MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Economic

&

Market Overview

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Malta Financial Services Authority

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Executive summary

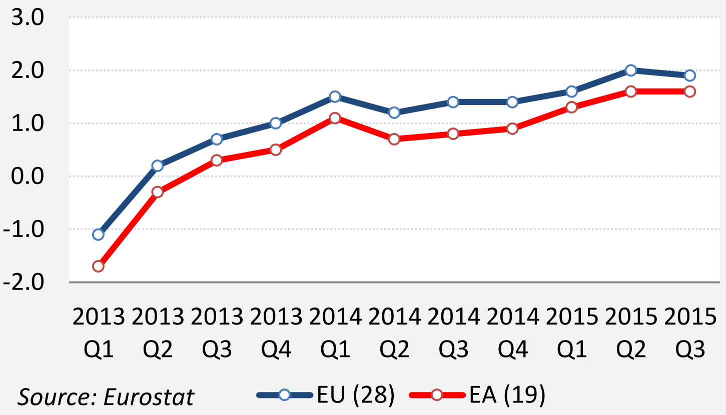
The international economic scenario during 2015 has been dominated by moderate euro area economic growth, financial market volatilities, increased global uncertainties, downturn in emerging market economies and geopolitical tensions. Despite these challenging conditions, the euro area is on the path of moderate recovery and has registered a higher than expected growth rate during 2015. This was mainly due to several temporary factors, including persistent low oil prices, euro exchange rate depreciation and easy financing conditions through the ECB's decision to set historically low interest rates. According to the last economic projections by the Commission, real GDP in the euro area is envisaged to have grown by 1.6 per cent during 2015, in tandem with persistent deflationary pressures. The latter is being addressed by the ECB's bond-buying program aimed towards re-anchoring inflation expectations. Moreover, public finances in the majority of euro area countries continued to improve, with positive developments registered with respect to both the deficit-to-GDP ratio as well as the debt-to-GDP ratio. Modest improvements have also been registered in the euro area's labour market albeit with significant discrepancies across countries. In general, risks to the outlook of the EU and the euro area remain elevated. This is mainly attributed to the fact that whilst the internal political risks within the EU have decreased, external risks, such as the slowdown in China and weaknesses in other emerging economies, are on the upside.

During 2015, Malta continued to register relatively higher economic growth than most of its euro area counterparts. According to the Commission's Economic Forecast, Malta's economy is expected to have expanded by 4.3% by the end of 2015. It attributes this significant economic growth to the boost in investment that took place during the year. Price inflation in Malta has remained above that of the Euro area and is expected to continue picking up. The favourable macroeconomic conditions are contributing to positive developments in public finances. Both the General Government deficit and the debt-to-GDP ratio are projected to decline further. Improvements have also been registered with respect to the labour market with a youth unemployment rate standing well below that of the euro area and total unemployment at historic lows. The IMF Concluding Statement of the 2015 Article IV Mission notes that Malta has remained resilient to the globally challenging environment, principally as a result of the relatively well diversified economy. The financial services sector continued to expand during 2015, contributing further to Malta's economic expansion. At a European level, ongoing efforts have been made so as to continue strengthening the regulatory and supervisory framework, including the move towards a banking union and the implementation of Solvency II for the insurance sector.

1. Economic performance and outlook for the EU and Euro Area

Against the background of a global economic environment dominated by temporary weaknesses in advanced economies and increasing vulnerabilities in emerging markets and developing countries, the economic recovery of the euro area and EU countries continues at a moderate pace.

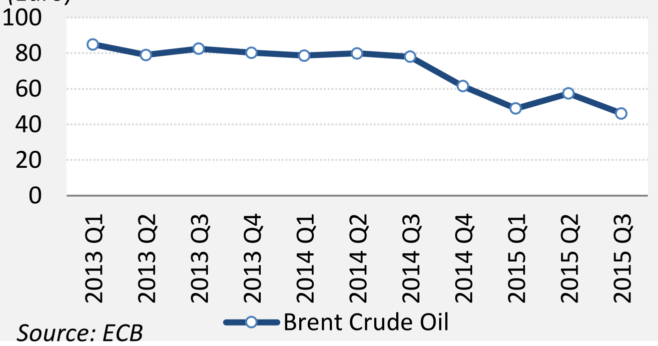
Chart 1.1
Economic Growth (Year on Year)
(per cent)



Source: Eurostat

The outlook is for moderate but increasing output growth. In the Commission's 2015 Autumn Economic Forecast report, the forecasted gross domestic product (GDP) growth rate for 2015 was revised slightly upwards and is now projected to stand at 1.6% for the euro area and 1.9% for the EU. A positive start was registered in 2015 with GDP in the euro area rising by 1.3% compared to the first quarter of the previous year. This continued going up so that GDP growth in the euro area in the third quarter of 2015 stood at 1.6% compared to the same quarter in 2014. Domestic demand remained the main contributor to GDP growth in the EU and the euro area, mainly as a result of private consumption and to a lesser extent, investment. Investment is expected to strengthen gradually, principally as a result of the favourable financing conditions and the gradual strengthening of domestic demand. The European Commission's Investment Plan for Europe, announced in November 2014, is expected to contribute further towards a more investment-friendly environment through initiatives such as the Energy Union and Capital Union initiatives.

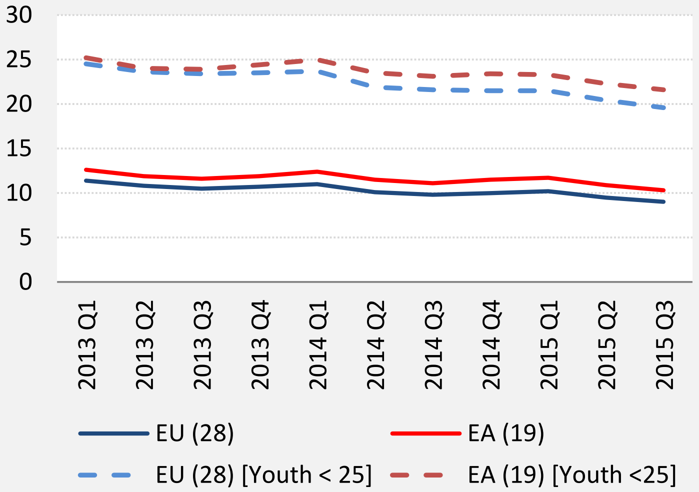
Chart 1.2
Brent crude oil 1-month forward
(Euro)



Source: ECB

Several temporary but favourable tailwinds underpinned EU economies progress towards a moderate economic recovery. These include the relatively weak euro, non-standard monetary policy and a broadly neutral fiscal stance. Moreover, one of the key factors that drove GDP growth in the short-run is the sharp fall in oil prices, resulting in lower energy costs. Consequently, real household income increased, boosting domestic demand and leading to improved business and consumer confidence. However, lower oil prices also contributed towards deflationary pressures. As depicted in *Chart 1.2*, in the third quarter of 2015, oil prices continued to slip. During 2015, there was only a temporary hike in oil prices during the second quarter, reflecting higher demand and a faster than expected slowdown in oil production growth in the US. Oil price expectatons were revised in the Commission's Autumn Forecast so that oil prices are now assumed to rebound later and by a lower amount than expected in the previous Commission's forecast.

Chart 1.3
Unemployment rate (Not seasonally adjusted)
(per cent)



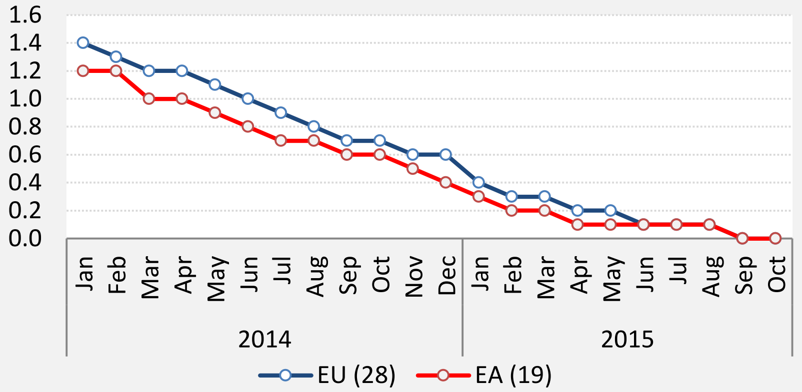
Source: Eurostat

Modest improvements in the labour market have been registered, primarily triggered by the improvements in countries with relatively high unemployment such as Spain, Portugal and Greece. The unemployment rate is declining only gradually and the substantial differences across Member States continued to persist. *Chart 1.3* indicates that the unemployment rate in the third quarter of 2015 stood at 9.0% in the EU and 10.3% in the euro area, down from 9.8% and 11.1% respectively, in the same quarter of 2014. This is in line with the Commission's Autumn 2015 Economic Forecast of projecting a decline in unemployment rates to 9.5% in the EU and to 11% in the euro area in 2015. The forecasted rates of unemployment for 2016 are 9.2% for the EU and 10.6% for the euro area. This notwithstanding the marked differences in unemployment rates persisted across member states such that in the third quarter of 2015, unemployment in Spain stood at 21.2% whereas Germany registered an unemployment rate of 4.4%.

The number of jobless people aged under 25 years remained relatively high compared to other age groups. In the third quarter of 2015, youth unemployment stood at 19.6% in the EU and 21.6% in the euro area. This masks even larger discrepancies between member states, with Germany registering the lowest youth unemployment rate at 8.2% in the third quarter of 2015, as against 46.2% registered in Spain during the same quarter. This implies underutilised human resources that might manifest itself into a constraint to economic growth and productivity as well as an increase in the risk of poverty and social exclusion.

In 2015, the HICP inflation rate continued to decline and remained well below the ECB's target of close to, but below 2%. The sharp decline in energy prices was a key factor that dragged the HICP 12-month moving average to a historically low level. In October 2014, HICP inflation stood at 0.7% in the EU and 0.6% in the euro area. By October 2015, a 0% HICP 12-month moving average was recorded for both the EU and the euro area.

