BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

Economic Projections

2020 - 2023

2021:1

Outlook for the Maltese economy

Economic projections

2020-2023

As a result of the pandemic, the Central Bank of Malta (the Bank) expects that after an estimated contraction of 8.2% in 2020, Malta's Gross Domestic Product (GDP), will grow by 5.0% in 2021, by 5.5% in 2022, and by 4.7% in 2023. Compared to the projections published in December 2020, GDP growth is being revised downwards for 2020 and 2021 due to the impact of stringent containment measures, that spilled further into 2021. However, GDP growth is being revised upwards for 2022 and 2023, with GDP in 2023 expected to be at a similar level to that projected in December 2020. The Bank thus maintains its expectation that 2019 GDP levels are to be recouped towards the end of 2022, conditional on the successful rollout of a vaccine in 2021.

Declining net exports were the main contributor to the contraction in GDP in 2020, reflecting a sharp drop in foreign demand, restrictions on travel-related activities, and disruptions to the global supply chain. However, domestic demand is also estimated to have contributed negatively, as the various containment measures curtailed various activities during the year, especially during the second quarter, and elevated levels of uncertainty which adversely impacted private consumption and investment. Contractions in these two expenditure components were only partially mitigated by increased government consumption. Domestic demand is expected to be the main driver of the projected recovery in subsequent years.

Despite the sharp contraction in 2020, the labour market has shown remarkable resilience. Unemployment initially rose during the first wave of COVID-19, but has since declined, as fiscal measures have been very supportive of employment. Employment growth is estimated to have remained positive in 2020, though moderating compared to 2019. It is then projected to pick up gradually in the following years, reaching 2.7% in 2023. These projections constitute an upward revision from the previous exercise, reflecting stronger than expected outcomes in 2020.

Annual inflation based on the Harmonised Index of Consumer Prices is set to edge up to 0.9% in 2021, from 0.8% in 2020, reflecting faster growth in services prices. Furthermore, non-energy industrial goods (NEIG) inflation is set to turn positive. Overall HICP inflation is set to edge up to 1.7% by 2023, reflecting a pickup in economic activity, which is expected to lift prices of services and NEIG further.

Public finances deteriorated sharply in 2020 due to the decline in economic activity and the introduction of COVID-19 related fiscal support. The Bank is now projecting that the general government will record a deficit of 9.5% of GDP in 2020. The deficit is expected to persist throughout 2021, although it is anticipated to narrow to

6.6%. As economic activity improves and the need for COVID-related support gradually fades, the deficit is set to narrow further to 3.9% of GDP by 2023. Consequently, the government debt-to-GDP ratio is projected to rise from 42.4% in 2019 to 60.3% by 2023.

Given the prevailing uncertainty, the Bank has also published a more severe scenario in which it considers the effects of some restrictive health protocols being maintained beyond 2021, in the event that the pace of vaccination is slower than currently projected and new infectious strains become harder to control. In such a scenario, the 2019 level of GDP would be reached only in 2023. Additionally, the government deficit would deteriorate more sharply in 2021, reaching 10.0% of GDP, before narrowing to 5.6% in 2022 and 2023, while the government debt-to-GDP ratio would rise to 68.2% by then.

This publication also includes two boxes. The first analyses the impact of lower tourism flows on private consumption expenditure, while the second delves into a more detailed account of labour market developments since the onset of COVID-19 in Malta.

1 Overview

Since the Bank's previous projections, which were published in December 2020, the global level of stringency of containment measures remained high. At the same time, vaccination against COVID-19 has commenced in many parts of the world, including Malta. Yet, there remain considerable uncertainties, especially in relation to the speed of achieving herd immunity. Firstly, the pace of vaccination could face supply disruptions. In some countries, moreover, limited public support for the vaccine means that a non-negligible part of the population may not receive the vaccination by the end of the year. Secondly, new variants of more infectious strains might make it difficult for vaccines to bring the pandemic to an earlier end. As a result, this projection exercise presents two scenarios: a baseline and a more severe scenario.

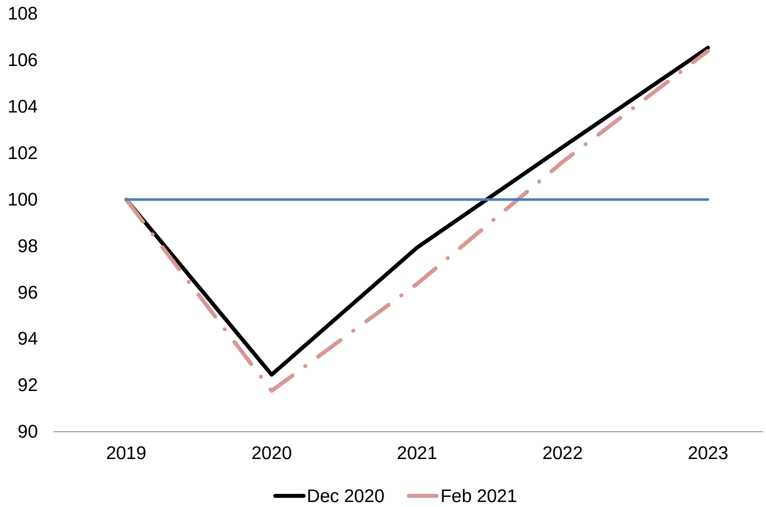
The baseline scenario accounts for the resurgence of infection rates across the globe in late 2020 and early 2021, and the consequent elevated level of containment measures. These stringent measures are expected to be only gradually phased out during the year as larger portions of the population are vaccinated. In the baseline scenario, the health crisis is expected to be resolved by early 2022. As a result, economic activity is expected to return to pre-pandemic levels that year, in spite of the projected prolonged weakness of tourism.

Risks are judged to be on the downside. These risks are presented in an alternative scenario to the baseline, whereby the successful implementation of the medical solution would take longer than anticipated due to emerging variants of the virus as well as a slower pace of vaccination. Hence, some containment measures would still be in place by the end of 2023. In this 'severe scenario', the recovery would be more timid, and levels of economic activity would remain even lower than those in the baseline scenario, with a recovery to 2019 GDP levels occurring only in 2023.

2 Economic Outlook

Economic activity is estimated to have contracted significantly in 2020. Conditional on the baseline pandemic narrative outlined above, the level of GDP is set to reach 2019 levels by the end of 2022, as economic conditions improve at a sustained pace, conditional on the successful implementation of a vaccine by early 2022 (see Chart 1). Compared to the Bank's previous projections published in December 2020, the level of GDP is being revised down in 2020 and 2021. Once the vaccination programme is completed by early 2022, economic activity is then expected to bounce back, and hence, we envisage no revision to the GDP level by 2023.

