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Transformation in Global Turbulent Times

I would like to start by thanking the IFS for its contribution to professional development within the financial services industry, and for the opportunity in this annual event to share my thoughts about matters concerning the economy and the financial sector in Malta.

We have all heard the expression "no man is an island". That expression equally applies to nation states. Although Malta is an island, we are intrinsically part of the global economy. We are an island that is inherently reliant on international trade, both in respect of the consumption needs of households, as well as the production requirements of all types of businesses, irrespective of size or nature. What happens in the global economy is not only relevant for Malta, but critical, because for many centuries throughout its history, this island has always relied on international trade for its survival.

We meet at a time of not only exceptional uncertainty globally, which has been around for quite some time now, but it is also a time of significant turbulence that is seeing social unrest, spreading across several Member States of the European Union, mostly driven by energy cost of living considerations, but also that for housing.

The global economy has been navigating from one major shock to another. Increasingly, these shocks overlap and amplify one another, prolonging the challenges that we have been facing for several years.

The crisis in the Middle East is the latest, but the unjustified invasion of Russia in Ukraine also remains a pressing one. These conflicts have upended global energy markets - increasing their volatility and raising energy prices to elevated levels for a prolonged period, apart from disruptions in transport routes that impact supply chains. This has made it not only harder for businesses to plan with confidence but has affected also households in maintaining their living

standards, let alone to improve them. Trade policy uncertainty is another shock that continues to linger.

The consequences of such shocks are very much visible. Inflationary pressures have re-emerged worldwide, and particularly for Europe, which is a net importer of energy, with inflation projections being revised upwards periodically this year, and most likely to be revised upward again by the ECB next month.

But apart from the impact on energy prices of such conflicts, the consequences of climate change and extreme weather events on food prices and costs of natural disasters, have become very much real, and impact both families and businesses.

The rapid development in technology, like that of AI, is also becoming another source of uncertainty. This is creating demand pressure for certain industrial inputs, like microchips, used by several industries, as well as more energy needs by data centres, spreading upward price pressure elsewhere. These technology firms are also borrowing heavily, tightening global financial conditions, where it is yet unclear whether AI will be able to generate the returns expected by investors, which could have repercussions on financial markets, and we have started to see some of this lately. This apart from its uncertain implications on the labour market, particularly for white collar jobs.

Within this context, monetary policy, at least in the Eurosystem, has responded decisively, with the Governing Council raising interest rates twice since June, and we stand ready to continue to act if new information shows that risks of indirect and second round effects on inflation are becoming more likely, or begin, to materialise.

Where does all this leave Malta?

The Government has remained fully committed to its policy of keeping energy prices stable, to shield households and businesses from the hikes in international energy prices.

But being shielded does not mean that our country is insulated from or unaffected by such global events.

Malta imports most of what it consumes, along with many of the inputs that local businesses depend on. If the cost of producing and transporting goods rises abroad, those increases will be transmitted to us through import prices, freight charges, and other business costs.

The crisis may also reach us through weaker activity abroad. Higher energy costs could slow growth among our trading partners and dampen demand for the goods and services we export to them.

From a country perspective, higher prices, both of energy products and all other goods and services, would mean higher payments to countries with whom we trade for our needs. This would require us to either earn more from our exports, borrow more from abroad, or sell our assets to finance such increased cost.

Similarly, from a fiscal perspective, Government policy to subsidise rising energy costs requires either stronger tax revenue, or restraint in expenditure to prevent the deficit from increasing beyond acceptable limits required by EU rules.

But there are still good reasons for optimism, provided we act diligently.

Malta's economy has weathered recent shocks remarkably well. Over the past four years, it has grown annually on average by 5.3%. Contrary to local popular belief, after accounting for the import content of domestic and foreign demand, much of that growth has come from exports, particularly services such as tourism, gaming, IT and other professional services. Indeed, the current account in the Balance of Payments has generally remained in surplus, underlining the central role of exports in financing our import needs, which has led to a rise in the country's holdings of foreign assets.

This resilience is no accident and neither a question of luck. It is the result of a longer transformation, in which Malta built a broader competitive services base, and its success in attracting foreign direct investment.

And we continue to see this again this year. Growth averaged 4.4% in the first half. Inflation averaged around 2.2% over the first nine months, suggesting that price pressures have so far remained largely contained, although risks of higher imported inflationary pressures are there.

However, it is no time for complacency as we expect inflation to rise next year with higher prices abroad gradually feeding through to the domestic economy.

It is also important to think more about beyond the immediate future. Because once again, we are at the juncture where we need to face stark, but necessary, choices. If we want to sustain our success, we need to ask ourselves the question:

What will determine the performance of the Maltese economy over the next decade or so?