Chart 1.4
Inflation Rate (HICP 12-month moving average)
(per cent)



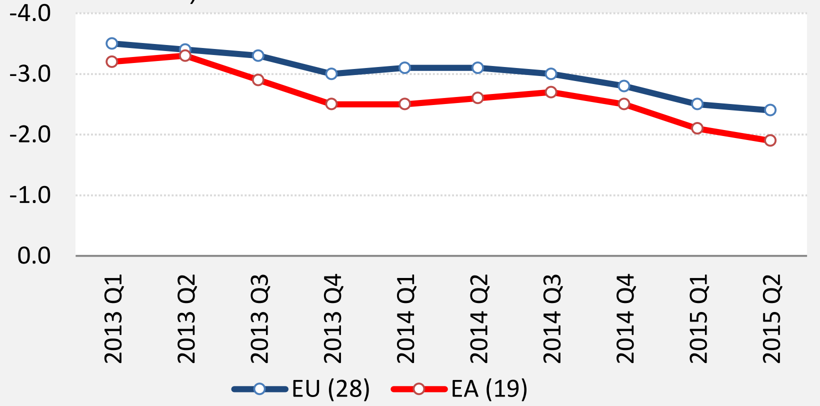
Source: Eurostat

According to the EC's Autumn Forecast, the HICP inflation rate is expected to be 0% for the EU and 0.1% in the euro area by the end of 2015. The Commission's forecast refers to the discrepancies that exist across member states, such that in 2015, HICP inflation is expected to be the lowest in Cyprus (-1.6%) and the highest in Malta (1.1%). A more positive outlook is envisaged for 2016 where inflation is expected to increase to 1.0% in the euro area and to 1.1% in the EU. This is fuelled by the stronger wage growth and domestic demand. However, external price pressures are expected to remain weak, given the sluggish increase in energy and non-energy prices.

The unconventional monetary policy of Quantitative Easing (QE) adopted by the ECB seeks to address the prolonged low inflationary environment and to stimulate growth within the euro area. This gave rise to the depreciation of the euro against other major currencies thus creating a better environment for investment to flourish within the bloc. This notwithstanding, the ECB cut its growth and inflation forecasts of the euro zone in September 2015 in view that several factors are putting prices under pressure. Such factors include the turmoil in emerging markets, the financial market volatility which continued to increase following the devaluation of the Chinese Yuan and the sharp falls in oil prices. These factors prompted the ECB to increase further the issue share limit of its bond-buying programme during the year. The ECB's expansionary monetary policy together with policies directed at reducing economic slack such as labour market reforms, higher budget spending on investment and the fostering of a pro-business environment, all contribute to attaining the ECB's mandate of price stability.

The gradual recovery in economic activity is expected to generate higher tax revenues which will contribute towards reducing the budget deficits. In 2014, the general government deficit fell below the Maastricht Treaty threshold of 3% of GDP. Moreover, the lower interest expenditure resulting from the unconventional monetary policy measures adopted by the ECB is also contributing to the favourable outlook for public finances in the EU and euro area. As depicted in *Chart 1.5*, in the second quarter of 2015, the deficit-to-GDP ratio stood at 2.4% for the EU and 1.9% for the euro area compared to 3.1% and 2.6% in the EU and euro area respectively for the same quarter of the previous year. According to the Commission's Autumn Forecast, it is projected that in 2015, it will fall to 2.5% and 2.0% of GDP in the EU and the euro area respectively. Assuming a no policy change, it is forecasted that deficit-to-GDP ratio will continue declining to 2% and 1.8% of GDP in the EU and euro area by 2016 and to narrow further in 2017, to 1.6% and 1.5% of GDP in the EU and the euro area, respectively.

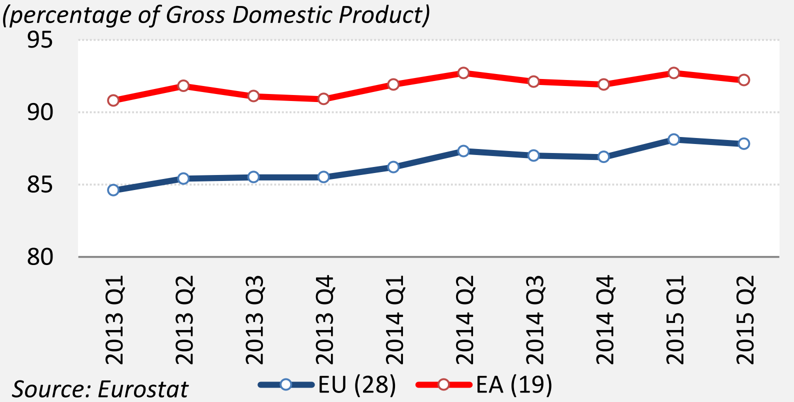
Chart 1.5
General Government Deficit to GDP
(seasonal and working day adjusted; percentage of Gross Domestic Product)



Source: Eurostat

The outlook for the public debt ratio improved moderately. In the second quarter of 2015, gross debt amounted to 87.8% of GDP for the EU and 92.2% of GDP for the euro area. The General Government Consolidated Gross Debt is expected to

Chart 1.6
General Government Consolidated Gross Debt
(percentage of Gross Domestic Product)

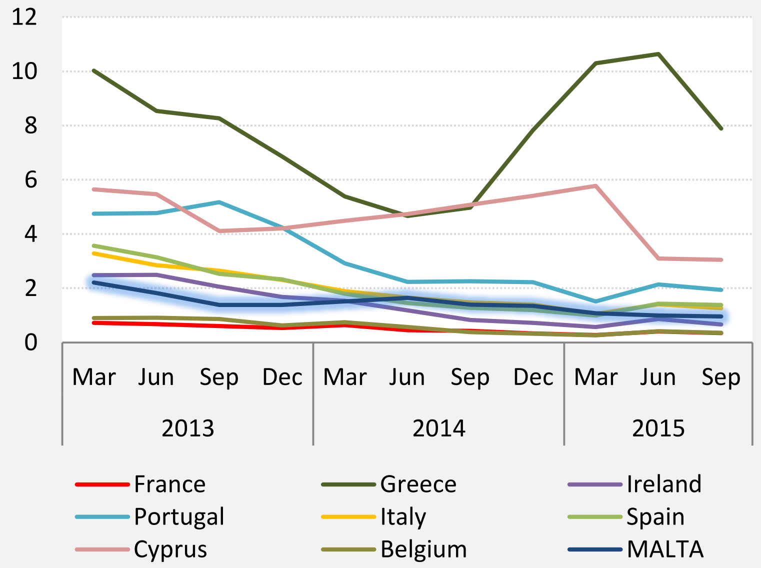


Source: Eurostat

continue declining, mainly due to a higher primary surplus and stronger nominal GDP growth. The Commission's Autumn Forecast projects a debt-to-GDP ratio (on a non-consolidated basis) of 87.8% in the EU and 94% in the euro area in 2015. These positive developments in the public debt ratio are expected to continue in 2016 due to the re-anchoring of inflation expectations brought about by the ECB's APP, higher economic activity and more surpluses in the primary account. These positive effects are expected to fully offset the still sizeable, yet gradually diminishing, interest burden on the high existing debt. The Commission forecasts that under a no-policy change assumption, the debt-to-GDP ratio continues to decline to 91.3% and to 85.8% of GDP for the euro area and the EU respectively in 2017.

The spreads in Euro zone sovereign bonds (to the German Bund) continued to narrow, with the exception of Greek paper. *Chart 1.7* depicts this narrowing which was primarily a result of the falling inflation expectations and the ECB's Asset Purchase Programme stimulus. In April 2015, the German ten-year yield fell historically low to 0.12%. The long-term interest rate spread of major government bonds widened slightly during the second quarter of the year and somewhat stabilised at that level. The long-term interest rate spread of Malta government bonds continued to narrow reaching 0.96% as at the third quarter of 2015. Conversely, Greek ten-year yields soared to 12% in April 2015 in view of the political turmoil that dominated 2015 with respect to its potential exit from the euro currency, inducing significant uncertainties. Over the course of the year, Greek long-term interest rates undertook a downward trajectory as the uncertainty over Greece's potential exit subsided.

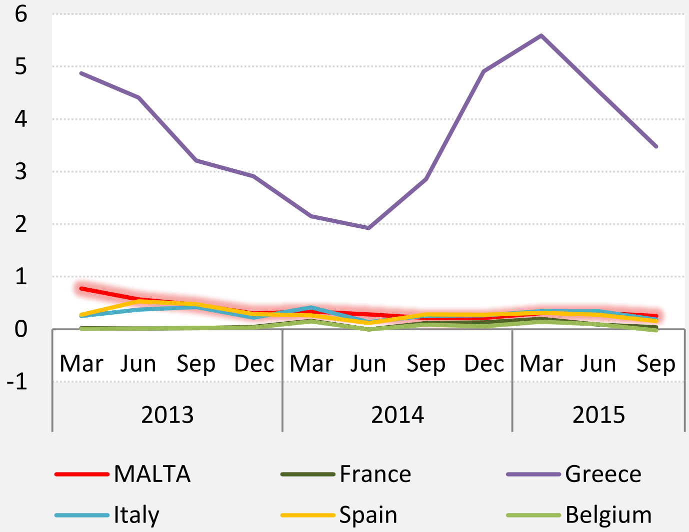
Chart 1.7
Harmonised Long-Term Interest Rates Spreads against German Bund (with maturities of close to ten years)
(per cent)



Source: ECB

Short-term spreads are a good gauge of current market sentiment. **As portrayed in *Chart 1.8,* which shows the 3-month spread to German bonds, Greek paper recorded the highest premium at the back of the Greek sovereign crisis.** However this spread seems to be on a downward trend as the political uncertainty surrounding Greece has somewhat declined. With respect to the other euro area member states, including Malta, the spreads are all converging to 0%. As for Belgium, the spread from the German short-term interest rate turned negative for the last quarter of 2015.

