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ABBREVIATIONS

APP	asset purchase programme
BLS	Bank Lending Survey
ECB	European Central Bank
EER	effective exchange rate
EONIA	Euro OverNight Index Average
ESI	economic sentiment indicator
FOMC	Federal Open Market Committee
GDP	gross domestic product
GVA	gross value added
HCI	harmonised competitiveness indicator
HICP	Harmonised Index of Consumer Prices
LFS	Labour Force Survey
MGS	Malta Government Stocks
MRO	main refinancing operation
MSE	Malta Stock Exchange
NEIG	non-energy industrial goods
NFC	non-financial corporation
NSO	National Statistics Office
PPI	Producer Price Index
RPI	Retail Price Index
SME	small and medium-sized enterprises
ULC	unit labour cost

FOREWORD

Economic activity in Malta gained further momentum in the second quarter of 2018, with real gross domestic product (GDP) rising by 5.9% in annual terms, after growing by 4.9% in the preceding quarter. The economic expansion was driven by a strong rise in domestic demand, as the contribution from net exports was negative.

In contrast, potential output growth eased slightly during the June quarter, although it remained relatively high from a historical perspective. The output surplus, measured as a four-quarter moving average continued the declining trend seen since 2017 and closed by the second quarter of this year.

Meanwhile, the Bank's Business Conditions Index continued to indicate above-average conditions, despite a slight easing.

Labour market conditions remained favourable in the second quarter of 2018, as employment grew strongly. Notwithstanding a further increase in labour market participation rates and rising foreign employment, the unemployment rate fell compared with the preceding year. At 3.8%, the unemployment rate remained below the structural measure of 4.2%, and thus continued to suggest a degree of tightness in the labour market.

Annual inflation based on the Harmonised Index of Consumer Prices (HICP) rose to 2.0% in June from 1.3% in March. This pick-up was mainly driven by a higher contribution from services related to tourism, with core inflation, in contrast, moderating to 0.8%. Inflation based on the Retail Price Index (RPI), which only takes into account expenditure by Maltese residents, stood at 1.0% in June and thus continued to indicate contained price pressures for Maltese households.

Cost pressures for producers remained on the upside, with annual growth in the Producer Price Index standing at 6.4% in June, supported by developments in the intermediate goods subcomponent. Malta's unit labour cost index continued to accelerate during the second quarter, although the annual rate of change remained moderate from a historical perspective. Malta's Harmonised Competitiveness Indicators indicated a further deterioration in competitiveness, owing to unfavourable exchange rate and relative price movements.

The surplus on the current account of the balance of payments narrowed when compared with the corresponding quarter of 2017. The lower surplus was mainly the result of a widening in the merchandise trade gap, and, to a lesser extent, to lower net inflows from secondary income. When measured on a four-quarter moving sum basis, the current account surplus was equivalent to 12.8% of GDP and the cyclically-adjusted measure was estimated at 12.6%. The small difference between the two suggests that Malta's current account surplus largely reflects structural factors.

In the quarter under review, the general government returned to a surplus after registering a deficit during the previous quarter. When measured as a four-quarter moving sum, the general government surplus was significantly higher when compared with the period ending in June 2017. The cyclically-adjusted surplus-to-GDP ratio also improved during this period. Meanwhile, general government debt as a share of GDP decreased slightly to 49.6% at the end of June 2018, from 50.5% at the end of March.

Growth in Maltese residents' deposits with monetary and financial institutions in Malta continued to moderate during the second quarter of 2018, following a prolonged period of strength. In contrast, credit growth continued to pick up, reflecting faster growth in credit to residents outside general government. Growth in mortgage loans to households remained strong, while growth in bank loans to non-financial corporations showed further signs of recovery. Meanwhile, the Bank's Financial Conditions Index deteriorated slightly in the second quarter of 2018, although the extent of tightness remained comparable to that estimated at the start of 2017.

The Governing Council of the European Central Bank maintained an accommodative monetary policy stance during the second quarter of 2018. The interest rates on main refinancing operations, the marginal lending facility and the deposit facility were kept at 0.00%, 0.25% and -0.40%, respectively. The Council confirmed that it continued to expect interest rates to remain at their current levels at least through the summer of 2019 and in any case, for as long as necessary in order to ensure that inflation remains aligned with the current expectations of a sustained adjustment path.

The Council also confirmed that the purchases under the asset purchase programme will continue at the monthly pace of €30 billion until the end of September 2018. It also announced that after September, it expected to reduce the monthly pace of asset purchases to €15 billion until the end of December 2018 and that net purchases will then end.

Reflecting the accommodative monetary conditions, the weighted average interest rate on deposits held by Maltese residents with domestic banks continued to fall in the second quarter. The weighted average lending rate also declined. The spread between the two narrowed marginally compared with that recorded in March, but remained above its year ago level. Yields on Treasury bills were unchanged from March, while those on ten-year Malta Government Stocks rose. Meanwhile, in the equity market, domestic share prices declined.

ECONOMIC SURVEY

THE EXTERNAL ENVIRONMENT AND THE EURO AREA

In the second quarter of 2018, economic growth, as measured by real Gross Domestic Product (GDP), gathered pace in the United States and the United Kingdom, while it remained stable in the euro area. The three-month average unemployment rate edged down in all the three economies. Annual consumer price inflation in the euro area increased from 1.3% in March to 2.0% in June. Inflation in the United States also edged up, reaching 2.9% in June from 2.4% three months earlier. On the other hand, at 2.4%, inflation in the United Kingdom was 0.1 percentage point lower in June compared with March.

During the second quarter, the monetary policy stance remained accommodative. However, while the European Central Bank (ECB) and the Bank of England kept their key rates unchanged, the Federal Reserve raised its policy rate.

Brent oil prices increased up till mid-May on the back of strong global demand and renewed geopolitical tensions between the United States and Iran. Thereafter, energy prices generally decreased, but nonetheless ended the quarter 12.6% higher than the level prevailing three months earlier. Non-energy commodity prices rose marginally during the quarter under review.

Key advanced economies

US economy expands at a faster pace

Economic activity in the United States gathered pace in the second quarter of 2018, with growth in quarter-on-quarter real GDP doubling. It rose by 1.0% from 0.5% in the preceding quarter (see Table 1.1).

The acceleration in real GDP growth mainly reflected stronger increases in personal consumption expenditure and government expenditure. At the same time the trade gap narrowed. On the other hand, growth in private fixed investment decelerated marginally, while the change in inventories turned negative.

In the labour market, employment continued to grow in the second quarter, with the annual rate of increase edging down marginally to 1.5%, from 1.6% in the first quarter. Non-farm payroll data suggest that the pace of job creation slowed down in the mining & logging sector and in the leisure & hospitality sector, but gathered pace in most of the other sectors.

Table 1.1
REAL GDP GROWTH IN SELECTED ADVANCED ECONOMIES

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

	2016		2017				2018	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
United States	0.5	0.4	0.4	0.7	0.7	0.6	0.5	1.0
Euro area	0.3	0.8	0.7	0.7	0.7	0.7	0.4	0.4
United Kingdom	0.5	0.7	0.4	0.3	0.4	0.4	0.1	0.4

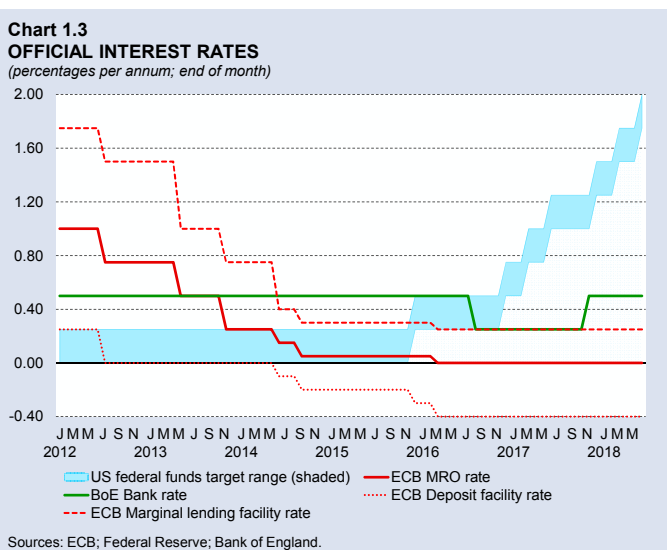
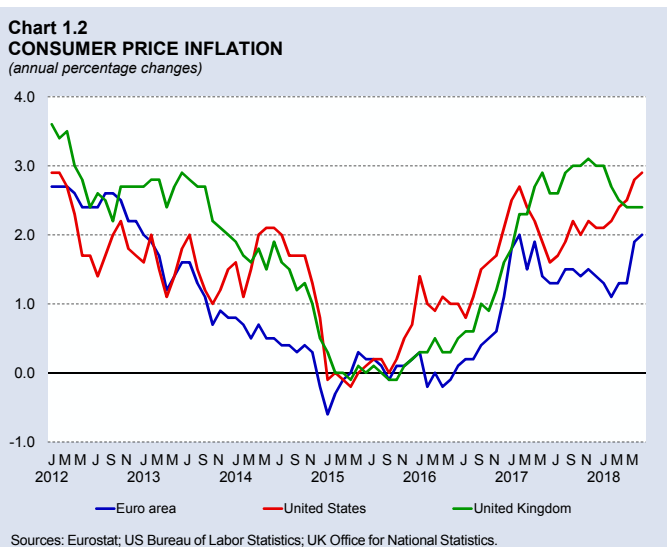
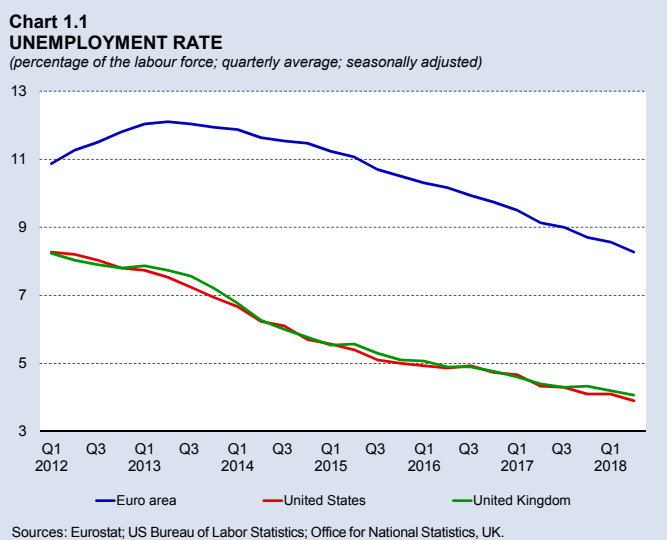
Sources: Bureau of Economic Analysis, US; Eurostat; Office for National Statistics, UK.

The unemployment rate fell to an average of 3.9% in the second quarter from 4.1% in the previous quarter (see Chart 1.1).

The annual rate of change of the US consumer price index (CPI) continued to increase in the quarter under review, rising to 2.9% in June from 2.4% in March (see Chart 1.2). The increase in the inflation rate was mainly attributable to strong increases in energy inflation, although most other inflation sub-indices also recorded faster growth. In fact, inflation excluding food and energy increased to 2.3% in June from 2.1% in March.

In May, the Federal Open Market Committee (FOMC) kept the target rate for the federal funds rate unchanged between 1.50% and 1.75%, and reiterated that the stance of monetary policy remains accommodative, thereby supporting strong labour market conditions and a sustained return to the 2 per cent inflation target (see Chart 1.3). In June, the FOMC revised the range for the federal funds rate to between 1.75% and 2.00%, in view of realised and expected market conditions and inflation. In particular, the labour market strengthened further, economic activity was rising at a solid rate and inflation had moved closer to target.

The FOMC stated that in determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess



realised and expected economic conditions relative to its maximum employment objective and its inflation target. The Committee also maintained its existing policy of reinvesting principal payments from its agency debt and agency mortgage-backed security holdings in agency mortgage-backed securities, and rolling over maturing Treasury securities at auction.¹

UK economic growth picks up but remains moderate

Quarter-on-quarter GDP growth in the United Kingdom rose from 0.1% in the first quarter of 2018 to 0.4% in the second quarter (see Table 1.1). This increase was mainly driven by a weaker contraction in investment. On the other hand, private consumption decelerated and government consumption fell compared with the first quarter. The contribution of net exports became more negative.

In the labour market, employment increased at a slower pace of 1.0% in the second quarter of 2018, from 1.3% in the previous quarter. The unemployment rate averaged 4.1% in the three months to June, 0.1 percentage point lower than in the preceding three-month period (see Chart 1.1).

Consumer price inflation fell marginally to 2.4% in June from 2.5% in March (see Chart 1.2). The rate of increase in the prices of food, non-energy industrial goods (NEIG) and services decelerated. On the other hand, energy price inflation increased remarkably. Inflation excluding energy, food, alcohol and tobacco eased to 1.9% in June from 2.3% in March.

In its meetings held in May and June, the Bank of England's Monetary Policy Committee maintained the Bank Rate unchanged at 0.50% (see Chart 1.3). The Committee's judgement remained that, were the economy to develop broadly in line with the Bank of England's inflation projections, *"an ongoing tightening of monetary policy over the forecast period would be appropriate to return inflation sustainably to its target at a conventional horizon."* All members agreed that any future increases in the Bank Rate are likely to be at a gradual pace and to a limited extent. The Committee maintained the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at GBP 10 billion. It also maintained the stock of UK government bond purchases, financed by the issuance of central bank reserves, at GBP 435 billion.²

The euro area

Euro area economic growth remains constant

The euro area continued to grow moderately during the second quarter of 2018, with real GDP rising by 0.4% on a quarterly basis, the same rate recorded in the first three months of the year (see Table 1.2). Growth was generated entirely from domestic demand, as the contribution of net exports was negligible.

Domestic demand remained the main driver behind growth in real GDP during the quarter under review. The largest contribution stemmed from growth in gross fixed capital formation which accelerated to 1.4% from 0.1% in the previous quarter and contributed 0.3 percentage point to real economic activity. Government consumption expenditure also increased at a faster pace, rising by 0.4% on a quarterly basis, following a 0.1% increase in the first quarter. On the other hand, growth in private consumption expenditure moderated to 0.2% from 0.5% in the previous quarter.

¹ This assessment was broadly confirmed at the FOMC's meeting held at the end of July and the beginning of August. In September, however, the FOMC increased the target range of the federal funds rate again, to between 2.00% and 2.25%.

² The Bank of England's Monetary Policy Committee raised the Bank Rate to 0.75% in August and kept it unchanged in September.

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

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

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

Source: Eurostat.

The latter two components together with changes in inventories added a further 0.2 percentage point to real GDP growth.

Imports grew by 1.2% during the first quarter, slightly faster than exports. As a result, net exports had a broadly neutral impact on GDP growth.

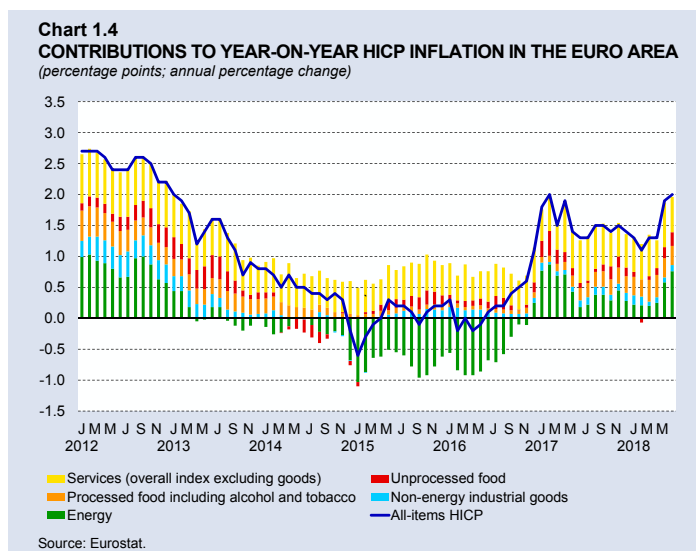
Euro area inflation picks up

The annual rate of inflation in the euro area, measured on the basis of the Harmonised Index of Consumer Prices (HICP), accelerated during the second quarter of 2018. The inflation rate rose to 2.0% in June from 1.3% in March (see Chart 1.4).

The pick-up in the overall rate of inflation reflected faster growth in energy prices as well as unprocessed food, which together added one percentage point to the HICP rate. Prices of NEIG also increased at a fast pace, but inflation on this component remained subdued. These developments offset a moderation in services and processed food inflation. HICP excluding energy and food fell marginally over the quarter, from 1.0% in March to 0.9% in June.

Labour market conditions improve

The seasonally-adjusted unemployment rate fell further over the quarter. In June it stood at 8.2%, down from 8.5% in March and 9.0% a year earlier (see Chart 1.1). The three-month



average also eased further, from 8.6% in the first quarter to 8.3% in the second. Meanwhile, employment growth remained unchanged at 1.5%.³

Euro area recovery to continue

According to the latest ECB staff macroeconomic projections, published in September 2018, the euro area growth is expected to remain stable in the next few quarters and then to rise slightly above potential. Real GDP growth will benefit from a number of factors that will support domestic demand. Private consumption and investment will set to benefit from the very accommodative monetary policy stance of the ECB, higher growth in lending to the private sector, lower deleveraging needs and robust labour market conditions. Investment will also be encouraged by rising profits and high capacity utilisation, while exports are set to benefit from the ongoing expansion of global economic activity and growth in euro area foreign demand.

However, economic growth is projected to slow down over the forecast horizon, reflecting a deceleration in euro area foreign demand and slower growth in employment, the latter reflecting labour supply shortages in some countries. Additionally, due to the cyclical expansion in some euro area member states, the normalisation of the saving ratio is expected to slow private consumption growth. Real GDP is projected to grow by 2.0% in 2018 as a whole, before moderating to 1.8% and 1.7% in the following two years (see Table 1.3).

Private consumption is expected to continue to grow strongly over the project horizon, supported by favourable bank lending and robust labour market conditions. Additionally, it is set to benefit from rising household net worth as well as progress in deleveraging.

After reaching a peak in early 2018, growth in residential investment is expected to moderate, as it will be dampened by higher capacity constraints in the construction sector and adverse demographic trends in some countries. Moreover, as financing conditions become slightly tighter, investors will likely have alternative long-term investment opportunities.

The recovery in business investment is expected to continue, although at a gradually declining pace. Growth in capital outlays is anticipated to benefit from high business confidence, above-average capacity utilisation, supportive financing conditions and higher profits. Additionally, companies

Table 1.3
MACROECONOMIC PROJECTIONS FOR THE EURO AREA⁽¹⁾

Annual percentage changes

	2018	2019	2020
GDP	2.0	1.8	1.7
Private consumption	1.5	1.7	1.6
Government consumption	1.4	1.4	1.3
Gross fixed capital formation	4.0	3.2	2.9
Exports	3.1	3.8	3.6
Imports	3.5	4.5	3.9
HICP	1.7	1.7	1.7

⁽¹⁾ ECB staff macroeconomic projections (September 2018).

Source: ECB.

³ Employment data for the euro area are based on the national accounts.

might invest in capital due to labour-related supply-side constraints and the leverage ratio in the non-financial corporations is close to its historical low. Nevertheless, domestic and foreign demand is expected to decelerate over the forecast horizon and would lead to a gradual loss of momentum in business investment. Government consumption expenditure is expected to grow at a relatively constant rate over the forecast horizon.

On the external side, extra euro area exports are set to grow at a moderate pace in line with dampened foreign demand. Extra euro area imports are forecasted to benefit from positive domestic demand developments and from an expected stronger euro. As import growth is projected to be higher than that of exports, net exports are set to be broadly neutral over the forecast horizon.

Compared with the Eurosystem staff projections published in June 2018, euro area real GDP growth was revised downwards by 0.1 percentage point in 2018 and 2019, mostly due to a weaker-than-expected foreign demand outlook and a stronger effective euro exchange rate. The GDP growth projections for 2020 remained unchanged.

HICP inflation is set to remain flat at 1.7% in each year of the projection horizon. HICP energy inflation is expected to decline, mirroring downward base effects and a slight decline in crude oil price futures. Nevertheless, this decline is expected to be offset by a gradual strengthening in HICP inflation excluding energy and food. This reflects the improving cyclical position of the economy and upward pressure on wage growth in the context of tightening labour markets. HICP inflation excluding energy and food is forecasted to rise from 1.1% in 2018, to 1.5% and 1.8% in 2019 and 2020, respectively.

There were no revisions from the last projections on the overall HICP inflation. HICP inflation excluding food and energy was revised down slightly in 2019 and 2020, as a result of the somewhat weaker growth outlook. On the other hand, HICP energy inflation was revised upwards to reflect higher electricity and gas prices in some Member States and the revised profile of the oil price assumptions in euro.

ECB maintains its accommodative monetary policy stance

The ECB's Governing Council continued with its accommodative monetary policy stance during the June quarter. The interest rates on the main refinancing operations (MRO), on the marginal lending facility and on the deposit facility were kept constant at 0.00%, 0.25% and -0.40%, respectively (see Chart 1.3). In June, the Council noted that it continued to expect these rates to remain at their current levels at least through the summer of 2019 and in any case, for as long as necessary in order to ensure that inflation remains aligned with the current expectations of a sustained adjustment path.⁴

The Council also confirmed that the purchases under the asset purchase programme (APP) will continue at the monthly pace of €30 billion until the end of September 2018. It also announced that after September, it expected to reduce the monthly pace to €15 billion until the end of December 2018 and that net purchases will then end.

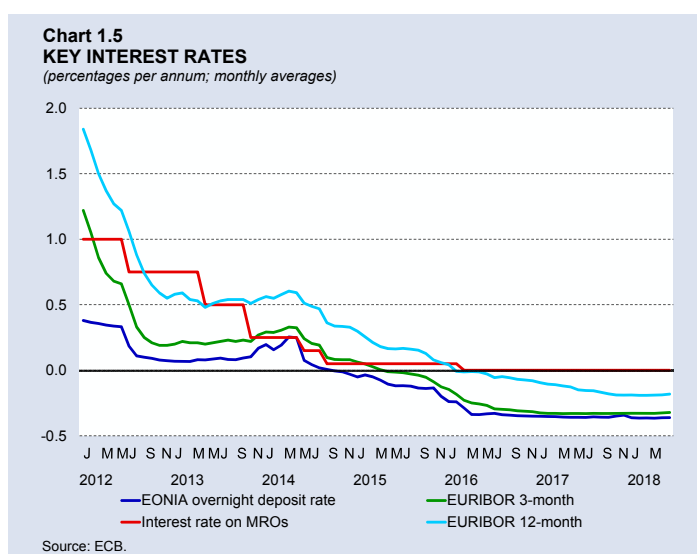
The Council also confirmed that it will continue to invest the principal payments from maturing securities purchases under the APP for a prolonged period of time after the end of its net asset

⁴ The Governing Council kept the key interest rates unchanged during its September 2018 monetary policy meeting and confirmed its expectation to reduce the monthly pace of asset purchases after September and to end such purchases in December.

purchases, and in any case for as long as required to keep favourable liquidity conditions and ample degree of monetary accommodation.

Money market rates remained low

Money market rates in the euro area remained low during the June quarter, reflecting the accommodative monetary policy stance of the ECB. The EONIA overnight deposit rate remained at its historical low of -0.36% between March and June (see Chart 1.5). Meanwhile, the 3-month and 12-month EURIBOR rates rose marginally and stood at -0.32% and -0.18%, respectively.⁵



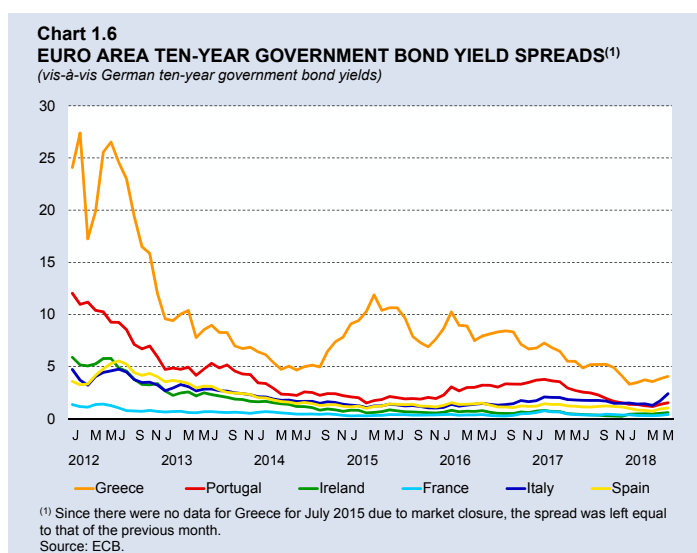
Euro area bond yields were mixed

Ten-year benchmark government bond yields in the euro area were mixed. German, French and Irish bond yields fell, while other countries' bond yields rose. The fall in bond yields partly reflected higher demand for safe haven assets, as fears of a trade war between the US and China rose and political uncertainty in Italy and Spain mounted. The strongest fall was seen in German yields, which declined by 20 basis points between March and June, to 0.33%. French and Irish yields fell by 9 basis points each, to 0.75% and 0.92%, respectively. On the other hand, the 10-year Italian government bond yield rose by 77 basis points, to 2.74% over the same period. Greek, Portuguese and Spanish bond yields rose by 12, 8 and 4 basis points respectively, to stand at 4.39%, 1.87% and 1.37% respectively.

As government bond yields in Germany fell strongly during the quarter, the spreads with the bond yields in other euro area countries generally widened, with the largest divergence recorded for Italy (see Chart 1.6).

The euro depreciates

The euro exchange rate depreciated against a number of



⁵ EURIBOR is an interest rate benchmark indicating the average rate at which principal European banks lend unsecured funds on the interbank market in euro for a given period. The EONIA (Euro OverNight Index Average) is an effective overnight interest rate, measured as the weighted average of all overnight unsecured lending transactions on the euro area interbank market.

major currencies during the second quarter of 2018, with the nominal effective exchange rate against the EER-19 group of countries falling by 0.7% between end-March and end-June.⁶

The euro fell by 5.4% against the US dollar. It also weakened against a number of other currencies, such as the Japanese yen and the Chinese yuan renminbi (see Chart 1.7). On the other hand, the euro rose against the pound sterling and a number of other European currencies.

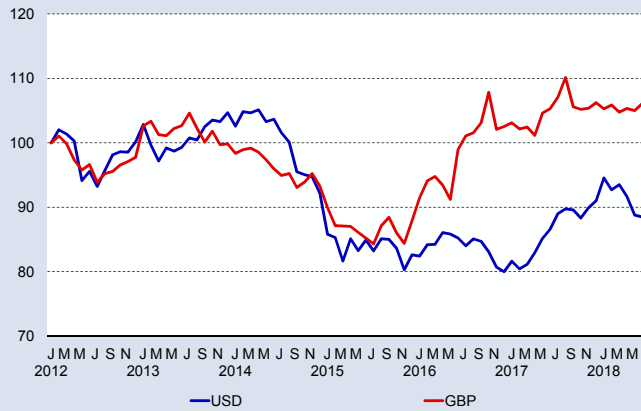
Commodities

Energy prices end the quarter at a higher level

The price of Brent crude oil continued to increase, rising from USD 68 per barrel at the end of March to nearly USD 80 per barrel by mid-May, propelled by a continued recovery in global demand and renewed geopolitical tensions between the United States and Iran (see Chart 1.8). Thereafter, oil prices declined somewhat on the possibility that some of the world's major oil suppliers might lift output caps in place since 2017. Nonetheless, the price of Brent crude oil stood at USD 76.80 per barrel at the end of June, 12.6% above the price prevailing three months earlier.

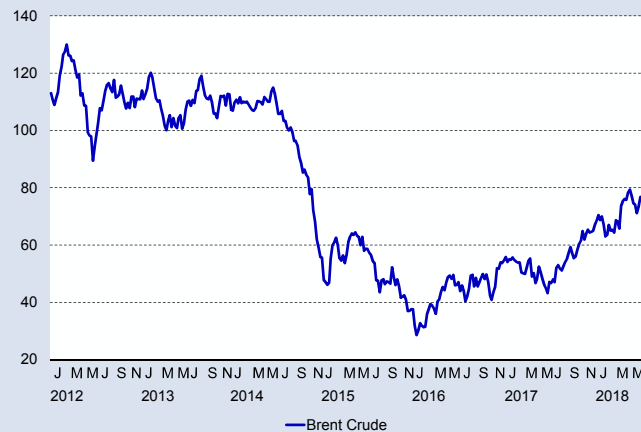
As regards non-energy commodity prices, World Bank data indicate that these rose marginally during the second quarter. Between March and June, non-energy commodity prices increased by 0.2%.

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



Source: Eurostat.

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



Source: Reuters.

⁶ The effective exchange rate (EER), is based on the weighted averages of the euro exchange rate against the currencies of Australia, Bulgaria, Canada, China, Croatia, Czech Republic, Denmark, Hong Kong, Hungary, Japan, Norway, Poland, Romania, Singapore, South Korea, Sweden, Switzerland, the United Kingdom and the United States.

2. OUTPUT AND EMPLOYMENT

The Bank's Business Conditions Index (BCI) continued to indicate above-average conditions, despite a slight easing to 0.7 in the second quarter of 2018, from 0.8 in the first quarter of the year. Similarly, potential output growth eased slightly during the June quarter, although it remained relatively high from a historical perspective. Growth in potential output decelerated to 5.4%, from 5.8% in the first quarter of 2018.

Meanwhile, growth in the Maltese economy accelerated during the second quarter of 2018. The real gross domestic product (GDP) rose to 5.9% in the June quarter in annual terms, up from 4.9% in the first three months of the year. Growth was driven by a strong rise in domestic demand, as the contribution from net exports was negative. During the quarter under review, gross value added (GVA) continued to be largely supported by services.

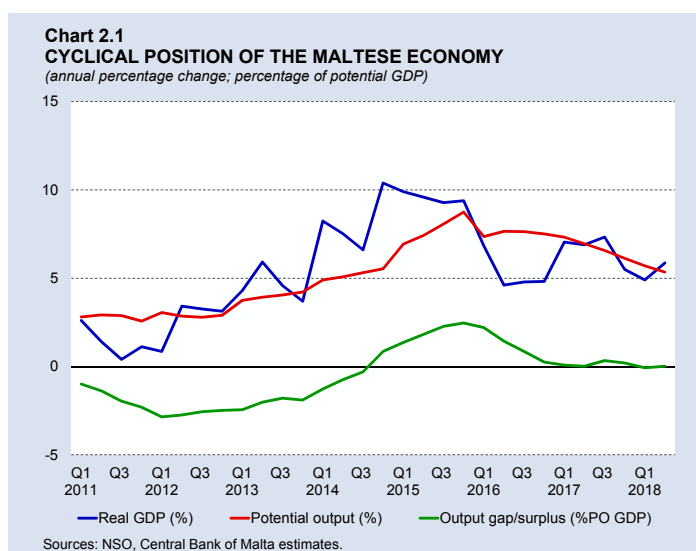
The output surplus, measured as a four-quarter moving average has largely closed in the June quarter. It narrowed from the high levels observed in 2015 and 2016, and continues the trend seen since 2017.

