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Macroeconomic Imbalances – Malta 2013

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

MALTA is *experiencing macroeconomic imbalances, which deserve monitoring and policy action.* In particular, the long-term sustainability of the public finances warrants attention while the very large financial sector, and in particular, the strong link between the domestically-oriented banks and the property market poses challenges for financial stability and deserves continued monitoring.

More specifically, the long-term sustainability of public finances is at risk due to the high projected cost of ageing and other sizeable contingent liabilities. While the real estate market does not appear to be exposed to an immediate risk of boom and bust, ensuring its proper functioning is of particular importance for financial stability. To this purpose, regular monitoring of developments in the property market appears warranted. Risks to domestic financial stability stemming from the presence of a very large financial sector should not be overstated, given the very limited exposure of internationally-oriented banks to the domestic economy, but continued regular monitoring of the activities of the internationally-oriented and the non-core domestic banks is important. Furthermore, the stability of the core domestic banks would benefit from further measures to strengthen loan loss provisions to limit risks arising from their exposure to the property sector.

Excerpt of country-specific findings on Malta, COM(2013) 199 final, 10.4.2013.

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EXECUTIVE SUMMARY AND CONCLUSIONS

In the previous round of the MIP, Malta was not identified as experiencing imbalances. In the updated scoreboard, a number of indicators are above their indicative thresholds, namely, private sector debt, the current account balance and government debt. In addition, the growth rate of total financial sector liabilities has exceeded the indicative threshold several times in the past decade and as a result the accumulated growth in 2011 significantly exceeded the average for the euro area. This in-depth review takes a broad view of the Maltese economy in order to identify actual or potential imbalances and the macroeconomic risks which they may entail. The main observations of this review are:

- **After posting sizeable deficits for most of the past decade, the current account balance has been on an upward path since 2009 and turned into a surplus in late 2011.** The adjustment appears to reflect a structural improvement in the trade balance as services exports increased and goods imports growth moderated, both on the back of a lower import content of exports and the slowdown in the import-intensive construction sector. Additional factors, such as a positive net international investment position and Malta's position as a net external creditor contribute to the sustainability of the external position.

- **The level of private debt in the scoreboard is high, but there are mitigating factors.** Starting from a low level, household debt has increased rapidly in recent years, mainly via growing mortgage lending. Nevertheless, households continue to hold sizeable net financial wealth. High gross corporate debt and leverage raise more concern, but potential risks are mitigated by a number of factors such as the mainly long-term structure of liabilities and the diversification of sources.

- **The long-term sustainability of public finances is at risk.** Government debt amounted to 70.4% of GDP in 2011, up from 60.9% of GDP when Malta adopted the euro in 2008. The government is currently not experiencing problems with debt financing thanks to high domestic demand for issued securities, but sizeable state-guarantees to state-owned companies, some of which not in a sound financial state, represent an important risk to the future dynamics of government debt. Moreover, the long-term projections for both pension and healthcare expenditure in Malta significantly exceed the EU average.

- **Despite some overvaluation and possible oversupply, the property market does not appear to be exposed to an immediate risk of a bust.** Housing prices increased significantly over the past two decades. Overvaluation appears to have occurred in the years before euro adoption, but since then some correction has been taking place. Sharp downward adjustments in prices in the short-term are not expected: demand is robust while developers' balance sheets are strong enough to allow them to abstain from selling at unfavourable prices, even if estimations suggest that there may be oversupply in some segments of the market.

- **The majority of the very large financial sector is internationally-oriented with very little link to the domestic economy, and therefore does not pose large risks for domestic stability.** The domestically-oriented financial sector, which invests in resident assets and funds itself in Malta, is significantly smaller, relatively well-capitalised and profitable. However, its high exposure to the real estate market warrants close monitoring, also in view of a relatively low coverage of non-performing loans through loan loss provisioning. The activities of the non-core domestic banks, which account for around 10% of total assets, appear riskier and therefore require strict supervision.

The IDR also discusses the policy challenges stemming from these imbalances and possible policy responses. A number of elements can be considered for further policy action. These include the need to closely monitor developments in the financial sector, including the internationally-oriented and non-core domestic segments, and to take any appropriate further measures to strengthen loan loss provisions in domestically-oriented banks; close monitoring of developments on the property market, in view of the exposure of the financial sector to it; finally, pension and healthcare reforms are needed to address the long-term sustainability of public finances, while measures to limit unsustainable growth of private indebtedness may be warranted.

1. INTRODUCTION

On 28 November 2012, 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 and what type of follow-up it will recommend to the Council.

The AMR suggested the need to look more closely at whether Malta is exhibiting macroeconomic imbalances of an external and internal nature. On the external side, the AMR highlighted persistent current account deficits in the past. On the domestic side, corporate and government debt levels are elevated. In addition, the size of the financial sector appears to be very large compared to the domestic economy and with a high exposure to the property sector, which has seen very dynamic price growth in recent years. Malta also faces challenges in ensuring the long-term sustainability of public finances in view of population ageing and sizeable contingent liabilities. 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).

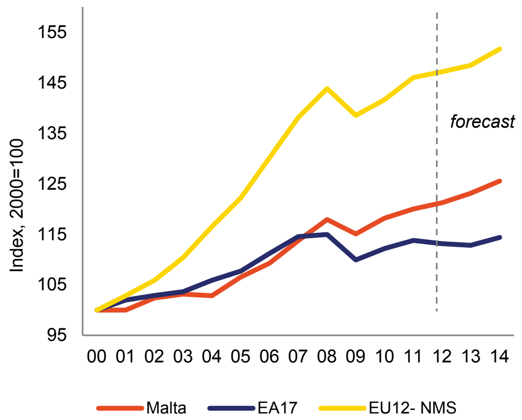
Against this background, Section 2 of this in-depth review looks more in detail into these developments covering both the external and internal dimensions, followed by a specific focus on potential vulnerabilities in the financial sector Section 3. Section 4 discusses policy considerations.

2. MACROECONOMIC SITUATION AND POTENTIAL IMBALANCES

2.1. MACROECONOMIC SCENE SETTER

The Maltese economy demonstrated resilience throughout the crisis. Economic growth in Malta in the years before the crisis was in line with the average for the euro area, but well below the group of new Member States (EU12 – see Graph 2.1). In the aftermath of the global crisis, the domestic economy proved resilient: in 2009, real GDP declined by 2.4%, well below the 4.4% contraction in the euro area. The subsequent rebound was more pronounced than for the euro area average (2.7% of GDP against 2.0% of GDP in the euro area), mainly driven by exports, while domestic demand and in particular the import-intensive investment were subdued. As a result, the current account balance has been gradually improving. Against the background of Malta's still very low participation rates, especially among women and older worker, job creation was strong and the unemployment rate remained at a low level compared to the euro area average. According to the Commission services' winter 2013 forecast, after moderating in 2012, economic growth is projected to accelerate in 2013-14 and to continue to outperform the euro area average, underpinned by gradually resuming business investment and household consumption. Growth is expected to remain job-rich and employment is forecast to continue increasing at a relatively fast rate, mainly thanks to catching up participation and employment among women and older workers, also resulting in decreasing unemployment. Recovering domestic demand is expected to result in worsening external trade balance over 2013-14, although the current account is forecast to remain in surplus.

Graph 2.1: **Malta's real GDP evolution, 2000 = 100**

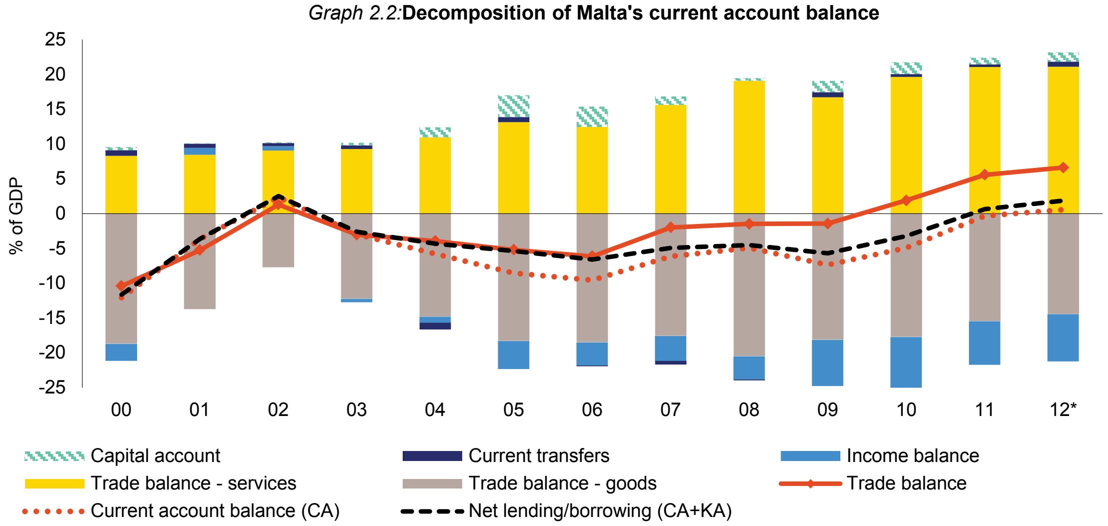


Source: Commission services

2.2. SUSTAINABILITY OF EXTERNAL POSITIONS

Malta's external balance has been characterised by persistent current account deficits for several years up to 2011. After recording a surplus in 2002, the current account averaged a deficit of 6.4% of GDP between 2003 and 2010 (see Graph 2.2). The persistent deficits mainly reflected a negative balance of goods, related to the large import-dependence of domestic demand, including nearly full dependence of the economy on imported oil for energy generation. The income account has also contributed significantly to the deficit in the current account, reflecting the big share of foreign companies operating in Malta, including the very large internationally-oriented banks. Net outflows averaged around 2% of GDP in 2000-08 before increasing substantially to average around 7% of GDP in 2009-11 on the back of higher profits by foreign-owned enterprises. The capital account, having averaged a surplus of just over 1% of GDP throughout the 2000s, has offset some of the current account deficit, thus contributing positively to the net external borrowing requirement.