Several factors have contributed to our growth in recent years, but these have particularly relied also on a rapidly expanding workforce, largely through migration, given Malta's indigenous demography, conditioned by its low fertility rate, which as with many advanced, financially rich economies, is really more a product of cultural factors - including fewer longer-term relationships, than of financial constraints, as indicated in a recent survey conducted for the State of the Nation event organised by the President of the Republic, where a large majority of respondents snubbed the introduction of financial benefits as an incentive for additional children.

While Malta's transition from a country characterised by mass emigration to inward migration reflects the success of Malta in investment and job creation, that has brought clear benefits, the tightness of the domestic labour market and the constraints of the physical size of the island, requires us now to rely much less on expanding our workforce alone to deliver further strong growth in the years ahead.

The answer is more productivity driven growth. This is nothing new and we have heard ad nauseum many commentators locally on this. But ultimately productivity-led growth rests on the private sector to be willing and able to engage in less labour-intensive activity, or in transforming its production processes to more productive ones through smarter investment. On its part, fiscal policy can provide incentives that would make the relative price of additional labour to capital more expensive to drive employers to make the switch. This is my interpretation of some of the measures announced in the latest Budget presented by the Minister for Finance.

However, the public sector, including the various authorities and bodies, need themselves to exercise restraint in expenditure and recruitment. Public expenditure is this year estimated at almost Eur10 billion (almost 38% of GDP). But rather than focussing on how much is being spent, attention needs to be more directed towards stronger accountability by assessing outcomes relative to cost, ideally benchmarking with best-performing countries. This is much needed in respect of various public services, especially in education which provides the potential for skills of the work force, in outlays related to development of the infrastructure, but also in the provision of various other public services and regulatory functions.

Both public and private economic operators need to evolve in how they operate.

Across all sectors, investment in and adaptation to technology is central. Artificial intelligence is already reshaping how we work. It can reduce time spent on repetitive tasks, improve access to information, and free workers to focus on activity that requires relevant experience and judgement. But buying new tools does not, by itself, increase productivity. It requires changes in the way we operate, and investment in reskilling people to enable them to adapt to these new tools and production processes.

Such change will not be without pain. Jobs will change, and certain tasks will disappear. Smaller firms may struggle with the cost of investment or lack the expertise they need. Support for training, reskilling and lifelong learning will therefore be essential, together with a strong social safety net for those who inevitably may fall by the wayside.

This is where Government has a vital role.

Investment in transport, energy, water, waste management and digital connectivity is intrinsic to the productivity agenda.

All of this requires financing, which is why sound public finances matter a lot. Malta's fiscal position is sound, with the deficit below 3% of GDP and government debt remaining well below the 60% threshold required by the EU. While this provides sufficient fiscal space, nevertheless, this is not a given and should not be taken for granted, as we will continue to face hard choices.

In times of energy crisis like these, we are quickly reminded how broad, open-ended subsidies impact public finances. Subsidies should be timely, targeted, and temporary. While the introduction of such subsidies was timely and now is certainly not the time to remove them, nevertheless these could be better targeted, and an exit plan needs to be carefully crafted. The prolonged presence of such costly outlays does not only impair the price signal from its effectiveness in altering consumer behaviour, but it may also push Government in postponing investments in resilience and efficiency because of the need to comply with EU fiscal rules.

That said, we should gradually move away from subsidies with great care, especially those relating to electricity, so that households and businesses have time to adjust, ensuring that the most vulnerable are protected, and at the same time expand our capacity in generating energy from renewable sources, despite challenges in reducing dependencies on third countries, given our limited land area.

A productive economy also needs a sound and resilient financial system.

The challenging international environment that we live in also has implications for the domestic financial sector. Banks need to navigate not only geopolitical and economic uncertainties, that traditionally affect market risk, but also cyber threats, climate-related risks, and rapid technological changes. Indeed, recent events have brought some of these novel risks into the forefront. The recurrence of extreme weather events and very high temperatures experienced during summer are testimony to the growing physical climate risks, while the rise of AI-enabled fraud cases demonstrates the evolving threat posed by new technologies. These are a stark reminder that risks once thought to be as emerging, are indeed increasingly becoming a very real present threat.

But this evening, I would like to focus on risks that are much closer to home. While these risks may appear less novel, they are no less important for the resilience of our financial system, and especially so for Malta's longer-term economic prospects.

Let me begin by highlighting that our financial system is in a position of strength. Domestic banks are well capitalised, highly liquid and profitable, while asset quality remains sound with NPL ratios standing at historic lows. This situation reflects prudent management, a strong deposit base, as well as years of nurturing resilience. Nevertheless, we must avoid complacency or assume resilience as a given. A business model that today may well be safe and profitable, does not necessarily mean that it remains fit for Malta's future needs.

