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ABBREVIATIONS

APP	asset purchase programme
BCI	Business Conditions Index
BLS	Bank Lending Survey
CEPII	Centre d'Etudes Prospectives et d'Informations Internationales
CPI	consumer price index
EC	European Commission
ECB	European Central Bank
EEC	European Economic Community
EER	effective exchange rate
EONIA	Euro OverNight Index Average
ESI	economic sentiment indicator
EU	European Union
EURIBOR	Euro Interbank Offered Rate
FCI	Financial Conditions Index
FOMC	Federal Open Market Committee
GDP	gross domestic product
GVA	gross value added
HCI	harmonised competitiveness indicator
HICP	Harmonised Index of Consumer Prices
IIP	Individual Investor Programme
LFS	Labour Force Survey
MFI	monetary financial institution
MGS	Malta Government Stocks
MIA	Malta International Airport
MRO	main refinancing operation
MSE	Malta Stock Exchange
NACE	statistical classification of economic activities in the European Community
NAIRU	non-accelerating inflation rate of unemployment
NEIG	non-energy industrial goods
NFC	non-financial corporation
NPISH	non-profit institutions serving households
NSO	National Statistics Office
OLS	ordinary least squares
PPI	Property Price Index
PPML	Poisson pseudo-maximum likelihood
ROW	Rest of World
RPI	Retail Price Index
SBS	Structural Business Statistics
SME	small and medium-sized enterprise
TLTRO	Targeted long-term refinancing operations
ULC	unit labour cost
UK	United Kingdom
US	United States
ZIP	zero-inflated Poisson

FOREWORD

In the first quarter of 2019, the pace of economic activity decelerated, with real gross domestic product (GDP) rising by 4.9% in annual terms, following a 7.6% increase in the preceding quarter. Growth was driven by domestic demand, as a strong increase in imports of transport equipment caused the contribution from net exports to become more negative.

Potential output growth also eased in the quarter under review, although the deceleration was less pronounced than that in GDP. In fact, the former remained relatively elevated from a historical perspective. The output surplus, measured as a four-quarter moving average, narrowed marginally compared with the fourth quarter and was well below 2015 and 2016 levels.

Meanwhile, the Bank's Business Conditions Index (BCI) fell in the first quarter of 2019, but continued to show above-average conditions, reflecting further decreases in unemployment, and an increase in tourism. The latest estimates continue to suggest that economic conditions are broadly stable, although at lower rates than the exceptional levels seen in the recent past.

Labour market conditions remained favourable in the first quarter of 2019, as employment grew strongly. Notwithstanding a further increase in labour market participation rates and rising foreign employment, the unemployment rate fell compared with the preceding year. At 3.5%, the unemployment rate remained below the Bank's structural measure of 4.1%, and thus continued to suggest a degree of tightness in the labour market.

Annual inflation based on the Harmonised Index of Consumer Prices (HICP) stood at 1.3% in March, slightly up from 1.2% in December. This pick up was largely supported by faster growth in services prices, which offset weaker dynamics in the other components. Inflation based on the Retail Prices Index (RPI), which only takes into account purchases by Maltese households, accelerated to 1.9% in March, from 1.5% three months earlier.

Cost pressures for producers eased, with the annual growth in industrial producer price index falling to 2.1% in March from 3.8% in December, reflecting slower growth in the cost of intermediate goods, which nonetheless remained the largest contributor to overall producer cost inflation. Malta's unit labour cost (ULC) index, measured on a four-quarter moving average basis, also decelerated. After a prolonged period of increases, Malta's harmonised competitiveness indicators (HCIs) contracted between December and March, thus signalling an improvement in Malta's international competitiveness.

In the first quarter of 2019, the surplus on the current account of the balance of payments decreased when compared with the corresponding quarter of 2018. The lower surplus was attributable to a widening in the merchandise trade gap as well as higher net outflows related to primary and secondary income. When measured on a four-quarter moving sum basis, the current account surplus was equivalent to 7.7% of GDP. The cyclically-adjusted measure was estimated at 8.9% of GDP. This indicates that Malta's current account surplus largely reflects structural factors.

As regards public finances, the general government balance was in deficit in the first quarter of 2019. When measured as a four-quarter moving sum, however, the balance reached a surplus of 1.9% of GDP, marginally lower than the ratio of 2.0% recorded in the previous quarter. The cyclically-adjusted surplus-to-GDP ratio broadly mirrored developments in the headline balance.

Meanwhile, the general government debt-to-GDP ratio rose by 0.7 percentage point to 46.6%, mainly due to a new issue of 62+ Government Savings bonds.

In the year to March, residents' deposits with monetary financial institutions (MFIs) in Malta expanded at a stronger pace compared with December. The shift to overnight deposits persisted, in an environment of low interest rates and a continued preference for liquidity. Meanwhile, credit growth continued to pick up, reflecting faster growth in credit to residents outside general government. Growth in mortgage loans to households and lending to non-financial corporations (NFCs) remained strong. According to the Bank's Financial Conditions Index (FCI), financing conditions were broadly neutral from a historical perspective.

The Governing Council of the European Central Bank (ECB) maintained an accommodative monetary policy stance in the first quarter of 2019. The interest rates on the main refinancing operations (MROs), on the marginal lending facility and on the deposit facility remained at 0.00%, 0.25% and -0.40%, respectively. On 6 June, the Governing Council announced that key ECB interest rates are expected to remain at their present levels through the first half of 2020.

The Governing Council further announced that it will also launch a new series of seven quarterly targeted long-term refinancing operations (TLTRO-III) starting in September 2019 and ending in March 2021, each with a maturity of two years. Counterparties will be entitled to borrow up to 30% of the eligible loan stock held as at end February 2019. The Council also extended the full allotment procedure for its lending operations at least until the end of the reserve maintenance period starting in March 2021.

The weighted average interest rate on deposits held by Maltese residents with domestic banks fell further in the first quarter of 2019. Likewise, the weighted average lending rate paid to resident MFIs by households and NFCs also decreased. The spread between the two narrowed marginally since December and remains elevated. The yield on Treasury bills stood unchanged from the rate prevailing at the end of December, while that on ten-year Malta Government Stocks (MGS) fell. Meanwhile, in the equity market, domestic share prices rose compared with their December level.

ECONOMIC SURVEY

1. THE EXTERNAL ENVIRONMENT AND THE EURO AREA

In the first quarter of 2019, economic growth as measured by real GDP edged up in the United States, the United Kingdom and the euro area. Compared with the last quarter of 2018, the three-month average unemployment rate fell slightly in the euro area and the United Kingdom, but increased marginally in the United States.

Inflation in the euro area decreased marginally from 1.5% in December to 1.4% in March. In the United Kingdom, inflation stood at 1.9% in March from 2.1% three months earlier. Meanwhile, at 1.9%, inflation in the United States was unchanged compared with December. The ECB, the Federal Reserve and the Bank of England all kept their key interest rates unchanged. However, the ECB announced a new set of TLTROs.

Brent oil prices generally increased in the first quarter of 2019, as oil supplies decreased and US sanctions against Iran and Venezuela continued to affect supply. Prices ended the quarter 35.6% higher than the level prevailing at end-December. Meanwhile, non-energy commodity prices also increased, although the rise was much less pronounced than that of oil prices.

Key advanced economies

US economy expands at a faster pace

In the first quarter of 2019, economic activity in the United States gathered pace with quarter-on-quarter real GDP growth rising to 0.8%, from 0.5% in the preceding quarter (see Table 1.1).

The acceleration in real GDP growth mainly reflected faster growth in state and local government expenditure and marginally faster growth in personal consumption spending, which offset a deceleration in private investment. Meanwhile, the contribution of net exports turned positive, as exports picked up while imports grew at a slower pace.

In the labour market, the participation rate increased marginally averaging 63.1% in the first quarter of 2019, marginally up from 63.0% in the previous quarter. However, employment grew at a slower pace, with the annual rate of increase edging down to 1.2% from 1.8% in the fourth quarter of 2018. Non-farm payroll data suggest that the slowdown in the pace of job creation was driven by the mining and logging, the construction and the manufacturing sectors. The average unemployment rate over the three months to March stood at 3.9%, 0.1 percentage point higher than

Table 1.1
REAL GDP GROWTH IN SELECTED ADVANCED ECONOMIES

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

	2017				2018				2019
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
United States	0.4	0.7	0.7	0.6	0.5	1.0	0.8	0.5	0.8
Euro area	0.7	0.7	0.7	0.7	0.4	0.4	0.1	0.2	0.4
United Kingdom	0.4	0.3	0.5	0.4	0.1	0.4	0.7	0.2	0.5

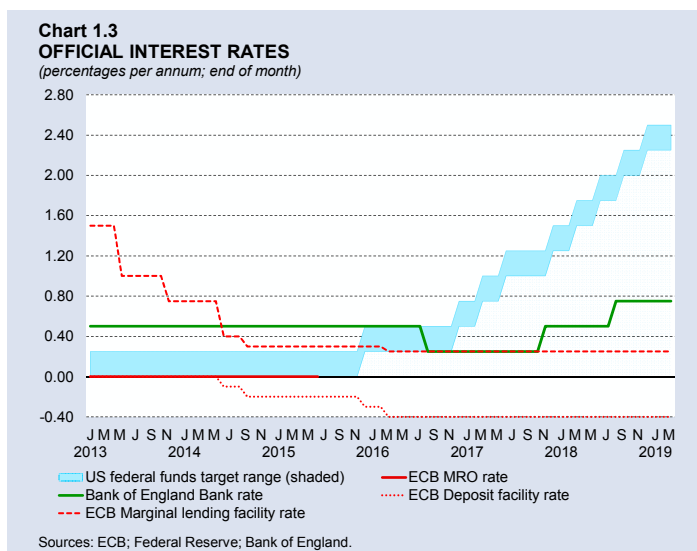
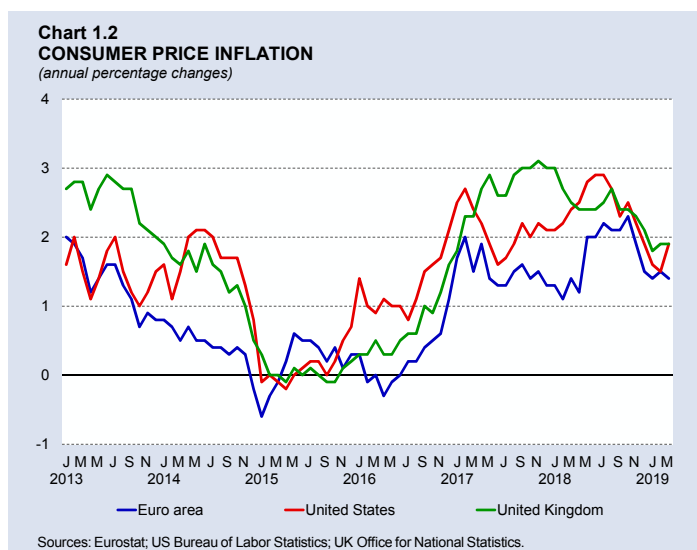
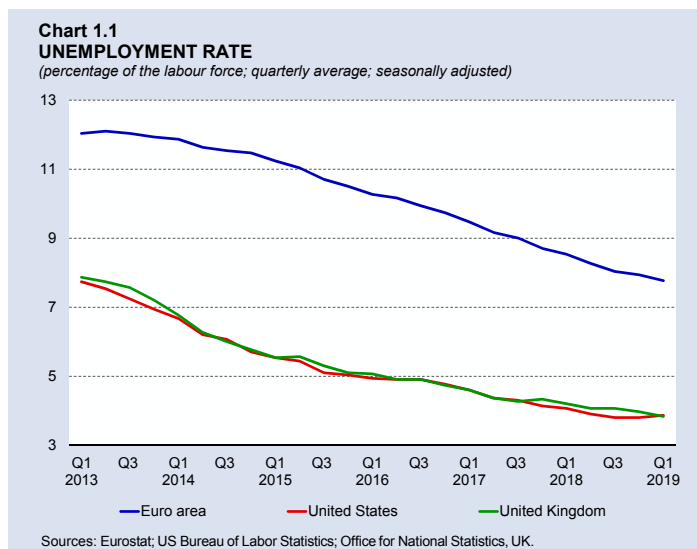
Sources: Bureau of Economic Analysis, US; Eurostat; Office for National Statistics, UK.

in the previous quarter, but still below the 4.1% recorded a year earlier (see Chart 1.1).

The annual rate of change of the US consumer price index (CPI) stood at 1.9% in March, unchanged from December (see Chart 1.2). Energy inflation was slightly more negative. It stood at -0.4% in March as against -0.3% in December. In contrast food inflation picked up while inflation excluding food and energy edged down to 2.0% from 2.2% in December.

The Federal Open Market Committee (FOMC) maintained the target range for the federal funds rate unchanged between 2.25% and 2.50% in its meetings held in January and March (see Chart 1.3). The FOMC said that it *“continues to view sustained expansion of economic activity, strong labour market conditions, and inflation near the Committee’s symmetric 2 percent objective as the most likely outcomes. In light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes.”* The Committee also decided to maintain its existing policy of reinvesting principal payments from its agency debt and mortgage-backed security holdings, and rolling over at auction principal payments from maturing Treasury securities, when these exceed specified caps.¹

¹ This assessment was broadly confirmed at the FOMC’s meetings held in the second quarter of the year.



UK economic growth increases

In the United Kingdom, quarter-on-quarter GDP growth increased to 0.5% in the first quarter of 2019, from 0.2% in the previous quarter (see Table 1.1). Investment growth turned positive, while private consumption and to a lesser degree government consumption, grew at a stronger pace compared with the preceding quarter. On the other hand, net exports shed 3.0 percentage points from GDP growth.

In the labour market, employment increased at a slower annual pace of 1.1% in the first quarter of 2019, from 1.4% in the preceding quarter. At the same time, unemployment averaged 3.8%, 0.2 percentage point lower than in the previous three-month period (see Chart 1.1).

Consumer price inflation in the United Kingdom eased further during the first quarter of 2019, standing at 1.9% in March, down from 2.1% in December (see Chart 1.2). The fall was mainly attributable to developments in energy prices. Prices of non-energy industrial goods also grew at a slower pace. On the other hand, food and, to a lesser extent, services inflation edged up. The annual rate of inflation based on the CPI excluding energy, food, alcohol and tobacco eased to 1.8% in March from 1.9% in December.

In its meetings held in February and March, the Bank of England's Monetary Policy Committee kept the Bank Rate unchanged at 0.75% (see Chart 1.3). The Committee noted that the broad-based softening in global GDP and trade growth has continued. Shifting expectations about the potential nature and timing of the United Kingdom's withdrawal from the European Union have continued to generate volatility in UK asset prices, particularly the sterling exchange rate. Brexit uncertainties also continue to weigh on confidence and short-term economic activity, notably business investment. Employment growth has been strong, although survey indicators suggest that the outlook has softened and most indicators of consumer spending were consistent with ongoing modest growth.

The Committee said that the economic outlook will continue to depend significantly on the nature and timing of the United Kingdom's withdrawal from the European Union and the response of the private sector. It also stated that if the UK economy were to develop broadly in line with the projections published in February's Inflation Report, an ongoing tightening of monetary policy over the forecast period, at a gradual pace and to a limited extent, would be appropriate.

As regards the monetary policy response to Brexit, this will not be automatic and could be in either direction. However, the current stance of monetary policy was deemed appropriate.

Meanwhile, the Committee also said that it will maintain the stock of sterling non-financial investment-grade corporate bond purchases, and the stock of UK government bond purchases, financed by the issuance of central bank reserves, at GBP 10 billion and GBP 435 billion, respectively.²

² The Bank of England's Monetary Policy Committee kept the Bank Rate unchanged in May and June. It also confirmed its policy as regards the stock of asset purchases financed by the issuance of central bank reserves and its stance on the monetary policy response to Brexit.

The euro area

GDP growth in the euro area picks up

The rate of economic expansion in the euro area edged up during the first quarter of 2019, with real GDP rising by 0.4% on a quarterly basis, following a 0.2% increase in the fourth quarter of 2018 (see Table 1.2).

The increase in real GDP during the first quarter of 2019 reflected marginal positive contributions from both domestic demand and net exports. As regards domestic demand, the main contributions stemmed from private consumption and gross capital formation. Government consumption had a negligible impact on GDP growth during the quarter under review, whilst changes in inventories shed off 0.3 percentage point from real economic growth. The contribution of net exports was modest, as the increase in exports was almost fully offset by higher imports.

Euro area inflation eases slightly

The annual rate of inflation in the euro area, measured on the basis of the HICP, eased to 1.4% in March from 1.5% in December (see Chart 1.4). Slower growth was registered across all the main sub-components except processed food. HICP excluding energy and food declined marginally, standing at 0.8% in March from 0.9% in December, mainly reflecting slightly weaker growth in services inflation.

Labour market conditions continue to improve

Labour market conditions in the euro area improved further during the quarter under review. The seasonally-adjusted unemployment rates fell to 7.7% in March from 7.9% in December and from 8.5% a

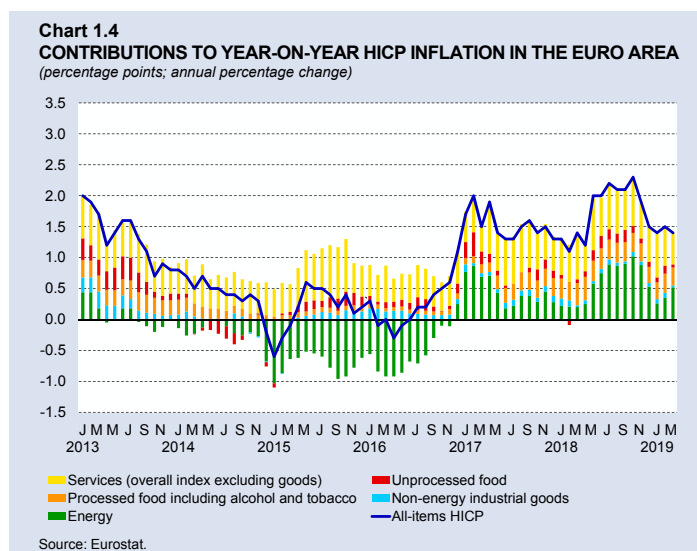


Table 1.2

CONTRIBUTIONS TO QUARTERLY REAL GDP GROWTH IN THE EURO AREA ⁽¹⁾

Seasonally and working day adjusted

	2017		2018				2019
	Q3	Q4	Q1	Q2	Q3	Q4	Q1
	<i>Percentage point contributions</i>						
Private consumption	0.3	0.1	0.3	0.1	0.1	0.1	0.3
Government consumption	0.1	0.1	0.0	0.1	0.0	0.1	0.0
Gross fixed capital formation	0.0	0.2	0.0	0.3	0.1	0.3	0.2
Changes in inventories	-0.1	-0.1	0.3	-0.1	0.4	-0.4	-0.3
Exports	0.6	1.0	-0.3	0.5	0.1	0.6	0.3
Imports	-0.2	-0.6	0.1	-0.5	-0.5	-0.5	-0.2
GDP	0.7	0.7	0.4	0.4	0.1	0.2	0.4

Source: Eurostat.

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

year earlier (see Chart 1.1). The three-month average rate fell to 7.8% in the first quarter of 2019, from 7.9% in the preceding quarter. Meanwhile, employment continued to grow, although in the quarter under review, the annual rate of change edged down marginally to 1.3% from 1.4% in the previous quarter.³

Euro area recovery to continue

According to the latest Eurosystem staff macroeconomic projections, published in June 2019, growth in real GDP was stronger than expected in the first quarter of 2019, partly due to specific factors which boosted growth temporarily. However, growth was expected to weaken in the second quarter and to increase moderately over the remainder of 2019 amid ongoing weakness in global trade in a highly uncertain global economic environment. However, over the medium-term, a number of fundamental factors should enable the euro area's economic expansion to regain traction. These include a very accommodative monetary policy stance, rising wages, higher net worth, a recovery in foreign demand and a degree of fiscal expansion.

Furthermore, the private sector should also benefit from resilient growth in lending spurred by low interest rates and favourable lending conditions as well as lower deleveraging needs. Over the medium-term, euro area exports should also benefit from a recovery in euro area foreign demand.

Nevertheless, the fading out of some headwinds would lead to slower growth towards the end of the projection horizon, mainly less favourable financing conditions and increasing labour supply constraints. Real GDP growth is projected to stand at 1.2% in 2019 as a whole, before accelerating to 1.4% in the following two years (see Table 1.3).

Private consumption growth accelerated in the first quarter of 2019, supported by robust growth in real disposable income, and should continue to grow strongly in the near term, sustained by still favourable consumer confidence, a further enhancement in labour market conditions and rising real wages. In some countries, private consumption should also benefit from a degree of fiscal loosening. Over the medium-term, private consumption should benefit from favourable bank lending conditions and rising household net worth. However, the expected gradual slowdown in employment growth and more neutral fiscal transfers are assumed to weigh down on private consumption.

Residential investment is forecasted to continue to increase, partly supported by a rising number of building permits. However, the expansion is set to progress at a more moderate pace over the

Table 1.3
MACROECONOMIC PROJECTIONS FOR THE EURO AREA⁽¹⁾
Annual percentage changes

	2018	2019	2020	2021
GDP	1.8	1.2	1.4	1.4
Private consumption	1.3	1.4	1.4	1.3
Government consumption	1.1	1.4	1.4	1.4
Gross fixed capital formation	3.3	2.7	2.0	2.0
Exports	3.2	2.2	2.9	3.2
Imports	3.2	2.7	3.2	3.4
HICP	1.8	1.3	1.4	1.6

Source: ECB.

⁽¹⁾ ECB staff macroeconomic projections (March 2019).

³ National accounts data.

projection horizon. This reflects increasing binding capacity constraints in the construction sector, adverse demographic trends in some countries and a decline in the share of households expecting to undertake home improvements in the following quarters.

Business investment is also expected to increase, but at a subdued pace. This reflects persistent concerns about global trade policies, a no-deal Brexit and a hard landing in China, all of which have adverse effects on business confidence. Nonetheless, growth is expected to be supported by a number of favourable fundamentals; high rates of capacity utilisation, supportive financing conditions and increasing profitability.

Growth in government consumption is expected to pick up to 1.4% in 2019 and remain unchanged thereafter.

On the external side, extra-euro area exports are forecasted to weaken and fall below the pace of foreign demand in the first half of 2019, amidst an adverse international environment. Over the medium term, extra-euro area exports are projected to recover and grow broadly in line with foreign demand. Extra-euro area exports are set to benefit from some gains in export market shares, offset by the effects of trade uncertainty as the composition of euro area exports tilts towards investment-related products. Meanwhile, extra-euro area imports are anticipated to grow in line with aggregate demand (domestic demand plus exports). As imports are estimated to outpace exports, the contribution of net trade is expected to turn negative during the remainder of 2019 and remain broadly neutral over the projected horizon.

Compared with the ECB staff projections published in March 2019, euro area real GDP growth was revised upwards by 0.1 percentage point in 2019. On the contrary, it was revised downwards by 0.2 and 0.1 percentage points in 2020 and 2021, respectively.