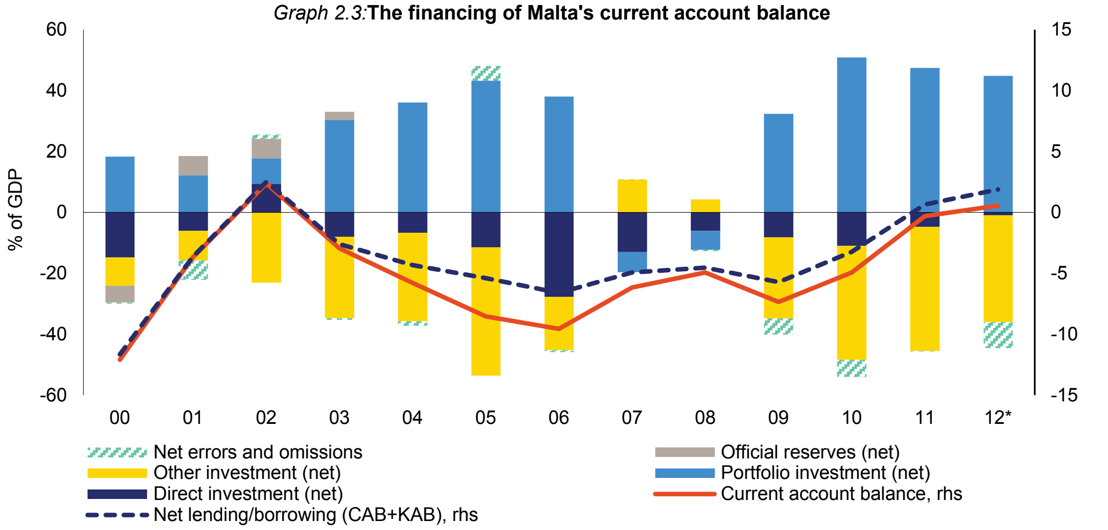
*Graph 2.2:***Decomposition of Malta's current account balance**



Source: Commission services

Past current account deficits have been comfortably financed by FDI inflows, mainly thanks to an expanding banking sector. Malta has historically been an attractive destination for foreign investment, despite the small size of its domestic market. FDI inflows have averaged around 10% of GDP since the beginning of the decade (see Graph 2.3). The majority of respondents in a recent survey by Ernst & Young (2012) indicated that Malta's attractiveness as a destination for foreign investment is related to its stable social climate and corporate taxation regime as well as the reliable and transparent regulatory environment. As Graph 2.4 illustrates, FDI inflows have been largely dominated by the financial sector, which by 2009 represented around 56% of the total stock of FDI in Malta and this share increased to around 80% in 2010, with the arrival of a major German international bank. In fact, FDI represents a relatively small proportion of the gross financing flows in Malta. The banking sector attracts also a significant amount of financing reported as 'other investment' in the balance of payments statistics, which mainly represents loans and deposits transferred from parent institutions into their banking branches and subsidiaries in Malta.

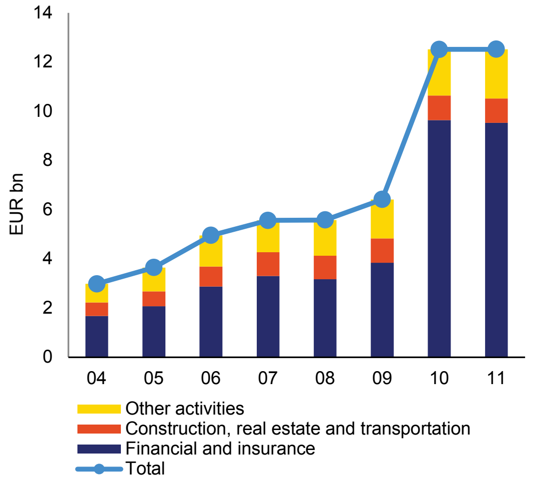
*Graph 2.3:***The financing of Malta's current account balance**



Source: Commission services

As Section 3 discusses, these very large capital flows do not stay in the country but are invested abroad either as loans or deposits in other banks or in the form of portfolio investment. ([1]) The construction sector also attracted a sizeable share of FDI inflows, but these appear to have dried up after 2007-08.

Graph 2.4: **Malta's inward FDI stocks**



Source: NSO

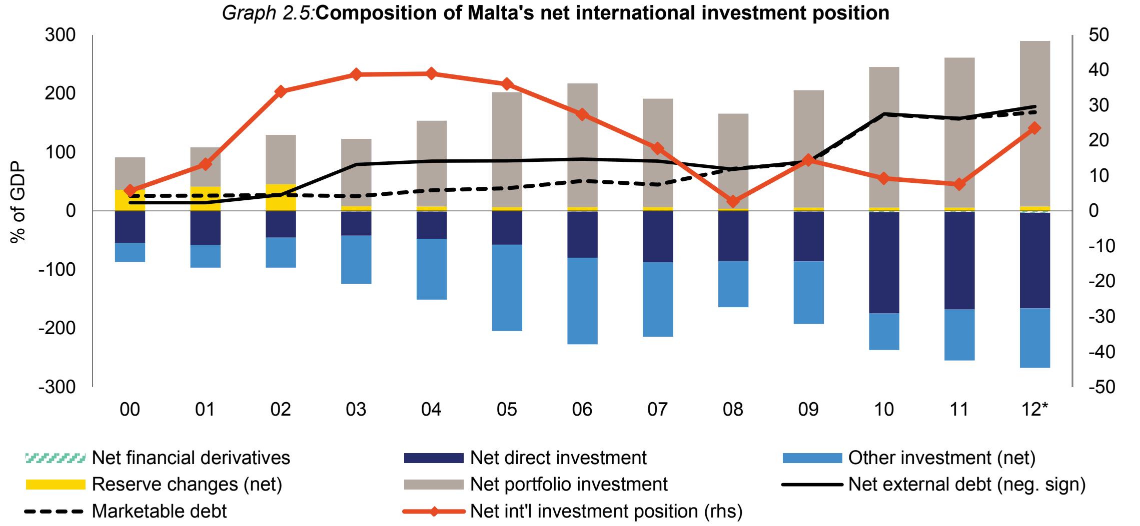
A notable improvement in the current account balance started in 2009. The current account balance moved from a deficit of nearly 8% of GDP at the end of 2009 to a 2% of GDP surplus in the second quarter of 2012 ([2]).

The improvement is mainly attributable to the goods balance, which moved from -21% of GDP at the beginning of 2009 to -15% of GDP in the third quarter of 2012. The slowdown in the import-intensive construction sector (see section 2.6 later), also related to the completion of a major construction project in 2007, as well as a strong increase in exports are key drivers of this development. The continuously expanding services exports also contributed to the improving external balance, driven in particular by tourism ([3]) and financial services as well as the remote gaming industry. A shrinking deficit in the income account has also been contributing to the improvement of the current account balance since the second half of 2011, as net portfolio investment inflows started recovering after the financial crisis in 2008-2009. According to the Commission services' 2013 autumn forecast, the current account is projected to remain in surplus during the forecast horizon. It should be noted, however, that quarterly statistics in Malta are very volatile and subject to sometimes significant revisions (see Box 2.1) and therefore it is still early to draw definitive conclusions based on these data.

([1]) Therefore, the headline capital flows data for Malta can be misleading as a significant share of those does not interact with the domestic economy.
([2]) All Graphs in this paragraph refer to 4-quarter sums. The last available data are for Q3 2012.

([3]) The tourism sector proved particularly resilient and managed to reach record-high levels of arrivals despite the challenging macroeconomic environment in the EU – Malta's main market.

Graph 2.5: **Composition of Malta's net international investment position**



Source: Commission services

The sustainability of Malta's external balance also benefits from a favourable net external debt and positive net international investment position. Thanks to large investments in foreign debt instruments, the net international investment position (NIIP) averaged a surplus of over 20% of GDP over 2001-2011 (see Graph 2.5). Malta is a net external creditor and its positive balance has increased from 4.5% of GDP in 1995 to nearly 160% of GDP in 2011.

The net international investment position (NIIP) reflects large asset and liability stock positions, which largely offset each other. ([4]) Gross foreign assets amounted to 689% of GDP in 2011, up from 122% of GDP in 1995. Of these, gross assets of monetary financial institutions, excluding the central bank, grew from 62% of

Box 2.1: Frequent revisions to Malta's economic data

Revisions of economic data occur frequently in Malta and at times their magnitude is particularly large. Table 1 illustrates the size of the revisions by showing key balance of payments and national accounts data for 2011 as reported in successive data releases by the National Statistical Office: the current account deficit was reported at 3.2% of GDP in March 2012, but was revised to only 0.3% of GDP six months later.

