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CENTRAL BANK OF MALTA
OUTLOOK FOR THE MALTESE ECONOMY

2024:1

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OUTLOOK FOR THE MALTESE ECONOMY 2023-2026

Overview[1,2]

Incoming information suggests that economic activity in Malta remained resilient despite the weakness exhibited in key trading partners. In particular, private consumption continues to grow at strong rates despite higher-than-average inflation, while services exports have remained robust.

Although inflation remains high from a historical perspective, it has moderated significantly in recent months, and is expected to ease further throughout the projection horizon.

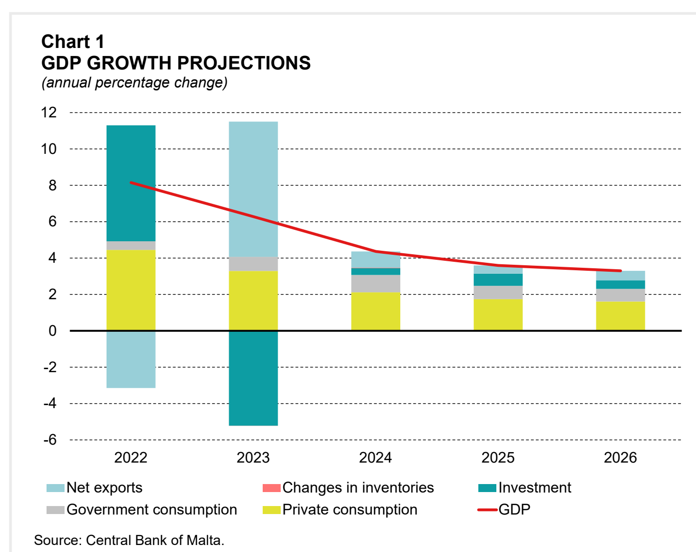
Given these factors, economic growth is expected to remain resilient, but is set to slow down and broadly converge to potential output growth by the end of the projection horizon. Moreover, the lagged impact of monetary policy tightening is expected to continue to weigh on activity in Malta's main trading partners, and hence contribute to a further moderation in growth in 2024 and 2025.

Economic outlook

According to the Bank's latest forecasts, Malta's gross domestic product (GDP) growth is projected to have moderated from 8.2% in 2022 to 6.3% in 2023. It is expected to decelerate further to 4.4% in 2024, 3.6% in 2025, and 3.3% in 2026 (see Table 1). Compared to the Bank's December projections, GDP growth is being revised strongly up in 2023, mainly on account of positive revisions in private consumption and net exports in the latest national accounts data release, which also featured significant upward revisions to the first two quarters of the year. The revision to GDP in 2024 reflects an upward revision in net exports. GDP growth for 2025 and 2026 remains broadly unchanged from the December exercise.

Whereas in 2023 growth is expected to have been primarily driven by net exports, domestic demand is envisaged to be the main driver of growth in 2024 (see Chart 1). The latter reflects continued strong expansion in private consumption and a recovery in private investment. Net exports are also projected to contribute positively, driven mainly by trade in services. Growth in 2025 and 2026 is also expected to be led by domestic demand.

Chart 1
GDP GROWTH PROJECTIONS
(annual percentage change)



Source: Central Bank of Malta.

Private consumption growth is set to gradually slow down but remain robust despite the high-inflationary period (see Box 1). Throughout the projection

[1] The Bank's projections for the Maltese economy are based on information available up to 6 February 2024. However, as at the cut-off date, there is insufficient information to quantify the impact of government measures aimed at lowering food prices that became effective on 1 February 2024.

[2] See Central Bank of Malta Outlook for the Maltese Economy 2023:4.

Table 1
PROJECTIONS FOR THE MAIN MACROECONOMIC AGGREGATES FOR MALTA[1]

	2022[2]	2023	2024	2025	2026
Real economic activity (% change)					
GDP	8.2	6.3	4.4	3.6	3.3
Private consumption expenditure	10.8	7.8	4.9	4.0	3.7
Government consumption expenditure	2.4	4.3	5.3	4.1	3.9
Gross fixed capital formation	31.4	-20.9	2.0	3.6	2.6
Exports of goods and services	7.1	7.9	3.8	3.0	3.0
Imports of goods and services	10.1	3.6	3.7	3.1	3.1
Contribution to real GDP growth (in percentage pts)					
Final domestic demand	11.2	-1.1	3.5	3.1	2.8
Net exports	-3.1	7.4	0.9	0.5	0.5
Changes in inventories	-0.1	0.0	0.0	0.0	0.0
Balance of payments (% of GDP)					
Goods and services balance	11.2	17.4	17.5	17.5	17.5
Current account balance	-2.9	2.1	2.2	2.1	2.1
Labour market (% change)[3]					
Total employment	6.0	5.8	3.2	2.5	2.4
Unemployment rate (% of labour supply)	2.9	2.6	2.6	2.7	2.9
Real disposable income[4]	3.0	1.8	4.0	4.1	3.7
Household saving ratio[4]	27.4	23.1	22.4	22.4	22.4
Prices and costs (% change)					
GDP deflator	5.3	5.5	3.0	2.5	2.1
RPI	6.2	5.1	2.8	2.0	1.8
Overall HICP	6.1	5.6	2.9	2.2	1.9
HICP excluding energy	6.6	5.9	2.6	1.9	1.7
Compensation per employee	3.3	4.2	5.3	4.0	3.2
ULC	1.3	3.7	4.2	3.0	2.2
Business cycle					
Potential output (% change)	7.3	7.4	4.6	4.0	3.4
Output gap (% of GDP)	2.3	1.2	1.0	0.7	0.6
Technical assumptions					
EUR/USD exchange rate	1.05	1.08	1.09	1.09	1.09
Oil price (USD per barrel)	103.7	83.7	77.7	73.8	71.4

Sources: NSO; Central Bank of Malta.