Country projections indicate that growth in the euro area is expected to be broad-based across Member States, but the expansion is set to moderate gradually in all countries (see Chart 1.5). Nonetheless, average growth rates over the projection horizon are anticipated to be quite diverse, ranging from a low of 0.6% in Italy to a high of 4.4% in Malta.

HICP inflation is set to fall from 1.8% in 2018 to 1.3% in 2019, before picking up to 1.4% in 2020. It is set to reach 1.6% by 2021. The decrease in 2019 is driven by expected developments in energy inflation. Meanwhile, food inflation is projected to hover around the rates of 2.0%.

In contrast, HICP inflation excluding energy and food is set to rise progressively over the forecast horizon, reaching 1.6% in 2021, from 1.0% in 2018. The



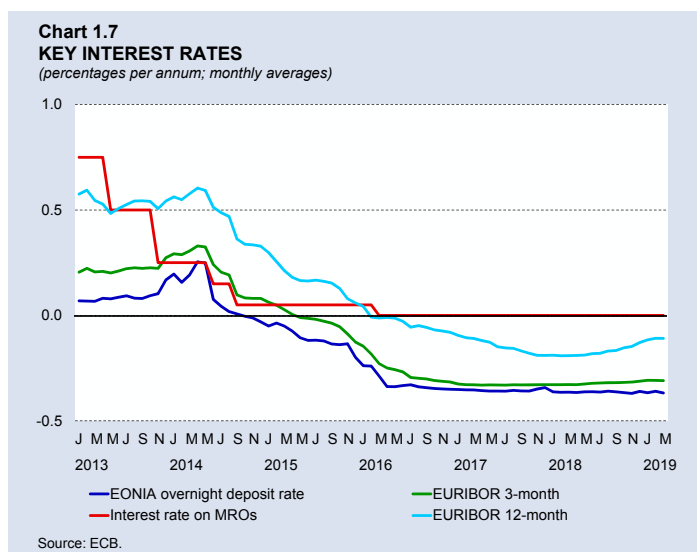
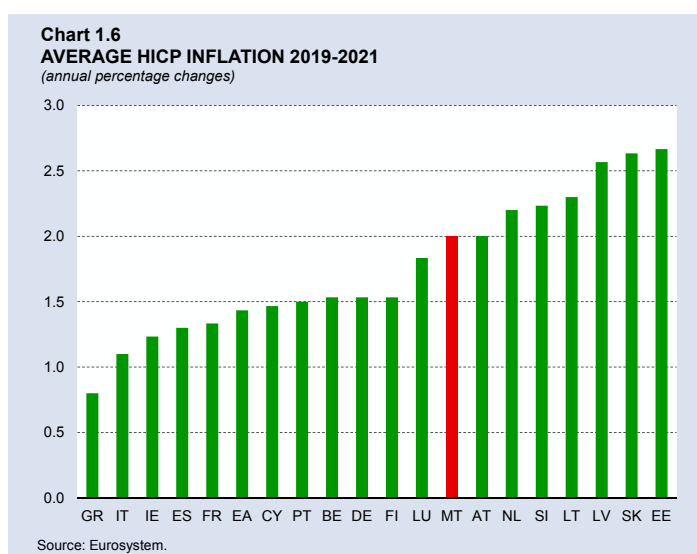
gradual upward path in this measure of inflation is expected to be supported by the continued economic expansion. Additionally, tighter conditions in the labour market should push up wage growth, while rising non-energy commodity prices should increase domestic cost pressures.

Compared with the March 2019 projections, overall inflation was revised slightly upwards in 2019 and downwards in 2020. These revisions are largely explained by the energy component which was revised upwards for 2019, due to stronger growth in oil prices, and downwards for 2020, due to a more steeply downward sloping profile for oil price futures. HICP inflation excluding energy and food is revised marginally downwards for the near term, mainly reflecting weaker data out-turns, but is otherwise unchanged compared with the March 2019 ECB staff projections.

From a cross-country perspective, inflation is expected to decelerate in the majority of euro area countries over the projection horizon. The lowest average inflation rate between 2019 and 2021 is expected to be recorded in Greece, at 0.8%, while the highest average rate is projected in Estonia, at 2.7% (see Chart 1.6). Inflation in Malta is set to average 2.0% over the forecast horizon, above the average of 1.4% for the euro area as a whole.

ECB maintained its accommodative monetary policy stance

The ECB's Governing Council continued with its accommodative monetary policy stance during the first quarter of 2019. The interest rates on the MROs, the marginal lending facility and the deposit facility remained at 0.00%, 0.25% and -0.40%, respectively (see Chart 1.7). The Council reiterated that it expected key ECB interest rates to remain at their present levels at least through the end of 2019 and in any case for as long as necessary to ensure the continued sustained convergence of inflation at levels below but close to 2% over the medium term.⁴



⁴ On 6 June, the Governing Council announced that key ECB interest rates are expected to remain at their present levels through the first half of 2020. The Governing Council further announced that the interest rate in each TLTRO-III operation will be set at a level that is 10 basis points above the average rate applied in the Eurosystem's main refinancing operations over the life of the respective TLTRO. For banks whose eligible net lending exceeds a benchmark, the TLTRO-III rate will be lower and can be as low as the average interest rate on the deposit facility prevailing over the life of the operation plus 10 basis points.

In March, the Governing Council also reaffirmed its intention to reinvest in full the principal payments from maturing securities under the Programme for an extended period of time past the date when it starts raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.

The Governing Council further announced that it will also launch a new series of seven quarterly targeted long-term refinancing operations (TLTRO-III) starting in September 2019 and ending in March 2021, each with a maturity of two years. Counterparties will be entitled to borrow up to 30% of the eligible loan stock held as at end February 2019. The Council also extended the full allotment procedure for its lending operations at least until the end of the reserve maintenance period starting in March 2021.

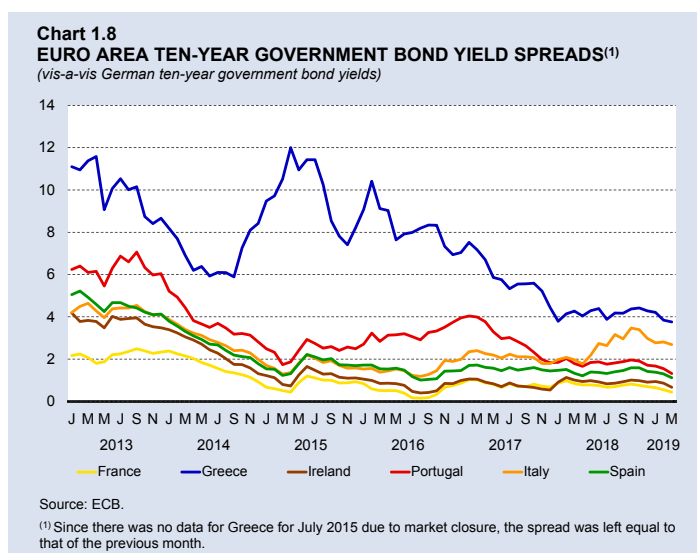
Money market rates remain subdued

Money market rates in the euro area remained rather flat during the first quarter of 2019, reflecting the accommodative monetary policy stance of the ECB. The EONIA overnight deposit rate declined marginally from its December level of -0.36% to -0.37% (see Chart 1.7), whilst the three-month EURIBOR remained unchanged at -0.31% in March. Meanwhile, the twelve-month EURIBOR rate rose to -0.11% in March, from -0.13% in December.⁵

Euro area bond yields decline

Ten-year benchmark government bond yields in the euro area decreased during the first quarter of 2019. The strongest decline was registered in Greek bond yields which fell by 52 basis points to 3.76%. Portuguese, Spanish and Italian bond yields followed, declining by 39, 30 and 29 basis points, to 1.32%, 1.12% and 2.69%, respectively. At the same time, German bond yields edged down by 18 basis points, reaching a 30-month low of 0.01%. The broad-based decrease in long-term euro area yields during the quarter under review partly reflected the markets' expectations of a slower intended pace of monetary policy tightening in the United States, with these expectations spilling also in the euro area. A number of worse than expected data releases for the euro area also contributed. Towards the end of the quarter, moreover, investors appeared more pre-disposed to invest in higher risk bonds, as yields in Germany fell towards 0.0%.

As in most countries government bond yields fell more strongly than they did in Germany, spreads over the ten-year German bond yield generally narrowed during the first quarter. The largest spread compression was recorded in



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 Over Night Index Average) is an effective overnight interest rate, measured as the weighted average of the interest rates on unsecured overnight lending transactions, in euro denomination, as reported by a panel of contributing banks.

Greece, amid perceptions that the country continues to recover from its debt crisis (see Chart 1.8).

The euro depreciates in effective terms

The euro weakened against a number of major currencies during the first quarter of 2019, with the nominal effective exchange rate against the EER-19 group of countries falling by 2.0%.⁶

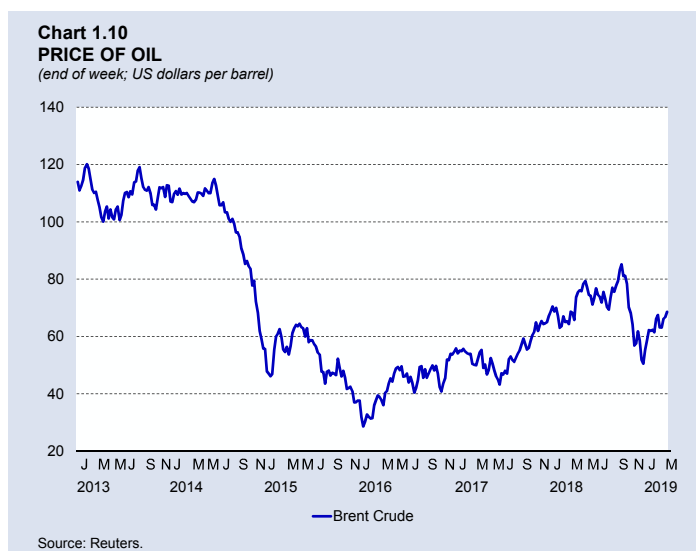
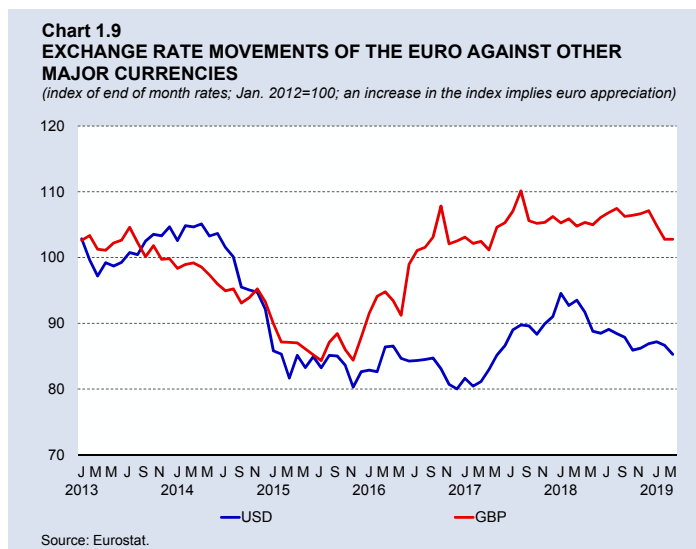
On balance, the euro declined by 1.9% and 4.1% against the US dollar and the British pound, respectively (see Chart 1.9). It also weakened against a number of other currencies, including the Japanese yen and the Chinese yuan renminbi.

Commodities

Commodity prices rise

During the first quarter of 2019, the price of Brent crude oil mostly rose. By the end of March, it stood at USD 68.5 per barrel, a 35.6% increase over the price prevailing at the end of December 2018 (see Chart 1.10). The recent recovery in the international oil price was mainly driven by lower oil supplies amid high compliance with the key suppliers' agreement to cut production. Moreover, US sanctions against Iran and Venezuela and power outages in Venezuela also negatively impacted supply.

As regards non-energy commodity prices, World Bank data show that these increased during the first quarter of 2019. Between December and March, non-energy commodity prices rose by 2.0%.



⁶ The EER-19 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.

2. OUTPUT AND EMPLOYMENT

Real GDP growth rose by 4.9% in annual terms, following a 7.6% increase in the fourth quarter of 2018. Growth was driven by domestic demand, as a strong increase in imports of transport equipment caused the contribution from net exports to become more negative. Nominal data on GVA show that the expansion continued to be largely supported by services, although GVA also rose in the manufacturing and construction sectors.

The Bank's BCI continued to indicate above-average conditions, although it dropped to 0.6 in the first quarter of 2019, from 1.0 in the final quarter of 2018.

The output surplus, measured as a four-quarter moving average, narrowed marginally compared with the fourth quarter of 2018. It was higher than the level estimated for the same quarter of 2018, but well below 2015 and 2016 levels.

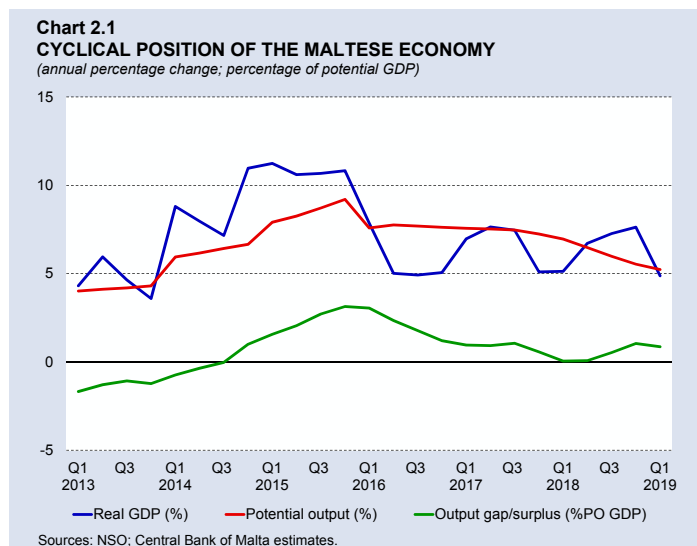
Labour market conditions remained favourable in the first quarter of 2019, as employment grew strongly. The unemployment rate based on the Labour Force Survey (LFS) fell compared with the preceding year, notwithstanding a further increase in labour market participation rates and rising foreign employment. In part, this reflects the robust pace of economic expansion and improved job matching in the context of a buoyant economy. The unemployment rate remained below the Bank's structural measure and thus continued to suggest a degree of tightness in the labour market during the quarter under review.

Potential output and BCI

Positive output gap narrow^{1,2}

In the first quarter of 2019, potential output growth eased slightly, although it remained relatively elevated from a historical perspective (see Chart 2.1). Potential output growth is estimated to have moderated to 5.2%, from 5.5% in the fourth quarter of 2018. GDP growth also decelerated, standing at 4.9% from 7.6% in the preceding quarter.

When measured as a four-quarter moving average, the output gap is estimated at 0.9% in the first quarter, below the 1.0% recorded in the previous quarter, yet above the 0.0% recorded in the corresponding quarter



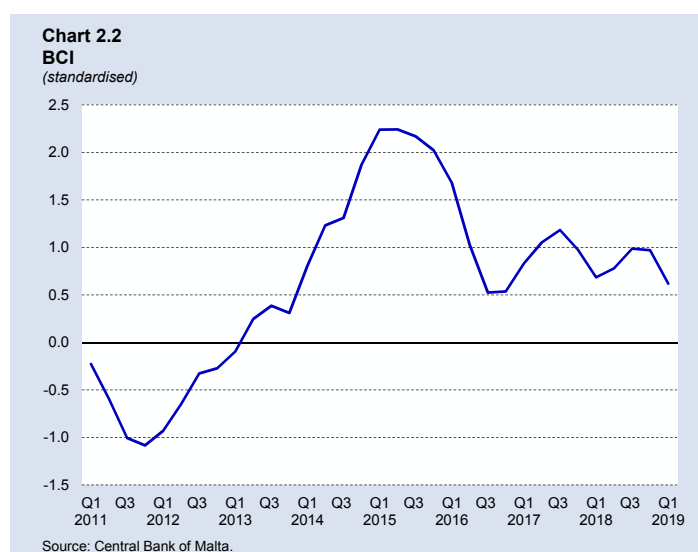
¹ Potential output measures the medium-to-long-term level of real output which is sustainable in an economy. The estimates presented here are derived using a production function approach. For further details on the methodology adopted see Micallef, B. and Ellul, R. (2017), "Medium-term Estimates of Potential Output Growth in Malta", in Grech, A. G. and Zerafa, S. (Eds.), Challenges and Opportunities of Sustainable Economic Growth: the Case of Malta, Central Bank of Malta.

² Real GDP and potential output are reported as annual growth rates in the respective quarter. The output gap/surplus is expressed as a percentage of potential output on the basis of four-quarter moving averages.

of 2018.³ The degree of over-utilisation of the economy's productive capacity thus remained well below levels seen in 2015 and 2016. Potential growth continues to be boosted by an increasing number of foreign workers and higher labour participation, with the labour contribution remaining close to its historical highs.

BCI falls⁴

In the first quarter of 2019, the Bank's BCI fell when compared with the preceding quarter (see Chart 2.2). The index stood at 0.6, significantly lower than the value in the previous quarter although comparable with an updated value of 0.7 a year earlier. The BCI continued to show above-average conditions, with further decreases in unemployment, and an increase in tourism. The latest estimates continue to suggest that economic conditions are broadly stable, although at lower rates than the exceptional levels seen in the recent past.



GDP and industrial production

Real GDP grows at a slower pace

The pace of economic activity decelerated in the first quarter of 2019, with real GDP rising by 4.9% on an annual basis, following a 7.6% increase in the previous quarter.⁵

Slower growth was underpinned by net exports, which shed 7.0 percentage point from GDP growth in the quarter under review. While exports edged up slightly, imports increased significantly compared with the corresponding quarter of 2018, resulting in a strongly negative net export contribution. On the other hand, domestic demand contributed 11.9 percentage points to GDP growth in the quarter under review (see Table 2.1). All domestic demand components rose on a year earlier, with gross fixed capital formation and government consumption driving most of this increase.

Private consumption expenditure grew by 3.9% in annual terms and added 1.8 percentage points to real GDP growth. It continued to be sustained by a buoyant labour market and, consequently, continued strong growth in compensation of employees. Nominal data show that the rise in

³ The output gap may be viewed as a gauge of over or underutilisation of the productive capacity of the economy over the business cycle. A positive gap signals overutilisation of resources, whereas a negative one indicates underutilised resources.

⁴ The BCI is a synthetic indicator, which includes information from a number of economic variables such as the term-structure of interest rates, industrial production, an indicator for the services sector, economic sentiment, tax revenues and private sector credit. By construction it has an average value of zero over the estimation period since 2000. A full time series can be found at <https://www.centralbankmalta.org/business-conditions-index>. For further details on the methodology underlying the BCI, see Ellul, R., (2016), "A real-time measure of business conditions in Malta," Working Paper 05/2016.

⁵ The analysis of GDP in this Chapter of the *Quarterly Review* is based on data published in NSO *News Release* 090/2019 and released on 4 June 2019.

Table 2.1
GDP⁽¹⁾

	2018				2019
	Q1	Q2	Q3	Q4	Q1
Private final consumption expenditure	4.8	8.7	8.2	7.5	3.9
Government final consumption expenditure	3.9	12.2	7.0	28.6	24.2
Gross fixed capital formation	-17.8	10.0	3.7	-0.1	31.8
Domestic demand	1.7	15.3	9.0	11.2	14.3
Exports of goods and services	3.6	1.2	4.4	-2.3	0.9
Imports of goods and services	1.5	5.4	4.8	-1.7	6.0
Gross domestic product	5.1	6.7	7.3	7.6	4.9
Private final consumption expenditure	2.3	3.8	3.5	3.3	1.8
Government final consumption expenditure	0.6	2.0	1.0	4.2	4.0
Gross fixed capital formation	-4.1	1.8	0.7	0.0	5.7
Changes in inventories	2.6	4.2	1.5	1.5	0.4
Domestic demand	1.4	11.8	6.6	8.9	11.9
Exports of goods and services	5.9	1.9	6.3	-3.5	1.5
Imports of goods and services	-2.1	-7.0	-5.6	2.1	-8.5
Net exports	3.7	-5.1	0.7	-1.3	-7.0
Gross domestic product	5.1	6.7	7.3	7.6	4.9

Sources: NSO; Central Bank of Malta calculations.

⁽¹⁾ Chain-linked volumes, reference year 2010.

expenditure was broad-based across expenditure categories, although the strongest increase in absolute terms was recorded in spending on housing, water, electricity, gas and other fuels.

Following an expansion of 28.6% in the fourth quarter of 2018, government consumption expenditure rose by 24.2% in the first quarter of 2019 and added 4.0 percentage points to annual GDP growth. This was in part due to higher outlays on intermediate consumption, including outlays on health and maintenance. Compensation of employees also rose on the same quarter of 2018, although the increase in the latter was less pronounced than that in intermediate consumption. At the same time, revenue from sales, which is netted against expenditure in national accounts declined, due to lower receipts related to the Individual Investor Programme (IIP).

Following a marginal decline of 0.1% in the previous quarter, real gross fixed capital formation increased by 31.8% in the first quarter of 2019 and contributed 5.7 percentage points to real GDP growth.

The rise in gross fixed capital formation was driven by all subcomponents except for investment in cultivated biological resources, which declined marginally on a year earlier. Total machinery investment was the main driver of the increase in total gross fixed capital formation with over 60% of the total increase in investment arising in this component. During the quarter under review, this component was boosted by significant investment in new sea vessels.

Changes in inventories contributed 0.4 percentage point to GDP growth in the first quarter of 2019.

While exports increased by 0.9% in the first quarter of 2019, imports increased by 6.0% on a year earlier. As a result, net exports shed 7.0 percentage points from real GDP growth. Such

developments reflected trade in goods, in particular the aforementioned investment in sea vessels. The services balance remained in surplus, as services exports outpaced services imports.

Nominal GDP growth decelerates; services remain the main driver of growth

Nominal GDP rose by 7.4% in annual terms during the first quarter of 2019, after increasing by 9.8% in the previous quarter (see Table 2.2). The deceleration partly reflected slower growth in GVA, which rose at an annual rate of 7.3% in the first quarter of 2019, after growing by 8.5% in the preceding quarter. In the quarter under review, GVA contributed 6.5 percentage points to nominal growth.⁶

Services remained the main driver of activity, adding 5.9 percentage points to nominal GDP growth. The largest additions came from the sector comprising professional and scientific activities, the sector which included arts and entertainment as well as public administration. Together, these three sectors contributed 3.7 percentage points to nominal GDP growth. Wholesale and retail trade, real estate activities, financial and insurance activities, as well as information and communication jointly added a further 2.1 percentage points. The contribution from construction and manufacturing stood at 0.4 and 0.3 respectively, while the agriculture and fishing sector as well as mining, quarrying and utilities sector had a negligible impact on GDP growth.

