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**COMMISSION STAFF WORKING DOCUMENT**

**Macroeconomic Imbalances – Malta 2014**

## **Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances**

The macroeconomic challenges in **Malta** *no longer constitute substantial macroeconomic risks and are no longer identified as imbalances in the sense of the MIP*. Although indebtedness remains high, risks to the sustainability of private and public sector debt and the stability of the financial sector appear contained, even if they deserve continued monitoring.

More specifically, the analysis in the IDR finds that financial stability indicators remain sound. Still, in light of the structural nature of the risks in the sector, a continuation of the current prudent supervisory and risk-taking practices is key. The housing market has stabilised and thus risks arising from over-exposure to property are limited. Private debt is on the decrease; the corporate deleveraging is taking place in an orderly manner and credit market pressures are limited. As regards public finances, Malta is expected to meet its nominal deficit targets in 2013 and 2014. As regards external sustainability, trade performance has been positive, thanks to product and geographical market orientation and non-cost competitiveness factors; the current account balance is in surplus. Still, external competitiveness could benefit from active policy response to cost-adjustments in competitor countries.

*Excerpt of country-specific findings on Malta, COM(2014) 150 final, 5.3.2014*

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## EXECUTIVE SUMMARY AND CONCLUSIONS

In April 2013, the Commission concluded that Malta was experiencing macroeconomic imbalances arising from the significant exposure of the financial sector to the property market and the risks for the long-term sustainability of public finances. In the Alert Mechanism Report (AMR) published on 13 November, the Commission found it useful, also taking into account the identification of imbalances in April, to examine further the persistence of imbalances or their unwinding. To this end, this in-depth review (IDR) provides an economic analysis of the Maltese economy with the scope of the surveillance under the Macroeconomic Imbalances Procedure (MIP). The main observations and findings from this analysis are:

- **The financial sector does not appear to pose imminent risks to macro-financial stability.** Maltese banks generally benefit from high liquidity and solvency ratios and have remained profitable. Risk-management and supervisory practices also appear prudent. The nature of the main risks is structural and as such will likely remain a characteristic of the sector in the future. So far, the authorities are managing these risks in an effective way, as evidenced by the robust performance and soundness indicators.
- **The high private sector indebtedness appears to be correcting in an orderly fashion.** There is no evidence of significant deleveraging pressures in the corporate sector. The ongoing decline in corporate debt seems to result from lower demand for loans, combined with a high cost of credit. Despite growing mortgage debt, the debt servicing burden of households does not appear to be problematic.
- **Public debt is still on an upward path, but short-term risks are contained.** The government continues to be able to finance the budget deficit without constraints and the treasury department has been successful in extending the average maturity of the debt stock. In response to the deterioration in public finances in 2012, the Council requested that Malta puts the government debt on a sufficiently decreasing path by 2014. Long-term sustainability, however, remains a concern due to rising age-related budgetary costs. High contingent liabilities pose an additional burden.
- **The export performance of the Maltese economy has been successful** and the economy has been able to attract new, growing industries while the core, traditional ones have continued expanding. This appears to have been supported by favourable non-cost factors, which lower the transaction costs of doing business. The robustness of external competitiveness and the attractiveness to FDI, however, need to be preserved.

The IDR also discusses policy elements stemming from these areas and possible avenues for the way forward. A number of elements can be considered:

- With a view to maintaining **financial stability**, tight risk-taking and supervisory practices as well as ensuring the robustness of the real estate market are key in managing the inherent structural risks related to the limited size of the economy. Moreover, maintaining an efficient supervisory approach would be instrumental in managing the future growth of the sector. Finally, indications of anti-competitive behaviour in the core banking segment warrant closer attention.
- In order to preserve **external competitiveness**, which is key for the growth of the domestic economy, as well as its attractiveness for FDI, it would be beneficial to keep both labour and transaction costs in check. This is particularly valid in an environment where some competitors are undergoing accelerated cost-adjustment.
- Meeting the fiscal targets set by the Council under the Excessive Deficit Procedure would put **government debt** on a more sustainable footing in the short-term, but tackling sustainability in the long-term remains a challenge.



# 1. INTRODUCTION

On 13 November 2013, the European Commission presented its second Alert Mechanism Report (AMR), prepared in accordance with Article 3 of Regulation (EU) No. 1176/2011 on the prevention and correction of macroeconomic imbalances. The AMR serves as an initial screening device helping to identify Member States that warrant further in depth analysis to determine whether imbalances exist or risk emerging. According to Article 5 of Regulation No. 1176/2011, these country-specific “in-depth reviews” (IDR) should examine the nature, origin and severity of macroeconomic developments in the Member State concerned, which constitute, or could lead to, imbalances. On the basis of this analysis, the Commission will establish whether it considers that an imbalance exists in the sense of the legislation and what type of follow-up in terms it will recommend to the Council.

This is the second IDR for Malta. The previous IDR was published on April 10 2013 on the basis of which the Commission concluded that Malta was experiencing macroeconomic imbalances arising from the significant exposure of the financial sector to the property market and the risks for the long-term sustainability of public finances. In the AMR the Commission found it useful, also taking into account the identification of imbalances in April, to examine further the persistence of imbalances or their unwinding. To this end this IDR takes a broad view of the Maltese economy in line with the scope of the surveillance under the Macroeconomic Imbalance Procedure (MIP).

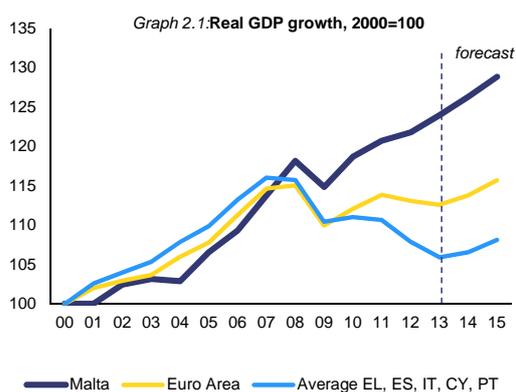
Against this background, Section 2 presents an overview of the general macroeconomic developments, while section 3 looks more in detail into the main imbalances and risks. Section [4] discusses policy considerations.



## 2. MACROECONOMIC DEVELOPMENTS

### Growth, inflation and unemployment

**The Maltese economy continues to outperform the euro area.** Since 2007-8, real GDP growth has been higher than the average for the euro-area and in particular other Mediterranean EU Member States (see Graph 2.1). This has been primarily the result of improving external trade, thanks to a more favourable product and geographical orientation (see Section 3.3), and higher private consumption. Following a two-year period of moderation, the economic activity regained pace in 2013. Growth is projected to remain at roughly the same level in 2014-15, remaining below the pre-crisis average.

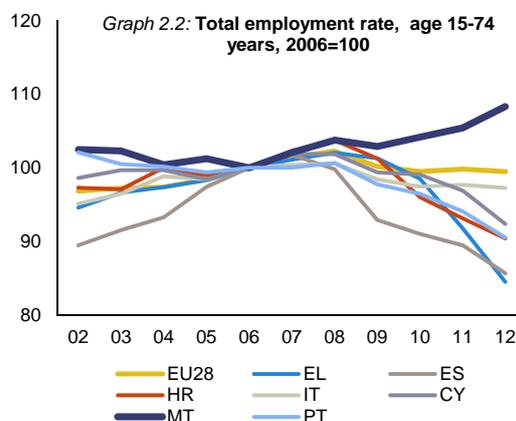


Source: Commission services

**Recovery from the 2009 downturn has been rather job rich.** Driven mainly by the services sector, job creation has been vibrant and employment grew by over 7% between 2009 and 2012. Thus, Malta performed better than the average for the EU and the Mediterranean countries (see Graph 2.2) and its employment rate has been steadily converging with the EU average. This has been particularly thanks to rising female employment. Nonetheless, the overall employment rate of 52.1%<sup>(1)</sup> remained five percentage points below the EU average, particularly due a still very low employment rate among women<sup>(2)</sup>. The positive dynamic is expected to persist, although Malta's employment rate is not projected to catch up with the EU average in the medium term.

<sup>(1)</sup> The figure refers to the 15-74 age group

<sup>(2)</sup> Despite the gains in recent years, Malta's female employment rate was the second lowest in the EU in 2012.



Source: Commission services (Eurostat)

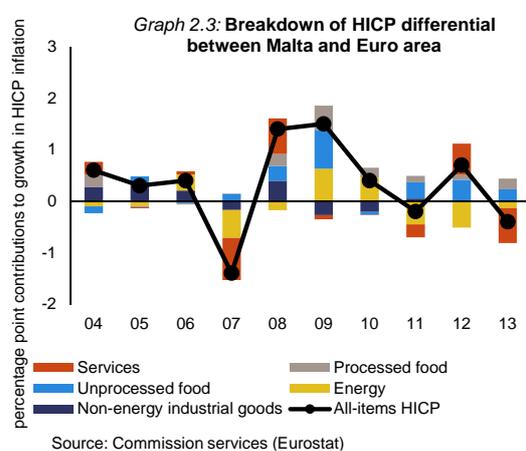
**The social consequences from the crisis have thus been milder than the average for the EU.** Total and youth unemployment have remained stable, well below the euro-area average and the increase in labour market activity lead to a decline in the number of people living in low-work-intensity households. In addition, the share of the population at risk of poverty<sup>(3)</sup> has remained broadly unchanged between 2009 and 2012 at around 15%, while in the EU as a whole it increased by 0.5 pp. to 16.9%. The share of the population living in material deprivation, however, went up notably since 2009, suggesting that social pressure has increased. As a result, the share of the population living at risk of poverty or social exclusion<sup>(4)</sup> increased in 2009-12, particularly for young people (age below 24 years). Still, the total at-risk-of-poverty-or-social-exclusion rate in Malta remained lower than the EU average.

**The Harmonised Index of Consumer Prices (HICP) has moved closer to the euro-area average.** Price inflation tended to be higher than the euro area, but the differential has narrowed in 2010-13 (see Graph 2.3). The persistently higher inflation observed in Malta in the past can be explained mainly with the structural characteristics of the domestic economy, such as smaller size, limited competition and higher product mark-ups

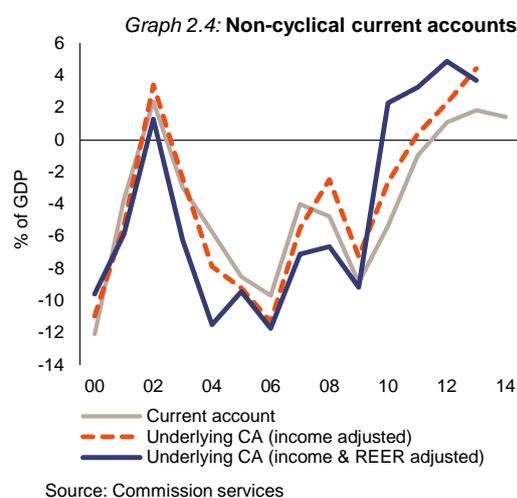
<sup>(3)</sup> This rate is defined as the share of the total population living with income less than 60% of the median equivalised income after social transfers.

<sup>(4)</sup> This measure refers to people living in either at risk of poverty, severe material deprivation or in a household with very low work intensity.

and transport costs. Evidence indicates that prices in Malta are thus more sensitive to shocks on international markets, due also to the higher import intensity of domestic consumption (see CBM 2013). Narrower inflation differential in recent years has been mainly due to less dynamic energy inflation, in particular reflecting the enacted freeze in electricity tariffs <sup>(5)</sup> and prices of liquid fuels. Looking forward, the government decision to lower electricity tariffs as of the spring of 2014 is expected to contribute to price inflation staying in line with that in the euro area, at least in the short term.



that the upward trend is even stronger than the headline figures suggest. Looking forward, the current account balance is projected to remain positive in the short term, also likely to benefit from government plans to reform the energy generation system, shifting it away from imported oil. A stronger rebound in investment, driven by a resumption of FDI inflows, might drag it down, but in general the restructuring of the economy towards less import-intensive services is expected to structurally improve the overall balance.



