EXECUTIVE SUMMARY

Global economic growth moderated sharply during 2022, as the war in Ukraine and other geopolitical factors offset tailwinds resulting from the re-opening of economic activity after the COVID-19 pandemic. The war in Ukraine and the international response to it led to further upward pressure on prices of energy and food commodities, as well as intermediate inputs in production, amid renewed uncertainties about supplies. As a result, consumer price inflation increased globally, in some countries reaching double digit rates. This has significantly dented households' spending power, while at the same time induced several central banks to embark on a monetary policy tightening path. Together with other factors such as concerns about fiscal sustainability, risk aversion and falling stock prices, this has been reflected in tighter global financial conditions.

The euro area economy

In the euro area, real gross domestic product (GDP) grew at a more moderate rate, but nevertheless still strong pace of 3.5% in 2022, after rebounding by 5.3% in 2021 from a low level of activity. Growth in 2022 mainly reflected a robust contribution from domestic demand from the reopening of activity, while the contribution from net trade was marginally negative.

The labour market continued to show resilience, with employment as well as the participation rate surpassing pre-pandemic levels and total hours worked not far off. Meanwhile, the unemployment rate fell to 6.7% by the end of the year, from an average rate of 7.7% in 2021.

As in many other advanced economies, the euro area economy was negatively hit by surging inflation. The annual average rate of inflation based on the HICP reached 8.4%, from 2.6% in 2021. This increase mainly reflected a very strong rise in energy prices, which rose by 37.0%, reflecting sharp increases in prices of fuels, gas and electricity following Russia's invasion of Ukraine. However, prices of food, non-energy industrial goods (NEIG) and services also rose at a faster pace compared to 2021. In fact, HICP inflation excluding energy and food reached a record yearly average of 3.9%, from 1.5% a year earlier.

In this environment of very high inflation, the Governing Council of the ECB started to unwind its accommodative monetary policy stance to achieve the inflation objective of 2% over the medium term. The three policy rates were raised by a cumulative 250 basis points by the end of 2022 – two further 50 basis point rate hikes were announced in February and March 2023.

During the year, the Council also took initial steps towards balance sheet normalisation. In March, the Governing Council revised the purchase schedule for the asset purchase programme (APP) for the ensuing months, lowering the amounts to be purchased. It also stated that if incoming data supported the expectation that the medium-term inflation outlook would not weaken, even after the end of these purchases, net purchases under the APP could end in the third quarter of 2022. Indeed, net purchases under the APP ended on 1 July. Initially, the Council restated its intention to continue reinvesting, in full, the principal payments from maturing securities purchased under this programme for an extended period after the ECB's first interest rate hike to maintain favourable liquidity conditions and an ample degree of monetary accommodation. In December, however, incoming data led the Council to reassess the situation, and it was decided that full reinvestments of maturing APP securities would only continue until the end of February 2023, after which the APP portfolio would decline at a measured and predictable pace. The decline will amount to €15 billion per month on average between March and June 2023, with the subsequent pace being reassessed over time.

As regards the pandemic emergency purchase programme (PEPP), net purchases under this programme ended in March 2022. However, reinvestments will continue until at least the end of 2024. Redemptions coming due in the PEPP portfolio were reinvested flexibly to prevent risks to the monetary policy transmission mechanism related to the pandemic.

During the year under review, the Governing Council also approved a new Transmission Protection Instrument (TPI) to help prevent disorderly market dynamics that pose a serious threat to the smooth transmission of monetary policy across euro area countries. By safeguarding the transmission mechanism against market fragmentation, the TPI will allow the Governing Council to more effectively deliver on its price stability mandate.

Meanwhile, the favourable conditions applicable to targeted longer-term refinancing operation III (TLTRO) ended on 23 June 2022. Furthermore, new interest rates became applicable on TLTRO III from 23 November 2022, and banks were also offered additional voluntary early repayment dates. This decision was taken in view of the unexpected and rapid rise in inflation, and the need to recalibrate the terms and conditions on this instrument to align them with the broader monetary policy normalisation process and reinforce its transmission to lending conditions in the wider economy.

In October, the Governing Council also decided to align the remuneration of minimum reserves with the ECB's deposit facility rate, thereby bringing this remuneration rate closer to money market conditions.

Maltese economy

Economic growth in Malta continued to exceed that recorded for the euro area. In 2022, GDP rose by 6.9%, with growth being driven by domestic demand.

The labour market continued to benefit from the reopening of the economy. According to the Labour Force Survey (LFS), employment increased at an average annual rate of 5.0% during the first three quarters of 2022, up from 2.4% in the corresponding period of 2021, and well above the average growth rate of 3.3% estimated since 2003. The unemployment rate based on LFS data, but incorporating also administrative data up to December, stood at 3.0% in 2022, down from 3.4% a year earlier. This decline occurred at a time of a significant increase in net inflows of migrant workers. The unemployment rate stood below the Bank's estimate of structural unemployment, confirming signals from other indicators – such as the ratio of the job vacancy rate to the unemployment rate – and from surveys, that labour market conditions are very tight. Unemployment also remained firmly below that in the euro area.

