BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

Economic Projections

2017 - 2020

2018:1

Outlook for the Maltese economy

Economic projections

2017-2020

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 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 expected to reach 4.2% in 2020. Hence, in line with the upward revision in economic activity, the unemployment rate has been revised down throughout the projection horizon.

Annual inflation, based on the Harmonised Index of Consumer Prices (HICP), is projected to trend up to 2.0% by 2020, reflecting a pick-up in domestic cost pressures.

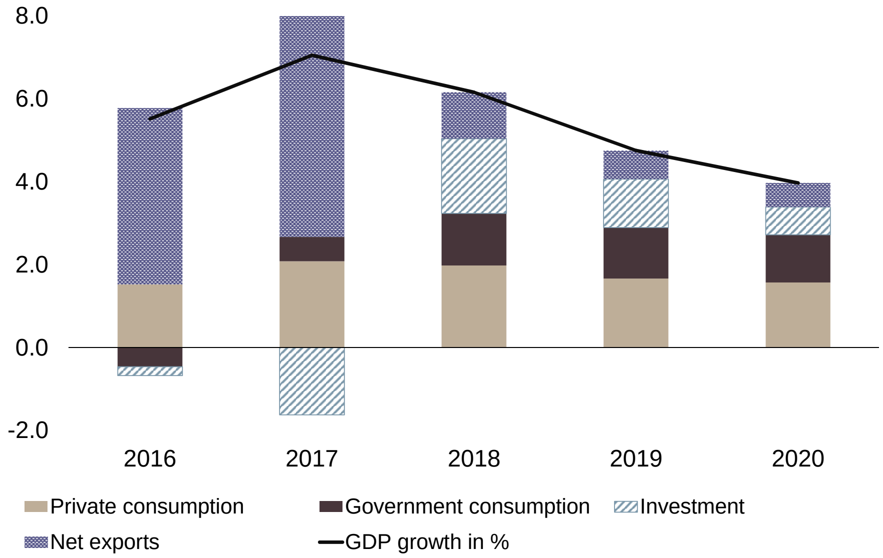
In terms of public finances, the general government balance is expected to remain in surplus over the coming years. Meanwhile the debt-to-GDP ratio is projected to fall to below 45% by the end of the projection horizon.

1 Economic outlook[1]

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 (see Table 1).

Compared with the Bank's latest projections, GDP growth is being revised upwards due to a positive surprise in official data for the third quarter of 2017. The upward revision is driven by further declines in import shares, resulting in a more upbeat assessment of net exports.

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



Source: Central Bank of Malta

While net exports are expected to be the main driver of economic growth in 2017, domestic demand is envisaged to become the main source of growth in economic activity for the period 2018-2020. However, net exports are forecast to continue contributing significantly in the next three years (see Chart 1). Domestic demand will be supported by a recovery in private investment from a dip in 2017, and continued strength in private and government consumption. On the other hand, net exports for the period 2018-2020 are envisaged to contribute positively but less than in the last few years, reflecting the expected pick-up in investment growth and the stabilisation of import shares.

The robust growth on the demand side should 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 last two years of the projection horizon and hence the output

[1]The Bank's outlook for the Maltese economy is based on information available up to 1 February 2018 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.

