BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

CENTRAL BANK OF MALTA
OUTLOOK FOR THE MALTESE ECONOMY

2024:2

© **Central Bank of Malta, 2024**

Address
Pjazza Kastilja
Valletta VLT 1060
Malta

Telephone
(+356) 2550 0000

Fax
(+356) 2550 2500

Website
www.centralbankmalta.org

Contact
https://www.centralbankmalta.org/contact-us

All rights reserved. Reproduction is permitted provided that the source is acknowledged.

The cut-off date for information in this publication is 22 May 2024. Figures in tables may not add up due to rounding.

ISSN 2789-2190 (online)

OUTLOOK FOR THE MALTESE ECONOMY 2024-2026

Overview[1,2]

Incoming information suggests that economic activity in Malta remained rather resilient during the first quarter of this year, due to strong domestic demand. On the other hand, export activity reflects the still persistently weak international environment. While services exports continue to be supported by buoyant activity in both tourism and non-tourism sectors, goods exports are envisaged to decelerate further this year before picking up in 2025 (see Box 1).

Economic growth is expected to moderate from the very high growth experienced in the last three years, which partly reflected the economy's recovery from the pandemic. Real GDP (gross domestic product) growth is envisaged to broadly converge to potential output growth by the end of the projection horizon.

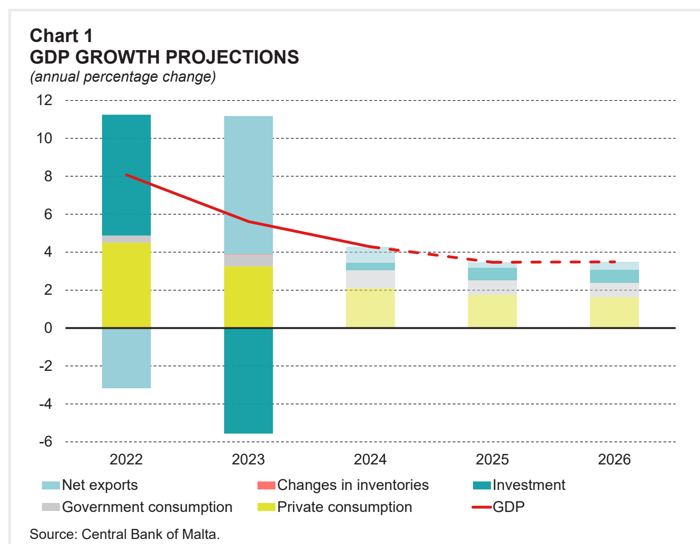
At the same time, the disinflationary process has gathered pace, with inflation expected to ease further over the projection horizon. The moderation in inflation is set to lead to a recovery in real disposable income this year, supporting private consumption.

Economic outlook

According to the Bank's latest forecasts, Malta's real GDP growth is expected to moderate from 5.6% in 2023 to 4.3% in 2024 and 3.5% in both 2025 and 2026 (see Table 1). Compared to the Bank's previous projections, GDP growth is being revised marginally down by 0.1 percentage point in 2024 and 2025, and up by 0.2 percentage point in 2026. The small GDP revision in 2024 is driven by a downward revision in private consumption and an upward revision in imports, outweighing an upward revision in exports. GDP growth for 2025 was also revised marginally downwards following revisions to investment while growth for 2026 was revised marginally upwards driven by consumption and investment by government.

Net exports were the main contributor to GDP growth in 2023, as domestic demand contributed negatively due to a negative base effect related to extraordinary outlays on aircraft in 2022 (see Chart 1). From 2024, domestic demand is expected to be the main driver of growth, as private consumption continues to grow at a brisk pace, and private investment begins to recover. Net exports are also projected to retain a positive contribution over the forecast horizon, driven mainly by services exports. However, their contribution is set to be much smaller than that estimated for 2023, and also more limited compared to that of domestic demand.

Chart 1
GDP GROWTH PROJECTIONS
(annual percentage change)



Source: Central Bank of Malta.

[1] The Bank's projections for the Maltese economy are based on information available up to 22 May 2024. The GDP release for the first quarter of 2024, published on 29 May, has not been taken into account. Technical assumptions were transmitted by the European Central Bank (ECB).

[2] See Central Bank of Malta Outlook for the Maltese Economy 2024:1.

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

	2023[2]	2024	2025	2026
Real economic activity (% change)				
GDP	5.6	4.3	3.5	3.5
Private consumption expenditure	7.7	4.9	4.0	3.7
Government consumption expenditure	3.3	5.4	4.3	4.3
Gross fixed capital formation	-22.2	2.0	3.5	3.7
Exports of goods and services	8.7	4.3	3.0	3.0
Imports of goods and services	4.6	4.3	3.2	3.2
Contribution to real GDP growth (in percentage pts)				
Final domestic demand	-1.7	3.4	3.2	3.1
Net exports	7.3	0.9	0.3	0.4
Changes in inventories	0.0	0.0	0.0	0.0
Balance of payments (% of GDP)				
Goods and services balance	16.1	16.4	16.3	16.2
Current account balance	0.9	1.1	1.1	1.0
Labour market (% change)[3]				
Total employment	6.5	3.7	2.6	2.4
Unemployment rate (% of labour supply)	3.1	3.1	3.1	3.1
Real disposable income[4]	-0.9	5.0	3.7	3.8
Household saving ratio[4]	20.7	20.8	20.6	20.6
Prices and costs (% change)				
GDP deflator	5.3	2.8	2.4	2.2
RPI	5.1	2.2	1.8	1.7
Overall HICP	5.6	2.4	2.0	1.9
HICP excluding energy	5.9	2.6	2.1	2.0
Compensation per employee	1.5	5.1	3.9	3.2
ULC	2.4	4.5	3.0	2.1
Business cycle				
Potential output (% change)	7.7	5.1	4.1	3.5
Output gap (% of GDP)	1.6	0.8	0.2	0.2
Technical assumptions				
EUR/USD exchange rate	1.08	1.08	1.08	1.08
Oil price (USD per barrel)	83.7	83.8	78.0	74.5

Sources: NSO; Central Bank of Malta.

