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EUROSISTEMA
CENTRAL BANK OF MALTA

Economic Projections

2020 - 2022

2020:2

Outlook for the Maltese economy

Economic projections

2020-2022

The Central Bank of Malta expects economic growth to be severely affected by the outbreak of COVID-19 and the containment measures imposed by governments worldwide to stem the spread of the virus. Given the high uncertainty surrounding the evolution of the pandemic, the Bank is presenting two scenarios, a baseline and a more severe scenario. In the baseline scenario, which accounts for a situation in which containment measures are at least partially successful, GDP is projected to contract by 4.8% in 2020, and grow by around 5.8% and 4.2% in the following two years. Despite the projected recovery, the level of economic activity is expected to be around 6% lower than that expected prior to the outbreak of COVID-19.

Under the baseline scenario, the largest contributor to the decline in GDP in 2020 is net exports, reflecting an expected decline in foreign demand, restrictions to travel-related activities, and disruptions to the global supply chain. Domestic demand is also expected to contribute negatively, as the shut-down of various activities and elevated uncertainty is expected to adversely impact private consumption and investment. Going forward, domestic demand is expected to be the main driver of the projected recovery in 2021 and 2022.

In view of the foreseen contraction in economic growth, employment is set to decline in 2020, leading towards an increase in the unemployment rate. Fiscal measures are however expected to be supportive of the labour market, and hence, the expected losses in headcount employment are rather mild when compared with the foreseen decline in GDP. The labour market is then expected to rebound in the following years, due to the projected improvement in economic activity levels.

In 2020, lower domestic and international price pressures should also lead toward an easing in annual inflation, based on the Harmonised Index of Consumer Prices (HICP). However, in the short-run, inflation is expected to be impacted by cost-push factors, in the context of disruptions to the global supply chain. It is then set to edge up to 1.5% by 2022, reflecting a pick-up in economic activity, affecting prices of services and non-energy industrial goods inflation (NEIG).

Public finances are expected to deteriorate in 2020 due to the expected decline in economic activity and the introduction of COVID-19 related measures. In the baseline scenario, the government balance is projected to be in deficit of 6.8% of GDP in 2020. As most COVID-19 related measures are set to end this year, the deficit is expected to narrow in 2021, and to stand at 2.9% of GDP by 2022. The government debt-to-GDP ratio is projected *to rise from 43.7% in 2019 to reach 55.0% by 2022.*

In the severe scenario, it is assumed that the health protocols would have to be enhanced and extended to contain a second wave of infections. We estimate that GDP could contract by 8.3% this year, and rebound by 6.8% and 3.8% in 2021 and 2022. In this case, the level of GDP would be around 9% lower than our March projections, and would only reach 2019 levels by the end of 2022. Moreover, the unemployment rate would rise further, and inflation would be slightly weaker. In addition, the government deficit would reach 10.4% in 2020, while the government debt-to-GDP ratio would rise to 63.0% by the end of 2022.

1 Overall Narrative

Prior to the onset of COVID-19, the Maltese economy was projected to continue growing robustly over the next few years, albeit with some moderation following a period of strong expansion. Since the Bank's latest projections - published in March 2020 - the outbreak of COVID-19 and the subsequent containment measures imposed by governments worldwide to stem the spread of the virus, meant a significant economic shock.[1] Given the high degree of uncertainty regarding the evolution of the pandemic, the Bank is presenting two scenarios for the outlook of the Maltese economy during the period 2020-2022.[2]

The baseline scenario assumes a situation in which the containment measures imposed by governments across the world are partially successful in containing the virus, with some resurgence in infections. Furthermore, containment measures are assumed to persist even as lockdown measures are lifted. For example measures, such as social distancing, would remain in place for a relatively extended period, at least until a vaccine is found and readily available world-wide. This entails a large temporary economic shock, which has some permanent effects on economic activity in the medium-term. In this scenario, one can expect a significant contraction in 2020, and a slow but steady recovery in economic activity, which however remains below pre-COVID expectations.

In the more severe scenario (see Box 2), containment measures are expected to have limited success in containing the virus. In this scenario, strict protocols both in Malta and abroad, are enhanced and extended to contain a second wave of infections. These measures are stringent and protracted, and thus extremely disruptive over a longer period of time compared to the baseline. This is reflected in an even more substantial contraction in 2020, followed by a very timid and slow recovery. In the severe scenario, the levels of economic activity would remain even lower than the baseline scenario, both in the medium and the longer-term.

In order to build a projection consistent with the narratives explained above, we take into account the evolution of the pandemic internationally through the usual foreign demand and price channels, while accounting for the specificities of Malta's case. During March, the Maltese Government announced several containment measures, including the closure of the airport and hence any travel-related activities; the closure of educational institutions and non-essential services; and social distancing measures. Since the beginning of May, some of the restrictions on non-essential services have been gradually relaxed, but social distancing measures remain in place.

[1] The Bank's March 2020 projections were based on information that preceded the first case of COVID-19 in Malta, and hence could be considered as the Bank's pre-COVID expectations of Malta's growth for the period 2020-2022. These projections can be found at https://www.centralbankmalta.org/archive-economic-projections.

[2] The two scenarios outlined here are fully consistent with the baseline and severe scenarios as outlined in the June 2020 Eurosystem staff projections.

In line with these containment measures, the projection is built around four main shocks:

1. a travel ban: The Government has gradually banned all travel in and out of Malta, which has had dramatic effects on specific economic sectors. The projection takes into account both direct and indirect effects on all economic sectors, and includes some judgement on the duration of the travel ban, and the transition thereafter. The travel ban leads to substantial drops to tourism exports, but also propagates through lower employment and a subsequent drop in private consumption and investment.

