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CENTRAL BANK OF MALTA

Economic Projections

2018 - 2020

2018:2

Outlook for the Maltese economy

Economic projections

2018-2020

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 a downward revision in growth in 2018, when compared to the previous set of forecasts, reflecting lower than anticipated growth in 2017. In contrast, GDP growth in 2019 and 2020 was revised up, as selected large investment projects are expected to be delayed to these years. 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 and increased labour market participation will support potential output. Moreover, domestic demand will be the primary driver supporting the economic expansion over the next three years.

As a result of fast economic growth, the labour market is projected to remain tight, with the unemployment rate expected to remain below 4.0% by 2020. In contrast to the downward revision in economic growth, the unemployment rate has been revised down throughout the projection horizon as new data continues to point towards lower unemployment levels than previously envisaged.

Annual inflation, based on the Harmonised Index of Consumer Prices (HICP), is projected to trend up to 1.9% by 2020, reflecting a pick-up in domestic cost pressures.

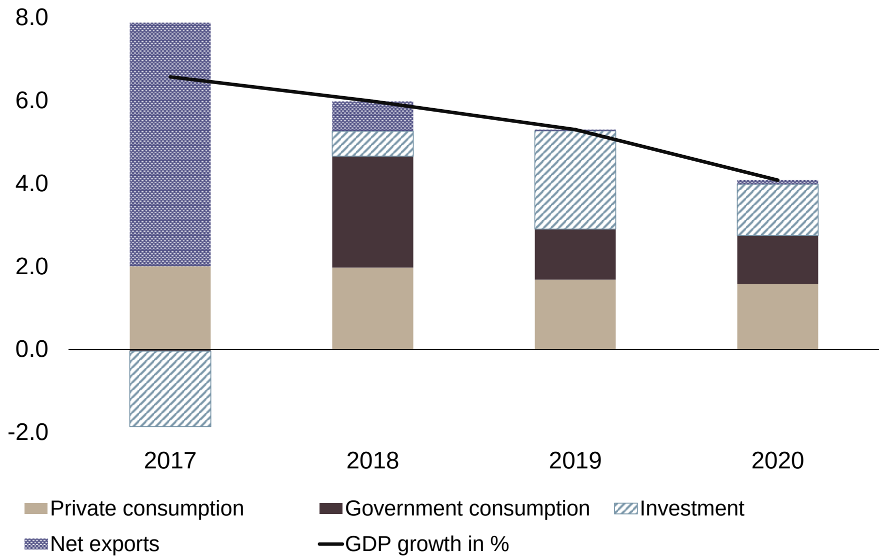
In terms of public finances, forecasts for the general government balance have been revised upwards, partly reflecting a better than expected outturn in 2017. Government finances are expected to remain in surplus over the coming years. Meanwhile the debt-to-GDP ratio is projected to fall to around 40% by the end of the projection horizon.

1 Economic outlook

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).[1]

Compared with the Bank's latest projections, GDP growth is being revised downwards in 2018, partly due to lower than expected outturns in 2017. Some delays in major health-related projects also contributed. Projections for 2019 are then being revised upwards as these health-related investment outlays start gathering pace. For 2020, no revisions to economic activity are foreseen.

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



Source: Central Bank of Malta

The dominant growth driver in 2017 was net exports, which reflected both a strong contraction in import-intensive private investment flows due to large base effects, and a continued decline in import shares. For the period 2018-2020, domestic demand is forecast to become the main contributor towards economic growth due to a pick-up in both private and government investment, while private consumption will remain buoyant (see Chart 1). Moreover, the increased fiscal space will allow government consumption to grow robustly. On the other hand, net exports are envisaged to contribute positively but less than in the last few years as import shares are projected to stabilise at low levels.

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 is projected to outpace GDP in 2020. Thus, the output gap is set to narrow in 2020, but remain positive.

[1] The Bank's outlook for the Maltese economy is based on information available up to 31 May 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.