Chart 1: Projected GDP level
(index, 2019=100)

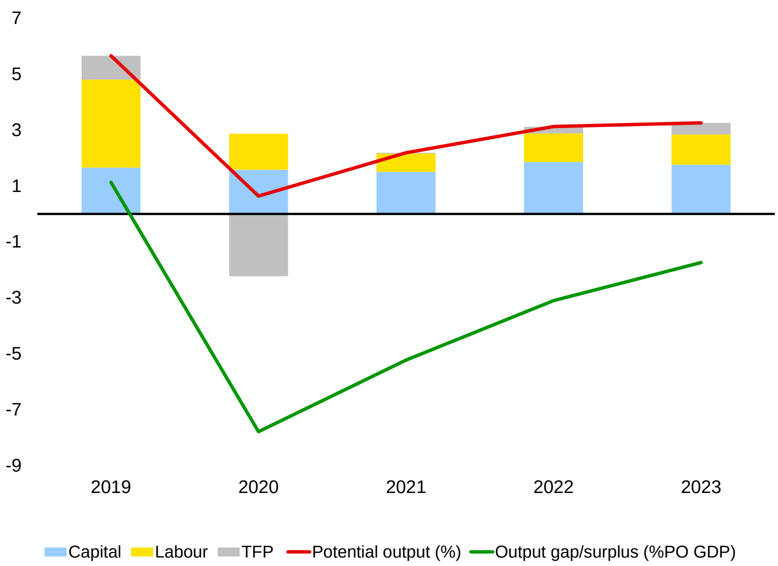


Source: Central Bank of Malta

Containment measures and uncertainty are expected to have negatively affected the supply-side of the economy (see Chart 2). In particular, the Maltese economy attracted fewer foreign workers in 2020 when compared to 2019. Average hours worked have also dropped substantially, while most business investment projects were postponed. In addition, the contribution of total factor productivity (TFP) declined due to the significant fall in capacity utilisation following the forced shut down of businesses during the second quarter of 2020 and subsequent quarantining. As a result, potential output growth is estimated to have slowed down from 5.7% in 2019 to 0.6% in 2020.

Potential output growth is expected to pick-up to 2.2% in 2021, reflecting a foreseen improvement in capacity utilisation, as well as a recovery in investment. It is projected to increase further in 2022 and 2023, mainly reflecting an envisaged improvement in net migration – driven by an increase in labour demand. Despite the projected recovery in GDP, the economy is expected to continue operating below its potential. Indeed, while the output gap is expected to narrow over the projection horizon, it remains negative throughout, partly reflecting the expectation that the tourism sector will likely continue to operate below potential for an extended period.

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

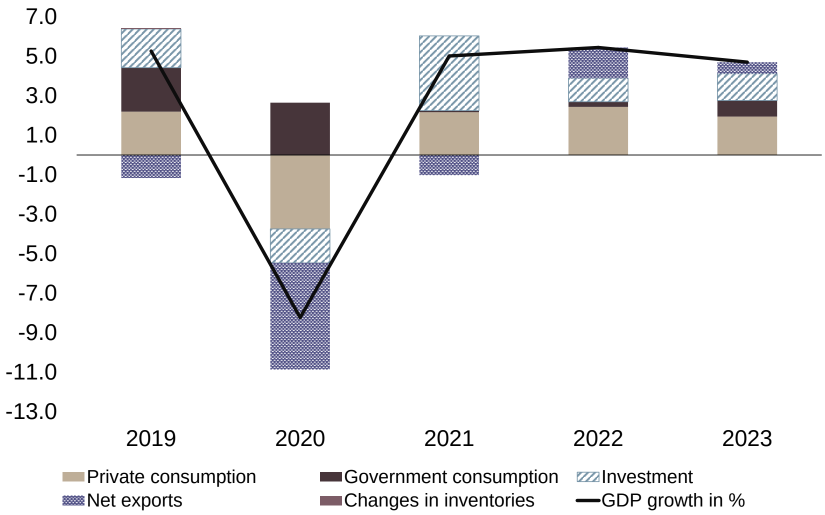


Source: Central Bank of Malta

GDP is estimated to have contracted by 8.2% in 2020. It is projected to grow by 5.0% in 2021, 5.5% in 2022 and 4.7% in 2023 (see Table 1). The downward revision compared to the Bank's earlier projections for 2020 and 2021 reflects lower than expected outcomes for the first three quarters of 2020, and the impact of the prolongation of some containment measures into the first quarter of 2021. However, GDP growth in 2022 and 2023 is being revised up reflecting an unchanged assumption regarding the rollout of the vaccine, as well as better-than-expected employment outcomes.

In 2020, all demand components, with the exception of government consumption, dented GDP growth markedly (see Chart 3). The rise in Government consumption, in turn, partially mitigated the contraction in domestic demand. Net exports, thus, were the leading contributor towards decreased economic activity as travel restrictions and, to a lesser extent, supply-chain disruptions weighed on exports during most of the year. In 2021, all domestic demand components are projected to grow significantly as the economy gradually recovers from the 2020 contraction. Overall, 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. Net exports are expected to exert a smaller negative impact on GDP growth as foreign demand starts to recover.

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 estimated to have fallen by 8.2% in 2020. This primarily reflects the impact of the temporary shutdown of non-essential services during the second quarter, as well as the re-introduction of some containment measures after summer and weaker growth in disposable income. Moreover, private consumption was affected markedly by lower consumption of resident households abroad as international travel decreased (see Box 1). Private consumption is set to recover somewhat in 2021, but the level of consumption will remain below pre-pandemic levels, as containment measures and related conditions affecting international travel will continue to weigh down on consumption. Such containment measures are then assumed to gradually fade by 2022. Along with faster growth in disposable income, this should support a further rise in growth in private consumption. Growth in private consumption is then foreseen to slow down somewhat in 2023 but remain higher than disposable income growth, as the saving ratio is expected to retreat from recent peaks.

Due to the elevated level of uncertainty, a large number of private investment projects were either postponed or cancelled last year. On the other hand, government investment in 2020 grew substantially, thus cushioning some of the drop in overall investment growth. As uncertainty begins to recede and the economy begins to recover in 2021 investment is expected to bounce back. Furthermore, the EU Budget as well as Next Generation EU (NGEU) funds will provide a substantial boost to government investment during the next three years.