Furthermore, sizeable reported amounts for net errors and omissions in the balance of payments – which could either stem from the current account side (an understatement of exports) or from the financial side (an overstatement of capital outflows) - obscure the picture that comes out of the data. In annual terms, net errors and omissions are reported at over 5% of GDP in 2009 and 2010 (data for these years is still provisional), among the highest in the EU. Large positive amounts for this item have also been reported in the quarterly data since the third quarter of 2011. Finally, changes in inventories – which are normally used as a residual category in national accounts - are often reported to have a significant role in economic activity and are reported to have contributed 1.3pp on average to annual real GDP growth between 2001 and 2011.

Frequent data revisions and the large use of residual categories can to some extent be explained by the difficulty to represent the highly volatile and narrow-based Maltese economy. They are also the result of a number of attempts by the National Statistical Office (NSO) to gauge the ongoing structural changes in the domestic economy. In particular, in 2011, the NSO undertook a major revision of national accounts data to take account of the emerging remote gaming industry. Table 2 shows that the impact of this revision on reported real GDP growth was very sizeable, although it was partly corrected in the latest release. More recently, data revisions were undertaken to reflect the emergence of the oil re-exporting activity as well as the availability of data reclassified under the NACE Rev. 2 methodology.

Overall, the instability of statistical data makes adequate monitoring and forecasting of the domestic economy particularly challenging.

Table 1:
Overview of revisions to balance of payments and national accounts data for 2011 in the latest releases

% of GDP	Mar-12	Jun-12	Sep-12	Dec-12
Current account balance	-3.2%	-1.3%	-0.3%	-0.5%
Trade balance	4.9%	4.2%	5.6%	5.2%
Balance of goods	-15.3%	-15.8%	-15.6%	-16.0%
Balance of services	20.2%	19.9%	21.2%	21.3%
Income balance	-8.6%	-6.8%	-6.3%	-6.1%
Real GDP growth (y-o-y)	2.1%	2.1%	1.9%	1.6%

Source: NSO, Eurostat

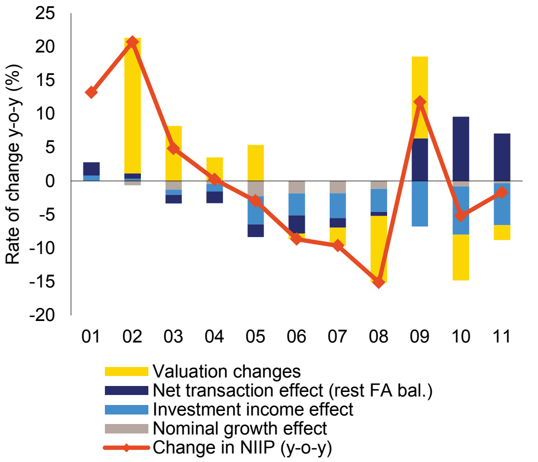
Table 2:
Real GDP growth before and after 2011 revision incorporating the remote gaming industry

y-o-y%	2006	2007	2008	2009
Before revision	3.3%	3.9%	2.7%	-1.9%
After revision	2.1%	4.4%	5.3%	-3.4%
Latest available information	2.6%	4.1%	3.7%	-2.4%

Source: NSO, Eurostat

GDP in 1995 to 581% of GDP, thereby accounting for almost the entire growth of assets abroad in the IIP. Loans and deposits abroad as well as holdings of debt instruments exceeded 600% of GDP in 2011 and represented around 90% of total assets. The liabilities side of the NIIP consists mainly of loans and deposits by parent banks into their subsidiaries in Malta (as well as FDI). In light of these large stock positions, the NIIP is vulnerable to valuation changes. In the past, the contribution of valuation changes to the annual changes in the NIIP has fluctuated between -10pp. and +10pp (see Graph 2.6). Given the presence of two large branches of Turkish banks, the appreciation of the Turkish lira also has a notable impact.

Graph 2.6: **Decomposition of Malta's net IIP changes**



Source: Commission services

The structure of liabilities in the NIIP appears benign although unavailability of data precludes precise conclusions. The majority of foreign liabilities belong to the internationally-oriented banks, which have very limited impact on the domestic economy (see Section 3). Furthermore, the high share of FDI in gross liabilities ([5]) indicates significant shock-absorbing capacity on the part of the banking sector to withstand significant losses, should financial market conditions worsen. Available data, however, is not disaggregated between domestically-oriented and internationally-oriented banks and therefore it is not possible to fully distinguish the impact of the much larger internationally-oriented banks.

2.3. COMPETITIVENESS AND TRADE PERFORMANCE

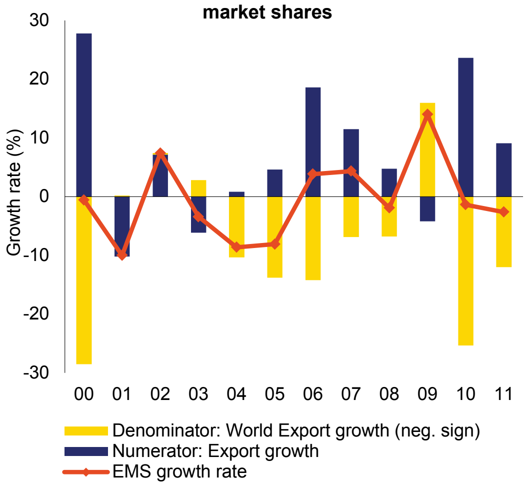
The Maltese economy is very open and total trade (exports plus imports) amounted to around 200% of GDP in 2011. In the trade of services, the main exports are tourism and remote gaming ([6]), whereas the economy imports business services, in particular management and accounting. In terms of goods, the main export is electrical machinery, while new high-technology activities have emerged in recent years, namely in the aircraft and pharmaceuticals sectors. As Malta has increasingly become an important trans-shipment centre for crude oil in the Mediterranean area, trade in oil has also seen significant growth over the past several years. Its net impact on the trade balance, however, appears to be small as it mainly represents re-exporting.

The trade balance has been gradually improving in recent years, mainly reflecting gains in market shares in services. Reflecting the structural shift in the economy, it was trade in the less import-intensive services that drove the improvement. This has been reflected in gains in market shares in the trade of services – in particular recreational services, legal and accounting services and IT – while losing in the trade of goods (machinery and electrical equipment as well as textiles, see Graph 2.7). The improvement in market share in the trade of goods in 2009 reflects the fact that goods exports in that year declined by much less than the world trade.

([5]) FDI represented over 28% of total foreign liabilities of the Maltese economy, slightly higher than the average for the euro area.

([6]) 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.

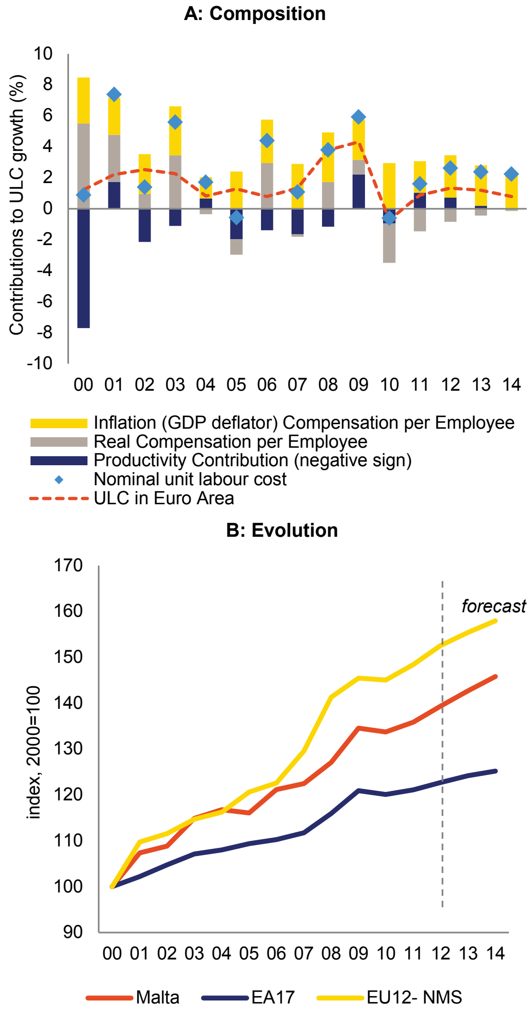
Graph 2.7: **Decomposition of Malta's export market shares**



Source: Commission services

The economy has been gradually losing cost competitiveness vis-à-vis the euro area over the past decade. The growth of nominal unit labour costs, an indicator of the cost of labour needed to produce one unit of output, was notably more moderate than the average for the new Member States but still exceeded the average for the euro area (see Graph 2.8). Compensation per employee increased faster than in the euro area, in particular in the years following EU accession, also because skill shortages in the emerging new industries increased competition for qualified employees and pushed up wages. At the same time, labour productivity growth in Malta has been modest, trailing behind the average increases for the euro area. After 2009, however, wage developments moderated and converged to the relatively slow productivity growth, thus helping the economy to regain some cost competitiveness and support the export-led recovery from the recession in 2009. While the existing automatic wage indexation mechanism (Cost-of-Living Adjustment) does not appear to have been a major hindrance to wage adjustment and overall labour market performance so far, looking forward it poses a potential risk to the economy in particular during strongly adverse phases of the economic cycle, by impeding the adjustment of real wages, in turn impeding the absorption of unemployment and hampering competitiveness.