2. Shut-down of non-essential services: A full shut-down was imposed on specific sectors of the economy. This had an impact on both supply and demand, with the demand impact beyond the lost demand due to the travel ban. Private consumption growth is hence directly impacted, as people are forced to lower their consumption. In addition, private investment is either postponed or cancelled, due to heightened uncertainty.

3. Supply chain disruption: The global supply chain has been severely affected by partial and full lockdowns imposed in a number of countries. This adversely affects production capabilities in Malta, especially in the manufacturing industry. Moreover, quarantine measures along with the closure of schools, are also temporarily disruptive to labour supply and hence production. This primarily leads to drops in imports and exports.

4. Fiscal measures: The government has announced a number of fiscal measures, aimed at supporting waning liquidity due to the closure of businesses, protecting employment, assisting individuals directly affected by the pandemic, and by increasing spending on health to boost Malta's preparedness to contain the virus. These fiscal measures primarily affect government consumption, but also reduce unemployment and corporate default rates (see Box 1 for further details).

Box 1: Fiscal Measures

The Maltese Government introduced several measures to overcome the adverse effects caused by COVID-19. A first set of measures, announced on 14 March, offered liquidity support to firms by deferring provisional tax, VAT and social security payments due in March and April. Additionally, the Government launched a tax refund scheme to assist business on outlays related to teleworking activities. On 18 March, a second set of measures was announced. These included loan guarantees, a wage supplement to firms, financial support to people in quarantine leave and parents who could not work in order to care for their children, as well as new benefits for the unemployed and vulnerable persons. Through this package, additional resources were also allocated to health authorities. On 24 March, a third set of measures introduced more generous terms for tax deferral schemes (extended to more sectors and applicable for a longer time period) and for the wage supplement scheme.

By May, other schemes were launched. These offer support to research and development and the production of items that assist in the fight against the virus. Additional funds offer help to local band clubs and other voluntary organisations. Moreover, VAT on face masks and shields was reduced from 18% to 5% and a Mask Subsidy Scheme offered refunds to pharmacies for wholesale losses made on stocks bought earlier in the year.

Overall, the above mentioned COVID-19 related measures can be grouped into four categories. The first category consists of economic support measures which provide assistance to industries in order to minimise the impact of COVID-19 on enterprises and employment. Other social measures include assistance to vulnerable sectors in society. A third category of measures offer liquidity support to firms in the form of loan guarantees, interest rate subsides on state-backed loans and deferral of tax payments. The final set of measures reflects health-related expenditure to expand healthcare capacity, including additional spending on equipment, testing and treatment.

Measures are expected to impact various government expenditure items, in line with the ESA classification adopted by the National Statistics Office following EUROSTAT guidelines. Liquidity and economic support measures are classified as subsidies, while social measures are classified as social benefits in cash. Meanwhile, the bulk of health-related spending is classified as intermediate consumption and social benefits in kind.

In the baseline, these measures are expected to amount to around 4.0% of GDP in 2020 (see Table A). Liquidity measures are in general not expected to affect the budget balance, as deferred taxes are expected to be repaid by end-2020 and state guarantees will not have an impact unless called. However, interest rate subsidies are expected to impact the budget balance by around 0.2% of GDP in 2020. Economic support measures are expected to cost around 2.5% of GDP with the bulk of spending allocated to the wage supplement schemes. Social measures are expected to cost around 0.3% of GDP mainly due to spending allocated to parent and additional unemployment benefit schemes. Moreover, additional health related outlays are expected to amount to around 1.0% of GDP in 2020 and approximately 0.3% of GDP in 2021.

Table A : Fiscal measures affecting the budget balance (% of GDP)

Measures	ESA classification	2020	2021
Liquidity measures	Subsidies	0.2	-
Economic support measures	Subsidies	2.5	-
Social measures	Social benefits in kind	0.3	-
Health-related measures	Intermediate consumption	0.5	0.1
	Social benefits in kind	0.3	0.1
	Compensation of employees	0.1	0.1
	GFCF	0.1	-

[i] Prepared by John Farrugia, a principal economist within the Economic Analysis Department at the Central Bank of Malta; and Juergen Attard, a senior economist within the Economic Analysis Department at the Central Bank of Malta.

2 Baseline Scenario

Main assumptions

In the baseline scenario, the following assumptions were made regarding the estimated shocks mentioned in the previous section:

1. Travel ban: A total ban on all travel-related activities is assumed to last around 12 weeks, that is, until mid to late June. This is followed by a gradual opening of selected routes and some recovery in tourist arrivals in the second half of 2020. Despite a sustained and strong recovery in growth rates in the following years, tourism expenditure is assumed to only reach 2019 levels by the end of the projection horizon.

2. Shut-down of non-essential services: The shut-down of a number of establishments is assumed to last between 6 to 8 weeks. As activity resumes, recovery in demand is expected to be slow at first; as society starts to adapt to the "new normal" and fear of contagion recedes. In the medium-term we assume a more sustained recovery in services activities, when compared with that in travel-related activities.

3. Supply-chain disruptions: Disruptions to the supply-chain are expected to slow down production for at least 12 weeks, affecting a subset of Maltese industries, especially following a drawdown of inventories. As lockdown measures begin to be eased around the world, global trade starts to pick-up, leading to a gradual but sustained improvement in production capabilities.