In 2020, exports are estimated to have declined by 7.9%, reflecting a sharp fall in foreign demand, disruptions to the global supply chains as well as the dramatic impact of the pandemic on tourism and transportation. In 2021, export growth is expected to recover somewhat from the sharp decline of last

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

	2019[2]	2020	2021	2022	2023
Real economic activity (% change)					
GDP	5.3	-8.2	5.0	5.5	4.7
Private consumption expenditure	4.8	-8.2	4.7	5.4	4.3
Government consumption expenditure	13.9	15.2	0.3	1.2	4.0
Gross fixed capital formation	9.3	-7.9	17.5	4.9	5.7
Exports of goods and services	6.2	-7.9	5.0	5.3	3.5
Imports of goods and services	7.9	-4.6	6.1	4.3	3.3
Contribution to real GDP growth (in percentage pts)					
Final domestic demand	6.4	-2.8	6.0	3.9	4.1
Net exports	-1.2	-5.4	-1.0	1.6	0.6
Changes in inventories	0.1	0.0	0.0	0.0	0.0
Real disposable household income[3]	5.9	0.8	1.8	2.3	3.1
Household saving ratio[3]	20.3	27.4	25.3	23.1	22.1
Balance of payments (% of GDP)					
Goods and services balance	14.1	9.7	8.8	10.0	10.4
Current account balance	4.6	-1.6	-1.2	0.6	1.5
Labour market (% change)[4]					
Total employment	6.1	2.4	0.5	2.2	2.7
Unemployment rate (% of labour supply)	3.5	4.4	4.3	4.2	4.2
Prices and costs (% change)					
GDP deflator	2.2	1.6	1.7	1.8	1.9
RPI	1.6	0.6	0.8	1.3	1.5
Overall HICP	1.5	0.8	0.9	1.4	1.7
HICP excluding energy	1.4	0.9	1.1	1.5	1.8
Compensation per employee	2.8	-1.6	0.9	2.6	2.9
ULC	3.6	9.8	-3.4	-0.6	1.0
Business cycle					
Potential output (% change)	5.7	0.6	2.2	3.1	3.3
Output gap (% of GDP)	1.1	-7.8	-5.2	-3.1	-1.7
Technical assumptions					
EUR/USD exchange rate	1.12	1.14	1.18	1.18	1.18
Oil price (USD per barrel)	64.0	41.6	44.0	45.7	47.0

[1] Data on GDP were sourced from NSO News Release 194/2020 published on 27 November 2020, while HICP and RPI data were sourced, respectively, from NSO News Release 009/2021 and 011/2021 (released on 20 and 23 January 2021, 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.

year, but levels will remain relatively low due to the partial recovery in foreign demand and tourism. The recovery in exports is expected to continue in 2022, as travel disruptions ease and travellers respond favourably to the envisaged successful resolution of the health crisis by the end of 2021.

In view of the decline in domestic demand and outbound travel, as well as disruptions to the global supply chain, imports are estimated to have contracted sharply in 2020. 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 positive contributions in the final years of the projection horizon. As a result, the current account is projected to be in deficit in 2020 and 2021, at 1.6% and 1.2% of GDP respectively. It is then set to return to surplus in the final two years of the projection horizon.

Box 1: The impact of lower tourism flows on private consumption expenditures[i]

The statistical notion of residency is very important when looking at household consumption data in national accounts. Final consumption expenditures of households in GDP follows the ‘national concept’. This means that it includes only the total expenditures of residents of Malta, whether in Malta or abroad. In other words, consumption by non-residents in Malta is excluded from final consumption expenditure, as this is classified as tourism exports. On the other hand, consumption of residents in foreign countries is included as final consumption expenditure. This implies that total final consumption expenditure is partly linked to the expenditure of Maltese residents in foreign countries, whether that consumption is made online or physically while abroad.

Consumption data can be further disaggregated into individual consumption by purpose (COICOP), although this reflects the ‘domestic concept’ of households’ final consumption. This includes all consumption expenditures in Malta, irrespective of whether these refer to expenditures by residents or non-residents.

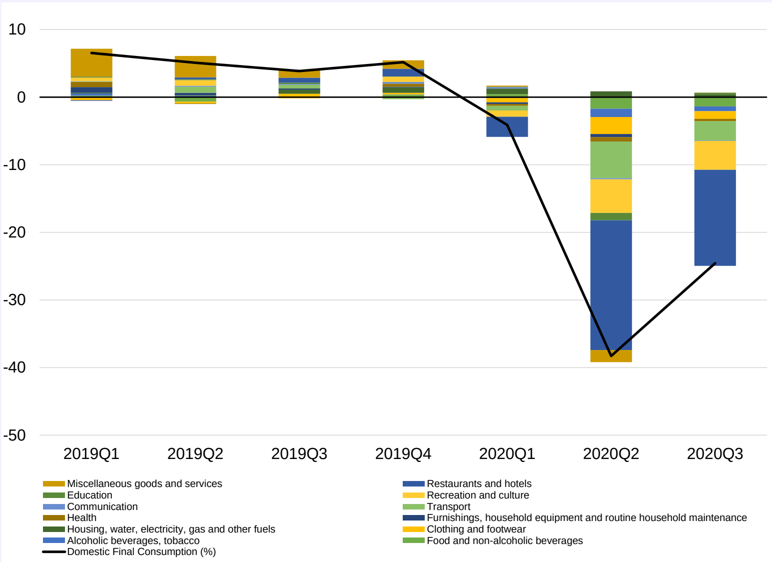
From March 2020 onward, there was a strong and sharp drop in international mobility, with the onset of the COVID-19 pandemic. This was reflected in a slump in tourism flows, both inbound and outbound. As a result, domestic consumption by non-residents, as well as consumption by residents of Malta abroad, declined sharply. This Box looks at the contributions of these different components to consumption expenditure in Malta, and their implications for private consumption in the near term.

Contributions to consumption

For the purposes of this Box, the expenditures of persons in Malta, whether they are resident or non-resident are defined as Total Domestic Consumption. As a way of example, a German tourist spending €80 on a meal in Malta would classify as domestic consumption on restaurants and hotels. However, those €80 would be subtracted from ‘total domestic consumption’ when compiling national consumption, as they are not expenditures by residents of Malta. This deduction from total domestic consumption data preserves the proper classification of residents’ expenditures in GDP.

On the other hand, a resident of Malta’s expenditure in Germany as a tourist, while not occurring in Malta, is added back to domestic consumption expenditure to derive the national measure of private consumption.

Chart A: Contributions to changes in total domestic consumption by COICOP category



Total domestic consumption decreased strongly in the first quarter of 2020 (-4.1% in annual terms), which worsened significantly in the next quarter (-38.3%), before recording a lower negative of -24.6% in the third quarter (see Chart A). Already by the first quarter, the drop in total domestic consumption was comparable to that recorded during the third quarter of 2008, (around the 2008/9 Global Financial Crisis), when it had decreased by 4.5%.