[1] Data on GDP were sourced from NSO *News Release 214*/2023 published on 28 November 2023, while RPI and HICP data were sourced, respectively, from NSO *News Releases* 12/2024 and 9/2024 (published on 22 January 2024 and 17 January 2024).

[2] Actual data. National accounts data is consistent with NSO News Release 214/2023 published on 28 November 2023.

[3] 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.

[4] Central Bank of Malta estimates.

horizon, growth in private consumption is set to normalise following three years of elevated growth. In 2024, growth in private consumption is set to outpace the Bank's estimate of real disposable income. However, in view of the strong decline in the saving ratio, private consumption is foreseen to grow in line with the Bank's estimate of real disposable income in the last two years of the projection horizon. The saving ratio is thus envisaged to decline slightly in 2024, but stabilise at its average seen in the last ten years by 2025.

Growth in government consumption is set to pick up in 2023, and to peak at 5.3% by 2024. It is then set to moderate slightly to 4.1% and 3.9% in 2025 and 2026, respectively. This profile is mainly driven by outlays on compensation of employees and intermediate consumption. The former reflects outlays on allowances, which are set to grow at strong rates, particularly in 2023 and 2024. The profile of intermediate consumption is driven by outlays on contractual services and maintenance.

After a significant contraction in 2023, investment is forecast to grow by 2.0% in 2024. It is then set to grow by 3.6% in 2025, and 2.6% in 2026. Residential construction is set to decline marginally in 2024, as sentiment in this sector remains weak and labour shortages should be increasingly binding as migration flows slow down. Non-dwelling private investment is expected to remain unchanged in 2024, while equipment investment is set to grow marginally.

After having fallen in 2022, government investment is estimated to have increased in 2023. It is then set to decline once again by 2.4% in 2024. Thereafter, it is projected to rise by 4.8% in 2025 and to decline by 0.6% in 2026. This profile is partly driven by the expected take up of EU funds, notably the full absorption of funds from the 2014-2020 financing framework by 2023, and the increased take up of Recovery and Resilience Facility (RRF) grants in 2023 and 2024. It also reflects the profile of domestically-funded investment, which is set to remain at elevated levels.

As regards export growth, this is set to ease to 3.8% in 2024 from 7.9% in 2023, largely driven by a moderation in services exports. This is then expected to decelerate further to just around 3.0% in the following two years and grow broadly in line with foreign demand.

In 2024, imports are projected to grow by 3.7%, before decelerating marginally to 3.1% in the following two years.

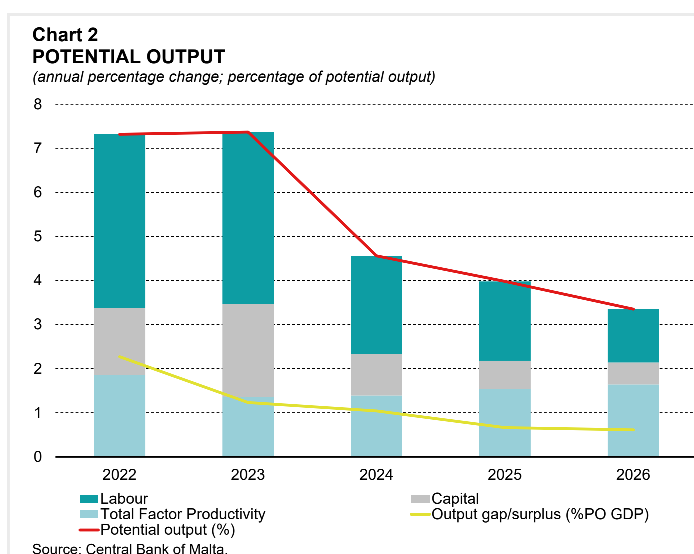
The current account is expected to show a surplus of around 2.1% throughout the forecast horizon.

Potential output

Potential output growth is expected to moderate throughout the projection horizon to stand at 4.6% in 2024, 4.0% in 2025, and 3.4% in 2026. This mostly reflects decreasing contributions from capital and labour. The decrease in the former relates to the lagged impact of the decline in investment in 2023 and muted developments going forward. Moreover, the decline in the contribution of labour primarily reflects a moderation in net migration flows.

The economy is expected to be operating above potential throughout the projection horizon, though the output surplus is set to shrink to 0.6% by 2026 (see Chart 2).

Chart 2
POTENTIAL OUTPUT
(annual percentage change; percentage of potential output)



Source: Central Bank of Malta.

BOX 1: RECENT DEVELOPMENTS IN PRIVATE CONSUMPTION AND FORECAST IMPLICATIONS[1]

Since the re-opening of the economy after the COVID-19 pandemic, private consumption in Malta has strongly recovered. Consumption exceeded pre-pandemic levels by 2022, and acted as one of the main drivers for economic growth. During the first three quarters of 2023, growth in private consumption averaged 8.0% year-on-year. This strong growth may be somewhat puzzling in the current context of high inflation. Indeed, the remarkable resilience of private consumption stands in sharp contrast to developments in real disposable income, which is estimated to have declined slightly during the first three quarters of 2023. It is therefore important to discern the underlying drivers behind the resilience of private consumption, to better understand its medium-term implications.