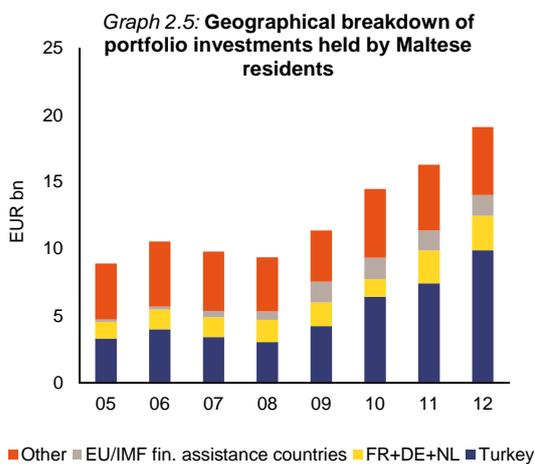
### The sustainability of the external position has strengthened

**The current account deficit has corrected and is now in surplus.** The current account deficit reached around 9% of GDP in the years following EU accession as a result of rapid deterioration of the balance of goods and increasing income outflows. This trend was reversed after 2009 as a weakening of domestic demand and particularly lower investment resulted in lower demand for imports, while exports rebounded quickly and income outflows stabilised. At the same time, the rate of increase of the surplus in the services balance moderated slightly but remained sizeable. As a result, the current account is estimated to have posted a surplus for the second consecutive year in 2013. Estimations by the Commission Services of the underlying current account balance, net of income flows and adjusted for the real effective exchange rate (see Graph 2.5), indicate

**The sustainability of the external position is reinforced by a positive net international investment position.** Malta has traditionally enjoyed a comfortable net international investment position (NIIP). The NIIP stood at 24.9% of GDP at the end of 2012, which was the highest balance since end-2006. A high domestic savings rate and less-diversified investment opportunities inside Malta have contributed to a large, positive net portfolio investment position (holdings of equity and debt securities). Funding takes place mainly through other foreign investments, in the form of bank loans and deposits, and a significant stock of foreign direct investments (FDI). It should be noted that the stock of portfolio investments is significantly inflated by the presence of large internationally-oriented foreign banks in Malta. Namely, around half of the total portfolio investments abroad, totalling €9.1 billion at end-2012, is into Turkish securities, due to the presence of two large branches of Turkish banks (see Graph 2.5), which get their funding from abroad and thus have a little impact on the domestic economy.

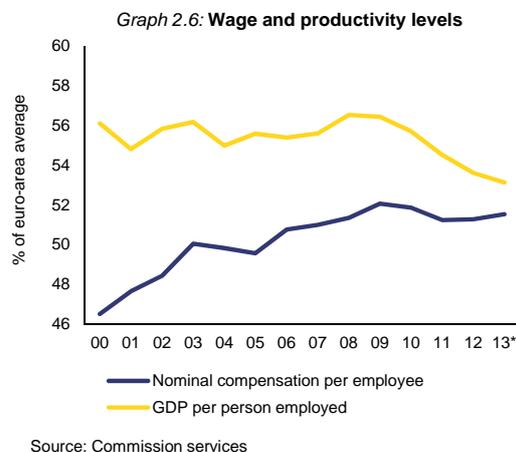
<sup>(5)</sup> The government decided to freeze electricity tariffs in 2011-13.

Therefore, the headline stock positions should be interpreted with caution.



**Despite eroding cost competitiveness, external competitiveness appears to have been maintained.** Nominal unit labour costs have grown faster than the average for the euro area. In particular, while the nominal level of compensation per employee has been converging with the euro-area average, labour productivity has actually moved away from it (see Graph 2.7).<sup>(6)</sup> Despite this, Malta's exports have been performing well, suggesting that there have been other factors at play, supporting its competitive position (see Section 3.3). Moreover, the economy registered gains in price competitiveness reflected in a depreciating real effective exchange rate, mainly due to the nominal depreciation of the euro in 2010 and 2012.

<sup>(6)</sup> Productivity developments in Malta need to be interpreted with caution. The negative trend in labour productivity observed over the past decade and in particular since 2008-9 reflects the significant employment growth during this period. In turn, this reflects the structural change in the economy towards more labour-intensive activities in the services sector.



### The financial system has remained stable

**The financial soundness indicators remained stable.** Profitability and solvency ratios in the core domestic banks remained high, while a low loan-to-deposit ratio meant that exposure to the volatility of the wholesale market was limited. The ratios improved in the first half of 2013, with rising non-interest income, thanks to trading profits, compensating for the drop in interest income thus allowing for retained earnings to further boost capital buffers. Liquidity also remained stable and resort to liquidity operations by the central bank was limited. The non-performing loans ratio increased somewhat in the first half of 2013 due to a worsening of the corporate portfolio, but appears to have stabilised in the second half of the year. Overall, the banking sector was able to withstand the slowdown of economic activity in Malta and the euro area as well as shocks on the international financial markets without suffering a marked decline in its performance indicators (see Section 3.2).

**The stock market has been showing gains since the beginning of 2012.** Malta's stock market lost some 50% of its capitalisation in 2008-9, but since then has stabilised and has been gradually gaining since early 2012. Developments have been largely in line with the markets in other EU countries in the Mediterranean region, failing to match the faster recoveries recorded by the indices in Germany and the US.

Table 2.1:

Key economic, financial and social indicators - Malta	2007	2008	2009	2010	2011	2012	Forecast		
							2013	2014	2015
Real GDP (yoy)	4.1	3.9	-2.8	3.3	1.7	0.9	2.0	2.1	2.1
Private consumption (yoy)	0.8	4.1	0.6	-0.3	3.3	-0.5	0.6	1.9	2.2
Public consumption (yoy)	0.5	12.7	-2.7	1.6	4.1	5.2	1.2	1.0	0.8
Gross fixed capital formation (yoy)	2.0	-13.6	-14.2	15.8	-21.5	-4.4	-2.0	1.3	1.8
Exports of goods and services (yoy)	3.7	2.1	-8.4	17.4	3.4	8.1	-2.9	4.0	5.9
Imports of goods and services (yoy)	0.5	1.3	-8.4	15.3	0.1	5.4	-3.9	3.7	5.9
Output gap	1.8	3.5	-1.3	-0.3	-0.1	-1.0	-0.4	0.2	0.9
Contribution to GDP growth:									
Domestic demand (yoy)	1.1	1.9	-2.7	2.7	-1.0	0.1	0.4	1.6	1.8
Inventories (yoy)	-0.1	1.3	-0.4	-0.7	-0.6	-2.0	0.8	0.0	0.0
Net exports (yoy)	3.1	0.7	0.3	1.4	3.3	2.8	0.9	0.5	0.3
Current account balance BoP (% of GDP)	-6.2	-4.8	-8.9	-6.0	-0.5	1.6	.	.	.
Trade balance (% of GDP), BoP	-2.0	-1.9	-2.3	0.1	3.8	6.7	.	.	.
Terms of trade of goods and services (yoy)	0.7	-1.4	-0.8	0.0	1.4	-0.1	0.9	-0.3	-0.2
Net international investment position (% of GDP)	17.7	2.6	14.8	10.0	8.4	24.8	.	.	.
Net external debt (% of GDP)	-85.0	-69.8	-82.4	-163.1	-154.1	-175.5	.	.	.
Gross external debt (% of GDP)	497.8	541.8	503.0	516.9	506.4	513.7	.	.	.
Export performance vs. advanced countries (5 years % change)	.	.	.	.	.	.	.	.	.
Export market share, goods and services (%)	.	.	.	.	.	.	.	.	.
Savings rate of households (Net saving as percentage of net disposable income)	.	.	.	.	.	.	.	.	.
Private credit flow (consolidated, % of GDP)	9.4	16.1	15.7	11.0	4.1	-1.5	.	.	.
Private sector debt, consolidated (% of GDP)	149.3	153.8	169.8	167.0	161.8	155.1	.	.	.
Deflated house price index (yoy)	18.6	7.5	-6.9	-1.8	-2.4	0.0	.	.	.
Residential investment (% of GDP)	6.2	4.6	3.4	2.6	2.5	2.2	.	.	.
Total Financial Sector Liabilities, non-consolidated (yoy)	21.3	9.9	-0.2	18.4	1.3	4.1	.	.	.
Tier 1 ratio (1)	12.2	11.8	14.1	13.3	13.3	12.7	.	.	.
Overall solvency ratio (2)	20.3	17.7	24.2	52.0	54.6	51.9	.	.	.
Gross total doubtful and non-performing loans (% of total debt instruments and total loans and advances) (2)	1.7	1.3	1.7	1.6	1.5	1.7	.	.	.
Employment, persons (yoy)	2.4	2.5	-0.2	2.1	2.5	2.4	2.4	2.2	2.0
Unemployment rate	6.5	6.0	6.9	6.9	6.5	6.4	6.5	6.4	6.4
Long-term unemployment rate (% of active population)	2.7	2.5	3.0	3.2	3.0	3.0	.	.	.
Youth unemployment rate (% of active population in the same age group)	13.9	12.2	14.4	13.1	13.8	14.2	13.9	.	.
Activity rate (15-64 years)	58.4	58.9	59.1	60.4	61.6	63.1	.	.	.
Young people not in employment, education or training (% of total population)	11.7	8.3	9.8	9.5	10.6	11.1	.	.	.
People at-risk poverty or social exclusion (% total population)	19.7	20.1	20.3	21.2	22.1	23.1	.	.	.
At-risk poverty rate (% of total population)	15.1	15.3	14.9	15.5	15.6	15.1	.	.	.
Severe material deprivation rate (% of total population)	4.4	4.3	5.0	6.5	6.6	9.2	.	.	.
Persons living in households with very low work intensity (% of total population)	9.6	8.6	9.2	9.2	8.9	9.0	.	.	.
GDP deflator (yoy)	2.9	3.0	2.8	3.7	2.3	2.2	2.2	1.7	2.4
Harmonised index of consumer prices (yoy)	0.7	4.7	1.8	2.0	2.5	3.2	1.0	1.2	1.9
Nominal compensation per employee (yoy)	3.1	4.2	3.2	1.6	0.9	2.1	1.4	1.5	1.7
Labour Productivity (real, person employed, yoy)	1.7	1.4	-2.6	1.2	-0.8	-1.5	.	.	.
Unit labour costs (whole economy, yoy)	1.4	2.8	6.0	0.3	1.7	3.7	1.8	1.6	1.6
Real unit labour costs (yoy)	-1.5	-0.2	3.1	-3.3	-0.6	1.4	-0.4	-0.1	-0.8
REER (ULC, yoy)	3.1	2.1	1.6	-2.9	1.1	-0.4	3.6	1.8	0.5
REER (HICP, yoy)	1.3	3.7	0.7	-5.0	-0.8	-2.0	1.5	1.5	-0.2
General government balance (% of GDP)	-2.3	-4.6	-3.7	-3.5	-2.8	-3.3	-3.0	-2.7	-2.7
Structural budget balance (% of GDP)	-3.7	-6.0	-3.8	-4.5	-3.4	-3.8	-3.1	-2.9	-3.2
General government gross debt (% of GDP)	60.7	60.9	66.5	66.7	69.3	71.1	72.0	72.4	71.5

(1) domestic banking groups and stand-alone banks.

(2) domestic banking groups and stand alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches.

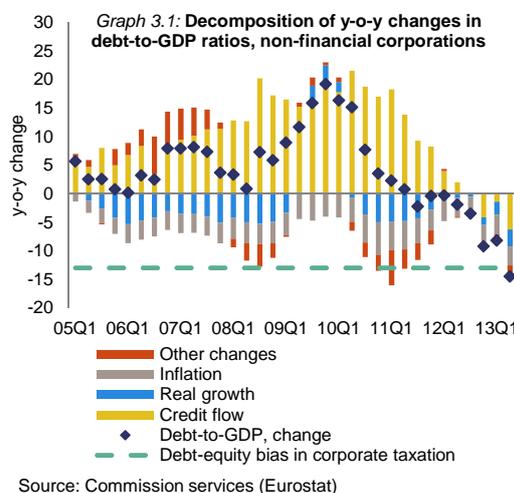
## 3. IMBALANCES AND RISKS

### 3.1. INDEBTEDNESS

High public and private debt levels make economic actors more vulnerable to asset price shocks or interest rate fluctuations. In addition, a high debt servicing burden can reduce profits for firms, thus restraining investment capacity and economic activity. These effects can be exacerbated in case deleveraging takes place simultaneously in more than one economic sector.

