Josef Bonnici: Strengthening economic resilience

Address by Professor Josef Bonnici, Governor of the Central Bank of Malta, at the Annual Dinner of the Institute of Financial Services, Saint Julian's, 20 November 2015.

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Honourable Minister, members of the Institute, distinguished guests,

I would like to thank the President and Committee of ifs Malta for once again organising this Annual Dinner and giving me the opportunity to share my thoughts with such a distinguished audience.

Mr President, I am pleased to hear you speak about the Institute's commitment towards raising the standards of financial services education, as this is exactly what we need for our dynamic financial sector to remain successful and a key contributor to our economic development.

Over the years, the Central Bank of Malta has worked closely with the Institute, and more recently participated in the successful ifs Annual Conference on The Future of Pensions. This national conference acted as a catalyst to rekindle the debate on private pensions in Malta. I commend the Institute for this important initiative. I wish you success in all the Institute's future endeavours.

Introduction

The current international economic environment poses a number of key challenges, including the weak recovery in the euro area, the slowdown in emerging economies, the enduring geopolitical tensions, and possible spill-overs from the US monetary policy that could affect financial conditions on a global scale. Clearly, our economy is not immune from developments beyond our shores. Against an uncertain economic and political landscape, our vision should be to turn challenges into opportunities to sustain economic growth in the long term.

Factors underpinning Malta's remarkable resilience

The Maltese economy has been vibrant, showing remarkable economic resilience in the face of the unstable economic environment elsewhere. In fact, the theme "Vibrant Malta" has been chosen for the European Cultural Days at the ECB in Frankfurt, which this year focus on Malta. Earlier this month, we launched a cultural programme aimed to enhance awareness of Malta's cultural heritage. The theme reflects not only the current cultural scene but also our vibrant economy.

Malta is the most open economy in the euro area, having exports and imports of goods and services each over 150% of GDP. Despite this challenging factor, the Maltese economy has managed to outperform its peers, with GDP growth consistently above that of the euro area average. A good perspective to this positive outcome is given in Chart 1, which is an update of a Chart I used in last year's presentation; since the onset of the global financial crisis in 2008, Malta's GDP increased by 18%, whereas that of Germany and the United Kingdom rose by just 5%, while that of the euro area as a whole contracted by 0.5%.

Chart 1: Real GDP growth by group of countries

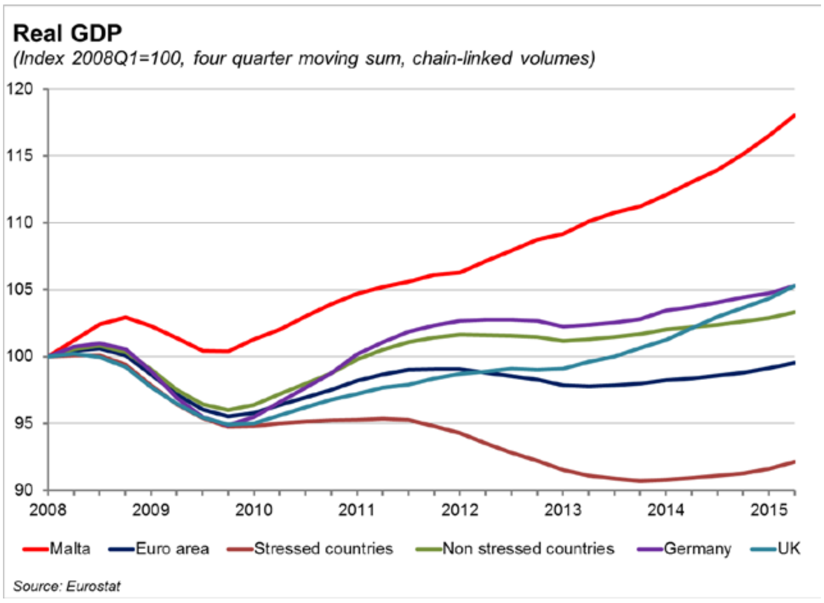


Chart 2 shows the unemployment rate in the stressed and non-stressed euro area members and Malta since 2005. Over this period, Malta's performance has been quite distinct, outperforming the non-stressed countries, while having a declining trend since 2013. This year, at 5.4%, it is the second lowest in the euro area, after Germany.