Contributions to consumption

To do this, we first decompose consumption using two-digit data on the Classification of Individual Consumption by Purpose (COICOP), which yields data for 12 items of expenditure incurred by both residents and non-residents. In this subsection we utilise the concept of 'total domestic consumption' which includes all consumption expenditures in Malta, irrespective of whether these refer to expenditures by residents or non-residents.

Growth in total domestic consumption rose very sharply during 2021 and 2022, driven by all categories of consumption, but especially restaurants and hotels (see Chart 1). The latter in turn partly mirrored the strong recovery in tourism levels following their sharp drop during the pandemic in 2020.

Growth in domestic consumption started to slow down somewhat in 2023, but it remained very strong with a year-on-year increase of 8.0% during the first three quarters of the year. In contrast with 2021 and 2022, the largest contributor to growth in domestic consumption in 2023 was not restaurant and hotels. Instead, this was driven by miscellaneous goods and services, which includes expenditure on personal care, insurance, and financial services, among others. This was followed by restaurants and hotels, and recreation and culture.

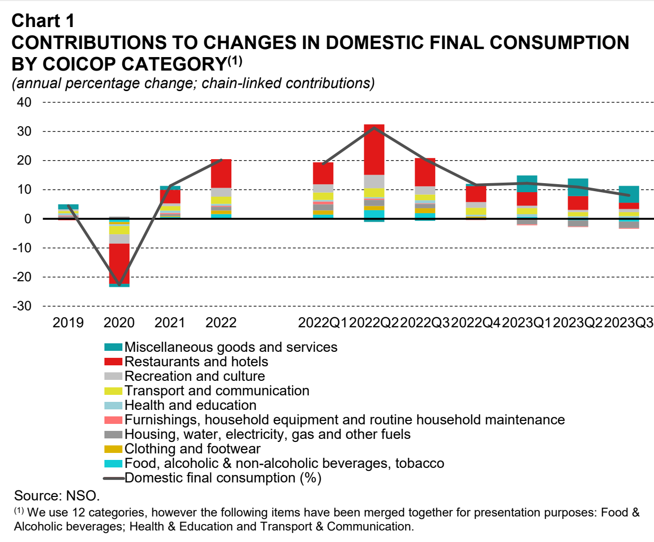


Chart 1
CONTRIBUTIONS TO CHANGES IN DOMESTIC FINAL CONSUMPTION BY COICOP CATEGORY[(1)]
(annual percentage change; chain-linked contributions)

Source: NSO.
[(1)] We use 12 categories, however the following items have been merged together for presentation purposes: Food & Alcoholic beverages; Health & Education and Transport & Communication.

Although most categories of consumption remained

[1] Prepared by Maria Christine Saliba, Senior Economist and Abigail Marie Rapa, Principal Economist within the Economic Projections and Conjunctural Analysis Office.

very resilient during 2023 despite the high inflationary environment, we can observe some declines in certain categories. In particular, spending on housing, water, and electricity contributed negatively to growth in consumption during the first three quarters of 2023, which may reflect relatively high inflation related to services for the maintenance and repair of dwellings. Moreover, consumption of food and non-alcoholic beverages as well as furnishings, household equipment and routine household maintenance also fell, also reflecting relatively high levels of inflation in these categories.

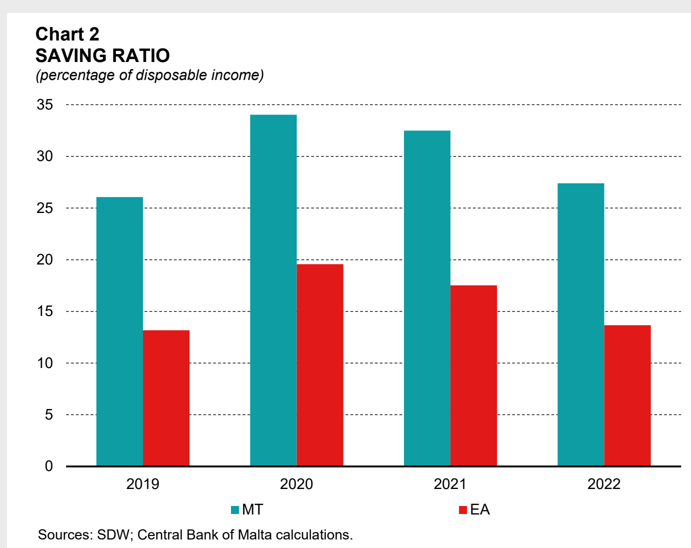
Developments in savings and distribution of pandemic-related excess savings

As outlined in Chart 2 the savings ratio to disposable income in Malta is estimated to have stood at 26.1% in 2019, which was 12.9 percentage points higher than that in the euro area. This difference further increased to 13.7 percentage points in 2022. This, coupled with fixed energy prices, shielded Maltese households, and facilitated consumption smoothing during the recent period of high inflation.

As shown in Borg (2022),[2] the pandemic had brought about an involuntary increase in saving levels due to the containment measures that prohibited certain categories of consumption. Households accumulated excess savings during this period, as they were forced to cut back on spending, while fiscal measures such as the wage supplement scheme supported incomes. Excess savings are hereby estimated as the difference between real savings accumulated in 2020, 2021, and 2022, and a counterfactual scenario whereby the saving ratio is kept equal to that in 2019 for all subsequent years. Between 2020 and 2022, excess savings as a percentage of disposable income are estimated to have amounted to 8.0%, 6.4% and 1.3%, respectively.

As outlined by Battistini and Gareis (2023),[3] understanding the composition of excess savings across different asset classes allows us to identify whether the allocation has been more inclined towards liquid or illiquid assets. When looking at the asset class proportion relative to the pre-pandemic trend, it is evident that between 2020 and 2022, Maltese households invested their excess savings in more

Chart 2
SAVING RATIO
(percentage of disposable income)



Sources: SDW; Central Bank of Malta calculations.