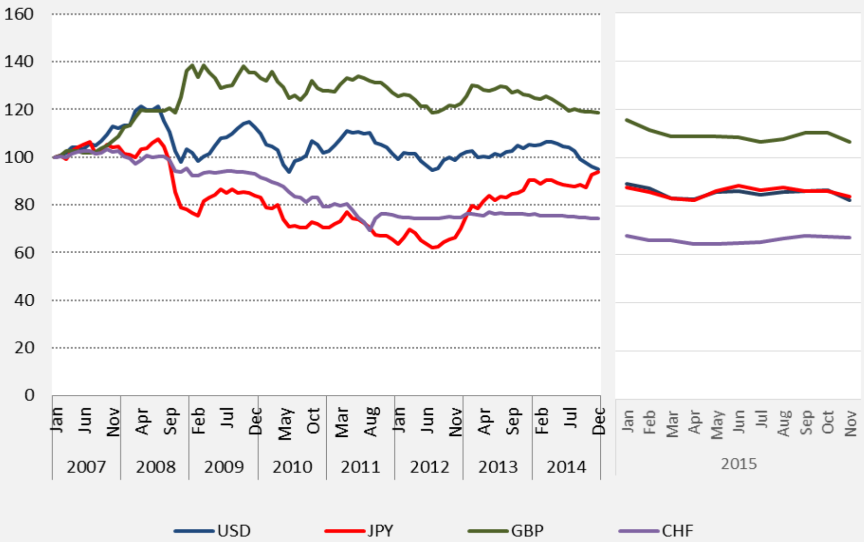
Chart 1.8
Short-term Interest Rate Spreads (3-month yield)
(per cent)



Source: investing.com

The euro currency exchange rate has fluctuated substantially against major currencies over the past year. *Chart 1.9* indicates the exchange rate movements of the euro against the US dollar, the Japanese yen, the British pound and the Swiss franc. A fall in the index implies a depreciation of the euro against the currency concerned whereas an increasing index indicates a strengthening of the euro whereby the euro currency buys more units of foreign currency.

Chart 1.9
Exchange Rate Index movements of EUR against other currencies (Jan 2007 Base Year = 100)
(index)



Source: ECB

According to the latest ECB data, the euro has depreciated by over 13% against the US dollar and by almost 13% against the British pound from November 2014 up to November 2015. This significant depreciation is the result of a combination of events namely, the simultaneous improvement of the US economic outlook, low growth and inflation in the euro area, as well as the diverging monetary policy stances adopted by major Monetary Authorities. Following the ECB's announcement of extending its Asset Purchase Programme in January 2015, the euro weakened significantly against the US dollar, dropping by almost 7% from January to November 2015. This scenario was further accentuated by the US Fed rate hike expectations.

On the 15th January 2015, the Swiss National Bank removed the peg with the euro, causing the Franc to rally against the European currency. Indeed over the twelve months to November 2015, the euro depreciated by about 7% against the Swiss franc. The euro exchange rate fluctuations against the Japanese yen were also quite significant, with the euro depreciating by 9% against the yen during 2015.

The impact of the euro exchange rate fluctuations on individual countries depends both on the degree of openness to non-euro area countries as well as the direction and magnitude of the euro's movements against the currencies of the respective trade partners. The depreciation of the euro is expected to improve the external balance of most EU countries, particularly of countries with a high sensitivity of the trade balance to relative prices.

Risks to the outlook of the EU and the euro area remain elevated and have moved towards the downside. Although the internal political risks within the EU have decreased, external risks such as the slowdown in China and weaknesses in other emerging market economies, are on the upside. ECB's QE programme has helped to moderate the risks stemming from a prolonged deflationary period, with inflation expected to pick up in the short-term in view of, an expected rebound in oil prices and persistent weak euro currency. In the long-run, the implementation of structural reforms and the increased room for investment will allow the economy to get closer to the full-employment level of output. An eventual rebound in oil prices would erode the gains in purchasing power resulting from lower energy costs on households and producers. Expectations about future oil prices remain volatile in view of geopolitical tensions, other supply-side factors and the slowdown in China. Moreover, the energy and commodity markets are likely to be directly impacted by the ongoing geopolitical tensions in Ukraine and parts of the Middle East and Northern Africa.

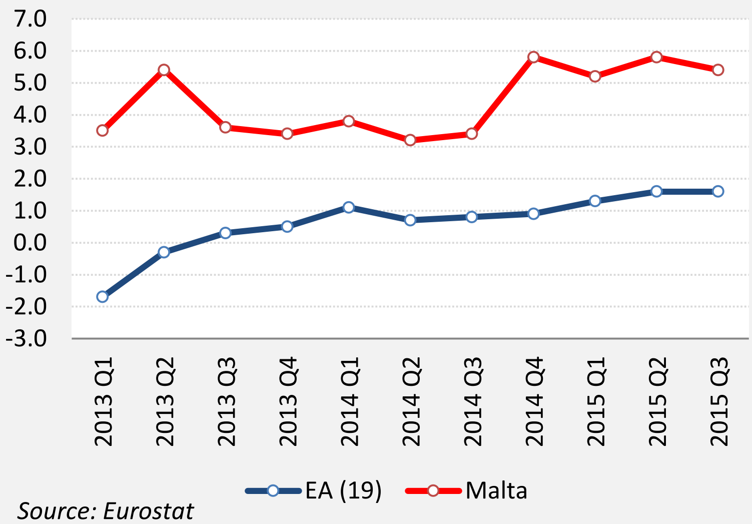
In view that the EU is still facing challenges in terms of sustainable growth prospects, the European Commission President Juncker highlights in the ‘Five Presidents’ Report’ (June 2015) the need to move from short-run policies to more lasting economic policies which reinforce the foundations to foster real convergence between member states. The ‘Five Presidents’ Report’ sets out concrete but challenging measures, expected for implementation in three stages up to 2025, seeking to guarantee a transparent and complete Economic and Monetary Union. This accentuates the need to focus on more permanent growth drivers through the setting up of Competitiveness Authorities, Fiscal Union and Financial Union.

2. Economic performance and outlook for Malta

Economic activity in Malta continued to expand during 2015, driven principally by robust consumer spending, investments in energy projects, higher tourism activity and improvements in the external balance. This contributed in improved performance of the domestic labour market, resulting in unemployment rates amongst the lowest in the EU. The positive macroeconomic outlook is also translating itself in a sustained improvement in public finances.

***Chart 2.1* shows that during 2015, the Maltese economy continued to expand.** During the first quarter, real GDP increased by 5.2% on a year earlier, well-above the euro area average of 1.3%. This upward trend in GDP growth continued so that in the third quarter of 2015, the economy grew by 5.4% in real terms relative to the same quarter in 2014. The Commission's Autumn Economic Forecast expects the Maltese economy to grow by 4.3% in real terms during 2015, reflecting a 0.8 percentage point increase from 2014. It is then expected to moderate to 3.6% in 2016.

Chart 2.1
Economic Growth (Year on Year)
(per cent)



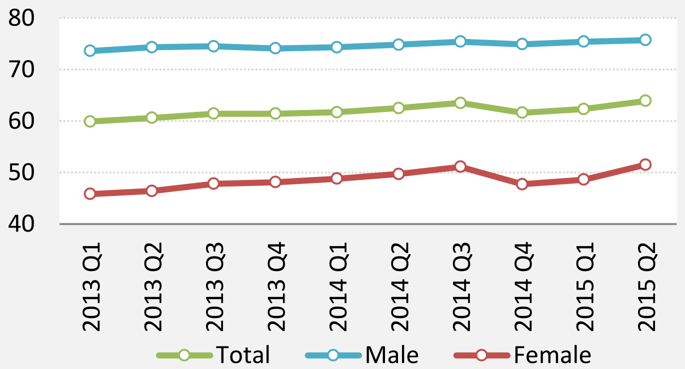
Source: Eurostat

Investment and private consumption were the main contributors to the economic growth registered during the year. The public sector also contributed positively to the expansion of the Maltese economy. However, the positive contribution of the latter is expected to be less than that registered in 2014. Another factor spurring expansion in economic activity includes the decline in energy prices which boosted private consumption through higher disposable income and reduced energy costs for the business sector, thus leading to a favourable consumer and business sentiment. Although global oil prices are registering a slow recovery, energy prices have remained moderate during 2015 amidst an environment characterised by large oil supplies and weak demand from China. With regards to the external side of the economy, growth in domestic demand is leading imports to expand faster than exports such that this poses a drag on real economic growth. Nevertheless, Malta's current account is expected to remain in surplus.

During the third quarter of 2015, the largest contributors to Malta's Gross Value Added (GVA) were wholesale and retail trade; repair of motor vehicles and motorcycles; transportation and storage; accommodation and food service activities; financial and insurance activities; professional, scientific and technical activities; administrative and support service activities and public administration and defence; education; human health and social work activities.

Turning to the labour market, Malta continued to outperform most of its euro-area peers. Following a marginal decline in the last quarter of 2014, total employment in Malta picked up again in the first quarter of 2015, reaching 62.3%. This further increased to 63.9% in the second quarter of 2015, representing a 1.4 percentage point increase relative to the same quarter in 2014.