GDP data by income distribution show that gross operating surplus decelerated during the first quarter of 2019, rising by 9.4% on an annual basis, following a 13.0% increase in the fourth quarter

Table 2.2
CONTRIBUTION OF SECTORAL GVA TO NOMINAL GDP GROWTH

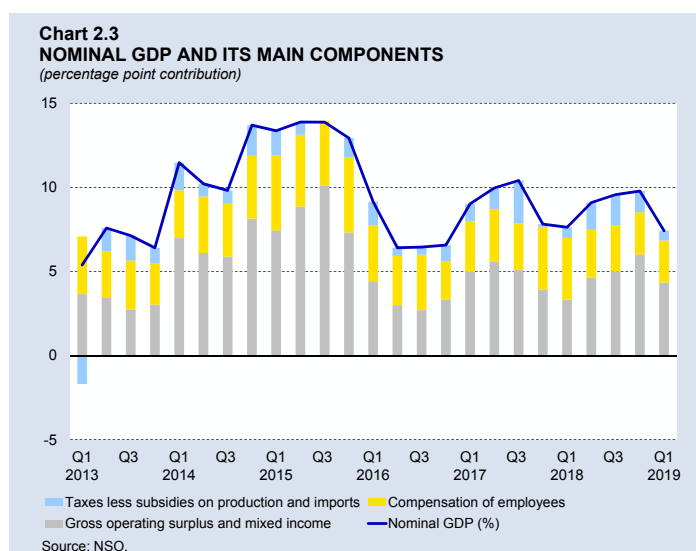
Percentage points

	Q1	2018			2019
		Q2	Q3	Q4	Q1
Agriculture, forestry and fishing	0.2	0.0	0.0	0.6	0.0
Mining and quarrying; utilities	0.2	0.3	0.3	-0.1	0.0
Manufacturing	0.2	0.7	0.7	1.0	0.3
Construction	0.4	0.3	0.3	0.4	0.4
Services	6.2	6.1	6.3	5.5	5.9
<i>of which:</i>					
Wholesale and retail trade; repair of motor vehicles; transportation; accommodation and related activities	1.0	0.7	0.6	0.6	0.9
Information and communication	0.4	0.2	0.4	0.1	0.4
Financial and insurance activities	0.4	0.7	0.4	0.6	0.4
Real estate activities	0.5	0.6	0.5	0.7	0.5
Professional, scientific, administrative and related activities	1.0	1.1	1.6	1.1	1.5
Public administration and defence; education; health and related activities	1.6	1.1	1.1	1.2	1.0
Arts, entertainment; household repair and related services	1.3	1.7	1.6	1.2	1.2
GVA	7.2	7.4	7.7	7.5	6.5
Taxes less subsidies on products	0.4	1.7	1.9	2.3	0.9
Annual nominal GDP growth (%)	7.6	9.1	9.6	9.8	7.4

Source: NSO.

⁶ The difference between nominal GDP and GVA is made up of taxes on products, net of subsidies.

of 2018. It contributed 4.3 percentage points to nominal GDP growth (see Chart 2.3). Compensation of employees continued to rise robustly, although the pace of growth moderated marginally to 5.9% from 6.0% in the last quarter of 2018. The latter added 2.5 percentage points to nominal growth. Net taxes on production and imports also increased on a year earlier and explain the remaining 0.6 percentage point contribution to nominal GDP growth.



Almost all sectors registered higher gross operating surplus when compared with the same quarter a year earlier, with the arts, entertainment and recreation sector as well as wholesale and retail trade sector, accounting for a significant share of the increase.

Compensation of employees continued to grow in almost all sectors, with the largest absolute increase registered in the sector incorporating public administration and defence. This was followed by the sector comprising professional, scientific and technical activities as well as the arts and entertainment sector.

Industrial production falls in the first quarter of 2019

During the first quarter of 2019, industrial production contracted by 1.5% when compared with the same quarter of 2018.⁷ This followed an expansion of 4.0% in the preceding quarter (see Table 2.3).

The contraction in activity in the quarter under review reflected developments within the manufacturing sector. Production in this sector, which accounts for over 80% of the index, fell by 4.3% in annual terms, following an expansion of 3.9% in the preceding quarter. On the other hand production in the quarrying sector rose by 24.4%, although this sector has a very small weight in the overall industrial production index. Output also rose strongly in the energy sector, where production increased by 15.3% compared with the first quarter of 2018.

Within the manufacturing sector, output declined strongly among producers of pharmaceuticals. Significant declines were also registered in the rubber and plastics and in the food sectors. Lower production was also registered among firms that produce beverages as well as in the computer, electronic and optical products sector. The “other manufacturing” sub-sector, which includes medical and dental instruments, toys and related products, also recorded a small decrease in production. These decreases more than offset higher production among producers involved in

⁷ 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 and takes no account of input costs. The sectoral 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.

Table 2.3
INDUSTRIAL PRODUCTION⁽¹⁾

Percentages; annual percentage changes

	Shares	2018				2019
		Q1	Q2	Q3	Q4	Q1
Industrial production	100.0	2.1	0.8	-1.9	4.0	-1.5
Manufacturing	87.1	-2.7	-0.7	-2.2	3.9	-4.3
<i>of which:</i>						
Food products	15.4	-15.3	-14.7	2.7	1.8	-9.0
"Other" manufacturing	10.3	-2.0	-10.5	-7.4	11.7	-1.8
Repair and installation of machinery and equipment	7.9	5.3	5.6	-8.9	6.7	4.5
Basic pharmaceutical products and pharmaceutical preparations	7.3	9.5	-1.6	-45.0	-18.6	-41.2
Printing and reproduction of recorded media	7.3	9.3	45.3	50.0	37.4	17.1
Beverages	5.6	2.4	4.2	3.8	1.7	-3.0
Rubber and plastic products	5.4	-4.7	-7.6	-11.4	-15.9	-11.9
Computer, electronic and optical products	5.0	-28.4	-24.6	3.5	-0.2	-0.8
Energy	12.5	38.9	13.8	1.8	11.0	15.3
Mining and quarrying	0.5	-0.7	46.4	24.9	25.2	24.4

Sources: NSO; Eurostat.

⁽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.

the printing and reproduction of recorded media and in the repair and installation of machinery and equipment.

BOX 1: SMALL AND MEDIUM-SIZED ENTERPRISES' (SMEs) CONTRIBUTION TO THE MALTESE ECONOMY¹

In recent years Malta's economy has expanded rapidly. Media reports tend to give greater exposure to large projects and new sectors, such as remote gaming, which may suggest that these are mostly contributing to economic growth. By contrast, this box uses data on value added and employment from Eurostat's Structural Business Statistics (SBS) to show that SMEs in the business economy sector (which excludes remote gaming²) were, in fact, the main drivers of growth in Malta.³ SBS data, in fact, indicate that in 2016 the value added of the business economy sector in Malta totalled €5.5 billion, up from €3.2 billion in 2010. During this period, the share of business economy SMEs rose from 39.6% to 47.6% of the Maltese economy's gross value added.

The latest estimates of the size of business economy SMEs in Malta

Table 1 shows value added by firm size⁴ and by economic sector for Malta. While data for the aggregates by size are readily available from the Eurostat database, for a significant number of cases of sectors by size (e.g. value added of construction and real estate small

¹ Prepared by Dr Aaron G Grech, Chief Officer - Economics. The views expressed in this Box, which are a summary of a broader article (Grech A.G. (2018), *SMEs' contribution to the Maltese economy and future prospects*, Central Bank of Malta, Policy Note, October) are the author's own and do not necessarily reflect the views of the Bank.

² Besides this sector, the business economy sector excludes agriculture and fisheries, financial services, public administration, education, social work, health, arts and recreation activities.

³ The analysis will be carried out till 2016, the last year for which SBS data was available at the time of writing.

⁴ Micro firms are those with less than 10 employees, small firms are enterprise having less than 50 employees, while medium-sized firms have between 50 and 249 employees.

Table 1
VALUE ADDED BY FIRM SIZE AND BY ECONOMIC SECTOR IN 2016 (€ millions)

	Micro	Small	Medium	Large	Total
Total	1,900	1,393	1,066	1,153	5,512
Industry	145 *	216 *	190	361 *	912 *
Construction and real estate	334 *	203 *	68 *	17 *	622 *
Wholesale and retail trade	445 *	376	204	15 *	1,040
Transport	79	111 *	173 *	231	594 *
Accommodation and food services	80	75 *	155	82 *	392
Information and communication	197	135 *	131	141 *	604
Professional services	385	196 *	78 *	157 *	816
Administrative support services	235	81	67	149	532

Sources: Eurostat; author's estimates where indicated by *.

firms) the figures shown in the Table are author's estimates. The latter were based on either past available data for these types of firms adjusted in line with more recent information on other variables such as employment for that category, or else derived as residuals from available information on sub-aggregates.

Focusing solely on the value added of the business economy sector, micro enterprises accounted for 34.5% of this total, as against 25.3% for small firms, 19.3% for medium-sized firms and 20.9% for large firms. This pattern differs by sub-sector. Construction and real estate are dominated by micro firms (that account for 53.7% of value added in the sector), while large firms account for a negligible share. The latter can also be said of the wholesale and retail sector, though within this sector small firms also account for a very large share. In the accommodation and food services sector, medium-sized firms account for approximately 39.5% of value added (double the proportion observed in other sub-sectors); while in the transport sub-sector it is large firms that account for this share.

Micro wholesale and retail firms account for the largest relative share in value added in Malta. They, in fact, generated €445.0 million in 2016, equivalent to 8.1% of the overall value added of the business economy sector or nearly a quarter of the value added of all Maltese micro firms. They were closely followed in importance by micro professional services firms, with about 7.0% of the overall value added of the business economy, and micro construction and real estate firms that accounted for 6.1%. Large industrial firms contributed 6.5% of business economy value added, making them the third largest business economy sector in Malta.

The business economy sector in Malta accounted for 69.3% of total employment in 2016. Table 2 presents a sectoral breakdown of employment within Malta's business economy sector by firm size. Micro firms comprise a third of all employment in the business economy sector, while small and medium enterprises amount to nearly a quarter each. Similarly to what was observed for value added, employment in the Maltese construction and wholesale and retail sectors is dominated by micro firms. SMEs account for the lion's share of employment of most sub-sectors in Malta, with the exception of administrative support services and transportation where large firms account nearly half of employment, while in industry large firms employ nearly a third of the workforce.

Table 2
EMPLOYMENT BY FIRM SIZE AND BY ECONOMIC SECTOR IN 2016

	Micro	Small	Medium	Large	Total
Total	45,922	33,881	31,841	30,962	142,606
Industry	4,307	5,902	5,671	8,900 *	24,780
Construction and real estate	7,093 *	2,162 *	1,984	1,671	12,911
Wholesale and retail trade	16,548	10,044	6,519	1,242	34,353
Transport	2,113	2,248 *	2,111 *	5,374	11,846
Accommodation and food services	5,783 *	4,880	6,303	2,290 *	19,255
Information and communication	1,954 *	2,086	2,516	2,004 *	8,560
Professional services	5,701	4,032	2,464	1,669	13,867
Administrative support services	2,423	2,527	4,273	7,812	17,034

Sources: Eurostat; author's estimates where indicated by *.

Micro wholesale and retail firms, who comprise the largest sectoral share of Malta's business economy value added, also account for the largest sectoral share of employment. However their share of employment, at nearly 11.6% of overall business economy employment, is much larger than their share of value added, at 8.1%. This contrasts with the second largest business economy category in terms of value added, i.e. micro firms operating in professional services. These firms account for 4.0% of overall business economy employment and 7.0% of its value added. On the other hand, large industrial firms (the third largest category) and micro construction firms (the fourth largest category) have similar relative shares in both value added and employment.

The growth of business economy SMEs since 2010

SBS data suggest that between 2010 and 2016, the contribution of business economy SMEs rose. Taken together, micro, small and medium-sized firms in the business economy sector increased their share in Malta's total gross value added from 39.6% to 47.6%. If one excludes Malta's non-business economy sector, growth in value added would have still been more than double the increase observed in the EU economy as a whole. SBS data suggests that instead of becoming more concentrated, economic activity in Malta is spreading over a growing number of SMEs.

For instance, between 2010 and 2016 micro-firms in professional services, information and communication and administrative support services increased their value added by €557 million, more than doubling their initial activity. In 2016 these firms employed approximately 10,000 persons, up by a quarter since 2010. Although they accounted for one in twenty of all employees in Malta, they contributed one sixth of the growth in value added during this period. By contrast small-sized wholesale and retail firms, who also employed about one in twenty of all employees in 2016, saw an increase of €211 million between 2010 and 2016, implying a contribution of one-fourteenth of overall growth in value added.

Table 3 shows estimates of the growth in value added of SMEs by sector as a percentage of the overall growth in value added in the Maltese economy between 2010 and 2016. To provide some perspective, the remote gaming sector – the sector that tends to attract most attention in the media as the driver of economic expansion – accounted for approximately

Table 3
SME CONTRIBUTION BY SECTOR (% OF 2010-2016 ECONOMY WIDE GROWTH)

	Micro	Small	Medium
Business Economy	31	21	13
Industry	0 *	1 *	0 *
Construction and real estate	3 *	4 *	1
Wholesale and retail trade	8 *	7	3 *
Transport	1	1 *	3 *
Accommodation and food services	1	1 *	2
Information and communication	4	3 *	2 *
Professional services	8	3 *	1 *
Administrative support services	5	1 *	1 *

Sources: Eurostat; author's estimates where indicated by *.

20.8% of overall growth in value added during this period. Table 3 indicates that SMEs in the business economy sector accounted for a much larger contribution, of close to two-thirds. The relative importance of micro firms in the business economy sector in generating value added has risen considerably over time, more than keeping pace with the growth of the remote gaming sector. In absolute terms, the rise in the remote gaming's value added mirrored the increase observed among micro-firms in professional services, information and communication and administrative support services.

Looking at employment growth during the same period, the rise observed in the remote gaming sector was only slightly higher than that seen amongst small-sized professional services firms and the same as that of micro wholesale and retail firms. Taken together, business economy SMEs accounted for nearly half of the growth in employment between 2010 and 2016. Comparing Table 3 and Table 4, there is a noticeable difference between the contribution to growth in value added of micro firms and their relative share of employment growth. This reflects the fact that micro-firms in professional services, information and communication and administrative support services accounted for a significantly smaller rise in employment than their very substantial contribution to growth in value added.

These trends show how vital the contribution of SMEs has been to the recent acceleration in growth of the Maltese economy. A recent survey carried out by the European Investment

Table 4
SME SHARE OF 2010-2016 ECONOMY WIDE GROWTH IN EMPLOYMENT

	Micro	Small	Medium
Business Economy	14	21	14
Industry	-1	0	-0
Construction & real estate	1 *	0 *	-0
Wholesale & retail trade	7	3 *	4
Transport	-0	1 *	1 *
Accommodation and food services	3 *	5	0
Information & communication	1 *	3 *	1 *
Professional services	2	6 *	3 *
Administrative support services	1	2	4

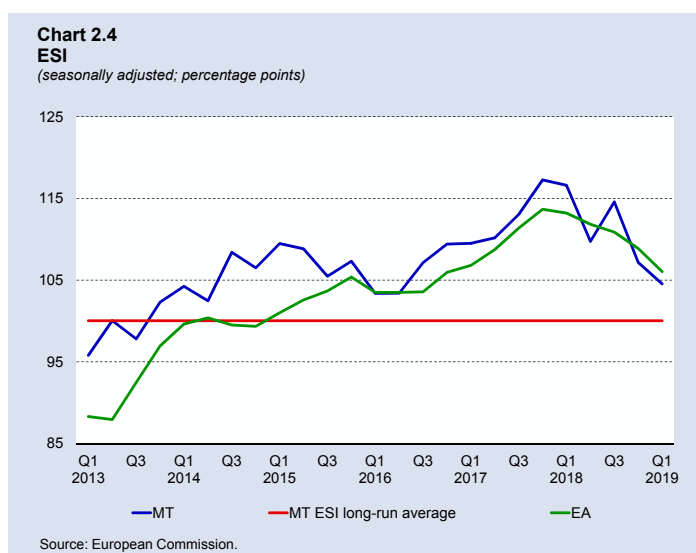
Sources: Eurostat; author's estimates where indicated by *.

Bank⁵ indicates that micro and small firms in Malta are planning to focus their investment much more to be able to launch new products, including improving their use of information technology. This suggests the potential for further growth in this sector. However, the survey shows that micro and small firms are relying to a large extent on internal financing, while they are facing significant skills shortages and infrastructure gaps. It is very important that policymakers use the current strong economic situation to take steps to ensure that SMEs operate in an optimal business environment, with better access to finance and skilled labour, and be sustained by an adequate infrastructure.

⁵ See “Business and investment and investment finance in Malta – Evidence from the EIBIS 2018 survey”, Quarterly Review 2019:2, Central Bank of Malta.

Business and consumer surveys

During the first quarter of 2019, the Economic Sentiment Indicator (ESI) declined to 104.5, from 107.2 in the preceding quarter. Notwithstanding this fall, it remained above its long-term average of 100.1 (see Chart 2.4).^{8,9} Sentiment weakened in industry and services as well as among consumers. In contrast, it improved in the construction and retail sectors. In the first quarter of 2019, the ESI for Malta fell below that in the euro area, where it averaged 106.0.



Confidence in the services sector declines¹⁰

Sentiment in the services sector edged down to 29.1 from 34.9 in the preceding quarter, but still stood above its long-term average of 23.2. The fall in confidence was mainly driven by respondents' weaker outlook for demand in the three months ahead, and, to a lesser extent, in the assessment of demand and of the business situation over the past three months (see Chart 2.5).

⁸ The ESI summarises developments in confidence in five surveyed sectors (industry, services, construction, retail and consumers). Quarterly data are three-month averages.

⁹ Long-term averages are calculated over the entire period for which data are available. For the consumer and industrial confidence indicators, data for Malta 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.

¹⁰ 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.

Supplementary survey data indicate that employment expectations were less optimistic than those in the preceding quarter, while a lower net share of respondents anticipated prices to increase in the three months ahead.

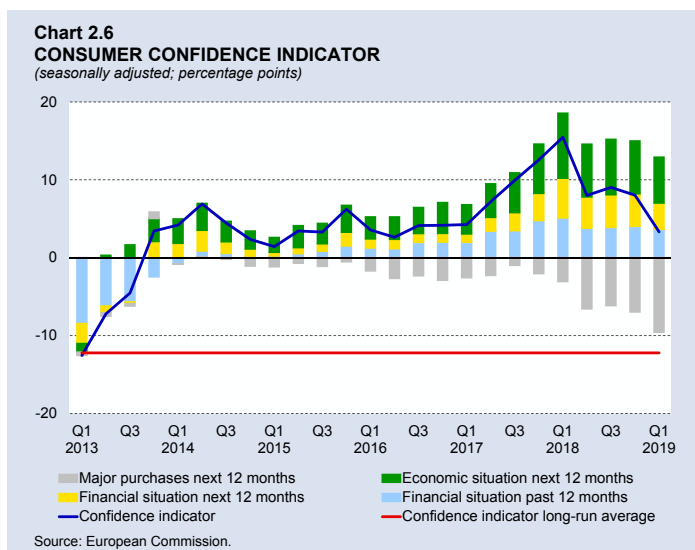
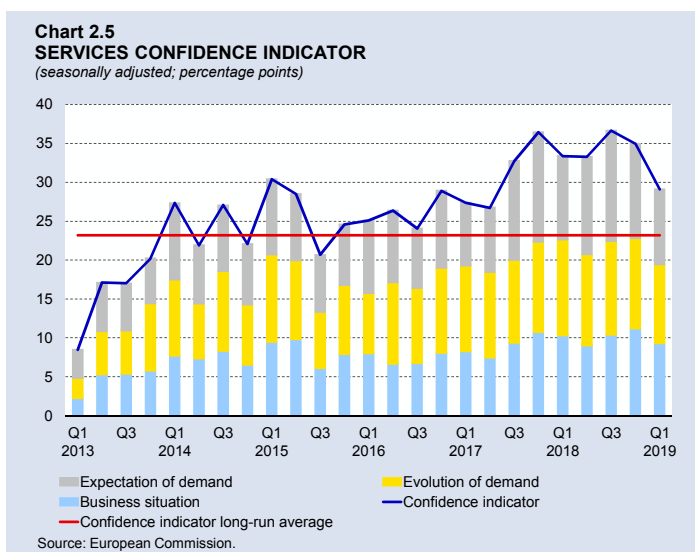
Consumer confidence weakens¹¹

Although consumer confidence fell from 8.0 in the last quarter of 2018 to 3.3 in the quarter under review, it remained above its long-run average of -12.2 (see Chart 2.6). Consumers' expectations of major purchases over the next 12 months were the main driver behind the latest decrease. However, respondents' assessment of their past and future financial situation also weakened. Respondents were also less optimistic about the general economic situation during the next 12 months.

Additional survey data suggest that on balance, a larger share of consumers expected prices to rise. At the same time, a lower net share of respondents expected unemployment to fall in the months ahead.¹²

Industrial confidence edges down marginally¹³

Confidence in the industrial sector stood at -2.0 in the quarter under review, down from -0.9 in the previous three-month period, lingering marginally above its long-term average of -3.0 (see Chart 2.7). During the quarter under review, production expectations, while still positive, weakened compared to the fourth quarter of 2018. At the same time, a higher share of respondents



¹¹ 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' assessment and expectations of their financial situation, their expectations about the general economic situation and their intention to make major purchases over the subsequent 12 months. The computation of this indicator was changed as reflected in the [January 2019 release](#) of the European Commission.

¹² Negative unemployment expectations affect the overall indicator in a positive way. Thus a fall in the number of respondents expecting unemployment to fall affects the overall indicator in a negative way.

¹³ 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.

reported falling orders. Meanwhile, the assessment of stock levels improved, as fewer firms reported above normal stocks of finished goods.¹⁴

Additional survey data show that on balance, a larger share of respondents anticipated an increase in employment. Meanwhile, selling price expectations turned positive.

Confidence in construction rebounds¹⁵

In the first quarter of 2019, confidence in the construction sector rose sharply to 34.1, from 7.5 in the preceding quarter, exceeding by a wide margin its long-term average of -14.2 (see Chart 2.8).

Survey results show that both subcomponents improved significantly during the quarter under review.

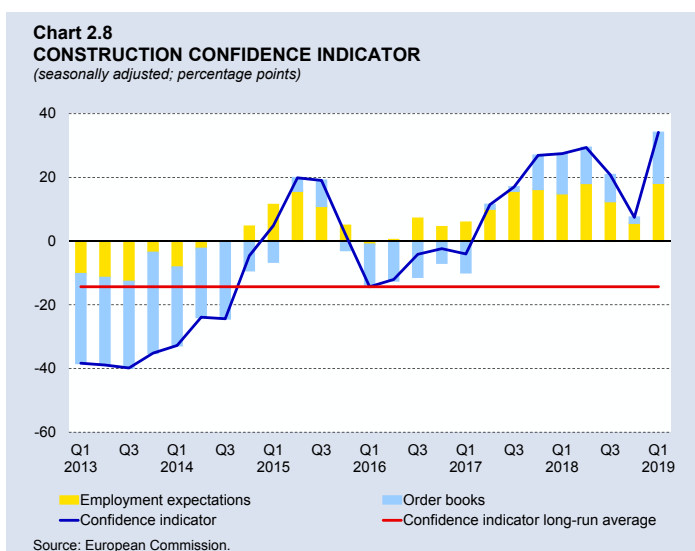
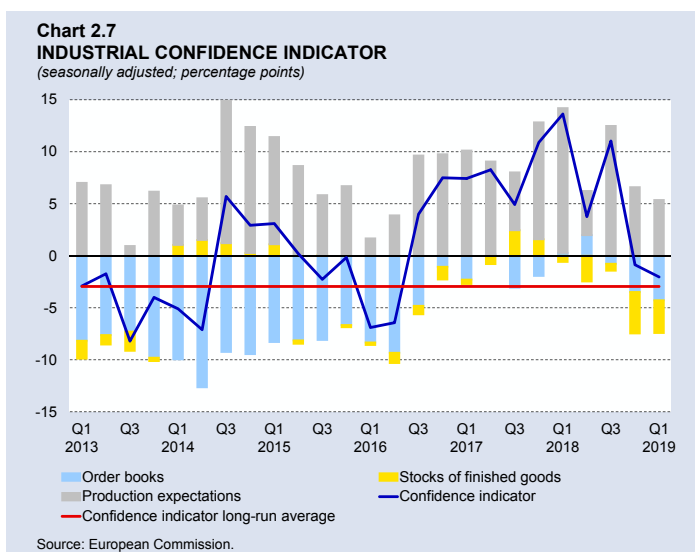
Supplementary survey data indicate that, on balance, a larger share of respondents anticipated higher inflation in the next quarter, whilst a greater net percentage of firms reported positive developments in building activity during the preceding three months, amid increasing labour shortages and, to a lesser extent, increasing financial constraints.

