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## ABBREVIATIONS

APP	asset purchase programme
BCI	Business Conditions Index
BLS	Bank Lending Survey
CPI	consumer price index
EC	European Commission
ECB	European Central Bank
EER	effective exchange rate
EONIA	Euro OverNight Index Average
ESI	economic sentiment indicator
EU	European Union
EURIBOR	Euro Interbank Offered Rate
FCI	Financial Conditions Index
FOMC	Federal Open Market Committee
GCI	Global Competitiveness Indicators
GDP	gross domestic product
GFCF	gross fixed capital formation
GVA	gross value added
HCI	harmonised competitiveness indicator
HFCS	Household Finance and Consumption Survey
HICP	Harmonised Index of Consumer Prices
IIP	Individual Investor Programme
IMF	International Monetary Fund
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
NDSF	National Development and Social Fund
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
ROW	Rest of World
RPI	Retail Price Index
SME	small and medium-sized enterprise
TLTRO	Targeted long-term refinancing operations
ULC	unit labour cost
UK	United Kingdom
US	United States

## FOREWORD

In the second quarter of 2019, the pace of economic activity decelerated further, with real gross domestic product (GDP) rising by 4.0% in annual terms, following a 5.4% increase in the previous quarter. This reflected slower growth in domestic demand, as the contribution of net exports turned positive.

Potential output growth eased slightly, although it remained elevated from a historical perspective. 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. The positive output gap, measured as a four-quarter moving average, narrowed marginally compared with the first quarter of 2019 and stood well below 2015 and 2016 levels.

Meanwhile, the Bank's Business Conditions Index (BCI) eased in the second quarter of 2019, but continued to indicate above-average conditions.

Labour market conditions remained favourable, as employment grew strongly. Notwithstanding a further increase in labour market participation rates and rising foreign employment, the unemployment rate fell compared with the previous year. At 3.4%, the unemployment rate remained below the Bank's structural measure of 4.0%, and thus continued to suggest a degree of tightness in the labour market.

Annual inflation based on the Harmonised Index of Consumer Prices (HICP) accelerated to 1.8% in June from 1.3% in March. Services inflation remained the largest contributor to overall HICP inflation, while also explaining part of the pick-up over the quarter. Inflation based on the Retail Price Index (RPI), which only takes into account purchases made by Maltese households, stood unchanged from the rate of 1.9% recorded three months earlier.

Cost pressures for producers continued to ease, with the annual growth in the industrial producer price index falling to 1.6% in June, from 2.4% in March. This reflected 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 rose at a slower pace. With regard to international competitiveness, Malta's harmonised competitiveness indicators (HCIs) showed a deterioration in competitiveness, driven by unfavourable exchange rate developments.

In the second quarter of 2019, the surplus on the current account of the balance of payments increased when compared with the corresponding quarter of 2018. The higher surplus was mainly attributable to larger net services receipts and a smaller merchandise trade gap. When measured on a four-quarter moving sum basis, the current account surplus was equivalent to 9.8% of GDP. The cyclically-adjusted measure was estimated at 11.6%, indicating that Malta's current account surplus largely reflects structural factors.

When measured as a four-quarter moving sum, the general government surplus narrowed to 1.0% of GDP in the second quarter of 2019, from 1.8% in the first quarter of the year. The cyclically-adjusted surplus-to-GDP ratio also declined, broadly mirroring developments in the headline balance. Meanwhile, the general government debt as a share of GDP fell to 45.7% from 46.4% at the end of March.

During the quarter under review, Maltese residents' deposits with monetary financial institutions (MFIs) in Malta continued to expand at a robust pace. 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 a return to positive growth in credit to general government and continued strong growth in credit to other residents. Growth in mortgage loans to households rose at a faster pace, while lending to non-financial corporations (NFCs) moderated. According to the Bank's Financial Conditions Index (FCI), financing conditions were slightly tight from a historical perspective.

The Governing Council of the European Central Bank (ECB) maintained an accommodative monetary policy stance during the second quarter of 2019. The interest rates on the main refinancing operations, on the marginal lending facility and on the deposit facility remained at 0.00%, 0.25% and -0.40%, respectively. The Council said that it expected rates to remain at present levels at least through the first half of 2020, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term.

The Governing Council also reiterated its intention to reinvest in full the principal payments from maturing securities under the asset purchase programme (APP) 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.

In September, however, the Governing Council cut the deposit facility by 10 basis points, to -0.50%, adding that key ECB interest rates are expected to remain at current or lower levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics. Furthermore, the Council decided that net purchases under the APP would resume at a monthly pace of €20 billion as from 1 November. These should end shortly before the key ECB interest rates start rising again.

Moreover, in order to support the bank-based transmission of monetary policy, the Governing Council decided to introduce a two-tier system for reserve remuneration in which part of banks' holdings of excess liquidity will be exempt from the negative deposit facility rate.

The weighted average interest rate on deposits held by Maltese residents with domestic banks fell below that for June 2018 and was unchanged from the rate recorded in March. The weighted average lending rate paid to resident MFIs by households and NFCs decreased slightly from March. The spread between the two remained elevated from a historical perspective.

The yield on Treasury bills fell marginally in June, from the level prevailing at the end of March. Meanwhile, the decline in secondary market yields on Malta Government Stocks (MGS) was more pronounced. In the equity market, domestic share prices rose between March and June.

## ECONOMIC SURVEY

### 1. THE EXTERNAL ENVIRONMENT AND THE EURO AREA

*In the second quarter of 2019, real GDP growth slowed down in the United States and the euro area and turned negative in the United Kingdom. The three-month average unemployment rate fell in the United States and the euro area, but edged up slightly in the United Kingdom.*

*Annual consumer price inflation in the United States decreased to 1.6% in June from 1.9% in March. Over this period, euro area inflation decreased marginally to 1.3%, from 1.4%. On the other hand, inflation in the United Kingdom rose marginally from 1.9% in March to 2.0% in June. The ECB, the Federal Reserve and the Bank of England all kept their key interest rates unchanged during the quarter under review.*

*Brent oil prices generally rose in the first half of the second quarter, on escalating political tensions in the Middle East and continued compliance with pre-agreed OPEC output targets. Thereafter, oil prices receded somewhat amid concerns that the China and US trade war could amplify the global economic downturn. The price of Brent oil ended the quarter 0.6% higher than the level prevailing at end-June. Meanwhile, non-energy commodity prices also rose marginally.*

#### Key advanced economies

##### *US economy slows down*

Economic activity in the United States slowed down in the second quarter of 2019, with quarter-on-quarter real GDP growth decelerating to 0.5%, from 0.8% in the previous quarter (see Table 1.1).

The deceleration in real GDP growth mainly reflected a downturn in gross private domestic investment, including inventories. Decreases in these components offset faster growth in personal consumption expenditure and government expenditure. Meanwhile, the net trade deficit widened.

In the labour market, the participation rate averaged 62.8% in the second quarter of 2019, from 63.1% in the preceding quarter. Meanwhile, employment grew at a slower pace, with the annual rate of increase edging down to 0.9% from 1.2% in the first quarter. Non-farm payroll data suggest that the slowdown was most significant in the mining and logging sector, and to a lesser extent in the construction and manufacturing sectors. Employment in services eased only marginally. The

**Table 1.1**  
**REAL GDP GROWTH IN SELECTED ADVANCED ECONOMIES**

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

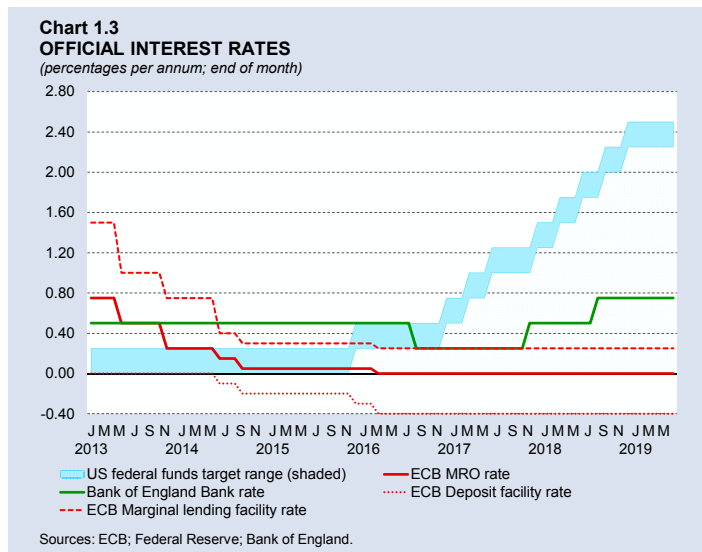
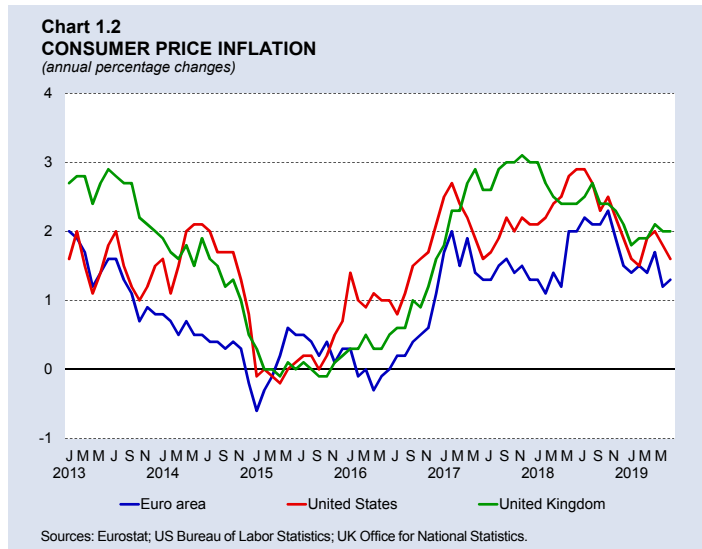
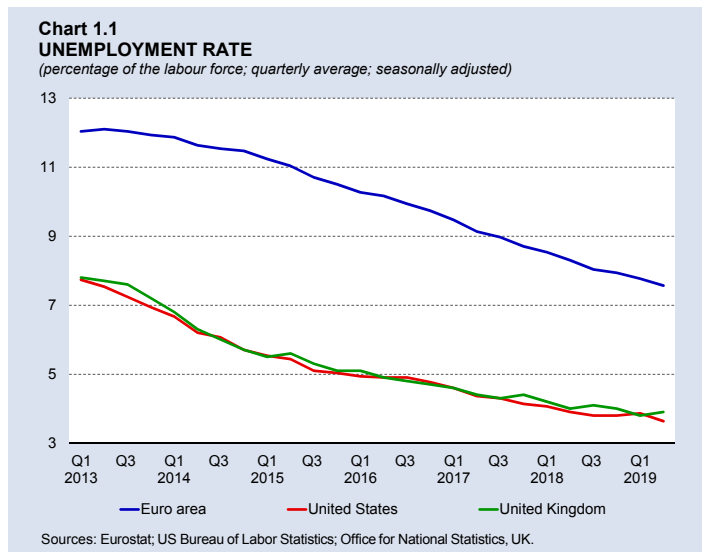
	2017			2018				2019	
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
United States	0.5	0.8	0.9	0.6	0.9	0.7	0.3	0.8	0.5
Euro area	0.7	0.8	0.8	0.3	0.4	0.2	0.3	0.4	0.2
United Kingdom	0.3	0.5	0.4	0.1	0.4	0.7	0.2	0.5	-0.2

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

average unemployment rate over the three months to June stood at 3.6%, as against 3.9% in the previous quarter (see Chart 1.1).

The annual rate of change of the US consumer price index (CPI) moderated to 1.6% in June from 1.9% in March (see Chart 1.2). This reflected developments in energy and food inflation. Energy inflation was more negative. It stood at -3.4% in June, as against -0.4% in March. Food inflation eased from 2.1% to 1.9%. Meanwhile, inflation excluding food and energy edged up slightly to 2.1% from 2.0% in March.

The Federal Open Market Committee (FOMC) kept the target range for the federal funds rate unchanged between 2.25% and 2.50% in the second quarter of 2019 (see Chart 1.3). In June 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, but uncertainties about this outlook have increased. In light of these uncertainties and muted inflation pressures, the Committee will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion, with a strong labour market and inflation near its symmetric 2 percent objective.”



The Committee also decided to maintain its existing policy of reinvesting in agency mortgage-backed securities the amount of principal payments from the Federal Reserve's holdings of agency debt and mortgage-backed security holdings, and rolling over at auction principal payments from maturing Treasury securities, when these exceed specified thresholds.<sup>1</sup>

### *UK economic growth contracts*

Quarter-on-quarter GDP growth in the United Kingdom turned negative, standing at -0.2% in the second quarter of 2019. This followed an increase of 0.5% in the first quarter (see Table 1.1). This mainly reflected a contraction in investment. At the same time, government and private consumption grew at a slightly slower pace compared with the preceding quarter. Meanwhile, the contribution of net exports turned positive, as imports fell much more strongly than exports.

Despite the decline in economic activity, employment rose by 1.3% in the second quarter from 1.1% in the first. Meanwhile, unemployment averaged 3.9%, 0.1 percentage point higher than in the preceding three-month period (see Chart 1.1).

Consumer price inflation in the United Kingdom increased slightly during the second quarter, standing at 2.0% in June, up from 1.9% in March (see Chart 1.2). Energy and, to a lesser extent, food price inflation increased. On the other hand, prices of non-energy industrial goods grew at a slower pace. Meanwhile, services price inflation was stable. In June, the annual rate of inflation based on the CPI excluding energy, food, alcohol and tobacco remained unchanged from March, at 1.8%.

In its meetings held in May and June, the Bank of England's Monetary Policy Committee maintained the Bank Rate unchanged at 0.75% (see Chart 1.3). The Committee noted that although near-term data was broadly in line with the May report, downside risks to growth had increased. Globally trade tensions have intensified, contributing to volatility in global equity prices and corporate bond spreads, as well as falls in industrial metals prices. Forward interest rates in major economies have fallen further. Increased Brexit uncertainties have put additional downward pressure on UK forward interest rates and led to a decline in the sterling exchange rate. UK data have been volatile, in large due to Brexit-related effects on financial markets and businesses. However, even looking through this volatility, it seemed that growth in the first half of the year was slightly below that in 2018 and also a little below potential, mainly reflecting weak business investment.

The Committee also noted that if the economy were to develop broadly as projected in the Bank of England's May Inflation Report, a gradual and limited tightening in monetary policy would be appropriate to return inflation sustainably to the 2% target. At the same time, the prevailing stance of monetary policy at that point was deemed appropriate.

The Committee added that the economic outlook will continue to depend significantly on the nature and timing of the UK's withdrawal from the European Union, in particular: the new trading arrangements between the European Union and the United Kingdom; whether the transition to them is abrupt or smooth; and how households, businesses and financial markets respond. The

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<sup>1</sup> In July, the FOMC lowered the target range for the federal funds rate to between 2.00% and 2.25%, in light of the implications of the weaker global economic outlook as well as muted inflation pressures. In September, the target rate was lowered further to between 1.75% and 2.00%.

appropriate path of monetary policy will depend on the balance of these effects on demand, supply and the exchange rate. The monetary policy response to Brexit, whatever form it takes, will not be automatic and could be in either direction.

Meanwhile, the Committee also said that it would maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at GBP 10 billion. The Committee also voted unanimously to maintain the stock of UK government bond purchases, financed by the issuance of central bank reserves, at GBP 435 billion.<sup>2</sup>

## The euro area

### *GDP growth in the euro area moderates*

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

The slowdown in real GDP during the second quarter of 2019 reflected a negative contribution from net exports, which shed 0.1 percentage point off GDP growth, following a positive contribution in the previous quarter. On the other hand, domestic demand continued to lift GDP, with the latter's contribution slightly higher than in the first quarter of the year. Changes in inventories had a negligible impact on GDP growth during the quarter under review, following a negative contribution in the preceding two quarters. At the same time, gross fixed capital formation rose at a faster pace. Movements in these components offset weaker growth in private consumption, while the contribution from government consumption remained broadly unchanged.

### *Euro area inflation eases slightly*

The annual rate of inflation in the euro area, measured on the basis of the HICP, eased to 1.3% in June from 1.4% in March, reflecting movements in food and energy prices (see Chart 1.4). In contrast, services and non-energy industrial goods (NEIG) inflation edged up. Consequently,

**Table 1.2**

**CONTRIBUTIONS TO QUARTERLY REAL GDP GROWTH IN THE EURO AREA<sup>(1)</sup>**

*Seasonally and working day adjusted*

	2017		2018				2019	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
	<i>Percentage point contributions</i>							
Private consumption	0.3	0.2	0.3	0.1	0.1	0.2	0.2	0.1
Government consumption	0.1	0.1	0.0	0.1	0.0	0.1	0.1	0.1
Gross fixed capital formation	-1.0	0.2	0.1	0.4	0.1	0.3	0.0	0.1
Changes in inventories	-0.2	-0.1	0.2	0.0	0.2	-0.3	-0.2	0.0
Exports	0.6	1.1	-0.2	0.5	0.2	0.5	0.5	0.0
Imports	1.0	-0.7	0.0	-0.6	-0.4	-0.4	-0.2	-0.1
<b>GDP</b>	<b>0.8</b>	<b>0.8</b>	<b>0.3</b>	<b>0.4</b>	<b>0.2</b>	<b>0.3</b>	<b>0.4</b>	<b>0.2</b>

Source: Eurostat.

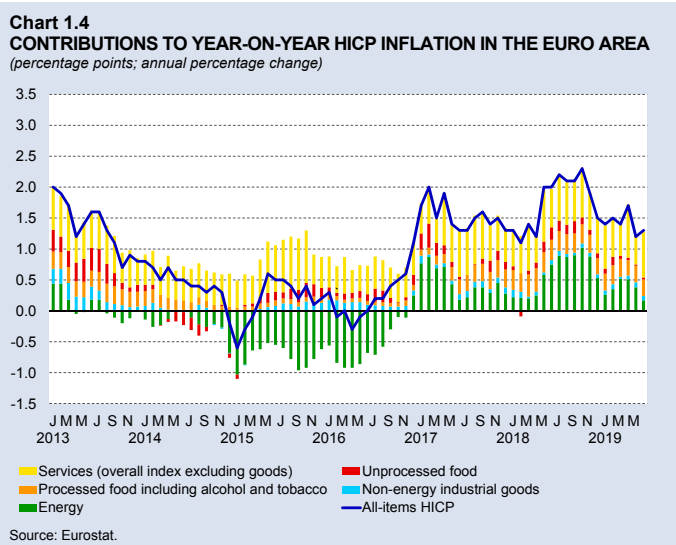
<sup>(1)</sup> Figures may not add up due to rounding.

<sup>2</sup> The Bank of England's Monetary Policy Committee kept the Bank Rate unchanged in August and September. 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.

HICP excluding energy and food reached 1.1% in June from 0.8% in March, mainly reflecting slightly stronger growth in services prices.

*Employment growth moderates, yet unemployment falls further*

Labour market conditions in the euro area improved further during the quarter under review. The seasonally-adjusted unemployment rate fell to 7.5% in June, from 7.7% in March and from 8.2% a year earlier (see Chart 1.1). The three-month average rate fell to 7.6% in the second quarter of 2019, from 7.8% in the preceding quarter. Meanwhile, employment continued to grow although, in the quarter under review, the annual rate of change edged down to 1.2%, from 1.4% in the first quarter of the year.<sup>3</sup>



*Euro area outlook weakens*

In its commentary on the latest ECB staff macroeconomic projections, published in September 2019, the ECB noted that although real GDP growth eased in the second quarter, it was in line with the June 2019 projections. At the same time, recent short-term indicators suggested that the recovery envisaged in the June projections for the remainder of the year, will be postponed amid ongoing weakness in global trade in a highly uncertain external economic environment.

Over the medium-term, a number of fundamental factors should enable the euro area’s economic expansion to regain traction. In particular, these include a very accommodative monetary policy stance, robust growth in wages, higher net worth, as well as declining unemployment and a degree of expansionary fiscal stance. Furthermore, the private sector should also benefit from resilient growth in lending spurred by an improving macroeconomic environment, very low interest rates, favourable lending conditions and lower deleveraging needs. Euro area exports are also expected to 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. In particular, low business confidence is expected to weaken business investment. The expiration of some tax incentives, as well as increasing labour supply constraints also play a role. Real GDP growth is projected to stand at 1.1% in 2019, before accelerating to 1.2% in 2020 and to 1.4% in 2021 (see Table 1.3).

Private consumption growth edged down in the second quarter of 2019, partly due to the unwinding of a temporary boost at the start of the year, but should continue to grow strongly over the projection horizon, in part sustained by still favourable consumer confidence. It is also set to benefit from a further amelioration in labour market conditions and rising real wages. In some

<sup>3</sup> National accounts data.

**Table 1.3**  
**MACROECONOMIC PROJECTIONS FOR THE EURO AREA<sup>(1)</sup>**  
*Annual percentage changes*

	2018	2019	2020	2021
<b>GDP</b>	<b>1.9</b>	<b>1.1</b>	<b>1.2</b>	<b>1.4</b>
Private consumption	1.4	1.3	1.3	1.3
Government consumption	1.1	1.5	1.5	1.4
Gross fixed capital formation	2.3	3.1	1.9	2.1
Exports	3.5	2.3	2.4	3.0
Imports	2.7	2.6	3.1	3.4
<b>HICP</b>	<b>1.8</b>	<b>1.2</b>	<b>1.0</b>	<b>1.5</b>

Source: ECB.

<sup>(1)</sup> ECB staff macroeconomic projections (September 2019).

countries, moreover, private consumption should also benefit from a degree of fiscal easing. Over the medium-term, private consumption should be supported by favourable financing conditions and rising household net worth.

Residential investment is expected to grow at a more moderate pace. This reflects a decline in building permits over the last quarter and a fall in the share of households expecting to undertake home improvements over the next year. Adverse demographic trends in some countries are also expected to dampen housing investment.

Business investment is also expected to increase, but at a rather subdued pace. This reflects relative weakness of global trade and concerns about further escalation of trade disputes, as well as the possibility of a no-deal Brexit and a hard landing in China, all of which have adverse effects on business confidence. Nonetheless, there are a number of factors that should favour business investment. These include high rates of capacity utilisation, stronger balance sheets, supportive financing conditions, increasing profitability and the need to compensate for labour shortages.

Growth in government consumption is expected to average 1.5% between 2019 and 2021.

On the external side, growth in extra-euro area exports has been volatile in recent months. However, over the medium term, these are projected to recover and grow broadly in line with foreign demand. Extra-euro area imports are anticipated to remain rather subdued in the near term, reflecting developments in exports and weakened investment and activity dynamics in some euro area countries. Extra-euro area imports are expected to grow broadly in line with aggregate demand (domestic demand plus exports) over the rest of the projection horizon. Overall, the contribution of net trade is expected to be negative during the remainder of 2019 and remain broadly neutral over the projected horizon.

Compared with the June 2019 projections, GDP growth has been revised down in 2019 and 2020. Downward revisions in the first few quarters of the projection horizon reflect the continued weakness in sentiment in the context of heightened global uncertainties. Nonetheless, the quarterly profile of economic growth has remained unchanged from early 2020, as the impact of downward revisions to foreign demand is broadly offset by the impact of more favourable financing conditions and lower oil prices (relative to the June 2019 oil price assumptions).

HICP inflation is set to average 1.2% in 2019 and to ease further to 1.0% in 2020, before picking up to 1.5% in 2021. The rather volatile but subdued levels of HICP inflation until the second half of 2020 mainly reflect expected developments in energy inflation.

In contrast, HICP inflation excluding energy and food is set to rise progressively over the forecast horizon, reaching 1.5% in 2021, from 1.0% in 2018. The moderate upward path of underlying inflation is expected to be supported by the anticipated pick-up in economic activity and the associated recovery in profit margins, as well as rising non-energy commodity prices and underlying global inflation.

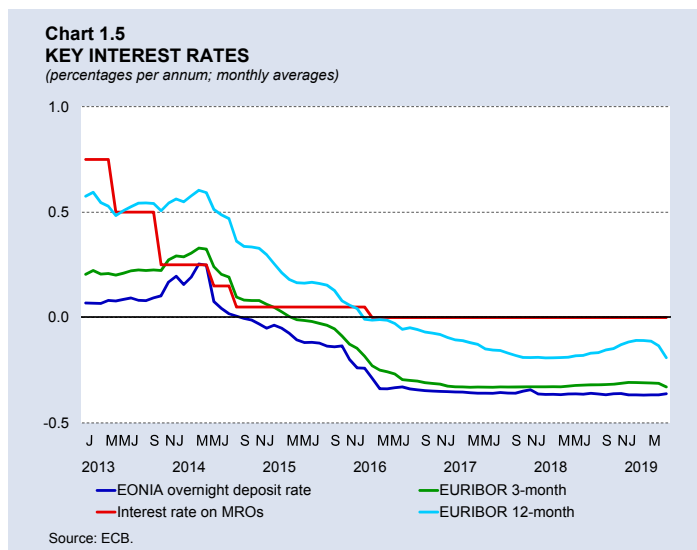
Compared with the June 2019 projections, overall inflation was revised downwards over the whole horizon. These revisions are largely explained by the energy component which was revised downwards quite significantly in 2019 and 2020. HICP inflation excluding energy and food was also revised down mainly reflecting weaker data outturns, weaker activity and indirect effects from lower energy prices, as well as persistent past over-predictions.