Labour market conditions remained favourable in the second quarter of 2018, as employment grew strongly. The unemployment rate based on the Labour Force Survey (LFS) fell compared with the preceding year, notwithstanding a further increase in labour market participation rates and rising foreign employment. In part, this reflects improved job matching in the context of a buoyant economy. The unemployment rate remained below the structural measure and thus continued to suggest a degree of tightness in the labour market during the quarter under review.

Potential output and Business Conditions Index

Positive output gap narrows^{1,2}

In the second quarter of 2018, 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 slowed slightly to 5.4%, from 5.8% in the first quarter of 2018. Meanwhile, GDP growth accelerated to 5.9% from 4.9%. The positive output gap, measured as a four-quarter moving average is estimated to have largely closed in the second quarter of 2018, narrowing from the high levels seen in

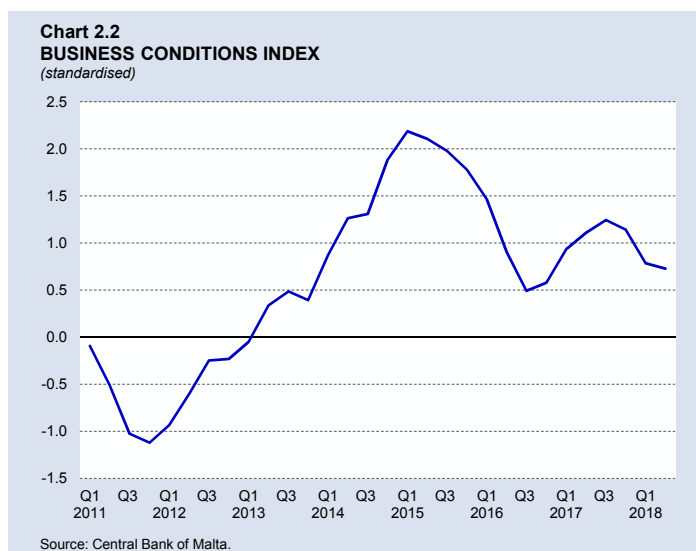


¹ Potential output measures the medium-to-long-term level of real output which is sustainable in an economy. The estimates presented here are derived using a production function approach. For further details on the methodology adopted see Micallef, B., and Ellul, R. (2017), "Medium-term Estimates of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

2015 and 2016, and in line with the rates observed in 2017. This indicates that the overutilisation of the economy's productive capacity has broadly declined over the recent period.³

While potential output growth has eased compared to 2015 and 2016, when it had been boosted by a spike in investment and total factor productivity, over recent quarters it has tended to exceed growth in aggregate demand. Potential growth continues to be boosted by an increasing number of foreign workers working in Malta and higher labour participation, with the labour contribution remaining close to its historical highs.



Central Bank's Business Conditions Index (BCI) eases⁴

The Central Bank's BCI eased over the previous quarter (see Chart 2.2). The index stood at 0.7 in the second quarter of the year, slightly lower than the revised value of 0.8 measured in the first quarter of the year and below its value of 1.1 a year earlier. The BCI continued to show above-average conditions, with changes reflecting a slowdown in industrial production, and offset partially by a decrease in unemployment and an increase in tourism. The latest estimates suggest that economic conditions appear to be stable over the quarter, and gradually easing back towards average levels, from the exceptional high rates seen in the recent past.

GDP and industrial production

Real economy grows at a faster pace

Aggregate demand in the Maltese economy accelerated during the second quarter of 2018, with real GDP rising by 5.9% on an annual basis, from 4.9% in the previous quarter.⁵

Real GDP growth reflected a strong rise in final domestic demand, as all components grew at a faster pace and contributed by 7.3 percentage points to economic activity (see Table 2.1). Changes in inventories also contributed positively to real GDP growth. On the other hand, the rate of growth of imports was higher than that of exports, as the latter remained unchanged during the quarter.

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

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

⁵ The analysis of GDP in this Chapter of the *Quarterly Review* is based on data published in NSO *News Release* 139/018 and released on 5 September 2018.

Table 2.1
GROSS DOMESTIC PRODUCT⁽¹⁾

	2017			2018	
	Q2	Q3	Q4	Q1	Q2
<i>Annual percentage changes</i>					
Private final consumption expenditure	4.1	3.4	2.7	4.8	7.0
Government final consumption expenditure	-5.4	19.0	1.9	2.5	11.5
Gross fixed capital formation	-28.5	-5.9	0.9	-15.2	12.2
Domestic demand	-10.7	2.6	3.7	1.8	14.3
Exports of goods and services	6.5	3.4	4.9	1.6	0.0
Imports of goods and services	-6.3	-0.6	3.6	-0.9	4.6
Gross domestic product	6.9	7.3	5.5	4.9	5.9
<i>Percentage point contributions</i>					
Private final consumption expenditure	1.9	1.6	1.2	2.3	3.1
Government final consumption expenditure	-1.0	2.6	0.3	0.4	1.9
Gross fixed capital formation	-7.9	-1.2	0.2	-3.6	2.3
Changes in inventories	-3.2	-0.7	1.4	2.3	3.9
Domestic demand	-10.2	2.1	3.2	1.5	11.2
Exports of goods and services	8.9	4.6	6.6	2.3	0.0
Imports of goods and services	8.3	0.6	-4.3	1.1	-5.3
Net exports	17.1	5.2	2.3	3.4	-5.3
Gross domestic product	6.9	7.3	5.5	4.9	5.9

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

Sources: NSO; Central Bank of Malta calculations.

Private consumption expenditure grew at a faster pace compared with the same period in the previous year, rising by 7.0% and adding 3.1 percentage points to real GDP growth. Private consumption continued to be sustained by a buoyant labour market and strong growth in compensation of employees. Nominal data show a rise in expenditure across all categories.

After contracting on an annual basis in the first quarter, real gross fixed capital formation increased at double-digit rates in the June quarter, rising by 12.2% and contributing 2.3 percentage points to real GDP growth. This annual expansion reflected a strong increase in total machinery and equipment as well as higher investment in dwellings. Capital outlays on cultivated biological resources and intellectual property products also rose. On the other hand, investment in non-residential construction declined on an annual basis.

Government consumption expenditure rose by 11.5% in the second quarter and added almost 2 percentage points to real GDP growth. The annual expansion reflected strong growth in the two components of government expenditure, being compensation of employees and intermediate consumption. Moreover, revenue from sales, which is netted against expenditure in national accounts, was lower, and therefore also contributed to the strong growth in government consumption. This was partly due to the Individual Investor Programme (IIP).

Imports rose by 4.6% compared with a year earlier, while exports remained constant. This led to net exports shedding 5.3 percentage points from real economic activity. This development reflected trade in services.

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

Nominal GDP rose by 8.6% in annual terms during the second quarter of 2018, after increasing by 7.1% in the previous quarter (see Table 2.2). The rise in nominal activity reflects 7.6% growth

Table 2.2
CONTRIBUTION OF SECTORAL GROSS VALUE ADDED TO NOMINAL GDP GROWTH
Percentage points

	2017			2018	
	Q2	Q3	Q4	Q1	Q2
Agriculture, forestry and fishing	0.0	0.0	0.0	0.1	0.0
Mining and quarrying; utilities	-0.2	0.1	0.9	0.2	0.2
Manufacturing	0.8	0.7	0.6	0.0	0.2
Construction	0.3	0.3	0.3	0.2	0.2
Services	7.8	7.4	6.4	6.1	6.1
<i>of which:</i>					
Wholesale and retail trade; repair of motor vehicles; transportation; accommodation and related activities	1.8	2.5	0.8	1.1	0.8
Information and communication	0.5	0.3	0.6	0.4	0.1
Financial and insurance activities	0.1	0.1	0.3	0.4	0.7
Real estate activities	-0.1	-0.1	-0.2	0.4	0.6
Professional, scientific, administrative and related activities	3.1	2.2	2.5	1.1	1.1
Public administration and defence; education; health and related activities	1.1	1.2	1.4	1.6	1.3
Arts, entertainment; household repair and related services	1.2	1.1	1.0	1.1	1.4
Gross value added	8.8	8.4	8.2	6.7	6.8
Taxes less subsidies on products	1.0	2.2	0.2	0.5	1.8
Annual nominal GDP growth (%)	9.7	10.6	8.5	7.1	8.6

Source: NSO.

in GVA, the same rate as that registered in the first three months of the year. Consequently, GVA contributed 6.8 percentage points to nominal growth. Net taxes also increased and added 1.8 percentage points to nominal GDP.⁶

Services continued to be the main driver of GVA growth, contributing 6.1 percentage points to increase in nominal GDP. The largest additions within the services sector came from the sectors specialising in arts and entertainment, public administration as well as professional and scientific activities. Together, these three sectors contributed 3.9 percentage points to nominal growth, equivalent to almost two-thirds of the contribution in GVA in services. The other services sectors comprising of wholesale and retail trade, financial and insurance activities, real estate as well as information and communication, jointly added a further 2.2 percentage points. The contribution from construction, manufacturing and utilities sectors was relatively lower, with each sector contributing 0.2 percentage point. Meanwhile, the agriculture and fishing sector had a negligible impact on nominal growth.

GDP data by income distribution show that gross operating surplus has accelerated during the second quarter, rising by 8.0% on an annual basis from 6.2% in the first quarter, and contributing almost 4 percentage points to nominal GDP growth (see Chart 2.3). Compensation of employees also continued to rise robustly, although the pace of growth moderated to 7.8% from 8.5% in the March quarter. Consequently, it added 3.2 percentage points to nominal growth. Additionally, net taxes on production and imports increased strongly and contributed 1.5 percentage points to nominal GDP growth.

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

In absolute terms, almost all sectors registered higher gross operating surplus when compared with the same quarter in the previous year. The largest increases were recorded in arts, entertainment and recreation, real estate, professional, scientific and technical as well as in the financial and insurance. On the other hand, gross operating surplus in the information and communication sector declined.

Compensation of employees continued to grow strongly in all sectors, with the largest absolute increase registered in the sectors of arts, entertainment and recreation, real estate, public administration, professional, scientific and technical activities as well as financial and insurance.

Industrial production declines for the second consecutive quarter

During the second quarter of 2018, industrial production declined by 1.3% when compared with the same quarter a year earlier.⁷ This followed a 2.5% year-on-year decline in the first quarter (see Table 2.3).

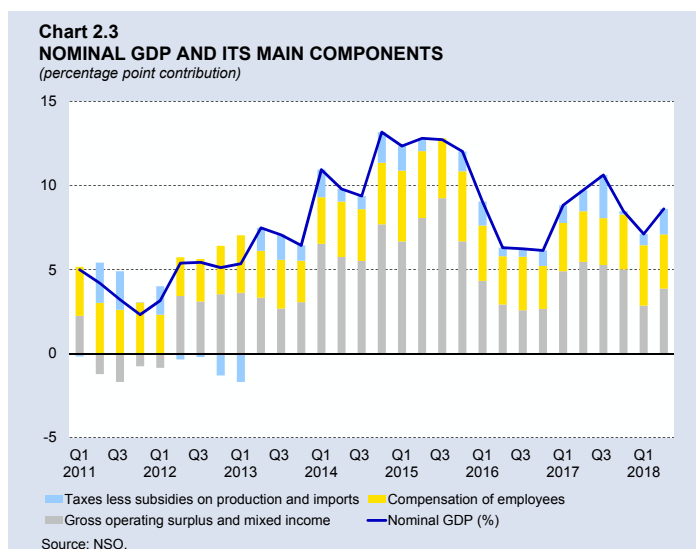


Table 2.3
INDUSTRIAL PRODUCTION⁽¹⁾

Percentages; annual percentage changes

	Shares	2017			2018	
		Q2	Q3	Q4	Q1	Q2
Industrial production	100.0	2.7	5.2	2.0	-2.5	-1.3
Manufacturing	87.1	1.5	4.1	1.2	-4.3	-1.9
<i>of which:</i>						
Food products	15.4	-8.8	6.7	3.9	-15.0	-14.0
Repair and installation of machinery and equipment	7.9	-4.0	3.6	1.0	5.3	6.6
Basic pharmaceutical products and pharmaceutical preparations	7.3	-21.5	5.5	5.4	9.6	-1.6
Printing and reproduction of recorded media	7.3	-0.9	-11.3	5.3	9.2	45.3
Beverages	5.6	3.0	3.0	5.4	2.4	4.1
Rubber and plastic products	5.4	9.1	5.9	-5.6	-7.7	-10.4
Computer, electronic and optical products	5.0	30.9	-12.8	-20.8	-28.1	-24.4
Energy	12.5	1.0	8.0	3.1	0.7	3.8
Mining and quarrying	0.5	-15.3	-20.3	22.7	-0.4	36.9

⁽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.

Sources: NSO; Eurostat.

⁷ Methodological differences may account for divergences between developments in GVA in the manufacturing sector and industrial production. GVA nets input costs from output to arrive at value added, and is expressed in nominal terms. Industrial production is a measure of the volume of output and takes no account of input costs. The sectoral coverage between the two measures also differs, since industrial production data also include the output of the energy and, water collection, treatment and supply sectors.

This contraction solely reflected a 1.9% decrease in the manufacturing sector, which accounts for over 80% of the index. On the other hand, output rose by more than a third, in the quarrying subsector following a slight decrease in the preceding quarter. However, this sector has a very small weight in the overall industrial production index and did not offset the fall in manufacturing output. Similarly, production in the energy sector grew by 3.8%, following a 0.7% increase in the preceding quarter.

Within the manufacturing sector, output declined strongly for the fourth consecutive quarter among producers of computer, electronic and optical products. Smaller declines in production were registered among manufacturers of food products, within the rubber and plastics sub-sector as well as among producers of pharmaceuticals. Output also fell in the “other manufacturing” sub-sector, which includes medical and dental instruments, toys and related products. These declines offset strong increases in production among producers involved in the printing and reproduction of recorded media. Moderate increases were also recorded among firms involved in repair and installation of machinery and equipment as well as among beverage manufacturers.

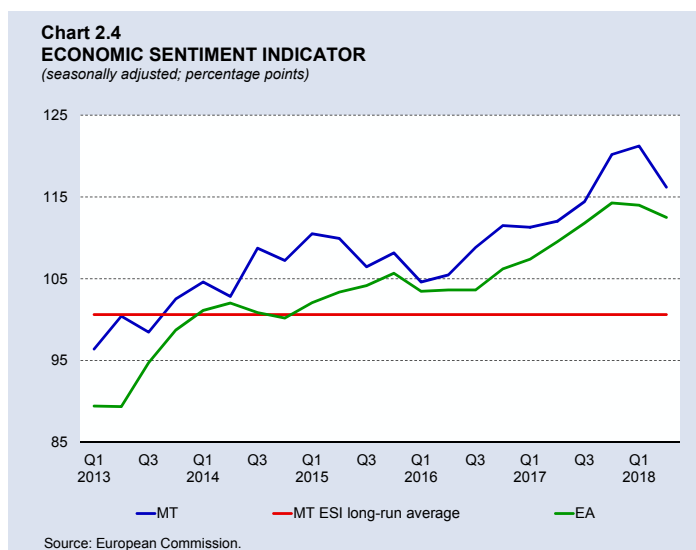
Business and consumer surveys

During the second quarter of 2018, the economic sentiment indicator (ESI) fell to 116, from 121 in the preceding quarter, but remained well above its long-term average of 101 (see Chart 2.4).^{8,9} Sentiment declined within retail firms and industry as well as among consumers, but was broadly unchanged in the services sector. In contrast, sentiment improved within construction, reaching a record level. During the second quarter of 2018, the ESI for Malta remained higher than that in the euro area, which averaged 113.

Confidence in the retail sector falls sharply¹⁰

Sentiment in the retail sector fell to 4, from 15 in the first quarter of 2018. Despite this decline, sentiment among retailers stood above its long-term average of 2 (see Chart 2.5).

The decline in confidence was driven by firms’ assessment of past and expected business activity, as the share expecting an improvement in business activity in the months ahead fell strongly from high levels recorded in the preceding two quarters. Similarly, on balance fewer firms considered that



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

⁹ Long-term averages are calculated over the entire period for which data are available. For the consumer and industrial confidence indicators, data became available in November 2002, while the services and construction confidence indicator data became available in May 2007 and May 2008, respectively. The long-term average of the retail confidence indicator is calculated as from May 2011, when it was first published. However, the long-term average of the ESI is computed from November 2002.

¹⁰ The 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.

business activity had improved in the preceding three months. In contrast, on balance, fewer firms reported stock levels to be above normal.¹¹

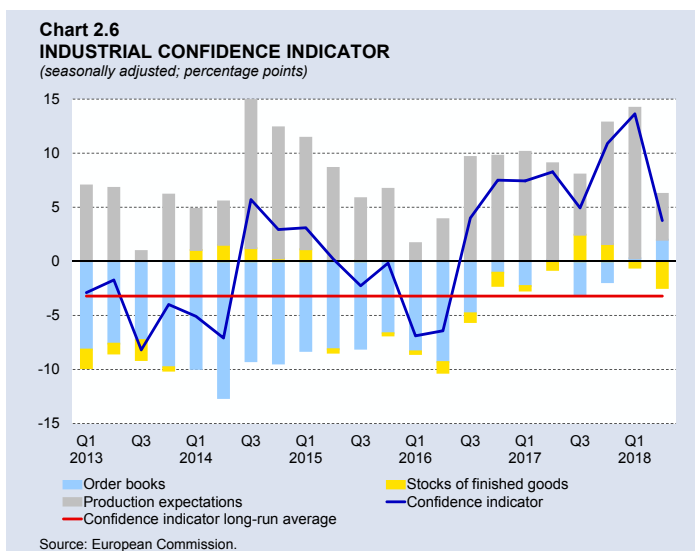
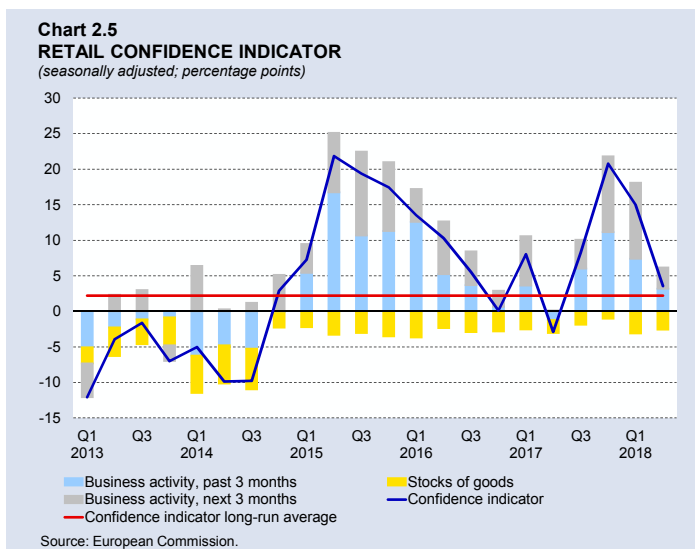
Additional survey data indicate that on balance, firms expected employment to remain unchanged during the following quarter. Whereas in the first quarter of 2018, firms on balance had anticipated a rise in selling prices, in the quarter under review they expected selling prices to fall.

Industrial confidence declines¹²

Confidence in the industrial sector fell to 4 in the second quarter of 2018, from 14 in the preceding quarter, but still stood above its long-term average of -3 (see Chart 2.6).

The fall in industrial sentiment was driven by both firms' production expectations and their assessment of stock levels. During the quarter under review a smaller net share of respondents expected production to rise in the months ahead. Furthermore, a larger number of respondents reported higher than normal stocks of finished goods in the second quarter.¹³ Meanwhile, more firms assessed order books to be above normal for the season.

Looking forward, additional survey data show that a smaller share of respondents anticipated an increase in their labour complement. In addition, firms expected their selling prices to fall in the subsequent three months.



¹¹ A fall in the balance of above-normal stock levels affects the overall indicator in a positive way.

¹² 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.

¹³ 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.

Consumer confidence declines for the first time since the first quarter of 2017¹⁴

The consumer confidence indicator fell slightly to 23 in the second quarter of 2018 from 26 in the preceding three-month period, although it still stood at very high levels (see Chart 2.7). Developments in almost all subcomponents affected the indicator in a negative way, except for unemployment expectations. In fact, on balance, more respondents expected unemployment to fall in the following twelve months.¹⁵ Almost half of the decline in sentiment recorded in this quarter can be attributed to somewhat lower expectations about the general economic situation.

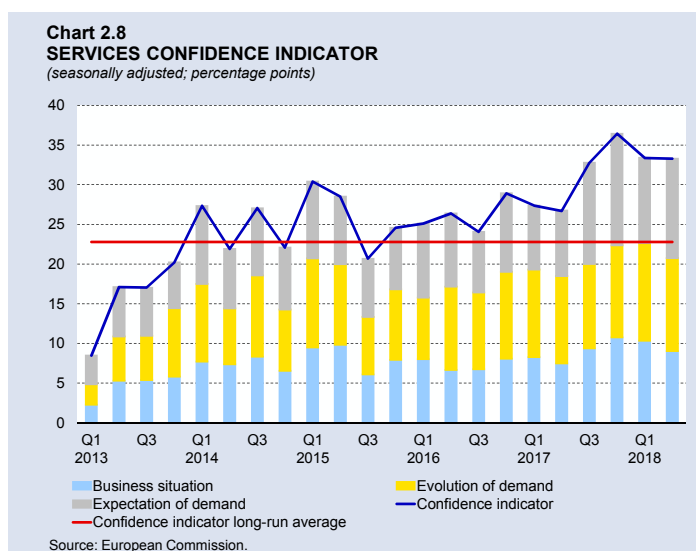
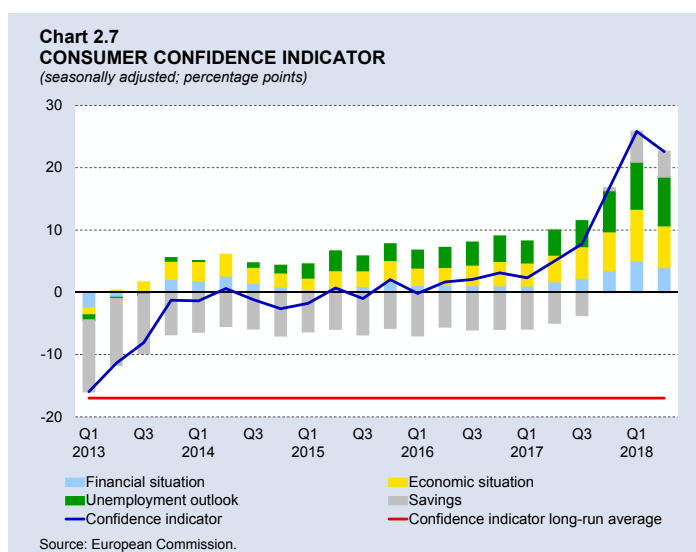
Additional survey data suggest that on balance, a smaller share of consumers anticipated higher inflation in the twelve months ahead. At the same time, the share of consumers intending to reduce major purchases over the subsequent 12 months increased significantly.

Confidence in the services sector remains unchanged¹⁶

In the second quarter of 2018, the services confidence indicator stood broadly unchanged at 33, when compared with the preceding quarter, but edged down from 36 in the last quarter of 2017. Nonetheless, it remained above its long-term average of 23, with all the indicator's components remaining positive (see Chart 2.8).

The share of firms that reported an improvement in the business situation and increased demand in the preceding months, declined. However, this was offset by a rise in demand expectations for the three months ahead.

Additional survey data indicate that when compared with the first quarter of 2018, a larger net share of respondents reported



¹⁴ 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' financial situation, their ability to save, the general economic situation and unemployment expectations over the subsequent 12 months.

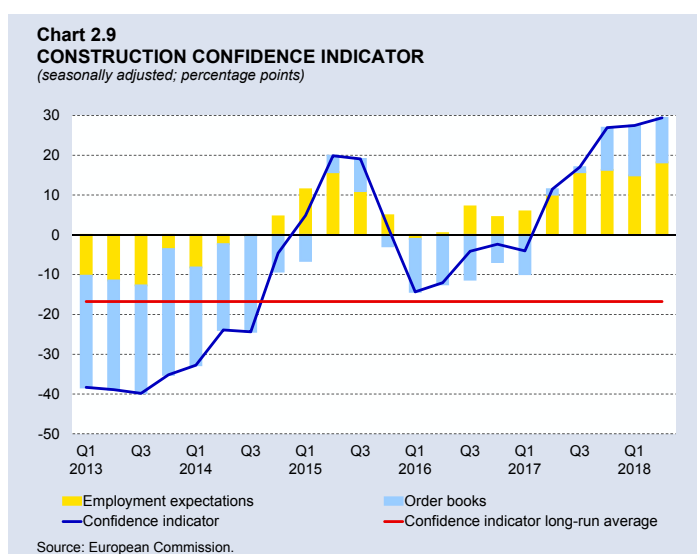
¹⁵ Negative unemployment expectations affect the overall indicator in a positive way. Such falls are thus represented by positive bars in Chart 2.7.

¹⁶ 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.

an increase in their past labour complement and anticipated and increase going forward. Also, on balance respondents foresaw no changes in prices in the three months ahead.

Confidence in the construction sector edges up¹⁷

In contrast, sentiment in the construction sector edged up to 29 in the second quarter of 2018, from 27 in the preceding quarter. This is the highest level recorded since survey results for Malta became available (see Chart 2.9).



Survey results show that a decline in the assessment of order books was more than offset by a rise in the share of firms expecting higher employment for the months ahead.

Additional survey data indicate that in the second quarter of 2018, fewer respondents, on balance, reported positive developments in building activity during the preceding three months. Indeed, labour shortages remained one of the main factors limiting production in this sector, although marginally fewer firms reported this as the main factor. Meanwhile, a higher net percentage of firms anticipated a rise in selling prices in the subsequent three months.

The labour market¹⁸

Labour force continues to grow strongly

LFS data show that in the second quarter of 2018 the labour force grew by 5.8% over the same quarter of 2017 (see Table 2.4).¹⁹ Employment rose by 6.0% in annual terms, while the number of unemployed increased at a more moderate pace of 3.1%.

The activity rate stood at 73.5% in the June quarter, up from 71.7% in the corresponding quarter of 2017.²⁰ This reflected increased activity among both females and males, with the former registering the largest increase. Indeed, the female participation rate edged up by 2.7 percentage points, to reach 62.5%, while that of males rose by 0.7 percentage point to 83.7%.

¹⁷ 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.

¹⁸ 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. LFS data for 2012 and the first half of 2018 are updated with the latest demographic revisions published by the NSO on 12 February 2018.

¹⁹ The LFS defines the labour force as all persons aged 15 and over who are active in the labour market. This includes those in employment, whether full-time or part-time, and the unemployed, defined as those persons without work but who are actively seeking a job and are available for work.

²⁰ The activity rate measures the number of persons in the labour force aged between 15 and 64, as a proportion of the working age population, which is defined as all those aged 15 to 64 years.

Table 2.4
LABOUR MARKET INDICATORS BASED ON THE LFS

Persons; annual percentage changes

	2017	2018	Annual change
	Q2	Q2	%
Labour force	227,037	240,311	5.8
Employed	218,150	231,152	6.0
<i>By type of employment:</i>			
Full-time	187,822	198,941	5.9
Part-time	30,328	32,211	6.2
Unemployed	8,887	9,159	3.1
Activity rate (%)	71.7	73.5	
Male	83.0	83.7	
Female	59.8	62.5	
Employment rate (%)	68.9	70.6	
Male	79.7	80.3	
Female	57.4	60.2	
Unemployment rate (%)	3.9	3.8	
Male	3.9	4.0	
Female	4.0	3.6	

Source: NSO.

Employment continues to grow at a fast pace

In the second quarter of 2018, the annual rate of change of employment stood at 6.0%. The annual increase in employment during the quarter reflected growth in both the number of full-time and part-time jobs (see Table 2.4). Full-time employment increased by 11,119, or 5.9% in annual terms, while the number of part-timers, which includes those employed on a full-time with reduced hours basis, rose by 1,883, or 6.2%.

During the second quarter of 2018 the overall employment rate rose by 1.7 percentage points in annual terms, reaching 70.6%.²¹ This reflected developments in both the male and female employment rates, which increased by 0.6 and 2.8 percentage points respectively. The male employment rate reached 80.3%, from 79.7% a year earlier, while that of females rose to 60.2% from 57.4%. The largest increases were registered among those in the 55 and 64 age bracket, where the total employment rate rose by 4.2 percentage points.

These developments in the employment rate imply that the Government continued to exceed the Europe 2020 target of 70% employment rate.²² Indeed, according to the LFS, the employment rate for those aged between 20 and 64 stood at 74.5% in the second quarter of 2018.

The unemployment rate edges down

In the second quarter of 2018, the unemployment rate, as measured in the LFS, stood at 3.8%. This was marginally lower than the 3.9% recorded a year earlier.²³ The jobless rate for males

²¹ The employment rate measures the number of persons aged between 15 and 64 employed on a full-time or part-time basis as a proportion of the working-age population.

²² See *The National Employment Policy*, Ministry for Education and Employment, May 2014, p.13 and *Malta: National Reform Programme 2018*, Ministry for Finance, April 2018, p.27.