4. Fiscal measures: Measures are expected to be in place for a temporary period of six months in 2020, and phased out thereafter. In 2021, however, additional outlays related to health treatment are still envisaged, in line with the overall narrative that additional containment measures may still be needed.

   A large portion of health-related outlays in 2020 (around 0.6% of GDP) is assumed to reflect 'fixed' costs such as the procurement of beds and ventilators, protective equipment and disinfectant, as well as efforts to step up recruitment of health workers. Costs associated with treatment and testing are based on the assumption that the number of active COVID-19 cases remains elevated for a period of three months. The number of COVID-19 patients is then expected to gradually decline over another three months.

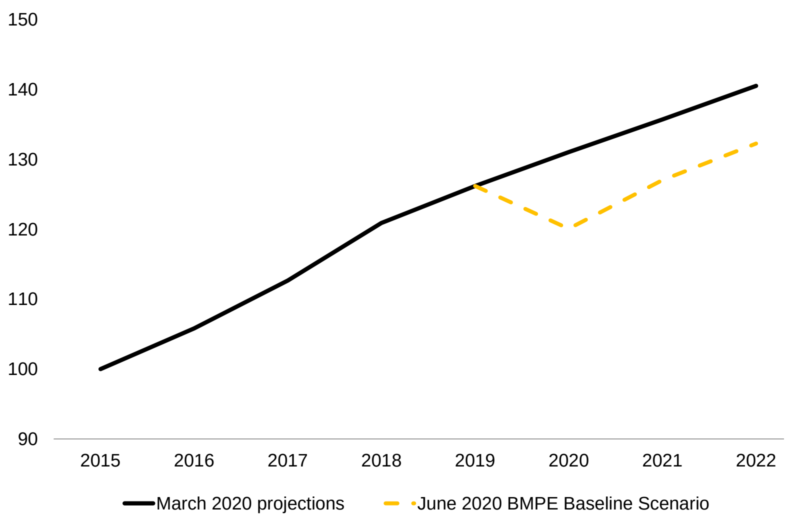
   In 2020, income tax revenue in Malta is set to fall by more than the expected decline in operating surplus, as profits made by internationally-oriented firms are assumed to deteriorate faster.

   Moreover, the value of new issues of Malta Government Stocks (MGS) in 2020 is set to exceed the required financing needs to service debt rollover and the expected deficit.[3] This 'excess' level of MGS issues is expected to be retained as bank deposits. According to ESA methodology, this impact is recorded as a debt-increasing deficit-debt adjustment (DDA). In 2021, these deposits are assumed to help service the expected financing needs for that year.

Economic Outlook

Conditional on the assumptions explained above, economic activity is projected to contract significantly in 2020, and recover somewhat in the following two years. When compared with the Bank's March 2020 projections, significantly lower levels of economic activity are expected throughout the projection horizon (see Chart 1).[4] Indeed, the level of GDP is set to reach 2019 levels only by end 2021, as economic conditions improve at a sustained pace following the easing of restrictions; the relatively successful containment of the pandemic; and the discovery of a vaccine by mid-2021. In 2022, despite strong projected growth, the level of economic activity would still be around 6% lower than that expected in the March 2020 projection exercise.

Chart 1: Projected level of economic activity
(index, 2015=100)



Source: Central Bank of Malta

Moreover, stringent containment measures are expected to produce permanent consequences on the supply-side of the economy. In particular, the Maltese economy is expected to be able to attract fewer foreign workers in 2020 when compared with recent years, as those that have been made redundant seek

[3] On 30 March 2020, Parliament passed Bill no 122, which amends the original 2020 Budget Act and authorises Government to borrow up to EUR2.0 billion.

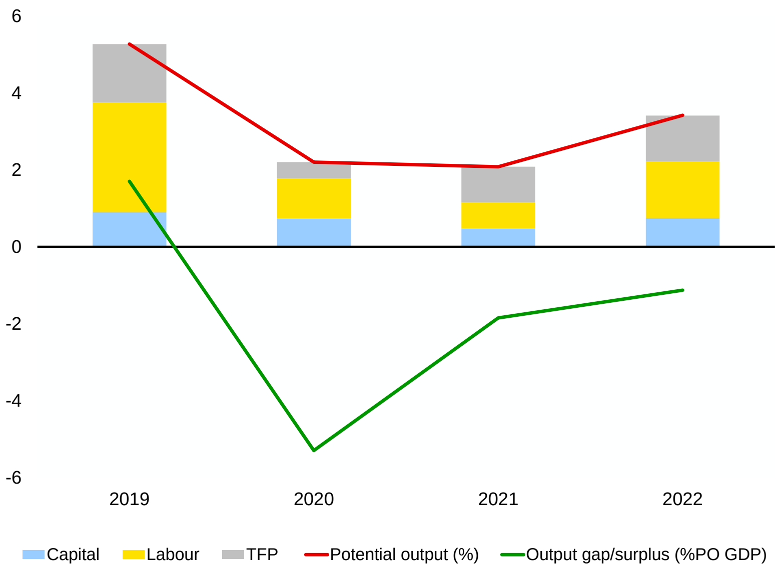
[4] The Bank's baseline and severe scenarios for the Maltese economy are based on information available up to 25 May 2020 and are conditional on the technical assumptions used in the June 2020 Eurosystem staff projections. They were prepared by the Central Bank of Malta, and peer reviewed externally by both Eurosystem colleagues and ECB staff. This outlook does not incorporate the latest release of national accounts for the first quarter of 2020, which was published on 29 May 2020.

to return to their home countries and thus exit the Maltese labour force. Net foreign worker migration is projected to increase again in the medium-term as the economy recovers, but the "lost" migration in 2020 would be permanent. In addition, hours worked are also envisaged to drop substantially as businesses seek to hoard labour despite lower activity. However, hours worked are expected to recover in the medium-term. Both these factors are expected to lower the contribution of labour to potential growth in 2020, which recovers only partially in the medium-term.

