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EUROSISTEMA
CENTRAL BANK OF MALTA

DYNAMIC BUT VIGILANT

ADDRESS BY DR MARIO VELLA

GOVERNOR, CENTRAL BANK OF MALTA

DELIVERED DURING THE *IFS* MALTA ANNUAL DINNER

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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 the IFS for this traditional annual opportunity to address this distinguished audience and, through it, all stakeholders.

I also join the President in welcoming to Malta the representatives of the Chartered Banker Institute, the London Institute of Banking and Finance, the International Compliance Association and the European Banking and Financial Services Training Association (EBTN).

Mr President, it is encouraging to hear of all the initiatives the Institute has undertaken in the area of financial services education. The topical theme of your recent Annual Seminar on 'Digital Transformation' and your pro-activeness in developing a Diploma in Digital Technology for our sector, demonstrate your willingness to embrace change and adapt to the evolving needs of the marketplace.

Let me assure you that the Central Bank of Malta will continue to support you.

I wish the Institute every success in the future.

Last year, I highlighted the fact that the performance of the Maltese economy had exceeded the Bank's expectations and those of other institutions. Key economic indicators were among the best in Europe, with the European Commission at the time projecting continued, though moderating, strong GDP growth through 2019.

This assessment can be broadly confirmed at the current juncture. GDP growth in the first half of 2018 averaged 5.4%, which is in line with the latest projections that the Central Bank published over the summer. The unemployment rate fell to a new record low of 3.8% in the second quarter of this year. Labour market participation, previously on the low side, now slightly exceeds the euro area average.

In the area of public finances, the general government balance remains in surplus, the debt-to-GDP ratio extended its downward path, and contingent liabilities, while still elevated, are now within the range observed in other countries. The external balance remains in surplus and inflationary pressures remain contained.

When compared with the information available a year ago, the economic record is even more impressive. Then, GDP growth in 2017 was recorded at 5.6%, now the latest vintage of data puts last year's growth rate at 6.7%. Growth in 2018 is also expected to be higher than previously expected. The European Commission's latest projections foresee growth this year at 5.4%, the second highest rate the European Union after that of Ireland. This compares with a projection of 4.9% in November 2017.

According to the European Commission, fast growth rates are expected to prevail through 2020, although as one might expect, the pace of expansion is set to moderate from recent highs, with annual growth reckoned to stand at 4.4% in 2020.

All this is positive news, but there is also some not so good news.

While the outlook for the Maltese economy remains bright, we have to acknowledge that the external environment is becoming less supportive than we expected a year ago, or even three months ago. Some of the external downside risks flagged by the Bank in recent projection rounds have started to materialise. Global economic growth has become more diverse across regions, with soft indicators suggesting that global trade is losing the buoyancy seen in 2017. Partly in response to the less benign economic conditions abroad, activity has also softened in the euro area.

The less favourable international environment partly reflects new restrictions on trade and the response of businesses' capital spending plans. In late 2017 and also in the course of 2018, the United States introduced additional trade protectionist measures, which have been followed by a degree of retaliation. Although these actions mostly concern trade between the United States and China, the overall impact may be considerably broader once global value chains and the effects of uncertainty on private spending are taken into account. This assessment is broadly confirmed by the latest assessments published by the IMF in October, and by the OECD a week ago. Indeed, year-on-year growth in world trade has slowed to 3.2% in the first half of this year, from the relatively fast growth of 5.0% recorded in 2017, while growth in container port traffic averaged 3.9% in the first nine months of this year, down from 6.5% in 2017.

Notwithstanding the deal reached during the special meeting of the European Council held on 25 November, the uncertainty surrounding the UK's future relations with the European Union continues. Should the deal be rejected, the immediate effect would be an amplification of the loss of momentum.

The European Central Bank continued to pursue an accommodative monetary policy throughout 2018, against the backdrop of a continued recovery in economic activity in the euro area as a whole, to ensure that inflation would converge sustainably to the target of below, but close to, 2% in the medium term.

Following very strong growth in 2017, real GDP in the euro area continued to expand during the first three quarters of this year, albeit at a slower pace, with an annual growth rate of 1.7% being registered in the third quarter. The latest information, while being somewhat weaker than expected, remains consistent with an ongoing economic expansion.

In turn, with the economy growing at rates above potential, and with the unemployment rate declining steadily, inflation should gain momentum. Indeed, the euro area inflation rate stood at 2.2% in October, up from 2.1% in September and from 1.4% a year earlier. That having been said, measures of underlying inflation, which strip out the contributions of volatile items such as energy and food, remain muted.

