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CENTRAL BANK OF MALTA

PRODUCTIVITY AND STABILITY FOR SUSTAINABLE GROWTH

ADDRESS BY DR MARIO VELLA

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DELIVERED DURING THE IFS ANNUAL DINNER

18 NOVEMBER 2016

Dear President and Members of the Committee of Institute of Financial Services (IFS) Malta, personally and on behalf of the Board of Directors of the Central Bank of Malta and of its Senior Management, I thank you for the opportunity to address this distinguished audience.

Dear Minister. Ladies and gentlemen.

This annual event brings together key stakeholders in this country's economic development and growth, and in the development of the social, educational and cultural conditions without which economic development and growth are not possible. It is now an established tradition that the Governor of the Central Bank seizes the opportunity of the Annual Dinner of IFS Malta to make a number of factually grounded remarks about some matters in the remit of the Central Bank.

The traditional presence of the Minister of Finance at this event is of vital importance because it provides the stakeholders present with a more dynamic view of the whole, in the light of the statutorily distinct roles of the Ministry of Finance and the Central Bank.

Before sharing some thoughts with you, I would like to commend IFS for its ongoing commitment to responding to the changing needs of the marketplace and its pursuit of excellence in the provision of financial services education.

It is encouraging to hear that the Institute has had a successful year and that you are working on new initiatives to promote even higher professional standards. This is most welcome, as education and professional development are fundamental to the sustainability of our financial sector and its continued success.

Your strategic partnerships with the University of Malta and overseas professional bodies such as the European Banking & Financial Services Training Association (EBTN), the London Institute of Banking and Finance, and the Global Association of Risk Professionals

(GARP) - whose representatives are with us tonight - reflects the Institute's excellent reputation. That a Committee member of IFS-Malta has been elected to the highest decision making body of a European association for a third consecutive term confirms the Institute's integrity and professionalism.

The Central Bank has always worked closely with IFS and will continue to support its activities. This year, we also cooperated with the IFS during the European Money Week to promote financial literacy to underprivileged youths and participated in the successful IFS Malta Annual Seminar on pension reform. I look forward to even more cooperation in the future.

Mr President, well done and thank you for taking a proactive stance towards raising the standards of financial services education. I wish you and your Committee every success in your future endeavours.

Malta's recent economic performance:

Against a backdrop of weak growth in Europe as a whole, economic activity in Malta remains robust. Following an exceptional increase of 6.2% last year, real GDP expanded at a more than respectable average annual rate of just over 4% during the first half of 2016.

The expansion in output is being driven by domestic demand, especially by strong growth in private consumption and investment. Exports of services are also performing well, indeed significantly better than the export of goods.

Growth is being driven by private market services, encompassing a mix of traditional and new sectors, including tourism and distribution, aviation and professional services. The utilities, which were formerly loss-making, have now returned to profit, reflecting the use of cheaper energy sources and efficiency gains.

Manufacturing is holding its own, with pockets of success and others that continue to face strong competitive pressures. At the same time, following vigorous growth last year, growth in value-added in construction has eased.

Growth in output depends upon and feeds into a dynamic labour market. According to administrative records, which are available up to April 2016, annual employment growth consistently exceeded 4% in recent quarters. The Labour Force Survey paints a similar picture, with employment gains averaging around 3% during the first half of the year. More recently, registered unemployment has continued to fall to record low levels over the summer.

Notwithstanding such a dynamic economic performance, price pressures remain contained, with inflation fluctuating in a narrow range around 1% since the beginning of the year.

The external balance, traditionally in deficit, has now been in surplus for a number of years, reflecting growth in services exports. The fiscal deficit narrowed to 1.4% of GDP in 2015 and should continue to decrease further this year. Indeed, in the foreseeable future the budget deficit is planned to fall to zero, while the government debt to GDP ratio should decrease to less than 60% of GDP.

This healthy economic performance and fiscal consolidation efforts have been well noted by the credit rating agencies. Indeed, last month, Standard & Poor's raised Malta's long-term sovereign rating to 'A-' with stable outlook. Earlier, Fitch had raised their outlook from neutral to positive.

In sum, the Maltese economy is going through an unprecedented period of strong growth, low unemployment, restrained inflation, a positive external balance and diminishing budget deficit and debt ratios.

Over the medium term, this performance has resulted in the convergence of Malta's real per capita income with the EU average. Real GDP per head went up from 81% of the EU average in 2004 to 89% in 2015.

The conditions that determine performance:

It is worth examining the conditions that have made this performance possible to ascertain the extent to which it is sustainable or otherwise.

Some of the growth can be attributed to cyclical factors. For example, Malta is benefiting from the European Central Bank's accommodative monetary policy stance. For reasons unrelated to the domestic situation, but reflecting a prolonged period of low inflation in the euro area, the ECB is using both conventional and unconventional measures to stimulate aggregate demand.

Hence interest rates are extremely low: consider that the domestic 10-year bond yield is now below 1%. Such low rates stimulate aggregate demand. One could also argue that, in the absence of the ECB's monetary policy measures, the euro would also be much stronger than it is today. This would have had adverse implications for external competitiveness and, hence, Maltese exports.