[1] Data on GDP were sourced from NSO *News Release 039*/2024 published on 28 February 2024, while RPI and HICP data were sourced, respectively, from NSO *News Releases* 072/2024 and 091/2024 (published on 23 April 2024 and 17 May 2024).

[2] Actual data. National accounts data is consistent with NSO *News Release* 039/2024 published on 28 February 2024.

[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.

Looking at the components of GDP in more detail, private consumption growth is set to moderate from 7.7% in 2023 to 4.9% in 2024. This reflects the continued normalisation of consumer demand following strong growth in the last three years. Private consumption growth is set to slow down

further in the following years. After the strong decline in the household savings ratio in 2023 to below 21%, this is envisaged to remain stable at just above 20% throughout the forecast horizon.

Government consumption is set to rise by 5.4% in 2024, before moderating to 4.3% in the outer years. This is partly driven by a moderation in growth in intermediate consumption, which reflects the profile of spending on contractual services. At the same time, revenue from sales (which is netted out of government consumption expenditure) is forecast to grow at a slower pace.

Overall investment in 2024 is expected to turn positive, growing by 2.0% after the sharp decline in 2023, reflecting a base effect in the aviation sector. Growth in investment is forecast to pick up gradually to 3.5% in 2025, and 3.7% in 2026. Residential construction is set to decline by 1.5% in 2024, after a period of rapid growth. It is then projected to increase by 0.4% on average in the outer years, as incoming permit data signals moderating activity in the sector, while labour shortages are expected to remain binding. Following declines in the last four years, non-dwelling private investment is expected to be broadly unchanged in 2024. It is then expected to grow at below historical rates in the following two years, as the ongoing weakness in the non-residential construction sector is expected to persist.

Government investment is estimated to decline by 1.2% in 2024. It is then set to rise by 4.3% in 2025, and by 5.9% in 2026. This profile partly reflects that of domestically funded investment, which is set to increase slightly in level terms but to decline as a share of GDP in 2024. EU-funded investment is meanwhile set to be driven by higher take up of Recovery and Resilience Facility (RRF) grants in 2024, and increased take up of funds from the 2021-2027 framework in 2025 and 2026.

Export growth is expected to decelarate somewhat, from 8.7% in 2023 to 4.3% in 2024. It is set to slow further to 3.0% in 2025, and stabilise at that rate in 2026. Growth in tourism exports is expected to slow down as the sector has more than fully recovered its pre-pandemic levels. Nevertheless, growth is still expected to remain strong, reflecting expanded flight capacity and improved seasonal distribution. Growth in non-tourism services exports is projected to be below that experienced in the last ten years, as certain high-growth industries appear to be maturing. With regard to goods exports, weak international demand is expected to hamper growth this year, but they are projected to pickup in the following two years, as growth in foreign demand is set to improve (see Box 1).

In 2024, imports are projected to grow by 4.3%, with growth easing to 3.2% in the following two years.

In view of the expected developments in external trade, the current account in the Balance of Payments is expected to show a surplus of 1.1% this year, which represents a slight improvement over the surplus of 0.9% in 2023, underpinned by a marginal improvement in the trade balance. It is expected to continue to record a surplus of around 1.0% in both 2025 and 2026.

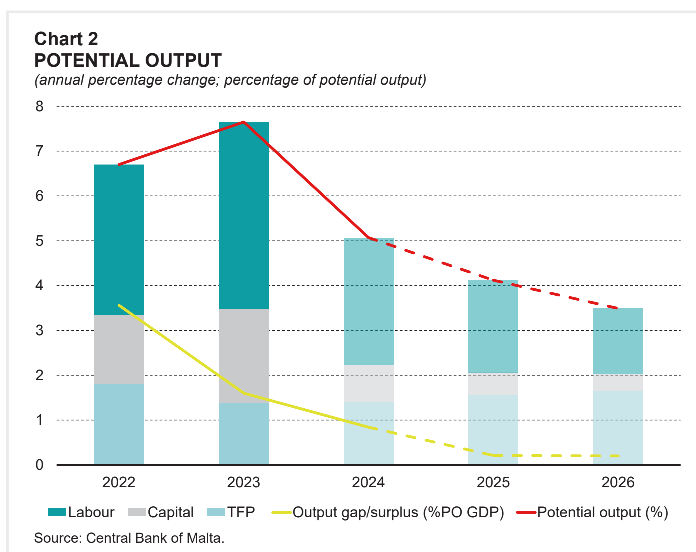
Potential output

Potential output growth is expected to moderate throughout the projection horizon, from 7.7% in 2023 to 5.1% in 2024, 4.1% in 2025, and 3.5% in 2026. This mostly reflects decreasing contributions

from both capital and labour. The contribution of capital decreases due 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 operate above potential throughout the projection horizon, though the positive output gap is set to shrink to 0.2% by 2026 (see Chart 2).

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



Source: Central Bank of Malta.

BOX 1: RECENT PERFORMANCE OF GOODS EXPORTS[1]

According to the 2023Q4 national accounts vintage used in this projections exercise, growth in real exports remained very strong despite the weakness in international demand. Indeed, exports rose by 8.7%, after growing by 8.6% in 2022.[2] However, this growth masks contrasting developments in goods and services exports with the latter significantly outperforming the former.