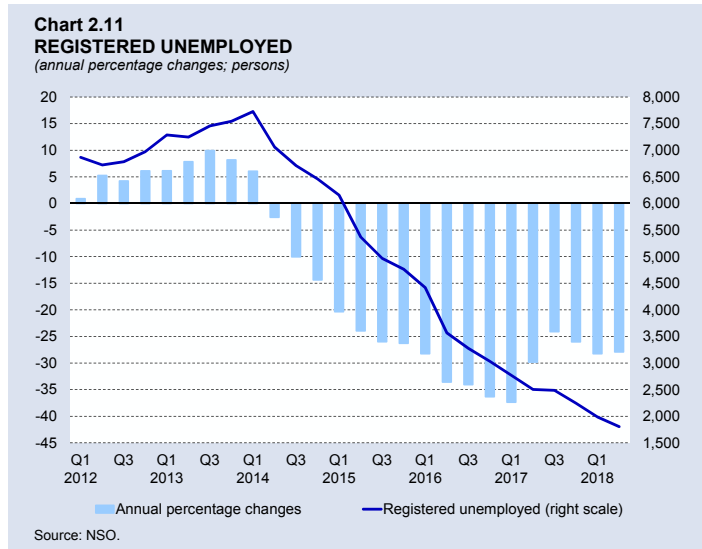
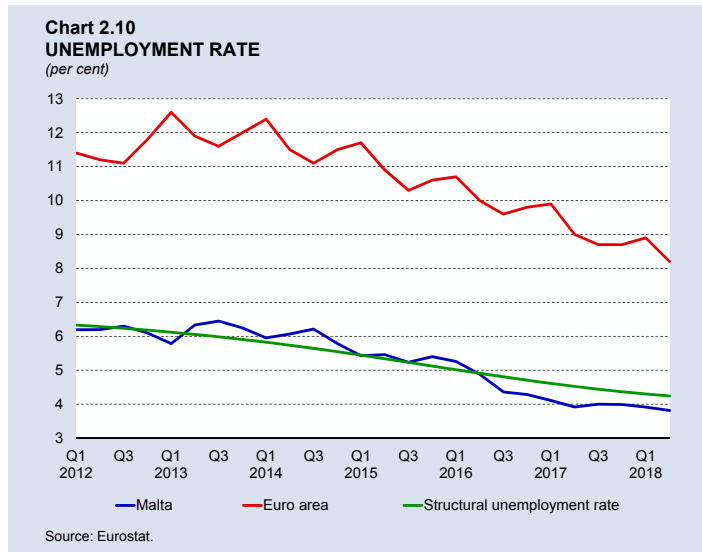
²³ According to the LFS the unemployed comprise persons aged between 15 and 74 years who are without work, available for work and who have actively sought work during the four weeks preceding the Survey. In contrast, the number of unemployed on the basis of the Jobsplus definition includes only those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

edged up by 0.1 percentage point to 4.0%, while that of females fell by 0.4 percentage point to 3.6% (see Table 2.4).

The LFS unemployment rate in Malta remains well below the average rate for the euro area, which stood at 8.2% in the quarter under review (see Chart 2.10). The unemployment gap remained negative, as the unemployment rate remained below the structural measure of 4.2% in the second quarter of 2018.²⁴

Jobsplus data also show favourable labour market developments. The average number of registered unemployed stood at 1,805 in the second quarter of 2018, 698 persons less than those registered in the same quarter of 2017 (see Chart 2.11).

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



²⁴ The structural unemployment rate in this chapter refers to the non-accelerating inflation rate of unemployment (NAIRU), i.e. 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.

BOX 1: LABOUR MARKET FLOWS IN MALTA¹

This Box summarises a study on labour market flows in Malta and their use in forecasting unemployment rates.² Labour market statistics are very useful in gauging the state of the economy, and can be used to assess a wide range of behavioural and socio-economic factors linked with individual labour market situations. The use of labour market flow data, for instance, helps to understand the dynamics between employment and unemployment levels as they qualify the changes in employment status.

The analysis focuses on the post-2002 economic environment, modelled as a two-state model, and using aggregate unemployment duration figures found in the LFS instead of micro-data. The flow rates in the study are calculated following established methods in the literature.³

The modelling framework posits that changes in the unemployment rate derive from workers who were employed in the previous period, and separated from work, less those who were unemployed who have found a job. The framework thus assumes the existence of only two states, with unemployment originating from non-participation in the labour force being excluded. A caveat of the approach is that unemployment will be described accurately only if one assumes that all the inflows originate from employment.⁴ This approach is limited in the sense that state switching from inactivity to activity is an important element in determining unemployment levels. However, in light of data constraints given the unavailability of LFS micro-data, this more standard two-state framework provides a useful and simpler benchmark. This notwithstanding, one has to consider that the Maltese economy has experienced significant structural change over the past decades. Female participation rose from 35.8% in 2000 to 59.7% in 2017. Moreover, foreign worker numbers surged from relatively low levels in the early 2000s to more than 32,000 foreign full-timers and more than 5,000 foreign part-time workers by end-2017. The unemployment rate in Malta fell considerably in recent years, with the decline being attributed to both the cyclical component (short-term unemployment – under one year), as well as changes in longer term unemployment segments (see Chart 1).⁵

¹ Prepared by Reuben Ellul. The author is a Senior Expert within the Economic Analysis Department at the Central Bank of Malta. The author would like to thank Dr A. G. Grech and Mr B. Micallef for their comments and suggestions to an earlier draft of this study, as well as an anonymous peer reviewer at the Banca d'Italia. The views expressed are those of the author and do not necessarily reflect those of the Central Bank of Malta. Any errors are the author's own.

² A more detailed discussion on the topic is available in Ellul, R. (2018), "Forecasting unemployment rates in Malta: A labour market flows approach", Working Paper 03/2018, Central Bank of Malta. For the sake of brevity, this Box focuses only on estimations of the labour market flow rates.

³ The evolution of the number of unemployed over time is modelled as $\frac{du_{t+\tau}}{d\tau} = s_{t+1}(1 - u_{t+\tau}) - f_{t+1}(u_{t+\tau})$. Persons can either be unemployed or employed. $u_{t+\tau}$ is the unemployment rate at instant $t+\tau$. Time t indexes the period (e.g. a quarter), τ is a continuous time measure within the period. s_{t+1} and f_{t+1} are the job separation and finding rates, respectively. For further details see Ellul, (2018).

⁴ For example, inflows may also originate from those entering the labour market for the first time without being previously in employment. Besides, unemployment could also be affected by outflows from the unemployed to non-participation in the labour market, either because they reached retirement age or because of the discouraged worker effect or emigration.

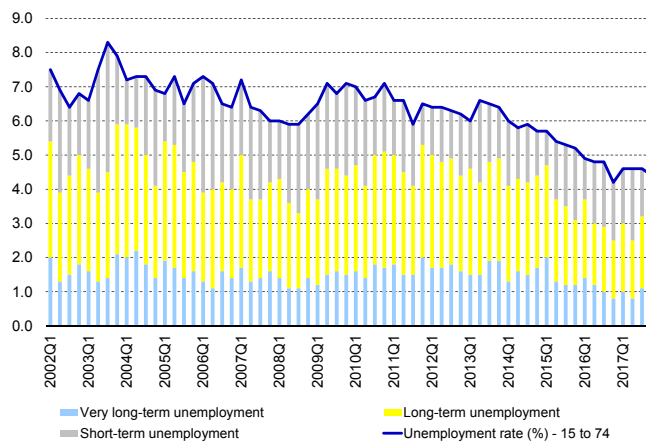
⁵ This Box is based on information available until the end of September 2018. The unemployment rate cited in this Box may differ from more updated estimates published by Eurostat after this date.

In its annual review on labour market and wage developments in Europe, the European Commission (EC) computes job finding and separation rates for EU countries, for the period 2002Q4 to 2016Q4. Most empirical studies define that fraction of unemployed persons who flow out of unemployment as the 'job-finding rate' and the fraction of workers who leave their jobs as the 'aggregate separation rate'. Job finding rates are presented as a quarterly series, and smoothed with a moving-average procedure.⁶ The finding rate estimates in this study follow closely the figures computed by the EC, when expressed as a four-quarter moving average (see Chart 2). Differences may result from different estimating periods, the optimisation procedures implemented and input data precision levels.⁷ The estimated

separation rate is not as close as the EC estimate pre-2006, but moves closer to it thereafter (see Chart 3). This might again result from differences in the estimation procedure, or underlying data differences in vintages or definitions.

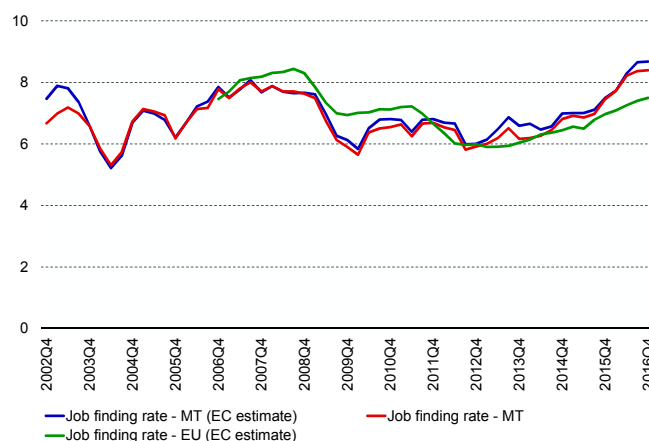
All in all, the flow rates in this study appear to be comparable with the EC's estimates for Malta. Both measures indicate that job finding rates for job-seekers with spells of unemployment shorter than 12 months have started to recover from early 2013 onward. This meant that by mid-2016, job finding rates exceeded the pre-crisis level, and that the average

Chart 1
UNEMPLOYMENT RATE
(per cent of active population)



Source: Eurostat.

Chart 2
JOB FINDING RATES
(four quarter moving averages; per cent)

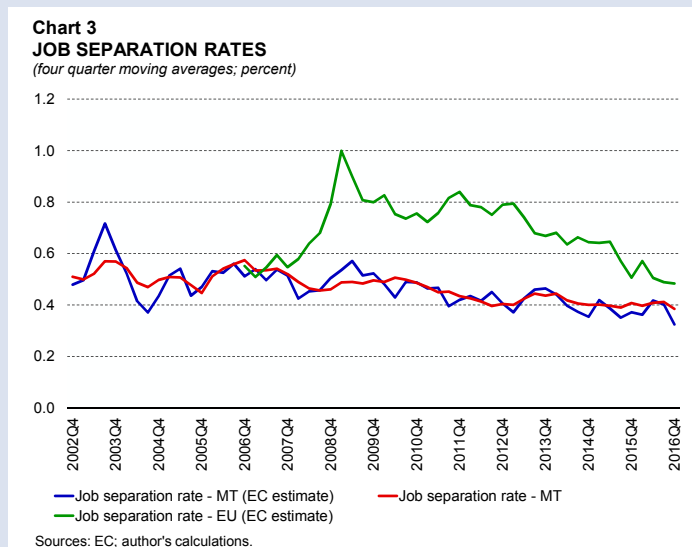


Sources: EC; author's calculations.

⁶ Average of four-quarters: reference quarter and previous three quarters.

⁷ The author acknowledges and is grateful for the data shared by the economists at Unit.A.3. – Country reform – DG Employment, Social Affairs & Inclusion, within the European Commission.

unemployment duration continued to drop. The decline in the unemployment rates observed from 2013 onward was linked to reductions in the job separation rates and increases in job finding rates. Thus, both the separation and the finding rates have improved, especially for people with short unemployment durations. Rates at which jobs losses occur have persistently fallen. Job finding prospects have risen consistently for the past four years.



The estimates show that the average job-finding probability in Malta, for the period 2001Q2 to 2017Q3 stood at 6.9%, while the average separation probability stood at 0.46%. While the job-finding rate in Malta tracks developments in the EU closely, the Maltese labour market did not experience the surge in separation rates seen in the aftermath of the financial crisis in the EU and has remained significantly below the EU estimate in more recent years. Another striking result of this calculation is the increase in job-finding probabilities from 2014 onwards in Malta. In fact, the job-finding rate in Malta diverges from the EU rate after 2014. This surge in job-finding prospects may be linked with various active labour market policies which have been put in place to aid job-finding in Malta. These have included a number of targeted training schemes designed to make target groups more employable, and national apprentice schemes.⁸

The observed trends may result from these active labour market initiatives, as well as efforts to reduce the reliance of the long-term unemployed on unemployment benefits, the tapering of social benefits and the curtailing of abuse and fraud, which may have reduced undeclared work and encouraged people to enter the formal economy. The active labour market policies and a clampdown on benefit fraud may have affected the unemployment duration composition. Changes in the duration composition of an unemployment pool will influence the pace of changes in unemployment. The literature suggests that the long-term unemployed are less likely to search effectively for jobs.⁹ Those unemployed for longer spells face lower job-finding rates.

⁸ See Micallef, B. (2016), "Empirical Estimates of Okun's Law in Malta," in *Applied Economics and Finance*, v. 4, n. 1, pp. 138-148; Micallef, B. (2015), "Estimating the impact on potential output of structural reforms to increase the female participation rate," Policy Note November 2015, Central Bank of Malta.

⁹ See Krueger et al. (2014), "Are the Long-Term Unemployed on the Margins of the Labor Market?," *Brookings Papers on Economic Activity*, Brookings Institution Press; and Kroft et al., (2013), "Duration Dependence and Labor Market Conditions: Evidence from a Field Experiment," *Quarterly Journal of Economics*, v. 128, Issue 3, pp. 1123-1167.

The estimates of separation and job-finding rates are useful indicators for policymakers. For example, if job-finding rates were to drop to mid-2000s levels, the long-term unemployment share may return to levels seen in the aftermath of the 2004 slowdown. The concern, then, would be that the Maltese labour market would once more converge to a higher (and perhaps more persistent) unemployment equilibrium.

Policymakers have to continue their efforts to increase the matching efficiency of the Maltese labour market, and further improve training schemes and other active labour market policies. These are particularly crucial in view of Malta's ageing population, slowing demographic dividend from the eventual deceleration of female participation, and the expected path of the labour market's contribution to supply-side growth. Adequate re-training should be provided to workers, especially those who find it difficult to thrive in fast-growing 'new' industries. Policies which drive labour market flexibility and the gradual weaning-off of able persons from social benefits should continue to be implemented.

Finally, the falling job separation rate may also be an indicator of labour market tightness – although migrant workers appear to have provided enough human capital for various industries to thrive, without compromising job prospects for Maltese workers. However, this foreign component appears to be more prone to job turnover and can create added costs to employers who need to find adequate replacements for staff who leave.

3. PRICES, COSTS AND COMPETITIVENESS

Annual inflation as measured by the Harmonised Index of Consumer Prices (HICP) accelerated strongly during the second quarter of 2018, reaching 2.0% in June. This pick-up was mainly driven by a higher contribution from services related to tourism, with core inflation moderating to 0.8%. Inflation based on the Retail Price Index (RPI), which only takes into account expenditure by residents, also continued to indicate contained price pressures for Maltese households, standing at 1.0% in June.

On the other hand, cost pressures for producers remained on the upside, with annual growth in the Producer Price Index (PPI) standing at 6.4% in June. Malta's unit labour cost (ULC) index continued to accelerate during the second quarter, although the annual rate of change remained moderate from a historic perspective. With regard to international competitiveness, Malta's Harmonised Competitiveness Indicators (HCI) indicated a further deterioration in competitiveness, owing to unfavourable exchange rate and relative price movements.

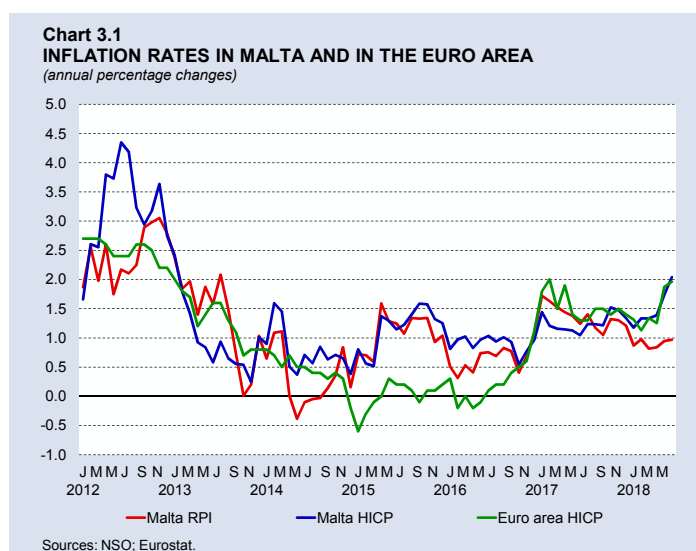
Inflation

HICP inflation picks up

Annual inflation as measured by the HICP accelerated during the June quarter, reaching 2.0% in June from 1.3% three months earlier (see Chart 3.1).¹ Inflationary pressures were mainly registered in services related to the tourism sector.

Similarly, HICP inflation in the euro area picked up during the quarter under review, standing at 2.0% in June. This led to a zero differential between consumer price inflation in Malta and the rest of the monetary union.

Among the main subcomponents of the HICP, services inflation remained the largest contributor to overall inflation, mainly on account of developments in recreational services (see Charts 3.2 and 3.3). The significant increase in contribution from services was mainly due to a statistical impact from a large increase in the weight of accommodation services in the HICP basket for 2018. This increase offset weaker annual price growth for services such as restaurants, package holidays, and cultural services.

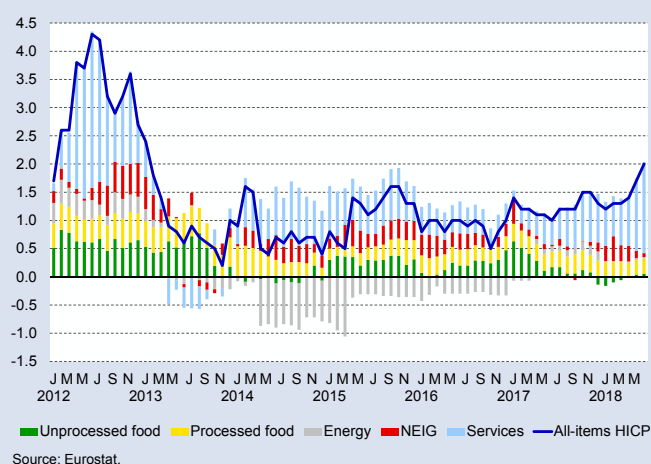


¹ The HICP weights are revised on an annual basis to reflect changes in household consumption patterns. In 2018 the weight allocated to energy stood at 6.3%, while that of non-energy industrial goods was 27.1%. Services accounted for 46.6% of the index, while the share allocated to food stood at 20.0%.

Consequently, services inflation accelerated from 1.8% to 2.8% between March and June, leading to an increase in its contribution to overall inflation by 0.8 percentage point to 1.6 (see Table 3.1).

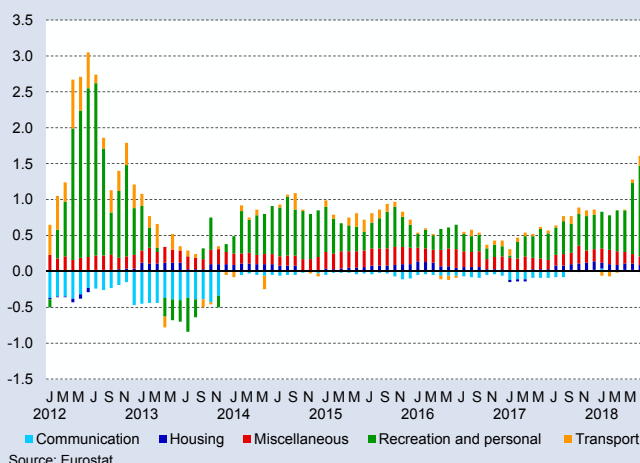
In contrast, with the exception of recreational services, annual inflation within the remaining HICP subcomponents continued to indicate contained price pressures during the second quarter. The contribution of the food subcomponent, which consists of unprocessed and processed food, rose only marginally in the three months to June, by 0.1 percentage point to 0.3. Although unprocessed food inflation recovered, it remained weak, reaching 0.6% in June from -0.8% three months earlier. This mainly reflected a pick-up in meat prices, while vegetable prices contracted at a slower annual pace. Similarly, processed food inflation accelerated slightly during the quarter under review, reaching 2.3% in June from 2.0% in March, largely due to faster growth in prices for bread and cereals.

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.

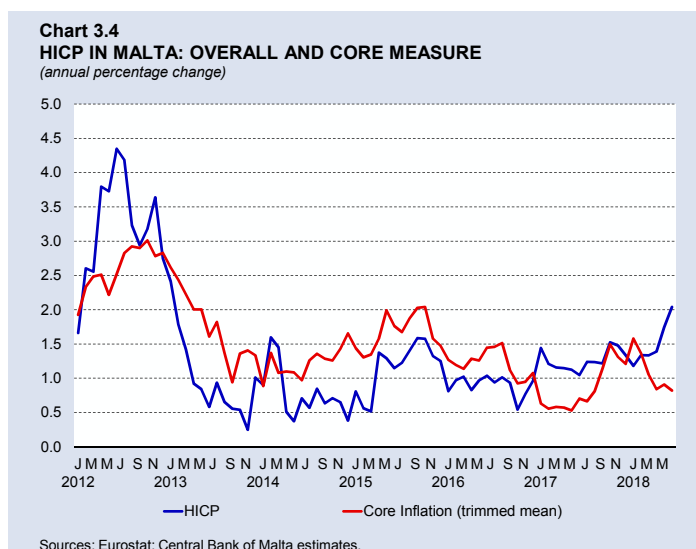
Table 3.1
HICP INFLATION

Annual percentage change

	2017			2018					
	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May	June
Unprocessed food	1.5	0.9	-1.8	-1.9	-1.3	-0.8	-0.2	0.5	0.6
Processed food including alcohol and tobacco	2.8	2.4	2.3	2.0	2.0	2.0	2.0	2.1	2.3
Energy	2.4	2.4	2.4	0.4	0.4	0.4	0.4	0.4	0.4
Non-energy industrial goods	0.1	0.3	0.6	0.8	1.4	0.9	0.9	0.4	0.2
Services (overall index excluding goods)	1.8	1.9	1.9	1.8	1.6	1.8	1.5	2.3	2.8
All Items HICP	1.5	1.5	1.3	1.2	1.3	1.3	1.4	1.7	2.0

Source: Eurostat.

After a recovery during the first quarter of the year, inflation in non-energy industrial goods (NEIG) weakened during the June quarter. On an annual basis, NEIG inflation dropped to 0.2% in June, from 0.9% three months earlier. Hence, the contribution of this subcomponent to overall inflation fell by 0.2 percentage point to 0.1. The broad-based weakness in the prices of goods can in part be attributed to external downward pressures on imported goods prices.



As regards the energy subcomponent, annual inflation stood at 0.4% during the second quarter, unchanged from the preceding quarter. As at June, gas, transport fuel, and electricity prices were the same as those registered three months earlier.

Notwithstanding the acceleration in overall HICP inflation, core HICP inflation as measured by the Bank's "trimmed mean" approach decelerated to 0.8% during the second quarter, from 1.1% three months earlier (see Chart 3.4).² The lower rate of core inflation vis-à-vis the overall measure suggests that some portion of HICP inflation is being supported by strong growth in a small number of subcomponents.

RPI inflation remains contained

Annual inflation based on the RPI accelerated slightly to 1.0% during the second quarter, from 0.8% at the end of the previous quarter (see Table 3.2). This mainly reflected a pick-up from low

Table 3.2
CONTRIBUTIONS TO YEAR-ON-YEAR RPI INFLATION

Percentage points

	2017					2018			
	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May	June
Food	0.6	0.6	0.3	0.3	0.3	0.3	0.4	0.4	0.5
Beverages and tobacco	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Clothing and footwear	-0.5	-0.3	-0.2	-0.5	-0.2	-0.3	-0.2	0.0	-0.1
Housing	0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.1	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	0.2	0.2	0.3	0.1	0.2	0.1	0.2	0.1	0.1
Transport and communications	0.3	0.4	0.3	0.4	0.3	0.2	0.2	0.1	0.0
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	0.2	0.1	0.2	0.1	0.1	0.1	0.0	0.1	0.1
Other goods and services	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
RPI (annual percentage change)	1.3	1.3	1.2	0.9	1.0	0.8	0.8	0.9	1.0

Source: NSO.

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

levels in food prices, as well as a slower annual contraction in prices for clothing and footwear. With the exception of food, the contribution from all subcomponents in the RPI basket remained close to or equal to zero during the period under review.

The contrasting developments in the overall HICP and RPI inflation rates mainly reflect the exclusion of tourist expenditure, such as that on accommodation services, from the RPI basket. The lower level of RPI inflation thus suggests that in general, price pressures for Maltese households remain contained.³

Residential property prices

Residential property prices grow at a slightly faster pace

The NSO's Property Price Index increased at a slightly faster pace during the second quarter of 2018 (see Chart 3.5). The index, which is based on actual transactions involving apartments, maisonettes and terraced houses, rose by 5.7% on a year earlier, after rising by 5.6% in the first quarter of 2018.⁴ In the quarter under review, the rate of growth in Malta was higher than that registered in the euro area, which stood at 4.3%.

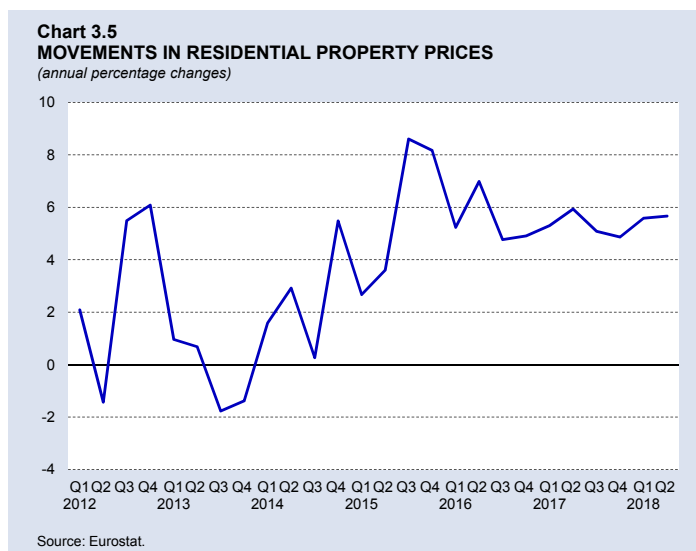
The rise in residential property prices continues to be supported by a number of factors, including the low interest rate scenario and the Government's schemes for first-time and second-time buyers. These incentives increase the attractiveness of property as an investment. Residential property prices are also being sustained by strong growth in disposable income, a buoyant labour market, and an increase in the number of foreign workers. The Individual Investor Programme also contributes to such growth in prices, although to a lesser extent.

The availability of residential property is responding to the increase in demand. On an annual basis, the number of residential permits issued has continued to increase steadily. Residential property price inflation should moderate when construction activity catches up with the demand for housing.

Costs and competitiveness

Producer price inflation remains strong

Producer cost inflation, as measured by the Industrial PPI,



³ The RPI differs from the HICP 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.

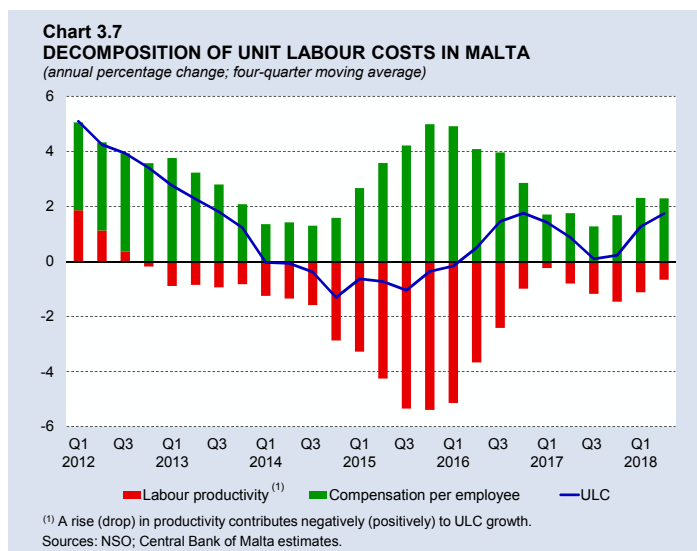
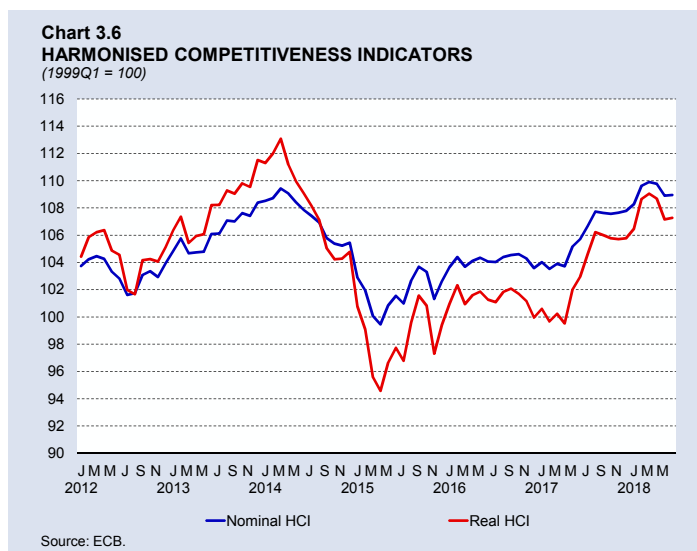
remained strong during the quarter under review, standing at 6.4% in June.⁵ PPI inflation has over the past year been supported by developments in the intermediate goods subcomponent, which is the largest subcomponent of the index and comprises a wide range of items, including computers and electronics. On the other hand, the remaining subcomponents of the overall PPI, namely consumer goods, capital goods, and energy, registered either meagre or negative inflation.

*HCI*s point to further deterioration in international competitiveness

Malta's HCI pointed towards further deterioration in international competitiveness during the second quarter. Annual growth in the nominal HCI, based on trade-weighted exchange rates, stood at 3.1% in June, while the real HCI, which also takes into account relative price pressures, grew by 4.2% (see Chart 3.6).⁶ This suggests that movements in the euro exchange rate and developments in relative prices vis-à-vis international trading partners over the past year have negatively impacted Malta's competitiveness. Nonetheless, the extent of this deterioration was more moderate when compared with previous quarters.

*Unit labour costs accelerate further*⁷

Malta's ULC index, measured as the ratio of compensation per employee to labour productivity, increased further during the second quarter of 2018. In annual terms, ULCs in Malta grew by 1.7%, following 1.3% growth in the previous quarter (see Chart 3.7). Although ULC pressures remain contained



⁵ The Industrial PPI measures the prices of goods at the factory gate and is commonly used to monitor inflationary pressures at the production stage.

⁶ The nominal HCI tracks movements in a country's exchange rate against the currencies of its main trading partners, weighted according to the direction of trade in manufactured goods. The real HCI incorporates both exchange rate changes and the relative inflation of a country vis-à-vis its main trading partners. A higher (or lower) score in the HCI indicates a deterioration (or improvement) in a country's international price competitiveness.

⁷ Annual growth in ULC, compensation per employee, and labour productivity is measured on a four-quarter moving average basis. A degree of caution is required in the interpretation of ULC in view of contemporaneous structural shifts in the composition and factor-intensity of production, notably the shift to labour-intensive services. See Micallef, B. (2015), "Unit labour costs, wages and productivity in Malta: a sectoral and cross-country analysis", Policy Note August 2015, Central Bank of Malta, available at <https://www.centralbankmalta.org/en/working-papers-2015>, and Rapa, N. (2016), "Measuring international competitiveness", *Quarterly Review* 2016(1), pp. 53-63, Central Bank of Malta.

from a historical perspective, growth in the index has accelerated at a steady, albeit modest, pace since mid-2017.

The latest acceleration in ULCs was driven by slower annual growth in labour productivity, which decelerated to 0.7% from 1.1% in the previous quarter. At the same time, annual growth in compensation per employee was unchanged when compared with the previous quarter, at 2.3%.