Graph 2.8: **Unit labour costs in Malta**



Source: Commission services

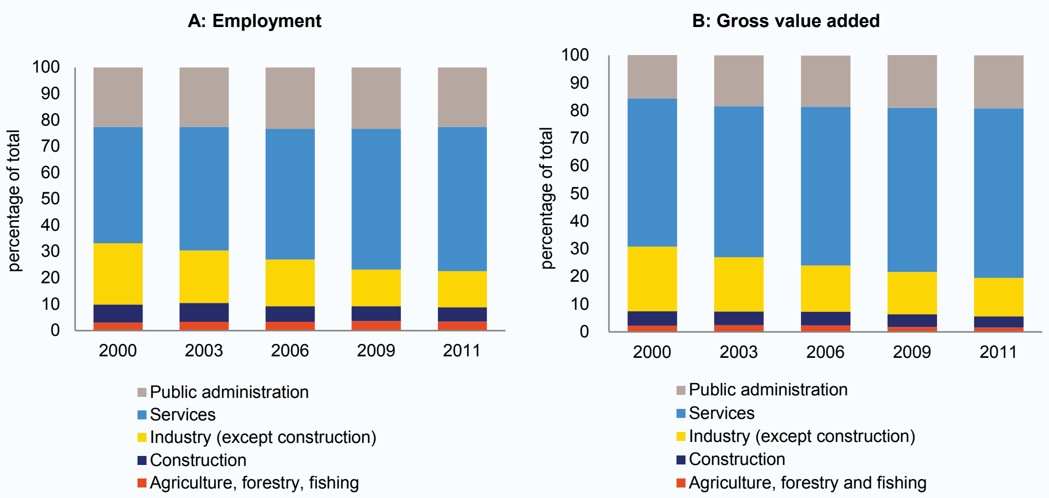
However, price competitiveness improved after the crisis. The real effective exchange rate, a measure of the economy's price competitiveness against a group of competitor countries, appreciated notably before the crisis also reflecting the nominal appreciation of the euro against the US dollar (see Graph 2.8, Panel A). Following 2009, the nominal exchange rate depreciation, which is particularly relevant for Malta given that a significant part of exports goes outside of the EU, and moderate price growth resulted in improving price competitiveness. This trend is also confirmed by dynamics of the ECB's Harmonised Competitiveness Indicator, which looks at a country's price competitiveness vis-à-vis the other

Box 2.2: Economic restructuring in Malta

Malta's production structure predominantly consists of domestic-owned micro enterprises operating alongside a small number of relatively large export-oriented subsidiaries of multinational companies. While the manufacturing sector remains an important pillar of the domestic economy, the share of total value added generated by this sector has been steadily declining - from 21% in 2000 to 13% in 2011 - and its share in total employment declined by almost 8 percentage points over the same period (see Graph 1). This structural change started already twenty years ago, thanks to foreign direct investment and the birth of new and growing industries. In addition, important changes have occurred within the manufacturing sector, with the emergence of activities in pharmaceuticals, precision engineering, aircraft maintenance and medical devices coming to complement the important electronics sector and moving the overall sector to higher technology activities.

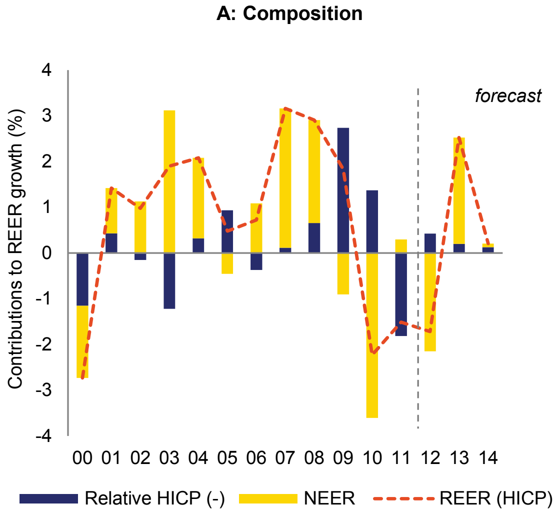
By contrast, the services sector has been gaining in importance, mainly thanks to the emergence of new activities such as remote gaming, financial intermediation, tourism, as well as, more recently, IT, legal and accounting services. In particular, the rapid growth of the remote gaming sector is striking as the number of people employed in it doubled and this sector increased its share in gross value added by around 8 percentage points since 2000. The shift towards services plays an important role in the current account balance improvement due to the much smaller share of imported inputs in total output in their production compared to the production of goods.

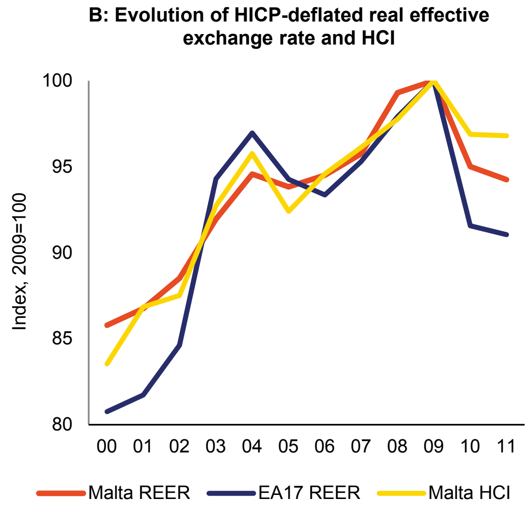
Graph 1: **Malta's production structure**



Source: Commission services

Graph 2.9: **REER**





Source: Panel A Commission services

Panel B Commission services and ECB

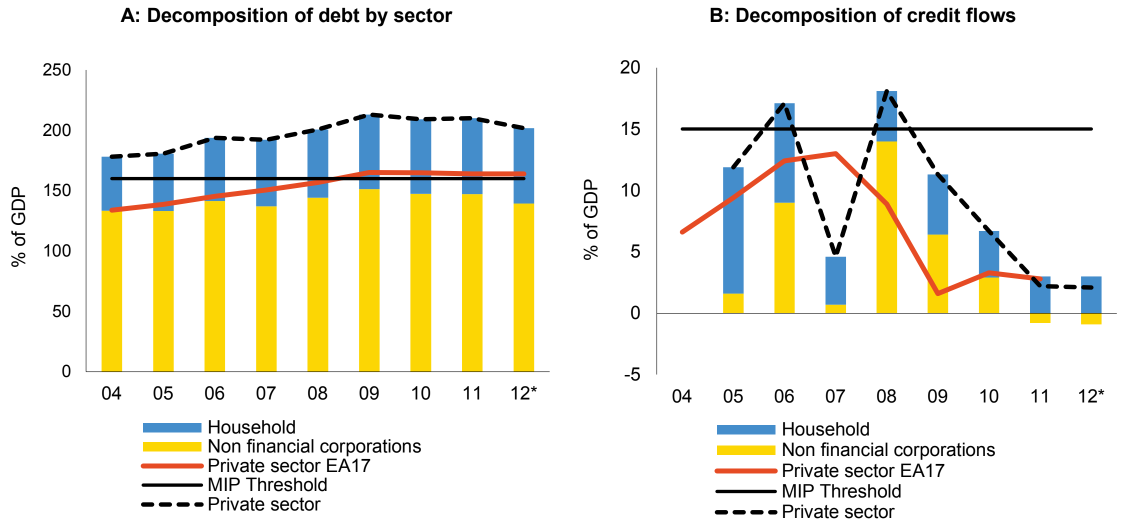
euro area Member States and the euro area's 20 main trading partners (see Graph 2.8, Panel B).

Overall, the economy does not appear to suffer from lack of competitiveness. The economy underwent a structural shift away from traditional manufacturing and towards higher technology activities, mainly in services, in a relatively smooth way. The restructuring was job-rich and thus able to absorb a significant increase in labour participation, in particular as more and more women entered the labour market. While remaining well below the EU average (at 57.6% and 41% in 2011 for the total population and for women, respectively), the employment rate in Malta thus increased substantially since the beginning of the decade, especially for women (7.9 pps). Export market shares increased, mainly in services, but also in some segments of the trade of goods. Price and cost competitiveness have improved following the crisis, thereby supporting an export-led recovery of the economy and a further improvement in the current account balance. A stable regulatory environment and a relatively cheap and skilled labour force certainly contributed to these favourable developments, although skill shortages in some growing sectors, such as financial services, have resulted in upward pressure on wages, which may hamper competitiveness going forward.

2.4. PRIVATE SECTOR INDEBTEDNESS

Private sector debt expanded since Malta joined the EU, to reach 204% of GDP in 2012. Private sector debt increased from 178.2% of GDP in 2004 to peak at 213% of GDP in 2009 before moderating to 204.4% of GDP in 2012 (see Graph 2.10, Panel A). The increase was mainly on the back of growing household indebtedness, reflecting a quickly expanding mortgage market, as a result of which the share of household debt in total private sector debt increased from 25% in 2004 to 30% in 2011. Private sector credit flows (Graph 2.10, Panel B) exceeded the MIP threshold twice during that period on the back of spikes in corporate borrowing, related mostly to the construction and real estate sectors. After 2009, private sector debt stabilised and started gradually decreasing, reflecting to some extent both tighter lending standards by banks and more moderate demand for financing by non-financial corporations, as also evidenced by the relatively low investment-to-GDP ratio in a historical perspective.

