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CENTRAL BANK OF MALTA

PROGRESSING SAFELY IN A RISKIER WORLD

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Dear President and Members of the Committee of the Institute of Financial Services (IFS) Malta, personally and on behalf of the Board of the Central Bank of Malta, I thank you for this opportunity to address this distinguished audience and through them the financial services industry. Dear Minister, distinguished guests, dear colleagues and friends.

Last year, I observed that the external environment was becoming less supportive of activity. Incoming data confirm this view. Global GDP growth has continued to weaken. According to the IMF's October 2019 World Economic Outlook, global growth in 2019 is projected to be 3.0%, the lowest rate since 2009 and 0.5 percentage points less than its January 2019 projection.

A number of factors are reflected in this state of affairs, a fluid state of affairs that is characterised by high volatility and uncertainty, a state of affairs that is anything but steady. Amongst these factors are simmering political tensions and flashpoints within and between states around the globe (some of which may eventually erupt as armed conflicts), uncertainty about future trade policies amongst which are (but certainly not the only ones and not the ones with the most far reaching negative consequences) those related to Brexit, and the impact of climate change and related policies including and especially policies that deny the man-made causes of climate change. The consequences of these factors on investment and trade are being amplified by a deterioration in business confidence.

Projections for 2020 also point to weak momentum, as most of the prevailing sources of uncertainty are expected to persist. While global GDP growth is expected to reach 3.4% next year according to the IMF, this is still below the 3.8% recorded in 2017 and the pick-up is largely driven by emerging and developing countries. By contrast, average GDP growth in advanced economies is expected at

1.7% this year and next, down from 2.3% in 2018. A lower rate is projected for the euro area, as growth in its larger economies with the exception of Spain is expected to stand far below 2.0%.

Although Malta is a small economy with a relatively high exposure to the international business cycle, it has maintained its resilience. In 2018, GDP grew by 6.8%, the second highest rate in the European Union. This mainly reflected a very robust expansion in domestic demand. Although smaller, the contribution of net exports was also positive, reflecting continued export growth. While GDP growth moderated in the first half of 2019, at 4.7% it remained comfortably above the euro area average of just above 1.0%.

We expect the positive momentum in Malta to persist in both 2019 and 2020. Domestic demand is foreseen to remain the main driver of economic activity. Favourable labour market conditions, as reflected in a further decrease in unemployment since late 2018, and a dynamic, albeit gradually normalising housing market, should continue to support household income and private consumption. Moreover, growth in government consumption will remain elevated, as Government is expected to use some of its fiscal space, while investment is expected to maintain a high share in GDP, reflecting the substantial upgrade to Malta's infrastructure.

Nevertheless, growth is set to moderate compared with 2018, reflecting two main factors. Firstly, given the less favourable external environment, we foresee lower contributions from exports. Secondly, it is to be expected that an economy that has been growing very fast to gradually return to rates that are more in line with its long-term growth.

The balance of risks is tilted to the downside. This mainly reflects the risk that economic conditions abroad deteriorate further, in which case the recent slowdown in some of our closest trading partners could develop into a more severe downturn, limiting the expansion in our exports. These risks are seen as more elevated than the upside risks associated with domestic factors. For example, the labour market's resilience and strong liquidity position of households could be reflected in higher than expected private consumption. Government expenditure could also surprise on the upside.

Indeed, Malta is one of few countries in the euro area which has the fiscal space necessary to mitigate the effects of weaker foreign demand. Ideally Government should utilise this space to enhance the economy's capital stock and potential growth. In a recently published study, Central Bank of Malta staff analysed in detail the effects of increases in government investment on the Maltese economy under different financing scenarios.

Under all financing scenarios considered, an increase in government investment is expansionary throughout. In the short run, the expansionary effects are limited to demand-side effects. However, as government capital stock accumulates, significant supply-side effects begin to kick in. A higher government capital stock helps reduce marginal costs, boosting factor productivity and helping to crowd-in other private factors of production. The reduction in economy-wide marginal costs in turn should lower overall prices, boosting competitiveness and exports.