Focusing on the second quarter, the main contributors to the drop were expenditures in restaurants and hotels (around 50.1% of the total decrease), followed by transport (14.2% of the decrease), and recreation and culture (13.0% of the drop). The same pattern is found for the third quarter, although the overall drop is smaller. The sharp drops recorded during this period reflect the sudden stop in tourist visits to Malta. In fact, in year-on-year terms, tourist arrivals fell by almost 90.0% in the six months to September 2020, with expenditure down by 77.6% over comparable months of 2019. This period typically represents the peak of the tourist season in Malta. In annual terms, tourist arrivals were down 76.2% in 2020, and expenditure fell by 79.5%.

Chart B: Contributions to changes in Household Consumption Expenditures (National Concept)

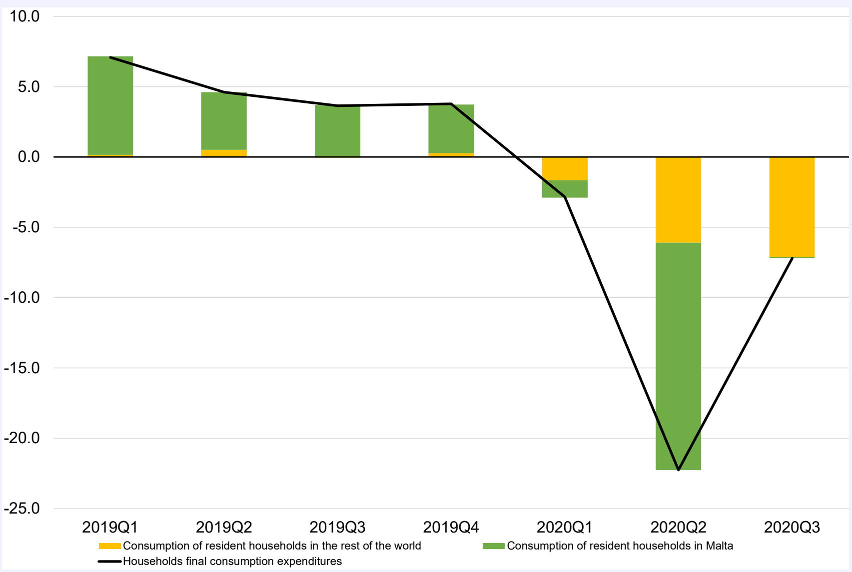


Chart B shows that, the negative contribution of residents' expenditure abroad has been substantial. Indeed, in 2020Q2 and 2020Q3, domestic households spent €85.6 million and €111.8 million less (in annual terms) abroad, respectively. This accounts for a negative contribution of 6.1 and 7.1 percentage points to private consumption (national concept) in both quarters. These declines explain 25% and almost 100% of the fall in private consumption during the second and third quarters, respectively.

Hence, travel disruptions due to COVID-19 had a strong impact on consumption, as residents of Malta were unable to travel abroad. Indeed, outbound travel ground to a complete halt in the second quarter, and while some travel resumed during the summer period, expenditure abroad was around 82.5% less than a year earlier.

Resident households may have substituted their consumption abroad by spending more locally. This reflected a shift in demand to domestic tourism due to the elevated uncertainty and constraints associated with travel during the pandemic period, as well as government support through the voucher scheme. Indeed, in the third quarter of 2020, Maltese residents in collective accommodation establishments more than doubled when compared to that of 2019, which suggests that domestic tourism contributed strongly to economic activity. However, this shift towards domestic tourism was not sufficient to offset the sharp drop in consumption abroad or that of non-residents in Malta.

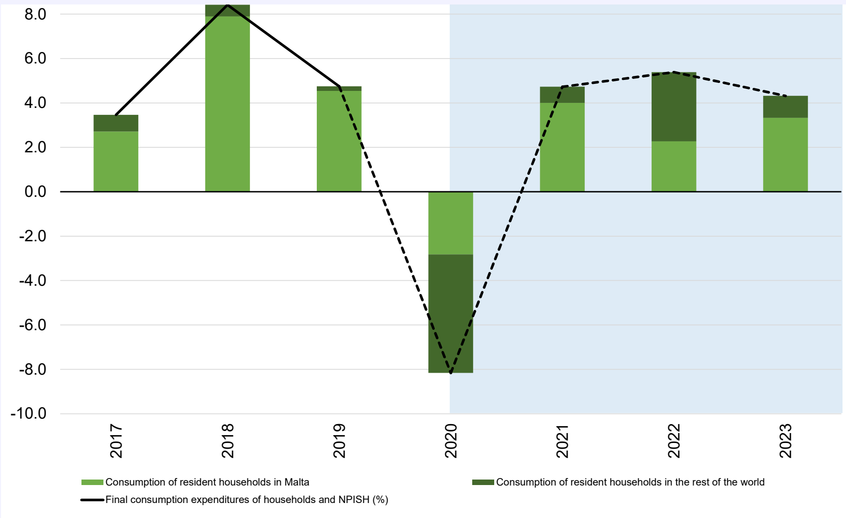
Forecast implications

Over the final months of 2020 and at the start of 2021, there was a widespread resurgence in COVID-19 cases in Europe. Many euro area countries heightened their response in terms of stringency of social distancing measures, and tougher testing or quarantine conditions on extra-EU visitors. Lockdowns were reintroduced in several European countries, and international travel remained constrained. These factors can be expected to continue to affect negatively tourism flows - both inbound and outbound - over the coming months. While in larger countries the substitution effect in favour of domestic tourism is likely to be sizeable, this will remain limited in Malta. As such, this implies that private consumption of Maltese households will continue to be adversely affected by travel disruptions. Moreover, given the possible international travel constraints in the years ahead, it is unlikely for private consumption to return to its 2019 patterns soon. Thus, consumption by residents abroad will continue to limit growth in private consumption in the years to come.

Several forward-looking indicators continue to signal unfavourable conditions for the tourism sector. Confidence in the services sector and in retail trade, as well as consumer confidence, although significantly better than in the second quarter of 2020, remains low. Both government response and stringency measures remain elevated, and coupled with limited improvements to flight capacity towards Malta, indicate significant weakness for tourism ahead.

Based on this assessment, the latest forecast for private consumption is built on the premise that confidence and the expenditures of households resident in Malta will be the main driver of growth in private consumption over the medium term (see Chart C).

Chart C: Consumption forecast 2020-2023



[i] Prepared by Reuben Ellul, a principal economist in the Economic Analysis Department.

3 Labour Market

Notwithstanding the contraction in economic activity, the labour market showed resilience during 2020. In particular, fiscal support measures have had a significant positive impact on employment. In 2020, employment is estimated to have increased by 2.4%. This represents an upward revision to that made in December - reflecting recent outcomes, and contrasts with the downward revision to the GDP growth estimate. In turn, this implies a strong decline in labour productivity per person (though less so in per hour terms).