Graph 2.10: **Private sector indebtedness**

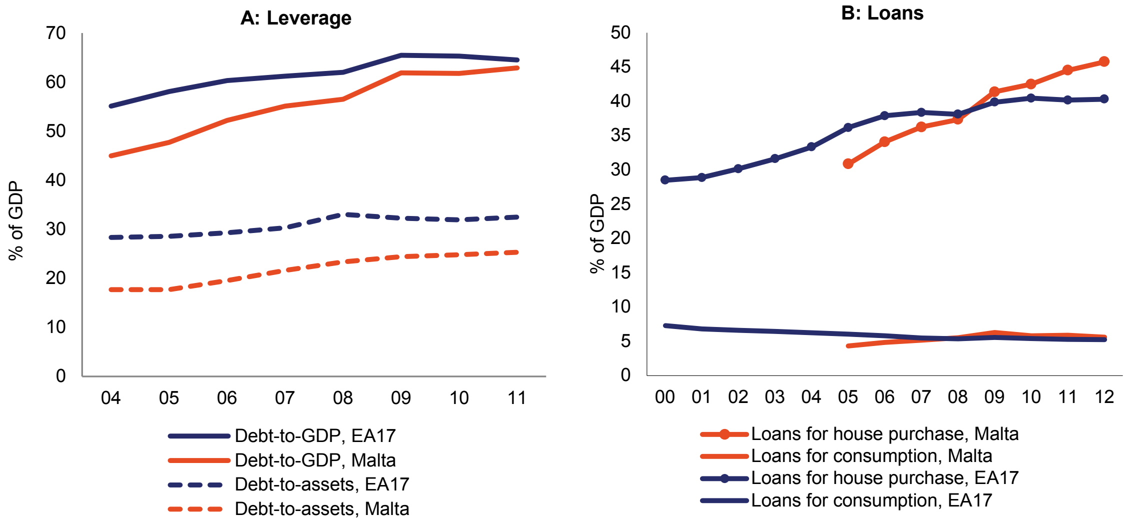


Source: Commission services
Note: * indicates estimated Graph based on quarterly data

Household debt has been increasing at a fast pace, but, starting from a low level, it remains below the euro-area average. At the time of EU accession in 2004, household debt in Malta was relatively low by EU standards, standing at 45% of GDP (see Graph 2.11, Panel A). Since then, it has increased at a fast pace to peak at nearly 63% of GDP in 2011, broadly catching up with the EU average, before moderating slightly in 2012. This has to a large extent been driven by strong demand for loans for house purchases, typically granted at variable rates, and is reflected in the strong increase in house prices.

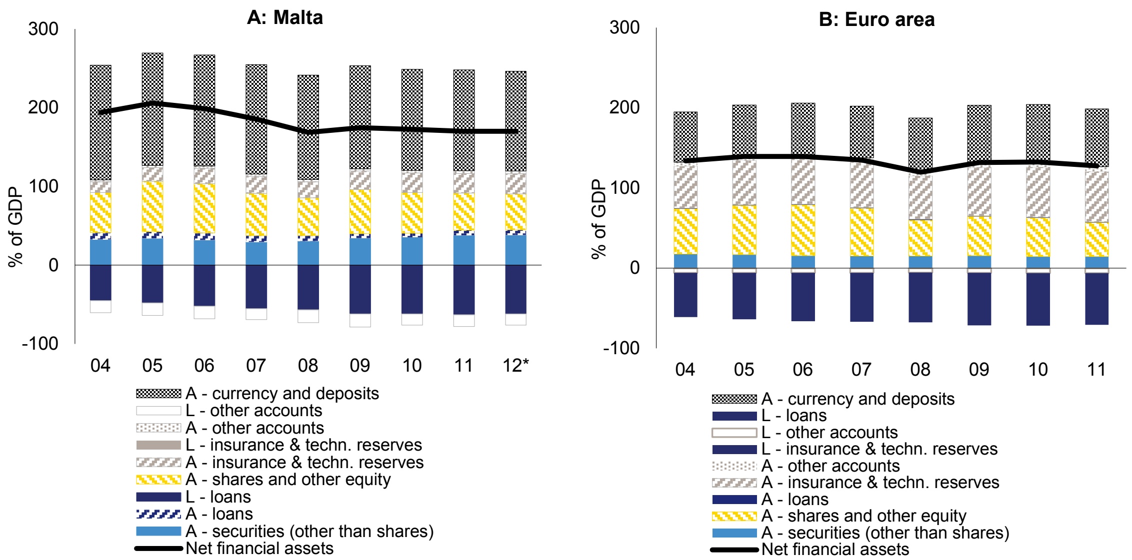
The loan-to-value ratio granted by banks was relatively low, at about 40%, until 2008, which helped to keep household debt in check. However, as demand for housing remained strong, the loan-to-value ratio for new loans has increased to between 70% and 80%. Demand for new mortgage and consumer loans has been more subdued recently, as evidenced by the results of the ECB's regular Bank Lending Survey, although it remains more dynamic than the average for the euro area

Graph 2.11: **Households indebtedness**



Source: Commission services, ECB
Note: * indicates estimated Graph using quarterly data

Graph 2.12: **Financial balance sheets of households**



Source: Commission services
Note: * indicates estimated figure using quarterly data

(see Graph 2.11, Panel B).

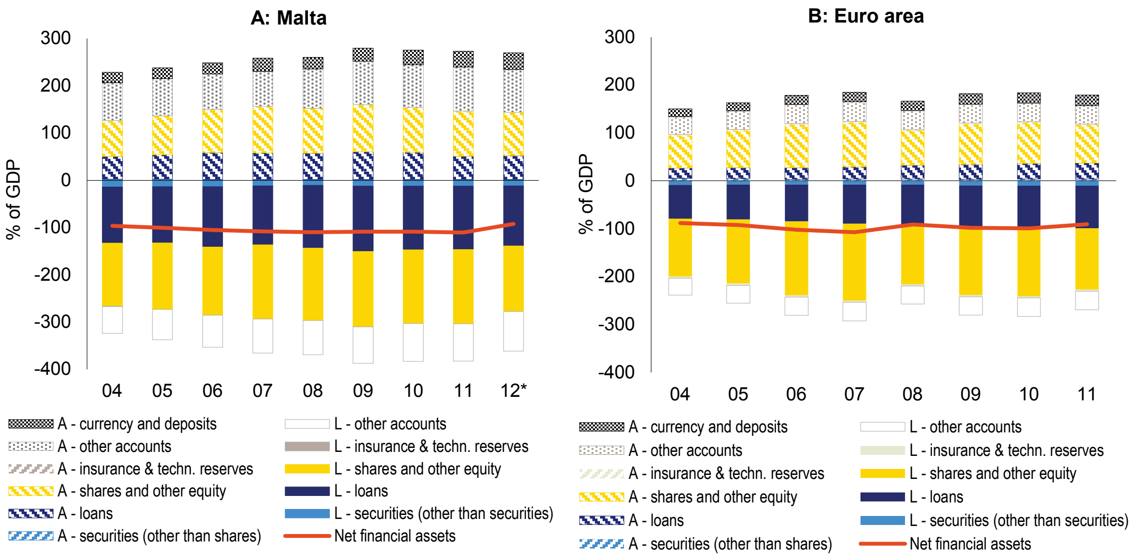
Despite the increase in their indebtedness, households' net financial assets remain positive. Thanks mainly to a high propensity to save, reflected in a high deposit base in the absence of particularly developed domestic insurance and investment fund industries, net financial assets of Maltese households are among the highest in the euro area, standing at 170% of GDP in 2011 (see Graph 2.12). This is an important factor underpinning domestic financial stability as it allows banks to fully finance their lending portfolio with retail deposits, thereby reducing the need for wholesale funding. Maltese households also have considerably more assets invested in government debt securities: as of December 2011, some 29% of Malta Government Securities were owned by individuals (MFEI 2011).

The debt ratio of non-financial corporations (NFC) increased substantially until 2009 on the back of increased borrowing. As a result of improving financing conditions, facilitated by EU and euro-area entry, and partly also thanks to a bias against equity in corporate taxation, [7] the non-consolidated debt of non-financial corporations grew substantially, from 133.2% of GDP in 2004 to 151% in 2009. The increase was entirely driven by loans, while debt in the form of securities is relatively low at around 13% of GDP due the underdeveloped domestic corporate bond market. Since 2009, corporate debt has been on a downward path and reached 143% of GDP in 2012. The main reason for this has been lower credit demand by companies, in line with the more subdued macroeconomic environment in Malta and in the euro area, leading to a drop in the investment-to-GDP ratio. Another important factor is the halt of bank lending to construction and real estate activities, as banks sought to reduce their concentration to the real estate market, as a result of which the share of these two sectors in total lending to residents (including lending to the public sector) fell from over 23% in 2009 to below 17% in November 2012.

The large gross debt figure for corporates hides some positive features. The term structure of debt has been fairly stable over time, with some 50% of total debt in long-term loans, 40% in short-term loans and the rest in securities other than shares. 2011 brought about a slight shift, as a result of which the share of short-term loans decreased to

(7) Malta has the largest gap between the effective marginal tax rates on debt- and equity-financed new corporate investment among the 27 Member States. See *Tax reforms in EU Member States 2012 – Tax policy challenges for economic growth and fiscal sustainability/*

Graph 2.13: **Financial balance sheets of non-financial corporations, non-consolidated**



Source: Commission services
Note: * indicates estimated figure using quarterly data

32%. The sources of financing for Maltese NFCs are quite diverse and in fact despite the presence of a large banking system, bank loans represent only about half of total loans to corporates, or 64% of GDP in 2011, down from a peak at 69% of GDP in 2009 (see Graph 2.13). In the same year, total loans in non-consolidated terms were 134% of GDP. An important part of the debt of non-financial corporations is in the form of short-term intra-company loans, including from abroad, which are fully matched by intra-group loans on the asset side. Thus, in consolidated terms corporate debt was much lower, at 106.3% in 2011 (up from 93% in 2004). Financing in the form of loans and deposits from non-residents increased from 6.6% of GDP in 2004 to 14.4% of GDP in 2011. Additional sources of financing include inter-sectorial and household loans. A diverse mix of funding sources reduces the funding risk for companies and therefore contributes to domestic financial stability.