In addition, postponed and cancelled investment plans are expected to lower the contribution of capital, especially in 2020 and 2021, although there is some recovery at the end of the projection horizon. The contribution of total factor productivity (TFP) is also envisaged to be slightly lower than assumed in March, as businesses and society at large take some time to adapt to a "new normal" and are bound to operate at lower levels of efficiency until they develop capabilities to mitigate the effects of the containment measures.

Despite the projected recovery in GDP, economic activity is projected to remain below potential during the projection horizon. Indeed, while there is a gradual closure of the output gap over the projection horizon, it remains negative (see Chart 2).

Chart 2: Potential output
(annual percentage change; percentage of potential GDP)

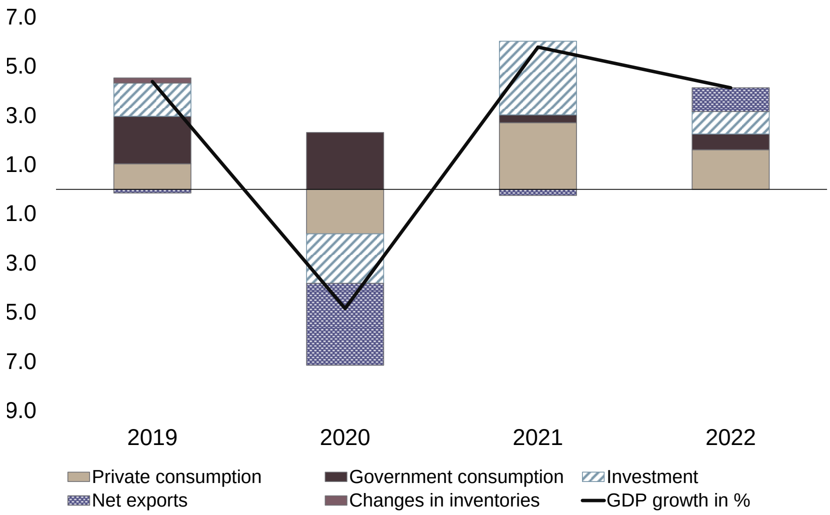


Source: Central Bank of Malta

GDP is projected to contract by 4.8% in 2020, and grow by around 5.8% and 4.2% in the following two years (see Table 1).

In 2020, all demand components, with the exception of government consumption, are set to dampen GDP growth markedly (see Chart 3). Nevertheless, exports are expected to be the leading contributor towards the drop in economic activity as travel restrictions and supply-chain disruptions should have a notable impact. In addition, private consumption and private investment will also contract significantly in 2020, especially due to the forced shut-down of several business activities. In the following years, all demand components are projected to recover somewhat and expand above their historical growth rates, primarily due to base effects. Domestic demand is expected to be generally the main driver of economic growth, as the recovery in all demand components will be partially absorbed by higher import growth.

Chart 3: GDP growth over the projection horizon
(percentage point contributions; annual percentage change)



Source: Central Bank of Malta

Private consumption is set to fall by 4.3% in 2020. In part, this reflects a relatively small drop in real disposable income due to some job losses and lower wage levels. However, losses in disposable income are partly offset by fiscal measures intended at cushioning the drop in household income. Private consumption growth is however expected to remain severely hindered this year. Firstly, the complete shut-down of various services has led to forced savings, as households, including those that did not experience any drop in their incomes could not consume certain goods and services. Secondly, prevailing social distancing measures are likely to restrain the speed of the recovery in private consumption in 2020, at least until consumer confidence is regained and the fear factor from the possibility of contracting the virus are allayed. As a result, the household saving ratio is projected to rise in 2020. In the following years however, private consumption growth is expected to recover as household incomes improve and the pandemic becomes less socially disruptive. Moreover, some postponement of consumption in 2020 should lead to a decline in the savings ratio in 2021 to a level close to that projected in the March projection exercise, before the outbreak of COVID-19. A further decrease in the savings ratio is foreseen in 2022, as labour market conditions improve further.

Due to the elevated levels of uncertainty, some private investment plans are likely to be either postponed

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

	2019[2]	2020	2021	2022
Real economic activity (% change)				
GDP	4.4	-4.8	5.8	4.1
Private consumption expenditure	2.4	-4.3	6.4	3.8
Government consumption expenditure	12.0	13.3	1.5	3.2
Gross fixed capital formation	7.2	-10.3	16.2	4.5
Exports of goods and services	1.7	-9.2	7.7	2.6
Imports of goods and services	2.5	-8.0	9.2	2.2
Contribution to real GDP growth (in percentage pts)				
Final domestic demand	4.3	-1.5	6.1	3.2
Net exports	-0.2	-3.1	-0.3	1.1
Changes in inventories	0.2	0.0	0.0	0.0
Real disposable household income[3]	5.7	-0.2	2.1	3.0
Household saving ratio[3]	21.1	24.3	21.1	20.5
Balance of payments (% of GDP)				
Goods and services balance	20.4	18.3	16.8	16.7
Current account balance	9.7	7.9	7.0	6.9
Labour market (% change)[4]				
Total employment	5.0	-0.9	2.2	2.9
Unemployment rate (% of labour supply)	3.4	5.5	4.6	4.5
Prices and costs (% change)				
GDP deflator	1.9	1.3	1.3	1.4
RPI	1.6	0.6	0.7	1.3
Overall HICP	1.5	0.7	0.9	1.5
HICP excluding energy	1.5	0.4	0.9	1.4
Compensation per employee	2.4	-2.8	4.0	3.0
ULC	3.6	1.2	0.5	1.7
Business cycle				
Potential output (% change)	5.3	2.2	2.1	3.4
Output gap (% of GDP)	1.7	-5.3	-1.9	-1.2
Technical assumptions				
EUR/USD exchange rate	1.12	1.09	1.08	1.08
Oil price (USD per barrel)	64.0	36.0	37.2	40.7