Over the last two years, the economy also benefited from exceptionally strong government investment - with a key role played by EU funds - as the administration made sure that available entitlements were absorbed to the fullest extent possible.

This capital spending has both a temporary and a permanent effect. While the projects themselves are under way, investment boosts aggregate demand as seen in the levels of activity in the construction sector. Once the projects are completed, the additional capital stock that has been put in place enhances efficiency and allows the economy to continue growing into the future.

This brings me to a crucial concept in the analysis of Malta's underlying economic performance: potential output. Potential output can be understood in many ways. Intuitively it can be seen as the maximum output an economy can produce without generating imbalances that show up in inflation. Potential output is a conceptual measure. It can be estimated, but not observed.

The Central Bank devotes much effort to estimating Malta’s potential output growth and its underlying determinants. Growth in potential output can be largely ascribed to structural reform measures that bring about changes in the factors of production, namely labour and capital, and the way they are combined, or productivity. We estimate that the potential growth rate of the Maltese economy has more than doubled from below 2% at the time of the global financial crisis to over 4% today.

This partly reflects a steady increase in the labour supply, coming from higher female participation in the work force, measures to increase the effective retirement age and the influx of foreign workers, mainly from EU countries. Apart from the increase in labour supply, the quality of human capital has also improved. At the same time, a pick-up in investment, partly driven by developments in the energy sector, has boosted the capital stock. However, there is ample scope for improvement of labour productivity in the coming years. Indeed it is critical that it must improve.

A sound and stable financial system is an essential pre-condition for strong and sustainable economic performance. The performance of the domestic financial system, especially the core domestic banks, which have the strongest linkages to the domestic economy, remained sound with strong capital ratios, high liquidity and remained very profitable despite the challenges of a prolonged low interest rate environment.

Asset quality continued to improve, as non-performing loans, especially to the non-financial corporate sector declined by almost 12%, mostly reflecting improved creditworthiness and an increased commitment by borrowers to honour their loan commitments. As a result the Non-performing Loan ratio declined to 6.5% by mid-year and is expected to decline further to below 6% later on this year. While banks have continued to adopt a prudent stance by increasing provisions, and while such loans are generally covered to a significant extent by collateral, nevertheless they need to build further coverage and exercise restraint in dividend distribution to shareholders to preserve further the soundness of the banking system.

In this regard, the authorities, namely the Central Bank and the Malta Financial Services Authority through the Joint Financial Stability Board, have taken policy measures to ensure that by preserving its soundness, the overall banking system remains supportive of economic growth. During 2016, the authorities introduced the Other Systemically Important Institutions capital buffer, to preserve capital in those banks that are the most systemically important for the domestic economy. We have also launched the Countercyclical Capital Buffer, although this has been currently set at 0% as credit growth has not been excessive relative to economic growth or contributing to asset price inflation.

Other decisions to maintain the soundness of the banking system relate to addressing the stock of NPLs, which is incidentally also high on the agenda of the Single Supervisory Mechanism. In this regard the authorities launched a consultation process with the stakeholders involved, to amend Banking Rule 9 which involves measures addressing credit risks arising from the assessment of the quality of asset portfolios of credit institutions.

In a nutshell, the proposal aims to establish a concrete plan with those banks with NPLs higher than 6% to reduce such NPLs below that level over a period of 5 years, where failure to adhere to this plan will require the institution to shore up its resilience through the accumulation of an additional capital reserve.

Meanwhile, on a European level, the European authorities are pushing for the establishment of a European Deposit Insurance Scheme (EDIS), which is a necessary ingredient to complete the architecture of the Banking Union project. This is because a common deposit insurance fund inspires the same level of confidence to depositors throughout the entire Banking Union, creating a consistent and common framework for supervision, resolution and depositor protection.

Moreover, this joint safety net within the Banking Union is expected to prevent the creation of competitive distortions, thus facilitating cross-border banking and hence strengthen financial integration. However, in this regard, there is still some way to go for agreement among all Member States, as risk reduction measures, particularly through asset quality reviews of the less significant institutions and addressing the banking-sovereign debt loop, need to be also implemented. Malta is committed to taking the EDIS file forward during its presidency.

Risks:

Going forward, we expect economic growth to moderate, while remaining robust and well above the euro area average. We consider that risks around this scenario are balanced. On the upside, there is the potential for private consumption to grow even more rapidly in a low interest rate environment especially if labour productivity increases to permit higher wage settlements.

The downside risks relate mostly to the external situation. Malta is one of the most open economies in Europe, heavily dependent on international trade for its long-term prosperity. Slower than expected growth in key trading partners, geopolitical tensions in our immediate neighbourhood and a resurgence of protectionism threaten this prosperity.

Another dimension of risk relates to inflation. I have already explained that the Bank believes that Malta's potential economic growth rate has risen in recent years, implying that the economy can grow more rapidly than it used to without fuelling inflation. Nevertheless, output currently exceeds potential.

Should such a situation persist, we would normally expect to see upward pressures on prices and costs. We have not observed them yet, as wage growth has remained largely contained and foreign inflation is subdued.