The leverage of non-financial corporations appears high, but corporations still have sizeable financial assets. Despite the high level of debt, the corporate sector also has sizeable assets and when expressed as a ratio to financial assets, Malta stands below the euro area average. In addition, the ratio has been declining since 2004 to reach 53.9% in 2011 thanks to increases in total financial assets and in particular in unquoted shares, trade credits and bank deposits. However, the debt-to-equity ratio exceeds the euro-area average, reflecting an underdeveloped domestic equity market and the tendency for the smaller family-owned Maltese enterprises (which make up the overwhelming majority of firms) to refinance themselves internally or take bank loans rather than to look for equity financing. The elevated ratio is also encouraged by the high bias towards debt-financing in corporate taxation. ([8]) Although the debt-to-equity ratio for NFCs in Malta has been gradually declining since 2004, companies face a growing debt-servicing burden as indicated by the relatively high ratio of debt to the gross operating surplus, which exposes them to interest rate fluctuations. Even though major liquidity problems are not expected in the short term due to the favourable structure of the debt, some deleveraging might be needed, in an environment of projected slower growth compared to the pre-crisis years, in order to free up more resources for productive investment thereby improving the economy's growth potential.

([8]) 2011 data showed that Malta had the highest debt bias in the EU (EC 2012f).

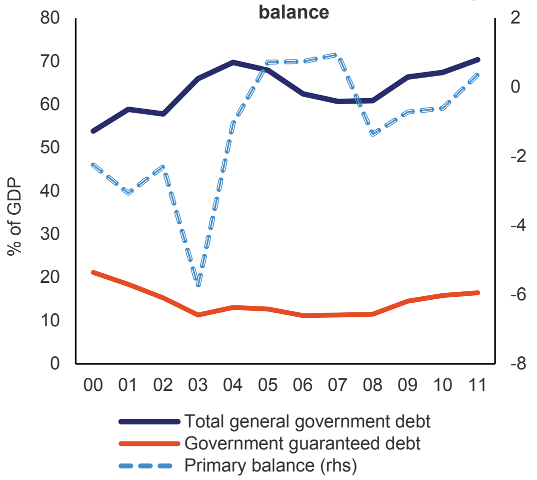
2.5. GOVERNMENT DEBT

A public debt above the Treaty threshold and an ageing population pose risks to the long-term sustainability of Malta's public finances. The government debt ratio in Malta is lower than the euro-area average but exceeds the reference value of 60% of GDP and has been on a rising trend, reaching 70.9% of GDP by end-2011. In the period prior to EU accession, Malta's government debt increased steadily, up from around 34% of GDP in 1995 to 69.8% of GDP in 2004, as a result of high primary deficits. In the run-up to the euro adoption, Malta's government debt fell from the peak reached in 2004 to around 62% in 2008, mainly thanks to an improving fiscal position and proceeds from the privatization process. In 2008, after euro adoption, the primary surplus turned negative and the debt-to-GDP ratio started increasing again (see Graph 2.14). The worsening fiscal position reflected the onset of the crisis as well as substantial deficit-increasing one-off measures (i.e., the reclassification of Malta Shipyards Ltd within the general government sector) and some slippages in current expenditure. Still, the increase in the general government debt was more moderate than in the rest of the euro area, also because the banking sector did not require public support.

The government debt does not have potential spillovers to other countries of the euro area. Government debt in Malta is almost entirely held by residents, with non-residents accounting for only 2% of the outstanding debt. Financing Malta's debt has so far not posed any problems and spreads between yield on Maltese and German sovereign bonds have not been significantly affected by the tensions in financial markets generated by the sovereign debt crisis. In fact, the apparent cost of debt (interest expenditure over total nominal debt) decreased over the period 2008-2012 from 5.1% to 4.4%, in spite of a large (around 12 pp due to the real GDP contraction in 2009) increase in the debt ratio. In addition, short-term debt has decreased significantly since the EU accession and in 2011 it accounted for 6.7% of total government debt (from 20.2% in 2004). The lengthening of the maturity structure of government debt is expected to further reduce the risk of a sudden increase in the interest rate on government debt that may materialise in the future should economic conditions deteriorate or sudden changes in interest rates and market sentiment occur.

However, population ageing will result in age-related expenditure growing faster than the EU-average (EC 2012h)**.** 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. The increase in pension expenditure, incorporating the impact of the 2006 pension reform, accounts for more than half of the total projected increase. Under the European Semester in 2011 ([9]) the Council issued a country-specific recommendation to Malta to take action to ensure the long-term sustainability of the pension system. In response, consultation with social partners has taken place, but concrete action has yet to be taken. Another important contributor to the increase in age-related expenditure is health care, which is projected to increase by 2.9 pps. of GDP over the period 2010-2060, the highest increase in the EU.

Graph 2.14: **Government debt and primary balance**



Source: Eurostat

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. At 16.4% of GDP in 2011, contingent liabilities imply a total public guaranteed debt of around 87% of GDP in 2011. More than half of these liabilities, as well as most

([9]) See http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2011:215:0010:0012:EN:PDF.

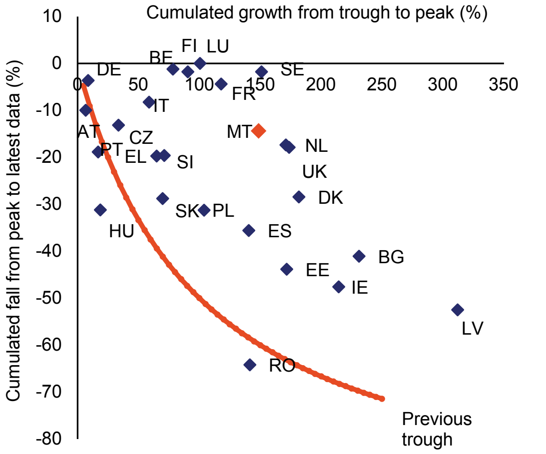
of their increase since 2008 are accounted for by the public energy utility corporation (Enemalta). A debt restructuring plan for Enemalta, adopted by the authorities in December 2012, concerns about half of the company's current debt (which, at end-2010 and including only bank and other borrowings, stood at EUR 687mn, or EUR 836mn when adding also trade-related and other payables). Currently, Enemalta remains in a challenging financial state.

2.6. PROPERTY MARKET DEVELOPMENTS

The real estate market is very important for domestic financial stability due to the high exposure of the banking sector to it. Real estate-related lending amounted to more than half of the total lending portfolio to residents in November 2012([10]). In addition, domestic lending is heavily collateralised with real estate. According to the national authorities, the valuation of real estate collateral is conservative as banks apply a significant haircut on an already prudent value, determined by third-party experts. This creates a significant buffer on banks' books and regular stress tests conducted by the Central Bank of Malta on the core domestic banks (see Section 3) show that it would take a further drop of over 50% in house prices, coupled with an increase in non-performing loans, to have a notable impact on the Core Tier I capital ratio of the banking sector (CBM 2012a). Moreover, banks are encouraged to monitor the value of their collateral on a regular basis, which further mitigates potential risks arising from the banking sector's exposure to real estate. The stress tests, however, are top-down and therefore do not exclude the existence of specific problems at individual-bank level.

Housing prices have been rising steadily for a prolonged period of time. Estimations in the December 2012 Quarterly Report on the Euro Area (EC 2012e) show that the latest pronounced growth phase of house prices from trough to peak (Q2 2002 – Q1 2008) has largely been in line with the average for the euro area and notably milder than countries like Ireland, Spain and Estonia. A downward correction started at the end of 2008, which brought prices down by 9% by the end of 2009. Since then, prices appear to have stabilised. Graph 2.15 below shows that despite some correction, prices in Malta are still considerably above their trough (the red line). This benchmark, however, needs to be interpreted with caution as price correction may not necessarily reach the previous trough.

Graph 2.15: **House price cycle**



Source: Eurostat, ECB, OECD

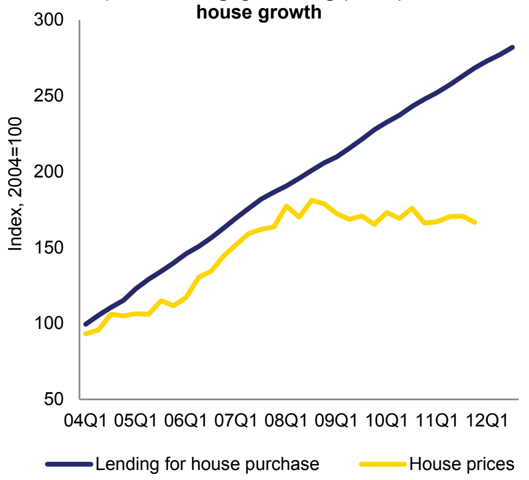
Estimations show that in the years before euro adoption, an overvaluation of housing prices developed. Indeed annual growth in nominal housing prices accelerated notably in the years before euro adoption and averaged around 20% over 2006-2007. These years were characterised by fast expansion of mortgage lending: between January 2005 and December 2007, the annual growth in mortgage loans averaged 18.5%. ([11]) Faster price dynamics was also fuelled by the increasing demand for real estate from abroad, either from Maltese citizens living abroad (also thanks to fiscal incentives) or foreign buyers. Additional factors supporting this trend have been the demographic developments and the lack of a recurrent property tax in Malta (see Box 2.3). Overvaluation estimates carried out by the European Commission (EC 2012e) show that the adjustment in housing prices that began at the end of 2009 is at a relatively early stage and further downward correction can be expected in order to

([10]) Loans for construction and real estate activities and mortgage loans amounted to 52.4% of total lending to residents in November 2012 (Source: Central Bank of Malta).