This box focuses on the performance of goods exports in terms of the evolution of market share as well as in terms of price competitiveness. It also delves into the recent drivers of growth in goods exports using an adjusted measure of nominal customs data (which excludes certain trade chapters).[3] The projections for real exports of goods and the outlook for the market share and price competitiveness are outlined in the last section.

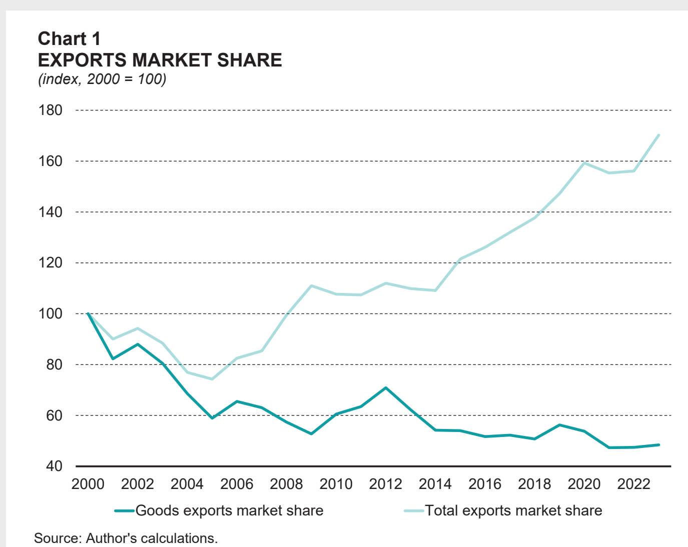
Export competitiveness indicators

Export competitiveness is evaluated in terms of the market share, computed as the ratio of real goods exports (national accounts concept) to global demand, and the Harmonised Competitiveness Indicator (HCI) for Malta as a measure of price competitiveness.

The market share of Maltese goods exports in real terms declined until 2009 (see Chart 1). It then improved slightly up to 2012, as growth in real goods exports outpaced foreign demand. However, it deteriorated again thereafter.

Despite the loss in market share for goods, overall export market share has been trending upwards since 2005. This implies that since joining the EU in 2004, exports generally outpaced foreign demand, partly due to better access to European and international markets, and the emergence of new sectors. The rise in overall market share is largely due to the strong growth in exports of services, which mirrored the rapid expansion of industries, such as gaming and financial and other professional services. The fall in the market share during the pandemic years was due to a slowdown

Chart 1
EXPORTS MARKET SHARE
(index, 2000 = 100)



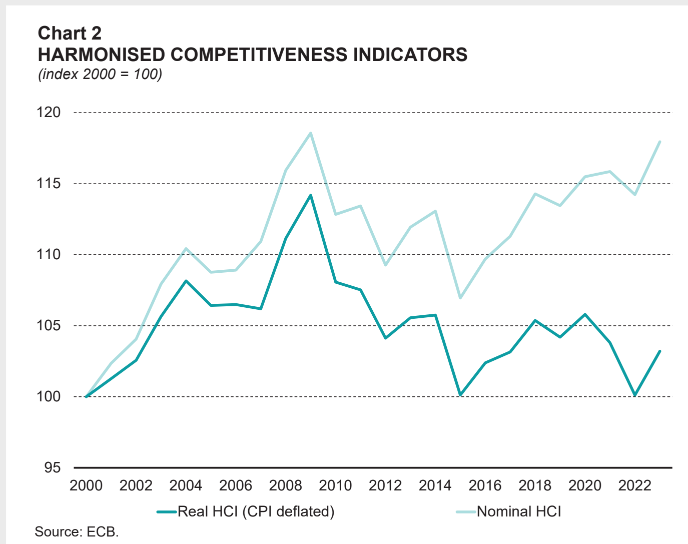
Source: Author's calculations.

[1] Prepared by Lynn Cumbo, Economist within the Economic Projections and Conjunctural Analysis Office.

[2] According to the 2024Q1 national accounts vintage, real export growth in 2022 and 2023 stood at 8.8% and 8.7%, respectively.

[3] The following trade chapters are excluded, which follows the same definition applied in NSO *News Releases*: mineral fuels, oils and products (Chapter 27), aircrafts and spacecrafts and parts thereof (Chapter 88) and ships, boats and floating structures (Chapter 89).

in goods exports and a sharper decline in tourism. However, market shares recovered in 2023, due to the exceptional improvement in the performance of services exports, as the market share of goods exports remained subdued.



The HCI is an indicator of price competitiveness which depicts an improvement (deterioration) when it decreases (increases).[4] In Chart 2, both the nominal and real HCI measures demonstrate worsening price competitiveness of Maltese exports up to 2009. Thereafter, the two indices have diverged from each other, such that by 2023, the real HCI was only marginally above its 2000 level while the nominal HCI stood firmly above its starting level. This indicates that while exchange rate developments contributed to some loss in competitiveness, this was mostly offset by an improvement in relative prices. This gap was particularly pronounced during the last three years, which may partly reflect the Maltese government's policy of maintaining stable energy prices during the latest energy shock, which helped contain production costs relative to Malta's main trading partners. Additionally, the generally small size of Maltese exporting firms may have limited their ability to fully pass on cost increases to their foreign customers. The deflated HCI measure increased in 2023, implying some loss in price competitiveness of exports, but it remains below the levels seen prior to the pandemic.

