BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

QUARTERLY REVIEW

2020

Vol. 53 No. 1

Address
Pjazza Kastilja
Valletta VLT 1060
Malta

Telephone
(+356) 2550 0000

Fax
(+356) 2550 2500

Website
www.centralbankmalta.org

E-mail
info@centralbankmalta.org

The cut-off date for statistical information published in the Economic Survey of this Review is 17 January 2020. However, for monetary and government statistics the cut-off date is extended to 31 January 2020. Figures in tables may not add up due to rounding.

ISSN 1811-1254 (online)

CONTENTS

FOREWORD		**5**
ECONOMIC SURVEY		**7**
1.	**The External Environment and the Euro Area**	**7**
	Key advanced economies	
	The euro area	
	Commodities	
2.	**Output and Employment**	**17**
	Potential output and BCI	
	GDP and industrial production	
	Business and consumer surveys	
	Box 1: The European Commission's business and consumer surveys and Maltese macroeconomic trends	
	The labour market	
	Box 2: A cross-sectional saving profile of Maltese households	
3.	**Prices, Costs and Competitiveness**	**40**
	Inflation	
	Residential property prices	
	Costs and competitiveness	
4.	**The Balance of Payments**	**45**
	The current account	
	Activity in the tourism sector	
	The capital account	
5.	**Government Finance**	**50**
	Quarterly developments	
	Headline and cyclically-adjusted developments	
6.	**Monetary and Financial Developments**	**55**
	Monetary and financial conditions	
	Box 3: Liquidity Conditions and monetary policy operations from maintenance period 1 to maintenance period 5 of 2019	
	The money market	
	The capital market	
PROGRESSING SAFELY IN A RISKIER WORLD		**67**
	Dr Mario Vella	
	Governor of the Central Bank of Malta	

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
GDP	gross domestic product
GFCF	gross fixed capital formation
GVA	gross value added
HCI	harmonised competitiveness indicator
HBS	Household Budgetary Survey
HICP	Harmonised Index of Consumer Prices
IIP	Individual Investor Programme
LFS	Labour Force Survey
LTRO	longer-term refinancing operation
MFI	monetary financial institution
MGS	Malta Government Stocks
MIA	Malta International Airport
MP	maintenance period
MRO	main refinancing operation
MSE	Malta Stock Exchange
NACE	statistical classification of economic activities in the European Community
NAIRU	non-accelerating inflation rate of unemployment
NEIG	non-energy industrial goods
NFC	non-financial corporation
NPISH	non-profit institutions serving households
NSO	National Statistics Office
PPI	Property Price Index
PSPP	Public Sector Purchase Programme
ROW	Rest of World
RPI	Retail Price Index
SMP	Securities Market Programme
TLTRO	targeted longer-term refinancing operation
ULC	unit labour cost
UK	United Kingdom
US	United States

FOREWORD

In the third quarter of 2019, the Maltese economy grew at a slower pace, with real gross domestic product (GDP) rising by 3.4% in annual terms, following a 4.9% increase in the second quarter. Slower growth was underpinned by a weaker expansion in final domestic demand and a larger negative contribution from changes in inventories. In contrast, the contribution of net exports strengthened in the quarter under review.

Potential output growth eased slightly, although it remained relatively elevated from a historical perspective, continuing to benefit from an increasing number of foreign workers and higher labour participation. The output surplus, measured as a four-quarter moving average, narrowed compared with the second quarter of 2019 and remained below 2015 and 2016 levels.

The Bank's Business Conditions Index (BCI) also suggests activity is normalising after a period of rapid growth. The Index fell during the third quarter of 2019, but continued to indicate slightly above-average conditions, reflecting continued decreases in unemployment. With the ongoing normalisation in GDP growth rates, the index is moving closer to its long-run average value.

Labour market conditions remained favourable in the third quarter of 2019, as employment continued to grow. Notwithstanding a further increase in the labour market participation rate and rising foreign employment, the unemployment rate fell compared with the preceding year. At 3.4%, it remained below the Bank's structural measure of 4.0%, and thus suggests a degree of tightness in the labour market.

Annual inflation as measured by the Harmonised Index of Consumer Prices (HICP) decelerated to 1.6% in September from 1.8% in June, largely due to slower growth in food prices. Inflation based on the Retail Price Index (RPI), which only takes into account purchases made by Maltese households, also eased to stand at 1.4% in September, from 1.9% three months earlier.

On the other hand, cost pressures for producers accelerated, with the annual growth in the industrial producer price index increasing to 2.0% in September, from 1.7% in June. This mainly reflected faster growth in the cost of intermediate goods, which 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 in the third quarter, though growth remained moderate. Meanwhile, Malta's harmonised competitiveness indicators (HCIs) showed an improvement in competitiveness, mostly driven by favourable exchange rate developments.

In the third quarter of 2019, the surplus on the current account of the balance of payments increased when compared with the corresponding period of 2018. The improvement was largely driven by a smaller deficit on merchandise trade and, to a lesser extent, by a larger surplus on services. When measured on a four-quarter moving sum basis, the current account surplus was equivalent at 10.1% of GDP. The cyclically-adjusted measure was estimated at 13.9%, indicating that Malta's current account surplus largely reflects structural factors.

As regards public finances the general government surplus declined, when compared with a year earlier. When measured as a four-quarter moving sum, the general government surplus narrowed to 0.8% of GDP in the third quarter of 2019, down from 1.2% in the previous quarter. The cyclically-adjusted surplus-to-GDP ratio also decreased, broadly mirroring developments in the headline balance. Meanwhile, the general government debt-to-GDP ratio fell to 43.1%, from 45.4% at end-June.

During the quarter under review, Maltese residents' deposits with monetary financial institutions (MFIs) in Malta continued to expand, albeit at a slower pace. The shift to overnight deposits persisted, in an environment of low interest rates and a continued preference for liquidity. Meanwhile, credit to Maltese residents increased further, reflecting a further recovery in credit to general government and continued strong growth in credit to other residents. Loans to households accelerated further, while lending to non-financial corporations (NFCs) moderated. According to the Bank's Financial Conditions Index (FCI), financing conditions were marginally loose from a historical perspective.

The Governing Council of the European Central Bank (ECB) maintained an accommodative monetary policy stance during the third quarter of 2019. The interest rates on the main refinancing operations (MROs) and on the marginal lending facility were kept at 0.00 and 0.25%, respectively. In September, however, the interest rate on the deposit facility was lowered by 10 basis points, to -0.50%. The Council said that it expected that rates would 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.

The Council also decided that net purchases under the asset purchase programme (APP) would resume and will be carried out at a monthly pace of €20 billion as from 1 November 2019. These should end shortly before the key ECB interest rates start rising again. The Council also reiterated its intention to reinvest in full the principal payments from maturing securities under the Programme for an extended period of time past the first ECB rate hike.

Moreover, 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.[1] This should support the bank-based transmission of monetary policy.

The weighted average interest rate on deposits held by Maltese residents with domestic banks was 4 basis points lower compared with a year earlier. The weighted average lending rate paid to resident MFIs by households and NFCs decreased by 10 basis points over this period. The spread between the two narrowed, but remained elevated.

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

1 The two-tier system for reserve remuneration entered into effect on 30 October 2019.

ECONOMIC SURVEY

1. THE EXTERNAL ENVIRONMENT AND THE EURO AREA

In the third quarter of 2019, economic growth as measured by real GDP turned positive in the United Kingdom and was unchanged in the United States and the euro area. Compared with the preceding quarter, the three-month average unemployment rate remained stable in the United States and the euro area, but eased slightly in the United Kingdom.

Annual consumer price inflation in the United States increased marginally from 1.6% in June to 1.7% in September. Meanwhile, in the United Kingdom, inflation stood at 1.7%, down from 2.0% in June. Euro area inflation also eased, going from 1.3% in June to 0.8% in September. During the quarter under review, the Bank of England kept its Bank Rate unchanged, while the Federal Reserve lowered the target range for the federal funds rate on two occasions. The ECB also announced new monetary policy measures, including a cut in the deposit facility rate and the resumption of asset purchases from 1 November 2019.

Brent oil prices generally increased up till mid-July supported by tensions in the Middle East and news of further supply cuts. Thereafter, crude oil prices receded ending the quarter around a tenth below their end-June level. Meanwhile, non-energy commodity prices declined.

Key advanced economies

GDP growth in the United States remains unchanged

In the third quarter of 2019, quarter-on-quarter GDP growth in the United States was unchanged from the previous quarter at 0.5% (see Table 1.1).

Growth in personal consumption and government expenditure decelerated while fixed investment and inventory investment decreased more slowly. Although the trade deficit widened further in real terms, the deterioration was less pronounced than that recorded in the second quarter.

In the labour market, the participation rate averaged 63.1% in the third quarter of 2019, from 62.9% in the previous three-month period. Meanwhile, employment grew at a stronger pace, with the annual rate of increase edging up to 1.3%, from 0.8% in the second quarter. Non-farm payroll data suggest that the faster pace of job creation was driven by the information sector and the public sector, as employment growth moderated in most other sectors. The average

Table 1.1
REAL GDP GROWTH IN SELECTED ADVANCED ECONOMIES
Quarter-on-quarter percentage changes; seasonally and working day adjusted

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

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

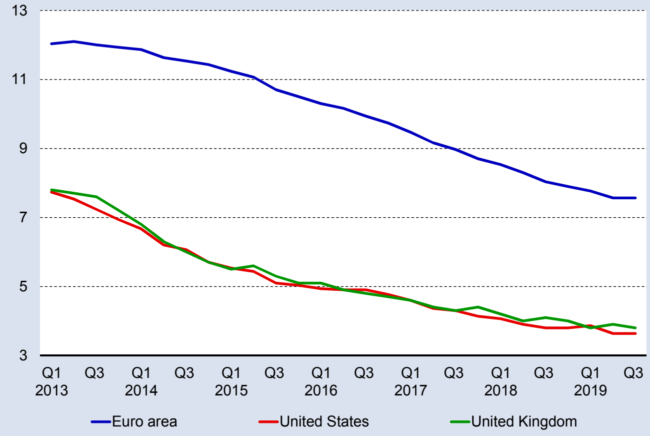
unemployment rate over the three months to September stood at 3.6%, unchanged compared with the preceding quarter (see Chart 1.1).

The annual rate of change of the US consumer price index (CPI) increased slightly to 1.7% in September, from 1.6% in June (see Chart 1.2). The increase reflected developments in inflation excluding food and energy, which rose from 2.1% in June to 2.4% in September. By contrast, energy inflation turned more negative and food inflation eased marginally.

In July, the Federal Open Market Committee (FOMC) lowered the target range for the federal funds rate to between 2.00% and 2.25% (see Chart 1.3). FOMC members noted that while the overall outlook remained favourable, significant risks and uncertainties remained in the external environment which could impact the US economy. Furthermore, inflationary pressures remained muted. In September, this assessment was broadly confirmed and the target rate was lowered further to between 1.75% and 2.00%.

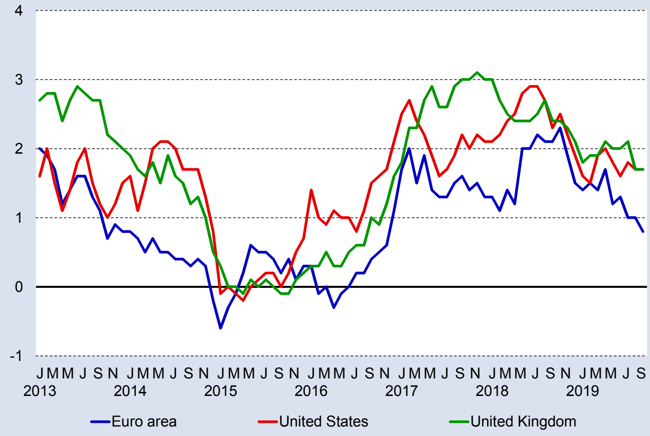
The Committee also decided to maintain its existing policy of reinvesting in agency mortgage-backed securities the amount of principal payments from the Federal Reserve's holdings of agency debt and mortgage-backed security holdings, and

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



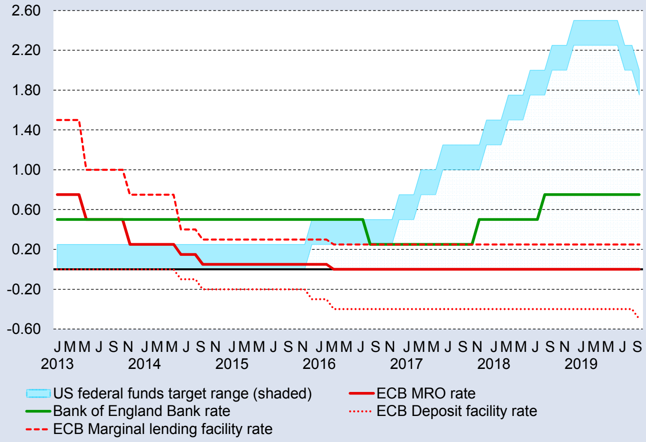
Sources: Eurostat; US Bureau of Labor Statistics; Office for National Statistics, UK.

Chart 1.2
CONSUMER PRICE INFLATION
(annual percentage changes)



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

Chart 1.3
OFFICIAL INTEREST RATES
(percentages per annum; end of month)



Sources: ECB; Federal Reserve; Bank of England.

rolling over at auction principal payments from maturing Treasury securities, when these exceed specified caps.[1]

UK economic growth turns positive

In the United Kingdom, quarter-on-quarter GDP growth turned positive again. GDP increased by 0.4% during the third quarter of 2019, after contracting by 0.2% in the second quarter (see Table 1.1). This was mainly attributable to gross capital formation. Private consumption grew at a marginally slower pace compared with the preceding quarter, while government consumption turned negative. The contribution of net exports decreased slightly.

Despite the recovery in economic activity, employment increased at a slower annual pace of 1.0% in the third quarter, from 1.3% in the second. At the same time, unemployment averaged 3.8%, 0.1 percentage point lower than in the previous three-month period (see Chart 1.1).

Consumer price inflation in the United Kingdom edged down to 1.7% in September, from 2.0% in June (see Chart 1.2). The fall was mainly attributable to weaker growth in energy prices, although prices of non-energy industrial goods also grew at a slower pace. On the other hand, food price inflation edged up. Meanwhile, services price inflation remained stable. The annual rate of inflation based on the CPI excluding energy, food, alcohol and tobacco eased to 1.7% in September, from 1.8% in June.

In its meeting held at the end of July, the Bank of England's Monetary Policy Committee voted unanimously to maintain the Bank Rate unchanged at 0.75% (see Chart 1.3). The Committee noted that uncertainties surrounding Brexit and global trade tensions were impacting the UK economy. In fact, the Committee said that *"underlying growth appears to have slowed since 2018 to a rate below potential, reflecting both the impact of intensifying Brexit-related uncertainties on business investment and weaker global growth on net trade. Evidence from companies, up to the middle of July, suggests that uncertainty over the United Kingdom's future trading relationship with the European Union has become more entrenched."* It also added that overall inflation stood at 2.0% in June, while core inflation was 1.8%.

This assessment was broadly confirmed in September, when the Bank Rate was also kept on hold at 0.75%. The Committee also noted that increased uncertainty about the nature of EU withdrawal meant that the economy could follow a wide range of paths over coming years. The appropriate response of monetary policy will depend on the balance of the effects of Brexit on demand, supply and the sterling exchange rate. In all circumstances, monetary policy would be set with a view to achieve the Bank of England's 2% inflation target.

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.[2]

---

[1] In October, the FOMC lowered the target range for the federal funds rate further to between 1.50% and 1.75%. In December, the range for the target rate was kept unchanged.

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

The euro area

GDP growth in the euro area remains moderate

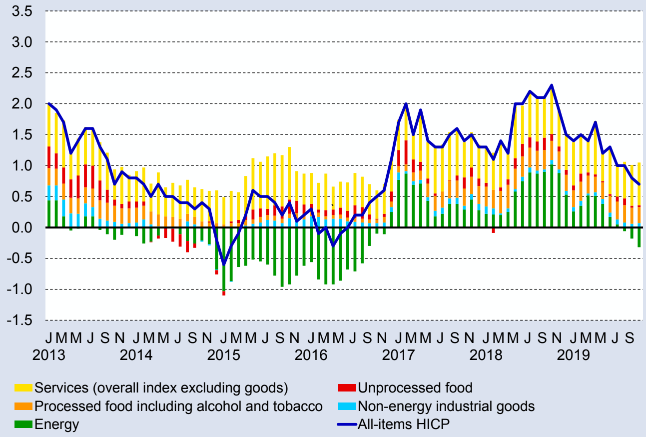
The rate of economic expansion in the euro area remained moderate in the third quarter of 2019, with real GDP rising by a moderate 0.2% on a quarterly basis, unchanged compared to the previous quarter and down from a 0.4% increase in the first quarter of 2019 (see Table 1.2).

The expansion during the third quarter of 2019 was driven by domestic demand, which added 0.3 percentage points to GDP growth. Private consumption grew at a faster pace compared with the previous quarter and was the main driver behind this increase. Government consumption and gross fixed capital formation contributed marginally, while changes in inventories lowered GDP growth by 0.1 percentage point during the quarter under review. Meanwhile, net exports shaved 0.1 percentage point off GDP growth, as imports rose faster than exports.

Euro area inflation eases significantly

The annual rate of inflation in the euro area, measured on the basis of the HICP, fell to 0.8% in September from 1.3% in June (see Chart 1.4). This fall largely stemmed from energy inflation, which turned negative. At the same time, the prices of services and non-energy industrial goods rose at a marginally slower pace than before, such that HICP inflation excluding energy and food edged down to 1.0% in September from 1.1% in June.

Chart 1.4
CONTRIBUTIONS TO YEAR-ON-YEAR HICP INFLATION IN THE EURO AREA
(percentage points; annual percentage change)



Source: Eurostat.

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

	2017	2018				2019		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
	Percentage point contributions							
Private consumption	0.2	0.2	0.1	0.1	0.2	0.2	0.1	0.3
Government consumption	0.0	0.0	0.1	0.0	0.1	0.1	0.1	0.1
Gross fixed capital formation	0.2	0.1	0.2	0.2	0.3	0.1	1.2	0.1
Changes in inventories	0.0	0.1	0.0	0.2	-0.2	-0.2	-0.1	-0.1
Exports	1.1	-0.2	0.4	0.1	0.5	0.4	0.1	0.2
Imports	-0.7	0.1	-0.5	-0.4	-0.5	-0.1	-1.3	-0.3
GDP	0.8	0.3	0.4	0.2	0.4	0.4	0.2	0.2

Source: Eurostat.

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

Labour market conditions remain broadly unchanged

Labour market conditions in the euro area remained largely unchanged during the quarter under review. The seasonally-adjusted unemployment rate stood at 7.6% in September, up from 7.5% in June. Notwithstanding the recent increase, the unemployment rate was still down significantly from 8.0% a year earlier (see Chart 1.1). The three-month average rate was unchanged from that in the second quarter of 2019, at 7.6%. Meanwhile, employment continued to grow, although the annual rate of growth moderated to 1.0% from 1.2% in the preceding quarter.[3]

Euro area recovery to continue

According to the December 2019 Eurosystem staff macroeconomic projections, real GDP growth is projected to stand at 1.2% in 2019 and 1.1% in 2020, before accelerating to 1.4% in the following two years (see Table 1.3).

Following moderate economic growth in the third quarter of 2019, recent short-term indicators point to subdued growth in the near term, amid ongoing weakness in global trade in a highly uncertain global economic environment. However, over the medium-term, the projections assume some dissipation of global headwinds. This should allow the fundamental factors supporting the euro area expansion to regain traction. In particular, the projections assume an orderly exit of the United Kingdom from the European Union and no further protectionist measures. Over the medium-term, the euro area economy should continue to respond to a very accommodative monetary policy stance, favourable financing conditions and a degree of fiscal loosening. Moreover, private consumption and investment should benefit from relatively robust growth in wages and net worth, as well as from declining unemployment, while the expected recovery in foreign demand should support exports.

Nevertheless, growth is set to slow down marginally in final quarters of the projection horizon. In particular, employment growth is expected to moderate over the medium term, mostly reflecting increasingly binding labour supply constraints in some countries.

After picking up in the third quarter, private consumption growth should moderate slightly in the near term. Nonetheless, in 2020, it is expected to be sustained by resilient consumer confidence, further decreases in unemployment and rising real wages per employee. In some countries,

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

	2019	2020	2021	2022
GDP	**1.2**	**1.1**	**1.4**	**1.4**
Private consumption	1.3	1.4	1.3	1.2
Government consumption	1.5	1.6	1.5	1.5
Gross fixed capital formation	4.5	1.7	1.9	2.1
Exports	2.3	1.9	2.5	2.6
Imports	3.1	2.5	2.8	2.8
HICP	**1.2**	**1.1**	**1.4**	**1.6**

Source: ECB.
(1) ECB staff macroeconomic projections (December 2019).

3 National accounts data.

private consumption should also benefit from a degree of fiscal easing. In the last two years of the projection horizon, private consumption is set to moderate slightly, reflecting slower growth in disposable income.

Residential investment is forecast to progress at a more moderate pace over the projection horizon. This reflects a decline in building permits granted, as well as a fall in the share of households expecting to undertake home improvements in the coming quarters. Over the medium term, housing investment growth is expected to stabilise at low levels, reflecting increasingly binding capacity constraints in construction and adverse demographic trends in some countries.

Business investment is expected to remain subdued in the short term, but should eventually strengthen. In the near term, business investment will be held back by weak external demand, a decline in capacity utilisation and elevated uncertainty. Although business investment will gather pace in the medium term, it will still be restrained by modest developments in global trade as well as lower new plant capacity needs. In the longer term, business investment growth should benefit from reduced uncertainty, robust aggregate demand, supportive financing conditions, healthier balance sheets and increasing profitability.

Growth in government consumption is expected to hover in a narrow range around 1.5% over the projection horizon.

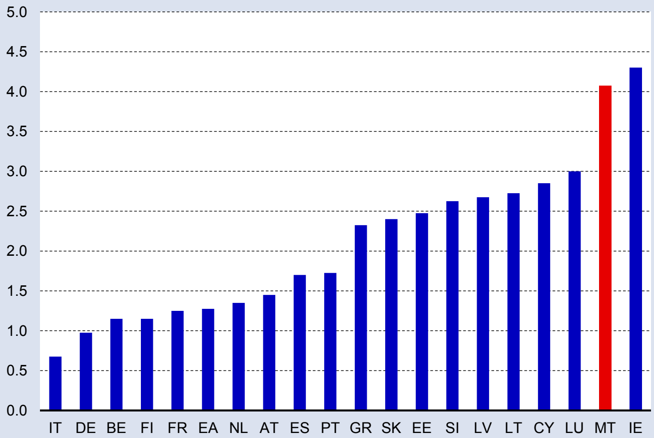
On the external side, export growth is expected to be weak in 2019, consistent with the slowdown in global trade. However, over the medium term, exports are projected to recover and grow broadly in line with foreign demand. Imports are expected to grow broadly in line with total demand over the projection horizon. On balance, the contribution of net trade to real GDP growth is projected to be broadly neutral over the entire projection horizon.

Compared with the ECB staff projections published in September 2019, euro area real GDP growth was revised upwards by 0.1 percentage point in 2019. However, it was revised down by 0.1 percentage point in 2020, while it was unrevised for 2021.

All euro area countries are expected to record positive growth between 2019 and 2022 (see Chart 1.5). Nonetheless, average growth rates over the projection horizon are anticipated to be quite diverse, ranging from a low of 0.7% in Italy to highs of 4.3% in Ireland and 4.1% in Malta.