4. THE BALANCE OF PAYMENTS

During the second quarter of 2018 the surplus on the current account of the balance of payments narrowed when compared with the corresponding quarter of 2017. The lower surplus was almost entirely attributable to a widening in the merchandise trade gap, and, to a lesser extent, to lower net inflows from secondary income. These movements partly offset an increase in net services receipts and lower net outflows related to primary income. Meanwhile, net inflows on the capital account decreased on a year earlier, while lower net lending was recorded on the financial account.

When measured on a four-quarter moving sum basis, the current account balance was equivalent to 12.8% of gross domestic product (GDP), compared with 3.5% of GDP in the euro area.

The cyclically-adjusted current account balance is estimated at 12.6%. The small difference between the unadjusted and adjusted balance indicates that Malta's current account surplus largely reflects structural factors.

The current account

The current account surplus narrows

In the April to June period of 2018, the current account registered a surplus of €384.8 million, a decline of €140.5 million on the same period of 2017. The lower surplus was largely driven by a widening of the merchandise trade deficit.

When measured on a four-quarter moving sum basis, the surplus on the current account widened to €1,474.9 million, from €1,359.4 million in the twelve months to June 2017. This increase was driven by both a narrowing of the merchandise trade deficit and higher surplus on trade in services (see Table 4.1). When compared with the twelve months to June 2017, the increase in the current account surplus was largely matched by a similar rise in GDP. As a result the current account to GDP ratio stood unchanged at 12.8%.

Malta's cyclically-adjusted current account balance stood at 12.6% of GDP, down from 14.7% in the year to June 2017.¹ The cyclically-adjusted and the unadjusted current account balances for the

Table 4.1
BALANCE OF PAYMENTS
EUR millions

	Four-quarter moving sums					2017 Q2	2018 Q2
	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2018 Q2		
Current account	1,359.4	1,498.1	1,531.8	1,615.5	1,474.9	525.4	384.8
Goods	-1,508.3	-1,413.5	-1,358.0	-1,234.7	-1,422.6	-258.0	-445.9
Services	3,427.4	3,521.5	3,565.2	3,548.6	3,582.3	963.2	996.8
Primary income	-739.2	-768.0	-811.1	-838.5	-822.5	-211.0	-195.1
Secondary income	179.6	158.1	135.7	140.1	137.8	31.2	28.9
Capital account	61.7	53.3	65.0	69.1	51.7	17.4	0.8
Financial account⁽¹⁾	1,833.7	1,430.1	1,379.4	811.5	727.3	648.6	564.4
Errors and omissions	412.5	-121.3	-217.4	-873.1	-978.8	105.9	178.9

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

Source: NSO.

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., & Zerfa, S. (eds.), *Challenges and Opportunities of Sustainable Economic Growth: the case of Malta*, Central Bank of Malta, 2017.

Maltese economy tracked each other closely in recent quarters (see Chart 4.1). This suggests that movements in Malta's current account are being driven largely by structural, rather than cyclical factors. The narrowing in the cyclically-adjusted balance since the second quarter of 2017 largely reflects a wider foreign output gap, which has a favourable impact on headline exports but is excluded from the cyclically-adjusted measure.

The merchandise trade deficit widens

In the June quarter of 2018, the merchandise trade deficit widened by €187.9 million on the corresponding period of 2017, reaching €445.9 million. This reflected a contraction in exports and a rise in imports.

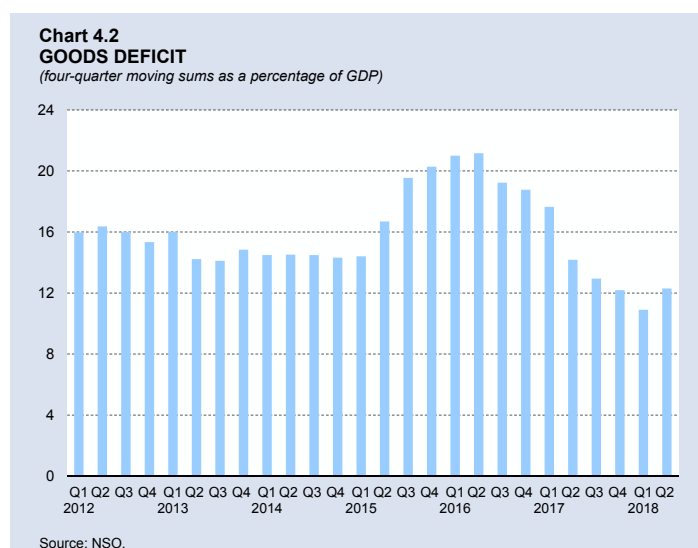
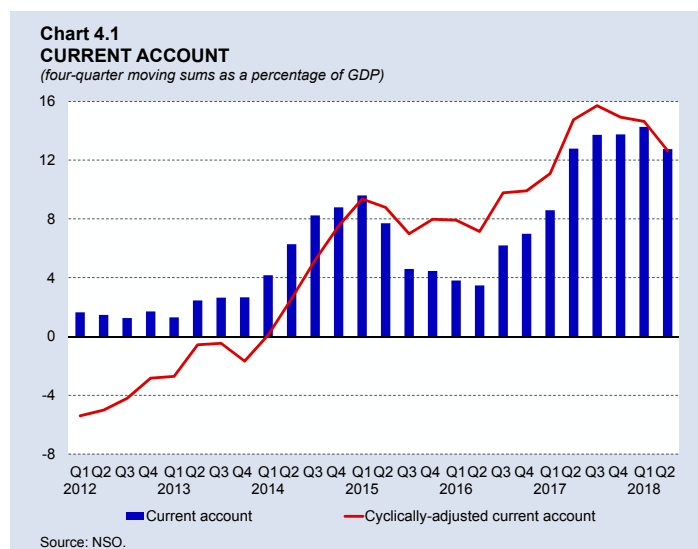
When measured on a four-quarter cumulative basis, the visible trade gap narrowed by €85.7 million, to €1,422.6 million. This improvement arose as exports grew at a faster pace than imports. The former increased by €152.3 million while the latter rose by €66.6 million. As a result, the share of merchandise deficit in GDP dropped to 12.3% in the year to June 2018, from 14.2% a year earlier (see Chart 4.2).

The surplus on services continues to rise

In the quarter under review, the surplus from services stood at €996.8 million, an increase of €33.6 million on the corresponding quarter of 2017. The higher surplus was supported by an expansion in exports which offset a smaller rise in imports.

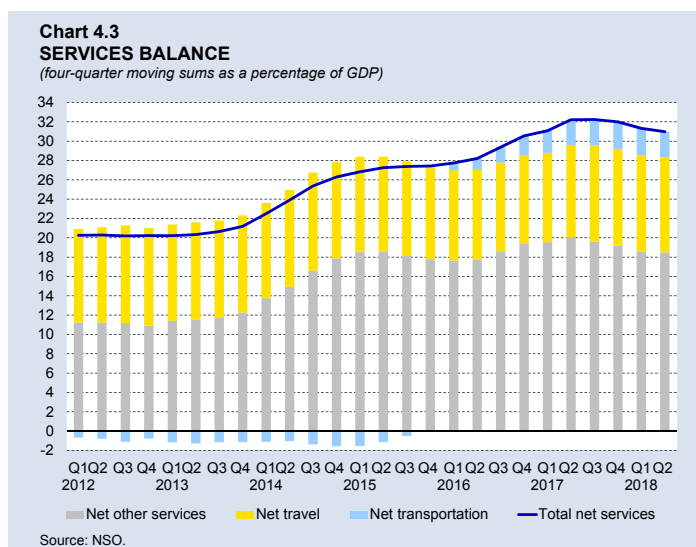
The higher net surplus was mainly driven by the "other services" category, with net receipts increasing by €33.2 million, to €574.3 million. This increase was predominantly spurred by higher net receipts related to remote gaming, which more than offset higher professional and management consultancy payments related to business services.

At the same time, net travel exports rose by €11.4 million to €335.8 million, in the second quarter of 2018, as an increase of €18.6 million in inbound tourists' spending offset an increase of €7.2 million in expenditure by Maltese residents abroad. The latter was due to higher spending in both



EU and non-EU destinations. These increases offset a €10.9 million decrease in net transport receipts, the latter reflecting a faster rise in payments.

On a four-quarter cumulative basis, the overall surplus from services stood at €3,582.3 million, an increase of €154.9 million on the balance recorded over the four quarters ending in June 2017. Despite such an increase, net services receipts as a percent of GDP dropped to 31.0% of GDP, from 32.2% a year earlier (see Chart 4.3).



Primary income account records lower net outflows²

Between April and June 2018, net outflows on the primary income account stood at €195.1 million, compared with net outflows of €211.0 million in the same period of 2017. This was largely on account of higher net interest earned on ‘other investment’ income which offset a drop in net interest receipts on portfolio investment inflow and higher net income payments related to direct investment.

On a four-quarter cumulative basis, net outflows on this account reached €822.5 million in the four quarters ending in June 2018; €83.3 million more than a year earlier. Developments on this account continued to be strongly influenced by internationally-oriented firms which transact predominantly with non-residents.

Inflows on the secondary income account decrease³

In the second quarter of 2018, net inflows on the secondary income account dropped by €2.3 million on a year earlier, to €28.9 million.

When measured on a four-quarter moving sum basis, inward secondary income flows declined to €137.8 million, €41.8 million less than the amount recorded a year earlier.

Tourism activity

The tourism sector remains buoyant

Activity in the tourism industry remained buoyant in the second quarter of 2018, with inbound tourists, nights stayed in Malta and expenditure all rising at double-digit rates compared with a year earlier.

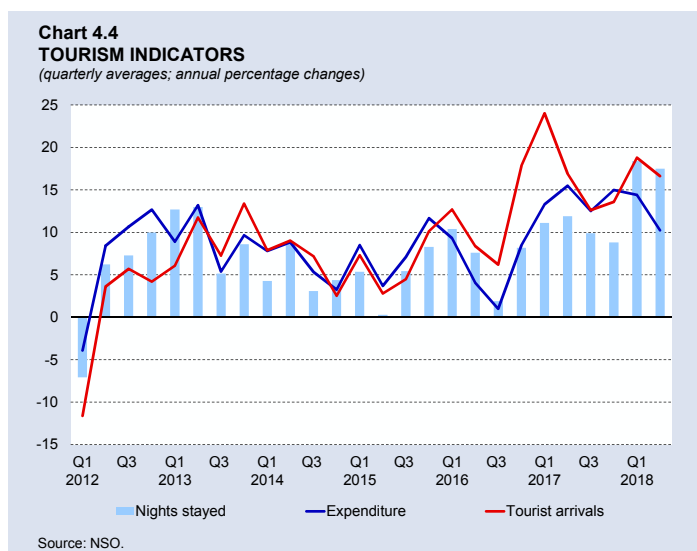
The number of inbound tourists totalled 747,944, a rise of 16.6% on a year earlier (see Chart 4.4). This increase continued to be driven by a higher number of tourists that visited Malta for leisure

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.

purposes, as those travelling for business purposes and other motives registered strong declines on a year ago.

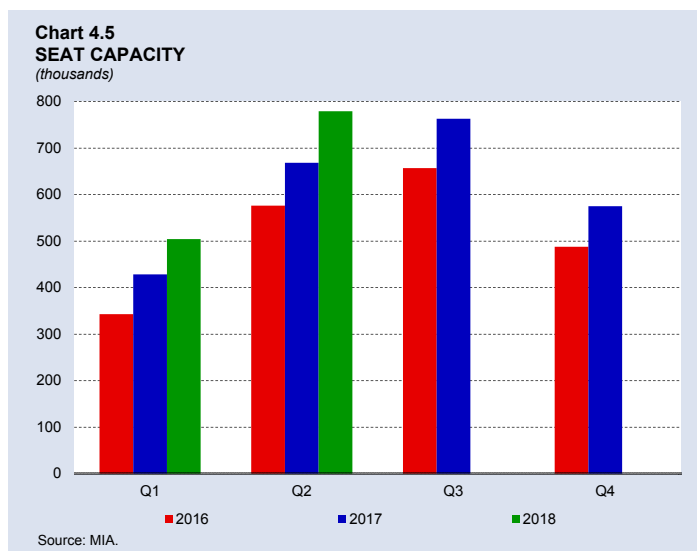
Over the period reviewed, the number of nights that tourists spent in Malta reached 5.0 million, a rise of 17.5% on the preceding year. Growth was mainly driven by an increase in nights stayed in private accommodation, which rose by 25.6% on an annual basis. Meanwhile, nights spent in collective accommodation went up by 12.1%.⁴



During the second quarter, tourist expenditure in Malta grew at an annual rate of 10.2% on the previous year, to €569.4 million.⁵ All sub-components within this category reported gains, with the largest additions in absolute terms being registered in the package category, which went up by 18.0%. The non-package category of tourism spending also grew significantly, increasing by 10.7% in annual terms. Similarly, the “other” component of tourism expenditure rose, albeit at a lower rate of 4.4%.⁶

As tourist spending increased at a slower pace compared with arrivals, expenditure per capita decreased to €761, from €805 in the second quarter of 2017. Meanwhile, the average length of stay increased marginally to 6.7 nights in the quarter under review from 6.6 nights in the same period a year earlier.

The tourism sector continued to benefit from the efforts being made to promote Malta as a year-round destination and from the introduction of new routes. According to Malta International Airport (MIA) data, seat capacity increased by 16.6% in the second quarter of 2018 compared with a year earlier (see Chart 4.5).⁷



⁴ Private accommodation includes self-catering apartments, farmhouses, and private residences. As per Eurostat recommendation, time-share accommodation is classified as “private accommodation”. Collective accommodation comprises hotels, apart-hotels, guesthouses, hostels and tourist villages.

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

⁶ Non-package holiday expenditure is subdivided into spending on accommodation and travel fares, while the “other” component captures any additional expenditure by tourists during their stay in Malta.

⁷ MIA data are subject to revisions.

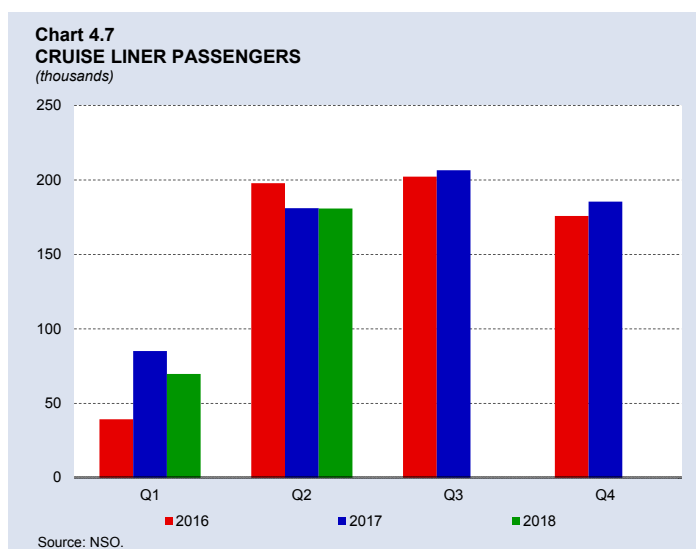
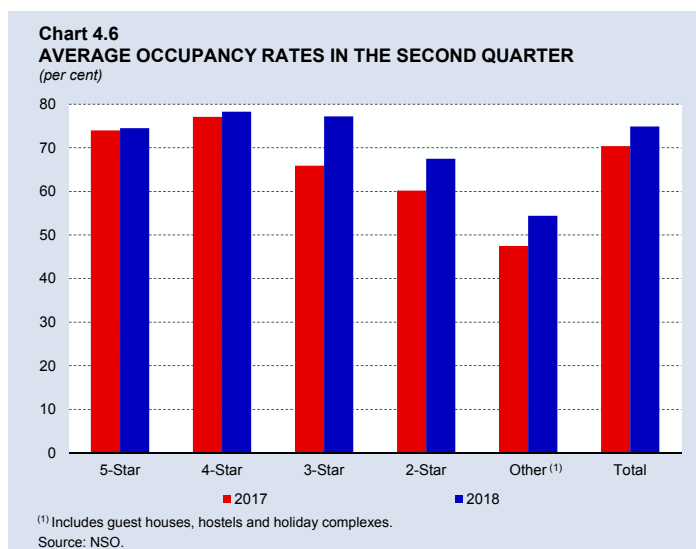
In the second quarter of 2018, the total occupancy rate in collective accommodation establishments reached 74.9% from 70.4% in the same quarter a year earlier (see Chart 4.6). Higher occupancy rates were recorded in all categories, with the largest increase being registered in three-star hotels.

The number of cruise liners visiting Malta during the June quarter totalled 103, 12 less than a year earlier. Nonetheless, the number of foreign cruise liner passengers was practically unchanged at 180,849 compared with 181,050 a year earlier (see Chart 4.7).

The capital account

Net inflows on the capital account decreased to €0.8 million during the second quarter of the year; down from €17.4 million in the corresponding period of 2017 (see Table 4.1). This was mostly attributable to lower transfers to government, which are influenced by the timing of funds received under EU financing programmes. When

measured on a four-quarter moving sum basis, capital inflows totalled €52.5 million in the four quarters to June 2018, down by €26.8 million on a year earlier.



THE EVOLUTION OF MALTA'S TOURISM PRODUCT OVER RECENT YEARS¹

Silvio Attard

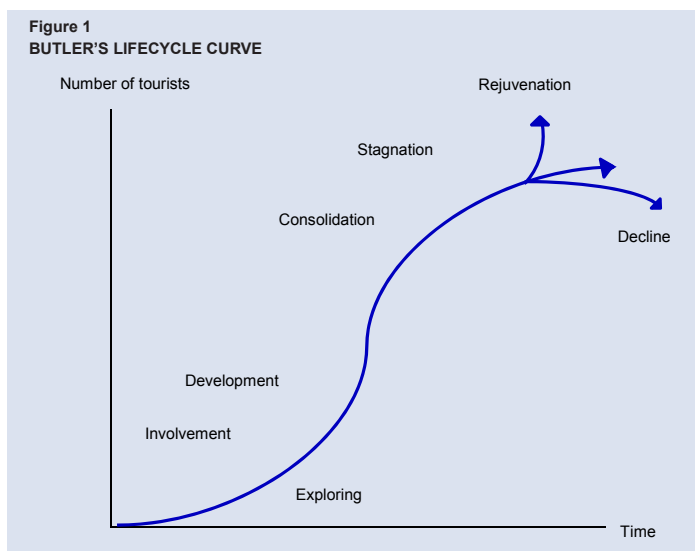
This study aims to analyse developments in Malta's tourism industry, focussing on the changing characteristics of demand and supply, as well as the economic importance of tourism for the Maltese economy. It also examines the issue concerning sustainable growth of the sector and seeks to draw some policy inferences.

Tourism in Malta: A historic perspective

The development of tourism in Malta started in the late 1950s, as the Maltese authorities sought to identify new areas of economic development in view of the diminishing role of the British military base in Malta. The Government initiated a programme of capital spending aimed at improving access to beaches, together with increased promotion and advertising. The ensuing increase in passengers and aircraft movements necessitated the construction of an air terminal for civilian activity in 1956, with the first passenger terminal inaugurated in 1958.

In the beginning, initiatives such as the setting-up of the Malta Government Tourist Board in 1958, had led to moderate increases in the number of tourist arrivals, partly due to the limited funds made available. However, the adoption of a grants programme to encourage business in the hotels sector in the mid-1960s, even though more costly, was very successful, with the sector expanding further through the seventies. This was followed by a period of decline following the second oil shock and the ensuing global recession, especially in the United Kingdom in the early 1980s, which had resulted in a sharp drop in arrivals from the United Kingdom. Since then, arrivals have increased almost uninterruptedly.

The evolution of tourism in Malta can be analysed in the light of Butler's tourism destination life cycle model.² According to this model, visitors will come to an area in small numbers initially, restricted by lack of destination access, facilities, and limited awareness of what the country offers. As facilities are provided and awareness grows, visitor numbers will increase. With marketing, information dissemination, and further facility provision, the area's popularity will



¹ Prepared by Silvio Attard, a Senior Expert within the Economic Analysis Department. The author would like to thank Mr Christian Ellul for his help with the collection and presentation of data. Thanks also goes to Mr Matthew Zerafa, Ms Lara Pace and Mr Keith Lia from the National Statistics Office, Ms Justine Baldacchino from Malta International Airport plc and Ms Tania Sultana from the Malta Tourism Authority for their valuable assistance in the collation of data. Helpful comments and suggestions by Ms Rita Schembri, Dr Aaron G. Grech and Mr Alexander Demarco are gratefully acknowledged. The views expressed in this paper are those of the author and do not necessarily reflect those of the Central Bank of Malta.

² A limitation of Butler's model relies on the assumption that the critical range of tourist capacity does not change during the whole cycle. Over the past two decades key additions to Butler's concept were made. These include references to the weaknesses and strengths of the destination, as well as the reasons for development, change, limitations, and interventions in a tourist area.

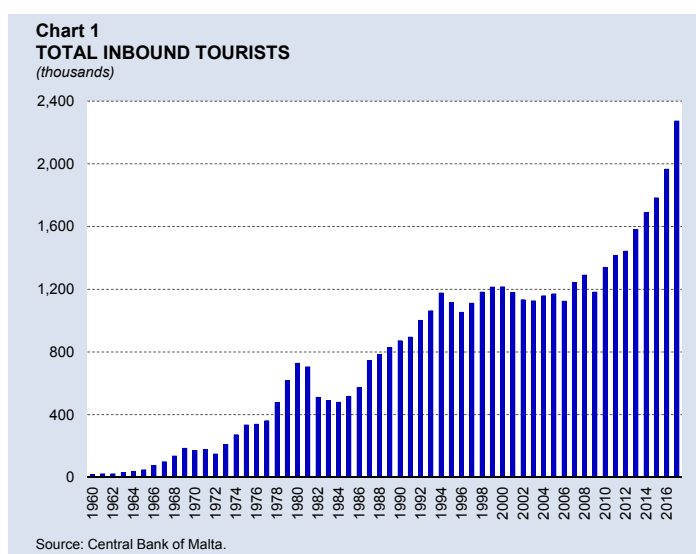
grow rapidly. Eventually, however, the rate of increase in visitor numbers will decline as levels of carrying capacity are reached. These may be identified in terms of environmental factors (e.g. land scarcity, water quality, air quality), physical plant (e.g. transportation, accommodation, other services), or social factors (e.g. crowding, resentment by the local population). As the attractiveness of the area declines relative to other areas, because of overuse and the impacts of visitors, the actual number of visitors may also eventually decline unless steps are taken to rejuvenate the tourist product. These stages are depicted in Figure 1.

Chart 1, which shows the number of tourists in Malta since 1960, conforms to Butler’s model. The development of the tourism industry involved tackling two main challenges, namely: the insufficient skills and education of the local population, and the lack of infrastructure. In fact, initially Malta was predominantly visited by the British to meet friends and family members stationed on the islands. As the numbers of visitors increased, Malta moved on to the involvement stage, where policymakers, having considered the potential of this industry, took steps to support tourism-friendly facilities. In Malta, this stage was characterised by notable private investment in the tourism industry; international hotels chains such as the Hilton and Sheraton groups started operating locally. As a result, different forms of employment such as travel agencies, real-estate, banking, insurance, leisure, and retail outlets were generated.

As the number of visitors continued to rise, the country moved to the development stage where heavy advertising takes place and the number of tourists is likely to be equal or exceed the permanent local population. At this stage, mass tourism had developed with structures of hotels built in a way to accommodate the peaks being reached during summers. The idea of Malta as a sun, sea and sand destination was already creating the problem of seasonality, especially where the labour force was concerned. The problems exacerbated to a point where Malta started to experience a shortage of water supply, a problem of sewage disposal in the peak months of summer, and, high dependence on British visitors.

The first half of the 1980s was characterized by a sharp decline in the number of arrivals. By 1984, the total number of tourists declined by about a third when compared with the high point reached in 1980, off the back of a severe slowdown in the arrivals of UK visitors. This slowdown was not exclusive to Malta, as other Southern European countries also experienced a lacklustre performance in their respective tourism markets in the wake of the second oil shock and deep recession in the United Kingdom. In the case of Malta, a strong exchange rate also led to a decline in cost competitiveness.

By the end of the decade, the losses in tourism were reversed. The market had returned to growth, mainly due to the authorities’ implementation of a diversification strategy



in source markets for tourists. This included more competitive packages offered by industry operators, as well as a dual exchange rate in respect of the British pound, which was introduced to reduce the impact of the Maltese Lira appreciation. As the country reached the mass tourism market, it moved to the consolidation stage where visitors rose above the one million mark in 1992. This momentum was maintained until 1995 when the total number of tourist arrivals fell for two consecutive years, mainly due to a reduced demand from some British tour operators.

From the mid-1990s through the mid-2000s the number of visitors reached a plateau and this can be considered Malta's stagnation stage according to Butler's model. The authorities worked hard to avoid going into the decline stage shown in Figure 1. With the setup of the Malta Tourism Authority in 1999, Government aimed to improve the Maltese tourism product by shifting attention from a practically exclusive sun and sea destination to a more segmented industry niches based on improvements in the quality of tourism services. The advent of low cost airlines in 2006 increased route connectivity with mainland Europe. The effects of the air transport reform were complemented in subsequent years by the woes of competing destinations in the wake of the Arab Spring. As a result of this during the past decade, the Maltese tourism product experienced the rejuvenation stage, with the industry returning to very strong growth.

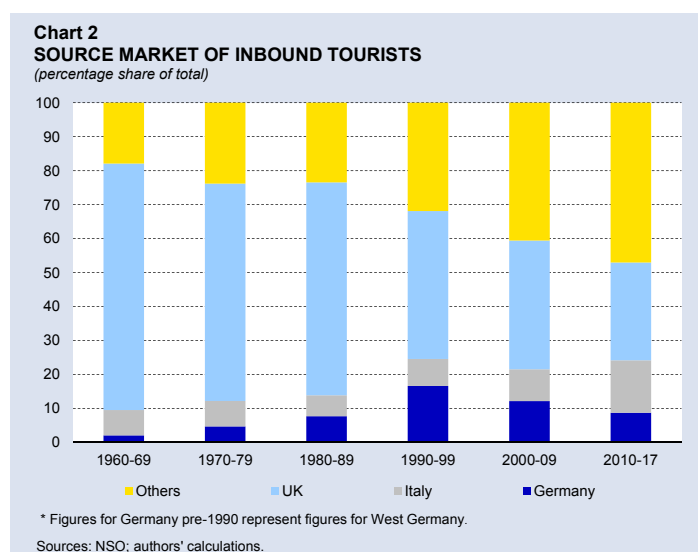
The changing characteristics of inbound tourism in Malta

Source markets and profile of visitors

Historically, reflecting the ties between Great Britain and Malta, the local tourism industry was practically exclusively reliant on the United Kingdom. Indeed, during the 1960s, when the first tourism statistics started to be compiled, almost 75% of all visitors were UK nationals (see Chart 2). Arrivals from other European markets were mainly from Italy, and to a lesser extent from Germany. This situation more or less prevailed until the late 1980s.

The composition of tourists began to change significantly during the 1990s as the authorities responded with diversification strategies aimed at reversing the decline in tourism activity recorded in the previous decade.

By 2017, when a record of 2.3 million tourists visited Malta, the United Kingdom's market share, albeit still the largest, had fallen to close to 25%. Meanwhile, for the first time, arrivals from Italy and Germany collectively exceeded UK visitors, and tourists coming from the remaining source markets represented more than half of total visitors. The decreased reliance on few source markets is largely credited to increasing airline connectivity, but also the authorities' ability to diversify the Maltese tourism product.



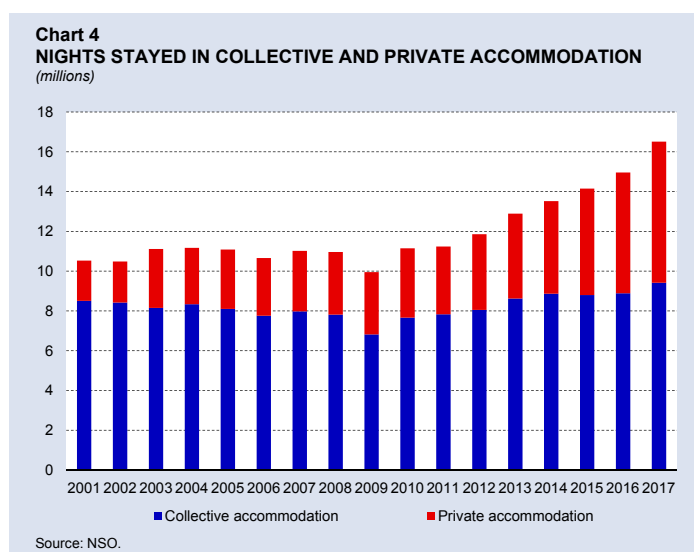
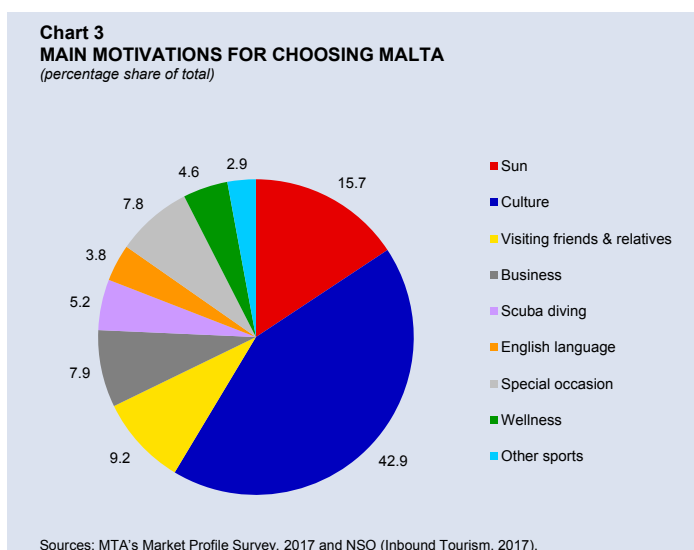
Leisure tourism remains the main purpose of visit for the vast majority of arrivals, with its share increasing from 83.7% in 2010 to 85.3% of total inbound tourists in 2017, largely reflecting the expansion in self-catering accommodation facilities and internet marketing. Over the same period, although the number of visitors for business purposes increased by over 62,000 persons, its share in total inbound tourism nevertheless declined to 7.9%, 0.9 percentage point less than in 2010. Meanwhile, the share of the “other” tourist segment, which includes tourism for educational, religious and health-related purposes, stood at 6.8%, accounting for more than 154,000 visitors in 2017.

Despite the increase in leisure tourism, there has also been some diversification within the Maltese holiday product itself. Indeed, based on the 2017 Malta Tourism Authority’s (MTA) Market Profile Survey, only 15.7% chose Malta as their destination solely for the traditional ‘sun and sea’ factor. The largest share of tourists, standing at 42.9% chose Malta for its culture and heritage. Moreover, important tourism niches such as, health, wellness, scuba diving and other sports segments were mentioned by a further 12.7% of the tourists surveyed as their main motivational factor in choosing Malta as their destination (see Chart 3).