Firms have generally been successful in retaining their staff and have instead opted to reduce the number of hours worked by their employees, in response to the lower activity levels (see Box 2). Indeed, actual hours worked declined sharply during 2020, and hence total employment hours are set to have dropped by 2.5%.

Given these developments in 2020, firms are expected to respond to an improvement in business conditions in 2021 by gradually returning to their normal working hours. This implies that there will be less need for further recruitment in 2021. Hence, employment growth is set to decelerate to 0.5% in 2021. Employment is then set to grow more rapidly in 2022 and 2023, but more slowly than GDP, as firms seek to regain some of the productivity losses experienced during the pandemic.

The unemployment rate is envisaged to have risen to 4.4% in 2020, from 3.5% in 2019, though this is still well below historical averages. In part, this rise in the unemployment rate is mitigated by the slowdown in the labour supply, due to migrant outflows during the early stages of the pandemic, and a temporary increase in inactivity. Moreover, fiscal measures have been highly supportive of employment. Going forward, the unemployment rate is projected to decline only marginally when compared to that for 2020, remaining above its 2019 level.

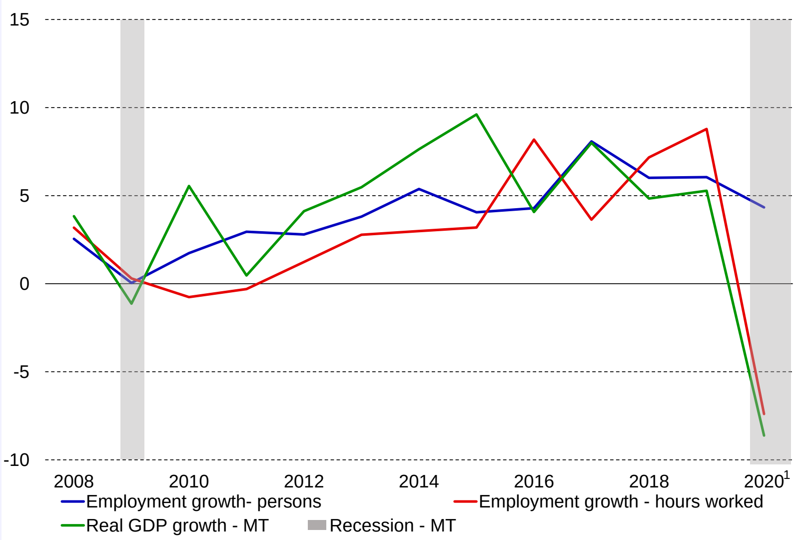
As regards compensation per employee, this decreased in 2020, partly reflecting the statistical impact of the wage supplement scheme. Under the scheme, the government and the employer pay employees a wage that is mostly lower than the normal average wage, at least for the duration of the scheme. Once the scheme ends, wage levels should begin to normalise. In addition, the labour market is expected to remain tight going forward, which should offer some support for wage growth.

Box 2: The impact of the COVID-19 pandemic on the Maltese labour market[i]

Despite the sharp decline in economic activity in the first three quarters of 2020, the Maltese labour market has shown a high degree of resilience. Indeed, employment levels were not only sustained when compared with those prevailing in 2019, but despite the pandemic, the number of jobs still increased in 2020. Despite the sharp drop in GDP during the first three quarters of 2020, employment grew at an average rate of 4.3%, when compared with the same period of 2019. While fiscal support in terms of the wage supplement scheme and other schemes to support liquidity have been fundamental in protecting jobs during such an unprecedented economic shock, the Maltese labour market did adjust to the declines in economic activity levels. The shutdown of non-essential services during April and May, travel disruptions, as well as lower foreign demand, meant that many workers - while still in employment - were unable to work as much as they used to before the pandemic. Indeed, total hours worked registered an average annual decline of 7.4% during the first three quarters of 2020, when compared with the same period in 2019. This is the sharpest contraction on record in total hours worked as declines surpass those in both the dot-com crisis in the early 2000s and the Global Financial Crisis of 2008/2009. The largest annual decline in both hours worked and GDP was registered in the second quarter of 2020, which is the period most affected by the containment measures. Quarter-on-quarter adjustments show that total hours worked recovered somewhat in the third quarter although they remained well below their levels in the corresponding quarter of 2019.

Chart A: Employment Developments in Malta

annual percentage changes



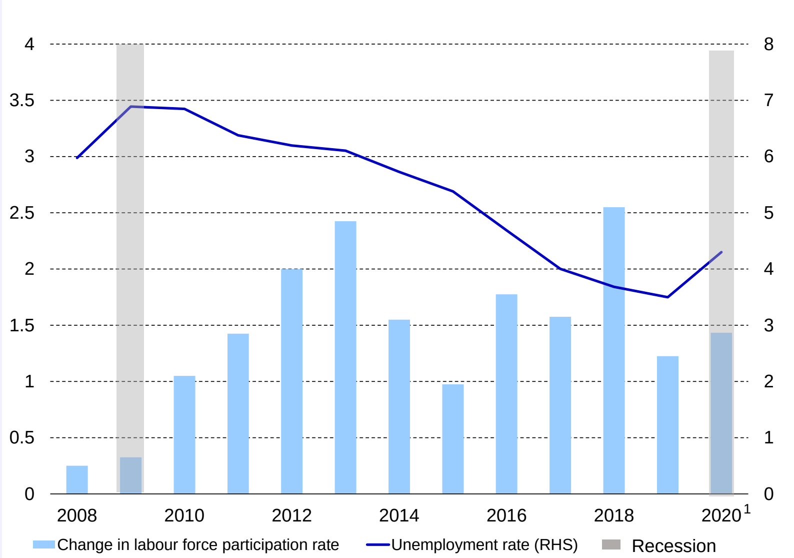
Source: Central Bank of Malta

[1] Data for 2020 is the average for the first three quarters

In Malta, it is not uncommon for hours worked to react more strongly than employment levels following drops in economic activity. Chart A outlines employment developments in Malta since 2008, which includes the contraction in 2009, and that in 2020. During 2009, Malta's GDP growth declined by 1.1%, while employment remained at broadly the same levels as those during 2008. At the same time, total employment hours grew by 0.3%. Employment hours declined in 2010 and 2011, despite some recovery in employment growth. This suggests that Maltese firms, supported in part by government intervention, tend to prefer reducing the hours worked rather than laying off workers.

