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Economic Projections

2018 - 2021

2018:4

Outlook for the Maltese economy

Economic projections

2018-2021

The Central Bank's latest projections foresee economic growth over the coming years to remain strong from a historical perspective. Projections to economic activity remain broadly unchanged when compared to the previous set of forecasts, as upward revisions to private consumption and investment are offset by downward revisions to net exports. During the projection horizon, growth will remain high, supported by both demand and supply factors. In particular, the continued impact of the energy reforms, new investment projects and increased labour supply are expected to keep potential output elevated. Domestic demand, driven by higher consumption and investment, is anticipated to become the primary driver supporting the economic expansion over the projection horizon. Net exports are expected to provide some support this year, but their contribution is expected to turn negative from 2019, reflecting higher import growth.

The pace of job creation is set to moderate, but remain quite strong. The labour market is projected to remain tight, with the unemployment rate projected at 4.0% by 2021.

Annual inflation, based on the Harmonised Index of Consumer Prices (HICP), is projected to edge up to 2.1% by 2021, reflecting a pick-up in domestic wage pressures.

Government finances are expected to remain in surplus over the coming years. Meanwhile the debt-to-GDP ratio is projected to decline to below 40% by the end of the projection horizon.

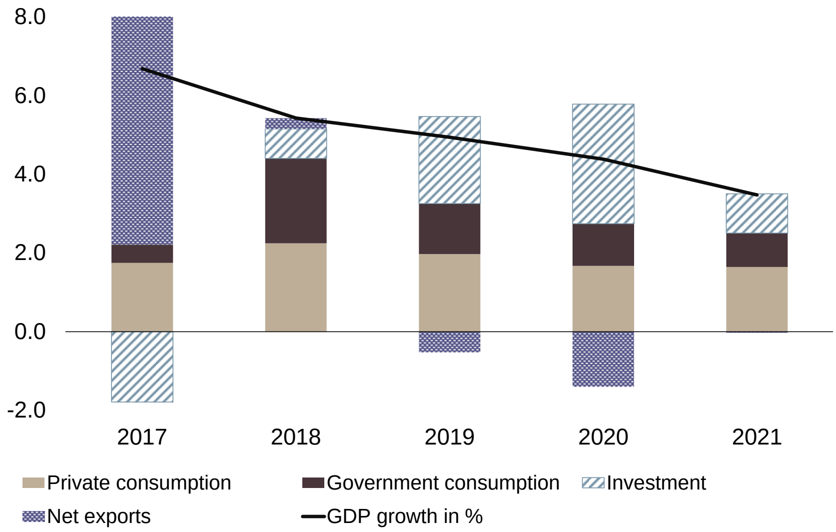
Looking forward, GDP projections are more likely to be revised upwards in forthcoming forecast rounds, reflecting more recent data on GDP that surprised on the upside. Similarly inflation forecasts could be revised upwards, if wage growth is faster than currently projected. Finally it is more likely that forthcoming public finance projections show higher surpluses and lower debt-to-GDP ratios than the ones found in this set of forecasts.

1 Economic outlook

The Central Bank's latest economic projections foresee economic growth over the years 2018-2021 to remain strong from a historical perspective, though at more sustainable levels than the rate seen in 2017 (see Table 1).[1]

Compared with the Bank's previous projections published in August, GDP growth is being revised slightly downwards in 2019, but is otherwise unchanged, with growth expected to ease from 5.4% in 2018 to 4.4% in 2020 and further to 3.5% in 2021. However, due to the outturns of the second quarter of this year, the composition of growth is being revised. In particular, private consumption and employment growth surprised on the upside and are thus being revised upwards. Conversely, the net export contribution is envisaged to be lower in this projection round, due to lower than expected export growth and a faster normalisation in import shares from recently low levels. Government consumption also surprised on the downside, mainly reflecting that a portion of sales related to the Individual Investor Programme (IIP) previously attributed to 2017 were subsequently recorded in 2018.