#### 3.1.1. Private sector debt

**The process of deleveraging in the corporate sector is picking up speed.** Following years of relatively strong lending growth, the flow of credit to the corporate sector turned negative in 2012 (see Graph 3.1). As a result, the debt-to-GDP ratio of non-financial companies in consolidated terms decreased to 156.3% in 2012, down from its peak at 170.9% in 2009. <sup>(7)</sup> Deleveraging picked up speed in 2013, spreading across the entire sector and as of December 2013 the year-on-year credit flow was positive only in the utilities sector. The contraction is strongest in construction and real estate activities. The sharp correction in credit to corporates is also partly due to a statistical effect – an outstanding loan to a company in the energy sector was reclassified to the financial sector at the end of 2012, thus leading to a lower stock of corporate loans and affecting the y-o-y rate of change in 2013. The correction does not appear to have been driven by government action as the tax treatment of corporate financing has remained unchanged in recent years and continues to be characterised by a relatively high debt-bias. <sup>(8)</sup> However, the leverage ratio (debt-to-equity), although gradually declining, remains elevated and significantly exceeds the euro-area average. Higher leverage means that companies have relatively low loss-absorbing buffers, thus increasing the risk of delays in servicing bank credits or even going into bankruptcy.

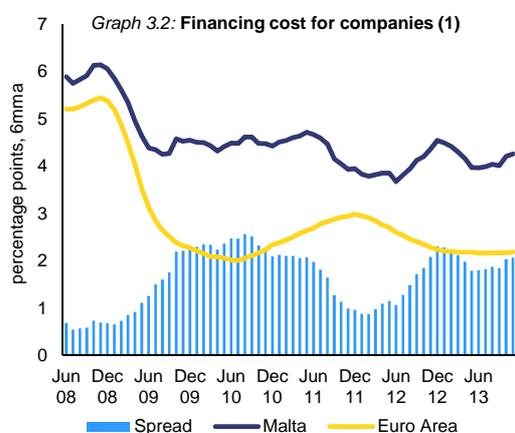


**Deleveraging appears to be driven by a mix of both supply and demand factors.** According to the ECB's Bank Lending Survey, lending standards were tightened significantly in response to the crisis, particularly for the construction sector, and have remained largely unchanged since then. At the same time, interest rates on loans in Malta are relatively high, exceeding the euro-area average (see Graph 3.2), which to some extent discourages credit demand. Moreover, the aforementioned structural shift in the economy to some extent lowers the capital intensity of the economy, resulting in lower need for new investment, thus also lowering the demand for credit. The Bank Lending Survey does not point to expectations for a change in credit demand in the near-term, with the exception of indications of some recovery in demand among SMEs, also supported by the availability of initiatives co-funded by the EU, such as JEREMIE <sup>(9)</sup>.

<sup>(9)</sup> Joint European Resources for Micro and Medium Enterprises Initiative

<sup>(7)</sup> Debt is defined as the sum of securities other than shares and loans, including also inter-company loans from abroad.

<sup>(8)</sup> The debt-equity bias in corporate financing indicates the difference between the effective marginal tax rate on new equity and new debt. A high debt bias means that companies might find it cheaper to finance themselves through loans rather than equity. Conclusions based on this indicator, however, need to be treated with caution.



(1) Credit instruments over 1 year initial rate fixation, over 1mn amount, new business coverage

Source: ECB

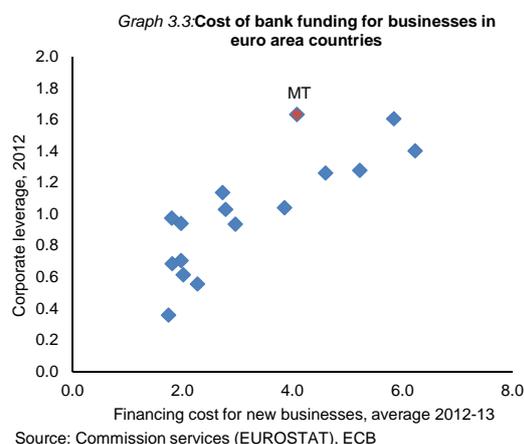
### Evidence at SME level seems to indicate prevalence of supply-side factors.

The European Commission's 2013 Access to Finance of Small and Medium-Sized Enterprises (SAFE) survey shows that over 75% of the participating SMEs did not apply for financing in the preceding six months, because of sufficient funds or other factors, which exceeds the corresponding ratios for the EU and the euro area. However, the ratio of SMEs that applied for financing, particularly bank loans and trade credit, increased, confirming that there is increasing appetite. At the same time, supply appears to have tightened – the ratio of SMEs that successfully applied for bank overdraft and trade credits dropped significantly compared to the results of the 2011 SAFE. This points to tighter risk-assessment practices by lenders, while at the same time participants in the survey indicate that the overall conditions, such as availability of instruments, collateral requirements, interest rates and other costs, have improved.

### To facilitate the access to credit of SMEs, the authorities are considering setting up a development bank.

The project is still at an early stage and no concrete plan has been made public. Negative credit flows in a relatively high-interest-rate environment might indeed indicate inefficiencies in the financial intermediation role of the banking sector in channelling the ample liquidity in the financial system into higher lending. High lending rates, however, need to also be seen in a context of a highly-leveraged corporate sector, and in particular the SMEs, as there appears to be a strong correlation between

the two indicators in the euro area (see Graph 3.3)<sup>(10)</sup>. In fact, countries with similar corporate leverage are charging even higher interest rates, which, however, could be explained also by the more difficult economic conditions these countries are experiencing. While a development bank could have a role to play in improving the efficiency of financial intermediation, it would be crucial that it does not compete with the commercial banks and that it is equipped with sufficient risk assessment capabilities to prevent it from mopping up lower-quality projects that could end up burdening the government's balance sheet.



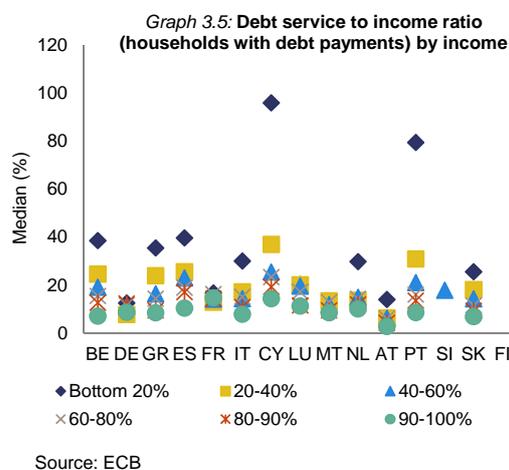
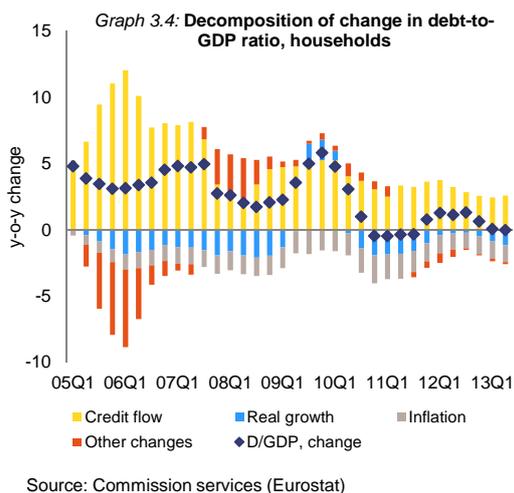
Source: Commission services (EUROSTAT), ECB

### Household balance sheets remain healthy and the debt-servicing burden appears manageable.

The flow of credit to households, and in particular credit for housing purchase, remained positive even as lending to companies contracted. The indebtedness of households, however, has remained broadly unchanged since 2011 as the increase in nominal credit on the nominator side has been offset by GDP growth and inflation (see Graph 3.4). While household debt remains close to the euro-area average, total financial assets stand well above it and thus Maltese households enjoy a relatively sound net financial wealth position. The debt servicing capacity also compares relatively well with other euro-area countries as the debt service-to-income ratio is relatively low across all income quintiles (see Graph 3.5). Even though financing costs for Maltese companies appear elevated compared to

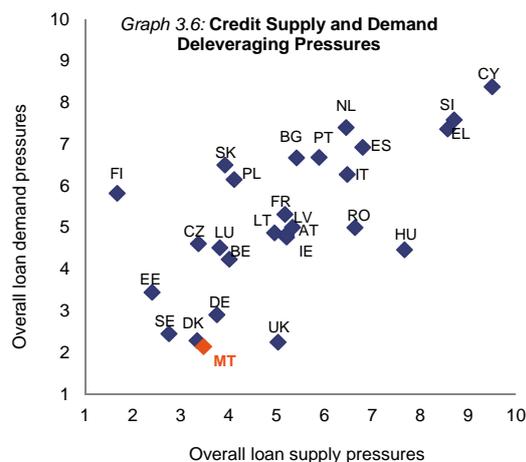
<sup>(10)</sup> Corporate leverage is defined as the ratio of debt to equity. The financing cost for new businesses is proxied by the interest rates on loans of over EUR 1mn amount and with original maturity of up to one year.

the euro-area average, those for households are competitive. In addition, household balance sheets have benefitted from the increasing role of the second earner due to the significant gains in female labour market participation in recent years.

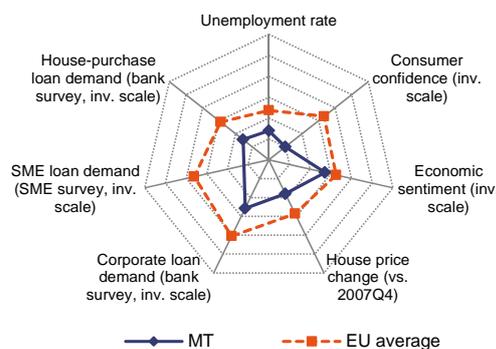


**Overall, private sector deleveraging pressures in Malta are less pronounced than in other Member States.** The Commission Services' composite indicator for supply and demand deleveraging pressures suggests that Malta positions relatively well with respect to the other Member States in terms of both demand and supply pressures (see Graph 3.6). Moreover, the assessment of both supply and demand pressures has abated since 2011. In particular, a closer look at the demand (Graph 3.7) and supply (Graph 3.8) factors driving deleveraging reveals that Malta's corporates compare favourably across-the-board.

The only exceptions are the levels of sovereign credit default swaps and the capital adequacy in banks on the supply side and the economic sentiment on the demand side, but even in these cases, Malta does not score worse than the EU average. Low deleveraging pressures translate into a lower risk for economic growth resulting from the high stock of private debt. <sup>(11)</sup> <sup>(12)</sup>



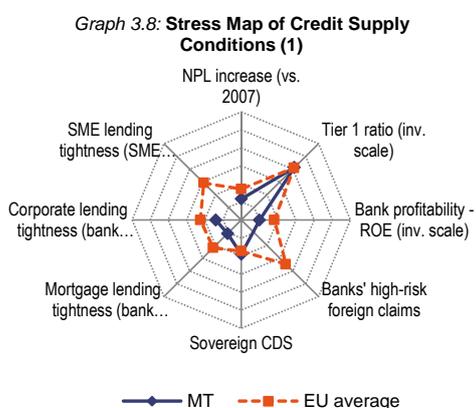
Graph 3.7: Stress Map of Credit Demand Conditions (1)



(1) Greater value indicates higher pressure; the chart does not imply that risks are equally important  
Source: ECB, Commission services

<sup>(11)</sup> It should be kept in mind that this Graph offers a comparative analysis and thus should not be interpreted in absolute terms.

<sup>(12)</sup> See details on the methodology in EC 2013a



(1) Greater value indicates higher pressure; the chart does not imply that risks are equally important

Source: ECB, BIS, IMF, Thomson Reuters, European Commission.

### 3.1.2. Government debt

**Government debt exceeded 70% of GDP in 2012.** The government debt ratio in Malta is lower than the euro-area average but it has been rising continuously since 2008 and exceeded 70% of GDP in 2012. The debt is projected to reach 71.2% of GDP in 2015 according to the Commission services' 2014 winter forecast. The failure to ensure a sufficient pace of debt reduction towards the 60%-of-GDP threshold in the Stability and Growth Pact was a key reason for the reopening of an Excessive Deficit Procedure against the country in June 2013. The European Council thus requested that Malta achieve a nominal budget deficit of 2.7% of GDP by 2014, which corresponds to a cumulative improvement in the structural balance of 1.4 pps. of GDP in 2013 and 2014, while also ensuring that the gross debt ratio declines at a satisfactory pace.<sup>(13)</sup> After correction of the excessive deficit, the Council recommended that Malta pursue the structural adjustment effort at an appropriate pace so as to reach the medium-term objective (MTO) of a balanced budget in structural terms by 2019.<sup>(14)</sup>

**A public debt above the Treaty threshold and an ageing population<sup>(15)</sup> pose risks to the long-term sustainability of Malta's public finances.**

<sup>(13)</sup> See [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/30\\_edps/126-07\\_council/2013-06-21\\_mt\\_126-7\\_council\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-07_council/2013-06-21_mt_126-7_council_en.pdf)

<sup>(14)</sup> See <http://register.consilium.europa.eu/doc/srv?l=EN&t=PDF&gc=true&sc=false&f=ST%2010645%202013%20REV%201>

<sup>(15)</sup> See EC 2012a

While Malta does not appear to face sustainability risks in the short term, risks increase in the medium and long term (see Box 3.1). In particular, the projected growth in age-related expenditure is well above the EU average, with the increase in pension expenditure – including the impact of the 2006 pension reform – accounting for more than half of it<sup>(16)</sup>. Sustainability pressures could also arise from health-related spending, as Malta records one of the highest projected increases in the EU for healthcare. The ongoing fiscal incentives and a pension reform, enacted in 2006 have helped to increase the labour market participation of older workers.