[1] Data on GDP were sourced from NSO News Release 034/2020 published on 28 February 2020, while HICP and RPI data were sourced, respectively, from NSO News Release 066/2020 and 083/2020 (released on 23 April 2020 and 20 May 2020).
[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.

or cancelled during 2020. Conversely, government investment in 2020 is set to grow somewhat, thus partially compensating for the drop in overall private investment. As the evolution of the pandemic becomes less uncertain and economic recovery gains traction in 2021 and 2022, private investment is expected to bounce back.

Both domestic and external factors are assumed to adversely impact exports in 2020. In particular, foreign demand is assumed to decline dramatically while the imposed travel ban implies a substantial negative impact on service exports. Additionally, global supply chains are expected to be disrupted, which limits the productive capacity of Maltese exporters. Exports are projected to decline by 9.2% in 2020, driven especially by a large contraction in travel. In 2021, export growth is projected to bounce back following the expected improvement in foreign demand, lower disruptions to the global supply chain, and the re-opening of tourism business. Nevertheless, unlike other components of GDP, export levels are expected to reach 2019 levels only by 2022, rather than 2021.

The decline in both domestic and external demand, as well as disruptions to the global supply chain, is expected to lead to a sharp contraction in imports during 2020. In particular, services imports are projected to fall, mainly reflecting the restrictions to outbound travel. In addition, goods imports are also set to contract, reflecting the decline in private consumption, private investment, and exports of goods. As the economy is set to recover in the following years, import growth is projected to grow strongly thereafter.

The trade surplus is set to narrow, reflecting the negative contribution of net exports in 2020 and 2021, and a muted increase is projected for the final year of the projection horizon. As a result, the current account surplus is also projected to decline during the forecast period.

Labour Market

Notwithstanding the sharp contraction in GDP in 2020, the announced fiscal measures are expected to stem the rise in unemployment. Contacts held with many firms, indicate that most seem to have decided to keep most of their employees. Many establishments have applied for the wage supplement scheme, and have halted most redundancies. Moreover, even other companies that have seen a large decline in their business, but do not qualify for Government assistance, have been opting for reducing the number of hours to avoid lay-offs.

In the baseline scenario, employment is set to contract by around 0.9% this year. Given that the loss in employment is less than that in GDP, this implies a strong decline in labour productivity. Employment growth in 2021 and 2022 is projected to trail GDP growth, as labour productivity is projected to recover some of the losses that are expected to occur in 2020.

In view of the decrease in employment in 2020, the unemployment rate is projected to rise to 5.5%, from 3.3% in the previous year. In part, this rise in the unemployment rate is mitigated by the envisaged drop in the labour supply, due to higher migrant outflows. As the economy is projected to recover in the following two years, the unemployment rate is set to gradually decline, but remain above that registered in 2019.

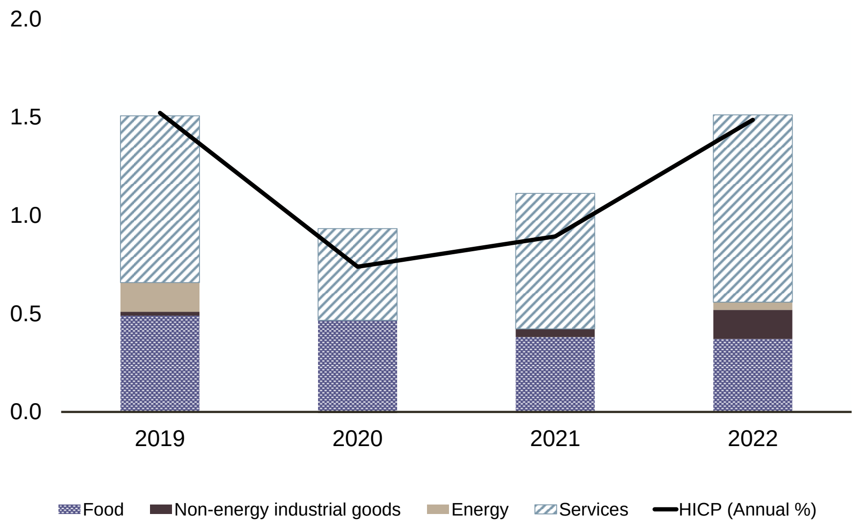
As regards wages, these are expected to drop somewhat in 2020. The envisaged contraction in 2020 primarily reflects the statistical treatment of the wage supplement scheme. Under the scheme, the government and the employer pay employees a wage that is lower than the average wage normally paid in the sector, at least for the duration of the scheme. Once the wage supplement scheme expires, wage levels begin to gradually recover, although in level terms annual compensation per employee is expected to be significantly lower than in 2019. Wage growth is projected to recover in 2021 and 2022 as labour market conditions improve.