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 contraction in import-intensive private investment flows (due to the completion of large projects in the energy and aviation sectors), and a continued decline in import shares. For the period 2018-2021, domestic demand is forecast to become the major contributor towards economic growth due to a recovery in both private and government investment, while private consumption will remain buoyant in the context of favourable

[1] The Banks outlook for the Maltese economy is based on information available up to 28 November 2018 and is conditional on the December BMPE 2018 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	2021
Real economic activity (% change)					
GDP	6.7	5.4	4.9	4.4	3.5
Private consumption expenditure	3.7	5.0	4.4	3.8	3.8
Government consumption expenditure	2.8	13.8	7.6	6.2	4.9
Gross fixed capital formation	-7.3	3.6	10.5	13.7	4.1
Exports of goods and services	3.8	0.8	2.4	2.5	2.8
Imports of goods and services	-1.9	0.7	3.3	4.2	3.2
Contribution to real GDP growth (in percentage pts)					
Final domestic demand	0.4	5.2	5.5	5.8	3.5
Net exports	7.8	0.3	-0.5	-1.4	0.0
Changes in inventories	-1.5	0.0	0.0	0.0	0.0
Real disposable household income[3]	4.4	4.9	4.1	3.7	3.2
Household saving ratio[3]	18.9	18.8	18.5	18.4	18.0
Balance of payments (% of GDP)					
Goods and services balance	19.4	18.7	17.4	15.3	14.7
Current account balance	13.4	12.7	11.6	10.3	10.0
Labour market (% change)[4]					
Total employment	5.2	5.0	4.1	3.3	2.8
Unemployment rate (% of labour supply)	4.0	3.8	3.8	3.9	4.0
Prices and costs (% change)					
GDP deflator	2.6	2.1	2.2	2.1	2.1
RPI	1.4	1.2	1.7	1.8	2.0
Overall HICP	1.3	1.9	1.9	2.0	2.1
HICP excluding energy	1.3	1.9	1.9	2.1	2.3
Compensation per employee	1.7	2.8	3.2	3.3	3.5
ULC	0.2	2.3	2.4	2.2	2.9
Business cycle					
Potential output (% change)	6.7	5.3	4.8	4.4	4.1
Output gap (% of GDP)	0.3	0.4	0.6	0.5	0.0
Technical assumptions					
EUR/USD exchange rate	1.13	1.18	1.14	1.14	1.14
Oil price (USD per barrel)	54.4	71.8	67.5	66.8	65.9

[1] Data on GDP were sourced from NSO News Release 139/2018 published on 6 September 2018, while data for prices were sourced from NSO News Release 183/2018 and 185/2018 (released on 16 and 23 of November 2018).

[2] Actual data.

[3] Central Bank of Malta estimates.

[4] Employment data are consistent with the national accounts. The unemployment rate is based on the number of unemployed and employed as reported in the Labour Force Survey.

labour market conditions and continued strong growth in disposable income (see Chart 1). Moreover, the increased fiscal space will allow government consumption to expand further. On the other hand, net exports are envisaged to contribute positively in 2018, but are set to dampen GDP growth in 2019 and 2020 due to the expected recovery in import shares and the pick-up in capital-intensive investment growth. The net export contribution is projected to become broadly neutral by 2021, as some investment projects are expected to reach completion in 2020 and investment in the aviation sector normalises after a period of rapid expansion.

The robust growth on the demand side should be supported by the supply side of the economy, reflecting continued increase in the labour supply due to net migrant flows, and efficiency gains. GDP growth is expected to remain above potential until 2019. Thereafter, it is projected to grow in line or above GDP. As a result a small positive output gap is set to persist until 2020, before closing in 2021.

