BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

Economic Projections

2020 - 2022

2020:3

Outlook for the Maltese economy

Economic projections

2020-2022

Latest data suggest that the Maltese economy is likely to have recorded an unprecedented contraction in the second quarter of 2020, though there are signs of some stabilisation in the third quarter. Nevertheless the Central Bank of Malta expects Malta's Gross Domestic Product (GDP) to contract by 6.6% in 2020. Subsequently it should grow by around 6.1% and 4.2% in the following two years. While this projection is significantly better than that for other euro area countries, Malta's level of economic activity is expected to be around 7% lower in 2022 compared to the projections that had been made prior to the outbreak of COVID-19. In fact it will take until mid-2022 for Malta's GDP to return to its 2019 level. Compared with the Bank's previous projections, GDP growth has been revised downwards in 2020, due to weaker tourism exports that offset a stronger positive impulse from fiscal measures that were announced in June. In total, Government fiscal and liquidity measures are estimated to boost GDP by 3 percentage points, reducing the decline in GDP by a third.

The largest contributor to the projected decline in GDP in 2020 is net exports, reflecting an expected decrease in foreign demand, restrictions on travel-related activities, and disruptions to the global supply-chain. However, domestic demand is also expected to contribute negatively, as the shut-down of various activities during part of the year and elevated uncertainty are expected to adversely impact private consumption and investment. Almost all sectors are expected to be negatively affected by the pandemic and the associated containment measures, but the accommodation and food services activities, transportation and storage, and wholesale and retail trade sectors, are expected to be the worst affected. Domestic demand is expected to be the main driver of the projected recovery in 2021 and 2022, although the net export contribution is also set to turn positive.

In view of the foreseen contraction in economic growth, employment is set to decline somewhat in 2020, leading to 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. Moreover local labour market developments are much better than the trends observed in the euro area, with Malta registering in June the lowest unemployment rate in the monetary union for the first time. The labour market is 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, *from 1.5% to 0.9%, based on the Harmonised Index of Consumer Prices (HICP). However, inflation is also expected to be supported by cost-push factors, in the context of disruptions to the global supply chain. It is then set to edge up to 1.4% 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 support measures. The government balance is projected to be in deficit of 8.6% of GDP in 2020. As most COVID-19 related measures are set to end this year, the shortfall is expected to narrow in 2021, and to stand at 3.5% of GDP by 2022. The government debt-to-GDP ratio is projected to rise from 43.7% in 2019 to 57.9% by 2022, thus remaining below the 60% reference value of the Stability and Growth Pact, and well below the levels projected for the euro area.

Given the persistent uncertainty surrounding the pandemic, particularly in respect of timelines for the availability of a vaccine, the Central Bank of Malta has also published a more severe scenario in which health protocols in Malta and overseas would have to be enhanced and extended to contain the spread of the virus. In such a scenario, the contraction in GDP could reach 9.3% this year. GDP growth should then rebound to 5.5% and 3.7%, respectively, in 2021 and 2022. In this case, the level of GDP would remain below 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 11.3% in 2020 before narrowing to 5.4% in the following two years, while the government debt-to-GDP ratio would rise to 66.0% by the end of 2022.

1 Overview

The outbreak of COVID-19 and the subsequent measures imposed by governments across the world to contain the spread of the virus, brought about an extraordinary global economic shock. Latest data related to employment and confidence indicators suggest that the Maltese economy has likely recorded an unprecedented contraction in the second quarter, though there are signs of some stabilisation in the third quarter. Yet, uncertainty regarding the evolution of the pandemic is still high, especially since prospects regarding the timing of the development of a vaccine are not yet clear and there has been a resurgence of COVID-19 cases world-wide. As a result, this projection publication maintains two scenarios, which envisage two different paths for the evolution of the pandemic and hence, the impact on the Maltese economy during the period 2020-2022.

The baseline scenario includes an estimate of the sectoral impact of COVID-19 in 2020, taking into account all containment measures and subsequent easing of restrictions announced until 14 August (see Box 1). Moreover, the baseline also includes an estimate of all fiscal and liquidity support measures that have been put in place by the Maltese authorities (see Box 2). We maintain the assumption made in the previous projection, that the global recovery will be slow but steady, as containment measures imposed by governments across the world have only been partially successful in containing the virus. However, global economic activity is expected to remain below pre-COVID levels for a couple of years.

Risks are judged to be on the downside. We account for these risks by presenting a more severe scenario, whereby the disruption to economic activity remains significant for a longer period of time compared to the baseline scenario. In the severe scenario, the recovery would be relatively timid and levels of economic activity would remain even lower than the baseline scenario throughout the projection horizon.

Box 1: The impact of COVID-19 on GDP in 2020: a sectoral approach[i]

Estimating the impact of COVID-19 on economic activity is very challenging. In part, this reflects the high uncertainty regarding the duration and evolution of the pandemic. Moreover, economic models used by both academia and policy institutions were not geared for modelling the impact of a pandemic on economic variables. This box outlines the method utilised by the Central Bank of Malta, along with the derivation of the projection for 2020, and sectoral deviations consistent with the estimated loss in overall output.

The normal forecasting process in use at the Central Bank of Malta is based on models which primarily focus on projecting macroeconomic aggregates using baseline assumptions for the whole economy. It utilises as a core framework an in-house macro-econometric model (STREAM),[ii] which is a traditional model composed of three main blocks: a supply block, a demand block and a price-wage block.[iii] However, the economic consequences of the pandemic together with the measures taken both locally and internationally, in an attempt to limit the spread of this pandemic, are expected to have large asymmetric effects on the different sectors of the economy.