As far as prices are concerned, HICP inflation is set to average 1.2% in 2019 and 1.1% in 2020, before picking up to 1.4% in 2021 and 1.6% in 2022. The moderation in 2020 largely

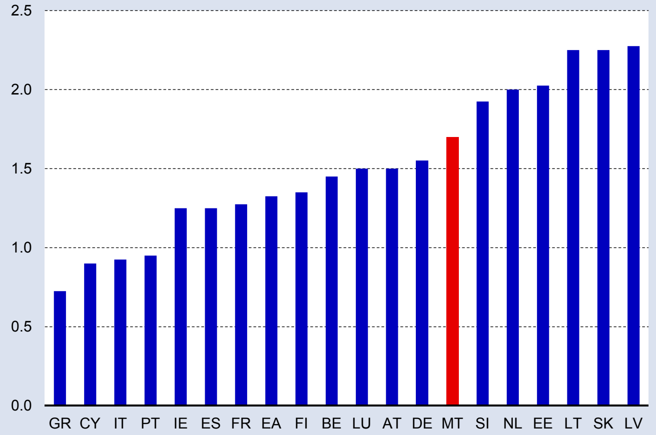
Chart 1.5
AVERAGE REAL GDP GROWTH 2019-2022
(annual percentage changes)



Source: Eurosystem.

reflects developments in energy inflation, which is expected to remain negative until the beginning of 2021. In contrast, HICP excluding energy is expected to edge up from 1.2% in 2019 to 1.4% in the following year. The pick-up in overall inflation in 2021 reflects a pick-up in both HICP energy and in HICP excluding energy. The former is set to turn positive in the second quarter of 2021, while the latter is expected to rise progressively over the projection horizon. HICP inflation excluding energy and food is also expected to accelerate over the projection horizon, going from 1.0% in 2019 to 1.6% in 2022. The upward path of underlying inflation is expected to be supported by strengthening economic activity, robust growth in wages and a recovery in profit margins, as well as rising non-energy commodity prices and the underlying global inflation. As a result, domestic cost pressures are bound to increase.

Chart 1.6
AVERAGE HICP INFLATION 2019-2022
(annual percentage changes)



Source: Eurosystem.

Compared with the September 2019 projections, overall inflation has been revised up for 2020 and down in 2021. These revisions are largely explained by the energy component.

HICP inflation excluding energy and food is also revised slightly upwards for 2020 and slightly down in 2021, mainly reflecting the interplay between, on the one hand, upward effects from a weaker exchange rate and the indirect effects of higher oil prices, and, on the other hand, weaker global prices as well as lower wages and profit margins.

From a cross-country perspective, inflation is expected to accelerate in the majority of euro area countries over the projection horizon. The lowest average inflation rate between 2019 and 2022 is expected to be recorded in Greece, at 0.7%, while the highest average rate is projected in Latvia, Lithuania and Slovakia, at 2.3% (see Chart 1.6). Inflation in Malta is set to average 1.7% over the forecast horizon, above the average of 1.3% for the euro area as a whole.

ECB maintained its accommodative monetary policy stance

The ECB's Governing Council continued with its accommodative monetary policy stance during the third quarter of 2019.

The interest rate on the MROs and the interest rate on the marginal lending facility were held at 0.00% and 0.25%, respectively. In September, however, the Governing Council announced that the interest rate on the deposit facility will be decreased by 10 basis points to -0.50% (see Chart 1.3). Furthermore, while the Governing Council had previously indicated that rates would remain on hold at least through the first half of 2020, it now expects the key ECB interest 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."*

The Council also stated that net purchases under the APP will restart at a monthly pace of €20 billion as from 1 November 2019. The Governing Council expects these to run for as long as necessary to reinforce the accommodative impact of its policy rates, and to end shortly before it starts raising the key ECB interest rates. It also reiterated its intention to reinvest in full the principal payments from maturing securities under the Programme for an extended period of time past the first ECB rate hike.

The Council also announced some changes to the modalities of the new series of quarterly targeted longer-term refinancing operations (TLTRO III), aimed at preserving favourable bank lending conditions, ensuring the smooth transmission of monetary policy and further supporting the accommodative stance of monetary policy.

Furthermore, a two-tier system for reserve remuneration was to be introduced, in which part of banks' holdings of excess liquidity will be exempt from the negative deposit facility rate.[4]

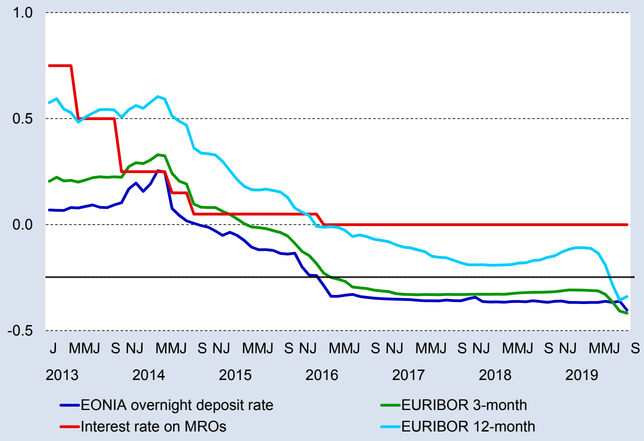
Money market rates further decrease

Money market rates in the euro area decreased during the third quarter of 2019, reflecting the accommodative monetary policy stance of the ECB and, in particular, the policy decisions announced in September. The EONIA overnight deposit rate fell to -0.40% from its June level of -0.36%, while the three-month EURIBOR declined to -0.42% from -0.33% over this period (see Chart 1.7).[5] Meanwhile, the 12-month EURIBOR rate dropped to -0.34% in September from -0.19% three months earlier.[6]

Euro area bond yields continue to decline

Ten-year benchmark government bond yields in the euro area further declined during the third quarter of 2019. The strongest decline was registered in Italian and Greek bond yields, which fell by 138 and 117 basis points to 0.90% and 1.50%, respectively. Portuguese, French, and Spanish bond yields followed, declining by 39, 36 and 32 basis points, to 0.20%, -0.28% and 0.18%, respectively. A smaller decline, of around 28 basis points, was

Chart 1.7
KEY INTEREST RATES
(percentages per annum; monthly averages)



Source: ECB.

---

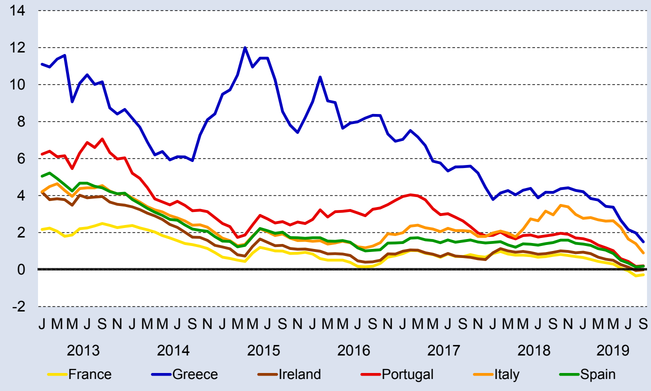
[4] The two-tier system for reserve remuneration entered into effect on 30 October 2019. The decisions announced in September were confirmed in October and December.

[5] 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.

[6] 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.

recorded in Ireland. During the quarter under review, French and Irish ten-year bond yields turned negative. German bond yields declined further, reaching -0.59%. The main contributing factor behind these declines was the growing expectation of further monetary accommodation in major economies, in an environment of increased uncertainty emanating from global trade relations and the general macroeconomic outlook.

Chart 1.8
EURO AREA TEN-YEAR GOVERNMENT BOND YIELD SPREADS[(1)]
(difference vis-a-vis German ten-year government bond yields in basis points)



Source: ECB.

[(1)] Since there were no data for Greece for July 2015 due to market closure, the spread was left equal to that of the previous month.

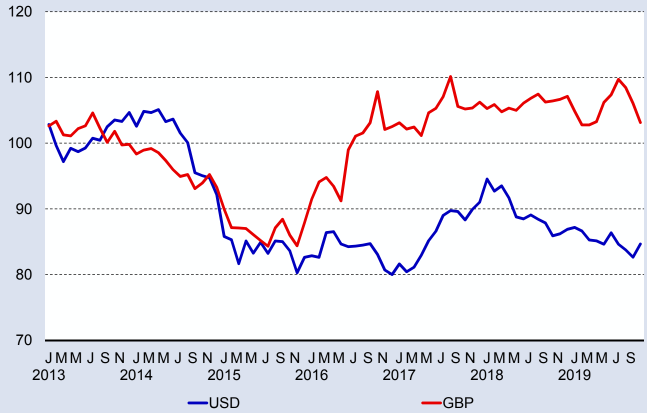
As in most euro area countries government bond yields fell more strongly than in Germany, spreads over the ten-year German bond yield generally narrowed during the third quarter (see Chart 1.8). The largest spread decreases were recorded in Italy and Greece. In Italy, this partly reflected optimism relating to the anticipation and subsequent formation of a new governing coalition. In Greece, a contributing factor was investors' perceptions that the Greek economy continues to make progress in terms of correcting imbalances, as well as the Greek government's decision to lift the remaining capital controls imposed in 2015 as from September.

The euro weakens slightly in effective terms

The euro decreased moderately against a number of major currencies during the third quarter of 2019, with the nominal effective exchange rate against the EER-19 group of countries falling by 1.1%.[7]

On balance, the euro depreciated by 4.3% and by 1.2% against the US dollar and the British pound, respectively (see Chart 1.9). The bilateral exchange rate against the pound sterling was heavily influenced by market sentiment regarding the withdrawal of the United Kingdom from the European Union, with the British pound gaining ground as prospects of an imminent hard Brexit receded. The euro also weakened against a number of

Chart 1.9
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.

[7] 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.

other currencies, including the Japanese yen and the Swiss franc. Meanwhile, the euro appreciated against the Chinese yuan renminbi and the Swedish krona.

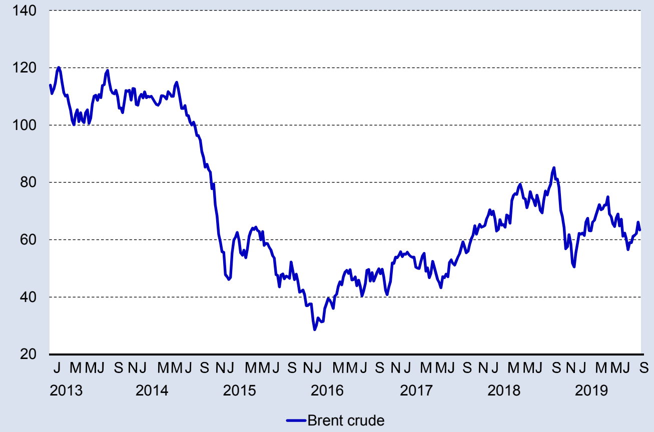
Commodities

Commodity prices end the third quarter at a lower level

In the first half of July, the price of Brent crude oil was supported by tensions in the Middle East and an agreement among key oil producers to extend their supply cuts until the end of the first quarter of 2020 (see Chart 1.10). From mid-July up to mid-August, crude oil prices receded mainly as the re-escalation of trade tensions between the United States and China led to renewed concerns about global growth. Thereafter, crude oil prices began to rise again, as an attack on Saudi Arabian oil facilities led to concerns about supply shortages. Nonetheless, by the end of September, the price of Brent crude oil had declined by 10.3% over the price prevailing at end-June.

As regards non-energy commodity prices, World Bank data show that these declined during the third quarter of 2019. Between June and September, non-energy commodity prices fell by 3.6%.

Chart 1.10
PRICE OF OIL
(end of week; US dollars per barrel)



Source: Reuters.

2. OUTPUT AND EMPLOYMENT

In the third quarter of 2019, real GDP growth rose by 3.4% in annual terms, following a 4.9% increase in the second quarter of 2019. Slower growth was underpinned by a weaker expansion in final domestic demand and a larger negative contribution from changes in inventories. In contrast, the contribution of net exports strengthened in the quarter under review. Nominal data on gross value added (GVA) show that the expansion continued to be largely supported by services, although the construction and manufacturing sectors also continued to expand.

The Bank's BCI continued to indicate slightly above-average conditions, although it dropped to 0.1 in the third quarter of 2019, from 0.5 in the previous quarter.

The output surplus, measured as a four-quarter moving average, narrowed compared with the second quarter of 2019, thus remaining well below 2015 and 2016 levels.

Labour market conditions remained favourable in the third quarter of 2019, as employment continued to grow. The unemployment rate based on the Labour Force Survey (LFS) fell compared with the third quarter of 2018, notwithstanding a further increase in labour market participation rate 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.

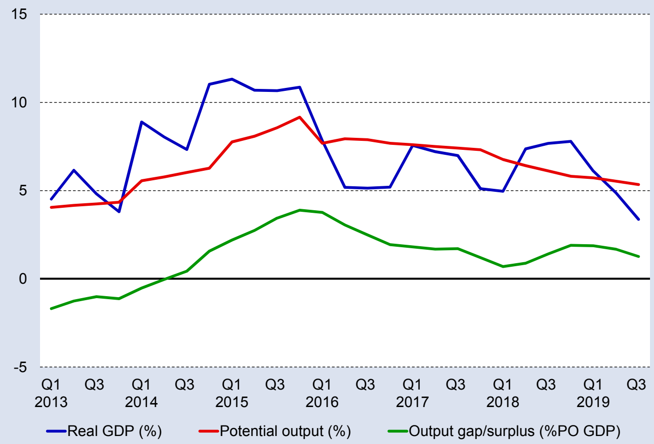
Potential output and BCI

Positive output gap narrows[1,2]

In the third quarter of 2019, potential output growth eased slightly, although it remained relatively elevated from a historical perspective (see Chart 2.1). Potential output growth is estimated to have edged down to 5.3%, from 5.5% in the second quarter of 2019. GDP growth also decelerated, standing at 3.4%, down from 4.9% in the preceding quarter.

When measured as a four-quarter moving average, the output gap is estimated at 1.3% in the third quarter of 2019, below the

Chart 2.1
CYCLICAL POSITION OF THE MALTESE ECONOMY
(annual percentage change; percentage of potential GDP)



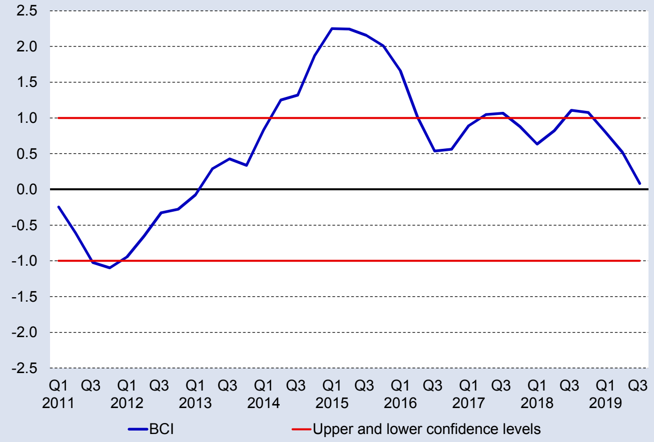
Sources: NSO; Central Bank of Malta estimates.

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

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

1.7% recorded in the previous quarter.[3] The degree of over-utilisation of the economy's productive capacity thus remained below levels seen in 2015 and 2016, when the output gap hovered between 2.0% and 4.0%. Potential growth continues to benefit from an increasing number of foreign workers and higher labour participation, with the labour contribution remaining close to its historical highs.

Chart 2.2
BCI
(standardised)



Source: Central Bank of Malta.

BCI drops, suggesting slightly better than normal economic conditions[4]

The Central Bank's BCI declined during the third quarter of 2019 (see Chart 2.2). The index stood at 0.1, lower than the value of 0.5 in the previous quarter as well as the updated value of 1.1 a year earlier. The BCI, however, continued to show slightly above-average conditions, reflecting continued decreases in unemployment. However, with the ongoing normalisation in GDP growth, the index is moving closer to its long run average value of 0.0. The index remains significantly above the lower confidence level that in the past was breached in episodes of low growth.[5]

GDP and industrial production

Real GDP grows at a slower pace

The pace of economic activity decelerated further in the third quarter of 2019, with real GDP rising by 3.4% on an annual basis, following a 4.9% increase in the previous quarter.[6]

Slower growth was underpinned by a fall in growth of domestic demand. This shed 0.4 percentage points from GDP growth in the quarter under review, following a contribution of 2.4 percentage points in the second quarter (see Table 2.1). All domestic demand components contributed to the slowdown, except for gross fixed capital formation, which grew modestly following a small contraction in the previous quarter.

In contrast to domestic demand, the positive contribution of net exports increased, as exports outpaced imports by a wide margin.

Private consumption expenditure grew by 2.0% in annual terms, following a 2.8% increase in the second quarter of 2019. It added 0.9 percentage points to real GDP growth. Private consumption

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

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

[5] Additional information on the interpretation of the BCI is available in the January 2020 edition of the Bank's *Economic Update*.

[6] The analysis of GDP in this Chapter of the *Quarterly Review* is based on data published in NSO *News Release* 199/2019 and released on 6 December 2019.

Table 2.1
GDP(1)

	2018		2019		
	Q3	Q4	Q1	Q2	Q3
	Annual percentage changes				
Private final consumption expenditure	9.0	7.0	4.3	2.8	2.0
Government final consumption expenditure	7.7	26.9	21.7	11.3	4.0
Gross fixed capital formation	3.4	-1.1	28.3	-0.5	0.2
Domestic demand	**10.1**	**9.3**	**11.9**	**3.0**	**-0.6**
Exports of goods and services	4.0	0.1	3.2	0.7	3.6
Imports of goods and services	4.6	-0.2	6.2	-1.1	1.0
GDP	**7.7**	**7.8**	**6.1**	**4.9**	**3.4**
	Percentage point contributions				
Private final consumption expenditure	3.8	3.1	1.9	1.2	0.9
Government final consumption expenditure	1.1	3.9	3.5	1.9	0.6
Gross fixed capital formation	0.6	-0.3	5.1	-0.1	0.0
Changes in inventories	1.9	0.7	-0.8	-0.6	-1.9
Domestic demand	**7.4**	**7.5**	**9.8**	**2.4**	**-0.4**
Exports of goods and services	5.6	0.1	5.0	1.1	4.9
Imports of goods and services	-5.3	0.2	-8.7	1.4	-1.1
Net exports	**0.3**	**0.3**	**-3.7**	**2.5**	**3.8**
GDP	**7.7**	**7.8**	**6.1**	**4.9**	**3.4**

Sources: NSO; Central Bank of Malta calculations.

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

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 underpinned by increases in most expenditure categories.

Following three quarters of double-digit growth, annual growth in government consumption expenditure moderated to 4.0% in the third quarter of 2019, mostly reflecting slower growth in intermediate consumption. Government consumption added 0.6 percentage points to annual GDP growth. This expansion was largely underpinned by higher outlays on intermediate consumption related to health care. Compensation of employees also rose on the same quarter of 2018, although to a lesser extent than intermediate consumption. These increases were partly offset by higher revenue from sales.

Following a decline of 0.5% in the previous quarter, real gross fixed capital formation rose by a modest 0.2% in the third quarter of 2019. Its contribution to real GDP growth was broadly neutral. Increased investment in non-residential construction and, to a lesser extent in intellectual property products offset a decrease in capital expenditure on equipment and residential construction.

Changes in inventories shed 1.9 percentage points from GDP growth.

In the third quarter of 2019, exports rose by 3.6% and imports increased by 1.0% on a year earlier. As a result, net exports contributed 3.8 percentage points to annual real GDP growth, following a contribution of 2.5 percentage points in the previous quarter. The widening in this contribution reflected developments in the goods balance (in volume terms), which narrowed significantly in year-on-year terms. Although the services balance also improved, the improvement was of a similar magnitude to that recorded in the second quarter.

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

Nominal GDP rose by 5.5% in annual terms in the third quarter of 2019, after increasing by 7.1% in the previous quarter (see Table 2.2). However, growth in GVA remained broadly unchanged at 7.0%, contributing 6.1 percentage points to nominal GDP growth.[7]

Services remained the main driver of activity, adding 5.3 percentage points to nominal GDP growth. The largest additions came from wholesale and retail trade, the arts and entertainment sector, as well as the sector comprising professional and scientific activities and public administration. Together, these four sectors contributed 4.1 percentage points to nominal GDP growth. Real estate activities and information and communication jointly added a further 1.0 percentage point. Furthermore, construction as well as manufacturing each added a further 0.4 percentage point to nominal GDP growth. Meanwhile, the impact of other sectors was negligible.

GDP data by income distribution show that gross operating surplus accelerated during the third quarter of 2019, rising by 8.8% on an annual basis, following a 7.8% increase in the preceding quarter. It contributed 4.3 percentage points to nominal GDP growth (see Chart 2.3). In contrast to gross operating surplus, compensation of employees grew at a more moderate pace of 5.2% compared with 6.3% in the previous quarter. This income component added 2.0 percentage points to nominal growth. Meanwhile, net taxes on production and imports fell on a year earlier.

Table 2.2
CONTRIBUTION OF SECTORAL GVA TO NOMINAL GDP
Percentage points

	2018		2019		
	Q3	Q4	Q1	Q2	Q3
Agriculture, forestry and fishing	0.0	0.5	0.0	0.0	0.0
Mining and quarrying; utilities	0.3	-0.1	0.0	0.1	0.0
Manufacturing	0.7	1.0	0.4	0.3	0.4
Construction	0.2	0.4	0.4	0.5	0.4
Services	6.9	6.3	6.4	5.3	5.3
of which:					
Wholesale and retail trade; repair of motor vehicles; Transportation; accommodation and related activities	1.4	1.5	1.3	0.7	1.4
Information and communication	0.4	0.1	0.6	0.7	0.6
Financial and insurance activities	0.4	0.4	0.6	0.1	0.1
Real estate activities	0.4	0.5	0.3	0.3	0.4
Professional, scientific, Administrative and related activities	1.7	1.3	1.5	1.4	0.8
Public administration and defence; Education; health and related activities	1.0	1.2	0.9	0.9	0.8
Arts, entertainment; household repair and related services	1.6	1.2	1.2	1.3	1.2
GVA	**8.1**	**8.1**	**7.3**	**6.2**	**6.1**
Taxes less subsidies on products	**1.9**	**1.8**	**1.0**	**0.9**	**-0.6**
Annual nominal GDP growth (%)	**10.0**	**9.9**	**8.2**	**7.1**	**5.5**

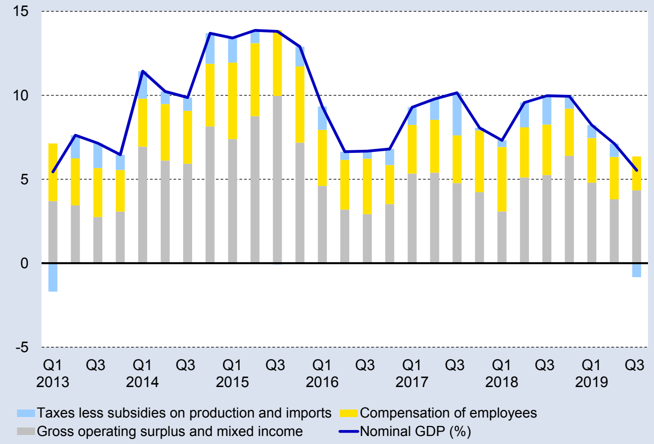
Source: NSO.

[7] The difference between nominal GDP and GVA is made up of taxes on products, net of subsidies. In the third quarter of 2019, taxes on products net of subsidies decreased in annual terms.

Almost all sectors registered a higher operating surplus when compared with the same quarter a year earlier, with the arts, entertainment and recreation sector, as well as the sector incorporating wholesale and retail trade, 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 professional, scientific and technical activities sector as well as the sectors comprising financial and insurance activities, construction, and information and communications.

Chart 2.3
NOMINAL GDP AND ITS MAIN COMPONENTS
(percentage point contribution)



Source: NSO.

Industrial production continued to recover in the third quarter of 2019

During the third quarter of 2019, industrial production increased by 4.7% when compared with the same quarter of 2018.[8] This followed a contraction in the first quarter of the year and a marginal expansion of 0.7% in the second quarter (see Table 2.3).

Table 2.3
INDUSTRIAL PRODUCTION[(1)]
Percentages; annual percentage changes

	Shares	2018		2019		
		Q3	Q4	Q1	Q2	Q3
Industrial production	**100.0**	**-1.9**	**4.3**	**-1.6**	**0.7**	**4.7**
Manufacturing	**87.1**	**-2.1**	**4.3**	**-4.4**	**-1.7**	**8.0**
of which:						
Food products	15.4	2.7	1.8	-6.2	-1.8	-4.9
"Other" manufacturing	10.3	-7.4	11.6	-1.8	13.9	26.8
Repair and installation of machinery and equipment	7.9	-8.8	6.7	4.0	8.8	18.8
Basic pharmaceutical products and pharmaceutical preparations	7.3	-45.0	-18.7	-41.2	-27.9	46.3
Printing and reproduction of recorded media	7.3	51.3	43.2	18.9	-14.6	16.3
Beverages	5.6	3.8	1.7	-18.0	9.4	2.6
Rubber and plastic products	5.4	-11.4	-15.9	-11.8	-5.6	-3.5
Computer, electronic and optical products	5.0	3.5	-0.2	-0.9	-4.0	-10.6
Energy	**12.5**	**1.8**	**11.0**	**15.3**	**14.4**	**-3.3**
Mining and quarrying	**0.5**	**24.9**	**27.2**	**20.3**	**7.1**	**3.6**

Sources: NSO; Eurostat.
[(1)] The annual growth rates of the industrial production index are averages for the quarter based on working-day adjusted data. The annual growth rates of the components are based on unadjusted data.

