

Alexander Demarco: No room for complacency with heightened global trade uncertainties

Address by Mr Alexander Demarco, Acting Governor of the Central Bank of Malta, at the Institute of Financial Services' annual dinner, St Julian's, 22 November 2024.

* * *

Introduction

Last year's annual dinner took place at a time when policy rates in key advanced economies had reached their highest level in a long time. Inflation was moderating but core inflation remained high and the case to start reducing the restrictiveness of monetary policy was not yet clear.

That picture has changed.

Disinflation has progressed in a broad-based manner and is not solely driven by lower energy inflation. Global core inflation has also come down steadily. As the inflation outlook improved, key central banks began to dial back the restrictiveness of monetary policy.

Monetary policy

Since last November, the inflation situation in the euro area has continued to improve. The annual inflation rate has fallen from 2.9% at the end of last year to 2.0% in October. Measures of core inflation have also come down over the same period, though services inflation still remains somewhat high. Overall, the decline in inflation reflects the unwinding of earlier shocks to energy prices and the easing of supply bottlenecks that were evident after the pandemic. At the same time, monetary policy tightening also played a role, by dampening domestic demand and keeping inflation expectations well anchored. Indeed, the ECB staff projections from September foresee inflation to average 2.5% this year, falling to 2.2% in 2025 and to 1.9% in 2026, though market participants now expect inflation to reach 2% already by early 2025.

At the same time, the economic recovery in the euro area is losing steam. After moderate growth in the first half of the year, incoming information points to weakness in domestic demand and strong competitive pressures on the external side. Additionally, trade fragmentation and decoupling among large geo-political blocs, with increased risks of trade tariffs, especially after the outcome of the US presidential election, does not bode well for open economies, like that of the EU. However, the labour market remains resilient, which, together with declining inflation and rising real incomes provides opportunities for recovery in growth going forward, though recent higher household saving may suggest a more muted recovery in consumption than previously expected.

Against this backdrop, the Governing Council of the European Central Bank has begun to unwind some of the restrictiveness of its monetary policy stance. After having raised interest rates rapidly in 2022 and 2023 in response to the sharp rapid rise in inflation,

the Governing Council cut interest rates in June, September, and October this year, bringing the deposit facility rate, which is the rate used to steer the monetary policy stance, down to 3.25%, and market expectations are that this is likely to continue in December.

At the current level, the monetary policy stance remains restrictive, with short-term interest rates above where we think the neutral rate should be. This means that there is still room for the Governing Council to cut rates further, as achieving the 2% medium-term inflation objective in a timely and sustainable manner is increasingly within reach. Nevertheless, in view of the elevated uncertainty, the Governing Council should continue to follow a cautious meeting-by-meeting approach in setting the interest rate path.

Maltese economy

The Maltese economy has benefited from the global disinflation process.

A year ago, overall HICP inflation and the core measure were close to 4%. By October 2024, overall HICP inflation fell to 2.4%, while HICP excluding energy and food decreased to 2.2%, which are both broadly in line with Malta's long-term average inflation. The degree of disinflation has been faster than expected. In December 2023, Bank staff expected HICP inflation to ease to 3.0% this year, but data up to October suggest that average inflation is likely to stand closer to 2.5%.

Domestic inflation decreased despite a still tight labour market and strong growth in services activities. Although economic growth in the first half of this year moderated when compared to 2023, partly due to base effects, it surprised on the upside and remained well above that in the euro area. In part, this reflects the continued, albeit declining, fiscal deficit, including the retention of energy subsidies which supported households' purchasing power as inflation was moderating. The limited pass-through of the ECB's tighter monetary stance to lending and deposit rates is also likely to have contributed.

The transition to a more neutral monetary stance should support foreign demand going forward and mitigate somewhat the slower recovery outlook for the euro area. Meanwhile, domestic demand should continue to benefit from the ongoing disinflation, with real wages catching up, and disposable income bolstered by the recently announced income tax savings and increases in social benefits. In view of these factors and the stronger than expected GDP growth in the first half of this year, the Bank intends to revise up its growth projections, while inflation projections are not expected to be revised materially.

Nevertheless, there are reasons to be cautious in the degree of optimism.

The inflation outlook remains sensitive to future developments in commodity prices, productivity growth, and firms' ability to absorb wage increases through profit margins.

The ongoing escalation of geopolitical tensions and recourse to trade protectionism could lead to renewed disruptions to global supply chains and higher import costs. Trade fragmentation instigates inefficiencies, with risks to jumps in the price level and

downside risks to growth. As Malta is a small open economy heavily dependent on international trade in various markets around the globe, trade fragmentation is a cause for concern.

Inflationary pressures may also arise from the transition to a climate neutral economy and the application of the EU's Emission Trading System (ETS) to additional sectors such as maritime and road transport. In this regard, preliminary analysis by Bank staff indicates that the increase in Malta's commodity import prices due specifically to the extension of the ETS to maritime transport should be small, as would be the effect on economic growth and inflation. Nevertheless, the impact differs significantly across products and sectors, with implications for the competitiveness of certain industries. The impact also depends on various factors, including the level of future ETS prices, the extent of spillovers from trading partners' import price shocks, and potential diversions in shipping routes. However, it needs to be emphasised that while the green transition is likely to entail costs in the short-term, the benefits of such transition are not only environmental, but are also economic in terms of reduced dependency on energy imports and exposure to the volatility of their prices.