### *ECB maintained its accommodative monetary policy stance*

The ECB's Governing Council continued with its accommodative monetary policy stance during the second quarter of 2019. The interest rates on the MROs and the marginal lending facility and the deposit facility remained at 0.00%, 0.25% and -0.40%, respectively (see Chart 1.5). In June, the Council announced that key ECB interest rates are expected to remain at present levels at least through the first half of 2020, 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.<sup>4</sup>

It also reiterated its intention to reinvest in full the principal payments from maturing securities under the APP 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.<sup>5</sup>

The Governing Council further announced that the interest rate in each operation in the TLTRO-III series 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 operation. For banks whose eligible net lending exceeds a benchmark, the



<sup>4</sup> On 12 September the Governing Council reduced the interest rate on the deposit facility by 10 basis points, to -0.50%. The interest rate on the MROs and the marginal lending facility remained unchanged. The Council also said that it expected rates to remain at their present or lower levels until it has seen the "inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon and such convergence has been consistently reflected in underlying inflation dynamics."

<sup>5</sup> In September, the Governing Council announced the resumption of net asset purchase, under the APP at a monthly pace of €20 billion from 1 November 2019.

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.<sup>6</sup>

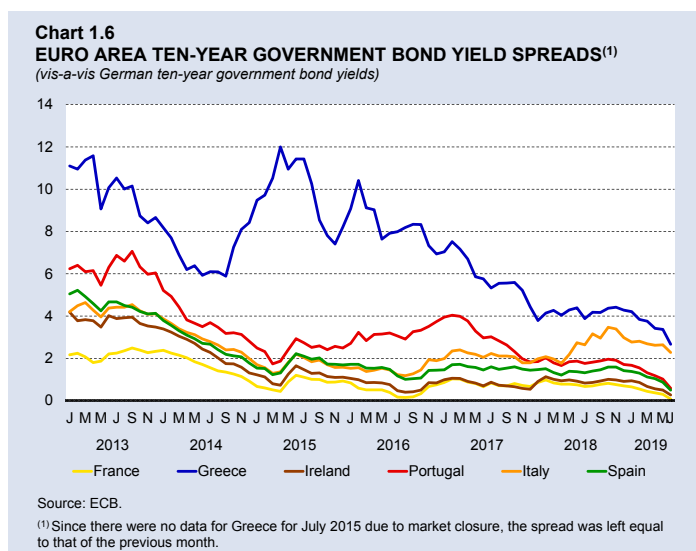
### Money market rates further decline

Money market rates in the euro area generally fell during the second quarter of 2019, reflecting the accommodative monetary policy stance of the ECB. Although the EONIA overnight deposit rate rose marginally to -0.36% from its March level of -0.37%, the three-month EURIBOR edged down slightly to -0.33% in June, from -0.31% in March. Over this period, the 12-month EURIBOR rate fell from -0.11% to -0.19%.<sup>7,8</sup>

### Euro area bond yields continue to decline

Ten-year benchmark government bond yields in the euro area further declined during the second quarter of 2019. The strongest decline was registered in Greek bond yields which fell by 109 basis points to 2.67%. Portuguese, Spanish and Italian bond yields followed, declining by 73 and 62 basis points, to 0.59% and 0.50%, respectively. Smaller declines, of around 40 basis points, were recorded in Ireland and Italy. In May, German bond yields turned negative. These fell by 32 basis points, reaching a 33-month low of -0.31%. Most of this decline occurred in June, amid signs of further monetary stimulus and a prolonged period of monetary accommodation by key central banks, including the ECB, as well as soft economic data.

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 second quarter (see Chart 1.6). The largest spread compression was recorded in Greece, where the announcement of an early general election led some investors to expect more market-friendly policies from the new administration. Additionally, an early election also meant that the economic risks stemming from a protracted pre-election period were limited.



<sup>6</sup> The modalities of these operations were modified in September, to preserve favourable bank lending conditions, ensure the smooth transmission of monetary policy and further support the accommodative stance of monetary policy. Furthermore, a two-tier system for reserve remuneration was also announced. See: <https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.mp190912~08de50b4d2.en.html>

<sup>7</sup> The EONIA (Euro Over Night Index Average) is a measure of the effective interest rate prevailing in the euro overnight market. Until 30 September 2019, it was measured as the weighted average of the interest rates on unsecured interbank overnight lending transactions, in euro denomination, as reported by a panel of contributing banks. As of 2 October 2019, and until its discontinuation on 3 January 2022, the EONIA will be calculated as €STR plus a fixed spread of 8.5 basis points. The euro short-term rate (€STR) is a reference rate based on money market data collected by the Eurosystem, reflecting the wholesale euro unsecured overnight borrowing costs of banks located in the euro area. It was first published by the ECB on 2 October 2019. See: [https://www.ecb.europa.eu/stats/financial\\_markets\\_and\\_interest\\_rates/euro\\_short-term\\_rate/html/index.en.html](https://www.ecb.europa.eu/stats/financial_markets_and_interest_rates/euro_short-term_rate/html/index.en.html)

<sup>8</sup> The euro interbank offered rate (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 euro rises moderately in effective terms*

The nominal effective exchange rate against the EER-19 group of countries rose by 1.6% between March and June.<sup>9</sup>

The euro appreciated by 4.5% and 1.3% against the British pound and the US dollar respectively (see Chart 1.7). It also increased against a number of other currencies, including the Chinese yuan renminbi and the Swedish krona. Meanwhile, it depreciated by 1.5% against the Japanese yen.

## Commodities

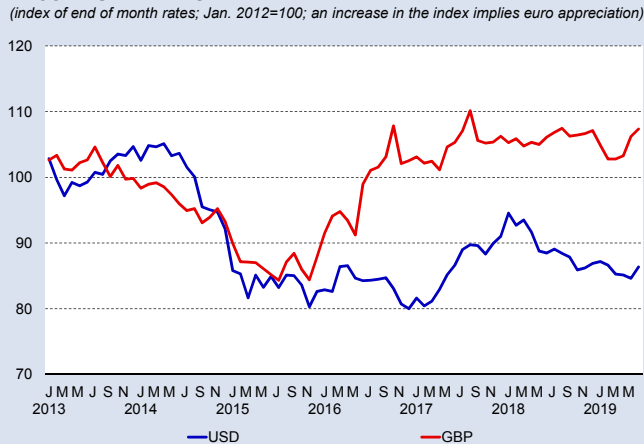
### *Commodity prices end the quarter at a slightly higher level*

The price of Brent crude oil generally rose from end-March to mid-May (see Chart 1.8). This increase was mainly attributable to escalating political tensions in the Middle East and continued compliance with pre-agreed OPEC output targets. Thereafter, crude oil prices receded somewhat amid growing fears that demand for oil

was weaker than expected as the global economy slowed down. Moreover concerns grew that the trade war between China and the United States could amplify the global economic downturn. At the end of June, the price of Brent crude oil stood at USD 69.0 per barrel, an increase of 0.6% over the price prevailing at the end of March.

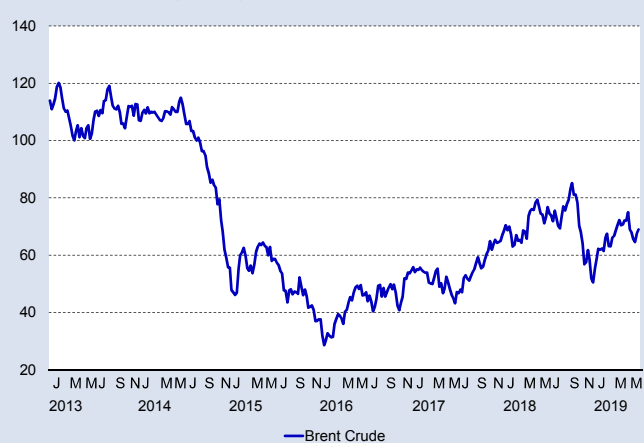
As regards non-energy commodity prices, World Bank data show that these increased slightly during the second quarter of 2019. Between March and June, non-energy commodity prices rose by 0.2%.

**Chart 1.7**  
**EXCHANGE RATE MOVEMENTS OF THE EURO AGAINST OTHER MAJOR CURRENCIES**  
(index of end of month rates; Jan. 2012=100; an increase in the index implies euro appreciation)



Source: Eurostat.

**Chart 1.8**  
**PRICE OF OIL**  
(end of week; US dollars per barrel)



Source: Reuters.

<sup>9</sup> 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

In the second quarter of 2019, real GDP growth rose by 4.0% in annual terms, following a 5.4% increase in the first quarter of 2019. Growth was mostly driven by net exports, although domestic demand also increased. Nominal data on gross value added (GVA) show that the expansion continued to be largely supported by services, although GVA also rose in the construction, manufacturing and quarrying sectors.

The Bank's Business Conditions Index (BCI) continued to indicate above-average conditions, although it eased to 0.4 in the second quarter of 2019, from 0.8 in the second quarter of 2018.

The positive output gap, measured as a four-quarter moving average, narrowed marginally compared with the first quarter of 2019 and stood well below 2015 and 2016 levels.

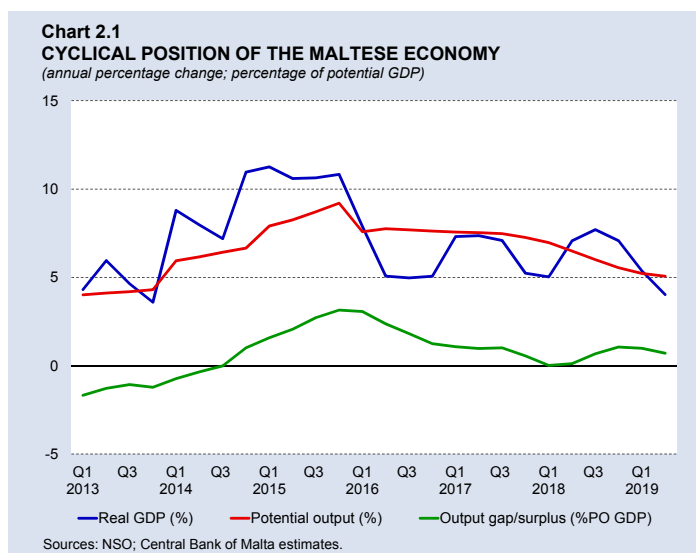
Labour market conditions remained favourable in the second quarter of 2019, as employment grew strongly. The unemployment rate based on the Labour Force Survey (LFS) fell compared with the second quarter of 2018, notwithstanding a further increase in labour market participation rates and rising foreign 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 narrows<sup>1,2</sup>

In the second quarter of 2019, potential output growth eased slightly, although it remained elevated from a historical perspective (see Chart 2.1). Potential output growth is estimated to have edged down to 5.1%, from 5.2% in the first quarter of 2019. GDP growth also decelerated, standing at 4.0%, down from 5.4% in the preceding quarter.

When measured as a four-quarter moving average, the output gap is estimated at 0.7% in the second quarter of 2019, below the 1.0% recorded in the



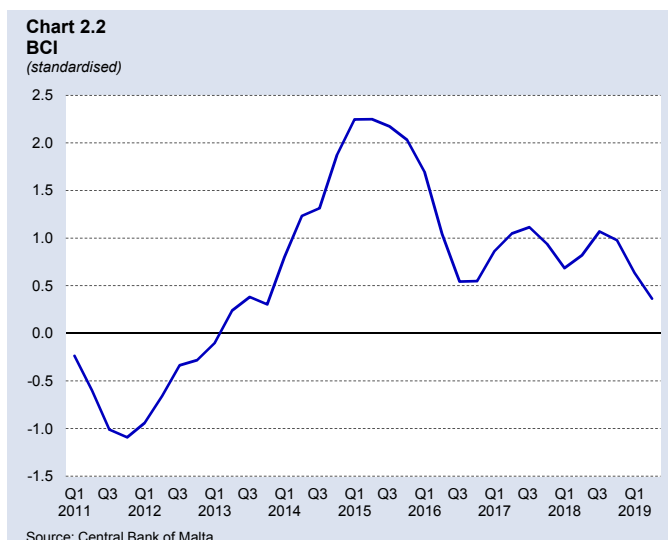
<sup>1</sup> Potential output measures the medium-to-long-term level of real output which is sustainable in an economy. The estimates presented here are derived using a production function approach. For further details on the methodology adopted see Micallef, B. and Ellul, R. (2017), "Medium-term Estimates 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.

<sup>2</sup> 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.

previous quarter.<sup>3</sup> The degree of overutilisation of the economy's productive capacity thus remained well below levels seen in 2015 and 2016, when the output gap mostly hovered between 2.0% and 3.0%. 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 falls<sup>4</sup>*

The BCI dropped over the last quarter (see Chart 2.2). The index stood at 0.4 in the second quarter of 2019, lower than the value of 0.6 in the previous quarter. The latest reading was also below the updated value of 0.8 a year earlier. The BCI, however, continued to show above-average economic conditions, reflecting further decreases in unemployment. The latest estimates continue to suggest that economic conditions are broadly similar to those prevailing in the last two years.



<sup>3</sup> 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.

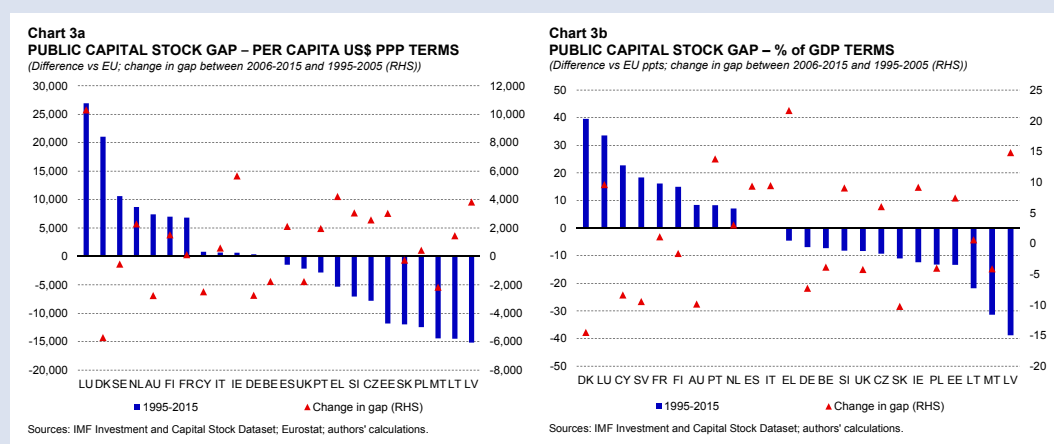
<sup>4</sup> The BCI is a synthetic indicator, which includes information from a number of economic variables such as the term-structure of interest rates, industrial production, an indicator for the services sector, economic sentiment, tax revenues and private sector credit. By construction it has an 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.



On average, Malta's government spending on GFCF is comparable to the EU and euro area averages. However, Malta compares less favourably to its EU and euro area peers when government investment dynamics are taken in consideration. Malta's contraction in its government investment ratios between the periods 1995-2005 and 2006-2017 is of a similar magnitude to that registered in Portugal, Cyprus, Ireland and Greece – economies whose investment shares have been affected by the fiscal consolidation strategies employed during the euro area sovereign debt crisis. Against this backdrop, Malta's public sector investment and capital stock appear to be significantly lagging behind those of its peers.

Government investment dynamics are mirrored in changes in government capital stock in EU countries, with the majority of economies that have negative capital gaps with the EU average registering increases in their public capital stock relative to both their population and output. Charts 3a and 3b show that, when expressed as a ratio of population and national income, Malta has one of the lowest levels of public capital stock in the EU with an average negative public capital output gap between 1995 and 2015 of around US\$ 15,000 per capita according to the International Monetary Fund's (IMF) Investment and Capital Stock dataset. Furthermore, Malta's public capital gap metrics have widened significantly in the last decade when compared to the EU average.

The analysis performed above suffers from a number of shortcomings mainly related to difficulties encountered when distinguishing between the effects of public investment and other government expenditure as well as when distinguishing between public and private investment.<sup>2</sup> In this light, qualitative measures of public capital stock try to overcome some of these shortcomings and add a qualitative dimension to measures of public infrastructure. Chart 4 shows that the Global Competitiveness Indicators (GCI) published by the World Economic Forum confirm the main trends identified by the metrics shown above with Malta's transport and utility infrastructure sub-indicators faring

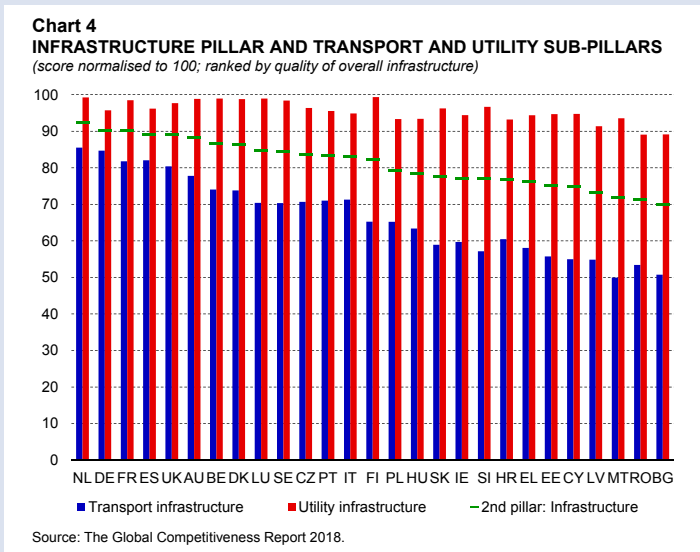


<sup>2</sup> To maximise comparability between public capital stock estimates across countries, this study makes use of government capital stock data found in the IMF Investment and Capital Stock Dataset. The database is computed using the perpetual inventory method using data found in the OECD Analytical Database, the Penn World Tables, IMF World Economic Outlook and European Investment Bank. The depreciation rates used are time-varying and depend on the country income-grouping.

considerably worse than the EU average, with particularly low scores for the former.<sup>3</sup>

### The relationship between public capital stock and economic growth

There are two broad strands of literature that aim to shed light on the effects public investment is expected to have on other macroeconomic variables, one based on partial equilibrium analysis and another based on general equilibrium effects. Partial equilibrium analysis is mainly conducted by augmenting a Cobb Douglas function with a public capital measure and estimating the output elasticity of public capital ( $\gamma_g$ ).



$$Y_t = A_t K_t^{\gamma_K} N_t^{\gamma_N} K_t^{\gamma_g} \quad \text{Eq 1.}$$

Literature suggests estimates of the output elasticity of public capital ranging from -1.7 to 2.0, with an average elasticity of 0.1.<sup>4</sup> This implies that a 1% increase in public capital stock is expected to increase long run output by 0.1%. Estimating equation 1 for Malta using a variety of specifications leads to estimates for  $\gamma_g$  ranging from 0.1 to 0.5, thus broadly in line with estimates of other EU economies.<sup>5</sup>

One disadvantage of using partial equilibrium analysis is the fact that such models are unable to explicitly take in consideration the two-way feedback that exists between public sector capital and output. VAR-based analysis reveals that the effects on output of an increase in public sector capital stock is positive and statistically different from zero but is lower than estimates derived from production function approaches. VAR estimates, however, confirm the results put forward by partial equilibrium studies, that indicate stronger positive effects of infrastructure spending when compared to other types of public capital.<sup>6</sup> Studies by the IMF show that apart from the state of the economy, the effects of public investment depend on the method of financing chosen by the government, with debt

<sup>3</sup> One needs to keep in consideration that GCI indicators for 2018 might still not fully take in consideration the effects of the recent overhaul of the energy sector which are expected to lead to significant long-run macroeconomic gains (see Rapa, N. (2018) "The Macroeconomic Effects of Energy Reforms in Malta", *Central Bank of Malta Research Bulletin* 2018, pp. 5-10).

<sup>4</sup> See Bom, P. R. D. and J. E. Lighthart. (2014). "What Have We Learned From Three Decades of Research on the Productivity of Public Capital?", *Journal of Economic Surveys*, vol. 28, issue 5, pp. 889-916 for a literature review survey.

<sup>5</sup> Technical details are available in Rapa, N. and Rapa, A. M. (2019)

<sup>6</sup> See Kamps, C. (2004). "New Estimates of Government Net Capital Stocks for 22 OECD Countries 1960–2001", *IMF Working Paper*, WP/04/67 and de Jong, J., Ferdinandusse M., Funda J. and I. Vetlov. (2017). "The Effect of Public Investment in Europe: A Model-Based Assessment", *ECB Working Paper Series*, No 2021/February 2017.

financing having significantly larger effects on economic activity than tax or expenditure financing.<sup>7</sup>

Structural models within a general equilibrium framework are especially useful to analyse the trade-off that exists between the positive effects of government investment and the negative effects brought about by the financing options chosen by the government. Furthermore, structural models are also able to internalise general equilibrium effects stemming from the two-way relation that exists between public capital stock and other factors of production. Moreover, this strand of literature argues that despite being significantly expansionary in the long run, positive public investment shocks can be mildly contractionary in the short run especially if investment outlays are financed by raising highly distortionary taxes such as labour taxes.<sup>8</sup>

The contained short-run effects of public investment shocks are also confirmed by another strand of literature that models public investment in a time-to-build setup.<sup>9</sup> These studies suggest that in the short run, implementation delays associated with public investment projects may lead to negative wealth effects.

### **The possible macroeconomic benefits of closing Malta's infrastructure gap**

In order to shed some light on the macroeconomic implications of a sustained increase in government investment meant to bridge Malta's public sector capital gap with the rest of the EU, we perform a number of simulations using the fiscal version of MEDSEA.<sup>10</sup> The model assumes that in order to ensure a stable debt ratio, the government can use internally-funded fiscal instruments consisting of distortionary taxes on consumption, labour and capital/dividend income as well as non-distortionary lump-sum taxes. In order to take into consideration the fact that the government can complement tax increases or expenditure cuts with external financing options relating to EU structural funds as well as Malta's sovereign fund which accumulates proceeds from the Individual Investor Programme (IIP), the baseline version of the model was extended in line with Varga and in't Veld (2009).<sup>11</sup> Since funds available through either EU structural funds or the IIP are not financed by levying taxes on Maltese residents, these two external funding options do not have distortionary effects on the Maltese output.

Chart 5 shows the dynamic effects of a transitory, but persistent, ex-ante increase in government investment under different assumptions on the source of financing chosen by

<sup>7</sup> Abiad, A., Furceri, D. and P. Topalova. (2015). "The Macroeconomic Effects of Public Investment: Evidence from Advanced Economies", *IMF Working Paper*, WP/15/95.

<sup>8</sup> Bom, P. R. D. and J. E. Lighthart. (2014). "What Have We Learned From Three Decades of Research on the Productivity of Public Capital?", *Journal of Economic Surveys*, vol. 28, issue 5, pp. 889-916.

<sup>9</sup> Kydland, F. E. and E. C. Prescott. (1982). "Time to Build and Aggregate Fluctuations", *Econometrica*, No. 50, pp. 1345-1370

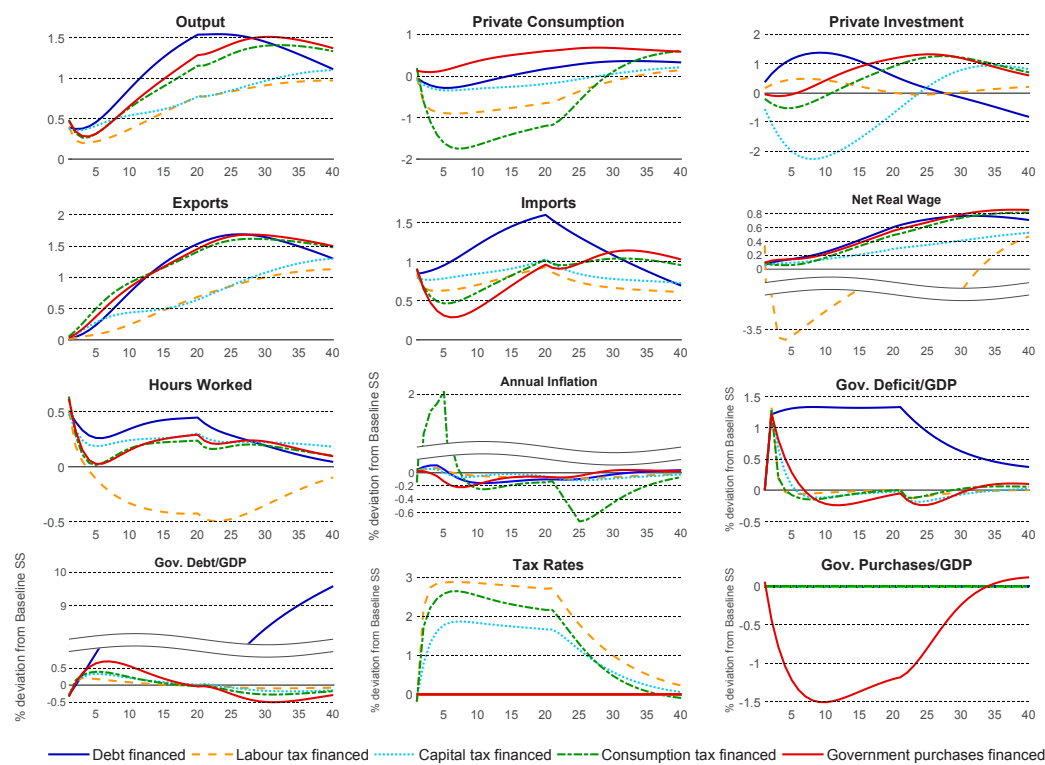
<sup>10</sup> Technical details of this model are available in Rapa, N. (2017). "Estimates of Fiscal Multipliers using MEDSEA", *Central Bank of Malta Working Paper*, WP/04/2017.