**Debt sustainability in the near term has benefited from efficient debt management.** Spreads on Maltese sovereign bonds have not been significantly affected by the tensions in financial markets generated by the sovereign debt crisis. The apparent cost of debt (interest expenditure over total nominal debt) decreased to 4.4% in 2012 (from 5.3% over the period 2004-2008), in spite of a large increase in the debt ratio (around 10 pps. in the last 4 years). The lengthening of the maturity structure of government debt since EU accession has resulted in a high share of debt with maturity between fifteen and thirty years (38.5% in 2012, up from 18.9% in 2004) while short-term debt has decreased significantly and, in 2012, it accounted for 4.8% of total government debt (from 20.2% in 2004). This is expected to further reduce the impact of fluctuations in the interest rate on government in case of changes market sentiment. In addition, government debt is almost entirely held by residents (with non-residents accounting for only 3% of the outstanding debt stock). This has further protected the sovereign against the tensions on international markets and indeed debt financing has not posed problems so far. At the same time, the high interconnectedness between the government sector and the domestic economy, in particular the financial sector and households<sup>(17)</sup>, implies that adverse developments in one of these sectors can have negative spillovers on the others.

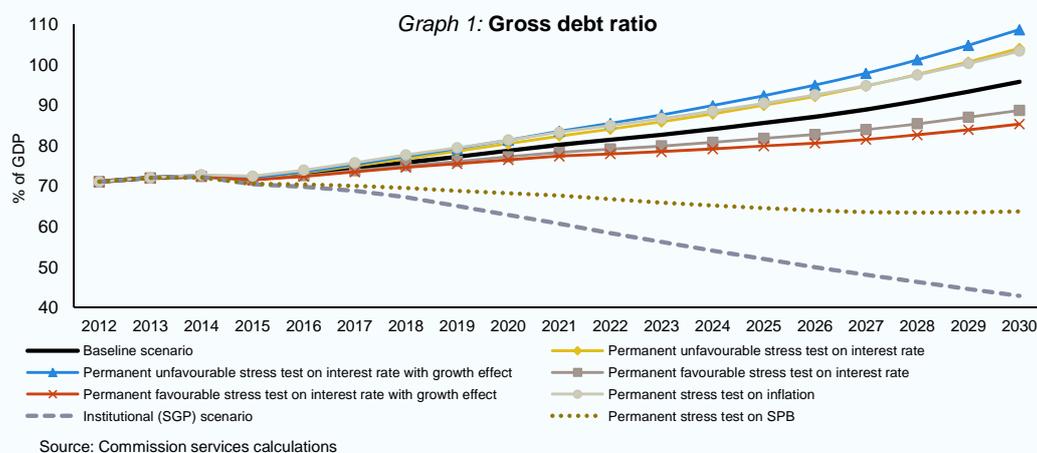
<sup>(16)</sup> Age-related expenditure in Malta is projected to increase by 8.2 pps. of GDP between 2010 and 2060, more than double the increase projected for the EU as a whole.

<sup>(17)</sup> About 30% of the outstanding stock of government debt is held by retail investors.

### Box 3.1: Debt sustainability analysis.

This debt sustainability analysis considers scenarios for debt developments until 2030, built around a baseline scenario that follows the usual assumptions in the Commission services' debt sustainability analysis. <sup>(1)</sup> The stress scenarios are:

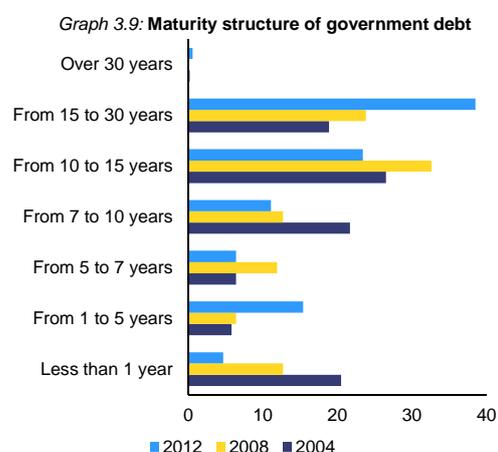
- **Symmetric sensitivity test on interest rate with no growth effects:** a permanent increase/decrease by 100 bps in short-term and long-term interest rates from 2014
- **Symmetric sensitivity test on interest rate with growth effects:** a permanent increase/decrease by 100 bps in short-term and long-term interest rates from 2014 accompanied by a decrease/increase in GDP growth (-0.5 p.p. growth for a 1 p.p. increase in the implicit interest rate)
- **Sensitivity test on inflation:** a permanent decrease in inflation (-0.5 p.p.) from 2014
- **Institutional (Stability and Growth Pact) scenario:** compliance with the fiscal effort recommended by the Council until meeting the MTO in 2019. Thereafter, the scenario assumes maintaining the MTO.
- **Permanent stress test on the structural primary balance (SPB):** an additional annual budgetary effort of 0.5pp of GDP between 2014 and 2017. This would lead to an ambitious structural primary surplus <sup>(2)</sup> of 1.6% of GDP from 2017 onwards, against a 0.4% structural primary deficit from 2015 onwards in the baseline scenario (based on the assumption of the SPB remaining constant after 2015).



The results show that debt declines only in the last two scenarios. Only the institutional scenario brings the debt below the 60%-of-GDP Treaty threshold within the considered time horizon. A determined, front-loaded fiscal effort to improve the primary budget balance is also seen to contribute positively to debt sustainability. These scenarios take place in a low-growth environment due to an average potential output growth of 1.7% in 2016-30, and gradually rising budgetary costs of ageing. This analysis underscores the importance of fiscal consolidation to bring the government debt projector on a sustainable path in the medium term.

<sup>(1)</sup> See details on methodology for the baseline scenario in EC 2012b

<sup>(2)</sup> The primary budget balance is the headline balance net of interest payments on the debt stock.



Source: Central Bank of Malta

### The high level of contingent liabilities represents an additional risk for Malta's public finances.

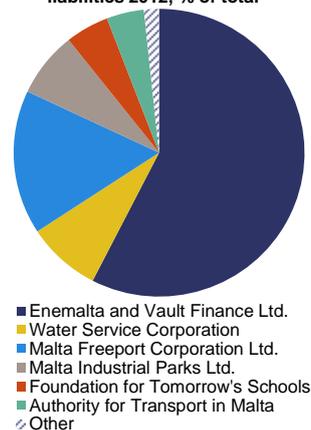
Government-guaranteed debt in Malta is high, following a substantial increase since the start of the crisis, from 11.5% of GDP in 2008 to 17.4% of GDP in 2012 (which would imply a total public guaranteed debt of around 88.7% of GDP in 2012). Around 9% of these liabilities are accounted for by the Water Service Corporation, 20% for by the Malta Freeport Corporation, while the bulk of these guarantees, around 60%, is accounted for by the public energy utility corporation (Enemalta). The difficult financial situation of Enemalta, reflecting the company's exposure to fluctuations in oil prices, the lack of timely and cost-effective adjustment in electricity tariffs and inefficiency costs<sup>(18)</sup>, thus continues to pose a challenge for the public finances. The government has embarked on a large-scale energy reform plan, an essential part of which is restructuring<sup>(19)</sup> Enemalta's debt. The agenda of the government, indeed, sees to lower the cost of electricity generation by reducing the dependence on oil and the costs emanating from operational inefficiencies. In particular, in order to be able to reduce of households' electricity tariffs by 25%, starting from March 2014, Enemalta is pursuing

<sup>(18)</sup> Enemalta has accumulated debts to the level of EUR 702 million, thus representing a significant contingent liability for the public finances.

<sup>(19)</sup> A debt restructuring plan for Enemalta, adopted by the authorities in December 2012, covers about half of the company's current debt (which, at end-2011 and including only bank and other borrowings, stood at EUR 702 million or EUR 867 million when adding also trade-related and other payables).

various projects which will be financed through public private partnerships.

Graph 3.10: Structure of contingent government liabilities 2012, % of total



Source: Government of Malta

*Debt financing in both the public and the private sector does not appear to be a burden and there is no evidence of the presence of strong deleveraging pressures. Despite decreasing indebtedness, however, high leverage in the corporate sector could be a source of vulnerability should economic conditions deteriorate significantly. The government's reliance on domestic sources of funding shielded it from the stress on international financial markets, but this can also be a source of vulnerability in case of shocks to the balance sheets of the households or the financial sector. Compliance with the Stability and Growth Pact rules would help put the gross government debt on a more sustainable path.*

### 3.2. FINANCIAL STABILITY

*Maintaining financial stability is of crucial importance for the channelling of savings into investment opportunities and the overall efficient functioning of the economy. The financial sector also plays an important role in financing the government deficit, which reinforces its role in ensuring macro-financial stability.*

**Risks related to the headline size of the banking system should not be overstated as it masks a very fragmented system.** Maltese banks can be split into three distinct groups of banks depending on their relation to the domestic economy: (i) the

core domestic ones, with assets of 220% of GDP, are closest to the Maltese economy; (ii) the non-core domestic banks with assets of 80% of GDP do business mainly outside Malta, but they offer products to residents as well, albeit mostly corporate; and finally (iii) the international banks, the largest segment with total assets of over 500% of GDP, who have no material links with the domestic economy. Table 3.1 reviews the main financial soundness indicators for each of the three groups.

Table 3.1:

**Core Financial Stability Indicators by bank groups**

June 2013	Core	Non-core	Int'l
Tier 1 capital adequacy ratio	10.6	23.9	131.5
Return on assets	1.7	1.5	1.0
Liquid assets to short-term liabilities	48.0	74.1	384.4
Loan-to-deposit ratio	69.3	143.6	112.3
NPL ratio	9.0	4.0	0.4
Resident loans to total loans	98.2	11.2	0.0
Non-resident loans to total loans	1.9	88.8	100.0
Domestic securities to total assets	12.5	4.8	0.0
Foreign securities to total assets	12.0	41.6	36.8

Source: Central Bank of Malta

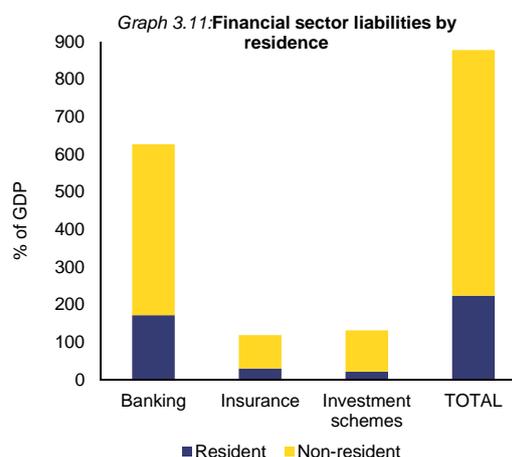
**Contingent liabilities for the state in case of disruptions to financial stability remain limited.**

The only major institution where the government has an ownership stake is the universal Bank of Valletta (BOV), which is the largest core domestic bank with a total balance sheet of over 100% of GDP. Despite the large headline size of the financial sector (banking, insurance and investment funds' liabilities stand at 875% of GDP<sup>(20)</sup>) a significant proportion of it is foreign-owned. Indeed, most large financial institutions operating in Malta are subsidiaries or branches of international financial groups (for example HSBC UK, Akbank T.A.C. and Turkiye Garanti Bankasi AS (Turkey), Deutsche Bank (Germany)) that would be expected to intervene in case of a potential capital or liquidity shortfall. Risks associated with the international banks are low due to the nature of their activities, consisting largely of intra-group transactions, and their funding profile.<sup>(21)</sup> Thus, the categories of banks of relevance for domestic financial stability are the core domestic banks and, to a smaller extent, the non-core domestic banks. The banking sector is a

<sup>(20)</sup> Preparation for the balance sheet assessment and stress test exercise by the ECB in 2014 can be expected to result in a decrease in the aggregate balance sheet of the Maltese banking system.