The situation in international financial markets during 2018 remained very challenging. Most asset classes today are in negative territory when compared to the start of the year, which is a very unusual phenomenon. Over the past year, developments in financial markets have been largely dominated by several political events, while generally positive economic news seemed to matter much less. These political events ranged from trade tensions, especially between the US and China, to Brexit-related developments, a slowdown in emerging market economies, most notably in Argentina and Turkey, and also the rise of populist movements in some European countries that have led to tensions, particularly between Italy and the European Commission. All this led to volatility in financial markets, with a constant turn in Risk-On /Risk-Off sentiment, which has made it more challenging for investment strategies.

As a Central Bank, financial market developments are of a direct interest to us as these have an impact on both the domestic banking system and the Central Bank itself. While such volatility in financial markets and persistence of interest rates at a relatively low level in Europe have continued to exert pressure on interest income flows and potential on capital gains, and hence impinge on profitability, nevertheless domestic banks have absorbed such turbulence relatively well. For the year ahead, the situation is likely to remain equally challenging on interest income and profitability, as signs are emerging that world economic growth, including in Europe, is losing momentum. This could be also particularly challenging for the process of the normalization of the monetary policy stance in Europe, which is likely to be very gradual.

As you are all well aware, during 2018, the European Central Bank gradually scaled back the non-standard monetary policy measures that it had introduced to combat the risks of a long period of low inflation and possible deflation. In January, the monthly purchases in terms of the Asset Purchase Programme were halved from €60 billion to €30 billion. They were halved again, to €15 billion, from October. The Governing Council currently anticipates that, subject to incoming data confirming the medium-term inflation outlook, the net purchases will cease altogether in December 2018.

Indeed, even after net asset purchases have ended, monetary policy will continue to provide support to the euro area economy as the stock on Central Banks' balance sheets will be maintained with the re-investment of maturing bonds. The ECB's key interest rates remain very low, with the overnight deposit rate standing at -0.4%. The Governing Council expects them to remain unchanged at least through the summer of 2019. At the same time, the Governing Council will ensure that ample liquidity conditions will continue to prevail for as long as needed by reinvesting principal payments from maturing securities for an extended period of time. This combination of very low interest rates and ample liquidity should ensure favourable financial conditions for firms and households, underpinning economic activity, and should strengthen the sustained convergence of inflation to the target.

Looking ahead, domestic demand will play an important role in economic growth. The prospects in this regard remain favourable. The still very low unemployment rate and the low interest rate environment should continue to shore up private consumption, while investment should benefit from increased public spending on infrastructure as well as new projects in education and health. Certain capital intensive sectors look set for further expansion. The continued strong growth in permits for residential dwellings should also lead to further growth in dwelling investment.

It is also evident, however, that maintaining the momentum registered in recent years is becoming an increasingly challenging feat, as a number of internal constraints already identified last year persist.

The rapid economic expansion and population growth have put pressure on the country's physical infrastructure, in particular as regards road transport and health and education facilities. Given the adverse effects of infrastructure gaps on business investment, productivity and social welfare, it should not be surprising that one of the key recommendations which IMF staff issued in January was to boost public investment, to address infrastructure bottlenecks and support medium-term growth in a budget-neutral manner. This need to boost investment in infrastructure was also acknowledged by the European Commission in its assessment of the Stability Programme and National Reform Programme. In this regard, the Government's announcement of a seven-year capital investment programme focusing on the road network is an encouraging step forward. However, given that this additional investment coincides with a booming construction sector and more stringent procedures as regards the utilisation of EU funds, the possibility of slippages should not be overlooked.

The Government's efforts need to be complemented with a better utilisation of savings accumulated by the private sector. The Malta Development Bank can help in this regard, by identifying gaps in the financing of viable projects and partnering with financial intermediaries and other stakeholders to develop financial instruments that can finance them.

Apart from infrastructure bottlenecks, international institutions that monitor the business environment flag other areas that warrant immediate attention. While we have significant reservations on a number of methodological aspects underlying such surveys, we also share the view that in some areas we do need to step up our efforts very considerably. This is notably the case as regards the efficiency of court proceedings. Although the time it takes to resolve court cases has more or less halved since 2010, it is still among the longest in the European Union. Other challenges we need to address concern the length of procedures to set up a business, the low educational attainment level relative to our peers and a limited capacity to innovate. These are essential elements that support investment and productivity. The development of an intelligent online business portal which ties all Government business-related services into a one solid platform should put businesses in a better position to do business. The new legislation in the area of digital innovation provides the legal framework for business to embrace disruptive technologies. The private sector is encouraged to exploit the opportunities that these technologies entail in terms of efficiency gains, adaptability and overcoming labour shortages which remain widespread across sectors and skill levels.