<sup>11</sup> See Varga, J. and J. in't Veld (2009). "A Model-based Analysis of the Impact of Cohesion Policy Expenditure 2000-06: Simulations with the QUEST III endogenous R&D model", *European Economy Economic Papers*, no. 387. This modification extends the government budget constraint with an externally-funded fiscal instrument which complements the existing number of domestic funding instruments available to the government. The external funds received by the Maltese state are significantly small when compared to the aggregate expenditure of donor countries. In this light, and in line with the modelling strategy employed for the rest of foreign variables present in the model, the externally-funded fiscal instrument is modelled in reduced form ignoring the (significantly small) second-round effects on foreign demand emanating from the need of the donor states to finance the structural funds transferred to the Maltese state.

the government. To this end, we shock government investment as percent of GDP by 1 percentage point over 20 quarters. Thereafter, the government investment-to-output ratio is allowed to gradually return to its baseline figure. This exercise assumes that the government can choose to finance its investment outlays by using one of the following five options: increasing debt, labour income tax, capital income tax, consumption tax or through a reduction in government purchases.<sup>12</sup>

Under all scenarios, an increase in government investment is expansionary throughout the time-period under consideration. Results also point at significantly different macro-dynamics depending on the instrument used by government to finance its capital projects. As expected, debt-financing has the most positive effect in the short-to-medium run (blue line). The lowest effects on overall output in the medium run are registered in the case government chooses to finance its investment outlays by levying distortionary taxes on factors of production such as labour (dashed orange line) and capital (dashed sky blue line). The distortionary effects on overall output brought about by a non-debt neutral financing strategy are lowest in the case of either a hike in consumption taxes (dotted green line) or a reduction in government purchases (red line).

**Chart 5**  
**IMPULSE RESPONSES FOR TEMPORARY SHOCK TO GOVERNMENT INVESTMENT**



<sup>12</sup> Under the debt financing option, it is assumed that no attempt is made to rebalance the debt-to-GDP ratio in the sample under consideration. Under a balanced-budget assumption, it is assumed that the government will either increase one tax rate at a time or reduce government purchases in order to stabilise its debt-to-GDP ratio.

In order to estimate the long-run economic implications of closing Malta's capital-to-output gap with that of the EU average, we simulate the model with a permanent shock to the government investment-to-GDP ratio. We calibrate the shock such that the change in the government capital stock-to-output ratio in the new steady state equals Malta's 2015 capital gap as estimated in the IMF Investment and Capital Stock Dataset. All simulations are performed under the assumption of government debt neutrality in the long run. The government can choose to finance its investment outlays either by raising one of the three tax rates at its disposal or by reducing its recurrent expenditure (see Table 1). To this end the table also contains information on the long-run change in the fiscal instrument chosen by the government to stabilise its debt-to-output ratio.<sup>13</sup> We also take in consideration the government's ability to utilise European Structural and Investment Funds, as well as funds available in the recently-established National Development and Social Fund (NDSF).

Results indicate that there are significant long-term GDP benefits to be achieved from increasing the public capital stock-to-output ratio. As expected, however, both the extent of the output gains as well as the drivers behind such gains vary significantly depending on the financing options chosen by the government. As already suggested by simulations in Chart 5, financing capital projects by increasing taxation on the returns of factors of production leads to the lowest impact on GDP. A rise in capital or labour income taxes distorts the optimal capital-to-labour ratio chosen by firms, as well as the optimal consumption, investment and labour supply decisions of households. Under the assumption of full internal financing, overall output gains of closing the public capital stock-to-output ratio lies

**Table 1**  
**LONG-RUN MACROECONOMIC EFFECTS OF CLOSING THE PUBLIC CAPITAL GAP**

*% deviation from baseline; fiscal instrument results shown in terms of pp deviations in tax rates and government purchases-to-GDP ratio*

	Labour income tax			Capital income tax			Consumption tax			Government purchases		
	No EU	EU	EU_NDSF	No EU	EU	EU_NDSF	No EU	EU	EU_NDSF	No EU	EU	EU_NDSF
<b>Real activity</b>												
GDP	7.2	8.1	10.0	6.1	7.2	9.6	10.2	10.4	11.0	10.9	11.0	11.2
Private Consumption	-2.1	-1.5	-0.4	-1.8	-1.3	-0.3	-0.2	-0.1	0.2	6.6	5.3	2.5
Private Investment	2.9	3.5	4.7	-6.0	-3.7	1.5	4.8	4.9	5.2	6.6	6.4	5.9
Exports	8.8	9.7	11.6	7.2	8.4	11.0	11.8	12.0	12.6	11.6	11.9	12.5
Imports	6.5	7.2	8.6	5.4	6.3	8.2	8.7	8.9	9.3	8.6	8.8	9.3
<b>Labour market</b>												
Real Wages	-11.4	-7.8	0.1	3.0	3.6	5.0	6.5	6.4	6.2	7.1	6.9	6.4
Employment	-2.5	-1.7	0.2	1.2	1.3	1.5	0.4	0.6	1.2	0.5	0.8	1.2
Fiscal Instrument	12.8	10.2	4.4	7.4	5.9	2.5	7.9	6.3	2.7	-4.0	-3.2	-1.4

Source: Authors' calculations.

<sup>13</sup> Long-run debt financing is not explored in this box. Debt financing implies a higher debt-to-GDP ratio in the long run which in turn requires a higher primary surplus in the long run to finance interest expenses. When conducting debt-neutral shocks in the long run one still needs to specify a fiscal instrument that will be used to stabilise the debt ratio by running a primary surplus. Thus, even under a debt-financing strategy, long-run results will still be dependent on the fiscal instrument chosen to pay for interest expenses. In general, while debt-neutral strategies are preferred in the short run, they consistently deliver lower output results in the long run.

between 6% and 7% in case of capital and labour income tax financing options respectively. Distortions are significantly less pronounced in case the government chooses to finance its capital projects through a rise in consumption taxes or a reduction in its government expenditure, with output gains ranging between 10% and 11% under the assumption of full internal financing. Results also show that the possibility for government to utilise EU-funds as well as funds accumulated within the NDSF would significantly reduce the distortionary effects of all financing options, most notably those consisting of increases in labour and capital income tax finances.

## GDP and industrial production

### *Real GDP grows at a slower pace*

The pace of economic activity decelerated further in the second quarter of 2019, with real GDP rising by 4.0% on an annual basis, following a 5.4% increase in the previous quarter.<sup>5</sup>

Slower growth was underpinned by lower growth of domestic demand. This contributed 1.4 percentage points to GDP growth in the quarter under review, following a contribution of 9.5 percentage points in the preceding quarter (see Table 2.1). All domestic demand components contributed to the slowdown.

By contrast, the contribution of net exports turned positive, as imports fell much more strongly than exports.

Private consumption expenditure grew by 3.8% in annual terms, following a 5.3% increase in the first quarter of 2019. It added 1.7 percentage points to real GDP growth. Private consumption 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 private consumption in the quarter under review 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 two quarters of double digit growth, annual growth in government consumption expenditure moderated to 7.3% in the second quarter of 2019. This expenditure component added 1.2

**Table 2.1**  
**GDP<sup>(1)</sup>**

	2018			2019	
	Q2	Q3	Q4	Q1	Q2
<i>Annual percentage changes</i>					
Private final consumption expenditure	8.4	8.7	7.5	5.3	3.8
Government final consumption expenditure	12.2	7.7	26.6	20.8	7.3
Gross fixed capital formation	10.0	3.4	-1.0	29.1	0.8
<b>Domestic demand</b>	<b>14.3</b>	<b>8.5</b>	<b>8.1</b>	<b>11.6</b>	<b>1.7</b>
Exports of goods and services	2.3	5.1	-0.5	3.2	-0.2
Imports of goods and services	5.8	5.0	-1.1	6.6	-2.3
<b>Gross domestic product</b>	<b>7.1</b>	<b>7.7</b>	<b>7.1</b>	<b>5.4</b>	<b>4.0</b>
<i>Percentage point contributions</i>					
Private final consumption expenditure	3.7	3.7	3.3	2.4	1.7
Government final consumption expenditure	2.0	1.1	3.9	3.4	1.2
Gross fixed capital formation	1.8	0.6	-0.2	5.2	0.2
Changes in inventories	3.6	0.9	-0.5	-1.5	-1.7
<b>Domestic demand</b>	<b>11.1</b>	<b>6.3</b>	<b>6.5</b>	<b>9.5</b>	<b>1.4</b>
Exports of goods and services	3.5	7.2	-0.8	5.2	-0.3
Imports of goods and services	-7.4	-5.8	1.4	-9.3	3.0
<b>Net exports</b>	<b>-4.0</b>	<b>1.4</b>	<b>0.6</b>	<b>-4.2</b>	<b>2.7</b>
<b>Gross domestic product</b>	<b>7.1</b>	<b>7.7</b>	<b>7.1</b>	<b>5.4</b>	<b>4.0</b>

Sources: NSO; Central Bank of Malta calculations.

<sup>(1)</sup> Chain-linked volumes, reference year 2010.

<sup>5</sup> The analysis of GDP in this Chapter of the *Quarterly Review* is based on data published in NSO *News Release* 145/2019 and released on 6 September 2019.

percentage points to annual GDP growth. This expansion was largely underpinned by higher outlays on intermediate consumption, reflecting spending in the public administration sector. 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 increased.

Following a strong increase of 29.1% in the previous quarter, mainly due to significant investment in new sea vessels, real GFCF rose by a modest 0.8% in the second quarter of 2019 and contributed 0.2 percentage point to real GDP growth. The rise in GFCF was mostly driven by increased investment in non-residential construction, and to a lesser extent, in dwellings and intellectual products. On the other hand, investment in in equipment declined on a year earlier.

Changes in inventories shed 1.7 percentage points from GDP growth in the second quarter of 2019.

Exports fell by 0.2% in the second quarter of 2019, and imports decreased by 2.3% on a year earlier. As a result, net exports contributed 2.7 percentage points to real GDP growth. In the quarter under review, most of the trade surplus (in volume terms) was driven by trade in goods, although the services balance remained in surplus.

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

Nominal GDP rose by 6.6% in annual terms in the second quarter of 2019, after increasing by 8.1% in the previous quarter (see Table 2.2). The deceleration largely reflected slower growth in

**Table 2.2**  
**CONTRIBUTION OF SECTORAL GVA TO NOMINAL GDP GROWTH**

*Percentage points*

	2018			2019	
	Q2	Q3	Q4	Q1	Q2
Agriculture, forestry and fishing	0.0	0.0	0.5	0.0	0.0
Mining and quarrying; utilities	0.3	0.3	-0.1	0.0	0.1
Manufacturing	0.7	0.8	1.0	0.4	0.1
Construction	0.3	0.2	0.4	0.4	0.6
Services	6.7	6.9	5.4	6.3	5.5
<i>of which:</i>					
Wholesale and retail trade; repair of motor vehicles; Transportation; accommodation and related activities	1.4	1.4	0.9	1.3	1.1
Information and communication	0.2	0.4	0.1	0.4	0.4
Financial and insurance activities	0.6	0.3	0.1	0.6	0.1
Real estate activities	0.6	0.5	0.7	0.5	0.6
Professional, scientific, Administrative and related activities	1.2	1.7	1.2	1.5	1.2
Public administration and defence; Education; health and related activities	1.1	1.1	1.2	0.8	0.8
Arts, entertainment; household repair and related services	1.6	1.6	1.2	1.2	1.3
<b>GVA</b>	<b>7.8</b>	<b>8.3</b>	<b>7.2</b>	<b>7.1</b>	<b>6.2</b>
<b>Taxes less subsidies on products</b>	<b>1.6</b>	<b>1.9</b>	<b>1.8</b>	<b>1.0</b>	<b>0.4</b>
<b>Annual nominal GDP growth (%)</b>	<b>9.5</b>	<b>10.2</b>	<b>9.0</b>	<b>8.1</b>	<b>6.6</b>

Source: NSO.

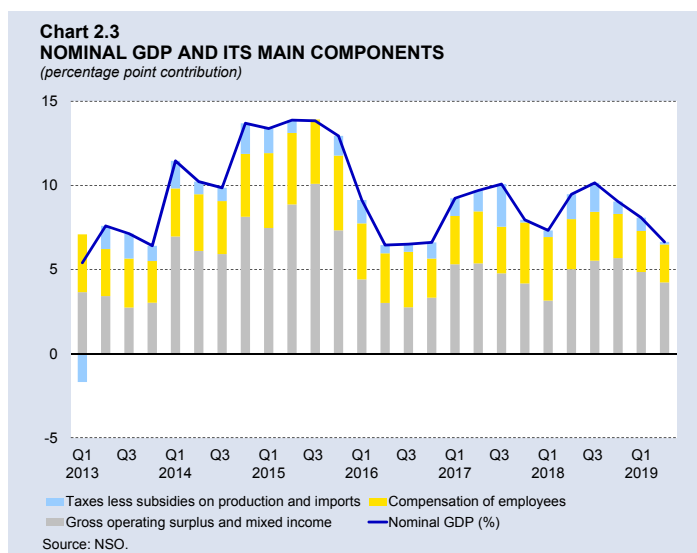
GVA, which rose at an annual rate of 7.0% in the second quarter of 2019, after growing by 8.0% in the preceding quarter. In the quarter under review, GVA contributed 6.2 percentage points to nominal growth.<sup>6</sup>

Services remained the main driver of activity, adding 5.5 percentage points to nominal GDP growth. The largest additions came from the arts and entertainment sector, the sector comprising professional and scientific activities, as well as the wholesale and retail trade. Together, these three sectors contributed 3.6 percentage points to nominal GDP growth. Public administration, real estate activities, information and communication as well as financial and insurance activities jointly added a further 2.0 percentage points. Furthermore, the contribution from construction stood at 0.6 percentage point, while that from manufacturing as well as mining, quarrying and utilities sector stood at 0.1 percentage point each. The agriculture and fishing sector had a negligible impact on GDP growth.

GDP data by income distribution show that gross operating surplus decelerated during the second quarter of 2019, rising by 8.6% on an annual basis, following a 10.4% increase in the preceding quarter. It contributed 4.2 percentage points to nominal GDP growth (see Chart 2.3). Compensation of employees continued to rise robustly, with the annual rate of change, at 5.6% only marginally below the previous quarter's 5.7%. This income component added 2.3 percentage points to nominal growth. Net taxes on production and imports also increased on a year earlier and explain the remaining 0.2 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 the sector incorporating real estate activities accounting for a significant share of the overall 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 wholesale and retail trade sector, the sector comprising professional, scientific and technical activities and that comprising of arts, entertainment and recreation.



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

### Industrial production grows marginally in the second quarter of 2019

During the second quarter of 2019, industrial production increased by 0.5% when compared with the same quarter of 2018.<sup>7</sup> This followed a contraction of 1.9% in the first quarter (see Table 2.3).

The expansion in activity in the quarter under review reflected developments within the energy and quarrying sector, although the latter has a very small weight in the overall industrial production index. In annual terms, production in these two sectors increased by 14.4% and 1.7%, respectively.

On the other hand, production in the manufacturing sector, which accounts for over 80% of the index, fell by 1.9% on a year earlier. This followed a contraction of 4.8% in the preceding quarter. Output declined strongly among producers of pharmaceutical products. Smaller declines were also registered among firms involved in the printing and reproduction of recorded media and those that produce rubber and plastic products and food. Production in the computer, electronic and optical products sector also decreased on a year earlier. These contractions more than offset higher production in the “other manufacturing” sub-sector, which includes medical and dental instruments, toys and related products. Output also expanded among firms involved in the repair and installation of machinery and equipment and in the production of beverages.

**Table 2.3**  
**INDUSTRIAL PRODUCTION<sup>(1)</sup>**  
*Percentages; annual percentage changes*

	Shares	2018			2019	
		Q2	Q3	Q4	Q1	Q2
<b>Industrial production</b>	<b>100.0</b>	<b>0.8</b>	<b>-1.9</b>	<b>4.3</b>	<b>-1.9</b>	<b>0.5</b>
<b>Manufacturing</b>	<b>87.1</b>	<b>-0.7</b>	<b>-2.1</b>	<b>4.3</b>	<b>-4.8</b>	<b>-1.9</b>
<i>of which:</i>						
Food products	15.4	-14.7	2.7	1.8	-9.3	-6.1
"Other" manufacturing	10.3	-10.5	-7.4	11.7	-1.8	13.7
Repair and installation of machinery and equipment	7.9	5.6	-8.9	6.7	4.4	10.0
Basic pharmaceutical products and pharmaceutical preparations	7.3	-1.6	-45.0	-18.6	-41.2	-27.9
Printing and reproduction of recorded media	7.3	45.3	51.3	43.1	18.8	-8.4
Beverages	5.6	4.2	3.8	1.7	-18.0	9.4
Rubber and plastic products	5.4	-7.6	-11.4	-15.9	-11.9	-6.5
Computer, electronic and optical products	5.0	-24.6	3.5	-0.2	-0.8	-4.1
<b>Energy</b>	<b>12.5</b>	<b>13.8</b>	<b>1.8</b>	<b>11.0</b>	<b>15.3</b>	<b>14.4</b>
<b>Mining and quarrying</b>	<b>0.5</b>	<b>46.4</b>	<b>24.9</b>	<b>24.9</b>	<b>23.5</b>	<b>1.7</b>

Sources: NSO; Eurostat.

<sup>(1)</sup> 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.

<sup>7</sup> 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.

## Business and consumer surveys

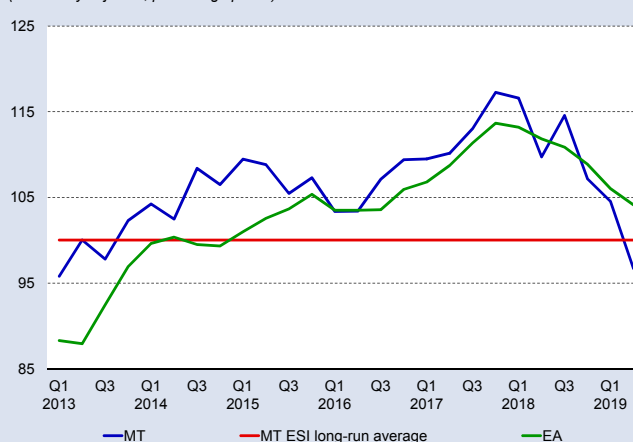
During the second quarter of 2019, the European Commission's Economic Sentiment Indicator (ESI) declined to 96.7, from 104.5 in the preceding quarter, thus standing below its long-term average of 100.0 (see Chart 2.4).<sup>8,9</sup> Sentiment weakened across all sectors, except among consumers. In the second quarter of 2019, the ESI for Malta fell further below that in the euro area, where it averaged 104.1. This reflected the more negative sentiment in industry in Malta.

### Confidence in the services sector declines<sup>10</sup>

Sentiment in the services sector fell to 16.3, from 29.1 in the preceding quarter, thus standing below its long-term average of 23.1. The fall in confidence was mainly driven by respondents' weaker assessment of demand over the last quarter and, to a lesser extent, by their expectations of demand in the coming months. Their assessment of the business situation over the past three months also weakened (see Chart 2.5).

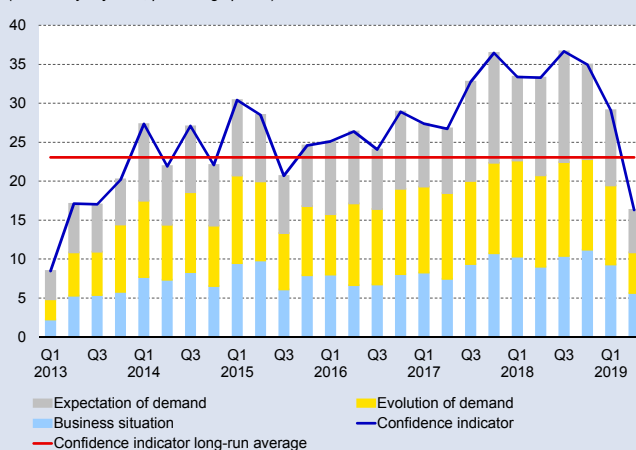
Supplementary survey data indicate that employment expectations were less optimistic than those in the preceding quarter. Furthermore, a lower net share of respondents anticipated prices to increase in the three months ahead.

**Chart 2.4**  
**ESI**  
(seasonally adjusted; percentage points)



Source: European Commission.

**Chart 2.5**  
**SERVICES CONFIDENCE INDICATOR**  
(seasonally adjusted; percentage points)



Source: European Commission.

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

<sup>9</sup> 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.

<sup>10</sup> 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.

### Confidence in construction weakens<sup>11</sup>

In the second quarter of 2019, confidence in the construction sector declined to 23.2, from 34.1 in the preceding quarter. Notwithstanding the recent decline, it remained well above its long-term average of -13.5 (see Chart 2.6).

Survey results show that the fall in sentiment was almost entirely driven by lower order book levels, which were assessed to be relatively high in recent quarters. On the other hand, employment expectations remained broadly unchanged.

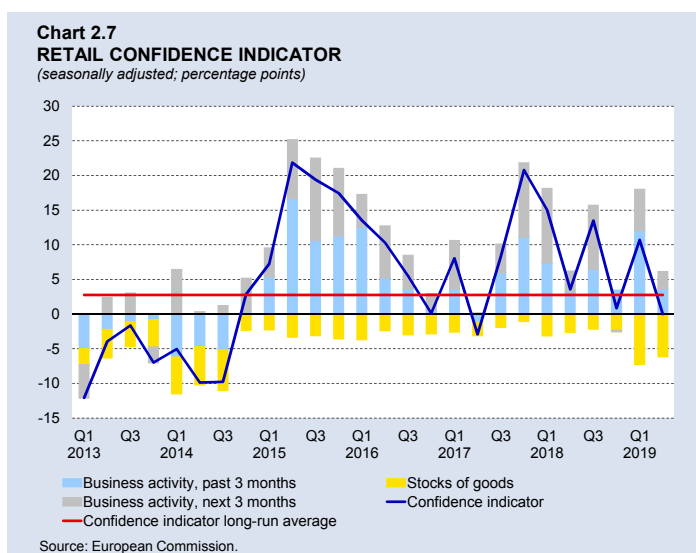
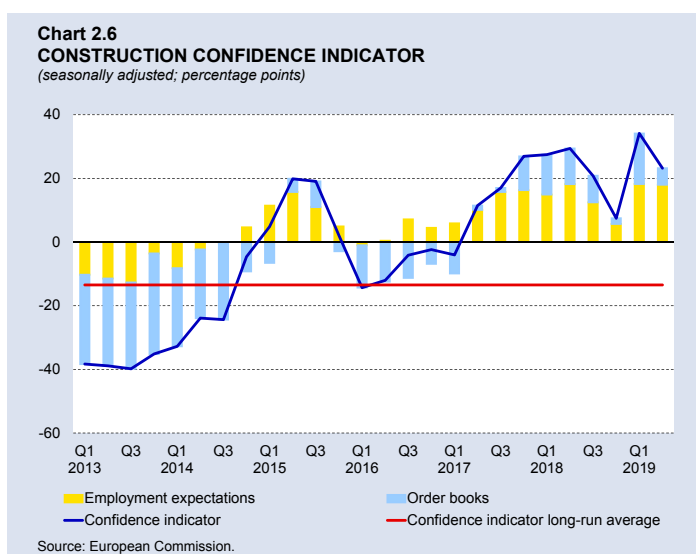
Supplementary survey data indicate that, on balance, a smaller net percentage of firms reported positive developments in building activity during the preceding three months, even though labour shortages were somewhat less pressing compared with the first quarter of the year. A marginally lower share of respondents anticipated prices to increase in the next three months.

### Confidence in the retail sector falls<sup>12</sup>

Sentiment in the retail sector edged down to 0 from 10.7 in the first quarter of 2019, thus falling below its long-term average of 2.8 (see Chart 2.7).

The recent fall in confidence was driven by firms' assessment of business activity in the past three months and their expectations for the next three months.<sup>13</sup> These movements offset a decrease in the share of respondents that considered their stock levels to be above normal.

Supplementary survey data indicate that on balance, both orders and employment expectations turned negative in the quarter under review. Price expectations, which were already negative in the previous quarter, decreased further.



<sup>11</sup> 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.

<sup>12</sup> 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.

<sup>13</sup> A fall in the balance of above-normal stock levels affects the overall indicator in a positive way.