[2] See Borg, I. (2022). "Box 1: Pandemic-related excess savings – how will this affect private consumption in the coming years." in CBM *Outlook for the Maltese Economy* 2022:3.
[3] See Battistini, N., & Gareis J. (2023). "Excess savings: To spend or not to spend". The ECB Blog.

liquid assets. The latter refers to deposits, with the allocation amounting to 6.2%, 4.9% and 1.4% of disposable income, respectively, between 2020 and 2022. On the other hand, the share of illiquid financial assets, such as debt securities and shares, declined across the three years. The liquidity of financial instruments that attracted excess savings suggests that the latter could easily be utilised for consumption during the re-opening period, which might have provided a strong impulse to consumption.

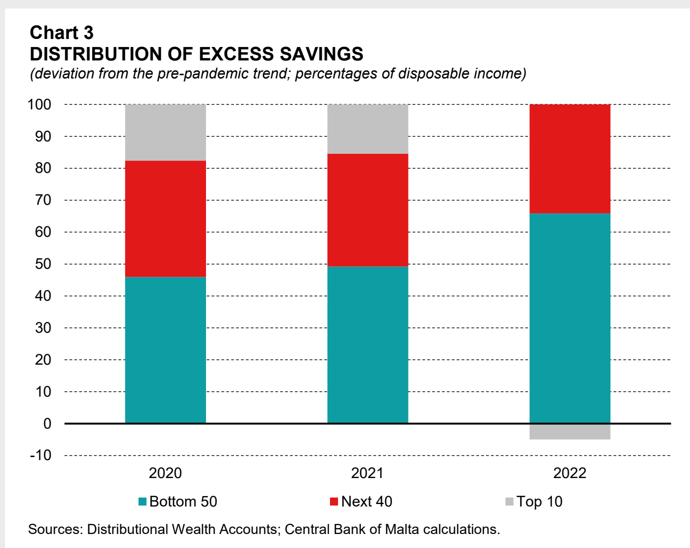
Moreover, as argued in Battistini et al. (2023), the distribution of such excess savings could be very important to understand recent developments in consumption. In particular, distribution towards richer households is likely to lead to lower private consumption growth going forward, as these income groups have a lower marginal propensity to consume.

Using a similar methodology to Battistini et al. (2023), we distribute the excess savings estimated above into three income groups based on their net wealth portfolio. The income groups utilised are the poorest households (Bottom 50) to the richest households (Top 10) based on their net wealth.

Chart 3 draws on data from the experimental Distributional Wealth Accounts (DWA), which contain data on the share of assets in the portfolio of each household group, and Bank estimates of the saving ratio and disposable income. The chart indicates that households in the bottom half of the distribution held most of the excess savings from 2020 to 2022, at 46.0%, 49.2% and 65.9% respectively. This was followed by middle and upper middle-income households. The richest 10% of households held a small share of excess savings with 2022 having a negative share of -5.0%. This reinforces the consumption impulse of these excess savings given that the poorest households generally have a much higher marginal propensity to consume relative to wealthy households.

The savings ratio in Malta is estimated to have decreased below the 2019 levels in 2023, suggesting that these excess savings are being depleted. This is consistent with an indicator for current savings collected in the European Commission's monthly consumer survey (see Chart 4).[4] This indicator gauges households' attitude towards saving, taking

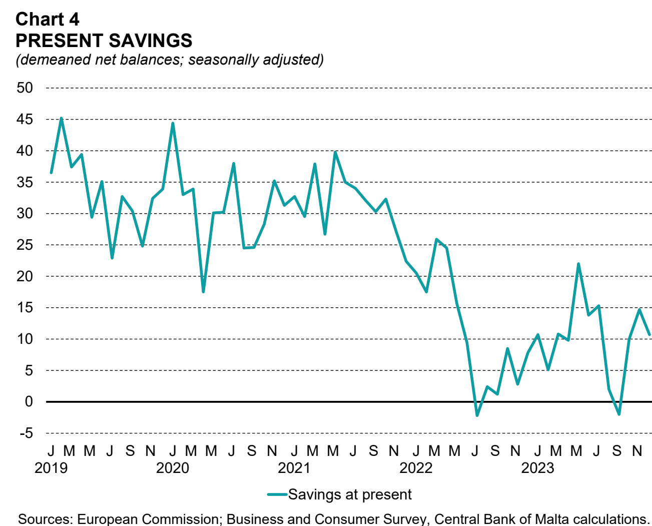
Chart 3
DISTRIBUTION OF EXCESS SAVINGS
(deviation from the pre-pandemic trend; percentages of disposable income)



Sources: Distributional Wealth Accounts; Central Bank of Malta calculations.