The labour market situation, however, is tightening, which could lead to an intensification of wage pressures. This underlines the need to achieve better results in labour productivity growth to support wage demands without loss of competitiveness. In addition, global oil prices are now rising after having reached a trough towards the beginning of this year.

Challenges ahead:

The Central Bank of Malta's prime responsibility is to ensure price stability. From this perspective the challenge is to ensure that the Maltese economy continues to expand at a sustainable pace, without overheating.

It is vital that we avoid the formation of asset price bubbles. The recent global financial crisis has shown the huge costs that can arise when asset prices depart from their fundamental values, eventually jeopardising the financial system and the economy as a whole.

At the Central Bank we are keeping a very watchful eye on the price developments in the property market. Earlier this year we have published work by our Economic Research Department exploring property price misalignment with fundamentals based on an index of 5 separate indicators. It shows that at the end of 2015 house prices were still below their equilibrium fundamental value but nevertheless price trends in this regard will continue to be closely monitored.

There are, however, other asset classes which need close observation to avoid formation of asset bubbles. In the current low interest rate environment investors' search for yield may stimulate excessive risk-taking behaviour. More investors' education is needed to ensure that there is better appreciation of the risks of unrated corporate debt, especially where markets are somewhat thin.

At the same time, we have to recognise that, as members of the euro area, the monetary policy tool is no longer available at the national level. This means that action needs to be taken in those policy domains where we do enjoy some freedom of manoeuvre, that is, fiscal policy, macro-prudential policy and structural reforms.

Policy recommendations:

On the fiscal front, the recent developments I have just highlighted are encouraging. I would stress the importance of meeting our fiscal targets in terms of structural adjustment and reduction in the debt ratio.

Apart from compliance with domestic and European fiscal rules, it is important for Malta to build up sufficient fiscal buffers to allow us to counter eventual adverse economic shocks with fiscal policy if needed. In this regard, judicious control of government expenditure is essential, bearing in mind that some important government revenue streams may be past their peak and need to be replaced through new initiatives.

Enhancing labour productivity is critical - forgive me for possibly boring you by repeating myself but I am sure you will agree with me that better bored than sorry. This requires ongoing investment in our labour force, in our people.

In terms of the general business environment, it is important to ensure that Malta remains an attractive location for investment, especially foreign direct investment. We need to keep costs competitive, not only labour costs but also the costs of ancillary services including energy, transport and finance, as well as transaction costs generally.

Permit me, at this point, to stress the importance of containing the asymmetries of knowledge facing investors, especially foreign direct investors. The Central Bank is doing its utmost and intends to boost its efforts and the quality of these efforts by providing top quality and highly reliable public domain quantitative and qualitative information. Our research capability is one of our top priorities. This enhancement of our capability to produce reliable knowledge will benefit all discerning stakeholders including the policy maker (who we are statutorily committed to advise) and the potential investor (who abhors any vacuum of knowledge concerning the target location).

Promoting a healthy business environment also requires action to reduce excessive bureaucracy, to increase the efficiency of our judicial system and to ensure that our legal and regulatory frameworks remain appropriately flexible.

At the Central Bank of Malta we have taken initiatives to help the business environment by launching the Credit Register and by promoting the setting up of the Development Bank to give better access to credit for SME's and to infrastructure investments on the Public Private Partnership (PPP) model.

We are also piloting changes to pre-insolvency procedures in an effort to curb unnecessary liquidations and save businesses that deserve a second chance through financial restructuring. We are also leading efforts to amend legislation to achieve more efficient contract enforcement procedures to address the long duration of NPL's on bank balance sheets. These initiatives will help us climb the admittedly steep ladder of international rankings measuring business efficiency.

The great efforts of other public sector organisations, led by the Office of the Principal Permanent Secretary and Malta Enterprise, to radically streamline business enabling procedures across the board, are critical if we are to succeed to radically upgrade the business environment. I insist on the word "radical" because only a radical upgrade (an upgrade from the very roots of the system) will make a difference.

We need to enhance competition. It is essential to ensure that consumers and businesses can acquire the goods and services they need at fair prices. Within the banking system, we believe that there remains scope for payment services charges to respond to more competition and for further pass-through of the current low interest rates to customers, although it is encouraging that we have seen reductions in recent months.

Fast economic growth does not come without some pain and costs. Infrastructure development has not kept up the pace and translates into practical problems. There are no easy solutions to such problems. Building infrastructure takes time and adopting urban development policies is inevitably complex, especially in a very small island where every space is somebody's back yard.

At an international level, as an extremely open economy, we need to take a resolute stand against policies that close borders to trade and to international flows. As a small open economy we need to defend open borders and globalisation.

However we need to acknowledge that the benefits of globalisation have been very unevenly distributed, even in the most developed economies where many wage earners have not seen a real increase in wages for decades and have lost their jobs and security. This is what populism feeds on whilst certainly not offering solutions intended to ensure social justice.

Economic growth is only a means to the ultimate end of providing a higher standard of living and confidence about the future for all citizens. But it is an absolutely necessary means.