### Industrial confidence edges down<sup>14</sup>

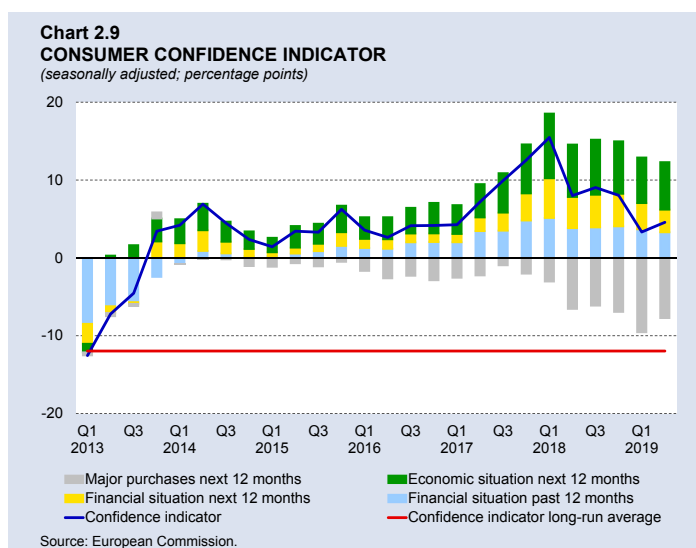
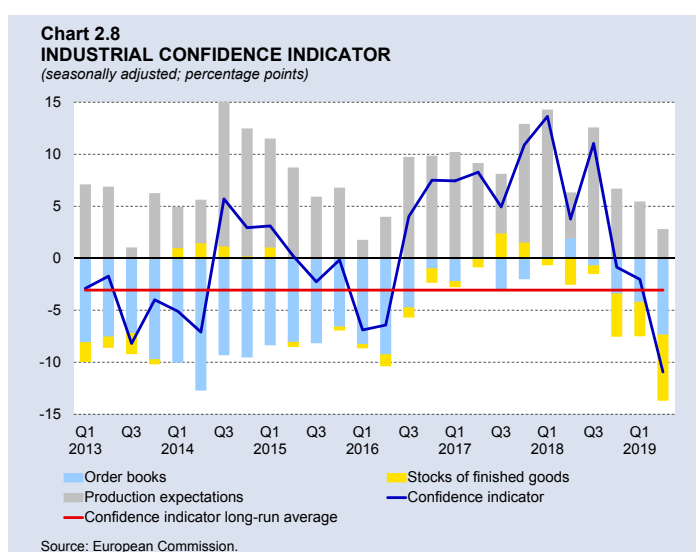
Confidence in the industrial sector stood at -10.9 in the quarter under review, down from -2.0 in the previous three-month period, and below its long-term average of -3.1 (see Chart 2.8). During the second quarter of the year, production expectations, while still positive, nearly halved when compared with the first quarter of 2019. At the same time, a higher share of firms reported falling orders. Meanwhile, the number of firms reporting above normal stocks of finished goods almost doubled.<sup>15</sup>

Additional survey data show that on balance, fewer respondents anticipated an increase in employment. This result is consistent with the aforementioned decrease in orders and with an increasing proportion of firms that view insufficient demand as a factor limiting production. Meanwhile, the share of firms anticipating price increases remained positive, but edged down marginally.

### Consumer confidence recovers slightly from recent declines<sup>16</sup>

Consumer confidence edged up from 3.3 in the first quarter of 2019 to 4.6 in the quarter under review. Although well above its long-run average of -12.0, it remained below the record high reading recorded in the first quarter of 2018 (see Chart 2.9).

Consumers' expectations of major purchases over the next 12 months were the main driver behind the latest increase in consumer confidence. At the same time, consumers' outlook of the general economic situation in the 12 months ahead increased marginally. In contrast, respondents' assessment of their past and future financial situation weakened slightly.



<sup>14</sup> 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.

<sup>15</sup> 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.

<sup>16</sup> 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.

Supplementary survey data suggest that on balance, a larger share of consumers expected inflation to rise over the next 12 months. At the same time, a lower percentage of respondents expected unemployment to fall in the months ahead.<sup>17</sup>

## The labour market<sup>18</sup>

### *Labour force continues to grow strongly*

LFS data show that in the second quarter of 2019, the labour force grew by 6.7% over the same quarter of 2018 (see Table 2.4).<sup>19</sup>

The activity rate stood at 75.7% in the quarter under review, up from 74.0% a year earlier. It also exceeded the euro area average of 73.6%.<sup>20</sup> The increase in participation reflected increased activity among females as the activity rate of males edged down. Indeed, the female participation rate increased by 3.7 percentage points, to reach 67.0%, while that of males edged down by 0.4 percentage point to 83.6%. Notwithstanding the increases recorded in recent years, the female participation rate remains below the euro area average of 68.4%. On the other hand, the activity rate of males is above the euro area average of 78.8%.

### *Employment continues to grow at a fast pace*

Employment rose by 7.0% in annual terms, while the number of unemployed persons declined by 2.5%.

**Table 2.4**  
**LABOUR MARKET INDICATORS BASED ON THE LFS**

*Persons; annual percentage changes*

	2018	2019	Annual change
	Q2	Q2	%
<b>Labour force</b>	<b>244,270</b>	<b>260,515</b>	<b>6.7</b>
Employed	235,232	251,700	7.0
<i>By type of employment:</i>			
Full-time	202,630	217,843	7.5
Part-time	32,602	33,857	3.8
Unemployed	9,038	8,815	-2.5
<b>Activity rate (%)</b>	<b>74.0</b>	<b>75.7</b>	
Male	84.0	83.6	
Female	63.3	67.0	
<b>Employment rate (%)</b>	<b>71.2</b>	<b>73.1</b>	
Male	80.6	80.7	
Female	61.1	64.6	
<b>Unemployment rate (%)</b>	<b>3.7</b>	<b>3.4</b>	
Male	3.9	3.3	
Female	3.5	3.5	

Source: NSO.

<sup>17</sup> 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.

<sup>18</sup> 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.

<sup>19</sup> 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.

<sup>20</sup> 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.

In absolute terms, the annual increase in employment in the second quarter of 2019 mostly reflected growth in the number of full-time jobs (see Table 2.4). These increased by 15,213, or 7.5% in annual terms, while the number of part-timers, which includes those employed on a full-time on reduced hours basis, rose by 1,255, or 3.8%.

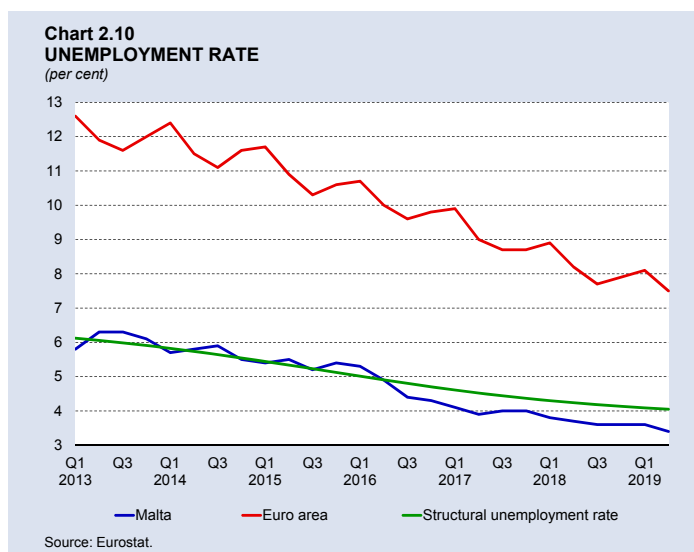
The overall employment rate rose by 1.9 percentage points on the same period of 2018, to 73.1%.<sup>21</sup> The male and female employment rates increased by 0.1 and 3.5 percentage points respectively. The male employment rate reached 80.7%, from 80.6% a year earlier, while that of females rose to 64.6% from 61.1%. The employment rate of women aged between 25 and 64 increased, while that of those aged 15 to 24 declined. The male employment rate edged up among those aged between 25 and 54, but declined among the younger cohort as well as among those aged 54 and over.

The increased overall employment rates imply that the Government continued to exceed the Europe 2020 target of 70% for the employment rate.<sup>22</sup> In fact, according to the LFS, the employment rate for those aged between 20 and 64, the age bracket relevant for this target, stood at 77.3% in the second quarter of 2019.

### The unemployment rate edges down

In the second quarter of 2019, the unemployment rate stood at 3.4%. This was lower than the rate of 3.7% recorded a year earlier and that of 3.5% recorded in the first quarter of 2019.<sup>23</sup> The jobless rate for males edged down by 0.6 percentage point in annual terms, to 3.3%, while that of females was broadly unchanged at 3.5% (see Table 2.4).

The unemployment rate in Malta remains well below the average rate for the euro area 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 4.0% in the second quarter of 2019.<sup>24</sup>



<sup>21</sup> 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.

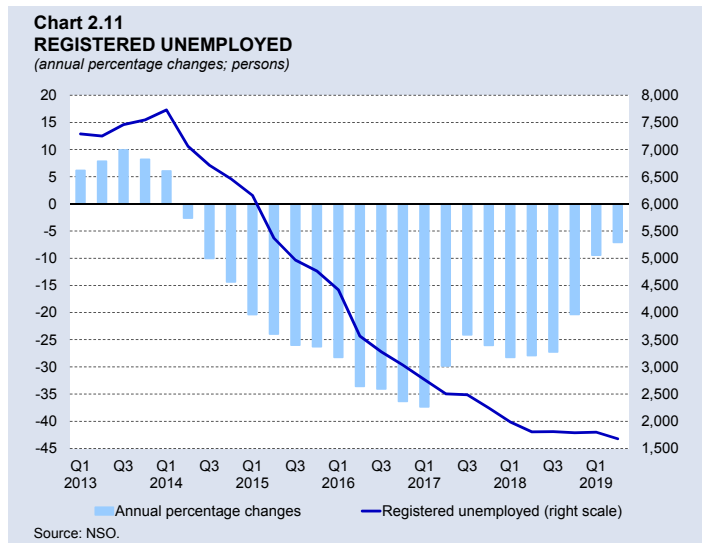
<sup>22</sup> See *The National Employment Policy*, Ministry for Education and Employment, May 2014, p. 13 and *Malta: National Reform Programme 2019*, Ministry for Finance, April 2019, p. 41.

<sup>23</sup> 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.

<sup>24</sup> 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.

Jobsplus data also show favourable labour market developments. The average number of registered unemployed persons stood at 1,678 in the quarter under review, 128 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 decrease 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.



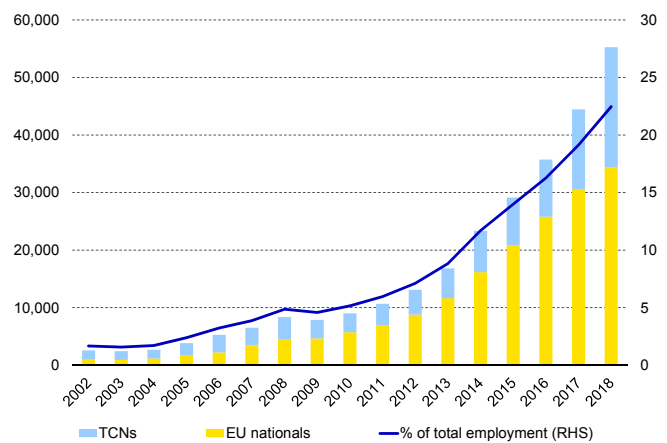
## BOX 2: DEVELOPMENTS IN THE FOREIGN WORKFORCE IN MALTA<sup>1</sup>

Since Malta joined the European Union (EU), its population has been largely expanding through positive net migrant flows. Surveys conducted with firms operating from Malta indicate that one of the main factors hindering production in recent years is the shortage of available labour force.<sup>2</sup> Often, firms state that they have tackled this problem by employing foreign nationals, as the supply of Maltese nationals has been exhausted. This is reflected in an increase in the share of foreign nationals among those employed from around 1.7% in 2002 to 22.5% in 2018 (see Chart 1). This Box aims to analyse recent developments in the number of foreign workers and their main characteristics.

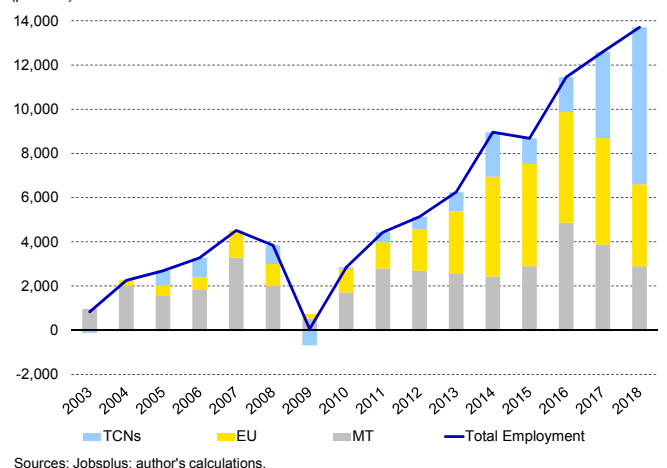
The number of foreign nationals within the Maltese labour market has increased significantly in recent years. According to Jobsplus, the number of foreign nationals in employment has increased from a low of 2,013 in 2000 to more than 55,000 in 2018. Since 2007, the number of EU nationals in employment has consistently outnumbered the number of third-country nationals (TCNs), with the former constituting 62% of all foreign employees in Malta in 2018.

As shown in Chart 2, in most years net migrant flows in Malta's employment were predominantly driven by inward migration of EU nationals. However, in 2018 the net migration of TCNs was almost double that of EU nationals. The number of TCNs in Malta rose from

**Chart 1**  
SIZE OF FOREIGN WORKFORCE IN MALTA  
(persons; % of total employment)



**Chart 2**  
INCREASE IN TOTAL EMPLOYMENT BY NATIONALITY  
(persons)



<sup>1</sup> Prepared by Abigail Marie Rapa, Senior Economist within the Economic Analysis Department of the Central Bank of Malta. The views expressed in this Box are the author's own and do not necessarily reflect the views of the Bank.

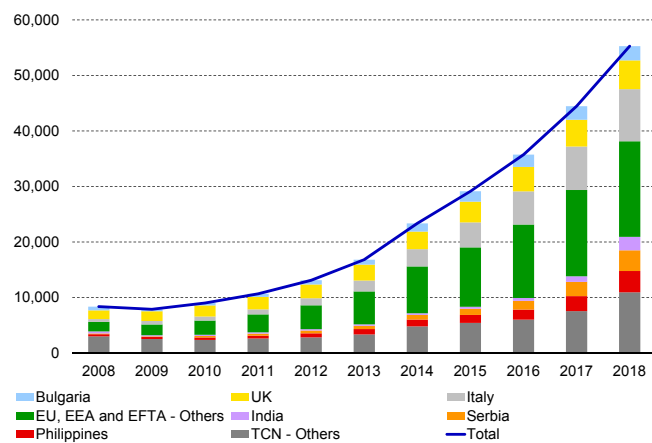
<sup>2</sup> This is indicated in both the European Commission's monthly Economic Sentiment Indicator, which is based on their Business and Consumer Surveys, and the recently published 'Wage Inflation Survey' conducted by the Malta Employers' Association.

almost 14,000 in 2017 to around 21,000 in 2018, whereas the number of EU nationals increased from around 30,000 to more than 34,000 persons. The increase in employment in the EU and downward trajectory in unemployment in recent years in Europe is likely to have slowed down the flow of migrants from EU countries to Malta, thus requiring more labour from third countries. In response to such development, a subsidiary legislation, in force since 2017 in terms of the Immigration Act (S.L.217.17), introduced simplified procedures for the issue, amendment and renewal of residence and work permits to TCNs.<sup>3</sup>

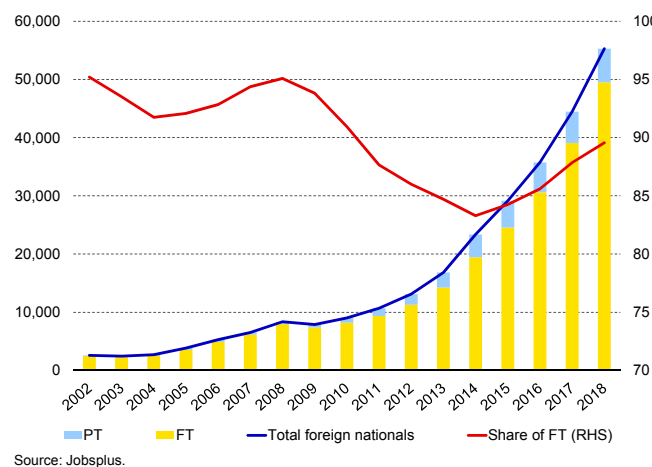
A decomposition of foreign workers by nationality reveals that over 9,000 Italian nationals were employed in Malta in 2018, equivalent to 27.3% of EU workers (see Chart 3). The number of Italian nationals participating in the Maltese labour market has increased rapidly since the global financial crisis, as these stood at just above 500 employees in 2008. At over 5,000 employees, the United Kingdom (UK) is the second largest country of origin. Bulgaria ranked third among EU countries of origin. The Philippines and Serbia were the most important third countries of origin, with each providing more than 3,500 employees. Reliance on Indian nationals has also increased significantly. There were around 2,400 Indian nationals employed in Malta at the end of 2018. Overall, nationals from the Philippines, Serbia and India accounted for around 47.7% of all TCNs working in Malta last year.

Around 90% of foreign nationals are employed on a full-time basis, although the number of foreigners engaged on a part-time basis has also increased strongly in recent years (see Chart 4). It is also notable that

**Chart 3**  
**TOP NATIONALITIES WITHIN THE MALTESE WORKFORCE**  
(persons)



**Chart 4**  
**FOREIGN NATIONALS IN EMPLOYMENT**  
(persons; per cent of total foreign employment)



<sup>3</sup> Subsidiary Legislation 217.17, Single Application Procedure for a Single Permit as regards residence and work and a common set of rights for those third country workers legally residing in Malta Regulations.

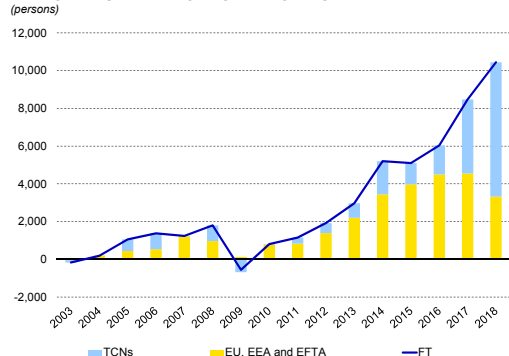
the share of foreigners employed on a full-time basis decreased progressively until 2014, but has returned to an upward path during the high growth period 2015 -2018.

Furthermore, the net flow of foreign nationals engaged on a full-time basis has been increasing almost uninterrupted since 2010. Indeed, this net flow has risen from 809 in 2010 to over 10,000 in 2018 (see Chart 5a). It is notable that while net migrant flows from EU countries typically exceeded net flows from third countries, in 2018 net flows of full-time persons were driven by TCNs, as the net flow of EU nationals moderated. Notwithstanding this, the number of EU nationals in full-time employment still increased strongly compared to 2017, by around 3,300 persons, equivalent to a 13.0% increase.

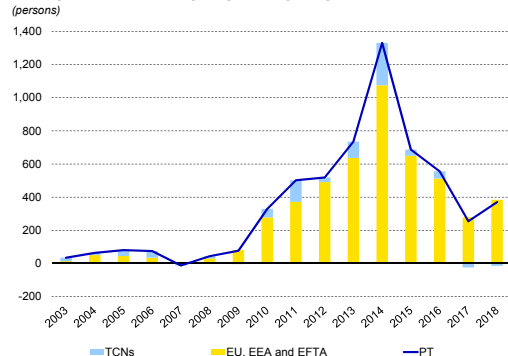
Since 2010, the number of foreign nationals employed on a part-time basis has increased from 817 persons to 5,771 persons in 2018. Contrary to developments in full-time employment, the net flow of foreign nationals employed on a part-time basis peaked in 2014 (see Chart 5b). The subsequent decrease was driven by both EU nationals and TCNs. Furthermore, the number of third-country nationals employed on a part-time basis has declined in the last two years.

Chart 6b shows the distribution of the foreign workforce by occupational position in 2018. TCNs have a higher probability of being employed in elementary occupations,

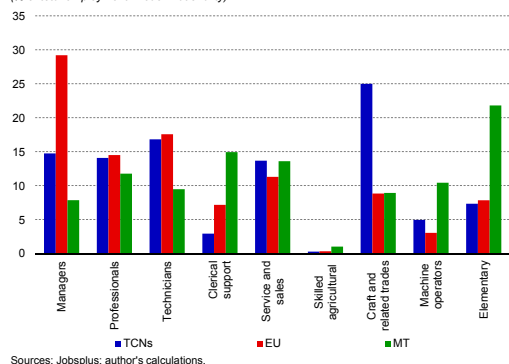
**Chart 5a**  
CHANGE IN FULL-TIME FOREIGN NATIONALS  
(persons)



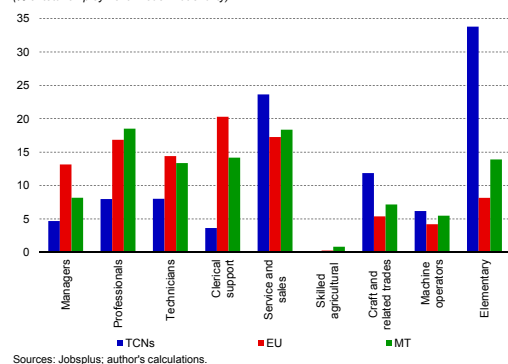
**Chart 5b**  
CHANGE IN PART-TIME FOREIGN NATIONALS  
(persons)



**Chart 6a**  
EMPLOYMENT BY OCCUPATION AND NATIONALITY IN 2002  
(% of total employment in each nationality)



**Chart 6b**  
EMPLOYMENT BY OCCUPATION AND NATIONALITY IN 2018  
(% of total employment in each nationality)



whereas Maltese and other EU nationals have a higher probability of being employed in more advanced positions. The probability of a TCN being employed in an elementary position was 33.8% in 2018, whereas that of EU and Maltese nationals was 8.2% and 13.9%, respectively. In contrast, the probabilities of an EU national being employed in a managerial or professional position are 13.2% and 16.9% respectively, with the corresponding probabilities for TCNs standing at 4.7% and 8.0%. Also, 8.2% and 18.5% of Maltese nationals engaged within the Maltese labour market are employed in managerial and professional positions respectively.

These probabilities have changed significantly since 2002 (see Chart 6a). Whereas in 2002, EU nationals were most likely to be employed in a managerial position, in 2018 clerical support positions hold the largest probability for EU nationals. Indeed, the probability of an EU national being employed in a managerial position has more than halved from 29.2% in 2002 to 13.2% in 2018. In the meantime, the probability of an EU national holding clerical support positions has almost tripled, from 7.2% in 2002 to 20.3% in 2018. The share of EU nationals working in services and sales also increased somewhat since 2002.

The distribution of TCNs by occupational status has also changed significantly. Whereas in 2002 TCNs were most likely to be employed in craft and other related trades positions, they are now most likely to be employed in an elementary position. Furthermore, similar to EU nationals, the probability of such nationals being employed in a managerial position has declined from 14.8% in 2002 to 4.7% in 2018. The probability of engagement in professional and technical positions has also declined significantly. On the other hand, at 33.8%, the probability of a TCN being engaged in an elementary position is more than four times that in 2002, when it stood at 7.4%. Over this period, one can also note that the share of TCNs employed in services and sales, related positions rose from 13.7% in 2002 to almost a quarter.

Shifts in the distribution of Maltese nationals by occupation differ from those seen for foreign workers. For example, the probability that a Maltese national would be employed in a low skill position has declined when compared to 2002. Indeed, whereas more than a fifth of the Maltese national workforce was employed in an elementary position in 2002, 13.9% of Maltese nationals are employed in this position in 2018. Similar developments were also observed in the case of machine operators and in craft and related trades. In the meantime, a larger share of Maltese nationals were employed as professionals and technicians compared to 2002. Moreover, whereas the share of foreign workers employed in managerial positions has declined, that of Maltese nationals remained broadly stable.

Turning to employment by sector and nationality, we note that Maltese nationals are more likely to be engaged within the sector comprising retail transport and tourism and in public administration, health and education (see Chart 7b). By contrast, EU nationals are more likely to be employed in the retail, transport and tourism, in professional and administrative support activities and in the arts, entertainment and recreation sector. The ranking for TCNs differ. In this case, professional and administrative support services account for most jobs held by this group, followed by retail, transport and tourism.

