BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

Economic projections

2017 - 2020

December 2017

Outlook for the Maltese economy

Economic projections

2017 - 2020

The pace of economic activity in Malta has picked up in 2017. The Central Bank's latest economic projections foresee economic growth over the coming three years to remain strong from a historical perspective, though somewhat lower than in 2017. These projections feature an upward revision in growth when compared to the previous set of forecasts, reflecting a stronger expansion in private consumption and in net exports. Growth in the coming years will be supported by both demand and supply factors. In particular, the continued impact of the energy reforms, new investment projects, increased labour market participation and robust services exports are the primary drivers supporting the economic expansion.

As a result of fast economic growth, the labour market is projected to remain tight, with the unemployment rate falling further to 4.1% in 2017. The unemployment rate is expected to pick up somewhat subsequently, as the pace of activity moderates, although it is set to remain low from a historical perspective over the entire projection horizon.

Annual inflation, based on the Harmonised Index of Consumer Prices (HICP), should rise from 0.9% in 2016 to 1.2% in 2017, partly reflecting higher international fuel prices. It is projected to trend up further to 2.0% by 2020, reflecting a pick-up in domestic cost pressures.

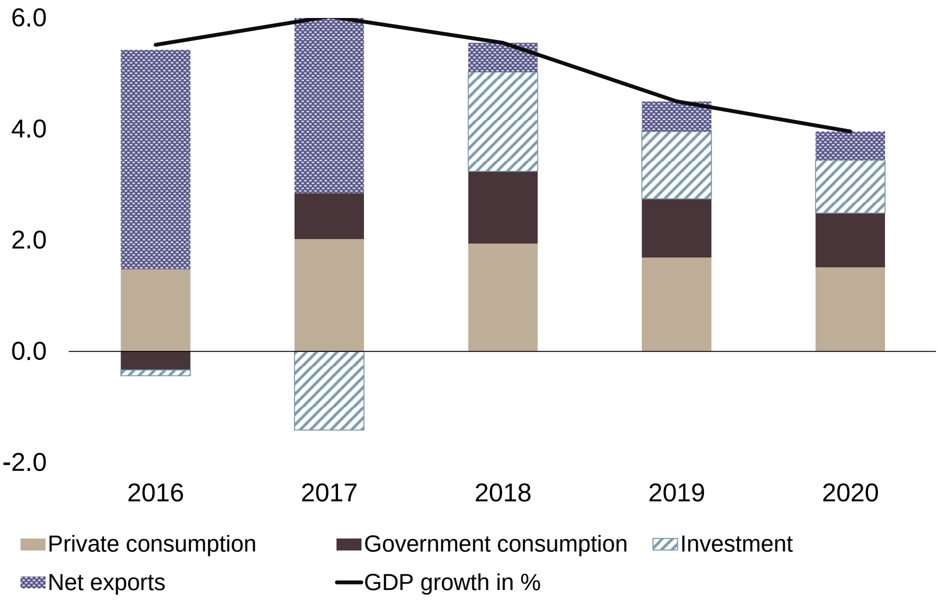
In terms of public finances, the general government balance is expected to remain in surplus between 2017 and 2020. Meanwhile the debt-to-GDP ratio is projected to fall to just above 45%.

1 Economic outlook[1]

The Bank's latest projections foresee economic growth to have picked up in 2017. Growth in the following years should remain strong from a historical perspective, albeit being somewhat lower than in 2017 (see Table 1).

Compared with the Bank's latest projections, GDP growth is being revised upwards due to the positive surprise in the first half of 2017. The upward revision is mainly driven by higher private consumption growth on account of an upward revision in disposable income, and more upbeat assessment of net exports, as a result of further declines in import shares.