Prices

Consumer price inflation in Malta is projected to moderate in the short-term, largely as a result of the impact of the expected drop in demand. However, downward price pressures from weaker demand are partly offset by cost-push factors related to supply-chain disruptions, and increased operational costs due to enhanced social distancing measures. As a result, the baseline scenario entails some inflation persistence for 2020.

In 2020, HICP inflation is projected to stand at 0.7%, from 1.5% in 2019. Thereafter, inflation is expected to recover, albeit gradually, reaching 0.9% in 2021 and 1.5% in 2022.

Chart 4: HICP Inflation over the projection horizon
(annual percentage change; percentage of potential GDP)



Source: Central Bank of Malta

The negative impact of the pandemic on prices is expected to be mainly felt in the services, non-energy industrial goods (NEIG), and energy sub-components. Services inflation is projected to moderate, mainly as a result of lower demand for tourism services. At the same time, prices for imported NEIG are expected to fall in the short-term, largely reflecting lower international price pressures. Energy inflation is also projected to turn negative, mainly as a result of the drop in the international oil price.

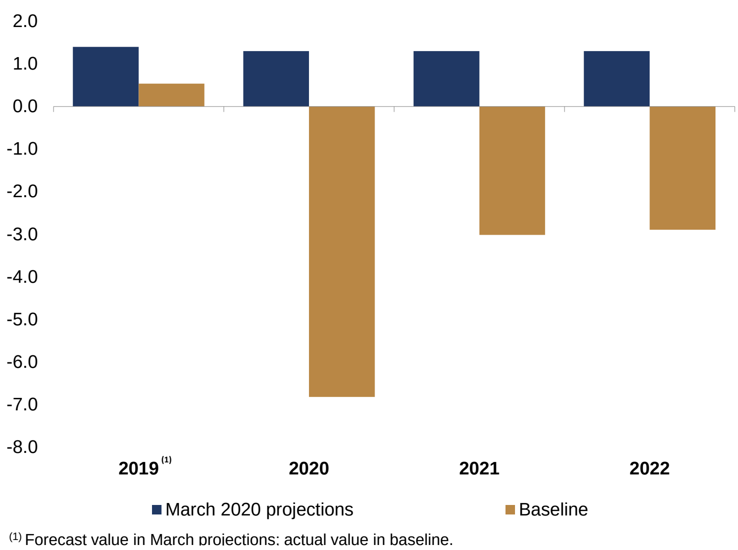
On the other hand, despite lower economic activity levels, food inflation is projected to hold up over the forecast horizon. In part this reflects lower international food supplies due to disruptions caused by the pandemic.

HICP inflation is expected to recover in the medium-term, reflecting the gradual pick-up in global demand and in the tourism sector.

Public finance

The general government finances are set to deteriorate significantly due to the expected contraction in economic activity, as well as the introduction of COVID-19 support measures. From a surplus of 0.5% of GDP in 2019, Government is set to post a deficit of 6.8% in 2020 (see Table 2). The deficit is set to decline in subsequent years, reaching 3.0% in 2021 and 2.9% in 2022. This profile represents a marked shift from the March 2020 exercise, where successive surpluses for the projection horizon were expected (see Chart 5).

Chart 5: General government balance
(% of GDP)



Source: Central Bank of Malta

The profile for the fiscal deficit largely reflects that for gross saving, which is set to deteriorate in 2020 and recover thereafter. The share of current revenue in GDP is expected to decline sharply in 2020 as

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

	2019	2020	2021	2022
Headline Aggregates				
Total revenue	38.2	38.3	38.1	38.0
Total expenditure	37.7	45.1	41.1	40.9
General Government Balance	0.5	-6.8	-3.0	-2.9
of which: Primary Balance	1.9	-5.5	-1.5	-1.4
General Government Debt	43.1	53.7	53.5	55.0
Detailed Breakdown				
Current Revenue	36.7	36.0	35.9	36.0
Current taxes on income and wealth	13.8	13.6	13.5	13.7
Taxes on production and imports	12.1	11.4	11.5	11.5
Social contributions	6.1	6.1	6.0	5.9
Other current revenue[2]	4.7	4.9	4.9	4.9
Current Expenditure	33.0	40.1	36.3	36.1
Compensation of Employees	11.2	12.4	12.4	12.5
Social benefits	9.4	11.0	10.3	9.9
Intermediate Consumption	7.5	9.2	8.7	8.7
Interest payments	1.4	1.4	1.5	1.5
Subsidies	1.5	4.0	1.4	1.4
Other current expenditure[3]	2.1	2.1	2.1	2.1
Gross savings	3.7	-4.1	-0.4	-0.1
Capital Revenue	1.5	2.3	2.2	2.0
Capital taxes	0.2	0.2	0.2	0.2
Other capital revenue[4]	1.3	2.1	2.0	1.8
Capital Expenditure	4.6	5.0	4.8	4.9
Gross Fixed Capital Formation	3.8	4.3	4.2	4.2
Capital transfers	0.8	0.8	0.7	0.7
Other capital expenditure[5]	0.0	-0.1	-0.1	-0.1
Capital Revenue Net of Capital Expenditure	-3.2	-2.7	-2.6	-2.8
Underlying Budgetary Position				
Cyclical component	0.9	-2.1	-0.9	-0.8
Temporary government measures	0.0	4.0	0.3	0.0
Structural balance	-0.4	-0.8	-1.8	-2.1

[1] CBM calculations based on NSO News Release 64/2020 (published on 22 April 2020) and News Release 34/2020 (published on 28 February 2020).
[2] Mainly includes revenue from dividends, rents and sales.
[3] Mainly includes spending on education and contributions to the EU budget.
[4] Mainly includes grants from EU Programmes.
[5] Mainly reflects the value of changes in inventories and in the net acquisition of valuables and other assets.

a result of a drop in tax revenue. This is mainly driven by taxes on production and imports, which are affected by the decline in domestic consumption, as well as the drop in tourism expenditure. Overall, tax revenue is expected to retain broadly similar shares in GDP in 2021 and 2022 to that projected for 2020.