Looking at the expenditure components in more detail, private consumption growth is set to accelerate in 2018 reflecting continued support from growth in labour income. It is projected to remain dynamic over the following three years but ease when compared with 2018. The profile of private consumption mirrors the very large accumulation of savings in recent years and the projected development of real disposable income. The latter is set to accelerate this year, as a pick-up in wage growth is set to offset a slight deceleration in employment. In line with the expected easing of economic activity, real disposable income is then set to decelerate over the following three years, but it is estimated to remain strong from a historical perspective and thus supportive of continued strong increases in private consumption. Furthermore, households are expected to gradually unwind their accumulated savings.

The profile of real government consumption is heavily influenced by inflows related to the IIP, which are netted against consumption expenditure. 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 , 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 expand only marginally due to the completion of energy-related projects in 2017 and lower capital outlays in the aviation sector. It is projected to recover strongly in 2019 and accelerate further in 2020 as investment in health-related projects is expected to pick up. Growth in investment is set to slow down in 2021, as some of these projects reach completion. Residential investment is foreseen to continue growing robustly but at a slower pace when compared to the last few years, reflecting some deceleration in the issuance of permits in the course of 2018 and an expected slowdown in migrant flows.

With regard to external trade, export growth is expected to moderate in 2018 due to continued weakness in goods exports and a decrease in IIP flows from the very high level recorded in 2017. In addition, services exports other than those related to the IIP are anticipated to slow down over the projection horizon. On the other hand, goods exports are projected to recover from their currently low level. Nevertheless, the weakness in goods exports is envisaged to persist, and hence, these 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. In particular, we foresee a smaller contraction in goods imports compared with 2017, in line with the mild recovery in private investment. Moreover services imports are expected to accelerate, as import shares are projected to stabilise after strong declines in the last few years. Import growth is then set to accelerate significantly in 2019 and 2020, as goods imports respond to the recovery in private investment and some pick up in goods exports. It is then projected to slow down in 2021, reflecting the deceleration in private investment growth foreseen that year.

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, due to the envisaged increase in the absorption of EU funds relative to 2018, secondary income inflows are projected to rise.

2 Labour market

Despite the envisaged easing of economic activity in 2018, employment growth is set to remain robust this year, reflecting the strong outturns for the first half of 2018. However, as activity loses some momentum over the following three years, employment growth is foreseen to slow down. 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 net migration flows and increased activity among nationals. Subsequently, as employment growth and economic activity moderate, the unemployment rate is foreseen to rise, but only slowly, and remain low from a historical perspective.

As regards wages, surveys and the Banks 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 and further moderate increases in productivity, growth in nominal compensation per employee is expected to accelerate over the projection horizon.

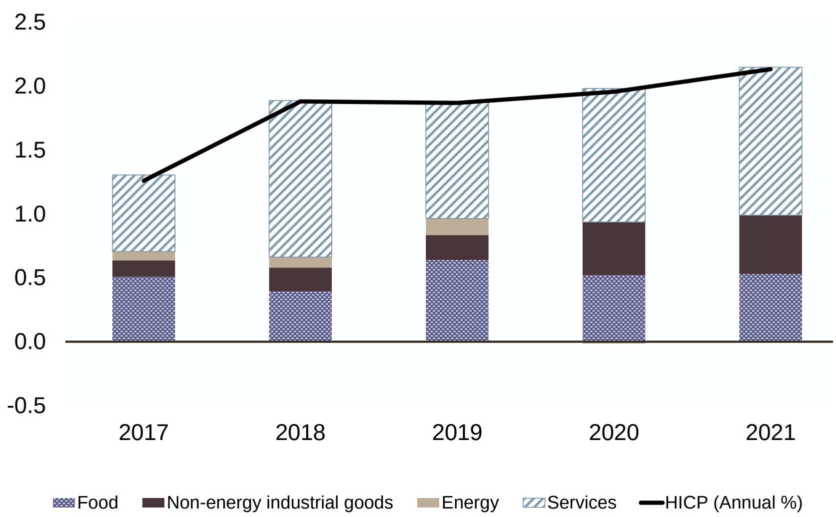
3 Prices

Against the background of the technical assumptions reported in Table 1 and the expected evolution of domestic cost pressures and economic activity, HICP inflation in Malta is set to accelerate over the forecast horizon, reaching 2.1% by 2021 (see Chart 2). This rate, however, is significantly lower than the historical average for Malta.