Chart 2.2
Employment Rate in Malta (15-64 years)
(per cent)

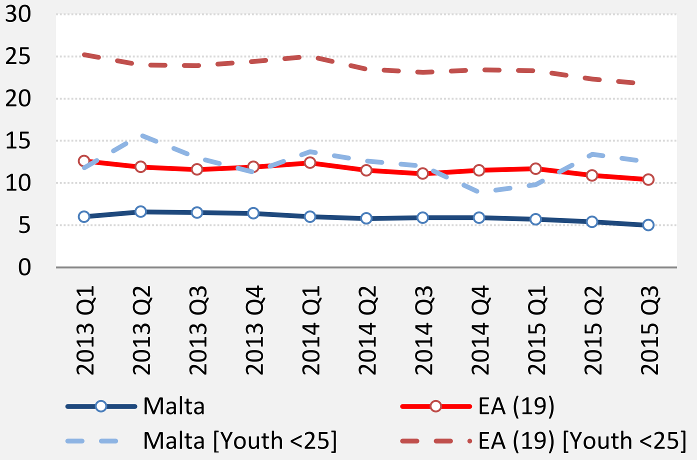


Source: Eurostat

The male employment rate stood at 75.7% in the second quarter of 2015, up by 0.9 percentage points from that registered in the second quarter of the previous year. During the first half of 2015, the female employment rate regained pace after falling marginally in the last quarter of 2014. The employment rate for females stood at 51.5% in the second quarter of 2015. The trend in female employment rate has increased significantly since the mid-2000s. From 2004 up to 2014, the employment rate (15-64 years) for females increased by 16.6 percentage points whereas that for males declined by 0.2 percentage points. This was triggered by several factors such as tax credits, provision of free childcare centres and more flexible work practices. The European Commission forecasts that although employment growth in Malta will remain well-above the euro area average, it is expected to moderate from 2015 onwards.

Unemployment in Malta continued to exhibit a downward trajectory. In quarter three of 2015, the unemployment rate declined to 5%, a 0.9 percentage point drop on the corresponding quarter of the previous year. During the same period, the euro area also registered a 0.7 percentage point decline in unemployment. This notwithstanding, many euro area economies continue to register high unemployment rates than Malta such that the total unemployment rate in the euro area in the third quarter of 2015 stood at 10.4%. With regard to youth unemployment, *chart 2.3* indicates clearly that there is a marked difference between the youth unemployment rate for Malta and that for the euro area. During the third quarter of 2015, Malta's youth unemployment rate stood at 12.5%, representing a fall of 0.5 percentage points from the same quarter of the previous year. This compares favourably with the 21.7% youth unemployment rate registered in the euro area. Apart from the favourable economic activity, Malta's relatively good performance in mitigating youth unemployment is also attributable to fiscal incentives such as the Youth Guarantee Scheme, which seeks to provide young people with skills which enhance their employability prospects.

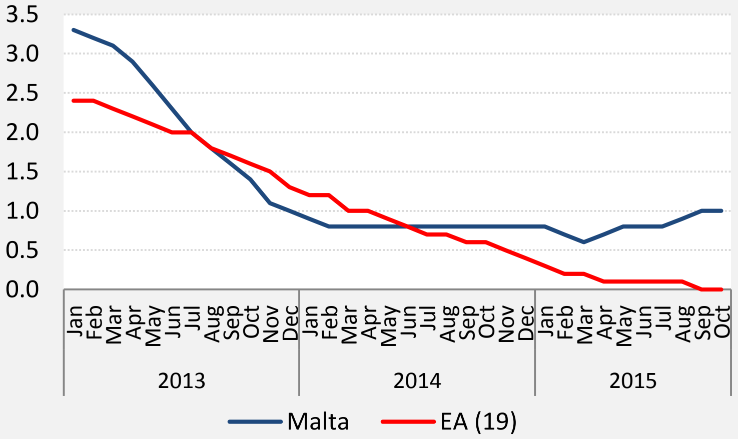
Chart 2.3
Unemployment Rate
(per cent)



Source: Eurostat

In 2015, price inflation in Malta has been above that in the euro area. *Chart 2.4* portrays the Harmonised Index for Consumer Prices (HICP) 12-month moving average for Malta and the euro area. Inflation in the euro area continued to decline, starting at 0.3% from the beginning of 2015 reaching 0% by September 2015. The Maltese HICP inflation rate, whilst standing at a contained level of 1% as at September 2015, is

Chart 2.4
Inflation Rate (HICP 12-Month Moving Average)
(per cent)



Source: Eurostat

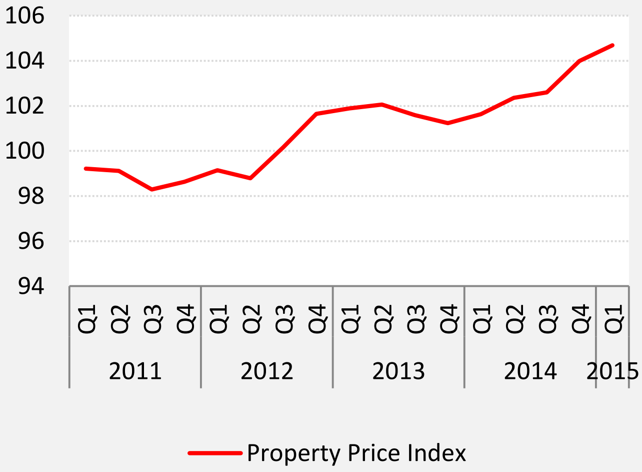
showing an upward trend. Food and service components have been major contributors to this upward trend.

The Ministry for Finance reported in the 'Malta: Update of Stability Programme 2015-2018' (April 2015) that HICP inflation (12-month moving average) will remain at 1% in 2015 and would pick up to 1.8% in 2016. The reduction in electricity tariffs for households in 2014 will no longer exert significant downward price pressures as its impact gradually wears off. However, the reduction in utility tariffs for the commercial sector in 2015 may dampen the inflation pressures in the short-term.

With respect to real estate prices, *chart 2.5* shows the four quarter moving average of the Property Price Index (PPI) and the Property Volume Index (PVI). Both the PPI and the PVI published by NSO cover apartments, maisonettes and terraced houses. In the first quarter of 2015, the four quarter moving average PPI registered a 3.06 percentage point increase, compared to the same quarter in the previous year. This is partly a result of government measures which contribute in boosting the demand for property in Malta, including the first buyers' scheme and the Individual Investor Programme.

The Property Volume Index (PVI), also compiled by the NSO, reflects the percentage changes registered in the total number of transactions recorded by the Inland Revenue Department in three dwelling types, namely apartments, maisonettes and terraced houses. Chart 2.5 shows that the four quarter moving average PVI increased markedly during

Chart 2.5
Property Price Index (PPI)
(Index with base year 2010- Four quarter moving average)

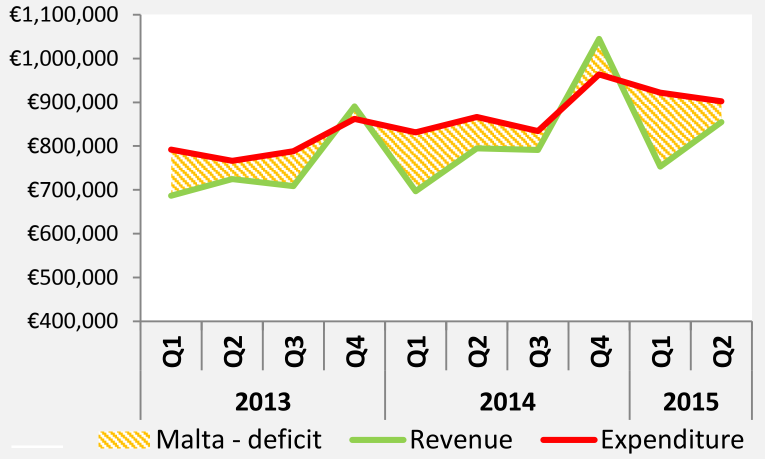


Property Volume Index (PVI)
(Index with base year 2010 - Four quarter moving average)

Source: NSO

2014, with a 39.5 percentage point increase from the fourth quarter of 2013 up to the end of 2014. In the first quarter of 2015, the four quarter moving average PVI stood at 153.93, reflecting a 4.05 percentage point increase from the previous quarter.

Chart 2.6
Malta's Government deficit
(Euros)



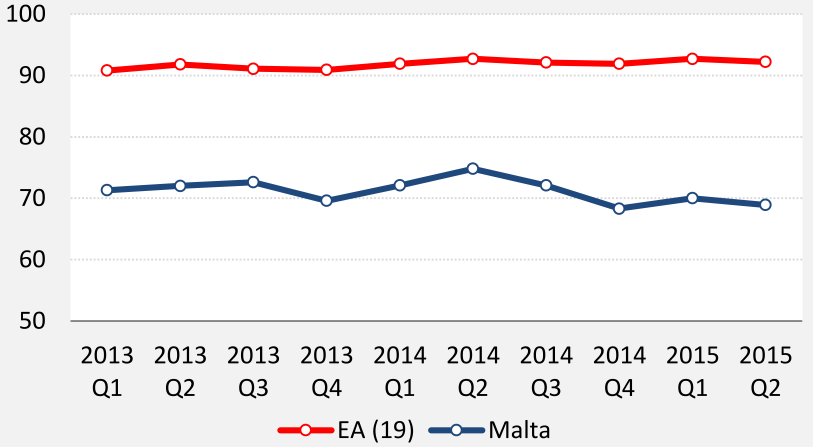
Source: NSO News Release 191/2015

The favourable macroeconomic outlook and government commitment to curb fiscal abuse and enhance the efficiency of taxation collection, contributed to higher tax revenue and consequently a further reduction in the budget deficit to 2.1% of GDP in 2014 from 2.6% registered in 2013. The Commission's forecasts project that the deficit-to-GDP ratio for Malta will exhibit a downward trajectory. On a no-policy change assumption, it is expected to amount to 1.7% of GDP in 2015 and to 1.2% of GDP in 2016.

In 2014, Malta's general Government revenue-to-GDP ratio, increased by 2 percentage points, primarily as a result of higher tax revenue. In the second quarter of 2015, total general Government revenue increased by 7.5% relative to the same quarter in 2014. This increase in revenue mainly stemmed from higher proceeds from Current taxes on income and wealth and receipts from Capital transfers. Taxes on production and imports and Property income receivable also registered increases whereas income from Current transfers declined. Conversely, in 2014 the ratio of general Government expenditure-to-GDP increased by 1.5 percentage points which continued to increase in 2015. In fact in the second quarter, General Government expenditure rose by 4.1% as compared to the same quarter in 2014. The key contributors to this increase were the higher outlays registered in compensation of employees and gross capital formation. The deficit recorded in the second quarter of 2015 amounted to €47.5 million.