Meanwhile, the share of current expenditure in GDP is expected to increase markedly in 2020, due to the increase in subsidies, intermediate consumption, social benefits and compensation of employees, mainly reflecting the introduction of COVID-19 support measures as well as higher health expenditure. Outlays are mostly set to decline in 2021 as most of these measures are expected to end. However, the share of interest payments in GDP is expected to increase for the first time since 2011, due to rising financing needs.

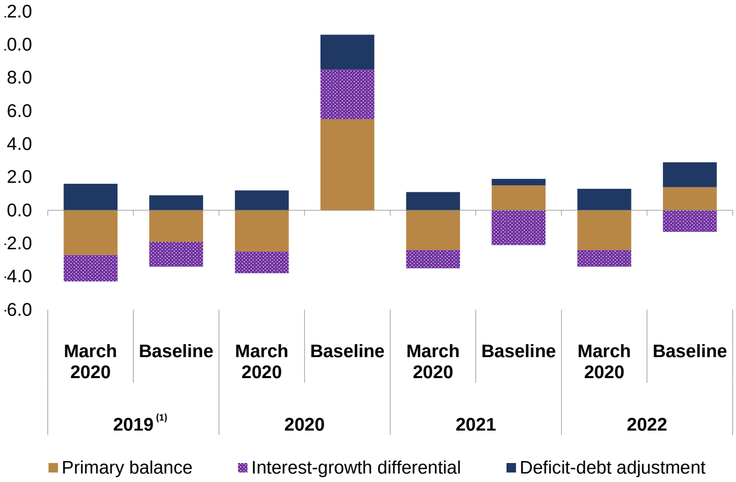
In 2022, most current spending items are set to grow in line with GDP. However, the share of social benefits in GDP is expected to decline, following slower growth in pension outlays resulting from an increase in the statutory retirement age in the reforms that were announced in 2006.

The shortfall in the balance between capital revenue and capital expenditure is expected to decline until 2021 and to rise again in 2022. Outlays in the profile of EU-financed expenditure are expected to peak in 2021 as work on large scale infrastructural projects, financed by the 2014-2020 funding framework, is eventually completed. At the same time, spending on domestically-funded projects is expected to remain elevated, and to increase in the outer years of the projection horizon.

The structural balance (i.e. the balance excluding temporary government measures and the economic cycle) is set to deteriorate from -0.4% of GDP in 2019 to -2.1% by 2022. This reflects underlying strong growth in capital expenditure, wages and outlays on health which are unrelated to the COVID-19 pandemic. However, structural balance estimates should be treated with caution, owing to significant uncertainty surrounding the value of the budgetary semi-elasticity and the output gap in times of crisis.

The general government debt-to-GDP ratio is projected to increase from 43.1% in 2019 to 53.7% in 2020, mainly driven by the expected primary deficit and interest-growth differential (see Chart 6). While this ratio is relatively low by historical standards and also remains below available projections for the euro area as a whole, the expected year-on-year increase is the strongest since 1999. Debt is expected to reach 55.0% of GDP by 2022, due to the projected primary deficits and debt-increasing deficit-debt adjustments.

Chart 6: Contribution to the debt ratio
(percentage points)



(1) Forecast value in March projections; actual value in baseline
(2) Difference between effective interest rate (interest payments at year t relative to debt outstanding at year t-1) and GDP growth.

Source: Central Bank of Malta

Box 2: Severe Scenario [i]

There are two main differences between the severe and the baseline scenario:

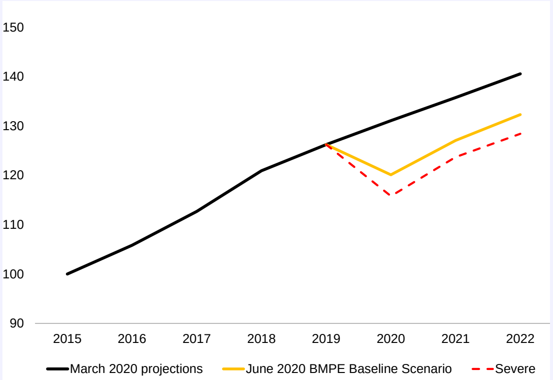
1. While the duration of the travel ban and global supply chain disruptions are maintained for 2020, the severe scenario expects an even more muted and timid recovery in tourist activity in the second half of 2020. Even as routes start to open up, travel demand will remain severely depressed for an extended period, partly reflecting extended containment measures aimed at limiting the impact of a resurgence in infections. In addition, global supply chain disruptions are assumed to affect more industries than in the baseline scenario. As such, this leads to an even larger fall in exports in 2020. Conversely, we do not assume further shocks to domestic demand than those assumed in the baseline.

2. In this scenario, fiscal measures are expected to be in place for nine months in 2020. Health treatment costs reflect the assumption that the number of active COVID-19 cases remains elevated for a period of six months. The number of patients is then expected to gradually decline over a further three months.