Data for the first three quarters of the year show a narrowing of the fiscal deficit, partly driven by buoyant tax revenue, and the phasing out of expenditures related to the pandemic. Nevertheless, the fiscal deficit remained significant, in part due to several inflation mitigation measures, exacerbated by the fallout from Russia's invasion of Ukraine. The Bank estimates that the general government balance will show a deficit of 5.2% of GDP in 2022, while debt is estimated to have reached 54.8% of GDP.

Between January and September, the current account balance showed a smaller surplus compared to the same period of 2021, reflecting a widening in the merchandise trade deficit, partly also because of higher imported inflation, and higher net income outflows. These outweighed an increase in net services receipts. When measured over the four quarters to September 2022, the current account surplus was equivalent to 2.2% of GDP.

The annual rate of inflation based on the Retail Price Index (RPI) reached 6.2% in 2022, from 1.5% a year earlier, while similarly HICP inflation also rose strongly, averaging 6.1%, from 0.7% in 2021. The rise in inflation over the course of 2022 was broad based across all non-energy components, while energy inflation stood at zero due to fiscal measures.

Nevertheless, HICP inflation in Malta remained below that in the euro area, which ended the year at 9.2%. The difference between Malta's inflation rate and that in the euro area reflected the latter's high energy inflation rate, which contrasted with zero energy inflation in Malta arising from Government measures.

According to the Bank's latest projections, GDP growth is set to moderate significantly from the strong growth registered in 2021 and 2022, as pandemic related re-opening effects diminish in importance and underlying headwinds from the international economic environment gain traction. At the same time, Malta is expected to avoid the short-term recessionary risks faced by some of its major trading partners, with economic growth expected to remain close to potential between 2023 and 2025.

Despite some easing of global supply chain disruptions, inflationary pressures are expected to remain elevated and widespread during most of the forecast horizon, as recent increases in imported inputs transmit to consumer prices. Hence, overall HICP inflation, while significantly higher than the ECB's target of 2%, should remain below that in most euro area countries. According to the Bank's latest projections, HICP inflation should moderate to 2.2% in 2025.

The fiscal deficit is also expected to shrink, falling just below the Treaty reference value of 3% in 2025, in part reflecting a decreasing profile of inflation support measures.

On balance, risks to economic activity are judged to be tilted slightly to the downside for 2023, and more balanced thereafter. The main downside risks relate to the possibility of stronger than envisaged weakness in the international economic environment, which could lead to lower exports. Foreign demand may also be weaker than expected, especially if monetary policy in advanced economies tightens more forcefully than assumed in this projection round. Some of these risks could be mitigated by stronger than expected wage growth, which could offer additional support to household consumption, though if not accompanied by productivity gains, would undermine competitiveness.

Risks to inflation are considered as balanced for the entire projection horizon. Upside risks emanate from pressures to wage inflation in Malta, reflecting also tight labour market conditions, and an incomplete lagged pass-through of past increases in energy costs in the euro area, which could increase commodity prices further. Downside risks relate to the re-opening of China, which should alleviate further supply bottlenecks and potentially dampen price pressures. A stronger pass-through of the appreciation of the euro since late September 2022, monetary tightening as well as lower international energy and transport costs could also ease inflation.

On the fiscal side, risks are on the downside (deficit-increasing) from 2023 onwards. These mainly reflect the likelihood of State Aid to the national airline, though possible weaker economic growth would also have an impact. These risks may be partly offset by the profile of outlays on price mitigation measures, which could be less than projected if oil and gas prices stabilise at lower levels.

Monetary policy implementation and macroprudential policy

During 2022 the Bank continued to implement the Eurosystem's monetary policy decisions in Malta through standing facilities, liquidity providing operations and asset purchases. Eligible credit institutions in Malta participated in main refinancing operations (MROs) conducted by the ECB, with a total cumulative amount of €185.0 million, up from €84.0 million in 2021. Local credit institutions also increased their utilisation of three-month long-term refinancing operations, borrowing €159.0 million through this facility. Meanwhile, during 2022, an amount of €513.5 million from the TLTRO-III operations was early repaid by credit institutions established in Malta, while an additional €40.0 million were repaid on maturity. By the end of 2022, most of the balances held in pandemic emergency long-term refinancing operations (PELTROs) had matured.

As in 2021, Maltese credit institutions did not utilise the marginal lending facility, but recourse to the overnight deposit facility increased to a daily average of €1,698.0 million.

