



**BANK ĊENTRALI TA' MALTA**  
EUROSISTEMA  
**CENTRAL BANK OF MALTA**

**LEVERAGING BETTER OUR CURRENT ECONOMIC SUCCESS**

**ADDRESS BY DR MARIO VELLA**

**GOVERNOR, CENTRAL BANK OF MALTA**

**DELIVERED DURING THE IFS MALTA ANNUAL DINNER**

**01 DECEMBER 2017**

Dear President and Members of the Committee of the Institute of Financial Services (IFS) Malta, distinguished guests, personally and on behalf of the Board of the Central Bank of Malta, I thank you for this annual traditional opportunity to address this distinguished audience and, through it, all stakeholders.

Also my personal and institutional welcome to the representatives of overseas professional bodies who are with us tonight, the London Institute of Banking and Finance, the Global Association of Risk Professionals, and the European Banking and Financial Services Training Association. You evidently hold IFS Malta in high esteem. So do we.

Mr President, we are pleased to hear about the many initiatives being undertaken in the area of financial services education and commend the Institute for its ongoing commitment to the professional development and up-skilling of financial services practitioners. This is definitely a positive contribution to the sustainability of our dynamic sector, and one we commit ourselves to support effectively. The Central Bank of Malta is a long-standing partner of the Institute. Rest assured that we will continue to offer our support wherever possible.

Tonight's event has become an important date in the calendar of key stakeholders in our country's economy, particularly but not only in the financial services sector. This dinner, in fact, provides us with an opportunity to meet together and discuss what went well, and

what went less well, in our economy in a less formal environment than that usually associated with discussions on economic and financial developments.

Traditionally, the Central Bank avails itself, through its Governor, of the opportunity of this occasion to give an extensive panoramic review of Malta's economic performance, of what in our view drove these results, outline the challenges ahead and conclude with policy recommendations.

This year we will depart from this tradition. While we will start with an overview of this year's developments and discuss briefly the outlook for 2018, we will use this as a basis for a broader, more thematic, discussion. In recent years, definitely since the European sovereign debt crisis, we have increasingly come to realise that whilst we are a very open economy dependent on foreign trade and investment, our economy has shown a degree of resilience and adaptability that has defied expectations, surprised foreign institutions and, indeed, ourselves too.

All forecasters including the International Monetary Fund, European Commission, European Central Bank and the credit rating agencies, as well as the Central Bank of Malta, were proven to have been conservative. One could argue that the comment on GDP projections is a bit unfair in as much as the December 2015 projections would have been based on the information available at that time. Since those projections were made, historical data would have been revised. The forecasters would not have known about these subsequent revisions. Nevertheless the results were certainly better than expected.

Let me give you a couple of examples. In December 2015 the Central Bank projected real GDP growth for 2017 at 3.2%. Two years after, we believe economic growth has reached 6%, or nearly double what we had originally projected. Back in December 2015 we had anticipated 2017's unemployment rate as 5.4%. Now we know it will be closer to 4%, or a quarter less. More striking is the divergence in fiscal projections. Back in December 2015 we thought Government would close 2017 with a deficit of 1.1% of GDP. Today we believe there will be a surplus of 0.9%. Two years ago we thought our national debt-to-GDP ratio would be 64% of GDP in 2017. Now we think it will be nearly ten percentage points less than that.

## **Malta's current economic performance**

Two weeks ago, in the concluding statement following their annual official staff visit to Malta, the IMF said that “Malta’s economic growth remains one of the strongest in Europe” and projected that this robust performance will continue on the back of rising incomes and historically-low unemployment, complemented by buoyant services exports. They also concluded that Malta will remain a surplus economy, both in terms of government finances and external transactions. This is, broadly speaking, the same assessment as that made by the European Commission in their Autumn 2017 forecasts. In fact, the Commission’s experts are forecasting that this year and over the next two, Malta will have the highest current account surplus as a percentage of GDP of all euro area countries, “beating” countries such as Germany and the Netherlands.