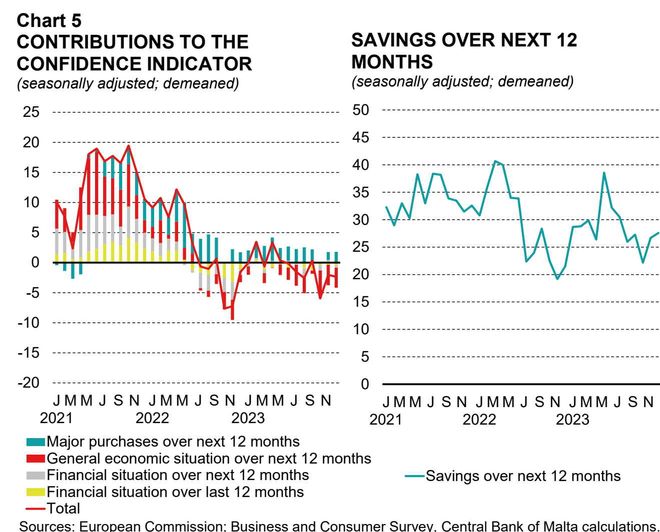
[4] This refers to question 10 in the consumer survey as outlined in the European Commission's Business and Consumer Surveys User Guide.

into account the current economic environment. In December 2023, present savings (demeaned) stood at 10.7, significantly below 2019 levels, which averaged at 33.3. This supports the view that households have been utilising both their savings accumulated during the pandemic as well as their regular savings to smoothen consumption.



Forecast implications

Chart 5 also draws on data collected in the consumer survey, in particular the confidence indicator and its decomposition on the left-hand side and future savings on the right-hand side. The former looks into households' perceptions and expectations on the general economic situation, their financial situation and future consumption. In the last half of 2023, consumer confidence has been declining steadily, standing at -2.4 in December 2023. The main contributor to this decline has been consumer's expectations on the economic environment. On the other hand, expectations on major purchases such as furniture and electronic equipment have remained strong. This suggests that private consumption will remain relatively strong over the forecast horizon, though less so than in 2023. Similarly, the savings expectations indicator,[5] which gauges households' perception on their ability to save in the next 12 months, has been recovering from the sharp declines witnessed in 2022. This suggests that the saving ratio should begin to stabilise.

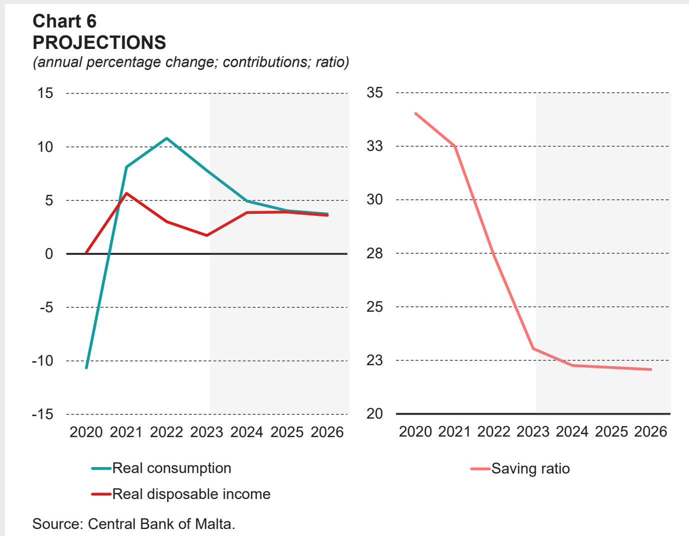


Given these indicators, as well as our assessment that excess savings have already been depleted by 2023, we expect real consumption growth to decline from a high of

[5] This refers to question 11 in the consumer survey as outlined in the European Commission's Business and Consumer Surveys User Guide.

10.8% in 2022 to 3.6% by the end of the forecast horizon (see Chart 6). On the other hand, we expect growth of real disposable income to accelerate marginally in 2024 and stabilise at around 3.8% between 2024 and 2026. As a result, the saving ratio is projected to stabilise at around 22.1% which is close to the average of the last ten years.

Chart 6
PROJECTIONS
(annual percentage change; contributions; ratio)



Source: Central Bank of Malta.

Labour market

Employment growth is set to decline to 3.2% in 2024 from 5.8% in 2023, before moderating gradually to 2.4% by 2026, as GDP growth eases.

The unemployment rate is forecast to stand at 2.6% in 2024 before edging up slightly to 2.7% and 2.9% in 2025 and 2026, respectively. The unemployment gap is forecast to remain slightly negative until the end of the projection horizon, as the NAIRU is projected at around 3.1% in 2026.

In view of high inflation in the recent past and lagged response of wages to past inflation, as well as tight labour market conditions, growth in compensation per employee is projected to accelerate to 5.3% in 2024 before edging down to 4.0% in 2025, and 3.2% in 2026. Real average wages are expected to recover to pre-pandemic levels by 2025.

A persistently negative employment gap implies that labour market tightness will be a key factor driving the wage outlook. However, as tightness dissipates over time, this should dampen upward pressure on wages by 2025 and 2026.

Prices

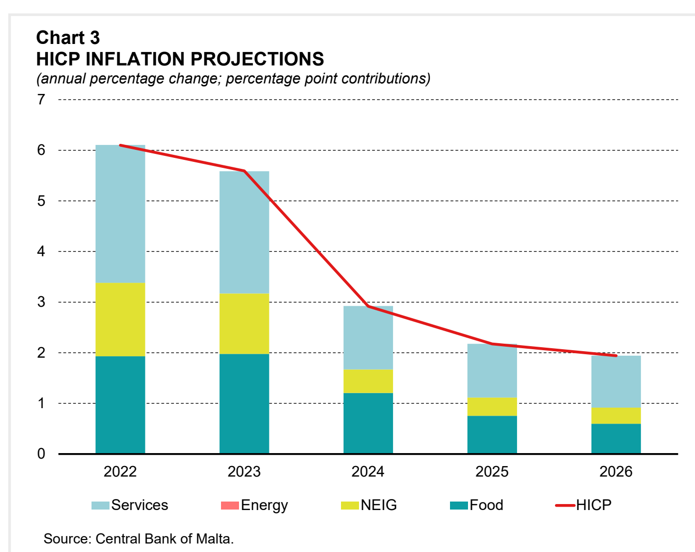
HICP inflation moderated to 5.6% in 2023, from 6.1% in 2022. It is expected to ease further in the coming years, reflecting a decline in food, services, and non-energy industrial goods (NEIG) inflation, as pipeline pressures are assumed to continue to ease (see Chart 3). Consequently, overall HICP inflation is projected to grow by 2.9% in 2024, 2.2% in 2025 and 1.9% in 2026. Meanwhile, HICP inflation excluding energy and food, is projected to stand at 2.4%, 2.0% and 1.9% over the forecast horizon.