Nights spent in Malta – private versus collective establishments

Over the ten year period to 2010, total nights spent by inbound tourists remained broadly stable (see Chart 4). From 2001 to 2008, total nights stayed averaged 10.9 million nights per year, before declining to 9.9 million nights in 2009 on the back of dwindling demand spurred by the global financial crisis. The effect of the crisis was limited to a single year and the losses of more than one million nights in 2009 was more than recouped in the following year. Subsequently visitor nights spent in Malta continued to increase steadily and exceeded 16.5 million nights in 2017, almost 50% more than in 2010.

For several years, the vast majority of tourists preferred to spend their stays abroad in collective accommodation



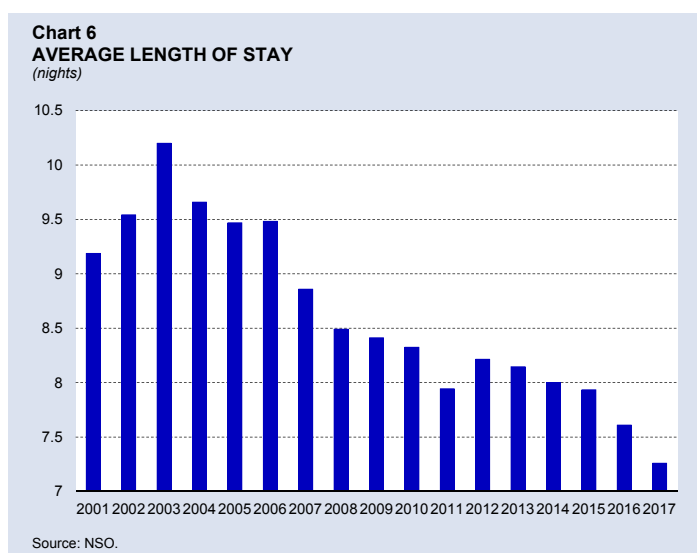
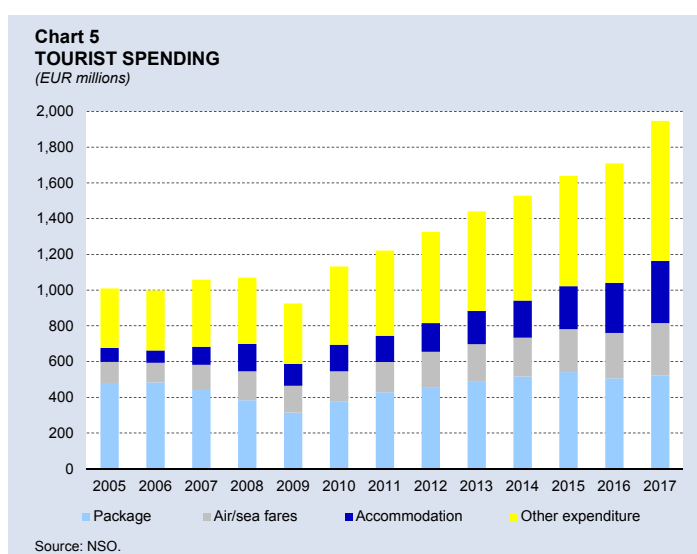
establishments.³ However, since the turn of the century there has been a pronounced shift in preferences from collective accommodation towards stays in private accommodation establishments.^{4,5} This change in preference is mainly driven by technological advances and the ease in booking alternative accommodation on online platforms. The switch towards private accommodation also reflects increasing attention to the concept of value for money and a search for more experiential tourism, where visitors seek authentic local experiences.

In 2001, out of the 10.5 million nights spent by tourists in Malta, nights in private accommodation amounted to only about 2 million nights, or slightly less than 20% of total nights. Over the following eight years this share continued to trend upwards, and in 2009 it surpassed the 30% mark, as the negative impact of the global financial crisis was almost entirely absorbed by collective accommodation establishments. By 2017 the nights spent in collective accommodation establishments reached a high of 9.4 million nights. Nevertheless, its share in total nights spent by tourists in Malta declined to 57.0%, as nights stayed in private accommodation establishments rose at a faster rate.

As the popularity of private accommodation increased, the tourism industry in Malta has gradually also shifted from package to non-package holiday makers, with the traditional tour operator business losing market. The share of spending on package holidays almost halved from 2005 to 2017, down from 47.8% to 26.8% of total expenditure. At the same time, the share of spending on accommodation rose by ten percentage points to stand at 17.7% of total expenditure by 2017 (see Chart 5).

Average length of stay and tourism expenditure

During the same period, the average length of nights spent in Malta has generally declined (see Chart 6). In 2001, on average, inbound tourists' spent 9.2 nights in Malta, rising to 10.2



³ As per NSO definition, these include hotels, guesthouses, hostels, tourist villages, holiday complexes, bed & breakfast, and campsites.

⁴ The changing trend in tourists' preference to stay in private accommodation is a global phenomenon and not exclusive to Malta.

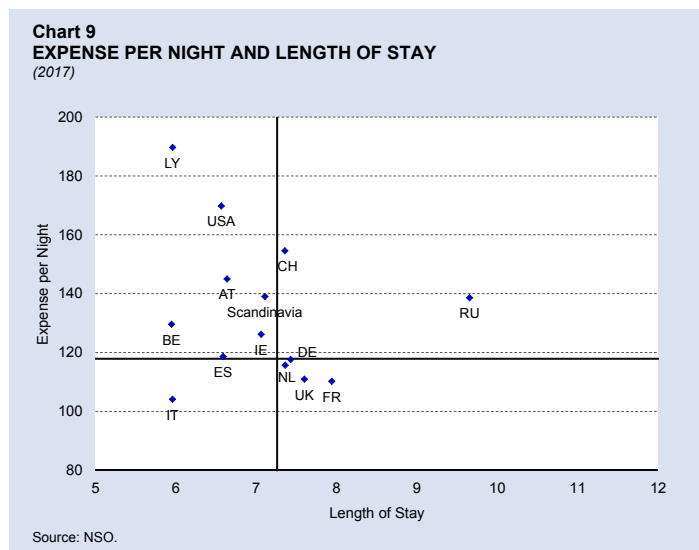
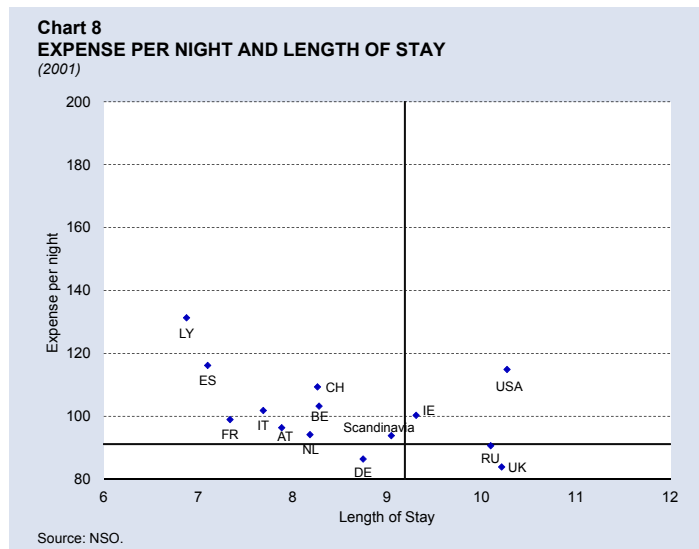
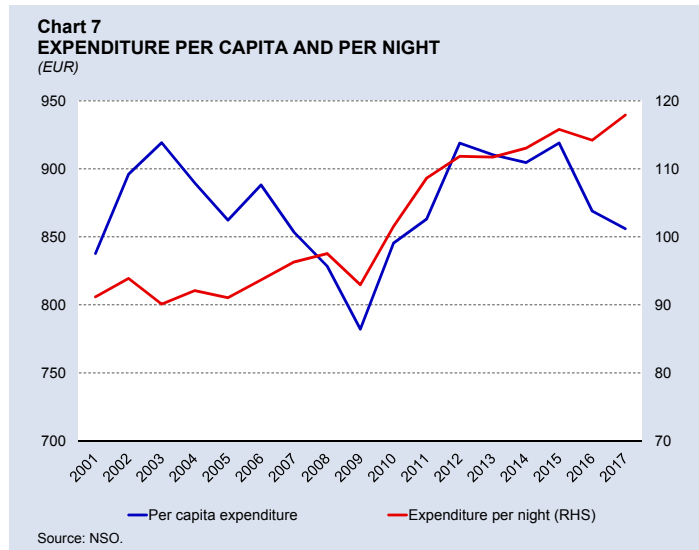
⁵ Private accommodation includes rented accommodation, own private residence, staying with friends and other private accommodations.

nights by 2003. However, since 2004, the average length of stay has been on a downward trend, standing at 7.3 nights in 2017. The drop in the average length of stay was more pronounced post-2007, partly reflecting the advent of low cost carriers which led to more frequent air-line connectivity of the islands, increasing Malta's viability as a short holiday destination.

Reflecting the rise in inbound tourists and total nights stayed in Malta, visitors' spending also surged markedly. In 2001, total tourist expenditure stood at €960.4 million. It surpassed the €1 billion mark in 2003. Spending remained broadly stable until 2008 before declining by 13.5% in 2009. From 2010 onwards, expenditure grew at an average annual rate of 9.9%, reaching €1.9 billion in 2017, more than double the level recorded in 2009 (see Chart 7).

Given the decline in the average length of stay, the average expenditure per visiting tourist did not change much from 2001 onwards. On a per capita expenditure basis, tourists spent €838 per stay in 2001, rising only to €856 in 2017 (see Chart 7). However, when taking into account the impact of shorter stays, the average expenditure per night increased from €91 in 2001 to €118 in 2017.

The relative stability in the average length of stay and spending per night masks notable heterogeneity across different source markets. Charts 8 and 9 compare



the various markets in 2001 and 2017, respectively. In both years, Libyan tourists recorded the largest expenditure per night spent in Malta, but on average also had the shortest stay. In contrast, in 2001, the average British visitor had the lowest expenditure per night amongst the different source markets (see Chart 8). At the same time, together with visitors from the USA and Russia, British tourists spent the longest stays in Malta. Meanwhile, German tourists spent only marginally more than British visitors and stayed for a shorter period of time.

The situation changed considerably by 2017 – the average length of stay fell to 7.3 nights while the average tourist expenditure per night edged up to €118 (see Chart 9). While visitors from Libya continued to lead in terms of expenditure per night, tourists from the USA, Switzerland, Austria and Scandinavia also spent substantially more than the average spend. At €104 per night, Italian tourists were the lowest spenders, followed by the French and British tourists. The practically unchanged spend per night by the Italian tourists between 2001 and 2017 can be partly attributed to increased connectivity and lower airfares between the two countries, which has changed the profile of the average Italian visitor. Meanwhile, only Russian tourists continued to prefer spending around 10 days in Malta. By contrast, recent years have seen the average Scandinavian and Swiss tourist lowering their average length of stay but increasing their spending considerably.

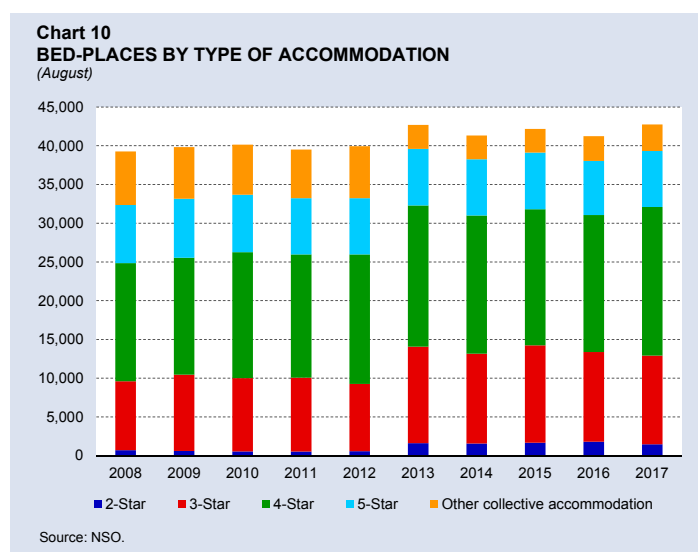
Adapting supply-side factors

Over the years, tourism-related supply factors have adjusted to more dynamic demand. In this study, we limit our consideration of supply to capacity in collective accommodation establishments, aircraft movements, seat capacity and seat load factor, as well as cruise liner calls. A more comprehensive analysis would also warrant an assessment on infrastructural needs and utilisation, and the increasingly importance of stays in private accommodation. However, data on the latter indicators are unavailable or fragmented at best.

Availability and occupancy rates in collective accommodation establishments

Possibly reflecting the requirement of relatively large tracts of land, which is a scarce resource, for the hotels sector, the number of collective accommodation establishments rose at a more muted pace than inbound tourism. Over the last decade, the number of collective establishments on the island rose from 161 in the peak month of August in 2008 to 188 in the same month of 2017. The majority of the new establishments were three-star hotels, followed by two-star establishments. Over this period, the number of five-star hotels remained unchanged at fifteen and only three new four-star establishments were opened.

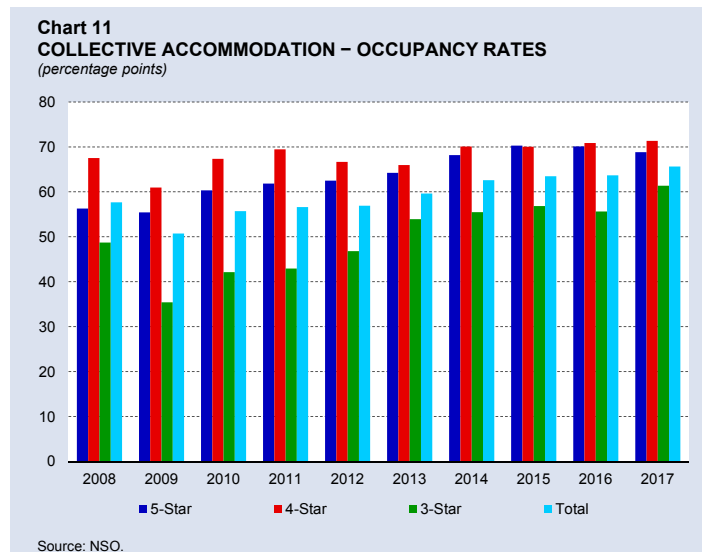
Since 2008, bed capacity in collective accommodation establishments rose by 8.9%, or close to 3,500 more bed-places (see Chart 10). Most of the increase emanated from the three and four-star segments. At the same time, capacity in



the 'other collective accommodation' establishments declined notably. This drop can be partly attributed to the increased preference towards transforming guesthouses and hostels into boutique hotels which tend to have a smaller number of rooms but offer higher quality standards and facilities.

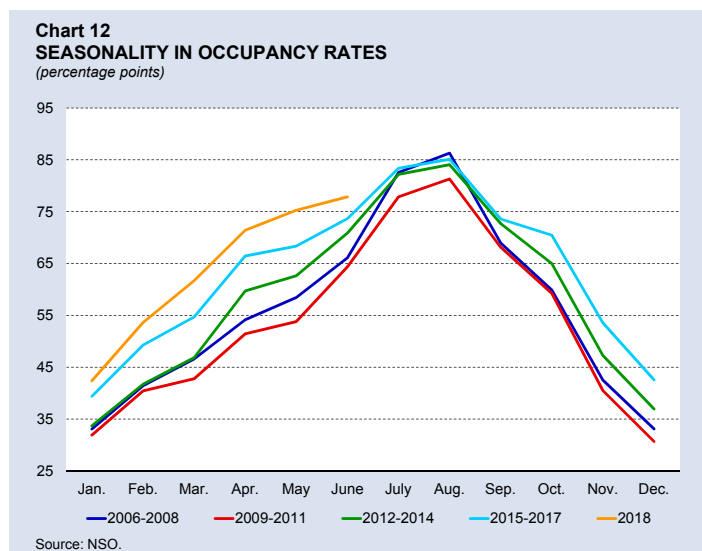
Despite losing market share to private accommodation establishments and increasing the number of bed-places, hotels still managed to increase their occupancy rates. Indeed, apart

from a dip in 2009, where occupancy rates bottomed out at 50.7%, occupancy rates in collective accommodation establishments increased steadily, reaching 65.6% in 2017 (see Chart 11). This rise was a result of higher occupancy rates across all hotel categories. Nonetheless, the most notable increases were recorded in the five and three-star sectors, where occupancy rates rose by 12.5 and 12.6 percentage points respectively since 2008. Throughout the period under review, four-star hotels continued to enjoy the highest average annual occupancy rates. Occupancy rates in this category edged up to 71.4% in 2017, from 67.5% in 2008.



Higher occupancy rates can be largely attributed to a concerted effort, by various stakeholders, to attract visitors during the winter and the shoulder months of the peak season. In fact, the occupancy rates of total collective accommodations during their peak experienced little change. As can be seen in Chart 12, apart from the period characterized by the global financial crisis, the occupancy rates in July and August remained broadly stable around the 85% mark when taken as three-year averages. However, occupancy rates have clearly risen in the shoulder months, and the increase is more pronounced in recent years. Data for the first half of 2018 show that occupancy rates averaged 63.7%, up from 50.0% in the 2006 to 2008 period.

Interestingly, higher occupancy rates were not achieved at the expense of lower room rates but through non-cost factors and



an improved quality product. As can be seen in Chart 13, hoteliers were able to increase daily room rates markedly from 2006 onwards.⁶ Average rates in the first half of every year suggest that between 2006 and 2018 five-star hotels increased their rates by around 80%, whereas the four-star establishments doubled the rates, and three-star hotels charged 115% more. However, over time, while wage bill and operational costs rose, hoteliers managed to increase their gross operating profit margin per available room.

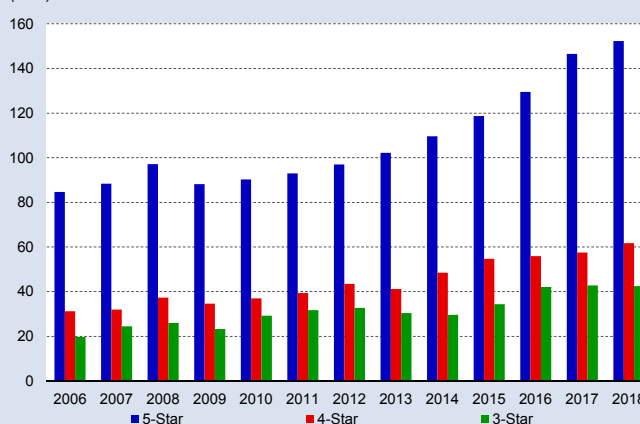
Airline connectivity and seat capacity

The island's tourism sector is very dependent on the operations of the country's sole airport. Route connectivity and increased aircraft movements are major supply-side factors in the country's tourism market. Over the last decade route connectivity increased from 61 in 2009 to 90 in 2017, and MIA claims that in summer 2018 over 100 destinations were being served (see Chart 14). Consequently, aircraft movements and the resulting seat capacity increased markedly.

After peaking at close to 28,400 in the year 2000, aircraft movements dropped to almost 24,300 in 2002, and remained close to 25,000 until 2006. The advent of low cost carriers in 2006 led to a rise in the number of aircraft movements but the high point reached in 2000 was only surpassed in 2010 (see Chart 15).

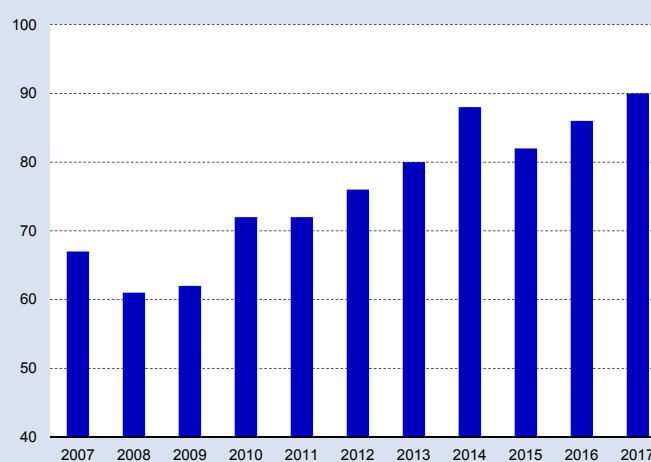
⁶ BOV-Deloitte MHRA Reports.

Chart 13
AVERAGE DAILY RATES⁽¹⁾
(EUR)



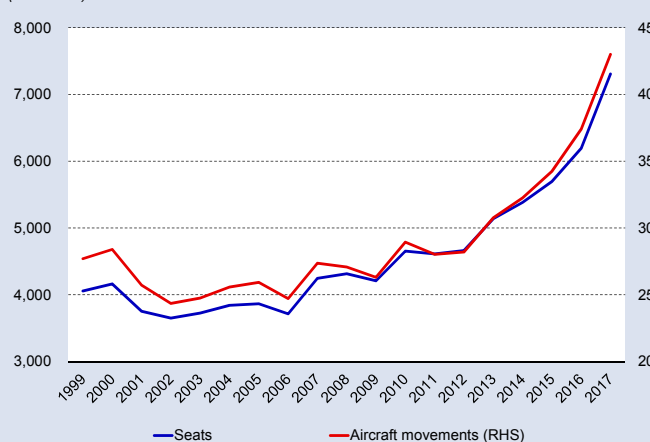
⁽¹⁾ Average based on rates charged between January and June of each year.
Source: BOV-Deloitte MHRA Reports.

Chart 14
ROUTES SERVED



Source: MIA.

Chart 15
AIRCRAFT MOVEMENTS AND AVAILABLE SEATS
(thousands)

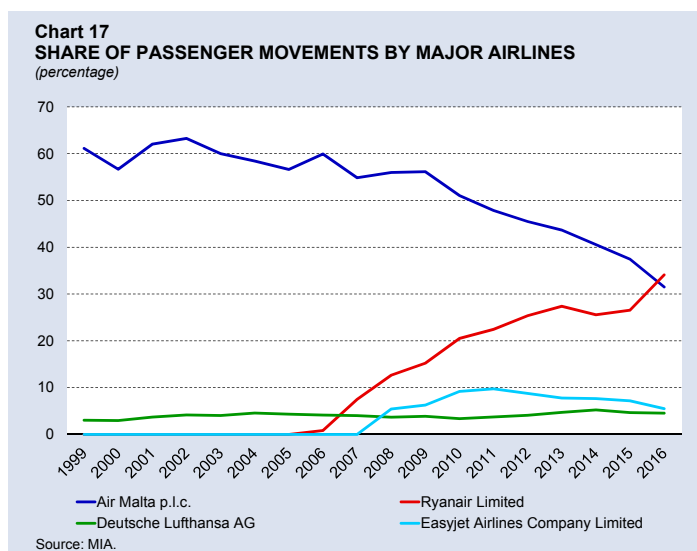
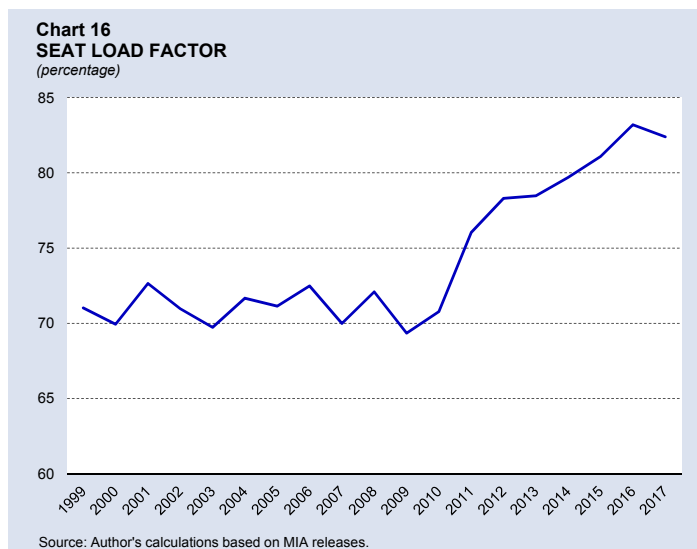


Source: MIA.

In the following years, aircraft movements continued to grow steadily, reaching close to 43,000 scheduled and chartered flights in 2017. In line with the rise in aircraft movements, the number of seats available to passengers surged to 7.3 million in 2017.

The increase in seat capacity was also met by a rise in passenger, or seat load factor, which measures the capacity utilisation of aircraft. Chart 16 shows that from 1999 to 2010 the seat load factor of aircraft to and from Malta hovered around 71%; meaning that on average, close to 30% of the aircraft seats were not being sold. Over the succeeding years, the seat load factor climbed gradually to reach 83.2% in 2016, before receding marginally in 2017.

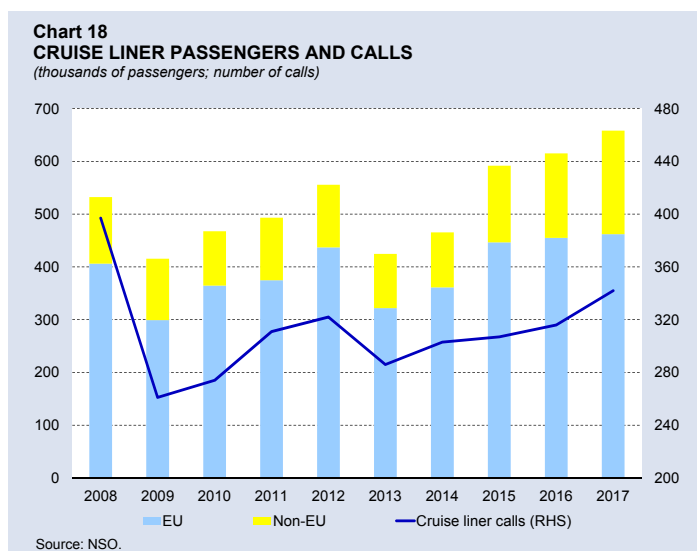
The rise in the seat load factor of aircraft can be partly attributable to the emergence of low cost carriers which are more flexible in altering routes to more profitable destinations. Moreover, as opposed to legacy airlines, low cost carriers tend to have less, or no, first class seating – which are more difficult to sell. Data show that improvements in the seat load factor coincided with the increased intensity of Ryanair. As can be seen in Chart 17, in 2006, the year during which Ryanair commenced its operations in Malta, Air Malta had a market share of 59.9% of all passengers travelling through the MIA. Over time, mainly through increases in the number of routes by Ryanair, but also due to financial challenges faced by the national airline, the share of Air Malta’s total passenger movements dipped to 31.5% in 2016. During the same year, Ryanair’s market share rose to 34.1%, becoming, for the first time, the largest carrier of passengers travelling to and from Malta.



Activity in cruise liner tourism

Malta’s unique geographical location has for long attracted the interest of major cruise liner companies operating in the Mediterranean Sea. The islands’ central position makes it possible to cater for both West and East bound cruises. In more recent years, improvements in port infrastructure and ancillary services, combined with challenging economic and political conditions in neighbouring competing destinations, have increased the country’s attractiveness.

Between 2008 and 2014 the number of cruise liner passengers arriving in Malta averaged slightly less than half a million passengers per year (see Chart 18). From 2015 onwards cruise liner passengers rose markedly, reaching 670,000 in 2017. Since 2008, EU nationals accounted for around three-quarters of all arrivals, with the share dipping marginally in the last few years. In 2017, Germany and the United Kingdom were the most important source markets, accounting for half of all EU arrivals, whereas the United States was the largest source of passengers from outside the European Union.

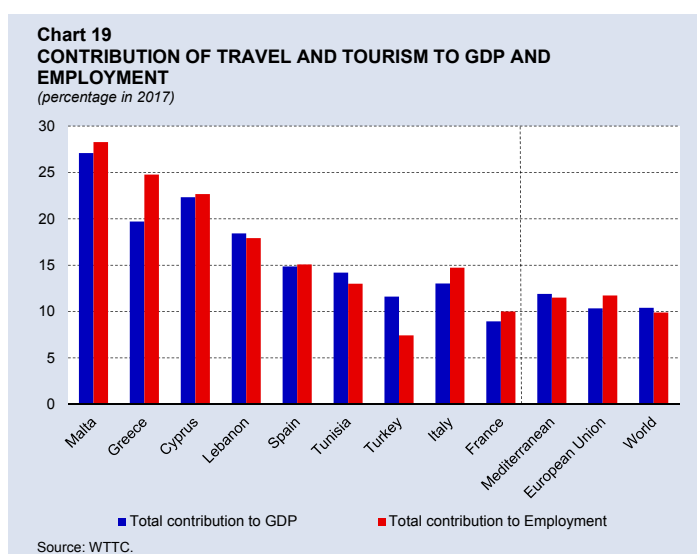


Interestingly, the increase in passenger arrivals was not matched by a similar rise in cruise liner calls (see Chart 18). In 2017, 342 cruise liner calls were made, significantly more than in the previous years, but still below the 397 calls made in 2008. This shows that larger vessels, with increased accommodation capacity are calling into the Maltese ports.

Economic importance of tourism

Data from the World Travel and Tourism Council (WTTC) show that the travel and tourism industry's total contribution to Malta's GDP stood at 27.1% in 2017 (see Chart 19).⁷ This was the highest share recorded within the Mediterranean region by a notable margin. The second highest share pertained to Cyprus, at 22.3% of GDP, followed by Greece and Lebanon. Malta's share was also well above the Mediterranean, European Union and World averages, which ranged between the 10% and 12%.

The contribution of the travel and tourism sector towards employment is correspondingly also very high in Malta when compared with other tourism destinations within the region. In 2016, it stood at 28.3%, once again higher than other countries surrounding the Mediterranean, as well as the Mediterranean, EU and World averages (see Chart 19). When compared with other countries in the region, the second highest total share was recorded by



⁷ Total contributions to GDP and employment include all activity and jobs generated directly, indirectly, as well as the induced impacts of the travel and tourism sectors.

Greece at 24.8%, followed by Cyprus. Such a high contribution of tourism towards employment serves to once again highlight the importance of tourism, both in the Maltese economic and social contexts.

The WTTC estimated that the direct contribution of travel and tourism to GDP in Malta during 2017 was equal to 14.2%. This primarily reflects the economic activity generated by industries such as hotels, travel agents, airlines and other passenger transportation services (excluding commuter services), but it also includes, for example, the activities of the restaurant and leisure industries directly supported by tourists. Estimates of the same Council show that in 2017 the travel and tourism sectors generated 31,000 jobs directly in Malta (15.7% of total employment). This includes employment by hotels, travel agents, airlines and other passenger transportation services, as well as jobs in restaurant and leisure industries directly supported by tourists. The total contribution of these sectors to employment including indirect and induced impacts was estimated to reach 55,000 jobs in 2017 (28.3% of total employment).