[8] 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.

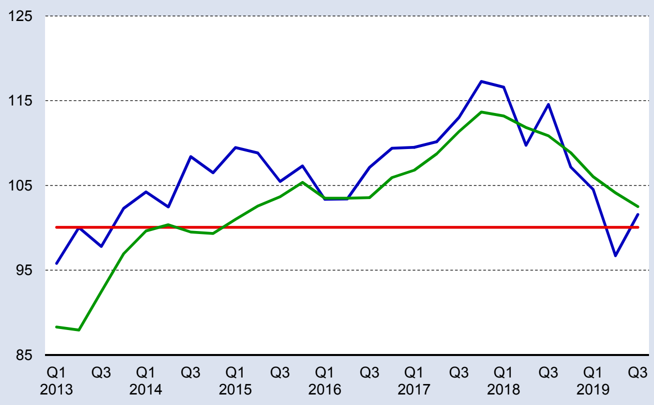
The expansion in activity in the quarter under review reflected developments within the manufacturing and quarrying sectors, although the latter has a very small weight in the overall industrial production index. In annual terms, production in these two sectors increased by 8.0% and 3.6%, respectively. On the other hand, production in the energy sector declined by 3.3% over the same quarter of 2018.

During the third quarter of the year, output in the manufacturing sector rose by 46.3% among producers of pharmaceutical products, following five quarters of declined production. Output also rose strongly within the "other manufacturing" sub-sector, which includes medical and dental instruments, toys and related products. Significant increases in production were also observed among firms involved in the repair and installation of machinery and equipment and among those involved in the printing and reproduction of recorded media. A relatively small increase was registered in the production of beverages. On the other hand, production in the computer, electronic and optical products sector declined on a year earlier. Smaller declines were also registered among firms that produce rubber and plastic products as well as within the food sector.

Business and consumer surveys

During the third quarter of 2019, the Economic Sentiment Indicator (ESI) increased to 101.6 from 96.7 in the preceding quarter (see Chart 2.4).[9,10] While it stood slightly above its long-term average of 100.0, it remained below the record high readings registered during 2017 and 2018. In the quarter under review, higher confidence was recorded across all sectors, with the strongest increase recorded in the retail sector. The ESI for Malta remained marginally below that of the euro area, where it averaged 102.5.

Chart 2.4
ESI
(seasonally adjusted; percentage points)



Source: European Commission.

Confidence in the retail sector increases significantly[11]

Sentiment in the retail sector rose to 10.5 from 0.0 in the second quarter of 2019, thus rising well above its long-term average of 3.0 (see Chart 2.5).

The recent rise in sentiment was driven by firms' assessment of business activity in the past three months and, to a lesser extent, by their expectations for the three months

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

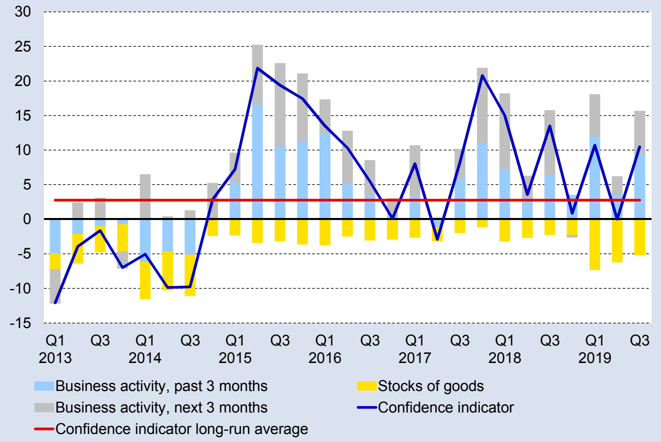
[10] Long-term averages are calculated over the entire period for which data are available. For the consumer and industrial confidence indicators, data for Malta became available in November 2002, while the services and construction confidence indicator data became available in May 2007 and May 2008, 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.

[11] The retail confidence indicator is the arithmetic average of the seasonally-adjusted balances (in percentage points) of replies to survey questions relating to the present and future business situation and stock levels.

ahead. Furthermore, the share of respondents that considered their stock levels to be above normal, edged down.[12]

Supplementary survey data indicate that, on balance, orders expectations turned positive in the quarter under review. Although price and employment expectations remained negative, they were significantly less negative than in the second quarter.

Chart 2.5
RETAIL CONFIDENCE INDICATOR
(seasonally adjusted; percentage points)

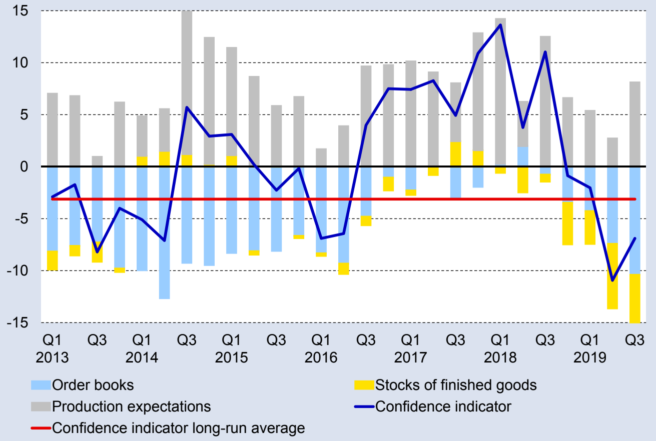


Source: European Commission.

Industrial confidence remains negative[13]

Confidence in the industrial sector improved, but remained negative in the quarter under review. It stood at -6.9, up from -10.9 in the previous three-month period, thus standing slightly below its long-term average of -3.1 (see Chart 2.6). During the third quarter of the year, production expectations increased almost threefold. At the same time, a smaller number of firms reported above normal stocks of finished goods.[14] By contrast, a higher share of firms reported falling orders.

Chart 2.6
INDUSTRIAL CONFIDENCE INDICATOR
(seasonally adjusted; percentage points)



Source: European Commission.

Additional survey data show that, on balance, there was an increase in the number of respondents anticipating a rise in employment in the three months ahead. Meanwhile, the share of firms anticipating price increases turned negative over the same period.

Confidence in the services sector rises[15]

Confidence in the services sector remained below its long-term average of 23.0, despite rising to 19.3 from 16.3 in the preceding quarter. The increase in sentiment was driven by higher demand expectations in the coming months and, to a lesser extent, an improvement in the respondents'

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

[13] The industrial confidence indicator is the arithmetic average of the seasonally-adjusted balances (in percentage points) of replies to a subset of survey questions relating to expectations about production over the subsequent three months, to current levels of order books and to stocks of finished goods.

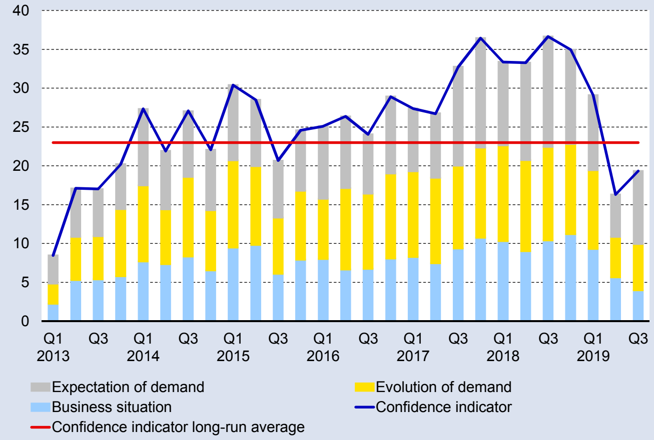
[14] Above-normal stock levels indicate lower turnover and affect the overall indicator in a negative way. Such levels are thus represented by negative bars in Chart 2.6.

[15] 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.

assessment of demand over the previous quarter. Meanwhile, their assessment of the business situation over the past three months weakened further (see Chart 2.7).

Supplementary survey data indicate that the share of respondents anticipating prices to increase in the three months ahead rose substantially. At the same time, employment expectations were less optimistic than in the preceding quarter.

Chart 2.7
SERVICES CONFIDENCE INDICATOR
(seasonally adjusted; percentage points)



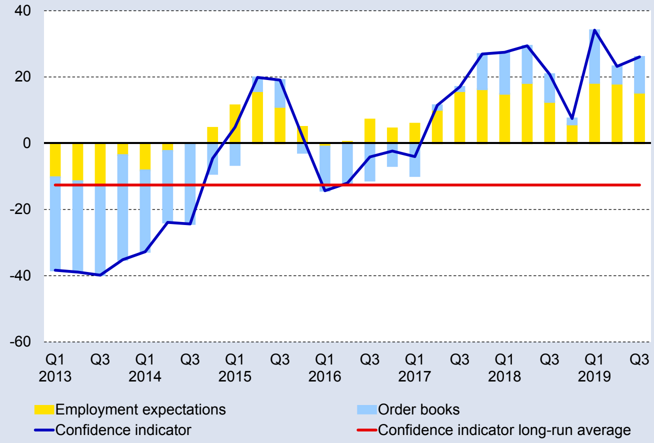
Source: European Commission.

Confidence in construction improves marginally[16]

In the third quarter of 2019, confidence in the construction sector edged up to 26.1, from 23.2 in the preceding quarter, thus remaining well above its long-term average of -12.6 (see Chart 2.8).

Survey results show that the increase in sentiment was entirely driven by higher order book levels. On the other hand, employment expectations for the coming quarter weakened.

Chart 2.8
CONSTRUCTION CONFIDENCE INDICATOR
(seasonally adjusted; percentage points)



Source: European Commission.

Supplementary survey data indicate that, on balance, the net percentage of firms reporting positive developments in building activity during the preceding three months decreased significantly. Meanwhile, labour shortages were less pressing when compared with the second quarter of the year, though still the main factor limiting production. Furthermore, a lower share of respondents anticipated prices to increase in the next three months.

Consumer confidence continues to recover from recent declines[17]

Consumer confidence improved during the quarter under review. It increased to 5.9 from 4.6 in the second quarter of 2019. Although it rose above its long-run average of -11.7, it remained well below the record high reading recorded in the first quarter of 2018 (see Chart 2.9).

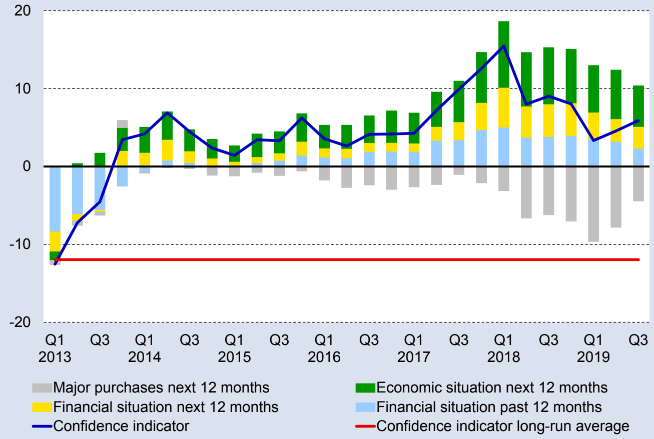
---

[16] 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.

[17] 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.

Consumers' expectations of major purchases over the next 12 months were the main driver behind the latest increase in consumer confidence, as these were less negative than before. Meanwhile, consumers' assessment of their past and future financial situation softened. At the same time, their outlook of the general economic situation in the 12 months ahead also weakened.

Chart 2.9
CONSUMER CONFIDENCE INDICATOR
(seasonally adjusted; percentage points)



Source: European Commission.

Supplementary survey data suggest that, on balance, a smaller share of consumers expected an increase in prices over the next 12 months. At the same time, a higher net percentage of respondents expected unemployment to fall in the months ahead.[18]

[18] 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.

BOX 1: THE EUROPEAN COMMISSION'S BUSINESS AND CONSUMER SURVEYS AND MALTESE MACROECONOMIC TRENDS[1]

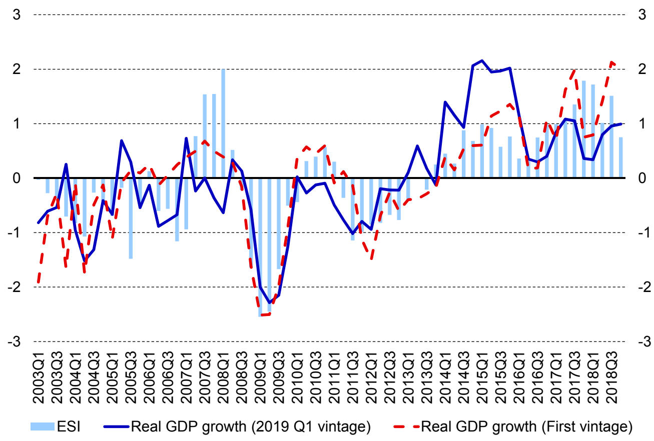
The European Commission's (EC) business and consumer surveys are the most extensive regular surveys of Maltese firms and households. They have been carried out among the manufacturing sector and households in Malta since November 2002 and subsequently extended to cover services firms, construction companies and the retail sector. This box analyses the link between these survey results and trends in macroeconomic data, focusing in particular on whether the ESI, which is a synthetic indicator derived from these confidence indices, is an effective coincident or leading indicator of Maltese GDP.

The relationship between the ESI and the state of the Maltese economy

Chart 1 shows real GDP growth and the ESI level for Malta, both of which have been standardised to facilitate comparisons.[2] As real GDP growth data tend to be revised extensively, the Chart also includes data on the first estimate of real GDP growth, which are the data issued closest to the date when the ESI was observed.

While the ESI for Malta is a much smoother variable than the Maltese economy's real GDP growth rate, particularly in the pre-crisis period, the two variables have a close positive correlation of 0.64. When one focuses on the first estimate of real GDP growth, the degree of correlation becomes even more pronounced at 0.78. The stronger correlation with the first vintage of national accounts data rather than later vintages indicates that opinions expressed by economic agents participating in the EC survey are partly driven by available economic data and news prevailing at the time. Moreover, as Table 1 shows, similar to most EU countries the correlation between the ESI and

Chart 1
TRENDS IN ESI AND REAL GDP GROWTH FOR MALTA
(standardised)



Source: Author's calculations.

[1] Prepared by Sandra Zerafa, Coordinator of economic publications within the Economic Analysis Department and Dr Aaron G. Grech, Chief Officer of the Economics Division of the Central Bank of Malta. This box summarises a policy note by Dr Aaron G. Grech on '*The European Commission's business and consumer surveys and Maltese macroeconomic trends*'; published by the Central Bank of Malta in May 2019. The views expressed are those of the authors and do not necessarily reflect the views of the Central Bank of Malta. Any errors are the authors' own.

[2] The time series of the variables is subtracted from its mean value and divided by its standard deviation. A graph of standardised values has the exact shape of a graph of the actual data, but will have a different range. This range, however, would be more easily comparable to that of another time series with different metrics. A positive value implies that the original value of the variable was above its mean, and vice versa.

Table 1
CORRELATION BETWEEN ESI AND REAL GDP GROWTH IN MALTA AND OTHER NATIONS

	Correlation between ESI and real GDP growth		Correlation between Malta's ESI and real GDP growth and those of other nations	
	Zero lag	First lag	ESI	Real GDP growth
Austria	0.86	0.83	0.65	0.26
Belgium	0.88	0.79	0.58	0.23
Bulgaria	0.83	0.73	0.36	0.12
Cyprus	0.90	0.89	0.50	0.08
Czechia	0.90	0.85	0.51	0.38
Estonia	0.92	0.92	0.29	0.26
Denmark	0.64	0.65	0.36	0.45
EU	0.89	0.84	0.70	0.47
Finland	0.83	0.83	0.41	0.24
France	0.87	0.81	0.53	0.27
Germany	0.78	0.74	0.70	0.42
Greece	0.88	0.83	0.31	0.13
Hungary	0.79	0.80	0.73	0.52
Malta	0.64	0.65		
Italy	0.86	0.80	0.55	0.40
Ireland	0.72	0.67	0.71	0.68
Lithuania	0.88	0.84	0.49	0.24
Latvia	0.95	0.93	0.35	0.18
Luxembourg	0.48	0.40	0.49	0.38
Netherlands	0.91	0.89	0.71	0.44
Poland	0.70	0.60	0.56	-0.03
Portugal	0.93	0.85	0.73	0.47
Romania	0.89	0.84	0.26	0.23
Slovakia	0.88	0.87	0.42	0.24
Slovenia	0.93	0.90	0.60	0.39
Spain	0.89	0.93	0.54	0.41
Sweden	0.79	0.73	0.67	0.41
UK	0.72	0.73	0.69	0.46

Source: Author's calculations.

growth in GDP is strongest at zero lag rather than at later lags, suggesting that the ESI is a coincident rather than a leading indicator of economic activity.

Malta's economic sentiment also appears to be quite synchronised with that of major exporting EU countries (see Table 1). In fact, the degree of correlation between Malta's ESI and that in other EU countries (particularly export-oriented economies like Germany and Ireland) is higher than that observed with Malta's own real GDP growth. This may reflect the fact that the ESI gives a disproportionate weight to industrial firms, which tend to be more exposed to common international factors, rather than to factors that may affect domestic demand (e.g. fiscal measures or changes in domestic credit availability).

Sectoral business survey results and their ability to predict future activity

The sectoral confidence indicators which underpin the ESI are quite highly correlated (see Table 2). While the retail sector's confidence indicator displays the least relative co-movement, the construction sentiment indicator is the one that is most synchronised with sentiment in other sectors.

Sectoral value added data from the national accounts for construction, services, retail and industry are much less correlated, though the construction sector again shows the highest degree of co-movement with other sectors. Correlation between the ESI and national accounts sectoral indicators varies greatly. On the one hand, private consumption expenditure and construction value added are strongly correlated with construction and consumer confidence indicators. Industry value added and the industrial confidence indicator show some degree of co-movement. By contrast, there is little correlation between national accounts estimates for the services and retail sectors and the sentiment indicators for these sectors. The strongest correlations are found between private consumption growth and the construction and services confidence indicators. The degree of co-movement is lowest between retail value added and services sector confidence.

Table 2

CORRELATION BETWEEN ESI AND NATIONAL ACCOUNTS INDICATORS (2011 TO 2018)

ECONOMIC SENTIMENT

	Construction ESI	Consumers ESI	Industry ESI	Retail ESI	Services ESI
Construction ESI	1.00	0.67	0.73	0.78	0.81
Consumers ESI	0.67	1.00	0.66	0.55	0.79
Industry ESI	0.73	0.66	1.00	0.47	0.71
Retail ESI	0.78	0.55	0.47	1.00	0.59
Services ESI	0.81	0.79	0.71	0.59	1.00

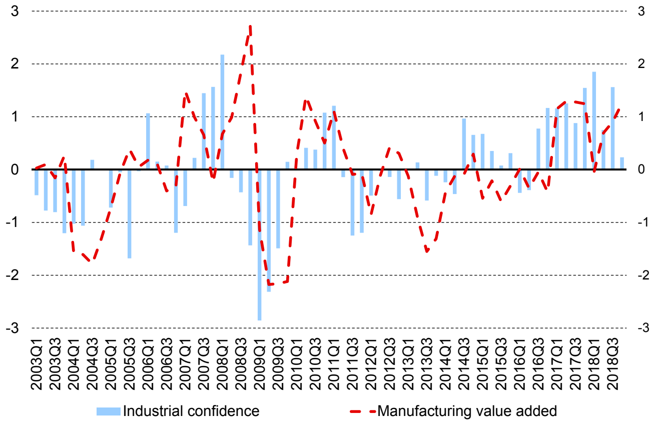
NATIONAL ACCOUNTS

	Construction	Consumers	Industry	Retail	Services
Construction	1.00	0.63	0.31	0.27	0.15
Consumers	0.63	1.00	0.37	0.32	0.08
Industry	0.31	0.37	1.00	-0.13	-0.16
Retail	0.27	0.32	-0.13	1.00	0.65
Services	0.15	0.08	-0.16	0.65	1.00

	Construction ESI	Consumers ESI	Industry ESI	Retail ESI	Services ESI
Construction	0.60	0.56	0.51	0.38	0.58
Consumers	0.69	0.60	0.43	0.57	0.68
Industry	0.53	0.20	0.48	0.19	0.50
Retail	0.11	0.10	-0.06	0.21	-0.04
Services	0.22	0.48	0.23	0.27	0.19

Source: Author's calculations.

Chart 2
TRENDS IN INDUSTRIAL CONFIDENCE AND IN MANUFACTURING VALUE ADDED GROWTH
(standardised)



Source: Author's calculations.

The change in manufacturing value added is not closely related with the concurrent level of industrial confidence (see Chart 2). However, if one looks at data after 2011 excluding the significant variation induced by the Great Recession, the degree of correlation between the concurrent values for the change in manufacturing value added and industrial confidence is nearly double that seen for the whole time series. Hence, the industrial confidence indicator appears to be becoming a good indicator of changes in manufacturing value added.

The change in manufacturing employment is also strongly correlated with the balance of manufacturing firms stating whether they would be increasing or decreasing employment in the months ahead. The degree of correlation in this case is noticeably stronger than that seen between industrial confidence and the change in manufacturing value added. Restricting the period to 2011, the degree of correlation between employment intentions and the actual change in employment is similar to that seen between industrial confidence and the change in manufacturing value added.

Responses to questions on manufacturing firms' planned or past production are only weakly correlated with changes in the index of industrial production compiled by the National Statistics Office (NSO). By contrast, manufacturing firms' replies to the two questions posed in the EC survey on past and planned future production appear very closely correlated suggesting that despite reported relatively volatile changes in output, expectations of future production are driven to a large extent by past production.

Table 3 looks at whether survey responses on future activity and employment changes are indicative of observed changes in national accounts sectoral estimates for different sectors.

Table 3
CORRELATION BETWEEN SECTORAL NATIONAL ACCOUNTS INDICATORS AND SURVEY EXPECTATIONS (2011 TO 2018)

	Manufacturing	Construction	Retail	Services
Activity	0.35	0.37	0.09	0.05
Employment	0.43	0.69	0.18	0.49

Source: Author's calculations.

In general, sectoral expectations on future activity appear to be less strongly correlated to changes in national accounts sectoral value added than survey responses to planned employment changes are to observed changes in sectoral employment. This is particularly true for services. Whereas services firms' expectations of activity are not indicative of subsequent observed changes in sectoral value added, employment expectations are much more closely related with actual outcomes. This may reflect the composition of the survey itself, as it may focus more on the larger employers in the sector.

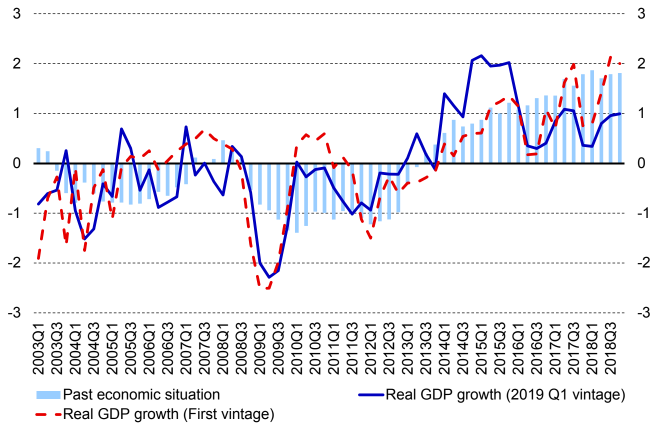
By contrast, the replies of construction firms are quite indicative of observed changes in both activity and employment, whereas the replies of retail firms have much less predictive properties on observed sectoral developments.