The general Government consolidated gross debt as a percentage of GDP continued to decrease, standing at 68.9% as at the second quarter of 2015, reflecting an almost 6 percentage point drop from that registered during the same quarter of the previous year. This decrease in the debt ratio was primarily a result of the ongoing restructuring of Enemalta's debt. *Chart 2.7* depicts the general Government consolidated gross debt as a percentage of GDP of Malta in comparison to the euro area average. The euro area registered a much larger gross debt-to-GDP ratio of 92.2% as at the second quarter of 2015. The Commission projects the debt ratio for Malta to continue declining to 61% of GDP by 2017. In the medium term, this reduction is expected to be primarily triggered by a growing primary surplus and the relatively high nominal growth scenario.

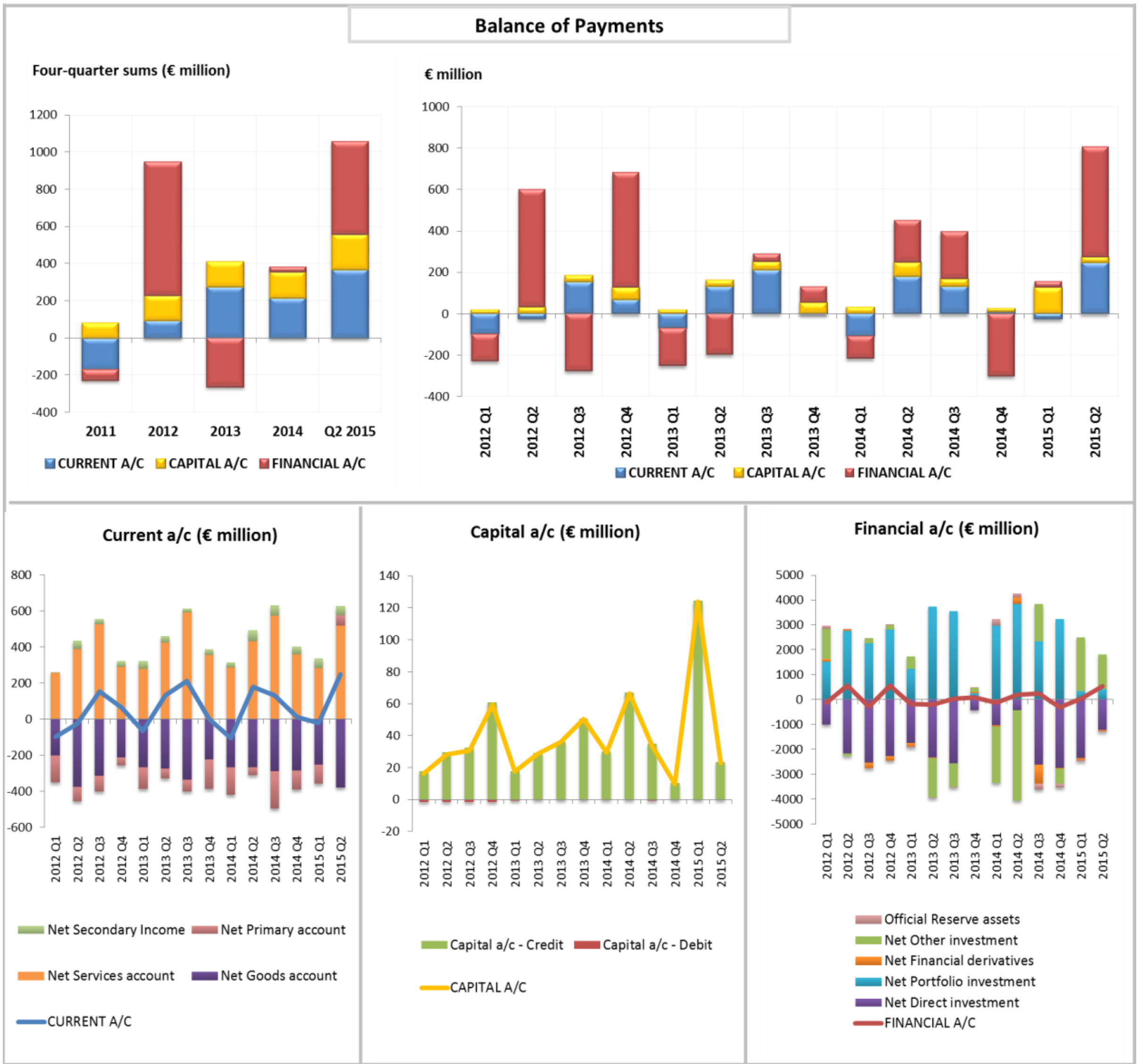
Chart 2.7
General Government Consolidated Gross Debt
(percentage of Gross Domestic Product)



Source: Eurostat

During 2014, the Balance of Payments of Malta, expressed as a four-quarter moving sum, registered a current account surplus together with a capital account surplus and a marginal financial account surplus. As at mid-2015, the surpluses registered continued to persist due to growth in the second quarter of the year, mainly driven by favourable developments on all the main components in the current account except for merchandise trade.

Chart 2.8



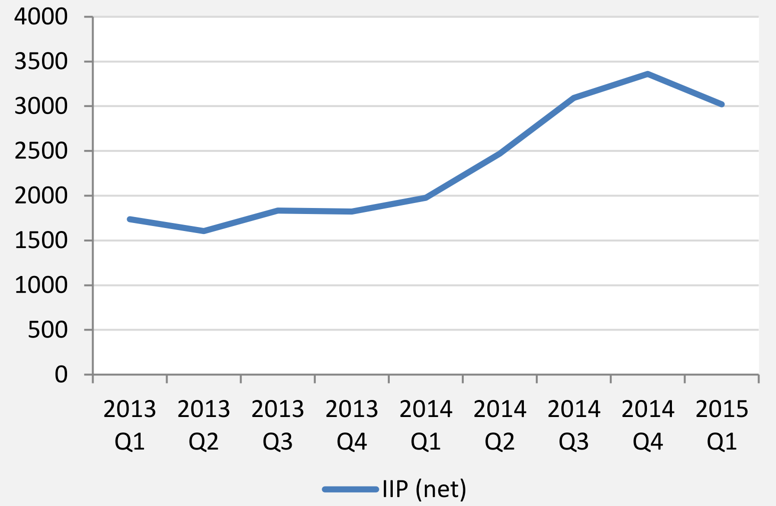
The current account provides information on trade in goods, transactions in services, income from employment and investment and current transfers.	***The capital account is where all international capital transfers are recorded.***	***The financial account records an economy's transaction in external financial assets and liabilities, it consists of flow variables since it records changes in the country's asset holdings during the year.***

The Current account of the Balance of Payments amounted to a surplus of €365.7 million as at the second quarter of 2015 measured as four quarter moving sum, reflecting a EUR 149.4 million increase from that registered during the end of 2014. The merchant trade gap increased by EUR 98.5 million whereas the services account registered an increase of EUR 86.9 million. Net outflows on primary income decreased by EUR 147.6 million, whereas the secondary income registered an increase in inward flows of EUR 13.4 million. The current account surplus as a proportion of GDP stood at 4.4% as at the second quarter of 2015 as compared to 2.7% registered as at the end of 2014. The Capital account expanded during 2015 registering EUR 190.8 million as at the second quarter of the year (four quarter moving sum). This reflects an increase of EUR 50.7 million on that registered at end 2014. The

Financial account registered net inflows of EUR 497.7 million during the second quarter of 2015 as compared to net inflows of EUR 23.5 million during 2014. Net portfolio investment inflows decreased by EUR 6.1 billion from the previous year, whereas net direct investment outflows increased by EUR 2.1 billion and financial derivatives outflows increased by EUR 328.8 million.

Chart 2.9: Net International Investment Position

(EUR million)

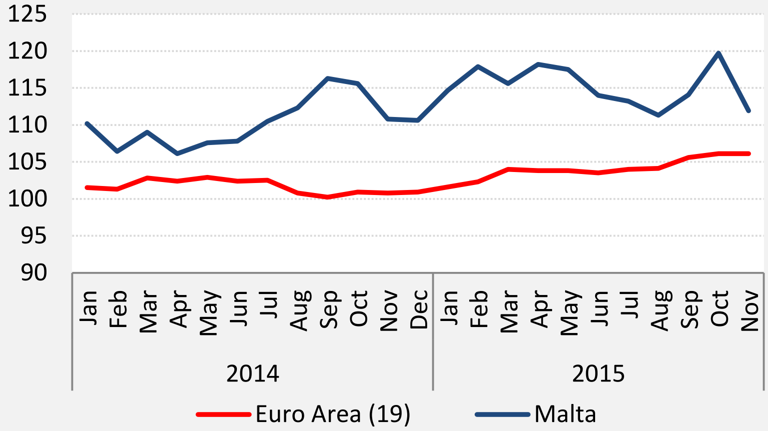


Source: Central Bank of Malta

The international investment position (IIP) shows all financial assets and liabilities of an economy's residents vis-à-vis non-residents. **The Net IIP amounted to EUR 3 billion in the first quarter of 2015.** Maltese residents' holdings of external financial assets amounted to EUR 226 billion in the first quarter of 2015, up by EUR 14 billion from the same quarter in the previous year. On the other hand, the liabilities of Maltese residents stood at EUR 223 billion, EUR 13 billion higher compared to the same quarter in 2014. The EUR 3 billion Net IIP implies that the balance of assets against liabilities grew by 53% when compared to the balance of EUR 2 billion in the same quarter of 2014. From the first quarter of 2014 up to the first quarter of 2015, Net Portfolio Investment increased substantially. This was partly offset by declines in Net Financial derivatives, Net Other Investments, Reserve Assets and an increase in the negative balance of Net Direct Investment. C*hart 2.8* clearly indicates that during 2014, Malta's net creditor position vis-à-vis the rest of the world became significantly stronger, such that the Net IIP had grown by 84% from the last quarter of 2013 up to the last quarter of 2014, mainly attributed to a substantial increase in holdings of foreign equity and long-term debt securities.