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

	2016[2]	2017	2018	2019	2020
Real economic activity (% change)					
GDP	5.5	7.1	6.2	4.8	4.0
Private consumption expenditure	3.1	4.3	4.2	3.6	3.5
Government consumption expenditure	-2.5	3.5	7.7	7.5	6.8
Gross fixed capital formation	-0.9	-6.8	8.6	5.4	3.1
Exports of goods and services	4.5	2.0	2.6	2.7	2.9
Imports of goods and services	1.6	-2.5	2.0	2.5	2.8
Contribution to real GDP growth (in percentage pts)					
Final domestic demand	0.9	1.1	5.0	4.1	3.4
Net exports	4.3	6.0	1.1	0.7	0.6
Changes in inventories	0.4	0.0	0.0	0.0	0.0
Real disposable household income[3]	3.4	4.6	4.6	3.9	3.5
Household saving ratio[3]	16.6	17.0	17.2	17.5	17.5
Balance of payments (% of GDP)					
Goods and services balance	11.2	16.6	16.4	16.2	16.2
Current account balance	6.6	9.6	9.8	9.8	9.8
Labour market (% change)[4]					
Total employment	3.7	5.1	3.7	3.2	3.0
Unemployment rate (% of labour supply)	4.7	4.0	4.0	4.1	4.2
Prices and costs (% change)					
GDP deflator	1.5	2.0	2.0	2.0	2.0
RPI[5]	0.6	1.4	1.7	1.9	2.0
Overall HICP[5]	0.9	1.3	1.6	1.8	2.0
HICP excluding energy[5]	1.3	1.3	1.7	1.9	2.1
Compensation per employee	2.7	2.0	3.5	3.3	3.2
ULC	1.0	0.1	1.1	1.8	2.3
Business cycle					
Potential output (% change)	6.9	6.4	5.4	5.3	5.0
Output gap (% of GDP)	0.5	1.1	1.8	1.3	0.3
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 193/2017 published on 6 December 2017.
[2] Actual data.
[3] 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.
[5] Data for 2016 and 2017 are actual data. Data for 2018 onwards are Central Bank of Malta projections.

gap is set to narrow but remain positive by 2020.

Looking at expenditure components in more detail, private consumption growth is set to ease over the next three years. The profile of private consumption growth mirrors that in real disposable income. The latter is in turn set to slow down 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, and thus the saving ratio is forecast to edge up slightly further over the projection horizon.

The profile of real government consumption 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, private investment in 2018 is projected to return to positive growth, 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 the latter is projected to moderate from very high rates recorded recently. Goods exports are forecast to recover following muted developments in previous years. The acceleration in goods exports is expected to offset the projected slowdown in services exports, leading to a pick-up in export growth over the projection horizon.

Mainly mirroring the investment and export projections, import growth is 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 pick up reflecting the acceleration in goods exports, and a stabilisation of import shares. 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 easing in the positive net export contribution, the trade surplus is expected to narrow slightly over the projection horizon. In turn, lower primary income outflows should contribute towards some widening in the current account surplus over the next three years. Moreover, due to the envisaged increase in EU funds, secondary income inflows are projected to rise.

2 Labour market

In line with the expected deceleration of economic activity over the period 2018-2020, the pace of employment growth is projected to ease somewhat. Nevertheless, both economic activity and growth in employment are expected to remain well above their historical average.

The Labour Force Survey (LFS) unemployment rate is expected to remain at record lows in 2018, reflecting continued increases in labour supply due to favourable net migration flows. Conversely, as employment growth and economic activity moderate in the following two years, the unemployment rate is foreseen to rise only slowly and remain low from a historical perspective.

As regards wages, a national skills survey 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.