Chart 2: Unemployment rates by groups of countries

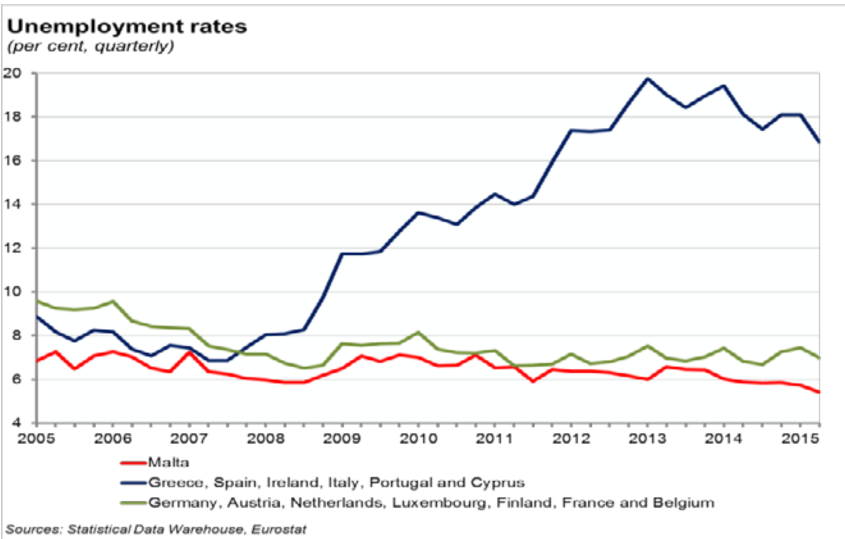
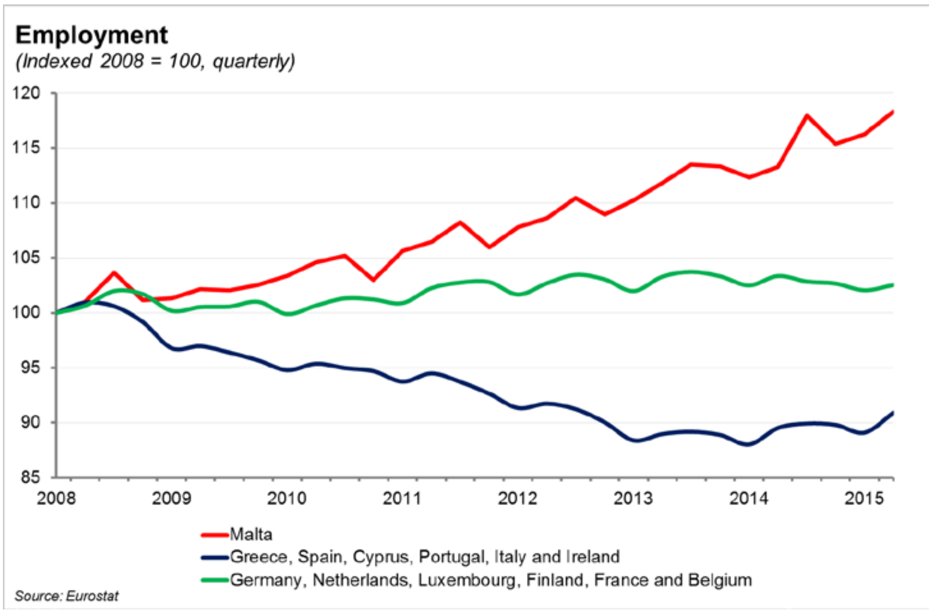