Against this backdrop, the toolkit used in the Bank's forecasting process has been expanded with a new integrated model, which combines STREAM, with an Input-Output based model. This approach allows a quantification of both the aggregate effects of sector-specific shocks while taking in consideration indirect effects, as well as a decomposition of aggregate effects into sectoral deviations. This new integrated approach was used in conjunction with the detailed fiscal framework in use at the Bank, to quantify the macroeconomic effects of the fiscal measures announced by the Maltese Government. This approach makes it possible to internalise both macro and sectoral information within the Bank's projections, while at the same time producing sectoral GVA results which are consistent with GDP expenditure aggregates.

To estimate the overall impact of the Covid-19 pandemic, we identify four main shocks, which are thought to characterise the effects that this pandemic and the associated containment are likely to have on the Maltese economy. Our scenario takes into account four separate shocks, calibrated in line with the following assumptions in the baseline projections:

1. Travel ban: 14-week closure of the airport, along with continued low tourism numbers for the remaining of 2020. We assume a drop of 70% in tourism exports compared with 2019.
2. Shut-down of non-essential services: the length of the shutdown is approximately 9 weeks long. The calibration of the sectoral final demand shocks reflects the fact that some sectors were allowed to operate through online shopping and delivery services.
3. Supply-chain disruptions: 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 start to be eased around the world, global trade starts to pick-up, leading to a gradual but sustained improvement in production capabilities.
4. Fiscal and liquidity measures: are expected to be in place for the period currently established by law and as announced by the Government.[iv] Moreover, health-related outlays are based on the assumption that the number of active cases gradually tapers off. Costs related to health treatment and containment measures are still envisaged to take place in 2021. Other assumptions remain in line with those included in the previous projection exercise.

The effects of the travel ban are simulated in a two-stage approach. We first simulate a shock to foreign demand, calibrated to capture a fall in tourism exports due to both the closure of international airports as well as subdued demand throughout 2020. We then shock STREAM and an Input-Output based model separately for the impact of the shock in terms of both aggregate expenditure and sectoral deviations in baseline GVA levels. The latter simulation is calibrated using Tourism Satellite Accounts which provide a sectoral breakdown of tourism expenditure.

The shutdown of non-essential outlets (including food services activities) has been simulated through a Leontief-based Input-Output approach, by assuming an almost complete drop in the final demand of some sectors for nine weeks. The sectors hit by this shock together with the length of the shutdown are consistent with the instructions issued by the health authorities. Moreover, the implementation of this shock also takes in consideration any overlaps that could occur between the tourism shocks and the shut-down of non-essential activities, as these occurred in roughly the same time frames.

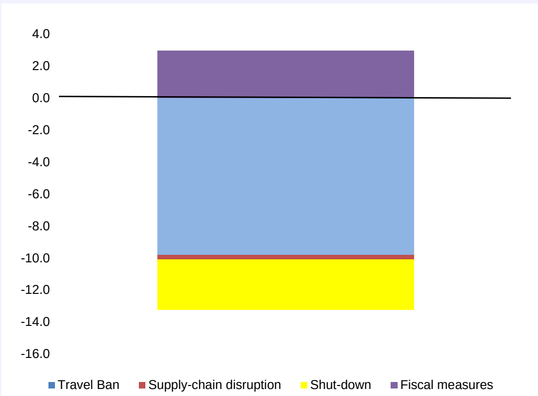
Supply chain disruptions are estimated through a shock to the primary inputs performed within a Ghoshian Input-Output model. The shock is calibrated so as to capture a six-week partial disruption of the imports utilised by the manufacturing sector. This shock is meant to capture the temporary closure of some international manufacturing plants that supply local manufacturing firms. Sectoral results for the shocks capturing supply chain disruptions and the shutdown of non-essential outlets are then transformed in changes in expenditure components using STREAM.

Finally, the current forecasting round accounts for the effects of fiscal and liquidity measures introduced by the Government throughout the course of the pandemic. These measures have been simulated within STREAM. Expenditure aggregates results derived from STREAM are then disaggregated in terms of responses to sectoral GVA through the newly developed integrated model.

Chart A decomposes the impact of COVID-19 on pre-COVID projected GDP in terms of the shocks described above. The major driver of the loss in output in 2020 is the travel ban. Tourism exports are assumed to drop by 70% in 2020 due to the pandemic, which results into a loss of output of 9.8%. This is followed by the shut-down of non-essential services, which account for an additional loss of 3.2%. Supply-chain disruptions are also estimated to impact GDP by a further 0.3%. Conversely fiscal and liquidity measures are estimated to increase GDP by around 3.0 percentage points. In total, COVID-19 is estimated to have reduced projected GDP negatively by 13.2%. However, when government support measures are taken into account, the GDP loss is estimated at 10.3%.

Chart A: The impact of COVID-19 on GDP in 2020

percentage points



Source: Central Bank of Malta

The overall impact is estimated in terms of deviations from the Bank's pre-COVID baseline published in March 2020, in which GDP was expected to grow by 3.8%, and reducing this by the net negative impact shown above. This results in a baseline projection of -6.6% for GDP growth in 2020.