The economic expectations of Maltese households

Households replying to the EC's consumer confidence survey are asked to provide their opinion on the current and future state of economic activity as well as to provide an evaluation on how the general economic situation evolved over the last 12 months and how they expect it to change in the 12 months ahead. Chart 3 suggests that when comparing the balance of consumers' replies on how the economic situation changed with the first and last vintages of real GDP growth, the degree of correlation is quite strong. It is also comparable to that found between real GDP growth and the ESI. However, whereas in the latter case the correlation is stronger for the first vintage, in the case of consumer replies on past economic growth the correlation is slightly stronger with the last vintage of GDP data. Nonetheless, restricting the analysis to more recent periods rather than the whole time series shows that the degree of correlation is strongest with the first vintage of GDP data.

Consumer evaluations of economic activity tend to be quite stable (see Chart 3). Once the evaluation turned negative in mid-2003, it remained so till early 2007, followed by a brief interlude during the pre-crisis peak in activity. This was followed by another long period during which replies remained negative, despite the recovery in activity after the crisis. Since mid-2013 the trend in consumer replies on the past economic situation have tended to be nearly consistently upwards, even though the rate of GDP growth has fluctuated.

Chart 3
TRENDS IN GDP GROWTH AND IN CONSUMER REPLIES ON PAST ECONOMIC SITUATION
(standardised)



Source: Author's calculations.

Consumer expectations about the future economic situation are very closely correlated with their evaluation of the past evolution of economic activity (degree of correlation of nearly 1). This suggests that Maltese consumers form their expectation mostly based on their assessment of the past. However, an equation that utilises the lagged value of consumer expectations about future economic activity beats a simple auto-regressive model of real GDP growth in terms of forecasting ability. This suggests that while consumer expectations of economic growth may be backward-looking they have some predictive power.

Maltese households expectations about future movements in unemployment are very closely correlated with past trends in the unemployment rate (as measured in the LFS). The degree of correlation seen for Maltese consumers is nearly double that observed at EU average level. However, Maltese households' expectations on unemployment are backward-looking whereas those at EU level appear to have more predictive power.

By contrast expectations of inflation are somewhat less related to past changes in official measures of inflation, though since 2011 Maltese consumers' inflation expectations and their experience of inflation are becoming more aligned with trends in the official measure of inflation. This possibly reflects the fact that during this period, Malta's inflation rate has become significantly less volatile. Nonetheless, consumer expectations on future inflation do not appear to have acquired any predictive properties and remain quite highly correlated to the current level of observed inflation.

Conclusion

This box summarises a first study that looks at the relevance of the EC surveys as coincident or leading indicators of economic activity in Malta. Analyses of correlation results indicate that the sectoral composition of the ESI is becoming less aligned with that of the national economy. Nonetheless, the ESI remains a good coincident indicator of economic activity and can help predict first estimates of Malta's real GDP growth.

Economic expectations of Maltese households appear to be mostly reflective of current conditions and can be useful as coincident indicators, particularly for forecasting variables that are issued with some time lag, like real GDP growth. Nonetheless, the usefulness of survey indicators is more limited for variables such as inflation and unemployment, where data is issued on a monthly basis.

With regard to industrial and construction firms, their replies are quite indicative of observed changes in their activity and employment. By contrast, the replies of retail firms have less predictive properties. In the case of services, it appears that the effectiveness of the survey may be declining over time, particularly if the focus is on trends in value added rather than those in employment.

The labour market[19]

Labour force grows at a slower pace

LFS data show that in the third quarter of 2019, the labour force grew by 4.2% over the same quarter of 2018 (see Table 2.4).[20] This followed a year-on-year increase of 6.7% in the second quarter.

The activity rate stood at 76.4% in the quarter under review, up from 76.1% a year earlier. It also exceeded the euro area average of 73.8%.[21] The increase in participation largely reflected increased activity among males as the activity rate of females edged down marginally. Indeed, the male participation rate increased by 0.7 percentage point, to reach 85.9%, while that of females edged down by 0.1 percentage point to 65.8%. Thus, the female participation rate remained below the euro area average of 68.5%. On the other hand, the activity rate of males stood above the euro area average of 79.1%.

Employment continues to grow

Employment rose by 4.5% in annual terms, following an increase of 7.0% in the second quarter of 2019. Meanwhile, the number of unemployed persons declined by 2.4%.

Table 2.4
LABOUR MARKET INDICATORS BASED ON THE LFS
Persons; annual percentage changes

	2018 Q3	2019 Q3	Annual change %
Labour force	**253,437**	**264,176**	**4.2**
Employed	244,342	255,297	4.5
By type of employment:			
Full-time	209,123	220,871	5.6
Part-time	35,219	34,426	-2.3
Unemployed	9,095	8,879	-2.4
Activity rate (%)	**76.1**	**76.4**	
Male	85.2	85.9	
Female	65.9	65.8	
Employment rate (%)	**73.3**	**73.7**	
Male	82.1	83.2	
Female	63.7	63.4	
Unemployment rate (%)	**3.6**	**3.4**	
Male	3.8	3.2	
Female	3.3	3.6	

Source: NSO.

[19] This section draws mainly on labour market statistics from two sources: the 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.

[20] 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.

[21] 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 third quarter of 2019 continued to be driven by full-time jobs, as the number of part-time employees declined on a year earlier (see Table 2.4). Persons holding full-time jobs increased by 11,748, or 5.6% in annual terms, while the number of part-time job holders, which include those employed on a full-time on reduced hours basis, fell by 793, or 2.3%.

The overall employment rate rose by 0.4 percentage point on the same period of 2018, to 73.7%.[22] The male employment rate reached 83.2%, from 82.1% a year earlier, while that of females declined to 63.4% from 63.7%. The employment rate of women aged between 15 and 54 declined, while that of those aged 55 to 64 increased. On the other hand, the male employment rate increased among those aged between 15 and 54, but declined among those aged 55 and over.

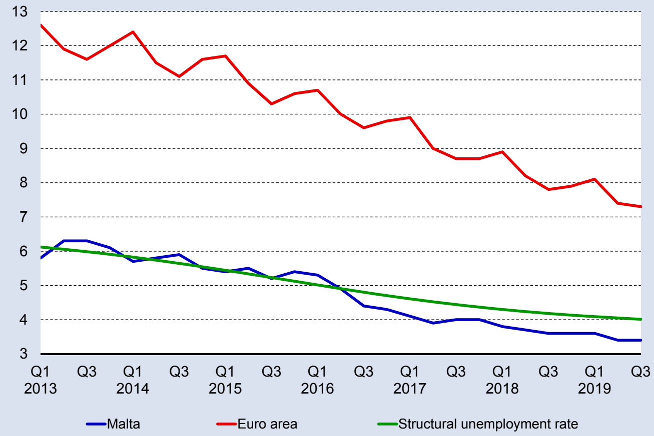
Recent gains in the overall employment rate imply that the Government continued to exceed the Europe 2020 target of 70% for the employment rate.[23] In fact, according to the LFS, the employment rate for those aged between 20 and 64, the age bracket relevant for this target, stood at 77.0% in the third quarter of 2019.

The unemployment rate edges down

In the third quarter of 2019, the unemployment rate stood at 3.4%. This was lower than the rate of 3.6% recorded a year earlier and unchanged from the second quarter of 2019.[24] The rate for males edged down by 0.6 percentage point in annual terms, to 3.2%, while that of females edged up by 0.3 percentage point to 3.6% (see Table 2.4).

The unemployment rate in Malta remained well below the average rate for the euro area (see Chart 2.10). The unemployment gap remained negative, as the unemployment rate remained below the Bank's structural measure of 4.0%.[25]

Chart 2.10
UNEMPLOYMENT RATE
(per cent)



Source: Eurostat.

[22] 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.

[23] 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.

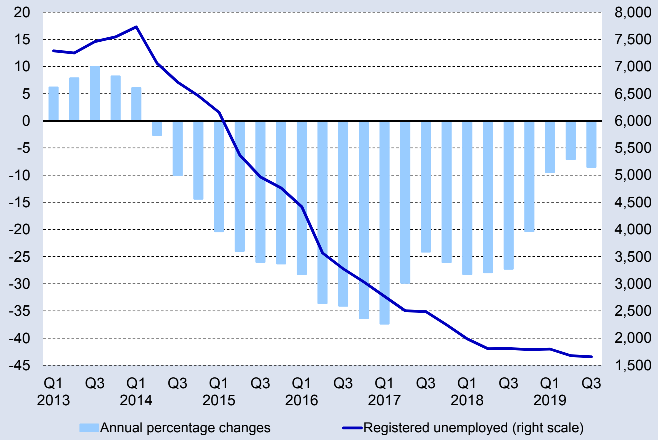
[24] According to the LFS the unemployed comprise persons aged between 15 and 74 years who are without work, available for work and who have actively sought work during the four weeks preceding the Survey. In contrast, the number of unemployed on the basis of the Jobsplus definition includes only those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

[25] 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 1,656 in the quarter under review, 154 persons fewer than a year earlier (see Chart 2.11).

Apart from a growing demand for labour in the context of a rapidly expanding economy, 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.

Chart 2.11
REGISTERED UNEMPLOYED
(annual percentage changes; persons)



Source: NSO.

BOX 2: A CROSS-SECTIONAL SAVING PROFILE OF MALTESE HOUSEHOLDS[1]

Household saving behaviour is of key interest to macro-economic analysis. From a theoretical perspective, the starting point for most research on consumption and saving is either the Permanent Income Hypothesis or the Life Cycle Hypothesis. The former states that consumption is mainly dependent on one's permanent income – a measure of a person's expected income over their lifetime – derived from an adjustment of current income.[2] The Life Cycle Hypothesis, which is the basis for most empirical work, predicts that rational consumers smoothen consumption over their lifetime, saving during working age and dis-saving in the early and retirement stages of the life cycle.[3]

This box focuses on saving behaviour in Malta of different types of households, using data collected by the NSO for the purpose of the 2015 Household Budgetary Survey (HBS). We use these data to identify how median saving behaviour compares to theoretical predictions. This box therefore presents an update on previous analysis which was based on the 2008 HBS wave.[4] To this end, we compare findings based on the more recent data with those from the 2008 wave.

In the HBS, a household is represented by the reference person, typically the bread-winner among all members of the household. The primary use of this survey is to update household expenditure weights used in, for example, the computation of price indices such as the HICP and the RPI. Since the survey collects data on both expenditure and income, it can also be used to study household saving patterns. Income includes income from employment, benefits and allowances, income from financial investments and other income from rent and private pension plans. Although HBS data are typically presented in terms of averages, in this box we use median values as both income and expenditure distributions are typically highly skewed. Median values are generally less sensitive to large movements at the tails of the distribution, and therefore make for more robust comparisons both across household types and across time. To this end, we observe a doubling in median saving rates across the two waves, from 8.7% in 2008 to 17.5% in 2015 (see Chart 1).

Saving rates across household characteristics

The HBS provides disaggregated information on a number of characteristics that are important for the analysis of saving behaviour, such as income, age, education, employment and homeownership status. In line with theory, saving rates and household disposable

1 Written by Glenn Abela, Intern at the Research Department and by William Gatt Fenech, Principal Research Economist at the Research Department of the Central Bank of Malta, and PhD candidate, School of Economics, University of Nottingham. We would like to thank Alexander Demarco, Aaron G. Grech and Brian Micallef for helpful comments and suggestions, and Josianne Galea from the NSO for assistance with the data we use in this article. Any views expressed are the authors' own and do not necessarily reflect the views of the Central Bank of Malta.

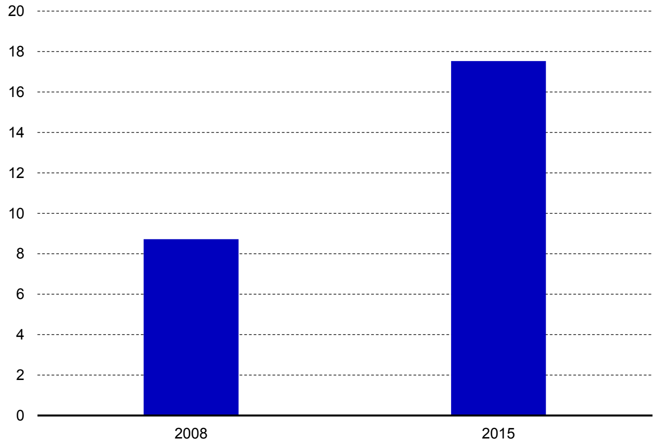
2 See Friedman, M. (1957). The permanent income hypothesis, in *A theory of the consumption function*. (pp. 20-37), Princeton University Press.

3 Working age households typically repay any outstanding debt and accumulate enough resources to see them through retirement. In addition, bequests are typically also an important driver of saving. See De Nardi, M., French, E., & Jones, J. B. (2016). Savings after retirement: A survey. *Annual Review of Economics*, 8, pp. 177-204.

4 See Gatt, W. (2015). A profile of household saving behaviour in Malta. Central Bank of Malta *Quarterly Review 2015:1*, pp. 35-38.

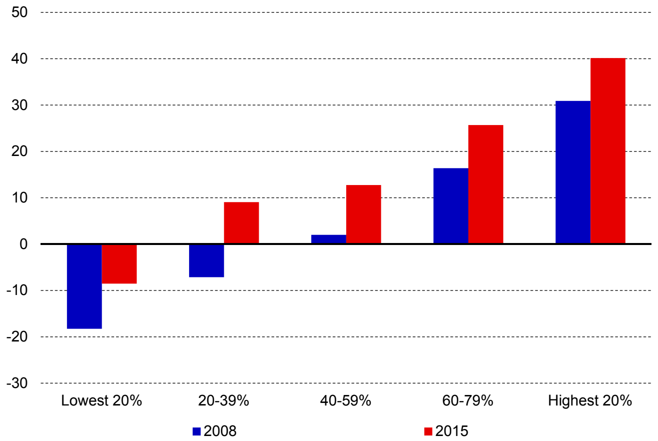
income are positively related.[5] Chart 2 shows that median saving rates rise over income quintiles, with households in the top 20th percentile saving around 40% of their disposable income in 2015. These findings are in line with those for the euro area.[6] The same pattern is observed for the 2008 wave, albeit saving rates are lower at all income quintiles, in line with the lower aggregate median saving rate reported in Chart 1. Whereas households in the two lowest income quintiles had negative saving rates in 2008, only those within the bottom income quintile had a negative median saving rate in 2015. This reflects the fact that median incomes rose by more than median expenditures across all income quintiles, shifting saving rates up.

Chart 1
MEDIAN SAVING RATES ACROSS HBS WAVES
(Median saving rate; percentage)



Source: NSO.

Chart 2
MEDIAN SAVING RATES BY INCOME QUINTILE
(Median saving rate of category; percentage)



Source: NSO.

The theoretical predictions of the Life Cycle Hypothesis are borne out by data for households whose reference person is under 65 years old. Indeed, households whose reference person is younger than 35 have the lowest saving rates (see Chart 3). These then start to rise with age, peaking with the 55-64 age bracket. However, the data indicate that households whose reference person is older than 65 years have the second highest median saving rate, despite the drop in income that comes with retirement. Maltese households thus appear

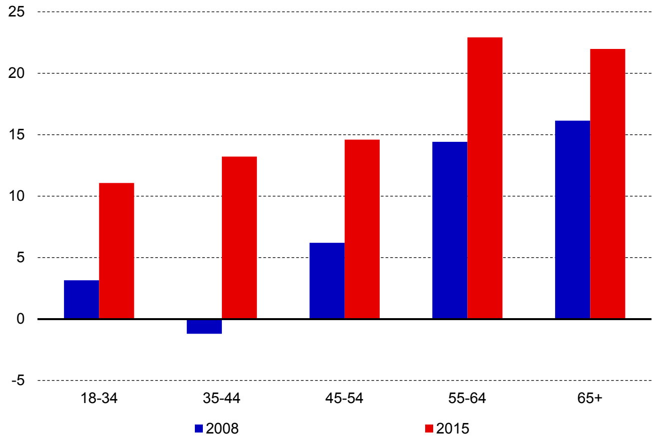
---

5 Current income is found to have both short-term and long-term impacts on saving rates. When minimum subsistence consumption is covered, savings rise sharply with income in the short-term. But development, which raises income levels, also brings changes in demographics and urbanisation, some of which tend to reduce saving in the longer term. See Servén, Loayza and Schmidt-Hebbel (1999), Saving – what do we know, and why do we care? *PREM Notes*, (No. 28). The World Bank, Washington, D.C.. See also Schmidt-Hebbel, K., & Serven, L. (1997). Saving across the world: Puzzles and policies. *World Bank Discussion Papers no. 354*. The World Bank, Washington, D.C. and Loayza, N., Schmidt-Hebbel, K., & Servén, L. (2000). What drives private saving across the world? *Review of Economics and Statistics*, 82(2), pp. 165-181.

6 See Rodriguez-Palenzuela, D., & Dees, S. (2016). Savings and investment behaviour in the euro area. *ECB Occasional Paper 167/January 2016*.

to be adjusting consumption downwards by more than the decline in income. Bequest motives may explain the high saving rates for this cohort. It could also be that since many of these households depend on just one pension as there was one breadwinner, they may be engaging in precautionary saving to provide for the eventual fall in pension income for surviving spouses.

Chart 3
MEDIAN SAVING RATES BY AGE GROUP OF REFERENCE PERSON
(Median saving rate of category; percentage)



Source: NSO.

Patterns across the two waves are similar, yet in 2008 households whose reference person was aged 35-44 had the lowest saving, with their saving rate being markedly lower than those in the 18-34 age group. However, the 2015 data show that income relative to expenditure rose by more for the former group than it did for the latter. As a result, the saving rate of the 35-44 age bracket not only turned positive but was also higher in absolute terms compared to 2008. It should be noted that between the two waves, labour participation rose greatly in this age group (from 67.5% and 66.5% in 2008 for those aged 35 to 39 and 40 to 44, respectively, to 82.1% and 78.4% in 2015). This boost mainly reflected an increase in female participation following measures such as free childcare.

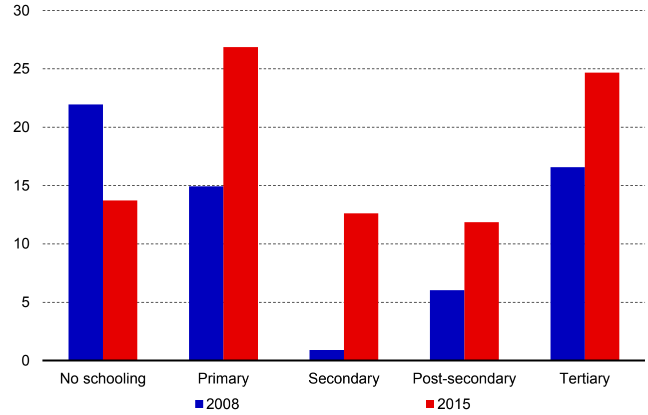
Higher educational attainment is in general linked to higher income although this does not always automatically translate into higher savings, as households tend to revise their consumption patterns when their income falls, as the case of pensioners suggests.[7] The data indicate that households whose reference person has up to primary school education have the highest saving rate, followed by those with tertiary education, while those with secondary and post-secondary school education saved the least in both waves of the HBS (see Chart 4). It may be hard to form priors on the link between education and saving. On one hand, higher educational attainment is expected to generate higher income, leading to higher saving rates *ceteris paribus*. On the other hand, higher actual and expected income is likely to relax borrowing constraints, meaning that these households could in theory have a lower precautionary motive, and therefore save relatively less.[8] The data suggest that the first channel is dominant for households with a secondary or higher level of education; saving rates rise with income. Conversely, households whose reference person has a primary level of education may be highly borrowing-constrained, and thus save rela-

[7] For example, as education rises from secondary to post-secondary, median income and median expenditure both rise by about 24%, implying little changes to the saving rate. See also Darmanin, J., Georgakopoulos, I., & Knoppe, C. (2018). Income distribution, inequality and mobility in Malta. *Research Bulletin (2018)*, Central Bank of Malta, pp. 19-26.

[8] For instance, Le Blanc, J., Porpiglia, A., Teppa, F., Zhu, J., & Ziegelmeyer, M. (2016). Household saving behavior in the euro area. *International Journal of Central Banking*, 12(2), pp. 15-69, make this point by noting that that households with higher education levels may face fewer credit constraints than those with low education levels.

tively more because of this.[9] Furthermore, indications from the sample suggest that households with up to primary school level are likely to be older households.[10] As discussed above, these tend to have higher saving rates. These arguments help to explain the patterns observed in both HBS waves.

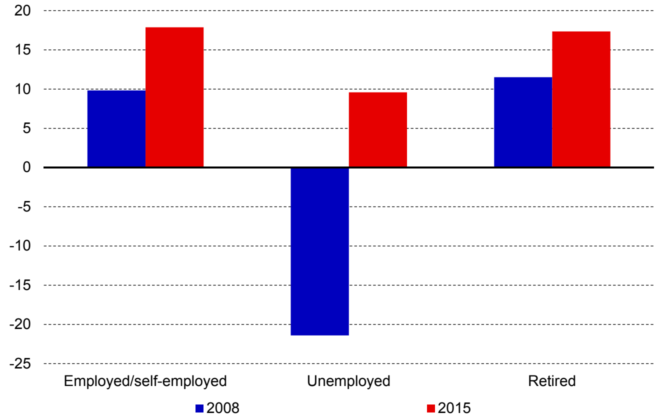
Chart 4
MEDIAN SAVING RATES BY EDUCATIONAL ATTAINMENT OF REFERENCE PERSON
(Median saving rate of category; percentage)



Source: NSO.

The HBS also provides data on saving by the employment status of the reference person. The first salient point is that saving rates for unemployed people are lower than those for people who are employed or self-employed (see Chart 5). Saving is expected to fall as income falls upon loss of work; however, consumption typically also falls in response to an unemployment shock and upon retirement.[11] In Malta these patterns are somewhat present, but we observe a large shift in saving rates between 2008 and 2015 for the households whose reference person is either unemployed or inactive. In addition, we also observe very similar median saving rates for both employed or self-employed and retired households. Median income for active households is about 2.1 times higher than for retired households, but roughly so is their consumption. Therefore, while saving rates are similar, the amount of saving by the former is also about double that of the latter in absolute terms.

Chart 5
MEDIAN SAVING RATE BY EMPLOYMENT STATUS OF REFERENCE PERSON
(Median saving rate of category; percentage)



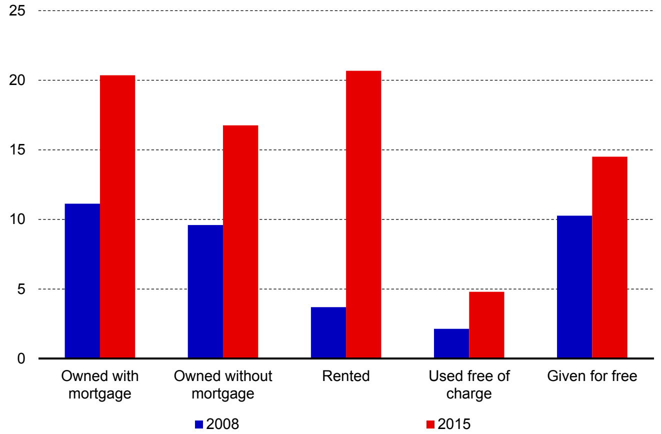
Source: NSO.

[9] The median income of households whose reference person has up to primary level of education was about €12,500 in 2015, compared to about €21,400 for a household with up to secondary level of education.

[10] It became compulsory to attend school until at least age 16 in 1974. See Cutajar, M. (2007). Educational reform in the Maltese islands. *Journal of Maltese Education Research*, 5(1), pp. 3-21. This implies that, in theory, the youngest reference persons featuring in the bottom two education levels were in their fifties in 2015.

[11] Banks, J., Blundell, R., & Tanner, S. (1998). Is there a retirement-savings puzzle? *American Economic Review, 88*(4), pp. 769-788.

Chart 6
MEDIAN SAVING RATE BY HOMEOWNERSHIP STATUS
(Median saving rate of category; percentage)



Source: NSO.

Turning to saving behaviour by housing tenure, we see that in both 2008 and 2015, homeowners with mortgages had a higher median saving rate than outright owners (see Chart 6). Since mortgage payments are not included in expenditure, it follows that this difference is likely explained by additional saving for the loan repayment.[12] Moreover, part of this higher saving rate can also be explained by the fact that, in both HBS waves, owners with a mortgage tended to have a higher median income than owners without a mortgage.