In the severe scenario, economic activity is foreseen to contract even more sharply in 2020 (see chart A). Although economic activity levels under the severe scenario are projected to recover somewhat in the following two years, they are estimated to remain around 9% lower than the March 2020 projections and the baseline scenario. Moreover, the consequences on the supply-side of the economy would be permanent, with losses to both the level and the long-term growth rate of potential output.

Chart A: Economic activity levels in different scenarios

index, 2015=100



Source: Central Bank of Malta

In the severe scenario, GDP would contract by 8.3% in 2020, and grow by around 6.8% and 3.8% in the following two years (see Table A).

Table A : Projections - baseline and severe scenarios

	Baseline			Severe		
	2020	**2021**	**2022**	**2020**	**2021**	**2022**
GDP	-4.8	5.8	4.1	-8.3	6.8	3.8
HICP	0.7	0.9	1.5	0.5	0.6	1.3
Unemployment rate	5.5	4.6	4.5	6.1	5.7	5.5
Potential Output	2.2	2.1	3.4	1.0	1.0	2.9
Output Gap	-5.3	-1.9	-1.2	-7.1	-1.8	-0.9
Contributions						
Domestic Demand	-1.5	6.0	3.2	-2.1	5.8	3.1
Net Exports	-3.3	-0.3	1.0	-6.1	1.1	0.7
Fiscal						
General Gov. Balance (% of GDP)	-6.8	-3.0	-2.9	-10.4	-4.7	-4.7
General Gov. Debt (% of GDP)	53.7	53.5	55.0	59.3	59.8	63.0

Similar to the baseline scenario, all demand components, with the exception of government consumption, would affect GDP growth adversely in 2020. In this scenario, the negative contribution of net exports in 2020 would be almost double that in the baseline scenario. This reflects an even more severe drop in export growth, driven by stronger declines in both travel exports and goods exports.

On the other hand, the drop in domestic demand would be only marginally lower than that in the baseline scenario, as no additional restrictive measures are expected to be in place this year, beyond those in the baseline. The lower domestic demand only reflects further negative amplifications from lower economic activity levels driven by lower exports. Private consumption growth would therefore be lower in the severe scenario compared to the baseline, due to stronger envisaged declines in household income. Moreover, more investment plans would be postponed or cancelled in view of the lower overall demand.

Going forward into 2021 and 2022, domestic demand would contribute less positively than in the baseline scenario, as the recovery under these assumptions would be comparatively slower. Indeed, the unemployment rate would remain high compared to the baseline, and hence, household incomes would be less supportive of consumer demand.

In addition, while private investment growth could be slightly higher in 2021 when compared with the baseline, overall levels should remain lower.

Similarly, in terms of growth rates, export growth would bounce back more strongly in 2021 when compared with the baseline, but only due to stronger base effects from the envisaged dramatic decline in 2020. Export levels on the other hand, would remain relatively weak over the whole projection horizon. The contribution of net exports would be positive in 2021 in this scenario, as the recovery in import levels would be lower than that in exports. Indeed, in 2022, the contribution of net exports, while positive, is expected to be lower than that in the baseline scenario, as export levels remain below their levels of 2019.

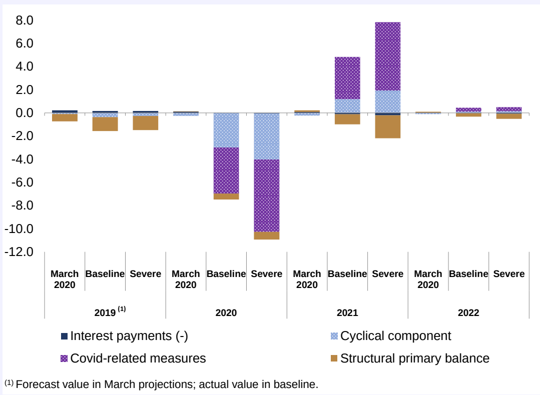
With regards to prices, HICP inflation would be slightly weaker in 2020 when compared with the baseline scenario. The lower projected inflation in the severe scenario would reflect slightly lower inflation in services and non-energy industrial goods. The former is due to the assumed prolonged impact of the pandemic on the tourism industry, and the latter results from the scenario of a stronger and more prolonged international economic downturn, which implies lower imported inflation. Nevertheless, some persistence in inflation in 2020 is expected despite the more negative output gap, as increased operational costs related to social distancing measures are assumed to be partly passed on to consumers. Inflation is expected to remain weak in the following years, standing at 0.6% in 2021, before recovering to 1.3% in 2022, reflecting the above-mentioned slow recovery in overall demand.

Under this scenario, the general government deficit is set to reach 10.4% of GDP in 2020. The deficit would then decline to 4.7% each year in 2021 and 2022. This profile reflects the impact of the economic slowdown as well as temporary fiscal measures introduced in 2020, both of which are set to exert a larger effect compared with the baseline (see Chart B). In 2021 government operations would be more restrictive, as the unwinding of support measures coincide with a larger expected widening of the output gap. A broadly neutral fiscal stance would then occur in 2022, in line with the baseline.

Meanwhile, the general government debt-to-GDP ratio would be expected to rise to 63.0% by 2022.

Chart B: Factors behind changes to government balance-to-GDP ratio

percentage points



Source: Central Bank of Malta

[i]Technical assumptions in this scenario are consistent with the severe scenario as published and transmitted by the ECB in the June BMPE 2020.