Supplementary survey data indicate that, on balance, a larger share of respondents anticipated higher inflation in the next quarter, whilst a greater net percentage of firms reported positive developments in building activity during the preceding three months, amid increasing labour shortages and, to a lesser extent, increasing financial constraints.

Confidence in the retail sector recovers¹⁶

Sentiment in the retail sector rose to 10.7 from 0.9 in the fourth quarter of 2018, thus exceeding its long-term average of 2.8 (see Chart 2.9).

The recent rise in confidence was driven by firms' assessment of business activity in the past three months and their expectations for the next three months.¹⁷ In contrast, a larger share of



¹⁴ 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 2.7.

¹⁵ 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.

¹⁶ 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.

¹⁷ A fall in the balance of above-normal stock levels affects the overall indicator in a positive way.

respondents considered that their stock levels were above normal.

Additional survey data indicate that on balance, a larger share of respondents expected employment to rise in the following quarters. Meanwhile, expectations for order levels turned positive. In contrast, retailers' price expectations turned negative.

The labour market¹⁸

Labour force continues to grow strongly

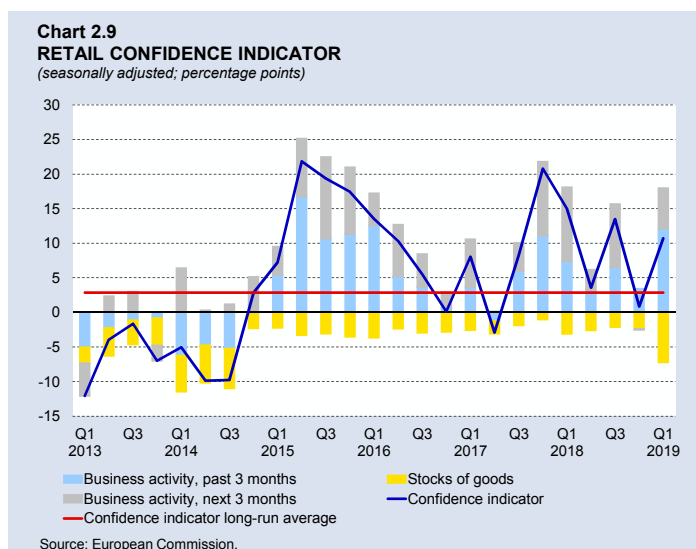
LFS data show that in the first quarter of 2019 the labour force grew by 6.2% over the same quarter of 2018 (see Table 2.4).¹⁹ Employment rose by 6.6% in annual terms, while the number of unemployed declined by 3.9%.

The activity rate stood at 74.9% in the quarter under review, up from 72.6% in the corresponding quarter of 2018, and above the euro area average of 73.4%.²⁰ This reflected increased activity among both females and males, with the former registering the largest increase. Indeed, the female participation rate increased by 3.9 percentage points, to reach 64.6%, while that of males edged up by 0.9 percentage point to 84.6%. Notwithstanding the significant increase in the female participation rate, it remained below the euro area average of 68.3%. On the other hand, the activity rate of males continued to exceed the euro area average, which stood at 78.5%.

Employment continues to grow at a fast pace

In absolute terms, the annual increase in employment in the first quarter of 2019 mostly reflected growth in the number of full-time jobs (see Table 2.4). These increased by 12,963, or 6.7% in annual terms, while the number of part-timers, which includes those employed on a full-time with reduced hours basis, rose by 1,954, or 6.1%.

During the first quarter of 2019, the overall employment rate rose by 2.5 percentage points on the same period of 2018, to 72.2%.²¹ The male and female employment rates increased by 1.3 and 3.7 percentage points, respectively. The male employment rate reached 81.6%, from 80.3% a year earlier, while that of females rose to 62.1% from 58.4%. Both male and female employment



¹⁸ This section draws mainly on labour market statistics from two sources: the Labour Force Survey (LFS), which is a household survey conducted by the NSO on the basis of definitions set by the International Labour Organization and Eurostat, and administrative records compiled by Jobsplus according to definitions established by domestic legislation on employment and social security benefits.

¹⁹ The LFS defines the labour force as all persons aged 15 and over who are 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.

²⁰ 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.

²¹ 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.

Table 2.4
LABOUR MARKET INDICATORS BASED ON THE LFS

Persons; annual percentage changes

	2018 Q1	2019 Q1	Annual change %
Labour force	235,762	250,321	6.2
Employed	226,551	241,468	6.6
<i>By type of employment:</i>			
Full-time	194,742	207,705	6.7
Part-time	31,809	33,763	6.1
Unemployed	9,211	8,853	-3.9
Activity rate (%)	72.6	74.9	
Male	83.7	84.6	
Female	60.7	64.6	
Employment rate (%)	69.7	72.2	
Male	80.3	81.6	
Female	58.4	62.1	
Unemployment rate (%)	3.9	3.5	
Male	3.9	3.4	
Female	3.9	3.8	

Source: NSO.

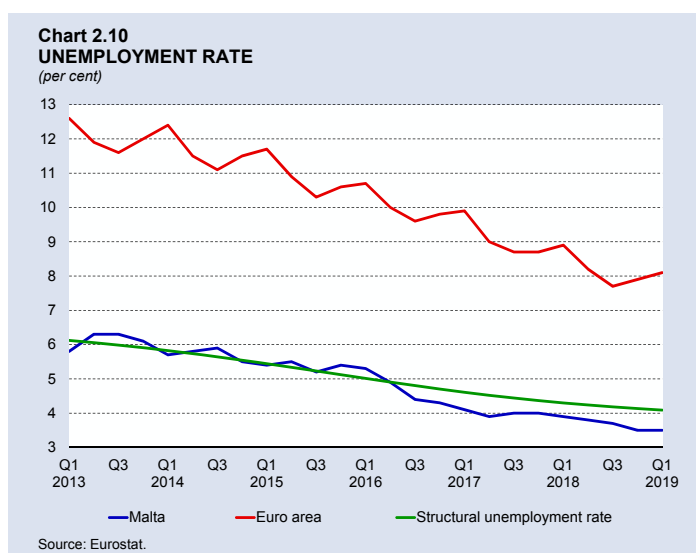
rates of those aged between 25 and 64 increased, while the employment rate of those aged 15 to 24 declined for both genders.

These developments imply that the Government continued to exceed the Europe 2020 target of 70% for the employment rate.²² In fact, according to the LFS, the employment rate for those aged between 20 and 64 stood at 76.4% in the first quarter of 2019.

The unemployment rate edges down

In the first quarter of 2019, the unemployment rate stood at 3.5%. This was lower than the 3.9% recorded a year earlier and unchanged from the fourth quarter of 2018.²³ The jobless rate for males edged down by 0.5 percentage point in annual terms, to 3.4%, while that of females fell by 0.1 percentage point to 3.8% (see Table 2.4).

The unemployment rate in Malta remains well below

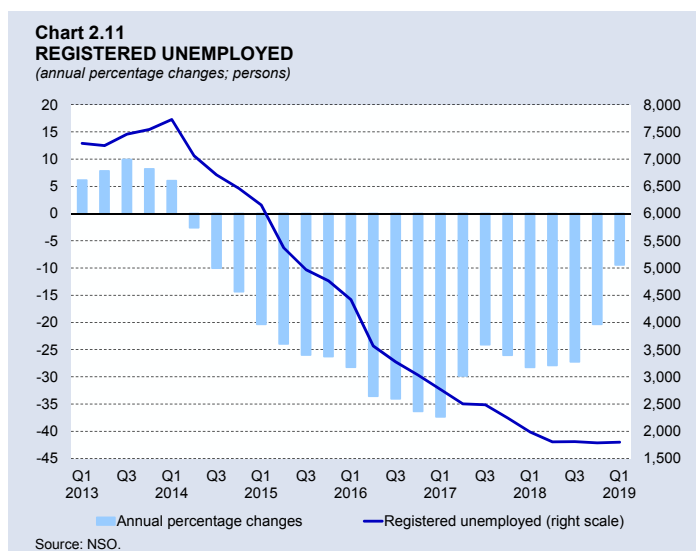


²² See *The National Employment Policy*, Ministry for Education and Employment, May 2014, p.13 and *Malta: National Reform Programme 2019*, Ministry for Finance, April 2019, p.41.

²³ According to the LFS the unemployed comprise persons aged between 15 and 74 years who are without work, available for work and who have actively sought work during the four weeks preceding the Survey. In contrast, the number of unemployed on the basis of the Jobsplus definition includes only those persons registering for work under Part 1 and Part 2 of the unemployment register.

the average rate for the euro area, which stood at 8.1% in the quarter under review (see Chart 2.10). The unemployment gap remained negative, as the unemployment rate remained below the Bank's structural measure of 4.1% in the first quarter of 2019.²⁴

Jobsplus data also show favourable labour market developments. The average number of registered unemployed stood at 1,799 in the first quarter of 2019, 187 persons less than a year earlier (see Chart 2.11).



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

BOX 2: THE EFFECT OF FOREIGN WORKERS AND THE PENSION REFORM ON THE PARTICIPATION RATE: A COHORT APPROACH¹

Introduction

The structure of the labour market is a fundamental determinant of a country's long-run productivity and potential output. At the same time, the decision to participate in the labour market is determined by a number of socio economic factors whose relevance varies across age, gender and time. Analysing the behaviour of different age and gender groups is therefore essential for understanding what drives the overall participation rate, its likely future evolution, and the implications for a country's potential output in the years ahead.

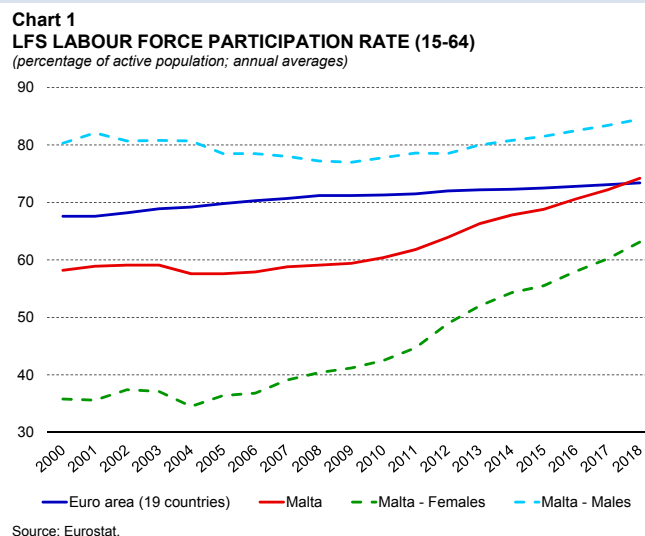
Recent developments in the Maltese labour market

LFS data show a strong increase in Malta's participation rate for those aged 15 to 64 since the country's accession to the European Union, from 57.6% in 2004 to 74.2% in 2018. Following these increases, for the first time since the inception of the survey, in 2018 Malta's participation rate stood above the euro area average of 73.7% (see Chart 1). Most of

¹ Prepared by Abigail Marie Rapa, senior economist within the Economic Analysis Department of the Central Bank of Malta. This Box applies the main methodology of Rapa, A. M. (2019) "A cohort approach to project the labour participation rate in Malta", Policy Note April 2019, Central Bank of Malta, to the 2018 Q4 LFS vintage. 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.

²⁴ The structural unemployment rate in this chapter refers to the non-accelerating inflation rate of unemployment (NAIRU), that is, the unemployment rate that is consistent with stable inflation. This measure of the unemployment rate is based on a multivariate filter as described in Micallef, B. (2014). "A Multivariate filter to estimate potential output and NAIRU for the Maltese economy," *Working Paper* 05/2014.

this rise can be attributed to gains in the female participation rate, which rose by 28.6 percentage points over this period, to 63.1%. Similarly, the male participation rate rose to an all-time high of 84.5%, from 80.7% in 2004. These developments were driven by a number of measures aimed at reaching the Europe 2020 target employment rate of 70% for those between 20 and 64 years old, which was achieved in 2016.²



Data on age-cohort profiles over time indicate that the profile of age-cohort participation rates for males has been fairly stable, whereas that of females has changed significantly. When analysing age-cohort profiles, one can also note that the participation rates of younger cohorts have decreased, while those of older cohorts have increased among both males and females. While the former reflects increased participation in post-secondary education, the latter reflects the implementation of the recent pension reform. Furthermore, the increased influx of foreign workers has led to changes in the participation rates among younger and middle-aged groups as well as among females.

Projections of the overall participation rate using a cohort model

In the light of these developments, a five-year cohort model of participation rates based on Carone (2005) is used to project LFS-consistent aggregate participation rates for the medium run, while taking into account gender, age, period and cohort effects.³

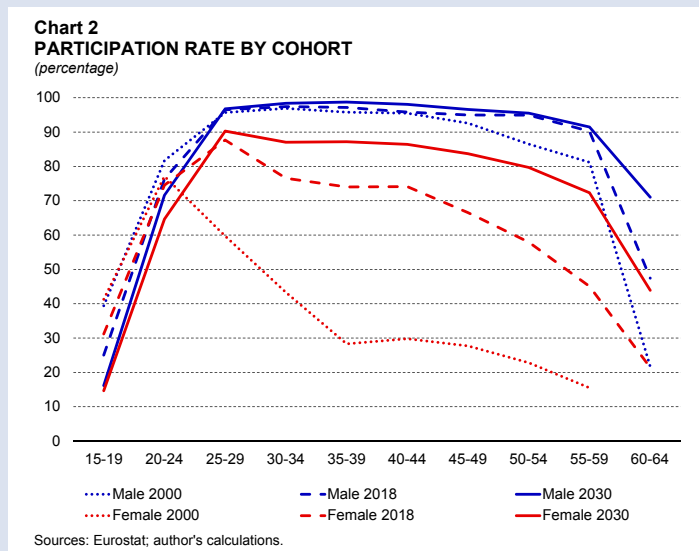
The overall participation rates are projected in three steps. First, the Maltese working age population by five-year cohort is forecasted using official past demographic data and EUROPOP-2015 projections. The number of foreign nationals are then forecasted by combining own assumptions on foreign worker flows for the immediate years (taking into account recent data on migration flows from Jobsplus administrative records) and, EUROPOP-2015 projections for more distant years.

Second, cohort-specific participation rates are projected by applying the rates of exit and entry from the labour force as appropriate, taking in consideration past patterns in gender and age-period-cohort characteristics, using the approach in Carone (2005). Given the substantial shifts within the Maltese labour market over the very recent years, this study largely

² See The National Employment Policy, Ministry for Education and Employment, May 2014, p.13 and *Malta: National Reform Programme 2019*, Ministry for Finance, April 2019, p.41.

³ In this study we analyse and forecast the labour supply of the following five-year cohorts; 15-19, 20-24, 25-29, 30-34, 35-39, 40-44, 45-49, 50-54, 55-59 and 60-64.

applies the average rates between 2014 and 2017 for most cohorts.⁴ Apart from taking into account the age effects, this dynamic cohort methodology also considers the development of labour market participation across different generations. Finally, the overall participation rate is obtained by weighting cohort specific participation rates by their relative share in total population in each period.



Using the dynamic cohort approach and under the assumption of no further policy changes other than those expected up to 2026 in relation to the pension reform, one can note that, as in recent years, both male and female participation rates of the first two cohorts are expected to continue to decline in the next decade. This is mainly driven by a higher proportion of people aged between 15 and 29 who seek higher education attainment levels. Driven mainly by the recent pension reform, activity among the older male cohort is expected to continue to increase. Older females are also expected to experience this effect given that the pension reform applies to both genders. However, age-period-cohort effects are also relevant in this case, as they are expected to gradually shift the participation of middle-aged females to higher levels. Also, the age-cohort profile of the female participation rate is expected to gradually become closer in shape to that of males implying a continued catching up process over the forecast horizon (see Chart 2). As a result, the female participation rate is expected to reach 74.5%, whilst the overall LFS participation rate is expected to reach 81.0% in 2030, from 74.2% in 2018.

The impact from a sustained influx of foreign workers and the pension reform

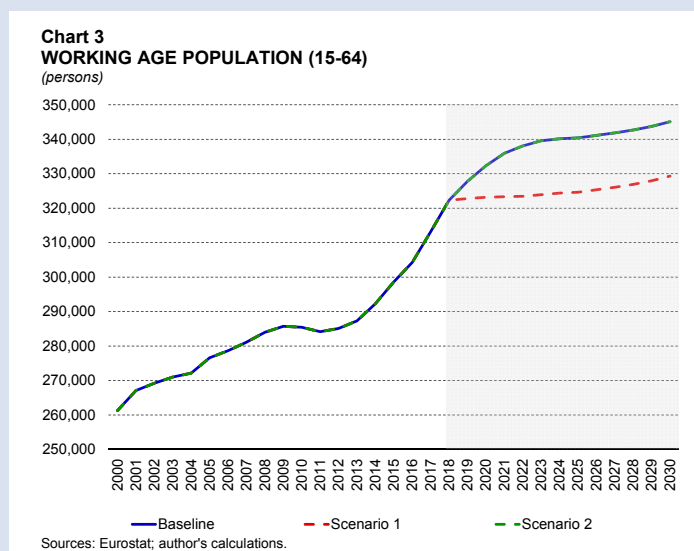
The implementation of the recent pension reform and the sustained influx of foreign workers in the Maltese labour market are two factors heavily shaping developments in both male and female participation rates. Since EU accession in 2004, the Maltese labour market has become ever more affected by the influx of foreigners. Since most foreign nationals who moved to Malta in recent years did so to seek employment, this has inevitably led to an increase in the overall participation rate. Moreover, the recent pension reform has resulted in significantly higher participation rates among the older age cohorts, serving as another push factor for the overall participation rate.

⁴ For further details about the computation of the rates of entry and exit refer to Rapa, A. M. (2019) "Forecasting the labour participation rate in Malta using a cohort approach", *Economic Projections*, Central Bank of Malta, June 2019.

Whereas, demographic statistics indicate that foreign nationals within the Maltese population have increased by an average of 8,283 in the three years to 2017, the EUROPOP-2015 population projections suggest a flow of 2,727 in 2017 which declines to 2,267 by 2030. In light of the apparent underestimation of the population of foreign nationals within EUROPOP-2015 data, the baseline scenario estimate for foreigners uses alternative assumptions that take into account the latest demographic and administrative flows data. The baseline scenario assumes that the projected number of foreign workers residing in Malta will continue to increase over the forecast horizon, with an average annual net flow of 4,122 persons over the period 2018-2030, which compares with an average of 2,401 in EUROPOP-2015. The net flow used in the baseline drops to the net flow forecasted by EUROPOP-2015 from 2025 onwards. In order to gauge the sensitivity of the results to the assumptions underpinning the baseline scenario, the participation rates derived in the previous section are re-estimated using the flows of EUROPOP-2015 migration projections (Scenario 1).

Scenario 2 estimates the impact of Malta's pension reform on the aggregate participation rate, driven by developments in the participation rates of the older cohort. The pension reform introduced in 2012 has raised the pension age to 62 for individuals born between 1952 and 1955, to 63 for those born between 1956 and 1958, 64 for persons born between 1959 and 1961 and to 65 for those born from 1962 onwards.⁵ This implies that the first effects from the pension reform were registered in 2013, with the final rise in pension age taking place in 2026. In order to estimate the effect of the pension reform on the overall participation rate, Scenario 2 uses the average rate of exit calculated over the period 2009-2012 for the 60-64 age bracket instead of the average rate of exit estimated for the period 2014 to 2017. The results are shown in Chart 3 and Chart 4.

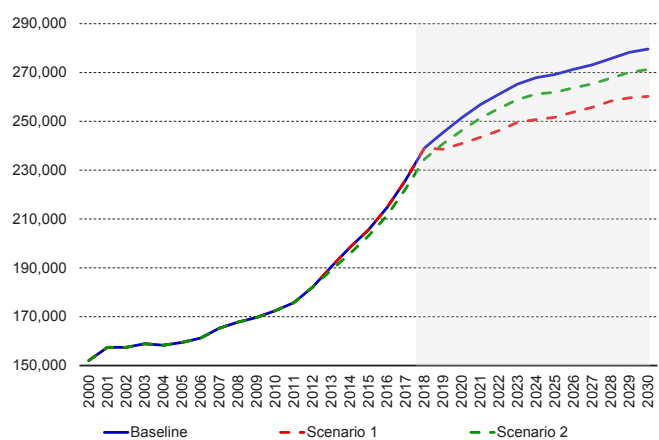
Chart 3 shows that EUROPOP-2015 inward migration estimates are consistent with a significantly lower working age population when compared to the baseline forecasts. The difference between the two series represents the cumulative difference between the flow estimates used in the baseline scenario and those predicted by EUROPOP-2015, confirming that the projected net inflow of foreign



⁵ For further analysis on the effects of the pension reform on the Maltese economy, refer to Grech A. (2016) "The Possible Impact of Pension Age Changes on Malta's Potential Output", *Policy Note* April 2016, Central Bank of Malta.

nationals is a substantial driver behind working-age population growth in Malta. Although the baseline working age population over the projection horizon exceeds that consistent with Scenario 1 by a wide margin, this partly reflects the fact that, according to the LFS the number of foreigners in Malta in 2018 (55,900) already substantially exceeds the EUROPOP-2015 figure for that year (11,491).

Chart 4
LFS LABOUR SUPPLY (15-64)
(persons)



Sources: Eurostat; author's calculations.

The lower working age population level in Scenario 1 implies an almost equivalent difference in the forecasted labour supply (see Charts 3 and 4). Since foreign nationals tend to have a higher participation rate than Maltese nationals, Scenario 1 entails a lower forecasted participation rate of 79.0% in 2030, compared to 81.0% in the baseline (see Table 1). The initial impact of higher migrant flows on the participation rate is estimated at around 1.0 percentage point in 2019. The impact reaches 2.0 percentage points by the end of the forecast horizon. The contribution of a continued influx of foreign nationals within the Maltese labour force affects both the male and female participation rates.