A more significant change since 2008 is in the median saving rate of households who rent their dwelling. Not only did they experience the largest absolute change in the saving rate, but they also reversed the pattern of 2008, and had the highest median saving rate in 2015. However, although market-driven rents have risen considerably over this period, the bulk of the renters in the survey are likely paying controlled rents. Moreover, during this period, the increase in rented accommodation was mainly to relatively well-paid foreign workers, changing the composition of tenant population. Therefore, the rise in the saving rate of renters reflects the fact that while median income rose by about 16%, median expenditure rose by about 7%. In relative terms this translates to a high saving rate.

Conclusion

The trends emerging from the data presented above are broadly consistent with the relevant theoretical predictions of the Life Cycle Hypothesis; saving rates are low for young households and higher for older working age households, with the saving rate rising with income. In addition, the analysis of saving across household characteristics sheds further light into the developments over time. The aggregate median saving rate has risen between the two reference years of the HBS, and this rise is reflected across most households, including those on low incomes.

That said, the above analysis confirms that the underlying distribution remains highly skewed, and therefore policymakers need to go beyond simple aggregates in order to target policies to reach intended beneficiaries. Given the overall improvement in aggregate figures, it is becoming ever more crucial to undertake micro data analysis prior to policy design.

[12] While mortgage payments are not included in expenditure, interest on the loan is. On the other hand, rent and imputed rent are included in expenditure.

3. PRICES, COSTS AND COMPETITIVENESS

Annual inflation as measured by the HICP decelerated to 1.6% in September, largely driven by slower growth in food prices. Similarly, annual inflation based on the RPI – which only takes into account expenditure by Maltese residents – eased to 1.4%. On the other hand, cost pressures for producers accelerated, with annual growth in the industrial producer price index standing at 2.0% in September. Annual growth in Malta's ULC index, measured on a four-quarter moving average basis, rose in the third quarter though it remained moderate. Meanwhile, Malta's HCIs showed an improvement in competitiveness, mostly driven by favourable exchange rate developments.

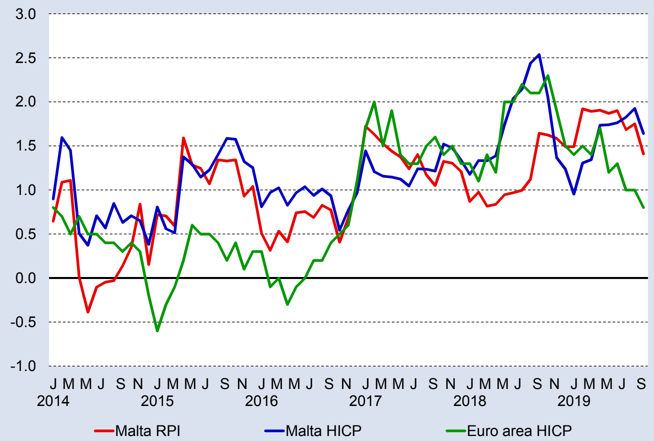
Inflation

HICP inflation decelerates

HICP inflation eased during the third quarter of 2019, going to 1.6% in September from 1.8% in June (see Chart 3.1 and Table 3.1).[1] Nonetheless, inflation remained above the rate observed in the euro area, which ended the third quarter at 0.8%.

Services inflation was unchanged at 1.7% when compared with June, thereby remaining the largest contributor to overall HICP inflation in Malta (see Chart 3.2). As a result, the contribution of services inflation to overall HICP remained stable at 0.9 percentage point. Inflation in this component is being largely

Chart 3.1
INFLATION RATES IN MALTA AND IN THE EURO AREA
(annual percentage changes)



Sources: NSO; Eurostat.

Table 3.1
HICP INFLATION
Annual percentage change

	2019								
	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sep.
Unprocessed food	4.9	5.6	3.8	4.7	7.1	5.6	4.3	4.8	2.3
Processed food including alcohol and tobacco	2.3	2.7	2.7	2.7	2.6	2.4	2.2	2.5	2.5
Energy	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.4	2.4
NEIG	-1.8	-0.7	-0.3	-0.4	0.1	0.5	0.3	0.5	0.5
Services (overall index excluding goods)	1.5	1.4	1.4	2.1	1.7	1.7	2.1	2.0	1.7
All Items HICP	**1.0**	**1.3**	**1.3**	**1.7**	**1.7**	**1.8**	**1.8**	**1.9**	**1.6**

Source: Eurostat.

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

supported by developments in recreational and personal services, such as restaurants (see Chart 3.3).

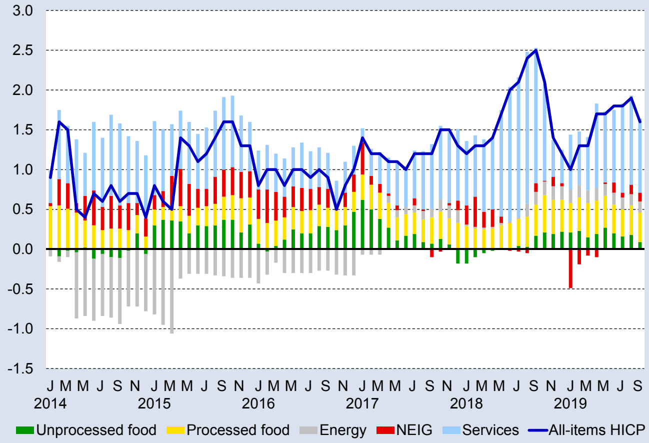
Food inflation decelerated during the third quarter. In particular, unprocessed food inflation eased to 2.3% in September, from 5.6% three months earlier. This was mainly driven by developments in the prices of fresh fruit and vegetables. In contrast, processed food inflation accelerated marginally to 2.5% in September, supported by an increase in milk prices during the quarter under review. Overall, the contribution of food to overall inflation dropped to 0.5 point in September, from 0.6 point three months earlier.

Meanwhile, annual growth in the prices of NEIG remained unchanged at 0.5%. Inflation in this component continues to be held down by weak price pressures on the import side. The contribution of this component remained unchanged at 0.1 point.

Energy inflation stood at 2.4% in September, supported by increases in transport fuel prices over the summer. Its contribution to overall HICP stood at 0.1 point, slightly below its contribution in the second quarter.

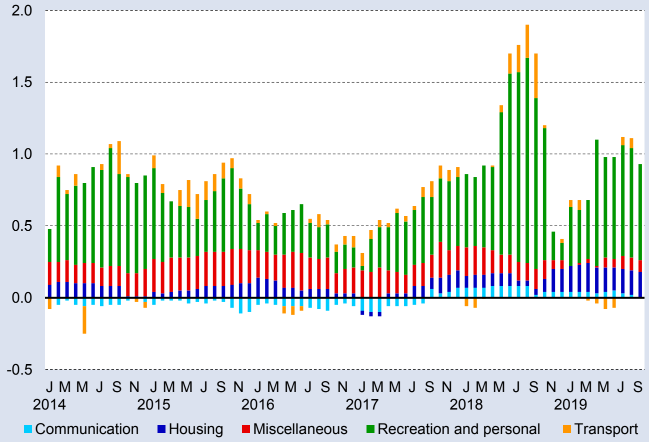
Core inflation, which excludes the more volatile components of the HICP index, accelerated to 1.4% in September, from 1.3% in June. Nonetheless, core inflation remains 0.3 percentage point below overall inflation (see Chart 3.4).[2] This gap suggests

Chart 3.2
CONTRIBUTIONS TO YEAR-ON-YEAR HICP INFLATION
(percentage points; annual percentage change)



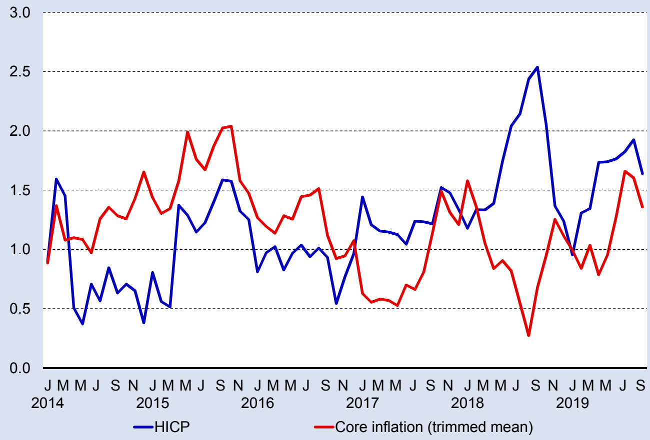
Source: Eurostat.

Chart 3.3
CONTRIBUTIONS FROM SERVICES TO HICP INFLATION
(percentage points)



Source: Eurostat.

Chart 3.4
HICP IN MALTA: OVERALL AND CORE MEASURE
(annual percentage change)



Sources: Eurostat; Central Bank of Malta estimates.

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

Table 3.2
CONTRIBUTIONS TO YEAR-ON-YEAR RPI INFLATION
Percentage points

	2019								
	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sep.
Food	1.0	1.1	1.0	1.0	1.0	0.9	0.8	0.8	0.5
Beverages and tobacco	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Clothing and footwear	-0.3	-0.2	0.0	0.0	-0.1	0.1	-0.1	0.0	0.0
Housing	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1
Water, electricity, gas and fuels	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Household equipment and house maintenance costs	-0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Transport and communications	0.3	0.3	0.3	0.3	0.4	0.4	0.3	0.3	0.3
Personal care and health	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Recreation and culture	0.1	0.2	0.0	0.2	0.1	0.1	0.2	0.2	0.2
Other goods and services	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1
RPI (annual percentage change)	**1.5**	**1.9**	**1.9**	**1.9**	**1.9**	**1.9**	**1.7**	**1.7**	**1.4**

Source: NSO.

that overall inflation is partly being supported by strong increases in the prices of a small number of consumables.

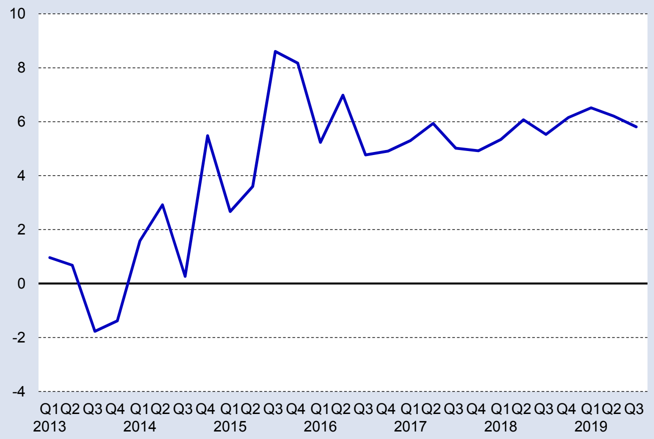
RPI inflation eases

Annual inflation based on the RPI index eased to 1.4% in September, from 1.9% at the end of the previous quarter (see Table 3.2).[3] Despite remaining the main contributor, food inflation was the main driver behind the deceleration during the period under review. Lower contributions were also observed from the housing and from the transport and communications sub-indices.

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 third quarter of 2019 (see Chart 3.5).[4] It rose by 5.8% when compared with the same quarter a year earlier, following an increase of 6.2% in the second quarter

Chart 3.5
MOVEMENTS IN RESIDENTIAL PROPERTY PRICES
(annual percentage changes)



Source: Eurostat.

[3] The RPI index differs from the HICP index in that RPI weights are based on expenditure by Maltese households, while HICP weights also reflect expenditure patterns by tourists in Malta, such as accommodation services. See Darmanin, J. (2018), "Household Expenditure in Malta and the RPI Inflation Basket", *Quarterly Review* 2018(3), pp. 33-40, Central Bank of Malta.

[4] 'Apartments' are defined as dwellings with self-contained rooms or a suite of rooms that have a separate entrance accessible from a common passage way, landing or stairway. 'Maisonettes' have a separate entrance that is accessible from the street and are either at ground-floor level with overlying habitation, or at first-floor level with underlying habitation. 'Terraced houses' are dwellings with at least two floors, own access at street level and airspace and with no underlying structures that are not part of the house itself. They are attached to other structures on both sides.

of the year. House price inflation in Malta remained above that in the euro area, where prices increased at an annual rate of 4.1%.

Residential property prices are being supported by numerous factors, including the low-interest rate environment that makes property more attractive as an investment, as well as the Government's schemes for first-time and second-time buyers. Demand for residential property also continues to benefit from favourable labour market conditions and an increase in foreign workers. The Individual Investor Programme has also contributed, although property acquisitions under this Programme account for a limited proportion of all property transactions.

The number of development permits declined by 31.2% when compared with the third quarter of 2018, after rising by an annual 2.8% in the previous quarter. The sharp decrease in permits in the third quarter of 2019 may reflect the fact that the construction and real estate sectors were still adapting to the new building regulations published in late June.[5,6] Notwithstanding this decline, 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

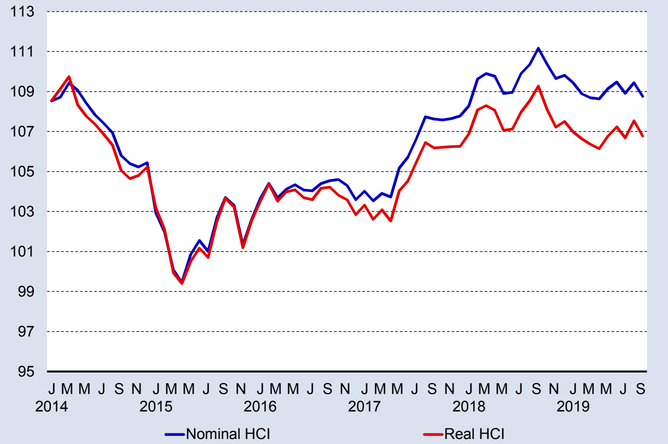
Producer price inflation accelerates

Producer cost inflation, as measured by the industrial producer price index, accelerated during the third quarter, going to 2.0% in September from 1.7% in June. This mainly reflected faster growth in the cost of intermediate goods, which remained the largest contributor to overall producer price inflation.[7] Consumer and capital goods contributed positively to inflation, while energy inflation remained nil.

HCIs point to improvement in competitiveness

Malta's HCIs contracted on an annual basis. In September, the nominal HCI declined at an annual rate of 2.2%, reflecting favourable developments in trade-weighted exchange rates. At the same time, the real HCI fell by 2.3%, suggesting that competitiveness gains from favourable exchange rate movements were slightly augmented by favourable movements in relative prices (see Chart 3.6).[8]

Chart 3.6
HCIs
(1999Q1 = 100)



Source: ECB.

[5] Legal Notice 136 of 2019, Avoidance of Damage to Third Party Property Regulations, 2019.

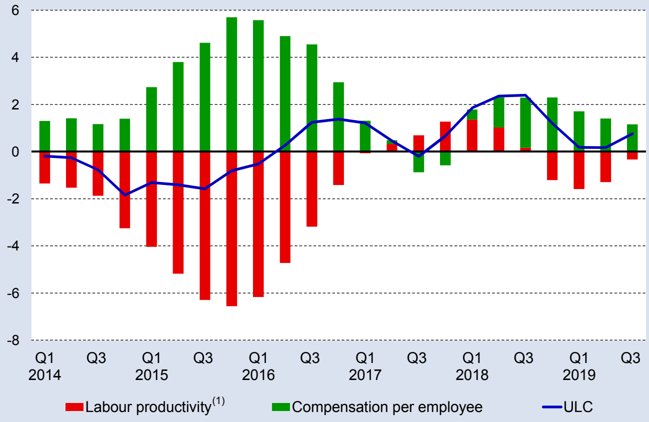
[6] The number of permits issued were relatively low in July and August. However, the number of permits issued began to normalise in September.

[7] 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.

[8] 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.

Overall, these developments suggest an improvement in competitiveness in the year to September.

Chart 3.7
DECOMPOSITION OF ULC IN MALTA
(annual percentage change; four-quarter moving average)



Sources: NSO; Central Bank of Malta estimates.
(1) A rise (drop) in productivity contributes negatively (positively) to ULC growth.

ULC growth picks up from low levels

Malta's ULC index, measured as the ratio of compensation per employee to labour productivity, accelerated during the third quarter of 2019.[9] When measured on a four-quarter moving average basis, ULC in Malta grew at an annual rate of 0.8%, following a 0.2% increase in the previous quarter (see Chart 3.7).

The latest increase in ULC growth was driven by slower annual growth in labour productivity, which decelerated to 0.3%, from 1.3% in the previous quarter. This was partly offset by weaker growth in compensation per employee. On a four-quarter moving average basis, growth in the latter eased to 1.2% from 1.4% in the second quarter.

9 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 here, 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 third quarter of 2019, the surplus on the current account of the balance of payments increased when compared with the corresponding quarter of 2018. Although all main current account sub-components contributed towards the higher surplus, the improvement was largely driven by a smaller deficit on merchandise trade and, to a lesser extent, to a larger surplus on services. Meanwhile, net inflows on the capital account increased, while net lending on the financial account decreased markedly on a year earlier.

When measured on a four-quarter moving sum, the current account balance was equivalent to 10.1% of GDP, compared with 2.9% of GDP in the euro area.

Meanwhile, the cyclically-adjusted current account balance is estimated to have reached 13.9%. This indicates that Malta's current account surplus largely reflects structural factors.

The current account

The current account surplus widens

Between July and September of this year, the current account registered a surplus of €603.7 million, exceeding the €457.2 million recorded in the same quarter of 2018 (see Table 4.1). The higher surplus was mainly driven by a narrowing in the merchandise trade deficit. Nonetheless, higher surplus from trade in services as well as lower net outflows on the primary and secondary income accounts also contributed.

When measured as a four-quarter moving sum, the surplus on the current account increased marginally to €1,310.7 million, from €1,294.8 million in the four quarters to September 2018. This improvement was driven by an increase in the net services balance and a narrowing in the merchandise trade gap. Nevertheless, as GDP grew faster, the current account-to-GDP ratio edged down to 10.1%, from 10.7% in the 12 months to September 2018 (see Chart 4.1).

Malta's cyclically-adjusted current account balance stood at 13.9% of GDP, up from 11.7% a year earlier.[1] The cyclically-adjusted and the unadjusted current account balances for the Maltese

Table 4.1
BALANCE OF PAYMENTS
EUR millions

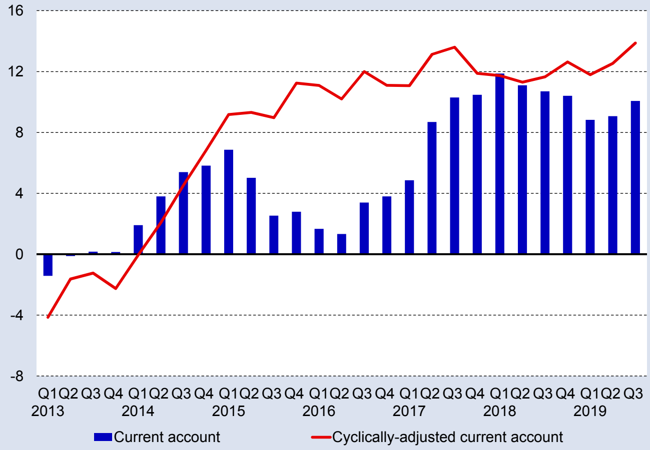
	Four-quarter moving sums						
	2018 Q3	2018 Q4	2019 Q1	2019 Q2	2019 Q3	2018 Q3	2019 Q3
Current account	**1,294.8**	**1,288.8**	**1,114.2**	**1,164.3**	**1,310.7**	**457.2**	**603.7**
Goods	-1,559.0	-1,575.1	-1,684.3	-1,631.5	-1,512.8	-491.1	-372.4
Services	4,102.3	4,135.4	4,158.6	4,203.8	4,223.9	1,288.0	1,308.0
Primary income	-1,096.1	-1,116.8	-1,203.9	-1,248.8	-1,242.9	-302.5	-296.6
Secondary income	-152.4	-154.8	-156.2	-159.2	-157.4	-37.1	-35.3
Capital account	**66.9**	**115.3**	**153.3**	**180.3**	**185.8**	**21.2**	**26.7**
Financial account[(1)]	**781.1**	**558.6**	**621.6**	**655.4**	**517.2**	**191.9**	**53.6**
Errors and omissions	**-580.6**	**-845.4**	**-645.9**	**-689.1**	**-979.4**	**-286.5**	**-576.8**

Source: NSO.
[(1)] Net lending (+) / net borrowing (-).

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

economy have tracked each other closely in the last two years. However, the gap between these two measures has widened in recent quarters, with the cyclically-adjusted measure exceedingly above the headline measure (see Chart 4.1). This reflects the fact that slower growth in Malta's trading partner economies is negatively impacting the cyclical component of Malta's current account surplus.

Chart 4.1
CURRENT ACCOUNT
(four-quarter moving sums as a percentage of GDP)

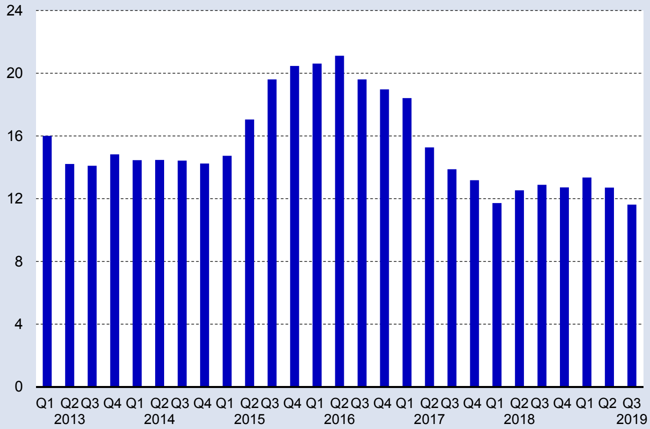


Source: NSO.

The merchandise trade deficit narrows

In the third quarter of 2019, the merchandise trade deficit narrowed by €118.6 million on the corresponding period of 2018, falling to €372.4 million. This was mainly driven by an increase in exports, although a small decrease in imports also contributed.

Chart 4.2
GOODS DEFICIT
(four-quarter moving sums as a percentage of GDP)



Source: NSO.

When measured on a four-quarter cumulative basis, the visible trade gap deficit amounted to €1,512.8 million in the third quarter of 2019, €46.2 million less than the balance recorded a year earlier. This stemmed from a €155.1 million increase in merchandise exports which offset a rise of €109.0 million in imports. As a result, the share of the goods deficit to GDP went down from 12.9% in the year to September 2018 to 11.6% a year later (see Chart 4.2).

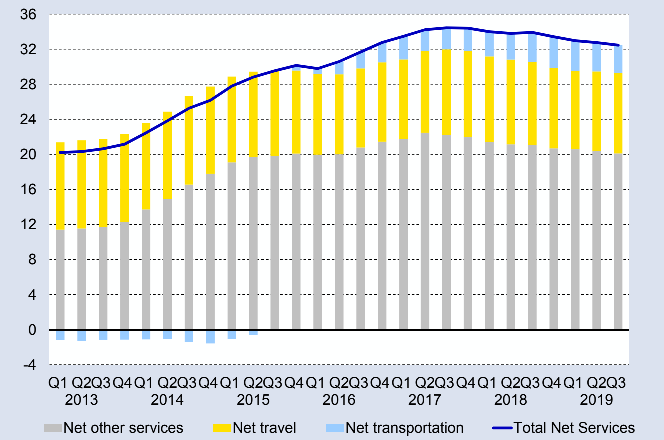
The surplus on services rises

In the quarter under review, net receipts generated by the services industry reached €1,308.0 million, €20.1 million more than in the July to September period of 2018. Both services exports and imports increased markedly on a year earlier. However, the rise in the former was larger.

The higher net surplus was driven by the travel services, with net receipts increasing by €32.6 million, to €519.7 million. The increase reflected higher tourist spending in Malta which offset a rise in residents' expenditure abroad.

On the contrary, the net surplus on transport services and 'other services' edged down. These were, respectively, €11.7 million and €0.8 million lower than in the third quarter of 2018. The relatively small movement on 'other services' masks a relatively large increase in net payments related to other business services and insurance & pension services, which offset most of the rise in net receipts related to personal, cultural, & recreational services, which include remote gaming.

Chart 4.3
SERVICES BALANCE
(four-quarter moving sums as a percentage of GDP)



Source: NSO.

On a four-quarter cumulative basis, the overall surplus from services stood at €4,223.9 million, an increase of €121.6 million over the year to September 2018. Despite such an increase, which was underpinned by higher exports, the share of net services receipts in GDP dropped from 33.9% to 32.4% in the 12 months to September 2019 (see Chart 4.3).