So far we have managed to address these gaps partly through labour activation policies targeting nationals and partly through foreign labour. However, one has to acknowledge that the national working age population is what it is. With the male participation rate already around the euro area average, a better utilisation of the domestic component of the labour supply can only be achieved if more women take up employment or if the labour force works longer. Alternatively, production processes would need to rely on upgraded technology, such as automation and artificial intelligence.

While further gains in the female participation rate are possible, these will likely materialise only gradually, as the participation rate of younger females already exceeds that in the euro area as a whole, while that of older females does not adjust upwards easily, as these tend to have fewer skills and experience or have to care for dependants. Longer hours are probably not compatible with a better quality of life. Technology upgrades through, for example, automation and artificial intelligence offer a promising avenue, but can be very costly for small firms and also require skills and financing that are not immediately available. Their effectiveness rests on a more active participation in training and re-skilling programmes as well as entrepreneurial willingness to support innovative activities.

The private sector is likely to maintain a high dependence on foreign workers. The latter, however, tend to stay for a relatively short period in Malta, which does not augur well for firms' return on investment in human capital and productivity. It may also put at risk the competitiveness of our exports and job prospects to the extent that wages begin to increase faster than productivity.

From this point of view, there is an urgent need to understand the factors behind the relatively short stay of foreign workers in Malta and devise solutions to this problem. A key factor that has been cited by firms and foreign workers alike is the recent rapid increase in rent in the private market, but there may be other reasons. The recently published White Paper on rent reform puts forward a number of proposals that should enable a better-informed assessment of the rental market in Malta and which seek to offer greater certainty and protection to landlords and tenants. With the public consultation on this subject now completed, we now look forward to the implementation of the proposed measures.

Permit me at this point to note that the Central Bank is itself an employer of specialist foreign staff, thus we also speak on the basis of a direct feel for some of the problems they face. Apart from the already mentioned rents issue, there are other apparently minor but certainly unhelpful matters, ranging from the difficulty of finding school places, opening a bank account and the time consuming effort to get an ID card.

While home ownership in Malta remains among the highest in the EU, it is also evident that the changing fabric of society and economic factors are pushing some segments of the population to resort to the rental market.

The continued rise in house prices reinforces this pattern. According to Eurostat, house prices rose at an annual rate of 5.6% in the first half of this year, following a 5.3% increase last year. The deflated measure has also picked up in the first half of this year. This acceleration suggests that although the issuance of permits for the construction of residential units continues at a brisk pace - growth exceeded 30% last year and up to September this year - supply still falls short of the demand for housing.

Continued increases in house prices risk rendering house ownership unaffordable for a wider segment of the population in a country accustomed to a very high rate of home ownership. Moreover, while overall risks to financial stability from real estate remain contained at the current juncture, an extension of recent trends may result in potential macro-financial imbalances.

Dear colleagues,

The year 2018 was a milestone date, marking the Central Bank of Malta's fiftieth anniversary of its establishment and also the tenth anniversary of Malta joining the Eurosystem. The latter had coincided with the start of the most-severe financial crisis since the Great Depression. Since then, the regulatory response and reform agenda intensified as authorities struggled to bolster the resilience of financial systems. Ten years on, banks around the globe have raised capital and strengthened their balance sheets. On their part, supranational authorities have gone to great lengths to enhance regulation and be better prepared for the next crisis. Apart from regulatory challenges, the system is still grappling with additional risks stemming from the macro-financial and geopolitical spheres.

Notwithstanding, in Malta, bottom lines remained healthy as banks and other financial institutions managed to record healthier profits in relation to their European peers. By mid-2018, the return on equity and assets of the core domestic banks stood at 7.6% and 0.6%, respectively as against the 6.2% and 0.4% reported by small European banks. But, just like them, domestic financial institutions had to weather headwinds from geopolitical uncertainties which have become more prominent in recent months - most notably Brexit, concerns on Italy's economic fundamentals and their implications for the euro, emerging market contagion, and the rise in trade wars between economic superpowers which many fear will lead to widespread protectionism. This is further compounded by the negative effects of a prolonged low interest rate environment which is increasingly exerting pressures on profitability, particularly to the more traditional business models of our domestic institutions.