Furthermore, although the fiscal deficit is narrowing towards 3% and the debt ratio is still well below 60% of GDP, an economy running at virtually full employment for some years well-into the post-pandemic period should not be recording fiscal deficits. Reducing the fiscal deficit at the pace of around 0.5% of GDP per annum would mean that it will take up to around 2033 to get back to a small surplus. While the gradual approach adopted in unwinding the fiscal deficit is understandable, fiscal policy could be bolder going forward to create additional space for future shocks, by for example adopting a more targeted approach to subsidies.

The favourable growth prospects for the Maltese economy also offer an opportunity to re-examine and reprioritise public expenditure towards more vulnerable groups, and initiatives that impact favourably productivity, innovation, and the green and digital transitions.

Macro-financial developments

Against the backdrop of a benign domestic macroeconomic environment, financial stability conditions in Malta improved. Our banking sector continues to maintain solid capital and ample liquidity positions, consistently surpassing regulatory requirements. Over the past year, banks have seen a notable rise in profitability, largely driven by higher net interest income, partly reflecting the substantial placements with the Eurosystem, but also opportunities to invest in securities as yields rose substantially. Income from intermediation also rose, as robust credit dynamics persisted, though predominantly driven by property-related activity. While this signals increased confidence among lenders and borrowers, it also raises concentration risk on banks' loan portfolios.

Such robust developments underscore the slow pass through of the transmission of monetary policy in Malta, as lending rates remained largely unchanged despite increases in key policy rates. Together with the continued strong growth in tourism

demand and employment, the limited transmission of monetary policy, especially on property-related lending rates, is partly contributing to sustain property-price inflation of around 7%.

As capital continues to flow into the property market, especially now that monetary policy is becoming less restrictive, we need to remain vigilant about potential vulnerabilities, particularly if economic conditions shift. So, while credit growth can reflect and support the economic momentum, if it grows unsustainably it might lead to imbalances and the materialisation of systemic vulnerabilities. Macroprudential policy has an important role to play in ensuring adequate resilience within the financial system. This is more so given that the low pass-through of monetary policy limits its ability to attenuate credit cycles. As it has done in the recent past, the Bank stands ready to use such tools once again to ensure adequate resilience in our financial system. In this regard, the Bank has already made its intention clear that it will strengthen its policy approach regarding concentration and cyclical risks emanating from the real estate sector, should the need arise.

However, systemic risks are not confined to the banking sector. As digitalisation and technological innovation proliferates, activities of financial sector players, including non-bank financial institutions (NBFIs), fintech firms, and traditional banks, increasingly overlap and compete for market share. The non-bank financial institutions sector comprises a wide spectrum of entities with very diverse business models and risk profiles. Indeed, it is becoming increasingly challenging to categorise key market players, as the domains of finance and technology continue to blur. This is why regulation both from a micro and a macro perspective is expanding beyond banking. Entities that perform some bank-like activities are susceptible to propagate bank-like risks and may amplify risks through the liquidity and leverage channels. These institutions are typically also less regulated, hence exacerbating counterparty risk for the banking sector. This is why at the European level we are now also looking at implementing macroprudential tools on non-bank financial institutions.

But beyond the systemic aspects of this sector, risks increase as the constellation of firms in this sector expands. While such risks need to be managed, the contribution of such firms in terms of innovation and competition is undoubtedly beneficial to the consumer. Therefore, a balance is needed to foster the right working environment for NBFIs to continue thriving, while minimising risks, including reputational ones for our jurisdiction from possible misconduct of individual firms. This must be seen in the context of the ever-intensifying competition on the speed of transaction execution and onboarding spurred by technology. Regulation and oversight need to keep pace with such developments, but, as the first line of defence, practitioners attracting such business also have a crucial role in fostering a safe environment for these emerging sectors to grow sustainably.

While delving into the topic of non-bank financial activity, I would also like to make some reflections on the local capital market and its potential to play a bigger role in funding the changing needs of Maltese firms, mostly arising from climate change and technology-driven considerations. To realise this potential, capital markets require the trust and confidence of investors. This is achieved, amongst others, by strengthening regulatory frameworks and requirements and minimising asymmetric information. Introducing private debt issuer and issuance ratings should be a fundamental

requirement to enable investors better assess whether yields are commensurate with the risk being taken, and to establish a more level playing field in financial markets. Similarly, use of sinking funds should be required to ensure private debt issuers have sufficient funds at redemption time, particularly in cases of rollover of such instruments or new issuances for re-financing purposes to minimise rollover risk and the underpricing of risk. Such measures would promote further transparency and resilience within our financial system, ultimately safeguarding economic stability.

The green transition, which involves onerous regulation, requires substantial capital investment in sustainable infrastructure, renewable energy, and technologies that support decarbonization. For the Maltese capital market to effectively fund these efforts, it needs to foster a strong ecosystem of green finance tools and mechanisms that align investor incentives with environmental objectives. Alongside capital markets, banks also have a role to play in financing the green transition, given their established relationships with businesses and their capacity for large-scale funding. To meet the demand for sustainable financing, banks need to continue expand their portfolios to include sustainability-linked credit facilities that support renewable energy projects, energy-efficient infrastructure, and eco-friendly business initiatives. Incorporating further ESG criteria into credit assessments would enable banks to better evaluate and price the risks associated with green investments, ensuring their loan portfolios align with the broader climate objectives.

Concluding remarks

To conclude, as inflation is now sustainably closer to target and the restrictiveness of monetary policy eases, Malta is well-positioned for steady growth but should not remain complacent. Risks from geopolitical tensions, trade fragmentation, and, in the local context, property-centric credit growth, highlight the need for careful monitoring. While fiscal discipline and safeguarding resilience of the financial sector will be crucial to sustain economic stability, economic agents, including policymakers, need to keep their focus on measures and investments that impact positively productivity and innovation, which are ultimately the real source of sustainable economic growth and better living standards.