Primary income account records lower net outflows[2]

Between July and September 2019, net outflows on the primary income account stood at €296.6 million, marginally lower than the €302.5 million in the third quarter of 2018. Lower net outflows were driven by higher net interest earned on 'other investment' income and a small drop in profits that foreign owned companies operating in Malta distributed abroad. Together these offset a decline in net receipts earned on portfolio investment income.

During the four quarters to September 2019 net outflows on this account reached €1,242.9 million, €146.8 million more than in the same period a year earlier. Flows relating to primary income continued to be strongly influenced by internationally-oriented firms which transact predominantly with non-residents.

Outflows on the secondary income account decrease[3]

In the third quarter of the year, net outflows on the secondary income account fell by €1.8 million on a year earlier, to stand at €35.3 million.

When measured on a four-quarter moving sum basis, net outflows relating to secondary income reached €157.4 million, €5.0 million more than the amount recorded a year earlier.

Activity in the tourism sector

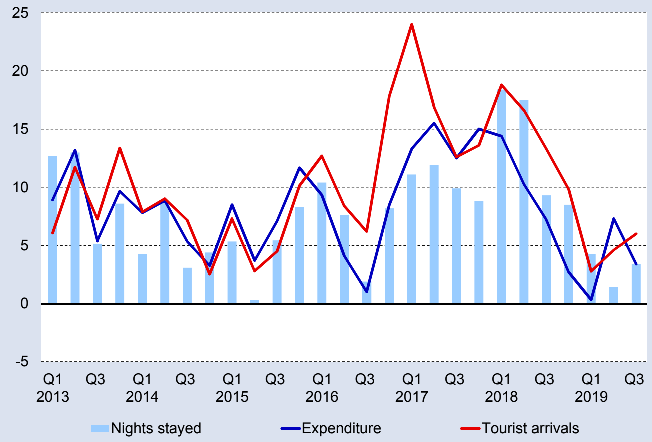
In the third quarter of 2019, the tourism sector continued to grow, although the pace of expansion stood well below that registered in 2017 and 2018.

The number of inbound tourists rose by 6.0% on a year earlier, to reach 927,358 (see Chart 4.4). This follows a 4.6% increase in the previous three-month period.

[2] The primary income account shows income flows related mainly to cross-border investment and compensation of employees.
[3] The secondary income account shows current transfers between residents and non-residents.

The increase was entirely driven by visitors coming to Malta for leisure purposes, as those travelling for business motives and for other reasons declined compared with the same quarter of 2018.

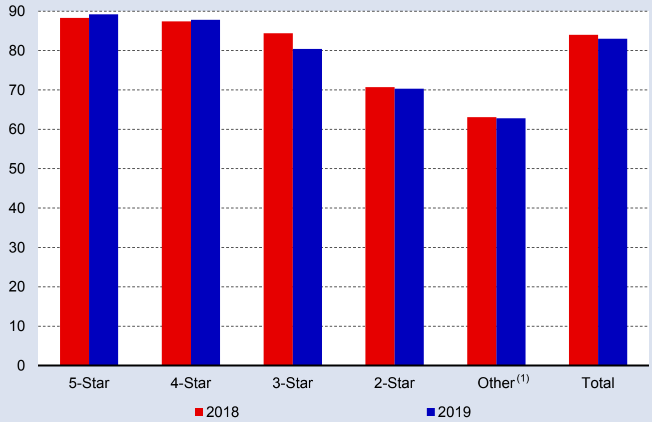
Chart 4.4
TOURISM INDICATORS
(quarterly averages; annual percentage changes)



Source: NSO.

Meanwhile, the number of nights that tourists spent in Malta totalled 7.4 million, a 3.4% rise on the third quarter of 2018. This was propelled by an increase in nights stayed in both rented and non-rented accommodation. In absolute terms, the largest increase was recorded in nights spent in "other rented" accommodation which accounted for over half of the overall increase in nights stayed in Malta.[4]

Chart 4.5
AVERAGE OCCUPANCY RATES IN THE THIRD QUARTER
(per cent)



Source: NSO.
(1) Includes guest houses, hostels and holiday complexes.

The total occupancy rate in collective accommodation establishments fell to 83.0%, from 84.0% in the same quarter of 2018 (see Chart 4.5). The three-star category was the largest contributor towards this decline. The two-star and the "other" collective accommodation categories also reported marginally lower occupancy rates. On the other hand, occupancy rates in 5-star and 4-star establishments were higher compared with a year earlier.

In the quarter under review, tourist expenditure in Malta was up by an annual rate of 3.4%, to reach €871.5 million.[5] As in previous quarters, the strongest gain was registered in the non-package category, which grew by 18.0%, while the "other" category was up by a more modest 1.5%.[6] In contrast, spending on package holidays declined by 11.5%.

---

[4] Collective accommodation comprises hotels, aparthotels, 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).

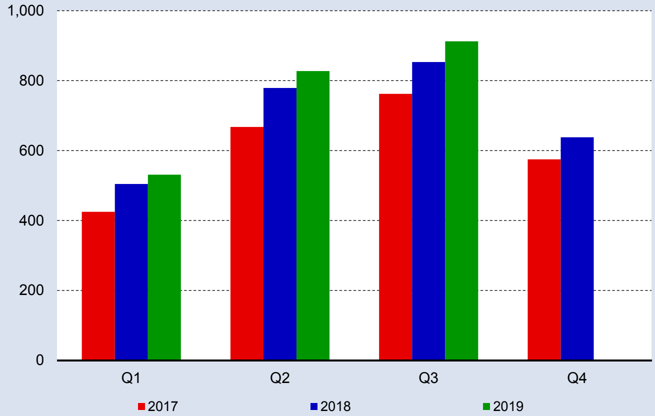
[5] Total expenditure is split into package, non-package and "other" with the latter component capturing any additional expenditure by tourists during their stay in Malta, such as expenditure on excursions and entertainment.

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

Compared with the same quarter of the preceding year, expenditure per capita decreased to €940, from €964, as tourist expenditure increased at a slower pace compared with arrivals. Meanwhile, the average length of stay declined to 7.9 nights, from 8.2 nights previously.

According to Malta International Airport (MIA) data, in the third quarter of 2019, average seat capacity increased by 6.9% compared with a year earlier (see Chart 4.6).[7]

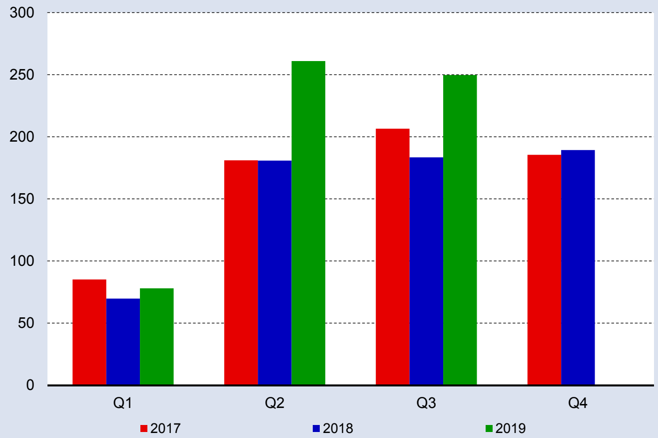
Chart 4.6
SEAT CAPACITY[(1)]
(thousands)



Source: MIA.
(1) Data include schedule and charter seats.

In the third quarter of 2019, the number of cruise liners visiting Malta totalled 122, 27 more than a year earlier. Foreign passengers were up to 249,735, from 183,480 in the same period of 2018; equivalent to a 36.1% increase. This reflected primarily increases from visitors coming from Germany and American markets (see Chart 4.7).

Chart 4.7
CRUISE LINER PASSENGERS
(thousands)



Source: NSO.

The capital account

Net inflows on the capital account stood at €26.7 million in the third quarter of 2019, €5.6 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 rose by €118.9 million on a year earlier, to stand at to €185.8 million.

[7] MIA data are subject to revisions.

5. GOVERNMENT FINANCE

During the third 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 0.8% of GDP, from 3.4% of GDP in the corresponding quarter of 2018 and 1.2% in the second 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 43.1% from 45.4% at end-June. Although the stock of financial liabilities held by government decreased considerably, financial assets decreased more strongly. Consequently, the net financial worth as a share of GDP declined.

Quarterly developments

General government surplus narrows

In level terms, the general government registered a surplus of €57.4 million in the third quarter of 2019, €55.4 million less than the surplus registered a year earlier. This decline resulted from a substantial increase in primary expenditure as well as a slight decline in revenue. As a result, while the primary balance remained in surplus, this narrowed by €58.4 million, to €101.7 million.

Revenue declines slightly

In the third quarter of 2019, general government revenue decreased by €3.6 million, or 0.3%, when compared with the corresponding quarter of 2018, to €1,215.7 million (see Table 5.1). The

Table 5.1
REVENUE, EXPENDITURE AND DEBT
EUR millions

	2018		2019			Change 2019Q3-2018Q3	
	Q3	Q4	Q1	Q2	Q3	Amount	%
Revenue	**1,219.3**	**1,329.3**	**1,140.6**	**1,290.6**	**1,215.7**	**-3.6**	**-0.3**
Taxes on production and imports	442.7	416.4	373.8	403.8	424.0	**-18.7**	**-4.2**
Current taxes on income and wealth	442.3	433.1	411.5	500.8	413.3	**-29.0**	**-6.5**
Social contributions	165.2	217.5	192.4	193.1	191.2	**26.0**	**15.7**
Capital and current transfers receivable	37.6	106.5	45.4	43.6	39.3	**1.7**	**4.6**
Other(1)	131.6	155.9	117.4	149.4	147.9	**16.4**	**12.4**
Expenditure	**1,106.5**	**1,310.6**	**1,178.6**	**1,230.9**	**1,158.3**	**51.8**	**4.7**
Compensation of employees	346.8	343.6	359.1	359.3	364.6	**17.9**	**5.2**
Intermediate consumption	189.6	260.9	212.8	257.4	222.2	**32.7**	**17.2**
Social benefits	281.6	309.6	308.2	312.5	285.9	**4.2**	**1.5**
Subsidies	37.3	53.3	41.3	49.6	49.7	**12.5**	**33.4**
Interest	47.3	46.7	43.9	45.7	44.3	**-3.0**	**-6.4**
Other current transfers payable	68.5	105.4	85.2	59.4	90.3	**21.8**	**31.8**
Gross fixed capital formation	98.3	152.3	97.4	114.1	81.3	**-17.0**	**-17.3**
Capital transfers payable	39.0	43.8	29.2	31.5	17.2	**-21.8**	**-55.8**
Other(2)	-1.9	-5.0	1.5	1.4	2.7	**4.6**	
Primary balance	**160.1**	**65.4**	**5.9**	**105.4**	**101.7**	**-58.4**	
General government balance	**112.8**	**18.7**	**-38.1**	**59.8**	**57.4**	**-55.4**	
General government debt	**5,543.6**	**5,641.1**	**5,826.7**	**5,832.0**	**5,614.9**		

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.

drop in government revenue mainly reflects lower tax receipts. In particular, revenue from current taxes on income and wealth declined by €29.0 million, on the back of lower income tax receipts. Intakes from taxes on production and imports also recorded a significant drop, of €18.7 million, mainly due to a decline in value added tax receipts. The decrease in VAT and income tax receipts in the quarter under review follows very strong growth in intakes in the first half of the year. On the other hand, revenue from social contributions increased by €26.0 million on the third quarter of 2018, sustained by a positive labour market environment.

Lower tax revenue was partly offset by higher non-tax revenue as both capital and current transfers receivable and the ''other'' component of government revenue increased. The latter rose by €16.4 million, mainly due to a rise in sales and dividend income. Meanwhile, capital and current transfers receivable registered a modest increase of €1.7 million.

Current expenditure increases

Total government expenditure soared by €51.8 million, or 4.7% when compared with the third quarter of 2018, as lower capital expenditure was offset by a larger increase in recurrent expenditure.

The largest increase in recurrent expenditure was recorded in intermediate consumption which grew by €32.7 million, reflecting higher outlays within the health sector. Meanwhile, current transfers payable surged by €21.8 million, largely due to the timing of transfers to church schools and payments to the EU budget. Compensation of employees rose by €17.9 million, reflecting higher outlays within the public administration sector. Furthermore, subsidies increased by €12.5 million, mostly owing to the frontloading of ordinary expenditure, while social benefits edged up by €4.2 million due to higher outlays on pensions. On the other hand, interest payments declined by €3.0 million.

Capital expenditure fell significantly, following two quarters of very strong growth. Outlays on gross fixed capital formation declined by €17.0 million, while capital transfers declined by €21.8 million. This reflects a slowdown in outlays financed from own resources and weak growth in spending on projects co-financed from the EU.

Debt decreases significantly

In September 2019, the stock of general government debt amounted to €5,614.9 million, €217.2 million less than in June. This was mainly due to a decline in debt securities which fell by €227.1 million, as the value of MGS redeemed exceeded the stock of new bond issues. While the stock of long-term securities outstanding (composed of MGS) fell by €173.6 million, their share in total debt remained virtually unchanged at 81.3%. Also, the stock of short-term securities (composed of Treasury bills) fell by €53.5 million. Hence, its share in total debt decreased by 0.7 percentage point to 5.0%.

Meanwhile, outstanding loans increased by €8.4 million, with their share in total debt rising to 7.0%, from 6.6% in the previous quarter.

Currency and deposits outstanding increased by a marginal €1.5 million, with their share in total debt increasing by 0.3 percentage point to 6.7%.

Headline and cyclically-adjusted developments

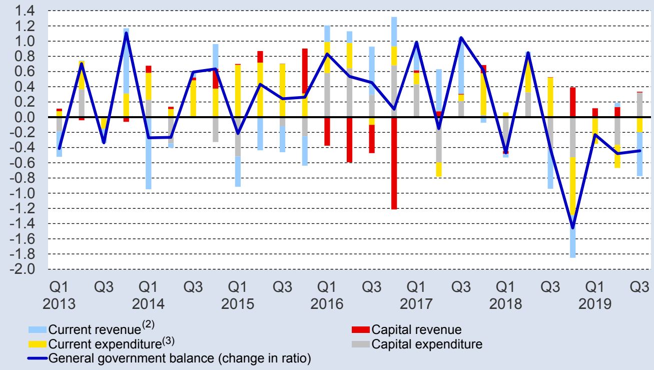
Headline surplus ratio narrows, while the debt ratio decreases

On a four-quarter moving sum basis, the general government balance remained in surplus. However, the surplus-to-GDP ratio declined to 0.8% of GDP from 1.2% of GDP in the second quarter of 2019 (see Chart 5.1).

This is largely due to a lower share of revenue in GDP that mainly reflects the fact that tax revenue fell when compared to the second quarter of the year. As a result, the ratio of current revenue in GDP declined by 0.6 percentage point. Meanwhile, capital revenue broadly retained its share in GDP.

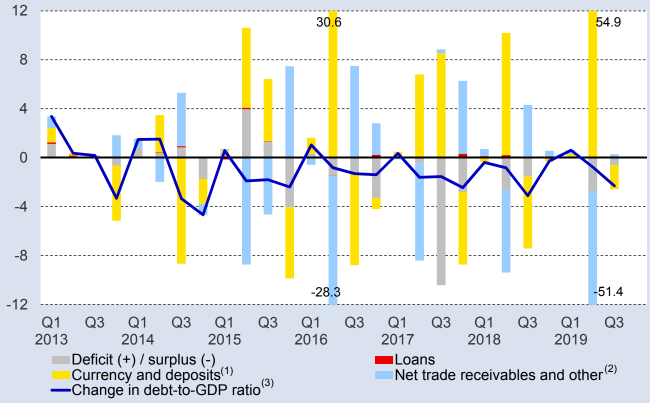
Overall, the share of government expenditure as a share in GDP remained broadly unchanged as a rise in the share of current expenditure was offset by a lower share of capital expenditure in GDP. The share of capital expenditure in GDP declined by 0.3 percentage point, while the share of current expenditure rose by 0.2 percentage point when compared with the previous quarter of 2019.

Chart 5.1
IMPACT ON GENERAL GOVERNMENT BALANCE[1]
(percentage point change from previous quarter)



Sources: NSO; Central Bank of Malta.
(1) Revenue items: +ve sign represents higher revenue and vice versa. Expenditure items: +ve sign represents lower expenditure and vice versa.
(2) The term 'current revenue' represents most tax revenue as well as income from investments and sales. 'Capital revenue' mainly represents capital taxes and grants received.
(3) The term 'current expenditure' mainly represents spending on wages, social benefits and operational and maintenance expenses. 'Capital expenditure' mainly represents spending on investment and capital transfers.

Chart 5.2
CONTRIBUTION TO CHANGE IN DEBT
(percentage point change from previous quarter)



Source: Central Bank of Malta.
(1) Composed mainly of transactions in deposits held with the Central Bank of Malta.
(2) Also includes transactions related to shares and other equity and adjustments for valuation and volume effects.
(3) GDP data are four-quarter moving sums.

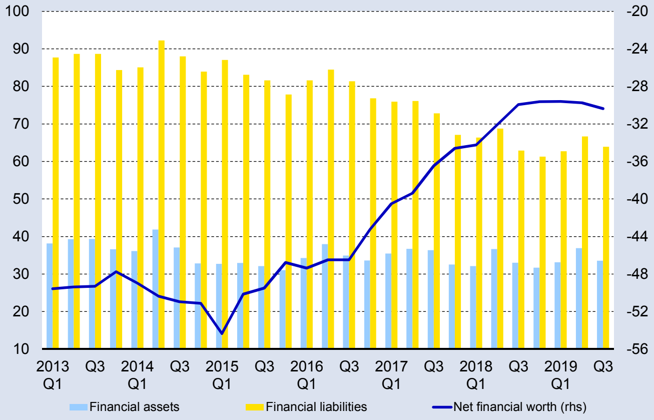
In the period under review, the debt-to-GDP ratio fell by 2.3 percentage points, to 43.1%, as the general government surplus reduced the need to raise additional debt to finance operations (see Chart 5.2). Debt-decreasing deficit-debt adjustments mainly reflected a drop in Government deposits related to time adjustments and tax refunds.

Net financial worth deteriorates

The market value of financial assets declined to €4,363.1 million between end-June and end-September. This was due to a decline in deposits and accounts receivables. Consequently, the share of financial assets in GDP declined by 3.4 percentage points to 33.5% (see Chart 5.3). At the same time, financial liabilities decreased by €237.8 million, ending the third quarter of 2019 at €8,316.1 million. This mostly reflected a drop in accounts payable, reflecting the impact of higher tax refunds, and a decline in the stock of outstanding debt securities. The share of financial liabilities in GDP declined by 2.8 percentage points to 63.9%.

The resulting net financial worth of general government as a share of GDP fell by 0.6 percentage point and closed the third quarter of the year at -30.4%, from -29.8% in the previous quarter.

Chart 5.3
GENERAL GOVERNMENT NET FINANCIAL WORTH
(% of GDP)[(1)]

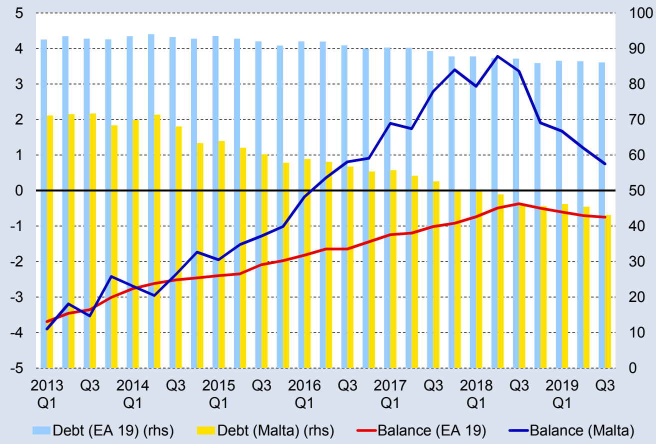


Sources: EUROSTAT; NSO.
[(1)] GDP data are four-quarter moving sums.

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

In September, the euro area general government deficit stood at 0.8% of GDP when measured on a four-quarter moving sum basis. This was broadly similar to the 0.7% recorded in the previous quarter (see Chart 5.4). Over the same period, the euro area debt ratio declined slightly to 86.1% of GDP, from 86.4%. 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 43 percentage points less than the corresponding ratio for the euro area.

Chart 5.4
GENERAL GOVERNMENT BALANCE AND DEBT
(four-quarter moving sums; % of GDP)



Sources: NSO; EUROSTAT.

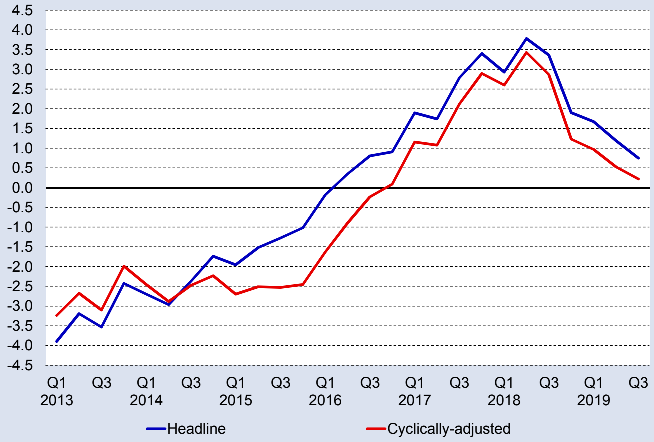
Cyclically-adjusted balance narrows[1]

On a four-quarter moving sum basis, the cyclically-adjusted surplus ended the quarter under review at 0.2% of GDP (see Chart 5.5), 0.3 percentage point less than the 0.5% surplus posted three months earlier. This is line with developments in the headline surplus-to-GDP ratio, which declined by 0.4 percentage point during the same period.

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

The cyclically-adjusted surplus ratio to GDP narrowed as a result of a lower share of revenue in GDP (see Table 5.2). In turn, this was due to a smaller share of current taxes on income and wealth, and taxes on production and imports in GDP. The share of these revenue items decreased by 0.4 and 0.3 percentage point, respectively. Meanwhile, the share of social contributions in GDP increased marginally while the share of the 'other' component of revenue remained broadly unchanged.

Chart 5.5
GENERAL GOVERNMENT BALANCE
(four-quarter moving sums; % of GDP)



Sources: NSO; Central Bank of Malta estimates.

Meanwhile, the share of cyclically-adjusted expenditure also decreased, reflecting lower shares of current and capital spending in GDP. The decline in the share of cyclically-adjusted current spending is mostly a result of low growth in social benefits, reflecting the ongoing efforts to reduce dependency on unemployment benefits and incentivise people to seek employment. Movements in the shares of other current expenditure items in GDP compared with the previous quarter were marginal and overall neutral. The drop in the share of capital expenditure reflects the abovementioned decline in investment outlays.

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	Q3
Revenue	**0.4**	**0.6**	**0.8**	**0.0**	**-0.1**	**0.1**	**-0.4**	**-0.1**	**0.1**	**0.1**	**-0.6**
Current taxes on income and wealth	0.0	-0.1	0.5	0.2	0.0	0.1	-0.2	-0.5	0.5	0.1	-0.4
Taxes on production and imports	0.1	0.0	0.3	-0.2	-0.1	0.2	0.2	0.1	-0.1	0.1	-0.3
Social contributions	0.0	0.0	0.0	0.0	0.0	0.2	-0.2	0.0	0.0	-0.2	0.1
Other(1)	0.3	0.7	-0.1	0.0	-0.1	-0.3	-0.2	0.3	-0.3	0.1	0.0
Expenditure	**-0.6**	**0.7**	**-0.3**	**-0.8**	**0.2**	**-0.7**	**0.1**	**1.5**	**0.3**	**0.6**	**-0.3**
Compensation of employees	-0.1	-0.1	-0.1	0.0	0.0	-0.1	0.0	0.0	-0.1	-0.1	-0.1
Intermediate consumption	0.0	0.3	0.3	-0.3	-0.1	0.0	-0.2	0.5	0.3	0.3	0.1
Social benefits	-0.2	-0.2	-0.1	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2
Interest payments	-0.1	-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	-0.2
Other(2)	-0.2	0.6	-0.3	-0.2	0.4	-0.4	0.3	0.6	0.0	0.2	0.0
Primary balance	**1.0**	**-0.2**	**1.0**	**0.7**	**-0.4**	**0.8**	**-0.6**	**-1.7**	**-0.3**	**-0.5**	**-0.4**
General government balance	**1.1**	**-0.1**	**1.0**	**0.8**	**-0.3**	**0.8**	**-0.6**	**-1.6**	**-0.3**	**-0.4**	**-0.3**

Sources: NSO; Central Bank of Malta estimates.