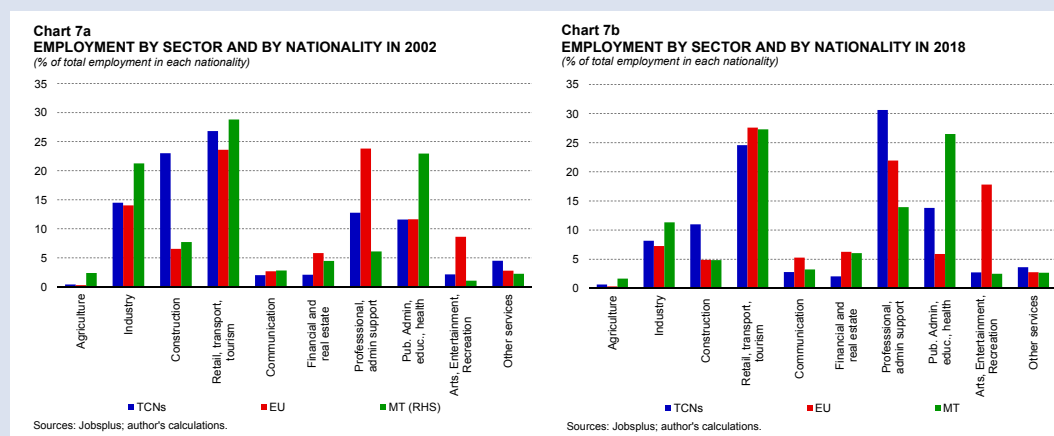
One can also detect some shifts across sectors (see Charts 7a and 7b). One major change among EU nationals is the increased probability of being employed in the arts, entertainment and recreation sector. In 2018, this sector held 17.8% of all EU nationals employed in Malta, compared to 8.6% in 2002. Another sector that gained in importance as a source of employment for EU nationals is the retail, transport and tourism sector. In contrast, the concentration of EU nationals in industry, professional and administrative support services as well as the sector incorporating public administration decreased over time.

Turning to TCNs, the probability of being employed in the professional and administrative support sector has increased from 12.8% in 2002 to 30.6% in 2018. On the other hand, the probability of TCNs employed in construction has more than halved, falling from 23.0% in 2002 to 11.0% in 2018, even if their number recorded an approximate six-fold increase between 2002 and 2018. The share employed in industry almost halved over the same period, notwithstanding a seven-fold increase in numbers.

As regards Maltese nationals, the share employed within industry, and to a lesser degree construction declined. Thus, while 21.3% of Maltese nationals were employed in industry in 2002, only 11.3% were employed in this sector in 2018. On the other hand, Maltese nationals now have a higher probability than before of being employed in the professional and administrative support activities as well as in the sector comprising public administration, health and education (in the latter case mostly reflecting developments in education).

The dependence on migrant workers differs across sectors. In the arts, entertainment and recreation sector, 58.6% of the workforce is foreign. Also, 34.4% of the staff complement in professional and administrative support services are foreign nationals. Dependence on migrant workers is close to 30% in the construction and communication sectors. Furthermore, while the arts, entertainment and recreation sector tends to be reliant on EU nationals, the construction sector as well as the sector incorporating administrative support services tend to rely more on TCNs.

The relatively high dependence on foreign nationals within these sectors does not mean that these have replaced Maltese nationals. Indeed, the number of jobs held by Maltese nationals

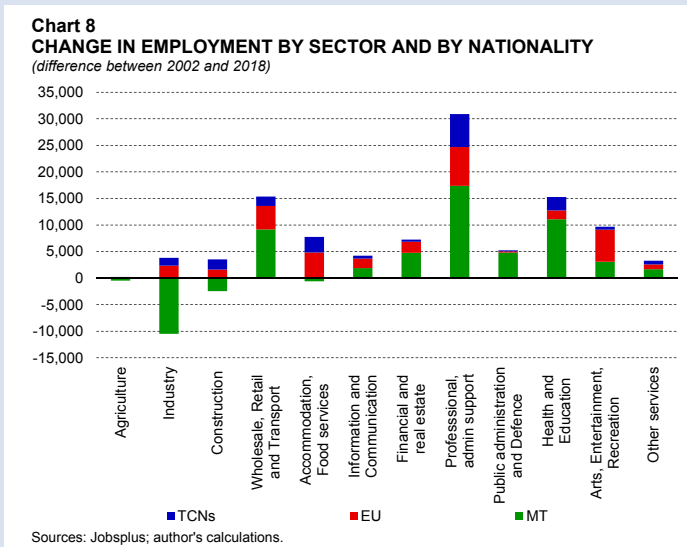


has also increased over time, with increases being registered in most sectors (see Chart 8).

The only sectors where employment of Maltese nationals has decreased are industry, construction and tourism. The largest decline among Maltese nationals was registered in industry, which was largely a result of restructuring within public sector institutions in the ship repair, ship building, energy, water supply and waste management sectors.<sup>4</sup>

Decreases in employment of Maltese nationals in construction and tourism were more limited. Declines in these three sectors were more than offset by new job positions filled by Maltese nationals in services-oriented sectors, in particular in the professional and administrative support sector, thus indicating that Maltese nationals have shifted into relatively higher skilled jobs.

Chart 8 also shows that the proliferation of TCNs is visible in most sectors, including health, professional and administrative support as well as in the arts, entertainment and recreation sector. Indeed, employment of foreign nationals, and of TCNs specifically, has shown the strongest increase in the professional and administrative support sector and not only increased in sectors characterised by relatively lower skill levels.



<sup>4</sup> Most of the decline in employment of Maltese nationals in industry was recorded between 2002 and 2008.

## BOX 3: INCOME AND WEALTH INEQUALITY IN MALTA: EVIDENCE FROM MICRO DATA<sup>1</sup>

### Introduction

The Maltese economy has undergone a strong and job-rich expansion in recent years, leading to higher household incomes, historically low unemployment rates and a booming property market. In many countries, such episodes have frequently been characterised by rising inequality, as some categories of households were not in a position to benefit from such an expansion, with the latter losing out in relative or, in some cases, even in absolute terms.

This Box summarises selected results from a study of the distribution of income and wealth in Malta based on data from the Household Finance and Consumption Survey (HFCS).<sup>2</sup> The survey is conducted by the Central Bank of Malta every three years as part of a Euro-system project coordinated by the ECB. It was conducted for the first time in 2010 and repeated in 2014 and 2017.<sup>3</sup> The HFCS contains a wealth of information on households' balance sheet, income and consumption patterns. Most of these questions are answered by the most financially knowledgeable household member (the 'reference person').<sup>4</sup>

### Distributional analysis

Table 1 reports some widely used measures of inequality for gross household income, net wealth, real assets, financial assets and liabilities, for the whole sample of participating households and households with a reference person of working age. The full sample results show that, according to the Gini coefficient, financial assets are the most unequally distributed variable among the ones chosen. Furthermore, their distribution on this basis has become more unequal over time. This statement is partly supported by other measures of inequality, such as the P-ratios, which represent ratios between different percentiles of the distribution, although in these cases the development is not linear over time.

The distribution of gross household income is less concentrated than that of net wealth, as evidenced by lower values of the Gini coefficient and P-ratios. Furthermore, while the P50-P10 ratio – that is, the ratio between the 50th percentile (median) and the 10th percentile, which covers the bottom half of the distribution – indicates rising inequality across the three waves, the P90-P10 ratio suggests decreasing inequality in the upper half of the distribution.

In 2016, households at the top of the income distribution earned 2.31 times more than those at the median of the distribution, down from 2.38 in 2010. Concurrently, households in the middle-to-upper parts of the distributions saw higher income increases relative to

<sup>1</sup> Prepared by Ilias Georgakopoulos. The author is an economist in the Economic Analysis Department of the Central Bank of Malta. Helpful comments by Mr Alexander Demarco, Ms Rita Schembri and Mr Brian Micallef are gratefully acknowledged. Any errors, as well as the views expressed in this article, are the author's sole responsibility.

<sup>2</sup> A more detailed discussion on the topic is available in Georgakopoulos, I. (2019), "Income and Wealth Inequality: Evidence from Micro Data," Working Paper 03/2019, Central Bank of Malta.

<sup>3</sup> Although fieldwork was conducted in these years, data refer to preceding year, except for the first wave of the survey, where the data are for 2010. Figures are expressed in nominal terms.

<sup>4</sup> For a detailed discussion about the survey see HFCN (2013), "The Eurosystem Household Finance and Consumption Survey: methodological report for the first wave", *Statistics Paper Series*, No.1, ECB.

**Table 1**  
**SUMMARY STATISTICS FOR THE SAMPLE AND WORKING-AGE HOUSEHOLDS**

EUR; number

	Sample households				Working-age households			
	Median	P90/P50	P50/P10	Gini	Median	P90/P50	P50/P10	Gini
<b>Gross household income</b>								
2010	20,562	2.38	2.82	0.378	25,872	1.99	2.56	0.334
2013	22,718	2.42	2.99	0.396	28,665	2.08	2.81	0.342
2016	25,417	2.31	3.31	0.409	33,301	1.96	2.64	0.357
<b>Net wealth</b>								
2010	204,908	3.12	12.86	0.566	218,672	2.94	9.07	0.565
2013	212,067	2.89	14.83	0.562	214,859	2.65	5.89	0.567
2016	236,529	2.93	18.75	0.598	237,690	2.87	7.72	0.601
<b>Real assets</b>								
2010	193,511	3.02	36.51	0.573	204,709	2.92	28.62	0.576
2013	209,840	2.74	10.84	0.538	215,448	2.60	5.35	0.552
2016	225,752	2.85	24.05	0.584	228,752	2.80	13.07	0.581
<b>Financial assets</b>								
2010	23,454	4.47	12.50	0.622	22,937	4.49	17.13	0.586
2013	22,150	6.33	8.14	0.653	22,067	4.99	7.53	0.614
2016	22,512	5.78	12.86	0.679	21,520	4.65	13.54	0.654
<b>Liabilities</b>								
2010	17,122	6.14	34.52	0.682	18,701	6.04	37.40	0.667
2013	19,273	6.85	48.09	0.643	24,900	5.54	53.27	0.619
2016	40,000	4.07	40.00	0.559	45,946	3.81	38.29	0.531

Sources: HFCS; author's calculations.

lower income groups. This has resulted in a small increase in the Gini coefficient over the period under review.<sup>5</sup>

With reference to inequality in household liabilities, the Gini coefficient dropped to 0.559 in 2016 from 0.682 in 2010. Inspection of the percentile ratios reveals that the main driver of the observed reduction in the Gini coefficient was the increasing availability of housing loans to households, particularly to those around the middle of the distribution of liabilities since 2010. This finding is reflected in the reduction of the P90-P50 ratio from 6.14 to 4.07 by the end of 2016.

As regards net wealth, the Gini coefficient rose from 0.566 in 2010 to 0.598 in the third wave of the survey. The P90-P50 ratio suggests that divergence within the top half of the distribution became less pronounced over time, indicating that the net wealth of the middle 50% exerts more weight on the distribution. It should be noted that real assets are more equally distributed than financial assets, partly due to the prevalence of home-ownership in Malta, which might also explain why net wealth is more equally distributed than financial assets. However, inequality in the bottom half of the distribution has increased over time, as indicated by the rise in the P50-P10 ratio. This ratio also remains significantly higher than the other relative measures of inequality considered here, which may reflect the fact that households at the lower end of the distribution may still find it challenging to acquire real assets.

<sup>5</sup> See also Darmanin, J., Georgakopoulos, I. and Knoppe, C. (2018), "Income Distribution, Inequality and Mobility in Malta," *Research Bulletin 2018*, Central Bank of Malta.

In order to investigate what drives the observed inequality, the focus of the analysis is shifted to households whose reference person is between 20 and 60 years old, which broadly corresponds to the working-age category in Malta (see Table 1).

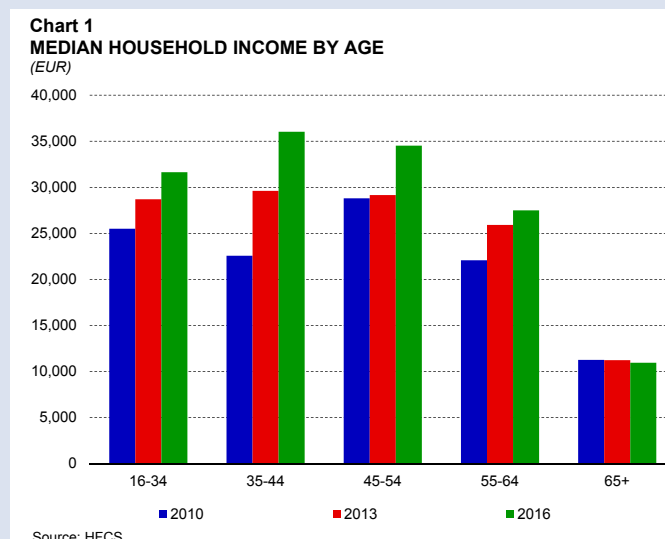
Comparison of the distributional statistics for the two sample sizes suggests that the picture of inequality changes slightly for gross household income and financial assets. For instance, the Gini coefficient for gross income is lower by some 0.04-0.05 compared with the whole sample, while all of the displayed percentiles ratios are lower. Therefore, it appears that the group of pensioners pushes up overall measures of inequality since their incomes are considerably lower compared to those of other low income households. Similarly, inequality in financial assets also decreases, based on the Gini coefficient, when households with a retired reference person are excluded from the sample.

According to the Gini coefficient, life-cycle features appear to be important for income and financial assets, however, their impact on real assets and net wealth is limited. Most of the inequality indicators for the working-age group are close to those of the whole population. This is most likely because most pensioners are asset rich but income poor at the household level.

### Income and wealth distribution by age

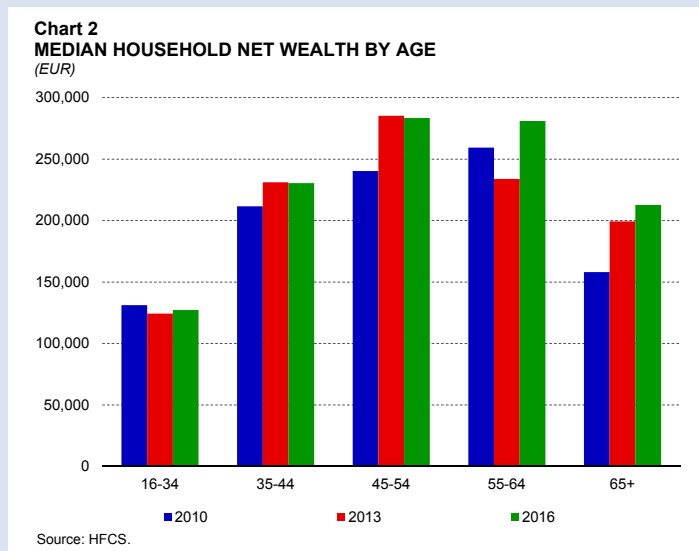
Chart 1, which depicts the distribution of median income by the age of the reference person in the household, shows a large gap between the income level of older households (65+) and that of younger ones. Over the three waves of the survey, this gap has increased, with the 65+ category being the only category that did not experience an increase in income across surveys. This suggests that old age pensions have lost their relativity with median income. Moreover, old age pensions have only increased in line with the cost of living during the period under review, while they are also subject to a cap on pensionable income.

Chart 2 shows the distribution of net wealth by age group. This exhibits the expected hump-shaped pattern often found in the literature.<sup>6</sup> Indeed, in Malta, median net wealth rises steadily with age, reaching its peak in the 45-54 age group on average. Households whose reference person is over 65 experienced



<sup>6</sup> See Azpitarte, F. (2010), "The household wealth distribution in Spain: The role of housing and financial wealth", *Hacienda Pública Española*, IEF, 194(3), pp. 65-90.

a marked increase in their net wealth in the period under review. This is related to a higher self-assessed value of their housing wealth as well as due to an increase in the perceived value of financial assets over time. On the other hand, net wealth of households in the 16-34 group remained broadly stable over time, as their increases in income were offset by a decrease in their financial assets coupled with a notable increase in their debt holdings by 2016.



### The joint distribution of income and net wealth

This section examines the relationship between income and wealth and in particular, the factors that influence the position of a household in the wealth distribution. For this purpose, the author estimates a generalised ordered logit model for the probability of a household to be in a net wealth quintile given its position in the income distribution, after controlling for socio-economic and demographic features.

The estimated coefficients of the income quintiles are positive and in most cases significant (see Table 2). A rise in income increases the probability of being in a higher wealth quintile with the exception of the fourth income quintile in the first wealth threshold. Conversely, within a given wealth threshold, the estimated coefficients tend to increase with income, suggesting that the probability of being in a given wealth quintile increases along the income distribution.

With regards to socio-economic and demographic features, the age of the reference person in a household is found to have a positive impact on the position in the distribution of wealth. Gender seems to have mixed effects on the position of a household in the wealth distribution, but this dummy variable is not statistically significant. One possible explanation for these results is the relative homogeneity in gender across the distribution of wealth.<sup>7</sup> As regards labour status, households with a self-employed reference person are more likely to be in a higher wealth quintile (compared to households with an employed reference person) because they hold high value assets. The effect of household size is ambiguous and statistically insignificant. This could be attributed to the similar household structure

<sup>7</sup> See Fessler, P. and Schürz, M. (2015), "Private Wealth across European Countries: The role of Income, Inheritance and the Welfare State", *Working Papers Series No. 1847*, ECB, September 2015 and Mathä, T., Porpiglia, A. and Ziegelmeier, M. (2014), "Household Wealth in the Euro Area: The Importance of Intergenerational Transfers, Homeownership and House Price Dynamics", *Working Paper Series No. 1690*, ECB, July 2014 for a discussion about such findings.

**Table 2**  
**GENERALISED ORDERED LOGIT REGRESSION RESULTS**

*Odds ratio*

	1st Wealth threshold	2nd Wealth threshold	3rd Wealth threshold	4th Wealth threshold
2 <sup>nd</sup> Income quintile	0.115	0.591 **	0.434 *	0.825 **
3 <sup>rd</sup> Income quintile	1.038 **	1.281 ***	1.122 ***	1.279 ***
4 <sup>th</sup> Income quintile	0.928 *	1.642 ***	1.340 ***	1.758 ***
5 <sup>th</sup> Income quintile	1.662 ***	2.117 ***	2.252 ***	2.879 ***
Gender	-0.282	-0.104	0.185	0.041
Age of reference person	0.429 ***	0.456 ***	0.375 ***	0.418 ***
Household size	-0.049	0.141	0.055	-0.146
Secondary education	0.926 ***	0.349	0.354 *	0.397
Tertiary education	1.425 ***	1.111 ***	1.103 ***	1.155 ***
Self-employed	0.757	1.223 ***	1.844 ***	2.426 ***
Retired	-0.329	0.135	0.173	0.508
Other	-1.156 **	0.001	0.116	0.388
Owner outright	5.251 ***	3.484 ***	4.622 ***	17.273
Owner with mortgage	3.961 ***	2.406 ***	3.527 ***	16.704
Credit-constrained households	-1.707 ***	-0.451	0.338	0.763
Inheritance/gifts	0.953 ***	1.149 ***	0.877 ***	0.491 **
Pseudo R2	0.28			
N.Obs	996			

Sources: 2016 HFCS; author's calculations.

\*\*\* denotes significant at 1 per cent level; \*\* denotes significant at 5 per cent level; \* denotes significant at 10 per cent level.

All estimates are weighted using household weights and take the multiple imputation structure into account.

across wealth quintiles. Lastly, a tertiary level of education has a positive impact on wealth distribution.

For households who own their homes with an outstanding mortgage, there is a positive and significant impact on the probability that a household would be in a higher quintile in the wealth distribution, except for the highest wealth quintile. Therefore, households that can save up enough money to partly or fully finance the purchase of a house have a high probability of being in the wealthiest quintiles in the future. With regards to households with a mortgage, this variable explains the position of households in the wealth distribution in a positive and significant way. This is related to the fact that households with a mortgage typically have higher (expected) incomes and therefore represent a lower risk to financial institutions.

Credit-constrained households in the first wealth quintile are negatively affected by the lack of credit, but there is no statistically significant effect on the rest of the wealth distribution.<sup>8</sup>

<sup>8</sup> Credit-constrained households are defined as those who responded affirmative to any of the following questions: (i) In the last three years, has any lender or creditor turned down any request you (or someone in your household) made for credit, or not given you as much credit as you applied for? (ii) In the last three years, did you (or another member of your household) consider applying for a loan or credit but then decided not to, thinking that the application would be rejected?

In addition, having received gifts or inheritance has a positive impact on the household position in the wealth distribution.

### **Conclusion**

To sum up, wealth inequality is more pronounced than income inequality. Furthermore, although wealth inequality increased moderately between 2010 and 2016, it widened at a quicker pace than income inequality. In relative terms, the distribution of wealth and income changed somewhat in favour of households in the upper parts of the distributions. In contrast, older households have seen stable pension income but were unable to keep up with the overall increase in national median income.

The financing structure of a household, in particular its ability to take a mortgage for its main residence, plays a crucial role in explaining its position in the wealth distribution. Furthermore, household income and the incidence of having received inheritance or gifts are among the most important determining factors of a household's position in the wealth distribution.

### 3. PRICES, COSTS AND COMPETITIVENESS

Annual inflation as measured by the HICP accelerated to 1.8% in June from 1.3% in March, largely supported by faster growth in prices for services and NEIG. By contrast, annual inflation based on the RPI, which only takes into account expenditure by Maltese residents, stood unchanged at 1.9%.

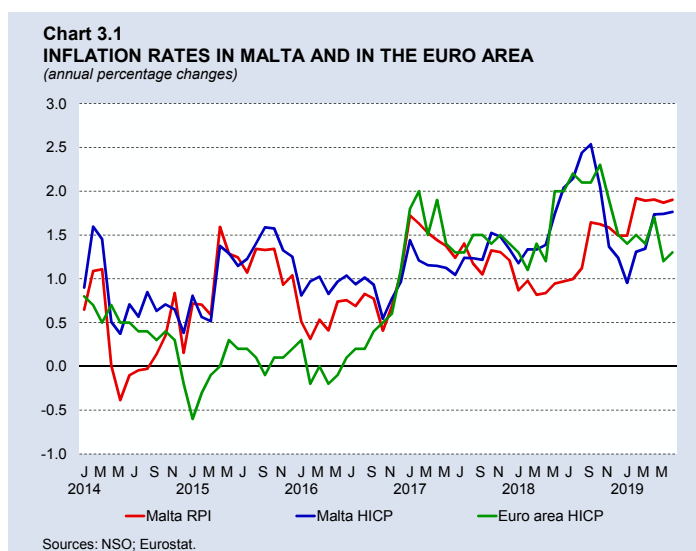
Cost pressures for producers continued to ease, with annual growth in the industrial producer price index standing at 1.6% in June, down from 2.4% in March. Annual growth in Malta's unit labour cost (ULC) index, measured on a four-quarter moving average basis, was marginal in the second quarter, and lower relative to the first, while Malta's harmonised competitiveness indicators (HCIs) showed a deterioration in competitiveness, driven by unfavourable exchange rate developments.

#### Inflation

##### HICP inflation accelerates

HICP inflation closed the second quarter at 1.8%, up from 1.3% in March (see Chart 3.1 and Table 3.1).<sup>1</sup> The June outcome also exceeded the inflation rate observed in the euro area, which stood at 1.3%. HICP excluding energy and food stood at 1.3% of June, slightly above the rate of 1.1% recorded in the euro area.

Services inflation remained the largest contributor to overall



**Table 3.1**  
**HICP INFLATION**

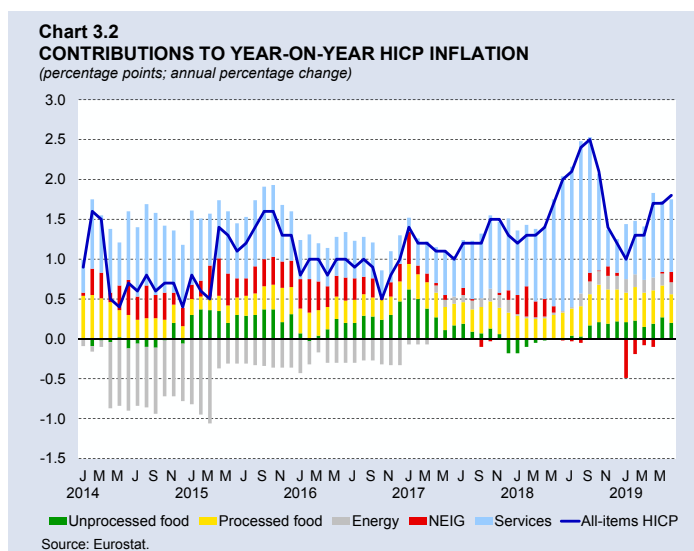
Annual percentage change

	2018			2019					
	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May	June
Unprocessed food	5.2	4.7	5.4	4.9	5.6	3.8	4.7	7.1	5.6
Processed food including alcohol and tobacco	3.1	2.7	2.5	2.3	2.7	2.7	2.7	2.6	2.4
Energy	2.7	2.7	2.7	2.6	2.6	2.6	2.6	2.6	2.6
NEIG	-0.1	0.4	0.1	-1.8	-0.7	-0.3	-0.4	0.1	0.5
Services (overall index excluding goods)	2.2	1.0	0.9	1.5	1.4	1.4	2.1	1.7	1.7
<b>All Items HICP</b>	<b>2.1</b>	<b>1.4</b>	<b>1.2</b>	<b>1.0</b>	<b>1.3</b>	<b>1.3</b>	<b>1.7</b>	<b>1.7</b>	<b>1.8</b>

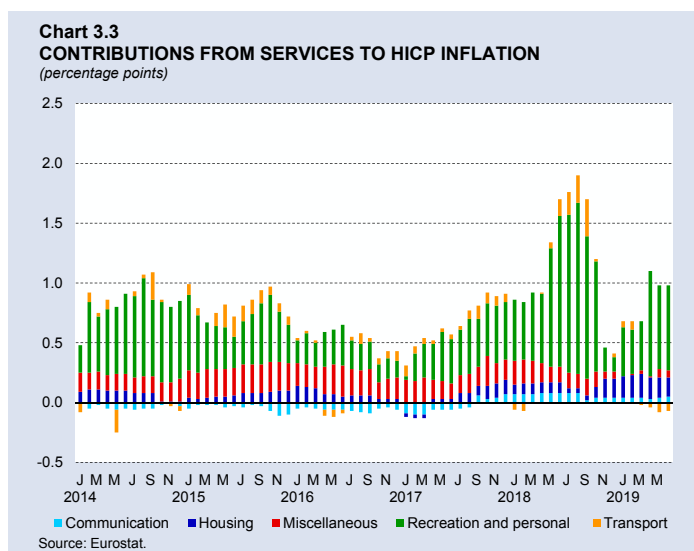
Source: Eurostat.