As highlighted earlier, if future growth is to be driven by productivity rather than by more labour inputs, then this will reshape demand for housing and construction finance. Banks need to look beyond the current strength of their balance sheet and consider whether their portfolios and lending capabilities are increasingly in tune with the direction of a more digital and less labour-intensive economy.

Currently, bank credit continues to expand rapidly, significantly more than GDP growth, but driven by mortgages and lending to construction, real estate and accommodation which together account for almost three-quarters of resident lending, and with sustained double-digit growth in credit directed to these same sectors, this concentration is set to keep growing. While property is a familiar form of collateral, one cannot ignore the existing concentration risks within the lending portfolios, even if NPLs are currently low. When several borrowers, firms, and banks are exposed to the same economic sector, the system can become vulnerable to common shocks. Besides, concentration in real estate related credit, risks also crowding out the financing needed in the transition to a more productivity-led growth, which from what I hear

from all quarters, is what Malta is aspiring for. To be fair, it is not just about credit supply, but also a question of supply of local entrepreneurs who are also truly willing and able to move in this direction, rather than sticking to real estate in their credit demand, including on the domestic capital market.

However, interest rates in Malta have remained comparatively low, partly reflecting the limited monetary policy passthrough. This has helped to sustain activity in the property market by keeping borrowing costs relatively stable and very low, with savers subsidising such borrowers, as property price inflation for several years has consistently outstripped lending rates, and by an increasingly wide margin over the past five years.

From a policy perspective, macroprudential policy, and in particular, borrower-based measures which regulate credit standards in lending, remains currently, borrowing from Mario Draghi's words, "*the only game in town*" to counter these demand pressures. If current trends continue, such standards could become more binding for a growing share of borrowers. Should this become the case, then one should not conclude that current standards are an impediment, but rather a symptom of an unsustainable demand for credit.

Relaxing borrower-based measures in such circumstances would not represent a responsible course of action by the Central Bank of Malta as the macroprudential authority. Easing such measures would imply that the price signalling mechanism would be increasingly distorted, as demand is accommodated further, in the same way that energy subsidies distort the price signalling properties needed to alter behaviour in energy consumption.

Some do expect the Central Bank to relax further such measures when the already lowered credit standards become binding again. But for those who are grey haired, like I am, this reasoning is reminiscent of a scenario that was the root cause of the great financial crisis of 2008, where overly loose credit standards and cheap funding contributed to excessive risk-taking, creating a sub-prime market with serious under-pricing of risk by the banking sector. Ultimately, households bore the brunt, especially those that had taken on unsustainable levels of debt. This is precisely the outcome that a responsible Macroprudential Authority seeks to avoid and pre-empt.

I am not suggesting that the current state of the real estate market in Malta is anywhere close to this scenario, but the reality is that the economic principles that apply to others, do apply also to us.

We need sober and disciplined policy making, aimed at minimising distortions in the signalling properties of the price mechanism, and reduce overreliance on demand stimulating or supporting policies, which in the end only sustain inflation, or alternatively a need to continue expand supply, which would mean a need for even more people to fill more residential units, which would fly in the face of the consensus we hear on support for productivity-led growth and less reliance on having more people on the island, for whatever purpose.

The Central Bank of Malta is steadfast in doing its part by maintaining discipline in credit standards. This may not make us popular, but our loyalty is to our mandate, which is price stability, as well as safeguarding financial stability. Our policies are aimed at reducing the risk to households in over-stretching themselves, as well as protecting the financial system from such risk. Policies related to borrower-based-measures are there to protect not only lenders but also borrowers, especially the more vulnerable ones, even though these measures could prima facie feel as overly restrictive. Such measures play a crucial role in limiting the build-up of excessive leverage and ensure that lending standards remain prudent as property market conditions evolve.

Housing affordability is, of course, an important social concern, but macroprudential policy needs to be vigilant to the risk associated with households and firms taking on more debt, unless this is sustainable. Hence, any affordability issues are better addressed through targeted structural and social policies. And even here, fiscal policy needs to appraise more thoroughly the expected effect that different measures have on prices and the beneficiaries' demand for more credit; as for example the impact that demand-side measures usually have on prices, as opposed to supply-side alternatives.

On its part, the Bank remains ready to act within its mandate to preserve financial stability, as well as to foster the right incentives for the financial sector to support the much-needed productivity-led growth that Malta aspires.

To conclude, we are currently navigating a very turbulent international environment, which brings with it several challenges. However, we have the advantage of starting from a position of strength, in terms of economic resilience, fiscal space, and soundness of the financial system. This does not mean that the status quo remains the optimal choice, but it neither implies that some radical revolution to our economy is needed.

The financial system always had a big role to play in previous periods of transformation, and this time is no different. The financial system too will also need to adapt and evolve as it

manages vast financial resources, where their mobilisation will be key in financing the needs of this economic transformation.

Once again, I thank the Institute for bringing us together this evening and I wish you all an enjoyable time.