<sup>(21)</sup> See also findings in EC 2013b

major tax payer and contributes around 18% of the total amount of direct taxes.



Source: Malta Financial Services Authority

**3.2.1. The core domestic banks**

**The core domestic banks are those focused on servicing the domestic economy.** The group consists of five banks with total liabilities of over EUR 13 billion (190% of GDP), out of which over 80% represents resident retail deposits. The core banks generally operate a conservative business model with limited reliance on wholesale funding, a low loan-to-deposit ratio and an investment portfolio that consists largely of held-to-maturity securities, thus shielding their balance sheets from market volatility. These banks are the main deposit takers and lenders to the private sector. They also play an important role in financing the government as they held around 25% of GDP of Malta Government Stocks in 2012, which is over one third of the total government debt stock (excluding any holdings of state-guaranteed debt).

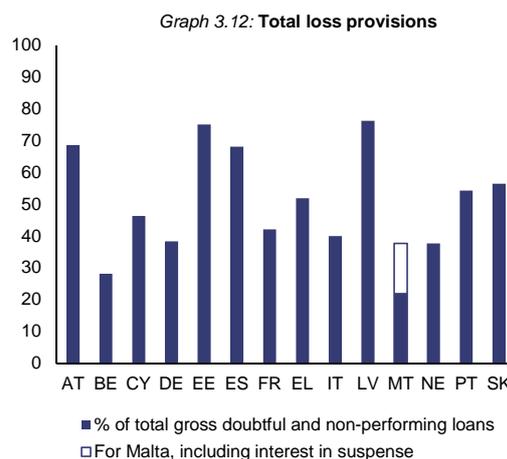
**The nature of the financial stability risks of the core domestic banks has remained unchanged.**

The main risks remain credit and concentration risks, particularly related to the construction sector in the loan book and the domestic sovereign in the investment portfolio. In terms of exposure to the domestic sovereign, securities issued by the Government of Malta amounted to around 12% of their aggregate balance sheet and 150% of the

aggregate equity.<sup>(22)</sup> Property market-related loans represented over half of the entire stock of loans to the private sector as of the end of 2013. A somewhat mitigating factor is the fact that nearly three-quarters of those correspond to lending for housing purchase by households, which, continue to have generally healthy balance sheets. Construction was among the most hit segments of the economy, losing about 15% of its net operating surplus between 2009 and 2012. This has had a correspondingly negative impact on asset quality with non-performing loans rising by two-thirds between the end of 2009 and the second half of 2013. After a period of correction in 2008-9, the housing market appears to have stabilised (see Box 3.2). The link with the property market is further strengthened by high reliance on real estate collateral (see Box 3.3).

**Banks have increased provisions in response to the increasing bad loans.** As loans tend to be well-collateralised, the coverage of doubtful and non-performing loans by specific provisions in Malta was historically low. Indeed the coverage ratio is among the lower ones in the euro area (see Graph 3.12). Still, the core banks, most notably the BOV, increased their loan-loss provisions over the past year. This increase was offset by additional non-performing loans resulting in a slight decline in the coverage ratio. Nevertheless, the gross value of non-performing loans is more than fully covered by collateral and provisions, including interest in suspense – the interest that is accrued on assets classified as non-performing. Overall, low loan-to-value ratios (LTV)<sup>(23)</sup> and a conservative valuation of the underlying collateral point to relatively prudent risk-management practices so far. This provisioning practice, linked also to the standard of high collateralisation, has limited the impact of the persistently high stock of bad loans on profitability and allowed banks to remain profitable even in an environment of deteriorating asset quality. Reflecting the structural nature of the relatively higher credit risk, the Maltese banking system has operated with even worse asset quality ratios in the past – the NPL ratio stood at well over 10% in the beginning of the 2000s – without a

significant impact on macro-financial stability. Still, it is crucial that the workout practices for bad loans are efficient and the legislative framework provides for the timely recovery of collateral in case a client enters into default.



**The authorities have taken steps to strengthen provisioning practices.** In line with the recommendation made by the European Council, the financial sector supervisor MFSA, together with the Central Bank, has adopted a revision to the Banking Rule 9 – the legislation governing banks' provisioning policies. The new BR09 has been in force since the beginning of 2014. Its implementation is expected to contribute to an increase in the coverage ratio by some further 3-4 percentage points. Moreover, banks have often been encouraged to use profit retention in order to strengthen their capital buffers. As a result, the ratio of NPLs net of provisions to capital in Malta does not stand out in comparison with the other EU Member States (see Graph 3.13). Still, it is in the low end of the spectrum and the ratio in Malta is among the highest for a given level of NPLs suggesting that there is room to further increase either specific provisions or capital buffers.

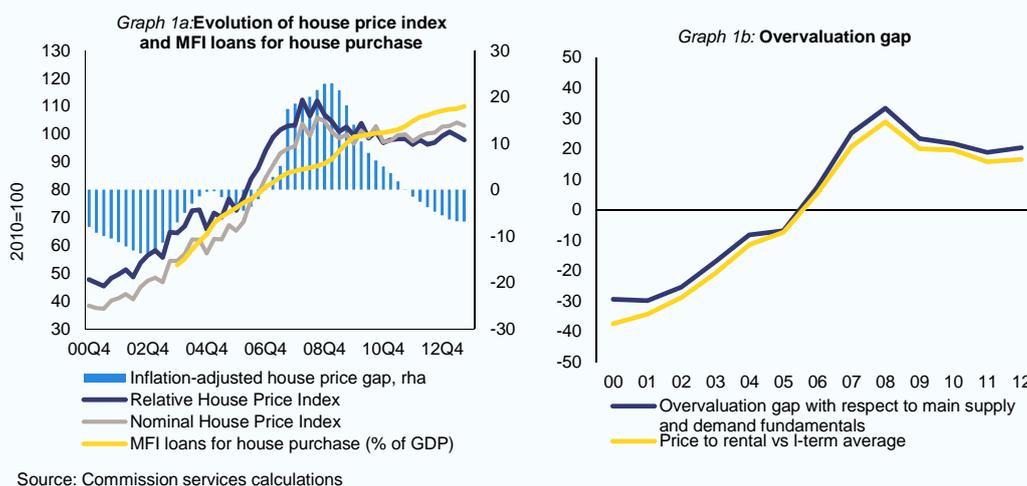
<sup>(22)</sup> The aggregate concentration figures in both the loan and investment portfolios mask significant differences across the individual banks.

<sup>(23)</sup> At June 2013, the LTV for loans backed by residential property was 73.6% and 63.1% for loans backed by commercial property.

### Box 3.2: The housing market

Housing market developments are of significant importance for financial stability in Malta due to the high exposure of the core domestic banks in terms of loans and through collateralisation. The housing market cycle appears to have bottomed out and in the second quarter of 2013, nominal house prices had fully recovered from the 2009-10 decline and surpassed their 2008 peak (see Graph 1a). In inflation-adjusted terms, however, housing prices still remain around 10% below their peak. Price stabilisation took place in relatively soft market conditions, with lending for house purchase decelerating, while residential investment and building permits declined to below 30% of their peak.

In order to assess the house price dynamics, a three-step analytical framework is applied: (i) characterising house price dynamics using cyclical developments to identify boom/bust periods; (ii) analysis of over/under-valuation and (iii) possible pressures coming from the credit market or household balance sheets. The "severity" of the cyclical phase of the housing market is calculated as the difference between the actual inflation-adjusted price and its filtered trend. <sup>(1)</sup> The bull phase, ending in the second quarter of 2008, can be qualified as a boom, given its "severity" relative to historical upturn episodes in other EU economies. The following correction phase, ending in the beginning of 2013, has been relatively mild and cannot be qualified as a bust. The valuation indicators signal that the overvaluation that formed before 2008 has narrowed (see Graph 1b). This analysis, however, needs to be interpreted with caution as it does not take into account personal income developments, which are likely to have contributed to a more notable correction particularly as increasing female employment further boosts household income through a second-earner effect. Finally, credit market and household balance sheet conditions (see Section 3.3) do not signal notable demand or supply pressures. Stress tests performed by the Central Bank of Malta indicate that the loss-absorbing buffers in the banking system are sufficient to absorb a drop of collateral values of up to 30%, combined with an increase in the level of non-performing loans by up to 40% without dropping below the regulatory minimum in terms of capital adequacy.

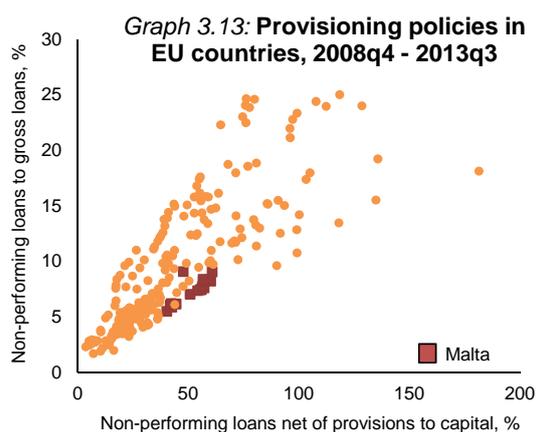


<sup>(1)</sup> See EC 2012c

### Box 3.3: Regulatory treatment of real estate collateral

At the end of 2012, collateral covered 75% of the stock of non-performing loans and around 90% of it was in the form of real estate. The treatment of real estate collateral is regulated by the domestic Banking Rule 04/2013 Capital Requirements of Credit Institutions. The regulation states that a property has to be valued by an independent valuer at or below the market value or the mortgage lending value. The value should be monitored on a regular basis – at least once a year for commercial property or once every three years for residential property. The rule gives the regulator discretion to request more frequent monitoring if needed. Depending on the outcome of the monitoring process, the value of the collateral may then be amended.

Loans secured by residential property are assigned a risk weight of 35% and those secured by commercial property – 50%. To be eligible for these lower risk weights, a number of conditions have to be met, among which is that the value of the property should exceed the exposure by a "substantial margin". The usual practice is to apply a haircut of 20-30% on the value of the real estate collateral and banks have been urged to maintain these haircut levels.



**The market structure of the core domestic segment is very heavily concentrated, which may give rise to inefficiencies in the channelling of savings to investment.** The two biggest banks, BOV and HSBC Malta, hold nearly 90% of the total assets of the core domestic banks. As a result, the Herfindahl-Hirschman concentration index by assets of the core domestic banking system is the highest in the euro area (see Graph 3.14).<sup>(24)</sup> In 2013, the non-core Mediterranean bank has increased its exposure to the domestic economy,

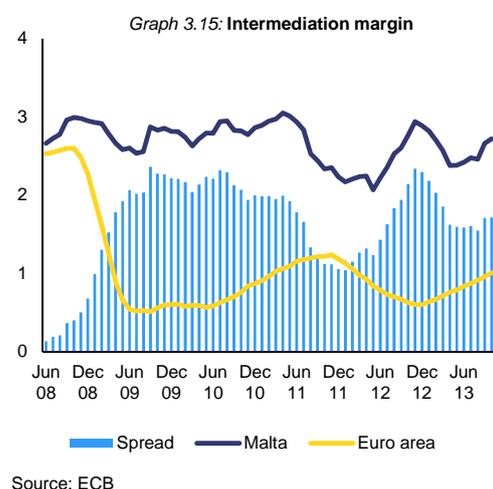
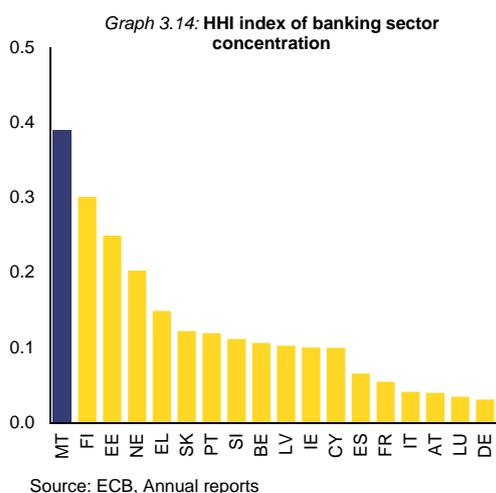
<sup>(24)</sup> The index is calculated by adding the squared values of the market shares of all banks in the respective countries. For Malta, only the core domestic banking segment is considered. It should be taken into account that the data for the other countries is on consolidated level. Therefore, it may include also institutions that are not entirely geared towards the respective domestic economies, making it not entirely comparable with the sample of banks for Malta.

but its market share is still too small for it to be a real competitor to BOV and HSBC in the retail products market. Lack of competition could create inefficiencies in financial intermediation, particularly in the pricing of products such as loans, deposits and the fees and commissions that commercial banks charge. Indeed the intermediation margin, the difference between reference interest rates on loans and deposits,<sup>(25)</sup> in Malta has been well above that in the euro area since end-2008 due to higher loan rates while the deposit rates have been at roughly similar levels (see Graph 3.15). Thus, a closer examination of the drivers of the high intermediation margin appears warranted.