Chart B: Unemployment rate and Labour force participation

percentage point change; percent



Source: NSO, Central Bank of Malta

[1] Data for 2020 is the average for the first three quarters

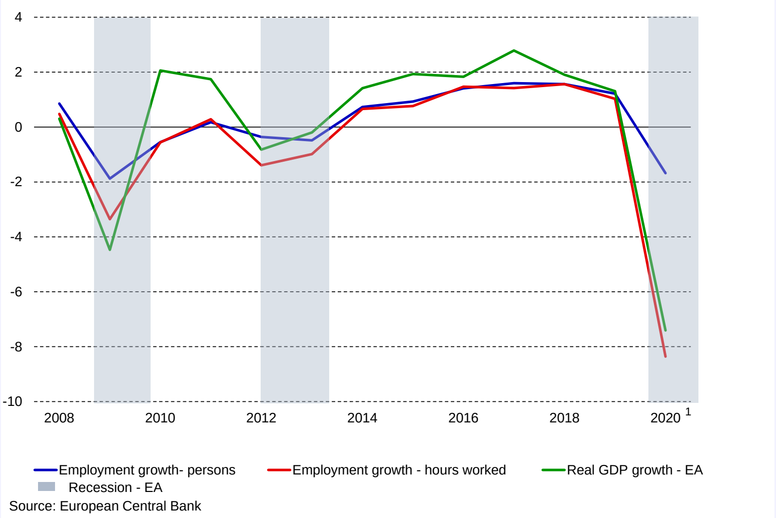
With regards to unemployment, this tends to be somewhat more in sync with the business cycle, but the reaction is also muted by the relatively low response in headcount employment during recessionary periods (see Chart B). During the 2009 recession, the unemployment rate rose from 6.0% in 2008 to 6.9% in 2009. Similarly, the unemployment rate rose from 3.5% in 2019 to an average of 4.1% in the first three quarters of 2020. Looking further into the age decomposition of the unemployment rate, the largest increase was registered among those aged between 15 and 24. This means that although the wage supplement scheme was successful in supporting jobs, the pandemic might have affected somewhat the demand for new recruits, who may also have been among the first to be laid off. As a result of the simultaneous rise in both employment and unemployment, the participation rate in Malta has increased in the first three quarters of 2020 when compared to the corresponding period of 2019.

Comparison to the euro area

Employment dynamics in the euro area tend to be more responsive to cyclical changes than those in Malta (see Chart C). Indeed, during the Global Financial Crisis, both employment growth and total employment hours declined sharply, but the latter dropped more strongly than the former. This implies that the euro area labour market tends to adjust in both employment levels and hours. With regards to 2020, there is a much stronger divergence between employment growth and hours. During the first three quarters of 2020, employment growth in the euro area declined by just 1.7%, while hours worked fell by 8.4%. The much sharper adjustment in hours during the 2020 recession reflects the nature of the current crisis. Similar to the developments in Malta, government support in terms of job retention schemes has been unprecedented also in the euro area. In addition, due to the shutdown of business during lockdown periods, as well as due to the impact of forced quarantine to stem the spread of the virus, hours worked in the euro area dropped sharply.[ii]

Chart C: Employment developments in the euro area

annual percentage changes



Source: European Central Bank

[1] Data for 2020 is the average for the first three quarters

Forecasting employment dynamics for 2020-2023

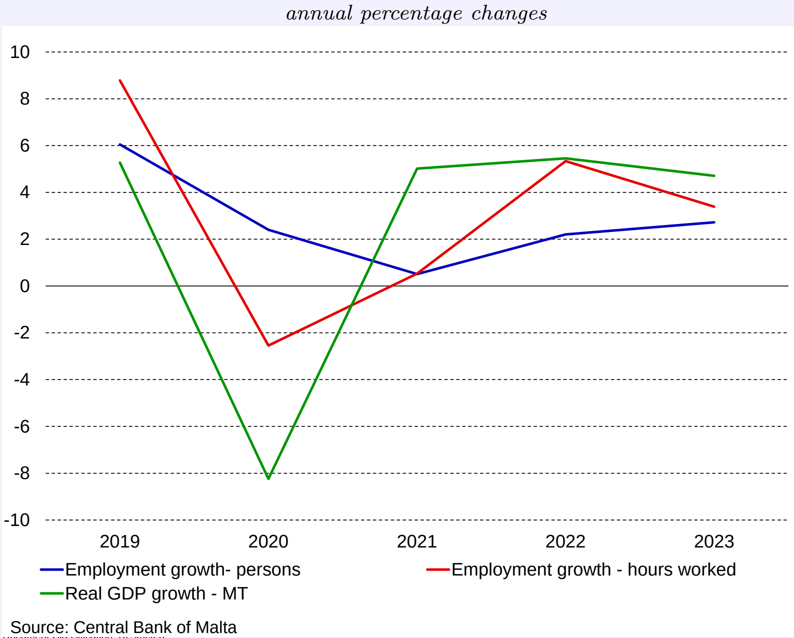
In view of the dynamics of headcount employment and employment hours during 2020, developments between these two indicators are expected to diverge over the forecast horizon (see Chart D). GDP growth in 2021 is projected to increase by 5.0% following the projected decline of 8.2% in 2020. It is then estimated to rise to 5.5% in 2022 and decelerate to 4.7% in 2023.

On the other hand, employment growth is projected to increase by just 0.5% in 2021, which implies a slowdown from the estimated increase of 2.4% in 2020. Total employment hours are expected to rise by 0.5% in 2021, after an estimated decline of 2.5% in 2020. In 2022, employment growth is expected to rise by 2.2%, a much slower recovery than that envisaged for GDP. On the other hand, total employment hours are projected to rise by 5.3%, driven by an increase in both headcount employment levels and a return to more historical working hours.

Finally, employment is set to rise further by 2.7% in 2023, still significantly below the projection of GDP growth, as firms continue to recuperate recent losses in productivity. Moreover, average hours worked are projected to return to historical levels in 2023, and hence, total employment hours are projected to rise by 3.4%.