Compared to the Bank's previous forecast publication, overall HICP inflation was revised downwards by 0.1 percentage point throughout the forecast period, mainly driven by lower core inflation, which offset an upward revision to food inflation.

NEIG inflation is expected to fall from 4.4% in 2023, to 1.7% in 2024. This reflects disappearing international supply-chain disruptions, which are reflected in a moderation in imported inflation. Consequently, NEIG inflation is expected to ease over the rest of the projection horizon, standing at 1.2% in 2026.

Services inflation is expected to ease from 5.1% in 2023, to 2.8% in 2024, and to 2.4% and 2.3% in 2025 and 2026, respectively. It has been revised downwards as incoming data show that this component is normalising more strongly than assumed, possibly reflecting the indirect effects from the slowdown in other

Chart 3
HICP INFLATION PROJECTIONS
(annual percentage change; percentage point contributions)



Source: Central Bank of Malta.

inflation components, as well as profit margins in certain sectors absorbing wage and other cost increases.

On the other hand, food inflation has been revised upwards, as a result of higher-than-expected outcomes in recent months. Processed food prices are projected to increase by 5.2% in 2024, from 9.6% in 2023, while unprocessed food inflation is set to reach 6.8% from 8.5% in the previous year. Overall food inflation is set to moderate gradually to 5.6% in 2024, 3.5% in 2025, and 2.8% in 2026, in line with expected developments in international commodity prices. The moderation in food inflation can be larger than projected following the Government's agreement with private operators to curb prices of selected food products, which came into force on 1 February. However, as at the cut-off date, there is insufficient information to quantify such impact.

Energy prices are projected to remain at current levels throughout the forecast horizon, reflecting the Government's commitment to keep these prices stable.

Public finance

The general government deficit-to-GDP ratio is set to decline to 4.5% in 2023, and to narrow further over the rest of the forecast horizon. By 2026, the deficit is forecast to reach 3.1% of GDP (see Table 2). This improvement is driven by a declining share of expenditure in GDP, mainly due to the profile of inflation-mitigation measures.

Compared with the Bank's earlier projections, the projected deficit is now 0.1 percentage points lower in each year of the projection horizon. This mainly reflects revised macro projections and their impact on tax revenue.

The share of current revenue in GDP is expected to remain broadly constant throughout the forecast horizon. Tax revenue as a share in GDP is set to increase slightly, driven by the profile of taxes on income and wealth. Taxes on production and imports and social contributions are expected to decline marginally as a share of GDP over time. Non-tax current revenue is also set to increase by less than nominal GDP.

The share of capital revenue in GDP is set to peak in 2023, decline in 2024, and to increase again in the outer years of the forecast horizon. This is due to the expected profile of EU grants, which part-finance capital expenditure.

The share of current expenditure in GDP is forecast to decline throughout the forecast horizon, mainly due to projected lower subsidies. This reflects the profile of spending on inflation-mitigation measures, which is set to decrease in line with forecast energy prices. It also reflects the end of restructuring assistance to Air Malta in 2023. Growth in compensation of employees is set to remain in line with nominal GDP throughout the forecast horizon. Meanwhile, the share of intermediate consumption and social benefits in GDP is expected to decline by 2026. The share of other current expenditure is first set to decline in 2023, due to a one-time refund from the EU. Its share in GDP is, however, set to increase over time, partly driven by the profile of interest payments.

The share of capital expenditure in GDP is projected to peak in 2023, before declining in 2024, and to remain constant thereafter. While remaining elevated in level terms from a historical perspective, the share of domestically funded investment in GDP is set to decline over the projection

Table 2
PROJECTIONS FOR MAIN FISCAL ITEMS (% of GDP)
(per cent of GDP)

	2022[1]	2023	2024	2025	2026
Headline aggregates					
Total Revenue	33.7	33.5	32.9	33.0	33.2
Total Expenditure	39.3	38.0	36.9	36.5	36.3
General Government Balance	-5.6	-4.5	-4.0	-3.5	-3.1
of which: Primary Balance	-4.7	-3.4	-2.7	-2.2	-1.7
General Government Debt	51.6	50.7	52.7	53.5	54.3
Detailed breakdown					
Current revenue	32.6	32.1	32.0	32.0	32.0
Current taxes on income and wealth	12.9	12.5	12.6	12.7	12.8
Taxes on production and imports	10.3	10.4	10.4	10.3	10.3
Social contributions	5.7	5.5	5.5	5.4	5.4
Other current revenue[2]	3.8	3.7	3.6	3.5	3.5
Current expenditure	35.2	33.4	32.9	32.5	32.3
Compensation of employees	10.5	10.1	10.0	10.1	10.1
Social benefits	8.5	8.2	8.4	8.2	8.0
Intermediate consumption	7.7	7.7	7.7	7.6	7.6
Interest payments	0.9	1.2	1.3	1.3	1.4
Subsidies	4.8	3.8	2.9	2.6	2.4
Other current expenditure[3]	2.7	2.5	2.6	2.7	2.7
Gross savings	-2.6	-1.3	-0.9	-0.5	-0.3
Capital revenue	1.1	1.3	0.9	1.0	1.2
Capital taxes	0.2	0.2	0.2	0.2	0.2
Other capital revenue[4]	0.9	1.1	0.7	0.8	1.0
Capital expenditure	4.2	4.5	4.0	4.0	4.0
Gross fixed capital formation	3.4	3.4	3.2	3.2	3.1
Capital transfers	0.8	1.2	0.9	0.8	0.9
Other capital expenditure[5]	0.0	0.0	0.0	0.0	0.0
Capital revenue net of capital expenditure	-3.1	-3.2	-3.1	-3.0	-2.9
Underlying budgetary outcome					
Cyclical component	0.7	0.7	0.6	0.4	0.3
Temporary Government measures	0.0	0.3	0.0	0.0	0.0
Structural balance	-6.4	-5.5	-4.6	-3.9	-3.4