As regards the pension reform (Scenario 2), this has no impact on the working age population, as individuals affected by the pension reform are already included in the working age population. As the pension reform started to have an effect in 2013, the labour supply is affected already in that year. As shown in Chart 4, the introduction of the pension reform is estimated to have a more muted effect on the labour supply compared with the sustained influx of foreign workers. On the other hand, its effect on the aggregate participation rate is estimated to be higher than that attributed to the sustained influx of foreign workers by the end of the forecast horizon (see Table 1). As soon as the pension reform was introduced, it immediately boosted the participation rate by 0.5 percentage point in 2013. This impact increases to 2.4 percentage points by the end of our forecast horizon. The impact of the pension reforms on the aggregate participation rate is mainly visible in the male component. Indeed by 2030, under the no pension reform scenario, the estimated participation rate of males is around 2.8 percentage points lower than that in the baseline scenario, while the participation rate of females is estimated to be around 2.0 percentage points lower than in the baseline.

This analysis indicates that more than half of the forecasted increase in the participation rate between 2019 and 2030 can be attributed to the sustained influx of foreign nationals

Table 1
PARTICIPATION RATE BASED ON LFS¹

Per cent of total working age population

	Baseline	Scenario 1	Scenario 2
2000	58.2	58.2	58.2
2001-2005 ⁽²⁾	58.4	58.4	58.4
2006-2010 ⁽²⁾	59.1	59.1	59.1
2011	61.9	61.9	61.9
2012	63.9	63.9	63.9
2013	66.3	66.3	65.8
2014	67.8	67.8	67.0
2015	68.8	68.8	68.0
2016	70.6	70.6	69.5
2017	72.2	72.2	71.0
2018	74.2	74.2	72.8
2019	74.9	73.9	73.5
2020	75.7	74.5	74.1
2021	76.5	75.3	74.8
2022	77.2	76.1	75.5
2023	78.1	77.0	76.3
2024	78.8	77.3	76.8
2025	79.1	77.5	76.9
2026	79.5	78.0	77.3
2027	79.9	78.4	77.6
2028	80.5	79.0	78.1
2029	81.0	79.2	78.6
2030	81.0	79.0	78.6

Sources: Eurostat; author's calculations.

⁽¹⁾ Forecasted figures are shown in bold.

⁽²⁾ Five year averages.

and the pension reform. The remaining increase reflects cultural changes and the unfolding effects of other recent reforms aimed at increasing activity, whose effect has not been specifically estimated in this study.

3. PRICES, COSTS AND COMPETITIVENESS

Annual inflation as measured by the HICP stood at a moderate 1.3% in March, slightly up from 1.2% in December. This pick up was largely supported by faster growth in services prices, which offset weaker dynamics in the other components. Meanwhile, annual inflation based on the RPI, which only takes into account expenditure by Maltese residents, accelerated to 1.9%, from 1.5% three months earlier.

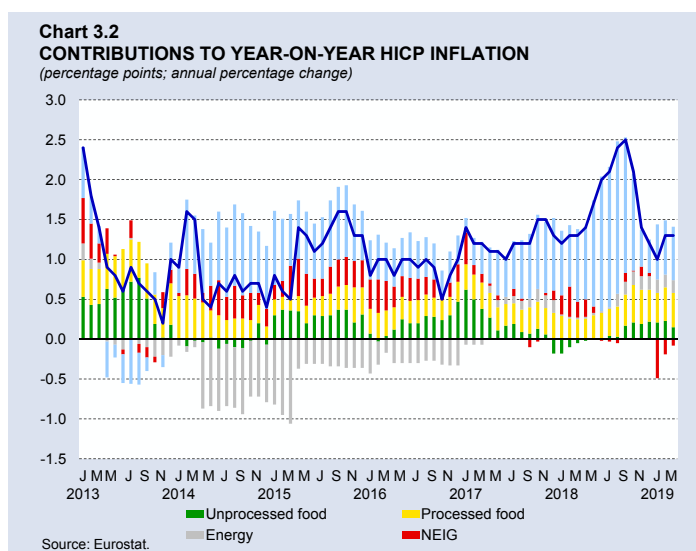
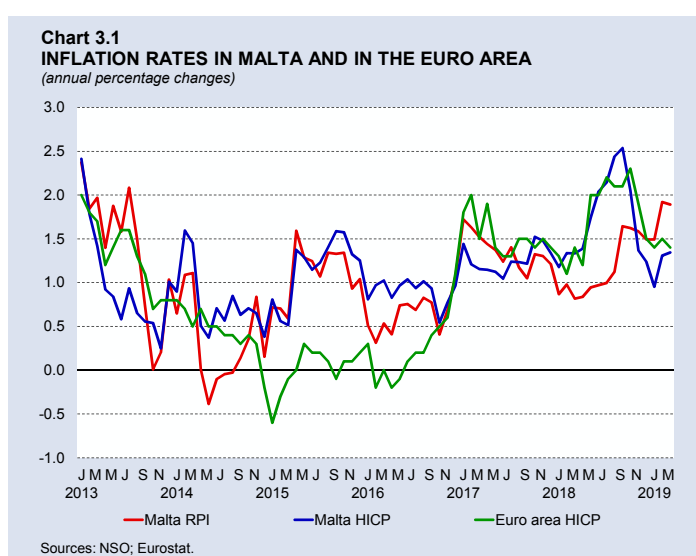
Cost pressures for producers eased, with annual growth in the industrial producer price index standing at 2.1% from 3.8% in December. Growth in Malta's ULC index also decelerated when compared with the last quarter of 2018, while Malta's HCIs indicated an improvement in competitiveness, following a prolonged period of deterioration in both annual and quarterly terms.

Inflation

HICP inflation remains moderate in the first quarter of the year

In March 2019, HICP inflation stood at 1.3%, marginally up from 1.2% in December 2018 (see Chart 3.1).¹ HICP inflation in the euro area ended the quarter under review at 1.4%, 0.1 percentage point above the rate registered in Malta.

Among the main subcomponents of the HICP index, services inflation remained the largest contributor to overall inflation (see Chart 3.2), while also explaining most of the pick-up in overall HICP inflation over the quarter. Inflation in this subcomponent accelerated to 1.4% in March, from 0.9% three months earlier (see Table 3.1). This acceleration reflected faster annual growth in prices for housing and for recreational services, such as restaurants



¹ The HICP weights are revised on an annual basis to reflect changes in overall consumption patterns. In 2019 the weight allocated to services stood at 46.7%, while that of non-energy industrial goods was 27.4%. Food accounted for 19.9% of the index, while the share allocated to energy stood at 6.0%.

Table 3.1
HICP INFLATION

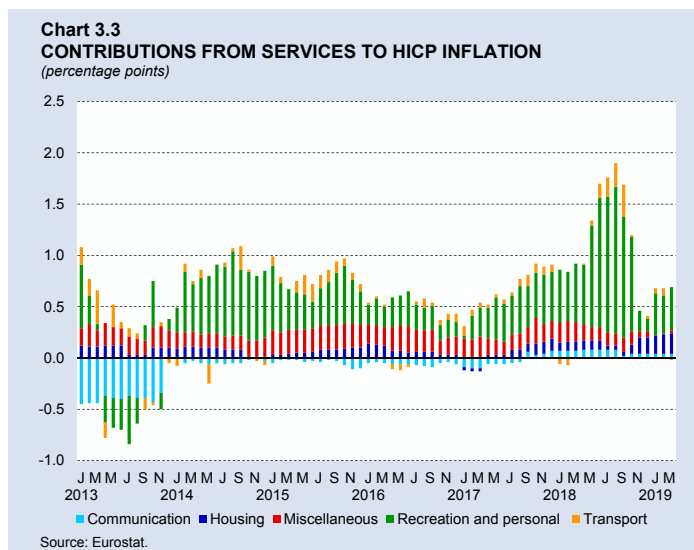
Annual percentage change

	2018						2019		
	July	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
Unprocessed food	1.0	0.7	4.2	5.2	4.7	5.4	4.9	5.6	3.8
Processed food including alcohol and tobacco	2.3	2.5	2.6	3.1	2.7	2.5	2.3	2.7	2.7
Energy	0.4	2.7	2.7	2.7	2.7	2.7	2.6	2.6	2.6
NEIG	-0.3	-0.4	0.2	-0.1	0.4	0.1	-1.8	-0.7	-0.3
Services (overall index excluding goods)	3.1	3.3	3.0	2.2	1.0	0.9	1.5	1.4	1.4
All Items HICP	2.1	2.4	2.5	2.1	1.4	1.2	1.0	1.3	1.3

Source: Eurostat.

(see Chart 3.3). Consequently, the contribution of services to overall HICP inflation rose to 0.7 point, from 0.4 percentage point in December.

On the other hand, inflation in non-energy industrial goods (NEIG) weakened further, with prices falling at an annual rate of 0.3% in March. This reflects a broad-based weakness in goods prices, which can in part be attributed to external downward pressures on import prices. As a result, the contribution of NEIG to overall HICP turned marginally negative.



In contrast, food inflation was robust, with its contribution to overall inflation remaining unchanged at 0.6 percentage point when compared with the last month of 2018. Although unprocessed food inflation decelerated from 5.4% in December 2018 to 3.8% in March this was offset by an acceleration in processed food inflation, which rose from 2.5% to 2.7% over the same period. Food inflation is being supported by increases in the prices for bread and dairy products over the past twelve months, as well as by strong annual growth in prices for fresh vegetables.

Meanwhile, energy inflation stood at 2.6% at the end of the first quarter, marginally below that of 2.7% in December. When compared with the previous quarter, the contribution of energy to overall inflation remained unchanged at 0.2 percentage point.

While overall HICP inflation edged up slightly since December, the core measure, which excludes the more volatile components of the HICP index, eased to 1.0% by the end of the first quarter,

from 1.1% three months earlier (see Chart 3.4).² Thus, the gap between the core and the overall inflation rate widened slightly, suggesting that the overall rate is partly being supported by strong growth rates in a small number of components.

RPI inflation accelerates

Annual inflation based on the RPI index accelerated to 1.9% in March, from 1.5% three months earlier (see Table 3.2). Food inflation remained the main contributor to overall RPI inflation. Its contribution rose to

1.0, a 0.1 percentage point increase over that in December. Higher contributions were also registered from transport and communication prices and from household equipment and house maintenance costs. The difference between the overall RPI and HICP inflation rates mainly reflects differences in the consumption basket used to measure the indices.³

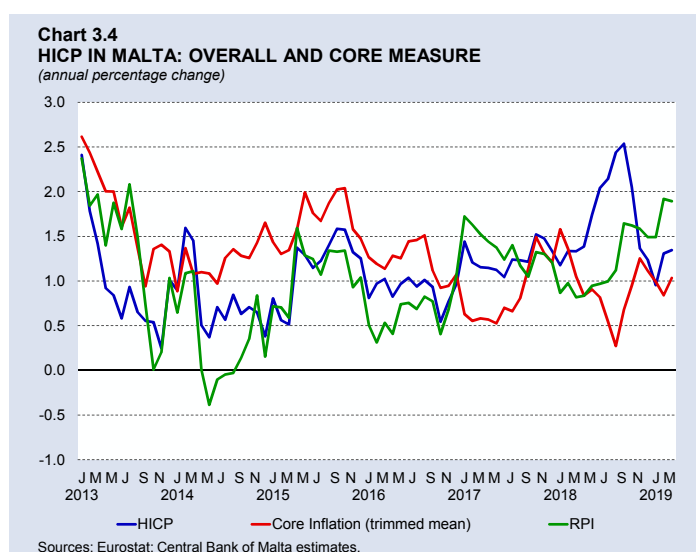


Table 3.2
CONTRIBUTIONS TO YEAR-ON-YEAR RPI INFLATION

Percentage points

	2018						2019		
	July	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
Food	0.6	0.7	0.9	1.1	0.9	0.9	1.0	1.1	1.0
Beverages and tobacco	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Clothing and footwear	-0.2	-0.3	-0.1	0.0	0.1	0.0	-0.3	-0.2	0.0
Housing	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2
Water, electricity, gas and fuels	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Household equipment and house maintenance costs	0.1	0.1	0.1	0.0	0.0	0.0	-0.1	0.1	0.1
Transport and communications	0.0	0.2	0.2	0.2	0.1	0.2	0.3	0.3	0.3
Personal care and health	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Recreation and culture	0.0	0.0	0.1	0.0	0.0	0.0	0.1	0.2	0.0
Other goods and services	0.0	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0
RPI (annual percentage change)	1.0	1.1	1.6	1.6	1.6	1.5	1.4	1.9	1.9

Source: NSO.

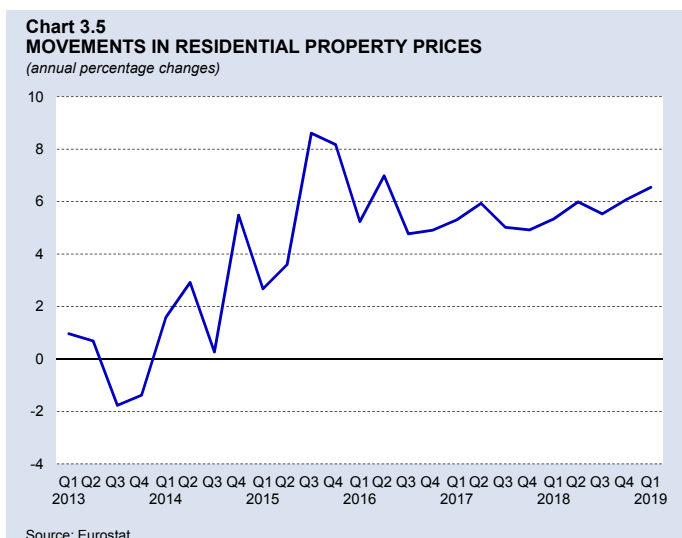
² The Central Bank of Malta uses a “trimmed mean” approach to measure core inflation, whereby the more volatile components of the index are removed from the basket of consumer goods so as to exclude extreme movements from the headline inflation rate. See Gatt, W. (2014), “An Evaluation of Core Inflation Measures for Malta”, *Quarterly Review* 2014(3), pp. 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, such as accommodation services. See Darmanin, J. (2018), “Household Expenditure in Malta and the RPI Inflation Basket”, *Quarterly Review* 2018(3), pp. 33-40, Central Bank of Malta.

Residential property prices

Residential property prices grow at a faster rate

The NSO's Property Price Index (PPI), which is based on actual transactions involving apartments, maisonettes and terraced houses, increased at a faster rate during the first quarter of 2019 (see Chart 3.5).⁴ It rose by 6.5% when compared with the same quarter of the previous year, after rising by 6.1% in the final quarter of 2018. House price inflation in Malta remained above that in the euro area, where it stood at 4.0%.



The increase in residential property prices reflects a number of factors, including the low-interest rate scenario and the Government's schemes for first-time and second-time buyers. These factors encourage demand for property for investment purposes. Residential property prices are also being supported by growth in disposable income, a buoyant labour market, and an increasing number of foreign workers. The IIP contributed further to the growth in residential property prices, although property acquisitions under this Programme account for a limited proportion of all property transactions.

The number of development permits issued continued to increase, though at a slower pace. The number of development permits rose by 10.0% when compared with the same quarter a year earlier, after rising by 14.8% in the previous quarter. As permits are reflected in an increased supply of dwellings on the market, this should mitigate upward pressure on house prices.

Costs and competitiveness

Producer price inflation moderates

Producer cost inflation, as measured by the industrial producer price index, eased during the first quarter decelerating to 2.1% in March, from 3.8% three months earlier. This mainly reflected slower growth in the cost of intermediate goods, which nonetheless remained the largest contributor to overall producer cost inflation.⁵ Consumer goods also contributed positively. In contrast, the contribution of capital goods and energy remained nil.

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 The industrial producer price index measures the prices of goods at the factory gate and is commonly used to monitor inflationary pressures at the production stage.

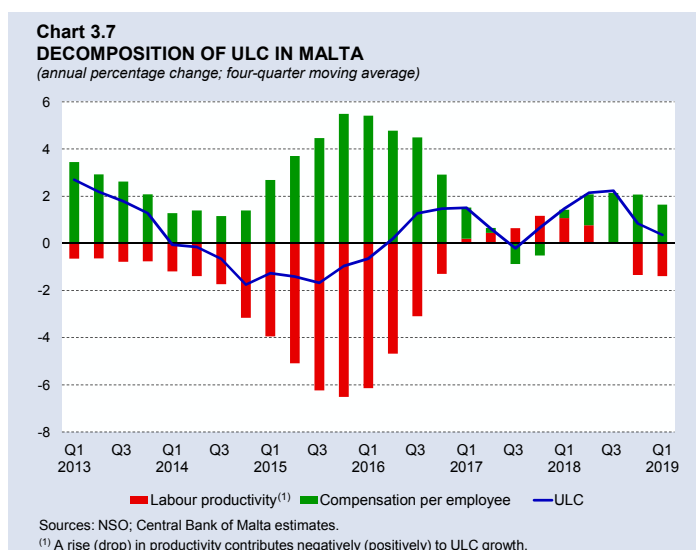
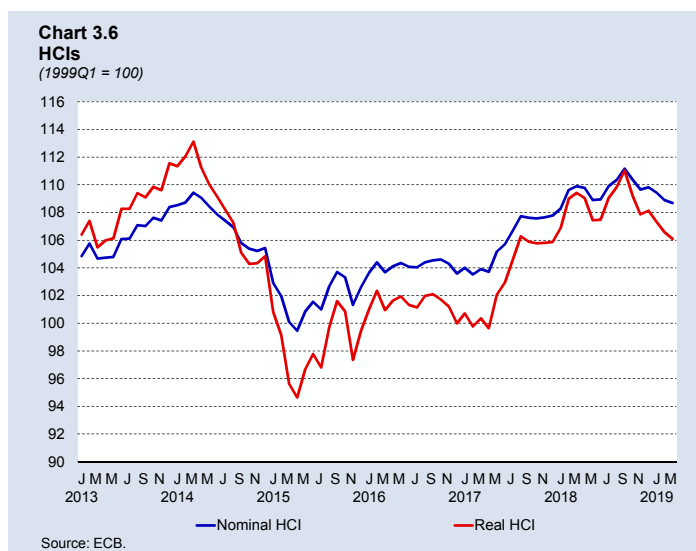
HCI's point to improvement in competitiveness

After a prolonged period of increases Malta's HCIs contracted during the first quarter, thus signalling an improvement in Malta's international competitiveness during the first quarter of the year. Both the nominal HCI, based on trade-weighted exchange rates, and the real HCI, which also takes into account relative price pressures, fell between December and March (see Chart 3.6).⁶ The two indicators also decreased in annual terms, with the nominal and real HCI down by 1.1% and 3.0%, respectively, on this basis. This suggests that both movements in the euro exchange rate and developments in relative prices vis-à-vis international trading partners over the past year have begun to positively impact Malta's international competitiveness.

ULC growth eases

Malta's ULC index, measured as the ratio of compensation per employee to labour productivity, continued to grow during the first quarter of 2019, albeit at a slower pace than before.⁷ When measured on a four-quarter moving average basis, ULC in Malta grew at an annual rate of 0.4% in the first quarter of the year, following a 0.8% increase in the previous quarter (see Chart 3.7).

The latest developments in ULC were driven by slower annual growth in compensation per employee, which decelerated to 1.6%, from 2.1% in the previous quarter. At the same time, annual growth in labour productivity rose marginally to 1.4%, from 1.3% three months earlier.



⁶ HCIs act as an effective exchange rate measure for countries operating within the euro area monetary union. The nominal HCI tracks movements in the euro exchange rate against the currencies of Malta's main trading partners, weighted according to the direction of trade in manufactured goods. The real HCI also takes into account the relative inflation rate of Malta vis-à-vis its main trading partners. A higher (or lower) score in the HCI indicates a deterioration (or improvement) in Malta's international price competitiveness.

⁷ Annual growth in ULC, compensation per employee, and labour productivity is measured on a four-quarter moving average basis. 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 <http://www.centralbankmalta.org/en/working-papers-2015>, and Rapa, N. (2016), "Measuring international competitiveness", *Quarterly Review* 2016(1), pp. 53-63, Central Bank of Malta.

4. THE BALANCE OF PAYMENTS

During the first quarter of 2019 the surplus on the current account of the balance of payments decreased when compared with the corresponding quarter of 2018. The lower surplus was attributable to a widening in the merchandise trade gap as well as higher net outflows related to primary and secondary income. The surplus on services edged up marginally on the same months of a year earlier. Meanwhile, net inflows on the capital account increased, whilst net borrowing was recorded on the financial account.

When measured on a four-quarter moving sum, the current account balance was equivalent to 7.7% of GDP, compared with 2.8% of GDP in the euro area.

Meanwhile, the cyclically-adjusted current account balance is estimated to have reached 8.9%. This indicates that Malta's current account surplus largely reflects structural factors.

The current account

The current account surplus narrows

In the first three months of the year, the current account registered a surplus of €48.9 million, significantly less than the €296.3 million recorded in the same quarter of 2018 (see Table 4.1). The lower surplus was driven by a widening of the merchandise trade deficit and higher net primary income outflows. Nonetheless, a rise in net outflows related to secondary income also contributed, albeit to a lesser extent. These developments offset a marginal widening in the surplus from services.

When measured as a four-quarter moving sum, the surplus on the current account narrowed to €964.3 million, from €1,305.8 million in the four quarters to March 2018. This decrease was predominantly driven by a widening in the merchandise trade deficit. As a result, the share of the current account surplus in GDP edged down to 7.7%, from 11.3% in the 12 months to March 2018 (see Chart 4.1).

Table 4.1
BALANCE OF PAYMENTS

EUR millions

	Four-quarter moving sums					2018 Q1	2019 Q1
	2018 Q1	2018 Q2	2018 Q3	2018 Q4	2019 Q1		
Current account	1,305.8	1,211.7	1,237.6	1,211.8	964.3	296.3	48.9
Goods	-1,356.8	-1,520.6	-1,579.2	-1,609.1	-1,776.4	-246.7	-414.0
Services	3,904.1	3,970.1	4,075.4	4,070.2	4,073.0	823.0	825.8
Primary income	-1,128.8	-1,122.4	-1,140.4	-1,124.8	-1,196.6	-252.6	-324.4
Secondary income	-112.7	-115.4	-118.2	-124.5	-135.6	-27.3	-38.5
Capital account	57.8	58.1	63.1	115.0	138.1	3.4	26.5
Financial account⁽¹⁾	779.0	781.5	769.5	603.1	720.5	-169.2	-51.8
Errors and omissions	-584.5	-488.3	-531.2	-723.7	-381.8	-468.9	-127.1

Source: NSO.

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

Malta's cyclically-adjusted current account balance stood at 8.9% of GDP, down from 10.5% a year earlier.¹ The cyclically-adjusted and the unadjusted current account balances for the Maltese economy tracked each other closely in recent quarters (see Chart 4.1). This suggests that cyclical factors explain a limited part of Malta's current account surplus, with the later instead largely driven by structural factors.