The Economic Sentiment Indicator (ESI) provides a summary overview of development registered in five surveyed sectors, namely industry, services, construction, retail and consumers. ***Chart 2.9*** **indicates that the ESI in Malta stood at 111.9 as at November 2015, well above the 106.1 sentiment level registered in the euro area.** During the first half of the year, Malta's ESI was driven mainly by improved confidence in the construction sector, services and retailers activities.

Chart 2.10
Economic Sentiment Indicator
(Index)



Source: Eurostat

The overall economic outlook for Malta is a positive one which must continue to be sustained by fiscal consolidation, a sound financial sector and adequate structural reforms as indicated by the IMF concluding statement.

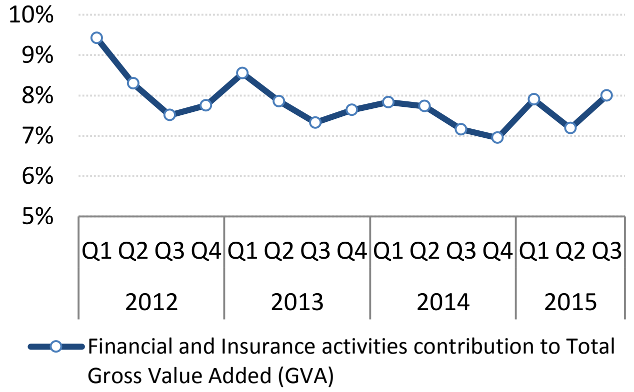
3. Financial services sector trends in Malta

Malta’s Financial and Insurance activities contribution to total Gross Value Added

Total Gross Value Added (GVA) during the third quarter of 2015 amounted to EUR 2 billion in absolute terms. This represents a 10 percent increase compared to the corresponding quarter a year ago

At EUR 160 million Malta’s direct financial intermediation contributed 8 percent of total GVA during the third quarter of 2015. This represents an increase of 23% when compared to the amount recorded in the same quarter of the previous year.

Chart 3.1
Malta's Financial and Insurance activities contribution to Gross Value Added (GVA)
(per cent)



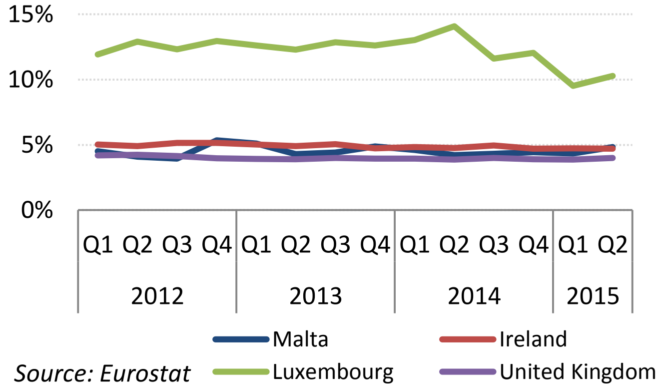
Source: NSO newsletter 224/2015

Monetary intermediation through credit institutions remained the major contributor to financial services activities representing over 50% of financial sector GVA.

Employment in Financial and Insurance activities

In the second quarter of 2015, employment within Malta’s financial services sector amounted to 8,800, representing 4.8% of total employment. In comparison, during the second quarter of 2014, employment in financial and insurance activities represented 4.2% of total employment, amounting to 7,500 in absolute terms. During 2015, gainfully occupied full timers in monetary intermediation activities represented 52% of the entire financial services sector; followed by 30% in other financial activities including that of holding companies, trusts, funds and similar financial entities; 10% in auxiliary activities to financial services and insurance activities; and 8% in insurance, reinsurance and pension funding. In major financial services jurisdictions, the share of employment in Financial and Insurance activities as a proportion to total employment amounted to 4.7% in Ireland, 10.3% in Luxembourg and 4% in the UK, as at the second quarter of 2015.

Chart 3.2
Employment in Financial and Insurance activities to Total Employment
(per cent)

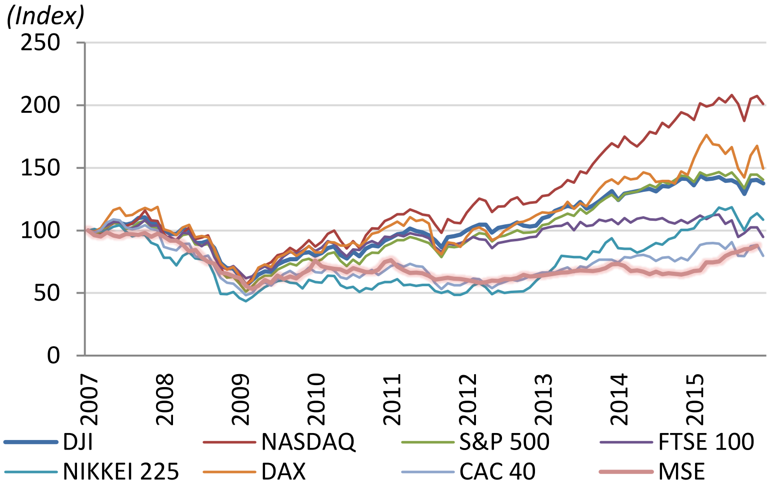


Source: Eurostat

Key stock market indices value (Jan 2007 base year = 100)

The performance of key indices of major stock groupings is portrayed in chart 3.3. Each of the indices measures the changes in the market value of a specific basket of stocks representing a particular market or sector of the economy. In order to monitor performance of stock indices over time, a base year of 100 was considered from January 2007.

Chart 3.3
Key stock market indices value
(Jan 2007 base year = 100)



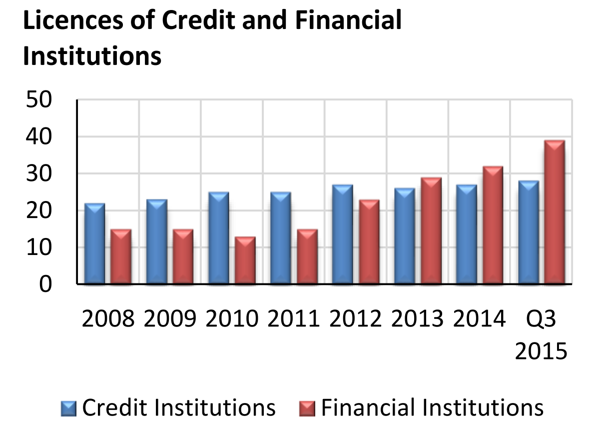
Source: Yahoo! Finance; Malta Stock Exchange

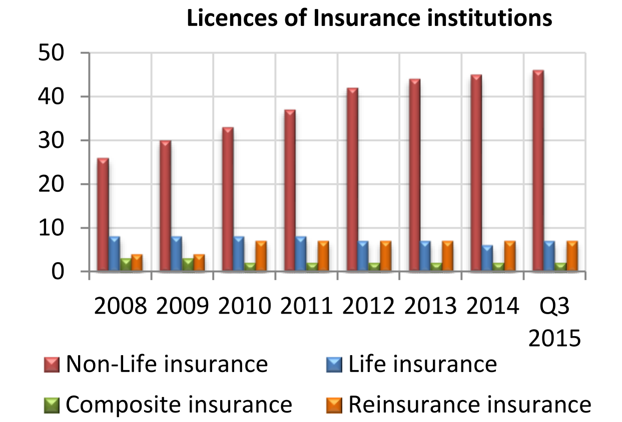
European stocks registered a general increase during the first half of 2015, driven principally by the announcement of the ECB's bond-buying program further monetary easing. Moreover, the weak euro currency also inflated export revenues of listed companies, explaining the marked increase in the DAX index which is mostly comprised of car manufacturers and other major exporters.

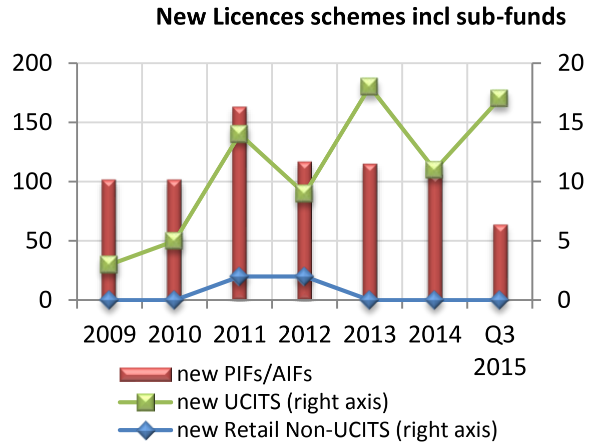
Conversely, during the second half of the year, European stocks were under pressure, principally as a result of the potential exit of Greece from the euro currency. After recovering in July, European stocks plunged in August 2015 due to fears about the health of China's economy, leading to a global selloff which sent stock markets reeling. China stock markets crashed coining 24th August as Black Monday, with Asian markets suffering major losses such as 8.23% drop in NIKKEI 225. Similarly, in the US, the DJI slumped 6.57%, together with the NASDAQ composite index and S&P500 index which dropped by 6.86% and 6.26% respectively in August. Movements in stock markets were also in response to uncertainty build-up over the potential interest-rate hike announcement by the US Federal Reserve and moreover concerns of the negative impact that low oil prices convey on oil-exporting countries, thus contributing to stock sell-offs.