Recent developments in goods exports[5]

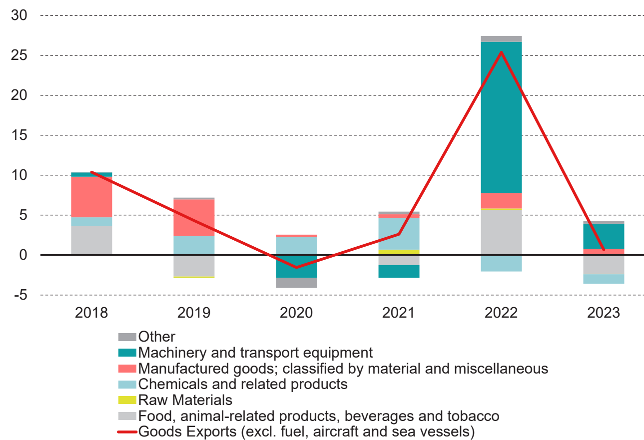
The analysis in this section draws on nominal customs data, which provides the most detailed data on goods exports. Moreover, we focus our analysis primarily on a measure that excludes certain volatile components that may have very little bearing on underlying economic conditions, thereby obtaining a measure of exports that is closer to that in the national accounts. Nevertheless, this measure may still differ slightly from that in national accounts due to differences in methodology and cut-off dates.

Chart 3 shows the contributions of different categories of goods to growth in goods exports, using the Standard International Trade Classification. Growth in goods exports in 2018 and 2019 was relatively strong, and was primarily driven by exports of manufactured goods, as well as chemical products. Goods exports declined during the pandemic in 2020, due to a sharp contraction in foreign demand in view of international trade disruptions. The decline

[4] The HCI acts as measure of the effective exchange rate for countries operating within the euro area. The nominal HCI tracks movements in the euro exchange rate against the currencies of Malta's main trading partners, weighted according to the direction of trade in manufactured goods. The real HCI also takes into account the relative inflation rate of Malta vis-à-vis its main trading partners.

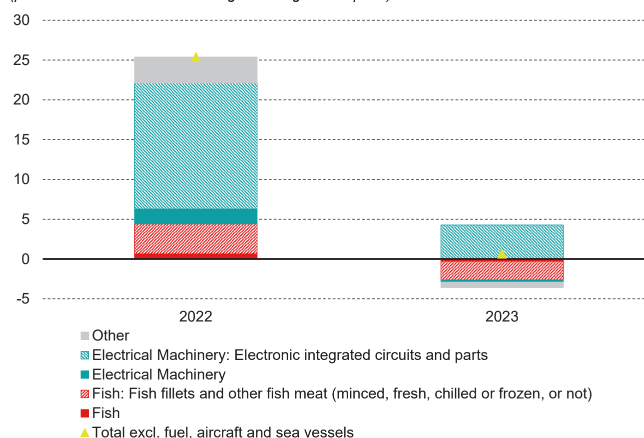
[5] This section draws on the March 2024 customs data vintage.

was mainly driven by a drop in exports of machinery and transport equipment. Meanwhile, exports of chemical and related products rose markedly during the pandemic years in 2020 and 2021, mainly due to strong demand for pharmaceutical products, which includes Personal Protective Equipment (PPE).



Goods exports grew very strongly in 2022, which partly mirrored the pandemic-related recovery in international demand but was also driven by certain specific developments. Indeed, the largest contributors to growth were the machinery and transport equipment sector, as well as the food and beverage category, which together contributed to almost 97% of the total 25.4% growth. Meanwhile, the weak growth of just 0.7% in 2023 reflected a sharp slowdown in the same categories of goods.

Detailed data in Chart 4 show that the strong growth in 2022 was primarily driven by a sharp increase in electrical machinery, classified within the broad category of machinery and transport equipment. In turn, the largest contribution within this category arose from an exceptional increase in exports of electronic integrated circuits and parts (microchips), which accounted for 15.8 percentage points of growth in nominal goods exports. The strong growth in this subcategory is likely related to stronger demand after a semiconductor shortage during the pandemic. As demand rose in the pandemic years, businesses stockpiled components in 2022 so as to prevent backlogs on their orders.[6]



[6] See Chip shortage: how the semiconductor industry is dealing with this worldwide problem | World Economic Forum (weforum.org) and Chip industry slowdown will last longer than expected, manufacturers warn (ft.com).

Given that the semiconductor industry in Malta is relatively large, this sharp rise in international demand for microchips brought about a strong increase in exports within this subcategory. Following this exceptional increase, growth decelerated sharply in 2023, as global microchip inventories had reached sufficient levels, but remained positive. Indeed, its contribution stood at 4.3 percentage points in 2023.

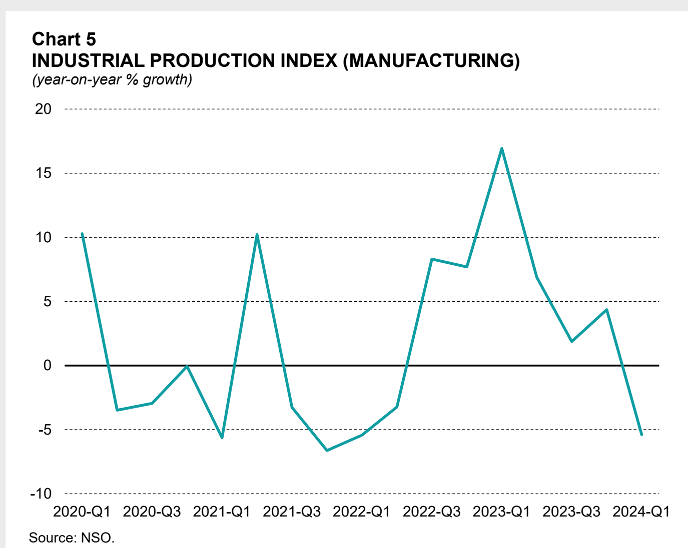
Moreover, fish exports rose by 60.0% in 2022, contributing 4.4 percentage points to total growth in goods exports. The strong increase in 2022 was driven by a sharp rise in exports of fillets of fish and other fish due to high demand for Maltese bluefin tuna in Asian markets.[7] Growth in exports of this subcategory turned negative in 2023, with this component lowering goods exports by 2.3 percentage points.