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

	2017[2]	2018	2019	2020
Real economic activity (% change)				
GDP	6.6	6.0	5.3	4.1
Private consumption expenditure	4.3	4.4	3.8	3.6
Government consumption expenditure	-0.3	17.6	7.2	6.7
Gross fixed capital formation	-7.4	2.8	11.4	5.7
Exports of goods and services	1.6	1.9	2.7	2.9
Imports of goods and services	-3.0	1.5	3.1	3.2
Contribution to real GDP growth (in percentage pts)				
Final domestic demand	0.0	5.3	5.3	4.0
Net exports	5.9	0.7	0.0	0.1
Changes in inventories	0.7	0.0	0.0	0.0
Real disposable household income[3]	6.0	4.4	3.8	3.5
Household saving ratio[3]	19.3	19.3	19.4	19.3
Balance of payments (% of GDP)				
Goods and services balance	17.2	17.3	16.7	16.1
Current account balance	12.1	11.9	11.2	10.7
Labour market (% change)[4]				
Total employment	5.4	4.0	3.3	3.0
Unemployment rate (% of labour supply)	4.0	3.7	3.8	3.9
Prices and costs (% change)				
GDP deflator	2.3	2.3	2.1	2.1
RPI	1.4	1.3	1.7	1.7
Overall HICP	1.3	1.6	1.8	1.9
HICP excluding energy	1.3	1.7	1.8	2.0
Compensation per employee	1.1	3.0	3.2	3.4
ULC	0.0	1.2	1.3	2.3
Business cycle				
Potential output (% change)	6.9	5.5	5.1	5.0
Output gap (% of GDP)	0.7	1.1	1.3	0.3
Technical assumptions				
EUR/USD exchange rate	1.13	1.20	1.18	1.18
Oil price (USD per barrel)	54.4	74.5	73.5	68.7

[1] Data on GDP were sourced from NSO News Release 038/2018 published on 6 March 2018.
[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.

Looking at the expenditure components in more detail, private consumption growth is set to accelerate slightly in 2018. It is then projected to slow down in 2019 and in 2020. The profile of private consumption mirrors the very large accumulation of savings in the last few years, and the development of real disposable income over the projection horizon. The latter is set to decelerate over the projection horizon reflecting the expected easing of economic activity, but it is estimated to remain strong from a historical perspective and thus supportive of continued strong increases in private consumption.

The profile of real government consumption is heavily influenced 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 2018 private investment is projected to decrease marginally due to the finalisation of energy projects in 2017 and lower capital outlays in aviation. It is projected to recover strongly in 2019 and grow further in 2020 as investment in health-related projects is expected to pick up and support the recovery in investment. Residential investment is foreseen to continue growing robustly but at a slower pace when compared to the last few years, as the pace of population increase is expected to slow down.

With regard to external trade, export growth is expected to accelerate in the projection horizon. Services exports are anticipated to slow down from very high growth rates in the last few years. On the other hand, goods exports are projected to recover in line with improved foreign demand. Nevertheless, the weakness in goods exports is envisaged to persist, and hence, goods exports are foreseen to grow less rapidly than foreign demand.

Mainly mirroring the investment and export projections, import growth is expected to turn positive in 2018 as goods imports are foreseen to contract less than 2017, in line with a lower decline in private investment and a pick-up in goods exports. On the other hand, services imports are expected to grow at a faster rate compared with 2017. Import growth is set to accelerate further in 2019 and 2020, due to the recovery in private investment growth and the acceleration in goods exports. Moreover, during the projection horizon we continue to expect that the recent decline in import shares will persist in 2018, but import shares are expected to edge up slightly in the following two years.

As a result of the easing in the positive net export contribution, the trade surplus is expected to narrow over the projection horizon. In turn, primary income outflows should also contribute towards some narrowing in the current account surplus over the next three years. However, 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, in spite of 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, though still remaining 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 over the projection horizon.