The WTTC estimates are the most recently available impacts of the contribution of the tourism industry on the Maltese economy and are one of the most widely referenced studies. Nonetheless, the input-output methodology used to estimate travel and tourism contributions to GDP and employment by the WTTC are based on assumptions which contrast with other studies conducted by other researchers and academics. Furthermore, it should be noted that the WTTC study did not utilize a fully specified input-output table for Malta for the derivation of the multiplier estimates, but applied technical coefficients obtained from the input-output tables of other countries where data was incomplete. It is important to point out that there is no indication of the country source of the input-output matrices which were applied to Malta.

In the research by Cassar et al. (2016) it is argued that the estimates of WTTC are relatively higher than what has been estimated separately by Blake et al. (2003) for 2001, Cassar (2015) for 2008 and NSO (2016) for 2010 (see Table 1).

Table 1, sourced from Cassar et al. (2016), shows that, notwithstanding the divergences in the three methodologies and time elapsed between 2001 and 2010, the results obtained from the three input-output based studies all seem to corroborate a direct and indirect contribution to the Maltese economy equal to approximately 12% of total gross value added (GVA).

Furthermore, observing the Type II value added multipliers, which in the case of Cassar (2015) are based on the computed Type II weighted average tourism value added multiplier, one can note further similarities in results between the two studies with a contribution of tourism at around 17% of total GVA. Within the context of assessing the true contribution of tourism to the Maltese economy

**Table 1
INPUT-OUTPUT BASED ESTIMATES OF THE CONTRIBUTION OF TOURISM TO THE
MALTESE ECONOMY**

	Blake et al. (2003) (% of GNP for 2001)	Cassar (2015) (% of total GVA for 2008)	NSO (2016) (% of total GVA for 2010)
Direct and indirect (Based on Type 1 multipliers)	12.3	12.5	11.5
Direct, indirect and induced (Based on Type 2 multipliers)	17.1	17.7	N/A

Sources: Blake et al. (2003); Cassar (2015); NSO (2016).

on the basis of the input-output studies discussed, would imply that a realistic contribution of the tourism sector to the Maltese economy would lie in the range of 12% to 17% of total GVA.

Sustainable tourism and policy considerations

In devising tourism policies, policymakers need to take into consideration the impact on various stakeholders, including the economy, the environment, entrepreneurs, visitors and residents. Nonetheless, striking this fine balance is by no means an easy feat. This is particularly challenging in small countries like Malta, which saw 5.3 visitors per inhabitant in 2017; the second highest ratio worldwide after Iceland. When one takes into account tourists' concentration on Malta's limited geographical size and high population density, the situation is significantly more severe. As one of the main economic pillars, Malta's tourism sector creates jobs, drives exports, and generates prosperity. However, more needs to be done to ensure that recent growth rates in inbound tourism are sustainable.

The United Nations has designated 2017 as the International Year of Sustainable Tourism for Development. The recent growth in tourism requires the sector to ensure sustainable policies and practices that minimise adverse effects of tourism on the use of natural resources, infrastructure, mobility and congestion, as well as its socio-cultural impact. Increased reports of negative attitudes among local populations towards visitors, due to perceived overcrowding, noise and other issues, have led to the spreading of terms such as 'overtourism' and 'tourismphobia' in the media. The first, and most prominent, cases of 'tourismphobia' occurred in Barcelona and Venice, where tensions have been rising for years over the unregulated surge in visitors and the negative impact on the local housing market. In these cities residents have voiced their anger over rising rents and pollution caused by huge cruise ships.

Looking closer at our shores, despite the general welcoming attitude of Maltese nationals towards tourists, the local tourism product faces the challenge of over-utilised infrastructure and the impact on the environment of construction and overcrowding in beaches, historic and cultural sites.

The success of the tourism industry cannot be merely measured by the number of inbound visitors but by a better economic and social return to society. As evidenced by official data, the increase in the number of inbound tourists was not matched by significant increases in nominal expenditure per night stayed. Furthermore, if one had to look at deflated figures, real expenditure per visitor per night is estimated to have declined in recent years, even after allowing for potentially lower airfares. This may suggest that the country's stakeholders' efforts were more successful in attracting higher volumes but lower spending visitors. It could also reflect the scarcity of large scale hotels and capacity constraints in established ones, which may have conditioned tourists to look for private accommodation, which tends to be cheaper.

The tourism product is composite and complex in nature. It encompasses anything that a tourist purchases, sees, experiences and feels from the moment they leave home to the time they return. It is in the interest of the operators within the tourism industry to sustain the destination. While many large operators are adopting better practices which will also bring environmental benefits, these practices are not generally being adopted by the smaller operators. Identifying and improving different aspects of the tourism product is key, but more importantly a holistic approach needs to be adopted, where the whole is greater than the sum of its parts. For example, the excellent provision of one sub-product (such as hotels) may not be worthwhile if the other inter-related services or sub-products (such as physical infrastructure) are not up to the expected standard.

Over the past few decades, synergies between key stakeholders – the Government, Malta Tourism Authority, Malta Hotels and Restaurants Association and Malta International Airport, amongst others – were instrumental in successfully reaping the economic benefits of the tourism industry. Efforts to increase route connectivity, thereby reducing dependence on few source markets, and creating important niche markets to diversify the Maltese tourism product have helped in significantly tackling the issue of seasonality. Improvements on roads infrastructure and embellishment projects in a number of key locations are also commendable. However, additional effort is required to enhance the quality of the tourism product and improve public transport services. Moreover, hoteliers and entrepreneurs should continue to invest in high-end establishments that can help in attracting more affluent visitors. This would enable better wages to employees in the local industry, which would render it more attractive as a vocational career while ensuring that a larger share of the population would benefit from the buoyancy of the sector. Finally, the education system should also do its part to instil a nurturing mind-set towards the local cultural heritage.

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5. GOVERNMENT FINANCE

During the second quarter of 2018, the general government balance swung back to a surplus, after registering a small deficit during the previous quarter. When measured as a four-quarter moving sum, the general government surplus widened significantly when compared with that recorded in the four quarters ending June 2017. The cyclically-adjusted surplus-to-GDP ratio also improved over this period. Meanwhile, general government debt as a share of gross domestic product (GDP) decreased slightly to below 50% at the end of June.

Quarterly developments

General government balance improves

In level terms, the general government registered a surplus of €114.1 million in the second quarter of 2018, a rise of €101.7 million over the surplus registered in the corresponding quarter of 2017. This was the result of a substantial increase in government revenue, which offset the mild increase in government expenditure. As a result, the primary surplus improved by €97.7 million to reach €161.9 million.

Higher tax receipts support revenue

In the second quarter, Government revenue grew by €108.2 million, or 10.2% in annual terms, reaching €1,173.2 million. Growth in revenue was mainly driven by higher tax receipts (see Table 5.1).

Table 5.1
REVENUE, EXPENDITURE AND DEBT

EUR millions

	2017			2018		Change 2018Q2-2017Q2	
	Q2	Q3	Q4	Q1	Q2	Amount	%
Revenue	1,065.0	1,159.2	1,236.3	1,036.9	1,173.2	108.2	10.2
Taxes on production and imports	313.6	385.1	370.3	350.3	358.7	45.1	14.4
Current taxes on income and wealth	404.2	416.0	449.3	320.9	454.2	49.9	12.3
Social contributions	168.8	172.8	195.9	180.3	201.4	32.6	19.3
Capital and current transfers receivable	17.5	34.0	50.8	23.3	13.6	-3.9	-22.1
Other ⁽¹⁾	160.8	151.3	170.0	162.0	145.3	-15.6	-9.7
Expenditure	1,052.6	1,002.0	1,050.3	1,045.1	1,059.1	6.5	0.6
Compensation of employees	318.6	324.3	320.2	343.9	345.6	27.1	8.5
Intermediate consumption	189.5	196.1	181.6	171.2	209.1	19.6	10.3
Social benefits	284.6	279.1	297.2	294.4	294.2	9.6	3.4
Subsidies	30.6	36.1	38.7	31.8	34.3	3.7	11.9
Interest	51.8	52.2	51.1	47.1	47.9	-3.9	-7.6
Other current transfers payable	60.4	48.4	46.6	51.8	46.8	-13.6	-22.5
Gross fixed capital formation	63.0	55.2	85.6	43.2	59.5	-3.5	-5.6
Capital transfers payable	55.5	12.1	24.4	63.5	22.8	-32.7	-58.9
Other ⁽²⁾	-1.4	-1.6	4.9	-1.9	-1.1	0.3	
Primary balance	64.2	209.5	237.1	39.0	161.9	97.7	
General government balance	12.4	157.2	186.1	-8.2	114.1	101.7	
General Government debt	5,861.8	5,837.9	5,670.6	5,718.9	5,735.0		

⁽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.

Source: NSO.

Current taxes on income and wealth registered the strongest increase in absolute terms. They rose by €49.9 million over the corresponding quarter of 2017, on the back of favourable economic conditions. This rise was augmented by higher intakes from taxes on production and imports, led by increased revenue from VAT, in line with the buoyant consumption recorded during the period. Revenue generated from social contributions also rose at a brisk pace, adding €32.6 million, reflecting the positive labour market environment.

Meanwhile, the “other” component of government revenue decreased by €15.6 million, mainly on the back of lower sales from the Individual Investor Programme (IIP). Moreover, capital and current transfers’ receivable declined by €3.9 million, largely due to lower capital taxes and EU grants.

Expenditure rises modestly driven by higher recurrent expenditure

During the period under review, total government expenditure increased by €6.5 million or 0.6% due to an increase in recurrent expenditure items.

The largest increase in recurrent expenditure was recorded in compensation of employees, which grew by €27.1 million. This was driven by higher wage increases in the education and health sectors. Intermediate consumption increased by €19.6 million, mainly due to expenditure on health. Social benefits increased by €9.6 million, largely on account of higher spending on pensions. On the other hand, other current transfers payable and interest fell by €13.6 million and €3.9 million, respectively.

Capital expenditure fell by €35.9 million in the second quarter of 2018, mainly due to a fall in capital transfers payable, which were boosted by payments from the Depositor Compensation Scheme in the same period a year earlier. At the same time, spending on gross fixed capital formation declined slightly.

Debt increases slightly

In June, the stock of general government debt amounted to €5,735.0 million, an increase of €16.1 million when compared with March 2018. Currency and deposits, and short-term securities (composed of Treasury Bills) increased by €95.3 million and €66.0 million to stand at 4.8% and 5.8% of total government debt, respectively.

On the other hand, the stock of long-term securities (composed of Malta Government Stocks) declined by €134.3 million. As a result, their share in total government debt declined by 2.6% to 83.7%. Loans decreased by €10.9 million, and accounted for 5.7% of total government debt outstanding in the quarter under review.

Headline and cyclically-adjusted developments

Headline balance and debt ratios continue to improve

On a four-quarter moving sum basis, the general government balance remained in surplus. The surplus-to-GDP ratio rose from 3.1% of GDP at the end of March 2018 to 3.9% in the second quarter of 2018.

This improvement was mainly due to a decline in the ratio of expenditure in GDP (see Chart 5.1). The share of current expenditure dropped by 0.3 percentage point, while the ratio of capital

spending in GDP declined by 0.4 percentage point. At the same time, the share of current revenue in GDP increased by 0.2 percentage point.

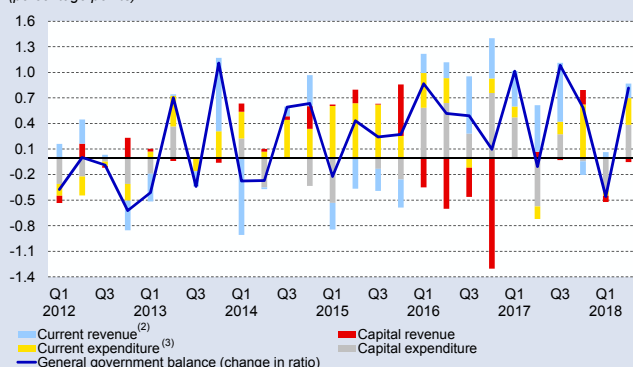
Overall, developments in capital revenue as a share of GDP had a negligible impact on the balance.

Meanwhile, the government debt-to-GDP ratio declined by 0.9 percentage point to reach 49.6%. This was due to the denominator effect – debt increased in level terms but this was offset by a greater increase in nominal GDP. The large surplus recorded in this quarter was offset by debt-increasing transactions in financial assets, mainly an increase in currency and deposits held by the government (see Chart 5.2).

Comparison with euro area

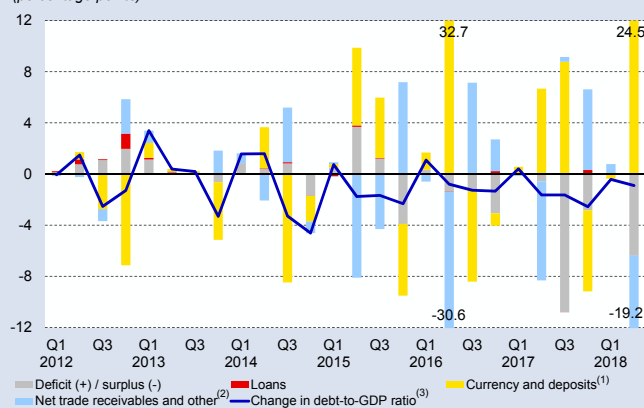
Developments in Maltese public finances continue to compare favourably with the euro area average (see Chart 5.3). The euro area general government deficit has narrowed markedly since 2012, reaching 0.5% of GDP on a four-quarter moving sum basis by June 2018. In the same period, the euro area debt ratio also edged down somewhat. However, the Maltese government balance improved at a much faster pace since the end of 2015, with the debt ratio declining to well below the 60% threshold referenced in the Stability and Growth Pact. In fact, at the end of June 2018, the debt ratio for Malta stood under 50%, while that of the euro area stood at 86.3%.

Chart 5.1
IMPACT ON GENERAL GOVERNMENT BALANCE⁽¹⁾
(percentage points)



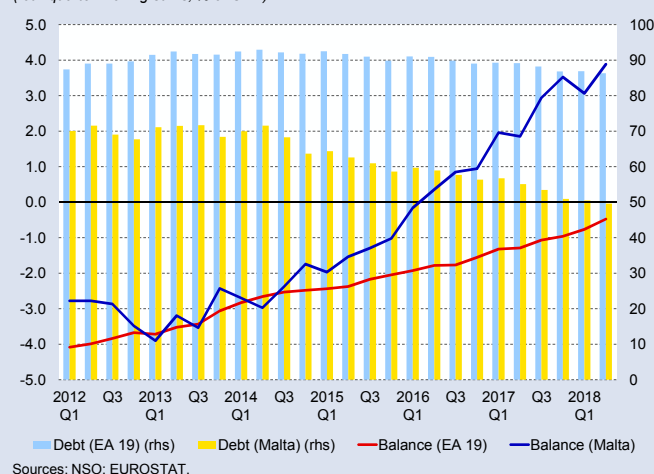
⁽¹⁾ Revenue items: +ve sign represents higher revenue and vice versa. Expenditure items: +ve sign represents lower expenditure and vice versa.
⁽²⁾ The term 'current revenue' represents most tax revenue as well as income from investments and sales. 'Capital revenue' mainly represents capital taxes and 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.
Sources: NSO; Central Bank of Malta.

Chart 5.2
CONTRIBUTION TO CHANGE IN DEBT
(percentage points)



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

Chart 5.3
GENERAL GOVERNMENT BALANCE AND DEBT
(four-quarter moving sums; % of GDP)



Sources: NSO; EUROSTAT.

Cyclically-adjusted balance¹

In the four quarters up to June 2018, the cyclically-adjusted surplus was lower than the headline surplus (see Chart 5.4). This is mainly due to comparatively smaller rates of growth in cyclically-adjusted tax revenue items relative to the headline measures, which in turn reflects the fact that the underlying macroeconomic variables were growing above trend.

Compared with the four quarters ending in June 2017, the cyclically-adjusted surplus improved markedly, reaching 3.2% of GDP from 1.2% previously. This shows that the improvement in the government balance is supported by factors other than the economic cycle.

The improvement in the cyclically-adjusted balance ratio was driven by a drop in the share of expenditure in GDP, coupled with an increase in the revenue-to-GDP ratio (see Table 5.2). The

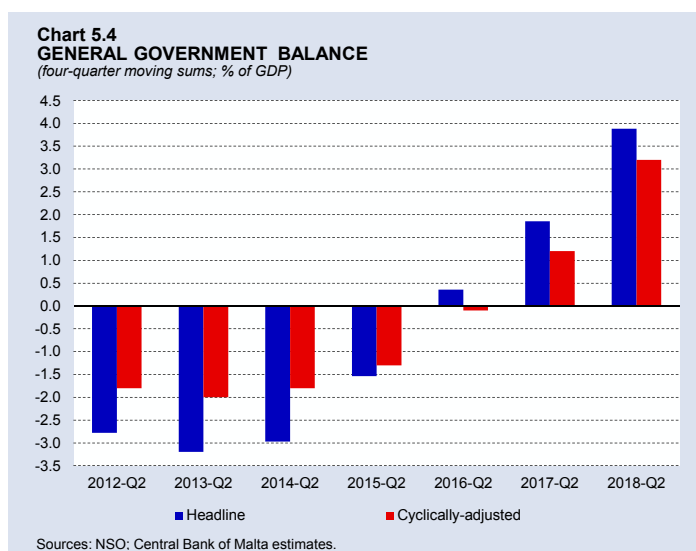


Table 5.2
CHANGES IN CYCLICALLY-ADJUSTED FISCAL COMPONENTS

Percentage points of GDP

	2012 Q2	2013 Q2	2014 Q2	2015 Q2	2016 Q2	2017 Q2	2018 Q2
Revenue	1.6	-0.3	-0.3	-0.6	-1.0	0.4	0.8
Taxes on production and imports	0.1	-0.7	0.4	-0.7	-0.4	0.0	0.0
Current taxes on income and wealth	0.8	0.9	-0.8	0.1	-0.4	0.1	0.7
Social contributions	0.1	-0.1	-0.1	-0.5	-0.1	-0.1	0.2
Other ⁽¹⁾	0.5	-0.4	0.3	0.6	-0.1	0.4	-0.2
Expenditure	0.9	-0.1	-0.5	-1.1	-2.3	-0.9	-1.3
Compensation of employees	0.0	0.0	-0.2	-0.5	-0.5	-0.2	0.1
Intermediate consumption	0.6	-0.3	-0.2	-0.3	0.4	0.2	0.1
Social benefits	-0.1	-0.1	-0.5	-0.9	-0.5	-0.3	-0.3
Interest payments	0.0	-0.2	-0.1	-0.2	-0.3	-0.3	-0.3
Gross fixed capital formation	0.3	0.1	0.1	0.8	-0.6	-0.9	-0.4
Other ⁽²⁾	0.1	0.5	0.5	0.0	-0.8	0.5	-0.4
Primary balance	0.7	-0.5	0.0	0.3	1.0	1.0	1.7
General government balance	0.7	-0.3	0.2	0.5	1.3	1.3	2.0

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

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

Sources: NSO; Central Bank of Malta estimates.

¹ The cyclically-adjusted balance is corrected for the impact of the economic cycle on government tax revenue and unemployment assistance. To compute this adjustment, the Bank applies a different methodology from the one used by the European Commission. For an overview of the methodologies currently in use, see Farrugia, J. (2014). Estimating the Cyclically Adjusted Budget Balance. *Quarterly Review* 2014(2), pp. 59-66, Central Bank of Malta.

latter rose by 0.8 percentage point, buoyed by an increase in the share of current taxes on income and wealth, as well as social contributions in GDP. These developments reflect a widening tax base, resulting from the entry of more females and foreign workers into the labour supply. It is also indicative of ongoing efforts by the authorities to enhance tax compliance. Meanwhile, the share of 'other' revenue in GDP declined, due to lower inflows from the IIP scheme over the four-quarter period to June 2018.

The share of cyclically-adjusted expenditure in GDP declined by 1.3 percentage points, due to lower or restrained growth across most current and capital outlays. Spending on social benefits grew at a slower pace than GDP, partly due to the impact of a one-year increase in the retirement age for pension beneficiaries born between 1956 and 1958. The decreasing share of social benefits in GDP can also be attributed to the extension of measures aimed at reducing dependency on unemployment benefits and incentivising people to seek employment.

Meanwhile, the share of interest payments in GDP declined as the prevailing low interest rate environment, coupled with lower financing requirements, led to a level decrease in spending. At the same time, the shares of 'other' expenditure and gross fixed capital formation in GDP declined, due to a drop in current transfers paid and investment respectively.

6. MONETARY AND FINANCIAL DEVELOPMENTS

The Bank's Financial Conditions Index (FCI) deteriorated slightly in the second quarter of 2018, although the extent of tightness is comparable to that estimated at the start of 2017.

Growth in Maltese residents' deposits with monetary and financial institutions (MFI) in Malta continued to moderate during the second quarter of 2018, following a prolonged period of strength.¹ The shift to overnight deposits persisted, in an environment of low interest rates and a continued preference for liquidity. At the same time, credit growth continued to pick up, reflecting faster growth in credit to residents outside general government. Growth in mortgage loans to households remained strong, while growth in bank loans to non-financial corporations (NFC) showed further signs of recovery. Financial accounts data show that NFCs continue to seek alternative sources of finance to bank lending. The spread between MFI interest rates on loans and deposits remained above its level in the corresponding quarter of 2017.

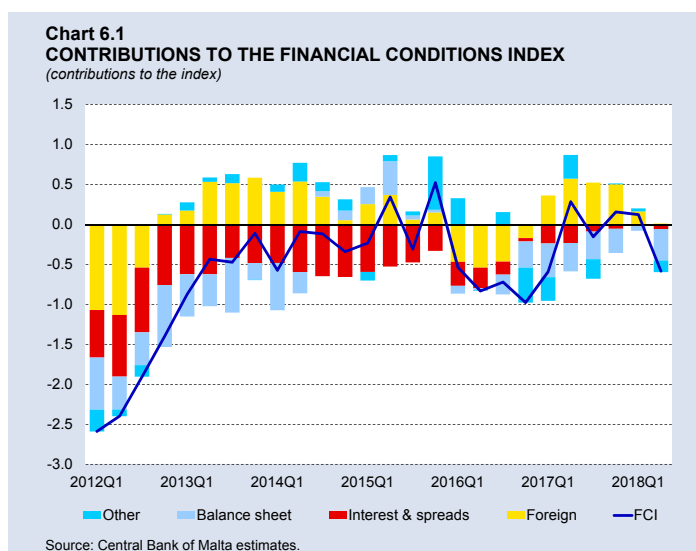
In June 2018, the primary market yield on Treasury bills was unchanged from March, while the secondary market yield on ten-year Malta Government Stocks (MGS) rose. In the equity market, domestic share prices fell during the quarter under review.

Monetary and financial conditions

Financial conditions deteriorated slightly

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

Financing conditions in the second quarter of 2018 were tight from a historical perspective and deteriorated when compared with the first quarter of 2018, owing mainly to weaker support from foreign influences and a larger negative contribution from balance sheet and other indicators (see Chart 6.1). In particular, euro area equity prices deteriorated markedly in the second quarter of this year, and offset the positive contribution from historically low systemic stress. Consequently, the contribution of foreign influences to the FCI, which was previously positive, turned neutral. Furthermore, stock prices in Malta deteriorated in the quarter under review, thus leading to a negative contribution of the 'other'



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

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

component. Finally, the negative contribution of balance sheet indicators increased markedly due to a deterioration in the return on equity of the banking sector.

During the quarter under review, the FCI also declined when compared with the level estimated for the second quarter of 2017, owing both to lower support from foreign influences and a deterioration in domestic variables. In particular, the negative contribution from the return on equity offset the improvement in real credit after NFC loans started to recover following long periods of declines. Despite the tight financing conditions when compared to historical levels, the FCI remains well within the standard deviation of this index.

Maltese residents' deposits expand at a slower pace

Total deposits held by Maltese residents with MFIs in Malta continued to expand during the second quarter of 2018, albeit at a slower pace. In June, the annual rate of change of residents' deposits stood at 3.2%, down from 4.3% three months earlier (see Table 6.1). Growth in residents' deposits has moderated in recent quarters, following a number of years of strong growth.

Annual growth in overnight deposits slowed to 5.4% in June, down from 8.6% in March, mainly reflecting slower growth in households' balances. Despite this moderation, overnight deposits remained residents' preferred financial instrument. The share of this category in total deposits stood at 75.4% in June, from 73.9% a year earlier (see Chart 6.2). In the first quarter of 2014, the corresponding share stood at 54.6%, suggesting considerable growth over the past years.

Meanwhile, demand for time deposits remained weak. In particular, deposits with an agreed maturity of over two years contracted by 10.6% in the year to June. At the same time, deposits with an agreed maturity of up to two years grew by a modest 1.2% over the same period. As a

Table 6.1
DEPOSITS OF MALTESE RESIDENTS

	EUR millions	Annual percentage changes				
		2018 June	2017			2018
			June	Sep.	Dec.	Mar. June
Overnight deposits	13,720	15.2	12.4	10.2	8.6	5.4
<i>of which</i>						
Households	8,161	18.8	18.1	15.8	16.2	12.8
Non-financial corporations	3,395	2.6	5.2	4.9	9.6	9.0
Deposits redeemable at notice of up to three months	46	-49.5	-53.8	-56.2	-50.7	-11.0
<i>of which</i>						
Households	35	-46.4	-48.6	-51.5	-54.4	-26.7
Non-financial corporations	8	-83.7	-88.1	-69.5	-32.7	377.0
Deposits with an agreed maturity of up to two years	3,089	-8.1	-2.1	-1.6	-3.7	1.2
<i>of which</i>						
Households	2,360	-6.1	-2.9	-3.1	-4.8	-3.2
Non-financial corporations	314	-4.9	10.8	23.7	6.1	28.5
Deposits with an agreed maturity above two years	1,343	-8.7	-15.8	-17.5	-11.0	-10.6
<i>of which</i>						
Households	1,226	-10.8	-16.9	-17.7	-11.6	-11.4
Non-financial corporations	64	15.2	-14.7	-29.7	3.7	-4.3
Total residents' deposits⁽¹⁾	18,198	7.6	6.4	5.0	4.3	3.2

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

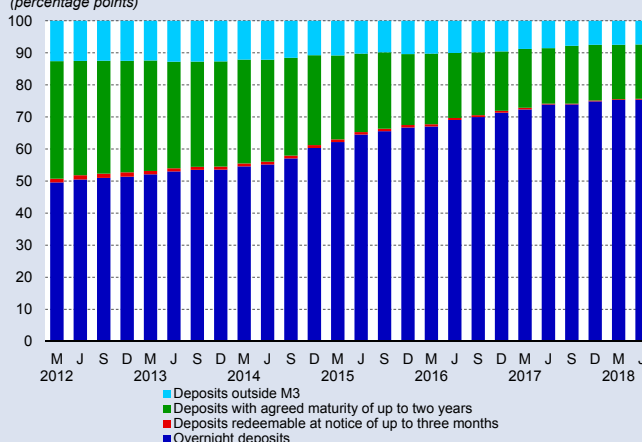
Source: Central Bank of Malta.

result, the share of deposits with an agreed maturity of over two years declined to 7.4% of total deposits, from 8.5% a year earlier, while that of deposits with an agreed maturity of up to two years edged down to 17.0%, from 17.3%. The share of deposits redeemable at notice of up to three months remained small.

Credit to residents expands at a faster pace

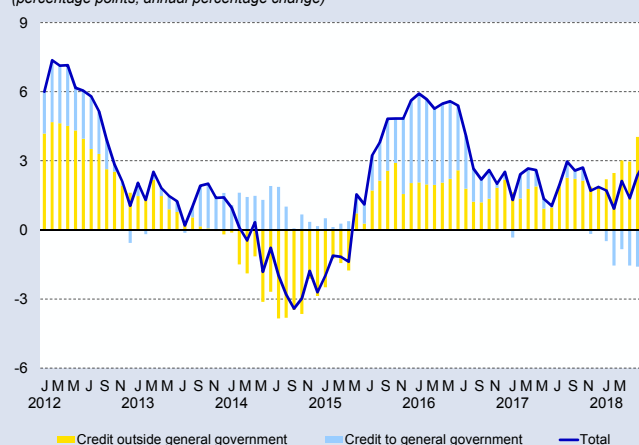
MFI credit to Maltese residents expanded by 3.0% during the second quarter of 2018, following 2.1% growth in the previous quarter (see Table 6.2 and Chart 6.3). The faster rate of growth was once again driven by movements in credit to residents outside general government, which rose at an annual rate of 5.6% in June, from 4.0% three months earlier. In contrast, credit to general government, which is mainly determined by changes in MFI holdings of MGSs, continued to contract in annual terms.