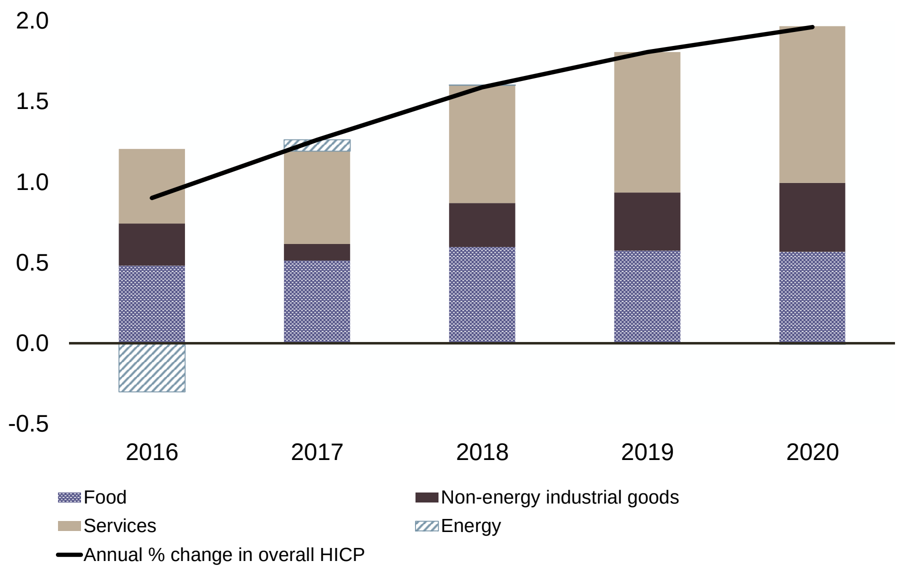
3 Prices

Against the background of the ECB's technical assumptions and the expected evolution of domestic cost pressures and economic activity, HICP inflation in Malta is set to accelerate gradually over the forecast horizon, reaching 2.0% by 2020 (see Chart 2).

The international price of oil showed 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 ease in 2018 and 2019, and turn marginally negative in 2020.

Inflation of HICP excluding energy is projected to gradually accelerate to 2.1% by 2020. This acceleration 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, mirroring a recovery in imported inflation. Meanwhile, food inflation is projected to remain robust throughout the forecast horizon, supported by external food prices.

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



Source: Central Bank of Malta

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). The general government surplus is expected to have increased from 1.1% of GDP in 2016 to 2.1% in 2017, as revenue growth is set to outpace an increase in expenditure. However, the surplus is then expected to decline to 0.6% of GDP by 2020, led by two factors. Gross savings are set to deteriorate, reflecting lower current revenue growth over time. Moreover, capital expenditure is set to grow at a faster pace at the end of the forecast period.

Compared with the Bank's previous projections, the outlook for the government balance is more favourable. This is mostly due to higher than expected tax revenue growth in 2017 and a revised profile for inflows from the IIP scheme. Consequently, the 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 is expected to peak in 2017 and decline thereafter, reflecting slowing growth in the Maltese economy. The share of current taxes on income and wealth in GDP is expected to increase, buoyed by higher income tax revenue from corporations. On the other hand, the share of taxes on production and imports in GDP is expected to decline, driven by slower growth in consumption. Revenue from social contributions is expected to increase at a smaller pace than GDP, in line with the provisions of Maltese law.[2]

The share of other current revenue in GDP is set to increase in 2017 but to decline significantly thereafter.

[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	39.2	40.3	39.7	39.4	39.3
Total expenditure	38.1	38.2	38.0	38.3	38.7
General Government Balance	1.1	2.1	1.6	1.1	0.6
of which: Primary Balance	3.3	4.0	3.4	2.7	2.2
General Government Debt	57.7	53.6	49.1	46.5	44.6
Detailed Breakdown					
Current Revenue	38.5	39.5	38.7	38.2	37.8
Current taxes on income and wealth	13.9	14.3	14.4	14.5	14.7
Taxes on production and imports	12.9	12.8	12.6	12.4	12.4
Social contributions	6.4	6.3	6.1	6.0	6.0
Other current revenue[3]	5.3	6.2	5.6	5.2	4.8
Current Expenditure	34.8	34.7	34.1	33.9	33.9
Compensation of Employees	11.9	11.7	11.6	11.7	11.8
Intermediate Consumption	6.4	7.1	7.0	6.9	7.0
Social benefits	10.9	10.5	10.3	10.1	10.1
Interest payments	2.2	1.9	1.8	1.6	1.6
Subsidies	1.3	1.2	1.2	1.2	1.2
Other current expenditure[4]	2.0	2.2	2.2	2.2	2.2
Gross savings	3.7	4.8	4.6	4.3	4.0
Capital Revenue	0.7	0.8	1.0	1.2	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	1.3
Capital Expenditure	3.3	3.5	4.0	4.4	4.8
Investment	2.5	2.5	2.9	3.2	3.5
Capital transfers	0.8	1.0	1.1	1.3	1.4
Other capital expenditure[6]	0.0	0.0	-0.1	-0.1	-0.1
Capital Revenue Net of Capital Expenditure	-2.6	-2.7	-2.9	-3.2	-3.4
Underlying Budgetary Position					
Cyclical component	0.2	0.5	0.7	0.6	0.4
Temporary government measures	0.0	0.0	0.0	0.0	0.0
Structural balance	1.0	1.6	0.9	0.5	0.2

[1] CBM calculations based on NSO News Release 193/2017 (published on 6 December 2017) and News Release 8/2018 (published on 18 January 2018).
[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.