Table A: Sectoral Gross Value Added impact of COVID-19 in Malta
(percentage deviation from baseline levels)

Agriculture, forestry and fishing	-12.5
Mining, quarrying and construction	-3.7
Manufacturing	-5.0
Electricity, gas, steam	-13.6
Wholesale and retail trade	-18.1
Transportation and storage	-31.1
Accommodation, food services activities	-65.6
Information and communication	-7.6
Financial and insurance activities	-2.5
Real estate activities	-9.7
Professional, scientific and technical	-4.9
Administrative and support services	-16.0
Public administration and defence	3.4
Education	-2.5
Human health and social work activities	2.5
Arts, entertainment and recreation	-1.8
Other service activities	-7.1
Households as employers	-6.5
Total	-10.3

Results in Table A suggest that the pandemic is likely to have significantly heterogeneous effects on Maltese economic sectors. As expected, almost all sectors, with the exception of public administration and health, are predicted to register declines in their GVA, with accommodation and food services activities, the sector comprising transportation and storage and the sector including wholesale and retail trade being the worst affected. Results for the former two sectors are mostly driven by the drop in tourism demand, while the expected drop in the GVA of the wholesale and retail sector is largely due to the shutdown of non-essential outlets. Despite not being directly affected by any of the shocks under consideration, the agriculture and fishing sector, and the sector comprising administrative and support services are expected to experience considerable drops in GVA, mainly driven by indirect effects associated with falls in the final demand of the accommodation and food services activities sector. Supply-side disruptions in the form of import constraints are mainly expected to affect the manufacturing sector, with limited indirect effects on other sectors. Finally, the measures undertaken by the Government are expected to significantly attenuate the economic effects of COVID-19 especially in the worst hit sectors, mainly accommodation and food services activities and the wholesale and retail trade sector.

[i] Prepared by Ian Borg and Noel Rapa, Manager Economic Analysis Department, and Principal Research economist in the Research Department, respectively.

[ii] See Borg, Farrugia, Ellul (2016). The Forecasting Process at the Central Bank of Malta. https://www.centralbankmalta.org/file.aspx?f=51493

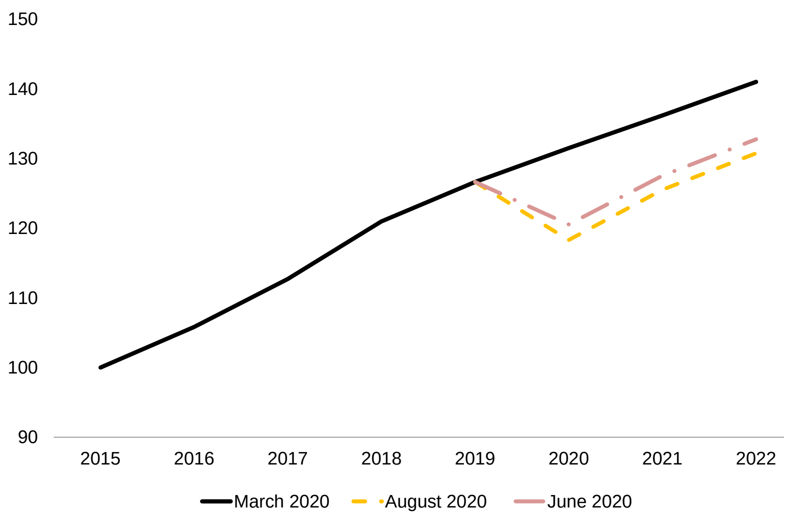
[iii] See Grech Rapa (2016). STREAM: A Structural Macro-Econometric Model of the Maltese Economy. WP/01/2016

[iv] Please see Box 2 for more details on the expected magnitude of measures.

2 Economic Outlook

Conditional on the assumptions explained in Box 1 and the estimated impact, economic activity is foreseen to contract significantly in 2020, and begin to recover in the following years. When compared with the Bank's projections in March 2020, which can be considered as a pre-COVID baseline,[3] the latest projections entail significantly lower levels of economic activity (see Chart 1).[4] Indeed, the level of GDP is set to reach 2019 levels only by mid-2022, 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 levels of economic activity would still be around 7% lower than that expected in March. Compared to the Bank's latest projections published in June 2020, the level of GDP is being revised down further. However, the decline in economic activity for Malta is expected to be below that for the euro area average, and the pace of recovery is expected to be quicker.

Chart 1: Projected GDP level
(index, 2015=100)



Source: Central Bank of Malta

Containment measures and a weaker global economic outlook are expected to impact the supply-side of the economy. In particular, the Maltese economy is expected to attract significantly fewer foreign workers in 2020 when compared with recent years, as those made redundant return to their home countries and thus exit the Maltese working age population. Net foreign worker flows are projected to recover in the medium-term as the economy recovers, but the "lost" migration in 2020 could be permanent. In addition, average hours worked are also envisaged to drop substantially this year as businesses seek to maintain

[3]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/file.aspx?f=92821 .