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



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

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				
		2018 June	2017			2018
		June	Sep.	Dec.	Mar.	June
Credit to general government	3,034	0.3	1.5	0.2	-3.4	-4.9
Credit to residents outside general government	10,320	1.3	2.9	2.4	4.0	5.6
Securities & equity	436	-7.3	-8.8	-4.9	-1.2	7.6
Loans	9,884	1.7	3.5	2.7	4.2	5.5
<i>of which:</i>						
Loans to households	5,290	6.0	6.6	6.6	6.9	7.1
Mortgages	4,719	8.3	8.6	8.2	8.3	7.8
Consumer credit and other lending	572	-8.8	-6.6	-4.2	-3.3	1.9
Loans to NFCs ⁽¹⁾	3,785	-4.4	-1.6	-1.8	0.1	4.0
Total credit to residents	13,347	1.0	2.6	1.9	2.1	3.0

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

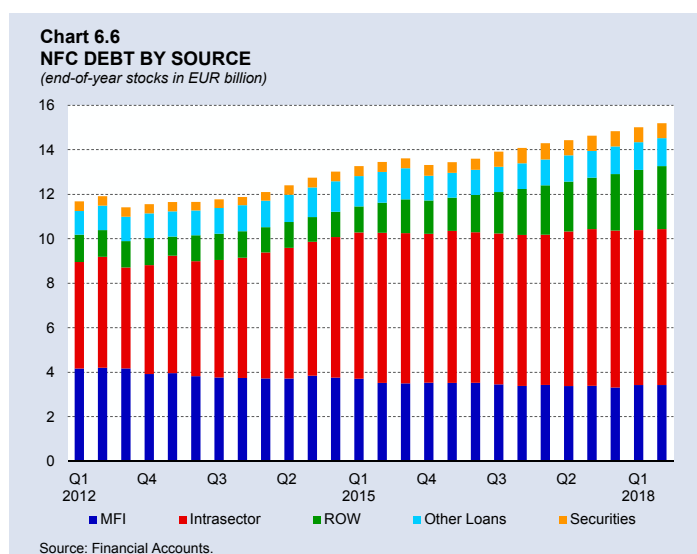
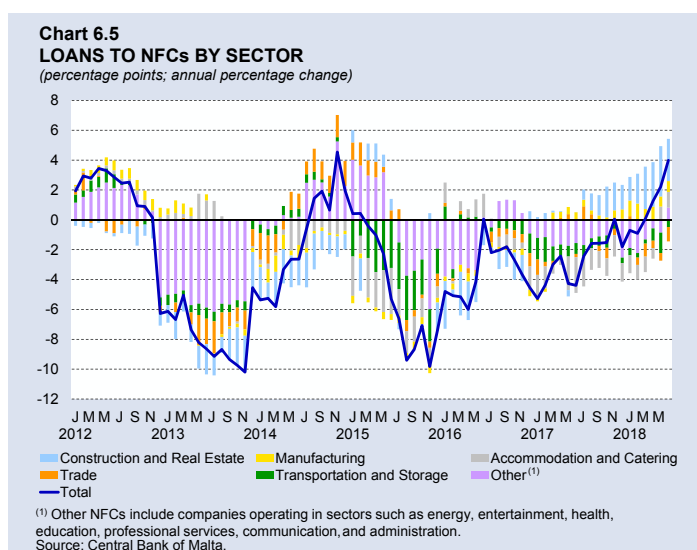
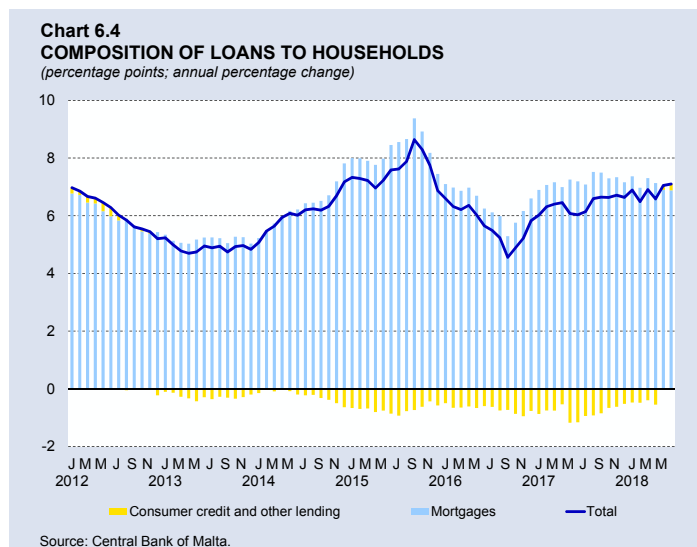
Source: Central Bank of Malta.

The acceleration in credit outside general government was mainly driven by a faster expansion in loans, which rose by 5.5% in the year to June, following a 4.2% increase in the year to March. Meanwhile, the annual rate of change of MFI holdings of securities and equity issued by corporates turned positive after a sequence of negative readings.

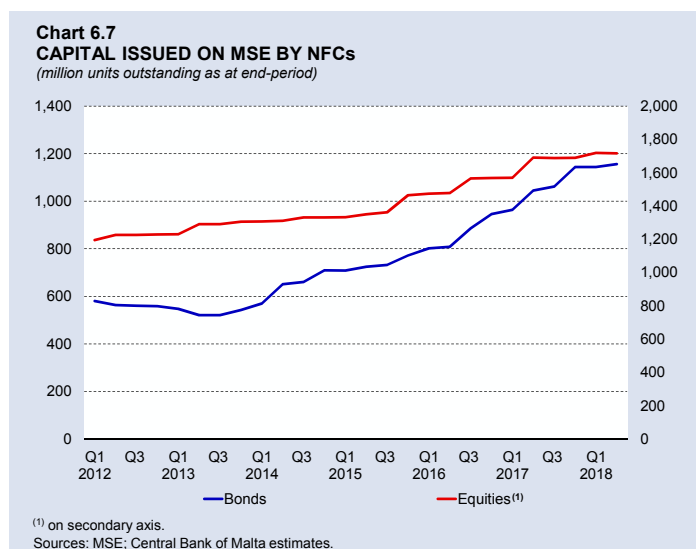
Loan growth was supported by loans to households, which were up by 7.1% in June (see Chart 6.4). In particular, annual growth in mortgage loans remained robust at 7.8%. At the same time, growth in consumer credit and other lending turned positive for the first time since 2012.

Meanwhile, annual growth in bank lending to NFCs continued to pick up following a prolonged period of weakness, reaching 4.0% in June from 0.1% at the end of the first quarter. A sectoral breakdown suggests that these developments largely reflect a recovery in loans to the construction and real estate sectors, which comprise over one-third of bank lending to NFCs (see Chart 6.5).

Financial Accounts data point to increased use of alternative forms of funding by NFCs. As a proportion of total NFC debt, bank lending to NFCs has been in near-constant decline over the past years, reaching 22.5% of the sector's financing in the second quarter of 2018 (see Chart 6.6). This decline could



reflect a number of factors, such as the increased use of internal funding by companies, and an overall shift in banks' loan portfolios towards households and away from NFCs.³ Indeed, the largest source of financing for NFC debt in the second quarter of 2018 was intrasectoral lending, with a share of 46.1%. Loans from the rest of the world (ROW), which mainly comprise loans from foreign banks or companies, made up 18.6% of NFC debt, while the share of loans from other sources was 8.3%.⁴



Recourse to debt securities remained limited at 4.4% of total debt financing in the second quarter, although public issuance of debt securities and equity on capital markets by NFCs has increased in recent years (see Chart 6.6 and Chart 6.7). As at June 2018, €1.2 billion in corporate debt was listed on the Malta Stock Exchange. This was 10.6% higher than the outstanding debt stock 12 months earlier.⁵

Interest rate spread between deposit and lending rate widens

Interest rates on residents' deposits with MFIs in Malta declined in the year to June 2018, with the weighted average deposit rate offered to households and NFCs going down by 6 basis points to 0.36% (see Table 6.3).⁶ This was mainly driven by a drop in rates on households' time deposits. Rates on NFC deposits rose marginally over the same period.

The weighted average lending rate paid to resident MFIs by households and NFCs fell by 5 basis points when compared with June 2017, reaching 3.61%. While rates paid by households dropped, those paid by NFCs increased slightly. Lending rates to NFCs thus remained above those charged to households, possibly reflecting different assessments of credit risk.

The spread between the weighted average lending rate and the deposit rate thus stood at 325 basis points in June 2018, marginally wider than its level of 324 points 12 months earlier. The elevated level of this spread suggests that the transmission of the ECB's monetary policy easing measures to retail lending rates remained weaker than that to deposit rates.

³ See Darmanin, J. (2017), "The financing of companies in Malta", Policy Note July 2017, Central Bank of Malta. Available at <https://www.centralbankmalta.org/file.aspx?f=61638>.

⁴ Loans from other sources include loans from non-bank financial institutions, households, and government.

⁵ A number of companies have also obtained capital from the recently launched MSE platform Prospects, which is mainly geared towards small and medium-sized enterprises (SME) issuing debt of not more than €5 million.

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

Table 6.3
INTEREST RATES ON DEPOSITS AND LOANS

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

	2015	2016	2017	2017		2018	
	June	June	June	Sep.	Dec.	Mar.	June
Total deposits⁽¹⁾	0.85	0.58	0.42	0.40	0.38	0.37	0.36
<i>of which</i>							
Overnight deposits							
Households	0.15	0.11	0.07	0.06	0.07	0.06	0.07
Non-financial corporations	0.12	0.08	0.02	0.03	0.04	0.06	0.05
Time deposits (less than 2 years)							
Households	1.40	0.88	0.79	0.78	0.78	0.75	0.76
Non-financial corporations	1.22	0.75	0.60	0.57	0.54	0.59	0.63
Time deposits (more than 2 years)							
Households	3.30	2.85	2.45	2.48	2.41	2.28	2.24
Non-financial corporations	2.60	1.97	1.89	1.99	1.98	2.04	2.11
Total Loans⁽¹⁾	3.90	3.75	3.66	3.63	3.64	3.64	3.61
<i>of which</i>							
Households and NPISH	3.64	3.57	3.52	3.50	3.48	3.46	3.44
Non-financial corporations	4.25	4.02	3.87	3.83	3.91	3.93	3.89
Spread⁽²⁾	3.05	3.17	3.24	3.22	3.26	3.28	3.25
ECB main refinancing operations rate	0.05	0.00	0.00	0.00	0.00	0.00	0.00

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

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

Source: Central Bank of Malta.

Bank Lending Survey indicates unchanged credit standards

Results from the July 2018 Bank Lending Survey (BLS) show that credit standards, and credit terms and conditions on loans to NFCs in Malta, remained unchanged during the second quarter of 2018. Similarly, NFCs' demand for credit was stable, with only one respondent bank reporting increased demand for corporate credit in the June quarter, as well as for the three months ahead.

Banks participating in the BLS also reported unchanged standards and terms and conditions for house purchases and consumer credit. As regards demand for consumer credit, no changes were reported and all participating banks anticipated demand to remain stable during the third quarter. In contrast, the assessment of demand for house purchases during the second quarter was mixed, with half of the respondent banks reporting unchanged demand in the June quarter, and the remaining banks reporting some increase. Going forward, though, none of the participating banks expected changes in the demand for credit for house purchases.

The majority of banks participating in the July BLS reported no changes in market access to wholesale and retail funding and their risk transfer capability as a result of the prevailing situation in financial markets. One bank however, reported some negative impact on selected segments of its retail funding operations, which was expected to persist in the third quarter. The same bank also reported slightly tighter conditions in the unsecured segment of the inter-bank money market, which was seen as relevant only for the second quarter.

The banks were also asked to gauge the impact of the new regulatory or supervisory requirements relating to capital, leverage, liquidity, or provisioning on their assets, capital and funding

conditions as well as on their lending policies. The majority of the participating banks reported no impact. However, one bank reported a slight increase in its assets, capital and retained earnings. It also expected this increase in assets and capital to persist in the six months ahead. Participating banks reported no recent or expected adjustments to their credit standards and margins.

Banks participating in the BLS were also asked to indicate the significance of a number of factors in determining the level of lending margins for new loans to enterprises and households over the past six months. Participating banks tended to report competition as the most significant factor determining lending margins on loans to NFCs, households for house purchases and consumer credit over the past six months. One bank also considered its liquidity position as being an important factor influencing margins on loans to NFCs.

Banks were also asked to comment on how the significance of these factors changed between 2014 and 2017. The majority of banks reported that competition has played an increasing role in the determination of lending margins on loans to households and NFCs. One respondent bank however, felt that its access to market financing, liquidity position, operating costs and profitability target had a less significant impact over time, on their lending margins to loans to enterprises, while its risk perception was now having a greater impact on margins on loans to households for house purchases.

Finally, participating banks claimed that their non-performing loan (NPL) ratio did not impact their credit standards, and credit terms and conditions in the preceding six-month period and in the six months ahead.

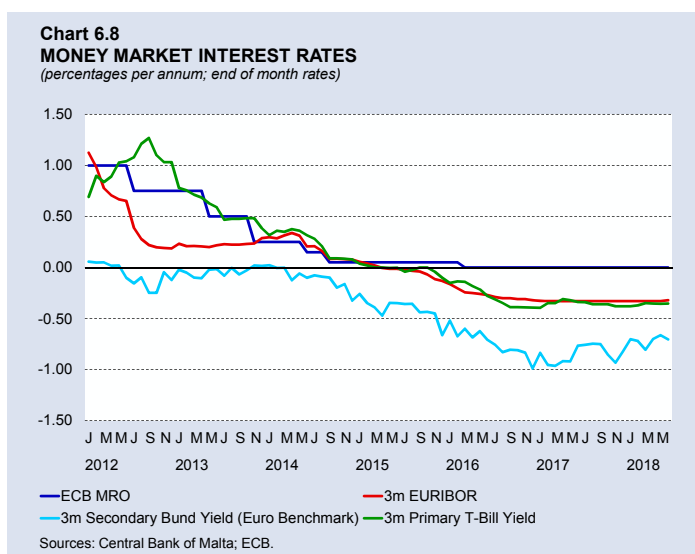
The money market

Domestic money market interest rates were unchanged

During the second quarter of 2018 the ECB maintained its key interest rates unchanged. In euro area money markets, the three-month EURIBOR rose marginally to -0.32% from -0.33% at the end of March. Meanwhile, secondary market yields on three-month German government securities, which act as a benchmark for euro area yields, rose from -0.81% at the end of the first quarter of 2018 to -0.71% at the end of June (see Chart 6.8).

In the domestic primary market, the yield on three-month Treasury bills stood unchanged from the rate prevailing at the end of March, at -0.35%.

As the yield on the euro area benchmark rose during this period, the spread between this rate and the yield on domestic three-month Treasury bills narrowed. At the end of June, it stood at 35 basis points, down from 46 basis points at end-March.



Between April and June 2018 the Government issued €275.0 million in Treasury bills, €63.0 million more than the amount of €212.0 million issued during the first quarter of 2018.

The capital market

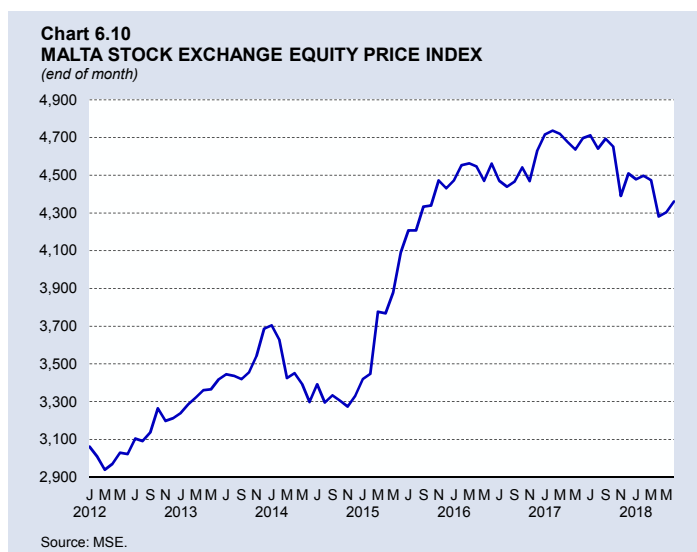
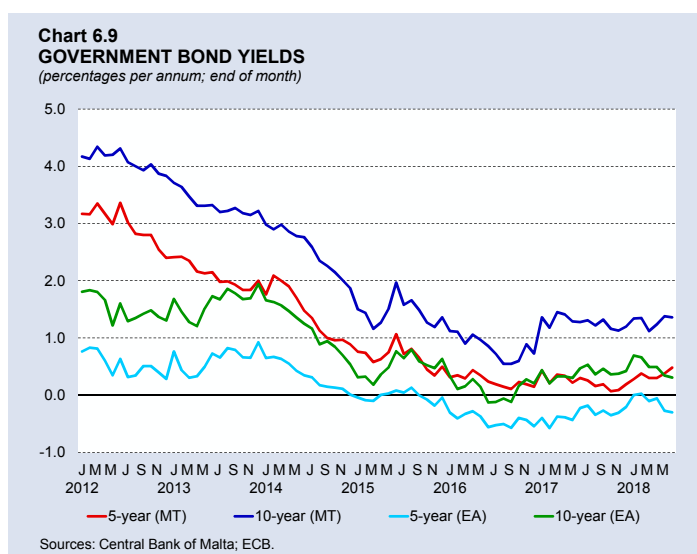
The Government did not issue any new MGSs during the first half of 2018. One public limited company: Hudson Malta plc issued €12.0 million in unsecured bonds in May. By the end of June 2018, eight firms had listed bonds through Prospects, up from six in March, bringing the total amount of bond issues through this facility to €25.5 million.⁷

In the secondary market, government bonds turnover fell to €47.5 million during the second quarter of 2018, from €53.5 million in the first quarter. In contrast, turnover in corporate bonds rose marginally to €21.0 million from €20.0 million over the same period.

Secondary market yields on Maltese government bonds rose during the second quarter of 2018 (see Chart 6.9). The yield on five-year bonds ended June at 0.48%, higher than the rate of 0.30% at end-March. Similarly, the yield on ten-year bonds rose by 24 basis points, and ended June at 1.36%. In the euro area, both the five-year and ten-year yields fell by 19 basis points, ending June at -0.30% and 0.31%, respectively. Hence, the spread against the ten-year euro-area benchmark yield widened to 105 basis points in the second quarter of 2018, from 63 basis points at the end of March.

MSE share index ended June at lower levels

Share prices in Malta, as measured by the Malta Stock Exchange (MSE) Equity Price Index fell during the second quarter of 2018. They ended June 2.5% lower than three months earlier, and 7.2% below the level in June 2017 (see Chart 6.10). The MSE Equity Total Return Index, which



⁷ Prospects is a multi-lateral trading facility operated by the Malta Stock Exchange with the aim of facilitating access to capital markets for SMEs.

accounts for changes in equity prices and dividends, declined by 0.5% from the level recorded at the end of March.

Equity turnover fell to €18.7 million during the second quarter of 2018 from €23.3 million in the first three months of the year.

THE HOUSEHOLD BUDGETARY SURVEY 2015: KEY FINDINGS ON THE EXPENDITURE PATTERNS OF HOUSEHOLDS IN MALTA AND GOZO¹

Josianne Galea

Introduction

Governments, policy makers and researchers need to know how the living standards of households in a country are changing, how these differ among different population groups, and whether they indicate growing equality, or inequality, along the years. Generally, this type of exercise is carried out by analysing the distribution of income among different societal groupings. However, several economists support the use of household consumption as a proxy variable to determine inequality among different sectors, household types and compositions.

The Household Budgetary Survey (HBS) is a crucially important survey for policy makers across Europe. It is carried out by EU national statistical institutes approximately every five years. The latest Household Budgetary Survey was carried out in Malta in 2015, and was recently published by the National Statistics Office. The study revealed interesting consumption and expenditure patterns among different households. When analysing the statistics published in the HBS, one can arrive at various conclusions and identify a number of points that are helpful to understand how consumption and expenditure patterns of Maltese households have evolved. The scope of this article is to identify these patterns, analyse how these can be a good proxy to evaluate living standards in Malta, and how these diverge among households.

Main findings

The Household Budgetary Survey 2015 revealed that in 2015 each household spent €2,771 more than in 2008, with the largest share of expenditure being recorded in the food and non-alcoholic beverages category (see Table 1). Households with dependent children spent more than households without dependent children in almost all expenditure categories, the only exception being in the alcoholic beverages and tobacco category. The largest discrepancy between these two types of households was recorded in the transport category, whereby households with dependent children spent €2,139 more than those without dependent children (see Table 2).

With regards to savings, HBS 2015 revealed that 'other households without dependent children' saved the most, with an average saving of €12,196 per household.² On the other hand, single-parent households with one or more dependent children recorded an average dissaving of €4,777 per household (see Chart 2). The persons who were mostly at-risk-of-poverty (ARP) were those living in households with dependent children, with 17.9% being at-risk-of-poverty. On the other hand, 15.4% of persons living in households without dependent children were at risk-of-poverty. When compared with results on poverty obtained from EU-SILC 2016, another household income survey carried out by the NSO, the two surveys show consistency. EU-SILC results showed that 69,920 persons (16.5%) were at-risk of poverty, while the HBS reported 70,656 persons (16.7%) (see Table 4).

¹ Prepared by Ms Josianne Galea. Ms Galea is Head of Unit – Living Conditions and Culture Statistics at the National Statistics Office (NSO). Any errors, as well as the views expressed in this article, are the author's sole responsibility.

² Such households include at least three adults.

Household Budgetary Survey 2015: methodology

Although it is not an EU-regulated survey, Eurostat regularly issues recommendations for best practices and for further harmonisation of the survey among Member States. The methodology used in the Maltese HBS is based on such recommendations. The results derived from HBS 2015 data were used for the first time in Malta in January 2017 with the publication of the Retail Price Index (RPI) news release, with the new weighting structure based on these results. A second important scope of the HBS is that this survey offers a unique potential to investigate socio-economic inequality, from a national perspective and comparatively in a European perspective. The HBS highlights the main differences and similarities between different household types and compositions. It also examines the relationship between expenditure and income.

Focusing on the expenditure behaviour of private households residing in a country, the HBS enables the analysis of changes in the trends and level of households' consumption expenditure according to their main social, economic and regional characteristics. These expenditure patterns are then used to calculate the weighting structures for the RPI. In this way the price indices, which are crucial for the calculation of the national inflation rate, are continuously being updated with realistic and updated expenditure on goods and services.

Data collection method

A sample of households from Malta and Gozo was selected to participate in the HBS. Out of a total population of 164,800 households, a systematic random sample was taken, from which 6,325 households were selected to participate. Data collection was carried out over a one-year period, from April 2015 until April 2016.

In agreement with Eurostat, the survey is based on the harmonised international classification of expenditure to ensure international comparability.³ This classification, which is made up of 12 major categories, is also used as the coding system for the Harmonised Index of Consumer Prices.

The households sampled list all their expenditures over a two-week period in a diary. The expenditures incurred by resident households must include all purchased goods and services exclusively devoted to household consumption (self-consumption, imputed rentals and presents are included). Every other expenditure for a different purpose, such as payments of fees and business expenditures, is excluded from the data collection. For the purpose of this exercise it is important to note that any goods purchased through bank loans or hire purchase arrangements were recorded in full with total fee incurred by agreement by the household rather than the actual price. Furthermore, the following households' expenditure categories were excluded when computing the household expenditure:

- Business expenses
- Additions to savings, amounts invested (including purchasing of property, which for the purposes of HBS was considered an investment) or loaned
- Gambling losses

³ See *Classification of Individual Consumption by Purpose – COICOP*, which is accessible at https://nso.gov.mt/metadata/classifications/COICOP_1999.pdf

- Goods or services produced as outputs of incorporated enterprises owned by households and retained for consumption by members of the household
- Retail value of home-grown produce (i.e. from own garden or farm) consumed by the household
- Subsistence expenditure incurred while abroad
- Repayments of loans (e.g. mortgage capital repayments)
- Fines
- Trade union, club and other memberships
- Licences
- Donations to non-profit institutions
- Life insurance services.

The households were also provided with a questionnaire in which they were requested to record any spending considered as 'infrequent purchases' over the preceding months. The questionnaire also asked for other aspects pertaining to the household members, including household composition, participation in labour force, housing conditions, mobility, furnishings and household equipment, information on socio-economic status and demography.

Expenditure levels and compositions: a comparison between HBS 2008 and HBS 2015

HBS 2015 showed that households in Malta and Gozo spent almost €1 billion more when compared with 2008 (see Table 1). In 2015 total expenditure was €3.7 billion, while €2.8 billion were spent in 2008. On average, each household spent €2,771 more in 2015, when compared with 2008. Overall, the largest increase was €151 million on transport, followed by miscellaneous goods and services, and restaurants and hotels, with increases of €143 million and €110 million, respectively.

Table 1
TOTAL AND AVERAGE EXPENDITURE BY YEAR AND COICOP

Main Item	2008				2015			
	Margin of error (%)	Average (€)	Sum (€)	% share	Margin of error (%)	Average (€)	Sum (€)	% share
Food and non-alcoholic beverages	1.6	4,399	623,926,200	22.5	1.8	4,417	727,930,138	19.8
Alcoholic beverages and tobacco	5.3	480	68,136,000	2.5	5.5	525	86,553,824	2.4
Clothing and footwear	5.5	1,397	198,146,200	7.1	6.1	1,768	291,435,845	7.9
Housing, water, electricity, gas and other fuels	7.4	1,637	232,223,800	8.4	6.0	1,875	309,012,125	8.4
Furnishing, household equipment and maintenance of the house	8.3	1,735	246,140,400	8.9	6.2	1,655	272,789,682	7.4
Health	8.6	1,250	177,236,700	6.4	9.8	1,252	206,372,617	5.6
Transport	5.3	2,703	383,399,100	13.8	6.0	3,241	534,220,959	14.5
Communication	2.6	788	111,807,700	4	3.4	970	159,831,759	4.3
Recreation and culture	6.7	1,658	235,238,600	8.5	16.2	1,739	286,624,037	7.8
Education	10.8	342	48,579,900	1.7	11.0	624	102,826,341	2.8
Restaurants and hotels	4.8	1,381	195,925,100	7.1	4.7	1,857	306,052,672	8.3
Miscellaneous goods and services	4.7	1,805	256,042,200	9.2	4.9	2,423	399,331,800	10.8
Total	2.4	19,575	2,776,801,900	100	2.9	22,346	3,682,981,799	100

Source: NSO.

The largest share of expenditure was recorded in the food and non-alcoholic beverages category, both in 2015 and in 2008. However, in 2015, 19.8% of households' outlay was on this category, dropping almost three percentage points from 2008. As in 2008, the second highest share of expenditure was on transport. However, this category recorded a slight increase in its percentage share and an annual average increase of €538 per household, when compared with the €18 increase in food from 2008 to 2015.

Although at 8.4%, the percentage share of expenditure on housing and energy remained the same as that in 2008, this category was the sixth largest expenditure share of the households in 2008, while in 2015 it was the fourth largest one. In 2015, on average, a household spent €238 more on this category when compared with 2008. With regard to restaurants and hotels, households in Malta and Gozo spent on average €476 more than in 2008. In 2015, this category had the fifth largest expenditure share, up from eighth in 2008. It is also interesting to note the annual average expenditure increase per household on clothing and footwear (€371) and education (€282).

Expenditure and consumption by household type: HBS 2015

On the whole, households with dependent children spent more on almost every item when compared with households without dependent children (see Table 2). On average, the categories that recorded the largest discrepancies between the two household types were transport (€2,139), food and non-alcoholic beverages (€1,347), recreation and culture (€1,219), and education (€1,218). On average, in total, households with dependent children spent over €10,000 more annually when compared with households without dependent children.

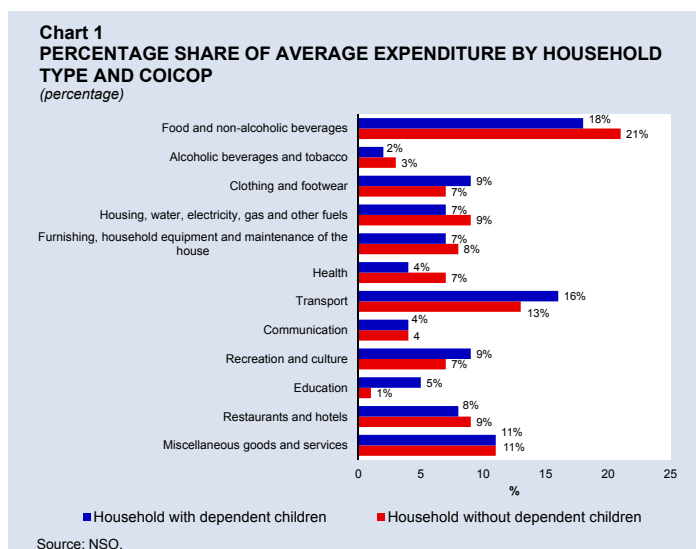
When analysing the percentage share of the average expenditure, one notes that both household types spent most on food and non-alcoholic beverages, followed by transport (see

Table 2
TOTAL AND AVERAGE EXPENDITURE BY HOUSEHOLD TYPE AND COICOP

Main Item	Household without dependent children	Household without dependent children	Household with dependent children	Household with dependent children
	Sum (€)	Average (€)	Sum (€)	Average (€)
Food and non-alcoholic beverages	423,068,956	3,946	304,861,182	5,293
Alcoholic beverages and tobacco	56,455,494	527	30,098,331	523
Clothing and footwear	144,196,429	1,345	147,239,416	2,556
Housing, water, electricity, gas and other fuels	190,487,556	1,777	118,524,569	2,058
Furnishing, household equipment and maintenance of the house	155,109,570	1,447	117,680,112	2,043
Health	131,958,057	1,231	74,414,559	1,292
Transport	260,954,671	2,434	263,390,670	4,573
Communication	89,272,264	833	70,559,495	1,225
Recreation and culture	147,175,652	1,373	149,324,003	2,592
Education	21,264,190	198	81,562,151	1,416
Restaurants and hotels	172,187,632	1,606	133,865,041	2,324
Miscellaneous goods and services	216,750,398	2,022	182,581,402	3,170
Total	2,008,880,869	18,737	1,674,100,930	29,064

Source: NSO.

Chart 1). However, households without dependent children spent a higher share of their expenditure on food and non-alcoholic beverages, furnishing, household equipment and maintenance of the house and housing, water, electricity, gas, and other fuels, restaurants and hotels, and alcoholic beverages and tobacco. On the other hand, households with dependent children as a share spent more on education, transport, recreation and culture, and clothing and footwear.



Income and savings by household composition: HBS 2015

As expected, households with a high net income were the ones with the higher average expenditure. HBS 2015 showed that on average, households with dependent children earned more and spent more than households without dependent children (see Table 3).

When considering the former, households with at least three adults and one or more dependent children earned the most and spent the most, while single-parent households with one or more dependent children earned the least and spent the least. HBS 2015 showed that for two-adult households, the greater the number of children in the household, the lower the average net income and the greater the average expenditure.

Table 3
HOUSEHOLD NET INCOME AND EXPENDITURE BY HOUSEHOLD COMPOSITION

Household composition	Average net income	Average expenditure	Total net income	Total expenditure
	€	€	€	€
Household without dependent children, of which:	23,124	18,737	2,479,238,936	2,008,880,869
One person household, under 65 years	14,942	13,495	282,665,994	255,288,184
One person household, 65 years and over	11,427	9,697	243,918,645	206,987,902
2 adults, no dependent children, both under 65 years	27,540	24,283	515,972,755	454,961,921
2 adults, no dependent children, at least one adult 65 years or more	18,871	16,416	470,788,150	409,543,025
Other households without dependent children	41,510	29,314	965,893,392	682,099,837
Household with dependent children, of which:	33,097	29,064	1,906,409,467	1,674,100,930
Single parent household, one or more dependent children	15,492	20,269	105,910,531	138,574,533
2 adults, one dependent child	33,516	28,506	635,106,088	540,164,058
2 adults, two dependent children	31,964	28,652	510,755,606	457,841,728
2 adults, three or more dependent children	30,789	30,635	123,469,359	122,854,617
Other households with one or more dependent children	44,915	35,064	531,167,882	414,665,994
Total	26,610	22,346	4,385,648,402	3,682,981,799

Source: NSO.

As regards households without dependent children, in 2015, one-person households where the householder was aged 65 and over earned the least and spent the least, while the households with at least three adults earned the most and spent the most.

In order to obtain a proxy of the amount of annual savings, the difference between the average net income and the average expenditure from HBS 2015 was calculated (see Chart 2).