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

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

6. MONETARY AND FINANCIAL DEVELOPMENTS

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

Maltese residents' deposits with MFIs in Malta continued to expand, albeit at a slower pace, compared to the second quarter of 2019.[1] *The shift to overnight deposits persisted, in an environment of low interest rates and a continued preference for liquidity. Credit to Maltese residents continued to expand, reflecting a further recovery in credit to general government and continued strong growth in credit to other residents. Loans to households accelerated further, 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.*

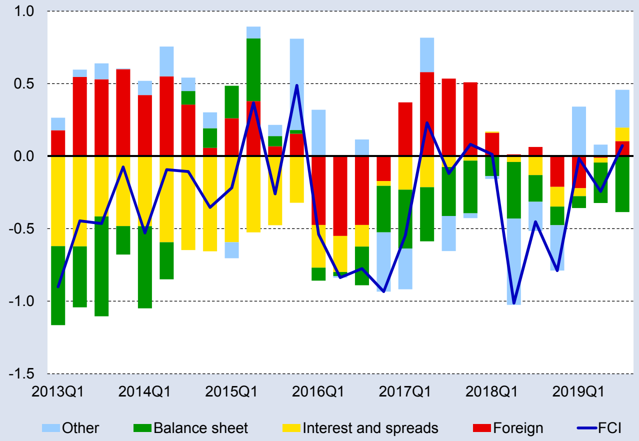
In September, the primary market yield on Treasury bills declined marginally from that prevailing at the end of June. Secondary market yields on five and ten-year MGS fell more significantly. Domestic share prices in the equity market rose between June and September.

Monetary and financial conditions

According to the Bank's FCI, in the third quarter of 2019, financing conditions were marginally loose from a historical perspective, and thus more favourable than in the second quarter (see Chart 6.1). The recent improvement in financial conditions reflected an improvement in both the contribution from domestic and foreign influences. In particular, net issues of securities by domestic NFCs (part of the 'other' component) rose when compared with the second quarter of 2019. Furthermore, the spread between Malta's ten-year government bond yield and German bonds narrowed, further supporting the loosening in financing conditions. In addition, foreign influences, which were broadly neutral in the second quarter of the year, turned positive in the third quarter as uncertainty diminished.

Compared to the third quarter of 2018, the improvement in financing conditions was much more significant. Assessed on this basis, the improvement mainly reflected the significant increase in net issues of securities by domestic NFCs and the improvement in the spread between Malta's ten-year government bond yield and the German Bund. Foreign influences also contributed, although to a limited degree.

Chart 6.1
CONTRIBUTIONS TO THE FCI
(contributions to the index)



Source: Central Bank of Malta estimates.

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

Table 6.1
DEPOSITS OF MALTESE RESIDENTS

	EUR millions	Annual percentage changes				
	2019	2018		2019		
	Sep.	Sep.	Dec.	Mar.	June	Sep.
Overnight deposits	**15,224**	**7.1**	**7.7**	**8.4**	**8.8**	**8.6**
of which						
Households	9,265	14.2	14.5	10.3	11.0	10.2
NFCs	3,338	10.1	3.8	4.1	-1.2	-1.9
Deposits redeemable at notice of up to three months	**71**	**52.5**	**63.2**	**63.0**	**43.4**	**-0.4**
of which						
Households	33	-14.9	-9.9	-5.1	-1.8	-5.3
NFCs	20	2,359.4	530.2	238.6	60.0	-37.6
Deposits with an agreed maturity of up to two years	**2,741**	**-6.7**	**-5.6**	**-6.6**	**-8.8**	**-8.1**
of which						
Households	2,154	-5.5	-6.3	-6.4	-6.6	-7.6
NFCs	285	7.3	-9.5	-3.4	-9.4	-3.8
Deposits with an agreed maturity above two years	**1,564**	**1.5**	**8.2**	**10.9**	**14.1**	**11.7**
of which						
Households	1,323	-0.9	3.8	5.4	5.8	5.8
NFCs	68	-1.1	9.9	-6.7	8.1	9.3
Total residents' deposits[1]	**19,599**	**4.3**	**5.5**	**6.2**	**6.3**	**6.1**

Source: Central Bank of Malta.
[1] Total residents' deposits exclude deposits belonging to central government.

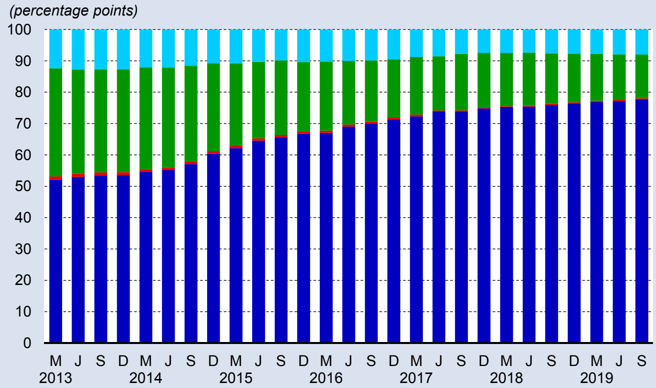
Maltese residents' deposits continue to expand, albeit at a slower pace

Total deposits held by Maltese residents with MFIs in Malta continued to expand, with the annual rate of change standing at 6.1% in September (see Table 6.1). This was marginally lower than the 6.3% 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, following an extended period of robust activity and income growth.

Overnight deposits remained residents' preferred deposit category. Annual growth in this component stood at 8.6% in September, slightly below the 8.8% recorded three months earlier. The share of this category in total deposits further increased. By September, it had reached 77.7%, up from 75.9% a year earlier, thereby extending the established upward pattern observed in recent years (see Chart 6.2).

Time deposits with an agreed maturity of over two years also continued to increase, albeit at a slower pace, with the annual rate of change down to 11.7%

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



Source: Central Bank of Malta.
[1] Deposits exclude those belonging to central government.

from 14.1% three months earlier. Their share in total deposits stood at 8.0%. On the other hand, deposits with an agreed maturity of less than two years contracted further. These decreased by 8.1% in the year to September. As a result, their share in total deposits declined to 14.0%, from 16.1% a year earlier. The share of deposits redeemable at notice of up to three months remained marginal.

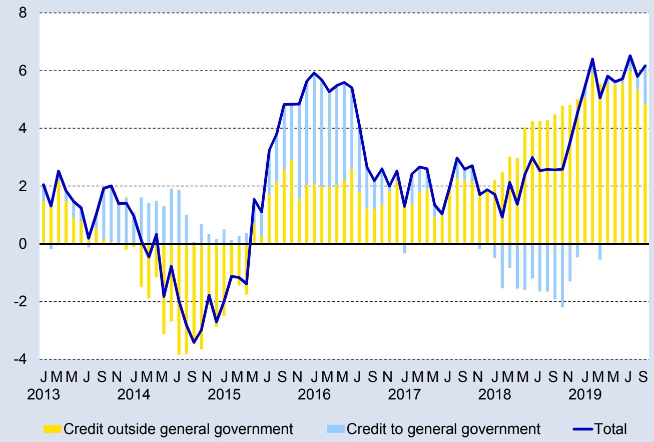
Credit to residents grows at a faster pace

Credit to Maltese residents expanded by 6.2% in the year to September 2019, after growing by 5.7% in the previous quarter (see Table 6.2). The acceleration was driven by credit to general government, which increased by 6.1% in the year to September, following a modest 0.4% increase in June. This partly reflected the take-up of new MGSs issued by the Government during the quarter. Notwithstanding the pick-up in credit to general government, the expansion in credit continued to be largely supported by credit to residents outside general government, the larger component. These rose at an annual pace of 6.2% (see Chart 6.3).

This expansion continued to be driven by loans, which rose by 6.2% in the year to September. Loans to households accelerated further, while loans to NFCs grew at a moderate pace compared with June.

Loans to households grew by 9.7% on an annual basis, following a 9.5% increase in June. Both mortgage lending and consumer credit and other lending

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



Source: Central Bank of Malta.

Table 6.2
MFI CREDIT TO MALTESE RESIDENTS

	EUR millions	Annual percentage changes				
	2019	2018		2019		
	Sep.	Sep.	Dec.	Mar.	June	Sep.
Credit to general government	**3,036**	**-8.0**	**-2.0**	**-2.4**	**0.4**	**6.1**
Credit to residents outside general government	**11,141**	**5.9**	**6.5**	**7.2**	**7.2**	**6.2**
Securities and Equity	462	9.9	5.1	9.1	4.2	4.9
Loans	10,679	5.7	6.6	7.1	7.3	6.2
of which:						
Loans to Households	5,936	7.5	7.8	8.7	9.5	9.7
Mortgages	5,328	8.2	8.8	9.6	10.1	10.2
Consumer Credit and Other Lending	607	2.0	-0.4	1.9	4.1	5.2
Loans to NFCs[(1)]	4,003	4.6	7.1	7.0	4.6	4.2
Total credit to residents	**14,176**	**2.6**	**4.5**	**5.1**	**5.7**	**6.2**

Source: Central Bank of Malta.
[(1)] NFCs include sole proprietors and non-profit institutions serving households (NPISH).

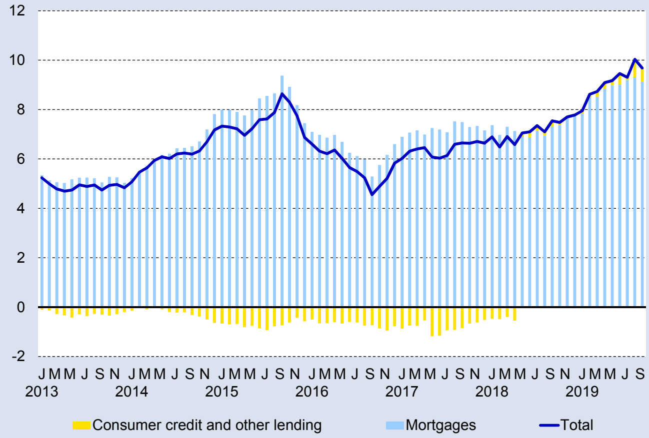
rose at a faster pace compared with June (see Chart 6.4).

Annual growth in loans to NFCs moderated to 4.2% in the year to September, after increasing by 4.6% in June. A sectoral breakdown shows that this moderation reflected a sharper rate of contraction in loans to the trade sector and manufacturing, followed by slower growth in loans to the accommodation and catering sector (see Chart 6.5).

Financial accounts data show that the share of bank lending in total NFC debt stood at 20.7% in September, lower than the share of 21.4% a year earlier (see Chart 6.6). The share attributed to the rest of the world decreased marginally over this period. This suggests that NFCs reduced their reliance on bank loans and to a limited extent their exposure to foreign financing in favour of alternative sources, mainly debt securities and, to a lesser extent, intra-sectoral lending.[2] The share of debt securities reached 4.9%, from 4.2% a year earlier.[3] The share of intra-sectoral lending in total NFC debt rose to 41.8%, from 41.6% in the third quarter of 2018.

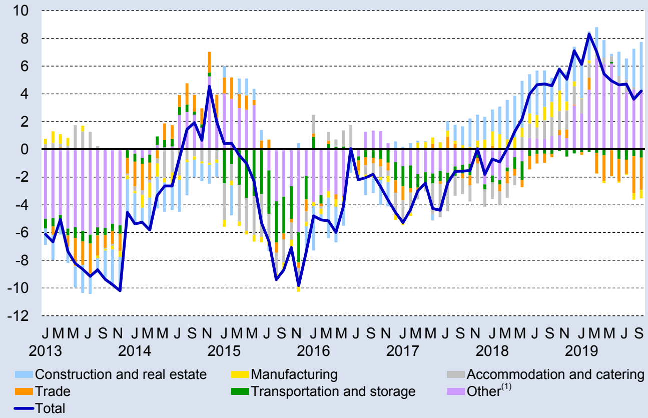
Malta Stock Exchange (MSE) data also show that large companies are increasingly making public issuances of corporate bonds and equity. As at September 2019, €1.5 billion in corporate debt was listed on the MSE, 20.7% higher than the outstanding stock 12 months earlier

Chart 6.4
COMPOSITION OF LOANS TO HOUSEHOLDS
(percentage points; annual percentage change)



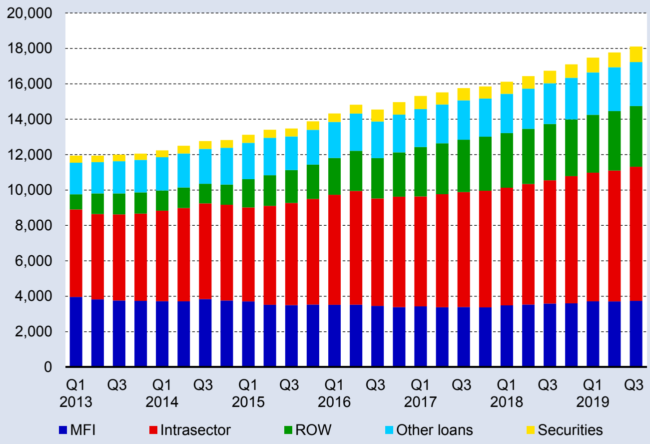
Source: Central Bank of Malta.

Chart 6.5
LOANS TO NFCs BY SECTOR
(percentage points; annual percentage change)



Source: Central Bank of Malta.
(1) Includes sectors such as energy, entertainment, health, education, professional services, communication, and administration.

Chart 6.6
NFC DEBT BY SOURCE
(end-of-period stocks in EUR billions)

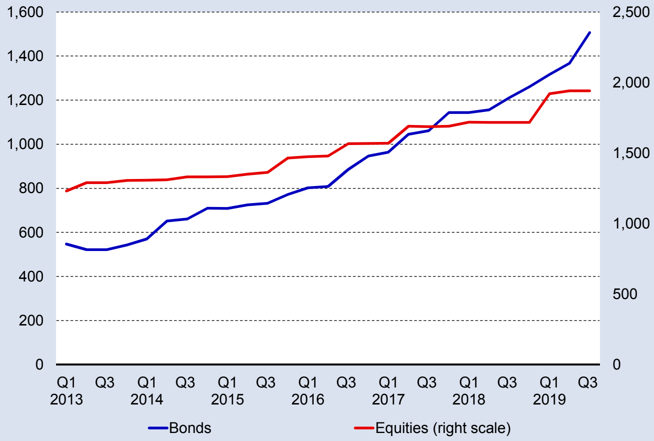


Source: Financial Accounts.

[2] See Darmanin, J. (2017). "The financing of companies in Malta", *Policy Note* July 2017, Central Bank of Malta.
[3] Other loan sources comprise loans from non-bank financial institutions and auxiliaries, households and government.

(see Chart 6.7).[4] The amount of equity listed on the MSE has also increased in the past years.

Chart 6.7
CAPITAL ISSUED ON MSE BY NFCs
(million units outstanding as at end-period)



Sources: MSE; Central Bank of Malta estimates.

Interest rate spread between deposit and lending rate remains elevated

Interest rates on residents' deposits with MFIs in Malta decreased by 4 basis points in the year to September, with the weighted average deposit rate offered to households and NFCs standing at 0.31% (see Table 6.3).[5] This was mainly sustained by a further decrease in rates on longer-term deposits, for both households and NFCs.

At the same time, the weighted average lending rate paid to resident MFIs by households and NFCs fell by 10 basis points since September 2018, to 3.48%. 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 in these two institutional sectors.

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	
	Sep.	Sep.	Sep.	Dec.	Mar.	June	Sep.
Total deposits(1)	**0.52**	**0.40**	**0.35**	**0.33**	**0.32**	**0.32**	**0.31**
of which							
Overnight deposits							
Households	0.07	0.06	0.06	0.05	0.05	0.05	0.05
NFCs	0.08	0.03	0.04	0.02	0.03	0.03	0.03
Time deposits (less than 2 years)							
Households	0.79	0.78	0.77	0.75	0.74	0.76	0.75
NFCs	0.71	0.57	0.74	0.76	0.71	0.62	0.73
Time deposits (more than 2 years)							
Households	2.76	2.48	2.20	2.13	2.07	2.03	1.98
NFCs	2.06	1.99	2.12	1.88	1.84	1.55	1.53
Total loans(1)	**3.69**	**3.63**	**3.58**	**3.55**	**3.52**	**3.50**	**3.48**
of which							
Households and NPISH	3.53	3.50	3.41	3.38	3.36	3.35	3.32
NFCs	3.92	3.83	3.85	3.83	3.79	3.75	3.74
Spread(2)	**3.16**	**3.22**	**3.23**	**3.22**	**3.20**	**3.18**	**3.17**
ECB MROs rate	0.00	0.00	0.00	0.00	0.00	0.00	0.00

Source: Central Bank of Malta.
(1) Annualised agreed rates on outstanding euro-denominated amounts belonging to households (incl. NPISH) and NFCs.
(2) Difference between composite lending rate and composite deposit rate.

4 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.
5 Basis points are rounded to the nearest whole number, and hence may not exactly match the figures given in Table 6.3.

The spread between the weighted average lending rate and the deposit rate closed the quarter under review at 317 basis points, slightly narrower than its level of 323 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 stable or falling demand for credit

According to the BLS, which was conducted in October 2019, respondent banks reported unchanged credit standards, terms and conditions for NFCs in Malta during the third quarter of 2019. Most banks surveyed also reported that credit standards were expected to remain unchanged in the fourth quarter of 2019. As regards the demand for credit by NFCs, half of the respondent banks assessed this to have decreased somewhat, while the remaining banks considered it to have remained unchanged. All banks anticipated stable demand in the fourth quarter.

Half of the respondent banks reported tighter standards, terms and conditions for credit for house purchases, while the remaining banks experienced no change. Looking forward into the fourth quarter of 2019, credit standards were expected to remain unchanged. As regards demand for house loans, half of the banks registered a decrease in credit demand in the third quarter of 2019, with the other half reporting unchanged demand. Responses on expected demand conditions in the fourth quarter of 2019 were mixed.

The assessment of developments in credit standards for consumer credit and other lending in the third quarter was also mixed. While half of the respondent banks reported that these were unchanged, other banks gave mixed replies. As regards demand for this type of credit, most banks reported unchanged conditions. Looking forward into the fourth quarter, no changes were expected in either standards or the demand for consumer credit and other lending.

The October 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, the majority of respondent banks generally reported unchanged market access to funding and risk transfer capabilities. One bank, however, reported some improvement in its retail funding conditions and access to the unsecured segment of the interbank money market in the previous three months. It also reported some improvement in access to medium to long-term debt securities and expected a further amelioration in the fourth quarter. No other changes were anticipated into the coming three months.

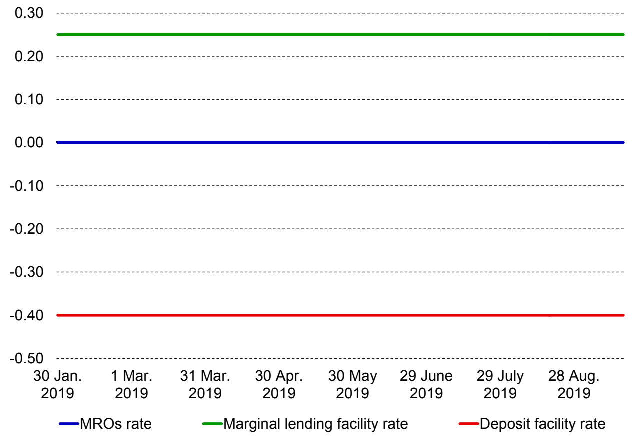
Banks were also asked to assess the impact of the expanded APP on their financial situation and on their lending policies and lending volumes. Banks reported that the APP had no impact on their balance sheets and profitability over the past six months and no changes were expected in the six months ahead. Furthermore, the APP had no impact on the participating banks' credit standards, lending volumes and terms and conditions.

As regards the impact of the ECB's negative deposit facility rate, most banks experienced a reduction in net interest income, which was expected to persist over the next six months. As regards lending costs and volumes, the majority of banks reported some loosening in lending rates and margins on loans to enterprises, loans to households for house purchases and, consumer credit and other lending as well as some increases in lending volumes. Such effects were expected to continue in the following six months. By contrast, none of the banks reported an impact on their non-interest rate charges.

BOX 3: LIQUIDITY CONDITIONS AND MONETARY POLICY OPERATIONS FROM MAINTENANCE PERIOD 1 TO MAINTENANCE PERIOD 5 OF 2019[1,2]

Introduction

Chart 1
KEY INTEREST RATE DEVELOPMENTS
(per cent)



Source: Central Bank of Malta.

This box describes the liquidity conditions in the Maltese banking system and monetary policy operations conducted by the Central Bank of Malta, as part of the Eurosystem's single monetary policy framework during the first five maintenance periods (MP) of 2019, covering the period between 30 January and 17 September 2019. The period under consideration follows the beginning of the reinvestment phase of the APP, resulting in the Eurosystem purchasing public sector debt securities, covered bonds, asset-backed securities as well as corporate sector securities to replace maturing assets bought under the APP. In this regard, the Bank only participates in the Public Sector Purchase Programme (PSPP) component of the APP.

During the period under review, the key ECB interest rates, that is, the rates on the MROs, the marginal lending facility and the overnight deposit facility, remained unchanged at 0.00%, 0.25% and -0.40%, respectively (see Chart 1).

Excess liquidity

Throughout the period reviewed, the Maltese banking system was characterised by high levels of excess liquidity. Excess liquidity is defined as the amount of deposits placed by banks at the overnight deposit facility of the Central Bank of Malta, net of the recourse to the marginal lending facility, plus current account holdings, in excess of the minimum reserve requirements (excess reserves).

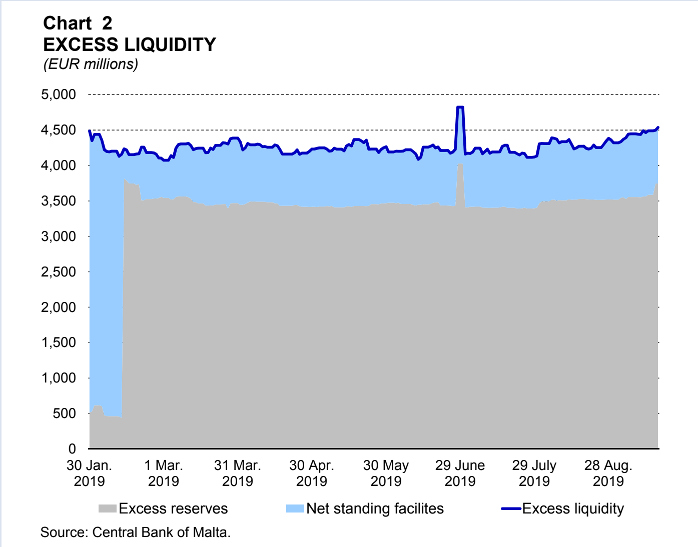
At the beginning of the period, excess liquidity stood at €4,487.4 million and remained relatively stable throughout the period reviewed, with a daily average of €4,263.8 million.

---

1 MP201901 (30 January-12 March); MP201902 (13 March-16 April); MP201903 (17 April-11 June); MP201904 (12 June-30 July); MP201905 (31 July-17 September).

2 Prepared by Ritlen Abela, Officer II, Monetary Operations and Collateral Management Office, and Nathan Chatland, Officer II, Monetary Operations and Collateral Management Office of the Central Bank of Malta and reviewed by Josette Grech, Manager, Monetary Operations and Collateral Management Office. The views expressed in the box are the authors' own and do not necessarily reflect the views of the Bank.

At the end of the period, excess liquidity stood at €4,536.9 million. The spike in excess liquidity that is illustrated in Chart 2 stemmed from excess reserves and is explained below.



At the beginning of the period, excess reserves stood at €511.9 million. Although they subsequently fluctuated slightly, excess reserves remained relatively stable around a daily average of €512.1 million up until mid-February. Following a shift from overnight deposits to excess reserves by one credit institution, excess reserves grew substantially, reaching €3,814.8 million on 13 February. Over the next few days, excess reserves fell gradually to €3,508.1 million, stabilising thereafter until the end of the fifth MP, averaging at €3,308.0 million. This stability was interrupted only temporarily by a significant current account deposit occurring on 28 June that boosted excess reserves to €4,027.7 million (refer to Chart 2). This deposit and subsequent withdrawal were the result of one bank temporarily depositing a higher amount in the current account at the end of the second quarter.