Sources: NSO; Central Bank of Malta.

[1] Actual data as per NSO *News Releases* 006/2024 (published on 12 January 2024) and 214/2023 (published on 28 November 2023).

[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.

horizon. Meanwhile, the share of EU funded investment in GDP – which constitutes a smaller component – is set to decline in 2024, following the completion of projects financed by the 2014-2020 EU financing framework in 2023. This, however, is set to be partly offset by a pick-up in spending

on projects financed through the RRF. Capital transfers are set to follow a similar profile as investment.

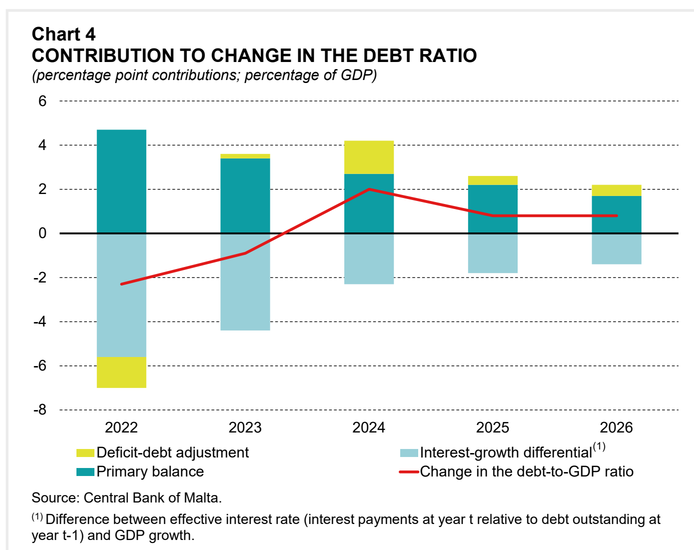


Chart 4
CONTRIBUTION TO CHANGE IN THE DEBT RATIO
(percentage point contributions; percentage of GDP)

Source: Central Bank of Malta.
(1) Difference between effective interest rate (interest payments at year t relative to debt outstanding at year t-1) and GDP growth.

The structural deficit is projected to narrow over the projection horizon, reaching 3.4% of GDP by 2026.[3] This profile is driven by the above-mentioned inflation support measures, which are not treated as temporary outlays, and thus affect the structural position.

The general government debt ratio is set to increase throughout the forecast horizon, reaching 54.3% by 2026. This is driven by the continuation of primary deficits (see Chart 4). Deficit-debt adjustments are set to exert a debt-increasing impact. This is particularly the case in 2024, due to the impact of an equity acquisition into a new airline following the closure of Air Malta. These factors offset the debt-decreasing impact of the interest growth differential.

[3] The structural balance is defined as the cyclically-adjusted balance, net of temporary government measures.

BOX 2: THE COMPOSITION OF SOCIAL BENEFITS[1]

Government expenditure on social benefits can take the form of cash payments and payments in kind. Benefits in cash make up the vast majority of social benefit payments in Malta. These include contributory and non-contributory benefits, such as pensions, unemployment benefits, child allowances, and the in-work benefit. Expenditure on benefits in kind mostly reflects the provision of goods such as medicine, and services such as childcare, school transport and public transport.

Until 2013, social benefits made up around 30% of government expenditure and averaged just over 12.0% of GDP. However, in subsequent years outlays on benefits increased at a slower pace than other government expenditure items and when compared with growth in economic activity. Consequently, by 2022 social benefits made up 21.7% of government expenditure and amounted to 8.5% of GDP. This reflects efforts to boost labour market participation, which include a gradual increase in the statutory retirement age, incentives to those remaining in employment past retirement age, and the tapering of benefits scheme. At the same time, buoyant economic activity and tight labour market conditions contributed to lower spending on unemployment assistance.

Due to these developments, the composition of social benefits changed over time (see Chart 1). The share of outlays on unemployment assistance and cash benefits excluding pensions, declined from around 25% of total benefit spending before 2013 to around 18% by 2022. On the other hand, spending on pensions rose from around 70% of total benefit spending to just over 71% by 2022. This is partly due to a series of increases in pensions, given out every year since 2016. In the same period, the share of outlays on benefits in kind more than doubled from around 4.5% to just below 11%. This reflects the extension of free school transport and the provision of free public transport to holders of the Tallinja Card.