<sup>1</sup> 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%.

HICP inflation in Malta (see Chart 3.2), while also explaining part of the pick-up over the quarter. Inflation in this component accelerated to 1.7% in June, from 1.4% three months earlier. This acceleration mainly reflected faster annual growth in the prices of recreational services, particularly restaurants (see Chart 3.3). Consequently, the contribution of services to overall HICP inflation rose to 0.9 point, from 0.7 percentage point in March.



Movements in prices of NEIG also supported the acceleration in overall inflation during the second quarter, with price growth turning positive at 0.5% in June, following a contraction of 0.3% in March. As a result, the contribution of this component to overall inflation turned marginally positive.



In contrast, developments in food inflation were mixed during the second quarter. Unprocessed food inflation accelerated strongly, reaching 5.6% in June, from 3.8% three months earlier. This was mainly driven by developments in the prices of fresh fruit. In contrast, processed food inflation eased to 2.4% in June, from 2.7% in March. As a result, the contribution of food inflation to overall HICP remained unchanged during the quarter under review, at 0.6 percentage point.

Energy inflation remained stable at 2.6% in June, and contributed 0.2 percentage point to overall inflation.

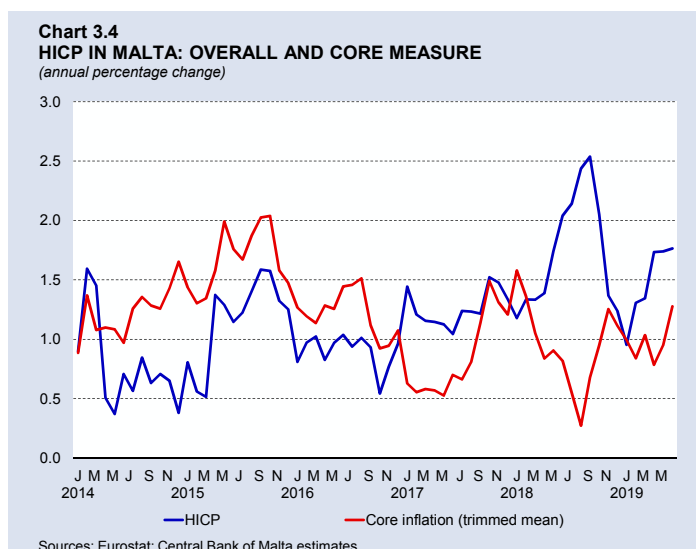
Core inflation, which excludes the more volatile components of the HICP index, accelerated to 1.3% in June, from 1.0% in March, thereby standing 0.5 percentage point below overall

inflation (see Chart 3.4).<sup>2</sup> This gap suggests that overall inflation is partly being supported by strong increases in the prices of a small number of consumables.

### RPI inflation unchanged at 1.9%

Annual inflation based on the RPI index stood at 1.9% in June, unchanged when compared with the end of the first quarter (see Table 3.2). Food inflation remained the main contributor to overall RPI inflation, though its contribution eased slightly

since March, to 0.9 percentage point. On the other hand, higher contributions were registered in the transport and communications and in the recreation and culture components. The difference between developments in the overall RPI and HICP inflation rates mainly reflects divergences in the consumption baskets used to measure the indices.<sup>3</sup>



**Table 3.2**  
**CONTRIBUTIONS TO YEAR-ON-YEAR RPI INFLATION**

Percentage points

	2018					2019				
	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May	June	
Food	1.1	0.9	0.9	1.0	1.1	1.0	1.0	1.0	0.9	
Beverages and tobacco	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	
Clothing and footwear	0.0	0.1	0.0	-0.3	-0.2	0.0	0.0	-0.1	0.1	
Housing	0.1	0.2	0.2	0.2	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	0.0	0.0	0.0	-0.1	0.1	0.1	0.0	0.0	0.0	
Transport and communications	0.2	0.1	0.2	0.3	0.3	0.3	0.3	0.4	0.4	
Personal care and health	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	
Recreation and culture	0.0	0.0	0.0	0.1	0.2	0.0	0.2	0.1	0.1	
Other goods and services	0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	
<b>RPI (annual percentage change)</b>	<b>1.6</b>	<b>1.6</b>	<b>1.5</b>	<b>1.5</b>	<b>1.9</b>	<b>1.9</b>	<b>1.9</b>	<b>1.9</b>	<b>1.9</b>	

Source: NSO.

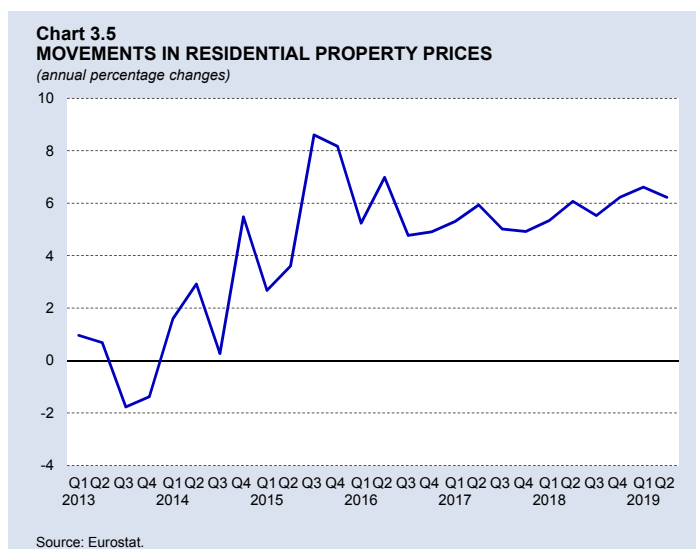
<sup>2</sup> The Central Bank of Malta uses a “trimmed mean” approach to measure core inflation, whereby the more volatile components of the index are removed from the basket of consumer goods so as to exclude extreme movements from the headline inflation rate. See Gatt, W. (2014), “An Evaluation of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

<sup>3</sup> 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 slower pace*

The NSO's Property Price Index (PPI), which is based on actual transactions involving apartments, maisonettes and terraced houses, increased at a slower pace during the second quarter of 2019 (see Chart 3.5).<sup>4</sup> It rose by 6.2% when compared with the same quarter a year earlier, following an increase of 6.6% in the first quarter of the year. House price inflation in Malta remained above that in the euro area, where prices increased at an annual rate of 4.2%.



The increase in residential property prices reflects a number of factors, including the low-interest rate environment 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, albeit at a more subdued pace. The number of development permits rose by 2.8% when compared with the second quarter of 2018, after rising by an annual 10.0% in the previous quarter. This deceleration notwithstanding, the number of permits issued since the start of 2019 remained high from a historical perspective. 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*

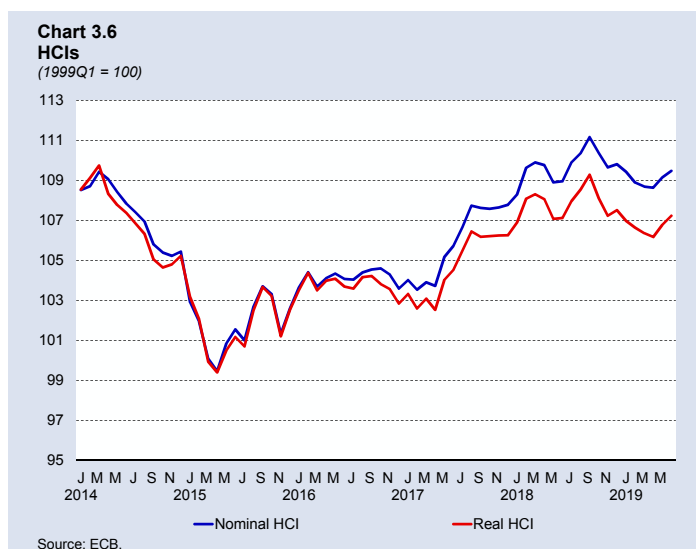
Producer cost inflation, as measured by the industrial producer price index, continued to ease during the second quarter, falling to 1.6% in June from 2.4% in March. This mainly reflected slower growth in the cost of intermediate goods, which nonetheless remained the largest contributor to overall producer cost inflation.<sup>5</sup> Consumer and capital goods contributed positively to inflation, while energy inflation remained nil.

<sup>4</sup> '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.

<sup>5</sup> 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.

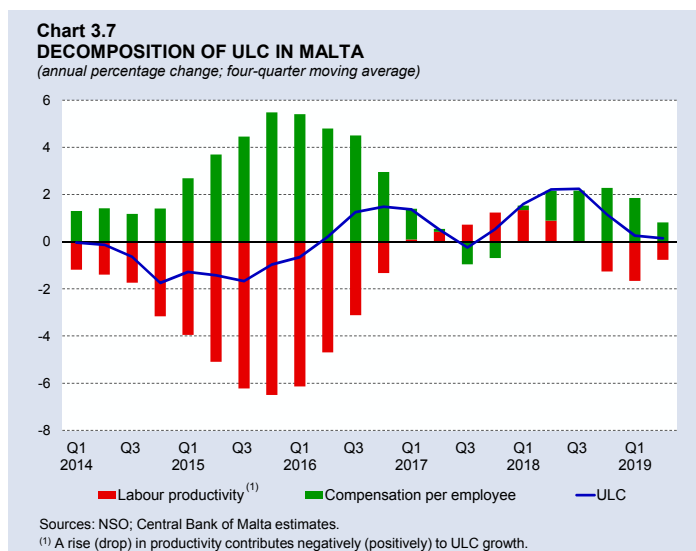
### HCI's point to deterioration in competitiveness

Following a contraction in the first quarter, Malta's HCIs returned to an increasing path during the second quarter. In June, these indicators exceeded their year-ago levels, thus signalling a deterioration in Malta's international competitiveness. The nominal HCI grew at an annual rate of 0.5% in June, suggesting unfavourable developments in trade-weighted exchange rates. At the same time, the real HCI rose by a slower 0.1%, suggesting that the unfavourable exchange rate movements were partly offset by favourable movements in relative prices (see Chart 3.6).<sup>6</sup>



### ULC growth eases

Malta's ULC index, measured as the ratio of compensation per employee to labour productivity, continued to grow during the second quarter of 2019, albeit at a slower pace.<sup>7</sup> When measured on a four-quarter moving average basis, ULC in Malta grew at an annual rate of 0.1%, following a 0.3% 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 0.8%, from 1.9% in the previous quarter. This was partly offset by slower annual growth in labour productivity, which eased to 0.8% from 1.7% three months earlier.

<sup>6</sup> 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.

<sup>7</sup> 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/policy-notes-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 second quarter of 2019, the surplus on the current account of the balance of payments increased when compared with the corresponding quarter of 2018. The higher surplus was mainly attributable to larger net services receipts and a smaller merchandise trade gap. At the same time, net outflows related to secondary income decreased slightly. These movements outweighed a rise in net income outflows.

Meanwhile, the positive balance on the capital account increased, while higher net lending was recorded on the financial account.

When measured on a four-quarter moving sum basis, the current account balance was equivalent to 9.8% of GDP, compared with 2.7% of GDP in the euro area.

Meanwhile, the cyclically-adjusted current account balance is estimated to have reached 11.6%. This indicates that Malta's current account surplus largely reflects structural factors.

### The current account

#### The current account surplus widens

Between April and June 2019, the current account registered a surplus of €361.0 million, an increase of €24.3 million on the same quarter of 2018 (see Table 4.1). The higher surplus was predominantly driven by a widening in the services surplus and a lower merchandise trade deficit. A small decrease in net secondary income outflows also contributed. These developments were partly offset by a notable rise in net primary income outflows.

When measured as a four-quarter moving sum, the surplus on the current account narrowed to €1,250.1 million, from €1,351.1 million in the four quarters to June 2018 (see Table 4.1). The lower surplus was driven by a widening merchandise trade deficit and higher net outflows on the income components of the current account. These offset a higher surplus on the services account. As a result of these movements, the share of the current account surplus in GDP edged down to 9.8%, from 11.5% in the year to June 2018 (see Chart 4.1).

**Table 4.1**  
**BALANCE OF PAYMENTS**

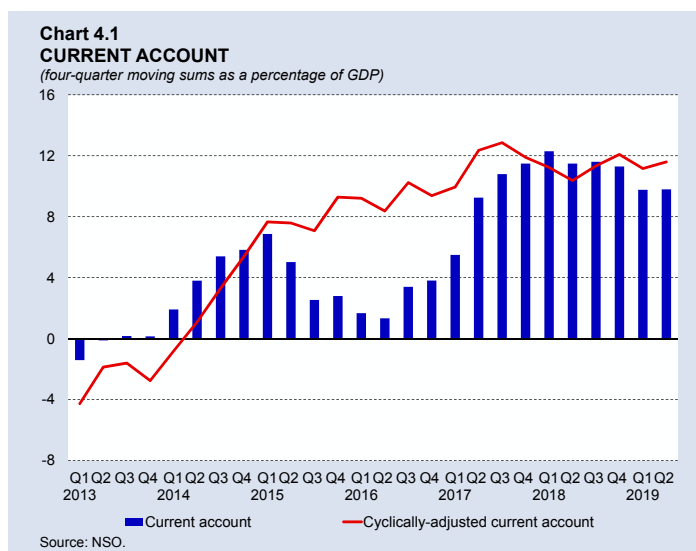
EUR millions

	Four-quarter moving sums					2018 Q2	2019 Q2
	2018 Q2	2018 Q3	2018 Q4	2019 Q1	2019 Q2		
<b>Current account</b>	<b>1,351.1</b>	<b>1,400.1</b>	<b>1,392.4</b>	<b>1,225.8</b>	<b>1,250.1</b>	<b>336.7</b>	<b>361.0</b>
Goods	-1,491.6	-1,533.5	-1,549.1	-1,645.0	-1,615.9	-472.5	-443.4
Services	3,979.9	4,092.5	4,128.4	4,137.8	4,181.8	1,108.7	1,152.7
Primary income	-1,018.0	-1,034.1	-1,055.3	-1,125.8	-1,174.8	-260.9	-309.9
Secondary income	-119.2	-124.8	-131.6	-141.2	-141.0	-38.7	-38.5
<b>Capital account</b>	<b>65.8</b>	<b>66.7</b>	<b>115.3</b>	<b>142.8</b>	<b>156.9</b>	<b>7.3</b>	<b>21.3</b>
<b>Financial account<sup>(1)</sup></b>	<b>794.8</b>	<b>787.0</b>	<b>580.1</b>	<b>665.5</b>	<b>711.6</b>	<b>631.3</b>	<b>677.5</b>
<b>Errors and omissions</b>	<b>-622.1</b>	<b>-679.7</b>	<b>-927.6</b>	<b>-703.1</b>	<b>-695.3</b>	<b>287.4</b>	<b>295.2</b>

Source: NSO.

<sup>(1)</sup> Net lending (+) / net borrowing (-).

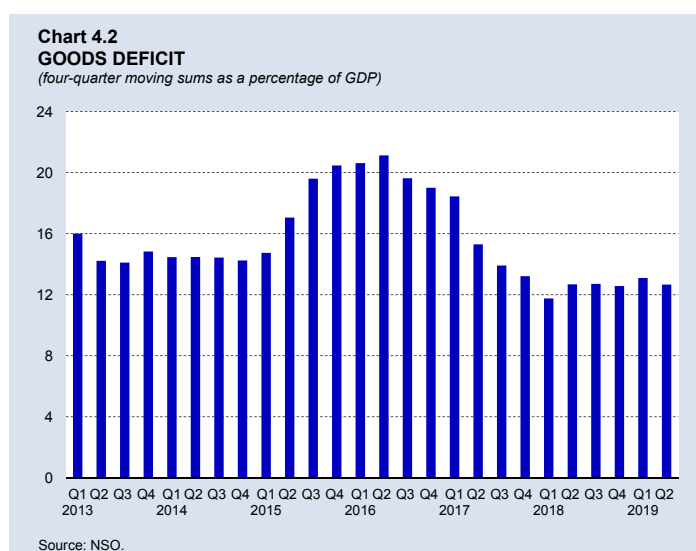
Malta's cyclically-adjusted current account balance stood at 11.6% of GDP, up from 10.4% a year earlier.<sup>1</sup> The cyclically-adjusted and the unadjusted current account balances for the Maltese economy have been close to each other in recent quarters (see Chart 4.1). This suggests that cyclical factors explain a limited part of Malta's current account surplus, with the latter instead largely driven by structural factors. The widening of the cyclically-adjusted balance relative to the second quarter of 2018 contrasts with the narrowing of the headline balance. This partly reflects the widening of the domestic output gap, which lifts imports and thus lowers the headline surplus.



#### The merchandise trade deficit narrows

In the second quarter of 2019, the merchandise trade deficit narrowed by €29.1 million on the corresponding period of 2018, standing at €443.3 million. This reflected a contraction in imports which offset a smaller decline in exports.

When measured on a four-quarter cumulative basis, the visible trade gap widened to €1,615.9 million in the second quarter of 2019, €124.3 million more than a year earlier. This increase stemmed from a €313.4 million increase in imports, which outpaced a €189.1 million rise in merchandise exports. The expansion in imports was partly driven by exceptional one-off purchases of ships and boats. As growth in GDP was equal to the rate of improvement in the merchandise trade deficit, the goods deficit as a percentage of GDP stood unchanged at 12.7% in the four-quarters to June 2019 (see Chart 4.2).



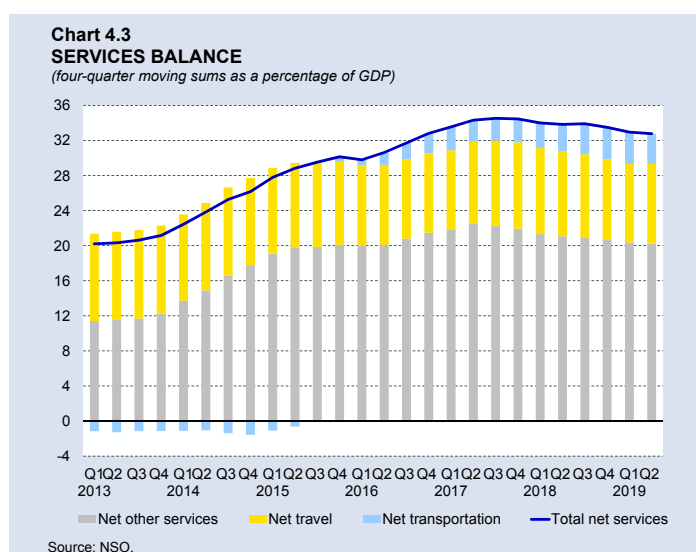
#### The surplus on services rises

During the quarter under review, net receipts generated

<sup>1</sup> 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.

by the services sector reached €1,152.7 million, €44.0 million more than in the second quarter of 2018. This increase was propelled by a €111.4 million rise in services receipts which exceeded a €67.4 million increase in services payments.

The higher net surplus was mainly driven by the travel category, where net receipts increased by €37.8 million, to €373.6 million. This reflected a rise of €46.2 million in inbound tourists' spending, which offset an €8.4 million growth in expenditure by Maltese residents abroad.



The higher services surplus was also supported by higher net receipts related to the “other services” category, which stood at €675.5 million in the second quarter of the year, €22.9 million more than in 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, and, to a lesser extent, by financial services. The rise in net receipts from these activities more than offset higher net payments from other business services, particularly professional and management consultancy fees.

By contrast, net transport receipts contracted by €16.7 million on the corresponding quarter of 2018, to stand at €103.6 million in the second quarter of 2019. This reflected a decline of €9.3 million in receipts and an increase of €7.3 million in payments.

On a four-quarter cumulative basis, the overall surplus from services stood at €4,181.8 million, an increase of €201.8 million over the year to June 2018. Despite such an increase, the share of net services receipts in GDP dropped to 32.8%, from 33.8% a year earlier (see Chart 4.3).

### *Primary income account records higher net outflows<sup>2</sup>*

Between April and June 2019, net outflows on the primary income account stood at €309.9 million. This compares with €260.9 million in the second quarter of 2018 (see Table 4.1). Higher net outflows were largely on account of lower net interest receipts on portfolio investment and higher net outflows related to profits that foreign-owned companies operating in Malta distributed abroad. These offset higher net interest earned on “other investment” income.

On a four-quarter cumulative basis, net outflows on the primary income account reached €1,174.8 million in the quarter under review, €156.7 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.

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

### Outflows on the secondary income account fall marginally<sup>3</sup>

In the second quarter of the year, net outflows on the secondary income account fell by €0.2 million on the same period of 2018, to stand at €38.5 million (see Table 4.1). When measured on a four-quarter moving sum basis, net outflows reached €141.0 million, from €119.2 million a year earlier.

### Activity in the tourism sector

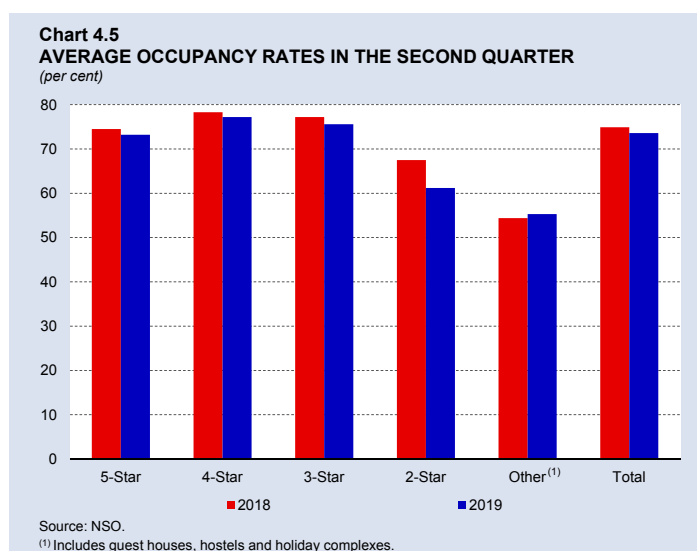
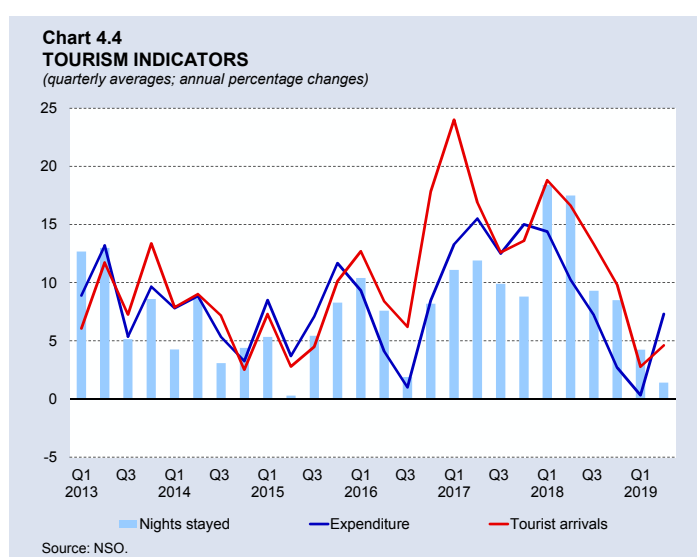
In the second quarter of 2019, tourism arrivals and expenditure expanded at a faster pace compared with the preceding quarter. However, the pace of expansion remained below that registered in 2017 and 2018.

In the quarter under review, the number of inbound tourists rose by 4.6% on a year earlier, to reach 782,176 (see Chart 4.4). This followed a 2.8% increase in the previous quarter.

The latest increase in arrivals was in great part driven by tourists visiting Malta for leisure purposes. Those coming over for business motives also rose. On the other hand, tourists travelling for other motives declined on a year earlier.

Meanwhile, the number of nights that tourists spent in Malta reached 5.1 million, a rise of 1.4% on the previous year. This increase was driven by the use of “other rented” accommodation. In contrast nights stayed in rented collective accommodation and non-rented accommodation decreased.<sup>4</sup>

In line with the above-mentioned decrease in nights stayed in collective accommodation, the total occupancy rate in collective accommodation establishments fell to 73.6%, from 74.9% in the same quarter of 2018 (see Chart 4.5). Lower occupancy rates were recorded across all categories,



<sup>3</sup> The secondary income account shows current transfers between residents and non-residents.