The international price of oil increased strongly during 2017. It is assumed to increase at an even faster pace in 2018, but decline progressively in the following three years. 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. In 2018, energy inflation is also supported by the increase in fuel prices in August 2018. Hence, energy inflation is set to remain positive in 2018 and 2019, before turning negative in 2020 and 2021.

HICP excluding energy is projected to accelerate from 1.3% in 2017 to 2.3% by 2021. This is mainly underpinned by faster growth in services prices, reflecting some intensification of demand and wage pressures. 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 3.5% of GDP in 2017 to 1.5% of GDP in 2018 and 1.1% in 2019. The balance is then expected to recover, reaching 1.6% of GDP by 2021. The narrowing in the surplus is mainly driven by the forecast deterioration in gross savings (i.e. the balance between current revenue and expenditure). The recovery in the outer years of the forecast period reflects the profile of the balance of capital expenditure net of capital revenue.

Compared with the Bank's earlier projections, the government surplus has been revised down for 2018 and 2019, and revised up for later years, mainly reflecting a revised government investment profile. Meanwhile, the general government debt-to-GDP ratio has been revised up throughout the forecast period, mainly due to lower primary surpluses during most of the projection horizon and revised less favourable interest-growth differential.

Overall, the share of tax revenue items in GDP is expected to decline slightly compared with 2017. 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 which limit these contributions.

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 is assumed to decline substantially from the high levels received in 2017.

Taken together the two largest current spending items are expected to grow broadly in line with GDP in aggregate. The share of social payments in GDP is expected to decline marginally by 2021, reflecting forecast low unemployment as well as the impact of an increase in the statutory retirement age in 2018, which will limit pension expenditure growth that year. Meanwhile, compensation of employees is expected to increase at a faster pace than GDP, driven by higher recruitment allowances in the health and education sectors. At the same time, the share of intermediate consumption in GDP is set to increase, driven mainly by continued fast growth in health-related costs.

Other current primary expenditure is forecast to grow in line with nominal GDP. At the same time, the ratio of interest payments in GDP is expected to decrease, reflecting lower financing needs as well as the prevailing low interest rate environment.

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

	2017[2]	2018	2019	2020	2021
Headline Aggregates					
Total revenue	39.7	38.9	38.7	38.6	38.6
Total expenditure	36.1	37.3	37.6	37.3	37.0
General Government Balance	3.5	1.5	1.1	1.3	1.6
of which: Primary Balance	5.3	3.1	2.5	2.6	2.8
General Government Debt	50.9	46.5	43.3	40.3	37.3
Detailed Breakdown					
Current Revenue	38.8	37.8	37.3	37.1	37.1
Current taxes on income and wealth	14.0	14.0	14.1	14.3	14.5
Taxes on production and imports	12.5	12.5	12.3	12.2	12.2
Social contributions	6.3	6.2	6.2	6.1	6.1
Other current revenue[3]	5.9	5.0	4.6	4.3	4.2
Current Expenditure	33.0	33.1	32.9	32.7	32.7
Compensation of Employees	11.4	11.5	11.5	11.5	11.6
Social benefits	10.2	10.0	10.1	10.0	10.0
Intermediate Consumption	6.4	6.7	6.8	6.8	6.7
Interest payments	1.8	1.6	1.4	1.3	1.2
Subsidies	1.2	1.2	1.2	1.2	1.2
Other current expenditure[4]	1.8	1.8	1.8	1.8	1.8
Gross savings	5.8	4.7	4.3	4.3	4.3
Capital Revenue	0.8	1.0	1.3	1.5	1.4
Capital taxes	0.1	0.1	0.1	0.1	0.1
Other capital revenue[5]	0.6	0.8	1.2	1.3	1.3
Capital Expenditure	3.1	4.2	4.6	4.5	4.2
Investment	2.2	2.8	3.4	3.4	3.3
Capital transfers	0.8	1.4	1.2	1.1	0.9
Other capital expenditure[6]	0.0	0.0	0.0	0.0	0.0
Capital Revenue Net of Capital Expenditure	-2.2	-3.2	-3.2	-3.0	-2.7
Underlying Budgetary Position					
Cyclical component	0.5	0.5	0.5	0.4	0.2
Temporary government measures	0.0	0.0	0.0	0.0	0.0
Structural balance	3.0	0.9	0.5	0.8	1.3