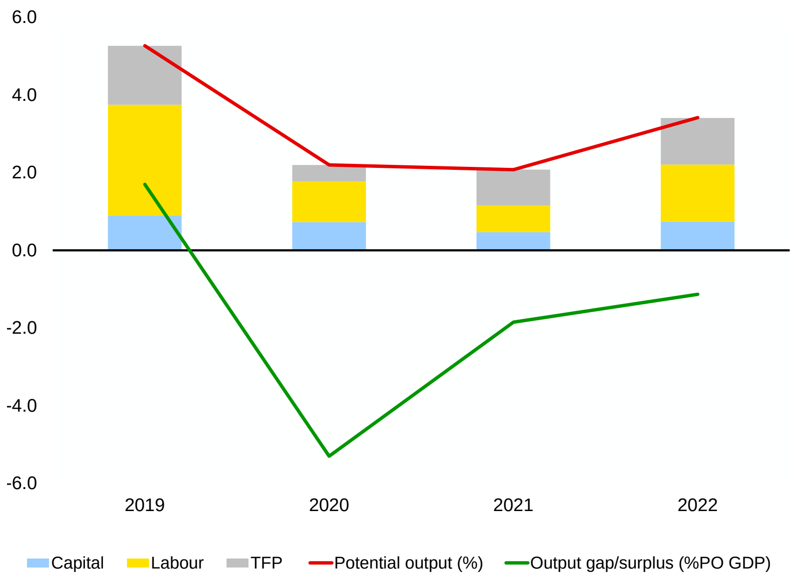
[4]The Bank's August 2020 projections are based on information available up to 14 August 2020.

their workforce despite lower activity. However, this is temporary, as average hours worked are foreseen to recover as containment measures are withdrawn. Both these factors are expected to lead towards a lower labour contribution to potential growth in 2020, which only partially recovers in the medium-term.

In addition, postponed and cancelled investment plans will lead towards a lower capital contribution, especially in 2020 and 2021, although there should be some recovery at the end of the projection horizon. The contribution of total factor productivity (TFP) is also envisaged to fall in 2020 when compared with previous years, as businesses and society at large take some time to adapt to a "new normal" and operate at lower levels of efficiency until they develop capabilities to mitigate the effects of the containment measures. TFP is expected to recover gradually over the medium-term.

Despite the projected recovery in GDP, the economy is expected to continue operating below its potential. Indeed, while there is a gradual closure of the output gap over the projection horizon, it remains negative throughout (see Chart 2).

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



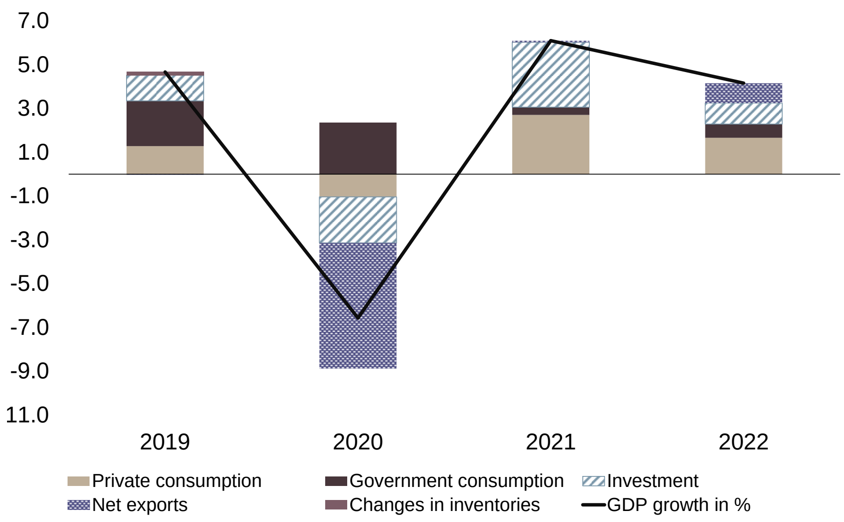
Source: Central Bank of Malta

GDP is projected to contract by 6.6% in 2020, and grow by around 6.1% and 4.2% in the following two years (see Table 1).[5] Compared to the Bank's latest projections, GDP in 2020 is being revised down significantly. This primarily reflects a more adverse outlook for tourism exports, which offsets upward revisions related to enhanced fiscal support. Conversely, GDP in 2021 was revised slightly upwards due to higher base effects from the stronger contraction envisaged in 2020.

[5] The Bank's latest projections were issued in June 2020 which can be found at https://www.centralbankmalta.org/file.aspx?f=92879 .

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 decreased economic activity as travel restrictions and supply-chain disruptions are expected to weigh on foreign demand. In addition, private consumption and private investment will also contract in 2020, reflecting the shut-down of non-essential services and uncertainty. In the following year, all demand components are projected to grow significantly, primarily due to large base effects from the envisaged drop in 2020. In general, domestic demand is expected to be the main driver of growth, though the recovery in all demand components will be partially absorbed by an increase in imports.

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



Source: Central Bank of Malta

Looking at the expenditure components in more detail, private consumption is set to fall by 2.4% 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 have been affected by the temporary shut-down of non-essential services and prevailing social distancing measures. 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 disruptive. Thus, in 2021 and 2022 private consumption is expected to grow more rapidly than disposable income, which implies a drop in the savings ratio. Compared to the latest projection, private consumption growth is being revised upwards despite the downward revision to economic activity, as the impact of fiscal measures (see Box 2) are expected to be mainly supportive of employment and consumption.