This is due to the forecast profile of income from the IIP. Revenue from the scheme grew strongly in 2017, but is then set to decline in the outer years of the forecast horizon.

Growth in the main current spending items is expected to remain at or below the profile of nominal GDP growth. The share of compensation of employees in GDP is set to remain broadly stable and in line with the 2016 outcome. Meanwhile, growth in social payments is expected to remain lower than GDP growth, owing mostly to forecast low unemployment and an increase in the statutory retirement age in 2018. Intermediate consumption is set to increase sharply in 2017, partly driven by operational costs associated with the Presidency of the EU Council. Its share in GDP is then expected to remain broadly stable, as higher costs in the health sector are expected to offset savings made from ongoing spending reviews in the public sector. Meanwhile, interest payments are forecast to grow at a smaller pace than GDP, owing to lower projected financing needs.

The shortfall in the balance between capital revenue and capital expenditure is expected to increase steadily over time. The increased shortfall in 2017 partly reflects a one-time transfer to commercial bank depositors from financial protection schemes.[3] Going forward, investment on domestically-funded projects is expected to pick up as work on a nationwide road building project 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 projects are identified and tenders are adjudicated.

The Central Bank of Malta also produces estimates for the structural government balance, which capture 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 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 have improved from a surplus of 1.0% of GDP in 2016 to 1.6% in 2017, before deteriorating to 0.2% of GDP by 2020. Nevertheless, it is expected to remain above the medium-term budgetary objective of a balanced budget in structural terms.

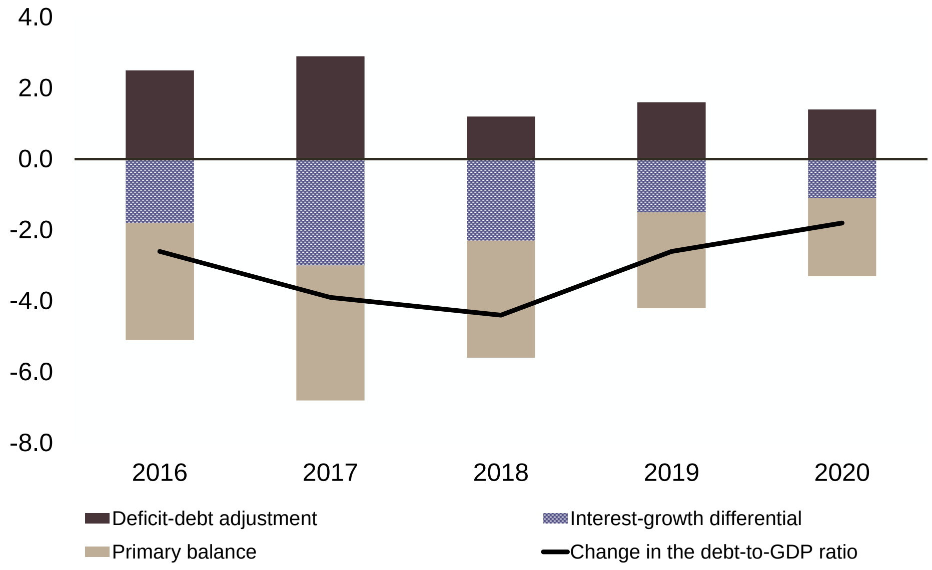
The general government debt-to-GDP ratio is forecast to decline from 57.7% in 2016 to 44.6% by 2020,

[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.

driven by high primary balances and a favourable interest-growth differential (see Chart 3).

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



Source: Central Bank of Malta

5 Risks to the projections

Risks to the GDP growth projections are balanced. Upside 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. 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 on infrastructure such that physical constraints may 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.