[1] CBM calculations based on NSO News Release 139/2018 (published on 6 September 2018) and News Release 168/2018 (published on 22 October 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.

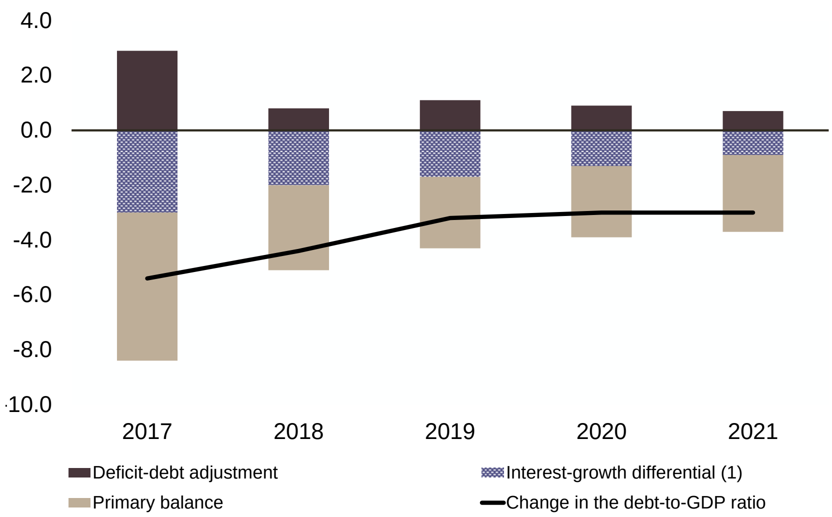
The shortfall in the balance between capital revenue and capital expenditure is expected to increase sharply in 2018 and to remain stable in the following year, before improving in the outer years of the forecast period. The increased shortfall in 2018 partly reflects a one-time capital transfer related to the acquisition of landing rights from Airmalta. Investment on domestically-funded projects is expected to pick up as work on nationwide road building projects gathers pace. 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.

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, which differs from the approach used by the European Commission and the Maltese Government.

The Central Bank expects a positive cyclical component which declines over time. In addition, no significant temporary measures are expected to take place throughout the forecast period. Overall, the structural balance is set to decline from a surplus of 3.0% of GDP in 2017 to 0.6% of GDP by 2019, before improving to 1.3% by 2021. This reflects the above-mentioned developments in the headline balance. 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 50.9% in 2017 to 37.4% by 2021, 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 on the upside in 2018 and broadly balanced thereafter. Downside risks relate to the increased likelihood of protectionism and global uncertainties. In particular, an intensification of trade wars and uncertainties regarding Brexit could have a stronger negative impact on export growth than assumed in the projections. 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 adjusts downwards faster than expected and if unemployment continues to decline. Moreover, the latest GDP data, which were released after the cut-off date for these projections, suggest that growth in 2018 is likely to be above the current projection for this year.

Risks to inflation are slightly on the upside. The growing weight of accommodation prices within the HICP, reflecting the buoyancy of Maltas tourism sector, may push the price level further up. Moreover labour tightness could bring about stronger than expected increases in wage pressures. On the other hand, if imported inflation remains weak, the expected pick up in NEIG inflation would be delayed.

On balance, 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, while the upside risks to the level of GDP could result in an improved debt-to-GDP ratio.