However, it is important to note

that to calculate this figure a number of assumptions were used, that may limit the quality of the indicator provided. The following are the assumptions used in this computation:

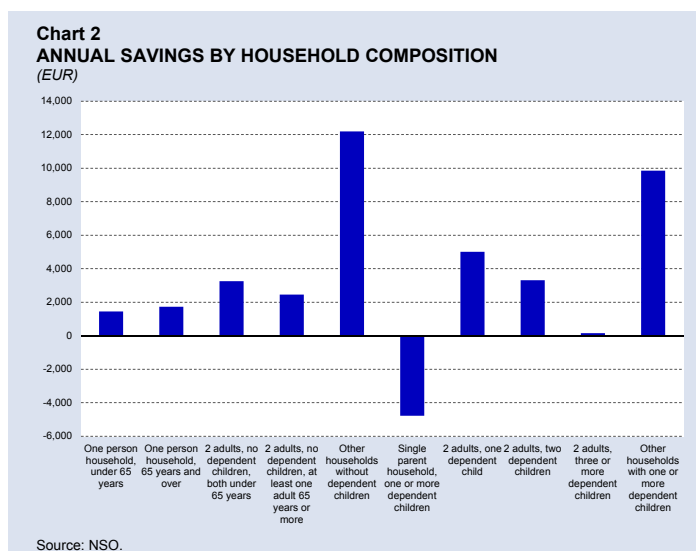
- Disposable income computation did not include any non-regular income such as inheritance for the year 2015;
- Social benefits in kind and any other benefits in kind were not included in the computation of disposable income;
- Purchased goods values were included in full in the expenditure computation, even if these were paid with more than one transaction;
- A number of expenditure components such as fines, donations etc were excluded when calculating expenditure.

The results obtained from the savings proxy show that the only household type that had negative savings is the single-parent household with one or more dependent children, with an average annual dissaving of €4,777. On the other hand, households with at least three adults but without dependent children had the largest amount of savings, while households with two adults and three or more dependent children, had the lowest amount of savings with an annual average of €154.

The relation between poverty and expenditure patterns from the Household Budgetary Survey 2015

Apart from examining and analysing the expenditure patterns, results obtained from the HBS survey enable one to analyse the living conditions in a country. This is done by observing relative differences among different levels of household income. Based on household disposable income variable, one of the most important indicators that can be calculated from HBS data is the ARP rate. This indicator was calculated from HBS data; however, in this case the same methodology which is applied for the ARP calculation from EU-SILC was used. The EU-SILC methodology is regulated under the European Regulation (EU) NO. 1177/2003.

According to EU-SILC methodology, the ARP rate calculation adhered to the following methodology: the at-risk-of-poverty threshold (ARPT) which is defined as 60% of the median of the net equivalised income (NEI), was calculated from HBS data, after which the ARP was calculated.

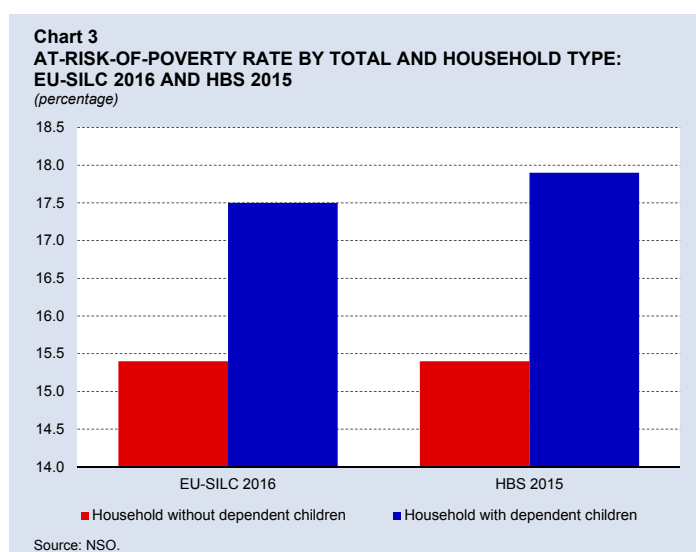


This rate corresponds to the percentage of respondents whose NEI falls below this threshold and eventually are defined to be at-risk-of-poverty. For the purpose of this article the ARP results for the HBS were compared with the results of EU-SILC 2016 (income reference year 2015) (see Chart 3).

At-risk-of-Poverty rates: A comparison with EU-SILC

When calculating the ARP rate from HBS 2015, it was estimated that 16.7% of the surveyed population were at-risk-of-poverty;

equivalent to 70,656 persons (see Table 4). Persons living in households with dependent children were more likely to be at-risk-of-poverty (17.9%) than those living in households without dependent children (15.4%). When comparing the ARP rate calculated from both HBS 2015 and EU-SILC 2016, with both surveys based on the 2015 income reference year, the similarity in the results is evident. The overall ARP rate for EU-SILC was estimated to be 16.5%, which was equivalent to 69,920 persons (see Table 4). As one can notice, when considering that both surveys have different data collection and data analysis methodologies, both surveys were carried out independently from one another, and income is a secondary variable for HBS, the differences are minimal.



Looking at Table 4, one can notice the positive relationship between the number of dependent children and its effect on monetary poverty and, thus on the APR rate. Looking at the results from

Table 4
AT-RISK-OF-POVERTY RATE (ARP) BY HOUSEHOLD COMPOSITION: SILC 2016 AND HBS 2015

Household composition	EU-SILC 2016			HBS 2015		
	Margin of error (%)	% of persons that are at risk of poverty	Number of persons	Margin of error (%)	% of persons that are at risk of poverty	Number of persons
Household without dependent children, of which:	1.8	15.4	32,028	2	15.4	32,007
One person household, under 65 years	5.3	23	4,277	6	25.2	4,761
One person household, 65 years and over	4.4	25.1	5,492	5.5	23.6	5,042
Two adults, no dependent children, both under 65 years	4.4	12.4	5,038	4.9	16.2	6,081
Two adults, no dependent children, at least one adult 65 years or more	3.5	26.5	12,774	3.8	26.4	13,193
Other households without dependent children	3.7	5.7	4,446	3.9	3.6	2,931
Household with dependent children, of which:	2.7	17.5	37,893	2.6	17.9	38,649
Single parent household, one or more dependent children	9.5	41.1	6,659	9.7	47.1	7,854
Two adults, one dependent child	5.2	10.7	5,728	5	11.8	6,732
Two adults, two dependent children	4.9	16.8	11,062	4.6	18.5	11,856
Two adults, three or more dependent children	9.3	35.7	7,081	9.1	43.2	9,518
Other households with one or more dependent children	5.6	12	7,362	5.4	4.8	2,688
Total	1.5	16.5	69,920	1.6	16.7	70,656

Source: NSO.

the HBS, it is very clear that, for households with dependent children, single-parent households were those most at-risk-of-poverty (47.1%). In addition, the same survey shows that almost 12% of the households with two adults and one dependent child were at-risk-of-poverty. This increases to almost 19% for households with two adults and two dependent children and to 43% for households with two adults and two or more dependent children.

When considering households without dependent children, the household compositions that were the most at-risk-of-poverty were the two-adult households with at least one person aged 65 years and over, making up 26.4% of the sampled population. When comparing the results of the ARP rate calculated from EU-SILC 2016 and from the Household Budgetary Survey 2015, which are both based on the 2015 income reference year, one can notice that both surveys show similar results. Both surveys show consistent ARP rates for both types of household compositions. The surveys show that households with dependent children were at a higher risk of poverty than those without dependent children. HBS 2015 showed that 17.9% or 38,649 persons were at-risk-of-poverty. This figure was just 756 persons more than that obtained from EU-SILC which showed that 17.5% of the persons living in households with dependent children were at-risk-of-poverty.

On the other hand the results obtained from both surveys showed that 15.4% of households without dependent children were at-risk-of-poverty. This is translated to 32,007 persons, which is just 21 persons less than the results obtained in EU-SILC.

At-risk-of-poverty and expenditure patterns: HBS 2015

Comparing expenditure patterns of households that are at-risk-of-poverty with those that are not, one can notice that, on average, on an annual basis, the latter spent €9,377 more (see Table 5). The most significant differences were in transport (+€1,862), miscellaneous goods and services (+€1,370) and restaurants and hotels (+€1,172). This confirms the hypothesis that households which are not at-risk-of-poverty can spend more on both basic needs such as transport, and on luxuries such as restaurants and hotels. On the other hand, it is interesting to note that the only category where both types of households almost had the same average expenditure was that of water and electricity, whereby households that are not at-risk-of-poverty spent just €83 more than those which were at-risk-of-poverty. Further examining percentage shares of expenditure by the

Table 5
EXPENDITURE PATTERNS BY AT-RISK-OF-POVERTY

Main Item	Not-At-Risk-of-Poverty			At-Risk-of-Poverty		
	Total expenditure	Average expenditure	% share expenditure	Total expenditure	Average expenditure	% share expenditure
Food and non-alcoholic beverages	€612,256,130	€4,570	19.0	€115,674,008	€3,749	25.5
Alcoholic beverages and tobacco	€73,859,115	€551	2.3	€12,694,709	€411	2.8
Clothing and footwear	€262,063,032	€1,956	8.1	€29,372,813	€952	6.5
Housing, water, electricity, gas and other	€253,265,865	€1,891	7.8	€55,746,260	€1,807	12.3
Furnishing, household equipment and maintenance	€242,483,230	€1,810	7.5	€30,306,452	€982	6.7
Health	€178,742,081	€1,334	5.5	€27,630,535	€896	6.1
Transport	€472,871,143	€3,530	14.6	€51,474,198	€1,668	11.3
Communication	€137,919,072	€1,030	4.3	€21,912,688	€710	4.8
Recreation and culture	€267,432,843	€1,996	8.3	€29,066,812	€942	6.4
Education	€90,654,190	€677	2.8	€12,172,151	€395	2.7
Restaurants and hotels	€278,160,554	€2,076	8.6	€27,892,118	€904	6.1
Miscellaneous goods and services	€358,942,030	€2,679	11.1	€40,389,770	€1,309	8.9
Total	€3,228,649,286	€24,102	100.0	€454,332,513	€14,725	100.0

Source: NSO.

two types of households one notes a 25% expenditure share on food and non-alcoholic beverages and a 12% share on housing costs for households which were at-risk-of-poverty. Households that were not at-risk-of-poverty spent 19% and 8% of their expenditure on these categories, respectively. This reconfirms the conclusion that households which are at-risk-of-poverty spend a significant amount of their expenditure on basic needs and edible goods.

The negative savings of households which are at-risk-of-poverty, as presented in Table 6, are evidence to the much larger weight that dependent children have on the financial situation of households which are at-risk-of-poverty when compared with those that are not at risk. Although both types of households that are at-risk-of-poverty dissave, a household with dependent children has a dissaving that is €2,255 more than households with no dependent children. On the contrary, irrespective of their composition, households which are not at-risk-of-poverty have very similar savings patterns with a difference of just €33.

When one probes into expenditure patterns, Table 6 confirms that the expenditure on housing costs, which includes water and electricity, is the only category which is almost the same for all types of households. On the other hand, as previously stated, a major difference can be noticed in the transport category. In this case the expenditure difference on transport between a household with no dependent children, which is not at-risk-of-poverty, and a household with the same composition but which is at-risk-of-poverty was of €1,662. The disparity increases to €2,170 for households that are at-risk-of-poverty and have dependent children. Significant differences were also recorded in the expenditure patterns on recreation and hotels.

Table 6
DISPOSABLE INCOME, EXPENDITURE PATTERNS AND SAVINGS BY HOUSEHOLD TYPES AND AT RISK OF POVERTY RATE

	Not At-Risk-of-Poverty		At-Risk-of-Poverty	
	Household without dependent children Average (€)	Household with dependent children Average (€)	Household without dependent children Average (€)	Household with dependent children Average (€)
Total disposable household income	€26,546	€37,528	€8,545	€13,167
Food and non-alcoholic beverages	€4,077	€5,480	€3,388	€4,452
Alcoholic beverages and tobacco	€554	€547	€410	€414
Clothing and footwear	€1,504	€2,790	€668	€1,505
Housing, water, electricity, gas and other	€1,787	€2,082	€1,733	€1,950
Furnishing, household equipment and maintenance	€1,577	€2,240	€893	€1,156
Health	€1,300	€1,397	€934	€820
Transport	€2,750	€4,967	€1,088	€2,797
Communication	€890	€1,286	€588	€949
Recreation and culture	€1,517	€2,879	€757	€1,302
Education	€240	€1,482	€21	€1,121
Restaurants and hotels	€1,786	€2,611	€837	€1,033
Miscellaneous goods and services	€2,244	€3,481	€1,073	€1,768
Total average expenditure	€20,227	€31,242	€12,390	€19,267
Savings	€6,319	€6,286	-€3,845	-€6,100

Source: NSO.

WELFARE STATE – NECESSITY NOT LUXURY¹

Professor Nicholas Barr

Introduction

It is a great pleasure to be in Malta for the first time, but I very much hope not the last. Many congratulations to the Central Bank on your 50th anniversary, which is being celebrated at an important time in the life of the European Union and of the Euro.

Today, I would like to talk about the welfare state, which many people regard either as an outdated 20th century institution or as a socialist plot. I want to make the argument that it is neither. It is arguably even more important in the 21st century than in the past.

The welfare state exists to increase individual wellbeing. It does so, first, through income security. That element includes helping people to find earning opportunities and offering insurance against adverse outcomes such as unemployment. Income security also involves assisting people with consumption smoothing over the life-cycle, so that younger people in their productive years can redistribute to themselves in retirement. A third aspect is poverty relief.

Alongside income security, the welfare state contributes to individual wellbeing also through the maintenance and improvement of physical and emotional health, and by expanding access to education and training, both for labour-market activity and personal development. Even more broadly the welfare state seeks to increase family and societal wellbeing.

I will discuss two questions: “Why do we have a welfare state?” and “How does one design a welfare state?”.

Why do we have a welfare state?

There are four sets of reasons.

Distribution

It is well known that the welfare state seeks to address distributional concerns, notably poverty and inequality. Although the early founders hoped that poverty would be a disappearing problem, that has not proved to be the case; additionally, inequality has widened in many countries. The policy responses to address these problems include redistributive taxes and transfers, including social insurance. Poverty and inequality can also be tackled by investing in people’s health and skills, and through family-friendly policies. Thus, the welfare state is not just about giving people money.

Addressing market failures

A second reason for a welfare state is to address market failures. I sometimes start my lectures at the London School of Economics (LSE) by asking students to put their hand up if they think that in a civilised society everybody should have access to adequate nutrition – and everybody’s hand goes up. I then say that in a civilised society everyone should have adequate access to health-care – and again everyone’s hand goes up. I then ask why Britain has a national health service

¹ Lecture delivered on 11 September 2018 by Nicholas Barr, FRSA, Professor of Public Economics at the London School of Economics as part of a series of lectures to commemorate the fifty years since the establishment of the Central Bank of Malta.

but not a national food service. It is mistaken to argue that if something is a necessity the state should provide it; in that case the state should distribute food as well as health care. The reason that governments intervene is to address market failure, to do things that private markets would do either inefficiently or not at all. Thus, the welfare state is not a socialist plot. Rather it exists to promote both equity and efficiency.

Although the welfare state's role in relieving poverty is well known, its role in addressing market failure is less well understood. Markets can fail to be efficient for multiple reasons.

Well-functioning markets require that consumers are well informed, but that condition can fail, particularly for complex products like healthcare. The problem is addressed by the economics of information, for which the Nobel Prize was awarded in 2001.

Well-functioning markets require also that people behave in a way that economists regard as rational. The failure of that assumption is addressed by the literature on behavioural economics, for which the Nobel Prize was awarded in 2002 and again in 2017.

Financial literacy – in particular the lack of it – illustrates both sets of problem. An international survey of financial literacy asked respondents three questions. The first was: “If you have \$100 in a bank account and the interest rate is 2%, how much money would you have in your account after five years: \$102, less than \$102, or more than \$102?”. Although that sounds like a very simple question, and the other two questions were equally simple, only about 35% of respondents in the United States (US) – the heart of capitalism – answered all three questions correctly. In Sweden, Japan and New Zealand the comparable figure was 25%, while in Russia only 2% got all three correct. In another survey, only 50% of Americans knew the difference between a stock and a bond. Limited financial literacy amongst the public is a major problem. In addition, some people who do have the necessary financial knowledge do not make the effort to make good financial decisions – we may think of these twin problems as “Can’t” and “Won’t”, respectively.

Alongside imperfect information and non-rational behaviour, a further market failure arises from missing markets. As an example, it is not possible for an individual to buy insurance against the inflation that he/she will experience in retirement – for technical reasons, such insurance policies do not exist. The topic is addressed by the literature on incomplete markets and incomplete contracts for which the Nobel Prize was awarded in 2016.

Finally, a welfare state that redistributes from rich to poor will necessarily require distortionary taxation, again resulting in inefficient markets. This issue is addressed by the literature on optimal taxation for which the 1996 Nobel Prize was awarded.

The reason for mentioning this array of Nobel prizes is to make the point that what I am arguing is not some strange, idiosyncratic view of the world, but one that is rooted in the very best of modern economics.

These market failures are directly relevant to the welfare state.

- It is not possible to buy private insurance against unemployment; there is a missing market because of asymmetric information, whereby the unemployed worker has better information than the insurance company about whether he/she is genuinely trying to find a job.

- Skills development faces problems of imperfect information. It may be difficult to decide in which skills to invest and which training institution is best; and if an individual needs to borrow money to finance his/her investment in skills there are major capital market imperfections.
- Pensions raise problems both of imperfect information and non-rational behaviour: people know they should be saving for their old age but they do not save or do not save enough. Moreover, as mentioned, there are uninsurable risks like inflation in old age.
- Uninsurable risks arise also for health care. Actuarial insurance, with premiums related to individual risk, is not a good fit for medical risks – the problems of US medical finance are entirely explicable in terms of economic theory.² Social care faces very similar insurance problems.

A counterpoint to market failure is government failure. Governments may be inefficient because of lack of capacity, or limited information or limited resources. Even where governments try to do the right things they may not do them well. Separately, a government may be corrupt or driven by political short-termism. Thus, market failure does not lead automatically to government intervention. Intervention increases efficiency only if it is cost-effective, that is, where the market failure is relatively large and where government is competent enough to improve matters.

Assisting economic growth

A third reason for a welfare state is to assist economic growth. Again, this topic is relatively new in the literature. Human capital is an increasingly important element in inclusive growth. Expanding access to education and health care invests in the nation's stock of skills. Thus, reducing inequality in access to education and health care reduces inequality of opportunity, improving the chances of poorer people to earn a decent living. Well-designed income transfers are not an unnecessary drain on a country's fiscal resources but also assist growth. The ability to afford a healthy diet improves educational outcomes. In addition, in the absence of a good safety net, people will be reluctant to start a new business because of the risk of destitution for the individual and his/her family.

An over-arching purpose: risk sharing

A framing that encompasses all three sets of reasons is to think of the welfare state as a device for risk-sharing. Poverty relief can be regarded as risk sharing behind Rawls' 'Veil of ignorance'.³ Another aspect is addressing major failures in private insurance markets. Optimal risk sharing also contributes to innovation and growth. Too much risk is bad: if there is no safety net, people are less likely to risk new business start-ups. But too little risk is also suboptimal, as shown by the Communist economic system, which stifled effort and initiative.

How should we think about risk?

Continuing with the idea of the welfare state as a device for sharing risk leads to consideration of the nature of risk. The narrow definition of insurance is an actuarial mechanism (i.e. with premiums related to individual risk), for example, automobile insurance and burglary insurance. In a broader definition, insurance does not have to be strictly actuarial, but is any institution that protects individuals against risk.

² See Nicholas Barr (2012), *The Economics of the Welfare State* (5th edition), Oxford University Press, Ch. 12.

³ The Veil of Ignorance is a hypothetical situation (used by the philosopher John Rawls) in which rational individuals negotiate a just constitution for a country in which they will all have to live, but without knowing who they will be (i.e. whether they will be born as one of the most or the least fortunate).

Actuarial and social insurance

The intuition of actuarial insurance is straightforward. The insurance company charges a premium based on (a) the probability that the insured event will occur and (b) the size of the loss. This can be shown as:

$$\text{Premium} = (1+\alpha) pL$$

where p is the probability that the insured event will occur, L is the size of the loss against which the individual is insuring, and α is the insurer's mark-up to cover administrative costs and competitive profit.

Insurance can take different forms.

- Premium based on individual risk: the premium charged to insure one's car depends on the probability of having an accident, which is higher for younger drivers, and the size of the loss which is higher for more expensive cars.
- Premium based on the average risk: this arrangement places everyone in the same pool and bases the premium on the average risk. This is the approach to social insurance in the Beveridge Report,⁴ which set the foundations for the modern British welfare state.
- Even more broadly, as noted, redistribution financed from general taxation, can be thought of as insurance behind Rawls' veil of ignorance.

Actuarial insurance works well only if a number of technical conditions hold. First, the insurance company needs to know the probability distribution of outcomes. With risk, the probability distribution of outcomes is reasonably well-known and, consequently, insurers can calculate a premium. But if the probability distribution is not well known, the problem is not one of risk but of uncertainty, for example, the probability distribution of future rates of inflation. The actuarial mechanism can cope with risk but not with the more difficult problem of uncertainty.

Adverse selection – a second problem – arises when the person buying insurance has a better knowledge than the insurance company of how risky he/she is. In those circumstances the people who buy insurance are disproportionately bad risks, creating an upward spiral in insurance premiums and, in the limit, the collapse of the market.

Social insurance can cope with both these difficulties. It differs from actuarial insurance, first, because membership is compulsory, thus finessing the problem of adverse selection because good risks cannot opt out. In addition, being compulsory, social insurance can be redistributive. The second difference from actuarial insurance is that the contract is not fully specified, so that the rules can be adjusted to accommodate unforeseen events, thus enabling protection against uncertainty.

The new social risks

The welfare state has had to adapt to what are sometime referred to as the 'new social risks'. Social policy in 1950 was based on a series of assumptions about work, families and skills.

As regards labour markets, the assumption in 1950 was that the husband was the main breadwinner and was in long-term full-time employment; thus the main risk was short-term unemployment. Today, long-term, full-time employment is less frequent. Labour-market relations are

⁴ Beveridge Report (1942), *Social Insurance and Allied Services*, Cmd 6404 (London: HMSO).

more fluid: people build portfolio careers with spells of employment, part-time employment, self-employment, unemployment or outside the formal labour force. Precarious employment such as zero hour contracts and the gig economy are also increasingly common. Because of these changing labour market patterns, contributions related to a worker's employment lead to less good coverage than in the past. A separate labour-market issue is widening inequality of pay.

Families also face changing risks. The post-war archetype was that men and women got married and stayed married, the man was the breadwinner and the woman the carer. In that world, the main risk was widowhood. Today, female participation in the labour market has increased greatly, more marriages end in divorce, and in many countries parenthood is less closely tied to marriage than formerly. Thus, social policy today is more interested in designing policies aimed at widening the choices between paid work and family obligations, including access to affordable childcare. Another issue is to design pensions in a gender neutral way, though noting that the concept of gender-neutrality is a complex one.

Changing risks present themselves also for skills development. The post-war assumption was that skills acquired when young would mostly serve the individual throughout their career. The main risk, a relatively rare one, was that somebody's skills would become redundant. Today, technical change creates a need for more, and more-highly skilled, workers; and the speed of change means that skills go out of date more rapidly. What is needed, therefore, is more education and training, more diverse education and training and repeated education and training, i.e. lifelong learning, and the need to finance these activities on a large-scale.

In addition to these social risks, the world faces major uncertainties, including economic uncertainties (a trade war, another economic crisis) and political uncertainties (instability in the Middle East). There are also technological risks such as globalisation and nuclear safety, and environmental risks, most obviously climate change. Finally, there are social risks which include the changing age structure of the population. It is important to note two things about these risks: they are mostly systemic; and they are also uncertainties rather than risks.

In sum, sharing risk and addressing systemic uncertainty are fundamental reasons for a welfare state in a modern economy and society.

How do we design the welfare state?

Turning from the 'Why' to the 'How', it is helpful to consider separately how to fit policy to social circumstances and how to do so in a way that fits economic circumstances. These can be thought of as the Ministry of Social Policy agenda and the Ministry of Finance agenda, respectively.

Fitting policy to social circumstances

When addressing income risks during working life, the policy agenda includes providing income to the jobless, restoring earning opportunities and expanding earning opportunities.

An issue in this context is whether there is a case for some variant of a universal basic income, an idea that has cropped up at intervals over the years. The difficulty is that in most countries there are many more poor people than rich ones. As a result, the level of taxation necessary to finance a generous universal basic income would create major disincentives against work. It is sometimes suggested that robots will soon take over many jobs. Historically, however, waves of technical advance have not caused mass unemployment. The question with robots and artificial

intelligence is whether the speed of change exceeds the absorptive capacity of labour markets and training. In this regard, Robert Shiller, a Nobel Prize winner, has proposed a tax on robots to allow society and labour markets time to adapt.

Alongside risks during working life are income risks in retirement. With fewer people in long-time full-time employment, fewer people have a fairly complete record of contributions. One approach which is gaining ground is to provide poverty relief through a non-contributory basic pension, that is, a flat-rate pension financed from taxation, awarded on the basis of age and a residence. There are plans of this sort in Australia, Canada, Chile, the Netherlands and New Zealand, and in a variety of developing countries (see the database on <http://www.pension-watch.net/>).

Though there is no single best pension system for all countries, there are interesting designs for earnings related pensions. A noteworthy approach is illustrated by the US Thrift Savings Plan (TSP) (www.tsp.gov) and the fairly new UK National Employment Savings Trust (NEST) (www.nestpensions.org.uk). Instead of giving workers considerable choice over pension provider, which is a choice that many workers do not want and which is administratively costly, TSP and NEST each has a single default into which workers who make no choice are placed. The default is a target date fund in which the asset allocation becomes more conservative as the target date (retirement) approaches. NEST has four additional options from which a worker can choose: a higher risk fund, a lower risk fund, an ethical fund and a Sharia fund. However, the vast majority of members of NEST are in the default fund. Overall, this design is beneficial because it provides a simple way for people to build up pension savings at low administrative cost and without the need to make complex choices.

Turning to health, private actuarial insurance is a bad fit for medical risks because of intractable market failures, the United States of America being a sad illustration. As with pensions, employment-related social insurance contributions are less useful than in the past because of changing social and labour-market realities. Thus it may be that what is left standing, at least in some countries, is to finance health care mainly from taxpayer resources, either through general taxation or a dedicated revenue source unrelated to a person's employment status, such as a fraction of value-added tax.

When it comes to investing in skills, a country can opt for taxpayer finance for school and a mix of taxpayer finance and well-designed student loans for post-school education and training. The modern approach to student loans differs from a conventional loan like a mortgage or bank overdraft. With a conventional loan, when a student leaves university, he/she has to repay a fixed amount per month, which is problematical for low earners. In what are known as income contingent loans, repayments are a fraction of the borrower's subsequent earnings until he/she has repaid the loan, collected alongside income tax and social security contributions. Thus repayments automatically adjust to a person's monthly earnings: higher earners repay more quickly, lower earners more slowly. Income-contingent loans are another example of risk sharing. The arrangement works well in Australia, New Zealand and the United Kingdom.

Fitting policy to economic circumstances

It is not enough for policy to fit social circumstances – it needs also to fit economic circumstances. A fundamental distinction is between the structure of an activity and its scale. The structure question is about whether the activity is done more effectively by the market or the state. This issue is often treated as ideological, because people can have strong beliefs about the relative roles of

markets and government. However, the question should not be treated as ideological: it is more a technical question, the answer to which depends on (a) the extent of market failures and (b) the capacity of government. If there are no substantial market failures, one should use market allocation to achieve efficiency, complemented by income transfers to achieve distributional objectives. On the other hand, if market failures are significant, there is a potential role for state activity. So structure is really a question of micro economics.

Scale is a very different question, the answer to which depends on what a country can afford to spend on the welfare state. What is affordable depends partly on the fiscal situation, which rests on the country's level of income and the effectiveness of tax collection. It also depends on the political economy of the country. For example, in the Scandinavian countries, people are prepared to pay high taxes in return for high-quality public services in a way that is not a political option in the United Kingdom or United States of America. Consequently, the scale of welfare activities in the Northern European countries is more generous than in the United Kingdom.

It is important to keep the issues of structure and scale separate. Following the 2008 economic crisis, some countries have felt the need to spend less on the welfare state, but fiscal constraint is not an argument for dismantling it.

Although in part their concerns differ, the Ministry for Social Security and the Ministry of Finance have a common agenda in addressing demographic risk. Advanced countries typically face population ageing, creating financial stress for pensions and health care. On the other hand, younger people in African countries create financial stress for financing education and training. The common denominator in tackling these different pressures are policies to promote economic growth, which have two strategic elements:

- Increasing the number of workers from a given population: to do so requires efficient labour markets and family policies that help to reconcile paid work with family obligations. Those, in turn, require flexible labour markets so that parents – typically women – can avoid a binary choice between full-time paid work and no paid work. Additionally, it is desirable also to have a pension design that supports flexible retirement, to encourage older people to stay in the labour force.
- Increasing the productivity of each worker through investment in human capital and in the physical capital that the worker will be using.

Implementing policy

The biggest lesson from my time on sabbatical at the World Bank is that implementation really matters. The message I want to give is “three skills, two parties, one table”.

The first of the three skills is strategic policy design which, I have come to learn, is the easy part. Implementing policy is harder. The second necessary skill is political implementation, requiring people with practical political skills, and the third, skills in technical and administrative implementation. The last is immensely important; many reforms fail because of inadequate administration.

Two parties: for example, in response to a country's request for technical assistance, the World Bank needs a team that includes a strategic policy design person, a political person and a technical implementation person (or several). A parallel group is necessary for the country receiving the support, in order to internalize the provider's suggestions and filter them through detailed local knowledge. Thus in principle six people are required.

One table: these people all need to be round the same table from the first day of talks. The only opportunity I had to put this approach into practise was when I was asked to advise the Hungarian government on the design and introduction of a student loan scheme. I led an LSE team: I provided the strategic policy design, accompanied by my LSE colleague Iain Crawford, in charge of political implementation, and a third team member, from the UK student loans administration, to cover technical aspects. We had three Hungarian counterparts with matching skills. Whichever one of us was talking would look round the table for nods of agreement. When someone disagreed, we would pause and discuss till we could devise an arrangement that made sense both in policy terms and in terms of politics and administration.

I have come to learn that it is profoundly mistaken to think that policy can be designed by PhDs and then handed over to peons to implement. A second profound mistake is an unrealistically short time frame.

Conclusion

The world is changing in ways that makes risk sharing more important than ever. The welfare state is able to do things that private markets would do badly or not at all. The single most important point is that the proper (and vital) place for ideology is in setting the objectives of policy, for example, how generous we want to be to the poor and how much we care about reducing inequality. Whether a particular activity should be organised by the market or the state, or whether there be an economically sensible partnership between them, should not be treated as ideological, but based on technical arguments relating to market efficiency.

To conclude where I started, the welfare state is not a 20th century anti-poverty institution whose time has gone, but an institution that is fundamental to sharing risk as countries move into an uncertain future – possibly a future that is more uncertain than the past.