([11]) For reference, the average annual growth in mortgage lending for the euro area in 2006-7 was 9.9%. (Source: ECB).

bring prices in line with their long-run trend. However, in light of the recent modest rebound in house prices, reaching the conservative scenario of a further drop of over 50% depicted in the stress test by the Central Bank of Malta appears unlikely. There are downside risks related to a weaker-than-expected macroeconomic environment and depressed domestic demand, and also in view of the high number of vacant properties. However, the extent to which the latter may indicate oversupply is not straightforward as a significant amount of vacant properties are not for sale for different reasons.

Graph 2.16: **Mortgage lending (stock) and house growth**



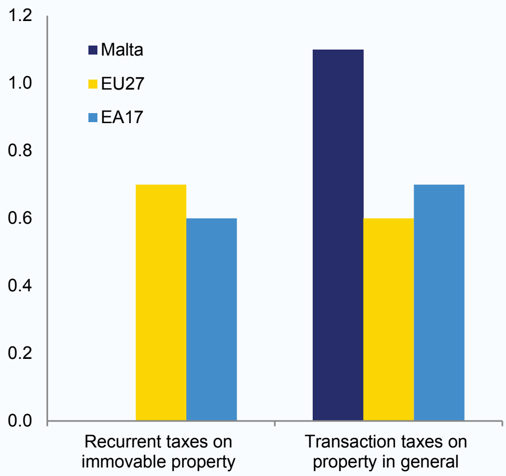
Source: Central Bank of Malta, ECB, Commission services

Box 2.3: **Immovable property taxation in Malta**

Immovable property taxes include different types of levies. One important distinction is between recurrent taxes, which typically take the form of annual payments due by the owner, whose amount is linked to some measure of the value of the property; and transaction taxes that are typically charged on the occasion of the sale or transfer of the property.

Taxes on immovable property represent 3.2% of total taxation in Malta (the EU-27 average is 3.6%). The Graph shows that Malta is the only EU country which does not have recurrent taxes. Looking at transaction taxes, the situation is exactly reversed for Malta, which raises a high amount of revenue (1.1 % of GDP in 2010, almost double the EU-27 average, equal to 0.6% of GDP) from these taxes.

Graph 1: **Property taxation**



Source: EC 2012f

Transaction taxes on property are generally considered more distortive than a recurrent tax. Indeed, a transaction tax reduces the number of transactions and hampers the price discovery process. Moreover, revenue from transaction taxes is often highly volatile, as it tends to follow the business cycle. At the same time, a transaction tax on real property transactions could deter speculation and thus possibly help to reduce the risk of housing market bubbles. A recurrent tax on immovable property is generally considered the least distortionary type of tax. In addition, revenue from these taxes is highly predictable, since they are more difficult to evade than taxes such as PIT or CIT. This also makes them, at least potentially, attractive from an equity point of view. Recurrent property taxes are usually characterised by low compliance costs for taxpayers and, once a system is set up, administrative costs for tax authorities are also moderate.

On the positive side, Malta does not have tax deductibility of mortgage interest payments. Normally, tax deductibility of interest payments leads to a favourable treatment of debt, which, coupled with low taxation of the return of the property (i.e. the imputed rent) encourages over-investment in the housing sector compared to other sectors and leads to growing incentives for debt accumulation by households.

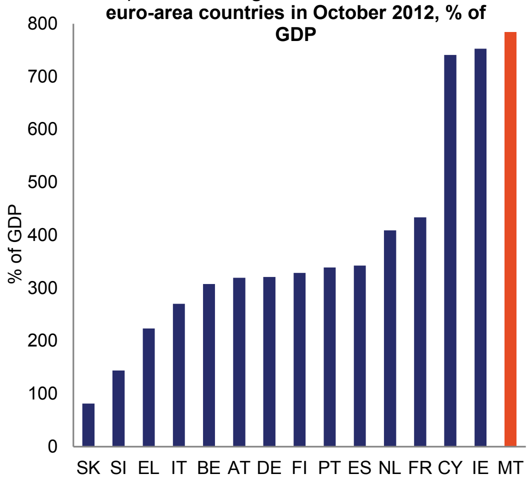
The increase in property taxes might theoretically offer some potential for limiting 'boom and bust' cycles in housing prices, by dampening excessive price increases in the build-up phase.

3. IN-DEPTH ANALYSIS OF SELECTED TOPICS

The financial sector expanded very rapidly after EU accession, with total liabilities, excluding equity, reaching around 850% of GDP as at end-2011. The majority of these liabilities, over 600% of GDP, belong to the banking sector. At the same time, the non-banking financial sector has expanded rapidly, with sizeable insurance and collective investment schemes, each with liabilities exceeding 100% of GDP, also reflecting the emergence of new activities such as captive insurance and asset management. In terms of total assets in relation to GDP, the Maltese banking sector is among the biggest in the euro area (see Graph 3.1). Regulatory responsibilities at micro level lie with the Malta Financial Services Authority (MFSA), whereas the Central Bank of Malta (CBM) is in charge of ensuring financial stability from a broader perspective. To strengthen co-operation as well as to follow up on recommendations issued by the European Systemic Risk Board (ESRB), ([12]) in January 2013, the two institutions set up a Joint Financial Stability Board (JFSB), which will be responsible for macro-prudential supervision in Malta.

The banking sector in Malta is very diverse in terms of interlinkages with the domestic economy. The sector can be split into three groups according to the extent to which it is interlinked with the domestic economy: (i) five core domestic banks whose main activities are collecting deposits and granting loans to Maltese residents, (ii) eight non-core domestic banks that have some business with residents but not as their core activity, and (iii) thirteen internationally-oriented institutions that have almost no links with the domestic economy. In terms of gross liabilities, the third group is by far the biggest and has assets of over 500% of GDP. The core and non-core domestic banks have assets of around 220% and 80% of GDP, respectively.

Graph 3.1: **Banking sector assets in selected euro-area countries in October 2012, % of GDP**



Source: ECB

Core domestic banks do not appear to be exposed to the volatility on international financial markets. The group consists of five banks, with Bank of Valletta (BoV) and HSBC Malta owning over 80% of the 220% of GDP of total assets held by this group. The Maltese government holds a 25% stake in BoV. The BoV successfully passed the EU-wide stress test conducted by the European Banking Authority in 2011, which revealed a healthy capital position, with a Core Tier I ratio of 10.6% in June 2012, in line with the average for the group of tested banks, and very limited exposure to non-Maltese sovereign debt. ([13])

([12]) See ESRB/2011/3.

([13]) Exposure to non-Maltese sovereign debt amounted to 7.7% of the gross direct sovereign exposures in June 2012, up from 6.3% in December 2011 (Source: EBA).

Table 3.1:
Selected financial soundness indicators for Maltese banks

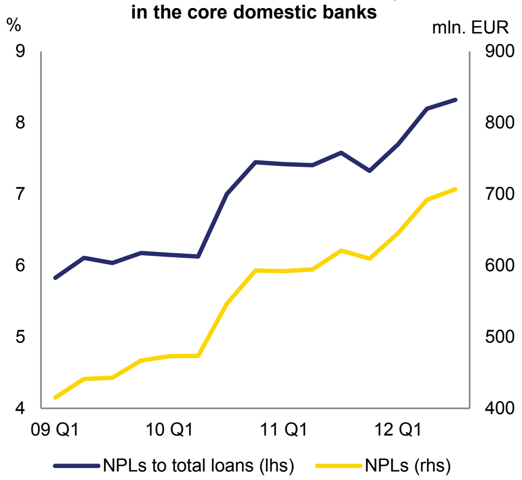
	Core domestic banks				Non-core domestic banks				Internationally-oriented banks			
	2009	2010	2011	Jun-12	2009	2010	2011	Jun-12	2009	2010	2011	Jun-12
Tier 1 capital adequacy ratio	10.1	9.2	9.6	9.8	30.5	27.9	27.4	25.9	31.8	110.2	114.4	103.4
Non-performing loans ratio	6.2	7.5	7.3	8.2	2.4	3.6	4.5	4.3	0.5	0.6	0.5	0.3
Return on assets	1.6	1.4	1.3	1.4	3.1	1.3	0.5	0.5	1.7	1.1	1.2	1.1
Return on equity	26.6	22.4	19.5	20.6	14.0	4.4	1.4	1.5	22.6	3.1	3.9	4.0
Coverage ratio	22.0	19.8	19.8	20.1	84.3	31.7	42.8	38.3	63.8	76.0	107.7	101.5
Distribution of total loans												
to residents as % of total loans	98.7	98.4	98.4	98.3	9.7	11.0	13.1	13.6	0.0	0.0	0.1	0.0
to non-residents as % of total loans	1.3	1.6	1.7	1.7	90.3	89.0	86.9	86.4	100.0	100.0	99.9	100.0
Investment securities to total assets												
Domestic investment securities	11.9	12.3	12.8	13.3	2.9	2.2	2.2	1.8	0.0	0.0	0.0	0.0
Foreign investment securities	13.2	11.9	11.5	11.1	27.0	35.1	36.1	41.5	27.8	28.8	31.5	32.8

Source: Central Bank of Malta

The core banks exercise a rather conservative business model that relies mainly on resident deposits for their funding and have low loan-to-deposit ratios, at around 70%. This, combined with a stable deposit base, thanks to the high propensity to save by Maltese households, helped the core domestic banks cope with the financial crisis and the volatility on the international wholesale markets. The banks did not need government support nor did they need to resort to the ECB's long-term refinancing operations to any significant degree to improve their liquidity.