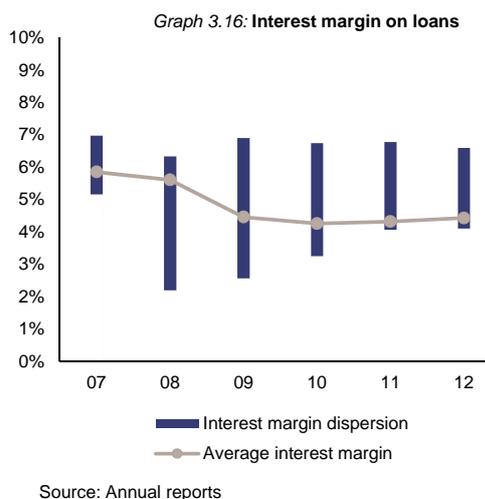
**Higher interest rates on loans could reflect lack of competitive pressure.** A higher intermediation margin could reflect a number of factors, such as different funding costs, higher price of risk or lower cost-efficiency. On the funding side, a sticky deposit base and low reliance on wholesale funding have shielded Maltese banks from fluctuations on international markets and prevented competition for retail deposits. This could explain the stable and low deposit rates. On the asset side, concentration risk in Malta is higher than in most euro-area Member States, which may have been a factor in banks' risk-taking and pricing

<sup>(25)</sup> For this chart, the intermediation margin is the difference between interest rates on new business lending to non-financial corporations of up to 1 year initial rate fixation and over EUR 1 million amount, and the interest rates on new household deposits with up to 3 months period of notice.

policies. The core banks, however, appear to be more cost-effective than banks in most other euro-area countries as their cost-to-income ratio is generally low. Overall, the persistently higher intermediation margin is indicative of slow and partial transmission of the ECB's monetary policy in Malta and could indicate that banks have pricing power.



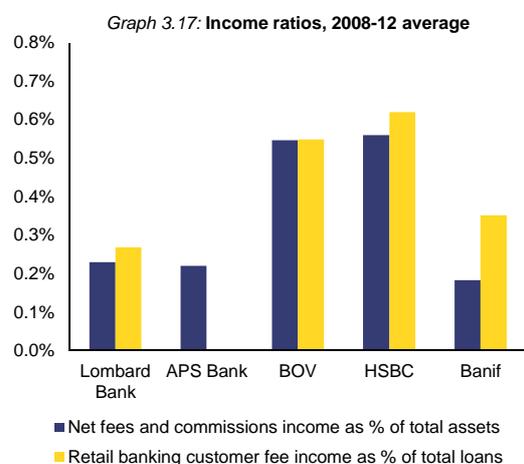
appears to be converging (see Graph 3.16). One bank is an outlier and charges higher rates on average, which can be explained by the higher level of credit and concentration risk on its books that is eventually passed on the prices of its products. Converging interest margins could reflect the broadly similar loan books across the institutions. On the other hand, however, it could be indicative of collusive behaviour as, excluding the one outlier, banks charge broadly similar interest margins despite possible differences in the risk profile of their assets. Moreover, there is notable divergence in the levels of fees and commissions, particularly fees related to retail services, between the top two banks and some smaller domestic banks (see Graph 3.17). The former thus appear to have been able to exercise their market power and charge higher fees than their peers.



and advances to customers. For BOV, the financial year is October – September, while for the rest of the sector it is January – December.

**A look at the structure of income of the core banks suggests some indications that there could be anti-competitive behaviour.** Divergence in the income ratios across the sector usually reflects differences in the asset portfolios. Even though there have been divergences in the past, the interest margin<sup>(26)</sup> on loans in the core banks

<sup>(26)</sup> The interest margin is calculated as the ratio of interest income on loans and advances to customers to gross loans



Source: Annual reports

### 3.2.2. The non-core domestic banks

**The non-core domestic banks are the smallest category of banks in Malta.** The group consists of nine banks with gross liabilities of around 60% of GDP, out of which less than 16% are raised from residents. The category is dominated by two institutions – Mediterranean Bank and FIMBank, that together account for two-thirds of total liabilities of this group. In particular, Mediterranean Bank has gross liabilities of over 30% of GDP, out of which 10% of GDP are resident. This makes it the fourth biggest bank in the country by exposure to the domestic economy. The resident liabilities in the non-core banks consist largely of deposits from corporate clients and thus pose little burden on the Deposit Compensation Scheme (DCS).<sup>(27)</sup> The financial services regulator is putting in place measures to ensure that liabilities to the DCS are sufficiently secured. There is no state ownership in any of the banks.

**The non-core banks carry out a very diverse range of activities with a limited link to the domestic economy.** The non-core domestic banks are generally not typical retail banks. Since they lack the extensive branch network of the larger core domestic banks, they are not in a position to compete for resident retail deposits, nor to expand their asset portfolios inside Malta. Therefore, their activities are largely focused abroad, including syndicated corporate lending or intra-group

<sup>(27)</sup> The non-core domestic banks held 6.2% of the total deposits eligible for the DCS as at end-2012 (CBM 2013a)

activities and specialising in niche activities like trade financing and factoring. A limited branch network also implies that these banks are not major employers on the island – the top two banks of this category directly employ around 400 people, which represents just 0.3% of the gainfully occupied employees.

**Non-interest income is the main source of profit.** On aggregate, around 60% of the gross income of the non-core banks comes from the non-interest component of the profit and loss account. This reflects their larger reliance on investment activities – investment securities represent over 40% of total assets, which is nearly twice as high as the ratio in the core banks. The sources of non-interest income vary across banks with some relying more on fees and commissions, while others registering gains on held-to-maturity investment securities. On the expenditure side, the non-core banks are generally more cost-effective, largely on account of lower personnel expenses and impairment costs.

**Profitability remains high.** On aggregate, the non-core banks posted profits for the fourth consecutive year in 2012 and data for the first half of 2013 indicates that the trend continues. As a result, the non-core banks have continuously been able to strengthen their capital levels through retained earnings. The return on assets is generally similar to that of the core domestic banks. It improved to 1.9% in 2012 before moderating somewhat to 1.5%. Due to the higher capital levels that the non-core banks are required to maintain, their return on equity is generally lower than that of the core banks.

**The non-core banks are generally healthy, but high reliance on wholesale funding increases their vulnerability to any potential future liquidity shock.** The non-core banks maintain high solvency ratios – the ratio of aggregate Tier 1 capital to risk-weighted assets was just under 24% as at June 2013, well above the statutory minimum. Higher capital adequacy reflects to some extent the supervisory approach of the MFSA, which may request that banks with more specialised and riskier asset and funding profiles or which fund themselves to some extent with retail deposits to maintain a higher level of capital. The aggregate loan quality is good and the ratio of non-performing loans to total loans stood at just over

4% in June 2013. The liquidity ratio was also very sound as liquid assets represented 74% of the short-term liabilities on aggregate, well above the statutory minimum of 30%. Ample liquidity is essential given the high reliance on wholesale funding and the business model of some banks that consist of maturity transformation – using short-term borrowing on the interbank market to invest in longer-term assets. This, however, implies that banks could be susceptible to a liquidity crunch if a significant tightening of the interbank market occurred. The successful operations even during the challenging conditions on international financial markets in 2008-9 suggest that banks and supervisors have been able to manage this risk successfully. However, the size of the non-core banks has substantially increased since then. The high level of diversity may also imply different levels of performance of the individual banks within the group. Ultimately bank level data would be required to make a definitive assessment which is not available for all non-core banks.

**Potential risks to financial stability are limited.**

Potential failure of a bank in this category would have a limited direct impact on the balance sheets of the government, private sector or the rest of the banking system. Such an event could impact financial stability rather through a contagion effect – reducing investor confidence in Maltese assets and increasing the risk spread on them as well as tightening access to the international financing. The direct effect of such a scenario would be mitigated by the fact that government, banks and firms get most of their financing from domestic sources.

### 3.2.3. The non-banking financial sector

**Besides banking, the Maltese financial sector offers a range of other activities.** These include insurance, investment funds, payment and electronic institutions and providers for a range of other services including trustees, fiduciary services and fund administrators. While the banking sector is by far the largest in terms of assets, insurance and collective investment schemes have seen very rapid development over the past several years and their aggregate assets stood at around EUR 19 billion at end-2012 (over 250% of GDP), up from around EUR 13 billion at end-2010. The nature of activities in the non-banking financial sector is

generally not very complex and a shadow banking sector appears not to exist at the moment.

**While growth slowed down in 2013, the sector is expected to continue expanding.** The implementation of several international directives in 2013, such as the Alternative Investment Fund Managers Directive (AIFMD) and work ahead of the introduction of SOLVENCY II, created some uncertainty on the market and halted the growth rates observed in the past. Still, the authorities expect non-banking sector to continue growing in the future related, including into new types of activities. The setting up of a voluntary third pension pillar might also incentivise the development of pension funds in Malta.

*The financial sector has managed to successfully navigate an environment of heightened risk and reduced confidence in the aftermath of the Cypriot crisis. With tensions on international markets abating and confidence returning, also in view of the planned establishment of the Single Supervisory Mechanism under the ECB, risks to macro-financial stability appear contained. The nature of the main risks facing the sector, namely credit and concentration, is structural and as such will likely continue to characterise it in the future. So far, the authorities are managing these risks in an effective way, as evidenced by the robust performance and soundness indicators.*

## 3.3. EXTERNAL TRADE AND COMPETITIVENESS

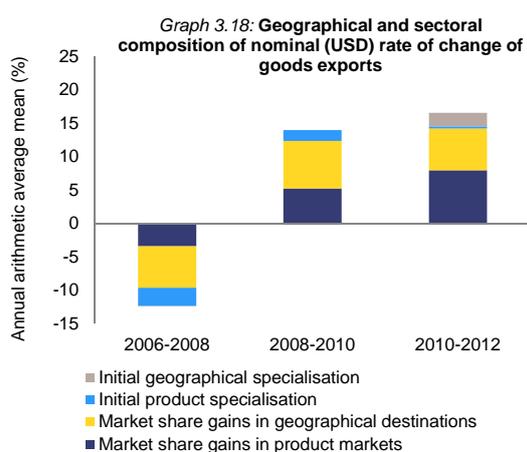
*External trade and competitiveness are of particular importance to the Maltese economy due to its high degree of openness. Relative export performance, measured as the evolution of export market shares, is thus a key indicator for the robustness of the economy. An analysis of cost and non-cost competitiveness factors offers an explanation of its drivers and potential obstacles.*

### 3.3.1. Export performance

**The exporting sector has been successful, as evidenced by the positive external trade performance.** National accounts data show that exports of goods and services expanded by over 40% between 2009 and 2012, after a relatively moderate contraction in 2009, which was one of the fastest recoveries in the euro area, after

Estonia, Latvia and the Slovak republic. The recovery was most pronounced in the export of goods, particularly to non-EU countries, although intra-EU goods exports and overall services exports also registered significant growth. At the same time, imports grew at a more moderate rate, largely due to weaker domestic demand, but also pointing to a structural lowering of the import content of exports. As a result, the trade balance improved and net exports have been the main driver of economic growth in 2009-12.

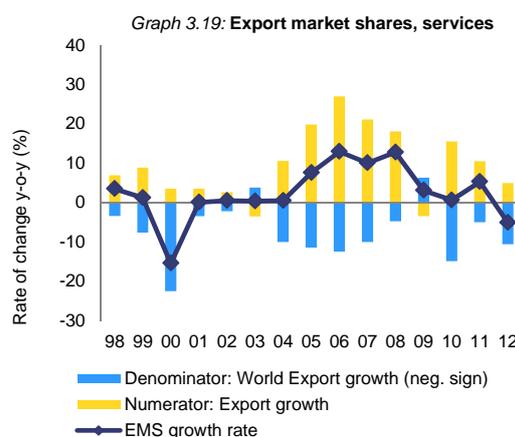
**Goods exports have been boosted by strong performance in the main sectors.** Goods exports have been boosted mainly by the traditional semi-conductors industry and the emerging trans-shipment of oil. In 2012, these sectors accounted for over half of the total value of goods exports. Malta continued to gain export market shares in particular in its main product markets (largely in the oil trans-shipment market) and in the main geographical destinations (mainly Turkey and Egypt, but also in Hong Kong and Libya). Moreover, exports have also benefitted from a favourable geographical and product orientation, where high market dynamism provided more opportunities for Maltese exporters (see Graph 3.9). Malta's export performance compares favourably with the rest of the EU Member States, most of which lost world market shares in the trade of goods in 2008-12.