The merchandise trade deficit widens

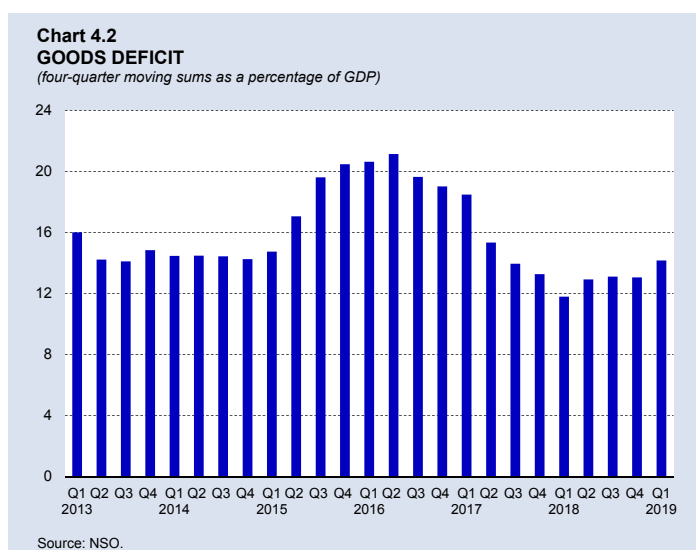
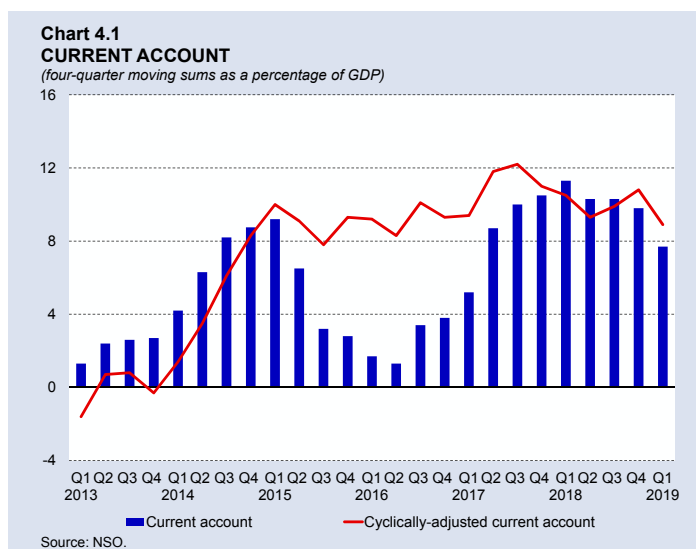
In the first quarter of 2019, the merchandise trade deficit widened by €167.3 million on the corresponding period of 2018, reaching €414.0 million. This reflected an increase in imports which offset a smaller rise in exports. The expansion in the former was partly driven by exceptional increases in imports of goods related to one-off purchases of ships and boats.

When measured on a four-quarter cumulative basis, the visible trade gap amounted to €1,776.4 million in the first quarter of 2019, €419.6 million more than a year earlier. This stemmed from a €408.1 million increase in imports, and a €11.4 million contraction in merchandise exports. As a result, the share of the merchandise deficit in GDP increased to 14.2%, from 11.8% a year earlier (see Chart 4.2).

The surplus on services rises marginally

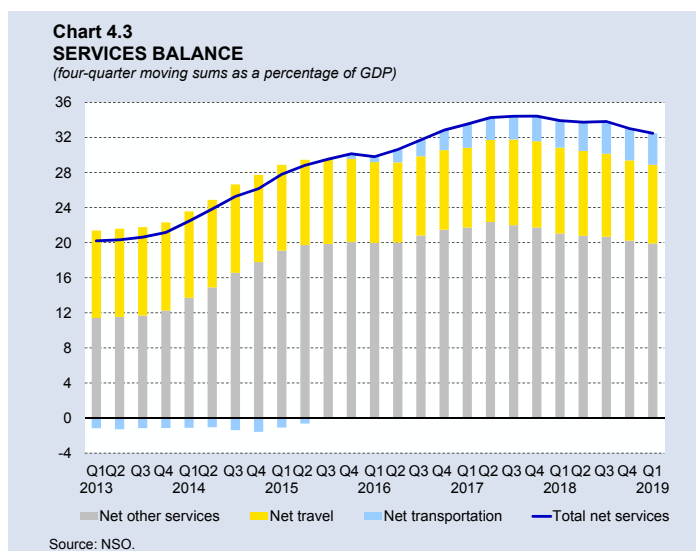
In the quarter under review, net receipts generated by the services industry reached €825.8 million, €2.8 million more than in the January to March period of 2018. Both services exports and imports increased markedly on a year earlier. However, the rise in the former was marginally larger.

The higher net surplus was mainly driven by the transport category, with net receipts increasing by €4.3 million, to €99.7 million in the first quarter of 2019. The improvement in this sub-com-



¹ For more information on Malta's cyclically-adjusted current account see Grech, A. G. & Rapa, N. "An evaluation of recent shifts in Malta's current account position", in Grech, A.G. & Zerafa, S. (eds.), *Challenges and Opportunities of Sustainable Economic Growth: the case of Malta*, Central Bank of Malta, 2017.

ponent continued to mirror the steady expansion of the aviation services sector in Malta. Furthermore, the higher surplus was also driven by increased net receipts related to the “other services” category, which stood at €616.3 million in the first three months of the year, up by €3.6 million on the same period of 2018. This increase was predominantly spurred by higher net receipts related to personal, cultural, and recreational services, which includes remote gaming. The increase in net receipts from these activities more than offset higher net payments related to other business services, particularly professional and management consultancy fees.



By contrast, net travel exports edged down by €5.2 million to stand at €109.8 million in the first quarter of 2019. This reflected an increase of €9.0 million in expenditure by Maltese residents abroad, whereas inbound tourists’ spending rose by only €3.8 million on the first quarter of 2018.

On a four-quarter cumulative basis, the overall surplus from services stood at €4,073.0 million, an increase of €168.8 million over March 2018. Despite such an increase, the share of net services receipts in GDP dropped to 32.5%, from 33.9% a year earlier (see Chart 4.3).

Primary income account records higher net outflows²

Between January and March 2019, net outflows on the primary income account stood at €324.4 million. This compares with €252.6 million in the first quarter of 2018. This increase was largely on account of higher net income payments related to foreign direct investment and lower net interest receipts on portfolio investment. These offset higher net interest earned on ‘other investment’ income.

On a four-quarter cumulative basis, net outflows on this account reached €1,196.6 million in the quarter under review, €67.8 million more than in the same period a year earlier. Flows related to primary income continued to be strongly influenced by internationally-oriented firms which transact predominantly with non-residents.

Outflows on the secondary income account also increase³

In the first quarter of the year, net outflows on the secondary income account increased by €11.1 million on a year earlier, to stand at €38.5 million.

When measured on a four-quarter moving sum basis, net outflows related to secondary income reached €135.6 million, €22.8 million more than the amount recorded a year earlier.

² The primary income account shows income flows related mainly to cross-border investment and compensation of employees.

³ The secondary income account shows current transfers between residents and non-residents.

BOX 3: THE GRAVITY MODEL FOR MALTESE GOODS EXPORTS AND IMPORTS¹

Introduction

Gravity models are equations that attempt to explain trade flows between countries. Generally, they are based on theories of international trade which suggest that pairs of countries which are close, either geographically or in terms of cultural similarities, will tend to trade more often with each other than with more distant countries. Gravity models consider factors like geographical distance, languages or common historical links as determinants of trade flows. The distance variable can be looked at as a proxy for transportation costs, which of course are a key variable to trade. Furthermore, gravity models try to account for the possibility that larger countries with a larger combined “economic mass” will have a larger GDP and will tend to trade in larger volumes than countries with smaller economic mass. Hence, a relatively limited number of variables would describe a good proportion of trade patterns between countries. In turn, this explains why gravity models have gained prominence over alternative models of international trade.

Malta’s economy emerged from a system based around the servicing of British military forces, over time developing in a very dynamic economy in the Mediterranean region, with high value-added goods exports, tourism as well as financial services exports. This development reflected a number of policy measures, which allowed a continued process of economic renewal to take hold and led to the attraction of new industries. This process allowed Malta to be resilient to shocks in the global economy, allowing for periods of strong economic growth and improved living standards.

In fact, over the period 1965 to 2017, Malta’s economic growth reflected its foreign trade performance. Total trade as a percentage of nominal GDP stood at 157.0% in 1965, rising to 254.0% in 1995, and reaching a high of 325.9% in 2012. Key turning points in Malta’s economic development came with the signing of an association agreement with the European Economic Community (EEC) in 1970, the setting up of an international financial services centre in the mid-1990s, and the accession to the European Union in 2004.

Nonetheless, this growth in Malta’s foreign trade has not drawn much attention from researchers. Indeed, the available studies on Malta’s trade patterns focus on the composition of Maltese trade with the expected impact of the 2008/9 crisis, (Azzopardi, 2009),² and a simple gravity model analysis on merchandise trade flows between Malta and the EU (Spiteri, 2008).³ The gravity model equations in Ellul (2019) are the first attempt to explain the historical development of export growth over time in Malta using these methodologies, and focusing on trade agreement effects.⁴

¹ Prepared by Reuben Ellul. The author is a Principal Economist within the Economic Analysis Department at the Central Bank of Malta. 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 Azzopardi, R.M. (2009), ‘Malta’s Open Economy: Weathering the Recessional Storm?’, *South European Society and Politics*, vol. 14, no. 1, pp. 103-120.

³ Spiteri, J. (2008), ‘Malta - EU Merchandise Trade Flows: A Gravity Model Approach,’ University of Malta: Msida.

⁴ Ellul, R. (2019), “The gravity model for Maltese goods exports and imports,” *CBM Working Paper WP/01/2019*, Central Bank of Malta.

The gravity model estimates for Malta

Trade data used in Ellul (2019) are sourced from the International Monetary Fund Direction of Trade Statistics. They cover the period from 1960 to 2016. There are more than 200 countries and territories included, with coverage depending on data availability. Information relating to geographical distances, common cultural background, including languages and colonial history, are obtained from the Centre d'Etudes Prospectives et d'Informations Internationales (CEPII) databases, following Mayer and Zignago (2011).⁵ In terms of methodology, the basis for gravity models is Sir Isaac Newton's law of universal gravitation. One of the earliest applications in economics belongs to Tinbergen (1962).⁶ This model attempts to link trade flows between countries and with their respective GDP, geographical distance, and other factors affecting trade – such as common languages and cultural backgrounds (Anderson and van Wincoop, 2003).⁷ In the simplest form, following Santos Silva and Tenreyro (2006),⁸ the econometric model for stochastic gravity states that

$$T_{ijt} = K_0 \frac{M_{it}^{\beta_1} M_{jt}^{\beta_2}}{D_{ij}^{\beta_3}} \varepsilon_{ijt}$$

where T_{ijt} is the bilateral trade flow between countries i and j in period t , M_{it} and M_{jt} are the GDP of country i and country j in period t , respectively; D_{ij} is the bilateral distance between country i and j , K_0 is an unknown constant while β_1 , β_2 and β_3 are unknown parameters. The basic equation is extended with other characteristics that affect bilateral trade, such as sharing a common border, historic colonial ties, entry into regional trade agreements, and tariffs. The equation is traditionally converted into linear form through logarithms, and estimated by ordinary least square (OLS) methods, such that

$$\ln T_{ijt} = \alpha_0 + \beta_1 \ln M_{it} + \beta_2 \ln M_{jt} - \beta_3 \ln D_{ij} + \varepsilon_{ijt}$$

where $\alpha_0 = \ln K_0$ and $\varepsilon_{ijt} = \ln \varepsilon_{ijt}$. This approach, while popular, was not originally based on micro-founded economic theories. Theoretical foundations for gravity models were eventually developed in the 1970s and 1980s. These equations included multilateral resistance terms to account for trade barriers, and elasticities of substitution between goods.

Ellul (2019) uses OLS, Poisson pseudo-maximum likelihood (PPML) methods, zero-inflated Poisson methodologies, and a Heckman estimator to estimate gravity equations applied to different datasets and periods.⁹ As a caveat, one has to remember that these methodologies have different assumptions which may lead to differing results. A number of attributes common in the gravity literature are included as regressors in the equation. These include

⁵ Mayer, T. and Zignago, S. (2011), 'Notes on CEPII's distances measures: the GeoDist Database,' CEPII Working Paper, 2011-25. The CEPII provides a large set of variables covering a wide array of geographical characteristics for almost all countries in the world.

⁶ Tinbergen, J. (1962), 'Shaping the World Economy: Suggestions for an International Economic Policy,' Books (Jan Tinbergen). Twentieth Century Fund, New York. Retrieved from <http://hdl.handle.net/1765/16826>.

⁷ Anderson, J. E. and van Wincoop, E. (2003), 'Gravity with Gravitas: A Solution to the Border Puzzle,' American Economic Review, 93 (1): 170-192. DOI: 10.1257/000282803321455214

⁸ Santos Silva, J. and Tenreyro, S. (2006), 'The Log of Gravity,' *The Review of Economics and Statistics*, 88, issue 4, pp. 641-658.

⁹ For more details on the methodologies discussed in this paper, kindly refer to Ellul, R. (2019), "The gravity model for Maltese goods exports and imports," *CBM Working Papers* WP/01/2019, Central Bank of Malta.

partners' GDP level, and Malta's GDP, distance between Malta and its respective bilateral partner, population, partners' geographical size, a variable that accounts for a common official language, a variable that represents a common colonial background, as well as dummies to account for Malta's membership in the EU and its association agreement with the EEC.

The main results from the study are that Maltese trade in goods is negatively affected by distance, and positively affected by a set of other variables which account for historical and cultural links.

The estimated values for the distance coefficients are broadly stable across methodologies and robustness checks employed (see Table 1). Nominal figures for the period 1960-2016 show how for every 10.0% difference in distance, exports and imports fall by 11.1% and 7.5% respectively, on average across the methodologies used. In real terms, a 10.0% difference in distance decreases real exports by 6.9%, on average, across the methodologies, and imports by 5.5%. Subsidiary gravity equations based on trade excluding fuel, aircraft and ships returned very close results to the previous estimates with respect to distance coefficients. However, differences emerged for the variables accounting for institutional and cultural backgrounds. Once these specific trade sectors are excluded, the likelihood of importing goods from countries with similar backgrounds becomes broadly insignificant.

Table 1
ESTIMATES FOR VARIABLE COEFFICIENTS

	Period	OLS	PPML	ZIP	Heckman (Exact Id.)	Heckman (Over Id.)	Heckman (2-step)	Average
Exports								
Distance coefficient (elasticity)								
Nominal	1960-2016	-1.1 ***	-0.7 **	-	-1.2 ***	-1.2 ***	-1.4 ***	-1.1
Excl. trade in fuel, ships, aircraft.	2000-2017	-0.9 ***	-0.9 ***	-	-1.0 ***	-0.9 ***	-1.0 ***	-1.0
Real	1960-2016	-0.9 ***	-	-	-0.5 ***	-0.9 ***	-0.5 ***	-0.7
% more likely to trade								
<i>Nominal</i>								
Common language	1960-2016	59.2 *	-	-	-	-	68.6 ***	63.9
Common colony	1960-2016	109.6 **	148.6 **	-	130.9 ***	124.3 ***	164.1 ***	135.5
<i>Excl. trade in fuel, ships, aircraft.</i>								
Common language	2000-2017	-	65.3 **	-	-	-	71.6 ***	68.5
Common colony	2000-2017	87.5 *	115.9 ***	-	102.7 **	59.0 *	123.1 ***	97.6
Imports								
Distance coefficient (elasticity)								
Nominal	1960-2016	-0.6 ***	-1.1 ***	-	-0.7 ***	-0.7 ***	-0.7 ***	-0.7
Excl. trade in fuel, ships, aircraft.	2000-2017	-0.9 ***	-1.0 ***	-	-0.9 ***	-0.9 ***	-0.9 ***	-0.9
Real	1960-2016	-0.5 **	-0.9 ***	-0.8 ***	-0.3 *	-0.5 **	-0.3 ***	-0.6
% more likely to trade								
<i>Nominal</i>								
Common language	1960-2016	158.5 ***	-	-	163.6 ***	160.2 ***	263.4 ***	186.4
Common colony	1960-2016	-	148.6 **	-	-	-	71.9 ***	110.2
<i>Excl. trade in fuel, ships, aircraft.</i>								
Common language	2000-2017	209.8 **	-	-	206.0 ***	208.6 ***	-	208.1
Common colony	2000-2017	-	-	-	-	-	33.7 ***	33.7

Sources: Ellul (2019); author's calculations.

*Significant at the 10% level, **Significant at the 5% level, ***Significant at the 1% level.

The importance of trade agreements

While data limitations and breaks in time series have to be considered, the estimates indicate that after correcting for variables such as country distance, country and population size, the EEC-Malta Association Agreement and EU accession had strong and significant impacts on both exports and imports (see Table 2). However, the former had a stronger impact on goods exports than Malta's entry in the EU. In contrast, Malta's entry in the EU had a stronger impact on goods imports. This finding may reflect the fact the Association Agreement opened up European markets for Maltese exports, while import controls were only completely lifted in the run up to EU accession.

Finally, one must note that over the roughly fifty years analysed, Malta passed through a sustained period of very strong change to its economic fabric. This history was marked by trade-driven economic success. In turn, this leads to particular data volatility which has to be highlighted, along with other limitations of this study.

The use of Customs data is affected by particular trade phenomena, such as the re-export of fuel oils by Maltese bunkering operators, and highly integrated firm specific value-chain trade. Such value chains may negate established norms in gravity modelling, such as distance. Moreover, services flows, which have grown significantly in recent years, are excluded from this analysis. The services sector may have experienced a different outcome to the manufacturing industry following EU accession. Finally, the imperfect measuring of price indices is also a caveat for the analysis of real trade flows.

Estimates in the study show how Malta's economic progress benefitted from trade agreements. The very strong rates of goods export growth registered over the past decades are indicative of a complete structural change in the fabric of the Maltese economy since 1960. This change was facilitated by trade agreements. The success story for trade in goods may now be dwarfed by the more recent successes the Maltese economy is registering in services. However, the estimates presented here confirm how economic development in Malta comes arm-in-arm with greater trade integration.

Table 2
ESTIMATES FOR TRADE AGREEMENT COEFFICIENTS

	OLS	PPML	ZIP	Heckman (Exact Id.)	Heckman (Over Id.)	Heckman (2-step)	Average
Exports							
MT EC Agreement							
Nominal	137.1 **	-	-	135.7 **	136.9 **	134.4 ***	136.0
Real	1,033.3 ***	520.8 ***	1,081.1 ***	943.8 ***	2,222.2 ***	918.8 ***	1,120.0
MT EU Membership							
Nominal	-	-	-	-	-	-	-
Real	662.7 ***	-	-	247.2 ***	379.9 ***	230.9 ***	380.2
Imports							
MT EC Agreement							
Nominal	112.6 **	-	-	108.6 **	111.1 **	108.3 ***	110.1
Real	2,218.9 ***	247.6 ***	775.9 ***	1,747.3 ***	3,655.3 ***	1,342.3 ***	1,664.5
MT EU Membership							
Nominal	448.8 ***	-	-	437.6 ***	445.1 ***	437.9 ***	442.3
Real	3,624.0 ***	284.8 ***	-	2,061.3 ***	3,478.0 ***	1,701.4 ***	2,229.9

Sources: Ellul (2019); author's calculations.

*Significant at the 10% level, **Significant at the 5% level, ***Significant at the 1% level.

Activity in the tourism sector

In the first quarter of 2019, the tourism sector continued to expand, though it slowed down compared with previous quarters.

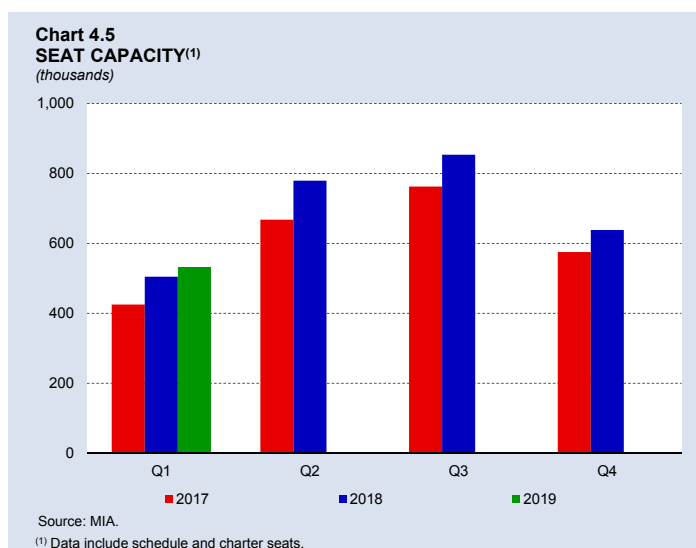
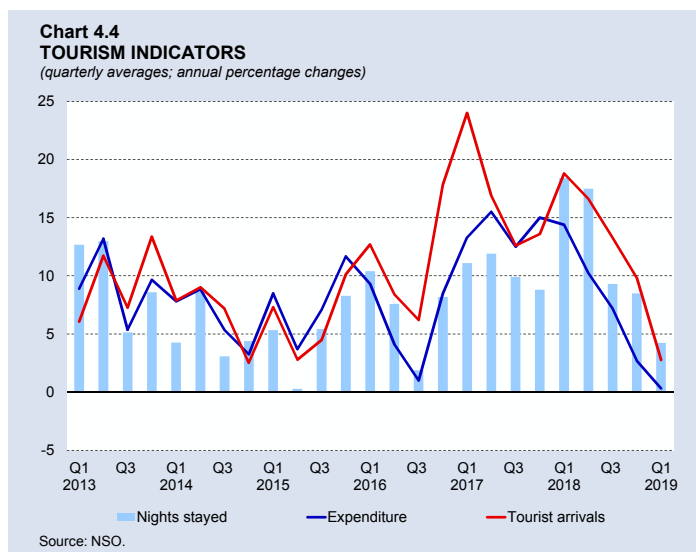
The number of inbound tourists grew by 2.8% on a year earlier, reaching 425,892 (see Chart 4.4). Those visiting for leisure purposes increased further, while those travelling for business motives and for other reasons declined compared with the same quarter of 2018.

Meanwhile, the number of nights that tourists spent in Malta totalled 2.8 million, an increase of 4.2% on the previous year. This rise was driven by an increase in nights stayed in private accommodation, which rose by 20.6%. On the other hand, nights stayed in collective accommodation decreased by 5.5%.⁴

Tourist expenditure in Malta increased marginally in the first quarter of 2019, rising at an annual rate of 0.3% to reach €272.4 million.⁵ Spending in the “other” category was up by 6.4% and that in the non-package category increased by a more modest 1.4%. In contrast, expenditure on package holidays declined by 8.6%.⁶

As tourist expenditure increased at a slower pace compared with arrivals, expenditure per capita fell to €640 from €655 in the first quarter of 2018. Expenditure per night also fell, edging down to €97.33 from €101.13. Meanwhile, the average length of stay increased marginally to 6.6 nights in the first three months of 2019 from 6.5 nights in the same quarter a year earlier.

According to Malta International Airport (MIA) data, in the first quarter of 2019, average seat capacity was up by 5.3% compared with a year earlier (see Chart 4.5).⁷



⁴ 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.

⁵ Total expenditure is split into package, non-package and “other” with the latter component capturing any additional expenditure by tourists during their stay in Malta, such as expenditure on excursions and entertainment.