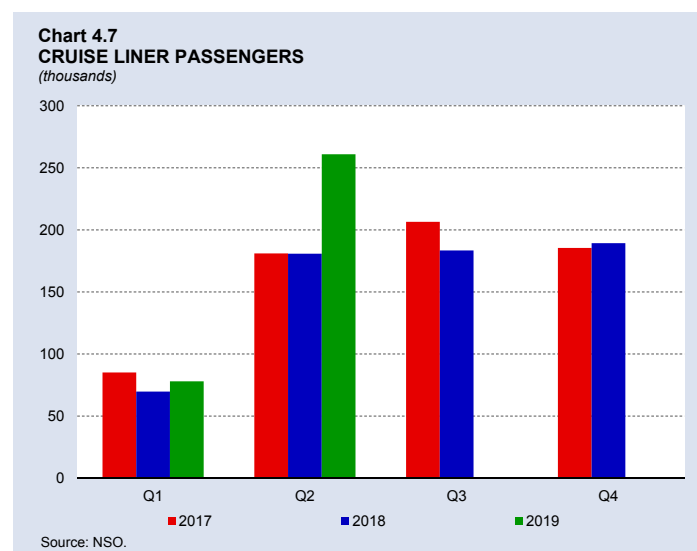
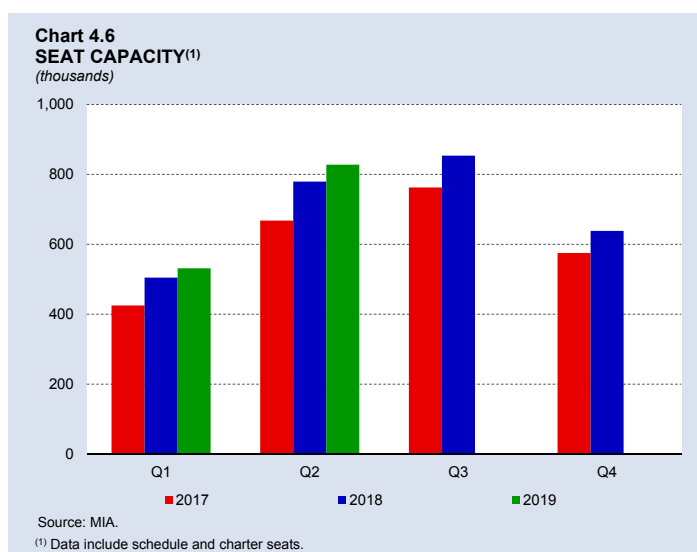
<sup>4</sup> Collective accommodation comprises hotels, apart-hotels, guesthouses, hostels and tourist villages. Non-collective rented accommodation comprises holiday furnished premises (farmhouses, flats and villas), host families, marinas, paid-convents, rented yachts and student dormitories. Non-rented accommodation includes own private residence, staying with friends or relatives and other private accommodation (e.g. free-convents or timeshare).

except in the “other” collective accommodation category, where occupancy rose marginally.

During the second quarter, tourist expenditure in Malta grew at an annual rate of 7.3%, to reach €611.1 million.<sup>5</sup> The strongest increase was registered in the non-package category, which increased by 21.2%, while spending in the “other” category was up by a more modest 6.6%.<sup>6</sup> On the other hand, expenditure on package holidays declined by 8.1%.

Compared with the same quarter of the previous year, expenditure per capita increased to €781, from €761 in the second quarter of 2018, as tourist expenditure increased at a faster pace than arrivals. Meanwhile, the average length of stay decreased to 6.5 nights in the three months to June, from 6.7 nights in the same period a year earlier and 6.6 nights in the first quarter of 2019.

According to Malta International Airport (MIA) data, in the first quarter of 2019, average seat capacity was up by 6.2% compared with a year earlier (see Chart 4.6).<sup>7</sup>



In the second quarter of 2019, the number of cruise liners visiting Malta totalled 130 – 27 more than a year earlier. Foreign passengers rose to 260,995, from 180,849 in the same period of 2018, partly reflecting an increase in the number of weekly calls by cruise liners that are popular with British, German and US nationals (see Chart 4.7).

### The capital account

Net inflows on the capital account stood at €21.3 million between April and June 2019; €14.0 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 €156.9 million, up by €91.0 million on a year earlier.

<sup>5</sup> 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.

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

<sup>7</sup> MIA data are subject to revisions.

## 5. GOVERNMENT FINANCE

During the second quarter of 2019, the general government surplus declined when compared with the corresponding period a year earlier. When measured as a four-quarter moving sum, the general government surplus narrowed to 1.0% of gross domestic product (GDP), from 1.8% in the first quarter of 2019. The cyclically-adjusted surplus-to-GDP ratio also declined, broadly mirroring developments in the headline balance. Meanwhile, the general government debt-to-GDP ratio fell to 45.7% from 46.4% at end-March. Although the stock of financial assets held by government increased considerably, this was offset by a larger increase in financial liabilities. Consequently, the net financial worth decreased as a share of GDP.

### Quarterly developments

#### General government surplus narrows

In level terms, the general government registered a surplus of €19.7 million in the second quarter of 2019, €98.0 million less than the surplus registered a year earlier. This was due to a substantial increase in primary expenditure offsetting a rise in revenue. As a result, while the primary balance remained in surplus, this narrowed by €100.9 million, to €65.3 million.

#### Higher tax receipts underpin revenue growth

In the second quarter of 2019, general government revenue increased by €88.9 million or 7.5% when compared with the second quarter of 2018, reaching €1,270.5 million (see Table 5.1).

**Table 5.1**  
**REVENUE, EXPENDITURE AND DEBT**

EUR millions

	2018			2019		Change 2019Q2-2018Q2	
	Q2	Q3	Q4	Q1	Q2	Amount	%
<b>Revenue</b>	<b>1,181.7</b>	<b>1,219.4</b>	<b>1,329.3</b>	<b>1,141.1</b>	<b>1,270.5</b>	<b>88.9</b>	<b>7.5</b>
Taxes on production and imports	364.2	442.7	416.4	373.8	392.7	28.5	7.8
Current taxes on income and wealth	454.2	442.3	433.1	411.5	500.8	46.6	10.3
Social contributions	201.8	165.2	217.5	192.4	193.1	-8.7	-4.3
Capital and current transfers receivable	22.6	37.6	106.5	46.5	42.8	20.2	89.1
Other <sup>(1)</sup>	138.9	131.6	155.9	116.8	141.2	2.3	1.7
<b>Expenditure</b>	<b>1,064.0</b>	<b>1,106.6</b>	<b>1,310.6</b>	<b>1,165.0</b>	<b>1,250.9</b>	<b>186.9</b>	<b>17.6</b>
Compensation of employees	339.3	346.8	343.6	358.2	356.8	17.5	5.2
Intermediate consumption	202.3	189.6	260.9	208.8	231.0	28.6	14.2
Social benefits	294.7	281.6	309.6	308.2	336.9	42.2	14.3
Subsidies	40.1	37.3	53.3	41.3	49.6	9.5	23.7
Interest	48.5	47.4	46.7	43.9	45.7	-2.9	-5.9
Other current transfers payable	47.8	68.5	105.4	73.8	81.8	34.1	71.4
Gross fixed capital formation	71.7	98.3	152.3	97.4	113.6	41.9	58.5
Capital transfers payable	22.2	39.0	43.8	31.3	33.6	11.4	51.5
Other <sup>(2)</sup>	-2.6	-1.9	-5.0	2.0	1.8	4.4	
<b>Primary balance</b>	<b>166.2</b>	<b>160.2</b>	<b>65.4</b>	<b>20.1</b>	<b>65.3</b>	<b>-100.9</b>	
<b>General government balance</b>	<b>117.7</b>	<b>112.8</b>	<b>18.7</b>	<b>-23.9</b>	<b>19.7</b>	<b>-98.0</b>	
<b>General Government debt</b>	<b>5,773.6</b>	<b>5,543.6</b>	<b>5,641.1</b>	<b>5,826.7</b>	<b>5,832.0</b>		

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.

Growth was driven by an increase in tax revenue. In particular, inflows from current taxes on income and wealth surged by €46.6 million, on the back of higher income tax receipts from households and companies. Intakes from taxes on production and imports also recorded a significant increase of €28.5 million. This was due to higher value-added tax receipts. Meanwhile, revenue from social contributions show an €8.7 million decline from the relatively high level recorded in the second quarter of 2018.

As regards non-tax revenue, capital and current transfers receivable rose by €20.2 million on the back of higher EU grants. Meanwhile, the “other” component of government revenue experienced a modest increase, as a rise in sales offset lower dividend income.

### *Both current and capital expenditure increase*

Total government expenditure soared by €186.9 million, or 17.6% when compared with the second quarter of 2018, due to an increase in both recurrent and capital expenditure.

The largest increase in recurrent expenditure was recorded in outlays on social benefits which grew by €42.2 million, partly due to higher outlays on retirement pensions. Meanwhile, current transfers payable surged by €34.1 million, driven by the timing of tax refunds to households and transfers to the Contingency Reserve.<sup>1</sup> Intermediate consumption rose by €28.6 million, reflecting higher outlays within the public administration sector. Furthermore, compensation of employees increased on the back of outlays within the public administration and health sectors. On the other hand, interest payments declined by €2.9 million.

Capital expenditure grew at a strong pace, mainly as a result of higher outlays on gross fixed capital formation. The latter grew by €41.9 million due to higher spending on road construction and other infrastructural projects. Meanwhile, capital transfers increased by €11.4 million, on account of higher outlays on EU-financed projects.

### *Debt increases slightly*

In June 2019, the stock of general government debt amounted to €5,832.0 million, €5.3 million more than in March. This was due to a €16.6 million increase in outstanding loans, which raised their share in total debt by 0.3 percentage point to 6.6%, from 6.3% in the previous quarter.

Meanwhile, the stock of short-term securities (composed of Treasury bills) fell by €8.0 million, meaning that its share of total debt decreased by 0.1 percentage point to 5.7%. The stock of long-term securities outstanding (composed of MGS) fell by €4.2 million, leading to a fall of 0.1 percentage point in their share in total debt to 81.2%, from 81.3% in the previous quarter.

Currency and deposits outstanding increased by a marginal €0.9 million, with their share in total debt remaining unchanged at 6.5%.

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<sup>1</sup> The Contingency Reserve was set up under the 2014 Fiscal Responsibility Act as a means to tap additional resources in the event of temporary and unforeseen circumstances, to ensure that budgetary targets are met. According to the Act, the Reserve should amount between 0.1% and 0.5% of GDP in any given year.

## Headline and cyclically-adjusted developments

### Headline surplus ratio narrows, while the debt ratio decreases

On a four-quarter moving sum basis, the general government balance remained in surplus. However, the surplus-to-GDP ratio declined to 1.0% of GDP from 1.8% of GDP in the first quarter of 2019 (See Chart 5.1).

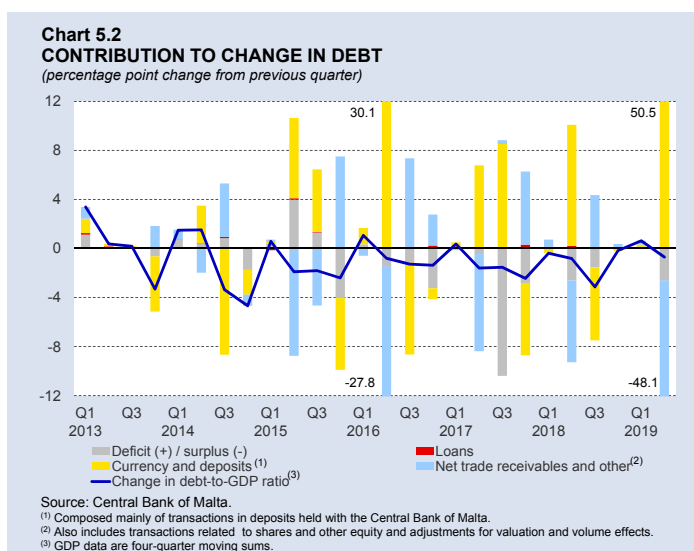
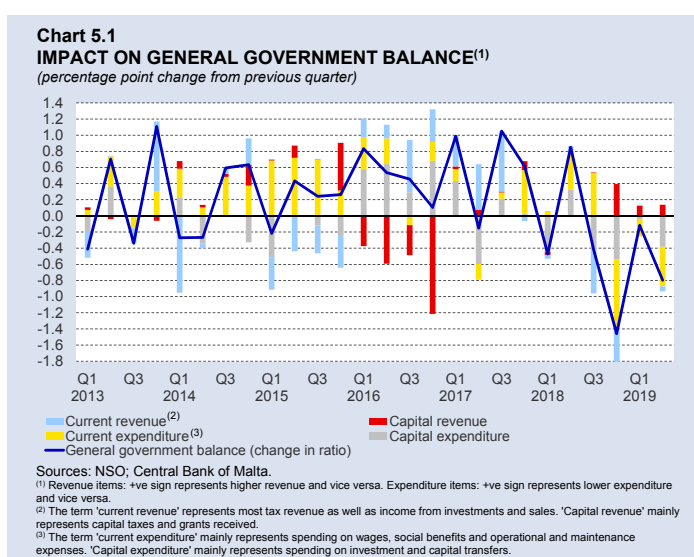
This is due to a higher share of expenditure in GDP, and partly reflects the above-mentioned increases in current and capital outlays in the second quarter of the year. The ratio of current spending in GDP rose by 0.5 percentage point, while capital expenditure's share in GDP increased by 0.4 percentage point.

Overall, revenue items broadly retained their share in GDP. 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.

In the period under review, the debt-to-GDP ratio fell by 0.7 percentage point as the rise in GDP was more pronounced than the rise in government debt (see Chart 5.2). The fall in the debt ratio also reflects a positive budget balance. In contrast, deficit-debt adjustments exerted a debt-increasing effect. This was due to a large increase in deposits held with banks, which offset higher net trade payables (shown in Chart 5.2 as lower net trade receivables). The latter effect reflects the impact of tax refunds and accruals adjustments carried out to tax revenue.<sup>2</sup>

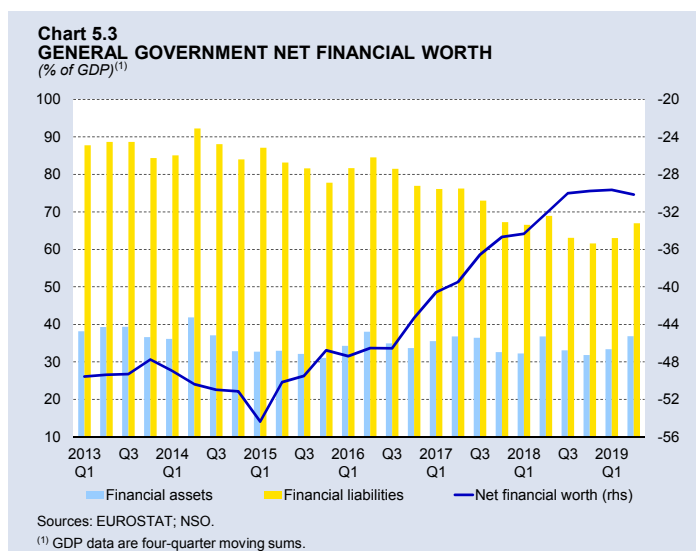
### Net financial worth deteriorates

The market value of financial assets grew to €4,698.9 million by June 2019, €507.5 million more than the level at end-March 2019. This was primarily due to the above-mentioned increase



<sup>2</sup> For further details, see Box 5: Deficit-debt Adjustments in Malta: 2007-2010, *Quarterly Review 2011:4*, Central Bank of Malta.

in deposits held by general government. Consequently, the share of financial assets in GDP rose by 3.4 percentage points to 36.8% (see Chart 5.3). At the same time, financial liabilities increased by €631.9 million, meaning that they now stand at €8,546.4 million. This mostly reflected an increase in accounts payable and a rise in the market value of outstanding debt securities. The share of financial liabilities in GDP rose by 3.9 percentage points to 67.0%.



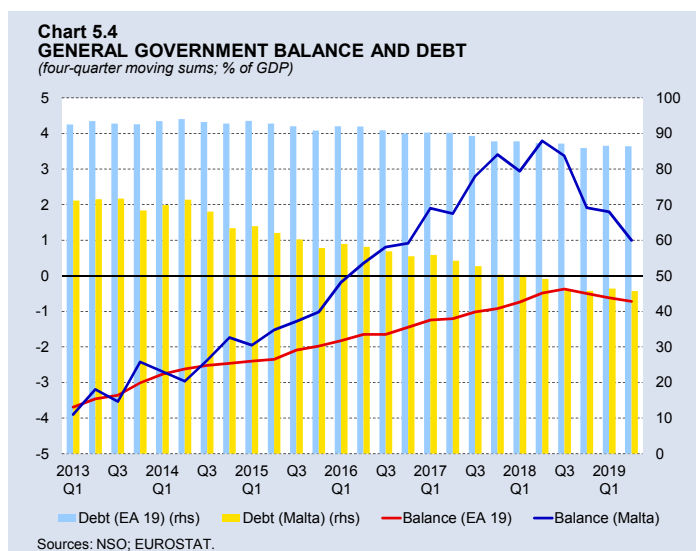
The resulting net financial worth of general government as a share of GDP decreased by 0.5 percentage point from -29.7% in the previous quarter, closing the first half of the year at -30.2%.

#### *Public finances continue to compare favourably with the euro area's*

In June, the euro area general government deficit stood at 0.7% of GDP on a four-quarter moving sum basis, broadly similar to the 0.6% for the previous quarter (see Chart 5.4). Over the same period, the euro area debt ratio declined slightly to 86.4% of GDP, from 86.5%. Malta's public finances therefore continued to compare favourably with the euro area average, as a surplus was maintained, even if its ratio narrowed in the period under review. Moreover, the Maltese debt ratio fell further below the 60% threshold referenced in the Stability and Growth Pact and stood approximately 40 percentage points less than the corresponding ratio for the euro area.

#### *Cyclically-adjusted balance narrows<sup>3</sup>*

On a four-quarter moving sum basis, the cyclically-adjusted surplus ended the quarter under review at 0.7% of GDP



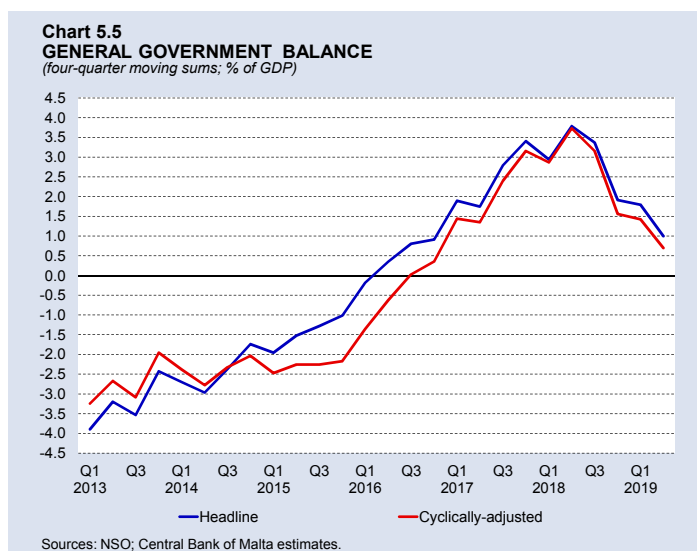
<sup>3</sup> The cyclically-adjusted balance is corrected for the impact of the economic cycle on government tax revenue and unemployment assistance. This methodology is in line with the approach used by the European Commission but is based on own estimates for fiscal items' elasticities and the output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

(see Chart 5.5), 0.7 percentage point less than the 1.4% surplus posted three months earlier. This is in line with developments in the headline surplus-to-GDP ratio, which declined by 0.8 percentage point during the same period.

The cyclically-adjusted surplus ratio to GDP narrowed due to a higher share of expenditure in GDP, in line with developments in recent quarters. This was mostly due to a higher share of gross fixed capital formation in GDP and the abovementioned

increase in current transfers paid (see Table 5.2). Movements in the shares of other expenditure items in GDP were marginal compared with the previous quarter and overall neutral.

The share of cyclically-adjusted revenue in GDP remained unchanged as an increase in the ratio of direct taxes in GDP, reflecting higher inflows from income taxes outlined above, was counter-balanced by a declining share of social contributions in GDP.



**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	Q2
<b>Revenue</b>	<b>0.4</b>	<b>0.7</b>	<b>0.8</b>	<b>0.0</b>	<b>-0.1</b>	<b>0.1</b>	<b>-0.4</b>	<b>-0.1</b>	<b>0.1</b>	<b>0.0</b>
Current taxes on income and wealth	0.1	-0.1	0.5	0.2	0.0	0.1	-0.2	-0.5	0.5	0.2
Taxes on production and imports	0.1	0.0	0.3	-0.2	-0.1	0.2	0.2	0.1	0.0	0.0
Social contributions	0.0	0.0	0.0	0.0	0.0	0.2	-0.2	0.1	0.0	-0.2
Other <sup>(1)</sup>	0.3	0.7	-0.1	0.0	-0.1	-0.3	-0.2	0.2	-0.3	0.0
<b>Expenditure</b>	<b>-0.7</b>	<b>0.7</b>	<b>-0.3</b>	<b>-0.8</b>	<b>0.2</b>	<b>-0.7</b>	<b>0.1</b>	<b>1.5</b>	<b>0.2</b>	<b>0.8</b>
Compensation of employees	-0.1	-0.1	-0.1	0.0	0.0	-0.1	0.0	0.0	-0.1	-0.1
Intermediate consumption	0.0	0.3	0.3	-0.3	-0.1	0.0	-0.2	0.5	0.3	0.1
Social benefits	-0.2	-0.2	-0.1	-0.2	-0.1	-0.1	-0.1	0.0	-0.1	0.1
Interest payments	-0.1	-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	0.0	0.0	0.3	0.5	0.3	0.3
Other <sup>(2)</sup>	-0.2	0.6	-0.3	-0.2	0.4	-0.4	0.3	0.6	-0.1	0.4
<b>Primary balance</b>	<b>1.0</b>	<b>-0.2</b>	<b>1.0</b>	<b>0.7</b>	<b>-0.4</b>	<b>0.8</b>	<b>-0.6</b>	<b>-1.7</b>	<b>-0.2</b>	<b>-0.8</b>
<b>General government balance</b>	<b>1.1</b>	<b>-0.1</b>	<b>1.0</b>	<b>0.8</b>	<b>-0.3</b>	<b>0.9</b>	<b>-0.6</b>	<b>-1.6</b>	<b>-0.1</b>	<b>-0.7</b>

Sources: NSO; Central Bank of Malta estimates.

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

<sup>(2)</sup> Mainly includes subsidies, current and capital transfers.

## 6. MONETARY AND FINANCIAL DEVELOPMENTS

The Bank's FCI suggests that in the second quarter of 2019, financing conditions were marginally tight from a historical perspective.

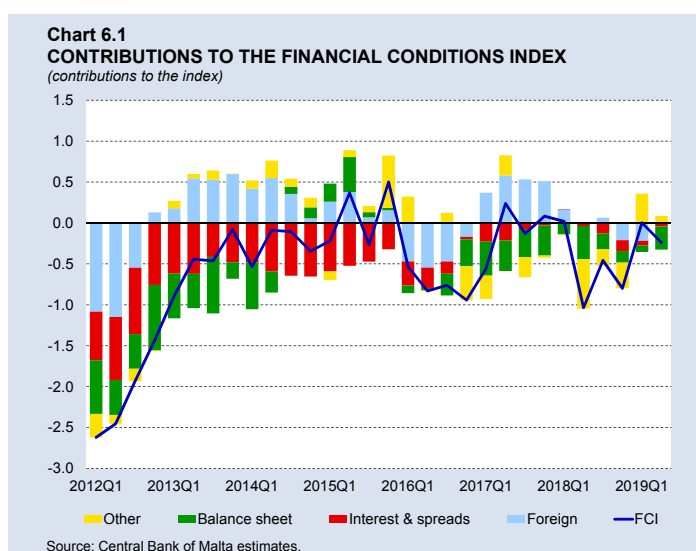
Maltese residents' deposits with MFIs in Malta continued to expand at a robust pace during the second quarter of 2019.<sup>1</sup> The shift to overnight deposits persisted, in an environment of low interest rates and a continued preference for liquidity. At the same time, credit growth continued to pick up, reflecting a return to positive growth in credit to general government and continued strong growth in credit to other residents. Loans to households for house purchases rose at a faster pace, while lending to NFCs moderated. Interest rates on loans and deposits fell further when compared with a year earlier, though the spread between the two rates remained elevated.

In June, the primary market yield on Treasury bills declined marginally from that prevailing at the end of March. Secondary market yields on five and ten-year MGS fell more significantly, broadly mirroring decreases in euro area benchmark rates. Between March and June, domestic share prices in the equity market rose.