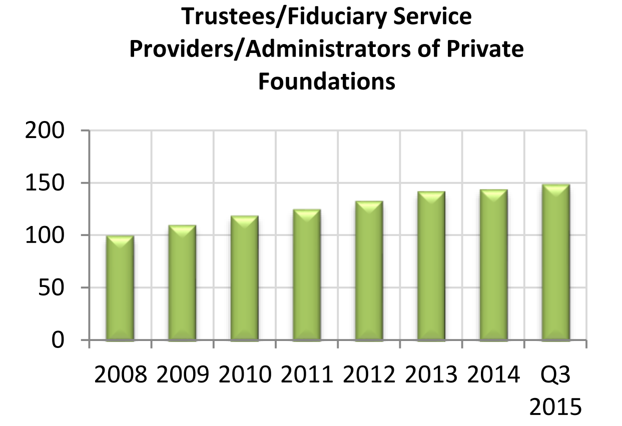
With respect to the domestic equity market, the MSE share index surged during the first quarter of 2015, reflecting an increase in both share prices and number of shares traded. The MSE index continued to rise strongly during the second and third quarters registering an index of 4,437 by November 2015, reflecting an increase of 36% from that of the previous year.

Licences and Assets of Financial institutions licenced by the MFSA

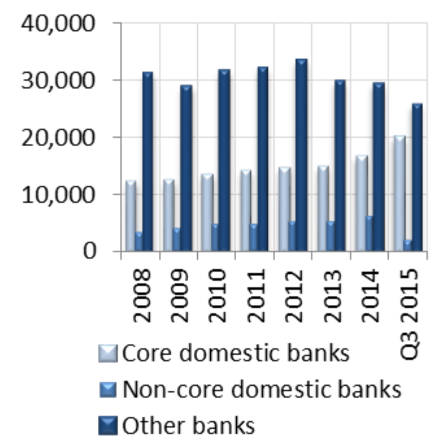


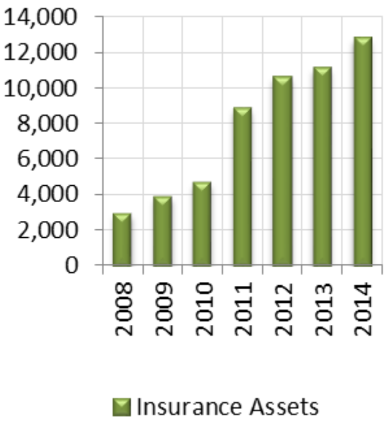


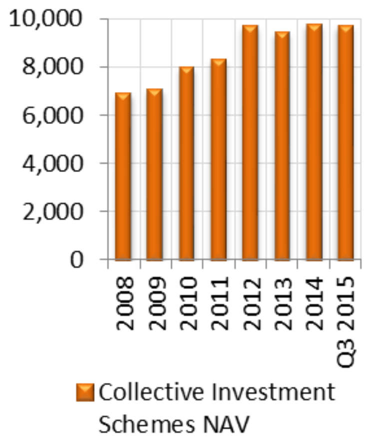




Aggregate Assets in Banking, Insurance and Collective Investment Schemes (NAV) [EUR million]







Source: Malta Financial Services Authority

Up to the third quarter of 2015, the total number of credit institutions stood at 28, registering one new licence from the previous year. During 2015 the Central Bank of Malta reclassified a number of credit institutions according to their domestic relevance. Mediterranean Bank plc and Mediterranean Corporate Bank Limited were reclassified as core domestic banks in June 2015, which were previously classified as non-core. Additionally, Credit Europe Bank N.V., previously classified as non-core, was reclassified as an international bank.

The number of licences issued to financial institutions also continued to increase, amounting to 39 by September 2015. These are made up of 26 payment institutions and 10 electronic money institutions.

Turning to the balance sheet assets, the banking sector aggregate assets amounted to EUR 47.7 billion as at the third quarter of 2015. This represents around 568% of GDP in terms of its assets. Around 60 per cent of bank assets belong to international banks having little or no interaction at all with the domestic economy. The balance sheet assets for core domestic banks that have systemic relevance to the local economy amounts to 238 % of GDP.

The insurance sector continued to expand, both in terms of the number of licences issued by the MFSA as well as aggregate assets. By September 2015, the number of licences issued to composite and reinsurance insurance remained unchanged from the amounts recorded in 2014. Non-life and life insurance increased by one licence respectively. Therefore, up to September 2015, the insurance sector registered a total of 46 non-life, 7 life, 2 composite and 7 reinsurances licences. Assets within the insurance sector increased by 15% from the previous year, amounting to 12,779 million in 2014. This implies that the insurance sector's assets amounted to 162% of GDP.

The number of new Collective Investment Schemes licenced by the MFSA up to September 2015 was that of 84. The largest number of licences was issued for Professional Investment Funds/Alternative Investment Funds, totalling to 64 new licences during the first three quarters of 2015. As for UCITS, 17 new licences were registered during the period under review. As at the end of September 2015, a total of 147 trustees, fiduciary service providers and administrators of private foundations were licenced. Total Net Assets Value for Collective Investment Schemes stood at EUR 9,727 million as at 2014, constituting around 123% of GDP.

World Economic Forum - The Global Competitiveness Report – Malta's rankings

	2015-2016
Global Competitiveness Index rank	48
Availability of financial services	25
Affordability of financial services	23
Financing through local equity market	33
Ease of access to loans	16
Soundness of banks	15

Source: World Economic Forum - The Global Competitiveness Report

The World Economic Forum's Global Competitiveness Report, places Malta well within the top 50 most competitive countries worldwide. Malta is ranked at the 48th place in the 2015-2016 Competitiveness Index. With respect to financial market development, which constitutes one of the 12 pillars of the Global Competitiveness Index, Malta ranks in the 40th place. This pillar includes criteria such as the availability of financial services, the affordability of financial services, financing through the local equity market, ease of access to loans and soundness of bank, with the latter ranking at 15th place. Moreover, in this report, Malta is grouped amongst the most advanced economies worldwide, together with countries such as Switzerland, Germany, Denmark, Sweden, UK, Japan and the United States.

Malta’s Sovereign Credit Rating

	Fitch	Moody's	Standard & Poor’s
2015	A	A3	BBB+

Source: Central Bank of Malta – Financial Stability report

In 2015, Fitch Ratings affirmed Malta’s ‘A’ rating for long-term foreign and local currency issuer default with a stable outlook. The key contributor to this rating has been the gradual improvement in Malta’s public finances, primarily triggered by the strong economic growth and lower nominal interest expenditure. Fitch Ratings outlook is projected on a decline in headline fiscal deficit during 2015, together with the improvement registered in fiscal management following the implementation of the Fiscal Responsibility Act, Eurozone fiscal rules and the establishment of a Fiscal Council. Moreover, falling unemployment, lower energy costs and steady credit growth have contributed positively to private consumption growth. Fitch also expects inflation to pick up and also acclaims Malta’s resilient banking sector.

Moody’s Investor Service maintained its rating of ‘A3 with a stable’ outlook. This rating is supported by Malta’s robust growth outlook and the reliable access to domestic funding. Moody’s also makes reference to the positive economic impact emanating from government reforms in the energy sector and labour market, as well as buoyancy in tourism and fiscal consolidation measures which led to more sustainable finances.

Malta’s outlook by Standard & Poor’s Rating Services was revised upwards in July 2015 from stable to positive, retaining the same ‘BBB+’ rating for long and short term foreign and local currency sovereign credit ratings. S&P’s expects Malta to continue outperforming its euro area peers, primarily as a result of investments in the energy sector. However, it cautions on the growing burden pursued by pension and health care systems on public finances in the medium term.

4. Regulatory and supervisory developments in the EU

Banking Union

The 2007/8 financial crisis has been an eye-opener on the vulnerabilities that the banking system may transmit to the stability of the financial system. The resolution to set up the Banking Union allowed for the supervisory harmonisation of 123 significant banks in the Euro Area through the setting up of the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the Single Rulebook. In the local context, the ECB identified Bank of Valletta plc, Deutsche Bank (Malta) Ltd, and HSBC Bank Malta plc, as being significant and thus falling under its direct supervision. These banks were classified as significant institutions on the technical grounds that each had total assets above 20% of GDP. The ECB also identified 16 banks operating in Malta which are of ''less significance'' which will continue to be supervised by MFSA. This notwithstanding, the less significant institutions may still be subject to direct supervision by the ECB in order to ensure consistent application of high supervisory standards.

The SSM seeks to ensure consistent supervision leading to further integration in financial regulation, thus increasing synergies between banks in the euro area. Although the SSM will contribute towards reducing the probability of bank failures, the eventuality of the latter will be addressed by the SRM. The Single Resolution Board (SRB), which has been in operation since 1 January 2015, is the resolution authority of the SRM overseeing the resolution of failing banks while ensuring that costs for taxpayers and the real economy are minimised. Set up under the SRM is the Single Resolution Fund (SRF) in which banks in the Banking Union are obliged to pay annual contributions to be used to help troubled banks after all other options have been exhausted. The SRB is expected to be fully operational, with a complete set of resolution powers, from January 2016.

The supervisory and resolution mechanisms form part of a set of common rules for banks in all 28 Member states, referred to as the 'Single Rulebook'. During 2014, the European Banking Authority (EBA) issued 93 technical standards providing EU banks with uniform definitions of key components such as non-performing loans, capital and high quality liquid assets. By the end of 2015, around 40 additional technical standards are expected to be issued, such that by the end of 2016, the whole reform package should be in place.

Developments from the banking comprehensive assessment

EU banks have made progress in strengthening their capital positions since the 2014 Asset Quality Review and EU-wide stress test. During 2015, the EBA conducted a transparency exercise, providing detailed data on EU banks' balance sheets and portfolios. The data collected covered the banks' capital positions, risk exposure amounts and asset quality for the reference dates of 31 December 2014 and 30 June 2015. In Malta, Bank of Valletta Plc also participated in this EU-wide transparency exercise. The main outcome of this exercise shows that, in general, EU banks have continued to strengthen their capital positions, principally through raising additional equity and retaining earnings. The common equity tier 1 ratio (CET1) reached 12.8% as of June 2015, 11.8% on a fully loaded basis. Malta registered a CET1 ratio of 11.24% as of June 2015, reflecting the CET1 ratio of Bank of Valletta Plc. Leverage ratios appear to have benefited from capital improvements in recent years with an EU aggregate ratio at 4.9% as of June 2015. The quality of assets and the levels of profitability have also improved, albeit from a low base and remain a source of concern.