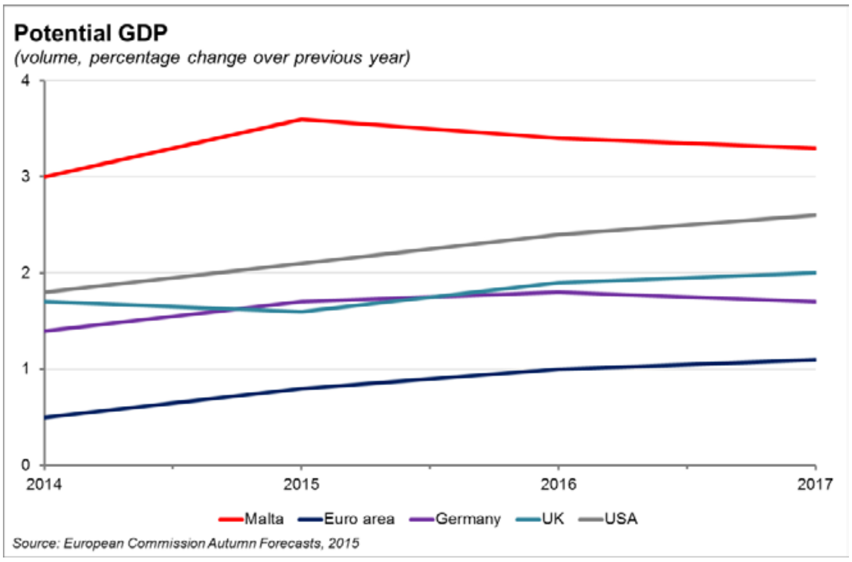
Chart 3 shows the employment performance. Since 2008 employment in Malta increased by around 18%, compared with a rise of just under 3% in the non-stressed economies and a contraction in employment in the stressed ones. In particular, the private sector employment growth rate averaged above 3% per year over the past three years.

Chart 3: Employment growth by groups of countries



Of significant importance is the strong potential output growth, which has been supported by the robust dynamics in the Maltese labour market. In its projections, the European Commission had foreseen potential output growth in 2015 in excess of 3.5%, compared with around 1% in the euro area as a whole, as shown in Chart 4. In fact, according to the European Commission, Malta and Germany were the only two Member States in which potential GDP in 2014 had already exceeded its pre-crisis growth rate.

Chart 4 – Potential GDP

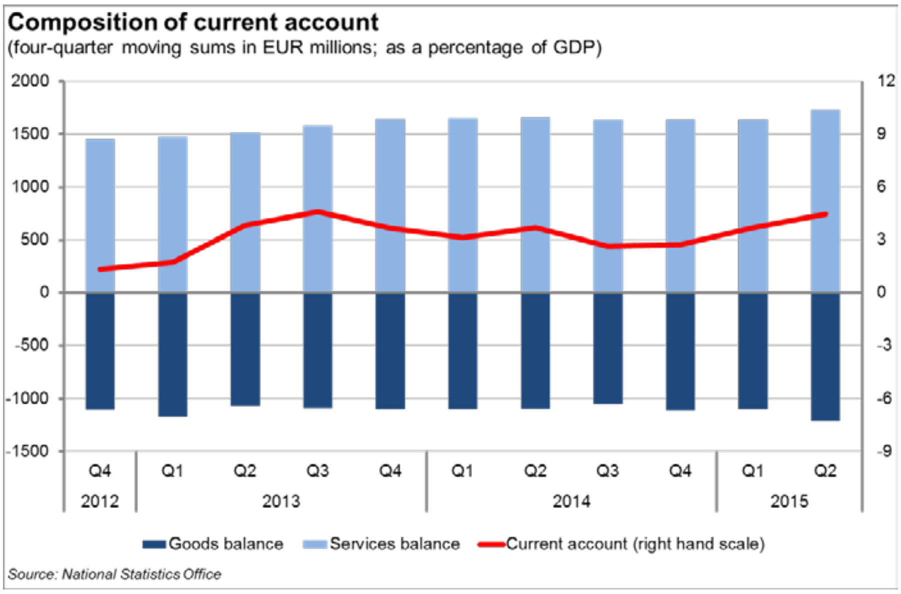


Labour market participation is a critical factor supporting potential output, particularly the steady increase in female participation. This is further reinforced by inward migration, mostly from the European Union. In fact, we estimate that in the period 2010 to 2014, migrant workers contributed to 0.6 percentage point of potential output growth. It is important to recognise that the bulk of migrant workers are in managerial, professional and technical occupations, although there is a growing number of foreign workers in elementary occupations in the hotel and restaurant sector, and in clerical and other support duties.

These workers enhance the human capital stock, bringing new skills and knowledge, while also helping to avoid bottlenecks in the labour supply in expanding sectors, including in tourism related jobs.