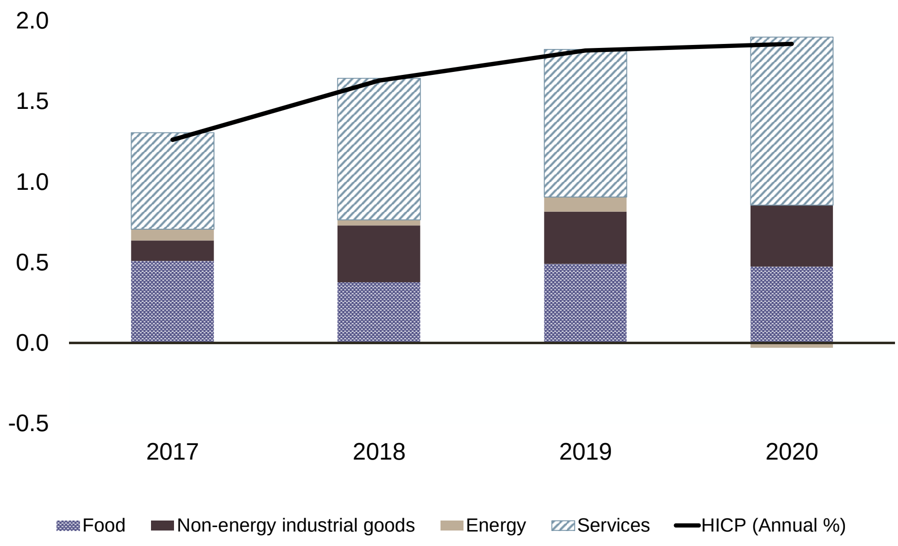
3 Prices

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 1.9% by 2020 (see Chart 2).

The international price of oil has shown strong growth during 2017. It is forecast to increase at an even faster pace in 2018, 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 remain positive in 2018 and 2019, before turning negative in 2020.

HICP excluding energy is projected to gradually accelerate to 2.0% by 2020. The acceleration in HICP excluding energy is foreseen to be primarily driven by faster growth in services prices, reflecting some intensification of demand and 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. Food inflation is projected to remain robust throughout the forecast horizon.

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). However, the general government surplus is expected to decline from 3.9% of GDP in 2017 to 1.0% of GDP in 2020. This is due to forecast lower gross savings (i.e. the balance between current revenue and expenditure) and a deterioration in the balance of capital expenditure net of capital revenue.

Compared with the Bank's earlier projections, the government surplus surprised on the upside in 2017, due to higher than expected growth in tax revenue and lower than expected increases in expenditure. Going forward, the government balance outlook is unchanged in 2018 but is more favourable in 2019 and 2020, due to a revised profile for government investment. The general government debt-to-GDP ratio was lower than expected in 2017, mainly due to the higher than expected surplus. It is now forecast to remain below the Bank's earlier projections over the whole forecast horizon.

Overall, the share of tax revenue items in GDP is expected to decline compared with 2017, 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 forecast to increase at a smaller pace than GDP, in line with the provisions of Maltese law which limit these contributions.

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

	2017[2]	2018	2019	2020
Headline Aggregates				
Total revenue	40.5	38.7	38.3	38.3
Total expenditure	36.5	37.1	36.9	37.2
General Government Balance	3.9	1.6	1.4	1.0
of which: Primary Balance	5.8	3.2	2.9	2.5
General Government Debt	50.8	46.0	42.6	40.1
Detailed Breakdown				
Current Revenue	39.6	37.6	37.1	36.9
Current taxes on income and wealth	14.1	14.1	14.3	14.4
Taxes on production and imports	12.7	12.5	12.3	12.2
Social contributions	6.3	6.2	6.1	6.0
Other current revenue[3]	6.5	4.8	4.4	4.2
Current Expenditure	33.4	32.8	32.5	32.5
Compensation of Employees	11.4	11.4	11.3	11.5
Intermediate Consumption	6.8	6.8	6.8	6.8
Social benefits	10.2	10.0	9.8	9.7
Interest payments	1.9	1.6	1.5	1.6
Subsidies	1.2	1.2	1.2	1.2
Other current expenditure[4]	1.9	1.9	1.9	1.9
Gross savings	6.2	4.8	4.6	4.4
Capital Revenue	0.8	1.0	1.2	1.4
Capital taxes	0.2	0.2	0.2	0.2
Other capital revenue[5]	0.7	0.9	1.0	1.2
Capital Expenditure	3.1	4.3	4.4	4.7
Investment	2.2	2.8	3.2	3.5
Capital transfers	0.9	1.5	1.2	1.3
Other capital expenditure[6]	0.0	-0.1	-0.1	-0.1
Capital Revenue Net of Capital Expenditure	-2.3	-3.3	-3.2	-3.3
Underlying Budgetary Position				
Cyclical component	0.6	0.7	0.7	0.5
Temporary government measures	0.0	0.0	0.0	0.0
Structural balance	3.3	0.9	0.7	0.5

[1] CBM calculations based on NSO News Release 38/2018 (published on 8 March 2018) and News Release 62/2018 (published on 23 April 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.