Chart 1: GDP growth over the projection horizon
(percentage point contributions; annual percentage change)



Source: Central Bank of Malta

In 2017, net exports are projected to be the main driver of economic growth, although domestic demand is also set to contribute positively (see Chart 1). The strong contribution of net exports reflects three main factors. Firstly, growth in services exports is projected to remain buoyant, supported by strong activity in tourism, aviation and business services. Secondly, import shares will continue on a downward path. Finally, import-intensive private investment in aviation is projected to contract this year following strong increases in recent years. For the period 2018-2020, domestic demand will then become the major contributor to economic growth due to continued strength in private and government consumption. At the

[1]The Bank's outlook for the Maltese economy is based on information available up to 30 November 2017 and is conditional on the technical assumptions shown in Table 1, which are sourced from the European Central Bank. These projections were prepared by the Central Bank of Malta and do not represent the views of the Eurosystem. National data published on 6 December 2017 suggest that growth, particularly in 2017, could be higher than presented here. In fact, as explained in section 6, risks to the projection are on the upside.

Table 1: Projections for the main macroeconomic aggregates for Malta[1]

	2016[2]	2017	2018	2019	2020
Real economic activity (% change)					
GDP	5.5	6.0	5.6	4.5	4.0
Private consumption expenditure	3.0	4.2	4.1	3.6	3.3
Government consumption expenditure	-1.8	4.9	7.8	6.2	5.6
Gross fixed capital formation	-0.4	-6.0	8.4	5.5	4.3
Exports of goods and services	3.5	3.4	3.5	3.5	3.5
Imports of goods and services	0.8	0.1	3.5	3.5	3.5
Contribution to real GDP growth (in percentage pts)					
Final domestic demand	0.9	1.4	5.0	4.0	3.4
Net exports	4.0	4.6	0.5	0.5	0.5
Changes in inventories	0.6	0.0	0.0	0.0	0.0
Real disposable household income[3]	3.3	4.5	4.4	4.0	3.5
Household saving ratio[3]	16.7	16.9	17.2	17.4	17.6
Balance of payments (% of GDP)					
Goods and services balance	11.0	14.8	14.4	14.3	14.2
Current account balance	6.4	8.0	8.1	8.1	8.1
Labour market (% change)[4]					
Total employment	3.7	4.8	3.7	3.2	3.0
Unemployment rate (% of labour supply)	4.7	4.1	4.3	4.4	4.6
Prices and costs (% change)					
GDP deflator	1.6	1.9	2.0	2.0	2.0
RPI	0.6	1.4	1.7	1.9	2.0
Overall HICP	0.9	1.2	1.6	1.8	2.0
HICP excluding energy	1.3	1.2	1.7	1.9	2.1
Compensation per employee	2.7	2.6	3.4	3.2	3.1
ULC	0.9	1.4	1.6	2.0	2.2
Business cycle					
Potential output (% change)	6.8	6.2	5.2	4.8	4.5
Output gap (% of GDP)	0.8	0.6	0.9	0.6	0.1
Technical assumptions					
EUR/USD exchange rate	1.11	1.13	1.17	1.17	1.17
Oil price (USD per barrel)	44.0	54.3	61.6	58.9	57.3

[1] Data on GDP were sourced from NSO News Release 141/2017 published on 6 September 2017.
[2] Actual data.
[3] Data for 2016 are Central Bank of Malta estimates.
[4] Data on the number of employed are consistent with national accounts data. The unemployment rate is based on the number of unemployed and employed as reported in the Labour Force Survey.

same time, private investment is expected to recover from this year's dip. As import shares normalise, the wedge between export and import growth eventually begins to close, such that the positive contribution of net exports is set to be relatively small over this period.

The robust growth on the demand side will be supported by the supply side of the economy, reflecting an increase in the labour supply due to net migrant flows, and efficiency gains. Potential output growth is projected to outpace that in GDP in the projection horizon and hence the output gap is set to narrow but remain slightly positive by 2020.

Looking at the expenditure components in more detail, private consumption growth is set to accelerate this year, and ease in the following three years. The profile of private consumption growth mirrors that in real disposable income. The latter is projected to accelerate in 2017 on the back of faster employment growth. It is set to slow down in the following three years in line with the path of economic activity. Despite above average consumer sentiment and record low unemployment, saving levels continued to surprise on the upside recently. The saving ratio is forecast to edge up slightly further over the projection horizon.

With regard to real government consumption, its profile is influenced heavily by inflows related to the Individual Investment Programme (IIP), which are netted against consumption expenditure, and a temporary boost to expenditure related to the EU Presidency. More details on projected developments in public consumption can be found in section 4.