The buoyant performance in output and employment has dampened concerns about macroeconomic imbalances. The current account of the balance of payments turned positive in 2012 and has remained in surplus on an annual basis since then, as shown in Chart 5. The shift into surplus in recent years was driven by exports of services on the back of a strong performance in tourism and the development of new areas of economic activity.

Chart 5: Current account



Imbalances in the public sector have also been narrowing. Malta has successfully emerged from the European Commission's excessive deficit procedure, and this year Government is aiming at a deficit of 1.6% and a declining national debt of 68.3% of GDP. Next year, the deficit is targeted at 1.1% of GDP, while the national debt is forecast to decline to 65.2%.

Although the economy is small and highly dependent on foreign trade, resource flexibility and ongoing structural change strengthened its ability to adjust to external shocks, so that Malta emerged from the crisis with strong economic fundamentals.

The transformation in the exports profile of Malta, labour market developments, the *modus operandi* of the banking sector and the prudent management of public finances have been the main determinants of this resilience. The post-EU accession period witnessed a sharp rise in export-oriented services. Liberalisation of various sectors, the higher availability of better educated human resources and a targeted strategy to attract foreign direct investment opened new service sectors.

The strong shift of the Maltese economy towards services could in fact explain the rising unit labour costs observed in the past decade. The service sector engages higher quality employees and is less capital intensive than the more traditional parts of the economy. Although this could increase unit labour costs, it does not necessarily imply a loss of competitiveness. The labour content per unit of output is higher in the changed composition of output of the economy.

The resilience of the Maltese economy can also be attributed to its banking sector, which operates in a sound and liquid framework and is profitable. The prudent business model adopted by the core domestic banks is the backbone of our financial system's resilience.

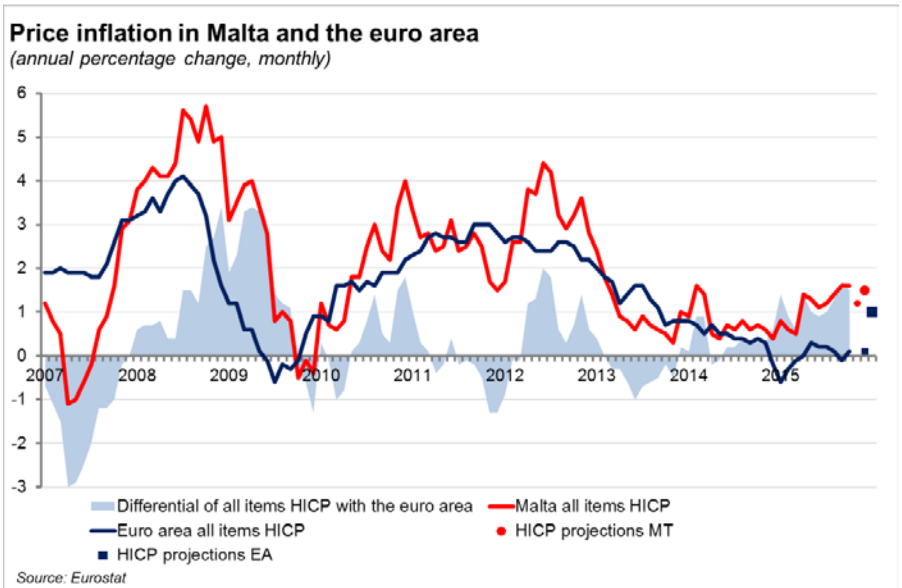
Finally, the prudent management of public finances, and the stable funding of Maltese government debt, have also contributed positively. Around 94% of local sovereign bonds are held by residents, largely with a buy-to-hold mentality.

What are the challenges ahead of us? How to strengthen resilience further?

Internationally, the risk of deflation has been the primary concern from a central banking and monetary policy perspective. In a low or negative inflation environment, consumption could be postponed in the expectation of further price reductions, putting pressure on firm revenues. Given the downward rigidity in wages, firms cannot easily adjust through lower wages in a deflationary environment. So a deflationary environment could lead to higher unemployment and stagnation. Also, low inflation increases the burden of servicing debt. Indeed, with deflation the real interest rate starts rising. When nominal policy rates are close to the zero lower bound, higher real rates cannot be corrected by reductions in policy rates.