The core domestic banks are profitable but specific provisioning against loan losses is rather low. About two-thirds of the private sector loans extended by the core domestic banks are secured with real estate collateral. ([14]) Banks apply a rather cautious valuation of collateral: they apply a significant discount on its value and this value is regularly monitored through third-party valuation and verification by the regulators. This practice, added to a still conservative, albeit increasing, loan-to-value ratio, mitigate the concentration risk arising from the high exposure of the core domestic banks to the real estate sector. Indeed, the slowdown in the construction sector did not hit banks' balance sheets particularly hard: the share of non-performing loans increased moderately in recent years, from around 5% in 2008 to just above 8% in June 2012 (see Graph 3.2). The return on equity remained strong throughout the crisis and as a result, the banking sector was able to generate own capital and no significant recapitalisations were needed. However, since banks provision against only the unsecured part of an exposure, the coverage ratio is relatively low at about 20%. Higher provisioning to strengthen NPL coverage as recommended by the Council under the 2012 European Semester, ([15]) as well as discouraging an increase in the loan-to-value ratio of real estate loans would further improve the soundness of the core domestic banks. In addition, it is important to ensure that the domestic judiciary system is efficient. The recently published EU Justice Scoreboard (EC 2013a) and successive World Bank's Doing Business reports highlight potential challenges in this area. Namely, Malta scores significantly worse than the EU average in terms of the time needed to resolve non-criminal cases and the clearance rate – i.e. the number of resolved cases as a share of incoming cases. It also compares unfavourably with the OECD average in terms of enforcing contracts and resolving insolvency, due to the long time the procedure takes and the limited amount of assets that claimants are able to recover from an insolvent entity.

Graph 3.2: **Evolution of non-performing loans in the core domestic banks**



Source: IMF Financial Soundness Indicators

The group of international banks are profitable and well capitalised. The international banks have assets of over 500% of GDP, mainly owned by branches and subsidiaries of large international institutions. They fund themselves mainly through the wholesale market or through the parent banks and deal mainly with intragroup activities. Overall, this group of banks is profitable and very well capitalised with their risk-weighted assets more than fully covered by Tier 1 capital (CBM 2012b), mainly reflecting the healthy position of one major bank that is almost entirely funded with equity. Furthermore, these banks have strong liquidity as evidenced by the very high ratio of liquid assets to short-term liabilities([16]). Tax incentives, alongside a trustworthy regulatory environment (these banks are subject to the same type of scrutiny as the domestically-oriented banks) and the advantage of having English as an official language appear to be

([14]) This refers just to the loan-replacement value of collateral, i.e. the value of loans fully backed up by collateral.

([15]) Measures to address this recommendation are in the pipeline, but the authorities are awaiting further guidance from the European Banking Authority.

([16]) The ratio of liquid assets to short-term liabilities was 153.4% in June 2012, far surpassing the required 30% ratio (CBM 2012b).

the main reasons attracting financial institutions to Malta.

Even though registered in Malta, the internationally-oriented banks hardly do any business in Malta, which limits the potential risk to domestic financial stability that they carry. Total resident liabilities, including private sector deposits, represented only 0.3% of total liabilities in 2011 (around 1.5% of GDP). Similarly, the international banks do not fund domestic businesses or resident households. Loans to residents represented only 0.01% of their total lending portfolio, while they did not hold any domestic investment securities in June 2012. Links with domestically-oriented banks in terms of liquidity management are also very limited due to the very small size of the domestic interbank market. In addition, while some banks have tapped the domestic bond market in the past, the obtained amounts represent a very small share of the listed private sector bonds and equity (CBM 2011). Overall, this group of banks carries out its business *from* and not *in* Malta, which significantly limits their impact on stability of the financial sector. Finally, the existing tax regime sets a lower tax rate for institutions that obtain a very small share of their profits from business with residents, which provides a further disincentive for these large international banks to increase their exposure to the domestic economy. The very small size of business with residents as well as the fact that the big institutions are foreign-owned indicates that the contingent fiscal liabilities that the internationally-oriented banks carry are minimal. As a result, the only channel through which potential problems in one or more banks that belong to this group could impact the domestic economy appears to be through possible negative reputational risks for Malta as a safe jurisdiction for the financial services industry.

The non-core domestic banks also display healthy financial soundness indicators, although they invest in riskier assets. The non-core domestic banks are the smallest group of banks in terms of size with total assets at around 80% of GDP. Similar to the international banks, their funding comes mostly from the wholesale market. Unlike the international banks, however, these banks are much more intertwined with the domestic economy and resident liabilities account for around 12% of the total, including deposits ([17]) and bonds and equity issued locally (around 9.5% of GDP). The asset side is rather diversified between non-resident (largely also non-EU) loans to companies and banks as well as a mix of corporate, government and other banks' debt securities. A significant proportion of the investment portfolio (around 30% as at end-2011; CBM 2012a) was invested in bonds issued by residents of EU Member States currently receiving financial assistance under an EU/IMF programme. This illustrates the riskier business profile of these banks, although the fact that the majority of these securities are not government bonds can be a mitigating factor. On the asset side, resident assets account for around 9% of total assets. ([18]) The lending portfolio is oriented predominantly towards the corporate sector and about half of the resident loans are for construction and real estate activities. This portfolio performs better than that for the core domestic banks as the ratio of non-performing loans was relatively low at just 4.5% at the end of 2011 (CBM 2012a). On aggregate, the shock absorbing capacity of the non-core domestic bank appears sufficient to absorb a deterioration in the quality of its assets as the Tier I capital adequacy ratio, although lower than for the international banks, stands much higher than the ratio for the core domestic banks. As a result, due to their limited exposure to the domestic economy, the non-core domestic banks do not represent significant contingent fiscal liabilities and do not seem to pose an immediate threat to domestic financial stability. Nevertheless, potential reputational and confidence risks could emerge should one of these banks run into trouble. Thus, strict scrutiny by the regulators is essential to ensure that financial stability is maintained.

([17]) Resident deposits represented around 10% of total liabilities for this banking group but still remained less 5% of total resident loans as at June 2012 (CBM 2012b).

([18]) In total, resident loans extended by non-core domestic banks and international banks accounted for around 3% of total resident loans as at end-2011. Source: Financial Stability Report 2011, Central Bank of Malta, September 2012

4. POLICY CHALLENGES

The analysis in sections 2 and 3 identifies potential imbalances for Malta in the financial sector, in particular as regards its exposure to the real estate market. Against this background, this section discusses different avenues that could be envisaged to address the policy challenges posed by these potential imbalances.

Ensuring the proper functioning of the real estate market is of particular importance for financial stability, given the strong link with the banking sector. Past dynamics of real estate prices may have been partly supported by the taxation regime in Malta, which lacks a recurrent property tax, while transaction taxes may impede the price discovery process. Therefore, the real estate market would benefit from reviewing the property tax system to ensure that it provides the right incentives to market participants. Furthermore, regular monitoring of property price developments and collateral valuation by commercial banks is important in maintaining financial stability. Supporting the development of the rental market would also contribute towards preventing excessive price growth and the accumulation of price bubbles.

Risks to domestic financial stability appear small but continued monitoring appears warranted. Risks to domestic financial stability stemming from the presence of a very large financial sector appear small due to the very limited exposure of internationally-oriented banks to the domestic economy. Nevertheless, continued regular monitoring and assessment, including more regular data dissemination of banking soundness indicators, of the activities of the internationally-oriented and the non-core domestic banks and their implication for financial stability is important. This is particularly relevant for the non-core domestic banks, which despite their smaller relative size and robust financial soundness indicators engage in riskier activities that necessitate strict supervision to ensure that risks are adequately provisioned against.

The stability of the core domestic banks would benefit from strengthening the provisions for loan losses to limit risks arising from their exposure to the property sector. Lending standards for construction and real estate services have already been tightened. Keeping household mortgage lending in check, also through a conservative policy on the loan-to-value ratio, is also essential in preventing excessive debt build-up and asset bubbles. Improving loan-loss provisioning to increase the relatively low coverage ratio would also contribute towards maintaining banking sector soundness, as recommended by the Council under the 2012 European Semester. Finally, the proper functioning of the financial sector would benefit from a review and, if necessary, improvements in insolvency legislation to make sure that collateral rights are enforceable when needed.

High public and private debt warrant policy attention. Given the small size in nominal terms, public debt issuances do not attract significant interest from foreign investors, leaving the burden of funding the government almost entirely on Maltese residents. This may crowd out private investment and consumption in case of insufficient liquidity in the financial system. Therefore, ensuring that public debt is put on a downward path and addressing the challenges to the long-term sustainability of public finances, namely through timely pension and healthcare reforms, would be beneficial for domestic stability and would ensure that financial intermediation works properly to finance economic growth in the medium to long-term. As regards private sector debt, while the current level of indebtedness does not appear to be excessive, measures to prevent unsustainable increases, such as by limiting the loan-to-value ratio for mortgage loans and addressing the debt bias in corporate taxation, could be considered.

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