rose in 2015 and 2016, this was due to government-induced projects.

has somewhat prompted increased debt issuance on the capital market, further encouraged by an increase in investment demand from households and a search for yield in a low interest rate environment.

However, a closer look at the figures suggests that issuance of corporate securities remains limited to a few large companies. Since 1992, only 40 different companies have

issued securities on the MSE, of which 34 were NFCs. Moreover, as shown in Chart 6, only six issues, out of a total of 87 new NFC bond issues, were for an amount of less than or equal to EUR5 million. Similarly, on the equity market, by the end of 2016 just 27 different companies had floated shares on the MSE since its founding, of which 22 were resident NFCs. Thus, although capital market issuance has increased since 2009, this is mainly limited to a few large companies. This could indicate that NFCs are still finding restrictions to issuing on capital markets, such as listing requirements and a relatively high market interest rate¹³ (see Chart 3 above), which stands above the bank lending rate.

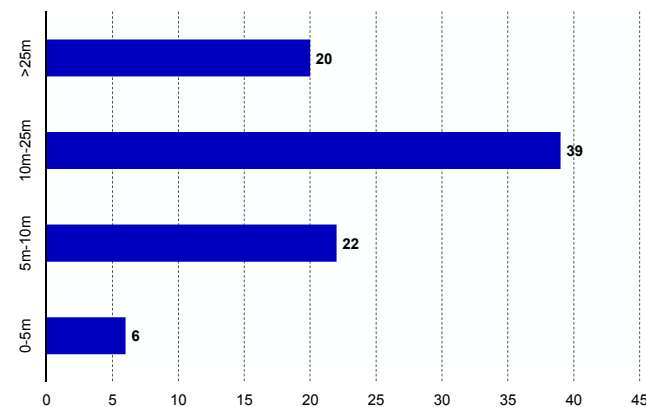
It is indeed telling that despite this relatively high market rate, large corporations are increasing their presence on the capital markets. This could be indicative to the presence of non-interest rate related lending restrictions from banks. Bond markets could offer certain advantages over bank finance, such as generally longer maturities and cash-flow considerations with the possibility of rollovers. At the same time, the large amounts borrowed by companies in the bond market could in part explain the unwillingness of banks to expose themselves to such transactions.

Policy implications and developments

The implication of the above analysis is that Malta's resilience to future economic shocks could be hampered if small enterprises, which comprise the large majority of resident businesses, are not in a position to obtain adequate funding. This is especially true in the eventuality of a drop in internal funds once the economy moves away from its current expansionary cycle. At the same time, a shift away from bank credit can reduce the effectiveness of the bank lending channel in the transmission mechanism of monetary policy. Lack of funding could make expansion more difficult for companies, with adverse consequences for Malta's potential growth in the future.

¹³ The synthetic capital market interest rate presented in Chart 3 is based on Central Bank of Malta estimates. See Darmanin, J. (2017), "The Financing of Companies in Malta." Policy Note July 2017, Central Bank of Malta.

Chart 6
NEW ISSUES OF NFC SECURITIES
(as at end-2016; number of issues per range, upper limit inclusive in EUR millions)



Sources: MSE; Central Bank of Malta estimates.

A number of initiatives are currently being undertaken to address the issues faced by firms in obtaining bank credit. The Malta Development Bank is intended to address the gaps in the domestic financial infrastructure, with particular attention given to SMEs and the financing of large-scale infrastructure projects. Meanwhile, in 2017, the MSE launched the National Capital Markets Strategic Plan, proposing a number of initiatives as part of its long-term strategy to develop a liquid and efficient securities market. The MSE has also recently launched Prospects, an exchange geared towards SMEs, giving them access to capital markets without need for collateral or minimum issue requirements.¹⁴ These developments, along with other government and EU funding initiatives, constitute an important step towards increasing the funding mix available for small firms.

¹⁴ See the MSE website dedicated to Prospects (www.smeprospects.com).