On balance, the Central Bank of Malta remains confident that risks to the domestic financial system are contained. Exposures to emerging market economies are low and limited as credit and financial institutions have taken measures to protect their balance sheet from any undue risk. Despite the strong historical ties with the UK, studies carried out by the Central Bank of Malta indicate that the potential direct adverse effects of a 'hard Brexit' on the Maltese economy are deemed to be manageable. The robust economic developments together with the regulatory measures implemented by domestic authorities have contributed to the further decline in credit risk and improving asset quality, with the non-performing loans ratio for the whole banking system falling to just 3.1% and comfortably below the EU average.

Following a contraction phase of four years, lending to non-financial corporates finally turned the corner, increasing by an annual rate of 4.6% in September 2018. This is a welcome sign since it does not only hint that bank disintermediation is normalising, but it also augurs well for monetary policy effectiveness, given that banks are the conduit for its proper functioning. Although such signs are encouraging, we have yet to stimulate more usage of the current liquidity lying idle at the Central Bank. Here, banks play a crucial role in finding new viable business niches.

Key performance indicators (KPIs) for domestic financial institutions are healthy but we must not become complacent. Vulnerabilities remain. Aggregate KPIs only give one side of the story masking the variability in operational performance at an institutional and sectoral level. The-not-so-distant past has taught us that structural overreliance on real estate poses considerable economic pain in a downturn. Indeed, despite a turnaround in the real estate market since 2014, some banks have not yet fully recovered from past overexposure to this sector. While households' balance sheets remained broadly sound, one also cannot overlook their increasing exposure to this sector. This, in turn, is being reflected in growing concentration in the banks' loan portfolios. The Central Bank of Malta, in consultation with the MFSA through the Joint Financial Stability Board, is taking pro-active steps by introducing borrower-based measures to increase the resilience of both banks and borrowers to such potential threats.

Undoubtedly, from a supervisory perspective, the past two years have been very challenging. Two banks had their licence withdrawn, while another was put under the administration of a competent person. Despite the negativity of such developments, these are in themselves indicative of the fact that Maltese Authorities are actively taking the right measures to protect the sector from inappropriate behaviour. We must constantly bear in mind that from a reputational point of view we are only as strong as our weakest link and that the externalities that each institution transmits to the system, be it big or small, in the periphery or at the core, is always material in a small financial centre such as Malta. Furthermore, such negative externalities may also impact the use of infrastructural gateways that service the industry, without which, the entire financial sector would be isolated.

We all have a role to play. We have to acknowledge that in good times, there is heavy inter-temporal discounting of future bad events, with calls for less regulation. This temptation must be resisted. We need a balanced view that is stable and fair, but also sufficiently rigorous and intrusive irrespective of economic cycles. Otherwise regulators will keep being found wanting when the bad times come, adversely affecting many ordinary people and feeding mistrust in authorities. The Central Bank of Malta welcomes the supervisory authorities' commitment to step-up their supervisory intensity as this is crucial for regulation and oversight to keep pace with market developments. Supervision must remain on-going to safeguard the system from moral hazard, while keeping the bar sufficiently high to minimise adverse selection at entry point. Practitioners also have a duty of care to their clients and the financial system as a whole. They play a critical role in safeguarding its integrity.

Christine Lagarde has recently said that while policies had addressed the mistakes that led to the crisis, there is still much more to do as a '*lot of the murkier activities are moving toward the shadow banking sector'.* This risk is also indicated in the most recent *IMF Global Financial Stability Review* as well as the work of the ESRB and ECB related to the non-bank financial sector. The CBM and MFSA participate actively in this work. The domestic non-bank financial sector in Malta is linked with the banking sector through cross shareholdings. These links need to be studied more rigorously, both at a micro and macro level, as well as across sectors. In this regard, regulation and supervision must aim at minimising regulatory arbitrage. Irrespective of the set-up, or technology, institutions transmitting common types of risks should be treated on the same footing.

It is also opportune to formulate a holistic strategy for our financial services sector that takes into account a national risk appetite. One must take stock of the risk/benefit quotient of each sub-sector, and the lessons learnt thus far, and put it in a long-term context on where to focus going forward.

During the year, at the request of the Maltese Government, Malta underwent an IMF Financial Sector Assessment Programme, which is an in-depth assessment of the financial sector. Furthermore, a comprehensive update of the 2015 National Risk Assessment (NRA) was carried out in 2017 and published earlier this year. It identified potential money laundering and terrorism financing threats and vulnerabilities that present risks to Malta's economic and societal stability. The NRA forms the basis of Malta’s National AML/CFT Strategy. In fact, some of the initiatives identified in the NRA are already being implemented.

In addition, a Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism (MONEVYAL) has just ended a rigorous on-site mission to assess Malta’s standing with international AML/CFT standards.