The profile of investment is strongly influenced by the interplay of expected developments in specific sectors that have a bearing on private investment, as well as the expectation of increased absorption of EU funds, which conditions the profile of government investment. In more detail, the contraction in overall investment in 2017 is entirely driven by private non-residential investment as both private residential investment and government investment are expected to grow at double-digit rates. The decrease in non-residential investment in turn reflects significant negative base effects arising from the strong expansion of the aviation sector in the previous two years. In 2018, private investment is projected to pick up again, reflecting continued robust growth in residential investment and the commencement of major construction projects in education and health. Private investment is then forecast to ease in the following two years, mirroring slower growth in both non-residential and residential investment.

With regard to external trade, exports are expected to continue to be supported by buoyant growth in the services sector, although growth in services exports is projected to moderate from very high growth rates recorded recently. Goods exports are forecast to recover following muted developments in previous years. The gradual deceleration in services exports is broadly counterbalanced by the pick-up in goods exports, leading to a relatively flat profile in total export growth over the projection horizon.

Mainly mirroring the investment and export projections, import growth is expected to decelerate further this year. This reflects a contraction in goods imports in line with the decline in both private non-residential investment and goods exports. Moreover, services imports are expected to grow at a lower rate than in 2016, in line with first half outcomes. Import growth is then set to accelerate sharply in 2018 due to a recovery in private investment and goods exports. In the following two years, import growth is expected to remain flat as the deceleration in domestic demand offsets the recovery in goods exports. During the projection horizon we continue to expect that the recent decline in import shares will persist in the medium-run, but to a much lesser extent than in the last few years.

As a result of the projected positive net export contribution, the trade surplus is expected to widen considerably in 2017, before easing in the following three years. The current account surplus is also expected to rise in 2017, but by less, as the widening of the trade surplus is partly offset by higher primary income outflows, the latter reflecting an expected increase in repatriated profits by foreign owned companies. In the following three years, the current account surplus is expected to remain around the 2017 ratio as higher primary income outflows should be offset by larger secondary income inflows. The latter are projected to rise due to the envisaged increase in EU funds.

2 Labour market

Partly reflecting the strong pace of job creation in the first half of the year and the acceleration in economic activity, employment growth in 2017 is set to exceed that of the previous year. In the period 2018-2020, we expect the pace of employment growth to ease somewhat. Nevertheless, both economic activity and growth in employment are expected to remain well above their historical average.

As a result, the Labour Force Survey (LFS) unemployment rate is expected to continue falling to record lows in 2017, reflecting developments in the first months of the year as well as continued drops in administrative data on the registered unemployed in the second half of the year. Conversely, as employment growth and economic activity moderate in the following three years, the unemployment rate is foreseen to rise slowly. It, however, is expected to remain low from a historical perspective.

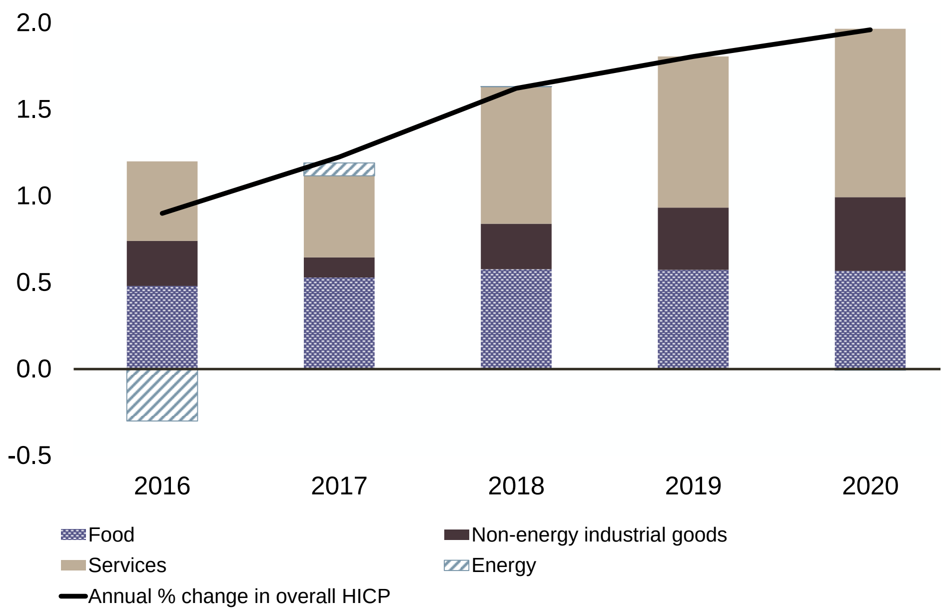
As regards wages, these continued to surprise on the downside in 2017. Accordingly, the Bank expects some slowdown in compensation per employee growth this year. Nevertheless, a national skills survey carried out last year and contacts from industry continue to highlight that labour market tightness and wage pressures are gaining pace. In this context, and reflecting also an expected pick up in consumer prices, growth in nominal compensation per employee is expected to accelerate in 2018. Wage growth is then forecast to decelerate in 2019 and 2020, as these factors are offset by slower growth in productivity.