The Board of Supervisors of the EBA decided to start preparations for an EU wide stress test in 2016. The 2016 EU-wide stress test will be based on a constrained bottom-up approach, including a static balance sheet assumption and wide risk coverage to assess EU banks' solvency. This stress test is expected to be launched in the first quarter of 2016 and concluded by the third quarter of the same year. Compared to previous exercises, it will be more closely aligned with the cycle of the annual supervisory review and evaluation process (SREP).

Systemically Relevant Banks

The Central Bank of Malta classifies banks in three main categories: core domestic banks, non-core domestic banks and international banks. This classification is generally revised every two years and is based on a methodology which takes into account five broad criteria reflecting size, substitutability and connectivity. In January 2015, this categorisation exercise was conducted using end-2014 data. The five core domestic banks, being APS Bank Limited, Banif Bank (Malta) plc, Bank of Valletta plc, HSBC Bank Malta plc and Lombard Bank Malta plc remained the most systemically relevant credit institutions in Malta. In addition, this methodology revealed an increase in the domestic relevance of Mediterranean Bank plc, primarily due to its engagement in resident deposits, higher holdings of domestic securities as well as the takeover of Volksbank Malta Limited, rebranded as Mediterranean Corporate Bank Limited in 2014. As a result of this development and product diversification, this group increased its local presence, thus classifying it as a core domestic bank. Moreover, Credit Europe Bank N.V., which was previously classified as a non-core domestic bank, will now be reclassified as an international bank. The main factor behind this reclassification is the declining trend in its resident deposits over recent years.

Assessment of banks' internal models and funding structures

During 2015, the EBA finalised the draft Regulatory Technical Standard (RTS) on the assessment of the Internal Ratings Based Approach (IRBA) methodology. The use of internal models provides banks with the opportunity to use their own estimated risk parameters for the purpose of calculating regulatory capital. Following the EBA's recapitalisation exercise conducted in 2011/2012 and the stress test conducted in 2014, a number of questions were raised regarding the significant differences in the denominator of capital ratios (the capital requirements) and in banks' regulatory parameters (probability of default – PH – and loss given default – LGD). This RTS led to a better understanding of the differences observed in risk weighted assets across EU institutions and contributed to the convergence of internal models including the estimation of risk parameters, their internal use and the calculation of own funds requirement.

During 2015, the EBA also assessed the sustainability of bank funding structures. Asset encumbrance was analysed using a sample of 200 banks. An overall weighted average asset encumbrance ratio of 27% was reported in the EU in March 2015. However, this ratio hides wide discrepancies both between countries as well as institutions. At a country level, the asset encumbrance ratio ranged from close to 0% for Estonia to 44% in the case of Denmark and Greece. Asset encumbrance implies a reduction in the assets available to the liquidator in the event of a default by a bank and therefore reduces the recovery rate of its depositors and other unsecured bank creditors. The asset encumbrance ratio reported for Malta was below 10% for both December 2014 and March 2015. The EBA intends to monitor trends in the level of total asset encumbrance, the availability of collateral for central bank funding and the use of central bank funding, on a yearly basis.

The implementation of Solvency II for the Insurance sector

Remarkable regulatory developments have been achieved in preparation for the implementation of the Solvency II framework in 1 January 2016. The first set of guidelines issued by the European Insurance and Occupational Pensions Authority (EIOPA) seek to ensure a consistent and uniform implementation of Solvency II. These guidelines include details on the valuation of technical provisions, on the use of internal models, on the classification of own funds and on group solvency.

Following these guidelines, the EU commission published the first set of Solvency II Implementing Technical Standards which principally dealt with the supervisory approval procedures for undertaking-specific parameters, ancillary own funds, matching adjustment, special purpose vehicles, internal models, and joint decision on group internal models. In April 2015, there has been the phasing-in of Solvency II whereby insurers could formally seek for the approval by their supervisors of the application of those particular elements of the new prudential framework. The second set of draft ITS and Guidelines for Solvency II were published by EIOPA in July 2015. These cover different areas from all three Solvency II pillars (quantitative basis; qualitative requirements; reporting and disclosure) and are aimed at facilitating the final preparations for reporting under Solvency II by insurance and reinsurance undertakings. The preparatory phase of implementing the new Solvency II framework for the insurance and occupational pensions sector terminates on 31 December 2015.

EU-wide pension stress test in 2015

In 2015, EIOPA conducted an exercise with respect to the resilience of the pensions sector. This exercise involves a stress test for Institutions for Occupational Retirement Provision (IORPs) and a quantitative assessment on the solvency of IORPs. It was launched in May 2015 and is expected to be concluded by the end of 2015. Pension funds are experiencing a challenging environment, both as a result of the prolonged period of low interest rates as well as the rising life expectancy.

This stress test will only be conducted for those countries whose IORP sector exceeds 500 million euros in assets and therefore Malta does not fall within the scope of this exercise. The stress test will contribute to assessing the resilience of this sector in the EU to various adverse scenarios and a longevity scenario. It is conducted in seventeen European countries and covers both defined benefit (DB) and defined contribution (DC) plans. The quantitative assessment on the solvency of IORPs will seek to determine the potential uses of the holistic balance sheet within an EU-wide supervisory framework. This will enable EIOPA to further develop its Advice to the European Commission on EU Solvency rules for IORPs which is expected to be delivered in March 2016.

Policy measures for Global Systematically Important Insurers (G-SII)

The International Association of Insurers Supervisors (IAIS) together with other standard setters, central banks and financial sector supervisors has sought to develop a framework of policy measures for Global Systematically Important Insurers (G-SII). The 2014 G-SII assessment exercise identified 9 insurers which are classified as global systemically important on the basis of size, global activity, interconnectedness, non-traditional insurance and non-insurance activities and substitutability. The identified insurers are Allianz SE, American International Group, Inc., Assicurazioni Generali S.p.A., Aviva plc, Axa S.A., MetLife, Inc., Ping An Insurance (Group) Company of China, Ltd., Prudential Financial, Inc. and Prudential plc. Global Systematically Important Insurers (GSIIs) can be described as those insurers whose distress would cause significant disruption to the global financial system and economic activity, as a result of their size, complexity and interconnectedness. Given the higher risks that such insurers pose to the financial system, a higher loss absorbency (HLA) is required by G-SII. The Basic Capital Requirement (BCR) combined with the HLA requirement for G-SII is a key component of the IAIS' G-SII policy measures. The development of BCR was finalised in October 2014 whereas the initial version of HLA was developed in September 2015. From 2019, G-SIIs will be expected to hold regulatory capital that is not less than the total required by the sum of the BCR and HLA requirements. From 2015, the BCR is reported by G-SIIs on a confidential basis to group-wide supervisors. Similarly, the HLA will start being reported on the same basis by G-SIIs as from 2016.

Developments in European securities and markets

The European securities and markets sector is endeavouring towards supervisory convergence with respect to the implementation, supervision and enforcement of common EU rules. This is in tandem with the continued work undertaken by ESMA towards enhancing the protection of investors and reinforcing stable and well-functioning financial markets in the EU. During the year, three important pieces of post-crisis financial regulation were published, namely the Markets in Financial Instruments Directive (MiFID II), the Market Abuse Regulation (MAR) and the Central Securities Depositaries Regulation (CSDR), all contributing towards a fairer, safer and more efficient market.

The key rules under MiFID II include the introduction of tests to determine whether a non-financial firm's speculative investment activities are large enough to be subject to MiFID II, rules governing high-frequency-trading, a newly introduced liquidity assessment for non-equity instruments, newly introduced reporting requirements for commodity derivatives and improved disclosure to strengthen the best execution regime. MAR will principally contribute towards increasing market integrity and investor protection by extending the scope of the existing market abuse framework to new markets, platforms and behaviours. Finally, the CSDR seeks to ensure that central securities depositaries (CSDs) are safe, efficient and sound by providing organisational, conduct of business and prudential requirements as well as introducing a settlement discipline regime.

A key framework that contributes to the further integration of financial systems between member states and deepening of the Economic and Monetary Union (EMU) is the proposed setting up of a Capital Markets Union (CMU). The importance of a CMU is reiterated in the Juncker Commission's Investment Plan and in the Five Presidents' Report. The Chair of ESMA, Mr Steven Maijoor, in a speech at the Luxembourg Stock Exchange Day, highlighted that the development of a CMU is of strategic importance in the quest for economic growth. It represents a new dimension of Europe's single market and its objective is to mobilise capital in Europe.

In view that the level of investment in the EU dropped by 10 per cent as a consequence of the economic and financial crisis since its peak in 2007, the CMU is envisaged to unlock investment that will assist in filling the existing gap. Stronger capital markets will principally contribute towards channelling capital to companies and provide households with better incentives with respect to retirement goals. Capital market integration better connects financing to investment projects across the EU and increase stability in the financial system through the sharing of risks. The CMU will also lead to more cross-border sharing, more liquid markets and more diversified sources of funding which deepens financial integration and increases competition.

The major challenges facing this CMU include the fact that investment in Europe is still heavily reliant on banks. Moreover, the differing rules and market practices for products like securitised instruments or private placements as well as the different financing conditions between member states may limit the mobilisation of capital in Europe. The European Commission also highlights the limited access to finance by SMEs as a challenge to the CMU.

For the CMU to be successful, a number of actions need to be taken. These principally involve supporting financing for innovation, start-ups and non-listed companies, making it easier for companies to enter and raise capital on public markets, investing for long-term, infrastructure and sustainable investment and fostering retail and institutional investment. Moreover, during 2015, action was taken with respect to leveraging banking capacity to support the wider economy. This includes work on an EU-wide framework for covered bonds and similar structures for SME loans. The Commission is also seeking to foster cross-border investment such that it plans to report on national barriers to the free movement of capital in 2016 and to review the EU macro prudential framework by 2017.

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