In line with other analyses, the study also shows that even if not debt-neutral, using fiscal space to finance government investment has the strongest effects on real activity in the short-to-medium run. A debt-financed 1 percentage point increase in the government investment-to-GDP ratio increases real GDP by 1.5 percentage points from its baseline level by the fifth year. Even if the investment ratio returns to its pre-shock level, GDP would still exceed its baseline level by around 1% by the tenth year. Thus, an expansion in public GFCF expenditure can help mitigate the negative impact that weaker external demand might have on Malta's economy.

Further investment in human capital is also necessary. Malta's positive economic record is also partly reflected by a growing influx of foreign workers. These now account for around a fourth of all employment. Although foreigners, including non-EU nationals, are present in all sectors and at all levels, their employment has increased mainly in professional and administrative support services, and not as is sometimes claimed, in sectors characterised by lower skill levels. The increased employment of foreign nationals across occupations has enabled organisations to grow and venture in new areas. A sudden reversal of this pattern could stall activity in several sectors. Efforts to upgrade the country's infrastructure should therefore be complemented by measures that prevent a disorderly depletion of foreign human resources and enhance the skills of Maltese nationals.

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Favourable economic developments, although easing somewhat, are expected to continue to buttress financial stability. Lending volumes remain supportive of interest income but pressures on margins persist due to the low interest rate environment. Notwithstanding, profitability remains a challenge for traditional banking models such as those of our banks. In fact, though still comparing favourably with their European peers, the profitability of domestic banks has been slimming. In addition to the limitations on their ability to generate more interest income, banks have to contend with 'no-fee' alternative products being developed by fintech players which operate with a lower cost base and hail from a less intrusive regulatory environment.

Concurrently, banks are facing a more rigorous and intrusive supervisory approach coupled with more rigorous standards of Anti Money Laundering and Combating the Financing of Terrorism. This is absolutely necessary and has our full and active support. Of course, this changing environment requires significant investment in technologies and human resources with added pressure on banks' bottom line. Also it may potentially encourage more risk aversion, despite the ultra-accommodative monetary policy stance. It is critical, therefore, that regulators ensure a level playing field to avoid regulatory arbitrage and push banks to retrench, thus creating market gaps that can be exploited by less regulated, or more importantly, by totally unregulated players. Today's increasingly digitalised world enables these gaps to be filled with relative ease.

Institutions must embrace innovation while exploiting more effectively and smartly the prevailing benign economic conditions, to discover new investment opportunities and niche markets. It is also an opportune time for banks to keep sight of their longer-term sustainability and maintain their efforts to repair their balance sheet, reduce concentrations and improve asset quality. This is what ultimately strengthens prospective future cash flows and what supports profitability. Banks are also, of course, entitled to set their own risk appetite. In well-functioning markets, business opportunities shunned by one bank will be taken up by a competitor, if the latter feels more confident that it can manage the underlying risks more effectively.

There will always be a residual sort of non-bankable business, and we must accept this fact. If, however, a business in search of a bank is especially risky but legitimate, there is no reason why we should not welcome specialist legitimate players capable of withstanding the most rigorous standards of supervisor scrutiny.

To blame all on-boarding failures only on an ultra-conservative banking sector is simplistic and counterproductive. Reality is more complex than that and the causes might vary from the risk appetite of the European supervisory landscape that follows a common rule book, to problems of asymmetric information, complex corporate structures or business models.

Unless we get down to this level, we can never really pass judgement on the actions of banks regarding who they on-board. Banking is all about risk management and banks with a zero risk appetite will eventually starve and be forced out of the market. Such risk aversion should not come at the expense of the right of all citizens to access basic banking services, as this will fuel financial and social exclusion. Banks should therefore be encouraged to use their judgment and sense of proportion when exercising due diligence, and to consider their responsibility given their pivotal role in the financing of the economy.