Smaller positive contributions to export growth in 2022 were also made by machinery and mechanical appliances, and other preparations of food and beverages (part of the "other" component in Chart 4). In 2023, some goods other than electrical machinery, such as printed material and rubber, also provided positive contributions but to a lesser extent. However, these were outweighed by larger negative contributions, mainly from exports of organic chemicals and toys (also part of the "other" component in Chart 4). As a result, the total contribution from other goods continued to lower growth by 0.7% percentage point in 2023.

Outlook for goods exports

Incoming data on industrial production in the manufacturing sector show that goods exports are likely to remain weak this year. Indeed, Chart 5 shows a year-on-year drop in industrial production of the manufacturing sector in the first quarter of this year. Since a significant part of the goods produced by the manufacturing sector in Malta is exported, the index can be utilised as an indicator of short-term developments in exports of goods.

Thus, growth in real exports of goods is expected to remain relatively subdued in the short term. We expect the weakness in goods exports to subside gradually this year, due to the positive developments in foreign demand. Moreover, we expect some loss in price competitiveness in 2024, following the significant improvements in recent years. Hence, growth in real goods exports is expected to decelerate from 1.7% in 2023 to 1.1% in 2024. Merchandise exports

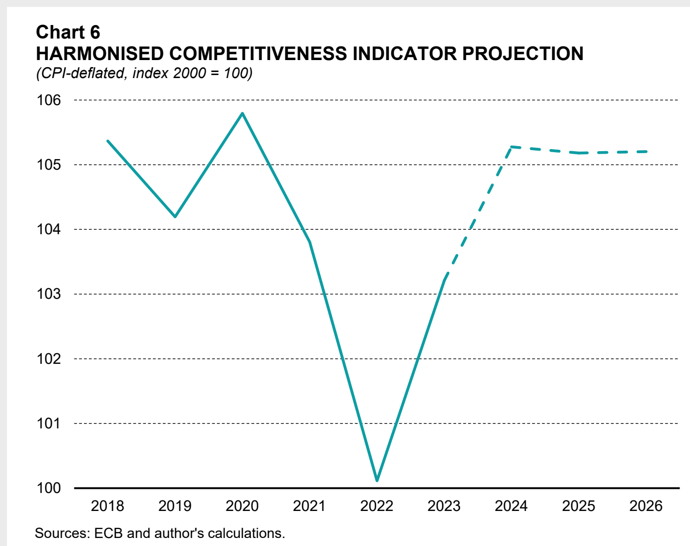


[7] See 40% increase in fish exports, but 'fresh challenges ahead' (businesstoday.com.mt).

are projected to pick up and grow by 2.5% and 2.6% in the following two years, as foreign demand increases further while the price competitiveness indicator broadly levels off.

The deterioration in price competitiveness reflects muted developments in competitors' prices, as energy prices for Malta's competitors are envisaged to decline following the sharp increases seen in the past years. Conversely, energy prices in Malta are expected to remain stable at the current levels. Despite such expected loss, over the next three years, price competitiveness is still expected to remain above the levels observed in 2022, as energy prices in Malta are expected to remain below those in competitor countries (see Chart 6).

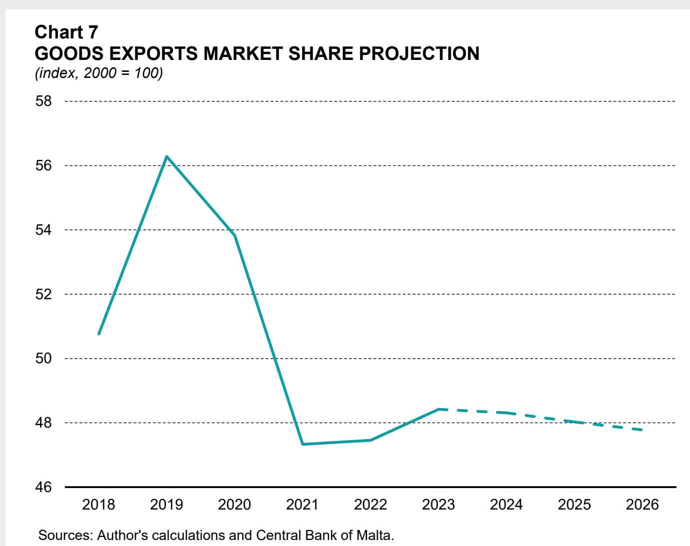
Chart 6
HARMONISED COMPETITIVENESS INDICATOR PROJECTION
(CPI-deflated, index 2000 = 100)



Sources: ECB and author's calculations.

These projections also imply a further loss in the market share of goods exports, extending the trend observed over the past years, and reverses some of the improvement observed in 2022 and 2023, which partly reflected transient factors (see Chart 7).

Chart 7
GOODS EXPORTS MARKET SHARE PROJECTION
(index, 2000 = 100)



Sources: Author's calculations and Central Bank of Malta.

Labour market

The labour market remains strong and demand for labour is envisaged to be high. However, demand is expected to moderate over the projection horizon, driven by the projected easing in economic growth and an assumed recovery in productivity. Employment growth is thus expected to stand at 3.7% this year, down from 6.5% in 2023. It is projected to moderate gradually to 2.4% by 2026, as GDP growth slows down.

The unemployment rate is forecast to stand at 3.1% throughout the projection horizon. The labour market is envisaged to remain tight, and, given that the NAIRU is projected at around 3.3% in 2026, the unemployment gap is forecast to be slightly negative.