⁶ Non-package holiday expenditure is subdivided into spending on accommodation and travel fares.

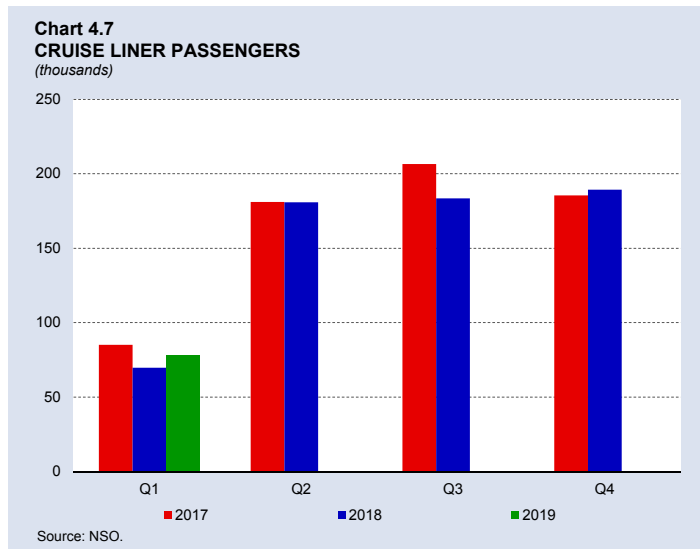
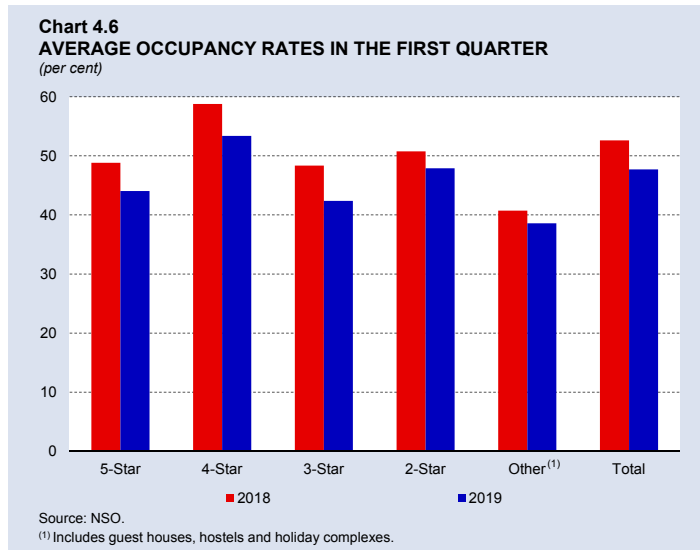
⁷ MIA data are subject to revisions.

In line with the above-mentioned decrease in nights stayed in collective accommodation, the total occupancy rate in collective accommodation establishments fell to 47.7%, from 52.6% in the same quarter a year earlier (see Chart 4.6). Lower occupancy rates were recorded across all categories.

In the first quarter of 2019, the number of cruise liners visiting Malta totalled 21, four more than a year earlier. Foreign passengers rose to 77,975, from 69,725 in the same period of 2018 (see Chart 4.7).

The capital account

Net inflows on the capital account stood at €26.5 million during the first three months of 2019; €23.1 million more than in the corresponding period of 2018 (see Table 4.1). This increase 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 totalled €138.1 million, up by €80.3 million on a year earlier.



5. GOVERNMENT FINANCE

In the first quarter of 2019, the general government balance was in deficit. However, when measured as a four-quarter moving sum, the balance reached a surplus of 1.9% of GDP. This is slightly lower than the 2.0% ratio posted in 2018 as a whole. The cyclically-adjusted surplus-to-GDP ratio broadly mirrored developments in the headline balance. Meanwhile, the general government debt-to-GDP ratio rose to 46.6% from 46.0% at the end of 2018, partly reflecting a build-up in financial assets. Consequently, the net financial worth as a share of GDP remained broadly stable compared with end-2018.

Quarterly developments

General government surplus narrows

The general government registered a deficit of €16.5 million in the first quarter of 2019, €10.6 million more than the deficit registered in the corresponding quarter of 2018. This was due to an increase in primary expenditure which offset a rise in revenue. While the primary balance remained in surplus, this narrowed by €13.7 million, to €27.4 million.

Higher tax receipts underpin revenue growth

Government revenue increased by €89.3 million or 8.6% in annual terms, reaching €1,130.8 million (see Table 5.1). Growth was mainly driven by an increase in tax revenue. In particular, inflows

Table 5.1
REVENUE, EXPENDITURE AND DEBT

EUR millions

	2018				2019	Change 2019Q1-2018Q1	
	Q1	Q2	Q3	Q4	Q1	Amount	%
Revenue	1,041.5	1,182.8	1,223.9	1,335.1	1,130.8	89.3	8.6
Taxes on production and imports	350.3	365.4	443.9	431.0	364.5	14.3	4.1
Current taxes on income and wealth	320.9	454.2	442.3	433.1	411.5	90.6	28.2
Social contributions	180.3	201.8	165.2	217.5	192.4	12.1	6.7
Capital and current transfers receivable	25.6	15.6	33.6	99.8	42.5	16.9	65.9
Other ⁽¹⁾	164.3	145.8	138.9	153.8	119.8	-44.5	-27.1
Expenditure	1,047.4	1,063.8	1,108.1	1,313.1	1,147.3	99.9	9.5
Compensation of employees	344.0	340.2	347.4	344.5	363.0	19.0	5.5
Intermediate consumption	169.2	208.1	194.5	262.6	216.7	47.5	28.1
Social benefits	293.3	293.4	280.4	308.3	293.7	0.4	0.1
Subsidies	32.3	37.4	34.8	53.1	36.1	3.8	11.8
Interest	47.0	47.9	46.7	46.1	43.9	-3.1	-6.6
Other current transfers payable	48.1	47.6	68.6	103.8	82.1	34.0	70.8
Gross fixed capital formation	50.3	67.6	96.7	156.0	84.8	34.5	68.7
Capital transfers payable	63.3	22.3	39.1	43.9	23.9	-39.4	-62.3
Other ⁽²⁾	-0.1	-0.7	-0.1	-5.2	3.1	3.2	
Primary balance	41.1	166.8	162.5	68.1	27.4	-13.7	
General government balance	-5.9	119.0	115.8	22.0	-16.5	-10.6	
General Government debt	5,734.0	5,769.5	5,538.9	5,664.7	5,847.3		

Source: NSO.

⁽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.

from current taxes on income and wealth surged by €90.6 million, driven by higher income tax receipts from households and companies. Intakes from taxes on production and imports and from social contributions also rose, albeit at a more moderate pace. These increases reflected higher intakes from Value Added Tax (VAT) and strong employment growth, respectively.

As regards non-tax revenue, capital and current transfers receivable rose on the back of higher grants from the EU. However, “other” revenue declined significantly, due to lower receipts from the IIP.

Current expenditure increases

Total government expenditure rose by €99.9 million or 9.5% when compared with the first quarter of 2018, mainly due to an increase in recurrent expenditure items.

Outlays on intermediate consumption posted the largest increase amongst current expenditure items, rising by €47.5 million. This increase was mainly driven by higher outlays related to public administration, health care and maintenance costs. Other current transfers payable also rose at a significant pace, partly due to higher transfers to the EU budget. Spending on compensation of employees, subsidies and social benefits also increased in the period under review, although absolute increases in these expenditure categories were significantly smaller. On the other hand, interest payments declined.

Outlays on gross fixed capital formation grew at a strong pace on the back of higher spending on road construction and other infrastructural projects. On the other hand, capital transfers declined significantly, due to a base effect as in the first quarter of 2018, capital transfers were boosted by the Government’s acquisition of landing rights from Airmalta.

Debt increases

In March 2019, the stock of general government debt amounted to €5,847.3 million, €182.5 million more than its level at end-2018. This was mainly due to a new issue of 62+ Government Savings bonds in March. Consequently, the value of currency and deposits outstanding increased by €99.3 million, while its share in total debt rose by 1.5 percentage points to reach 6.4%.¹

Meanwhile, the stock of short-term securities (composed of Treasury bills) rose by €50.8 million, while its share in total debt increased by 0.7 percentage point to reach 5.8%. Although the stock of long-term securities outstanding (composed of MGS) went up by €32.7 million, their share in total debt declined to 81.1%, from 83.1% in the previous quarter.

The value of loans outstanding remained broadly unchanged in level terms, while their share in total debt edged down to 6.6%.

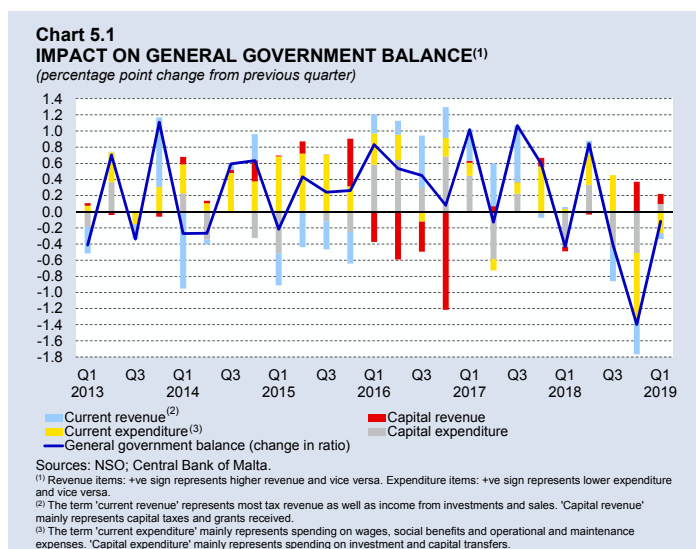
Headline and cyclically-adjusted developments

Headline surplus ratio narrows slightly, while the debt ratio increases

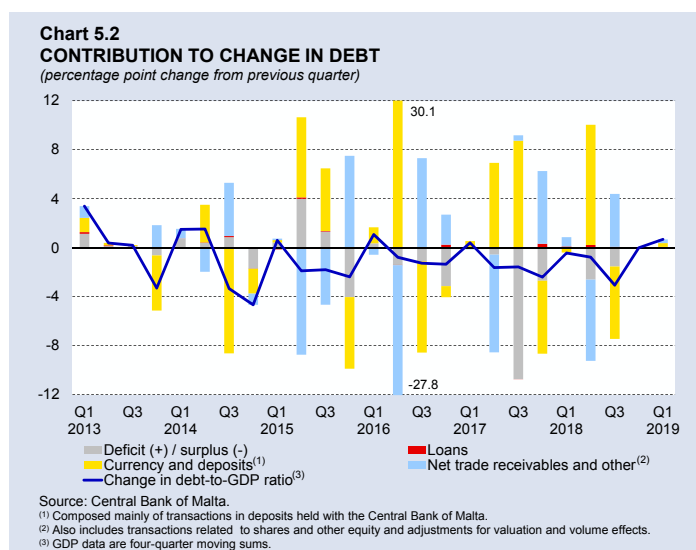
On a four-quarter moving sum basis, the general government balance remained in surplus. However, the surplus-to-GDP ratio declined to 1.9% of GDP from 2.0% of GDP in the final quarter of 2018 (see Chart 5.1).

¹ As these bonds are non-tradeable, according to ESA methodology, they are classified as deposits.

Developments in revenue items during the quarter under review had a neutral effect on this ratio. While the share of capital revenue in GDP increased by 0.1 percentage point compared with the previous quarter, the share of current revenue declined by a similar amount. Meanwhile, the ratio of current spending in GDP rose by 0.3 percentage point, offsetting a 0.1 percentage point decline in the share of capital expenditure in GDP.



In the period under review, the debt-to-GDP ratio rose by 0.7 percentage point, despite the Government posting a surplus (see Chart 5.2). This was due to positive deficit-debt adjustments, notably the accumulation of government deposits and an increase in net trade receivables. Government typically builds up cash buffers in the first half of the year, before drawing them down in the second half to finance ongoing operations.



Net financial worth remains stable as a share in GDP

Mainly as a result of the abovementioned increases in cash deposits and accounts receivable, the market value of financial assets grew to €4,109.9 million by March 2019, €248.1 million more compared with the level at end-2018.² Consequently, the share of financial assets in GDP rose by 1.4 percentage points to 32.8% (see Chart 5.3). At the same time, the market value of financial liabilities increased by €317.4 million to €7,843.3 million, owing mainly to issues of 62+ Government Savings bonds and higher debt securities, as outlined above. The share of financial liabilities in GDP rose by 1.5 percentage points to 62.5%

² According to the EUROSTAT methodology, gross government debt is recorded at face value and includes the value of currency, deposits, debt securities and loans outstanding. In contrast, the value of financial assets and liabilities is recorded at market value, and also includes the stock of equity, financial derivatives and accounts. The value of financial liabilities net of financial assets is referred to as the net financial worth. For more details, refer to Part VIII of EUROSTAT's Manual on Government Deficit and Debt: <https://ec.europa.eu/eurostat/web/products-manuals-and-guidelines/-/KS-GQ-16-001>.

As a result, at -29.8%, the net financial worth of general government as a share of GDP remained broadly stable compared with end-2018.

Public finances compare favourably with the euro area's

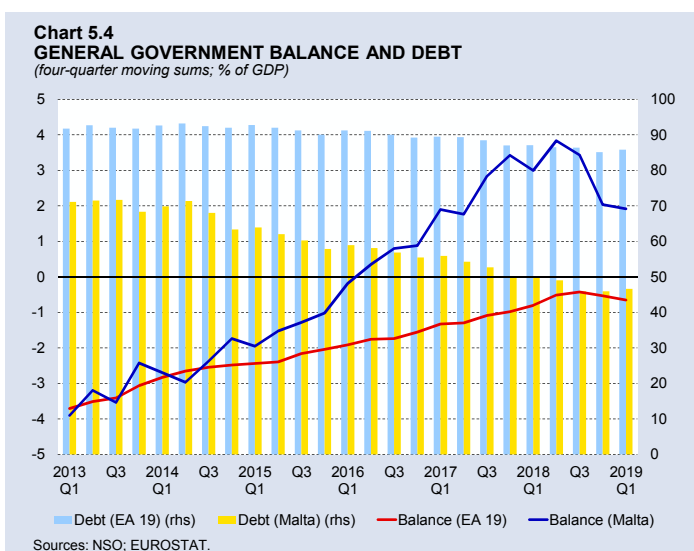
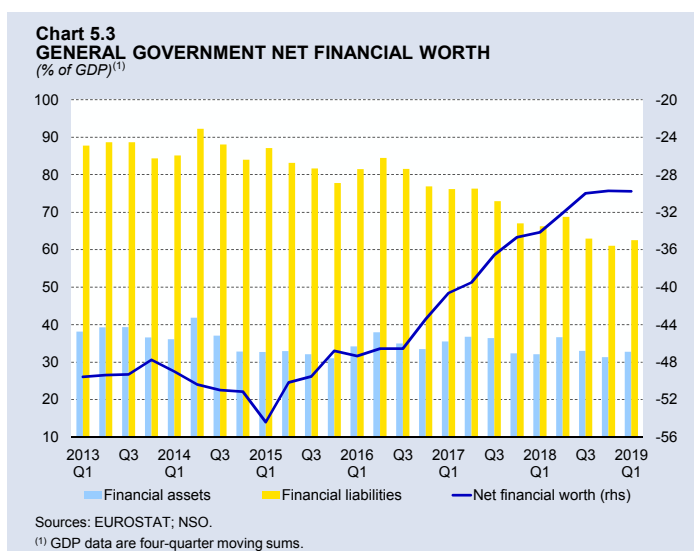
Developments in Maltese public finances continue to compare favourably with those in the euro area (see Chart 5.4). The euro area general government deficit has narrowed markedly since 2013, reaching 0.7% of GDP on a four-quarter moving sum basis at the end of March. In the same period, the euro area debt ratio edged from just over 90% to around 86%. Compared with end-2018, the fiscal outcome across the euro area deteriorated slightly.

Maltese public finances also deteriorated somewhat in the first quarter of 2019. However, compared with the euro area average, the Maltese government balance improved at a much faster pace since 2015, achieving a surplus while the debt ratio has fallen further below the 60% threshold.

Cyclically-adjusted balance narrows slightly³

On a four-quarter moving sum basis, the cyclically-adjusted surplus ended the quarter under review at 1.5% of GDP (see Chart 5.5). This is slightly smaller than the 1.6% surplus posted at the end of 2018. Compared with developments in the headline balance, the cyclically-adjusted surplus declined at a similar rate, as changes in the output gap over this period were marginal.

The small deterioration in the cyclically-adjusted surplus ratio was due to a 0.1 percentage point increase in the share of cyclically-adjusted expenditure in GDP, as the revenue-to-GDP ratio



³ The cyclically-adjusted balance is corrected for the impact of the economic cycle on government tax revenue and unemployment assistance. This methodology is in line with the approach used by the European Commission but is based on own estimates for fiscal items' elasticities and the output gap. For an overview of the method used by the Commission, see Mourre, G., C. Astarita, and S. Princen (2014): "Adjusting the budget balance for the business cycle: the EU methodology," European Economy – Economic Papers 536, (DG ECFIN), European Commission.

remained unchanged (see Table 5.2). Although the share of direct taxes in GDP increased significantly, reflecting higher inflows from income taxes as outlined above, this was mostly offset by a declining share of non-tax revenue in GDP due to lower IIP proceeds. At the same time, the share of cyclically-adjusted indirect taxes in GDP declined slightly.

Cyclically-adjusted expenditure as a share in GDP increased due to higher ratios of intermediate consumption and invest-

ment in GDP. These mostly reflected higher expenditure on health and infrastructure as outlined above. Meanwhile, the share of social benefits in GDP declined, mirroring ongoing efforts to reduce dependency on unemployment benefits and incentivise people to seek employment. The ratios of compensation of employees and interest payments in GDP also declined slightly in the period under review.

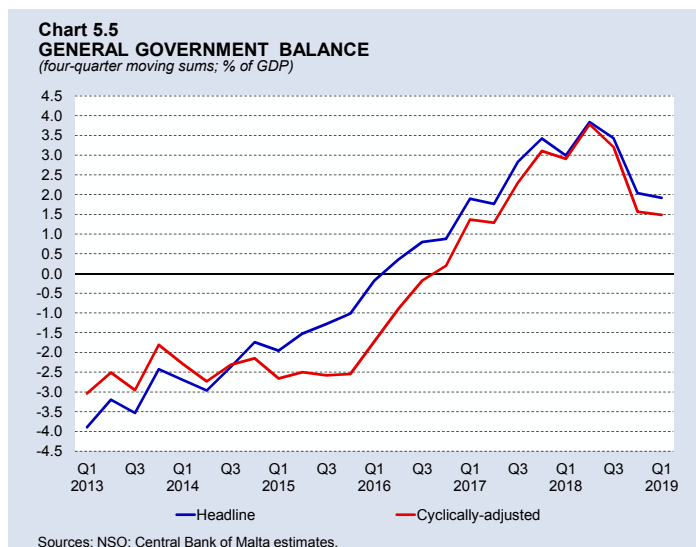


Table 5.2
QUARTER-ON-QUARTER CHANGES IN CYCLICALLY-ADJUSTED FISCAL COMPONENTS

Percentage points of GDP

	2017				2018				2019
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Revenue	0.4	0.6	0.7	0.1	0.0	0.2	-0.4	-0.1	0.0
Current taxes on income and wealth	0.1	-0.1	0.5	0.2	0.0	0.1	-0.2	-0.5	0.5
Taxes on production and imports	0.1	0.0	0.3	-0.2	-0.1	0.2	0.2	0.2	-0.1
Social contributions	0.0	0.0	0.0	0.0	0.0	0.2	-0.2	0.1	0.0
Other ⁽¹⁾	0.3	0.7	-0.1	0.0	0.1	-0.3	-0.2	0.1	-0.3
Expenditure	-0.7	0.7	-0.3	-0.7	0.2	-0.7	0.2	1.5	0.1
Compensation of employees	-0.1	-0.1	-0.1	0.0	0.0	-0.1	0.0	0.0	-0.1
Intermediate consumption	0.0	0.3	0.3	-0.3	0.0	0.0	-0.1	0.6	0.3
Social benefits	-0.2	-0.1	-0.1	-0.2	-0.1	-0.1	-0.1	0.0	-0.2
Interest payments	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Gross fixed capital formation	-0.2	0.2	-0.1	-0.1	-0.1	0.0	0.3	0.5	0.2
Other ⁽²⁾	-0.2	0.6	-0.3	-0.1	0.4	-0.4	0.3	0.6	-0.1
Primary balance	1.1	-0.2	0.9	0.7	-0.3	0.8	-0.7	-1.7	-0.1
General government balance	1.2	-0.1	1.0	0.8	-0.2	0.9	-0.6	-1.6	-0.1

Sources: NSO; Central Bank of Malta estimates.

⁽¹⁾ Includes market output, income derived from property and investments and current and capital transfers received.

⁽²⁾ Mainly includes subsidies, current and capital transfers.

6. MONETARY AND FINANCIAL DEVELOPMENTS

The Bank's FCI suggests that in the first quarter of 2019, financing conditions were broadly neutral from a historical perspective.

Maltese residents' deposits with MFIs in Malta expanded at a faster pace during the first quarter of 2019.¹ The shift to overnight deposits persisted, in an environment of low interest rates and a continued preference for liquidity. At the same time, credit growth continued to pick up, reflecting faster growth in credit to residents outside general government. Growth in mortgage loans to households and lending to NFCs remained strong. Interest rates on loans and deposits generally fell further when compared with a year earlier, though the spread between the two rates remained elevated.

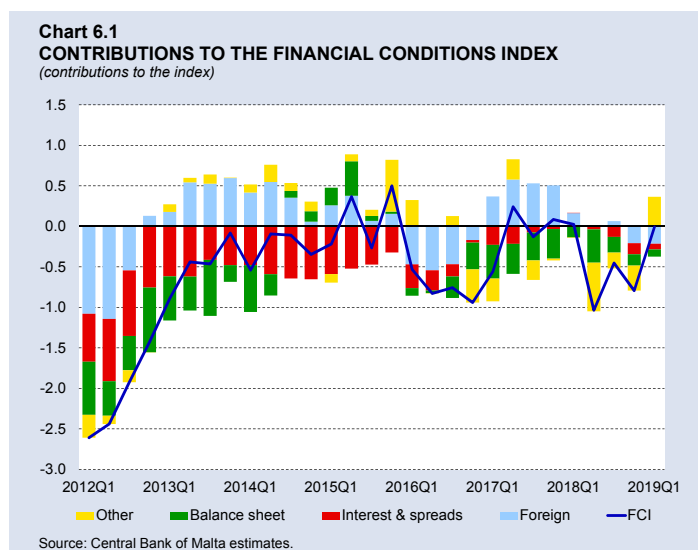
In March, the primary market yield on Treasury bills was unchanged from that prevailing at the end of December. Meanwhile, the secondary market yield on MGS fell. In the equity market, domestic share prices rose between December and March.