Source: COMTRADE, Commission's calculations

**Trade in services has also performed well, thanks to Malta's main sectors of specialisation.** Malta's main services exports remain tourism (see Box 3.4) and other personal, cultural and

recreational services (mainly remote and digital gaming) as well as, more recently, financial services. The growth of the remote gaming industry has been particularly impressive and over the past ten years Malta has become the largest exporter of such services worldwide, overtaking Malaysia and Turkey. Together, tourism and remote gaming accounted for some 70% of the total services exports in 2012, which puts Malta among the more concentrated economies in the euro area in this respect. The exports of services slowed down in 2012, particularly in the personal and recreational services sector, which appears to be reaching maturity.<sup>(28)</sup> This was partially offset by financial services, which have seen significant gains since 2011, but remain relatively small in absolute terms. As a result, despite still growing in nominal terms, Malta lost export market shares in 2012 (see Graph 3.10). This loss, however, comes after a prolonged period of significant gains.

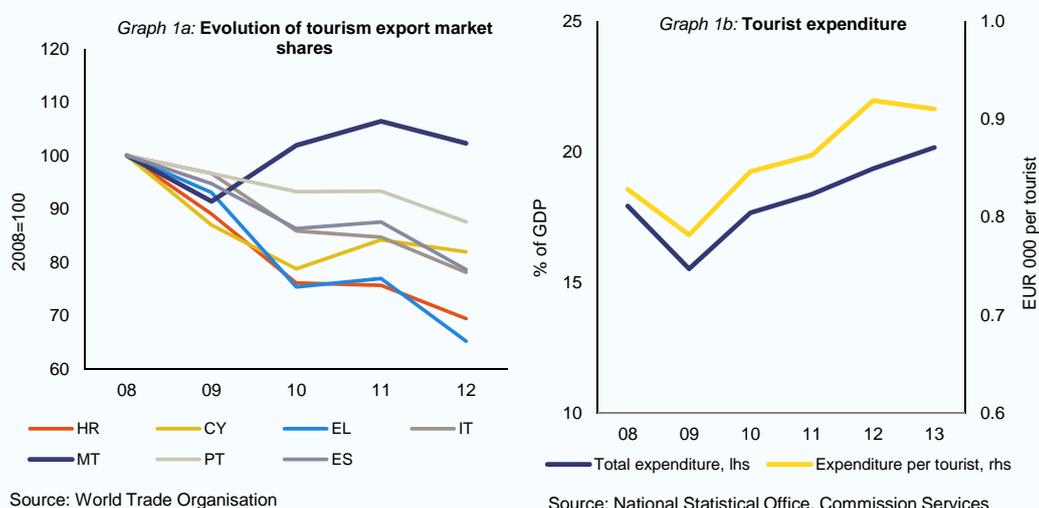


Source: Commission services (EUROSTAT)

<sup>(28)</sup> Following the so-called "VAT package" adopted by the council in Council Directive 2008/8/EC of 12 February 2008, Malta's attractiveness as a location for remote gaming could diminish. Malta currently exempts from VAT such activities. The new Council Directive stipulates that as of 2015 VAT must be charged on the basis of where the customer is located. Since several Member States do not apply a blanket exemption to gaming, service suppliers established in Malta will have to charge and account for VAT where this is applicable. Any VAT advantage gained by choosing Malta as a location for remote gaming will thus disappear.

#### Box 3.4: External competitiveness of the tourism sector.

The tourism sector is one of the major pillars of the domestic economy. Even though its importance is diminishing due to the restructuring and diversification of the economy, tourism remains one of the biggest employers, directly responsible for over 8% of total employment, over 3pps higher than in the euro area. The main markets for Maltese tourism services are the United Kingdom, Italy, Germany and France, which altogether account for around 60% of all tourist visits. The sector rebounded quickly from the downturn in 2009, fully recovering the lost positions by 2010, which was in stark contrast with the dynamics in competitor markets (see Graph 1a). By 2013, tourist arrivals had risen by 22.6% over their 2008 level mainly thanks to the Italian market, but also expansion into some smaller markets such as Libya.



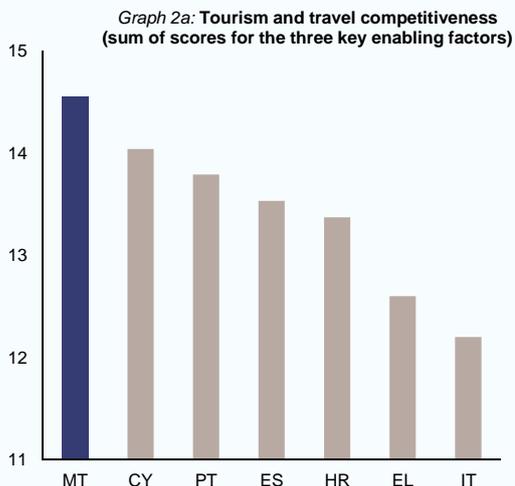
Malta's tourism sector enjoys a good competitive position relative to the EU competitors in the Mediterranean region. The main strengths include the good quality of tourism infrastructure, the prioritisation of tourism in government policy, and the health and safety conditions on the island. The 2013 World Economic Forum's Travel & Tourism Competitiveness Report ranked Malta 24<sup>th</sup>, up from 26<sup>th</sup> in 2011 and 29<sup>th</sup> in 2009, in the list of participating countries and third among the competitors, trailing behind Spain and Portugal, while being ahead of Italy, Cyprus and Croatia. In terms of regulatory framework and business environment and infrastructure, Malta is second behind Spain, but the small size of the island to some extent constrains the value of the third component making up the overall indicator – human, cultural and natural resources.

The Report identifies three areas that are key enablers in terms of international competitiveness and impact on GDP growth of the tourism sector in developed economies. These are policy rules and regulations, price competitiveness and the affinity for travel and tourism. Overall, Malta has highest aggregate sum of the scores of the three enablers (see Graph 2a). In terms of price competitiveness, which compares, among others, ticket taxes and airport charges, hotel and fuel prices, Malta scores higher than the other Mediterranean countries. Nevertheless, price developments in recent years point to faster increases compared to the competitor countries, which might lead to an erosion of price competitiveness in the future (see Graph 2b). In terms of affinity for travel and tourism, Malta also outperforms the rest reflecting the stable growth in tourism exports in recent years. When it comes to policy rules and regulations, Malta scores second only behind Portugal. The score in this category is to a large extent constrained by the relatively long

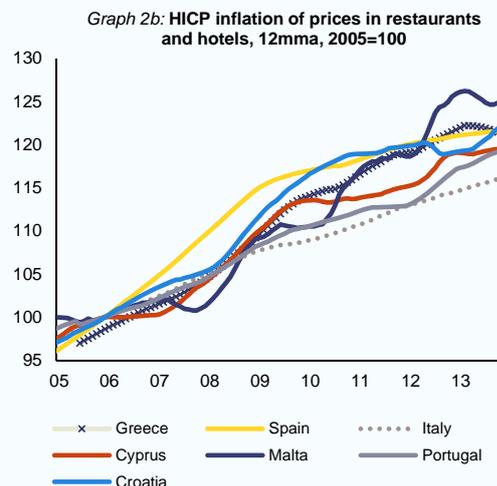
(Continued on the next page)

Box (continued)

time to start a business – a shortcoming that is flashed also by the World Bank's Doing Business report.

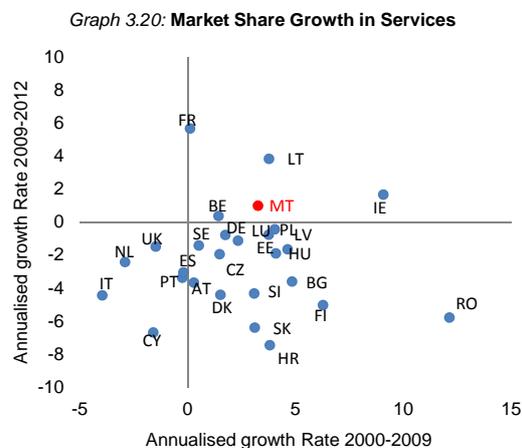


Source: The Travel and Tourism Competitiveness Report, 2013



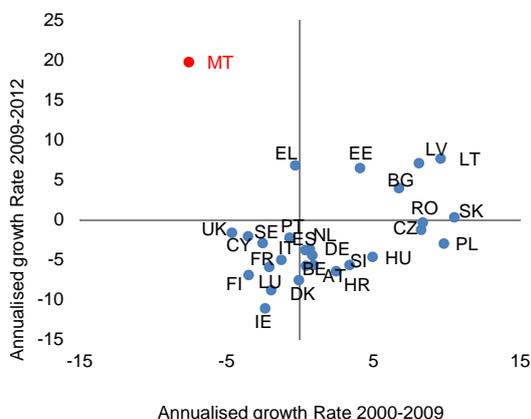
Source: Commission services (Eurostat)

**The overall external trade performance points to a favourable competitive position in comparison with other EU Member States.** Malta's export performance compares well with the rest of the EU Member States. In terms of services exports, the growth in export market shares has been among the highest in the EU and moreover Malta was among the few Member States that has been able to consistently expand its world market shares (see Graph 3.20). In the trade of goods, the domestic economy has successfully been able to recover from the decline of the textiles industry in the beginning of the past decade and gain market shares (see Graph 3.21).



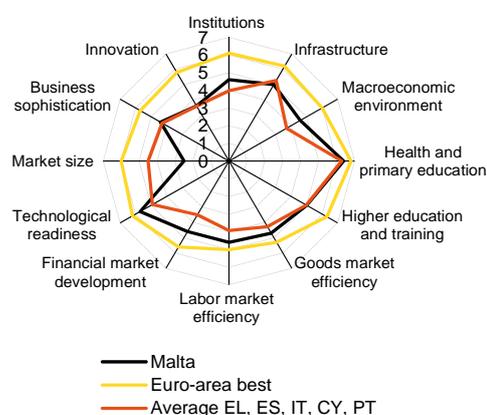
Source: Commission services (EUROSTAT)

Graph 3.21: Market Share Growth in Goods



Source: COMTRADE

Graph 3.22: Global Competitiveness Index



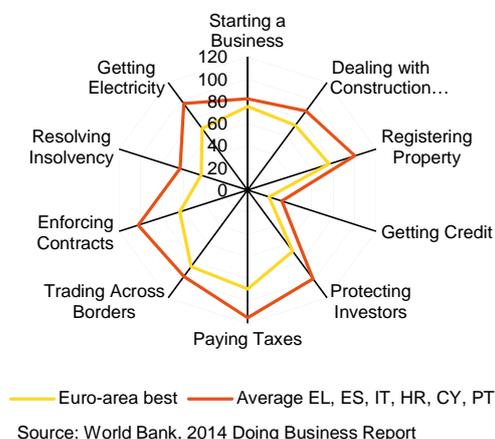
Source: World Competitiveness Forum, 2013-2014

### 3.3.2. Competitiveness drivers

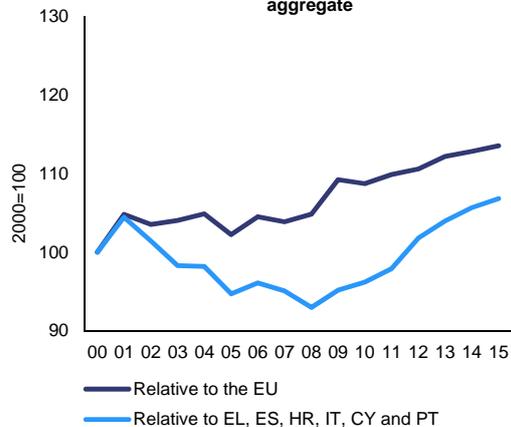
**Competitiveness indicators paint a relatively favourable picture.** Apart from natural shortcomings arising from the small size of the domestic market, which limits the opportunity to exploit economies of scale, making export the only possibility for growth, the institutional and regulatory features of the Maltese economy are generally in line with, or in some cases better than, competitor euro-area economies in the Mediterranean region. In particular, survey data points to a better perception of the efficiency of the goods and labour markets, technological readiness and the development of the financial market, supported by a more favourable macroeconomic environment (see Graph 3.22). Still, room for improvement remains to allow Malta to exploit its competitive advantages with its competitors and compensate for inherent disadvantages. The most problematic factors for doing business are perceived to be the inefficiency of public administration, related to a still high regulatory burden, as well as the access to financing and the inadequate supply of infrastructure, particularly related to the quality of roads and of electricity supply.