### Monetary and financial conditions

According to the Bank's FCI, in the second quarter of 2019, financing conditions were slightly tight from a historical perspective, in contrast to broadly neutral conditions in the first quarter of 2019 (see Chart 6.1). The recent tightening in financial conditions mainly reflected a negative contribution from domestic influences. In particular, net issues of securities by domestic NFCs fell when compared with the first quarter of 2019. Furthermore, balance sheet indicators deteriorated as the growth in real credit to NFCs decelerated. Conversely, foreign influences, which were relatively tight in the first quarter of the year, were broadly neutral in the second quarter. The improvement in foreign influences was driven by movements in euro area equity prices, and marginally lower uncertainty.

Notwithstanding the recent tightening, financing conditions were much more favourable than in the second quarter of 2018, mainly reflecting the significant increase in net issues of securities by domestic NFCs. Balance sheet indicators also contributed to the improvement in overall FCI, as the return on equity of the banking sector increased since the second quarter of 2018.



<sup>1</sup> 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.

**Table 6.1**  
**DEPOSITS OF MALTESE RESIDENTS**

	EUR millions	Annual percentage changes				
		2019 June	2018			2019
		June	Sep.	Dec.	Mar.	June
<b>Overnight deposits</b>	<b>14,926</b>	<b>5.4</b>	<b>7.1</b>	<b>7.7</b>	<b>8.4</b>	<b>8.8</b>
<i>of which</i>						
Households	9,058	12.8	14.2	14.5	10.3	11.0
Non-financial corporations	3,354	9.0	10.1	3.8	4.1	-1.2
<b>Deposits redeemable at notice of up to three months</b>	<b>66</b>	<b>-11.0</b>	<b>52.5</b>	<b>63.2</b>	<b>63.0</b>	<b>43.4</b>
<i>of which</i>						
Households	34	-26.7	-14.9	-9.9	-5.1	-1.8
Non-financial corporations	13	377.0	2359.4	530.2	238.6	60.0
<b>Deposits with an agreed maturity of up to two years</b>	<b>2,818</b>	<b>1.2</b>	<b>-6.7</b>	<b>-5.6</b>	<b>-6.6</b>	<b>-8.8</b>
<i>of which</i>						
Households	2,203	-3.2	-5.5	-6.3	-6.4	-6.6
Non-financial corporations	285	28.5	7.3	-9.5	-3.4	-9.4
<b>Deposits with an agreed maturity above two years</b>	<b>1,533</b>	<b>-10.6</b>	<b>1.5</b>	<b>8.2</b>	<b>10.9</b>	<b>14.1</b>
<i>of which</i>						
Households	1,298	-11.4	-0.9	3.8	5.4	5.8
Non-financial corporations	69	-4.3	-1.1	9.9	-6.7	8.1
<b>Total residents' deposits<sup>(1)</sup></b>	<b>19,344</b>	<b>3.2</b>	<b>4.3</b>	<b>5.5</b>	<b>6.2</b>	<b>6.3</b>

Source: Central Bank of Malta.

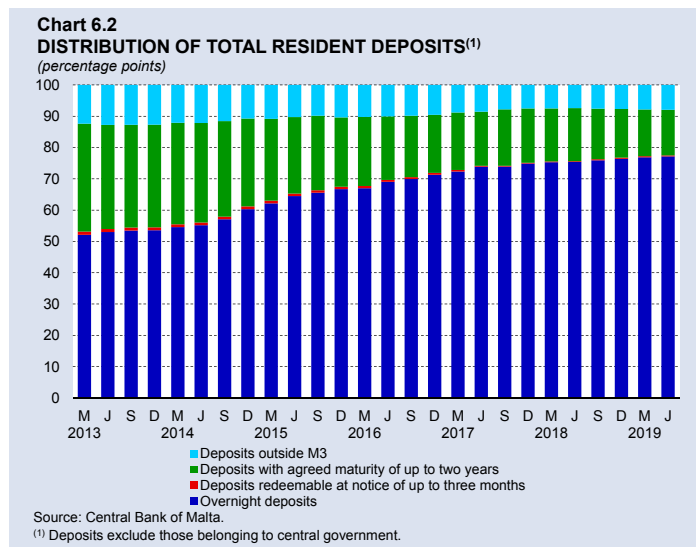
<sup>(1)</sup> Total residents' deposits exclude deposits belonging to central government.

### *Maltese residents' deposits continue to expand*

Total deposits held by Maltese residents with MFIs in Malta continued to expand, with the annual rate of change standing at 6.3% in June (see Table 6.1). This was marginally above the 6.2% year-on-year increase recorded in the previous quarter. The continued strength in deposit growth is consistent with the elevated level of liquidity in the economy, supported by robust activity and income growth.

Overnight deposits remained residents' preferred deposit category. Annual growth in this component rose to 8.8% in June, from 8.4% three months earlier. The share of this category in total deposits thus increased to 77.2%, from 75.4% a year earlier, thereby extending the established upward pattern observed in recent years (see Chart 6.2).

At the same time, time deposits with an agreed maturity of over two years continued to



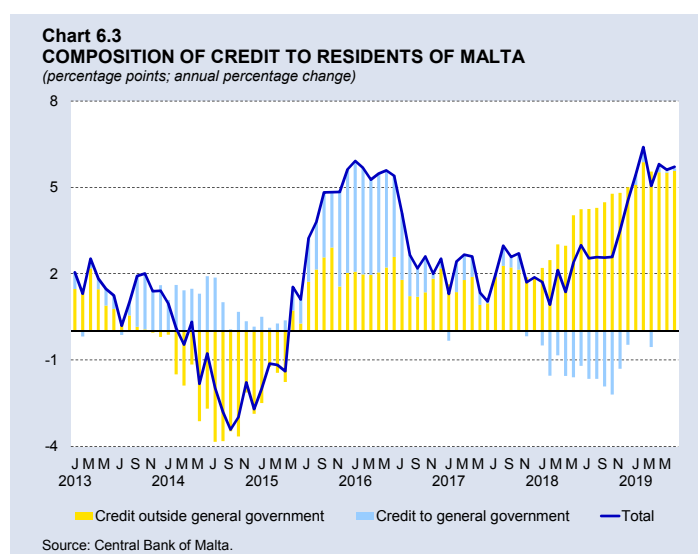
accelerate, with the annual rate of change reaching 14.1% from 10.9% three months earlier. Their share in total deposits edged up to 7.9%. On the other hand, deposits with an agreed maturity of less than two years contracted further. These decreased by 8.8% in the year to June. As a result, their share in total deposits declined to 14.6% from 17.0% a year earlier. The share of deposits redeemable at notice of up to three months remained marginal.

### *Credit to residents grows at a faster pace*

Credit to Maltese residents expanded by 5.7% in the year to June 2019, after growing by 5.1% in the previous quarter (see Table 6.2). Growth continued to be largely supported by credit to residents outside general government, which rose at an unchanged annual pace of 7.2% (see Chart 6.3). At the same time, credit to general government rose slightly, following a sequence of contractions.

Growth in credit outside general government continued to be driven by loans, which rose by 7.3% in the year to June. Loans to households accelerated further, while loans to NFCs moderated compared with March.

Loans to households grew by 9.5% on an annual basis, following an 8.7% increase in March. This was driven by a faster rate of expansion in



**Table 6.2**  
**MFI CREDIT TO MALTESE RESIDENTS**

	EUR millions 2019 June	Annual percentage changes				
		2018		2019		
		June	Sep.	Dec.	Mar.	June
<b>Credit to general government</b>	<b>3,045</b>	<b>-4.9</b>	<b>-8.0</b>	<b>-2.0</b>	<b>-2.4</b>	<b>0.4</b>
<b>Credit to residents outside general government</b>	<b>11,064</b>	<b>5.6</b>	<b>5.9</b>	<b>6.5</b>	<b>7.2</b>	<b>7.2</b>
Securities & Equity	455	7.6	9.9	5.1	9.1	4.2
Loans	10,610	5.5	5.7	6.6	7.1	7.3
<i>of which:</i>						
Loans to Households	5,791	7.1	7.5	7.8	8.7	9.5
Mortgages	5,196	7.8	8.2	8.8	9.6	10.1
Consumer Credit and Other Lending	595	1.9	2.0	-0.4	1.9	4.1
Loans to NFCs <sup>(1)</sup>	3,960	4.0	4.6	7.1	7.0	4.6
<b>Total credit to residents</b>	<b>14,110</b>	<b>3.0</b>	<b>2.6</b>	<b>4.5</b>	<b>5.1</b>	<b>5.7</b>

Source: Central Bank of Malta.

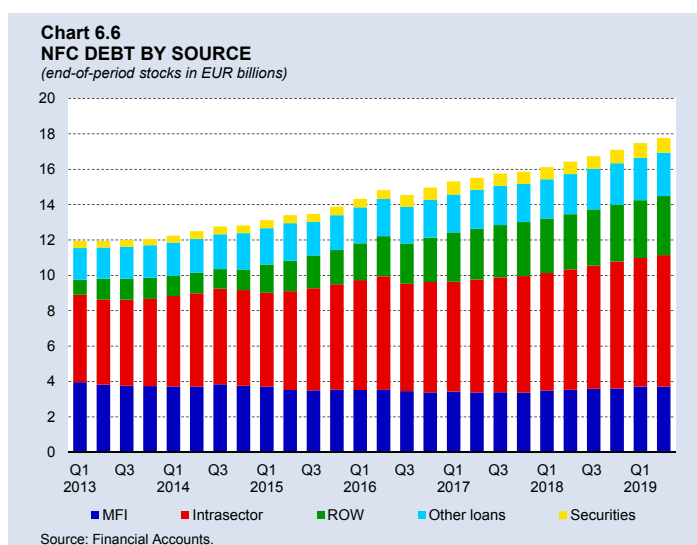
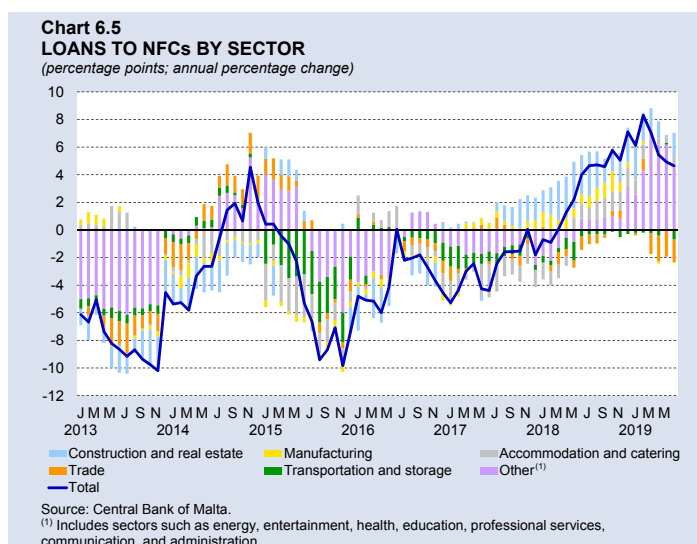
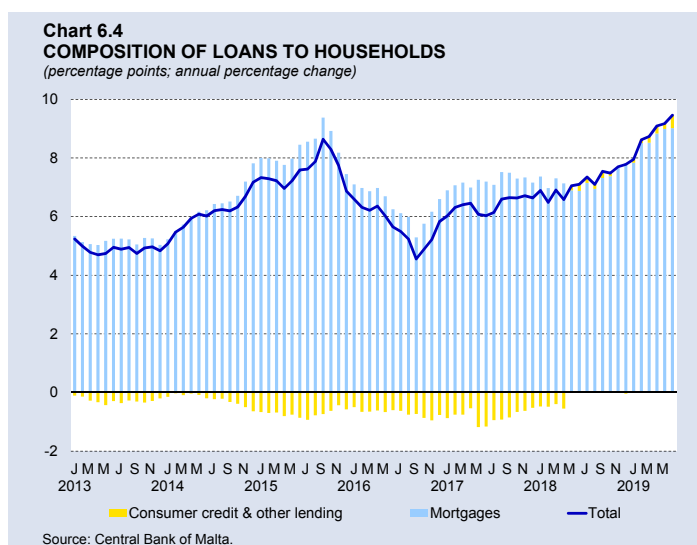
<sup>(1)</sup> NFCs include sole proprietors and non-profit institutions serving households.

mortgage lending, though consumer credit and other lending also continued to recover (see Chart 6.4).

Annual growth in loans to NFCs moderated to 4.6% in the year to June, after increasing by 7.0% in March. A sectoral breakdown shows that this moderation reflected slower growth in loans to the professional, scientific, and technical sector, as well as a contraction in loans to the energy sector (both part of the “other” component) (see Chart 6.5).

Financial accounts data show that the share of bank lending in total NFC debt stood at 20.9% in June, lower than the share of 21.5% recorded a year earlier (see Chart 6.6). The share attributed to the rest of the world also decreased over this period. This suggests that NFCs reduced their reliance on bank loans and foreign financing in favour of alternative sources, mainly intra-sectoral lending and debt securities.<sup>2</sup> The share of intra-sectoral lending in total NFC debt rose to 41.8%, from 41.4% in the second quarter of 2018. The share of other loan sources remained stable at 13.8% of total NFC debt, while the share of debt securities stood at 4.7% in the quarter under review, up from 4.3% a year earlier.<sup>3</sup>

Malta Stock Exchange (MSE) data show that large companies are increasingly making public issuances of corporate bonds and equity. As at June 2019,



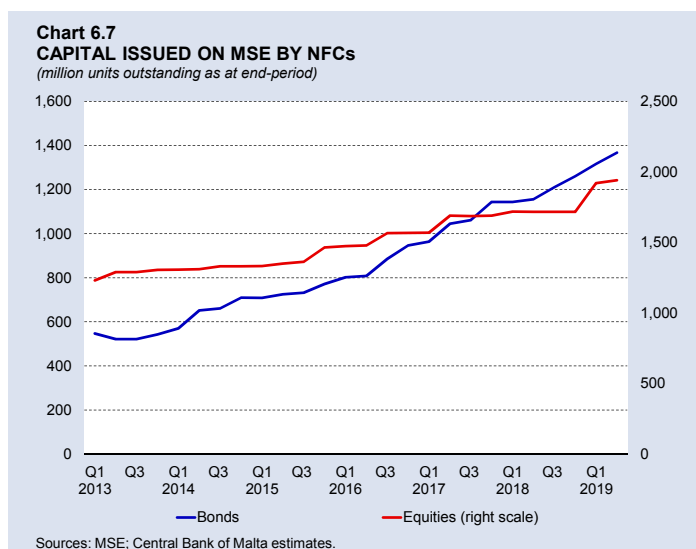
<sup>2</sup> See Darmanin, J. (2017), “The financing of companies in Malta”, *Policy Note* July 2017, Central Bank of Malta.

<sup>3</sup> Other loan sources comprise loans from non-bank financial institutions and auxiliaries, households and government.

€1.4 billion in corporate debt was listed on the MSE, 18.3% higher than the outstanding stock 12 months earlier (see Chart 6.7).<sup>4</sup> The amount of equity listed on the MSE has also increased in the past years.

### *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 June, with the weighted average deposit rate offered to households and NFCs down by 4 basis points, to 0.32% (see Table 6.3).<sup>5</sup> 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	
	June	June	June	June	June	Sep.	Dec.	Mar.	June	June	
<b>Total deposits<sup>(1)</sup></b>	<b>0.58</b>	<b>0.42</b>	<b>0.36</b>			<b>0.35</b>	<b>0.33</b>	<b>0.32</b>	<b>0.32</b>		
<i>of which</i>											
<b>Overnight deposits</b>											
Households	0.11	0.07	0.07			0.06	0.05	0.05	0.05		
Non-financial corporations	0.08	0.02	0.05			0.04	0.02	0.03	0.03		
<b>Time deposits (less than 2 years)</b>											
Households	0.88	0.79	0.76			0.77	0.75	0.74	0.76		
Non-financial corporations	0.75	0.60	0.63			0.74	0.76	0.71	0.62		
<b>Time deposits (more than 2 years)</b>											
Households	2.85	2.45	2.24			2.20	2.13	2.07	2.03		
Non-financial corporations	1.97	1.89	2.11			2.12	1.88	1.84	1.55		
<b>Total Loans<sup>(1)</sup></b>	<b>3.75</b>	<b>3.66</b>	<b>3.61</b>			<b>3.58</b>	<b>3.55</b>	<b>3.52</b>	<b>3.50</b>		
<i>of which</i>											
Households and NPISH	3.57	3.52	3.44			3.41	3.38	3.36	3.35		
Non-financial corporations	4.02	3.87	3.89			3.85	3.83	3.79	3.75		
<b>Spread<sup>(2)</sup></b>	<b>3.17</b>	<b>3.24</b>	<b>3.25</b>			<b>3.23</b>	<b>3.22</b>	<b>3.20</b>	<b>3.18</b>		
ECB MROs rate	0.00	0.00	0.00			0.00	0.00	0.00	0.00		

Source: Central Bank of Malta.

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

<sup>(2)</sup> Difference between composite lending rate and composite deposit rate.

<sup>4</sup> Additionally, 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).

<sup>5</sup> 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 11 basis points, to 3.50%. This decrease was reflected in rates paid by both households and NFCs, although the weighted average lending rate paid by NFCs remained above that 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 318 basis points, slightly narrower than its level of 325 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*

Results from the July 2019 BLS show that credit standards, terms and conditions on loans to NFCs in Malta remained unchanged during the second quarter of 2019. Most banks also reported stable demand conditions. Going forward, most of the participating banks also expected credit standards to remain unchanged in the third quarter of 2019. Only one institution expected some tightening. As regards credit demand, expectations were more mixed, with only half of the respondent banks expecting stable demand.

As regards credit for house purchases, views on credit standards, terms and conditions for the second quarter were varied, while credit demand was assessed to have remained unchanged. Looking forward to the third quarter of 2019, half of the respondent banks foresaw no change in credit standards and demand, while the remaining half expected tighter standards and lower demand.

Meanwhile, the majority of banks participating in the BLS reported unchanged standards, terms and conditions for consumer credit and other lending during the second quarter. Only one bank reported some easing in credit standards, terms and conditions – though it expected credit standards to tighten in the third quarter. Credit demand was also stable, with no changes anticipated for the third quarter.

The July 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, respondent banks generally reported unchanged market access to funding and risk transfer capabilities. One bank, however, reported some impact on its retail funding operations and the unsecured segment of the interbank money market in the previous three months. It also reported some deterioration in its medium to long-term debt securities. Looking forward, this bank anticipated a worsening of its long-term term deposits and other retail funding instruments, which was, however, expected to reverse in the third quarter.

Banks were also asked to gauge the impact of the new regulatory or supervisory requirements relating to capital, leverage, liquidity or provisioning on their assets, capital and funding conditions as well as on their lending policies. The majority of participating banks did not report any changes in their assets, risk-weighted assets, capital and funding conditions in the previous six months. Similarly, no changes were reported in credit standards or margins as a result of new regulatory or supervisory requirements. One bank, however, reported a slight increase in its risk-weighted assets over the past six months, and an expected increase in capital in the third quarter, along with some tightening in credit standards on loans to firms and on consumer credit and other lending. Two banks reported tighter credit standards on loans for house purchases.

Finally, participating banks claimed that their non-performing loan (NPL) ratio had not affected their credit standards, and credit terms and conditions in the preceding six-month period and in

general no impact was expected in the six months ahead. However, one bank reported some easing in the bank's credit standards for loans to households for house purchases in the six months preceding the survey.

## The money market

### *Domestic money market interest rates declined slightly*

During the second quarter of 2019, the ECB maintained its key interest rates unchanged.

In euro area money markets, the three-month EURIBOR fell marginally to -0.33% from -0.31% at the end of March. Meanwhile, secondary market yields on three-month German government securities, which act as a benchmark for euro area yields, fell to -0.63% from -0.56% three months earlier (see Chart 6.8).

In the domestic primary market, the yield on three-month Treasury bills declined marginally to -0.36%, from -0.35% at the end of March. As the yield on the euro area benchmark fell to a greater extent during this period, the spread between this rate and the yield on domestic three-month Treasury bills widened. At the end of June, it stood at 33 basis points, up from 29 basis points at end March.

The Government issued €269.8 million in Treasury bills during the second quarter of 2019, €16.7 million more than the amount of €253.1 million issued between January and March.

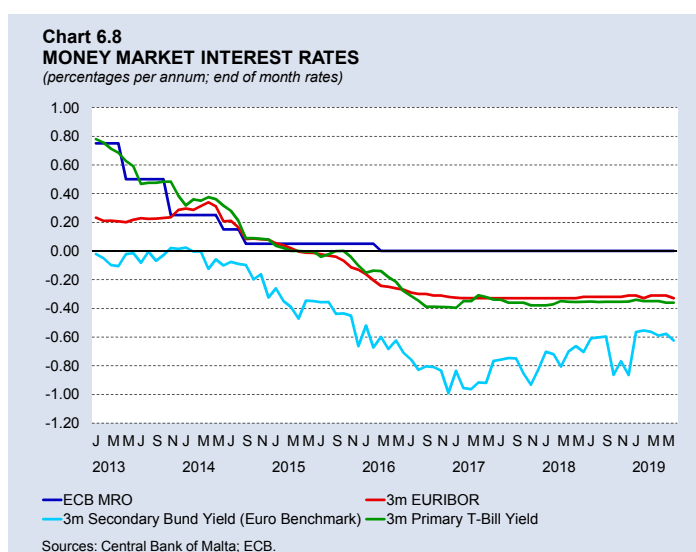
## The capital market

During the second quarter of 2019, the Government did not issue any new MGS. However, three public limited companies announced new bond issues: Gap Group plc issued €40.0 million in secured bonds, while SP Finance plc and TUM Finance plc issued €12.0 million and €20.0 million in secured bonds, respectively.

By the end of June 2019, 21 firms had listed bonds through Prospects, up from 16 at the end of March. Hence, €24.8 million worth of bonds were issued through this facility during the second quarter of 2019.

In the secondary market, government bonds turnover rose to €75.2 million during the quarter under review, compared with €61.1 million in the first quarter of the year. In contrast, over the same period, turnover in corporate bonds fell to €22.5 million, from €27.4 million.

Secondary market yields on Maltese government bonds fell during the second quarter of 2019 (see Chart 6.9). The yield on five-year bonds dropped significantly and ended June at -0.03%, from 0.17% three months earlier. Similarly, the yield on ten-year bonds fell by 33 basis points and ended June at 0.63%. In the euro area, the yields on five-year and ten-year bonds fell by 18 and



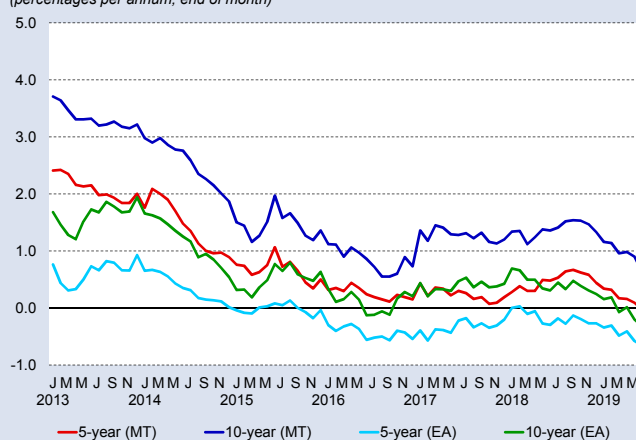
25 basis points, ending the second quarter of 2019 at -0.66% and -0.33%, respectively. As the domestic ten-year yield fell faster than the euro area benchmark yield, the spread against the latter narrowed marginally to 96 basis points in the June quarter, from 103 basis points in the preceding quarter.

### *MSE share index ends June at higher levels*

Share prices in Malta, as measured by the MSE Equity Price Index, rose during the second quarter of 2019. At end-June, the Index stood 2.2% above its level at end-March, and 10.4% above its level a year earlier (see Chart 6.10). The MSE Equity Total Return Index, which accounts for changes in equity prices and dividends, rose by 4.0% since the end of March.

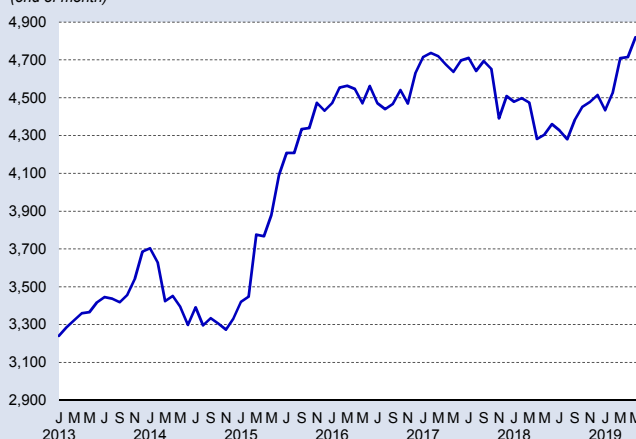
Equity turnover edged down to €21.9 million during the second quarter of 2019, from €28.8 million in the March quarter.

**Chart 6.9**  
**GOVERNMENT BOND YIELDS**  
(percentages per annum; end of month)



Sources: Central Bank of Malta; ECB.

**Chart 6.10**  
**MALTA STOCK EXCHANGE EQUITY PRICE INDEX**  
(end of month)



Source: MSE.