Monetary and financial conditions

FCI improves

The Bank monitors domestic financial conditions through a summary measure that combines a number of local and international financial variables that influence economic activity.²

According to the Bank's FCI, in the first quarter of 2019 financing conditions were broadly neutral from a historical perspective, and improved considerably when compared with the fourth quarter of 2018 (see Chart 6.1). The recent improvement mainly reflected a positive contribution from domestic influences. In particular, net issues of securities by domestic NFCs increased markedly. Furthermore, balance sheet indicators improved significantly as the return on equity of core banks increased when compared with the previous quarter. Conversely, foreign influences continued to have a tightening effect that was broadly similar to that in the fourth quarter of 2018, as a small improvement in euro area equity prices was offset by higher uncertainty.



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

² The analysis in this section is based on the Bank's FCI, as described in Micallef, B. & Borg, I. "A Financial Conditions Index for the Maltese Economy", in Grech, A.G. & Zerfa, S. (eds.), *Challenges and Opportunities of Sustainable Economic Growth: the case of Malta*, Central Bank of Malta, 2017, and later updated in the Central Bank of Malta - Annual Report 2017.

In the quarter under review, the FCI was approximately equal to that registered in the first quarter of 2018, as the deterioration from foreign influences was offset by an improvement in domestic factors. The stronger tightening through foreign influences reflects elevated international uncertainty, weaker activity and a deterioration in equity prices. Conversely, the improvement in balance sheet indicators and the rise in net issues of securities increased considerably, thus contributing to a positive contribution of domestic factors in the first quarter of 2019.

Maltese residents' deposits expand at a faster pace

Total deposits held by Maltese residents with MFIs in Malta continued to expand during the first quarter of 2019, with the annual rate of change standing at 6.2% in March (see Table 6.1). This followed a 5.5% year-on-year increase in the previous quarter. The continued strength in deposit growth is consistent with the elevated level of liquidity in the economy, supported by robust income growth.

Overnight deposits remained residents' preferred deposit category. Annual growth in this component rose to 8.4% in March, from 7.7% in December 2018. The share of this category in total deposits thus increased to 76.9%, from 75.3% a year earlier, thereby extending the established upward pattern observed in recent years (see Chart 6.2).

At the same time, growth in time deposits with an agreed maturity of over two years continued to accelerate, reaching 10.9%, from 8.2% three months earlier. Their share in total deposits edged up to 7.8%, from 7.5% a year earlier. On the other hand, growth in deposits with an agreed maturity of less than two years contracted further, decreasing by 6.6% over the year to March.

Table 6.1
DEPOSITS OF MALTESE RESIDENTS

	EUR millions	Annual percentage changes				
		2018	2019			
		Mar.	June	Sep.	Dec.	Mar.
Overnight deposits	14,709,799	8.6	5.4	7.1	7.7	8.4
<i>of which</i>						
Households	8,807,586	16.2	12.8	14.2	14.5	10.3
Non-financial corporations	3,523,037	9.6	9.0	10.1	3.8	4.1
Deposits redeemable at notice of up to three months	74,133	-50.7	-11.0	52.5	63.2	63.0
<i>of which</i>						
Households	34,731	-54.4	-26.7	-14.9	-9.9	-5.1
Non-financial corporations	19,995	-32.7	377.0	2359.4	530.2	238.6
Deposits with an agreed maturity of up to two years	2,854,693	-3.7	1.2	-6.7	-5.6	-6.6
<i>of which</i>						
Households	2,246,222	-4.8	-3.2	-5.5	-6.3	-6.4
Non-financial corporations	255,833	6.1	28.5	7.3	-9.5	-3.4
Deposits with an agreed maturity above two years	1,496,970	-11.0	-10.6	1.5	8.2	10.9
<i>of which</i>						
Households	1,302,933	-11.6	-11.4	-0.9	3.8	5.4
Non-financial corporations	58,368	3.7	-4.3	-1.1	9.9	-6.7
Total residents' deposits⁽¹⁾	19,135,594	4.3	3.2	4.3	5.5	6.2

Source: Central Bank of Malta.

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

As a result, their share in total deposits declined to 14.9%. The share of deposits redeemable at notice of up to three months remained marginal.

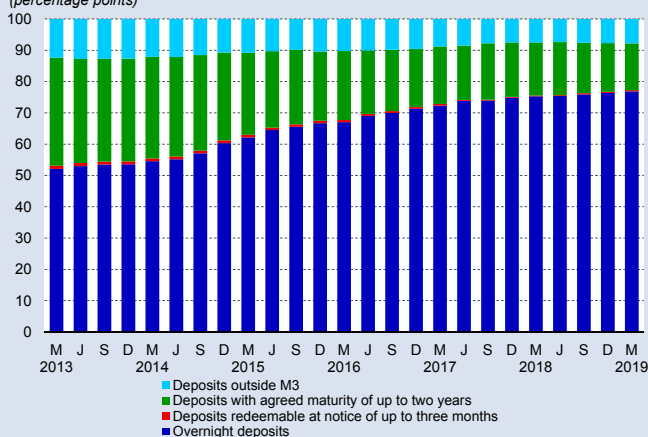
Credit to residents expands further

Credit to Maltese residents expanded by 5.1% in the year to March 2019, after growing by 4.5% in the previous quarter (see Table 6.2). This acceleration reflected faster growth in credit to residents outside general government (see Chart 6.3). At the same time, credit to general government continued to contract, reflecting a drop in banks' holdings of MGS.

The acceleration in credit outside general government was mainly driven by a faster expansion in loans. These rose by 7.1% in the year to March, reflecting faster growth in loans to households and continued robust growth in loans to NFCs.

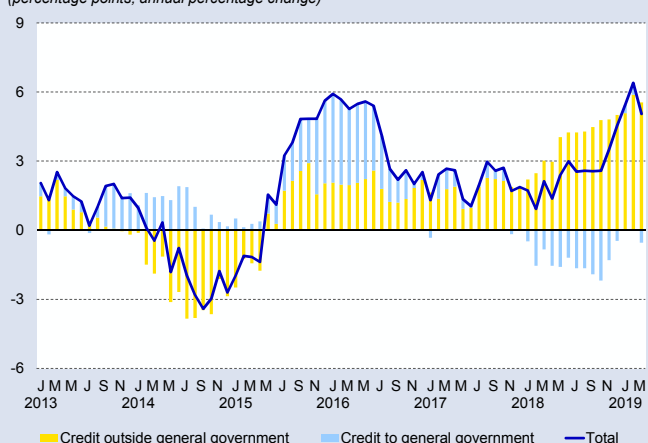
Loans to households grew by 8.7% on an annual basis,

Chart 6.2
DISTRIBUTION OF TOTAL RESIDENT DEPOSITS⁽¹⁾
(percentage points)



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

Chart 6.3
COMPOSITION OF CREDIT TO RESIDENTS OF MALTA
(percentage points; annual percentage change)



Source: Central Bank of Malta.

Table 6.2
MFI CREDIT TO MALTESE RESIDENTS

	EUR millions	Annual percentage changes					
		2019 Mar.	2018 Mar.	2018 June	2018 Sep.	2018 Dec.	2019 Mar.
Credit to general government	3,001		-3.4	-4.9	-8.0	-2.0	-2.4
Credit to residents outside general government	10,913		4.0	5.6	5.9	6.5	7.2
Securities & Equity	449		-1.2	7.6	9.9	5.1	9.1
Loans	10,465		4.2	5.5	5.7	6.6	7.1
<i>of which:</i>							
Loans to Households	5,670		6.9	7.1	7.5	7.8	8.7
Mortgages	5,090		8.3	7.8	8.2	8.8	9.6
Consumer Credit and Other Lending	580		-3.3	1.9	2.0	-0.4	1.9
Loans to NFCs ⁽¹⁾	3,964		0.1	4.0	4.6	7.1	7.0
Total credit to residents	13,914		2.1	3.0	2.6	4.5	5.1

Source: Central Bank of Malta.

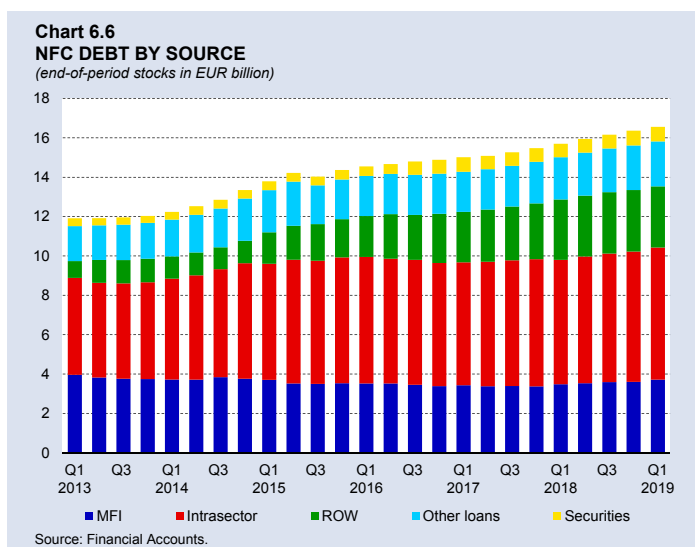
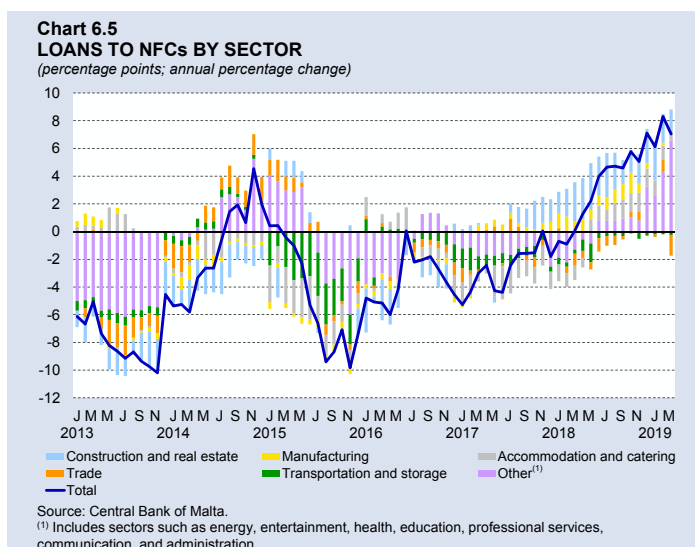
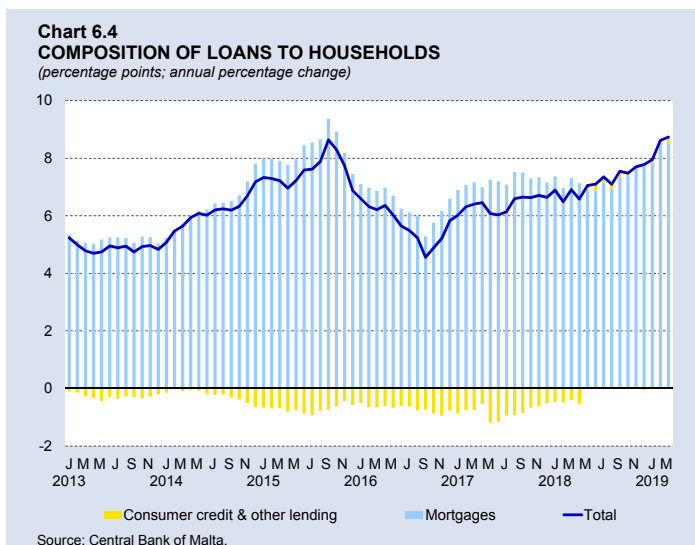
⁽¹⁾ NFCs include sole proprietors and non-profit institutions serving households.

underpinned by a further expansion in mortgage lending (see Chart 6.4). Consumer credit and other lending recovered, although the rate of growth was more moderate than that of mortgages.

Loans to NFCs grew by 7.0% in the year to March, after increasing by 7.1% in December. A sectoral breakdown shows that lending increased to several sectors, including professional, scientific, and technical activities (part of 'other' component), construction and real estate as well as accommodation and catering (see Chart 6.5).

Financial accounts data show that the share of bank lending in total NFC debt stood at 22.4% in March 2019, slightly above the share of 22.2% recorded a year earlier. This increase notwithstanding, NFCs still relied to a larger extent on intra-sectoral lending than on MFI credit.³ In fact, the share of the former in total NFC debt stood at 40.5%, marginally above the 40.2% registered in March 2018 (see Chart 6.6). On the other hand, the share of loans from the Rest of World sector (ROW), which mainly comprises loans from foreign banks or companies, eased to 18.8%. Other loan sources comprised 13.8% of total NFC debt.⁴ The share of debt securities remained limited, at 4.5%.

Malta Stock Exchange (MSE) data show that large companies are also increasingly making public issuances of corporate



³ See also Darmanin, J. (2017), "The financing of companies in Malta", Policy Note July 2017, Central Bank of Malta.

⁴ Other loan sources comprise loans from non-bank financial institutions and auxiliaries, households and government.

bonds and equity. As at March 2019, EUR 1.3 billion in corporate debt was listed on the MSE, 15.1% higher than the outstanding stock twelve months earlier (see Chart 6.7).⁵ The amount of equity listed on the MSE also increased, though it remains below that of debt securities.

Interest rate spread between deposit and lending rate remains elevated

Interest rates on residents' deposits with MFIs in Malta continued to decline in the year to March, with the weighted average deposit rate offered to households and NFCs down by 5 basis points, to 0.32% (see Table 6.3).⁶ This was mainly driven by a drop in rates on longer-term deposits, for both households and NFCs.

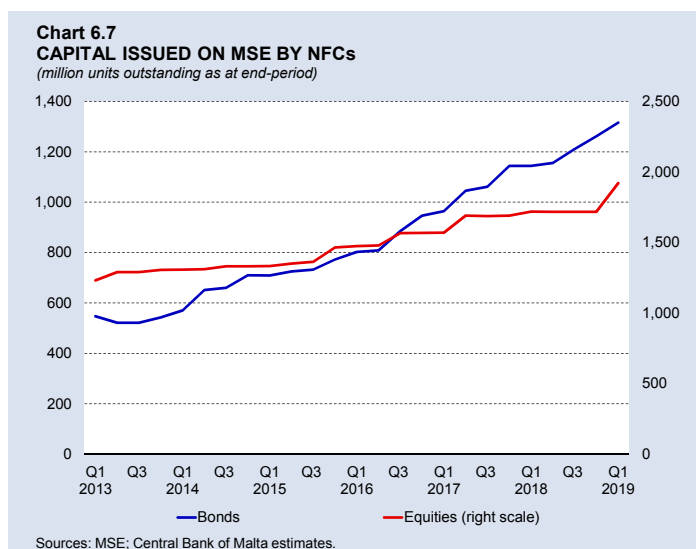


Table 6.3
INTEREST RATES ON DEPOSITS AND LOANS

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

	2016	2017	2018	2018			2019
	Mar.	Mar.	Mar.	June	Sep.	Dec.	Mar.
Total deposits⁽¹⁾	0.64	0.45	0.37	0.36	0.35	0.33	0.32
<i>of which</i>							
Overnight deposits							
Households	0.11	0.06	0.06	0.07	0.06	0.05	0.05
Non-financial corporations	0.09	0.03	0.06	0.05	0.04	0.02	0.03
Time deposits (less than 2 years)							
Households	0.98	0.79	0.75	0.76	0.77	0.75	0.74
Non-financial corporations	0.80	0.61	0.59	0.63	0.74	0.76	0.71
Time deposits (more than 2 years)							
Households	2.90	2.54	2.28	2.24	2.20	2.13	2.07
Non-financial corporations	2.13	1.89	2.04	2.11	2.12	1.88	1.84
Total Loans⁽¹⁾	3.78	3.64	3.64	3.61	3.58	3.55	3.52
<i>of which</i>							
Households and NPISH	3.58	3.49	3.46	3.44	3.41	3.38	3.36
Non-financial corporations	4.06	3.87	3.93	3.89	3.85	3.83	3.79
Spread⁽²⁾	3.14	3.19	3.28	3.25	3.23	3.22	3.20
ECB MROs rate	0.00	0.00	0.00	0.00	0.00	0.00	0.00

Source: Central Bank of Malta.

⁽¹⁾ Annualised agreed rates on outstanding euro-denominated amounts belonging to households (incl. NPISH) and non-financial corporations.

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

⁵ A number of companies have obtained capital from the recently launched MSE platform Prospects, which is mainly geared towards Small and Medium-Sized Enterprises (SMEs).

⁶ Basis points are rounded to the nearest whole number, and hence may not exactly match the figures given in Table 6.3.

At the same time, the weighted average lending rate paid to resident MFIs by households and NFCs fell by 12 basis points, to 3.52%. This decrease was reflected in rates paid by both households and NFCs, although the weighted average lending rate paid by NFCs remained above those charged to households, reflecting different assessments of credit risk.

The spread between the weighted average lending rate and the deposit rate closed the quarter under review at 320 basis points, slightly narrower than its level of 328 points 12 months earlier. The elevated level of the spread suggests that the transmission of the ECB's monetary policy easing measures to retail lending rates remained weaker than that to deposit rates.

Bank Lending Survey (BLS) indicates increasing demand for credit to NFCs

According to the BLS, which was conducted in April 2019, respondent banks reported unchanged credit standards, terms and conditions for NFCs in Malta during the first quarter of 2019. Going forward, participating banks also expected credit standards to remain unchanged in the second quarter of 2019. However, as regards, the demand for credit, half of the respondent banks assessed the demand for credit by NFCs to have increased and anticipated a further increase in the second quarter of the year, with the remaining banks expecting stable demand.

Generally, respondent banks reported unchanged standards, terms and conditions for credit for house purchases. Only one bank registered an increase in the demand for credit for house purchases during the first quarter, whilst all banks anticipated stable demand in the second.

Banks participating in the BLS reported unchanged standards, terms and conditions for consumer credit and other lending. Credit demand was also stable, with no changes anticipated for the second quarter.

The April BLS posed ad hoc questions on banks' access to wholesale and retail funding and on their risk transfer capability as a result of the prevailing situation in financial markets. In this regard, half of the participating banks reported unchanged market access to funding and risk transfer capabilities. One bank however, reported some impact on its unsecured segment of its inter-bank unsecured money market in the preceding three months. Meanwhile, half of the participating banks reported some easing on their retail funding operations in the preceding three months and the three months ahead.

Banks were also asked to gauge their current level of credit standards against those that prevailed between the first quarter of 2003 and now and between the second quarter of 2010 and present levels. The majority of banks considered the level of credit standards on loans to enterprises in 2019 to be tighter than in 2003 and 2010. With regard to households, half of the banks participating in the survey reported moderately tighter conditions for house purchases, while the other half reported looser standards currently. One bank claimed that standards for consumer credit and other lending have remained constant during this period. Another noted that standards had loosened, whilst the remaining banks reported a moderate tightening.

Banks were also asked to assess the impact of the expanded asset purchase programme (APP) as well as the reinvestment of the principal payments from maturing APP securities on their financial situation and assets. Banks reported that the APP had no impact on their operations in

the past six months and no changes were expected in the six months ahead. Furthermore, the APP had no impact on the participating banks' credit standards, lending volumes and terms and conditions.

Finally, as regards the impact of the ECB's negative deposit facility rate, the majority of banks reported a decline in their net interest income. Half of the banks reported some loosening in lending rates and margins on loans to enterprises over the past six months. These banks expected some further loosening over the following six months. The effect of the negative deposit rate on loans to households appears more limited. None of the responding banks reported any effects on lending rates and lending margins on loans to households. However, one bank reported some increase in the volume of loans to households for house purchase, which should also be observed in the following six months.

The money market

Domestic money market interest rates remain unchanged from their end 2018 level

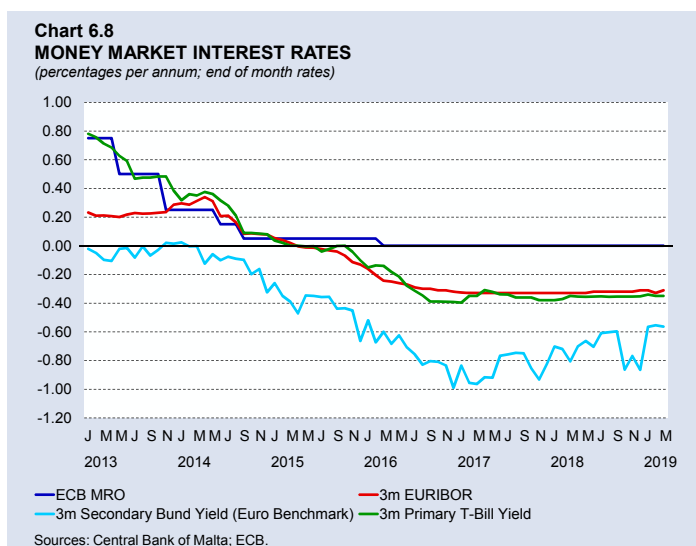
The ECB maintained its key interest rates unchanged during the first quarter of 2019. At -0.31%, the three-month EURIBOR was also unchanged from the rate prevailing at the end of December 2018. Meanwhile, secondary market yields on three-month German government securities, which act as a benchmark for euro area yields, rose to -0.56% from -0.87% (see Chart 6.8)

In the domestic primary market, the yield on three-month Treasury bills stood unchanged from the rate prevailing at the end of December, at -0.35%. As the yield on the euro area benchmark rose during this period, the spread between this rate and the yield on domestic three-month Treasury bills narrowed. At the end of March, it stood at 29 basis points, down from 63 basis point at end-December.

During the first quarter of 2019 the Government issued €253.1 million in Treasury bills, €174.7 million less than the amount of €427.8 million issued between October and December.

The capital market

During the first quarter of 2019, the Government issued two new MGS with a total value of €80.0 million. Meanwhile, three public limited companies announced new bond issues: International Hotel Investments plc issued €20.0 million in unsecured bonds, Endo Finance plc issued €13.5 million in unsecured bonds, while Mercury



Projects Finance plc issued two secured bonds amounting to €11.5 million and €11.0 million, respectively.

By the end of March 2019, 16 firms had listed bonds through Prospects, up from 12 at the end of December. Hence, €15.9 million worth of bonds were issued through this facility in the first quarter of 2019.

In the secondary market, government bonds turnover fell to €61.1 million during the quarter under review, compared with €64.5 million in the preceding quarter. In contrast, over the same period, turnover in corporate bonds rose to €27.4 million, from €25.3 million.

During the first quarter of 2019, secondary market yields on Maltese government bonds fell (see Chart 6.9). The yield on five-year bonds dropped significantly and ended March at 0.17%, from 0.44% at the end of December. Similarly, the yield on ten-year bonds fell by 37 basis points, and ended March at 0.96%. In the euro area, the yields on five-year and ten-year bonds fell by 22 and 32 basis points, ending the first quarter of 2019 at -0.49% and -0.07%, respectively. As the domestic ten-year yield fell faster than the euro area benchmark yield, the spread against the latter narrowed marginally to 103 basis points in the March quarter, from 108 basis points three months earlier.

MSE share index ends March at higher levels

Share prices in Malta, as measured by the MSE Equity Price Index rose during the first quarter of 2019. At end-March, they stood 4.3% higher than three months earlier and 5.3% above their level in March 2018 (see Chart 6.10). The MSE Equity Total Return Index, which accounts for changes in equity prices and dividends, rose by 4.5% since the end of December.

Equity turnover rose to €28.8 million during the first quarter of 2019, from €22.5 million in the December quarter.