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, which are set to decline substantially from the high levels received in 2017. Moreover, certain inflows that materialised in 2014, are assessed to be of temporary nature.

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 2017 outcome. Meanwhile, growth in social payments is expected to 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. Meanwhile, the share of intermediate consumption, subsidies and other current primary expenditure is forecast to grow in line with nominal GDP.

The shortfall in the balance between capital revenue and capital expenditure is expected to increase in 2018 and to remain broadly stable thereafter. The increased shortfall in 2018 partly reflects a one-time capital transfer reflecting the acquisition of landing rights from Airmalta. Going forward, investment on domestically-funded projects is expected to pick up as work on nationwide road building projects gathers pace. Meanwhile, spending on projects which are partly-financed by EU funds under the 2014-2020 funding framework is also expected to increase compared with the outcome in 2017, albeit not by the same extent as domestically-funded outlays.

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[2], which differs from the approach used by the Commission and the Maltese Government.

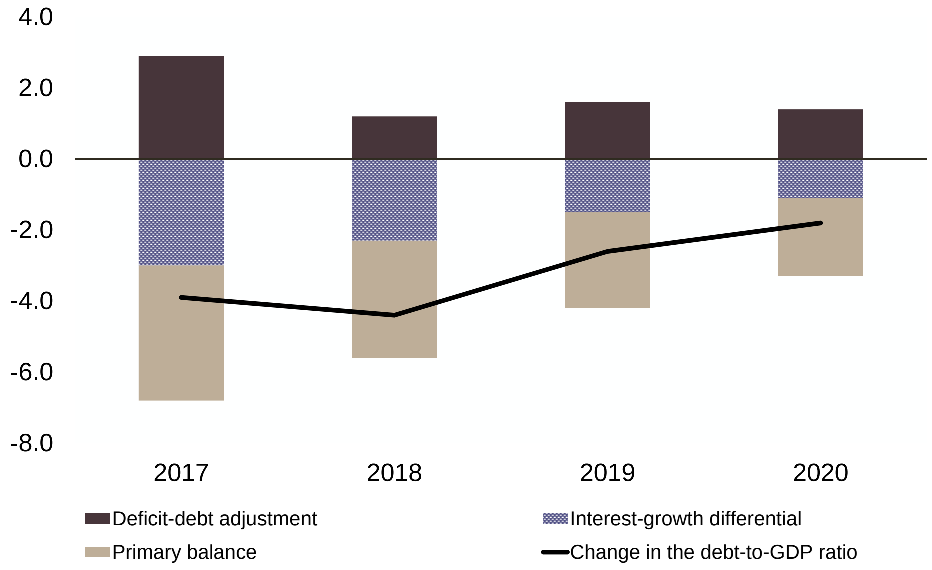
In the absence of significant temporary measures, the profile of the structural balance is determined by the extent to which the headline balance is influenced by the economic cycle. The Bank expects a positive and broadly flat cyclical component in 2018 and 2019, which declines slightly by2020. This 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 3.3% of GDP in 2017 to 0.5% of GDP by 2020, due to developments in the headline balance as outlined above. It is thus 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 50.8% in 2017 to 40.1% by 2020,

[2]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 broadly balanced. Downside risks relate to the increased likelihood of protectionism and global uncertainties. In particular, an intensification of trade wars and uncertainties regarding Brexit would negatively impact export growth. Moreover, environmental and infrastructural constraints may become binding after a prolonged period of above average economic activity. On the other hand, there are upside risks if competitive gains in services exports and the decline in import shares persist for a prolonged period. Private consumption may also surprise on the upside if the savings ratio surprises on the downside and if further declines in unemployment materialise.

Risks to inflation are balanced. A continuation of the current weak inflation environment in Malta's main trading partners would limit growth in import prices, which should in turn translate into weaker domestic inflationary pressures. On the other hand, if wage growth accelerates more strongly than expected, inflation would be higher than expected.

Risks to the public finances tilt on the upside (i.e. balance-improving). These stem from possible slippages in the implementation of locally-financed investment projects.