Although certain AML/CFT vulnerabilities had already been identified at a national level and actions were already underway and although the Authorities pledged their commitment to fully address these issues, the Moneyval report has set targets that we must reach. Financial systems trade in confidence and credibility and unless we address these shortcomings, we will be unable to develop our sector further.

The most challenging recommendations found in the report are those requiring a change in mind-set, such as the identified lack of awareness of AML risks in non-bank financial institutions and the wider professional community, resulting in a very low number of suspicious transactions reports being filed by them. We all have a collective responsibility and nobody can procrastinate in getting our house in order.

On a related note, our size will always present diseconomies of scale for large correspondent banks when evaluating their risk-adjusted returns from Maltese business. The risk aversion of these banks is impacting more heavily on the smaller jurisdictions. It is essentially a market failure, a true manifestation of asymmetric information. This does not mean, however, that we should be complacent and fatalist. While banks and authorities continue to search for technical solutions, we are all duty-bound to endeavour to convince these banks that they are dealing with a reputable jurisdiction and that our market players are fit-for-purpose in an age of increasing global financial transparency. These correspondent banks have neither the time nor the interest to understand risky business models or the overly-complex structures of your clients. As practitioners, you are the system's first line of defence. The more layers of controls in the system, including a thorough understanding of clients and business models, and the less complex their corporate structure, the easier it is for banks to service them.

There is indeed purpose in our cause to safeguard what we have achieved so far. This sector, which directly contributes to a significant 5.3% of gross value added and provides for the livelihood of over 11,600 employees, is in good health. This is attested by the positive assessments from major rating agencies and the IMF as recently as last year. These conclusions are also corroborated by the results of the CBM's stress tests which regularly feature in our publications. So let us all rise to the occasion, and work towards preserving the sustainability and reputation of our sector.

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Inequalities are of two broad types: legacy inequalities and inequalities that are consequences of present social and economic developments. Gender inequalities have roots deep in the past. Today's faster economic growth, however, does bring with its own risk of social shocks. The risk of higher inequality is a case in point. As already announced in my previous IFS address, the Bank has begun to develop a social research capability that focuses on studying inequalities of both types. This is a new experience for the Central Bank of Malta and we are striving, within the limits of available resources, to produce high quality empirically based results by the first quarter of next year.

We are, however, striving to go beyond producing knowledge. In our efforts to promote inclusiveness and diversity in the Bank itself, we have made modest but significant steps forward.

Whereas in 2008 there were no women in the Central Bank's Board of Directors, in 2013 there were two women Board directors, and in the current year, 2019, we continue to have two women Board Directors, that is half of the non-executive directors. In 2008, there were no female members of staff among the 31 employees in the top band, comprising the grades of senior executive, head and chief officers. In 2013, there were 6 out of 38. Presently, in November 2019, there are 12 out of 45. Small steps forward indeed but not insignificant: a clear sign of progress is shown by the fact that if we take the key role of heads, whereas there was only one female head in 2014, there are now 6. The gender distribution of staff below the senior executive grade is predictably more equitable, with 56.7 per cent of all staff in the grades concerned being women, compared to 47.3 per cent in 2008. Conversely at the very top level, that of the Deputy Governors and the Governor, we have to date no woman. That at the very top of the European Central Bank, in the Governing Council, the situation is even less balanced than ours, is certainly no consolation for us. However, that the new President is a woman, Christine Lagarde, is hugely significant.

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As hinted during the launch of our Annual Report last May, the Bank is stepping up its involvement in sustainable finance. In July, the Central Bank of Malta joined the Network of Central Banks and Supervisors for Greening the Financial System, a collaborative structure that aims to green the financial system and strengthen the efforts of the financial sector in achieving the Paris climate agreement goals. This includes mobilising capital for green and low-carbon investments. Staff members have joined work streams to further research in this area and adopt a number of proposals. Furthermore, the Central Bank of Malta is also represented in the Sustainable Advisory Committee of the Bank for International Settlements and is working in aligning our international portfolio towards holding more green bonds.