Whereas, going forward, growth is expected to moderate somewhat, Malta will continue to out-perform significantly the euro area. The Commission’s Autumn 2017 Forecasts put us at the head of the league table both in terms of real GDP growth and employment increases. Though there are downside risks stemming from more inward-looking policies abroad and an uncertain external environment, including the impact of Brexit on the continent’s economy, domestic demand in Malta should continue to grow at a fast rate, particularly as wage growth will boost disposable income while investment is expected to remain sustained.

In last year’s speech I described what we believe are the conditions leading to this performance. Part of our success is attributable to cyclical factors, such as the effects of the ECB’s monetary policy actions to stimulate the euro area economy. Accommodative monetary policy is boosting aggregate demand, locally and in our trading partners, and lowering the external value of the euro, which helps our exporters. We also noted how strong government investment, partly financed by EU funds, is helping the Maltese economy.

However in last year’s speech we emphasised that most of our current economic growth is attributable to structural changes, which have contributed to more than double our potential growth rate since the global financial crisis. On the one hand, this was due to a significant improvement in our labour supply, both in terms of quantity and quality. Part of this is related to inflows of foreign workers, but our success in raising female participation

and improving financial incentives to work has played a key role. On the other, we have also radically transformed our energy sector, through the linking of our system with the European grid bolstered by investment in new power plants.

The divergence between our growth and that observed in the rest of the euro area is also due to the different performance of our respective financial sectors. Malta's financial system has proven to be more stable than that of neighbouring countries. Our core domestic banks have remained sound with strong capital ratios, high liquidity and healthy profits. Asset quality has continued to improve, while banks remained prudent, boosting provisions. We believe that besides being a testament to the prudence of our local banking community, these results are also due to the actions of regulatory authorities.

### **How to address some of the challenges of our economic success**

Rapid economic growth, such as that which Malta is currently experiencing, brings about its own challenges. Opinion surveys confirm how the Maltese have shifted from worrying about the cost of living and economic uncertainty to being concerned about the environment and traffic congestion. This shift is also evident at the level of policymakers. In fact policy documents, such as the 2018 Pre-Budget Document and the Budget for 2018, have stressed the need to upgrade infrastructure and enhance environmental protection. Similarly, international institutions have emphasised the need to shift attention towards sustaining growth and making it more inclusive. Going back to the latest IMF Article IV mission, their recommendations focus on addressing housing market pressures, closing the infrastructure gap, upskilling and reskilling the labour force and strengthening innovation.

We would like to discuss some of these challenges, before outlining how we think that our financial sector can play a role in helping to tackle them.

### **The housing market**

In last year's speech, we touched upon the need to avoid the formation of asset price bubbles. We quoted Central Bank research indicating that house prices were still below their equilibrium fundamental value, but warned that price trends would nevertheless continue to be closely monitored. House prices, as you know, have continued to rise.

National statistics data suggest an increase of 5.3% during the first half of this year, as against 6.1% in the same period of 2016 and 3.2% in 2015. That said, housing supply is responding to the high demand that is contributing towards house price inflation. In the first seven months of 2017 building permits were 62% higher than they were in the same period of 2016 and 153% higher than in 2015. This increased supply, unless there is a further acceleration in demand, should result in housing price inflation moderating. This should also help to reduce pressure on the rental market, where there is evidence that from being at the lower end of cross-country rent-to-wage ratios, we have moved relatively quickly to being close to ratios found in the most expensive European cities. Besides the impact that this rise could have on our capacity to attract foreign workers, we need to consider its impact on Maltese tenants, which in turn will impact on the broader costs of doing business and, consequently, competitiveness.

We believe that, going forward, if we continue to grow at the rates observed in recent years, we will need to have a much more dynamic housing market. But before discussing private provision, let us discuss social housing. Recent developments have reinforced the case for replenishing our social housing stock. However, this expansion needs to be accompanied by a change in approach. In recent years, most of Malta's benefit system has been changed so as to create clear incentives to shift from benefit dependence to participation in the formal labour market.