During 2022, the Central Bank of Malta purchased €109.0 million worth of Maltese sovereign bonds under the public sector purchase programme (PSPP), bringing its cumulative purchases since the programme started to €1,515.6 million. Purchases of sovereign bonds under the PEPP amounted to €77.5 million in 2022, with the total amount bought since the programme's inception reaching €548.6 million. Apart from purchasing sovereign bonds for its PSPP and PEPP portfolios, the Bank also purchased such bonds for the ECB's portfolios.

The Central Bank's balance sheet contracted to €10,469.9 million in 2022, from €12,400.1 million a year earlier. As was the case also for the ECB, the Bank registered a zero financial result for 2022, driven by the shift in the monetary policy stance by the Eurosystem and central banks of other advanced economies during the year. In the preceding financial year, the Bank had generated a profit of €22.2 million which was paid to the Government of Malta.

In its capacity as the macroprudential authority in Malta, the Bank continued to carry out regular assessments of financial sector conditions, in part by means of stress tests and sensitivity analyses. Such analysis featured in the Bank's Financial Stability Report (FSR) as well as in a working paper documenting a stress testing framework for Maltese households. The Bank also continued to carry out the Bank Lending Survey (BLS) with four core domestic banks in Malta.

In 2022, the countercyclical capital buffer (CCyB) was kept unchanged at 0%, as the credit-to-GDP gap narrowed slightly on account of the faster recovery in GDP, compared to growth in bank credit. Supplementary indicators also suggested that an activation of the CCyB was not necessary. Meanwhile, the capital conservation buffer remained active, with banks required to hold an additional capital of 2.5% of risk-weighted assets.

In line with the European Systemic Risk Board (ESRB) recommendation (ESRB/2015/1), on recognising and setting CCyB rates for exposures to third countries, in 2022 the Bank carried out its annual exercise with the aim of identifying material exposures of the domestic banking sector to third countries. The three countries that were identified in 2021 were re-confirmed for the period Q2 2022 until Q2 2023.

The Bank, together with the Malta Financial Services Authority (MFSA), undertook the annual exercise on the identification of the Other Systemically Important Institutions (O-SII) and the related applicable capital buffer rates. The same four credit institutions identified as O-SIIs in 2021 were re-confirmed in 2022.

The Bank also reviewed the external audit reports for 2021 that the credit institutions submitted in terms of Directive No. 16 on borrower-based measures (BBMs) and found them overall compliant with such Directive.

Other bank activities

Financial stability-related issues were discussed regularly with the relevant substructures within the ECB, the ESRB and other EU fora. Such issues as well as the general economic situation were also discussed with the European Commission, the International Monetary Fund (IMF) and the rating agencies.

Meanwhile, the Bank remained active in the Joint Financial Stability Board as well as the Domestic Standing Committee and its Crisis Management Task Force. The Bank also participated in the Forum for Financial Stability and monitored closely developments in the anti-money laundering (AML) efforts of the various stakeholders in addressing earlier recommendations of relevant international bodies. A new Financial Crime Compliance Department led by the Money Laundering Reporting Officer was set up during 2022.

Given the significant rise in global bond yields, the Bank increased the size of its internally managed euro and foreign currency fixed income held-to-maturity portfolios, with the latter also contributing to an increase in official reserves. As regards the non-monetary policy portfolios, the Bank embarked on a diversification strategy rather than remaining fully concentrated on fixed income instruments. It liquidated part of its externally managed corporate bond portfolio as well as one of the unconstrained fixed income funds, whilst increasing the strategic exposure to inflation-linked bonds and equities at better valuations. The Bank continued to diversify its fixed income component geographically, whilst ensuring that such investments remain predominantly invested in high-quality financial assets.

Meanwhile, it continued incorporating climate change considerations in its non-monetary policy portfolios alongside liquidity, capital preservation and return. In this regard, the Bank has adopted several sustainable and responsible investment (SRI) practices in its investment decisions, while looking into ways to improve the quality of analysis and disclosures related to climate change related risks and opportunities.

The share of green, social and sustainable bonds in the Bank's internally managed portfolios continued to increase in 2022. In September, the Board approved the setting up of an SRI Desk within the International Asset Management Office.

The Bank closely monitored the economic impact of the war in Ukraine and its effect on the global economy, supporting the common EU position in this respect. Following an agreement with the Central Bank of Ukraine, in 2022, the Central Bank of Malta started providing exchange facilities of Hryvnia banknotes for Ukrainians benefitting from protection in Malta.

The Bank's regular economic publications were adapted to provide more information that is relevant for assessing inflation and the housing market. The Bank also maintained its regular dialogue with business representatives and public sector institutions to obtain a timelier gauge of economic conditions and prospects. The main results of this exercise are published on a quarterly basis in the Bank's Business Dialogue publication.