The prolonged period of low inflation in the euro area since 2014 has prompted the ECB to introduce unconventional monetary policy measures (See Chart 6).

Chart 6 – HICP inflation

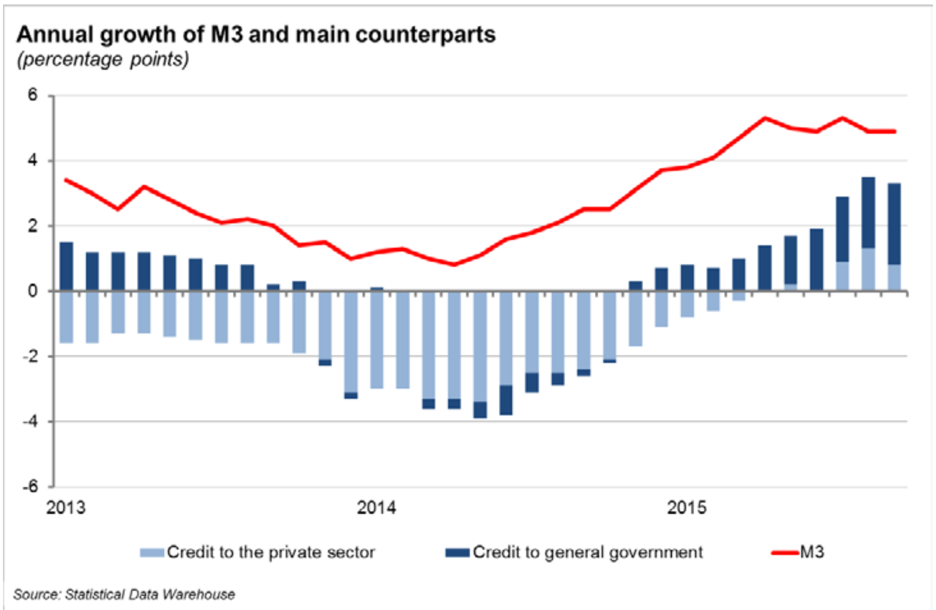


These complement the reductions in the main policy rate so as to maintain an accommodative monetary stance. In January 2015 the ECB announced the launch of the Asset Purchase Programme (APP), first encompassing ABS and covered bonds, and later extended to the purchase of sovereign bonds.

At the euro area level, the ECB's monetary policy strategy has gradually improved financial and credit conditions, as well as the ongoing economic recovery.

The non-standard measures have resulted in higher equity and bond prices, higher liquidity and improved lending conditions. Since June 2014 the transmission of policy rates to lending rates has improved, with declines in lending rates becoming more pronounced and more widely distributed across euro area countries. The bank lending survey confirms the improvements in broader credit conditions since the introduction of the APP. As a result, credit to the private sector in the euro area has shown signs of recovery and registered a positive growth since May 2015, the first time in 36 months, as shown in Chart 7.