**The environment for doing business appears in line with that in the main competitors, but gaps in some important areas remain.** Malta compares well with other EU Mediterranean countries in most indicators examined by the World Bank's Doing Business survey (see Graph 3.23). Particular strengths include a simplified system of paying taxes, where more payments can take place online, while relatively low costs facilitate external trade. Still, while the total cost to import and export is relatively low, ports and terminal handling costs are elevated, particularly when importing. Given the high import-intensity of domestic demand, tackling this inefficiency would further boost the economy's competitiveness. At the same time, a high number of associated procedures and the long time needed to complete them can burden the start-up and every-day operations of businesses. Some procedures, such as getting electricity and enforcing contracts, are associated with high accompanying costs. Resolving insolvency appears to be a particularly problematic area, due to the long time the procedures take and the low recovery rate for claimants.

Graph 3.23: Malta's distance to frontier (frontier = 100, result over 100 means better than frontier)



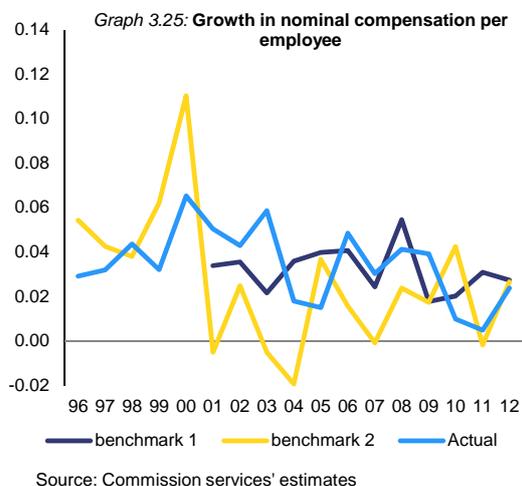
Graph 3.24: Unit labour costs relative to a country aggregate



**Labour cost competitiveness has recently showed signs of erosion.** The evolution of nominal unit labour costs (ULCs) relative to the EU Member States has been quite unfavourable as ULCs in Malta increased faster than the reference group. This has been to a large extent due to the job-rich growth in Malta as employment increased faster than in most other industrialised countries, particularly in recent years, also reflecting some element of labour hoarding. As a result, the growth of productivity per person employed has been more subdued, particularly since 2009. It is useful to gauge Malta's performance in terms of labour cost competitiveness against direct competitor countries. Graph 3.24 illustrates the evolution of nominal ULCs relative to EU MS in the Mediterranean region that are the main competitors on the tourist services market, but also for other activities. Between 2000 and 2012, Malta's relative nominal unit labour costs have remained largely unchanged as initial gains in the beginning of the decade were lost after 2008. The erosion of cost competitiveness with respect to the EU Mediterranean region is projected to continue in 2013-15, also due to sharp cost-adjustment in these countries, which could put pressure on the external trade performance of the Maltese economy.

**Still, wage developments have been in line with fundamentals.** Commission estimates assess actual wage developments until 2012 against domestic wage determinants, taking into account domestic price inflation and the terms of trade, productivity developments, unemployment and education attainment (benchmark 1). In addition, wage developments are assessed against price competitiveness, benchmarking them against a constant value of the ULC-adjusted real effective exchange rate (benchmark 2). Results show that after a period of misalignment particularly with respect to benchmark 2, wage increases since 2010 have been in line with or even below the benchmarks (see Graph 3.25).<sup>(29)</sup> This has been facilitated by a flexible wage setting environment where wage bargaining takes place at company level (see Aumayr-Pintar, Cabrita, Foden 2013). Nevertheless, the existence of an automatic wage indexation mechanism (cost-of-living adjustment or COLA), which is often added on top of the wage increase coming out of collective agreements (see IMF 2013), could result in real wage rigidity and trigger wage-inflation spirals.

<sup>(29)</sup> See details on methodology in EC 2013d

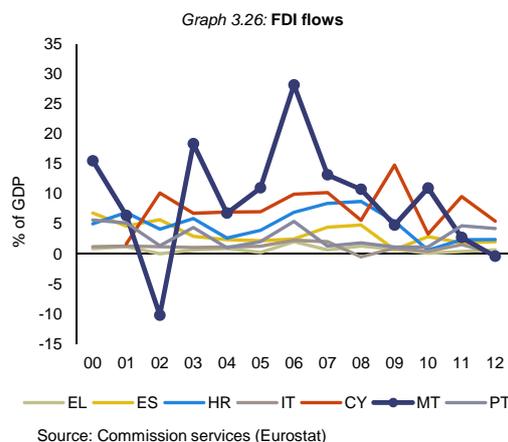


**Labour cost levels and skills are among the main FDI attractiveness factors.** Labour costs in Malta remain well below the average for the euro area as well as most countries in the Mediterranean region. Most foreign investors in Malta indeed indicate that labour costs are among the main factors attracting foreign investment to the island.<sup>(30)</sup> The lowest implicit tax rate on labour in the euro area contributes to the low level of labour costs. Commission services estimates<sup>(31)</sup> show that the level of nominal compensation per employee in purchasing power standards (thus eliminating the effect of different price levels) has actually been lower than the levels predicted on the basis of the two benchmarks above. Low labour costs, however, reflect also the relatively low skill level of the domestic labour force, which exhibits the second highest ratio of low-skilled workers in total employment in the euro area and the EU28 as a whole. Nevertheless, there appears to be an effective training framework in place and particular sectors, such as pharmaceutical production and aviation repair, have been able to benefit and train their staff for specific activities at the Malta College of Arts, Science and Technology. Furthermore, E&Y's 2013 Attractiveness Survey points to the stability of social climate and the political, legal and regulatory environment, corporate taxation and the growth potential as other key factors attracting FDI.

<sup>(30)</sup> See E&Y 2013

<sup>(31)</sup> See EC 2013d

**Despite a favourable competitive position, foreign direct investment inflows have dried up in recent years.** The stock of foreign direct investment (FDI) as a share of GDP in Malta is among the highest in the EU and significantly exceeds those in the other Mediterranean EU Member States. The majority of the stock is into financial and insurance activities, reflecting the presence of subsidiaries and branches of large international banking groups. In recent years, however, FDI inflows have decreased significantly, more so than in other Member States from the Mediterranean region. Since 2009, FDI inflows not related to financial or insurance activities have been negative or just above zero. Given the small size of the domestic economy, FDI is an important source of innovation. Therefore, lack of foreign investment flows, combined with the observed decline in investment, limit the future growth potential of the economy.



*The export performance of the Maltese economy has been strong. It has been able to expand into new niche areas such as the remote gaming industry and, more recently, the trans-shipment of oil while establishing a solid base for further development in the more traditional activities. This seems to be confirmed by an analysis of cost and non-cost factors, which indicate that the Maltese economy enjoys a relatively healthy competitive position. Maintaining external competitiveness and attracting FDI, however, is a continuous challenge.*



## 4. POLICY CHALLENGES

The analysis in sections 2 and 3 indicates that macroeconomic developments in the areas of financial stability, external competitiveness and public indebtedness may warrant some policy attention in Malta. It should be recalled that these challenges were identified under the MIP in the first IDR and relevant policy responses were reflected and integrated in the country-specific recommendations issued for Malta in July 2013. The assessment of progress in the implementation of those recommendations will take place in the context of the assessment of the National Reform Programme and Stability programme under the European Semester. Against this background, this section discusses different avenues that could be envisaged to address the above challenges.

### Public debt sustainability

**Improving the quality of public finances is crucial for ensuring debt sustainability.** Numerical fiscal rules and credible institutions have an important role to play in improving the quality of public finances, in particular to limit fiscal slippages and strengthen fiscal monitoring and planning. In this respect, Malta has not yet implemented the Treaty on Stability Coordination and Governance and the deadline of end-2013 was missed. The expenditure review undertaken by the authorities is a positive development. It would be important that any expenditure savings, resulting from the findings of the review, are used to reinforce fiscal consolidation and reduce the debt stock.

**Medium-term debt sustainability would benefit from compliance with the Stability and Growth Pact.** Meeting the EDP headline government deficit target of 2.7% of GDP in 2014 and, thereafter, progress towards the MTO, as recommended by the Council, are expected to contribute to the medium-term sustainability of government debt.

**In the long-run, the budgetary costs of ageing need to be contained.** Despite the observed improvement in labour market participation, the demographic trends and the characteristics of the welfare system suggest that the budgetary impact of ageing in Malta are projected to be higher than the EU average in the medium to long-term. Thus, policy action to improve the sustainability of the

pension system, while also ensuring its adequacy, and of the healthcare system appears warranted.

### Financial stability

**Maintaining and in some cases strengthening the current prudent supervisory framework would be beneficial for financial sector stability.** Low loan-to-value ratios, coupled with high capital buffers point to prudent supervisory practices, as also confirmed by the 2011 independent assessment of the MFSA. Supervision was further reinforced by the strengthening of provisioning practices undertaken in 2013 with the implementation of a revised Banking Rule 9. Faced with concentration risk of structural nature, due to the relatively small size of the domestic market, it is crucial that the supervisor and the commercial banks remain vigilant and their risk-management practices remain prudent. Further supervisory action, such as introducing a cap on the loan-to-value ratio for new lending or further encouraging banks to use profit retention as a counter-cyclical buffer to strengthen their capital positions could be beneficial in reinforcing confidence in domestic financial stability. The consolidation of prudential oversight into the Single Supervisory Mechanism in 2014 will also contribute to strengthening confidence in the stability of the banking sector.

While the MFSA is up-to-date with the regulatory framework for banking and non-banking financial services, keeping up with the evolving framework will pose a continuous challenge. Thus, it will be important that the MFSA has sufficient resources to cope with the task. In light of this, the strengthening of the staff capacity in the past year is a positive development.

**Managing credit risk would benefit from an efficient judiciary system.** A persistently high stock of NPLs implies reduced profitability for the banks as a result of increased provisioning needs as well as loss of output for the real economy due arising from inefficient allocation of resources. Bringing down the stock requires an efficient judiciary system that deals with insolvency cases in a timely and cost-efficient manner. The authorities have launched a comprehensive review of the judicial system, which is expected to result in a three-year reform process starting in the

beginning of 2014. Targeted measures to raise the overall efficiency of the judiciary, followed by timely and efficient implementation, would thus benefit the banking sector and the overall economy.

**Efficient real estate market monitoring is also important.** The significant link between the core domestic banks and the real estate market calls for attention to property market developments in order to limit boom/bust episodes. Strengthening the provision of statistical data would be beneficial such as by developing series on property market transactions.

**Low levels of competition among the core domestic banks could result in inefficiencies.** Although not posing a direct risk for macro-financial stability, anti-competitive behaviour in the banking system could result in higher costs for businesses and consumers and present a drag on growth. The interest rates charged by the core domestic banks segment on corporate loans appear relatively high, while retail banking fees in the two dominant banks appear higher than in the rest of the sector. A closer look at the drivers of the high intermediation margin and fee and commission income could, thus, be warranted.

#### External competitiveness

**External competitiveness benefits from keeping labour costs in check.** Foreign investors identify competitive labour costs as one of Malta's key advantages. The importance of labour cost is increasing in view of the rising labour-intensiveness of the economy. Thus, authorities and stakeholders need to continue monitoring wage developments and stand ready to introduce cost-adjustment reforms if required in order to stay in line with competitor countries.

**Strengthening the business environment would reflect positively on competitiveness, FDI attractiveness and growth.** Keeping transaction costs at minimal levels boosts the attractiveness of Malta to foreign investors, thus enhancing the prospects for growth and jobs. To that end, ongoing efforts to restructure the energy sector and lower costs to industry and households would have a positive impact. In addition, the authorities have implemented reforms aimed at reducing administrative burdens on businesses.

Strengthening the reform momentum in this area and addressing procedural shortcomings, such as the relatively long time required to start a business, would be beneficial. In view of the possibly negative impact on competitiveness, collective bargaining could be enhanced in a way that any cost of living adjustment is incorporated into the negotiated wage agreements so as to ensure that wages are more closely aligned with productivity developments. Education policies also have an important role to play, particularly in ensuring that the labour force has the necessary basic skills to attract investment and offer services of sufficient quality at competitive prices.

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