3 Prices

Against the background of the ECBs technical assumptions, official data up to October 2017, and the expected evolution of domestic cost pressures and economic activity, HICP inflation in Malta is set to pick up from 0.9% in 2016 to 1.2% in 2017. Inflation will then continue to accelerate gradually over the forecast horizon, reaching 2.0% by 2020 (see Chart 2).

Compared with the Bank's latest projections, HICP inflation is being revised down slightly in 2017 and 2018, largely reflecting downward revisions to the NEIG and food components.

Chart 2: HICP inflation over the projection horizon
(percentage point contributions; annual percentage change)



Source: Central Bank of Malta

The international price of oil has shown strong growth during 2017. It is forecast to increase further in 2018, albeit at a slower pace, before contracting in 2019 and 2020. This path influences the profile of the fuel and gas price projections through a lagged and impartial pass-through, while electricity prices are assumed to remain fixed during the forecast horizon as per government policy. Hence, energy inflation is set to turn positive this year, ease in 2018 and 2019, and turn marginally negative in 2020.

HICP excluding energy is projected to register 1.2% in 2017, before gradually accelerating to 2.1% by 2020. The acceleration in HICP excluding energy is foreseen to be primarily driven by faster growth in services prices reflecting some intensification of wage pressures. At the same time, inflation in non-energy industrial goods (NEIG) is also set to contribute to the rise in HICP excluding energy, mirroring a recovery in imported inflation. Meanwhile, food inflation is projected to remain robust throughout the forecast horizon, supported by external food prices.

4 Public finance

The headline budget balance is expected to remain in surplus throughout the forecast horizon, sustained by large positive primary balances (see Table 2). However, the general government surplus is expected to decline from 1.1% of GDP in 2016 to 0.9% in 2017, and eventually reach 0.5% of GDP in 2020. This is due to a faster decline in the ratio of current revenue in GDP compared with the current expenditure-to-GDP ratio.

Compared with the Bank's earlier projections, the outlook for the government balance is much more favourable in 2017 but more cautious in 2019. This is mostly due to a revised profile for revenue from the IIP scheme. Moreover, general government debt-to-GDP ratio is forecast to remain below the Bank's earlier projections over the whole projection horizon.

Overall, the share of tax revenue items in GDP over the projection horizon is expected to decline when compared with 2016, reflecting slowing growth in the Maltese economy. Although the share of current taxes on income and wealth in GDP is expected to increase, buoyed by higher income tax revenue from corporations, that of taxes on production and imports is expected to decline, driven by slower growth in consumption. Revenue from social contributions is also expected to increase at a smaller pace than GDP, in line with the provisions of Maltese law.[2]

Meanwhile, the share of other current revenue in GDP is also set to decline significantly. This is due to the forecast profile of income from the IIP. Revenue from the scheme increased sharply in 2017. However, it is then projected to decline substantially by 2020.