In view of high inflation in the recent past and the lagged response of wages, together with tight labour market conditions, growth in compensation per employee is projected to accelerate to 5.1% in 2024, before edging down to 3.9% in 2025, and 3.2% in 2026. The strong pick-up in nominal wages allows for a catch-up of real wages to the levels prevailing before the inflation surge.

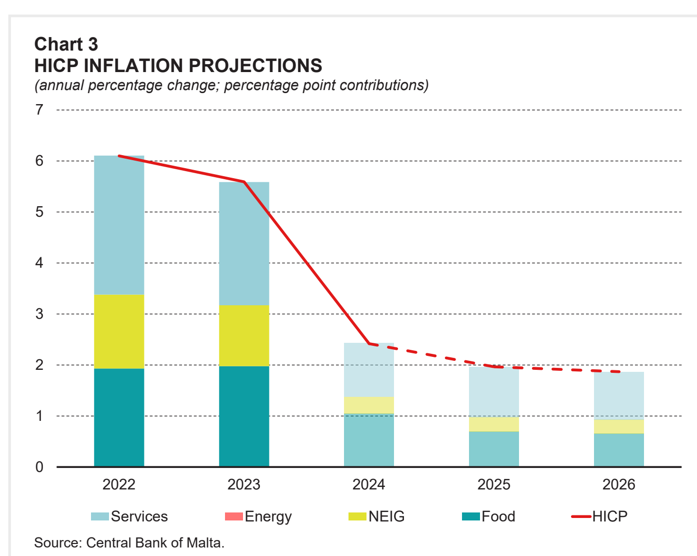
A persistently negative unemployment gap implies that labour market tightness will be a key factor driving the wage outlook. However, as tightness dissipates over time, this should dampen upward pressure on wages by 2025 and 2026.

Prices

During 2023, Harmonised Index of Consumer Prices (HICP) inflation moderated to an average of 5.6%. Data for the first four months of 2024 shows a further moderation as pipeline pressures continued to ease. Indeed, annual HICP inflation eased from 3.7% in December 2023 to 2.4% in April 2024. It is expected to ease further in the coming years, reflecting a broad-based decline in food, services, and non-energy industrial goods (NEIG) inflation (see Chart 3). Consequently, HICP inflation is projected to decline to 2.4% in 2024, 2.0% in 2025, and 1.9% in 2026. Meanwhile, HICP inflation excluding energy and food, is projected to stand at 1.9% in 2024, 1.8% in 2025 and 1.7% in 2026.

Compared to the Bank's previous forecast publication, HICP inflation was revised down by 0.5 percentage point in 2024, reflecting recent outcomes. Downward revisions were made to all subcomponents, apart from energy, as incoming data shows a faster disinflation process than anticipated in the previous exercise. HICP inflation in 2025 and 2026 has been revised down by 0.2 percentage point and 0.1 percentage point, respectively, which mainly reflects some carryover effects from the downward revisions in 2024.

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



Source: Central Bank of Malta.

Services inflation is projected to ease significantly over the projection horizon, falling from 5.1% in 2023 to 2.3% this year, and further to 2.1% by 2026.

Services inflation has been revised downwards, as incoming data show that this component is normalising more quickly than previously assumed, possibly reflecting the indirect effects from the slowdown in other inflation components. In addition, profit margins for certain sectors are receding to absorb wage and other cost increases.

Food inflation has also been revised downwards because of lower-than-expected outcomes in recent months. Processed food prices are projected to increase by 4.8% in 2024, as against an increase of 9.6% in 2023. In part, the easing reflects lower imported prices as well as the introduction of the Stabbilta' scheme in February 2024. Similarly, unprocessed food inflation is set to decline to 5.0% from 8.5% in the previous year. Overall food inflation is set to moderate gradually to 4.9% in 2024, 3.2% in 2025, and 3.0% in 2026, also in line with expected developments in international commodity prices.

NEIG inflation is expected to fall from 4.4% in 2023, to 1.2% in 2024. This reflects normalising international supply-chain conditions, which are reflected in a moderation in imported inflation, as well as in domestic producer price pressures. At this point, supply chain disruptions arising from geopolitical developments do not seem to be having a major impact on this sub-component, although this remains an important risk for the inflation projections. Going forward, NEIG inflation is expected to ease over the rest of the projection horizon, standing at 1.0% in 2026.

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 improve from 4.9% in 2023 to 4.1% in 2024, 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 higher throughout the forecast horizon. This mainly reflects revisions in the profile of capital expenditure.

The share of current revenue in GDP is expected to remain broadly constant over 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. The share of taxes on production and imports is expected to remain constant, whilst 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 decline in 2024, and to increase 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. Meanwhile, outlays on compensation of employees and intermediate consumption are set to grow broadly in line with nominal GDP. The share of