The local authorities are eagerly expecting the final results of these evaluations as they represent a standardised global yardstick against which to benchmark our state of play. This will leave a wealth of information for authorities to exploit as they direct efforts into strengthening further the current institutional framework and operations. All stakeholders are encouraged to seize the opportunity to improve the reputation, soundness and resilience of our financial services sector.

Malta is also actively working to embrace blockchain technologies, including virtual assets. 2018 will also be remembered as the year when Malta was propelled to the fore with the introduction of a holistic legislative and regulatory framework for fintech and virtual assets, asserting itself as a digital hub. Such technologies provide the benefits of reducing transaction costs which can be passed on to consumers; greater efficiency, transparency, advancement in KYC capabilities and competition. While these benefits are acknowledged and duly welcomed, one must also be sensitive to the underlying potential risks they might pose as they become more main-stream.

The effective implementation of the new legislation and regulation requires expertise not only in the underlying technology, but also in its legal aspects and all the risks involved, such as cyber risks. The fast technological advancements are also a challenge and staying ahead of the game from a regulatory perspective should be given high importance for the successful development in this new field. Thus, while all the legislative initiatives for this new technology to succeed augur well, the authorities need to remain vigilant about the implications for financial stability stemming from the digital economy.

Fast economic growth does not happen without shaking a society's economic, social, cultural, political and institutional equilibria. This 'shaking' is both a condition *and* a consequence of economic acceleration. It is both an effect of economic, social, cultural, political and institutional disruption *and* a cause of economic, social, cultural, political and institutional disruption. This is not a moral judgement; it is a statement of what I believe is a sober understanding of the state of affairs.

In the well-known words of the Foreword to the Second Edition of *Liquid Modernity*, the late Zygmunt Bauman, remarks that "*Forms of modern life may differ in quite a few respects – but what unites them all is precisely their fragility, temporariness, vulnerability and inclination to constant change.*" Bauman's "liquid modernity" is characterised by, I quote him, "*the growing conviction that change is the only permanence, and uncertainty the only certainty. A hundred years ago 'to be modern' meant to chase 'the final state of perfection' -- now it means an infinity of improvement, with no 'final state' in sight and none desired*."

Of course Joseph Schumpeter, almost sixty years before (and he was not the first one), had already emphasised the centrality of the disruptive process of transformation that characterises modern economic reality. He described it as *"…by nature a form or method of economic change and not only never is but never can be stationary.* [...] *The fundamental impulse that sets and keeps* […] (it) *in motion comes from the new consumers' goods, the new methods of production or transportation, the new markets, the new forms of industrial organization* […] (as a) *process of industrial mutation that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one*."

When confronted with this state of affairs – a state of affairs that is admittedly disquieting and unsettling – the worst possible reaction is to retreat into nostalgic denial, and to pretend that we are living in temporary blips of disequilibrium, in exceptional situations, that will at some unspecified point in time revert to a blissful state of economic, social, cultural, political and institutional equilibria. The only reasonable approach is to endeavour tirelessly and to the best of our technical ability to navigate a reality that is complex, characterised by change and prone to crises. If there is no going back, then going forward we can only go forward.

Navigating this reality requires us to be constantly vigilant to the risks involved, a task that requires us to understand reality and to deal with it to best of our technical competences. Change brings with it challenges and opportunities, which challenges and opportunities easily morph into each other, and generate further challenges and opportunities.

Of course, the financial system, like any other, cannot reduce risk to zero. We will always face inappropriate behaviour, but we are confident that Malta's financial system can withstand the shocks generated by such behaviour, given constant vigilance.

Precisely because the economy is everybody's business, it is in everybody's business that we do not underestimate the critical importance of the technical competences required to understand and manage the challenges and opportunities that change inevitably implies. It is an aspect of contemporary reality where words matter, where words are performative, where they have practical consequences, where – therefore – it is critical that we know what we are talking about.

In this address today, my colleagues and I have highlighted some of the issues we face as we deal with change within our remit and within perspective of our main institutional objective, namely to maintain price stability within the framework of our enthusiastically committed membership of the Eurosystem and our participation in the formulation and implementation of the Eurosystem's monetary policy. The Central Bank of Malta's Mission Statement, declares that amongst our institutional obligations, we must "*contribute effectively to the stability of the financial system by identifying and assessing systemic risks and imbalances, and making the appropriate policy recommendations*", and that "*we must formulate and implement a macro-prudential policy to fulfil the tasks of the Bank as the national macro-prudential authority*". We will continue to do so with all the energy, consistency and competence required.