Overall, growth in the main current spending items is expected to be restrained throughout the forecast period. The ratio to GDP of compensation of employees in GDP is set to remain broadly stable around the 2016 outcome. Meanwhile, growth in social payments should remain slower than GDP growth, owing mostly to forecast low unemployment and an increase in the statutory retirement age in 2018, which will limit pension expenditure growth that year. The share of intermediate consumption in GDP is set to increase in 2017 and to decline thereafter. This is due to the end of operational costs associated with Malta's 2017 Presidency of the EU Council, and savings resulting from ongoing spending reviews in the public sector. Interest payments are also forecast to grow at a slower pace than GDP, owing to lower projected financing needs.

The shortfall in the balance between capital revenue and capital expenditure is expected to increase in 2017 and to remain broadly stable thereafter. The increased shortfall in 2017 partly reflects a one-time transfer to depositors from the Depositor Compensation Scheme, which is classified under capital

[2] According to the Social Security Act (tenth schedule), the weekly rate of contributions cannot exceed a specified ceiling.

Table 2: Projections for main fiscal items (% of GDP) [1]

	2016[2]	2017	2018	2019	2020
Headline Aggregates					
Total revenue	39.1	39.5	38.8	38.7	38.6
Total expenditure	38.0	38.6	38.2	38.1	38.1
General Government Balance	1.1	0.9	0.7	0.6	0.5
of which: Primary Balance	3.3	2.8	2.5	2.3	2.1
General Government Debt	57.6	55.0	51.0	48.4	45.9
Detailed Breakdown					
Current Revenue	38.4	38.7	37.7	37.4	37.1
Current taxes on income and wealth	13.9	13.9	14.0	14.2	14.3
Taxes on production and imports	12.8	12.7	12.6	12.5	12.4
Social contributions	6.4	6.3	6.2	6.1	6.1
Other current revenue[3]	5.3	5.7	5.0	4.6	4.3
Current Expenditure	34.7	34.7	34.0	33.8	33.6
Compensation of Employees	11.9	11.8	11.8	11.8	11.8
Intermediate Consumption	6.4	6.9	6.6	6.5	6.4
Social benefits	10.9	10.6	10.4	10.3	10.2
Interest payments	2.2	1.9	1.8	1.7	1.6
Subsidies	1.3	1.3	1.3	1.4	1.4
Other current expenditure[4]	2.0	2.1	2.1	2.1	2.1
Gross savings	3.7	4.0	3.7	3.6	3.5
Capital Revenue	0.7	0.8	1.1	1.3	1.5
Capital taxes	0.2	0.2	0.2	0.2	0.2
Other capital revenue[5]	0.6	0.6	0.9	1.1	1.4
Capital Expenditure	3.3	3.9	4.1	4.3	4.5
Investment	2.5	2.8	3.1	3.2	3.5
Capital transfers	0.8	1.2	1.1	1.1	1.1
Other capital expenditure[6]	0.0	0.0	-0.1	-0.1	-0.1
Capital Revenue Net of Capital Expenditure	-2.6	-3.1	-3.1	-3.0	-3.0
Underlying Budgetary Position					
Cyclical component	0.3	0.5	0.6	0.5	0.4
Temporary government measures	0.0	0.0	0.0	0.0	0.0
Structural balance	0.0	0.4	0.1	0.1	0.1