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

	2023[1]	2024	2025	2026
Headline aggregates				
Total revenue	33.4	33.2	33.3	33.7
Total expenditure	38.4	37.4	36.9	36.8
General government balance	-4.9	-4.1	-3.6	-3.1
of which: primary balance	-3.8	-2.8	-2.2	-1.6
General government debt	50.4	52.5	53.5	54.3
Detailed breakdown				
Current revenue	32.3	32.2	32.3	32.2
Current taxes on income and wealth	12.5	12.6	12.7	12.8
Taxes on production and imports	10.0	10.0	10.0	10.0
Social contributions	5.5	5.5	5.5	5.4
Other current revenue[2]	4.3	4.1	4.0	4.0
Current expenditure	33.1	32.8	32.5	32.3
Compensation of employees	10.1	10.0	10.0	10.0
Social benefits	8.2	8.4	8.3	8.2
Intermediate consumption	7.9	7.9	7.9	8.0
Interest payments	1.1	1.4	1.4	1.5
Subsidies	3.8	2.9	2.6	2.4
Other current expenditure[3]	2.1	2.3	2.3	2.3
Gross savings	-0.8	-0.6	-0.3	0.0
Capital revenue	1.1	1.0	1.1	1.4
Capital taxes	0.2	0.2	0.2	0.2
Other capital revenue[4]	0.9	0.9	0.9	1.3
Capital expenditure	5.2	4.5	4.4	4.5
Gross fixed capital formation	3.5	3.3	3.3	3.4
Capital transfers	1.7	1.2	1.0	1.1
Other capital expenditure[5]	0.1	0.0	0.0	0.0
Capital revenue net of capital expenditure	-4.1	-3.5	-3.3	-3.1
Underlying budgetary outcome				
Cyclical component	0.9	0.6	0.2	0.1
Temporary government measures	0.3	0.0	0.0	0.0
Structural balance	-6.1	-4.7	-3.8	-3.2

Sources: NSO; Central Bank of Malta.

[1] Actual data as per NSO *News Releases* 071/2024(published on 22 April 2024) and 039/2024 (published on 28 February 2024).

[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.

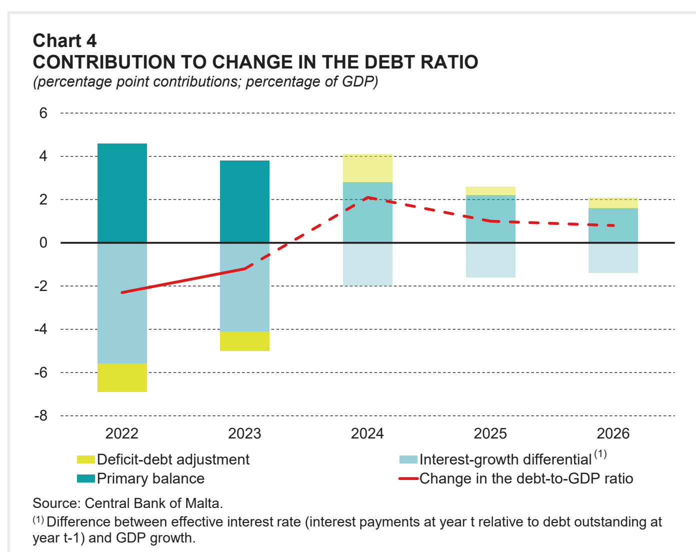
social benefits in GDP is set to rise in 2024, driven by the increase in benefit rates announced in the latest Budget Speech. Thereafter, outlays are expected to grow by less than GDP. The share of interest payments in GDP is set to increase throughout the forecast horizon.

The share of capital expenditure in GDP is projected to decline in 2024, and to remain broadly constant thereafter. The ratio of gross fixed capital formation in GDP is set to decline in 2024, and to remain mostly unchanged thereafter. However, the share of capital transfers in GDP is set to decline throughout the forecast horizon. These projections reflect the expected profile of EU-funded and domestically-financed capital expenditure (see Box 2).

The structural budget deficit is projected to narrow substantially over the projection horizon, reaching 3.2% of GDP by 2026 from 4.7% in 2024.[3] This is driven by the profile of inflation mitigation 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 mostly driven by the continuation of primary deficits (see Chart 4). Deficit-debt adjustments are also set to exert a debt-increasing impact. This is particularly the case in 2024, due to the impact of a one-off equity acquisition into the new airline which replaced Air Malta. These factors offset the debt-decreasing impact of the favourable interest-growth differential.

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.

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

BOX 2: COMPOSITION OF GOVERNMENT CAPITAL EXPENDITURE[1]

Gross fixed capital formation and capital transfers are the main components of capital expenditure in the general government accounts. Their share in GDP is set to decline from their level in 2023. However, the ratio of these items in GDP is set to remain at or close to their long run average. These projections reflect the forecast path of projects financed from the EU and from own resources. This Box sheds light on the factors shaping the Bank's projections for capital expenditure.

Overview of EU-funded capital expenditure

The Bank forecasts the outlays on projects financed by grants from the EU's largest structural and investment funds. These include the European Regional and Development fund (ERDF), the Cohesion Fund (CF), and the Migration and Security Funds. The level of grants available to each EU member state is agreed at the start of a seven-year multiannual financing framework. In order to make full use of the available grants, projects need to be completed until three years after the end of the financing framework.

Besides the 2021-2027 budgeting framework, EU member states agreed on a temporary EU-wide stimulus package known as NextGenerationEU, to mitigate the economic and social impact of the COVID-19 pandemic. The largest fund in this package is the RRF. Member States are required to devote a large part of their allocated financing for projects related to the green transition and the digital transformation. RRF-financed projects must be completed by 2026.

Under the 2014-2020 financing framework, Malta received grants for projects completed by 2023. These included investment in roads, waste treatment, water distribution, the construction of new facilities at MCAST and the University of Malta, and the building of a new regional health hub.