The only area where this is not happening yet is social housing, where the tendency remains that, once allocated, social housing tends to become a lifetime entitlement. We need to change this so that social housing schemes act to activate individuals and empower them rather than encourage passivity. Such a transition could itself be helpful in financing the expansion of social housing. Instead of seeing social housing as a passive benefit, we can eventually develop projects which become to an extent self-financing, through a combination of social housing provision and programmes to enhance the employability of individuals, enabling them to eventually pay market rents. The financial sector could play a role here. We have already seen how some banks have partnered with government to offer social loans, which are beginning to decrease reliance on the social housing stock. Going forward, we can see the possibility of other innovative initiatives where the Housing Authority partners with financial institutions to develop social housing projects.

At this point, I take this opportunity to inform you that the Central Bank of Malta has set up a lean but highly competent and proactive Social Research Unit to study amongst other issues, access to credit by the lower income groups.

Another area where we need to register progress is home equity release. We have a situation where many elderly persons are asset rich but cash poor. They live on relatively modest pensions, while residing in large and relatively expensive homes. This creates issues for financing long-term care, as many find it difficult to sell their homes outright in order to go into a private home. If, over the coming years, we manage to come up with ways of releasing part of the equity in homes, this could raise the supply of available housing, reduce the pressure on state long-term care institutions and hospitals while guaranteeing better living standards for our elderly. This, of course, needs to be done carefully, sensitively and in a well-regulated environment. Once again, we believe that financial institutions can have a key role to play here.

The rental market is another area where we believe we need to act, with due consideration of the trade-offs involved. Any measures that are too restrictive could take us back to a previous situation where the rental market was utterly dysfunctional. On the other hand, we should not shy away from reforms that facilitate a better functioning of the market. We need more legal clarity about the rights and obligations of landlords and tenants. We also need to have this market operate in the formal economy, with rent contracts duly registered. Stabilising this sector will be beneficial to our economy's competitiveness, whilst also helping to address social inequalities. Although loan-to-value (LTVs) ratios range from 60% to 90% (and lately we have observed a shift to the upper bound) the banks have largely kept to their cautious approach when extending credit for buy-to-let purposes. We think that their prudence bears witness to the maturity of our financial institutions, though more caution in mortgage credit for secondary residences is called for.

### **The need for long-term investment**

Let's now shift to a more critical gear. At present, financial institutions deposit with the Central Bank close to four times the average of the previous ten years. In essence, all the growth this year in deposits from Maltese residents has ended up being deposited with us

at the Central Bank. Loans to the private sector have essentially remained flat. Taking a longer term perspective, bank lending to nonfinancial corporations has fallen from 62% of GDP in 2009 to 31% in the first half of this year. From a situation where credit to the nonfinancial sector amounted to more than half of all bank loans, the share has fallen to slightly more than a third. Now, the usual explanation is that banks welcome any feasible projects that comes forward, and that the decline is therefore demand and not supply driven. Moreover, stricter regulation on bank capital and liquidity has made life tougher for bankers, and this, it is argued, has warrants a higher level of caution regarding which projects are financed.

Permit me, however, to submit some other facts for your consideration. The recent IMF mission concluded that the cost of bank borrowing for corporates in Malta is among the highest in the euro area, and the spread has been widening in recent years. In their forthcoming report in January 2018 they will furthermore show that credit supply constraints impact SMEs disproportionately. While surveys do not suggest that access to finance is the private sector's main concern, this is probably due to the fact that firms have been able to finance projects through their own funds. Over the last decade, companies shifted to intragroup loans and intercompany lending instead of bank loans as a main source of financing.

One, of course, needs to distinguish between intragroup loans (parent to subsidiaries or subsidiaries to other subsidiaries) which we think make up the bulk of "intercompany" lending and other intercompany lending undertaken through factoring, trade credit and loan funds.

Also bear in mind that the Financial Institutions Act related companies (within a group) do not need a licence to lend to each other. To give loans outside the group (intercompany) one does need a licence.