Chart D: Projected Employment Developments in Malta

annual percentage changes



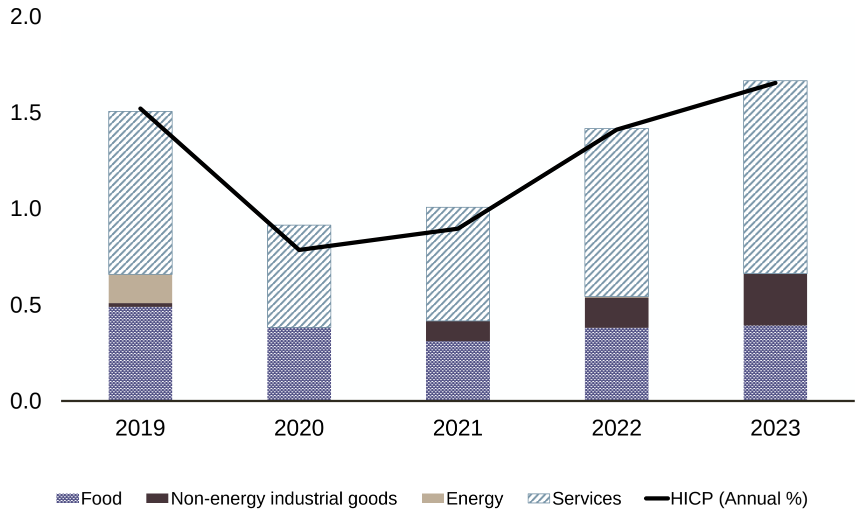
[i]Prepared by Abigail Marie Rapa, a senior economist in the Economic Analysis Department.
[ii]See 'The Impact of the COVID-19 pandemic on the euro area labour market', ECB Economic Bullettin, Issue 8/2020, pp 105-127

4 Prices

With regards to consumer prices, HICP inflation in Malta is projected to edge up marginally in 2021 but remain muted as economic activity in Malta and abroad are expected to remain below pre-pandemic levels.

In 2021, HICP inflation is projected to stand at 0.9%, marginally up from 0.8% in 2020. Thereafter, inflation is expected to pick up, reaching 1.4% in 2022 and 1.7% in 2023.

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



Source: Central Bank of Malta

Services inflation is expected to pick up to just above 1% in 2021, as economic activity is projected to improve when compared with 2020. Moreover, NEIG inflation is expected to turn slightly positive as import prices are projected to recover from the drops experienced in 2020.

By contrast, energy inflation is expected to turn more negative in 2021, reflecting the cuts to gas and fuel prices in April and June 2020, respectively. These are expected to be partly offset by higher oil prices if these are transmitted to fuel prices. In addition, food inflation is projected to decelerate in 2021, due to lower processed and unprocessed food inflation, reflecting weaker than expected outcomes for January and expected developments in international commodity prices.

HICP inflation is expected to pick up in the medium term though still remaining moderate, reflecting the expected partial recovery in global demand and tourism following a successful vaccination drive by early 2022.

When compared with the Bank's latest forecasts published in December 2020, overall HICP inflation has remained broadly unchanged.

Inflation forecasts are subject to a higher degree of uncertainty due to significant changes in weights of certain HICP components which were not yet available by the cut-off date. For 2021, these risks are assessed to be on the downside.

5 Public finance

Public finances deteriorated sharply, due to the measures introduced to cushion the impact of the pandemic as well as the impact on revenues from the contraction in economic activity. These projections incorporate the impact of all COVID-related measures announced by mid-February 2021. From a surplus of 0.5% of GDP in 2019, the general government is set to post a deficit of 9.5% in 2020 (see Table 2). The deficit is projected to gradually decline over the forecast horizon, narrowing to 3.9% of GDP by 2023. This improvement is driven by the gradual unwinding of COVID-19 measures and a more favourable macroeconomic environment.

Compared with the Bank's earlier projections, the deficit was revised up in 2020 and 2021, mainly reflecting lower tax intakes on the back of a downward revision in GDP growth. In addition, COVID-19 related health spending was revised upwards in 2021 in line with the upsurge in active cases observed in the final quarter of 2020. It is assumed that the number of active cases will remain elevated until mid-2021 before gradually declining and eventually brought to very low levels by early 2022. The deficit was revised down in the outer years of the projection horizon, as a result of upward revisions in the GDP forecasts.

Overall, the deficit mirrors the profile of gross savings, which deteriorated in 2020 but which should recover thereafter. The share of current revenue in GDP decreased sharply in 2020 as declining profits and lower domestic and tourist consumption led to a drop in tax revenue. The decline in revenue from taxes on production and imports also reflected the reduction of stamp duty on property transfers. Owing to the relatively weak rate of recovery in tax-rich underlying macroeconomic items, the share of tax revenue in GDP is set to decline further in 2021. This is then set to increase in the outer years of the forecast horizon, on the back of growth in indirect tax receipts.

Meanwhile, the share of current expenditure in GDP is expected to increase over the forecast horizon. This mainly reflects the fiscal measures which were introduced in response to the pandemic as well as additional outlays related to healthcare and containment measures. Consequently, growth in subsidies, intermediate consumption, social benefits and compensation of employees is expected to outpace GDP. Current spending is set to decline in 2021 as most of these measures are expected to gradually end. However, the share of subsidies in GDP is expected to remain elevated due to the extension of the COVID-19 wage supplement scheme until end-March 2021, as well as the reintroduction of the vouchers scheme.

Subsequently, the share of current spending in GDP is expected to decline gradually as all COVID-19 related measures are phased out. However, the share of interest payments in GDP is expected to increase

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

	2019[2]	2020	2021	2022	2023
Headline Aggregates					
Total revenue	37.6	37.1	37.4	37.6	37.3
Total expenditure	37.1	46.7	44.1	41.7	41.2
General Government Balance	0.5	-9.5	-6.6	-4.1	-3.9
of which: Primary Balance	1.9	-8.2	-5.3	-2.6	-2.4
General Government Debt	42.4	55.3	59.7	59.9	60.3
Detailed Breakdown					
Current Revenue	36.1	35.2	35.0	35.2	35.1
Current taxes on income and wealth	13.6	13.1	13.0	12.9	13.0
Taxes on production and imports	12.0	11.0	11.2	12.0	12.1
Social contributions	5.9	6.3	6.0	5.8	5.7
Other current revenue[3]	4.6	4.7	4.7	4.6	4.4
Current Expenditure	32.4	41.5	38.4	35.9	35.6
Compensation of Employees	11.0	12.4	12.2	12.0	11.8
Social benefits	9.2	11.1	10.7	10.1	9.9
Intermediate Consumption	7.2	9.6	8.9	8.5	8.5
Interest payments	1.4	1.3	1.3	1.4	1.6
Subsidies	1.4	4.8	2.8	1.4	1.4
Other current expenditure[4]	2.2	2.3	2.5	2.5	2.5
Gross savings	3.7	-6.3	-3.4	-0.7	-0.6
Capital Revenue	1.5	1.9	2.4	2.4	2.2
Capital taxes	0.2	0.2	0.2	0.2	0.2
Other capital revenue[5]	1.3	1.7	2.3	2.2	2.0
Capital Expenditure	4.7	5.2	5.7	5.8	5.6
Gross Fixed Capital Formation	3.9	4.5	4.9	4.8	4.7
Capital transfers	0.8	0.7	0.9	1.0	1.0
Other capital expenditure[6]	0.0	-0.1	-0.1	-0.1	-0.1
Capital Revenue Net of Capital Expenditure	-3.2	-3.2	-3.2	-3.4	-3.4
Underlying Budgetary Position					
Cyclical component	0.7	-3.1	-2.5	-1.9	-1.1
Temporary government measures	0.0	0.0	0.0	0.0	0.0
Structural balance	-0.2	-6.3	-4.1	-2.2	-2.8

[1] CBM calculations based on NSO News Release 194/2020 (published on 27 November 2020) and News Release 6/2021 (published on 13 January 2021).
[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.