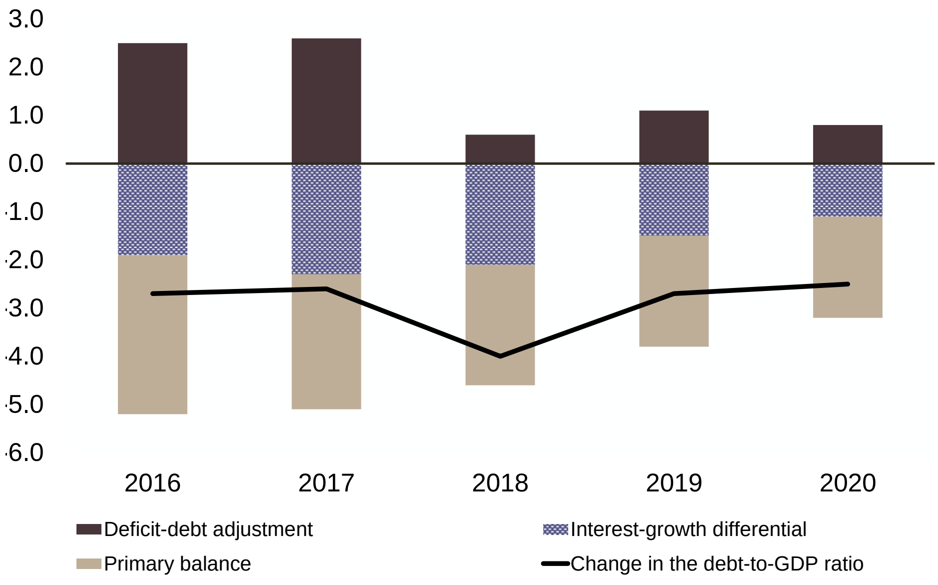
[1] CBM calculations based on NSO News Release 141/2017 (published on 6 September 2017) and News Release 170/2017 (published on 23 October 2017).
[2] Actual Data.
[3] Mainly includes revenue from dividends, rents and sales.
[4] Mainly includes spending on education and contributions to the EU budget.
[5] Mainly includes grants from EU Programmes.
[6] Mainly reflects the value of changes in inventories and in the net acquisition of valuables and other assets.

transfers.[3] Going forward, investment on domestically-funded projects is expected to pick up as work on nationwide road building projects starts to gather pace. Meanwhile, spending on projects which are partly-financed by EU funds under the 2014-2020 funding framework is expected to increase substantially from the low levels seen in 2016, as additional projects are identified and tenders are adjudicated.

The Central Bank of Malta also produces estimates of the structural government balance, which measures the underlying budgetary position corrected for the economic cycle and temporary government measures. This is computed using a methodology applied within the ESCB[4], which differs from the approach used by the European Commission and the Maltese Government.

In the absence of significant temporary measures, the profile of the structural balance is determined by the extent to which the headline balance is influenced by the economic cycle. The Bank expects a positive cyclical component which declines slightly over time. This reflects the diminishing contribution of the economic cycle, in line with the forecast partial closure of the positive output gap. Overall, the structural balance is set to decline from a surplus of 0.9% of GDP in 2016 to 0.1% of GDP by 2020, mainly due to expected lower growth in current revenue items as outlined above. It is thus expected to remain marginally above the medium-term budgetary objective of a balanced budget in structural terms.

Chart 3: Contribution to change in the debt ratio
(percentage point contributions; percentage of GDP)



Source: Central Bank of Malta

[3] According to a EUROSTAT decision, transactions by such schemes have been classified within government finance statistics, and listed as capital transfers. In Malta, this reclassification took place in the 2017 Q2 vintage (NSO News Release 170/2017 published on 23 October 2017.)

[4] Projections by national central banks are used to generate bi-annual forecasts for the euro area GDP and budget balance. For further details, see https://www.ecb.europa.eu/pub/projections/html/index.en.html.

5 Risks to the projections

Risks to the GDP growth projections are on the upside. Such risks relate to a further persistence in the buoyancy in services exports and stronger than forecast pick-up in wages which would support higher private consumption. At the same time, the expected normalisation in import shares assumed in the Bank's projections may take longer to materialise, as indicated in national accounts data published on 6 December. Downside risks relate to the geopolitical uncertainties and delays of major construction projects in health and education. Moreover, the rapid growth the Maltese economy has experienced in the last few years may impinge markedly on infrastructure such that physical constraints may become binding and limit future expansions.

Risks to inflation are slightly on the upside. In particular, survey data indicate that wage inflation is creeping up and hence, wage growth may accelerate more strongly than expected, which would support a stronger than expected increase in overall inflation. On the other hand, a further appreciation of the euro or a prolonged period of weak inflation in trading partners would weigh down on inflation in Malta.

Risks to the public finances tilt on the upside (i.e. balance-improving), especially in the outer years of the forecast horizon. These stem from possible lower government investment on locally-financed projects, reflecting delays in the capacity building exercise on road construction as announced in the 2018 Budget. Such developments are likely to offset possible downside (balance-worsening) risks, relating to the future of the national airline and negotiations over side wage agreements in health and education.