Due to the elevated levels of uncertainty, a substantial amount of private investment plans is expected

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

	2019[2]	2020	2021	2022
Real economic activity (% change)				
GDP	4.7	-6.6	6.1	4.2
Private consumption expenditure	2.9	-2.4	6.1	3.7
Government consumption expenditure	12.9	13.6	1.7	3.1
Gross fixed capital formation	6.2	-10.8	16.1	4.7
Exports of goods and services	2.5	-17.2	7.4	2.5
Imports of goods and services	3.0	-15.4	8.5	2.0
Contribution to real GDP growth (in percentage pts)				
Final domestic demand	4.5	-0.8	6.0	3.3
Net exports	0.0	-5.7	0.1	0.9
Changes in inventories	0.2	0.0	0.0	0.0
Real disposable household income[3]	5.3	-1.1	2.1	1.9
Household saving ratio[3]	20.7	21.8	18.7	17.3
Balance of payments (% of GDP)				
Goods and services balance	20.5	15.9	14.8	14.9
Current account balance	9.8	6.7	5.9	6.0
Labour market (% change)[4]				
Total employment	5.8	-0.7	1.9	2.2
Unemployment rate (% of labour supply)	3.4	4.9	4.6	4.4
Prices and costs (% change)				
GDP deflator	2.3	1.3	1.3	1.3
RPI	1.6	0.7	0.8	1.2
Overall HICP	1.5	0.9	1.0	1.4
HICP excluding energy	1.4	0.9	1.1	1.4
Compensation per employee	1.5	-3.2	4.0	2.8
ULC	2.5	3.0	-0.2	0.8
Business cycle				
Potential output (% change)	5.6	1.9	1.8	3.2
Output gap (% of GDP)	1.9	-6.6	-2.7	-1.8
Technical assumptions				
EUR/USD exchange rate	1.12	1.13	1.16	1.16
Oil price (USD per barrel)	64.0	42.3	45.9	47.8

[1] Data on GDP were sourced from NSO News Release 091/2020 published on 29 May 2020, while HICP and RPI data were sourced, respectively, from NSO News Release 122/2020 and 118/2020 (released on 23 and 20 July 2020, respectively).

[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.

to be either postponed or cancelled this year. Conversely, government investment in 2020 is set to grow substantially, thus cushioning the drop in overall investment growth. As the economy begins to recover, and the evolution of the pandemic becomes less uncertain, investment should bounce back.

Both domestic and external factors are assumed to be severely negative for 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. In addition, global supply chains are expected to be partially disrupted, which limits the productive capacity of Maltese exporters, although such disruptions should dissipate over time. Exports are projected to decline by 17.2% in 2020, driven especially by the expected large contraction in travel exports. In 2021, export growth is then assumed to bounce back following the projected improvement in foreign demand, lower disruptions to the global supply chain, and a muted increase in inbound tourists.

In view of the decline in demand, but also due to disruptions to the global supply chain, imports are set to contract sharply this year. In particular, services imports are projected to fall, reflecting the drop in services exports and restrictions on outbound travel. In addition, goods imports will also contract, reflecting drops in private consumption, private investment, and goods exports. 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. This reflects the negative net export contributions in 2020 and 2021, and only a muted increase in the final year of the projection horizon. As a result, the current account surplus is also projected to decline during the forecast period.

3 Labour Market

Notwithstanding the indications that economic activity has declined, the announced fiscal measures have already had a significantly positive impact on employment. Administrative data show that while unemployment rose during the first phase of containment measures, it appears to be stabilising. Moreover, Bank's contacts with firms indicate that the wage supplement scheme has limited the extent of redundancies. Employment conditions, though weaker than previously, remain relatively buoyant by euro area standards, such that in June for the first time ever Malta had the lowest unemployment rate in the monetary union.

Employment is set to fall by 0.7% this year. This represents an upward revision to our previous projections, despite the downward revision to economic activity. As the contraction in employment is less than that in GDP, this implies a strong decline in labour productivity per person (though less so in per hour worked terms). Given the relatively small drop in employment in 2020, employment growth in the following two years is projected to trail GDP growth, as labour productivity is assumed 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 envisaged to rise to 4.9%, from 3.4% in the previous year, though still well below historical averages. In part, the rise in the unemployment rate this year is mitigated by the envisaged drop in the labour supply, due to migrant outflows. Moreover, fiscal measures are highly supportive of employment. As the economy is projected to recover in the following two years, the unemployment rate is set to gradually decline, but remain slightly above that registered in 2019.

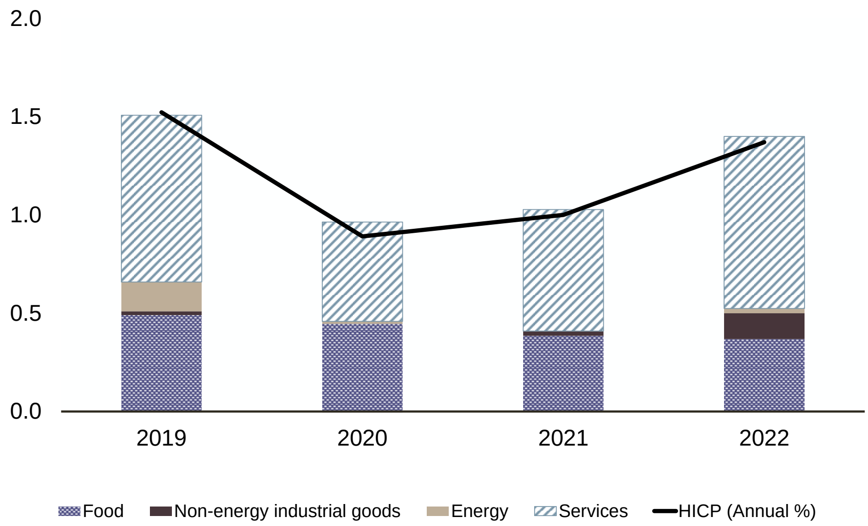
As regards wages, these are expected to drop significantly. The envisaged contraction in 2020 primarily reflects the fact that during part of the year, certain employees were participating in the wage supplement scheme. Under the scheme, the government and the employer pay employees a wage that is mostly lower than the average wage normally paid in the sector, at least for the duration of the scheme. Once the scheme expires, wage levels begin to normalise, although in level terms annual compensation per employee is expected to be significantly lower than in 2019. It is then projected to increase strongly in 2021 and 2022 as labour market conditions improve.