Developments in excess liquidity also reflect the use of standing facilities. Standing facilities are monetary policy instruments that facilitate the provision and absorption of overnight liquidity. The Eurosystem provides two types of standing facilities: the marginal lending facility and the overnight deposit facility. The marginal lending facility allows counterparties to borrow in order to meet short-term liquidity needs. On the other hand, the deposit facility allows counterparties to deposit overnight funds with the Eurosystem.

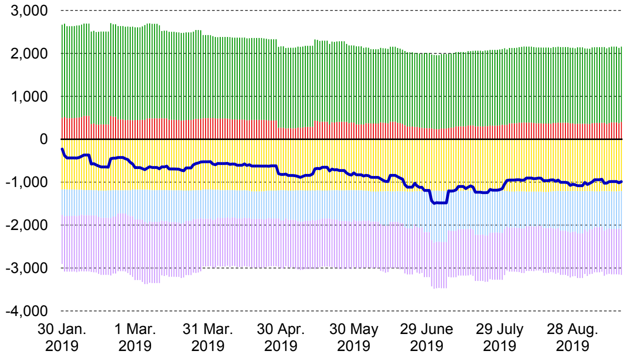
During the period reviewed, there was no utilisation of the marginal lending facility by local credit institutions.

During MP1, the balance on the overnight deposit facility stood at €3,975.5 million and remained relatively stable, with a daily average of €3,775.1 million until 12 February. Following the aforementioned shift from the overnight deposit facility to the current account, this figure fell to €420.4 million as at 13 February. Subsequently, the balance held in the overnight deposit facility followed an upward trend for the first few days and subsequently settled into a stable path, averaging €995.9 million for the period under consideration. By the end of the period, this figure stood at €790.7 million.

Autonomous liquidity factors

Autonomous liquidity factors are items in the central bank balance sheet that are neither monetary policy operations nor current account holdings of credit institutions. As the transactions driving autonomous factors involve central bank money, they have a liquidity-providing or liquidity-absorbing effect.[3,4] Essentially, increases in central bank assets entail the provision of liquidity, while increases in central bank liabilities involve the absorption of liquidity, and vice-versa.

Chart 3
AUTONOMOUS FACTOR EVOLUTION BETWEEN MP1 AND MP5 2019[(1)]
(EUR millions)



Source: Central Bank of Malta.
(1) Liquidity-providing factors are shown in positive figures while liquidity-absorbing factors are in negative figures.

Total autonomous factors were net liquidity-absorbing and stood at an average of -€531.0 million during MP1.[5] Autonomous factors continued to decline throughout MP4 reaching an average of -€1,161.5 million, before increasing slightly to an average of -€979.6 million during MP5 (see Chart 3).

The decline in autonomous factors was mainly the result of a drop in liquidity-providing factors, partially offset by a decrease in liquidity-absorbing factors. For the period under review, the average amount of liquidity provided via autonomous factors decreased by €485.0 million. This effect was mainly driven by a drop in net assets denominated in euro from an average of €2,163.6 million in MP1 to €1,764.3 million in MP5, as well as a fall in net foreign assets from an average value of €461.4 million in MP1 to €374.6 million in MP5. The average amount of liquidity absorbed via autonomous factors decreased by €36.3 million. This effect was mostly attributable to the effect of 'other autonomous factors' decreasing from €1,345.1 million in MP1 to €1,040.0 million in MP5. This decline was partially offset by increases in government deposits held with the Central Bank of Malta from an average value of €636.6 million in MP1 to €875.1 million in MP5 and in banknotes in circulation from an average of €1,182.3 million in MP1 to €1,212.6 million in MP5.

Monetary policy instruments

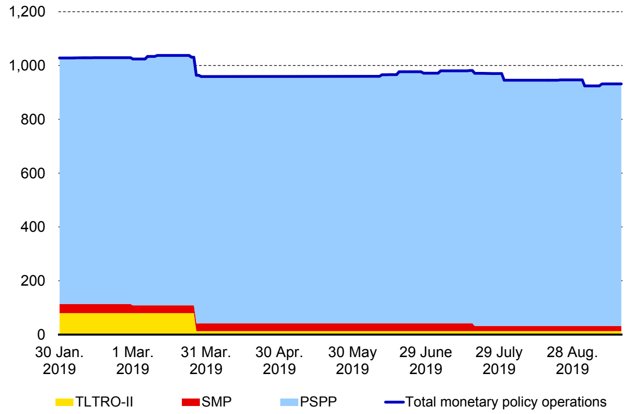
Open market operations

The Eurosystem uses open market operations to provide liquidity to monetary policy counterparties. During the period reviewed, given ample liquidity in the domestic banking

[3] Liquidity-providing factors include net foreign assets and net assets denominated in euro.
[4] Liquidity-absorbing factors consist of government deposits, banknotes in circulation and other autonomous factors.
[5] Given that total autonomous factors were net liquidity-absorbing, figures are depicted with a negative sign.

system, there was little participation by Maltese counterparties in such operations. In fact, there was no participation by Maltese banks in MROs except on 17 July when participation amounted to €1.0 million. Regarding the longer-term refinancing operations (LTRO), at the beginning of the period under review, there was an outstanding balance of €80.0 million from the TLTRO-II. On 27 March, voluntary early repayments for the TLTRO-II operations lowered the outstanding balance to €13.0 million. There was no participation by local banks in the 3-month LTRO during the period (see Chart 4).

Chart 4
EVOLUTION OF MONETARY POLICY OPERATIONS[1]
(EUR millions)



Source: Central Bank of Malta.
[1] There was minimal participation in the MRO and no participation in the 3-month LTRO.

Asset purchases

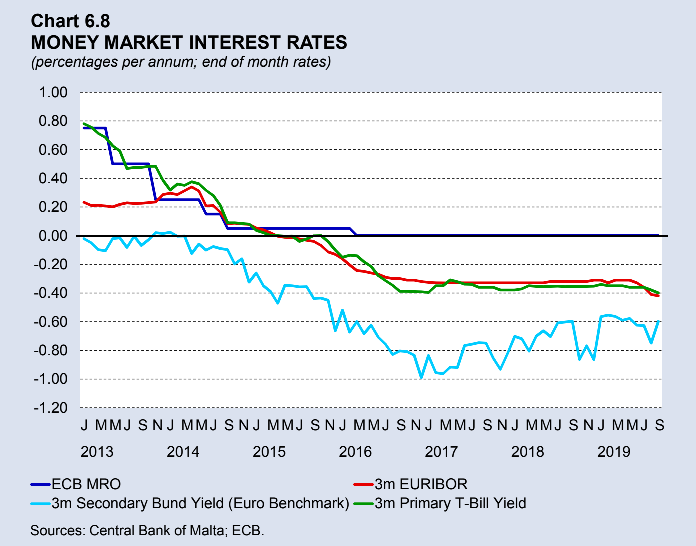
During MP1, the Central Bank of Malta's holdings of debt instruments under the Securities Markets Programme (SMP) stood at an average of €32.5 million.[6] These holdings subsequently declined, reflecting the maturing of securities, falling to an average value of €19.0 million in MP5.

PSPP holdings under the APP stood at an average of €916.6 million in MP1. These holdings remained relatively stable throughout, standing at an average value of €908.1 million in MP5. This change in volume reflects the net effect of the purchase of securities as well as the redemption of maturing securities that occurred in the interim.

[6] The SMP was announced by the Governing Council of the ECB on 10 May 2010, with the intention of ensuring depth and liquidity in malfunctioning segments of the debt securities markets and to restore an appropriate functioning of the monetary policy transmission mechanism. The SMP was terminated as from 6 September 2012 with the purchased securities held to maturity.

The money market

Domestic money market interest rates declined slightly



During the third quarter of 2019, the ECB lowered the interest rate on the deposit facility by 10 basis points to -0.50%. The interest rate on the MROs and the rate on the marginal lending facility remained unchanged at 0.00% and 0.25% respectively. In euro area money markets, the three-month EURIBOR fell to -0.42% from -0.33% at the end of June. Meanwhile, secondary market yields on three-month German government securities, which act as a benchmark for euro area yields, rose marginally to -0.60%, from -0.63% (see Chart 6.8).

In the domestic primary market, the yield on three-month Treasury bills declined to -0.40% from -0.36% at the end of June. The three-month yield in the secondary market also declined.

As the yield on the euro area benchmark rose during this period, the spread between this rate and the yield on domestic three-month Treasury bills narrowed. It fell to 25 basis points at the end of September, from 33 basis points at end June.

During the third quarter of 2019 the Government issued €248.0 million in Treasury bills, €21.8 million less than the amount of €269.8 million issued between April and June.

The capital market

During the third quarter of 2019, the Government issued four MGS with a total value of €180.0 million. Five institutions announced new bond issues: Bank of Valletta plc issued €50.0 million in unsecured subordinated bonds, Together Gaming Solutions plc issued €20.0 million unsecured callable bonds, Stivala Group Finance plc issued €15.0 million secured bonds, Merkanti Holdings plc issued €25.0 million in secured bonds and Hili Finance Company plc issued €80.0 million unsecured bonds.

By the end of December 2019, 22 firms had bonds that were listed on the MSE through Prospects, up from 21 at the end of June. Overall, €2.0 million worth of bonds were issued through this facility during the third quarter of 2019. In the secondary market, government bonds turnover rose to €89.6 million during the quarter under review, compared with €75.2 million in the second quarter of the year, while turnover in corporate bonds rose to €23.1 million, from €22.5 million.

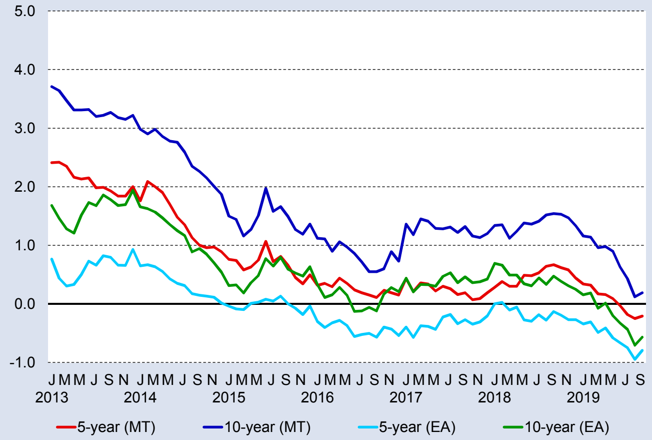
During the third quarter of 2019, secondary market yields on Maltese government bonds fell (see Chart 6.9). The yield on five-year bonds fell significantly and ended September at -0.21%, from -0.03% at the end of June. The decrease in the yield on ten-year bonds was even more pronounced, as this fell by 44 basis points, to end September at 0.19%. In the euro area, the yields on five-year and ten-year bonds fell by 13 and 24 basis points, ending the third quarter of 2019 at -0.79% and -0.57%, respectively. As the domestic ten-year yield fell faster than the euro area benchmark yield, the spread against the latter narrowed to 76 basis points, from 96 basis points in the preceding quarter.

MSE share index ends September at higher levels

Share prices in Malta, as measured by the MSE Equity Price Index, rose during the third quarter of 2019, gaining 2.1%. The Index stood 12.1% above its level in the preceding year (see Chart 6.10). The MSE Equity Total Return Index, which accounts for changes in equity prices and dividends, was 2.3% higher than its level at end June.

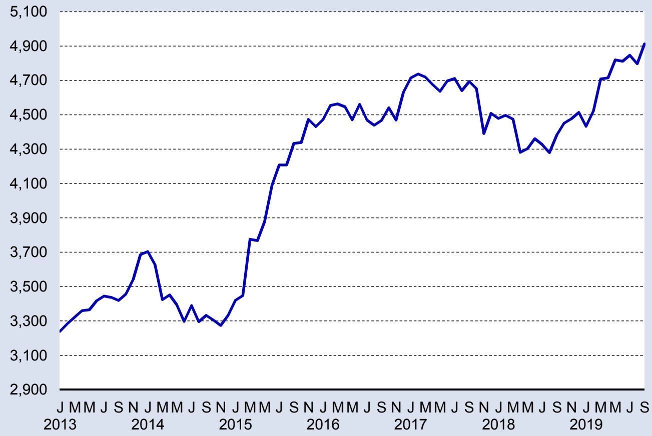
Equity turnover rose to €22.4 million during the third quarter of 2019, from €21.9 million in the second quarter.

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



Sources: Central Bank of Malta; ECB.

Chart 6.10
MSE EQUITY PRICE INDEX
(end of month)



Source: MSE.

PROGRESSING SAFELY IN A RISKIER WORLD[1]

Dr Mario Vella
Governor of the Central Bank of Malta

Dear President and Members of the Committee of the Institute of Financial Services (IFS) Malta, personally and on behalf of the Board of the Central Bank of Malta, I thank you for this opportunity to address this distinguished audience and through them the financial services industry. Dear Minister, distinguished guests, dear colleagues and friends.

Last year, I observed that the external environment was becoming less supportive of activity. Incoming data confirm this view. Global GDP growth has continued to weaken. According to the IMF's October 2019 World Economic Outlook, global growth in 2019 is projected to be 3.0%, the lowest rate since 2009 and 0.5 percentage points less than its January 2019 projection.

A number of factors are reflected in this state of affairs, a fluid state of affairs that is characterised by high volatility and uncertainty, a state of affairs that is anything but steady. Amongst these factors are simmering political tensions and flashpoints within and between states around the globe (some of which may eventually erupt as armed conflicts), uncertainty about future trade policies amongst which are (but certainly not the only ones and not the ones with the most far reaching negative consequences) those related to Brexit, and the impact of climate change and related policies including and especially policies that deny the man-made causes of climate change. The consequences of these factors on investment and trade are being amplified by a deterioration in business confidence.

Projections for 2020 also point to weak momentum, as most of the prevailing sources of uncertainty are expected to persist. While global GDP growth is expected to reach 3.4% next year according to the IMF, this is still below the 3.8% recorded in 2017 and the pick-up is largely driven by emerging and developing countries. By contrast, average GDP growth in advanced economies is expected at 1.7% this year and next, down from 2.3% in 2018. A lower rate is projected for the euro area, as growth in its larger economies with the exception of Spain is expected to stand far below 2.0%.

Although Malta is a small economy with a relatively high exposure to the international business cycle, it has maintained its resilience. In 2018, GDP grew by 6.8%, the second highest rate in the European Union. This mainly reflected a very robust expansion in domestic demand. Although smaller, the contribution of net exports was also positive, reflecting continued export growth. While GDP growth moderated in the first half of 2019, at 4.7% it remained comfortably above the euro area average of just above 1.0%.

We expect the positive momentum in Malta to persist in both 2019 and 2020. Domestic demand is foreseen to remain the main driver of economic activity. Favourable labour market conditions, as reflected in a further decrease in unemployment since late 2018, and a dynamic, albeit gradually normalising housing market, should continue to support household income and private

[1] Speech given at the Annual Dinner of the *IFS* Malta on 19 November 2019.

consumption. Moreover, growth in government consumption will remain elevated, as Government is expected to use some of its fiscal space, while investment is expected to maintain a high share in GDP, reflecting the substantial upgrade to Malta's infrastructure.

Nevertheless, growth is set to moderate compared with 2018, reflecting two main factors. Firstly, given the less favourable external environment, we foresee lower contributions from exports. Secondly, it is to be expected that an economy that has been growing very fast to gradually return to rates that are more in line with its long-term growth.

The balance of risks is tilted to the downside. This mainly reflects the risk that economic conditions abroad deteriorate further, in which case the recent slowdown in some of our closest trading partners could develop into a more severe downturn, limiting the expansion in our exports. These risks are seen as more elevated than the upside risks associated with domestic factors. For example, the labour market's resilience and strong liquidity position of households could be reflected in higher than expected private consumption. Government expenditure could also surprise on the upside.

Indeed, Malta is one of few countries in the euro area which has the fiscal space necessary to mitigate the effects of weaker foreign demand. Ideally Government should utilise this space to enhance the economy's capital stock and potential growth. In a recently published study, Central Bank of Malta staff analysed in detail the effects of increases in government investment on the Maltese economy under different financing scenarios.

Under all financing scenarios considered, an increase in government investment is expansionary throughout. In the short run, the expansionary effects are limited to demand-side effects. However, as government capital stock accumulates, significant supply-side effects begin to kick in. A higher government capital stock helps reduce marginal costs, boosting factor productivity and helping to crowd-in other private factors of production. The reduction in economy-wide marginal costs in turn should lower overall prices, boosting competitiveness and exports.

In line with other analyses, the study also shows that even if not debt-neutral, using fiscal space to finance government investment has the strongest effects on real activity in the short-to-medium run. A debt-financed 1 percentage point increase in the government investment-to-GDP ratio increases real GDP by 1.5 percentage points from its baseline level by the fifth year. Even if the investment ratio returns to its pre-shock level, GDP would still exceed its baseline level by around 1% by the tenth year. Thus, an expansion in public GFCF expenditure can help mitigate the negative impact that weaker external demand might have on Malta's economy.

Further investment in human capital is also necessary. Malta's positive economic record is also partly reflected by a growing influx of foreign workers. These now account for around a fourth of all employment. Although foreigners, including non-EU nationals, are present in all sectors and at all levels, their employment has increased mainly in professional and administrative support services, and not as is sometimes claimed, in sectors characterised by lower skill levels. The increased employment of foreign nationals across occupations has enabled organisations to grow and venture in new areas. A sudden reversal of this pattern could stall activity in several sectors. Efforts to upgrade the country's infrastructure should therefore be complemented by measures that prevent a disorderly depletion of foreign human resources and enhance the skills of Maltese nationals.

***

Favourable economic developments, although easing somewhat, are expected to continue to buttress financial stability. Lending volumes remain supportive of interest income but pressures on margins persist due to the low interest rate environment. Notwithstanding, profitability remains a challenge for traditional banking models such as those of our banks. In fact, though still comparing favourably with their European peers, the profitability of domestic banks has been slimming. In addition to the limitations on their ability to generate more interest income, banks have to contend with 'no-fee' alternative products being developed by fintech players which operate with a lower cost base and hail from a less intrusive regulatory environment.

Concurrently, banks are facing a more rigorous and intrusive supervisory approach coupled with more rigorous standards of Anti Money Laundering and Combating the Financing of Terrorism. This is absolutely necessary and has our full and active support. Of course, this changing environment requires significant investment in technologies and human resources with added pressure on banks' bottom line. Also it may potentially encourage more risk aversion, despite the ultra-accommodative monetary policy stance. It is critical, therefore, that regulators ensure a level playing field to avoid regulatory arbitrage and push banks to retrench, thus creating market gaps that can be exploited by less regulated, or more importantly, by totally unregulated players. Today's increasingly digitalised world enables these gaps to be filled with relative ease.

Institutions must embrace innovation while exploiting more effectively and smartly the prevailing benign economic conditions, to discover new investment opportunities and niche markets. It is also an opportune time for banks to keep sight of their longer-term sustainability and maintain their efforts to repair their balance sheet, reduce concentrations and improve asset quality. This is what ultimately strengthens prospective future cash flows and what supports profitability. Banks are also, of course, entitled to set their own risk appetite. In well-functioning markets, business opportunities shunned by one bank will be taken up by a competitor, if the latter feels more confident that it can manage the underlying risks more effectively.

There will always be a residual sort of non-bankable business, and we must accept this fact. If, however, a business in search of a bank is especially risky but legitimate, there is no reason why we should not welcome specialist legitimate players capable of withstanding the most rigorous standards of supervisor scrutiny.

To blame all on-boarding failures only on an ultra-conservative banking sector is simplistic and counterproductive. Reality is more complex than that and the causes might vary from the risk appetite of the European supervisory landscape that follows a common rule book, to problems of asymmetric information, complex corporate structures or business models.

Unless we get down to this level, we can never really pass judgement on the actions of banks regarding who they on-board. Banking is all about risk management and banks with a zero risk appetite will eventually starve and be forced out of the market. Such risk aversion should not come at the expense of the right of all citizens to access basic banking services, as this will fuel financial and social exclusion. Banks should therefore be encouraged to use their judgment and sense of proportion when exercising due diligence, and to consider their responsibility given their pivotal role in the financing of the economy.

Although certain AML/CFT vulnerabilities had already been identified at a national level and actions were already underway and although the Authorities pledged their commitment to fully address these issues, the Moneyval report has set targets that we must reach. Financial systems trade in confidence and credibility and unless we address these shortcomings, we will be unable to develop our sector further.

The most challenging recommendations found in the report are those requiring a change in mind-set, such as the identified lack of awareness of AML risks in non-bank financial institutions and the wider professional community, resulting in a very low number of suspicious transactions reports being filed by them. We all have a collective responsibility and nobody can procrastinate in getting our house in order.

On a related note, our size will always present diseconomies of scale for large correspondent banks when evaluating their risk-adjusted returns from Maltese business. The risk aversion of these banks is impacting more heavily on the smaller jurisdictions. It is essentially a market failure, a true manifestation of asymmetric information. This does not mean, however, that we should be complacent and fatalist. While banks and authorities continue to search for technical solutions, we are all duty-bound to endeavour to convince these banks that they are dealing with a reputable jurisdiction and that our market players are fit-for-purpose in an age of increasing global financial transparency. These correspondent banks have neither the time nor the interest to understand risky business models or the overly-complex structures of your clients. As practitioners, you are the system's first line of defence. The more layers of controls in the system, including a thorough understanding of clients and business models, and the less complex their corporate structure, the easier it is for banks to service them.

There is indeed purpose in our cause to safeguard what we have achieved so far. This sector, which directly contributes to a significant 5.3% of gross value added and provides for the livelihood of over 11,600 employees, is in good health. This is attested by the positive assessments from major rating agencies and the IMF as recently as last year. These conclusions are also corroborated by the results of the Central Bank of Malta's stress tests which regularly feature in our publications. So let us all rise to the occasion, and work towards preserving the sustainability and reputation of our sector.

***

Inequalities are of two broad types: legacy inequalities and inequalities that are consequences of present social and economic developments. Gender inequalities have roots deep in the past. Today's faster economic growth, however, does bring with its own risk of social shocks. The risk of higher inequality is a case in point. As already announced in my previous IFS address, the Bank has begun to develop a social research capability that focuses on studying inequalities of both types. This is a new experience for the Central Bank of Malta and we are striving, within the limits of available resources, to produce high quality empirically based results by the first quarter of next year.

We are, however, striving to go beyond producing knowledge. In our efforts to promote inclusiveness and diversity in the Bank itself, we have made modest but significant steps forward.

Whereas until 2003 there were no women in the Central Bank of Malta's Board of Directors, in 2010 there were two women Board directors, and in the current year, 2019, we continue to have two women Board Directors, that is half of the non-executive directors. In 2008, there were no female members of staff among the 31 employees in the top band, comprising the grades of senior executive, head and chief officers. In 2013, there were 6 out of 38. Presently, in November 2019, there are 12 out of 45. Small steps forward indeed but not insignificant: a clear sign of progress is shown by the fact that if we take the key role of heads, whereas there was only one female head in 2014, there are now 6. The gender distribution of staff below the senior executive grade is predictably more equitable, with 56.7 per cent of all staff in the grades concerned being women, compared to 47.3 per cent in 2008. Conversely at the very top level, that of the Deputy Governors and the Governor, we have to date no woman. That at the very top of the ECB, in the Governing Council, the situation is even less balanced than ours, is certainly no consolation for us. However, that the new President is a woman, Christine Lagarde, is hugely significant.

***

As hinted during the launch of our Annual Report last May, the Bank is stepping up its involvement in sustainable finance. In July, the Central Bank of Malta joined the Network of Central Banks and Supervisors for Greening the Financial System, a collaborative structure that aims to green the financial system and strengthen the efforts of the financial sector in achieving the Paris climate agreement goals. This includes mobilising capital for green and low-carbon investments. Staff members have joined work streams to further research in this area and adopt a number of proposals. Furthermore, the Central Bank of Malta is also represented in the Sustainable Advisory Committee of the Bank for International Settlements and is working in aligning our international portfolio towards holding more green bonds.