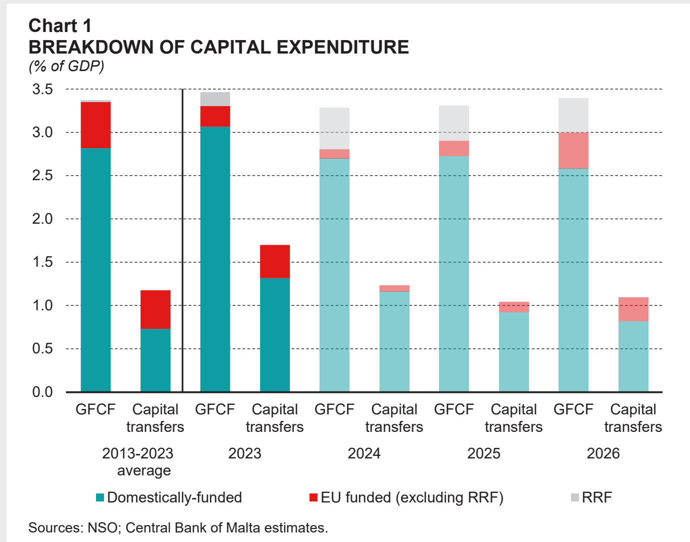
Under the 2021-2027 framework, Malta will receive grants from the ERDF and CF for projects until 2030, which include investment in sustainable waste and water management, the development of a second electricity interconnector, and investment in healthcare and sustainable urban mobility. In addition, Malta is implementing institutional reforms and carrying out additional investment projects, financed by grants from the RRF. Projects mainly include investment in sustainable transport, the circular economy, digital transformation of the public administration and the legal system, renewable energy, and energy-efficiency in buildings.

Outcome in 2023

In 2023, government investment amounted to around 3.5% of GDP, broadly in line with the average share in the last ten years (see Chart 1). Capital transfers stood at 1.7% of GDP, significantly above its average in the last ten years. Outlays on domestically-financed projects constituted the largest part of capital expenditure.

[1] Prepared by John Farrugia, Manager Fiscal Affairs and Reports Office within the Economic Analysis Department of the Central Bank of Malta. The views expressed are those of the author and do not necessarily reflect the views of the Central Bank of Malta. Any errors are the author's own.

Domestically-financed investment stood at 3.1% of GDP, mainly due to outlays related to road building, the construction and restoration of buildings, and investment in IT systems and other equipment. Domestically-financed capital transfers amounted 1.3% of GDP, mainly due to spending on electricity distribution, water management, grants for electric vehicles, and energy efficiency schemes. It also reflects the impact of a scheme awarding grants to first-time buyers of residential property.[2] Both components had a higher share in GDP compared to the average share estimated in the last decade.



Capital expenditure on EU-funded projects stood slightly below its average share in the last ten years. Outlays mainly reflected the completion of projects financed from the 2021-2020 framework, and progress in the implementation of the above mentioned RRF-financed projects. The latter is classified as part of government investment.

Decomposition of capital expenditure over the projection horizon

In the coming years, the Bank expects that Government prioritises the completion of EU-funded projects and large scale domestically-financed projects. Specifically, all RRF-financed projects and most projects related to energy distribution and waste management need to be completed within the forecast horizon to address infrastructure bottlenecks and to ensure full take-up of EU funds. The Bank expects relatively little progress on other initiatives until the above-mentioned projects are completed. Consequently, between 2024 and 2026, the level of domestically-financed investment is set to remain broadly unchanged, while the level of domestically-financed capital transfers is set to decline.

The share of domestically-financed investment in GDP is set to decline from 3.1% in 2023 to 2.6% by 2026, while that of domestically-financed capital transfers in GDP is set to decline from 1.3% in 2023 to 0.8% in 2026 (see Chart 1). In this period, the share of domestically-financed investment in total outlays is forecast to decline from around 88% to around 76%. Meanwhile, by 2026 locally-financed capital transfers are set to amount to around 75% of total outlays, only marginally down from around 77% in 2023.

[2] This scheme was announced in the 2023 Budget and applies to purchases of residential properties made from 2022 onwards. Applicants are awarded a €10,000 grant, in the form of €1,000 payments every year for ten years. According to ESA methodology, the impact of these grants is recorded in full in the first year of operation, and is classified as capital transfers paid.

According to the financial estimates accompanying the 2024 Budget Speech, the largest projects financed from domestic resources relate to road building, investment in ICT, and waste management.

Outlays on EU-funded projects not financed by the RRF are set to decline in level terms in 2024, but to rise again in 2025 and in 2026. This reflects the forecast profile of projects financed from the 2021-2027 framework. Work on the latter is expected to scale up in the coming years, now that projects funded by the previous financing framework have been completed.

Meanwhile, outlays financed by the RRF are set to increase in 2024, and to retain a broadly stable share in GDP thereafter. RRF-financed projects are expected to be completed by 2026.

The share of EU-funded investment (including RRF-financed projects) in GDP is set to increase from 0.4% of GDP in 2023 to 0.6% each year in 2024 and 2025, and to 0.8% in 2026. Meanwhile, the share of EU-funded capital transfers in GDP is forecast to decline from 0.4% in 2023 to 0.1% each year in 2024 and in 2025, and to rise to 0.3% in 2026.

Risks

Risks to activity are broadly balanced over the projection horizon. Downside risks largely emanate from possibly adverse trade effects related to geopolitical tensions. On the other hand, the labour market could exhibit even stronger dynamics than envisaged in this projection round, both in terms of employment and wages. This could then result in stronger private consumption growth.

Risks to inflation are balanced over the project horizon. Upside risks to inflation could stem from extreme weather events and possible supply-side bottlenecks from the effects of geopolitical developments. Other upside risks to headline inflation include the potential impact of measures to combat climate change. Furthermore, wage pressures could be stronger than envisaged in the baseline. On the downside, imported inflation could fall more rapidly than expected, while services inflation could normalise more quickly than envisaged in this projection round.

On the fiscal side, risks are tilted to the downside (deficit-increasing). These mainly reflect the likelihood of slippages in current expenditure, including higher-than-expected outlays on energy support measures if commodity prices are higher than assumed. They also reflect the likelihood of additional increases in pensions and public wages in the outer years of the forecast horizon. Should these risks materialise, they are set to be partly offset by the likelihood of additional fiscal consolidation to comply with the EU's fiscal rules.