4 Prices

With regards to consumer prices, inflation in Malta is projected to moderate in the short-term, largely as a result of the foreseen drop in overall demand in Malta and abroad. This will mainly affect prices for goods and for recreational services. However, downward price pressures from weaker demand will be partly offset by cost-push factors related to supply-chain disruptions, and increased operational costs due to social distancing measures. As a result, inflation is expected to show some degree of persistence.

In 2020, HICP inflation is projected to stand at 0.9%, down from 1.5% in 2019. Thereafter, inflation is expected to increase, albeit at a gradual pace, reaching 1.0% in 2021 and 1.4% in 2022.

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



Source: Central Bank of Malta

Services inflation is projected to decelerate in the short-term, mainly as a result of lower demand for tourism services, before gradually recovering thereafter. At the same time, import price pressures are expected to be low. Hence, non-energy industrial goods (NEIG) inflation is expected to remain weak throughout the forecast horizon, largely reflecting a weakening of the euro area inflation outlook as well as a continuation of recent trends. Energy inflation is also projected to turn negative, reflecting recent cuts in fuel and gas prices as well as the pass-through from the drop in the international price of oil. On the other hand, despite lower economic activity levels, food inflation is projected to remain robust, partly reflecting domestic and international supply chain disruptions.

HICP inflation is expected to pick up in the medium term while remaining moderate, reflecting the expected partial recovery in global demand and tourism.

When compared with the Bank's latest forecasts published in June 2020, HICP inflation has been revised marginally upward during 2020 and 2021, and slightly downward in 2022. The upward revision in the short-term mainly reflects an observed degree of inflation persistence, as businesses deal with higher costs relating to social distancing measures.

5 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 8.6% in 2020 (see Table 2). The deficit is set to

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

	2019	2020	2021	2022
Headline Aggrsssegates				
Total revenue	38.0	38.0	38.1	37.8
Total expenditure	37.5	46.6	41.6	41.3
General Government Balance	0.5	-8.6	-3.5	-3.5
of which: Primary Balance	1.9	-7.2	-2.0	-1.9
General Government Debt	42.9	56.0	56.1	57.9
Detailed Breakdown				
Current Revenue	36.6	35.7	35.8	35.8
Current taxes on income and wealth	13.8	13.7	13.4	13.5
Taxes on production and imports	12.1	10.9	11.7	11.6
Social contributions	6.0	6.2	6.0	5.9
Other current revenue[2]	4.7	4.9	4.8	4.7
Current Expenditure	32.8	41.5	36.7	36.4
Compensation of Employees	11.2	12.5	12.4	12.5
Social benefits	9.3	11.2	10.4	10.0
Intermediate Consumption	7.4	9.3	8.8	8.7
Interest payments	1.4	1.4	1.5	1.6
Subsidies	1.5	5.0	1.5	1.5
Other current expenditure[3]	2.1	2.1	2.1	2.1
Gross savings	3.7	-5.8	-0.9	-0.6
Capital Revenue	1.4	2.3	2.2	2.1
Capital taxes	0.2	0.2	0.2	0.2
Other capital revenue[4]	1.2	2.1	2.0	1.9
Capital Expenditure	4.6	5.1	4.9	4.9
Gross Fixed Capital Formation	3.8	4.4	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	-2.8	-2.7	-2.9
Underlying Budgetary Position				
Cyclical component	1.0	-2.6	-1.3	-1.1
Temporary government measures	0.0	5.1	0.3	0.0
Structural balance	-0.5	-0.8	-1.9	-2.3

[1] CBM calculations based on NSO News Release 112/2020 (published on 9 July 2020) and News Release 91/2020 (published on 29 May 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.

narrow in subsequent years, reaching 3.5% of GDP each year in 2021 and in 2022.

Compared with the Bank's previous projections,a larger deficit is expected throughout the forecast horizon. This reflects the impact of newly-announced fiscal measures (see Box 2), and revisions in the forecast profile of macroeconomic variables.

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 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 and tourist consumption, as well as the introduction of certain COVID-19 stimulus measures. The share of tax revenue in GDP is then set to increase in 2021 and to remain unchanged in 2022, led by a pickup in indirect tax receipts.