Chart 7 – M3 and main counterparts

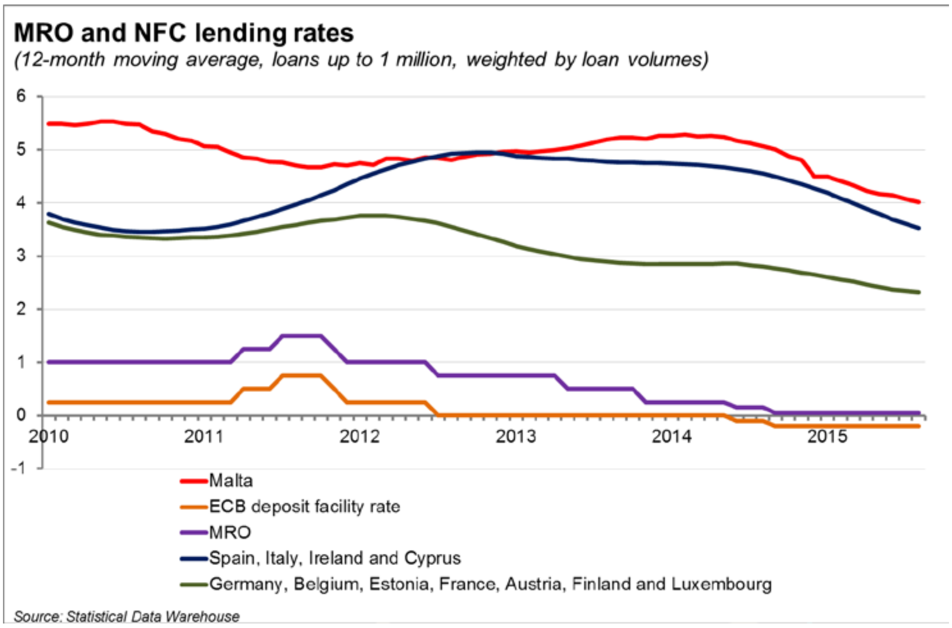


On the inflation front, however, results continue to disappoint on the downside. The harmonised index of consumer prices in the euro area is just 0.1% in October 2015, following a period of negative or close-to-zero inflation. On the other hand, the latest inflation rate for Malta, at 1.6%, is within reach of the ECB's below but close to 2% target; it attests to the buoyancy of the economy. It also indicates that the APP has had positive effects on Malta's economy. The main transmission channel has worked through the exchange rate. The depreciation of the euro against other major currencies has kept inflation in Malta closer to the ECB target and it also boosted competitiveness on the exports side. Countries with high openness to trade with non-euro area countries have been more sensitive to the depreciation of the euro. In Malta exports of goods towards non-euro area countries represent around 72% of total goods exports and around 87% in the case of service exports.

The wealth effect is another transmission channel of the APP that has been evident in Malta. The Malta Stock Exchange has gained 32% since the beginning of the year, while the property market continued to perform buoyantly. A higher level of wealth positively affects consumption and general consumer confidence.

On other fronts, however, Malta can position itself better to reap more benefits from this unprecedented scenario of accommodative monetary policy, particularly in the area of access to finance. As just mentioned, the ECB's monetary policy has enabled significant reductions in lending rates across the euro area. Bank lending rates in Malta did go down but still remain higher than in other euro area countries, as shown in Chart 8.

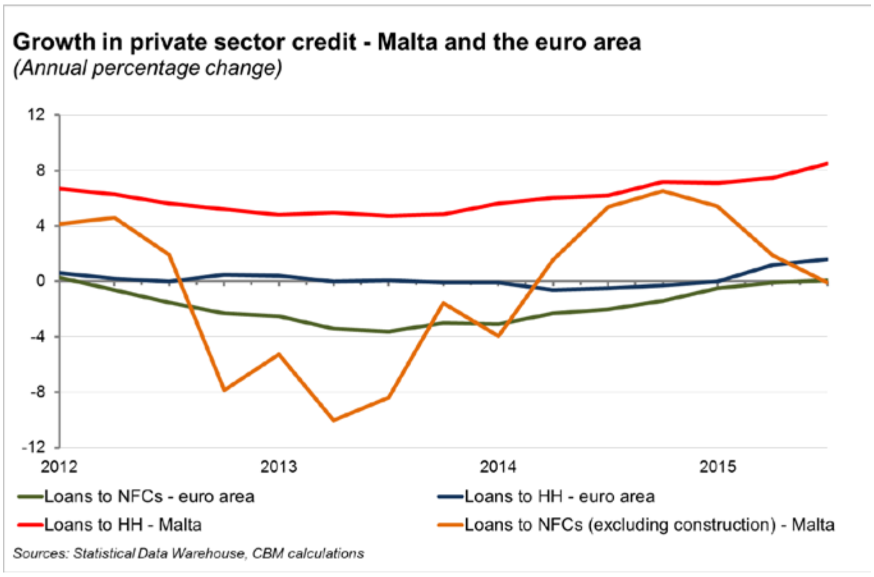
Chart 8 Bank lending rates and ECB rates



The transmission of central bank policy rates to retail bank rates is an essential condition for the monetary policy transmission mechanism. This is especially important in Malta where the predominant types of businesses are SMEs, which use banks as a main source of financing. In fact, although Malta outperformed the euro area on the main macroeconomic indicators, credit to the non-financial corporate sector has remained subdued, although this partly reflects deleveraging in certain sectors, particularly in construction and real estate.