The Bank projects outlays on social benefits to grow at a declining rate in the coming years. Consequently, the share of benefits in GDP is expected to decline from 8.5% in 2022 to 8.0% in 2026 (see Chart 2). This is partly due to the methodology with which the Bank compiles the fiscal forecasts. Any government measures which are not specified in detail and have not yet been approved by Parliament

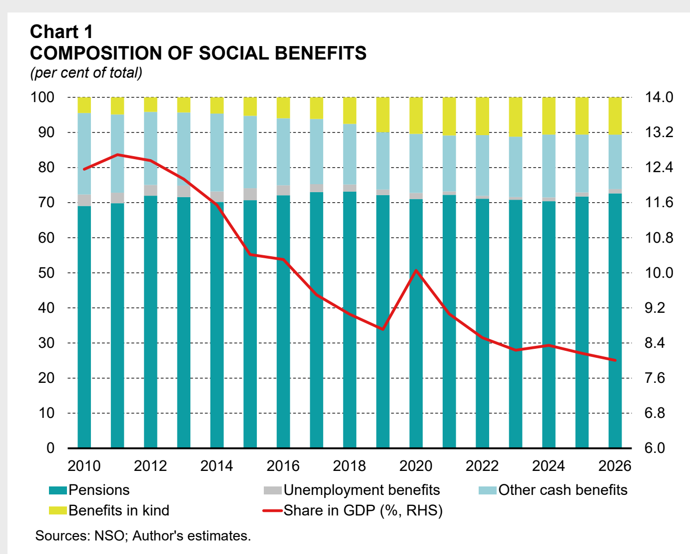


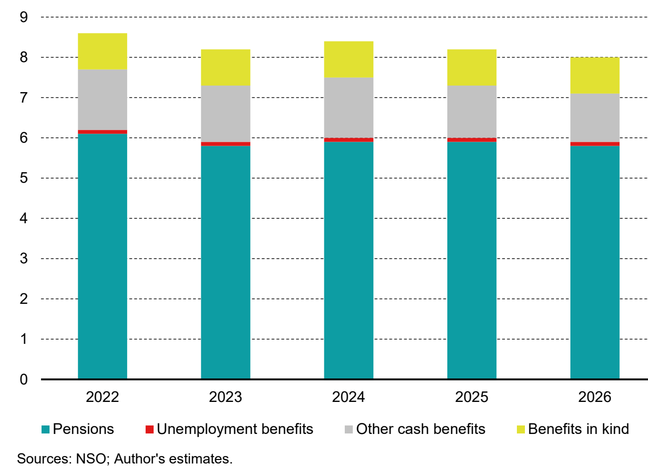
Chart 1
COMPOSITION OF SOCIAL BENEFITS
(per cent of total)

Sources: NSO; Author's estimates.

[1] Prepared by John Farrugia, Manager Fiscal Affairs and Reports Office and Kurt Sant, Senior Economist within the same office.

are not included in the projections. These forecasts thus do not account for the likelihood of additional increases in social benefits, beyond what was announced in the 2024 Budget.

As a result, cash benefits excluding pensions and unemployment benefits, are set to amount to around 1.2% of GDP in 2026, down from 1.5% in 2022.



Pension expenditure is however set to broadly amount to just below 6% of GDP throughout the projection horizon. Forecasts for this benefit type are partly based on the expected profile of beneficiaries, which in turn is based on population projections. Beneficiaries are set to grow at a broadly constant rate in the coming years, except in 2026 when growth is set to be slower. This is due to the coming into force of the final mandated increase in the retirement age, to 65 years.

In the absence of additional known measures beyond the 2024 Budget, growth in average pensions is set to decline in the outer years of the forecast horizon. Their forecast profile is mostly determined by the index used to compute the increase in pensions included in the law, which is based on the national average wage and the rate of inflation.[2]

Outlays on unemployment benefits and benefits in kind are set to grow in line with GDP. They are thus set to retain a stable ratio in GDP, amounting to around 0.1% and 0.9%, respectively.

[2] According to law, 70% of the annual rate of increase of two-thirds pensions (the largest form of pension) is determined by the previous year's increase in national average wages. The remaining 30% is based on the previous year's rate of inflation. In the 2024 Budget, it was announced that this formula will be applied to all beneficiaries of the two-thirds pensions, and not just to those born after 1961 as was the case previously.

Risks

Risks to activity are tilted to the downside in 2024. In part this reflects the ongoing geopolitical tensions, which could weigh on trade. In particular, disruptions to shipping around the Suez Canal, could give rise to some supply bottlenecks or longer waiting times, apart from higher costs. Besides, the Bank's latest Business Dialogue and European Commission surveys seem to signal less optimism with respect to hiring intentions, even though businesses still lament skill shortages. This may reflect wage pressures. Risks are more balanced in the following years.

Risks to inflation are balanced over the projection horizon. Upside risks to inflation could stem from extreme weather events and effects of geopolitical developments (such as disruptions arising from the Red Sea conflict). Other upside risks to headline inflation include the potential impact of measures to combat climate change, which can spillover to the medium-term. Furthermore, wage pressures could be stronger than envisaged in the baseline, which could slow the envisaged decline in inflation. On the other hand, food prices may rise less sharply than expected following the Government's initiative to curb imported food inflation, following negotiations with importers and retailers. Meanwhile, inflation in key trading partners has also surprised on the downside in recent months, which could be reflected in a firmer reduction in pipeline pressures in the near term. In addition, a stronger pass-through from monetary tightening to domestic financial and real economic conditions could ease inflationary pressures in the medium-term.

On the fiscal side, risks are tilted to the downside from 2024 (deficit-increasing). These mainly reflect the likelihood of higher-than-expected outlays on energy support measures, in the event that commodity prices are higher than envisaged. They also reflect the likelihood of additional increases in pensions and public sector wages. These risks are partly offset by the likelihood of a pick-up in the pace of fiscal consolidation in the outer years of the forecast horizon to comply with the EU's fiscal rules.