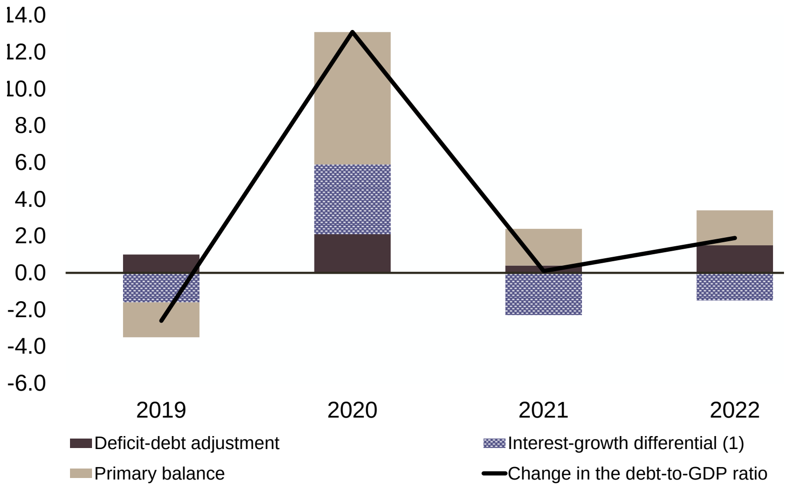
Meanwhile, the share of current expenditure in GDP is expected to increase markedly in 2020, due to a forecast increase in subsidies, intermediate consumption, social benefits and compensation of employees. This mainly reflects the introduction of COVID-19 support measures as well as higher health expenditure. Current spending is then 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.

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 is 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 -0.5% of GDP in 2019 to -2.3% 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 42.9% in 2019 to 56.0% in 2020, mainly driven by the expected primary deficit and interest-growth differential (see Chart 5). While this ratio remains below the 60% reference value of the Stability and Growth pact and below available projections for the euro area as a whole, the expected year-on-year increase is the strongest on record. Debt is expected to reach 57.9% of GDP by 2022, due to the projected primary deficits and debt-increasing deficit-debt adjustments.

Chart 5: Contribution to change in the debt ratio
(percentage point contribution; percentage of GDP)



(1) 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: The impact of Fiscal and Liquidity Measures on GDP [i]

In response to the COVID-19 pandemic, the Government introduced several support measures for businesses, employees and vulnerable persons between March and May 2020.[ii] On 8 June, the Government announced a new package of measures aimed at supporting an economic recovery. Around a third of this package consists of measures with a direct budgetary impact in the immediate term. These mainly include the extension of the wage supplement scheme, subsidised rates for rent and electricity, reduced stamp duties on property purchases and the introduction of a retail voucher scheme. In addition, fuel prices were reduced, the in-work benefit scheme was extended and various new grants to businesses were introduced. While some of these measures – notably the wage supplement extension and retail voucher schemes – are set to be in effect only for the third quarter of 2020, others will remain in place for a longer period.

The recovery package also includes initiatives which are not expected to immediately impact the budget balance. The tax deferral scheme was extended until August 2020, while the deadline for repaying taxes was postponed to May 2021. However, general government statistics for 2020 are adjusted for accrued taxes, in line with the ESA methodology. Consequently, they should not affect the general government balance in 2020.

The package also includes various large-scale capital projects aimed at improving the quality of infrastructure. However, these projects are expected to take place gradually, over the medium term.

Budgetary Impact

In the baseline, all measures announced between March and June are estimated at around 5.3% of GDP in 2020 and 0.3% of GDP in 2021 (see Table A).[iii] Hereunder, measures are classified in the same manner as in the previous forecast publication for ease of comparability. An expenditure of 0.9% of GDP is allocated towards liquidity support to firms in the form of interest rate subsides on state-backed loans, subsidised rent and electricity and other grant schemes. Expenditure on economic support measures, which aim to minimise the impact of COVID-19 on enterprises and employment, amounts to 3.1% of GDP. Additional spending on health-related measures and social measures to assist vulnerable sectors in society amounts to 1.0% of GDP and 0.2% of GDP, respectively.

Table A : Fiscal measures affecting the budget balance (% of GDP)			
Measures	**ESA classification**	**2020**	**2021**
Liquidity measures	Subsidies	0.9	-
Economic support measures	Subsidies	2.8	-
	Indirect taxes	0.3	-
Social measures	Social benefits in kind	0.2	-
Health-related measures	Intermediate consumption	0.5	0.1
	Social benefits in kind	0.4	0.1
	Compensation of employees	0.1	0.1
Total		5.3	0.3

Estimated impact on GDP

In addition to the fiscal measures outlined above, several other liquidity measures have been announced by the Government, including a moratorium on loan repayments, and a Malta Development Bank (MDB) COVID-19 Guarantee Scheme (CGS) for the purpose of guaranteeing new loans granted by commercial banks for working capital purposes to businesses facing liquidity shortfalls as a result of the pandemic. The scheme enables credit institutions to leverage government guarantees up to a total portfolio volume of €777.8 million.[iv] Until June 2020, around €1.7 billion of loans were subject to a moratorium, while €161 million of loans were sanctioned under the CGS, with withdrawn amounts reaching €64.9 million.

Therefore, the estimated impact of fiscal measures, includes measures that affect the budget balance as explained in Table A, and other measures that have no direct budgetary impact. For the latter, the following assumptions apply:

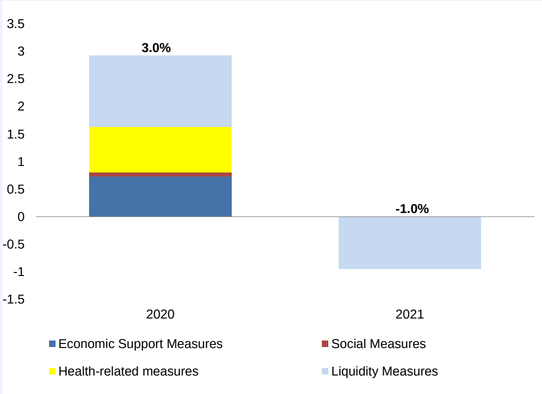
1. The CGS would be fully taken up, but only €700 million are disbursed this year.
2. A total of €2 billion loans will be subject to moratoria by end of September 2020, which implies a saving of 167 million in terms of loan repayments.
3. Tax deferrals are expected to amount to €200 million this year, which are then repaid by May 2021.