Work on a new Computable General Equilibrium model for the Maltese economy reached an advanced stage and new tools were developed to improve simulation and forecasting capabilities. Staff once again carried out specialised economic research that was published as working papers, policy notes and short boxes. In 2022, the Bank organised its fifth Annual Research Workshop, which focused on climate and energy issues and the Household Finance and Consumption Survey (HFCS).

Meanwhile, the Bank remained active in certain local fora, such as the National Productivity Board and the Building Industry Consultative Council. It also contributed to the work of the Rental Observatory, set up by the Housing Authority.

As in past years, the Bank continued to compile and disseminate a range of statistics to official institutions and the public, and to operate the Central Credit Register (CCR). Credit institutions' data were amended to cater for new reporting requirements that came into force in January 2022, and securities holdings statistics were enhanced. Furthermore, a new statutory return was implemented for payments statistics, with the collected statistics subsequently transmitted to the ECB. The Bank is now also publishing an aggregated statement of assets and liabilities of pension funds on its website. In addition, preparatory work was carried out in relation to the ECB's investment funds regulation, ECB requirements for financial accounts statistics and climate indicators. To improve communication with reporting agents, the Bank began to publish periodic statistical newsletters.

Discussions continued with the ECB and the National Statistics Office (NSO) on the validation of the fourth wave results of the HFCS. The first results for Malta from this wave were presented in the Bank's Annual Research Workshop. In the meantime, staff began to collaborate with the ECB on an experimental set of distributional wealth statistics, which combine information from the HFCS with financial accounts statistics. This dataset, which is still being developed, could be used to better assess how different households react to specific shocks.

The Bank also continued to collaborate with the NSO to enhance the quality of external statistics and to follow-up on the recommendations of the ECB and Eurostat in this area. The two institutions made steady progress towards adherence to the IMF's Special Data Dissemination Standard (SDDS) Plus initiative.

During 2022, the Bank continued to monitor credit institutions and other professional cash handlers, ensuring that all cash handlers were appropriately certified and trained, while certifying professional cash handlers using its dedicated online platform. Once again random inspections were carried out on cash handling machines. In 2022, Central Bank of Malta Directive No. 10 on the authentication fitness checking and recirculation of euro banknotes and coins was amended to further expand the list of items that cash handlers need to report to the Bank.

As the regulator and overseer of payment and securities settlement systems in Malta, the Bank carried out its annual assessment of the Malta Stock Exchange (MSE) (in its role as Central Securities Depository) which was approved by the Eurosystem's decision-making bodies. The Bank also continued to participate in Eurosystem discussions related to a digital euro.

The Bank's physical and IT infrastructure received further upgrades in 2022. A new telephony solution was rolled out across all the Bank, and a new anti-malware solution was applied at all endpoints and servers. Security enhancements were implemented for services hosted on the public cloud, and new services were introduced to enable end-users to work securely, even remotely. The Bank's email solution was also upgraded. Another key development was the go live of the Market Activities Processing System (MAPS). MAPS is the Treasury Management System for Central Banks which was developed by *Banque de France* and *Banco de España*. It integrates with the main trading platforms, offering a straight through process spanning from front to back-office, risk management, accounting, and financial reporting functions. Furthermore, a new payment acquisition platform was introduced to enable external clients to independently manage and automate instructions for SEPA payments.

Apart from offering staff training and development support, the Central Bank of Malta is committed to equality, diversity and inclusion (EDI). In 2022, the Bank became signatory to the new ESCB & Single Supervisory Mechanism (SSM) EDI Charter. It also set up an internal EDI Committee to better address EDI issues. The Committee organised several initiatives specifically to celebrate and support Malta Pride Week 2022 and is engaged in obtaining the Equality Mark Certification.

Future developments

In 2023, the Bank will continue to implement projects in line with its 2023 Corporate Strategic Plan and align its operational framework with steps the ECB may take in relation to monetary policy, and the inclusion of climate change in the monetary policy framework. As from March 2023, the Bank will be publishing annual climate related disclosures for its euro denominated non-monetary policy portfolios. Within its remit, the Bank will also continue to strengthen the framework for anti-money laundering and combating the financing of terrorism.

Risk assessment tools and stress testing frameworks will be reviewed to be in a better position to assess potential financial stability risks at an early stage. The Bank will be recommending the introduction of a sectoral systemic risk buffer to mitigate against concentration risk and rising cyclical vulnerabilities in the mortgage lending sector.

Research plans for 2023 include an assessment of BBMs and the development of a network model that captures financial interlinkages across Malta's financial sector. On the economic side, the Bank will continue to monitor closely inflation developments. There are also research plans related to long-term structural trends such as climate policies as well as monetary policy transmission topics and labour market issues. The Bank will also assess the potential for presenting selected survey results by means of dashboards and to make better use of social media to reach out to the public.