Apart from the impaired transmission of ECB policy rates to retail rates, charges and commissions of commercial banks are found to be relatively high. In a recent report, the Malta Competition and Consumer Affairs Authority made a number of recommendations to address issues primarily related to price transparency, barriers to expansion and consumer mobility in view of improving competition and borrowing costs for SMEs. Bank charges on SME loans and charges for credit transfers need to be revised downwards to facilitate access to finance and also to encourage the use of electronic money, which would ultimately result in lower processing costs to banks.

Chart 9 – Credit growth to households and businesses



In keeping constant focus on maintaining competitiveness, the Government took a significant step by committing itself to set up the Malta Development Bank. Preparatory work on the establishment of the Bank is well advanced. The development bank will strengthen and diversify the local financial base and will contribute to economic growth by funding sectors and projects that are not catered for by commercial banks on their own. It will provide attractive wholesale financing and risk sharing facilities. It will be a powerful tool to bring to realisation more economically feasible projects.

The delay in tackling non-performing loans (NPL) on the bank's books is another factor that puts a drag on credit growth and reflects a dimension of credit risk that should be resolved. An efficient judiciary system that deals with insolvency cases in a timely and cost efficient manner facilitates credit risk management by bringing down the stock of NPLs. An improved corporate insolvency regime facilitates the rehabilitation of viable firms and speeds up the exit of non-viable ones. This would boost banks' profitability as a result of reduced provisioning needs, while it would also generate gain of output for the real economy arising from more efficient allocation of resources. The authorities have launched a comprehensive review of the judicial system, which is expected to result in a reform that would benefit the banking sector and the overall economy.

As I said earlier, the APP has had some positive effects on our economy. However, we need to be vigilant to identify any arising risks from liquidity flows. Accordingly, the Central Bank of Malta, through its participation with the Malta Financial Services Authority on the Joint Financial Stability Board, is monitoring credit developments for any undue credit growth that could potentially lead to the formation of asset bubbles. Should it be required, we will take offsetting macro-prudential measures to safeguard financial stability and maintain the resilience of the financial sector.

Given the limited depth of our capital market, the APP has somewhat tightened investment options for the Maltese investor. In this context we need to diversify our capital market further, with securities that are sufficiently backed by assets, such that the integrity of our capital market and the stability of our investors' base remain intact.

During the Governing Council meeting held in Malta last October, President Mario Draghi stated that "Monetary policy should not be the only game in town", indicating that monetary policy could not solve the euro zone's economic problems alone, and that "…all countries should strive for growth-friendly fiscal policies".

In the current state of affairs, an efficient budgetary policy must be built around structural reforms, fiscal responsibility and productive public investment. With the Maltese economy operating close to its potential output, it is the appropriate time to create fiscal buffers that could act as a cushion against any future need.

Conclusion

The single currency has proved to be a challenge to various countries in the euro area. Instead of exploiting the opportunities offered by the single market, some Member States have been impacted by the fixed nominal exchange rate and their inability to correct macroeconomic imbalances through internal adjustment. This made them more vulnerable in times of crisis. One fundamental lesson to be learnt is that, with a fixed exchange rate, it is of utmost importance that the rest of the economy is as flexible as possible to correct imbalances.

In this regard, the Maltese economy has been nimble enough to adapt to the new realities of the single currency. Yet, the challenges that lie ahead will require further structural changes that increase flexibility and strengthen economic fundamentals. To this end, Government has identified health and education as new sectors with growth potential that could be transformed into exportable services. Malta has the ability to develop a regional cluster in these areas, attracting students and patients from the region and beyond. This year we have seen a significant correction in the exchange rate, which is expected to exert a positive influence on economic growth in the year ahead.

There are other major elements that add to Malta's positive outlook. In addition to being an efficient and profitable international business location, Malta is a meeting point of cultures and languages at the centre of the Mediterranean. There is, therefore, potential for further development of economic activities that exploit our location, our strengths in doing business from Malta that add value to current activities, such as, for example, developing further cultural niches in the tourism sector so as to maintain a vibrant and evolving economy.

Thank you