Chart A shows that fiscal measures are estimated to impact GDP positively by around 3.0 p.p. in 2020, thus providing a substantial boost to the economy. Liquidity measures are the largest contributor. These are expected to contribute around 1.3 p.p. in 2020. In addition, both health-related measures and other economic support measures are estimated to contribute significantly, by 0.7% and 0.8% respectively.

Liquidity measures are then expected to contribute negatively to GDP in 2021, as the repayment of tax deferrals is estimated to offset the continued disbursement of the CGS.

Chart A: Impact of fiscal and liquidity measures on GDP

annual percentage change, %



Source: Central Bank of Malta

These measures are modelled as shocks that affect government consumption and disposable income. Hence, fiscal measures are expected to have a strong positive impact on government consumption, employment and private consumption in 2020.

[i] This box was prepared by John Farrugia, Juergen Attard, and Ian Borg; principal economist, senior economist, and manager, respectively, all within the Economic Analysis Department.

[ii] For further details, see Box 1 of the Economic Projections 2020:2 publication. https://www.centralbankmalta.org/file.aspx?f=928

[iii] These estimates are based on official information and Central Bank of Malta staff's judgement.

[iv] The MDB COVID-19 Guarantee Scheme has been approved by the European Commission on 2 April 2020. See https://mdb.org.mt/en/Schemes-and-Projects/Pages/MDB-Working-Capital-Guarantee-Scheme.aspx for further details.

6 Risks - Severe scenario

Risks to economic activity are assessed to be to the downside. To account for risks and uncertainty around our projections, we produce a more severe scenario to the baseline. The main differences relative to the baseline are the following:

1. Tourism exports are projected to decline even more sharply than in the baseline. These are assumed to be around 85% lower than in 2019.

2. The wage supplement scheme is assumed to be extended until end-2020. Moreover, since firms are assumed to face comparatively more adverse liquidity positions, some government guarantees extended to working capital loans are assumed to be called in. Health treatment costs reflect the assumption that the number of active COVID-19 cases remains elevated for a number of months, such that the number of new infections is only brought down in early 2021.

3. The recovery in global economic activity in 2021 and 2022 is assumed to progress at a slower

pace relative to the baseline. Whereas in the baseline scenario, Malta's foreign demand in 2022 is expected to be around 3% lower when compared with 2019, in the severe scenario it is assumed to be around 13% lower.

In the severe scenario, GDP would contract by 9.3% in 2020, and grow by 5.5% and 3.7% in the following two years (see Table 3). The main driver behind the lower projection in 2020 is the lower net export contribution, reflecting a more severe drop in services exports. Moreover, the recovery in exports is more muted when compared with the baseline, reflecting a slower pick-up in tourism and a relatively weaker international environment. Thus, in the severe scenario, economic activity levels are projected to remain below 2019 levels through the end of the projection horizon.

Table 3: Projections - baseline and severe scenario

	Baseline			**Severe**		
	2020	**2021**	**2022**	**2020**	**2021**	**2022**
GDP	-6.6	6.1	4.2	-9.3	5.5	3.7
HICP	0.9	1.0	1.4	0.8	0.8	1.2
Unemployment rate	4.9	4.6	4.4	5.1	4.9	4.8
Potential Output	1.9	1.8	3.2	1.0	0.8	2.9
Output Gap	-6.6	-2.7	-1.8	-8.2	-3.8	-3.1
Contributions						
Domestic Demand	-0.8	6.0	3.3	-1.2	6.1	2.9
Net Exports	-5.7	0.1	0.9	-8.1	-0.6	0.8
Fiscal						
General Gov. Balance (% of GDP)	-8.6	-3.5	-3.5	-11.3	-5.4	-5.4
General Gov. Debt (% of GDP)	56.0	56.1	57.9	60.7	62.8	66.0

With regards to prices, HICP inflation would be slightly weaker in 2020 when compared with the baseline scenario - 0.8% this year compared to 0.9% in the baseline. The lower forecasted inflation in this scenario would reflect slightly lower inflation in services and in NEIG. The former would be due to the assumed prolonged impact of the pandemic on the tourism industry, and the latter would result from the scenario of a stronger and more prolonged international economic downturn, thereby putting downward pressure on import prices. Nevertheless, some persistence in inflation is still expected despite the more negative output gap, as increased operational costs related to social distancing measures are assumed to be partly passed on to the end consumer. Inflation would remain weak in the following years, standing at 0.8% in 2021, before partially recovering to 1.2% in 2022, as overall demand starts to recover.

The general government deficit is set to reach 11.3% of GDP in 2020, before reaching 5.4% each year in 2021 and 2022. This profile reflects the impact of a more persistent economic slowdown as well as a prolongation of COVID-related fiscal measures.

In 2020, the debt-to-GDP ratio is set to increase to 60.7%, and rise further to 66.0% by 2022. This is mainly due to the expected larger budget shortfall under this scenario.