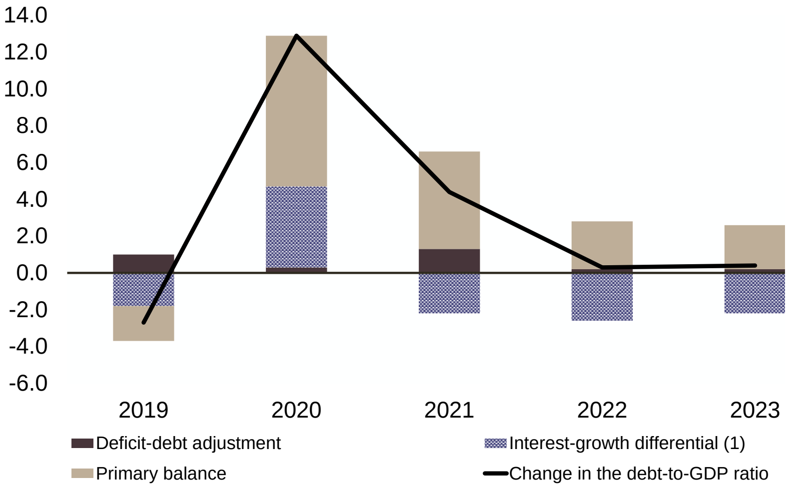
for the first time since 2011, due to rising financing needs.

Capital expenditure is expected to rise substantially over the forecast horizon on the back of higher spending on infrastructural projects. Overall, spending on domestically-funded projects is expected to remain elevated throughout the forecast horizon, owing mostly to investment in health, transport and the environment. At the same time, outlays on EU-financed projects are set to increase sharply in 2021, as works on projects which were delayed in the previous year due to the pandemic come to completion. EU-funded capital expenditure is set to remain elevated in the outer years of the forecast horizon, as projects financed by the 2014-2020 framework are completed and the Government starts using NGEU funds.

The structural balance is estimated to have deteriorated from -0.2% of GDP in 2019 to -6.3% in 2020. It is then projected to improve to -2.2% by 2022, as COVID-related measures are unwound (the latter are not treated as one-off and thus affect the underlying structural position). However, the structural deficit is then set to worsen in 2023, to -2.8%, as the improvement in the headline deficit for the year is set to be mostly driven by cyclical factors. It should be noted that owing to significant uncertainty surrounding the value of the budgetary semi-elasticity and the output gap in times of crisis, structural balance estimates should be treated with caution.

The general government debt-to-GDP ratio is projected to have risen from 42.4% in 2019 to 55.3% in 2020, mainly driven by the estimated primary deficit and interest-growth differential (see Chart 5). 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 on record, reflecting the severity of the economic shock. Debt is expected to reach 60.3% of GDP by 2023, 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

6 Risks - Severe scenario

Risks to economic activity are assessed to be on the downside. To account for risks and uncertainty around the projections, the Bank is publishing a severe scenario in addition to the baseline projections. This accounts for a scenario whereby some containment measures would still be in place until the end of 2023.

As a result, we envisage a scenario whereby travel exports, as well as the recovery in global economic activity, would be lower than that assumed in the baseline. In addition, and in response to continued weak economic activity levels, the Government is assumed to extend the wage supplement scheme until end-2021. Moreover, health treatment costs would be higher than those assumed in the baseline as active cases would be only brought down towards end-2021.

In the severe scenario, GDP would rise by 3.9% in 2021 and by 4.0% in 2022 and 2023. (see Table 3). The main driver behind the lower projection in 2021 is the lower net export contribution, reflecting a more muted recovery in exports in light of a slower pick-up in tourism and a relatively weaker international environment. Thus, in the severe scenario, economic activity levels are projected to return to 2019 levels only in 2023.

Table 3: Projections - baseline and severe scenario

	Baseline				Severe			
	2020	**2021**	**2022**	**2023**	**2020**	**2021**	**2022**	**2023**
GDP	-8.2	5.0	5.5	4.7	-8.2	3.9	4.0	4.0
HICP	0.8	0.9	1.4	1.7	0.8	0.8	1.2	1.4
Unemployment rate	4.4	4.3	4.2	4.2	4.4	4.4	4.3	4.3
Potential Output	0.6	2.2	3.1	3.3	0.6	1.0	2.7	2.8
Output Gap	-7.8	-5.2	-3.1	-1.7	-7.7	-5.1	-3.9	-2.9
Contributions								
Domestic Demand	-2.8	6.0	3.9	4.1	-2.8	5.6	3.0	3.7
Net Exports	-5.4	-1.0	1.6	0.6	-5.4	-1.7	1.0	0.3
Fiscal								
General Gov. Balance (% of GDP)	-9.5	-6.6	-4.1	-3.9	-9.5	-10.0	-5.6	-5.6
General Gov. Debt (% of GDP)	55.3	59.7	59.9	60.3	55.3	63.8	66.2	68.2

With regards to prices, HICP inflation is projected to be marginally weaker in 2021 when compared to the baseline, before partially recovering to 1.4% in 2023, as overall demand starts to recover. Overall, the recovery in inflation is more muted when compared to the baseline due to lower envisaged economic activity levels.

The general government deficit is set to rise further, to 10.0% in 2021. It is then projected to decline to 5.6% by 2023. This profile reflects the impact of a more persistent economic slowdown as well as higher outlays on COVID-related fiscal measures.

The debt-to-GDP ratio is projected to rise further to 68.2% by 2023. This is mainly due to the expected budget shortfall, as well as the interest-growth differential.

Other risks include the possibility that the pandemic would have a more adverse long-term impact on GDP, which would delay the restoration to pre-pandemic levels. On the other hand, large government projects such as a link between Malta and Gozo have not been incorporated due to the lack of information. These risks are assessed to be balanced.

On the fiscal side, other risks are deemed to be deficit increasing, with the largest risks expected to materialise in 2021. These include the possibility of state aid to Air Malta (as announced during the 2021 Budget Speech), and the likelihood that some government guarantees extended to working capital loans are called in during the outer years of the projection horizon.