While it is beneficial to see a diversification of firms' financing sources, this change raises some issues. Let us start with something we discussed last year. We need to be careful that in the current low interest environment, investors' search for yield does not stimulate excessive risk-taking. Therefore, we need to complement the rise in corporate bond issuance with a significant effort in improving investors' education and compel corporates

borrowing from the domestic capital market to provide more information to investors about their creditworthiness.

Secondly, even if we believe that the recent disintermediation process was a matter of choice, reflecting firms' current liquidity, this nevertheless begs the question as to what would happen when the economy slows down and internal funds diminish. We believe that if the disintermediation process goes too far, our resilience to future shocks could be hampered. Whenever activity slows down, firms will tend to cut back on investment and innovation. Moreover as a Central Bank, we have to be concerned that in such an environment, the transmission of monetary policy, which mainly occurs through the banking channel, could be impaired. This would make it harder for policymakers to react to economic needs.

The current situation, with a lot of savings lying unutilised at the Central Bank, seems to me to be a wasted opportunity to leverage our current success in order to build a better future. At a time when everybody agrees that we need to invest strongly in infrastructure and to upgrade the competences of our workforce – both of which are long-term investments –, it is painful to note that we opt instead to pile our savings in what is essentially the most short-term of investments: deposits with the Central Bank. The fact that, despite overall excess liquidity, some smaller banks continue to borrow from us through regular monetary operations, is an indication that the domestic interbank market still faces some structural inefficiencies.

A more efficient financial system would facilitate the allocation of capital to its most productive uses. This would boost capital stock and total factor productivity and, hence, sustainable economic growth going forward.

I believe that the setting up of the Malta Development Bank should help increase the availability of finance to the real economy, while also supporting long-term investment projects. This bank is going to fill in an institutional gap in our financial sector, which recent developments have made ever more evident. In a banking sector, which remains relatively well profitable, compared to their European peers, despite the decline in lending to nonfinancial corporations, we need an institution that can help create an environment where banks feel comfortable to extend credit to innovative firms, namely firms that may



not be able to provide adequate collateral due to the nature of their business, but which are still good business opportunities.

Besides the Development Bank, there are other policy measures that should help facilitate the flow of credit. At the Central Bank we will continue to evolve our credit register to provide more information to banks and help reduce credit risk. More broadly we will continue supporting government in its attempts to reduce excessive bureaucracy and further improve the insolvency process. We will also continue to take macroprudential measures to ensure timely policy interventions to safeguard the stability of the financial system.

The struggle against bureaucracy is a key element in the broader effort to improve the ease of doing business in this country. We are pleased to note that the World Bank Ease of Doing Business team is finally making serious efforts to understand our national specificities. The Central Bank urges and supports Government's ongoing efforts to take the Ease of Doing Business conditions to a new level. Of course, it would be unforgivable of me not to seize this opportunity to urge the consultancy community to ensure that the information we provide to international competitiveness ranking agencies is up to date and factually correct.

I also take this opportunity to observe that in 2018, Malta will undergo a comprehensive and detailed analysis of its financial sector through a Financial Sector Assessment Programme (FSAP) conducted by the International Monetary Fund. At the same time, Malta will be evaluated against international standards on Anti-Money Laundering and Counter-Terrorism Financing (AML/CFT) by MONEYVAL as part of the Council of Europe's peer review process. We are eagerly looking forward to both.

Our economy has managed to outperform because we managed to evolve and diversify rapidly. I believe that our financial services and banking sector needs to mirror this, to continuously evolve and adapt to the changing economy.

After the success of recent years, we are now in an excellent position to solidify our gains. This requires us all to focus our glance further into the future, and to devote a greater share of current economic prosperity towards financing more long-term projects. If we do not, we run the risk of undermining our own future prosperity.

I believe that the financial services community can and must contribute to change our nation's mentality. At the interface between our nation's savings and investment it is best placed to leverage more effectively our current economic success.

Thank you.